Financial Institutions, Markets, and Money

Second Edition

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Preface

Training in the areas of money and banking and financial institutions has long been recognized as an important part of the curriculum in both business schools and economics departments. Traditionally, these courses have been taught with a macroeconomic emphasis stressing the effects of monetary policy on the United States economy, placing a secondary emphasis on the institutions and markets forming its financial system.

Because of the dramatic changes that have occurred in the U.S. financial system in recent years, it is our belief that, at the introductory level, a student should receive a balanced view of the system and its major participants. By a balanced view, we mean that emphasis should be given to the student's understanding of all financial institutions, financial markets, and financial instruments—not just banks and monetary policy. We feel that such an approach will accommodate the educational and professional needs of a greater number of students. Those who are majoring in finance or economics can take specialized courses, such as monetary theory or management of financial institutions, at a more advanced level. Our book provides the background for students to pursue more advanced training.

Thus, the goal of this textbook is to give the student a broad introduction to the operation, mechanics, and structure of the financial system within the United States, emphasizing its institutions, markets, and instruments. The Federal Reserve System and monetary policy are also given special attention. We stress the impact of monetary policy on the economy and on the operation of financial institutions.

This book is intended for use as a primary text in a school of business administration for a first course in financial institutions or the financial system. The book is also appropriate for an introductory money and banking course in a professionally oriented economics department. The text assumes that the student has taken an introductory economics course, preferably one with some coverage of macroeconomics. A knowledge of mathematics, other than high school algebra, is not required. Any college student or informed business person should feel comfortable reading this book.

Features of the Book

Pedagogically, the book attempts to blend a descriptive narrative of the *operations of the financial system with a sufficient amount of theory to enable* the reader to understand the underlying principles of the financial system. Utilizing the theory and analytical tools presented in this book, the student should have the background to understand and evaluate events in the financial world, and therefore be able to make intelligent, real-world decisions concerning the management of money and the operation of financial institutions and markets.

This book has several unique characteristics that distinguish it from other texts. First, and most significant, it provides a balanced view of the financial institutions and markets that form our nation's financial system. In the past, introductory courses have provided only cursory attention to banking practices and nonbank financial institutions while emphasizing the Federal Reserve System and monetary policy. Our book goes beyond this, devoting four in-depth chapters to commercial banking, five to nonbank financial institutions; and four to financial markets. For balance, six chapters discuss the Federal Reserve System, the money supply, and monetary policy.

Second, this book differs from other texts in that monetary policy is also examined from the perspective of the firm. The model of national income determination is used to discuss the direct and indirect effects of monetary policy upon financial institutions and the general level of interest rates. This approach serves to integrate the descriptive materials on financial markets and institutions with the changes in monetary policy that affect the entire economy. From a teaching standpoint, we wish to note that the model of income determination is presented in schematic form, which clarifies the transmission mechanism for monetary policy and increases the student's understanding.

Finally, we have provided numerous tables and diagrams to augment the discussions in the text. Each chapter opens with an overview of the material to be covered and ends with a detailed summary recounting the major concepts and points covered within that chapter. Questions are included at the end of each chapter for discussion and review. For instructors and students who wish to explore a topic in more detail, suggested annotated readings are listed at the end of each chapter. An instructor's manual is also available.

Changes in this Edition

The 1980s have brought about deregulation and rapid change in the structure of the U.S. financial system. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Garn-St. Germain Depository Institutions Act of 1982 made far-reaching changes in the nation's financial system. Commercial banks can now enter lines of business previously closed to them; the distinction between banks and nonbank financial institutions is rapidly becoming blurred. The second edition of this textbook has been revised to reflect these dramatic changes. A summary of major changes is presented below:

1. The single chapter on interest rates has been expanded to two chapters to allow extensive coverage for this important topic. (Chapters 3 and 4)
2. A chapter has been added on financial futures and their use by financial institutions. (Chapter 21)
3. Boxed items, called "People and Events," have been added to nearly every chapter. Thse vignettes are designed to enhance the student's interest in the course and to provide the instructor with actual situations to illustrate important concepts presented in each chapter.
4. Careful attention has been given to analyzing the impact of such recent legislation as the Garn-St. Germain Act of 1982 and DIDMCA of 1980 has had upon the operations of financial institutions and the structure of the U.S. financial system.
5. The chapters on international banking and markets (Chapters 25 and 26) have been expanded. Specifically, the Eurocurrency market is covered in greater depth and an impact analysis of the International Bank Act (IBA) of 1978 on both U.S. and foreign banks is included.

Organization of the Book

The organization of this book reflects the way we would teach an introductory course in the financial system. The book is designed so that, after Parts 1 and 2, some chapters can be omitted or sections assigned in alternative sequence without adversely affecting the flow of discussion. The book is organized around seven major sections.

