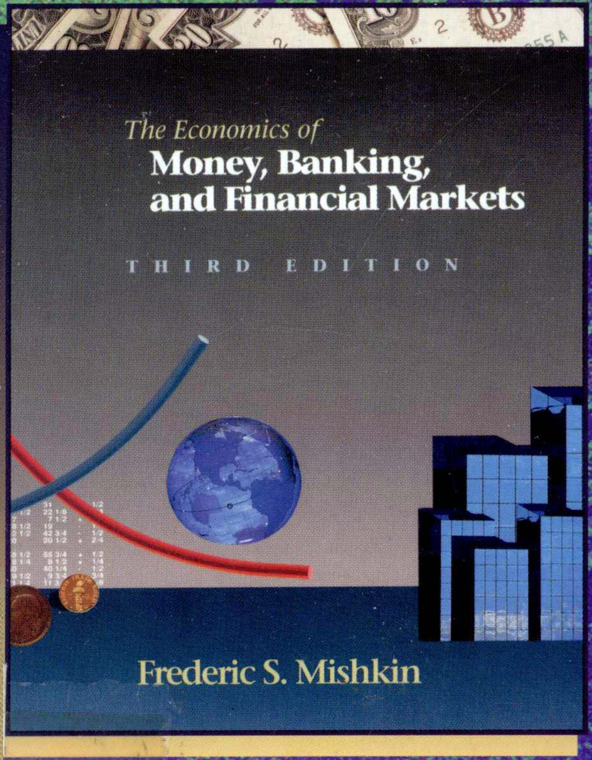
1993 Edition

READINGS for THE ECONOMICS OF MONEY, BANKING, and FINANCIAL MARKETS



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Readings for the Economics of Money, Banking, and Financial Markets 1993 Edition

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Credits:

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Alan Murray, "Inflation Hawks: Fed Banks' Presidents Hold Private Positions But Major Public Role," *The Wall Street Journal*, August 1, 1991. Reprinted by permission of The Wall Street Journal, © 1991 Dow Jones & Company, Inc. All Rights Reserved Worldwide.

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ACKNOWLEDGEMENTS

Reading 1 "*Progress in Retail Payments*," Elizabeth Laderman, Federal Reserve Bank of San Francisco *Weekly Letter*, February 7, 1992.

Reading 2 "*Monetary Aggregates*", John R. Walter, Federal Reserve Bank of Richmond *Macroeconomic Data: A User's Guide* (1990), 36-44.

Reading 3 "*Small Investor Continues to Give Up Control of Stocks*," William Power, *The Wall Street Journal*, May 11, 1992.

Reading 4 "*Auctioning Treasury Securities*," E. J. Stevens and Diana Dumitru, Federal Reserve Bank of Cleveland *Economic Commentary* June 15, 1992.

Reading 5 "*Treasury Bond Rates Defy Best-Laid Plans of the Federal Reserve*," Fred R. Bleakley and David Wessel, *The Wall Street Journal*, February 28, 1992.

Reading 6 "*Recent Views of Viewing the Real Rate of Interest*," Rosemary Thomas Cunningham and Thomas J. Cunningham, Federal Reserve Bank of Atlanta *Economic Review*, July/August 1990, 28-37.

Reading 7 "*The Truth about Junk Bonds*," Sean Becketti, Federal Reserve Bank of Kansas City *Economic Review*, July/August 1990, 45-54.

Reading 8 "*Will 30-Year T-Bond Become Extinct Species?*" Constance Mitchell and David Wessel, *The Wall Street Journal*, January 6, 1992.

Reading 9 "*Shapely Curves*," *The Economist*, March 7, 1992, 83.

Reading 10 "*Solving the Mystery of High Credit Card Rates*," Randall J. Pozdena, Federal Reserve Bank of San Francisco *Weekly Letter*, November 29, 1991.

Reading 11 "*Is There Too Much Corporate Debt?*" Ben Bernanke, Federal Reserve Bank of Philadelphia *Business Review*, September/October 1989, 3-13.

Reading 12 "*Lessons on Lending and Borrowing in Hard Times*," Leonard I. Nakamura, Federal Reserve Bank of Philadelphia *Business Review*, July/August 1991, 13-21.

Reading 13 "*Credit Flows and the Credit Crunch*," Steven Strongin, Federal Reserve Bank of Chicago *Chicago Fed Letter*, November 1991.

Reading 14 "*Banking and Commerce: The Japanese Case*," Sun Bae Kim, Federal Reserve Bank of San Francisco *Weekly Letter*, March 29, 1991.

PREFACE

This *Reader* is designed to make *The Economics of Money, Banking, and Financial Markets* a unique teaching package that meets the current needs of both the professor and the students. A basic problem of textbooks in the Money and Banking or Financial Markets and Institutions field is that current events and financial innovation make many of the facts in the textbooks obsolete soon after they are published. To minimize this problem, *The Economics of Money, Banking, and Financial Markets* focuses less on a set of facts, but rather stresses a few basic economic principles that never go out of date to understand the role of money in the economy and the structure of financial markets and institutions. To make this economic approach to teaching Money and Banking or Financial Markets and Institutions even more effective, it is important to keep the textbook analysis up to date by supplementing it with current articles on money, financial markets and institutions. This is what this *Reader* does.

UNIQUE FEATURES OF THIS READER

This *Reader* is unique in the Money and Banking and Financial Markets and Institutions field because of features such as its being the most up-to-date, its use to provide a new way to teach financial markets and institutions, its pedagogical aids and its low price when purchased with the textbook.

