A Model of Capital and Crisis with Structured Ambiguity*

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Abstract

I present a general-equilibrium framework of intermediary asset pricing where agents are uncertain about parameters and states. Using observable information and an understanding of the underlying economic structure, agents develop a set of alternative beliefs about parameters and states, predicting different future asset returns. Intermediaries fear scenarios with low expected excess returns, leading to reduced asset demand due to uncertainty aversion and amplifying the risk premium, especially during crises when capital within the intermediation sector is scarce. I evaluate government policies that restrict the set of beliefs that intermediaries view as plausible, such as deposit insurance, capital requirements, and government guarantees for risky asset payoffs. I demonstrate the efficacy of announcements that eliminate pessimistic prospects for cash-flow growth and restore risk appetite.

Keywords: Asset prices, financial frictions, heterogeneous agent model, risk, robustness, model uncertainty

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