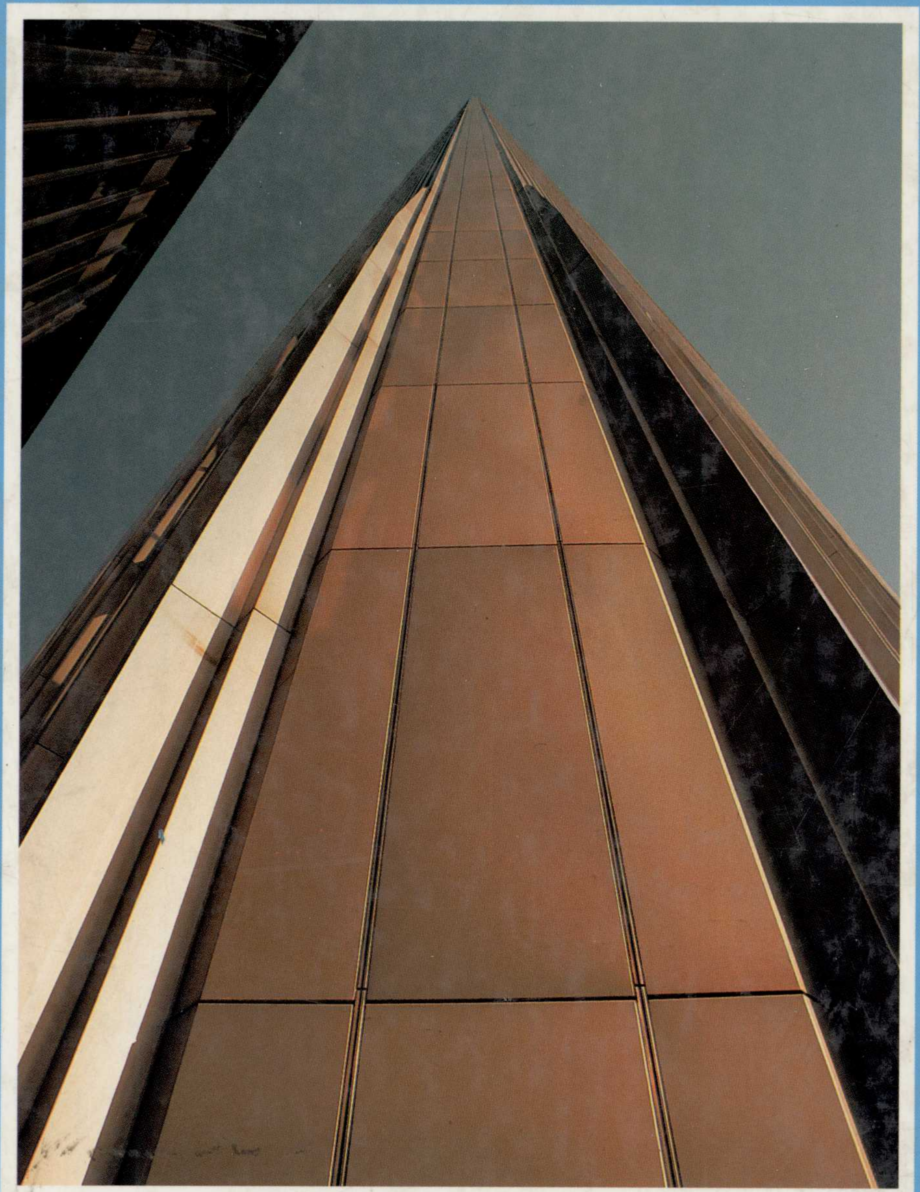
PRINCIPLES OF MONEY, BANKING, AND FINANCIAL MARKETS

SEVENTH EDITION



LAWRENCE S. RITTER WILLIAM L. SILBER

7TH EDITION

PRINCIPLES OF MONEY, BANKING, AND FINANCIAL MARKETS

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

The *Mishnah*
Pirkei Avot, 4

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NOTES TO THE INSTRUCTOR

In preparing this seventh edition of *Principles of Money, Banking, and Financial Markets* we have tried to take account of the rapid evolution of the monetary and financial system, primarily by updating the institutional and statistical dimensions of the book. To foster continuity with the previous edition, we have maintained the same chapter order, as well as the casual conversational style that students have enjoyed in the past.

