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Session 3
Financial globalization in a world without a riskless asset

Comments by Peter R. Fisher on
"Global Safe Assets" by Pierre-Olivier Gourinchas & Olivier Jeanne

Gourinchas and Jeanne have provided a disciplined analysis of the critical challenge faced by both investors and central bankers: how to think about the apparent paucity of safe assets in the world today. Their paper has helped sharpen by own thinking, which I will briefly describe before making a few suggestions of further areas the authors might want to consider. I would like to thank the BIS for the honor of inviting me and recognize my BlackRock colleagues Ewen Cameron Watt, Ed Fishwick and Terry Keeley whose thoughts in this area have been of great benefit to me (but who bear no responsibility for my lack of discipline).

Our collective thinking on the apparent paucity of safe assets, and the "demise" of the risk-free rate, is badly muddled. First, we all fall into the trap of giving too much attention to supply and not enough to demand. Second, we need to be narrow our focus and distinguish more carefully four concepts that have shaped our thinking in recent years, namely (a) measures of the time value of money, (b) references for value, (c) hedging of interest-rate risk, and (d) the base asset, or reserve asset, of the banking system. Third, in our analysis of "safe assets" we need to be much clearer about "safety from what?" – the different elements of risk that are always present in an asset. Fourth, much greater emphasis needs to be given to differences in investment horizon – both between different agents and across time.

Think more about changes in demand. Ten years ago, when I was responsible for the U.S. Treasury's debt management, I gave a speech about the long-run fiscal outlook in which I tried to draw attention to the U.S. government's unfunded retirement and health care commitments and to suggest that more attention be paid to the actuarial position of the federal government. ("Beyond Borrowing: Meeting the Government's Financial Challenges in the 21st Century", Nov. 14, 2002.) As gloomy as I was then, looking back ten years, I could not have imagined that over the next decade we would triple federal debt outstanding, the federal government would explicitly assume the liabilities of Fannie Mae and Freddie Mac as wards of the state, and we would see a vast expansion of unfunded federal health care liabilities through both the Medicare drug benefit and universal coverage in the recent health care reform and the result would be that yields on the ten-year U.S. Treasury security would *fall* from 4.05 percent at the time of my speech to well below 2 percent today.

Clearly, demand has changed even more than supply. As has been already discussed in earlier sessions, emerging market and particularly Asian central banks have chosen to accumulate much higher levels of foreign currency reserves both to stabilize their exchange rate with the U.S. dollar and to insure themselves against having to seek resources in future crises from international authorities. The just-extended operation twist by the Federal Reserve is another source of extraordinary demand, for longer-maturity Treasury securities. Of course, other sources of changes in the behavior of demand can be attributed to higher household and corporate savings, weaker expected growth and a lower expected path of short-term rates, and safe-haven demand because of the European debt crisis.

So while supply of safe assets is easier to measure we must be careful not to let that distract us form what is more important if more elusive: the variability of demand.

Let me note here that while central banks may not feel bounded by the constraint of zero interest rates, in important ways investors are constrained by the zero interest rate boundary, a point I will return to.

What are we talking about? When we talk about safe assets, or the risk-free rate, there are several different subjects that we often conflate.

First, we need to have *a measure of the time value of money*. We need a discount rate to apply to future cash flows to bring them into present values and we can use sovereign bond curves, interest rate swap curves or corporate credit yield curves to do this.

Second, we need a *reference for value*. In market practice, we think of the benchmark from which we measure credit spreads – which could be sovereign bonds or corporate bonds. Let me note that in the 1960s and 1970s, when we spoke of the "benchmark" in the U.S. market we were most likely to be talking about either bonds of General Motors or American Telephone & Telegraph which were thought of as the appropriate "reference for value" in assessing spread relationships. But in discussing references for value we can also be thinking (with much more formality and rigor) about the capital asset pricing model and the use of a risk-free rate to help construct portfolio preferences.

Third, there is a related but distinct concept of the hedgin*g-vehicle of choice* – meaning the asset or instrument that investors turn to when they seek to hedge away certain risks, most tellingly interest rate risk. Indeed, the switch from thinking about corporate bonds as the benchmark to the ten-year U.S. Treasury security occurred as investors came to think about how best to hedge interest rate risks, particularly the duration risks associated with mortgage-backed securities.

