EduTap

SUMMARY SHEET

Global Financial Markets and International Banking

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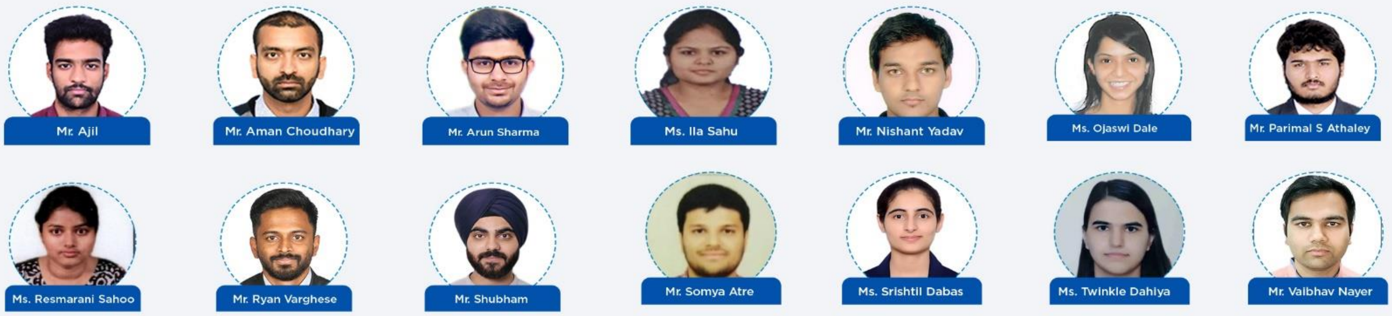
EduTap Hall of Fame

RBI Grade B 2020 - 21

198 Selections Out of 257



SEBI Grade A 2020

63 Selections Out of 80

NABARD Grade A 2020

65 Selections Out of 69

1 International Finance

It mainly discusses the issues related with monetary interactions of at least two or more countries. International finance is concerned with subjects such as exchange rates of currencies, monetary systems of the world, foreign direct investment (FDI), and other important issues associated with international financial management

1.1 Importance of International Finance

1. International finance is an important tool to find the exchange rates, compare inflation rates, get an idea about investing in international debt securities, ascertain the economic status of other countries and judge the foreign markets.
2. Various economic factors help in making international investment decisions.
3. International finance helps understand the basics of all international organizations and keeps the balance intact among them.
4. An international finance system maintains peace among the nations. Without a solid finance measure, all nations would work for their self-interest. International finance helps in keeping that issue at bay.
5. International finance organizations, such as IMF, the World Bank, etc., provide a mediators' role in managing international finance disputes.

1.2 Benefits and Risks of Financial Globalization

One of the major benefits of Financial Globalization is that the risk of a "credit crunch" has been reduced to extremely low levels.

Another benefit is that, with more choices, borrowers and investors get a better pricing on their financing.

The disadvantage is that the markets are now extremely volatile, and this can be a threat to financial stability.

With financial globalization, creditworthy banks and businesses in emerging markets can now reduce their borrowing costs. However, emerging markets with weak or poorly managed banks are at risk.

2 Global Financial Markets

The field of international finance has witnessed explosive growth and dynamic changes in recent decades. This has been stimulated by several forces:

(a) The change in the international monetary system from a fairly predictable system of exchange rates to a flexible and volatile system of exchange rates,

(b) Emergence of new institutions and markets and a greater need for international financial intermediation,

(c) A greater integration of the global financial system.

2.1 International Monetary System

An international monetary system is a set of internationally agreed rules, conventions and supporting institutions that facilitate international trade, cross border investment and generally the reallocation of capital between nation states.

2.1.1 Present System of Exchange Rates

In 1971 the U.S. dollar was delinked with gold. The system of fixed exchange rates, where devaluations and revaluations occurred only very rarely, gave way to a system of floating exchange rates.

In a truly floating exchange rate regime, the relative prices of currencies are decided entirely by the market forces of demand and supply. However, such an idealized free float probably does not exist. Governments of almost all countries regard exchange rate as an important macro-economic variable and attempt to influence its movements either through direct intervention in the exchange markets or through a mix of fiscal and monetary policies. Such floating is called managed or dirty float.

In India, the exchange rate of the rupee is managed by the RBI. RBI has been intervening heavily in the market to hold the rupee-dollar rate within tight bounds while rupee rates with other currencies fluctuate as the U.S. dollar fluctuates against them.

