

# Contents

## Preface

xvii

## PART I MONEY AND FINANCE

### 1 Introduction and Overview

1

Importance of the Financial Sector 5

Savers and Borrowers 11

Economic and Financial Theory 14

Questions 15    References 16

### 2 Money and Prices

17

Money Defined 17

*What Money Is Not* 17

*What Money Is* 18

*Functions of Money* 19

Development of Money 20

*Inconvenience of Money* 21

Measures of Money 22

The Value of Money 25

*Real Values* 29

Prices 30

*Past Prices* 30

*Future Prices* 31

*Hyperinflation* 31

Money Management 35

Summary 36    Questions 36    References 37



**PART II FINANCIAL MARKETS**

<b>3</b>	<b>Financial Markets</b>	<b>38</b>
	Private Financial Market	40
	Intermediation Financial Market	42
	The Intermediation Process	45
	Classification of Financial Markets	53
	Summary	58
	Questions	59
	References	59
<b>4</b>	<b>Financial Instruments</b>	<b>60</b>
	Money-Market Instruments	65
	Capital-Market Instruments	71
	Summary	78
	Questions	78
	References	79
<b>5</b>	<b>Interest Rates and Bond Prices</b>	<b>80</b>
	What Interest Rates Are	80
	Mathematics of Interest Rates and Bond Prices	82
	<i>Present Value</i>	83
	<i>Yield to Maturity</i>	85
	<i>Current Yield</i>	93
	<i>Realized Yield</i>	94
	Summary	95
	Questions	96
	References	97
	APPENDIX 5A Duration	97
	References	104
	APPENDIX 5B Closed-Form Macaulay Duration Equations	104
<b>6</b>	<b>The Level of Interest Rates</b>	<b>106</b>
	Inflation Premium	107
	Determinants of the Interest-Rate Level	114
	<i>Loanable Funds</i>	114
	<i>Liquidity Preference</i>	116
	Interest Rates over the Business Cycle	120
	Summary	122
	Questions	122
	References	123
<b>7</b>	<b>The Structure of Interest Rates I</b>	<b>124</b>
	Term to Maturity	125
	<i>Expectations Theory</i>	126
	<i>Market-Segmentation Theory</i>	131
	<i>Yield-Curve over the Business Cycle</i>	133
	Risk of Default	135
	Summary	141
	Questions	142
	References	143

<b>8</b>	<b>The Structure of Interest Rates II</b>	<b>144</b>
	Tax Treatment	144
	Marketability	146
	Special Features—Options	146
	<i>Interrelationship Among Rates</i>	149
	Winning with Bonds	151
	Realized Returns	154
	Summary	156
	Questions	157
	References	157

### **PART III FINANCIAL INSTITUTIONS**

<b>9</b>	<b>Financial Intermediaries: An Overview</b>	<b>158</b>
	Institutions on the Private Financial Market	159
	<i>Investment Banks</i>	159
	<i>Mortgage Banks</i>	166
	Institutions on the Intermediation Financial Market: Overview	167
	Summary	171
	Questions	176
	References	176
<b>10</b>	<b>Commercial Banks</b>	<b>178</b>
	Development of Banking	178
	<i>Fractional Reserve Banking</i>	180
	<i>Bank Failure</i>	181
	<i>Capital and Liquidity</i>	183
	<i>Deposit Banking</i>	184
	Bank Balance Sheet	187
	Bank Management	192
	Summary	193
	Questions	197
	References	197
<b>11</b>	<b>More on Commercial Banks</b>	<b>199</b>
	Bank Failure	199
	Bank Structure and Organization	211
	<i>Charter</i>	212
	<i>Branching</i>	213
	<i>Holding Companies</i>	215
	<i>Bank Size</i>	219
	<i>Bank Franchising</i>	220
	<i>Structure and Performance</i>	221
	<i>U.S. Overseas Offices</i>	222
	<i>Foreign Offices in the United States</i>	223
	Summary	225
	Questions	226
	References	226

