

## Chapter 3 International Financial Markets

- 3.1 Financial Markets
- 3.2 The Foreign Exchange and Eurocurrency Markets
- 3.3 Domestic and International Bond Markets
- 3.4 Domestic and International Stock Markets
- 3.5 Derivatives Markets
- 3.6 Summary

## Liquidity is a financial market's most important characteristic

- **Liquidity** - the ease of capturing an asset's value
  - Reflects a market's **operational efficiency**
  - Impacts a market's **informational and allocational efficiency**
  - The interbank foreign exchange market for large transactions is the world's most liquid market

## Other market characteristics

- **Maturity**
  - Short-term **money markets**
  - Long-term **capital markets**
- **Regulatory jurisdiction**
  - Single-country **internal markets**
  - Multi-country **external markets**
- **Middlemen**
  - **Intermediated** through a commercial bank
  - **Non-intermediated** or direct to the public, through a broker or investment bank

## Foreign exchange markets conducted through commercial banks

- **Spot market**
  - **Cash market with delivery in two business days**
- **Forward market**
  - **Trade at a prearranged date and price**
- **Volume**
  - **More than \$1 trillion per day**
  - **75% is in the interbank market**

## Intermediated markets in bank deposits and loans

	Money markets	Capital markets
<b>Internal markets</b>	Short term accounts with domestic clients	Long term accounts with domestic clients
<b>External markets</b>	Eurocurrency deposits and loans	Long term accounts with foreign clients

## International banks (ranked on percent of foreign assets)

Rank	Commercial bank	Country	Foreign assets (%)	Total assets (\$ billions)	World rank
1	American Express Bank	U.S.	86.2%	11.6	456
2	UBS	Switzerland	84.4%	747.2	21
3	Arab Banking Corp	Bahrain	83.5%	26.6	156
4	Credit Suisse Group	Switzerland	79.6%	609.6	36
5	Standard Chartered	U.K.	69.6%	107.4	70
6	Deutsche Bank	Germany	66.6%	809.2	12
7	ABN-AMRO	Netherlands	65.2%	526.4	22
8	BNP Paribas	France	63.5%	446.4	15
9	Investec	South Africa	63.3%	23.3	255
10	KBC	Belgium	57.9%	190.3	56

*The Banker*, February 2003

## Eurocurrency markets

### > Eurocurrencies

Bank deposits and loans residing outside any single country

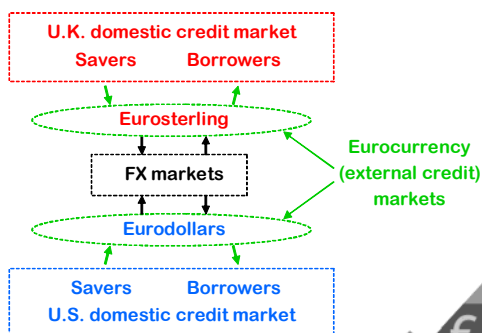
- **Floating rate pricing**  
usually with maturities less than five years
- **Few regulatory restrictions**  
because they are outside the jurisdiction of any single government
- **Competitive pricing**  
more than \$2.5 trillion outstanding

## Eurocurrency markets are dominated by domestic issuers

Eurodollar issuers	1 USA	\$806 million
	2 Supnationals	\$98
	3 Germany	\$79
Euro issuers	1 Germany	\$585
	2 France	\$170
	3 USA	\$124
Eurosterling issuers	1 Great Britain	\$73
	2 Supnationals	\$30
	3 Germany	\$27

Source: MSCI Eurocurrency credit indexes (Jan 7, 2003)

## Credit and currency markets



## The Eurocurrency market has few regulations

### > Typically, there are

- No reserve requirements
- No interest rate regulations or caps
- No withholding taxes
- No deposit insurance requirements
- No credit allocation regulations
- Less stringent disclosure requirements

## The Eurocurrency market uses floating rate pricing

### > Low interest rate risk

- Interest rates tied to a variable rate base such as the London Interbank Offer Rate (LIBOR)

### > Low default risk

- Traded between large commercial banks, investment banks, and multinational corporations

### > Relatively short maturities

- Typically less than 5 years

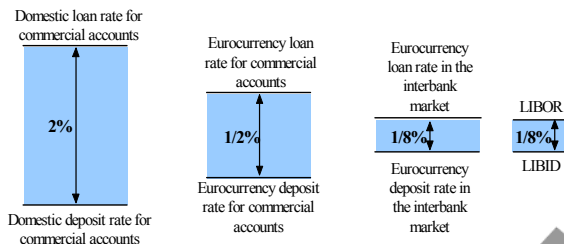
## A competitive Eurocurrency market

### > Active trade in \$2.5 trillion of outstanding Eurocurrency deposits and loans

ensures

### > Competitive bid and offer prices

## Spreads in domestic and Eurocurrency credit markets



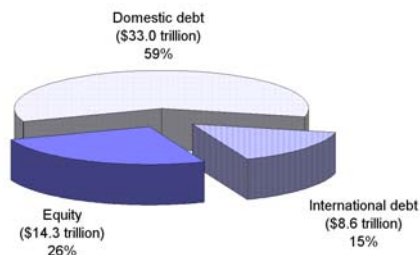
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## Non-intermediated (direct) markets

	Money markets	Capital markets
Internal markets	Short term commercial paper	Stocks & bonds issued in the domestic market
External markets	Eurocommercial paper	Global equity Foreign bonds Eurobonds

Kirt C. Butler, *Multinational Finance*, South-Western College Publishing, 3e

## Publicly traded debt & equity



Debt data from the Bank for International Settlements (December 2002).  
Equity data estimated from the FTSE world index (December 2002).