2.1.2 Agencies That Facilitate International flows

Several agencies have been established since the early 1940s to promote international trade and financial transactions. The more important ones are described below briefly;

1) World Bank- **Covered in ESI**

2) IMF- **Covered in ESI**

3) World Trade Organization- **Covered in ESI**

4) Bank for International Settlements (BIS) The BIS facilitates cooperation among countries with respect to international transactions and assists countries experiencing financial crisis. It is sometimes referred to as central banks' central bank.

(BIS is also covered in Risk Management)

5) Regional Development Agencies: In addition to the above agencies which have a global scope, there are several agencies that have a more regional character. For example: Asian Development Bank, the African Development Bank, etc.

Multinational corporations (MNCs)

A multinational, or global, corporation is a firm that operates in an integrated fashion in a number of countries. **Companies "go global" for various reasons.**

- **Trade Barriers:** Confronted with restrictions to export its products to foreign markets, a firm may set up production facilities in foreign countries to circumvent trade barriers.

- **Imperfect Labour Markets:** Due to immigration barriers, labour mobility is limited. So firms locate their plants or facilities to countries that offer labour cost advantage.
- **Intangible Assets:** Companies often possess special intangible assets like superior R&D capabilities, marketing savvy, brand equity, and managerial talent. So they invest in foreign countries to leverage these competitive advantages.
- **Vertical Integration Companies:** invest in countries to enjoy the benefits of vertical integration. While the majority of vertical foreign direct investments are backward to secure supplies of raw materials (oil, mineral deposits, and forest produce), some are forward as they involve an industry using the MNC's outputs.
- **Product Life Cycle:** According to Raymond Vernon, it is advantageous for a firm to set up production base in foreign countries when the product has reached the stage of maturity.
- **Diversification:** By geographically diversifying their production base and markets, firms can reduce the risk of adverse economic developments in a single country.
- **Shareholder Diversification:** If there are restrictions to cross-border portfolio diversification, firms can provide their shareholders the benefits of indirect diversification by investing in foreign countries.

2.2 International Financial Markets

The International Financial Market is the place where financial wealth is traded between individuals (and between countries).

Major Global Finance Markets

1. **The US financial market:** It is biggest and most versatile financial market around the globe. The financial system of US finance market include the network of commercial banks, domestic and foreign international banks, non-bank financial institution, insurance companies, pension funds, mutual funds, savings, and loan associations. Three authorities such as comptroller of currency the Federal Reserve board and the federal deposit insurance corporations regulate the commercial banks in the US.
2. **Euro market is composed of Euro dollar bond, FRNs, NIFs.** Euro dollar bond accounts for large share of euro bond issues. The main factor that makes the Eurocurrency market so attractive to both depositors and borrowers is its lack of government regulation.
3. **Japanese market:** Japanese financial system was integrated with the international market since 1970s. The main components of Japan's financial system are much the same as those of other major industrialized nations. Ministry of finance closely monitors the financial system.
4. **German market:** The Deutshe mark denominated German market. It occupies an important place in the entire gamut of euro market. Since 1985, Germanys' financial system was attuned to world financial order marked by liberalization and deregulation. Universal banking is popular in Germany.

5. **Swiss financial market**: It is well developed banking system especially for the foreign investors who made the Swiss market global player in global financial market.
6. **Australian market:** Australian dollar became very popular in the offshore market on the issue of bonds. The dominant participants in Australian markets are banks, especially in foreign exchange and derivatives. As a consequence, supervision of the banking system carries with it the supervision of a large part of the activity in financial markets.
7. **Indian financial market:** Indian financial market is one of the prominent financial markets of the world. Indian economy had remained steady because of the cost-effective control and after 1991 generally when the liberalization has been started in India which made Indian security market boom and helped Indian economy in its growth.
   Discussed in more details separately under Primary and Secondary Markets Chapters
8. **Sterling market:** It has significant place in global financial market.

2.2.1 International Money Market

The international money market is a market where international currency transactions between numerous central banks of countries are carried on.

The international money market is governed by the transnational monetary transaction policies of various nations' currencies. This process of trading a country's currency with another one is also known as **forex trading**.

Some of the major international money market participants are – Citigroup, Deutsche Bank, HSBC, Barclays Capital, UBS AG etc.

