

# Money in OLG Models

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# Topics

We study the value of money in OLG models.

Philosophy question:

*What is money?*

# Money in the OLG model

## Definition

Money: Pieces of paper with pictures of dead presidents.

The central question of monetary economics:

Why and when is money valued in equilibrium?

Rate of return dominance is a problem:

- ▶ other assets offer a higher rate of return
- ▶ why hold money?

# Money in the OLG model

In the OLG model:

- ▶ Money is a bubble.
- ▶ Its value derives solely from the expectation that money will be valued tomorrow.

Money is valued like any other asset.

- ▶ It is only held if no other asset offers a higher rate of return.

# Dynamic efficiency

Can money alleviate dynamic inefficiency?

- ▶ Previous models lacked a long-lived asset that would facilitate intergenerational trade.
- ▶ Money could solve this problem.

# An OLG Model of Money

Start with the standard two period OLG model without production or bonds.

Demographics:  $N_t = (1+n)^t$

Preferences:  $u(c_t^y, c_{t+1}^o)$

Endowments:  $e_1$  when young;  $e_2$  when old

Technologies: Goods can only be eaten:

$$N_t c_t^y + N_{t-1} c_t^o = N_t e_1 + N_{t-1} e_2 \quad (1)$$

Markets:

- ▶ goods ( $P_t$ ), money (numeraire)

# Introducing Money

- ▶ In period 1, the initial old are given  $M_0$  bits of green paper
- ▶ In every subsequent period, the government prints additional paper and hands it to the current old *in proportion* to current paper holdings.
- ▶ Effectively, money pays (nominal) interest if held from young to old age.
- ▶ The money growth rate is constant:

$$M_{t+1}/M_t = 1 + \theta$$

# Timing

Beginning of  $t$ :

- ▶  $N_t$  young are born and receive  $e_1$  goods.
- ▶  $N_{t-1}$  old
  - ▶ receive  $e_2$  goods
  - ▶ carry over  $M_{t-1}/N_{t-1}$  units of money
  - ▶ receive money transfer  $\theta M_{t-1}/N_{t-1}$ .
  - ▶ they now hold  $M_t/N_{t-1}$  each



# Timing

During  $t$

- ▶ the young sell goods to the old
- ▶ the old sell money to the young

At the end of  $t$ :

- ▶ the young hold  $M_t/N_t$  each

## Household: budget constraints

Young:

$$P_t e_1 = P_t (c_t^y + x_t) \quad (2)$$

or

$$e_1 = c_t^y + x_t \quad (3)$$

$x_t P_t$ : nominal purchases of money (household saving).

## Budget constraints

Old:

$$P_{t+1}c_{t+1}^o = P_{t+1}e_2 + x_t(1 + \theta)P_t \quad (4)$$

or

$$c_{t+1}^o = e_2 + x_t R_{t+1} \quad (5)$$

where

$$R_{t+1} = (1 + \theta)P_t/P_{t+1}$$

is the gross real interest rate earned by holding money.

## Lifetime budget constraint

$$e_1 - c_t^y = \frac{c_{t+1}^o - e_2}{R_{t+1}}$$

The household looks exactly like a model with a one-period bond.

The household does not care where  $R$  comes from.

Euler equation:

$$u_1(t) = R_{t+1}u_2(t)$$

## Household: Solution

A solution to the household problem is a triple  $(c_t^y, c_{t+1}^o, x_t)$  which satisfies

- ▶ the Euler equation and
- ▶ the two budget constraints.

Optimal behavior can be characterized by a savings function

$$x_t = s(R_{t+1}, e_1, e_2) \quad (6)$$

The only new item:  $x$  is real money purchases (not bond or capital purchases).

# Equilibrium

The government is simply described by a money growth rule:

$$M_{t+1}/M_t = 1 + \theta$$

Market clearing:

Careful about notation: the young in  $t$  take  $M_t$  into  $t+1$ .

# Equilibrium Definition

A sequence of prices and quantities  
such that

## Characterizing Equilibrium

- ▶ We look for a difference equation in terms of the economy's state variables.
- ▶ State variables are  $M$  and  $P$ .
- ▶ But in this model (and typically) only the ratio  $m = M/PN$  matters.



## Characterizing Equilibrium

Start from the money market clearing condition

$$m_t = s(R_{t+1}) \quad (7)$$

Substitute out  $R$  using

$$R_{t+1} = (1 + \theta)P_t/P_{t+1} \quad (8)$$

We need an expression for inflation. From

$$1 + \theta = \frac{M_{t+1}}{M_t} = \frac{m_{t+1}}{m_t} \frac{P_{t+1}}{P_t} \frac{N_{t+1}}{N_t}$$

we have

$$R_{t+1} = (1 + \theta)P_t/P_{t+1} = (1 + n)m_{t+1}/m_t$$

The law of motion is

$$m_t = s((1 + n)m_{t+1}/m_t) \quad (9)$$

## Characterizing Equilibrium

A more explicit way of deriving this.

