On the Instability of Fractional Reserve Banking

Heon Lee

Department of Economics
University of Missouri

EGSC at Washington University in St. Louis,
Oct. 23, 2021

Introduction

Is fractional reserve banking particularly unstable?

- Yes:
  - Peel's Banking Act of 1844
  - Chicago plan of banking reform with 100% reserve requirement
  - Friedman (1959) supported the Chicago plan.
  - An important cause of boom-bust cycles:
    Fisher (1935), Von Mises (1953), Minsky (1957), and Minsky (1970):
- No:
  - Becker (1956)
  - Adam Smith's the Wealth of Nations (Book II, chapter 2)
- Sargent (2011) summaries the historical debate on this.
- Still on going debate: Switzerland's national referendum of 100% reserve banking in 2018.

This Paper

- Focuses on the instability as endogenous cycles (self-fulfilling prophecy)
    - not focusing on banking panic or bank run.
- Constructs a search-theoretic monetary model of fractional banking by extending Berentsen et al. (2007, JET)
- An economy is more prone to exhibit cyclic, and chaotic dynamics under lower reserve requirements
    - Different from the argument that fluctuations due to exogenous shocks can be amplified by fractional reserve banking.
    - The endogenous cycles arises even if we shut down the stochastic component of the economy

Literature

- Money, credit and banking in the search model:
  Berentsen et al. (2007), Lotz & Zhang (2016), Gu et al. (2016)
- Fractional reserve banking:
  Freeman & Huffman (1991), Freeman & Kydland (2000), Chari & Phelan (2014), Andolfatto et al. (2020)
- Endogenous fluctuations, chaotic dynamics, and indeterminacy:
  Baumol & Benhabib (1989), Azariadis (1993), Benhabib & Farmer (1999) Gu et al. (2013), Gu et al. (2019)

Model

Environment

- Time, goods
- Agents, banks, and the central bank
- Preferences

Environment

- Time, goods
  1. $t = 0, 1, 2..., \infty$
  2. Each period has three subperiods:
     - Centralized Settlement Market (CM)
     - Centralized Financial Market (FM)
     - Decentralized Goods Market (DM): bilateral trade, subject to anonymity, limited commitment
  3. Perishable DM/CM goods.
- Agents, banks, and the central bank
- Preferences

Environment

- Time, goods
- Agents, banks, and the central bank
  1. Agents: measure 1; maximize life time utility; with prob σ, buyer, with prob $1-\sigma$, seller in the DM; DM types are realized in the FM.
  2. Banks accept deposit and lend loan.
  3. The central bank control money supply M_t via lump-sum tax/transfer. Let γ money growth rate.
- Preferences

Environment

- Time, goods
- Agents, banks, and the central bank
- Preferences
$$U(X) - H + u(q) - c(q)$$
  - CM consumption X; CM disutility for production H; DM consumption q; discount factor: β
  - efficient DM consumption, q^* solves $u'(q^*) = c'(q^*)$.

CM Problem

$$W_t(m_t, d_t, \ell_t) = \max_{X_t, H_t, \hat{m}_{t+1}} U(X_t) - H_t + \beta G_{t+1}(\hat{m}_{t+1})$$

$$\text{s.t. } \phi_t \hat{m}_{t+1} + X_t = H_t + T_t + \phi_t m_t + (1 + i_{d,t})\phi_t d_t - (1 + i_{l,t})\phi_t \ell_t \tag{1}$$

- Standard results: $W_t(m_t, d_t, \ell_t)$ is linear in m_t, d_t, and ℓ_t
- FOC for $\hat{m}_{t+1}$:

$$\phi_t = \beta G'_{t+1}(\hat{m}_{t+1}) \tag{2}$$

FM Problem

- Types are realized at the FM.

$$G_t(m) = \sigma G_{b,t}(m) + (1-\sigma) G_{s,t}(m) \tag{3}$$

- Type-j agent solves the following problem

$$G_{j,t}(m) = \max_{d_{j,t},\ell_{j,t}} V_{j,t}(m - d_{j,t} + \ell_{j,t}, d_{j,t}, \ell_{j,t}) \quad \text{s.t} \quad d_{j,t} \leq m \tag{4}$$

where $j \in \{b, s\}$

- FOCs are:

$$\frac{\partial V_{j,t}}{\partial \ell_{j,t}} \leq 0 \tag{5}$$

$$\frac{\partial V_{j,t}}{\partial d_{j,t}} - \lambda_d \leq 0 \tag{6}$$

where λ_d is the Lagrange multiplier for $d_{j,t} \leq m$.

