Central Bank Haircut Policy*

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August 17, 2009

Abstract

The paper develops a model to study the optimal choice of the central bank haircut policy. In the presence of uncertainties regrading liquidity needs and asset prices, there is a trade-off between providing liquidity to constrained agents and controlling the abundance of liquidity in the economy. The choice of the haircut involves balancing impacts on the liquidity positions of agents with different portfolio choices and different liquidity needs. In general, a full haircut and a zero haircut are both sub-optimal. The optimal choice will depend on the relative tightness of agents' liquidity constraints, the predictability of the liquidity shocks, and the volatility of asset prices. The optimal haircut is higher when the central bank is unable to lend exclusively to agents who actually need liquidity. Finally, for a temporary, surprise drop in the haircut, the central bank can be more aggressive than setting the permanent level of the haircut.

J.E.L. Classification Numbers: E40, E50

Keywords: collateral, haircut, liquidity, central bank, monetary policy, search theory

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*We have benefited from the comments and suggestions from Lindsay Cheung, Brett Stuckey, participants in seminars at the Bank of Canada, Bank of England and Workshop on Central Bank Liquidity Tools at the Federal Reserve Bank of New York. The views expressed in the paper are those of the authors. No responsibility for them should be attributed to the Bank of Canada. This is a preliminary and incomplete draft.

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1 Introduction

When a lender seeks to make a collateralized loan of some liquid asset from a borrower the value of the collateral is subject to a discount or "haircut" to ensure that in the event of a default the collateral can be liquidated to repay the loan fully; since the price of the collateralized asset may have declined in the intervening period. The typical way these haricuts are calculated in the private sector—as described in Garcia and Gençay (2006, section 6.2)—is via an examination of the historical volatility of the collateral and calculating a haircut to minimize the loss of the lender. This is an appropriate methodology for a market participant who as little market power and where the net amounts of collateral or the liquid asset are fixed.

In contrast, a central bank is a large market participant in interbank and other funding markets. In addition, it has the unique ability to create liquid assets in the form of central bank liabilities. Therefore, we make the case below that the typical calculations for calculating haircuts as described in Garcia and Gençay (2006) and related risk management literature referenced therein is not appropriate for a central bank; which must take into account the effect its operations have on the portfolio decisions of other financial market participants.

In this paper we examine how a central bank should make loans of a liquid asset (in this case money) that are collateralized by illiquid and risky assets. This is an important theoretical question since in an economy with decentralized trading and idiosyncratic liquidity shocks, the equilibrium allocation is typically inefficient because some agents are liquidity constrained due to their ex-post excessive holding of illiquid assets. This inefficiency leads to a role for a central bank in creating and distributing liquidity.

In this economy, a benevolent central bank may desire to provide liquidity to constrained agents by using a lending facility. This facility is similar to the facility studied by Berentsen and Monnet (2008) with the exception that we relax the assumption of perfect enforcement that they assume. In the lack of perfect enforcement of these loans illiquid assets can be taken as collateral for borrowing the central bank loans. However, the value of this collateral can change over time and it is therefore necessary to require a pledge of collateral large enough to adequately cover losses in the event of a default.[1] The magnitude by which the initial value of the collateral is discounted via a haircut.

One may argue that it is *ex-post* efficient to impose a low haircut in order to effectively insure agents against their idiosyncratic liquidity shocks. What is ignored is that, as long as the central bank is not setting a full haircut, the lending facility provides not only insurance against liquidity shocks, but also provides insurance against asset price declines. Therefore, by changing the haircut an agent's initial portfolio is affected since their incentive to default and therefore the returns to different assets will be change endogenously.

We show that lowering the haircut will have different effects on agents depending on both their portfolios and liquidity needs. On the one hand, it can relax the liquidity constraint of illiquid asset holders. On the other hand, it will lower the value of liquid assets (e.g. money) by both reducing the returns to holding liquidity and increasing the cost of holding liquidity. Therefore, it will tighten the liquidity constraint of liquid asset holders. As a result, there is a trade-off between lowering the haircut and lowering the interest cost of holding liquidity. In general, in the absence of instruments to freely withdraw extra liquidity from the economy (such as lump sum taxation), it is not feasible for a policy-maker to lower the haircut and the interest rate simultaneously. The choice of the haircut involves balancing the impacts on the liquidity positions of different groups.

The optimal choice will depend on the relative tightness of agents' liquidity constraints, the relative sizes of different groups (which in turn depends on the

[1] In addition the haircut has to be sufficient to induce the lender to repay the loan and not default if strategic default is allowed.

predictability of the liquidity shocks), and the volatility of asset prices.

In addition, We would also point out that one key factor is whether the central bank is able to lend exclusively to agents who actually need liquidity. When exclusive lending is not feasible, the cost of providing liquidity insurance to the illiquid asset holders by lowering the haircut becomes more costly in terms of distorting the liquid asset holders' liquidity constraint. Owing to this trade-off, it is generally not optimal to set the haircut too low.

Finally, we also illustrate that, if the central bank can commit not to repeat in the future, a temporary, surprise cut in the haircut can be welfare improving.

Our model fits in the recent literature that deals with how the central bank's operating procedures can effect the allocation of the economy. Specifically our paper is closely related to the papers by Berentsen and Monnet (2008) and Martin and Monnet (2008). Examples of related work in this area are Chapman and Martin (2007) and Suárez-Lledó (2009).

The rest of the paper is organized as follows. In section 2 we provide detailed description of how the model environment as well describing the equilibrium. We provide a characterization of an equilibrium solution in section 2.4 and provide additional description and numerical examples for a special case of the model in section 4 before going on to the general case in section 5. Finally we conclude in section 6.

2 Model

This paper aims to develop a model to study the design of the hair-cut policy in the Canadian Large Value Payment System (LVTS). We provide an overview of the model before going into the mechanics of the model.

2.1 Overview

The model builds on four key features to motivate the role of the hair-cut policy. First, agents make a portfolio choice between liquid and illiquid assets. Second, idiosyncratic liquidity shocks realize after they make their portfolio choice. Therefore, some agents may end up holding too much illiquid assets when they are facing a high liquidity need. In the absence of intra-day interbank money market, there is a role for the central bank lending facility. Third, these loans are subject to potential default by the borrowers. This motivates the need to require borrowers to pledge collateral. Fourth, the asset price of the collateral is uncertain. This generates the need to impose a haircut on the collateral. We will use this model to study how changing the hair-cut policy will induce the endogenous response of default and portfolio choice. When the central bank does not possess the fiscal power to collect revenue from agents through non-distortionary tax instruments, there exists a trade-off between liquidity insurance and the distortion generated by decreasing the hair-cut.

The model is an infinite horizon model where each period consists of three alternating markets: a centralized asset market (denoted AM), a decentralized goods market (denoted DM), and a centralized goods market (denoted CM). Our model bases on the alternating market formulation from Lagos and Wright (2005), and liquidity shocks of Berentsen and Monnet (2008). This allows us to study frictions in the inter-bank market but still have frictionless trade in the asset market and the goods market.

There is a continuum of infinitely lived anonymous agents. As in Berentsen and Monnet (2008), one can interpret each of these agents as a consolidated unit consisting of a bank and their clients.[2] In each period, agents participate in these three consecutive markets. In the first subperiod an asset market opens where agents make portfolio choice between liquid and illiquid assets in the

[2]We think that modeling the bank-client relationship explicitly is interesting, but may not be of first order importance for the main question of the paper. We will leave this extension for future research.

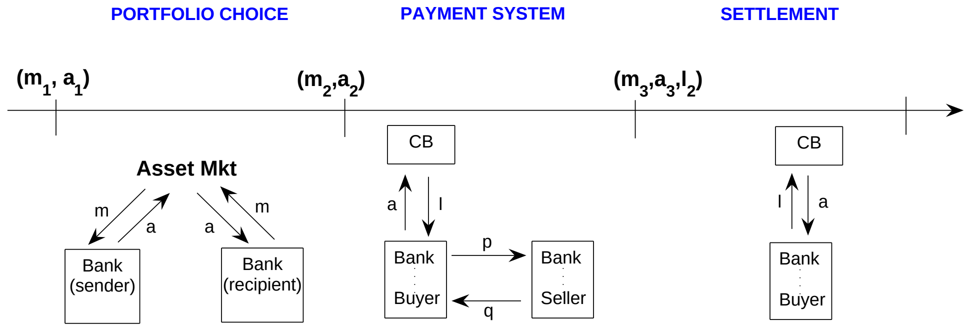

Figure 1: Timeline of Markets and Actions in a Given Period t

AM. In the second subperiod agents trade goods against the liquid assets in a decentralized fashion in the DM. We interpret this market as banks sending payments to each other in the payment system to settle the goods transactions among their underlying clients. IN the second market The central bank provides intra-day collateralized loans to agents that are subject to a hair-cut. In the third subperiod, agents enters the third centralized market to trade a numeraire good and to settle their intra-day loans with the central bank. The timeline of these markets is given in figure 1.

