25 Money markets

A The money markets

The **money markets** consist of a network of corporations, financial institutions, investors and governments, which need to borrow or invest **short-term** capital (up to 12 months). For example, a business or government that needs cash for a few weeks only can use the money market. So can a bank that wants to invest money that depositors could withdraw at any time. Through the money markets, borrowers can find short-term **liquidity** by turning assets into cash. They can also deal with irregular **cash flows** – in-comings and out-goings of money – more cheaply than borrowing from a commercial bank. Similarly, investors can make short-term deposits with investment companies at **competitive** interest rates: higher ones than they would get from a bank. Borrowers and lenders in the money markets use banks and **investment companies** whose business is trading **financial instruments** such as stocks, bonds, short-term loans and debts, rather than lending money.

B Common money market instruments

- **Treasury bills** (or **T-bills**) are bonds issued by governments. The most common **maturity** – the length of time before a bond becomes repayable – is three months, although they can have a maturity of up to one year. T-bills in a country's own currency are generally the safest possible investment. They are usually sold at a **discount** from their **nominal value** – the value written on them – rather than paying interest. For example, a T-bill can be sold at 99% of the value written on it, and **redeemed** or paid back at 100% at maturity, three months later.
- **Commercial paper** is a short-term loan issued by major companies, also sold at a discount. It is **unsecured**, which means it is not guaranteed by the company's assets.
- **Certificates of deposit** (or **CDs**) are short- or medium-term, interest-paying **debt instruments** – written promises to repay a debt. They are issued by banks to large depositors who can then trade them in the short-term money markets. They are known as **time deposits**, because the holder agrees to lend the money – by buying the certificate – for a specified amount of time.

Note: **Nominal value** is also called **par value** or **face value**.

C Repos

Another very common form of financial contract is a **repurchase agreement** (or **repo**). A repo is a combination of two transactions, as shown below. The dealer hopes to find a long-term buyer for the securities before repurchasing them.

A **dealer** has unsold securities. →

Dealer sells securities, agreeing to repurchase them at a higher price on a fixed future date. →

Short-term investor buys securities. Amount investor lends to dealer, by buying securities, is less than the market value of the securities. This is so investor avoids a loss if price of securities, and their value as collateral, falls. →

Short-term investor sells securities back to dealer a few days or weeks later. →

Dealer repurchases securities. ↓

Dealer sells securities to long-term buyer.

(A dealer has unsold securities. ↓ Dealer tries to find long-term buyer for securities.)

25.1 Are the following statements true or false? Find reasons for your answers in A and B opposite.

1 Organizations use the money markets as an alternative to borrowing from banks.
2 Money markets are a source of long-term finance.
3 All money market instruments pay interest.
4 Certificates of deposit are issued by major manufacturing companies.
5 Commercial paper is guaranteed by the government.
6 Some money market instruments can have more than one owner before they mature.

25.2 Match the words in the box with the definitions below. Look at A and B opposite to help you.

cash flow	competitive	discount
liquidity	maturity	par value
redeemed	short-term	unsecured

1 a price below the usual or advertised price
2 adjective describing a good price, compared to others on the market
3 the ability to sell an asset quickly for cash
4 (in finance) adjective meaning up to one year
5 adjective meaning with no guarantee or collateral
6 repaid
7 the length of time before a bond has to be repaid
8 the movement of money in and out of an organization
9 the price written on a security

25.3 Match the two parts of the sentences. Look at B and C opposite to help you.

1 Most money market securities
2 A treasury bill is safe because it
3 Commercial paper
4 Certificates of deposit (CDs)
5 Repurchase agreements (repos)

a is issued by corporations, so it is riskier than T-bills.
b are short-term, liquid, safe, and sold at a discount.
c is guaranteed by the government.
d are short-term exchanges of cash for securities.
e are issued to holders of time deposits in a bank.

Over to you

What kind of money market instruments are you familiar with? Which ones would be most useful for your company, or for a company you would like to work for?