

# Money and Capital Markets

Financial Institutions and Instruments in a Global Marketplace

Eighth Edition

Peter S. Rose

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## McGraw-Hill Higher Education 👷

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#### MONEY AND CAPITAL MARKETS:

Financial Institutions and Instruments in a Global Marketplace

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This book is printed on acid-free paper.

domestic

1234567890CCW/CCW098765432 international 1234567890 CCW/CCW 098765432

ISBN 0-07-248676-7

Publisher: Stephen M. Patterson Developmental editor: Jennifer Rizzi

Executive marketing manager: Rhonda Seelinger Producer, Media technology: Melissa Kansa Senior project manager: Jean Lou Hess Production supervisor: Gina Hangos Director of design BR: Keith J. McPherson Supplement producer: Matthew Perry Senior digital content specialist: Brian Nacik Cover illustrator: Tom Nemoda, Asylum Studios

Cover design: Trudi Gershenov Typeface: 10/12 Times Roman Compositor: GAC Indianapolis Printer: Courier Westford

#### Library of Congress Cataloging-in-Publication Data

#### Rose, Peter S.

Money and capital markets: financial institutions and instruments in a global marketplace / Peter S. Rose - 8th ed.

p. cm.— (The McGraw-Hill/Irwin series in finance, insurance, and real estate)

Includes bibliographical references and index.

ISBN 0-07-248676-7 (alk. paper) — ISBN 0-07-119880-6 (international : alk. paper) 1. Finance—United States. 2. Money market—United States. 3. Capital market—United

States. I. Title. II. Series.

HG181 .R66 2003

2002069217

#### INTERNATIONAL EDITION ISBN 0-07-119880-6

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## **Preface**

The global tragedy in terror that rocketed into the headlines in September of 2001 has served as a reminder to us of how fragile our lives are on this planet and how all of our institutions can be significantly impacted by shocking, unexpected events. Anything that happens to us as individuals or to our key institutions, including sudden changes in the economy and the financial system, can profoundly change how we look at life and how we prepare for the future.

However hard as it is to believe, there is often a small glimmer of light behind such tragedies. We begin to appreciate, more than ever before, our loved ones and our institutions and take positive steps to protect them and keep our lives moving forward.

One of the consequences of the September 2001 tragedy in terror was a clear demonstration of how important the financial system of money and capital markets that girdles the globe is to our economic and personal well-being. The terror attacks on New York City damaged or put out of commission the offices of several leading banking and securities houses in this world financial center. Frightened investors in stocks and bonds suddenly lost contact with many members of the financial-services community and feared for the fate of their savings and their investments. Payments that needed to be made to security traders and those repaying old loans or seeking new loans were suddenly shut down or delayed. The U.S. economy—strongest in the world—slowed and then tipped into a recession with rising unemployment and business bankruptcies. Yet, the financial system of money and capital markets soon righted itself; financial-service businesses that suffered huge losses of talented people and funds fought their way back to full service to the public with amazing speed and determination.

Recent tragedy, then, has demonstrated how resilient is the institution we are about to study—the money and capital markets that make up the heart of our global financial system. Recent events have also shown the many important ways the money and capital markets and the financial system—when operating at full speed and efficiency and when dealing with crisis—impact every household (individual or family) and every business and governmental institution around the globe. More than ever before, we recognize how much we rely upon the vital services that our financial markets and institutions readily provide us every day.

Today more than ever we recognize the money and capital markets as that important institution in our society that *supplies credit* to those in need of borrowing funds; *encourages saving* for the future on the part of millions of businesses and individuals; *allocates whatever savings are available into investments* in new plant and equipment and stocks of goods so that businesses may grow and provide more jobs; provides a channel through which trillions of currency units pass daily to *carry out payments* so that spendable funds flow from buyers to sellers; supplies *a method for liquidating our assets* to provide ready cash (liquidity) for spending that must be done; offers *risk protection* in the form of insurance policies, derivatives, and other financial products; and serves as a *policy channel* by which governments work to regulate their economies and achieve each nation's economic goals, including full employment, avoidance of inflation, and sustainable economic growth.

