International Financial Management
Paper Code: MS 509
Topic: International Financial Markets

Unit – 2: International Financial Markets

Structure of Unit

2.0 Objectives

After completing this unit, you would be able to:

- Develop an understanding of the meaning, nature and significance of financial markets;
- Explore alternate forms of raising funds for an entity;
- Compare different financial markets;
- Assess the cost involved in raising funds from different markets;

2.1 Introduction

The economic system of a country depicts the economic climate of a country. The economic climate and condition of a country is measured in terms of its Gross Domestic Product, investment rate, savings rate and employment rates. These are known as the macroeconomic indicators. These indicators are maneuvered in the financial system of a country. In other words, financial system comprises of individuals, institutions and organizations with the objective of transferring funds and resources from the surplus areas to the deficit areas. This ultimately results in the economic development of a country. Normally households save and these savings have to be channelized into proper avenues of investment. Though savings are considered as the vehicle to growth, investments are considered as drivers to growth. While savings give normal returns to your money, investments give compounded returns. Investments assure regular return and a capital gain at the time of liquidation. But the returns that we get from investments are not generally stable. The return depends upon the general business climate and economic conditions. With higher level of integration of global economies, if one country in the globe gets affected, it is passed on to the other. This makes the investments riskier than savings. The financial system becomes complete, only when the investors are protected. They should be able to enjoy a premium for the risk taken. Thus a financial system shall attain its objective of developing the economy, only when it is able to optimize returns to investors for the risks that they have taken. Financial markets aid in optimizing returns to the investors as it has separate markets for investments and risk mitigation. The meaning, nature, components, types and significance of financial markets are discussed in the subsequent headings.

2.1.1 Meaning and Nature of Financial Markets

A financial market is a market in which people and entities can trade financial securities. These markets could be domestic or international. A global financial market represents a collection of all financial markets scattered across the globe. It deals with the buying of financial securities at the global level. The transactions become efficient only when the transaction costs and prices are kept at a minimum. These prices should be determined by the market forces. In other words, the efficiency of a market depends upon the demand and supply. The investors can invest in either securities like stocks and bonds or in commodities like agricultural products, gold etc. The present day markets have been a result of transformation from the previous markets due to increased competition and regulatory measures. International financial markets intermediate by transferring purchasing power from lenders and investors to parties who desire to acquire assets that they expect to yield future benefits. International financial transactions involve exchange of assets between residents of different financial centers across national boundaries. International financial centers are reservoirs of saving and transfer them to their most efficient use irrespective of where the savings are generated.

2.1.2 Significance of Financial Markets

Capital is an important requirement for any corporation or government to finance its operations and for long-term investments. They can do this by adopting either any one or a combination of the following alternatives. Procure funds by taking out a loan from a bank and repaying it with interest. If the fund required is large, then the loan is financed by the participation of more than one lending institution. This facility is known as consortium finance. The companies can otherwise, raise money through the sale of its stocks and bonds in its name. These are bought and sold to the investors, who have surplus, in the capital markets. Firms can raise their capital from the financial institutions and financial markets. Financial markets are present in every nation with varying number of participants. Some markets have limited number of participants while in exchanges like NYSE trading is done in trillions of dollars. Previously the markets were accessible only to private participants and some exclusively for professional investors but in the current scenario the markets are accessible by all investors and to a wide range of financial products.

2.1.3 Recent Trends in Financial Markets

Financial markets have seen a lot of changes in the recent years. These changes could be attributed to more economies being opened up. As economies have opened up, they have become more interdependent. The markets too have been more regulated and integrated due to this reason. The trends seen are as listed below.

1. **Accessibility**:

   Markets have become more accessible now a day because they can be reached through internet and mobile phones. The increases in the usage of information technology in finance have made this possible. Almost all markets are over the counter traded. Due to this, firms do have been able to mobilize funds quicker than earlier days.

2. **Transmission Effect:**

   All markets are inter-connected. Due to this, if any country witnesses financial disturbances, it shall have impact on all markets with which it is connected. The Japanese markets open up first and the Western Markets close last. The impact of the performance of the market that closed last the previous day could be felt on the markets that subsequently open up. In other words, if the US markets closes with a dip in the index the previous day, the Eastern markets open up in red. Subsequently the trade has to be pick up to make it otherwise.

