CHAPTER 8

Money Markets

Overview of the Money Market

- Short-term debt market -- most under 120 days.
- A few high quality borrowers.
- Many diverse investors.
- Informal market centered in New York City.
- Standardized securities -- one security is a close substitute for another.

Overview of the Money Market (concluded)

- Good marketability -- secondary market.
- Large, wholesale open-market transactions.
- Many brokers and dealers are competitively involved in the money market.
- Payment in Federal Funds -- immediately available funds.
- Physical possession of securities seldom made -- centralized safekeeping.

Economic Role of Money Market (MM)

- The money market is a market for liquidity
  - Liquidity is stored in MM by investing in MM securities.
  - Liquidity is bought in MM by issuing securities (borrowing).

Characteristics of Money Market Instruments

- Low default risk - high credit standing
- Short maturity - low intrest rate risk
- High marketability - active secondary market

Money Market Balance Sheet Position of Major Participants

Instrument	Commercial Banks A	Commercial Banks L	Federal Reserve System A	Federal Reserve System L	Treasury Department A	Treasury Department L	Dealers and Brokers A	Dealers and Brokers L	Corporations A	Corporations L
Treasury Bills	■		■			■	■		■	
Agency securities	■		■				■		■	
Negotiable CDs		■					■		■	
Commercial paper		■					■		■	■
Banker's acceptances	■	■	■				■		■	
Federal Funds	■	■								
Repurchase agreements	■	■	■				■	■	■	

Note: A = Assets, L = Liabilities.

Commercial banks are both important investors in and issuers of money market instruments.

Commercial Banks -- Most Important Participant in the MM

- Bank assets or investments
  - Treasury bills.
  - Agency securities.
  - Bankers' acceptances (from other banks).
  - Federal Funds sold.
  - Repurchase agreements (securities purchased under agreements to resell).

Commercial Banks,cont.

- Bank liabilities or borrowing
  - Negotiable CDs.
  - Commercial paper.
  - Bankers' acceptances.
  - Federal Funds purchased.
  - Repurchase agreements (securities sold under agreements to repurchase).
- MM securities provides sources and uses of liquidity due to wide fluctuations in loans and deposits.

The Federal Reserve in the Money Markets

- Money market securities is the major asset category of the Fed.
- Open-market operations (buying and selling of MM securities by Fed) is the primary tool for implementing monetary policy.
  - Purchase -- increases member bank reserves.
  - Sale -- decreases member bank reserves.

Dealers in U.S. Securities --

- Involved in both primary and secondary markets.
- Purchases new treasury debt and resells it (primary).
- "Makes a market" by buying/selling (dealer) securities (bid/ask).
- Purchases are financed by repurchase agreements or fed funds.

U.S. Treasury Bills

- Characteristics
  - Sold on discount basis.
  - Maturities up to one year.
  - Denominations are in multiples of $1000.

Auctioning New Bills

- Weekly sale by U. S. Treasury of three- and six-month maturities; longer-term bills, monthly or quarterly.
- Competitive vs. noncompetitive bid: states both the quantity of bills and bid price. Large bids. Multiple bids (35% rule)
- Noncompetitive bid: states only the quantity of bills requested at weighted average price. Smaller bids.

Book-entry Securities

- No physical securities: only record entries.
- Book-entry record keeping
- Most of marketable Treasury debt is now in book- entry form.

Negotiable Certificates of Deposit

- Characteristics of Negotiable CDs
  - Large denomination time deposit, less than six month's maturity.
  - Negotiable -- may be sold and traded before maturity.
  - Issued at face value with coupon rate.
- Development of the CD Market
  - Issued by Citibank in 1961.
  - Offset declining demand deposits as a source of funds.

Negotiable Certificates of Deposit (concluded)

- The CD Market
  - Rate negotiated between buyer and seller.
  - Market is sensitive to rates above or below the market rates.
  - Rates are lower for money center banks and are tiered upward for regional banks.
  - Purchased mainly by corporate businesses.

Commercial Paper

Short term -- one to 270 days.

- Unsecured.
- Large denominations -- $100,000 and up.
- Issued by high-quality borrowers.
- A wholesale money market instrument -- few personal investors.
- Sold at a discount from par.
- Directly or dealer sold.
- Backed by bank lines of credit.

The Commercial Paper Market

- Major investors
  - Commercial banks.
  - Insurance companies.
  - Nonfinancial business firms.
  - Bank trust departments.
  - State and local pension funds.
- Banks are involved
  - Backup lines of credit.
  - Act as agents in issuance.
  - Hold notes in safekeeping.

The Commercial Paper Market (concluded)

- Credit ratings important for commercial paper issuance.
- Backup lines of credit from banks support or guarantee quality.
- Placement
  - Directly by a sales force of the borrowing firm.
  - Indirectly through dealers.

Bankers' Acceptances

- Time draft -- order to pay in future.
- Drafts are drawn on and/or accepted by commercial bank.
- Direct liability of bank.
- Mostly relate to international trade.
- Secondary market -- dealer market.
- Discounted in market to reflect yield.
- Standard maturities of 30, 60, or 90 days -- max of 180.

