



MONEY, THIRD EDITION
BANKING, AND
THE ECONOMY

Thomas Mayer
James S. Duesenberry
Robert Z. Aliber

MONEY, BANKING, AND THE ECONOMY

THIRD EDITION

Thomas Mayer, *University of California, Davis*

James S. Duesenberry, *Harvard University*

Robert Z. Aliber, *University of Chicago*

W. W. NORTON & COMPANY
New York • London

Copyright © 1987, 1984, 1981 by W. W. Norton & Company, Inc.
ALL RIGHTS RESERVED.
PRINTED IN THE UNITED STATES OF AMERICA.

Library of Congress Cataloging-in-Publication Data

Mayer, Thomas, 1927-

Money, banking, and the economy.

Includes bibliographies and index.

1. Money—United States. 2. Banks and banking—United States. 3.
Monetary policy—United States.

I. Duesenberry, James Stemble, 1918- . II. Aliber, Robert Z. III. Title.
HG540.M39 1987 . 332.1'0973 . 86-33160

ISBN 0-393-95557-5

W. W. Norton & Company, Inc., 500 Fifth Avenue, New York, N.Y. 10110
W. W. Norton & Company Ltd., 37 Great Russell Street, London WC1B 3NU

ALSO AVAILABLE:

Study Guide to Accompany Money, Banking, and the Economy

Third Edition

by Steven Beckman and Janet L. Wolcott

Wichita State University

PREFACE

Our aim in this Third Edition remains the same as in the first two: to give a concise, up-to-date, and well-balanced picture of financial institutions, theory, and policy. That this edition looks substantially different from its predecessors reflects both continuing change in the field of money and banking and suggestions for improvement that have arisen from widespread class use of this text. We had three goals: to cut the length of the book, to clarify the presentation of theory, and to take account of all the relevant changes that have occurred in the last three years.

Length is an important concern. Money and banking courses hardly suffer from a dearth of material to be covered, but choices have to be made. As a disciplinary device, we set ourselves a goal in this edition of no more than 500 pages, a length we have found to be a realistic limit to the amount of material that can be covered in most courses.

The issue of length brought us smack up against a critical question: how much space to allocate to institutional description as opposed to monetary theory and policy. Behind that question was our awareness of the “class struggle” that sometimes arises between instructors who prefer to stress theory and policy and a class that prefers to learn about bank management, capital markets, and the operations of the Federal Reserve. This conflict is less severe than it once was. With stresses and strains in the financial system often front-page news, policy debates involve both the functioning of institutions and the theories that influence the actions of monetary authorities. So, without skimping on strictly institutional material, our book does more than describe the activities of banks, financial intermediaries, the central bank, and regulatory agencies; it pays greater attention than most other texts to the impact policy measures have on the financial sector.

The book has the following shape. Parts 1 and 2, roughly the first third, deal with financial institutions, the creation of money and bank reserves, and the measurement of money. Part 3 takes up monetary theory and inflation. The development of aggregate supply, aggregate demand, and the wage-price spiral provides a bridge to Part 4, on monetary policy. The text ends with a full part on international money and finance.

Those familiar with earlier editions will find major changes in the theory chapters, Part 3, which have been thoroughly reworked in the interests of brevity and clarity. We now focus on those parts of macroeconomic theory that relate more directly to money. Chapter 12 summarizes the income-expenditure approach and shows that the interest rate is one of the variables

determining aggregate demand. Chapter 13 deals with factors determining interest rates. One of these, important in the short run, is the demand for money, which is the topic of Chapter 14. Finally, a brief chapter, Chapter 15, pulls the analysis together by means of IS-LM analysis. We have tried to demystify the IS-LM diagram by showing both its power in summarizing Keynesian analysis and its limits with respect to changes in the price level.

