

# Principles of Money, Banking, and Financial Markets

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THIRD, REVISED AND EXPANDED EDITION

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*Lawrence S. Ritter*

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*William L. Silber*

Basic Books, Inc., Publishers

New York

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*Principles of Money,  
Banking, and  
Financial Markets*

For  
JONATHAN, *who likes to win*  
DANNY, *who likes his way*  
TAMMY, *who likes people*  
and for  
STEVE and PETER

WITH LOVE

“ . . . be careful in teaching,  
for error in teaching amounts  
to deliberate sin.”

*The Mishnah*

*Pirkei Avot, 4*

# 1981 Supplement: Legal and Regulatory Developments

Congressional legislation and Federal Reserve administrative changes during 1980 have significantly altered the institutional framework of our financial system. We think these developments are sufficiently important to warrant a special bulletin for users of this book. We have, therefore, prepared the following concise summary of these changes, together with their implications for principles of money, banking, and financial markets.

## Definitions of Money (Chapter 1)

In 1980 the Federal Reserve completely revamped its money supply definitions. Table 1 on page 5 is revised below to incorporate the Fed's new money supply definitions. Note that the new M1B is the same as the old M1, so throughout the book whenever we refer to the money supply we mean M1B unless otherwise specified.

TABLE 1.  
*Four Definitions of the Money Supply*  
(mid-1980)

M1A	Currency outside banks (\$110 billion) plus demand deposits at commercial banks (\$260 billion)	\$ 370 billion
M1B	Add checking-type accounts at thrift institutions and automatic transfers from savings to demand deposits (\$20 billion)	390 billion
M2	Add passbook savings deposits (\$380 billion) and small-size time deposits (\$720 billion) at both commercial banks and thrift institutions, shares in money market mutual funds (\$75 billion), and bank overnight repurchase agreements (\$25 billion)	1,590 billion
M3	Add large-size (\$100,000 and over) time deposits (\$230 billion)	1,820 billion

SOURCE: *Federal Reserve Bulletin*.

NOTE: Money market mutual funds and bank repurchase agreements are discussed in subsequent chapters.

## Reserve Requirements (Chapters 3 and 12)

Congressional passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 marks the most important banking legislation since the 1930s. The Act provides that reserve requirements will

now be uniformly applied by the Federal Reserve to *all* transactions or checking-type deposits at all depository institutions, *regardless of Federal Reserve membership or type of institution*.

Transactions deposits include demand deposits, NOW (negotiable order of withdrawal) accounts, automatic transfers from savings to demand deposits, and similar accounts at all commercial banks, savings banks, savings and loan associations, and credit unions. The Act provides for an eight-year gradual phase-in period for the reserve requirements of nonmember banks and thrift institutions. By the end of that period (i.e., by 1988), all depository institutions—member and nonmember, commercial bank and thrift—will have to hold reserves of 3 percent against that portion of their transactions accounts below \$25 million, and 12 percent (the Fed can vary this between 8 and 14 percent) against the portion above \$25 million.

For time and savings deposits, reserve requirements are being eliminated entirely against personal or individual deposits. Against business time deposits, all depository institutions will have to hold reserves of 3 percent (the Fed can vary this between 0 and 9 percent).

Thus Federal Reserve membership has been made essentially irrelevant and the perennial problem of dropouts from the Federal Reserve System (pages 33, 159–162) has finally been resolved.

## **Discounting (Chapters 3 and 13)**

In return the Act provides that nonmember banks and thrift institutions will now have the same access to borrowing from the Federal Reserve Banks as member banks have, and on exactly the same terms.

## **Deposit Interest Rate Ceilings (Chapters 7 and 9)**

Regulation Q's ubiquitous interest rate ceilings on time and savings deposits appear, at long last, to be on their last legs. The Act phases them out as economic conditions warrant and within a six-year period. However, don't cheer too soon: Congress could always change its mind at the last minute.

And the ban against paying interest on demand deposits has disappeared: the Act permits all depository institutions nationwide to offer NOW accounts—interest-bearing checking accounts—starting on January 1, 1981.

## **Deposit Insurance (Chapter 8)**

Finally, federal deposit insurance has been raised from \$40,000 to \$100,000 at commercial banks, savings banks, savings and loan associations, and credit unions.



## About the Authors

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# *Notes to Instructor:*

## *Possible Course Outlines*

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The organization of this textbook reflects the way we would teach a course, in Money and Banking or Money and Financial Markets. However, we realize that there are alternative ways to organize such a course, ways that would involve a different ordering of chapters. We have, therefore, written the book with the ideal of flexibility in mind. The only constraint is that Part I (Chapters 1 through 6) should be assigned at the beginning, since it lays the basic foundations regardless of eventual topic emphasis. Even there, however, some might want to move the Appendix to Chapter 3 back into Part III. The book is written so such a move will not interfere with comprehension.

While every teacher can best structure his or her own course, here are some illustrative examples of the ways this book can be adapted to different approaches.

The two major types of course organization are (1) a financial institutions and markets and central banking emphasis, and (2) a monetary theory and policy emphasis. The ordering of the chapters as they appear in the Table of Contents reflects the first type of approach: financial institutions and markets and central banking. Even within each of these categories, it is possible to emphasize different subjects. Here are some suggestions:

1. *Financial institutions and markets and central banking:* After the Basics in Part I, Parts II and III present a comprehensive analysis of the business of financial intermediaries—with emphasis on commercial banking—and the art of central banking. A limited amount of theory on the role of money in the economy is given in

Chapters 1 and 4 to provide the proper framework for the discussions of central banking. When the formal presentation of monetary theory begins, in Part IV, it is possible to reduce the emphasis on theory by eliminating Chapters 19 and 22 and the Appendix to Chapter 23. These sections construct and then apply IS-LM analysis, but the rest of the book is written so that the omission of this material will not interrupt its continuity or intelligibility. It is also possible to move more quickly into financial markets by going directly to Part VII (“Financial Markets and Interest Rates”) after Part I or after any subsequent part. Many professors seem to prefer teaching Parts I, II, and III in sequence, and then moving to Part VI or VII before returning to Parts IV and V.

2. *Monetary theory and policy*: After Part I is completed, monetary theory can be introduced immediately by going directly to Part IV. This can be followed with the Monetarist-Keynesian debate in Part V and the discussion of the effectiveness of monetary policy in Part VI. One can then backtrack to Parts II and III, which discuss financial institutions and central banking, and then continue with Part VII (“Financial Markets and Interest Rates”). In fact, Chapters 29 and 30 in Part VII (“Forecasting Interest Rates” and “The Structure of Interest Rates”) could be brought into a theory-oriented course much earlier, right after Part V (the Monetarist-Keynesian debate).

3. *History and international aspects*: It is possible to put all of Part VIII (“International Finance”) virtually anywhere one wishes, provided the basics in Part I have been covered. The international chapters, for example, could easily follow Part III (“The Art of Central Banking”) or Part VI (“The Effectiveness of Monetary Policy”). Although there is only one chapter devoted explicitly to history (Chapter 37), historical materials are interspersed throughout the book—especially in Chapters 7-10, on financial intermediaries and banks; in Chapters 11-13, on central banking; and in Chapter 34, on international financial crises.

An Instructor’s Manual and Student Workbook are available from Basic Books. Write for them if you wish. Also note that we have sprinkled a few news clippings through the text to help illustrate the relevance of the material.

# Acknowledgments

The first two editions of this book generated a number of unsolicited communications from students and teachers. Some were favorable, others critical, but all helped us prepare this third edition. We would like to thank the following for taking the time and effort to help improve this revision:

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