

8 MONEY, INFLATION, GROWTH, AND CYCLES

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A. Topics and Tools

We have now completed half a semester of analysis of macroeconomic models and we have yet to introduce one of the principal variables of macroeconomics: money. How did the Ramseys and Diamonds of these worlds buy and sell things without money? What, if not money, did they borrow and lend in order to execute their precisely calibrated lifetime consumption plans, maintaining their knife-edge balance on the saddle path?

We answer that question below by demonstrating how the highly artificial assumptions of these models freed their occupants from needing money. In doing so we will explore the reasons why money is needed when we abandon these assumptions. This leads us to discuss money's role in modern economies and what physical and virtual commodities fulfill that role.

The basic definition of money and its role in the economy is standard content in both introductory and intermediate macroeconomics courses, which means that the typical reader of Romer's textbook will have studied this material twice and need no review. Because you are using Romer at a much earlier stage of your macroeconomics education, we'll have to fill in a lot of basic information here in this chapter that would normally appear in the textbook.

To summarize the basic theory of money in stark brevity: Money is demanded by households and firms as the medium with which to accomplish transactions in the markets for goods, labor, and credit. The supply of money comes from the banking system. The ability of the private banking system to create monetary assets depends in part on the amount of "base money" provided by the central bank, which is usually an agency of the national government. In the short run, imbalances between the demand for money and its supply are likely to be resolved by changes in interest rates, though in the long run changes in the general price level may supplant these interest-rate effects. Changes in interest rates affect investment, consumption, and saving, so monetary conditions may have a substantial impact on aggregate demand.

B. Money

As noted above, the basic story of how the monetary system works is one of the glaring omissions—for our purposes—from Romer's text. Given his intended audi-

ence of economics graduate students, there is probably no need to cover these basics. However, since we are using it in an undergraduate context, we cannot take for granted that everyone is fully up to speed on what money is and the various theories of why people demand it. This coursebook chapter fills in some basic information about the monetary system.

We can introduce monetary issues only briefly here. Students who would like to learn more details about the monetary system and monetary policy should consider enrolling in Economics 341: Monetary and Fiscal Policy.

What is money?

Everyone “knows” what money is, but putting a precise definition on it can be a little tricky. Economists usually define money functionally—by what it does rather than as a specific commodity or set of commodities. The two most common (and very closely related) functions of money are *means of payment*, and *medium of exchange*. An asset is a means of payment if receiving it from the buyer in a transaction extinguishes all of the buyer’s obligations to pay for the commodity being purchased. If you handed Lois a \$20 bill as payment for the coursebook, you owe nothing further and thus the \$20 bill was accepted as a means of payment.

While means of payment and medium of exchange are often used interchangeably, Goodhart (1989) makes a subtle distinction between the two. Suppose that Lois accepts an IOU—a slip of paper from you promising to pay \$20 on your next payday—and gives you the coursebook. In this case, the IOU functioned as a medium of exchange because it allowed the transaction to proceed and facilitated the transfer of the coursebook. However, it did not extinguish your liability for payment, thus it did not function as a means of payment. When you bring a \$20 bill to Lois to retire your debt, the transaction will be complete and it is the \$20 bill that provides the ultimate means of payment.

In many, perhaps most, cases the medium of exchange can also be thought of as a means of payment. However, in cases such as credit purchases it is clear that there is a distinction and that money would be defined differently depending on whether we consider it to be only the asset that provides the means of payment function or all assets that served the less restrictive function of medium of exchange.

Money also provides several other functions. The use of money as a means of payment makes it convenient to quote prices in terms of money—to use money as a *unit of account*. Thus the dollar in the United States is not only a physical commodity such as a bill or coin, but also an abstract unit in which value is measured. The unit of account and the means of payment need not always be the same. For example, in some tourist locations prices are quoted in the local currency, but dollars are also accepted as means of payment.

Money also usually serves as a *standard of deferred payment*, meaning that future payments are contracted in terms of dollars. Rapid and (particularly) variable inflation reduces money's effectiveness in this role.

Finally, like nearly all other assets, money is a *store of value*. The effectiveness of an asset as a store of value depends on the degree and certainty with which the asset maintains its value over time. Money retains its value well as long as inflation is predictably low and the likelihood of replacement of the current monetary asset (perhaps through revolution) is remote. When money's role as a store of value is compromised, people will not want to hold it, hence it will tend to be replaced as a means of payment as well.

Money supply and money demand

The role of money in the macroeconomy is usually examined in a supply/demand framework. The *supply of money* in modern economies is usually determined by the combined interactions of the monetary policy authority (central bank) and the financial system (especially commercial banks). The *demand for money* depends on the behavior of the households and firms that hold monetary assets.

Macroeconomists agree on simple models of the money-supply process. The central bank conducts monetary policy by controlling the creation of "high-powered money" (or the monetary base), which can be used in transactions or held in reserve by depository financial institutions such as banks to back up their customers' deposits. These deposits perform at least some of the key functions of money, hence are usually included in the money supply. However, as long as banks hold reserves against their deposits, the amount of deposit money that banks can create is limited by the availability of high-powered central-bank money, thus providing the central bank with a mechanism to control the overall money supply.

In contrast to the simple and effective models of the supply of money, the modeling of money demand has been a source of great frustration for macroeconomists since about 1970. Rapid technological progress and regulatory changes have redefined how people use various liquid "money" assets. This has made it difficult to find a stable sample period over which to test even the most basic propositions about money demand.

Money as a social institution

Most of us have grown up under a stable regime of government-issued "fiat" money. This can make the institution of money seem static and even immutable, but it is important to remember that money is whatever people accept as means of payment, which ultimately depends on the behavior of those people.

At most times in the recent history of most countries, the government has defined a specific monetary commodity such as dollars, pounds, yen, or euros. These government currencies are usually legislated to be "legal tender," which means that

they serve by law as means of payment, in particular for payments to government such as taxes.

However, in extreme times such legislated mandates may not be enforced or enforceable. In a country whose currency is undergoing extreme inflation—hyperinflation—people may refuse to hold or accept the country’s currency and instead insist on payment with either physical commodities (such as gold) or stable foreign currency (such as U.S. dollars).

Ultimately, it is the members of society who, by their willingness to accept it in exchange, determine what commodity or commodities will serve the role of money. As long as currency is in common use for exchange the money supply should include people’s holdings of currency. If personal checks are widely accepted as means of payment, then checking account balances should be included in one’s holdings of money. Thus, money is a social construction; money is whatever the members of society routinely accept as a means of payment. Governments can influence societies’ choice of monetary assets by providing a stable currency and mandating it as legal tender, but money is ultimately a social rather than a government institution.

Why don’t the Ramsey and Diamond economies need money?

Exchange is the mechanism through which households and firms buy and sell the goods, services, and productive resources that give the former utility and income and the latter revenue and profit. Until now, we have devoted no attention at all to the process of exchange. It’s rather remarkable that we could reach the midpoint of a macroeconomics course without having discussed money, prices, or inflation. Thinking about why that has been possible will help us understand the essential role of money in modern economies.

First consider the economy of the Ramsey growth model. Each household produces at moment t an amount of the generic output good equal to

$$f[k(t)] \frac{A(t)L(t)}{H},$$

output per effective labor unit times the number of effective labor units in the household. Of these units produced, some are consumed and some are invested in new capital. Does this household need to undertake any transactions whatsoever with others? No. There is only one generic good, so there is no need to trade one’s own apples for apples produced by others. All households are identical, so there are no households that are saving while others are dissaving. This model works exactly the same if the economy is one gigantic household or if it comprises millions of small

ones.¹ There is no need for exchange, so there is no need to model the mechanism or technology of exchange and thus no need for money.

The Diamond overlapping-generations model is a bit closer to needing money because it involves, in any period, distinct groups: the young and the old. To clarify the transaction process in the Diamond model, we can distinguish between two alternative assumptions. First, think about a case in which capital investment is freely reversible. This means that a unit of the generic good that has been designated for use as capital can later be transformed back into consumption.² The alternative assumption is that capital investment is irreversible: once a unit of the good has been designated as capital, it cannot be transformed back into consumption. An example might be a seed that could be eaten or planted but, once planted, cannot be dug up and eaten.

The dynamics of the Diamond model involve individuals saving while they are young by accumulating capital. They dissave when they are old, consuming the principal and earnings of their capital. Does this require exchange? Not if capital investment is reversible: the old can simply consume the capital that they accumulated when young, ignoring the actions of the younger generation.

If investment is irreversible, then the Diamond model does require exchange. The old must sell their installed capital to the young in exchange for consumable units of the good. However, since these are just one-for-one exchanges of the same generic good (albeit in capital form vs. consumption form), the exchange is so simple that there is no real need for money. The old simply show up and trade their units of capital goods one-for-one for units of the consumption good belonging to the young. This is the only transaction that will ever occur, so it doesn't seem like money would be essential to facilitate exchange even with irreversible investment.

Why do real economies need money?

If we move out of the highly abstract world of the Ramseys and Diamonds, exchanges between households are inevitable. Once we abandon the convenient abstraction of the single generic good and introduce specialization in production, every agent needs to trade some of the surplus of the good she produces for quantities of other goods she wants to consume.

Those of us who have grown up in modern economic systems tend to take for granted the idea that exchange involves passing items of equal value reciprocally be-

¹ Indeed, this is the essence of the proof of Pareto optimality: a benevolent planner who maximized the utility of the entire economy as though it were a single household would end up with the same outcome as the maximization of utility by many individual households.

² The generic good is always assumed to be, at least initially, homogeneous—it can be used either for capital or consumption. If investment is reversible this free convertibility persists even after its initial use as capital.

tween two individuals. We are also accustomed to the idea that in the vast majority of these exchanges, a sum of money is one of the two items exchanged. But in order to have a satisfactory motivation for the use of money in the economy, we need to answer two questions:

- Why does exchange occur in bilateral, equal-value transactions?
- Why do we use money for these transactions?

