Preface *xiii*

Part I: Introduction to Monetary Economics **1**

1 Overview 5

2 Money in the Utility Function 26

3 The Welfare Cost of Inflation in a Growing Economy 57

4 Government 72

5 More Explicit Models of Money 86

6 Optimal Fiscal and Monetary Policy 100

7 Money and the Business Cycle: Does Money Matter? 123

8 Sticky Prices in a Demand-satisfying Model 147

9 Sticky Prices with Optimal Quantity Choices 155

10 Flexible Prices 170

Part II: An Introduction to the Economics of Uncertainty **179**

11 Preliminaries 182

12 Does Insurance Require Risk Aversion? 197

13 Asset Prices and the Lucas "Tree Model" 202

Part III: An Introduction to Uncertain and Sequential Trade (UST) **207**

14 Real Models 210

15 A Monetary Model 250

16 Limited Participation, Sticky Prices, and UST: A Comparison 261

17 Inventories and the Business Cycle 280

18 Money and Credit in the Business Cycle 302

19 Evidence from Micro Data 313

20 The Friedman Rule in a UST Model 327

21 Sequential International Trade 333

22 Endogenous Information and Externalities 356

23 Search and Contracts 369

References 385

Index 395

Contents

Preface *xiii*

Part I: Introduction to Monetary Economics 1

1 **Overview** 5

1.1 Money, Inflation, and Output: Some Empirical Evidence 5
1.2 The Policy Debate 8
1.3 Modeling Issues 13
1.4 Background Material 14
1.4.1 The Fisherian diagram 15
1.4.2 Efficiency and distortive taxes 18
1.4.3 Asset pricing 21

2 **Money in the Utility Function** 26

2.1 Motivating the Money in the Utility Function Approach: The Single-period, Single-agent Problem 26
2.2 The Multi-period, Single-agent Problem 28
2.3 Equilibrium with Constant Money Supply 33
2.4 The Social and Private Cost for Accumulating Real Balances 34
2.5 Administrative Ways of Getting to the Optimum 36
2.6 Once and for All Changes in M 36
2.7 Change in the Rate of Money Supply Change: Technical Aspects 37
2.8 Change in the Rate of Money Supply Change: Economics 38
2.9 Steady-state Equilibrium (SSE) 41
2.10 Transition from One Steady State to Another 41
2.11 Regime Changes 43
2.12 Introducing Physical Capital and Bonds 45

2.13 The Golden Rule and the Modified Golden Rule 47
Appendix 2A A dynamic programming example 53

3 The Welfare Cost of Inflation in a Growing Economy 57

3.1 Steady-state Equilibrium in a Growing Economy 57
3.2 Generalizing the Model in Chapter 2 to the Case of Growth 58
3.3 Money Substitutes 64
Appendix 3A A dynamic programming formulation 69

4 Government 72

4.1 The Revenues from Printing Money 72
4.1.1 Steady-state revenues 72
4.1.2 Out of the steady-state revenues 73
4.1.3 The present value of revenues 75
Appendix 4A Non-steady-state equilibria 76
4.2 The Government's "Budget Constraint" 78
4.2.1 Monetary and fiscal policy: Who moves first? 81
4.2.2 The fiscal approach to the price level 81
4.3 Policy in the Absence of Perfect Commitment: A Positive Theory of Inflation 82

5 More Explicit Models of Money 86

5.1 A Cash-in-advance Model 86
5.1.1 A two-goods model 87
5.1.2 An analogous real economy 89
5.1.3 Money super-neutrality in a one-good model 92
5.2 An Overlapping Generations Model 94
5.3 A Baumol–Tobin Type Model 96
Appendix 5A 98

6 Optimal Fiscal and Monetary Policy 100

6.1 The Second-best Allocation 100
6.2 The Second Best and the Friedman Rule 103
6.3 Smoothing Tax Distortions 109
6.4 A Shopping Time Model 112

7 Money and the Business Cycle: Does Money Matter? 123

7.1 VAR and Impulse Response Functions: An Example 125
7.2 Using VAR Impulse Response Analysis to Assess the Money–Output Relationship 127