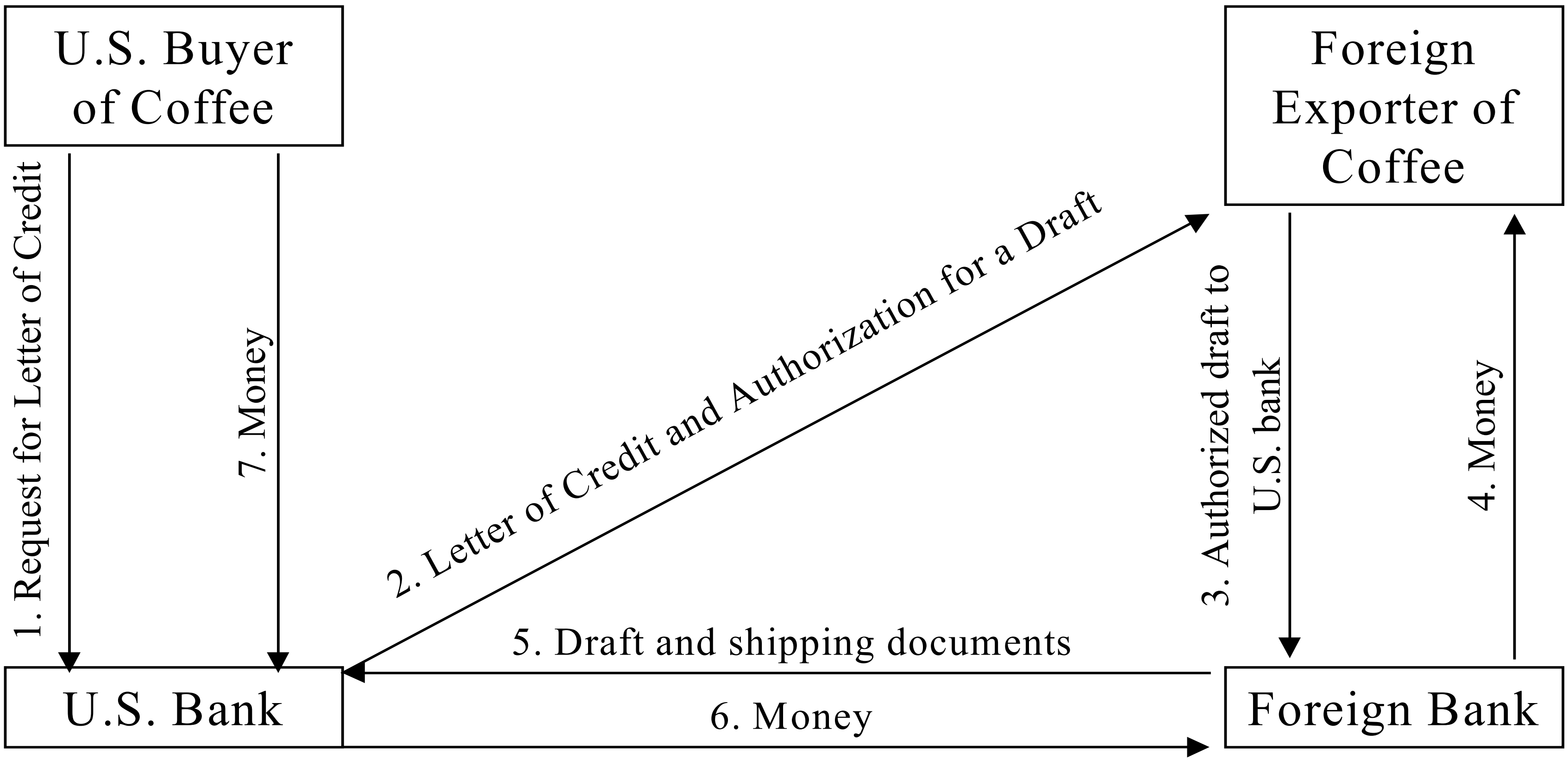
Creating a Banker's Acceptance

- Importer initiates purchase from foreign exporter, payable in future.
- Importer needs financing; exporter needs assurance of payment in future.
- Importer's bank writes irrevocable letter of credit for exporter
  - Specifies purchase order.
  - Authorizes exporter to draw time draft on bank.

Creating a Banker's Acceptance (concluded)

- Importer's bank accepts draft (liability to pay) and creates a banker's acceptance.
- Advantage of a banker's acceptance (BA)
  - Exporter receives funds by selling BA in the market.
  - Exporter eliminates foreign exchange risk.
  - Importer's bank guarantees payment of draft in future.

The Sequence of a Banker's Acceptance Transaction



Federal Funds (Interbank borrowing)

- Characteristics of Federal Funds
  - Market for depository institutions.
  - Most liquid of all financial assets.
  - Related to monetary policy implementation.
- Yields related to the level of excess bank reserves.
- Originally a market for excess reserves -- Now a source of investment (federal funds sold) and continued financing (federal funds purchased).