For ease of notation assume

$$u(c_t^y, c_{t+1}^o) = v(c_t^y) + \beta v(c_{t+1}^o) \quad (10)$$

Sub budget constraint into Euler equation:

$$v'(e_1 - x_t) = R_{t+1} \beta v'(e_2 + R_{t+1} x_t) \quad (11)$$

Sub in  $m_t = x_t$  and  $R_{t+1} = (1+n)m_{t+1}/m_t$ :

$$v'(e_1 - m_t) = (1+n) \frac{m_{t+1}}{m_t} \beta v'(e_2 + (1+n)m_{t+1}) \quad (12)$$

## Intuition

$$m_t = s((1+n)m_{t+1}/m_t) \quad (13)$$

Why is this true?

- ▶ we really have  $m_t = s(R_{t+1})$
- ▶ fixed: nominal money growth and  $n$
- ▶ higher growth in  $m = M/PN \implies$  lower inflation  $\implies$  higher return

# The Offer Curve

## The Offer Curve

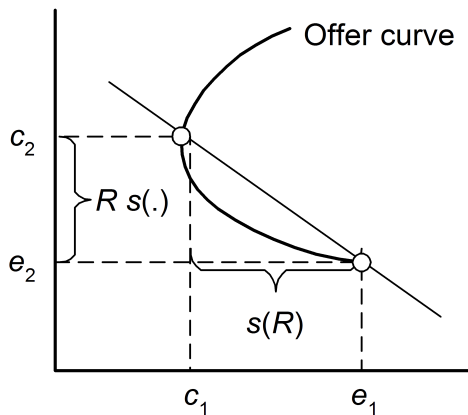
We want to determine the shape of the law of motion.

The key idea is to use the household's intertemporal consumption allocation to figure out how money evolves over time.

## Household consumption choice

The lifetime budget constraint has slope  $-R_{t+1}$ .

Plot the tangencies between budget constraint and indifference curves for all interest rates  $\rightarrow$  offer curve.



# Offer curve

What do we know about the offer curve?

1. It goes through the endowment point.
2. At low levels of  $R$  the household would like to borrow (but cannot).
3. For interest rates where the household saves very little, income effects are small
  - $\implies$  savings rise with  $R_{t+1}$
  - $\implies$  the offer curve is upward sloping
4. The offer curve intersects each budget line only once.

## Law of motion for $m$

The offer curve maps  $s(R_{t+1})$  into  $R_{t+1}s(R_{t+1})$ .

But we want to map  $m_t$  into  $m_{t+1}$ .

The horizontal axis actually shows  $m_t$ .

Because money demand equals saving of the young:

$$m_t = s(R_{t+1}) = e_1 - c_t^y \quad (14)$$



## Law of motion for $m$

The vertical axis actually shows  $(1+n)m_{t+1}$ .

Because for the old:

$$c_{t+1}^o - e_2 = R_{t+1}s(R_{t+1}) \quad (15)$$

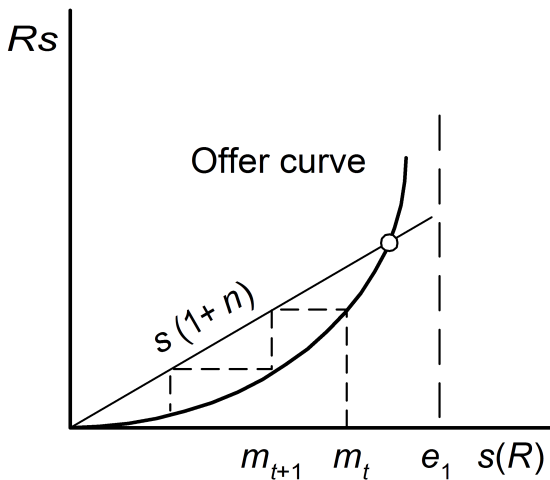
$$= (1+n) \frac{m_{t+1}}{m_t} m_t \quad (16)$$

$$= (1+n)m_{t+1} \quad (17)$$

Implicitly, the offer curve gives a law of motion for  $m$ :

$$(1+n)m_{t+1} = F(m_t)$$

## Law of motion



Using a line of slope  $(1+n)$  we can find the path of  $m_t$  for any start value  $m_0$ .

## Steady state

- ▶ There is a unique monetary **steady state** (intersection of offer curve and ray through origin).
- ▶ It is *unstable*.

## Properties of the steady state

$m$  is constant over time.

