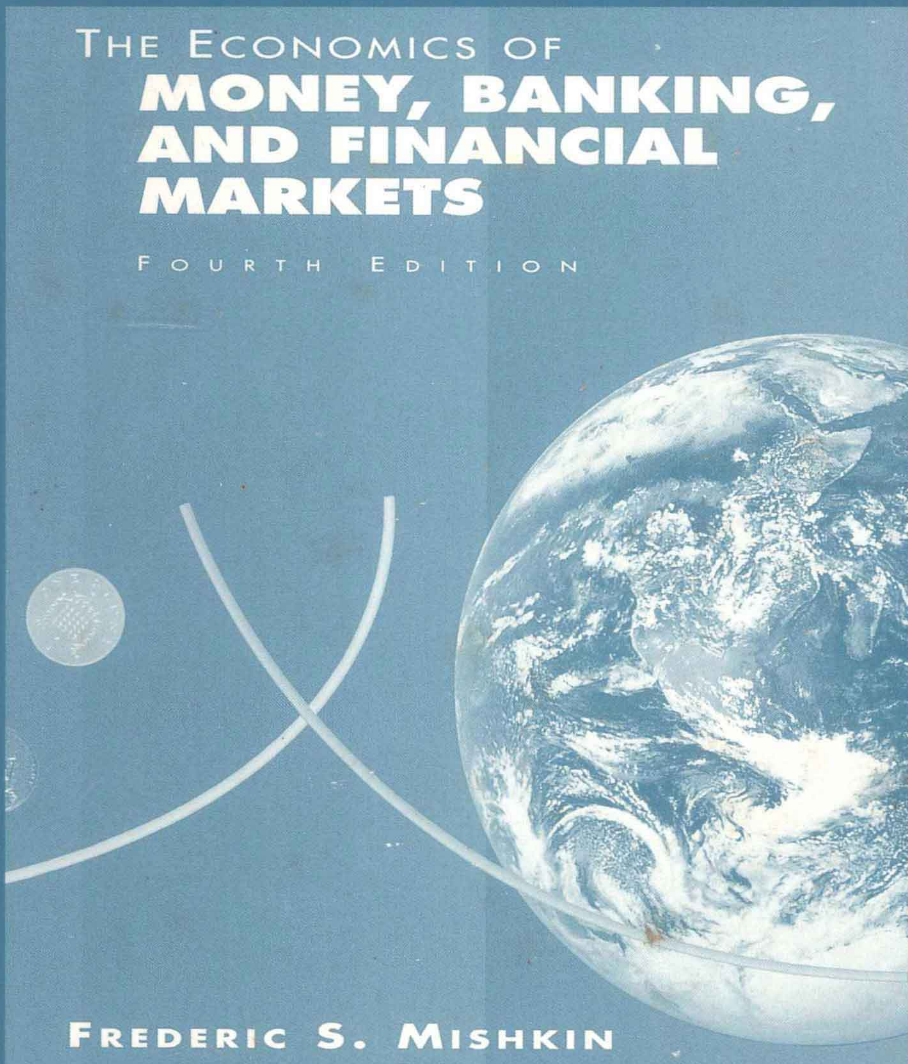
'95 READER

to accompany

Economics of Money, Banking and Financial Markets, 4th Edition



James W. Eaton and Frederic S. Mishkin

1995 READINGS

to accompany

Mishkin
THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS
Fourth Edition

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HarperCollins*CollegePublishers*

Credits:

Barbara Donnelly Granito, "Bond's Duration is Handy Guide on Rates," *The Wall Street Journal*, April 19, 1993. Reprinted by permission of The Wall Street Journal,

Constance Mitchell, "Big Deficit Cut Could Sharply Reduce Rates," *The Wall Street Journal*, January 25, 1993. Reprinted by permission of The Wall Street Journal,

Kenneth H. Bacon, David Wessell, and Michael R. Sesit, "Biggest Show of Force in a Decade Halts Slide of the Dollar-For Now," *The Wall Street Journal*, May 5, 1994. Reprinted by permission of The Wall Street Journal,

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ISBN: 0-673-52403-5

95 96 97 98 9 8 7 6 5 4 3 2

PREFACE

This *Reader* helps make *The Economics of Money, Banking, and Financial Markets* a unique teaching package to meet the needs of both professors and students. A basic problem of textbooks in the Money and Banking or Financial Markets and Institutions field is that current events and financial innovation make many of the facts in the textbooks obsolete soon after they are published. To minimize this problem, *The Economics of Money, Banking, and Financial Markets* stresses a few basic economic principles that never go out of date, rather than a set of facts that quickly do so, to understand the role of money in the economy and the structure of financial markets and institutions. To make this economic approach to teaching Money and Banking or Financial Markets and Institutions even more effective, it is important to keep the textbook analysis up to date by supplementing it with current articles on money, financial markets and institutions. This is what this *Reader* does.