DM trade

- In the DM, a buyer meets a seller with probability α and a seller meets a buyer with probability α_s.
- The buyer's DM value function

$$V_{b,t}(m_t - d_{b,t} + \ell_{b,t}, d_{b,t}, \ell_{b,t}) = \alpha[u(q_t) - p_t] + W(m_t - d_{b,t} + \ell_{b,t}, d_{b,t}, \ell_{b,t})$$

where $p_t \leq m_t - d_{b,t} + \ell_{b,t}$.

- The seller's DM value function

$$V_{s,t}(m_t - d_{s,t} + \ell_{s,t}, d_{s,t}, \ell_{s,t}) = \alpha_s[p_t - c(q_t)] + W_t(m_t - d_{s,t} + \ell_{s,t}, d_{s,t}, \ell_{s,t})$$

DM trade

- A general trading mechanism $p = v(q)$, where $p \leq z$ and $v'(q) > 0$. (Gu & Wright 2016).
  (This includes Nash bargaining and Kalai bargaining)
  general trading mechanism

- Let p^* be a payment to get q^*.

- Terms of trade are given by

$$p = \begin{cases} z & \text{if } z < p^* \\ p^* & \text{if } z \geq p^* \end{cases} \qquad q = \begin{cases} v^{-1}(z) & \text{if } z < p^* \\ q^* & \text{if } z \geq p^* \end{cases}$$

DM trade

Differentiating $V_{b,t}$ yields

$$\frac{\partial V_{b,t}}{\partial m} = \phi_t[\alpha\lambda(q_t) + 1] \tag{7}$$

$$\frac{\partial V_{b,t}}{\partial \ell} = \phi_t[\alpha\lambda(q_t) - i_l] \tag{8}$$

$$\frac{\partial V_{b,t}}{\partial d} = \phi_t[-\alpha\lambda(q_t) + i_d] \tag{9}$$

where liquidity premium λ is defined as $\lambda(q) \equiv u'(q)/v'(q) - 1$ if $p^* > z$ and $\lambda(q) \equiv 0$ if $z \geq p^*$. Differentiating $V_{s,t}$ yields

$$\frac{\partial V_{s,t}}{\partial m_t} = \phi_t, \qquad \frac{\partial V_{s,t}}{\partial d} = \phi_t i_d, \qquad \frac{\partial V_{s,t}}{\partial \ell} = -\phi_t i_l.$$

Bank's Problem

- A representative bank accepts nominal deposit and lends nominal loan.
- The bank maximizes profit

$$\max_{d,\ell} \quad (i_l \ell - i_d d) \quad s.t. \quad \chi\ell \leq d \tag{10}$$

subject to reserve requirement, χ

- FOCs are

$$0 = i_l - \lambda_L \tag{11}$$
$$0 = -i_d + \lambda_L/\chi \tag{12}$$

- For $\lambda_L > 0$, we have

$$i_l = \chi i_d$$

Equilibrium

Definition
Given (γ, χ), an equilibrium consists of the sequences of prices $\{\phi_t, i_{l,t}, i_{d,t}\}_{t=0}^{\infty}$, real balances $\{m_t, \ell_{b,t}, \ell_{s,t}, d_{b,t}, d_{s,t}\}_{t=0}^{\infty}$, and allocations $\{q_t, X_t, \ell_t\}_{t=0}^{\infty}$ satisfying the following:

- Agents solve CM and FM problems: (1) and (4)
- A representative bank solves its profit maximization problem: (10)
- Markets clear in every period:
    1. Deposit Market: $\sigma d_{b,t} + (1-\sigma) d_{s,t} = d_t$
    2. Loan Market: $\sigma \ell_{b,t} + (1-\sigma)\ell_{s,t} = \ell_t$
    3. Money Market: $m_t = M_t$

Equilibrium

Given (γ, χ), an equilibrium can be summarizes into the following difference equation:

$$z_t = f(z_{t+1}) \equiv \frac{z_{t+1}}{1+i}\left[\frac{1-\sigma+\sigma\chi}{\chi}\alpha L(z_{t+1}) + 1\right] \qquad (13)$$

where $1+i \equiv \gamma/\beta$, $z_t = \phi_t m_t(1-\sigma+\sigma\chi)/\sigma\chi$, and $L(z) \equiv \lambda \circ v^{-1}(z)$ is liquidity premium.

Stationary Equilibrium

- Given $i \in [0, \bar{\iota})$ and $\chi \in (0, 1]$ with $\bar{\iota} = \alpha(1 - \sigma + \sigma\chi)L(0)/\chi$, an unique stationary monetary equilibrium exists satisfying

$$\chi i = (1 - \sigma + \sigma\chi)\alpha L(z_s)$$

  where $z_s = v(q_s)$.

- Simple examples for $\bar{\iota}$ under the Inada condition $u'(0) = \infty$
  - with the Nash bargaining we have $\bar{\iota} = \infty$
  - with the Kalai bargaining we have $\bar{\iota} = \theta\alpha(1 - \sigma + \sigma\chi)/\chi(1 - \theta)$

Proposition

In the stationary equilibrium, lowering the nominal interest rate or lowering reserve requirement increases DM consumption.

