Global Safe Assets

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Introduction

- Widespread concern that the global economy is running short of safe assets...
- ...and that this will affect negatively the global financial system

  "*the shrinking set of assets perceived as safe, now limited to mostly high-quality sovereign debt, coupled with growing demand, can have negative implications for global financial stability.*" (IMF GFS 2012).

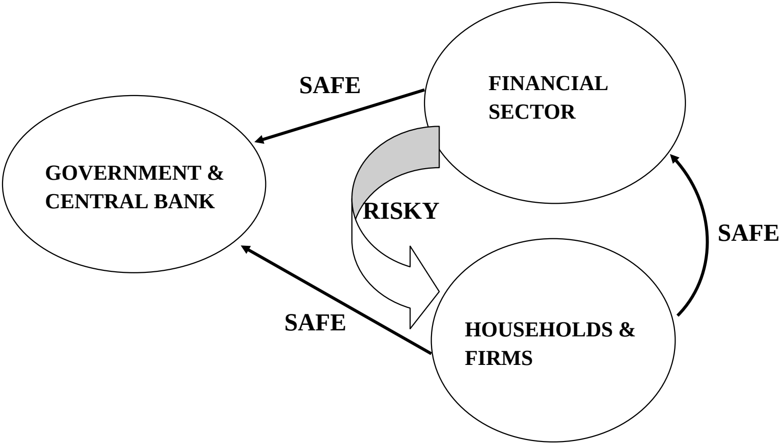
- We define a 'safe asset' as a liquid debt claim with negligible default risk

Introduction

Structure of presentation

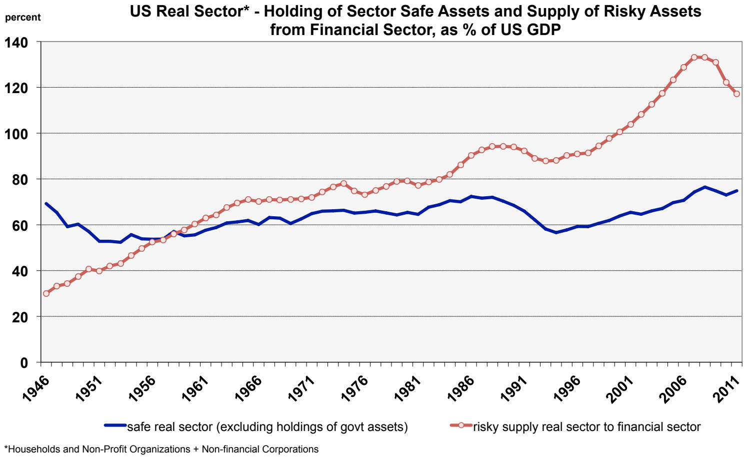
- Demand for safe assets
- Supply of safe assets
- Challenges ahead

Demand for safe assets: a sectoral decomposition



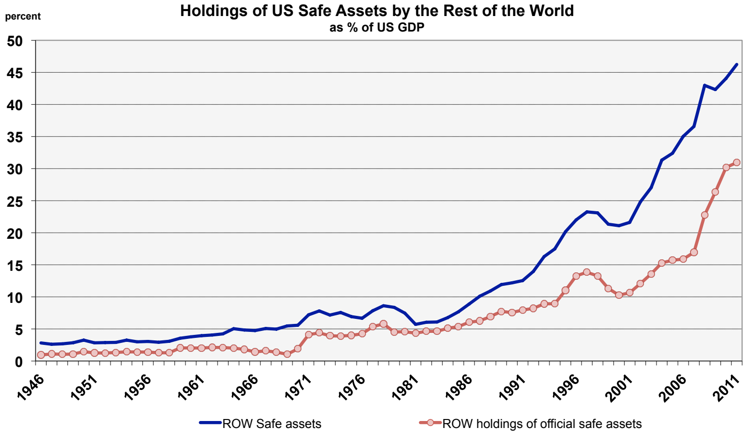
Demand for safe assets

The private real sector's demand for safe assets has been remarkably stable (in the US, the UK, Germany, France, euro area...). Supply of risky assets has increased in the US.



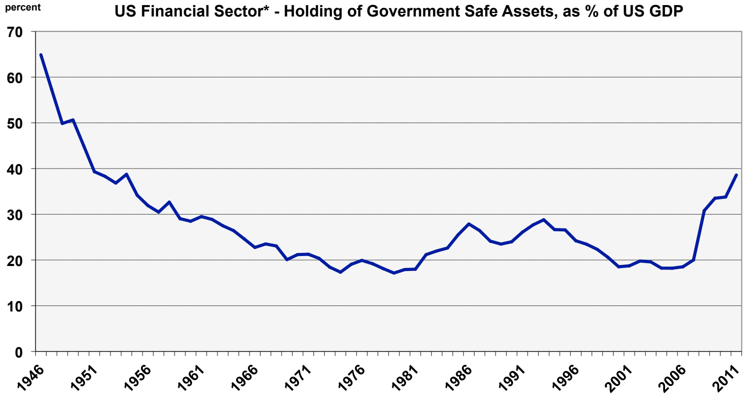
Demand for safe assets

The rest of the world financed the gap (foreign official + financial)



Demand for safe assets

The US financial sector's demand for government safe assets has been stable from the 1970s until the crisis, when inside liquidity was replaced by outside liquidity (Holmström -Tirole)



*Financial Business, net of Monetary Authority

Demand for safe assets

The demand for safe assets reflects frictions and inefficiencies

1) Financial sector:

- Destruction of inside liquidity
  - in the long run, either inside liquidity should come back, or the demand for outside liquidity should go down (through deleveraging, etc.)

2) Foreign official sector (reserves)

- Precautionary accumulation: lack of international lender of last resort
- Mercantilist accumulation

Should the priority be to increase supply of safe assets or to address the underlying inefficiencies?

Supply of safe assets

Analysis based on model of global store of value of Caballero, Farhi and Gourinchas (2008)

- Decrease in supply of safe assets leads to increase in their price $\rightarrow$ lower real interest rate
- To some extent this is stabilizing
  - raises effective supply and makes the borrower more solvent
- But pushed too far, the fall in the real interest rate is destabilizing
  - liquidity trap
  - financial instability: 'Gresham law" for bubbles
- Hence, it is important to maintain a sufficient supply of safe assets relative to the size of the economy

Supply of safe assets

Three layers of safe assets:

1) Central bank liabilities

2) Government debt

3) 'Private label" safe assets (Bernanke et al, 2011)

- The crisis affected layers 3 (US) and then 2 (euro): are safe assets becoming extinct?

- We argue that euro debt crisis is driven by features specific to the euro, and does not necessarily prefigure similar crises elsewhere

Supply of safe assets

- Monetary backstop for government debt rollover crisis
  - will the central bank prevent a government debt rollover crisis from turning into a default?
  - should an intervention be viewed as lending-in-last-resort or as debt monetization?

- Model based on Jeanne (2012)

	MONETARY DOMINANCE	BACKSTOP
DEFAULT RISK	HIGH	ZERO
INFLATION RISK	ZERO	HIGH (euro) OR LOW (US

- Incentives to fiscal adjustment are different in euro area and elsewhere

- Creating safe assets is a problem for the euro area

Challenges Ahead

- Not clear that we should be alarmed by growing gap between demand and supply of global safe assets
- Implications for the International Monetary System:
  - dollar reinforced as currency of denomination for safe assets (and global banking)
  - but in the long run, is a multipolar safe asset system stable?