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# Liquidity, liquidity everywhere, not a drop to use

Why flooding banks with central bank reserves may not expand liquidity<sup>1</sup>

Viral V Acharya

(NYU Stern School of Business,  
CEPR, ECGI and NBER)

Raghuram Rajan

(University of Chicago Booth School and  
NBER)

## Abstract

Central bank balance sheet expansion is run through commercial banks. While liquid central bank reserves held on commercial bank balance sheets increase, demandable uninsured deposits issued to finance the reserves also increase. A subsequent shrinkage in the central bank balance sheet may entail a shrinkage in bank-held reserves without a commensurate reduction in deposit claims. Furthermore, during episodes of liquidity stress, when many claims on liquidity are called, surplus banks may hoard reserves. As a result of such bank behavior, central bank balance sheet expansion may create less systemic liquidity than typically thought, and in fact, the demand for liquidity can occasionally exceed available reserves, exacerbating liquidity stress.

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Despite a significant expansion in central bank balance sheets, some markets like the US money market have experienced increasing interest rate volatility, including alarming spikes in the repo rate, notably in December 2018 and September 2019 (see D’Avernas and Vandeweyer (2021)). The disruption in markets that depend intimately on the availability of liquidity seems puzzling when Fed officials set reserve levels not just at a multiple of levels before the global financial crisis, but also above their estimate of private sector demands, with adequate buffers for unexpected variations such as in the Treasury’s Fed account (see Logan (2019)).<sup>2</sup> Greater private sector reserves holdings do not seem to have made markets for liquidity fully immune to liquidity shocks. Indeed, even after the Fed injected more reserves in September 2019, markets were disrupted yet again in March 2020 at the onset of the COVID-19 pandemic, and the banking system was found short in its ability to accommodate the demand for liquidity.<sup>3</sup> In response, the Federal Reserve expanded its balance sheet yet more (see, for example, Kovner and Martin (2020)), buying financial assets from the private sector and placing large quantities of liquid reserves with it (or promising to do so). And in March 2023, a number of mid-sized regional banks failed whereupon the authorities made liquidity freely available through the discount window and a new facility, in addition to lending by the Federal Home Loan Banks, while the Treasury implicitly guaranteed all demandable deposits. Where had all the prior liquidity gone?

A number of answers have been suggested, including changes in liquidity- or capital regulations and supervision, and changes in the public demand for liquidity.<sup>4</sup> While these have merit, our intent is to augment them by asking a fundamental question: what theoretical effect should the expansion of central bank balance sheets have on systemic liquidity, taking into account the endogenous response of the banking system?

Intuition would suggest that when the central bank issues more liquid central bank reserves to finance its balance sheet expansion, the supply of liquidity to the financial system increases, bringing down illiquidity premia in markets, and reducing private financing costs. This intuition neglects three key private sector responses. First, central banks effectively issue these reserves to commercial banks (henceforth “banks”), which typically finance them with short-term liabilities such as uninsured deposits,

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<sup>2</sup> Copeland, Duffie and Yang (2021) estimate that banks made do with about \$50 billion in reserve balances before the global financial crisis, and had \$1.3 trillion in balances in September 2019.

<sup>3</sup> Corporate debt, but also segments of the US Treasuries market experienced significant illiquidity, see Duffie (2020), Fleming and Ruela (2020), He, Nagel and Song (2020), Liang and Parkinson (2020), Schrimp, Shin and Sushko (2020)), and Vissing-Jorgensen (2020). Corporates drew down bank credit lines, see Kashyap (2020) and Acharya, Engle and Steffen (2021); and, dealer banks found it difficult to make markets, see Boyarchenko, Kovner and Shachar (2020), Breckenfelder and Ivashina (2021), Kargar *et al.* (2021), and Vissing-Jorgensen (2020).

<sup>4</sup> See, for example, Copeland, Duffie and Yang (2021), Correa, Du and Liao (2021), D’Avernas and Vandeweyer (2021, 2022), IAWG Treasury Market Surveillance Report (2021), Lopez-Salido and Vissing-Jorgensen (2022), Poszar (2019), and Yang (2021).

an offsetting claim on liquidity. Second, available reserves could shrink for a variety of reasons. Third, banks may exacerbate shortages by hoarding spare liquidity. In short, central bank reserves expansion works through commercial bank balance sheets, which could raise the future demand for liquidity and constrain its supply, limiting its benefits and potentially creating costs.

On net then, the free liquidity generated by central bank balance sheet expansion can be much smaller than one might think if bank behavior were disregarded. Indeed, central bank balance sheet expansion can leave the financial system more dependent on liquidity, and hence more vulnerable to adverse liquidity shocks such as those the existing explanations analyze. Particularly consequential could be liquidity shocks emanating from adverse macroeconomic shocks, such as the onset of the pandemic, or interest rate hikes.

Let us elaborate. We assume the central bank wants to expand its balance sheet over the medium term (via Quantitative Easing or QE), buying financial assets from the private sector with newly issued reserves. We take any direct effect of the asset purchases on economic activity initially as given, so as to focus on what happens to liquidity after that. Reserves eventually find their way back to commercial bank balance sheets (so non-banks cannot hold reserves, as is typically the case in most financial systems, and the public does not need more cash). More specifically, if the central bank simply buys long-term securities from the commercial banks, the commercial banks will be swapping securities for central bank reserves. This requires no financing. However, a significant expansion of the central bank balance sheet will require it to buy securities from non-banks. In this case, commercial bank balance sheet expansion occurs automatically; the non-banks deposit the central bank's check in their banks, giving the commercial banks both reserves and offsetting deposits. Of course, banks rebalance their balance sheet after these transactions (which we allow in our model), but banks in aggregate have to hold the reserves.

Key in our analysis is the mix of how banks finance these reserves. A number of authors (Calomiris and Kahn (1991), Dang, Gorton, and Holmstrom (2010), Flannery (1986), and Gorton and Pennacchi (1990), among others) have argued that banks have a comparative advantage in issuing short-term or demandable debt. Others (see, for example, Diamond and Dybvig (1984) or Stein (2012)) have attributed an implicit liquidity/money premium to demandable bank liabilities that makes them relatively attractive for investors, and Diamond and Rajan (2001) argue that one leads to the other. We are agnostic as to why longer-term financing (that is, capital) is costlier for banks, but assume functional forms that make it so. Naturally then, a first effect of QE is that banks finance a large portion of the reserve expansion with demandable deposits, an effect the literature has underemphasized.

We assume that after commercial banks get reserves, make loans, and set their capital structure accordingly, there is a probability that the economy will become *liquidity stressed*, and the demand for liquidity in the real economy will increase significantly. Demand will be concentrated on some banks. Call these the *stressed* banks. We assume that their wholesale depositors, fearful of any loss, withdraw their cash in such states, increasing the stressed banks' need for funds.

In times of liquidity stress, healthy banks may see a valuable *convenience yield* to liquid reserves – for instance, because it is dry powder in case conditions worsen.<sup>5</sup> Consequently, a fraction of healthy banks may hoard liquidity and seek to maintain unimpeachable balance sheets, in order to be perceived as safe and attract more deposit flows, rather than lending reserves out to stressed banks.

Banks may also find some of the initially issued bank-held reserves are not available to pay out in stressed states. For instance, they may have shrunk because of Quantitative Tightening (QT), where the central bank sold commercial banks securities in exchange for reserves. We will show that banks have an incentive to buy securities, even if less liquid than reserves. Reserves may also be unavailable for use because of regulatory encumbrances, or because banks utilize “excess” reserves in supporting speculative activity, and obtaining fees from it.

The financing of eventually shrunken or partially encumbered reserves with short-term deposits, coupled with reserve hoarding by some of the healthy banks that are recipients of flight-to-safety deposits, sets up an interesting dynamic in episodes of liquidity stress: loan rates in the interbank market can shoot up as stressed banks try and attract liquidity from healthy banks (see Acharya and Mora (2015) for empirical documentation of such a dynamic during 2007-08). The interbank market may even shut forcing banks to rely on costly capital issuance. A higher anticipated cost of funding in the future then cascades up front into a higher rate for term loans made by banks (as in Diamond and Rajan (2011), Shleifer and Vishny (2010), or Stein (2012)), lower firm investment, and lower aggregate activity.

In sum, the demand for reserves is not static, it ratchets up with supply, leaving fewer “free” reserves than one might otherwise think. Under some circumstances, every additional dollar of reserves the central bank issues up front can increase the net demand for liquidity in situations of liquidity stress, and can increase the interbank borrowing premium.<sup>6</sup> That *the ex-ante supply of reserves affects the ex-*

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<sup>5</sup> For earlier work on liquidity hoarding, see for example, Acharya, Shin and Yorulmazer (2011), Acharya, Gromb and Yorulmazer (2012), Alfonso, Kovner, and Schoar (2011), Bech (2008), Copeland, Duffie, and Yang (2021), and Diamond and Rajan (2011).

<sup>6</sup> We show that if an implicit or explicit reserve requirement leads demand deposits to grow faster than reserves, a pattern suggested by the evidence, an increase in the net demand for liquidity with an increase in reserves can arise even without any shrinkage of, or encumbrance on, reserves in the future.

*post demand for them* is because QE operates through commercial bank balance sheets; if central bank reserves were instead placed directly with households, or with financial intermediaries that did not issue claims on liquidity after swapping their assets for reserves, the effects we hypothesize would be mitigated.

Evidence for the underlying assumptions of our paper and our results has accumulated since our early drafts. Exhibit 1A-1C are from Acharya, Chauhan, Rajan, and Steffen (2022). Exhibit 1A suggests that as the Federal Reserve expanded reserves through various rounds of quantitative easing between late 2008 and 2014, commercial banks increased their issuance, not just of deposits, but eventually also of lines of credit. Indeed, Acharya et al. (2022) find that overall deposits went up approximately one for one with reserves, but demandable deposits went up more than reserve issuance. Moreover, Exhibit 1B suggests it was uninsured demandable deposits, the most volatile form of borrowing, which increased the most with reserve expansion. Finally, Exhibit 1C shows that the ratio of claims on liquidity (outstanding credit lines, deposits and specifically uninsured demandable deposits) to reserves reached a peak after QE ended in 2014 Q3, specifically in September 2019 when the Fed was forced to resume quantitative easing to alleviate liquidity stress. This evidence suggests that bank-issued claims on liquidity are important to understand liquidity stress.

Turning to pricing, Lopez-Salido and Vissing-Jorgensen (2022) argue that the opportunity value of liquidity, measured as the effective federal funds rate minus the central-bank-paid interest on excess reserves, is affected not just by the quantity of outstanding reserves but also by the outstanding stock of commercial banking deposits. In the cross-section, Acharya et al. (2022) show that banks with substantial exogenous quantities of reserves do issue more demandable deposits to finance them. They also reduce the spread they are willing to pay for time deposits, and originate more credit lines to firms. More generally, as our model suggests, the value of liquidity is negatively related to the supply of reserves, *but only after correcting for claims on these reserves*, which grow endogenously with reserves.

Closely related to our paper is Diamond, Jiang, and Ma (2021), who ask how the reserve build-up by the Federal Reserve could affect bank lending. While they too emphasize the need to finance reserves, their focus is on the crowding-out effects of such reserve holdings on corporate loans. Our focus instead is on the effects of reserves on ex-post liquidity, and how that would consequently impact corporate lending.

Studies of the recent rate spikes in usually liquid money markets have attributed them to regulatory and supervisory action (see footnote 4), to sudden increases in demand for, and decreases in supply of, reserves due to Treasury actions (see, for example, Copeland, Duffie and Yang (2021)), or to

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an exogenous growth in household financial assets and thus, mechanically, to their demand for deposits (Lopez-Salido and Vissing-Jorgensen (2022)). Our theory, with banks affecting both demand for, and supply of reserves once the central bank issues them, and making the system possibly more prone to disruption, complements these explanations. For instance, a binding capital or Liquidity Coverage Ratio requirement or rising household demand for deposits would not explain why banks deliberately reduced their share of financing from time deposits during QE, increased their share of financing from uninsured demand deposits (typically not held by households), and increased their issuance of lines of credit (typically to firms). The endogeneity of bank responses to reserve issuance also suggests that while an understandable response to liquidity stress is for the central bank to expand the quantum of reserves yet more, if the claims on liquidity eventually grow with higher levels of reserves, as we argue and Acharya et al. (2022) document, there will be a ratcheting up in needed reserves. We discuss ex-post central bank interventions in depth in the paper.

There are many moving parts in a model with firms, banks, investors, and the central bank, so we introduce the basic model in section I, and analyze it in section II, first assuming a fixed exogenous fraction of hoarding by healthy banks and reserve shrinkage. In section III we endogenize hoarding, and in section IV, anticipated reserve shrinkage from quantitative tightening. In section V, we examine robustness, in section VI we compare the privately optimal choices to the central bank/planner's choices, as well as discuss ex-post central bank intervention, and conclude in section VII.

## I. The Model

Consider an economy with three dates, 0, 1, and 2. Subscripts denote the date in what follows and Greek letters are parameters. There are four sets of agents in the economy: firms, banks, risk-averse savers, and risk-neutral savers (with the central bank playing a cameo role in determining reserves). The state of the economy  $\tilde{y}$  is revealed at date 1. It can be healthy ( $y = 0$ ) or liquidity stressed ( $y = 1$ ). Firms and banks maximize expected profits.

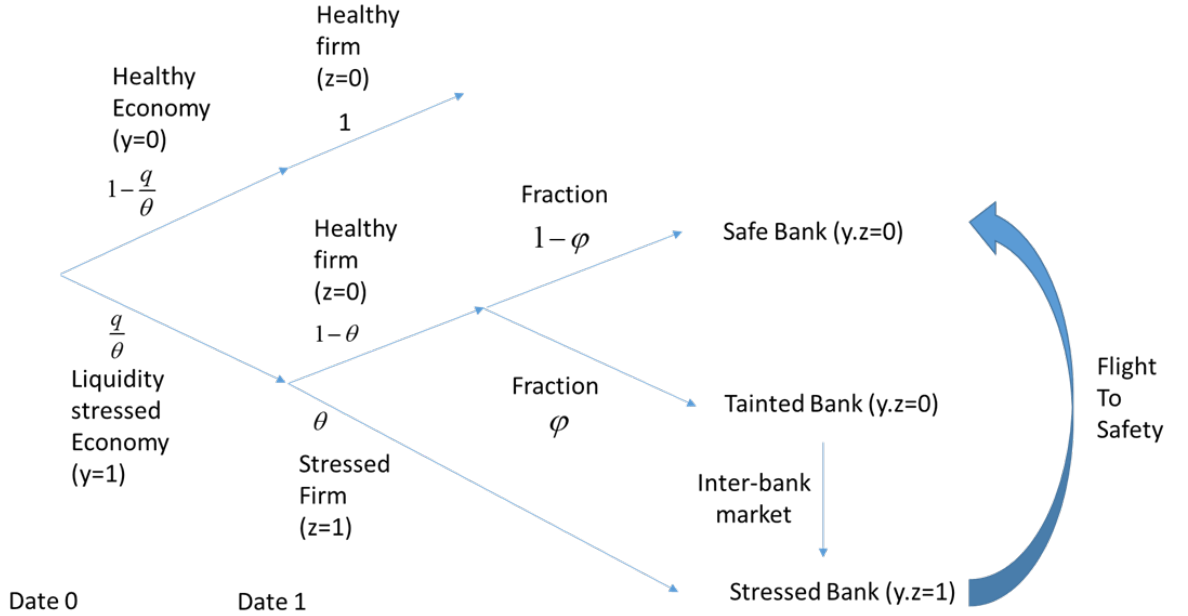
### 1.1. Firms

Each firm could be thought of as representing an entire sector of the real economy. The firm has access to an investment opportunity at date 0. The state of the firm  $\tilde{z}$  is revealed at date 1. It is always healthy ( $z = 0$ ) when the economy is healthy. As in Holmstrom and Tirole (1998), the firm can be hit by an independent and identically distributed shock that makes it stressed ( $z = 1$ ) with probability  $\theta$  when the economy is liquidity stressed, which occurs with probability  $\frac{q}{\theta}$ . So the date-0 probability of a firm

getting stressed at date 1 is  $q$ . The time line for the state space of economic outcomes is in Figure 1 (we will shortly explain the bank-level outcomes illustrated there).

An investment of  $I_0$  at date 0 produces  $g_0(I_0)$  at date 2 if the firm is healthy. If stressed, the firm produces nothing at date 2 from its original investment. However, it has the possibility of “rescuing” some of its earlier investment at date 1 by investing an additional amount  $I_1$ . The expected output from such investment is  $g_1(I_1)$ . This output of the rescue investment is high enough in expectation to allow the firm to repay the expected value of its loans, both for the initial investment and the rescue investment. There is, however, a non-zero probability that nothing is produced from the rescue investment also and the entire sequence of investments is a write-off. Both  $g_0$  and  $g_1$  are increasing and concave, and obey Inada conditions.

Liquidity stress in our model stems from real needs for spending at date 1, which in turn precipitate larger financial demands for liquidity. A model where losses on financial investment precipitate margin calls, which necessitate new funding to avoid fire sales, would have similar effects.



**Figure 1: The state space of economic and bank-level outcomes**

The firm starts out with own funds of  $W_0^F$ , and will supplement it with  $L_0^F$  of long-term borrowing from the bank. Apart from the real investment at date 0, it can also place deposits of  $D_0^F$  in the bank. We can think of this as the firm's precautionary liquidity holdings, and is isomorphic (up to the fees

charged) to pre-contracted credit lines from the bank. At date 1, the stressed firm can withdraw its deposit, as well as borrow from the bank, in order to make its rescue investment,  $I_1$ .

### 1.2. Banks

Each bank lends to a firm (or in the alternative interpretation, an entire sector). So a bank and a firm constitute a pair. The analysis will be conducted on a per bank-firm pair basis. At date 0, the bank can make a two-period loan of amount  $L_0$  at a cumulative gross interest rate of  $R_0^L$ . The bank incurs a cost of  $\frac{1}{2} \lambda (L_0)^2$  in making the loan – the cost is increasing and convex because the bank has to manage, and lay off, an increasing amount of risk. At date 0, each bank also has to hold  $S_0$  of reserves that the central bank has issued. For now, we assume it has no choice about the size of reserves it holds, these arise automatically from its (symmetric) share of financial activity, which is given. We will refer to a bank that has lent to a firm that has become stressed at date 1 also as “stressed”.

### 1.3. Bank Financing

To finance its asset holdings, a bank can raise deposits at date 0 from the risk-averse saver, whose rate of time preference is 1. So if  $D_0$  is the quantum of overall deposits it raises, then  $(D_0 - D_0^F)$  is what it raises risk-averse saver, receiving the rest from the firm. Implicit here is the assumption that there are only a limited number of risk-neutral savers in the economy so deposits cannot be financed by them.

The risk-averse saver has log utility over consumption at date 2. We assume that if the low probability event that the stressed firm repays nothing on the rescue loan materializes at date 2, the bank will have to default on deposits at date 2. Anticipating their deposits to be haircut, risk-averse depositors will certainly run on the bank at date 2 to avoid being the one at the back of the line that gets nothing. In turn, anticipating a run at date 2 and thus possible zero consumption even with small probability, risk-averse depositors will ask for their money back from a stressed bank at date 1. Put differently, even though the bank is solvent at date 1, as in Stein (2012) it will have to repay its risk-averse depositors immediately if stressed.<sup>7</sup> The stressed firm also withdraws some or all of its bank deposits to make the date-1 rescue investment.