Cycles

Recall the difference equation (13)

$$z_t = f(z_{t+1}) \equiv \underbrace{\frac{z_{t+1}}{1+i}}_{\text{increasing in } z_{t+1}} \underbrace{\left[\frac{1-\sigma+\sigma\chi}{\chi}\alpha L(z_{t+1}) + 1\right]}_{\text{decreasing in } z_{t+1}}$$

- $f(z_{t+1})$ is generally nonmonotone.
- If the second term dominates the first term, we can have $f'(\cdot) < -1$ which is a standard condition for the existence of cyclic equilibria
  - If $f'(z_s) < -1$, there is a two-period cycle with $z_1 < z_s < z_2$. (Azariadis 1993)

Proposition

Assume that the buyer makes a take-it-or-leave-it offer to the seller in the DM. Let $-qu''(q)/u' = \eta$ and $c(q) = q$. If $\chi \in (0, \chi_m)$, where

$$\chi_m \equiv \frac{\alpha\eta(1-\sigma)}{\eta(1-\alpha\sigma)+(2-\eta)(1+i)} \tag{14}$$

then $f'(z_s) < -1$.

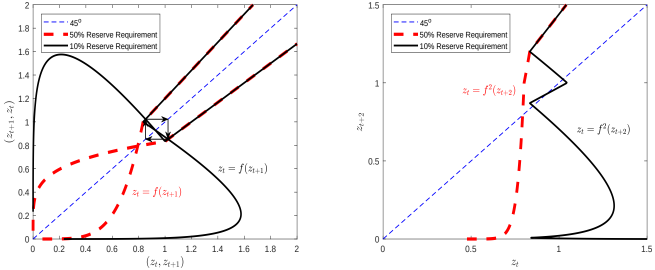

Figure 1: A Two-period Cycle under Fractional Reserve Banking

Proposition (**Three-period Monetary Cycle and Chaos**)

There exists a three-period cycle with $z_1 < z_2 < z_3$ if $\chi \in (0, \hat{\chi}_m)$, where

$$\hat{\chi}_m \equiv \frac{(1-\sigma)\alpha L\left(\frac{p^*}{1+i}\right)}{(1+i)^3 - 1 - \sigma\alpha L\left(\frac{p^*}{1+i}\right)}$$

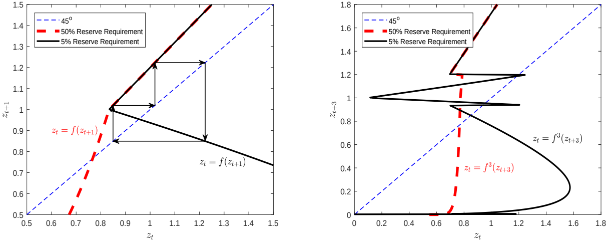

Figure 2: A Three-period Cycle under Fractional Reserve Banking

The existence of three period-cycle implies cycles of all orders as well as chaotic dynamics (see Sharkovskii 1964 and Li & Yorke 1975).

Self-Fulfilling Bubble and Burst Equilibria

- For simplicity, assume followings
  - the buyer makes a take-it-or-leave-it offer to the seller;
  - the DM utility function and the cost function satisfies $-qu''(q)/u'(q) = \eta$ and $c(q) = q$.
- Consider the equilibria that real balance increases above the steady state until certain time, T, and crashes to zero.
  - More specifically, consider a sequence of real balance $\{z_t\}_{t=0}^{\infty}$ with $z_T \equiv \max\{z_t\}_{t=0}^{\infty} > z_s$ (bubble) that crashes to 0 (burst) as $t \to \infty$, where $T \geq 1$ and $z_T > z_0 > 0$.

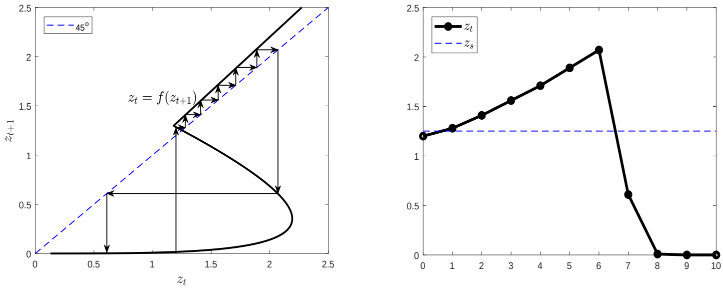

Figure 3: Self-Fulfilling Bubble and Burst Equilibria

Definition (**Self-Fulfilling Bubble and Burst Equilibria**)

For initial level of real balance $z_0 > 0$, a self-fulfilling bubble and burst is a set of sequence $\{z_t\}_{t=0}^{\infty}$ satisfying (15)

$$z_t = \frac{z_{t+1}}{1+i}\left[\frac{1-\sigma+\sigma\chi}{\chi}\alpha[u'(z_{t+1})-1]+1\right] \qquad (15)$$

where $0 < z_s < z_T$, $\lim_{t\to\infty} z_t = 0$, $z_T = \max\{z_t\}_{t=0}^{\infty}$ with $T \geq 1$.

