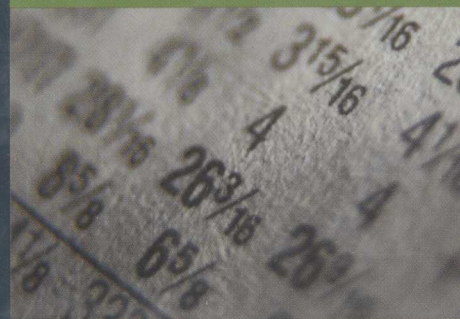


The Financial System & The Economy ^{3e}

Principles of Money & Banking



Burton & Lombra



The Financial System & The Economy

Principles of Money & Banking
3rd Edition

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To my husband, Al Gagnon,

To my daughter, Suzanne Zehntner, and

To my sisters, Mary McCarthy, Judy Burton, and Rosemarie Evans

Maureen Burton

To my wonderful children—Sherri, Brian, and Todd

Ray Lombra

Preface

Introduction to the Text

The financial system has undergone significant changes in recent years. Transformations have been driven by technological advances, deregulation, and globalization. Flexible exchange rates and the growth of international trade have escalated the development of currency markets. Financial institutions have entered nontraditional venues. Laws forbidding the mergers of banks, securities firms, and insurance companies have been overturned. Mega-mergers have occurred that have altered the scope, size, and activities of financial institutions. Changes in information and computer technologies have fostered the development of new financial instruments and products as well as new and creative ways to hedge and manage risks in a globalized environment. Managers of financial institutions must now make decisions in this new and dynamic milieu where technological innovations are the driving force.

In the early 2000s, financial market participants face new challenges as they continue to adapt to the changing political and economic environment. Even before the September 11, 2001 terrorist attacks on the World Trade Center and the Pentagon, falling stock prices raised global uncertainty while rates of economic growth among key industrialized countries slowed. The terrorist attacks further threatened the economic health of financial institutions and markets. Controversy continues over monetary policy and the Fed's response to the events of September 11, which included massive injections of reserves into the banking system, coordinated decreases in interest rates, and a currency swap agreement with the newly created European Monetary System.

Given this climate, the motivation for developing this text is twofold. First, we wish to capture the ongoing changes in the financial system, particularly with regard to technology and globalization. Second, and most importantly, we seek to present an analytical framework that enables students to understand and anticipate changes in the financial system and the accompanying changes in financial markets and institutions.

Intended Audience

The text is intended for an introductory undergraduate course in money and banking or financial markets analysis taught in either an economics or finance department. It may also be suitable for use in a financial markets course in an M.B.A. program.

Contents of the Text

The Financial System & The Economy, 3rd edition, covers the traditional material found in a money and banking text and incorporates many of the recent changes and controversies within the financial services industry.

In addition, there are several unique features to this edition including:

- greater focus on technological change and its effects on the financial system
- superior coverage of the securities industry and newly created financial holding companies

- new coverage of the efficient markets hypothesis
- expanded coverage on equity and debt markets, securities firms, and the growing use of derivatives and securitizations
- discussion of how the Fed's modus operandi has dramatically changed in recent years

The 3rd edition continues to have a clear and engaging writing style and strong intuitive approach. It avoids encyclopedic overload and seeks a balance between policy, theory, and institutions. Students will find it easy to understand and enjoyable to read. The text makes use of many examples and analogies to illustrate how financial innovation, technological and structural change, and globalization affect the financial environment. Much attention is paid to how and why institutions evolve. Graphs are used sparingly and equations are used even more sparingly.

Financial markets are evolving at a rapid pace due to changes in technology, regulations, and globalization. We do not focus on isolated facts regarding the current state of the financial system. Instead we emphasize how the current state evolved and where it is likely to be heading. We erect an analytical framework that allows students to unravel the dynamics and intricacies of the financial system.

Chapter features include examples, historical and international perspectives, and projections about the future that bring the material to life for students. Professors often view the examples that come along at the end of a lecture as a means to tie up loose ends. We view the examples and illustrations as the nails in the wall on which we hang the analysis; our experience suggests it is the real-world dimension to the text and examples that stays with students well beyond the lecture and indeed beyond the course.

A sample of topics covered in these features includes recent mega-mergers among financial institutions, changes in the payments mechanism due to technology, the new U.S. currency, the implicit guarantee of government-sponsored enterprise securities, buying and selling stocks over the Internet, the causes of the Asian crisis, Europe's new single currency, how price expectations are formed, the collapse of Barings Bank and Orange County, the current Federal Reserve Board, the use of intermediate targets since 1970, and the bailout of Long-Term Capital Management, among others.

The text contains annotated suggested readings that give the students some idea about how the readings relate to the material in the chapters. In addition, the suggested readings sections contain Internet addresses that pertain to the financial system.

Internet addresses also appear throughout the body of the text to direct students to sites relevant to the topics being discussed. Some chapters have review and analytical questions and problems that direct the student to go to an Internet address to locate and analyze financial market data. Internet applications and interactive quizzes can be found at the Web site for the text, <http://burton.swcollege.com/>.

New Chapters

Three new chapters have been added to the 3rd edition. The first is Chapter 9, "Market Efficiency." This chapter rounds out the discussions in Part II on financial prices by presenting the efficient markets hypothesis to demonstrate how prices of all financial instruments (and interest rates) are related. In addition, the chapter shows how the flow of funds among sectors changes in response to changes in financial prices that alter spending, saving, borrowing, and lending behavior among spending units.