What an incredible array of jobs for one of society's great institutions! How lucky we are to have the money and capital markets and the surrounding financial system! Moreover,

as recent global tragedies illustrate, how different our lives become when it is significantly damaged or can no longer perform as efficiently as we might wish!

## WAYS THIS BOOK CAN BE USED

As *Money and Capital Markets* enters its eighth edition, the book, though somewhat shorter with 26 chapters instead of the original 30 chapters, continues to be one of the most comprehensive texts in its field. So comprehensive, in fact, that it offers professors, instructors, and other users not one approach to the field, but several alternative routes through the vast playing field represented by the money and capital markets and the financial system. Every reader and every teacher can self-select the type of course they would like to offer dealing with the financial system.

- A Security Markets—Oriented Course. For example, users of this text who would like to focus upon security markets and security trading would be more likely to read or assign to those they work with parts One (Chapters 1–4), Two (Chapters 5–9), Three (Chapters 10–14), Six (especially Chapters 21 and 22), and Seven (particularly Chapter 25).
- A Financial Institutions—Related Course. In contrast, those who want to know as much
  as possible about financial-service firms, including the great financial institutions represented by banks, insurance companies, mutual funds, pension funds, finance companies, and security dealers, would find it most helpful to center their course around Part
  One (Chapters 1–4) and Chapters 5–7 and 11–14 as well as Part Four (Chapters 15–18),
  and Chapters 21, 22, and 26.
- A Policy and Regulations—Oriented Course. For our readers and instructors who have the greatest interest in public policy and government regulation within the financial system, key chapters to assign would include Part One (Chapters 1–4), Chapters 5 and 6, Chapters 11–14, Chapters 18–20, and Chapters 23–24.
- An Internationally Focused Course. The increasing globalization of our financial system
  has aroused great interest in a global view of the money and capital markets and financialservice firms. While internationally focused material appears throughout this text, certain
  sections and chapters do have a heavier emphasis on the international finance field. A
  strongly internationally focused course would want to emphasize such portions of the text
  as Part One (Chapters 1–4), Chapters 5, 7, and 9, Part Three (Chapters 10–14), Chapters
  15 and 18, Chapters 21 and 22, and Part Seven (Chapters 25 and 26).
- A Financial Theory—Oriented Course. For readers and teachers most interested in the basic theoretical concepts of Finance there are several chapters that deserve special note.
  These include Part One (especially Chapters 1 and 2), Part Two (especially Chapters 5, 7, 8, and 9), Part Three (especially Chapters 10 and 13), Chapter 19, and Chapters 21 and 22.

## **KEY FEATURES OF THIS BOOK**

As in the earlier editions, *Money and Capital Markets* in its eighth edition pursues its key goals by employing a variety of helpful learning aids for the user. For example:

Each chapter begins with a statement of that chapter's learning objectives (now expanded from earlier editions)—what do we hope the reader will learn in that chapter and the key issues each chapter addresses.

- Following the learning objectives is a topical outline of the key concepts and issues to be presented in each chapter.
- Numerous graphs, tables, and examples appear in the text's pages in order to make key
  points more vivid and memorable.
- Numerous boxes reporting special events and key facts within the financial system appear throughout the text. These boxes, which heighten the reader's interest in the subject, carry such labels as Management Insights, International Focus, and Financial Developments. These boxes of pertinent information have been expanded and updated and represent one of the key highlights of this new eighth edition.
- Nearly all the end-of-chapter problems from the previous edition have been retained and at least one new problem added to each chapter in the new edition.
- Especially important in this new eighth edition are the greatly expanded references to
  Internet Web sites dealing with money and capital markets issues. Each chapter contains
  a box near the front, listing key Web sites dealing with the topics presented in the particular chapter. Then, scattered liberally throughout the book in the text margins are additional URLs for readers who prefer to make extensive use of the Web to learn as much
  as possible about the financial system.
- Questions to Help You Study are placed at strategic points within each chapter to aid the reader in making sure he or she has understood key points just made.
- Key Terms are listed at the end of each chapter, along with their page numbers to help the
  reader find them again. Moreover, a Money and Capital Markets Dictionary at the end of
  the book allows the reader to double-check his or her understanding of each key term.
- In this new eighth edition a Chapter Summary, with key points bulleted, appears at the
  close of every chapter in the text. This feature makes it so much easier for users of the text
  to make sure they have mastered the most important points in any reading assignment.
- New to this edition, Standard & Poor's Market Insight problems will be available on the Rose, Money and Capital Markets, eighth edition Web site, <a href="www.mhhe.com/business/finance/rose8e">www.mhhe.com/business/finance/rose8e</a>, for both students and faculty. Some chapters ask for problem solutions that could benefit from the use of the Educational version of Market Insight, a Standard and Poor's Compustat® database. See how easily this Web asset, unique to McGraw-Hill/Irwin, can add value to your entire teaching and learning experience. Over 300 companies and key financial data will be available as a problem-solving resource, of which over 40 are financial-service institutions.

