

Does Money Always Make People Happy?¹

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This paper presents an overlapping generations model with private information, in which the use of fiat money and the rampant moral hazard incentives sustain each other. It is shown that there is a monetary equilibrium, despite the fact that the rate of return on the nonmonetary asset is significantly higher than the rate of economic growth in the nonmonetary case; the valuation of money is not necessarily Pareto-improving, but rather can be harmful to almost all generations; an inflationary policy can improve the welfare of all generations except the initial one. *Journal of Economic Literature* Classification Number: E41. © 2001 Academic Press

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1. INTRODUCTION

This paper explores a possible interaction between positive valuation of fiat money and rampant moral hazard incentives in an overlapping generations model. Since the pioneering work of Samuelson (1958), many economists have examined a variety of overlapping generations models in order to find the conditions for fiat money having positive value and its welfare implications. It now seems to be a shared view that an overlapping generations model exhibits both monetary and nonmonetary equilibria if and only if the long-run dominance of the economy's growth rate over the interest rate holds in the nonmonetary case and that the valuation of fiat

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money leads to an improvement in economic welfare.² Such conclusions, however, are not necessarily true in an environment where the valuation of money causes a moral hazard problem, which, in turn, motivates individuals to hold money.

In the model described below, young agents must save for their old age, either by hoarding fiat money or by inputting their endowments into an investment project the return on which is random but publicly observable, and investment risks are offset when aggregated. The expected rate of return on investment activity dominates the economy's growth rate. Thus if full insurance against risky returns is provided, money cannot have positive value. It is also assumed that neither individual investment activity nor individual money hoarding is publicly observable. Under this informational asymmetry, it is impossible for insurers to identify the cause of an observed zero investment outcome. Hence, when money has a positive value, each agent has a moral hazard incentive. That is, there is an incentive to claim investment of all of the endowment though he or she actually invests a zero amount, thus ensuring a zero outcome so as to collect an insurance indemnity, while selling extra goods for money revenue. As will be shown, this model has a nonmonetary equilibrium and a stationary monetary equilibrium. In the nonmonetary equilibrium, investors are completely insured against the risky returns. Despite the unobservability of their investment activities, competitive insurers securely provide them with full insurance, because in that equilibrium young agents have no saving option other than to pursue the investment activity. In the stationary monetary equilibrium, in contrast, investors are only partially insured. There, the valuation of money exacerbates moral hazard incentives on the part of investors, which leads to incomplete insurance coverage. To supplement this underinsurance, the investors choose to hoard money, which ensures its positive value.

Three striking results are reported. First, in contrast to the shared view, the model exhibits a monetary equilibrium, despite the fact that the long-run interest rate unambiguously dominates the economy's growth rate in the nonmonetary case. As stated above, the valuation of money provides a side-trading opportunity for individuals, which reduces the rate of return on investment activity to a level rendering a monetary equilibrium feasible. Second, the valuation of money does not lead to an improvement in economic welfare. Rather, it is detrimental to all generations except the initial one, because the insurance coverage in a monetary equilibrium must

² The long-run dominance of the growth rate over the interest rate in the nonmonetary equilibrium may result from dynamic inefficiency [see, e.g., Samuelson (1958), Wallace (1980), Tirole (1985)] or from some sort of private information [see, e.g., Freeman (1985), Williamson (1992), Azariadis and Smith (1993)]. In both cases, the valuation of money is shown to be Pareto-improving: it mitigates dynamic inefficiency in the first case and mitigates the inefficiencies due to private information in the second case.

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