Preface xxvii

PART I FOUNDATIONS

Chapter 1 The Financial System 1

1.1 Financial Markets 2
   Bonds 2
   Stocks 3

1.2 Economic Functions of Financial Markets 4
   Matching Savers and Investors 4
   Risk Sharing 5

CASE STUDY Employee Stock Ownership and the Collapse of Enron 6

1.3 Asymmetric Information 7
   Adverse Selection 8
   Moral Hazard 9

1.4 Banks 10
   What Is a Bank? 10
   Banks versus Financial Markets 11
   Why Banks Exist 11

1.5 The Financial System and Economic Growth 12
   Saving and Growth 13
   The Allocation of Saving 13
   Evidence on Growth 14

CASE STUDY Unit Banking and Economic Growth 15

CASE STUDY Microfinance 16
   Markets versus Central Planning 18

CASE STUDY Investment in the Soviet Union 18

Summary 20

Key Terms 21

Questions and Problems 21

Appendix: Measuring Output and the Price Level 23
Chapter 2 Money and Central Banks 25

2.1 What is Money? 26
   The Medium of Exchange 26
   Money versus Barter 27

CASE STUDY Nineteenth-Century Visitors to Barter Economies 28
   The Unit of Account 28
   A Store of Value 29

2.2 Types of Money 29
   Commodity Money 30
   Fiat Money 31
   From Commodity Money to Fiat Money 32

CASE STUDY The History of the U.S. Dollar 32
   Alternatives to a National Currency 34

CASE STUDY Clean and Dirty Money 35

2.3 Money Today 36
   Measuring the Money Supply: M1 36
   How We Spend Money 37
   What About Credit Cards? 38
   The Payments System 39
   New Kinds of Money 40

2.4 Liquidity and Broad Money 42
   The Need for Liquidity 42
   Degrees of Liquidity 42
   Measuring Broad Money: M2 43

CASE STUDY Sweep Programs 45

2.5 Functions of Central Banks 46
   Clearing Payments 47
   Monetary Policy 47
   Lending 47
   Bank Regulation 47

CASE STUDY The Fed and September 11 47

2.6 The Rest of this Book 48
   Financial Markets 49
   Banking 49
   Money and the Economy 49
   Monetary Policy 50

Summary 50
Key Terms 51
Questions and Problems 51
PART II FINANCIAL MARKETS

Chapter 3 Asset Prices and Interest Rates 53

3.1 Valuing Income Streams 54
   Future Value 54
   Present Value 55

3.2 The Classical Theory of Asset Prices 57
   The Present Value of Income 57
   What Expectations? 58
   What Interest Rate? 59

3.3 Fluctuations in Asset Prices 60
   Why Do Asset Prices Change? 60

CASE STUDY The Fed and the Stock Market 60
   Which Asset Prices Are Most Volatile? 62

3.4 Asset-Price Bubbles 63
   How Bubbles Work 63

CASE STUDY Tulipmania 64
   Looking for Bubbles 65

CASE STUDY The Millennium Boom 66

3.5 Asset-Price Crashes 68
   How Crashes Work 68

CASE STUDY The Two Big Crashes 69
   Crash Prevention 70

3.6 Measuring Interest Rates and Asset Prices 71
   Yield to Maturity 71
   The Rate of Return 72
   Returns on Stocks and Bonds 73
   Rate of Return versus Yield to Maturity 74

3.7 Real and Nominal Interest Rates 74
   Real Interest Rates: Ex Ante versus Ex Post 75

CASE STUDY Inflation and the Savings and Loan Crisis 77
   Inflation-Indexed Bonds 77

Summary 78
Key Terms 79
Questions and Problems 80
Chapter 4 What Determines Interest Rates? 83

4.1 The Loanable Funds Theory 84
    Saving, Investment, and Capital Flows 85
    Effects of the Real Interest Rate 86
    The Equilibrium Real Interest Rate 87

4.2 Determinants of Interest Rates in the Loanable Funds Theory 89
    Shifts in Investment 89
    Shifts in Saving 91

CASE STUDY Budget Deficits and Interest Rates 93
    Shifts in Capital Flows 94
    Nominal Interest Rates 95

4.3 The Liquidity Preference Theory 97
    The Market for Money 98
    The Equilibrium Interest Rate 98
    Changes in Interest Rates 100
    Relating the Two Theories of Interest Rates 102

