Chapter 3

International Financial Markets

International Financial Markets

Can be segmented as follows:

1. The Foreign Exchange Market
2. The International Money Market
3. International Capital Markets:

   (a) bond markets, and

   (b) stock markets

1. The Foreign Exchange Market

- A 24-hour market where currencies are traded to facilitate BOP adjustments
- A $5 trillion/day market: most widely traded currencies include $, €, ¥, and £
- Major FX centers: London, New York, Tokyo, Hong Kong, Singapore, and Dubai
- Other FX centers are located in the commercial cities of countries

Key Players in FX Markets

- Currency traders and FX brokers
- Major commercial banks
- Speculators
- Central Banks of countries

Each of the above players has its own objective for participating in the FX market.

The Foreign Exchange Market

- The foreign exchange market allows currencies to be exchanged in order to facilitate international trade or financial transactions (recall BOP statistics).
- The system for exchanging foreign currencies has evolved from the gold standard, to agreements on fixed exchange rates, to a floating rate system.

The Spot Market for Foreign Exchange

- The market for immediate delivery and exchange of currencies is known as the spot market.
- Currency trading between banks occurs in the interbank market. Within this market, brokers sometimes act as intermediaries.
- The exchange rate quoted in newspapers are for large transactions of over $1 million

The Forward Market for Foreign Exchange

- The forward market enables traders and firms/banks to lock in the exchange rate today at which they will buy or sell a certain quantity of currency on a specified future date, e.g., 30, 60, 90 or 180 days from today.
- Customers in need of foreign exchange are concerned with quote competitiveness, special banking relationship, speed of execution, current market conditions, and forecasting advice.

Foreign Exchange Transactions

- Banks provide foreign exchange services for a fee: a bank's bid (buy) quote for a foreign currency will always be less than its ask (sell) quote.

$$\text{bid/ask spread} = \frac{\text{ask rate} - \text{bid rate}}{\text{ask rate}}$$

Example   Suppose bid price for £ = \$1.52,

ask price = \$1.60.

$$\text{Spread} = \frac{(1.60 - 1.52)}{1.60} = .05 \text{ or } 5\%$$

The “bid-ask” Spread

- The spread on currency quotations is positively influenced by order costs, inventory costs, and currency risk, and negatively influenced by competition, and volume.
- The spread for heavily traded currencies like the $, €, £, and ¥ are low because of their liquidity.

Foreign Exchange Quotations

- The exchange rate quotations published in newspapers normally reflect the ask prices for large transactions.
- Direct quotations represent the value of a foreign currency in dollars, while indirect quotations represent the number of units of a foreign currency per dollar.
- $$\text{Indirect quotation} = \frac{1}{\textbf{Direct quotation}}$$

Cross Rates

- A cross exchange rate reflects the amount of one foreign currency per unit of another foreign currency.

Example

Direct quote: $1.50/£, $.009/¥

Indirect quote: .67£/$, 111.11¥/$

Value of £ in ¥ = value of £ in $ / **value of ¥ in $**

= **$1.50/£** / **$.009/¥**

= 166.67¥/£

Motives for Using the International Money & Capital Markets

- The markets for real or financial assets are prevented from full integration by barriers like tax differentials, tariffs, quotas, labor immobility, communication costs, cultural and financial reporting differences.
- Yet, such market imperfections also create unique opportunities for specific geographic markets, helping these markets attract foreign creditors and investors.

Motives for Using the International Money & Capital Markets

- Investors invest in foreign markets:
  - to take advantage of favorable economic conditions;
  - when they expect foreign currencies to appreciate against their own; and
  - to reap the benefits of international diversification.

Motives for Using the International Money & Capital Markets

- Creditors provide credit in foreign markets:
  - to capitalize on higher foreign interest rates;
  - when they expect foreign currencies to appreciate against their own; and
  - to reap the benefits of diversification.
- Borrowers borrow in foreign markets:
  - to capitalize on lower foreign interest rates;
  - and when they expect foreign currencies to depreciate against their own.

2. The International Money Market

- Financial institutions in this market serve firms and investors by accepting deposits and offering loans in a variety of currencies.
- Multinational banks try to meet the short-term (less than a year) needs of their customers, i.e., accepting MNC deposits and making loans (e.g., working capital) in various currencies.

The Eurocurrency Market

- History, characteristics, and growth (money multiplier) of the Eurodollar market: the Cold War and dollar deposits
- Investing dollars with non-US financial institutions in Europe (London), i.e., outside the control of the US Government, the Fed, FDIC, etc.
- The Eurocurrency market (75% Eurodollars) developed during the 1970s, stimulated by regulatory changes in the U.S. and the growing savings surplus of OPEC.

International Banking

- The move to standardization of global banking regulations has contributed towards the globalization of the industry.
  - The Single European Act opened up the European banking industry and increased its efficiency.
  - The Basel Accord outlined risk-weighted capital adequacy requirements for banks.
  - The Basel II & III Accord attempts to account for operational risk and bank capital adequacy.

3. International Capital Markets

- MNCs sometimes obtain medium or long-term capital from global banks for foreign direct investment, M&A activity, and international portfolio investments
- Eurocredit loans refer to loans of one year or longer extended by banks in Europe to foreign MNCs or government agencies.
- Such loans are generally based on the LIBOR, since bank asset and liability maturities may not match.

