SWEDISH HOUSE OF FINANCE
STOCKHOLM SCHOOL OF ECONOMICS
NOBEL SYMPOSIA

Nobel Symposium
"Money and Banking"

https://www.houseoffinance.se/nobel-symposium

May 26-28, 2018
Clarion Hotel Sign, Stockholm

RIKSBANKENS JUBILEUMSFOND
THE SWEDISH FOUNDATION FOR HUMANITIES AND SOCIAL SCIENCES

Why debt?

Nobel Symposium
Stockholm, June 27, 2018

Bengt Holmström
MIT and NBER

Debt is cheap – no price discovery

- Pawn shop
  - Haggling over price of sale is costly
  - Solution: give seller the right to buy back pawn at same price plus interest
  - Age old, robust logic

- Repo
  - Modern day version of pawning
  - Often initiated by money lender (“depositor”)

Money markets are different

Money markets

Liquidity provision

- Few, small traders (bilateral)
- Heterogenous
- **Matrix pricing (NQA)**
- Information insensitive
- Opaque
- Modest investments in info
- Urgent

Stock markets

Risk sharing

- Many, large traders (centralized)
- Homogenous
- **Price discovery**
- Information sensitive
- Transparent
- Big investments in info
- Not urgent

A common but false inference

Widely agreed:

Symmetric information about payoffs => liquidity

But:

Transparency ≠> symmetric information

Two ways to symmetric information:

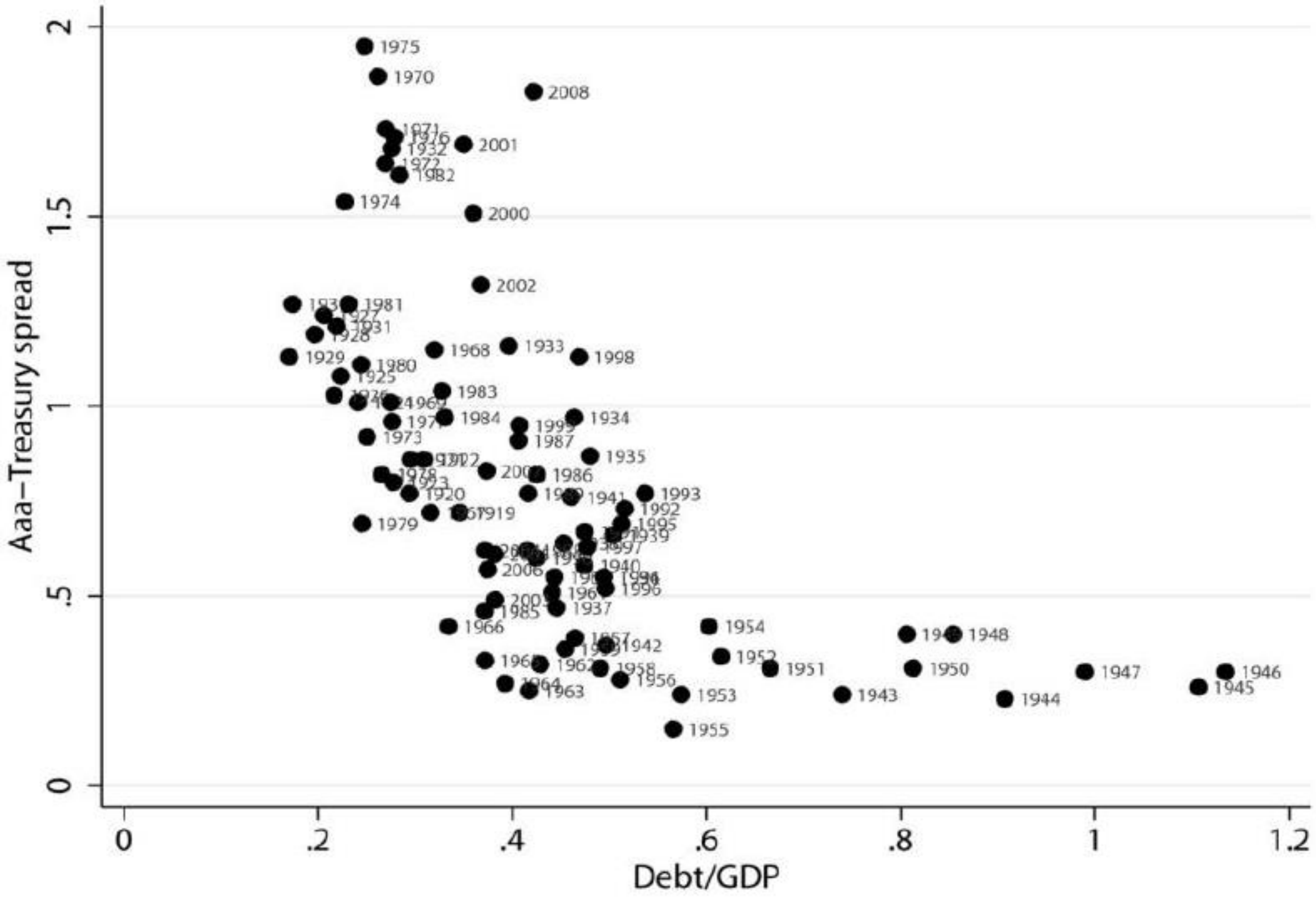
(i) Investors know everything of relevance (EMH in stock mkts)

(ii) Symmetric ignorance (over-collateralized debt)

