## Contents

- Exchanges and Over-the-Counter Markets .................................................. 71
- Money and Capital Markets ........................................................................ 71
- Financial Market Instruments .................................................................... 72
- Money Market Instruments ......................................................................... 72

### Following the Financial News
- Money Market Rates .................................................................................. 73
- Capital Market Instruments ......................................................................... 74

### Following the Financial News
- Capital Market Interest Rates .................................................................... 75

### Global
- Are U.S. Capital Markets Losing Their Edge? ............................................. 77
- International Bond Market, Eurobonds, and Eurocurrencies ....................... 77
- World Stock Markets .................................................................................... 78

### Function of Financial Intermediaries: Indirect Finance ......................... 78

### Following the Financial News
- Foreign Stock Market Indexes .................................................................... 79

### Global
- The Importance of Financial Intermediaries Relative to Securities Markets: 80
  - An International Comparison

### Risk Sharing.................................................................................................. 80
### Asymmetric Information: Adverse Selection and Moral Hazard ............... 81
### Economies of Scope and Conflicts of Interest ........................................... 83

### Types of Financial Intermediaries ................................................................. 83
- Depository Institutions ................................................................................ 83
- Contractual Savings Institutions .................................................................. 85
- Investment Intermediaries ............................................................................ 86

### Regulation of the Financial System ............................................................ 87
- Increasing Information Available to Investors .............................................. 87
- Ensuring the Soundness of Financial Intermediaries .................................... 87

### Financial Regulation Abroad ....................................................................... 90

### Summary ......................................................................................................... 90
### Key Terms ....................................................................................................... 91
### Questions ........................................................................................................ 91
### Applied Problems ........................................................................................ 92
### Web Exercises ............................................................................................... 93
### Web References ............................................................................................. 93

## CHAPTER 3
### What Is Money? .............................................................................................. 94

### Meaning of Money ........................................................................................ 94
### Functions of Money ....................................................................................... 95
- Medium of Exchange ...................................................................................... 95
- Unit of Account ............................................................................................... 96
- Store of Value ................................................................................................. 97

### Evolution of the Payments System ............................................................... 98
- Commodity Money ........................................................................................ 98
- Fiat Money ....................................................................................................... 98
- Checks ............................................................................................................. 98
- Electronic Payment ........................................................................................ 99
- E-Money .......................................................................................................... 99

### FYI
- Are We Headed for a Cashless Society? ......................................................... 100
### PART 2

**FINANCIAL MARKETS** 107

#### CHAPTER 4

**Understanding Interest Rates** 108

- Measuring Interest Rates ........................................ 108
  - Present Value .................................................. 108

  **APPLICATION** Simple Present Value .......................... 110

  **APPLICATION** How Much Is That Jackpot Worth? .......... 110
  - Four Types of Credit Market Instruments .................... 111
  - Yield to Maturity ................................................. 112

  **APPLICATION** Yield to Maturity on a Simple Loan ........ 112

  **APPLICATION** Yield to Maturity and the Yearly Payment on a Fixed-Payment Loan ..................................... 114

  **APPLICATION** Yield to Maturity and the Bond Price for a Coupon Bond ................................................. 115

  **APPLICATION** Perpetuity ........................................ 117

**Global** Negative T-Bill Rates? It Can Happen 119

- The Distinction Between Interest Rates and Returns ........ 119
- Maturity and the Volatility of Bond Returns: Interest-Rate Risk ............................................................. 122
- Summary .................................................................. 123

- The Distinction Between Real and Nominal Interest Rates ................................................................. 123

  **APPLICATION** Calculating Real Interest Rates .......... 124

  **FYI** With TIPS, Real Interest Rates Have Become Observable in the United States 126

**Summary** 126 • Key Terms 126 • Questions 127 • Applied Problems 127 • Web Exercises 128 • Web References 129 • Web Appendices 129

#### CHAPTER 5

**The Behavior of Interest Rates** 130

- Determinants of Asset Demand .................................... 130
  - Wealth .................................................................. 131
  - Expected Returns .................................................. 131
  - Risk .................................................................... 131
  - Liquidity ............................................................... 132

  **Theory of Portfolio Choice** ...................................... 132

- Supply and Demand in the Bond Market ......................... 133
  - Demand Curve ....................................................... 133
Contents

Supply Curve ................................................................. 134
Market Equilibrium ....................................................... 135
Supply and Demand Analysis ............................................ 136
Changes in Equilibrium Interest Rates ................................. 136
Shifts in the Demand for Bonds ......................................... 136
Shifts in the Supply of Bonds ............................................ 140

APPLICATION Changes in the Interest Rate Due to Expected Inflation: The Fisher Effect ............................................ 142

APPLICATION Changes in the Interest Rate Due to a Business Cycle Expansion .................................................. 143

APPLICATION Explaining Low Japanese Interest Rates ............... 145

Supply and Demand in the Market for Money: The Liquidity Preference Framework ........................................... 146

APPLICATION Changes in the Equilibrium Interest Rate Due to Changes in Income, the Price Level, or the Money Supply .............. 149

