

Conventional and Unconventional Monetary Policy with Endogenous Collateral Constraints*

Aloísio Araújo
IMPA and EPGE-FGV

Susan Schommer
IMPA

Michael Woodford
Columbia University

October 15, 2013

Abstract

We consider the effects of central-bank purchases of a risky asset, financed by issuing riskless nominal liabilities (reserves), as an additional dimension of policy alongside “conventional” monetary policy (central-bank control of the riskless nominal interest rate), in a general-equilibrium model of asset pricing and risk sharing with endogenous collateral constraints of the kind proposed by Geanakoplos (1997). When sufficient collateral exists for collateral constraints not to bind for any agents, we show that central-bank asset purchases have no effects on either real or nominal variables, despite the differing risk characteristics of the assets purchased and the ones issued to finance these purchases. At the same time, the existence of collateral constraints allows our model to capture the common view that large enough central-bank purchases would eventually have to effect asset prices. But even when central-bank purchases raise the price of the asset, owing to binding collateral constraints, the effects need not be the ones commonly assumed. We show that under some circumstances, central-bank purchases relax financial constraints, increase aggregate demand, and may even achieve a Pareto improvement; but in other cases, they may tighten financial constraints, reduce aggregate demand, and lower welfare. The latter case is almost certainly the one that arises if central-bank purchases are sufficiently large.

*We thank Kyle Jurado and Savitar Sundaresan for research assistance, and John Geanakoplos, Steve Williamson, and participants at presentations at IMPA, MIT, the Cowles Foundation Conference on General Equilibrium and its Applications, and the Annual Fall Conference of the Federal Reserve Bank of St. Louis for helpful comments. We also acknowledge financial support from CAPES-PNPD and IMPA (Schommer), and the NSF under grant SES-0820438 (Woodford).

One of the more notable developments in central banking since the global financial crisis has been an increase in the diversity of types of market transactions through which central banks have sought to influence financial conditions. Before the crisis, it had become common to think of monetary policy as a uni-dimensional decision: the periodic reconsideration of the central bank’s operating target for a single, short-term (typically overnight) nominal interest rate. Over the past five years, instead, a number of leading central banks (including the Federal Reserve, the Bank of Japan, and the Bank of England) have made almost no changes in their policy rates — having taken those rates to levels viewed as their effective lower bounds by the beginning of 2009, while additional monetary easing continued to be desired — yet have been quite active on other dimensions, making dramatic changes in both the size and composition of their balance sheets.

While the theoretical literature on the effects of changes in interest-rate policy, and on the way in which variations in the supply of bank reserves and adjustment of the rate of interest paid on reserves allow central banks effective control of short-term interest rates, is well-developed, much less is understood about the effects that should follow from variations in the central bank’s balance sheet apart from those involved in implementing interest-rate policy. On one traditional view, the assets held by the central bank to “back” its issuance of monetary liabilities are of little macroeconomic significance — only the quantity of reserves created should matter, and that only because of its implications for the determination of short-term interest rates. There would then be little reason to conceive of multi-dimensional monetary policy options. On an alternative view, the asset-purchase programs recently implemented by central banks are simply a variant of what monetary policy has always been about: central banks exchanging one type of financial instrument for another, so as to influence market rates of return. On this view, there are naturally multiple possible dimensions of policy to the extent that there are multiple interest rates — as there naturally are, given the different risk characteristics of different instruments.

Here we undertake a theoretical analysis of the effects of alternative dimensions of monetary policy, in a general-equilibrium asset-pricing framework in which assets with different risk characteristics co-exist and earn different rates of return in equilibrium. We introduce a central bank with effective control over short-term nominal interest rates, that can determine the general level of prices (of goods and services in terms of money) through this “conventional” monetary policy; but we also allow the central to engage in open-market purchases and sales of the various types of assets with differing

risk characteristics that are traded in the marketplace, and consider the extent to which allowing for variations in the size and composition of the balance sheet, holding interest-rate policy fixed, provide useful additional dimensions of policy.

It is important to note that we do not here seek to model central-bank *credit policies*: lending by a central bank to specific types of borrowers at below-market rates, either because it wishes to subsidize certain activities or institutions, or because private intermediation has become highly inefficient, as during the most severe phase of the recent financial crisis.¹ (There is little mystery about the fact that such policies should affect the allocation of resources and that they are not equivalent to conventional interest-rate policy in their effects — and we shall not discuss them here.) The policies with which we are concerned, such as the Fed’s asset-purchase programs since the fall of 2010, involve open-market purchases of assets that are traded on highly liquid markets, and are aimed at achieving macroeconomic goals by influencing financial conditions for the economy as a whole, rather than at providing credit for specific borrowers or categories of borrowers. Our model is therefore one in which financial markets are efficient, in the sense that all traders are able to purchase the same set of assets, at prices that are independent of the identity of the purchaser and of the quantity purchased, and that the spread between the price paid by a buyer and that received by the seller of assets is assumed to be negligible; and all central-bank trades are assumed to occur at these well-defined market prices.²

There is, however, one important respect in which we shall assume that financial markets are not frictionless in the sense of Arrow and Debreu, and this is important for the consequences of “unconventional” monetary policy: we shall assume, as in Geanakoplos (1997) and Araújo *et al.* (2002), that all privately issued financial claims

¹Many of the novel policies introduced by the Federal Reserve during the acute phase of the global financial crisis were of this kind; Bernanke (2009) characterized the Fed’s policies during this period as “credit easing,” to distinguish them from the “quantitative easing” of the Bank of Japan during the period 2001-2006 (which instead mainly involved open-market purchases of highly liquid securities, mostly Japanese government bonds). The Fed’s more recent asset-purchase programs can less obviously be characterized in this way.

²Models such as those of Cúrdia and Woodford (2010) or Gertler and Karadi (2011, 2013) instead consider central-bank purchases of assets that many investors cannot directly purchase themselves, because only certain specialized intermediaries (with limited capital and constraints on their access to financing) have the expertise required to evaluate them. These are more obviously appropriate as models of programs such as the Fed’s “credit easing” policies during the acute phase of the financial crisis, rather than its more recent asset-purchase programs.

(as opposed to physical assets or government liabilities) must be collateralized. While the collateral requirements in our model represent a friction, in the sense that some mutually beneficial trades are precluded, we believe that this assumption is not only realistic, but a characteristic of the markets that are most *efficient* in the senses referred to above, since insistence on collateral of a standardized type is precisely an institution that makes it possible for transacting parties to be much less concerned with the identity of the parties with which they trade and the other trades of those parties.³

Moreover, rather than assuming collateral requirements (and hence borrowing limits) of an arbitrary form, we endogenize the collateral requirements, as in the models of Geanakoplos (1997) and Geanakoplos and Zame (2013).⁴ This approach allows markets potentially to exist for both more and less well-collateralized private debts, with both the questions of what interest rate is required in the case of a given degree of collateral and which types of partially-collateralized debt will actually be issued being determined through competition in the marketplace.

Our main conclusions can briefly be summarized. We find that pure changes in the central bank's balance sheet, in the absence of any change in the short-term nominal interest rate, can affect asset prices, the allocation of resources and the general level of prices; hence they do constitute a potentially useful independent dimension of policy. However, these effects depend critically upon the way in which and degree to which collateral constraints bind in equilibrium; hence the allowance for collateral constraints is crucial to our results. We show that when collateral is sufficiently abundant for no households' collateral constraints to bind, central-bank asset purchases are *irrelevant*, affecting neither the equilibrium prices of financial assets nor the money prices of goods and services nor the allocation of resources.

And even when collateral constraints bind, the effects of asset purchases depend critically on the particular way in which they bind; for example, we show that central-

³Sharp increases in collateral requirements were a notable feature of the recent financial crisis (as discussed, for example, by Adrian and Shin, 2010; Brunnermeier, 2009; and Gorton and Metrick, 2012). This makes it of particular interest to ask how collateral constraints matter for the effects of both conventional and unconventional monetary policies.

⁴Araújo *et al.* (2000, 2005) instead propose an alternative approach to the endogenization of collateral requirements, in which the collateral requirement is set by the lender, rather than being market-determined. We leave for future work the extent to which our conclusions may depend on the method used to determine the endogenous collateral constraints.

bank purchases of the risky good used as collateral will loosen private borrowers' collateral constraints under some circumstances, but tighten them under others. The conditions that determine which will be the case are somewhat complex; but one quite general observation is that acquisition of a sufficiently large fraction of the total supply of the collateral good by the central bank makes it almost inevitable that the collateral constraints of a non-trivial part of the population will be tightened by the central bank's policy. There are, however, conditions under which central-bank asset purchases will improve the situation of all parties, and thus achieve a Pareto improvement relative to an inefficient initial status quo; we offer both analytical sufficient conditions for this to be the case and a numerical illustration.

Finally, we consider the extent to which asset-purchase policies are properly considered to be nearly equivalent to interest-rate policy, in the sense that asset purchases can achieve similar macroeconomic effects as an interest-rate reduction, though without requiring any change in the short-term nominal interest rate. Such an equivalence would suggest that asset purchases are appropriate when further interest-rate cuts are precluded by the zero lower bound, but perhaps unnecessary under other circumstances. It would also suggest that standard guidelines for interest-rate policy, such as the Taylor Rule, should have direct implications for an appropriate use of asset-purchase policy, once the correct equivalence scale between asset purchases and interest-rate changes has been worked out.

In fact, we find that while asset purchases can, under at least some circumstances, achieve certain effects (such as raising the general level of prices) that might be the goal of an interest-rate cut, this does not mean that they achieve this effect in the same way — and with the same collateral effects on other variables — as an interest-rate cut would. Indeed, under circumstances where conventional interest-rate policy would affect the price level with no effects on any real variables, asset purchases will instead, if able to affect the price level, do so only by *also* affecting the severity of financial distortions and hence the real allocation of resources. Asset-purchase policies, when effective, are thus best viewed as a relatively orthogonal dimension of policy to conventional interest-rate policy — and hence potentially useful even when interest rates are not at the zero lower bound.

We introduce conventional monetary policy (i.e., interest-rate policy) into the model of collateral-constrained equilibrium proposed by Geanakoplos and Zame (2013) and Araújo *et al.* (2012) in section 1, and show that in our model conventional mon-

etary policy has relatively standard effects. We then turn in section 2 to the effects of central-bank asset purchases. We first establish an irrelevance proposition for the case when collateral is sufficiently abundant, but then discuss why the same argument will not continue to be valid when the collateral constraint binds for at least some households. We further distinguish between two different ways in which the collateral requirement may constrain a household’s decisions, and the different effects of asset-purchase policies upon the household’s situation in these two cases.

The general-equilibrium effects of asset purchases on financial and macroeconomic equilibrium when collateral constraints bind are then developed in more detail in section 3, focusing on a case of particular interest, in which the collateral requirement limits the degree to which “natural buyers” of the risky asset are able to leverage themselves to take a longer position in this asset. Section 4 explores a broader variety of ways in which collateral constraints may bind, depending on the different endowment patterns (and corresponding risk exposures) of differently situated households, through a series of numerical examples; it especially highlights the characteristic distortions that result when too large a fraction of the supply of the asset used as collateral comes to be held by the central bank. Section 5 summarizes our conclusions.

1 A Monetary Model with Endogenous Collateral Constraints

Here we present a finite-horizon general-equilibrium model with endogenous collateral constraints, along the lines of Geanakoplos and Zame (2013) and Araújo *et al.* (2012), but with a nominal unit of account, the value of which is determined by conventional monetary policy, and a central bank that is not subject to the same collateral constraint as private actors. We use the model to examine the effects of two independent dimensions of monetary policy, interest-rate policy (“conventional monetary policy”) and central-bank asset purchases (“unconventional policy”).⁵

⁵The model can also be used to show the effects of “forward guidance,” a further dimension of policy that has also been used more extensively when conventional policy is constrained by the interest-rate lower bound. Our primary interest in this paper, however, is in interest-rate policy and central-bank asset purchases.

We consider a pure exchange economy over two time periods $t = 0, 1$, with uncertainty about the state of nature in period 1 denoted by the subscript $s \in \mathcal{S} = \{1, \dots, S\}$. The economy consists of a finite number of households denoted by the superscript $h \in \mathcal{H} = \{1, \dots, H\}$ which can each consume two goods or commodities each period. One good is a non-durable consumer good, while the other is a durable good, which yields a service flow in both periods; the service flow from the durable (which might be thought of as housing) is not perfectly substitutable with non-durable consumption, and is possibly risky in period 1. The importance of the durable good in our model is as the only acceptable collateral in private loan contracts, discussed below; hence the supply of durables will be an important determinant of the scarcity of collateral.⁶

Because the durable good is assumed to be the only possible form of collateral, it is possible that the households that choose to hold the durable at the end of period 0 will differ from those that choose to consume the services of the durable in period 0. We therefore assume the existence of a market for “rental” of the durable (i.e., consumption of its service flow) in addition to purchases of it as an asset to hold until the next period.⁷

There are then effectively three goods each period — the non-durable good (good 1), the service flow from the durable (good 2), and the durable good itself, held as an asset (good 3) — though utility is obtained from the consumption of only the first two of these goods. Each household has an initial endowment $e_1^h \geq 0$ of the

⁶In practice, housing is an important form of collateral. However, collateral need not be a real asset; a longer-term nominal asset might serve as collateral for a shorter-term loan contract, as in the US Treasury repo market. It is important, however, to treat the case in which collateral has a risky market value in period 1; and in our two-period model, such risk is most naturally introduced by supposing that the asset used as collateral is a risky real asset, rather than a riskless nominal government liability. Most of our conclusions about central-bank purchases of the risky durable good would apply equally to central-bank purchases of longer-term nominal government debt, in a multi-period model with interest-rate risk.

⁷Alternatively, we would have to distinguish between markets for sale of the durable in period 0 before enjoyment of the period 0 service flow and after such enjoyment (but while the durable can still be used as collateral). The device of treating the asset and its service flow as separate “goods” allows us instead to write a single budget constraint for each period. The need for a rental market is especially evident once we allow for the possibility of central-bank purchases of the durable, given that the central bank cannot consume the service flow.

non-durable and $e_3^h \geq 0$ of the durable in period 0,⁸ and an initial endowment $e_{s1}^h \geq 0$ of the non-durable in state s of period 1. (There are no further period-1 endowments of the durable.) The preference ordering of household h is represented by a utility function $u^h : \mathbb{R}_+^{2(S+1)} \rightarrow \mathbb{R}$, defined over consumption $x^h = (x_l^h, x_{1l}^h, \dots, x_{Sl}^h) \in \mathbb{R}_+^{2(S+1)}$ of the first two goods ($l = 1, 2$); this function is assumed to be increasing in each of its arguments and strictly quasi-concave. We shall also use the notation $x_3^h \geq 0$ for the quantity of the durable good held as an asset in period 0, though this is not an element of the vector x^h (which denotes only the consumption plan).

1.1 Monetary Policy in a Finite-Horizon Model

In addition to the decision to accumulate the durable good, we allow trading in financial assets of several types. *Money* is a riskless nominal government liability. It does not matter, in our simple model, whether money is a nominal liability of the government itself, or a liability of the central bank (“backed” by an equal quantity of nominal government debt held on the balance sheet of the central bank), as we abstract from any transactions role of central-bank liabilities; in our model, like the baseline model of Wallace (1981), base money and Treasury bills are equivalent assets, and must earn the same return in equilibrium. Each household has an initial endowment $m^h \geq 0$ of money in period 0; $m \equiv \sum_h m^h > 0$ is therefore the initial “money supply.”⁹

Money yields a riskless nominal return i ; that is, one unit of money held after trading in period 0 becomes a claim to $(1+i)$ units of money in period 1, regardless of the state s . This riskless nominal interest rate is a policy variable, that may be freely set by the central bank; this represents “conventional monetary policy” in our model. Note that the central bank is free to set the interest rate on its liabilities (in practice, the interest rate paid on overnight balances held at the central bank) at whatever level it likes, given that the unit of account is only *defined* in terms of balances held at the central bank, and the only link between the unit of account in two successive

⁸As explained below, for purposes of pricing the various goods, we number the non-durable as good 1, the *service flow* from the durable as good 2, and the durable as good 3.

⁹Despite our reference to the “money supply,” this variable actually represents total initial nominal liabilities of the government, aggregating both Treasury securities in the hands of the public and central-bank liabilities (base money); alternatively, it is the supply of nominal government debt, aggregating government debt directly held by the public and that held by the central bank.

periods arises from the central bank’s willingness to deliver future money in exchange for money held now on particular terms.¹⁰ Under the assumption that $m > 0$, so that some amount of money earning the return i must be voluntarily held, in any equilibrium (defined below) i will also have to be the rate of return on any *other* (privately issued) riskless nominal asset that may be traded; hence monetary policy determines “the” riskless nominal interest rate.

There is, however, an important constraint on the central bank’s ability to freely choose the value of i , under typical institutional arrangements. This is that it is not possible to choose a value of i less than zero, if people are also free to hold currency that offers a riskless nominal return of zero. In practice, currency (which for practical reasons earns a return of zero) typically coexists with reserve balances at the central bank (which instead pay interest), because of certain special uses for currency (not modeled in this paper); but the fact that holders of reserves always have the right to convert them into currency at a fixed parity (one dollar of reserves = one dollar of currency) prevents the central bank from driving the riskless rate below zero by paying a negative interest rate on reserves.¹¹

In our model, there are no special uses of currency, and so currency will not be held in the case that the interest on reserves is positive. We may nonetheless suppose that the central-bank liabilities on which the interest rate i is paid represent reserves held at the central bank, and that holders have the right to demand zero-interest

¹⁰In practice, central banks choose the interest rate paid on reserves as a policy variable, but the equilibrium riskless nominal rate of interest is not this rate, but one that differs from it because of the liquidity premium earned by reserves owing to their role in the payments system; and central banks influence the riskless rate *both* by varying the interest rate paid on reserves and the supply of reserves (which influences the liquidity premium by affecting the scarcity of reserves), as discussed in Woodford (2003, chap. 1). Here we simplify by abstracting from the existence of a liquidity premium, as in the “cashless economy” of Woodford (2003, chap. 2). The analysis here is also applicable to the case of an economy in which the supply of reserves is maintained at all times at such a high level as to satiate the economy in reserves, allowing direct control of the riskless rate by variations in the rate of interest paid on reserves, as in the “floor system” for the implementation of monetary policy used by the Norges Bank (the central bank of Norway) over the past decade (Bowman *et al.*, 2010).

¹¹In fact, the existence of small positive holding costs for currency mean that a slightly negative interest rate on reserves is possible; but this does not change the fact that the existence of currency puts a floor on the central bank’s interest-rate target. For simplicity, we abstract from holding costs of currency here, and treat the lower bound as exactly zero.

currency in exchange for them, should they wish. Then, even though currency will not be issued or held in any of our equilibria corresponding to policies $i > 0$, the *possibility* of requesting currency matters, because it implies that the central bank cannot choose a value of i less than zero. Setting $i < 0$ on reserves would simply make currency the relevant central-bank liability — the one referred to as “money” in our discussions below — rather than reserves. We accordingly simply assume that a single kind of “money” is issued by the central bank, but that the nominal interest rate paid on it must satisfy the constraint $i \geq 0$.

Monetary policy also specifies the redemption value of money in each state s in period 1. (Such redemption is necessary, in our finite-horizon model, since there is no motive for anyone to wish to hold money in the terminal period.¹²) Each unit of money is redeemed for a specified (positive) number of units of good 1 in state s ; then for each state s , the price p_{s1} of good 1 in units of money is fixed by monetary policy. One can think of this as a sort of “commodity money” scheme in period 1; but it is intended to represent the fact that in an actual economy (with no terminal period), the value of money each period is determined by monetary policy (in that period and later), even under a pure fiat system.¹³ The revenues required to redeem the money supply are raised through lump-sum taxation. The share of taxes raised from each household h is $\theta^h \geq 0$, assumed to be the same for each state s , where $\sum_h \theta^h = 1$. Hence the tax obligation of household h in state s is $\theta^h m(1 + i)$ in units of money.

1.2 Private Borrowing with Endogenous Collateral Requirements

We also allow for trading in privately issued financial claims; but contrary to what is assumed in the Arrow-Debreu [A-D] model or in standard models of general equilib-

¹²The assumption that the government is committed to redeem money in the terminal period will perhaps seem less surprising if it is recalled that “the money supply” actually refers to the outstanding nominal liabilities of the government.

¹³See Woodford (2003, chap. 2) for illustration of how the price level (or exchange value of money) can be determined in each of an infinite sequence of periods purely by interest-rate policy in each of the sequence of periods. In the present model, the price level in period 1 cannot be determined by interest-rate policy in period 1, as there is no interest rate in a terminal period.

rium with incomplete asset markets [GEI],¹⁴ we do not assume that households can issue arbitrary quantities of financial claims as long as they are able to deliver the promised amount in each possible state of the world. Instead, we assume that borrowing must be collateralized, as in the models of Geanakoplos (1997) and Araújo *et al.* (2002), though the collateral requirements are determined endogenously (by what people will pay for private financial claims that are collateralized to a greater or lesser extent), rather than specified exogenously (for example, by law or social custom). We first introduce the notation that we use to describe collateralized borrowing, and then discuss what it means for the collateral requirements to be endogenously determined.

We assume that any privately issued financial claim specifies a quantity of money that must be repaid (independently of the state s) in order to extinguish the debt, and also a quantity of the durable good that must be held by the borrower (i.e., issuer of the claim) as collateral for the debt, and that can be seized by the lender (i.e., holder of the claim) in the event of default (i.e., non-payment of the specified amount of money). We also assume that the claim gives the holder no rights to assets of the issuer *except* the right to seize the assets pledged as collateral for the loan in the event of default; and it gives the issuer the right to discharge the claim (preventing seizure of the collateral) by paying the specified amount of money. Different types of private financial claims may simultaneously be traded, that are collateralized to different extents; thus there may be both “prime” and “subprime” loans collateralized by housing, where in our model the difference relates to the value of the collateral relative to the size of the loan, and not to any personal characteristics of the borrowers. But we assume a competitive equilibrium in which arbitrary quantities of a given type of financial claim can be purchased at a given per-unit price; hence we may without loss of generality normalize each of the types of private financial claims so that “one unit” of the claim promises delivery of one unit of money at maturity.

Thus we assume trading in a variety of types of privately issued financial claims $j \in \mathcal{J}$. Each asset j promises delivery of one unit of money in period 1, regardless of the state s . The collateral requirement for asset j is denoted $C_j \geq 0$; any issuer must hold C_j units of the durable in period 0 per unit sold of asset j . Given the possibility of default, the actual payoff of asset j in state s is $\min(1, p_{s3}C_j)$ in units of money, where p_{s3} is the price of the durable (in units of money) in state s of period 1. We let q_j denote the price (in units of money) at which assets of type j trade in period 0.

¹⁴See Geanakoplos and Zame (2013) for discussion of these alternative model structures.

Thus far, we have supposed that the set of assets that may be issued and the collateral requirement associated with each of them is given; but in fact, these can be endogenously determined. As first proposed by Geanakoplos (1997) and developed more thoroughly by Geanakoplos and Zame (2013), we may actually suppose that competitive markets exist in which *all* possible collateralized financial claims are traded, though the equilibrium quantities issued of most of these securities will be zero. (The “market-determined” collateral requirements will then simply be those values of collateral for which the existence of such a market is not redundant.)

In the present example, the set of possible private financial claims corresponds to different possible values of C_j . Moreover, one can show that it suffices to assume trading in a particular finite set of assets, $j = 1, \dots, S$, such that

$$C_j = 1/p_{j3} \tag{1.1}$$

for each j ; that is, asset j is a claim with a collateral requirement such that if state j is realized in period 1, the value of the collateral will exactly equal the face value of the debt. In the case of any equilibrium for an economy with a set of private financial claims that includes the S types (1.1), but possibly other types as well, there necessarily exists a corresponding equilibrium for an economy with only the S markets (1.1) open, in which the prices of all goods and assets traded in the restricted economy are the same as in the original equilibrium, and the consumption allocation is also the same. (See Proposition 1 of Araújo *et al.*, 2012.¹⁵)

Because of this result, we do not reduce the set of equilibria by assuming that only (at most) the set of S assets defined above are traded.¹⁶ From now on, we assume that $\mathcal{J} = \{1, \dots, S\}$ and $C_s = 1/p_{s3}$ for each j . These are our endogenously determined collateral requirements, as in Araújo *et al.* (2012).

¹⁵The model and definition of equilibrium with collateral constraints in Araújo *et al.* (2012) is somewhat different than here, because of the absence of money, monetary policy, or a central bank in that paper. But the demonstration in the earlier paper that the S assets of the form (1.1) suffice applies directly to the present extension of the model as well.

¹⁶In fact, asset 1 is also redundant, as shown in Lemma 1 below. We nonetheless retain a market for asset 1 in our notation for the general case, in order to preserve a simple association between the number of the asset and the state in which the value of the collateral just suffices to allow repayment in full of the debt.

1.3 Equilibrium

Let p_1, p_2, p_3 denote the prices (in units of money) of the non-durable, the service flow from the durable, and the durable good respectively in period 0, and similarly let p_{s1}, p_{s2}, p_{s3} be the prices of the same three goods in state s in period 1. In fact, we necessarily have $p_{s3} = p_{s2}$ in each state s (as there is no reason to acquire the durable in period 1 other than to enjoy the period 1 service flow). We then have $2S + 3$ goods prices to determine (where we omit the redundant prices $\{p_{s3}\}$ from the price vector), along with the S privately-issued financial asset prices. Each household h chooses a consumption plan x^h and a portfolio described by a vector $\psi^h \in \mathbb{R}_+^S$ of asset purchases (lending), a vector $\varphi^h \in \mathbb{R}_+^S$ of asset issuance (borrowing), a quantity $\mu^h \geq 0$ of post-trade period 0 money balances, and a quantity $x_3^h \geq 0$ of post-trade holdings of the durable good. Note that we must separately specify financial asset purchases and issuances (rather than simply net trades, as in a GEI model), because of the need to satisfy the collateral requirements, that are increased by issuance of financial claims but not reduced by purchases of such claims. These are the prices and quantities that we seek to determine.

