Optimal Bank Regulation and Fiscal Capacity

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Abstract

Financial regulation is synchronized across countries despite the fact that countries vary widely in their ability to bail-out their banking sector in the event of a financial crisis. This paper addresses the question of whether countries with different fiscal capacity should optimally have different ex-ante minimum bank capital requirements. In an environment with endogenously incomplete markets and overinvestment due to moral hazard and pecuniary externalities, I show that countries with larger fiscal capacity should have lower ex-ante minimum bank capital requirements. This result is the opposite of what one might expect, given that countries with larger fiscal capacity often have stronger moral hazard. I also show that, in addition to a minimum bank capital requirement, regulators in countries with strong moral hazard (those with a concentrated financial sector and large fiscal capacity) should impose a limit on the liabilities pledged by financial institutions in a crisis state. This would entail restricting the amount of put options/CDS contracts sold by financial institutions, among other measures.

1 Introduction

Countries differ significantly in their ability to bail-out their financial system during a crisis. At the same time, there is a substantial synchronization of the type and the level of ex-ante financial sector regulation across countries due to the Basel Accords. This paper addresses the question of whether governments with different abilities to bail-out their banking system during a financial crisis (different fiscal capacity) should have more- or less-stringent ex-ante minimum bank capital

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requirements.\textsuperscript{2} It also examines the issue of what other types of regulatory instruments, if any, are required in addition to minimum bank capital requirements.

In a model with both pecuniary externalities and moral hazard, I show that countries with larger fiscal capacity should have lower ex-ante minimum bank capital requirements. This result is the opposite of what one might expect, given that countries with larger fiscal capacity often have stronger moral hazard. Furthermore, a second interesting and novel result emerges; countries with large fiscal capacity and a concentrated banking sector (those with strong moral hazard) should also impose a limit on the liabilities of the financial sector in a future crisis state, when a government bail-out is anticipated. In particular, in addition to imposing minimum bank capital requirements, the regulators of countries with strong moral hazard should, among other measures, limit the sale of put option contracts by financial institutions, such as CDS contracts.

I build a three-period model in the spirit of Lorenzoni (2008), in which markets are endogenously incomplete. Bankers are modeled as entrepreneurs that have access to a linear production technology. Bankers invest and borrow every period using short-term, state-contingent collateralized contracts. The project has to be refinanced in the middle period in order to remain productive. If a crisis state occurs, in order to refinance the project, bankers are forced to sell part of their capital stock to the less productive outside sector (consumers), which generates fire-sales.\textsuperscript{3} One can interpret the assumption that bankers are more productive than the outside sector at channeling savings into investment as bankers being better at monitoring loans and screening, which I do not model explicitly. The government can intervene during a crisis and provide a bail-out to the bankers by taxing the consumers. However, taxing is costly, and the cost depends on the country’s fiscal capacity.

The combination of future fire-sales and the assumption that the banking sector is more productive than the outside sector generates pecuniary externalities in the spirit of Lorenzoni (2008), which lead to ex-ante overinvestment relative to the constrained Central Planner’s allocation. Bankers do not internalize the fact that the more they invest ex-ante, the larger is the fire sale of financial assets during a future crisis, which tightens the budget constraints of the other bankers. This is welfare-reducing because it increases the inefficient transfer of resources from the bankers — the more productive agents — to the consumers — the less productive agents. Moral hazard, which one can think of as "Too Big to Fail" type of moral hazard, is a second source of ex-ante inefficiency in the model. When banks are not infinitesimally small and they anticipate a bail-out in the future, they internalize the fact that the more they invest ex-ante, the larger the aggregate fire sale is during a crisis, which will lead to a larger bail-out ex-post. The moral hazard also leads to ex-ante overinvestment and is stronger, the more concentrated the banking sector is and the larger the fiscal capacity of the country is.

\textsuperscript{2}The minimum bank capital requirement constrains banks to finance at least a fraction of their risky assets using equity. This fraction is referred to as the minimum bank capital ratio.

\textsuperscript{3}Capital stock/capital will be sometimes used as a synonym for investment in the paper and should not be confused with the capital in the "minimum bank capital requirement" expression, which refers to bank equity.
In this framework, conditional on assuming that the policy maker has a sufficient number of instruments to replicate the constrained Central Planner’s allocation, one can prove the first key result of this paper — that countries with smaller fiscal capacity should have higher ex-ante minimum bank capital requirements. This result will be present even if the model has no moral hazard and is driven by the two key assumptions that drive the pecuniary externalities — the presence of fire-sales combined with the assumption that the banking sector is more productive than the outside sector. The intuition is as follows: For a given investment level, countries that can afford a smaller bail-out will have a larger fire sale in a crisis. This will lead to a larger transfer of resources from the more productive to the less productive sector. Therefore, the constrained Central Planner in more fiscally constrained countries perceives ex-ante investment as less attractive, and he optimally chooses to invest less, relative to the constrained Central Planner of a country with a larger fiscal capacity. Since the ex-ante investment chosen by the constrained Central Planner and the optimal minimum bank capital ratio are inversely related, smaller fiscal capacity implies optimally a higher ex-ante minimum bank capital ratio. In summary, countries with larger fiscal capacity can prop up asset prices more during a crisis and can alleviate any inefficiencies arising from fire-sales. As a result, they can "afford" to have larger investment booms ex-ante.

Since a larger bail-out will lead to stronger moral hazard if the banks are not infinitesimally small, intuitively, one would expect that larger fiscal capacity would imply a higher (not lower) ex-ante minimum bank capital requirement. The reason why this intuition proves to be incorrect relies crucially on the fact that the ex-ante regulatory instrument considered — a minimum bank capital requirement — is a "quantity" policy instrument and on the assumption that the policy maker has a sufficient number of instruments to replicate the constrained Central Planner’s allocation. By setting the minimum bank capital ratio, the policy maker can replicate the constrained Central Planner’s allocation by directly setting the quantity bankers invest. Moral hazard does not play a role since it does not affect the investment chosen by the constrained Central Planner. However, the strength of the moral hazard affects the first-order conditions of the banker in the decentralized equilibrium, who internalizes the benefit but not the cost of the bail-out. Therefore, if a "price" instrument were used instead, such as a tax on ex-ante investment, the optimal ex-ante regulation would be a function of the strength of the moral hazard. With such a "price" instrument, the policy maker can affect only the marginal cost of investment as perceived by the banker, but cannot directly set the amount that the banker invests.

The second key result of this paper is that countries with strong moral hazard should impose a second ex-ante regulatory instrument that limits bank liabilities during a crisis when a bail-out is expected. Moral hazard in this model works through two different channels. The first is the standard channel where bankers overinvest ex-ante. In the second channel, if moral hazard is strong enough and the bankers already face a minimum bank capital requirement, they optimally choose to pledge too high of a payment in the crisis state relative to what the constrained Central Planner would optimally pledge. The intuition for the second channel is that a larger payment

\[4\] "Price" instruments, similar to a tax on period zero investment, have been considered in the literature (see Stein (2012), Bianchi (2011) and Jeanne and Korinek (2012)).
promised in the crisis state leads to a more severe fire sale and, therefore, to a larger expected bail-out.

More than one hundred countries worldwide currently have some form of a minimum liquidity requirement, and Basel III also promotes liquidity regulation in the form of a minimum amount of safe asset holdings. In addition, derivative regulations are at the forefront of the current policy debate. However, there is little theoretical understanding as to why such instruments would be required in addition to the minimum bank capital requirement. According to the results of this paper, the "sufficient" statistic, which regulators should target, is not the ex-ante bank holdings of safe assets, but the liabilities of the financial sector in a potential future crisis when a bail-out will be required. Knowledge of derivative positions will be crucial for forecasting financial sector liabilities. In this paper, I argue that countries with strong moral hazard should regulate derivative contracts (for example, regulate the quantity of CDS contacts sold), among other measures, even if there is no counterparty risk and even if the trades are fully collateralized. Furthermore, such a regulatory instrument will be required in addition to the minimum bank capital requirement.

The cross-country heterogeneity of fiscal capacity (the government’s ability to provide a bail-out during a financial crisis) plays a crucial role in this model. I model the fiscal capacity of a country by introducing an exogenous parameter that directly affects the marginal cost of taxing and, as a result, the cost of an extra dollar of bank bail-out. In reality, a bank bail-out can be financed by taxing, borrowing or printing money (if an independent monetary policy is available). The access to and the cost of these policy tools jointly determine a country’s fiscal capacity. However, a country will optimally use all of these instruments up to the point where the marginal costs of each of them are equalized. The marginal cost of each of these instruments, in equilibrium, will be equal to the cost of an extra dollar of bail-out. Therefore, one can think of the marginal cost of the bail-out as a sufficient statistic, which is why I abstract from modelling sovereign borrowing and printing money explicitly. Such an approach simplifies the model significantly and, at the same time, preserves the generality of the results.

The last crisis provided plenty of evidence that countries vary widely in their abilities to provide a financial sector bail-out. For a given size of the banking sector and for a given bail-out, the marginal cost of the bail-out will be larger if a country has a smaller tax base or a higher cost of sovereign borrowing during a crisis or does not have access to an independent monetary policy. For example, a country like Switzerland, which has a large banking sector relative to the GDP of the country, is

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5 The World Bank survey on bank regulation shows that in 2010, 103 out of 127 countries had some form of a minimum ratio on liquid assets, such as a regulatory minimum ratio on liquid assets as a percentage of total balance sheet or deposit base.

6 In order to be able to forecast the net liabilities of financial institutions in a future crisis, regulators will need information on the entire bank balance sheet of every bank and also on how the various exposures are correlated. They will also have to rely on comprehensive Value at Risk models.

7 In the presence of no counterparty risk and well-collateralized positions, according to Basel III, financial institutions need not hold equity against their derivative positions.

8 Borrowing from the future can be thought of as future taxation, while printing money is an inflationary tax—hence the title "Optimal Bank Regulation and Fiscal Capacity."
relatively more fiscally constrained than the United States and would optimally choose to bail-out a smaller fraction of its banking sector during a crisis. In response to the 2007-2008 financial crisis, in 2011, Swiss regulators deviated from the Basel I norm of an eight-percent minimum bank capital ratio by significantly increasing the minimum bank capital requirement to nineteen percent, which according to this paper’s conclusion, was a change in the right direction. During the 2011-2013 European sovereign debt crisis, Greece and Spain are two prime examples of countries that were fiscally constrained since they faced a high cost of sovereign borrowing and were limited in the amount of bail-outs they could provide to their financial sectors. Finally, all else equal, countries with independent monetary policy, such as the United States, are less fiscally constrained than the countries in the European Monetary Union since, in order to reduce the marginal cost of the bail-out, they can print money during a financial crisis in addition to borrowing and taxing.

**Related Literature**

There are three key assumptions that lead to the main result of this paper and they are fairly standard in the literature. The first assumption — in the spirit of Kiyotaki and Moore (1997) and Hart and Moore (1994) — is that bankers face a borrowing constraint. The second assumption, that the banking sector is more productive than the outside sector (the consumers), has been used in many papers, such as Kiyotaki and Moore (1997), Lorenzoni (2008), and Brunnermeier and Sannikov (2013), among others. It can be further justified by the fact that financial institutions are considered more efficient than savers at providing credit to firms because of their ability to monitor the borrower at a lower cost (for example, see Holmstrom and Tirole (1997)). Hence, the value of loans (investment) is higher in the hands of the bankers than in the hands of the consumers. On the empirical side, the literature on relationship banking studies the importance of the banking sector and the value lost by terminating the relationship between banks and firms (see Slovin, Sushka, and Polonchek (1993), Peek and Rosengren (1997), Gan (2007), Boot (2000) and Freixas and Rochet (2008) for a literature review). The third key assumption is that the government can circumvent the banker’s borrowing constraint via its power to tax. We see this in Holmstrom and Tirole (1998) and Gorton and Huang (2004), among others. Any paper with a government bank bail-out uses a similar underlying assumption.

Starting with the seminal work of Bagehot (1873), moral hazard has been proposed as one of the main reasons for bank regulation. However, a growing literature on financial sector regulation has emerged, which emphasizes the role of fire sales and pecuniary externalities (Geanakoplos and Polemarchakis (1986), Lorenzoni (2008), Stein (2012), Jeanne and Korinek (2012), He and Kondor (2012)). The importance of fire sales during financial crises has been emphasized by many papers, starting with Shleifer and Vishny (1992) (see Shleifer and Vishny (2011) for a survey of the

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9. Using BankScope data, in 2007, in the US, the assets of the banking sector were 120% of the GDP of the country. Even counting the shadow banking sector in the US, the total assets of the banking sector (as defined above) plus the shadow banking system becomes 300% of the US GDP in 2007 (see the Financial Stability Board estimates, 2007). In 2007, in Switzerland, the assets of just UBS and Credit Suisse were 700% of the GDP of the country.

10. In 2011, the ten-year sovereign debt interest rate was 5.4% in Spain and 35% in Greece.

11. Hart and Moore (1994) show that if entrepreneurs can run away with the cash flow and can threaten to withdraw their human capital, they can borrow only against collateral.
literature). I build on the paper by Lorenzoni (2008), who shows how pecuniary externalities can emerge in a microfounded environment. The key difference between this paper and Lorenzoni (2008) is that he does not allow for an ex-post bail-out and, as a result, for heterogeneous fiscal capacity. Also Lorenzoni does not study concentrated banking sectors, and optimal policy plays a minor role in his paper. I also simplify Lorenzoni (2008)'s framework: He assumes that in addition to the borrowing constraint on the bankers' side, there is a limited commitment friction on the consumers' side. I show that as long as the banks are owned by the consumers (an implicit ex-post lump sum transfer), limited commitment of the consumers will not be necessary to generate pecuniary externalities.

To my knowledge, the only other paper, besides this one, that studies the optimal mix of ex-ante regulation and ex-post bailout and includes both pecuniary externalities and moral hazard is the one by Jeanne and Korinek (2012). In contrast to this paper, in Jeanne and Korinek (2012), markets are exogenously incomplete. Endogenous market incompleteness is important to understanding the key sources of inefficiency. It is also crucial for some of the key results of this paper, such as the result that regulators need to control the liabilities of the banking sector in a crisis state (impose derivative regulation) in countries with strong moral hazard. Most importantly, Jeanne and Korinek (2012) do not ask one of the key questions raised by this paper: How should the optimal mix of ex-ante and ex-post bank regulation vary with the country’s fiscal capacity?

Some of the papers that find a role for a minimum liquidity regulation due to moral hazard are Farhi and Tirole (2012), Acharya, Shin, and Yorulmazer (2011), Repullo (2005) and Keister (2012). In an environment with a non-targeted bail-out in the form of lowering banks’ borrowing rate, Farhi and Tirole (2012) show that there are complementarities in the actions of bankers and, as a result, multiple equilibria. If banks expect low interest rates during crises, they might end up holding too little of the safe asset, which, in equilibrium, will force the policy maker to keep interest rates low in a crisis. As a result, minimum liquidity requirements can improve welfare. In a Diamond and Dybvig (1983) environment with multiple equilibria, Keister (2012) shows that an expected government bail-out leads to moral hazard and to bankers choosing lower liquidity ex-ante relative to what the Central Planner would choose.

The synchronization of regulation is often justified by the idea of creating a "level playing field" for banks. For a summary of the bank regulation literature, see Santos (2001). Acharya (2002) studies whether minimum capital requirements should be synchronized across countries given the presence of different bank closure policies, and he argues in favor of heterogeneous cross-country bank regulation. Bengui (2011) builds a two-country model and discusses optimal bank regulation in an environment with pecuniary externalities, emphasizing the importance of international coordination.

There is a large literature on pecuniary externalities in which the inefficiency comes from binding borrowing constraints, where prices enter the borrowing constraint (for example, Stein (2012), Bianchi (2011)). In this paper, as in Lorenzoni (2008), the source of the pecuniary externality will be that bankers do not internalize the fact that their actions are tightening the budget constraints, not the borrowing constraints, of the other bankers.
Finally, this paper also relates to the literature about different types of regulatory instruments, pioneered by Weitzman (1974). According to Weitzman (1974), if the policy maker has access to state-contingent policy instruments, she can replicate the constrained Central Planner’s allocation using either a "price" or a "quantity" instrument. However, the comparative statics can be very different, depending on which type of instrument is used, as I show in this paper.

The paper is structured as follows. In Section 2, I present the setup of the model. Section 3 provides the solution to the decentralized problem and the constrained Central Planner’s problem. Section 4 proves that there is overinvestment in this economy, while Section 5 shows how the constrained Central Planner’s allocation can be decentralized. Section 6 discusses optimal policy as a function of fiscal capacity and proves the key results of this paper. Section 7 compares "quantity" regulatory instruments to "price" regulatory instruments. Section 8 concludes and provides further discussion.

2 Model Setup

The model is a three-period model where \( t = 0, 1, 2 \). The discount factor between periods is one. There is aggregate uncertainty only in the middle period, \( t = 1 \), and there is no idiosyncratic uncertainty. In \( t = 1 \), there are two states of nature — a high state and a low state. The period-zero probabilities of the high and low states occurring are \( \pi_h \) and \( \pi_l \), where \( \pi_l + \pi_h = 1 \). I will consider parametrization where the fire sale occurs only in the low state in period-one, which is what I will refer to as the crisis state. There are two goods — a capital good and a consumption good, where the consumption good is the numeraire good. In each period and state of nature, the consumption good can be transformed into a capital good one-to-one. The capital good has to be employed in a production technology in every period, and the consumption good is perishable.

There are three agents in the economy — consumers, bankers (modelled as entrepreneurs) and the government. The banks are owned by the consumers, who are risk-neutral.\(^{13}\) The implicit assumptions are that the banks cannot borrow from their equity owners and that the objective function of the bankers is to maximize dividend payments to equity holders. The government is benevolent and optimizes consumers’ welfare. It chooses the optimal regulatory instruments and provides a bail-out to the banking sector in a crisis.

\(^{13}\) Alternatively, one can think of this setup as there being a representative family that splits into bankers and consumers in the beginning of period zero and the bankers are given an exogenous starting capital. The bankers and consumers reunite in \( t = 2 \) and consume jointly. The bankers can borrow only from consumers that are not members of their family and can optimize only the profits from operating their production technology. This interpretation is in the spirit of Gertler and Kiyotaki (2010).

\(^{14}\) The model can be easily changed so that both consumers and bankers are treated as agents that consume separately, and I can impose an ex-ante welfare Pareto improvement criterion as in Lorenzoni (2008). Most of the qualitative results would remain unchanged as long as the government has access to last-period lump sum transfers from the bankers to the consumers.
2.1 Bankers

Production Technology

Assume that there are $N$ identical bankers/entrepreneurs. Every banker has access to a bank-specific linear production technology. In $t = 0$, banker $i$ starts with no pre-existing capital stock and has to choose the amount he invests given by $k^i_0$, where the price of capital is $q_0$. In $t = 1$ and state $s$, the project produces $a_{1s}k^i_0$ units of the consumption good, where $s \in \{l, h\}$ and $a_{1l} < a_{1h}$. In $t = 1$, in order for the capital stock, $k^i_0$, to remain productive, it has to be refinanced. Banker $i$ has to invest an additional amount of $\gamma < 1$ per every unit of period-zero capital. Otherwise, the capital depreciates one hundred percent. One can think of the refinancing cost as a long-term project that requires refinancing in order to remain productive (for example, workers have to be paid and more equipment has to be purchased). The total required re-investment in order for all capital to remain productive is $\gamma k^i_0$ units of the consumption good. I will consider functional forms such that it will be always optimal to re-finance all of the capital. In $t = 1$, banker $i$ can also adjust the scale of the project by choosing $k^1_{1s}$, where the price of period-one capital is $q_{1s}$. The capital sold by banker $i$ in state $s$ and period-one is $k^i_{1s} = \min \{0, k^i_0 - k^i_{1s}\}$. I will refer to $k^i_{1s}$ as the fire-sold capital, and the aggregate amount of fire-sold capital is defined as an average $k^i_{1s} = \sum_{i=1}^{N} \frac{1}{N} k^i_{1s}$. Using averages instead of simple sums is standard in macro models and implies that when one takes the limit of $N \to \infty$, the equilibrium allocation converges to the case of a continuum of banks distributed uniformly on $[0, 1]$. Finally, in $t = 2$, there is no further uncertainty, and the amount invested in $t = 1$ produces $Ak^i_{1s}$, where $A > 0$. Also in $t = 2$, banker $i$ can sell the capital to the consumers for the price of $q_{2s}$, after he pays the refinancing cost, $\gamma$.

State-Contingent Debt Contracts Subject to Borrowing Constraints

In $t = 0$, each banker is endowed with $n$ units of the consumption good. $n$ is an exogenous parameter and, in this model, represents the banker’s equity. Banker $i$ can also borrow from the consumers that are not the equity owners of bank $i$. However, credit markets are imperfect due to an agency friction in the spirit of Hart and Moore (1994) and Kiyotaki and Moore (1997). I assume that the state of nature is verifiable, but banker $i$ can always run away with the cash flow ($a_{1s}k^i_0$ and $Ak^i_{1s}$) and can also withdraw her human capital.

Given these assumptions, the contract that emerges in equilibrium is a short-term, state-contingent debt contract subject to a collateral constraint on the part of the banker. In $t = 0$, banker $i$ can sell a promise to pay $d_{1s}$ units of the consumption good in $t = 1$, state $s$, at the price $\pi_s p_{1s}$ per unit. This implies that banker $i$’s total period-zero borrowing is $\sum_{s} \pi_s p_{1s} d_{1s}$. Also in $t = 1$ state $s$, banker $i$ can sell a new promise to pay $d_{2s}$ units of the consumption good in $t = 2$ state $s$.  

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15 Implicitly, I shut off any frictions between the firm and the bank, which, while relevant for the real world, are not the focus of this paper because they will not affect the key qualitative results.
16 Alternatively, I could have set $\gamma$ to zero and assumed that $a_{1l} < 0$, which would be another way to generate a fire-sale.
17 This assumption is just for simplicity and can be relaxed.
18 The results do not change if simple sums are used instead of averages.
at the price \( p_{2s} \) per unit. As a result, her period-one, state \( s \) borrowing is \( d_{2s} \), \( p_{2s} \). The prices, \( p_{1s} \) and \( p_{2s} \), will be determined in equilibrium.

I assume that if banker \( i \) borrows in period-zero, in period-one, she can give an enforceable "take it or leave it" offer to the lender — either take \( \theta (q_{1s} - \gamma) k_0^i \) or the bank will be closed (the banker will withdraw her human capital), and no output will be produced in period two. \( 1 - \theta \) is the fraction of the value of the collateral that has to be paid in legal fees if the consumer has to seize the collateral. (One can set \( \theta \) equal to one and all the results remain.\(^{19} \)) If the bank is closed, the consumer will withhold the capital, pay the legal fees and the refinancing cost and resell the capital, which will generate \( \theta (q_{1s} - \gamma) k_0^i \) units of the consumption good. In equilibrium, the consumer will always accept the "take it or leave it" offer. Anticipating that, in \( t = 0 \), the consumer will write only a short-term, state-contingent debt contact with the banker subject to the collateral constraint, \( d_{1s}^i \leq \theta (q_{1s} - \gamma) k_0^i \). Once the banker repays her old debt in \( t = 1 \), she can enter a new collateralized contract with the consumers. Since, in period two, she will never pay more than the value of the collateral after legal fees, the banker can borrow only against the collateral constraint, \( d_{2s}^i \leq \theta (q_{2s} - \gamma) k_{1s}^i \).

Finally, in the low state in period-one (the crisis state), banker \( i \) will receive a bail-out equal to \( B_i^l \) as a transfer from the government, where \( B_i^l \) is endogenously determined. Banker \( i \) can pay dividends in every period and state of nature, but she will do so optimally only in the last period, \( t = 2 \), when she gives all of the profits to the consumers.

### 2.2 Consumers

There is a continuum of risk-neutral consumers distributed uniformly over the unit interval. They are the only agents that consume in this economy. In every period and state of nature, every consumer receives an endowment \( e \). He can enter a state-contingent debt contract with each banker in both periods zero and one, as described in the previous section. The preferences of the representative consumer are given by

\[
U_0^c = c_0 + \sum_s \pi_s (c_{1s} + c_{2s}) ,
\]

Consumers also have access to a production technology that uses capital as an input good and transforms it into the consumption good within the same period. Once the production technology produces the consumption good, the capital depreciates one hundred percent.\(^{20} \) When modelling the consumers’ production technology, in order to generate a downward-sloping demand for capital, I use an approach similar to that in many papers in the literature on financial frictions, following the seminal paper of Kiyotaki and Moore (1997). In \( t = 0, 1 \), the consumers’ production technology

\(^{19} \)In fact, for the simulations presented in the paper, I will set \( \theta \) equal to 1.

