

Optimal Contracting and Spatial Competition among Financial Service Providers

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Abstract

We present a contract-based model of industrial organization for markets characterized by information and other frictions (Moral Hazard, Adverse Selection, Limited Commitment etc) and different market structures (Monopoly, Oligopoly, Competition), the latter driven by spatial costs, logit errors, and number of financial service providers. Our methods work in a variety of settings and links to recent literature: changes in the number of bank branches in the US or China, experiments varying intermediation in Kenya, and competition of local relationship banks with less-informed national banks. Model simulations show the sensitivity of difference-in-difference statistics to the interaction of contracting frictions and market structure. We derive a likelihood estimator for the structural parameters that determine contracting frictions and market structure and apply this to the Townsend Thai data on entrepreneurs with secondary data on bank locations. Reducing spatial costs by 50% is equivalent to increasing consumption by 4.85%, which we compare to other policies. But crucially, we also establish methods that do not need to specify both frictions and market structure., depending on the counterfactual of interest and available data.

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