Given prices and financial conditions described by $p \in \mathbb{R}_{++}^{2S+3}$, $q \in \mathbb{R}_+^S$, $C \in \mathbb{R}_+^S$, and $i \geq 0$, household h chooses a consumption plan and portfolio $(x^h, \psi^h, \varphi^h, \mu^h, x_3^h)$ that solve the problem

$$\begin{aligned}
 & \max_{x^h \geq 0, \psi^h \geq 0, \varphi^h \geq 0, \mu^h \geq 0, x_3^h \geq 0} u^h(x^h) \quad \text{s.t.} \\
 & p_1(x_1^h - e_1^h) + p_2(x_2^h - x_3^h) + p_3(x_3^h - e_3^h) + q \cdot (\psi^h - \varphi^h) + \mu^h - m^h \leq 0, \\
 & p_{s1}(x_{s1}^h - e_{s1}^h) + p_{s2}(x_{s2}^h - x_3^h) - \sum_{j=1}^S (\psi_j^h - \varphi_j^h) \min\{1, p_{s2}C_j\} \\
 & \quad + (1+i)(\theta^h m - \mu^h) \leq 0, \quad \forall s \in \mathcal{S} \\
 & x_3^h - \sum_{j=1}^S \varphi_j^h C_j \geq 0.
 \end{aligned} \tag{1.2}$$

A competitive equilibrium is then defined as usual as a situation in which each household's plan is optimal and markets clear. Our concept of competitive equilibrium with endogenous collateral constraints involves the additional requirement that the set of

privately issued assets include all non-redundant financial assets of the kind discussed above.

Definition 1 *Let an economy \mathcal{E} be defined by preferences and endowments $(u^h(\cdot), e_1^h, e_3^h, \{e_{s1}^h\}_{s \in \mathcal{S}})$ for each $h \in \mathcal{H}$ and a monetary policy specification $(i, \{p_{s1}\}_{s \in \mathcal{S}})$. Then an equilibrium for the economy \mathcal{E} is a vector $[(\bar{x}, \bar{\psi}, \bar{\varphi}, \bar{\mu}, \bar{x}_3); (\bar{p}, \bar{q}); \bar{C}]$ consistent with the monetary policy specification, such that in addition*

- (i) *for each $h \in \mathcal{H}$, $(\bar{x}^h, \bar{\psi}^h, \bar{\varphi}^h, \bar{\mu}^h, \bar{x}_3^h)$ solves problem (1.2), given prices (\bar{p}, \bar{q}) , the interest rate i , and collateral requirements \bar{C} ;*
- (ii) $\sum_{h=1}^H \bar{x}_1^h = \sum_{h=1}^H e_1^h$;
- (iii) $\sum_{h=1}^H \bar{x}_2^h = \sum_{h=1}^H e_3^h$;
- (iv) $\sum_{h=1}^H \bar{x}_3^h = \sum_{h=1}^H e_3^h$;
- (v) $\sum_{h=1}^H \bar{x}_{s1}^h = \sum_{h=1}^H e_{s1}^h$ for each $s \in \mathcal{S}$;
- (vi) $\sum_{h=1}^H \bar{x}_{s2}^h = \sum_{h=1}^H e_3^h$ for each $s \in \mathcal{S}$;
- (vii) $\sum_{h=1}^H (\bar{\psi}^h - \bar{\varphi}^h) = 0$;
- (viii) $\sum_{h=1}^H \bar{\mu}^h = m$; and
- (ix) $\bar{C}_s = 1/p_{s2}$ for each $s \in \mathcal{S}$.

Here condition (ix) reflects the endogenous determination of the collateral requirements (1.1).

A useful general observation about equilibrium in this model is the following.

Lemma 1 *Consider any equilibrium of any economy \mathcal{E} . Then either the market for asset 1 (private debt contracts which are so poorly collateralized that they default in all states but the one in which the durable good has its highest value) is inactive, in the sense that zero units of this security are issued in equilibrium; or it is inessential, in the sense that the same allocation of resources and same prices for all goods and assets could also be obtained as an equilibrium if the market were closed (i.e., if all households were subject to the additional constraint that they must choose $\psi_1^h = \varphi_1^h = 0$).*

Proof. The state-contingent payoffs on a unit of asset 1 are equivalent to those on C_1 units of the durable good (after the period 0 service flow). A household will therefore be unwilling to purchase any units of asset 1 at any price higher than $(p_3 - p_2)C_1$, since C_1 units of the durable could be purchased at that price, yielding the same period 1 state-contingent return *and* relaxing the household's collateral constraint as well. Moreover, no household will be willing to purchase any units when $q_1 = (p_3 - p_2)C_1$ exactly, either, except if the household's collateral constraint does not bind.

On the other hand, an issuer must hold C_1 units of the durable in order to issue a unit of asset 1, and surrenders the durable in all states in period 1. (Technically, there need be no default in state 1, the state in which the durable is most valuable; but the issuer must pay the holder of the security an amount that is as costly as surrender of the durable in that state as well.) Hence the issuer obtains no income in any state in period 1 from the transaction, and so will not be willing to issue the security at any price less than $(p_3 - p_2)C_1$, the cost of the collateral that will then have to be surrendered.

It follows that asset 1 cannot be issued and held, in equilibrium, unless $q_1 = (p_3 - p_2)C_1$, *and* the households that hold asset 1 would obtain no value from a relaxation of their collateral constraints. But then the same equilibrium (same allocation \bar{x} and same prices (\bar{p}, \bar{q})) can be obtained if the market for asset 1 is closed: the issuers of asset 1 could simply sell the collateral (after collecting the period 0 rental income from it) to the buyers instead, rather than using the collateral to back issuance of asset 1. The issuers should be indifferent between this plan and issuance of asset 1, since they must surrender the durable in all states in period 1 anyway, and since they would obtain the same sale price in period 0. The buyers should be indifferent as well, as they obtain an asset with the same state-contingent returns in period 1, pay the same price in period 0, and do not care about the fact that acquiring the durable relaxes their collateral constraints. Hence if an equilibrium exists in which asset 1 is issued, the existence of this market is inessential. \square

The model is one that allows, in general, for the coexistence of multiple types of privately issued debt that default with different probabilities (and hence promise different rates of interest, conditional upon repayment, as well). But Lemma 1 shows that *more than two* states in period 1 are necessary in order for default to occur in equilibrium, at least on securities the existence of which matters for the character of

equilibrium.¹⁷

Another useful general result concerns the market for riskless (fully collateralized) private debt securities (asset S).

Lemma 2 *There exists no equilibrium in which $\bar{q}_S < 1/(1+i)$. Moreover, if in equilibrium, some household h holds a quantity of collateral x_3^h that exceeds the quantity required to satisfy the household's collateral constraint, then $\bar{q}_S = 1/(1+i)$. Finally, if in equilibrium, $\bar{q}_S > 1/(1+i)$, no units of asset S are issued in equilibrium, and the market is inessential, in the sense that the same equilibrium could be obtained if the market were to be closed.*

Proof. The period-1 return on one unit of asset S and on $1/(1+i)$ units of money are identical: in either case, the holder obtains one unit of money in period 1, in every possible state s . (Recall that $C_S = 1/p_{2S} \geq 1/p_{2s} \forall s \in \mathcal{S}$. Thus private borrowing under a contract of type S is sufficiently collateralized to be perfectly safe.) Since a positive quantity of money earning the interest rate i must be held in equilibrium, it is necessary that $q_S \geq 1/(1+i)$; otherwise, money would not be held. But if $q_S > 1/(1+i)$, no household will choose to hold asset S , since money is a perfect substitute available more cheaply; hence this would have to be an equilibrium with no issuance of asset S , and one in which the market for asset S is inessential.

One can also show that no equilibrium of the latter sort is possible if at least one household type has excess collateral. For suppose that $q_S > 1/(1+i)$. Then any household can obtain an arbitrage profit, relaxing its budget constraint in period 0, by increasing μ^h by a quantity $\epsilon > 0$ and issuing $(1+i)\epsilon$ units of asset S . (This would result in no change in its period 1 budget in any state of the world, but increase the amount that it can spend on either non-durable consumption or rental of durable goods in period 0, given that the proceeds of issuance of the riskless debt would exceed the addition to its money balances.) Each household must, under an optimal plan, exploit this opportunity to the greatest extent allowed by the collateral constraint. If there exists any household with a collateral constraint that remains slack, no such opportunity must exist, and hence $q_S = 1/(1+i)$ exactly. \square

¹⁷We nonetheless find it convenient to study mainly examples with only two states below. This means that the occurrence of default in equilibrium is not essential for the type of financial frictions with which we are concerned. In the equilibria that we study, the *possibility* of default can lead to distortions of the equilibrium allocation of resources, even though in most of our examples no default actually occurs.

The significance of this result is to show that if riskless private debt exists, it must promise the nominal interest rate i set by monetary policy. Hence our model is one in which the central bank has effective control of the riskless (one-period) nominal interest rate, subject to the constraint that it must choose a value $i \geq 0$.

1.4 A Neutrality Result for Conventional Monetary Policy

We first consider the effects of “conventional” monetary policy, by which we mean changes in the nominal interest-rate target i , while assuming (for now) that the central bank holds no assets other than riskless nominal government debt (one-period bills) on its balance sheet. We can obtain a simpler characterization of the effects of such policy if we generalize the model just set out to allow for possible (positive or negative) lump-sum transfers of additional money to households in period 0, which additional money is redeemed in period 1 as described above.

Let τ^h be an additional lump-sum net transfer (in units of money) to household h in period 0, where we assume that $\tau^h > -m^h \forall h$, so that each household continues to have a positive endowment of money after the transfers. The household’s budget constraints continue to be as written above, except that the endowment m^h must be replaced by the post-transfer endowment $\tilde{m}^h \equiv m^h + \tau^h$, and the aggregate money supply m (that is redeemed in period 1) must be replaced by $\tilde{m} \equiv \sum_h \tilde{m}^h$. The definition of equilibrium remains as in Definition 1, except that m must be replaced by \tilde{m} in condition (viii). We can then show the following about a certain kind of combined monetary and fiscal policy.

Proposition 1 *Consider an economy \mathcal{E} (which includes a specification of the initial money endowments $\{m^h\}_{h \in \mathcal{H}}$), and let period-1 monetary policy commitments $\{p_{s1}\}_{s \in \mathcal{S}}$ be fixed, but consider alternative interest-rate policies $i \geq 0$. Suppose that for any interest-rate policy, the period-0 fiscal transfers are given by*

$$\tau^h = \frac{i^* - i}{1 + i} m^h \quad \forall h \in \mathcal{H} \quad (1.3)$$

for some parameter $i^* > -1$. Then in the flexible-price model, variations in interest-rate policy have no effect on the equilibrium allocation of resources \bar{x} , on any relative prices $(p_2/p_1, p_3/p_1, p_{s2}/p_{s1}, q_j/p_1)$, or on any real rates of return $((1 + i)p_1/p_{s1}, p_{s3}/(p_3 - p_2) \cdot p_1/p_{s1}, \min\{1, p_{s2}C_j\} \cdot p_1/q_j p_{s1})$. That is, if there is an equilibrium

associated with a given value of i , then for any other value of the interest rate (leaving unchanged the $\{p_{s1}\}$ and all other aspects of the specification of the economy, but changing the fiscal transfers in accordance with (1.3)), there exists a corresponding equilibrium, in which the allocation, relative prices, and real rates of return are the same, as are all period 1 prices, while period 0 prices vary inversely with $1 + i$.

Proof. One observes that the household problem (1.2) can be written entirely in terms of choice variables $x^h, x_3^h, \psi^h, \varphi^h$, and real money balances μ^h/p_1 ; endowments e_1^h, e_3^h, e_{s1}^h , and the real money endowment \tilde{m}^h/p_1 ; the collateral requirements $\{C_j\}$; period 0 relative prices $p_2/p_1, p_3/p_1, q/p_1$; period 1 prices; and the quantity $(1 + i)p_1$, but not p_1 or i individually. The requirements for equilibrium can also be written entirely in terms of these variables.

Consider now any equilibrium associated with a given value of i and a given set of fiscal transfers. Associated with this equilibrium are particular values for each of the variables listed in the previous paragraph. If now i is varied (to some other non-negative value), these same values for each of those variables will continue to constitute an equilibrium, if the unchanged value of \tilde{m}^h/p_1 continues to be consistent with households' post-transfer money endowments, despite the implied change in p_1 . If fiscal transfers are zero, so that $\tilde{m}^h = m^h$, this will not be true (given that m^h is not zero for all households), for constancy of $(1 + i)p_1$ would require p_1 to vary inversely with $(1 + i)$; but if p_1 changes, m^h/p_1 will not be invariant (for any h with $m^h > 0$). But if fiscal transfers are given by (1.3), then

$$\frac{\tilde{m}^h}{p_1} = \frac{(1 + i^*)m^h}{(1 + i)p_1}.$$

The numerator of this quantity is unchanged by the change in policy, and the denominator will be unchanged if $(1 + i)p_1$ does not change.

Hence an equilibrium exists for arbitrary $i \geq 0$ with the properties stated in the proposition. Because p_1 varies inversely with $1 + i$, and the relative prices $p_2/p_1, p_3/p_1, q_j/p_1$ are invariant, all period 0 prices must vary inversely with $1 + i$. \square

Technically, this proposition does not show that interest-rate policy alone can influence the general level of prices in period 0 (though that is easy to establish), since the policy assumed in the proposition is a combination of monetary and fiscal policy. However, the size of the fiscal transfers required to achieve the exact result are only

proportional to the initial money endowments. If we consider the case of a “cashless limiting economy,” by letting $m^h \rightarrow 0$ for all h , while holding fixed the specification of all other aspects of preferences and endowments, then the fiscal transfers that are required in order to obtain the result of Proposition 1 with regard to the effects of interest-rate policy converge to zero as well, while the predicted effects of a change in i on the other variables all converge to well-defined limiting values.

Hence in such a cashless limit, it is easy to see that interest-rate policy can determine the general level of prices in period 0, and indeed that any price level below a certain upper bound (the one achieved by the “loosest” possible policy, $i = 0$) is achievable by an appropriate choice of interest-rate policy, even in the absence of fiscal transfers. Moreover, interest-rate policy has an effect on prices of the conventional sign: a “tightening” of current policy (raising i) is disinflationary (lowers the period 0 prices of all goods).

But the simple case also shows that conventional monetary policy need not be able to affect any real quantities or relative prices. In a cashless limiting economy (with flexible prices, as here), interest-rate policy will have no effect on real quantities, and by continuity, the effects continue to be small as long as money endowments are small enough. Even when money endowments are non-negligible, Proposition 1 can be viewed as showing that any real effects of interest-rate policy in our flexible-price model are due only to a failure to offset the *fiscal* effects of a change in interest-rate policy on the period-1 value of households’ money endowments. Once these fiscal effects are neutralized, through the transfers specified in (1.3), interest-rate policy has no real effects.¹⁸

2 Collateral Constraints and the Effects of Unconventional Policy

We now consider additional (“unconventional”) dimensions of policy, by allowing the central bank to purchase assets other than government debt with a riskless one-period nominal return, financing such purchases either by issuing riskless nominal liabilities

¹⁸Note, however, that even in the cashless limit, interest-rate policy will have real effects in the case of price stickiness. The implications of collateral constraints for the real effects of both conventional and unconventional monetary policies in a sticky-price model will be pursued in future work.

of its own, or by selling other assets held on its balance sheet. Purchases of riskless one-period nominal government debt, financed by issuing equivalent liabilities of the central bank itself, will obviously have no effect on equilibrium, since the supply of “outside money” will not change. But what if the central bank purchases a risky asset, namely the durable good, and finances the purchases by increasing the supply of “money” — either by issuing additional riskless central-bank liabilities, or selling riskless government debt that had previously been held by the central bank? Can such transactions by the central bank change the equilibrium prices of financial assets, and as a consequence influence macroeconomic equilibrium more generally? And if so, are the effects similar to or different from the effects of interest-rate policy?

Suppose that the central bank can hold durables on its balance sheet at the end of period 0, in addition to its holdings of riskless nominal government debt.¹⁹ We let x_3^{CB} denote the central bank’s holdings of the durable, and treat this as an additional policy variable. We assume that the central bank has no use for the service flow from the durable, and therefore rents the durables that it holds, while owning the asset.

When we compare equilibria associated with alternative quantities of durables purchases by the central bank, we must also take account of the implications for the supply of “outside money” (riskless nominal assets in the hands of the public, other than those supplied by private issuers). We suppose, as in the previous section, that households come into period 0 with endowments $\{m^h\}$ of money, and that the initial endowments of the durables are entirely in the hands of households (so that $e_3 \equiv \sum_h e_3^h$ is the total supply of durables). The central bank’s holdings x_3^{CB} of the durable therefore represent purchases during period 0, resulting in a total money supply of

$$M = m + (p_3 - p_2)x_3^{CB}. \quad (2.1)$$

Note that $p_3 - p_2$ is the part of the purchase price of a durable that the central bank must finance other than out of the rental income received in period 0 from the

¹⁹In practice, central banks are more likely to hold securities that represent claims to income flows linked to real estate, rather than directly owning real estate. Nonetheless, it is the nature of the risk to which the assets acquired by the central bank are exposed that matters for the analysis here, and not whether the asset is real property or a financial claim. Also, in our model, the durable good is the only acceptable form of collateral for private borrowing, and central banks certainly do acquire risky assets, such as longer-term Treasury bonds, that are commonly used as collateral in financial transactions.

asset. And the quantity of money in the hands of the public increases by this amount whether the shortfall is financed by creating new central-bank liabilities or by selling riskless government debt previously held on the central bank's balance sheet.

The outside money supply defined in (2.1) must again be redeemed in period 1, but there are now assets of the central bank (other than liabilities of the government) that can be used to redeem part of it. In general, though, the value of the additional assets will not exactly cancel the increased value of the money that must be redeemed. In other words, there are fiscal consequences of the central bank's balance-sheet gains and losses, given that its assets and liabilities no longer have equal state-contingent returns in general. Any trading profits of the central bank are assumed to be distributed lump-sum to households in period 1, and any losses are correspondingly assumed to be made up by lump-sum taxation of the households; these net lump-sum transfers are assumed to be distributed across households in the same proportions $\{\theta^h\}$ as other taxes and transfers. The net lump-sum tax obligation of household h in period 1 is therefore now equal to $\theta^h[(1+i)M - p_{s2}x_3^{CB}]$ in state s , where M is defined in (2.1).

Since feasible purchases of durables by the central bank must satisfy the bound $0 \leq x^{CB} \leq e_3$, it is useful to parameterize this dimension of policy by the fraction ω of the aggregate supply of durables purchased by the central bank. Thus we write $x_3^{CB} = \omega e_3$, where the policy parameter ω is constrained to lie in the range $0 \leq \omega \leq 1$.²⁰ In terms of this notation, the problem of household h is now to maximize $u^h(x^h)$ subject to the same constraints as in (1.2), except that the budget constraint in period 1, state s , now takes the form

$$p_{s1}(x_{s1}^h - e_{s1}^h) + p_{s2}(x_{s2}^h - x_3^h) - \sum_{j=1}^S (\psi_j^h - \varphi_j^h) \min\{1, p_{s2}C_j\} + \theta^h[(1+i)(m + (p_3 - p_2)\omega e_3) - p_{s2}\omega e_3] - (1+i)\mu^h \leq 0. \quad (2.2)$$

An equilibrium is again defined as in Definition 1, except that now the policy parameter ω is part of the specification of the economy \mathcal{E} ; condition (iv) must now be written

$$\sum_{h=1}^H \bar{x}_3^h = (1 - \omega)e_3; \quad (2.3)$$

²⁰In fact, we shall only consider policies $\omega < 1$, so that a private market for the durable continues to exist.

and condition (viii) must now be written

$$\sum_{h=1}^H \bar{\mu}^h = m + (p_3 - p_2)\omega e_3. \quad (2.4)$$

With this generalized definition of equilibrium (but again allowing initial money endowments to be modified through lump-sum transfers in period 0), Proposition 1 will continue to hold;²¹ interest-rate policy will again have no real effects, except those due to the fiscal consequences of changes in the period 1 value of households' money endowments. But we now have an additional dimension of policy to consider, however, which is the effect of variations in ω .

2.1 Irrelevance of Central-Bank Asset Purchases when Collateral is Sufficient

A first important result is that there need not be any effects of central-bank asset purchases at all, on either real or nominal variables.

Proposition 2 *In a flexible-price model with central-bank asset purchases of quantity $0 \leq \bar{\omega} < 1$, suppose there is an equilibrium in which each household h holds a quantity of collateral x_3^h that exceeds the quantity required to satisfy the household's collateral constraint. Then for any ω satisfying $\bar{\omega} < \omega < 1$ and*

$$(\omega - \bar{\omega})e_3 \leq \min_h \frac{x_3^h - \sum_j \varphi_j^h C_j}{\theta^h}, \quad (2.5)$$

additional central-bank purchases that increase the central bank's share of durables to ω result in an equilibrium in which all prices are unchanged (both goods prices and asset prices), and the consumption allocation $\{x^h\}_{h \in \mathcal{H}}$ is similarly unchanged.

Proof. Consider any value of ω satisfying (2.5). (Note that the assumption that each household holds excess collateral implies that there is an open interval of such values.²²) Suppose that prices continue to be given by (\bar{p}, \bar{q}) , and that the collateral requirements continue to be given by \bar{C} .

²¹The same proof as above goes through, requiring only minor modifications.

²²Here we rely on the assumption of only a finite number of household types. In the case of an infinite number of household types, it would be necessary to strengthen the hypothesis of the proposition to require the existence of a positive lower bound for the right-hand-side of (2.5).

Then for each household h , it is possible to achieve the same consumption plan \bar{x}^h as before, with a portfolio plan that is the same as before, except that now

$$x_3^h = \bar{x}_3^h - \theta^h(\omega - \bar{\omega})e_3 \quad (2.6)$$

and

$$\mu^h = \bar{\mu}^h + (\bar{p}_3 - \bar{p}_2)\theta^h(\omega - \bar{\omega})e_3. \quad (2.7)$$

Condition (2.5) guarantees that the right-hand side of (2.6) is non-negative, while the assumption that $\omega > \bar{\omega}$ guarantees that the right-hand side of (2.7) is non-negative as well; thus these stipulations remain consistent with the non-negativity constraints on the household's portfolio. Substitution of the proposed consumption and portfolio plan into the budget constraints verifies that each is still satisfied. And finally, condition (2.5) guarantees that the household's collateral constraint continues to be satisfied. Hence the proposed plan is feasible for each household h .

One can further show that the proposed plan is not only feasible for household h , but optimal. This requires that we show that no consumption plan preferable to \bar{x}^h is attainable. Consider any consumption plan \tilde{x}^h such that $u^h(\tilde{x}^h) > u^h(\bar{x}^h)$. It follows that for any convex combination

$$\hat{x}^h \equiv (1 - \lambda)\bar{x}^h + \lambda\tilde{x}^h,$$

where $0 < \lambda < 1$, \hat{x}^h will also be strictly preferred to \bar{x}^h , given the quasi-concavity of preferences.

Now suppose that consumption plan \tilde{x}^h is attainable, that is, that there exists a plan $(\tilde{x}^h, \tilde{\psi}^h, \tilde{\varphi}^h, \tilde{\mu}^h, \tilde{x}_3^h)$ that is consistent with all of the household's constraints in the case of policy ω . But then a plan identical to this, except with

$$x_3^h = \tilde{x}_3^h + \theta^h(\omega - \bar{\omega})e_3,$$

$$\bar{q}_S \varphi_S^h = \bar{q}_S \tilde{\varphi}_S^h + (\bar{p}_3 - \bar{p}_2)\theta^h(\omega - \bar{\omega})e_3,$$

would satisfy the household's budget constraints in both period 0 and period 1, under the original policy $\bar{\omega}$. (Here we use Lemma 2 to show that the period 1 budget constraint is satisfied in each state.) Given that $\omega > \bar{\omega}$, this plan obviously satisfies all non-negativity constraints as well.

Moreover, because of the convexity of the constraint set, any convex combination of the optimal plan under policy $\bar{\omega}$ and this plan will also satisfy the household's budget constraints in both periods, and will satisfy all non-negativity constraints. And

since the collateral constraint is (by hypothesis) a strict inequality under the optimal plan, there exists some sufficiently small $\lambda > 0$ for which the convex combination of the plans will also satisfy the collateral constraint. Hence the convex combination plan satisfies all of the household's constraints, under the original policy $\bar{\omega}$.

This would imply that the convex combination consumption plan \hat{x}^h is attainable under the policy $\bar{\omega}$. But since \hat{x}^h is strictly preferable to \bar{x}^h , this contradicts the assumption that the household's behavior in the equilibrium associated with policy $\bar{\omega}$ is optimal. Hence we may conclude that the plan described by (2.6)–(2.7) is optimal, under the unchanged prices (\bar{p}, \bar{q}) and collateral requirements \bar{C} .

One can further show that this collection of plans for the households implies market clearing. Note that (2.6) and (2.7) imply that

$$\sum_h x_3^h = \sum_h \bar{x}_3^h - (\omega - \bar{\omega})e_3 = (1 - \omega)e_3,$$

$$\sum_h \mu^h = \sum_h \bar{\mu}^h + (\bar{p}_3 - \bar{p}_2)(\omega - \bar{\omega})e_3 = m + (\bar{p}_3 - \bar{p}_2)\omega e_3,$$

so that conditions (2.3) and (2.4) are satisfied. The other market-clearing conditions are unchanged by the change in ω . Finally, condition (ix) of Definition 1 continues to be satisfied, since neither the prices nor the collateral requirements have changed. Hence all requirements for equilibrium are satisfied. \square

Thus in this case, we obtain an irrelevance result for central-bank asset purchases in the spirit of Wallace (1981), though we do not assume A-D financial markets, as Wallace does.²³ It is also worth pointing out that while Wallace's result appears to prove too much — his baseline model is one in which the central bank is *also* unable to influence short-term nominal interest rates,²⁴ something that is obviously not true

²³It might be thought that the result requires an assumption about the sufficiency of collateral that implies that the equilibrium of our model is equivalent to an A-D equilibrium, but this is not quite correct. It is possible, at least in non-generic cases, that the set of assets allowed for in our model will not span all states of the world; yet Proposition 2 remains true in this case as well. In fact, the form of proof given above can be used to establish irrelevance of central-bank purchases in a GEI model, without any need for the assumption about the quantity of collateral held by households.

²⁴This is because his model assumes a zero nominal interest rate on money, and so (in the absence of financial frictions) concludes that the equilibrium interest rate on riskless nominal claims must be zero, regardless of monetary policy. In fact, a similar irrelevance result for open-market asset purchases can be obtained in general-equilibrium monetary models in which money is assumed to

in actual economies — our model is one in which the central bank *can* control the short-term nominal interest rate (subject to the zero lower bound), including under the assumptions of Proposition 2; but it does not follow that open-market purchases of risky assets will necessarily have any effect on financial conditions.

