

An Appraisal Of The  
CURRENT INNOVATIONS  
In The  
MONEY & CAPITAL  
MARKETS

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## INTRODUCTION

As the topic for this essay, "An Appraisal of the Current Innovations in the Money and Capital Markets", is extremely broad, my discussion shall also be broad ranging. For the first part of the essay I focus on recent events in the City of London, starting with an introduction to financial markets, then looking at the forces that have brought about the current 'innovations'. I choose to focus on British financial markets for the bulk of this essay for three reasons:

- A. It has recently undergone major changes.
- B. A large amount of documented information is available on these changes.
- C. Irish financial markets are closely linked to developments in the British markets.

Having discussed current innovations I turn to look at some longer established innovations such as the Unlisted Stock Market, the Futures market and the Business Expansion Scheme. This leads on to a brief look at some topical issues in financial markets. At this point I look at the case of Ireland in detail, at some traditional aspects of the Irish financial markets and at recent innovations and their effects. The essay concludes with my appraisal of deregulation, current innovations, internationalisation of markets and Ireland's situation.

Throughout this essay I use the term innovation to refer to new responses to changing conditions in markets. These responses may take the form of financial regulations, new bodies or indeed new markets.

## FINANCIAL MARKETS

"Financial markets are arenas where financial instruments change hands."

C. Geisst 1.

Financial markets have a unique function. They are analogous to a central nervous system for the whole economy. The financial system exists to facilitate activities in the rest of the economy from which it draws its income and its profit. Financial markets is the collective term given to the following markets.

### Money Markets

"A money market is the set of arrangements and procedures which enable financial institutions to invest in short term financial assets which constitute their first line interest earning, liquidity reserves."

T. Hoare 2.

Basically money markets trade debt instruments with final maturities of one year or less. These instruments include Treasury and commercial bills and short term bonds. Since 1950 parallel short term money markets have developed in deposits of foreign currency and sterling owned by nonresidents and in sterling funds of banks. These markets include those for Eurocurrencies, certificates of deposit and interbank deposits.

Capital markets deal with securities with longer than one year to maturity, longer term bonds (gilts and debentures) and equities. The commodity, foreign exchange and options markets are not capital markets since they do not raise new money. They are referred to as hedging markets where holders of capital assets may mitigate the risk attached to holding them. The Bank of England is the central bank and has primary responsibility for supervision and control of the financial system of the country.

### The Traditional Structure of the Financial System

To put the following sections in the proper perspective I now look at the traditional system before the major changes of 1986. The traditional system was characterised by the interaction of two types of market institution. First there were the specialist institutions distinguished by their special functions in the financial system, discount, acceptance and issuing houses and foreign exchange brokers. The second kind of market operation was that of providing access to these specialist services. Thus access to the Stock Exchange for the public was obtained through stockbrokers and merchant banks provided access for commercial customers to the discount, acceptance and capital markets. However a number of long term trends have been taking place over the past ten years which were to bring about change in this system. The financial markets have been institutionalised, the principal investors in shares have turned from individuals to insurance companies, banks, pension trusts, corporations and other similar institutions. There has been a long term trend toward integration which means that the performance of a variety of activities previously the

preserve of specialist companies has been taken over within a single firm in order to provide a full range of services to clients.

### Forces for Change

The breakdown of the distinction between specialist and access institutions and the dissolution of the traditional financial system was accelerated by the following factors:

A. Deregulation: the speeding up of deregulation has two objectives, increasing competition (i.e. the number of firms operating against each other in particular financial markets) and secondly the strengthening of firms to face competition from overseas.

B. Internationalisation of the Financial Structure: this has been characterised by the integration of U.K. firms into international offshore markets and the integration of overseas financial institutions into the U.K. financial system.

C. Technology: the speed of technological innovation in financial markets has increased dramatically.

Each of these merit closer attention.

### Deregulation in the U.K.

During the 1980's the London financial markets were being increasingly bypassed by big institutional investors. Not only were British investors using foreign security firms for their purchases of overseas securities but foreign security firms operating in other countries were creating markets in British securities. For example more than 60% of the trading in I.C.I. shares in 1984 took place in New York, mostly through American brokers. It was obvious that action must be taken. The financial Big Bang started off as a change in the system of trading on the London Stock Exchange and subsequently developed into a large scale restructuring of the 'City'. The Stock Exchange changes were compounded by the introduction of the Financial Services Bill (to improve investor protection) and the Buildings Societies Act giving new powers to building societies. The original purpose behind the changes on the Stock Exchange was a desire by the government to end the system whereby competition on the exchange was restricted by fixed minimum commissions on share dealings. The government also argued that to retain a role in the growing international trading of stocks and shares the London market had to open up its membership to the increasingly powerful international financial groups. From October 27th 1986 commissions became negotiable, jobbers disappeared and were replaced by marketmakers, including brokers, who can now deal in shares as principals. Stock brokers now charge a spread between bid and