Syndicated Loans

- Sometimes a single bank is unwilling or unable to lend the amount needed by a particular MNC or government agency.
- A lead bank may then organize a syndicate of banks to underwrite the loan.
- Borrowers that receive a syndicated loan typically incur front-end management and commitment fees, in addition to the floating rate interest on the loan.

International Bond Market

There are two types of international bonds:

❶ Bonds denominated in the currency of the country where they are placed but issued by borrowers foreign to the country are called foreign bonds or parallel bonds.

❷ Bonds that are sold in countries other than the country of the currency denominating the bonds are called Eurobonds. Usually, they are issued in bearer form, pay annual coupons, and have call provisions. Some also carry convertibility clauses, or have variable rate provisions.

International Bond Market

- 70 to 75 percent of Eurobonds are denominated in the U.S. dollar.
- Eurobonds are underwritten by a multi-national syndicate of investment banks and simultaneously placed in many countries.
- In the secondary market, the market makers are often the same underwriters who sell the primary issues.

Comparing Interest Rates Among Currencies

- Interest rates are crucial because they affect the MNC’s cost of financing.
- The interest rate for a specific currency is determined by the demand for and supply of funds in that currency.
- As the demand and supply schedules for a specific currency change over time, the equilibrium interest rate will also change.

International Stock Markets

- In addition to issuing stock locally, MNCs can also obtain investor funds by issuing stock in international markets.
- This will enhance the firms’ image, name recognition, diversify their shareholder base, and match currency revenues with expenditure.
- A stock offering may also be more easily digested when it is issued in several markets.

International Stock Markets

- Non-U.S. firms may also issue American depository receipts (ADRs), which are certificates representing bundles of stock.

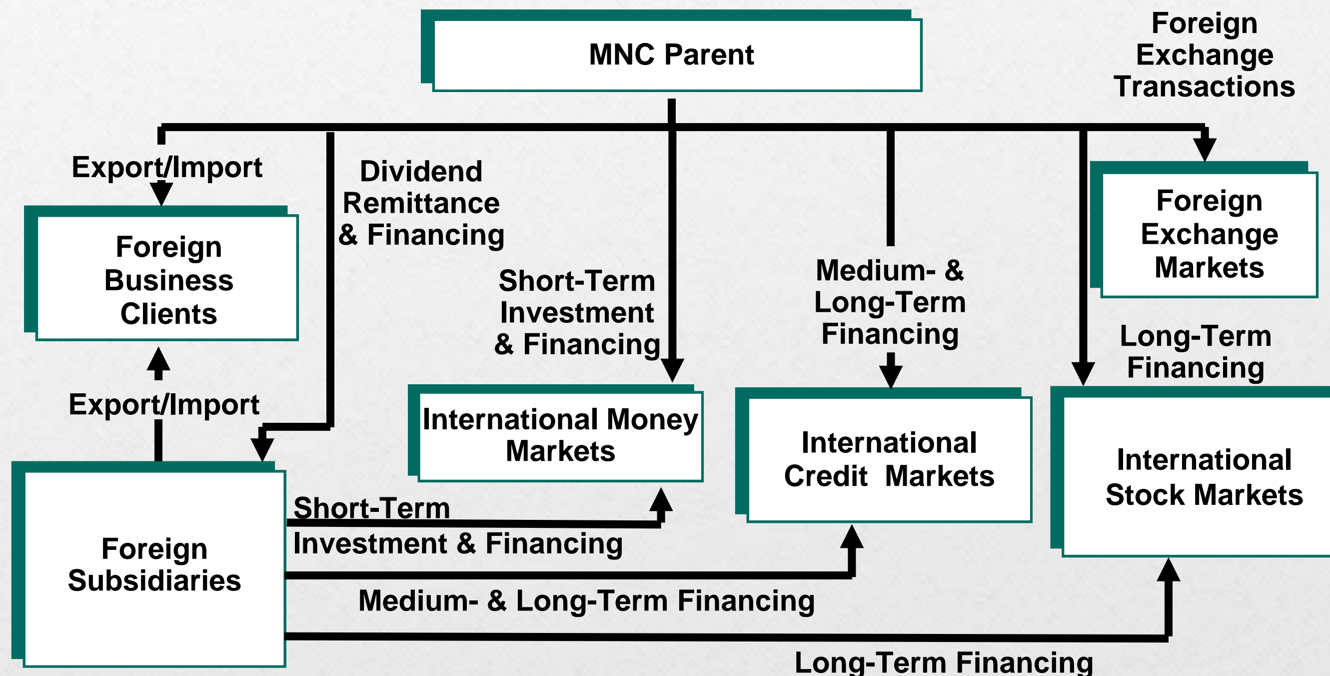
  $P_{ADR} = P_{FS} \times S_{\text{(spot rate in \$/LC)}}$

- The locations of an MNC's operations can influence the decision about where to place its stock, in view of the cash flows needed to cover dividend payments.
- Market characteristics are important too. Stock markets may differ in size, trading activity level, and proportion of individual versus institutional share ownership

MNC Use of International Money and Capital Markets

- The foreign cash flow movements of a typical MNC can be classified into:
  1. Foreign trade flows – exports and imports
  2. Direct foreign investment (DFI) activity – acquisition of foreign real assets
  3. Short-term investment or working capital needs
  4. Longer-term financing in the international bond or stock markets

Foreign Cash Flow Chart of an MNC



How Financial Markets Affect an MNC's Value

- Since interest rates commonly vary among countries, an MNC may use the international financial markets to reduce its cost of capital, thereby achieving a higher valuation.