

# The Global Capital Market

## Chapter 21

1. Description of the global capital market
2. Gains from trade and global capital markets
3. International banking

# **1 Description of the global capital market**

## **1.1 Interconnected markets in major financial centers**

## **1.2 Actors**

- Commercial banks
- Large corporations
- Governments

## 1.3 Assets traded

<http://dallasfed.org/research/eclett/2007/el0701.pdf> (Chart 1)

- Debt (bonds) denominated in different currencies
  - nominal returns guaranteed if firm remains solvent
  - can be indexed for inflation to guarantee real returns
  - traded on organized markets
  
- Portfolio equity

- no effective control
- returns depend on profitability of firm
- traded on organized markets

- Foreign direct investment

- requires relationship between parent and affiliate
- parent enterprise injects equity capital by purchasing shares in foreign affiliates
- parent reinvests affiliate's earnings
- short or long-term lending between parents and affiliates

- Bank deposits denominated in different currencies
- commodities (like petroleum, wheat, bauxite, gold)
- forward contracts, futures contracts, swaps, options contracts
- real estate and land
- factories and equipment

## **1.4 Gains from trade and capital markets**

### **1.4.1 Intratemporal trade – trade goods for goods**

- Specialize in production according to comparative advantage
- Trade according to preferences
- Increase utility – gains from trade

## 1.4.2 Intertemporal trade – trade assets for goods (= goods today for goods tomorrow)

- Investment

- Efficient resource allocation – investment occurs where capital has highest marginal product, not where funds are available
- Developing economy – efficient to borrow to finance investment instead of reducing consumption because agents want smooth consumption

- Consumption

- Since business cycles are not perfectly synchronized across countries, optimal for countries in recession to borrow from countries in a boom allowing smooth consumption in both

### 1.4.3 Portfolio diversification –trade assets for assets

- Risk aversion
  - fair gamble – refuse if risk averse
  - portfolio diversification reduces risk
  - "Don't put all of your eggs in one basket."

- Evidence on increasing portfolio diversification

**TABLE 21-1 Gross Foreign Assets and Liabilities of Selected Industrial Countries (percent of GDP)**

		1983	1993	2003
Australia	Assets	13	33	68
	Liabilities	52	89	136
Canada	Assets	34	49	95
	Liabilities	70	90	93
France	Assets	40	69	165
	Liabilities	45	78	172
Germany	Assets	38	66	148
	Liabilities	31	55	139
Italy	Assets	23	43	102
	Liabilities	27	54	111
Netherlands	Assets	94	150	374
	Liabilities	73	134	384
United Kingdom	Assets	152	208	352
	Liabilities	136	203	357
United States	Assets	29	45	70
	Liabilities	25	49	96

**Source:** Philip R. Lane and Gian Maria Milesi-Ferretti, "Financial Globalization and Exchange Rates." Photocopy, Trinity College, Dublin and IMF, June 2004.

## 2 International Banking

### 2.1 Structure of international capital markets

- Commercial banks
  - liabilities are deposits of varying maturities
  - assets are loans, deposits at other banks, bonds
  - multinational banks can underwrite corporate stocks and bonds by agreeing to find buyers at a set price

- Corporations

- Seek financing

- Bank loans

- Bonds denominated in various currencies

- Sell new equity

- Non-bank financial institutions

- Insurance companies, pension funds, mutual funds

- hold foreign assets to diversify portfolios

- Investment banks (not really banks)
  - underwrite sales of stocks and bonds
  - US commercial banks can behave as investment banks abroad
  
- Governments
  - intervene in the foreign exchange market
  - borrow to finance government deficits

## 2.2 Growth of the international capital market

- Removal of capital controls
  - Efficient allocation directed by relative prices
  - Controls breed corruption
- Trilemma
  - free capital mobility
  - independent monetary policy
  - fixed exchange rates

- Post-Bretton Woods
  - lose fixed exchange rates
  - gain capital mobility

## 2.3 Offshore Banking

- Business a bank's foreign offices conduct outside home countries
- Three types of institutions
  - Agency office abroad – arranges loans and transfers funds but does not accept deposits
  - Subsidiary bank located abroad – subject to local regulations, not to regulations of parent bank's country
  - Foreign branch bank – usually subject to local and home country regulations

