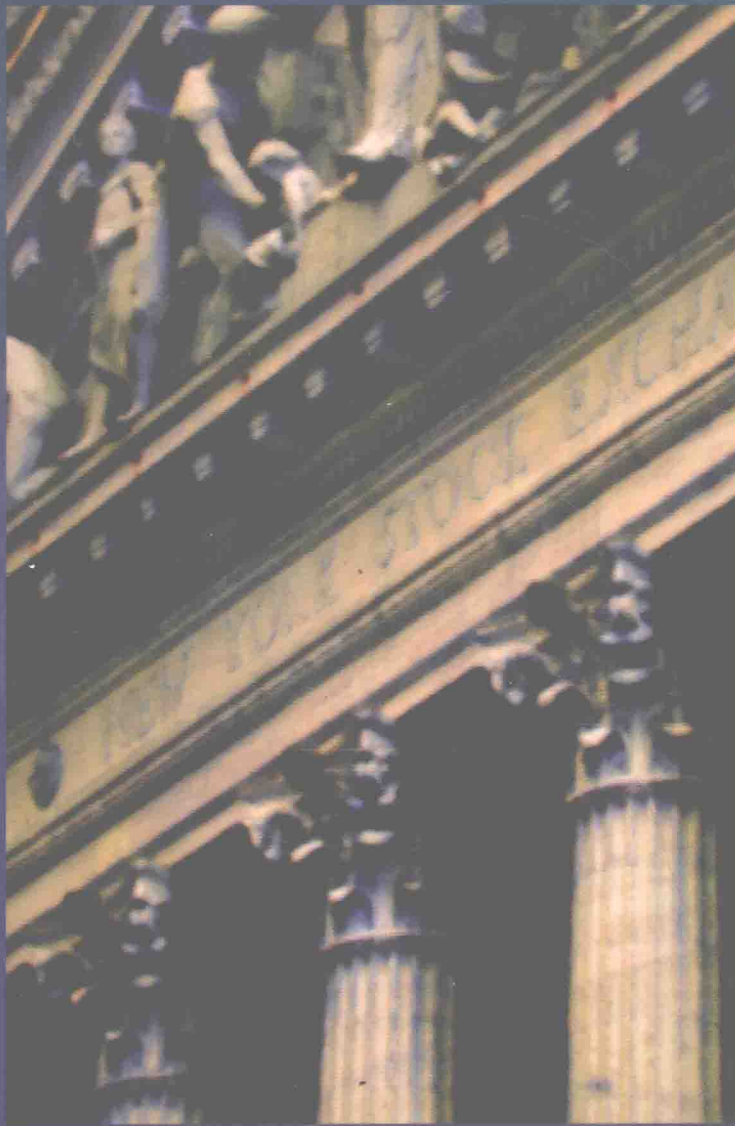


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fifth edition

Financial Markets & Institutions

Frederic S. **Mishkin**

Stanley G. **Eakins**

FIFTH
EDITION

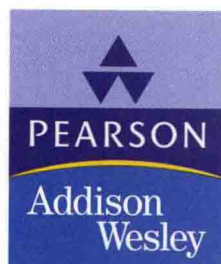
Financial Markets and Institutions

FREDERIC S. MISHKIN

*Graduate School of Business,
Columbia University*

STANLEY G. EAKINS

East Carolina University



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Financial Markets and Institutions

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Solnik/McLeavey

International Investments

To My Dad

—F. S. M.

To My Wife, Laurie

—S. G. E.

PREFACE



The fifth edition of *Financial Markets and Institutions* is a practical introduction to the workings of today's financial markets and institutions. Moving beyond the descriptions and definitions provided by other textbooks in the field, *Financial Markets and Institutions* encourages students to understand the connection between the theoretical concepts and their real-world applications. By enhancing students' analytical abilities and concrete problem-solving skills, this textbook prepares students for successful careers in the financial services industry or successful interactions with financial institutions, whatever their jobs.

To prepare students for their future careers, *Financial Markets and Institutions* provides the following features:

- A unifying analytic framework that uses a few basic principles to organize students' thinking. These principles include:
 - Asymmetric information (agency) problems
 - Conflicts of interest
 - Transaction costs
 - Supply and demand
 - Asset market equilibrium
 - Efficient markets
 - Measurement and management of risk
- "The Practicing Manager," nearly twenty hands-on applications that emphasize the financial practitioner's approach to financial markets and institutions.
- 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 in the manner they prefer
- Complete integration of international perspectives throughout the text
- "The *Wall Street Journal*: Following the News" and "Case: The *Wall Street Journal*," features to encourage the reading of a financial newspaper
- Numerous cases that increase students' interest by applying theory to real-world data and examples
- A focus on the impact of electronic (computer and telecommunications) technology on the financial system. The text makes extensive use of the Internet with Web exercises, Web sources for charts and tables, and Web references in the margins. It also features special E-Finance boxes that explain how changes in technology have affected financial markets and institutions.

