

Recovery is Never Easy - Dynamics and Multiple Equilibria with Financial Arbitrage, Production and Collateral Constraints

Ally Quan Zhang

University of Zurich - Department of Banking and Finance; Swiss Finance Institute

Abstract

We develop a simple general equilibrium model to study the interactions between financial arbitrage and the real economy under collateral constraints. In good times, arbitrage activities help boost the production sectors by providing external funds to capital investment. However, when exposed to adverse shocks and panic market reactions, arbitrage also amplifies the financial distress and makes it easier for the economy to fall into self-fulfilling crises. Moreover, the possibility of regime switches triggered by exogenous shocks also complicates the path to recovery. The combination of financial distress and pessimistic market anticipation not only slows down the recovery process, but also can trap the economy in a less healthy steady state.