APPLICATION Money and Interest Rates ................................. 152

Does a Higher Rate of Growth of the Money Supply Lower Interest Rates? .................................................. 153

Summary 156 • Key Terms 157 • Questions 157 • Applied Problems 158 • Web Exercises 159 • Web References 159 • Web Appendices 1, 2, 3 159

CHAPTER 6

The Risk and Term Structure of Interest Rates 160

Risk Structure of Interest Rates ............................................ 160

Default Risk ................................................................. 160

FYI Conflicts of Interest at Credit-Rating Agencies and the Global Financial Crisis 164

APPLICATION The Global Financial Crisis and the Baa-Treasury Spread .................................................. 164

Liquidity ................................................................. 165
Income Tax Considerations .............................................. 165
Summary ................................................................. 167

APPLICATION Effects of the Bush Tax Cut and Its Possible Repeal on Bond Interest Rates ........................................ 167

Term Structure of Interest Rates ............................................ 168

Following the Financial News Yield Curves 168

Expectations Theory ...................................................... 170
Segmented Markets Theory .............................................. 173
Liquidity Premium and Preferred Habitat Theories .................. 174
Evidence on the Term Structure ........................................ 176
Summary ................................................................. 176
FYI  The Yield Curve as a Forecasting Tool for Inflation and the Business Cycle  178

APPLICATION Interpreting Yield Curves, 1980–2011 .................................................. 178

Summary 179 • Key Terms 180 • Questions 180 • Applied Problems 181 • Web Exercises 182 • Web References 182

CHAPTER 7
The Stock Market, the Theory of Rational Expectations, and the Efficient Market Hypothesis  183

Computing the Price of Common Stock ................................................................. 183
  The One-Period Valuation Model ................................................................. 184
  The Generalized Dividend Valuation Model ..................................................... 185
  The Gordon Growth Model ............................................................................. 185

How the Market Sets Stock Prices ..................................................................... 186

APPLICATION Monetary Policy and Stock Prices .............................................. 187

APPLICATION The Global Financial Crisis and the Stock Market .................. 188

The Theory of Rational Expectations ................................................................. 188
  Formal Statement of the Theory ..................................................................... 190
  Rationale Behind the Theory ......................................................................... 190
  Implications of the Theory ............................................................................ 191

The Efficient Market Hypothesis: Rational Expectations in Financial Markets ......................................................................................... 191
  Rationale Behind the Hypothesis .................................................................... 193

APPLICATION Practical Guide to Investing in the Stock Market .................... 194
  How Valuable Are Published Reports by Investment Advisers? ................. 194
  Should You Be Skeptical of Hot Tips? ............................................................. 195
  Do Stock Prices Always Rise When There Is Good News? .......................... 195

FYI Should You Hire an Ape as Your Investment Adviser?  196
  Efficient Market Prescription for the Investor ................................................. 196
  Why the Efficient Market Hypothesis Does Not Imply That Financial Markets Are Efficient ................................................................. 197

  Behavioral Finance ......................................................................................... 198

Summary 199 • Key Terms 200 • Questions 200 • Applied Problems 201 • Web Exercises 202 • Web References 202 • Web Appendix 202

PART 3
FINANCIAL INSTITUTIONS  203

CHAPTER 8
An Economic Analysis of Financial Structure  204

Basic Facts About Financial Structure Throughout the World ........................... 204

Transaction Costs .................................................................................................. 207
  How Transaction Costs Influence Financial Structure .................................. 207
  How Financial Intermediaries Reduce Transaction Costs ............................ 207
<table>
<thead>
<tr>
<th>Contents</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asymmetric Information: Adverse Selection and Moral Hazard</td>
<td>208</td>
</tr>
<tr>
<td>The Lemons Problem: How Adverse Selection Influences Financial Structure</td>
<td>209</td>
</tr>
<tr>
<td>Leons in the Stock and Bond Markets</td>
<td>210</td>
</tr>
<tr>
<td>Tools to Help Solve Adverse Selection Problems</td>
<td>210</td>
</tr>
<tr>
<td>FYI The Enron Implosion</td>
<td>212</td>
</tr>
<tr>
<td>How Moral Hazard Affects the Choice Between Debt and Equity Contracts</td>
<td>214</td>
</tr>
<tr>
<td>Moral Hazard in Equity Contracts: The Principal-Agent Problem</td>
<td>215</td>
</tr>
<tr>
<td>Tools to Help Solve the Principal-Agent Problem</td>
<td>216</td>
</tr>
<tr>
<td>How Moral Hazard Influences Financial Structure in Debt Markets</td>
<td>217</td>
</tr>
<tr>
<td>Tools to Help Solve Moral Hazard in Debt Contracts</td>
<td>218</td>
</tr>
<tr>
<td>Summary</td>
<td>220</td>
</tr>
<tr>
<td>APPLICATION Financial Development and Economic Growth</td>
<td>221</td>
</tr>
<tr>
<td>FYI Should We Kill All the Lawyers?</td>
<td>222</td>
</tr>
<tr>
<td>APPLICATION Is China a Counterexample to the Importance of Financial Development?</td>
<td>222</td>
</tr>
<tr>
<td>Summary</td>
<td>223</td>
</tr>
<tr>
<td>Key Terms</td>
<td>224</td>
</tr>
<tr>
<td>Questions</td>
<td>224</td>
</tr>
<tr>
<td>Applied Problems</td>
<td>225</td>
</tr>
<tr>
<td>Web Exercises</td>
<td>226</td>
</tr>
<tr>
<td>Web References</td>
<td>226</td>
</tr>
</tbody>
</table>