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<sup>7</sup> The assumption of savers with log utility is simply to produce a run at date 1 without assuming banks are insolvent at date 1. Such behavior mirrors that of institutional wholesale depositors such as corporations or financial institutions where their CFOs lose their job if they have inadvertently left low-yielding transaction deposits in a bank that is risky or fails – this induces extreme risk-aversion about wholesale (uninsured) transaction deposit accounts. Alternatively, depositors could believe that only perfectly safe assets have the requisite “moneyness” (Stein (2012)) or they have no ability to monitor a bank’s risky claims (Dang, Gorton, Holmstrom (2010)).



The bank can raise long-term bank capital (consisting of long-term bonds or equity) from the risk-neutral investor (a Warren Buffet or a sovereign wealth fund), at both date 0 and date 1. The bank faces a repayment cost of  $e_t + \frac{\alpha_t}{2} e_t^2$  at date 2 when it raises amount  $e_t$  at date  $t$ . The quadratic term represents costs associated with patient capital relative to short-term deposits, including higher illiquidity premia, higher term premia, higher borrower moral hazard, and due diligence costs. These costs could be higher at date 1, when the economy is liquidity stressed, than at date 0. An alternate interpretation of “capital” is that these are insured or sticky deposits, which can be paid the going zero rate of interest but raising these requires opening branches for servicing which leads to convex costs for the bank (for example, see Drechsler, Savov, Schnabl and Wang (2023)). Viewed this way, what we are referring to as  $D_0$  are the runnable uninsured deposits. Capital is all other bank liabilities that will not run at date 1.

#### 1.4. Firm Financing in the Stressed State at Date 1

To make its date-1 rescue investment, the stressed firm supplements the deposit it withdraws by borrowing  $l_1^F$  from its bank at date 1 (since the bank is never insolvent and aggregate liquidity conditions are all that matter, the assumption it borrows from its bank is only for convenience). The bank will have to do due diligence given the stressed state of the firm, so the interest rate charged will be  $(1 + r_1 + \gamma)$  where  $\gamma$  is the bank’s deadweight screening and monitoring costs which are passed on to the firm. For simplicity, we assume that all interest rates reflect expected values (so loan face values are set to deliver that rate after accounting for any default risk). This reduces notation and lets us focus on liquidity.

#### 1.5. Reserves Shrinkage or Encumbrance at Date 1

We assume that a bank can use only  $(1 - \tau)$  fraction of its initial reserves to meet depositor or lending needs at date 1. The shrinkage of bank reserves is a critical assumption, which we endogenize later in Section IV, and can occur because of anticipated quantitative tightening, regulatory encumbrances on reserves, or pre-positioning of bank reserves to support funding of speculation. Importantly, bank assets and liabilities are optimally set assuming this expected shrinkage or encumbrance on reserves.<sup>8</sup>

#### 1.6. Interbank Market

A stressed bank can borrow in the interbank market, where healthy banks with surplus reserves can lend. The gross interest rate over the second period in the inter-bank market is 1 if there is an excess

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<sup>8</sup> We show in Online Appendix IV that our results are robust to assuming  $\tau$  to be a fixed *level* of reserves (instead of a fixed *share* of reserves).

of loanable funds relative to demand. If not, the gross interest rate will rise to  $(1 + r_1)$  to equalize the demand and supply for funds. When this is the case, stressed banks and healthy banks that lend in the interbank market will find it attractive to issue some capital at date 1.

### 1.7. Flow of Reserves due to Deposit Flight

When there are ample reserves, the location of reserves is unimportant. In stressed times, when everyone dashes for cash for final settlement, location is paramount. Where do deposits that flee the distressed banks go? This is a critical issue and will influence important results in the paper. We assume these deposits get parked in *safe* banks. But what is safe? Any healthy bank that lends in the interbank market bears some risk of not being repaid, raising concerns among risk-averse institutional depositors about how much risk the bank is taking; in particular, these institutional depositors may learn from interbank markets that the bank has run down its reserve balances. We therefore assume that to be seen as *safe*, a healthy bank should maintain an unimpeachable balance sheet and, in particular, not lend to distressed banks in the date-1 interbank market. It will then attract a proportional share (along with other safe banks) of the flight-to-safety deposits that flee the distressed banks (see Figure 1).

Of course, given the high rate prevailing in the interbank market at date 1, some healthy banks may lend. These banks become *tainted*. Tainted banks will not attract any flight-to-safety deposits.<sup>9</sup>

### 1.8. Convenience Yield on Reserves in Stressed State of the Economy

For a healthy bank's choice to remain safe to be interesting, there should be some value to attracting flight-to-safety deposits and passing up the opportunity to earn a premium in lending to the interbank market. To this end, we assume that when the economy is liquidity stressed, each dollar of reserves has a *convenience yield*  $\delta \geq 0$  to the final holder. This could be thought of as the precautionary value of reserves in case there is further un-modeled stress (or in case assets are sold at a fire sale discount in the future), their value in signaling a "fortress balance sheet" to investors looking for safety, or the franchise value of deposits associated with those reserves. Since the convenience yield is enjoyed by the final holder, any reserve transfer is a private wealth transfer that washes out in the aggregate. However, the convenience yield significantly affects banks' responses to a liquidity shock, as we will see.

### 1.9. Payments and Reserve Transfers

Note that the banking system as a whole does not gain or lose reserves as a result of date-1 capital issuance or payments, but any purchase or payment leads to a transfer of reserves between banks, which

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<sup>9</sup> We assume depositors of tainted banks do not run, though alternative assumptions are easily handled.

we have to keep track of. We assume that any date-1 bank capital issued is bought by risk-neutral investors who first acquire deposits in safe banks (for instance, by selling their treasury bills to risk-averse depositors), and then transfer the safe bank's reserves to the capital-issuing bank by writing the latter a check (alternative assumptions would worsen the date-1 illiquidity problem). Conversely, any payment received for equipment sold for the rescue investment is (naturally) deposited in the safe banks. Finally,

- i) Banks have to hold all the reserves (this is a requirement in most financial systems), and we assume all banks hold them symmetrically initially. So non-banks don't hold reserves. We study bank incentives to hold reserves later, as well as possible non-bank holdings, as recently allowed by the Fed.
- ii) We net out the volume of deposit creation engendered by the issuance of high-powered reserves, looking only at final "reduced-form" balance sheets. The pyramiding of deposits via the money multiplier typically introduces additional complications as to how claims are run upon, netted and settled (see, for example, Kashyap (2020)) that would magnify the problems we examine.

## II. Analysis

We first solve the model assuming that the fraction of healthy banks that choose to become tainted by lending in the interbank market at date 1 is exogenously set at  $\varphi$ , which is known at date 0, and the convenience yield,  $\delta$ , from holding reserves is zero. We will then allow  $\delta > 0$  and endogenize the fraction of tainted healthy banks  $\varphi$  at date 1.

### 2.1. The Firm's Problem

To ease understanding of the calculations that follow, we present firm and bank balance sheets at date 0 and date 1 in Figure 2. With probability  $q$  the firm will be stressed at date 1, and it will be healthy with probability  $(1-q)$ . So its maximization problems at date 0 and date 1 are as follows:

$$\text{Date 0: } \quad \underset{L_0^F, D_0^F}{\text{Max}} (1-q) \left[ g_0(I_0) + D_0^F \right] + q \left[ g_1(I_1) - l_1^F (1 + \gamma + r_1) \right] - R_0^L L_0$$

$$\text{Date 1: } \quad \underset{l_1^F}{\text{Max}} g_1(I_1) - l_1^F (1 + \gamma + r_1)$$

$$\text{s.t. } I_0 = L_0 + W_0^F - D_0^F \text{ and } I_1 = l_1^F + D_0^F$$

The constraints are just budget constraints at each date. The firm's first order conditions (FOCs) then are

$$\text{w.r.t. firm's long-term borrowing from bank } L_0: \quad (1-q)g_0' - R_0^L = 0 \quad (1.1)$$

w.r.t. firm's deposit in the bank  $D_0^F$  :

$$(1-q)(-g_0' + 1) + q(g_1') = 0 \quad (1.2)$$

w.r.t. date-1 firm borrowing from bank  $l_1^F$  :

$$g_1' - (1 + \gamma + r_1) = 0 \quad (1.3)$$

Substituting the value of  $g_1'$  from (1.3) into (1.2), we get  $(1-q)g_0' = (1 + q\gamma + qr_1)$ . Term the right-hand side of this expression  $R_0^{DF}$  : it is the expected opportunity return for the firm of holding an additional dollar of deposit, and thus avoiding borrowing from the bank at date 1 if stressed. Comparing with (1.1) where the firm's marginal expected return on date 0 investment is equal to the cost of long-term borrowing from the bank, we get  $R_0^L = R_0^{DF}$ . In words, the cost of long-term borrowing is equal to the opportunity return on holding an additional dollar of deposit. Let us now turn to the bank's problem.

## 2.2. The Bank's Problem

The bank maximizes profits given constraints, that is,

$$\begin{aligned} \text{Max}_{l_0^B, e_0, e_1} \quad & R_0^L L_0 + S_0 - e_0 - \frac{\alpha_0}{2} e_0^2 - D_0 \\ & + \frac{q}{\theta} \theta \left[ -\frac{\alpha_1}{2} e_1^2 - r_1 (b_1(y=1, z=1) - l_1^B) \right] \\ & + \frac{q}{\theta} (1-\theta) \varphi \left[ -\frac{\alpha_1}{2} e_1^2 - r_1 b_1(y=1, z=0) \right] \end{aligned}$$

$$\text{s.t. } D_0 + e_0 = L_0 + \frac{1}{2} \lambda (L_0)^2 + S_0 \quad (1.4)$$

$$b_1(y=1, z=1) = l_1^B + D_0 - S_0(1-\tau) - e_1 \quad (1.5)$$

$$b_1(y=1, z=0) = -S_0(1-\tau) - e_1 \quad (1.6)$$

$$l_1^B = l_1^F = I_1 - D_0^F \quad (1.7)$$

The first line of the maximization is the bank's expected profits at date 2 from date-0 lending and financing activities. The second line is the expected loss for a stressed bank. The stressed bank funds the loan to the stressed firm (in equilibrium,  $l_1^B (= l_1^F)$ ) and deposit repayments using reserves (after

shrinkage), date-1 capital raised, and interbank borrowing (of  $b_1(y=1, z=1)$ , see (1.5)). Its expected loss is the cost of capital raised plus the interbank borrowing less the return on the loan to the firm. The third line of the maximization is the expected profits to a healthy bank from becoming tainted and lending  $-b_1(y=1, z=0)$  into the interbank market when the economy is stressed at date 1, which it finances from its reserves and the capital it raises (see (1.6)). Note that both the stressed bank and the tainted bank will raise the same amount of capital in equilibrium because they will both see the same marginal return of using that capital in the interbank market (for the stressed bank it reduces borrowing, and for the tainted bank it increases loans).

The constraint (1.4) simply reflects the sources and uses of funds at date 0 (the bank raises money from deposits and long-term capital, and invests in long-term loans, the cost of making loans, as well as forced reserve holdings). Then, the first order conditions are

$$\text{w.r.t. long-term loans to the firm } L_0: \quad R_0^L - (1 + \lambda L_0)(1 + qr_1) = 0$$

From the bank's perspective, the date-0 return from making another dollar of loan should equal the cost of funding that dollar (and the associated marginal risk management cost,  $\lambda L_0$ ) via flighty deposits, which have an expected cost of  $(1 + qr_1)$ . Let us term this  $R_0^{DB}$ . Hence,  $R_0^L = (1 + \lambda L_0)R_0^{DB}$ .

$$\text{FOC w.r.t. date-0 capital issuance } e_0: \quad -(1 + \alpha_0 e_0) + (1 + qr_1) = 0$$

This implies the marginal cost of raising an additional dollar of long-term funding or capital at date 0

should equal the saving on funding via deposits. So  $e_0 = \frac{(R_0^{DB} - 1)}{\alpha_0} = \frac{qr_1}{\alpha_0}$ . In words, the bank raises more

capital at date 0 the higher the expected premium it will pay in the interbank market in the stressed state.

$$\text{Finally, FOC w.r.t. date-1 capital issuance } e_1: \quad -(1 + \alpha_1 e_1) + (1 + r_1) = 0$$

So, the bank's cost of raising an additional dollar of capital at date 1 equals the cost of borrowing in the interbank market. Simplifying,

$$r_1 = \alpha_1 e_1 \tag{1.8}$$

Hence the premium  $r_1$  in the interbank market drives capital-raising at date 1 by stressed and healthy tainted banks and vice versa. Firm and bank maximizations also link the various interest rates to it. So

$$R_0^L = R_0^{DF} = (1 + q\gamma + qr_1) = (1 + \lambda L_0)R_0^{DB} = (1 + \lambda L_0)(1 + qr_1) \quad (1.9)$$

### 2.3. Market-clearing at Date 1

We know that the inter-bank premium is necessary in order to equalize the date-1 demand and supply of funds when the economy is liquidity stressed – essentially the premium draws forth more date-1 issuance in the capital market by stressed and tainted banks even while reducing rescue investment by stressed firms. The net date-1 shortfall in the interbank market in the liquidity stressed economy is

$$\theta [I_1 + (D_0 - D_0^F)] - [\varphi(1 - \theta) + \theta] S_0(1 - \tau). \text{ The first term in the first square bracket is the “rescue”}$$

investment by the stressed firms and the second term is the expected withdrawal by the risk-averse depositors from stressed banks (which is redeposited in safe banks). The sum is the call on liquidity by the system, which is reduced by the last term, the available shrunken reserves with stressed and tainted healthy banks. This overall shortfall exactly equals  $[\varphi(1 - \theta) + \theta]e_1$ , the date-1 capital raised by the tainted and stressed banks (note that safe banks do not raise date-1 capital because they have no profitable way to deploy it). So when  $r_1^*$  is positive, we have from (1.8),

$$[\varphi(1 - \theta) + \theta]\alpha_1^{-1}r_1 = \theta [I_1 + (D_0 - D_0^F)] - [\varphi(1 - \theta) + \theta] S_0(1 - \tau)$$

$$\text{or } r_1 \equiv \alpha_1 f(r_1, S_0) \text{ where } f(r_1, S_0) \equiv \frac{\theta}{[\varphi(1 - \theta) + \theta]} [I_1 + (D_0 - D_0^F)] - S_0(1 - \tau). \quad (1.10)$$

Note that in equilibrium,  $D_0^F = L_0 + W_0^F - I_0$  and  $D_0 = L_0 + \frac{1}{2}\lambda(L_0)^2 + S_0 - e_0$ . We denote the equilibrium interbank rate premium as  $\bar{r}_1$ . Then it is clear that if  $f(0, S_0) \leq 0$ ,  $\bar{r}_1 = 0$  because there is sufficient liquidity to meet needs at date 1 without capital issuances. Otherwise,  $\bar{r}_1 > 0$ . We have

*Theorem 1:* The date-1 equilibrium interest rate in the inter-bank market is (i) unique and (ii)  $\frac{d\bar{r}_1}{dS_0} > 0$  if

$$\text{and only if } \theta > \frac{\varphi(1 - \tau)}{\tau + \varphi(1 - \tau)}.$$

*Proof:* See Appendix I.

Uniqueness follows directly from (1.10) and  $f(r_1, S_0)$  decreasing in  $r_1$ , which we show in the appendix. More interesting is the possibility that  $\frac{d\bar{r}_1}{dS_0} > 0$ , that more reserves supplied at date 0 increase liquidity stress at date 1. At first pass, the result seems counterintuitive, but only from a partial-equilibrium perspective – not taking into account the effect of running reserves through bank balance sheets. Recognize first that the marginal source of funding of the reserves is demand deposits, which potentially create their own demand for liquidity in the stressed state (in proportion to the fraction of stressed banks,  $\theta$ ). Moreover, only  $(1 - \tau)$  of each dollar of any bank's reserves is available at date 1, and furthermore, only a fraction  $\varphi$  of the  $(1 - \theta)$  healthy banks use their shrunken reserves to meet the liquidity demands of stressed banks. Put differently,  $\frac{d\bar{r}_1}{dS_0} > 0$  whenever  $\theta$ , the marginal call on liquidity when demand deposits are withdrawn from stressed banks, is higher than the marginal liquidity provided by each dollar of reserves,  $(1 - \tau) [\varphi(1 - \theta) + \theta]$ . Rearranging, this leads to the condition  $\theta > \frac{\varphi(1 - \tau)}{\tau + \varphi(1 - \tau)}$  in Theorem 1.

The traditional view – that disregards bank responses – is that more reserves injected at date 0 will reduce the date-1 interbank premium. This will always be true if  $\tau = 0$ . Since every dollar of reserves is fully available at date 1 to pay down the dollar of deposit that financed it, any stressed bank is self-sufficient, and has no need for the interbank market. In this case, the value of  $\varphi$  does not matter.

Conversely, when  $\varphi = 0$  so that all healthy banks hoard and there is no lending from the interbank market, the condition  $\theta > \frac{\varphi(1 - \tau)}{\tau + \varphi(1 - \tau)}$  in Theorem 1 (for the counterintuitive result that

$\frac{d\bar{r}_1}{dS_0} > 0$ ) is always met as long as  $\tau > 0$ . Intuitively, so long as there is some reserve shrinkage for

every additional dollar of reserves issued, the stressed bank has to raise an increasing amount of date-1 capital to pay deposits issued to fund reserves, since nothing is available from the interbank market. This raises  $\bar{r}_1$ . As we will see when we endogenize  $\varphi$ , an interbank market that shuts down under stressed conditions is entirely possible.

Next, when  $\varphi = 1$  so that all healthy banks lend in the interbank market, the condition in Theorem 1 holds whenever  $\theta > (1 - \tau)$ , that is, the aggregate stressed deposits  $\theta$  that run exceeds aggregate shrunken reserves. This requires a high value of  $\theta$ , suggesting a serious crisis or a low value of  $(1 - \tau)$  suggesting significant reserve shrinkage (that is, substantial QT as we will argue). Finally, for intermediate values of  $\tau$  and  $\varphi$ , the condition holds even for moderate values of  $\theta$ .

#### 2.4. Aggregate Reserves and Interest Rate Premia

Now consider the threshold level of reserves  $\hat{S}_0$  that solves  $f(0, \hat{S}_0) = 0$  after substituting the equilibrium values of  $D_0$  and  $D_0^F$  in (1.10) when  $r_1 = 0$ . Rearranging, we get

$$\hat{S}_0 \left( \frac{\theta}{[\varphi(1-\theta) + \theta]} - (1-\tau) \right) = \frac{\theta}{[\varphi(1-\theta) + \theta]} \left( W_0^F - I_0 - I_1 - \frac{1}{2} \lambda (L_0)^2 \Big|_{r_1=0} \right) \equiv NLS \quad (1.11)$$

The left hand side is the net liquidity demand created by reserves. The right hand side is the net liquidity supplied ( $NLS$ ) by the corporate sector anticipating a date-1 interbank premium of zero (and adjusting for any cost to the bank of long term lending).  $NLS$  is high when the corporate sector has a high level of starting internal funds  $W_0^F$  and a relatively low demand for funds for investment and loans. Lemma 1 suggests that if  $\theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$ , there exists a threshold level of reserves,  $\hat{S}_0$ , such that  $\bar{r}_1 > 0$  is the unique equilibrium for  $S_0 > \hat{S}_0$  and  $\bar{r}_1 = 0$  for  $S_0 \leq \hat{S}_0$ . Conversely, if  $\theta < \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$ ,  $\bar{r}_1 > 0$  is the unique equilibrium for  $S_0 < \hat{S}_0$  and  $\bar{r}_1 = 0$  for  $S_0 \geq \hat{S}_0$ . In Appendix I, we trace how  $\hat{S}_0$  changes with  $\theta$  in greater detail (in particular, depending on the sign of  $NLS$ ).

