

FREDERIC S. MISHKIN

THIRD EDITION

FINANCIAL

MARKETS

AND

INSTITUTIONS

STANLEY G. EAKINS

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INSTITUTIONS**

FREDERIC S. MISHKIN

Graduate School of Business, Columbia University

CONTRIBUTING AUTHOR

STANLEY G. EAKINS

East Carolina University

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Financial Markets and Institutions

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TO MY DAD
— F. S. M.



TO MY WIFE, LAURIE
— S. G. E.



PREFACE

The third edition of *Financial Markets and Institutions* has been revised to match the organization of typical financial markets and institutions courses. The book continues to offer features that make it highly distinctive from other textbooks in this field. Other textbooks are almost entirely descriptive and so do not adequately prepare students either for jobs in the financial services industry or for successful interaction with financial institutions, whatever their jobs. In contrast, *Financial Markets and Institutions* provides the following features:

- A unifying analytic framework that uses a few basic principles to organize students' thinking, including:
 - asymmetric information (agency) problems
 - transaction costs
 - supply and demand
 - asset market equilibrium
 - efficient markets
 - measurement and management of risk
- A financial practitioner's approach to financial markets and institutions through emphasis of an applied managerial perspective that includes nearly 20 special applications called "The Practicing Financial Institution Manager"
- A careful step-by-step development of models that enables students to master the material more easily
- A high degree of flexibility that allows professors to teach the course however they want
- Complete integration of an international perspective throughout the text
- Special features called "Following the Financial News" and "Reading the *Wall Street Journal*" to encourage the reading of a financial newspaper
- Numerous applications that increase students' interest because it lets them apply theory to real-world data and examples

■ WHAT'S NEW IN THE THIRD EDITION

Thorough Reorganization

The book has been reorganized to follow the typical course outline of financial markets and institutions courses. We have also increased emphasis on the practitioner's approach by adopting the voice and terminology of financial practitioners rather than those of economists. Two chapters on central banking and the conduct of monetary policy (now Chapters 7 and 8) have been moved to follow the chapters on the principles of financial markets. The chapter on the foreign exchange market (now Chapter 12) has been moved to follow the chapters on money markets, capital markets, and mortgage markets, and the chapter on the international financial system (Chapter 13) now appears immediately after the foreign exchange market chapter. The rest of the chapters follow a conventional structure, except for our placing discussion of derivatives (Chapters 23 and 24) in a separate part of the book on the management of financial institutions (Part VI). Although derivatives could be taught earlier with the other material on financial markets, we believe that it is better to embark on the subject only after students understand why hedging is such an important activity for financial institutions. This will make this material not only more interesting but more relevant as well.

New Material

In addition to the expected updating of all figures, data, boxes, and discussions of empirical evidence, there is substantial new material in every part of the text, specifically:

- Extensive treatment of the crisis in East Asia, with applications on the currency crisis (Chapter 12), the sequence of events in the financial crisis (Chapter 14), and the specifics of the banking crisis in these countries (Chapter 18)
- A full discussion of recent events in the Japanese economy and why they have occurred, including the appearance of negative interest rates (Chapters 3 and 4), the recent reforms affecting the Bank of Japan and the Ministry of Finance (Chapter 7), and the banking crisis (Chapter 18)
- Recent developments in financial consolidation, especially the Citicorp-Travelers merger (Chapters 16 and 20)
- The structure and independence of the newly created European Central Bank, with updates on the change in structure and independence of the Bank of England and the Bank of Japan (Chapter 7)
- A new section on the market for reserves and the determination of the federal funds rate (Chapter 8)

- Updated coverage of credit unions, including the new laws affecting the common bond requirement (Chapter 17)
- The most recent proposals for fixing the Social Security system (Chapter 19)
- A new section on hedge funds outlining the factors that caused the near failure of Long Term Capital Management (Chapter 21)

Flexibility

There are as many ways to teach financial markets and institutions as there are instructors. Thus there is a great need to make a textbook flexible in order to satisfy the diverse needs of instructors, and that has been a primary objective in writing this book. This textbook achieves this flexibility in the following ways:

- Core chapters provide the basic analysis used throughout the book, and other chapters or sections of chapters can be assigned or omitted according to instructor preferences. For example, Chapter 2 introduces the financial system and basic concepts such as transaction costs, adverse selection, and moral hazard. After covering Chapter 2, an instructor can decide to teach a more detailed treatment of financial structure in Chapter 14, or can skip this chapter or take any of a number of different paths.
- The approach to internationalizing the text using separate, marked 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 12 (on the foreign exchange market) and Chapter 13 (on the international financial system).
- The “Practicing Financial Institution Manager” applications, as well as Part VI on the management of financial institutions, are self-contained and so can be skipped without loss of continuity. Thus an instructor wishing to teach a less managerially oriented course, who might want to focus more on public policy issues, will have no trouble doing so. Alternatively, Part VI can be taught earlier in the course, immediately after Chapter 15 on bank management.