Having set forth the income-expenditure approach in Chapters 12–15, we examine the quantity theory and monetarism in Chapter 16. Since teachers vary in the amount of time they spend on monetarism we have moved some of this material into an appendix to that chapter. Chapter 17 then sets the two schools in perspective, summing up the points at issue between monetarists and Keynesians. A slimmed-down version of Chapter 18, dealing with inflation, closes the theory section.

Throughout the theory chapters, we continue to stress an intuitive understanding of basic principles rather than the pyrotechnics of diagrams and equations that students tend to forget the moment the last exam is taken. Simply put, we have tried to show students how economists think about macroeconomics.

Innovations in the financial sector, new regulations on financial institutions, and new Fed policies combine to make regular updating essential. Major developments, such as the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Depository Institutions (Garn–St. Germain) Act of 1982 discussed in the Second Edition, became established history a few years later. New concerns arise, such as the problem of deposit insurance and the FSLIC, the rise of “nonbank banks,” and the speed with which state compacts on interstate banking will change.

As for updates in the policy area, the classic debate about whether the Fed should choose the money supply or long-term interest rates as its target has now been largely replaced by the choice between the money supply and GNP. We have therefore substantially expanded our discussion of the GNP target. The difficulty of predicting velocity brings up the question of whether the Fed should pay attention to a money target, or should instead simply accommodate changes in the demand for money, and led us to add a section on accommodative policy in Chapter 21.

In addition, without being trendy, we have tried to make the book reflect recent discussions in the professional journals. Rational expectations, no longer a new development but still much discussed, receives expanded attention in this edition. We continue to integrate this topic into the theory and policy discussions, in Chapters 13, 22, and 23. The proposal by some economists that we return to a system where private banks issue their own money may rank low on lawmakers’ agendas, but it raises interesting questions about money creation and inflation. We cover it in Chapter 25.

Finally, in the interest of keeping our readers abreast of new developments in regulations and policy, we will continue to issue the *Newsletter* twice yearly. This popular supplement, available from W. W. Norton, gives us a chance to continue the updating process even without writing whole new editions.

As important as touching on recent developments is our attempt to anticipate them. In our rapidly changing financial system, one thing is certain: students will emerge from school to face innovations and regulations that did not exist when they took the money and banking course. We therefore provide a chapter on the evolution of both the financial structure and its regulation. This chapter, Chapter 8, largely rewritten for this edition, should help students understand future changes as they occur.

A final comment on the distinctive features of our text. At one time international finance could be treated very briefly, since it had little direct impact on domestic monetary institutions and policy. But this is no longer the case. The United States has become a much more open economy in recent years, and monetary policy is now influenced to a much larger extent by international considerations. Accordingly, after covering the evolution of the international payments system and operations of the foreign exchange market, we conclude with whole chapters on the structure of international banking and the most recent developments in the international monetary system.

This book is organized to permit flexible use in the classroom. In general, we have tried to write chapters so that they will stand independently. This requires occasional recapitulation, but has the advantage that some chapters can readily be shifted around or omitted. For example, some instructors may want to take up the tools of monetary policy along with Part 1, or shift the chapter on Fed organization from Part 1 to Part 3. Some instructors may prefer to skip most of Chapter 24 dealing with the history of Fed policy, but assign the last part that deals with the Fed's current procedures. A short course, stressing institutions, might well omit Chapters 11 (from page 175 to 181), 13–18, and 25–26, while a course that focuses on monetary theory and policy might want to omit Chapters 3–6, 8, and 11 (from page 175 to 181), or assign them as outside reading.

A Study Guide by Steven Beckman and Janet Wolcutt of Wichita State University contains highlights, exercises, and problems for each chapter. An Instructor's Manual, prepared by us, contains a battery of multiple-choice test questions. The test questions are also available on computer diskette.

We are deeply indebted to those whose comments and suggestions have helped shape this book. For this edition, Steven Beckman of Wichita State University, Peter Frevert of the University of Kansas, Jack Gelfand of the State University of New York at Albany, Richard C. Harmstone and Peter Olsheski of Pennsylvania State University, Worthington-Scranton Campus, and Joseph Lo of the University of California at Los Angeles offered detailed critiques based on their classroom experience.

