Unit II

NEW YORK MONEY MARKET AND LONDON MONEY MARKET

INTRODUCTION

New York money market

The New York money market is another international financial center. The New York money market is mostly concentrated in the Wall Street area where national and foreign surplus funds seek short-run investment and outlet through lending to the needy borrowers.

It is America's biggest financial center where the country's short-term binds flow and find temporary employment with a small return and without much risk of loss.

It is through the New York financial network that the open market operations at the Federal Reserve System are conducted. In short, like other money markets, the New York money market also brings together the lenders and borrowers of short-term funds.

New York as international Centre of Finance a number of factors are responsible for the growth of America as an international financial center, particularly after 1914:

(i) The establishment of the Federal Reserve Bank in 1913 as the central bank of America strengthened the monetary system and monetary institutions in the country.

(ii) Rapid growth of financial institutions was able to deal with the domestic transactions which were previously operated through London.

(iii) The World War 1 and its after-effects reduced the importance of other European money markets.

(iv) The import of gold by America provided a solid backing to the dollar and raised its strength and importance as an international currency.

(v) America converted itself from a debtor country to a creditor and emerged as the topmost industrial country in the world. This increased its reputation in the international financial markets.

(vi) There was an accumulation of large capital resources in America. These resources strengthened its financial position in the world.

(vii) Considerable increase in inter-governmental transactions due to foreign aid programs of international financial institutions, like International Monetary Fund and the World Bank, and the increased outflow of American capital led to the emergence of dollar as the most important currency of the world and of New York as a major international center of finance in the postwar period.

The New York money market deals with a number of financial instruments, such as commercial papers, treasury bills, banker's acceptances, certificates of deposit, federal funds, repurchase agreements, etc. Likewise, New York money market can be sub-divided into its component sectors on the basis of these financial institutions.

1. Commercial Paper Market:

Commercial paper market is the oldest form of New York money market. It deals in the short-term promissory notes of large, well-known business firms with high creditworthiness. Commercial papers are of three to six months maturity.

The business firms use this market for short-term borrowing by selling their papers through commercial paper dealers. These dealers resell the papers to the banks.

Traditionally, commercial banks were the buyers of commercial papers, but now other institutions, such as non-financial corporations, pension funds, insurance companies and foreign investors have also started supplying funds to the market.

Commercial paper market is a restricted seasonal market which has declined in importance over the years.

2. Acceptance Market:

Banker's acceptances, which have been introduced only after the Federal Reserve System came into being in 1913, are mainly used for catering short-term financial needs of international trade.

A bank gives a letter of credit to its importer-customer through which it agrees to accept bills drawn by the exporter up to a certain amount.

The importer sends this letter of credit to the exporter assuring him that the bank will pay the specific amount. When the bank receives the bill drawn on it by the exporter, it signs or accepts the bill. Once accepted, the bill becomes banker's acceptance, and a negotiable money market instrument.

There are no acceptance houses in New York, but a big acceptance market has developed, with New York as the central market. Trading in the acceptance market is done by several large banks and the dealers. Banker's acceptances are mostly held by the investors.

3. Certificates of Deposit Market:

A large denomination (i.e., of $ 100,000 denomination or more) certificate of deposit is a negotiable instrument mainly used by financial institutions on the demand side of the money market. This instrument has been recently invented by main aggressive U.S. commercial banks in 1961.

The certificates of deposit are issued by the borrowing institutions and are mostly owned by business firms which invest their idle funds for short period. The business firms can further sell the certificates in the market. No legal interest rate ceiling applies to these certificates.

4. Treasury Bills Market:

U.S. Treasury bills market constitutes the largest sector of the New York money market. Treasury bills are the obligation of the U.S. Government or that of state government and are payable at par. They are the short-term U.S. Treasury securities issued for maturity periods of 3, 6, 9 months, as well as one year. These bills bear no interest.

Rather they are sold at a discount. After their issue the Treasury bills are discountable in the market and have a broad and active market. In the absence of discount houses, trading in Treasury bills takes place in the over-the-counter market.

Commercial banks are the largest participants in the Treasury bills market they both buy and sell bills unlike their counterparts in the London money market who only buy.

The Federal Reserve plays an important part in the market. They bring buyers and sellers of bills together. But unlike brokers, the dealers buy and sell securities for their own account as well as simply execute order for their customers.

5. Federal Funds Market:

The Federal Funds market is another relatively new form of money market. In this market the banks borrow from and lend to each other the reserve they have with the Federal Reserve Bank. Federal funds are the statutory balances which the banks have to maintain with the Federal Reserve Bank.

Banks with excess reserves come as lenders and banks with deficient resources come as borrowers. Funds are borrowed in the Federal Funds market for very short period and as an alternative to rediscounting with the Federal Reserve Bank. The banks make use of the Federal Funds market to meet reserve requirements or to earn interest over short period.

6. Repurchase Agreement Market:

Repurchase agreement market is still .another important constituent of New York money market in modem times. The repurchase agreement market enables a holder of securities to acquire funds by selling the securities and simultaneously agreeing to repurchase them at a later date.

This market, on the one hand, facilitates borrowing and lending for short periods, and, on the other hand, provides the lender with liquidity because the securities are obtained and returned the next day.

Under the repurchase agreement, a commercial bank sells government securities to a customer (e.g., to a corporation) and promises to repurchase them after the next day at predetermined higher price.