The course outlines listed next for a semester teaching schedule illustrate how this book can be used for courses with a different emphasis. More detailed information about how the text can be used flexibly in your course is available in the *Instructor’s Resource Manual*.

Financial markets and institutions emphasis: Chapters 1–5, 9–11, 15–21, and four other chapters

Financial markets and institutions with international emphasis: Chapters 1–5, 9–13, 15–21, and two other chapters

Managerial emphasis: Chapters 1–5, 15–18, 22–24, and eight other chapters

Public policy emphasis: Chapters 1–5, 7–8, 15, 18, and eight other chapters

Making It Easier to Teach Financial Markets and Institutions

The demands for good teaching at business schools have increased dramatically in recent years. To meet these demands, we have provided the instructor with supplementary materials, unavailable with any competing text, that should make teaching the course substantially easier.

Along with the usual items in the *Instructor's Resource Manual*—sample course outlines, chapter outlines, overviews, teaching tips, and answers to the end-of-chapter problems that are not included in the text—this manual includes over 300 pages of lecture notes. The lecture notes are comprehensive and outline all the major points covered in the text. They have been class-tested successfully by the authors and should make it much easier for other instructors to prepare their lecture notes as well. The lecture notes are perforated so that they can be easily detached for class use or to make transparency masters.

This edition of the book comes with a powerful teaching tool, an *Instructor's Resource CD-ROM*. Fully compatible with the Windows 95 platform and Macintosh computers, the CD-ROM contains Word files for the entire contents of the *Instructor's Resource Manual* (including the lecture notes), PowerPoint Electronic Transparencies, and Computerized Test Bank files. Using this handy supplement, instructors can prepare student handouts such as solutions to problem sets made up of end-of-chapter problems or the outline of the lecture of the day. We have used handouts of this type in our classes and have found them to be very effective. To facilitate classroom presentation even further, the PowerPoint Electronic Transparencies include all the book's figures and tables in full color, as well as all the lecture notes; all are fully customizable. The Computerized Test Bank software (TestGen-EQ with QuizMaster-EQ for Windows and Macintosh) is a valuable test preparation tool that allows professors to view, edit, and add questions. Instructors have our permission and are encouraged to reproduce all of the materials on the CD-ROM and use them as they see fit in class.

■ SUPPLEMENTARY MATERIALS

The third edition of *Financial Markets and Institutions* includes the most comprehensive program of supplementary materials of any textbook in its field. These items are available to qualified domestic adopters but in some cases may not be available to international adopters. These include the following items:

For the Professor

1. ***Instructor's Resource Manual***, prepared by the authors, which includes sample course outlines, chapter outlines, overviews, teaching tips, and answers to questions and problems in the text. In addition it has **Lecture Notes**, numbering over 300 in transparency master format, that comprehensively outline the major points covered in the text.
2. ***Instructor's Resource CD-ROM***, which contains Word files for the *Instructor's Resource Manual*, PowerPoint Electronic Transparencies, and the Computerized Test Bank.
3. **Test Bank**, available in both print and electronic form, prepared by Michael Sullivan of Florida International University. It comprises over 2500 multiple-choice, true-false, and essay test items. The Test Bank is computerized so that the instructor can easily produce exams automatically.
4. **Mishkin-Eakins Companion Web Site** (located at <http://www.awlonline.com/mishkin-eakins>), which features links to relevant data sources and Federal Reserve Web sites. The site also offers multiple-choice quizzes for each chapter. An on-line syllabus builder allows instructors to create a calendar of assignments for each class. Users of the Companion Plus system will be able to track student activity with an electronic gradebook (see your sales representative for details).
5. **Addison Wesley Longman's Product Support Web Site** (located at <http://techsupport.awl.com>), which provides media product information and technical help for all technology-oriented supplements.

