

BRIEF CONTENTS

PART 1

INTRODUCTION 1

CHAPTER 1 The Importance of Money 2

PART 2

THE U.S. FINANCIAL SYSTEM: *The Participants, the Instruments, and the Environment* 19

CHAPTER 2 Introducing the Participants 20

CHAPTER 3 A Framework for Understanding Financial Instruments 42

CHAPTER 4 The Basic Financial Instruments 67

CHAPTER 5 The Evolution to the New Financial Environment 92

PART 3

MONEY, INTEREST RATES, AND PRICES 117

CHAPTER 6 The Public's Portfolio Choice: *The Laws of Asset Demand* 118

CHAPTER 7 Deposit Rate Deregulation and Money Demand 131

CHAPTER 8 The Basics of the Money Supply 147

CHAPTER 9 Two Tales of Determining the Interest Rate 172

CHAPTER 10 A Framework for the Economy: *The Real and the Financial Sectors* 191

PART 4

THE FEDERAL RESERVE AND ITS BEHAVIOR 221

CHAPTER 11 The Federal Reserve System: *Form and Function* 222

CHAPTER 12 Functions of Federal Reserve Banks: *The Details* 248

CHAPTER 13 Instruments, Targets, and Goals of the Federal Reserve 267

CHAPTER 14 Open Market Operations and Movements in Reserves 291

CHAPTER 15 Deposit Creation and the Money Supply 310

CHAPTER 16 Targeting Monetary Aggregates: *Theory and Experience* 329

PART 5

**FINANCIAL INSTITUTIONS:
Structure, Regulation, and Behavior** 353

CHAPTER 17

**The Structure, Regulation, and
Supervision of U.S. Depository
Institutions** 354

CHAPTER 18

The Profit-Maximizing Banking Firm 382

CHAPTER 19

Nondepository Financial Institutions 411

PART 6

**FINANCIAL MARKETS,
INTEREST RATES, AND THE
CONDUCT OF MONETARY
POLICY** 429

CHAPTER 20

The Theory of Money Demand 430

CHAPTER 21

**The Deposit Market and Money
Demand** 448

CHAPTER 22

The Money Market 472

CHAPTER 23

The Structure of Rates of Return 496

PART 7

**THE INTEGRATION OF THE
FINANCIAL AND REAL
SECTORS** 521

CHAPTER 24

**Determining the Interest Rate and
Real Income: *The IS-LM Model*** 522

CHAPTER 25

**Monetary and Fiscal Policy in the
IS-LM Model** 547

CHAPTER 26

**The Price Level and Real Income: *The
Aggregate Demand-Aggregate Supply
Model*** 572

CHAPTER 27

**Aggregate Supply, Expectations, and
Policy** 604

CHAPTER 28

**Inflation, Unemployment, and
Economic Policy: *History and Theory*** 630

PART 8

INTERNATIONAL FINANCE 663

CHAPTER 29

**International Payments and the
Foreign Exchange Market** 664

CHAPTER 30

Economic Policy in an Open Economy 696

Glossary G-1

Answers to Try-It-Out Exercises A-1

Index I-1

CONTENTS

PART 1

INTRODUCTION 1

CHAPTER 1 The Importance of Money 2

- Chapter Preview 2
- The Mystery of Money 3
- The Functions of Money 3
 - Medium of Exchange 3
 - Unit of Account 5
 - Store of Value 5
- Measurements of Money throughout History 6
 - From Unminted to Minted Gold 6
 - Fractionally Backed Paper Money 6
 - Fiat Money (Paper and Coins) and Checking Accounts 7
 - Controlling the Quantity of Money 8
- Current Measures of Money 9
- Money and the Economy: A Preview 11
- FedWatch 1.1: Tracking the Monetary Aggregates 12*
 - Money, Financial Markets, and Rates of Return 12
 - Nominal GDP, Real GDP, and the Price Level 13
 - Money, Economic Activity, and Prices 13
- GlobalWatch 1.2: Plummeting Purchasing Power of the Russian Ruble 15*
- Looking Ahead: The Two-Pillar Framework 15
- Summary 16
- Key Terms and Concepts 17
- Questions and Problems 17
- Suggested Readings 18

PART 2

THE U.S. FINANCIAL SYSTEM: *The Participants, the Instruments, and the Environment* 19

CHAPTER 2

Introducing the Participants 20

- Chapter Preview 20
- Who Are the Participants? 21
 - Households 21
 - Nonfinancial Firms 22
 - Financial Intermediaries 22
 - Government 23
 - The Federal Reserve 23
 - Foreign Participants 24
 - A Word on Stocks and Flows 24
- Why Do the Participants Issue and Acquire Financial Instruments? 25
 - The Role of Surplus and Deficit Units 25
 - GlobalWatch 2.1: Is Foreign Borrowing Bad 32*
 - The Role of Financial Go-Betweens 33
 - SectorWatch 2.2: A Web of Bank Regulators 38*
 - The Role of Monetary Policymaker 39
- Looking Ahead 39
- Summary 40
- Key Terms and Concepts 40
- Questions and Problems 41
- Suggested Readings 41

