LIQUIDITY MOTIVES OF HOLDING MONEY UNDER INVESTMENT RISK: A DYNAMIC ANALYSIS*

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Abstract

Jones and Ostroy (1984) argue that money, as an asset of the least transaction cost, offers flexibility to its holder, which other assets cannot provide. We extend the idea of Jones and Ostroy into a truly dynamic framework of infinite horizon with a risk-neutral decision-maker. We then investigate the effect of an increase in investment risk on the demand for liquidity à la Jones and Ostroy. In particular, we prove that the optimal strategy exists, that it has a reservation property, and that the reservation value increases when investment risk increases in the sense of a mean-preserving spread. While the effect of a mean-preserving spread on the reservation value is unambiguous, its effect on money demand is ambiguous. We then provide conditions on increasing investment risk under which money demand unambiguously increases.

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