4.4. The Term Structure of Interest Rates 102
    The Case of Certainty 103
    The Expectations Theory of the Term Structure 104
    Accounting for Risk 105
    The Yield Curve 106

Online Case Study
    The Recent Behavior of the Yield Curve

CASE STUDY Inverted Yield Curves 109

4.5 Default Risk and Interest Rates 110
    Default Risk on Sovereign Debt 110

CASE STUDY The Paradox of Japanese Interest Rates 111
    Default Risk on Corporate Debt 112

CASE STUDY General Motors Bonds 112

CASE STUDY The High-Yield Spread 114

4.6 Two Other Factors 115
    Liquidity 115
    Taxes 115

Summary 116
Key Terms 117
Questions and Problems 117
Chapter 5 Securities Markets 119

5.1 Participants in Securities Markets 120
   Individuals 120
   Securities Firms 121
   Other Financial Institutions 122

5.2 Stock and Bond Markets 123
   Primary Markets 123

CASE STUDY Google's IPO 125

CASE STUDY Treasury Bill Auctions 126
   Secondary Markets 127
   Finding Information on Security Prices 130

5.3 Firms' Capital Structure 130
   Is Capital Structure Irrelevant? 131
   Why Capital Structure Does Matter 132
   Debt Maturity 133

5.4 What Assets Should Savers Hold? 133
   The Risk-Return Trade-off 133
   Choosing the Mix 136

CASE STUDY Age and Asset Allocation 138

5.5 Which Stocks?, 138
   The Efficient-Markets Hypothesis 139
   Two Kinds of Mutual Funds 140
   Can Anyone Beat the Market? 141

CASE STUDY The Oracle of Omaha 143

5.6 Derivatives 144
   Futures 145
   Options 145
   Hedging with Derivatives 146
   Speculating with Derivatives 147

CASE STUDY Derivative Disasters 148
   New Frontiers 149

Summary 150
Key Terms 151
Questions and Problems 152
Chapter 6 Foreign Exchange Markets 155

6.1 Currency Markets and Exchange Rates 156
   The Trading Process 156
   Measuring Exchange Rates 158

6.2 Why Exchange Rates Matter 160
   Effects of Appreciation 160

CASE STUDY The Politics of the Dollar 162
   Hedging Exchange-Rate Risk 163
   Real versus Nominal Exchange Rates 164
   The Trade-Weighted Real Exchange Rate 166

CASE STUDY Exchange Rates and Steel 167

6.3 The Long-Run Behavior of Exchange Rates 169
   Purchasing Power Parity 169
   How Reasonable is PPP? 170
   Evidence for PPP 170

6.4 Real Exchange Rates in the Short Run 172
   Net Exports and Capital Flows 172
   Effects of the Real Exchange Rate 173
   The Equilibrium Exchange Rate 173

6.5 Fluctuations in Exchange Rates 174
   Shifts in Net Capital Outflows 174

CASE STUDY The Euro versus the Dollar 176
   Shifts in Net Exports 178
   Nominal Rates Again 180

6.6 Currency Speculation 180
   Forecasting Methods 182

CASE STUDY More on Technical Analysis 183
   Summary 185
   Key Terms 186
   Questions and Problems 186
Chapter 7 Asymmetric Information in the Financial System 189

7.1 Adverse Selection 190
  The Lemons Problem 191
  Lemons in Securities Markets 192
  A Numerical Example 193

7.2 Moral Hazard 195
  Moral Hazard in Stock Markets 196

CASE STUDY Dennis Kozlowski 196
  Moral Hazard in Bond Markets 197
  The Numerical Example Again 198

7.3 Reducing Information Asymmetries 198
  Information Gathering 199
  The Free-Rider Problem 199
  Information-Gathering Firms 200
  Boards of Directors 200

CASE STUDY International Differences in Shareholder Rights 202
  Private Equity Firms 203

7.4 Regulation of Financial Markets 205
  Information Disclosure 205
  Insider Trading 207
  Online Case Study
  An Update on Financial-Markets Regulation

CASE STUDY Some Inside Traders 208

7.5 Banks and Asymmetric Information 209
  Screening Borrowers 209
  Collateral and Net Worth 210
  Covenants and Monitoring 211
  Interest Rates and Credit Rationing 211

CASE STUDY The Five C’s of Business Lending 212

CASE STUDY Traditional Home Mortgages 212

7.6 Banks and Transaction Costs 214
  Reducing Costs to Savers 214
  Reducing Costs to Investors 214

Summary 215
Key Terms 216
Questions and Problems 216
Chapter 8 The Banking Industry 219

