

International Capital Markets & Their Importance

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This section will attempt to give you a basic understanding of the international capital markets. After reading this section, you will be better prepared to study other sections of the E-Book, especially those relating to the Mexican and Asian financial crises.

The first half of this section will define capital markets and describe how they are structured. The second half will discuss the internationalization and globalization of the capital markets during the late 1990s. We conclude by emphasizing the increasingly important role that private capital played in market development during the late 1990s.

A. What are Capital Markets?

Capital markets are markets where people, companies, and governments with more funds than they need (because they save some of their income) transfer those funds to people, companies, or governments who have a shortage of funds (because they spend more than their income). Stock and bond markets are two major capital markets. Capital markets promote economic efficiency by channeling money from those who do not have an immediate productive use for it to those who do.

1. Capital Markets Efficiently Direct Capital to Productive Uses.

Capital markets carry out the desirable economic function of directing capital to productive uses. The savers (governments, businesses, and people who save some portion of their income) invest their money in capital markets like stocks and bonds. The borrowers (governments, businesses, and people who spend more than their income) borrow the savers' investments that have been entrusted to the capital markets.

When savers make investments, they convert cash or savings (risk-free assets) into risky assets with the hopes of receiving enhanced benefits in the future. Since all investments are risky, the only reason a saver would put cash at risk is if returns on the investment are greater than returns on holding risk-free assets. Buying stocks and bonds and investing in real estate are common examples. The savers hope that the stock, bond, or real estate will "appreciate," or grow in value.

For example, suppose Carlos and Anna make \$50,000 in one year, but they only spend \$40,000 that year. They can invest the \$10,000—their savings—in a mutual fund

(pools of money managed by an investment company) investing in stocks and bonds all over the world. Carlos and Anna know that making such an investment is riskier than keeping the \$10,000 at home or in a savings account. But they hope that over the long-term the investment will yield greater returns than cash holdings or interest on a savings account. The borrowers in this example are the companies that issued the stocks or bonds that are part of the mutual fund portfolio. Because the companies have spending needs that exceed their income, they finance their spending needs by issuing securities in the capital markets.

2. Finance can be Direct or Indirect.

The example we just used illustrates a form of "direct" finance. In other words, the companies borrowed directly by issuing securities to investors in the capital markets. By contrast, indirect finance involves a financial intermediary between the borrower and the saver. For example, if Carlos and Anna put their money in a savings account at a bank, and then the bank lends the money to a company (or another person), the bank is an intermediary. Financial intermediaries are very important in the capital marketplace. Banks lend money to many people, and in so doing create economies of scale. That is, by lending out funds many times each day, costs per transaction decrease.

3. Capital Markets are Important because they Promote Efficiency and Productive Investments.

Capital markets promote economic efficiency. In our example, Carlos and Anna want to invest their \$10,000 productively. Any number of companies might have great business ideas but no funds to carry them out. By shifting the funds from Carlos and Anna to the companies through the capital markets, the funds are employed to their maximum extent. If there were no capital markets, Carlos and Anna might have kept their \$10,000 in cash or in a low-yielding savings account. The companies might have put off or canceled their business plans.

B. The Structure of Capital Markets

1. Many Types of Securities are Sold in Primary and Secondary Capital Markets.

The primary market is where new securities (stocks and bonds are the most common) are issued. The corporation or government agency that needs funds (the borrower) issues securities to purchasers in the primary market. Big investment banks assist in this issuing process. The banks underwrite the securities. That is, they guarantee a

minimum price for a business's securities and sell them to the public. Since the primary market is limited to issuing new securities only, it is of lesser importance than the secondary market.

The vast majority of capital transactions, like the transaction in our example, take place in the secondary market. The secondary market includes stock exchanges (like the New York Stock Exchange and the Tokyo Nikkei), bond markets, and futures and options markets, among others. All of these secondary markets deal in the trade of securities.