#### 2.5. The Central Bank/Planner's Problem and Optimal Reserves



In taking the ex-ante level of reserves as given, we have in mind the central bank setting reserves for un-modeled monetary purposes.<sup>10</sup> We now examine where the central bank/planner would set reserves with the view of maximizing welfare in the context of our framework, ignoring the un-modeled monetary effects of setting  $S_0$ .

The central bank/planner wants to maximize output net of real costs (such as due diligence and intermediation costs of capital issuances and term loans), that is, maximize w.r.t.  $S_0$

$$U \equiv ((1-q)g_0(I_0) - I_0) + q(g_1(I_1) - I_1 - (I_1 - D_0^F)\gamma) - \frac{1}{2}\alpha_0 e_0^2 - \frac{q}{\theta}[(1-\theta)\varphi + \theta](\frac{1}{2}\alpha_1 e_1^2) - \frac{1}{2}\lambda(L_0)^2 \quad (1.13)$$

where  $(I_1 - D_0^F)$  is the firm's date-1 borrowing from the bank that is associated with a per unit

deadweight monitoring cost  $\gamma$ . It follows that  $\frac{dU}{dS_0} = \frac{\partial U}{\partial \bar{r}_1} \cdot \frac{d\bar{r}_1}{dS_0}$  since  $\frac{\partial U}{\partial S_0} = 0$  (the central bank has no

direct cost of supplying reserves as suggested by Friedman (1969)). It is easily shown (see Appendix I)

that  $\frac{\partial U}{\partial \bar{r}_1} < 0$ . Consequently, the central bank wants to raise  $S_0$  only if the date-1 interbank market rate

premium is positive and  $\frac{d\bar{r}_1}{dS_0} < 0$ . Conversely, if  $\frac{d\bar{r}_1}{dS_0} > 0$ , the central bank wants to reduce ex-ante

reserve issuance. In sum, the central bank will set the reserves at any level such that the anticipated

interbank rate premium  $\bar{r}_1$  is zero.

## 2.6. Discussion

The inter-bank premium is always zero when the economy is healthy. Any idiosyncratic liquidity demands are likely to be diversified across a large set of liquidity suppliers (see Kashyap, Rajan and Stein (2002), for example). Central bank supplied liquidity is likely to be ample for such needs and the location of reserves is unimportant. However, in stressed situations, liquidity demands are substantial (for example, as witnessed by banks in the United States during 2007-08, see Acharya and Mora (2015), or as witnessed by firms at the onset of the pandemic in March 2020, see Kashyap (2020) and Acharya, Engle

<sup>10</sup> Central banks have sought to expand reserves in order to implement quantitative easing, where the effects range from signaling monetary policy stance (see Krishnamurthy and Vissing-Jorgensen (2011)), recapitalizing banks through the back door, or repairing markets (see, for example, Acharya, Eisert, Eufinger, and Hirsch (2019)).

and Steffen (2021)), available liquidity with each bank can be shrunk ( $\tau > 0$ ), and liquidity hoarding ( $1 - \varphi > 0$ ) can further restrict supply. As discussed in Section 2.4, there is a threshold ex-ante central bank reserve issuance level at date 0 beyond which further issuance increases the net interbank date-1 rate  $r_1$ . Whether increased ex-ante reserves reduce ex-post liquidity is an empirical question, depending on the extent of shrinkage and hoarding (which as we will see in the next section can be substantial). Undoubtedly, however, the “free” reserves available to deal with liquidity stress at date 1 will be significantly lower than the aggregate reserves issued at date 0 because of the endogenous issuance of claims on reserves by the banking sector. Reserve demand is not static, indeed supply will create some of its own demand, a phenomenon the literature has not emphasized.

For instance, some commentators argue that central bank balance sheet expansion might reduce systemic risks (see Stein (2012) and Greenwood, Hanson, and Stein (2016)). Essentially, the argument is that central bank reserves will compete with short-term bank deposits for place on private investor portfolios. Being more money-like, the former will displace the latter, and make the financial system safer (by avoiding deposit-induced run risk). Our analysis qualifies this conclusion by noting that because reserve expansion typically runs through commercial bank balance sheets, the demand for liquidity is affected by the issuance of reserves. Far from crowding out bank deposits, central bank reserve issuance may enhance them (as also pointed out by Nagel (2016)). Greenwood, Hanson, and Stein (2016) argue that the optimal way for the central bank to crowd out the money premium in deposits is to do reverse repo transactions directly with a broader set of non-bank investors, as the Fed started doing in 2021 with money market funds. But so long as much of central bank reserve expansion runs through bank balance sheets, our qualifications hold.

### III. Endogenous $\varphi$ : Liquidity Hoarding

We assumed so far that in stressed situations an *exogenous* fraction  $\varphi$  of healthy banks lend in interbank markets, and the remaining fraction receives the flighty deposits of stressed banks. We now endogenize the fraction  $\varphi$ , by allowing healthy banks to choose between lending in the interbank markets and consequently becoming *tainted*, or staying clear of profitable albeit risky interbank lending and instead attracting flight-to-safety deposits on which recipient banks earn a convenience yield  $\delta > 0$ .<sup>11</sup> In equilibrium, healthy banks must be indifferent between choices.

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<sup>11</sup> Why do safe banks not compete for flight-to-safety deposits by raising deposit rates? Acharya and Mora (2015) show that safe banks did not raise deposit rates during the GFC, while distressed banks did. Caglio, Dlugosz and Rezende (2023) document a similar pattern in deposit rates when regional banks lost a significant quantity of deposits to large banks in the early 2023. One explanation is that safe banks were trying to signal that they did not

In the benchmark model of Section 2.1, the interbank market was always open so that  $r_1$  was both the interbank rate as well as the lending rate to stressed firms net of bank monitoring cost  $\gamma$  (that is, firms borrow at  $r_1 + \gamma$  but the bank earns the net rate  $r_1$ ). Now, the interbank market may be shut that is,  $\varphi = 0$ . However, stressed firms will still borrow from their banks, and  $r_1$  is the bank lending rate to the firm net of the monitoring cost. As before, we will use the notation  $\bar{r}_1$  for the equilibrium interbank lending rate when the interbank market is open (in which case it will equal  $r_1$ ). However, when the interbank market is closed in a stressed situation, we will denote the equilibrium rate as the *autarky* rate  $r_1^A$ . This is simply the rate that equilibrates liquidity demand and supply (via capital issuances) when the interbank market is closed. Finally, the presence of a convenience yield for reserves implies the interbank market will be open only if the interbank rate exceeds a “breakeven rate” which we will denote as  $r_1^\varphi$ .

### 3.1. Equilibrium as $S_0$ changes

In the liquidity stressed state, three cases may arise (details are in Appendix II):

Case 1: *Stressed banks have enough liquidity (while raising date-1 capital commensurate with the convenience yield) to meet the needs of deposit outflows and to fund rescue investment without accessing the inter-bank market.*

This first case arises when the level of reserves, and in turn of demandable deposits, is adequately low.

Case 2: *The liquidity needs of each stressed bank can be entirely met by its raising date-1 capital (beyond that warranted by the convenience yield).*

In this second case, the level of reserves is moderately high and the interbank market remains shut ( $\varphi = 0$ ) even though stressed banks are liquidity-deficient; formally, this occurs because the autarky rate  $r_1^A$  is below the breakeven rate  $r_1^\varphi$  that healthy banks require to enter the interbank market.

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need funds in order to avoid the stigma associated with risky banks. Relatedly, the inflow from risk-averse flight-to-safety institutional depositors may be driven by convenience and a desire for principal protection rather than to exploit small differences in rates. For instance, depositors may flee their stressed bank to the most proximate safe bank. Finally, a bank will have to pay any higher rate to all its depositors. If the flight-to-safety deposits are only a small fraction of a receiving bank’s overall deposits, safe banks may be reluctant to compete for them. This is a similar effect to Drechsler, Savov and Schnabl (2017), who document that banks in concentrated banking areas are reluctant to pay flighty depositors higher rates when the Fed raises rates, since they have to also pay captive depositors that rate. Given these considerations, we assume safe banks cannot (or will not) raise rates to attract more flight-to-safety deposits.

Case 3: The liquidity needs of the stressed banks are high enough that at the equilibrium autarkic interest rate, some of the healthy banks are willing to lend in the interbank market and become tainted. The equilibrium rate then is lower than the (now counterfactual) autarkic rate.

The third case arises when the level of reserves is high enough that the autarky rate  $r_1^A$  rises above the breakeven rate  $r_1^\varphi$  and the inter-bank market opens up ( $\varphi > 0$ ). Some surplus banks are induced by the high inter-bank premium to provide liquidity to deficient banks.<sup>12</sup>

### 3.2. Determining $\varphi$ when the interbank market opens

Let us characterize this third case to understand when in equilibrium the interbank market opens up or remains shut. The  $\varphi$  healthy banks that choose to lend in the date-1 interbank market will lend all their shrunken reserves as well as the capital raised at date 1 at rate  $r_1$ . The date-1 profits from doing so

are  $V_1^\varphi = \left[ (r_1 - \delta)S_0(1 - \tau) + \frac{r_1^2}{2\alpha_1} \right]$ , where the first term is the incremental value from lending out

own shrunken reserves, and the second term is the profit from raising capital ( $e_1 = \frac{r_1}{\alpha_1}$ ) and lending the proceeds. The net reserve outflows from the stressed and now tainted banks amount to

$S_0(1 - \tau)[\theta + (1 - \theta)\varphi]$  and these go to the  $(1 - \theta)(1 - \varphi)$  banks that choose to be safe. So the profit

from being seen as safe and attracting the flight-to-safety deposits is  $V_1^{1-\varphi} = \frac{\delta S_0(1 - \tau)[\theta + (1 - \theta)\varphi]}{(1 - \theta)(1 - \varphi)} =$

$\delta S_0(1 - \tau) \left( \frac{1}{(1 - \theta)(1 - \varphi)} - 1 \right)$ . In equilibrium, healthy banks should be indifferent between choosing to

become tainted or stay safe. So  $V_1^\varphi = V_1^{1-\varphi}$ , and rearranging terms

$$(1 - \varphi) = \frac{\delta S_0(1 - \tau)}{(1 - \theta) \left( r_1 S_0(1 - \tau) + \frac{r_1^2}{2\alpha_1} \right)} \quad (1.12)$$

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<sup>12</sup> We assume that  $\delta$  is sufficiently large for these cases to arise. The condition is formally stated in Appendix II, in the Proof of Theorems 2-3. When the convenience yield  $\delta$  is small, it is possible that only Cases 1 and 3 arise since the breakeven rate  $r_1^\varphi$  may be lower than  $\delta$  at the level of reserves that requires a switch out of Case 1.

Inspecting (1.12), it is clear that  $\frac{\partial \varphi}{\partial S_0} < 0$ ,  $\frac{\partial \varphi}{\partial \delta} < 0$ ,  $\frac{\partial \varphi}{\partial r_1} > 0$ . In words, the share of healthy banks lending

in the interbank market falls in the ex-ante level of reserves (because, as  $S_0$  increases, the relative profits from raising and lending capital fall relative to attracting the flight-to-safety deposits) as well as in the convenience yield, and increases in the available interbank rate.<sup>13</sup>

Then, requiring that  $\varphi > 0$  yields the “breakeven interbank rate”  $r_1^\varphi$ , that induces some banks to lend in the interbank market. When  $\varphi > 0$ , the equilibrium interest rate  $\bar{r}_1$  and  $\varphi$  are now jointly determined by equations (1.10) and (1.12). Finally, comparing the breakeven interbank rate  $r_1^\varphi$  and the autarky rate  $r_1^A$  determines when Case 2 versus Case 3 arise. These details are worked out in Appendix II where we show formally that

*Theorem 2:* For  $\delta > 0$  and  $\tau > 0$ , there exist critical thresholds for the level of reserves,  $S_0^*$  and  $S_0^{**}$ ,

where  $S_0^{**} > S_0^* > 0$ , such that the inter-bank market is open, that is,  $\varphi > 0$ , only for  $S_0 > S_0^{**}$ , and

(i) for  $S_0 \leq S_0^*$ , stressed banks are not liquidity-deficient (taking into account their capital raise dictated by the convenience yield), and  $r_1$  charged to firms equals  $\delta$ ;

(ii) for  $S_0 \in (S_0^*, S_0^{**}]$ , stressed banks are liquidity-deficient and raise more capital at date 1 than dictated by the convenience yield, but the inter-bank market remains shut (autarky). Furthermore, the autarkic

lending rate to firms  $r_1^A$  satisfies  $r_1^A > \delta$ ,  $\frac{dr_1^A}{dS_0} > 0$ , and  $r_1^A(S_0^{**}) = r_1^\varphi(S_0^{**}) > 0$ ; and,

(iii) for  $S_0 > S_0^{**}$ , stressed banks are liquidity-deficient and raise capital as well as borrow in the inter-bank market at date 1; the inter-bank rate satisfies  $\bar{r}_1(S_0) \geq r_1^\varphi(S_0) > 0$ , with  $r_1^\varphi(S_0)$  increasing in  $S_0$ .

We also show in Appendix II that the equilibrium  $r_1$  is increasing in  $S_0$  in Case (iii) whenever

$\theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$  as in section 2.1. However, it is only a sufficient condition now, since with endogenous

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<sup>13</sup> As an aside, as  $\delta \rightarrow 0$ , we have  $\varphi \rightarrow 1$ . That is, as the convenience yield of reserves falls to zero, virtually all healthy banks choose to lend in the interbank market. Only a sliver of the healthy banks prefers being seen as safe, and these attract all the flight-to-safety reserves, which carry an infinitesimal convenience yield  $\delta$ .

$\varphi$ , the incentive to hoard and attract deposits also increases in  $S_0$ , further increasing the equilibrium interest rate. Furthermore, since  $\varphi$  rises from zero at the breakeven interest rate  $r_1^\varphi$  at which the interbank market opens, there is always a region in Case (iii) in which  $r_1$  increases in  $S_0$ .

Finally, as the convenience yield  $\mathcal{S}$  associated with the possession of reserves increases, the inter-bank market remains shut over a wider range of the level of reserves, and the level of the inter-bank rate increases with  $\mathcal{S}$  whenever the inter-bank market is open. Formally,

*Theorem 3:* (i)  $S_0^*$  and  $S_0^{**}$  are increasing in  $\mathcal{S}$ ; and, (ii) for  $S_0 > S_0^{**}$ ,  $\frac{d\bar{r}_1}{d\mathcal{S}} > 0$ .

Interestingly, because safe banks do not make any decisions after date 0 (other than deciding whether to lend), and because banks take  $\varphi$  and  $\bar{r}_1$  as given, the ex-ante bank maximization problem is the same as what we analyzed earlier, though  $\varphi$ ,  $\bar{r}_1$ , and bank expected profits will be altered by  $\mathcal{S}$ .

### 3.3.. Examples and details

Figures 3A and 3B illustrate model outcomes for a specific parameterization where  $\delta = 0.2, \tau = 0.2$ . In Figure 3A,  $\theta = 0.8 = (1 - \tau)$  and in Figure 3B,  $\theta = 0.6 < (1 - \tau)$ . Other parameters are  $\lambda = 1, \gamma = 0.4, q = 0.1, \alpha_0 = \alpha_1 = 1, W_0^F = 2, g_0' = g_1' = 1/I$ . The breakeven interbank rate  $r_1^\varphi(S_0)$  is in green, the autarkic bank lending rate  $r_1^A(S_0)$  is in yellow (with its hypothetical value extrapolated if the inter-bank market were to remain shut even for  $S_0 > S_0^{**}$ ), and the equilibrium interbank rate  $\bar{r}_1(S_0)$  when some healthy banks choose to enter the inter-bank market is in blue. While the entry of some healthy banks pulls the inter-bank rate down (blue line relative to the yellow line), it nevertheless remains above  $r_1^\varphi(S_0)$  and is increasing in  $S_0$  for both sets of parameters.

Figures 4A and 4B illustrate the effects of varying the convenience yield  $\mathcal{S}$ , with  $\theta$  set at 0.6, less than  $(1 - \tau)$ . In Figure 4C,  $\mathcal{S}$  takes values close to zero, whereas in Fig 4B, it takes significantly higher values. In both cases, as  $\mathcal{S}$  increases, the threshold reserve level above which the inter-bank market opens shifts higher to the right, though this shift is relatively modest at low values of  $\mathcal{S}$ . Also, as  $\mathcal{S}$  increases, the inter-bank rate is higher whenever the inter-bank market is open. Finally, Figure 4C shows that as  $\mathcal{S}$  increases, the proportion  $\varphi$  of surplus banks that enter the inter-bank market decreases.

### 3.4. Endogenous $\delta$

Thus far, we have assumed the date-1 convenience yield is exogenous, but it likely depends on the net liquidity mismatch. A good proxy for the date-1 mismatch is  $r_1$ . The higher is  $r_1$ , the more worried market participants may be about hidden prospective problems (and opportunities to buy in fire sales) emanating from the current stress, and the more they may value the convenience yield in holding reserves. If  $\delta(r_1) = \delta^A + \delta^B r_1^2$  where  $\delta^A \geq 0$ ,  $\delta^B \geq 0$ , we show in Appendix II that such a convenience yield on reserves that rises in liquidity-stressed states magnifies date-1 stress as the inter-bank market remains closed over a wider parameter range.<sup>14</sup>

### 3.5. Discussion

In a stressed situation, healthy banks may be unwilling to lend, especially if the convenience yield associated with reserves is high. With the interbank market shut ( $\varphi \rightarrow 0$ ), a plausible scenario in recent stress episodes, the condition for the interbank rate to rise in the level of reserves (Theorem 1) holds even with minor reserve shrinkage ( $\tau \rightarrow 0$ ). Additional reserve issuance at date 0 then raises the risk premium conditional on the market getting stressed.

Is liquidity hoarding significant? Certainly, studies do find that the interbank market is disrupted during periods of stress or likely reserve shortage (see, for example, Afonso et al. (2011) or Copeland et al. (2021)). In the United States, one measure of the reluctance of commercial banks to lend to one another at such times is the amount of funding that is run through the Federal Home Loan Banks, institutions that are considered to be implicitly guaranteed by the federal government, and thus entail almost no credit risk. Essentially, by acting as a counterparty between banks (or between banks and money market funds), the FHLB intermediates funds when the private market for liquidity is stressed or frozen. Put differently, the implicitly guaranteed FHLBs do not fear the taint from lending that private banks fear, and thus reallocate liquidity when banks on their own would not.<sup>15</sup> Cecchetti et al. (2023) document the huge expansion in FHLB balance sheets in 2008, again as reserves shrank after quantitative easing ended in 2014 till the Fed resumed quantitative easing in September 2019, again in March 2020 before the Fed flooded the market with reserves, and again when the Fed started quantitative tightening in March of 2022.