For the Student

1. **Study Guide and Workbook**, prepared by Frederick Schadler of East Carolina University, which includes chapter synopses and completions, exercises, self-tests, and answers to the exercises and self-tests.
2. **Readings in Financial Markets and Institutions**, edited by James W. Eaton of Bridgewater College and Frederic S. Mishkin. Updated annually, with over half the articles new each year, this valuable resource is available on-line at the text's Web site (www.awlonline.com/mishkin-eakins).

■ PEDAGOGICAL AIDS

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

1. **Chapter 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. **“The Practicing Financial Institution Manager”** is a set of special applications that introduce students to real-world problems that managers of financial institutions have to solve.
4. **Numerical Examples** guide students through solutions to financial problems using formulas, time lines, and calculator key strokes.
5. **Case Studies**—short “cases” appearing at the end of many chapters—take students through real-world situations in which they can apply the managerial tools they have learned in the text.
6. **“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.
7. **“Inside the Fed” Boxes** give students a feel for what is important in the operation and structure of the Federal Reserve System.
8. **Special-Interest Boxes** highlight dramatic historical episodes, interesting ideas, and intriguing facts related to the subject matter.
9. **Study Guides** are highlighted statements scattered throughout the text that provide hints on how to think about or approach a topic as students work their way through it.
10. **Summary Tables** are useful study aids for reviewing material.
11. **Key Statements** are important points that are set in boldfaced type so that the students can easily find them for later reference.
12. **Graphs** with captions, numbering over 60, help students understand the interrelationship of the variables plotted and the principles of analysis.
13. **Summary** at the end of each chapter lists the main points.
14. **Key Terms** are important words or phrases that appear in boldfaced type when they are defined for the first time and are listed at the end of the chapter.
15. **End-of-Chapter Questions and Problems**, numbering 400, help students learn the subject matter by applying economic concepts and feature a special class of problems that students find particularly relevant, titled “Predicting the Future.”
16. **Glossary** at the back of the book defines all the key terms.
17. **Solutions to Problems** at the back of the book provides the solutions to about half the questions and problems, indicated in the text by an asterisk (*).

■ ACKNOWLEDGMENTS

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Stanley G. Eakins

ABOUT THE AUTHOR

FREDERIC S. MISHKIN is the Alfred Lerner Professor of Banking and Financial Institutions in the Division of Finance and Economics at the Graduate School of Business, Columbia University. 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. From 1994 to 1997 he was executive vice president and director of research at the Federal Reserve Bank of New York and was an associate economist to the Federal Open Market Committee of the Federal Reserve System.

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); *Money, Interest Rates, and Inflation* (London: Edward Elgar, 1993); *The Economics of Money, Banking, and Financial Markets* (Reading, Mass.: Addison Wesley Longman, 1998); and co-author of *Inflation Targeting: Lessons from the International Experience* (Princeton, NJ: Princeton University Press, 1999). In addition, he has published over 100 articles in such journals as the *American Economic Review*, the *Journal of Political Economy*, *Econometrica*, the *Quarterly Journal of Economics*, the *Journal of Finance*, the *Journal of Financial Economics*, and the *Journal of Monetary Economics*.

Professor Mishkin has served on the editorial board of the *American Economic Review*, has been an associate editor at the *Journal of Business and Economic Statistics*, and was the editor of the Federal Reserve Bank of New York's *Economic Policy Review*. 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*, the *Journal of Economic Perspectives*, *International Finance*, *Macroeconomics and Monetary Economics Abstracts*, and the Federal Reserve Bank of New York *Economic Policy Review*. He has been a consultant to the Board of Governors of the Federal Reserve System, the World Bank, and the International Monetary Fund, as well as a visiting scholar at the Ministry of Finance in Japan and the Reserve Bank of Australia. He is currently on the Academic Advisory Panel of the Federal Reserve Bank of New York.