Many new topics appear in this latest edition, including such key items as:

- The debate over personal financial privacy—protecting the consumer's private information from unwanted viewing, solicitation, identity theft and fraud.
- The restructuring of banks and financial holding companies in the wake of the Gramm-Leach-Bliley (GLB) Financial Services Modernization Act and the rise of universal banking in the United States.
- The continuing *integration of Europe's money and financial system* and the struggle of the Euro to become a key vehicle currency and assert leadership around the globe.
- The rising concern over *terrorism* and its implications for the stability of the economy and financial system as well as the health and welfare of law-abiding citizens.

- The *changing focus of financial institutions' regulation*, relying more heavily today upon the private marketplace (i.e., market discipline), rather than rigid government-imposed rules, to govern how financial institutions operate and perform for the public.
- The rising fear in selected nations (such as Japan), not about inflation, but about deflation as a weakening economy leads to falling prices for goods and services and lower interest rates.
- *Tax reform* and the new U.S. Economic Growth and Tax Relief Reconciliation Act and its implications for saving, investment, and the financial marketplace.
- The great debate over the "good" and "evil" of *subprime and predatory lending to lower income individuals and families* and its implications for consumers and financial institutions.
- The financial disaster represented by the collapse of Enron Corporation—the seventh largest U.S. company—and its consequences for businesses, employees, pension funds, and regulators.
- Whether *bankruptcy reform* is really needed to stem the rising tide of bankrupt businesses and households or if tougher bankruptcy laws might do more harm than good.

There are so many *new* topics and issues in the eighth edition that the list above seems just to scratch the surface!

## SUPPLEMENTARY MATERIALS

Important supplements strengthen the usefulness and teaching impact of this new edition. Among the key supplements instructors may wish to draw upon is:

• Instructor's Resource CD ROM (ISBN 0072486791)—This contains:

*Instructor's Manual and Test Bank* This important supporting material outlines each chapter and contains hundreds of questions and problems available for testing or for use in classroom presentations.

**Power Point Presentation System** It is a recent addition to *Money and Capital Markets* and contains clear and concise slides that provide the instructor and his or her class with sharply focused ideas and illustrations. There are numerous graphs, charts, and examples as well as frequent listings of key points to be retained. The user can easily edit or rearrange each slide set to meet his or her unique style.

## ACKNOWLEDGMENT OF THE MANY PROFESSIONALS WHO HAVE HELPED MAKE THIS BOOK BETTER OVER TIME

As this book has worked its way through eight editions, it has benefited beyond measure from the criticisms and helpful suggestions of numerous professionals. These are people who care about the quality of classroom instruction and about their students achieving a richer understanding of the financial world and our place within it. There have been so many great contributors to this book over the years that the author is always hesitant to start a list for fear of omitting at least some worthwhile contributions and the names of several deserving professional educators.