2.2.2 International Capital Market

International capital markets are the same mechanism but in the global sphere, in which governments, companies, and people borrow and invest across national boundaries. In addition to the benefits and purposes of a domestic capital market, international capital markets provide the following benefits:

1. **Higher returns and cheaper borrowing costs.**
2. **Diversifying risk.**

Major types of Capital market are as following:

2.2.2.1 International Bond Market

An international bond is a bond sold outside the country of the borrower. There are two major types of international bonds: Eurobonds and foreign bonds.

- A Eurobond is a bond issued in one country but designated in the currency of some other country. For example, an issue of a dollar denominated bond in London is a Eurobond.

- Foreign bonds are issued by a foreign borrower but denominated in the currency of the country where the issue is made. For example, a British firm may issue dollar denominated bonds in the US capital market.

2.2.2.2 International Equity Market

International equity markets are an important platform for global finance. They not only ensure the participation of a wide variety of participants but also offer global economies to prosper. Cross-listing, Yankee stocks, ADRs and GDRs are important elements of equity markets.

Cross-listing

Cross-listing refers to having the shares listed on one or more foreign exchanges. In particular, MNCs do this generally, but non-MNCs also cross-list. A firm may decide to cross-list its shares for the following reasons –

- Cross-listing provides a way to expand the investor's base
- Cross-listing offers recognition of the company in a new capital market
- Cross-listing offers more investors.
- Cross-listing may be seen as a signal to investors that improved corporate governance is imminent.
- Cross-listing diminishes the probability of a hostile takeover of the firm via the broader investor base formed for the firm's shares.

Yankee Stock Offerings

"Yankee" stock offerings are dollar-denominated shares in foreign companies originally sold to U.S. investors

ADRs and GDR

In the depository receipts mechanism the shares issued by a firm are held by a depository, usually a large international bank, who receives dividends, reports, etc., and issues claims against these shares. These claims are called depository receipts with each receipt being a claim on a specified number of shares. The underlying shares are called depository shares.

Note: ADR and GDR are covered in Primary and Secondary Market.

The key factors for the increased growth in the international equity markets are the following:

- **Growth of developing markets.**
- **Drive to privatize.**
- **Investment banks.** These specialized banks seek to be retained by large companies in developing countries or the governments pursuing privatization to issue and sell the stocks to investors with deep pockets outside the local country.
- **Technology advancements.**

Do you know?

Eurocurrency Markets

The Eurocurrency markets originated in the 1950s when communist governments in Eastern Europe became concerned that any deposits of their dollars in US banks might be confiscated or blocked for political reasons by the US government. These communist governments addressed their concerns by depositing their dollars into European banks, which were willing to maintain dollar accounts for them. This created what is known as the Eurodollar—US dollars deposited in European banks.

Over the years, banks in other countries, including Japan and Canada, also began to hold US dollar deposits and now Eurodollars are any dollar deposits in a bank outside the United States. (The prefix *Euro-* is now only a historical reference to its early days.) An extension of the Eurodollar is the Eurocurrency, which is a currency on deposit outside its country of issue. While Eurocurrencies can be in any denominations, almost half of world deposits are in the form of Eurodollars.

INTERNATIONAL PARITY RELATIONSHIPS

For this purpose the following theories are discussed:

1) **Purchasing power parity (PPP)** is a measurement of prices in different countries that uses the prices of specific goods to compare the absolute purchasing power of the countries' currencies. In many cases, PPP produces an inflation rate that is equal to the price of the basket of goods at one location divided by the price of the basket of goods at a different location. The PPP inflation and exchange rate may differ from the market exchange rate because of poverty, tariffs, and other transaction costs. It is expressed as

$$\frac{S_1^e}{S_o} = \frac{1+i_h}{1+i_f}$$

where S_1^e is the expected spot rate a year from now, S_o is the current spot rate, i_h is the expected inflation rate in home country, and i_f is the expected inflation rate in foreign country.

2) Fisher Effect and the International Fisher Effect (IFE)

The Fisher Effect defines the connection between the rate of inflation and interest rates. It suggests that the nominal rate of an economy is equal to the inflation rate plus the real interest rate. From this equation, it can be said that the real interest rate can be gotten by subtracting the rate of inflation from the nominal interest rate.

Nominal Rate – Inflation Rate = Real Interest Rate

The International Fisher Effect

On its part, the IFE adds to the Fisher Effect theory. It states that the estimated increase (appreciation) or decrease (depreciation) of the currencies of two countries is directly proportional to the difference in their nominal interest rates.