Two specific changes are worth emphasizing, because they are designed to stimulate student interest even further. First, we have focused attention on the increasing role of computers and communications technology in the financial sector. In particular, six chapters now have subsections and/or discussion boxes devoted to exploring how technological advances have altered the financial landscape and how this evolution will continue as we move toward the turn of the millenium. Second, on a somewhat more mundane level, we now provide questions at the end of each chapter, so that students can immediately test their understanding of key issues.

These improvements have been mirrored in both the *Study Guide* by Gabriel Hawawini and the separate *Instructor's Manual with Test Bank* by Paul Warner. The test bank is available to instructors on Harper Test, a microcomputer test-generation system for Apple II and IBM PC computers. We think this entire package will permit you to tailor the course to meet the needs of your students.

The specific organization of the book reflects the way we would teach a course in Money and Banking or Financial Institutions and 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. Although every instructor can best structure his or her own course, here are some illustrative examples of the ways this book can be adapted to different approaches.

Part 1 ("The Basics") forms the foundation for all future topics. Thus the chapters in Part 1 might all be assigned in the beginning of the course. Alternatively, each of the chapters in Part 1 can be used to initiate subsequent parts of the book. For example, Chapter 2 ("Money, the Economy, and Inflation") belongs with Part 3 ("The Art of Central Banking") or even with Part 4 ("Monetary Theory"); Chapter 3 ("Financial Instruments and Markets") goes with Part 5 ("Financial Markets and Interest Rates"); Chapter 4 ("Financial Institutions: Purposes and Profile") introduces Part 2 ("Intermediaries and Banks"); finally, Chapter 5 ("Calculating Interest Rates") and Chapter 6 ("The Level of Interest Rates") can be used to launch Part 4 ("Monetary Theory") or any other section, for that matter.

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 1, Parts 2 and 3 present a comprehensive analysis of the business of financial intermediaries 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 2, and interest rates are introduced in Chapters 5 and 6, to provide the proper framework for the discussion of central banking.

   When the formal presentation of monetary theory begins in Part 4, it is possible to reduce the emphasis on theory by eliminating Chapters 21 and 22; these chapters construct and then apply *ISLM* analysis, but the rest of the book is written so that the omission of this material will not interrupt its continuity or intelligibility.

   In a course devoted exclusively to financial institutions and markets, it is possible to avoid formal monetary theory entirely by going directly to Part 5 ("Financial Markets and Interest Rates") after Part 1. For such courses, the overview of money in Chapters 1 and 2 and the framework for interest rate determination in Chapter 6 provide a more than adequate discussion of theoretical material.

Many professors seem to prefer teaching Parts 1, 2, and 3 in sequence, then moving to Part 5 and possibly even 6 before backtracking to Part 4 ("Monetary Theory").

2. *Monetary theory and policy:* After Part 1 is completed, monetary theory can be introduced immediately by going directly to Part 4. One can then backtrack to Parts 2 and 3, which discuss financial institutions and central banking, and then continue with Part 5 ("Financial Markets and Interest Rates"). In fact, Chapters 28 and 33 ("The Structure of Interest Rates" and "Financial Futures and Options") could be brought into a theory-oriented course much earlier, right after Part 4.
3. *International aspects:* It is possible to put all of Part 6 ("International Finance") virtually anywhere one wishes, provided the basics in Part 1 have been covered. The international chapters, for example, could easily follow Part 3 ("The Art of Central Banking") or Part 4 ("Monetary Theory").

We hope that you find both the new and continuing features of the book useful teaching devices. If you have any comments or suggestions for the next edition, we would appreciate hearing from you.

