Safety Traps in the Global Economy

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[For models see work with E. Farhi and P.O. Gourinchas]

The Idea

- Availability of Stores of Value is an important input into production, investment, and consumption activities
- SAFE stores of value play a very special role in this context, particularly so at times of great uncertainty
- A scarcity of them has the potential to cause a host of macroeconomic problems, from excessive risk build up in the financial system, to acute and stubborn forms of recessions and chronic economic malaise
- This is a serious problem for the Global Economy today

Big Picture

Kocherlakota (2013)

In my view, the biggest challenge for central banks is changes in the nature of asset demand and asset supply since 2007. Those changes are shaping current monetary policy, and are likely to shape policy for some time to come.
The demand for safe financial assets has grown greatly since 2007. At the same time, the supply of the assets perceived to be safe has shrunk over the past six years. Americans thought in 2007 that it was highly unlikely that American residential land, and assets backed by land, could ever fall in value by 30 percent. They no longer think that. Similarly, investors around the world viewed all forms of European sovereign debt as a safe investment. They no longer think that either.
The increase in asset demand, combined with the fall in asset supply, implies that households and firms spend less at any level of the real interest rate—that is, the interest rate net of anticipated inflation. It follows that the Federal Open Market Committee (FOMC) can only meet its congressionally mandated objectives for employment and prices by taking actions that lower the real interest rate relative to its 2007 level. The FOMC has responded to this challenge by providing a historically unprecedented amount of monetary accommodation.

What is a Safe Asset?

Which assets do you consider as safe in the current environment?

* Other: Covered bonds /agencies, Diversification, Renewables, Insurance policies, Lifecycle product, Arrow-Debreu securities, Long short event driven, Commodities, Swaps, Global businesses, Art.

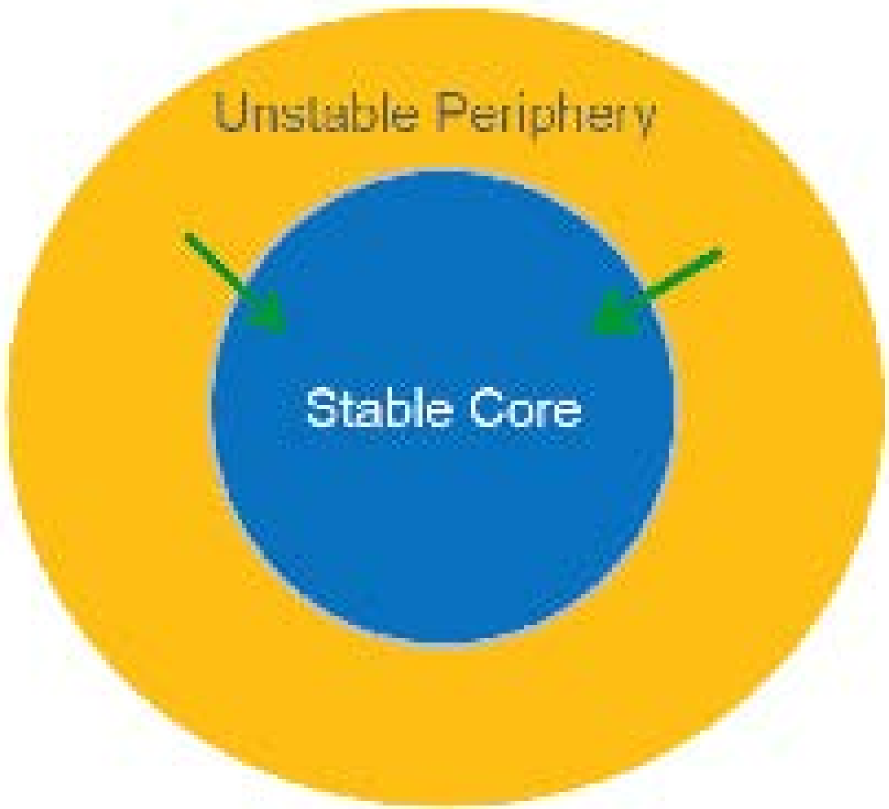
Survey of institutional portfolio managers, in AllianzGI *Risk Monitor* 2012.
'13 respondents said there is no such thing as a safe asset.'

- Working definition: An asset that preserves much of its value in a large systemic event

The Players

- Who demands "safe" assets?
  - Sovereigns (EMs)
  - Insurance companies, pensions funds, retirees, mutual funds...
  - The financial system (collateral, repo)
- Who produces "safe" assets?
  - Sovereigns (DMs)
  - Very few corporations
  - The financial system (pooling and tranching)

How did the shortage develop?



How did the shortage develop?

