MONEY, BANKING, and the ECONOMY

FIFTH EDITION

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PREFACE

In the decade of the 1980s public policy questions relating to money and banking seem even more crucial than in earlier decades. In 1980 an important law governing the rules affecting banks and other financial institutions was passed by Congress. This law is nearly as important as the 1913 law establishing the Federal Reserve System. The 1980 law gives power to the Federal Reserve to control the expansion of transaction accounts by all financial institutions and changes some of the rules governing competition between financial institutions. Control of inflationary pressures through tighter control of the various monetary aggregates by our central bank has also received greater emphasis in the early 1980s. In addition, the effect of greater monetary discipline has impacted on interest rates and the financial markets in which they are determined.

Because of the greater emphasis on the importance of money supply expansion in a period of inflationary pressures, the material on creating money appears earlier than in the previous edition. The money market chapters are also presented earlier so as to emphasize the importance of interest rates in the 1980s. There is even an early discussion of interest rates and inflation in Chapter 1. The chapters on banks and their competitors now follow the chapters on financial markets. Subsequently, there are chapters on central banking followed by the monetary theory chapters and, in conclusion, the public policy chapters.

As well as reorganizing the order of presentation of chapters in order to highlight the subject matter that is of critical importance in the 1980s, there is, of course, substantial revision and updating of all chapters throughout. Inflation continues to be of great concern, not only in the United States, but in every country in the world. This concern comes up not only in the separate chapter on inflation but in numerous other chapters throughout the book. This is particularly true in the chapters on interest rates, monetary policy, and the American balance of payments and the international monetary system.

The United States in the 1980s is even more of an "open economy" in which both exports and imports are of greater importance to the economy than they were in earlier decades. Furthermore, American interest rates have an impact on the value of the U.S. dollar in foreign exchange markets and thus on the value of other foreign currencies. Changes in the values of various currencies in turn affect the balance of payments of various countries and their domestic economies as well.

For the beginning student of money and banking, a number of terms likely to be unfamiliar are set in bold type and defined in the Glossary at the end of the book. This is a new feature of this edition.

As in earlier editions, both students and colleagues at Arizona State University have been helpful with their critical and encouraging comments. Professors Tim Hogan, Dennis Hoffman, and Don Schlagenhauf all reviewed chapters in their particular areas of interest. Naturally, any errors that remain are my responsibility.

Once again, my wife, Mary, has been most helpful with her labor of love. This has included editorial suggestions and many hours of typing both the book and the accompanying expanded Instructors' Manual. With all of the innovations in money and banking this remains a most stimulating and rewarding field of study. We hope that this proves true for new students as well as for more senior scholars.

J. A. C.

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PART 1

MONEY

No complaint, however, is more common than that of a scarcity of money. Money, like wine, must always be scarce with those who have neither wherewithal to buy it, nor credit to borrow it.*

THE WEALTH OF NATIONS

1 CHAPTER

Introduction to Money and Interest Rates

In the more than two hundred years since Adam Smith published his classic work in which the foundations of modern economics were established, most people have continued to be fascinated with the subject of money. Monetary policy is debated in political campaigns and receives a great deal of attention on the financial pages of daily newspapers. The American economy is not only a market economy but also a monetary economy and, as John Maynard Keynes, noted British economist, pointed out in 1936, a monetary economy is different from a pure market economy without money. Interest rates, or the cost of borrowed money, are also quite important to a market economy. By the decade of the 1980s, such interest rates to would-be borrowers, whether charged by financial institutions, such as banks, or those prevailing in the impersonal financial markets, had become quite volatile. We are concerned with understanding the reasons for changes in interest rates, as well as the nature and functioning of money.

*All the quotations at the beginning of each chapter come from the classic work, first published in 1776, by Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations.*

THE IMPORTANCE OF MONEY

The American market economy is intimately affected by the stock and flow of money. People use **money**, or credit substitutes for money, whenever they buy goods and services. If they save part of their income, they may hold part of these savings in the form of money balances. The prices of goods are quoted in money terms. When credit is extended to finance expenditures, it too is expressed in terms of money as a measure of the amount of credit involved. Money is almost everywhere in the economic system where the production and exchange of goods and services are involved.

But money, which is such a useful and desired servant, at times misbehaves. Sometimes a country has so much money that the money price of everything keeps increasing in an inflationary spiral. Then the value of money tomorrow in terms of its purchasing power will be less than its value today. On the other hand, sometimes a country seems to have so little money that hardly anyone has enough to spend. When money is in too short a supply, as in the Great Depression of the 1930s, the wheels of factories do not turn as rapidly as they can and breadlines of unemployed workers form. Money can be either a great blessing or a great curse.

PRIVATE FINANCIAL INSTITUTIONS AND CENTRAL BANKING

The functioning of major financial institutions in our financial system is a matter of importance for the entire economy. Many **financial institutions**, including commercial banks, are financial intermediaries in that they transfer surplus funds from those who save to those who want to spend more than their current income would permit. In transferring these financial funds, financial intermediaries are also aiding efficient resource allocation. They tend to lower the real rate of interest and thus increase real investment, which in turn increases economic growth.

A number of these financial intermediaries, such as commercial banks and savings and loan associations, also create transaction accounts to facilitate expenditures. Demand deposits of banks, however, are still the largest part of transaction accounts. Beginning in 1980, Congress permitted the Federal Reserve System (the central bank of the United States) to impose uniform reserve requirements on all financial institutions offering transaction accounts. (These reserve requirements are discussed in Chapter 15.) Transaction accounts, such as demand