CHAPTER 3

A Framework for Understanding Financial Instruments 42

- Chapter Preview 42
- Maturity 43
- Marketability 44
 - Primary and Secondary Markets 44
 - Money and Capital Markets 45
 - Spot and Futures Markets 45
- Rate of Return: The Most Watched Characteristic 45
 - Approximating the Rate of Return 46
 - MarketWatch 3.1: Is Gold a Good Investment? 48*

| | |
|--|----|
| Timing of Receipts and Expenditures | 48 |
| Calculating Present and Future Values | 49 |
| The Rate of Return | 50 |
| The Language and Mechanics of Notes and Bonds | 51 |
| Try It Out 3.1 | 53 |
| <i>MarketWatch 3.2: Tracking Rates on Treasury Notes and Bonds</i> | 54 |
| Risk | 55 |
| Market Risk, or Interest Rate Risk | 55 |
| Default Risk | 56 |
| Risk of Inflation | 57 |
| <i>MarketWatch 3.3: The Rise, Fall, and Rise of Junk Bonds</i> | 58 |
| Liquidity | 58 |
| Divisibility | 60 |
| More Details on Calculating Interest Rates: Zero Coupon Securities | 60 |
| A “Zoo of Zeros” | 61 |
| Coupon Equivalent Yield on Zero Coupon Notes and Bonds | 61 |
| Coupon Equivalent Yield on Treasury Bills | 62 |
| Yield on a Discount Basis | 63 |
| <i>MarketWatch 3.4: Tracking Treasury Bill Rates</i> | 64 |
| Summary | 64 |
| Key Terms and Concepts | 64 |
| Questions and Problems | 65 |
| Suggested Readings | 66 |

CHAPTER 4

The Basic Financial Instruments 67

| | |
|---|----|
| Chapter Preview | 67 |
| Classifying Domestic Financial Instruments | 68 |
| Government Debt | 68 |
| U.S. Treasury Securities | 68 |
| Federal Agency Securities | 70 |
| <i>SectorWatch 4.1: Will Sallie Mae Survive?</i> | 71 |
| Municipal Securities | 72 |
| Why Hold U.S. Government Debt? | 72 |
| Open Market Debt and Equity of Firms | 72 |
| Corporate Bonds | 72 |
| <i>GlobalWatch 4.2: The Foreign Presence in the U.S. Financial System</i> | 73 |

GlobalWatch 4.3: A Surge in Convertible Bonds in Japan 74

| | |
|---|----|
| Commercial Paper | 74 |
| Bankers’ Acceptances | 75 |
| Corporate Stock | 76 |
| The Debt of Households and Firms to Banks: Bank Loans | 78 |
| <i>MarketWatch 4.4: Debt Hangover in the 1990s</i> | 79 |
| The Debt of Banks: Bank Deposits | 80 |
| The Federal Reserve’s Debt | 82 |
| Currency in Circulation | 82 |
| Total Reserves | 82 |
| Federal Funds | 82 |
| Try It Out 4.1 | 83 |
| Placing the Financial Instruments into the Participants’ Balance Sheets | 84 |
| What’s in a Balance Sheet? | 84 |
| The Balance Sheet of Households | 85 |
| The Balance Sheet of Firms | 85 |
| <i>SectorWatch 4.5: National Balance Sheet Distress</i> | 86 |
| The Balance Sheet of Banks | 86 |
| The Balance Sheet of the U.S. Government | 87 |
| The Balance Sheet of the Fed | 87 |
| The External Balance Sheet | 88 |
| Two Key Questions and the Two Pillars | 88 |
| Summary | 89 |
| Key Terms and Concepts | 89 |
| Questions and Problems | 90 |
| Suggested Readings | 91 |

CHAPTER 5

The Evolution to the New Financial Environment 92

| | |
|--|-----|
| Chapter Preview | 92 |
| The Rise and Fall of the Old Financial Environment | 93 |
| Financial Innovations and the Public | 95 |
| Cash Management Practices of Nonfinancial Firms | 95 |
| Cash Management Practices of Households | 97 |
| Financial Innovations and Banks | 98 |
| Financial Innovations in Bank Liabilities | 98 |
| Financial Innovations in Bank Assets | 103 |
| <i>MarketWatch 5.1: The Essence of an Interest Rate Swap</i> | 108 |

| | |
|---|-----|
| Technological Progress and Financial Innovations | 109 |
| MarketWatch 5.2: Will Debt Cards Replace Cash and Checks? | 110 |
| Financial Innovations and the Federal Reserve | 111 |
| A Crisis and a Crunch in the New Financial Environment | 112 |
| The Thrift Crisis of the 1980s | 112 |
| The Credit Crisis of the 1990s | 113 |
| Looking Ahead | 114 |
| Summary | 114 |
| Key Terms and Concepts | 115 |
| Questions and Problems | 115 |
| Suggested Readings | 116 |

PART 3

MONEY, INTEREST RATES, AND PRICES 117

CHAPTER 6

The Public's Portfolio Choice: *The Laws of Asset Demand* 118

| | |
|---|-----|
| Chapter Preview | 118 |
| The Balance Sheet Equation | 119 |
| Try It Out 6.1 | 121 |
| Asset Choice: Risk and Rate of Return | 121 |
| SectorWatch 6.1: Explaining Portfolio Choice to the Press | 122 |
| Factors Affecting Asset Demand | 123 |
| The Laws of Asset Demand | 124 |
| Looking Ahead | 129 |
| Summary | 129 |
| Key Terms and Concepts | 129 |
| Questions and Problems | 130 |
| Suggested Readings | 130 |

