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**Research Report**

# The Safe Asset Controversy: Policy Implications after the Crisis

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# DIW Roundup

Politik im Fokus

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# The Safe Asset Controversy: Policy Implications after the Crisis

Christoph Große Steffen

# The safe asset controversy: Policy implications after the crisis

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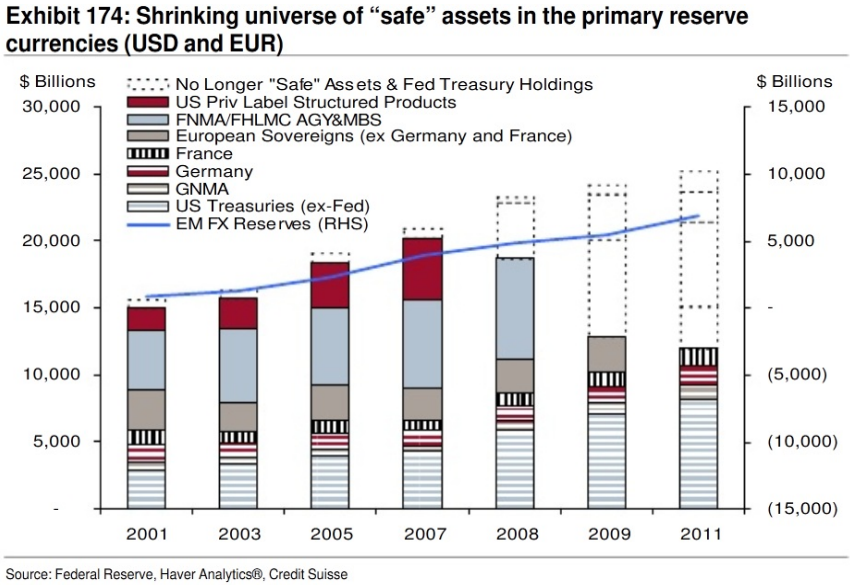
Safe assets are the lubricant of the financial system. They serve as a store of value, to meet regulatory requirements, and as a pricing benchmark. Some researchers identify a severe and chronic global safe asset shortage; others disagree, while empirical evidence remains ambiguous. In the post-Lehman world, the availability of safe assets entails new policy challenges. While still a potential source for global imbalances, the debate today stretches further to implications for financial stability and economic policy effectiveness.

## A long-lasting discussion, the prospect of a potential shortage of safe assets returned on the agenda of policymakers

A safe asset can be understood as a secure store of value which contains no uncertainty about future payments. In practice, it is nearly impossible to find a financial asset which falls into this category, since some riskiness can never be excluded in the real world where war times or exceptionally severe economic crises expose even government debt to default risk. Therefore, the policy debate around "safe assets" centers around private and publicly issued financial paper grouped in the prime category of credit rating agencies ("triple A"). As was pointed out by Dang, Gorton and Holmström (2013) these assets share the characteristic that their value is highly "information insensitive" which makes them a reliable store of value and an effective tool in overcoming financial frictions.

The elevated and increasing demand for safe assets as a store of value was already at the center of the policy debate prior to the global financial crisis when Federal Reserve Board chairman Ben Bernanke coined the term 'global savings glut' for the build-up of dollar denominated reserves by emerging market countries and commodity exporters. At that time, Ricardo Caballero with his co-authors Emmanuel Farhi and Pierre-Olivier Gourinchas (2006) presented the hypothesis that the inability of emerging markets to create safe assets lead to global imbalances and low U.S. interest rates. In a harmful conjunction with a securitization boom in the U.S. that was fueled by foreign demand for high grade U.S. assets, so the narrative in Caballero and Krishnamurthy (2009), financial sector vulnerabilities could arise. With the global financial crisis hitting hard in late 2008 with an overall revaluation of risk, the subject was taking a back seat for a while. It was primarily the downgrades of major euro area countries in the course of the European sovereign debt crisis which has pushed the topic up on the policy agenda again.

Figure 1.



