

THE ECONOMICS OF
**MONEY, BANKING,
AND FINANCIAL
MARKETS**

FOURTH EDITION



FREDERIC S. MISHKIN






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P r e f a c e

The study of money, banking, and financial markets has become one of the most exciting areas in economics. Financial markets are changing rapidly, and new financial instruments appear almost daily; the once staid banking industry has become highly dynamic, and the difficulties in the savings and loan and commercial banking industries are continually featured in the media. Well-functioning international trade and financial markets have created an integrated world economy in which events in one country's financial markets have a major impact on financial markets in other countries, the conduct of monetary policy is at center stage in debates about economic policy, and new developments in monetary theory have changed the way we think about the role of money in the economy.

This fourth edition of *The Economics of Money, Banking, and Financial Markets* is a major revision that conveys these exciting developments and addresses issues of concern to instructors and students alike.

BASIC FEATURES

In writing this edition, I have continued to be guided by several basic features that have always distinguished this book from its competitors: a unifying analytic framework that stresses the economic way of thinking; careful, step-by-step development of models; an applications-oriented perspective; a thorough integration of an international perspective throughout the text; flexibility; and pedagogical aids and supplementary materials that make it easier for students to learn and instructors to teach money and banking.

A Unifying Analytic Framework

Instead of focusing on a mass of dull facts that will soon become obsolete, this textbook stresses the economic way of thinking by developing a unifying analytic framework for the study of money, banking, and financial markets. This

framework uses a few basic economic principles to organize students' thinking about the structure of financial markets, the foreign exchange market, bank management, and the role of money in the economy. The basic principles are a simplified approach to portfolio choice (what I call the *theory of asset demand*), the concept of equilibrium, an asset market approach that uses basic supply and demand analysis to explain behavior in financial markets, profit maximization, a transactions cost and asymmetric information approach to financial structure, and aggregate supply and demand analysis.

The unifying framework developed in this book not only makes the material more interesting and keeps students' knowledge from becoming obsolete, but it also discourages them from memorizing a mass of facts that will be forgotten soon after the final exam. The framework also provides students with the tools for understanding trends in the financial marketplace and in variables such as interest rates, exchange rates, inflation, and aggregate output.

An additional benefit of teaching money, banking, and financial markets with unifying analytic models is that instructors can teach the material using a modern approach based on the latest research. The model used to analyze interest rate and exchange rate determination, for example, is based on a modern asset market approach. Many other textbooks take an older approach that stresses flows rather than stocks of assets. Because the modern asset market approach is much better suited to explaining the high volatility we see in asset prices such as interest rates, exchange rates, and stock prices, it has been adopted by the economics profession in the professional literature.

To reinforce the models' usefulness, this text emphasizes the interaction of theoretical analysis and empirical data. The text and numerous special-interest boxes present evidence that supports or casts doubt on the theories being discussed. This exposure to real-life events and data should dissuade students from thinking that all economists make abstract assumptions and develop theories that have nothing to do with actual behavior.

Careful, Step-by-Step Development of Models

To help students understand and apply the unifying analytic framework, the text adopts an approach found in the best principles-of-economics textbooks: Simple models are constructed in which the variables being held constant are carefully delineated, each step in the derivation of the model is clearly and carefully laid out, and the models are then used to explain various phenomena by focusing on changes in one variable at a time, holding all other variables constant.

No other book in this market spends as much time and effort as this one does to make the models clear and easy to learn. Not only does the careful, step-by-step development of models improve students' performance in the course, but it also makes the instructor's job easier because students are less likely to have to seek extra help.

Applications-oriented Perspective

In teaching money, banking, and financial markets over the past 20 years, I have found that students get more out of the course if it is applications-oriented. This book contains more than 25 major applications that demonstrate how the analysis in the book can be used to explain many important real-world situations. There are applications on the following topics, among others: explaining the relationship between money and interest rates (Chapter 6), explaining the rise and fall of the dollar in the foreign exchange market (Chapter 8), predicting the future evolution of the financial system (Chapter 10), evaluating the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 (Chapter 13), explaining why foreign exchange crises such as the one in September 1992 occur (Chapter 22), and examining the role of credibility in recent successes in controlling inflation (Chapter 28).

