

Topic 1: Globalisation and the MNC

Sunday, 26 February 2017

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- Globalisation refers to **increasing connectivity and integration of countries, corporations and the people within them**
 - Involves countries becoming closer in **social, political and economic interaction**

International trade growth

- An important product/determinant of globalisation is the **rise of the multinational corporation**, i.e. company that produces/sells goods and services in more than one country
 - The BRIC countries especially have offered a huge opportunity in **expansion and demand** for goods and services
- Trade liberalisation is the **movement towards 'free trade' between countries**. Benefits include:
 - **Specialisation** based on comparative advantage
 - **Outsourcing** parts of the production process
- In the 1960s, only 20% of countries were considered 'open', and by the 2000s the figure was 70%
- Trade liberalisation is developed through **trade agreements**:
 - Free Trade Agreements, e.g. GATT from 1947-1985, or **WTO signed by 123 nations in 1994**
 - Regional trade agreements, e.g. EU, NAFTA, ASEAN, ChAFTA

Globalisation of financial markets

- **Securitisation** is the **repackaging of pools of loans or receivables to create a new financial instrument**
 - History dates back to 1800s, became more widespread in 1980s
- Globalisation and securitisation occurred at **around the same time**
 - Advantage: **banks and companies could hedge against risk** (since only a small percentage of loans would default)
 - Disadvantage: **complex instruments led to opaqueness in the financial system**
 - GFC: started in the US, was the longest and deepest recession in the post-war era
 - Raised issues with **how well the global financial system worked**
- There were ~37,000 MNCs in 1990, with now 80,000+ today
 - Due to the **globalisation of financial markets**, brought on by
 - **Trends in financial openness**
 - Deregulation of financial systems in the 1980s, allowed more foreigners to invest in domestic markets
 - Creation of a new asset class - the **emerging markets**
 - **Rise of derivatives trading**
 - A derivative is a security which has a payoff dependent on the performance of an underlying asset or security
- The GFC:
 - **Growth in sub-prime mortgages** from 2000-06 was **fuelled by securitisation** and the US government's quest to allow everyone to own a home
 - People bought houses they couldn't afford, banks securitised the loans and sold them to investors
 - As house prices fell, many defaulted on mortgages and banks holding assets backed by these mortgages got shafted

- A bank in the UK faced a bank run (everyone tries to take their money out at once) in 2007
- JPM bought Bear Stearns in 2008 because it couldn't fund itself in the money markets
- Fannie Mae and Freddie Mac were taken over by the government
- Lehman Brothers declared bankruptcy in 2008 and money markets froze
- Ramifications:
 - Debates over who was responsible
 - Correction of global imbalances, e.g. US trade deficit and China's trade surplus
 - Regulatory issues:
 - Central banks pumped money into major banks
 - **Effectiveness of expansionary monetary and fiscal policies** (Japan's quantitative easing)
 - Policy implications of a bank being **too big to fail**

Multinational corporations

- A parent company exists in the firm's originating country, with operating subsidiaries and affiliates abroad (aka **transnational corporations**)
- How do they enter foreign markets?
 - **Exporting/importing**
 - **Licensing** gives local firms the right to manufacture their products in exchange for a fee
 - **Franchising** where the firm provides sales or services strategies in exchange for a fee
 - **Joint venture** where two or more firms form a new legal entity owned by all the parent firms
 - **Greenfield** involves starting a company from scratch
- Primary goal of a multinational corporation:
 - In Australia, Canada, UK and US it is to **maximise shareholder wealth over a long-term time horizon**
 - However in Europe and Asia there is debate over the merits of aiming to **maximise stakeholder wealth** instead
 - Stakeholders referring to shareholders but also employees, creditors, management, customers; anyone who depends on the company
- How do owners make sure **shareholder/stakeholder wealth is maximised?**
 - **Agency theory** studies problems that arise from the **separation of ownership and control**, i.e. corporate governance issues
- Methods of overcoming the agency problem:
 - Independent board of directors
 - **Advantage:** protection of minority shareholders' interests and increased risk sharing
 - **Disadvantage:** not usually sufficiently independent of management
 - Partial concentration of ownership and control with a large shareholder
 - **Advantage:** shareholder has the self-interest to monitor management's activities
 - **Disadvantage:** shareholder can collude with management against minority shareholders
 - Executive compensation with performance incentives
 - **Advantage:** direct incentive to maximise share price
 - **Disadvantage:** rewards management for good luck and is subject to manipulation and short-term focus
 - Clearly defined fiduciary duties for CEOs with class-action lawsuits
 - **Advantage:** complementary disciplining device
 - **Disadvantage:** increases legal costs at the expense of shareholders