The gross rate of return on money is

$$\begin{aligned}R_{t+1} &= (1 + \theta)P_t/P_{t+1} \\ &= (1 + n)m_{t+1}/m_t\end{aligned}$$

Therefore, in steady state, the Golden Rule holds:

$$R = 1 + n$$

Steady state inflation is

$$P_{t+1}/P_t = \frac{1 + \theta}{1 + n}$$

# Dynamics

Assumption: the offer curve is not backward bending.

Take  $m_0$  as given for now.

What if  $m_0 > m_{ss}$ ?

- ▶ This cannot happen because  $m_t$  would blow up towards  $\infty$ .
- ▶ But then consumption will exceed total output at some point.

# Dynamics

If  $m_0 < m_{ss}$ :  $m_t$  collapses towards 0.

- ▶ Because  $M$  grows at a constant rate, this must happen through inflation.
- ▶ Along this path  $R$  falls over time  $\Rightarrow$  inflation accelerates.

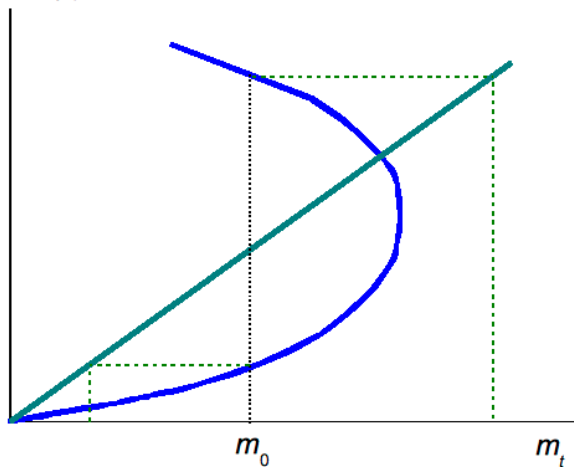
Intuition:

- ▶ If  $m_0 = m_{ss}$  people save just enough to keep  $m$  constant.
- ▶ If  $m_0$  is a bit lower, then  $R$  is a bit lower. People save less.
- ▶ That requires a lower  $m_1$ , hence more inflation.
- ▶ That leads people to save less again, etc.

## Dynamics: Backward bending Offer Curve

We have **multiple equilibria** and **complex dynamics**.

$$(1+n) m_{t+1}$$



## Initial money stock

- ▶ Nothing in the model pins down  $m_0$ . Any value below  $m_{ss}$  is acceptable.
- ▶ There is a continuum of equilibrium paths.
- ▶ The reason: money is a bubble.
- ▶ As long as expectations are such that people are willing to hold  $m_0$ , we have an equilibrium.
- ▶  $m_0 = 0$  is also an equilibrium.



# Dynamic Efficiency

Does money solve the dynamic inefficiency problem?

- ▶ It might because it permits intergenerational trade.

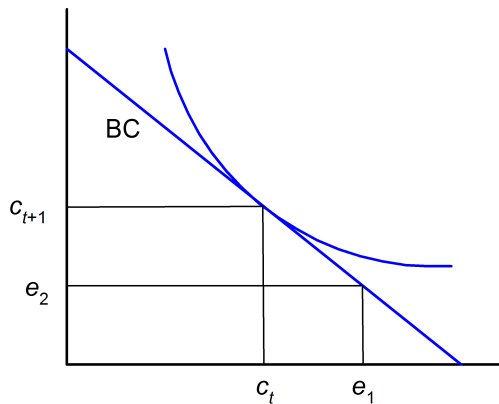
Two cases:

1. Samuelson case: the offer curve at the origin is flatter than  $1 + n$ ;
2. Classical case: it is steeper than  $1 + n$ .

# Dynamic Efficiency

- ▶ Why is the slope of the offer curve at the origin interesting?
- ▶ Because it is the interest rate in the non-monetary economy.
- ▶ Therefore:
  - ▶ Samuelson case: non-monetary economy is dyn. **inefficient**
  - ▶ Classical case: it is **efficient**

## Samuelson case



Non-monetary interest rate is  
 $< 1 + n$

At  $R = 1 + n$  households want  
to save

Money can be valued in  
equilibrium

## Classical Case

- ▶ The non-monetary economy is dynamically **efficient**.
- ▶ The offer curve is too steep to intersect the  $1 + n$  line.
- ▶ A monetary equilibrium does not exist.

Result:

Money is valued in equilibrium only in an economy that would be dynamically inefficient without money.

## Is this a good theory of money?

Good features of the OLG model of money are:

1. The outcome that money is valued in equilibrium is not assumed (e.g. because money yields utility or is simply required for transactions).
2. The value of money depends on expectations and is fragile.

The problem:

1. The model does not generate rate of return dominance.
2. A key feature of money seems to be missing: liquidity.

How to construct a theory of money that resolves the problems without introducing new ones is an open question.

