

Topic 3 – International Financial Markets and Euro Currency Markets

International Financial Markets (IFM)

- Foreign exchange market
- Euro markets
 - Euro currency market
 - Euro bond market
 - Euro note
 - Euro commercial paper
- International stock markets
- Islamic financial markets

Intermediated vs Non-Intermediated International Finance

- **International *direct* finance (non-intermediated)**
 - Surplus Unit (SU) → Deficit Unit (DU)
 - No intermediary
 - May involve brokers/underwriters that match SU to DU for a fee
 - Egs. Euro bonds or foreign bonds, Euro Commercial paper, Stocks
- **International *indirect* finance (intermediated)**
 - $SU \rightarrow FI(1) \rightarrow \dots \rightarrow FI(n) \rightarrow DU$
 - Egs. Euro deposits, CDs, euro loans, syndicated loans

Intermediated Markets

- Intermediated through a commercial bank

	Money Markets (< 12 months)	Capital Markets (> 12 months)
Internal Financial Markets	Domestic savings accounts, lines of credit with domestic borrower	Long term accounts with domestic clients
External Financial Markets	Eurocurrency deposits and loans	Long term accounts with foreign clients

Non-intermediated Markets

- Direct to the public, through a broker or investment bank

	Money Markets (< 12 months)	Capital Markets (> 12 months)
Internal Financial Markets	Short-term commercial paper (CP) issued in domestic markets	Stocks or bonds issued in domestic markets
External Financial Markets	<u>Euro</u> commercial paper (ECP) issued in international markets	Stocks issued in foreign markets. Foreign bonds issued in foreign markets. Eurobonds

Role of International financial intermediation

- **Risk intermediation** by portfolio diversification and credit analysis
 - Credit/default risk
 - Liquidity risk
 - Interest rate risk
- **Maturity intermediation** - borrow short, lend long
- **Size intermediation**
- **Interest rate intermediation** - floating to fixed
- **Currency intermediation**
- **Country intermediation** - avoid costs of regulation, taxes etc
- Banks play role as a match maker
- More than one financial intermediary involved)
 - (maybe 6 or more financial institutions utilised as Surplus Units from one country go from national market to off-shore markets to interbank market to Deficit Units in another country)
 - $SU \rightarrow FI_1 \rightarrow FI_2 \dots FI_{n-1} \rightarrow FI_n \rightarrow DU$

Features of International Financial Markets and Entrepôts

- An entrepôt is a trading post where merchandise can be imported and exported without paying import duties, often at a profit.
- Involves different currencies
- Largely unregulated
- No barriers to entry/exit
- No specific physical location (electronic)
- Operate on narrow margins
- Net supplier of capital to foreign borrowers
- Financial services to **both** domestic and foreign residents
- Higher risk - political risk, currency risk, different legal jurisdictions

Foreign Exchange Market

- **Spot transactions**- trades are made for immediate delivery
- **Forward transactions** – for future delivery with an agreed exchange rate, specified date and amount.
- Allows currencies to be exchanged to facilitate international trade or financial transactions.
- Largely an interbank market deals in spot and forward transactions
- The exchange rate system/market has evolved over time
 - Gold Standard (1876-1913), each currency was convertible to gold
 - Period of instability, World War I, the Great Depression and The 1944 *Bretton Woods Agreement* - called for fixed currency exchange rates
 - By 1971, the U.S. dollar appeared to be overvalued. The *Smithsonian Agreement* devalued the U.S. dollar (from \$35 to \$38 an ounce of gold) and widened the boundaries for exchange rate fluctuations from $\pm 1\%$ to $\pm 2\%$.
 - Governments still had difficulties maintaining exchange rates within the stated boundaries. In 1973, the official boundaries eliminated and the *floating exchange rate system* came into effect

The EuroMarkets

- The **most important** international financial market today
- Consists of Euro-banks that accept deposits and make loans in foreign currency
- The **dominant currency is the US\$**
- The term Euromarkets encompasses the following:
 - the Euro-currency markets
 - the Euro-bond markets
 - the Euro-note market
 - the Euro-commercial paper market

1) Euro-currency market

- **Euro**
 - Location of the bank or market differs from the country of the currency used
- **Eurocurrencies**
 - A currency deposited in a bank outside its country of origin
 - E.g. Eurodollars, euro yen, euro-euros!
- **Eurobanks**
 - Financial intermediaries that accept bank deposits and/or make loans in currencies other than the legal tender of the country where located

Growth of Eurocurrency markets

- *Political considerations* – ‘Iron Curtain’ (Post WW II)
 - Soviet Union placed US\$ in French and London banks to avoid seizure of funds by USA
 - The Iron Curtain symbolized the ideological conflict and physical boundary dividing [Europe](#) into two separate areas from the end of [World War II](#) in 1945 until the end of the [Cold War](#) in 1991.
- *Failure of Bretton Woods Systems* – (discussed before)
- *International Monetary System failure*
 - Failed to provide adequate liquidity to fund Balance of payment deficits, hence used private sector funds instead (contributed to Debt crisis of 1982)
- *Few regulations, relaxation of regulations*
 - No reserve requirements, interest rate regulations, withholding taxes, deposit insurance requirements, or credit allocation regulations; less stringent disclosure requirements

Eurocurrency features

- Wholesale nature of business
 - Economies of Scale (EOS), and increased efficiency
- Low risk
 - **Relatively short maturities:** Maturities of less than 5 years
 - **Low interest rate risk:**
 - 📊 Interest rates tied to a variable rate base such as the London **Interbank Offer Rate (LIBOR)**
 - 📊 Market provides a natural hedge, borrow in one currency and lend in another