The Financial System, Financial Regulation and Central Bank Policy

Traditional money and banking textbooks are long, expensive and full of so much institutional and technical modeling detail that students can't understand the big picture. Thomas F. Cargill presents a new alternative: a short, inexpensive book without the "bells and whistles" that teaches students the fundamentals in a clear, narrative form. In an engaging writing style, Cargill explains the three core components of money and banking, and their interactions: 1), the financial system; 2), government regulation and supervision; and, 3), central bank policy. Cargill focuses on the interaction between government financial policy and central bank policy and offers a critique of the central bank's role in the economy, the tools it uses, how these tools affect the economy and how effective these policies have been, providing a more balanced perspective of government policy failure versus market failure than traditional textbooks.

Professor Thomas F. Cargill has taught and conducted research on financial and monetary economics at the University of California, Davis; the University of Hawaii, at both Honolulu and Saigon (Ho Chi Minh City), Vietnam; California State University, Sacramento; Purdue University, at West Lafayette, Indiana; and, since 1973, the University of Nevada, Reno. He has written extensively as a single and joint author on U.S. financial and central banking issues and has also conducted similar research on China, South Korea, Japan and Vietnam. His work has been published in *The Journal of Economic History*, *Journal of Money, Credit and Banking*, *The Journal of Finance*, *Journal of Political Economy*, *Review of Economics and Statistics* and *International Finance*. His work has also been published by Cambridge University Press, Hoover Institution Press, the MIT Press and Oxford University Press.

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Preface

There are many excellent monetary economics textbooks in terms of coverage and pedagogical tools written by accomplished monetary economists. So why another textbook? This book differs from the traditional money and banking textbook in three significant ways: first, it offers a unifying framework; second, it approaches many topics from a different perspective from other textbooks; and, third, it offers a less encyclopedic approach than that presented in other textbooks.

Unifying Framework in This Book

The topics and the order of chapters are presented in the context of a unifying framework referred to as the nation's financial and monetary regime. The nation's financial and monetary regime consists of these three parts: 1) the financial system; 2) government regulation and supervision; and 3) central banks and central bank policy. Each component of the regime is addressed in a logical order so that the student can obtain a unified perspective of the most important topics covered in a monetary economics course.

Approach to Topics in This Book

In the context of the unifying framework of the nation's financial and monetary regime, this book offers different perspectives, both in terms of pedagogical presentation and issues.

First, discussion of central bank policy itself is organized around a five-step sequence to assist student understanding of the role of central banks and central bank policy: 1), the central bank; 2), the tools of monetary policy; 3), policy instruments; 4), the model; and, 5), the final policy targets. Like the unifying framework of the nation's financial and monetary regime, this five-step sequence provides a unifying framework for the student to organize the many elements of central banks and central bank policy.

Second, the book aims to incorporate history and policy along with the analytical concepts necessary to understand the nation's financial and monetary regime; that is, the subject is viewed more from a political economy perspective than from the analytical and detailed model perspective of most traditional textbooks. The analytical subjects are not central to the book and are developed only to the extent necessary to understand the nation's financial and monetary regime. The IS/LM model is not included. Instead, the "old" and "new" Phillips curves, along with a brief introduction to the AD/AS model, are used to illustrate the relationship between central bank policy and the economy. Rather than devote space to a detailed macroeconomic model, more attention is devoted to the three major periods of economic distress in the United States – 1), the Great Depression; 2), the Great Inflation; and, 3), the Great Recession – as well as two periods of a stable macroeconomic environment: 4), the Great Moderation; and, 5), financial liberalization.

Third, the book emphasizes the interaction between government financial policy and central bank policy as the source of much economic and financial distress and, unlike traditional textbooks, focuses on the problems of Federal Reserve policy. The majority of textbooks, in this writer's opinion, devote insufficient attention to the policy errors made by the Federal Reserve in the past. Some may regard this as normative, but the large body of research now available suggests that the Federal Reserve has importantly contributed to economic and financial distress far more often than is discussed in the majority of commonly used textbooks. This book attempts to present a more balanced perspective of government policy failure versus market failure. There is indeed much market failure, and there is indeed much necessity for government involvement in the financial and monetary regime to support economic growth, but, at the same time, there have been mistakes in monetary policy and financial regulation that have generated economic and financial distress, and this needs to be presented.

