Finance in the Global Market

Module Introduction and Overview

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1 Introduction to the Module

The starting point for understanding any financial market is that, on a large scale, firms and governments have to turn to institutions (such as banks) and markets (such as bond markets) to finance their core operations. Even if a government or firm currently has no need to borrow or obtain new capital funds, it operates on financial markets to manage its old financial liabilities (such as its outstanding bonds which are traded on markets) or to invest currently surplus funds. At the same time, banks and other financial institutions essentially operate on financial markets as their main business activity.

The fundamental fact underlying this module is that such large players' financial operations take place on financial markets that are international in character. That is especially true now that, since the 1970s, economies have experienced a fast pace of *globalisation*. For centuries firms' and governments' financial operations have generally involved an international dimension, but modern globalisation has been accompanied by changes in both its *scale* and its *character*.

What do we mean by saying that today 'financial markets…are international in character'? When firms and governments, or banks, arrange finance or rearrange it, how do international matters come into play? We can list three dimensions:

- Much borrowing and lending occurs on markets that have no national home (such as eurodollar – or, more generally, eurocurrency – markets).
- National capital, credit, and money markets are highly integrated with other countries' (for example, variations in the price index or in market returns in the stock markets of Tokyo, London, Frankfurt and New York exhibit significant correlation).
- An important element in the costs of financing and the returns on financial assets is exchange rate movement. Firms, banks and investors of all types, including individuals, have to take account of possible exchange rate movements in calculating the expected yield of their investments or costs of borrowing; that means they have to take account of foreign exchange markets.

In this module we give much attention to the third item listed, the great role that exchange rate variations have in financial markets, and the foreign exchange dealing and risk management techniques that relate to that.

We first put that in context by studying how the processes of foreign exchange markets and exchange rates are themselves conditioned by government policies towards them – their 'exchange rate regimes'. And, since exchange rate regimes have evolved over time, we study the main historical episodes. By looking at how exchange rates and foreign exchange markets operate under different exchange rate regimes, your study deals with the question: *how did we get to where we are now?*

You will study a variety of theories throughout the module, which seek to explain the ways in which finance is handled internationally. One question we want you to keep in mind throughout your study of is: 'Is the theory true?' Whatever your answer, your next step should be to consider the related, but different question 'Is the theory useful?'

2 The Module Authors

Laurence Harris is Professor of Economics in the University of London and is a member of CeFiMS in the Department of Financial and Management Studies, SOAS, University of London. He has previously taught at several universities including London School of Economics; University of California Berkeley; Harvard University; Birkbeck, University of London; the Open University; University of Zimbabwe. He has published nine books and eighty articles. Books include *Monetary Theory; New Perspectives on the Financial System; City of Capital* and *Peculiarities of the British Economy.*

Additional material for this edition of the module has been written by **Norman Williams**, who graduated with an MA in Economics from the University of Manchester and worked in a variety of research and advisory roles at the Bank of England, specifically in the areas of monetary policy, financial markets and banking regulation. He then moved to H.M. Treasury where he worked on exchange rate policy and implementation, the strategic management of the official reserves and government borrowing. Thereafter, Norman worked for a large global investment bank focusing on European economic and investment research and advice. He is now a full-time academic specialising in banking and finance.

Parts of this module have also been updated by **Zeynep Kacmaz**. Dr Kacmaz is a researcher and lecturer in the fields of International Business and Banking and Finance. She is currently working as associate lecturer at the University of Bradford and also tutors on the Centre for Financial and Management Studies distance learning programmes. Zeynep gained a PhD in Banking from Marmara University, Turkey.

The current version of this module has been updated by **Alessandra Dal Colle**. Dr Dal Colle is currently credit risk manager in a major European bank. She has also worked in designing stock and derivatives exchanges and in research departments of banking institutions. She has spent a research period at the United Nations UNU–WIDER centre in Helsinki working on finance and development, and has been lecturing and tutoring in banking and finance for over 15 years. Alessandra holds an MPhil in Economics from the University of Cambridge (UK) and a PhD in economics and finance from SOAS.

3 Study Resources

This study guide is your central learning resource as it structures your learning unit by unit. Each unit should be studied within a week. It is designed in the expectation that studying the unit and the associated core readings will require 15 to 20 hours during the week, but this will vary according to your background knowledge and experience of studying.