To introduce an interesting portfolio choice into the model, we assume that there are two assets: a liquid asset and an illiquid asset. The liquid asset is the only asset that is acceptable as a means of payment in the DM. It is denoted by m_t, and can be interpreted as fiat money or bank reserves. The supply of the stock of this asset is controlled by the central bank. The illiquid asset is denoted by a_t. It is illiquid because it cannot be used as a means of payment in the DM. One can interpret it as claims to investment projects held by the agents. For simplicity, we assume that each agent is endowed with A one-period projects at the beginning of a period. yields certain amounts of CM numeraire goods at the end of a period (in the CM). To introduce the feature of asset price uncertainty, we assume that the return of the illiquid asset is a random i.i.d. (over time and across owners) variable. The price of these projects are denoted by ψ.

At the beginning of each period, each agent receives a noisy signal which suggests whether an agent is likely to be a payment sender (buyer) in the DM (i.e. high liquidity need), or likely to be a payment recipient (seller) in the DM (i.e. low liquidity need). Given the signal, agents trade in the AM and make portfolio choice of liquid asset m and illiquid asset a. Typically, an agent expecting high liquidity need will choose to hold more liquid asset, and one expecting low liquidity need will choose more illiquid asset.

To introduce idiosyncratic liquidity shocks, we assume that the signal will turn out to be incorrect with a positive probability. In particular, after the portfolio choice is made, an agent enters the DM and observes the realization of his/her trading status: buyer (i.e. payment sender) or a seller (i.e. payment recipient). Since trading in the DM is subject to liquidity constraint (only m is acceptable as means of payment), some agents will end up holding too much illiquid asset when they want to purchase goods. Their liquidity constraints can be relaxed by borrowing from the central bank's intra-day lending facility. Before trade, agents have access to this facility and borrow a nominal loan l by posting illiquid asset a, subject to a hair-cut h, implying the following borrowing constraint

$$l \leq a\psi_2(1-h),$$

where ψ_2 is the price of the asset when the loan is lent out in the second sub-period. This loan has to be settled in the CM in the third sub-period.[3] To introduce the role of strategic default, we assume that at the beginning of the CM, the values of all projects become public information, and after that borrowers decide whether to settle the loan (and get back the asset) or to default (and lose the asset). In the absence of additional punishment device, a

[3]Intra-day loans are interest free in the LVTS, therefore we make this assumption here.

borrower who has pledged asset a and borrowed l will default if[4]

$$l \geq a\psi_3,$$

where ψ_3 is the price of the asset when the loan is repayed in the third subperiod. So borrowers choose to default whenever the realization of the asset value is low.

We use this model to study the equilibrium effects of the hair-cut on the default decision, consumption, asset prices, portfolio choice and welfare. We found two key elements in determining the optimal level of the hair-cut.

First, the model implies that the lending facility is indeed providing a bundle of two insurances: an insurance against the liquidity risk and an insurance against the downside risk of the illiquid asset. On the one hand, lowering the hair-cut relaxes the liquidity constraint of the illiquid agents (which can be welfare improving). On the other hand, it also provides the borrowers an option to shift the investment loss to the central bank when the value of the asset turns out to be low (which is not welfare improving). As a result, decreasing the hair-cut will make illiquid asset more attractive, and may distort agents' portfolio choice: inducing an agent with high liquidity need to hold a portfolio which is illiquid.

Second, lowering the hair-cut will increase the exposure of the central bank. When lump-sum taxation is not an instrument available to the central bank, liquidity loaned out for payment may not be fully re-absorbed if the borrowers default. This will increase potential inflation, and the equilibrium opportunity

[4]In general, one can assume that default also involves a cost of R (e.g. punishment, reputation cost). As a result, an agent will default only if $l \geq a\psi_3 + R$. When R is a finite number, agents may still strategically default. When $R = +\infty$, agents have perfect commitment. When R is drawn randomly from the set $\{-\infty, +\infty\}$, then it is exogenous default. Furthermore, agents are assumed to be anonymous, so the central bank or other agents cannot induce repayment by future punishment (e.g. forever autarky). One may relax this assumption and endogenize the value of R. While the current setup is probably unrealistic, we try to study this extreme case as a benchmark, and leave other extensions for future research.

Market	Value Function	Nominal Price of Asset	Real Price of Money
Subperiod 1: AM	$Z(m_1)$	ψ_1	N.A.
Subperiod 2: DM	$V^{DM}(m_2, a_2)$	N.A.	N.A.
AM	$V^{AM}(m_2, a_2)$	ψ_2	N.A.
Subperiod 3: CM	$W(y_3)$	ψ_3	ϕ_3

Table 1: Markets, Value Functions and Prices in Sub-Periods
AM: Walrasian market for trading money and asset
DM: Bilateral bargaining for trading money and DM good
CM: Walrasian market for trading money and CM good

costs of holding liquid assets, tightening the liquidity constraint of liquid asset holders.

2.2 Environment

(a) Sequence of Markets

Time is discrete and denoted $t = 0, 1, 2, ...$ In this economy, there is a measure one continuum of infinitely lived agents. Each period is divided into three consecutive sub-periods. In sub-period 1 and 2 , there is an asset market (denoted by AM) for trading asset. In sub-period 2, there is a (decentralized) goods market (denoted by DM) for trading goods. In sub-period 3, there is an (centralized) goods market (denoted by CM) for settlement. (See Table 1)

We are going to consider a stationary environment. The per-period utility of an agent is given by

$$u(q_2^b) - q_2^s - H_3,$$

where $q_2^b \in \mathbb{R}_+$ denotes the consumption of the DM goods when the agent is a buyer, and and $q_2^s \in \mathbb{R}_+$ denotes the production of the DM goods when the agent is a seller in the second sub-period. $u : \mathbb{R}_+ \to \mathbb{R}$ denotes the utility of consuming q units of the DM goods. $H_3 \in \mathbb{R}$ denotes the production (net of consumption) of the CM goods. We assume that $u(.)$ is twice continuously differentiable, strictly increasing, strictly concave, satisfies $u(0) = 0$, $u'(0) = \infty$, $u'(\infty) = 0$, $u'(q^*) = 1$ for some $q^* > 0$.

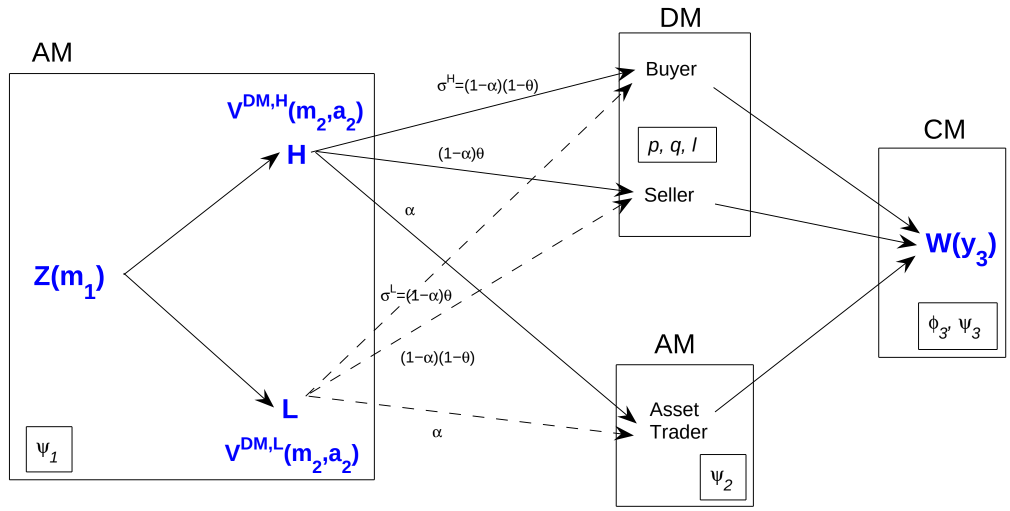

Figure 2: Flows of Agents

(b) Money and Asset

In this economy, there are two perfectly divisible, and costlessly storable objects which cannot be produced or consumed by any private individual: *fiat money* and *asset*. Money pays no dividends. Government injects money by a constant lump sum transfers ΔM in the CM. At the beginning of each period t, each agent is initially endowed with A units of asset. Each unit of asset yields real dividend δ_t (in terms of CM goods) at the end of the period t CM. For simplicity, we will focus on one-period asset which is storable only within a period, but not across periods.

δ is a random i.i.d. (owner specific) variable, drawn from a *uniform* distribution over the support $[\bar{\delta}(1-\varepsilon), \bar{\delta}(1+\varepsilon)]$, and with mean $\bar{\delta} < 1$. ψ_1 is the nominal price of the asset in the subperiod 1 AM. ψ_2 is the nominal value of the dividend of the asset in the subperiod 2 AM. And ψ_3 is the price in the subperiod 3 CM after the realization of δ (before the dividend is paid).