Self-Fulfilling Bubble and Burst Equilibria

Proposition (**Existence of Self-Fulfilling Bubble and Burst Equilibria**)

There exist self-fullfilling bubble and burst equilibria, $\{z_t\}_{t=0}^{\infty}$ if

$$0 < \chi < \min\left\{\frac{(1-\sigma)\alpha\eta(1+i)}{(1-\eta)^2 q^* + (1+i)[(1-\eta)(3+i-\eta)-\alpha\sigma\eta]}, \frac{(1-\sigma)\alpha\eta}{2+i(2-\eta)-\alpha\sigma\eta}\right\}$$

- When $z_s > \bar{z}$, where $\bar{z}$ solves $f'(\bar{z}) = 0$, there exist multiple equilibria.
- Then, if $f(\bar{z}) \geq q^*$, the self-fulfilling bubble and burst equilibria exist.

Introducing Unsecured Credit

- Assume the buyer makes a take-it-or-leave-it offer to the seller in the DM and $c(q) = q$

$$V_t^b(m_t + \ell_t, 0, \ell_t) = \alpha[u(q_t) - q_t] + W_t(m_t + \ell_t, 0, \ell_t)$$

  where $q_t = \min\{q^*, \phi_t(m_t + \ell_t) + \bar{b}_t\}$.
- For compact notation, let $w_{t+1} \equiv z_{t+1} + \bar{b}_{t+1}$.
- Given $\bar{b}_t$, solving equilibrium yields

$$z_t = \begin{cases} \dfrac{z_{t+1}}{1+i}\left\{\dfrac{1-\sigma+\sigma\chi}{\chi}\alpha\left[u'(q_{t+1}) - 1\right] + 1\right\} & \text{if } w_{t+1} < q^* \\ \dfrac{z_{t+1}}{1+i} & \text{if } w_{t+1} \geq q^*. \end{cases} \tag{16}$$

where $z_{t+1} = (1-\sigma+\sigma\chi)\phi_{t+1}m_{t+1}/(\sigma\chi)$ appendix

Endogenous Credit Limits

- Credit limit, $\bar{b}_t$, is determined by the incentive condition for voluntary repayment as Kehoe & Levine (1993).
- The buyer is captured with probability μ if she reneges.
- The punishment for a defaulter is permanent exclusion from the DM trade.
- The incentive condition for voluntary repayment is

$$\underbrace{-b_t + W_t(0,0,0)}_{\text{value of honoring debts}} \geq \underbrace{(1-\mu)W_t(0,0,0) + \mu\underline{\mathrm{W}}(0,0,0)}_{\text{value of not honoring debts}}.$$

- where the value of autarky is $\underline{\mathrm{W}}(0,0,0) = \{U(X^*) - X^* + T\}/(1-\beta)$

Use the incentive condition to get the difference equation of credit limit:

$$\bar{b}_t = \begin{cases} \beta \bar{b}_{t+1} + \dfrac{\chi\mu\sigma[-\gamma z_t + \beta z_{t+1}]}{1-\sigma+\sigma\chi} + \beta\alpha\mu\sigma S(w_{t+1}) & \text{if } w_{t+1} < q^* \\ \\ \beta \bar{b}_{t+1} + \dfrac{\chi\mu\sigma[-\gamma z_t + \beta z_{t+1}]}{1-\sigma+\sigma\chi} + \beta\alpha\mu\sigma S(q^*) & \text{if } w_{t+1} \geq q^* \end{cases} \tag{17}$$

where $S(w_{t+1}) \equiv [u(w_{t+1}) - w_{t+1}]$ is the buyer's trade surplus and $w_{t+1} = z_{t+1} + \bar{b}_{t+1}$.

The equilibrium can be collapsed into a dynamic system satisfying (16)-(17).

See more on money-credit economy

Cycles with Unsecured Credit

For compact notation, let $\iota \equiv \max\{i, r\}$ where $r = 1/\beta - 1$.