UNIQUE FEATURES OF THIS READER

Up-to-date

In contrast to other readers in the Money and Banking or Financial Markets and Institutions field, this *Reader* is updated annually, with over half the articles new each year. For example, in this edition nineteen of the thirty-six articles are new; nine of them were published in 1994 and ten during the second half of 1993. These include articles on the efficiency of foreign exchange markets, exchange market intervention prompted by the U.S. dollar's decline, derivatives and their risks for banks, future prospects for branch banking and bank securities activities, banks' responses to new capital standards, the Clinton administration's plan to consolidate bank regulatory agencies, central bank independence, the role of gold in monetary policy, and the costs of disinflation. No other reader in the field is as current, and this will continue to be the case with the appearance of a new edition of the *Reader* every year.

A New Way to Teach Financial Markets and Institutions

The fourth edition of *The Economics of Money, Banking, and Financial Markets* develops a unifying economic framework to organize students' thinking about financial markets and institutions so that they can make sense of, rather than be confused by, all the facts about our financial system. The strength of this approach, in contrast to the approach used in other textbooks which focus on a set of facts about financial institutions, is that it will not go out of date. Because this approach stresses lasting economic concepts, it allows instructors to discuss the latest developments in financial markets and institutions. As part of this approach to teaching financial markets and institutions, instructors will want to use current articles in class to illustrate the economic forces that are driving changes in financial markets. This *Reader* is designed to make it easier for instructors to do this and keep their teaching current. Half of the readings are devoted to financial markets and institutions. Because the need for current discussion of financial markets and institutions is so important to teaching Money and Banking or Financial Markets and Institutions, future annual editions of the *Reader* will make a special effort to have a similarly high proportion of current articles focus on financial markets and institutions.

The numerous, current readings on financial markets and institutions that will appear annually in this and future editions of the *Reader* and the stress on economic analysis in the textbook provide a whole new way of teaching financial markets and institutions. This new approach will make it less likely that students will memorize a mass of facts that will be forgotten after the final exam and that soon become obsolete because of the rapid pace of financial innovation. Instead, they will have an understanding of the dynamism of our financial markets and institutions and will see that what they have learned applies to current developments in financial markets, illustrating the relevance of their course work.

Pedagogical Aids

Each of the *Reader*'s six parts begins with an introduction (written by James Eaton) which provides the student with a brief summary of each article. In addition, the introduction provides suggestions for which chapter(s) the reading might be assigned to, thus helping instructors decide how they might like to organize their courses. We suggest that instructors read through all the part introductions as they plan their courses to become aware of the various options for matching readings with the text chapters they assign.

James Eaton has also written several discussion questions which follow each reading in order to encourage students to think about how the reading relates to material in the text. Instructors may find these questions useful for class discussions of the reading or as written assignments in problem sets.

Low Price

Because we believe that this *Reader* is such an important supplement to courses in Money and Banking or Financial Markets and Institutions, it will be sold with the text at a particularly low price. This should give students the benefit of the *Reader* without making its cost prohibitive.

SUGGESTIONS AND ACKNOWLEDGMENTS

It is hoped that instructors and students who use this *Reader* will indeed find it an effective pedagogical tool. The editors look forward to receiving any comments or suggestions concerning the articles in this edition of the *Reader* or ones which would be appropriate for future editions. Your comments and suggestions may be sent to:

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We owe sincere thanks to several people who have given expert assistance in the preparation of this *Reader*. Special thanks go to Elizabeth Middleton, who's skillful retyping of each article gives the *Reader* its uniform, polished appearance;

and to Bruce Kaplan, economics editor, and Julie Zasloff, supplements editor, at HarperCollins for their advice and encouragement. Above all, we would like to thank our wives Mary and Sally, and our children Amanda, Elizabeth and Matthew (for Eaton) and Matthew and Laura (for Mishkin), who put up with us while projects like this claim a large share of our time. We hope they know that they are infinitely more important to us than a book.

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PART ONE

INTRODUCTION

The two readings for Part One focus on two institutions critical to the successful operation of the financial system—the money market and the payments mechanism.

In Reading 1, **"The Money Market,"** Timothy Q. Cook and Robert K. LaRoche provide an overview of the money market's participants and financial instruments. This reading supplements Chapter 2's introduction to the financial system.

Reading 2 is **"A Beginner's Guide to the U.S. Payments System"** by Paul Bauer. Bauer explains the importance of an efficient payments system and discusses the payments system's evolution. He notes the relative importance and cost of the various payments instruments in use in the U.S. and considers the institutional and technological challenges to increasing the system's efficiency. This reading is for use with Chapter 3's discussion of money and the payments system.

READING 1

The Money Market

Timothy Q. Cook and Robert K. LaRoche

The major purpose of financial markets is to transfer funds from lenders to borrowers. Financial market participants commonly distinguish between the "capital market" and the "money market," with the latter term generally referring to borrowing and lending for periods of a year or less. The United States money market is very efficient in that it enables large sums of money to be transferred quickly and at a low cost from one economic unit (business, government, bank, etc.) to another for relatively short periods of time.