Fourth, this book presents a more realistic perspective of central bank independence. The treatment of central bank independence in traditional textbooks is often superficial and misleading; for example, ignoring the distinction between *de jure* and *de facto* independence; ignoring the documented close relationship between the Federal Reserve and the government during the period of the Great Inflation from 1965 to 1979; and failing to point out that formal independence has been a rather poor predictor of good monetary policy outcomes, as manifested by the experiences of the Federal Reserve and the Bank of Japan during the Great Inflation period. In contrast to most traditional textbooks, which downplay the political economy of monetary policy and the public choice perspective of central bank policy, this book emphasizes the overwhelming evidence that the policy of the Federal Reserve, despite its formal independence, has been strongly influenced by government. Central bank independence is more myth than reality.

Fifth, the book emphasizes how the structure of the financial system and monetary policy interact and, at times, generate economic and financial distress. The financial distress in the 1970s was not only due to inflation in the context of Regulation Q and other portfolio limitations but was also a well-documented failure of the Federal Reserve to even take into account the resource allocation effects of Regulation Q. The same error was made in the first few years of the new century, when the Federal Reserve failed to take into account how an unprecedented easy monetary policy combined with a financial structure designed to allocate credit to imprudent mortgage lending supported by government-sponsored enterprises distorted resources and generated a bubble, such as had happened in Japan 15 years earlier. The United States devotes significant resources to subsidizing the housing sector, with two suboptimal outcomes: first, in terms of homeownership, the United States ranks well below other countries that do not subsidize housing to the same degree as in the United States; and, second, the subsidization of housing has imposed a serious resource cost on the economy, especially in its contributing role in the Great Inflation and the Great Recession.

Sixth, there is no serious debate in the economic profession over the long-run neutrality of monetary policy, but considerable debate over the nonneutrality of monetary policy in the short run. While current textbooks do a good job explaining the difference between the short- and long-run effects of monetary policy, the detailed models presented in most traditional money and banking textbooks confuse students because the limits of monetary policy are not emphasized, implying that monetary policy is capable of short-run stabilization, whereas institutional, historical and theoretical developments over the last four decades suggest that this is not realistic. This book emphasizes the limits of central bank policy to a greater extent than the traditional money and banking textbooks.

The Structure of This Book Focuses on the Primary Elements of the Nation's Financial and Monetary Regime

The structure of typical money and banking textbooks shares several common features. They are encyclopedic in coverage. They are long. They are expensive, because of length, production characteristics and other attempts at product differentiation. In their effort to be encyclopedic in coverage, they lack a unifying framework that can be used to organize the various topics. This writer includes his own money and banking textbook, published by Prentice Hall in 1979, in this group. The book was reasonably successful; however, by the fourth edition, published in 1991, it had become encyclopedic, long and expensive. As a result, this writer ceased using his own textbook and resorted to a "yellow book" approach, consisting of a few chapters from the book, specifically prepared notes, data and figures, and articles organized around a unifying framework. The objective was to cover all of the relevant topics in a one-semester course, which is virtually impossible with any traditional textbook. The "yellow book" designation came from the color of the front and back covers. The yellow book, combined with lectures, presented a different perspective on the subject with a unifying structure that made it easier for the students to understand the various topics as part of one framework rather than a series of disconnected chapters. The students appreciated the cost (cheap compared to any textbook) and seemed to better understand the material because of the unifying framework. The majority of my money and banking students are business majors who need an overview of money and banking as part of their business program. I have used the approach presented in this book for a number of years in various monetary economic courses at both the undergraduate and MBA level at the University of Nevada, Reno, the University of Hawaii, Honolulu, and the University of Hawaii, Saigon (Ho Chi Minh City), Vietnam.