**CHAPTER 9**

Financial Crises in Advanced Economies 227

| What Is a Financial Crisis? | 227 |
| Dynamics of Financial Crises in Advanced Economies | 228 |
| Stage One: Initiation of Financial Crisis | 228 |
| Stage Two: Banking Crisis | 230 |
| Stage Three: Debt Deflation | 231 |
| APPLICATION The Mother of All Financial Crises: The Great Depression | 231 |
| Stock Market Crash | 231 |
| Bank Panics | 232 |
| Continuing Decline in Stock Prices | 232 |
| Debt Deflation | 233 |
| International Dimensions | 233 |
| Causes of the 2007–2009 Financial Crisis | 234 |
| FYI Collateralized Debt Obligations (CDOs) | 235 |
| Effects of the 2007–2009 Financial Crisis | 236 |
| Inside the Fed Was the Fed to Blame for the Housing Price Bubble? | 237 |
| Global Ireland and the 2007–2009 Financial Crisis | 240 |
| Height of the 2007–2009 Financial Crisis | 240 |
| Government Intervention and the Recovery | 241 |
| Global Worldwide Government Bailouts During the 2007–2009 Financial Crisis | 242 |
| Summary | 242 |
| Key Terms | 243 |
| Questions | 243 |
| Web Exercise | 244 |
| Web References | 244 |
CHAPTER 10
Financial Crises in Emerging Market Economies 245

Dynamics of Financial Crises in Emerging Market Economies 245
Stage One: Initiation of Financial Crisis 245
Stage Two: Currency Crisis 249
Stage Three: Full-Fledged Financial Crisis 249

APPLICATION Crisis in South Korea, 1997–1998 251
Financial Liberalization/Globalization Mismanaged 251
Perversion of the Financial Liberalization/Globalization Process: Chaebols and the South Korean Crisis 252
Stock Market Decline and Failure of Firms Increase Uncertainty 254
Adverse Selection and Moral Hazard Problems Worsen and Aggregate Demand Falls 254
Currency Crisis Ensues 255
Final Stage: Currency Crisis Triggers Full-Fledged Financial Crisis 255
Recovery Commences 256

APPLICATION The Argentine Financial Crisis, 2001–2002 257
Severe Fiscal Imbalances 257
Adverse Selection and Moral Hazard Problems Worsen 257
Bank Panic Begins 257
Currency Crisis Ensues 258
Currency Crisis Triggers Full-Fledged Financial Crisis 259
Recovery Begins 260

Preventing Emerging Market Financial Crises 261
Beef Up Prudential Regulation and Supervision of Banks 261

Following the Financial News When an Advanced Economy Is like an Emerging Market Economy: The Icelandic Financial Crisis of 2008 262
Encourage Disclosure and Market-Based Discipline 263
Limit Currency Mismatch 263
Sequence Financial Liberalization 263

Summary 264 • Key Terms 264 • Questions 264

CHAPTER 11
Banking and the Management of Financial Institutions 265

The Bank Balance Sheet 265
Liabilities 265
Assets 268

Basic Banking 269

General Principles of Bank Management 272
Liquidity Management and the Role of Reserves 272
Asset Management 275
Liability Management 276
Capital Adequacy Management 277

APPLICATION Strategies for Managing Bank Capital 279

APPLICATION How a Capital Crunch Caused a Credit Crunch During the Global Financial Crisis 280
### Contents

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ........................ 316
Future Regulation ........................................................................................................... 317

Summary 318 • Key Terms 318 • Questions 319 • Applied Problems 319 •
Web Exercises 320 • Web References 320 • Web Appendices 1, 2 320