Proposition 2 demonstrates the fallacy in a common way of discussing the effects of asset purchases. Central banks often appeal, in their explanations of the effects that they expect their asset-purchase programs to have, to a theory of “portfolio balance effects”: if the central bank holds less of certain assets and more of others, then the private sector is forced (as a requirement for equilibrium) to hold more of the former and less of the latter, and (according to this theory) a change in the relative prices of the assets should be required to induce the private parties to change the portfolios that they prefer. In order for such an effect to exist, it is thought to suffice that private parties not be perfectly indifferent between the two types of assets, owing to differences in their pattern of state-contingent payoffs.²⁵

But Proposition 2 shows that this is not the case. The flaw in the “portfolio-balance” theory is a simple one. The theory assumes that if the private sector is forced to hold a portfolio that includes more exposure to a particular risk — say, a low return in the event of a real-estate crash — then private investors’ willingness to hold that particular risk will be reduced: investors will anticipate a higher marginal utility of income in the state in which the real-estate crash occurs, and so will pay less than before for securities that have especially low returns in that state. But the fact that the central bank takes the real-estate risk onto its own balance sheet,

pay a zero nominal interest rate, but a spread exists between the return on money and other riskless short-term assets, because of a special role for money in facilitating transactions. In such models, the irrelevance result applies to balance-sheet policies that do not alter the volume of monetary liabilities of the central bank, but only shift the composition of its assets (Cúrdia and Woodford, 2010), or to asset purchases when the supply of money is already sufficient to keep the short-term nominal interest rate at the zero lower bound (Eggertsson and Woodford, 2003). Cúrdia and Woodford highlight the importance of an absence of financial frictions, other than the transactions frictions that create a special role for money and possible incompleteness of the set of traded securities, for such a result. (This discussion is in section 1 of the working paper version of their paper, but is omitted from the published version.)

²⁵Thus Gagnon *et al.* (2010) discuss the theoretical basis for the Fed’s Large Scale Asset Purchase program by noting that “the LSAPs have removed a considerable amount of assets with high duration from the markets.... In addition, the purchases of MBS [mortgage-backed securities] reduce the amount of prepayment risk that investors have to hold in the aggregate.”

and allows the representative household to hold only securities that pay as much in the event of a crash as in other states, does not make the risk disappear from the economy. The central bank's earnings on its portfolio will be lower in the crash state as a result of the asset exchange, and this will mean lower earnings distributed to the Treasury, which will in turn mean that higher taxes will have to be collected by the government from the private sector in that state; so households' after-tax income will be just as dependent on the real-estate risk as before. This is why the asset pricing kernel does not change, in the case illustrated by Proposition 2, and why asset prices are unaffected by the open-market operation.

In fact, households that correctly understand the fiscal implications of the asset-purchase policy have a motive to change their own portfolios (assuming unchanged prices) in ways that *exactly offset* the transactions of the central bank. If household h bears fraction θ^h of the fiscal consequences, this creates a hedging motive for a portfolio shift that offsets exactly θ^h of the central bank's trades (selling fraction θ^h of the durables purchased by the central bank, and increasing its money holdings by fraction θ^h of the increase in the money supply); summing over all households, the central bank's transactions are exactly offset.

We can thus already give an answer to the question whether central-bank asset purchases have effects that are equivalent to those achieved by a cut in the short-term nominal interest rate in the case of conventional monetary policy. When Proposition 2 applies, the answer is obviously no. If the fiscal transfers hypothesized in Proposition 1 are also present (or a cashless limiting economy is considered), then neither policy would have any effect on *real quantities*; but interest-rate policy would still be able to influence the general price level (for example, to head off unwanted deflation, as long as it is not constrained by the zero lower bound), while asset purchases would have no effect on equilibrium prices or quantities. (Nor, in the case described by Proposition 2, is there any effect on financial market prices, while conventional monetary policy influences not just the riskless rate but the equilibrium interest rates on the various types of risky private debts as well.)

The validity of Proposition 2 depends, however, on the assumption that all households have more collateral than they need to satisfy their collateral constraints. The interest of the result therefore depends on this being a possibility. The following result indicates that such a situation can indeed occur.

Proposition 3 *Consider a flexible-price economy in which all households are identical, both as to their preferences and their endowments, and pay an equal share of taxes ($\theta^h = 1/H \forall h$) as well. Then for any specification of central-bank policy with $\omega < 1$, there is an equilibrium in which each household holds durables in excess of the quantity required to satisfy its collateral requirement.*

Proof. If all households have the same preferences and endowments, the household problem (1) is the same for each of them. Then because the household's budget set is convex and the common preferences are assumed to be strictly quasi-concave, there is a unique optimal consumption plan that solves this problem for any prices (p, q) and collateral requirements C , though the associated portfolio plan may be indeterminate. It follows that each household necessarily chooses the same consumption plan in equilibrium. Market clearing is then only possible if each household chooses to consume exactly its share of the aggregate endowment. Hence the equilibrium allocation of resources must be given by

$$\bar{x}_1^h = e_1^*, \quad \bar{x}_2^h = e_3^*, \quad \bar{x}_{s1}^h = e_{s1}^* \forall s, \quad \bar{x}_{s2}^h = e_3^* \forall s$$

for each $h \in \mathcal{H}$, where stars indicated the common endowments of each of the goods.

This plan can be seen to be consistent with the household's budget constraints if the household's portfolio plan satisfies

$$\begin{aligned} \bar{\mu}_3^h &= (1 - \omega)e_3^*, & \bar{\mu}^h &= m^* + (\bar{p}_3 - \bar{p}_2)\omega e_3^* = M/H, \\ \bar{\psi}_j^h &= \bar{\varphi}_j^h \geq 0 \forall j, & \sum_j &(\bar{\varphi}_j^h / \bar{p}_{j2}) \leq (1 - \omega)e_3^*. \end{aligned} \quad (2.8)$$

One possible way to satisfy all requirements of (2.8) is by choosing $\psi_j^h = \varphi_j^h = 0 \forall j$, though this is not the unique solution; thus these conditions can be satisfied. Moreover, any specification of portfolio plans for the households that satisfy the above conditions will satisfy all market-clearing conditions for assets.

It remains only to show that there exist prices under which it will be optimal for a household to choose the feasible plan described above. The prices required can then be determined from the household's marginal rates of substitution, evaluated at this consumption plan. They are in fact the prices associated with an A-D equilibrium. Since the consumption plan \bar{x}^h specified above is the optimal element of the A-D budget set defined by these prices, and the budget set in our model is a proper subset

of the A-D budget set, the plan (which is also feasible in our model) must be the optimal element of the budget set in our model as well. Hence we have described an equilibrium.

If the equilibrium is supported by a portfolio plan for each household h in which $\psi_j^h = \varphi_j^h = 0 \forall j$, then since $(1 - \omega)e_3^* > 0$, the collateral constraint is a strict inequality for each household. This establishes the existence of an equilibrium in which each household holds excess collateral. We can also have equilibria in which one or more households is both an issuer and a purchaser (in equal quantities) of private debt securities, to such an extent as to use all of its available collateral in issuing such securities. (There is no economic motive for a household to do so, but no penalty either, given that we abstract from transactions costs in our model.) But even in such a case, the collateral constraint could actually be tightened without requiring the household to change its consumption allocation, or to change its behavior in any way that interferes with market clearing. Thus even if the hypothesis of Proposition 2 would technically not be satisfied in such a case, the conclusion could still be established. \square

This result shows that it is possible to have an economy for which the hypothesis of Proposition 2 holds. Proposition 3 might seem to refer to an extremely special case, as it requires exact equality between the endowment patterns of the different households. But in fact the result that the collateral constraints do not bind in equilibrium for any household will continue to be true for any economy with an endowment pattern *close enough* to one satisfying the assumptions of Proposition 3: as long as the households have endowment patterns that are *similar enough*, there will be no need for them to choose *large* net positions in the financial assets, or for them to choose to hold *much* less than their proportional share of the aggregate supply of durables not held by the central bank, so that households will all continue to hold durables in excess of the quantity needed to satisfy their collateral requirement. Thus there will be an open set of endowment specifications satisfying the hypothesis of Proposition 2, though we omit a formal demonstration of this.

But while robust examples can be constructed to which the irrelevance result of Proposition 2 applies, it is equally possible to construct robust examples of economies in which central-bank asset purchases *do* affect financial conditions — and affect the equilibrium allocation of resources, not just prices, as we now explain.

2.2 A Special Case: Homothetic Preferences, Two States

The case in which collateral is insufficient, so that collateral constraints bind for at least some households, is more complex to analyze, and the effects of central-bank asset purchases depend on the precise way in which the constraints bind. In order to illustrate some of the different possible cases, and provide insight into the conditions under which they arise, it is useful to consider a special case of the model proposed above, in which the number of endogenous variables that must simultaneously be determined can be reduced to a minimum without trivializing the problem with which we are concerned.

We can simplify our analysis by restricting attention to the case of two equiprobable possible states ($s = 1, 2$) in period 1, and supposing further that the utility function of each household h is of the form

$$U^h = u(x_1^h, x_2^h) + \frac{1}{2}u(x_{11}^h, x_{12}^h) + \frac{1}{2}u(x_{21}^h, x_{22}^h)$$

where $u(x_1^h, x_2^h)$ is a *homothetic* function, in addition to being strictly increasing and strictly concave. Note that we assume identical preferences for all households, so that any differences in their asset demands (and any reasons for the irrelevance result of Proposition 2 not to obtain) must be linked to differences in endowment patterns. Similarly, the assumption of an identical period sub-utility function over time and across states means that any differential valuation of income across states or over time will have to result from non-uniform endowment patterns, rather than from preferences.²⁶

The assumption of identical, homothetic preferences has useful consequences. It implies that in any period, and any state of the world, each household chooses the same *relative* consumption x_1^h/x_2^h (given that all face the same relative price of the two consumption goods, p_2/p_1), and thus is determined purely by p_2/p_1 , regardless of the intertemporal allocation of expenditure that is chosen. The relative consumption of any household is given by $x_1^h/x_2^h = r(p_2/p_1)$, where $r(p_2/p_1)$ is implicitly defined by

$$\frac{u_2(1,r)}{u_1(1,r)} = \frac{p_2}{p_1}.$$

²⁶Here our goal is not to deny the potential importance of preferences in influencing financial equilibrium, but simply to allow ourselves to parameterize the range of alternative cases that we wish to discuss in a more parsimonious way. As we shall see, there remain a number of distinct cases that must be considered.

Since each household's demands are in this proportion, so are *aggregate* demands for the two goods. Market clearing requires that the ratio of aggregate demands equal the ratio of aggregate supplies; hence the equilibrium relative price must be given by

$$\frac{p_2}{p_1} = \frac{u_2(e_1, e_3)}{u_1(e_1, e_3)} \quad (2.9)$$

where $e_l \equiv \sum_h e_l^h$ for $l = 1, 3$ are the aggregate endowments of the two goods in that period and state of the world.

In this way the relative prices p_2/p_1 , p_{12}/p_{11} , p_{22}/p_{21} , can each be determined from the economy's endowment pattern alone, in the flexible-price model. These must therefore be independent of policy, and can be solved for without having to solve for the intertemporal allocation or asset prices. Hence we can treat them as already known, in solving the rest of the model.

It is then possible to define an indirect utility function

$$\tilde{u}(c) = \max_{x_1, x_2} u(x_1, x_2) \quad st. \quad x_1 + \left(\frac{p_2}{p_1}\right)x_2 \leq c$$

where c is the value of total *expenditure* (in units of the nondurable good) in a given period and state of the world. The definition of the indirect utility function depends on the value of (p_2/p_1) , but this is independent of policy. However, the relative price may differ across periods and states of the world (because of differing relative endowments), so that the indirect utility function may differ as well. We shall use the notation $\tilde{u}(c)$ for the indirect utility function for period 0 expenditure, and $\tilde{u}_s(c)$ for the state s in period 1. Then the model can be written entirely in terms of the intertemporal allocation of *expenditure*, without any further reference to endowments or consumption of the two individual goods.

Since p_{11} and p_{21} are given as part of the specification of monetary policy, it follows that we can also treat p_{12} and p_{22} as already known.²⁷ (Recall that this means that p_{13} and p_{23} are already known as well.) The only goods prices that remain to be determined are therefore p_1 and p_3 . (Note that p_1 can be viewed as the money price of real *expenditure*, in the reduced model that avoids reference to individual goods.)

In a model with only two states in period 1, the number of types of private debt securities that we must consider can be reduced to two, as discussed in section 1.2.

²⁷We are interested in using the reduced-form description of the model developed in this section to analyze the consequences of alternative choices of i and ω , keeping fixed the dimension of policy that specifies the period 1 price-level targets.

Moreover, the market for asset 1 is inessential, as shown in Lemma 1; so we can economize on notation by eliminating the market for this asset. There is then only one kind of private debt: riskless (fully collateralized) private debt (asset 2).²⁸ By Lemma 2, this must be equivalent to government-supplied money, in any equilibrium where it is actually issued. There are thus no additional asset prices to determine in equilibrium, given that i is fixed by monetary policy.

There are also only two independent ways in which a household can shift income between period 0 and period 1: either by holding or issuing money-equivalents (where it does not matter whether government-supplied money or privately-issued riskless debt is held), or by holding durable goods. A household can hold arbitrary positive quantities of these two types of assets (subject to the constraint that period 0 expenditure must be non-negative), but is limited in the extent to which it can hold a net *negative* position of either type: it cannot short the durable good at all,²⁹ while the size of its negative holdings of money-equivalents is subject to a limit proportional to its holdings of the durable (because of the collateral requirement for issuing riskless debt).

The implications of equilibrium asset prices for a household's ability to shift expenditure over time and across states can then be specified in terms of the feasible choices of a vector y^h with two elements,

$$y_s^h = \left(\frac{1+i}{p_{s1}} \right) [\mu^h + \frac{1}{1+i}(\psi_2^h - \varphi_2^h)] + \left(\frac{p_{s2}}{p_{s1}} \right) x_3^h,$$

indicating the amount of real purchasing power transferred into each state $s = 1, 2$, as a result of the household's portfolio decision, where the quantity in square brackets is the household's net holding of money-equivalents. The only thing that matters about the household's portfolio, in terms of the implications for its budget constraints in period 1, is the implied value of this vector y^h .

Let us assume that $p_{12} \neq p_{22}$, so that the durable is not a second asset with

²⁸Fostel and Geanakoplos (2013) similarly establish that markets for risky collateralized debt are inessential, in the case that there are only two possible states in the second period. Note that it would not generally be true in the case of more than two states.

²⁹Issuance of "asset 1" would amount to sale of a security that has the same state-contingent payoffs as the durable good, but the collateral constraint implies that a household that issues asset 1 must hold an equivalent quantity of the durable as collateral, so that it is not able to achieve a net negative position in assets with this pattern of returns.

a riskless nominal return.³⁰ (Using the convention proposed in section 1.2 for the ordering of states, we shall therefore assume that $p_{12} > p_{22}$. Then there is a unique combination of money-equivalents and durables that must be held to achieve a given vector y^h ; so given the market prices of the two types of assets, we can assign a well-defined cost (in terms of reduced period 0 expenditure) of any choice of y^h . This cost will be a linear function $a'y^h$, where a is a vector of *state prices*, defined as the two quantities $a_1, a_2 > 0$ that satisfy

$$a_1 \left(\frac{1+i}{p_{11}} \right) + a_2 \left(\frac{1+i}{p_{21}} \right) = \frac{1}{p_1} \quad (2.10)$$

$$a_1 \left(\frac{p_{12}}{p_{11}} \right) + a_2 \left(\frac{p_{22}}{p_{21}} \right) = \left(\frac{p_3 - p_2}{p_1} \right) \quad (2.11)$$

Given (p_1, p_3) , these two equations can be uniquely solved for (a_1, a_2) , and vice versa. Hence we can alternatively treat the two “prices” that remain to be endogenously determined in the model as (a_1, a_2) .³¹

The constraints on a household’s ability to choose a given vector of transfers y^h result not only from the market prices of assets, though, but also from the lower bounds on its net asset positions just discussed. The fact that the durable (the only asset that pays more, in nominal terms, in state 1 than in state 2) cannot be shorted means that $p_{11}y_1^h$ must be at least as large as $p_{21}y_2^h$ for any household. And y_2^h must be non-negative, since the collateral constraint requires a household to hold durables that are worth at least as much in state 2 as the face value of the riskless debt issued by the household. Subject to these two inequalities, however, any vector y^h is attainable if the household is willing (and able) to reduce period 0 expenditure by $a'y^h$ to pay for it.

The household decision problem can then be written in a more compact form, as the choice of a plan $(c^h, c_1^h, c_2^h, y_1^h, y_2^h)$ to maximize

³⁰Note that this is a property of our specification of the economy, that either holds or does not, independently of both interest-rate policy and asset-purchase policy. And for generic specifications it will hold.

³¹See Fostel and Geanakoplos (2013) for further discussion of the possibility of characterizing households’ budget constraints in terms of state prices, in the case that (as here) there are only two possible states in the second period. Note that this would not always be possible if there were more than two states.

$$u^h = \tilde{u}(c^h) + \frac{1}{2}\tilde{u}_1(c_1^h) + \frac{1}{2}\tilde{u}_2(c_2^h) \quad (2.12)$$

subject to the constraints

$$c^h + a_1y_1^h + a_2y_2^h \leq e^h + \frac{p_3 - p_2}{p_1}e_3^h + \frac{1}{p_1}m^h \quad (2.13)$$

$$c_s^h \leq e_{s1}^h + y_s^h - \theta^h \frac{(1+i)M - p_{s2}\omega e_3}{p_{s1}}, \quad \text{for } s = 1, 2 \quad (2.14)$$

$$p_{21}y_2^h \leq p_{11}y_1^h \quad (2.15)$$

$$y_2^h \geq 0 \quad (2.16)$$

where $e^h \equiv e_1^h + (p_2/p_1)e_3^h$ is the value of the household's "total non-durable endowment" in period 0, if we split the endowment of the durable good into the period 0 service flow (counted as part of the "total non-durable endowment") and treat only the value of the asset after the period 0 service flow as an asset endowment; and M is the money supply defined in (2.1). Here (2.13) and (2.14) are the budget constraints for period 0 expenditure and period 1 expenditure (in each of the two possible states) respectively. Inequalities (2.15) and (2.16) are two additional restrictions implied by the collateral constraint.³²

Budget constraints (2.13)–(2.14) are the same as in an A-D model; only the additional constraints (2.15)–(2.16) make our model different. In the absence of the latter two constraints, it would be possible to combine (2.13)–(2.14) into a single intertemporal budget constraint, that makes no reference to the elements of y^h . But we find it useful to write the separate period budget constraints as above in our model, since

³²It might seem surprising that we obtain *two* inequality constraints for each household, given that the collateral constraint is a *single* inequality constraint, indicating a minimum amount of collateral that a household must hold, given all of the debt contracts that it issues of various sorts. However, the required level of collateral in order to achieve a given vector of intertemporal transfers y^h is not a linear function of y^h , for while more negative net holdings of a given asset (i.e., greater issuance of that asset) increase the collateral requirement, more positive net holdings of the same asset do not correspondingly reduce the collateral requirement. This results in a kink in the boundary of the attainable region of the $y_1 - y_2$ plane (see Figures 1 and 2 below). The boundary can therefore be conveniently represented by a pair of linear constraints.

the collateral constraints (2.15)–(2.16) are more conveniently written in terms of the vector y^h .

We can write constraints (2.13)–(2.14) purely in terms of the choice variables, the state prices, and exogenous terms, if we use (2.1) to substitute for M , and then use (2.10)–(2.11) to express the period 0 goods prices as functions of the state prices. The value of the household's initial asset endowment (the final two terms in (2.13)) can be expressed in the form $a_1 f_1^h + a_2 f_2^h$, where

$$f_s^h \equiv \left(\frac{p_{s2}}{p_{s1}}\right)e_3^h + \left(\frac{1+i}{p_{s1}}\right)m^h.$$

This way of writing it allows us to preserve the dependence of the value on the endogenous state prices a . The quantities (f_1^h, f_2^h) are now known without having to solve for endogenous asset prices or allocations, and in particular are independent of policy. Constraint (2.13) can then be written more compactly in the form

$$c^h + a_1 y_1^h + a_2 y_2^h \leq e^h + a_1 f_1^h + a_2 f_2^h \quad (2.17)$$

We can write the household's problem still more compactly by treating the elements of y^h as the only choice variables, and solving equations (2.13)–(2.14) for the implied intertemporal allocation of expenditure (e^h, e_1^h, e_2^h) . We can use the solution to the latter system to substitute for the expenditure allocation in the objective (2.12), and obtain an indirect utility function $U^h(y^h)$. We can then express the household's problem simply as the choice of y^h to maximize $U^h(y^h)$ subject to constraints (2.15)–(2.16).

This indirect utility function, however, has the disadvantage of not being invariant under changes in ω , the size of central-bank asset purchases (even for fixed prices). It is therefore desirable instead to write the household's problem in terms of the alternative choice variables

$$\tilde{y}_s^h \equiv y_s^h + \theta^h \left\{ \left(\frac{p_{s2}}{p_{s1}}\right) - \frac{(1+i)p_1}{p_{s1}} \left[a_1 \left(\frac{p_{12}}{p_{11}}\right) + a_2 \left(\frac{p_{22}}{p_{21}}\right) \right] \right\} \omega e_3.$$

Note that for given asset prices, a household's choice of y_s^h implies a value for \tilde{y}_s^h , and vice versa, so that we can consider \tilde{y}_s^h as a choice variable of household h , even though some terms in this expression are not under the household's control.

Since this definition implies that $a_1 \tilde{y}_1^h + a_2 \tilde{y}_2^h = a_1 y_1^h + a_2 y_2^h$ because of (2.10), we can alternatively write (2.17) as

$$c^h + a_1 \tilde{y}_1^h + a_2 \tilde{y}_2^h \leq e^h + a_1 f_1^h + a_2 f_2^h. \quad (2.18)$$

In addition, (2.14) can now be written more simply as

$$c_s^h \leq g_s^h + \tilde{y}_s^h \quad (2.19)$$

using the notation

$$g_s^h \equiv e_{s1}^h - \theta^h (1 + i) \frac{m}{p_{s1}}.$$

With this change of notation, the only endowments that need to be specified are $(e^h, f_1^h, f_2^h, g_1^h, g_2^h)$. These specify the value of household h 's endowment (in units of real expenditure) in each state at each date, and also indicate how the value of the initial endowment depends on the endogenous state prices. Once this notation is adopted, there need no longer be any reference to prices such as $p_1, p_2, p_3, p_{s1}, p_{s2}, p_{s3}$ in stating the household's problem.

We can again solve equations (2.18) and (2.19) for the expenditure allocation implied by any choice of the vector \tilde{y}^h , and substitute this into the objective (2.12) to obtain the indirect utility function

$$U^h(\tilde{y}^h) \equiv \tilde{u}(e^h + a_1(f_1^h - \tilde{y}_1^h) + a_2(f_2^h - \tilde{y}_2^h)) + \frac{1}{2}\tilde{u}_1(g_1^h + \tilde{y}_1^h) + \frac{1}{2}\tilde{u}_2(g_2^h + \tilde{y}_2^h). \quad (2.20)$$

Note that with this definition, $U^h(\tilde{y}^h)$ is unaffected by changes in ω (considering only the partial-equilibrium effects on a household's problem, i.e., holding fixed the state prices a).

In terms of this new notation, the collateral constraints (2.15)-(2.16) take the form

$$p_{21}\tilde{y}_2^h \leq p_{11}\tilde{y}_1^h - \theta^h [p_{12} - p_{22}]\omega e_3 \quad (2.21)$$

$$\tilde{y}_2^h \geq -\theta^h \phi(a)\omega e_3 \quad (2.22)$$

where

$$\phi(a) \equiv \frac{a_1(p_{12} - p_{22})}{a_1 p_{21} + a_2 p_{11}} > 0 \quad (2.23)$$

is a homogeneous degree zero function of the vector a . Note that $\phi(a)$ is a known function given the data $(p_{12}/p_{11}, p_{22}/p_{21})$ that are determined by the endowments, and p_{21}/p_{11} that is determined by monetary policy.

We can then define equilibrium more compactly as follows.

Definition 2 *Given a two-state flexible-price economy with homothetic preferences \mathcal{E} and a policy specified by $(p_{11}, p_{21}, i, \omega)$, an equilibrium is a vector of state prices a and a vector of intertemporal transfers \tilde{y}^h for each h , such that*

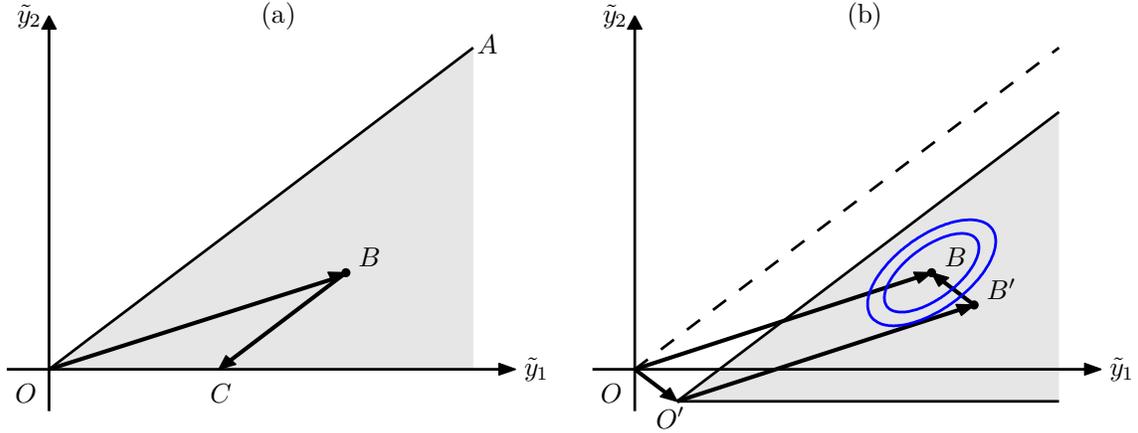


Figure 1: How central-bank purchases shift the set of feasible vectors \tilde{y} of intertemporal transfers.

- (i) for each h , \tilde{y}^h maximizes $U^h(\tilde{y}^h)$ subject to the constraints (2.21)-(2.22); and
- (ii) for each $s = 1, 2$,

$$\sum_{h=1}^H \tilde{y}_s^h = \sum_{h=1}^H f_s^h. \quad (2.24)$$

Once one finds equilibrium values for the state prices, the implied value of the initial price level p_1 is given by (2.10). Thus solution for the equilibrium state prices for a given policy allows us to determine how both conventional and unconventional monetary policy affect price level determination. If we define the *expected real rate of return* on riskless nominal assets as

$$1 + r \equiv p_1(1 + i) \left[\frac{1}{2} \frac{1}{p_{11}} + \frac{1}{2} \frac{1}{p_{21}} \right], \quad (2.25)$$

then solving for p_1 also allows us to solve for r . The implied value of the nominal price of durables p_3 is similarly given by (2.11); and we can also solve for the real price of durables p_3/p_1 .

2.3 Collateral Constraints and the Effects of Open-Market Operations

This more compact reformulation of the model in the two-state case provides insight into the source of the irrelevance result in Proposition 2, and into the difference that

binding collateral constraints should make. A simple geometrical exposition may help to clarify the way in which central-bank asset purchases affect the set of intertemporal expenditure allocations that are possible.