LSR
WLS

READING THE FINANCIAL NEWS: GOVERNMENT BOND MARKET QUOTATIONS

(1)			(2)	(3)	(4)	(5)
Rate	Mat.	Date	Bid	Asked	Bid chg.	Yld.
8¼s,	2000–05	May	105.25	106.1	+.4	7.53
12s,	2005	May	141.12	141.20	+.4	7.72
10¾s,	2005	Aug	129.8	129.16	+.2	7.73
9⅜s,	2006	Feb	117.10	117.18	...	7.61
7⅝s,	2002–07	Feb	100.25	101.1	+.5	7.51
7⅞s,	2002–07	Nov	103.4	103.12	+.2	7.51
8⅜s,	2003–08	Aug	106.26	107.2	+.8	7.62
8¾s,	2003–08	Nov	110.4	110.12	+.3	7.64
9⅛s,	2004–09	May	113.18	113.26	+.7	7.67
10⅜s,	2004–09	Nov	125.6	125.14	+.8	7.77
11¾s,	2005–10	Feb	137.18	137.26	+.6	7.81
10s,	2005–10	May	122.12	122.20	+.11	7.68
12¾s,	2005–10	Nov	147.24	148	+.7	7.83
13⅞s,	2006–11	May	158.30	159.6	+.5	7.87
14s,	2006–11	Nov	160.24	161	+.4	7.87
10⅜s,	2007–12	Nov	126.16	126.24	+.5	7.76
12s,	2008–13	Aug	143	143.4	+.7	7.83
13¼s,	2009–14	May	156	156.8	+.9	7.86
12½s,	2009–14	Aug	148.23	148.27	+.6	7.85
11¾s,	2009–14	Nov	142.8	142.16	+.8	7.75
11¼s,	2015	Feb	140.10	140.14	+.6	7.71
10⅝s,	2015	Aug	133.19	133.27	+.9	7.68
9⅞s,	2015	Nov	125.4	125.12	...	7.68
9¼s,	2016	Feb	119.10	119.18	+.9	7.58
7¼s,	2016	May	97.8	97.12	+.8	7.47
7½s,	2016	Nov	101.11	101.15	+.9	7.38

Column (1) identifies each government bond in terms of its coupon rate and maturity date. For example, the *second* bond in Column (1) carries a 12 percent coupon and will mature in May of the year 2005. (Conversationally, it is referred to as "the twelves of oh five," which explains the *s* following each coupon rate.) The next bond has a 10¾ percent coupon and will mature in August of 2005 (the ten and three-quarters of oh five).

Many bonds—like the first one, the eight and a quarter of May 2000–05—have *two* maturity dates. Such bonds mature on the second date but are *callable* by the Treasury starting with the first date. The 8¼s of May 2000–05, for example, will mature in May of 2005; however, if it wishes, the Treasury can call them for redemption in May of 2000 or at six-month intervals thereafter until it *has* to redeem them by May of 2005.

Columns (2) and (3) indicate what government securities dealers were "bidding" and "asking" for each bond at the close of trading yesterday—that is, their "buying price" (bid) and "selling price" (asked). Government bonds normally have a face value of $1,000 and, like corporate bonds (see the box in Chapter 31), their price is conventionally expressed as a percentage of face value. Note that the numbers after the period are not decimals but 32nds. Thus, with respect to the last bond on the list, the 7½s of 2016, government securities dealers were willing to buy at $101\frac{11}{32}$ (= $1,013.4375) and willing to sell at a slightly higher price of $101\frac{15}{32}$ (= $1,014.6875).

Column (4) is the change in the dealers' bid price at the close of trading yesterday compared with the previous day's close. It is also in 32nds. For example, the 7½s of 2016 closed at $101\frac{11}{32}$ bid, up $\frac{9}{32}$ from the previous day's close of $101\frac{2}{32}$.

Column (5) is the bond's yield to maturity. For callable bonds, the yield to maturity is calculated in one of two ways: (a) to first call date when the asked price is above par (100), and (b) to maturity date when the asked price is equal to or below par. In Column (5) the period is a true decimal point, so there is an implied percent sign (%) after each yield.

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