6.3: Key Market Distinctions

There are several different classification schemes which are applied to financial markets which are discussed below. It is important to note that these are merely classification schemes and do not represent specific, physical marketplaces. For instance, there is not a national "capital market" where all capital market securities trade. Instead the term "capital market" merely seeks to characterize a particular type of security. Also, specific securities may trade on multiple types of financial markets. For instance, IBM common stock is a capital market security that trades on the secondary market at an organized exchange (the NYSE). There are also additional market designations, but the ones listed below represent the principle classifications of market types.

Money Markets vs. Capital Markets

Money Markets include all markets in which securities with 1-year or less remaining until maturity trade. Two examples here would be Treasury Bills and Commercial Paper. Both of these are short-term debt securities issued by the federal government (T-Bills) or corporations (Commercial Paper). Another example of a money market security would be Repurchase Agreements.

Capital Markets include all markets in which securities with more than 1-year remaining until maturity. Some examples here would be stock markets, Treasury bond markets, and corporate bond markets.

Primary Markets vs. Secondary Markets

Primary Markets are markets in which the security is sold for the first time. The security changes hands from the corporation (or government) that issues the security to the investor that purchases the security. The issuing body receives the capital. An example here would be the IPO (Initial Public Offering) market in which a firm issues shares of stock for the first time. Another example may include the US Treasury issuing 5-year Treasury Notes. The US Treasury receives the capital from this transaction and the purchaser of the security gets the security. It should be noted that a security can only trade in the primary market one time. Any trade of the security after it is issued will take place in the secondary market.

Secondary Markets are markets in which the security is sold between investors. The firm that originally issued the stock or bond is not involved in the transaction and receives no money. The NYSE is an example of a secondary market. For example, consider the 5-year Treasury Note discussed above. When that security is issued, it is issued in the primary market. However let's assume that, after holding it for one year, the original purchaser decides to sell the security. This transaction will take place in the secondary market. The secondary market accounts for the bulk of trading activity in the financial markets.

Primary markets are essential for raising money. Since this is where securities are issued, corporations and governments use the primary market to raise capital for their investments. Without a strong primary market, the ability of firms to raise money to pursue long-range business goals would be significantly damaged. Secondary markets are essential for providing liquidity and valuation information. Let's first consider liquidity. Liquidity (as will be discussed later) refers to the ability to sell an asset quickly and for fair market value. Investors like liquidity. Without active secondary markets, there would not be any liquidity (if you purchased shares of stock issued by a corporation, you would have a hard time selling it later when you wanted to convert it into cash). Without liquidity, people would stop buying securities on the primary market (would you want to buy stock in a company if there was no active secondary market to sell it in later?). Therefore, secondary markets are necessary to keep primary markets viable. Another role of secondary markets is to provide valuation information. We can see the value of a particular stock by the price at which people are willing to buy/sell. Without an active secondary market, we would have much less information about the value of stocks and bonds.