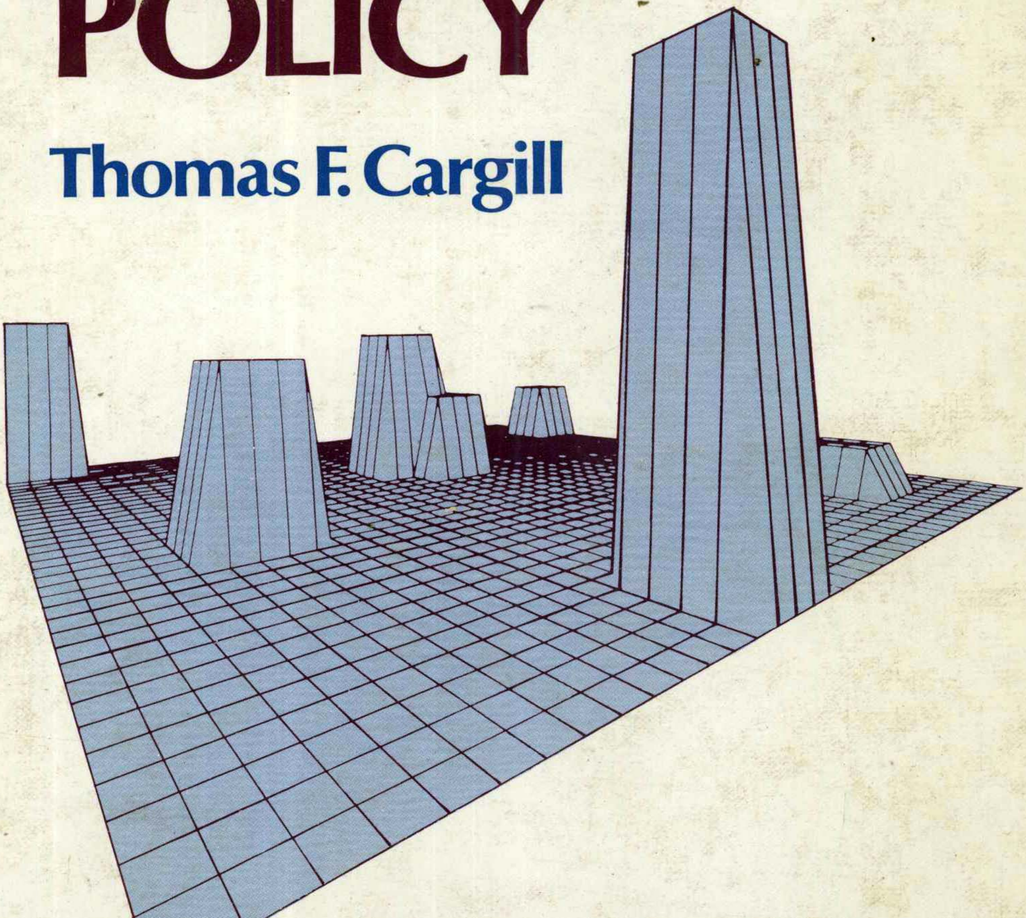
MONEY, THE FINANCIAL SYSTEM, and MONETARY POLICY

Thomas F. Cargill



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PREFACE

One may well ask, why another textbook in money and banking? I gave the question considerable attention before embarking on the present textbook project. There is an enormous amount of effort and time required to produce a textbook of this size and any author who cannot satisfactorily answer the question has no business misallocating his time. Of course, if one's opportunity cost is low, one may go ahead and produce a text without asking or answering the question. This is not the situation in my case. I've taken a considerable amount of time from my other professional and family responsibilities to complete the present textbook and believe that I have not misallocated my efforts. The market, however, will be the final judge of the wisdom of my personal allocation decision.

This book attempts to capture the essence of significant changes in monetary economics over the past decade, primarily from the policy point of view. It offers a reasonably differentiated product compared to currently available textbooks in money and banking. The book is designed for a one–semester course in money and banking offered in either business schools or separate economics departments. The primary emphasis is placed on understanding the financial system and the formulation and execution of monetary policy. The text assumes that the student has taken at least one introductory economics course, preferably with an emphasis in macroeconomics. Knowledge of mathematics other than high school algebra is not required and many diagrams and tables are employed throughout to enhance the verbal discussion. Each chapter ends with a detailed summary of major points and a fairly extensive reading list to aid student understanding and to provide a source of additional information for going beyond the material presented in the text. In addition, discussion questions have been included in the text. One final note on the mechanics of the text. A separate instructor's manual has been prepared by Gary Horton which contains multiple choice and true–false questions for each chapter. The manual also includes a brief discussion of most of the questions listed at the end of chapters.

CHARACTERISTICS OF THE TEXTBOOK

The text has several differentiating characteristics that I feel provide a good part of the answer to the question posed at the beginning of this preface.

First and foremost, the book emphasizes policy formulation and execution by the Federal Reserve System. The book attempts to answer questions that every educated individual is asking about the issues he/she reads about in the news or hears on the 6 o'clock news program. What is the Fed? What is monetary policy? What is the financial system? Why are interest rates going up? Who causes and what's wrong with inflation? What is fiscal policy? Does monetary and fiscal policy really work? Do we know as much about the economy and the way it reacts to stabilization policy as sometimes suggested by elaborate theoretical and econometric models of the economy? These and other questions are discussed throughout the text. The issues are shown to be complex and the emphasis is often on pointing out the difficulty of active stabilization policy. While the author does not believe the Fed should be replaced with an exponential function as suggested by some, he is convinced that active stabilization policy has often promised more than it delivers. The student should be made aware of the real world difficulties in achieving goals of economic stabilization. Separate chapters on inflation and unemployment, the lag in effect of monetary policy, indicators of monetary policy, various approaches to the conduct of monetary policy, and the debate between the Keynesians and Monetarists underline the policy orientation of the text.