Panel (a) of Figure 1 shows the feasible set of intertemporal transfers y for a given household³³ as a grey region, where y_1 is on the horizontal axis, and y_2 on the vertical axis. (Alternatively, Figure 1(a) shows the attainable vectors \tilde{y} for the case of no central-bank purchases of durables, $\omega = 0$.) Ray \overrightarrow{OA} represents transfers of purchasing power to period 1 that are possible by holding different amounts of money (only);³⁴ ray \overrightarrow{OB} instead represents transfers that are possible by holding durables (only). (Ray \overrightarrow{OB} is clockwise relative to \overrightarrow{OA} under the assumption that the durable is worth more, in terms of money, in state 1 than in state 2.) Points in the region between these two rays are attainable by holding a positive quantity of each of the two assets.

Points in the grey region below ray \overrightarrow{OB} are instead attainable only by holding a positive quantity of durables and issuing riskless debt (collateralized by the durables). For example, point C can be achieved by holding a quantity of durables corresponding to vector \overrightarrow{OB} and then issuing debt corresponding to vector \overrightarrow{BC} . (Note that \overrightarrow{CB} is parallel to \overrightarrow{OA} , since both represent changes in the quantity of money-equivalents held by the household.) Point C is on the lower boundary of the grey region, because \overrightarrow{BC} is the greatest amount of riskless debt that can be issued, given the collateral requirement and the household's durables holdings of \overrightarrow{OB} . (The vertical component of \overrightarrow{OC} is zero, indicating that this amount of collateral is just enough to allow the debt to be repaid even in state 2. The positive horizontal component indicates that in state 1, the collateral will be worth more than the face value of the debt.)

Figure 1(b) instead shows how the attainable set of vectors \tilde{y} shifts as a result of central-bank purchases $\omega > 0$. The change in the value of \tilde{y} corresponding to $y = 0$ (no holdings of any assets by the household, nor any borrowing) is shown by the vector $\overrightarrow{OO'}$. It is the sum of household h 's "share" of the central bank's purchases of the durable (a vector on the ray \overrightarrow{OB}) and household h 's "share" of the riskless debt issued to finance those purchases (a vector parallel to \overrightarrow{BC}). However, the quantity of

³³We dispense with the superscript h in this discussion, as we discuss the budget constraints of a single household.

³⁴This ray is the diagonal if $p_{11} = p_{21}$, i.e., the price level target in period 1 is independent of the state.

riskless liabilities issued by the central bank to finance its purchases is greater than the maximum amount that a household would be able to issue using the durables as collateral, since the central bank is not subject to a collateral constraint.³⁵ Hence the vector $\overrightarrow{OO'}$ points clockwise relative to \overrightarrow{OC} , the maximum degree of leverage possible for a household. In fact, the ray $\overrightarrow{OO'}$ is part of the line defined by the equation $a'\tilde{y} = 0$, which is downward-sloping because both state prices are positive. (O' must lie on this line, because the liabilities issued to finance the asset purchases have the same market value as the durables that are purchased.)

Every value of y is mapped into a value of \tilde{y} obtained by adding to y the vector $\overrightarrow{OO'}$, so the entire attainable region (again shown as the grey region) is linearly translated down and to the right. The indirect utility function $U(\tilde{y})$ is not affected by the change in ω , however. The iso-utility curves can be drawn in the plane, and remain fixed as ω varies. These iso-utility curves are shown as ellipses in the figure; in the case shown, point B represents the highest possible value of U .³⁶

Since point B is in the interior of the grey region when $\omega = 0$ (panel (a)), this is the intertemporal expenditure plan that the household will choose, achieved through the portfolio represented by vector \overrightarrow{OB} . When the central bank purchases durables in the amount indicated in panel (b), the attainable part of the plane shifts, but point B remains in the interior of the grey region, so the household still prefers exactly the same pattern of intertemporal expenditure (assuming no change in the state prices), and can still achieve. However, the portfolio choice required to support this plan is no longer represented by vector \overrightarrow{OB} , but instead by $\overrightarrow{O'B}$. Relative to the portfolio that it would have chosen in the absence of the central-bank purchases (\overrightarrow{OB} , or equivalently, its parallel translation $\overrightarrow{O'B'}$), the household makes additional net trades $\overrightarrow{B'B}$, in order to achieve its desired intertemporal expenditure plan.³⁷ This is the additional hedging demand created by the central bank's purchases.

Note that the change in the household's desired portfolio $\overrightarrow{B'B}$ is exactly the additive inverse of the vector $\overrightarrow{OO'}$, representing the household's share θ^h of the central

³⁵The geometry of Figure 1 should make it clear that central-bank asset purchases can allow a household to achieve intertemporal allocations that would not otherwise be feasible for it *only* because the central bank is not subject to the same kind of collateral constraint as households.

³⁶Point B in panel (b) need not be the same point as that labeled B in panel (a); it represents the maximum of the indirect utility function, and need not correspond to a portfolio consisting only of durables.

³⁷This change in the household's portfolio is stated algebraically in (2.6)–(2.7).

bank's trades. Hence in the absence of any change in asset prices, the household chooses to undo fraction θ^h of the central bank's trades. If *each* household is in a situation like that depicted in Figure 1(b), as assumed in Proposition 2, then the aggregate additional trades of the households will exactly offset the central bank's trades, and markets will continue to clear at the same prices as before. Hence the conclusion of Proposition 2: there is no change in asset prices, no change in goods prices, and no change in the equilibrium allocation of resources.

This result depends, however, on the assumption that each household's decision is the one depicted in Figure 1(b): the collateral constraint does not restrict the household's intertemporal expenditure plan, either before or after the central bank's purchases. This need not be the case. Households might be constrained by the collateral constraint, in either of two ways, depicted in the two panels of Figure 2.

In the case shown in Figure 2(a), the household's preferred intertemporal transfers in the absence of central-bank purchases is shown by point D; this is not the household's unconstrained optimum, but represents the highest indifference curve that the household can reach while remaining in the grey region. Such a household would like to reduce expenditure in state 2 even further, by borrowing more while acquiring durables that pay off more in state 1 than in state, but cannot because it would violate its collateral constraint. In this case, if the central bank purchases durables, then if asset prices do not change, the attainable region shifts as shown, and the household's constrained optimum will now be point E. Effectively, the central bank borrows on the household's behalf, and so relaxes the collateral constraint for such a household.

Alternatively, a household's situation could be the one shown in Figure 2(b). In this case, the household's preferred intertemporal transfers when $\omega = 0$ are shown by point F. Here again, this is not the household's unconstrained optimum; but in this case, the collateral constraint prevents the household from *increasing* its expenditure in state 2 — or more precisely, it prevents it from carrying more purchasing power into state 2 than into state 1. In this case, if the central bank purchases durables, then if asset prices do not change, the household's constrained optimum will now be point G. Once again, the household does not undo the central bank's trades, owing to the binding collateral constraint — but in this case, because it *cannot*. Effectively, the household's collateral constraint is *tightened* in this case, rather than being relaxed.

These examples illustrate how collateral constraints can invalidate the argument

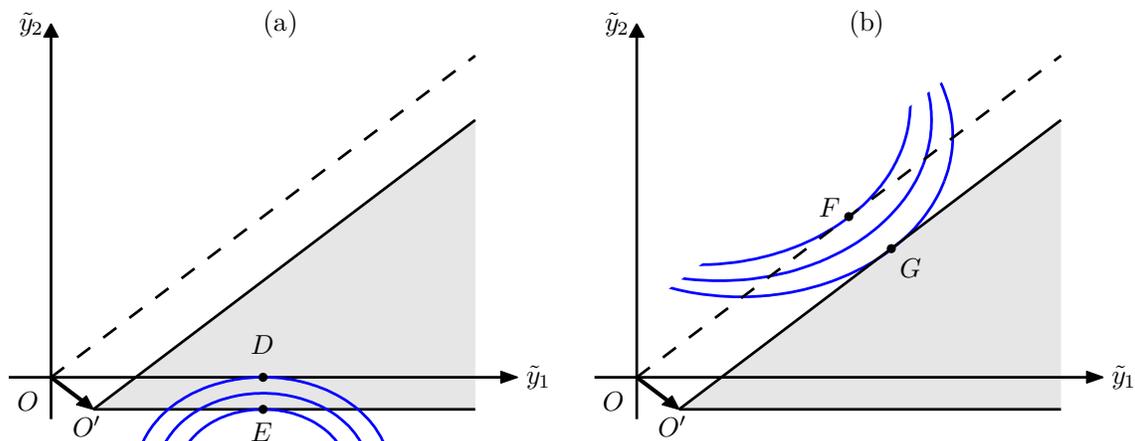


Figure 2: Two ways in which a household's collateral constraint might bind.

relied upon to establish Proposition 2. In either case, constrained households will fail to adjust their portfolios so as to offset their “share” of the central bank's trades, and may adjust their portfolios little at all; the aggregate effect, if some households are constrained while others are not, will thus typically be an excess demand for the durable good and an excess supply of money, at unchanged asset prices. One should then expect the central bank's purchases to raise the equilibrium price of the asset that it purchases (the durable good), as we illustrate through both analytical and numerical examples below.

Yet even this simple partial-equilibrium discussion should indicate that the effects are more complex than common discussions of central-bank asset purchases assume. First of all, there *need not* be effects of asset purchases on asset prices; this only occurs when collateral is sufficiently scarce (relative to the degree of asymmetry in the situations of different economic agents) for collateral constraints for a sufficient number of traders. Second, even when collateral constraints bind, there are a variety of ways in which central-bank asset purchases can interact with them. The asset purchases may effectively relax the collateral constraints, as in Figure 2(a), but they might equally well tighten them further, as in Figure 2(b). And third, the mere fact that the central bank's purchases succeed in raising the price of the asset (when they do) is not necessarily informative as to whether financial constraints are eased by the policy. For both in Figure 2(a) and in Figure 2(b), the central bank's policy creates excess demand for the durable at unchanged prices, and so is likely to increase the

price of the durable. But in one case the excess demand is created by *loosening* the constraint on a household's ability to hold more risk correlated with the return on the durable, while in the other case, it is created by *tightening* the constraint on a households' ability to short such risk.

It is also important to recognize that the welfare effects of the asset purchases cannot be simply read off from these partial-equilibrium diagrams. The figures show how a household's level of expected utility would change in each case *if prices were not to change*, but in the cases where collateral constraints bind, prices must change in order for markets to clear. The welfare effects of the price changes must be taken into account as well, and they may outweigh the partial-equilibrium welfare effects shown here.

For example, Figure 2(a) shows a household that achieves a higher level of expected utility as a result of central-bank purchases of the durable, if prices do not change. But the price changes that are needed to clear markets — exactly because of the behavior shown in the figure for the case of unchanged prices — are likely to *hurt* a household in this situation. The excess demand for durables and excess supply of money-equivalents in the case of unchanged prices should be expected to raise the price of the durable and lower the price for which riskless debt can be issued; but since this household issues riskless debt and acquires durables in order to satisfy the collateral requirement for such issues, such price changes are likely to reduce the budget of the household shown in the figure. We show explicitly in the next section that because of such price effects, it is possible for the welfare of a household in the situation shown in Figure 2(a) to be reduced.³⁸

3 Effects of Asset Purchases When Leverage Constraints Bind

A full consideration of the effects of central-bank asset purchases requires that we go beyond the partial-equilibrium analysis presented above, and also consider the endogenous price changes that result, in general, when collateral constraints bind for at least some households. To keep the calculations tractable, we now further specialize our analysis to a still more restrictive class of preferences, in which the

³⁸See Figure 3 below, and discussion in section 3.3.

indirect utility functions \tilde{u}, \tilde{u}_s are such that

$$\tilde{u}'(c) = \alpha c^{-\gamma}, \quad \tilde{u}'_s(c) = \alpha_s c^{-\gamma} \quad (3.1)$$

for some coefficients $\alpha, \alpha_1, \alpha_2, \gamma > 0$.³⁹ This assumption implies that the indirect utility function U^h defined in (2.12) will also be a homothetic function of (c^h, c_1^h, c_2^h) . (From now on, when we assume that households have “homothetic preferences,” we should be understood to refer to this stronger version of the assumption.)

We also restrict attention in this section to equilibria of a particular type: ones in which the collateral constraint of each household either binds in the way shown in Figure 2(a), or does not bind at all. We focus on the situation in which the collateral constraints bind in the way shown in Figure 2(a) — that is, in which constraint (2.22) binds rather than (2.21) — because, as shown in the figure, this is the case in which the asset purchases would increase the welfare of the constrained households in the absence of asset-price changes. The case in which the constrained households are *leveraged* households — who wish to borrow more in order to acquire even more of the risky durable, but are unable to owing to the collateral constraint — is also of particular interest because authors such as Adrian and Shin (2010) and Geanakoplos (2010) emphasize, in their models of the role of financial constraints in asset pricing, the role of variations in degree to which the “natural buyers” of risky assets are able to leverage themselves in order to acquire as much of these assets as they would like.

It is not possible, however, for constraint (2.22) to bind for everyone. For if (2.22) binds, the household chooses a portfolio that transfers no income to state 2 in period 1 ($y_2^h = 0$); such a household must issue the maximum quantity of debt allowed by the collateral requirement given its holdings of durables, and hold no money or money-equivalents. But *everyone* cannot issue debt while no one chooses to hold such assets. (And there must be a positive aggregate capacity to issue debt, since households in aggregate must hold a positive quantity of durables, as long as $\omega < 1$.) Hence in the case of only two types, we consider equilibria in which one household is constrained, and one not. We first consider the conditions required for such an equilibrium, and then ask, when these conditions are satisfied, what the effects of increased central-bank holdings of durables will be.

³⁹Note that both our previous assumption of homotheticity of the period utility functions and this assumption would follow from an assumption that $u(x_1, x_2) = (1 - \gamma)^{-1}(x_1^{1-\gamma} + \beta x_2^{1-\gamma})$ for some $\beta > 0$, though our assumptions remain more general than simply assuming this familiar case.

3.1 Equilibrium When Only the Leverage Constraint Binds

We first note some general properties of collateral-constrained equilibria in which only constraint (2.22) binds (on some households), while constraint (2.21) binds for no one. These results do not depend on the restriction to an economy with only two household types, though they do rely upon our strengthening of the assumption about the form of preferences.

The fact that constraint (2.21) does not bind implies that in equilibrium, $U_1^h = 0$ for all $h \in \mathcal{H}$, where we use the notation U_s^h for the partial derivative of the indirect utility function U^h defined in (2.20) with respect to \tilde{y}_s^h , evaluated for the equilibrium state prices \bar{a} . This implies that

$$\frac{\tilde{u}'_1(c_1^h)}{\tilde{u}'(c^h)} = 2a_1$$

for all $h \in \mathcal{H}$. Assumption (3.1) then implies that the expenditure ratio c_1^h/c^h must be the same for all households. But the aggregate expenditure ratio must equal the ratio of the values of the aggregate endowments in the two states; hence the expenditure ratio for each household must equal the ratio of the endowments. This allows us to determine each household's marginal rate of substitution, and hence the equilibrium value of a_1 . We thus obtain the following result.

Lemma 3 *In a flexible-price economy with homothetic preferences and two states in period 1, if an equilibrium exists in which constraint (2.21) does not bind for any household, then the equilibrium value of state price a_1 must equal*

$$\bar{a}_1 = \frac{1}{2} \left[\frac{e_1 + (p_2/p_1)e_3}{e_{11} + (p_{12}/p_{11})e_3} \right]^\gamma,$$

where $e_1 \equiv \sum_h e_1^h$, $e_{11} \equiv \sum_h e_{11}^h$. Thus the state price a_1 will be unaffected by policy (either conventional or unconventional monetary policy), to the extent that the variation in policy does not change the fact that constraints (2.21) do not bind.

This simple result is already enough to allow us to establish some useful conclusions about the possible effects of monetary policy on asset prices. By analogy with (2.25), let us define the *expected real return* on the durable r^{dur} as⁴⁰

$$1 + r^{dur} \equiv \left(\frac{p_1}{p_3 - p_2} \right) \left[\frac{1}{2} \frac{p_{12}}{p_{11}} + \frac{1}{2} \frac{p_{22}}{p_{21}} \right],$$

⁴⁰Here we treat the cost of investment in a unit of this asset as $p_3 - p_2$, i.e., the cost of a unit of

and the spread between the expected returns on the durable and on riskless debt as

$$\hat{r}^{dur} - \hat{r} \equiv \log \frac{1 + r^{dur}}{1 + r},$$

where r is defined in (2.25).

Proposition 4 *In a flexible-price economy with homothetic preferences and two states in period 1, suppose that for any policy in some set under consideration, an equilibrium exists in which constraint (2.21) does not bind for any household, though constraint (2.22) may bind for some. Suppose also that the period 1 price-level commitments $\{p_{s1}\}_{s \in \mathcal{S}}$ are the same for all policies in the set. Then if any policy change (whether in interest-rate policy or in the central bank's asset purchases) raises (lowers) the real price of the durable p_3/p_1 in period 0 must also lower (raise) the expected real return on riskless debt r ; and while it also lowers (raises) the expected real return r^{dur} on the durable, it increases (decreases) the spread $\hat{r}^{dur} - \hat{r}$.*

Suppose further that only the central bank's asset-purchase policy is changed, while the interest-rate target i remains fixed. Then a policy that raises (lowers) the real price of the durable in period 0 must lower (raise) the general price level in period 0 (i.e., the money prices of both non-durables and rental of the services of durables). Moreover, the general price level must fall (rise) by a greater amount, in percentage terms, than the increase (decrease) in the real price of durables, so that the nominal price of the durable good in period 0 must also fall (rise). Thus an asset-purchase policy that increases (decreases) the nominal price of the durable in period 0 must increase (decrease) the equilibrium real return r on riskless nominal debt, reduce (increase) the size of the spread $\hat{r}^{dur} - \hat{r}$ between the expected real returns on durables and those on riskless debt, and increase (decrease) aggregate nominal expenditure on goods and services, resulting (in our flexible-price endowment economy) in an increase (decrease) in the general level of prices.

Proof. By Lemma 3, the equilibrium state price \bar{a}_1 must be the same for all policies for the set under consideration, and by hypothesis p_{11}, p_{21} are the same under all

the durable *after* it has already been rented in period 0, or alternatively, the purchase price prior to rental, net of the amount that the buyer can obtain back in period 0 by renting the durable. In this way, r^{dur} is the return that would have to equal r in an economy with risk-neutral investors and no financial frictions that prevent arbitrage between the two assets.

policies as well. We have shown earlier that (under the assumption of homothetic preferences) $p_2/p_1, p_{12}/p_{11}$ and p_{22}/p_{21} are independent of policy as well. It then follows from (2.11) that the real price of durables can be changed by one of the policies under consideration if and only if the state price a_2 changes, and more specifically that p_3/p_1 increases if and only if a_2 increases as a result of the policy change. Moreover, $1 + r^{dur}$ must vary inversely with $(p_3 - p_2)/p_1$, so that r^{dur} falls if and only if a_2 increases.

Similarly, (2.10) implies that the quantity $(1 + i)p_1$ can be changed if and only if a_2 changes, and more specifically that $(1 + i)p_1$ falls if and only if a_2 increases. It then follows from (2.25) that r similarly falls if and only if a_2 increases. Thus the expected real returns on both the risky durable and on riskless debt must fall if and only if a_2 increases. We can furthermore sign the difference between the percentage changes in the two expected returns, in the case of a given change in a_2 . One observes that

$$\frac{1 + r^{dur}}{1 + r} = C \cdot \frac{a_1 \left(\frac{1}{p_{11}} \right) + a_2 \left(\frac{1}{p_{21}} \right)}{a_1 \left(\frac{p_{21}}{p_{11}} \right) + a_2 \left(\frac{p_{22}}{p_{21}} \right)},$$

where C is a positive constant (a function only of the prices $\{p_{sl}\}$ that are independent of policy). It follows from this that $(1 + r^{dur})/(1 + r)$ is an increasing function of a_2 (holding fixed a_1 and the $\{p_{sl}\}$). Hence the spread $\hat{r}^{dur} - \hat{r}$ increases if and only if a_2 increases. Since a_2 increases if and only if p_3/p_1 increases, the assertions in the first paragraph of the lemma have all been established.

In the case that there is no change in i , a decline in $(1 + i)p_1$ necessarily requires a decline (in the same proportion) in p_1 (and hence in p_2 as well, since p_2/p_1 is independent of policy). As shown above, an increase in a_2 necessarily implies a decrease in $(1 + i)p_1$ (and hence in p_1) by a factor that is larger than the factor by which $1 + r^{dur}$ declines (and hence by which $(p_3 - p_2)/p_1$ increases). It follows that the product

$$\frac{p_3 - p_2}{p_1} \cdot p_1$$

decreases if and only if a_2 increases. Hence $p_3 - p_2$ decreases, and since p_2 also decreases, it follows *a fortiori* that p_3 decreases, if and only if a_2 increases. Thus an asset-purchase policy that raises the nominal price of the durable in period 0 (whether one considers the pre-rental price p_3 or the post-rental price $p_3 - p_2$) must be one that lowers a_2 , from which the conclusions stated in the second paragraph of the lemma

then follow. \square

Thus to the extent that an asset-purchase policy is able to raise the nominal price of the asset purchased by the central bank, consequences necessarily follow for both the equilibrium real returns on other assets, and for aggregate nominal spending. This suggests that the concern of central banks with policies intended to raise the prices of particular assets, as a way of influencing macroeconomic conditions more generally, is not misguided. However, it is worth noting that the effects allowed by Proposition 4 are rather different than those implied by the “portfolio balance” theory typically relied upon by central banks as a theory of these policies.

According to the “portfolio balance” theory, the central bank’s purchase of assets that are more exposed to a particular type of risk than are assets in general — in this case, the risk of a low return in state 2, the state in which the return on durables is relatively low compared to that on money, and hence to that on the economy’s aggregate portfolio as well — should lower the market risk premium associated with that type of risk, and hence lower the risk premium for holding the type of assets purchased by the central bank. It is generally supposed that this reduction in the risk premium should also reduce the expected real return on the risky asset purchased by the central bank, since there is less reason for the riskless real rate to be influenced by the purchase of risky assets; and it is this reduction in the expected real return on risky assets that is relied upon to increase aggregate demand.

It remains to be analyzed whether asset purchases by the central bank should indeed reduce the risk premium associated with the assets purchased; below, we give conditions under which this will be true, though they are not as general as might be expected. But even granting that they do, it is already evident from Proposition 4 that the conventional story does not match what happens in our model. An asset-purchase policy that reduces the spread $\hat{r}^{dur} - \hat{r}$ would have to reduce a_2 ; such a policy would indeed reduce aggregate nominal expenditure, according to the proposition, but it would be associated with an *increase* rather than a decrease in the expected real return r^{dur} on the risky asset, and a decrease rather than an increase in the asset’s real price. Thus the conventional account would not be correct, either about the implications of the reduction in the spread for the expected real return on the risky asset purchased by the central bank, or about the role of this return in explaining the effects on aggregate demand.

In order to consider how central-bank asset purchases should affect a_2 (and hence the asset prices and returns just discussed), it is useful to further simplify our definition of equilibrium for the special case under consideration. The result that the expenditure ratio c_1^h/c^h must be the same for each household means that we can solve for both c^h and c_1^h for any household, as a function of the total present value of expenditure

$$c_{01}^h \equiv c^h + \bar{a}_1 c_1^h$$

allocated to period 0 and state 1 of period 1. Hence we can write the total contribution to utility from expenditure in these two states,

$$\tilde{u}(c^h) + \frac{1}{2} \tilde{u}_1(c_1^h)$$

as a function of c_{01}^h . Let this function be denoted $(1/2)\tilde{u}_{01}(c_{01}^h)$. Note that it will be the same function for each household, and will have the property that $\tilde{u}'(c) = \alpha_{01}c^{-\gamma}$ for some constant $\alpha_{01} > 0$.

We can then write each household's preferences over the remaining dimension of the intertemporal allocation of expenditure — shifting expenditure between state 2 in period 1 and the aggregate of the other two states — as

$$U^h = \frac{1}{2} [\tilde{u}_{01}(c_{01}^h) + \tilde{u}_2(c_2^h)]. \quad (3.2)$$

Note that this function can be defined independently of the value of a_2 (the relative price of these remaining two components of expenditure).

Finally, in any equilibrium of this kind, a household's expenditure in state 1 of period 1 will be given by $c_1^h = \chi c_{01}^h$, where

$$\chi \equiv \frac{\sum_h k_1^h}{\sum_h e^h + \bar{a}_1 \sum_h k_1^h} > 0,$$

introducing the notation $k_s^h = f_s^h + g_s^h$, for all h and s . Constraint (2.21) can alternatively be written in the form

$$p_{21}c_2^h \leq p_{11}c_1^h + (p_{21}e_{21}^h - p_{11}e_{11}^h) - \theta^h(p_{12} - p_{22})\omega e_3,$$

so that the condition required for the allocation (c_{01}^h, c_2^h) to be consistent with our assumption that constraint (2.21) does not bind is

$$p_{21}c_2^h \leq \chi p_{11}c_{01}^h + (p_{21}e_{21}^h - p_{11}e_{11}^h) - \theta^h(p_{12} - p_{22})\omega e_3. \quad (3.3)$$

We can then state necessary and sufficient conditions for an equilibrium in which constraint (2.21) binds for no households.

Definition 3 *A state price \bar{a}_2 and intertemporal expenditure plans $(\bar{c}_{01}^h, \bar{c}_2^h)$ for each of the $h \in \mathcal{H}$ describe an equilibrium in which the short-sale constraint (2.21) binds for no households if*

(i) *for each $h \in \mathcal{H}$, the plan $(\bar{c}_{01}^h, \bar{c}_2^h)$ maximizes the indirect utility function U^h defined in (3.2), subject to the constraints that*

$$c_{01}^h + \bar{a}_2 c_2^h \leq e^h + \bar{a}_1 k_1^h + \bar{a}_2 k_2^h, \quad (3.4)$$

$$c_2^h \geq g_2^h - \theta^h \phi(\bar{a}_2) \omega e_3; \quad (3.5)$$

(ii) *markets clear in state 2, so that*

$$\sum_{h=1}^H c_2^h = \sum_{h=1}^H k_2^h; \quad (3.6)$$

and

(iii) *inequality (3.3) is satisfied for each $h \in \mathcal{H}$.*

In this statement of the household's problem, (3.4) is the intertemporal budget constraint implied by the set of period budget constraints (2.18)–(2.19), and (3.5) is an alternative expression of the leverage constraint (2.22), with both constraints now written in terms of the expenditure allocation (c_{01}^h, c_2^h) . (In condition (3.5), the function $\phi(a_2)$ is simply the function $\phi(a)$ defined earlier, in which the value \bar{a}_1 defined in Lemma 3 has been substituted for a_1 .) Condition (ii) is the condition for market-clearing in state 2 of period 1; we need not add a corresponding market-clearing relation for aggregate expenditure in the initial period and in state 1, as this is guaranteed by condition (ii) and Walras' Law. This alternative statement of the conditions required for an equilibrium is useful in determining the effects of central-bank asset purchases on the equilibrium value of a_2 , and hence on the other asset prices and expected returns discussed above.