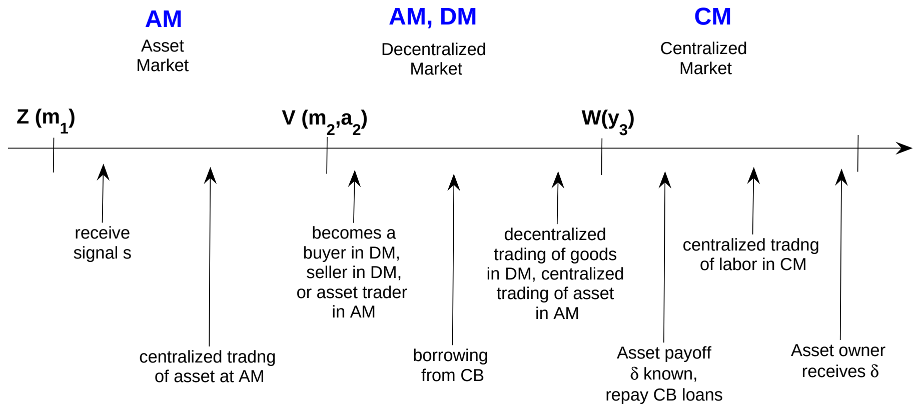

Figure 3: Sequence of Events

2.2.1 TImeline

Figure 3 shows the timeline of the model. Agents first receive a signal of future liquidity needs they are then able to trade with each other in a centralized market. This is followed by a decentralized market where the central bank can provide liquidity through a collateralized facility. In the final period the dividend is realized and agents default and settle loans made in the second period.

2.3 Solving the Model

We are going to solve the model in a backward fashion: first solving for the CM problem in sub-period 3, then the DM and AM problems in sub-period 2, and finally the AM problem in sub-period 1.

(a) Subperiod 3: Centralized market

We now start to discuss the three subperiods in a backward fashion.

In the CM, agents observes the payoffs of the assets (δ_t) and then choose money holding (m_{+1}) for the following AM. The price of money in terms of CM goods is ϕ_3. We use y_3 to denote the real value of wealth an agent brings to the

CM (which is the real value of the money and assets in his portfolio). Agent's optimization problem is to choose production H_3, and money holding m_{+1} to maximize payoff:

$$W(y) = \max_{H_3, m_{+1}} -H_3 + \beta Z_{+1}(m_{+1})$$

subject to

$$-H_3 = y_3 - \phi_3 m_{+1} + \phi_3 \Delta M.$$

Here, $\Delta M = M_{+1} - M_3$ with M_3 and M_{+1} being the total money stock at the beginning and at the end of sub-period 3 respectively. The linearity of utility implies that

$$W(y_3) = \max_{m_{+1}} y_3 - \phi_3 m_{+1} + \phi_3 \Delta M + \beta Z_{+1}(m_{+1})$$

F.O.C.s:

$$m_{+1} \quad : \quad \phi_3 \geq \beta \frac{\partial}{\partial m_{+1}} Z_{+1}(m_{+1}), = \text{if} \quad m_{+1} > 0$$

Note that the choice of m_{+1} is independent of y_3. We will focus on symmetric equilibrium with $m_{+1} = M_{+1}$ for all agents, so that the distribution of money holding at the beginning of each period is degenerate. The envelope condition is given by

$$W'(y_3) = 1.$$

So

$$W(y_3) = W(0) + y_3$$

In principle, agents can also trade their assets in the CM, but they do not have incentive to do so because of the linear utility. No arbitrage condition implies that an asset which is going to deliver δ units of goods at the end of the period is traded at a nominal price $\psi_3(\delta) = \delta/\phi_3$. The following lemma summarizes the result.

Lemma 1. *The CM problem implies*

(i) $W(y)$ *is linear in* y*, with* $W'(y) = 1$*;*

(ii) All agents choose the same $m_{+1} = M_{+1}$*;*

(iii) $\psi_3(\delta) = \delta/\phi_3$.

(b) Subperiod 2: Asset market

In subperiod 2, agents start with money holding m_2 and asset holding a_2. There is a shock that determines an agent's trading status. With a probability α, an agent enters the AM as an asset trader. With a probability $1 - \alpha$, an agent enters the DM as a goods trader.[5]

When an agent enters the AM as an asset trader, his optimization problem is given by

$$V^{AM}(m_2, a_2) = \max_{m_3, a_3} W(y_3) = \phi_3 m_3 + \phi_3 E(\psi_3) a_3 + W(0)$$

subject to

$$(\lambda_2) m_2 + \psi_2 a_2 = m_3 + \psi_2 a_3$$

F.O.C.s:

$$\begin{aligned} m_3 &: \lambda_2 \geq 1, = \text{if } \ m_3 > 0 \\ a_3 &: \lambda_2 \psi_2 \geq E(\psi_3), = \text{if } \ a_3 > 0 \end{aligned}$$

Market clearing conditions imply $\psi_2 = E(\psi_3)$. Note that the choices (m_3, a_3) are independent of (m_2, a_2).

$$\begin{aligned} V_m^{AM}(m_2, a_2) &= \phi_3 \\ V_a^{AM}(m_2, a_2) &= \phi_3 E(\psi_3) \end{aligned}$$

[5] We only need an asset market in the second sub-period to pin down the price of the asset. For this purpose, α has to be non-zero, but can be arbitrarily small.

Therefore,

$$\begin{aligned} V^{AM}(m_2, a_2) &= \phi_3 m_3 + \phi_3 E(\psi_3) a_3 + W(0) \\ &= \phi_3 m_3 + \phi_3 \psi_2 a_3 + W(0) \\ &= \phi_3 m_2 + \phi_3 E(\psi_3) a_2 + W(0) \end{aligned}$$

Trading in AM does not affect the payoff of agents. The following lemma summarizes the result.

Lemma 2. *The AM problem implies*
(i) $V_m^{AM}(m_2, a_2) = \phi_3$*;*
(ii) $V_a^{AM}(m_2, a_2) = \phi_3 E(\psi_3)$*;*
(iii) $\psi_2 = E(\psi_3)$*.*

(c) Subperiod 2: Decentralized market

In the DM, an agent is either a buyer or a seller. In a bilateral meeting, the buyer makes a take-it-or-leave-it offer (q, p) to the seller, where q denotes the quantity of goods and p denotes the quantity of money to be traded. Before trade, buyers (but not sellers or asset traders) have access to central bank standing facilities. The loan is repaid in the next CM. The intra-day interest rate is 0. Therefore, a buyer can pay the price p by using his initial money holding (m_2) and/or by borrowing a nominal loan l_2 from the central bank standing facilities by posting the asset as collateral.

The borrowing constraint in nominal terms is set by the central bank:

$$l_2 \leq \psi_2 a_2 (1 - h),$$

where $h \in [0, \varepsilon]$ is the haircut. Here, l_2 is the nominal repayment in the CM, $\psi_2 a_2$ is the nominal value of the asset in sub-period 2. The central bank sets a haircut h to make sure that the value of the collateralized asset in the CM will be sufficiently high to cover the potential loss (at least in certain realization of

δ).

Before we consider the DM problem, let's first determine the continuation value in the following CM. At the beginning of the next centralized market, agents observe δ and $\psi_3(\delta) = \delta/\phi_3$ and choose whether to pay back l_2 or to give up the collateral and default. Note that the real wealth at the beginning of the following centralized market is

$$y_3 = \phi_3[m_2 - (p - l_2)] + \phi_3\psi_3[a_2 - \frac{l_2}{\psi_2(1-h)}] + \max\{\phi_3\psi_3\frac{l_2}{\psi_2(1-h)} - \phi_3 l_2, 0\}$$

That is, the real wealth is equal to the real value of the unspent money holding ($\phi_3(m_2 - (p - l_2))$), plus real value of the unpledged asset ($\phi_3\psi_3[a_2 - \frac{l_2}{\psi_2(1-h)}]$), plus the potential gain from repaying the loan ($\phi_3\psi_3\frac{l_2}{\psi_2(1-h)} - \phi_3 l_2$). Note that the agent always has an option to default, in particular it happens when the asset value drops too much (i.e. $\frac{\psi_3}{\psi_2}$ too low) relative to the haircut (i.e. $\frac{1}{1-h}$ too low). Simplifying the above expression, we get

$$y_3 = \phi_3 m_2 - \phi_3 p + \phi_3\psi_3 a_2 + \max\{0, \phi_3 l_2 - \phi_3\psi_3\frac{l_2}{\psi_2(1-h)}\}$$

If the central bank wants to ensure repayment in *any* circumstances, the following inequality has to be satisfied for any δ:

$$\begin{aligned} \phi_3 l_2 - \phi_3\psi_3(\delta)\frac{l_2}{\psi_2(1-h)} &\leq 0 \\ \text{or } \frac{\psi_2 - \psi_3(\delta)}{\psi_2} &\leq h \end{aligned}$$

Therefore, the no-default constraint is particularly binding when ψ_3 (i.e. δ) is low. When $\delta = \bar{\delta}$ in all realization (i.e. $\varepsilon = 0$), h can be set to zero (no haircut). When $\psi_3 = 0$ in some realization (i.e. $\varepsilon = 1$), h has to be one (i.e. the asset cannot be pledged as a collateral) to satisfy the no-default constraint.