<b>12 Thrift and Insurance Intermediaries</b>	<b>228</b>
Thrift Institutions 228	
<i>Savings and Loan Associations</i> 229	
<i>Savings Banks</i> 234	
<i>Credit Unions</i> 236	
Insurance Intermediaries 237	
<i>Life Insurance Companies</i> 239	
<i>Casualty Insurance Companies</i> 241	
Summary 242    Questions 243    References 244	
 <b>13 Other Nonbank Financial Intermediaries</b>	 <b>245</b>
Investment Companies 245	
<i>Mutual and Closed-End Funds</i> 245	
<i>Money-Market Funds</i> 249	
Other Financial Intermediaries 251	
<i>Pension Funds</i> 251	
<i>Finance Companies</i> 255	
Nonfinancial Firms 257	
Summary 258    Questions 260    References 261	
 <b>14 The Payments System</b>	 <b>262</b>
Paper Transfer Systems 263	
<i>Currency</i> 263	
<i>Checks</i> 265	
<i>Credit Cards</i> 273	
Electronic Funds Transfer Systems 274	
<i>Wire Transfers</i> 274	
<i>Automated Clearinghouse</i> 275	
<i>Automated Teller Machines</i> 276	
<i>Point-of-Sale Transfers</i> 277	
Summary 280    Questions 281    References 281	
 <b>15 Depository Institutions and the Supply of Money</b>	 <b>283</b>
Currency 284	
<i>A Digression: The Case of the "Excess" Currency</i> 285	
Transaction Deposits 287	
<i>An Individual Bank</i> 287	
<i>The Banking System</i> 289	
<i>The Deposit Multiplier</i> 291	
Money Supply 295	
Summary 296    Questions 296    References 297	

APPENDIX 15A Deposit Expansion Process	297
Reference	301

## **16 Regulation of the Financial System** 302

Reasons for Regulation	303
Types of Regulation	306
<i>Safety</i>	306
<i>Structure</i>	309
<i>Money Control</i>	315
Evaluation of Regulation	315
Regulatory Agencies	318
<i>Comptroller of the Currency</i>	318
<i>Federal Reserve System</i>	320
<i>Federal Deposit Insurance Corporation</i>	320
<i>Federal Home Loan Bank System</i>	322
<i>National Credit Union Administration</i>	323
Bank Examinations	323
Summary	329
Questions	330
References	330

## **PART IV CURRENT ISSUES IN FINANCIAL MARKETS AND INSTITUTIONS**

### **17 Managing Interest-Rate Risk** 332

<i>A Hypothetical Bank Balance Sheet</i>	333
Duration Analysis	337
Managing Interest-Rate Risk	342
Practical Problems with Applying Duration Gap Analysis	346
<i>Advantages of Duration Gap Analysis</i>	350
Summary	354
Questions	354
References	355

### **18 Deposit Insurance** 356

Determination of Premiums	357
<i>Total versus Insured Deposits</i>	358
<i>Risk-Related Premiums</i>	359
Percent of Deposits Insured	361
Who Should Pay the Premiums?	366
<i>Who Pays Now?</i>	366
Who Should Provide Insurance?	368
How Should Failed Banks Be Treated?	369
The FDIC as Insurer and Regulator	373
Recent Developments in Deposit Insurance	374
Summary	376
Questions	377
References	377

