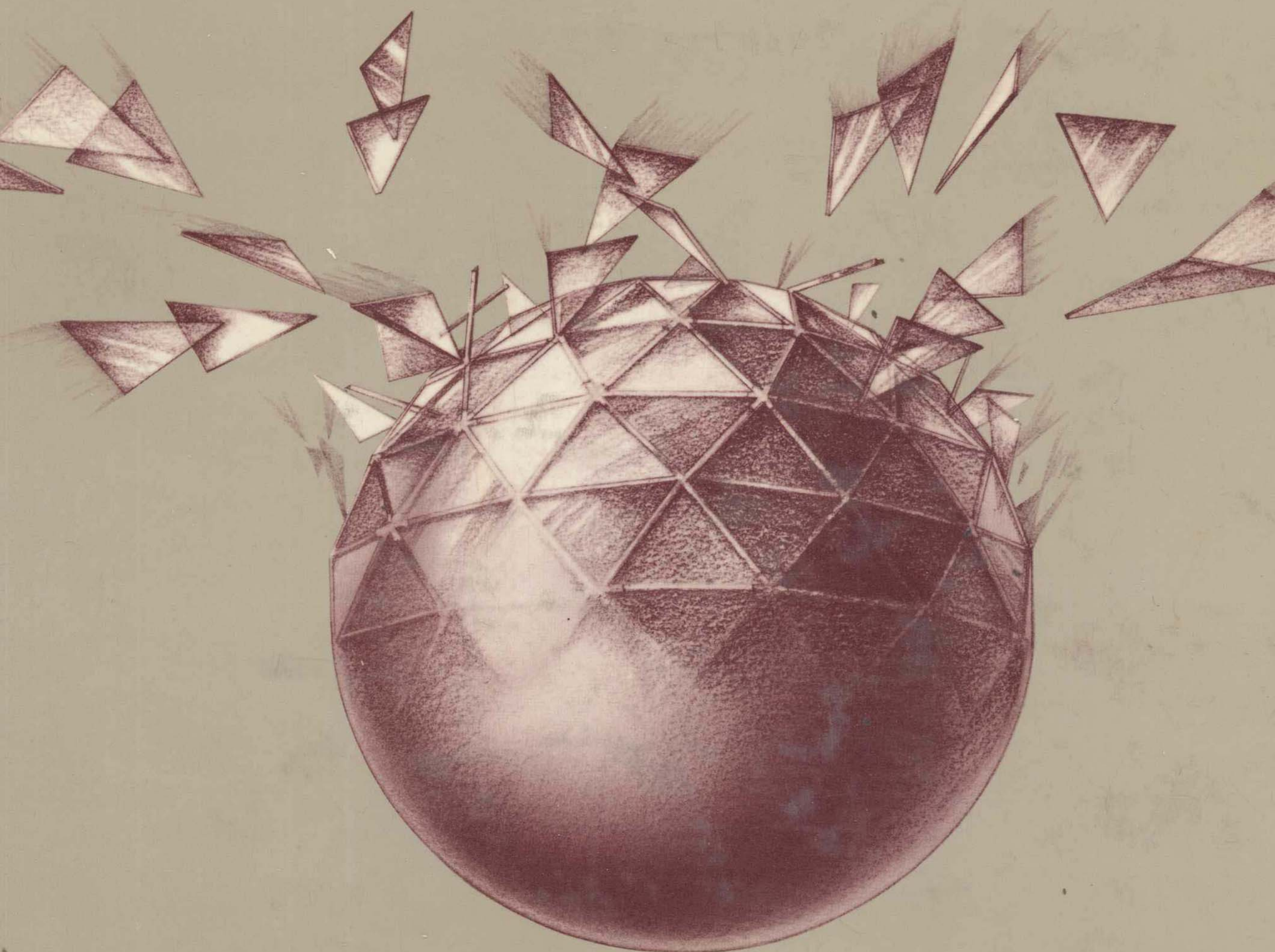
MONETARY AND FINANCIAL ECONOMICS



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MONETARY AND FINANCIAL ECONOMICS

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To Jonathan, Susan, and Samuel.

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PREFACE

During the several years that I have taught money and banking to undergraduates at Berkeley, I have become increasingly frustrated with existing textbooks. Several recent texts have demonstrated that modern macroeconomics can be presented successfully to undergraduates on a relatively rigorous and sophisticated level. I believe that this text does the same for modern monetary and financial economics.

This book contains a great deal of economics. The tools of modern economics are used not only in the macroeconomics and policy chapters, but also to explain institutional and historical factors, the behavior of individual depository institutions, the money "supply," and other subjects that occupy money and banking texts.

Great changes have occurred in the last several years in both the American financial system and in the economic analysis used to study that system. For that reason, this book is concerned not only with money and banking but with the broader issues that constitute monetary and financial economics. In addition, the topics of conventional money and banking texts are covered from a modern perspective. For example, I emphasize depository institutions rather than banks, and transactions accounts rather than demand deposit accounts. The role of money is covered in detail, but within the context of a world in which changes in demands and supplies of various assets are important.

Basic economic principles are discussed in detail. For example, the concept of the interest rate is defined and motivated by a Robinson Crusoe story that stresses the relationship between consumer preferences concerning current versus future consumption and the marginal productivity of capital. The tools of portfolio theory are developed and used to study the demand for assets and supply of liabilities for households, nonfinancial firms, and financial intermediaries (with em-

phasis on depository institutions). Portfolio theory is also used to analyze the determinants of the term structure of interest rates, showing, that interest rate expectations are important for thrifts, banks, and for the investment decisions of firms.