To function better in the real world outside the classroom, students must be given the tools to follow the financial news that appears in leading financial publications such as the *Wall Street Journal*. Encouraging students to read the financial section of the newspaper helps them understand and apply the material covered in the money and banking course. To this end, this book contains two special features.

The first is a set of special boxed inserts titled “Following the Financial News” that contain relevant columns and data from the *Wall Street Journal* that typically appear daily or periodically. These self-contained boxes give students the detailed information and definitions they need to evaluate the data being presented.

The second feature is a set of special applications titled “Reading the *Wall Street Journal*” that elaborate on a “Following the Financial News” box. These applications show students how the analytic framework in the book can be used directly to understand the daily columns in the United States’ leading financial newspaper. They include reading the bond page (Chapter 4), the “Credit Markets” column (Chapter 6), the “Commodities” column (appendix to Chapter 6), and the “Foreign Exchange” column (Chapter 8). Once students see how to use the analytic framework by working through these applications in the textbook, they can do this analysis every day when they read the newspaper. In teaching, I bring the previous day’s *Wall Street Journal* columns into class and use them to conduct a case discussion along the lines of the “Reading the *Wall Street Journal*” applications in the text.

One important characteristic of the “Following the Financial News” boxes and the “Reading the *Wall Street Journal*” applications is that they never go out of date. Because the columns or data analyzed in these two special features typically appear daily or periodically, the information or analysis provided in these two special features will continue to prove useful to the student well into the future.

In addition to these applications, this book also contains 450 end-of-chapter problems that ask students to apply the economic concepts they have learned to other real-world issues. Particularly relevant to students are a special class of

problems headed "Using Economic Analysis to Predict the Future." The problems, half of which are answered at the back of the book, should further stimulate interest among students and help them learn the subject matter.

Thorough Integration of an International Perspective

In recent years, financial markets throughout the world have become highly integrated across national borders. In light of this development, both students and professors want to see the study of money, banking, and financial markets thoroughly internationalized. This book integrates an international perspective throughout the text.

Many books cover international material in separate chapters that are usually placed later in the book. This book, by contrast, integrates an international perspective right at the outset with discussions starting as early as Chapter 1. These self-contained sections cover issues such as the growing internationalization of financial markets (Chapter 2), basic puzzles of financial structure throughout the world (Chapter 9), international banking (Chapters 11 and 13), the conduct of monetary policy in other countries (Chapter 21), and the September 1992 foreign exchange rate crisis (Chapter 22). An additional vehicle for integrating an international perspective throughout the text is a distinctive set of more than 20 special-interest boxes (not found in other money and banking texts) titled "A Global Perspective." These boxes continually give students an international perspective by comparing the financial system and monetary policy in the United States to those in other countries. They discuss topics such as problems of financial intermediation in the countries of Eastern Europe and the former Soviet Union (Chapter 2), the globalization of financial futures markets (Chapter 10), Japanese and German banking arrangements (Chapter 11), problems in the banking industry outside of the United States (Chapter 12), the woes of Lloyd's of London (Chapter 14), and a comparison of central bank independence and macroeconomic performance in 17 countries (Chapter 18).

The book also includes two chapters that are devoted exclusively to international issues and are not relegated to the back. The discussion of the foreign exchange market appears early in the book in Chapter 8 because the early placement of this material allows a more coherent discussion of an international perspective in later chapters. Chapter 22 on the international financial system and monetary policy deals with closely related topics such as how developments in the foreign exchange market and other international financial markets affect the U.S. economy and the conduct of monetary policy.

