Introduction to Search Theory of Money

Yiting Li

September 2013
A microfoundation of monetary economics

Ref. “Viewpoint: A microfoundation of monetary economics” (Shi, 2006)

• Existence and essentiality of fiat money
  Why would intrinsically worthless money have value? How can fiat money improve the efficiency of resource allocations?

• Return dominance
  Why is money dominated in the rate of return by other assets and, in particular, by government issued nominal bonds?

• Optimal monetary policy
  What is the optimal inflation rate?
A microfoundation of monetary economics (con’t)

• Money, banking, and payments systems
  What is the role of fiat money in banking and payments systems?

• Monetary propagation
  How are monetary shocks propagated to affect the price level and real activities in business cycles?

• International monetary arrangements
  What determines the nominal exchange rate between currencies? Should a country maintain its national currency or join a currency union?
Fiat money and the essentiality of money

- Fiat money is an object that circulates in the market and that has two characteristics:
  - intrinsically uselessness in the sense that fiat money does not yield direct utility or facilitate production;
  - not backed or expected to be backed by any government policy such as taxes.

- Money is essential if it improves the efficiency of resource allocations relative to an economy without money.
Microfoundation of money

- A microfoundation of monetary economics is a theoretical framework that endogenizes the value and essentiality of fiat money by explicitly specifying the frictions that impede the functioning of markets. Such a framework must be able to trace all potential changes in the role of money to changes in the underlying environment and policy.
New Monetarists

Ref. “New Monetarist Economics: Methods” (Williamson and Wright, 2010)

- Microfoundations matter: analyses of macro and monetary economics, including policy discussions, require adherence to a sound and internally consistent economic theory.

- Money matters: use models that are explicit about the frictions that give rise to a role for money; as Wallace (1998) puts it, money should not be a primitive in monetary economics.
New Monetarists (con’t)

- Financial intermediation matters.

- Modeling frictions: needs appropriate levels of abstraction and tractability (e.g. OLG and search models).

- To have a framework making use of similar assumptions and technical devices, that can be applied to a variety of issues.