The Global Capital Market

Introduction

- The rapid globalization of capital markets facilitates the free flow of money around the world
- Traditionally, national capital markets have been separated by regulatory barriers
- Therefore, it was difficult for firms to attract foreign capital
- Many regulatory barriers fell during the 1980s and 1990s, allowing the global capital market to emerge
- Today, firms can list their stock on multiple exchanges, raise funds by issuing equity or debt to investors from around the world, and attract capital from international investors

Benefits Of The Global Capital Market

- There are <u>market functions</u> that are shared by both domestic and international capital markets
- However, global capital markets offer some benefits not found in domestic capital markets

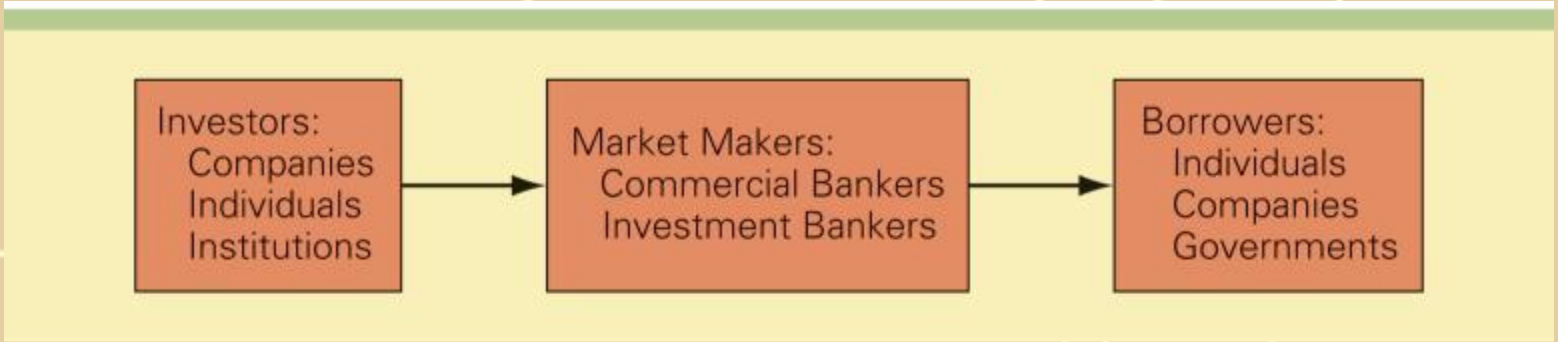
Functions Of A Generic Capital Market

Capital markets bring together investors and borrowers

- Investors include corporations with surplus cash, individuals, and non-bank financial institutions
- Borrowers include individuals, companies, and governments
- Markets makers are the financial service companies that connect investors and borrowers, either directly or indirectly
- Commercial banks are indirect market makers, and investment banks are direct market makers (http://en.wikipedia.org/wiki/Investment_bank)
- Capital market loans can be equity (stock) or debt (cash loans or bonds)

