International Business
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Lecture – 38
International Money Market, Euro Credit, Capital Market, Features, Components, ADR & GDR's

Welcome everyone to our course on International Business. So, as you know in the last lecture we were discussing about the financial markets and there we talked on what is a financial market. What are the basically the major components of the financial market. Where we talked about the money market and capital market right and how they are the financial markets are classified on basis of certain you know certain measures. For example, the primary market, secondary market, then exchange traded market and over the counter market right.

So, on basis of certain ways we can classify the market, but to understand largely it is the major two ways are one is the money and the other is the capital market. And then we tried to understand what is this money market, what is its importance right.

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So, we understood that money market is a market where lending and borrowing is generally done on short term funds right. And it comprises the short-term credit instruments and the institutions and individuals who participate in the lending and borrowing business.

So, what it is saying basically? The money market is that for example, where there is a like an immediate requirement or a urgency of funds is required, in that case it is the fund may be required for a very short term duration right. So, when it is required for a short-term duration, one would not go for a long term borrowing rather would go for a short term borrowing right.

So, in this when you say a short-term borrowing, lending or borrowing whatever so in that case we would say that it is a money market right. So, the money market has some instruments these are not all, but there are few more also. But some of the instruments in the money market are for example, the Euro credits, commercial paper, certificate of deposit, treasury bills, etcetera right. And here I am talking largely about those you know all those short term basically, instruments right.

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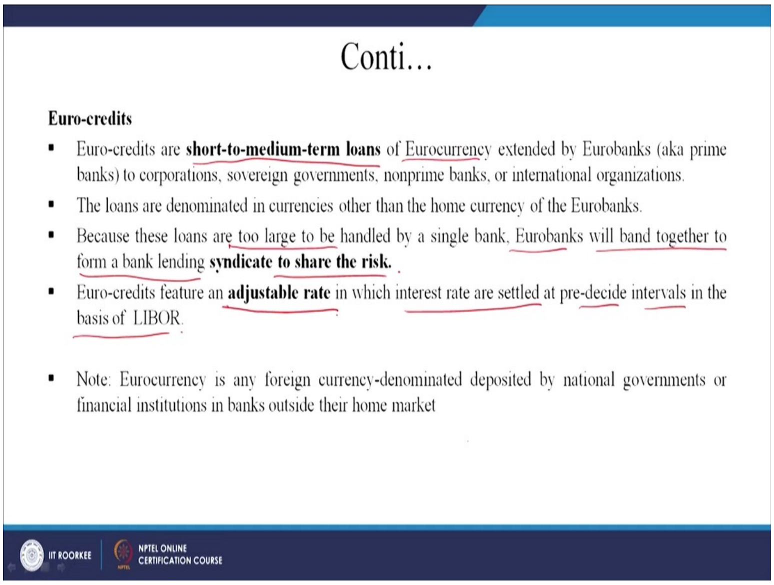

So, what is let us start with the first one; the Euro credits right. So, Euro credits are basically short to medium term loans of Euro currency. Now, what is a Euro currency? If you remember, in the last class we discussed. The Euro currency has got nothing to do with the euro, it is just a prefix right. So, here you can see the definition is there. Euro currency is any foreign currency denominated, deposited by national governments or institutions in banks outside their home market.

So, suppose for example, the US bank the US government would like to deposit some amount of some dollars in UK right, then you would be called Euro you know it is a part of the Euro currency right. So, Euro dollars or Euro yen we say that.

So, Euro is not related with Europe right, it is only a prefix right. So, the loans are denominated in currencies other than the home currency of the European, Euro banks right and these loans are too large to be handled by a single bank, because these loans are too large to be handled by a single bank Euro banks will band together to form a bank lending syndicate to share the risk.

So, Euro credits are basically you know they talk about large values right, they are the loans are of large values and the Euro credits feature an adjustable rate in which interest rate are settled at pre decided intervals in the basis of LIBOR. So, you remember in the last lecture we discussed about LIBOR; the London Interbank Offered Rate, in which we also understood how to calculate the LIBOR right. So, once you calculate the LIBOR, the LIBOR is changes frequently. So, the LIBOR plus the lending margin right, every bank would add to that. So, that is what is finally, the rate, final rate right.

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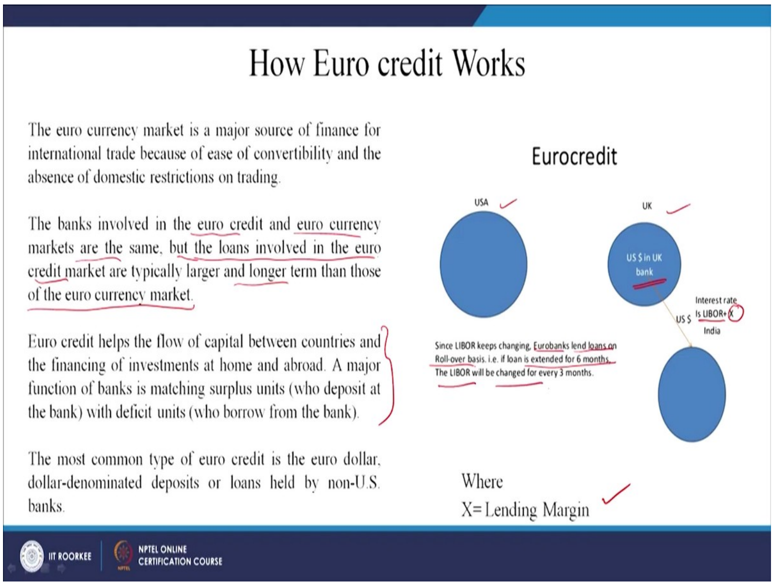

How does the Euro credit work? Let us see. The Euro currency market is a major source of finance for all international trade, because of ease of convertibility and the absence of domestic restrictions on trading.

