

# SOLUTIONS MANUAL

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APOSTOLOS SERLETIS

## THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS

FOURTH CANADIAN EDITION

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# **PART ONE**

## **How to Use the Instructor's Manual and Other Textbook Ancillaries**



# Organization of the Instructor's Manual

To help instructors cope with the increased demands for good teaching in recent years, *The Economics of Money, Banking, and Financial Markets*, Fourth Canadian Edition, includes the most comprehensive package of supplementary materials of any money, banking, and financial markets textbook. As part of these supplemental materials, we have designed the Instructor's Manual to help save you time in preparing class materials, such as class outlines, solutions to homework problems, lecture notes, and overhead transparencies.

This Instructor's Manual is divided into four parts. Part One discusses how to use the Instructor's Manual and the other textbook ancillaries to make your teaching of the money and banking course both more effective and less time-consuming. Part Two contains an overview of all the textbook chapters along with teaching tips that we have found effective. Part Three contains the answers to the end-of-chapter problems that are not answered in the back of the textbook, and so are excellent candidates for assignment as problem sets. Part Four contains transparency masters of chapter outlines, which can be used either to make overhead transparencies for use in class or to make handouts for the students.

To obtain any of the available ancillaries, adopters of the text just need to get in touch with their Pearson sales representative, or alternatively they can visit the website for the book at [www.myeconlab.com](http://www.myeconlab.com).



# Alternative Course Outlines

There are many different ways to teach a course on money, banking, and financial markets. For this reason, the material in *The Economics of Money, Banking, and Financial Markets*, Fourth Canadian Edition, has been arranged with flexibility in mind, so that many teaching styles can be accommodated. The following sections suggest sample outlines for four main approaches to teaching money, banking, and financial markets, showing how the text can be adapted to each approach, as well as to quarter and semester teaching schedules. Note, however, that many variations on these outlines are possible.

## ■ Outline for General Money and Banking Course

### Core Chapters

#### Chapter No. Chapter Title

1. Why Study Money, Banking, and Financial Markets?
2. An Overview of the Financial System
3. What Is Money?
4. Understanding Interest Rates
5. The Behaviour of Interest Rates
10. Economic Analysis of Financial Regulation
11. Banking Industry: Structure and Competition
13. Banking and the Management of Financial Institutions
15. Central Banks and the Bank of Canada
17. Tools of Monetary Policy
18. The Conduct of Monetary Policy: Strategy and Tactics
24. Aggregate Demand and Supply Analysis
26. Money and Inflation

*For a one-semester course, cover any six of the following optional chapters:*

#### Chapter No. Chapter Title

6. The Risk and Term Structure of Interest Rates
7. The Stock Market, the Theory of Rational Expectations, and the Efficient Markets Hypothesis
8. An Economic Analysis of Financial Structure
9. Financial Crises and the Subprime Meltdown
16. The Money Supply Process
19. The Foreign Exchange Market
20. The International Financial System
21. The Demand for Money
22. The *ISLM* Model
23. Monetary and Fiscal Policy in the *ISLM* Model
25. Transmission Mechanisms of Monetary Policy: The Evidence
27. Rational Expectations: Implications for Policy

*A one-quarter course would probably only include one or two of the optional chapters unless some of the chapters on central banking and the conduct of monetary policy (Chapters 15, 17, and 18) were deleted.*

## ■ Outline for General Money and Banking Course with an International Emphasis

### Core Chapters

Chapter No.	Chapter Title
-------------	---------------

- |     |  |
|-----|--|
| 1.  | Why Study Money, Banking, and Financial Markets?     |
| 2.  | An Overview of the Financial System                  |
| 3.  | What Is Money?                                       |
| 4.  | Understanding Interest Rates                         |
| 5.  | The Behaviour of Interest Rates                      |
| 10. | Economic Analysis of Financial Regulation            |
| 11. | Banking Industry: Structure and Competition          |
| 13. | Banking and the Management of Financial Institutions |
| 15. | Central Banks and the Bank of Canada                 |
| 17. | Tools of Monetary Policy                             |
| 18. | The Conduct of Monetary Policy: Strategy and Tactics |
| 19. | The Foreign Exchange Market                          |
| 20. | The International Financial System                   |
| 24. | Aggregate Demand and Supply Analysis                 |
| 26. | Money and Inflation                                  |