## IV. Shrinkage of Reserves

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<sup>14</sup> Specifically, we show that depending on parameters, it is possible (i) the interbank market never opens (in particular when  $\delta^B$  is sufficiently high, because the convenience yield grows fast with the inter-bank premium, increasing the returns to hoarding more than lending), or (ii) that it opens only if the date-1 rate lies in a range and is closed otherwise, or (iii) that it opens above a certain rate as with a fixed  $\delta$ .

<sup>15</sup> In so doing, the FHLBs prevent more damage from stress situations, but at the potential cost of taking on significant lending risk and crowding out private interbank market in the first place (a theme we will return to when we consider ex-post central bank interventions in Section 6.2).

We have argued that a share  $\tau$  of reserves is not available at date 1 for any inter-bank transfers, either because of shrinkage or encumbrances. We now explain in greater detail the role of quantitative tightening QT (where the central bank sells government bonds or other eligible securities for reserves) in shrinking bank reserves. In Online Appendix IV, we consider regulations and banks tying up “spare” reserves in funding speculative activity as two other channels through which reserve encumbrance can be endogenized.

#### 4.1. Reserves Shrinkage Factor $\tau$ due to Quantitative Tightening

Exhibits 1A-1C show that while reserves injection into the banking system during quantitative easing (QE) leads to an expansion of bank balance-sheets via a corresponding increase in demandable bank claims (such as uninsured demandable deposits and lines of credit), reserves withdrawal during quantitative tightening (QT) is *not* associated with a corresponding reduction in these claims.

To generalize our model in this direction, consider the central bank undertaking QT just before date 1 uncertainty is realized. Suppose that QT shrinks each bank’s reserves by  $\tau S_0$  and also shrinks bank deposits in the process (symmetrically across banks for simplicity) by a factor  $\tau^D S_0$  where  $\tau^D \leq \tau$ . Thus, each bank has swapped some of its reserves with the central bank for securities (as elaborated below) and now holds  $(\tau - \tau^D)S_0$  in securities.<sup>16</sup> The date-1 market-clearing condition (1.10) takes the modified form

$$[\varphi(1-\theta) + \theta]\alpha_1^{-1}r_1 = \theta[I_1 + (D_0 - D_0^F) - \tau^D S_0] - [\varphi(1-\theta) + \theta]S_0(1-\tau).$$

It is then straightforward to show that a *necessary* condition for higher  $S_0$  followed by QT to raise  $r_1$  is that  $\tau^D < \tau$ . Conversely, if QT is exactly a reversal of QE, i.e.,  $\tau^D = \tau$ , then we have to appeal to encumbrances (see Online Appendix IV) rather than QT to explain liquidity stress. Further, the sufficient condition for reserves to be destabilizing now takes the form  $\theta > \frac{\varphi(1-\tau)}{(\tau - \tau^D) + \varphi(1-\tau)}$ .

Empirically, Acharya et al. (2022) find  $\tau^D \approx 0$  in the post-QE period before the pandemic, validating our starting assumption in the model that  $\tau^D = 0$ .<sup>17</sup> This could be, for example, because QT is

<sup>16</sup> None of our earlier analysis changes since stressed banks cannot use securities to pay running depositors or to make loans. Of course, securities can be used as collateral to borrow reserves, but we have assumed no bank borrowing constraints, so the analysis is unaffected when aggregate reserves are in short supply.

<sup>17</sup> The post-pandemic QT experience to date suggests banks are losing deposits as reserves shrink, i.e.,  $\tau^D > 0$ , but as QT is still in progress, it is too early to evaluate whether  $\tau^D < \tau$  or not.



in large part an asset-swap with banks. Furthermore, Acharya et al. (2002) document that the liquidity distribution across banks deteriorates during QT relative to QE. In our model, this would correspond to  $\tau$  being higher for liquidity-stressed banks and/or  $\tau^D$  being lower for these banks, which would expand the parameter space over which an expansion of ex-ante reserves is likely to be destabilizing.

Let us put  $\tau^D < \tau$  on firmer footing. Suppose the central bank announces QT, where it will sell a quantity  $\tau S_0$  of securities (per bank). Each bank is a primary broker-dealer, which has to decide what fraction  $s$  of reserves to use to purchase securities being offered by the central bank, and thus what residual fraction it offers to its non-bank clients. Non-banks will purchase securities and pay for them with their deposit accounts held at the bank. So the total reduction of reserves in the banking system is  $\tau S_0$  regardless of the bank's choice. However, if the bank purchases securities, it simply swaps reserves for securities, which does not alter the quantity of its deposits, whereas non-bank purchases reduce bank reserves and deposits by  $\tau^D S_0 = (1-s)\tau S_0$ . Suppose that securities are sold at market value and they can be tendered at the central bank's lender-of-last-resort (LOLR) operations for reserves in the future at a haircut  $h \leq 1$ .

Then we can solve for banks' optimal choice of participation in QT, summarized by  $s$ , as in Section 2.2 (equations (1.4)-(1.7)). In particular, banks anticipate their liquidity need when stressed as

$$b_1(y=1, z=1) = (I_1 - D_0^F) + [D_0 - (1-s)\tau S_0] - [S_0(1-\tau) + (1-h)s\tau S_0] - e_1$$

which captures the reduction in deposits due to security purchases by non-banks, as well as the state-contingent increase in reserves if the bank borrows reserves from the LOLR, collateralized by its security purchases amounting to  $s\tau S_0$  at a haircut  $h$ . Similarly, banks anticipate that when they are not stressed but other banks are, their spare liquidity to lend in inter-bank markets is

$$b_1(y=1, z=0) = -[S_0(1-\tau) + (1-h)s\tau S_0] - e_1.$$

Then, banks' choice of  $s$  maximizes the following objective function:

$$\text{Max}_s \quad -\frac{q}{\theta} \theta \left[ r_1 (b_1(y=1, z=1) - (I_1 - D_0^F)) \right] - \frac{q}{\theta} (1-\theta) \varphi [r_1 b_1(y=1, z=0)]$$

Simplifying the first order condition with respect to  $s$  indicates that it is positive if and only if

$$r_1 \left[ \left( 1 + \frac{(1-\theta)}{\theta} \varphi \right) (1-h) - 1 \right] > 0 \quad \text{or} \quad \text{iff} \quad \left( 1 + \frac{(1-\theta)}{\theta} \varphi \right) > \left( \frac{1}{1-h} \right).$$

Intuitively, the bank prefers to swap reserves with the central bank for liquid securities ( $s=1$ ) whenever the LOLR haircut against securities is sufficiently small, rather than see both its reserves and deposits fall when it leaves the securities purchases to its non-bank clients. The reason is interesting. If the bank is stressed, it is always better off with lower reserves and lower deposits than holding securities, so long as the haircut is positive – essentially, its need for funds in the stressed state increases because securities are not as good a source of liquidity as reserves. However, healthy banks that propose to lend in the interbank market are always better off if they had bought securities with reserves rather than see both sides of the balance sheet shrink; their depositors do not run, while their securities can be used to raise reserves that can be lent in the inter-bank market. So the higher the ratio of healthy banks that lend to stressed banks, and lower the haircut, the more likely is QT to occur as an asset swap with banks (with bank deposits not falling) rather than as an asset purchase from non-banks.

Formally, it follows then (from Theorem 1) that if  $\theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$ ,  $\frac{dr_1}{dS_0} > 0$  and in turn  $r_1 > 0$  for high enough  $S_0$ . Furthermore, if  $\left( 1 + \frac{(1-\theta)}{\theta} \varphi \right) > \left( \frac{1}{1-h} \right)$ , then QT occurs as an asset swap with banks ( $s = 1$ ), bank deposits do not shrink ( $\tau^D = 0$ ), and this ensures that  $r_1 > 0$  in equilibrium for high enough  $S_0$ . In other words, each bank buys securities in QT from the central bank to maximize profits, taking aggregate liquidity risk ( $r_1$ ) as given, but collectively this ensures that bank deposits do not shrink giving rise to aggregate liquidity risk ( $r_1 > 0$ ) in equilibrium. This form of QT is however socially undesirable as it would be better that the asset swap occurs strictly with non-banks ( $s=0$ ) and bank deposits shrink one for one with reserves ( $\tau^D = \tau$ ), so there is no aggregate liquidity risk ( $r_1 = 0$ ) in equilibrium, even when  $\theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$ .

## V. Robustness

We now elaborate on some of the assumptions we have made and discuss their robustness.

### 5.1. Binding Reserve Requirement, Reserve Expansion, Activity, and Financial Fragility

Thus far we have taken the central bank's monetary motives in injecting reserves as given, and focused on the consequences of commercial bank decisions. Since there are many rationales for why central bank reserve expansion could directly affect date-0 activity, let us focus on an obvious one – it alleviates an explicit or implicit reserve requirement on the commercial bank's deposit issuance. Explicit reserve requirements used to be the norm, but more recently, implicit requirements such as a liquidity coverage ratio (LCR), wherein liquid assets must exceed some “run-offs” on deposits (and other demandable claims on the bank), have taken their place. We will show that with a binding reserve requirement, deposits issued can be a multiple greater than 1 of reserves, and we no longer need  $\tau > 0$  for

$\frac{dr_1}{dS_0} > 0$ . Interestingly, real activity need not be enhanced by additional reserves, even when the reserve constraint is binding.

Suppose we add to the model in section I a requirement that a bank's deposits cannot exceed a multiplier  $\varsigma > 1$  of its reserves holding, i.e.,  $D_0 \leq \varsigma S_0$ . The requirement likely binds when date-0 equity issue costs,  $\alpha_0$ , are so high that no additional equity is issued. We assume this for simplicity, though by continuity, the results will hold when equity issuance costs are merely high. When the requirement binds, deposits are no longer the residual from the date-0 funding constraint (equation 1.4).

Formally, denoting the Lagrangian on the reserve constraint on deposits as  $\Lambda \geq 0$ , the cost of deposits when the constraint binds is  $(1 + qr_1 + \Lambda)$ . Then  $(1 + \lambda L_0) = (1 + qr_1 + \Lambda)^{-1}(1 + q\gamma + qr_1)$ . As

before, we have  $\frac{r_1}{\alpha_1} = \frac{\theta}{[\varphi(1-\theta) + \theta]} [I_0 + I_1 - L_0 - W_0^F + D_0] - S_0(1-\tau) \equiv f(r_1, S_0)$ . Totally

differentiating,  $\left( \frac{1}{\alpha_1} - \frac{\partial f}{\partial r_1} \right) \frac{dr_1}{dS_0} = \frac{\partial f}{\partial S_0}$ . We know  $\frac{\partial I_0}{\partial r_1} < 0$  and  $\frac{\partial I_1}{\partial r_1} < 0$ . Also, when the deposit

constraint binds, i.e.,  $D_0 = \varsigma S_0$ , and with no date-0 equity issuance, the date-0 resource constraint for the

bank takes the form  $L_0 + \frac{1}{2}\lambda(L_0)^2 = (\varsigma - 1)S_0$ , whereby  $\frac{\partial D_0}{\partial r_1} = 0$  and  $\frac{\partial L_0}{\partial r_1} = 0$ , so we have  $\frac{\partial f}{\partial r_1} < 0$  as

before. Therefore,  $Sign\left(\frac{dr_1}{dS_0}\right) = Sign\left(\frac{\theta}{[\varphi(1-\theta) + \theta]} \left(\frac{\partial D_0}{\partial S_0} - \frac{\partial L_0}{\partial S_0}\right) - (1-\tau)\right)$ . Furthermore,  $\frac{\partial D_0}{\partial S_0} = \varsigma$

and  $\frac{\partial L_0}{\partial S_0} = \frac{(\varsigma - 1)}{1 + \lambda L_0} < (\varsigma - 1)$ . So  $\frac{dr_1}{dS_0} > 0$  if and only if  $\theta > \frac{\varphi(1-\tau)}{\left(\varsigma - \frac{(\varsigma - 1)}{1 + \lambda L_0}\right) - (1-\varphi)(1-\tau)}$ , which can

also be expressed as the condition  $\theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau) + (\zeta - 1)\frac{\lambda L_0}{1 + \lambda L_0}}$ , the same as earlier except for the

extra positive term in the denominator  $(\zeta - 1)\frac{\lambda L_0}{1 + \lambda L_0}$ .

Note that even if  $\tau = 0$ , the condition can now hold because the right hand side of the condition is always smaller than 1. When the condition does hold, the date-1 demand for liquidity increases more than one for one with reserves because deposit issuance was constrained by reserves earlier. So somewhat paradoxically, date-0 corporate investment falls (because  $r_1$  is higher), date-0 firm borrowing  $L_0$  increases, and the excess is stored as a deposit with the bank (equivalently, this is a committed line of credit). Then, central bank balance sheet expansion raises term lending and corporate leverage but this translates into greater corporate deposits or savings rather than real investment.

Throughout this paper, we have taken the effects of quantitative easing on activity as given. It has, however, been hard to discern the net positive macroeconomic effects of quantitative easing (see Fabo, Jancokova, Kempf, and Pastor (2021), Greenlaw et al. (2018) and Moreno (2019)). One reason is perhaps because so much else is going on over the period of the interventions. Our analysis suggests another possible reason, enhanced ex-post stress stemming from higher ex-ante reserves. Earlier, we focused on enhanced stress stemming from a high reserve shrinkage,  $\tau$ , or hoarding,  $(1 - \varphi)$ . Here, we focus only on the possible offsetting effects of central bank balance sheet expansion of an even greater expansion of banking sector's demandable deposits. All these sources can lead to financial fragility and raise the interbank premium  $r_1$ , which dampens real investment. This may partly account for why the effects of unconventional monetary policy are hard to discern.

## 5.2 Private Incentives to Hold Reserves: Gap between Effective Fed Funds Rate and Interest on Reserves

What if banks were not forced to hold  $S_0$ ? It turns out, not surprisingly, that banks will privately not have the same incentives as the planner/central bank and will want to optimally hold different levels of reserves (often lower) in a variety of circumstances. Formally, suppose that banks can pass around the reserves after date 0 in a secondary market at the (“effective federal funds”) rate  $r^{EFFR}$  which for simplicity of exposition we assume is earned at date 2. As before, we continue to assume that the central bank pays the “risk-free” rate on reserves  $r^{IOR} = 0$ . The tradeoff faced by the bank is that it can seek to

earn an extra return on its reserves in the secondary market, but this enhances its rollover risk as liquidity stress and a depositor run could materialize before its loans in the federal funds market are repaid, which reduces its ability to gain from inter-bank lending in stressed conditions if it were to remain healthy.

Focusing only on the bank's marginal choice of releasing  $\Delta$  of its reserves in the secondary market, i.e., taking the total reserves shrinkage  $\tau S_0$  in future as given, and assuming for simplicity that  $\delta \rightarrow 0$  so that  $\varphi \rightarrow 1$  (all surplus banks lend in the interbank market in the stressed state of the economy at date 1), this choice, based on bank's objective function in Section 2.1, boils down to

$$\text{Max}_{\Delta} \quad (r^{EFFR} - r^{IOR})\Delta - \frac{q}{\theta}\theta r_1\Delta - \frac{q}{\theta}(1-\theta)r_1\Delta$$

where  $(r^{EFFR} - r^{IOR})$  represents the effective rate earned on reserves released in the secondary market relative to the opportunity cost of holding them on balance sheet. The first order derivative with respect to  $\Delta$  is:

$$(r^{EFFR} - r^{IOR}) - qr_1 - \frac{q}{\theta}(1-\theta)r_1$$

Therefore, the secondary-market rate  $r^{EFFR}$  at which banks are indifferent to holding reserves or not holding them is given by:

$$(r^{EFFR} - r^{IOR}) = \frac{q}{\theta}r_1.$$

This corresponds to the so-called *EFFR-IOR*, the difference between the effective federal funds rate and the interest on reserves, and has been the subject of recent empirical study in Lopez-Salido and Vissing-Jorgensen (2022) and Acharya et al. (2022).

Note that if  $\theta > (1 - \tau)$  then as shown in Theorem 1,  $r_1$  is positive for high enough reserves so that  $r^{EFFR} > r^{IOR}$ , reflecting that as with term loan rates, the secondary market rate on reserves must also compensate banks for the fact that deposits issued to finance the reserves lead to rollover problems at date 1. However, for low enough level of reserves, or if  $\theta < (1 - \tau)$ , then  $r_1 = 0$ . The point is that if the impact of reserves on *EFFR-IOR* is estimated over low and high reserves periods, then the impact may not be easily identifiable from a statistical standpoint, as Lopez-Salido and Vissing-Jorgensen (2022) document. Even more interestingly, taking the derivative with respect to  $S_0$  yields

$$\frac{d(r^{EFFR} - r^{IOR})}{dS_0} = \frac{q}{\theta} \frac{dr_1}{dS_0} = \frac{q}{\theta} \left[ \frac{\partial r_1}{\partial S_0} + \frac{\partial r_1}{\partial D_0} \frac{dD_0}{dS_0} \right].$$

This then implies that to statistically “identify” the intuitive negative (stabilizing) effect of reserves on  $EFFR-IOR$  ( $\frac{\partial r_1}{\partial S_0} < 0$ ), it is important to control for deposits given the counterintuitive positive effect of reserves on  $EFFR-IOR$  working via deposits ( $\frac{\partial r_1}{\partial D_0} > 0, \frac{dD_0}{dS_0} > 0$ ), the latter being the primary thrust of our model and analysis. This is indeed what Lopez-Salido and Vissing-Jorgensen (2022) and Acharya et al. (2022) find empirically to be the case.

### 5.3. Reserves with the Non-Bank Financial Sector and the Growth of its Demandable Claims

Our simple model allows for many other possible extensions and explorations. An important one concerns the question: what if the central bank issues reserves directly to the non-bank financial sector? Here again (see Online Appendix V), a desire to match the duration of liabilities with assets to reduce risk will result in non-banks financing with short-term liabilities.

There is evidence suggestive of this. In April 2021, the Federal Reserve reinstated the supplementary leverage ratio (SLR) for commercial banks. This is a regulatory capital requirement that was suspended in April 2020 in the wake of the pandemic (see Covas, 2021). Given the increased cost to banks of funding reserves with long-term capital, they released reserves. Interestingly, money market funds, themselves funded with short-term liabilities, took on the reserves, redepositing them at Fed through reverse-repo facilities. This suggests the natural way for intermediaries, even from the non-bank financial sector, to fund reserves is short-term and will likely lead to concerns of financial fragility akin to the ones we have analyzed for the banking sector.