Earlier editions benefited from the comments of George Bentson, University of Rochester; William Brainard, Yale University; Philip Brock, Duke University; Karl Brunner, University of Rochester; Jonathan Eaton, Princeton University; Wilfred J. Ethier, University of Pennsylvania; Milton Friedman, Stanford University; Beverly Hadaway, University of Texas at Austin; Thomas Havrilesky, Duke University; Arnold Heggstad, University of Florida, Gainesville; Robert S. Holbrook, University of Michigan; Walter Johnson, University of Missouri, Columbia; David Laidler, University of Western

Ontario; Edmund S. Phelps, Columbia University; James L. Pierce, University of California, Berkeley; William Poole, Brown University; Uri M. Possen, Cornell University; and John Rutledge, Claremont Men's College.

Donald S. Lamm at W. W. Norton did much more for this book than any author has a right to ask of an editor. And Drake McFeely and Debra Makay, editor and manuscript editor, respectively, of the Third Edition, did a sterling job. Finally, we owe a debt to Marguerite Crown and to Ann Frischia for excellent secretarial services.

T. M.	Davis, California
J. S. D.	Cambridge, Massachusetts
R. Z. A.	Chicago, Illinois

January 1987

CONTENTS

PREFACE xi

PART 1: THE FINANCIAL STRUCTURE 1

CHAPTER 1: INTRODUCTION 3

Different Uses of the Word “Money” 3 The Functions of Money 5
Medium of Exchange Standard of Value and Deferred Payment Store of Wealth
Interaction of the Functions of Money M-1 Types of Money 9 *Nature of*
Credit Money The Cashless Society 11 Money, Near-Money, and
Liquidity 12 Summary 13 Questions and Exercises 13 Further
Reading 13

CHAPTER 2: THE FINANCIAL SYSTEM: AN OVERVIEW 15

The Role of Financial Institutions 15 *Advantages of Using Financial*
Institutions Portfolio Balance 18 *Types of Risks Diversification*
Government Supervision of Financial Institutions 22 Summary 24
Questions and Exercises 25 Further Reading 25

CHAPTER 3: THE BANKING INDUSTRY 26

A Sketch of Banking History 26 Chartering, Examination, and Fed
Membership 29 Bank Capital 32 Deposit Insurance 34 The FDIC and
Bank Failures 35 Check Clearing 38 Correspondent Banking 39
Holding Companies 39 Concentration in Banking 40 Branching 42
Social Regulations of Bank Loans 44 Summary 45 Questions and
Exercises 45 Further Reading 46

CHAPTER 4: THE BANKING FIRM 47

The Bank’s Balance Sheet 47 *Transactions Accounts Savings and Other Time*
Deposits Liabilities The Bank’s Assets 50 *Primary Reserves Securities and*
Loans Other Assets Asset and Liability Management 60 *Matching the*
Maturities of Assets and Liabilities Other Banking Activities 61
Summary 62 Questions and Exercises 63 Further Reading 63

CHAPTER 5: OTHER FINANCIAL INTERMEDIARIES 64

Thrift Institutions: A Profile 66 *Savings Banks Savings and Loan*
Associations Money-Market Funds Credit Unions Investment Portfolios of
Thrift Institutions 68 How Thrift Institutions Compete for the Consumer’s
Dollar 71 Competition for Savings 71 *Regulation Q Problems with*
Regulation Q Phasing Out Regulation Q Problems with Maturity Mismatch
Deposit Insurance Insurance and Retirement Savings 76 *Life Insurance*
Pension Funds Other Forms of Insurance Mutual Funds 78 Federal Credit
Agencies 79 Summary 81 Questions and Exercises 81 Further
Reading 81

