1 Introduction

This thesis studies some theoretical problems that arise in models of monetary economics. The intrinsically uselessness of contemporary money presents special challenges for economic theory. Unlike in the case of commodities which are objects of consumption or means of production, the demand for token money cannot be derived from exogeneously specified tastes and preferences. Rather the demand for money is a derived demand, arising from the role that money plays in the social processes of exchange and division of labour. It is true that one can formally view the institutions of exchange too as a form of technology, but it is, so to speak, economic technology and therefore its study cannot ultimately be kept outside of the realm of economics. In the present thesis we critically examine the different ways in which the existing literature has looked at the role played by money in a modern economy and argue in favour of a point of view that emphasises expectations and intertemporal linkages.

The plan of our work is as follows. In Chapter 1 we survey the existing literature. Contemporary research in monetary economics, as in macroeconomics as a whole, is marked by the effects of the Keynesian Revolution and sympathetic and critical responses to it. However, these response of-
1 Introduction

ten derive from ways of thought that predate Keynes. We therefore begin our survey from the eighteenth century contributions of Hume and look at the salient features of pre-Keynesian monetary theory before going on to discuss the Keynesian revolution, the responses and reactions to it and the emergence of the subject of the foundations of monetary economics in its present form.

Chapter 2 looks at theories which see money primarily as a means of exchange. While the importance of the means of exchange role of money has always been recognised by monetary economists, it has proved hard to provide a tractable framework for studying the precise sources and nature of transactions frictions and the tradeoffs involved in overcoming them through the use of money. This problem has been approached in recent times through the use of techniques from search theory and mechanism design. We critically examine the resulting models and note the limitations that continue to be imposed on these methods by requirements of tractability. These technical limitations apart, we argue that an emphasis on transactions costs faces the risk of ignoring the links between monetary variables and intertemporal terms of trade which are at the heart of mechanisms linking money to the real economy.

Intertemporal terms of trade take the centre stage in Chapter 3 where we set out the approach to monetary economics that we favour. Our approach follows the temporary equilibrium framework of Grandmont and his collaborators and is an intellectual descendant to the work of Keynes and Hicks. The model set out in this chapter aims to achieve two tasks.
1 Introduction

First, it shows that it is possible to develop a coherent theory of money without explicitly invoking the transactions role of money. Second, it shows that it is possible to have a monetary equilibrium in a competitive equilibrium model as long as the economy in the model is seen as existing in history, with pre-existing nominal contracts and expectations. We contrast the nature of equilibrium in this class of models with the equilibria of overlapping generations models which also ignore the transactions role of money. We also show how it is possible to model monetary policy in this framework and derive the constraints that need to be imposed on monetary policy rules to ensure the existence of monetary equilibria.

We have consciously chosen to call the subject of our study "intrinsically valueless money" rather than the more common phrase "fiat money". Contemporary money is of course both: it does not enter into production and consumption functions and it also has the backing of the State. Our decision not to explicitly introduce the State in the models in the study does not reflect a judgement on the importance of political factors but is more of an admission of our own lack of competence in analysing political and ideological aspects of money. We also felt that trying to explain the functioning of money in a purely private economy would still be a worthwhile exercise since the failures or shortcomings of this purely economic approach might help show us where non-economic forces play an important part. To what extent this is actually the case is taken up in the conclusion to this study. We also discuss the implications of this study for some other open problems in the foundations of monetary economics and briefly discuss the directions in
1 Introduction

which the present work can be further extended.