3. **Highly Liquid Secondary Market:**

   These days, the investors have become exposed to a lot of sources for information regarding markets. They have become aware of various investment avenues. Due to this there exists a secondary market for every asset. This feature adds up to the liquidity of the market too.

4. **Increased Risk:**

Due to the increased exposure of the markets to the movements of other markets, the investors are exposed to higher levels of risks. The investments have to be, therefore, protected from all risks. Though risks cannot be mitigated completely, it can be minimized through effective means.

5. **Regulated:**

The shift of economies from restrictive to regulatory environment has made the markets more regulated. The markets are expected to work under a code of conduct and obey rules of the land which ever they are associated with. When markets extend beyond the territorial boundary of one country, it is expected to abide by the rules of both the countries. Market regulators such as the SEBI in India and SEC in the United States impose penalties if the code of conduct is violated by any of these participants.

6. **Innovation:**

Financial innovation has been recent phenomenon seen in financial markets. Innovation is seen not only on the products, but on the deliverables too. The products are more customized to a great extent for customers. The availability of various financial tools for managing risk has encouraged more investor- participation to the markets. Examples for innovation are Credit Default Swaps, Credit Default Obligations etc.

2.2 Financial Markets and Economic Functions

A financial market is where the financial instruments are traded between the buyers and sellers. The economic functions provided by the financial markets are, price discovery liquidity and reduction of transaction costs.

2.2.1 Price Discovery:

Price discovery is determining the price of the asset to be traded between the buyer and the seller in a financial market. The rate of return from the particular financial asset is determined by the market conditions. The rate of return obtained by the investors from those in need of funds is the motivating factor for the investors. These functions of the financial market determine how the funds from the investors are allocated to those in need of funds.

2.2.2 Liquidity:

Liquidity is the characteristic ability of an asset to be sold at a fair price in the market at any desired time. An asset which is not liquid would have to be held by the investor until favorable conditions arise to sell the asset or until the completion of the contract. Different financial markets have different level of liquidity. Equity is liquidated if the company calls back the shares or shuts down while debt is liquidated at maturity.

2.2.3 Reduction of Transaction Cost:

The trading of financial instruments by market participants' result in transaction costs. The financial institutions which have the lowest transaction costs are the most successful ones in the market.

2.3 Classification of Financial Markets

Investors have a wide variety of financial products that they can invest in through the financial markets. Major international banks and financial professionals were the main participants in the financial markets while certain other markets were mainly used by private investors. Financial markets can be classified in a number of ways.

2.3.1 Based on Nature

(1) Debt Market (2) Equity Market

1. Debt Market:

The debt market is the financial market for the fixed claims. It is also called as the bond market. A bond is a debt instrument which is issued by companies or governments for a fixed period of time and fixed interest rate to get capital for short term. Bonds are available in credit markets also called as debt or fixed income markets. The types of bonds available are corporate bonds, US Treasury bonds, municipal bonds, notes and bills. All of these together are termed as "Treasuries".

2. Equity Market:

The equity market is the financial market for residual claims. The equity market is the market in which the equity shares of a company are issued and purchased by the investors. These investors then trade these equity shares among themselves at the equity market. Equity is the cheapest source of fund as the company issuing equity does not have a permanent obligation to the investors. The equity market allows the investors to be partial owners of the company they hold the share in.

2.3.2 Based on Maturity

(1) Money Market (2) Capital Market

1. Money Market:

Instruments with short maturity and high liquidity are traded at the money market. The money market is used as a source for borrowing for a period of few days to less than one year. Money market instruments are also called cash instruments because of the short maturity period. The money market can be used for a number of reasons like companies selling commercial paper to loan money for short term to investors buying CDs to safeguard their money for a short period. The money market has risk in terms of default on commercial papers. Otherwise the risk involved in money markets is very low when compared to other markets hence the rate of return is low. The money market is seen as the safest place to invest as it has a short maturity period and high liquidity.

2. Capital Market:

Capital market is the market where securities are traded. In order to raise funds the organizations and governments sell their securities to raise capital for their needs. Capital markets consist of primary market and secondary market. The securities are issued, sold and purchased at the capital market.

2.3.3 Based on Tenure

Primary Markets vs. Secondary Markets:

The capital market consists of the primary market and the secondary market. The primary market is the market where the companies which are publically listed issue their shares to the general public on the exchange to raise capital. The primary market consists of the investment bankers who would set a price to the price range in the primary market and also ensure the sale of the securities to the investors. Once the investors have purchased the shares in the primary market they are then traded further in the secondary market. The price of a share in a primary market is preset whereas it varies in the secondary market based on demand and supply.