*For a one-semester course, cover any four of the following optional chapters:*

Chapter No.	Chapter Title
-------------	---------------

- |     |   |
|-----|---|
| 6.  | The Risk and Term Structure of Interest Rates   |
| 7.  | The Stock Market, the Theory of Rational Expectations, and the Efficient Markets Hypothesis |
| 8.  | An Economic Analysis of Financial Structure   |
| 9.  | Financial Crises and the Subprime Meltdown  |
| 16. | The Money Supply Process  |
| 21. | The Demand for Money  |
| 22. | The <i>ISLM</i> Model   |
| 23. | Monetary and Fiscal Policy in the <i>ISLM</i> Model   |
| 25. | Transmission Mechanisms of Monetary Policy: The Evidence                                    |
| 27. | Rational Expectations: Implications for Policy  |

*A one-quarter course would probably not include any other chapters unless some of the chapters on central banking and the conduct of monetary policy (Chapters 15, 17, and 18) were deleted.*

## ■ Outline for Financial Markets and Institutions Course

### Core Chapters

Chapter No.	Chapter Title
1.	Why Study Money, Banking, and Financial Markets?
2.	An Overview of the Financial System
3.	What Is Money?
4.	Understanding Interest Rates
5.	The Behaviour of Interest Rates
6.	The Risk and Term Structure of Interest Rates
7.	The Stock Market, the Theory of Rational Expectations, and the Efficient Markets Hypothesis
8.	An Economic Analysis of Financial Structure
9.	Financial Crises and the Subprime Meltdown
10.	Economic Analysis of Financial Regulation
11.	Banking Industry: Structure and Competition
12.	Nonbank Financial Institutions
13.	Banking and the Management of Financial Institutions

*For a one-semester course, cover any seven of the following optional chapters:*

Chapter No.	Chapter Title
15.	Central Banks and the Bank of Canada
16.	The Money Supply Process
17.	Tools of Monetary Policy
18.	The Conduct of Monetary Policy: Strategy and Tactics
19.	The Foreign Exchange Market
20.	The International Financial System
21.	The Demand for Money
22.	The <i>ISLM</i> Model
23.	Monetary and Fiscal Policy in the <i>ISLM</i> Model
24.	Aggregate Demand and Supply Analysis
25.	Transmission Mechanisms of Monetary Policy: The Evidence
26.	Money and Inflation
27.	Rational Expectations: Implications for Policy

*A one-quarter course would probably only include one or two of the optional chapters.*



## ■ Outline for Monetary Theory and Policy Course

### Core Chapters

Chapter No.	Chapter Title
-------------	---------------

- |     |  |
|-----|--|
| 1.  | Why Study Money, Banking, and Financial Markets?         |
| 2.  | An Overview of the Financial System                      |
| 3.  | What Is Money?   |
| 4.  | Understanding Interest Rates                             |
| 5.  | The Behaviour of Interest Rates                          |
| 15. | Central Banks and the Bank of Canada                     |
| 16. | The Money Supply Process                                 |
| 17. | Tools of Monetary Policy                                 |
| 18. | The Conduct of Monetary Policy: Strategy and Tactics     |
| 24. | Aggregate Demand and Supply Analysis                     |
| 25. | Transmission Mechanisms of Monetary Policy: The Evidence |
| 26. | Money and Inflation                                      |
| 27. | Rational Expectations: Implications for Policy           |

