“A Theory of Safe Asset Creation, Systemic Risk, and Aggregate Demand” by Levent Altinoglu

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What is this paper about?

Broad questions:

- Is there an intimate link between financial stability and safe-asset creation?
- If yes, what are its implications for economic activity and for corrective policy?

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- **Macroeconomic spillovers** of crises, and
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Framework: A canonical model of financial crises augmented with:

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- **Aggregate-demand** externalities.

Main findings:

1. Safe-asset creation $\mapsto$ financial instability, due to risk transformation.
2. Fear of financial instability $\mapsto$ safe-asset creation, due to macroeconomic spillovers.
3. Possibility of economic stagnation, merely due to anticipation of crises.
4. Scope for corrective policies, such as QE or macro-prudential policy.

Result 1

Safe-asset creation $\mapsto$ financial instability

- Safe-asset creation $\approx$ risky assets $+$ leverage $+$ no risk-sharing
- Recipe for financial instability in much of the literature on financial accelerator

  Kiyotaki-Moore 1997, He-Krishnamurthy 2011, Brunnermeier-Sannikov 2014...
- But, why so little risk-sharing/so much risk-concentration to begin with?

  Shiller 1994, Krishnamurthy 2003, Farhi-Tirole 2012, DiTella 2017, Asriyan 2021, Bocola-Lorenzoni 2023...

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This paper adopts **missing markets** as in Schiller 1994 + **macroeconomic spillovers** as in Bocola-Lorenzoni 2023:

- if households anticipate income losses in crises, they themselves demand insurance

Result 2

Fear of financial instability $\mapsto$ safe-asset creation

- Risk-sharing through contracts is not allowed by assumption...
- ...Thus, extent of risk-sharing is a function of bank leverage
    - banks face a trade-off: scale of investment vs. risk-sharing

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Questions:

1. Hints at the possibility of multiple equilibria... can crises be self-fulfilling?
2. Are missing risk markets essential for the story?
    - During the 2008-09 GFC, not all "safe assets" turned out to be safe... How would defaultable debt alter the picture? What if A-D securities could be traded?

Result 3

Possibility of economic stagnation, merely due to anticipation of crises.

- Precautionary safe-asset demand by households depresses r^*...
- CB could fully accommodate if $r^* \geq 0$, but
- If $r^* < 0$ and prices are rigid $\mapsto$ demand-driven economic stagnation

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Questions:

1. Does economic stagnation dampen or reinforce "safe-asset creation $\Longleftrightarrow$ crises"?
   - Unclear to me: recessions make both borrowers and savers poorer; effect should depend on whose net worth is more sensitive to changes in aggregate demand
2. Even if $r^* \geq 0$, would CB ever want to pursue lean-against-the-wind policy?
   - Cool-down economy today, so as to reduce safe-asset demand and ameliorate crises

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3. Would be useful to reinterpret this finding within the post-GFC economic context
   - Also, reminiscent of literature on precautionary reserve accumulation by CB's

Scope for corrective policy

- QE absorbs asset-risk from bank balance sheets and plays a stabilizing role
  - However, it does so by overcoming the two key frictions of the model: incomplete contracts and limited access to funds in crises
  - By this logic, the government should simply run all production and distribute its proceeds among economic agents through transfers!

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Suggestions:

- Thus far, least developed part of the paper
- The model already features pecuniary and aggregate-demand externalities...
- ...Thus, focus on a normative analysis where policy-maker is no magician and respects the central frictions of the environment

Conclusions

Thought-provoking paper...

After some streamlining and re-focusing of the analysis, it will be a nice contribution to our understanding of financial stability and regulation.

Look forward to seeing the next iterations!

Thank you!