So, we have understood the government interactions interventions are not there right. The banks involved in the Euro credit and Euro currency markets are the same. What you are saying? The banks involved in the Euro credit and the Euro currency markets are the same, then what is the difference, but the difference is that the loans involved in the Euro credit is typically much larger and long term in nature then those of the Euro currency market right.

So, it is a long term and it is a large valued loan right. Euro credit helps the flow of capital between countries and the financing of investments at home and abroad. A major function of the banks is matching surplus with deficit units.

So, this is you have understood. This is basically the major reason why financial markets have come into play. The most common type of Euro credit is the Euro dollar, dollar denominated deposits or loans held by non US banks right. So, Euro dollar is the dollar deposited by US government in maybe some other country, parked in some other country. So, this is for example, the US right, this is the UK.

So, US dollars are in some UK bank for example, now India for example, wants a loan in US dollars. So, they can get this loan from this either directly here or they can directly get it from here even right, looking at the condition so they can get it from anywhere.

So, suppose they find that this is preferable so, what they would do is the interest rate charged, when the India ah borrower is borrowing the money would be that the LIBOR right which is calculated as we have seen and plus the X which is the margin right. So, X is the lending margin.

So, since LIBOR, but keeps changing, LIBOR is constantly changing; obviously, because we are calculating continuously. Euro banks lend loans on roll over basis; that is if loan is extended for suppose 6 months you have taken a loan and is extended for 6 months, the LIBOR will be, but changed for every 3 months. So, the value changes, because the LIBOR is constantly changing, it is calculated every 3 months so, the value that you have the loan that you have taken the rate would continuously be changing right.

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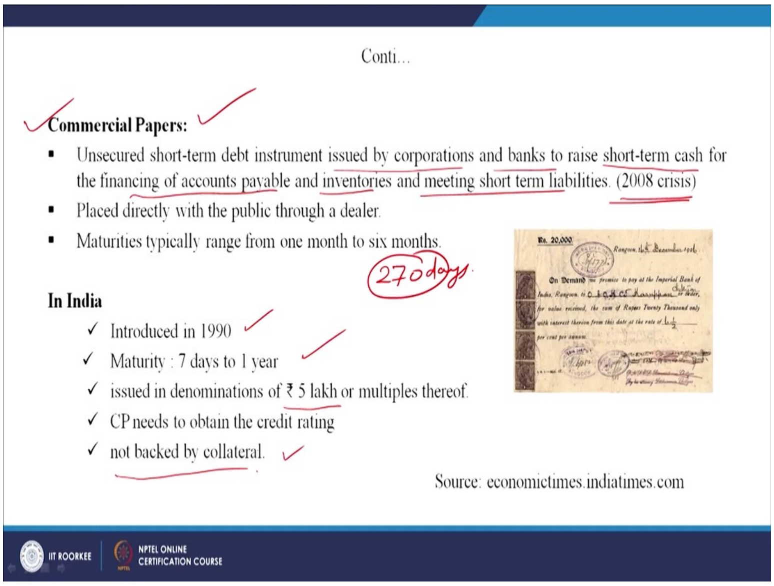

The next instrument in the international money market that is largely used is the money market is the commercial paper. Now, what is this? What is this commercial paper? Now, you can look at this right and you may get an idea also.

So, unsecured it is an unsecured short-term debt instrument, it is an unsecured short term debt instrument issued by corporations and banks to raise short term cash; for financing of the accounts payable and inventories and meeting short term liabilities. They say that in the 2008, 7 to 8 crisis when the subprime crisis happened, the one of the major reasons for the crisis was this commercial paper which frozen got frozen down at that time, because of people got scared and they were worried the about the financial market, the about the movement of the market.

So, this was one of the major causes for the 2008 crisis and Lehman brothers downfall right. It is placed directly with the public through a dealer and matures typically range, the maturity typically ranges between one to six months, it maximum goes up to 270 days ok.

In India it was introduced in 1990 as it is the maturity period and it is issued in the domination of 5 lakh or multiples right. Commercial paper needs to obtain the credit rating, it has to be it has to obtain the credit rating right and it is not backed by collateral. So, this is the danger which since, it is not backed by collateral. So, this was also a very prominent reason why it was instrumental in that 2008 crisis, financial crisis ok.

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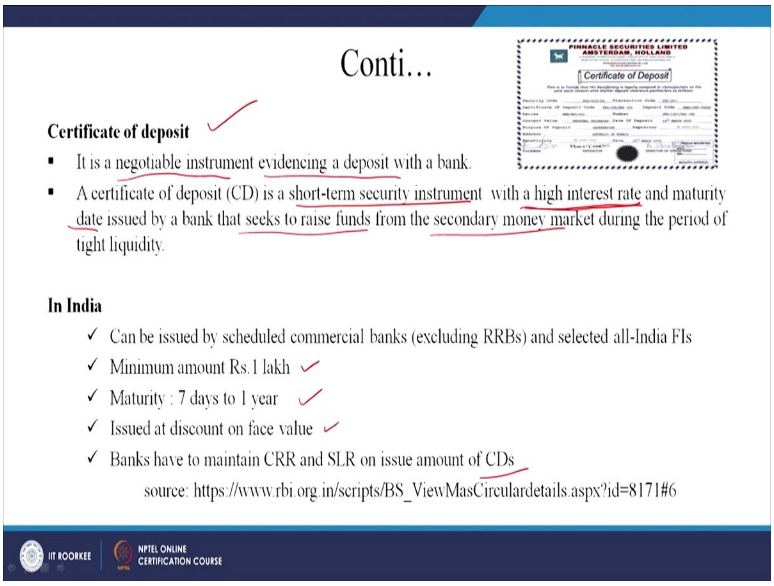

The next is the certificate of deposit now, what is the certificate of deposit? It is a negotiable instrument right, evidencing a deposit with the bank. So, you can see this right it is a short term security instrument with a high interest rate and maturity date issued by a bank that seeks to raise funds from the secondary market during; the period of tight liquidity, when liquidity is not when the market is not highly liquid and there is not enough funds available.