*For a one-semester course, cover any six of the following optional chapters:*

Chapter No.	Chapter Title
-------------	---------------

- |     |   |
|-----|---|
| 6.  | The Risk and Term Structure of Interest Rates   |
| 7.  | The Stock Market, the Theory of Rational Expectations, and the Efficient Markets Hypothesis |
| 8.  | An Economic Analysis of Financial Structure   |
| 9.  | Financial Crises and the Subprime Meltdown  |
| 10. | Economic Analysis of Financial Regulation   |
| 11. | Banking Industry: Structure and Competition   |
| 12. | Nonbank Financial Institutions  |
| 13. | Banking and the Management of Financial Institutions  |
| 19. | The Foreign Exchange Market   |
| 20. | The International Financial System  |
| 21. | The Demand for Money  |
| 22. | The <i>ISLM</i> Model   |
| 23. | Monetary and Fiscal Policy in the <i>ISLM</i> Model   |

*A one-quarter course would probably only include three or four of the optional chapters.*

## **Overviews of the Textbook Chapters and Teaching Tips**

We have been teaching money and banking now for over twenty years. The overviews and teaching tips in Part Two of the Instructor's Manual are intended to share with you some of our experiences in the classroom with teaching the material in the textbook. The overview and teaching tips for each chapter provide a brief description of the contents of the chapter, discuss the novel features of the chapter, indicate what central points need to be transmitted to the student, suggest teaching tips that we have found useful in class, and provide guidance as to what material can easily be skipped in each chapter.

## Answers to End-of-Chapter Problems

Part Three of the Instructor's Manual contains all answers to end-of-chapter problems, including those that are not answered in the back of the textbook. Some of these questions require students to look up current data, and in these cases no answers are given; however, for the rest of the questions, the answers are quite complete.

Many instructors will use the end-of-chapter questions for homework assignments, as we do. We have found it useful to hand out answers to the questions provided in Part Three to the students as solutions sets after they have completed their assignments; they find them to be an invaluable study aid. Making up these solution sets for reproduction should be quite easy, either by cutting and pasting from Part Three, using the files on the Instructor's Resource CD-ROM, or downloading the files from the book's website at [www.myeconlab.com](http://www.myeconlab.com).

## PowerPoint Presentation

Also offered in the instructor supplement's package is a PowerPoint Presentation that contains lecture notes and a selection of the textbook's figures and tables. These slides are comprehensive and outline all the major points covered in the text. The lecture notes have been class-tested successfully—they are the ones that we use in class—and they should help other instructors prepare their lectures as they have helped us.

Please note that unless you have access to PowerPoint version 4.0 or higher you will only be able to project the provided images using the viewer that is included; editing or adding material will not be possible unless you have the software program.

To obtain the Instructor's Resource CD-ROM (with PowerPoint files), adopters of the text just need to get in touch with their Pearson sales representative.

# **Instructor's Resource CD-ROM (With Electronic Files of the Instructor's Manual, Test Bank, PowerPoint Presentation, and Image Gallery)**

To instructors who adopt the money and banking textbook, Pearson offers an Instructor's Resource CD-ROM, housing on one convenient disk the files for this Instructor's Manual (including the full set of lecture notes, modifiable to the instructor's needs). Also featured on the CD are the complete electronic test bank files in TestGen format and a PowerPoint Presentation. All of the textbook's figures and tables are also available in the Image Gallery. To obtain a copy of this indispensable teaching aid, contact your local sales representative. All instructor resources may also be downloaded from the Instructor's Resource Center at [www.myeconlab.com](http://www.myeconlab.com).

## Printed and Computerized Test Bank

The Test Bank contains over 2,500 multiple-choice questions, many with graphs, that are appropriate for use as quiz or test questions. It is provided in Macintosh and Windows versions of TestGen on the Instructor's Resource CD-ROM. It can also be downloaded from the Instructor's Resource Center at [www.myeconlab.com](http://www.myeconlab.com). These various forms provide alternative methods for the instructor to make up exams.

The Pearson TestGen program offered is a computerized test generator that lets you construct tests by choosing questions from the item bank that was prepared specifically for this textbook and your course. The test construction process involves the use of a simple TestGen screen that you fill in on the computer to choose questions for your test. If desired, test questions can be viewed on the screen, and test questions can be edited, saved, or printed. In addition, you can add questions, which may include graphics.