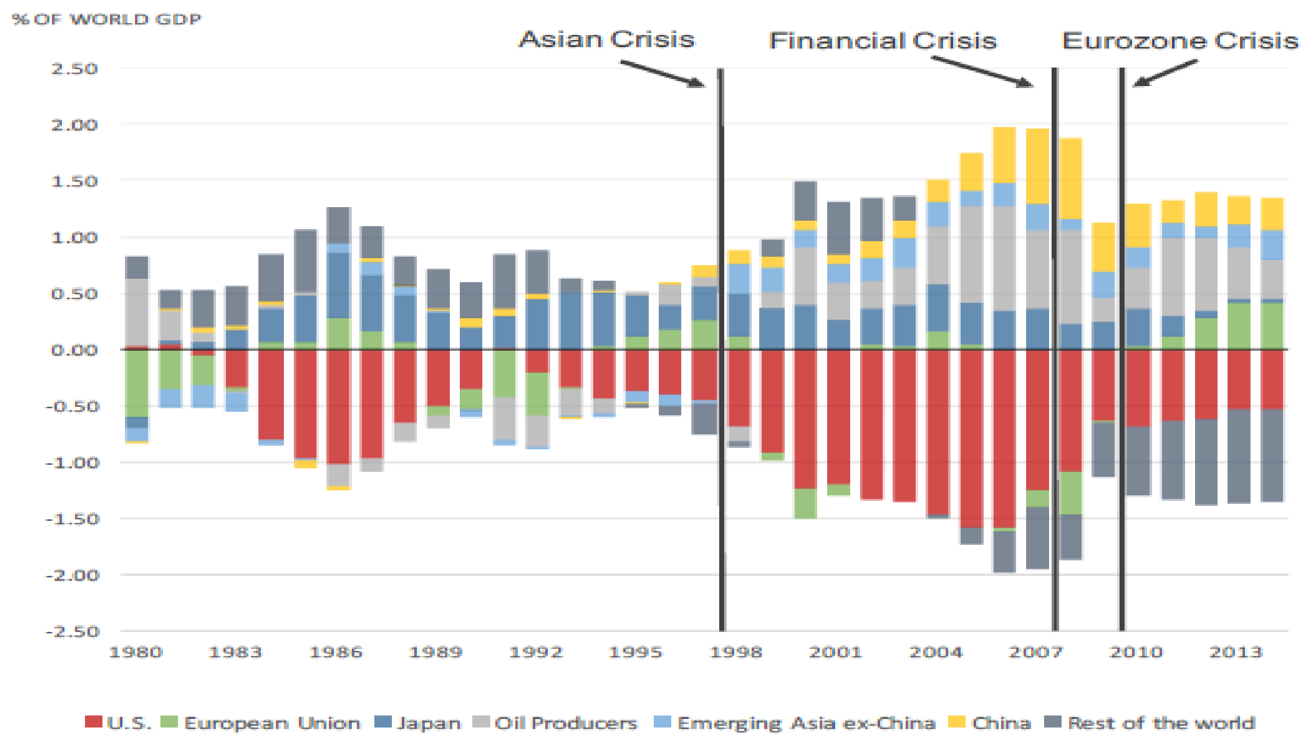
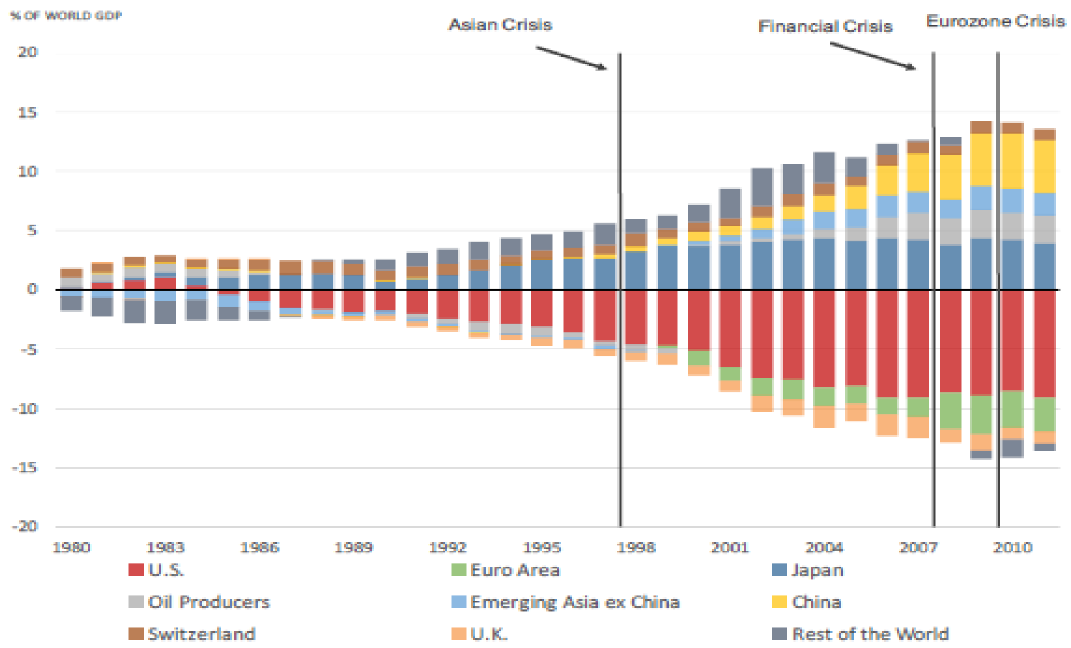


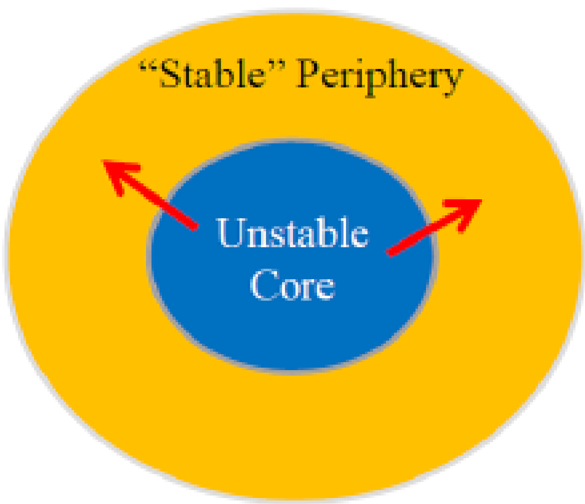
Figure: Current Account, % of World GDP

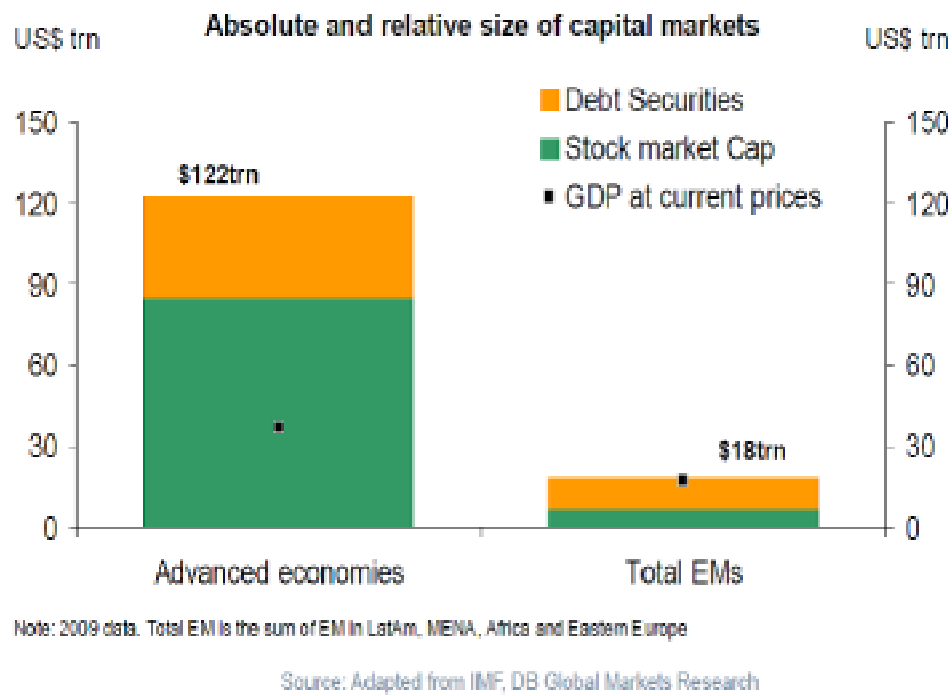
How did the shortage develop?



Note: Net Safe positions defined as the sum of Official Reserves (minus Gold), Portfolio Debt and Other Assets, minus Portfolio Debt and Other Liabilities. Source: Lane & Milesi-Ferretti (2007). Regions defined as in Figure 1.

How did the shortage develop?