Financial innovation and deregulation have accelerated in recent years. These forces are probably beneficial for the financial system, but they certainly complicate the life of a textbook writer. Several chapters were rewritten to keep up with innovation and deregulation as they occurred. The text discusses both the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982. It also examines the effects of having money that pays a market rate of interest, and the effects of the virtually total decontrol of time deposit interest rates that occurred in October 1983.

Perhaps more important, the text stresses the economic forces that have produced financial innovation and deregulation. Armed with the appropriate economic tools, students can evaluate the consequences of the further innovation and deregulation that will occur after this book's publication.

Much of the sterile debate among the extreme members of the Keynesian and monetarist factions of economics has been replaced in recent years by a synthesis of views. This synthesis can be seen in the similarities of the models used by Tobin, and by Brunner and Meltzer. I have attempted to carry over that synthesis to the macroeconomic chapters of this book. The *IS-LM* framework is used, but attention is paid to the price level, inflation, inflationary expectations, and wealth. Some of the conclusions reached are appealing to monetarists and some to Keynesians. For example, Chapter 16 shows that sustained inflation is a monetary phenomenon and, therefore, is ultimately the responsibility of monetary policy. Furthermore, in Chapter 18, a balanced discussion is presented concerning the debate over the wisdom of monetary policy rules. Chapter 18 shows that there is an analytic basis for preferring rules, but that the basis may not be met in reality. For the Keynesians we have a role for fiscal policy and for supply-side shocks that can produce substantial periods of inflation and of unemployment. The inability of either monetary or fiscal policy to deal effectively with stagflation in the short run is discussed.

Chapter 18 is concerned with monetary policy in theory and practice, and Chapter 19 is concerned with the actual execution of policy 1965 through 1982. In writing those chapters, I have been able to draw on my "insider's" knowledge as a former senior staff member of the Board of Governors of the Federal Reserve System and former associate economist for the Federal Open Market Committee. These positions gave me an appreciation that is not available to outsiders for the difficulties of effectively executing monetary policy. To be sure that my knowledge of the policy process has not become dated, I interviewed current senior staff members, Federal Reserve governors, and Reserve bank presidents. These discussions helped me to understand the policy procedures and problems that developed after my departure from the Federal Reserve in 1975.

Some of the material presented in this text is more advanced than one typically finds in a money and banking text. For example, there are separate chapters on portfolio theory (Chapter 5) and on the term structure of interest rates (Chapter

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6). There is also a chapter that introduces wealth into a conventional macromodel (Chapter 15); this allows monetary policy and government budget deficits to be studied in depth. Chapter 18, Monetary Policy in Theory and Practice, puts considerable emphasis on the effects of uncertainty concerning the current and future state of the economy, and of uncertainty concerning the timing and extent of effect of policy changes.

There are three reasons why the material in this book can be presented successfully to undergraduates. First, I have covered all the material in this text in my undergraduate course at Berkeley with considerable success. Second, reviewers from schools with undergraduate programs that are less demanding than Berkeley's have endorsed the approach. Third, the success of the newer intermediate macroeconomics texts indicates that undergraduates can handle relatively advanced material.

I realize that many users will not want to teach as intensive and exhaustive a course as is possible with this text. As a result, the book is written so that whole chapters, and parts of chapters, can be omitted without disturbing the flow of the text or the understanding of later material. For example, some instructors may want to skip Chapter 5 and 6. While it is important to understand portfolio theory and the determinants of the term structure of interest rates, enough is said about these topics in later chapters to allow the more formal material of Chapters 5 and 6 to be omitted. Similarly, Chapter 7 presents a model of bank behavior that allows one to analyze liability management, the relationship between the interest rates on liabilities and loans, and the effects of interest rate ceilings for liabilities. It is possible to cover the more conventional material on banks and thrifts in Chapters 8 through 10 while skipping Chapter 7. Chapter 15 presents a fairly sophisticated macromodel that introduces wealth. Some instructors may consider this material to be too advanced and this chapter can be omitted. Chapter 17 contains an extended discussion of international trade and finance. These topics have become increasingly important in recent years, but this material can be omitted without losing continuity. Finally, the historical discussions that appear as parts of Chapters 2, 9, and 10 can be omitted without loss of continuity.

In a nutshell, individual instructors have considerable flexibility to design their own course when using this text. The level of difficulty of the book depends on how much of the material from the more demanding chapters and sections is included. In all situations, however, material is developed assuming that students only have had an introductory course in economics and high school algebra.

Many people have helped me with this project. Earl Rolph and William Dudley read a draft of the entire manuscript and gave detailed and highly constructive comments. Richard Esposito, the economics editor for Wiley, recruited several reviewers who also read the entire manuscript and whose comments helped improve the final version of this book. Edward Ettin offered many helpful comments on monetary policy issues, institutionals, and data. Roger Craine, Jeffrey Frankel, and Spencer Krane made many excellent comments on various chapters. I thank all these people for their help.

I also thank the students in my Economics 136 class who acted as guinea pigs by using chapter drafts as their text. They uncovered several errors and their ex-

perience with the text drafts helped to improve the presentation. Janet Ceglowski and Phyllis Hallinan were teaching assistants for the course and they also contributed excellent suggestions. Jonathan and Susan Pierce (Sam is too young) read much of the manuscript and their thoughtful comments are appreciated, if not their glee in finding Dad's prose less than crystal clear at times.

William Dudley and Spencer Krane were my research assistants for this book. I appreciate the excellent work they did.

Last, and most, I thank Suzanne Edwards. Suzanne typed countless drafts of the book, became the world's expert on word processing, and took care of the administrative and procedural aspects of the book's production. Her skill and enthusiasm were all the more remarkable when one considers that she was pursuing a demanding, fulltime administrative job in the Berkeley Economics Department at the same time. By her good example, Suzanne kept my spirits up when they waned. Thanks, Suzy!

James L. Pierce

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