# Fiscal Theory of the Price Level

# Model With Government Spending

We add government spending to the model and get an odd result.

Preferences, endowments, demographics are unchanged

Government

- ▶ buys  $G_t = g_t N_t$  goods
- ▶ prints money to finance the purchases

Markets: There are markets for goods and for money.

## Government Budget Constraint

The government budget constraint is

$$M_{t+1} - M_t = P_{t+1}G_{t+1}$$

Divide both sides by  $P_{t+1}N_{t+1}$ :

$$m_{t+1} = m_t / [(1+n)(1+\pi_{t+1})] + g_{t+1} \quad (18)$$

where  $m = M/(PN)$



## Household

The household problem is exactly the same as in the OLG model with one period bonds.

Young budget constraint:  $c_t^y = e_1 - x_t$ .

Old budget constraint:  $c_{t+1}^o = e_2 + x_t P_t / P_{t+1}$

Lifetime budget constraint:

$$c_t^y + c_{t+1}^o / R_{t+1} = e_1 + e_2 / R_{t+1}$$

where the real interest rate is now

$$R_{t+1} = P_t / P_{t+1}.$$

We get the saving function  $s(R_{t+1}; e_1, e_2)$  as usual from the Euler equation and the budget constraints.

# Equilibrium

A CE consists of sequences  $\{c_t^y, c_t^o, x_t, m_t, P_t\}$  that satisfy

- ▶ 3 household conditions (2 b.c. and saving function);
- ▶ government budget constraint (18);
- ▶ Goods market clearing:

$$c_t^y + c_t^o / (1 + n) + \underbrace{g_t}_{\text{new}} = e_1 + e_2 / (1 + n)$$

- ▶ Money market clearing:  $M_t = N_t P_t x_t$  or

$$x_t = m_t = s(P_t / P_{t+1})$$

## Offer Curve

Start from  $m_t = s(P_t/P_{t+1})$ .

Rewrite the government budget constraint as

$$P_t/P_{t+1} = (1+n)(m_{t+1} - g_{t+1})/m_t$$

Then:

$$m_t = s((1+n)(m_{t+1} - g_{t+1})/m_t), \quad (19)$$

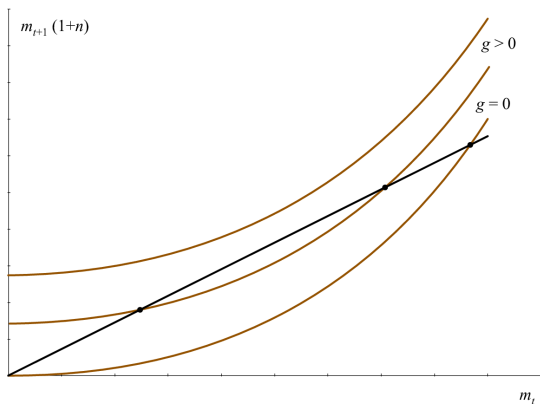
The offer curve now relates  $m_{t+1} - g_{t+1}$  to  $m_t$ .

With  $g = 0$  this is the model we studied earlier.

Assume

- ▶  $g$  is constant over time
- ▶  $s(1+n) > 0$  (Samuelson case).
- ▶ the offer curve is convex, but not backward bending.

## Offer Curve: Varying $g$



$g \uparrow$  shifts the offer curve up  
There is a continuum of equilibria indexed by  
 $m_1 \in (0, m^*)$

## Multiple Steady States

- ▶ There are two steady states.
- ▶ How do the 2 steady states differ?
- ▶ The lower steady state is stable, while the higher one is not.
- ▶ From the government budget constraint

$$1 = 1/[(1+n)(1+\pi)] + g/m$$

- ▶ A higher  $m$  implies a lower  $\pi$  (given  $g$ ).

## No Non-monetary Equilibrium

- ▶ The odd finding:  
With  $g > 0$  the non-monetary equilibria have disappeared!
- ▶ The reason: the government promises to violate its budget constraint in equilibria it does not like
- ▶ This is the essence of the “Fiscal Theory of the Price Level.”
- ▶ Government spending, via the budget constraint, determines the value of money in equilibrium.

## Reading

- ▶ Blanchard and Fischer (1989), ch. 4.1 [A clear exposition.]
- ▶ Krueger, "Macroeconomic Theory," ch. 8 discusses offer curves (can be found online).
- ▶ Ljungqvist and Sargent (2004), ch. 9 [Detailed.]
- ▶ McCandless and Wallace (1991)

## References I

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

Ljungqvist, L. and T. J. Sargent (2004): *Recursive macroeconomic theory*, 2nd ed.

McCandless, G. T. and N. Wallace (1991): *Introduction to dynamic macroeconomic theory: an overlapping generations approach*, Harvard University Press.