\(^{20} \)The assumption that 100% of the capital depreciates after the consumers’ production technology is employed can be relaxed and is only for simplicity.
is given by $F(k_{ts}^T)$, where $k_{ts}^T$ is the amount of capital employed. In $t = 2$, I assume that the production technology is such that one unit of capital is transformed into one unit of consumption. The assumption that the production technology is different across periods is a simplification and can be relaxed. However, given that the model is a finite period model, relaxing it would imply that there will be always a fire sale in $t = 2$ in both the high and the low state. This will be an unappealing feature of the model given that, in reality, crises are followed by normal times. The assumption that the production technology is different across periods is a simplification and can be relaxed. However, given that the model is a finite period model, relaxing it would imply that there will be always a fire sale in $t = 2$ in both the high and the low state. This will be an unappealing feature of the model given that, in reality, crises are followed by normal times.

The production technology satisfies the following assumptions. $F(k_{ts}^T)$ is at least three times differentiable on $(0, \infty)$. $F(k_{ts}^T)$ and $F'(k_{ts}^T)$ are continuous on $[0, \infty)$. Also, $F(0) = 0$, $F'(0) = 1$, $F''(0) = F'''(0) = 0$, $F''(k_{ts}^T) < 0$ if $k_{ts}^T \in (0, \infty)$ and $\lim_{k_{ts}^T \to \infty} F''(k_{ts}^T) \geq \gamma$. The assumptions made on $F(\cdot)$ guarantee that if there is no fire sale, it will never be profitable for the consumers to transform consumption into capital one-to-one in order to use the production technology since the marginal product of capital is less than one. Therefore, from market clearing, it will be the case that $k_{ts}^T = k_{ts}^F$. The assumption $F''(\cdot) < 0$ guarantees that the larger the fire sale is, the lower the price of capital will be, which is a proxy for a downward-sloping demand for capital. Finally, $\lim_{k_{ts}^T \to \infty} F''(k_{ts}^T) \geq \gamma$ ensures that the resale price of capital, $q_{ts}$, is always greater than the refinancing cost and, hence, all the capital is refinanced. Note that the bankers’ production technology is more productive than the consumers’, which is a key assumption.

If the consumers’ production technology is employed in $t = 0, 1$, which will be the case only when there is a fire sale, the price of capital will be pinned down by the marginal product of capital of the consumers’ production technology, $q_{ts} = F'(k_{ts}^T)$. If it is not employed, then $q_{ts} = 1$. In $t = 2$, the price of capital will be always equal to one, $q_{2s} = 1$, given the assumption that capital can be transformed into consumption one-to-one. In equilibrium, in $t = 0$, $q_0 = 1$ because bankers enter period-zero with no capital and, therefore, there will never be a fire sale. I will consider parametrization where, in $t = 1$, there will be a fire sale only in the low state, $q_{1l} < 1$, and not in the high state, $q_{1h} = 1$. Since consumers are risk-neutral, in equilibrium, the prices of the state-contingent debt contracts will be $p_{1s} = p_{2s} = 1$. A detailed solution to the consumer’s problem is provided in the Appendix, Section A.1.

### 2.3 Policy Maker

The policy maker optimizes the welfare of the consumers, who are also the owners of the banks. He has access to ex-ante and ex-post policy instruments. The ex-ante policy instruments are a minimum bank capital requirement and a limit on the payment that bankers promise in the crisis state. The minimum bank capital requirement is defined as $\rho^j \leq \frac{n}{K_0}$, where $\rho^j$ is the minimum bank capital

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21 The fact that crises are followed by normal times will be naturally captured if the model is extended to an infinite-period model and the production technology is given by $F(k_{ts}^T)$ in all periods.

22 More precisely, the assumptions that guarantee this result are that $F'(k_{ts}^T)$ is continuous on $[0, \infty)$, $F'(0) = 1$, and $F''(k_{ts}^T) < 0$ if $k_{ts}^T \in (0, \infty)$. 

10
ratio of bank $i$. $\rho^i$ is the minimum fraction of period-zero investment that has to be financed using equity. I focus throughout most of the paper on the minimum bank capital requirement as the ex-ante policy instrument used to address overinvestment because it is the regulatory policy currently implemented by almost all countries worldwide. I also explicitly allow the policy maker to restrict the amount of payments a banker pledges in the crisis state by imposing the constraint $d^{i}_{ij} \leq \nu^i$. While such an instrument is currently not used in practice, in this paper, I will show that the presence of such an instrument will allow policy makers of countries with strong moral hazard to improve upon aggregate welfare. From a regulatory perspective, in order to map this regulation to contracts used in the real world, policy makers would want to limit the liabilities bankers face in a crisis state due to standard debt contracts, as well as to certain derivative contracts such as CDS contracts.

The ex-post regulatory instrument is an optimal government bail-out during crises. I implicitly assume that the government can circumvent the collateral constraint of bankers during crises via its power to tax the consumers and transfer resources to the bankers. For simplicity, I assume that bail-outs are prohibitively costly when there is no crisis due to the high political costs of transferring money from taxpayers to the financial sector in normal times. Denote the levied tax as $T_l$. Market clearing implies that $T_l = B_l$. I assume that taxation is costly, and this cost can vary across countries. The size of the deadweight loss from taxing is given by $\delta (B_l, \chi)$, where $0 \leq \chi < \infty$. $B_l = \sum_{i=1}^{N} \frac{1}{N} B^i_l$ is the aggregate bail-out and $B^i_l$ is the targeted bail-out given to bank $i$.  

The parameter $\chi$ captures the ability of a country to provide an extra dollar of bail-out, which I call fiscal capacity in this paper. The smaller $\chi$ is, the more fiscally constrained the country is (lower fiscal capacity). Instead of introducing the exogenous parameter $\chi$, I could have chosen to model the cost of the bail-out simply as the deadweight loss from the taxes, $T_l$, scaled by the tax base, $e$, which would have a closer mapping to the public policy literature. In that case, one can interpret the fiscal capacity parameter $\chi$ as $e$ — the tax base of the country. However, in reality, bail-outs are financed in three different ways — by taxing the residents of the country during the financial crisis, by sovereign borrowing or by printing money if the government has an independent monetary policy. The costs associated with sovereign borrowing, taxing and printing money can be realistically proxied using convex cost functions. In equilibrium, a country with access to all three instruments will use all of them, up to the point where the marginal cost of taxing is equal to the marginal cost of printing money and to the marginal cost of sovereign borrowing, which will, in turn, equal the marginal cost of the bail-out. As a result, even if I were to write a full-blown model with sovereign borrowing and printing of money in addition to taxing, the marginal cost of the bail-out would be a sufficient statistic. Therefore, I choose to model the marginal cost of taxing and,

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23 In order to link the model to the Basel III minimum bank capital requirement, one can interpret $k$ as loans, fixed income and investment in stocks and state-contingent borrowing, $d$, as derivative positions. In this model, I assume that no equity provisions are required for $d$ (and only for $k_0$) because in Basel III, derivative positions require equity holdings only if there is counterparty risk and there is no counterparty risk in this model.

24 One can relax the assumption that there are bail-outs only in the crisis state. The qualitative results remain.

25 This assumption captures the fact that it is the aggregate tax size that affects the deadweight loss from taxing.
hence, bail-out, in a reduced-form way in order to obtain analytical results. The interpretation of \( \chi \) is flexible and should be linked not only to the size of the country’s tax base but also to variables such as the size of the sovereign debt, the cost of printing money and the country’s ability to collect taxes.

I assume that \( \delta (B_t, \chi) \) is a convex and increasing function with respect to the aggregate bail-out, which implies that \( \frac{\partial \delta (B_t, \chi)}{\partial B_t} > 0 \) and \( \frac{\partial^2 \delta (B_t, \chi)}{\partial B_t^2} > 0 \) if \( \chi < \infty \). The larger the total size of the bail-out, the larger the deadweight loss is; and the marginal cost of the bail-out increases with bail-out’s total size. In the public finance literature, the convexity of the deadweight loss is a standard assumption that captures the distortionary cost of labor taxation in a reduced-form way. A few additional assumptions are required. For a given \( B_t \), I assume that \( \frac{\partial \delta (B_t, \chi)}{\partial \chi} < 0 \) and \( \frac{\partial^2 \delta (B_t, \chi)}{\partial B_t \partial \chi} < 0 \), which implies that the larger the fiscal capacity of a country is, the smaller are the deadweight loss from the bail-out and the marginal cost of the bail-out. The final set of assumptions are that \( \frac{\partial^3 \delta (B_t, \chi)}{\partial B_t^2 \partial \chi} < 0 \), and the deadweight loss due to the bail-out, \( \delta (B_t, \chi) \), the marginal cost of the bailout, \( \frac{\partial \delta (B_t, \chi)}{\partial B_t} \) and \( \frac{\partial^2 \delta (B_t, \chi)}{\partial B_t^2} \) are all equal to zero when \( \chi \to \infty \) (infinite fiscal capacity) and approach infinity when \( \chi = 0 \) (no fiscal capacity). For example, a functional form that satisfies all of these conditions and will be used in the simulations is \( \delta (B_t, \chi) = \frac{1}{\chi} B_t^\eta \), where \( \eta > 1 \).

### 2.4 Assumptions

In addition to the assumptions made so far on the functional forms of \( F(\cdot) \) and \( \delta (\cdot) \), in order to have a well-defined and non-trivial problem, I also assume that the following inequalities are satisfied. The first assumption is that the expected return on the period-zero investment is less than one when the return in the low state is zero:

\[
\pi_h (1 + a_{1h} - \gamma) < 1 \quad \text{Assumption 1}
\]

If Assumption 1 is violated, it will always be optimal for the banker to lever to the maximum in period-zero and to invest as much as possible, which will make the problem trivial. The following assumption ensures that if there is no fire sale, the expected return on period-zero investment is greater than the cost

\[
1 < \sum_s \pi_s [1 - \gamma + a_{1s}] \quad \text{Assumption 2}
\]

If Assumption 2 is violated, period-zero investment will always be zero. In order to have a fire sale in the model, it must be the case that the fraction of the capital value that can be pledged, \( \theta (1 - \gamma) \), plus the return on period-zero capital in the crisis state, \( a_{1l} \), is less than the refinancing cost of capital, \( \gamma \). I also assume that the refinancing cost is less than one, which is the highest possible price of capital.

\[
a_{1l} + \theta (1 - \gamma) < \gamma < 1 \quad \text{Assumption 3}
\]
To ensure uniqueness, I also assume that

\[ F' (k_{\text{II}}^T) - \theta (1 - \gamma) + F'' (k_{\text{II}}^T) k_{\text{II}}^T > 0 \]  
Assumption 4

\[ \frac{\partial (F' (k_{\text{II}}^T) - \theta (1 - \gamma) + F'' (k_{\text{II}}^T) k_{\text{II}}^T)}{\partial k_{\text{II}}^T} = F''' (k_{\text{II}}^T) k_{\text{II}}^T + F'' (k_{\text{II}}^T) < 0, \]

Assumption 5 guarantees that in the high state, there is never a fire sale (i.e., the output per unit of \( k_0 \) is higher than the refinancing cost of \( k_0 \)):

\[ a_{1h} > \gamma, \]  
Assumption 5

Assumption 6 is necessary in order to generate fire sales in the model. It guarantees that the optimal bail-out and the amount of resources that can be transferred to the crisis state using state-contingent debt contracts are not sufficient to cover the refinancing cost of period-zero capital during the crisis state.

\[ \frac{(a_{1l} - \gamma) n}{1 - \theta (1 - \gamma)} + (\delta')^{-1} \left( \frac{A - \gamma}{1 - \theta (1 - \gamma)} \right) < 0, \]  
Assumption 6

Assumption 7 ensures that the return to period-zero and period-one investment (after the refinancing cost is paid) is non-negative:

\[ A - \gamma > 0, \quad a_{1s} \geq 0. \]  
Assumption 7

3 Solving the Model

3.1 Decentralized Equilibrium

This section develops the optimization problem of banker \( i \), assuming no commitment and that the policy maker provides an optimal ex-post bail-out during a crisis. For now, I do not introduce any ex-ante policy instruments in order to compare the decentralized equilibrium with no ex-ante regulation to the constrained Central Planner’s allocation and to prove that there is a role for ex-ante regulation. Throughout the paper, I will do the analysis for any number of banks \( N \), and occasionally will consider the special case for a continuum of banks, which maps to the case where \( N \to \infty \).

Banker \( i \) optimizes the dividend payments to the equity owners (consumers).\(^{27}\) She takes into account the market-clearing condition, \( k_{1s}^T = k_{1s}^F = \sum_{i=1}^{N} \frac{1}{N} k_{1s}^{i, F} \), where \( k_{1s}^{i, F} = \max \{ 0, k_0^i - k_{1s}^i \} \); the

\(^{26}\)In models with binding borrowing constraints, there might be multiple equilibria because both the demand for and the supply of fire-sold capital is downward-sloping. For details, see Lorenzoni (2008). The possibility of multiple equilibria in this class of models is interesting but is not the focus of this paper.

\(^{27}\)The assumption that bankers optimize dividend payments is equivalent to the bankers optimizing the welfare of the equity holders (consumers) in the case where there are an infinite number of banks. If banks are large (finite number), in order for banks to maximize the welfare of their equity holders, in addition to maximizing the dividend payments, they will have to internalize the effect of their decisions on consumers’ profits via prices (conditional on the
equilibrium prices of the state-contingent debt contracts, \( p_{1s} = p_{2s} = 1 \), and the equilibrium prices of capital given by \( q_0 = q_{2s} = 1 \) and \( q_{1s} = F' (k_{1s}^T) \). It is important to note that if \( N < \infty \), banker \( i \) internalizes the fact that her actions affect the price of capital in the middle period because they affect the aggregate fire sale. Furthermore, in equilibrium, it will never be optimal to pay dividends in \( t = 0 \) and \( t = 1 \), and, hence, I omit those choice variables from the setup without loss of generality. Since I assume that banker \( i \) does not have access to a commitment technology, I solve the model backwards.\(^{28}\)

The actions in reverse order are the following. In \( t = 2 \), all bankers produce and pay out all the profits as dividends to the consumers. At the end of \( t = 1 \), banker \( i \) maximizes the dividend payment in the last period by choosing \( \{k_{1s}^i, d_{2s}^i\} \) and taking as given the endogenous state variables \( \{B_s^i, k_0^i, d_{1s}^i\} \). Banker \( i \) maximizes

\[
\max_{k_{1s}^i, d_{2s}^i} (A + 1 - \gamma) k_{1s}^i - d_{2s}^i,
\]

subject to the collateral constraint in \( t = 1 \)

\[
d_{2s}^i \leq \theta (1 - \gamma) k_{1s}^i [\lambda_{2s}^i]
\]

where the Lagrangians are given in square brackets. Banker \( i \) also takes into account the period-one budget constraint

\[
 k_{1s}^i F' (k_{1s}^T) + d_{1s}^i \leq (F' (k_{1s}^T) + a_{1s} - \gamma) k_{0s}^i + B_{s}^i + d_{2s}^i [z_{1a}^{i,1}]
\]

where \( B_{s}^i = 0 \) since I assumed bail-outs are prohibitively costly if there is no crisis.

First, at the beginning of \( t = 1 \), banker \( i \) repays the promised debt \( d_{1s}^i \) to the consumers. After that, if the low state is realized, the policy maker chooses \( B_1^i \) given the state variables \( \{k_{1s}^i, d_{1s}^i\} \). He also takes into account that his choice of \( B_1^i \) affects the choices banker \( i \) will make at the end of \( t = 1 \). Given that consumers are risk-neutral, the objective function of a benevolent policy maker in \( t = 1 \) in the low state is to maximize last period’s total output.

\[
\max_{k_{11}, B_1^i} 2e + F (k_{11}^T) - F' (k_{11}^T) k_{11}^T - \delta (B_1, \chi) + d_{11}
\]

\[
\quad + \sum_{i=1}^{N} \frac{1}{N} \left[ z_{11}^{i,1} (F' (k_{11}^T) + a_{11} - \gamma) k_{0}^i + B_{i}^i + d_{21}^i - k_{11}^T F' (k_{11}^T) - d_{11}^i \right]
\]

additional assumption that the bail-out of bank \( i \) is not financed by taxing the equity owners of bank \( i \). However, if I were to assume that bankers maximize the welfare of the equity owners rather than dividend payments, all the results remain with even fewer assumptions. The reason I chose dividend payments as the objective function of bankers is because it is closer to reality.

\( ^{28}\)Potentially, there can be time inconsistency in the decentralized problem. When banks are large, they internalize the fact that their period-one investment decision will affect the tightness of their period-zero borrowing constraint against the low state, if it is binding, through the fire sale price. There will be no time inconsistency in the case with a continuum of banks. For more details, see Davila (2011).
(A + 1 - \gamma) k_{1l}^i - d_{2i}^l are the dividends paid by banker \( i \) to the equity owners (consumers) in \( t = 2 \) in the low state, and \( F \left( k_{1l}^T \right) - F' \left( k_{1l}^T \right) k_{1l}^T \) are the consumers’ profits from operating their production technology if a fire sale is present. \( d_{1l}^i \) is the period-one payment by the bankers to the consumers. \( \delta (B_t, \chi) + B_t \) is the cost of the bail-out — the direct cost plus the deadweight loss from taxing.\(^{29} \) 

\( z_{1l}^{i,1,P} \) is the Lagrangian on the period-one budget constraint of banker \( i \) in the low state from the policy maker’s problem.

At the end of \( t = 0 \), banker \( i \) optimizes the expected dividends paid to the consumers in \( t = 2 \), taking into account her future optimal actions and the first-order condition of the policy maker with respect to the bail-out in the crisis state. The period-zero objective function of banker \( i \) is given by

\[
\max_{k_0^i, d_{1s}^i} \sum_s \pi_s \left[ (A + 1 - \gamma) k_{1s}^i - d_{2s}^i \right]
\]

subject to his period-one budget constraints given by equation 2 (with a period-zero Lagrangian \( \pi_s z_{1s}^{i} \)). Also, banker \( i \) takes into account the period-zero budget constraint

\[
k_0^i \leq \sum_s \pi_s d_{1s}^i + n \quad [z_0^i] \tag{3}
\]

The optimization problem is also subject to the period-zero collateral constraints.

\[
d_{1s}^i \leq \theta \left( F' \left( k_{1s}^T \right) - \gamma \right) k_0^i \quad [\pi_s \lambda_{1s}^i] \tag{4}
\]

For detailed derivations, see Appendix, Section A.2.

**Proposition 1** Given Assumptions 1-7 and the Assumptions made on the functional forms of \( F (\cdot) \) and \( \delta (\cdot) \), considering a symmetric equilibrium with an ex-post optimal bail-out and no ex-ante regulation, one can prove the following:

(i) There is no fire sale in the high state, \( q_{1h} = 1 \), and there is a fire sale in the low state, \( q_{1l} < 1 \).

(ii) Given the additional Assumption 8 provided in the Appendix, (required only for the \( N < \infty \) case), the equilibrium is unique and exists and is one of the following types:

- **Type 1** \( z_0 = z_{1l} > z_{1h} = (\lambda_{1l} = 0, \lambda_{1h} > 0) \) (interior equilibrium)
- **Type 2** \( z_0 > z_{1s} = (\lambda_{1s} > 0) \) (corner equilibrium where the banker borrows to the maximum in \( t = 0 \)), where

\[
z_0 = \sum_s \pi_s \left[ z_{1s} \left( F' \left( k_{1s}^T \right) + \frac{1}{N} F'' \left( k_{1s}^T \right) k_{1s}^T + a_{1s} - \gamma + \frac{\partial B_i^l}{\partial k_0} \right) + \lambda_{1s} \theta \left( F' \left( k_{1s}^T \right) - \gamma + \frac{1}{N} F'' \left( k_{1s}^T \right) \right) k_0 \right] \tag{5a}
\]

\[
z_{1s} = \frac{A + (1 - \theta) (1 - \gamma) - \lambda_{1s} \theta \frac{1}{N} F'' \left( k_{1s}^T \right) k_0}{\frac{1}{N} F'' \left( k_{1s}^T \right) k_{1s}^T - \frac{\partial B_i^l}{\partial k_{1s}^T} + F' \left( k_{1s}^T \right) - \theta (1 - \gamma)} \tag{5b}
\]

\(^{29}\)I also assume that the endowment of the consumer, \( e \), is large enough so that \( B_t < e + d_{1l} - p_{2l} d_{2l} \).
The optimal bail-out is pinned down by

\[ 1 + \frac{\partial \delta(B_t, \chi)}{\partial B_t} = z_{1l}^P = \frac{F''(k_{1l}^T)}{F''(k_{1l}^T) k_{1l}^T + A + (1 - \theta)(1 - \gamma)} + \frac{F'}{F'}(k_{1l}^T) - \theta(1 - \gamma), \] 

where

\[ \frac{\partial B_i^i}{\partial k_{1l}^P} = \frac{\partial B_i^i}{\partial k_0^P} = -\frac{\partial B_i^i}{\partial k_{1l}^P} = \frac{1}{\partial^2 \delta(B_t, \chi)} \cdot \frac{\partial z_{1l}^P}{\partial k_{1l}^T} \geq 0. \] 

Also, \( B_h^i = 0 \), and \( \frac{\partial z_{1l}^P}{\partial k_{1l}^T} \) is given by equation 24 in the Appendix. The first-order conditions with respect to \( d_{2s} \) and \( d_{1s} \) imply \( \lambda_{2s} > 0 \) and \( \lambda_{1s} = z_0 - z_{1s} \geq 0 \).

**Proof of Proposition 1.** See Appendix, Section A.4.1.

The key variables that characterize the equilibrium type are \( z_{1s} \) and \( z_0 \). \( z_0 \) is the period-zero marginal value of one unit of the consumption good (which, from now on, I will refer to as the marginal value of one dollar) in the hands of the banker as perceived by the banker. \( z_{1s} \) is the scaled marginal value of a dollar in \( t = 1 \), state \( s \), in the hands of the banker as perceived by the banker. When the banker decides optimally whether to keep an extra dollar in \( t = 0 \) or to "transfer" it to \( t = 1 \), state \( s \), using a state-contingent contract, the relevant variables to compare are \( z_0 \) and \( z_{1s} \).

If the banker saves/"transfers" an extra dollar from \( t = 0 \) to period 1, state \( s \), she will get \( \frac{1}{\pi_s} \) units of the consumption good in \( t = 1 \), state \( s \), and her ex-ante welfare will increase by \( (\pi_s z_{1s}) \frac{1}{\pi_s} = z_{1s} \).

If the banker keeps the dollar in \( t = 0 \), her ex-ante welfare will improve by \( z_0 \). Throughout the rest of the paper, I will refer to \( z_{1s} \) and \( z_0 \) as the marginal value of wealth in the hands of the banker, as perceived by the banker, in \( t = 1 \), state \( s \), and in \( t = 0 \), respectively.

Let us analyze the first-order conditions in more detail. One can prove that, given the assumptions made, \( z_{1s} > 1 \) and \( z_0 > 1 \). \( z_{1s} > 1 \) and \( z_0 > 1 \) imply that in \( t = 0 \) and in \( t = 1 \), the banker optimally does not pay dividends to the consumer whose marginal value of wealth is one.\(^{30}\)

Also, \( z_{1s} > 1 \) implies that the banker wants to transfer the maximum amount of resources from period two to periods zero and one since in the last period, the marginal value of wealth is equal to one — the marginal utility of consumption. As a result, the period-one borrowing constraints will always bind, implying that \( \lambda_{2s} > 0 \) and \( d_{2s} = \theta(1 - \gamma) k_{1s} \). If the equilibrium is interior, then \( z_0 = z_{1l} > z_{1h} \), which implies that the banker values wealth more in period-zero and in the crisis state than she values wealth in the high state in \( t = 1 \). Therefore, in period-zero, the banker borrows to the maximum against the high state, which implies that \( \lambda_{1h} > 0 \) and \( d_{1h} = \theta(1 - \gamma) k_0 \).