Flexibility

In using previous editions, adopters, reviewers, and survey respondents have continually praised this text's flexibility. There are as many ways to teach money,

banking, and financial markets as there are instructors, and to satisfy the diverse needs of educators, the text achieves flexibility in a variety of ways:

- Core chapters provide the basic analysis used throughout the book, and other chapters or sections of chapters can be used or omitted according to instructor preferences. For example, Chapter 2 provides an introductory view of the financial system and basic concepts such as transactions costs, adverse selection, and moral hazard. After covering Chapter 2, an instructor can decide to teach a more detailed coverage of financial structure in Chapter 9 or choose to skip this chapter or take any of a number of different paths through the book.
- The text has also been designed to allow instructors to cover the most important issues in monetary theory and policy without having to use the *ISLM* model in Chapters 24 and 25, while more complete treatments of monetary theory make use of the *ISLM* chapters.
- The approach to internationalizing the text using both the “Global Perspective” boxes, separate international sections within chapters, and separate chapters on the foreign exchange market and the international monetary system is comprehensive yet flexible. Although many instructors will teach all the international material, others will choose not to. Instructors who want less emphasis on international topics can easily skip Chapter 8 (foreign exchange market) and Chapter 22 (international financial system and monetary policy). Instructors who would like to teach material on the foreign exchange market later in the course can easily teach Chapter 8 on the foreign exchange market just before Chapter 22 on the international financial system and monetary policy.
- In addition, because the “Global Perspective” boxes are self-contained, as are the chapter sections on international banking, internationalization of financial markets, and the conduct of monetary policy in other countries, they can also be skipped without any loss of continuity.

To illustrate how this book can be used for courses with a different emphasis, several course outlines are suggested for a semester teaching schedule. More detailed information about how the text can be used flexibly in your course is available in the *Instructor's Manual*.

General Money and Banking Course: Chapters 1–6, 11–13, 18, 20–21, 26, 28, with a choice of 6 of the remaining 16 chapters.

General Money and Banking Course with International Emphasis: Chapters 1–6, 8, 11–13, 18, 20–22, 26, 28, with a choice of 4 of the remaining 14 chapters.

Financial Markets and Institutions Course: Chapters 1–7, 9–14, 29 with a choice of 6 of the remaining 16 chapters.

Monetary Theory and Policy Course: Chapters 1–6, 15–16, 18, 20–21, 23, 26–28, with a choice of 5 of the remaining 15 chapters.

NEW TO THE FOURTH EDITION

Although the basic features and material of the previous edition have been retained, the fourth edition represents a major revision.

Further Development of an International Dimension

Because of events such as the foreign exchange crisis in September 1992 and the debate over NAFTA, professors and students have increased their demand for further internationalization of the text. To meet this demand, I have added many new major sections on international topics including international banking regulation (Chapter 13), the conduct of monetary policy in five other countries (Chapter 21), the European Monetary System (Chapter 22), and a new application on the September 1992 foreign exchange crisis (Chapter 22). In addition, I have added seven new "Global Perspective" boxes, on the globalization of financial futures markets (Chapter 10), the BCCI scandal (Chapter 13), the woes of Lloyd's of London (Chapter 14), the structure and independence of foreign central banks (Chapter 18), why there has been a worldwide decline in reserve requirements (Chapter 20), the growing European commitment to price stability (Chapter 21), and budget deficits and high inflation in Russia and other former members of the Soviet Union (Chapter 28).

Another major change is the placement of the chapter on the foreign exchange market early in the book (Chapter 8). This early placement is more logical because the foreign exchange market *is* a financial market. In addition, the early placement of this material enables instructors to give a more international slant to their course if they so choose. However, because some instructors might prefer to teach this chapter later in their course (typically right before Chapter 22 on the international financial system and monetary policy), the book has been written to make this possible with no loss of continuity.

An Integrated Approach for Understanding Financial Structure and Institutions

In the third edition of this book, I introduced the concepts of transactions costs and asymmetric information to explain the structure of our financial system and the operations of financial institutions. Reviewers and users of the book have found this new approach to thinking about financial markets and institutions quite exciting. However, because this material was so new, I did not fully integrate it into the chapters on financial institutions. With further thought, I have realized that by using an integrated approach for understanding financial structure and institutions, I could reorganize the text to make the flow of information more logical, thereby making it easier for students to see how financial institutions and markets all fit together. As a result, I have thoroughly reorganized Part III of the text.