It will also be useful to consider a modified equilibrium concept, in which constraints (3.3) are ignored.

Definition 4 *An equilibrium neglecting short-sale constraints is a state price \bar{a}_2 and intertemporal expenditure plans $(\bar{c}_{01}^h, \bar{c}_2^h)$ for each of the $h \in \mathcal{H}$ such that*

(i) for each $h \in \mathcal{H}$, the plan $(\bar{c}_{01}^h, \bar{c}_2^h)$ maximizes the indirect utility function U^h subject to constraints (3.4)–(3.5); and

(ii) condition (3.6) holds.

This can be thought of as an equilibrium of a model in which short sales of the durable are allowed, though issuance of riskless debt is still constrained by the collateral requirement; and when a household chooses a *short* position in the durable, it is required to hold a minimum quantity of money or money-equivalents, $1/C_2$ units for each unit of the durable that is sold short. The interest of the concept, however, is that the set of equilibria neglecting short-sale constraints can be more easily characterized than the set of equilibria of the model with collateral constraints set out above. The equilibria of the model with collateral constraints in which constraint (2.21) binds for no household are then equivalent to the set of equilibria neglecting short-sale constraints for which (in addition to the equilibrium requirements) inequality (3.3) is satisfied for all households.

3.2 Effects of Asset Purchases with One Constrained Household

Explicit calculations of the effects of central-bank asset purchases are especially simple if we further restrict ourselves to the case of an economy made up of households of only two types ($h = 1, 2$), assumed to exist in equal numbers. Note that there is no loss of generality in assuming that the number of households of the two types are equal since, in the case of homothetic preferences, the only thing that matters for equilibrium is the *share* of the aggregate endowment of each good that is controlled by households of a given type, and not the *number* of households among whom the endowment is divided. Thus when we refer to parameters such as e_3^1/e_3^2 , they should be understood to specify the relative quantities owned by households of the two types in aggregate, and not the relative size of the endowments of individuals.

In the case of only two households, the possible equilibrium allocations of expenditure, in any equilibria of the kind defined in Definition 3 can be represented using an

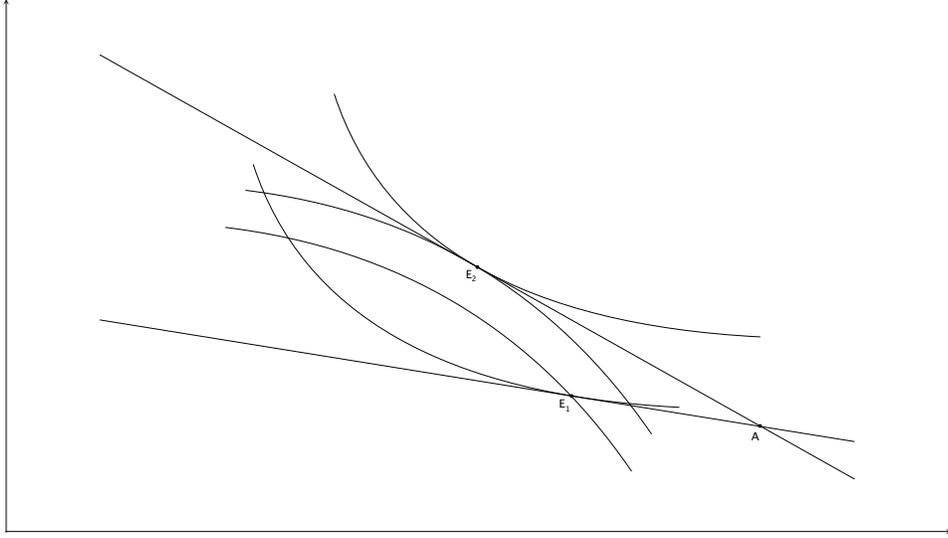


Figure 3: Equilibria in the case of two households and two states, shown in an Edgeworth Box diagram. The equilibrium at E_2 corresponds to a larger central-bank balance sheet.

Edgeworth Box diagram. In Figure 3, the allocation between the two households of expenditure in the initial period and in state 1 is indicated on the horizontal axis: movement to the right indicates an increasing value of c_{01}^1 , and a corresponding decreasing value of c_{01}^2 , since in any feasible allocation these must sum to $\sum_h e^h + \bar{a}_1 \sum_h k_1^h$, a quantity independent of policy. Similarly, the allocation between the two households of expenditure in state 2 of period 1 is indicated on the vertical axis: movement upward indicates an increasing value of c_2^1 , and a corresponding decreasing value of c_2^2 , since these must sum to $\sum_h k_2^h$, a quantity that is also independent of policy.

The preferences of each household can be depicted by indifference curves in the plane, representing the level curves of the indirect utility function U^h defined in (3.2). In the figure, the indifference curves of household 1 are the ones that are concave upward, and indifference curves that are higher and farther to the right represent higher expected utility for this household. The indifference curves of household 2 are the ones that are concave downward, and indifference curves that are lower and farther to the left represent higher expected utility for household 2.

The budget constraint (3.4) can be represented by a straight line with slope $-1/\bar{a}_2$, passing through the endowment point A , which corresponds to the allocation $c_{01}^h =$

$e^h + \bar{a}_1 k_1^h, c_2^h = k_2^h$ for each household. The location of this point is also unaffected by changes in a_2 or the central bank's balance sheet.⁴¹ A household for which the leverage constraint (3.5) does not bind must choose an expenditure plan on this line where the line is tangent to one of its indifference curves. A household for which the leverage constraint binds, instead, must choose the point on the line which reaches the highest indifference curve that is attainable given the lower bound on c_2^h implied by the leverage constraint.

An equilibrium in which the leverage constraint binds for neither type must correspond to point E_2 in Figure 3, as this is the unique point with the property that (i) the indifference curves of the two types are tangent to each other at this point, and (ii) the common tangent line to the two indifference curves passes through point A . (It corresponds to the A-D equilibrium of this economy, which can easily be shown to be unique given our assumption of homothetic preferences.) Point E_2 will represent an equilibrium neglecting short-sale constraints if when a_2 has the value implied by the slope of the budget line through point E_2 , constraints (3.5) are satisfied for both households.⁴² Specifically, the lower bound for c_2^1 must correspond to a vertical height somewhere below point E_2 , while the lower bound for c_2^2 must correspond to a vertical height somewhere higher than point E_2 . Since these constraints depend on the value of ω , this condition may be satisfied for some values of ω but not for others.

An equilibrium in which the leverage constraint binds for household 2 only is illustrated by point E_1 in Figure 3. At this point, household 1's indifference curve is tangent to the budget line passing through the point, so this represents an allocation that household 1 would choose (if a_2 takes the value implied by the slope of the budget line) if not constrained by its leverage constraint. Household 2, instead, would prefer to move up and to the left on the budget line, as it could reach higher indifference curves in that case. However, point E_1 can be a constrained optimum for household 2, if its leverage constraint requires c_2^2 to be no lower than the value corresponding to point E_1 . Thus point E_1 represents an equilibrium neglecting short-sale constraints, if the leverage constraints imply a lower bound for c_2^1 somewhere below the value corresponding to the vertical height of point E_1 , while they imply a lower bound for c_2^2 exactly equal to the corresponding to the vertical height of E_1 . Since the heights

⁴¹It may be affected by changes in interest-rate policy, as discussed further below.

⁴²It will also be an equilibrium of the model with collateral constraints if, in addition, constraint (3.3) is satisfied for both households.

of these lower bounds depend on ω , there will be at most one precise value of ω for which point E_1 will be an equilibrium. The value of ω that is required is the unique value that causes (3.5) to hold with equality at the allocation represented by point E_1 .

We can now consider how central-bank asset purchases can affect the location of the equilibrium in this diagram, assuming a fixed value for i . For any value of $a_2 > 0$, let $(\hat{c}_{01}^1(a_2), \hat{c}_2^1(a_2))$ be the plan for household 1 that maximizes U^1 subject to constraint (3.4). These functions parametrically define a curve in the Edgeworth Box, household 1's "offer curve." This curve passes through points E_1 and E_2 (in the case shown in the figure), as well as through point A . The value of a_2 for which the offer curve passes through the A-D equilibrium (point E_2) is given by

$$a_2^* = \frac{\alpha_2}{\alpha_{01}} \left(\frac{\sum_h e^h + \bar{a}_1 \sum_h k_1^h}{\sum_h k_2^h} \right)^\gamma,$$

where $-1/a_2^*$ is also the slope of the line $\overrightarrow{AE_2}$ in the figure.

Generically, the A-D equilibrium is not at the endowment point A , and if so, the slopes of the indifference curves of the two types through point A will be unequal; moreover, one must have an indifference curve steeper than $\overrightarrow{AE_2}$, and the other an indifference curve that is flatter. Without loss of generality, let us suppose that

$$\frac{k_2^1}{e^1 + \bar{a}_1 k_1^1} < \frac{k_2^2}{e^2 + \bar{a}_1 k_1^2}, \quad (3.7)$$

so that household 1 has the flatter indifference curve through point A . Then the value of a_2 for which household 1's offer curve passes through the endowment point A is given by

$$a_2^{**} = \frac{\alpha_2}{\alpha_{01}} \left(\frac{e^1 + \bar{a}_1 k_1^1}{k_2^1} \right)^\gamma > a_2^*.$$

Moreover, $c_2^{1*} \equiv \hat{c}_2^1(a_2^*)$, household 1's expenditure in state 2 in the A-D equilibrium, will necessarily be greater than k_2^1 , as also shown in the figure. We can then establish the following general result about equilibria neglecting short-sale constraints.

Proposition 5 *Consider a model with two states in period 1, and two types of households with homothetic preferences, where household 1 is identified by the inequality (3.7), and let the value of $i \geq 0$ be fixed. Then for any value of c_2^1 in the interval*

$$k_2^1 \leq c_2^1 \leq c_2^{1*}, \quad (3.8)$$

there is a unique value of a_2 in the interval $a_2^* \leq a_2 \leq a_2^{**}$ such that $\hat{c}_2^1(a_2) = c_2^1$. If in addition these values (c_2^1, a_2) satisfy the bounds

$$\underline{c} \leq c_2^1 < \underline{c} + \theta^2 \phi(a_2) e_3, \quad (3.9)$$

where

$$\underline{c} \equiv \left(\frac{p_{22}}{p_{21}} \right) e_3 - \theta^2 \left(\frac{1+i}{p_{21}} \right) m + e_{21}^1,$$

then there exists an asset-purchase policy $0 \leq \omega < 1$ for which the point on household 1's offer curve corresponding to the values (c_2^1, a_2) represents an equilibrium neglecting short-sale constraints, in which household 2's borrowing is constrained by the leverage constraint (3.5), except in the limiting case in which $c_2^1 = c_2^{1*}$, but household 1 is unconstrained.

In the case of any $c_2^1 < c_2^{1*}$, the unique value of ω consistent with this equilibrium is

$$\omega = \hat{\omega}(c_2^1) \equiv \frac{c_2^1 - \underline{c}}{\theta^2 \phi(a_2)} e_3, \quad (3.10)$$

while for the case $c_2^1 = c_2^{1*}$, any value of ω in the interval $[\hat{\omega}(c_2^{1*}), 1)$ is consistent with the equilibrium. The value of \bar{a}_2 associated with each of these possible equilibria is a monotonically decreasing function of c_2^1 . Moreover, a higher value of c_2^1 is associated with a lower value of the real price p_3/p_1 for the durable, with the consequences for other asset prices and rates of return stated in Proposition 4.

Proof. It follows from standard properties of offer curves that for all values $a_2 < a_2^{**}$, the points on the offer curve will involve $c_2^1 > k_2^1$, and that $\hat{c}_2^1(a_2)$ is a monotonically decreasing function over this range, increasing without bound as $a_2 \rightarrow 0$. Instead, for values $a_2 > a_2^{**}$, the function need not be monotonic, but necessarily all points on this part of the offer curve involve $c_2^1 < k_2^1$. Hence for any value $c_2^1 \geq k_2^1$, there is a unique $0 < a_2 < a_2^{**}$ such that $\hat{c}_2^1(a_2) = c_2^1$, and the required value of a_2 is monotonically decreasing as a function of c_2^1 .

Moreover, assumption (3.7) implies that the indifference curve of household 2 through the endowment point A is steeper than that of household 1. Because the A-D equilibrium is unique, there can be only one point on the offer curve at which the slopes of the indifference curves are identical (namely, point E_2 , corresponding to the A-D equilibrium), so for all values of a_2 in the interval $a_2^* < a_2 \leq a_2^{**}$, the slope

of the indifference curve of household 2 is more negative than $-1/a_2$ at the point on the offer curve corresponding to a_2 ; and when $a_2 = a_2^*$, the slope is exactly $-1/a_2^*$.

Hence for any value of c_2^1 in the interval (3.8), there is a unique point on the offer curve, corresponding to a value of a_2 in the interval $a_2^* \leq a_2 \leq a_2^{**}$, for which $\hat{c}_2^1(a_2) = c_2^1$. This corresponds to an allocation in which household 1's expenditure plan is optimal, given the budget line defined by a_2 ; thus it will solve the problem for household 1 defined in condition (i) of Definition 4, as long as the lower bound defined by (3.5) is no higher than the assumed value of c_2^1 . When $c_2^1 = c_2^{1*}$, household 2's expenditure plan is also optimal, given the budget line; thus it will solve the problem defined in condition (i) as well, as long as the lower bound defined by (3.5) for household 2 is no higher than the implied value $c_2^2 = \sum_h k_2^h - c_2^1$. If instead $c_2^1 < c_2^{1*}$, household 2 has an indifference curve through this point that is steeper than the budget line. This implies that household 2's plan is optimal among all those on the budget line that involve a value of c_2^2 no lower than $\sum_h k_2^h - c_2^1$. Thus household 2's plan solves the problem defined in condition (i) if and only if the lower bound defined by (3.5) for household 2 is exactly equal to $\sum_h k_2^h - c_2^1$.

This point on the offer curve, together with the associated value of a_2 , accordingly constitutes an equilibrium neglecting short-sale constraints only if the lower bound for c_2^2 defined by (3.5) is exactly equal to $\sum_h k_2^h - c_2^1$, if $c_2^1 < c_2^{1*}$. This requires that

$$g_2^2 - \theta^2 \phi(\bar{a}_2) \omega e_3 = \sum_h k_2^h - c_2^1, \quad (3.11)$$

which requires that $\omega = \hat{\omega}(c_2^1)$, the value defined in (3.10). This is a feasible policy only if $0 \leq \hat{\omega}(c_2^1) < 1$, which is true if and only if the bounds (3.9) are satisfied. In the case that $c_2^1 = c_2^{1*}$, it is instead only necessary that the lower bound for c_2^2 be no higher than $\sum_h k_2^h - c_2^1$, which requirement is satisfied if and only if $\omega \geq \hat{\omega}(c_2^{1*})$. This defines a non-empty interval of feasible values for ω if the bounds (3.9) are satisfied (though actually only the upper bound in (3.9) is necessary in this case).

Thus any such point on the offer curve satisfies all of the conditions to be an equilibrium neglecting short-sale constraints, in the case of an asset-purchase policy of the kind defined in the proposition, as long as the lower bound for c_2^1 defined by (3.5) for household 1 is no higher than the assumed value of c_2^1 . This requires that inequality (3.5) be satisfied by the proposed values of c_2^1 , a_2 , and ω . But the fact that (3.11) holds when $\omega = \hat{\omega}(c_2^1)$ implies that (3.5) holds as well (and is a strict inequality); this is just the observation already made earlier, that it is not possible for the leverage

constraint (3.5) to simultaneously bind for both households. Moreover, the fact that the lower bound defined in (3.5) is a monotonically decreasing function of ω implies that (3.5) must also be satisfied in the case of any $\omega \geq \hat{\omega}(c_2^1)$. Hence all conditions for an equilibrium neglecting short-sale constraints, as defined in Definition 4, are shown to be satisfied.

It has already been noted in the above derivation that the implied value of a_2 is a monotonically decreasing function of c_2^1 . The fact that this then implies that the equilibrium value of p_3/p_1 will be a monotonically decreasing function of c_2^1 follows from the discussion in the proof of Proposition 4. \square

This result establishes conditions under which there will exist a continuum of distinct real allocations of resources, each of which corresponds to an equilibrium neglecting short-sale constraints under an appropriate choice of ω . (Only one of these, however, corresponds to an equilibrium in which the leverage constraints do not bind for either household; thus the possibility of obtaining different real allocations and different equilibrium asset prices through variation in the central bank's asset purchases depends on the fact that the leverage constraint binds for household 2.) These will also correspond to distinct possible equilibria of the model with collateral constraints, as long as the additional inequality constraints (3.3) do not bind. This must be checked in addition to the conditions stated in Proposition 5; but since these are inequalities, it is possible for a non-empty interval of values of c_2^1 to satisfy both of them, as we verify through numerical examples below.

Under somewhat stronger assumptions, we can sign the relationship between the change in the central bank's balance sheet and the changes in the endogenous variables that are related to one another in Proposition 5.

Lemma 4 *If preferences are of the form (3.1) with $\gamma \leq 1$, then the value of ω defined by (3.10) is an increasing function of c_2^1 .*

Proof. The offer curve of household 1 consists of the values (c_{01}^1, c_2^1) that satisfy the first-order condition

$$\frac{c_{01}^1}{c_2^1} = \left(\frac{\alpha_{01}}{\alpha_2} \bar{a}_2 \right)^{1/\gamma} \quad (3.12)$$

and budget constraint 3.4) with equality, for any value of \bar{a}_2 . Using (3.12) to substitute for c_{01}^1 in (3.4), and differentiating the resulting relationship between \bar{a}_2 and c_2^1 at any

point where $c_2^1 > k_2^1$, one finds that

$$\begin{aligned}\eta_{a_2, c_2}^1 &\equiv \frac{\partial \log \bar{a}_2}{\partial \log c_2^1} = -\frac{c_{01}^1 + \bar{a}_2 c_2^1}{\bar{a}_2(c_2^1 - k_2^1) + \gamma^{-1} c_{01}^1} \\ &> -\frac{c_2^1}{c_2^1 - k_2^1}.\end{aligned}\tag{3.13}$$

Here the inequality (3.13) relies upon the assumptions that $c_2^1 > k_2^1$ and $\gamma \leq 1$. Note that $\eta_{a_2, c_2}^1 < 0$ as well.

Total differentiation of the relation (3.11) with respect to c_2^1 at any point $c_2^1 > k_2^1$ then yields

$$\frac{d\omega}{dc_2^1} = \frac{\Gamma}{\theta^2 \phi(\bar{a}_2) e_3},\tag{3.14}$$

where

$$\begin{aligned}\Gamma &\equiv 1 - \theta^2 \phi'(\bar{a}_2) [\bar{a}_2 \eta_{a_2, c_2}^1 / c_2^1] \omega e_3 \\ &> 1 - \theta^2 \phi(\bar{a}_2) \omega e_3 / (c_2^1 - k_2^1) = 1 - \frac{g_2^2 - c_2^2}{c_2^1 - k_2^1} = \frac{f_2^2}{c_2^1 - k_2^1} > 0.\end{aligned}\tag{3.15}$$

Here the inequality uses the fact that the definition (2.23) implies that

$$-\phi(\bar{a}_2) < \phi'(\bar{a}_2) \bar{a}_2 < 0,$$

and inequality (3.13); the next equality follows from the fact that (3.5) holds with equality for household 2; and the final equality follows from the market-clearing relation (3.6). The final inequality then follows from the fact that $f_2^2 > 0$ and the assumption that $c_2^1 > k_2^1$. It then follows from (3.14) that ω is an increasing function of c_2^1 . \square

In this case, over the range of values for c_2^1 satisfying the hypotheses of Proposition 5, increases in central-bank holdings of the durable are associated with relaxations of the leverage constraint of the constrained household (household 2) — i.e., a reduction of the lower bound for c_2^2 — as in the partial-equilibrium analysis shown in Figure 2(a). Hence increasing ω results in a movement up the offer curve (away from the endowment point A and toward the Pareto-optimal equilibrium E_2), which must be associated with a decrease in \bar{a}_2 .

In such a case, we can give a clear answer to our questions about the effects of central-bank purchases on both asset prices and goods prices. If ω is increased while

i is held constant, then — over the range of variation in ω for which an equilibrium exists in which constraints (3.3) do not bind — \bar{a}_2 must fall. Proposition 4 then implies that the real price of the durable p_3/p_1 falls, while its nominal price p_3 rises; that the expected return r^{dur} rises, along with the expected return r on riskless debt, but that the spread $\hat{r}^{dur} - \hat{r}$ decreased; and that the money prices of goods and services in period 0 increase, so that aggregate nominal expenditure in period 0 also increases.

3.3 Welfare Consequences of Asset Purchases

We have shown in the previous section that under certain conditions, central-bank purchases of the durable have a variety of effects on real and nominal variables. This means that this dimension of policy is not irrelevant, under circumstances where the leverage constraints of some economic agents bind in equilibrium. Moreover, our results show that the effects of asset-purchase policy are distinct from those of interest-rate policy. For example, if conventional monetary policy is accompanied by the kind of fiscal transfers assumed in Proposition 1, then changes in i have no effect on any real variables or relative prices, and only change the general level of prices in period 0. Our results above show, instead, that under certain conditions, central-bank asset purchases change a variety of relative prices and real rates of return, in addition to their effects on the prices of goods and services in period 0. Since our calculations above were all conducted under the assumption of a fixed value for $(1+i)m$, they would be unaffected by the assumption of a fiscal rule of the kind posited in Proposition 1.

But in judging how best to use this additional dimension of policy, it is important to consider not merely whether asset prices are affected, by how these price changes affect the welfare of economic agents. In fact, the mere fact that central-bank purchases of the durable can loosen a household's leverage constraint does not always imply that the household benefits from such a policy. Consider the shift from equilibrium E_1 to equilibrium E_2 in Figure 3, which results from an increase in central-bank holdings of the durable (under the assumption made in Lemma 4), that reduces the lower bound on c_2^2 for household 2. In this example, household 2 is the one whose collateral constraint binds in equilibrium, and the constraint is relaxed — indeed, it ceases to bind, if purchases are sufficient to shift the equilibrium all the way to point

E_2 . In the absence of any price changes, the situation of household 2 would be the one depicted in Figure 2(a), and the household would clearly benefit. But in fact, in the case shown in Figure 3, the expected utility of household 2 is *reduced* by the policy. This results from the adverse effect on household 2 of the price changes resulting from the policy: these leveraged investors suffer an income loss when the real market price of the debt that they issue falls by more than does the real market price of the risky assets that they purchase, and this loss more than offsets the gain from relaxation of the leverage constraint.

On the other hand, household 1 benefits from the policy change, in the case shown in Figure 3, even though household 1's collateral constraint does not bind. The income effect of the price changes is positive for household 1, for the same reason that it is negative for household 2. One's conclusion about the desirability of the policy change will therefore depend on the relative weight placed on the welfare of households in the two situations.

In fact, the effects of central-bank asset purchases on the welfare of the constrained household depend on how sharply this household is constrained by its leverage constraint; that is, on how close the equilibrium allocation is to the A-D allocation (the allocation in the limiting case in which the leverage constraint no longer binds).

Proposition 6 *In any equilibrium neglecting short-sale constraints of the kind described in Proposition 5, the expected utility of household h is given by $\hat{U}^h(c_2^1)$, the value of the function U^h defined in (3.2) evaluated at the point in the Edgeworth Box that is the unique point on the offer curve of household 1 with this value of c_2^1 . The function $\hat{U}^1(c_2^1)$ is a monotonically increasing function of c_2^1 over the entire range (3.8); thus if asset purchases by the central bank relax the leverage constraint of household 2 (as under the hypothesis of Lemma 4), raising the equilibrium value of c_2^1 , they necessarily increase the welfare of household 1. The function $\hat{U}^2(c_2^1)$, instead, is non-monotonic. In particular, it is necessarily monotonically increasing for values of c_2^1 close enough to k_2^1 , but monotonically decreasing for values of c_2^1 close enough to c_2^{1*} . Over the entire range (3.8), it is on average increasing, since $\hat{U}^2(c_2^{1*}) > \hat{U}^2(k_2^1)$.*

Proof. As explained in the proof of Proposition 5, equilibria neglecting short-sale constraints corresponding to values of c_2^1 in the interval (3.8) involve allocations on the offer curve of household 1, for budget lines corresponding to state prices in the interval $a_2^* \leq \bar{a}_2 \leq a_2^{**}$; moreover, higher values of c_2^1 correspond to lower values of

a_2 (steeper budget lines). For any value of c_2^1 in the interval (3.8), the point on the offer curve is a point on the budget line above and to the left of the endowment point A . It then follows that a decrease in a_2 (steepening the budget line through point A) rotates the budget line so that the point previously preferred by household 1 (indeed, all points on the previous budget line above and to the left of A) is now in the interior of household 1's budget set, so that a point that household 1 strictly prefers is now attainable. Hence the expected utility of household 1 must be monotonically increasing as one moves up the offer curve, so that \hat{U}^1 is a monotonically increasing function of c_2^1 .

