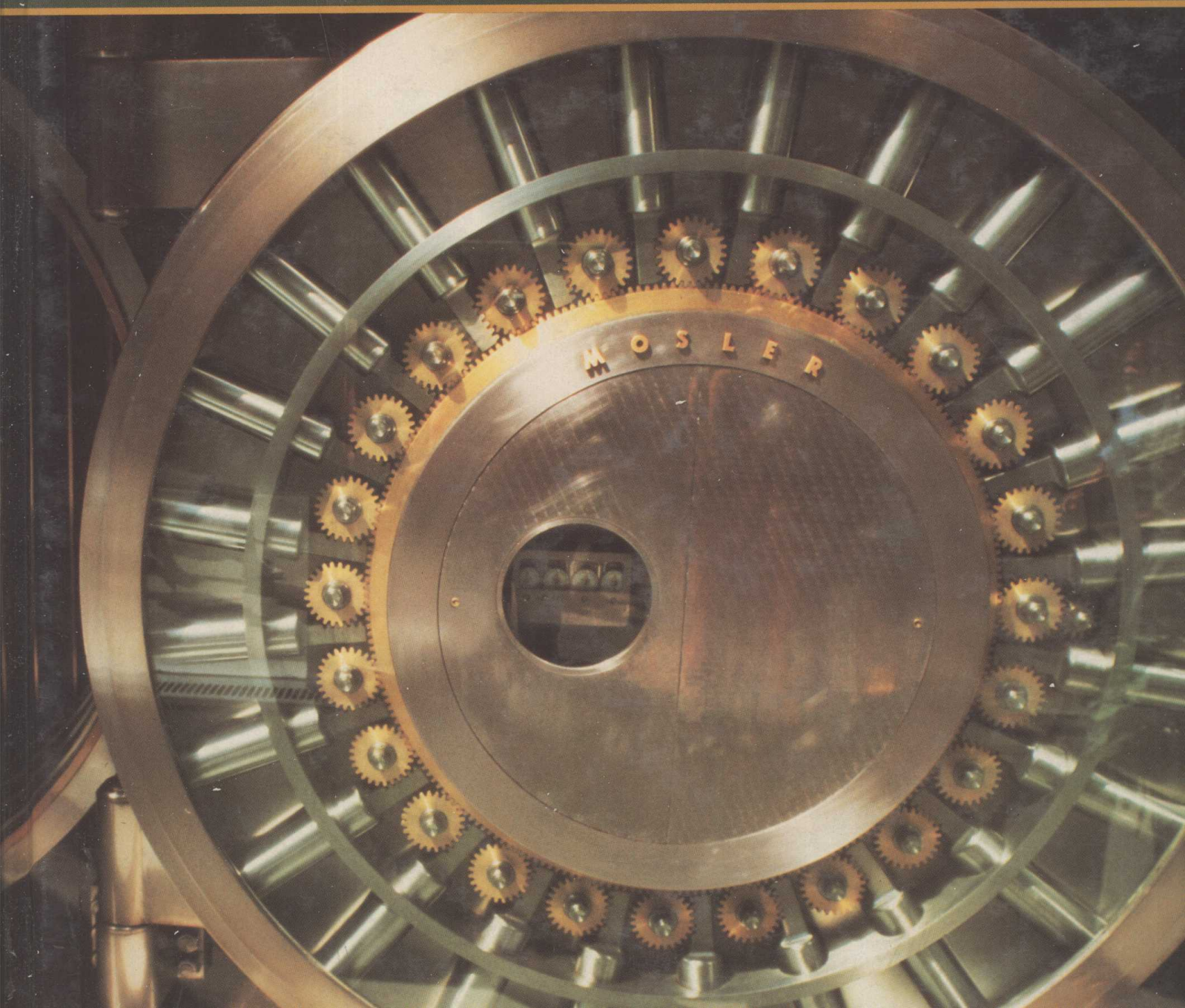


FOURTH EDITION

# THE U.S. FINANCIAL SYSTEM

MONEY, MARKETS, AND INSTITUTIONS

GEORGE G. KAUFMAN



**FOURTH EDITION**

# **The U.S. Financial System**

**MONEY, MARKETS, AND INSTITUTIONS**

**George G. Kaufman**

*John Smith Professor of Finance and Economics  
Loyola University of Chicago*



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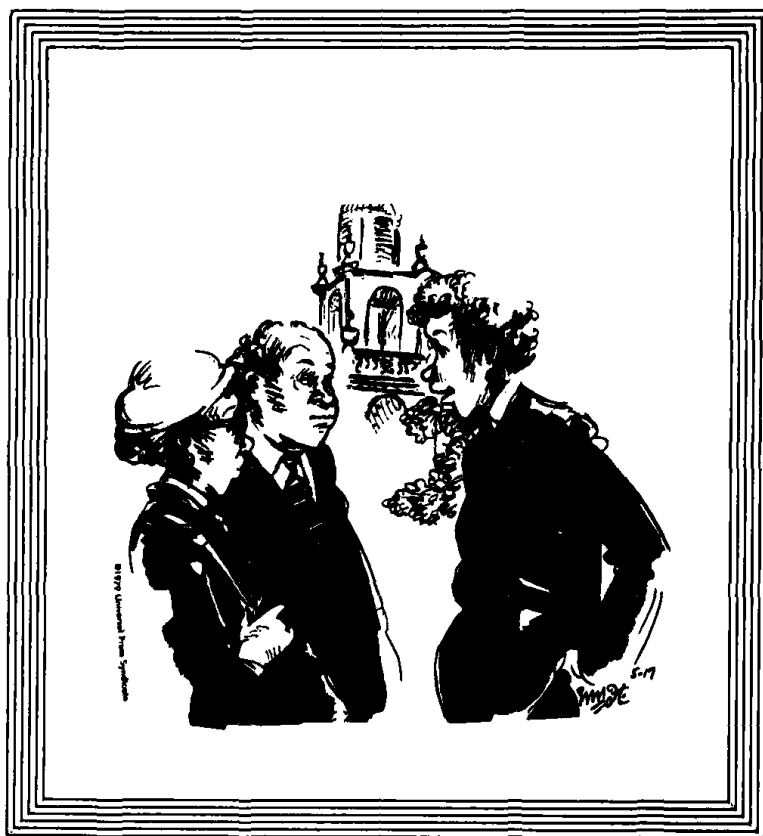
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*There is nothing about money that cannot be understood  
by the person of reasonable curiosity, diligence, and  
intelligence.*

JOHN KENNETH GALBRAITH\*

\*From his book, *MONEY: Whence It Came, Where It Went* (Boston: Houghton Mifflin, 1975).



"Of course, it's hard to make it singing and dancing, so I'm going to take a lot of economics in case I have to fall back on banking."

"Keeping Up" by William Hamilton. Copyright 1979, Universal Press Syndicate. Reprinted with permission. All rights reserved.



# Preface

The fourth edition of *The U.S. Financial System: Money, Markets, and Institutions* has been thoroughly revised and updated to incorporate both the unprecedented structural, policy, operational, legislative, and regulatory changes that have occurred in the financial system since the publication of the earlier editions and the suggestions and comments of the users of these editions. In addition, the exposition has been improved to make the book more understandable to the students. In particular:

- The analysis of the level and structure of interest rates and bond prices has been expanded from two to four chapters (Chapters 5–8). This reflects both the increased interest in debt markets and the increased knowledge about the behavior of these markets. The discussion on duration has been enlarged and brought forward as an appendix to Chapter 5.
- The early chapters on financial markets and institutions (Chapters 3 and 4) have been expanded to provide readers with a more complete understanding of these areas.
- A number of new exhibits have been introduced in order to provide readers with greater in-depth analysis of important current topics, such as a minute by minute chronology of how the FDIC closes a failed bank (Chapter 11), how S&P rates bonds (Chapter 7), and how mixing banking and commerce has worked in Germany (Chapter 19).
- The analysis of the causes and implications of bank failure has been enlarged to reflect their greater frequency and the role of deregulation.

- Increased emphasis has been devoted to problems of and tools for managing financial institutions. Off-balance sheet as well as on-balance sheet activities are discussed.