However, among the most significant contributors through the editions have been James C. Baker of Kent State University, Ivan T. Call of Brigham Young University, Eugene F. Drzycimski of the University of Wisconsin System, Mona J. Gardiner of Illinois Wesleyan University, Timothy Koch of the University of South Carolina, David Mills of Illinois State University, John P. Olienyk of Colorado State University, Colleen C. Pantalone of Northeastern University, Richard Rivard of the University of South Florida, Paul Bolster of Northeastern University, Robert M. Crowe, formerly of the American College at Bryn Mawr, Joseph P. Ogden of SUNY-Buffalo, Donald A. Smith of Pierce College, Oliver G. Wood, Jr., of the University of South Carolina, Larry Lang of the University of Wisconsin-Oshkosh, Jeffrey A. Clark of Florida State University, James F. Gatti of the University of Vermont, Gioia P. Bales of Hofstra University, Ahmed Sohrabian of California State Polytechnic University at Pomona, Thomas A. Fetherston of the University of Alabama at Birmingham, Mary Piortrowski of Northern Arizona University, Rick Swasey of Northeastern University, Owen K. Gregory of the University of Illinois at Chicago, Thomas Dziadosz of the American College, and Tom Potter of the University of North Dakota.

The author adds a special note of gratitude to those who helped with their comments and suggestions in the construction of this eighth edition: Lester Hadsell of State University of New York-Albany, John Hysom of George Mason University, Frank Ohara of the University of San Francisco, Robert Schweitzer of the University of Delaware, and Donald J. Smith of Boston University.

In addition, the author expresses deep appreciation to the staff of professionals at McGraw-Hill, particularly Steve Patterson, Jennifer Rizzi, and Jean Lou Hess, whose guidance, suggestions, and kindnesses throughout the revision and production process were truly invaluable.

A special thank you also goes to Professor Yee-Tien (Ted) Fu, Visiting Scholar at Stanford University, for his work on creating the Instructor's Manual, Test Bank, and Power-Point presentations. In addition to these outstanding contributors are many associations and institutions that have contributed to the content of this text in a wide variety of ways over the years. These important institutions and associations include the American Council of Life Insurance, the Canadian Banker (official publication of the Canadian Bankers Association), the Chicago Board of Trade, the Credit Union National Association, the Insurance Information Institute, Moody's Investors Service, and Standard and Poors' Corporation.

The author also gratefully acknowledges the support and patience of the members of his family, who made the completion of this new edition possible. Any shortcomings that remain belong to the author, who nevertheless, strives to make the text better with each successive edition.

## A NOTE TO THE STUDENT AND OTHER READERS OF THIS TEXT

The money and capital markets, along with the financial system that supports them, are an exciting area for study. What goes on daily in these markets and within the financial system as a whole has a powerful impact upon our daily lives. Indeed, our ability to function as human beings and as professionals in our chosen careers is shaped, in so many ways, by the functionings of the financial system. Moreover, the money and capital markets and the financial system in which they do their work are constantly in a state of flux. Broad changes are forever remaking the financial marketplace as new institutions, new methods, new problems, and new services continually appear.

The rapidity of change that characterizes the financial system means that we have no choice but to try to keep up with our unfolding financial world. Indeed, so rapid and sweeping are the changes going on in the money and capital markets today that no book, no matter how many times it is revised, can serve as more than an *introduction*—indeed an invitation—to learn about the goings-on within the financial marketplace.

Without question you need to read this book and understand what it is trying to say. But reading this book cannot be the end of the road. You cannot stop here. A great American poet, Robert Frost, admonished each of us that we "cannot stop here" for we have "promises to keep" and "miles to go before we sleep." For the sake of your own future success, personally and professionally, plan to enjoy what you discover in the pages that follow, but view this book as only the first step in what must, of necessity, be a lifetime journey of learning about the financial system and its effects on our everyday existence. Truly, each one of us has promises to keep to ourselves and others and miles to go before we can be satisfied at what we have accomplished.

As you begin each new chapter in this book set your sights on true *mastery* of the subject. Make the most of the time you spend with this text. Plan for success and hit the target dead center through your determination and well-organized study.

But how can you do that? How can you learn what you need to know in today's complex financial world?

