MONEY AND BANKING

Dudley G. Luckett

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Third Edition

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Preface

When I first began teaching monetary economics some twenty-five years ago, I followed the practice, common in those days, of rushing through the material on banking structure and financial markets. Banking was considered a very dull subject to teach, primarily because the practice of banking itself was so staid; very little had changed in the past twenty-five years, and it seemed unlikely that things would be much different over the next twenty-five. The exciting parts of the course were monetary theory and policy and, when one at last got to them, one began to develop delusions of grandeur: Maybe—just maybe—the students in the back row would finally wake up.

Nowadays, of course, matters are quite different. In the past few years we have been bombarded with so many institutional, political, and theoretical changes that one is hard-pressed just to stay current in the subject. Not the least of these changes is in the nature of banking, and in the innovations that have occurred in the financial markets. The institutional arrangements that were one outgrowth of the Great Depression remained stable for a remarkably long period—some forty years. They are now in the process of giving way to new arrangements. What these new institutions will be is anyone's guess, for at the very most, we can hope only to see the future through a glass, darkly. Additionally, monetary theory has changed markedly in the past few years, and, thus impelled, the conduct of monetary policy has also undergone radical change.

As a consequence of these developments, the third edition of this text is substantially different from its predecessor. To attempt to catalogue such extensive changes in the Preface would be fatuous. Instead, it should be sufficient here to suggest the underlying principles I have attempted to follow in revising the text, and to mention, briefly, what I consider the major innovations of this edition.

First the principles. The most obvious institutional change that has occurred in the past few years is the Depository Institutions Deregulation and Monetary Control Act, passed in 1980. While this act signals a very fundamental departure from past financial arrangements to people such as myself, who have been studying and researching the financial sector for many years, undergraduate students are likely to take a much more phlegmatic view of it. The act was passed, after all, when most of them were in their early adolescence, so that they became aware of banking and finance under the present institutions, not the old. Accordingly, I have attempted to integrate the Monetary Control Act into the text without making much of a fuss about it.

I have followed much the same practice when dealing with international finance, though not for the same reason. For many years, international banking and finance have been relegated to two or three prefunctory chapters toward the end of textbooks, where the whole subject could easily be ignored. Indeed, it seems safe to say that international finance has been the most widely untaught and unassigned topic in courses on money and banking. But where in the past such a practice was unexceptionable, I believe that as teachers we can no longer afford this luxury. The world economy has simply become too large, too integrated, and, in a word, too important to be treated in such a cavalier fashion. I have therefore attempted to integrate the institutional material of international finance into the mainstream of the text. International banking, for example, is discussed in Chapter 3, along with such recent developments and current trends as electronic banking and interstate banking. Only those aspects of international finance that are peculiar to the world economy (e.g., the foreign exchange markets and the International Monetary Fund) are now contained in the international finance section.

This edition of the text also contains two new chapters. The first of these, Chapter 8, discusses the time-preference theory of "the" rate of interest. The purpose of this chapter is to explain the economic function of interest rates—how they allocate resources across time. It seems to me that the current generation of students is very goal-oriented, and that consequently, as academicians, we should occasionally remind students of how the *system* works. I feel compelled to add that Chapter 8 is entirely self-contained, so that instructors who do not share my prejudices, or who are too pressed for time, may either treat this chapter as a reading assignment or omit it.

The other new chapter, Chapter 13, has to do with modern bank management. I have become increasingly dissatisfied with the discussion of bank management contained in previous editions of my text, but have searched in vain for a more contemporary treatment that would be suitable for undergraduates. In the summer of 1979 I had the pleasurable experience of working in the research department of the Federal Reserve Bank of Kansas City on precisely this topic. Chapter 13 grew out of this experience. I find it a much more satisfying description of modern banking practices, and hope that other instructors will feel the same.

Notwithstanding the very substantial changes that have been made in this edition, the original conception of the text remains unaltered. Specifically, I have continued to make occasional use of the statistical technique of regression analysis, and to discuss professional research results when this could be done gracefully at a level understandable to undergraduates. The favorable response given this approach by instructors and students alike persuades me not only that the approach is viable, but also that it is the path undergraduate economics must take if the discipline is to be made believable to the public generally.

I would like to extend more than merely token thanks to the people who have assisted me in revising this book. Among these, Tom Boggess has been particularly helpful. Tom spent a summer as my research assistant, and his aid in updating tables, figures, and other data was invaluable. Among those who were kind enough to comment on various parts of the book, I would like to thank, without implicating, James A. Stephenson of Iowa State University; Frank Zarnowski of Mt. St. Mary's College, Maryland; Vinod P. Maniyar of Christopher Newport College; Donald B. Billings of Boise State University.

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PART 1

INTRODUCTION

The purpose of Chapter 1 is to introduce the remainder of the book. To be candid, introductions are usually a bore; they tell you what they are going to tell you, rather than telling you what they're telling you. Students may understandably become impatient at being treated like this, especially since the book was bought with their money. Nevertheless, *some* introduction is necessary if for no other reason than that the reader needs to have an initial orientation to the material. Without such an orientation, it is possible to become lost among the trees of finance and consequently never see the forest of monetary policy.

