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Money and Capital Markets – Do we use the proper definitions?

Levente KOVÁCS –Szabolcs PÁSZTOR –

Mariann VERESNÉ SOMOSI

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Research Institute of Competitiveness and Economy

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Gazdaság és Versenyképesség Kutatóintézet

1083 Budapest, Ludovika tér 2.
E-mail: gvk@uni-nke.hu

Abstract:

Our paper focuses on challenging the widely-used definitions of money and capital markets. Basically, duration is the invisible dividing line but owing to the constant development of the financial systems other features also should be taken into consideration. First, we introduce the theoretical basis on how and why the 'one-year' and 'more than one-year' differentiation was made and later we try to find the most important similarities and differences between the two markets. Finally we take into consideration those factors which affect the capital and money markets and try to give a better definition for the two in which we highlight the importance of complementarity. With our paper we intend to call the attention to the fact that from time to time we have to reconsider our old definitions and theoretical frameworks. Also, we have to adjust them to fast changing financial markets.

Keywords: financial markets, money and capital markets, economic features, complementarity

Összefoglaló: A tanulmány arra vállalkozik, hogy felhívja a figyelmet a pénz és a tőkepiacok kapcsán használt definíciók hiányosságaira. Alapvetően a rövid- és hosszú táv, tehát az időtartam alapján történik a megkülönböztetés, azonban a pénzügy rendszer fejlődésének köszönhetően más tényezőket is figyelembe kell vennünk. Elsőként arra teszünk kísérletet, hogy azt mutassuk be, hogy az egy év és több mint egy év megkülönböztetés hogyan vert gyökeret a szakirodalomban, később pedig feltárjuk a legfontosabb különbségeket és hasonlóságokat a két piac között. Végezetül figyelembe vesszük azokat a tényezőket, melyek ezen piacokat befolyásolják és megpróbálunk olyan definíciókat alkotni, melyek kiemelik a komplementaritás fontosságát. Tanulmányunkkal azt is hangsúlyozni kívánjuk, hogy időről időre át kell gondolnunk a korábbi értelmezéseinket és elméleti kereteinket, és ezeket a gyorsan változó pénzügyi piacokhoz kell igazítanunk.

Kulcsszavak: pénzügyi piacok, pénz- és tőkepiac, gazdasági jellemzők, komplementaritás

JEL: A11, G15, O16

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1. Introduction

The structure of financial markets is a constantly developing organism showing an ever-changing pattern of the weight in the overall financial market structure of its constituents such as money market, capital market and the market of financial derivatives which is the product of the two (Jasiene & Paskevicius, 2009). A number of reasons and factors are causing changes and new developments in these markets not to mention the interactions between them. Following and understanding these changes are of great importance for the investors and for the investment portfolio managers alike.
In one of our previous studies (Kovacs & Kajtor-Wieland, 2017) we were shedding more light on the legal aspects of the financial and money markets just to discover that there is no proper and widely accepted definition for the two. With the help of this paper we would like to continue the comparison and focus on the economic aspects of the differences. We think that from time to time we indeed have to rethink our definitions of money and capital markets and we also have to make a summary of the recent changes. We also argue that we have to make a differentiation between the concepts as they show different levels of resistance in case financial crises. In addition, the recent economic development and economic dynamism also necessitates the comparison as Levine and Zervos (1998) reminds us that both banks and capital markets are integral parts of a co-evolving system and they complement each other.

In the light of the above mentioned, first of all this paper tries to highlight the differences and similarities between capital markets and money markets from an economic point of view. Our aim is to better understand the two markets and to what extent they are interrelated. We also try to focus on those effects which causes similar or dissimilar changes in these markets resulting in continuous transformations. In addition, we claim that the old approach of putting an equation sign between short term and one year is too obsolete and we try to point to the fact that in the financial markets it is almost irrelevant. Also, we intend to show how they started to equate short term with one year and how it was used in case of the financial markets and investments as well. In the hope of better understanding the changes and their effects, we take into consideration those forces which have been shaping the capital and money markets and finally we try to unearth the possibilities of creating proper definitions for the two.