2.3.4 Based on Delivery

1. Cash or Spot Market:

Investing in cash market is highly risky as it may result in high losses or high gains. Similar to a cash market where goods are delivered as soon as cash is paid, in the spot market the contracts bought and sold are effective immediately. The current market price is paid in cash. The cash market is complicated and suitable for experienced traders. The products traded are complicated and hence detailed analysis, high end information and macroeconomic analysis is necessary and hence it is dominated mainly by institutional market players.

2. Derivatives Market:

A derivative market consists of financial products whose value is derived from the underlying asset. A derivative is a contract and is used mainly in the case of risk management. This market is complex and hence its main participants are experienced traders. The derivative market needs the use of strategies and hence is not suitable for private investment.

2.3.5 Based on Physical Set up

1. Forex and the Interbank Market:

The trading of currencies among banks and financial institutions is called as interbank market. The interbank markets are mainly used for a bank's own purposes but in certain cases they also trade for large corporations. The Forex market is where currencies are traded where any country, company or individual can participate. There is no central market place where trading takes place, it is conducted over the counter. Forex market is one of the moat liquid markets and the highest amount of trading in terms of total value takes place in this market. With the widespread use of the internet now currencies can be traded through broking accounts.

2. The OTC Market:

The over-the-counter (OTC) market or dealer market is a kind of secondary market. The stocks that are traded at the OTC market are not traded in the stock exchanges. These stocks are traded on over-the-counter bulletin board (OTCBB) or pink sheets. OTCBB and pink sheet companies have few regulations to comply with than those that trade shares on a stock exchange and hence they are more susceptible to risk. The securities traded in this market are stocks of small companies.

2.4 Segments of International Financial Market

2.4.1 International Bond Market

The international bond market consists of two main markets namely the Euro Bonds and foreign bond. A foreign bond is offered by a foreign borrower to the investors in the national capital market and denominated in the nation's currency. An example is a Japanese MNC issuing a dollar denominated bond in the US market to the US investors. A Euro bond is the one denominated in one currency but sold in the capital markets of other countries. Example is a German borrower issuing a dollar denominated bond in the UK.

The international bond market has a number of instruments. Some of them are:

- Straight Fixed Rate Bonds
- Euro Medium Term Notes
- Floating Rate Notes (FRN)
- Convertible Bonds
- Zero Coupon Bonds
- Callable and Puttable Bonds
- Sinking Fund Bonds

2.4.2 International Equity Market

Equity capital is raised by issuing shares in the market which are then traded among investors in the secondary market on the stock exchanges of the country. MNCs would like to raise capital from different markets for a number of reasons. The local market may be too small to accept the vast number of shares that they issue. They may also issue shares in multiple markets to increase their prestige in the global market. These MNCs are registered and listed in the stock exchanges of all the countries in which they issue their shares.

Non US companies raise equity from the US markets through the issue of ADRs which are certificates representing bundle of shares. These ADRs are then traded in the US stock exchanges. GDRs are issued for trading equity outside the US market. The GDRs are traded in the stock exchanges where they are issued.

Many countries now allow non-resident investors especially institutional investors to buy and sell shares in their stock exchanges. Investors can now invest in the securities of different countries seeking risk reduction through international portfolio diversification.

2.4.3 International Money Market

Money market acts as a platform for market participants with need for short term funds to obtain them from agents (corporations, financial institutions, individuals, government) with excess funds. They play central role in the country's financial system, by influencing it through the country's monetary authority. The money market allows financial institutions and to some extent to other non-financial companies' money for executing such functions as:

- Fund raising
- Cash management
- Risk management
- Speculation or position financing
- Signaling
- Providing access to information on price.

Money markets are wholesale markets with very large amounts of transactions. This is the most active financial market in terms of volumes of trading. From the start of emergence the traditional money markets performed the role of monetary policy. In order to influence the supply side, governments have employed methods of direct regulation and control of the savings and investment behavior of individuals and companies. However due to fast technological advances, internationalization and liberalization of financial markets, possibilities to carry out policy objectives through such measures have diminished. Current policy through market oriented measures is aimed primarily at demand side.

