John Hardman Moore on Money and Liquidity

THE UNIVERSITY *of* EDINBURGH

***Focus* paper**

School of Economics

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John Hardman Moore outlines his joint research with Nobu Kiyotaki on the macroeconomic questions to do with the nature of money and liquidity, and the interplay between the financial system and the aggregate economy.

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Kiyotaki and Moore (KM) define inside money very broadly as any privately-issued long-term paper that is held by a number of agents in succession. Whenever paper circulates as a means of short-term saving (liquidity), it can properly be considered as money, or a medium of exchange, because agents hold it not for its maturity value but for its exchange value. KM construct a model of an economy in which agents borrow by issuing long-term paper, and use the model to ask:

When and why is circulation of the paper essential to the smooth running of the economy? If there is a shortage of liquidity, what are the symptoms? Does the economy respond efficiently?

KM draw a distinction between two aspects of financial contracting: bilateral commitment versus multilateral commitment. On the one hand, there may be a limit on how much a private agent can credibly promise to repay someone who provides finance: i.e., the degree of bilateral commitment a borrower can make to an initial lender when selling a paper claim. On the other hand, there may be a limit on the extent to which the initial lender can resell the paper to someone else in a secondary market: in effect, the degree of multilateral commitment the borrower can make to repay any bearer of the claim.

Economists have long held the view that the development of the financial system (financial deepening) and economic development are closely intertwined. KM use the distinction between bilateral commitment and multilateral commitment to develop a model of financial deepening. They explore the effects of secular changes in financial depth on investment and output; on intermediation and interest rates; on the long-run velocities of circulation of different monetary instruments and the use of outside money; and on the patterns of saving and trade in paper. The theory allows us to trace the evolution of different kinds of money, from ancient to modern.

The framework can also be used to examine shorter-term fluctuations. KM construct a business cycle model with an essential role for money, that allows us to examine the interaction between the circulation

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A second Focus Paper outlines John Hardman Moore's joint research with Oliver Hart, looking at the economics of power and control and the foundations of contractual incompleteness