The latter question is a relatively familiar one and we will recite the usual arguments about money's suitability for exchange in due course. First, however, we should consider the first, more basic, question: Why does the movement of goods and services in the economy take the form of exchanges of items of equal value?

We begin by considering the task that equal-value exchanges perform in our economic models. By forcing each person to relinquish purchasing power (money, other goods, or a promise of future payment of one of these) in order to obtain goods, the equal-value-exchange mechanism assures that no one consumes more goods than the amount to which her production (or wealth or income) entitles her. In other words, the process of equal-value exchange assures that each agent remains on her budget constraint.

In the models we have studied up to this point, as well as in the standard Walrasian general-equilibrium model of microeconomics, we *assume* that each agent is on her budget constraint, but we have not considered how this restriction is enforced. One can imagine situations in which mechanisms other than equal-value (and particularly monetary) exchange could serve this purpose. For example, in a company enclave where workers do all of their spending at the company store, no money need ever change hands. The store could maintain an accounting system that would add in workers' wages and deduct their purchases in order to keep them on their budget constraints. There would still need to be a unit of account, but there would be no need for a physical currency. (In such enclaves trade sometimes occurs using a local money called "scrip" rather than the national currency.)

In a more general setting, equal-value exchanges would be unnecessary if everyone could be absolutely trusted to stay on her budget constraint. Each person would take only as much of various consumption goods as she could afford; no one would actually have to be paid. This may be feasible in some small-scale societies such as families, communes, etc. However, in our less-than-Utopian world, we often transact with individuals about whom we know little. When *uncertainty* limits our mutual trust, we typically require assurance that the individual to whom we are transferring valuable goods or services actually has the purchasing power to afford them and insist on receiving in exchange something that will demonstrate to others that we have

gained the corresponding amount of purchasing power. Hence we need to obtain something of equal value in exchange.³

Given that we are going to transfer equal values of goods and services in exchange, we can now proceed to ask how *money* facilitates these exchanges. By having a universally agreed-upon commodity serve as money, we avoid the need for a ***double coincidence of wants***. If we didn't have such a medium of exchange, not only would I need to find a seller of the particular commodity I want to buy, but also to find one such person who wants to buy exactly what I have to sell. (Imagine me hunting the streets for two professional soccer teams who want to hear an economics lecture!) It is practically impossible to imagine this happening in specialized societies, so we collectively agree on a particular commodity (or small set of commodities) to be the standard medium of exchange, or money.

As noted above, governments usually, but need not always, play a role in determining the commodity to be used as money. As long as government money works well (is in sufficient supply, does not lose its value too quickly through inflation, and is generally accepted by others), it usually functions as the unique medium of exchange. However, during times of rapid inflation people may abandon the government currency if they are able to obtain sufficient quantities of a stable alternative. In recent times, the U.S. dollar has played this role in many high-inflation countries.

C. Highlights in the History of Money

What are the characteristics of an ideal medium of exchange? ***Durability*** is clearly important: a good medium should not lose a substantial amount of its value between when it is received and when it is used.⁴ A good medium of exchange should also be ***difficult to counterfeit and easy to recognize as genuine*** (for obvious reasons). ***Divisibility*** is important since transactions may require either very small or very large quantities of the medium. ***Portability*** is also crucial since people will need to carry the medium around in order to transact.

Precious metals, or ***specie***, are durable, divisible, and, because they have high value per unit of weight, portable. Many societies have used gold or silver as money. However, the some refinements of the gold and silver monetary system were im-

³ The idea that uncertainty lies at the root of the need for money is emphasized by Goodhart (1989). See especially his Chapter 2.

⁴ Note that inflation can be thought of as reducing the durability of money. We shall study this issue in detail in Chapter 17.

portant to its effectiveness. Before *coinage*, banks and stores had to have scales and assay equipment to determine the weight and purity of any given hunk of metal if they were to accept it as a medium of exchange. Under early coinage systems, the sovereign's mint bought metals from citizens, refined the metals to a particular standard of purity, and minted coins of precise weight and quality, stamping the coin's worth (in terms of some established unit of account) and the sovereign's seal or other insignia on the coin to make it recognizable. This guaranteed the metal content of the coin to someone accepting it. The final step in the development of coin money was the introduction of milling—the engraving of little marks into the edges, as in today's quarters and dimes. Unmilled coins are subject to shaving or “clipping.” That is, an individual can slice a little metal off the edge of the coin and still pass the coin off as having full value. After doing this to enough coins, the individual has a sizable pile of gold or silver shavings that can be melted together and sold to the mint. Milling prevents clipping by making it more noticeable. After a coin is clipped a few times, the milling marks will begin to disappear, advertising the coin's debasement.

Paper money came about in the late Middle Ages through the work of goldsmiths and moneylenders, who were the predecessors of modern bankers. Individuals owning substantial amounts of precious coins were naturally concerned about theft. Goldsmiths and moneylenders needed secure vaults in which to keep their own supplies of gold, and soon discovered that they could rent out vault space to others, issuing claim receipts to those who deposited their specie. Someone with gold stored at the goldsmith who wanted to make a purchase would take his claim receipt to the goldsmith, redeem it for gold, take the gold to the seller and make the transaction. The seller would often then take the gold right back to the goldsmith for storage and receive another deposit receipt. People soon figured out that they could simply exchange the deposit receipts and save themselves two trips to the goldsmith.

When deposit receipts began to circulate directly, it became unnecessary to make frequent transactions with gold itself. Goldsmiths discovered that most of their collective customers' gold was just sitting around in the vault; very little “reserve” was needed on any given day to satisfy those wanting to redeem their receipts for specie. They began to lend some of the accumulated specie in order to earn interest. As long as the loans were repaid, all of their customers' deposit receipts were fully backed by assets—partially in the form of loans and partially in specie. These early bankers kept sufficient *reserves* of specie to satisfy (with an acceptable margin of safety) day-to-day redemptions; they lent the rest. This was the beginning of *fractional-reserve banking*.

Until the late 19th century, banks operated in much the same way as the medieval goldsmiths. They accepted deposits of specie and issued *bank notes* in return, which then circulated as currency in the economy. Bank notes were backed by a combination of a fractional reserve of specie and the remainder in securities and

bank loans. The bank-note system provided a serviceable currency as long as bank notes were easily *convertible* into specie.

Problems arose when the convertibility of notes issued by particular banks was called into question. This often led to *runs* on these banks, where everyone tried to redeem their notes at once, before the bank ran out of specie reserves. With only fractional reserves, banks could never pay out all of their notes *at short notice*, although a solvent bank should *eventually* be able to pay all depositors once securities are sold and loans collected.

A bank run would usually force a temporary suspension of note convertibility. What happened next depended on whether the value of the bank's overall assets was sufficient to repay the outstanding notes—whether the bank was solvent. If the bank was able to demonstrate its solvency, then it could usually recover its credibility and stop the run. Even if the run continued for a time, a solvent bank could sell enough assets (or borrow from other banks that recognized its solvency) to build reserves and redeem the notes being presented. If the bank was insolvent, it would close down, liquidate its assets, and pay off as many of the outstanding notes as it could.

In the twentieth century, note issue has been monopolized by the government's central bank in most countries. Rather than issuing notes, commercial banks hold their customers' money in the form of *deposits*. Checking deposits work very much like notes, except that checks are usually retired after being “cashed” or deposited by the recipient, rather than continuing to circulate as notes.

Until the Great Depression, the central banks of most major countries maintained currencies that were directly convertible into gold or silver.⁵ Since World War II, however, very few countries back their currencies with specie. The acceptability of government-issued *fiat money* is based not on the legal promise to convert it into something of intrinsic value but rather on confidence that others will accept it in exchange.

From the end of World War II until 1971, the major economies of the world operated under the *Bretton Woods System*, in which the U.S. dollar was supposed to be convertible into gold, and all other currencies were convertible into dollars. However, the gold-convertibility commitment of the U.S. dollar applied only to other central banks, not to the general public. In fact, the holding of gold bullion by U.S. citizens and companies was illegal. Because foreign central banks did not regularly attempt to redeem dollars for gold, the Federal Reserve (the U.S. central bank) did not worry very much about maintaining convertibility. At times, the Fed issued many more dollars than could plausibly be backed by the U.S. gold stock. Such an expansion of the U.S. money stock in the late 1970s led to steady inflation and eventually

⁵ The major exception was during wars and times of financial crisis, when central banks (like note-issuing commercial banks) would often suspend convertibility.

to the abandonment in 1971 of gold convertibility when France forced the hand of the Nixon Administration by attempting to redeem large amounts of dollars for gold.

Since 1971, most central banks have allowed their currencies' values to float against one another. However, many of Europe's currencies have been linked together first by the European Monetary System of the late 1970s, then by the Exchange Rate Mechanism in the 1980s and 1990s, and finally through currency union in which the euro has replaced long-established national currencies such as the Deutsche mark and the French franc.

D. Defining Money in Modern Economies

The “functional” definition of money says that money is whatever set of assets is regularly used as a *means of payment*. Modern economies use currency, coins, and checks as the predominant means of making payments, so these assets are surely to be included as money. However, if individuals treat “near-monies” such as savings accounts as very close substitutes for these means-of-payment assets, then the near-monies may in effect be part of the money supply as well. The Federal Reserve System and other central banks now publish statistics for a family of monetary aggregates that range from “narrow money,” which includes only assets actually used in transactions, to broader aggregates that include all highly liquid financial assets.

The evolution of financial technology in modern economies has required that the definitions of the monetary aggregates undergo regular revisions. Several new categories of bank accounts emerged in the 1970s and the changing structure and regulations of the banking industry have changed the characteristics of some kinds of deposits in important ways. As a result, the definitions of the U.S. monetary aggregates have been revised several times since World War II.

