THE U.S. FINANCIAL SYSTEM

money, markets, and institutions



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preface

The U.S. Financial System: Money, Markets, and Institutions is designed as an introduction to the structure, mechanics, and operation of the financial system, and to some of the more important current issues in this field. Although specifically focused on the United States financial system, the analysis and the description are also useful in understanding financial systems in other countries. The book is intended for use as a primary text in the first undergraduate course in money and banking in departments of economics, and in money and capital markets, financial institutions, financial system, and financial environment courses in schools of business administration. An introductory course in economics is a useful prerequisite, primarily to introduce the student to the terminology and method of analysis in economics and finance. The exposition is readable, but precise; mathematics is used sparingly and only when absolutely necessary. Any college student or informed lay person should feel comfortable with this book.

Balanced emphasis is placed on theory and practice so that the reader is provided with a firm understanding of the principles underlying the financial system, a description of the existing financial institutions, and a taste of some of the controversies and pending future developments. The book provides the analytical tools necessary to make intelligent decisions in the management of money and to evaluate public monetary management. The financial system cannot be analyzed accurately in isolation from the remainder of the economy. Thus, the book examines the system within the context of the overall

economy. The impact of financial institutions and markets on real economic activity and of real activity on financial institutions and markets is stressed throughout. The first two-thirds of the book develops the micro analysis of the financial system, including international finance. It includes a discussion of the development and operation of financial markets, instruments, and institutions; the payments system; and regulation of the financial system. The last third of the book develops the macro structure of the economy beyond the financial sector. This part includes a discussion of the structure, purposes, and functions of the Federal Reserve System, the transmission process for monetary policy, and the conduct and strategy of monetary policy. Traditional *LM-IS* analysis is employed.

The book is unique in a number of ways. Perhaps most significant is the emphasis placed on important current issues in financial institutions and monetary policy. Fully one-third of the book, eleven chapters, explores the reasons for these issues, discusses the importance of each issue, objectively reviews the major arguments on all sides, and considers the implications of alternative solutions. These chapters are placed after the introduction to the subject so that the reader has an informed perspective from which to evaluate each issue. The issues were selected on the basis of their importance based on my experience both as an employee of policy-making organizations, such as the Federal Reserve System and the U.S. Treasury Department, and as a teacher and informed observer.

Another unique feature is the early discussion of interest rates. Both the level and structure of interest rates are discussed in Chapters 3 and 4. I believe that it is difficult to analyze either financial markets or monetary policy intelligently without an appreciation of how interest rates are determined and why interest rates differ on different securities. The early placement of the interest rate chapters is consistent with the strategy of the book to develop the subjects in building block fashion. A complete, integrated structure is constructed from the ground up. Each chapter builds on what was developed in previous chapters.

Finally, the book is unique in its emphasis on a number of topics not generally discussed at length in other textbooks. Complete chapters are devoted to the payments system, regulation of the financial system, innovations in financial instruments, inflation, and alternative monetary theories. The monetarist and neo-Keynesian theories are examined fully on a comparative basis.

The book is designed for either a one-quarter or a one-semester course. The large number of short chapters provides the instructor with flexibility to tailor the course; the instructor may pick and choose among the current-issue chapters without loss of continuity. References to additional readings are presented at the end of each chapter. Each chapter also contains a summary section and is followed by a

number of thought-provoking questions. A bank of additional questions is included in the *Teacher's Manual* prepared by Professor Cynthia Latta (Suffolk University). These questions include true-false, multiple-choice, and essay types. Answers to these questions, as well as to the questions at the end of the chapters, are provided in the *Manual*. The *Manual* also highlights the key points in each chapter.

Parts of the book were completed while I was a visiting scholar at the Comptroller of the Currency (Washington, D.C.) and visiting professor at the School of Business at the University of California. Berkeley, while on leave from the University of Oregon. I am indebted to a large number of people for helpful comments, suggestions, and review, as well as encouragement. These include G. O. Bierwag, Henry Goldstein, and Christopher James (all at the University of Oregon), Hanson Cheng (Federal Reserve Bank of San Francisco), Ian Giddy (Columbia University), Paul Leonard (State University of New York at Albany), Thomas Mayer (University of California, Davis), George Morgan (University of Texas), Harvey Rosenblum (Federal Reserve Bank of Chicago), Robert Schweitzer (Comptroller of the Currency), and David Walker (Federal Deposit Insurance Corporation). Particularly helpful were the detailed reviews for Prentice-Hall by Michael Butler (University of Northern Alabama), Michael Salemi (University of North Carolina, Chapel Hill), and Stanton Warren (State University of New York at Albany). Cynthia Latta not only prepared the Teacher's Manual but provided a painstaking and cold-blooded review of the manuscript. Asked for and, on occasion, unasked for-comments on the content of the course for which the book is intended were provided by students in my classes.

A number of organizations generously provided data or reviewed sections of the book. These include the American Bankers Association, American Council of Life Insurance (Iris Elfenbein and Thomas Robinson), A. M. Best and Company, Insurance Information Institute, National Consumer Credit Association (Frances Wrocklage), and the staffs and libraries at the Comptroller of the Currency, Board of Governors of the Federal Reserve System, the Federal Reserve Bank of San Francisco, and the Federal Reserve Bank of Chicago. Research assistance was provided by Daniel Margulas. Typing assistance was provided by the University of Oregon, the Comptroller of the Currency, and the University of California, Berkeley. Susan Drake typed a considerable portion of the numerous drafts and corrections. Jean Scotten also typed corrections. Renee Barnow helped transform my scribbling into readable prose. At Prentice-Hall, the editorial and production process was supervised by Sonia Meyer; David Hildebrand was acquisitions and development editor; Suzanne Behnke was the designer. To all, I will be forever grateful.

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