The economic intuition behind the first-order conditions is as follows: The first-order condition of the policy maker with respect to the bail-out at the beginning of \( t = 1 \), equation 5c, determines the optimal bail-out, \( B_t \), by equating the marginal cost to the marginal benefit of the bail-out. The marginal cost of the bail-out is simply the direct transfer of one dollar from the consumer to the

\(^{30}\) The proof that \( z_{1s} > 1 \) can be found in Section A.2 of the Appendix and \( z_0 > 1 \) follows from the proof of Proposition 1, which shows that in both feasible equilibria types, it is the case that \( z_0 \geq z_{1s} \). This confirms the assumption made when solving the problem that dividends will be optimally paid out only in \( t = 2 \).
banker, plus the marginal increase of the deadweight loss from the bail-out, \( \frac{\partial \delta(B_i, \lambda)}{\partial B_i} \). The marginal benefit of the bail-out is the marginal value of an extra dollar in the hands of the banker in the crisis state as perceived by the policy maker, \( z_{1s}^F(k_{1s}^T) \). From equation 5c, it is clear that only the aggregate bail-out is pinned down, \( B_l \), and not the bank-specific bail-out, \( B_i^l \). In order to solve the model, I assume that the equilibrium is symmetric where the government gives the same bail-out to each bank, \( B_l = B_i^l \), and every banker internalizes that when making decisions in period \( t = 0 \),

By totally differentiating equation 5c with respect to \( k_{1i}^F \), one can derive how banker \( i \) perceives her individual fire sale affecting the targeted bail-out she receives, \( \frac{\partial B_i^l}{\partial k_{1i}^F} \), which will be an important term that enters the first-order conditions with respect to \( k_{10}^i \) and \( k_{1i}^T \). The formula for \( \frac{\partial B_i^l}{\partial k_{1i}^F} \) is given by equation 5d. When banks are not infinitesimally small and the country has some fiscal capacity, \( N < \infty \) and \( \chi > 0 \), banker \( i \) partially internalizes the fact that the larger her individual fire sale is, the larger the optimal bail-out is, \( \frac{\partial B_i^l}{\partial k_{1i}^F} > 0 \). Since the banker is large, she realizes that her actions affect the fire sale and, therefore, the optimal amount of bail-out received. A larger fire sale implies a larger transfer of resources from the more productive sector — bankers — to the less productive sector — consumers, leading to a larger optimal bail-out (captured by the term \( \frac{\partial z_{1i}^F(k_{1i}^T)}{\partial B_{1i}^l} > 0 \)). For countries with a large number of banks, for a given level of fire sale, the perceived impact of the individual fire sale on the aggregate fire sale is smaller (captured by the term \( \frac{1}{N} \)). In the limiting case, with a continuum of banks, \( N \to \infty \), \( \frac{\partial B_i^l}{\partial k_{1i}^F} = 0 \). This result will be crucial in order to prove later on that with a continuum of banks there is no moral hazard, while there will be moral hazard if banks are large. Finally, the bail-out received is smaller for a given level of fire sale, if the country is more fiscally constrained, (captured by the fact that \( \frac{\partial^2 \delta(B_i, \lambda)}{\partial^2 B_i} \) is positive and increases when \( \chi \) decreases). When \( \chi = 0 \), the bail-out will be zero and, hence, \( \frac{\partial B_i^l}{\partial k_{1i}^F} = 0 \).

Equation 5b is the first-order condition with respect to \( k_{1i}^s \) (from the period-zero optimization problem), which pins down the marginal value of wealth in the hands of the bankers in period-one as perceived by the banker, \( z_{1s} \). In equilibrium, \( z_{1s} \) is equal to the marginal benefit of \( k_{1s} \) over the "effective" marginal cost of purchasing an extra unit of \( k_{1s} \). The marginal benefit of an extra dollar invested in \( t = 1 \) is the cash flow received in \( t = 2 \), \( A \), plus the resale value of capital of one minus the refinancing cost minus the debt payment \((1 - \gamma) - \theta (1 - \gamma)\). If the Lagrangian on the period-zero borrowing constraint is binding, \( \lambda_{1s} > 0 \), and there is a fire sale, the extra unit of

\[ 31 \text{In this model, with linear production technology of the bankers, the policy maker is indifferent whether to give the bail-out money to Bank of America which takes over Merill Lynch (the bank that needs the bail-out) or he gives the money directly to Merill Lynch. Optimally, the policy maker wants to achieve an aggregate fire sale of } k_{1i}^F = k_{1i}^T \text{ which is determined by equation 5c. For a proof of this result, see Appendix, Section A.2. Of course, the ex-post bail-out design affects the ex-ante incentives of banks. Acharya, Shin, and Yorulmazer (2011) and Nosal and Ordonez (2013) are two interesting papers that address the question of what is the optimal ex-post bail-out design that minimizes moral hazard ex-ante.} \]

In this model I focus on an environment where the policy maker has a sufficient number of ex-ante instruments to correct for the moral hazard (he can replicate the constrained Central Planner’s allocation). Therefore, the ex-post bail-out design is not crucial for the comparative static of the optimal minimum bank capital requirement with respect to fiscal capacity.
capital purchased in period-one will increase the resale value of period-zero capital and relax the period-zero borrowing constraint, which is captured by the $-\lambda_1 s \theta \frac{1}{N} F''(k_{1s}^T) k_0 > 0$ term. This will increase the marginal benefit of $k_{1s}$. Next, let us consider the denominator of equation 5b, which is the "effective" marginal cost of an extra $k_{1s}$. The direct marginal cost of investment is the price of an extra unit of investment $q_{1s} = F'(k_{1s}^T)$, which is reduced by the fact that the banker can lever against the capital — captured by the term $-\theta (1 - \gamma)$. The indirect marginal cost is given by the term $\frac{1}{N} F''(k_{1s}^T) k_{1s}^T - \frac{\partial B_l}{\partial k_{1s}}$, and is relevant only if the bank is not infinitesimally small, $N < \infty$, and there is a fire sale. The indirect cost includes a monopolistic effect, $\frac{1}{N} F''(k_{1s}^T) k_{1s}^T < 0$, which makes the "effective" cost of period-one capital lower because the banker realizes that an extra unit of period-one capital will increase the per unit price of the fire-sold capital for a given $k_0$. In addition, if the bank is large and there is a fire sale, the bank also realizes that an extra $k_{1s}$ will decrease the marginal bail-out received because the fire sale will be smaller, which is captured by the term $-\frac{\partial B_l}{\partial k_{1s}} > 0$. This last effect will increase the "effective" marginal cost of period-one capital.

The first-order condition with respect to $k_0$, given by equation 5a, pins down $z_0$ — the marginal value of wealth in period-zero as perceived by the banker. Since the price of period-zero investment is one, an extra dollar in $t = 0$ implies an extra unit of investment purchased in $t = 0$. Therefore, the marginal value of wealth in period-zero, $z_0$, in equilibrium, is equal to the marginal benefit of $k_0$. In $t = 1$, state $s$, the return from an extra dollar $k_0$ is the cash flow, $a_{1s}$, plus the resale price, $q_{1s} = F'(k_{1s}^T)$, minus the refinancing cost, $\gamma$. In addition, if the banker is not infinitesimally small, she internalizes the fact that the "effective" marginal return to $k_0$ is smaller, because an extra $k_0$ (for a given $k_{1s}$) leads to a larger fire sale and a lower price of the fire-sold capital. Hence the return will decrease by $\frac{1}{N} F''(k_{1s}^T) k_{1s}^T < 0$ (a monopolistic effect). However, higher $k_0$ will also increase the perceived bail-out received by increasing the fire sale, which is captured by the term $\frac{\partial B_l}{\partial k_0} > 0$. This will increase the "effective" return to an extra dollar invested in period-zero. Note that the banker internalizes only the benefit but not the cost of the bail-out. The "effective" period-one return on $k_0$ is re-invested, which is why it is multiplied by the marginal value of wealth in $t = 1$ state $s$, $z_{1s}$. If the period-zero collateral constraint is binding, an extra $k_0$ has the additional benefit of relaxing the borrowing constraint, which is why the marginal benefit of $k_0$ also includes the term $\lambda_1 s \theta (F'(k_{1s}^T) - \gamma + \frac{1}{N} F''(k_{1s}^T) k_0)$. 

**Graphical Proof of Existence and Uniqueness**

In order to solve for the optimal allocation, I first solve for the optimal amount of period-zero investment, $k_0$. I will provide intuition for the proof of existence and uniqueness using a graphical approach of how $k_0$ is determined. In subsequent sections, I will build on Figure 1 to prove that there is overinvestment if the policy maker does not have an access to any ex-ante regulatory instruments.

Define the following function of $k_0$

$$\psi (k_0) = z_{11} (k_0) - z_0 (k_0) \text{ where } k_0 \in [\hat{k}_0, k_0^{\text{max}}]$$
where in Proposition 1 of the Appendix, I derive the relevant range \([k_0, k_0^{\text{max}}]\). Also, \(z_{1l}(k_0)\) and \(z_0(k_0)\) are the marginal values of wealth in period-zero and in the low state in period-one if the equilibrium is of Type 1. If the equilibrium is Type 1 (interior equilibrium), then \(k_0^*\) will be determined by \( \psi(k_0^*) = 0\), where the asterisk denotes equilibrium values. If the equilibrium is Type 2 (corner equilibrium) then \(k_0^* = k_0^{\text{max}}\) and the bank will borrow to the maximum in \(t = 0\).  

I focus on the Type 1 interior equilibrium, which will be the more interesting case. \(k_0\) is pinned down using the first-order condition with respect to \(d_{1l}\), which is similar to an Euler equation and given by \(z_{1l}(k_0^*) = z_0(k_0)\). In equilibrium, the banker is indifferent between investing an extra dollar in period-zero and saving the extra dollar towards the crisis state using a state-contingent contract.  

Figure 1: Existence and Uniqueness of the Decentralized Equilibrium

One can prove that \(\psi(k_0)\) is a strictly increasing function of \(k_0\) which implies that \(\psi(k_0)\) will cross the zero line at most once. \(\psi'(k_0)\) because the marginal value of wealth in the crisis state, as perceived by the banker, increases with period-zero investment, \(\frac{\partial z_{1l}}{\partial k_0} > 0\), while the marginal value of wealth in period-zero decreases with period-zero investment, \(\frac{\partial z_0}{\partial k_0} < 0\). Let us start with \(\frac{\partial z_{1l}}{\partial k_0} > 0\). In the case with a continuum of banks \((N \to \infty)\), \(\frac{\partial z_{1l}}{\partial k_0} > 0\) because a larger \(k_0\) increases the fire sale which lowers the price of capital during a crisis. As a result, an extra dollar is more valuable in the crisis state since it can purchase more units of capital. If banks are large \((N < \infty)\), in order for \(\frac{\partial z_{1l}}{\partial k_0} > 0\) Assumption 8 is required, as well. Assumption 8 guarantees that the "effective" cost of \(k_{1l}\) decreases as \(k_0\) increases, because the direct effect of the price decrease in the crisis state is not offset by the fact that the perceived marginal bail-out received increases with \(k_0\), \(\frac{\partial^2 B_j}{\partial k_{1l} \partial k_0} > 0\) (since the fire sale increases).  

Next let us consider why \(\frac{\partial z_0}{\partial k_0} < 0\). In equilibrium, \(z_0\) is equal to the marginal benefit of an extra unit of \(k_0\). The equilibrium is of Type 2 if \(\psi(k_0) < 0\) for all \(k_0 \in (k_0, k_0^{\text{max}})\).  

\[32\] The equilibrium is of Type 2 if \(\psi(k_0) < 0\) for all \(k_0 \in (k_0, k_0^{\text{max}})\).  

\[33\] If the banker invests the extra dollar in period zero, her ex-ante welfare increases by the benefit of investing an extra unit of \(k_0\), which is given by \(z_0(k_0)\). If she saves the extra dollar towards the crisis state and invests it then, her ex-ante welfare increases by \(z_{1l}(k_0)\). Figure 1 depicts \(\psi(k_0)\).  

\[34\] The functional forms used for \(\delta(\cdot)\) and \(F(\cdot)\) in the graph are given in the beginning of the Appendix. The parameters, used to produce Figure 1 are \(\gamma = 0.7, \alpha = 0.8, A = 1, a_{1h} = 1.5, a_{1l} = 0, \pi_h = .55, n = .5, \theta = 1, \eta = 1.5, N = 10\)
An extra $k_0$ will lead to a larger fire sale and to a lower re-sale price of $k_0$ in the crisis state, thereby lowering the marginal benefit of an extra dollar invested in $t = 0$. In addition, if $N < \infty$, larger $k_0$ leads to a larger perceived marginal bail-out, $\frac{\partial^2 B_i}{\partial k_{1s} \partial k_0} > 0$, which increases the marginal benefit of an extra dollar invested in $t = 0$. In the case of a finite number of banks ($N < \infty$), Assumption 8 guarantees that the first effect dominates the second effect, leading to an unique equilibrium.

### 3.2 Constrained Central Planner’s Problem Without Commitment

In this section, I solve for the constrained Central Planner’s problem without commitment. The constrained Central Planner optimizes the welfare of the consumers who are also the owners of the banks. The Central Planner faces exactly the same constraints as the banker in the decentralized equilibrium — the borrowing constraints plus the first-order conditions of the consumer. Setting up the constrained Central Planner’s problem in such a way implies that he cannot directly transfer resources from the consumer to the banker unless he uses the bail-out instrument, which is costly.

Essentially, the Central Planner chooses the investment and borrowing decision of every banker, taking into account any externalities this decision imposes on the rest of the bankers and on consumers. Given that the equilibrium considered is symmetric, this maps into a problem where the Central Planner chooses aggregate variables, taking into account that his actions affect prices and, in particular, the price of capital in $t = 1$, $q_{1s} = F'(k^T_{1s})$. The Central Planner also takes into account the rest of the equilibrium prices given by $q_0 = q_{2s} = 1$, $p_{1s} = p_{2s} = 1$. In this section, I preserve the assumption that the fire sale will occur only if there is a fire sale.

Solving the problem backwards, in $t = 1$, the Central Planner maximizes the welfare of the consumers:

$$\max_{B_s, k_{1s}, d_{1s}} 2c + F(k^T_{1s}) - F'(k^T_{1s}) k^T_{1s} + d_{1s} - (B_s + \delta (B_s)) + (A + 1 - \gamma) k_{1s} - d_{2s}$$

subject to the collateral constraint in period-one, equation 1, with a Lagrangian given by $\lambda^{CP}_{2s}$, and subject to the period-one budget constraint, equation 2, with a Lagrangian given by $z_{1s}^{CP}$. Note that the Central Planner, unlike the banker in the decentralized equilibrium, also internalizes the cost of the bail-out, $- (B_s + \delta (B_s))$. Another difference from the banker’s optimization problem is that the Central Planner also takes into account that a larger aggregate fire sale improves consumers’ welfare via the profits from operating the consumers’ production technology given by $F(k^T_{1s}) - F'(k^T_{1s}) k^T_{1s}$. Last but not least, the Central Planner also internalizes the fact that the actions of a single banker impose an externality on consumers and other bankers by affecting the price of fire-sold capital, $F'(k^T_{1s})$. This mechanism will be at the heart of the pecuniary externality.

In $t = 0$, the Central Planner chooses $\{k_0, d_{1s}\}$, taking into account his future optimal actions, in order to optimize the following ex-ante welfare function:
\[ \max_{k_0,d_1^s} 3e + \sum_s \pi_s \left[ F(k_{1s}^T) - F'(k_{1s}^T) k_{1s}^T - (B_s + \delta(B_s)) + (A + 1 - \gamma) k_{1s} - d_{2s} \right] \]

The period-zero optimization problem is subject to the budget constraint in \( t = 1 \), equation 2, with a Lagrangian given by \( \pi_s z_{1s}^{CP} \) and the budget constraint in \( t = 0 \), equation 3, where the Lagrangian is \( z_0^{CP} \). The Central Planner also takes into account the period-zero collateral constraints given by equation 4 with a Lagrangian \( \pi_s \lambda_{1s}^{CP} \). For details on the setup and the solution, see Appendix, Section A.3.

**Proposition 2** (i) Given Assumptions 1-7 and the assumptions made on the functional forms of \( F(\cdot) \) and \( \delta(\cdot) \), there is never a fire sale in the high state, \( q_{1h} = 1 \), and there is a fire sale in the low state, \( q_{1l} < 1 \).

(ii) The equilibrium of the constrained Central Planner’s problem exists and is unique and is one of the following types:

- **Type 1** \( z_{0l}^{CP} = z_{1l}^{CP} > z_{1h}^{CP} \) (interior equilibrium);
- **Type 2** \( z_{0l}^{CP} > z_{1s}^{CP} \) (corner equilibrium where the banker borrows to the maximum in \( t = 0 \)).

The optimal bail-out is determined by

\[
1 + \frac{\partial \delta(B_l, \chi)}{\partial B_l} = z_{1l}^{1, CP} \tag{6a}
\]

(iii) If Assumption 9 also is satisfied (provided in the Appendix, Section A.4.2), the only possible equilibrium is the Type 1 interior equilibrium where

\[
\sum_s \pi_s (-F''(k_{1s}^T) k_{1s}^T + z_{1s}^{CP} (F'(k_{1s}^T) + a_{1s} - \gamma + F''(k_{1s}^T) k_{1s}^T)) + \pi_h \lambda_{1h}^{CP} \theta (1 - \gamma) = z_0^{CP} \tag{6b}
\]

\[
z_{1h}^{CP} = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta(1 - \gamma)} \tag{6c}
\]

\[
z_{1l}^{CP} = z_{1l}^{CP} = \frac{F''(k_{1l}^T) k_{1l}^T + A + (1 - \theta)(1 - \gamma)}{F'(k_{1l}^T) - \theta (1 - \gamma) + F''(k_{1l}^T) k_{1l}^T}, \tag{6d}
\]

and the first-order conditions with respect to \( d_{2s} \) and \( d_{1s} \) imply that \( \lambda_{2s}^{CP} > 0, \lambda_{1l}^{CP} = 0, \lambda_{1h}^{CP} = z_0^{CP} - z_{1h}^{CP} > 0 \).

**Proof of Proposition A.4.2.** See Appendix, Section A.4.2. ■
productive sector — bankers — to the less productive sector — consumers. Finally, since the Central Planner internalizes the cost and the benefit of the bail-out and in equilibrium, he chooses a bail-out such that the marginal cost and benefit of the bail-out are equated, the bail-out does not enter the first-order conditions of the Central Planner.

Regarding proving the existence and uniqueness of the constrained Central Planner’s allocation, one can use a graphical approach similar to that of the decentralized equilibrium. Define the following function

$$\psi^{CP}(k_0) = z^{CP}_{1l}(k_0) - z^{CP}_0(k_0),$$

where \(z^{CP}_0(k_0)\) and \(z^{CP}_{1l}(k_0)\) are the marginal values of wealth in the hands of the bankers as perceived by the Central Planner in period-zero, and in the low state in period-one if the equilibrium is Type 1. If the equilibrium is Type 1, \(k^{CP}_0\) will be determined by \(\psi^{CP}(k^{CP}_0) = 0\), and if the equilibrium is of Type 2, \(k^{CP}_0 = k^{max}_0\) (the bank will borrow to the maximum in \(t = 0\)). In order to prove existence and uniqueness, it will be sufficient to prove that \(\psi^{CP}(k_0) > 0\). As before, larger \(k_0\) implies larger fire sale. As a result, more wealth is transferred from the more productive to the less productive sector and, hence, the marginal value of wealth in the crisis state as perceived by the Central Planner, \(z^{CP}_{1l}\), is larger. At the same time, \(z^{CP}_0\), which, in equilibrium, equals the marginal benefit of an extra \(k_0\) as perceived by the Central Planner, decreases with \(k_0\). The reason is that a larger \(k_0\) implies a larger fire sale and larger inefficient transfer of resources. Hence, the marginal benefit of \(k_0\), \(z^{CP}_0\), decreases with \(k_0\).\(^{35}\)

4 Overinvestment

In this sub-section I compare the constrained Central Planner’s allocation to the decentralized equilibrium with no ex-ante regulation. I prove that in period \(t = 0\), when the economy is in normal times (no fire sale), bankers overinvest relative to the constrained Central Planner.\(^{36}\) If \(N \to \infty\), the overinvestment is due to future pecuniary externalities and, if \(N < \infty\), it is due to both future pecuniary externalities and moral hazard.

Before proving overinvestment, I first prove Corollary 1, which states that the Central Planner perceives the marginal value of wealth in the hands of the banker in the crisis state to be larger than the banker in the decentralized equilibrium does, \(z^{CP}_{1l} > z_{1l}\). This result will be the main component to the proof that there is ex-ante overinvestment in this model.

\(^{35}\)For details on the derivations, see the proof of Proposition 2.

\(^{36}\)In an extension in an older version of the paper, I showed that if the economy starts in a crisis state with a fire sale, contemporaneous pecuniary externalities can potentially lead to underinvestment and not overinvestment. The reason why this is the case is similar to the result in He and Kondor (2012).
Corollary 1 Conditional on Assumptions 1-7, and 9 and the assumptions made on the functional forms of $F(\cdot)$ and $\delta(\cdot)$ and given Assumption 10 (required only for the $N < \infty$ case),

$$\frac{1}{\delta^{\prime\prime}(B_{l}) N} \frac{\partial z_{1l}^{CP} \partial^{\prime\prime}z_{1l}^{CP}} {\partial k_{1l}^{T} \partial k_{1l}^{T}} > \left( \left( 1 - \frac{1}{N} \right) z_{1l}^{CP} - 1 \right) F^{\prime\prime}(k_{1l}^{T}) k_{1l}^{T},$$

Assumption 10

the Central Planner values an extra dollar in the hands of the banker in the crisis state by more than the banker does in the decentralized equilibrium, for a given $k_{0}$. 

$$z_{1l}^{CP} > z_{1l}$$

Proof of Corollary 1.  
See Appendix, Section A.4.3. ■

Having proved Corollary 1, I proceed to prove overinvestment.

Proposition 3 Conditional on Assumptions 1-8 and 10 and the assumptions made on the functional forms of $F(\cdot)$ and $\delta(\cdot)$, comparing the constrained Central Planner’s allocation and the decentralized equilibrium with no ex-ante regulation, there is always overinvestment, $k_{0}^{CP} < k_{0}^{*}$, if the equilibrium is Type 1 for the Central Planner (interior equilibrium) and there is no overinvestment, $k_{0}^{CP} = k_{0}$, if the equilibrium is Type 2 for the Central Planner (corner equilibrium).

Proof of Proposition 3. Since I already proved in the previous sections that given the assumptions made — $\psi^{CP}(k_{0}) > 0$ and $\psi^{'}(k_{0}) > 0$ — in order to prove that there is overinvestment, it is sufficient to show that as long as both the Central Planner’s and the decentralized equilibria are of Type 1, $\psi^{CP}(k_{0}) > \psi(k_{0})$ (see Figure 2 below). One can rewrite $\psi^{CP}(k_{0}) - \psi(k_{0})$ as

$$\psi^{CP}(k_{0}) - \psi(k_{0}) = \frac{\left( z_{1l}^{CP}(k_{0}) - z_{1l}(k_{0}) \right) \left( 1 - \theta \left( 1 - \gamma \right) + \pi_{l} \left( \gamma - a_{ll} \right) \right) \left( 1 - \pi_{l} \theta \left( 1 - \gamma \right) \right)} {1 - \pi_{l} \theta \left( 1 - \gamma \right) \left( 1 - \gamma \right)} > 0,$$

(8)

where the inequality follows from Assumption 3 and Corollary 1, and the expressions for $\psi^{CP}(k_{0})$ and $\psi(k_{0})$ are given by equations 52 and 46 in the Appendix. It is clear that if the equilibrium is Type 1 for the Central Planner (Assumption 9 is satisfied) and Type 2 for the banker, then there is overinvestment since the Type 2 equilibrium implies that the banker will borrow and invest to the maximum in period-zero. Also if the equilibrium of the Central Planner is Type 2, there will be no overinvestment, and one can easily show that the equilibrium will be Type 2 for the banker, as well. ■

Figure 2 depicts $\psi(k_{0})$ and $\psi^{CP}(k_{0})$, using the same parametrization as in Figure 1.

From equation 8, one can see that proving overinvestment is equivalent to proving that $z_{1l}^{CP}(k_{0}) > z_{1l}(k_{0})$, where the equilibrium is Type 1 for the Central Planner and for the banker in the decentralized equilibrium. In what follows, I present the intuition for the proof of 1 (the formal proof is presented in the Appendix, Section A.4.3).

There are two reasons why there is overinvestment in this model — future pecuniary externalities and moral hazard.
**Future Pecuniary Externality**

In order to isolate the pecuniary externality channel, let us first consider the case of a country with no fiscal capacity, \( \chi = 0 \), and, hence, no bail-out \( B_I = 0 \). The lack of bail-out implies that the difference between \( z_{1l}^{CP} (k_0) \) and \( z_{1l} (k_0) \) is only due to the pecuniary externalities. If \( \chi = 0 \), the main reason why \( z_{1l}^{CP} (k_0) \) differs from \( z_{1l} (k_0) \) is that the Central Planner internalizes the fact that an extra dollar in the crisis state in the hands of a banker will decrease the fire sale, which will relax the other bankers’ budget constraints and will ameliorate the inefficient transfer of capital from the more productive to the less productive sector.\(^{37}\) This effect pushes \( z_{1l}^{CP} (k_0) \) to be larger than \( z_{1l} (k_0) \).\(^{38}\) Since the Central Planner values wealth in the crisis state more than the banker does, and higher \( k_0 \) leads to a lower bank net worth in the crisis state, the Central Planner optimally chooses a lower \( k_0 \) than the banker in the decentralized equilibrium (as can be seen in Figure 2).\(^{39}\) If banks are infinitesimally small (\( N \to \infty \)), they take the price of capital as given, and the pecuniary

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\(^{37}\)This effect is captured by the \( F'' (k_{1l}^I) k_{1l}^T < 0 \) term in the denominator of \( z_{1l}^{CP} (k_0) \). In contrast, if \( \infty > N > 1 \), the banker only partially internalizes his impact on prices (captured by the \( k_0 F'' (k_{1l}^I) k_{1l}^T < 0 \) term in the denominator of \( z_{1l} (k_0) \)).