First, begin with the *Learning Objectives* and the *Key Topics Outline* that open each chapter. These are really road signs, alerting you to the key questions and issues each chapter will address. They tell you what you should *expect to learn* in the pages that follow. It is a useful idea to review the list of learning objectives and the Key Topics Outline as you sit down to tackle each new chapter and then to review them when you are finished reading. Have you touched base with each learning objective and each key topic as you read the material? If you are not sure of one or more of the learning objectives or key topics, please go back and review the relevant portions of the chapter that apply to that particular topic or objective. Ask yourself if the learning objective or key topic you are focusing upon makes sense to you and if you now feel better informed about it than you did before.

Next, examine the list of *Key Terms* at the close of each chapter. There are page numbers telling you where each key term is defined and discussed. Return to the pages where any key terms appear that still seem to be a mystery to you. Let me suggest that you make a list of these key terms in your personal computer or in a notebook and accumulate them as the assigned chapters roll by. This is much more than an act of memorizing terms; rather, this is reaching out to learn the "language" of the financial marketplace.

You want to make the language of the money and capital markets second nature to you so that everything you subsequently read and hear about the financial system you will understand and be able to make it work for you. You may even want to write out or type into the computer a definition of each key term and then double-check that definition against the meaning that appears in the *Money and Capital Markets Dictionary* that appears at the end of this book.

In each chapter, at selected points, appear *Questions to Help You Study*. These questions appear at key places so you can pause after reading several pages and ask yourself: Do I really understand what I just read? Try to answer each of these study questions, either verbally or, better still if you have time, by writing out a brief answer and then double-checking its accuracy by referring back to the relevant portion of the chapter you are working on. You may want to store the answers you develop in your personal computer or in a paper file for future reference, particularly just before exams come along.

In each chapter of this new eighth edition several useful *Web sites* are given. First, there is a box near each chapter's opening that gives key Web site addresses for the topics in the chapter you are reading. Then, scattered in the margins throughout the text are additional URLs to let you enter the World Wide Web and learn more. Check out these Web sites,

pursuing especially those that interest you or seem the most challenging. This is a way to repeat key text ideas through a new format. As always, *repetition* is a key to learning.

At the end of each chapter are *Problems* to work through, many requiring numerical calculations. This is another important dimension of our subject for you to tackle. Finance is about problem solving and the better a problem solver you can become in this field, the greater your chances for success. As you work through each problem save the solutions for future reference, either in your computer, in a notebook, or in a paper file.

Finance in general and the money and capital markets in particular are moderately difficult disciplines to master. Finance does have its challenges. Group study sessions are often helpful in tackling its hardest issues and problems. See if you can form a study group that periodically gets together and goes over some of the hardest concepts and problems. Be a contributor to these sessions, take the lead in explaining and helping others. *Teaching others* is one of the best ways to learn a new subject for yourself.

Try to keep in mind that this book has two fundamental purposes: (1) to give you an arsenal of *analytical tools* that you can apply to any financial problem so as to make better financial decisions; and (2) to make you feel comfortable with the *language of the financial marketplace* so you can learn to speak that language fluently with comfort and with maximum understanding. A truly successful course of study will develop in you both the tools and the language of the financial system and get you started along the road to mastery and personal success.

This course is a foundation-stone for many promising future careers. Perhaps you've considered becoming the financial manager or CEO of a large corporation, the head of the financial division of an important unit of government, possibly a member of a legislature or of the Congress, a trader (dealer or broker) in securities or derivative contracts, a consultant or adviser to those who must enter the global financial marketplace, or an active investor in your own right, striving to build up your personal wealth and prepare for a rewarding life style. Wherever your career path leads you, superior knowledge and understanding of the financial marketplace will be an absolutely essential companion on your journey.

But you already know from prior experience with other challenging fields of study that to make the money and capital markets and the financial system your faithful servant, mastery of them will *not* be easy. Your future success in moving forward, in the words of the poet, to keep the "promises" you have made and to travel successfully the many "miles to go" before you "sleep," will depend crucially upon the energy and enthusiasm, the commitment to excellence, and the hard work that you bring to this subject. By any measure, it is a challenge worthy of your best efforts. Good luck on your journey!

Peter S. Rose

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