### CHAPTER 13

Banking Industry: Structure and Competition 321

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Historical Development of the Banking System</td>
<td>321</td>
</tr>
<tr>
<td>Multiple Regulatory Agencies</td>
<td>323</td>
</tr>
<tr>
<td>Financial Innovation and the Growth of the “Shadow Banking System”</td>
<td>324</td>
</tr>
<tr>
<td>Responses to Changes in Demand Conditions: Interest-Rate Volatility</td>
<td>325</td>
</tr>
<tr>
<td>Responses to Changes in Supply Conditions: Information Technology</td>
<td>326</td>
</tr>
<tr>
<td><strong>FYI</strong> Will “Clicks” Dominate “Bricks” in the Banking Industry?</td>
<td>328</td>
</tr>
<tr>
<td>Avoidance of Existing Regulations</td>
<td>329</td>
</tr>
<tr>
<td><strong>FYI</strong> Bruce Bent and the Money Market Mutual Fund Panic of 2008</td>
<td>331</td>
</tr>
<tr>
<td>Financial Innovation and the Decline of Traditional Banking</td>
<td>332</td>
</tr>
<tr>
<td>Structure of the U.S. Commercial Banking Industry</td>
<td>335</td>
</tr>
<tr>
<td>Restrictions on Branching</td>
<td>336</td>
</tr>
<tr>
<td>Response to Branching Restrictions</td>
<td>337</td>
</tr>
<tr>
<td>Bank Consolidation and Nationwide Banking</td>
<td>338</td>
</tr>
<tr>
<td>The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994</td>
<td>340</td>
</tr>
<tr>
<td>What Will the Structure of the U.S. Banking Industry Look Like in the Future?</td>
<td>340</td>
</tr>
<tr>
<td><strong>Global</strong> Comparison of Banking Structure in the United States and Abroad</td>
<td>341</td>
</tr>
<tr>
<td>Are Bank Consolidation and Nationwide Banking Good Things?</td>
<td>341</td>
</tr>
<tr>
<td>Separation of the Banking and Other Financial Service Industries</td>
<td>342</td>
</tr>
<tr>
<td>Erosion of Glass-Steagall</td>
<td>342</td>
</tr>
<tr>
<td>The Gramm-Leach-Bliley Financial Services Modernization Act of 1999:</td>
<td>342</td>
</tr>
<tr>
<td>Repeal of Glass-Steagall</td>
<td>342</td>
</tr>
<tr>
<td>Implications for Financial Consolidation</td>
<td>343</td>
</tr>
<tr>
<td>Separation of Banking and Other Financial Services Industries Throughout the World</td>
<td>343</td>
</tr>
<tr>
<td><strong>FYI</strong> The Global Financial Crisis and the Demise of Large, Free-Standing Investment Banks</td>
<td>344</td>
</tr>
<tr>
<td>Thrift Industry: Regulation and Structure</td>
<td>344</td>
</tr>
<tr>
<td>Savings and Loan Associations</td>
<td>344</td>
</tr>
<tr>
<td>Mutual Savings Banks</td>
<td>345</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>345</td>
</tr>
<tr>
<td>International Banking</td>
<td>346</td>
</tr>
<tr>
<td>Eurodollar Market</td>
<td>346</td>
</tr>
<tr>
<td><strong>Global</strong> Ironic Birth of the Eurodollar Market</td>
<td>347</td>
</tr>
<tr>
<td>Structure of U.S. Banking Overseas</td>
<td>347</td>
</tr>
<tr>
<td>Foreign Banks in the United States</td>
<td>348</td>
</tr>
<tr>
<td>Summary 349 • Key Terms 350 • Questions 350 • Web Exercises 351 •</td>
<td></td>
</tr>
<tr>
<td>Web References 352</td>
<td></td>
</tr>
</tbody>
</table>
## PART 4

### CENTRAL BANKING AND THE CONDUCT OF MONETARY POLICY 353

#### CHAPTER 14

Central Banks: A Global Perspective 354

- Origins of the Federal Reserve System .......................................................... 354
- Structure of the Federal Reserve System ......................................................... 355
  - Federal Reserve Banks ................................................................................. 355
  - Member Banks ............................................................................................ 357
  - Board of Governors of the Federal Reserve System ................................. 357
  - Federal Open Market Committee (FOMC) .................................................. 358

**Inside the Fed** The FOMC Meeting 359

- How Independent Is the Fed? ........................................................................... 360
- Should the Fed Be Independent? ...................................................................... 361
  - The Case for Independence ......................................................................... 361

**Inside the Fed** How Bernanke's Style Differs from Greenspan's 362

  - The Case Against Independence .................................................................. 363
  - Central Bank Independence and Macroeconomic Performance
    - Throughout the World ................................................................................ 364

- Explaining Central Bank Behavior .................................................................. 364

- Structure and Independence of the European
  - Central Bank ................................................................................................ 365
  - Governing Council Executive Board and General Council ....................... 366

- Central Banks Round the World ...................................................................... 370
  - Bank of Canada ............................................................................................ 370
  - Bank of England ........................................................................................... 371
  - Bank of Japan ............................................................................................... 371
  - Central Banks in Transition Economies ....................................................... 372
  - Central Banks in Developing Countries and Emerging Economies .......... 372

**Global** Islamic Finance: Alternative Ethical Solutions to Financial Stability 373

- People's Bank of China ..................................................................................... 374
- Multinational Central Banks in Developing Countries ................................. 375
- Central Bank Reforms in South America ....................................................... 375
- Currency Unions in Developing Nations ....................................................... 375
- The Trend Toward Greater Independence ....................................................... 376

- Summary 376 • Key Terms 377 • Questions 377 • Web Exercises 378 • Web References 378