CHAPTER 7

Deposit Rate Deregulation and Money Demand 131

| | |
|----------------------------------|-----|
| Chapter Preview | 131 |
| The Laws of Deposit Demand | 132 |
| The Opportunity Cost of Deposits | 132 |

| | |
|--|-----|
| A Theory of Deposit Rate Determination | 134 |
| The Deposit Rate Curve | 135 |
| MarketWatch 7.1: Historical Movements in the M2 Deposit Rate | 137 |
| Ultimate Factors Affecting Deposit Demand | 139 |
| Movements along the D^d Curve | 139 |
| MarketWatch 7.2: Falling Deposit Rates in the 1990s | 140 |
| Shifts in the D^d Curve | 140 |
| Factors Affecting the Demand for Money | 142 |
| Try It Out 7.1 | 143 |
| Looking Ahead | 143 |
| Summary | 144 |
| Key Terms and Concepts | 145 |
| Questions and Problems | 145 |
| Suggested Readings | 146 |

CHAPTER 8

The Basics of the Money Supply 147

| | |
|--|-----|
| Chapter Preview | 147 |
| Six Steps to Derive the Money Supply | 148 |
| Supply of Reserves | 148 |
| Changes in the Supply of Total Reserves | 150 |
| Demand for Reserves | 153 |
| From the Reserves Constraint to Deposits | 154 |
| The Reserves Constraint | 154 |
| Deposits Supported by Reserves | 155 |
| FedWatch 8.1: Tracking the Reserves Constraint | 156 |
| Try It Out 8.1 | 157 |
| The Money Supply Equation | 157 |
| Factors that Affect the Money Supply | 158 |
| Nonborrowed Reserves | 158 |
| Borrowed Reserves | 158 |
| Excess Reserves | 159 |
| Currency in Circulation | 159 |
| Try It Out 8.2 | 159 |
| Reserve Requirement Ratio | 159 |
| Interest Sensitivity of the Money Supply | 160 |
| Money Supply Curve | 160 |
| The Equations for M1 and M2 | 162 |
| The M1 Equation | 162 |
| The M2 Equation | 163 |
| Illustration of the Two Equations | 164 |
| Looking Ahead | 164 |

| | |
|--|-----|
| Summary | 165 |
| Key Terms and Concepts | 165 |
| Questions and Problems | 166 |
| Suggested Readings | 167 |
| Appendix: The Monetary Base Multiplier | 168 |
| Key Terms and Concepts | 171 |

CHAPTER 9

Two Tales of Determining the Interest Rate 172

| | |
|---|-----|
| Chapter Preview | 172 |
| The Second Pillar: How Markets Work | 173 |
| The Money Market: Liquidity Preference Theory | 173 |
| Determining the Interest Rate and the Quantity of Money | 174 |
| The Deposit Rate | 175 |
| Factors Affecting Rates and Money | 176 |
| Try It Out 9.1 | 177 |
| GlobalWatch 9.1: Fed and Bundesbank Push Rates in Opposite Directions | 180 |
| FedWatch 9.2: The Fed Responds to the Stock Market Crash of 1987 | 182 |
| The Securities Market: Loanable Funds Theory | 182 |
| The Demand for Securities | 182 |
| The Supply of Securities | 184 |
| The Interest Rate | 185 |
| Factors Affecting the Interest Rate | 186 |
| Try It Out 9.2 | 188 |
| Looking Ahead | 188 |
| Summary | 189 |
| Key Terms and Concepts | 189 |
| Questions and Problems | 189 |
| Suggested Readings | 190 |

CHAPTER 10

A Framework for the Economy: The Real and the Financial Sectors 191

| | |
|--|-----|
| Chapter Preview | 191 |
| The Real-Sector Framework and Foreign Exchange | 192 |
| The Real Sector | 192 |
| Foreign Exchange | 197 |

| | |
|--|-----|
| Linkages between the Financial Sector and the Real Sector | 198 |
| From the Financial Sector to the Real Sector | 198 |
| From the Real Sector to the Financial Sector | 200 |
| Try It Out 10.1 | 204 |
| The Aggregate Demand–Aggregate Supply Model | 204 |
| The Aggregate Demand Curve | 204 |
| Try It Out 10.2 | 205 |
| The Aggregate Supply Curve | 205 |
| Determination of P and Y | 206 |
| Demand-Side Shocks | 206 |
| Money, Interest, and Prices: Putting the Pieces Together | 208 |
| Liquidity Effect | 208 |
| Income Effect and Price-Level Effect | 209 |
| Neutrality of Money | 210 |
| Expected Inflation Effect | 211 |
| FedWatch 10.1: The Fed, Inflation, and Interest Rates: 1979–1982 | 214 |
| Economic Policy in the United States and Japan: The 1990s | 214 |
| The U.S. Economy | 215 |
| The Japanese Economy | 217 |
| Summary | 218 |
| Key Terms and Concepts | 219 |
| Questions and Problems | 219 |
| Suggested Readings | 220 |

