On Separation between Payment and Saving Instruments

Hajime Tomura*

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Abstract

This paper presents a parsimonious model to analyze why the central bank, which issues payment instruments, and commercial banks, which supply saving instruments, must be separated from each other. Credit creation by commercial banks improves risk sharing in the economy, as commercial-bank IOUs can serve as payment instruments pooling idiosyncratic default risks of IOUs issued by payers. If there is sunk cost of production, however, this characteristic of commercial-bank IOUs also involves the possibility of a self-fulfilling run due to payees' refusal of the IOUs. The parameter space in which a self-fulfilling run can happen shrinks if commercial banks pool IOUs issued by payers in a separate entity and supply the separate entity's IOUs to payers as payment instruments. This condition is satisfied if the central bank re-discounts IOUs issued by payers.

*Faculty of Political Science and Economics, Waseda University, 1-6-1 Nishiwaseda, Shinjyuku-ku, Tokyo, 169-8050, Japan. Email: tomura.hajime@gmail.com. I am grateful for financial support from JSPS Grant-in-Aid for Scientific Research (16K03756).