- Transactions costs, adverse selection, and moral hazard are now introduced at the beginning of the text in Chapter 2 so that instructors can use the book more flexibly.
- The chapter on financial innovation has now been moved from the end of this part of the book to Chapter 10 in order to show how the process of financial innovation has contributed to major changes in the banking industry and to the crisis in banking regulation. It has also been revised to emphasize how changes in demand and supply conditions related to changes in information collection technology have led to financial innovation and the growth of such markets as the commercial paper and junk bond markets.
- Chapter 11 on the banking firm and bank management has a new section on capital adequacy, an increasing concern for bank managers in recent years. The link between increases in capital requirements and the credit crunch (which helped cause the 1990–1991 recession and led to a slow recovery) is also covered in this chapter.
- Chapter 12 on the banking industry has been made more dynamic with new sections on the historical development of the banking system and on how developments in transactions cost and information technology have led to a decline of the banking industry.
- The discussion of regulation is no longer spread out over several chapters as in the previous edition. Now it is discussed primarily in Chapter 13, which describes the current regulatory system and its problems. It has new sections on how asymmetric information explains the regulatory structure, international banking regulation, the response of regulation to financial innovation, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, and the Glass-Steagall separation of the banking and securities industries.
- Chapter 14 on nonbank financial institutions now has a more dynamic focus to reflect how changes in information technology have led to the rapid growth of nonbank financial institutions at the expense of banks.

Other New Material

- New material in the financial markets section of the book includes the new applications mentioned earlier on reading the *Wall Street Journal*, which teach students how to read that paper's bond page (Chapter 4), "Credit Markets" column (Chapter 6), "Commodities" column (appendix to Chapter 6), and "Foreign Exchange" column (Chapter 8), and a new appendix to Chapter 6 on applying the asset market approach to a commodities market, gold.
- The monetary theory part of the book also has new material on how developments in financial markets affect the business cycle. New sections focus on the money view versus the credit view and on the credit crunch and the slow recovery from the 1990–1991 recession.
- A new section on the *ISLM* model in the long run has been added to Chapter 25.
- Boxes, discussions of empirical evidence, and all figures and tables have been thoroughly updated, at least through the end of 1993.

An Easier Way to Teach Money, Banking, and Financial Markets

From my experience, the demands for good teaching have increased dramatically in recent years. To meet this demand, I have worked hard to provide instructors with new supplementary materials for this edition, unavailable with any competing text, that should make teaching this course substantially easier.

This edition of the book not only comes with over 200 full-color transparencies of all the figures and tables in the book (as in the previous edition) but now also makes available a full set of lecture notes on overhead transparencies. Furthermore, the *Instructor's Manual* has been thoroughly reorganized to make it easier to use and contains transparency masters of the lecture notes that are perforated so that they can be easily detached from the manual for use in class.

The lecture notes are comprehensive and outline all the major points covered in the text. They have been class-tested successfully—they are in fact the ones that I use in my class—and they should help other instructors prepare their lectures as these notes have helped me. Some instructors might use these lecture notes as their own class notes but prefer to teach from a chalkboard. Others might prefer to teach with transparencies, and the lecture notes on transparencies in combination with the full-color transparencies of the figures and tables provide the flexibility to do this.

I am also aware that many instructors want to make variations in their lectures that depart somewhat from material covered in the text. To make this easy to do, the entire set of lecture notes has been put on diskette using WordPerfect 5.1, and the diskette is included with the *Instructor's Manual*. This will allow instructors to modify the lecture notes as they see fit for their own use, for class handouts, or for transparencies to be used with an overhead projector.

