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PII: S0304-3932(16)30092-7
DOI: http://dx.doi.org/10.1016/j.jmoneco.2016.09.001
Reference: MONEC2878

To appear in: *Journal of Monetary Economics*

Received date: 19 January 2015
Revised date: 7 September 2016
Accepted date: 8 September 2016

Cite this article as: Gilles Chemla and Christopher Hennessy, Government a Borrower of First Resort, *Journal of Monetary Economics* http://dx.doi.org/10.1016/j.jmoneco.2016.09.001

Government as Borrower of First Resort

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Received Date; Received in Revised Form Date; Accepted Date

Abstract

Optimal government bond supply is examined under asymmetric information and safe asset scarcity. Corporations issue junk debt when demand for safe debt is high since uninformed investors then migrate to risky overheated debt markets. Uninformed demand stimulates informed speculation, driving debt prices toward fundamentals, encouraging pooling at high leverage. As borrower of first resort, government can issue bonds, siphoning off uninformed demand for risky corporate debt, reducing wasteful informed speculation. Government bonds eliminate pooling at high leverage or improve risk sharing in such equilibria. Optimal government bond supply is increasing in demand for safe assets and non-monotonic in marginal Q.

Keywords: Safe assets, risky corporate debt, information, investment, government debt.

JEL classification: G21, G28, G32, D82.

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†We thank seminar participants at Toulouse School of Economics, London School of Economics, the Bachelier Seminar, University of Bath, LBS, Inova, Bocconi, Princeton University, UBC, SFU, the Rising Stars Conference, the WFA Conference, the Cambridge Theory Conference, and the Barcelona GSE Conference. We owe special thanks to Franklin Allen, Sudipto Bhattacharya, James Dow, Denis Gromb, Pablo Kurlat, Sebastien Pouget, Conrad Raff, Joel Shapiro, and Jean Tirole for helpful comments and Mario Milone for excellent research assistance. Hennessy acknowledges support from an ERC Grant.