The Fed - Information Externalities, Funding Liquidity, and Fire Sales

Author:Levent Altinoglu and Jin-Wook Chang

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Information Externalities, Funding Liquidity, and Fire Sales  
Levent Altinoglu and Jin-Wook Chang  
Abstract: We develop a theory of learning in a model of fire sales and collateralized debt to study how beliefs about fundamentals are shaped by market conditions. Agents exchange short-term debt contracts to invest in a long-term risky asset, and receive shocks to the opportunity cost of funds (cost shocks) and news about the fundamental of the asset, both of which are private information. Asset prices play a dual role of clearing markets and conveying agents' private information, but markets are informationally inefficient: Agents can partially, but never fully, infer their counterparties' private information from asset prices. The informational inefficiency of markets is more acute when liquidity conditions are especially tight or loose, as this impairs ability of prices to reveal private information about fundamentals. As a result, beliefs about fundamentals are shaped endogenously by cost shocks which are orthogonal to fundamentals, leading to socially costly booms and busts in asset prices. The equilibrium is constrained inefficient due to an information externality in which agents do not internalize how their choices affect the information set of other agents. Interventions in funding markets can stabilize asset prices by altering perceptions of risk.  
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