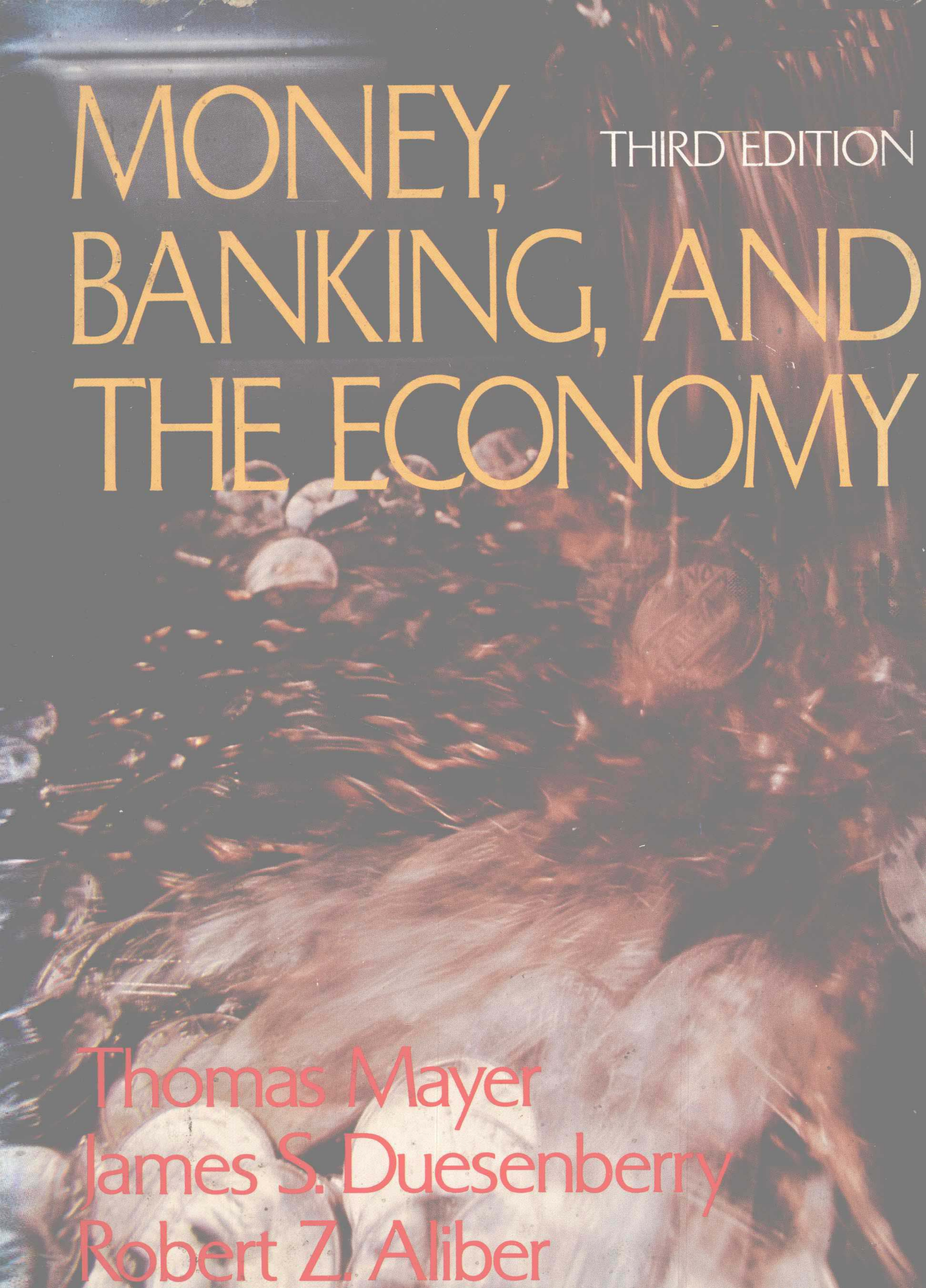

MONEY, BANKING, AND THE ECONOMY

THIRD EDITION

Thomas Mayer
James S. Duesenberry
Robert Z. Aliber

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ALSO AVAILABLE:

Study Guide to Accompany Money, Banking, and the Economy

Third Edition

by Steven Beckman and Janet L. Wolcutt
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 Decontrol 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 Heggestad, 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

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PART ONE

THE FINANCIAL STRUCTURE

CHAPTER 1

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-