CHAPTER 6: CAPITAL MARKETS 82

Surpluses and Deficits 83 *Financing Deficits* Capital Markets: A Profile 87 Short-Term Security Markets 87 *Commercial Paper* Bank Certificates of Deposit Functions of the Short-Term Market 90 *Balancing Cyclical Swings* Short-Term Interest-Rate Linkages Long-Term Markets 95 *Bond Markets* The Stock Market Residential Mortgage Markets Valuation in Long-Term Markets 98 *Valuing Bonds* Valuing Common Stocks Inflation and Common-Stock Prices Specialization and Competition in Long-Term Capital Markets 103 Term Structure 105 *Permanent Investors* Holding-Period Yields Expectations and Timing Rational Expectations Inflation and Term Structure Supply and Demand Factors Valuing Wealth 113 *Wealth and Government Debt* Real versus Nominal Wealth Summary 115 Questions and Exercises 116 Further Reading 116

CHAPTER 7: CENTRAL BANKING 118

The Central Bank: A Profile 118 *Origin of Central Banks* Purposes and Functions of Central Banks 119 *Controlling the Money Supply* Lender of Last Resort Core Functions Other Aspects of Central Banking The Formal Structure of the Federal Reserve System 121 *The Federal Reserve Banks* The Board of Governors The Federal Open Market Committee The Informal Structure of the Federal Reserve System 127 *Distribution of Power within the Federal Reserve* The Federal Reserve's Constituency The Federal Reserve as a Bureaucracy Finances of the Federal Reserve System 130 Federal Reserve Independence 130 *Actual Independence* Independence: Pros and Cons 132 *The Case for Independence* The Case against Independence Possible Compromises Summary 134 Questions and Exercises 135 Further Reading 135

CHAPTER 8: CURRENT ISSUES IN FINANCIAL STRUCTURE 136

Deposit Insurance: Yesterday's Success and Today's Problem 137 *The Incentive to Take Too Much Risk* Today's Incentives to Take Risk Solutions Proposed: Changes in the Deposit Insurance System Higher Capital Ratios Greater Disclosure Lowering the Insurance Ceiling Deposit Insurance in Perspective The Separation of Banking from Other Lines of Business 143 Problems with the Regulatory Structure 144 *"Competition in Laxity"* The Role of Congress in Regulation Summary 146 Questions and Exercises 146 Further Reading 147

PART 2: THE SUPPLY OF MONEY 149**CHAPTER 9: THE MEASUREMENT OF MONEY 151**

The a Priori and Empirical Approaches 151 The Measures of Money 153 Alternative Definitions and Money Substitutes 155 Measuring Money as a Weighted Aggregate 155 Refining the Money Measurements 156 How Reliable Are the Data? 156 Summary 159 Questions and Exercises 159 Further Reading 159

CHAPTER 10: THE CREATION OF MONEY 161

Currency Creation 161 Multiple Deposit Creation 162 *The Nature of Deposits* Two Special Cases: 100 Percent Reserves and 100 Percent Currency Drain How Multiple Deposit Creation Occurs The Deposit Multiplier

Multiple Deposit Contraction 166 Leakages from the Deposit Creation Process 167 *Excess Reserves Deposits into Currency Checkable Deposits into Time Deposits* From Multiplier to Stock of Deposits: The Multiplier 169 *The Money Multiplier Money Supply Theory* 170 The “New View” of Money Creation 171 Summary 173 Questions and Exercises 173 Further Reading 174

CHAPTER 11: BANK RESERVES AND RELATED MEASURES 175

Bank Reserves 175 *Factors that Increase Bank Reserves Factors that Decrease Member Bank Reserves* The Fed’s Control 180 The Reserve Base and Other Measures of Reserves 180 The Reserve Base, the Money Multiplier, and the Money Stock 182 Summary 184 Questions and Exercises 184 Further Reading 185