- Hostile takeovers and proxy contests
 - **Advantage:** incentive for management to not screw up because they get fired
 - **Disadvantage:** provides incentive for raiders to expropriate wealth from creditors and employees

FDI and other international players

- **Foreign direct investment** refers to when a company buys a 10% or greater stake in a company in a different country
 - Has increased 30x since 1980, to \$18 trillion
 - But has decreased as a % of GDP since 2000
- Other international players
 - International banks (see topic #)
 - **International Monetary Fund (IMF)**
 - Ensures stability of the international monetary and financial system through surveillance and assistance
 - **The World Bank**
 - Focuses on development, advisory duties and alleviation of poverty in mainly developing/emerging countries
 - Multilateral development banks
 - Regional development banks (like small versions of the World Bank) providing financing and grants
 - **World Trade Organisation (WTO)**
 - Mediates trade disputes and has the ability to place sanctions on countries
 - **Organisation for Economic Cooperation and Development (OECD)**
 - Examines, devises and coordinates policies across 34 relatively wealthy nations
 - Goal is to foster sustainable economic growth and employment and higher quality of life and financial stability
 - **Bank for International Settlements (BIS)**
 - Fosters international monetary and financial cooperation, e.g. the central bank for central banks
 - **European Union (EU)**
 - Economic and monetary union to foster cross-border cooperation in Europe
 - Others:
 - Governments
 - Investors (individual and institutional)
 - Sovereign wealth funds (run by the government)
 - Hedge funds and private equity funds

Globalisation: pros and cons

- Recently, especially in the era of Trump's presidency, globalisation and **trade liberalisation is slowing down** giving way to a **rise in protectionism**
 - e.g. increasing tariffs and trade litigation barriers for political sway since globalisation can be seen as a threat to domestic employment
- There are the arguments of countries which opened their markets to foreigners and subsequently got dragged into the GFC
- Benefits:
 - **Specialisation** increases gross world product
 - **Sharing of risk** beyond domestic possibility
 - **Buffering of domestic recessions** with international borrowing

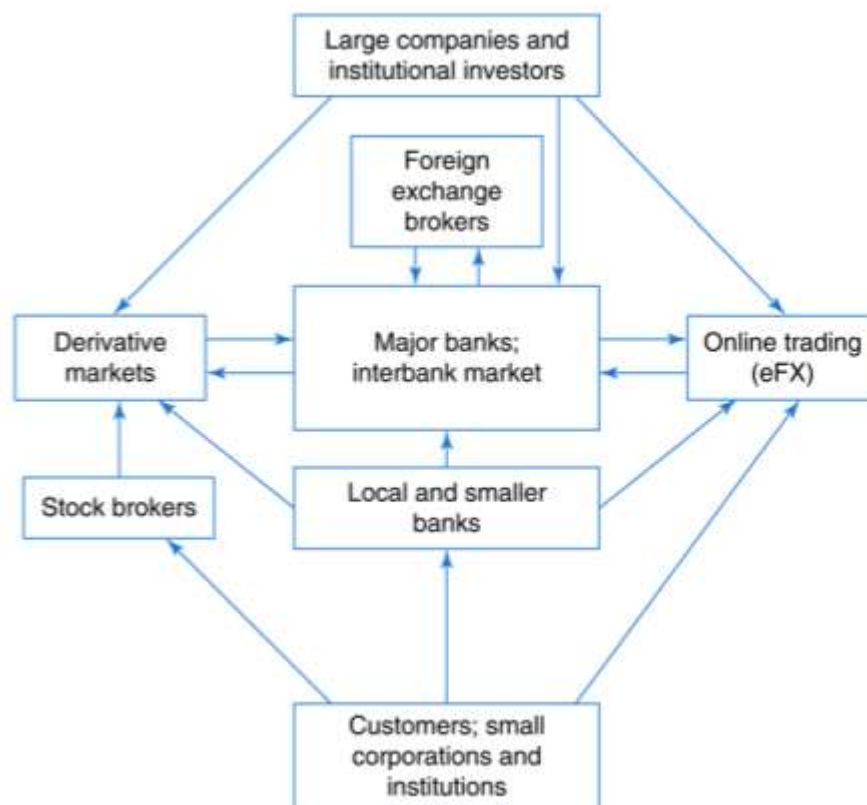
- **Lower cost of capital**
- **Costs:**
 - **Capital is not always used wisely**, e.g. sub-prime mortgages
 - **Foreign capital can dry up very quickly** causing financial volatility
 - **Harder for governments to tax profits** of MNCs
 - **Difficult to control capital flows**

