Financial Market Participation, Cost Volatility, and Demand Shocks

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Abstract

This paper extends a tractable monetary model as in Lagos and Wright (2005), so that the cost-bound agent can decide whther to gain credit access in a search-based decentralized market. We show that the agent whose idiosyncratic credit cost is higher than the threshold level will opt out of credit access and carry money, and that the aggregation is achieved through the threshold level which is affected partly by the cross-sectional volatility of credit cost, nominal interest rate, and inflation. Hence, the changes in participation on the credit market generates the fluctuation in terms of the extensive margin, and impulse reponses to the target inflation shock are consistent with those from the VAR analysis.

JEL Clssification: C5, E4, E5
Keywords: Extensive margin; Mean-preserving spread; Credit cost; Search-theoretic DSGE model; Bayesian analysis

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