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Comments to

“Global safe assets”, by Pierre-Olivier Gourinchas and Olivier Jeanne

General remarks

Before commenting on some aspects of the paper by Gourinchas and Jeanne, I would like to make some general remarks on the broad policy issue raised by the topic of this seminar of the conference. We have achieved a full globalization of financial markets, truly global as emerging markets have been included; we have witnessed the creation of a huge amount of financial wealth but we ended up having no global safe assets. Nowadays, we see that there is a constant erosion of creditworthiness of issuers of safe assets, both public and private, and this process has been accelerated by the declaration taken in the French–German meeting in Deauville, on October 2011, where the introduction of the Private Sector Involvement (PSI) in the European crisis management has generated a plenty of tension.

The history of the International Monetary System, since the end of WWII, can be interpreted as the endless search for safe assets, safe from the erosion of value and the debasement of the currency that can derive from the misguided actions of elected governments, parliaments and central banks.

Gold was initially considered the safest asset as it was nobody's liability, but then the relative shortage of gold led to the creation of the gold-dollar standard, where the safety of dollar-denominated assets was indirectly guaranteed by the link of the dollar to gold. When that link was severed, the world *de facto* delegated to financial markets the task of determining which assets are to be considered safe and which not.

The problem with this arrangement is that markets are fickle and they can oscillate between one extreme, where all assets are safe, even junk bonds, Greek bonds, or Depfa bonds, and the opposite extreme, where there are virtually no safe assets, except a happy few, where every investor would like to place his or her money, irrespective of the yield.

Then, modeling the demand and the supply of safe assets should consider that the safety of an asset is a matter of convention and cannot be delegated to rocket scientists. One can compute it as the probability of default, the credit risk and the market risk. However, an important role is played by perceptions which, by their very nature, bring into the picture a qualitative assessment of the credibility of the issuer. In other words whether the issuer – private or public – will be able to carry on what is implicit in the definition of safe asset – namely to do everything to maintain the creditworthiness of its liabilities.

The age of financial globalisation has brought us to the verge of this second extreme. The extraordinary growth of financial activity has far outstripped the growth of real economies, leading to the accumulation of financial assets that are largely the liabilities - i.e. the debts - of countries, banks, corporations. The markets are telling us now that this process has gone too far and that a “deleveraging” - i.e. a reduction of the indebtedness - is now required by all debtors, public and private.

The world economy is, in other words, confronted with a “global Triffin dilemma” in which the excessive indebtedness of the issuers of financial assets is now affecting the value of the assets themselves; of all assets, not just of reserve currencies, as in the early Triffin dilemma.

But, how is it possible to carry out this huge process of deleveraging in an orderly manner and without further destabilizing the world economy?

The obvious answer is that it may take time and in any case a longer period of time than that financial markets, suddenly become aware of the unsustainability of the situation, seem willing to concede.

The Model

The authors propose a stylized model for the supply and the demand of safe assets. The model not only shows that a safe asset can be backed by the fiscal and the monetary policy, but also points out that fiscal and monetary interventions are crucial in order to make the government debt a true safe asset and, as a consequence, “tying one’s hands” is sub-optimal. In this sense both fiscal and monetary instruments should be seen as viable policy instruments for stabilizing the price of government securities.

A crucial role is delegated to the real interest rate which acts as a stabilizing mechanism by clearing the safe asset market; as a consequence there should be no shortage of safe assets. At the same time monetary policy can act in fostering solvency of public debt and backstop a safe asset.

The core assumption of the paper is that the process of deleveraging can be assisted by policy actions by increasing the supply of safe assets. Hence the model embeds an optimistic view of the current situation: as the real interest rate is a stabilizing mechanism, in equilibrium there is no shortage of safe assets. All in all, the model projects a sense of complacency that contrasts with recent developments in the International Monetary System.

Based on IMF projections (GFSR, April 2012), by 2016 the supply of safe assets could decrease by $9 trillions due to the reduction in the number of sovereigns whose debt is considered safe. Moreover, the global demand for safe assets by the financial sector has steadily increased, and this sector represents the most relevant component of the total outstanding amount (the share of government securities worldwide held by the financial sector is greater than 50%; GFSR, April 2012).

