The Absence of Safe Assets and Fiscal Crisis

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Abstract

Consider the problem of fiscal crisis in a world without safe assets. The multiplicity of equilibria survives even when there is no safe asset. The absence of safe assets explains why the interest rate factor on debt is low even when the default probability is high. As the fiscal risk correlates with the return on the other asset, the interest rate factor is insensitive to the default risk. Put differently, the burden of fiscal cost is transferred from bond holders to holders of the other asset. The welfare of agents may or may not be ranked according to the sensitivity, or the interest factor, depending on parameters.