The function $\hat{U}^2(c_2^1)$ is obtained by evaluating the expected utility of household 2 as one moves up the offer curve of household 1. For values of c_2^1 close enough to k_2^1 , the offer curve passes through the endowment point A with a slope of $-1/2a^{**}$, the slope of the indifference curve of household 1 through point A . The indifference curve of household 2 through point A is steeper, as noted earlier, as a consequence of (3.7). Hence near point A , the offer curve moves up and to the left from point A with a slope flatter than the indifference curve of household 2, so that the expected utility of household 2 is increasing as one moves up the offer curve. Hence $\hat{U}^2(c_2^1)$ must be an increasing function for values of c_2^1 close enough to k_2^1 . On the other hand, the offer curve must approach the A-D allocation (point E_2 in Figure 3) from below, from a direction that is to the left of the line $\overrightarrow{AE_2}$, and therefore from the interior of the set of points that household 2 prefers to point E_2 (a set bounded by the indifference curve of household 2 passing through E_2 , which is tangent to the line $\overrightarrow{AE_2}$). Hence the expected utility of household 2 is necessarily decreasing as one moves up the offer curve, at least from initial values close enough to the A-D allocation. Thus $\hat{U}^2(c_2^1)$ must be a decreasing function of c_2^1 for all values of c_2^1 close enough to c_2^{1*} . Finally, the total change in the value of $\hat{U}^2(c_2^1)$ as one moves up the offer curve from the endowment point to the A-D allocation must be positive, since the endowment point A is also a point on the budget line $\overrightarrow{AE_2}$ associated with the A-D equilibrium, and household 2 must strictly prefer point E_2 to this point, as shown in Figure 3. \square

This result shows that the fact that in Figure 3, household 2 is harmed by the policy that relaxes its leverage constraint, is no error in the drafting of the figure; this is necessarily the case if the asset-purchase policy moves the economy to the A-D equilibrium E_2 from any sufficiently nearby equilibrium E_1 in which household 2's

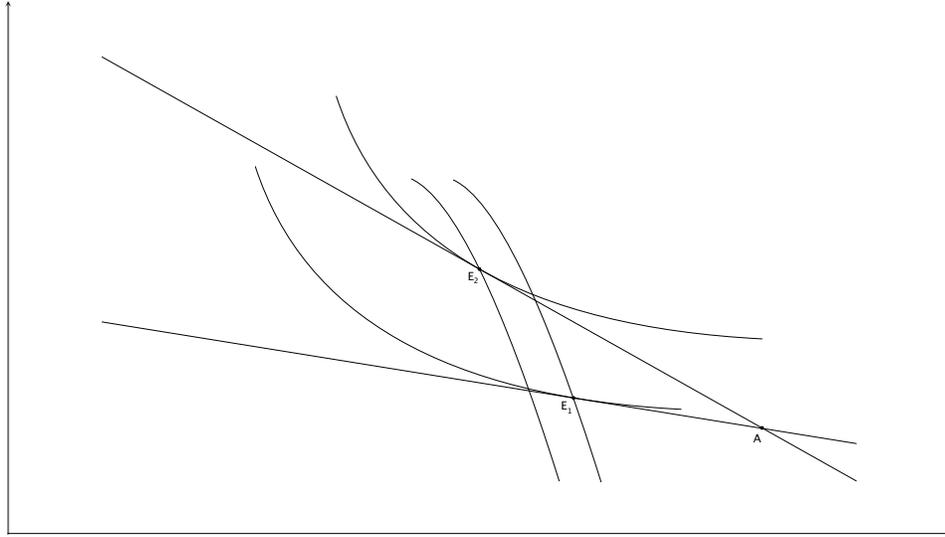


Figure 4: Another example of equilibria in the case of two households and two states, showing the possibility of a Pareto improvement as a result of central-bank asset purchases.

leverage constraint binds. However, the proposition also implies that it is possible for an increase in the central bank's holdings of the durable to increase the welfare of *both* types of households. This possibility is illustrated graphically in Figure 4. In this figure, central-bank purchases of the durable again reduce the lower bound for c_2^2 implied by household 2's leverage constraint (3.5), but not by enough for household 2's leverage constraint to cease to bind. In the case shown, equilibrium E_2 is strictly preferred by both households to the original equilibrium E_1 ; hence there is a clear benefit from central-bank asset purchases in this case. This result depends on the indifference curves of household 2 being a good deal steeper than those of household 1, in both equilibria; in other words, the Lagrange multiplier associated with the leverage constraint for household 2 is substantial.

Figure 4 only illustrates the possibility of a Pareto improvement to the extent that the equilibria neglecting short-sale constraints shown in the Figure are actually equilibria of the model with collateral constraints; that is, that the short-sale constraints (3.3) are satisfied for both households in the allocations corresponding to both points E_1 and E_2 . We show through numerical examples in the next section that this can be the case.

4 Distortions Resulting from Central-Bank Monopolization of Collateral

In the previous section, we have emphasized the possibility of equilibria in which the collateral constraints bind for some households in the way shown in Figure 2(a) — what we have called a binding leverage constraint — rather than binding in the way shown in Figure 2(b), the case of a binding short-sale constraint. This does not mean, however, that the short-sale constraint cannot also be relevant in equilibrium; our numerical examples below show that either or both of the two types of constraints may bind, depending on parameter values. Indeed, it is worth remarking that sufficiently *large* asset purchases by the central bank will almost certainly create a situation in which many households are constrained in the way shown in Figure 2(b).

When ω approaches 1, so that most of the durable is held by the central bank, equilibrium will necessarily involve many households holding more money than durables, so that they will be at a position not far from the upper boundary of the grey region shown in Figures 1 and 2. (Recall that the upper boundary corresponds to portfolios made up solely of riskless assets.) Equilibrium will require asset prices that lead households to choose points in that region; and assuming some degree of heterogeneity in the endowment patterns of the different households, it will almost certainly be the case that many households are driven entirely to the boundary (so that they would like to short the durable, at the equilibrium prices, but are unable to), while the (now very expensive) durable is held only by those households with the greatest desire to shift more income into state 1 than into state 2. Hence except in very special cases (such as the one assumed in Proposition 3), as $\omega \rightarrow 1$, one will eventually have an equilibrium in which the short-sale constraint binds for many households, while none may be constrained in the way shown in Figure 2(a).

This will mean that while the central bank will still be able to further increase the price of the durable by purchasing more of it, these effects will surely be achieved by tightening traders' financial constraints, rather than relaxing them. Moreover, this tightening of financial constraints will necessarily reduce welfare for many (though not necessarily all) households. If nearly all collateral is held by the central bank, risk-sharing between households ceases to be possible, as does borrowing; households can only obtain an expenditure pattern different from that determined by their endowments by accumulating non-negative money balances. In addition to preventing

mutually beneficial trades, the fact that the policy raises the price of the durable good redistributes period 0 income from households with shares of the aggregate endowment of durables less than θ^h to households with shares greater than θ^h . The latter benefit from this redistribution, but the former are hurt. Thus central-bank asset purchases on too large a scale will necessarily have significant costs, owing to the impairment of the functioning of financial markets that predictably results from an induced scarcity of collateral.

We illustrate this point with numerical examples. In each of the examples, there are two states in period 1, and the economy has two types of household $h = 1, 2$, each with a utility function of the form

$$u^h(x) = \sum_{l=1}^2 \log(x_l) + \frac{1}{2} \sum_{s=1}^2 \sum_{l=1}^2 \log(x_{sl}). \quad (4.1)$$

Note that preferences of this form are both homothetic in the sense assumed in section 2.2 and thereafter, and satisfy the additional restriction (3.1), for the value $\gamma = 1$. This value of γ also satisfies the stronger hypothesis of Lemma 4, so that all of our analytical results above to the examples considered in this section.

4.1 Relevant Dimensions of Variation in Endowment Patterns: The Log Utility Case

In our numerical examples, we consider not only the effects of variation in ω on the various endogenous variables, holding fixed the other exogenous parameters, but also the way in which the nature of equilibrium, and the corresponding effects of unconventional policy, vary as a result of changes in the assumed endowment patterns of the households. An advantage of the log utility specification (4.1) is that in this case, the properties of the equilibria of interest do not depend on the aggregate endowments of the different goods at the different dates and in different states, but only upon the *shares* of the aggregate endowment of each type that are held by each of the household types. This reduces the number of parameters that need to be varied in order to explore all of the ways in which alternative endowment patterns can result in different types of equilibria.

Let us define endowment shares

$$s_1^h \equiv \frac{e_1^h}{\sum_h e_1^h}, \quad s_3^h \equiv \frac{e_3^h}{\sum_h e_3^h}, \quad s_{s1}^h \equiv \frac{e_{s1}^h}{\sum_h e_{s1}^h} \quad (s = 1, 2)$$

for each of the households h ; feasibility requires that these each be non-negative, and that the sum of the shares of each type (over all households $h \in \mathcal{H}$) equal 1. Let us also define

$$s_m^h \equiv \frac{(1+i)m^h}{p_{21} \sum_h e_{21}^h + p_{22} \sum_h e_3^h},$$

indicating the tax revenues that must be raised in period 1 to redeem the money endowment of household h , inclusive of the interest paid on it, as a share of the value of the economy's aggregate endowment in state 2 (the state in which durables are less valuable). Then we can establish the following equivalence result.

Lemma 5 *Let \mathcal{E} and \mathcal{E}' be two economies, in each of which each household has preferences of the form (4.1). Suppose furthermore that the values of the share parameters $\{s_1^h, s_3^h, s_{s1}^h, s_m^h, \theta^h\}$ are the same for both economies, and that the price ratio $\rho \equiv p_{12}/p_{22}$ is also the same for both economies. (Note, however, that the aggregate endowments $\sum_h e_1^h, \sum_h e_3^h, \sum_h e_{s1}^h, \sum_h m^h$ and the future price-level commitments p_{s1} may be different in the two economies.) Then for any value of ω and any equilibrium of economy \mathcal{E} associated with this policy, there is a corresponding equilibrium of economy \mathcal{E}' for the same value of ω , in which the consumption shares*

$$\hat{x}_1^h \equiv \frac{x_1^h}{\sum_h e_1^h}, \quad \hat{x}_2^h \equiv \frac{x_2^h}{\sum_h e_3^h}, \quad \hat{x}_{s1}^h \equiv \frac{x_{s1}^h}{\sum_h e_{s1}^h}, \quad \hat{x}_{s2}^h \equiv \frac{x_{s2}^h}{\sum_h e_3^h}$$

are the same, the normalized intertemporal transfers⁴³

$$\hat{y}_s^h \equiv \frac{\tilde{y}_s^h - (1+i)m^h/p_{s1}}{\sum_h k_s^h}$$

are the same, and the normalized state prices⁴⁴

$$\hat{a}_s \equiv a_s \cdot \frac{\sum_h k_s^h}{\sum_h e^h}$$

are the same. It follows that the normalized real value of the aggregate initial money endowment

$$\hat{m} \equiv \frac{m}{p_1 \sum_h e^h}$$

⁴³Here we again use the notation $\sum_h k_s^h \equiv \sum_h [f_s^h + g_s^h] = \sum_h [e_{s1}^h + (p_{s2}/p_{s1})e_3^h]$.

⁴⁴Here we again use the notation $e^h \equiv e_1^h + (p_2/p_1)e_3^h$ for the value of the household's "total non-durable endowment" in period 0.

will be the same in the corresponding equilibria of the two economies, as will be the normalized real price of the durable asset,

$$\hat{p}_3 \equiv \frac{p_3 \sum_h e_3^h}{p_1 \sum_h e^h}.$$

Hence conclusions about the effects of varying ω , both on the period 0 price level (and aggregate nominal expenditure) and on the equilibrium price (both nominal and real) of the durable asset, will be the same (in percentage terms) for both economies. Moreover, if the utility of household h in the equilibrium of economy \mathcal{E} is U^h , then the utility of that household in the equilibrium of economy \mathcal{E}' is $U^h + \kappa^h$, where the constant κ^h depends only on the aggregate endowments of the two economies, but is the same for different equilibria corresponding to different asset-purchase policies ω . Hence utility comparisons between the equilibria associated with different asset-purchase policies are the same for both economies.

Proof. Preferences of the form (4.1) have the property that each household's utility $u^h(x^h)$ is equal to an expression of the form $\hat{u}^h(\hat{x}^h)$ plus a constant which depends only on the aggregate endowment pattern. Hence the household's decisions can be modeled as maximizing \hat{u}^h , and we can reformulate the household's decision problem in terms of its choice of a relative consumption plan \hat{x}^h , without having to specify the implied absolute consumption levels.

As above, the homotheticity of preferences implies that each household must choose to consume goods 1 and 3 in any state in the ratio of the aggregate endowments of those goods in that state, so that we can further reduce a household's choice of a relative consumption plan to its choice of an intertemporal relative expenditure plan $(\hat{c}^h, \hat{c}_1^h, \hat{c}_2^h)$, where we define

$$\hat{c}^h \equiv \frac{c^h}{\sum_h e^h}, \quad \hat{c}_s^h \equiv \frac{c_s^h}{\sum_h k_s^h}.$$

Log utility has the additional, stronger implication that

$$\frac{p_2 \sum_h e_3^h}{p_1 \sum_h e^h} = \frac{p_{s2} \sum_h e_3^h}{p_{s1} \sum_h k_s^h} = \frac{1}{2} \tag{4.2}$$

in each state, as a consequence of (2.9).

The household decision problem can then be expressed as the choice of a plan $(\hat{c}^h, \hat{c}_1^h, \hat{c}_2^h, \hat{y}_1^h, \hat{y}_2^h)$ to maximize

$$\hat{u}^h = \log \hat{c}^h + \frac{1}{2} \log \hat{c}_1^h + \frac{1}{2} \log \hat{c}_2^h$$

subject to the constraints

$$\hat{c}^h + \hat{a}_1 \hat{y}_1^h + \hat{a}_2 \hat{y}_2^h \leq \hat{e}^h + \hat{a}_1 \hat{f}_1^h + \hat{a}_2 \hat{f}_2^h;$$

$$\hat{c}_s^h \leq \hat{g}_s^h + \hat{y}_s^h, \quad \text{for } s = 1, 2;$$

$$\rho \hat{y}_2^h \leq \hat{y}_1^h - \theta^h \frac{\rho - 1}{2} \omega;$$

and

$$\hat{y}_2^h \geq -\theta^h \hat{\phi}(\hat{a}) \omega - s_m^h;$$

where

$$\hat{\phi}(\hat{a}) \equiv \frac{(\rho - 1)\hat{a}_1}{2\hat{a}_1 + 2\rho\hat{a}_2},$$

and we define the additional normalized quantities

$$\hat{e}^h \equiv \frac{e^h}{\sum_h e^h} = \frac{s_1^h + s_3^h}{2},$$

$$\hat{f}_s^h \equiv \frac{f_s^h - (1+i)m^h/p_{s1}}{\sum_h k_s^h} = \frac{s_3^h}{2},$$

$$\hat{g}_s^h \equiv \frac{g_s^h + (1+i)m^h/p_{s1}}{\sum_h k_s^h} = \frac{s_{s1}^h}{2} + \rho^{s-2}(s_m^h - \theta^h \sum_h s_m^h).$$

(Here we have repeatedly used (4.2) to simplify the expression of the constraints.)

An equilibrium can then be defined as a collection of normalized household plans and normalized state prices \hat{a}_s such that each household's normalized plan solves the problem stated in the previous paragraph, and in addition, for each $s = 1, 2$,

$$\sum_h \hat{y}_s^h = \sum_h \hat{f}_s^h.$$

Since both the household problems and the market-clearing conditions can be written entirely in terms of the normalized household plans, the normalized state prices, the share parameters, the price ratio ρ , and the policy parameter ω , it follows that if economies \mathcal{E} and \mathcal{E}' have the same share parameters and the same value for ρ and

ω , the possible equilibria must also be identical, to the extent that those equilibria are described in terms of the normalized household plans and the normalized state prices.

Moreover, (2.10) implies that

$$\hat{m} = [\rho^{-1}\hat{a}_1 + \hat{a}_2] \sum_h s_m^h,$$

so \hat{m} will be the same in corresponding equilibria of the two economies as well. This implies that the percentage change in p_1 (and in aggregate nominal expenditure in period 0, the quantity $p_1 \sum_h c^h = p_1 \sum_h e^h$) caused by a given change in ω will be the same for both economies. Similarly, (2.11) implies that

$$\hat{p}_3 = 1 + \left(\frac{p_3 - p_2}{p_1} \right) \frac{\sum_h e_3^h}{\sum_h e^h} = 1 + \frac{\hat{a}_1 + \hat{a}_2}{2},$$

so that \hat{p}_3 will be the same in corresponding equilibria of the two economies as well. This implies that the percentage change in both p_3 and in p_3/p_1 caused by a given change in ω will be the same for both economies.

Finally, each household's utility is given by the quantity \hat{u}^h (which depends only on its normalized expenditure plan), plus a constant that depends only on the economy's aggregate endowment of the various goods in the various states. So the increase in \hat{u}^h in moving from one equilibrium to another is equal to the increase in u^h . Thus our conclusions about the effects of asset-purchase policies on the welfare of each household type will also be the same for economies \mathcal{E} and \mathcal{E}' . \square

Hence the alternative numerical values that need to be considered, if we assume preferences of the form (4.1) and only two household types, as in the examples considered in this section, can be reduced to eight real numbers: $\theta^1, s_1^1, s_3^1, s_{11}^1, s_{21}^1, s_m^1, s_m^2$, and ρ .⁴⁵ If (as here) we restrict attention to economies in which money endowments are small, we need only consider alternative points in a five-dimensional space.

In the examples below, we give particular attention to the consequences of variation in the values of s_{11}^1 and s_{21}^1 , indicating the relative endowments of the non-durable good in each of the two possible states in period 1, holding fixed the household's period-0 endowments. Variation in these parameters allows us to show how the way

⁴⁵Note that in the case of parameters indicating tax shares and endowment shares, a specification of household 1's share implies a value for household 2's share as well, as the shares must sum to 1.

in which the collateral constraints bind depends on the nature and degree of the heterogeneity in the hedging demands of the two household types, owing to differences in their state-contingent period-1 income unrelated to their portfolio choices. We use the algorithm described in Schommer (2013) to numerically solve for the collateral-constrained equilibrium associated with each possible parameter configuration.

In each of several figures, we consider how the character of equilibrium changes as s_{11}^1 varies between 0 and 1 (on the horizontal axis) and s_{21}^1 varies between 0 and 1 (on the vertical axis). We use the following shorthand to report the way in which the collateral constraints bind in a given equilibrium. “ SC^h ” means that the short-sale constraint (2.21) binds for household h , while “ LC^h ” means that the leverage constraint (2.22) binds for household h . Thus the notation “ LC^1, SC^2 ” means that the leverage constraint of household 1 binds *and* that the short-sale constraint of household 2 binds, in the same equilibrium. We use the notation “ AD ” (since the equilibrium of our model coincides with the Arrow-Debreu equilibrium in this case) if neither constraint binds for any household.

Several figures also report, for the same range of variation in the period-1 endowment patters, the signs of the derivatives with respect to ω of the expected utilities of each of the two household types, evaluated at the particular value of ω for which the figure is drawn. Plus and minus signs are used to indicate these signs: thus “++” means that the welfare of both types increases when ω is increased by a small enough amount (the case shown in Figure 4 above), “+ -” means that the welfare of household 1 increases while that of household 2 decreases (the case shown in Figure 3 above), and so on. In the case of an A-D equilibrium, to which Proposition 2 applies, we write “00” to indicate that both derivatives are zero.⁴⁶

4.2 Example 1: Symmetric Initial-Period Endowments

In this example, we assume that both households have equal endowments of both the non-durable and durable goods in period 0 ($s_l^h = 0.5$, for $h = 1, 2$ and $l = 1, 3$), and that tax shares are equal as well ($\theta^h = 0.5$ for $h = 1, 2$). Money endowments are also

⁴⁶There are never open regions of parameter space over which either derivative is exactly zero, except the region to which Proposition 2 applies, in which case both derivatives must be zero simultaneously.

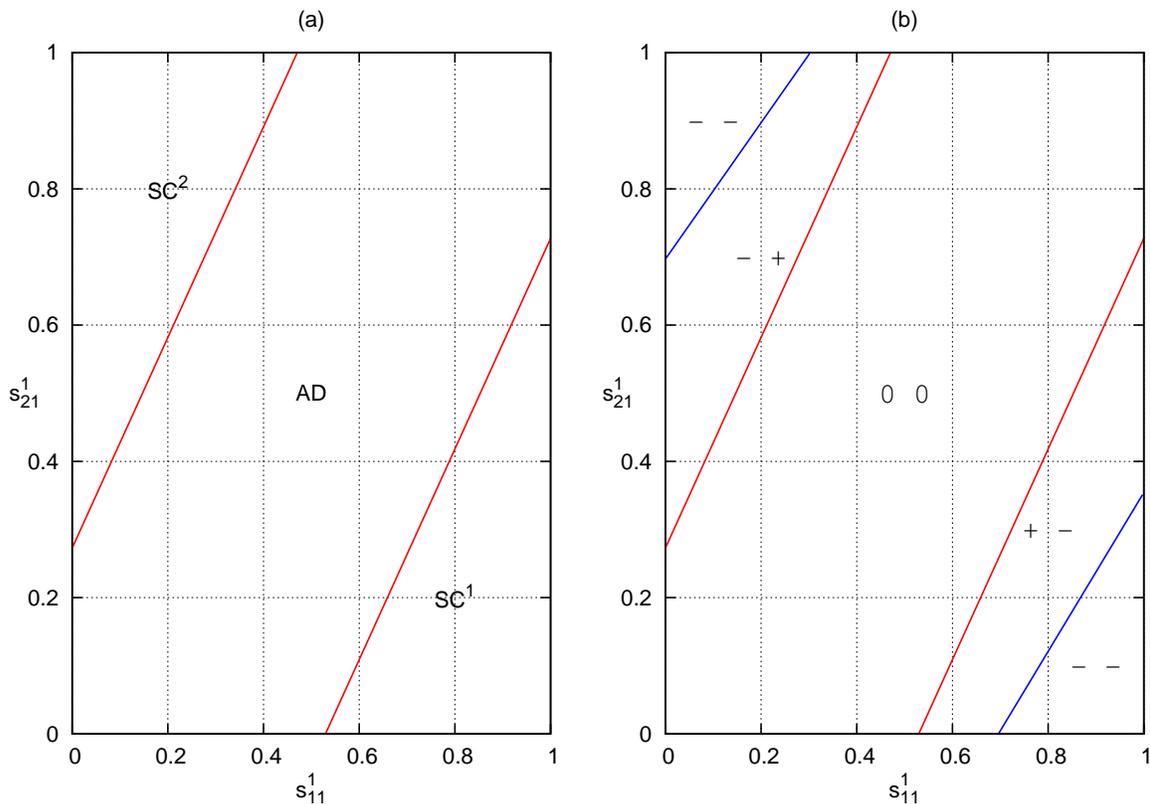


Figure 5: Example 1 with $\omega = 0$: (a) regions where collateral constraints bind; (b) welfare effects of a small increase in ω .

assumed to be equal, and of negligible magnitude.⁴⁷ We assume that the aggregate non-durable good endowment in state 1 is $15/7$ times the aggregate endowment of the durable good, while in state 2 it is only $6/7$ times the durable endowment; (4.2) then implies that $p_{12}/p_{11} = 15/7$ in state 1, while $p_{22}/p_{21} = 6/7$ in state 2. We also assume a period 1 monetary policy commitment to achieve the same inflation rate regardless of the state, so that $p_{11} = p_{21}$; hence $\rho = 5/2$ in this example. Thus the nominal value of the durable in state 2 is only 40 percent of its value in state 1.⁴⁸ The collateral requirement for debt that defaults in state 2 but not in state 1 is

⁴⁷In the numerical results reported, we assume that $m^h = 0.0005$ for $h = 1, 2$; that $i = 0.1$; that $p_{11} = p_{21} = 1$; and that the aggregate non-durable endowment in state 2 is 6; so that $s_m^h = 0.000046$ for $h = 1, 2$.

⁴⁸Note that only the implied value of ρ matters for our conclusions below, and not our specific assumptions about aggregate endowments or monetary policy individually, as a consequence of

accordingly $C_1 = 7/15$, while the collateral requirement for riskless debt is $C_2 = 7/6$.

We first consider the kind of equilibrium that results in this case when $\omega = 0$ (the central bank holds none of the durable asset), for alternative assumptions about the households' relative shares of the period 1 non-durable endowment. Panel (a) of Figure 5 shows which collateral constraints bind in equilibrium, for alternative possible values of s_{11}^1 and s_{21}^1 .⁴⁹ As required by Proposition 3, in the symmetric case ($s_{s1}^1 = 0.5$ for $s = 1, 2$), no collateral constraints bind, and we effectively have an A-D equilibrium. The figure shows that this continues to be true for specifications which are not perfectly symmetrical, but in which the endowment patterns of the two types are sufficiently similar. In particular, as long as the non-durable endowment shares are sufficiently *similar in the two states* that are possible in period 1, we have an A-D equilibrium, regardless of whether one household has a larger share of the period 1 endowment in both states.

The fact that the two households may have different motives to save (because one has more income in period 1 than in period 0, while the other has less) is not in itself a reason for any household's collateral constraint to bind. As long as each household's relative endowments in the two states is similar to the relative aggregate endowment in these states (that is, a non-durable endowment in state 2 that is about 40 percent of the size of the household's state 1 endowment), then households' desired intertemporal trade can largely occur simply by adjusting their holdings of the durable; and even if one household holds *all* of the period-1 non-durable endowment in both states (and therefore has the strongest possible motive to borrow), it can equalize its consumption share over time (consuming 5/8 of the aggregate supply of both goods in each state at each date) by selling half of its initial durable endowment in period 0, and thus entering period 1 (in either state) owning all of the non-durable endowment but only 1/4 of the aggregate supply of durables (worth 5/8 of the total supply of non-durable and durable goods, in either state). Thus for all points close enough to the diagonal in Figure 5(a), even the household with the smaller period-1 endowments continues to hold some of the durable and issues little debt, so that its collateral constraint does not bind.

If, instead, the non-durable endowment shares are sufficiently different in the two

Lemma 5.

⁴⁹Here and in all of the numerical examples discussed below, there is a unique equilibrium for each endowment pattern and policy considered.

possible states in period 1, one household's collateral constraint will bind, while the other remains unconstrained. The constrained household is the one that has a large share of the non-durable endowment in state 1, but a small share in state 2 (household 1 in the lower right region of the figure, household 2 in the upper left region); and the constraint that binds is the short-sale constraint (2.21). Thus in equilibria in the lower right region (labeled “ SC^1 ”), household 1 is constrained in the way shown in Figure 2(b). Because household 1 has a larger endowment share in state 1, it would prefer a portfolio that paid off more in state 2 than in state 1; but this would require it to take a *short* position in the durable (that is worth more in state 1 than in state 2), which it cannot do because of the collateral constraint.