8.1 Types of Banks 220
   Commercial Banks 221
   Thrift Institutions 222
   Finance Companies 223

8.2 Dispersion and Consolidation 223
   Why So Many Banks? 223

CASE STUDY The Politics of Banking in U.S. History 224
   Consolidation in Commercial Banking 226
   International Banking 228
   Consolidation Across Businesses 228

CASE STUDY Citigroup 229

8.3 Securitization 231
   The Securitization Industry 231
   Why Securitization Occurs 232

8.4 Subprime Lenders 233
   Finance Companies 233

Online Case Study
An Update on the Mortgage Crisis

CASE STUDY The Subprime Mortgage Fiasco 234
   Payday Lenders 236

CASE STUDY Is Payday Lending Predatory? 237
   Pawnshops 239
   Illegal Loan Sharks 239

8.5 Government's Role in Lending 239
   Mortgage Agencies 240
   Loan Guarantees 241

CASE STUDY Student Loans 241
   The Community Reinvestment Act 243
   Government-Owned Banks 244

Summary 245
Key Terms 246
Questions and Problems 247
Chapter 9 The Business of Banking 249

9.1 Banks’ Balance Sheets 250
   Liabilities and Net Worth 251
   Assets 252

9.2 Off-Balance-Sheet Activities 253
   Lines of Credit 253
   Letters of Credit 254
   Asset Management 254
   Derivatives 254
   Investment Banking 254

9.3 How Banks Make Profits 255
   Melvin Opens a Bank 255
   The Income Statement 256
   Profit Rates 257

9.4 The Evolving Pursuit of Profits 258
   Sources of Funds 258

CASE STUDY Commerce Bank 261
   Seeking Income 262

CASE STUDY Tying 264

CASE STUDY Fees 265

9.5 Managing Risk 266
   Liquidity Risk 267
   Credit Risk 269
   Interest-Rate Risk 270

CASE STUDY Fixed- versus Floating-Rate Mortgages 273
   Market and Economic Risk 274
   Interactions Among Risks 274

9.6 Insolvency 275
   An Example 275
   The Equity Ratio 275

CASE STUDY The Banking Crisis of the 1980s 277

Summary 278
Key Terms 280
Questions and Problems 280
Chapter 10 Bank Regulation 283

10.1 Bank Runs 284
   How Bank Runs Happen 284
   An Example 285
   Suspension of Payments 285

CASE STUDY Bank Runs in Fiction and Fact 286
   Bank Panics 288

CASE STUDY Bank Panics in the 1930s 288

10.2 Deposit Insurance 290
   How Deposit Insurance Works 290
   Deposit Insurance in the United States 290

10.3 Moral Hazard Again 291
   Misuses of Deposits 291

CASE STUDY The Keystone Scandal 292
   The Problem with Deposit Insurance 293
   Limits on Insurance 294

CASE STUDY Deposit Insurance and Banking Crises 294

10.4 Who Can Open a Bank? 295
   Chartering Agencies 296
   Obtaining a Charter 296
   The Separation of Banking and Commerce 296

CASE STUDY Wal-Mart Bank? 297

10.5 Restrictions on Balance Sheets 299
   Who Sets Regulations? 299
   Restrictions on Assets 300
   Capital Requirements 300

10.6 Supervision 303
   Information Gathering 303
   CAMELS Ratings 303
   Enforcement Actions 305

10.7 Closing Insolvent Banks 305
   The Need for Government Action 305
   Forbearance 306

CASE STUDY Regulatory Failure in the S&L Crisis 307
   Deciding on Closure 308
   The Closure Process 308

Summary 309
Key Terms 310
Questions and Problems 310
PART IV MONEY AND THE ECONOMY