PART 4

THE FEDERAL RESERVE AND ITS BEHAVIOR 221

CHAPTER 11

The Federal Reserve System: Form and Function 222

| | |
|---|-----|
| Chapter Preview | 222 |
| A Brief History of the Federal Reserve | 223 |
| GlobalWatch 11.1: Historical Tidbits on Foreign Central Banks | 224 |
| The Board of Governors of the Federal Reserve System | 225 |
| An Overview of the Functions of the Board | 226 |
| FedWatch 11.2: Backgrounds of Board Members | 227 |

| | |
|---|-----|
| Financing the Activities of the Board | 229 |
| Federal Reserve Banks | 229 |
| The Organization and Control of the Reserve Banks | 230 |
| An Overview of the Functions of the Reserve Banks | 231 |
| The Earnings of the Reserve Banks | 231 |
| The Federal Open Market Committee | 232 |
| Composition of the FOMC | 232 |
| FOMC Meetings and Deliberations | 233 |
| Policy Directives | 233 |
| Member Banks | 235 |
| Independence and Accountability of the Fed | 236 |
| Financial Independence | 236 |
| Accountability to Congress | 236 |
| Reform versus the Status Quo | 237 |
| Independence and Central Bank Performance | 241 |
| Political Pressures | 242 |
| <i>GlobalWatch 11.3: Comparing the Performance of Central Banks</i> | 243 |
| Looking Ahead | 245 |
| Summary | 245 |
| Key Terms and Concepts | 246 |
| Questions and Problems | 246 |
| Suggested Readings | 247 |

CHAPTER 12

Functions of Federal Reserve Banks: *The Details* 248

| | |
|---|-----|
| Chapter Preview | 248 |
| Banker to Banks | 249 |
| Check Collecting and Clearing | 249 |
| Try It Out 12.1 | 251 |
| Bookkeeping Services | 253 |
| Discount Window Loans | 253 |
| <i>FedWatch 12.1: Discounting, Rediscounting, and Discount Window Loans</i> | 254 |
| Distribution of Coin and Currency | 257 |
| Banker to the U.S. Government | 258 |
| The U.S. Treasury's Checking Account | 258 |
| Brokerage Services | 259 |
| Management of Foreign Exchange Reserves | 259 |
| Banker to Foreign Organizations | 260 |
| Examiner and Supervisor of Member Banks | 260 |

| | |
|--|-----|
| Participant in the Design of U.S. Monetary Policy | 261 |
| <i>FedWatch 12.2: Tug of War between the Board and Federal Reserve Banks</i> | 262 |
| Economic Researcher | 263 |
| The Consolidated Balance Sheet of All Reserve Banks | 263 |
| Summary | 265 |
| Key Terms and Concepts | 265 |
| Questions and Problems | 266 |
| Suggested Readings | 266 |

CHAPTER 13

Instruments, Targets, and Goals of the Federal Reserve 267

| | |
|---|-----|
| Chapter Preview | 267 |
| From Instruments to Ultimate Goals | 268 |
| From Intermediate Targets to Ultimate Goals | 270 |
| The Long-Run Interest Rate as the Intermediate Target | 271 |
| The Quantity of Money as the Intermediate Target | 271 |
| <i>FedWatch 13.1: The Growth of M2 and the Economy in 1992</i> | 275 |
| From Operating Targets to Intermediate Targets | 276 |
| Federal Funds Rate Operating Target | 277 |
| Reserves Operating Targets | 278 |
| <i>FedWatch 13.2: Interpreting the Cryptic Domestic Policy Directives</i> | 285 |
| Back to a Federal Funds Rate Target | 286 |
| The Change in Policy in 1993 | 287 |
| From Instruments to Operating Targets | 287 |
| Summary | 287 |
| <i>FedWatch 13.3: Searching for a Neutral Policy Stance in 1994</i> | 288 |
| Key Terms and Concepts | 289 |
| Questions and Problems | 289 |
| Suggested Readings | 290 |

CHAPTER 14

Open Market Operations and Movements in Reserves 291

| | |
|------------------|-----|
| Chapter Preview | 291 |
| The Trading Desk | 292 |

| | |
|--|-----|
| A Day of Fedwatching | 294 |
| Scenario 1: A Defensive Open Market Operation | 295 |
| Scenario 2: A Dynamic Open Market Operation | 295 |
| Scenario 3: A Hybrid Open Market Operation | 295 |
| The Euthanasia of Fedwatchers | 295 |
| <i>FedWatch 14.1: Fedwatchers Blunder</i> | 296 |
| Policy Shifts | 297 |
| Sources and Uses of Reserves Statement | 297 |
| A Simplified Statement | 298 |
| An Actual Statement: The H.4.1 Statistical Release | 300 |
| Try It Out 14.1 | 301 |
| The Individual Technical Factors | 303 |
| Looking Ahead | 307 |
| Summary | 307 |
| Key Terms and Concepts | 308 |
| Questions and Problems | 308 |
| Suggested Readings | 309 |

CHAPTER 15

Deposit Creation and the Money Supply 310

| | |
|--|-----|
| Chapter Preview | 310 |
| The Bouncing Ball of Deposit Creation | 311 |
| Open Market Operations and Multiple Deposit Creation | 312 |
| Step 1: An Open Market Purchase of Securities | 313 |
| Step 2: Bank A | 314 |
| Step 3: Group B Banks | 316 |
| The Process at a Glance | 317 |
| Try It Out 15.1 | 319 |
| Deposit Contraction | 319 |
| Determinants of the Money Supply | 319 |
| Deposits Supported by Reserves | 320 |
| M1: The Narrow Measure of Money | 321 |
| M2: The Broad Measure of Money | 323 |
| Summary | 326 |
| Key Terms and Concepts | 327 |
| Questions and Problems | 327 |
| Suggested Readings | 328 |