### 5.4. Assumptions about $\theta$

An important simplification in our model is that the share of stressed banks,  $\theta$ , is invariant to the build-up in reserves. It might seem that the risks to commercial bank balance sheets should fall as the share of reserves composing those balance sheets increases. If so, our model would hold for only the range of reserve expansion where commercial bank credit risk is not swamped by reserve expansion. Yet this neglects both leverage and additional sources of risk. First, as we have argued and Acharya et al (2022) find, incremental reserves are fully, or more than fully, funded by demandable deposits. So absent

commercial bank capital-raising, even small amounts of credit risk relative to the size of the commercial bank's assets can have large adverse consequences. Second, the un-modeled effects of central bank balance sheet expansion on activity, if sizeable, should expand corporate borrowing and increase the risk thereof. Third, as we show in Online Appendix IV, banks have an incentive to fund speculative activity and provide margin or collateral services, which can become a source of encumbrance on reserves. Thus it is not obvious the assumption of an invariant  $\theta$  is implausible. However, deeper analysis of the underpinnings of  $\theta$  and  $S_0$  and their relationship is an important avenue for future research.

## VI. Bank Capital Structure and Ex-post Central Bank Intervention

### 6.1. The Central Bank/Planner's Problem in Setting the Bank Capital Structure

It might seem that the planner can prevent all liquidity shortages by asking banks to finance with sufficient capital at date 0. However, this need be neither privately or socially optimal since capital is costly. So it is useful to ask whether bank capital requirements be an added instrument for the central bank – if for example, it needs to set reserves for monetary reasons at a level that induces a positive  $r_1$ ?

While there is a pecuniary externality when a bank makes its financing choice between deposits and capital (the bank takes  $r_1$  as given and does not internalize the fact that its choice of higher deposit financing will increase the net demand for liquidity at date 1 and raise  $r_1$ ), it is well known that pecuniary externalities need not cause a divergence between the private optimal and social optimal choices. Indeed, we show in Appendix III that this is the case in our model when we take as given the fraction  $\varphi$  of banks that lend in the interbank market. So the planner will not want to alter bank capital choices in the basic model. This result is unlike that in Lorenzoni (2008) or Stein (2012) where banks finance excessively with deposits.

However, with endogenous  $\varphi$ , there is a divergence between the private and the social optimal, but interestingly in a different direction from Lorenzoni (2008) and Stein (2012). The social planner would finance with more deposits and less capital at date 0 than the bank privately would!

*Theorem 4:* If  $\bar{r}_1 > 0$ ,  $\left. \frac{dU}{de_0} \right|_{e_0 = \frac{\varphi r_1}{\alpha_0}} < 0$ , so at the private bank's optimal financing choice, the central

bank/planner wants the bank to finance reserve holdings with less capital.

*Proof:* See Appendix III.

Our result differs from Stein (2012) because the nature of the spillover differs. In Stein (2012), higher bank capital reduces the fire-sale discount, causing lending by non-banks at date 0 to increase (the source of spillover). In a sense, non-banks hoard less ex ante anticipating fewer fire sales, and that increases lending. In our framework, the bank makes all lending decisions. So the pecuniary externality embedded in  $r_1$  (our measure of fire-sale discounts) does not distort private financing choices away from the social optimal – there are no non-banks to be influenced. However, when  $\varphi$  is endogenous, something the bank ignores in its maximization, a higher date-0 capital issue directly reduces liquidity stress and hence  $r_1$ , a direct effect that the bank internalizes. As this lowers the gains to inter-bank lending, the higher induced hoarding by others indirectly increases the liquidity shortfall and increases dissipative date-1 equity issuance. The indirect effect, which is not internalized, implies the social planner wants lower date-0 capital than the private optimal. Importantly, our focus is only on liquidity. Incorporating costly bank insolvency in our model could certainly alter these implications.

Finally, Diamond, Jiang, and Ma (2021) and Liang and Parkinson (2020) suggest the supplementary leverage ratio (requiring capital to be held against *all* assets including the relatively safe ones) should not apply to reserves. However, their reason for weaker capital requirements is to eliminate a regulatory encumbrance on the use of reserves (see Online Appendix IV). Our point is different; lower capital will reduce bank incentives to hoard liquidity ex post. Of course, in making policy, all externalities in banks' capital issuance decision will have to be accounted for, including ones we have not modeled.

## 6.2. *Ex-post Central Bank Intervention*

Note that the central bank's provision of  $S_0$  at date 0 in our model is not temporary (overnight or crisis-time) liquidity, it is (more) durable infusion of liquidity, caused by actions such as quantitative easing. A fundamental role of central banks is to provide temporary liquidity when the system is short. Indeed, Walter Bagehot's dictum to central bankers is to lend freely against good collateral at a penal rate when the system is stressed. So could the central bank alleviate liquidity stress by lending at date 1?

The most effective way for the central bank to intervene ex post is for it to lend unsecured into the interbank market. However, this entails significant risk of central bank loan losses. If it does lend against high-quality securities, though, the financial sector will have to hold those high-quality securities ex ante. If they are financed with deposit issuance, they add no extra liquidity to a stressed bank, even allowing for central bank lending against them. Of course, the central bank can broaden the range of assets it will lend against (for example, lend against corporate securities) even while increasing the size of the haircut it levies on collateral value. The higher the haircut, the less liquidity it will provide the bank.



So the central bank does face a trade-off between alleviating liquidity risk and taking on credit risk, with the weight increasingly on the latter as the quantum of required intervention increases.

Central bank reserve injection at date 1 will reduce the interbank rate. But then fewer healthy banks will want to lend into that interbank market. So the act of intervention *ex post* can crowd out private lending and associated price discovery (see Filardo (2020)), potentially keep interbank markets shut over a wider range of *ex-ante* reserves, and increase the *ex-post* quantum of needed central bank intervention. Another subtle effect is also at play. Note that in our model, the incentive of safe banks to hoard reserves is diminished by the capital issuance of stressed and tainted banks. If, however, capital issuances fall because the central bank adds new reserves to the system (which eventually find their way to the safe banks), it further increases the incentive to hoard over and above any effect on the interbank rate because a greater net stock of reserves flows to the safe banks.

Thus far, we have discussed temporary interventions. Yet it is unclear how the central bank can signal its intervention will be temporary, without risking the reappearance of liquidity stresses when the intervention ends. If the banking sector thinks the intervention will be longer term, as it appeared to believe with the pandemic QE the Fed engaged in in March 2020 to alleviate liquidity stress, then the banking sector may build up still more demandable liabilities to finance the reserve issuance or be even more inclined *ex ante* to write future claims on liquidity such as credit lines, thereby becoming ever more dependent on the central bank backstop and setting the stage for yet larger possible intervention in the future. The central bank moves from temporary emergency infusions of liquidity to ever increasing permanent infusions. In other words, central bank intervention may not be emergency “once and done”, but may continue to ratchet up, with attendant distortions to asset prices and capital allocation. The size of the central bank balance sheet may then eventually run up against political costs and limits (Plosser (2018)) as well as any aggregate constraints on the stock of pledgeable safe assets.

In a related vein, a number of papers that attribute market stress to regulatory and supervisory action (see, for example, Correa, Du and Liao (2021), D’Avernas and Vandeweyer (2021, 2022), IAWG Treasury Market Surveillance Report (2021)) propose that a permanent increase in outstanding reserves and the size of the central bank balance sheet will be helpful (also see Copeland, Duffie, and Yang (2021)). Our theory, with banks increasing the demand for reserves once the central bank issues them, would qualify this solution because the subsequent endogenous bank response may make matters worse over the medium term (see later).

Anticipation of *ex post* intervention has its own costs. If leveraged illiquid banks expect to receive central bank funds *ex post*, they may not reduce their illiquid assets in a timely manner, taking on further liquidity risk in the process (Acharya and Tuckman, 2014). Similarly, the more the financial sector

expects central bank intervention, the more it will increase the ex-ante issuance of claims on liquidity, effectively reducing liquidity holdings net of liquidity promises (see Acharya, Shin and Yorulmazer (2011), Diamond and Rajan (2012) or Farhi and Tirole (2012)), and necessitating intervention of yet greater magnitude.<sup>18</sup>

Our model suggests the system is most vulnerable during a period of quantitative tightening. QT is usually undertaken when inflation perks up, since it is a form of monetary tightening. If a shock hits, the need for renewed balance sheet expansion to alleviate liquidity stress can undermine the central bank's fight against inflation. It may also send confusing messages on the central bank's monetary stance. Indeed, the rate increases that accompany monetary tightening may be the source of the  $\theta$  shock – it decapitalizes banks that have interest rate exposure, as was the case with mid-sized US banks in March 2023, and can precipitate wider liquidity stress.<sup>19</sup>

Finally, central bank balance sheet expansion typically eases government financing, and progressively larger central bank balance sheets induced by commercial bank illiquidity may lead to monetary financing of fiscal deficits, a large cost when an economy is close to fiscal dominance. If there are eventual limits to central bank intervention for monetary or fiscal reasons, the private sector's greater liquidity dependence at that time could eventually result in significant losses.

## VII. Conclusion

The significant expansion of central bank balance sheets in recent years should have reduced liquidity stress, and even perhaps increased real activity. Since the central bank's injection of reserves is typically financed by commercial banks with uninsured demandable deposits, the ex-ante supply of reserves affects the ex-post demand for them. The ex post supply of reserves may also shrink without a commensurate shrinkage in bank deposits, and some banks may hoard reserves during episodes of stress. Taken together, central bank balance sheet expansion may exacerbate situations of liquidity stress. Consequently, its usefulness in enhancing real activity may be more muted than one might think a priori.

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<sup>18</sup> Indeed, some central banks recognize that their provision of liquidity on demand creates dependence for more. Nelson (2019) cites a Norges Bank statement in 2010 justifying its move to a deficit reserves position in the system thus: *"When Norges Bank keeps reserves relatively high for a period, it appears that banks gradually adjust to this level...With ever increasing reserves in the banking system, there is a risk that Norges Bank assumes functions that should be left to the market. It is not Norges Bank's role to provide funding for banks...If a bank has a deficit of reserves towards the end of the day, banks must be able to deal with this by trading in the interbank market."*

<sup>19</sup> As of writing, this seems to have been brought under control by a blanket implicit insurance of demand deposits, substantial lending from the Fed's discount window as well as a new facility that lent against the full face value of securities presented as collateral, and a ratcheting up of loans from the FHLBs.

We have likely only scratched the surface in sketching out implications of this phenomenon. The scope for further research is clear.

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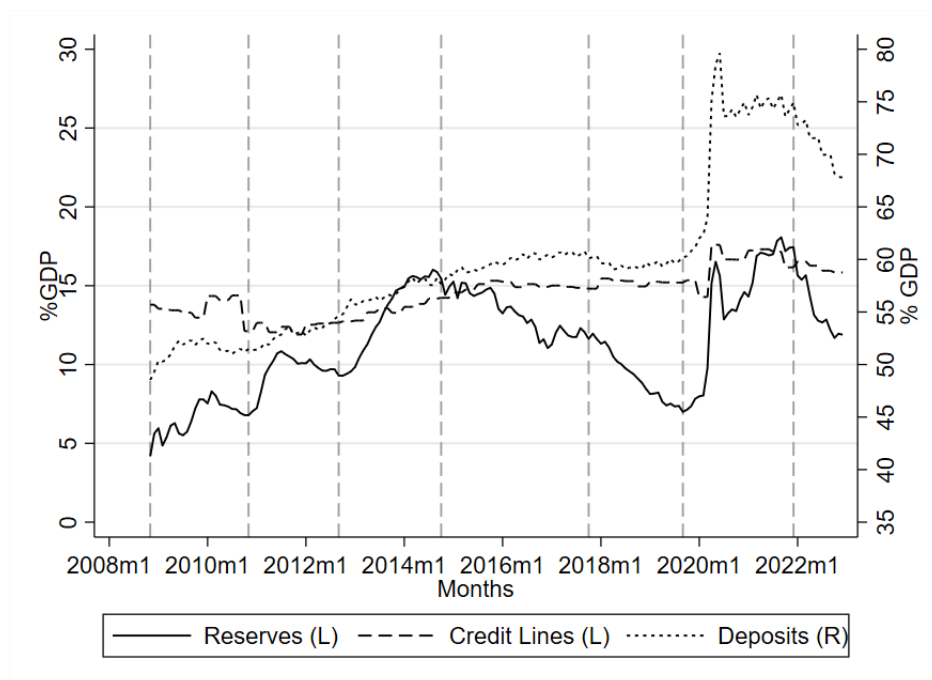
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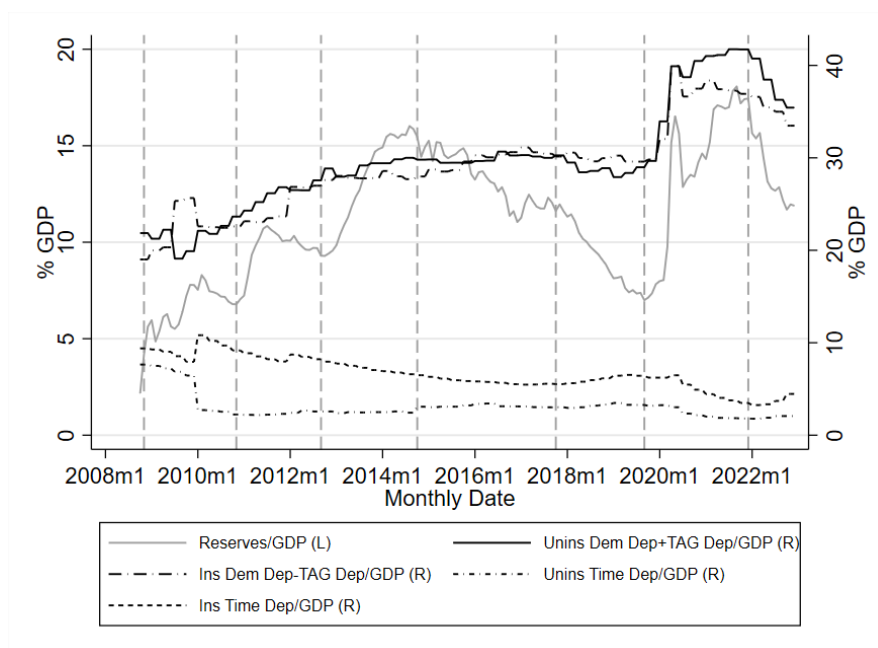
## Exhibit 1. Time-Series of Credit Lines, Deposits and Reserves

This exhibit plots the time-series of credit lines, deposits and reserves of the 2008Q4 to 2023Q1 period using data from the Federal Reserves' Flow of Funds. Panel A plots credit lines (left y-axis), deposits (right y-axis) and reserves (left y-axis) as percentage of gross domestic product (GDP) for all commercial banks. Panel B shows the break-up of demand and time deposits into insured and uninsured time-series using FDIC's Call Reports Data. Estimation of Insured and Uninsured Domestic Deposits are based on the items in the call report schedule RC-O. Insured deposits are defined as deposits lying below the FDIC deposit insurance thresholds of \$100,000 before 2008Q4 and \$250,000 after 2008Q4. Uninsured deposits are domestic deposits above the aforementioned deposit insurance thresholds and all foreign deposits. Insured deposits and Uninsured Deposits should be adjusted for the FDIC Transaction Account Guarantee (TAG) program. Split of Time Deposits into Insured vs. Uninsured Deposits are based by splits of Time Deposits by the aforementioned deposit insurance thresholds in schedule RC-E. Demandable Deposits (which is the sum of demand, savings and money market deposits) are split into Insured and Uninsured deposits by taking the difference of Total Insured/Uninsured Deposits and Insured/Uninsured Time Deposits respectively. All Deposit variables are shown on the right y-axis whereas Reserves are shown on the left y-axis. Panel C plots credit lines, total deposits and uninsured demandable deposits as multiples of central bank reserves. Time deposits are the sum of small and large time deposits (H6 and H8 release). Demand and Other Liquid deposits are from the H6 release. The vertical lines correspond to the beginning of the different Federal Reserve QE / QT phases: (1) Nov 2008 (QE I), (2) Nov 2010 (QE II), (3) Nov 2012 (QE III), (4) Oct 2014 (Post-QE III), (5) QT period, (6) Sept 2019 (Pandemic QE).

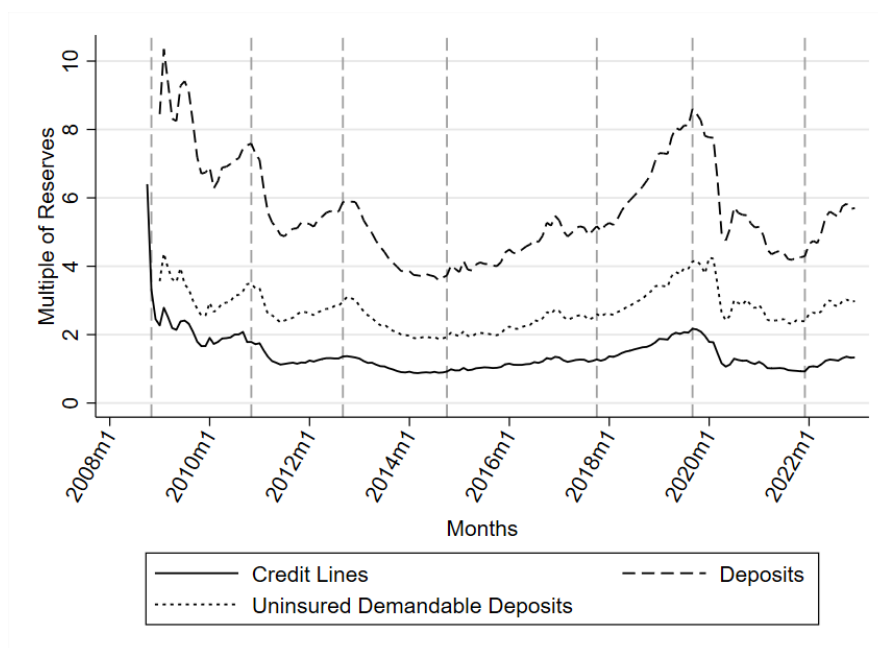
**Panel A. Credit Lines, Deposits, and Reserves as percentage of GDP**



**Panel B. Uninsured and Insured Demand and Time Deposits, and Reserves as percentage of GDP**



**Panel C. Credit Lines, Deposits and Uninsured Demandable Deposits as multiples of Reserves**





**Figure 2: Bank and Firm Balance Sheets**

| Firm Balance Sheet at Date 0             |                    | Bank Balance Sheet at Date 0                                                                         |                                      |
|------------------------------------------|--------------------|------------------------------------------------------------------------------------------------------|--------------------------------------|
| <u>Assets</u>                            | <u>Liabilities</u> | <u>Assets</u>                                                                                        | <u>Liabilities</u>                   |
| $I_0$                                    | $L_0^F (= L_0^B)$  | $L_0^B + \frac{1}{2} \lambda (L_0^B)^2$                                                              | $D_0$                                |
| $D_0^F$                                  | $W_0^F$            | $S_0$                                                                                                | $e_0$                                |
|                                          | Net worth          |                                                                                                      | Net worth                            |
| Firm Balance Sheet at Date 1 if stressed |                    | Bank Balance Sheet at Date 1 if bank stressed                                                        |                                      |
| <u>Assets</u>                            | <u>Liabilities</u> | <u>Assets</u>                                                                                        | <u>Liabilities</u>                   |
| $I_1$                                    | $L_1^F$            | $L_0^B + \frac{1}{2} \lambda (L_0^B)^2$                                                              | Possible interbank borrowing = $b_1$ |
|                                          | $L_0^F$            | $\tau S_0$                                                                                           | $e_1$                                |
|                                          | Net worth          | $l_1^B (= l_1^F)$                                                                                    | $e_0$                                |
|                                          |                    |                                                                                                      | Net worth                            |
| Firm Balance Sheet at Date 1 if healthy  |                    | Bank Balance Sheet at Date 1 if economy stressed, bank healthy but “tainted” (makes interbank loans) |                                      |
| <u>Assets</u>                            | <u>Liabilities</u> | <u>Assets</u>                                                                                        | <u>Liabilities</u>                   |
| $I_0$                                    | $L_0^F$            | $L_0^B + \frac{1}{2} \lambda (L_0^B)^2$                                                              | $D_0$                                |
| $D_0^F$                                  | $W_0^F$            | Interbank loans of up to $e_1 + (1 - \tau)S_0$                                                       | $e_1$                                |
|                                          | Net worth          | Reserves of $(S_0 + e_1 - \text{interbank loans})$                                                   | $e_0$                                |
|                                          |                    |                                                                                                      | Net worth                            |