\(^{38}\)The Central Planner, unlike the banker, also internalizes the fact that an extra dollar in the hands of the banker in the crisis state implies a smaller fire-sale and lower profits for the consumer (captured by the \( F'' (k_{1l}^I) k_{1l}^T \) term in the numerator of \( z_{1l}^{CP} (k_0) \)), which pushes \( z_{1l}^{CP} (k_0) \) to be lower than \( z_{1l} (k_0) \). One can think of this force as a monopolistic underinvestment force. Assumption 10 is a sufficient and necessary condition for \( z_{1l}^{CP} (k_0) \) to be higher than \( z_{1l} (k_0) \). For example, if \( N \to \infty \), Assumption 10 is always satisfied while if \( N = 1 \) it will not be satisfied if \( \chi = 0 \). If \( N = 1 \), there could still be overinvestment due to the moral hazard channel if \( \chi > 0 \). Assumption 10 will not be required if the banker maximizes consumer’s welfare rather than dividends even for the \( N < \infty \) case.

\(^{39}\)It is a well known fact that in a standard Arrow-Debreu economy with no frictions, where agents are small and take prices as given, there are pecuniary externalities, as well, but there is no inefficiency (unlike in this model). The reason is that, in a standard Arrow-Debreu economy, the change in the price is just a wealth transfer from one agent to another and, in equilibrium, the marginal utility of wealth across agents is equalized, implying that the net effect on welfare is zero. This is why the assumption that bankers are more productive than consumers (i.e. they have different marginal valuations of wealth) is crucial for the pecuniary externalities in this model to lead to an inefficient decentralized allocation.
externality is the strongest.\textsuperscript{40}

\textit{Moral Hazard}

First, consider the case of a continuum of banks ($N \rightarrow \infty$): There is no moral hazard, despite the presence of a targeted bail-out. If a country has a continuum of banks $N \rightarrow \infty$, one can show that the first-order conditions of the banker from the decentralized equilibrium do not vary with the size of the fiscal capacity, $\chi \geq 0$, and, therefore, with the size of the bail-out. Given that the moral hazard enters only through the first-order conditions of the banker from the decentralized equilibrium, this implies that there is no moral hazard in the case of a continuum of banks. The intuition is that when banks are small, they do not internalize the fact that their actions affect the bail-out they receive since the bail-out, even when targeted, depends only on the aggregate fire sale (i.e., $\frac{\partial B_i}{\partial k_{1i}} = 0$).\textsuperscript{41} As a result, if $N \rightarrow \infty$, the reason for the overinvestment is only due to the pecuniary externalities and not due to the moral hazard.

Next, consider the case of $N < \infty$ and some fiscal capacity $\chi > 0$, which will be the only case in which there will be moral hazard — i.e., the moral hazard in this model can be thought of as "Too Big to Fail" type of moral hazard. The moral hazard is captured by the term $\frac{\partial B_i}{\partial k_{1i}} = \frac{1}{\frac{\partial z_{1i}}{\partial k_{1i}}} \frac{z_{1i}}{N}$ in the denominator of $z_{1i}(k_0)$. When banks are large and the country has some fiscal capacity, they internalize the fact that the amount they invest in period zero will affect the aggregate fire-sale in the crisis state and, as a result, the optimal bail-out received. As a result, in order to maximize the bail-out received, bankers choose a larger $k_0$ than the Central Planner would want them to choose.

In general, as we increase $N$, it is unclear whether the overinvestment, which is given by $k_0^* - k_0^{CP}$, will be smaller or larger since the pecuniary externality is stronger but the moral hazard is weaker. As it turns out, the size of the overinvestment will not be relevant when determining the optimal minimum bank capital requirement, conditional on the policy maker having a sufficient number of instruments to replicate the constrained Central Planner’s allocation.

5 \hspace{1em} \textbf{Decentralize the Constrained Central Planner’s Allocation}

In the previous section, I proved that given the assumptions made, in $t = 0$, the banker overinvests relative to the constrained Central Planner and, hence, there is a role for ex-ante regulation. One way to correct for the overinvestment is to use a minimum bank capital requirement, which is the policy instrument currently employed by almost all countries. Banker $i$ is required to finance at least a fraction $\rho^i$ of her risky investment using equity, which, in this model, is equal to the

\textsuperscript{40}One can see that clearly in the $\chi = 0$ case. The smaller $N$ is, the difference between $z_{1i}^{CP}(k_0)$ and $z_{1i}(k_0)$, which proxies the extent of the overinvestment, shrinks. As a result, smaller $N$ implies weaker pecuniary externality.

\textsuperscript{41}The linearity of the bankers’ production technology is one of the key reasons why moral hazard is not present in the case of $N \rightarrow \infty$. Assuming a concave production technology will change the result, but, even then, the moral hazard will be stronger if $N$ is smaller, for the same reasons as the ones discussed in the remainder of this sub-section. Therefore, all the results derived here apply for a concave production technology with slight modifications.
period-zero net worth of banker $i$, $n$. The minimum bank capital requirement constraint is given by $\rho k_0^i \leq n$ and will be an additional constraint that banker $i$ will have to take into account when choosing her optimal allocation. The following proposition presents the results from the banker’s optimization problem given the minimum bank capital constraint.\footnote{For details regarding the setup see Appendix, Section A.2.}

**Proposition 4** Given Assumptions 1-8, Assumption 10 and the assumptions made on the functional forms of $F(\cdot)$ and $\delta(\cdot)$, for a given exogenous minimum bank capital ratio such that $\rho > \frac{n}{k_0^i (\rho = 0)}$ and considering a symmetric equilibrium, the decentralized equilibrium can be one of the following four types:

- **Type 1** $z_{1l} (k_{1l}^T (\rho)) = z_{0} (k_{1l}^T (\rho)) > z_{1h} \text{ if } k_{1l}^T (\rho) \in (k_{1l}^{T_{\max}}, \tilde{k}_{1l}^T)$
- **Type 2** $z_{0} (k_{1l}^T (\rho)) > z_{1h} \text{ if } k_{1l}^T (\rho) = k_{1l}^{T_{\max}}$
- **Type 3** $z_{1l} (k_{1l}^T (\rho)) = z_{0} (k_{1l}^T (\rho)) = z_{1h} \text{ if } k_{1l}^T (\rho) = \tilde{k}_{1l}^T$
- **Type 4** $z_{1h} = z_{0} (k_{1l}^T (\rho)) > z_{1l} (k_{1l}^T (\rho)) \text{ if } k_{1l}^T (\rho) \in [0, k_{1l}^T)$

where $k_{1l}^{T_{\max}}$ is determined in Section A.4.1 in the Appendix. $\tilde{k}_{1l}^T$ is unique and exists, and if $0 < \tilde{k}_{1l}^T < k_{1l}^{T_{\max}}$, $\tilde{k}_{1l}^T$ is determined by $M (\tilde{k}_{1l}^T) = 0$, where

$$M (\tilde{k}_{1l}^T) = \frac{1}{N} F'' (k_{1l}^T) k_{1l}^T + \frac{1}{\delta(B_1)} N \frac{\partial z_{1l}^{1P}}{\partial k_{1l}^T} + F' (k_{1l}^T) - 1.$$

**Proof of Proposition 4.** See Appendix, Section A.4.4. \hfill \blacksquare

The condition that the exogenous $\rho$ is such that $\rho > \frac{n}{k_0^i (\rho = 0)}$ guarantees that the minimum bank capital requirement constraint will always be binding. The most interesting case to consider is to set the minimum bank capital ratio to replicate the optimal period-zero investment chosen by the Central Planner — i.e. $k_0^* = k_0^{CP}$. Therefore, from now on, let us consider the case $\rho^* = \frac{n}{k_0^{CP}}$. Notice that the minimum bank capital ratio is a "quantity" regulatory instrument since it directly determines the quantity of period-zero investment chosen by the banker.

Given the presence of a binding ex-ante minimum bank capital requirement, Proposition 4 states that the decentralized equilibrium can be one of four types. What differentiates the equilibria is how much the banker values wealth in the high state in $t = 1$ relative to the low state in $t = 1$ (the crisis state). In Proposition 2, I proved that the only two possible borrowing contracts for the Central Planner are Types 1 and 2. If the equilibrium is interior (of Type 1), the Central Planner always values wealth more in the crisis state than in the high state in $t = 1$ and, thus, borrows to the maximum against the high state and only then borrows against the crisis state. From Proposition 4, it is clear that a single instrument in the form of a minimum bank capital requirement might not be sufficient to replicate the constrained Central Planner’s allocation. In addition to choosing $k_0$ in $t = 0$, the banker has another degree of freedom, which is to choose how to transfer resources across states of nature and time. More precisely, she can choose how much to borrow/save towards the crisis state, $d_{1l}$.$\footnote{The amount of period zero borrowing is given by $\sum \tau_s d_{ls} = k_{0}^{CP} - n$, and $d_{2s}$ is determined by the borrowing constraint in $t = 2$, which is binding. Hence, what is left for the banker to choose is $d_{1l}$ since $d_{1h} = \frac{k_{0}^{CP} - \sum \tau_s d_{1l} - n}{\delta_{h} k_{1l}^{T_{\max}}}$ and $k_{0}^* = k_{0}^{CP}$.}$ For example, if the decentralized equilibrium is Type 4, even though $k_0^* = k_0^{CP}$,
the banker optimally chooses to borrow first to the maximum against the low state and only then to borrow against the high state, which implies \( d^*_{11} > d^C_{11} \). This result is represented graphically below.

Consider parametrization where the equilibrium is Type 1 for the Central Planner (Assumption 9 is satisfied) and set \( \rho^* = \frac{n}{k_0} \).\(^{44}\)

![Figure 3: Payment Pledged in the Crisis State by Bankers](image)

When the banking sector is fairly concentrated (in the Figure above, \( N = 3 \)) and when the country has a large fiscal capacity (which is when moral hazard will be strong), the banker optimally chooses to borrow too much (save too little) towards the crisis state relative to the Central Planner. If the dashed line in Figure 3 is above the solid line, the borrowing contract for the banker is either Type 3 or Type 4, while for the Central Planner, the borrowing contract is always of Type 1. The intuition for the result is the following.

Moral hazard presents itself in two different dimensions. On the one hand, the banker is tempted to invest too much in \( t = 0 \), relative to the Central Planner and, on the other hand, the banker might be also tempted to pledge too high a payment in the crisis state if the moral hazard is strong enough. Both too much investment in period-zero, \( k_0 \), and too high a payment pledged in the crisis state, \( d_{11} \), will lead to a larger fire sale which will maximize the bail-out received. This result is stated formally in Corollary 2.

**Corollary 2** If \( N < \infty \) and \( \chi > 0 \), bankers realize that they affect the bail-out received both via \( k^i_0 \) and \( d^i_{11} \) — i.e. \( \frac{\partial B^i_1}{\partial k^i_0} > 0 \) and \( \frac{\partial B^i_1}{\partial d^i_{11}} > 0 \) where \( \frac{\partial B^i_1}{\partial k^i_0} \) and \( \frac{\partial B^i_1}{\partial d^i_{11}} \) are total derivatives. Also, for a given \( k^i_{11} \), the fewer the banks are and the larger the fiscal capacity is, the stronger the moral hazard is; \( \frac{\partial^2 B^i_1}{\partial k^i_0 \partial \chi} < 0 \) and \( \frac{\partial^2 B^i_1}{\partial d^i_{11} \partial \chi} < 0 \). \(^{44}\)

\(^{44}\)The parameters used are the same as in Figures 1 and 2, with the exception that \( N = 3 \) and I vary the fiscal capacity, \( \chi \).
Proof of Corollary 2. See Appendix, Section A.4.5. ■

Corollary 2 states that as long as the country has some fiscal capacity, \( \chi < \infty \), and the number of banks is finite, \( N < \infty \), the banker internalizes the fact that his period-zero actions (both period-zero investment and the amount of borrowing against the crisis state) affect the size of the bail-out, which is how the moral hazard enters the model. Moral hazard is captured by \( \frac{\partial B_l^1}{\partial k_0^1} > 0 \) and \( \frac{\partial B_l^1}{\partial k_T} > 0 \). A large fiscal capacity and a more concentrated banking sector exacerbate the moral hazard problem. The intuition is that when the banks are large (small number of banks), they know that their marginal impact on the fire sale is large and, as a result, they affect the optimal bail-out by more, leading to a stronger moral hazard. Similarly, if a country has a larger fiscal capacity, it can afford to provide a larger bail-out, which implies that the moral hazard is stronger.

As a result, a second ex-ante instrument in the form of a limit on the payment promised in the crisis state \( d_{il}^1 \leq \nu^i \), in addition to the minimum bank capital requirement, might be necessary to replicate the constrained Central Planner’s allocation for countries with strong moral hazard. Proposition 5 specifies the exact conditions.

**Proposition 5**  Consider parametrization where the equilibrium is Type 1 for the constrained Central Planner.

Part 1) A single instrument, given by \( \rho^* = \frac{n}{k_0^T} \), is sufficient to replicate the constrained Central Planner’s allocation if

(i) There is no moral hazard — \( N \to \infty \) or \( \chi = 0 \)

(ii) There is small fiscal capacity — \( \chi \leq \chi^* (N) \) for any \( N \)

(iii) There are large number of banks — \( N \geq N^* (\chi) \) for any \( \chi \)

Part 2) Two instruments, given by \( \nu^* = d_{il}^{CP} \) and \( \rho^* = \frac{n}{k_0^T} \), are required to replicate the constrained Central Planner’s allocation if

(i) There is large fiscal capacity — \( \chi > \chi^* (N) \) for any \( N < \infty \)

(ii) There are a small number of banks — \( N < N^* (\chi) \) for any \( \chi > 0 \)

If \( N^* (\chi) \) are \( \chi^* (N) \) are interior solutions, they are determined by the systems of equations \( M \left( k_{1l}^T, N^* (\chi) \right) = 0 \), \( BC_{1l} (k_{1l}^T) = 0 \) and \( M \left( k_{1l}^T, \chi^* (N) \right) = 0 \), \( BC_{1l} (k_{1l}^T, \chi^* (N)) = 0 \), respectively, where,

\[
M = \frac{1}{N} F'' (k_{1l}^T) k_{1l}^T + \frac{1}{\partial^2 (B_l, \chi)} N \frac{\partial z_{1l}^{1,P}}{\partial k_{1l}^T} + F' (k_{1l}^T) - 1
\]

\[
BC_{1l} = \pi_l \left[ k_{1l}^T (F' (k_{1l}^T) - \theta (1 - \gamma)) + B_l (k_{1l}^T, \chi) \right] - \left( (1 - \theta) (1 - \gamma) + \pi_l (\gamma - a_{1l}) \right) \frac{n}{\rho^*} - n.
\]
Proof of Proposition 5. See Appendix, Section A.4.6. ■

Proposition 5 states that a second instrument, in addition to the minimum bank capital requirement, is required only if the banking sector is fairly concentrated and the country has a large fiscal capacity. The intuition for why the policy maker should optimally limit the pledged payments by the bankers in the crisis state only if the moral hazard is strong enough is as follows: There are two sets of forces that determine whether the banker values wealth more in the crisis state or in the high state in \( t = 1 \), and they push in different directions. The first set of forces, which pushes towards higher valuation of wealth in the crisis state, are that capital is cheaper during a crisis, and an extra dollar in the crisis state will lead to a lower fire sale, which implies higher resale value of the fire-sold capital.\(^{45}\) However, the countervailing force is the benefit from maximizing the bail-out by pledging too high a payment in the crisis state. The banker starts to value wealth in the crisis state less relative to the high state only once the perceived benefit of the bail-out becomes large enough (which is the case when both fiscal capacity and banks are large). That is why a second regulatory instrument would be required only for countries with strong moral hazard.

The way to interpret the limit on the banker \( i \)'s payment pledged in the crisis state, \( v^i \), more broadly is as a limit on the liabilities of banker \( i \) in a future crisis during which a bail-out is anticipated. In order to be able to forecast the liabilities in a crisis state, the regulator will need detailed bank balance sheet data and will have to rely on projections from value-at-risk models. For example, the sale of put options and CDS contracts, in particular, can leave banks with significant liabilities during a systemic banking crisis. Therefore, imposing limits on some derivative positions (even if there is no counterparty risk, as in this model) will be crucial for countries with strong moral hazard.

6 Comparative Statics of Optimal Bank Regulation With Respect to Fiscal Capacity

The question arises of how the optimal minimum bank capital requirement, \( \rho^* \), and the optimal limit on the payment pledged in the crisis state by bankers, \( v^* \), should vary across countries with different fiscal capacity. In this subsection, I prove one of the key results of this paper — that smaller fiscal capacity implies a larger optimal ex-ante minimum bank capital requirement. I also build on the result from the previous section, which showed that countries with larger fiscal capacity are more likely to need a second regulatory instrument in the form of a limit on the liabilities pledged by the financial sector in a crisis. In this section, I show that conditional on a country requiring a second ex-ante regulatory instrument, countries with larger fiscal capacity can afford to pledge a larger payment in a crisis state.

\(^{45}\) See equation 5b.
Proposition 6 Conditional on Assumptions 1-8 and 10 and the assumptions made on the functional forms of $F(\cdot)$ and $\delta(\cdot)$, if the policy maker has a sufficient number of instruments to replicate the constrained Central Planner’s allocation, and the parametrization is such that the Central Planner’s equilibrium is Type 1 (Assumption 9 is satisfied), the optimal minimum bank capital ratio is smaller for countries with larger fiscal capacity, $\frac{\partial \rho^*}{\partial \chi} < 0$.

Proof of Proposition 6. See Appendix, Section A.4.7. ■

In this section, I assume that the policy maker has a sufficient number of instruments to replicate the constrained Central Planner’s allocation. The optimal minimum bank capital ratio, $\rho^*$, and $k^0_{CP}$ are inversely related, $\rho^* = \frac{n}{k^0_{CP}}$. As a result, in order to prove Proposition 6, it is sufficient to prove that the Central Planner of a country with a larger fiscal capacity will optimally choose to invest more ex-ante relative to the Central Planner of a country with a smaller fiscal capacity — i.e., $\frac{\partial k^0_{CP}}{\partial \chi} > 0$. I present the intuition of the proof graphically.46

Figure 4: Larger Fiscal Capacity Implies Larger Ex-Ante Investment

Figure 4 plots $\psi^{CP}(k_0, \chi)$ for two countries with different fiscal capacity. On the graph, the country with $\chi = 0.6$ has a smaller fiscal capacity and a larger marginal cost of an extra dollar of bail-out relative to the country with $\chi = 1$. Given that $\frac{\partial \psi^{CP}(k_0; \chi)}{\partial k_0} > 0$, in order to prove that the Central Planner of a country with a larger fiscal capacity would optimally choose to invest more ex-ante relative to the Central Planner of a country with a smaller fiscal capacity, it is sufficient to prove that, for a given $k_0$, the dashed line is below the solid line — i.e., $\frac{\partial \psi^{CP}(\chi; k_0)}{\partial \chi} < 0$. Larger fiscal capacity for a given $k_0$ implies a larger bail-out and a smaller fire sale during a crisis, leading to a smaller inefficient transfer of resources from the bankers to the consumers. Therefore, the policy maker who can optimally afford a larger bail-out will value a dollar in the hands of the bankers in a crisis by less, $z^{CP}_{III}(\chi = 0.6) > z^{CP}_{III}(\chi = 1)$. Similarly, the policy maker of a less fiscally constrained country can contain the downside of a crisis, which would imply that the return on $k_0$ in a crisis is higher; thus, from an ex-ante perspective, the marginal benefit of $k_0$ is higher.

46 With the exception of $\chi$, the rest of the parameters are the same as in Figure 1.
$z_0^{CP}(\chi = 0.6) < z_0^{CP}(\chi = 1)$. Intuitively, ex-post during a crisis, the policy maker in the country with the larger fiscal capacity can prop up prices by more and control the downside for a given level of bank assets, which implies that ex-ante he optimally chooses to have a larger investment boom ($k_0^{CP}(\chi = 1) > k_0^{CP}(\chi = 0.6)$). As it turns out, the assumptions that generate the pecuniary externality are the key driving force behind the result that less fiscally constrained countries should have lower ex-ante minimum bank capital requirements. The result holds even if there is no ex-post bail-out and, as a result, no moral hazard in this model. It is driven by the ingredients that generate pecuniary externalities — fire sale and the assumption that the bankers are more productive than consumers.

Next, let us consider how $v^*$ varies with the fiscal capacity of the country where the assumption is still that the policy maker has a sufficient number of instruments to replicate the constrained Central Planner’s allocation. Larger fiscal capacity implies larger $k_0^{CP}$. Given that it is always the case that the period-zero borrowing constraint binds in the high state for the Central Planner, the larger period-zero investment is financed with larger ex-ante borrowing against the crisis state (or less money transferred to the crisis state). This implies that larger fiscal capacity results in larger optimal borrowing against the crisis state — larger $v^*$ ($\frac{\partial k_0^{CP}}{\partial \chi} = 2v^* > 0$). The second regulatory constraint will be binding only for countries with fiscal capacity, $\chi$, for which the dashed line is above the solid line in Figure 3. In that sense, no regulation will be required for countries with a small fiscal capacity. However, conditional on the constraint binding, $v^*$ increases as the fiscal capacity increases.

According to the results of this model, if one compares the US (large fiscal capacity) and Switzerland (small fiscal capacity), the US should optimally have a lower ex-ante minimum bank capital requirement than Switzerland, which is consistent with current regulation. However, since the moral hazard might be potentially stronger in the US due to its larger fiscal capacity, US regulators might need to use a second instrument that limits the amount of CDS contracts and put options that US financial institutions can sell (among other measures). Such an instrument might not be required in Switzerland. However, if both the US and Switzerland were to need a second regulatory instrument, Swiss banks would face a tighter limit on the net amount of put options they can sell, for example.

7 "Price" Versus "Quantity" Instrument

The result that countries with a larger fiscal capacity should optimally have lower ex-ante minimum bank capital requirements might appear counter-intuitive at first; the reason is that large fiscal capacity implies stronger moral hazard, while the optimal policy recommendation is less stringent ex-ante regulation. In the spirit of Weitzman (1974), one can show that the constrained Central Planner’s allocation can be achieved using either a tax on period-zero investment or a minimum bank capital requirement (conditional on also imposing a limit on the payment promised in the crisis state, if necessary). However, in this section, I show that whether larger fiscal capacity implies
more or less stringent ex-ante regulation depends critically on the instrument used. More precisely, if the policy maker has access to a "price" instrument, such as a tax on period-zero investment, the result is the opposite of the case in which the instrument used is a "quantity" instrument, such as a minimum bank capital requirement. If the regulatory instrument were a tax on period-zero investment, larger fiscal capacity would imply an optimally higher tax on period-zero investment if moral hazard was present.

I solve the problem of the banker using a tax on period-zero investment instead of a minimum bank capital requirement. The only change in the setup is that the period-zero budget constraint becomes

\[ k_0^i (1 + \tau_{k_0}^i) - n + T_{k_0}^i \leq \sum_s \pi_s d_{1s}^i \left[ z_0^i \right] \]  

(10)

where \( \tau_{k_0}^i \) is the bank-specific tax on period-zero capital. The revenues from the proportional tax are distributed equally back to the bankers using a lump sum tax, \( T_{k_0}^i \), which is negative and given by \( T_{k_0}^i = -\sum_{i=1}^N \frac{1}{N} k_0^i \tau_{k_0}^i \). Equation 10 makes it clear that by setting \( \tau_{k_0}^i \), the policy maker can no longer directly set the amount of \( k_0^i \), which he was able to do in the case of a minimum bank capital requirement. \( \tau_{k_0}^i \) affects the marginal cost of \( k_0^i \) (or the "price" of \( k_0^i \)), as perceived by the banker, which is why a tax instrument can be thought of as a "price" instrument.

The following proposition states that a larger fiscal capacity implies a larger tax on period-zero investment as long as \( 1 < N < \infty \), and the tax on period-zero investment is constant if \( N \to \infty \) (the case with a continuum of banks and no moral hazard).

**Proposition 7** Conditional on Assumptions 1-10 and on the functional forms assumed for \( F(\cdot) \) and \( \delta(\cdot) \), if the policy maker has access to two ex-ante instruments — an ex-ante tax on period-zero investment ("price" instrument), \( \tau_{k_0} \), and a limit on the payment promised in the crisis state, \( \nu \), one can show that \( \tau_{k_0}^* \geq 0 \). If \( N \to \infty \) (no moral hazard), then \( \frac{\partial \tau_{k_0}^*}{\partial \chi} = 0 \). If \( 1 < N < \infty \), then \( \frac{\partial \tau_{k_0}^*}{\partial \chi} > 0 \). \( \tau_{k_0} \) and \( \frac{\partial \tau_{k_0}^*}{\partial \chi} \) are given by

\[
\tau_{k_0}^* = \left[ \frac{z_{11} \left( k_{11}^{TCP} \right)}{z_{11} \left( k_{11}^{TCP}, \chi \right)} - 1 \right] \Phi > 0 
\]

(11a)

\[
\frac{\partial \tau_{k_0}^*}{\partial \chi} = -\frac{\partial z_{11} \left( k_{11}^{TCP}, \chi \right)}{\partial \chi} \left[ \frac{z_{11} \left( k_{11}^{TCP}, \chi \right)}{z_{11} \left( k_{11}^{TCP} \right)} \right]^2 \Phi \geq 0, 
\]

(11b)

where \( \Phi = \frac{1 - \theta (1 - \gamma) + \pi_j (\gamma - \alpha_1)}{1 - \frac{1}{N}} > 0 \).

