M A C R O E C O N O M I C S

Two Monetary Tools: Interest Rates and Haircuts

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Financial institutions play a key role as credit providers in the economy, and liquidity crises arise when they become credit constrained themselves. In such liquidity crises, financial institutions' ability to borrow against their securities plays a key role. In the private markets, it can become virtually impossible to borrow against certain illiquid securities, and, more broadly, the "haircuts" on many securities increase in crises.

Furthermore, security prices may drop significantly, especially for securities with high haircuts (also called margin requirements). To alleviate the financial institutions' funding problems, and their repercussions on the real economy, central banks have a number of monetary policy tools available, such as interest rate cuts and lending facilities with low haircuts.

This paper studies the links between haircuts, required returns and real activity, and evaluates the different monetary policy tools theoretically and empirically. In a production economy with multiple sectors financed by agents facing margin constraints, we show that binding constraints increase required returns and propagate business cycles. A central bank policy of reducing the interest rate decreases the required returns of low-haircut assets but, surprisingly, may increase those of high-haircut assets, since it may increase the shadow cost of capital for constrained agents. A reduction in the haircut of an asset unambiguously lowers its required return and can ease the funding constraints on all assets.

Hence, to reduce business cycles, a central bank may need capital requirements in good times and lending facilities that stand ready in periods of liquidity crisis.

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