CHAPTER 16

Targeting Monetary Aggregates: Theory and Experience 329

| | |
|---|-----|
| Chapter Preview | 329 |
| Definitions of Velocity, Velocity-Indexed Money, and Related Concepts | 330 |
| The Definition of Velocity and the Cambridge k | 330 |
| The Equation of Exchange | 331 |
| The Cambridge Equation | 332 |
| Recent History of Velocity | 332 |
| Theories of Velocity and Velocity-Indexed Money | 332 |
| Velocity as a Behavioral Relation | 333 |
| The Quantity Theory of Money | 335 |
| Quantity Theory and Monetary Aggregate Targeting | 336 |
| The Quantity Theory Equation Expressed in Rates of Change | 336 |
| Long-Run Monetary Aggregate Targeting | 337 |
| Short-Run Monetary Aggregate Targeting | 338 |
| Pragmatic versus Rigid Monetary Aggregate Targeting | 339 |
| The U.S. Experience in the 1980s | 341 |
| M1: The Narrow Monetary Aggregate | 341 |
| M2: A Broad Monetary Aggregate | 344 |
| The U.S. Experience in the 1990s | 346 |
| Summary | 349 |
| Key Terms and Concepts | 350 |
| Questions and Problems | 350 |
| Suggested Readings | 351 |

PART 5

FINANCIAL INSTITUTIONS: Structure, Regulation, and Behavior 353

CHAPTER 17

The Structure, Regulation, and Supervision of U.S. Depository Institutions 354

| | |
|-------------------------------------|-----|
| Chapter Preview | 354 |
| Financial Firms: An Overview | 355 |
| Financial versus Industrial Firms | 355 |
| Depositories versus Nondepositories | 355 |
| Commercial Banks versus Thrifts | 357 |

| | |
|---|-----|
| National Banks versus State Banks: Dual Banking | 357 |
| Bank Holding Companies | 357 |
| The Structure of Commercial Banks | 358 |
| Geographic Restrictions | 358 |
| Pros and Cons of Branching | 359 |
| Introduction of Nationwide Branching | 360 |
| The Supervision and Regulation of Banks | 360 |
| Reasons for Bank Regulation | 360 |
| Multiple and Overlapping Regulatory and Supervisory Jurisdictions | 361 |
| Streamlining Regulatory Agencies | 362 |
| Details of Bank Supervision | 363 |
| <i>FedWatch 17.1: Two Views on Centralizing Bank Regulation</i> | 364 |
| CAMEL Rating | 365 |
| Capital Adequacy | 365 |
| Prompt Corrective Action | 368 |
| The FDIC and Deposit Insurance | 368 |
| Resolving Bank Failures | 369 |
| Keeping Banks Open | 369 |
| <i>GlobalWatch 17.2: Deposit Insurance Systems around the World</i> | 370 |
| Arguments For and Against the Too-Big-to-Fail Policy | 371 |
| Pros and Cons of Deposit Insurance | 372 |
| Reforming Deposit Insurance | 373 |
| The Structure and Regulation of Thrifts | 375 |
| Saving and Loan Associations (S&Ls) | 375 |
| Savings Banks | 377 |
| Credit Unions | 378 |
| Summary | 378 |
| Key Terms and Concepts | 380 |
| Questions and Problems | 380 |
| Suggested Readings | 381 |

CHAPTER 18

The Profit-Maximizing Banking Firm 382

| | |
|--|-----|
| Chapter Preview | 382 |
| The Balance Sheet of U.S. Banks | 383 |
| The Income Statement of Banks: Revenue, Cost, and Profit | 385 |
| Revenue | 386 |
| Expenses | 386 |
| Banking and Information | 386 |

| | |
|---|-----|
| Assessing and Pricing Risk on Loans | 386 |
| <i>SectorWatch 18.1: Accounting for Troubled Loans</i> | 387 |
| Preventing Adverse Selection: Screening | 388 |
| Coping with Moral Hazard | 389 |
| Bringing the Balance Sheet to Life | 390 |
| The Structure and Functions of the ALCO | 390 |
| The Simplified Balance Sheet | 391 |
| Profit Maximization | 391 |
| The Supply of Deposits | 392 |
| The Net Marginal Revenue from Supplying Deposits | 392 |
| The Marginal Cost of Supplying Deposits | 393 |
| The Supply of Deposits Curve | 394 |
| Shifts in the Supply of Deposits Curve | 395 |
| Try It Out 18.1 | 397 |
| Reserve Management | 397 |
| Borrowed Reserves | 398 |
| Excess Reserves | 401 |
| The Demand for Loans and Securities | 403 |
| The Determinants of Demand for Loans and Securities | 403 |
| The Credit Crunch of the 1990s: Connecting Theory with Practice | 405 |
| Summary | 407 |
| Key Terms and Concepts | 408 |
| Questions and Problems | 408 |
| Suggested Readings | 410 |

