The Side Effects of Safe Asset Creation

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Motivation and Question

- Low r* interferes with conventional monetary policy.
- Low r* attributed to shortage of safe assets.
- Is it good policy to increase supply of safe assets to raise r*?

The Big Picture

- Is there actually a problem at ZLB?
  - Unconventional policy effective at moving long-term rates.
    Swanson (2018), Wu and Xia (2016).
- Still worthwhile to explore role of fiscal policy.
  - Uncertainty over unconventional MP effectiveness or political constraints.
  - Understanding consequences of debt useful even if changes in debt are random.
  - Understanding market for safe assets may be useful for understand LSAPs.

Model and Main Mechanisms

- OLG-NK model.
  - Individuals subject to stochastic productivity of capital.
  - Increase in risk reduces investment.
- Fiscal policy.
  - Debt financed with taxes on young.
  - Debt provides safe assets, diversifies portfolio and provides insurance benefit.
  - Debt raises interest rates, which reduces investment.
- At the ZLB.
  - Paradox of thrift: income falls to clear bond market.
  - Increasing debt means income need not fall.
  - Investment is higher than laissez faire but lower relative to the optimal flexible price outcome.

Crowding Out

- $R^K = (R^K - R^S) + R^S$
- How does B affect R^S and $(R^K - R^S)$?
- Empirical evidence incomplete.
- Model:
  - Debt moves economy along asset demand curve to higher R^S
  - Insulates old consumption to squeeze $(R^K - R^S)$
  - Capital and bonds held by same investors -> substitution.

What Is Role of Safe Assets?

- Understanding the microfoundations of demand for safe assets is important to understanding the response of the safety premium to the supply of safe assets.
- In the model, safe assets are not subject to idiosyncratic investment risk.
- S&P500 index fund?
- Interpretation: model really about aggregate risk, but idiosyncratic risk is easier to model.

(How (Much)) Does Public Debt Affect Interest Rates for Firms?

- Total asset supply view:
    - Global debt: $200 - 250 tr
    - PDV of 75 years US entitlements: $200 tr
    - US federal debt held by public $15 tr
- Segmented markets view:
    - Supply of safe assets much smaller than total debt.
    - But changes in supply of safe assets may affect safe interest rates without changing prices of corporate bonds or equities (see Lenel 2018).

Goods Market Perspective

- Walras's Law: bond market clearing not needed to analyze equilibrium.
- Intuition from perspective of goods market clearing:
  - Promise to tax the next generation and give proceeds to the old (currently young).
  - Transfer from zero-MPC cohort (not born yet) to current young.
  - Next period's consumption is diversified: invest more.
  - Young would want to consume more now due to redistribution and consumption smoothing.

Social Security System

- Add transfer to old: relevant quantity is $B + T^O$
- Social security crowds out demand for safe assets 1-for-1 without changing the "debt."
- Mechanism in paper can operate through a channel we wouldn't normally consider to change the supply of safe assets.

A Targeted Policy?

- Mechanism: diversify consumption of those investing in capital with idiosyncratic return risk.
- Paper assumes all households are entrepreneurs.
- 11% of SCF respondents have some stake in non-public firm. (Moskowitz & Vissing-Jorgensen)
- With distortionary taxes, inefficient to make transfers to all old just to insure entrepreneurs.
- Not clear how policy should be adapted to insulate consumption of entrepreneurs.

More Problems With Debt Policy

- Roll-over risk.
- Lack of flexibility for of future shocks.
- Unsustainable fiscal path leads to uncertainty.

Relation To Lit on Optimal Debt

- Ricardian equivalence: debt doesn't matter.
- Tax distortions: use debt to smooth distortions.
  - Optimal debt often depends on initial debt.
  - If large initial capital levy possible, set debt negative.
- Here OLG and incomp. markets break RE.
  - No tax distortions and focus on crowding out.

