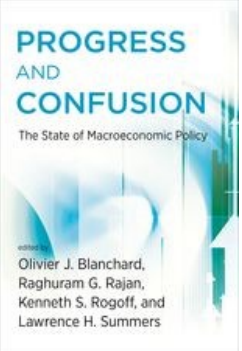

Progress and Confusion: The State of Macroeconomic Policy

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CHAPTER

26 Global Safe Asset Shortage: The Role of Central Banks

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Abstract

The chapter argues that there is a global shortage of safe assets, which puts downward pressure on safe real rates and leads to a stubborn form of liquidity trap (a safety trap). Central banks are contributing to the shortage by accumulating safe assets through international reserve accumulation and quantitative easing (QE) policies centered on safe assets. The chapter calls for greater efforts in the global pooling of macro risks to reduce the need for self-insurance by central banks in emerging markets. It also calls for refocusing QE on risky assets.

Keywords: safe assets, global shortage, central banks, quantitative easing, reserve accumulation

Subject: Public Economics

My assignment is to talk primarily about international liquidity provision and interlinkages of central banks' policies ... I know what I'm expected to say about these topics, and I know that most attendees and readers also know what I'm supposed to say. So we might as well skip all that and talk about something else ... although, as you will see, there are some points of contact between this something else and my mandate, but it will take a little while to get there.

I will focus on a central imbalance in global financial markets that has key implications for how we think about liquidity provision policies and central bank policies more broadly.

We currently live in a world where investment is having a hard time catching up with saving, which is leading to ever-lower real interest rates. This phenomenon started well before the subprime crisis. I often mention the Asian crisis as a defining moment, although Brad Delong has taken it further back, to the mid-1980s. In any case, this phenomenon was temporarily exacerbated by the crisis, but it seems to have a more secular nature. Larry Summers, in his irreproducible and insightful style, did a great service to this view by dubbing it the "secular stagnation hypothesis."

I believe, however, that a central aspect of this secular problem is not just an imbalance between investment and saving but a poor alignment between the financial assets that the private sector's real investment can naturally produce (or back) and the financial assets the average saver is looking for when trying to store value.

In particular, there is a shortage of *safe assets*, and when I say safe I mean mostly macroeconomic or systemic safe assets.

p. 262 There are two broad implications of this shortage:

1. At the *macroeconomic level*, the shortage of safe assets puts downward pressure on safe real rates and can eventually lead to a very stubborn form of liquidity trap (a *safety trap*, if you will),[1] one that is unresponsive to forward guidance–type policies or to the emergence of financial bubbles. In a safety trap, economic agents are acutely concerned with further negative macroeconomic shocks, and it is that concern that drives their assessment of the future. In contrast, forward guidance and bubbles are promises of further riches in good future macroeconomic states and hence do not address the core problem. This form of liquidity trap is very responsive to "policy puts" as these set a floor on the states that directly concern economic agents and therefore reduce the demand for safe assets.

2. At the *microeconomic level*, this shortage generates a strong incentive for the financial system to create such safe assets, and we know that the massive effort to squeeze a safe tranche from portfolios of sub-prime mortgages didn't work out too well last time. It is very hard for the private sector alone, in particular for the financial sector, which is naturally levered, to create truly systemic safe assets in significant quantity.[2]

With this background in mind, let us now look for solutions to this *safe asset shortage problem*, and in particular, as they relate to the topics of international liquidity provision and policy spillover.

I want to focus on one aspect of this solution: if we can't produce these safe assets easily, at the very least we *should not be wasting them*.

When one thinks about safe assets wasting, one's thoughts immediately go to central banks, both because of the size of their portfolios and because of their buy-and-hold nature (so when they remove a safe asset from the system, they typically do it on a nearly permanent basis).

To mention one pocket: of the $18 trillion of US Treasuries more than 30 percent is stationed at central banks, two-thirds of which is at foreign central banks and one-third is at the Fed itself.

The main reasons for central bank accumulations of safe assets are international reserves accumulation and quantitative easing (QE) policies. The former is about the hoarding of foreign safe assets, and the latter is about the accumulation of domestic safe assets and occasionally riskier ones (although in the case of Japan, both policies get mixed together at times).

p. 263 There are many reasons for international reserves accumulation, one of which, especially in emerging market economies (EMEs), is a precaution-ary motive against the sudden stop of capital flows. That is, the demand of safe assets by the central bank is for *self-insurance* purposes.

Several years ago, when Peter Diamond was president of the American Economic Association, he organized a session at the annual meeting on international financial institutions, and I was asked to talk about the future of the IMF. I felt that topic was too big for me to handle, as the IMF does many things, so I decided to interpret "IMF" as an initialism for "international market facilitator." My main point then was that self-insurance is a very inefficient form of insurance, and that the IMF has a major role to play toward completing the country-level systemic insurance market.

Of course, completing insurance markets also requires monitoring, as rogue countries can do more damage in a more complete markets environment, but that's something the IMF is accustomed to doing. I also discussed levered arrangements with the private sector, where the IMF could, in addition to playing the role of monitor, take the toxic waste layer of a special-purpose vehicle whose assets would be made of approved EMEs' debt.

At the time, I took the perspective of a country seeking insurance against sudden stops. I am now taking the perspective of a global economy facing a shortage of safe assets, but the conclusion is the same: we need to pool more global macro risks. This will cheapen the insurance cost for individual economies and reduce the massive squeeze on safe assets and its economic consequences.

