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Gilles Chemla, Christopher Hennessy



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Government as Borrower of First Resort

Gilles Chemla^a, Christopher Hennessy^{b†}

^a Imperial College Business School, DRM/CNRS and CEPR;

^b London Business School, CEPR and ECGI.

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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.

*Corresponding author. London Business School, Regent's Park, London, NW1 4SA, U.K. E-mail: chennessy@london.edu. . Tel: 44 (0) 20 7000-8285.

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