The diskette also contains the entire contents of the *Instructor's Manual*, which includes chapter outlines, overviews and teaching tips, answers to the end-of-chapter problems that are not answered in the text, and discussion questions. This will make it easier for instructors to prepare handouts for their students, such as solutions to problem sets made up of end-of-chapter problems, outlines of the lecture of the day, or essay questions for homework. I have used handouts of this type in my teaching and have found them to be very effective. Instructors have my permission and are encouraged to photocopy all of the materials on the diskette and use them as they see fit in class.

PEDAGOGICAL AIDS

A textbook must be a solid motivational tool. To this end, a wide variety of pedagogical features are incorporated into this textbook.

1. *Previews* at the beginning of each chapter tell students where the chapter is heading, why specific topics are important, and how they relate to other topics in the book.

2. *Applications* demonstrate how the analysis in the book can be used to explain many important real-world situations. A special set of applications, called "Reading the *Wall Street Journal*," shows students how to read daily columns in this leading financial newspaper.
3. "*Following the Financial News*" boxes introduce students to relevant news articles and data that are reported daily in the press and explain how to read them.
4. "*Global Perspective*" boxes give students an international perspective by comparing the financial system and monetary policy in the United States to those in other countries.
5. *Special-interest boxes* highlight dramatic historical episodes, noteworthy ideas, and interesting facts related to the subject matter.
6. *Study guides*, scattered throughout the text, provide hints on how to think about or approach a topic as students work their way through it.
7. *Summary tables* serve as a useful study aid when reviewing material.
8. *Key statements* are important points set in boldface type so that students can easily find them for later reference.
9. Over 120 *graphs* with captions help students understand the interrelationship of the variables plotted and the principles of analysis.
10. A *summary* at the end of each chapter reviews the main points.
11. *Key terms* are important words or phrases, boldfaced when they are defined for the first time and listed at the end of the chapter.
12. End-of-chapter *questions and problems*, 450 of them, help students learn the subject matter by applying economic concepts, including a special class of problems that students find particularly relevant, under the heading "Using Economic Analysis to Predict the Future."
13. The *glossary* at the back of the book provides the definitions for all key terms.
14. An *answer section* at the back of the book provides the solutions to half of the questions and problems (marked by *).

SUPPLEMENTARY MATERIALS

This fourth edition of *The Economics of Money, Banking, and Financial Markets* includes the most comprehensive package of supplementary materials of any textbook in its field.

1. The *Study Guide and Workbook*, prepared by John McArthur of Wofford College and myself, includes chapter synopses and completions, exercises, problems, self-tests, and answers to the exercises, problems, and self-tests.
2. The *Instructor's Manual*, prepared by myself, includes sample course outlines, chapter outlines, answers to questions and problems in the text, and transparency masters for the lecture notes.

3. A *diskette* with the entire contents of the *Instructor's Manual* (including the lecture notes) contains WordPerfect files that can be modified to fit any particular course.
4. *Readings in Money, Banking, and Financial Markets*, edited by James W. Eaton of Bridgewater College and myself, is updated annually with over half the articles new each year to enable instructors to keep the content of their course current throughout the three-year life of an edition of the text; it will be sold with the text at a particularly low price.
5. *Custom publishing option* of the readings
6. *Money Game Computer Software*, prepared for IBM-compatible PCs by Richard Alston and Wan Fu Chi of Weber State College, provides students with hands-on experience with the analytic concepts of the text.
7. *Full-color transparencies*, numbering over 150, are provided for *all* figures, tables, and summary tables.
8. *Lecture note transparencies*, numbering over 150, comprehensively outline all points covered in the text.
9. *Electronic transparencies*
10. A *test bank*, available both in print form and on computer disks, includes over 2500 multiple-choice test items, many with graphs. The test bank is computerized so that the instructor can easily produce exams automatically.