The Federal Reserve reports three major money-supply measures, **M1**, **M2**, and **M3**. M1 is the narrowest definition of the money supply and is limited to those assets commonly used for transactions. The first component of M1 is the stock of *currency and coin*, excluding that held by the U. S. Treasury, Federal Reserve Banks, and depository financial institutions such as commercial banks, savings-and-loan institutions, and credit unions. *Travelers' checks* are the second (and smallest) component of M1. The final category of assets in M1 is balances held in *demand deposits* and *other checkable deposits*. This category includes accounts (except those owned by other financial institutions or governments) from which withdrawals can be made by writing checks to a third party.

The broader monetary aggregate M2 includes all the assets in M1, plus additional bank deposits that are easily transferred by households into M1. *Savings deposits*

(including *money-market deposits*) at banks and other financial institutions are included in M2, as are small-denomination (less than \$100,000) *time deposits*, which are commonly called *certificates of deposit*, and retail (small initial investment) *money-market mutual fund shares*. All of these assets share the characteristic that they can be converted into demand deposits or currency quickly at low cost and with very little day-to-day risk of fluctuations in value. If households treat their balances of these non-transaction assets as interchangeable with demand deposits, then M2 is a more appropriate definition of money than M1. Empirically, the relationship of M2 to other macroeconomic variables has been somewhat more stable than that of M1 in recent decades.

The broadest aggregate—M3—includes all of the M2 assets plus large-denomination time deposits, large-investment money-market mutual funds, *repurchase agreement* liabilities of U.S. financial institutions and *Eurodollars* held by U. S. residents at banks in the United Kingdom and Canada and at all foreign branches of U.S. banks. Repurchase agreements (RPs) are contracts under which a financial institution buys an asset (for example, a government bond), usually from a large corporation, with the agreement that it will be repurchased by the corporation some time later at a fixed price. RPs are essentially similar to certificates of deposit in that the corporation “deposits” a government bond with an agreement about when and how much “interest” it will get in return. However, because the bond appears differently on the bank’s balance sheet, RPs have different legal and regulatory standing than ordinary certificates of deposit. A Eurodollar deposit is a deposit in dollars at a bank outside the United States. The Eurocurrency market developed rapidly when inflation pushed market interest rates upward in the 1960s and 1970s. Onshore banks were subject to low ceilings on deposit interest rates, so these unregulated “offshore” transactions were a way for banks to pay high interest to (large) customers, avoiding the restrictions on interest rates that applied to domestic transactions.

Details vary from country to country, but most countries publish statistics for a range of monetary aggregates from narrow to broad. Roughly comparable monetary statistics for a large collection of countries are published by the International Monetary Fund in *International Financial Statistics*, which is available online through the Reed Library. The IMF publishes a series for “money,” which is basically M1 and a series for “money plus quasi money,” which is much like M2.

Having grown up in the 1990s and 2000s, you are probably wondering where the ubiquitous *credit card* fits into this monetary scheme. After all, credit cards facilitate many transactions in our economy. There are several reasons why credit-card accounts are not included in the money-supply aggregates. First and foremost, unlike the consumer assets in M1, credit-card accounts (distinct from the now-popular debit cards that draw directly from one’s checking account) are not assets. Instead they are pre-approved lines of credit that allow individuals to incur debt at a moment’s notice.

Second, “payment” by credit card does not really constitute final payment for the good or service being purchased. If you buy a good by credit card, you replace a debt to the seller with a debt to the card-issuer; there is still a debt. Recall the subtle distinction between a medium of exchange that allows exchange to proceed and a means of payment, which completes the transaction and leaves no debtor-creditor relationship among the parties. Credit cards may be a medium of exchange, but are not means of payment.⁶

Finally, it is difficult to know what number one should count for credit cards if one were to add them into a transactions-money aggregate. To treat them symmetrically with bank deposits, one would have to add in the entire credit limit to which individuals have access. But this almost certainly overstates the relevant balance. Keeping a large checking-account balance incurs the opportunity cost of using the money in another way, so people have a strong incentive to monitor and control their account balance. A large credit limit has no additional cost associated with it; many credit-card holders are probably unaware of what their credit limits are. Using outstanding credit balances or the volume of actual transactions instead of the credit limit would be more reasonable, but is disturbingly asymmetric to the treatment of bank deposits and other assets. Empirical work on money demand has either ignored credit cards or simply brought in a variable such as the volume of credit-card transactions as an additional explanatory variable for money demand, rather than attempting to integrate credit-card accounts into the money stock directly.

E. Monetary Policy and the Supply of Money

Assets and liabilities in a simple monetary system

We now build a simple, textbook model of a monetary system involving a central bank, a commercial banking industry, and the general public. For purposes of our analysis we will consider money to be currency in the hands of the public plus deposits at banks, being ambiguous about exactly which kinds of deposits we include. Banks back their deposits with some reserves, which are held either as cash in their vaults or as deposits at the central bank, but lend the majority of the proceeds from their deposits either through bank loans or through the purchase of securities such as government bonds.

⁶ Note that pre-paid Visa cards and merchant gift cards are both assets and means of final payment. They could be included in the money supply; perhaps someday they will, if their volume becomes quantitatively significant.

The model is most easily expressed through a series of simple financial accounts. These accounts, called *balance sheets*, summarize the assets, liabilities, and net worth of three groups in the economy. *Assets*, which are items of value owned by the group, are listed on the left side of the accounts. *Liabilities*—what is owed to members of other groups—are listed on the right. The difference between assets and liabilities is the *net worth* of the group and is shown below the dividing line on the right-hand side in Table 1.

Table 1. Financial accounts of major groups

Central Bank		Financial Institutions	
Assets	Liabilities & Net Worth	Assets	Liabilities & Net Worth
Gold	Currency held by public (C)	Loans to public	Deposits of public (D)
Foreign exchange	Vault cash of financial institutions (R _v)	Vault cash (R _v)	Financial institutions' net worth ("capital")
Government bonds	Deposits of financial institutions (R _D)	Deposits at central bank (R _D)	
Physical assets	Central bank net worth	Government bonds & other securities Physical assets	

Non-Financial Public	
Assets	Liabilities & Net Worth
Currency (C)	Loans from financial institutions
Deposits at financial institutions (D)	Public's net worth
Other assets	

The major inter-group financial relationships in our simple economy are shown in Table 1. The central bank holds various assets such as gold and foreign currencies as well as a large stock of government bonds. It issues high-powered money in the forms shown as its liabilities: currency (which can be held by financial institutions as vault cash or by the public) and deposits of financial institutions. The latter are used in the central bank's role of clearing payments between financial institutions.⁷

⁷ If you and I are customers of different banks and you write a check to me (or pay me with a debit card), someone must intermediate between the two banks, allowing my bank to receive money from your bank in exchange for the check. Central banks in most countries (including the Federal Reserve System in the United States) offer such services, although large banks located close to one another sometimes find it cheaper to swap their mutual checks directly or to contract with local, private "clearinghouses" to clear checks.

Banks and other financial institutions obtain funds from two sources. One is the “capital” paid into the bank at its creation by its owners plus whatever additional net worth has accumulated from prior undistributed profits. This is the bank’s net worth and is crucially important in assuring that the owners of the bank behave responsibly: if a bank’s capital were to drop near zero, the owners would have nothing to lose (and perhaps much to gain) from pursuing risky policies that could result in large losses. Because of this important role in mitigating banks’ incentives to take on excessive risk, modern financial systems require minimum levels of capital as a percentage of the bank’s assets.⁸

The other source of banks’ funds is the deposits of their customers. While capital is the bank’s net worth, deposits are liabilities that are owed to the depositors.

The major financial assets are the bank’s *reserves* (held either as vault cash or as deposits at the central bank), loans to the public, and financial assets such as government bonds. Financial institutions have traditionally earned no interest on their reserves so they have a profit incentive to hold interest-bearing assets (loans and bonds) instead.⁹ However, banks must maintain some reserves both because the central bank usually requires them to and because they must have sufficient reserves to cover day-to-day transactions: both withdrawals of cash by customers and transfers out of their central-bank account that result from the clearing of checks that their customers have written.

The public holds a variety of assets, but the ones that are important for the financial system are currency and deposits at banks. Their major financial liability is loans that they have taken out from financial institutions.

⁸ Even with zero or negative capital, banks may continue operations unless forced to close by regulators or by a flood of deposit redemptions (a bank run). Under modern deposit-insurance systems, depositors have no incentive to instigate runs, so the burden of closing down insolvent banks falls to government regulators. If they fail to do so promptly, negative-capital “zombie” banks have incentives to pursue risky investment strategies in an attempt to get back above water. (For example, betting 10 percent of bank assets on the Super Bowl might offer a 50/50 chance of making the bank solvent again.) Unscrupulous bank owners and managers may also have incentive to “loot” the bank by engaging in transactions that inflate immediate profits (which can then be withdrawn in bonuses to executives and dividends to owners) but that incur large losses in the future (when the cost will be borne by the deposit insurer who has to clean up the debris of the failed bank). See Akerlof and Romer (1993) for a discussion of looting and Kane (1989) and Curry and Shibut (2000) for analysis of the impact on taxpayers of not closing down zombie financial institutions in the 1980s.

⁹ In the current financial crisis, the Fed began paying interest on banks’ deposits. The interest rate on reserves is tied to the Fed’s target for the federal funds interest rate, which was lowered to 0.25% in late 2008. Thus, even under this new policy the interest available on reserves is miniscule compared with rates on bank loans or bonds.

Money, the monetary base, and the money multiplier

In the simple economy whose financial accounts are depicted in Table 1, we define money to include currency and deposits held by the public, $M = C + D$. The stock of money includes deposits held at banks, accounts to which the central bank is not a party. Hence the central bank has only limited ability to “control” the quantity of money in circulation. It influences the money stock directly or indirectly by manipulating its financial liabilities, which we call the ***monetary base*** or the stock of ***high-powered money***.

The monetary base B consists of the three central-bank liabilities listed in Table 1: currency held by the public, currency in the vaults of financial institutions, and deposits of financial institutions at the central bank. The latter two comprise financial institutions’ reserves, so we can write the monetary base as $B = C + R$, where $R = R_V + R_D$ consists of vault cash and financial-institution deposits.