The term "securities" encompasses a broad range of investment instruments. You're probably most familiar with stocks and bonds. Investors have essentially two broad categories of securities available to them: equity securities (which represent ownership of a part of a company) and debt securities (which represent a loan from the investor to a company or government entity).

Savers who purchase debt instruments are creditors. Creditors, or debt holders, receive future income or assets in return for their investment. The most common example of a debt instrument is a bond. When investors buy bonds, they are lending the issuers of the bonds their money. In return, they will receive interest payments (usually at a fixed rate) for the life of the bond and receive the principal when the bond expires. National governments, local governments, water districts, global, national, and local companies, and many other types of institutions sell bonds.

Stock is the type of equity security with which most people are familiar. When investors (savers) buy stock, they become owners of a "share" of a company's assets and earnings. If a company is successful, the price that investors are willing to pay for its stock will often rise and shareholders who bought stock at a lower price then stand to make a profit. If a company does not do well, however, its stock may decrease in value and shareholders can lose money. Stock prices are also subject to both general economic and industry-specific market factors. In our example, if Carlos and Anna put their money in stocks, they are buying equity in the company that issued the stock. Conversely, the company can issue stock to obtain extra funds. It must then share its cash flows with the stock purchasers, known as stockholders.

C. Internationalization of Capital Markets in the Late 1990s

One of the most important developments since the 1970s has been the

internationalization, and now globalization, of capital markets. Let's look at some of the basic elements of the international capital markets.

1. The International Capital Market of the Late 1990s was Composed of a Number of Closely Integrated Markets with an International Dimension.

Basically, the international capital market includes any transaction with an international dimension. It is not really a single market but a number of closely integrated markets that include some type of international component. The foreign exchange market was a very important part of the international capital market during the late 1990s. Internationally traded stocks and bonds have also been part of the international capital market. Since the late 1990s, sophisticated communications systems have allowed people all over the world to conduct business from wherever they are. The major world financial centers include Hong Kong, Singapore, Tokyo, London, New York, and Paris, among others.

It's not hard to find examples of securities that trade in the international capital markets. Foreign bonds are a typical example of an international security. A bond sold by a Korean company in Mexico denominated in Mexican pesos is a foreign bond. Eurobonds are another example. A Eurobond is a bond denominated in a currency other than that of the country in which it is sold. A bond denominated in Japanese yen that is sold in France is an example. In the late 1990s, the Eurobond became the primary bond of choice in the international marketplace. In 1995, over 80% of new issues in the international bond market were Eurobonds. The primary reason for their popularity was that because they could be repaid in any of several predetermined currencies, the issuing company could choose the currency it preferred.

Maybe you have heard of American Depository Receipts (ADRs) or Global Depository Receipts (GDRs). In the late 1990s, these were used extensively in the privatization of public enterprises in developing and transitioning (i.e. socialism to capitalism) countries. ADRs and GDRs are certificates issued by a depository bank, representing shares of stock of a foreign corporation held by the bank.

Of course, the foreign exchange market, where international currencies are traded, was a tremendously large and important part of the international capital market in the late 1990s. During this time, it was enormous, with market turn-over well above \$1 trillion daily. The average daily turnover in traditional foreign exchange markets rose to \$1.9 trillion in April 2004. Commercial banks use the foreign exchange market to meet the needs of their

corporate customers, multinational corporations use the market to hedge against risks, and central banks enter into the market to manage the value of currencies. In another part of this E-Book, you will learn how the foreign exchange market affected developments in the Asian financial crisis.

2. The Need to Reduce Risk Through Portfolio Diversification Explains in Part the Importance of the International Capital Market During the Late 1990s.

A major benefit of the internationalization of capital markets is the diversification of risk. Individual investors, major corporations, and individual countries all usually try to diversify the risks of their financial portfolios. The reason is that people are generally risk-averse. They would rather get returns on investments that are in a relatively narrow band than investments that have wild fluctuations year-to-year. All portfolio investors look at the risk of their portfolios versus their returns. Higher risk investments generally have the potential to yield higher returns, but there is much more variability.

