Monetary Policy, Credit Markets and Banking Regulation*

Todd Keister
Rutgers University
todd.keister@rutgers.edu

Daniel Sanches
Federal Reserve Bank of Philadelphia
daniel.sanches@phil.frb.org

February 15, 2016

Abstract

We study a model in which both money and private credit instruments can potentially be used as media of exchange to overcome trading frictions in decentralized markets. Entrepreneurs in our model have access to productive projects, but face credit constraints due to limited pledgeability of their returns. If credit claims cannot circulate, the optimal monetary policy is the Friedman rule, which leads to efficient patterns of exchange, but the equilibrium level of investment is inefficiently low. When credit claims do circulate, monetary policy affects the liquidity premium on private credit and thereby influences the cost of borrowing and the level of investment. The Friedman rule is no longer optimal; we show that the optimal policy instead strikes a balance between easing borrowing constraints for entrepreneurs and promoting efficient exchange. We relate our result to the traditional bank lending channel of monetary policy and derive implications for optimal banking regulation.

JEL classification: *E32, E42, E52, G28.*

Keywords: *Monetary theory and policy, Liquidity premium, Friedman rule, Investment, Bank lending channel, Investment*

*Preliminary and incomplete. Prepared for submission to the 2016 SED meetings. The views expressed herein are those of the authors and do not necessarily reflect those of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.