**Figure 3: Numerical example for the model of section 2.2 with endogenous interbank market opening: The effect of varying the size of the shock  $\theta$**

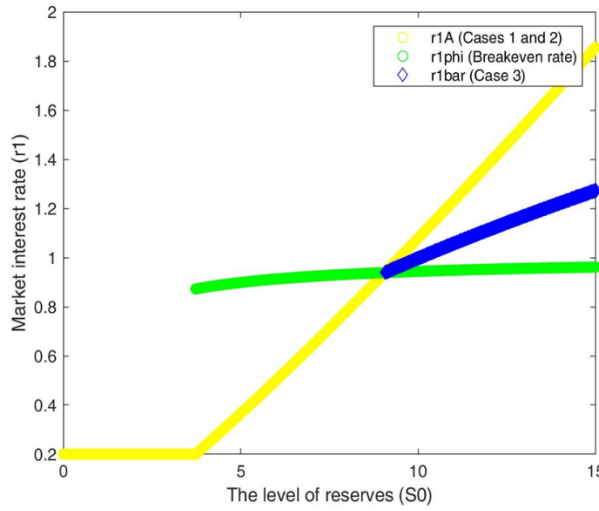


Figure 3A: Market Rate and Reserves

$$\delta = 0.2, \tau = 0.2, \theta = 0.8$$

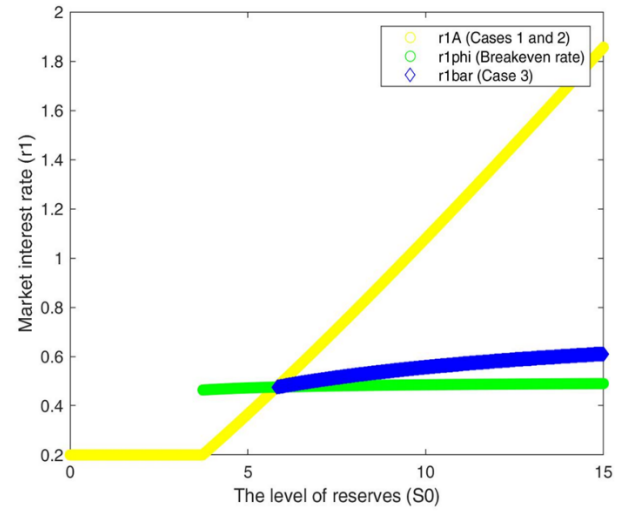
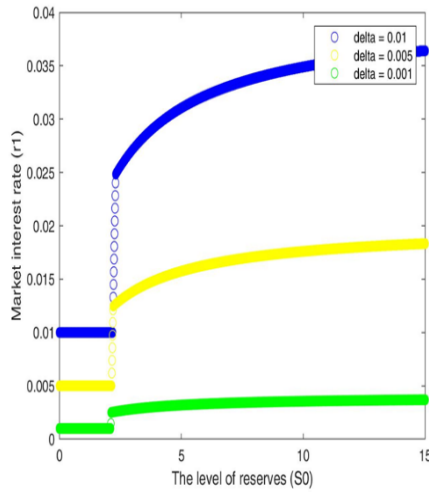
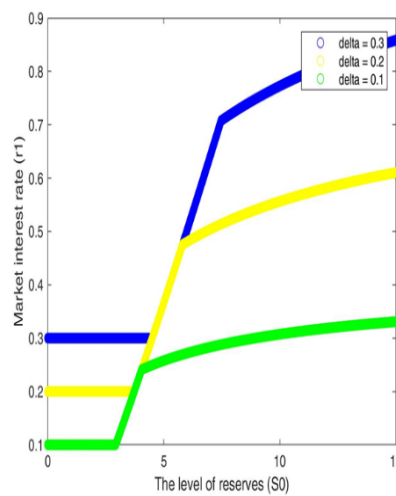
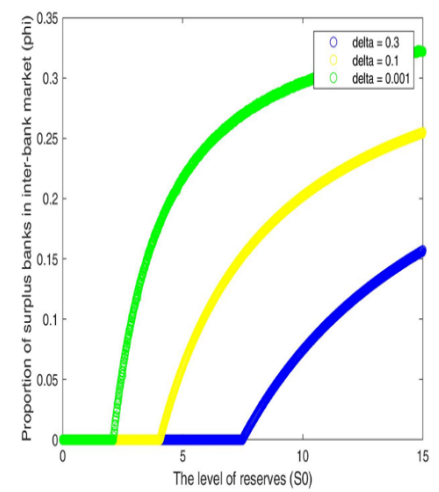


Figure 3B: Market Rate and Reserves

$$\delta = 0.2, \tau = 0.2, \theta = 0.6$$

**Figure 4: Numerical example for the model of section 2.2 with endogenous interbank market opening: The effect of varying the convenience yield on reserves  $\delta$**

Figure 4A: Market Rate and Reserves for low  $\delta$ Figure 4B: Market Rate and Reserves for high  $\delta$ Figure 4C:  $\phi$  and reserves for various  $\delta$

**Proof of Theorem 1:** The proof essentially demonstrates that the net need for capital issuance,  $f(r_1, S_0)$ , falls in  $r_1$ . To see this, note that the right hand side of (1.10) is decreasing in  $r_1$  (we will see this shortly). The left hand side is obviously increasing in  $r_1$ . If so, if the right hand side of (1.10) is positive when  $r_1 = 0$  then there is excess demand for funds in the inter-bank market when the premium is zero, and hence there is an unique positive crossing point, the equilibrium  $r_1$ . If the right hand side is non-positive when  $r_1 = 0$ , there is (weakly) excess supply, and  $r_1$  is zero. So it remains to show the right hand side of (1.10) is decreasing in  $r_1$ . From (1.3),  $I_1 = g_1'^{-1}(1 + \gamma + r_1)$ , which is decreasing in  $r_1$ . Turn next to the second term in the square brackets,  $(D_0 - D_0^F)$ . This equals

$$\left[ I_0 - e_0 + (S_0 - W_0^F) + \frac{1}{2} \lambda (L_0)^2 \right]. \text{ We know } I_0 = g_0'^{-1} \left( \frac{1 + q\gamma + qr_1}{(1-q)} \right) \text{ which is decreasing in } r_1. \text{ Also, } -e_0 = -\frac{qr_1}{\alpha_0}, \text{ which is decreasing in } r_1. \text{ The next term, } (S_0 - W_0^F), \text{ is a constant. That leaves the last}$$

$$\text{term, in the expression for } (D_0 - D_0^F), \frac{1}{2} \lambda (L_0)^2. \text{ From (1.9), } L_0^B = \frac{1}{\lambda} \left( \frac{R_0^{DF} - R_0^{DB}}{R_0^{DB}} \right) = \frac{q}{\lambda} \left( \frac{\gamma}{1 + qr_1} \right),$$

which decreases in  $r_1$  whence given  $L_0$  is positive,  $\frac{1}{2} \lambda (L_0)^2$  also decreases in  $r_1$ . So we have

$(D_0 - D_0^F)$ , the deposits the bank raises from the public, decreasing in  $r_1$ . Finally, the last term on the right hand side of (1.10),  $-\alpha_1 S_0 (1 - \tau)$ , is a constant. So the right hand side of (1.10) is decreasing in  $r_1$  and the equilibrium  $r_1$  is unique.

Next, we examine how does the possible positive equilibrium rate,  $\bar{r}_1$ , implicitly determined by (1.10), varies with central bank reserves. Totally differentiating (1.10), we have

$$\frac{1}{\alpha_1} \frac{d\bar{r}_1}{dS_0} = \frac{\partial f}{\partial r_1} \cdot \frac{d\bar{r}_1}{dS_0} + \frac{\partial f}{\partial S_0}. \text{ Therefore, } \left( \frac{1}{\alpha_1} - \frac{\partial f}{\partial r_1} \right) \frac{d\bar{r}_1}{dS_0} = \frac{\partial f}{\partial S_0} = \frac{\theta}{[\varphi(1-\theta) + \theta]} - (1-\tau).^{20} \text{ Since } \frac{\partial f}{\partial r_1} \text{ is}$$

<sup>20</sup> This requires substituting in (1.10)

$$(D_0 - D_0^F) = (S_0 + L_0 + \frac{1}{2} \lambda (L_0)^2 - e_0) - (W_0^F + L_0 - I_0) = I_0 - e_0 + (S_0 - W_0^F) + \frac{1}{2} \lambda (L_0)^2.$$

negative as shown above,  $\left(\frac{1}{\alpha_1} - \frac{\partial f}{\partial r_1}\right)$  is positive, and  $Sign\left(\frac{d\bar{r}_1}{dS_0}\right) = Sign\left(\frac{\theta}{[\varphi(1-\theta) + \theta]} - (1-\tau)\right)$ .

Q.E.D.

**Characterizing the threshold level of reserves determining if  $\bar{r}_1$  is positive (Section 2.4):** Because

$f(r_1, S_0)$  is decreasing in  $r_1$  (see proof of Theorem 1), it must be that  $\bar{r}_1$  is positive iff  $f(0, S_0) > 0$ . We

$$f(r_1, S_0) = \frac{\theta}{[\varphi(1-\theta) + \theta]} \left( g_1'^{-1}(1 + \gamma + r_1) + g_0'^{-1}\left(\frac{1 + q\gamma + qr_1}{(1-q)}\right) - \frac{qr_1}{\alpha_0} - W_0^F + \frac{1}{2} \frac{q^2}{\lambda} \left(\frac{\gamma}{1 + qr_1}\right)^2 \right) \\ \text{have} \\ + S_0 \left( \frac{\theta}{[\varphi(1-\theta) + \theta]} - (1-\tau) \right)$$

So, for  $f(0, S_0) > 0$ , it must be that

$$S_0 \left( \frac{\theta}{[\varphi(1-\theta) + \theta]} - (1-\tau) \right) > \frac{\theta}{[\varphi(1-\theta) + \theta]} \left( -g_1'^{-1}(1 + \gamma) - g_0'^{-1}\left(\frac{1 + q\gamma}{(1-q)}\right) + W_0^F - \frac{1}{2} \frac{q^2}{\lambda} (\gamma)^2 \right) \equiv NLS.$$

Note that  $NLS$  is the net liquidity supplied by the corporate sector anticipating a date-1 interbank premium of zero (and adjusting for any cost to lending). Then, we can characterize the level of date-0 central bank reserves  $\hat{S}_0$ , at which the interbank rate turns positive and how the interbank rate moves with reserves around that threshold:

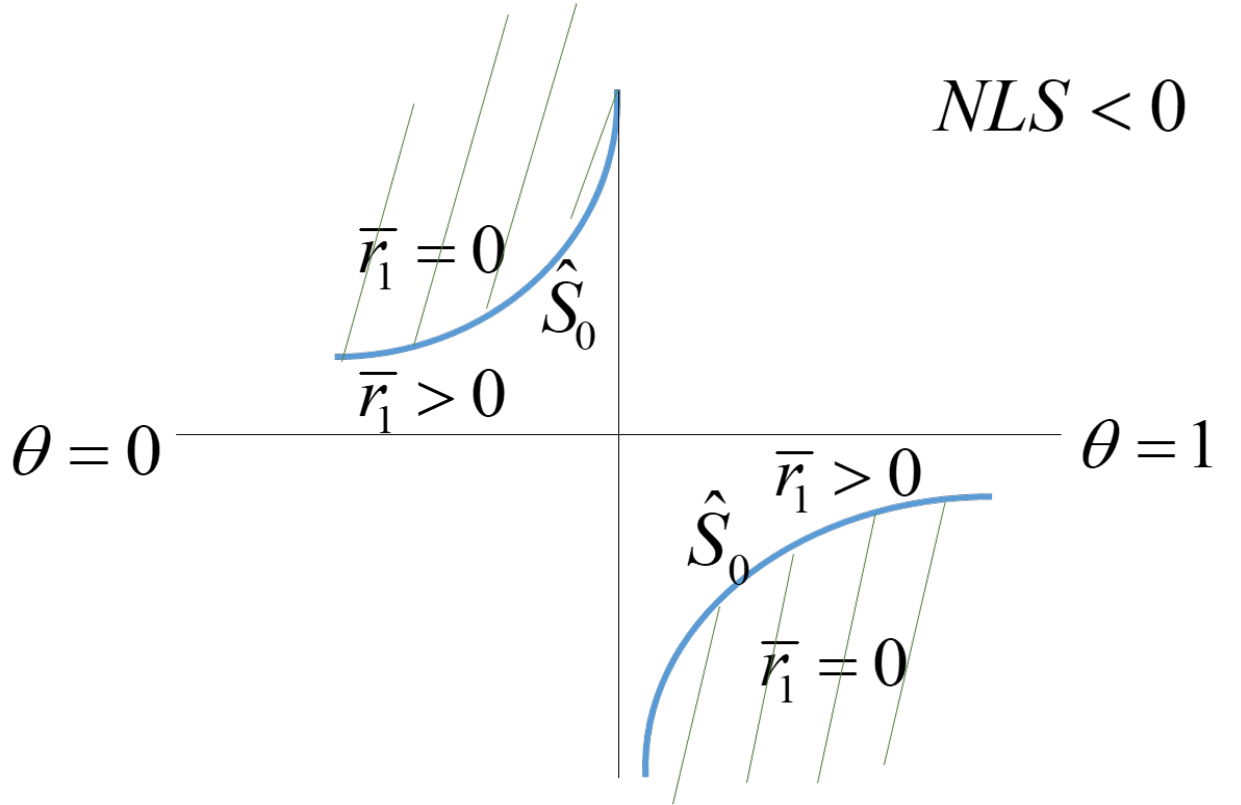
*Theorem A1:*

- (i) If  $\theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$ , then  $\bar{r}_1 > 0$  is the unique equilibrium for  $S_0 > \hat{S}_0$  with  $\bar{r}_1$  increasing in  $S_0$ ; and,  $\bar{r}_1 = 0$  for  $S_0 \leq \hat{S}_0$ . Note that  $\hat{S}_0 \leq 0$  if  $NLS \leq 0$ .
- (ii) If  $\theta \leq \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$ , then  $\bar{r}_1 > 0$  is the unique equilibrium for  $S_0 < \hat{S}_0$  with  $\bar{r}_1$  decreasing in  $S_0$ ; and,  $\bar{r}_1 = 0$  for  $S_0 \geq \hat{S}_0$ . Note that  $\hat{S}_0 \leq 0$  if  $NLS \geq 0$ .

Theorem A1 (ii) is the traditional view of reserves. An increase in reserves should alleviate future illiquidity, reduce the interbank rate, and increase current (and future) real investment. A preponderance

of reserves,  $S_0 \geq \hat{S}_0$ , ensures that the date-1 interbank interest rate premium will be zero. Theorem A1 (i) is the alternative view our model also offers.

*Threshold level of reserves when  $NLS < 0$ :* We plot in Figure A the threshold value of reserves at which the date 1 interbank rate is zero,  $\hat{S}_0$ , for different values of  $\theta$  (the fraction of the banking sector that becomes liquidity stressed) for the case when  $NLS < 0$ . The size of reserves is on the vertical axis and  $\theta$  is on the horizontal axis.



**Figure A:** Reserves are on the y axis,  $\theta$  on x axis, with the axes intersecting at  $\theta = \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$

When  $\theta < \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$  (to the left of the vertical axis),  $\hat{S}_0$  is positive, and rises in  $\theta$ . Because higher ex-ante reserves loosen liquidity conditions,  $\bar{r}_1$  falls in  $S_0$ , and the unhatched region below the  $\hat{S}_0$  curve is where  $\bar{r}_1$  is positive with  $\bar{r}_1$  decreasing in  $S_0$ . When  $\theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$  (to the right of the vertical axis),  $\hat{S}_0$  is negative, and increases in  $\theta$ . Because higher ex-ante reserves tighten liquidity in the

stressed state,  $\bar{r}_1$  increases in  $S_0$ , and the unhatched region above the  $\hat{S}_0$  curve is where  $\bar{r}_1$  is positive with  $\bar{r}_1$  increasing in  $S_0$ . In this unconventional case, the central bank cannot provide the demanded date-1 liquidity via banks through asset purchases at date 0 – reserve issuance also tends to absorb liquidity on net.