The program features:

- Test and item banks can include five types of question types: multiple choice; true/false; short answer; and essay.

- A supplementary page attached to each item bank question can contain its topic, objective, skill, difficulty, and other user-added information.

- Test questions can be chosen in a variety of ways including manual selection, random selection, choose while viewing, and choose by searching.

- Questions chosen for a test can be viewed and edited without affecting the original versions of the questions in the item bank.

- Test size is limited only by the memory size of the computer and the length of the questions you choose.

- Test questions can be printed in the exact order you specify or grouped and sorted automatically by the program.

- Printer files can be created or modified to take advantage of the capabilities of your printer.

## Course Management with MyEconLab

Every student who buys a new textbook receives a prepaid subscription to MyEconLab. MyEconLab delivers rich online content and innovative learning tools to your classroom. Instructors who use MyEconLab gain access to powerful communication and assessment tools, and their students receive access to the additional learning resources described below.

### Students and MyEconLab

MyEconLab delivers the content and tools your students need to succeed online. Students whose instructors use MyEconLab gain access to a variety of study and practice tools that put them in control of their own learning:

- Practice tests enable students to check their understanding and identify areas in which they need to do further work.
- A personalized study plan based on test results will show students where further study is needed.
- Interactive exercises based on specific end-of-chapter questions as well as general topics allow the student to review the material at any time. Some exercises require students to draw a graph. See the preface to the textbook to view sample exercises.
- An eText with additional assets including animations of key figures, links to videos of the US text author speaking about economic headlines, audio downloads of the chapter summaries, links to the relevant CANSIM data for a selection of the Web Exercises, and links to all of the appendices, mini-cases, and readings for the text.
- A selection of *Readings in Money, Banking, and Financial Markets*, regularly updated by Rick Mishkin and James W. Eaton and updated for the Canadian edition by Lance Shandler at Kwantlen Polytechnic University provides current articles related to topics covered in the textbook.
- Each week during the semester, students will be asked to read an article from a major online news source and answer questions on it. This is an effective and natural way to bring current events into the classroom.
- Sample quizzes give students a chance to double-check their understanding and application of the main topics in each test chapter.
- Supplements to the textbook, such as chapter synopses, videos, glossary flashcards, and links to other Web sites, help instructors to expand on the material.

The Student Access Kit that arrives bundled with all new books walks students step-by-step through the registration process.

### Instructors and MyEconLab

With MyEconLab, instructors can customize existing content and add their own. They can manage, create, and assign tests to students, choosing from the exercises in the Study Plan as well as from our Test Banks. MyEconLab also includes advanced tracking features that record students' usage and performance and a Gradebook feature to see students' test results. Please contact your Pearson sales representative for more information.

## ***Readings in Money, Banking, and Financial Markets*** **(Online Reader)**

A basic problem of textbooks in the money and banking field is that current events and financial innovation make many of the facts in the textbook obsolete soon after publication. To minimize this problem, *The Economics of Money, Banking, and Financial Markets*, Fourth Canadian Edition, focuses less on a set of facts, but rather stresses the underlying principles to understand money, banking, and financial markets. The advantage to this approach is that these principles never become obsolete, and as a result, the material in the text continues to promote understanding of the financial system as it evolves over time.

Because of the emphasis on basic principles, the text works extremely well when it is supplemented by current readings on banking and financial markets. To make it easy for instructors to supplement the text with current readings, we have provided up-to-date readings, many of which are Canadian specific, in our *Reader*, which is part of the MyEconLab for this text. The *Reader* includes summaries of the articles, provides suggestions for which textbook chapter(s) the reading might be assigned, and contains discussion questions that follow each reading in order to encourage students to think about how the reading relates to material in the text.

