

Inefficient Liquidity Creation

Stephan Luck and Paul Schempp

Discussion by Savitar Sundaresan
Imperial College

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Introduction

- A simple and elegant model.
- A mechanism with clean intuition.
- Interesting and unexpected predictions.
- One comment.

Model

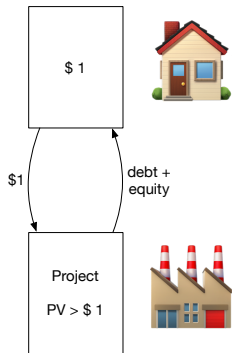
\$ 1



Project
 $PV > \$ 1$



Model



Model

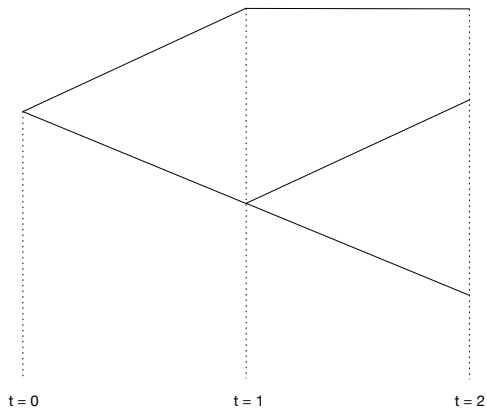
$D + e$
 valued at
 $(1+\gamma) D + e$



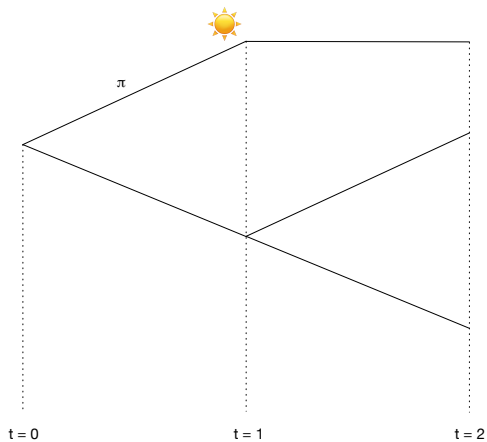
A	L
Project	e_1
	e
	D



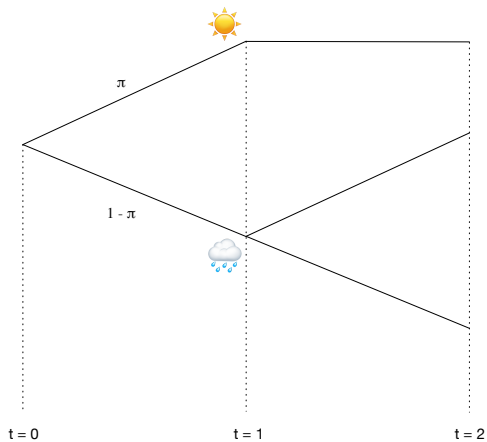
Model



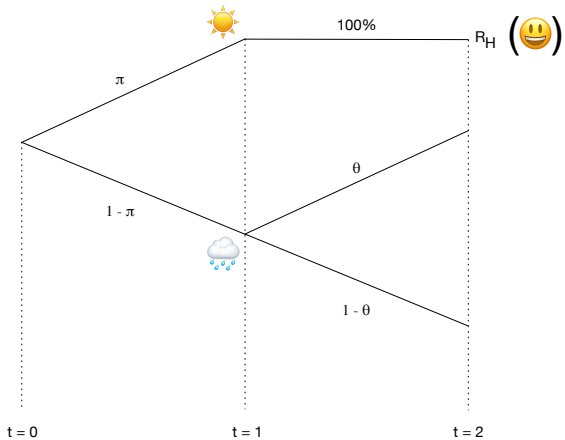
Model



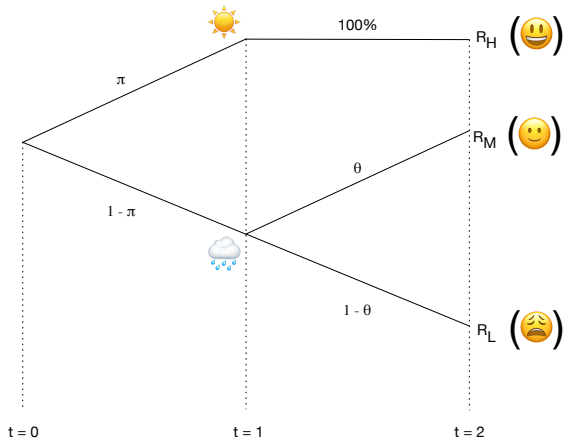
Model



Model



Model



Model

ASSETS	LIABILITIES
R_0	e_1
	D

Model



ASSETS	LIABILITIES
R_1	e_1
	D

Model



ASSETS	LIABILITIES
R_M	e_1
	D

Model



ASSETS	LIABILITIES
R_L	D

Model

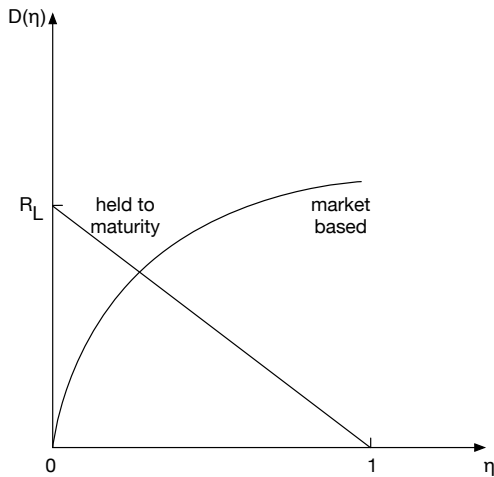


ASSETS	LIABILITIES
Cash	e_1
R_1	D

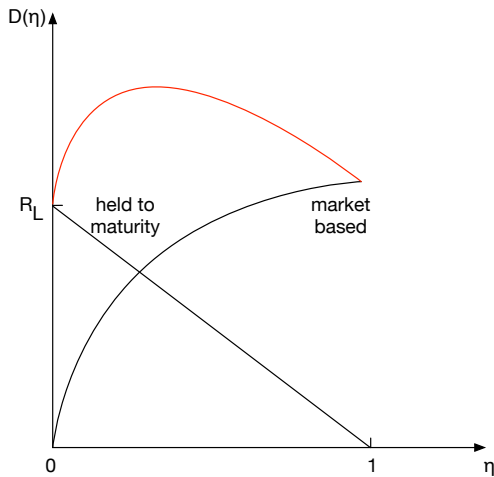
Firesale Tradeoffs

- The more that is sold, the more debt that can be created.
- The more that is sold, the more is given up in R_L .

Firesale Tradeoffs



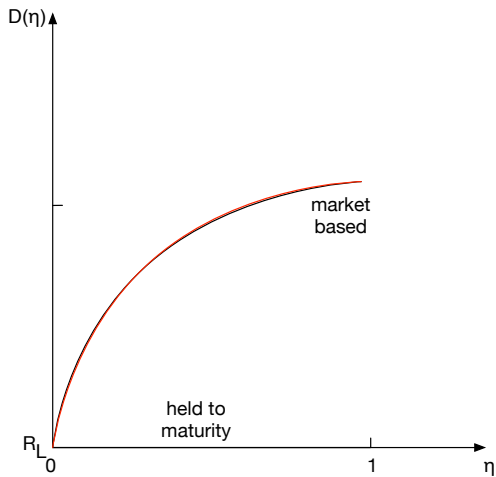
