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The differentiation and definition of money and capital markets

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The purpose of the article is to create a definition for money and capital markets, relying on previous theories and solutions used in provisions of law. In specialised literature the most usual division of financial markets entails splitting them into money markets and capital markets. The question is along which criteria the two can and should be divided beyond the usual pattern (time factor), and where will such a division have significance afterwards. After answering these questions, we aim to provide definitions that can be consistently applied in practice, in specialised literature and also in the legislative process.

Keywords: money market, capital market, financial market, definitions.
JEL codes: A11, G15, O16.

Introduction

The financial market is a platform that brings together the needs of sellers and buyers for the trading of financial instruments, which facilitates one particular form of financing, helping investors and savers find each other. Traditionally, we split the financial market into money markets and capital markets. The reason for distinguishing the two is that the funding of the economy is based on tradition and differs in individual countries/cultures, and therefore in some places, it is achieved through the intermediation of commercial banks (typically using loans with shorter tenors), while in others, it is done via funding through the stock exchange, in the form of securities (with typically longer tenors).

Financial regulation is increasingly drafted in an international, cross-border format. The concept of single financial regulation is also gaining ground within the European Union's legislative authority. The tightening of financial regulation, occurring as a result of the recent crisis, manifests itself mostly as a shift towards the maximum harmonisation guidelines and decrees that become directly effective, with both aiming to promote a single regulation. For the purpose of filling the gap in professional literature and supplementing regulations, it is especially important

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to create neutral notions that are resting on the EU's legal foundations and are void of any international characteristics.

However, we have noticed that the notions covering two segments of the financial markets, namely *money market* and *capital market* are not unequivocally defined. They are being referred to in provisions of law and in professional literature; however, no actual single definition exists for these markets. Our article looks into the traits along which money and capital markets are split, highlighting the distinction criteria, as well as the ways of use of the two notions. The purpose of the current article is to create the definitions for money market and capital market, relying on previous theories and solutions used in provisions of law.

Research methodology

The present article aims to highlight the traditional differences between money and capital markets and, based on these, to offer potential definitions for the two concepts.

First, we introduce the definitions available at specialised literature, textbook and legislative level, reflecting on the evolution of definitions in time. The article also highlights theories that are based on the characteristics of traded products, including half-way solutions combining the time and product aspects. The role of intermediary institutions, the scope of users and the breakdown of markets by liquidity are also considered to ensure that the characteristics that distinguish individual markets are also described, thus supporting the creation of new definitions that can be used more widely.

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The concepts of money and capital markets in financial literature

The classical grouping of financial markets (Table 1) offers the opportunity to get to know markets relatively thoroughly.

Table 1. The grouping of financial markets

Criteria	Market types
time factor	money market and capital market
issuing	open and closed market
function of the market	primary and secondary market
due date of transactions	spot and forward market
based on the nature of the financial instrument	securities market can be highlighted

Source: author's own design based on Kerekes et al. (1998)

Beyond the above mentioned, there are numerous further grouping criteria, such as the degree of concentration, the level of organisation, the intentions of stakeholders, or even their quality (Kerekes et al. 1998).

The crafting of a definition cannot be self-serving or, in a branch of science that's developing fast, superfluous, owing to traditions. Consequently, there is a need for a definition that supports the logical structure, development and embeddedness of this branch of science. We look at the definitions of money market and capital market from this aspect – definitions created, mainly due to traditions, using the *time factor*. In financial literature, the timescale of using funding is widely used as a distinguishing factor. Typically, we can speak of short-term funding, which is up to one year, and medium-term (2–5 or 7 years) or long-term (longer than 5 or 7 years) financing. Splitting the financial market in two, along a subjectively defined timescale, is only justified if we see this timescale as a crucial component.

Let's take the classification of commercially traded receivables by *maturity*: "The market of short-term debt instruments (i.e. those with a maturity of up to one year) is called money market, while the market of long-term debt instruments and shares is defined as capital market" (Bodie 2011. 46). Pálinkó and Szabó (2006. 40) give a practically identical definition, as follows: "Money market covers short-term transactions with durations of a mere few hours to one year… while capital market focuses on deals with longer maturities". Frederic S. Mishkin (2010. 43) defines money market and capital market as follows: "Money market is a financial market that trades in short-term debt instruments only (those with maturities of up to 1 year), while capital market is the market that trades in long-term debt and equity instruments (with maturities of longer than 1 year)".

