



# Imperfect Competition in the Interbank Market for Liquidity as a Rationale for Central Banking

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## Abstract

We study interbank lending and asset sales markets in which banks with surplus liquidity have market power vis-à-vis banks needing liquidity, frictions arise in lending due to moral hazard, and assets are bank-specific. Surplus banks ration lending and instead purchase assets from needy banks, an inefficiency more acute during financial crises. A central bank acting as a lender-of-last-resort can ameliorate this inefficiency provided it is prepared to extend potentially loss-making loans or is better informed than outside markets, as might be the case if it also performs a supervisory role. This rationale for central banking finds support in historical episodes. (JEL E58, G01, G21, G28, L13, N21)

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## Additional Materials

[Online Appendix \(139.68 KB\)](#)

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## JEL Classification

**E58** Central Banks and Their Policies

**G01** Financial Crises

**G21** Banks; Other Depository Institutions; Micro Finance Institutions; Mortgages

**G28** Financial Institutions and Services: Government Policy and Regulation

**L13** Oligopoly and Other Imperfect Markets

**N21** Economic History: Financial Markets and Institutions: U.S.; Canada: Pre-1913

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