

Bank Liquidity Preference and the Investment Demand Constraint

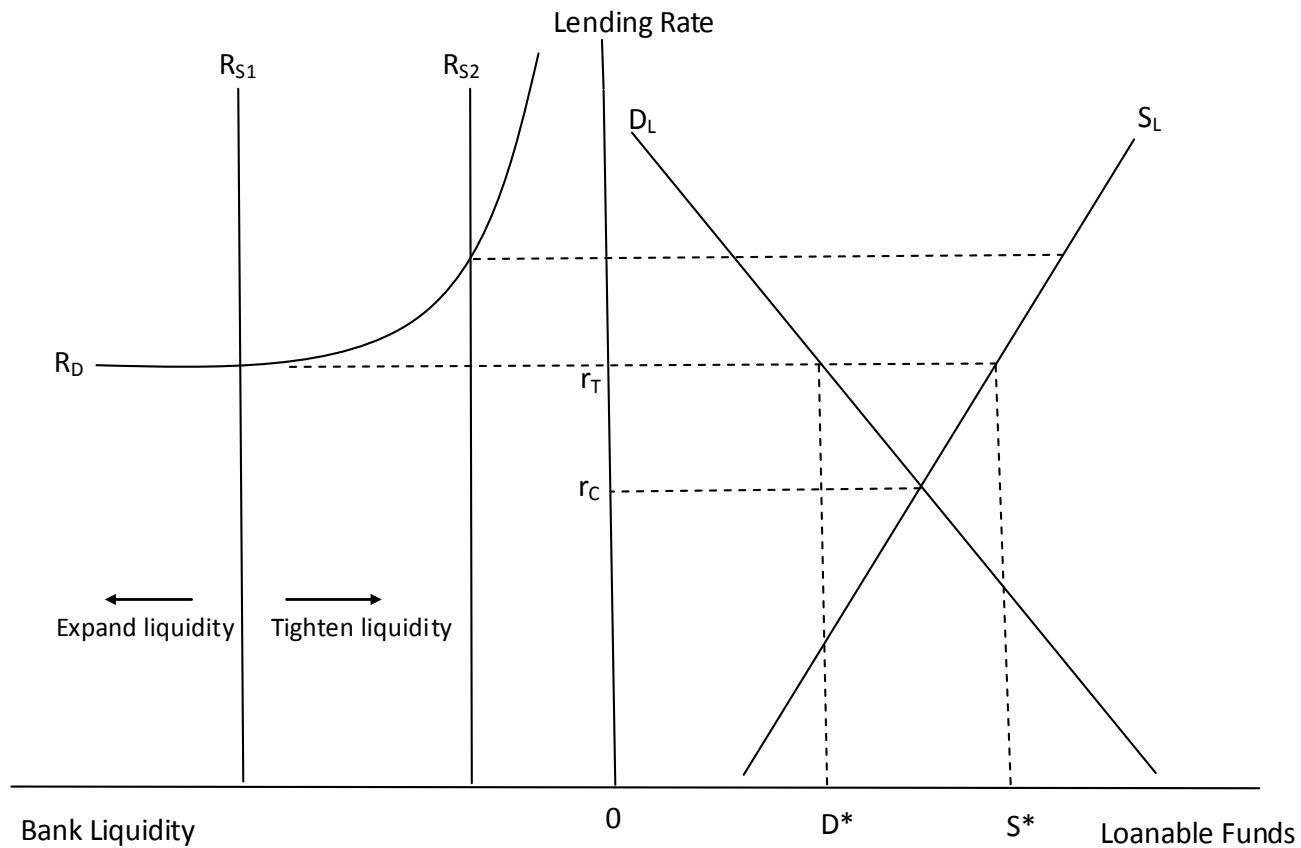
- This paper develops a theoretical framework in which the liquidity preference of oligopolistic commercial banks creates an investment demand constraint.
- The paper analyzes monetary policy (namely liquidity management) under a regime of an investment demand constraint.
- The hypothetical situation of a liquidity trap is also analyzed using the proposed model framework.

- It is noted that the **liquidity trap** is more likely to occur in a financial structure where **capital markets are dominant**. On the other hand, the investment demand constraint is more likely to occur in **bank dominated structures**, which is the case in developing economies.
- The paper presents another interpretation of the investment demand constraint that was proposed by Rodrik and Subramanian (2009). For RS (2009) the investment demand constraint comes from the **appreciation of the real exchange rate**. In this paper the constraint comes from the **mark-up interest rate of oligopolistic banks**.
- The liquidity preference of oligopolistic banks is represented by a **reciprocal function** in loan rate-bank reserves space.

How is this work different?

- This work has several features that are different from my previous attempts to model oligopolistic banks and liquidity preference. The main differences in this effort include: (i) The Framework is **dynamic**. (ii) It is based on **three equations**. (iii) **Non-zero lower bound lending rate threshold (the mark-up lending rate)**.

Diagram showing the investment demand constraint



- The Reserve-Loan Equation

$$L_{Dt} = \frac{1}{\gamma}(r_T - r_{Lt-1}) + \frac{\beta}{\gamma}R_S^{-1}$$

- The Augmented IS Equation

$$Y_t = \alpha_r(r_t - \pi_{t-1}) + \alpha_L L_{Dt} + \sigma_Y \varepsilon_t$$

- Dynamic Phillips Curve

$$\pi_t = \lambda \pi_{t-1} + \phi(Y_t - Y^*)$$

- The three equations are solved recursively to obtain **dynamic multipliers**

See research paper.