The distribution along the time factor is widely used in specialised literature (Zucchy 2016; Jaksity 2004; Bod 2001; Bailey 2005; Haan et al. 2015; Kohn 2007). Authors tried to resolve the over-mystification of duration by considering the time factor a characteristic of the product type. However, the half-way, time/product combination principle is not exact enough, and does not offer the possibility of moving forward. The differentiation by subjective maturity (the magic one year) does not distinguish sufficiently the two markets, as there are/may be short-term products and securities that would rather belong to capital markets, if assessed solely on the nature of the product.

This collision results from the difference between individual distinction criteria, meaning that some players try and define the concept of capital market on a product basis (securities), while others along the time horizon (short-term). However, existing definitions either do not clarify the contradiction between the two (e.g. short-term securities), or regard them as exceptions to the rule, that define the rule.

Markets are sometimes distinguished by the *type of receivables* or the *subject of trading*; such as the securities market or the market of other financial instruments. "Liquid cash that can be directly swapped for a product or service; i.e. money itself is the subject of money markets, where demand and supply are not necessarily linked through the act of sale/purchase" (Solt–Kiss 2007. 187). This approach is a subset within the maturity-based approach, as definitions contain the short period remaining until maturity (e.g. Bailey 2005), or in some places duration is set as up to one year (e.g. Haan et al. 2015).

Bailey (2005) uses a *product and time-based* approach, and says that the purpose of money markets is to create a trading platform for securities (3 or 6-month government bonds) or facilitate other short-term loans. As a result of such securities being traded on the market, the holder of the money market instrument does not typically have to wait until the end of the contract's full tenor; i.e. execution by the issuer.

The need to go beyond the time aspect was also pointed out by András Vígvári (2008. 177–178): "The conventional approach of looking at maturities was the right one until state regulations clearly distinguished the institutions of indirect and direct financing, and therefore also their markets, and the liquidity of financial markets wasn't overly high". In other words, with the development of financial markets, globalisation and the mixing of financial cultures and products it entails, the definition based on subjective timescales can no longer be sustained.

One solution for going beyond the maturity-based approach was to use the *types and financing methods of intermediary institutions* as key traits in the definition, instead of the timescale. This approach considers capital markets to be part of money markets. Iklódi (2005) splits the capital market into three parts: the market of capital instruments, the market of goods and the market of money and securities. The economic players are split into savers and those looking for resources/capital, the two being connected by the financial intermediary system, which helps them find each other. The scene of this connection can also be split into two parts: the money market, which, with the co-operation of banks, turns deposits into loans, and the capital market with the stock exchange as one of its constituents (Iklódi 2005).

The separation by *volume* and *risk-taking* might serve as a guideline to investors; however, it does not draw the market demarcation line with due precision. "Capital markets spread the ownership of capital or certain risky investments between numerous investors, thus allowing players to take on much larger investments and/or risks than what individual owners could tolerate" (Samuelson–Nordhaus 2005.189). Mishkin (2010. 43) says that "the trading of money market securities is typically conducted in a wider circle than that of long-term securities, and they are also typically more liquid". The author notes that the price fluctuation of short-term papers is smaller than that of long-term papers, and thus it is safer to invest into these. Therefore, companies and financial institutions use this (safe money) market to earn interest on superfluous but only temporarily available resources. At the same time, capital market securities are typically held by financial intermediaries, e.g. insurance companies and pension funds, as they have less uncertainty about the future availability of resources.

Gábler's (2008) definition unites various considerations and says that money market is basically the market of short-term (up to 1 year), liquid, fixed-interest, low-risk, easy-to-trade credit instruments. As such instruments are typically traded in bulk, individual investors may only access them in the form of money market funds. Money markets typically mostly serve the purpose of bridging the time gap between the realisation of the income and expenditure items of companies and the state.