Thus money markets serve the interface between execution of monetary policy and the national economies another role of domestic money markets is to serve public policy objectives, i.e. financing public sector deficits and managing the accumulated government deficits. Government public debt policy is an important determinant of the money markets operations, since government debt typically forms a key part of the country's money markets (as well as debt markets). The scope and measures of monetary policy are also linked to the government's budget and fiscal policies.

The global capital markets became critical to development in an open economy. Developing countries, like all countries, must encourage productive investments to promote economic growth. Domestic savings could be used to make productive investments. If the foreign savings are invested wisely, the borrowing country will grow economically. Thus, foreign savings, which many people simply call foreign investment, can benefit developing countries.

2.4.4 International Credit Market

Short term funds for companies in terms of foreign currencies can be obtained from the international money market and the long term funds can be obtained from the international bond market. The medium term funds are exchanged between the borrowers and suppliers in the international credit market. The banks issue loans for a medium term which are mostly floating rate loans where the interest rate on the loans changes periodically based on market interest rate like LIBOR. This method is followed by banks in order to avoid the risk arising from asset- liability mismatch. Another popular practice in the international credit market is syndicated loans. Banks join together less than one bank and issue loans together. This kind of loan helps in sharing the risks among the participating banks.

2.4.5 Foreign Exchange Market

Foreign exchange market is the market where there is an exchange of currencies. Borrowing or settling internationally requires the conversion between currencies. This is facilitated by the foreign exchange market. The foreign exchange market aids in the inter-conversion of home currency to foreign currency and vice versa.

2.5 Financial Intermediaries

Financial intermediaries are special financial entities who act help in dealing with allocation of funds of the investors to the borrowers of funds. Financial intermediaries include depository institutions, insurance companies, regulated investment companies, investment banks, and pension funds. The financial intermediaries ensure a smooth and efficient transaction of funds between the investor and the borrower. The fund that a financial intermediary gets becomes its asset that they invest in other companies making them the liability or any equity participants in the intermediary. Financial intermediaries are involved in converting financial assets, which are highly risky for investing in by the public into financial assets at their own liabilities which less risky and preferred by the investors.

Case Study

How does the growth of emerging markets strain global finance?

Short-term doldrums aside, the world's corporations would seem to be in a strong position to grow as the global economy recovers. They enjoy healthy cash balances, with $3.8 trillion in cash holdings at the end of 2009, and they have access to cheap capital, with real long-term interest rates languishing near 1.5 percent. Indeed, as developing economies continue to pick up the pace of urbanization, the prognosis for companies that can tap into that growth over the next decade looks promising.

Yet all those new roads, ports, water and power systems, and other kinds of public infrastructure—and the many companies building new plants and buying machinery— may put unexpected strains on the global financial system. A leading consultancy team finds that by 2030, the world's supply of capital—that is, its willingness to save—will fall short of its demand for capital, or the desired level of investment needed to finance all those projects. Indeed, household saving rates have generally declined in mature economies for nearly three decades, and an aging population seems unlikely to reverse that trend. China's efforts to rebalance its economy toward increased consumption will reduce global saving as well.

The gap between the world's supply of, and demand for, capital to invest could put upward pressure on real interest rates, crowd out some investment, and potentially act as a drag on growth. Moreover, as patterns of global saving and investment shift, capital flows between countries will likely change course, requiring new channels of financial intermediation and policy intervention. These findings have important implications for business executives, investors, government policy makers, and financial institutions alike.

Surging demand for capital

Several economic periods in history have required massive investment in physical assets such as infrastructure, factories, and housing. These eras include the industrial revolution and the post–

World War II reconstruction of Europe and Japan. We are now at the beginning of another investment boom, this time fueled by rapid growth in emerging markets.

Across Africa, Asia, and Latin America, the demand for new homes, transport systems, water systems, factories, offices, hospitals, schools, and shopping centers has already caused investment to jump. The global investment rate increased from a recent low of 20.8 percent of GDP in 2002 to 23.7 percent in 2008 but then dipped again during the global recession of 2009. The increase from 2002 through 2008 resulted primarily from the very high investment rates in China and India but reflected higher rates in other emerging markets as well. Considering the very low levels of physical-capital stock these economies have accumulated, our analysis suggests that high investment rates could continue for decades. In several scenarios of economic growth, we project that global investment demand could exceed 25 percent of GDP by 2030. To support growth in line with the forecasters' consensus, global investment will amount to $24 trillion in 2030, compared with about $11 trillion in 2008. When we examine alternative growth scenarios, we find that investment will still increase from current levels, though less so in the event of slower global GDP growth.