Functions Of A Generic Capital Market

Figure 11.1: The Main Players in a Generic Capital Market



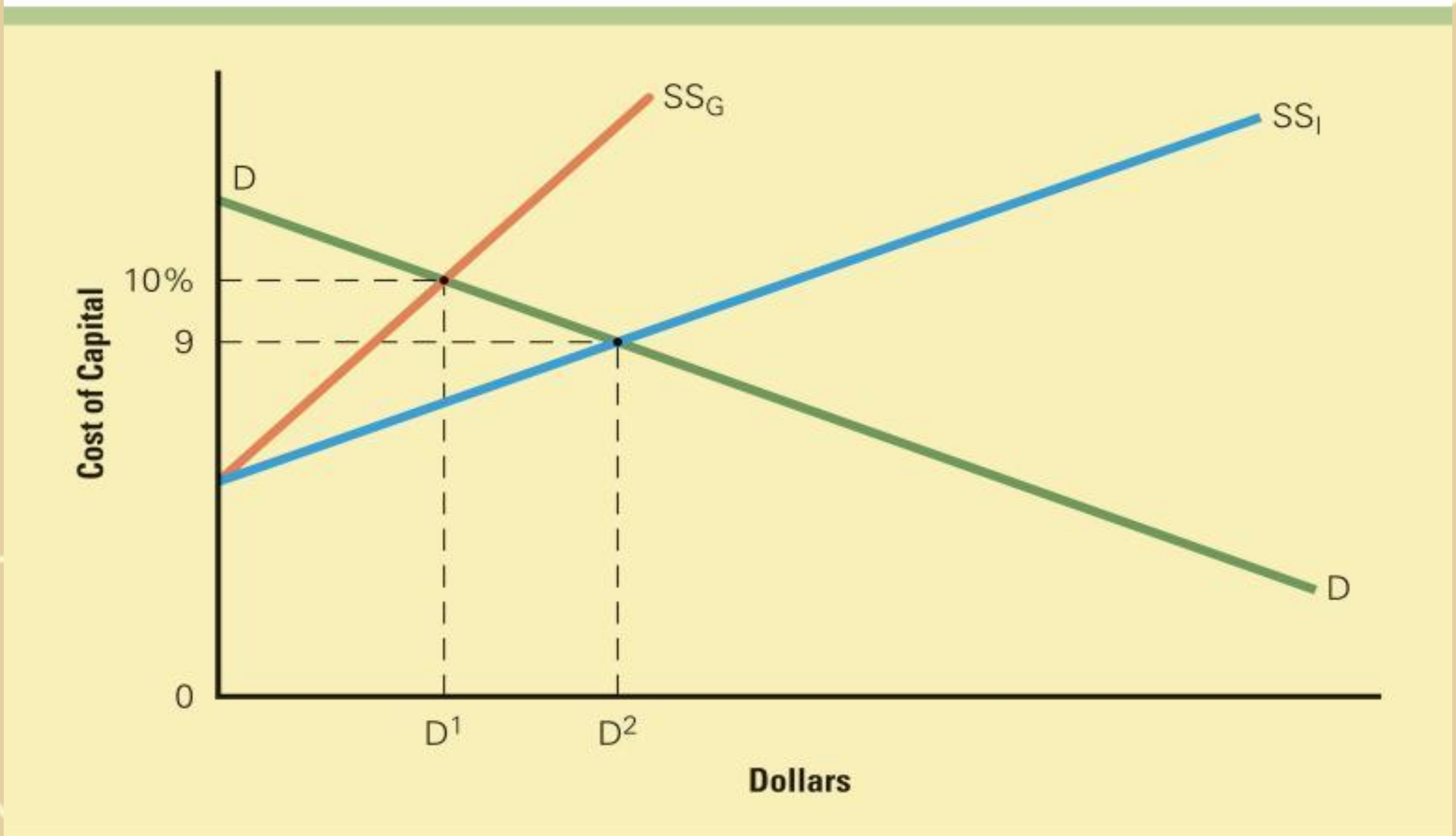
Attractions Of The Global Capital Market

Borrowers benefit from:

- the additional supply of funds global capital markets provide
- the associated lower cost of capital (the price of borrowing money or the rate of return that borrowers pay investors)
- The cost of capital is lower in international markets because the pool of investors is much larger than in the domestic capital market

Attractions Of The Global Capital Market

Figure 11.2: Market Liquidity and the Cost of Capital



SSg supply of money in German market; SSi is supply in global market

So …. more $'s for less costs

Attractions Of Global Capital Market (GCM)

- Investors also benefit from the wider range of investment opportunities in GCMs that allow them to diversify their portfolios and lower their risks
- Studies show that fully diversified portfolios are only about 27 percent as risky as individual stocks
- International portfolio diversification is even less risky because the movements of stock prices across countries are not perfectly correlated
- This low correlation reflects the differences in nations' macroeconomic policies and economic policies and how their stock markets respond to different forces, and nations' restrictions on cross-border capital flows