<b>19</b>	<b>Deregulation and Regulatory Reform</b>	<b>379</b>
	Reform of Regulations 380	
	<i>Specialized Powers of Financial Institutions</i> 382	
	<i>Branching</i> 387	
	Reform of Regulatory Agencies 394	
	<i>The Case against Multiple Agencies</i> 396	
	<i>The Case for Multiple Agencies</i> 399	
	<i>Prospects for Reform</i> 400	
	Summary 402    Questions 402    References 403	
<b>20</b>	<b>Separation of Commercial and Investment Banking</b>	<b>405</b>
	History 405	
	The Banking Act of 1933 407	
	<i>Reasons for the Banking Act</i> 408	
	Permissible Bank Securities Activities 410	
	<i>Underwriting and Trading Securities</i> 412	
	<i>Customer Money Management Services</i> 412	
	<i>Brokerage Activities</i> 413	
	<i>Private Placements</i> 415	
	Nonpermissible Bank Securities Activities 416	
	<i>Selling Mutual Funds</i> 416	
	Should Banks Be Permitted to Expand Their Securities Activities? 417	
	<i>Competition and Concentration</i> 417	
	<i>Economies of Scale and Scope</i> 419	
	<i>Bank Stability and Risk</i> 420	
	<i>Conflict of Interest and Other Abuses</i> 421	
	Summary 422    Questions 423    References 424	
<b>21</b>	<b>The Mortgage Market</b>	<b>425</b>
	Effect of Regulation Q 427	
	The Mathematics of Mortgages 429	
	<i>Fixed-Rate Mortgage (FRM)</i> 429	
	Alternate Mortgage Plans 433	
	<i>Graduated-Payment Mortgage (GPM)</i> 434	
	<i>Variable-Rate Mortgage (VRM)</i> 435	
	<i>Price-Level-Adjusted Mortgage (PLAM)</i> 436	
	Interest-Rate Risk and Financial Intermediation 437	
	The Secondary Market 440	
	Summary 443    Questions 444    References 445	

<b>22</b>	<b>Financial Futures and Options</b>	446
	Financial Futures	446
	<i>Hedging</i>	453
	<i>Hedging Fixed-Rate Loans</i>	457
	<i>Speculating</i>	459
	<i>Forward and Futures Interest Rates</i>	459
	Financial Options	460
	Summary	464
	Questions	465
	References	465
<b>23</b>	<b>Financial Innovation</b>	467
	New Institutions	469
	New Instruments	471
	New Technology	487
	Summary	488
	Questions	489
	References	490
 <b>PART V INTERNATIONAL FINANCE</b>		
<b>24</b>	<b>Foreign Exchange Rates and the Balance of Payments</b>	491
	Exchange Rates	493
	<i>Fixed vs. Flexible Exchange Rates</i>	496
	Balance of Payments	503
	<i>U.S. Balance of Payments</i>	504
	<i>Relation to Exchange Rates</i>	505
	<i>Balance-of-Payments History</i>	506
	Summary	507
	Questions	508
	References	508
<b>25</b>	<b>International Financial Institutions and Markets</b>	510
	International Monetary Fund (IMF)	510
	<i>Borrowing Facilities</i>	511
	<i>Special Drawing Rights</i>	513
	World Bank	515
	<i>International Development Association</i>	516
	Eurodollars	516
	International Financial Markets	520
	<i>Short- and Intermediate-Term Financing</i>	521
	<i>International Bond Financing</i>	522
	Summary	523
	Questions	526
	References	526

## **PART VI MONETARY THEORY AND POLICY**

- 26 Economic Goals** 528
- The Goals of the Economy 528
    - Full Employment* 529
    - Economic Growth* 531
    - Price Stability* 533
    - Stability in the International Balance of Payments and Foreign Exchange Rates* 534
    - Equitable Distribution of Income and Wealth* 535
    - Efficiency* 537
  - Responsibility for Goals 538
  - Economic Policy 540
  - Economics and Politics 541
  - Summary 544    Questions 544    References 545
- 27 The Federal Reserve System: Purposes and Organization** 547
- Structure of the Federal Reserve 548
    - Board of Governors* 548
    - Federal Open Market Committee (FOMC)* 549
    - Regional Banks* 550
  - Independence of the Federal Reserve 552
  - Federal Reserve Balance Sheet and Reserves 554
    - Assets* 554
    - Liabilities* 556
    - Control of Reserves* 557
    - Interpreting the Balance Sheet* 558
  - Summary 560    Questions 561    References 561
- 28 The Federal Reserve System: Tools and Instruments** 563
- Quantitative Tools 564
    - Changing the Multiplier ( $k$ )* 564
    - Changing the Amount of Reserves ( $R$ )* 566
    - Target Rates of Monetary Expansion* 573
  - Qualitative Tools 575
    - Regulation Q* 575
    - Margin Requirements* 576
    - Moral Suasion* 576