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## Public debt markets

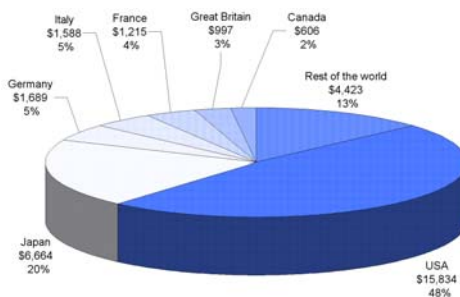
### Domestic markets

- **Domestic bonds** are issued and traded domestically and denominated in the domestic currency

**GMAC zr 15** issued in dollars by General Motors Acceptance Corporation trade on the NYSE

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## Major domestic debt markets (billions)



Source: Bank for International Settlements (June 2002)

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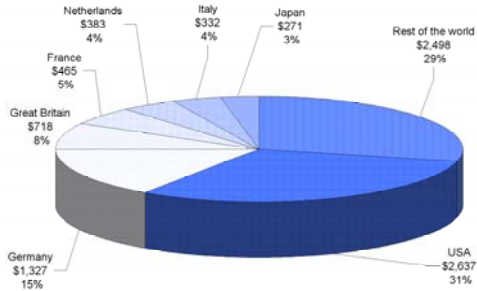
## Public debt markets

### International markets

- **Foreign bonds** are issued in a domestic market by a foreign borrower  
**Toronto Dominion 6.45 09** trade OTC in the U.S.
- **Eurobonds** are placed outside the borders of the country issuing a currency  
**FNMA 7.25 30** traded OTC outside the U.S.
- **Global bonds** trade in the Eurobond market as well as in one or more internal bond markets

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### Major international debt markets (billions)



Source: Bank for International Settlements (December 2002)

### Bond market taxonomy from a U.S. perspective

Domestic	International	
	Foreign bonds	Eurobonds
GMAC zr 15 (NYSE)	Toronto Dominion 6.45 09 (US OTC)	FNMA 7.25 30 (non-US OTC)
	Internal	External

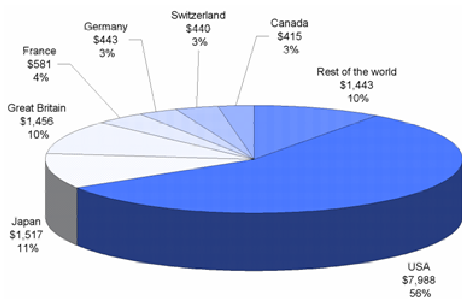
### Internal bond market conventions

	Ownership	Coupons	Day count
Canada	Registered	Semiannual	Actual/365
Japan	Registered	Semiannual	Actual/365
Switzerland	Bearer	Semiannual	30/360
U.K.	Bearer	Semiannual	Actual/365
Euro-zone	Bearer	Semiannual or annual	Actual/Actual
<b>United States</b>			
Treasury	Registered	Semiannual	Actual/365
Corporate	Registered	Semiannual	30/360

### External bond market conventions

	Ownership	Coupons	Day count
<b>Eurobonds</b>			
Fixed rate	Bearer	Annual	30/360
Floating rate	Bearer	Quarterly or semiannual	Actual/360
<b>Eurocurrencies</b>			
LIBOR	Registered	Quarterly or semiannual	Actual/360

### Major stock markets (billions)



Source: Compiled from FTSE and MSCI Indices (December 2002)

### Stock returns around the world



Source: Morgan Stanley Capital International Indices

## Securities regulation in the U.S.

### > Securities & Exchange Commission

- A registration statement is required for public securities offerings of more than \$1.5 million
- Private placements are handled separately
- The **Financial Services Modernization Act (1999)** deregulated the financial services industry

## Securities regulation in Japan

### > Ministry of Finance

- The registration procedure is similar to U.S., but with a longer “waiting period” before issuance to the public
- The 1995 **Big Bang** allowed banks into investment banking and securities trading industries

## Securities regulation in the E.U.

### > EU Directives

- **Capital Adequacy Directive (1996)** specifies minimum risk standards for EU financial institutions
- **Investment Securities Directive (1996)** provides a “passport” to EU financial institutions

## Global equity offerings

- > Cross-listing shares on more than one stock exchange can increase demand and enhance share price
- U.S. companies listing abroad experience less of an *adverse price reaction* than similar companies issuing equity in the United States
- Non-U.S. companies listing in the United States often increase in value

## Derivatives

### > The price of a derivative contract is derived from some underlying instrument

- Derivatives contracts are traded on derivatives exchanges and through commercial and investment banks
- > Derivatives are traded on a wide variety of financial prices
- Interest rates, currency values, commodity prices, stock prices, stock price indexes, and other financial prices

## Types of derivatives contracts

- > **Futures** - A commitment to exchange one asset for another asset at a specified time in the future
- > **Options** - A contract giving the option holder the right to buy or sell an underlying asset at a specified price and on a specified date
- > **Swaps** - An agreement to exchange two assets or liabilities and, after a prearranged length of time, to re-exchange the assets or liabilities