7.3 Specification Search 135
7.4 Variance Decomposition 142

8 Sticky Prices in a Demand-satisfying Model 147

9 Sticky Prices with Optimal Quantity Choices 155

9.1 The Production to Order Case 156
9.2 The Production to Market Case 161

10 Flexible Prices 170

10.1 Lucas' Confusion Hypothesis 170
10.2 Limited Participation 174

Part II: An Introduction to the Economics of Uncertainty 179

11 Preliminaries 182

11.1 Trade in Contingent Commodities 185
11.2 Efficient Risk Allocation 190

12 Does Insurance Require Risk Aversion? 197

12.1 The Insurance-buying Gambler 200
12.2 Socially Harmful Information 201

13 Asset Prices and the Lucas "Tree Model" 202

Part III: An Introduction to Uncertain and Sequential Trade (UST) 207

14 Real Models 210

14.1 An Example 210
14.1.1 Downward sloping demand 215
14.1.2 Welfare analysis 218
14.1.3 Demand and supply analysis 221
14.2 Monopoly 224
14.2.1 Procyclical productivity 226
14.2.2 Estimating the markup 227
14.3 Relationship to the Arrow–Debreu Model 228
14.4 Heterogeneity and Supply Uncertainty 231
14.4.1 The model 233

14.5 Inventories 237
14.5.1 Temporary (partial) equilibrium 238
14.5.2 Solving for a temporary equilibrium 240
14.5.3 Full equilibrium 243
14.5.4 Efficiency 243
Appendix 14A The firm's problem 247
Appendix 14B The planner's problem 248

15 A Monetary Model 250

15.1 An Example 251
15.2 Working with the Money Supply as the Unit of Account 253
15.3 Anticipated and Unanticipated Money 255
15.4 Labor Choice, Average Capacity Utilization and Welfare 256
15.5 A Generalization to Many Potential Markets 256
15.6 Asymmetric Equilibria: A Perfectly Flexible Price Distribution is Consistent with Individual Prices That Appear to Be "Rigid" 258
15.7 Summary of the Implications of the Model 259

16 Limited Participation, Sticky Prices, and UST: A Comparison 261

16.1 Limited Participation 261
16.2 Sticky Prices 265
16.3 UST 268
16.4 A Real Business Cycle Model with Wedges: Some Equivalence Results 274
16.5 Additional Tests Based on Unit Labor Cost and Labor Share 276

17 Inventories and the Business Cycle 280

17.1 Introducing Costless Storage 282
17.2 Adding Supply Shocks 288
17.3 Testing the Model with Detrended Variables 292
17.4 Using an Impulse Response Analysis with Non-detrended Variables to Test for Persistence 297
Appendix 17A The Hodrick–Prescott (H–P) filter 300

18 Money and Credit in the Business Cycle 302

18.1 A UST Model with Credit 302
18.2 Inventories Are a Sufficient Statistic for Past Demand Shocks 305
18.3 Estimating the Responses to a Money Shock 306

18.4 Estimating the Responses to an Inventories Shock 310
18.5 Concluding Remarks 312

19 Evidence from Micro Data 313

19.1 A Menu Cost Model 313
19.2 The Serial Correlation in the Nominal Price Change 315
19.3 A Two-Sided Policy 316
19.4 Relative Price Variability and Inflation 317
19.5 A Staggered Price Setting Model 319

20 The Friedman Rule in a UST Model 327

20.1 A Single-Asset Economy 327
20.2 Adding a Costless Bonds Market 330
20.3 Costly Transactions in Bonds 331

21 Sequential International Trade 333

21.1 A Real Model 334
21.2 A Monetary Model 341
21.3 Exchange Rates 348
Appendix 21A Proofs of the Claims in the Monetary Model 350
Appendix 21B Example 7 in detail 353

22 Endogenous Information and Externalities 356

22.1 A Real Model 356
22.2 A Monetary Model 361
22.3 Relationship to the New Keynesian Economics 367

23 Search and Contracts 369

23.1 Search over Time 369
23.2 Random Choice of Markets 371
23.3 Capacity Utilization Contracts and Carlton's Observations 375

References 385

Index 395