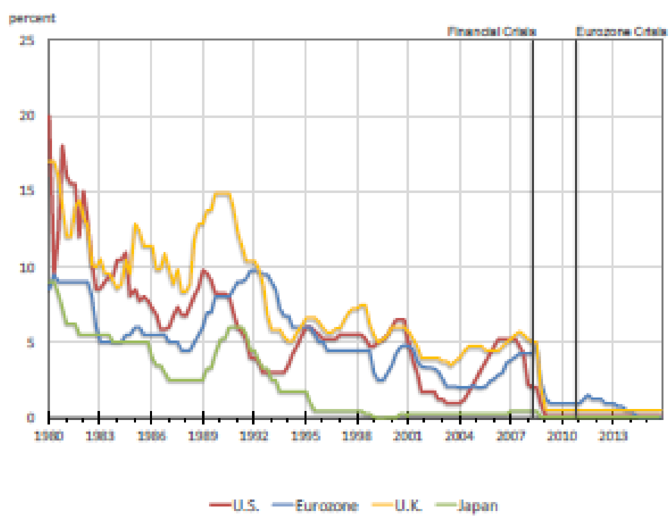


How did the shortage develop?

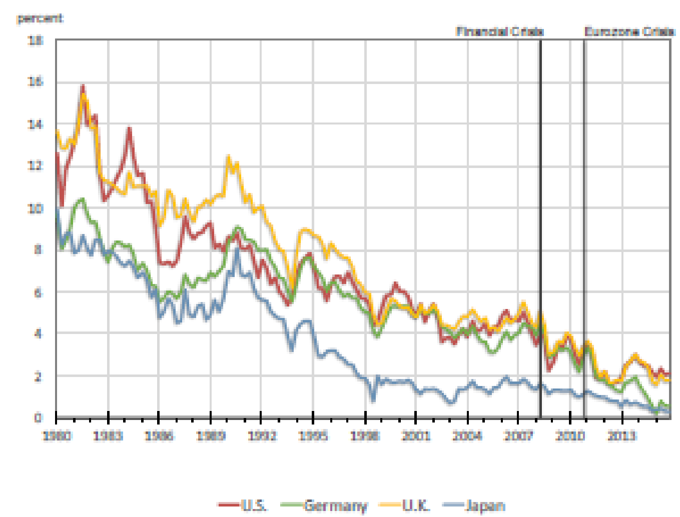
	$ bn		% of World GDP	
	2007	2011	2007	2011
US Federal Government Debt held by the public	5,136	10,692	9.20%	15.80%
Held by the Fed	736	1,700	1.30%	2.50%
Held by private investors	4,401	8,992	7.90%	13.30%
GSE obligations	2,910	~~2,023~~	5.20%	~~3.00%~~
Agency- and GSE-backed mortgage pools	4,464	~~6,283~~	8.00%	~~9.30%~~
Private-issue ABS	3,901	~~1,277~~	7.00%	~~1.90%~~
German and French government debt	2,492	3,270	4.50%	4.80%
Italian and Spanish government debt	2,380	~~3,143~~	4.30%	~~4.70%~~
Safe assets	**20,548**	**12,262**	**36.90%**	**18.10%**

Note: Numbers are struck through if they are believed to have lost their "safe haven" status after 2007.
Source: Federal Reserve, Haver Analytics, Barclays Research

