

An Idealized View of Financial Intermediation
By Carolyn Sissoko

Review

The author develops a two cycle model of trading to motivate a medium of exchange role for money. Within a period, $\frac{1}{2}$ of the agents are consumers and $\frac{1}{2}$ are sellers (have endowments) in the first subperiod, then the roles are reversed in the second subperiod. The competitive equilibrium gives every agent the same consumption of each good each period. In a monetary economy, the first-best allocation can be attained only if the Friedman rule is following – a zero nominal interest rate and prices deflating at the rate of time discount. She then considers an inside money economy with default free intermediaries. The claim is that default-free intermediaries are the critical feature that makes the inside money equilibrium generate the first-best allocation. As long as agents do not face binding credit constraints, then inside money will generate the first-best allocation.

While the question addressed is a fundamental issue in monetary economics and the model appropriate for studying this issue, I do not think the author truly understands what is driving her results, nor do I think she has correctly solved the model.

Comments:

1. As I read the description of endowments, it appears that agents receive different sized endowments. On page 2 it states “Each consumer is endowed with a quantity y of one good every period where $y \in \{1, 2, \dots, k\}$.” This must be true given the definition of the endowment of each good. This implies that agents have **permanently** different lifetime endowment streams. So would one expect that each agent have the same credit constraint as is assumed in (22)?

2. The default condition, page 12. Why are you suddenly assuming that the discount factors are different? If they are, then everything in the monetary economy is wrong and the Friedman rule cannot possibly generate the competitive allocation (see Camera and Boel, JME 2006 for proof of this.)

3. The appropriate way to model the default problem is not to pick β to satisfy it – the discount parameter is a deep parameter. It is trivially to show that for β close to 1 everyone repays. The more interesting case is when β is not close to 1. Then you have to choose the credit constraint for each agent such that they voluntarily repay credit.

4. I don't quite understand the derivation of the default condition. Agents get utility from all goods. If an agent defaults he can only eat the endowment he receives of the ONE good. So what is $u(0)$ for the other goods? Is it negative infinity as it would be with log utility? Is it zero? Without this specification, it's hard to see what the default payoff is.

5. Do not change the environment when you introduce money; it makes no sense to introduce a different environment (with two subperiods) when introducing money. Do it from the beginning.

6. I do not get what it means to say "Consumption takes place at the end of the second subperiod." Does this mean goods are durable across subperiods? If so, why use money? Let sellers in subperiod 1 receive their endowments, hold onto them and barter with the subperiod 2 sellers for goods and consume. Done. If the goods are perishable in each subperiod, then things are not solved correctly.

7. In this paper, credit card companies are record-keeping technologies from what I can see. This is not typically what one means by inside money. Inside money would be a tangible object that can be passed hand to hand. Why does this matter? If inside money were a durable object (fully backed by commodities from the private issuer) then agents could default and still use inside money to trade in the future. A seller would sell for this object and hold onto it to purchase goods in the future. This means agents still have the outside option of trading with a medium of exchange even if they are booted out of the recordkeeping technology. See Berentsen, Camera and Waller (JET forthcoming) for more on this point.

8. Credit card companies are not default free here – if all borrowers failed to repay their loans, the credit card company would default with probability one. They are simply recordkeeping technologies. The credit card companies' creditworthiness is only as good as the creditworthiness of the borrowers. In short, their creditworthiness is a 'derivative' of their own assets. So do not argue that the key reason for the inside money economy generating the competitive allocation is because CCC are default free.

9. page 9; just before bullet list item i); you say "the economy can reach the first best..". You have never defined the first best allocation in this paper and it is NOT the competitive allocation. Why? Because agents have different endowments! The first best allocation would redistribute resources away from the high endowment types to the low endowment types to equate marginal utility of consumption across agents for each good. Of course this would require enforcement such as coercive taxes but it's still the first-best allocation.