#### CHAPTER 15

The Money Supply Process 379

- Three Players in the Money Supply Process ................................................... 379
- The Fed's Balance Sheet ................................................................................ 379
  - Liabilities .................................................................................................... 380
  - Assets .......................................................................................................... 381
Contents

Control of the Monetary Base ............................................................... 381
    Federal Reserve Open Market Operations ........................................... 382
    Shifts from Deposits into Currency .................................................. 385
    Loans to Financial Institutions ....................................................... 386
    Other Factors That Affect the Monetary Base .................................... 386
    Overview of the Fed's Ability to Control the Monetary Base ................. 387

Multiple Deposit Creation: A Simple Model ......................................... 388
    Deposit Creation: The Single Bank .................................................... 388
    Deposit Creation: The Banking System .............................................. 389
    Deriving the Formula for Multiple Deposit Creation ........................... 392
    Critique of the Simple Model ........................................................... 393

Factors That Determine the Money Supply .......................................... 394
    Changes in the Nonborrowed Monetary Base, MB_n ................................ 394
    Changes in Borrowed Reserves, BR, from the Fed ................................ 394
    Changes in the Required Reserve Ratio, rr ......................................... 394
    Changes in Currency Holdings .......................................................... 394
    Changes in Excess Reserves .............................................................. 395

Overview of the Money Supply Process .............................................. 395

The Money Multiplier ........................................................................... 396
    Deriving the Money Multiplier ............................................................ 396
    Intuition Behind the Money Multiplier ................................................. 398

APPLICATION The Great Depression Bank Panics, 1930–1933, and the Money Supply ........................................................................... 400

APPLICATION The 2007–2009 Financial Crisis and the Money Supply ........... 402

Summary 405 • Key Terms 405 • Questions 406 • Applied Problems 406 • Web Exercises 407 • Web References 408 • Web Appendices 1, 2, 3 408

CHAPTER 16
Tools of Monetary Policy 409

The Market for Reserves and the Federal Funds Rate .................................. 409
    Demand and Supply in the Market for Reserves .................................... 409

Inside the Fed Why Does the Fed Need to Pay Interest on Reserves? 411

How Changes in the Tools of Monetary Policy Affect the Federal Funds Rate ........................................................................... 412

APPLICATION How the Federal Reserve's Operating Procedures
    Limit Fluctuations in the Federal Funds Rate ...................................... 416

Conventional Monetary Policy Tools .................................................... 418
    Open Market Operations ....................................................................... 418

Inside the Fed A Day at the Trading Desk 419

Discount Policy and the Lender of Last Resort ....................................... 420

Inside the Fed Using Discount Policy to Prevent a Financial Panic 422

    Reserve Requirements ........................................................................ 423
    Interest on Reserves .......................................................................... 424
    Relative Advantages of the Different Tools ........................................... 424
Contents

Nonconventional Monetary Policy Tools During the Global Financial Crisis ............ 425
  Liquidity Provision ........................................................................................................ 425
  Asset Purchases ............................................................................................................. 426
  Quantitative Easing Versus Credit Easing .................................................................. 426

Inside the Fed Fed Lending Facilities During the Global Financial Crisis 427
  Commitment to Future Policy Actions ........................................................................ 428

Monetary Policy Tools of the European Central Bank .................................................. 429
  Open Market Operations .............................................................................................. 430
  Lending to Banks ......................................................................................................... 430
  Reserve Requirements .................................................................................................. 430

Summary 431 • Key Terms 431 • Questions 432 • Applied Problems 433 •
  Web Exercises 433 • Web References 433

CHAPTER 17
The Conduct of Monetary Policy: Strategy and Tactics 434

The Price Stability Goal and the Nominal Anchor ....................................................... 434
  The Role of a Nominal Anchor .................................................................................... 435
  The Time-Inconsistency Problem ................................................................................. 435

Other Goals of Monetary Policy .................................................................................. 436
  High Employment and Output Stability ...................................................................... 436
  Economic Growth ........................................................................................................ 437
  Stability of Financial Markets ...................................................................................... 437
  Interest-Rate Stability .................................................................................................. 437
  Stability in Foreign Exchange Markets ....................................................................... 437

Should Price Stability be the Primary Goal of Monetary Policy? ............................... 438
  Hierarchical Versus Dual Mandates ............................................................................ 438
  Price Stability as the Primary, Long-Run Goal of Monetary Policy ......................... 439

Inflation Targeting ........................................................................................................ 439
  Inflation Targeting in New Zealand, Canada, and the United Kingdom ...................... 440
  Advantages of Inflation Targeting .............................................................................. 442
  Disadvantages of Inflation Targeting ........................................................................ 443

The Federal Reserve's Monetary Policy Strategy .......................................................... 445
  Advantages of the Fed's "Just Do It" Approach ............................................................ 446
  Disadvantages of the Fed's "Just Do It" Approach ....................................................... 446

Lessons for Monetary Policy Strategy from the Global Financial Crisis ...................... 447

Inside the Fed Chairman Bernanke and Inflation Targeting 448
  Implications for Inflation Targeting ........................................................................... 449
  How Should Central Banks Respond to Asset-Price Bubbles? .................................. 450