2.3 Types of Risk in Global Financial Markets

Generally, risks which a firm face has been categorized as:

- **Foreign Exchange Rate Risk:**
  The variance or changes of the real domestic currency value of assets, liabilities or operating income on account of unanticipated changes in exchange rates referred as Foreign Exchange Risk.
- **Interest Rate Exposure and Risk:**
  Interest rate uncertainty exposes a firm to the following types of risks.
  Borrowings on floating rate bring uncertainty relating to future interest payments, for the firm. The floating rate makes borrowing cost of capital unknown. The problem is that there is a rise of variation in interest rate risk for the firm due to the fluctuating or floating rate clause in loan agreement.
- **Credit Risk:**
  A credit risk is the risk, in a transaction, of counter party of the transaction failing to meet its obligation towards the transaction. This risk is present in all trade and commerce transactions; thus it also includes the transactions relating to foreign trade and foreign exchange.
- **Legal Risk:**
  The risk arising due to legal enforceability of a contract, or a transaction is known as legal risk.
- **Liquidity Risk:**
  If the markets turn illiquid or the positions in market are such that cannot be liquidated, except huge price concession, the resultant risk is known as liquidity risk.
- **Settlement Risk:**
  This is the risk of counterparty failing during settlement, because of time difference in the markets in which cash flows the two currencies have to be paid and received viz. settled.
- **Political Risk:**
  Political Risk is the risk that results from political changes or instability in a country. Such variability or changes always result into some kind of changes in the monetary, fiscal, legal, and other policies of the country facing the changes.
  Political Risk can broadly classify into the following four categories:
  1. Country Risks
  2. Sector Risks
  3. Project Risks
  4. Currency Risks

2.4 Global financial markets and Economic growth

The Global Financial System Promotes Economic Growth in the following ways:

1) Creates money and facilitates its flow.

A host of institutions participate in the process of creating money and money-like claims, and these different types of monies are used for different (sometimes overlapping) purposes, that is, for different settlement purposes.

2) Facilitates Specialization and Trade

The financial system also facilitates global trade by way of allocating liquidity from liquidity-surplus areas of the world to liquidity-starved areas.

3) Facilitates Global Risk Management for Individuals and Companies

As the global financial system evolves, it develops a greater variety of risk management instruments and processes. This enables individuals and firms to hedge against a growing variety of risks, benefiting not only them but also society because it enables them to invest more in economic growth

4) Mobilizes Resources and Creates New Resources by Encouraging Innovation

Two of the biggest impediments to innovation are lack of funding and lack of talent or people. A strong global financial system helps to reduce these impediments. Moreover, participating in the global mobilization of resources is enormously beneficial to a country; hence, a global financial system that fosters this mobilization also boosts the economic growth of nations.

5) Obtains Information for the Evaluation of Businesses and Individuals and Allocates Capital

Private equity firms, banks, venture capitalists, and a host of other institutions that make up the global financial system help Main Street to raise financing, fund growth, and create enhanced economic value in countless ways.

6) Increases the Set of Opportunities Available to Companies, Entrepreneurs, and Individuals

The growth of the global financial system creates new opportunities for businesses and governments to drive economic growth, and it increases access for new participants from different countries, in addition to expanding opportunities for innovation.

3 International Banking

An international bank is a financial unit that provides financial services, such as payment accounts and lending opportunities, to foreign customers. These foreign clienteles can be individuals and companies, though every international bank has its own strategies which decide with whom they do business.

Major functions of international banking:

- Facilitate imports and exports of their clients -trade financing.
- Arrange for foreign exchange - cross-border transactions and foreign investments
- Assist in hedging exchange rate risk
- Trade foreign exchange products for their own account.
- Borrow and lend in the Eurocurrency market

- Participate in international loan syndicate - lending to MNCs- project financing and to sovereign governments - economic development
- Participate in underwriting of Eurobonds and foreign bonds issues.
- Provide consultancy and advice on hedging strategies, interest rate and currency swap financing and international cash management services.

3.1 Advantages of International Banking

1. Safe and secure global access to your money 24/7.
2. Quick and easy transfers in multiple currencies gives customers greater flexibility over their finances.
3. Simple and convenient to operate and offers one central location for all banking requirements of customers.
4. Unlimited access to foreign exchange.
5. Provides security against exchange rate fluctuations.
6. Grow and protect money in a stable offshore jurisdiction.
7. Confidential service wherever customers are in the world.

3.2 Role of International Banking in Economy

First, international banking has been major component of a broader process of financial globalisation and integration. In addition, the local operations of foreign banks have spurred the development of financial systems in emerging markets and helped to alleviate information problems via close and sustained customer relationships.