Even if we accepted the possibility to use monetary policy to stabilize the price of government bonds, major problems may emerge in terms of implementation.

It is unclear to which extent monetary policy can act in fostering solvency of public debt and backstop a safe asset. For example, an unlimited monetary support of public debt would be unsustainable in the long run or a very conservative fiscal policy could become at some point politically unfeasible.

Assume the case of Japan (with a debt/GDP ratio around 230%) or even the US (with a debt/GDP ratio over 100%). Do you think that monetary policy, in case of a loss of confidence, could successfully intervene to safeguard the public debt of these countries? In order to examine the impact of monetary intervention to preserve safe assets one should use a model with multiple periods, in which the trade-offs between short-term and long-term effects are modeled and where policy-maker's preferences with respect to inflation and insolvency are fully taken into account.

Finally, fiscal and monetary policies of individual countries, oriented to make their assets safe, are necessary but not sufficient conditions to cope with the growing divergence between the demand and the supply of safe assets. A coordinated international approach is needed both at IMF and EU level, where the main source of tensions comes from. The authors seem to be confident that US Treasuries will continue to be the principal risk-free asset in the international market. Even if this is a strong conventional belief that will continue for some time, we should not rule out the possibility of a shift to a multipolar system. In this system there could be, potentially, an increase in the supply of a safe asset thanks to safe assets' supplies originated in other reserve-currency centers. But at the same time the coexistence and the competition among these centers would require a high degree of international cooperation because in the short run, since volatility can increase as investors and intermediaries shift their investment from one currency to another.

International Monetary System

That is where the international dimension comes in. From a global perspective the scarcity of safe assets could lead to short-term volatility and runs on sovereign debt. As the US debt still represents the principal risk-free asset in the international markets, a possible shift from a dollar-based system to a multi-polar one could increase the supply of safe assets, alleviating exchange rate misalignments, large and persistent external imbalances and the accumulation of huge stocks of official reserves.

The leading idea of a multipolar system should be the setup of a strong multilateral surveillance, or perhaps even the creation of a multilateral reserve asset – as advocated by the President of the People's Bank of China – which can be accepted by everybody.

The coexistence and the competition between two or more reserve currencies would probably require a high degree of international cooperation for ensuring the mutual consistency of national policies and containing the risk of instability due to the high degree of integration and interdependence of the International Monetary System. This calls for the G20 and the IMF to play an effective role in the governance of the International Monetary System.

The euro area

Let me consider the case of the euro area. Here the reforms introduced to deal with the crisis have increased the orientation of governments towards the adoption of programs of fiscal consolidation and debt reduction in a coordinated fashion through various procedural arrangements. However, as the ECB monetary policy must continue to be oriented towards the maintenance of price stability over the medium term, there is the need to enhance the crisis-management mechanisms. This could partially address the problems connected with the scarcity of safe assets. The search for safe assets is indeed indicated by the widening of spreads which reflects, on the one hand, the flight-to-quality process among European sovereign markets towards the German Bunds and, on the other hand, the lack of confidence towards highly indebted countries, which should carry on the policies they committed to. Lately, the spreads appear to incorporate also the risk of the break of the euro.

In these circumstances, the goal of policy makers should be to establish a link between the activity of the ECB and the new financial mechanisms that have been created to deal with this crisis; this link must be built and achieved and a cooperative approach should be adopted to deal with the legal and institutional problems that may arise. If we do not introduce this additional dimension it will be difficult to convince markets that the process of deleveraging and flight-to-quality will not lead to further source of instability and tensions.

However, as a final point let me say that monetary policy alone cannot be sufficient in stabilizing the asset prices of sovereign debts in Euro area. The crisis points to a failure in achieving a complete convergence and cooperation between national fiscal policies and national banking supervision practices. Although significant progress has been made in reinforcing euro-area governance, a change of pace is required.

If governments, the EU authorities, the ECB itself, judge the progress of the crisis-hit countries in fiscal consolidation and structural reform positively, this must be followed by a practical commitment on their part to orient the markets' assessments in the same direction. The current yield spreads of government securities do not seem to take account of what has been accomplished and seem to reflect a risk of the demise of the euro, which all authorities are solemnly excluding. A strong measure of consistency between policy objectives and policy actions is required.