On financial frictions and firm's market power*

Miguel Casares — Universidad Pública de Navarra

Luca Deidda† — Università di Sassari

Jose E. Galdon-Sanchez — Universidad Pública de Navarra

September 27, 2022

Abstract

There are two opposing welfare effects of market power in a model with monopolistic competition, loan defaults and moral hazard. The loss of output produced if firms set a higher mark-up over marginal costs confronts with some gain due to higher expected profits and the reduction of defaults. Such tradeoff results in an optimal level of market power that decreases with the efficiency of liquidation following default on a loan. If moral hazard is pervasive, credit rationing cuts down the default rates and mitigates the welfare cost of financial frictions.

JEL Classification: E44, G21, G33.

*We thank Dominik Thaler, three anonymous referees and the editor for helpful comments and suggestions, and Banco de España for the project "Política monetaria en economías con fricciones financieras y bancarias". Miguel Casares and Jose E. Galdon-Sanchez also acknowledge Spanish *Ministerio de Ciencia, Innovación y Universidades* for research project PGC2018-093542-B-100. Luca Deidda also acknowledges the financial support by the Italian Ministero dell'Università (Grant No. 20157NH5TP), Fondazione di Sardegna, Università di Sassari (Una tantum 2019), and RAS (Grant No. RASSR89213).

†Corresponding author. Postal address: Dipartimento di Scienze Economiche e Aziendali, Via Muroni, 25, 07100, Sassari (Italy). Telephone: +39 079213542. E-mail: deidda@uniss.it