2. Theoretical Basis

After having browsed the relevant literature and economic textbooks for secondary school and university students, it is quite easy to point to the fact that short-term and one year are regarded the same (Fazekas, 2010a; 2010b; Solt & Lázár, 2002a; 2002b; Pearson, 2016; Mishkin, 2018; Nordhaus & Samuelson, 2019). No surprise that the younger generations of economists simply accepts this similarity and the international literature is short of those papers challenging it.

When we dig a bit deeper, and when for example it comes to the factors of production available, most textbooks argue that there is a very short run, a short run, a long run, and a very long run (Mankiw, 2019). In case of the very short run they highlight the fact that the factors of productions are fixed and cannot be changed. In the short run at least one factor of production is fixed and this is a time period of less than four or six months. In the long run all factors of production are variable and the period is greater than four or six months or one year. In the very long run every single factor of production can be changed and also the factors outside the control of the company. The period is as long as seven years (Mankiw, 2019). Basically, no proper explanation is given for the exact timeframes and the international literature is not really interested in rethinking and challenging them. However, we try to give an explanation for the 'one year or more' versus the 'less than one year' division and intend to show how it filtered into finance and investments and how it made its way in our general economic way of thinking.

First of all, we argue that centuries ago when the economies were built on mainly agriculture and agricultural activities, the most important crops had, and still has, an exact growing season which were definitely less than one year. (The seeds were bought, and planted, the harvest took place a couple of months later, and the products were sold in the local markets and from the revenue new seeds were purchased.) Also, those economies were almost closed and the communities consumed what they produced and produced what they consumed (Baldwin, 2016). At that time there were no geographical divisions between the places of production and consumption so the products were made mostly for satisfying the immediate needs of the locals. In the agrarian societies, certain crops were available for a limited period only and the inclemency of weather may have caused serious disruptions in the supply. In this way a kind of short-termism started characterising the economies activities from the very beginning: at that time it

was relatively easy to calculate the growing season and the supply available after harvesting, so it became relatively comfortable and easy to equate business activities with one year or less.

When bookkeeping became widespread, the accountants mostly pointed to the fact that there were assets which equalled cash or would be converted into cash within a year in parallel with those assets which could not be converted into cash within a year. In this respect the timeframe for short term was created and since then, mostly because of complying with accounting standards and largely because it is comfortable, we are still using it. In the terminology of the accountants, the word *current* refers to short-term and they regularly use it when they deal with *current assets* and *current liabilities*. In this way we argue that the growing importance of bookkeeping helped the spread of this distinction. Also, we have to point to the fact that there are a number of business activities which are definitely shorter than one year. These may be repeated several times in a business year and they are not always related to agriculture. In retail and animal husbandry for example the business cycle does not follow the one-year principle and in case of these activities pointing to a watershed timeframe like one year is pretty much useless.

The financial market, which is an institution or an arrangement that facilitates the exchange of not only agricultural and non-agricultural products but financial instruments as well including deposits and loans, corporate bonds and stocks, government bonds and other instruments (Gursamy, 2009), has seen a massive transformation in its role and size for many decades. As there are a lot of instruments available in this market it is quite comfortable to label those instruments short-term which could be converted into cash within a year. This kind of differentiation is still one of the most important guidelines of the financial markets as well and it is a well-known fact that the money market is regarded as a short-term market and the capital market is a long-term market (Madura, 2014). Every single section of the financial market started to be seen in this light and for example a division was made between long-term and short-term investments as well. Long term investments were/are those investments that we intend to hold for more than one year or for several years. In the light of this, we usually hold short term investments for one year or less. As we will see later, the timeframe is one of the most important indicators when it comes to comparing the two markets (money and capital) and actually this kind of comparison is poorly justified. After

doing some research it becomes obvious that finance simply followed the logic of the previously presented economic activity differentiation largely for the sake of simplicity. No matter what kind of financial instruments we are talking about, some of them simply did not exist a couple decades ago, we still highlight the importance of two types and make a differentiation between money markets and capital markets. Most of the authors claim that the timeframe is the best way of comparing the two but in the next section we try to show whether the other areas for comparison can be a better option or not.