In general, if the central bank set an haircut such that

$$h < 1 - \frac{\psi_3(\delta)}{\psi_2} = 1 - \frac{\delta}{\bar{\bar{\delta}}},$$

then there will be default when δ is sufficiently low.

As a result,

$$y_3 = \begin{cases} \phi_3 m_2 - \phi_3 p + \phi_3 \psi_3 a_2 + l_2 \max\{\phi_3 - \frac{\phi_3\psi_3}{\psi_2(1-h)}, 0\} & \text{, for a buyer} \\ \phi_3 m_2 + \phi_3 p + \phi_3 \psi_3 a_2 & \text{, for a seller} \end{cases}$$

Therefore, the payoff of a buyer in the DM is

$$\begin{aligned} & u(q) + EW(y) \\ = \; & u(q) + EW(0) + E(y) \\ = \; & u(q) + EW(0) + \phi_3 m_2 - \phi_3 p + \phi_3 a_2 E(\psi_3) + l_2 E \max\{\phi_3 - \frac{\phi_3\psi_3}{\psi_2(1-h)}, 0\} \\ = \; & u(q) + \text{constant} + \phi_3 m_2 - \phi_3 p + \phi_3 a_2 E(\psi_3) + \phi_3 l_2 S(h), \end{aligned}$$

where $S(h)$ is the option value of default, derived in the following lemma (see appendix A).

Lemma 3. *The option value of default is equal to* $S(h) = \frac{(\varepsilon-h)^2}{4\varepsilon(1-h)}$.

Note that, $S \geq 0$ and S is positive whenever $h < \varepsilon$ (i.e. partial haircut). Now, we look at the bargaining problem in the decentralized market when the standing facility is available:

$$\max_{q,p} u(q) + (\phi_3 m_2 - \phi_3 p + \phi_3 a_2 E(\psi_3) + \phi_3 l_2 S(h))$$

subject to

$$\begin{aligned}
\text{Liquidity constraint} &: \quad m_2 + l_2 \geq p \\
\text{Borrowing constraint} &: \quad l_2 \leq \psi_2 a_2 (1-h) \\
\text{Seller's participation constraint} &: \quad \phi_3 p = q
\end{aligned}$$

This is equivalent to solving

$$\max_{q,l_2} u(q) - q + \phi_3 l_2 S(h)$$

subject to

$$\begin{aligned}
m_2 + l_2 &\geq q/\phi_3 \\
\psi_2 a_2 (1-h) &\geq l_2
\end{aligned}$$

Using η_m and η_a to denote the multipliers of the two constraints, then the FOCs are given by

$$\begin{aligned}
q &: \quad \phi_3(u'(q) - 1) = \eta_m \\
l_2 &: \quad \phi_3 S(h) + \eta_m = \eta_a
\end{aligned}$$

From now on, we will focus on monetary equilibria with $\phi_3 > 0$. The first condition implies that whenever $u'(q) > 1$, the liquidity constraint is binding. The second condition implies that whenever $S(h) > 0$ or $u'(q) > 1$, the borrowing constraint is binding:

Lemma 4. *If $h < \varepsilon$, then $l_2 = \psi_2 a_2 (1-h)$.*

That is, whenever the haircut is partial, buyers will borrow up to the borrowing limit to take advantage of the positive option value of default. And the bargaining solution implies

$$q(m_2, a_2) = \begin{cases} q^*, & \text{if } \phi_3 m_2 + \phi_3 \psi_2 a_2(1-h) \geq q^* \\ \phi_3 m_2 + \phi_3 \psi_2 a_2(1-h), & \text{if } \phi_3 m_2 + \phi_3 \psi_2 a_2(1-h) < q^* \end{cases}$$

where q^* satisfies $u'(q) = 1$. Denote the solution by $q(m_2, a_2)$.

(d) Subperiod 2 value function

$$\begin{aligned} V^j(m_2, a_2) &= (1-\alpha)V^{DM,j}(m_2, a_2) + \alpha V^{AM}(m_2, a_2) \\ &= \phi_3 m_2 + \phi_3 E(\psi_3) a_2 + W(0) + \sigma^j [u(q(m_2, a_2)) - q(m_2, a_2)] \\ &\quad + \sigma^j [\phi_3 l_2 S(h)], \text{ for } j = H, L, \end{aligned}$$

Again, we have shown that $l_2 = \psi_2 a_2(1-h)$ if $h < \varepsilon$ or if $\phi_3 m_2 + \phi_3 \psi_2 a_2(1-h) < q^*$. So the envelope conditions are,

$$V_m^j(m_2, a_2) = \phi_3 + \sigma^j [u'(q(m_2, a_2)) - 1] \phi_3 \mathtt{1}\{\phi_3 m_2 + \phi_3 \psi_2 a_2(1-h) < q^*\}$$

$$\begin{aligned} V_a^j(m_2, a_2) &= \phi_3 E(\psi_3) + \sigma^j [u'(q(m_2, a_2)) - 1] \phi_3 \psi_2 (1-h) \mathtt{1}\{\phi_3 m_2 + \phi_3 \psi_2 a_2(1-h) < q^*\} \\ &\quad + \sigma^j \phi_3 \psi_2 (1-h) S(h) \mathtt{1}\{\phi_3 m_2 + \phi_3 \psi_2 a_2(1-h) < q^* \text{ or } h < \varepsilon\}, \end{aligned}$$

We will focus on equilibrium in which the liquidity constraints are binding. Therefore, we have the following result:

Lemma 5. *Suppose the liquidity constraints are binding in the DM, then*

$$\begin{aligned} V_m^j(m_2, a_2) &= \phi_3 + \sigma^j \Delta^j \phi_3 \\ V_a^j(m_2, a_2) &= \phi_3 E(\psi_3) + \sigma^j [\Delta^j + S(h)] \phi_3 \psi_2 (1-h), \end{aligned}$$

where $\Delta^j = u'(q(m_2, a_2)) - 1$.

(e) Subperiod 1: Asset market

At the beginning of a period, each agent receives a signal $s \in \{H, L\}$. A signal H denotes the case in which the agent will likely become a buyer in the DM (high liquidity need). A signal L denotes the case in which the agent will likely become a seller in the DM (low liquidity need). The signal will turn out to be incorrect with a probability $\theta < \frac{1}{2}$. Therefore, an agent with a high signal will be a buyer with a probability $\sigma^H = (1-\alpha)(1-\theta)$, and an agent with a low signal will be a buyer with a probability $\sigma^L = (1-\alpha)\theta$. And an agent will attend the asset market with a probability α. After receiving the signal s, an agent solves the following portfolio choice problem:

$$\max_{m_2, a_2} V^j(m_2^j, a_2^j)$$

subject to

$$\begin{aligned} m_1 + \psi_1 A &\geq m_2^j + \psi_1 a_2^j (\text{with multiplier } \lambda^j) \\ m_2^j &\geq 0, \\ a_2^j &\geq 0. \end{aligned}$$

F.O.C.s:

$$\begin{aligned} m_2^j &: \lambda^j \geq V_m^j(m_2^j, a_2^j), \ (= \text{if } m_2^j > 0) \\ a_2^j &: \lambda^j \psi_1 \geq V_a^j(m_2^j, a_2^j), \ (= \text{if } a_2^j > 0) \end{aligned}$$

And the envelope conditions of the second sub-period are

$$
\begin{aligned}
V_m^j(m_2, a_2) &= \phi_3 + \sigma^j \Delta^j \phi_3 \\
V_a^j(m_2, a_2) &= \phi_3 E(\psi_3) + \sigma^j [\Delta^j + S(h)] \phi_3 E(\psi_3)(1-h)
\end{aligned}
$$

So, depending on whether the non-negativity constraints are binding or not, agents' portfolio choice can lead to three different outcomes: only money, only asset, or both. By comparing the marginal rate of substitution (i.e. V_a^j / V_m^j) and the relative price (i.e. ψ_1), we get the following lemma.