Most Up-to-date

In contrast to other readers in the Money and Banking or Financial Markets and Institutions field, this *Reader* will be updated annually, with over half the articles new each year. In this edition the number of articles has expanded from forty to forty-five; nearly three-fourths of these are new to this edition. Thirty of the forty-five articles — two-thirds — have been published since July 1991. These include articles on Treasury security auctions, the steepening of the yield curve, credit card interest rates, banking and deposit insurance reforms legislated by Congress in late 1991, securitization, international comparisons of central bank independence, debt monetization, Latin American currency pegging, the relative effectiveness of monetary and fiscal policies, and stock market efficiency. No other reader in the field is as current, and this will continue to be the case with the appearance of a new edition of the *Reader* every year.

A New Way to Teach Financial Markets and Institutions

The third edition of *The Economics of Money, Banking, and Financial Markets* develops a unifying economic framework to organize students' thinking about financial markets and institutions so that they can make sense of, rather than be confused by, all the facts about our financial system. The strength of this approach, in contrast to the approach used in other textbooks which focus on a set of facts about financial institutions, is that it will not go out of date. Because this approach stresses lasting economic concepts, it allows instructors to discuss the latest developments in financial markets and institutions. As part of this approach to teaching financial markets and institutions, instructors will want to use current articles in class to illustrate the economic forces that are driving changes in financial markets. This *Reader* has been designed to make it easier for instructors to do this and keep their teaching current. Over half of the readings are devoted to financial markets and institutions, and two-thirds of these articles have been published since July 1991. Because the need for current discussion of financial markets and institutions is so important to teaching Money and Banking or Financial Markets and Institutions, future annual editions will make a special effort to have a similarly high percentage of current articles in the *Reader* focus on financial markets and institutions.

The numerous, current readings on financial markets and institutions that will appear annually in this and future editions of the *Reader* and the stress on economic analysis in the textbook provide a whole new way of teaching financial markets and institutions. This new approach will make it less likely that students will memorize a mass of facts that will be forgotten after the final exam and that soon become obsolete because of the rapid pace of financial innovation. Instead, they will have an understanding of the dynamism of our financial markets and institutions and will see that what they have learned applies to current developments in financial markets, illustrating the relevance of their coursework.

Pedagogical Aids

Each of the *Reader*'s seven parts begins with an introduction (written by James Eaton) which provides the student with a brief summary of each article. In addition, the introduction provides suggestions for which chapter(s) the reading might be assigned to, thus helping instructors decide how they might like to organize their course.

James Eaton has also written several discussion questions which follow each reading in order to encourage students to think about how the reading relates to material in the text. Instructors may find these questions useful for class discussions of the reading or as written assignments in problem sets.

Low Price

Because we believe that this *Reader* is such an important supplement to courses in Money and Banking or Financial Markets and Institutions, it will be sold with the text at a particularly low price. This should give students the benefit of the *Reader* without making its cost prohibitive.

SUGGESTIONS AND ACKNOWLEDGMENTS

It is hoped that instructors and students who use this *Reader* will indeed find it an effective pedagogical tool. The editors look forward to receiving any comments or suggestions concerning the articles in this edition of the *Reader* or ones which would be appropriate for its next edition. Your comments and suggestions may be sent to:

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We owe sincere thanks to several people for their help in preparing this *Reader*. Our thanks go first to Elizabeth Middleton, whose retyping of each article accounts for the

Reader's uniform, polished appearance; and to Dan Spitzer, Jr., Ted Flory, and Scott Moomaw, who on many occasions shared helpful hints about word processing; and to Bruce Kaplan, economics editor at HarperCollins, and Evelyn Owens, supplements editor at HarperCollins, for their advice and encouragement. Above all, we would like to thank our wives Mary and Sally, and our children, Amanda, Elizabeth and Matthew (for Eaton) and Matthew (for Mishkin), who put up with us while this project claims a large share of our time. We hope they know that they are infinitely more important to us than a book.

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PART ONE

INTRODUCTION

The four readings for Part I introduce several basic issues related to money and the financial system: alternative means of making payments, the definition and measurement of the money supply, ownership of financial instruments and the distinction between direct and indirect finance, and the operation of a financial market.

Reading 1 is "Progress in Retail Payments" by Elizabeth Laderman. Laderman asks why electronic alternatives to checks haven't become more widely used in making retail payments. She suggests that the answer lies in the benefits of check float and difficulties in pricing the new payments services. This reading is recommended for use with Chapter 2's discussion of the evaluation of the payments system.

"The Monetary Aggregates" by John R. Walter is Reading 2. Walter reviews the origin and evolution of the monetary aggregates and describes how they are prepared and released and how the monetary data is used by economists. This reading provides an extended look at the monetary aggregates and the theoretical and empirical definitions of the money supply which are covered in Chapter 2. (Because this reading also discusses the money supply process, some instructors might wish to save it for discussion with Chapter 15.)

Reading 3 is "Small Investor Continues to Give Up Control of Stocks" by William Power. Power looks at the long term decline in individual stock ownership and the concomitant rise in the proportion of stocks held by pension funds, mutual funds and other institutions. His discussion of the causes and implications of these trends can be a springboard for the coverage of direct and indirect finance, financial instruments, and financial intermediaries in Chapter 3.

Reading 4 is "Auctioning Treasury Securities" by E.J. Stevens and Diana Dumitru. Much attention has been focused on Treasury auctions since attempts by Salomon Brothers to control specific Treasury note issues in 1991. Stevens and Dumitru contrast the current multiple price, sealed bid auction format with alternative formats which might eliminate the incentives and opportunities for market manipulation. This reading is recommended for use with Chapter 3's discussion of Treasury securities and financial markets.