Implications

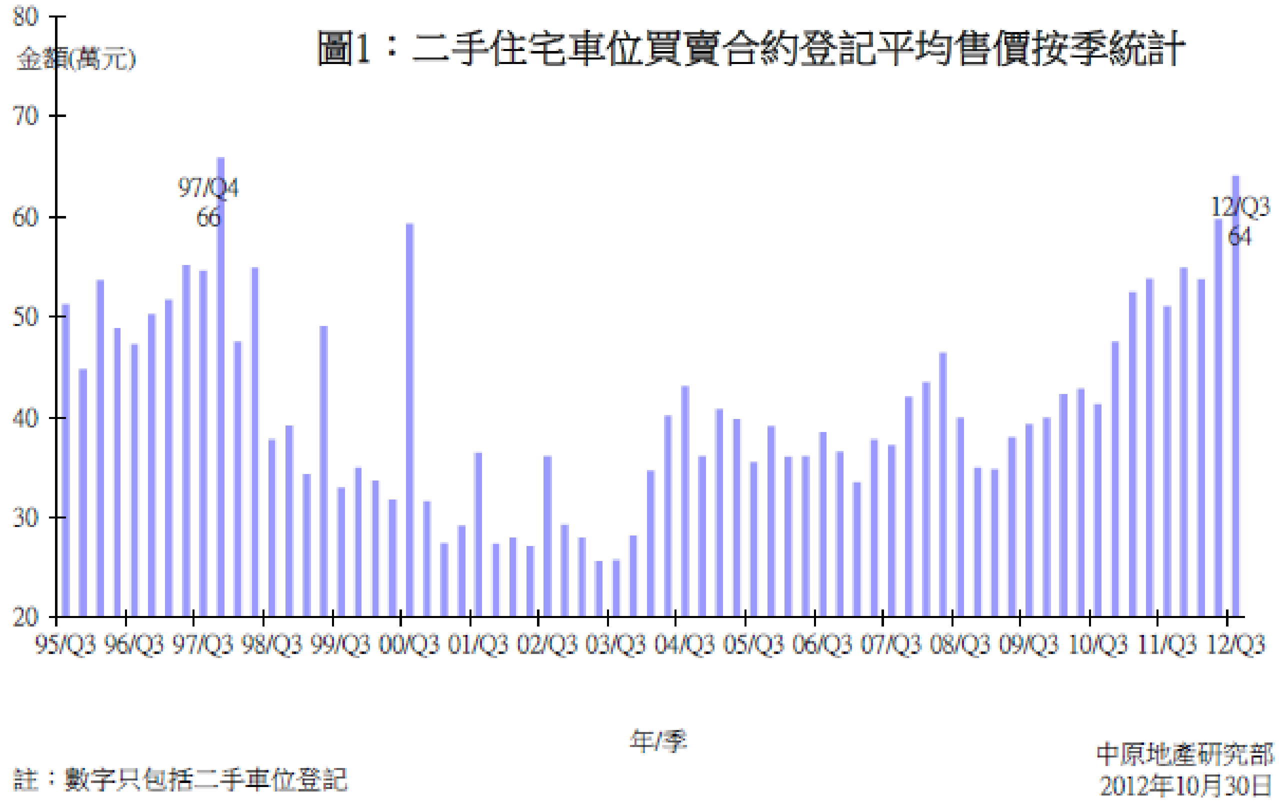


(a) policy rates



(b) 10-year nominal yields

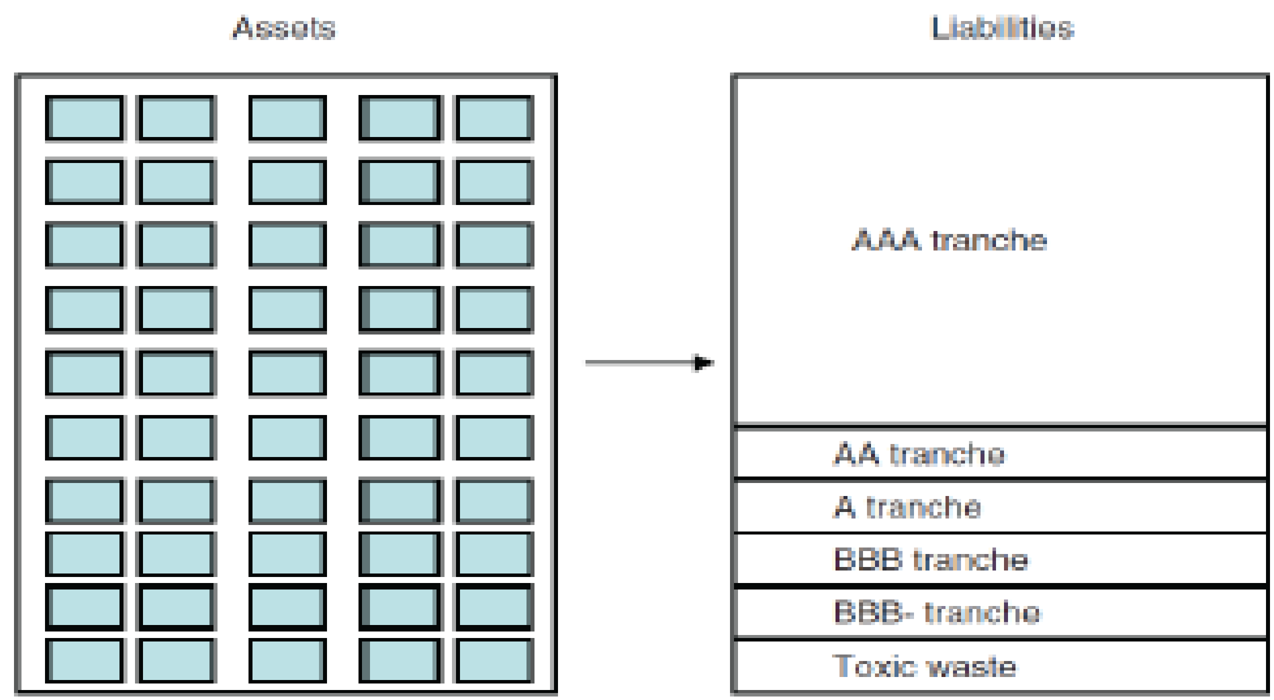
Implications



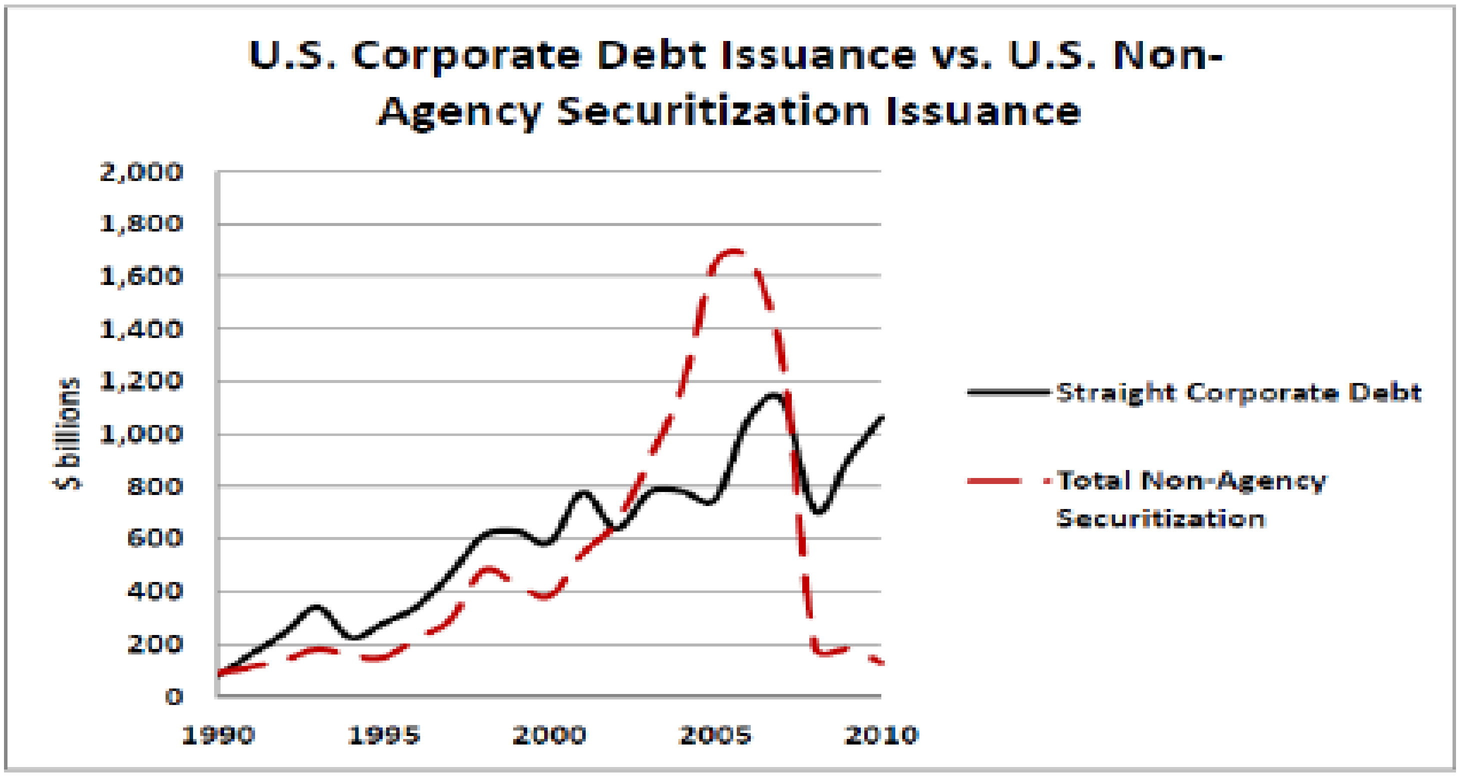
Implications

Figure 10

The balance sheet of a CDO

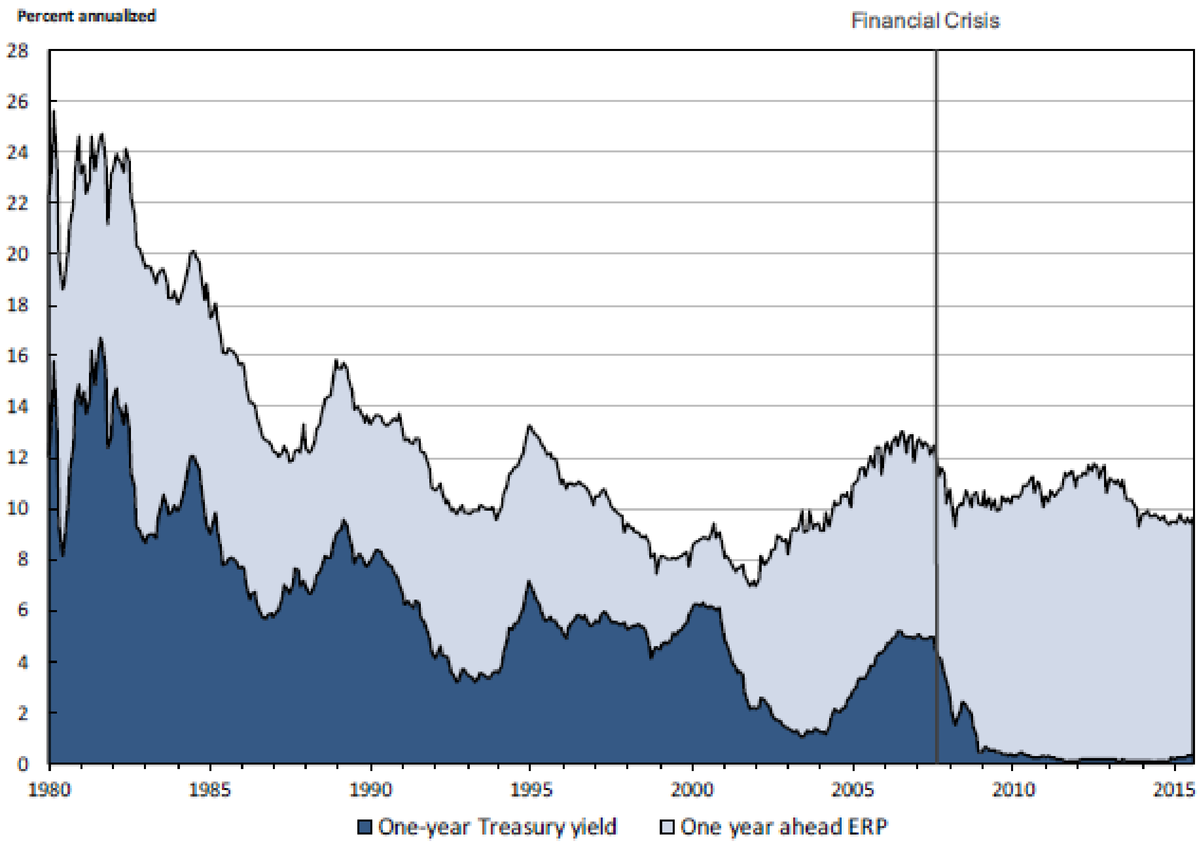


Implications