The other new chapters—Chapter 16, “Securities Firms, Mutual Funds, and Financial Conglomerates,” and Chapter 18, “The Debt Markets”—were written to satisfy the need for additional coverage as financial institutions and financial markets evolve, particularly since the Gramm–Leach–Bliley Act became law.

Finally, the two chapters in the 2nd edition on the financial aspects of the behavior of the household, business, government, and rest-of-the-world sectors were combined into one chapter.

Organization of the Text

The Financial System & The Economy, 3rd edition, is organized in six parts.

Part I consists of a six-chapter introduction. The student is introduced to the economy, money and credit, financial intermediaries, the circular flow, the Federal Reserve System, and financial markets and products.

Part II consists of four chapters that focus on how interest rates and exchange rates (financial prices) are determined. In addition, a new chapter has been added on market efficiency that covers the efficient markets hypothesis and the flow of funds among sectors.

Part III consists of six chapters on financial institutions and the forces that shape them. The roles of technology, competition, globalization, and regulation are emphasized in a discussion of how institutions evolve. The chapters on financial innovation and financial instability have been updated. A new chapter has been added on securities firms, mutual funds, and financial conglomerates.

Part IV offers four chapters that focus on financial markets including the stock market; the debt markets; the forward, futures, and options markets; and the international financial system. As noted earlier, the chapter on debt markets is new to this edition.

Part V presents four chapters that cover monetary theory including the money supply process; the demand and supply of money and credit; the financial aspects of the behavior of households, firms, governments, and foreign sectors; and the aggregate demand and supply model.

Part VI consists of four chapters that analyze monetary policy in an increasingly globalized environment and focus on the formulation of monetary policy by the Fed Open Market Committee and subsequent execution of the policy directive by the Trading Desk of the New York Fed. The role of the Fed watcher and the growing need for international coordination are also analyzed.

This text is designed to be flexible. After completing Part I, the instructor can emphasize financial prices (Part II), financial institutions (Part III), financial markets (Part IV), monetary theory (Part V), or monetary policy (Part VI), depending on the focus of the class. In parts that are not being emphasized, chapters may be skipped.

Pedagogical Features of the Text

In addition to presenting the material in a clear and concise manner, we have incorporated the following pedagogical tools to enhance the student's understanding.

- **Learning Objectives** at the beginning of each chapter tell the student where the chapter is heading and what questions will be answered by studying the chapter.

- **Recap** sections are interspersed throughout each chapter to summarize analytical material the student should know before moving forward, and also to check if the student has mastered the preceding material.
- Highlighted features include:
 - **A Closer Look** boxes, which delve more deeply into the topic being discussed and provide enhancement material.
 - **Looking Out** boxes, which add relevant international material that emphasizes the interrelationships of global financial systems.
 - **Looking Back** boxes, which provide historical background on the foundations of current economic circumstances.
 - **Looking Forward** boxes, which make projections about possible future situations within the arena of the financial system and economies.
- **Cracking the Code** features show students how to interpret the financial pages of daily newspapers, including stock, bond, Treasury bill, mutual fund, and foreign exchange quotes, and futures and options prices.
- **Key Terms** are boldfaced in the text where they are defined and are listed at the end of each chapter. They also appear in the margins with definitions.
- **Summary of Major Points** features are chapter summaries intended to reinforce the chapter content and aid in studying for exams and quizzes, as well as provide another check for students to make sure they have not missed any important concepts.
- End-of-chapter materials include:
 - Annotated **Suggested Readings** that direct the student to related material and include relevant information available on the Internet.
 - **Review Questions, Analytical Questions, and Internet Exercises.** Questions marked with an icon can be answered with a short answer or number. Instructors may choose to use these objective questions in larger sections.

Supplements to the Text

The Financial System & The Economy offers a comprehensive and well-crafted supplements package for both students and instructors. Contact your Thomson Learning/South-Western Sales Representative for more details, or visit the Burton Web site at <http://burton.swcollege.com/>.

- **Study Guide** (ISBN: 0-324-12073-7). The study guide provides chapter outlines and review questions to reinforce learning. Features include Highlights in Detail; Terms and Concepts with definitions; Fill-in Questions by topic; True/False, Multiple Choice, and Essay Questions; and Problems, all with answers at the end of each chapter. Answers to True/False Questions, Essay Questions, and Problems include detailed explanations.
- **Instructor's Manual** (ISBN: 0-324-12074-5). This manual includes chapter summaries, teaching tips, and solutions to all end-of-chapter questions.
- **Test Bank** (ISBN: 0-324-12076-1). The test bank contains multiple choice questions for each chapter.
- **ExamView Testing Software—Computerized Testing Software** (ISBN: 0-324-12077-X). This testing software contains all of the questions in the printed test bank. The program is an easy-to-use test creation software compatible with Microsoft Windows. Instructors can add or edit questions, instructions, and answers, and select questions by previewing them on the screen, selecting them randomly, or selecting them by number. Instructors can also create and

administer quizzes online, whether over the Internet, a local area network (LAN), or a wide area network (WAN).

- **Microsoft PowerPoint™ Slides.** These user-friendly slides can serve as a lecture enhancement tool for instructors and a study aid for students. They are available on the text Web site at <http://burton.swcollege.com/>.

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