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Financial Markets, Banking, and Monetary Policy

THOMAS D. SIMPSON

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To my partner in life, best friend, and wife—Cindy.

Preface

The financial system—financial markets along with commercial banks and other institutions—can be likened to a mosaic. The individual pieces appear to be dissimilar and unrelated when they are set apart. However, when they are put together, they represent a coherent and magnificent system. This system is affected in a major way by monetary policy, and monetary policy is transmitted through the financial system to the economy and inflation. The recent financial crisis and the ensuing Great Recession amply demonstrated the dependence of the economy on a well-functioning financial system. Disruptions in certain parts of the financial market spread throughout the financial system and led to the most severe economic downturn and loss of jobs since the Great Depression of the 1930s.

In this book, I introduce and develop the role of each major financial market and institution, and describe how each becomes part of the greater mosaic of the financial system. I also describe important features of central banks—which have been given primary responsibility today for achieving macroeconomic goals—and how they go about pursuing goals for inflation and the economy. A special focus is placed on the nexus of monetary policy and the financial system, most notably the commercial banking sector. While much attention is placed on the United States, the book develops principles in a generic manner that applies to other financial systems and economies.

My approach is to base the material of each chapter on sound economic principles—those developed at the principles of economics level—and to center some of the core material on the key term structure of interest rates relationship. Notably, attention is given to how the term structure relationship plays a vital role in the conduct of monetary policy. I also develop a framework for understanding financial crises and the systemic risk entailed, and how financial disturbances affect achievement of monetary policy goals. This includes an examination of the evolving integration of central banks' methods for conducting monetary and financial stability (macroprudential) policies.

This basic approach underlying the book helps to deepen reader understanding. To further help the reader, I begin each chapter with a list of points that inform the reader of what he or she will learn from the chapter, with a series of statements about the importance and everyday relevance of chapter material to motivate the reader to want to go on. Throughout the book, I have worked in the critical interconnection between financial markets and institutions, monetary policy, and performance of the economy. In addition, each chapter has a well-distilled summary. The concluding section of each chapter contains challenging questions that help the reader better learn the material and develop the ability to apply that material to new situations as they are encountered.

The book has quite a number of illustrations that are worked into the text. Some are analytical charts that I have developed to make the concepts easier for readers to understand, while others present actual data showing how concepts developed in the text work in practice.

Throughout the book, material is presented in a way that only someone with my considerable experience working in the field of financial markets, banking, and monetary policy could accomplish.

Overall, this book will take the reader to a new higher level of understanding of how the financial sector of the economy works and how monetary policy is conducted. This level of understanding will enable the reader to follow ongoing discussions of monetary policy and important financial developments that are experienced each day. For instructor materials, please go to wiley.com

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Wilmington, North Carolina
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