It is clear that these approaches are based on customs and do not look into why it is even necessary to define and separate money and capital markets. Some argue that we should generally use the term *money market*, and if required, we can specify individual transactions after the products, keeping in mind the objective in hand.

By applying a more complex approach, we can state that the money market is the scene of money exchange, and the entirety of players contributing to the intermediation of money exchange (individuals and institutions), financial means, mechanisms, as well as provisions of law, regulations and customary laws. The primary function of financial intermediation is the conveying of free liquid cash generated in the economy (savings, in a broader sense of the word) and capital to users (Losoncz–Farkas 2011).

The definitions of money and capital markets from aspects such as time, liquidity, risk or product characteristics, do not offer additional information or investor protection guidelines to investors; however, it must be noted that they may be suitable for differentiating between the banking activities pursued by investors, which may serve as a logical starting point.

The concepts of money and capital market in the legislation

Although we do use the terms money market and capital market with natural ease in provisions of law and contracts, the underlying content is interpreted individually by each player, because, at present, no definitions exist for these markets in financial legislation. These concepts have not been defined in the EU's, Hungary's or the USA's legal systems either. In some cases, the legal approach also shows a certain degree of tautology in this respect when Section 17, Article 4 of the MiFID II directive (EP 2014), or Act No. CXX of 2001 on capital markets in Hungary defines the *money market instrument* as an instrument that is traded on the money market, without defining the exact nature of the money market. In addition, there is also a certain degree of contradiction in the sense that the law defines money market instruments as a subset of financial instruments, which, by the way, are traded on the capital market. Nevertheless, it can be assumed that here the legislator wishes to point out the unsecured and short-term nature of the product, instead of trying to define a market differentiator trait.

It must be noted that the general contracting terms and conditions of financial institutions also use the concepts of money and capital markets. However, the specialists who draft such general contracting terms and conditions have not attempted the precise description and definition of such markets either.

EU institutions also use these concepts without defining their underlying content. For example, according to the position paper issued by the European Parliament on 19 January 2016 (EP 2016), the capital market union (CMU) could be an effective solution for creating a single, cross-border capital market. Amongst the underlying reasons, the document mentions that the capital market of the European Union remains dispersed, and therefore, the CMU may offer a valuable framework for providing equal access to SMEs to funding EU-wide, as well as for promoting the creation of innovative platforms for market-based financing. It also notes that the CMU creates the opportunity to strengthen the capital markets of the EU with a view to boosting their ability to supplement financing by banks. The objective of the capital market union is to deepen and even more tightly integrate the capital markets of the EU member states, where the legislator can set the content behind such objectives through the definition of EU pillars for individual capital markets.

It is to be noted that the concepts of money market and capital market are used at all levels of the EU legislation without being defined. The *Treaty on the Functioning of the European Union* (EU 2012) also uses these concepts, as well as the regulations specific to individual sectors.

Due to the inability to arrive at a definition of these concepts, in specific provisions of law, legislators bypassed the issue by enlisting the market components (e.g. products) required in that specific piece of legislation to achieve its purpose. However, such components were mostly mentioned as examples, even though the full list could be replaced by a single, unified definition.

The differences between money and capital markets from an economic perspective

Traditionally, in continental Europe, money market-based forms of financing are more typical and traditional, while the same is true for capital market financing in the US. The different financial structures prevailing in individual countries determine the typical access path for companies to the various forms of financing. In a different study, it may also be worth looking into how different forms of financing impact growth in different economic cycles. However, for us to be able to discuss economic issues in an effective manner, we need to fine-tune concepts and definitions, and get them generally accepted.

In boom periods legislative bodies are also more relaxed to see an institution, e.g. an investment bank performs more and more activities and sell more and more products “alien to the world of the institution in question’, as there are also cost efficiency factors at play. At the same time, world crises and major economic declines yet again raise the rightful worry that can be typically linked to such periods, that there is a lack of clarity when it comes to products and, ultimately, activity profiles, and such products and activities are not clearly allocated to specific types of institutions. Consequently, it can be rightfully argued that the notions of money market and capital market should be differentiated.