For example, a short-term U.S. government bond is low risk and has a correspondingly low return (currently under 5%). If you buy a short-term bond, you will make fewer than 5%, but no more than that. Buying stock in a start-up company, however, is higher risk. You could potentially get 100% or more returns, or you could lose all the money you invested. Portfolio diversification looks at the risk versus the return available to get the highest return possible at the lowest possible risk.

When an investor or a company invests in many different assets (stocks, bonds, mutual funds, etc.), risk is reduced because there is less reliance on any single asset. By using world markets, risk can be reduced even more. Here is an example:

Suppose Corporation XYZ in 1996 had the following portfolio:

- 1000 shares of Japanese utility company stock;
- 1000 shares of Mexican petroleum company stock;
- German government bonds valued at 8000 deutsche marks (today called “euros”);
- 1000 shares of a Moroccan mutual fund;

- Canadian municipal bonds valued at 8000 Canadian dollars.

Suppose Corporation ABC in 1996 had the following portfolio:

- 10,000 shares of Swedish steel company.

If the steel company in Sweden has a poor year for sales and profits, its stock value decreases. Corporation ABC, which has not diversified, will have a terrible return on its portfolio. The next year, the steel company may have a great year, so ABC will have a terrific portfolio return.

Corporation XYZ, with a diversified portfolio, can overcome a single poor return and still have a good overall return on the portfolio. If utilities in Japan have a poor year, but Morocco is experiencing strong economic growth, the Moroccan gain can offset the Japanese stock loss. Then, the next year, perhaps the reverse would occur (Morocco experiences a slowdown while the Japanese utility realizes higher profits than anticipated). The year-to-year return would fluctuate much less for Corporation XYZ than for ABC.

3. The Principal Actors in the International Capital Markets of the Late 1990s were Banks, Non-Bank Financial Institutions, Corporations, and Government Agencies.

Commercial banks powered their way to a place of considerable influence in international markets during the late 1990s. The primary reason for this was that they often pursued international activities that they would not have been able to undertake in their home countries. The lack of international regulation fueled bank growth over the decades leading up to the 1990s.

Commercial banks undertook a broad array of financial activities during the late 1990s. They granted loans to corporations and governments, were active in the bond market, and held deposits with maturities of varying lengths. Special asset transactions, like underwriting were undertaken by commercial banks. By underwriting, the bank guaranteed a company issuing stocks or bonds that it would find buyers for the securities at a minimum price.

Non-bank financial institutions became another fast-rising force in international markets during the late 1990s. Insurance companies, pension and trust funds, and mutual funds from many countries began to diversify into international markets in the 1990s. Together, portfolio enhancement and a widespread increase in fund contributors have

accounted for the strength these funds had in the international marketplace.

Corporations often use foreign funds to finance investments. Corporations may sell stock, issue bonds, or obtain loans from commercial banks. The trend in the late 1990s was for corporations to issue securities that attracted investors from all over the world. The Eurobond, which we described above, was an example of this. A Eurobond is a corporate bond not denominated in a single currency, but gives the lender the right to demand repayment from a preset spectrum of currencies. For example, a bond may allow its holder the right to be repaid in yen, euros or pounds. When the holding period is over, the holder chooses the most preferable currency at that time. This partially protects buyers from exchange rate fluctuations.

Government agencies, including central banks, were also major players in the international marketplace during the late 1990s. Central banks and other government agencies borrowed funds from abroad. Governments of developing countries borrowed from commercial banks, and state-run enterprises also obtained loans from foreign commercial banks.

4. Changes in the International Marketplace Resulted in a New Era of Global Capital Markets During the Late 1990s, which were Critical to Development.