So at that time a certificate of deposit is issued which is with a high interest rate right, because money is not available so; obviously, the lender would charge a higher interest rate right. It can be issued by scheduled commercial banks right and selected All India Financial Institutions.

Minimum amount is 100000 maturity period, issued at a discount on the face value and banks have to maintain CRR right and SLR on issue amount of CD’s the corporate, the certificate of deposits right.

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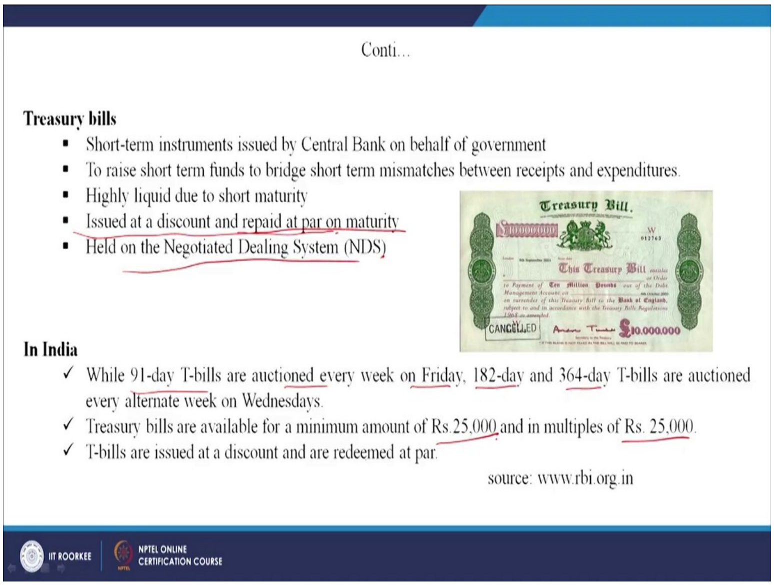

Then the next is the treasury bill right. The treasury bill is just again a short term instrument, issued by the central bank on behalf of the government right. It is used to raise short term funds to bridge short term mismatches between receipts and expenditure right. So, if there is a mismatch, you can raise short term funds ok.

Highly liquid due to short maturity, it is very highly liquid, issued at a discount and repaid at par on maturity. Treasury bills are often, this is very important part of the treasury bill it is issued at a discount right and would be paid repaid at par during the maturity right, held on the negotiated dealing system.

It is in India 91 day T-bills or treasury bills are auctioned, every week on Friday. 182 day and 364 day treasury bills are auctioned every alternate week on Wednesday's. Treasury bills are available for a minimum amount of rupees 25000 and in multiples of it. It is also issued at a discount and redeemed at par right. Now, this is all what we discussed was about the money market right.

So, the money market we understood that it has a lot of importance, because it takes care of the short term requirements of any borrower right or any let us say industrialists or in any industry for that. So, they want money at a short term notice or even the government or anybody. And this is; obviously, at a higher generally, the interest rates are high right and ah, but it supports and helps in the regular day to day expenses right.

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Then the other part of the financial market, as we said financial market is largely on two basis can be divided into two parts the money market and the capital market. So, money market we have understood. So, all the commercial paper, certificate of deposit, bank acceptance, deposits, treasury bills, all these short term once which are within 1 to within 1 year are part of the money market. Now, we will go to the long ones or the higher valued long term you know long duration once instruments right.

A capital market often refers to the market for long term funds right. So, that was a short-term fund, it is a long term fund. It deals with long term securities which have a maturity period of above 1 year or and goes up to 10 years. To do this the company raises money through the sale of securities, stocks, and bonds in the company's name which are bought and sold in the capital market. So, capital market again you must, the capital market also has a primary market and secondary market right.

The international capital market is a network of individuals, companies, financial institutions and government that invest and borrow across the national boundaries. Large banks international banks gather excess cash of investors and savers around the world and then channel it to global borrowers across the world. So, in forms of debt, it can be in forms of debt so, bond and mortgages or equity through the stock market at two major components of the capital market right. So, features of an international capital market.

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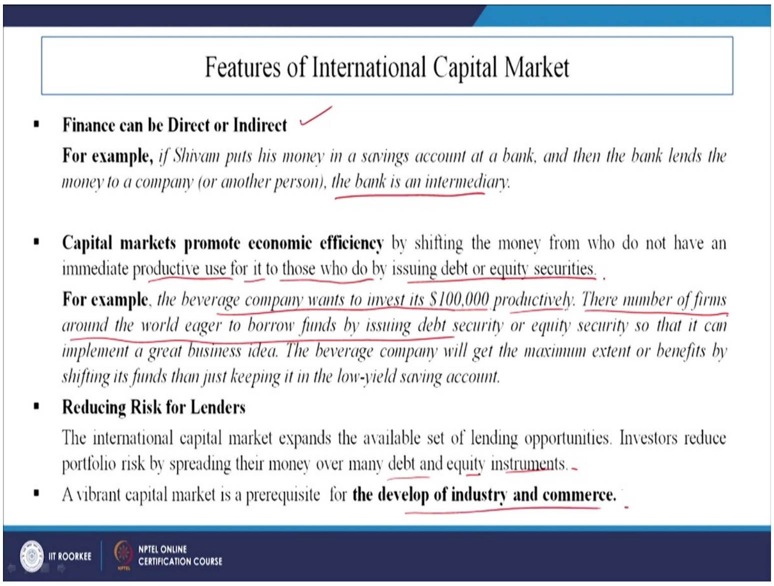