PART 3: MONEY, NATIONAL INCOME, AND THE PRICE LEVEL 187

CHAPTER 12: THE DETERMINANTS OF AGGREGATE DEMAND 189

Aggregate Demand Explained from the Money Side 190 The Quantity Theory Equations 191 *The Cambridge Equation The Transactions Version* The Income-Expenditure Approach: Basic Ideas 193 *Consumption Consumption and the Rate of Interest The Consumption Function Permanent Income, the Life Cycle, and Wealth* Investment 197 *The Marginal Productivity of Capital and the Pace of Investment The User Cost of Capital Output and Investment The Stability of Investment* The Interaction of Investment and Consumption: The Investment Multiplier 203 Government Expenditures, Taxes, and Exports 204 The Stability of Income 205 Summary 205 Questions and Exercises 206 Further Reading 206

CHAPTER 13: THE INTEREST RATE 207

Importance of the Interest Rate 207 Determinants of Interest Rates 208 *The Loanable Funds Approach: Supply Side The Loanable Funds Approach: Demand Side Supply and Demand in the Loanable Funds Market The Liquidity Preference Approach The Effect of Selected Variables on the Interest Rate Predicting Interest Rates* Nominal Money Supply and the Interest Rate 215 *Constant Prices Complete Price Flexibility The Effect of Taxation* The Sequence of Interest-Rate Changes: The Error-learning Model 218 *What Are Rational Expectations? The Sequence of Interest-Rate Changes: Rational Expectations* 220 *The Plausibility of Rational Expectations The Empirical Evidence More on the Real Interest Rate and Inflation* Policy Implications 223 Summary 223 Questions and Exercises 224 Further Reading 224

CHAPTER 14: THE DEMAND FOR MONEY 225

A Simple-minded Approach 225 The Transactions Approach 226 Precautionary and Speculative Demand 228 The Money Demand Function 230 Statistical Money Demand Functions 231 The Behavior of Velocity 233 Summary 235 Questions and Exercises 236 Further Reading 236

APPENDIX: A Model of Transactions Demand 236

CHAPTER 15: A COMPLETE KEYNESIAN MODEL 238

Combining the Elements 238 *The Goods and Services Market The Money Market Combining the IS and LM Curves The Slopes of the IS and LM Curves Shifts of the IS and LM Curves* Fiscal and Monetary Policies in the IS-LM Framework 246 *Fiscal Policy Monetary Policy* Summary 251 Questions and Exercises 251 Further Reading 252

APPENDIX: Flexible Prices and the IS-LM Diagram 252

CHAPTER 16: THE MONETARIST APPROACH 253

The Quantity Theory: Basic Principles 254 Development of the Quantity Theory 255 The Chicago Approach 256 *The Transmission Process Some Empirical Evidence on the Importance of Money* The St. Louis Approach 261 Some Monetarist Propositions 263 The Stability Issue 265 Summary 267 Questions and Exercises 268 Further Reading 268

APPENDIX A: The Real Balance Effect 269

APPENDIX B: The Brunner-Meltzer Model 272

CHAPTER 17: THE MONETARIST-KEYNESIAN DEBATE IN PERSPECTIVE 275

Interest Elasticities in the IS-LM Model 277 *Demand for Money Interest Elasticity of Expenditure* Recent Models 278 Policy Differences 279

CHAPTER 18: INFLATION AND UNEMPLOYMENT 281

Inflation: Definition and Types 281 *Inflations in the United States* Unemployment 283 The Phillips Curve with Expectations of Constant Prices 284 *The Expectations-augmented Phillips Curve* The Nonaccelerating Inflation Rate of Unemployment 288 The Causes of Inflation 289 *The Aggregate Demand Curve The Aggregate Supply Curve* Price Increases and Inflation: Supply-Side Shocks 291 *Relative Prices and the Price Level* Price Increases and Inflation: The Demand Side 292 *Is Money the Cause?* Policies to Fight Inflation 293 Indexing: Good or Bad? 294 The Causes of Unemployment 295 *New Classical Theory and Real Business Cycles* Summary 297 Questions and Exercises 297 Further Reading 297