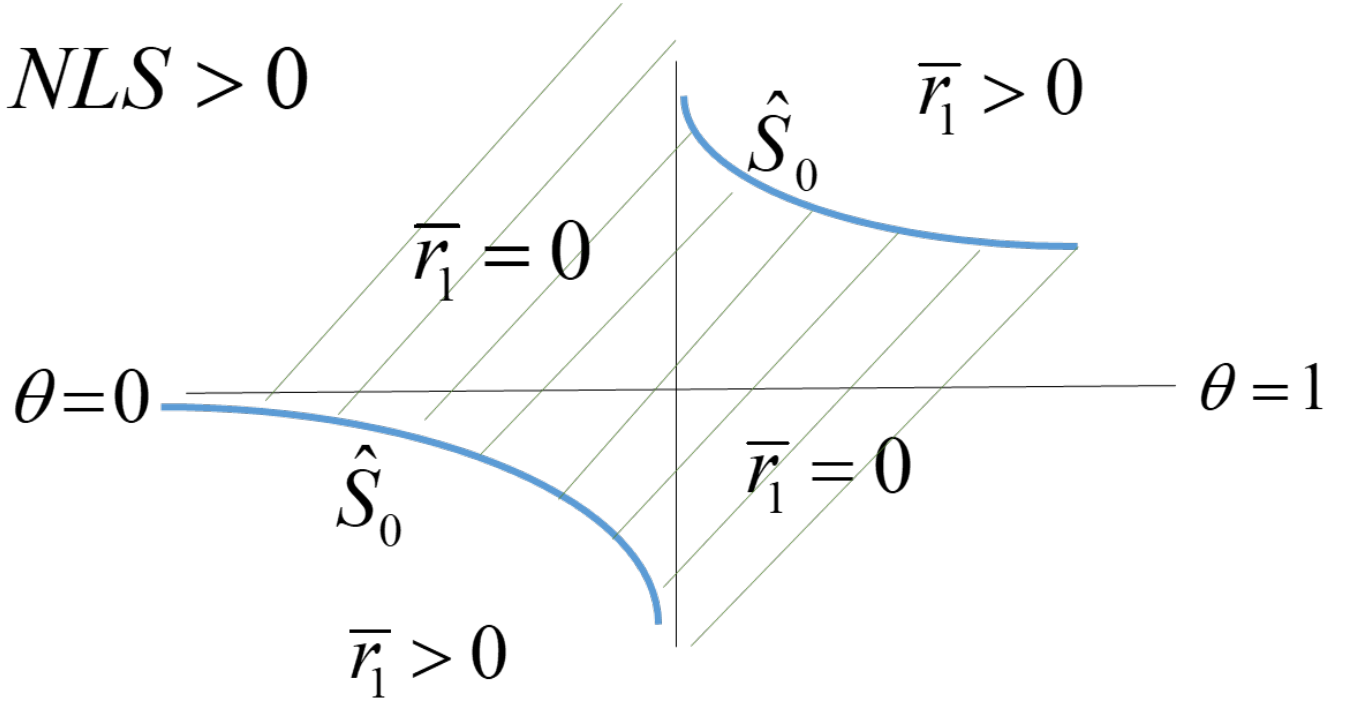
How general is this result? As can be seen from Theorem A1 and Figure A, if  $\varphi = 1, \tau = 0$  then we are always in case (i), but whenever  $\varphi < 1, \tau > 0$  there exists a critical value of  $\theta = \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$  to the right of which the unconventional case (ii) arises. Formally, the figure and the theorem together clarify that in the economically more interesting region above the x-axis where  $S_0 > 0$ , as we traverse from the left of the critical value  $\theta = \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$  to its right, we switch – discontinuously – from  $\frac{d\bar{r}_1}{dS_0} \leq 0$  ( $\frac{d\bar{r}_1}{dS_0} = 0$  in the hatched region) to  $\frac{d\bar{r}_1}{dS_0} > 0$ . In other words, while case (ii) is unconventional, it arises robustly for high liquidity stress  $\theta$ , high reserves shrinkage  $\tau$ , and lower participation of banks in the inter-bank market at date 1,  $\varphi$ .<sup>21</sup>

*Threshold level of reserves when  $NLS > 0$ :* When  $NLS > 0$  and the risk of liquidity stress in the economy is high, *that is*,  $\theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$  (this is the region to the right of the vertical axis in Figure B),  $\hat{S}_0$  is positive, and falls in  $\theta$ . Intuitively, because higher ex-ante reserves tighten liquidity in the stressed state, and a higher  $\theta$  consumes more liquidity per dollar of reserves, the reserve threshold at which the net liquidity supplied by the corporate sector is fully consumed is positive and falls in  $\theta$ . Furthermore,  $\bar{r}_1$  increases in  $S_0$ , and the unhatched region above the  $\hat{S}_0$  curve is where  $\bar{r}_1$  is positive. When  $NLS > 0$  and the risk of liquidity stress in the economy is low, *that is*,  $\theta < \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$  (that is, in the region to the

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<sup>21</sup> What does it mean if the threshold level of reserves,  $\hat{S}_0$ , is negative? While “negative” reserves may be required in theory, it is unclear how this can be implemented. Perhaps it is best to recognize that when reserves do not add to net future liquidity, the central bank should find other instruments – for instance make long-term loans to the banking sector to encourage the purchase of long-term corporate financial assets/loans, and then be prepared to lend against those assets in case the economy becomes liquidity stressed. Parenthetically, this may resemble the European Central Bank’s Long-Term Refinancing Operation (LTRO) interventions.

left of the vertical axis in Figure B),  $\hat{S}_0$  is negative, and falls in  $\theta$ . Because higher ex-ante reserves loosen liquidity conditions,  $\bar{r}_1$  falls in  $S_0$ , and the unhatched region below the  $\hat{S}_0$  curve is where  $\bar{r}_1$  is positive. The hatched area is where  $\bar{r}_1$  is zero.



**Figure B:** Reserves are on the y axis,  $\theta$  on x axis, with the two axes intersecting at  $\theta = \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}$

**Proof that  $\frac{\partial U}{\partial \bar{r}_1} < 0$  (Section 2.5):** Substituting  $D_0^F = (L_0 + W_0^F - I_0)$  in (1.13), the planner maximizes

objective  $U =$

$$((1-q)g_0(I_0) - I_0(1+q\gamma)) + q(g_1(I_1) - I_1(1+\gamma)) - \frac{1}{2}\alpha_0 e_0^2 - \frac{q}{\theta}[\varphi(1-\theta) + \theta](\frac{1}{2}\alpha_1 e_1^2) - \frac{1}{2}\lambda(L_0)^2 + q(L_0 + W_0^F)\gamma$$

Differentiating  $U$  w.r.t.  $r_1$ , we get  $\frac{\partial U}{\partial \bar{r}_1} =$

$$\left((1-q)g_0' - (1+q\gamma)\right)\frac{dI_0}{dr_1} + q\left(g_1' - (1+\gamma)\right)\frac{dI_1}{dr_1} - \alpha_0 e_0 \frac{de_0}{dr_1} - \frac{q}{\theta}[\varphi(1-\theta) + \theta]\alpha_1 e_1 \frac{de_1}{dr_1} + (q\gamma - \lambda L_0)\frac{dL_0}{dr_1}.$$

Substituting from the firm's FOC, that is,  $(1-q)g'_0 = (1+q(\gamma+r_1))$ ,  $g'_1 = (1+\gamma+r_1)$ , and

$\lambda L_0 = \frac{q\gamma}{1+qr_1}$ , inspection reveals that the first 4 elements are all negative, so  $\frac{\partial U}{\partial r_1} < 0$  if

$(q\gamma - \lambda L_0) \frac{dL_0}{dr_1} \leq 0$ . But  $L_0 = \frac{q}{\lambda} \left( \frac{\gamma}{1+qr_1} \right)$ . So  $(q\gamma - \lambda L_0) \geq 0$ . Since  $\frac{dL_0}{dr_1} < 0$ ,  $\frac{\partial U}{\partial r_1} < 0$ . Q.E.D.

## Appendix II – Proofs and Analysis for Section 3.2

### Bank Choices at Date 1 (in the presence of a convenience yield $\delta$ )

Consider the three cases for the aggregate liquidity condition at date 1. We will denote the incremental value of a bank at date 1 as  $V_1(y, z)$  where recall that  $y = 1$  if the economy is liquidity stressed and zero otherwise, while  $z = 1$  if the bank is stressed and zero otherwise.

Case 1: *Stressed banks have enough liquidity to meet the needs of deposit outflows and to fund rescue investment without accessing the inter-bank market.*

Since reserves have a convenience yield  $\delta$ , stressed banks will issue some capital  $e_1$  to add to reserves even if they do not need to use it for loans or deposit outflows. Furthermore, no bank will loan out reserves without earning at least the convenience yield. Finally, since liquidity is in surplus, any competition to make bank loans would push the bank lending rate down to the convenience yield. The

bank solves  $\max_{e_1} V_1(y=1, z=1) \equiv \left[ r_1 (I_1(r_1) - D_0^F) - \delta (D_0 - D_0^F + I_1(r_1) - e_1) - \frac{\alpha_1}{2} e_1^2 \right]$  where the

first term of the maximization is the return on loans, the second term the cost of the reserve outflow reduced by the inflow of capital, while the last term is the incremental cost of raising capital over and above the gross cost of 1. Since  $r_1 = \delta$ , the stressed bank makes no profit from the rescue loan. Solving,

$e_1 = \frac{\delta}{\alpha_1} > 0$  even if the stressed bank has no need to use the funds to meet depositor outflows or loan

demand (details are in proofs of Theorems 2-3 below but follows the structure in Section 2.1).



Safe banks will not issue capital since they know capital issuance will not alter their reserves on net – any investor in capital will first acquire reserves from the safe banks to buy the capital.<sup>22</sup> Since there is no need for interbank loans, no healthy bank will become tainted. This means that the reserve outflows from the stressed banks are spread across all the healthy banks, and their incremental date-1 value is

$$V_1(y=1, z=0) = \frac{\delta\theta(D_0 - D_0^F + I_1 - e_1)}{(1-\theta)}$$

where the numerator is the value of flight-to-safety deposit

outflows (plus new deposits created by purchases less capital issued) to the healthy banks, and the

denominator is the measure of healthy banks. It also follows then at date 0,  $e_0 = \frac{q\delta}{\alpha_0}$ .

Finally, this case arises when the stressed bank's reserves are enough to meet the demands on it, that is,  $S_0(1-\tau) \geq (D_0 - D_0^F + I_1 - e_1)$ . Substituting for the endogenous  $(D_0 - D_0^F)$ , we see this case

arises when  $\tau S_0 \leq \left[ \left( \frac{q\delta}{\alpha_0} + \frac{\delta}{\alpha_1} \right) + W_0^F - I_0 - I_1 - \frac{1}{2} \lambda L_0^2 \right]$  where  $I_1$  is the optimized value

evaluated at  $r_1 = \delta$ ,  $I_0$  at  $R_0^L = (1 + q\gamma + q\delta)$  and  $L_0 = \frac{q\gamma}{\lambda(1+q\delta)}$  (see proofs of Theorems 2-3 for all

steps). Note that since  $r_1$  is a constant, as  $S_0$  increases deposits increase dollar for dollar since no additional capital is issued. Since a fraction  $\tau$  of the reserves will be encumbered, the distressed bank's net need for date-1 funds grows as  $S_0$  grows. Eventually, it will exhaust available own funds at date 1, and have to issue more capital (compared to the amount that would be optimal considering only the convenience yield). This is when the economy moves into Case 2.

Case 2: *The liquidity needs of each stressed bank can be entirely met by its raising date-1 capital (beyond that warranted by the convenience yield).*

Now, the rate at which the stressed bank lends to the firm,  $r_1$ , rises above  $\delta$  to incentivize further date-1 capital-raising. However, the rate stays too low for any of the healthy banks to lend in the interbank market. Essentially, the stressed bank is in *autarky* and has to issue costly capital even though there is plentiful lending capacity in the system. Let the equilibrium bank lending rate in autarky be  $r_1^A$ .

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<sup>22</sup> Of course, safe banks may issue capital assuming it will come from reserve flows from other safe banks. If everyone does this, no one will have any additional reserves, but everyone will have issued capital commensurate with the size of the convenience yield and incurred the associated costs. Allowing for this adds little to the analysis.

The stressed bank maximizes

$$V_1(y=1, z=1) = \max_{e_1} \left[ r_1^A \left( I_1(r_1^A) - D_0^F \right) - \delta S_0(1-\tau) - \frac{\alpha_1}{2} e_1^2 \right] \quad \text{such that}$$

$e_1 = (D_0 + I_1(r_1^A) - D_0^F - S_0(1-\tau))$ . It follows that  $e_1 = r_1^A / \alpha_1$  (and  $e_0 = q r_1^A / \alpha_0$ ). As before, a rise in the date-1 interest rate equilibrates the demand and supply of liquidity by decreasing the size of the rescue investment and increasing the capital raised. Expanding the constraint for the maximization, we get

$$r_1^A / \alpha_1 = \left( I_0 + I_1 + \frac{1}{2} \lambda L_0^2 - W_0^F - q r_1^A / \alpha_0 + \tau S_0 \right). \quad \text{Furthermore, because the stressed banks are on their}$$

own, once again an increase in ex-ante reserves  $S_0$  always raises  $r_1^A$ , regardless of the size of  $\tau$  (so long as  $\tau > 0$ ).<sup>23</sup> Since the stressed banks just meet liquidity demand using all their shrunken reserves, the

healthy banks get all of it. So  $V_1(y=1, z=0) = \frac{\delta \theta S_0(1-\tau)}{(1-\theta)}$ .

Case 3: *The liquidity needs of the stressed banks are high enough that at the equilibrium autarkic interest rate, some of the healthy banks are willing to lend in the interbank market and become tainted. The equilibrium rate then is lower than the (now counterfactual) autarkic rate.*

Given the analysis in Section 2.2 for this case, for Case 3 to occur, it must be that  $\varphi > 0$ , that is,

$$\frac{\delta S_0(1-\tau)}{(1-\theta) \left( r_1 S_0(1-\tau) + \frac{r_1^2}{2\alpha_1} \right)} < 1. \quad \text{Rearranging, this requires } \left[ \frac{r_1^2}{2\alpha_1} + r_1 S_0(1-\tau) - \frac{\delta S_0(1-\tau)}{(1-\theta)} \right] > 0.$$

Since the expression on the left hand side of the inequality is increasing in  $r_1$ , it must be that the threshold value or the “breakeven interbank rate”  $r_1^\varphi$  that induces banks to lend in the interbank market is the positive root of the quadratic equation obtained by setting the expression to zero. So

$$r_1^\varphi = \alpha_1 S_0(1-\tau) \left[ \sqrt{1 + \frac{2\delta}{\alpha_1(1-\theta)S_0(1-\tau)}} - 1 \right]. \quad \text{Since this increases in } S_0, \text{ we know that in Case 2, an}$$

increase in  $S_0$  expands both the autarky rate  $r_1^A$  as well as the rate  $r_1^\varphi$  necessary for the system to move into Case 3. However, under reasonable assumptions, we show in proofs of Theorems 2-3 that  $r_1^\varphi$

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<sup>23</sup> Since all the endogenous variables on the right hand side are decreasing in  $r_1^A$  while the left hand side is increasing in  $r_1^A$ , there is a unique equilibrium  $r_1^A$ , and  $S_0$  shifts it up whenever  $\tau > 0$ .

increases at a decreasing rate while  $r_1^A$  does not, so at a high enough  $S_0$ ,  $r_1^A > r_1^0$  and the interbank market will open.

**Proofs of Theorems 2-3:** We now provide remaining steps of the proofs by first detailing the date-0 maximization problems in the presence of a convenience yield on reserves at date 1. The firm's maximization problem remains unchanged. The bank's maximization problem is

$$\text{Max}_{L_0^B, e_0} R_0^L L_0^B + S_0 - e_0 - \frac{\alpha_0}{2} e_0^2 - D_0 + E_0 [V(y, z) | L_0, e_0]$$

$$\text{s.t. } D_0 + e_0 = L_0 + \frac{1}{2} \lambda (L_0)^2 + S_0$$

*Case 1:* The convenience yield associated with reserves in the stressed state,  $\delta$ , is an opportunity cost for stressed banks, and they pass it on while lending to their firm at date 1. So they lend at rate  $(1 + \gamma + \delta)$  where  $\gamma$  is their monitoring cost. Therefore,

$$V(y = 1, z = 1) = \text{Max}_{e_1} \left[ -\delta(D_0 - e_1) - \frac{\alpha_1}{2} e_1^2 \right]$$

In turn,  $e_1 = \delta / \alpha_1$ ,  $e_0 = q\delta / \alpha_0$ . The  $(1 - \theta)$  healthy banks divide the deposit outflows from the stressed banks so

$$V(y = 1, z = 0) = \frac{\theta\delta(D_0 - D_0^F + I_1 - \delta / \alpha_1)}{(1 - \theta)}. \text{ Note that in making decisions at date 0, the inflows that}$$

come into the bank if it were healthy at date 1 are unrelated to any decision it takes at date 0 – it stems from decisions (on the size of loans, capital raise, and deposit funding) taken by other banks.<sup>24</sup> So, maximizing at date 0 w.r.t.  $L_0$ , we get  $R_0^L = (1 + q\delta)(1 + \lambda L_0)$ . From the firm's maximization, we know

$$R_0^D = (1 + q\gamma + q\delta) = R_0^L, \text{ so } L_0 = \frac{q\gamma}{\lambda(1 + q\delta)}. \text{ We now derive when } (D_0 - D_0^F + I_1 - e_1) < S_0(1 - \tau).$$

Since  $(D_0 - D_0^F) = (S_0 + L_0 + \frac{1}{2} \lambda (L_0)^2 - e_0) - (W_0^F + L_0 - I_0) = I_0 - e_0 + (S_0 - W_0^F) + \frac{1}{2} \lambda (L_0)^2$ , where the second equality uses  $L_0^B = L_0^F$ , the condition simplifies to

$$\tau S_0 \leq \left[ \left( q\delta / \alpha_0 + \delta / \alpha_1 \right) + W_0^F - I_0 - I_1 - \frac{1}{2} \lambda L_0^2 \right].$$

<sup>24</sup> Put differently, all the variables in this expression should have a superscript O to signify they are decisions made by other banks. In the symmetric equilibrium, however, they will be equal to the values chosen by the bank whose maximization decisions we are studying.

Case 2: Here the opportunity cost of lending at date 1 is  $r_1$  (since this is the marginal cost of raising capital, the source of incremental funding at date 1), and it replaces  $\mathcal{S}$  in the bank's maximization in Case 1. The stressed bank sees

$$V(y=1, z=1) = \underset{e_1}{\text{Max}} \left[ -r_1(D_0 - e_1) - \frac{\alpha_1}{2} e_1^2 \right]. \text{ The healthy banks receive}$$

$$V(y=1, z=0) = \frac{\theta \mathcal{S}_0(1-\tau)}{(1-\theta)}. \text{ Furthermore, } \tau S_0 = \left[ \left( q r_1 / \alpha_0 + r_1 / \alpha_1 \right) + W_0^F - I_0 - I_1 - \frac{1}{2} \lambda L_0^2 \right] \text{ for}$$

liquidity demand to equal liquidity supply. Since the right hand side increases in  $r_1$ , a higher  $S_0$  always induces a higher  $r_1$ , whatever the level of  $\tau$  so long as it is positive.

Case 3: For the bank, the date-0 maximization is similar to the one in Case 2. In this case, if healthy, the bank may use its reserves to lend at date 1. However, this will not enter its maximization since it takes the reserves as given. The bank's maximization problem at date 0, and the stressed bank's problem at date 1 then is as in case 2, where it takes  $r_1$  as given.

Let  $S_0^*$  be the level of reserves at which the stressed bank can just meet liquidity needs with the (shadow) rate  $\mathcal{S}$  and reserves having a convenience yield  $\mathcal{S}$ . That is,

$$S_0^* = \frac{1}{\tau} \left[ \left( q \mathcal{S} / \alpha_0 + \mathcal{S} / \alpha_1 \right) + W_0^F - I_0 - I_1 - \frac{1}{2} \lambda L_0^2 \right] \text{ where } g_0'(I_0) = \frac{1+q(\gamma+\delta)}{1-q},$$

$$g_1'(I_1) = (1+\gamma+\delta), \text{ and } L_0 = \frac{q\gamma}{\lambda(1+q\delta)}. \text{ Note the right hand side is increasing in } \mathcal{S} \text{ so } S_0^* \text{ is}$$

increasing in  $\mathcal{S}$ . Furthermore, the net rate the stressed banks charge firms is  $(\gamma+\delta)$  for  $S_0 < S_0^*$ .