The yellow book approach attracted the attention of another academic publisher while I was working on a Japanese financial and monetary policy project, but as the project evolved I was increasingly encouraged to make the book more traditional, such as including the IS/LM macroeconomic model, at which point I lost interest and returned the publisher's advance. A decade later, while working with Cambridge University Press on another Japan project, I was encouraged to prepare a manuscript that would be an alternative in presentation and less expensive than the traditional money and banking textbooks that now dominate the market. This book is the outcome.

Organization of the Book

The book is divided into five parts, for a total of 17 chapters.

Part I – Introduction to the Financial and Monetary Regime: Chapters 1 and 2 present the basic elements of the nation's financial and monetary regime: the three components of the regime; the relationship between the regime and economic activity; case studies of how a malfunctioning regime generates economic and financial distress (Chapter 1); and basic concepts regarding the definition, measurement and value of money and the basic short-run and long-run relationship between money and economic activity (Chapter 2).

Part II – The Financial System Component of the Financial and Monetary Regime: Chapters 3 through 7 discuss the first component of the regime – the financial system – and present the structure of the financial system in flow of funds terms (Chapter 3), interest rate basics (Chapter 4), the level of the interest rate (Chapter 5), the structure of interest rates (Chapter 6) and exchange rates and other international dimensions of the financial system (Chapter 7).

Part III – The Role of Government in the Financial and Monetary Regime: Chapters 8 through 10 discuss the second component of the regime – the general argument for the role of government to prevent the "economic equivalent of counterfeiting" – in the context of the historical evolution of monetary systems (Chapter 8), asymmetric information and adverse selection and the various levels of government financial regulation and supervision (Chapter 9) and a short history of government financial regulation and central banking in the United States (Chapter 10).

Part IV – Five Steps to Understanding Central Banks and Central Bank Policy: Chapters 11 through 16 discuss the third component of the regime – central banks and central bank policy – in terms of a five-step sequence of central bank policy. These chapters discuss the institutional design of central banks (Chapter 11 – Step 1), the money supply process in the context of a modern monetary system (Chapter 12), the tools of monetary policy and monetary policy instruments (Chapter 13 – Steps 2 and 3), the central bank macroeconomic model (Chapter 14 – Step 4) and the final policy targets (Chapter 15 – Step 5). A separate discussion of the tactics and strategy of monetary policy involving all five steps is presented (Chapter 16), with a discussion of the Federal Reserve's evolution of a tactical and strategic framework, the Taylor rule, debate between the discretion and rules approaches to monetary policy, and the concepts of the Lucas critique and time inconsistency.

Part V – Performance of the U.S. Financial and Monetary Regime: Chapter 17 completes the book with a review of the performance of the U.S. financial regime, focusing on five periods in chronological order: 1), the Great Depression; 2), the Great Inflation; 3), financial liberalization; 4), the Great Moderation; and, 5), the Great Recession. Three are periods of economic and financial distress while two are periods of stability. The different views of the Great Recession are presented, along with a concluding discussion of the challenges facing the Federal Reserve as we close the second decade of the new century.

The chapters are designed for a one-semester course in money and banking. The length of the book is designed so that most, or even all, chapters can be assigned. Instructors who might use this book can eliminate any chapter they wish; however, the book is written as a unified presentation. Chapters 10 and 17 are the most historical of the book and thus would be candidates for omission without an adverse impact on presenting the topics as part of the unified framework of the nation's financial and monetary regime.

Note of Appreciation

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author. I would also like to thank the many undergraduate and graduate MBA students at the University of Nevada, Reno, the University of Hawaii, Honolulu, and the University of Hawaii, Ho Chi Minh City, Vietnam, who over the years have used the yellow book version of this manuscript. The manuscript for this book was used by this writer in Vietnam in June 2016 and at the University of Nevada, Reno, in fall 2016. I especially wish to thank University of Nevada, Reno, money and banking students Hannah Bass, Megan Boyden and Narae Wadsworth for providing a number of comments on many chapters.

It was these students and their need for a straightforward approach to monetary economics that served as the catalysts for this book. I thank Cambridge University Press for their confidence in me and willingness to offer a different alternative to the traditional money and banking textbook. Finally, I thank Mary Cargill, my wife of 53 years, for her support and encouragement.