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Interest Rates and Prices in an Inventory Model of Money with Credit*

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Abstract

Using a segmented market model that includes state-dependent asset market decisions along with access to credit, we analyze the impact that transactions credit has on interest rates and prices. The availability of credit allows agents to significantly smooth consumption, reduce the movements in velocity, prices become quite flexible and liquidity effects are dampened. As credit costs decline in the model so does the effectiveness of monetary policy. We also investigate the recessionary consequences of a shock to the cost of credit, and find that the model's predictions align well with the empirical evidence.

Keywords: Segmented markets, Credit, Money

JEL classification numbers: E31, E40, E41, E43

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