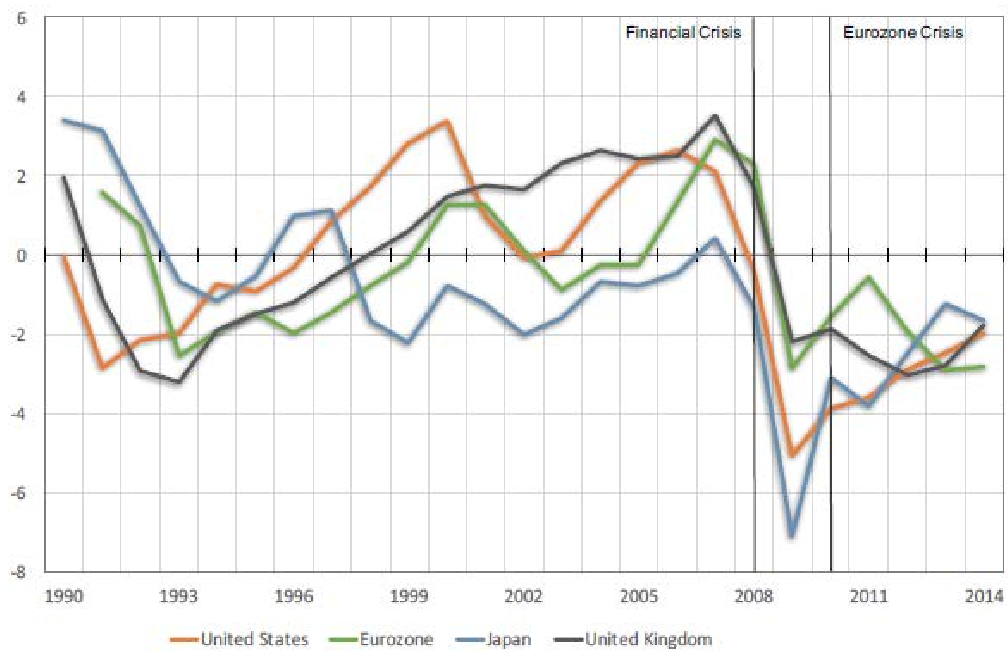
Sources: Bloomberg, Dealogic, Fitch Ratings, Moody's, prospectus filings, Standard and Poor's, Thomson Reuters, compiled by the Securities Industry and Financial Markets Association.

Implications (Safety Trap)



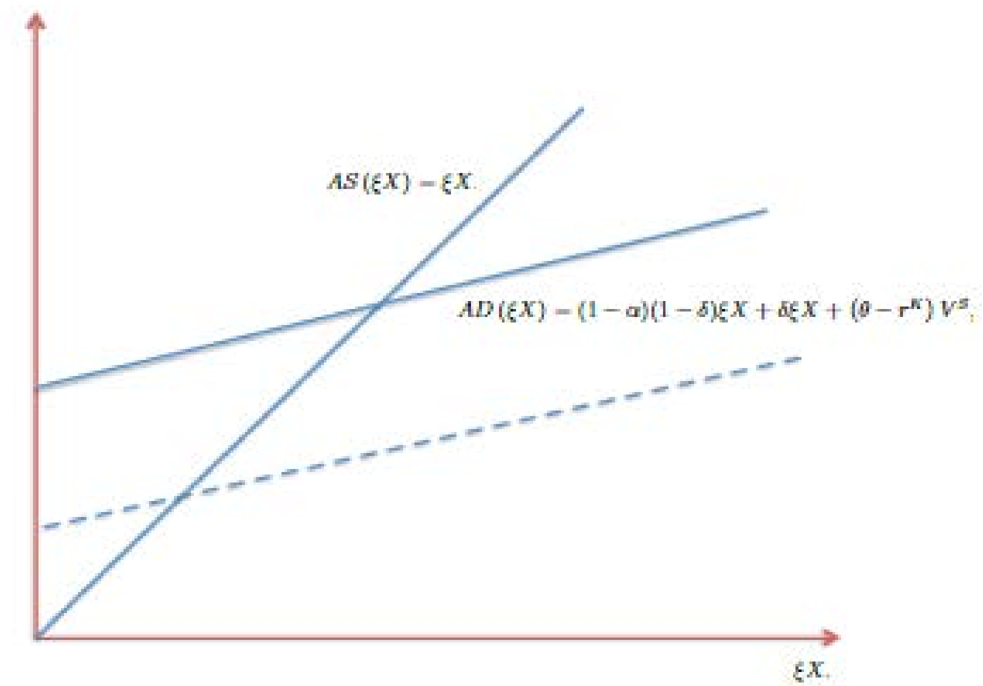
Implications (Safety Trap)

