

The Maturity Structure of Inside Money

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February 14, 2015

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Abstract

In practice, bank liabilities circulate, acting as inside money. What are the implications of the usefulness of these liabilities to facilitate trade for the bank's choice of maturity structure? Suppose that a bank finances illiquid long term real assets with long and short term financial claims. The households purchasing these claims use them as inside money to trade in a sequence of decentralized markets. Trade in decentralized markets is subject to search frictions as in Rocheteau and Wright (2005).

The maturity structure of the bank's financial claims impacts their usefulness in facilitating trade and the bank's costs from liquidating long term real assets. Too much short-term money leads to excessive early liquidation of real long term assets, reducing the ability of inside money to facilitate trade in decentralized markets. Too much long-term money leads to too little costly liquidation of real assets, also reducing the ability of the inside money to facilitate decentralized exchange. The optimal maturity structure minimizes the cost of asset liquidation and maximizes the usefulness of the bank's claims in facilitating trade. We examine how the severity of the search frictions, the cost of early reversals, and the riskiness of the long-term real assets impact optimal maturity of the bank's inside money.