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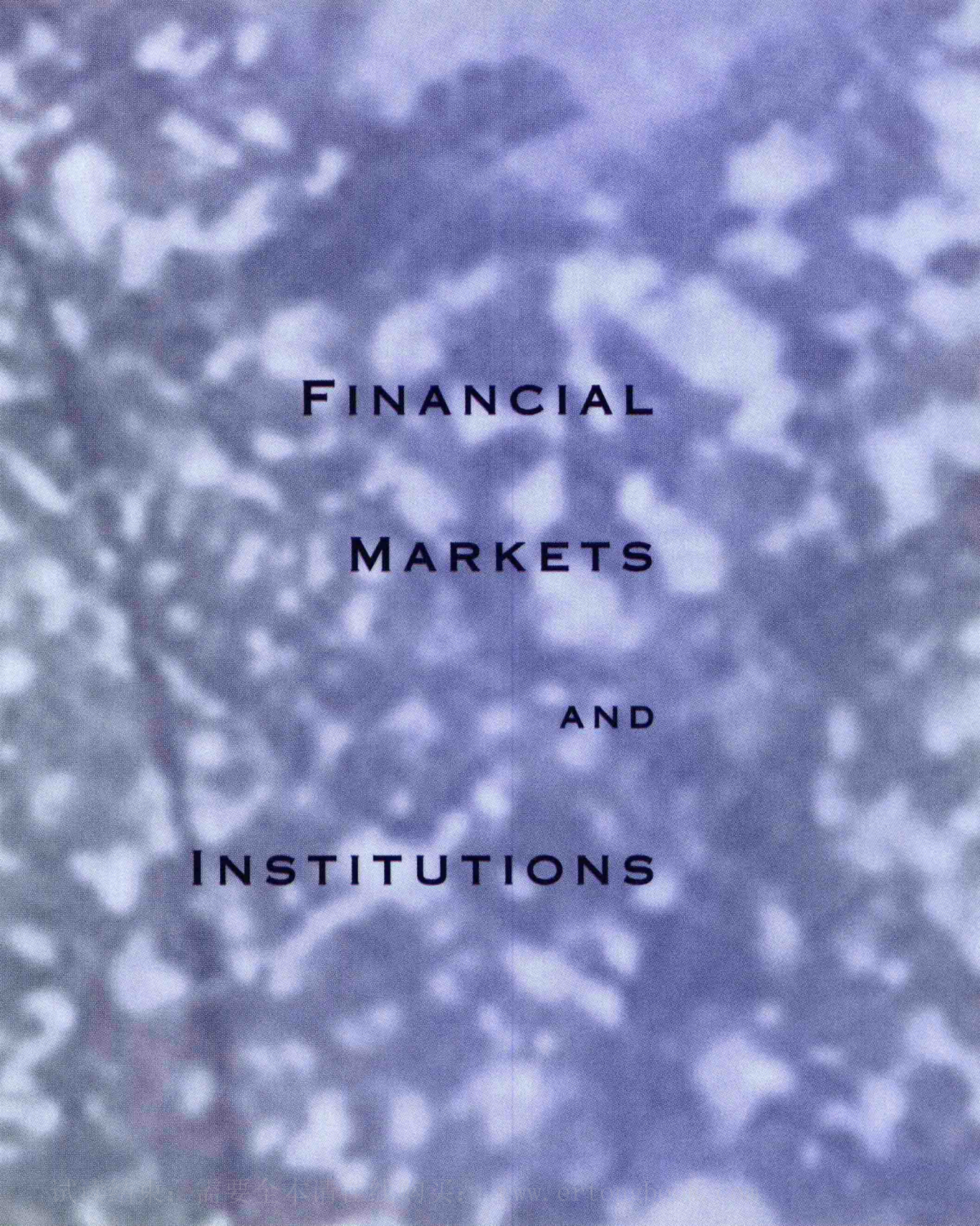
ABOUT THE CONTRIBUTING AUTHOR

STANLEY G. EAKINS has notable experience as a financial practitioner, serving as vice president and comptroller at the First National Bank of Fairbanks and as a commercial and real estate loan officer. A founder of Denali title and escrow agency, a title insurance company in Fairbanks, Alaska, he also ran the operations side of a bank and was the chief finance officer for a multi-million-dollar construction and development company.

Since receiving his Ph.D. from Arizona State University, Professor Eakins has been an associate professor at East Carolina University. His research is focused primarily on the role of institutions in corporate control and how they influence investment practices. He is also interested in integrating multimedia tools into the learning environment and has received grants from East Carolina University in support of this work.

A contributor to journals such as the *Quarterly Journal of Business and Economics*, the *Journal of Financial Research*, and the *International Review of Financial Analysis*, Professor Eakins is also the author of *Finance: Institutions, Investments, and Management* (Reading, Mass.: Addison Wesley Longman, 1999).





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