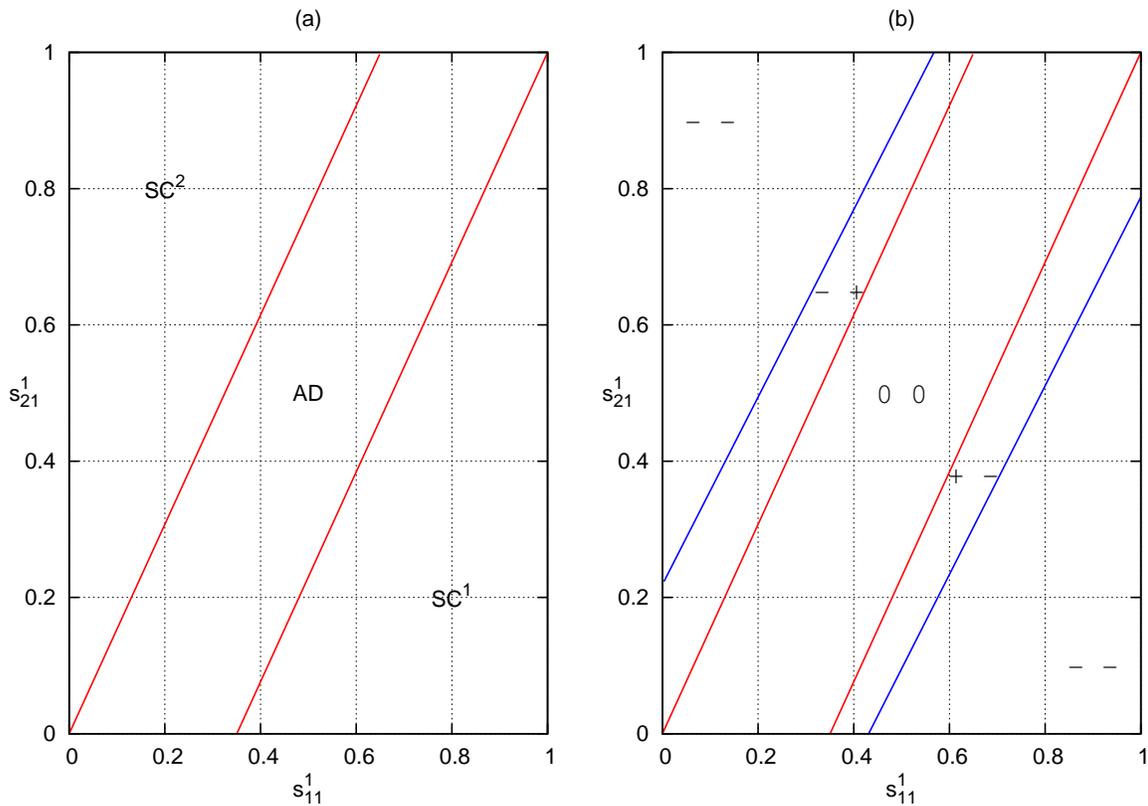


Figure 6: Example 1 with $\omega = 0.5$: (a) regions where collateral constraints bind; (b) welfare effects of a small increase in ω .

We turn to the question of how welfare is affected by small asset purchases by the central bank (a small increase in ω). Panel (b) of Figure 5 indicates for each of the cases the sign of the derivative of the utility level of each of the household types with

respect to ω . In the case of economies in the diagonal region (labeled “ AD ”) in panel (a), (sufficiently small) asset purchases have no effect on the equilibrium allocation of resources, by Proposition 2; hence there is no effect on welfare, and this region is labeled “ 00 ” in panel (b). When the relative endowments of the two types are sufficiently different in the two states, instead, asset purchases tighten the collateral constraint of the constrained household type, as shown in Figure 2(b).

The partial-equilibrium effect shown in that figure, however, does not suffice to sign the welfare effects. In order for markets to clear, the price of the durable rises, and this results in a positive income effect for the constrained household (a net seller of durables, since its short-sale constraint binds), and a negative one for the unconstrained household (that must be a net buyer). When the collateral constraint does not bind too tightly (so that the welfare effects of a small further tightening of the constraint are modest), this is the dominant effect, and the welfare of the constrained household is improved by central-bank purchases of the durable, while the welfare of the unconstrained household is reduced. Thus in Figure 5(b), the region just below and to the right of the diagonal region is labeled “+ -”, indicating that the utility of household 1 increases while that of household 2 decreases.

In the case of an even more asymmetric endowment pattern, however, the distortion associated with the constrained household’s binding collateral constraint is larger, and the consequences for welfare of further tightening of the constraint (shown in Figure 2(b) if one neglects the effects of price changes) are more substantial. For a sufficiently asymmetric endowment pattern, this becomes the dominant effect on the welfare of the constrained household; in such cases (indicated by the upper left corner and lower right corner of Figure 5(b)), the welfare of both household types is reduced by central-bank asset purchases. Such a policy change would thus be unambiguously undesirable.

In Figure 6, we instead assume an initial level of central-bank holdings of the durable of $\omega = 0.5$, and consider the effects of small additional asset purchases beyond that level. Figure 6 has the same format as Figure 5. In panel (a), we again observe that no collateral constraints bind for endowment patterns along the diagonal; but now the region labeled “ AD ” is a narrower strip around the diagonal. As the central bank purchases a larger share of the aggregate supply of the durable, the restrictions required in order for the collateral constraints not to bind become progressively more stringent; in fact (though we do not show this in a figure), for

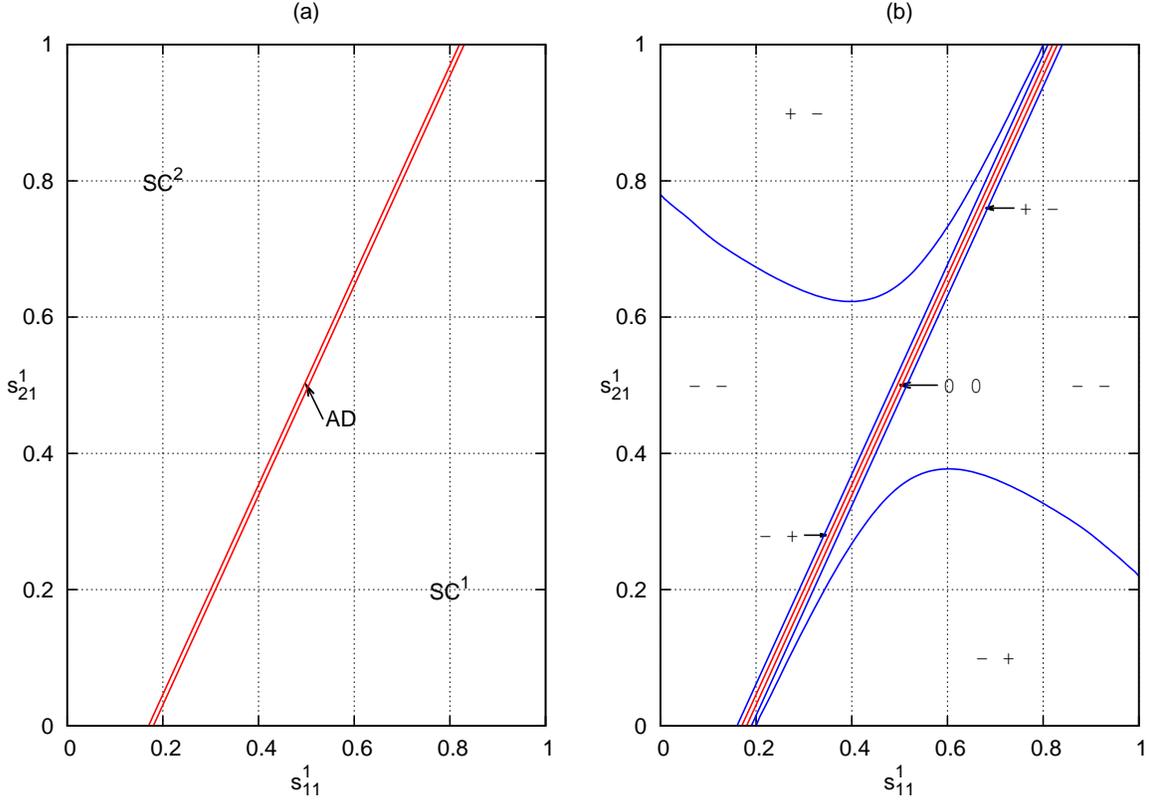


Figure 7: Example 1 with $\omega = 0.98$: (a) regions where collateral constraints bind; (b) welfare effects of a small increase in ω .

almost all possible endowment patterns, the collateral constraint eventually binds for one of the households, if ω is made large enough. Again, in this example, it is always the short-sale constraint rather than the leverage constraint that binds; and the welfare effects in the case of endowment patterns far enough from the diagonal are qualitatively the same as in the $\omega = 0$ case. However, when ω is larger, the degree of asymmetry in the period-1 non-durable endowments required in order for further asset purchases to reduce the welfare of both households is less extreme, as shown in panel (b) of this figure.

Figure 7 shows how the results change if the central bank's share of the durable is increased still further. Further increases in ω continue to shrink the range of period-1 endowment patterns for which neither household's short-sale constraint binds; as shown in panel (a), by the time $\omega = 0.98$, both households' short-sale constraints

fail to bind only in the case of endowments in a very narrow diagonal strip.⁵⁰ The regions near the “*AD*” region in which the short-sale constraint binds to such a mild extent that the household with the binding constraint *benefits* from additional asset purchases, despite the fact that such purchases tighten its short-sale constraint (e.g., the region below the diagonal region “00” in panel (b), labeled “+ -”), also become very narrow strips. In most of the plane, the welfare of the household with the binding short-sale constraint is reduced by further central-bank asset purchases. However, in the case of large enough values of ω , it is no longer always the case that the *unconstrained* household is harmed. As shown in panel (b) of this figure for the case $\omega = 0.98$, if the unconstrained household has a sufficiently large share of the aggregate endowment, then its welfare is increased by additional asset purchases, though the constrained household is harmed.

The effects of central-bank purchases over the entire range of possible values of ω are shown for an illustrative example in Figure 8. In the case considered here, type 1 households own all of the non-durable goods endowment in state 1, while type 2 households own the entire endowment in state 2. (This endowment pattern corresponds to the point in the lower right corner of the panels in Figures 5 through 7.) These endowments are sufficiently asymmetric for household 1’s short-sale constraint to bind, regardless of the value of ω . In this case, further central-bank purchases of the durable progressively *reduce* aggregate nominal spending, as shown by the monotonic decline in p_1 in panel (a). Nonetheless, the price p_3 of the durable is *increased*, until central-bank holdings of the durable reach nearly 60 percent of the total supply.⁵¹ Thus the mere fact that asset purchases raise the price of the asset is not sufficient to imply that such purchases increase aggregate demand.

Nor does it suffice for one to conclude that welfare is increased. As shown in panel (b) of Figure 8, the welfare of household 1 is monotonically decreasing in ω in

⁵⁰The “*AD*” region no longer includes the entire diagonal, but is instead a narrow strip somewhat steeper than the diagonal, because in our numerical example households do have positive (though small) initial endowments of money, and these are important for the location of the boundaries of the “*AD*” region for values of ω close enough to 1.

⁵¹In panel (a) of this figure, as in Figure 12(a) below, what is plotted is not the prices themselves, but the amount by which the log price changes relative to its equilibrium value when $\omega = 0$. Thus, for example, p_1 is 2 percent lower when $\omega = 0.2$ than when $\omega = 0$, for the assumed values of the other parameters.

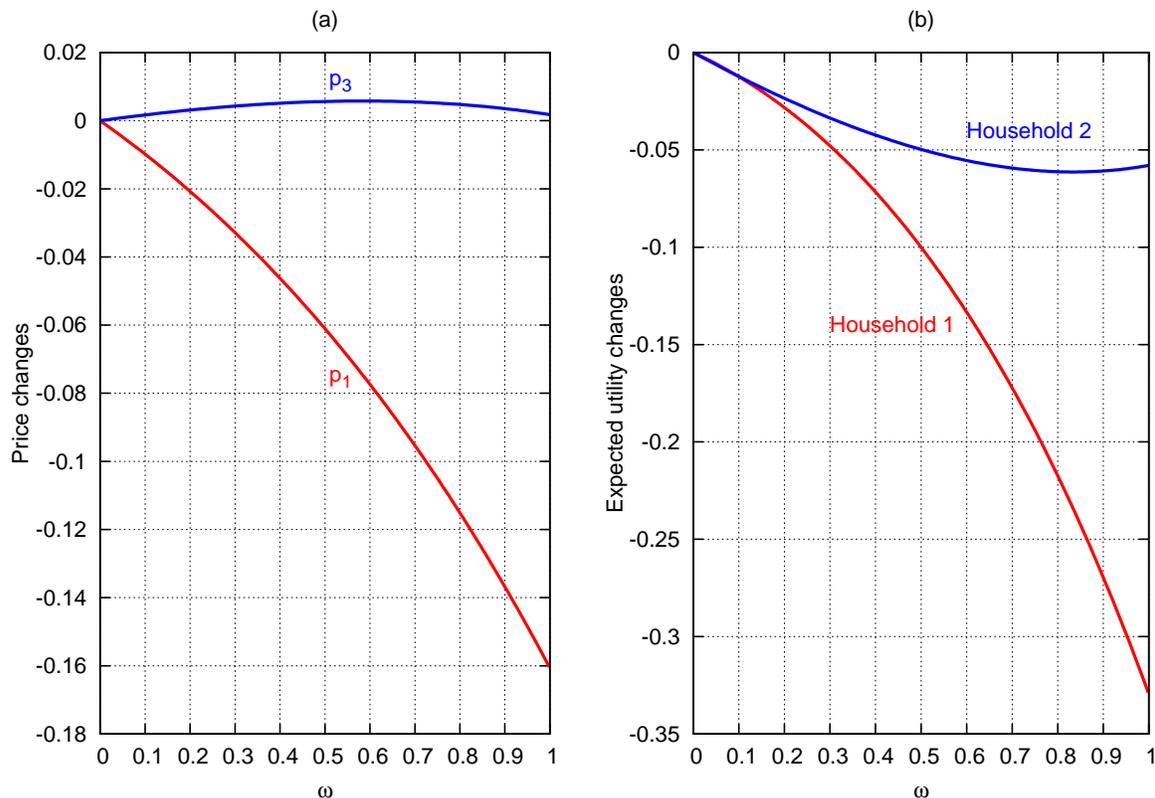


Figure 8: Effects of variation in ω over its entire feasible range, for Example 1 when $s_{11}^1 = 1, s_{21}^1 = 0$: (a) effects on prices; (b) welfare consequences.

this example, over the entire feasible range of values.⁵² The welfare of household 2 is also decreasing as ω increases, until the central bank already holds more than 80 percent of the total supply, though for very high values of ω , further asset purchases raise these households' level of expected utility somewhat.⁵³ Thus everyone's welfare is reduced, in all of the cases in which the policy raises the price of the durable; at the same time, at least some can benefit, when the policy *reduces* the asset price to a

⁵²In panel (b) of this figure, as in Figure 12(b) below, what is plotted is not the absolute value of U^h for each household, but rather the amount by which U^h differs from the level of expected utility when $\omega = 0$. Thus the fact that the "household 2" curve is above the "household 1" curve in the figure does not mean that household 2 has a higher level of expected utility, but that its utility has been *decreased by less* as a result of the central-bank purchases. In fact, household 1 has the higher level of expected utility, for all of the cases shown in this figure.

⁵³This last observation is consistent with the fact that this point belongs to the region labeled "-+" in Figure 7(b).

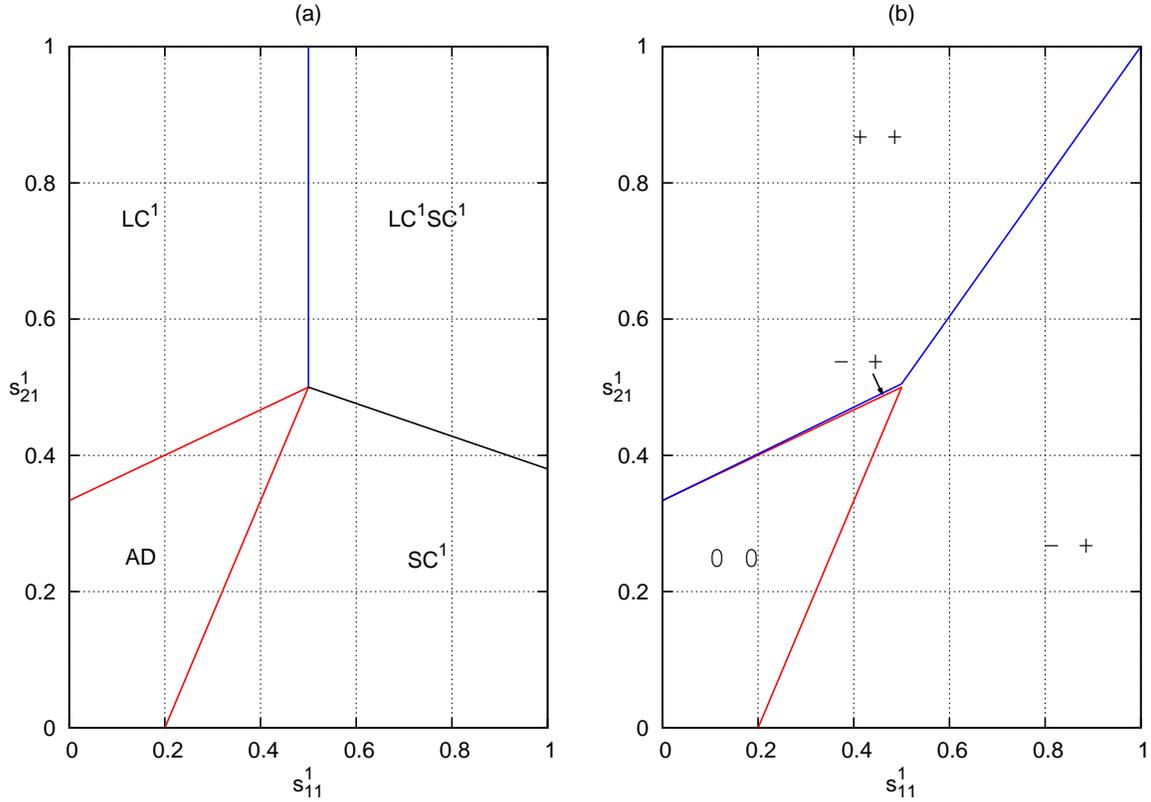


Figure 9: Example 2 with $\omega = 0$: (a) regions where collateral constraints bind; (b) welfare effects of a small increase in ω .

sufficient extent. Even in this last case, however, the reduction in the welfare of type 1 as ω increases is greater than the increase in the welfare of type 2; and the equilibria with very high values of ω are in any event Pareto dominated by those with low values of ω (even if they are not Pareto dominated by the equilibria associated with only *slightly* lower values of ω). Hence in this example, central-bank asset purchases are clearly undesirable.

4.3 Example 2: Leverage-Constrained Investors

We now illustrate how a greater degree of asymmetry in the situations of the two household types can make possible equilibria in which the “natural buyers” of the risky asset are constrained (by the collateral requirement) in their ability to make as large a leveraged position in this asset as they would otherwise wish. Aggregate

endowments (and hence the value of ρ) are the same as in Example 1, and we again assume that $s_1^h = 0.5$ for $h = 1, 2$; but now we assume that only households of type 2 are initially endowed with the durable good ($s_3^1 = 0$). We also now assume asymmetric tax shares: $\theta^1 = 0.9, \theta^2 = 0.1$. (The larger tax share for type 1 in this example amplifies the effects of central-bank asset purchases on the collateral constraints of this type; recall that the shifts in the feasible regions shown in Figure 2 are proportional to θ^h .) We continue to assume that money endowments are very small.⁵⁴

We again plot numerical results for alternative values of s_{11}^1, s_{21}^1 in the plane. Figure 9 is for the case in which the central bank holds none of the durable asset. Along the diagonal in panel (a), we again have economies in which period-1 non-durable endowments are the same for the two households, and hence in which every household's endowment income in state 1 relative to that in state 2 is in the same ratio as the relative payoff of the durable asset in the two states. It thus again follows (in the limiting case of zero money endowments) that the A-D allocation could be supported purely through trade in the durable. The difference is that now households of type 1 have no initial endowment of the durable, so that the required trade might involve a short sale of the durable by these households (which is not allowed by the collateral constraint). This is in fact the case if households of type 1 have a large enough share of the period-1 endowment income, so that they wish to borrow against their period-1 income in order to smooth their consumption level over time. Thus in Figure 9(a), the “AD” region no longer includes all of the diagonal. For points near the diagonal with $s_{11}^1, s_{21}^1 < 1/2$, the A-D allocation can be supported with positive holdings of the durable by both types (and net positions near zero in the riskless asset for both); but for points near the diagonal with $s_{11}^1, s_{21}^1 > 1/2$, we instead have an equilibrium in which *both* constraints (2.21)–(2.22) bind for type 1. This means that type 1 households choose to be at the corner of the grey region in Figure 1(a), corresponding to a zero position in both the durable and the riskless asset.

Figure 9(a) also differs from Figure 5(a) in that in the region above the “AD” region, we now have equilibria in which constraint (2.22) binds for households of type

⁵⁴The aggregate money endowment is again of the same size as in Example 1. But as in that example, we assume that initial money endowments are distributed between the two types in proportion to their tax shares, so that now $m^1 = 0.0009, m^2 = 0.0001$.

1.⁵⁵ In these cases, households of type 1 have a substantial period-1 endowment in state 2, but not in state 1. This makes households of type 1 the “natural buyers” of the durable, as the durable (which is worth more in state 1 than in state 2) allows them to hedge their endowment risk, whereas the opposite is true for type 2 (who need to reduce their holdings of the durable in order to hedge their endowment risk). In Example 1, this kind of asymmetry, if pronounced enough, resulted in an equilibrium in which the short-sale constraint bound for households of type 2. But now, with the durable asset initially held entirely by type 2, there is never a problem of household 2 wishing to take a short position in that asset. Instead, the constraint that prevents implementation of the A-D allocation is the *leverage* constraint of type 1: because households of type 1 initially own none of the durable (and do not have a large period-0 endowment of the non-durable good with which to purchase it, either), they need to borrow in order to acquire enough of the durable good for efficient risk-sharing with households of type 2. When the asymmetry of the period-1 endowments is severe enough, the required degree of leverage is no longer compatible with the collateral constraint. We thus obtain the possibility of an equilibrium in which the “natural buyers” of the risky asset are constrained in their ability to further leverage themselves in order to purchase as much of it as they would like. If in addition, as assumed here, θ^h is large for these investors, central-bank purchases of the durable will relax this leverage constraint to a significant extent.

As discussed in section 3, the observation that household 1’s leverage constraint is relaxed does not suffice to determine the welfare effects of central-bank asset purchases. In the region where only household 1’s leverage constraint binds, if the constraint does not bind too tightly (that is, at points near the boundary of the “AD” region), asset purchases reduce the welfare of household 1, while increasing the welfare of household 2, as in Figure 3 (but with the roles of the households reversed). Hence this region is labeled “-+” in Figure 9(b). For endowment patterns for which the constraint binds more tightly (points farther in the upper left corner of the figure), the welfare of both households is increased, as in Figure 4 (the region labeled “++” in Figure 9(b)). In this case, central-bank asset purchases are Pareto-improving.⁵⁶

In the region where both the short-sale constraint and the leverage constraint

⁵⁵The existence of an “SC¹” region to the right of the “AD” region occurs for the same reason as in Example 1, and so requires no further discussion.

⁵⁶The example shown in Figure 12 below belongs to this region.

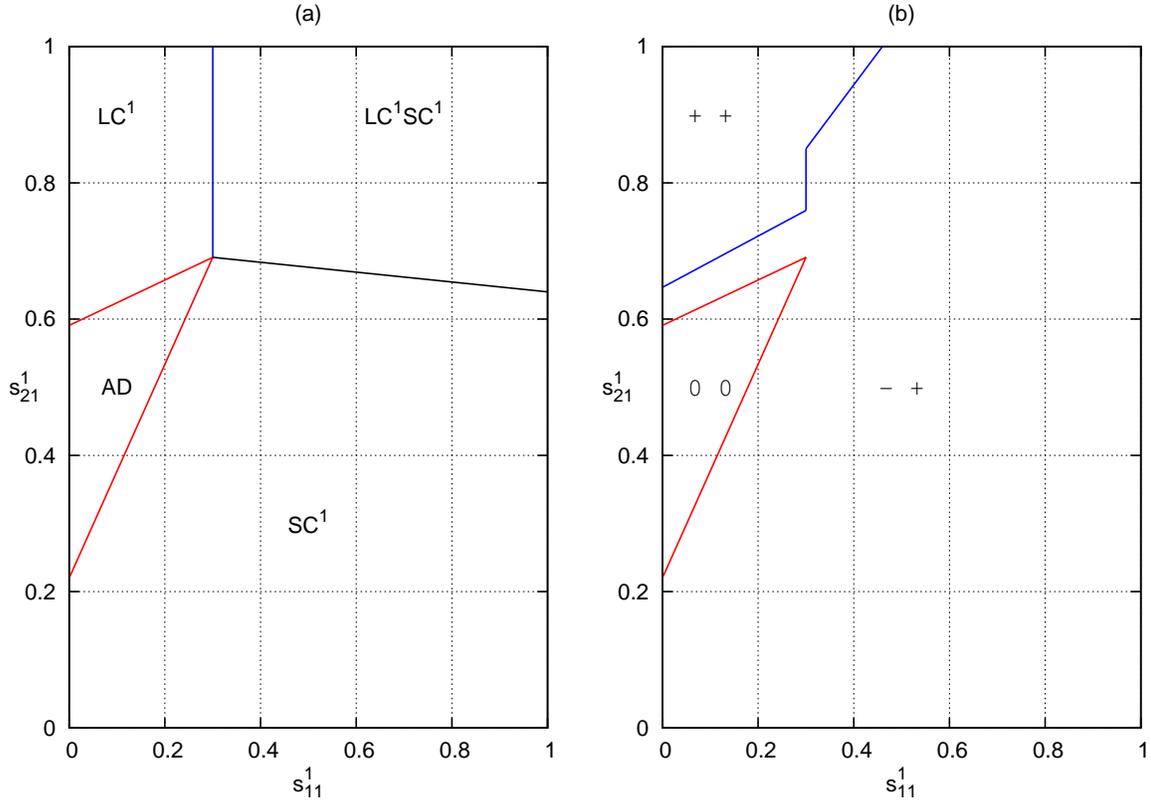


Figure 10: Example 2 with $\omega = 0.5$: (a) regions where collateral constraints bind; (b) welfare effects of a small increase in ω .

bind for household 1 (that is, household 1 is at the corner of the set of feasible intertemporal transfers shown in Figure 1(a)), central-bank asset purchases relax the leverage constraint, but also *tighten* the household’s short-sale constraint. Which of these effects is more important for the welfare of household 1 depends on which constraint binds more tightly. In the upper-left part of this region (the part closer to the region where only the leverage constraint binds), the most important effect is the relaxation of the leverage constraint, and a Pareto improvement results; but in the lower-right part of the region (the part closer to the region where only the short-sale constraint binds), the most important effect is the tightening of household 1’s short-sale constraint, and the welfare of household 1 is reduced, though household 2 benefits from central-bank asset purchases.

