Financial Frictions: Micro vs Macro Volatility*

Seungcheol Lee[†], Ralph Luetticke[‡], Morten O. Ravn[§]

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Abstract

We introduce frictional financial intermediation into a HANK model. Households are subject to idiosyncratic and aggregate risk and smooth consumption through savings and consumer loans intermediated by banks. The banking friction introduces an endogenous countercyclical spread between the interest rate on savings and on loans. This interacts with incomplete markets because borrowers and savers face different intertemporal prices, and induces a time-varying mass point of high MPC households. Aggregate shocks through their impact on the spread give rise to consumption inequality. We show this mechanism to be empirically relevant. Ex-ante macro prudential regulation reduces welfare by reducing consumption smoothing.

JEL Codes: C11, D31, E32, E63

Keywords: Business cycles, financial frictions, incomplete markets, macroprudential regulation, monetary policy.

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[†]Bank of Korea

[‡]University College London and the CEPR

[§]University College London and the CEPR