Secondly, the role of international banks in the international economy is related to international financial markets. As they execute complementary functions, both forms of financial intermediation are indispensable, together with a resilient market infrastructure, for smooth functioning of the financial system.

Do you know?

International banking activity occurs today via sophisticated international communication facilities that help in interbank communications such as

IBAN

IBAN stands for The International Bank Account Number and is a 34-digit long code that carries all the identifying information about your bank, its branch, its location and your account number in both digit and letter form. The IBAN is used in most European countries as well as in many parts of the Middle East and the Caribbean.

BIC (or SWIFT)

The Bank Identifier Code (sometimes called SWIFT) contains information about the receiving country, bank and branch. It contains numbers and letters and is eight to 11 digits long. The acronym SWIFT refers to the Belgian Society for Worldwide Interbank Financial Telecommunication that developed the code as part of its mission to help global financial institutions send and receive information about financial transactions in a secure, standardized and reliable manner.

CHIPS

CHIPS stands for the Clearing House Interbank Payments System Universal Identifier. The CHIPS Uid is a six-digit code that contains all the information that is necessary to identify the person who is wiring the money. Thus your name, address, routing number, account number, and so forth are all contained in this CHIPS code. The Clearing House Interbank Payments System confidentially stores the code, or information, as it does that of all individuals.

3.3 International Banking Activities

- International banks facilitate the imports and exports of their clients by arranging trade financing.
- They arrange for foreign exchange necessary for their clients to conduct cross-border transactions and make foreign investments. Banks assist in hedging exchange rate risk in foreign currency receivables and payables through forward and options contracts.
- Two major features that distinguish international banks from domestic banks are the types of deposits they accept and the loans and investments they make. Large international banks both borrow and lend in the Eurocurrency market.
- International banks provide consulting and advice to their clients in the areas of foreign exchange hedging strategies, interest rate and currency swap financing, and international cash management services.
- While direct lending is the major activity of commercial banks, their activities cover investment banking, banker's acceptance, commercial paper, medium-term notes, and direct lending.

DOCUMENTS IN INTERNATIONAL TRADE

Trade Draft: The international trade draft, also referred to as a bill of exchange, is a written order by the exporter (the drawer) asking the importer (the drawee) to pay a specified amount of money at a certain time.

Bill of Lading: A bill of lading is a document of shipping employed when the exporter transports goods to the importer. It serves several functions: (i) It is a document of title to goods, (ii) Itis a receipt given by the transportation company acknowledging their commitment to deliver the goods to a specified party at a certain destination.

Letter of Credit: A letter of credit is issued by a bank on behalf of the importer. As per this document, the bank agrees to honour the draft drawn on the importer provided certain conditions are satisfied.

3.4 Features and Benefits of International Banking

- **Flexibility**
  International banking facility provides flexibility to multinational companies to deal in multiple currencies.
- **Accessibility**
  International banking provides accessibility and ease of doing business to companies from different countries.
- **International Bank Transfers/ Transaction**
  International banking allows the business to make international bill payments.
- **Accounts Maintenance**
  A multinational company can maintain the records of global accounts in a fair manner with the help of international banking.

3.5 Key Risks in International Banking

- **Country risk**: Country risk is associated with the risk of investing or lending in a country, arising from possible changes in the business environment that may adversely affect operating profits or the value of assets in the country.
- **Credit Risk**: A credit risk is the risk of default on a debt that may arise from a borrower failing to make required payments.
- **Currency Risk**: Currency risk is a type of risk that initiates from changes in the relative valuation of currencies.
- **Foreign Exchange Risk**: Foreign exchange risk is a financial risk that exists when a financial transaction is denominated in a currency other than that of the base currency of the company.

3.5.1 Foreign exchange exposure

Foreign exchange exposure can be classified into three broad categories:

1) Transaction Exposure: Transaction exposure (or transaction exposure) is the level of uncertainty businesses involved in international trade face. Specifically, it is the risk that currency exchange rates will fluctuate after a firm has already undertaken a financial obligation.

2) Translation Exposure: Translation exposure (also known as translation risk) is the risk that a company's equities, assets, liabilities, or income will change in value as a result of exchange rate changes.

3) Operating Exposure: An operating exposure is the measurement of the extent to which the firm's operating cash flows are affected by the exchange rate.