- The chapter on managing interest-rate risk at financial institutions (Chapter 17) has been substantially rewritten to increase its understandability without losing its message. A supplementary computer tutorial on asset and liability management is available from the author.
- Chapter 18 on federal deposit insurance has been expanded to incorporate the experience of recent years and the recent proposed solutions for correcting the problems of perverse risk-taking incentives.
- The discussion of financial futures and options (Chapter 22) has been expanded to reflect both their greater popularity and the events of October 1987.
- Chapter 23 on financial innovations has been expanded to discuss more recent new financial instruments, including expanded coverage of swap arrangements, securitization, and commercial bank market index deposits (MIDs).
- The chapter on stagflation and incomes policy in the third edition was deleted in part in the hope that inflation will not be rekindled during the life of the fourth edition to the extent that these issues become important again.

The fourth edition retains its emphasis on constructing a consistent general framework at a basic level in the first chapters of each section within which students can analyze and understand financial markets and institutions and Federal Reserve monetary policy. This is followed by chapters in which the theory developed is applied to analyze important specific “real-world” issues of current importance, such as bank failures, separation of commercial and investment banking, and inflation. One-third of the chapters are devoted to such issues. These chapters are at a somewhat higher level than the earlier chapters. The book remains an introductory undergraduate and MBA text for courses both in financial institutions and markets in business schools and in money and banking in economics departments that emphasize “commercial” rather than “central” banking. However, it may be used for a second course by emphasizing the current issues chapters, particularly at quarter term programs. The chapters remain brief in length but large in number to permit the instructor to pick and choose among topics in order to tailor the course both to his or her own needs and to the issues particularly important at the time. Cynthia Latta of DRI Inc./McGraw-

Hill has revised her accompanying instructor's manual and expanded the number of examination questions. Answers to the questions at the end of each chapter also appear in the manual.

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