Topic 2: Foreign Exchange Markets

Monday, 27 February 2017
7:10 PM

Structure of the foreign exchange market

- Most important cities are London, New York and Tokyo
- Operates 24 hours a day, with the interbank market making up 50% of trading volume
- Most trades are greater than US\$1.0m
- Largest financial market in the world, **\$5.5 trillion a day**



- Contracts traded on the forex market:
 - **Spot contracts** for trades made today
 - **Future transactions** including swaps and forwards (see Topic 3)
 - **Derivatives** including futures and options (see Topic #)
- Dealers and brokers
 - **Foreign exchange dealers** are commercial banks and investment banks, and they are market makers (i.e. bring buyers and sellers together)
 - **Brokerage firms** are intermediaries who facilitate trades
 - Other forex participants include central banks and MNCs
- **Liquidity** refers to the ease with which one can sell an asset **at its fair value**
 - Highly liquid assets have **low transaction costs**
- Forex is a competitive market because **there is no product differentiation**, i.e. my 100 AUD is exactly the same as the 100 AUD Goldman Sachs is trying to sell
- The top 4 players in the exchange market account for 40% of trades, and the top 20 account for over 90% (CHECK THIS WTF)

Exchange rates

- The **exchange rate** is the price of one currency in terms of another
- Quoting exchange rates:
 - Direct** involves expressing in terms of the domestic currency (i.e. it's the numerator)
 - AUD/GBP = 1.6136, i.e. 1 pound is worth that many A\$
 - Indirect** involves expressing in terms of the foreign currency
 - GBP/AUD = $1/1.6136 = 0.6197$
 - American** if expressed in USD, **European** if expressed in pounds (check with textbook that it's not euro)
- For the rest of the course, we have to express in the stupid textbook method which is \$1.24/£1

Cross-rates

- A **vehicle currency** is a currency used in many international financial transactions
 - Usually due to transaction costs of making markets in certain currencies
 - USD makes up ~89% of all transactions
- Cross-rates** are where both currencies are not expressed in the domestic currency
 - there is currently seeing a trend towards cross-rate transactions globally
 - Cross rate table example:

	USD	EUR	GBP	CHF	MXN	JPY	CAD
Canada CAD	1.0207	1.3367	1.5798	1.0502	0.08217	0.01213	.....
Japan JPY	84.118	110.16	130.19	86.5495	6.7715	.....	82.411
Mexico MXN	12.422	16.268	19.226	12.781	.....	0.14768	12.170
Switzerland CHF	0.97191	1.2728	1.5042	.....	0.07824	0.01155	0.95218
United Kingdom GBP	0.64612	0.84616	.....	0.66479	0.05201	0.00768	0.63300
Euro	0.76359	.....	1.1818	0.78566	0.06147	0.00908	0.74809
United States USD	.....	1.3096	1.5477	1.0289	0.08050	0.01189	0.97970

- Theoretically, if you knew the AUD/USD exchange rate and the GBP/AUD exchange rate, then you know what the implied USD/GBP rate is
- Cross exchange rate equilibrium:**
 - $AUD/JPY = AUD/USD * USD/JPY$, or
 - $¥/A\$ * A\$/US\$ * US\$/¥ = 1$
- Triangular arbitrage** involves arbitrage where cross-rates are not in equilibrium
 - If $¥/A\$ * A\$/US\$ * US\$/¥ < 1$, this means one of the three **cross-rates must rise**
 - Whichever cross-rate is too low, the denominator currency is valued too low relative to the numerator currency (e.g. 1.24 A\$/£ compared to 1.5 A\$/£ << USD is valued higher in the second one)
 - Since one of the rates should rise, you should **buy each denominator currency with the respective numerator currency**
 - If $¥/A\$ * A\$/US\$ * US\$/¥ > 1$, one of the three **must fall** as the denominator currency is valued too high
 - Since one of the rates should fall, you should **buy each numerator currency with the respective denominator currency**
 - Example:
 - ZAR11.5/\$, ¥9/ZAR, \$0.01/¥
 - $11.5 * 9 * 0.01 = 1.035$, meaning one of the rates should fall and you will make a 3.5% profit (excluding transaction costs)
 - If you had \$1, you would buy ZAR11.5, then use that to buy 103.5¥, then use that to buy \$1.035, for 3.5c profit