Lemma 6. *For a type $j = H, L$ agent,*
If $Q(\sigma^j) > \sigma^j \Delta^j$, then $a_2^j > 0, m_2^j = 0$;
If $Q(\sigma^j) < \sigma^j \Delta^j$, then $a_2^j = 0, m_2^j > 0$;
If $Q(\sigma^j) = \sigma^j \Delta^j$, then $a_2^j > 0, m_2^j > 0$;
where $Q(\sigma^j) = \frac{E(\psi_3)[1+\sigma^j S(h)(1-h)] - \psi_1}{\psi_1 - E(\psi_3)(1-h)}$

Finally, the envelope condition in the first sub-period is given by:

$$
\begin{aligned}
Z_m(m_1, a_1) &= \frac{1}{2} Z_m^H(m_1, a_1) + \frac{1}{2} Z_m^L(m_1, a_1) = \frac{1}{2}(\lambda^H + \lambda^L) \\
Z_a(m_1, a_1) &= \frac{1}{2} Z_a^H(m_1, a_1) + \frac{1}{2} Z_a^L(m_1, a_1) = \frac{1}{2}\psi_1(\lambda^H + \lambda^L)
\end{aligned}
$$

And the market clearing conditions are:

$$
\begin{aligned}
M &= \frac{1}{2} m_2^H + \frac{1}{2} m_2^L \\
A &= \frac{1}{2} a_2^H + \frac{1}{2} a_2^L
\end{aligned}
$$

2.4 Characterization of Equilibrium

In this section, we will characterize the steady state equilibrium given the policy set by the government (i.e. the money supply M and the money growth rate across periods γ[6]) and the stock of asset A. Below, the analysis will focus on the case in which liquidity constraints are binding for both types. Moreover, we are interested in symmetric steady state equilibria in which nominal prices are growing at the rate of money growth, and real quantities are constant over time: $\frac{\phi}{\phi_{+1}} = \frac{\psi_{+1}}{\psi} = \gamma$, and $q = q_{+1}$.

In particular, a steady state equilibrium can be defined as (m_2^H,m_2^L,a_2^H,a_2^L,q^H, q^L,ϕ_3, ψ_1,ψ_3, λ^H, λ^L) satisfying the following set of conditions. Let's first define some notations. Below, we will use superscript "a" to denote the type who holds only assets, and use "m" to denote the type who holds only money. In case one type holds both assets, w.l.o.g., we will use "m" to denote H and "a" to denote L.[7]

Equilibrium conditions:

[6]Note that γ is the rate of growth of money stock from one period to the next, which is a result of both lump-sum transfers and loan default.

[7]Both conditions (10) and (11) have to be satisfied for a type holding both money and asset.

$$\begin{aligned}
\phi_3 &= \beta Z_{+1,m} = \beta\frac{1}{2}(\lambda^a_{+1} + \lambda^m_{+1}) && (2.1)\\
q^a &= \phi_3 m^a_2 + \phi_3 E(\psi_3) a^a_2 (1-h) && (2.2)\\
q^m &= \phi_3 m^m_2 + \phi_3 E(\psi_3) a^m_2 (1-h) && (2.3)\\
m^a_2 + m^m_2 &= 2M && (2.4)\\
a^a_2 + a^m_2 &= 2A && (2.5)\\
\lambda^m &= V^m_m = \phi_3(1+\sigma^m\Delta^m) && (2.6)\\
\lambda^a &= V^a_a/\psi_1 = \phi_3 E(\psi_3)[1+\sigma^a(\Delta^a + S(h))(1-h)]/\psi_1 && (2.7)\\
m^m_2 + \psi_1 a^m_2 &= M + \psi_1 A && (2.8)\\
\psi_3(\delta)\phi_3 &= \delta && (2.9)\\
Q(\sigma^a) &\geq \sigma^a\Delta^a && (2.10)\\
\sigma^m\Delta^m &\geq Q(\sigma^m) && (2.11)
\end{aligned}$$

Here, (2.1) is the condition for the optimal money demand in the CM. (2.2) and (2.3) are the binding liquidity constraints in the DM. (2.4) and (2.5) are the market clearing conditions in the first subperiod AM. (2.6),(2.7), (2.10) and (2.11) are conditions for the optimal portfolio choice in the first sub-period. (2.8) is the budget constraint in the first sub-period. (2.9) is the market price of an asset that delivers δ.

Defining i as the (net) nominal interest rate, then the Fisher's equation and (2.1) imply

$$1 + i = \frac{\gamma}{\beta} = \frac{\phi_3}{\beta\phi_{3,+1}} = \frac{1}{2}(\frac{\lambda^m_{+1} + \lambda^a_{+1}}{\phi_{3,+1}})$$

(2.6) and (2.7) then imply

$$1+i = \frac{1}{2}\left[\{1+\sigma^m[u'(q^m)-1]\} + \frac{E(\psi_{3,+1})}{\psi_{1,+1}}\{1+\sigma^a[u'(q^a)-1+S(h)](1-h)\}\right] \quad (2.12)$$

The budget constraint, (2.8), implies the asset price is

$$\psi_1 = \frac{(m_2^m - M)}{(A - a_2^m)}$$

Combining (2.2)-(2.5), (2.9) and (2.12) gives one equation in terms of (ϕ_3, m_2^a, a_2^a):

$$1+i = \frac{1}{2}\left[\begin{array}{c} \{1+\sigma^m[u'(\phi_3(2M-m_2^a)+\bar{\delta}(2A-a_2^a)(1-h))-1]\} \\ +\frac{\bar{\delta}}{\phi_3\psi_1}\{1+\sigma^a[u'(\phi_3 m_2^a+\phi_3 E(\psi_3)a_2^a(1-h))-1+S(h)](1-h)\} \end{array}\right] \quad (2.13)$$

where $\psi_1 = \frac{(m_2^m - M)}{(A-a_2^m)}$. We can now define the steady state equilibrium as follows.

Definition 7. *A steady state monetary equilibrium consists of a price of money* $\phi_3 > 0$ *and a portfolio* (m_2^a, a_2^a) *such that equation (2.13) and conditions (2.10)-(2.11) are satisfied.*

3 Policy Constraint

In the previous section, we characterize the set of equilibrium given any arbitrary policy i (i.e. which is pinned down by the money growth rate γ) and h. However, not all (i, h) policy pairs are feasible for the central bank to pick. In particular, the choice of h will imply a minimum size of money injection, and thus a minimum level of interest rate i.

Note that whenever a buyer defaults its loan l_2, the new money temporarily lent out by the central bank in sub-period 2 will only be partially withdrawn by the central bank who sells the asset for $\psi_3(\delta) = \delta/\phi_3$ in sub-period 3.

Lemma 3 implies that, for each unit of asset posted as collateral, the expected nominal size of default is

$$E\max\{\psi_2(1-h)-\psi_3,0\}=\frac{\bar{\delta}}{4\phi_3\varepsilon}(\varepsilon-h)^2.$$

Let $\bar{A}(h)$ be the amount of asset posted as collateral (as a function of the haircut policy), the money growth is equal to

$$\gamma-1=\bar{A}\frac{\bar{\delta}}{4M\phi_3\varepsilon}(\varepsilon-h)^2+\frac{\Delta M}{M}. \tag{3.1}$$

The first term is the money injection due to unrepaid loans, and the second term is the lump sum transfers from the central bank in the third sub-period. We are going to restrict that the central bank does not possess any taxation power (i.e. $\Delta M \geq 0$). Therefore, there is a lower bound on the nominal interest rate, as summarized by the following proposition.

Proposition 8. *Suppose the central bank does not have taxation power. The steady state nominal interest rate is subject to the constraint:* $1+i=\frac{\gamma}{\beta}\geq \bar{A}\frac{\bar{\delta}}{4M\beta\phi_3\varepsilon}(\varepsilon-h)^2+\frac{1}{\beta}$.

4 Equilibrium (Special Case)

In this section, we will first consider one simple equilibrium in which the H-type brings only money and the L-type brings only asset to the second sub-period. A *simple equilibrium* is a symmetric steady state monetary equilibrium with $m_2^H=m_2^m=2M, a_2^H=a_2^m=0$. For simplicity, assume that $u(q)=\log(q)$. The following result is proved in Appendix B.

Proposition 9. *Suppose* $u(q)=\log(q)$. *In a simple equilibrium,*

(i) The equilibrium quantities are $q^H=2M\phi_3$, *and* $q^L=2A\bar{\delta}(1-h)$;

(ii) The equilibrium asset price in sub-period one is $\psi_1=\frac{M}{A}$.

(iii) The equilibrium price of money in sub-period three is

$$\phi_3 = \frac{1}{2M(1+2i+\sigma^H)}\left[(1-\alpha)+2\bar{\delta}A\left(1-\sigma^L[1-h-\frac{\bar{\delta}}{2}(\varepsilon-h)^2]\right)\right] \quad (4.1)$$

We can show that the simple equilibrium exists under some conditions.

Proposition 10. *Suppose $\alpha = \theta = 0$ and $h = \varepsilon$. A simple equilibrium exists if $1 - 4i\bar{\delta}A < 2\bar{\delta}A < 1$.*

To show this, substitute the parameter values to lemma 6 to show that agents specialize in their portfolio choice. Then, proposition 9 is used to show that the liquidity constraint is binding, as asserted. The idea is that, when the signal is perfect ($\theta = 0$), the L-type does not need to hold money for consumption. When the haircut is high ($h = \varepsilon$), the H-type does not want to hold asset for consumption. The interest rate i has to be high to make the liquidity constraint binding. Moreover, the real value of asset dividend ($\bar{\delta}A$) cannot to too high or too low. If it is too low, the L-type does not want to hold assets. If it is too high, the H-type also wants to hold assets. Therefore, in the neighborhood of this point in the parameter space, a simple equilibrium exists.