CHAPTER 19

Nondepository Financial Institutions 411

| | |
|---|-----|
| Chapter Preview | 411 |
| Finance Companies | 412 |
| Early Finance Companies | 412 |
| Anatomy of Today's Finance Companies | 412 |
| Operation of Finance Companies | 414 |
| Regulation of Finance Companies | 415 |
| Mutual Funds | 415 |
| Types of Mutual Funds | 416 |
| <i>SectorWatch 19.1: Banks and Mutual Funds</i> | 417 |
| Regulation of Mutual Funds | 418 |
| Money Market Mutual Funds | 418 |
| Insurance Companies | 419 |
| Some Fundamentals of Insurance | 420 |

| | |
|--|-----|
| Life Insurance Companies | 420 |
| Property/Casualty Insurance Companies | 423 |
| Pension Funds | 423 |
| Types of Pension Funds | 424 |
| Size and Assets of Pension Funds | 424 |
| Regulation of Pension Funds | 424 |
| Investment Banks, Brokers, and Dealers | 425 |
| Summary | 426 |
| Key Terms and Concepts | 427 |
| Questions and Problems | 427 |
| Suggested Readings | 428 |

PART 6

FINANCIAL MARKETS, INTEREST RATES, AND THE CONDUCT OF MONETARY POLICY 429

CHAPTER 20

The Theory of Money Demand 430

| | |
|--|-----|
| Chapter Preview | 430 |
| The Early Quantity Theory Approach | 431 |
| The Keynesian Approach | 433 |
| Modern Treatment of the Transactions Demand | 435 |
| Tobin's Explanation | 435 |
| Try It Out 20.1 | 438 |
| Baumol's Explanation | 438 |
| <i>SectorWatch 20.1: Illustrating Baumol's Money Demand Equation</i> | 441 |
| A Word on the Precautionary Demand | 442 |
| Modern Treatment of Speculative Demand | 442 |
| Modern Treatment of the Quantity Theory | 444 |
| Stability of Money Demand | 445 |
| Summary | 446 |
| Key Terms and Concepts | 446 |
| Questions and Problems | 447 |
| Suggested Readings | 447 |

CHAPTER 21

The Deposit Market and Money Demand 448

| | |
|--|-----|
| Chapter Preview | 448 |
| The Deposit Market | 449 |
| The Demand Curve for Deposits | 449 |
| The Supply Curve for Deposits | 449 |
| Equilibrium in the Deposit Market | 449 |
| The Interest Rate and the Deposit Market | 452 |
| The Interest Rate, the Deposit Rate, and the Quantity of Deposits | 452 |
| The Equilibrium Relations | 454 |
| A Numerical Illustration | 456 |
| Try It Out 21.1 | 457 |
| Other Factors Affecting the Deposit Market | 458 |
| A Change in Real Income | 458 |
| A Change in the Collective Variable | 459 |
| A Change in the Technology and Regulatory Index | 459 |
| <i>MarketWatch 21.1: Banks Bid Less Aggressively for Deposits</i> | 461 |
| A Change in the Reserve Requirement Ratio | 461 |
| Summary | 461 |
| Money Demand | 462 |
| The Old Financial Environment: A Special Case | 463 |
| Empirical Studies of Money Demand | 466 |
| Shifts in the Demand Curve for M1: The Case of "Missing Money" | 466 |
| Shifts in and Tilts of the Demand Curve for M1: The Case of "Too Much Money" | 467 |
| Deregulation of the Deposit Rate and Interest Sensitivity of Demand for M2 | 468 |
| The Case of Missing M2 | 468 |
| Summary | 469 |
| Key Terms and Concepts | 469 |
| Questions and Problems | 470 |
| Suggested Readings | 471 |

CHAPTER 22

The Money Market 472

| | |
|--|-----|
| Chapter Preview | 472 |
| Determinants of Money Market Equilibrium | 473 |
| Factors Affecting Money Demand | 473 |

| | |
|--|-----|
| Factors Affecting Money Supply | 474 |
| Grouping the Factors | 475 |
| Changes in the Instruments of Monetary Policy | 476 |
| Open Market Operations | 476 |
| Discount Window Operations | 477 |
| Changes in the Reserve Requirement Ratio | 479 |
| Changes in the Behavior of the Public and Banks | 480 |
| Money Demand Shocks | 480 |
| Money Supply Shocks | 482 |
| <i>GlobalWatch 22.1: Shocks to the Japanese Money Market in 1993</i> | 483 |
| Try It Out 22.1 | 484 |
| Changes in Real-Sector Variables | 485 |
| Changes in the Price Level | 485 |
| Changes in Real Income | 486 |
| Targeting Money versus Targeting the Interest Rate or Doing Nothing | 486 |
| A Numerical Example | 487 |
| Uncertain Money Demand | 490 |
| One Rule for All Reasons? | 491 |
| Summary | 493 |
| Key Terms and Concepts | 494 |
| Questions and Problems | 494 |
| Suggested Readings | 495 |

CHAPTER 23

The Structure of Rates of Return 496

| | |
|--|-----|
| Chapter Preview | 496 |
| The Term Structure of Interest Rates | 497 |
| The Yield Curve | 497 |
| <i>MarketWatch 23.1: Tracking the Yield Curve in The Wall Street Journal</i> | 498 |
| Forward Rates and the Term Structure | 499 |
| Try It Out 23.1 | 499 |
| The Pure Expectations Hypothesis of the Term Structure | 499 |
| The Liquidity Preference Hypothesis and the Liquidity Premium | 502 |
| The Preferred Habitat Hypothesis | 503 |
| <i>MarketWatch 23.2: Reducing the Supply of T-Bonds</i> | 504 |
| The Segmented-Markets Hypothesis | 505 |
| The Default Risk Structure of Interest Rates | 506 |
| Default Risk, the Default Risk Premium, and Interest Rates | 506 |

| | |
|---|-----|
| The State of the Economy and Default Risk | 507 |
| Liquidity, Marketability, and Default Risk | 507 |
| <i>MarketWatch 23.3: Tracking Default Risk Premiums</i> | 508 |
| Tax Features and Interest Rates | 509 |
| Equity Capital in a Four-Asset Model | 509 |
| The Model | 510 |
| Effects of Monetary Policy on Rates of Return | 511 |
| Try It Out 23.2 | 513 |
| The Q -Ratio, the Stock Market, and Investment Demand | 514 |
| <i>MarketWatch 23.4: Tobin on Q</i> | 516 |
| Summary | 517 |
| Key Terms and Concepts | 518 |
| Questions and Problems | 518 |
| Suggested Readings | 519 |

