Money Market Instruments

U.S. Treasury Bills

United States Treasury securities are short-term debt obligations of the U.S. government. They also are the most liquid money market instrument because they have the largest trading volume. The federal government has the option of raising taxes and/or issuing currency in order to repay the amount borrowed, so there is virtually no risk of default. Treasury securities with maturities of less than one year are called Treasury bills (T-bills). Although individual can hold them, the largest holders of T-bills are commercial banks, followed by other financial intermediaries, businesses, and foreign investors.

Commercial Paper

Commercial paper issues provide a liquid short-term investment for savers and a source of funds for corporations. Dormant since the 1930s, the commercial paper market began to take on new life as various borrowers turned to it as a cheaper alternative to borrowing from banks. Since commercial paper is unsecured, the market is open only to the largest and most creditworthy borrowers. Moreover, as with any public issue, selling commercial paper involves substantial fixed costs. Commercial paper of maturity less than 270 days is exempt from registration with the SEC (Securities Exchange Commission). However, rating is essential, and it costs the issuer $5,000 to $25,000 a year. There are also substantial underwriting costs. As a result, only large borrowers find it economical to borrow in this way. The average issue is about 120 million; the largest issuers have several billion dollars outstanding. Only 1200 or so of the approximately 2 million corporations and United States issue commercial paper.

Bankers' acceptances

Designed to facilitate international trade, bankers acceptances are instruments that establish credit between parties who do not know each other. The bankers' acceptance is a checklike promise that the bank will pay the amount of funds indicated to the recipient. It is issued by a firm, usually an importer and is payable on a date indicated. The bank that marks the draft excepted guarantees the payment to the recipient, usually an exporter or its representing bank. The issuing firm is required to deposit funds in the bank sufficient to cover the draft; if it does not do so, the bank is still obligated to make good on the draft. The bank's good name is likely to enable an importer to buy goods from an overseas exporter that lacks knowledge about whether the importer will be able to pay. In recent years, acceptances generally have been resold in secondary markets and held by other banks, households, and businesses

Repurchase agreements

Repurchase agreements a.k.a. repos or RPs, are used for cash management by large corporations. They are very short-term loans typically with maturities of less than two weeks. In many cases a firm loans a bank money overnight. For example, if a large firm such as IBM has idle cash, it purchases T-bills from a bank that agrees to buy them back the next morning at a higher price, reflecting the accumulated interest. The T-bills serve as collateral; that is, if the borrower defaults, the lender receives the T-bills. Since their inception in 1969, repurchase agreements have become a significant source of funds for banks.

Federal funds

Federal funds instruments represent overnight loans between banks of their deposits with the Federal Reserve System (the U.S. central bank). Banking regulations require that banks deposit a percentage of their deposits as reserves with the Fed. If a bank is temporarily low on reserves, it can borrow funds from another bank that has reserves greater than the required level. The federal funds market reflects the credit needs of commercial banks, so the ***federal funds rate*** (the interest rate charged on these overnight loans) is closely watched by money market analysts. When it is high, banks need additional funds; when it is low, banks have low credit needs.

Eurodollars

Eurodollars are U.S. dollars deposited in foreign branches of U.S. banks or in foreign banks outside the United States (not necessarily in Europe). Rather than being converted into the currency of the foreign country, the deposits remain denominated in dollars. U.S. banks can then borrow these funds. Eurodollar funds raised abroad have become an important source of funds for American banks.

Negotiable bank certificates of deposit

A certificate of deposit (CD) is a fixed maturity instrument sold by a bank to depositors; it pays principal and interest at maturity. You might, for example, take the $1000 you earned over vacation and put it in a CD for six months at five percent interest (an annual rate). After six months, your investment would be worth $1025. Before 1961, CDs were illiquid because they were nonnegotiable; that is, they could not be sold by the depositors to someone else prior to redemption. In 1961, Citibank created the negotiable certificates of deposit -- a CD in a large denomination (over $100,000, and today typically over $1,000,000), which could be sold again in a secondary market. Negotiable CDs are an important source of funds for banks today and are held principally by mutual funds and nonfinancial corporations.