Now, the welfare measured by ex-ante expected utility is

$$W(i,h) = \sigma^H(\log(q^H) - q^H) + \sigma^L(\log(q^L) - q^L).$$

The policy constraint (3.1) is now given by

$$i \geq \frac{\sigma^L A\bar{\delta}}{4\beta M\phi_3\varepsilon}(\varepsilon-h)^2 + \frac{1}{\beta} - 1. \quad (4.2)$$

The welfare maximizing policy of the planner is a (h,i) pair which maximizes $W(i,h)$ subject to the policy constraint (4.2).

Comparative Statics

Focusing on a simple equilibrium, the following proposition summarizes several comparative statics results.

Proposition 11. *In a simple equilibrium,*

(i) $\frac{d\phi_3}{di} < 0$, $\frac{dq^H}{di} < 0$, $\frac{dq^L}{di} = 0$;

(ii) $\frac{d\phi_3}{dh} > 0$, $\frac{dq^H}{dh} > 0$, $\frac{dq^L}{dh} < 0$ *if* $\bar{\delta} < 1$;

(iii) $\frac{d\phi_3}{dA\bar{\delta}} < 0$, $\frac{dq^H}{dA\bar{\delta}} < 0$, $\frac{dA\bar{\delta}}{di} < 0$;

(iv) $\frac{d\phi_3}{d\varepsilon} > 0$, $\frac{dq^H}{d\varepsilon} > 0$, $\frac{dq^L}{d\varepsilon} = 0$;

1. Effect of an increase in i

If (4.2) is not binding, an increase in the interest rate i lowers the equilibrium value of money (ϕ_3) (by (4.1)), and lowers the equilibrium consumption of the H-type (q^H), and reduces the average welfare.

2. Effect of an decrease in h

A cut in the haircut h relaxes the borrowing constraint of the L-type and thus increases the equilibrium consumption of the L-type (q^H). Given that $\bar{\delta} < 1$, a cut in hair cut will lead to a lower ϕ_3 (by (4.1))[8] and thus lower consumption of the H-type.

If (4.2) is initially binding, a cut in h will also tighten the policy constraint (by (4.2)), raising the lower-bound of the interest rate, which will further reduce the consumption of the H-type.

Here, we can see that lowering the haircut has different effects on agents with different portfolio choices. On the one hand, it can relax the liquidity constraint of illiquid asset holders. On the other hand, it will lower the value of liquid assets (e.g. money) by both reducing the returns to holding liquidity and increasing the cost of holding liquidity (by increasing i). As a result, it will tighten the liquidity constraint of liquid asset holders.

3. Effect of a drop in $\bar{\delta}$ or A

An drop in $\bar{\delta}$ or A will lower the consumption of the L-type, and it will also

[8]The marginal effect of h on ϕ_3 is given by sign$[\frac{\mathrm{d}}{\mathrm{d}h}\phi_3]$=$1 - \bar{\delta}(\varepsilon - h) > 0$.

decrease the value of ϕ_3 and thus lower the consumption of the H-type. If (4.2) is initially binding, it will relax the policy constraint and allow for a higher h or a lower i.

4. Effect of increase in ε

An increase in ε will not affect the consumption of the L-type, but it will increase the value of ϕ_3 and thus increases the consumption of the H-type. If (4.2) is initially binding, it will tighten the policy constraint and require a higher h or a higher i to satisfy the policy constraint.

4.1 Numerical Examples

In this section, we will use a numerical example to illustrate the model implications derived above. In particular, we will set the parameter values as follows: $M = 1$, $A = 7.5$, $\beta = 0.94$, $\bar{\delta} = 0.06$, $\varepsilon = 0.4$, $\alpha = 0.1$, $\theta = 0.02$.

Equilibrium

The previous analysis shows that a simple equilibrium exists when equations (2.10), (2.11), (4.1) and condition (4.2) are all satisfied. Figure 4 shows the existence of equilibrium over the (h, i) plain. In particular, equations (2.10), (2.11), (4.1) are satisfied inside the area bounded by the green line. Condition (4.2) is satisfied for any (h, i) pairs lying above the blue curve. As shown above, the policy constraint is downward sloping. Therefore, inside the grey area, a simple equilibrium exists.

Choice of policy

The choice of (h, i) depends on the preference of the policy maker. The consumption of H-type is increasing in h and decreasing in i. The consumption of L-type is decreasing in h and is independent of i. In our example, the total output and the welfare are both decreasing in h and i. It turns out that, in order to maximize the consumption of the H-type, the policy maker should choose $h = \varepsilon = 0.4000$ and $i = 0.0638$. Alternatively, a policy maker who wants to maximize the consumption of the L-type, the total output or the

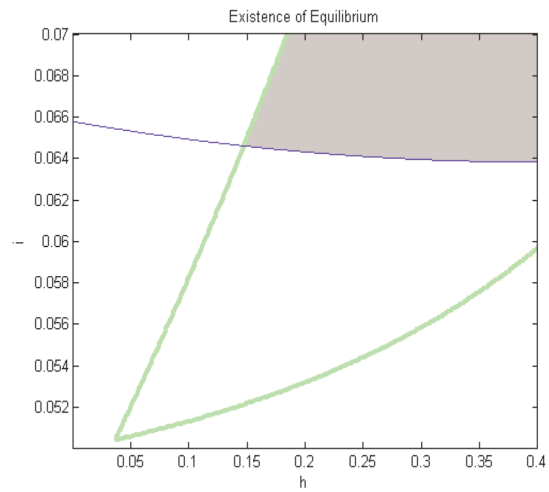

Figure 4: Existence of Equilibrium

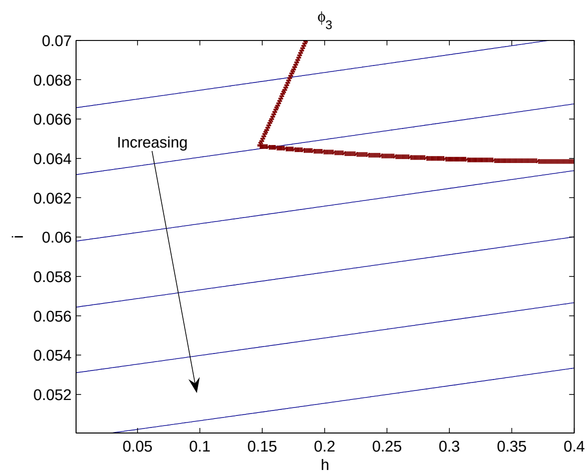

Figure 5: Real Price of Money

welfare should set $h = 0.1480$ and $i = 0.0646$ (**choosing within the set of simple equilibrium**).

4.2 Extensions

Non-exclusive Lending Facility

In the previous sections, we assume that the central bank is able to lend exclusively to buyers who are in need of liquidity. Now, suppose the central bank is unable to exclude sellers from borrowing from the lending facility, then the equilibrium value of money is modified to

