Asset Quality Cycles

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Abstract

Financial crises seem particularly likely and severe when the asset quality deteriorates during preceding booms. I explain this through a model in which market liquidity and asset quality interacts over business cycles. In times of boom, since people can sell assets easily, they become less sensitive about information on underlying quality of their assets. In a secondary asset market in which buyers cannot observe the quality, this magnifies booms by reducing informational asymmetry. However, since investment projects are less screened in booms, this results in the deterioration of quality. Financial crises are characterized by severe adverse selection whereby every owner of an asset tries to learn about its quality in response to a negative shock. The crisis is more likely and severe after long and/or large booms in which the average asset quality, and thereby the market liquidity, has dropped significantly. I further show that this equilibrium is constrained inefficient: people ignore underlying information too much in booms, but they become too sensitive in recessions. The model highlights a novel channel on how the systemic risk builds up during booms. Implications on exiting policy of asset-purchase programs are discussed.

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