Beyond this, Chapter 1 will also serve to introduce the reader to the method of contemporary economics. Like other applied areas in economics, the field of money and banking rests to a considerable extent on factual evidence. The following chapter attempts to explain the sorts of evidence economists find persuasive. For those students with no background at all in statistics, an appendix is provided at the end of Chapter 1 that explains a few basic statistical concepts in very elementary terms. The Appendix is meant to be read by those students who need it but not discussed by the instructor. It is sufficient for an understanding of the remainder of the book.

1 Introduction and Plan of Book

As the title implies, this book is about two things: It is about the role played by *money* in the economy, and it is about *banking*.[1] It is necessary to emphasize the dual purpose of the book at the outset in order to avoid confusion. For while the subjects of money and banking are closely related to one another, they are not inseparable. One could study money—or, more generally, monetary policy—with only a sketchy understanding of commercial banking. And, by the same token, one could study banking—or, more generally, depository financial institutions—while having only a limited knowledge of monetary policy. This book, however, deals with both topics. And therein lies a danger.

The danger is that readers may become so enmeshed in the details of one topic that they lose sight of the other. This danger is particularly acute in the study of depository institutions (DIs). The inner workings of the financial machinery of the United States is a subject of considerable interest for many people. And it is all too easy to become so involved with the details of finance that one loses sight of monetary policy. Accordingly, the purpose of this chapter is to orient the reader with respect to the way that money and banking fit together.

[1] More properly, the book is about money and *depository institutions*—i.e., financial institutions that hold the checking deposits of the public. Traditionally, however, the subject has been called "money and banking" (banks are by far the main type of depository institution).

1-1 AN OUTLINE OF MONETARY POLICY

How monetary policy works can be understood in very general terms with the aid of Figure 1-1. The reader should become familiar with this figure since it will be referred to again in the introduction to most of the remaining nine parts of the book. Its purpose is to keep the reader oriented with respect to the way the material of each part fits into the overall structure of monetary policy.

Look first at the extreme right-hand side of Figure 1-1, at the box numbered "7" on top. (For the moment, ignore the letters along the bottom of the figure.) This box represents the *macroeconomy*, that is, aggregate economic activity. Our concern with the macroeconomy ultimately lies in the behavior of various performance indicators such as the price level, percentage of the labor force that is unemployed, and rate of economic growth. Naturally, we would like to have these performance indicators behave as well as they can; that is, we would like to have a stable price level (no inflation), full employment (no involuntary unemployment), and so forth. But bear in mind that the United States has a free-enterprise economy, which means that these goals cannot be attained through *direct* governmental intervention. In our economy, the government cannot tell businesses what prices they must charge or how many people they must hire. Some other, *indirect* method must therefore be found to achieve these goals. This is where monetary policy comes in.

In the United States, the governmental agency charged with the formulation and execution of monetary policy is the Federal Reserve System. The

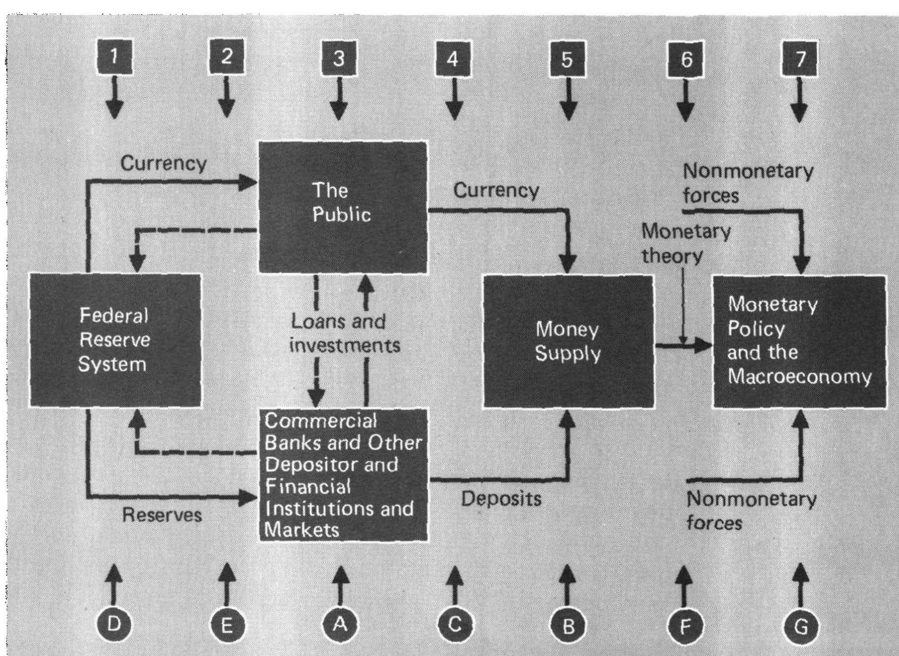

Figure 1-1
Schematic of monetary policy.