IWH Halle Institute for Economic Research
Member of the Leibniz Association

IWH Research Seminar in Economics

Monday, June 4, 2018, 2.15pm – 3.45pm, conference room, ground floor

Interest Rates, Market Power, and Financial Stability

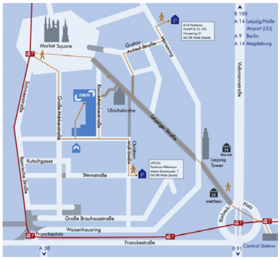
Professor David Martinez-Miera, University of Madrid

(together with Professor Rafael Repullo, CEMFI, Madrid)

This paper analyzes the effects of policy rates on financial intermediaries' risk-taking decisions. We consider an economy where (i) intermediaries have market power in granting loans, (ii) intermediaries monitor borrowers which lowers their probability of default, and (iii) monitoring is not observable which creates a moral hazard problem. We show that lower policy rates lead to lower intermediation margins and higher risk-taking when intermediaries have low market power, but the result reverses for high market power. We also show that when intermediaries have high market power competition from (non-monitoring) financial markets results in a U-shaped relationship between policy rates and risk-taking. The paper examines the robustness of these results to introducing heterogeneity in monitoring costs, entry and exit of intermediaries, and funding with deposits and capital.

Scientific contact at IWH:
Professor Michael Koetter, PhD
Tel +49 345 7753 771, Michael.Koetter@iwh-halle.de

Halle Institute for Economic Research (IWH) – Member of the Leibniz Association
Kleine Maerkerstrasse 8, D-06108 Halle (Saale)
Tel +49 345 7753 60, Fax +49 345 7753 820



Leibniz Association

www.iwh-halle.de/en