Part I (Chapters 1–4) introduces the basic elements and vocabulary necessary to understand the operation of the financial system. The first chapter introduces the student to the course and discusses the fundamentals of money, prices, and inflation. The basic elements of the financial system are presented in Chapter 2. These elements, when integrated, form a conceptual model of the financial system. Chapters 3 and 4 discuss how financial claims are priced, how the general level of interest rates is determined, and how interest rates on financial instruments are influenced by their default risk, term to maturity, marketability, and tax treatment, as well as by the expected rate of inflation.

Part 2 (Chapters 5–7) focuses on the development of the U.S. financial system and the Federal Reserve System. Chapter 5 explains the economic, political, and regulatory forces that have shaped our current financial system; Chapters 6 and 7 explain the Federal Reserve System, how it manages the money supply, and the deposit expansion process of money for all financial institutions holding checkable deposits.

Part 3 (Chapters 8–11) presents the operation, regulation, and structure of the commercial banking system. Banks have been selected for particular study because of the diversity of their business activity and because they are the primary transmitters of monetary policy. Once bank operations are understood, it is easier to understand the operations of other specialized, nonbank financial institutions. Chapter 8 describes bank operations by examining balance sheets. Chapter 9 then looks at how banks resolve the conflict between bank profitability and bank safety through the careful management of their assets and liabilities. Chapter 10 explains bank regulation, emphasizing the regulatory dilemma of whether too much bank regulation impairs competition. Finally, Chapter 11 discusses important issues in bank structure, such as economies of scale, bank holding companies, bank branching, and interstate banking.

Part 4 (Chapters 12–17) is devoted to a description of important nonbank financial intermediaries in the nation's economy. The institutions discussed are savings and loan associations and mutual savings banks in Chapter 12, credit unions in Chapter 13, finance companies in Chapter 14, insurance companies and pension funds in Chapter 15, investment companies, money market mutual funds, real estate investment trusts, broker-dealers, retailers, and other financial entities in Chapter 16. Chapter 17 presents current policy issues affecting commercial banks and nonbank financial institutions, integrating material presented earlier in this book.

Part 5 (Chapters 18–21), devoted to the major financial markets in which commercial banks and other financial intermediaries participate, presents a discussion of money markets in Chapter 18, capital markets in Chapter 19, mortgage markets in Chapter 20, and futures markets in Chapter 21. Chapter 21 also stresses financial institutions' use of the futures markets.

Part 6 (Chapters 22–24) explains the effect of monetary policy on the financial system. Chapter 22 presents monetary policy and various policy issues. Chapter 23 discusses the impact of monetary policy on the financial markets and the economy, lags in the effect of monetary policy, and the rational expectations view of how monetary policy affects the economy. Chapter 24 then considers the impact of monetary policy on major financial institutions.

Part 7 (Chapters 25–26) covers the international financial system. Chapter 25 discusses international banking both from the perspective of U.S. banks operating abroad and foreign banks operating in the United States; this chapter also analyzes the International Bank Act of 1978. Chapter 26 discusses international flows of funds, the Eurodollar market, exchange rates, and other financial services that banks provide to firms conducting international trade and business operations.

Possible Course Outlines

As we have previously mentioned, we have organized this book with a financial institutions and markets approach, which is the way we would teach an introductory financial systems course. However, depending upon individual preference and course emphasis, there are many alternative ways to organize the course. We have therefore written this book to allow a different ordering of the chapters. The only constraint in our flexible design is that Parts 1 and 2 should be assigned first, since it provides the conceptual foundation and vocabulary of the financial system regardless of subsequent topic emphasis. Below are some possible organizational sequences we feel could be successfully employed utilizing this book. Exhibit 1 shows a flow chart outlining possible alternative sequences.

Financial Institutions Emphasis

This organization follows the current sequence of the text except that Part 6, *Monetary Policy,* is not covered. Instructors utilizing this emphasis may wish to supplement the text with a book of readings or with a reading packet prepared from the end-of-chapter references.

Financial Markets Emphasis

After Parts 1 and 2 are completed financial markets can be introduced by turning directly to Part 5. The instructor may want to use some of the readings listed as references at the end of these chapters to supplement the discussions of financial markets. Following the completion of Parts 1, 2, and 5, Part 3, *Commercial Banking,* and Part 7, *The International System,* are to be covered; then Part 4, *Nonbank Intermediaries,* and Part 6, *Monetary Policy.* Some instructors may wish to cover Chapter 26 on international markets with Part 5; however, we feel it comes best after Chapter 25, which provides an overview on international banking.