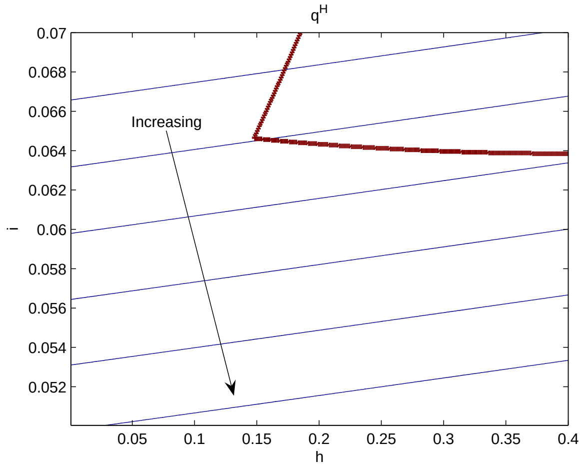

Figure 6: Consumption of H-type

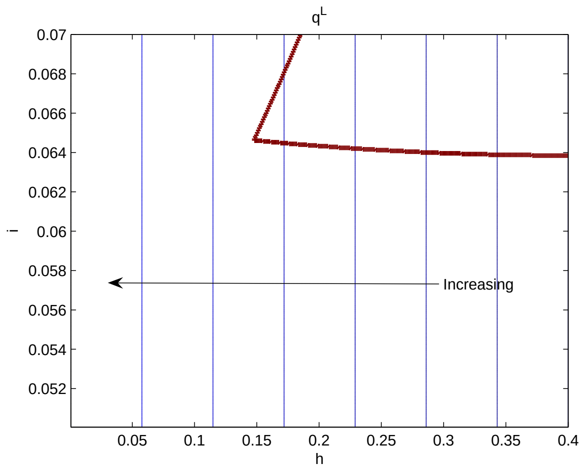

Figure 7: Consumption of L-type

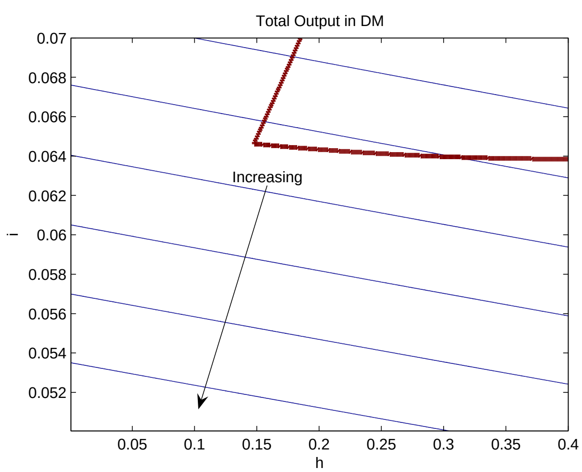

Figure 8: Total Consumption

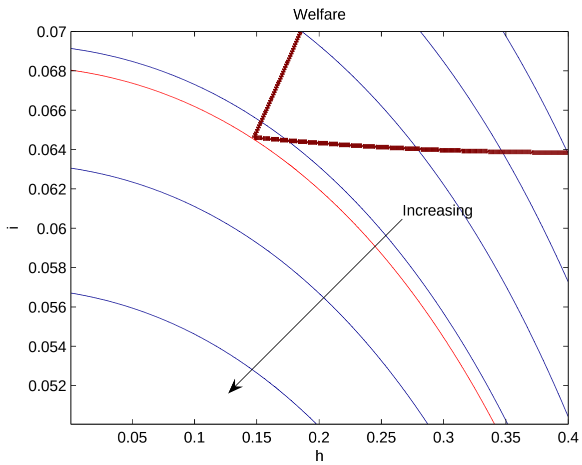

Figure 9: Welfare

$$\phi_3 = \frac{1}{2M(1+2i+\sigma^H)}\left[1-\alpha+2\bar{\delta}A(1-(1-h)\sigma^L)+\bar{\delta}^2A(1-\alpha)(\varepsilon-h)^2\right].$$

And the portfolio choice is also modified to

$$Q(\sigma^H) = Q(\sigma^L) = \frac{E(\psi_3)[1+(1-\alpha)S(h)(1-h)]-\psi_1}{\psi_1 - E(\psi_3)(1-h)}.$$

The policy constraint becomes

$$i \geq \frac{(1-\alpha)A\bar{\delta}}{4\beta M\phi_3\varepsilon}(\varepsilon-h)^2 + \frac{1}{\beta} - 1.$$

Comparing this policy constraint with constraint (4.2) suggests that the policy constraint is tightened when the central bank cannot restrict lending to the buyers only: the i lower bound is higher for any given h, and the marginal effect of h on the i lower bound is higher. Therefore, in Figure 10, the feasible set of policy becomes smaller.

The welfare maximizing policy is given by $i = 0.0671$ and $h = 0.3264$. When the central bank cannot restrict lending, the cost of providing consumption insurance to the L-type by lowering the haircut h becomes more costly in terms

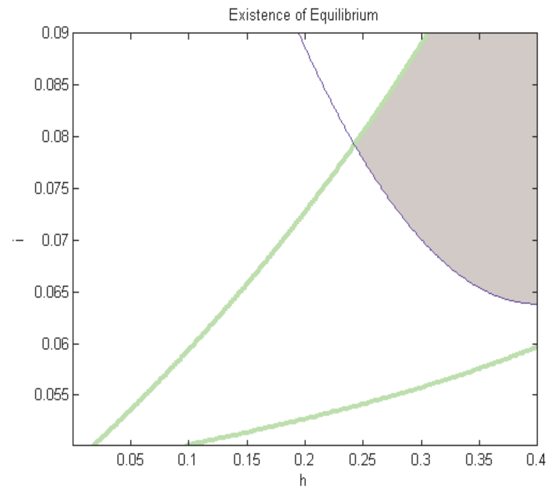

Figure 10: Non-exclusive Lending: Existence

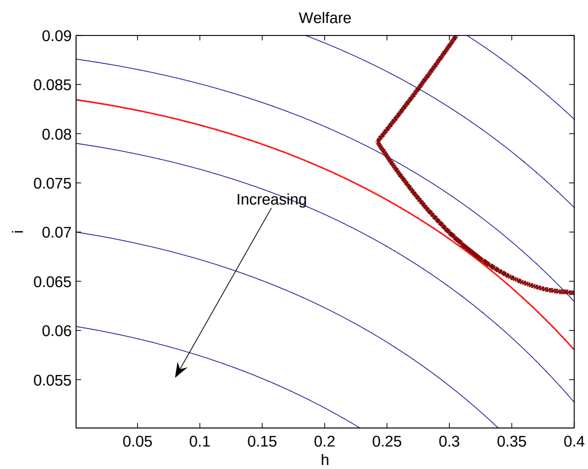

Figure 11: Non-exclusive Lending: Welfare

of distorting the H-type's consumption. Under this trade-off, it is generally not optimal to set the highest or lowest possible haircut.

[`TO ADD: Policy Discussion`]

Temporary versus Permanent Change in Haircut

In the previous section, we consider optimal permanent changes in haircut. Here, we study how a one-time change in haircut can improve on the allocation temporarily.

Here, we consider the case in which the central bank can exclude borrowing from the sellers. Suppose the central bank is following the optimal policy (i.e.

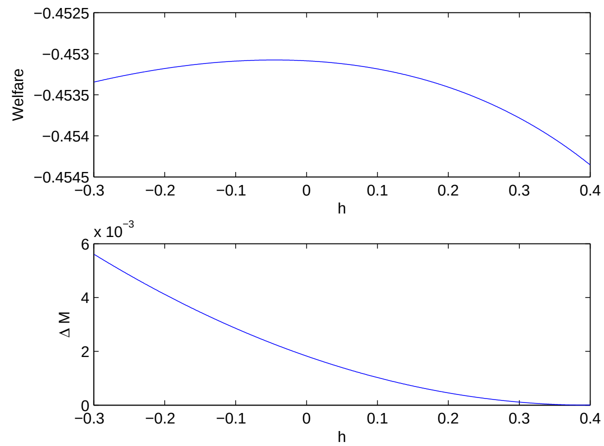

Figure 12: One-time Change in Haircut: Welfare and Change in Money Stock

$h = 0.1480$, $i = 0.0646$) and is allowed to make one-time change in h in the current period (with the agents believing the central bank will bring the (i, h) back to the original levels before the change).

Since this is a one-time change in h, it will have no effect on future allocation. In particular, it will not affect the policy constraint (4.2). The only effect is on the current stock of money supply and on the current price of money in the third sub-period. Denoting $\tilde{h}$ as the haircut in the current period, the current period equilibrium $\{\phi_3(\tilde{h}), \Delta M(\tilde{h}), q^H(\tilde{h}), q^L(\tilde{h})\}$ is then determined by

$$\begin{aligned}
\phi_3(\tilde{h}) &= \frac{(1-\alpha) + 2\bar{\delta}A\left(1 - \sigma^L[1 - h - \frac{\bar{\delta}}{2}(\varepsilon - h)^2]\right)}{2(M + \Delta M(\tilde{h}))/\gamma(1 + 2i + \sigma^H)} \\
\Delta M(\tilde{h}) &= \frac{\sigma^L A\bar{\delta}}{4\phi_3\varepsilon}(\varepsilon - \tilde{h})^2 \\
q^H(\tilde{h}) &= 2M\phi_3(\tilde{h}) \\
q^L(\tilde{h}) &= 2A\bar{\delta}(1 - \tilde{h}).
\end{aligned}$$

As shown in Figure (12), it is welfare maximizing to temporarily lower the hair cut from $h = 0.1480$ to $h = -0.0.0452$. Note that the optimal one-period deviation of the haircut is indeed negative to improve ex-post efficiency. This will temporarily increase the money stock (additionally by 0.16%), lower the price of money (by 0.15%), increase the consumption of the L-type (by 22.68%) and lower the consumption of the H-type (by 0.15%).

In the table, we also report the case of a one-time change in the haircut in the case of non-exclusive lending facilities. As expected, in this case, it is not optimal to lower the haircut by too much.

	h	i	W	$\tilde{h}$	$\tilde{U}$
Exclusive Lending	0.1480	0.0646	-0.4533	-0.0452	-0.4531
Non-Exclusive Lending	0.3264	0.0671	-0.4540	0.3128	-0.4540

[TO ADD: Policy Discussion]

5 Equilibrium (General Case)

Figure 13 plots the equilibrium outcomes for different combinations of h and i. When the haircut h is high (the right portion of the graph), the H-type will bring only money to the second sub-period, and the L-type will bring only asset to the second sub-period. For lower haircut (the middle portion of the graph), the H-type is induced to hold both money and asset because of the higher value of the "default option" $S(h)$. For even lower haircut (the left portion of the graph), the H-type choose to hold only asset and the L-type choose to hold only money. Figure 14 plots the welfare over the (h, i) plain.

