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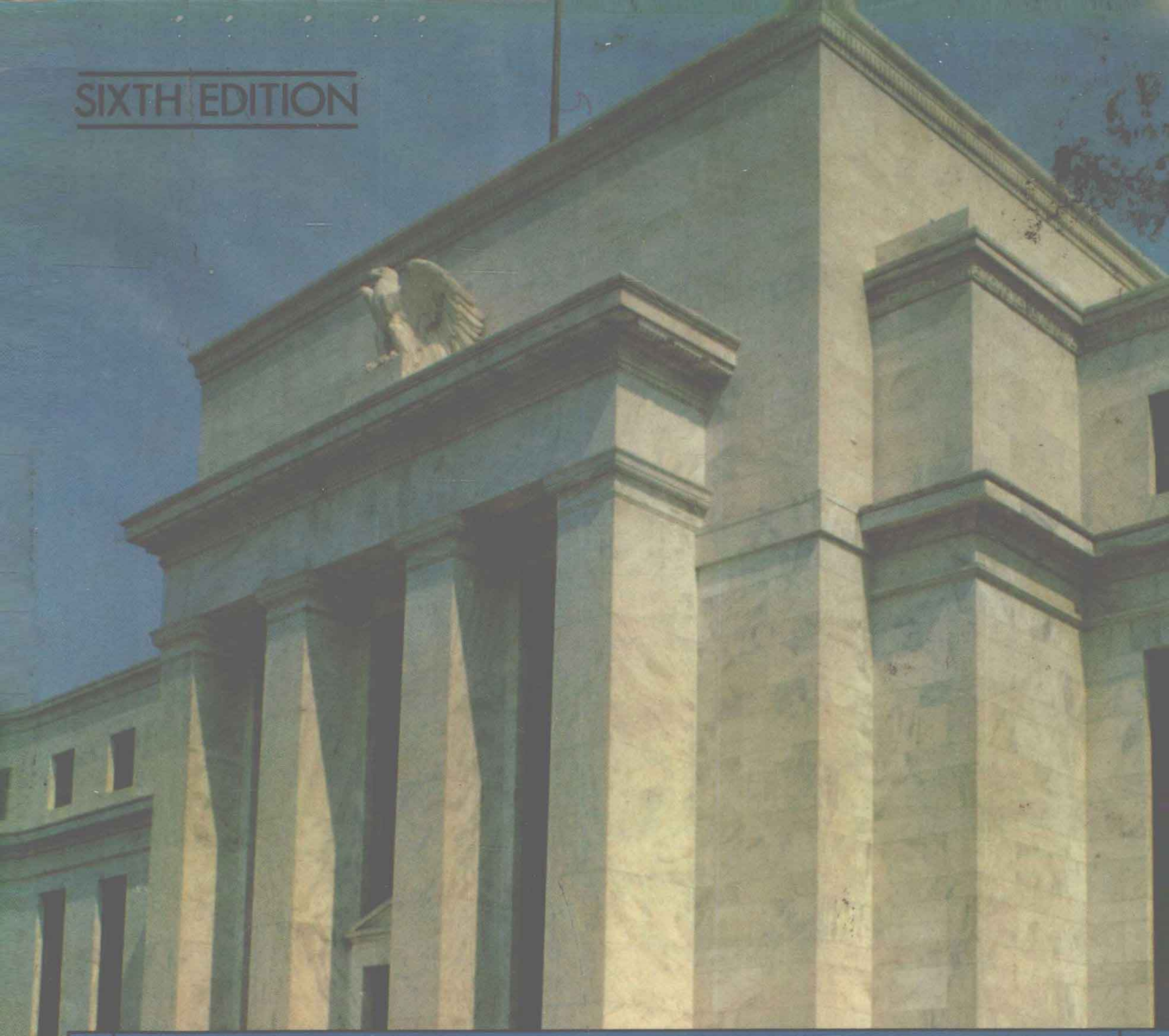

MONEY, BANKING, AND THE UNITED STATES ECONOMY

HARRY D. HUTCHINSON

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Preface

This book is intended for use in undergraduate or survey MBA courses in the economics of money and banking. Its scope and approach are more or less traditional although it may lean more toward discussion of current issues in the field than the average text.