The distinction between the two concepts also carries statistical relevance, for example, when it comes to the balance of payments. Although the international methodological framework is mainly defined by the balance-of-payments/statistics manual, yet, the original separation applied by the financial profession can also come in handy when it comes to real economy and financial deals taking place in the economy.

We instinctively identify financial institutions and financial intermediaries with markets, credit institutions with money markets and investment businesses (brokers) with capital markets (Szász 1947). Financial intermediary institutions collect small-value, temporarily available liquid cash from savers, and use them to satisfy the much higher-value financing needs of economic players. Intermediaries perform an efficiency-boosting, quality asset transformation (risk management) and resource-reallocation function between savers and companies to be financed, which gives them an important role on the financial market (Erdős–Mérő 2010).

The distinction of specific markets has significance for defining the concepts prevailing in financial intermediation, and, within that, for identifying the content of operating licences. The activities pursued by institutions on the financial market can be distinguished by the form and characteristics of financing offered by them; i.e. in what form they enjoy the utilisation of certain types of savings. Thus, it is not the target audience that determines the market's identity, but the scope of activity of the institution offering the service. The previous objective of the law, i.e. the classical institutional distinction could only be achieved through the precise allocation of activities, meaning that a credit institution can collect deposits or offer a credit facility of cash loan (i.e. perform credit institution or financial activities), while an investment business performs investment services, e.g. is involved in security trading.

At the same time, it is clear to see that no given bank can be present on the market as a money market player and a capital market actor at the same time; i.e. as an entity both offering and using such services. In order to be able to define the market, it is necessary to start out from the products and the provision of services, and the operating licence sets the framework for these. When defining markets, looking at the services used by the institution as a starting point may trigger us to draw the wrong conclusions, as banks may, on occasion, acquire the resources required for performing their banking activities from the capital market. Accordingly, the scope of players emerging on the demand side does not offer good guidance for the distinction of the two different markets, as households, the state and the representatives of the non-financial sector also emerge on the demand side of individual markets.

Having established the importance of the supply side, it can be suspected that it may guide the process of market definition. However, in terms of the provision of services and the granting of operating licences it is also important to stipulate, right from the start, that there are the so-called universal 'banks', whose operating licences are not necessarily determined by the company's form of association or name under financial law, or even the possession of licences for activities that are classically linked to the name of such an institution. Legal stipulations also increasingly depart from the concept of linking clear-cut definitions of institutions to clear-cut definitions of activities, as the development of market requirements and economic rationales (cost efficiency) demand a certain degree of interchangeability between activities and institutions.

It's worth looking into whether the distinction between money market and capital market has significance from an investor and customer protection point of view as well. In the case of a universal bank, the client faces a specific institution, where it can benefit from multiple services, meaning that in his/her capacity as a buyer, the client emerges on different markets. Therefore, it is a rightful requirement from customers to have a clear picture on how they can settle any losses resulting from the services used by him/her or from issues faced by its business partner. To be able to make a decision based on a thorough risk assessment, the customer must also see how much the service they are using is 'protected', i.e. whether they can get any 'external' indemnification or damages, should certain events take place. The type of the institution itself does not clearly define the guarantees linked to the deals closed with the institution or the insurance system, as it always depends on the type of the service in hand provided by the institution; i.e. on which market the deal is concluded. We only briefly refer to customer and investor protection aspects because, on the one hand, the identification of the guarantee from the market's aspect does not offer the true picture, as not all services are offered. On the other hand, this aspect is only relevant in relationships between universal banks and non-financial institutional investors and customers[3], e.g. in relationship(s) between natural persons, but not for institutional contracting parties, and therefore its usage for solely market-based distinction would be strongly misleading.

The scope and content of the operating licence can truly show the character of a given market through the services and instruments offered by the institution. Accordingly, the provision of financial services takes place on the money market, or, looking at it the other way, it is on the money market that financial services are being provided and such services are used. According to Act No. CCXXVII of 2013 on Credit Institutions and Financial Enterprises, financial services include the provision of credit and cash loans, financial leasing, deposit collection, the acceptance from the public of other repayable financial instruments, money exchange or the provision of payment services, whose underlying subject is cash or cash-substituting means of payment. This is also significant because there are services, e.g. custody services that can occur in the activity range of both credit institutions and investment businesses; however, their subjects are different (cash vs. financial instrument).