What's New in the Fifth Edition

In addition to the expected updating of all data, there is major new material in every part of the text.

Conflicts of Interest

Recent corporate and accounting scandals have attracted tremendous public attention. Resulting bankruptcies have cost employees of these firms their jobs or pensions and may have played a role in the stock market crash that ensued in March 2000. Conflicts of interest—which occur when people who should act in the investing public's interests by providing reliable information have personal incentives to hide the truth—have contributed to these events. The growing concern in the financial community about the proliferation and effects of conflicts of interest has been echoed by the decision of many schools to add business ethics courses to their curriculums. To examine the impact of this issue on the financial industry, we have added a new chapter and a new set of boxes throughout the text that examine conflicts of interest.

New Chapter 16 An entirely new Chapter 16, “What Should Be Done About Conflicts of Interest in the Financial Industry?” defines conflicts of interest and explains why we should care about them. The chapter also surveys the different types of conflicts of interest in the financial services industry and discusses policies to remedy them. Placing this chapter before the chapters on the financial institutions industry in Part 6 allows us to introduce students to the basic concepts associated with this pervasive problem before we look at it in context. However, this chapter is self-contained and can be taught after Part 6 if professors prefer to cover the individual financial institutions before addressing conflicts of interest.

Conflicts of Interest Boxes To demonstrate the real-world implications of conflicts of interest, we have added a new type of box entitled “Conflicts of Interest” at key points in the discussion.

Mutual Funds

Scandals in the mutual fund industry have made headlines recently and increased students' overall interest in mutual funds. We now devote an entire chapter to this topic: Chapter 21, “The Mutual Fund Industry.” This chapter discusses the history, growth, fee structure, and investment practices of the mutual fund industry. It also addresses many of the abuses that the industry has been charged with in recent years and explains the resulting regulatory action.

Expanded Coverage of the Money, Bond, and Stock Markets

We have increased our coverage of the money, bond, and stock markets by including separate chapters for each market. The expanded content includes more detail on valuation and marketing of securities, more examples of the valuation principles, and new discussions on the growth and influence of electronic communications networks (ECNs).

Other New Material on Financial Institutions

Continuing changes in financial markets and institutions have led us to make the following additions.

- Extensive discussion of recent accounting and corporate scandals and their impact on financial markets (Chapters 5, 11, and 16)

- New section on behavioral finance, which applies concepts from other social sciences such as anthropology, sociology and particularly psychology to analyze the behavior of securities prices (Chapter 6)
- New material on Federal Reserve transparency (Chapter 7)
- Discussions of the changes (implemented in 2003) in the way the Federal Reserve administers the discount window (Chapter 8)
- An updated discussion of the market for reserves and the Federal Reserve's setting of the federal funds rate (Chapter 8)
- Perspective on the growing concerns about the safety and soundness of Fannie Mae and Freddie Mac and their accounting scandals (Chapter 12)
- Detailed discussion of mutual fund abuses including the late trading and market timing scandals by Janus, Putnam, and other prominent mutual fund families (Chapter 21)

Increased International Perspective

Given the continuing, growing importance of the global economy, we have incorporated new material with an international focus. A special “global icon” designates these text sections and cases, and “Global” boxes report on specific international developments.

New to this edition:

- Analysis of how central banks set overnight rates in other countries (Chapter 7)
- A discussion of how the euro has fared over the last six years (Chapter 13)
- Examination of problems in the Chinese banking system (Chapter 20)
- An update on developments in Argentina (Chapter 15) and in the Japanese banking industry (Chapter 20)

Streamlined Coverage and Organization

Helpful comments from reviewers have encouraged us to improve the flow and streamline the organization of the fifth edition. Thus, despite the addition of substantial new material, our text has not increased in length. Please note that we have posted deleted material that may still be of interest to readers on the book's website (as described in the next subsection).