2.1. Similarities and Differences between the Money and Capital Markets

We usually put an equation sign between the money market and the capital market as they are parts of the financial market (Weston & Copeland, 1992) but until money markets are good for depositing funds to be used in a shorter period, capital markets are good for those investors who are usually patient and not shying away from shouldering more risk. Stocks, bonds, deposits, bills of exchange, collateral loans and acceptances are those financial instruments which are used in capital markets. The institutional network of the market consists of mainly acceptance houses, commercial banks, central banks. The money markets are an unorganised aspect of the financial markets and they are unsystematic as well. It means that trading is mainly done over the counter (OTC) as the two counterparts agree to the terms.

When it comes to liquidity, money markets are important for the corporate and government entities and for the individuals as well. Operating expenses or working capital are covered by issuing short-term debts. Also when companies want to invest funds overnight or when they have to cover payroll, they turn to the money market. The main purpose of the money market is to maintain the appropriate level of liquidity of companies and governments on a daily basis at the lowest price possible. As money markets are said to be less risky than capital markets, the risk-averse investors invest funds and they can still access them as they are liquid. These markets are so safe that individuals making a fixed income also use them without encountering any types of excessive risks.

Basically, there is one obvious reason why they tend to equate the capital markets with the money markets: much data is available in the capital markets and many people follow it. Bond and stock markets are important indicators when it comes

to the general economic conditions of the world markets. In the capital markets there are non-bank financial institutions (insurance companies, mortgage banks), stock exchanges, and commercial banks. For the participants of the capital markets the long-term purposes (for example mergers and acquisitions, new line or a completely new type of business, capital projects) are vital and they try to raise capital. There are many capital markets like the bond market where companies issue corporate bonds, also governments and federal governments may issue bonds in a different bond market. Stock market is mainly for those companies which would like to raise money by issuing equity. The investors are not only buying these stocks or bonds but they trade with them. The sellers and the buyers may trade on the primary and on the secondary market as well, depending on whether the securities have been already issued or not. The buyers of securities usually use funds that are targeted for longer-term investment and large-scale projects so the capital markets are riskier than the money markets. The investors have a lengthy time horizon and they save for retirement or education.

Most of the time the differences are quite obvious between the two markets. Money markets offer safer, less risky assets and the returns are lower but at least steady. In case of the capital markets there are mainly higher-risk investments. Apart from these, we can classify the differences and point to ten well-defined areas in total.

i. *Maturity period.* The money markets are about lending and borrowing short-term finance, while the capital market is clustered around lending and borrowing long-term finance.
ii. *Credit instruments.* The main credit instruments of the money market are bills of exchange, call money, treasury bills, certificates of deposit, commercial papers, collateral loans, and acceptances while in case of the capital market there are bonds, securities, stocks, shares, debentures, and derivatives.
iii. *Nature of credit instruments.* There is a difference between the level of heterogeneity as well as the credit instruments in the capital markets are less homogeneous than in the money market. It is widely accepted that more homogeneity of credit instruments is needed for the proper operation of the financial markets as too much diversity causes problems for the investors.

iv. *Institutions.* The institutional network is also different as among others, there are bill brokers, non-bank financial institutions, acceptance houses, central banks, and commercial banks in the money market. In case of the capital market there are stock exchanges, insurance companies, mortgage banks, building societies, commercial banks, and non-bank institutions.
v. *Purpose of loan.* As the money market provides working capital for the companies, it meets the short-term credit needs of business. In case of the capital market the long-term credit needs are met and fixed capital is provided to buy machinery and land.
vi. *Risk factor.* The general level of risk is smaller in the money market than in the capital market. The reason is that the maturity of one year or even less leaves little time for a default to happen so the risk is minimised. In case of the capital market the level of risk and its nature varies quite significantly.
vii. *Basic role.* The main role of the money market is liquidity adjustment while in case of the capital market the focus is on putting capital to work related to long-term, secure and productive employment.
viii. *Relation with central bank*. Until the capital market only "feels" the influence of the central bank through the money market, the money market is directly and closely linked with the central bank of a country (Chen Wu, 2013).
ix. *Market regulation.* There is a significant level of difference between the overall regulation as the commercial banking industry is closely regulated but the institutions of the capital market are much less regulated.
x. *Accessibility.* Money markets are not easily accessible to the general public with the exception of commercial paper and certificate of deposits. Capital markets are easily accessible especially in the secondary market. Owing to the high amount of liquidity, transactions are larger and higher in volume.

