Discussion of "A Model of the Safe Asset Mechanism (SAM): Safety Traps and Economic Policy," by Caballero and Farhi

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October 19, 2013

Background

- Financialization and the growth of secured lending
- The run on repo, collapse of ABCP market, etc.
- Volatility in the supply of safe assets
- The flight to quality and the zero lower bound
- The Safety Trap

This paper

- Model of Safety Trap
- Quantitative Easing, Operation Twist, Forward Guidance
- Comparison of Safety Trap and Liquidity Trap

- Crucial elements of the model are exogenous
- Interpretation of policies seems strained
- The results have intuitive explanations but do they extend to richer models?
- Microfoundations of demand for safe assets

Assumptions

- Overlapping generations:
  - There is a unit mass of agents
  - In an interval of length dt, a measure θdt of agents dies and is replaced by θdt new agents
- Trees and assets
  - A unit measure of trees produces a flow of output X
  - A fraction δ is paid out as dividends to holders of assets (claims on trees)
  - A fraction $(1-\delta)$ is paid out to newborn agents as an endowment
- Asset markets
  - The "dying" agents supply assets in exchange for goods
  - Surviving agents and newborns supply goods in exchange for assets

Assumptions

- Risk preferences
  - A fraction α of agents are infinitely risk averse (Knightians)
  - A fraction $1-\alpha$ are risk neutral (Neutrals)
- Productivity shock
  - An absorbing state is reached with Poisson probability $\lambda \longrightarrow 0$
  - In this state, output falls to μX
- Securitization
  - A fraction ρ of assets can be structured to produce risk free as well as risky claims on tree dividends

Frictions

- The supply of safe assets is limited by two exogenous factors:
  - the fraction δ of pledgeable income that is
  - and the fraction ρ of structured assets
- Potential and actual output:
  - one way to reduce the demand for liquid assets is to reduce wealth (output)
  - potential (full employment) output is X
  - in a recession, actual output is reduced to ξX, where $\xi < 1$
- Equilibrium

Unconventional monetary policy

- Quantitative Easing (QE) consists of swapping (risky) "trees" for short-term debt
- Claim: QE increases the supply of safe assets (for the Knightians)
- Where does risk go? Implicitly borne by Neutrals?
- Operation Twist (OT) consists of swapping short-term for long-term debt
- OT reduces supply of safe assets because long-term debt is a "bearish" asset and thus has a multiplier effect
- In practice, QE consists of swapping reserves for LT debt: How is this different from OT in the model?
- Compared to real world QE, OT maintains a constant money supply: Does money supply matter in this model?)

Monetary policy commitments

- Add a good state to represent the prospect of recovery
- Commitment to keep interest rates low in the good state does nothing to increase the supply of safe assets
- Hence, in this model, forward guidance is ineffective
- What is the role of forward guidance?
- Overshooting and the Great Unwind

Final questions

- What is the role of safe assets in the financial system?
- Final demand versus intermediate demand
- Two roles of collateral: ability to pay, willingness to pay
- Is there too much or too little high quality, liquid collateral?
- Bubbly collateral can improve welfare (Farhi and Tirole; Miao and Wang) . . .
- . . . but some doubt the social usefulness of finance
- The Big Question: Financialization and the future of risk sharing