In figure 15, the blue downward sloping curve denotes the policy constraint. The grey curves denotes the indifference curves. The red dot indicates the welfare-maximizing policy which is given by $h = 0.16$ and $i = 0.065$.

[MORE DISCUSSION/ANALYSIS NEEDED]

6 Conclusion

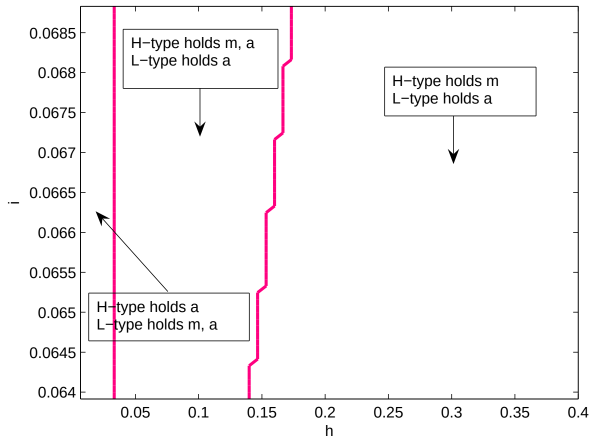

Figure 13: Distribution of Equilibria

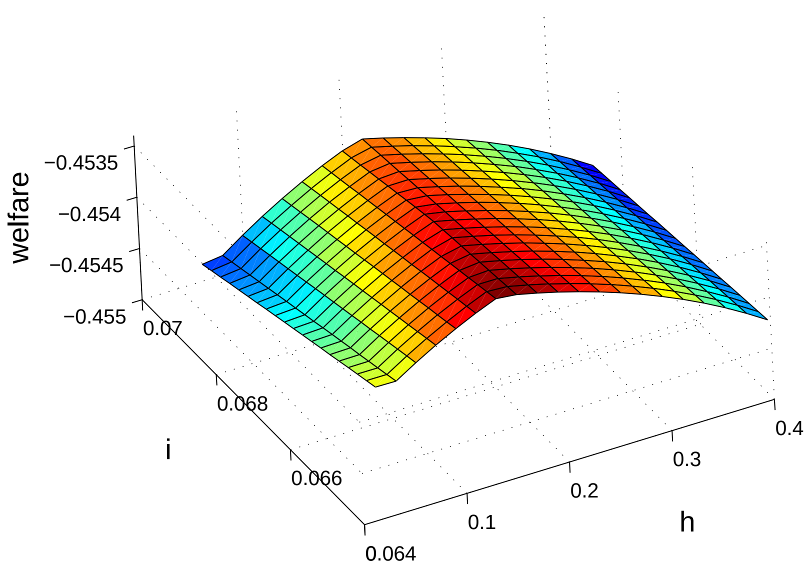

Figure 14: Welfare

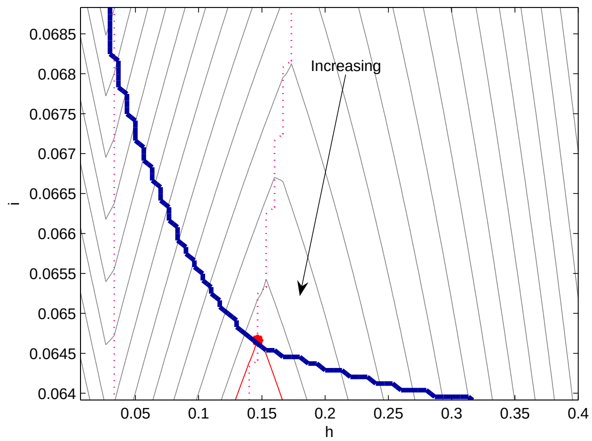

Figure 15: Welfare-maximizing Policy

Appendix A

$$
\begin{aligned}
& l_2 E \max\{\phi_3 - \frac{\phi_3 \psi_3}{\psi_2(1-h)}, 0\} \\
= & \frac{\phi_3 l_2}{\psi_2(1-h)} E \max\{\psi_2(1-h) - \psi_3, 0\} \\
= & \frac{l_2}{\psi_2(1-h)} E \max\{\bar{\delta}(1-h) - \delta, 0\} \\
= & \frac{\phi_3 l_2}{\bar{\delta}(1-h)} E \max\{\bar{\delta}(1-h) - \delta, 0\} \\
= & \frac{\phi_3 l_2}{2\varepsilon\bar{\delta}^2(1-h)} \int_{\bar{\delta}(1-\varepsilon)}^{\bar{\delta}(1-h)} [\bar{\delta}(1-h) - \delta] d\delta \\
= & \frac{\phi_3 l_2}{2\varepsilon\bar{\delta}^2(1-h)} \left[\int_{\bar{\delta}(1-\varepsilon)}^{2\varepsilon\bar{\delta}^2(1-h)} \bar{\delta}(1-h) d\delta - \int_{\bar{\delta}(1-\varepsilon)}^{\bar{\delta}(1-h)} \delta d\delta \right] \\
= & \frac{\phi_3 l_2}{2\varepsilon\bar{\delta}^2(1-h)} \left[\bar{\delta}^2(\varepsilon - h)(1-h) - \frac{1}{2}\delta^2 |_{\bar{\delta}(1-\varepsilon)}^{\bar{\delta}(1-h)} \right] \\
= & \frac{\phi_3 l_2}{\bar{\delta}(1-h)} \left[\bar{\delta}^2(\varepsilon - h)(1-h) - \frac{1}{2}\bar{\delta}^2 \{(1-h)^2 - (1-\varepsilon)^2\} \right] \\
= & \frac{\phi_3 l_2}{2\varepsilon\bar{\delta}^2(1-h)} \left[\bar{\delta}^2(\varepsilon - h)(1-h) - \frac{1}{2}\bar{\delta}^2 (\varepsilon - h)(2 - h - \varepsilon) \right] \\
= & \frac{\phi_3 l_2}{4\varepsilon(1-h)} (\varepsilon - h)^2
\end{aligned}
$$

Appendix B

$$
\begin{aligned}
1+i &= \frac{1}{2}\left[\begin{array}{c} \{1+\sigma^m[u'(\phi_3(2M))-1]\} \\ +\frac{\bar{\delta}}{\phi_3\psi_1}\{1+\sigma^a[u'(2A\phi_3E(\psi_3)(1-h))-1+S(h)](1-h)\}, \end{array}\right] \\
1+i &= \frac{1}{2}\left[\{1+\sigma^m[\frac{1}{\phi_3 2M}-1]\}+\frac{\bar{\delta}A}{\phi_3 M}\{1+\sigma^a[\frac{1}{2A\bar{\delta}(1-h)}-1+S(h)](1-h)\}\right] \\
1+i &= \frac{1}{2}\left[\{1+\sigma^m[\frac{1}{\phi_3 2M}-1]\}+\frac{\bar{\delta}A}{\phi_3 M}\{1+\sigma^a[\frac{1}{2A\bar{\delta}}-(1-h)+S(h)(1-h)]\}\right] \\
1+i &= \frac{1}{2}\left[\{1+\frac{\sigma^m}{\phi_3 2M}-\sigma^m\}+\frac{\bar{\delta}A}{\phi_3 M}\{1+\frac{\sigma^a}{2A\bar{\delta}}-\sigma^a(1-h)+\sigma^a S(h)(1-h)\}\right] \\
1+i &= \frac{1}{2}\left[\{1+\frac{\sigma^m}{\phi_3 2M}-\sigma^m\}+\frac{\bar{\delta}A}{\phi_3 M}\{1+\frac{\sigma^a}{2A\bar{\delta}}-\sigma^a(1-h)+\sigma^a S(h)(1-h)\}\right] \\
1+2i+\sigma^m &= \frac{1}{\phi_3 2M}\left[\sigma^m+2\bar{\delta}A\{1+\frac{\sigma^a}{2A\bar{\delta}}-\sigma^a(1-h)+\sigma^a S(h)(1-h)\}\right] \\
1+2i+\sigma^m &= \frac{1}{\phi_3 2M}\left[\sigma^m+2\bar{\delta}A+\sigma^a-2\bar{\delta}A\sigma^a(1-h)+2\bar{\delta}A\sigma^a S(h)(1-h)\right] \\
1+2i+\sigma^m &= \frac{1}{\phi_3 2M}\left[(1-\alpha)+2\bar{\delta}A\left(1-\sigma^a(1-h)[1-S(h)]\right)\right] \\
\Rightarrow \phi_3 &= \frac{1}{2M(1+2i+\sigma^m)}\left[(1-\alpha)+2\bar{\delta}A\left(1-\sigma^a(1-h)[1-S(h)]\right)\right] \\
\phi_3 &= \frac{1}{2M(1+2i+\sigma^m)}\left[(1-\alpha)+2\bar{\delta}A\left(1-\sigma^a[1-h-\frac{\bar{\delta}}{2}(\varepsilon-h)^2]\right)\right]
\end{aligned}
$$

Appendix C

[A PROOF OF PROPOSITION 10 NEEDED]

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