COMMENTS ON "A SAFE-ASSET PERSPECTIVE FOR AN INTEGRATED POLICY FRAMEWORK"
by Markus Brunnermeier, Sebastian Merkel and Yuliy Sannikov

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As the time of writing these remarks, it is one week since Alberto Alesina, who pioneered academic work on political economy, left us. Some of what I say below is inspired by the emphasis throughout his life-long research in political economy on the role of institutions in determining a country's growth and on the fiscal origins of business cycles.

Brunnermeier, Merkel and Sannikov provide an ambitious and rich *safe-assets* perspective for an integrated policy framework for emerging market countries. While several aspects of their framework apply also to developed economies, I will assume the piece is meant primarily for policy-making in emerging markets.

There are at least three results that emerge from their perspective that I like very much:

1. Safe assets offer a *convenience yield* of various forms such as collateral role in inter- bank markets, providing storage to meet heightened precautionary demand, etc. All such convenience yield is factored into the price of safe assets giving them a "bubbly" property. Domestic government bonds and foreign safe assets can both provide this convenience yield (up to the point of bank solvency, so can bank deposits), but which is the preferred habitat depends in part on capital controls in place and this affects economic outcomes. In the "bubbly" phase, firms invest in domestic bonds as safe assets and borrow at low foreign rates (easy phase of the global financial cycle) to grow, giving sustainability to domestic safe assets.

2. Shocks – external (such as a rise in foreign interest rates) or domestic idiosyncratic ("fear") shocks or their coincidence – lead to a flight to quality in firms and citizens, given limited risk-sharing capacity of markets in emerging economies. Such flight can jeopardize growth and can cause the domestic safe-asset bubble to unravel. It can also lead to disinflation with capital controls but the same force can lead to inflation without capital controls (via capital flight and depreciation channels); in other words, there is the possibility of both a classic recession as well as stagflation based on the nature of capital controls in place in the emerging economy.

3. Capital controls can make monetary policy more effective in such times of "wobbly bubble" or in the extreme case of a sudden stop; they also limit ex-ante external sector exposure. Capital requirements, which would limit direct and indirect financial sector exposure to risks and foreign denominated debt, can also perform this role. Interestingly, therefore, capital controls and capital requirements act as substitutes.

My key point of departure with this interesting and important safe-assets perspective offered by Brunnermeier et al. is that it is largely, if not entirely, silent on the role of the government in emerging economies and its interaction with the safe-asset bubble.

Suppose the government is not the benevolent central planner we often assume it to be in normative economics, but as in Alesina's positive theory of governments, is self-interested. The government undertakes fiscal policy – expenditures and taxes – and potentially also other policies that affect the financial sector (as I will explain below) to maximize its own objectives.

Suppose also that what distinguishes emerging economies from developed ones is not just the nature of risk-sharing markets (which could be endogenous too), but first and foremost the governance of the government and its expenditures. Given weak governance, the government's expenditures can be myopic in motivation and wasteful in terms of long-run economic outcomes.

Myopic and wasteful expenditures, in contrast to public good provision (health, education, infrastructure, etc.), imply that government borrowing may not lead to crowding-in benefits for private sector growth, but instead, especially beyond certain levels, start to crowd out private sector growth (as most domestic savings remain parked in the safe assets).

Furthermore, being myopic, the government may wish to excessively expand its debt capacity and divert or spend during its present term. Governments in such countries will, as often observed in data, borrow and spend to the hilt, including from external savings, and have little room left for countercyclical fiscal policy when shocks arise.

Therefore, it matters to economic outcomes what is done with the proceeds of the bubbly safe assets; this, in turn, depends on the quality of domestic institutions governing expenditures of the government, and their fiscal multipliers, if any (possibly negative), on private sector and overall growth. It is in this sense that it is not sufficient to employ the safe-assets perspective to understand the bubbly phase of these economies and their eventual bust; *endogenous risk arising from the safe-asset bubble is intricately linked to the government, its governance, and the political economy driving the nature of its expenditures, which in turn affects the sustainability of sovereign debt (the "bubbly" safe-asset)*.

While the safe asset would still carry the convenience yield of various types as in Brunnermeier et al., the endogenous risk it creates is that of repressive economic and financial policies, and crowding-out of private sector growth. Risk-sharing markets in such economies may be repressed to favor the "bubbly" safe asset which is the government's borrowing instrument.

Paradoxically, therefore, too much investment in developing liquidity for the government safe asset, if at the expense of policies to develop other risk-sharing markets, can in fact result in greater endogenous risk in such economies. The bubble in safe assets could be a sign of economic and financial repression, rather than of exogenously assumed weak risk-sharing.

How would the policy recommendations of the Brunnermeier et al. perspective change in the presence of such endogenous risks? I conjecture that there arise difficult tradeoffs.

Take capital controls. On the one hand, capital controls are desirable in good times to limit the exposure to external shocks; on the other hand, capital controls – by choking the growth of already crowded-out private sector – can aggravate the endogenous risk to the bubble.

Similarly, take bank capital requirements (which are typically zero for domestic sovereign debt) or liquidity requirements (which are met predominantly through holdings of domestic sovereign debt). While such requirements reduce exposure to external shocks, they only feed the domestic safe-asset bubble and via wasteful government expenditures increase the endogenous risk by weakening the growth of the private sector.

I am not suggesting that emerging market policy-makers do not enhance liquidity of domestic sovereign bonds markets, or remove altogether the capital controls on private firms, or feed private sector and banking leverage booms. I wish to simply highlight the difficult policy tradeoffs when the issuer of the safe asset – the government – has conflicted objectives and what it does with the issuance proceeds affects economic outcomes.

Is there in fact a role for multilateral agencies to promote enforceable debt ceilings on governments of emerging markets and help create institutions for democratic accountability of adherence to such ceilings?

Finally, would policy-makers such as central banks, prudential regulation authorities and securities market regulators, in the presence of weakly governed governments of these economies, be independent in the first place, or be coerced into adopting policies that feed government expenditures?

As late Alberto Alesina might have put it, the quality of policy-making institutions and the nature of fiscal policy would matter while answering these difficult questions. It is my view that these considerations are increasingly becoming germane even for developed economies given the nature of political economy forces at work. The reason is that their government policies and public finances are increasingly resembling those in emerging markets.