<i>Minimum Down Payment</i>	577
<i>The Credit Control Program of 1980</i>	577
<i>Evaluation of Qualitative Tools</i>	578
Summary	579
Questions	580
References	580

## **29 Monetary Theories** 582

Quantity Theory	584
Keynesian Theory	589
<i>Speculative Demand for Money</i>	590
<i>Total Demand for Money</i>	592
The Supply of Money	594
Interest Rates	596
Summary	598
Questions	599
References	599

## **30 Money and Income** 600

The Financial Sector	601
The Real Sector	603
<i>Consumption</i>	603
<i>Investment</i>	606
<i>Government</i>	607
<i>Total Spending</i>	608
<i>Full-employment Income</i>	610
Summary	612
Questions	612
References	613

## **31 Monetary Policy** 614

The Strength of Monetary Policy	615
<i>Slope of the LM Function</i>	615
<i>Slope of the IS Function</i>	617
The Transmission Mechanism	619
<i>Policy Lags</i>	625
Summary	629
Questions	630
References	631

## **32 Monetary Policy in the Post-World War II Period** 632

Overview	632
1947–1960: Years of Economic Innocence	637
1960–1970: Years of Economic Experimentation and Promise	640
1970–1980: Years of Economic Pain, Frustration, and Disillusionment	644
1980–1988: Return to Stability	647
Summary	649
Questions	650
References	651

## PART VII CURRENT ISSUES IN MONETARY POLICY

### 33 Interest Rates, Indicators, and Targets 652

- Complete Money—Interest-Rate Relationship 652
  - Price-Expectations Effect* 653
  - Empirical Evidence* 657
- Indicators of Monetary Policy 657
  - Interest Rates* 659
  - Money Supply* 660
- Intermediate Targets for Monetary Policy 661
  - Interest Rates or Money Supply?* 662
  - Uncertainty in the Financial Sector* 664
  - Uncertainty in the Real Sector* 665
  - Federal Reserve Targets* 666
  - How Good Has Federal Reserve Control Been?* 669
- Fed Watching 671
- Summary 671    Questions 675    References 676

### 34 Inflation and the Phillips Curve 677

- Costs of Inflation 679
  - Aggregate Income Loss* 681
  - Income and Wealth Redistribution* 683
  - The Evidence* 684
- The Phillips Curve 689
  - Stability of the Phillips Curve* 691
  - Rational Expectations* 697
- Summary 700    Questions 700    References 701

### 35 Keynesianism, Monetarism, and Other Isms 702

- Keynesians vs. Monetarists 702
  - Differences in Transmission* 705
  - Differences in Assumptions* 712
  - Differences in Policy Recommendations* 712
- Other Monetary Theories 714
  - Availability Theory* 715
  - Bankers Theory* 716
- Summary 718    Questions 719    References 720

### Index 721

- Exhibit 7-1**    Methodology Used by Standard & Poor's to Rate Industrial Firms 138

- Exhibit 9-1** For 4 Days' Work, \$126,582 an Hour 162
- Exhibit 10-1** Life at a Bank's Money Desk 193
- Exhibit 11-1** Chronology of a Bank Failure: What Goes on Behind Closed Doors at the FDIC Before an Insured Bank's Doors Are Closed for Good 201
- Exhibit 18-1** The Failure and Rebirth of the Continental Illinois National Bank 363
- Exhibit 19-1** Bootleggers and Baptists—The Education of a Regulatory Economist 383
- Exhibit 19-2** Mixing Commerce and Banking: The German Case 388
- Exhibit 23-1** Example of Interest-Rate Swap 484
- Exhibit 25-1** ECU, Who? 524
- Exhibit 31-1** The Liquidity Trap 618
- Exhibit 31-2** Digression on Fiscal Policy, Deficits, and Crowding Out 621
- Exhibit 33-1** Life of a Fed Watcher 673
- Exhibit 34-1** Anatomy of Failure: The Collapse of Brazil's Cruzado Plan 698