Chapter 11 The Money Supply and Interest Rates 313
11.1 The Federal Reserve System 314
11.2 The Fed and the Monetary Base 315
   The Monetary Base 315
   Creating the Base 315
   The Fed’s Balance Sheet 317
11.3 Commercial Banks and the Money Supply 317
   An Economy Without Banks 318
   A Bank Creates Money . . . 318
      . . . and More Money 320
   Limits to Money Creation 321
11.4 A Formula for the Money Supply 322
   Deriving the Formula 322
   Changes in the Money Supply 323
   The U.S. Money Multiplier 324
CASE STUDY The Money Multiplier and the Great Depression 324
11.5 The Fed’s Monetary Tools 326
   Open-Market Operations 326
   Lending Policies 327
   Reserve Requirements 328
CASE STUDY Another Mistake: The Fed in 1937 328
CASE STUDY The Decline of Reserve Requirements 329
11.6 Money Targets versus Interest-Rate Targets 330
   Two Approaches to Monetary Policy 331
   Does the Choice Matter? 332
   The Fed’s Choice 333
CASE STUDY The Monetarist Experiment 334
11.7 Interest-Rate Policy 335
   The Federal Funds Rate 335
   The Federal Open Market Committee 336
   Implementing the Targets 336
Summary 339
Key Terms 340
Questions and Problems 341
Chapter 12 Short-Run Economic Fluctuations 343

12.1 The Business Cycle 345
   Long-Run Output and Unemployment 345

CASE STUDY The Natural Rate in the United States 346
   Booms and Recessions 347

CASE STUDY What Is a Recession? 350
   Aggregate Expenditure 351

12.2 What Determines Aggregate Expenditure? 352
   The Components of Expenditure 352
   The Role of the Interest Rate 352
   Monetary Policy and Equilibrium Output 353
   Expenditure Shocks 354
   Countercyclical Monetary Policy 357

12.3 Fluctuations in the Inflation Rate 358
   Expected Inflation 358
   What Determines Expected Inflation? 358
   The Effect of Output 360
   Supply Shocks 363

CASE STUDY Oil Prices and Inflation 366

12.4 The Complete Economy 367
   Combining the Two Curves 367
   The Economy Over Time 369

JUMBO CASE STUDY The U.S. Economy, 1960–2007 373
   Conclusion: What Causes the Business Cycle? 375

12.5 Long-Run Monetary Neutrality 376
   Long-Run Output and Unemployment 376
   A Permanent Boom? 376
   The Neutral Real Interest Rate 377

Summary 378
Key Terms 379
Questions and Problems 379

Appendix: The Loanable Funds Theory and the Neutral Interest Rate 381
Chapter 13 Economic Fluctuations, Monetary Policy, and the Financial System 383

13.1 Monetary Policy and the Term Structure 384
   The Term Structure Again 384
   A Policy Surprise 385
   Expected Policy Changes 387

CASE STUDY Measuring the Effects of Monetary Policy on the Term Structure 389

13.2 The Financial System and Aggregate Expenditure 390
   Changes in Asset Prices 391
   Changes in Bank Lending Policies 392

CASE STUDY Asset Prices, Banking, and the Japanese Slump 393
   The Investment Multiplier 396

13.3 The Monetary Transmission Mechanism 397
   Effects in Financial Markets 398
   Effects on Bank Lending 398
   Effects on Expenditure 398
   Multiplier Effects 398
   Some Lessons 399

CASE STUDY Monetary Policy, Inventories, and Small Firms 399

13.4 Time Lags 400
   Lags in the AE Curve 401
   Lags in the Phillips Curve 401
   Evidence 402

13.5 Time Lags and the Effects of Policy 403
   A Disinflation 403
   Countercyclical Policy 405

CASE STUDY Fiscal versus Monetary Policy 406
Summary 409
Key Terms 410
Questions and Problems 410
Chapter 14 Inflation and Deflation 413

14.1 Money and Inflation in the Long Run 414
   Velocity and the Quantity Equation 414
   Deriving the Inflation Rate 415
   The Data 416
   The Phillips Curve Again 417

14.2 What Determines Money Growth? 419
   Commodity Money 419

CASE STUDY The Free Silver Movement 420
   Fiat Money and Inflation 421
   The Output–Inflation Trade-off 421
   Seigniorage and Very High Inflation 422

CASE STUDY The German Hyperinflation 424

CASE STUDY The Worldwide Decline in Inflation 425

14.3 The Costs of Inflation 427
   The Inflation Fallacy 427
   Very High Inflation 428

CASE STUDY Life in Inflationary Brazil 429
   Moderate Inflation 430

CASE STUDY The After-Tax Real Interest Rate 432

14.4 Deflation and the Liquidity Trap 433
   Money Growth Again 433
   The Liquidity Trap 433

CASE STUDY Japan’s Liquidity Trap 437

Summary 438
Key Terms 439
Questions and Problems 439
PART V  MONETARY POLICY

Chapter 15 Policies for Economic Stability 443

15.1 Choosing the Long-Run Inflation Rate 444
   The Case for Zero Inflation 444
   The Case for Positive Inflation 445
   Current Practice 446