**Proof of Proposition 7.** See Appendix, Section A.4.8. ■

If the instrument of choice is a tax on period-zero investment, equation 11a shows that the optimal tax is positive since the banker wants to overinvest relative to the Central Planner due
to both pecuniary externality and moral hazard. This is captured by the fact that \( z^C_P(l^T_{HI}, \chi) > z^C_H(l^T_{HI}, \chi) \), which I proved in Corollary 1. The optimal tax, \( \tau^*_k \), equals approximately the size of the overinvestment given by the scaled difference between the marginal benefit of \( k_0 \), as perceived by the banker, minus the marginal benefit of \( k_0 \), as perceived by the constrained Central Planner. This difference equals approximately \( \frac{z^C_H(l^T_{HI}, \chi) - z^C_H(l^T_{HI}, \chi)}{z^C_H(l^T_{HI}, \chi)} \). The larger the difference in the perceived marginal benefit of \( k_0 \) is, the larger the tax on capital has to be in order for the policy maker to be able to replicate the constrained Central Planner’s allocation. \( \chi \) does not directly or indirectly enter the marginal benefit of \( k_0 \), as perceived by the Central Planner, since the Central Planner internalizes both the marginal cost and the marginal benefit of the bail-out and they cancel out in equilibrium. Also due to the linearity assumption, the equilibrium fire sale from the Central Planner’s problem, \( k^T_{HI,CP} \), does not vary with the fiscal capacity of the country (see equation 6b). In contrast, if \( N < \infty \), \( \chi \) directly enters the marginal benefit of \( k_0 \), as perceived by the banker.

Conditional on a finite number of banks, \( N < \infty \), the banker perceives the bail-out to be larger for countries with a larger fiscal capacity.\(^{47}\) Therefore, in order to achieve a given level of \( k_0 \), the policy maker will have to increase \( \tau_k \) by more for countries with a larger fiscal capacity, since the perceived bail-out and, hence, the moral hazard in those countries are stronger. If \( N \rightarrow \infty \), then \( \frac{\partial z^C_H(l^T_{HI,CP})}{\partial \chi} = 0 \) because there is no moral hazard. In that case, \( \tau_k \) is still positive, but it is no longer a function of fiscal capacity.\(^{48}\)

In summary, the key reason why the size of moral hazard affects the "price" instrument and not the "quantity" instrument is the following. Moral hazard enters into the model through the first-order condition of the banker since the banker internalizes the benefit of the bail-out, but not the cost. If the ex-ante regulatory instrument is a tax on period-zero investment, \( \tau^*_k \) is determined by combining the first-order condition of the banker with respect to \( k_0 \), and the first-order condition of the Central Planner with respect to \( k_0 \). In contrast, when the instrument is a minimum bank capital requirement, the first-order condition of the banker with respect to \( k_0 \) no longer plays a role, and, hence, the strength of the externalities does not affect the optimal minimum bank capital requirement. The strength of the moral hazard will affect only the Lagrangian of the minimum bank capital requirement, which one can think of as a shadow tax. This is why, as long as the policy maker can replicate the constrained Central Planner’s allocation, the size of the moral hazard, per se does not affect the optimal minimum bank capital ratio — a "quantity" instrument but it affects the ex-ante tax on period-zero investment — a "price" instrument.

---

\(^{47}\) Mathematically, this implies that \( \frac{\partial z^C_H(l^T_{HI,CP})}{\partial \chi} > 0 \) and \( \frac{\partial z^C_H(k^T_{HI,CP})}{\partial \chi} = 0 \).

\(^{48}\) The pecuniary externality does not affect the size of the ex-ante tax, even though the externality enters the first order condition of the banker in the decentralized equilibrium because \( k^T_{HI,CP} \) does not vary with the fiscal capacity due to the linearity assumption. If one were to introduce concavity in the bankers’ production technology, then there would be two opposing forces. Larger fiscal capacity will imply stronger moral hazard, which will push \( \tau^*_k \) higher. It will also imply smaller \( k^T_{HI,CP} \) in equilibrium (unlike in the linear case), and the pecuniary externalities will become smaller, which will push the optimal ex-ante tax in the opposite direction (make it lower). In contrast, if a minimum capital requirement were used instead, the comparative static of \( \rho^* \) with respect to \( \chi \) would still be that larger fiscal capacity implies smaller ex-ante minimum bank capital requirement, as long as the decreasing returns to scale are not too strong during a crisis, which is a reasonable assumption.
8 Conclusion and Further Discussion

This paper derives the normative result that there should be differential cross-country bank regulation, given that countries vary in their ability to bail-out their financial sector during a crisis. More precisely, countries with a larger fiscal capacity should have lower ex-ante minimum bank capital requirements relative to countries with a smaller fiscal capacity, conditional on the policy maker having sufficient instruments to replicate the constrained Central Planner’s allocation. In order to know whether one country should have a lower ex-ante minimum bank capital requirement than another, a policy maker has to forecast the country’s fiscal capacity in future crisis states of nature. He can do this by considering variables such as the size of the banking sector relative to GDP, the availability of independent monetary policy and a forecast of the cost of sovereign borrowing in a crisis. The second key result of the paper is that countries with a large fiscal capacity and concentrated banking sectors should also impose a limit on the amount of liabilities banks have during a crisis that requires a government bail-out. This includes regulating derivative contracts, which will leave the financial sector with a high liability during a systemic crisis.

One can argue that one of the main reasons why countries followed the Basel Accords and synchronized their bank regulation was to introduce a "level playing field" for their banks. This model is a legacy model and does not consider the dynamics of what might happen if one were to introduce heterogeneous regulation and banks were allowed to relocate across countries. However, there are usually large fixed costs to banks relocating, either because of fixed investment in human capital and buildings or because markets are naturally segmented. The segmentation is due to the fact that monitoring costs are lower if the banks are closer to the borrowers. Given this natural market segmentation, governments would have some leeway in terms of having differential regulation up to a certain limit.

References


### A Appendix

The functional forms used for the simulations are as follows: The consumers’ production technology in \( t = 0, 1 \) is given by

\[
F(k_{ts}^T) = \begin{cases} 
\frac{(1-\gamma)}{\alpha} - \frac{(1-\gamma)e^{-\alpha k_{ts}^T}}{\alpha} + \gamma k_{ts}^T & \text{if } k_{ts}^T > 0 \\
0 & \text{if } k_{ts}^T = 0 
\end{cases}
\]

where \( \alpha > 0 \) is a parameter that controls the concavity of the consumers’ production technology, and \( 0 < \gamma < 1 \) is the refinancing cost. The larger \( \alpha \) is, the smaller \( q_{ts} \) is, for a given \( k_{ts}^T \). This functional form guarantees that the assumptions made regarding \( F(\cdot) \) are satisfied. If \( k_{ts}^T > 0 \)

\[
q_{ts} = F'(k_{ts}^T) = (1 - \gamma) e^{-\alpha k_{ts}^T} + \gamma > \gamma \quad \text{where } 1 > \gamma > 0
\]

\[
F''(k_{ts}^T) = -\alpha (1 - \gamma) e^{-\alpha k_{ts}^T} < 0
\]

\[
F'''(k_{ts}^T) = \alpha^2 (1 - \gamma) e^{-\alpha k_{ts}^T} > 0
\]

\( F(k_{ts}^T) \) and \( F'(k_{ts}^T) \) are continuous on \( \in [0, \infty) \); \( F(k_{ts}^T) \) is at least three times differentiable on \( k_{ts}^T \in (0, \infty) \); \( F(0) = 0, F'(0) = 1, F''(0) = F'''(0) = 0, F'''(k_{ts}^T) < 0 \) on \( k_{ts}^T \in (0, \infty) \) and \( \lim_{k_{ts}^T \to \infty} F''(k_{ts}^T) \geq \gamma \). The functional form for the deadweight loss due to taxing is \( \delta(B_1, \chi) = \frac{1}{\chi} B_1^\eta \), where \( \eta > 1 \).
A.1 The Problem of the Representative Consumer

I solve the problem of the representative consumer backwards. Consumers are infinitesimally small, which implies that they take prices as given. In period 2, the representative consumer maximizes

\[ \max_{k_{1s}^T, d_{2s}} \left( 2e + d_{1s} - p_{2s}d_{2s} + d_{2s} + F \left( k_{1s}^T \right) - q_{2s}k_{1s}^T \right) \]

The first-order condition with respect to \( k_{1s}^T \) pins down the equilibrium price of capital in \( t = 1 \) as a function of the amount of equilibrium fire-sold capital, \( q_{1s} = F' \left( k_{1s}^T \right) \). The first-order condition with respect to \( d_{2s} \) is a Euler equation, which implies that \( p_{2s} = 1 \). In \( t = 0 \), the representative consumer optimizes (taking into account his period 1 and 2 first-order conditions)

\[ \max_{d_{1s}, k_0^T} \left[ 3e - \sum_s \pi_sp_{1s}d_{1s} + \sum_s \pi_s \left( d_{1s} + F \left( k_{1s}^T \right) - q_{1s}k_{1s}^T \right) \right] \]

The first-order conditions with respect to \( d_{1s} \) and \( k_0^T \) imply that \( p_{1s} = 1 \) and \( q_0 = F' \left( k_0^T \right) \). However, since the bankers enter period zero with no capital stock, then \( q_0 = 1 \). Given that \( F' \left( k_0^T \right) \leq 1 \), in \( t = 0 \), consumers will not use their production technology and in equilibrium, \( k_0^T = 0 \). Since the representative consumer is risk-neutral, his demand for state-contingent debt at the equilibrium price of one is infinitely elastic up to the point where he runs out of money. I consider only parametrization where the consumer never runs out of money.\(^49\)

A.2 Decentralized Equilibrium – No Commitment

In this section of the Appendix, I solve the optimization problem of banker \( i \) where the policy maker provides an optimal bail-out in \( t = 1 \). Also, the policy maker has access to two ex-ante (period-zero) policy instruments \( \rho^ik_0^T \leq n \) and \( d_{1s}^i \leq \nu^i \). I assume that the policy maker cannot commit. As a result, the optimal targeted bail-out, \( B_i^T \), will be determined in \( t = 1 \), and banker \( i \) will internalize the fact that his actions in period \( t = 0 \) will affect \( B_i^T \). In contrast, \( \rho^i \) and \( \nu^i \) are predetermined at the beginning of period \( t = 0 \), before banker \( i \) makes any decisions. Also, since I solve the model for an economy with \( N \) banks, banker \( i \) takes into account the consumers’ first-order conditions, which pin down prices \( p_{1s} = p_{2s} = 1 \), \( q_0 = q_{2s} = 1 \) and \( q_{1s} = F' \left( k_{1s}^T \right) \) where, from market clearing,

\[ k_{1s}^T = k_{1s}^F = \sum_{i=1}^N \frac{1}{N} k_{1s}^i = \sum_{i=1}^N \frac{1}{N} \max\{0, k_0^i - k_{1s}^i\}. \]

I solve the model backwards. In \( t = 2 \), all bankers produce and pay out all the profits as dividends to the consumers. At the end of \( t = 1 \), banker \( i \) maximizes the dividend payment in the last period by choosing \( \{k_{1s}^i, d_{2s}^i\} \) and taking as given the endogenous state variables \( \{k_0^i, d_{1s}^i\} \) and the predetermined policy instruments \( \{B_i^T, \rho^i, \nu^i\} \).

\(^{49}\) The assumption that capital cannot be stored and has to be used for production every period implies that consumers cannot simply purchase capital in \( t = 1 \) in the low state (which is the state where there will be a fire-sale and the price will be lower than one) and keep it until \( t = 2 \) in order to get a return of one. If that were the case, there would be no fire sales in the first place.
\[
\max_{k_{1s}, d_{2s}} (A + 1 - \gamma) k_{1s}^i - d_{2s}^i
\]

subject to the collateral constraint in \( t = 1 \) and the period-one budget constraint

\[
d_{2s}^i \leq \theta (1 - \gamma) k_{1s}^i \quad [\lambda_{2s}^i]
\]

\[
k_{1s}^i F'(k_{1s}^i) + d_{1s}^i \leq (F'(k_{1s}^i) + a_{1s} - \gamma) k_{1s}^i + B_s^i + d_{2s}^i \quad [z_{1s}^{i,1}]
\]

The first-order condition with respect to \( k_{1s}^i \) can be re-written as

\[
z_{1s}^{i,1} = \frac{A + 1 - \gamma + \lambda_{2s}^i \theta (1 - \gamma)}{F'(k_{1s}^i) + \frac{1}{N} F''(k_{1s}^i) k_{1s}^i} > 1. \tag{12}
\]

The fact that \( z_{1s}^{i,1} > 1 \) comes from the assumptions that \( \gamma < q_{1s} = F'(k_{1s}^i) \leq 1, \frac{1}{N} F''(k_{1s}^i) k_{1s}^i \leq 0 \) and \( A - \gamma > 0 \) and from the fact that \( \lambda_{2s}^i \geq 0 \). The first-order condition with respect to \( d_{2s}^i \) (Euler equation) is

\[-1 - \lambda_{2s}^i + z_{1s}^{i,1} = 0.\]

Next, I prove that \( \lambda_{2s}^i > 0 \). Since \( z_{1s}^{i,1} > 1 \), then \( \lambda_{2s}^i = z_{1s}^{i,1} - 1 > 0 \), which implies that the period-one collateral constraint always binds and \( d_{2s}^i = \theta (1 - \gamma) k_{1s}^i. \footnote{One can rewrite equation 12 as}

At the beginning of \( t = 1 \), if the low state is realized, the policy maker chooses \( B_s^i \) given the state variables \( \{k_{1s}^i, d_{1s}^i\} \) and the policy instruments predetermined in \( t = 0, \{\rho, \nu_i\} \). He also takes into account the first-order conditions of banker \( i \) at the end of \( t = 1 \), which are a function of \( B_s^i \). Assuming that the Central Planner maximizes the welfare of all risk-neutral consumers, the objective function of the policy maker in \( t = 1 \) in the low state is to maximize second period output, which is also the consumption of the consumers. The optimization problem of the policy maker in the beginning of \( t = 1 \) in the low state is (taking into account the fact that \( \lambda_{2s}^i > 0 \))

\[
\max_{k_{1l}, B_s^i} 2e + F(k_{1l}^T) - F'(k_{1l}^T) k_{1l}^T - \delta (B_s, \chi) + d_{1l}
\]

\[
+ \sum_{i=1}^{N} \frac{1}{N} \left[ z_{1l}^{i,1,P} \left( (A + (1 - \theta) (1 - \gamma)) k_{1l}^i - B_s^i + (A + (1 - \theta) (1 - \gamma)) k_{1l}^i + B_s^i + \theta (1 - \gamma) k_{1l}^i - k_{1l}^i F'(k_{1l}^T) - d_{1l} \right) \right]
\]

First-order condition with respect to \( k_{1l}^i \)

\[
F''(k_{1l}^T) k_{1l}^i + A + (1 - \theta) (1 - \gamma) + z_{1l}^{i,1,P} (\theta (1 - \gamma) - F'(k_{1l}^T)) = F''(k_{1l}^T) \sum_{j=1}^{N} \frac{1}{N} z_{1l}^{j,1,P} k_{1l}^j F(k_{1l}^T).
\tag{13}
\]
The first-order condition with respect to period two dividends given by equation 15 is the same for every \( i \) and one can simplify equation 13 as

\[
z^{i,1,P}_{1,t} = z^{1,P}_{1,t} = F''(k^T_{1,s}) k^T_{1,t} + A + (1 - \theta) (1 - \gamma) > 1
\]

where \( z^{1,P}_{1,t} > 1 \) comes from the assumptions \( \gamma < F'(k^T_{1,s}) \leq 1 \), \( \frac{1}{N} F''(k^T_{1,s}) k^{i,F}_{1,s} < 0 \) and \( A - \gamma > 0 \). The first-order condition with respect to \( B^i_t \) is

\[
1 + \frac{\partial \delta (B^i_t, \chi)}{\partial B^i_t} = z^{1,P}_{1,t} (k^T_{1,t})
\]

The policy maker is indifferent about whom to give the bail-out to. He wants to control the size of the fire sale given the cost of the marginal bail-out but he is indifferent between giving all the money to a single bank or splitting it equally among all banks. I will consider the symmetric equilibrium in order to solve the model — i.e., \( B^i_t = B^t \). At the end of \( t = 0 \), banker \( i \) chooses \( \{k^0_i, d^i_1, \nu^i\} \), taking as given \( \{\rho^i, \nu^i\} \) and internalizing her effect on \( B^i_t \) and on her own future actions. I plug in for \( d^i_2 \) and take into account that \( k^1_s \) is pinned down by the period-one budget constraint, while \( B^i_t \) is pinned down by equation 15. At the end of period \( t = 0 \), banker \( i \) optimizes the expected value of period two dividends given by

\[
\max_{k^0, d^i_1, k^1_s} \sum_s \pi_s (A + (1 - \theta) (1 - \gamma)) k^1_s,
\]

subject to the period-one budget constraint, the period-zero budget constraint, the period-zero borrowing constraint, the minimum bank capital requirement and subject to the limit on the promised payment in the crisis state by banker \( i \):

\[
k^1_s (F'(k^T_{1,s}) - \theta (1 - \gamma)) + d^i_1 \leq (F'(k^T_{1,s}) + a_{1s} - \gamma) k^0_i + B^i_s \quad [\pi_s z^{1,i}_{1,s}]
\]

\[
k^0_i - n \leq \sum_s \pi_s d^i_1 \quad [z^0_i]
\]

\[
d^i_1 \leq \theta (F'(k^T_{1,s}) - \gamma) k^0_i \quad [\pi_s \lambda^{1,i}_s]
\]

\[
\rho^i k^0_i \leq n \quad [\nu_i]
\]

\[
d^i_1 \leq \nu^i \quad [\pi_i \varphi^i]
\]

The first-order condition with respect to \( k^0_i \):

\[
\sum_s \pi_s z^{i}_{1,s} \left( F'(k^T_{1,s}) + a_{1s} - \gamma + \frac{1}{N} F''(k^T_{1,s}) k^{i,F}_{1,s} + \frac{\partial B^i_s}{\partial k^0_i} \right) - z^0_i - \rho^i \nu^i + \sum_s \pi_s \lambda^{1,i}_s \theta \left( F'(k^T_{1,s}) - \gamma + \frac{1}{N} F''(k^T_{1,s}) k^0_i \right) = 0.
\]
The first-order condition with respect to $k_{1s}^i$:

\[
A + (1 - \theta) (1 - \gamma) + z_{1s}^i \left[ - \frac{1}{N} F'' (k_{1s}^T) k_{1s}^i + \frac{\partial B_i}{\partial k_{1s}} - (F' (k_{1s}^T) - \theta (1 - \gamma)) \right] + \lambda_{1s}^i \theta \left[ - \frac{1}{N} F'' (k_{1s}^T) k_0 \right] = 0. 
\]

The first-order condition with respect to $d_{1l}^i$:

\[-z_{1l}^i + z_0^i - \lambda_{1l}^i - \varphi^i = 0.\]

The first-order condition with respect to $d_{1h}^i$:

\[-z_{1h}^i + z_0^i - \lambda_{1h}^i = 0,\]

where, using equation 15, one can show that

\[
\frac{\partial B_i}{\partial k_{1l}} = \frac{\partial B_i}{\partial k_0} = - \frac{\partial B_i}{\partial k_{1l}} = \frac{1}{\delta'' (B_i) N} \frac{\partial z_{1l}^i}{\partial z_{1l}}.
\]

**A.3 Constrained Central Planner’s Problem – No Commitment**

Since I assume no commitment, I solve the problem backwards. In period-one the Central Planner maximizes the welfare of the consumers assuming a symmetric equilibrium

\[
\max_{k_{1s}, B_s, d_{2s}} \ 2 \epsilon - (\delta (B_s) + B_s) + F (k_{1s}^T) - F' (k_{1s}^T) k_{1s}^T + d_{1s} + (A + 1 - \gamma) k_{1s} - d_{2s}
\]

subject to the collateral constraint in $t = 2$ and to the period-one budget constraint

\[
d_{2s} \leq \theta (1 - \gamma) k_{1s} \quad [\lambda_{2s}^{CP}].
\]

\[
k_{1s} F' (k_{1s}^T) + d_{1s} \leq (F' (k_{1s}^T) + a_{1s} - \gamma) k_0 + B_s + d_{2s} \quad [z_{1s}^{1CP}]
\]

From the first-order conditions with respect to $k_{1s}$, $d_{2s}$ and $B_s$

\[
Z_{1s}^{1CP} = \frac{F'' (k_{1s}^T) k_{1s}^T + A + 1 - \gamma + \lambda_{2s}^{CP} \theta (1 - \gamma)}{F' (k_{1s}^T) + F'' (k_{1s}^T) k_{1s}^T}
\]

\[
z_{1s}^{1CP} = 1 + \lambda_{2s}^{CP} \geq 1
\]

First, I prove that $\lambda_{2s}^{1CP} > 0$. Since $F' (k_{1s}^T) \leq 1$ and $A + 1 - \gamma + \lambda_{2s}^{CP} \theta (1 - \gamma) > 1$, then $z_{1s}^{1CP} > 1$. From equation 19 $\lambda_{2s}^{1CP} = z_{1s}^{1CP} - 1 > 0$ which completes the proof that $\lambda_{2s}^{1CP} > 0$. Hence, $d_{2s} = \theta (1 - \gamma) k_{1s}$. Rewriting the first-order condition with respect to $k_{1s}$ and using the fact that $\lambda_{2s}^{1CP} = z_{1s}^{1CP} - 1:$

\[
40
\]
The Central Planner’s optimization problem in $t = 0$ becomes (taking into account that in equilibrium, $p_{2s} = p_{1s} = 1$):

\[
\max_{k_0,\{k_{1s},d_{1s}\}_{s=1,h}} 3e - \sum \pi_{1s}d_{1s} + \sum \pi_s \left[ \frac{d_{1s} - d_{2s} + d_{2s} + F(k_{1s}^T)}{F'(k_{1s}^T) + F''(k_{1s}^T)k_{1s}^T - \theta (1 - \gamma)} \right].
\]

Using the fact that $d_{2s} = \theta (1 - \gamma) k_{1s}$ and simplifying, one can rewrite the optimization problem as

\[
\max_{k_0,\{k_{1s},d_{1s}\}_{s=1,h}} 3e + \sum \pi_s \left[ F(k_{1s}^T) - F'(k_{1s}^T)k_{1s}^T - B_s - \delta (B_s) + (A + (1 - \gamma) (1 - \theta)) k_{1s} \right]
\]

subject to the budget constraint in $t = 1$ and $t = 0$ and the period-one collateral constraint

\[
k_{1s} (F'(k_{1s}^T) - \theta (1 - \gamma)) + d_{1s} \leq \left( F'(k_{1s}^T) + a_{1s} - \gamma \right) k_0 + B_s \quad \left[ \pi_s z_{1s}^{CP} \right]
\]

\[
k_0 \leq n + \sum \pi_s d_{1s} \quad \left[ z_0^{CP} \right]
\]

\[
d_{1s} \leq \theta (F'(k_{1s}^T) - \gamma) k_0 \quad \left[ \pi_s \lambda_{1s}^{CP} \right]
\]

The first-order condition with respect to $k_0$ is

\[
\sum \pi_s \left( z_{1s}^{CP} \left( F'(k_{1s}^T) + a_{1s} - \gamma + F''(k_{1s}^T)k_{1s}^T + \frac{\partial B_s}{\partial k_0} \right) \right) = z_0^{CP}
\]

(22)

where $\frac{\partial B_s}{\partial k_0} = \frac{1}{\sigma'(B_s)} \frac{\partial z_{1s}^{1,CP}}{\partial k_{1s}}$. The first-order condition with respect to $k_{1s}$ is

\[
F''(k_{1s}^T)k_{1s}^T - \frac{\partial B_s}{\partial k_{1s}} (1 + \delta'(B_s)) + A + (1 - \gamma) (1 - \theta)
\]

\[
+ z_{1s}^{CP} \left[ -F''(k_{1s}^T)k_{1s}^T + \frac{\partial B_s}{\partial k_{1s}} - (F'(k_{1s}^T) - \theta (1 - \gamma)) \right] - \lambda_{1s}^{CP} \theta F''(k_{1s}^T) k_0 = 0,
\]

(23a)

where $\frac{\partial B_s}{\partial k_{1s}} = - \frac{1}{\sigma'(B_s)} \frac{\partial z_{1s}^{1,CP}}{\partial k_{1s}}$, and the first-order condition with respect to $d_{1s}$ is $z_0^{CP} - z_{1s}^{CP} - \lambda_{1s}^{CP} = 0$. 

41
A.4 Proofs

A.4.1 Proposition 1

Proposition 1: See text. Assumption 8 is given by

\[
\left( \frac{1}{N} + 1 \right) F''(k_{11}^T) + \frac{1}{N} F'''(k_{11}^T) k_{11}^T + \left[ \frac{1}{\delta''(B_l)} \frac{\partial z_{11}^{1,P}}{\partial k_{11}^T} N \partial k_{11}^T \delta k_{11}^T - \frac{\delta''(B_l)}{(\delta''(B_l))^2} \frac{\partial B_l}{\partial k_{11}^T} \frac{\partial z_{11}^{1,P}}{\partial k_{11}^T} \right] < 0
\]

Assumption 8

Before I prove Proposition 1, I prove Lemmas 1 and 2.