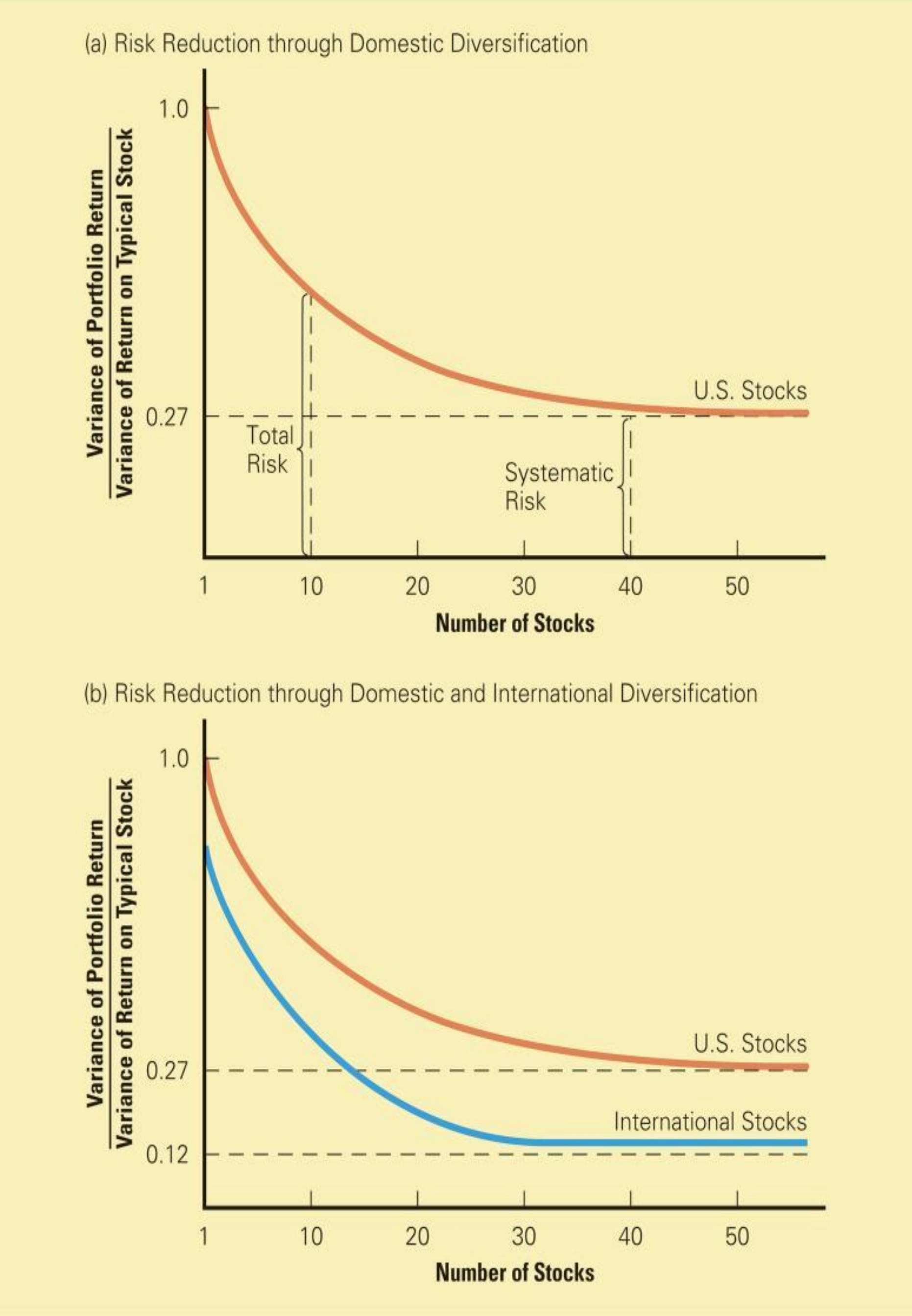


Figure 11.3: Risk Reduction through Portfolio Diversification

In probability theory the expected value (or expectation value,) of a discrete random variable is the sum of the probability of each possible outcome of the experiment multiplied by the outcome value (or payoff).

Growth Of The Global Capital Market

- Global capital markets are growing at a rapid pace
- In 1990, the stock of cross-border bank loans was just $3,600 billion
- By 2006, the stock of cross border bank loans was $17,875 billion
- The international bond market shows a similar pattern with $3,515 billion in outstanding international bonds in 1997, and $17, 561 billion in 2006
- International <u>equity offerings</u> were $18 billion in 1997 and $377 billion in 2006

Growth Of The Global Capital Market

Two factors are responsible for the growth of GCM

1. Advances in information technology
2. Financial services companies now engage in 24-hour-day trading – the international capital market never sleeps
3. However, this also means that shocks that occur in one financial market spread around the globe very quickly

Growth Of The Global Capital Market

4. deregulation by governments

Traditionally, governments have limited the ability of foreign investors to purchase significant equity positions in domestic companies, and the amount of foreign investment citizens could make

