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Payments, credit and asset prices

(co-authored with Monika Piazzesi)

Abstract

This paper studies a modern monetary economy: trade in both goods and securities relies on money provided by intermediaries. While money is valued for its liquidity, its creation requires costly leverage. Inflation, security prices and the transmission of monetary policy then depend on the institutional details of the payment system. The price of a security is higher if it helps back inside money, and lower if more inside money is used to trade it. Inflation can be low in security market busts if bank portfolios suffer, but also in booms if trading absorbs more money. The government has multiple policy tools: in addition to the return on outside money, it affects the mix of securities used to back inside money.