PART 4: MONETARY POLICY 299

CHAPTER 19: THE GOALS OF MONETARY POLICY 301

The Goals 301 *High Employment Price Stability Economic Growth Prevention of Widespread Bank Failures and Financial Panics Interest-Rate Stability Sharing the Burden of a Restrictive Policy* Conflict Among Goals 305 What Should the Fed Do? 306 *Coordination of Monetary and Fiscal Policies The Government Budget Constraint* Summary 309 Questions and Exercises 310 Further Reading 310

CHAPTER 20: TOOLS OF MONETARY POLICY 311

Open-Market Operations 311 *Advantages of Open-Market Operations* The Discount Mechanism 314 The Discount Rate 317 *The Announcement Effect* Reserve-Requirement Changes 318 Selective Controls 318 *Stock Market Credit Consumer Credit Moral Suasion* 319 Publicity and

Advice 320 Summary 320 Questions and Exercises 321 Further Reading 321

CHAPTER 21: THE FED'S TARGETS AND INSTRUMENTS 322

Target Variables 323 *Criteria for Target Variables Potential Targets Administrative and Political Problems In Conclusion Credit or Debt Variables* 333 *Instruments The Instrument Variables Evaluation of Instruments Alternative Approaches* 336 *Accommodating versus Nonaccommodating Policy Control Theory The Nominal Income Target A Real GNP Target The Base* Summary 341 Questions and Exercises 342 Further Reading 342

CHAPTER 22: THE IMPACT OF MONETARY POLICY 343

Strength of Monetary Policy 343 The Transmission Process 343 *Portfolio Equilibrium The Keynesian Approach Impact of Money-Market Imperfections Monetary Policy and Stock Prices The MPS Model International Trade Effects* 349 *Rational Expectations* 352 *A Potential Problem: A Flexible Interest Rate on Money* 353 *Allocation Effects* 354 *The Criteria Impacted Sectors* Summary 357 Questions and Exercises 357 Further Reading 357
APPENDIX: Credit Allocation 358

CHAPTER 23: CAN COUNTERCYCLICAL MONETARY POLICY SUCCEED? 360

The Problem of Lags 361 *A Formal Model Problems Created by the Lag Empirical Estimates of the Lag Policy Tools: A Further Consideration Rational Expectations and Market Clearing* 367 *The Impact of Stabilization Policy Predicting the Effects of Policies Political and Administrative Problems* 369 Summary 372 Questions and Exercises 372 Further Reading 373

CHAPTER 24: THE RECORD OF MONETARY POLICY 374

The Early Years 374 Other Events in the 1920s 377 The Great Depression 377 Federal Reserve Policy 380 *Effects of Federal Reserve Policy Challenges to the Friedman-Schwartz Interpretation War Finance and Interest-Rate Pegging* 385 *Pegged Rates The Debate 1952 to 1969* 387 *Policy Formulation in the 1950s and 1960s 1969 to 1980* 389 *Policy Procedures in the 1970s Defending the Dollar Policy Procedures from October 1979 to August 1982 The 1981–1982 Recession and the Subsequent Recovery* 394 *Lessons from the Monetarist (?) Experiment The End of the Monetarist (?) Episode Current Goals and Targets* 399 Summary 399 Questions and Exercises 400 Further Reading 400

CHAPTER 25: ALTERNATIVE MONETARY STANDARDS 402

A Stable Money Growth Rate Rule and Other Monetarist Recommendations 402 *The Case for a Monetary Rule The Case against a Monetary Rule Some Possible Compromises Other Monetarist Policy Positions* 407 *The Gold Standard Private Money The Full-Employment Approach* Summary 410 Questions and Exercises 411 Further Reading 411

PART 5: INTERNATIONAL MONEY AND FINANCE 413

CHAPTER 26: THE EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM 415

The Gold Standard 416 *Gold and International Reserves Gold and Payments Imbalances "Rules of the Game" Gold and the Commodity Price Level* The Gold-Exchange Standard 421 The Bretton Woods System 422 *The International Monetary Fund The Activities of the International Monetary Fund* The Move to Floating Exchange Rates 426 *The Breakdown of Bretton Woods* Summary 428 Questions and Exercises 428 Further Reading 428