The need for a money market arises because receipts of economic units do not coincide with their expenditures. These units can hold money balances—that is, transactions balances in the form of currency, demand deposits, or NOW accounts—to insure that planned expenditures can be maintained independently of cash receipts. Holding these balances, however, involves a cost in the form of foregone interest. To minimize this cost, economic units usually seek to hold the minimum money balances required for day-to-day transactions. They supplement these balances with holdings of money market instruments that can be converted to cash quickly and at a relatively low cost and that have low price risk due to their short maturities. Economic units can also meet their short-term cash demands by maintaining access to the money market and raising funds there when required.

Money market instruments are generally characterized by a high degree of safety of principal and are most commonly issued in units of $1 million or more. Maturities range from one day to one year; the most common are three months or less. Active secondary markets for most of the instruments allow them to be sold prior to maturity. Unlike organized securities or commodities exchanges, the money market has no specific location. It is centered in New York, but since it is primarily a telephone market it is easily accessible from all parts of the nation as well as from foreign financial centers.

The money market encompasses a group of short-term credit market instruments, futures market instruments, and the Federal Reserve's discount window. The table summarizes the instruments of the money market. The major participants in the money market are commercial banks, governments, corporations, government-sponsored enterprises, money market mutual funds,

Reprinted from *Instruments of the Money Market* edited by Timothy Q. Cook and Robert K. LaRoche, Federal Reserve Bank of Richmond, 1993, 1-5.

The Money Market

Instrument	Principal Borrowers
Federal Funds	Banks
Discount Window	Banks
Negotiable Certificates of Deposit (CDs)	Banks
Eurodollar Time Deposits and CDs	Banks
Repurchase Agreements	Securities dealers, banks, nonfinancial corporations, governments (principal participants)
Treasury Bills	U.S. government
Municipal Notes	State and local governments
Commercial Paper	Nonfinancial and financial businesses
Bankers Acceptances	Nonfinancial and financial businesses
Government-Sponsored Enterprise Securities	Farm Credit System, Federal Home Loan Bank System, Federal National Mortgage Association
Shares in Money Market Instruments	Money market funds, local government investment pools, short-term investment funds
Futures Contracts	Dealers, banks (principal users)
Futures Options	Dealers, banks (principal users)
Swaps	Banks (principal dealers)

futures market exchanges, brokers and dealers, and the Federal Reserve.

COMMERCIAL BANKS

Banks play three important roles in the money market. First, they borrow in the money market to fund their loan portfolios and to acquire funds to satisfy noninterest-bearing reserve requirements at Federal Reserve Banks. Banks are the major participants in the market for federal funds, which are very short-term—chiefly overnight—loans of immediately available money; that is, funds that can be transferred between banks within a single business day. The funds market efficiently distributes reserves throughout the banking system. The borrowing and lending of reserves takes place at a competitively determined interest rate known as the federal funds rate.

Banks and other depository institutions can also borrow on a short-term basis at the Federal Reserve discount window and pay a rate of interest set by the Federal Reserve called the discount rate. A bank's decision to borrow at the discount window depends on the relation of the discount rate to the federal funds rate, as well as on the administrative arrangements surrounding the use of the window.

Banks also borrow funds in the money market for longer periods by issuing large negotiable certificates of deposit (CDs) and by acquiring funds in the Eurodollar market. A large denomination CD is a certificate issued by a bank as evidence that a certain amount of money has been deposited for a period of time—usually ranging from one to six months—and will be redeemed with interest at maturity. Eurodollars are dollar-denominated deposit liabilities of banks located outside the United States (or of International Banking Facilities in the United States). They can be either large CDs or nonnegotiable time deposits. U.S. banks raise funds in the Eurodollar market through their overseas branches and subsidiaries.

A final way banks raise funds in the money market is through repurchase agreements (RPs). An RP is a sale of securities with a simultaneous agreement by the seller to repurchase them at a later date. (For the lender—that is, the buyer of the securities in such a transaction—the agreement is often called a reverse RP.) In effect this agreement (when properly executed) is a short-term collateralized loan. Most RPs involve U.S. government securities or securities issued by government-sponsored enterprises. Banks are active participants on the borrowing side of the RP market.

A second important role of banks in the money market is as dealers in the market for over-the-counter interest rate derivatives, which has grown rapidly in recent years. Over-the-counter interest rate derivatives set terms for the exchange of cash payments based on subsequent changes in market interest rates. For example, in an interest rate swap, the parties to the agreement exchange cash payments to one another based on movements in specified market interest rates. Banks frequently act as middleman in swap transactions by serving as a counterparty to both sides of the transaction.

A third role of banks in the money market is to provide, in exchange for fees, commitments that help insure that investors in money market securities will be paid on a timely basis. One type of commitment is a backup line of credit to issuers of money market securities, which is typically dependent on the financial condition of the issuer and can be withdrawn if that condition deteriorates.