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Safe Asset Scarcity and Aggregate Demand

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Abstract

We explore the consequences of safe asset scarcity on aggregate demand in a stylized IS-LM/Mundell Fleming style environment. Acute safe asset scarcity forces the economy into a "safety trap" recession. In the open economy, safe asset scarcity spreads from one country to the other via capital flows, equalizing interest rates. Acute global safe asset scarcity forces the economy into a global safety trap. The exchange rate

becomes indeterminate but plays a crucial role in both the distribution and the

magnitude of output adjustment across countries. Policies that increase the net supply

of safe assets, somewhere or in all countries, can be welfare improving.

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E23 Macroeconomics: Production

E32 Business Fluctuations; Cycles

E43 Interest Rates: Determination, Term Structure, and Effects

E52 Monetary Policy

F41 Open Economy Macroeconomics

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