PART 7

THE INTEGRATION OF THE FINANCIAL AND REAL SECTORS 521

CHAPTER 24

Determining the Interest Rate and Real Income: The IS-LM Model 522

| | |
|--|-----|
| Chapter Preview | 522 |
| Genesis of the Modern Theory of Income Determination | 523 |
| Determining National Income: The Market for Goods and Services | 524 |
| Endogenous and Exogenous Changes in Aggregate Demand | 526 |
| The Effect on Real Income of Exogenous Changes in Aggregate Demand | 528 |
| Changes in Fiscal Policy and Other Shocks: The Details | 530 |
| <i>SectorWatch 24.1: Aggregate Demand and the Recession of 1990–1991</i> | 531 |
| The Simple Algebra of Income Determination | 535 |
| Try It Out 24.1 | 536 |
| Goods Market Equilibrium: The IS Curve | 536 |
| Investment Demand | 536 |
| Derivation of the IS Curve | 539 |
| Adding the International Linkages | 539 |

- Money Market Equilibrium: The *LM* Curve 540
- The *IS-LM* Model 540
 - Determining the Interest Rate and Real Income: The *IS-LM* Graph 541
 - Shifts of the *IS* and *LM* Curves 541
- Summary 543
- Key Terms and Concepts 544
- Questions and Problems 544
- Suggested Readings 546

CHAPTER 25

Monetary and Fiscal Policy in the *IS-LM* Model 547

- Chapter Preview 547
- Monetary Policy 548
 - Open Market Operations 548
 - Adding the International Linkages 550
 - Discount Window Operations 550
- Fiscal Policy 551
 - Effects of an Increase in Government Spending 552
 - The Crowding Out of Net Exports 554
 - Effects of a Reduction in Taxes 554
 - Financing the Budget Deficit 555
- GlobalWatch* 25.1: The Twin Deficits: The United States and Germany 557
- Other Shocks: Changes in the Behavior of the Public and Banks 558
 - LM* Sector Shocks 558
 - IS* Sector Shocks 561
- The Choice of an Intermediate Target for the Conduct of Monetary Policy 561
- FedWatch* 25.2: Headwinds 562
 - Targeting the Quantity of Money and the Slope of the *LM* Curve 563
 - Targeting the Quantity of Money versus Targeting the Interest Rate 564
 - Variability in Real Income versus Variability in the Interest Rate 567
- FedWatch* 25.3: Downgrading Money in 1993 569
- Summary 569
- Key Terms and Concepts 570
- Questions and Problems 570
- Suggested Readings 571

CHAPTER 26

The Price Level and Real Income: The Aggregate Demand-Aggregate Supply Model 572

- Chapter Preview 572
- Looking Backward and Forward 573
- Aggregate Demand 573
 - The Schematics of the *AD* Curve 573
 - The Graphics 574
 - Shifts of the Aggregate Demand Curve 576
- The Aggregate Supply 579
 - The Keynesian Fixed-Price Aggregate Supply Curve 580
 - The Classical Aggregate Supply Curve 581
 - The Keynesian Short-Run Aggregate Supply Curve 582
 - Combining the Keynesian Short Run with the Classical Long Run 586
- The Effects of Policy and Shocks in the Keynesian Short Run and the Classical Long Run 590
 - The Keynesian Short Run 590
- Try It Out 26.1 592
- MarketWatch* 26.1: The Oil Shock of 1990 596
 - The Classical Long Run 597
- Economic Policy and Schools of Thought 600
- Looking Ahead 601
- Summary 601
- Key Terms and Concepts 602
- Questions and Problems 602
- Suggested Readings 603

CHAPTER 27

Aggregate Supply, Expectations, and Policy 604

- Chapter Preview 604
- Evolution of the Theory 605
- The Lucas Aggregate Supply Curve 606
 - Continuous Clearance of the Labor Market 606
 - Rational Expectations 609
 - Two Approaches to the Lucas Supply Curve 610
- The Policy Ineffectiveness Proposition of the New Classicists 614
- Painless Disinflation 615

| | |
|--|-----|
| Empirical Investigations of the Policy Ineffectiveness Proposition | 616 |
| Other New Classical Results | 616 |
| Theoretical Challenges to Policy Ineffectiveness and the Emergence of the New Keynesians | 617 |
| Imperfect Information | 617 |
| <i>MarketWatch 27.1: Are Tax Cuts Effective?</i> | 618 |
| Rigidity in Nominal Wages | 619 |
| Rigidity in Real Wages | 620 |
| Rigidity in Prices | 621 |
| The Role of Policy: Keynesians, Classicists, New Classicists, and New Keynesians | 622 |
| An Inward Shift in Aggregate Demand | 622 |
| The Consequences of an Anti-Inflationary Policy | 624 |
| The Legacy of Rational Expectations | 625 |
| <i>GlobalWatch 27.2: Credibility of Monetary Policy: The United States and Japan</i> | 626 |
| Summary | 627 |
| Key Terms and Concepts | 628 |
| Questions and Problems | 628 |
| Suggested Readings | 629 |