We have given new titles to all of the chapters in Part 2 to make them more meaningful to students. Chapter 3, “Understanding Interest Rates,” has been changed to “What Do Interest Rates Mean and What Is Their Role in Valuation?” Chapter 4, “The Behavior of Interest Rates,” has been changed to “Why Do Interest Rates Change?” Chapter 5, “The Risk and Term Structure of Interest Rates,” has been changed to “How Do Risk and Term Structure Affect Interest Rates?” However, despite the title changes, the content has essentially remained the same.

Chapter 10 in the fourth edition, “The Stock Market and the Efficient Market Hypothesis,” has been split into two chapters: Chapter 6, “Are Financial Markets Efficient?” and Chapter 11, “The Stock Market.” Chapter 14 in the fourth edition, “Theory of Financial Structure,” has been renamed and is now Chapter 15, “Why Do Financial Institutions Exist?” This is the first chapter in a new part of the

book, Part 5, “Fundamentals of Financial Institutions,” which also includes the new Chapter 16 on conflicts of interest. The material in Chapters 19 through 21 in the fourth edition has been reorganized into three new chapters: Chapter 21, “The Mutual Fund Industry,” Chapter 22, “Insurance Companies and Pension Funds,” and Chapter 23, “Investment Banks, Security Brokers and Dealers, and Venture Capital Firms,” which includes the material on venture capital firms, investment banks, and brokerage firms.

New Pedagogy

In this edition, we have added a substantial number of *new* numerical problems that challenge students to use their quantitative skills to test their knowledge. In addition, a greatly enhanced set of lecture notes is available as PowerPoint presentation slides.

New Web Material

We have been able to both retain material and add new material for the book by posting content on the book’s website at www.aw-bc.com/mishkin_eakins.

Animated Graphs Narrated animated graphs and figures help students master key concepts.

Web Chapter An entire chapter devoted to finance companies and financial conglomerates, Chapter 26, “Finance Companies,” is posted on the website.

Web Appendices Appendices on the website include:

Chapter 4: Models of Asset Pricing

Chapter 4: Applying the Asset Market Approach to a Commodity Market: The Case of Gold

Chapter 4: Supply and Demand in the Market for Money: The Liquidity Preference Framework

Chapter 8: The Fed’s Balance Sheet and the Monetary Base

Chapter 14: Balance of Payments

Chapter 20: Evaluating FDICIA and Other Proposed Reforms of the Banking Regulatory System

Chapter 25: More on Hedging with Financial Derivatives

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 or conflicts of interest in Chapters 15 and 16, or can skip these chapters and 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 13 (on the foreign exchange market) and Chapter 14 (on the international financial system).
- “The Practicing Manager” applications, as well as Part 7 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 7 can be taught earlier in the course, immediately after Chapter 17 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 offer flexibility in your course is available in the *Instructor's Resource Manual*.

Financial markets and institutions emphasis: Chapters 1–5, 9–11, 15, 17, 18, 20, and six other chapters

Financial markets and institutions with international emphasis: Chapters 1–5, 9–11, 13–15, 17, 18, 20, and four other chapters

Managerial emphasis: Chapters 1–5, 17, 18, 20, 24, 25, and eight other chapters

Public policy emphasis: Chapters 1–5, 7, 8, 15, 16, 17, 20, 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 questions and quantitative problems—this manual includes over 850 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 Windows and Macintosh computers, the

CD-ROM contains Word files for the entire contents of the *Instructor's Resource Manual* (including the lecture notes), PowerPoint presentations, Computerized Test Bank files, and animated graphs. 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 presentations 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.

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. **Cases** demonstrate how the analysis in the book can be used to explain many important real-world situations. A special set of cases called "Case: The *Wall Street Journal*" shows students how to read daily columns in this leading financial newspaper.
3. **"The Practicing Manager"** is a set of special cases 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. **"The Wall Street Journal: Following the News" Boxes** introduce students to relevant news articles and data that are reported daily in the *Wall Street Journal* and explain how to read them.
6. **"Inside the Fed" Boxes** give students a feel for what is important in the operation and structure of the Federal Reserve System.
7. **"Global" Boxes** include interesting material with an international focus.
8. **"E-Finance" Boxes** relate how changes in technology have affected financial markets and institutions.
9. **"Conflicts of Interest" Boxes**, which outline conflicts of interest in different financial service industries.
10. **"Mini-Case" Boxes**, which highlight dramatic historical episodes or apply the theory to the data.
11. **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.
12. **Summary Tables** are useful study aids for reviewing material.
13. **Key Statements** are important points that are set in boldface type so that students can easily find them for later reference.
14. **Graphs** with captions, numbering over 60, help students understand the interrelationship of the variables plotted and the principles of analysis.

