A Discussion of **“The Risks of Safe Assets”**

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Overview

- Terminology: "Safe Assets" = U.S. government debt.

- This paper: consider the **dual impact** of government debt on credit market – **liquidity provision** and **tax distortions**.

* Liquidity provision: households smooth consumption via government debt.

  Holmstrom and Tirole 1998; Krishnamurthy and Vissing-Jorgensen 2012; ...

* Taxation

  (1) Distort capital investment;
  (2) Change corporate leverage;
  (3) Tax uncertainty affects long-term productivity growth and risk premium.

  Croce, Kung, Nguyen, Schmid 2012.

Implications

- A risk channel of government debt supply: more debt $\Rightarrow$ higher credit spread
- Limited debt capacity: $r < g$ may be overturned when there is too much debt.
- Perils of QE and government lending: government bearing credit risks
  $\Rightarrow$ (in bad states) more tax and taxation risks
  $\Rightarrow$ larger risk premium and lower economic growth

Mechanism

- Credit Spread (maturity matched)

  $$= \text{Corporate Bond Yield} - \text{Treasury Yield}$$

  $$= \underbrace{\text{Corporate Bond Yields} - \text{Risk-Free Rate}}_{\text{Credit Component}} + \underbrace{\text{Risk-Free Rate} - \text{Treasury Yield}}_{\text{Liquidity Premium}}$$

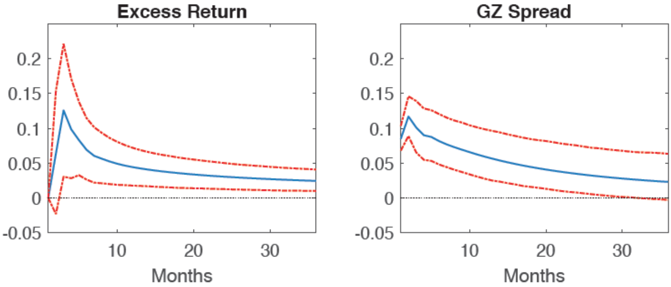
- Larger Treasury supply $\Rightarrow$ better satisfy liquidity demand and thus lower liquidity premium.

- Larger Treasury supply $\Rightarrow$ higher taxation in the future $\Rightarrow$ lower economic growth and smaller tax base $\Rightarrow$ more tax-rate volatility $\Rightarrow$ increase consumption volatility and further depress capital investment.

Does government debt supply affects the liquidity premium?

- Krishnamurthy and Vissing-Jorgensen (2012), Greenwood, Hanson, and Stein (2015): both low and high frequency supply of Treasuries affect the Treasury liquidity premium.
- Nagel (2016): at monthly frequency, once monetary policy is controlled, the supply of Treasuries does not explain the liquidity premium.
- Li (2019): debt supply is strongly related to the liquidity premium even after controlling for the monetary policy.
  - Key: Treasuries and money are not perfectly substitutable.
  - Treasury supply has very broad implications via this result:
    - ⋆ Treasury supply and foreign exchange rates;
    - ⋆ Treasuries partially priced as money – addressing the debt valuation puzzle.
    - ⋆ Higher Treasury supply lowers risk premium.

Government Debt Supply and Risk Premium: Which Channel?



- This paper: taxation uncertainty.

Other Channels of Government Debt and Risk Premium

There are many plausible explanations of how government debt supply can affect the risk premium.

1. Constrained financial intermediaries.
   - Vayanos and Vila (2009): the "preferred-habitat" theory.
   - More government debt $\Rightarrow$ more debt holding by constrained intermediaries $\Rightarrow$ the larger risk exposure causes a higher risk premium.
2. Inflation risk.
   - The government can pressure the Fed to "inflate the debt away". This increases the inflation risk exposure of all credit instruments.
   - Kang and Pflueger (2015): inflation risk is an important factor in corporate bond pricing.
3. Fiscal default risk.
   - More debt $\Rightarrow$ higher probability of a fiscal default.
   - Chernov, Schmid and Schneider (2016): reflected in sovereign CDS spreads.

Other Channels of Government Debt and Risk Premium

Does a further differentiation of channels matter? – Yes, if we care about policies to reduce credit spread under high debt/GDP.

- This paper: reduce taxation uncertainty.
- Constrained intermediaries: improve the intermediation structure; strengthen intermediary capital.
- Inflation risks: better central bank independence.
- Fiscal default risk: congressional oversight.

Summary

- An interesting paper on an important and timely topic!
- More evidence is needed to nail down the taxation channel.
- Many other comments
  - Implications on multiple asset classes.
  - Pricing Treasury debt in the long-run and the relation to government debt valuation puzzle (Jiang, Lustig, Nieuwerburgh, and Xiaolan 2019)
  - ...