CHAPTER 27: THE ORGANIZATION OF THE FOREIGN EXCHANGE MARKET 429

The Market for Foreign Exchange 431 Organization of the Foreign Exchange Market 432 The Relation between the Spot Exchange Rate and the Forward Exchange Rate 434 Forward Exchange Rates as Forecasts of Future Spot Exchange Rates 437 The Level of the Exchange Rate 438 Analyzing Exchange Rate Disturbances 441 Central Bank Intervention in the Foreign Exchange Market 443 The Segmentation of National Money Markets 445 The Balance of Payments Accounts 447 Summary 452 Questions and Exercises 453 Further Reading 453

CHAPTER 28: INTERNATIONAL BANKING AND NATIONAL MONETARY POLICIES 454

The Internationalization of Commercial Banking 454 *The Eurodollar Market International Banking and Domestic Monetary Policy* The Structure of International Banking 457 Competition and Regulation in the Banking Industry 459 The Growth of Offshore Banking 461 *Interest Rates in Domestic and Offshore Banks* The Monetary Implications of Offshore Deposits 464 *Reducing the Advantages of Offshore Banks Bank Regulation and Monetary Policy* Summary 468 Questions and Exercises 469 Further Reading 469

CHAPTER 29: THE AGENDA OF INTERNATIONAL FINANCIAL ISSUES 470

Toward a New International Monetary System 470 International Monetary Developments in the Last Decade 473 *The Impact of Inflation Optimal Currency Areas and Monetary Unions 474 The European Community and Currency Unification* The Choice between Floating and Pegged Exchange Rates 477 *The Litany between Proponents of Pegged and of Floating Exchange Rates Uncertainty and Independence under a Floating-Rate System Problems of Managing an Exchange-Rate System* The System of Reserve Assets 481 Gold as International Money 482 The Dollar and Other Fiat Assets 483 The Role of Multinational Monetary Institutions 485 Summary 487 Questions and Exercises 487 Further Reading 488

INDEX 489

PART **ONE**

THE FINANCIAL STRUCTURE

Introduction

It would certainly be an exaggeration to say that *all* economic problems are the result of malfunctions in the monetary system, but some of the most important ones are. Inflation is a monetary problem in the obvious sense that it means that our monetary unit, the dollar, is losing value. It is also a monetary problem in a much less obvious way: substantial and sustained inflations have occurred only when the quantity of money has risen at a fast rate. Hence, in one sense of the much abused term *cause*, one can say that major inflations are “caused” by a rapid rise in the supply of money. Unemployment, while it has many nonmonetary aspects, is also closely connected with changes in the money supply. If the supply of money rises at a faster than expected rate, this lowers unemployment temporarily, while a sharp decrease in the quantity of money usually increases unemployment temporarily. While one may well argue about which one is cause and which is effect, most recessions since 1908 have been associated with a decline in the growth rate of the money supply. And, as we shall show, the relative growth rates of the money supply in various countries are a major factor in determining the exchange rates of their currencies.

Obviously, **monetary theory**, the theory that *deals with the relation between changes in the quantity of money, interest rates, and changes in money income*, is an important topic, and so is **monetary policy**, which is concerned with *how the quantity of money and interest rates should be managed*.

But to understand how money and monetary policy affect the economy one must know something about banks and other depository institutions. This is so because they create the major part of our money stock. In addition, financial institutions are the main providers of credit. Beyond this, there is the fact that all of us have day-to-day dealings with financial institutions and we should therefore know something about how they operate. But first a few words about money and what it does.

DIFFERENT USES OF THE WORD “MONEY”

We have used the word *money* as though it were obvious what it means, but this is far from the truth. Actually, a major reason why students often have diffi-