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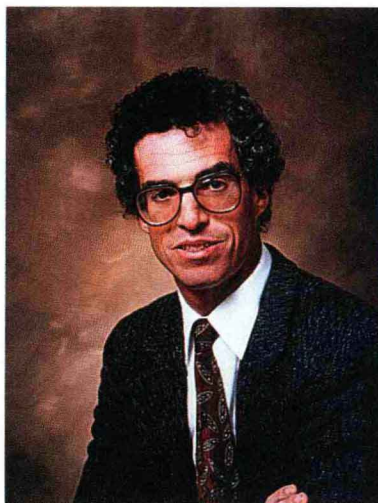
Frederic S. Mishkin

ABOUT THE AUTHOR

Frederic S. Mishkin is currently an executive vice president and director of research at the Federal Reserve Bank of New York. He is on leave from the Graduate School of Business at Columbia, where he is the A. Barton Hepburn Professor of Economics. He is also a Research Associate at the National Bureau of Economic Research. Since receiving his Ph.D. from the Massachusetts Institute of Technology in 1976, he has taught at the University of Chicago, Northwestern University, Princeton University, and Columbia.

Professor Mishkin's research focuses on monetary policy and its impact on financial markets and the aggregate economy. He is the author of *A Rational Expectations Approach to Macroeconometrics: Testing Policy Ineffectiveness and Efficient Markets Models* (Chicago: University of Chicago Press, 1983) and *Money, Interest Rates, and Inflation* (London: Edward Elgar, 1993). In addition he has published over 50 articles in such journals as the *American Economic Review*, the *Journal of Political Economy*, *Econometrica*, the *Quarterly Journal of Economics*, the *Journal of Finance*, and the *Journal of Monetary Economics*.

Similarly, Professor Mishkin has served on the editorial board of the *American Economic Review* and has been an associate editor at the *Journal of Business and Economic Statistics*. He is currently an associate editor at the *Journal of Applied Econometrics*, the *Journal of International Money and Finance*, the *Journal of Money, Credit and Banking*, and the *Journal of Economic Perspectives*. He has been an academic consultant to the Board of Governors of the Federal Reserve System, a member of the Academic Advisory Panel of the Federal Reserve Bank of New York, and a visiting scholar at the Ministry of Finance in Japan and the Reserve Bank of Australia.



The Economics of Money, Banking and Financial Markets

Fourth Edition

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Columbia University

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The fourth edition of Frederic Mishkin's *The Economics of Money, Banking, and Financial Markets* continues to build upon the foundation that has made it a market leader. Rather than giving students a mass of quickly dated facts, Mishkin provides students with simple economic concepts that build a unifying analytic framework for interpretation. This framework enables students to critically evaluate and understand such things as why and how markets are set up, as well as what role money and information play in the economy. Mishkin also provides careful, step-by-step development of models that aid in student learning. To help students apply this knowledge to the everyday world, this text is filled with applications of financial events and policy issues. This fourth edition represents a major revision that now fully prepares students to enter the global financial arena with an increased integration and focus on international events and issues. Mishkin also includes a more integrated approach for understanding financial structure and institutions, making it easier to see the dynamic nature of the financial system and the pressure for innovation. This edition also includes a revised bank management chapter that brings in the consequences of the new rules on capital adequacy, and many new real-world applications.

Chapter 5

PORTFOLIO CHOICE: THE THEORY OF ASSET DEMAND

PREVIEW

Suppose you suddenly struck it rich. Maybe you've just won \$25 million in the lottery and your first payment of \$600,000 has arrived. Or your dear departed Aunt Thelma has remembered you with a \$200,000 bequest. There are a lot of things you might want to do with this windfall: put a down payment on a mansion, buy a Ferrari, or invest in gold coins, land, Treasury bills, or AT&T stock. How will you decide what portfolio of assets you should hold to store your new-found wealth? What criteria should you use to decide among these various stores of wealth? Should you buy only one type of asset or several different types?

This chapter helps answer these questions by developing an economic theory known as the *theory of asset demand* (or the *theory of portfolio choice*). This theory outlines criteria that are important when deciding which assets are worth buying. In addition, it gives us an idea why it is good to diversify and not to put

one basket.

UNIFYING ANALYTICAL FRAMEWORK

Rather than memorizing a mass of facts that will soon go out of date, Mishkin provides students with tools for understanding which they can use during and after the course. This framework helps them organize their thinking about money, banking, and financial markets.