So, the finance can be direct or indirect right. For example, let us say if Shivam puts his money in a savings account at a bank, and then the bank lends the money to a company, the bank is an intermediary. This we have also learnt in the last lecture also. Capital markets promote economic efficiency by shifting the money from who do not have an immediate productive use.

So, you had some money and you had no immediate use. So, you can give it to somebody and you know where he can or she can use it or the company can use it by issuing productive use for it to those who do by issuing debt or equity securities. Let us see this example; the beverage company wants to invest its 100,000 dollar productively, a beverage company has got off lot has lot of cash reserves so it wants to use it. There number of firms around the world are eager to borrow funds by issuing debt security or equity security.

So, it can implement a great business idea. So, some companies want to use this money. The beverage company will get the maximum extent or benefits by shifting its from funds then just keeping it in the low yielding saving account. Similarly, as you can think of for example, your own account you can suppose you have money you can either keep it in a saving account or a fixed deposit for example, the fixed deposit is giving you a larger interest, but the point is the liquidity is little rigid right.

The saving account is more liquid, because you can anytime liquidate and you can get the money, but the fixed deposit if you break it, then you will not get the required amount. Reducing risk for lenders; the international capital market expands the available set of lending opportunities. Investors reduce portfolio risk by spreading their money over many debt and equity instruments. What it is saying? It is spreading the risk or dividing the risk by you know spreading the money over large number of debt and equity instruments.

So, the what are the debt instruments and what are the equity instruments we can talk about it right. A vibrant capital market is a prerequisite for the development of industry and commerce for example, I can take some equities in the stock market for example, right another component of the international capital market is the international bond market.

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What is a bond? I you all must have heard about bonds right. Bonds are basically as it says the most common form of debt instrument right, which is basically a loan from the holder to the issuer of the bond. So, it is a loan from the holder to the issuer of the bond.

It consists of all bonds sold by issuing companies governments and other organizations outside their own countries so; that means, if you buy a bond at a 10 percent, let us say rate so at the, after certain period of time the owner would the holder of the bond would get a desired sum of money right. Instruments must pay a fixed value or rate regardless, the economic circumstances right. Types of international bonds are foreign bonds, Euro bonds ok.

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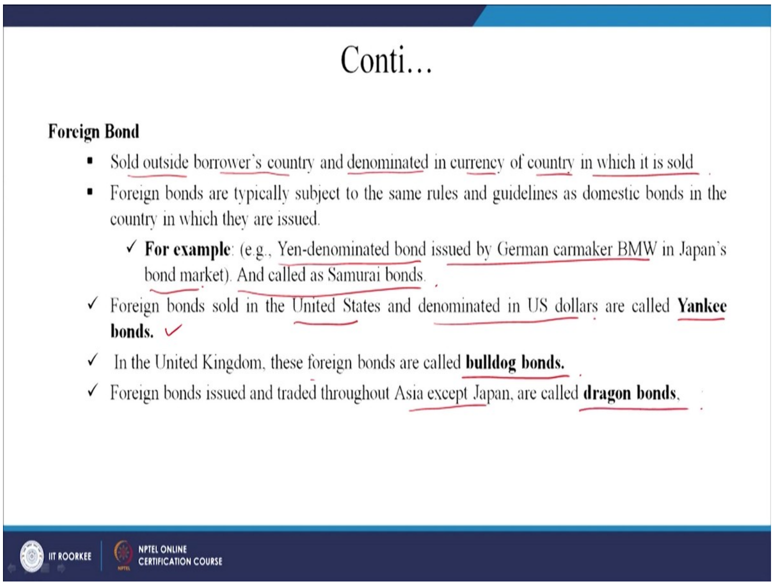

Now, what is a foreign bond? A bond which is sold outside the borrowers country; that means, let us say the it is sold outside a borrower some other country and denominated in currency of country in which it is sold; that means, in dollars or Euro or pound, sterling. Foreign bonds are typically subject to the same rules and guidelines as domestic bonds in the country in which they are issued for example, if it is issued in India it will be, it will be following all the rules and regulations of India right.

For example, a Yen-denominated bond issued by a German car maker BMW in Japan's bond market and called as Samurai bonds right, a Yen-denominated bond issued by German car maker BMW in Japans bond market right. Foreign bonds sold in the United States and denominated in US dollars are called Yankee bonds right.

What do you saying foreign bonds sold in the United States and denominated in US dollars are called Yankee bonds. In the United Kingdom this bonds are called bulldog bonds bulldog right. Foreign bonds issued and traded throughout Asia except Japan are called dragon bonds. So, there are different names given right.