*Here is the table of contents for the Reader to accompany the Fourth Canadian Edition.*

- Reading 1-1: “Deficits, Debt, and Looming Disaster” (Chapters 1, 2, 5, 24)
- Reading 1-2: “Evaluating the Relative Strength of the U.S. Capital Markets” (Chapter 2)
- Reading 1-3: “Are Consumers Cashing Out?” (Chapter 3)
- Reading 1-4: “Remarks by Mark Carney, Governor of the Bank of Canada, to the Greater Victoria Chamber of Commerce” (Chapter 2)
- Reading 1-5: “The History of the Canadian Dollar” (Chapter 2, 3)
- Reading 1-6: “Canada’s Balance Sheets, 2004–2008” (Chapter 2)
- Reading 2-1: “Inflation Expectations: How the Market Speaks” (Chapters 4 and 5)
- Reading 2-2: “Globalization’s Effect on Interest Rates and the Yield Curve” (Chapters 5 and 6)
- Reading 2-3: “The Yield Curve as a Leading Indicator: Some Practical Issues” (Chapter 6)
- Reading 2-4: “The Term Structure of Interest Rates: Yield Curves” (Chapter 6)
- Reading 2-5: “How Economic News Moves Markets” (Chapter 7)
- Reading 2-6: “Asset Price Bubbles” (Chapter 7)
- Reading 2-7: “Understanding the Canadian Capital Markets” (Chapter 7)



- Reading 3-1: “Bank Credit Standards” (Chapters 8 and 10)
- Reading 3-2: “How Will a Credit Crunch Affect Small Business Finance?” (Chapters 8 and 10)
- Reading 3-3: “Going Private” (Chapter 8)
- Reading 3-4: “Perils of Price Deflation: An Analysis of the Great Depression” (Chapter 9)
- Reading 3-5: “The Rise and Fall of Subprime Mortgages” (Chapter 9)
- Reading 3-6: “House Prices and Bank Loan Performance” (Chapter 10)
- Reading 3-7: “Too Big to Fail: The Way Forward” (Chapter 11)
- Reading 3-8: “The Costs and Benefits of Bank Supervisory Disclosure” (Chapter 11)
- Reading 3-9: “Seeking Stability: What’s Next for Banking Regulation?” (Chapter 11)
- Reading 3-10: “If Fed Becomes Super Regulator, Politicians Would Be Its Kryptonite” (Chapter 11)
- Reading 3-11: “The Canadian Deposit Insurance Corporation” (Chapter 11)
- Reading 3-12: “The Office of the Superintendent of Financial Institutions of Canada” (Chapter 11)
- Reading 3-13: “Federal Pre-emption of State Bank Regulation: A Conference Panel Summary” (Chapters 11 and 12)
- Reading 3-14: “Banking Consolidation” (Chapter 12)
- Reading 4-1: “The Present and Future of Pension Insurance” (Chapter 13)
- Reading 4-2: “Social Security Restructuring: Tough Decisions Ahead” (Chapter 13)
- Reading 4-3: “Mutual Funds, Fee Transparency, and Competition” (Chapter 13)
- Reading 4-4: “Risky Business” (Chapter 14)
- Reading 5-1: “U.S. Monetary Policy: An Introduction. Part 2: What Are the Goals of U.S. Monetary Policy?” (Chapter 15)
- Reading 5-2: “The Myth of the Money Multiplier” (Chapters 15 and 16)
- Reading 5-3: “Central Bank Independence: The Key to Price Stability?” (Chapters 15 and 18)