The first four chapters deal with the definition and components of the money supply, an overview of the role of the financial system in the economy, a description of financial markets, and a brief discussion of the characteristics of a number of the more important nonbank financial institutions.

Following this we turn to three chapters on banking legislation and the history and recent changes in bank regulation and deregulation. From that point we go on to the business of commercial banking and the structure of the commercial banking system in the United States, concentrating on the dramatic changes that have occurred in the 1980s. Then, in Chapters 9 through 13, we consider various aspects of the Federal Reserve System and the limits on money creation. Chapter 14 concludes this primarily institutional section by dealing with the U.S. Treasury's impact on the money supply and the derivation of the Statement of Factors Affecting Depository Institution Reserves and the Monetary Base.

Chapters 15 through 22 are devoted to a consideration of monetary theory beginning with the (pre-1930s) version of the quantity theory, and progressing through a four chapter development of an essentially Keynesian income-expenditure model. Following this we allow for a variable price level by introducing aggregate demand and supply curves in Chapter 20 and then follow up with a thorough consideration of the modern monetarist viewpoint. Finally, in Chapter 22, some of the analytical devices developed to deal with such problems as inflation and stagflation are presented.

Chapter 23 gives consideration to transmission mechanisms connecting the money supply and economic activity as well as a number of the alleged weaknesses of monetary policy. Chapter 24 deals with the prime alternatives to monetary policy as a stabilization device—fiscal policy, debt management, and incomes policies.

The concluding three chapters concentrate on international finance, including payment across national boundaries, exchange rate determination, the balance of payments statement, and the causes and significance of current account deficits and surpluses. Included in this section are thorough descriptions of the old gold standard, the International Monetary Fund and the Bretton Woods "exchange rate system" as well as the so-called managed floating system in effect since 1973. Special emphasis is placed on the performance of the U.S. balance of payments during the 1980s.

Every textbook writer claims that his or her book is "written for the student." I can think of no satisfactory way of varying this familiar theme. Throughout, I have assigned the highest priority to keeping the discussion as clear and straightforward as the subject and my expository ability permit. Whether this effort will be a success, of course, only the student can judge. I simply attest that clarity has been my most important objective.

All teachers labor under certain preconceptions regarding the needs of their students. Mine include the belief that repetition of many fundamental principles already covered in the standard introductory course is a desirable and, indeed, necessary technique. For those students who really learned these basic tools in their first course, the cost involved in reviewing them once again is slight. For those who got through their principles course satisfactorily, but didn't quite fully grasp (or have already forgotten) such concepts as multiple credit expansion, the multiplier, or the balance of payments, repetition at this level is absolutely essential. Basically, I have tried to start "from scratch" in all areas, first recapitulating what is normally taught in the introductory course and then superimposing more advanced material on that base.

This edition includes substantial revision in a number of areas. Chapter 5 is extensively altered while Chapters 6 and 7 are essentially new. In Chapter 5 the key features of federal commercial bank legislation from the First Bank of the United States in 1791 through the Competitive Equality Banking Act of 1987 are discussed. Then in Chapters 6 and 7 the nature, scope, and reasons for bank regulation are considered, along with a commentary on the rationale behind the deregulation of the 1980s as well as a much-expanded discussion of the Federal Deposit Insurance Corporation. In the theory section, an entirely new chapter introduces aggregate demand and aggregate supply curves, while the international finance chapters involve substantial revision and updating with a careful look at the reasons for, and significance of, the unprecedented U.S. current account deficits of the 1980s.

I am indebted to many people for support, encouragement, and valuable suggestions for improvement. Especially helpful have been reviews and comments provided by Professors Maureen Dunne, Framingham State College; Donald Ellickson, University of Wisconsin at Eau Claire; Darryl W. Lowry, Roanoke College; H. Bruce Throckmorton, Tennessee Technological University; Lee B. Wallerstein, Benjamin Franklin University; Harold A. Wolf, University of Texas at Austin; and James S. Worley, Vanderbilt University. The above offered constructive suggestions and a major regret is that I was unable to incorporate them all due to the twin pressures of time and text length. As always, my col-

leagues at Delaware in both economics and finance have unstintingly provided their time and expertise. To all of them as well as to Prentice Hall's Esther Koehn, who came along at just the right time to provide the exceptional efficiency and professional competence needed to see the production job through, I am very grateful. For any errors of omission or commission that remain despite our efforts to root them out, I follow long established custom by accepting full responsibility. *Ite Caerulei!*

Contents

1

What Is Money?