15.2 Inflation and Output Stability 446
   Inflation Stability 447
   Output Stability 447
   Balancing the Goals 448

CASE STUDY How Costly Is the Business Cycle? 448

15.3 The Taylor Rule 449
   Martin’s Metaphor 450
   Taylor’s Formula 450
   Applying the Rule 451
   The Rule in Action 451

15.4 The Taylor Rule in the AE/PC Model 452
   An Example 453
   Choosing the Coefficients 453

15.5 Uncertainty and Policy Mistakes 454
   A Mistake About the AE Curve 455
   Mismeasurement of the Output Gap 457

CASE STUDY The Fed and the Great Inflation 460

CASE STUDY The Fed and the Roaring 90s 462
   Coping with Uncertainty 463

15.6 Making Interest-Rate Policy 464
   Monitoring the Economy 465
   Forecasts 466
   Policy Options 467
   The FOMC Meeting 467

15.7 Monetary Policy and Financial Events 468
   Responses to Financial Crises 468
   Responses to Bubbles 470

Summary 471
Key Terms 472
Questions and Problems 472
Chapter 16 Monetary Institutions and Strategies 475

16.1 Time Consistency and Inflation 476
   Rational Expectations and the Phillips Curve 476
   The Time-Consistency Problem 477
   How the Time-Consistency Problem Increases Inflation 478
   Solving the Time-Consistency Problem 481

16.2 Central Bank Independence 483
   The Independent Federal Reserve 483
   Independence Around the World 484
   Opposition to Independence 485
   The Traditional Case for Independence 486
   Independence and Time Consistency 487
   Evidence on Independence and Inflation 488

16.3 Monetary Policy Rules 489
   Two Approaches to Policy 489
   Traditional Arguments for Rules 490

CASE STUDY Nixon and Burns 491
   Time Consistency Again 492
   Money Targets 492

16.4 Inflation Targets 493
   How Inflation Targeting Works 494
   The Spread of Inflation Targeting 495
   The Case for Inflation Targeting 497
   Opposition to Inflation Targeting 499

CASE STUDY Targeters and Nontargeters 500

CASE STUDY The ECB’s Two Pillars 501

16.5 Communication by Central Banks 502
   Reputation 502

CASE STUDY Alan Blinder 503
   Transparency 504

Summary 507
Key Terms 508
Questions and Problems 508
Chapter 17 Monetary Policy and Exchange Rates 511

17.1 Exchange Rates and Stabilization Policy 512
   Exchange Rates and Aggregate Expenditure 512
   Offsetting Exchange-Rate Shocks 513

CASE STUDY Canadian Monetary Policy 515

17.2 Costs of Exchange-Rate Volatility 516
   Exchange Rates and Risk 516
   Risk and Economic Integration 517

17.3 Exchange-Rate Policies 517
   Interest-Rate Adjustments 518
   Foreign-Exchange Interventions 519

CASE STUDY Do Interventions Work? 522
   Capital Controls 523
   Policy Coordination 525

CASE STUDY The Yuan 526

17.4 Fixed Exchange Rates 528
   Mechanics of Fixed Exchange Rates 528
   Devaluation and Revaluation 529
   Loss of Independent Monetary Policy 529
   Controlling Inflation 530
   The Instability of Fixed Exchange Rates 531

CASE STUDY George Soros versus the Pound 533
   A Brief History of Fixed Exchange Rates 534

17.5 Currency Unions 535
   The Euro 535
   The Economics of Currency Unions 538
   The Politics of Currency Unions 539
   More Currency Unions? 540

Summary 540
Key Terms 541
Questions and Problems 541
Chapter 18 Financial Crises 543

18.1 The Mechanics of Financial Crises 544
   Events in the Financial System 544
   Financial Crises and the Economy 545

CASE STUDY Disaster in the 1930s 547

18.2 Policy Responses to Financial Crises 549
   Expansionary Monetary Policy 549
   Liquidity Crises and the Lender of Last Resort 550
   Bailouts of Insolvent Institutions 551


18.3 Financial Crises in Emerging Economies 558
   Capital Flight 558
   Capital Flight and Financial Crises 559

CASE STUDY Argentina’s Crisis, 2001–2002 561
   The Role of the IMF 564

Summary 566
Key Terms 566
Questions and Problems 566

Glossary G-1

Index I-1