Output Gap (Advanced Economies), percent



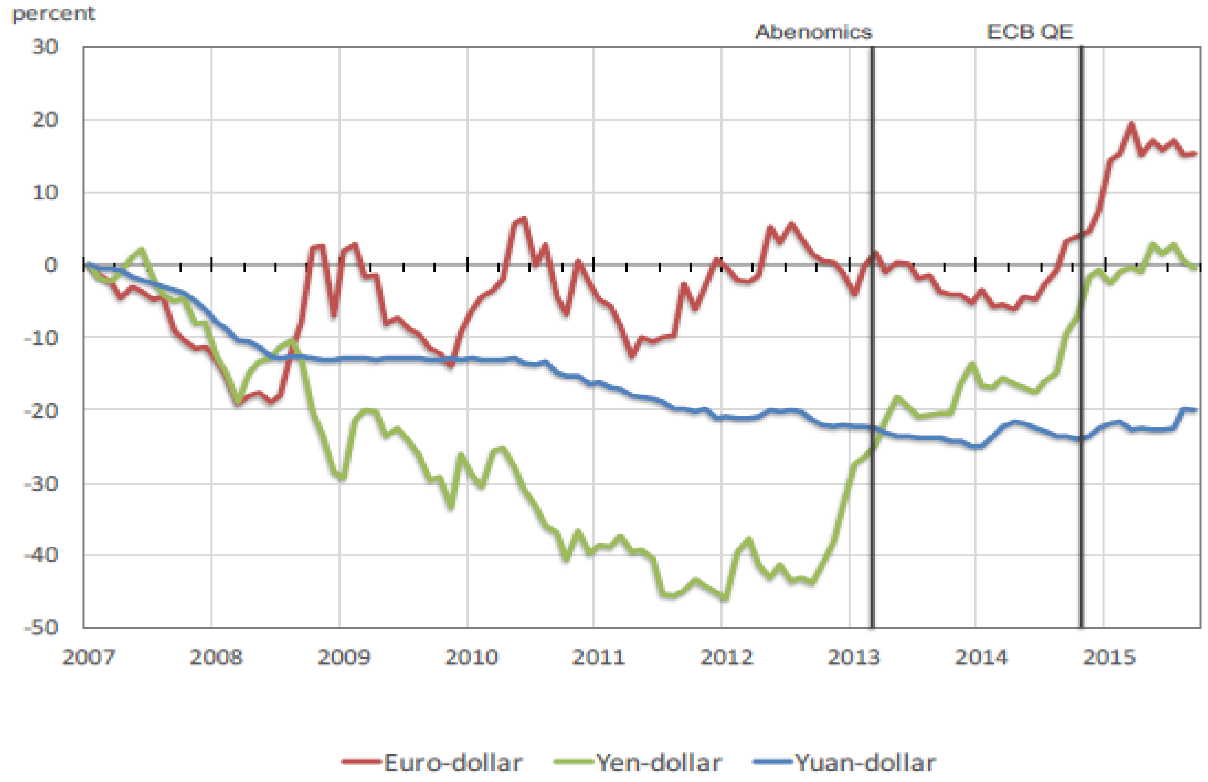
Implications

AGGREGATE DEMAND



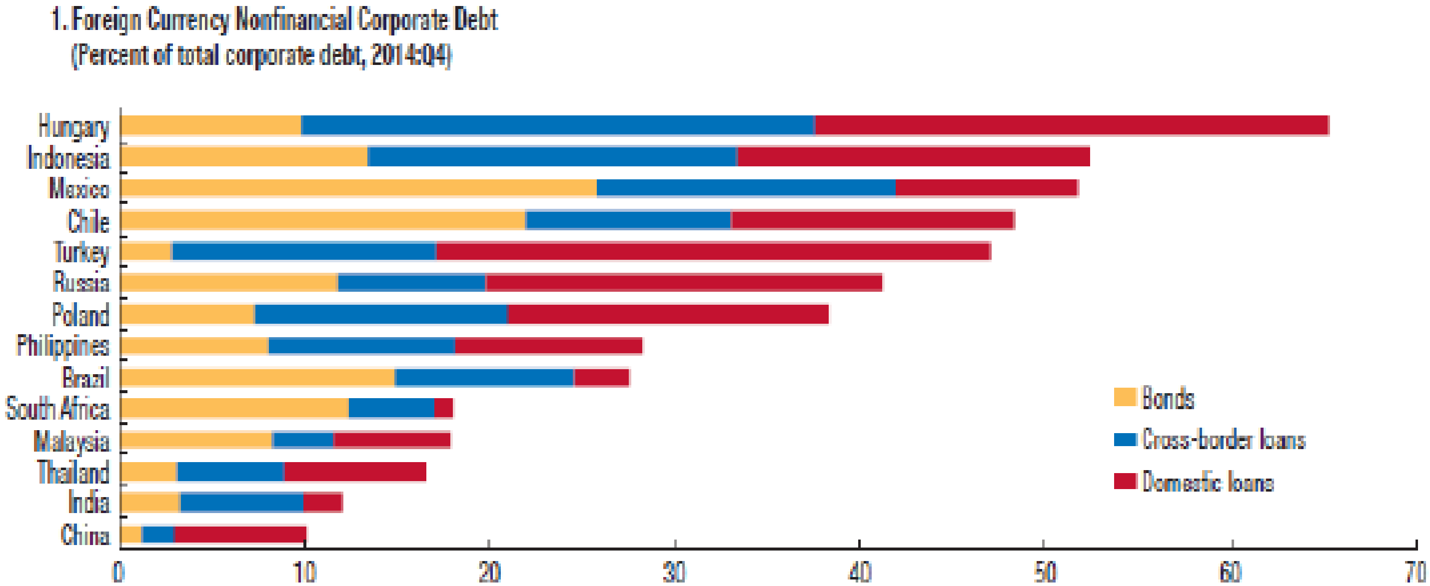
Go ESBies!!!