Tactics: Choosing the Policy Instrument ....................................................................... 454
  Criteria for Choosing the Policy Instrument ................................................................ 456

Tactics: The Taylor Rule ............................................................................................... 457

Inside the Fed The Fed's Use of the Taylor Rule 460

Inside the Fed Fed Watchers 460

Summary 461 • Key Terms 461 • Questions 462 • Applied Problems 463 •
  Web Exercises 463 • Web References 464 • Web Appendix 464
APPENDIX TO CHAPTER 17
Fed Policy Procedures: Historical Perspective 465
The Early Years: Discount Policy as the Primary Tool ........................................ 465
Discovery of Open Market Operations .............................................................. 466
The Great Depression ......................................................................................... 466
Reserve Requirements as a Policy Tool .............................................................. 467
War Finance and the Pegging of Interest Rates: 1942–1951 ............................... 468
Targeting Money Market Conditions: the 1950s and 1960s ................................. 468
Targeting Monetary Aggregates: the 1970s ......................................................... 469
Federal Funds Targeting Again: Early 1990s and Beyond .................................. 472
Preemptive Strikes Against Inflation .................................................................... 472
Preemptive Strikes Against Economic Downturns and Financial Disruptions: 
LTCM, Enron, and the Global Financial Crisis .................................................. 473
International Considerations ................................................................................ 473

INTERNATIONAL FINANCE AND MONETARY POLICY 475

CHAPTER 18
The Foreign Exchange Market 476
Foreign Exchange Market ................................................................................... 476
What Are Foreign Exchange Rates? ..................................................................... 477
Following the Financial News Foreign Exchange Rates 478

Why Are Exchange Rates Important? .................................................................. 478
How Is Foreign Exchange Traded? ....................................................................... 479
Exchange Rates in the Long Run ................................................................--------- 479
Law of One Price ................................................................................................. 479
Theory of Purchasing Power Parity ...................................................................... 480
Why the Theory of Purchasing Power Parity Cannot Fully Explain 
Exchange Rates .................................................................................................. 481
Factors That Affect Exchange Rates in the Long Run ......................................... 482
Exchange Rates in the Short Run: A Supply and Demand Analysis ................. 483
Supply Curve for Domestic Assets ........................................................................ 484
Demand Curve for Domestic Assets ..................................................................... 484
Equilibrium in the Foreign Exchange Market ..................................................... 485
Explaining Changes in Exchange Rates ............................................................... 485
Shifts in the Demand for Domestic Assets ........................................................... 486
Recap: Factors That Change the Exchange Rate ................................................ 488
APPLICATION Effects of Changes in Interest Rates on the Equilibrium 
Exchange Rate ..................................................................................................... 490
APPLICATION Why Are Exchange Rates So Volatile? 491
APPLICATION The Dollar and Interest Rates 492
APPLICATION The Global Financial Crisis and the Dollar 493
Summary 494 • Key Terms 494 • Questions 495 • Applied Problems 495 • Web Exercises 496 • Web References 496

APPENDIX TO CHAPTER 18
The Interest Parity Condition 497
Comparing Expected Returns on Domestic and Foreign Assets 497
Interest Parity Condition 499

CHAPTER 19
The International Financial System 500
Intervention in the Foreign Exchange Market 500
Foreign Exchange Intervention and the Money Supply 500
Inside the Fed: A Day at the Federal Reserve Bank of New York's Foreign Exchange Desk 501
Unsterilized Intervention 503
Sterilized Intervention 504
Balance of Payments 504
Global Why the Large U.S. Current Account Deficit Worries Economists 505
Exchange Rate Regimes in the International Financial System 506
Gold Standard 506
The Bretton Woods System 507
Global The Euro's Challenge to the Dollar 508
How a Fixed Exchange Rate Regime Works 508
APPLICATION How Did China Accumulate Over $3 Trillion of International Reserves? 511
Managed Float 512
European Monetary System (EMS) 513
APPLICATION The Foreign Exchange Crisis of September 1992 514
APPLICATION Recent Foreign Exchange Crises in Emerging Market Countries: Mexico 1994, East Asia 1997, Brazil 1999, and Argentina 2002 516
Capital Controls 517
Controls on Capital Outflows 517
Controls on Capital Inflows 517
The Role of the IMF 518
Should the IMF Be an International Lender of Last Resort? 518
How Should the IMF Operate? 519
Global The Global Financial Crisis and the IMF 521
CHAPTER 21  
The IS Curve  551
Planned Expenditure and Aggregate Demand .......................... 551
The Components of Aggregate Demand ............................. 552
Consumption Expenditure ........................................ 552
FYI  Meaning of the Word Investment  553
Planned Investment Spending ........................................ 553
Net Exports .......................................................... 555
Government Purchases and Taxes ...................................... 556
Goods Market Equilibrium ........................................... 557
Solving for Goods Market Equilibrium ............................... 557
Deriving the IS Curve .............................................. 558
Understanding the IS Curve ......................................... 558
What the IS Curve Tells Us: Intuition ............................... 558
What the IS Curve Tells Us: Numerical Example .................... 558
Why the Economy Heads Toward the Equilibrium ................... 559
Factors that Shift the IS Curve ..................................... 560
Changes in Government Purchases .................................... 560
APPLICATION  The Vietnam War Buildup, 1964–1969 ................... 560
Changes in Taxes ..................................................... 561
APPLICATION  The Fiscal Stimulus Package of 2009 ..................... 562
Changes in Autonomous Spending ..................................... 563
Changes in Financial Frictions ....................................... 564
Summary of Factors That Shift the IS Curve ......................... 564
Summary 565  •  Key Terms 566  •  Questions 566  •  Applied Problems 567  •
Web Exercises 568  •  Web References 568

