Product Market Competition and Financial Market Screening

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Abstract

How is the financial market condition interrelated to the product market condition? I introduce heterogeneous firm model to financial intermediary screening model to answer this problem. Product market selection has a significant effect in my model: whether or not unproductive entrepreneur quit to enter product market, properties of the model change. First, without selection, intermediaries screen entrepreneurs more severely in a highly differentiated product market; with selection, screening efforts do not depend on product differentiation. Second, without selection, the interest rate spread is not correlated to trade cost; with selection, the interest rate is correlated to trade cost. Third, without selection, high R&D cost implies high productivity of entrants; with selection, opposite is happened.

In contrast to previous studies, inefficient screening technology implies low interest rate spread and a high entry rate: i.e. intermediaries are successfully paid back the money more often when screening technology is inefficient than when screening technology is efficient.

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