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**INTRODUCTION
TO GLOBAL
FINANCIAL
MARKETS**

STEPHEN VALDEZ

**THE FINANCIAL
TRAINING COMPANY**

SECOND EDITION



**MACMILLAN
Business**

An Introduction to Global Financial Markets

An extensively revised edition of
An Introduction to Western Financial Markets

STEPHEN VALDEZ





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Published 1993 as *An Introduction to Western Financial Markets*

Reprinted twice

This extensively revised edition published 1997

Published by

MACMILLAN PRESS LTD

Houndmills, Basingstoke, Hampshire RG21 6XS

and London

Companies and representatives
throughout the world

ISBN 0-333-69584-4 hardcover

ISBN 0-333-69394-9 paperback

A catalogue record for this book is available
from the British Library.

This book is printed on paper suitable for recycling and
made from fully managed and sustained forest sources.

10 9 8 7 6 5 4 3 2
06 05 04 03 02 01 00 99 98 97

Printed and bound in Great Britain by
Antony Rowe Ltd, Chippenham, Wilts.

Preface

The idea of a book on global financial markets came to me when I hit the problem of recommended reading for candidates coming from the continent of Europe to one of our courses.

Since the course in question was about the markets in general, books called 'How the City of London Works' (or similar titles) did not exactly answer the problem. This was particularly true when we found ourselves facing audiences from the former Russian republics and from East Europe.

It seemed to me that there was a need for a more general book about the global markets as a whole, as opposed to one about markets in one particular country such as the US or the UK. In any case, the financial world is becoming more integrated and global in its operations. A parochial knowledge of just one country is proving less and less satisfactory. This book attempts to answer this need.

Having said that, the book does not attempt a systematic coverage of the markets in all countries. Such a book would be far bulkier than this one and, probably, unreadable! Instead I have usually concentrated on examples from the US, UK, Germany, France and Japan. From time to time, illustrations will also be given from markets such as the Netherlands, Spain, Italy and Switzerland. The aim is not only to give a basic idea of how the markets work, but also to show the diversity of customs and practices within a common theme.

The book should prove useful for those preparing for a variety of examinations (MBA, banking, finance, economics and business studies), those working in banking and financial institutions in a support role (computer staff, accountants, personnel, public relations, back office and settlement) and, finally, staff in the many suppliers of information and computer services to the financial markets (computer manufacturers and software houses, Reuters, Telerate and so on).

In preparing the second edition, I have acted on suggestions from readers that a summary at the end of each chapter would be useful and that the scope of the book would be improved by more coverage of the Japanese markets. I have also followed up useful suggestions for additions to the glossary.

I have, of course, brought all the statistical tables up to date and included more recent events such as international bank mergers (for example, the Bank of Tokyo/Mitsubishi and Chemical/Chase Manhattan), the spate of changes in the UK building society movement, the Nick Leeson affair, the BIS 1995 survey of OTC derivative markets, the Lloyd's of London recovery plan and developments in the European Union, especially the moves towards a single currency in 1999.

Extra subjects now included in the text are a mention of credit unions in the banking chapter, a widening of the topics discussed in money markets and bonds to cover repos, asset backed securities, coupon stripping and dragon bonds and, in the equity chapter (Chapter 9), the addition of bought deals, share buy backs, GDRs as

well as ADRs and the increasingly popular scrip dividend.

Finally, after much heart searching and discussions with my publisher, we have decided that *An Introduction to Global Financial Markets* is a slightly more apposite title than that used in the first edition.

Stephen Valdez

Acknowledgements

Many organisations kindly gave permission for copyright material to be used and these were:

Association for Payment Clearing Services
Acquisitions Monthly
The Banker
Bank of England
Bank for International Settlements
Datastream International
Euromoney Publications plc
European Association of Cooperative Banks
Federal Trsut
Financial Times
London Stock Exchange
Organisation for European Cooperation and Development
PDFM
SBF – Paris Bourse
Society for Worldwide Interbank Financial Telecommunications
Technimetrics Inc.
Union Bank of Switzerland

Once again, as with the first edition, my thanks to Tina Shorter of Firm Focus for her excellent work in preparing the text, including camera-ready copy.