Models of debt

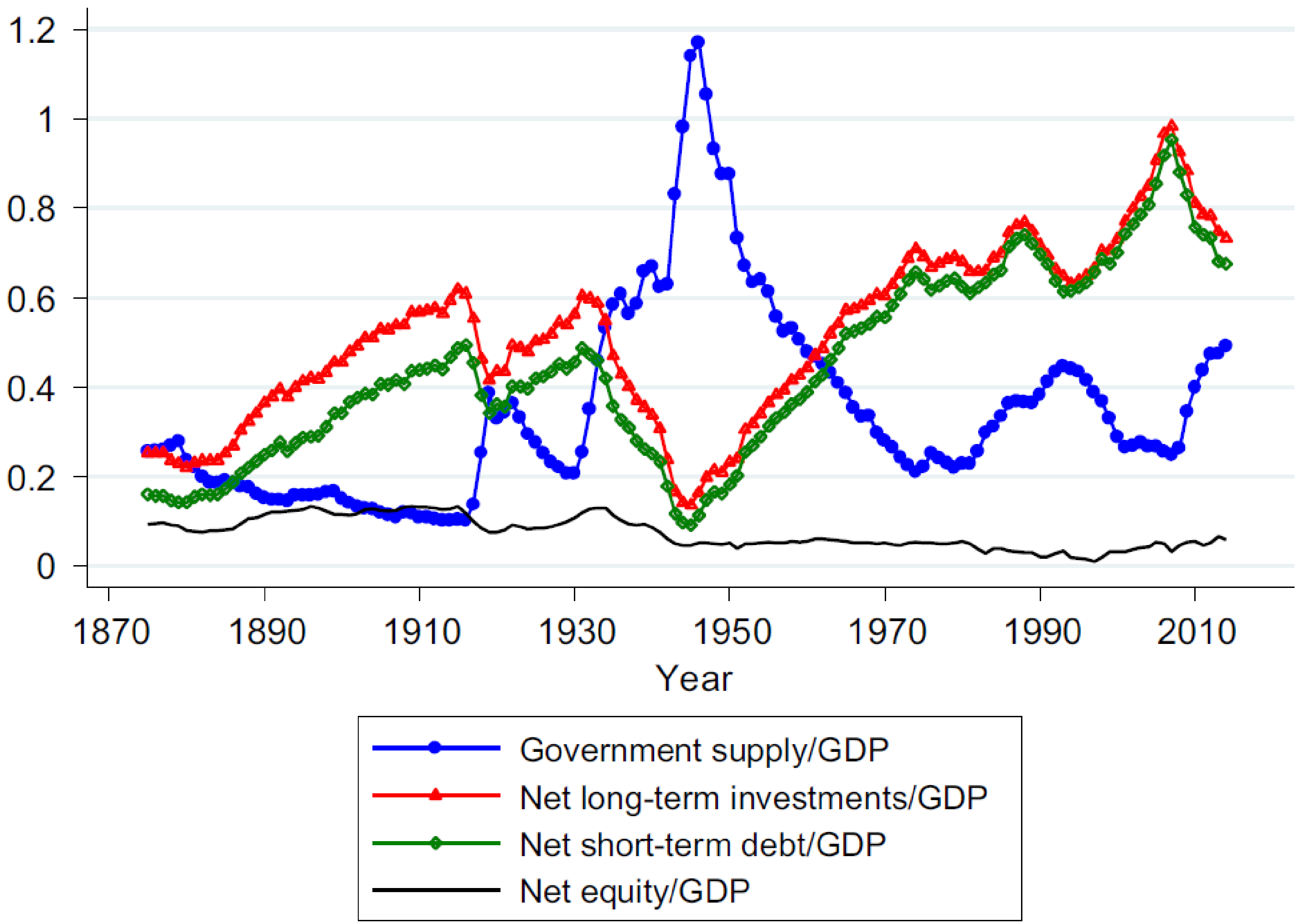
- CSV model (Townsend 1979, Gale-Hellwig 1985)
  - Contingent “price discovery”
- Diamond (1984)
  - Economizing on monitoring
- Gorton-Pennacchi (1990)
  - Liquidity provision (safe debt)
- DeMarzo-Duffie (1999), Dang et al (2012)
  - Optimal collateral

Demand for safety/liquidity: convenience yield on government debt



Krishnamurthy and Vissing-Jorgensen (2012)

US Financial sector 1875-2014



Krishnamurthy and Vissing-Jorgensen (2015)

Shadow banking: creating “parking space”

- New housing (modest)
- More marginal collateral (subprime, relatively modest?)
- Home equity loans (huge)
- More efficient use of collateral (originate and-distribute; repo market)
- Price increases, bubbles (huge)
- New loan pools (student, car, etc.; modest)

Wall Street response was for the most part logical

Role of government

- Central part of system
  - Contingent insurance – ex post!
- Get back to “No Questions Asked” state
  - Recapitalization (explicit and implicit)
  - “whatever it takes”
- Regulation
  - Higher capital requirements
  - Stress tests – plus corrective action: EU vs US

Concluding remarks

- Money markets need a more central place in financial economics – do not fit asset pricing framework
- How should we handle systemic risk in a system designed to be information sparse?
  - Paradox of safety: the safer the system, the less attentive and riskier the behavior of investors (Tri-party repo)
- Will digitalization change the information logic of debt?
  - BigTech bigger threat than FinTech
  - CBDC a bad idea?

Thank you!