LIQUIDITY INSURANCE WITH MARKET INFORMATION

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Abstract
This paper studies how market signals – such as stock prices – can help alleviate the severity of the asymmetric information problem in credit and liquidity management. Asymmetric information hinders the ability of borrowers (firms, investment banks, etc.) to undertake profitable investment opportunities and to insure themselves against liquidity shocks. I show that on the equilibrium path creditors do not learn anything from market signals because they can use a menu of contracts to screen the different types of borrowers. However, by conditioning liquidity insurance on ex-post price signals, creditors are able to provide the borrowers with better incentives for truth-telling. At the same time, prices depend on the liquidity that creditors offer to the borrowers. This two-way feedback impacts the design of the optimal contract and potentially generates multiple equilibria in financial markets.

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