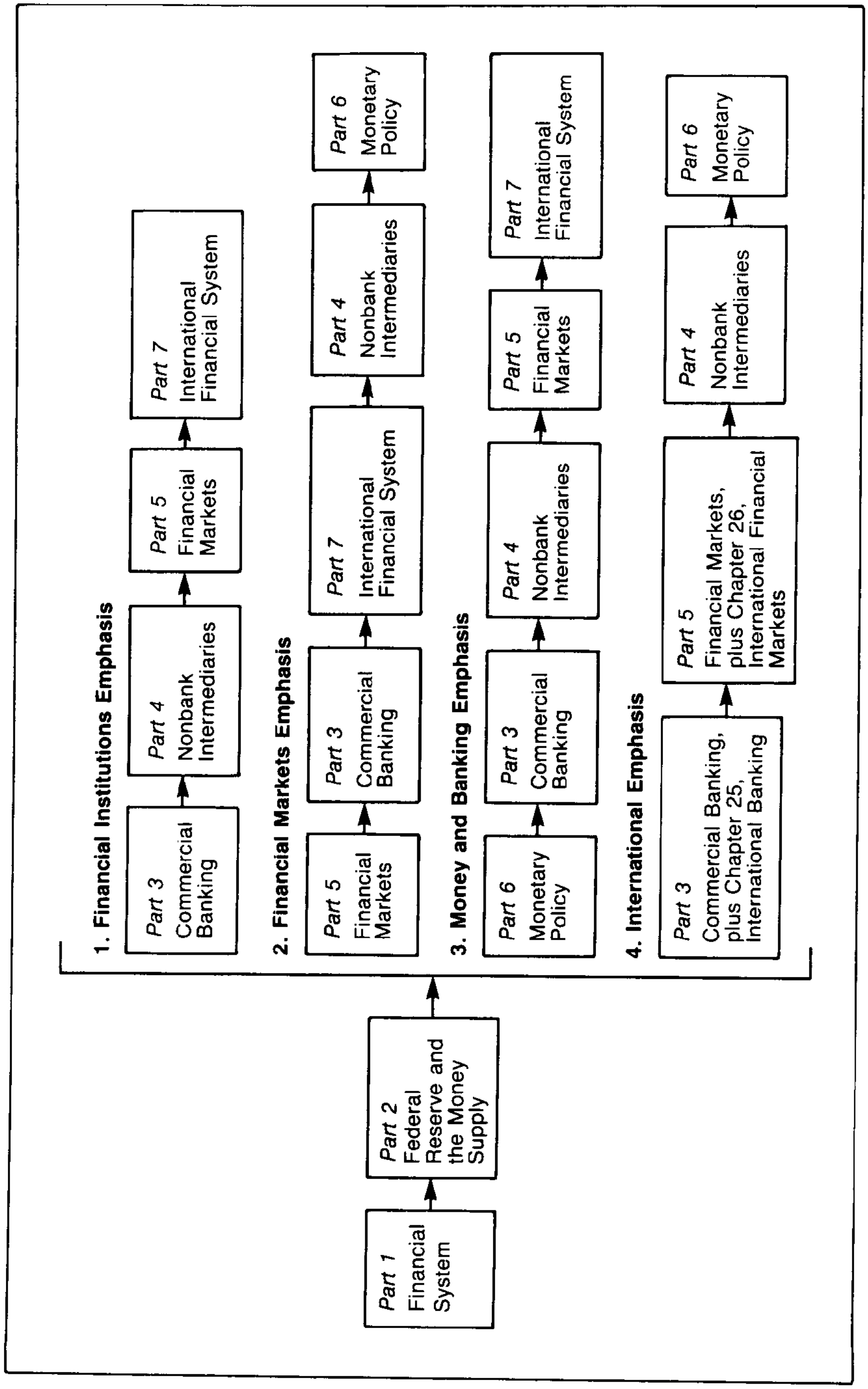
Money and Banking Emphasis

After Parts 1 and 2, the instructor may emphasize monetary policy by going directly to Part 6, *Monetary Policy.* The text can then be followed in order. As an option, some instructors may wish to follow Part 6 with Chapter 18, *Money Markets,* then return to Chapter 7 and follow the order of the text.

International Emphasis

After covering Parts 1 and 2, the instructor choosing this sequence will stress Part 3, *Commercial Banking,* and Chapter 25; next, Part 5, *Financial Markets,* and Chapter 26; and, finally, the balance of the book is covered in order.

Exhibit 1


Part 1 Financial System
Part 2 Federal Reserve and the Money Supply
1. Financial Institutions Emphasis
Part 3 Commercial Banking
Part 4 Nonbank Intermediaries
Part 5 Financial Markets
Part 7 International Financial System
2. Financial Markets Emphasis
Part 5 Financial Markets
Part 3 Commercial Banking
Part 7 International Financial System
Part 4 Nonbank Intermediaries
Part 6 Monetary Policy
3. Money and Banking Emphasis
Part 6 Monetary Policy
Part 3 Commercial Banking
Part 4 Nonbank Intermediaries
Part 5 Financial Markets
Part 7 International Financial System
4. International Emphasis
Part 3 Commercial Banking, plus Chapter 25, International Banking
Part 5 Financial Markets, plus Chapter 26, International Financial Markets
Part 4 Nonbank Intermediaries
Part 6 Monetary Policy

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December 1983

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