The central bank exerts complete control over B . Transaction between other entities of the economy, such as a decision by a person to deposit currency into a bank account, can change the composition of B among its components, but cannot influence the aggregate monetary base. Only when the central bank buys or sells something will the monetary base change.

In practice, central banks control the monetary base through ***open-market operations***, buying and selling government bonds to individuals, firms, or financial institutions.¹⁰ If the central bank buys a \$10,000 Treasury bill, it pays for the open-market purchase (usually) by crediting the seller’s account (or the seller’s bank’s account) or (rarely) by giving the seller newly issued currency. These funds always end up in one or another part of the monetary base, so the open-market purchase increases the monetary base by \$10,000 regardless of who sells the Treasury bill to the central bank and what the seller does with the proceeds.

What remains is to link B , which the central bank controls, to M , which is the variable through which it can affect the economy. We do this by examining the ratio M/B , which we call the ***money multiplier***. Using the definitions of M and B above,

$$\frac{M}{B} = \frac{C + D}{C + R} = \frac{C/D + 1}{C/D + R/D},$$

¹⁰ In the current financial crisis, the Fed has expanded its open-market purchases to include a variety of private assets in addition to government bonds. These transactions have served not only to provide general liquidity to banks by expanding reserves but also to increase liquidity in selected financial markets that were paralyzed by illiquidity and concerns about counterparty risk.

where the final step is achieved by dividing all terms in the numerator and denominator by D .

Let $u = C/D$ and $v = R/D$. We can then rewrite the money multiplier as

$$\frac{M}{B} = \frac{u+1}{u+v}. \quad (1)$$

We consider u and v to be behavioral parameters of the economy. The households and firms in the economy decide on the value of u when they determine how much of their money to hold as currency *vis à vis* deposits. For example, if the public holds 90% of its money as deposits and 10% as currency, then u will be $10\%/90\% = 0.111$. The ratio v is a decision parameter of financial institutions: the amount of reserves they hold out of each dollar of deposits. As noted above, financial institutions are usually required to hold some reserves, so v is bounded from below by official reserve requirements. However, it is important to note that banks would choose to hold some volume of reserves voluntarily even if they were not required to do so. In some times and places, banks have held significant quantities of excess reserves above and beyond reserve requirements.

The money multiplier therefore depends on two decision parameters, one made by the public and one by the financial institutions. To the extent that these decisions are stable and predictable, the central bank can effectively control the money supply by anticipating what the multiplier will be and manipulating the monetary base to provide just the desired amount of money. In normal times, u and v do tend to be quite predictable (and central banks devote a lot of energy to predicting them), so central banks can usually control M quite effectively.

We call this ratio a “multiplier” because it reflects the degree to which the private sector “multiplies” the monetary base into a larger stock of monetary assets. If banks held 100% of their deposits in reserve, then $v = 1$ and the numerator and denominator are equal, so the money supply equals the monetary base and the multiplier is one. However, as we noted in our brief history of money, fractional-reserve banking has for centuries been the universal norm. If banks hold less than full reserves $v < 1$ and the money multiplier exceeds one.

The intuition of multiple expansion of the money supply is easiest to grasp in an even simpler setting where the public holds no currency ($u = 0$). In that case, the multiplier is $1/v$. Suppose that an open-market purchase increases the monetary base by \$10,000. Since households hold no currency, this all ends up getting deposited in the banking system, which increases reserves by \$10,000. If banks want to hold a ratio v , say 0.10, of their deposits in reserves, then this additional \$10,000 of reserves will support $1/v \times \$10,000 = \$100,000$ of additional deposits. Thus, the increase in the money supply is $1/v = 10$ times as large as the increase in the base.

It is easy to see both intuitively and in terms of equation (1) that currency holding by the public ($u > 0$) will reduce the size of the multiplier. Each dollar that gets held in currency supports only itself; it does not get deposited into the banking system to be a dollar of reserves supporting multiple dollars of deposits. The money multiplier depends inversely on both the currency-deposit ratio and the reserve-deposit ratio.

Monetary policy and interest rates

A detailed examination of monetary policy is far beyond the scope of this chapter. Selected topics of monetary policy are discussed in Romer's Chapter 11. A detailed treatment is available in the Reed curriculum in Economics 341: Monetary and Fiscal Policy.

However, it is very important to attempt to reconcile the monetary control mechanism examined above with the contemporary practices of central banks. In their attempts to influence their economies through monetary policy, central banks face a choice of *instruments* that they can use. The model we examined above suggests that central banks would effect their monetary policy by establishing target growth rates for the money supply, the monetary base, or bank reserves. In fact, central banks have often used such reserve or monetary-aggregate targets. The West German Bundesbank (before it became integrated into the European Central Bank with the currency union) famously targeted monetary aggregates. In the United States, the Federal Reserve under Paul Volcker switched to a strict reserves target in 1979, when inflation was at unprecedented levels and public confidence in the dollar was low.

Most central banks now use an interest-rate target rather than a monetary target. If you follow the financial news at all, you undoubtedly hear about the latest Federal Reserve decision to raise or lower "interest rates." While interest-rate targeting is conceptually somewhat different than targeting a monetary aggregate, the mechanism through which monetary policy operates is similar.

The interest rate that the Federal Reserve targets is the *federal-funds rate*. This is the interest rate on overnight loans or reserves between banks. Banks that on any particular day find themselves with reserves in excess of their desired holdings will try to lend their excess reserves overnight to other banks that are short.¹¹ The supply of and demand for federal funds is very sensitive to the reserve position of banks. If reserves

¹¹ Reserve requirements are calculated over a two-week period. The average volume of reserves over a two-week reserve holding-period must be at least the required fraction of the average volume of deposits over a corresponding deposit period. The reserve-holding period is lagged two days relative to the deposit period so that banks can calculate the average value of their deposits at the end of the deposit period (and thus know the amount of reserves required) and still have two days to make up any deficits in their reserves relative to the requirement.

are scarce then there will be more borrowers than lenders and the federal-funds rate will tend to rise. If reserves are abundant then there will be many lenders and the rate will fall.

Thus the federal-funds rate acts as a “thermometer” for the scarcity of reserves in the banking system. When it targets the federal-funds rate, the Federal Reserve increases or decreases the monetary base (and thus bank reserves) in such a way as to keep the rate—the “temperature” of the reserve market—at the target level. If the Fed’s target is 3% and the funds rate starts to creep upward to, say, 3.05%, the trading desk at the Federal Reserve Bank of New York will buy Treasury bills, releasing additional high-powered money into the economy to act as additional bank reserves. This releases the upward pressure on the funds rate and pushes it back down toward the 3% target. Similarly, if the funds rate slips below the target the Fed sells Treasury bills and absorbs reserves out of the banking system.

In the financial crisis of 2007–08, the federal-funds-rate target essentially reached zero. Nominal interest rates cannot be negative, so there is no further possibility of stimulating aggregate demand by lowering this interest rate. In this case, there are still several stimulative options open to a central bank. It can still pursue “quantitative easing” by expanding the monetary base rapidly. Although they cannot drive the federal-funds rate down, they can increase banks’ reserves, which may encourage them to lend. The central bank can also target its open-market purchases on particular parts of the credit market that need liquidity or support. For example, the Fed began purchasing longer-term government bonds, commercial paper, and new high-quality asset-backed securities in late 2008 to support these markets.¹²

F. Theories of the Demand for Money

Quantity theory: Money in the classical macro model

Money is a stock. At every moment there is a stock quantity of monetary assets available to satisfy the needs of consumers and firms. In contrast, the central use of money—spending—is a flow. Thus, theories of the demand for money have a temporal dimensionality that relates the stock of dollars to the flow of dollars per year. In the *quantity theory of money*, our first and simplest theory of money demand, that temporal dimensionality takes the form of the *velocity* of money: how many times per year the average dollar is spent.

The quantity theory is how the classical economists completed their general-equilibrium system by explaining the role of money and the determination of the lev-

¹² The monetary aspects of the ongoing financial crisis are discussed in more detail in Section H of this chapter.

el of prices.¹³ Classical economists took a narrow view of the role of money in the economy. They believed that money was held as an asset solely for its *liquidity*—its ability to be used in transactions—so the quantity of money demanded would be locked tightly to the volume of transactions individuals undertook. The connection between the stock of money held and the flow of transactions is called the *transactions velocity of money*, defined as

$$V_T \equiv \frac{PQ}{M}, \quad (2)$$

where PQ is the total nominal quantity of transactions in the economy and M is the stock of money. Because it is the ratio of a flow to a stock, transactions velocity has the temporal dimension of “number per period.” Since we are assuming that all transactions are made with money, transactions velocity measures how many times per year the average dollar is spent. For example, if there are \$500 billion dollars in the economy and total transactions are worth \$10 trillion, then transactions velocity would be \$10 trillion/\$500 billion = 20 times per period.

Because it is difficult to measure the total value of all transactions (including those for intermediate goods) in the economy, we usually work with *income velocity*, which is the number of times per year the average dollar is spent on *final* goods and services. Income velocity V can be computed as

$$V \equiv \frac{PY}{M}, \quad (3)$$

where Y is real GDP and thus PY is nominal GDP, equal to the GDP deflator P times real GDP.

The classical quantity theory stems from assumptions about the behavior of variables in equation (3). First, microeconomic factors such as those in the real-business-cycle model are assumed to determine real GDP in a way that is independent of monetary factors.¹⁴ Second, the income velocity of money was thought to depend on

¹³ Although there were several variants of the quantity theory, they led to largely similar conclusions. A typical classical exposition can be found in Irving Fisher (1913). A more modern version is Milton Friedman’s famous article “The Quantity Theory of Money: A Restatement,” which is reprinted as Chapter 2 of Friedman (1969).