Many observers say we entered an era of global capital markets in the 1990s. The process was attributable to the existence of offshore markets, which came into existence decades prior because corporations and investors wanted to escape domestic regulation. The existence of offshore markets in turn forced countries to liberalize their domestic markets (for competitive reasons). This dynamic created greater internationalization of the capital markets. Up until the 1990s, capital markets in the United States were larger and more developed than markets in the rest of the world. During the 1980s and 1990s, however, the relative strength of the U.S. market decreased considerably as the world markets began to grow at phenomenal rates. Three primary reasons account for this phenomenon.

First, citizens around the world (and especially the Japanese) began to increase their personal savings. Second, many governments further deregulated their capital markets since 1980. This allowed domestic companies more opportunities abroad, and foreign companies had the opportunity to invest in the deregulated countries. Finally, technological advances made it easier to access global markets. Information could be retrieved quicker, easier, and cheaper than ever before. This allowed investors in one country to obtain more detailed

information about investments in other countries, and obtain it quite efficiently. So, in the late 1990s we witnessed the globalization of markets - i.e., the increased integration of domestic markets into a global economy. This differed from the process of internationalization, which connected less integrated domestic markets of the past with offshore markets.

The global capital markets became critical to development in an open economy. Developing countries, like all countries, must encourage productive investments to promote economic growth. Domestic savings could be used to make productive investments. Typically, developing countries have suffered from low domestic savings rates (although this is not true of the Asian economies of the late 1990s). Thanks to global capital, however, developing countries added to domestic savings by borrowing savings from abroad.

If the foreign savings are invested wisely, the borrowing country will grow economically. Thus, foreign savings, which many people simply call foreign investment, can benefit developing countries. But, as you will learn from the E-Book's discussion of the 1994-1995 Mexican and Asian financial crises, sudden surges in capital can destabilize countries, especially those with relatively small economies.

Before you click to the E-Book sections that discuss those crises, you may want to take a moment to review the sources of capital that developing countries have relied upon.

D. Sources of Capital

There are two sources of capital: private sources and public sources. Both sources are very important to the economies of the world. Capital flows result when funds are transferred across borders; the flows are recorded in the balance of payments account. Read on for definitions, examples, and trends in capital flows.

1. Private Sources of Capital.

Foreign direct investment and portfolio investment (both debt and equity flows) are important sources of private capital. Each is defined below.

a. Foreign direct investment.

Foreign direct investment is capital invested by corporations in countries other than their places of domicile (their home countries). Direct investment is not nearly as liquid as portfolio investment and is therefore less volatile. The normal requirement to qualify as

foreign direct investment is for the foreign firm to own at least ten percent of voting stock. An example of foreign direct investment is a Japanese company that starts a joint venture (50-50) in Mexico with a Mexican company. The Japanese company has a long-term investment in the assets of the joint venture and not merely a passive investment like portfolio investors, who can remove their money from a country almost instantaneously.

b. Portfolio investment: debt flows and equity flows.

Portfolio debt flows result from foreign investors buying domestic debt securities. A German investor buying bonds in Canada is an example. Commercial bank lending (loans from private financial institutions) is also portfolio debt. Portfolio equity flows occur, similarly, when foreign investors purchase equity securities domestically. A Japanese investor who purchases stock in the Brazilian stock market is creating an equity capital flow into Brazil. ADRs and GDRs also fit into this category.

2. Public Sources of Capital.

Public sources of capital include official non-concessional loans of both multilateral and bilateral aid and official development assistance (ODA). ODA is made up of grants and concessional multilateral and bilateral loans. Each is discussed in turn below.

a. Official non-concessional loans: multilateral & bilateral aid.

Official non-concessional multilateral aid consists of loans from the World Bank, regional development banks, and other intergovernmental agencies such as multilateral organizations. The term "non-concessional" refers to the fact that these loans are based on market rates, must be repaid, and are not partly grants. By contrast, official non-concessional bilateral aid is loans from governments and their central banks or other agencies. Export credit agency loans are also included here. "Bilateral" refers to the fact that the entities providing the funding provide aid only in their home country.

b. ODA: official grants and concessional loans.