3.5.2 Management of Foreign Exchange Exposure

Management of Transaction Exposure

Transaction exposure arises mainly on account of imports, exports, and foreign currency borrowings. To cope with transaction exposure the firm can use financial contracts and operational techniques.

1) Financial Contracts: A financial contract is a deal in the form of an independently arranged agreement, contract, or an option to sell, buy, swap, lend, or repurchase, or some other similar independently arranged transaction that is typically entered into between parties participating in the financial markets.

Types of Financial Contracts:

- **Forward Market Hedge**: A hedge that involves the use of foreign exchange forwards (FX forwards). It consists of an outright purchase of a currency at a forward exchange rate. The hedge is affected by interest rates in the two countries whose currencies are involved and the spot exchange rate between the two currencies.
- **Money Market Hedge**: A money market hedge is a technique used to lock in the value of a foreign currency transaction in a company's domestic currency. Therefore, a money market hedge can help a domestic company reduce its exchange rate or currency risk when conducting business transactions with a foreign company.
- **Swaps**: Financial Swaps basically involves an exchange of one set of financial obligations with another. (Refer Derivative Notes for more details)
- **Option Forwards:** A variant of the forward contract is an option forward in which the exchange rate between the currencies is fixed when the contract is entered into, but the delivery date is not fixed.

2) Operational Technique:

- **Choice of Invoice Currency**: A firm can shift, share, or diversify exchange risk by its choice of the currency of invoice. For example, Bharat Forge may invoice its supplies to a British Customer in dollars rather than pound sterling.
- **Leading and Lagging**: Sometimes, exposures can be managed by altering the timing of foreign currency flows through leading and lagging. Leading involves advancing and

lagging involves delaying. The general rule is to lead payables and lag receivables in "strong" currencies. By the same token, lead receivables and lag payables in "weak currencies."

- **Netting and Offsetting**: If a firm has receivables and payables in different currencies, it can net out its exposure in each currency. Suppose an Indian firm has exports of $100,000 to the US and imports of $120,000 from the US. It can use its receivables of $100,000 and hedge only the net US dollars payable. If the timings of the flows are not matched, it can lead or lag one or both of them to achieve a match.

Management of Operating Exposure

Transaction exposure is short-term in nature and well-identified. Operating exposure, on the other hand, is long-term in nature and can scarcely be identified with precision.

The important levers for managing operating exposure are briefly described below.

Product Strategy A firm may introduce new products and expand its product line after its home currency depreciates. Conversely, after its home currency appreciates, a firm may reorient its product line so that it caters to market segments which are more quality-conscious and less price-sensitive.

Pricing Strategy When faced with currency volatility, should a firm emphasise market share or profit margin? Economies of scale and price elasticity of demand are the key factors that drive the pricing strategy. If significant economies of scale exist or price elasticity of demand is high, it makes sense to hold prices down, expand demand, and lower unit cost of production. If economies of scale are insignificant or if price elasticity of demand is low, it may be profitable to charge higher prices.

Plant Location A firm may locate its production to countries whose currencies have depreciated in real terms to lessen the adverse impact of exchange rate variation.

Sourcing A firm may source its inputs in countries where it sells its products to achieve a better match between currency footprints of revenues and costs. Multinational giants such as Toyota, Honda, GM, and IBM manage their operating exposure through a better matching of currency footprints.

Product Cycle In a world of volatile exchange rates, a firm can get a competitive edge by reducing the time it takes to bring new products to market. A shorter product cycle compresses the adjustment period following a significant exchange rate change.

Liability Structure Suppose an Indian firm derives a good portion of its revenues from exports to the US. It would do well to hold a portion of its liabilities denominated in the US dollar. This way it can achieve a certain match between its earnings and debt servicing burden.

Protectionism: Major challenge to International Trade & Banking

It is a concept brought into reality as required by various countries with two objectives, one to control the deterioration of domestic trade and two to write a growth story of economy in a different manner.

Some of the major reasons for resorting to protectionism can be summarized as under:

- To protect the Sunrise Industries for obvious reasons, considering the technology adapted by them and enabling them to stand in competition locally and globally.
- To protect the sunset Industries which are in declining trend and need some care.
- To protect strategic industries which are important from country's perspective.
- To protect industries which threatens the job opportunities for local talent.
- Sometimes the protection is resorted to due to political reasons.

Some Important tools of protectionism: Tariffs, Quotas, Subsidy, Free Trade Agreements (This is indirect manner of protecting domestic trade. The free trade agreements reduce the imbalance and can get rid of evil effects of directly protecting the domestic industries).