Lemma 1 Conditional on Assumptions 1-6 and conditional on a fire sale in the low state, \( k_{11}^T > 0 \), then \( \frac{\partial B_l(k_{11}^T)}{\partial k_{11}^T} > 0 \) and \( \frac{\partial z_{11}^{1,P}}{\partial k_{11}^T} > 0 \).

Proof of Lemma 1. Differentiating the first-order condition of the policy maker in the beginning of \( t = 1 \), given by equations 14 and 15, and using the fact that \( z_{11}^{1,P} > 1 \) (see Section A.2), Assumption 4 and the assumption \( F''(k_{11}^T) < 0 \), then

\[
\frac{\partial z_{11}^{1,P}}{\partial k_{11}^T} = \frac{F''(k_{11}^T) + F'''(k_{11}^T) k_{11}^T \left( 1 - z_{11}^{1,P}(k_{11}^T) \right) - z_{11}^{1,P}(k_{11}^T) F''(k_{11}^T)}{F''(k_{11}^T) + F''(k_{11}^T) - \theta (1 - \gamma)} > 0.
\]

(24)

Since \( \frac{\partial z_{11}^{1,P}}{\partial k_{11}^T} > 0 \) and since \( \delta''(B_l) > 0 \), one can show that a larger fire sale leads to a larger optimal bail-out:

\[
\frac{\partial B_l(k_{11}^T)}{\partial k_{11}^T} = \frac{1}{\delta''(B_l)} \frac{\partial z_{11}^{1,P}}{\partial k_{11}^T} > 0
\]

Lemma 2 Given Assumptions 1-7 and considering a symmetric equilibrium, there is never a fire sale in the high state, \( q_{1h} = 1 \), and there is a fire sale in the low state, \( q_{1l} < 1 \).

Proof of Lemma 2. Assuming a symmetric equilibrium, first, I show that \( q_{1h} = 1 \). In Section A.2, I proved that \( \lambda_{2s} > 0 \) and \( d_{2s} = \theta (1 - \gamma) k_{1s} \). I can rewrite the budget constraint in \( t = 1 \) and state \( s \) as

\[
(k_{1s} - k_0) (q_{1s} - \theta (1 - \gamma)) \leq (a_{1s} - \gamma + \theta (1 - \gamma)) k_0 + B_s - d_{1s}.
\]

Using the fact that the maximum promised payment in \( t = 1 \) in the high state is pinned down by the binding borrowing constraint, \( d_{1h}^{\text{max}} = \theta (q_{1h} - \gamma) k_0 \), and also from Assumption 5, \( a_{1h} > \gamma \), then one can show that

\[
(k_{1h} - k_0) (q_{1h} - \theta (1 - \gamma)) = (a_{1h} - \gamma + \theta (1 - \gamma)) k_0 - d_{1h} \geq (a_{1h} - \gamma + \theta (1 - q_{1h})) k_0 > 0.
\]

Since \( k_{1h} - k_0 > 0 \), there is no fire sale in the high state, \( q_{1h} = 1 \).

The proof that \( q_{1l} < 1 \) proceeds in two steps.
**Step 1)** First, I show that, given Assumption 2, if there is no fire sale in \( t = 1 \) in the low state (i.e. \( q_{11} = 1 \)), the only possible equilibrium is the corner one where the banker borrows to the maximum in \( t = 0 \) (Type 2 equilibrium). This implies that if the equilibrium is not the Type 2 corner equilibrium, then there must be a fire sale in the low state.\(^{51}\)

**Step 2)** The second step is to show that given Assumption 6, even if the Type 2 equilibrium is the optimal one, there will be always a fire sale in \( t = 1 \) in the low state.

Steps 1 and 2 are sufficient to prove that there is always a fire sale in equilibrium in the crisis state, given the assumptions made. Finally, via simulations, I prove that the set of parameters for which the Type 1 equilibrium is the optimal one is non-empty. Assumption 6 is the most general assumption that guarantees the presence of a fire sale in the crisis state.

**Proof of Step 1** I will prove that conditional on Assumption 2 being satisfied, \( q_{11} = 1 \), and if I assume that \( q_{11} = 1 \), then \( z_0 > z_{1s} \). This implies that the only possible equilibrium if there are no fire-sales is Type 2 (the corner equilibrium). Since \( q_{1s} = 1 \), then \( \frac{\partial B_i^s}{\partial k_{1s}} = 0 \) and \( F''(k_{1s}^{T}) = 0 \), and one can rewrite the first-order condition with respect to \( k_0 \) as \( \sum_s \pi_s [z_{1s} (1 + a_{1s} - \gamma) + \lambda_{1s} \theta (1 - \gamma)] = z_0 \).

Let’s consider all the possible cases based on all the possible combinations of \( \lambda_{1h} \) and \( \lambda_{1l} \): Case 1) \( \lambda_{1s} = 0 \). If \( \lambda_{1s} = 0 \), then \( z_{1s} = z_0 \), which is impossible since if Assumption 2 were satisfied, then \( z_{1s} \sum_s \pi_s (1 + a_{1s} - \gamma) = z_0 > z_{1s} \), which is a contradiction. Case 2) \( \lambda_{1l} = 0 \) and \( \lambda_{1h} > 0 \). This case is impossible since it implies that \( z_0 = z_{1l} > z_{1h} = z_0 - \lambda_{1h} \). However, from the first-order condition with respect to \( k_{1s} \), \( z_{1l} = z_{1h} \), which is a contradiction. Case 3) \( \lambda_{1h} = 0 \) and \( \lambda_{1l} > 0 \). Similarly, the case \( \lambda_{1h} = 0 \) and \( \lambda_{1l} > 0 \) is impossible due to the same argument as to why Case 2 is impossible. Case 4) \( \lambda_{1s} > 0 \). This is the case where banker \( i \) borrows to the maximum in \( t = 0 \) (Type 2 equilibrium). From the first-order condition with respect to \( d_{1s} \), \( z_{1s} + \lambda_{1s} = z_0 > z_{1s} \). One can rewrite \( z_0 \) as

\[
  z_0 = z_{1s} \sum_s \pi_s \left[ (1 - \gamma) (1 - \theta) + a_{1s} \right] / (1 - \theta (1 - \gamma)) \tag{25}
\]

\( z_0 > z_{1s} \) implies

\[
  \sum_s \pi_s \left[ (1 - \gamma) (1 - \theta) + a_{1s} \right] / (1 - \theta (1 - \gamma)) > 1. \tag{26}
\]

One can show that the condition \( z_0 > z_{1s} \) is satisfied as long as Assumption 2 is satisfied, which completes the proof that as long as Assumption 2 is satisfied and there is no fire sale, the banker always optimally borrows to the maximum in \( t = 0 \) (Type 2 equilibrium).

**Proof of Step 2** Next, I prove that given Assumption 6 and if the banker borrows to the maximum in \( t = 0 \) (Type 2 equilibrium), there is always a fire sale in \( t = 1 \) in the low state. To do that, I show that if the banker borrows to the maximum, there exists a unique \( k_{1l}^{T \text{ max}} > 0 \) where the superscript \( \text{max} \) stands for the fire sale if the equilibrium is Type 2.

\(^{51}\) Also, since \( k_0 = 0 \) implies no fire sale in equilibrium (no borrowing in period zero and only lending to the maximum), proving the first step automatically implies that the corner solution \( k_0 = 0 \) is impossible, which justifies my omission of the \( k_0 \geq 0 \) constraint when solving for the banker’s problem.
In order to solve for $k_0^{\text{max}}$ as a function of $k_{1l}^{T,\text{max}}$, I use the period-zero budget constraint (imposing the condition that all the borrowing constraints are binding),

$$
  k_0^{\text{max}} = \frac{n}{1 - \pi_h \theta (1 - \gamma) - \pi_i \theta (F' (k_{1l}^{T,\text{max}}) - \gamma)}
\tag{27}
$$

First, I prove by contradiction that if the equilibrium is of Type 2 and if $k_{1l}^{T,\text{max}}$ exists, then $k_{1l}^{T,\text{max}} > 0$. Assume that banker $i$ borrows to the maximum in $t = 0$ and that $k_{1l}^{T,\text{max}} = 0$ (i.e., $q_{1s} = 1$). Rewriting the budget constraint in the low state in $t = 1$:

$$(k_{1l}^{\text{max}} - k_0^{\text{max}}) (1 - \theta (1 - \gamma)) = \frac{(a_{1l} - \gamma) n}{1 - \theta (1 - \gamma)} + (\delta')^{-1} \left( \frac{A - \gamma}{1 - \theta (1 - \gamma)} \right) < 0,$$

where the last inequality follows from Assumption 6 and implies that $k_{1l}^{\text{max}} - k_0^{\text{max}} = -k_{1l}^{T,\text{max}} < 0$. This contradicts the assumption that $k_{1l}^{T,\text{max}} = 0$. Therefore, if $k_{1l}^{T,\text{max}}$ exists and the banker borrows to the maximum in $t = 0$, then $k_{1l}^{T,\text{max}} > 0$.

Next, I prove the existence and uniqueness of $k_{1l}^{T,\text{max}}$. Using the fact that $d_{2s} = \theta (1 - \gamma) k_{1s}$ and $d_{1s} = \theta (q_{1s} - \gamma) k_0$ and using the period-one budget constraint in the low state, define

$$
  H \left( k_{1l}^{T}; k_0 = k_0^{\text{max}} \right) = (a_{1l} - \gamma + \theta (1 - \gamma) - \theta (F' (k_{1l}^{T} - \gamma))) k_0^{\text{max}} + B_i (k_{1l}^{T}) + (F' (k_{1l}^{T}) - \theta (1 - \gamma)) k_{1l}^{T} \tag{28}
$$

Next, I prove that $H \left( k_{1l}^{T,\text{max}}; k_0 = k_0^{\text{max}} \right) > 0$, $H \left( k_{1l}^{T} = 0; k_0 = k_0^{\text{max}} \right) < 0$ and $\frac{\partial H (k_{1l}^{T})}{\partial k_{1l}^{T}} > 0$.

This is sufficient to guarantee that there exists a unique $k_{1l}^{T,\text{max}} > 0$.

$$
  H \left( k_{1l}^{T} = k_0^{\text{max}}; k_0 = k_0^{\text{max}} \right) = (a_{1l} + (F' (k_0^{\text{max}}) - \gamma) (1 - \theta)) k_0^{\text{max}} + B_i (k_0^{\text{max}}) > 0.
$$

Given Assumption 6,

$$
  H \left( k_{1l}^{T} = 0; k_0 = k_0^{\text{max}} \right) = \frac{(a_{1l} - \gamma) n}{1 - \theta (1 - \gamma)} + (\delta')^{-1} \left( \frac{A - \gamma}{1 - \theta (1 - \gamma)} \right) < 0. \tag{29}
$$

Since $F'' (k_{1l}^{T}) < 0$, $B_i' (k_{1l}^{T}) > 0$ (derived in Lemma 1), also using Assumption 4, and since Assumption 3 implies $\theta (1 - F' (k_{1l}^{T})) < \theta (1 - \gamma) < \gamma - a_{1l}$, then one can show that

$$
  \frac{\partial H (k_{1l}^{T})}{\partial k_{1l}^{T}} = -\theta F'' (k_{1l}^{T}) k_0^{\text{max}} + (a_{1l} - \gamma + \theta (1 - F' (k_{1l}^{T}))) \frac{\partial k_0^{\text{max}} (k_{1l}^{T})}{\partial k_{1l}^{T}}
  + B_i' (k_{1l}^{T}) + F' (k_{1l}^{T}) - \theta (1 - \gamma) + F'' (k_{1l}^{T}) k_{1l}^{T} > 0,
$$

where, after differentiating equation 27,

$$
  \frac{\partial k_0^{\text{max}} (k_{1l}^{T})}{\partial k_{1l}^{T}} = \frac{\pi_i \theta F'' (k_{1l}^{T}) k_0^{\text{max}}}{1 - \pi_h \theta (1 - \gamma) - \pi_i \theta (F' (k_{1l}^{T}) - \gamma)} < 0 \text{ if } k_{1l}^{T} > 0.
$$

44
The fire sale that will emerge in equilibrium if the bank borrows to the maximum in \(t = 0\) is pinned down by \(H\left(k_{1l}^{T,\text{max}}, k_0 = k_0^{\text{max}}\right) = 0\). This completes the proof that there exists a unique equilibrium \(k_{1l}^{T,\text{max}} > 0\) (i.e. \(q_{1l}\left(k_{1l}^{T,\text{max}}\right) < 1\)).

**Proof of Proposition 1.**

**Part 1) First, I prove that the only two types of equilibria that can emerge are Type 1 and Type 2.**

In order to characterize the equilibrium, I consider all four combinations of whether \(\lambda_{1h}\) and \(\lambda_{1l}\), are greater than or equal to zero.\(^{52}\) First, let’s consider the case \(\lambda_{1s} = 0\), which implies \((z_{1h} = z_0 = z_{1l})\), and let’s prove that given Assumption 2, this case will never be an equilibrium. If the policy maker does not have access to ex-ante regulatory instruments, from the first-order condition with respect to \(k_0\),

\[
z_{1l} = \frac{A + (1 - \theta)(1 - \gamma)}{\frac{1}{N} F''(k_{1l}) k_{1l}^T + \frac{1}{\sigma'(B_l)N} \frac{\partial z_{1l}^P}{\partial k_{1l}^T} + F'(k_{1l}^T) - \theta(1 - \gamma)} = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta(1 - \gamma)} = z_{1h},
\]

which implies

\[
1 - F'(k_{1l}^T) = \frac{1}{N} \left[ F''(k_{1l}) k_{1l}^T + \frac{1}{\sigma'(B_l)N} \frac{\partial z_{1l}^P}{\partial k_{1l}^T} \right]
\]

From the first-order condition with respect to \(k_{1s}\),

\[
A + (1 - \theta)(1 - \gamma) + z_0 \sum_s \pi_s (\theta(1 - \gamma) + a_{1s} - \gamma) = z_0
\]

Plugging \(z_{1h} = z_{1l} = z_0 = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta(1 - \gamma)}\) into equation 31 and simplifying implies that \(1 = \sum_s \pi_s (1 + a_{1s} - \gamma)\). However, given Assumption 2, the equation above will not be satisfied, and, hence, \(\lambda_{1s} = 0\) will not be an equilibrium given the assumptions made. Next, I show that the case \(\lambda_{1h} = 0, \lambda_{1l} > 0\), which implies \((z_{1h} = z_0 > z_{1l})\), is impossible. Rewriting the bankers’ first-order, \(\lambda_{1l} = z_0 - z_{1l}, z_{1h} = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta(1 - \gamma)}\) and

\[
z_{1l} = \frac{A + (1 - \theta)(1 - \gamma) - z_{1h} \theta \frac{1}{N} F''(k_{1l}^T) k_0}{\varpi(k_{1l}^T)}
\]

where \(\varpi(k_{1l}^T) = \left[ \frac{1}{N} F''(k_{1l}^T) k_{1l}^T + \frac{1}{\sigma'(B_l)N} \frac{\partial z_{1l}^P}{\partial k_{1l}^T} + F'(k_{1l}^T) - \theta(1 - \gamma) - \theta \frac{1}{N} F''(k_{1l}^T) k_0 \right] > 0\). In order for \(z_{1h} > z_{1l}\), it will have to be the case \(z_{1h} > \frac{A + (1 - \theta)(1 - \gamma)}{\varpi(k_{1l}^T)}\) which implies

\[
\frac{1}{N} F''(k_{1l}^T) k_{1l}^T + \frac{1}{\sigma'(B_l)N} \frac{\partial z_{1l}^P}{\partial k_{1l}^T} + F'(k_{1l}^T) - 1 > 0.
\]

\(^{52}\)I already proved that the period-two borrowing constraints are always binding, \(\lambda_{2s} > 0\).
Rewriting the bankers’ first-order condition with respect to \( k_0 \) and using the fact that \( z_{1h} = z_0 \)

\[
  z_0 = \frac{\pi_l z_{1h} \left( \varpi \left( k_{11}^T \right) + \theta \left( 1 - F' \left( k_{11}^T \right) \right) + a_{1l} - \gamma \right)}{[1 - \pi_l \theta \left( F' \left( k_{11}^T \right) - \gamma + \frac{1}{N} F'' \left( k_{11}^T \right) k_0 - \pi_h (1 + a_{1h} - \gamma) \right)]}. \tag{34}
\]

Combining equations 34 and 32, one can solve for \( z_0 \):

\[
  z_0 = \frac{\pi_l \left[ A + (1 - \theta) (1 - \gamma) \right] \left[ 1 + \frac{\theta (1 - F' \left( k_{11}^T \right)) + a_{1l} - \gamma}{\varpi \left( k_{11}^T \right)} \right]}{1 - \pi_l \theta \left( F' \left( k_{11}^T \right) - \gamma \right) - \pi_h (1 + a_{1h} - \gamma) + \pi_l \theta \frac{1}{N} F'' \left( k_{11}^T \right) k_0 \left[ \theta (1 - F' \left( k_{11}^T \right)) + a_{1l} - \gamma \right]} \tag{35}.
\]

Next, I prove that given Assumption 2, Assumption 3 and the inequality 33, it will be impossible that \( z_0 = z_{1h} = \frac{A + (1 - \theta) (1 - \gamma)}{1 - \theta (1 - \gamma)} \), where \( z_0 \) is given by equation 35. Equating \( z_0 = z_{1h} \) and simplifying, one gets

\[
  0 < LHS = \left[ \sum_s \pi_s \left( 1 + a_{1s} - \gamma \right) \right] - 1 =
\]

\[
  \left( \frac{\frac{1}{N} F'' \left( k_{11}^T \right) k_{11}^T}{\varpi \left( k_{11}^T \right)} + \frac{1}{\delta'' \left( B_1 N \right)} \frac{\partial z_{1p}^2}{\partial k_{11}^T} + F' \left( k_{11}^T \right) - 1 \right) \pi_l \left[ \theta (1 - F' \left( k_{11}^T \right)) + a_{1l} - \gamma \right] = RHS < 0.
\]

where \( \left[ \theta (1 - F' \left( k_{11}^T \right)) + a_{1l} - \gamma \right] < \theta (1 - \gamma) + a_{1l} - \gamma < 0 \). Since it is impossible for both \( LHS > 0 \) and \( RHS < 0 \) to be true, the case \( \lambda_{1h} = 0, \lambda_{1l} > 0 \) will never be an equilibrium outcome. Next, I consider the remaining two cases that can occur in equilibrium.

**Type 1 equilibrium:** \( \lambda_{1h} > 0, \lambda_{1l} = 0 \) (\( z_{1l} = z_0 > z_{1h} \)). Using the fact that \( \lambda_{1h} = z_0 - z_{1h} \) and rewriting equations 17 and 18, one can show that \( z_{1h} = \frac{A + (1 - \theta) (1 - \gamma)}{1 - \theta (1 - \gamma)} \),

\[
  z_0 = \frac{\pi_h z_{1h} \left[ (1 - \gamma) (1 - \theta) + a_{1h} \right] + \pi_l \left[ A + (1 - \theta) (1 - \gamma) \right] + \pi_l \left( a_{1l} + \theta (1 - \gamma) - \gamma \right) z_{1l}}{[1 - \pi_h \theta (1 - \gamma)]}, \tag{36}
\]

\[
  z_{1l} = \frac{A + (1 - \theta) (1 - \gamma)}{\frac{1}{N} F'' \left( k_{11}^T \right) k_{11}^T + \frac{1}{\delta'' \left( B_1 N \right)} \frac{\partial z_{1p}^2}{\partial k_{11}^T} + F' \left( k_{11}^T \right) - \theta (1 - \gamma)} \tag{37}.
\]

Using the equations above, one can solve for \( k_{11}^T \). In order for \( z_{1l} > z_{1h} \), it has to be the case that \( z_{1l} > \frac{A + (1 - \theta) (1 - \gamma)}{1 - \theta (1 - \gamma)} \), which implies,

\[
  \frac{1}{N} F'' \left( k_{11}^T \right) k_{11}^T + \frac{1}{\delta'' \left( B_1 N \right)} \frac{\partial z_{1p}^2}{\partial k_{11}^T} + F' \left( k_{11}^T \right) - 1 < 0. \tag{38}
\]

The rest of the endogenous variables are given by the following system of equations:

\[
  k_0 = \frac{\pi_l B_1 + n + \left[ F' \left( k_{11}^T \right) - \theta (1 - \gamma) \right] k_{11}^T \pi_l}{(1 - \pi_h \theta (1 - \gamma) + (\gamma - a_{1l} - \theta (1 - \gamma)) \pi_l)} \tag{39}.
\]
\[ k_{1l} = k_0 - k_{1l}^T \]  
\[ k_{1h} = \frac{((1 - \theta) (1 - \gamma) + a_{1h}) k_0}{[1 - \theta (1 - \gamma)]} \]  
\[ d_{2s} = \theta (1 - \gamma) k_{1s}; \quad d_{1l} = \frac{1}{\pi_l} [(k_0 - n) - \pi_h \theta (1 - \gamma) k_0] \]  
\[ d_{1h} = \theta (1 - \gamma) k_0 \]  

and \( B_t = (\delta')^{-1} \left( z_{1l}^{P^1} (k_{1l}^T) - 1 \right) \). Finally \( p_{1s} = p_{2s} = 1 \) and \( q_0 = q_{2s} = q_{1h} = 1, q_{1l} = F' (k_{1l}^T) \).

**Type 2 equilibrium:** \( \lambda_{1s} > 0 \) \( (z_0 > z_{1s}) \). It will be the case that \( \lambda_{1s} = z_0 - z_{1s} \), and using the first-order conditions with respect to \( k_0 \) and \( k_{1s} \), equations 17 and 18, one can solve for \( z_{1s} \) and \( z_0 \) as a function of \( k_{1l}^T \). The rest of the endogenous variables \( d_{2s}, d_{1s}, k_{1l}, k_{1h} \) and \( B_t \) are pinned down by the following system of equations: \( k_{1l}^{T,\text{max}} \) is determined by the solution to the equation \( H \left( k_{1l}^{T,\text{max}}; k_0 = k_{0}^{\text{max}} \right) = 0 \), where \( H (\cdot) \) is given by equation 28. \( k_{0}^{\text{max}} \) is given by equation 27. Also, \( d_{1s} = \theta (q_{1s} - \gamma) k_0, d_{2s} = \theta (1 - \gamma) k_{1s} \) and

\[ k_{1l} = \frac{((F' (k_{1l}^T) - \gamma) (1 - \theta) + a_{1l}) k_0 + B_t}{F' (k_{1l}^T) - \theta (1 - \gamma)} \]
\[ k_{1h} = \frac{((1 - \gamma) (1 - \theta) + a_{1h}) k_0}{1 - \theta (1 - \gamma)} \]

and \( B_t = (\delta')^{-1} \left( z_{1l}^{P^1} (k_{1l}^T) - 1 \right) \). Finally \( p_{1s} = p_{2s} = 1 \) and \( q_0 = q_{2s} = q_{1h} = 1, q_{1l} = F' (k_{1l}^T) \).

**Part 2) Existence and Uniqueness**

The proof of existence and uniqueness proceeds in two steps:

*Step 1)* Solve for the equilibrium by solving for \( k_0 \). First, I show that for every \( k_0 \in [0, k_{0}^{\text{max}}] \), there exists a unique \( k_{1l}^T \). I will consider two regions for \( k_0 \) separately. If the equilibrium \( k_0 \) is such that \( k_0 \in [0, \hat{k}_0] \) then there will be no-fire sale, \( k_{1l}^T = 0 \), where I will derive \( \hat{k}_0 \) as a function of exogenous variables. If the equilibrium \( k_0 \) is such that \( k_0 \in (\hat{k}_0, k_{0}^{\text{max}}] \), then there will be a fire sale \( k_{1l}^T > 0 \) and \( k_{1l}^T \) is unique. Also, I prove that if \( k_0 \in (\hat{k}_0, k_{0}^{\text{max}}] \), then \( \frac{\partial k_{1l}^T (k_0)}{\partial k_0} > 0 \).

*Step 2)* Prove existence and uniqueness using Step 1.