Proposition (**Monetary Cycles with Unsecured Credit**)

There exist two period cycles of money and credit with $w_1 < q^* < w_2$ *if* $\chi \in (0, \chi_c)$, *where* $w_j = z_j + \bar{b}_j$ *and*

$$\chi_c \equiv \frac{(1-\sigma)\alpha\left[u'\left(\frac{q^*}{1+\iota}\right) - 1\right]}{(1+i)^2 - 1 - \sigma\alpha\left[u'\left(\frac{q^*}{1+\iota}\right) - 1\right]}.$$

There exist three period cycles of money and credit with $w_1 < q^* < w_2 < w_3$, *if* $\chi \in (0, \hat{\chi}_c)$, *where*

$$\hat{\chi}_c \equiv \frac{(1-\sigma)\alpha\left[u'\left(\frac{q^*}{1+\iota}\right) - 1\right]}{(1+i)^3 - 1 - \sigma\alpha\left[u'\left(\frac{q^*}{1+\iota}\right) - 1\right]}.$$

Other Applications

Sunspot cycles

- Stochastic cycles which are independent from the fundamental.

  Sunspot cycles

Empirical Evaluation

- Negative association between required reserve ratio and volatility of real balance of inside money.

  See empirical evaluation

Conclusion

- Lowering reserve requirement induce instability:
  more prone to exhibit endogenous cyclic, chaotic, and stochastic dynamics
- This result holds in the extended model with credit.
- Lowering the reserve requirement increases the welfare at the steady state.

Appendix

Trade Mechanisms

A general trading mechanism Γ mapping the buyer's z_b into pair (p, q) with it feasibility constraint $p \leq z_b$

- **Axiom 1**: (Feasibility)
  $\forall z$, $0 \leq \Gamma_p(z) \leq z, 0 \leq \Gamma_q(z)$.
- **Axiom 2**: (Individual Rationality)
  $\forall z$, $u \circ \Gamma_q(z) \geq \Gamma_p(z)$ and $\Gamma_p(z) \geq c \circ \Gamma_q(z)$
- **Axiom 3**: (Monotonicity)
  $\Gamma_p(z_2) > \Gamma_p(z_2) \Leftrightarrow \Gamma_q(z_2) > \Gamma_q(z_2)$
- **Axiom 4**: (Bilateral Efficiency)
  $\forall z$, (p', q') with $p' \geq z$ such that
  $u(q') - p' \leq u \circ \Gamma_q(z) - \Gamma_p(z)$ and
  $p' - c(q') \geq \Gamma_p(z) - c \circ \Gamma_q(z)$

Trade Mechanisms

- Let $p^* = \inf\{\hat{z}_b : \Gamma_p(\hat{z}_b) = q^*\}$ be a payment to get q^*.
- Gu & Wright (2016) show that Any Γ satisfying Axioms 1-4 takes the following form

$$\Gamma_p(z) = \begin{cases} z & \text{if } z < p^* \\ p^* & \text{otherwise} \end{cases} \qquad \Gamma_q(z) = \begin{cases} v^{-1}(z) & \text{if } z < p^* \\ q^* & \text{otherwise} \end{cases}$$

where v is some strictly increasing function with $v(0) = 0$ and $v(q^*) = p^*$

DM trade

Sunspot Cycles

- Consider a Markov sunspot variable $S \in \{1, 2\}$. This sunspot variable is not related with fundamentals.
- Let $Pr(S_{t+1} = 1|S_t = 1) = \zeta_1$, $Pr(S_{t+1} = 2|S_t = 2) = \zeta_2$
- The sunspot is realized in the CM.
- CM value function is written as

$$\begin{aligned} W_t^S(m_t, d_t, \ell_t) = \max_{X_t, H_t, \hat{m}_{t+1}} & \; U(X_t) - H_t \\ & + \beta \left[\zeta_s G_{t+1}^S(\hat{m}_{t+1}) + (1-\zeta_s) G_{t+1}^{-S}(\hat{m}_{t+1}) \right] \end{aligned}$$

s.t. $\phi_t^S \hat{m}_{t+1} + X_t = H_t + T_t + \phi_t^S m_t + (1 + i_{d,t})\phi_t^S d_t - (1 + i_{l,t})\phi_t^S \ell_t$.

- The first order condition can be written as

$$-\phi_t^S + \beta\zeta_s G_{t+1}'^S(\hat{m}_{t+1}) + \beta(1-\zeta_s) G_{t+1}'^{-S}(\hat{m}_{t+1}) = 0. \qquad (18)$$

$$G'^{S}_{t+1}(m^S_{t+1}) = \phi^S_{t+1}\left[\frac{1-\sigma+\sigma\chi}{\chi}\alpha L(z^S_{t+1})+1\right] \tag{19}$$

Substituting (19) into (18) and multiplying $(1-\sigma+\sigma\chi)m_{t+1}/(\sigma\chi)$ to the both sides yield

$$\begin{aligned} z^S_t =& \frac{\zeta_s z^S_{t+1}}{1+i}\left[\frac{1-\sigma+\sigma\chi}{\chi}\alpha L(z^S_{t+1})+1\right] \\ &+ \frac{(1-\zeta_s)z^{-S}_{t+1}}{1+i}\left[\frac{1-\sigma+\sigma\chi}{\chi}\alpha L(z^{-S}_{t+1})+1\right] \\ =& \zeta_s f(z^S_{t+1}) + (1-\zeta_s)f(z^{-S}_{t+1}) \end{aligned} \tag{20}$$

Sunspot Cycles

Definition (**Proper Sunspot Equilibrium**)

A proper sunspot equilibrium consists of the sequences of real balances $\{z_t^S\}_{t=0,S=1,2}^{\infty}$, where z_1 is not equal to z_2, and probabilities (ζ_1, ζ_2), solving (20) for all t.

