"Money, Credit and Imperfect Competition Among Banks"

Allen Head (Queen's), Timothy Kam (ANU/SKKU), Ieng-Man Ng (ANU), Isaac Pan (Sydney)

Abstract

This paper develops a micro-founded monetary framework where bank market power in lending is endogenous and responds to policy. We study its equilibrium consequences for financial intermediation, allocations and welfare. Calibrated to match the empirical money demand relationship, the model also matches the co-movement between the average bank markup and the policy interest rate in macro data. We show that noisy consumer loan search generates in equilibrium a non-degenerate distribution of loan interest rates, the characteristics of which rationalize the empirically observed relationship between the dispersion and average level of bank lending markups at both the U.S. national and state levels. Further, we find that financial intermediation need not be welfare-improving if inflation is sufficiently low, a result which speaks to concerns regarding market power in the banking sectors of low-inflation countries. Lastly, there is a role in equilibrium for demand stabilization via the central bank's liquidity-management ("elastic currency") policy given a long-run inflation target. Efficiency gains arise from the central bank's ability to reduce the ability of banks to exploit their market power in loan pricing.

JEL codes: E41; E44; E51; E63; G21
Keywords: Banking and Credit; Noisy Search; Dispersion; Financial Stability; Policy