CHAPTER 22  
The Monetary Policy and Aggregate Demand Curves  569
The Federal Reserve and Monetary Policy ................................ 569
The Monetary Policy Curve .......................................... 570
The Taylor Principle: Why the Monetary Policy Curve
Has an Upward Slope ................................................ 570
Shifts in the MP Curve ............................................. 571
APPLICATION  Autonomous Monetary Easing at the Onset of the
2007–2009 Financial Crisis .......................................... 572
The Aggregate Demand Curve ....................................... 573
Deriving the Aggregate Demand Curve Graphically ................. 573
Factors That Shift the Aggregate Demand Curve .................... 574
FYI  Deriving the Aggregate Demand Curve Algebraically ......... 574
Summary 579  •  Key Terms 579  •  Questions 579  •  Applied Problems 580  •
Web Exercises 581  •  Web References 581
CHAPTER 23
Aggregate Demand and Supply Analysis  582

Following the Financial News: Aggregate Output, Unemployment, and Inflation  583

Deriving the Aggregate Demand Curve  583
Factors That Shift the Aggregate Demand Curve  584

Aggregate Supply  587
Long-Run Aggregate Supply Curve  587
Short-Run Aggregate Supply Curve  588

Shifts in Aggregate Supply Curves  590
Shifts in the Long-Run Aggregate Supply Curve  590
Shifts in the Short-Run Aggregate Supply Curve  591

Equilibrium in Aggregate Demand and Supply Analysis  594
Short-Run Equilibrium  594
How the Short-Run Equilibrium Moves to the Long-Run Equilibrium over Time  594
Self-Correcting Mechanism  597

Changes in Equilibrium: Aggregate Demand Shocks  597

APPLICATION The Volcker Disinflation, 1980–1986  599

APPLICATION Negative Demand Shocks, 2001–2004  599

Changes in Equilibrium: Aggregate Supply (Price) Shocks  601
Temporary Supply Shocks  601

Permanent Supply Shocks and Real Business Cycle Theory  603

APPLICATION Positive Supply Shocks, 1995–1999  606

Conclusions  606

APPLICATION Negative Supply and Demand Shocks and the 2007–2009 Financial Crisis  608
AD/AS Analysis of Foreign Business Cycle Episodes  608

APPLICATION The United Kingdom and the 2007–2009 Financial Crisis  610

APPLICATION China and the 2007–2009 Financial Crisis  611

Summary  611 • Key Terms  613 • Questions  613 • Applied Problems  614 • Web Exercises  614 • Web References  615 • Web Appendices 1, 2, 3, 4  615

APPENDIX TO CHAPTER 23
The Phillips Curve and the Short-Run Aggregate Supply Curve  616

The Phillips Curve  616
"Phillips Curve Analysis in the 1960s  616
The Friedman-Phelps Phillips Curve Analysis  617

FYI The Phillips Curve Tradeoff and Macroeconomic Policy in the 1960s  618

The Phillips Curve After the 1960s  620
The Modern Phillips Curve ................................................................................................. 620
The Modern Phillips Curve with Adaptive (Backward-Looking) Expectations ................. 620
The Short-Run Aggregate Supply Curve ............................................................................ 621

CHAPTER 24
Monetary Policy Theory 624
Response of Monetary Policy to Shocks ........................................................................... 624
Response to an Aggregate Demand Shock ........................................................................ 625
APPLICATION Quantitative (Credit) Easing in Response to the Global Financial Crisis ........................................................... 627
Response to a Permanent Supply Shock .......................................................................... 627
Response to a Temporary Supply Shock ........................................................................ 629
The Bottom Line: The Relationship Between Stabilizing Inflation and Stabilizing Economic Activity ......................................................... 631
How Actively Should Policymakers Try to Stabilize Economic Activity? ....................... 632
Lags and Policy Implementation ...................................................................................... 632
Inflation: Always and Everywhere a Monetary Phenomenon .......................................... 633
FYI The Activist/Nonactivist Debate over the Obama Fiscal Stimulus Package 634
Causes of Inflationary Monetary Policy .......................................................................... 634
High Employment Targets and Inflation ........................................................................ 635
APPLICATION The Great Inflation .................................................................................. 638
Summary 640 • Key Terms 640 • Questions 641 • Applied Problems 642 • Web Exercises 642 • Web References 642