Figure 10 shows how these figures change if instead we consider a situation in which the central bank holds half of the aggregate supply of the durable. The figures

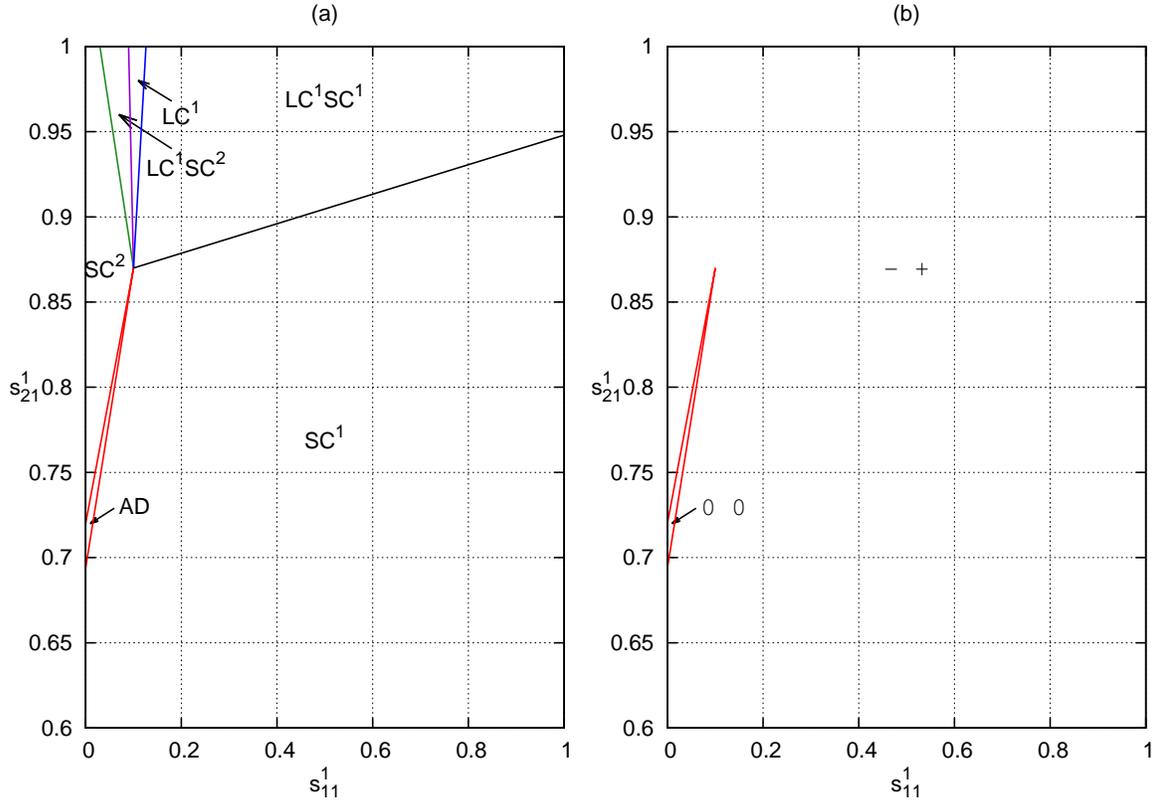


Figure 11: Example 2 with $\omega = 0.98$: (a) regions where collateral constraints bind; (b) welfare effects of a small increase in ω .

are qualitatively the same, but now the location of both the region in which the A-D allocation is achieved and the region in which a Pareto improvement occurs (the region “+ +” in panel (b) of the figure) are shifted up and to the left. The central bank’s policy increases the tax liability of household 1 in state 2 (the state in which the central bank suffers losses on the risky assets that it has acquired), while reducing it in state 1; this requires a more extreme asymmetry of the period-1 endowments in order for household 1 to be leverage-constrained, so that the region in which this occurs shifts up and to the left. Consequently, both the region in which asset-purchase policy is neutral and the region in which it is Pareto-improving are smaller parts of the plane in Figure 10(b) than in Figure 9(b).

If central-bank purchases are even larger, the picture changes even further, as illustrated by Figure 11 for the case $\omega = 0.98$. For large enough values of ω , it becomes possible for the short-sale constraint to bind for household 2 as well. In fact, for

values of ω near enough to 1, the short-sale constraint binds for one household or the other, except in the case of fairly special endowment patterns (the two narrow slivers labeled “AD” and “LC¹” in Figure 11(a)). The conditions under which central-bank purchases of the durable are Pareto-improving become progressively more special as ω increases, and eventually this ceases to be possible for any endowment patterns of the kind considered in this example. For high enough values of ω , under any endowment patterns other than the fairly special ones for which the A-D allocation continues to be achieved, further asset purchases always lower the welfare of households of type 1 (who largely bear the fiscal costs of the central bank’s balance-sheet losses in state 2, and do not enjoy any income effect of increases in the market value of an initial endowment of durables), while increasing the welfare of households of type 2.

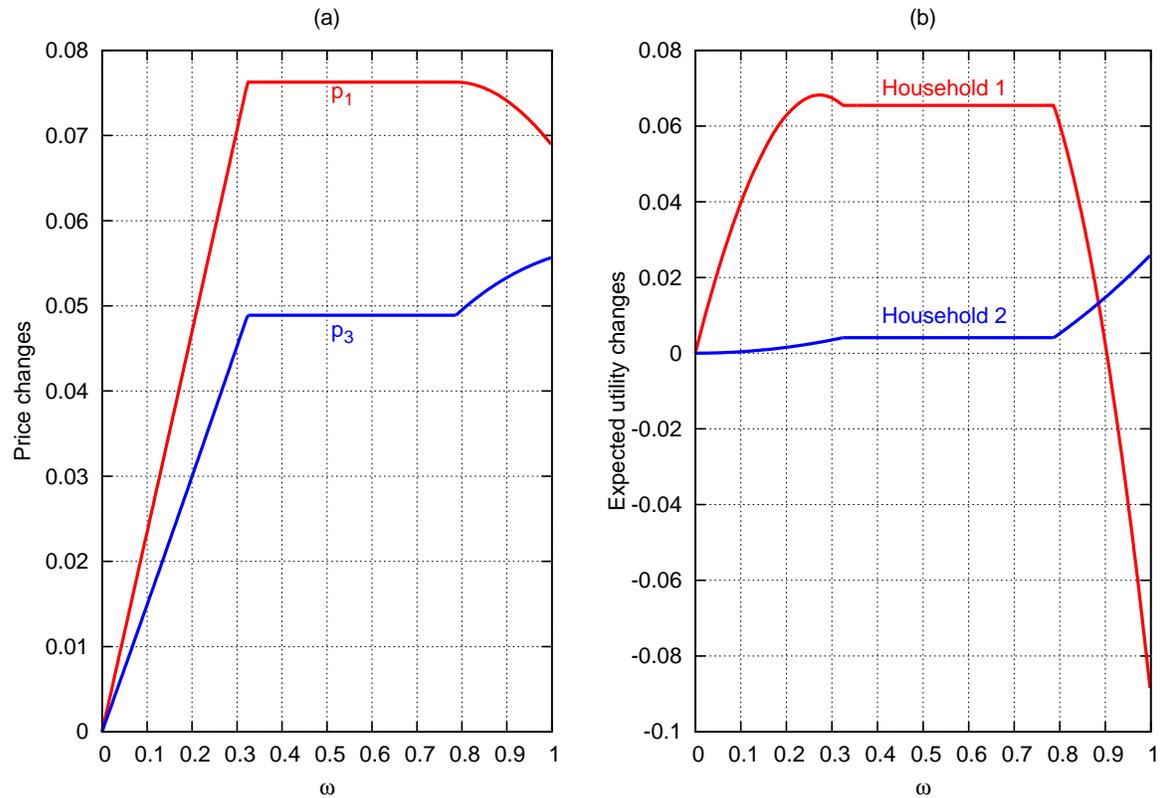


Figure 12: Effects of variation in ω over its entire feasible range, for Example 2 with $s_{11}^1 = 0, s_{21}^1 = 0.5$: (a) effects on prices; (b) welfare consequences.

This is illustrated for a particular endowment pattern in Figure 12, which shows the effects of varying ω over its entire feasible range. In period 1, household 1 is

assumed to have no endowment of the non-durable good in state 1, while the non-durable endowment is equal for the two households in state 2. This asymmetric endowment pattern makes household 1 the “natural buyer” of the good. It corresponds to a point in the middle of the vertical axis on Figures 9 and 10.

As indicated in Figure 9(a), for low values of ω , the leverage constraint binds for household 1, and no other financial constraints bind. Then Proposition 5) implies that p_1 and p_3 both increase with ω , though the relative price p_3/p_1 falls, as shown in Figure 12(a) by the fact that $\ln p_3$ increases less steeply than does $\ln p_1$. This continues to be the case as long as the central bank owns less than 32 percent of the total supply of the durable.

Initially (until the central bank owns about 28 percent of the durables), the leverage constraint of household 1 binds to a sufficient extent for the welfare of both types to be increased by a modest increase in central-bank holdings of the durable, as indicated in Figure 9(b). (The effects of asset purchases are those shown in Figure 4, but with the roles of the two households reversed.) But as the leverage constraint of household 1 is relaxed to a sufficient extent (and the A-D allocation is approached), the adverse income effect of the relative-price change dominates the benefit to household 1 of relaxation of the constraint. The expected utility of household 1 then decreases with additional central-bank purchases, though the expected utility of household 2 continues to rise, in accordance with Proposition 6.

Once the central bank owns more than 32 percent of the durable, neither household’s leverage constraint binds any longer, and the A-D allocation results.⁵⁷ In this case, neither prices nor the allocation of resources are affected by further central-bank purchases (up until the bank owns 79 percent of the total supply), in accordance with Proposition 2, resulting in flat regions of the plots in both panels of Figure 12.⁵⁸

But if the central bank continues to increase its share beyond 79 percent, the collateral constraint of household 1 binds again — but now in the way shown in Figure 2(b); that is, it is the short-sale constraint (2.21) that now binds. Because of the central bank’s losses on its large holdings of the durable in state 2, tax obligations are substantially higher in state 2 than in state 1; and because of the effects of this on after-tax income, household 1 eventually no longer wishes to hold the durable as a hedge, and instead would prefer to short the durable (or issue debt on which it could

⁵⁷See, for example, Figure 10(a) for the case $\omega = 0.5$.

⁵⁸See Figure 10(b) for the welfare derivatives when $\omega = 0.5$.

default in state 2), if the collateral constraint did not prevent this.⁵⁹

In the numerical example, the short-sale constraint eventually binds for household 1 rather than household 2, because of the assumed distribution of tax obligations: households of type 1 are assumed to pay 90 percent of the taxes, and therefore are more strongly affected by the central bank's balance-sheet risk. While the equilibrium allocation of resources does not change as ω increases from 32 percent to 79 percent, household 1's holdings of the durable steadily decline, as the amount of this asset needed to achieve its desired balance of after-tax income between states 1 and 2 falls, reaching zero as ω reaches 79 percent.

Beyond this point, further central-bank purchases cause household 1's short-sale constraint to bind ever more tightly. As in the example shown in Figure 8, central-bank asset purchases reduce aggregate demand (and hence the equilibrium price level p_1) in this case, even though they succeed in increasing the price of the durable p_3 , as shown in Figure 12(a). Moreover, the welfare of household 1 is reduced by the tighter financial constraint, as seen in Figure 12(b).⁶⁰ Household 2 continues to benefit from the higher relative price of the durable, as household 2 sells all of the durables purchased by the central bank; but household 1's budget suffers, as household 1 bears a disproportionate share of the burden of paying for the central bank's losses on the transactions that have been so profitable for household 2.⁶¹ Household 1's losses are a consequence of two factors: the income redistribution to household 2, but also the progressive reduction in risk-sharing between the two households, as household 1 is forced to accept an after-tax income pattern that is skewed further toward greater income in state 1 (the state in which the central bank's risky assets pay off well) than is that of household 2. Though in this example household 2 continues to benefit from additional central-bank purchases, even when ω is already large, household 1 suffers a substantial welfare loss.

Thus even in the case of an endowment pattern for which central-bank asset purchases of a modest size are clearly beneficial — because (when ω is small) the “natural buyers” of the risky asset are constrained in the degree to which they can lever themselves to buy more of the asset, and thereby achieve more efficient risk-

⁵⁹See Figure 11(a): the equilibrium corresponding to this numerical example lies in the region labeled “ SC^1 ,” that extends beyond the bottom of the figure.

⁶⁰The format for this figure is the same as in the case of Figure 8, explained above.

⁶¹Note that these conclusions are consistent with the signs of the welfare derivatives at $\omega = 0.98$, shown in Figure 11(b).

sharing; and asset purchases by the central bank are effectively a way of allowing further intermediation, and hence a greater degree of risk-sharing, to occur — it remains the case that *too large* a quantity of asset purchases by the central bank will be harmful. In fact, in the example shown in Figure 12, it is the “natural buyers” of the risky asset who are eventually harmed — to such an extent that their welfare is lower for high values of ω than if there had been no asset purchases by the central bank at all.

5 Conclusions

We have considered the consequences of central-bank purchases of a risky asset, which is also the asset used as collateral for private debt contracts, in a general-equilibrium asset pricing model with endogenous collateral constraints. We have shown that it is possible for purchases of such an asset by the central bank to increase its equilibrium price, as has been the intention of recent central-bank asset-purchase programs. Yet as elementary as such a conclusion might seem, we have found that it will not obtain under all circumstances. In our model, if there exists a sufficient level of collateral for no household’s collateral constraint to bind in equilibrium, central-bank asset purchases will have no effect on equilibrium asset prices, as the fiscal consequences of the changes in the central bank’s state-contingent revenues provide households with a hedging motive to adjust their portfolios in ways that, in aggregate, will perfectly offset the trades by the central bank.⁶² Moreover, even when this is not true, owing to a greater degree of heterogeneity in the situations of different households, the mere fact that collateral constraints bind and that central-bank purchases alter financial conditions does not imply that the price of the asset purchased by the central bank will necessarily *increase*. It is possible, instead, for it to decrease.⁶³ And even when purchases increase the *nominal* price of the asset (p_3), they do not necessarily increase its *real* price (p_3/p_1).⁶⁴ To the extent that the goal of policy is to lower real yields on assets in order to encourage borrowing and discourage saving, asset purchases fail to

⁶²See Proposition 2 above.

⁶³See, for example, the case in which the central bank owns more than 60 percent of the total supply of the asset, in Figure 8(a) above.

⁶⁴See, for example, Proposition 5, and the case illustrated in Figure 12(a), when the central bank owns less than 32 percent of the total supply.

achieve the desired goal in the latter case, even though collateral constraints bind.

We have also shown that the effects of asset purchases are not *equivalent* to those of adjusting the central bank's nominal interest-rate target by a certain amount. This means that the mere fact that a central bank is prevented from lowering the nominal interest rate as much as it would wish to, owing to the zero lower bound, does not suffice to imply that asset purchases are desirable. On the other hand, the non-equivalence of these two types of policies also means that the mere fact that interest-rate policy is available (because the lower bound has not been reached) does not necessarily imply that there is no reason to consider asset purchases. In principle, multiple objectives can be more fully achieved when multiple (non-equivalent) policy instruments are available. In particular, asset-purchase policies may be of interest because they can affect the size of distortions associated with financial constraints, and hence the efficiency of risk sharing, *in addition* to their consequences for aggregate demand. When a central bank is free to adjust policy along both dimensions independently, it may make sense to use unconventional policy mainly to influence the allocation of risk, while the consequences of the central bank's asset purchases for aggregate demand are offset by a suitable adjustment of the interest-rate target.

However, it is important to note that the effects of unconventional policy on the market price of the asset acquired by the central bank is not sufficient information from which to draw a conclusion as to whether the policy will be successful at "easing financial conditions," increasing aggregate demand, or preventing unwanted disinflation or deflation. When collateral constraints bind, one cannot say in general whether purchases of the risky asset by the central bank will loosen households' borrowing constraints, or instead *tighten* them. This depends on whether the constraints bind in the way shown in Figure 2(a) or in the way shown in Figure 2(b).⁶⁵ It follows that even when asset purchases increase the real price of the asset, one cannot conclude that the corresponding intertemporal marginal rate of substitution (IMRS) is reduced for everyone in the economy; for if the increase in the real price of the asset is associated with a tightening of the short-sale constraints of some households (as in the example shown in Figure 8 for values of ω less than 0.7, or the example shown in Figure 12 for values of ω greater than 0.8), then the wedge between these households' IMRS and the reciprocal of the asset price increases, so that an increase in the asset

⁶⁵Of course, it is possible for constraints of both types to bind in a given equilibrium, as some of our numerical examples illustrate.

price need not imply a decrease in every household’s IMRS.

We have also shown that asset purchases do not necessarily raise p_1 , the general price level in period 0,⁶⁶ even when they increase the real price of the durable.⁶⁷ This means that when the central bank is unable to use conventional interest-rate policy to prevent deflation, or unwanted disinflation, due to the zero lower bound on i , a resort to asset purchases will not necessarily be of any help — these may lower the equilibrium price level still further.⁶⁸ In such a case, central-bank asset purchases also lower aggregate nominal expenditure (on goods and services, as opposed to assets) in period 0 — the “aggregate demand” that interest-rate cuts are intended to increase. Because we assume an endowment economy, a reduction in nominal aggregate demand has no consequences for the aggregate quantity of goods that are produced and consumed; but in an extension of the model with an endogenous supply of goods in period 0 and sticky wages or prices, the reduction of nominal aggregate demand can translate into reduced output — again, the opposite of what a cut in the nominal interest rate (if one is possible) would achieve.⁶⁹ This it is not always even approximately correct to view asset purchases as a substitute for an interest-rate cut, that can be used even when an interest-rate cut is precluded by the zero lower bound. Moreover, while the conditions that determine which types of effects asset purchases will have are complex, our numerical examples suggest that asset purchases typically reduce aggregate demand (and lower the price level) when some households are short-sale constrained, and none are leverage-constrained — and this case is quite likely to arise once the central bank owns a sufficiently large share of the total supply of the asset.

These conclusions make the welfare consequences of central-bank asset purchases complex to assess. In our flexible-price model, there are no effects of monetary policy (whether conventional or unconventional) on output, nor are there any consequences of changes in the general price level for household utility. Hence our analysis of the

⁶⁶Recall that under our assumption of homothetic preferences, p_1 and p_2 must change in the same proportion, so that the change in $\log p_1$ is also the change in the log of an index of the prices of both non-durable goods and the services received from durable goods, *i.e.*, the entire household consumption basket in period 0.

⁶⁷See Figure 8, and Figure 12 for the case of ω greater than 0.8.

⁶⁸Of course, if there is sufficient collateral for households’ constraints not to bind, asset purchases have no effect on the price level of either sign — just as they have no effect on other asset prices, or on the equilibrium allocation of resources.

⁶⁹We leave the analysis of this extended model for a separate paper.

consequences of policy for household utility takes account only of the consequences of policy for the efficiency of the equilibrium consumption allocation, owing to changes in the size of the financial wedges that separate the IMRS of differently situated households, and for the redistributions of income among households that may result from changes in equilibrium asset prices. We have seen that financial constraints may be either tightened or loosened by central-bank asset purchases, depending on the way in which households are constrained. If households are prevented from issuing as much riskless debt as they would like, central-bank asset purchases relax this constraint and hence reduce the associated distortion (Figure 2(a)); but if instead households are prevented from shorting the risky asset, central-bank purchases tighten this constraint and increase the associated distortion (Figure 2(b)). In the former case, at least one type of household benefits from the more efficient allocation of resources, but some may be hurt, owing to the redistributive effects of price changes (Figure 3); only under certain more special circumstances will the purchases result in a Pareto improvement (Figure 4). When short-sale constraints bind, the welfare of at least some households must be reduced by the increase in financial distortions as a result of central-bank purchases; and while at least some households may benefit from the associated price changes (the “+ -” and “- +” regions in Figure 5(b)), in some cases the welfare of all households will be reduced (the “- -” regions in that same figure).

These conclusions about welfare do not take account of any desire on the part of the central bank to influence aggregate spending or the general level of prices. If interest-rate policy can be used to offset the policy’s effects on aggregate demand, these may not be the consequences of interest in any event (except in order to determine how interest-rate policy must be adjusted in light of the asset purchases). But when interest-rate policy is constrained by the zero lower bound, this argument will not apply; and in fact, the unconventional policies undertaken by central banks recently have primarily been motivated the hope that these policies can increase aggregate demand and prevent unwanted disinflation or deflation. In order to analyze the desirability of unconventional policy under such circumstances, we should consider not only the effects of household purchases on the utilities of the various households in our model, but *also* the effects of aggregate expenditure (or the general price level, p_1) in period 0. In the case that only leverage constraints bind (in our two-household model), we have seen that asset purchases raise p_1 , which is a further benefit of the policy in this case. (In an extended model with nominal rigidities, the

conditions required for a Pareto improvement are likely to be somewhat weaker than in the analysis here, as all households could benefit from higher utilization of productive capacity in period 0.) But when (only) short-sale constraints bind instead, our examples indicate that asset purchases *reduce* aggregate demand and the general level of prices — which would be an additional *negative* effect of the policy, under circumstances where aggregate demand is already insufficient, owing to a binding lower bound on the nominal interest rate.

It thus matters greatly, in judging the likely benefits of central-bank asset purchases, which sorts of financial constraints bind, and to what extent. The mere fact that aggregate demand is judged to be insufficient in the absence of such purchases (or given the quantity of purchases that have already been made) is not a sufficient ground for expecting additional purchases to have a desirable effect. First, the effects of the purchases on the degree to which financial constraints bind *also* matters for welfare, apart from the consequences for aggregate demand; and second, the effects of asset purchases on aggregate demand cannot be predicted, without taking into account the way in which they will tighten or loosen the financial constraints of differently situated parties. Nor can these questions be answered simply by observing whether central-bank purchases succeed in raising the market price of the assets purchased; the price p_3 of the asset purchased by the central bank may increase either in a case in which financial constraints are loosened and aggregate demand is increased (Figure 12(a) when $\omega < 0.32$), or in a case in which financial constraints are tightened and aggregate demand is reduced (Figure 8(a) when $\omega < 0.59$, or Figure 12(a) when $\omega > 0.79$). Thus our analysis suggests that such policies should be undertaken only on the basis of a careful analysis of the consequences of the policies for the allocation of risk through the financial system, and not simply on the basis of an assessment of the current output or unemployment gap and of the degree to which central-bank purchases seem to affect market prices.

While our model's general implications for the effects of asset purchases on financial constraints are difficult to summarize, one fairly simple conclusion is worth noting. Regardless of whether asset purchases on a modest scale relax financial constraints or tighten them, our model implies that continued asset purchases by the central bank will *eventually* result in a situation where many households are constrained in their ability to short the asset acquired by the central bank. Once a sufficient fraction of the total supply of the asset is held by the central bank, it becomes almost inevitable that

the primary effect of further purchases will be to *tighten* financial constraints, rather than to loosen them, and to *contract* aggregate demand, rather than to increase it. Thus even under circumstances where asset purchases on a sufficiently modest scale are clearly beneficial (as in the numerical example considered in Figure 12), at some point further asset purchases of the same kind become counter-productive from both microeconomic (efficient risk-sharing) and macroeconomic (aggregate-demand management) perspectives. Central banks would thus do well to avoid the trap of thinking that if asset-purchase policies have proven useful, even larger-scale purchases must always be better.

References

- [1] Adrian, Tobias, and Hyun Song Shin, “Financial Intermediaries and Monetary Economics,” in B.M. Friedman and M. Woodford, eds., *Handbook of Monetary Economics*, vol. 3A, Amsterdam: Elsevier, 2010.
- [2] Araújo, Aloísio, José Fajardo, and Mário R. Páscoa, “Endogenous Collateral,” *Journal of Mathematical Economics* 41: 439-462 (2005).
- [3] Araújo, Aloísio, Felix Kubler, and Susan Schommer, “Regulating Collateral when Markets are Incomplete,” *Journal of Economic Theory* 147: 450-476 (2012).
- [4] Araújo, Aloísio, Jaime Orrillo, and Mário R. Páscoa, “Equilibrium with Default and Endogenous Collateral,” *Mathematical Finance* 10: 1-21 (2000).
- [5] Araújo, Aloísio, Mário R. Páscoa, and Juan Pablo Torres-Martinez, “Collateral Avoids Ponzi Schemes in Incomplete Markets,” *Econometrica* 70: 1613-1638 (2002).
- [6] Bernanke, Ben S., “The Crisis and the Policy Response,” Stamp Lecture, London School of Economics, January 13, 2009. [Available online at: <http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm>]
- [7] Bowman, David, Etienne Gagnon, and Mike Leahy, “Interest on Excess Reserves as a Monetary Policy Instrument: The Experience of Foreign Central Banks,” International Finance Discussion Paper no. 996, Federal Reserve Board, March 2010.
- [8] Brunnermeier, Markus, “Deciphering the Liquidity and Credit Crunch 2007-08,” *Journal of Economic Perspectives*, 23(1): 77-100 (2009).
- [9] Cúrdia, Vasco, and Michael Woodford, “The Central-Bank Balance Sheet as an Instrument of Monetary Policy,” NBER Working Paper no. 16208, July 2010.
- [10] Eggertsson, Gauti B., and Michael Woodford, “The Zero Bound on Interest Rates and Optimal Monetary Policy,” *Brookings Papers on Economic Activity* 2003:1, pp. 139-211.

- [11] Fostel, Ana, and John Geanakoplos, “Leverage and Default in Binomial Economies: A Complete Characterization,” Cowles Foundation Discussion Paper no. 1877R, revised July 2013.
- [12] Gagnon, Joseph, Matthew Raskin, Julie Remache, Brian Sack, “Large-Scale Asset Purchases by the Federal Reserve: Did They Work?” Federal Reserve Bank of New York Staff Report no. 441, March 2010.
- [13] Geanakoplos, John, “Promises, Promises,” in W.B. Arthur, S. Durlauf, and D. Lane, eds., *The Economy as a Complex, Evolving System, II*, Reading, MA: Addison-Wesley, 1997.
- [14] Geanakoplos, John, “The Leverage Cycle,” in D. Acemoglu, K. Rogoff, and M. Woodford, eds., *NBER Macroeconomics Annual 2009*, Chicago: University of Chicago Press, 2010.
- [15] Geanakoplos, John, and William R. Zame, “Collateral Equilibrium: A Basic Framework,” Cowles Foundation Discussion Paper no. 1906, August 2013.
- [16] Gertler, Mark, and Peter Karadi, “A Model of Unconventional Monetary Policy,” *Journal of Monetary Economics* 58: 17-34 (2011).
- [17] Gertler, Mark, and Peter Karadi, “QE1 vs. 2 vs. 3...: A Framework for Analyzing Large-Scale Asset Purchases as a Monetary Policy Tool,” *International Journal of Central Banking* 9 (S1): 5-53 (2013).
- [18] Gorton, Gary, and Andrew Metrick, “Securitized Banking and the Run on Repo,” *Journal of Financial Economics* 104: 425-451 (2012).
- [19] Schommer, Susan, “Computing General Equilibrium with Incomplete Markets, Collateral and Default Penalties,” *Annals of Operations Research* 206: 367-383 (2013).
- [20] Wallace, Neil, “A Modigliani-Miller Theorem for Open-Market Operations,” *American Economic Review* 71: 267-274 (1981).
- [21] Woodford, Michael, *Interest and Prices: Foundations of a Theory of Monetary Policy*, Princeton: Princeton University Press, 2003.