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1 The Debt Merry-Go-Round

RAISON D'ÊTRE OF THE MARKETS

The beginning is always a good place to start. Let's go straight to the heart of the matter and ask the most fundamental question of all – what are the financial markets *for*? What is their purpose? What is the *raison d'être*?

The markets are all about the raising of capital and the matching of those who *want* capital (borrowers) with those who *have* it (lenders).

How do the borrowers find the lenders? Clearly, with difficulty but for the presence of intermediaries, such as banks. Banks take deposits from those who have money to save and bundle it up in various ways so that it can be lent to those who wish to borrow.

More complex transactions than a simple bank deposit require markets in which borrowers and their agents can meet lenders and their agents, and existing commitments to borrow or lend can be sold on to other people. Stock exchanges are a good example. Companies can raise money by selling shares to investors and existing shares can be freely bought and sold.

The money goes round and round, just like a carousel on a fairground (see Table 1.1).

Table 1.1 *The debt merry-go-round*

<i>Lenders</i>	<i>Intermediaries</i>	<i>Markets</i>	<i>Borrowers</i>
Individuals	Banks	Interbank	Individuals
Companies	Insurance companies	Stock Exchange	Companies
	Pension funds	Money market	Central government
	Mutual funds	Bond market	Municipalities
			Public corporations

Lenders

Let's have a look at some of those who might be lenders:

Individuals Individuals may have conscious savings in banks of various kinds. Individuals also may not think of themselves as conscious savers at all but, nevertheless, pay monthly premiums to insurance companies and contributions to pensions. Regarding pensions, there are different traditions. The US, UK, the

Netherlands, Switzerland and Japan have a strong tradition of pension funds. They invest the money paid into either private pension plans or employers' pension schemes. In France, the state takes care of most pensions and pays them out of current taxation, not out of a fund. In Germany, company pensions are important but the company decides on the investment, which may be in the company itself. Where pension funds exist, these funds of money, along with those of insurance companies, are key determinants of movements in the markets. They have to look ahead to long-term liabilities, and will assist the borrowers of capital by buying government bonds, corporate bonds, corporate equities and so on. The shortage of such funds in many of the newly emerging economies is a major reason for the slow growth of local securities markets there.

Companies We think of commercial companies as borrowers of capital. However, even if the company is a borrower, if some of the money is not needed for a short period of time, it will seek to make money by lending in the short-term markets called 'money markets' (that is, transactions of up to 1 year in duration).

There are also companies whose cash flow is strong and who tend to be lenders rather than borrowers. A major company in the dissemination of financial information is Reuters. Their Annual Report for 1995 showed liquid funds in excess of £850m.

Borrowers

Who, then, are the borrowers of capital?

Individuals Individuals may have bank loans for domestic purchases or longer-term mortgages to fund house purchase.

Companies Companies need money short-term to fund cash flow. They need money longer term for growth and expansion.

Governments Governments are typically voracious borrowers. Their expenditure exceeds their receipts from taxes and they borrow to make up the deficit. They may also borrow on behalf of municipalities, federal states, nationalised industries and public sector bodies generally. The total is usually called the 'Public Sector Borrowing Requirement' (PSBR). The cumulative total for all the borrowing since they started is called the 'National Debt'. The first surprise for many of us is that governments don't pay off the national debt, it just gets bigger. Of this, more in Chapter 3.

Municipalities and similar bodies Apart from the government borrowing on behalf of various local authorities, these bodies may borrow in their own name. This would cover municipalities like Barcelona, counties like Berkshire in the UK, federal states like Hesse in Germany.

Public corporations This might include nationalised industries, like SNCF in France or the German railways and post office authorities, or general public sector bodies like Crédit Local de France or the German Unity Fund.

Within an economy, many of the above will not be nationals but foreigners, with implications for the *foreign exchange* market.