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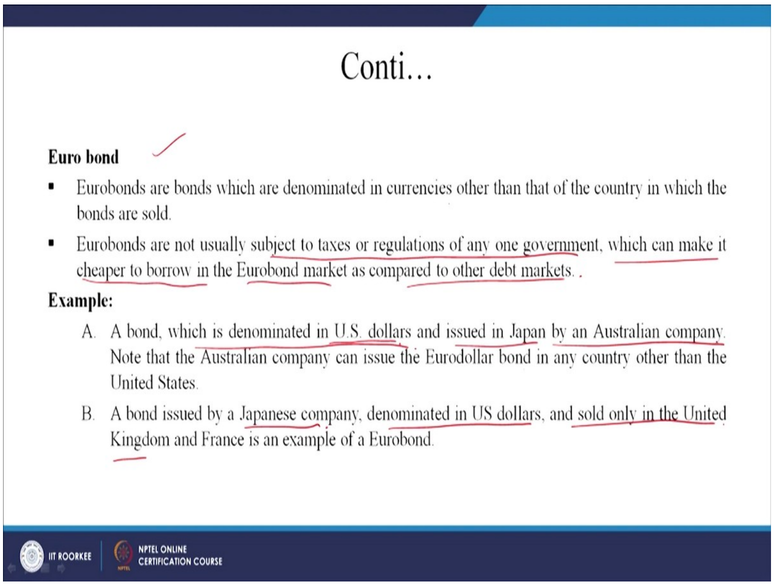

The next is after the foreign bond, there is the Eurobond. Eurobonds are bonds which are denominated in currencies other than that of the country in which the bonds are sold again like the first one only. The Eurobonds are not usually subject to taxes or regulations of any one government which can make it cheaper to borrow it in the Eurobond market as compared to other debt markets, example let us see the example.

A bond, which is denominated in US dollars and issued in Japan by an Australian company. So, there are three countries right; one is US dollars three things US dollars issued where in Japan, by whom? An Australian company. Note that the Australian company can issue the Eurodollar bond in any country other than the United States right. This is what it says.

A bond issued by a Japanese company, denominated in us dollars and sold only in the United Kingdom and France is also an example of a Eurobond right. Let us read again, a bond issued by a Japanese company, denominated in the US dollars right, here it was issued by a Australian company and sold only in the United Kingdom, Britain or France is an example of a Eurobond.

So, what it is saying? Eurobonds are denominated in currencies other than that of the country in which the bonds are sold right.

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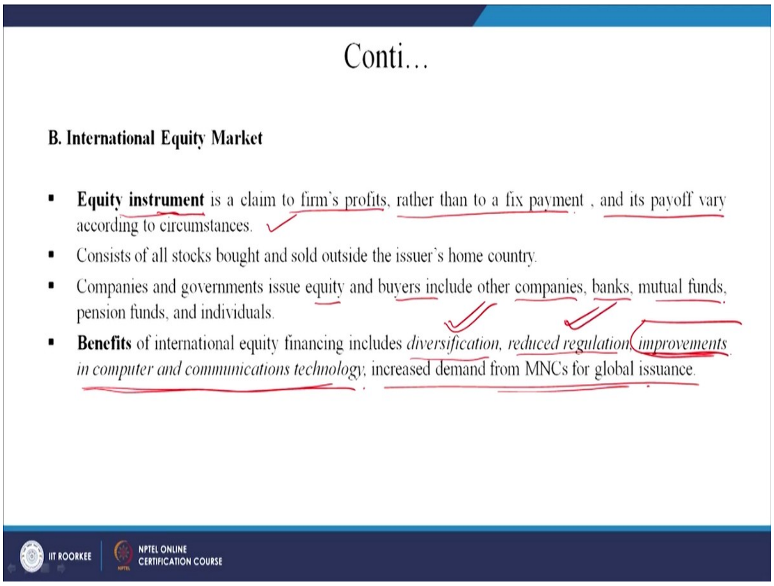

International equity market; so, equity market when we talk about so, is it is a equity what is an equity instrument? It is an instrument to claim to the firms profits, but it is not only profits, it is it can be the losses also. Suppose, you are since, equity as a equity holder you are a part of the company, part owner of the company right.

So, if there is a profit you own the profit if there is a loss you take the loss rather than to a fixed payment and its pay off vary according to the circumstances ok. It consists of all stocks bought and sold outside the issuers home country, let us see. Companies and governments issue equity and buyers include other companies banks, mutual funds, pension funds and individuals. What it is saying?

Companies and governments issue equity and buyers include banks for example, when the government issues equity or companies for example, Reliance or Tata or let us say any company Infosys is has its own equity in the stock market.

So, who are the major buyers? Retail investors like you and me, companies, other banks, mutual fund agencies, etcetera. The benefits of this international equity financing includes diversification, reduced regulation, improvements in computer and communication technology right, increased demand from MNCs for global issuance.

So, what are the benefits it says? Basically, the benefits is it has helped in diversification and reduced regulation and how it has improved, because there has been a significant improve not it this is not an advantage right this is this is happened, because there has been a significant improvement in computer and communication technology nowadays. So, one can take easily the advantage right of these international equity financing right and there has been increased demand for from MNCs on this. Here, when we talk about the equity market there is one term which is very important which is called the cross listing of shares.

