linked to their demand for assets K_t. The relationship is positive due to the concavity of F. A higher K_t is associated with fewer assets being used in the unproductive agents' technology which implies a higher marginal product there. In equilibrium, this higher marginal product has to be balanced by a higher opportunity cost of holding assets $q_t - q_{t+1}/R$. This is captured by the function M being increasing. Rewriting the equilibrium condition (13) and iterating forward we see that with a transversality condition the asset price q_t equals the discounted sum of future marginal products

$$q_t = \sum_{s=0}^{\infty} \frac{1}{R^s} M\left(K_{t+s}\right) \tag{14}$$

In the steady state, the productive agents borrow to the limit – always rolling over their debt – and use their tradable output a to pay the interest. The steady state asset price q^* therefore satisfies

$$q^* - \frac{1}{R} q^* = a,$$

which implies that the steady state level of capital K^* used by the productive agents is given by

$$\frac{1}{R} \underline{F}' \left(\frac{\bar{K} - \eta K^*}{1 - \eta} \right) = a.$$

Note that the capital allocation is inefficient in the steady state. The marginal product of capital in the unproductive sector is a as opposed to $a + c$ in the productive sector where c is the untradable fraction of output.

The main effects of KM97 are derived by introducing an unanticipated productivity shock and studying the reaction of the model log-linearized around the steady state. In particular, suppose the economy is in the steady state in period $t - 1$ and in period t there is an unexpected one-time shock that reduces production of all agents by a factor $1 - \Delta$.

The percentage change in the productive agents' asset holdings $\hat{K}_t$ for a given percentage change in asset price $\hat{q}_t$ is given by

$$\hat{K}_t = -\frac{\xi}{1 + \xi} \left(\Delta + \frac{R}{R - 1} \hat{q}_t \right), \tag{15}$$

where ξ denotes the elasticity of the unproductive agents' residual asset supply with