When  $S_0$  rises from  $S_0^*$ , the (shadow autarky) rate  $r_1^A$  rises from  $\mathcal{S}$ . It solves

$$\tau S_0 = \left[ \left( q r_1^A / \alpha_0 + r_1^A / \alpha_1 \right) + W_0^F - I_0 - I_1 - \frac{1}{2} \lambda L_0^2 \right] \text{ where } g_0'(I_0) = \frac{1+q(\gamma+r_1^A)}{1-q},$$

$$g_1'(I_1) = (1+\gamma+r_1^A), \text{ and } L_0 = \frac{q\gamma}{\lambda(1+q r_1^A)}. \text{ Once again, since the right hand side increases in } r_1^A, r_1^A \text{ is}$$

increasing in  $S_0$ . If we further assume  $g_0'''$ ,  $g_1'''$  are both positive, then it is convex.

$$\text{Also } r_1^\varphi = \alpha_1 S_0(1-\tau) \left[ \sqrt{1 + \frac{2\delta}{\alpha_1(1-\theta)S_0(1-\tau)}} - 1 \right]. \text{ So } r_1^\varphi > 0 \text{ for } S_0 > 0. \text{ Furthermore, it is}$$

straightforward to show that  $r_1^\varphi$  is increasing in  $S_0$  and it is concave. Assume for now, and we will revisit

later, that at  $S_0^*$ ,  $r_1^\varphi > r_1^A$ . Since both rates are increasing in  $S_0$ , and  $r_1^A$  is convex in  $S_0$  while  $r_1^\varphi$  is

concave, they can intersect only once at  $S_0^{**}$ . So the (shadow) rate is  $r_1^A$  as  $S_0$  increases from  $S_0^*$  to  $S_0^{**}$

after which it becomes the rate dictated by the interbank market. Finally,  $r_1^\varphi$  increases in  $\mathcal{S}$  (as does  $r_1^A$ ,

see above). So  $S_0^{**}$  increases in  $\mathcal{S}$ . Finally, since the equilibrium  $\varphi$  falls in  $\mathcal{S}$ , the required equilibrating interbank rate also increases in  $\mathcal{S}$ . Now, it can be shown using the 2<sup>nd</sup> order Taylor-series

expansion of  $\sqrt{1+x}$  in  $r_1^\varphi$ , that at  $S_0^*$ ,  $r_1^\varphi - r_1^A > \frac{\delta\theta}{(1-\theta)} - \frac{\delta^2}{2\alpha_1(1-\theta)^2 S_0^*(1-\tau)} > 0$ , if

$\delta < 2\alpha_1\theta(1-\theta)(1-\tau)S_0^*$ . Substituting for  $S_0^*$ , and doing some algebra, it can be shown that a sufficient condition for this is that  $\theta(1-\theta) > \frac{\tau}{2(1-\tau)}$  and  $\delta > \delta^*$  where  $\delta^*$  satisfies

$$\frac{\tau}{2\alpha_1\theta(1-\theta)(1-\tau)}\delta^* = \left[ \left( q\delta^* / \alpha_0 + \delta^* / \alpha_1 \right) + W_0^F - I_0(\delta^*) - I_1(\delta^*) - \frac{1}{2}\lambda [L_0(\delta^*)]^2 \right]. \text{ This}$$

guarantees that there exists a unique  $S_0^{**} > S_0^*$  such that  $r_1^\varphi < r_1^A$  (interbank market is open) if and only if  $S_0 > S_0^{**}$ . Q.E.D.

**Condition for  $r_1$  to be increasing in  $S_0$  in Case 3:** Recognize that in this region,  $r_1$  is determined by equating the demand by stressed banks for loans in the inter-bank market to the supply by tainted banks of those loans. So  $\theta[D_0 - D_0^F + I_1 - S_0(1-\tau) - e_1] = \varphi(1-\theta)[S_0(1-\tau) + e_1]$ . Substituting

$$(D_0 - D_0^F) = [I_0 - e_0 + (S_0 - W_0^F) + \frac{1}{2}\lambda(L_0^B)^2] \text{ and } e_1 = \frac{r_1}{\alpha_1} \text{ and rearranging, we get}$$

$$\frac{r_1}{\alpha_1} = \frac{\theta}{[\varphi(1-\theta) + \theta]} [I_0 + I_1 - e_0 + \frac{1}{2}\lambda(L_0^B)^2 - W_0^F] + \frac{[\theta\tau - \varphi(1-\theta)(1-\tau)]}{[\varphi(1-\theta) + \theta]} S_0. \text{ Denoting the right hand}$$

side of this equality as  $f$  as before and totally differentiating, we get  $\left[ \frac{1}{\alpha_1} - \frac{\partial f}{\partial r_1} \right] \frac{dr_1}{dS_0} = \frac{\partial f}{\partial \varphi} \frac{\partial \varphi}{\partial S_0} + \frac{\partial f}{\partial S_0}$ .

Since  $\frac{\partial f}{\partial r_1} < 0$ ,  $\frac{dr_1}{dS_0} > 0$  if  $\frac{\partial f}{\partial \varphi} \frac{\partial \varphi}{\partial S_0} + \frac{\partial f}{\partial S_0} > 0$ . But  $\frac{\partial f}{\partial \varphi} < 0$  by inspection, and we argued in the text that

$\frac{\partial \varphi}{\partial S_0} < 0$ . So  $\frac{\partial f}{\partial \varphi} \frac{\partial \varphi}{\partial S_0} > 0$  and a sufficient condition for  $\frac{dr_1}{dS_0} > 0$  is that  $\frac{\partial f}{\partial S_0} > 0$ . This then requires

$$[\theta\tau - \varphi(1-\theta)(1-\tau)] > 0, \text{ which on simplifying requires } \theta > \frac{\varphi(1-\tau)}{\tau + \varphi(1-\tau)}. \text{ Note that this is only}$$

sufficient, since even if it does not hold, it may still be that  $\frac{dr_1}{dS_0} > 0$ . Intuitively, there is now a new

channel through which a higher  $S_0$  leads to a higher  $r_1$ : a higher  $S_0$  leads to a lower  $\varphi$  ceteris paribus, since healthy banks have more reason to stay on the sideline given the larger flight to safety flows, which in turn leads to a greater net need for liquidity from capital-raising, and hence a higher  $r_1$ .

### Section 3.4: Endogenous $\mathcal{S}$ .

If  $\delta(r_1) = \delta^A + \delta^B r_1^2$  where  $\delta^A \geq 0$ ,  $\delta^B \geq 0$ , then it follows from (1.12) that

$$(1-\varphi) = \frac{(\delta^A + \delta^B r_1^2)S_0(1-\tau)}{(1-\theta)\left(r_1 S_0(1-\tau) + \frac{r_1^2}{2\alpha_1}\right)}. \text{ Let } A = \frac{\delta^B}{(1-\theta)}, B = \frac{1}{2\alpha_1 S_0(1-\tau)}, C = \frac{\delta^A}{(1-\theta)}. \text{ Then the}$$

previous expression is  $(1-\varphi) = \frac{C + Ar_1^2}{r_1 + Br_1^2}$ . Note that  $A, B, C$  are all positive.

We want to see when the RHS  $\geq 1$  so that there is no  $r_1$  for which  $\varphi > 0$ . This requires

$$(A-B)r_1^2 - r_1 + C \geq 0. \text{ The roots of the quadratic are } r_1 = \frac{1 \pm \sqrt{1-4C(A-B)}}{2(A-B)}.$$

Case 1: If  $4C(A-B) > 1$ , there are no real roots to the quadratic. So  $C + Ar_1^2$  always lies above  $r_1 + Br_1^2$  (as at  $r_1 = 0$ ), which means  $\varphi$  is always zero. The interbank market never opens in this case.

Case 2: If  $4C(A-B) \leq 1$  and  $A > B$ , there are two positive real roots,  $r_1^+ > r_1^-$ , and  $\varphi > 0$  if and only if  $r_1 \in (r_1^-, r_1^+)$ . Essentially, the two curves  $C + Ar_1^2$  and  $r_1 + Br_1^2$  intersect at two points, and  $\varphi > 0$  in between. The interbank market opens only in a range of rates and is closed both above and below.

Case 3: If  $A < B$ , then there is only one positive root, which is  $r_1^+ = \frac{-1 + \sqrt{1+4C(B-A)}}{2(B-A)}$ , and  $\varphi > 0$

iff  $r_1 > r_1^+$ . Essentially, the slope of  $r_1 + Br_1^2$  is higher than  $C + Ar_1^2$ , so it intersects once from below, after which  $\varphi > 0$ . The interbank market opens only above a specific rate.

### Appendix III – Proofs and Analysis for Section 6.1

**Proof that with exogenous  $\varphi$ ,  $\frac{dU}{de_0} = 0$  at the privately optimal  $e_0 = \frac{qr_1}{\alpha_0}$ .** Recall from (1.13) that

$$U = ((1-q)g_0(I_0) - I_0(1+q\gamma)) + q(g_1(I_1) - I_1(1+\gamma)) - \frac{1}{2}\alpha_0 e_0^2 - \frac{q}{\theta}[\varphi(1-\theta) + \theta](\frac{1}{2}\alpha_1 e_1^2) - \frac{1}{2}\lambda(L_0)^2 + q(L_0 + W_0^F)\gamma$$

Assume  $e_0$  is set exogenously (so it does not respond to the interest rate). Now we know that

$$\frac{dU}{de_0} = \frac{\partial U}{\partial e_0} + \frac{\partial U}{\partial r_1} \frac{dr_1}{de_0} = -\alpha_0 e_0 + \frac{\partial U}{\partial r_1} \frac{dr_1}{de_0}.$$

$$\frac{\partial U}{\partial r_1} = [(1-q)g_0' - (1+q\gamma)] \frac{\partial I_0}{\partial r_1} + q[g_1' - (1+\gamma)] \frac{\partial I_1}{\partial r_1} - \frac{q}{\theta} [\varphi(1-\theta) + \theta] \alpha_1 e_1 \frac{\partial e_1}{\partial r_1} + [q\gamma - \lambda L_0] \frac{\partial L_0}{\partial r_1}.$$

Substituting from the firm's FOC, that is,  $(1-q)g_0' = (1+q(\gamma+r_1))$ ,  $g_1' = (1+\gamma+r_1)$ , and

$$\lambda L_0 = \frac{q\gamma}{1+qr_1}, \text{ as well as recognizing that } e_1 = \frac{r_1}{\alpha_1}, \text{ we get}$$

$$\frac{\partial U}{\partial r_1} = qr_1 \left[ \frac{\partial I_0}{\partial r_1} + \frac{\partial I_1}{\partial r_1} + \frac{q\gamma}{1+qr_1} \frac{\partial L_0}{\partial r_1} + \frac{\varphi(1-\theta) + \theta}{\alpha_1 \theta} \right].$$

$$\text{From (1.10), } r_1 = \frac{\alpha_1 \theta}{[\varphi(1-\theta) + \theta]} \left[ I_1 + (D_0 - D_0^F) \right] - S_0(1-\tau).$$

$$\text{Therefore, } \frac{dr_1}{de_0} = \frac{\alpha_1 \theta}{[\varphi(1-\theta) + \theta]} \left[ \lambda L_0 \cdot \frac{dL_0}{dr_1} \cdot \frac{dr_1}{de_0} - 1 + \frac{dI_0}{dr_1} \cdot \frac{dr_1}{de_0} + \frac{dI_1}{dr_1} \cdot \frac{dr_1}{de_0} \right].$$

$$\text{Rearranging, and substituting } \lambda L_0 = \frac{q\gamma}{1+qr_1}, \frac{dr_1}{de_0} = \frac{-\frac{\alpha_1 \theta}{[\varphi(1-\theta) + \theta]}}{1 - \frac{\alpha_1 \theta}{[\varphi(1-\theta) + \theta]} \left[ \frac{q\gamma}{1+qr_1} \frac{dL_0}{dr_1} + \frac{dI_0}{dr_1} + \frac{dI_1}{dr_1} \right]}.$$

Returning to the expression, we obtain that  $\frac{dU}{de_0} = -\alpha_0 e_0 + \frac{\partial U}{\partial r_1} \frac{dr_1}{de_0}$ . We know  $\alpha_0 e_0 = qr_1$  at the private optimal. Also, multiplying the earlier expressions, we get  $\frac{\partial U}{\partial r_1} \frac{dr_1}{de_0} = qr_1$ , so  $\frac{dU}{de_0} \Big|_{e_0 = \frac{qr_1}{\alpha_0}} = 0$ . Q.E.D.

**Proof of Theorem 4 (endogenous  $\varphi$ ).** Recall from (1.13) that

$$U = ((1-q)g_0(I_0) - I_0(1+q\gamma)) + q(g_1(I_1) - I_1(1+\gamma)) - \frac{1}{2}\alpha_0 e_0^2 - \frac{q}{\theta} [\varphi(1-\theta) + \theta] \left( \frac{1}{2} \alpha_1 e_1^2 \right) - \frac{1}{2} \lambda (L_0)^2 + q(L_0 + W_0^F) \gamma$$

Since  $\varphi$  is not influenced directly by  $e_0$  but only indirectly via  $r_1$ , we have

$$\frac{dU}{de_0} = \frac{\partial U}{\partial e_0} + \left( \frac{\partial U}{\partial r_1} \Big|_{\varphi=const} \right) \frac{dr_1}{de_0} + \frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial r_1} \frac{dr_1}{de_0} = -\alpha_0 e_0 + \left( \left( \frac{\partial U}{\partial r_1} \Big|_{\varphi=const} \right) + \frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial r_1} \right) \frac{dr_1}{de_0}.$$

$$\text{Also } r_1 = \alpha_1 f(r_1, \varphi, e_0). \text{ Therefore, } \frac{dr_1}{de_0} = \alpha_1 \left[ \frac{\partial f}{\partial e_0} + \frac{\partial f}{\partial r_1} \cdot \frac{dr_1}{de_0} + \frac{\partial f}{\partial \varphi} \cdot \frac{\partial \varphi}{\partial r_1} \frac{dr_1}{de_0} \right].$$

Rearranging,  $\frac{dr_1}{de_0} = \frac{\alpha_1 \frac{\partial f}{\partial e_0}}{\left[1 - \alpha_1 \left( \frac{\partial f}{\partial r_1} + \frac{\partial f}{\partial \varphi} \cdot \frac{\partial \varphi}{\partial r_1} \right)\right]}$ . Substituting in the earlier expression, we get

$$\frac{dU}{de_0} = -\alpha_0 e_0 + \left( \left( \frac{\partial U}{\partial r_1} \right)_{\varphi=const} + \frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial r_1} \right) \frac{\alpha_1 \frac{\partial f}{\partial e_0}}{\left[1 - \alpha_1 \left( \frac{\partial f}{\partial r_1} + \frac{\partial f}{\partial \varphi} \cdot \frac{\partial \varphi}{\partial r_1} \right)\right]} \quad (A)$$

Now we can see that

$$\frac{\partial U}{\partial \varphi} = -\frac{q}{\theta}(1-\theta) \frac{1}{2} \alpha_1 e_1^2 < 0 \quad (\text{the direct effect of a higher } \varphi \text{ is more dissipative date-1 equity}$$

$$\text{issuance by tainted banks). Also from (1.12), } (1-\varphi) = \frac{\delta S_0(1-\tau)}{(1-\theta) \left( r_1 S_0(1-\tau) + \frac{r_1^2}{2\alpha_1} \right)}.$$

$$\text{So } \frac{\partial \varphi}{\partial r_1} = \frac{\delta S_0(1-\tau)}{(1-\theta)} \frac{\left( S_0(1-\tau) + \frac{r_1}{\alpha_1} \right)}{\left( r_1 S_0(1-\tau) + \frac{r_1^2}{2\alpha_1} \right)^2} > 0, \text{ and } \frac{\partial f}{\partial \varphi} = \frac{-\theta(1-\theta)}{(\varphi(1-\theta) + \theta)^2} \left[ I_1 + (D_0 - D_0^F) \right] < 0.$$

We can then understand the effect of internalizing  $\varphi$  on how the social planner would set  $e_0$  from scrutinizing the terms containing  $\varphi$  on the right hand side of (A) above. In the numerator,

$$\frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial r_1} \alpha_1 \frac{\partial f}{\partial e_0} > 0. \text{ An increase in } e_0 \text{ reduces the liquidity shortfall } f, \text{ reducing the rate } r_1, \text{ reducing the}$$

mass of tainted banks  $\varphi$ , and reducing dissipative date-1 equity issues by tainted banks, thus increasing welfare. However, there is an offsetting dampening effect from the term in the denominator,

$$-\alpha_1 \frac{\partial f}{\partial \varphi} \cdot \frac{\partial \varphi}{\partial r_1} > 0, \text{ because a fall in the ex-post inter-bank rate increases the degree of liquidity hoarding,}$$

and thus increases the degree of liquidity shortfall that has to be met by date-1 dissipative capital issues.

To check whether the social planner's capital choice is higher than the private optimal (which ignores the dependence of  $\varphi$  on the bank's capital issuance), we need to see whether



$$\frac{dU}{de_0} = -\alpha_0 e_0 + \left( \left( \frac{\partial U}{\partial r_1} \right)_{\varphi=const} + \frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial r_1} \right) \frac{\alpha_1 \frac{\partial f}{\partial e_0}}{\left[ 1 - \alpha_1 \left( \frac{\partial f}{\partial r_1} + \frac{\partial f}{\partial \varphi} \cdot \frac{\partial \varphi}{\partial r_1} \right) \right]}$$

is greater or less than zero at the

private optimal  $e_0 = \frac{qr_1}{\alpha_0}$ . In other words, we need to check whether

$$\left( \left( \frac{\partial U}{\partial r_1} \right)_{\varphi=const} + \frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial r_1} \right) \frac{\alpha_1 \frac{\partial f}{\partial e_0}}{\left[ 1 - \alpha_1 \left( \frac{\partial f}{\partial r_1} + \frac{\partial f}{\partial \varphi} \cdot \frac{\partial \varphi}{\partial r_1} \right) \right]} > qr_1.$$

Multiplying both sides by the denominator on

the left hand side, and recognizing from our earlier analysis with exogenous  $\varphi$  that

$$\left( \frac{\partial U}{\partial r_1} \right)_{\varphi=const} \alpha_1 \frac{\partial f}{\partial e_0} = qr_1 \left( 1 - \alpha_1 \frac{\partial f}{\partial r_1} \right), \text{ we require that } \frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial e_0} > -qr_1 \frac{\partial f}{\partial \varphi}.$$

$$\text{Now } \frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial e_0} = \left( -\frac{q}{\theta} (1-\theta) \frac{1}{2} \alpha_1 e_1^2 \right) \cdot \left( \frac{-\theta}{\varphi(1-\theta) + \theta} \right). \text{ We substitute } e_1 = \frac{r_1}{\alpha_1}.$$

$$\text{Note also that } -qr_1 \frac{\partial f}{\partial \varphi} = -qr_1 \cdot \left( \frac{-\theta(1-\theta)}{(\varphi(1-\theta) + \theta)^2} (I_1 + (D_0 - D_0^F)) \right).$$

Substituting on both sides of the

$$\text{inequality and recognizing that } r_1 = \frac{\alpha_1 \theta}{[\varphi(1-\theta) + \theta]} [I_1 + (D_0 - D_0^F)] - \alpha_1 S_0 (1-\tau), \text{ we get}$$

$$\frac{\partial U}{\partial \varphi} \frac{\partial \varphi}{\partial e_0} > -qr_1 \frac{\partial f}{\partial \varphi} \text{ iff } \frac{r_1}{2} > r_1 + \alpha_1 S_0 (1-\tau) \text{ which is impossible. Indeed, the inequality goes the other}$$

$$\text{way, so } \left. \frac{dU}{de_0} \right|_{e_0 = \frac{qr_1}{\alpha_0}} < 0. \text{ The social planner prefers lower capital than the privately optimal level. Q.E.D.}$$