Using the textbook treatment from Azariadis (1993), it is straightforward to show that if $f'(z_s) < -1$, there exist (ζ_1, ζ_2), $\zeta_1 + \zeta_2 < 1$, such that the economy has a proper sunspot equilibrium in the neighborhood of z_s.

Back to other applications

Equilibrium

The equilibrium can be collapsed in to a dynamic system satisfying (21)-(22).

$$z_t = \begin{cases} \frac{z_{t+1}}{1+i}\left\{\frac{1-\sigma+\sigma\chi}{\chi}\alpha\left[u'(w_{t+1})-1\right]+1\right\} & \text{if } w_{t+1} < q^* \\ \frac{z_{t+1}}{1+i} & \text{if } w_{t+1} \geq q^*. \end{cases} \tag{21}$$

$$\bar{b}_t = \begin{cases} \beta\bar{b}_{t+1} + \frac{\chi\mu\sigma[-\gamma z_t + \beta z_{t+1}]}{1-\sigma+\sigma\chi} + \beta\alpha\mu\sigma S(w_{t+1}) & \text{if } w_{t+1} < q^* \\ \beta\bar{b}_{t+1} + \frac{\chi\mu\sigma[-\gamma z_t + \beta z_{t+1}]}{1-\sigma+\sigma\chi} + \beta\alpha\mu\sigma S(q^*) & \text{if } w_{t+1} \geq q^* \end{cases} \tag{22}$$

where $z_{t+1} = (1-\sigma+\sigma\chi)\phi_{t+1}m_{t+1}/(\sigma\chi)$, $w_{t+1} = z_{t+1} + \bar{b}_{t+1}$, and $S(z_{t+1}+\bar{b}_{t+1}) \equiv [u(z_{t+1}+\bar{b}_{t+1}) - z_{t+1} - \bar{b}_{t+1}]$.

Stationary Equilibrium

Let $r = 1/\beta - 1$. The debt limit at the stationary equilibrium, $\bar{b}$, is a fixed point satisfying $\bar{b} = \Omega(\bar{b})$ where

$$\Omega(\bar{b}) = \begin{cases} \frac{\mu\sigma\alpha}{r}[u(\tilde{q}) - \tilde{q}] - \frac{i\mu\sigma\chi}{1-\sigma+\sigma\chi}[\tilde{q} - \bar{b}] & \text{if } \tilde{q} > \bar{b} \geq 0 \\ \frac{\mu\sigma\alpha}{r}[u(\bar{b}) - \bar{b}] & \text{if } q^* > \bar{b} \geq \tilde{q} \\ \frac{\mu\sigma\alpha}{r}[u(q^*) - q^*] & \text{if } \bar{b} \geq q^* \end{cases} \tag{23}$$

where $\tilde{q}$ solves $u'(\tilde{q}) = 1 + i\chi/[\alpha(1-\sigma+\sigma\chi)]$.
Money and credit coexist if and only if $0 < \mu < \min\{1, \tilde{\mu}\}$, where

$$\tilde{\mu} \equiv \sigma\left\{i\chi[(1-\sigma+\sigma\chi)/\tilde{q} - 1] + (\alpha/r)(1-\sigma+\sigma\chi)^2[u(\tilde{q})/\tilde{q} - 1]\right\}$$

since they coexist when $\bar{b} < \tilde{q}$. The DM consumption is decreasing in i in the monetary equilibrium.