- Since the 1980s, these restrictions have been falling in response to the development of the Eurocurrency market, and also pressure from financial services companies

Growth Of The Global Capital Market

- Many countries have also dismantled capital controls making it easier for both inward and outward investment to occur
- This trend has spread from the developed world to the emerging nations
- The global capital market is expected to continue to grow

Global Capital Market Risks

- Some analysts worry that the deregulation of capital markets and loosening of controls on cross-border capital flows make individual nations more vulnerable to the destabilizing effects of <u>speculative capital flows</u> (flash capital)
- Speculative capital flows <u>may be</u> (?) the result of inaccurate information about investment opportunities
- If global capital markets continue to grow, better quality information is likely to be available from financial intermediaries

The Eurocurrency Market

- A eurocurrency is any currency banked outside of its country of origin
- About two-thirds of all eurocurrencies are Eurodollars (dollars banked outside the United States)
- Other important eurocurrencies are the euro-yen, the euro-pound, and the euro-euro

Genesis And Growth Of The Market

- The eurocurrency market began in the 1950s when the Eastern bloc countries were afraid the United States might seize their holdings of dollars
- So, instead of depositing their dollars in the United States, they deposited them in Europe
- Additional dollar deposits came from Western European central banks and companies that exported to the United States
- In 1957, the market surged again after changes in British laws
- Today, London continues to be the leading center of the eurocurrency market

Growth Of The Global Capital Market

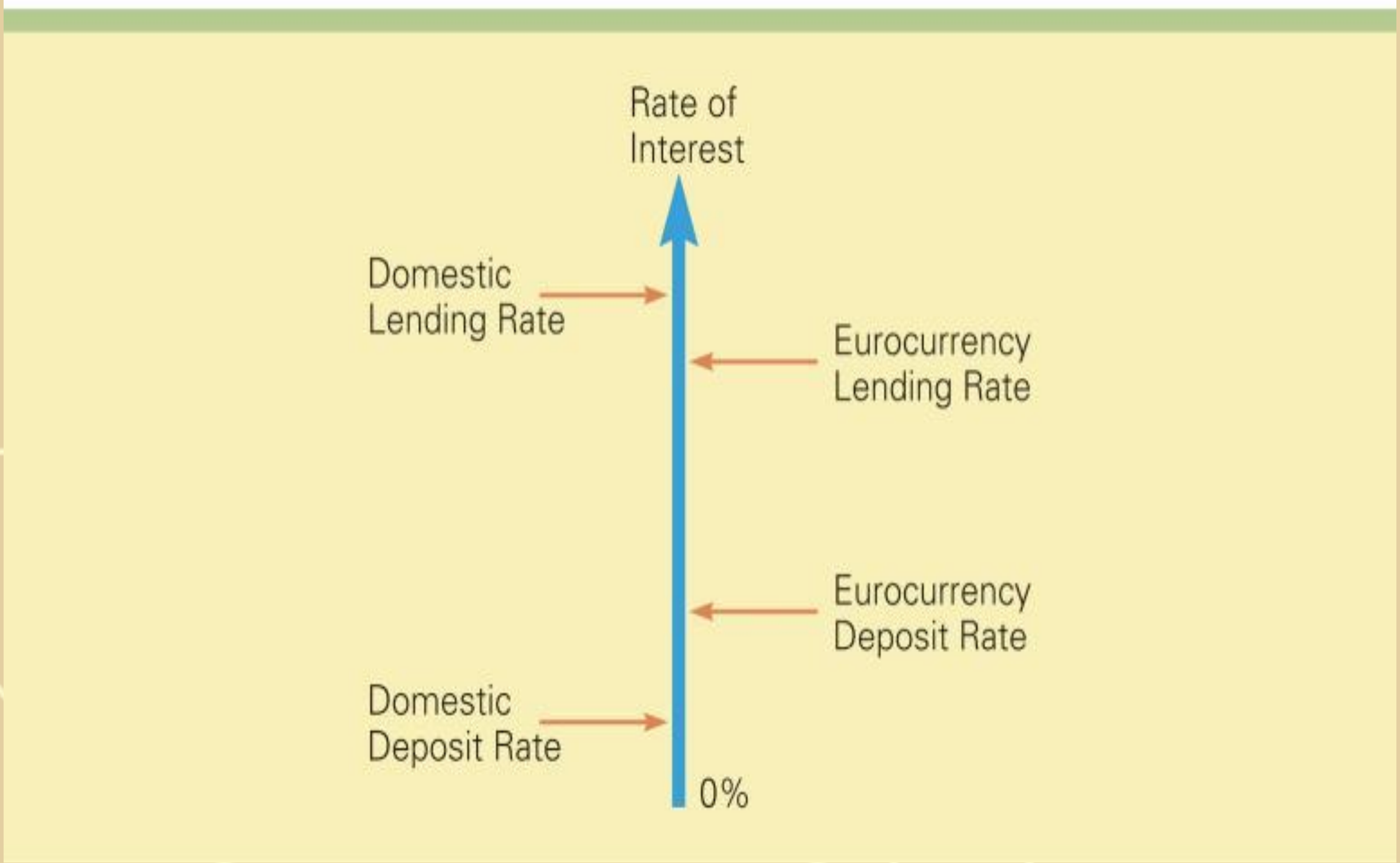
- In the 1960s, the market grew once again when, after changes in U.S. regulations discouraged U.S. banks from lending to non-U.S. residents, would-be borrowers of dollars outside the United States turned to the euromarket as a source of dollars
- The next big increase in the eurocurrency market came after the 1973-74 and 1979-80 oil price increases
- OPEC members avoided potential confiscation of their dollars by depositing them in banks in London