Fourth, there is the concept of *the base asset or reserve asset* in any banking system, on which banks build their balance sheets. One can think of this simply as a low volatility asset, or low credit risk asset, around which investors or bank balance sheet managers diversify into riskier assets. Or one can think of this as the base asset in the sense of being the starting point for the money multiplier. While some prefer to think of only central bank liabilities as playing the role of “high-powered money” and, thus, the beginning of the money multiplier, it does appear that sovereign bonds in general, and U.S. Treasury securities in particular, also play an effective role as the base asset in the banking system.

Part of the cause of our muddled thinking about this subject is a consequence of the fact that, over the last few decades, sovereign bonds have happened to be pretty good at playing each of these four roles. The sovereign yield curve provides a measure of the time value of money. The capital asset pricing model provided a context for us to use sovereign bonds and, particularly, U.S. Treasuries, as a proxy for the theoretical risk-free rate in pricing other assets. As we experienced significant interest rate volatility in the 1980s and1990s, sovereign bonds played as useful role as a hedging vehicle for interest rate risks. And finally, sovereign bonds have increasingly been recognized as the base asset on bank balance sheets – and central bank balance sheets.

(As a personal note, in the early 1990s when I worked at the Federal Reserve Bank of New York, I recall fondly the stern lectures that I received from my counterparts at the Bundesbank about how embarrassed I should be because a real central bank would not monetize the profligacy of its Treasury – the way that the Federal Reserve did. What I recall fondly is the fact that I never received a satisfactory explanation of why we should be embarrassed to finance the profligacy of our Treasury in light of the Bundesbank’s readily-apparent willingness to finance the profligacy of our Treasury.)

In a gold regime, however, while gold can play the role of the banking system’s base asset, gold cannot and did not provide us with a measure of the time value of money. We might debate whether gold can play the role of a reference for value although I would suggest that because of it’s lack of intrinsic value it can play the role of unit of account precisely because of it’s lack of intrinsic value it cannot help us value other assets in constructing a portfolio.

Safe from what? In discussing the apparent paucity of safe assets we need greater attention to all the different elements of risks that investors and bankers are seeking safety from.

The concept of a risk-free rate, or risk-free asset, helps frame our thoughts about valuing assets but ultimately it leads us astray. There is no such thing as a risk-free asset, never was and never will be. There are assets with that carry less of certain risks than other assets and than other risks. While sovereign bonds in general, and U.S. Treasuries in particular, have been thought of as having high credit quality and as being highly liquid and, thus as having negligible credit and liquidity risks, for much of the last few decades we have been entirely accustomed to high levels of interest rate and currency volatility and, thus, mark-to-market risks in the value of bonds. Nominal bonds, of course, carry the risk of a loss of real value because of inflation. However, if you are worried more about deflation then sovereign bonds are a particularly attractive investment. And so on.

Frankly, the apparent paucity of safe assets is not the issue. The issue is the apparent paucity of high quality, liquid assets *with the returns from the term structure that both public and private investors have come to expect.*

Risk is deviation from objective. So depending on our objectives we value risks in different ways and are comfortable with some and not others.

The importance of horizon. Investment horizon is a tremendously important and less analyzed piece of the puzzle. Financial euphoria can be thought of a condition in which investors have indefinitely long investment horizons and, thus, systematically under value liquidity. Financial crisis can be thought of as the condition when investors have extraordinarily short investment horizons and place an extremely high value on liquidity. This frames the portfolio construction process as choices relative "liquidity give up" – and the longer one's investment horizon the more likely one is to think in terms liquidity foregone.

I mentioned that central banks might feel unconstrained by the zero-interest rate boundary. Unfortunately, because of our relatively short investment horizon most investors are forced to live in a nominal world and, as a consequence, we are constrained by the zero interest rate boundary. While investors can calculate real returns they cannot "eat" them in a given quarter's performance. Longer horizons might be desirable. But it is a fact that investment horizons tend to be short and variable.

A few suggestions for the authors.

First, the issue of horizon is immensely important and complicated and deserves considerable further attention by Gourinchas and Jeanne – and all scholars interested in clear thinking about safe assets. For example, the liquidity of an asset can be thought of as a hedge against investment horizon.

Second, I do not find the concept to the "inherently safe asset" to be either useful or durable. Changes in the macroeconomic and financial environment will always be changing what it is that we worry about and, therefore, will create changes in the risks that we are aware of and focus on. Thus, I would suggest looking at many more elements of risk than just credit and liquidity. I would also suggest that the stability of the banking system requires that (ex ante) we need to anticipate the reality that (ex poste) we will recognize the mistakes that have been made in assessing what is and what is not a safe asset.

Third, the problem of moral hazard is not resolved by limiting the definition of safe asset to public assets – as the ongoing European debt crisis reminds us. This is something the authors should give further attention.