¹⁴ The *classical dichotomy* refers to the segregation of the economy into two separable parts: the real side and the monetary sector. Under classical postulates, the real side of the economy is assumed to be completely independent of any monetary factors. All of our growth and RBC models, because they have assumed that the real side of the economy could be determined without reference to money or prices, have followed the classical dichotomy.

such characteristics of the monetary system as whether people used cash or checks and the general desire of people to hold money. Finally, the supply of money was viewed as exogenously determined by the central bank, backed in classical times by its reserves of gold under the gold standard. With Y and V determined by nonmonetary factors, equation (3) implies a lock-step connection between exogenous changes in the money supply and the general price level,

$$P = \frac{V}{Y} M. \quad (4)$$

Equation (4) shows that changes in the money supply lead to exactly proportional changes in the general price level (and in all nominal prices in the economy), but to no changes in real variables. This classical result is known as *monetary neutrality*. It holds in the quantity-theory framework as long as V and Y are not influenced by changes in the money supply.

Quantity theorists varied in the rigidity with which they held these assumptions. The so-called “Cambridge school” of English classical economists recognized that changes in interest rates could affect the desire to hold money vis-à-vis other assets and therefore could affect velocity.¹⁵ Higher interest rates make interest-bearing assets more attractive relative to money and may therefore increase velocity. Thus, if monetary changes cause interest rates to change, velocity might be affected and the relationship between money and prices would not be strictly proportional.

Irving Fisher and other American theorists were more faithful to the assumption that monetary changes would not affect velocity and pushed a stricter version of the quantity theory. Fisher was also convinced that changes in the money supply could not affect interest rates in a sustained or substantial way.

More recent quantity theorists such as the late Milton Friedman adopted a much more flexible approach to equation (4). Friedman recognized that money might affect interest rates—and therefore velocity and even real output—in the short run. But he argued that interest rates, velocity, and real output should be independent of monetary influences in the long run, so that equation (4) would still hold over longer periods of time. Many important models of modern macroeconomics lead to this same general conclusion: money is neutral in the long run but has real effects in the short run.

¹⁵ The Cambridge school cast its theory in terms of the reciprocal of velocity, the Cambridge k , which is the ratio of money holdings to nominal income.

The evolution of money-demand theory

The demand function for money is one of three major behavioral relationships of early Keynesian macroeconomic models. (The other two are the consumption and investment functions.) The “standard” formulation of money demand makes the real money holdings a function of real income and the nominal interest rate. This formula fit the data very well for the first three decades after World War II, leading macroeconomists to place considerable confidence in the stability of the money-demand relationship.

However, like other empirical macroeconomic relationships, the performance of the money-demand function deteriorated rapidly with the arrival of ongoing inflation in the 1970s. The first indication that something was amiss was documented in a famous study by Stephen Goldfeld called “The Case of the Missing Money.” Goldfeld (1976) noted that simulations of empirical money demand functions started veering off course in the 1970s, predicting that people should have been holding much larger real money balances than they actually were, hence the “missing money” in his title. In terms of the quantity theory, the velocity of money accelerated in the 1970s relative to the prediction of the earlier model.

As usually happens with empirical conundrums, the case of the missing money spawned a large empirical literature seeking to explain the decline in money holdings. Some argued that the rise of credit-card use was an important factor; others stressed that high inflation caused firms and financial intermediaries to devise new methods to economize on non-interest-bearing deposits. The introduction of new kinds of financial assets—money-market mutual funds, certificates of deposit, and money-market deposit accounts, to name three—changed the definition of the money supply and complicated the already-difficult task of finding a stable empirical relationship.

Since the 1970s, money demand has behaved erratically. Predictions from estimated models have sometimes missed on the high side and sometimes missed on the low side. Many macroeconomists have lost confidence in the ability to predict the relationship between money demand and its presumed determinants, interest rates and income. This has been a particular problem for policymakers at the Federal Reserve, who rely on the money-demand function as a crucial lever in the connection between their monetary-policy instruments and the real economy.

The empirical instability of money demand mirrors the unsatisfactory state of our theoretical understanding of the demand for money. As noted above, the Walrasian general-equilibrium model includes no role for money. We need money in the real-life economy because of uncertainty and transaction costs, which are ignored in the standard microeconomic setup. Economists have made only limited progress in modeling these imperfections, so money-demand theory is often based on a somewhat shaky framework.

Keynes's three motives for money demand

In the *General Theory*, Keynes identified three motives for holding money. Individuals have a ***transactions motive*** to hold money for use in transactions that they plan to undertake. This category of money demand is consistent with the thinking of the quantity theory.

The ***precautionary motive*** causes people to hold extra money to deal with uncertainty about the flow of expenditures. Since you never know when you will need money for cab fare on a rainy night or when you will encounter an unexpected bargain, it is always useful to have a little extra money available for unexpected purchases. Finally, under certain special conditions an individual might expect to earn a higher rate of return on money than on other assets, which would result in a ***speculative motive*** for holding some monetary assets.

Keynes argued that the transactions and precautionary demand for money would depend largely on the volume of transactions undertaken in the economy, while the speculative demand would depend on the interest rate. Thus, Keynes ended up with a money-demand function that featured the two variables that have been central to money-demand theory ever since: aggregate income and the interest rate. Modern theories have shown that transactions and precautionary demand should also depend on interest rates, which has reduced the importance of speculative demand in providing an explanation for the interest elasticity of money demand.

In the following sections, we will consider simple models of each of these motives for holding money. What complicates the analysis is that money balances held for one purpose may be available for other purposes as well, so one cannot just add up demand arising from the three motives to get a total demand. Since the models are difficult to combine in a single integrated framework, standard textbook treatments of money demand usually present one or more models each of which is focused on a single motivation for holding money. They then assert that one can (magically) combine these models to yield a general demand function.

The money-demand decision

To someone who has not studied economics, it may seem silly to be talking about the “demand for money.” Doesn’t everyone always want more money? Of course the answer is yes if there is no opportunity cost to holding money. However, in thinking about the demand for money, it is crucially important not to confuse “money” with “wealth.” Individuals always want more wealth, other factors held constant, but they may not always want to hold more money. The demand for money is not a decision about how much wealth an individual would like to command (where more is always better). It is a decision about how much of one’s given stock of wealth should be held in the form of money rather than as other assets such as bonds.

Thus, when we model the demand for money, we put agents in a situation where they have a fixed stock of wealth that they must allocate among two or more assets, one of which is money. The simplest (and most common) modeling framework has two assets, money and bonds. These assets differ in two basic ways. First, money is *liquid* in that it can be used in making transactions in the goods market; bonds cannot. Second, money is assumed to bear a zero nominal interest rate while bonds bear interest at nominal rate i . Thus, holding money yields liquidity services to the agent, but incurs a forgone-interest cost. Optimal money holding balances the marginal (liquidity) benefit of money holding with the marginal (interest) cost.

Baumol and Tobin's transactions-demand model

Perhaps the most famous treatment of transactions demand is the inventory-theoretic model developed by William Baumol (1952) and (independently) James Tobin (1956). In this model, households receive their income in lump sums at the beginning of each period, but make expenditures smoothly through time. They hold inventories of money to enable the flow of expenditures and the flow of income to be asynchronous.¹⁶

The motivation for holding money in this model is that money must be used in all goods-market transactions. However, as noted above, there is an opportunity cost of holding money: the interest forgone on an interest-bearing asset such as a bond. In order to maximize interest earnings, the agent would like to hold as much of her wealth as possible in the form of bonds, while still being able to finance her flow of monetary expenditures.

If there is no cost to doing so, she could keep all of her wealth in the form of the “bond” and transfer an appropriate amount into money an instant before she wants to spend it, allowing her to earn interest on the bond until the last moment. This money-holding strategy would drive average money holdings to zero, since positive money holdings would only occur for a vanishingly short instant. However, if her flow of expenditures were smooth through the period, she would need to make many transfers from bonds to money in order to implement this strategy. Making these transfers generally incurs some kind of cost, either explicitly through a transaction fee or implicitly through the time and inconvenience of making the transfer. This cost

¹⁶ One can derive a similar result from a model in which expenditures are lumpy and income arrives smoothly. The key features of the model are that income and expenditures are not synchronized and that at least one flow is fairly smooth. Any model having these features will lead to a demand for money result that is similar to the one in the Baumol-Tobin model.

may easily outweigh the interest that is earned from a few hours or minutes of additional bond-holding.¹⁷

The Baumol-Tobin model derives the optimal frequency of bond-money transfers that minimizes the sum of the two components of cost: the forgone interest cost (which rises as average money balances increase) and the transaction cost (which falls as fewer money-bond transfers are made or more money is held). The strategy that minimizes total cost makes real money demand equal to

$$\frac{M}{P} = \sqrt{\frac{YF}{2i}}, \quad (5)$$

where Y is real income, F is the real cost of making a transfer from bonds to money, and i is the nominal interest rate. Note that equation (5) expresses the demand for money in *real* terms. Changes in the price level P increase the nominal demand for money exactly in proportion, leaving the real amount demanded unchanged.

Equation (4) shows that increases in real income lead to greater money demand; more transactions require additional money holdings. A higher cost of money/bond transactions also raises money demand, since it becomes more costly to replenish money balances frequently. A higher interest rate lowers money demand because more bond interest is forgone for each dollar held as money.

It is interesting to consider what happens to equation (5) in various limiting cases. As i goes to zero, the demand for money becomes infinite, which means that agents want to hold all of their wealth in the form of money rather than interest-bearing assets. This makes sense because as the nominal interest rate approaches zero, the interest benefit of holding bonds vanishes. Since money still provides superior liquidity services, there is no reason to hold bonds.

A second interesting limiting case occurs when the transaction cost F approaches zero. If there is no transaction cost, we are in the ideal world we considered earlier, where an individual can costlessly transfer bonds to money an instant before making each transaction and the demand for money would approach zero. While we do not yet live in this perfect world, modern innovations in banking technology have made such transactions much less costly in time and inconvenience. This has probably lowered the demand for non-interest-bearing money as more households find it beneficial to keep wealth in an interest-bearing form for a larger portion of the pay period.