Attractions Of The Eurocurrency Market

- The eurocurrency market is attractive to depositors and borrowers because it is not regulated by the government
- This means that banks can offer higher interest rates on eurocurrency deposits than on deposits made in the home currency
- Similarly, banks can also charge lower interest rates to eurocurrency borrowers than to those who borrow the home currency
- The spread between the eurocurrency deposit and lending rates is less than the spread between the domestic deposit and lending rates giving eurocurrency banks a competitive edge over domestic banks

Attractions Of The Eurocurrency Market

Figure 11.4: Interest Rate Spreads in Domestic and Eurocurrency Markets



Drawbacks Of The Eurocurrency Market

The eurocurrency market has two drawbacks:

1. because the eurocurrency market is unregulated, there is a higher risk of **bank failure**
2. companies borrowing eurocurrencies can be exposed to foreign exchange risk

The Global Bond Market

- The global bond market grew rapidly during the 1980s and 1990s
- The most common kind of bond is a fixed rate bond which gives investors fixed cash payoffs

There are two types of international bonds:

1. foreign bonds are sold outside the borrower's country and are denominated in the currency of the country in which they are issued
2. eurobonds are underwritten by a syndicate of banks and placed in countries other than the one in whose currency the bond is denominated

Attractions Of The Eurobond Market

The eurobond market is attractive for three main reasons:

1. it lacks regulatory interference – since companies do not have to adhere to strict regulations, the cost of issuing bonds is lower
2. it has less stringent disclosure requirements than domestic bond markets – it can be cheaper and less time consuming to offer eurobonds than to issue dollar-denominated bonds
3. it is more favorable from a tax perspective – eurobonds can be sold directly to foreign investors

The Global Equity Market

- The largest equity markets are in the United States, Britain, and Japan
- Today, many investors invest in foreign equities to diversify their portfolios
- In the future, this type of trend may result in an internationalization of corporate ownership
- Companies are also helping to promote this type of shift by listing their stock in the equity markets of other nations
- By issuing stock in other countries, firms open the door to raising capital in the foreign market, and give the firm the option of compensating local managers and employees with stock

Foreign Exchange Risk And The Cost Of Capital

- Adverse exchange rates can increase the cost of foreign currency loans
- While it may initially seem attractive to borrow foreign currencies, when exchange rate risk is factored in, that can change
- Firms can hedge their risk by entering into forward contracts to purchase the necessary currency and lock in the exchange rate, but this will also raise costs
- Firms must weigh the benefits of a lower interest rate against the risk of an increase in the real cost of capital due to adverse exchange rate movements

Implications For Managers

- Growth in global capital markets has created opportunities for firms to borrow or invest internationally
- Firms can often borrow at a lower cost than in the domestic capital market
- Firms must balance the foreign exchange risk associated with borrowing in foreign currencies against the costs savings that may exist
- The growth of capital markets also offers opportunities for firms, institutions, and individuals to diversify their investments and reduce risk
- Again, though investors must consider foreign exchange rate risk