

**Cooleconomics.com****Financial Markets and Institutions****Money Markets-Supplemental Notes**

*A money market credit instrument* is one whose original time to maturity is less than 1 year. Banks, governments, and corporations issue these instruments, and they are traded in money markets.

Here are some **characteristics** that are generally (not always) true about money market credit instruments:

- Each transaction is large, generally between \$100,000 and \$ 10,000,000. This is why money markets are wholesale markets-transactions are often beyond the financial capabilities of most individuals.

- Secondary markets are well established, so these instruments have good liquidity.

- Original time to maturity is usually less than 120 days.

- Since time to maturity is short, default risk is low.

Who are the **major buyers and sellers** of money market securities (primary and secondary markets)?

- Banks

- The Fed

- Corporations

- Investment and securities firms

- Individuals (indirectly, through mutual funds)

- The U.S. Treasury Department

What are some of the major types of money market securities?

1. Treasury Bills (T-Bills):

- issued by the U.S. Treasury using T-Bill auctions

- original time to maturity: 91 days, 182 days, or 1 year

- denominations: \$10,000 to \$1 million

- typical primary market transaction: \$5 million or more.

- no coupon. Sold at discount to face value

- very low default and liquidity risk

- on secondary markets, often bought and sold by banks and by the Fed

2. Federal Funds (aka Fed Funds)

- interbank loans of excess reserves held at the Fed

- maturity: usually overnight

- interest rate affected by open market operations of the Fed

- unsecured loan

### 3. Repurchase Agreements (Repos)

--In which a corporation or the Fed sells Treasury securities, promising to buy them back at a slightly higher price in a few days.

--The Fed participates in this market as both buyer and seller.

### 4. Negotiable Certificates of Deposit

--Bank receives a deposit, then issues a CD with an interest rate and a maturity date.

--These CDs can be bought and sold on secondary markets. (They are *bearer* instruments.)

--Typical sizes: \$100,000 to several million dollars.

--Do not confuse with ordinary CDs, which are not bearer instruments.

### 5. Commercial Paper

--IOUs (promissory notes) issued by corporations.

--Maturity: usually less than 270 days.

--Unsecured loan.

### 6. Bankers Acceptances.

These are a bit complicated. Let's look at the steps that can create one:

A. Biff Co. wants to buy some stuff from Suzuki co. Biff sends Suzuki an order for goods, along with a letter from Biff's bank (call it Chase Bank) saying that Biff has good credit and can pay for the goods.

B. Suzuki sends the goods to Biff, and takes the letter from Chase Bank and gives it to their own (Suzuki's) bank (call it Domo Bank).

C. Domo bank sends a "time draft" for the amount that Biff owes to Chase Bank.

D. Chase bank stamps the time draft "accepted" and sends it back to Suzuki bank. (The time draft specifies that Chase Bank will pay the bearer the amount that Biff owes, plus a bit of interest, at a specified time. Of course, Biff better have sufficient funds deposited in Chase bank to cover this amount, or Chase will be mad.)

E. (Optional) Suzuki bank sells the time draft to someone, then uses the proceeds to pay Suzuki the money owed by Biff.

### 7. Eurodollars

--Any U.S. dollars that aren't actually located in the U.S. are called Eurodollars.

--Both U.S. and foreign banks borrow Eurodollars overnight if they need to shore up reserves (an alternate to Fed Funds for U.S. banks).

--LIBOR-the London Interbank Offer Rate-is the interest rate at which Eurodollars can be borrowed overnight.

--there are also EuroCDs.

Calculating the annualized yield (rate of return) on a money market security.

--Recall: Money market securities don't earn interest and are held for less than a year. To calculate their annualized yield, use this formula:

$$i_{yt} = \frac{F - P}{P} \times \frac{365}{n}$$

F is the face value of the security

P is the purchase price of the security

N is the number of days until the security matures.