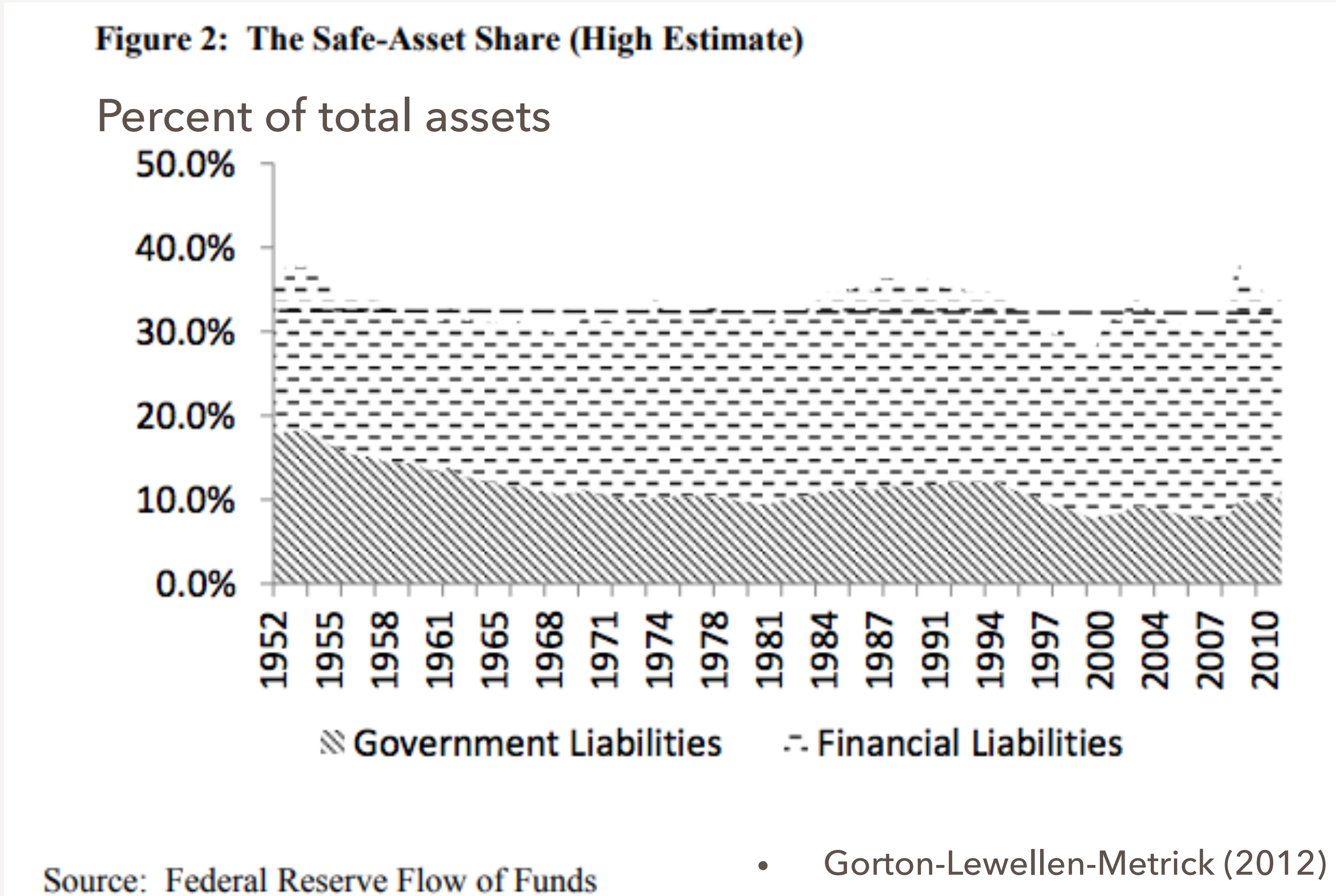
Other Aspects of Fiscal Policy

- Changes in debt require changes in taxes/transfers.
- Paper assumes lump-sum rebate/tax on young.
- Why not use the proceeds for an investment tax credit or hiring subsidy?
- Can we draw conclusions about debt level/issuance in isolation of rest of fiscal policy?
- Lump-sum tax reduces complexity of analysis, but comes with a caveat.

Does the Type of Risk Matter?

- Model assumes idiosyncratic capital income risk.
  - Capital depressed due to lack of insurance.
- Does labor risk lead to inefficiently high investment?
- If so, are implications for optimal debt different?
- Aiyagari-McGrattan (1998): positive debt is optimal.

Can't the Private Sector Do It?



- Gorton-Lewellen-Metrick (2012)

- Does the total supply of safe assets change?

Summing Up

- Great question.
- Elegant, tractable model.
- Would push them for more on
  - special role of safe assets,
  - other options for government financing,
  - quantitative argument.