Back

Empirical Appendix

Table 1: Effect of Required Reserve Ratio

Price level	CPI		Core CPI		PCE		Core PCE	
Dependent variable: σ_t^{Roll}	OLS (1)	CCR (2)	OLS (3)	CCR (4)	OLS (5)	CCR (6)	OLS (7)	CCR (8)
χ	-0.283***	-0.245***	-0.267***	-0.221***	-0.306***	-0.227***	-0.307***	-0.220***
	(0.027)	(0.002)	(0.027)	(0.003)	(0.029)	(0.004)	(0.027)	(0.005)
`ffr`		-0.109***		-0.125***		-0.187***		-0.207***
		(0.002)		(0.003)		(0.004)		(0.004)
Constant	0.074***	0.074***	0.070***	0.071***	0.074***	0.075***	0.073***	0.073***
	(0.003)	(0.000)	(0.004)	(0.000)	(0.004)	(0.000)	(0.004)	(0.000)
Obs.	49	49	49	49	49	49	49	49
$adjR^2$	0.700	0.621	0.728	0.648	0.740	0.650	0.764	0.665
$\lambda_{trace}(r=0)$	**9.807**	35.688	**9.120**	35.145	**9.109**	35.367	**8.593**	35.028
5% CV	15.41	29.68	15.41	29.68	15.41	29.68	15.41	29.68
$\lambda_{trace}(r=1)$	3.324	**10.682**	2.839	**10.065**	2.723	**9.894**	2.417	**9.345**
5% CV	3.76	15.41	3.76	15.41	3.76	15.41	3.76	15.41

Note: For (1), (3), (5) and (7), OLS estimates are reported, and Newey-West standard errors with lag 1 are reported in parentheses. For (2), (4), (6), and (8), first-stage long-run variance estimations for CCR are based on the quadratic spectral kernel and Bayesian information criterion. The bandwidth selection is based on Newey-West fixed lag, $4 \times (T/100)^{2/9}$; χ denotes the required reserve ratio, `ffr` denotes federal funds rates and σ_t^{Roll} denotes the cyclical volatility of real inside money balances. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

Empirical Appendix

Table 2: Unit Root Tests

		Phillips-Perron test		ADF test
		$Z(\rho)$	$Z(t)$	$Z(t)$ w/ lag 1
`ffr`		-6.766	-1.704	-2.362
χ		-1.492	-1.173	-1.341
σ_t^{Roll}	(CPI)	-4.708	-2.191	-2.090
σ_t^{Roll}	(Core CPI)	-4.681	-2.189	-1.978
σ_t^{Roll}	(PCE)	-4.329	-2.038	-2.047
σ_t^{Roll}	(Core PCE)	-4.076	-1.954	-1.930
Δ`ffr`		-28.373***	-5.061***	-6.357***
$\Delta\chi$		-31.818***	-4.802***	-3.693***
$\Delta\sigma_t^{Roll}$	(CPI)	-24.905***	-3.416**	-2.942**
$\Delta\sigma_t^{Roll}$	(Core CPI)	-24.758***	-3.509**	-2.942**
$\Delta\sigma_t^{Roll}$	(PCE)	-23.691***	-3.330**	-2.842*
$\Delta\sigma_t^{Roll}$	(Core PCE)	-22.826***	-3.296**	-2.768*

Note: `ffr` denotes federal funds rates, χ denotes required reserve ratio, and σ_t^{Roll} denotes cyclical volatility of real inside money balances. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

Empirical Appendix

Table 3: Effect of Required Reserve Ratio:Robustness Check (Quarterly)

Price level	CPI		Core CPI		PCE		Core PCE	
Dependent variable: σ_t^{Roll}	OLS (1)	CCR (2)	OLS (3)	CCR (4)	OLS (5)	CCR (6)	OLS (7)	CCR (8)
χ	-0.282***	-0.452***	-0.266***	-0.400***	-0.305***	-0.485***	-0.306***	-0.476***
	(0.016)	(0.001)	(0.014)	(0.003)	(0.015)	(0.000)	(0.014)	(0.006)
`ffr`		-0.050***		-0.058***		-0.015***		-0.047***
		(0.000)		(0.002)		(0.000)		(0.005)
Constant	0.074***	0.085***	0.070***	0.079***	0.074***	0.089***	0.073***	0.086***
	(0.002)	(0.000)	(0.002)	(0.000)	(0.002)	(0.000)	(0.002)	(0.001)
Obs.	196	196	196	196	196	196	196	196
$adjR^2$	0.696	0.240	0.725	0.263	0.737	0.222	0.761	0.268
$\lambda_{trace}(r=0)$	**9.496**	31.950	**11.045**	33.808	**10.930**	34.481	**12.103**	35.951
5% CV	15.41	29.68	15.41	29.68	15.41	29.68	15.41	29.68
$\lambda_{trace}(r=1)$	1.677	**11.162**	1.959	**12.266**	1.938	**12.094**	1.887	**12.485**
5% CV	3.76	15.41	3.76	15.41	3.76	15.41	3.76	15.41

Note: For (1), OLS estimates are reported, and Newey-West standard errors with lag 1 are reported in parentheses. For (2) and (3), first-stage long-run variance estimations for CCR are based on the quadratic spectral kernel and Bayesian information criterion. The bandwidth selection is based on Newey-West fixed lag, $4 \times (T/100)^{2/9}$; `ffr` denotes federal funds rates and σ_t^{Roll} denotes cyclical volatility of real inside money balances. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