The difference between today's selling price and tomorrow's repurchase price is the interest payment included in the repurchase price.

LONDON MONEY MARKET

The London money markets are a collection of markets in which short-term assets are traded. They consist of the money or discount market and the remaining, parallel markets. The distinction has historical roots. Traditionally the operation of the banking sector revolved around the activities of the clearing banks, and the discount market provided the clearing banks with liquid assets. Further, the payments mechanism was largely based on the use of clearing bank deposits as a medium of exchange and, to maintain confidence, the authorities supported the mechanism indirectly through the discount market. The Bank of England acted as a 'lender of last resort' to the market and supplied cash when the market experienced shortages. The market contributed to the safety of its funds by using the assets that it purchased as security for most of its borrowing.

Commercial bills and treasury bills are the two main financial instruments in which the London money market deals. Hence the money market is composed of two sub-markets: (a) Commercial bill market and (b) Treasury bill market. Following the structure of London money market

1. Commercial Bill Market:

Commercial bills dominated the London money market till the World War I. A bill of exchange is a written order by a seller or an exporter to the buyer or importer to pay a specified sum of money on demand or at a specified future date. Most bills are drawn for three months after date for making payment for goods sold.

The bill thus drawn is sent to the buyer or importer who gets it accepted by either a bank or an acceptance house.

The acceptance house accepts the bill by giving an undertaking to pay the specified amount in the event of default by the drawee of the bill (i.e., buyer or importer). On acceptance, the bill becomes a complete document and is returned to the seller or exporter.

There are now three options open to the seller or exporter who possesses the accepted bill: (a) he can hold it himself for three months when it is due for payment (b) he can endorse it in favour of his creditor in settlement of the debt (c) he can sell it to a discount house and get it discounted, i.e., receive payment minus interest for the outstanding period and some service charges.

Generally, the third option is chosen. In this way, the bill is thrice blessed: (a) it blesses the drawer (seller or exporter) who immediately receives the liquid funds; (b) it blesses the drawee (buyer or importer) who gets his goods and will make the payment on maturity of the bill, and (c) it blesses the holder of the bill (the discount house) who earns a good return in the form of interest.

The discount houses generally sell the bills to the bankers through brokers. The banks then ultimately receive the payment of the bills on their maturity.

2. Treasury Bills Market:

Treasury bill is a bill of exchange drawn by the Treasury on itself, usually for three months. They are issued in denominations of £ 5000 or multiple of £ 5000 and carry just over 5% rate of interest. These bills can be purchased only by institutions.

Treasury bills are issued in two forms:

(a) When the Treasury bills are offered by tender to the highest bidder in the money market, they are known as tender bills. Such bills are purchased by British banks, discount houses, foreign banks and governments, and big industrial and commercial firms,

(b) When the Treasury bills are bought by government departments, the Bank of England and some foreign monetary authorities, they are known as tap bills.

4. Emergence of Short Term Bonds:

Although the Treasury bills dominate the London money market, the profit yield on the Treasury bills had been very low. This led the discount market to look for other more profitable sources of investment. Such a source was found in the short-term government bonds.

Short-term government bonds were of two types: (a) short-term bonds of one to five year maturity, and (b) long-term bonds of 15 to 20 years becoming short-term bonds nearing maturity. The short-term bonds were preferred on the considerations of safety and higher return.

COMPARISON BETWEEN NEW YORK MONEY MARKET AND LONDON MONEY MARKET

The London money market and the New York money market are among the leading international money markets of the world. Though the general functions of these two money markets are broadly the same, they differ considerably in the development of institutions and instruments and in the mode of operations.

1. Period of Supremacy:

The London and New York money markets have different periods of supremacy. The London money market remained supreme in the world up till 1914. The supremacy of the New York money market began after 1914.

2. Different Circumstances:

The Two money markets developed under different circumstances. The London money market was developed in the 19th century and, therefore, the requirements of industry and trade of that period and the financial requirements of the foreign governments have influenced its development.

The New York money market developed after the establishment of the Federal Reserve Banks in 1913. The rapid development of America and other European countries and the growth of international institutions, like the IMF and the World Bank also contributed to the development of the New York money market.

3. Different Institutions:

The two money markets have different financial institutions. The London money market has well- developed institutions of discount houses and acceptance houses, which are specialised in the businesses of discounting and acceptance of bills.

These two institutions are a peculiar feature of the London money market and account for its supremacy as an international financial centre.

The New York money market, on the other hand, did not develop such specialised institutions. It operates through commercial banks which have direct access to the central bank.

4. Different Instruments:

The two money markets deal with different financial instruments and have different sub-markets. A unique feature of the New York money market is the development of the commercial bill market. The London money market has no such market.

Similarly, the New York money market has other peculiar sub-markets, such as certificates of deposit market, Federal Funds market, repurchase agreement market, etc., which have no parallel in the London money market.

5. Modes of Operation:

The two money markets differ in the modes of operation. The London market mainly functions by convention and experience. The New York money market, on the other hand, operates through law and legislation.

For example, the relation between the Bank of England and the London money market is determined by convention, while the relation between the Federal Reserve Bank and the member banks is determined by law.

6. Growing Importance of Treasury Bills:

There is however, one similar feature of the London and the New York money markets. In both these markets, the Treasury bills have been gaining importance over other financial institutions over the year