Money in the Utility Function

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Econ720

September 27, 2016

Money in the utility function

- A shortcut for getting money valued in equilibrium: assume that households gain utility from holding money.
- "Sidrauski" model.
- Benefits: Tractability.
- ▶ Drawbacks: Arbitrary specification of utility affects results.

The Economic Environment

- Much of the model is a standard growth model.
- ► The government prints paper (costlessly).
- ► Households gain utility from holding paper.

Environment

- Demographics: 1 representative household
- Endowments:
 - ▶ 1 unit of work time at each instant
 - ► *k*₀ units of the good
 - ► M₀ bits of paper
- ▶ Technology:
 - $F(K,L) \delta K = c + \dot{K}$

Environment

Preferences:

$$\int_{t=0}^{\infty} e^{-\rho t} u(c_t, m_t) dt \tag{1}$$

$$m_t = M_t/p_t$$

- Government:
 - prints \dot{M}_t and hands it to households
- Markets:
 - goods, labor, capital rental, money

Household

Households solve:

$$\max \int_{t=0}^{\infty} e^{-\rho t} u(c_t, m_t) dt \tag{2}$$

subject to k_0, m_0 given and

$$p(c+\dot{k}) + \dot{M} = p(w+rk+x) \tag{3}$$

x are lump-sum transfers (of money).

Budget constraint in real terms

$$\dot{k} + \dot{M}/p = w + rk + x - c \tag{4}$$

Note that

$$\dot{m} = \dot{M}/p - (M/p^2)\dot{p}$$
$$= \dot{M}/p - m\pi$$

where π is the inflation rate $(\pi = \dot{p}/p)$.

Therefore

$$\dot{k} + \dot{m} = w + rk + x - c - \pi m \tag{5}$$

Budget constraint

- ▶ We seem to have 2 state variables (k,m) but only one law of motion.
- ▶ The reason: the correct state variable is wealth: A = k + m.
- ➤ To transform the budget constraint into a law of motion for A, write it as

$$\dot{A} = w + rA + x - c - (r + \pi)m \tag{6}$$

Every unit of wealth held in money reduces income by the nominal interest rate $(r+\pi)$.

An Equivalence

- ► The household problem is exactly the same as in a real two-good economy.
- ▶ Money is like a consumption good with price $r + \pi$.

Solving the household problem

$$H = u(c,m) + \lambda [w + rA + x - c - (r + \pi)m]$$
(7)

FOC:

$$u_c = \lambda$$
 $u_m = \lambda(r+\pi)$
 $\dot{\lambda} = (\rho-r)\lambda$

TVC:

$$\lim_{t\to\infty}e^{-\rho t}\lambda_t A_t=0$$

Household optimality

Static condition:

$$u_c = u_m/(r+\pi) \tag{8}$$

Intuition?

Intertemporal condition:

$$\dot{\lambda}/\lambda = g(u_c) = -(r - \rho) \tag{9}$$

where $g(z) \equiv \dot{z}/z$ denotes a growth rate.

Household: Separable utility

If the utility function is separable,

$$u(c,m) = v(c) + \overline{v}(m) \tag{10}$$

then

$$u_c = v'(c) \tag{11}$$

and

$$g(u_c) = v''(c)\dot{c}/v'(c) = -\sigma g_c \tag{12}$$

Then a very common expression emerges:

$$g(c) = (r - \rho)/\sigma \tag{13}$$

Equilibrium

Firms solve the standard static profit maximization problem:

$$r = f'(k) - \delta \tag{14}$$

$$w = f(k) - f'(k)k \tag{15}$$

Government

- ▶ The government grows the money supply at the constant rate $\mu = g(M)$.
- ▶ Implied lump-sum transfers are

$$x = \dot{M}/p = \mu m \tag{16}$$

Market clearing

- ▶ Money and factor market clearing are implicit in the notation.
- Goods market clearing is feasibility:

$$\dot{k} + c = f(k) - \delta k \tag{17}$$

Equilibrium

An equilibrium is a set of functions of time that satisfy

These are 9 variables and 10 equations.

The boundary conditions are initial values for M and k and the TVC.

Characterization

- ▶ We reduce the CE to 4 equations in (c,p,k,m).
- Household first-order conditions:

$$g(u_c[c,m]) = -(f'(k) - \delta - \rho)$$

$$u_c(c,m) = u_m(c,m)/(f'(k) - \delta + \pi)$$

Goods market clearing:

$$\dot{k} + c = f(k) - \delta k$$

► Money growth rule:

$$\dot{m} = (\mu - \pi)m$$

Monetary Neutrality

Assume: the utility function is additively separable

$$u(c,m) = \bar{u}(c) + v(m) \tag{18}$$

- Then money has absolutely no effect on the real sector.
- ▶ The evolution of c and k is determined by the Euler equation and the goods market clearing condition alone.
- ► Intuition?

Steady state

In steady state c, k, m are constant.

The Euler equation then determines the steady state capital stock:

$$r = f'(k) - \delta = \rho \tag{19}$$

Goods market clearing then yields consumption:

$$c = f(k) - \delta k$$

Constant real balances require $\pi = \mu$.

The static optimality condition yields an implicit equation for m:

$$u_m(c_{SS}, m_{SS}) = (\rho + \mu)u_c(c_{SS}, m_{SS})$$
 (20)

 \Rightarrow

$$m_{SS} = m^d(c_{SS}, \rho + \mu) \tag{21}$$

Super-neutral money

- ► Changes in money growth (μ) only affect the inflation rate, but not real variables (k_{ss}, c_{ss}) .
- Intuition: inflation does not alter the intertemporal tradeoff between consumption today and tomorrow.
- ► Inflation only affects the relative levels of goods and money consumed

Inflation and welfare

What is the effect of inflation on real money balances? Differentiate (20) to obtain

$$u_{mm}dm = (\rho + \mu)u_{cm}dm + u_c d\mu \tag{22}$$

$$\Rightarrow$$

$$dm/d\mu = u_c/[u_{mm} - (\rho + \mu)u_{cm}]$$
 (23)

▶ Unless money and consumption are too strong complements (u_{cm}) large and positive, higher inflation is associated with lower real money balances and thus lower steady state utility.

The Friedman Rule

- Which money growth rate maximizes steady state utility?
- Since μ does not affect c_{ss} , we only need to know how to maximize m_{ss} .
- ▶ If we set $\rho + \mu = 0$, then $u_m = 0$, which is the best we can do: satiate the household with money.
- ▶ If $u_m > 0$ even asymptotically, the problem does not have a solution.
- ▶ The intuition is quite general:
 - If money provides some kind of benefit, the best we can do is to make it costless to hold money.
 - ► That will be the case when money pays the same rate of return as capital (the Friedman rule).

Is This a Good Theory of Money?

Pros:

► tractable

Cons:

- the value of money is assumed therefore: no non-monetary equilibrium / hyperinflation
- money is not used in transactions it's really a consumption good

Where Is this Used?

Models of the financial sector, where the details why households hold money play a minor role

▶ Van den Heuvel, Skander J. "The welfare cost of bank capital requirements." Journal of Monetary Economics 55.2 (2008): 298-320.

Reading

▶ Blanchard and Fischer (1989), ch. 4.5

References I

Blanchard, O. J. and S. Fischer (1989): Lectures on macroeconomics, MIT press.