

A Finance Theory of Credit-Money and Inflation

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Wallace, Sargent and Smith have shown that the value of fiat money is determined by the value of the assets backing it. Their theory is extended to Black's (1970) model in which the only medium of exchange is credit-money (bank deposits) created as a result of the financing decisions of firms. Optimizing behavior by shareholders in a perfect competition, rational expectations environment produces equilibrium values for the marginal debt-capital ratio, the rate of inflation and the economic growth rate. Price stability can be maintained by adopting Wicksell's monetary policy rule for the banking system's base interest rate.

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