This is a book about money. Accordingly, logical order and the dictates of tradition require that we begin our discussion by defining the subject. *What,* precisely, *is money?*

On its face, the question may seem to be an absurdity and, indeed, something of an insult to the intelligence of the reader. "Surely," as one of my more outspoken students informed me recently, "everyone knows what money is. Is it really necessary to waste valuable class time discussing the obvious?"

The question is, of course, rhetorical. It is never necessary to "discuss the obvious." But that which appears obvious to some may not be so clear-cut to others. It is not a fact that "everyone knows what money is." For even if no one else had any doubts about it, monetary economists have been struggling for a number of years now to arrive at some consensus on the definition of money.

The problems show up at two levels. On the one hand, there are long-standing philosophical differences as to what constitutes the true "essence" of money. One group—undoubtedly the majority—argues that the distinguishing characteristic of money is its capacity to serve as a "generally accepted medium of exchange." Another group, however, sees the essential feature of money as its ability to serve as a "temporary abode of purchasing power—in which sellers of goods, services, or financial assets hold the proceeds in the interim between sale and subsequent purchase of other goods, services or assets."[1] This difference of opinion has never really been settled, but it has been neatly sidestepped by the monetary authorities who regularly collect and publish several different money

[1] *Improving the Monetary Aggregates,* report of the Advisory Committee on Monetary Statistics (Washington, D.C.: Board of Governors of the Federal Reserve System, 1976), p. 9.

supply series (labeled M1, M2, etc.), each aimed at satisfying the members of one of the two groups.

The other problem—recently a much more vexing one—is that of deciding precisely where to draw the line separating those financial instruments that are money and those that are not. This task would be difficult enough to undertake in a static economy without change. But the unprecedented rate of financial innovation in the last 15 years has so severely magnified the problem that one high Federal Reserve official was led to observe, "I have concluded, most reluctantly, that we can no longer measure the money supply with any precision."[2]

In light of all this, we must recognize at the outset that defining money and agreeing on the financial assets that shall be counted as money is a complex and challenging task. Yet if we are to speak of the money supply, as indeed we must, meaningful communication requires that we agree on a single definition. The remainder of this chapter is aimed at that objective.

How Money Contributes to the Economy

Despite their many differences, virtually all economists agree that money must be defined functionally. That is, **items that are to be considered money should be selected on the basis of the functions they perform** rather than on such alternative characteristics as the identity of the issuer or the commodity of which they are made. We need, then, to consider carefully the particular functions that money does perform. Before doing so, however, it should be revealing to consider the difficulties inherent in an economy without money.

The Problems with Barter

If no money at all existed, each income recipient would necessarily have to be paid in kind—that is, in the form of his or her share of the actual goods that he or she had helped produce. If, for instance, one worked for a brewery, one's weekly paycheck might consist of 50 cases of beer.

Sounds great, you say? Don't be so sure. After the first couple of six-packs were consumed, most people would find it necessary to start bartering their remaining beer to others who happened to possess the food, clothing, and fuel and myriad other goods and services most of us choose to consume on a regular basis. The process of barter without money to serve as a common medium for which anything can be bought or sold would surely turn out to be a nightmare.

The problems encountered would be enormous. Not only would our beer peddler have to search out others who wished to trade off the things he or she wanted, but for a direct deal to be struck, these people would have to be people who desired to trade what they had for beer. To put it in the terms most commonly employed, exchange under barter conditions would require a *double*

[2] Frank E. Morris, "Do the Monetary Aggregates Have a Future as Targets of Federal Reserve Policy," *New England Economic Review*, Federal Reserve Bank of Boston, March–April, 1982, p. 5.