**Proof of Step 1)** Since I proved that the only possible case is \( \lambda_{1h} > 0, \lambda_{2s} > 0 \) (which encompasses the Type 1 and 2 equilibria), from the period-zero budget constraint and borrowing constraint,

\[ d_{1l} (k_{1l}^T; k_0) = \min \left\{ \frac{1}{\pi_l} (k_0 (1 - \pi_h \theta (1 - \gamma)) - n), \theta (F' (k_{1l}^T) - \gamma) k_0 \right\} \]

Using the budget constraint in the low state in \( t = 1 \), define the following function:
\[ H(k_{1l}^T; k_0) = (a_{1l} - \gamma (1 - \gamma)) k_0 + (F'(k_{1l}^T) - \theta (1 - \gamma)) k_{1l}^T + B_l (k_{1l}^T) - d_{1l} (k_{1l}^T; k_0) \]

Next, consider how the function \( H(k_{1l}^T; k_0) \) behaves in the range \( k_{1l}^T \in [0, k_0] \). First, I show that \( H(k_{1l}^T = k_0; k_0) > 0 \) for every \( k_0 \):

\[
H(k_{1l}^T = k_0; k_0) = (a_{1l} - \gamma + F'(k_0)) k_0 + B_l (k_0) - d_{1l} (k_0; k_0) \\
\geq (a_{1l} + (F'(k_0) - \gamma) (1 - \theta)) k_0 + B_l (k_0) > 0,
\]

where for the first inequality, I used the fact that \( d_{1l}(k_{1l}^T; k_0) \leq \theta (q_{1l} - \gamma) k_0 \). Next, I show that \( H(k_{1l}^T = 0; k_0) > 0 \) if \( k_0 \in [0, \hat{k}_0] \) and \( H(k_{1l}^T = 0; k_0) < 0 \) if \( k_0 \in (\hat{k}_0, k_{0}^{\text{max}}] \). Since I already showed that if \( k_0 = k_0^{\text{max}} \), \( H(k_{1l}^T = 0; k_0 = k_0^{\text{max}}) < 0 \) (inequality 29), here consider only the case \( k_0 \in [0, k_{0}^{\text{max}}] \), which implies that \( d_{1l}(k_{1l}^T; k_0) = \frac{1}{\pi_l} (k_0 (1 - \pi_l \theta (1 - \gamma)) - n) \),

\[
H(k_{1l}^T = 0; k_0) = (a_{1l} - \gamma + \theta (1 - \gamma)) k_0 + B_l (0) - \frac{1}{\pi_l} (k_0 (1 - \pi_l \theta (1 - \gamma)) - n) \\
= \frac{1}{\pi_l} ((a_{1l} - \gamma) \pi_l - 1 + \theta (1 - \gamma)) k_0 + n) + (\delta')^{-1} \left( \frac{A - \gamma}{1 - \theta (1 - \gamma)} \right).
\]

Since \( (a_{1l} - \gamma) \pi_l - (1 - \theta (1 - \gamma)) < 0 \), \( \frac{\partial H(k_{1l}^T = 0; k_0)}{\partial k_0} < 0 \). One can show that

\[
H(k_{1l}^T = 0; k_0) \begin{cases} 
\geq 0 & \text{if } k_0 \leq \hat{k}_0 \\
< 0 & \text{if } k_0 > \hat{k}_0 
\end{cases},
\]

where

\[
\hat{k}_0 = \left( n + \pi_l (\delta')^{-1} \frac{A - \gamma}{1 - \theta (1 - \gamma)} \right) \frac{1}{1 - \theta (1 - \gamma) + (\gamma - a_{1l}) \pi_l}.
\] (44)

I prove that \( H(k_{1l}^T; k_0) \) is continuous in \( k_{1l}^T \) and \( \frac{\partial H(k_{1l}^T; k_0)}{\partial k_{1l}^T} > 0 \). The continuity of \( H(k_{1l}^T; k_0) \) follows from \( B_l(k_{1l}^T) \) and \( F'(k_{1l}^T) \) being continuous with respect to \( k_{1l}^T \). From Assumption 4 and Lemma 1,

\[
\frac{\partial H(k_{1l}^T; k_0)}{\partial k_{1l}^T} = \begin{cases}
F'(k_{1l}^T) - \theta (1 - \gamma) + F''(k_{1l}^T) k_{1l}^T + \frac{\partial B_l(k_{1l}^T)}{\partial k_{1l}^T} > 0 & \text{if } k_{1l}^T > 0 \\
0 & \text{if } k_{1l}^T = 0
\end{cases}
\] (45)

Since in the region \( k_0 \in [0, \hat{k}_0) \), \( H(k_{1l}^T = 0; k_0) \geq 0 \) and \( H(k_{1l}^T = k_0; k_0) > 0 \) and since \( \frac{\partial H(k_{1l}^T; k_0)}{\partial k_{1l}^T} \geq 0 \), it follows that \( k_{1l}^T(k_0) = 0 \) if \( k_0 \in [0, \hat{k}_0) \). In the region \( k_0 \in (\hat{k}_0, k_{0}^{\text{max}}] \), \( H(k_{1l}^T = 0; k_0) < 0 \), \( H(k_{1l}^T = k_0; k_0) > 0 \) and \( \frac{\partial H(k_{1l}^T; k_0)}{\partial k_{1l}^T} > 0 \). As a result, there exists an unique \( k_{1l}^T(k_0) > 0 \) if \( k_0 \in (\hat{k}_0, k_{0}^{\text{max}}] \). This completes the proof that for every \( k_0 \in [0, k_{0}^{\text{max}}] \), there exists a unique \( k_{1l}^T \geq 0 \).
I totally differentiate $H (k_0) = 0$ with respect to $k_0$ to solve for $\frac{\partial k^T_{1l}(k_0)}{\partial k_0}$ in the relevant range $k_0 \in (\hat{k}_0, k_0^{\text{max}}]$ where there is a fire sale. (This is the only relevant range since I already proved that given the assumptions made, there is a fire sale in the low state in $t = 1$). In that range, for a given $k_0$, $k^T_{1l}$ is pinned down by setting $H (k^T_{1l}; k_0) = 0$.

Totally differentiate $H (k^T_{1l}; k_0) = 0$ with respect to $k_0$ to solve for $\frac{\partial k^T_{1l}(k_0)}{\partial k_0}$. From Lemma 1 and from Assumption 3 and Assumption 4

$$\frac{\partial k^T_{1l}(k_0)}{\partial k_0} = \begin{cases} \frac{1}{N}[1-\pi_0(1-\gamma)-(\sigma_1(1-\gamma)+\theta(1-\gamma))] + F''(k^0_{1l})\theta(1-\gamma)+F''(k^0_{1l})k^{T}_{1l}+B''(k^0_{1l}) & > 0 \text{ if } k_0 \in (\hat{k}_0, k_0^{\text{max}}] \\ 0 & \text{if } k_0 \in [0, \hat{k}_0] \end{cases}$$

**Proof of Step 2)** I already proved that given the assumptions made, the only two types of equilibria are Type 1 (interior equilibrium) and Type 2 (corner equilibrium). In order to prove existence and uniqueness, I define the following function:

$$\psi (k_0) = z_{1l} (k_0) - z_0 (k_0),$$

where $z_{1l} (k_0)$ and $z_0 (k_0)$ are the marginal value of wealth in the crisis state and in period-zero, as perceived by the banker and as defined in the Type 1 equilibrium (equations 37 and 36). I will prove that $\psi (k_0)$ is strictly increasing and crosses the zero line, at most, once, which will be sufficient to prove existence and uniqueness.

In Step 1, I proved that there is a one-to-one mapping from $k^T_{1l}$ to $k_0$, and one can solve for $k_0$ as a function of $k^T_{1l}$ using equation 39 if the equilibrium is Type 1. Also, if there is a fire sale in the crisis state, which is the relevant region, then $\frac{\partial k^T_{1l}(k_0)}{\partial k_0} > 0$. Since both $z_{1l}$ and $z_0$ are functions only of $k^T_{1l}$, which, in turn, is a function of $k_0$, I can rewrite $\psi$ as

$$\psi (k^T_{1l}(k_0)) = z_{1l} (k^T_{1l}(k_0)) - z_0 (k^T_{1l}(k_0)).$$

Define

$$M (k^T_{1l}) = \frac{1}{N}F'' (k^0_{1l})k^T_{1l} + \frac{1}{\delta'' (B_0)}N\frac{\partial z^1_{1l}}{\partial k^T_{1l}} + F' (k^T_{1l}) - 1.$$ 

Inequality 38 implies that if the equilibrium is Type 1, then $M (k^T_{1l}) < 0$. In order to derive the support of the $\psi (k^T_{1l}(k_0))$ function, let’s investigate the properties of $M (k^T_{1l})$ in the range $k^T_{1l} \in [0, k^T_{1l}^{\text{max}}]$ so that we can derive for what values of $k^T_{1l}$, $M (k^T_{1l}) < 0$. One can show that given Assumption 8, $M' (k^T_{1l}) < 0$. Define the range for $k^T_{1l}$ over which the equilibrium is Type 1 as $[\hat{k}^T_{1l}, k^T_{1l}^{\text{max}}]$. If $M (\cdot) < 0$ for every $k^T_{1l} \in [0, k^T_{1l}^{\text{max}}]$, then $\hat{k}^T_{1l} = 0$. If $M (\cdot) > 0$ for every $k^T_{1l} \in [0, k^T_{1l}^{\text{max}}]$, then $\hat{k}^T_{1l} = k^T_{1l}^{\text{max}}$. Otherwise, $\hat{k}^T_{1l}$ is pinned down by $M (\hat{k}^T_{1l}) = 0$. $\hat{k}^T_{1l}$ is unique since $M' (k^T_{1l})$ is strictly decreasing due to Assumption 8.

\[53] k^T_{1l}^{\text{max}} \text{ is pinned down by setting equation 28 equal to zero. (I already proved that } k^T_{1l}^{\text{max}} \text{ exists and is unique.}\]
Therefore, the relevant range one needs to consider for the \( \psi(k_0) \) function is \( k_0 \in [\hat{k}_0, k_0^{\text{max}}] \), where \( \hat{k}_0 = k_0 \left( \hat{k}_{11}^T \right) \) if \( 0 < \hat{k}_{11}^T < k_{11}^{T,\text{max}} \). Also, \( \hat{k}_0 = \hat{k}_0 \) if \( k_{11}^T = 0 \) (where \( \hat{k}_0 \) is pinned down by equation 44) and \( \hat{k}_0 = k_0^{\text{max}} \) if \( k_{11}^T = k_{11}^{T,\text{max}} \). Also, \( k_0^{\text{max}} \) is given by equation 27. Notice that in the case of a continuum of banks, \( N \to \infty \), \( \hat{k}_{11}^T = 0 \), which implies that \( \hat{k}_0 = \hat{k}_0 \).

Given Assumption 8, which implies that \( \frac{\partial}{\partial k_0} F''(k_{11}^T) k_{11}^T + \frac{\partial}{\partial k_{11}^T} \frac{\partial z_{11}}{\partial k_{11}^T} z_{11} < 0 \), I can differentiate equation 37 to prove that

\[
\frac{\partial z_{11}}{\partial k_0} = - \frac{\partial}{\partial k_{11}^T} \left( \frac{1}{N} F''(k_{11}^T) k_{11}^T + \frac{1}{\sigma(B_i) N} \frac{\partial z_{11}}{\partial k_{11}^T} (1 - \gamma) \right) \frac{\partial z_{11}}{\partial k_{11}^T} z_{11} > 0.
\]

Combining equations 37 and 36,

\[
\psi \left( k_{11}^T (k_0) \right) = z_{11} (1 - \theta (1 - \gamma) - \pi_l (a_{11} - \gamma)) - z_{11} \pi_l ((1 - \gamma)(1 - \theta) + a_{11}) - (A + (1 - \theta)(1 - \gamma)) \pi_l \frac{1}{1 - \pi_l \theta (1 - \gamma)}
\]

Next, evaluate \( \psi \left( k_{11}^T (k_0) \right) \) at \( k_{11}^T = \bar{k}_{11}^T \) and \( k_{11}^T = \bar{k}_{11}^{T,\text{max}} \), which is the relevant range for the Type 1 equilibrium. If \( k_{11}^T = \bar{k}_{11}^T \), then one can show that \( z_{11} \left( \bar{k}_{11}^T \right) = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta (1 - \gamma)} \). Given Assumption 2,

\[
\psi \left( \bar{k}_{11}^T \right) = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta (1 - \gamma)} \left( 1 - \sum s \pi_s (a_{1s} - \gamma + 1) \frac{1}{1 - \pi_l \theta (1 - \gamma)} < 0.
\]

If \( \psi \left( k_{11}^T \right) < 0 \) for every \( k_{11}^T \in [\bar{k}_{11}^T, \bar{k}_{11}^{T,\text{max}}] \), then the equilibrium is a Type 2 corner equilibrium. If \( \psi \left( k_{11}^{T,\text{max}} \right) > 0 \), the equilibrium is Type 1 interior equilibrium. This completes the proof of existence and uniqueness.

A.4.2 Proposition 2

**Proposition 2:** See text. Assumption 9 is given by

\[
[\pi_l (a_{11} - \gamma) + 1 - \theta (1 - \gamma)] \frac{A + (1 - \gamma)(1 - \theta)}{1 - \theta (1 - \gamma)} \quad \text{(Assumption 9)}
\]

\[
< \frac{F''(k_{11}^T) k_{11}^T + A + (1 - \gamma)(1 - \theta)}{F''(k_{11}^T) k_{11}^T - \theta (1 - \gamma)} [\pi_l (\gamma - a_{11}) + 1 - \theta [1 - \gamma]].
\]
Before I prove Proposition 2, I prove Lemmas 3 and 4.

**Lemma 3** Conditional on Assumptions 1-6 and conditional on a fire sale in the low state, \( \frac{\partial B_l(k_{1l}^l)}{\partial k_{1l}^l} > 0 \) and \( \frac{\partial z_{1CP}^{1CP}}{\partial k_{1l}^l} > 0 \).

**Proof of Lemma 3.** The proof is identical to the proof of Lemma 1 since \( z_{1l}^{1CP} (k_{1l}^l) = z_{1l}^{1P} (k_{1l}^l) \).

**Lemma 4** Given Assumption 5, considering a symmetric equilibrium, there is never a fire sale in the high state, \( q_{1h} = 1 \). Given Assumption 2 and the additional Assumption 6, it is always the case that there is a fire sale in the low state, \( q_{1l} < 1 \).

**Proof of Lemma 4.** The proof that \( q_{1h} = 1 \) is identical to the one in Lemma 1. The proof that \( q_{1l} < 1 \) is very similar since one can rewrite the first-order conditions of the Central Planner’s problem, assuming that \( q_{1l} = 1 \), as

\[
\sum \pi_s \left( -\frac{\partial B_s}{\partial k_0} (1 + \phi'(B_s)) + z_{1s}^{CP} \left( 1 + a_{1s} - \gamma + \frac{\partial B_s}{\partial k_0} \right) + \lambda_{1s}^{CP} \theta (1 - \gamma) \right) = z_{0}^{CP}.
\]

Since \( z_{1l}^{1CP} (k_{1l}^l) = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta(1 - \gamma)} \) implies that \( \frac{\partial z_{1l}^{1CP}}{\partial k_{1l}^l} = 0 \), then \( \frac{\partial B_s}{\partial k_0} = \frac{1}{\phi'(B)} \frac{\partial z_{1l}^{1CP}}{\partial k_{1l}^l} = 0 \) and \( \frac{\partial B_s}{\partial k_1} = -\frac{1}{\phi'(B)} \frac{\partial z_{1l}^{1CP}}{\partial k_{1l}^l} = 0 \). As a result,

\[
\sum \pi_s \left( z_{1s}^{CP} (1 + a_{1s} - \gamma) + \lambda_{1s}^{CP} \theta (1 - \gamma) \right) = z_{0}^{CP},
\]

where \( z_{1s}^{CP} = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta(1 - \gamma)} \) and \( z_{0}^{CP} - z_{1s}^{CP} = \lambda_{1s}^{CP} \). The equations above coincide with the equations in the proof of Lemma 2, Step 1. The rest of the proof is identical to the proof in Lemma 2.

**Proof of Proposition 2:**

Part 1) First, I prove that the only two types of equilibria are Types 1 and 2. The proof is similar to the proof in Proposition 1. In order to characterize the equilibrium, I consider all four possible combinations of whether \( \lambda_{1h} \) and \( \lambda_{1l} \) are greater than or equal to zero. If \( \lambda_{1h} = 0 \) and \( \lambda_{1l} = 0 \), then \( z_{1l}^{CP} = z_{1l}^{CP} = z_{0}^{CP} \). Plugging equation 20 into equation 23a, one gets \( z_{1l}^{CP} (k_{1l}^l) = \frac{F''(k_{1l}^l)k_{1l}^l + A + (1 - \theta)(1 - \gamma)}{F''(k_{1l}^l)k_{1l}^l + F'(k_{1l}^l) - \theta(1 - \gamma)} \). However, since there is a fire sale only in the low state and no fire sale in the high state, one can prove that \( z_{1l}^{CP} > z_{1h}^{CP} \). This is true since

\[
(1 - F' (k_{1l}^l)) (A + (1 - \theta)(1 - \gamma)) > (A - \gamma) F''(k_{1l}^l) k_{1l}^l.
\]

Hence, it will never be the case that \( \lambda_{1h} = 0 \) and \( \lambda_{1l} = 0 \). If \( \lambda_{1h} = 0 \) and \( \lambda_{1l} > 0 \), then \( z_{1h}^{CP} = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta(1 - \gamma)} \) and \( \lambda_{1h} = z_{1l}^{CP} - z_{1l}^{CP} = \frac{A + (1 - \theta)(1 - \gamma)}{1 - \theta(1 - \gamma)} \), where

\[
z_{1l}^{CP} = \frac{F''(k_{1l}^l) k_{1l}^l - \frac{\partial B_l}{\partial k_{1l}^l} z_{1l}^{1CP} + A + (1 - \gamma)(1 - \theta) - z_{0}^{CP} \theta F''(k_{1l}^l) k_{0}}{F''(k_{1l}^l) k_{1l}^l - \frac{\partial B_l}{\partial k_{1l}^l} + F'(k_{1l}^l) - \theta(1 - \gamma) - \theta F''(k_{1l}^l) k_{0}}.
\]

I prove by contradiction that it is impossible that \( z_{1l}^{CP} < z_{1l}^{CP} \). After plugging in \( z_{1l}^{1CP} \), given by equation 20 in equation 48 and taking into account that \( z_{1l}^{CP} = z_{0}^{CP} \), one can rewrite the inequality
\[ z_{1h}^CP < z_{1h} \] as \[ F'' (k_1^T) k_1^T A + (1 - \theta) (1 - \gamma) \] \[ < z_{1h}^CP = \frac{4 + (1 - \theta) (1 - \gamma)}{1 - \theta (1 - \gamma)} \], which is a contradiction. As a result, it is impossible that \( \lambda_{1h} = 0 \) and \( \lambda_{1l} > 0 \).

**Type 1 equilibrium:** \( \lambda_{1h} > 0 \) and \( \lambda_{1l} = 0 \) \((z_{0h}^CP = z_{1h}^CP < z_{1h}^CP)\)

Note that \( z_{1h}^CP = z_{1h}^CP = z_{1h}^CP + \lambda_{1h}^CP > z_{1h}^CP \), and from the first-order condition with respect to \( k_{1h} \), \( z_{1h}^CP = \frac{4 + (1 - \theta) (1 - \gamma)}{1 - \theta (1 - \gamma)} \)

\[ z_0^CP = \pi_h z_{1h}^CP (1 - \gamma) (1 - \theta) + a_{1h} + \pi_l (A + (1 - \theta) (1 - \gamma) + z_{1l}^CP [\theta (1 - \gamma) + a_{1l} - \gamma]) \] \( \frac{(1 - \pi_h \theta (1 - \gamma))}{(1 - \pi_h \theta (1 - \gamma))} \) \( (49) \)

Plugging in for \( z_{1l}^1CP \), from the first-order condition with respect to \( k_{1l} \),

\[ z_{1l}^1CP = z_{1l}^CP = \frac{F'' (k_1^T) k_1^T A + (1 - \theta) (1 - \gamma)}{F' (k_1^T) - \theta (1 - \gamma) + F'' (k_1^T) k_1^T} \] \( (50) \)

The rest of the endogenous variables are determined by the same set of equations as the ones in the Type 1 equilibrium in Proposition 1. The Type 1 equilibrium is possible since I already proved that \( z_{1l}^CP > z_{1h}^CP \).

**Type 2 equilibrium:** If \( \lambda_{1h} > 0 \) and \( \lambda_{1l} > 0 \) \((z_{0h}^CP > z_{1l}^CP > z_{1h}^CP)\)

Since I already proved that \( \lambda_{2h} > 0 \), in this type of equilibrium, the banker borrows to the maximum in \( t = 0 \).

**Next, I prove existence and uniqueness.**

As in the proof of Proposition 1, one can show that for every \( k_0 \in [0, k_{0max}] \), there exists a unique \( k_{1l}^0 \), and if the equilibrium \( k_0 \) is such that \( k_0 \in (k_{0l}, k_{0max}] \), then there will be a fire sale, \( k_{1l}^T > 0 \), where \( k_{0l} \) is pinned down by equation 44. Also, as in Proposition 1, one can prove that \( \frac{\partial k_{1l}^T (k_0)}{\partial k_0} > 0 \) if \( k_0 \in (k_{0l}, k_{0max}] \).

I take into account that it will be always the case that \( \lambda_{1l}^CP > 0, \lambda_{1l}^CP > 0 \). Consider the interior Type 1 equilibrium which implies that \( \lambda_{1l}^CP = 0 \). Following the same steps as in the Proof of Proposition 1, define the following function, which will be used to pin down the equilibrium \( k_0 \):

\[ \psi^CP (k_0) = z_{1l}^CP (k_0) - z_{0l}^CP (k_0) \text{ if } k_0 \in [k_{0l}, k_{0max}], \] \( (51) \)

where \( z_{0l}^CP (k_0) \) and \( z_{1l}^CP (k_0) \) are given by equations 49 and 50. If \( \psi^CP (k_0) = 0 \), then the equilibrium is interior and of Type 1. If for every \( k_0 \) in the range \( [k_{0l}, k_{0max}] \), \( \psi^CP (k_0) < 0 \), then the equilibrium is a corner equilibrium where it is optimal to borrow to the maximum in period-zero against the high and the low states. Since \( \frac{\partial k_{1l}^T (k_0)}{\partial k_0} > 0 \) and since \( z_{1l}^CP = z_{1l}^1CP \) in the interior equilibrium,

\[ \frac{\partial z_{1l}^CP (k_0)}{\partial k_0} = \frac{\partial k_{1l}^T (k_0)}{\partial k_0} \] \( z_{1l}^CP L \frac{\partial k_{1l}^T}{\partial k_{1l}} > 0 \),

where \( \frac{z_{1l}^CP}{\partial k_{1l}} = \frac{\partial z_{1l}^CP}{\partial k_{1l}} > 0 \) and is given by equation 24.
\[ \psi_{CP} (k_0) = z_{1I}^{CP} (k_0) (1 - \theta [1 - \gamma - \pi_l (a_{1H} - \gamma)]) - \pi_h z_{1H}^{CP} ((1 - \gamma) (1 - \theta) + a_{1H}) - \pi_l (A + (1 - \theta) (1 - \gamma)) (1 - \pi_h \theta [1 - \gamma]) \]

\[ \frac{\partial \psi_{CP} (k_0)}{\partial k_0} = \frac{\partial z_{1I}^{CP} (k_0)}{\partial k_0} \left[ 1 - \theta (1 - \gamma) + \pi_l (\gamma - a_{1H}) \right] > 0. \]

Given that \( \psi_{CP} (k_0) > 0 \) in the relevant range \( k_0 \in [\hat{k}_0, k_{0}^{\text{max}}] \), the interior equilibrium exists and is unique.

Finally, I prove that Assumption 9 ensures that a Type 2 equilibrium never occurs. Consider the case where \( \lambda_{ts} > 0 \), and assume that Assumption 6 is satisfied, which implies that even if the equilibrium is Type 2 there will be a fire sale in the crisis state. It is sufficient to show that given Assumption 9, it is always the case that \( z_{1I}^{CP} > z_{0}^{CP} \) and, as a result, a Type 2 equilibrium will never occur. One can show that \( z_{1I}^{CP} - z_{0}^{CP} > 0 \) by rewriting the first-order conditions of the Central Planner.

\[ (z_{0}^{CP} - z_{1I}^{CP}) = \frac{\pi_h (a_{1H} - \gamma) + 1 - \theta (1 - \gamma)}{1 - \theta (1 - \gamma) - \pi_l \theta [F'(k_{1I}^P) - \gamma]} < 0. \]

In order for the inequality above to be true, it will have to be the case that

\[ [\pi_h (a_{1H} - \gamma) + 1 - \theta (1 - \gamma)] \frac{A + (1 - \gamma) (1 - \theta)}{1 - \theta (1 - \gamma)} < z_{1I}^{CP} [\pi_l (\gamma - a_{1H}) + 1 - \theta (1 - \gamma)]. \]

But, since if \( \lambda_{ts} > 0 \), then \( z_{1I}^{CP} > z_{1I}^{CP} = \frac{F''(k_{1I}^T) k_{1I}^T + A + (1 - \gamma) (1 - \theta)}{F'(k_{1I}^T) + F''(k_{1I}^T) k_{1I}^T - \theta (1 - \gamma)} \), a sufficient condition is given by Assumption 9.