CHAPTER 28

Inflation, Unemployment, and Economic Policy: *History and Theory* 630

| | |
|---|-----|
| Chapter Preview | 630 |
| Demand-Pull versus Cost-Push Inflation | 631 |
| Demand-Pull Inflation | 631 |
| Cost-Push Inflation | 633 |
| Of Wars, Peace, Stock Market Crashes, and Other Economic Shocks | 635 |
| Economic Performance during Wars | 635 |
| Supply-Side Shocks of the 1970s | 637 |
| Deliberate and Inadvertent Shocks to the Monetary Sector: 1981–1982 | 639 |
| Two Stock Market Crashes: 1929 and 1987 | 639 |
| Headwinds and Economic Policy in the 1990s | 642 |
| Revolutions in Economic Policy: Kennedy and Reagan | 645 |
| The Kennedy Years | 645 |
| The Reagan Years | 646 |
| Comparison of Revolutions | 647 |
| Inflation and Unemployment: The Phillips Curve | 648 |
| A Simple Derivation of the Phillips Curve | 649 |

| | |
|--------------------------------------|-----|
| The Vertical Long-Run Phillips Curve | 652 |
| Try It Out 28.1 | 656 |
| Costs of Inflation | 657 |
| Unexpected Inflation | 657 |
| Fully Expected Inflation | 659 |
| Summary | 660 |
| Key Terms and Concepts | 661 |
| Questions and Problems | 661 |
| Suggested Readings | 662 |

PART 8

INTERNATIONAL FINANCE 663

CHAPTER 29

International Payments and the Foreign Exchange Market 664

| | |
|--|-----|
| Chapter Preview | 664 |
| Balance of Payments Accounts | 665 |
| Anatomy of the Current Account | 665 |
| Anatomy of the Capital Account | 666 |
| The Foreign Exchange Market | 668 |
| The Mechanics of Exchange Rates | 668 |
| <i>MarketWatch 29.1: Tracking Exchange Rates in <i>The Wall Street Journal</i></i> | 669 |
| Try It Out 29.1 | 670 |
| The Demand for Foreign Exchange | 670 |
| The Supply of Foreign Exchange | 671 |
| Flexible Exchange Rates | 672 |
| Fixed Exchange Rates | 674 |
| A Hybrid System | 675 |
| <i>MarketWatch 29.2: An Ineffective Intervention in 1994</i> | 676 |
| Factors Affecting Exchange Rates | 676 |
| Foreign and Domestic Interest Rates | 676 |
| Expectations of Currency Appreciation or Depreciation | 677 |
| Interest Rate Parity | 678 |
| Foreign and Domestic Incomes | 679 |
| Foreign and Domestic Prices | 680 |
| The Real Exchange Rate | 682 |
| The Mechanics of the Real Exchange Rate | 682 |
| Try It Out 29.2 | 682 |

| | |
|---|-----|
| Purchasing Power Parity | 683 |
| Real Interest Rate Parity | 685 |
| The Exchange Rate Mountains of the 1980s | 687 |
| A Brief History of the International System of Payments | 687 |
| The Gold Standard | 687 |
| The Bretton Woods System | 688 |
| Managed, or Dirty, Float | 689 |
| The Fiftieth Anniversary of Bretton Woods | 690 |
| The European Monetary System | 691 |
| Summary | 692 |
| Key Terms and Concepts | 693 |
| Questions and Problems | 693 |
| Suggested Readings | 695 |

CHAPTER 30

Economic Policy in an Open Economy 696

| | |
|---|-----|
| Chapter Preview | 696 |
| A Model of the Open Economy | 697 |
| The <i>IS-LM-BP</i> Graph | 697 |
| The <i>IS</i> Curve in the Open Economy | 697 |
| The <i>LM</i> Curve in the Open Economy | 698 |
| The <i>BP</i> Curve | 699 |
| Perfect and Imperfect Capital Mobility | 701 |

| | |
|--|-----|
| Equilibrium in the <i>IS-LM-BP</i> Model | 703 |
| Monetary Policy under Fixed and Flexible Exchange Rates | 703 |
| Flexible Exchange Rates | 703 |
| Fixed Exchange Rates | 704 |
| Fiscal Policy under Fixed and Flexible Exchange Rates | 705 |
| Flexible Exchange Rates | 706 |
| Investment, National Savings, and Capital Inflows | 707 |
| Fixed Exchange Rates | 709 |
| Summary of the Effects of Policy | 710 |
| Shocks from the Foreign Exchange Market | 711 |
| A Rise in Foreign Interest Rates | 711 |
| Crises in the European Monetary System | 713 |
| Expected Currency Appreciation or Depreciation | 713 |
| <i>FedWatch</i> 30.1: How to Respond to a Falling Dollar | 714 |
| Summary | 714 |
| Key Terms and Concepts | 715 |
| Questions and Problems | 716 |
| Suggested Readings | 716 |

| | |
|---------------------------------|-----|
| Glossary | G-1 |
| Answers to Try-It-Out Exercises | A-1 |
| Index | I-1 |