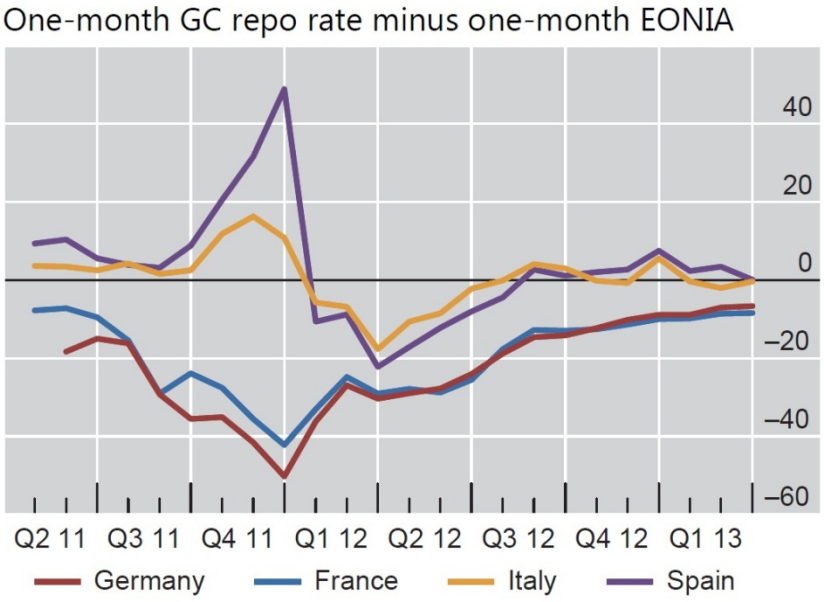

Source: Credit Suisse, *2012 Global Outlook*, December 2011, p. 143.

The Financial Times Blog FT Alphaville spread the topic by advertising a chart of the Credit Suisse 2012 Global Outlook (see Figure 1), hinting to the dramatic decline in safe assets which "(…) has come at a time when investor demand for these assets has only climbed for them and as the deep freeze in European unsecured lending has meant a big shift towards collateralized lending". The graph tracks the rapid decline of globally available save assets when the U.S. subprime crisis led to an erosion of confidence in private label "safe assets", while the European sovereign debt crisis was putting questions around the creditworthiness of securities issued in the euro area periphery. What concerns policymakers then and today is that the increasing demand and a perceived reduction in supply of safe assets seem to hint towards a shortage on the market, with potentially adverse consequences for the economy. The IMF phrased its concern in its Global Financial Stability Report from April 2012 that "(…) it is clear that market distortions pose increasing challenges to the ability of safe assets to fulfill all their various roles in financial markets. (…) The tightening market for safe assets can have considerable implications for global financial stability, including an uneven or disruptive pricing process for safety".

## Collateral scarcity in the euro area?

The fact that safe assets are able to overcome financial frictions and agency problems put them into a key position during crisis times. What happens if assets previously perceived as safe turn information sensitive became visible in the course of the European sovereign debt crisis when high quality collateral was increasingly difficult to obtain for banks in the euro area periphery.

Figure 2.




Source: CGFS Papers No 49, Asset encumbrance, financial reform and the demand for collateral assets, May 2013.

Figure 2 form a report of the Committee on the Global Financial System at the Bank for International Settlements (BIS) shows the spread between the secured general collateral (GC) repo rate backed by collateral issued in different jurisdictions of the euro area and the unsecured rate for interbank loans (EONIA). For France and Germany, this spread turned more and more into negative territory over the year 2011, indicating an exceptionally high demand for these as safe perceived assets. The proposal by a group of European economists to introduce European Safe Bonds (ESBies) was formulated against the backdrop of this particular weakness in the design of the European Monetary Union which lies in the absence of a distinct safe asset to overcome the self-enforcing feedback mechanism between the banking sector and central governments in the euro area periphery. However, while the quantity view laid out in Figure 1 is rather dramatically pointing to a severe shortage of the supply of safe assets over a prolonged period of time, the price dimension in Figure 2 reveals a more temporary phenomenon of collateral scarcity during crisis times. In particular, the two long term refinancing operations launched by the ECB at the beginning of 2012 in conjunction with a modified collateral framework lowered pressures in the market for secured funding.

Hence, can the example of the euro area turmoil prove the case for a general shortage of collateral assets in the euro area? When it comes to an empirical assessment of a supply-demand mismatch, Fender and Lewrick (2013) conclude that "overall, neither price nor quantity indicators currently indicate any signs of a broad-based collateral shortage at the aggregate level". Although the authors from the BIS spot an increase in demand for safe assets for cyclical and structural reasons, in particular for regulatory liquidity requirements, they hint to market-driven adjustment mechanisms which are likely to bridge any future tensions. Singh (2013) from the IMF discusses in detail the changes undergoing the collateral framework in global money markets. He concludes that the ECB should consider to rent out high quality collateral in order to stimulate collateral velocity.