### A.4.3 Corollary 1

**Corollary 1:** See text.

**Proof of Corollary 1:** Combining equations 37 and 50, one can rewrite \( z_{1I}^{CP} > z_{1I} \) as

\[ \left[ \frac{1 - N - 1}{N} F''(k_{1I}^T) k_{1I}^T + \frac{1}{N} \frac{\partial z_{1I}^{1,P}}{\partial k_{1I}^T} \right] z_{1I}^{CP} > -F''(k_{1I}^T) k_{1I}^T. \]

If \( N \to \infty \), \( z_{1I}^{CP} > z_{1I} \) is always true since \( z_{1I}^{CP} > 1 \). If \( N < \infty \), then in order for \( z_{1I}^{CP} > z_{1I} \), Assumption 10 has to be satisfied. If \( N = 2 \) and the country has zero fiscal capacity, a sufficient condition is \( 2 < A + (1 - \gamma) (1 + \theta) \) since

\[ F''(k_{1I}^T) k_{1I}^T + 2F'(k_{1I}^T) < 2 < A + (1 - \gamma) (1 + \theta). \]
A.4.4 Proposition 4

Proposition 4: See text.

Proof of Proposition 4: The proof that $k_{1l}^T$ is unique and exists is provided in the proof of Proposition 1. Since the minimum capital requirement constraint is binding, $k_0$ is pinned down by $k_0(\rho) = \frac{n}{\rho}$. Let’s consider the different types of equilibria.

Type 1 Equilibrium: If $\lambda_{1h} > 0$ and $\lambda_{1l} = 0$, $(z_{1l} = z_0 > z_{1h})$. $k_{1l}^T(\rho)$ is pinned down from the budget constraint in the low state in $t = 1$:

$$[1 - \theta (1 - \gamma) + \pi_l (\gamma - a_{1l}) \frac{n}{\rho} - n = \pi_l [k_{1l}^T (F' (k_{1l}^T) - \theta (1 - \gamma)) + B_l (k_{1l}^T)]$$

(54)

The rest of the equations are:

$$k_{1l} (\rho) = k_0 (\rho) - k_{1l}^T (\rho); \quad k_{1h} (\rho) = \frac{((1 - \theta) (1 - \gamma) + a_{1h}) k_0 (\rho)}{[1 - \theta (1 - \gamma)]}$$

$$d_{1h} (\rho) = \theta (1 - \gamma) k_0 (\rho); \quad d_{1l} (\rho) = \frac{1}{\pi_l} [k_0 (\rho) - n - \pi_h \theta (1 - \gamma) k_0 (\rho)]$$

$$d_{2s} (\rho) = \theta (1 - \gamma) k_{1s} (\rho).$$

$k_{1l}^T$ in the Type 1 equilibrium is determined by equation 54, where the condition $z_{1l} > z_{1h}$ has to be satisfied, which implies $M (k_{1l}^T) = \frac{1}{N} F'' (k_{1l}^T) k_{1l}^T + \frac{1}{s'(B_l)N} \frac{\partial z_{1l}^l}{\partial k_{1l}^T} + F' (k_{1l}^T) - 1 < 0$ (see the proof of Proposition 1) and the borrowing constraint in the low state has to be non-binding — i.e.,

$$d_{1l} (\rho) = \frac{1}{\pi_l} \left[ (1 - \pi_h \theta (1 - \gamma)) \frac{n}{\rho} - n \right] < \theta \left( F' (k_{1l}^T) - \gamma \right) \frac{n}{\rho}$$

$$1 - \pi_h \theta (1 - \gamma) - \theta \pi_l \left( F' (k_{1l}^T) - \gamma \right) < \rho.$$

Type 2 Equilibrium: If $\lambda_{1s} > 0$, $(z_0 > z_{1s})$. This will be the optimal equilibrium only if $\rho = \frac{n}{\pi_0}$. The rest of the equations are the same as the equations in the Type 2 equilibrium in Proposition 1.

Type 3 Equilibrium: If $\lambda_{1s} = 0$, $(z_{1l} = z_0 = z_{1h})$. $k_{1l}^T$ is pinned down by $M (k_{1l}^T) = 0$ and $k_{1l} (\rho) = \frac{n}{\rho} - k_{1l}^T$:

$$d_{1l} (\rho) = (F' (k_{1l}^T) + a_{1l} - \gamma) \frac{n}{\rho} + B_l + [\theta (1 - \gamma) - F' (k_{1l}^T)] k_{1l} (\rho)$$

$$d_{1h} (\rho) = \frac{n - n - \pi_h d_{1l}}{\pi_h}; \quad k_{1h} (\rho) = \frac{d_{1h} - (1 + a_{1h} - \gamma) \frac{n}{\rho}}{\theta (1 - \gamma) - 1}$$

In order for the equilibrium to be Type 3, the borrowing constraints in $t = 0$ against the high and low states should not be binding. One has to check that

$$d_{1l} < \theta \left( F' (k_{1l}^T) - \gamma \right) k_0; \quad d_{1h} < \theta (1 - \gamma) k_0$$
Type 4 Equilibrium: If $\lambda_{1} = 0$, $\lambda_{11} > 0$ ($z_{11} > z_{11} < z_{11}$), $k_{11}^{T}$ is pinned down by the budget constraint in $t = 1$ in the low state:

$$0 = \left( a_{11} - \gamma + \theta \left( 1 - F' \left( k_{11}^{T} \right) \right) \right) \frac{n}{\rho} + B_{1} \left( k_{11}^{T} \right) - k_{11}^{T} \left[ \theta \left( 1 - \gamma \right) - F' \left( k_{11}^{T} \right) \right]$$

The rest of the equations are given by

$$d_{11} = \frac{1}{\rho} \left[ \frac{n}{\rho} \left( 1 - \pi_{1} \theta \left( F' \left( k_{11}^{T} \right) - \gamma \right) \right) - n \right]$$

$$k_{11} = \frac{(1 + a_{11} - \gamma) \frac{n}{\rho} - d_{11}}{1 - \theta \left( 1 - \gamma \right)}; \quad d_{11} = \theta \left( F' \left( k_{11}^{T} \right) - \gamma \right) \frac{n}{\rho}.$$

In order for the equilibrium to be Type 4, the following conditions also have to be satisfied: $z_{0} > z_{11}$ which implies that $M \left( k_{11}^{T} \right) > 0$ and $d_{11} < \theta \left( 1 - \gamma \right) k_{0}$, which implies that

$$\frac{n}{\rho} \left( 1 - \pi_{1} \theta \left( F' \left( k_{11}^{T} \right) - \gamma \right) - \pi_{h} \theta \left( 1 - \gamma \right) \right) - n < 0$$

A.4.5 Corollary 2

Corollary 2: See text.

Proof of Corollary 2: Totally differentiate the budget constraint in the low state with respect to $k_{0}^{i}$ holding $d_{11}^{i}$ fixed to solve for $\frac{\partial k_{11}^{i}}{\partial k_{0}^{i}}$

$$\frac{\partial k_{11}^{i}}{\partial k_{0}^{i}} = \frac{F' \left( k_{11}^{T} \right) + a_{11} - \gamma + F'' \left( k_{11}^{T} \right) k_{11}^{i,F} \frac{1}{N} + \frac{\partial B_{1}^{i}}{\partial k_{0}^{i}}}{F' \left( k_{11}^{T} \right) - \theta \left( 1 - \gamma \right) + \frac{1}{N} F'' \left( k_{11}^{T} \right) k_{11}^{i,F}}$$

(55)

Totally differentiate the budget constraint in the low state with respect to $d_{11}^{i}$ holding $k_{0}^{i}$ fixed to solve for $\frac{\partial k_{11}^{i}}{\partial d_{11}^{i}}$

$$\frac{\partial k_{11}^{i}}{\partial d_{11}^{i}} = \frac{\frac{\partial B_{1}^{i}}{\partial d_{11}^{i}} - 1}{\left[ F' \left( k_{11}^{T} \right) - \theta \left( 1 - \gamma \right) + \frac{1}{N} F'' \left( k_{11}^{T} \right) k_{11}^{i,F} \right]}$$

(56)

From the first-order condition with respect to $B_{1}$ of the policy maker in the middle period,

$$\frac{\partial B_{1}^{i}}{\partial k_{0}^{i}} = \frac{1}{\delta \left( B_{1} \right) N} \frac{\partial z_{11}^{1,P} \left( k_{11}^{T} \right) \partial k_{11}^{i,F}}{\partial k_{0}^{i}} = \frac{1}{\delta \left( B_{1} \right) N} \frac{z_{11}^{1,RP} \left( k_{11}^{T} \right)}{\partial k_{11}^{i,F}} \left( 1 - \frac{\partial k_{11}^{i}}{\partial k_{0}^{i}} \right)$$

(57)

$$\frac{\partial B_{1}^{i}}{\partial d_{11}^{i}} = \frac{1}{\delta \left( B_{1} \right) N} \frac{\partial z_{11}^{1,P} \left( k_{11}^{T} \right) \partial k_{11}^{i,F}}{\partial d_{11}^{i}} = - \frac{\partial k_{11}^{i}}{\partial d_{11}^{i}} \frac{1}{\delta \left( B_{1} \right) N} \frac{z_{11}^{1,RP} \left( k_{11}^{T} \right)}{\partial k_{11}^{i,F}}$$

(58)

Combining equations 55 and 57, as well as equations 56 and 58, and also from Assumption 3 and Assumption 4:
The figure below depicts

Also note that for a given $T$, the fewer the banks are and the larger the fiscal capacity is, the larger the moral hazard is: $\frac{\partial B_i^I}{\partial k_{0i}} < 0$, $\frac{\partial^2 B_i^I}{\partial k_{0i} \partial N} > 0$ and $\frac{\partial^2 B_i^I}{\partial k_{0i} \partial f} < 0$. The comparative statics with respect to fiscal capacity follow from the fact that the larger $\chi$ is, the smaller $\delta'' (B_i)$ is.

A.4.6 Proposition 5

Proposition 5: See text.

Proof of Proposition 5: I already proved that given Assumption 8, $M'(k_{00}T) < 0$, and $BC_{1l} (k_{00}T) > 0$ follows from Assumption 4 and Lemma 1. The system of equations pins down either $\{k_{00}T, \chi^*(N)\}$ or $\{k_{00}T, N^*(\chi)\}$ if $\chi^*(N)$ and $N^*(\chi)$ are interior. $k_{00}T$ is determined by $BC_{1l} (k_{00}T) = 0$, and the solution exists and is unique given that we proved existence and uniqueness of the constrained Central Planner’s allocation, which is the allocation being replicated, (i.e., $k_{00}T = k_{00}T;CP$).

Before I start with the proof, it is useful to note that if $\chi > 0$, then $\lim_{k_{00}T \rightarrow 0} M (k_{00}T) > 0$ since

Also note that for a given $N < \infty$, $\lim_{\chi \rightarrow \infty} M (k_{00}T, \chi) \rightarrow \infty$ for $N < \infty$, $\lim_{\chi \rightarrow \infty} M (k_{00}T, \chi) \rightarrow \infty$ for $\chi < \chi^*(N)$, which is why the equilibrium is always Type 1.

The decentralized equilibrium will be Type 1 as long as $M (k_{00}T) < 0$, and in that case, only a minimum bank capital requirement is needed to decentralize the constrained Central Planner’s allocation since both the Central Planner and the banker value wealth more in the crisis state than in the high state in $t = 1$. If $N \rightarrow \infty$ or $\chi = 0$, then $M (k_{00}T) < 0$ for every $k_{00}T \in \left[0, k_{00}T_{t,max}\right]$, which is why the equilibrium is always Type 1.

Next, I prove that if $\rho^* = \frac{n}{k_{00}}$ and $\chi \leq \chi^*(N)$, then the decentralized equilibrium is Type 1. The figure below depicts $M (k_{00}T)$ and the budget constraint in the crisis state, $BC_{1l} (k_{00}T)$, for two

54This will be the case since I proved that $z_{00}^1 (k_{00}T) > 1$. I also assumed that $F'' (k_{00}T) > 0$ for every $k_{00}T > 0$ in addition to Assumption 4 and the assumption $\frac{\partial^2 k_{00}T}{\partial f_{00}^2} > 0$.

$$\lim_{k_{00}T \rightarrow 0} \frac{\partial z_{00}^1 (k_{00}T)}{\partial k_{00}T} = \frac{F'' (k_{00}T) \left[1 - 2z_{00}^1 (k_{00}T)\right]}{F'' (k_{00}T) - \theta (1 - \gamma)} > 0$$

(59)
different values of fiscal capacity where the decentralized equilibrium is of Type 1. As the fiscal capacity increases, $BC_{II}(k_{II}^T)$ shifts up (since $\frac{\partial B_I(\chi, k_{II}^T)}{\partial \chi} > 0$ for a given $k_{II}^T$) and so does $M(k_{II}^T)$ (since I assumed that $\frac{\partial \delta(B_I, \chi)}{\partial B_I} \frac{\partial \chi}{\partial B_I} < 0$ for a given $k_{II}^T$).

Therefore, to solve for the maximum possible fiscal capacity such that a Type 1 equilibrium is achieved, one has to solve the following system of two equations and two unknowns, $k_{II}^T*$ and $\chi^*$ (for a given $N$).

\[
M(k_{II}^T*, \chi^*(N)) = 0 \\
BC_{II}(k_{II}^T*, \chi^*(N)) = 0
\]

It is possible that $M(k_{II}^T, \chi) > 0$ for every $k_{II}$, in which case the equilibrium will never be Type 1 unless $\chi = 0$ implying that $\chi^* = 0$. If $\chi > \chi^*(N)$, then $BC_{II}$ will cross the zero line at a point where $M(k_{II}^T*) > 0$ and, hence, the requirement $M(k_{II}^T*) < 0$ will be violated and the equilibrium will not be Type 1. In the figure below $\chi^*(N = 3) = .77$.

Next, I prove that if $\rho^* = \frac{n}{B_0'}$ and $N \geq N^*(\chi)$, then the decentralized equilibrium is Type 1, and the minimum bank capital requirement is a sufficient instrument to replicate the constrained Central Planner’s allocation. Since $BC_{II}$ is not a function of $N$ directly, one can solve for $k_{II}^T$ from $BC_{II}(k_{II}^T) = 0$ and $k_{II}^T$ will not depend on $N$. If, for the equilibrium value $k_{II}^T*$,

$$\Lambda(k_{II}^T*) = \left[ F''(k_{II}^T*) k_{II}^T* + \frac{1}{F''(k_{II}^T*)} \frac{\partial^2 \delta(B_I, \chi)}{\partial k_{II}^T} \right] > 0 \text{ then } \frac{\partial M(k_{II}^T)}{\partial N}|_{k_{II}^T=k_{II}^T*} = \frac{1}{N^2} \Lambda(k_{II}^T*) < 0,$$

which implies that as $N$ increases, $M$ shifts down and leads to the result that for $N > N^*(\chi)$, the equilibrium is Type 1, where we can solve explicitly for $N^*(\chi)$ from $M(k_{II}^T*, N^*) = 0$, $N^*(\chi) = \frac{1}{1-F'(k_{II}^T*)} \Lambda(k_{II}^T*) > 0$. If $\Lambda(k_{II}^T*) < 0$, then $M(k_{II}^T*) < 0$ and the Type 1 equilibrium will be achieved for any $N$ — i.e., $N^*(\chi) = 1$.

\(^{55}\)The parameters are the same as in Figure 3 (where $N=3$).

\(^{56}\)See the Proof of Proposition 6 for derivation.
A.4.7 Proposition 6

Proposition 6: See text.

Proof of Proposition 6: Consider an interior equilibrium for the Central Planner. By setting \( \rho^* = \frac{n}{k_0 T} \) and \( v^* = d_{ll}^{CP} \) (if necessary), the policy maker can replicate the constrained Central Planner’s allocation. Since I proved that \( \frac{\partial \psi^{CP} (k_0; \chi)}{\partial \chi} > 0 \), it is sufficient to prove that, holding \( k_0 \) constant, \( \frac{\partial \psi^{CP} (\chi; k_0)}{\partial \chi} < 0 \) (partial derivative) in order to prove that \( \frac{\partial k_0^{CP}}{\partial \chi} > 0 \). The banker’s budget constraint is

\[
H (\chi; k_0) = \pi_t B_t (k_{ll}^T, \chi) + n + \left[ F' (k_{ll}^T) - \theta (1 - \gamma) \right] k_{ll}^T \pi_t \\
- k_0 (1 - \theta (1 - \gamma) + \gamma - a_{ll}) = 0.
\]

(60) (61)

For a given \( k_0 \), differentiate \( H (\chi; k_0) = 0 \) with respect to \( \chi \) (partial derivative) in order to derive the relationship between fiscal capacity and fire sale size, for a given level of ex-ante investment — i.e., \( \frac{\partial k_{ll}^T (\chi; k_0)}{\partial \chi} \):

\[
\frac{\partial k_{ll}^T (\chi; k_0)}{\partial \chi} = \frac{- \frac{\partial B_t (\chi; k_{ll}^T)}{\partial \chi}}{\left[ \frac{\partial B_t (k_{ll}^T; \chi)}{\partial k_{ll}^T} + F' (k_{ll}^T) - \theta (1 - \gamma) + F'' (k_{ll}^T) k_{ll}^T \right]} < 0. \tag{62}
\]

The denominator is positive because of Assumption 4 and Lemma 1. One can solve for \( \frac{\partial B_t (\chi; k_{ll}^T)}{\partial \chi} \) by totally differentiating the first-order condition that pins down \( B_t \), holding \( k_{ll}^T \) constant. The derivative is given by

\[
\frac{\partial B_t (\chi; k_{ll}^T)}{\partial \chi} = - \frac{\partial^2 \delta (B_t, \chi)}{\partial B_t \partial \chi} \frac{\partial^2 \delta (B_t, \chi)}{\partial^2 B_t} = \frac{B_t}{(\eta - 1) \chi} > 0
\]

where I assumed that \( \frac{\partial^2 \delta (B_t, \chi)}{\partial B_t \partial \chi} < 0 \) and \( \frac{\partial^2 \delta (B_t, \chi)}{\partial^2 B_t} > 0 \). The result \( \frac{\partial k_{ll}^T (\chi; k_0)}{\partial \chi} < 0 \) is intuitive and means that for a given level of period-zero investment, the fire sale will be smaller if the country has a larger fiscal capacity.

\[
\frac{\partial \psi^{CP} (\chi; k_0)}{\partial \chi} = \frac{\partial z_{ll}^{CP}}{\partial \chi} - \frac{\partial z_0^{CP}}{\partial \chi} = \left[ \frac{1 - \theta (1 - \gamma) + \pi_t (\gamma - a_{ll})}{1 - \pi_t \theta (1 - \gamma)} \right] \frac{\partial k_{ll}^T (\chi; k_0)}{\partial \chi} \frac{\partial z_{ll}^{CP}}{\partial k_{ll}^T} < 0,
\]

where in Lemma 3, I proved that \( \frac{\partial z_{ll}^{CP}}{\partial k_{ll}^T} > 0 \) and given that the equilibrium is Type 1, \( z_{ll}^{1.P} = z_{ll}^{CP} \).
A.4.8 Proposition 7

Proposition 7: See text.

Proof of Proposition 7: Conditional on the policy maker having an access to two ex-ante instruments — ex-ante tax on period-zero investment ("price" instrument), \( \tau^i_{k_0} \), and a limit on the payment promised in the crisis state, \( d^i_{1t} \leq v^i \) — the constrained Central Planner’s allocation can be replicated. Consider parametrization such that the equilibrium is Type 1 for the constrained Central Planner.

The only difference between the problem of the banker where the ex-ante instrument is a "price" instrument and the problem of the banker where the ex-ante instrument is a "quantity" instrument is that the period-zero budget constraint becomes

\[
k^i_0 (1 + \tau^i_{k_0}) - n + T_{k_0} \leq \sum_s \pi_s d^i_{1s} \quad [z^i_0]
\]

where \( \tau^i_{k_0} \) is the tax on period-zero capital. The revenues from the proportional tax are distributed equally back to the bankers using the lump sum tax, \( T_{k_0} = -\sum_{i=1}^{N} \frac{1}{N} k^i_0 \tau^i_{k_0} \) in the form of a non-targetted tax. Banker \( i \) chooses \( k^i_0 \) at the end of \( t=0 \); while \( k^i_0 \) is determined in the beginning of \( t=0 \) and banker \( i \) takes it as given. However, banker \( i \) internalizes the fact that she affects the lump sum tax \( T_{k_0} \) since she is large (not essential). Banker’s \( i \) optimization problem at the end of \( t=0 \) is

\[
\max_{k^i_0, d^i_{1s}, k^i_{1s}} \sum_s \pi_s (A + (1 - \theta) (1 - \gamma)) k^i_{1s},
\]

subject to the period-one budget constraint, the borrowing constraint

\[
k^i_{1s} (F' (k^T_{1s}) - \theta (1 - \gamma)) + d^i_{1s} \leq (F' (k^T_{1s}) + a_{1s} - \gamma) k^i_0 + B^i_{s} \quad [\pi_s z^i_{1s}]
\]

and to the period-zero budget constraint given by equation 63. The first-order condition with respect to \( k^i_0 \)

\[
\sum_s \pi_s z^i_{1s} \left( F' (k^T_{1s}) + a_{1s} - \gamma + \frac{1}{N} F'' (k^T_{1s}) k^i_{1s} + \frac{\partial B^i_{s}}{\partial k^i_0} \right) - z^i_0 \left[ 1 + \tau^i_{k_0} \left( 1 - \frac{1}{N} \right) \right] + \sum_s \pi_s \lambda^i_{1s} \theta \left( F' (k^T_{1s}) - \gamma + \frac{1}{N} F'' (k^T_{1s}) k^i_{1s} \right) = 0,
\]

and the rest of the first-order conditions are the same as in the decentralized equilibrium with a "quantity" ex-ante instrument. After imposing a symmetric equilibrium and using the fact that \( z_0 = z_{1t} > z_{1h}, \lambda_{2s} > 0, \lambda_{1t} = 0 \) and \( \lambda_{1h} > 0 \), one can rewrite the first-order condition with respect to \( k_0 \) from the decentralized problem as
\[ z_{il} \left[ 1 + \tau_{k_0} \left( 1 - \frac{1}{N} \right) - \pi_h \theta (1 - \gamma) - \pi_l (\theta (1 - \gamma) + a_{il} - \gamma) \right] = \frac{(A + (1 - \theta) (1 - \gamma))}{1 - \theta (1 - \gamma)} (1 - \theta (1 - \gamma) + \pi_h (a_{1h} - \gamma)), \quad (66) \]

where \( z_{il} \) is given by equation 37. From equation 49,

\[ z_{il}^{CP} (1 - \pi_h \theta [1 - \gamma] - \pi_l (\theta (1 - \gamma) + a_{il} - \gamma)) = \frac{(A + (1 - \theta) (1 - \gamma))}{1 - \theta (1 - \gamma)} [\pi_h (a_{1h} - \gamma) + 1 - \theta (1 - \gamma)]. \quad (67) \]

Subtracting equation 66 from equation 68, since \( z_{il}^{CP} \left( k_{il}^T - z_{il} \left( k_{il}^T, \chi \right) > 0 \right. \) for a given \( k_{il}^T \), which I proved in Corollary 1,

\[ \tau_{k_0}^* = \left[ \frac{z_{il}^{CP} \left( k_{il}^{T,CP} \right)}{z_{il} \left( k_{il}^{T,CP}, \chi \right)} \right] (1 - \frac{1}{N}) \Phi > 0, \]

where

\[ \Phi = \frac{[1 - \theta (1 - \gamma) + \pi_l (\gamma - a_{il})]}{1 - \frac{1}{N}} > 0. \]

Since the equilibrium \( k_{il}^{T,CP} \) does not vary with \( \chi \) in the Central Planner problem and \( z_{il}^{CP} \) is a function only of \( k_{il}^{T,CP} \), \( \frac{\partial z_{il}^{CP}(k_{il}^{T,CP})}{\partial \chi} = 0 \)

\[ \frac{\partial \tau_{k_0}^*}{\partial \chi} = - \frac{\partial z_{il} \left( k_{il}^{T,CP}, \chi \right)}{\partial \chi} \frac{z_{il}^{CP} \left( k_{il}^{T,CP} \right)}{z_{il} \left( k_{il}^{T,CP}, \chi \right)} \frac{\Phi \geq 0}{2}, \quad (69) \]

where

\[ \frac{\partial z_{il} \left( k_{il}^{T,CP}, \chi \right)}{\partial \chi} = - \frac{\partial B_l \left( k_{il}^{T,CP} \right)}{\partial \chi} \left[ F_l \left( k_{il}^{T,CP} \right) - \theta (1 - \gamma) + \frac{1}{N} F_l \left( k_{il}^{T,CP} \right) k_{il}^{T,CP} + \frac{\partial B_l}{\partial k_{il}^{T,CP}} \right] \leq 0, \]

where in Corollary 2, I proved that \( \frac{\partial B_l}{\partial k_{il}^{T,CP}} \geq 0 \). If \( N \to \infty \), \( z_{il} \) is not a function of \( \chi \) because \( \frac{\partial B_l}{\partial k_{il}^{T,CP}} = 0 \), which implies that \( \frac{\partial \tau_{k_0}^*}{\partial \chi} = 0 \). If \( 1 < N < \infty \), \( \frac{\partial B_l}{\partial k_{il}^{T,CP}} > 0 \) and \( \frac{\partial \tau_{k_0}^*}{\partial \chi} > 0 \).