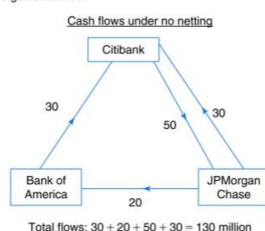
Bid-ask spreads and bank profits

- **Bid** is the rate at which the **bank will buy the base (denominator) currency**;
 - **Ask** is the rate at which the **bank will sell the base currency**
 - Obviously the ask rate is going to be higher than the bid for the banks to profit from a forex transaction
 - The difference is measured with the **bid-ask spread** which is (as a percentage)
 - $$100\% * \frac{\text{ask} - \text{bid}}{\text{ask}}$$
 - The bid-ask spread is also effectively what you would lose if you were to immediately buy and sell with this bank
- Magnitude of bid-ask spreads:
 - In the **interbank market**, it is within 5 'pips' (fourth decimal point in a currency quote)
 - Usually about 0.05% to 0.07% for major currencies, and lower for more liquid, higher for less liquid
 - On a physical exchange, e.g. using a credit card to pay for something in another country, bid-ask spread can be **higher than 3%**
 - This is because banks have to transact with brokers, and they need to have the currency in their inventory hence it is **not interest bearing**

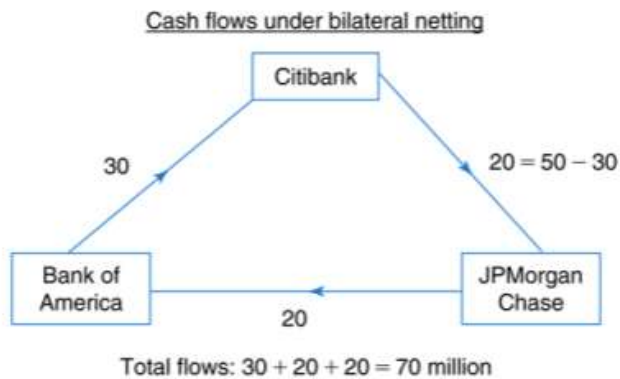
Communication systems and risk

- The **Society of Worldwide Interbank Financial Telecommunications (SWIFT)** links 7500+ banks in 200 countries
 - Others include:
 - CHIPS - clearing house in US for USD
 - Fedwire, links computers of 7500+ institutions that have deposits with the US Federal Reserve
 - TARGET - European version of Fedwire
- **Cross-currency settlement risk** (aka Herstatt risk) is the risk that a financial institution may not deliver the currency on one side of the transaction
 - Addressing the risk:
 - The Bank of International Settlements (BIS) encourages the **voluntary restriction of transaction amounts** to limit the risk
 - **Simultaneity of both transactions** - continuous linked settlement acts as a global clearing house
 - **Netting arrangements**
- Netting arrangements work as a sort of bundling together of cash flows between different banks:

- Citibank owes JPMorgan Chase \$50 million from a foreign exchange deal.
- JPMorgan Chase owes Citibank \$30 million from another foreign exchange deal.
- Bank of America owes Citibank \$30 million from a foreign exchange deal.
- JPMorgan Chase owes Bank of America \$20 million from another foreign exchange transaction.



- The above is with no netting; all amounts are fully paid
- Below we see **bilateral netting**, where foreign exchange amounts to be paid are summed up between two banks



- Below we see **multilateral netting**, where a netting organisation is used to bundle all cash flows together for a group of banks:
 - Citibank owes 20 and is owed 30 = net 10
 - JPM owes 20 and is owed 20 = net 0
 - Bank of America owes 30 and is owed 20 = net -10
 - Hence BAML will pay 10 and Citi will receive 10