Empirical Appendix

Table 4: Unit Root Tests:Robustness Check (Quarterly)

		Phillips-Perron test		ADF test
		$Z(\rho)$	$Z(t)$	$Z(t)$ w/ lag 1
`ffr`		-8.611	-1.956	-2.183
χ		-1.335	-1.145	-1.199
σ_t^{Roll}	(CPI)	-4.320	-2.062	-1.554
σ_t^{Roll}	(Core CPI)	-4.388	-2.201	-1.924
σ_t^{Roll}	(PCE)	-3.822	-1.946	-1.868
σ_t^{Roll}	(Core PCE)	-3.565	-1.928	-2.023
Δ`ffr`		-139.701***	-10.792***	-10.288***
$\Delta\chi$		-163.796***	-12.272***	-9.909***
$\Delta\sigma_t^{Roll}$	(CPI)	-23.132***	-2.604*	-3.576***
$\Delta\sigma_t^{Roll}$	(Core CPI)	-30.423***	-3.544***	-4.894***
$\Delta\sigma_t^{Roll}$	(PCE)	-24.507***	-2.874*	-4.362***
$\Delta\sigma_t^{Roll}$	(Core PCE)	-28.054***	-3.373**	-5.138***

Note: `ffr` denotes federal funds rates, χ denotes required reserve ratio, and σ_t^{Roll} denotes cyclical volatility of real inside money balances. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

Empirical Appendix

Table 5: Effect of Required Reserve Ratio:Robustness Check (pre-2008)

Price level	CPI		Core CPI		PCE		Core PCE	
Dependent	OLS	CCR	OLS	CCR	OLS	CCR	OLS	CCR
variable: σ_t^{Roll}	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
χ	-0.266***	-0.297***	-0.266***	-0.268***	-0.307***	-0.288***	-0.305***	-0.277***
	(0.030)	(0.001)	(0.030)	(0.001)	(0.032)	(0.002)	(0.029)	(0.002)
`ffr`		-0.107***		-0.124***		-0.189***		-0.210***
		(0.001)		(0.001)		(0.002)		(0.002)
Constant	0.070***	0.080***	0.070***	0.076***	0.074***	0.082***	0.072***	0.080***
	(0.004)	(0.000)	(0.004)	(0.000)	(0.004)	(0.000)	(0.004)	(0.002)
Obs.	43	43	43	43	43	43	43	43
$adjR^2$	0.727	0.659	0.727	0.710	0.739	0.708	0.759	0.734
$\lambda_{trace}(r=0)$	**8.373**	32.228	**7.438**	31.299	**7.661**	31.867	**6.897**	31.250
5% CV	15.41	29.68	15.41	29.68	15.41	29.68	15.41	29.68
$\lambda_{trace}(r=1)$	1.504	**9.554**	1.125	**8.428**	1.146	**8.603**	0.938	**7.693**
5% CV	3.76	15.41	3.76	15.41	3.76	15.41	3.76	15.41

Note: For (1), OLS estimates are reported, and Newey-West standard errors with lag 1 are reported in parentheses. For (2) and (3), first-stage long-run variance estimations for CCR are based on the quadratic spectral kernel and Bayesian information criterion. The bandwidth selection is based on Newey-West fixed lag, $4 \times (T/100)^{2/9}$; `ffr` denotes federal funds rates and σ_t^{Roll} denotes cyclical volatility of real inside money balances. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

Empirical Appendix

Table 6: Unit Root Tests:Robustness Check (pre-2008)

		Phillips-Perron test		ADF test
		$Z(\rho)$	$Z(t)$	$Z(t)$ w/ lag 1
ffr		-9.476	-2.258	-2.868**
χ		-0.768	-0.660	-0.877
σ_t^{Roll}	(CPI)	-2.966	-1.738	-1.770
σ_t^{Roll}	(Core CPI)	-2.860	-1.641	-1.495
σ_t^{Roll}	(PCE)	-2.662	-1.515	-1.627
σ_t^{Roll}	(Core PCE)	-2.412	-1.371	-1.400
Δffr		-25.378***	-4.773***	-5.833***
$\Delta\chi$		-28.208***	-4.594***	-3.658***
$\Delta\sigma_t^{Roll}$	(CPI)	-25.627***	-4.281***	-3.813***
$\Delta\sigma_t^{Roll}$	(Core CPI)	-25.836***	-4.329***	-3.764***
$\Delta\sigma_t^{Roll}$	(PCE)	-24.420***	-4.101***	-3.594**
$\Delta\sigma_t^{Roll}$	(Core PCE)	-23.848***	-4.034***	-3.464**

Note: ffr denotes federal funds rates, χ denotes required reserve ratio, and σ_t^{Roll} denotes cyclical volatility of real inside money balances. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

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