Implications (FX)



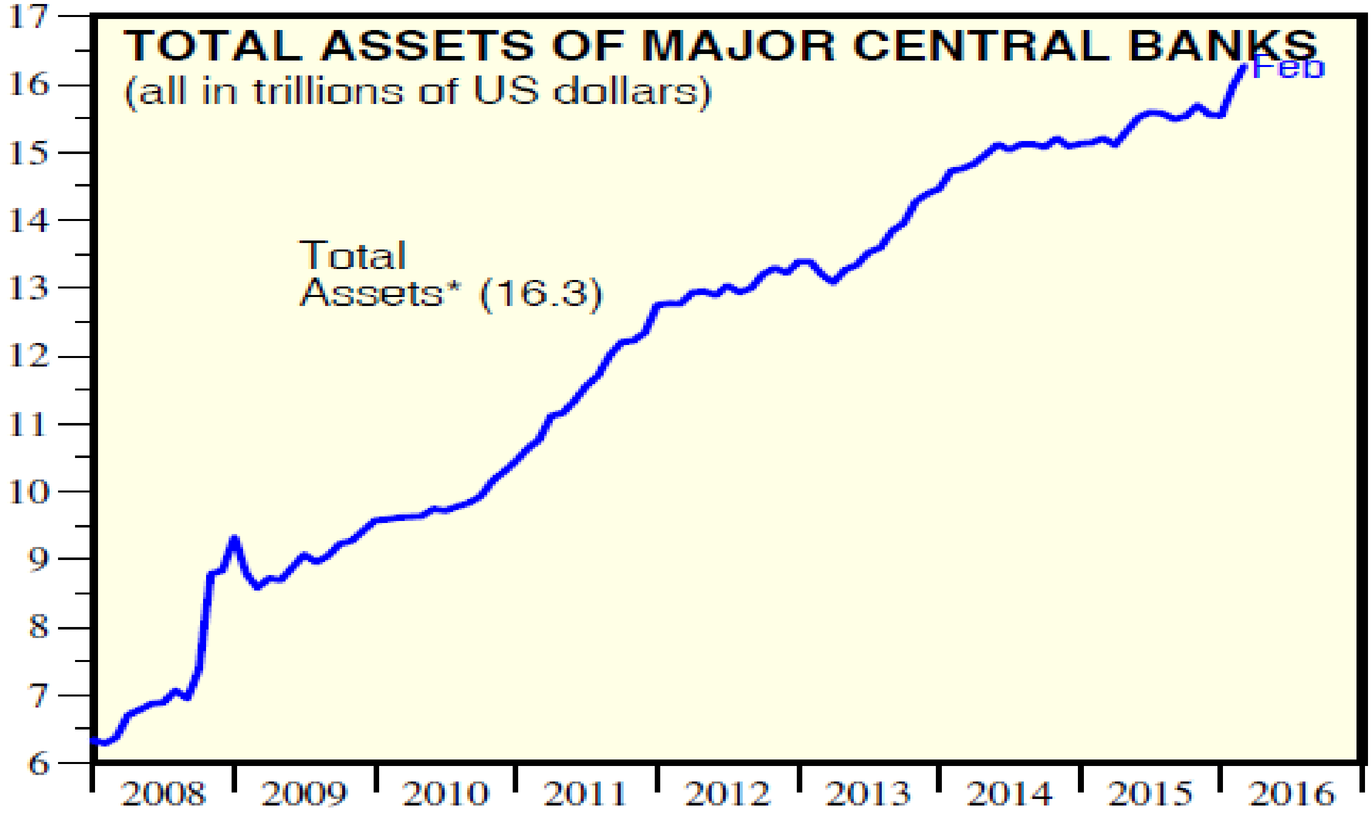
The figure reports $\ln(E/E_{2007m1})$ where E denotes the foreign currency value of the dollar.

Implications



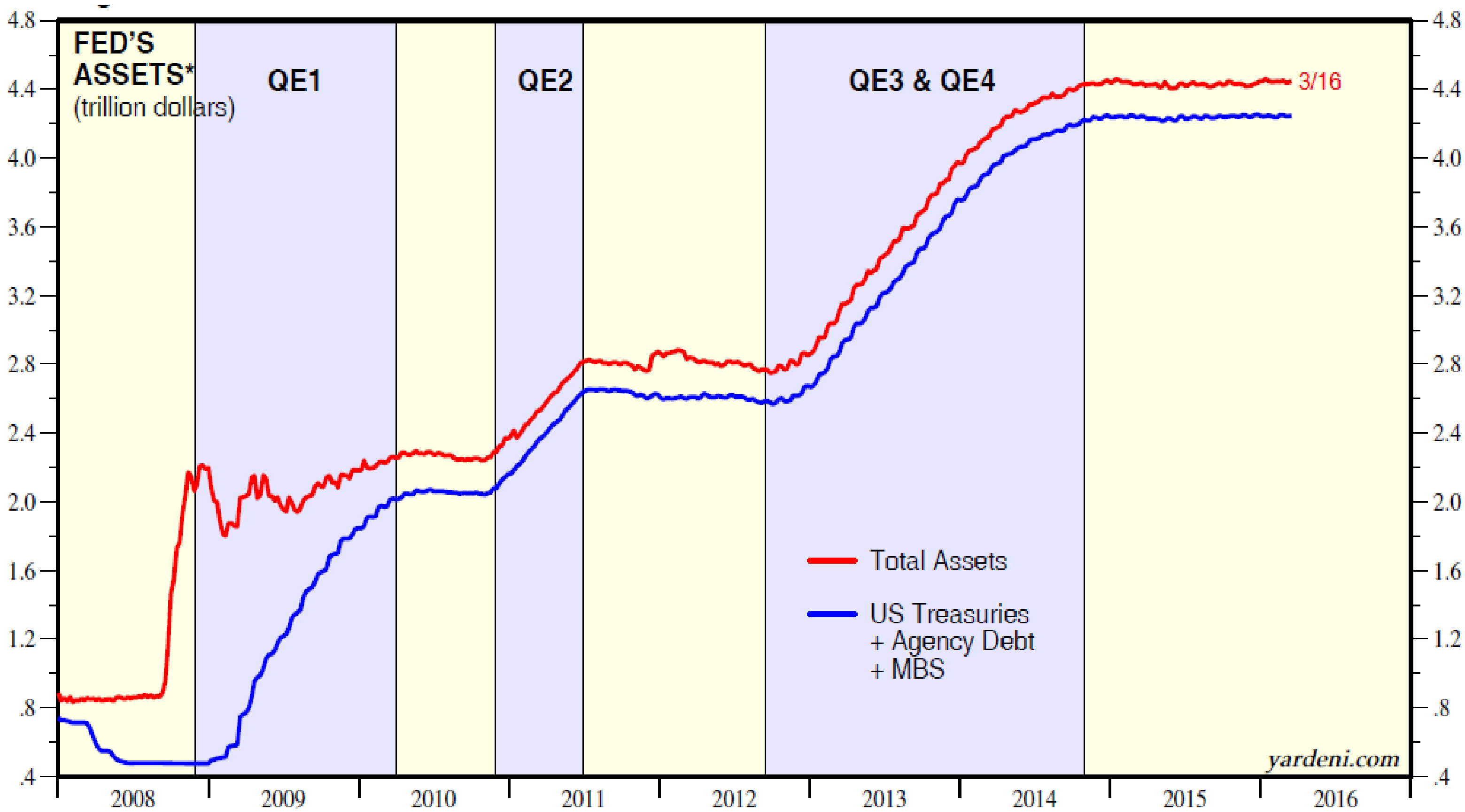
Sources: Bank for International Settlements (BIS); Bloomberg, L.P.; CEIC; IMF, Monetary and Banking database; and IMF staff calculations
Note: Bonds include securities issued abroad and are as of September 2015 (Bloomberg). Cross-border loans are for the nonbank sector. We approximate cross-border loans denominated in foreign currency using the level of cross-border loans for each country denominated in specific currencies as reported in the bank for International Settlements international banking statistics. Indian domestic loans are as of 2013:Q3.