CHAPTER 25
The Role of Expectations in Monetary Policy 643
Lucas Critique of Policy Evaluation ............................................................................... 643
Econometric Policy Evaluation ...................................................................................... 644
APPLICATION The Term Structure of Interest Rates ...................................................... 644
Policy Conduct: Rules or Discretion? .............................................................................. 645
Discretion and the Time-Inconsistency Problem ............................................................ 645
Types of Rules ................................................................................................................ 646
The Case for Rules ......................................................................................................... 646
FYI The Political Business Cycle and Richard Nixon 647
The Case for Discretion ................................................................................................. 647
Constrained Discretion ................................................................................................. 648
Global The Demise of Monetary Targeting in Switzerland 648
The Role of Credibility and a Nominal Anchor .............................................................. 649
Benefits of a Credible Nominal Anchor ....................................................................... 649
Credibility and Aggregate Demand Shocks ..................................................................... 650
Credibility and Aggregate Supply Shocks ....................................................................... 652
APPLICATION A Tale of Three Oil Price Shocks ........................................... 653
Credibility and Anti-Inflation Policy ......................................................... 654

Global Ending the Bolivian Hyperinflation: A Successful Anti-Inflation Program 656

APPLICATION Credibility and the Reagan Budget Deficits .......................... 657
Approaches to Establishing Central Bank Credibility ............................... 657

Inside the Fed The Appointment of Paul Volcker, Anti-Inflation Hawk 658

Appoint "Conservative" Central Bankers .................................................... 658
Summary 659 • Key Terms 659 • Questions 660 • Applied Problems 661 •
Web Exercises 661 • Web References 661

CHAPTER 26 Transmission Mechanisms of Monetary Policy 662

Transmission Mechanisms of Monetary Policy ......................................... 662
Traditional Interest-Rate Channels .......................................................... 663
Other Asset Price Channels ...................................................................... 664
Credit View ............................................................................................... 667

FYI Consumers' Balance Sheets and the Great Depression 670

Why Are Credit Channels Likely to Be Important? .................................... 670

APPLICATION The Great Recession .......................................................... 671
Lessons for Monetary Policy .................................................................... 671

APPLICATION Applying the Monetary Policy Lessons to Japan ................ 673
Summary 674 • Key Terms 674 • Questions 674 • Applied Problems 675 •
Web Exercises 676 • Web References 676 • Web Appendix 676

Glossary .................................................................................................... 677

Credits ...................................................................................................... 689

Index ....................................................................................................... 695

CONTENTS ON THE WEB

The following updated chapter and appendices are available on our Companion Website at www.pearsonglobaleditions.com/mishkin.

WEB CHAPTER
The ISLM Model
Keynes' Fixed Price Level Assumption and the IS Curve
The LM Curve
Equilibrium in the Market for Money: The LM Curve
ISLM Approach to Aggregate Output and Interest Rates

Factors That Cause the LM Curve to Shift

Changes in Equilibrium Level of the Interest Rate and Aggregate Output
Response to a Change in Fiscal Policy

APPLICATION The Economic Stimulus Act of 2008
Effectiveness of Monetary Versus Fiscal Policy

Monetary Policy Versus Fiscal Policy: The Case of Complete Crowding Out

APPLICATION Targeting Money Supply Versus Interest Rates

ISLM Model in the Long Run

Summary • Key Terms • Questions • Applied Problems • Web Exercises • Web References

APPENDIX TO WEB CHAPTER
Algebra of The ISLM Model

Basic Closed-Economy ISLM Model
IS and LM Curves
Solution of the Model
Implications

Open-Economy ISLM Model
Implications

CHAPTER APPENDICES
Chapter 4: Measuring Interest-Rate Risk: Duration
Chapter 5: Models of Asset Pricing

Chapter 5: Applying the Asset Market Approach to a Commodity Market: The Case of Gold

Chapter 5: Loanable Funds Framework
Chapter 7: Evidence on the Efficient Market Hypothesis
Chapter 11: Duration Gap Analysis
Chapter 11: Measuring Bank Performance
Chapter 12: The Savings and Loan Crisis and Its Aftermath
Chapter 12: Banking Crises Throughout the World
Chapter 15: The Fed’s Balance Sheet and the Monetary Base
Chapter 15: The M2 Money Multiplier
Chapter 15: Explaining the Behavior of the Currency Ratio
Chapter 17: Monetary Targeting
Chapter 20: The Baumol-Tobin and Tobin Mean Variance Models of the Demand for Money
Chapter 20: Empirical Evidence on the Demand for Money
Chapter 22: Algebra of the ISLM Model
Chapter 23: The Effects of Macroeconomic Shocks on Asset Prices
Chapter 23: Aggregate Demand and Supply: A Numerical Example
Chapter 23: The Algebra of the Aggregate Demand and Supply Model
Chapter 23: The Taylor Principle and Inflation
Chapter 26: Evaluating Empirical Evidence: The Debate Over the Importance of Money in Economic Fluctuations