While the Baumol-Tobin approach to money demand yields insights on certain aspects of money-holding behavior, it is subject to important criticisms. First, it takes the timing of income receipts and expenditures to be exogenous. As a society, these

¹⁷ And interest-bearing accounts at financial institutions, which are the most liquid interest-bearing assets, only calculate interest daily, so at most one would make a bond-to-money transfer daily.

institutional factors can and do vary in response to economic conditions and incentives. For example, during the German hyperinflation of the 1920s, workers were paid twice daily so they could spend their morning earnings during the lunch hour, before inflation depreciated their value in the afternoon. Closer synchronization of income and expenditures reduced the demand for money without agents having to make more money-bond transfers. As another example, many kinds of expenditures in modern economies occur in a lumpy pattern. We pay rent, utility bills, car payments, and credit-card bills once per month. If we can synchronize the due dates of these bills with our pay date(s), we can substantially reduce the average amount of money in our checking accounts.

A second criticism relates to the empirical evidence on the money demand function. The Baumol-Tobin model asserts that the elasticity of real money balances with respect to income should be $\frac{1}{2}$ and that the elasticity with respect to the interest rate should be $-\frac{1}{2}$. As discussed in Case Study 18–3 in Mankiw (2003), the empirical evidence suggests that the interest elasticity is smaller and the income elasticity larger than these predicted values. Evidence also suggests that elasticities are greater in the long run than in the short run (contrary to the theory).

Finally, the tradeoff analyzed in the Baumol-Tobin model is one that is relevant for only a small subset of the population. Suppose that the interest rate is 6% per year, or $\frac{1}{2}\%$ per month. A person who earns and spends \$24,000 per year (or \$2,000 per month) holds \$1,000 in average money balances if she buys no bonds and holds all unspent income in the form of money. By making one extra bond-money transfer, she can reduce average money holdings to \$500 and hold an average of \$500 in bonds. The interest earned on this \$500 of average bond holdings is $\$500 \times 0.005 = \2.50 . When all explicit and implicit costs of making the transfer are taken into account, it seems unlikely that very many people would find this worthwhile. It is even less likely if, as is usually the case, a substantial fraction of monthly income is paid in a lumpy manner through bills or large shopping trips. Suppose that \$1,000 per month is spent immediately on rent, utilities, and other beginning-of-month expenses. Then the amount of smooth monthly expenditures is only \$1,000 (half as much as before) and the interest earned by making the extra transfer is only \$1.25.

Modeling precautionary demand

Our model of the precautionary demand is based on the exposition of David Laidler (1993). It uses a simple representation of the stochastic, or random, behavior of expenditures. The stochastic approach departs from the Baumol-Tobin model, in which the agent knows the amount and timing of both income and expenditures with certainty. Under certainty, she is able to replenish her money holdings at the exact time they are exhausted. A more realistic model of expenditures should include unpredictable variability in the flow of expenditures (and perhaps in income as well).

In our model, the agent will undertake an amount of expenditures that varies from expected spending by a random variable S that has mean zero and standard deviation σ_S . If the agent holds enough extra money (beyond the amount used for expected transactions) to cover whatever unexpected expenditures occur, then she is able to make the expenditures without incurring any additional cost. However, if her precautionary money holdings are insufficient to cover expenditures, she incurs a “brokerage cost” (which might include time, inconvenience, and other implicit components) equal to b . The agent’s objective in deciding how much “precautionary money balances” to hold is to minimize the sum of two components of cost: the expected brokerage cost and the forgone interest cost. Both are a function of the amount of precautionary money held: an increase in money balances lowers the expected brokerage cost because the agent is less likely to run short, but increases the forgone interest cost.

Suppose that the volume of unexpected expenditures S follows a probability distribution with density function $f(S)$, so that the probability that S is less than or equal to some specific value s is

$$P[S \leq s] = \int_{-\infty}^s f(S) dS. \quad (6)$$

The agent who holds s in precautionary money balances incurs brokerage cost b when $S > s$, which happens with probability equal to $1 - P[S \leq s]$. Her forgone interest cost is is . Total costs associated with holding s are thus $TC = (1 - P[S \leq s])b + is$.

Choosing s to minimize total cost implies setting $dTC/ds = 0$. Differentiating yields $dTC/ds = -b dP[S \leq s]/ds + i$. But using equation (5), the inverse relationship between integrals and derivatives implies that $\partial P[S \leq s]/\partial s = f(s)$, thus the first-order condition for maximization becomes $-bf(s) + i = 0$, or $bf(s) = i$.

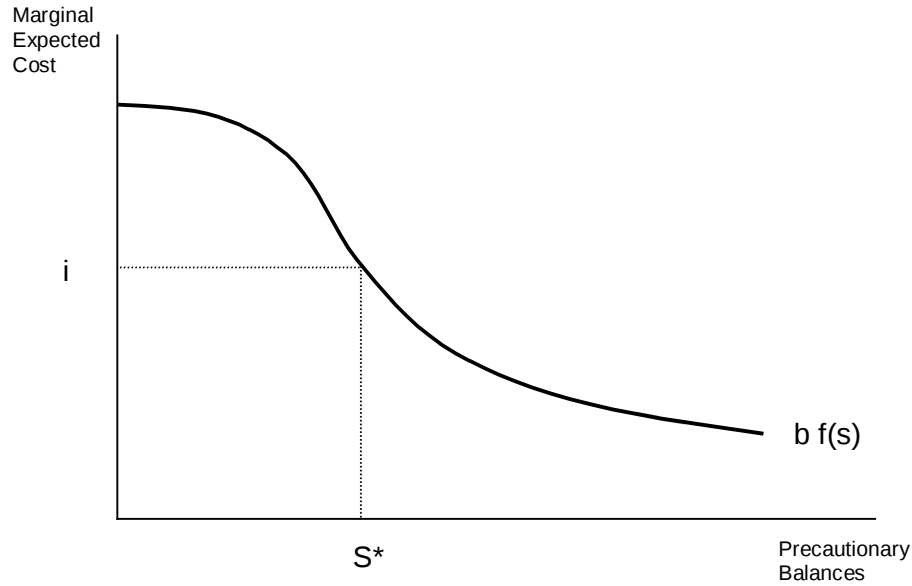


Figure 1. Demand for precautionary money balances.

The agent will never hold negative precautionary balances, so the relevant part of the probability density function $f(S)$ is the positive portion.¹⁸ If the probability distribution of S is approximately normal, then the positive part of the $bf(s)$ function looks similar to the one shown in Figure 1. The optimal amount of precautionary money balances occurs where the nominal interest rate on the vertical axis equals the vertical level of the $bf(s)$ curve representing brokerage cost b multiplied by the density function of unexpected expenditures. This curve can be thought of as the demand curve for precautionary balances.

It is easy to examine the effects of exogenous changes on precautionary balances using Figure 1. An increase in the nominal interest rate raises the opportunity cost of holding precautionary balances and reduces optimal holdings along the demand curve. If brokerage cost increases, that raises the cost of being caught short and shifts the demand curve outward, leading to higher precautionary balances at any given interest rate. Finally, if expenditure patterns become less predictable due to an increase in σ_s , the standard deviation of unexpected expenditures, then the probability density function $f(s)$ will spread toward the right, shifting the demand curve outward and leading to higher precautionary balances.

How does this theory relate to contemporary trends in the banking industry? It is likely that new technologies in banking have affected both b and σ_s in ways that have lowered the precautionary demand for money. The wide availability of automatic

¹⁸ The second-order condition for a minimum (which is not discussed here) rules out the negative side of the probability distribution.

teller machines and increasing acceptability of credit cards have likely made the brokerage cost of being caught short of M1 (especially currency) much lower than it was before. This lowers b and shifts the demand curve down proportionally. This effect has likely lowered the precautionary demand for the currency component of M1 greatly. You still need money in the bank to use your ATM card, so the effect on the demand for total M1 and on M2 are probably smaller than the effect on currency demand.

Since most unexpected expenditures can be “smoothed out” by using a credit card for the original transaction, variation in actual payments has probably fallen in recent decades. This too would lower the demand for precautionary balances by shifting the demand curve to the left.

Is there a speculative demand for money?

The conventional interpretation of the speculative demand for money in the postwar Keynesian literature was the model developed by James Tobin (1958) in his famous paper “Liquidity Preference as Behavior Towards Risk.” This model looked at the optimal allocation of a wealth-holder’s portfolio between a risky interest-bearing asset and a safe asset—money. Tobin showed that risk-averse wealth-holders would hold some positive amount of money in order to reduce the risk of their overall portfolios.

This approach has a couple of major flaws as an explanation for the speculative demand for money in modern economies. First, money is not necessarily a safe asset. If inflation is subject to uncertainty then although the nominal rate of return on money is known to be zero, the real return (which is the nominal return minus the inflation rate) will vary unpredictably. Second, there are assets such as short-term Treasury bills that pay positive nominal interest and that also have negligible nominal risk. Tobin’s model may explain the demand for *these assets* as agents attempt to reduce risk in their portfolios, but it is unclear why an agent would use currency or demand deposits for this purpose.

Despite the problems with Tobin’s formulation, it is possible to develop another motivation for speculative balances based on Keynes’s original argument. Keynes motivated the speculative demand for money by considering the behavior of someone who believes market interest rates are likely to rise in the near future. Such an individual will expect that the secondary-market price of existing bonds will fall when interest rates rise, so that he expects to suffer a capital loss if he holds bonds.¹⁹

¹⁹ Recall that the market price of existing bonds is inversely related to the market interest rate on new bonds. The following example may clarify this relationship. Suppose that an individual purchases a brand-new \$1,000 bond with an interest rate of 5% with principal and interest due in one year. This person will get a payment of \$1,050 in one year. Now suppose that later in the day the market interest rate on one-year bonds goes up to 10%. New bonds priced at \$1,000 will now yield

If the *average* investor in the market believes that the interest rate is likely to rise, then there will be a general sell-off of bonds, which will raise interest rates immediately and extinguish the expectation of an increase and with it the average agent's speculative demand for money. Thus, the *average* market participant cannot have a positive speculative demand for money for more than an instant. However, if expectations vary across participants in the market, then *those few individuals* with expectations about the immediate course of interest rates that are much higher than average could find that they would earn a higher expected rate of return by holding money than by holding bonds. Thus, the fringe of market participants with the most extremely “bearish” view of future prices of bonds (or other non-money assets) might hold extra money balances above and beyond those necessary for transaction and/or precautionary purposes.