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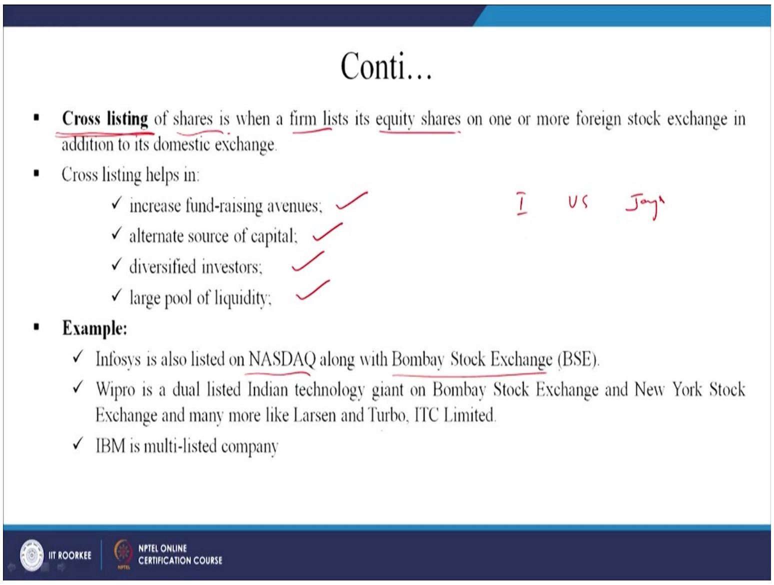

What is this cross listing? Cross listing of shares is when a firm lists it equity shares on one or more foreign stock exchange; that means, suppose Infosys stock is listed in India and US and let us say Japan right so, or India and US. So, cross listing helps in increasing fund avenues, alternate source of capital, diversified investors, large pool of liquidity. So, this as we understood here so, benefits of international it is diversification and reduced regulation. So, the regulations it is all standardized, normalized basically right ok.

This is the example Infosys is also listed on NASDAQ along with the Bombay Stock Exchange right and also NYSE and other places. Wipro is a dual listed India technology giant on BSE and New York Stock Exchange and in many more like L&T, ITC, etcetera.

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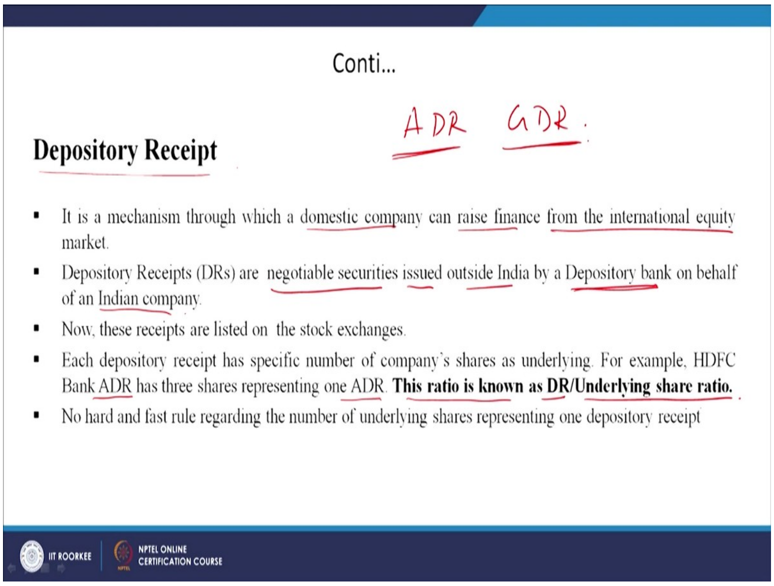

So, the next instrument in the you know we will talk about is the depository receipt. Now, depository receipt is a mechanism right through which a domestic company can raise finance from the international equity market. You must have heard of ADRs and GDRs right. So, these are very popular terms; the American depository receipt and global depository receipt. We will see what are they. First let us understand the depository receipts.

Depository receipts are negotiable securities, issued outside India by a depository bank on behalf of an India company right. So, there are two parties let us say so, that is a depository bank and an India company for example, who this bank would help in issuing the stock in some other market.

Now, these receipts are listed on the stock exchanges. Each depository receipt has specific number of company shares as underlying. For example, HDFC bank ADR, ADR stands for American Depository Receipt, has three shares representing one ADR. This ratio is known as depository receipts or underlying share ratio. No hard and fast rule regarding the number of underlying shares representing one depository receipt. There is no hard and fast rule.

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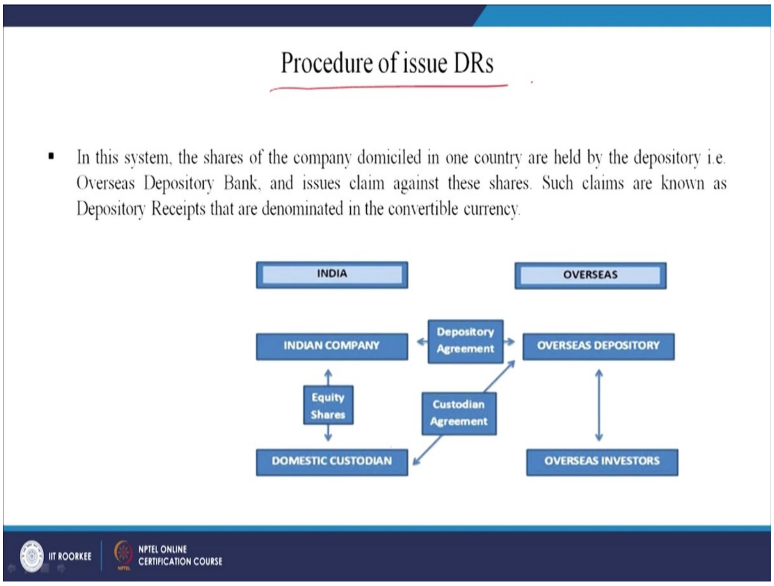

Let us see how; what is the procedure of issue of this DRs or depository receipts. In this system the shares of the company domiciled in one country that is example Infosys or something are held by the depository, that is the Overseas Depository Bank. So, the another bank Overseas is holding the stocks and issues claim against this shares. Such claims are known as Depository Receipts and are denominated in the convertible currency.