Moreover, the exceptional reward received by those that can issue safe debt today makes the special-purpose vehicle structures I mentioned then even more attractive today. This is what investment banks would love to do and would be doing massively if they weren't so regulated today.

In recent years, the IMF and major central banks have made significant progress along this front through the creation of credit line and swap facilities, but there is room for a lot more. At least this is what equilibrium safe rates, which are dangerously close to sticky regions, are telling us today. In my opinion, central banks are holding too many safe assets in their reserves.

I now turn to QE, which is a very different kind of policy from international reserves accumulation. It is *not*
p. 264 an insurance policy. It is an ex ↳ post policy designed to compress risk spreads. In a sense, using John Geanakoplos's language, it is a policy that ought to be targeting the credit surface.

When you think about QE as a risk spread compressor, it is not clear at all that there is a role in it for the purchase of safe assets. In fact, if a shortage of safe assets is the main reason behind the liquidity trap, and the constraints on those that demand these assets to shift their portfolios into riskier assets are severe, reducing the available supply of safe assets may not only increase the risk spread but also could increase the sum of safe rates plus this spread, that is, the cost of capital for risky projects and investment.

The early QEs in the United States were very nicely targeted to risk spreads. There are aspects of the current European QE that have that feature as national central banks in periphery countries target the long and risky end of their sovereign curves.

I like much less, from the perspective of a safe assets shortage, Operation Twist–type policies (in which the central bank effectively takes out of the system the hardest safe assets for the private sector to produce, namely, long-term safe assets). For similar reasons, I don't like the purchase of Bunds among the assets targeted by European QE. Of course, there are institutional constraints necessitating this, but sometimes institutional constraints are more costly than at other times. Today they are costly, and we may well need to revisit some of them.

Hyun Song Shin has mentioned the negative real term premia in Bunds as a potential contradiction of the positive risk premium observed in high-yield spreads. I'm not so sure there is a contradiction. Long-term safe debt is very scarce and is a negative beta asset, especially during severe crises. Thus, to me, this is simply a reflection of fear and mandates, not of bullishness. As non-risk-spread-based QE promises to take Bunds away, it is only natural for the private sector to run toward them before is too late (although in these early stages of European QE, core central banks have yet to target the back end of their curves, an aspect that was missed by markets initially and probably played a role in the recent European tantrum).

There is an important footnote to all this, which is that the commitment to intervene in those long-term
p. 265 assets is an important factor supporting and enhancing the negative beta of long-term safe assets. But that

↳ points toward a tail policy put promise rather than to hoarding of safe assets by developed markets' central banks.

At any rate, the problems of non-risk-spread-targeted QE don't stop at their impact on the supply of safe assets, as this kind of QE also amplifies the negative spillovers that have been so frequently mentioned at the conference. When QE is not targeted to specific risk spreads, it has to be much larger to gain traction as it leaks to many assets and countries. These leakages can cause all sort of problems.

We don't have a full understanding of how non-risk-spread-targeted QE works, but it appears that an important channel is through volatility markets. It depresses *implied and realized volatilities* by anchoring an important curve for asset pricing. Once the swap curve in a major economy is pinned down, most assets look less risky, which is a paradise for all ilk of carry trades, many of which have undesirable consequences, especially for EMs trying to stabilize their capital accounts.

Note that this is a channel which is distinct from the conventional uncovered interest parity (UIP) type of effect of an interest rate cut, for it is not a movement along the UIP but operates mostly by shifting down the effective UIP for EM currencies and other risky assets.

Now, if the main purpose of QE is not risk compression but exchange rate depreciation, it may well be that intervention in safe assets is the most powerful mechanism because it operates over a smaller and more inelastic basis. Essentially, by squeezing enough of these markets so that only those unable to run away stay in it, the UIP no longer is a constraint as the safe asset market becomes segmented, and all-in returns, including an expected depreciation, can drop below international rates.

But as Agustín Carstens has said, this type of deliberate action often leads to what he wonderfully characterizes as "competitive reserves accumulation," which means that the net supply of safe assets gets hit twice, once from the QE-initiating country and another from the response of EM countries. This can't be a good outcome in the current environment of shortages. Non-risk-spread-targeted QE feels very inefficient, both from the point of view of the major safe assets imbalance we are experiencing and from the point of view of the global spillovers they cause.

In conclusion, I have argued that many of the instruments and programs created to deal with emerging
p. 266 market crises, such as swap lines ↳ and IMF liquidity programs, which have often been motivated from the perspective of an individual country in the past, now have another, globally systemic reason supporting them: We have a shortage of safe assets, which will keep us too close to secular stagnation unless we do something about it. One natural way to reduce this problem is by finding mechanisms for central banks to reduce their use of these scarce assets in achieving their policy goals.

Doing so requires extensive global cooperation as it involves global macro risk pooling and consideration for the policy spillovers of the different QE options available to a major economy. It may well be worth it for the world economy for developed markets to work on the institutional reforms that allow them to focus more directly on risk-spread-targeted QE rather than on the wholesale safe assets type of QE. Put differently, in the current environment (things do change, as we know), the central banks of developed markets have no business hoarding assets that have a large safe assets component beyond those required for conventional monetary policy.

Notes

1. See Ricardo J. Caballero and Emmanuel Farhi, "The Safety Trap," faculty paper, Department of Economics, MIT; Department of Economics, Harvard University; and NBER, April 6, 2015, http://economics.mit.edu/files/9543 .

2. See Ricardo J. Caballero and Arvind Krishnamurthy, "Global Imbalances and Financial Fragility," *American Economic Review* 99, no. 2 (May 2009): 584-588.