Some of the criticisms of the transactions-demand model apply here as well. Some bank deposits (such as savings accounts and money-market accounts) have interest rates that vary with market rates. Money deposited in these accounts would not suffer a capital loss, but would instead immediately start earning the higher rate of interest after the market rate increased. Since there would be no capital loss on these assets, an agent who wanted to avoid a capital loss would be better off putting his money in one of these than in currency or demand deposits. Thus, this argument for the speculative motive for money holding might apply to the broader definitions of money that includes such assets (M2 and M3) but would not be appropriate for M1.

An integrated model of money demand

In his text on monetary economics, Bennett McCallum (1989) develops a model in which the demand for money is integrated with the general utility-maximization problem of the household.²⁰ McCallum chooses to put money in the household's budget constraint. The household's time is now assumed to be devoted to three activities: work, leisure, and making transactions. Holding larger money balances (for a given flow of consumption expenditures) saves the household transaction time, al-

\$1,100 in one year, so the old bond that promises to pay \$1,050 cannot be worth \$1,000 after the change in the interest rate. The present value of the \$1,050 payment when the market interest rate is 10% is $\$1,050/(1.10) = \954.55 . Thus, the agent has incurred a capital loss of \$45.45 due to the increase in the market interest rate on new bonds. The capital loss is larger the longer the term of the bond. In the case of a perpetuity that never matures, the loss would be \$500 or half of the original investment! Clearly the negligible amount of interest earned in a few hours (which we have ignored here) is minuscule compared with the capital loss.

²⁰ See his Chapter 3.

lowing leisure (or work) time to be higher, which gives greater utility. This is an example of a so-called “shopping-time” model.

Formally, the households maximize discounted lifetime utility. Utility in each period is a function of consumption and leisure in the period. Thus, households maximize

$$U = \sum_{t=0}^{\infty} \frac{1}{(1+\rho)^t} u(c_t, l_t). \quad (7)$$

The household’s work decision is assumed to be already made independently of the money-holding and consumption decisions, so the household earns y_t in period t and devotes a fixed amount of time to work.

Households maximize (7) subject to two constraints. The first is the budget constraint that the present value of the lifetime stream of consumption equals the present value of the lifetime stream of income. This budget constraint must be slightly altered to recognize that the part of the household’s financial wealth that is held in the form of money does not bear interest. The basic building block of the lifetime budget constraint is the intertemporal condition

$$P_t c_t + B_t + M_t = P_t y_t + i_{t-1} B_{t-1} + M_{t-1}, \quad (8)$$

where B_t is net bond holdings (net lending) at the end of period t and M_t is net money holdings at the end of t , both expressed in nominal terms, c_t and y_t are real consumption and income in t , and i_{t-1} is the nominal interest rate on bonds (lending) held from period $t-1$ to period t . The left-hand side of equation (8) measures nominal uses of funds in period t ; the right-hand side is nominal sources.

If the nominal interest rate is constant at some value i , the inflation rate is constant at π , the initial price level P_1 is normalized to one, and initial and terminal holdings of bonds are both assumed to be zero, then solving for B_t and substituting repeatedly yields

$$\sum_{t=1}^{\infty} \frac{c_t}{(1+r)^t} + \sum_{t=1}^{\infty} \frac{M_t - M_{t-1}}{(1+i)^t} = \sum_{t=1}^{\infty} \frac{y_t}{(1+r)^t}, \quad (9)$$

where $r \equiv i - \pi$. Note that the real variables c and y in equation (9) are discounted at the real interest rate, while the nominal variable M is discounted at the nominal interest rate. This property has important implications. The opportunity cost of current consumption is $(1+r)$ units of future consumption while the opportunity cost of one dollar of current money holding is $(1+i)$ dollars of future money holdings. This implies that the demand for consumption goods will depend on the real interest rate r while the demand for money depends on the nominal rate i .

The second constraint applying to the consumer is that leisure in each period depends on the amount of consumption the household does (number of transactions) and the amount of real money it holds, so $l_t = \psi(c_t, m_t)$. The partial derivatives of the ψ function are $\partial\psi/\partial c_t < 0$ and $\partial\psi/\partial m_t > 0$. More consumption expenditure with the same amount of money means that more time must be devoted to transactions and less is available for leisure. Holding higher money balances for any given amount of consumption means transactions require less time and more leisure is available.

McCallum shows that the solution of this consumer-maximization problem yields a highly conventional demand function for real money balances that depends negatively on the nominal interest rate and on positively the real volume of consumption expenditures. Thus, it is possible to embed the money-demand problem in a general model of consumer equilibrium and derive a result that is consistent with the other models we have studied: Higher transaction volume means more money demand, while higher nominal interest rates mean lower demand.

G. Money in Economic Growth Models

Simple macroeconomics of money and growth

The simple models of money demand described above suggest that the real demand for money will depend on the volume of real transactions, often proxied by real GDP, the opportunity cost of money, usually measured by a short-term nominal interest rate, and transaction costs, which are usually left out for lack of a convenient measure. This simple model of money demand can be written

$$\left(\frac{M}{P}\right)^d = L(Y, r + \pi^e), \quad (10)$$

where $r + \pi^e$ is the nominal interest rate: the sum of the real rate and the expected rate of inflation.

Despite the prediction of the Baumol-Tobin model that the elasticity of money demand with respect to income should be one-half, empirical evidence supports the conclusion that it is close to one. If the income-elasticity is unity, then we can rewrite equation (10) as

$$\frac{M}{P} = Y \cdot L(r + \pi^e). \quad (11)$$

In Chapter 2 of the coursebook, we considered a dynamic equilibrium in the aggregate-supply-demand model that involved growth and inflation. We asserted there that the rate of inflation would be the difference between the rate of monetary growth and the rate of real-output growth. We can now establish this important relationship mathematically.

If we take the growth rate of both sides of equation (11), we get

$$\frac{\dot{M}}{M} - \frac{\dot{P}}{P} = \frac{\dot{Y}}{Y} + \frac{dL(i + \pi^e)}{dt} \frac{1}{L(i + \pi^e)}.$$

In steady-state equilibrium, the interest rate and the (expected) inflation rate will be constant, so the last term vanishes. Thus, if the growth rate of money is μ , the rate of price inflation is π , and the growth rate of real output is g , then

$$\pi = \mu - g. \quad (12)$$

Equation (12) is the fundamental steady-state inflation equation that follows from the standard demand-for-money equation. Most basic formulations of monetary growth models lead to a conclusion that is similar to (12).

Building money into the microfoundations of growth models

With the exception of the McCallum model discussed at the end of Section F, all of the money-demand models discussed above have the weakness that they are *ad-hoc* formulations that are not integrated in any way with the usual utility-maximization framework of the general-equilibrium microeconomy. Modern theorists usually integrate money into household-level macro models by one of several simple mechanisms. Among the simplest (and most common) is imposing a ***cash-in-advance constraint***. In a discrete-time model, a cash-in-advance constraint forces households to hold an amount of money at the beginning of each period that is at least as great as its expenditures for that period. This is essentially a return to the quantity theory, because it ignores the possibility of varying money holdings by making more money-bond transactions in order to earn additional interest.

More sophisticated models try to give money a role in household's utility maximization or in firms' production process. The simplest way to do this is to add real money balances to the utility function or production function. For households, this is problematic because we do not usually think of money as yielding utility directly—it is a means to an end rather than an end in itself. Similarly, incorporating money as a factor of production fails to examine *how* money is used by firms to reduce costs or increase output.

A formal analysis of these models is beyond our scope here, but a detailed treatment can be found in the early chapters of Walsh (2003).

H. The Financial Crisis of 2008–09

Most of you do not have extensive training in financial markets, so we'll begin with a brief introduction to some of the main components of the crisis. From there we will proceed to an analysis of how they have combined together to put us where we are. Finally, we will discuss the policies that the Bush and Obama Administrations pursued in trying to right the economy.

Major elements of the crisis

- **Housing bubble.** U.S. urban residential real estate has been increasing in value rapidly since the 1980s. In some places the increase has been meteoric. Once people begin to expect home prices to rise, they build such expectations into their financial plan. They begin to speculate on houses or to buy homes that they cannot really afford with the confidence that they will be able to sell them at a profit if they cannot make their payments. Similarly, financial institutions are willing to lend on very generous terms (including low down payments and minimal credit checking) because they anticipate that the collateral asset pledged to them in case of default will appreciate. When expectations of rising prices fuel the demand that increases prices even more, a *bubble* occurs. All bubbles eventually burst and the U.S. housing bubble seems to have peaked in 2007. Since then, prices have fallen in most urban markets and have fallen the most in those markets where they rose the most. When home prices fall, the value of some properties will fall near or below the amount owed on the mortgages. If the owner needs to sell, the proceeds from the sale will not cover repayment of the mortgage, so the owner would take a loss. This gives “underwater” owners a strong incentive to default on their mortgages, leaving the lender with the devalued collateral and transferring the loss to the lender.
- **Sub-prime mortgage loans.** Traditional or “prime” mortgage loans must adhere to some basic safety guidelines. In order to qualify for guarantees by the quasi-federal institutions Fannie Mae and Freddy Mac, the loan must be less than 80 percent of the appraised value of the home and the borrower must have sufficient income and credit background to assure the likelihood of repayment. Sub-prime loans are ones that do not satisfy these standards. They are riskier because the cushion of collateral value over the loan value is

smaller (less than 20 percent) and/or because the borrower's creditworthiness has not been satisfactorily established. Sub-prime loans present little problem in an environment of rapidly rising home values. Even a loan for 100 percent of the appraised value will be down to 80 percent within a couple of years if property values are spiraling upward at 10 percent per year, as occurred in many property markets in the early 2000s. The dodgiest of the sub-prime loans also lowered borrowers' payments for the first few years, adding to the outstanding loan balance over time but reducing the probability of early default. Availability of these loans expanded the demand for houses and fueled the bubble in house prices. The inevitability of collapse is obvious once prices stopped rising rapidly.