The subject of investment service activities is financial instruments, and therefore such services, as the taking and execution of orders, portfolio management or investment advice, may only be performed by institutions with a licence to perform investment services. Investment businesses and institutions with a licence to offer investment services provide such services on capital markets. Looking at it the other way, the capital market is the place where the provision of investment services takes place.

In summary, the market turnover that can be established from the above does not serve as a direct starting point or a distinction criterion from a consumer protection aspect, it does not offer guidance in terms of transparency or profitability, and it's not possible to draw direct conclusions from it regarding risk. It is, however, the place where activities and services detailed in the operating licence are performed/provided, where demand and supply for the subject of the service also occur.

In a nutshell, the first reading of economic and legal approaches may suggest the instinctive solution of associating credit institutions with money markets and investment businesses (brokers) with capital markets. However, in respect of the

[3] Customers not excluded from the indemnification scheme of the National Deposit Insurance Fund and the Investor Protection Fund in Hungary.

licensing of individual financial activities, we have come to a more sophisticated solution by identifying a clear demarcation line. The distinction criteria and gaps between markets are presented in Table 2.

Table 2. Distinction criteria for money and capital markets

Criteria	Money market	Capital market
Role	Serves the purpose of compliance with working capital requirements in the economy, and it has a role in ensuring sufficient liquidity for banks	It serves an investment purpose with a view to achieving an increase in capital
The content of interest (rate)	The money market interest rate is determined by the demand for and supply of money; i.e. it represents the value of money. Therefore, in any given country, the short-term interest rate is the indicator of monetary and banking conditions.	The operation of the capital market largely depends on the conditions characteristic of money markets. The short-term interest rate affects longer-term interest rates characteristic of capital markets.
Key institutional players	Central bank, commercial bank, non-financial institutions	Stock exchange, commercial bank and other financial institutions (e.g. insurance company and mortgage bank)
Characteristic of the market	Informal	Formal
Typically traded financial instruments	Draft, cheque, short-term certificates of deposit, treasury bonds, commercial loans, short-term bonds, FX derivatives, interest rate swap transactions, commodity derivatives, loan derivatives)	Shares, bonds (medium or long-term), other long-term securities
Liquidity	Typically high	Relatively low
Risk	Lower risk Investors step on the market with the expectation that liquidity is available, and they can trade on a secure market.	Relatively high risk Objectives include savings and the realisation of medium and long-term investments.
Yield	Lower	Relatively high

Source: authors' own design based on Marmilava (2017), Haan et al. (2009) and O'Sullivan (2003)

In view of the above parameters, we suggest the following definitions:

Money market: *a system of transactions closed in respect of liquid cash or other short-term financial assets typically involving short-term financial obligations (of up to one year), where the purpose of the deals is typically to ensure financing for current operations, short-term profit-making or the management of financial risks in the short run.*

Capital market: *a system of transactions closed in respect of financial assets, including, in particular, securities, derivative deals or financial agreements which typically involve long-term financial obligations, whose objective is to satisfy capital requirements or boost capital.*

These new definitions, on the one hand, identify the product itself and – through the product's unique traits – the characteristics of the market (maturity, risk), and, on the other hand, they define participants on the supply side.

Conclusion

In financial literature, the definitions of money market and capital market are inconsistent, and are characterised by significant deviations and definition gaps, in the spirit of author's freedom. We could not derive a single, consistent definition from the provisions of law prevailing in Hungary, the European Union and in the US either.

The new definitions proposed combine previous approaches; however, it eases the previous practice of erecting a Chinese wall between the two markets based on, for example, the product's features, and uniqueness (one year, risky, etc.).

Due to the clarity and simplicity of the new definitions – which correctly grab the character of the matter, and combine the various classical notions that exist about financial markets without citing categories from corporate law –, they can be easily extended if so required by potential changes in law, and therefore they are put forth for general acceptance.

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