Most of the cases when we talk about the money and capital markets, we point to the differences but we regard highlighting the similarities and interrelations equally important. These are clustered around *interdependence, institutional network,* and *complementarity.*

i. *Interdependence.* The money markets and capital markets are interdependent as the policies and activities of one market have a direct impact on the other. When there is a decreased demand for funds in the

capital market, the demand is also reduced in the money market. The monetary policy has a direct influence on the capital market as well.

ii. *Same institutions.* Commercial banks for example are present in both the money markets and the capital markets so we can find certain institutions which are there in both markets. We have seen this trend because of the growth of time deposits and higher rate of return on long-term loans.

iii. *Complementarity.* The money market and the capital market are not competitive, they are complementary to each other. The short-term and long-term programmes of economic development are too integrated and without a proper coordination between the short-term and long-term it would be quite difficult to manage the funds. From the investor point of view, the two markets are permeable.[1]

Bearing these differences and similarities in mind it is important to highlight that a number of factors are contributing to the continuous change of the two markets. These factors affect the different markets in various ways and lead us to rethink our views on them.

2.2. Factors affecting the money, capital and stock markets

When we try to collect the most important factors shaping the financial world, first of all we have to point to the study of Foley (1994) who classifies the factors into two major groups: global factors and internal market factors. Damodaran (2002) also tries to categorise with the help of risk factors related to the market and entities, and highlights the importance of government policies, currency exchange changes, interest rate, inflation, and various economic development indicators. Among the most important factors, Schröder (2001) points to the following macroeconomic indicators: economic development, savings, labour productivity, inflation, budget deficit. Jasiene and Paskevicius (2009) for example claim that a number of factors, such as the gross domestic product, consumer price index, the gross public debt ratio to the gross domestic product, foreign direct investment,

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[1] Complementarity is such an important feature that we have to include it when making definitions for the money and capital markets. We argue that without this feature we simply cannot understand the real difference between the two. Also, we point to the fact that the definitions in finance have been becoming more and simpler and show signs of complementarity or the basic meanings are pointing towards complementarity.

unemployment level, household savings in most general cases affect the capital and money markets in a different manner and thus produce a diversified effect upon the competitive environment. They point to the fact that the gross domestic product was making a positive effect upon the capital market, and played the role of a negative factor in the money markets. Among others they claim that in more rapidly developing countries the competition between the capital and money markets is more prominent and in a number of countries the capital and money markets develop as two systems complementing each other. Tsaurai (2018) tries to find the determinants of stock market development in emerging markets. He argues that the major factors influencing stock market development in line with empirical literature includes foreign direct investment (FDI), economic growth, infrastructural development, savings, inflation, trade openness, exchange rates, banking sector development and stock market liquidity. Ho and Lyke (2017) point to the fact that certain institutional factors like trade openness, financial liberalisation, corporate governance and legal protection of investors have a positive effect on stock market development. Macroeconomic variables such as high inflation, weak exchange rates reduce stock market growth whilst real GDP and high growth rate have a positive influence on stock market development. According to Zafar (2013) the banking sector development has a negligible impact on stock market development and the real interest rates negatively influence stock market development. Based on data from Pakistan FDI and stock market value trade positively and significantly affect stock market development. Drazenovic and Kusenovic (2016) focus on the new member countries of the European Union (EU) and they conclude that positive connection is demonstrated between financial development and economic growth of some Central and Eastern European (CEE) countries. They provide evidence for the importance of complementary development of intermediation in the capital market and in the banking sector. Also they claim that transition economies should strive to improve the development of the long-term financial market. Blurring the distinctions and strong links between banks and other financial intermediaries indirectly leads to the development of other non-bank institutional investors and development of the entire financial system as well. Levine and Zervos (1998) go so far that they include measures of macroeconomic and institutional determinants of capital market development in 42 transition countries and found positive and significant effects on economic activity. In their interpretation banks and capital markets are