Now, take this India and there is an overseas market right, some country. Let us say US or something there is an India company and there is an overseas depository there is a depository agreement. So, what is this there is a domestic custodian of the equity shares right of this India company and there is an Overseas Depository and overseas investors right. So, what is happening? This is a custodian agreement between these Overseas Depository and this domestic custodian right.

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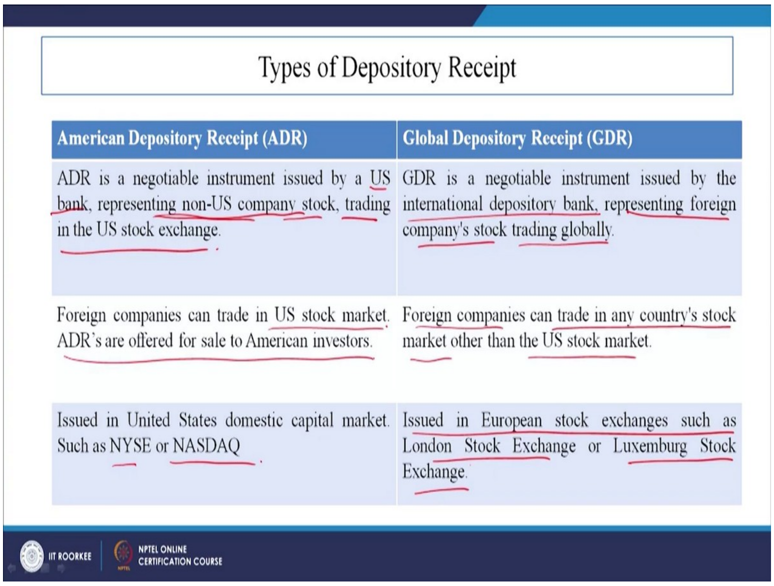

So, let us look at this two; American depository receipt and global depository receipt. What is the difference between the two? ADR is a negotiable instrument issued by a US bank, GDR is a negotiable instrument issued by the international depository bank. Here, is a US bank, representing non-US company stock right, representing foreign company stock trading globally.

So, this is non this is hard about the US and trading this is a non US company stock, trading in the US stock exchange, in case of American depository receipt and in this case what is happening? It is a global depository receipt, it is a negotiable instrument issued by the international depository bank, representing foreign company stock trading globally.

So, this is purely about the American stock market in the US stock exchange and we here we are talking about the global international depository bank right. So, foreign companies can trade in the US stock market, ADRs are offered for sale to American investors. So, suppose the foreign companies like Infosys, Reliance, HDFC suppose, they want to trade in the US stock market to get better value let us say to you know.

So, the ADRs are offered for sale to the American investors who can buy this India stocks. So, you do not need to buy the you know suppose, you I want to buy suppose some or you want to buy some stock let us say like apple in of in US right. So, we can do that right.

So, we do not need exactly to go through a very tedious mechanism foreign companies can trade, in case of GDR foreign companies can trade in any country's stock market other than the US stock market. What it is saying? Foreign companies can trade in any country's stock market other than the US stock market right. This is issued in the United States domestic capital market.

Such as NYSE New York Stock Exchange or the NASDAQ. This is issued in the European stock exchange such as London Stock Exchange or Luxemburg Stock Exchange right. So, this is the basic types of depository receipts and this is the basic difference between the ADR and the GDR right. Then there is a CDR.

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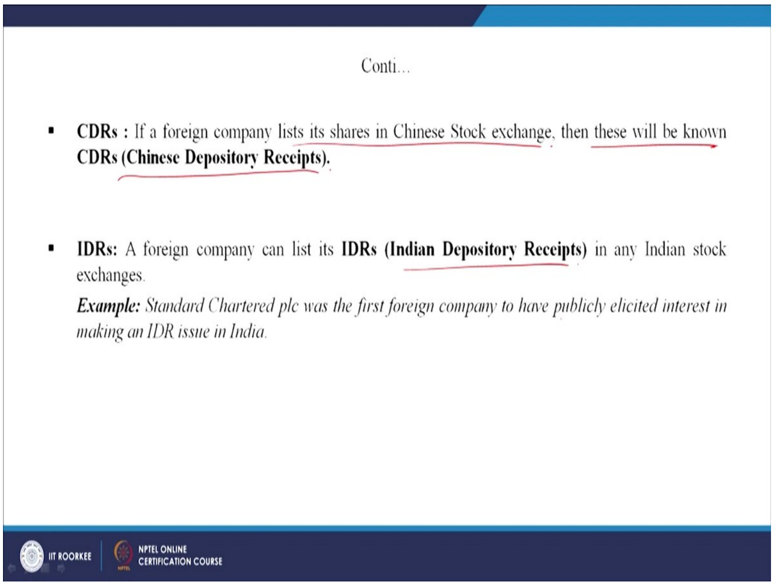

If a foreign company lists its shares in the Chinese Stock exchange, then this will be known as Chinese depository receipts right, IDRs India depository receipts right. For example, Standard Chartered was the first foreign company to have publicly elicited or shown interest in making an IDR issue in India. It was the first time; Standard Chartered was the first company.

