Discussion of

The Supply and Demand for Safe Assets

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Summary

- A very transparent model of shadow banking
- Connects private asset creation with monetary policy
- *Bond Exchange Facility*...not so different from current practice
    - Long run: Agency MBS
    - Recent: Term Securities Lending Facility, Primary Dealer Credit Facility
    - Alternative: Direct Lending Programs

My discussion

1. Model recipe
2. Importance of savings = investment
3. Analyzing the policy implications

The Model “Recipe”

Ingredient 1: Government saving technology

Government issues bonds $\rightarrow$ (initially) only asset that transfers resources across time.

- Establish Euler equation as efficiency benchmark
- Give monetary policy a role

Ingredient 2: Distortionary taxation

If bonds are "mispriced" then resources are wasted.

- Using policy tool to offset private asset creation is costly

Ingredient 3: Collateralized Production

Production in 2nd period depends on having enough collateral.

- Real consequences of low savings
- Reason for convenience yield

Ingredient 4: Risky production

A fraction of HH randomly receive production opportunities.

- Reason for lenders and borrows

Ingredient 5: Private asset creation

Concave production fcn for private savings/collateral assets.

- Private assets potential substitute for government bonds
- Game between private financial markets and government

Ingredient 6: Good collateral/Bad Collateral

Mean-preserving spread in the collateral value of private assets.

- Concave production & utility function $\rightarrow$ losses from volatility
- Qualitative difference compared to government savings technology

Ingredient 7: Endogenous information acquisition

Increasing returns to scale cost of information acquisition.

- Connection between asset supply and asset risk
- Reason for government to accept intertemporal distortions
- Government can transform into safe assets

Savings and Investment

Safe Asset Creation

Model: government *unilaterally transfers real resources across time.*
$\hookrightarrow$ increasing collateral means excess savings

Reality: government borrows *potentially crowding out real investment.*
$\hookrightarrow$ increasing collateral may imply savings too high or too low

Savings = Investment: Implications

- Model of benefit of collateral is very convincing
- Policy *tradeoffs* less clear
  - may or may not be consistent with other policy goals
  - sign may even flip depending on context

Policy Implications and Challenges

Some Policy Implications

- Reinforces/consistent with arguments for Euro bonds
- Mechanism strength depends on source of production funding
- Complex securitization good: $CDO^2 >> CDO$

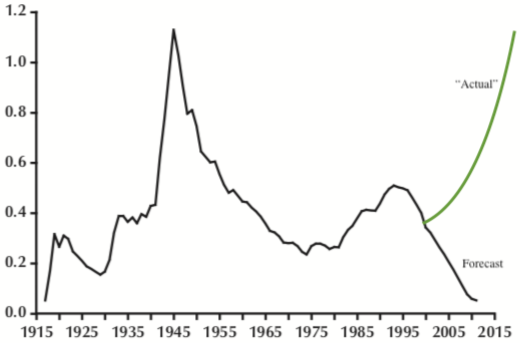
Challenges

- Solution for friction requires embracing degree of moral hazard.
  $\hookrightarrow$ tradeoff clearly perceived by CB's during crises
- Defining acceptable "exchanges" becomes political choice
  $\hookrightarrow$ threatens CB independence

Government Debt Shortage?

Figure 1

U.S. Government Debt / GDP
Annual data, 1917-2011*



*CBO forecasts for 2001-11.
SOURCE: Board of Governors of the Federal Reserve System, Bureau of Economic Analysis, and Robert Gordon, *Macroeconomics* (2000).

Reproduced from Wheelock, "Conducting Monetary Policy Without Government Debt", FRB ST Louis, 2002

Conclusions

- A very clear model ...
- of an important mechanism for policy makers.
- Potential for clarifying of the costs of adapting policy to it.

Extra note

I didn't understand the origin of the m term in equation (1). The fact that $m \neq 1$ appears in the Euler equation implies taxation is not lump sum: agents are internalizing the effect of bond holdings on their tax bill.

- With true lump sum taxes, still get $P = 1$ implements optimal. And get deviations from optimality whenever $P \neq 1$.
- Whereas, in current model, need $\chi \neq 1$ to have distortion if too many bonds issued, and to have resources thrown in ocean if too few bonds.
- So, couldn't you get the same/similar tradeoffs with true lump sum taxes?