## 2.4 Offshore Currency

- Bank deposit denominated in a currency different from that of a country in which bank is located
- Called Eurocurrencies although traded in many centers outside of Europe
- Eurobanks accept deposits in non-local currencies

- Growth

- 1957 Britain prohibited British banks from lending pounds to finance non-British trade – banks attracted dollar deposits and lent in dollars
- Cold War between Soviet Union and US – Soviets received dollars from sale of gold and oil and placed them in European banks, fearing they could be confiscated if placed in US
- Regulation Q – ceiling on interest rates US banks could pay on time deposits – as interest rates increased, US banks used dollars attracted to European branch banks (where no regulation Q) to make loans
- OPEC placed its oil dollars in Europe for fear of confiscation if placed in US

- Regulatory asymmetries - reserve requirements apply only to onshore own-currency deposits

- Does unregulated growth in Euro-currency create inflation?
  - Near-money not money because short-term time deposits
  - No evidence that it has contributed to inflation
  - Regulation would be difficult
    - \* Countries with least regulation would attract most business
    - \* All countries would have to agree

# 3 Bank Regulation

## 3.1 Bank Failure

- Assets are long-term (loans)
- liabilities are short-term (deposits)

- Problem:

- if depositors fear bank has bad loans, can demand deposits
- since assets are long-term cannot be sold without capital loss, forcing bankruptcy
- rumors of a bank run can cause a run and failure even if the bank is sound as everyone tries to get their deposits before the bank runs out of short-term assets

## 3.2 Bank Safety Net in US

- Deposit insurance - deposits are insured up to \$100,000 by FDIC, eliminating the incentive to run for small depositors
- Reserve requirements assure that a portion of assets is held in liquid form

- Capital requirements

- Bank capital = bank net worth = assets - liabilities

- Minimum capitalization requirements

- \* serve as a buffer against bankruptcy

- \* assets would be lost in bankruptcy, giving owners incentive to reduce risk

- Banks cannot hold assets considered to be very risky

- Bank examination

- Moral Hazard

- \* banks have an incentive to take on risky behavior knowing that the government will pay depositors in the event of loss
    - \* depositors have no incentive to monitor the bank to prevent this
    - \* monitoring falls to government

- Lender of last resort
  - Fed creates currency and lends to banks facing massive deposit withdrawals
  - if Fed believes the banks are sound
  - must monitor to have information on the bank's soundness

### 3.3 Bank Safety in Other Countries

- Deposit insurance is virtually absent
  - deposit insurance is implicit
  - desire to avoid macroeconomic instability caused by large bank failures
- Absence of reserve requirements in Euro-currency
- Bank examination to enforce rules is inconsistent and at times weak
- No international lender of last resort

## 3.4 Regulatory Cooperation – Basle Committee

- 1975 Concordat
  - Response to 1974 banking crisis
  - allocated supervision responsibility between parent and host
- 1988 capital requirements
  - 8% of risk-weighted assets
  - hard to enforce
  - Japan values equity at purchase price instead of at market value

- 1997 Core Principles for Effective Banking Supervision
  - established minimum requirements for effective bank supervision
  - no clear responsibility for lender of last resort
- Non-bank financial intermediaries are behaving more like banks and do not have the supervision

## 3.5 Importance of Non-Bank Financial Institutions :Long Term Capital Management Crisis

- Banks had loans to Long Term Capital – failure of Long Term Capital could lead to non-performing loans threatening solvency of banks
- Strategy
  - sell short new issues of 30 year Treasury bonds –very liquid
  - use proceeds to buy previously issued 30-year Treasury bonds –slightly cheaper due to less liquidity
  - only slightly cheaper, so tiny spreads mean need large trades to make money

- Problem when Russia defaulted in 1998
  - increase in world demand for safe assets increasing their price
  - Long-Term capital was short in safe assets
  - and long in slightly more risky assets whose price fell
- NY Fed organized a rescue
  - 14 American and European financial institutions provided new capital
  - in exchange for 90% of profits and control