- Reading 5-4: “Explaining Bank Credit Crunches and Procyclicality” (Chapters 15 and 16)
- Reading 5-5: “Why Monetary Policy Matters: A Canadian Perspective” (Chapters 1, 17, 18, 26)
- Reading 5-6: “Actions to Restore Financial Stability” (Chapters 17 and 18)
- Reading 5-7: “Negating the Inflation Potential of the Fed’s Lending Programs” (Chapters 17 and 18)
- Reading 5-8: “The Taylor Rule: A Guidepost for Monetary Policy?” (Chapters 17 and 18)
- Reading 5-9: “The Fed’s Monetary Policy Response to the Current Crisis” (Chapter 18)
- Reading 5-10: “Monetary Policy and Asset Prices” (Chapter 18)
- Reading 5-11: “Financial Crisis in S, M, and L” (Chapter 18)
- Reading 5-12: “U.S. Monetary Policy: An Introduction. Part 4: How Does the Fed Decide the Appropriate Setting for the Policy Instrument?” (Chapter 18)
- Reading 5-13: “Uncertainty and Monetary Policy” (Chapter 18)
- Reading 5-14: “Publishing Central Bank Interest Rate Forecasts” (Chapter 18)
- Reading 5-15: “Reflections on Monetary Policy: Flexibility, Transparency, and Inflation” (Chapter 18)
- Reading 5-16: “Does the Bank of Canada Simply Follow a Monetary Policy Rule?” (Chapter 18)
- Reading 6-1: “Interest Rates, Carry Trades, and Exchange Rate Movements” (Chapter 19)
- Reading 6-2: “Purchasing Power Parity” (Chapter 19)
- Reading 6-3: “China’s Foreign Exchange Reserves” (Chapters 19, 20, and 21)
- Reading 6-4: “On the Rotation of the Earth, Drunken Sailors, and Exchange Rate Policy” (Chapters 20 and 21)
- Reading 6-5: “Dollarization Explained” (Chapters 3 and 20)
- Reading 6-6: “The Canadian Dollar and the Gold Standard” (Chapter 20)
- Reading 6-7: “Raising Capital: The Role of Sovereign Wealth Funds” (Chapter 20)
- Reading 6-8: “U.S. Risks Japan-like ‘Lost Decade’ on Stimulus Exit” (Chapter 21)

- Reading 7-1: “Money Demand and Economic Uncertainty” (Chapter 21)
- Reading 7-2: “U.S. Household Deleveraging and Future Consumption Growth” (Chapters 22, 23, and 24)
- Reading 7-3: “What We Do and Don’t Know about Discretionary Fiscal Policy” (Chapters 22, 23, and 24)
- Reading 7-4: “The Great Moderation: Good Luck, Good Policy, or Less Oil Dependence?” (Chapters 24 and 26)
- Reading 7-5: “U.S. Monetary Policy: An Introduction. Part 3: How Does Monetary Policy Affect the U.S. Economy?” (Chapter 25)
- Reading 7-6: “Why Policymakers Might Care about Stock Market Bubbles” (Chapter 25)
- Reading 7-7: “Stock Prices and Output Growth: An Examination of the Credit Channel” (Chapter 25)
- Reading 7-8: “Rising Relative Prices or Inflation: Why Knowing the Difference Matters” (Chapter 26)
- Reading 7-9: “Inflation, Banking, and Economic Growth” (Chapter 26)
- Reading 7-10: “The Risk of Deflation” (Chapter 26 or 27)
- Reading 7-11: “Sticky Situation” (Chapter 27)
- Reading 7-12: “Activist Monetary Policy for Good or Evil? The New Keynesians versus the New Classicals” (Chapter 27)
- Reading 7-13: “When Will Inflation Really Hit Us?” (Chapters 26 and 27)

# Study Guide

The only way to learn effectively about money, banking, and financial markets is by continual, and active, application of the basic concepts developed in the textbook. To help the student in this endeavor, the *Study Guide* can also be used.

The *Study Guide* contains the following elements for each chapter:

**Chapter Synopsis/Completions:**

Each chapter begins with a summary of the chapter. Students complete the key terms from the text in the synopsis. This section is particularly important because a working economic and financial vocabulary is necessary in order for the student to advance through the material.

**Helpful Hints:**

This section provides some additional suggestions and examples to help clarify the more difficult material.

**Practice Problems and Short-Answer Questions:**

We provide a number of multi-step problems that require numerical, graphical, or written solutions. The problems are based on the larger issues developed in the chapter. Smaller issues are addressed with short-answer questions.

**Critical Thinking:** This section provides a single multi-step problem that is an application of one of the major issues developed in the chapter.

**Self-Test:**

The self-test section provides fifteen true/false and thirty multiple-choice questions to validate areas of successful learning and to highlight areas needing improvement.

**Solutions:**

Detailed solutions for all problems and questions are provided at the end of each chapter.