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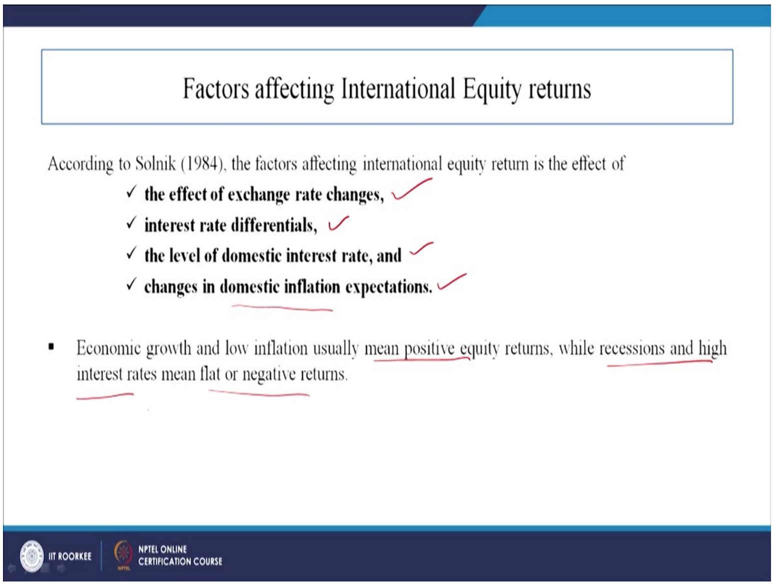

What are the factors that affect the international equity returns right? So, equity is highly volatile, we all know that. So, according to Solnik, the factors affecting international equity return is the effect of the exchange rate changes, the interest rate differentials, the level of domestic interest rate, and changes in domestic inflation expectations. So, what is it happening? So, the four factors that affect the international equity returns are the exchange rate change.

So, there is a change in the exchange rate one, there is a difference in the interest rate in between different countries, let us say India the interest rate is different, US it is different, U K it is different, so that effects. The level of wherever the you know we are more, because of the difference in interest rate the investors would like to find out the best locality or the best location where they could park their funds ok.

The level of domestic interest rate, the current the home country and domestic inflation, what is going to be the inflation? So, we have also learned that when inflation is going to increase so fund the investors would like to take away the fund from the home market to some other market right.

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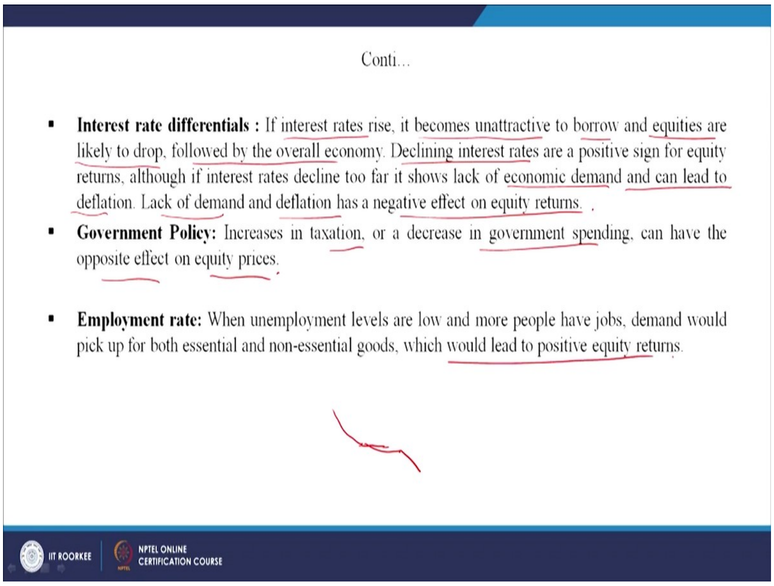

Economic growth and low inflation usually mean positive equity returns, while recession and high interest rates mean flat or negative right. The high interest rates or high inflation for that also mean flat negative returns. How does interest rate differentials help? If interest rates rise, it becomes unattractive to borrow and equities are likely to drop right. People cannot borrow money followed by the overall economy. Declining interest rates are a positive sign for equity returns right.

Although, if interest rates decline, because you see, if interest rates are declining people would tend to go for the equity market right, but if the interest rates are high, if I am getting more interest, why will I go for the equity market right. So, although if interest rates decline too far, it shows lack of economic demand so, this is a connection right.

So, there has to be some steadiness, some equilibrium among them and can lead to deflation. Lack of demand and deflation again has a negative effect on equity returns. So, it is not necessary that interest rate should go down and the stock equity market will go up. Because there is up to a certain level, it may you know it will when the interest rates are declining, maybe the equity market will go up, but after a certain level when it grows to a very low level let us say, then from here the equity market also does not gain, because the economy is itself not doing well.

So, it will fall further maybe right. Again, government policy for example, taxation decrease in government spending can also have the opposite effect on equity prices right.

So, basically the equity is nothing, but a feeling or it is a pulse of the people about the economy at large. Suppose, the Indian citizens feel good about India and so, the investors are also feeling good about India, then India it is a very lucrative market. Automatically, it will have a good effect on the India equity market right.

Employment rate; when employment levels are low and more people have jobs, demand would pick up for both essential and non essential goods, which will again lead to a positive equity returns. So, this is all we had. So, today we talked about the money market, a bit of the capital market.

So, money market we did a bit and then the capital market we discussed. And we discussed what are the different you know instruments in the capital market and how the equity international equity market gets effected by certain factors like interest rate, employment and you know for example, the inflation in a country and all. So, looking at all these things what is the how do they issue or what is an ADR we learnt about what is the difference between ADRs American Depository Receipts and GDRs right.

So, Global Depository Receipts and what is basically a depository receipt; we also explained that. So, I think you got at least somewhat idea about what we discussed. As you go further and try to read it, read this, you know slides, you will get fair amount of idea and in case you have questions, because obviously, it is a little slightly complicated. So, if you have questions and whenever you want to you can write to me or you know during some interaction we can discuss.

Thank you very much.