ODA refers in part to official public grants that are legally binding commitments and provide a specific amount of capital available to disburse (give out) for which no repayment is required. Concessional bilateral aid refers to aid from governments, central banks, and export credit agencies that contains a partial grant element (25% or more), or partially forgives the loan.

Similarly, concessional multilateral aid contains a partial grant, or forgiveness of the loan. Multilateral aid comes from the World Bank, regional development banks and intergovernmental agencies.

3. Private Capital Became Very Important to Development in the Late 1990s.

During the 1990s, the sources of capital for developing countries changed drastically. In 1990, a World Bank publication listed aggregate net long-term resource flows to developing countries (private and public sources of capital) as 101.9 billion U.S. dollars. Of that number, approximately 57% was from official loans or grants, and the remaining 43% came from private sources. Just five years later, in 1995, only 28% of the resources were from official sources, with the remaining 72% from private sources. During the course of those five years, official funding remained relatively constant. Private funding, however, skyrocketed. From the 1990 figure of \$44 billion, private sources increased almost 400% to \$167 billion.

All types of private funding increased. Portfolio equity flows went from \$4 billion to \$22 billion over the 5-year period. Foreign direct investment went from \$25 billion to \$90 billion. Private debt flows went from \$15 billion to almost \$55 billion. Clearly, there was a fundamental change in the sources of funds for developing countries to draw from during the late 1990s.

Why did this major change occur? As stated previously, international portfolio diversification became more prevalent every day. Insurance companies, mutual funds, pension funds, and securities houses were looking to diversify. They also had more funds than ever to invest. Worldwide, portfolios were absorbing an increasing share of aggregate savings. These portfolios were coming more and more under the control of professional fund managers. The "pros" are generally more apt to diversify in the international marketplace.

As overall international portfolio diversification grew, so too did the share of international portfolio diversification that went to developing countries. For example, according to the IMF, the five largest industrial countries in the late 1990s (U.K., U.S., Japan, Germany and France) increased their international investments from \$100 billion in 1980 (about 5% of assets) to \$900 billion in 1993 (more than 7% of assets). In 1987, \$0.50 of every \$100 of foreign portfolio investment went to emerging markets—by 1993, that figure increased to \$16 of every \$100. Net capital inflows to developing countries as a

percentage of world savings more than doubled (from 0.8% to 2%) between 1990 and 1993.

Capital flows to developing countries acted as catalysts, propelling the world closer to a seamless global marketplace during the late 1990s. The growth of global institutional investors resulted in capital flows to emerging markets based more on short-term liquidity and performance than long-term business ventures. To protect themselves from the risks of these volatile cash flows, developing countries can take some precautionary measures. The central bank can intervene in foreign exchange markets and capital controls can be imposed. As the Asian financial crisis illustrates, however, the dangers are real and very powerful.

Net private capital flows to major emerging market economies fell to about \$200 billion in 1997, from a peak of \$295 billion in 1996. The Asian crisis was the primary reason for the turnaround. The five economies most affected by the crisis (South Korea, Indonesia, Thailand, Malaysia and the Philippines) had an inflow of \$93 billion in 1996. In 1997, they had a combined outflow of \$12 billion. That is a net change of \$105 billion in one year! That fact succinctly illustrates the perils of globalization and the upheaval that it can cause to governments and individuals.

Portfolio equity investment outside Asia increased from 1996 to 1997, growing 50%. Commercial banks around the world cut back their financing the most during the late 1990s. After lending about \$100 billion in 1996, commercial banks actually took in more than they lent out in emerging markets in 1997.

Net official cash flows rose in 1997, as the IMF and other financial institutions came to the aid of the Asian economies. Even as net official flows increased by \$27 billion over the previous year, 1997 total capital flows were only \$229 billion after reaching almost \$300 billion in 1996.

Emily Marriott, a UICIFD staff member, contributed to the 2007 update.