Firesale Tradeoffs



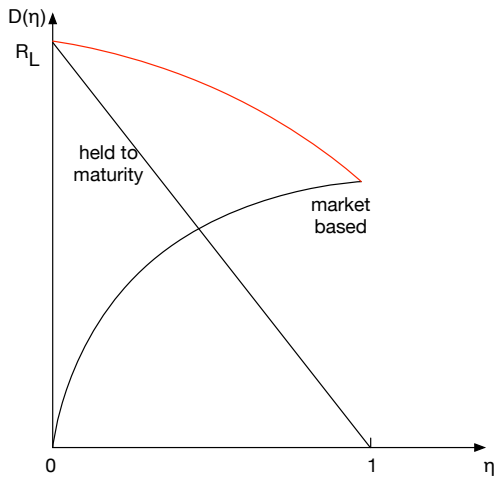
Excessive Fire Sales

- Incomplete Contracting yields excessive sales.
- But excessive fire sale can increase / decrease liquidity.

Firesale Tradeoffs



Firesale Tradeoffs



Comment 1

- What happens when R_L goes up?
- More likely to have *under-provision* of liquidity.
- What happens when R_L goes down?
- More likely to have *over-provision* of liquidity.
- Higher risk \Rightarrow higher *relative* liquidity but lower *absolute* liquidity.
- Lower risk \Rightarrow lower *relative* liquidity but higher *absolute* liquidity.

Comment 1 (cont'd)

- Safe asset supply typically seen as *pro-cyclical*.
- Want more liquidity provision in recessions / times of high risk.
- But this paper suggests, we're actually not pro-cyclical enough!
- Would like to know more about this context.

Minor Comments

- Why do households care about c_1 ?
- Why is there no discounting? Or rather, it works in reverse.
- Some typos.
- Inconsistent notation ($R_1(\theta)$, later R_1).
- More detailed explanation of some results.

Conclusion

- Fun model to dig through and understand.
- Simple innovation with surprising results!