Reactions



TOTAL ASSETS OF MAJOR CENTRAL BANKS
(all in trillions of US dollars)
Total
Assets* (16.3)
Feb
17
16
15
14
13
12
11
10
9
8
7
6
2008
2009
2010
2011
2012
2013
2014
2015
2016

Reactions



FED'S ASSETS* (trillion dollars)
QE1
QE2
QE3 & QE4
3/16
Total Assets
US Treasuries + Agency Debt + MBS
yardeni.com
4.8
4.4
4.0
3.6
3.2
2.8
2.4
2.0
1.6
1.2
.8
.4
2008
2009
2010
2011
2012
2013
2014
2015
2016

Reactions

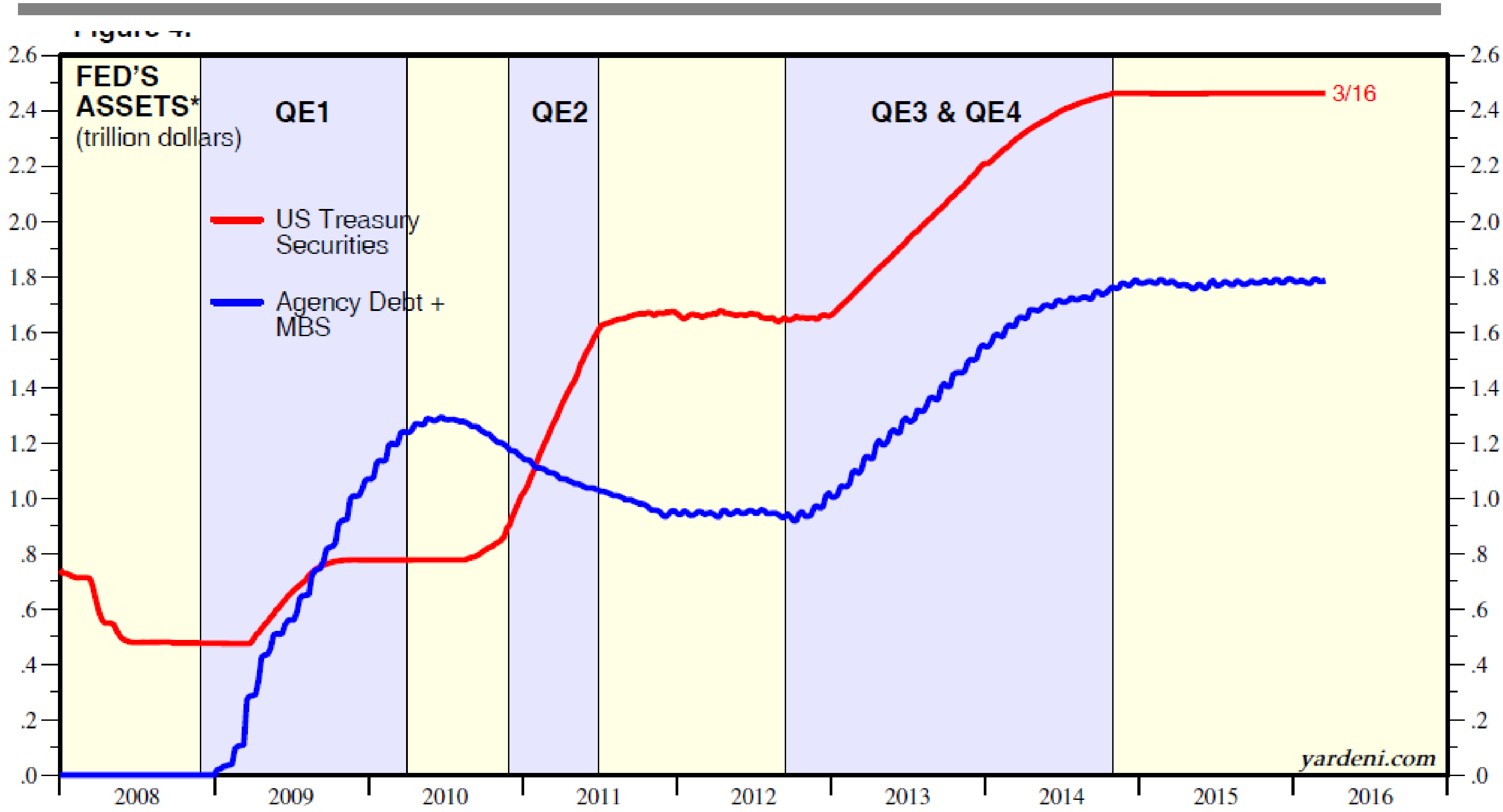


Figure 4.
FED'S ASSETS*
(trillion dollars)
QE1
QE2
QE3 & QE4
US Treasury Securities
Agency Debt + MBS
3/16
yardeni.com
2.6
2.4
2.2
2.0
1.8
1.6
1.4
1.2
1.0
.8
.6
.4
.2
.0
2008
2009
2010
2011
2012
2013
2014
2015
2016

What's next?

- Hotelling like… the price of an exhaustible resource rises ad infinitum… very much the situation of safe debt normalized by global demand for it
- Potential medium term "solutions":
  - Valuation:
    - Exhausted rates channel (ZLB)
    - Appreciation of core currencies

      Paradox of reserve currency

      It has international political limits

What's next?

– Quantities:

- More public debt…

  Political limits and bubble like equilibrium…

  Funding infrastructure makes sense

- Private substitutes

  Fragility is a real concern. Public-private? TICs?

- Reducing Demand for Safe Assets – Central Banks

  EM: More pooling

  DM: Focus on risky assets

Wasteful….

Figure 12.