integral parts of a co-evolving system and they complement each other. Darrat (1990) takes into consideration the changes in fiscal policy (government debt) to exert important effect on stock market and equity returns. His results indicate that fiscal policy plays an important role is determining stock prices in the US as changes in the stance of fiscal policy have significant effect on changes in aggregate stock prices. Darrat (1990) confirms that stock market can be seen as an important channel transmitting the influence of fiscal policy to the real side of the economy. According to Andrews (2004) the general market impacts more than half of a stock's price, while earnings account for most of the rest. Stocks, commodities and existing bond prices tend to rise in a falling interest rate environment. As Russel and Torbey (2002) argue movements in stock prices cannot be attributed only to the rational expectations of investors, but also involves an irrational component. Shleifer and Summers (1990) claim that there are two types of investors in the markets: *(i)* rational speculators or arbitrageurs who trade on the basis of information and *(ii)* noise traders who trade on the basis of imperfect information.

Many papers confirm the fact that there is a strong leading relationship between changes in money supply and stock prices. Basically, the growth rate of the money supply could serve as a leading indicator of stock price changes (Reilly & Brown, 2003). Cleary (2001) calls our attention to two interesting aspects: levels of government expenditures and taxation. He points to the fact that when there is an increase in government spending the stimulative effect on the economy is visible which is reflected in the share prices also. The cutback in spending has the opposite effect and tax increases dampen consumer spending and business profitability, while tax cuts spur the economy and boost profits and common share prices (Cleary, 2001). The previously mentioned authors, Reilly and Brown (2003) argue that stock prices reflect expectations of earnings, dividends, and interest rates. As investors attempt to estimate these future variables, their stock price decisions reflect expectations for future economic activity, not current activity.

Based on our literature review, it is clear that among the determinants of capital market development we have to point to the *(i)* legal and institutional framework, *(ii)* political and macroeconomic stability, *(iii)* broadening the pool of investors (King & Levine, 1993; Tvaronaviciene & Michailova, 2006; Yartey, 2008; Cherif & Gazdar, 2010). As for the stock markets are concerned, among others, we have

to point to the level of economic growth, interest rates, stability, confidence and expectations, related markets and the world market, bandwagon effect, price to earnings ratio(s), internal developments within companies (Mishkin, 2018). When we talk about the factors influencing the money markets, basically, we are referring to the elements of the monetary policy within which three parts are to be mentioned: *(i)* instruments, *(ii)* intermediate targets, and *(iii)* final targets. The instruments of monetary policy are required reserve ratio, open market operations and other tools, rediscount policy. The intermediate targets are money supply and interest rate. As for the final target, it is quite clear that in case of the advanced economies the primary role for monetary policy is price stability (Jing-xin & Yuan, 2012).

Bearing the above mentioned in mind, it is clear that a number of factors are affecting the money, capital, and stock markets in their own ways. Quantifying the possible effects is not in the focus of this paper and we just want to call the attention to the fact that, among a couple of other things, the influencing factors are blurring the boundaries of the durations of the financial instruments as well.

3. Results and Discussion

According to our regulations in finance and accounting, we have to follow the one-year principle even if it is not properly justified and counts to be obsolete. When claiming this, we are not referring to extending or shortening the period, instead we are pointing to a rule which is used extensively without challenging it. In economics we can find many old models and theories which count to be long-standing and actually they do not serve the purpose of understanding the current trends. Keynes (1936) has already called our attention to the fact that "*the difficulty lies not so much in developing new ideas but in escaping from old ones*" (p. viii) so in the followings we try to argue why it is irrelevant to use the old duration patter in financial markets. As we will see most of the authors refer to short-term and long-term only without mentioning the exact duration.

Cortina et al. (2016) study corporate borrowing and debt maturity and they take into consideration the effects on market access and crises. In one of the footnotes they acknowledge that there is no widely accepted benchmark of what long term is. In one of their conclusions they highlight the opaque maturity of corporate bond in case of developing countries and throughout their paper they try to highlight

that during crises financial conditions deteriorate; financing dries up and maturities shorten. In a different paper Heyman et al. (2007) focus on the mix of debt and they conclude that maturity matching between debt and the life of assets plays an important role in deciding the length of the debt maturity. Hernandez-Canovas and Koeter-Kant (2008) run an econometric analysis and suggest that the important variables determining small and medium-sized enterprises (SMEs) long-term debt include the length of the banking relationship and the number of banks involved. Alfaro and Kanczuk (2007) claim that prior to the financial crisis of 2008 many emerging market countries borrowed large amounts of short-maturity liabilities. Later they had to roll over large amounts of short-term debt to meet the payment obligations. Thus, the latest financial crisis has also contributed to the changing interpretation and relevance of short-term and long-term in international finance.

