# Money, Banking, and Financial Intermediation


Gary Smith

# MONEY,

# BANKING,

# AND

# FINANCIAL INTERMEDIATION

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# TO THE INSTRUCTOR

Banks and other financial intermediaries can be extremely innovative in adapting to government regulations, responding to new opportunities, and offering additional services to their customers. Financial markets are often quite turbulent — sometimes exhilarating, at other times frightening. In this book, I have tried to convey some of this flux and excitement by emphasizing important economic principles and by illustrating these principles with interesting anecdotes and historical incidents.

Recent years have seen the development of many new kinds of monetary assets, and new ones are being introduced all the time. No precise definition of "money" can remain relevant for very long. There are just too many near-moneys and new-moneys. The same is true of banks. Many financial intermediaries, near-banks, now do virtually the same things that traditional banks do. And the list of things that banks do is continually expanding.

This aggressive innovation makes money-and-banking courses exciting, but also very challenging. This book responds to that challenge by taking a broad view of money and banks — looking across a spectrum of financial assets and institutions, emphasizing general principles rather than soon-outdated numbers. Facts are indispensable for understanding the relevance of economic concepts. And this book does have its share of facts. But facts can be overdone, deluging students with technical minutiae. Bewildered and tired, the students struggle to memorize these details or quickly skim over them. In either case, there is a great danger that students will miss the concepts that the facts were intended to illustrate. And, ironically, in a dynamic field like money and banking, many of the "facts" in textbooks are already obsolete.

An emphasis instead on the broad principles of money and financial intermediation can make a book more readable and the course more exciting. The enthusiasm of the professors and, even more importantly, of the students who have read drafts of this book has been extremely gratifying. One student wrote: "Really enjoyed your book a lot. I even read portions of it aloud to people around my house." Another wrote: "Of all the economics textbooks I own (nearly a dozen), this is the only one that I have read twice in one semester. . . . I may even read it again."

## Pedagogy

Several pedagogical tools in this book focus attention on the principles of money and banking:

1. **Repetition.** The most important concepts are highlighted in the margin and repeated in summaries at the end of each chapter. In addition, important principles reappear throughout the book for reinforcement. Important terms are boldfaced and reappear in a short list at the end of each chapter and in a full glossary at the end of the text.
2. **Intuitive verbal explanations.** I have tried mightily to explain everything in simple English. Familiar, even homely, examples are used to involve students in the economic reasoning. The principles of money and banking need not use arcane mathematics or tales of an alien culture.
3. **Real-world examples.** Anecdotes and quotations from the financial press are used throughout the book to show the everyday application of economic principles. There are 102 highlighted examples that reinforce this message. They are listed in the table of contents and inside the front cover. The real-world relevance of economic concepts, as illustrated by the Highlights, is much more than tables of soon-outdated numbers.
4. **Interesting exercises.** There are an average of 26 exercises per chapter that allow students to apply the principles they have just learned. Rather than simple recall, many of these exercises require thought and analysis. These exercises ask for interpretation of historical incidents, evaluation of institutional changes, and critique of provocative quotations.

## Optional Material

There is an incredible diversity in money-and-banking courses. Students have a wide variety of backgrounds and interests, and instructors place widely varying emphases on economic theory, institutional details, policymaking, economic history, microeconomics, macroeconomics, finance, accounting, and mathematics. Professors freely reshape textbooks to suit themselves and their students. Many instructors will omit certain sections or even entire chapters. Anticipating this, I have identified the optional sections that seem the most likely candidates for omission. These include some historical material, esoteric topics, and more difficult analyses.

Chapters 3, 8, 9, and 10 are particularly flexible. Chapter 3 (International Moneys) introduces the idea of exchange rates early in the book, in response to instructors who want to emphasize the global nature of banking and financial markets. This chapter can alternatively be covered at the end of the course, before Chapter 23 (The Macroeconomics of a Large, Open Economy), or can be omitted entirely. Chapter 8 (Financial Futures and Options) provides a substantial explanation of futures and options, which are increasingly used by financial institutions for speculation and hedging; this chapter can be skimmed or omitted. Chapter 9 (Loans) explains some details about loans, including loan payments, creative financing, and adjustable-rate loans. Students find this material especially relevant and interesting, but much — or all — of this chapter can be omitted. Chapter 10 (The Stock Market) is another nonessential chapter that students enjoy, if there is time for it.

The *IS-LM* model is also a flexible topic. I have written the macroeconomic analysis (Part 5) so that these chapters can be read whenever the instructor wishes, or dropped entirely if the students already know this material or do not need to learn it. One possible course outline is to cover Chapters 1 through 18 (with Chapters 3, 8, 9, and 10 optional). Chapters 16, 17, and 18 cover the major macroeconomic controversies — the quantity theory, monetary targeting, rules versus discretion, rational expectations, and the new classical macroeconomics — without using the *IS-LM* model. If there is time, most of Chapter 22 (Inflation) and Chapter 23 (The Macroeconomics of a Large, Open Economy) can also be covered; those sections requiring knowledge of the *IS-LM* model are at the end of these two chapters and are labeled optional.

An instructor who wants to use the *IS-LM* model can cover Chapters 19, 20, and 21 and the optional sections of Chapters 22 and 23. To allow sufficient time for this material, some of the financial market chapters earlier in the text may be skimmed or omitted: Chapter 6 (Default Risk), Chapter 8 (Financial Futures and Options), Chapter 9 (Loans), Chapter 10 (The Stock Market), and perhaps Chapter 11 (Risk and Return).

## Text Supplements

The text is supplemented by an excellent Study Guide for students, written by Nozar Hashemzadeh of Radford University. The text author has prepared an Instructor's Guide with 1,000 examination questions, and computer software that includes financial calculations, macroeconomic modeling, and an instructive banking simulation game.

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