Key text

David K Eiteman, Arthur I Stonehill and Michael H Moffett (2016) *Multinational Business Finance*, 14th Edition.

This is a widely used and authoritative coverage of contemporary international finance, which aims to explain and illustrate the unique features of global markets. It uses real-life cases to illustrate current industry practices, allows you to test yourself with review questions and exercises, and provides appendices throughout the text which add advanced material on the basic topics covered in the chapter.

Module readings

In your module readings, you are provided with access to a selection of academic articles and extracts from books, which you are expected to read as part of your study of this module. You will note from reading them that the topics covered in these articles often vary widely from the study guide. The module readings articles are often more technical or adopt a more in-depth approach. This should not put you off, as many were written with an academic audience in mind. These articles were selected so that the central arguments and concepts could be understood and appreciated at a level appropriate to this module.

Optional reading

You are provided with access to all the reading essential for this module, and we do not expect you to undertake extra reading on your own, partly because not all students have ready access to good libraries or bookshops. However, the reference section of each unit lists academic articles, book chapters or web-based sources that you can choose to read if you wish to further investigate a particular topic. Many of these readings can be accessed on the Internet, but it is important to note that they will not be assessed in examination or assignments.

Although not required, we think that you will enrich your study of this module by looking at such articles. Indeed, you are encouraged to choose your own additional reading on topics related to global finance. You can do this through searching the Internet and by making use of the online academic journals through the Online Library.

You are also recommended to browse through your key text for additional coverage of the topics studied in this module.

4 Module Overview

Unit 1 The International Context of Finance

1.1 Exchange Rate Regimes
1.2 Fixed and Floating Exchange Rates
1.3 Exchange Rate Regimes – a Bipolar Future?
1.4 Recent Examples of Hard Pegs and Intermediate Regimes
1.5 A New Bretton Woods System?
1.6 Conclusion

Unit 2 The Markets for Foreign Exchange

2.1 A Global Twenty-Four-Hour Market
2.2 Mechanics of the Foreign Exchange Market
2.3 Hedging Techniques
2.4 Market Microstructure
2.5 Conclusion

Unit 3 Exchange Rates and Prices

3.1 Introduction
3.2 The Balance of Payments
3.3 A Standard for Measuring Economies
3.4 Purchasing Power Parity Theory
3.5 The Big Mac Measures
3.6 Empirical Evidence – Short-Run Deviations from Purchasing Power Parity
3.7 Conclusion

Unit 4 Exchange Rates and Interest Rates

4.1 Introduction
4.2 Interest Rates and Exchange Rates
4.3 Interest Rate Parity
4.4 Conclusion

Unit 5 Managing Foreign Exchange Exposure

5.1 Introduction
5.2 Types of Risk Exposures and Their Management
5.3 Financial Firms' Management of Currency Exposure
5.4 Empirical Studies on Currency Hedging
5.5 Conclusion

Unit 6 International Corporate Finance and Project Finance

6.1 Introduction
6.2 Corporate Finance – Going International
6.3 Corporate Finance – International Equity Markets
6.4 International Bond Issues
6.5 How Diversification Affects Firms' Financial Needs
6.6 More Reading and a Conclusion

Unit 7 Capital Structure and Cost of Capital in International Financing

Unit 8 Tax Policies of Multinationals

5 Learning Outcomes

When you have completed your study of this module you will be able to:

- explain the nature of an exchange rate regime, and assess the future evolution of such regimes
- identify and discuss drivers of the growth of the global foreign exchange market
- explain the nature of exchange rate quotations
- discuss the foreign exchange market microstructure
- interpret balance of payments accounts
- use purchasing power parity measures of gross domestic product (GDP)
- explain the law of one price
- assess the uses of absolute purchasing power parity and relative purchasing power parity
- explain how firms can use currency derivatives to manage risks through hedging
- discuss what determines whether firms do use currency derivatives for hedging
- discuss models and empirical evidence on the difference between the beta coefficient of multinational enterprises as compared with domestic firms
- outline evidence on the connection between agency costs and the capital structure of multinational enterprises
- explain the main features of 'third generation' models of currency crises
- discuss the effects of regulatory regimes on firms' choice of stock exchange for their foreign listings
- explain the differences and relative merits of project finance compared to corporate finance as methods of raising international finance
- compare them with the main features of first and second generation models.