Moro et al. (2009) highlight that from the entrepreneur's point of view, short-term debt is the best financing tool because it is perceived to be cheaper. Thus, both entrepreneur and bank prefer short-term debt (Landier & Thesmar, 2009). Choe (1994) examines analytically and empirically the impact of debt maturity changes on the expected returns of common stocks. The results suggest that an increase in short-term debt which displaces the same amount of long-term debt increases the expected returns of common stocks, possibly because the substitution transfers risk from long-term debtholders to shareholders. When reading the paper, it becomes clear that the author is not focusing on giving a definition for short-term and long-term. These papers and a couple of others (Garcia-Terul & Martinez-Solano, 2007; Alfaro & Kanczuk, 2007) are using the words short-term and long-term without pointing to any type of duration. In most of the cases we readers and researchers simply follow the mental association stemming from the old textbooks and put an equation sign between short-term and one year.

When it comes to creating a more meaningful definition which better represents the ongoing changes happening in the capital and money markets, highlighting the issue of complementarity is much needed. We argue that the one-year and not one-year dichotomy had been already built on this feature and the simplicity of the approach gave rise to its popularity. We go further and we claim that for a better understanding of the two markets there is a need for thinking in dichotomies. By using them we can shed more light on the main differences and

we not only focus on the issue of duration but on other important features as well. Our recommended dichotomies are as follows:

i. In the capital markets they mostly turn to securitisation, while in case of the money markets securitisation is not common.[2]

ii. When we are pursuing long-term goals (investment loans, mortgages) we usually turn to the capital markets but in case of short-term goals we usually turn to the money markets. Bearing this in mind we can claim that the duration of our goals can be also a dividing line between the two markets.

iii. As a consequence, we can argue that the long-term goals, which are mostly about extending our business operations, are more capital market related but the sort-term goals, mainly maintaining the current level of operations, are largely related to the money markets.

iv. We have to make a differentiation between savings and investments as well. Our mental association is quite simple: savings are mostly short-term while investments are mainly long-term. Also, savings seem to be less risky and we regard them a more conservative option.

v. The connections between the participants of the capital and money markets also matter as they can be direct or indirect. In case of the money markets the connections are clear and direct while in case of the capital markets the connections are less clear and definitely not direct. Good examples are the special purpose loans as they can be used for certain purposes (buying a property or a car). However, the non-special purpose loans do not come with such an obligation.

These dichotomies help us better understand the main differences between the money and capital markets and directly point to the fact that focusing on the duration only is over-simplistic and tells less and less about the true nature of the two. When we try to give a proper definition, we definitely have to highlight that the capital and money markets complement each other in many different ways: what is true for one of them, may not be true for the other and we can better understand the differences by pointing to the existing and non-existing features.

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[2] *However it is a question whether securitisation is enough when highlighting the differences between the two markets.*

Capital markets are where there are mainly securitised assets clustered around longer-term goals with a longer duration and higher risk. Also, the connections are not clear and direct between the parties. Money markets are pretty much the complementary of these most important features.

4. Summary and Conclusion

Our study was clustered around challenging a well-known definition in finance. Capital and money markets are differentiated mostly by pointing to the average duration and we tend to say that capital markets are for long-term (usually more than one year) while money markets are for short-term (usually less than one year) transactions. Throughout the paper we argued that this approach is obsolete and after showing why the one-year principle became popular we summarized the most important similarities (ten) and differences (three) between them. The financial markets have been undergoing deep changes and understanding the nature of the changes are also of great importance. With the help of some papers we tried to shed more light on the most important factors leading to the transformation. Based on this summary and the comparison of the two markets, one feature is striking: there is a strong complementarity between the two markets. We simply cannot understand these markets separately. When rethinking the definitions we definitely have to take the feature of complementarity and other features into consideration. Finally we have created our own definition for capital and money markets and we were deliberately not focusing on the duration only but highlighted the some other features as well.

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