- **Securitization.** In the old days, banks and “thrifts” (savings and loan associations and their kin) simply lent money. A customer took out a mortgage to buy a house and that mortgage remained on the bank or thrift's books as an asset until it was gradually repaid over 15 to 30 years. Holding long-term, illiquid assets such as mortgages can be risky for banks because the liability side of their balance sheets is dominated by short-term deposits. Should they suffer a reduction in deposits, the bank would not be able to “call in” these mortgage loans. During the 1990s, banks began to “securitize” mortgages and other loans on a large scale. A collection of similar mortgages was bundled together into a set of *mortgage-backed securities* (MBSs) and sold to other investors. Each MBS was a claim on a part of the payments stream of the bundle of mortgages. The bank continued to process the borrowers' payments and then passed them along to the holders of the corresponding MBSs. Securitization was beneficial to banks because it allowed them to do what they do best—dealing with retail customers, evaluating their credit risks, and processing their payments—without having to hold very-long-term mortgage assets on their books.²¹ However, as Quigley (2008) points out, when banks plan to extinguish their creditor position quickly, they may have weakened incentives to evaluate credit risk adequately and disclose adverse credit information to prospective buyers of MBSs.
- **Collateralized debt obligations.** Mortgage-backed securities allow the banks to offload their long-term lending commitments to others who desire to hold such assets. However, there may be investors who want long-term assets such as mortgages but who have a greater or lesser tolerance for risk than the overall MBS would offer. Modern financial markets have become expert at tailoring exotic *derivative securities* to calibrate the risk, maturity, and return of existing securities. *Collateralized debt obligations* (CDOs) take an asset such

²¹ For brief discussion of securitization in the recent past, see Rosen (2007).

as an MBS and slice it up into prioritized tranches with differing levels of risk. The highest tranche gets first claim on the stream of payments made by the bundle of mortgage borrowers, making it relatively safe. Mid-level (“mezzanine”) tranches get paid next, assuming that defaults are few enough to keep the payments stream adequate. The bottom tranches are like the irrigator at the very end of the river: if enough payments come through (because there are no defaults) they will get the full amount of income, but if defaults are high there may be nothing left once the upstream tranches have taken their cuts.

- **Credit-default swaps.** Another exotic derivative that emerged in the last decade is the *credit-default swap* (CDS). These assets are essentially insurance policies that banks can take out to protect themselves from loan defaults. While this might seem like a terrific idea to reduce a bank’s default risk—and it is for an individual bank—an insurance policy is only valuable if the insurer is financially healthy. In a general financial crisis, uncertainties about the creditworthiness of CDS counterparties (insurers) may raise doubts about the solvency of banks. Mengle (2007) provides an introduction to CDSs.

Downturn

All bubbles eventually burst. U.S. urban housing prices peaked in about September 2006 and began to decline. As noted above, the most speculative sub-prime mortgages were a time bomb waiting to explode as soon as the inflation in property values began to ebb. The banks that had pushed these loans most aggressively naturally began to lose money and their cushion of capital was squeezed.

Foreclosing homes is very costly for lenders. By some estimates, banks lose an average of 40 percent on loans that have to be foreclosed. It is often in the mutual interest of lender and borrower to “work out” a new loan that stretches out payments and perhaps lowers interest rates a little bit. In most property crises this has been common practice and a large fraction of non-performing loans have been renegotiated to avoid foreclosure.

However, any workout loan must be agreed upon by both the borrower and the lender. This is easy when the bank itself is the sole lender but can be impossible when hundreds of owners of mortgage-backed securities and collateralized debt obligations each hold tiny stakes on the lending side. Short of a “cram-down” provision by a bankruptcy court (which they cannot at present do on mortgages, though permissive legislation is pending), there is no practical way to get all the fractional lenders to agree to a workout loan.

This is not the only way in which repeated division and resale of mortgages through MBSs and CDOs caused difficulties when the housing market turned down.

The opaqueness of these securities caused transaction partners of large financial institutions to worry about whether they would be able to fulfill their obligations.

This “counterparty risk” has traditionally been a worry in check-clearing and similar interbank transactions, as well as in transactions on major stock, bond, and commodity exchanges. In these situations, the exchange or clearinghouse usually “nets” out the vast volume of transactions of each participant, cancelling debits with credits so that only the net amount must be settled at the end of the day. But many modern derivative securities, including MBSs and CDOs, are not traded on an exchange. This means that transactions are not netted, which greatly expands counterparty risk.

Suppose that two banks engage in two transactions: A buys an asset from B for \$1 million and B buys a different asset from A for \$1 million. If the two transactions are performed on an exchange, they will be netted against each other so that if A fails during the day, B will not suffer. In an “over-the-counter” market without netting, the failure of bank A leaves B unable to collect its \$1 million, even though it has paid the corresponding \$1 million to A. Bank B would have to stand in line with all of A’s other creditors to try to collect its money.

With the value of assets such as MBSs, CDOs, and CDSs sinking and great uncertainty about both their values and who is holding them, financial institutions became reluctant to do business with one another due to counterparty risk. The over-the-counter markets for short-term commercial paper, MBSs, CDOs, and federal funds froze up. Financial firms were crippled and non-financial firms that counted on regular extensions of credit through the commercial-paper market were disrupted.

Because of the extensive interrelationships among banks, it has long been realized that (even with netting) allowing a major bank to fail could put at risk other banks that are creditors of the failing bank. The transmission of risk from one large bank to another through their payments-system interactions is called payments-system risk or systemic risk. The “too-big-to-fail” (TBTF) hypothesis argues that the largest banks cannot be allowed to fail because the risk of systemic collapse would be too great.²²

The recent crisis has extended the TBTF problem beyond the commercial banking industry that is directly involved in the payments system. Because commercial banks have come to rely heavily on investment banks and insurance companies (think Bear Stearns, Lehman Brothers, and AIG) as counterparties in MBS, CDO, and most especially CDS transactions, the failure of one of these institutions could easily have catastrophic effects on banks and thus on the payments system. Concerns about systemic risks have led the Fed and the Treasury to spend hundreds of billions

²² The too-big-to-fail argument is highly controversial. For arguments against, see Kaufman (1990) and Stern and Feldman (2004).

of dollars bailing out these non-bank firms whose failure would not have in earlier times provoked concern about the payments system.

All of these difficulties, while located squarely within the financial system, have spilled over into the real economy. Banks have been reluctant to lend and commercial-paper markets have been sclerotic at best, limiting access to credit for both households and firms. Households have lost a large share of their wealth, whether that wealth was invested in houses or in the stock market. Without easy access to credit and with evaporating wealth, both firms and households have cut spending dramatically, especially on durable goods. The auto and construction industries have been blasted by declining demand. These declines have been transmitted to other industries as well, leading to a dramatic downturn of a rapidity not seen since the 1930s.²³

Policy alternatives

Economists have long laid the blame for the length and severity of the Great Depression on poor policy choices made in the early years of decline. Now those economists advising policymakers will get the opportunity to test out the alternative policies that macroeconomists have argued for the last 70 years should have been used in the 1930s.²⁴

We shall have better tools to analyze the policy alternatives in the next chapter. For now, we shall just consider three aspects of the current policy response: fiscal expansion (the “stimulus package”), monetary expansion, and the targeted purchase of private-sector assets by the Federal Reserve.

One can argue that the Great Depression didn’t end until the massive expansion in government spending associated with World War II.²⁵ Keynes (1936) argued that the best way out of a depression is to start income flowing through the system by expanding government purchases. The Obama Administration’s stimulus package attempts to do this, hoping that the increased income that flows to those who sell goods and services to the government will be “recycled” into additional rounds of spending that will help the general economy recover.

Monetary policy is problematic in the current setting. As in the Great Depression and in the lengthy Japanese recession of the 1990s, the short-term nominal interest rate that the central bank uses for policy has reached zero. Thus monetary policy

²³ We will begin studying the models of how aggregate demand may affect output in the next chapter.

²⁴ Interestingly, Federal Reserve Chairman Ben Bernanke and Council of Economic Advisors Chairman Christina Romer (who departed the administration in 2011) both studied the Great Depression as a central part of their academic research.

²⁵ Although the New Deal rightfully gets a lot of attention as a watershed in fiscal policy, it was quantitatively quite small and was financed mostly through taxes rather than deficits.

cannot stimulate the economy any further by lowering short-term interest rates.²⁶ Economists are not unanimous agreement about whether monetary policy can actually do anything positive once rates are near zero. The Fed is currently pursuing a policy of “quantitative easing,” in which they are continuing to increase the monetary base through open-market purchases. Such expansion could be helpful if the enhanced reserve position of banks encourages them to increase lending.

Finally, the Federal Reserve is currently using targeted purchases of assets other than Treasury bills to provide demand and liquidity to otherwise moribund markets. They have established a lending facility for commercial paper in which they buy commercial paper backed by solid collateral. They have introduced a similar facility to buy newly issued asset-backed securities (but not sub-prime ones!) from banks in an attempt to restore mortgage, auto-loan, student-loan, and credit-card lending. The Fed can also buy longer-term Treasury bonds if it wants to try to lower long-term interest rates, which are still well above zero even on U.S. Treasury bonds.

The goal of all of these policies is to try to turn around the severe contraction that is currently occurring. Time will tell how successful they are.

I. Suggestions for Further Reading

The nature and history of money

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²⁶ Keynes called this situation a “liquidity trap.” We shall study liquidity traps in the next chapter.

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