15. **Summaries** at the end of each chapter list the chapter's main points.
16. **Key Terms** are important words or phrases that appear in boldface type when they are defined for the first time and are listed at the ends of the chapters.
17. **End-of-Chapter Questions**, help students learn the subject matter by applying economic concepts, and feature a special class of questions that students find particularly relevant, titled "Predicting the Future."
18. **End-of-Chapter Quantitative Problems**, numbering over 250, help students to develop their quantitative skills.
19. **Web Exercises** encourage students to collect information from on-line sources or use on-line resources to enhance their learning experience.
20. **Web Sources** report the URL source of the data used to create the many tables and charts.
21. **Marginal Web References** point the student to websites that provide information or data that supplement the text material.
22. **Glossary** at the back of the book defines all the key terms.
23. **Full Solutions to the Questions and Quantitative Problems** appear in the *Instructor's Resource Manual* and on the *Instructor's Resource CD-ROM*. Professors have the flexibility to share the solutions with their students as they see fit.

Supplementary Materials

The fifth 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 complete solutions to questions and problems in the text. In addition it has **PowerPoint slides**, numbering over 850 in transparency master format, that comprehensively outline the major points covered in the text.
2. **Enhanced PowerPoint** presentation prepared by Rick Swasey (Northeastern University). The presentation, which contains the lecture notes and the complete set of figures from the textbook, has been greatly expanded from the previous edition and now contains more than 850 slides.
3. **Instructor's Resource CD-ROM**, which contains Word files for the *Instructor's Resource Manual*, PowerPoint presentations, the Computerized Test Bank, and animated graphs.
4. **Test Bank**, updated and revised by James W. Eaton (Bridgewater College), available in both print and electronic form, which 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.
5. **Mishkin-Eakins Companion Website** (located at http://www.aw-bc.com/mishkin_eakins), which features a Web chapter on finance companies, Web appendices, animated graphs, and links to relevant data sources and Federal Reserve websites. 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.

For the Student

1. **Study Guide and Workbook** (updated and revised by T. Shawn Strother, 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 numerous new articles each year, this valuable resource is available on-line at the text's website (www.aw-bc.com/mishkin_eakins).
3. **Mishkin-Eakins Companion Website** (located at www.aw-bc.com/mishkin_eakins) includes a Web chapter on finance companies, Web appendices, animated graphs, glossary flashcards, numerical and integrative mini-cases, self-assessment quizzes, Web exercises, and links from the textbook.

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Stanley G. Eakins

ABOUT THE AUTHORS



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Frederic S. Mishkin is the Alfred Lerner Professor of Banking and Financial Institutions at the Graduate School of Business, Columbia University. He is also a research associate at the National Bureau of Economic Research, a Senior Fellow at the FDIC Center for Banking Research, and is the President of the Eastern Eco-

nomic Association. 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. He has also received an honorary professorship from the People's University of China (Renmin). From 1994 to 1997 he was executive vice president and director of research at the Federal Reserve Bank of New York and an associate economist of 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 more than ten books, including *A Rational Expectations Approach to Macroeconometrics: Testing Policy Ineffectiveness and Efficient Markets Models* (University of

Chicago Press, 1983); *Money, Interest Rates, and Inflation* (Edward Elgar, 1993); *Inflation Targeting: Lessons from the International Experience* (Princeton University Press, 1999); *The Economics of Money, Banking, and Financial Markets*, 7th edition (Addison-Wesley, 2004); and has published over 100 articles in professional journals and books.

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*, *Journal of Applied Econometrics*, and the *Journal of Economic Perspectives*, and was the editor of the Federal Reserve Bank of New York's *Economic Policy Review*. He is currently an associate editor (member of the editorial board) at six academic journals: the *Journal of Money, Credit and Banking*; *Macroeconomics and Monetary Economics Abstracts*; *Journal of International Money and Finance*; *International Finance*; *Finance India*; and *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 to many central banks throughout the world. He was also a member of the International Advisory Board to the Financial Supervisory Service of South Korea. He is currently an academic consultant to and serves on the Economic Advisory Panel of the Federal Reserve Bank of New York.



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 the 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 multimillion-dollar construction and development company.

Professor Eakins received his Ph.D. from Arizona State University. He is the Associate Dean for the College of Business 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*, 2nd edition (Addison-Wesley, 2004).

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