Second, early attention is placed on providing the student with an understanding of the financial system, including its institutions and current structural problems. Extensive use of flow of funds is employed to promote an understanding of the basic function of the financial system before discussing bank and nonbank financial institutions. A separate chapter on structural problems and recommended solutions is included as part of the discussion of the financial system.

Third, in line with the policy emphasis, the theoretical material is developed only to a stage necessary to understand the nature of the transmission process of monetary and fiscal policy. The Monetarist model is the most sketchy because the Monetarists have not been particularly successful in developing a detailed theoretical formulation of their view of the economy. The Keynesian model is developed in a simple form that allows extension to more complicated versions if so desired by the instructor. The development of the famous IS–LM version of the Keynesian system has been structured with the instructor's flexibility in mind. The Keynesian model is first developed in a partial equilibrium setting keeping the goods and money market separate and only indicating the direction and nature of the feedback between the two sectors. Then the sectors are combined in an IS–LM framework. Subsequent use of the Keynesian model is handled both with and without the IS–LM framework, thus allowing the instructor to use the IS–LM model throughout the text or to omit the model entirely. Such a presentation has made the text somewhat longer than desirable, but given the differences of opinion among instructors over the usefulness of the IS–LM framework in introductory money and banking courses, the dual development was felt to be a satisfactory compromise rather than omitting IS–LM entirely or presenting a complex theoretical development that would overburden the course.

Fourth, considerable attention has been devoted to the debate between the Keynesians and Monetarists since the debate reflects the most important issues regarding the conduct of monetary policy. The debate is discussed from three aspects: (1) the similarities between the two groups; (2) the technical differences between the two groups; and (3) the ideological differences between the two groups. To place the debate within a historical context, a separate chapter is devoted to discussing the evidence supporting the reemergence of the Monetarist view that "money is important."

ORGANIZATION OF THE TEXTBOOK

Chapters are written to provide continuity of information and discussion; however, some chapters may be omitted from the text without adversely affecting the flow of discussion. The textbook is organized around five divisions.

Part 1 (Chapters 1–9) is devoted to an overview of money, the economic function of the financial system, and institutions of the financial system in the United States. Following the introductory chapter, the basic elements of the financial system are presented in Chapter 2 in terms of the flow of funds concepts. Chapter 3 presents a survey of the three major accounting systems used in the United States to describe economic activity: the national income, flow of funds, and balance of payments accounts. Chapters 4 through 9 provide discussion of various aspects of the financial system such as the role of commercial banks, nonbank financial institutions, structural problems in the financial system along with suggested reforms, and determinants of the level and structure of interest rates.

Part 2 (Chapters 10–13) deal with the institutions, the formulation, and the execution of monetary policy. Chapter 10 presents a short historical survey of the role of stabilization policy in a market oriented economic system. This background information contributes to a better understanding of the current debate over the role of government stabilization efforts. Chapters 11, 12, and 13 deal with the structure of the Federal Reserve System, the way in which the Fed can alter the monetary base and hence the money supply, and the various tools of monetary policy.

Part 3 (Chapters 14–16) develops the basic theoretical background required for understanding how monetary policy functions. Chapter 14 provides a general discussion of economic and econometric models, setting the stage for the Keynesian and Monetarist views. Chapter 15 (Parts I and II) and Chapter 16 develop the Keynesian and Monetarist views, respectively.

Part 4 (Chapters 17–22) is devoted to various policy issues. Extensive attention is devoted to the debate between the Keynesians and Monetarists, evidence on the importance of monetary policy, the crowding out hypothesis of fiscal policy, indicators of monetary policy, the lag in effect of monetary and fiscal policy, and the possible conflict between price stability and full employment.

Part 5 (Chapter 23) contains a lengthy chapter on the financial relationship between the United States and other countries. There is additional material in Chapters 3 and 10 setting the stage for the discussion of international issues. The basic objective of Chapter 23 is to acquaint the student with the concept of balance of payments adjustment, the two polar adjustment mechanisms of the fixed and flexible exchange rate systems, a brief history of the exchange rate system since 1944, and discussion of the current state of affairs (late 1970s). In addition, the functions performed by the Fed in the United States' international transactions is discussed. There is considerable uncertainty about the international framework and rather than bewilder the student with an immense amount of material that may quickly become outdated, it was felt that a discussion of the basic elements would be satisfactory.

NOTE OF APPRECIATION

I've always read the author's comments in textbooks thanking many individuals and until now, have not appreciated the gratitude that an author owes others in the writing of a textbook. I've received enormous help and encouragement from many individuals along the way and would like to express appreciation to the individuals who either read the entire manuscript or made significant contributions to one or more chapters: Richard Cotter, Larry Larsen, Willem Houwink, James Walker (University of Nevada, Reno), and Gary Horton (Nevada National Bank, Reno). The comments made by my reviewers were especially valuable. I want to thank Michael W. Butler (University of North Alabama), Richard V. Cotter (University of Nevada), Charles J. Ellard (Pan American University), Walter L. Johnson (University of Missouri), James R. Ostas (Bowling Green State University), and David L. Roberts (Rutgers University) for their suggestions. Appreciation is also extended to Jackie Supencheck, Darleen Stringer, and Cheryl Troxel for typing numerous pages of manuscript, and Ken Cirac for student assistance. Finally, I would especially like to thank my wife, Mary, for her help and encouragement and for putting up with my emotional swings over a two-year period. For her and my own sake, I hope this book makes "money to bank."

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