The mix of global investment will shift as emerging-market economies grow. When mature economies invest, they are largely upgrading their capital stock: factories replace old machinery with more efficient equipment, and people make home improvements. But the coming investment boom will involve relatively more investment in infrastructure and residential real estate. Consider the fact that emerging economies already invest in infrastructure at a rate more than two times higher than that of mature economies (5.7 percent of GDP versus 2.8 percent, respectively, in 2008). The gap exists in all categories of infrastructure but is particularly large in transportation (for instance, roads, airports, and railways), followed by power and water systems. We project global investment demand of about $4 trillion in infrastructure and $5 trillion in residential real estate in 2030, if the global economy grows in line with the consensus of forecasters.

Shifting investor strategies

Investors will want to rethink some of their strategies as real long-term interest rates rise. In the short term, any increase in interest rates will mean losses for current bondholders. But over the longer term, higher real rates will enable investors to earn better returns from fixed-income investments than they have in the years of cheap capital. This change could shift some investment portfolios back to traditional fixed-income instruments and deposits and away from equities and alternative investments.

For pension funds, insurers, endowments, and other institutional investors with multi decade liabilities, the world's growing infrastructure investment could be an attractive opportunity. Many of these institutions, however, will need to improve their governance and incentive structures, reducing pressure to meet quarterly or annual performance benchmarks based on mark-to-market accounting and allowing managers to focus on longer-term returns. This change would be required as institutions come to manage portfolios with a growing proportion of less liquid, long-term investments, since volatility in market prices may reflect market liquidity conditions rather than an investment's intrinsic, long-term value.

Emerging markets, though they may present attractive opportunities, also pose many risks and complexities, and returns could vary significantly across countries. As incomes in emerging markets rise and capital markets develop, nonfinancial businesses can expect healthy growth from investing in both physical and financial assets. Returns to financial investors are less certain, however, particularly in countries with low returns on capital or savings trapped in domestic markets by capital controls or a "home bias" among domestic savers and investors. These countries will remain susceptible to bubbles in equity, real-estate, and other asset markets, with valuations exceeding intrinsic levels. Foreign investors will need to assess valuations carefully before committing their capital. They will also have to take a long-term perspective, since volatility in these bubble-prone markets may remain higher than it is in the developed world.

A call for government action

Governments will need to encourage the flow of capital from the world's savers to places where it can be invested in productive ways while minimizing the risks inherent in closely intertwined global capital markets. Governments in countries with mature markets should encourage more saving and domestic investment, rebalancing their economies so they depend less on consumption to fuel growth. Policy makers in these countries, particularly the United Kingdom and the United States, should start by putting in place mechanisms to sustain recent increases in household saving. They could, for instance, implement policies that encourage workers to increase their contributions to saving plans, enroll in pension plans, and work longer than the current retirement age. Further, governments can themselves contribute to gross national savings by cutting expenditures.

To replace consumption as an engine of economic growth, governments in these countries also should adopt measures aimed at boosting domestic investment. They could, for example, provide accelerated tax depreciation for corporations, as well as greater clarity on carbon pricing—the current uncertainty is holding back clean-tech investment. They should also address their own infrastructure-investment backlog, although this could require them to revise government accounting methods that treat investment and consumption in the same way. In emerging economies, governments should promote the continued development of deep and stable financial markets that can effectively gather national savings and channel funds to the most productive investments. Today, the financial systems in emerging markets generally have a limited capacity to allocate savings to users of capital. We see this in these countries' low level of financial depth—or the value of domestic equities, bonds, and bank deposits as a percentage of GDP. Policy makers should also create incentives to extend banking and other financial services to the entire population.

At the same time, policy makers around the world should create the conditions to promote long-term funding and avoid financial-protectionist measures that obstruct the flow of capital. This will require removing constraints on cross-border investing, whether through restrictions on pension funds and other investors or on capital accounts. Policy makers must also create the governance and incentives that enable managers of investment funds with long-term liabilities, such as pension funds, insurance companies, and sovereign-wealth funds, to focus on long-term returns and not on quarterly results that reflect market movements and can deviate from long-term valuations. At this writing, global investment already appears to be rebounding from the 2009 recession. The outlook for global saving is less certain. A climate of costlier credit will test the entire global economy and could dampen future growth. The challenge for leaders will be to address the current economic malaise and simultaneously create the conditions for robust long-term growth for years to come.