## The Triffin Dilemma and the safe asset shortage view

Timothy Taylor discusses a 'modern version' of the Triffin Dilemma which recurs in the debate of the safe asset shortage view. He refers to an interview that Paul Volcker gave to Martin Feldstein in July 2013. The problem described by Robert Triffin emerged under the Bretton Woods system during the 1960s. At the time the U.S. dollar was the single dominant international reserve currency. Although its issuer enjoyed – according to Valéry Giscard d'Estaing – an "exorbitant privilege", U.S. policymakers faced the dilemma of either choosing to meet increasing international demand for U.S. dollars, undermining the credibility of the gold backing of the dollar, or cutting the supply of dollars at the cost of lower global trade growth and deflationary pressures in the U.S. Lorenzo Bini Smaghi claims that "Triffin-dilemma-like pressures" are "still alive and well" despite a much changed international monetary system. The U.S. dollar is still used as a reserve currency either by emerging market countries which want to keep their currencies undervalued or intend to hedge against sudden capital outflows, and by commodity exporters who use dollar denominated assets as a store of value. This "exorbitant privilege enjoyed by the United States (…) contributes to a weakening of US policy discipline as the country tends to excessively rely on easy credit in normal times and very expansionary macroeconomic policies in times of crisis." This has led to a highly indebted official sector in the United States today, such that new dollar denominated debt might be constrained in the future by fiscal capacity concerns. As the international monetary system is still unable to deal with the resulting imbalances, Bini Smaghi concludes that "(e)ven the more flexible IMS [international monetary system] of today may therefore, in this sense, prove inherently unstable." Timothy Taylor agrees in a broad sense to Bini Smaghi's conclusion by calling into question the continuity of the United States as unique provider of safe assets to the world. He concludes that this would also put an end to the sustained U.S. current account deficits with potentially disruptive consequences for the U.S. economy. While Taylor stresses the risks to the U.S. economy, Farhi, Gourinchas and Rey (2011) call in their policy report for the development of a multipolar international monetary system as a solution to the policy dilemma. They argue that the provision of additional safe assets denominated in euro or yuan could effectively stabilize the world economy and provide the amount of safe assets required by the growth of the global economy. As Barry Eichengreen (2011) underlines in his book, with a floating regime between the future reserve currencies dollar, euro and prospectively the yuan, central banks can provide as many currency as there is demand, with relative prices allowing for gradual adjustments if needed. For similar reasons, Richard Portes disagrees to the view that there is a Triffin Dilemma at play today. In his view, the development of a multipolar international monetary system is arising out of the desire of reserve holders to diversify their portfolios.

## "Safety Traps" and effectiveness of economic policy

Ricardo Caballero and Emmanuel Farhi investigate in a recent paper a "Safe Asset Mechanism" and its implications for policy effectiveness. The basic mechanism in their model is the following: The private sector is limited in its ability to produce risk-free assets. A shock brings the economy into equilibrium with excess demand for safe assets from risk averse investors. Similar to a credit crunch scenario where the supply of loans is constrained due to financial frictions, the spread between the risky rate and the risk-free interest rate rises. Normally, the risk-free interest rate would fall until supply and demand for safe assets balance. It is the interaction with a lower bound on the rate on safe assets that creates a "safety trap". In this world, only a recession can restore equilibrium by reducing the wealth of agents with excess demand for safe assets.

The policy implications of the "Safe Asset Mechanism" are quite distinct from the traditional Keynesian liquidity trap which operates over a shortage in aggregate demand (e.g. Eggertsson and Krugman 2013, on vox.eu). Specifically, fiscal stimulus in a "safety trap" is beneficial because it increases the amount of safe assets available to risk-averse investors, lowering the pressure on the economy. However, the authors emphasize that their "model identifies the same leers but reverses the pecking order by making long-run fiscal consolidation the key policy instrument since in its absence the government may not be able to create the safe debt that is in short supply." Taking the argument of Caballero and Farhi one step further, it would be possible that fiscal consolidation is the best policy when the fiscal capacity constraint is already reached, since any further expansion would reduce the stock of outstanding as safe perceived assets. I refer the interested reader to the original paper or to a summary piece in FT Alphaville to read about the implications for monetary policy of the "safe asset mechanism".

## Any conclusions from the debate?

While there is no consensus over the "safe asset shortage" reached, there are nevertheless some conclusions possible from the ongoing debate. First, disruptions in the price of safety are potentially destructive and deserve close monitoring and decisive policy intervention where necessary. Second, market developments to cope with the elevated structural demand for collateral assets by the financial sector should be promoted to increase collateral velocity while simultaneously kept under close surveillance by macroprudential regulators in order to anticipate and identify emerging systemic risks. Third, a truly multipolar international monetary system is still a long way off in particular since the euro area does not have a counterpart to US Treasury debt. Fourth, the shortage of safe assets and the "Safe Asset Mechanism" might contain implications for fiscal policy at the capacity constraint.

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