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**The Demand For - And Failure To Deliver - Safe Assets Is Harming The Market**

[The word gold is curiously absent, here.]

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by Brad DeLong Dec 22, 2011

"Show me the collateral" -- one of the three major market failures underlying our current difficulties -- is the extraordinary demand on the part of investors for "safe" assets--and the concomitant failure of financial markets to mobilize the risk-bearing capacity of the global economy to bear risk/provide safety.

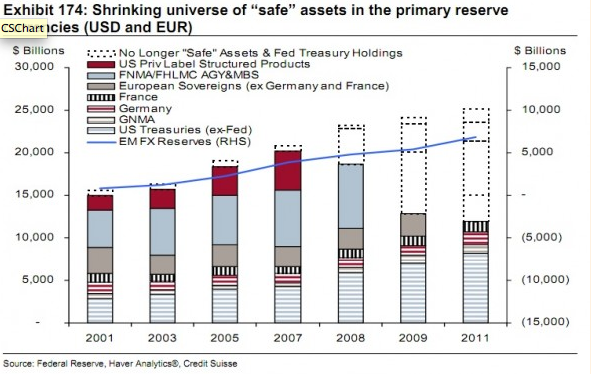
David Wessel on demand and supply for "safe" assets:

World's Supply of 'Safe' Assets Runs Short: The world economy faces a shortage of super-safe financial assets, bonds for which there is almost no risk of default and for which the market is so big that investors can buy and sell them readily. When anything is in short supply, its price rises. The bond market is no exception. It has been pushing up the price of U.S. Treasurys, still seen as safer than nearly all alternatives. That has pushed down the yield, the rate at which the U.S. government borrows, to extraordinarily low levels. Persistent shortages prompt lasting change. The hard-to-answer question: What changes will a persistent shortage of these risk-free assets provoke?

This phenomenon, more pronounced lately, predates the financial crisis. For years, high-saving economies like China and others bought dollars to keep their own currencies from rising in foreign-exchange markets. This yielded ever-larger piles of dollars to invest. In the mid-2000s, this money flowed into U.S. Treasurys and other AAA-rated dollar securities, depressing long-term yields even when the Federal Reserve was trying to boost them. Then-Federal Reserve Chairman Alan Greenspan called this "a conundrum;" his successor, Ben Bernanke, "the global savings glut."...

"In the financial system," says Mohamed El-Erian, co-chief investment officer of bond-market heavy Pimco, "you cannot replace something with nothing." For now, this benefits governments in the U.S. and (to the consternation of France) the U.K., which can borrow cheaply because they are drawing so much frightened money. Bill Gross, the other half of the Pimco team, describes the U.S. Treasury as "the cleanest shirt in the dirty-laundry pile."

Longer term? That's hard to know.

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Perhaps someday there may be proliferation of very safe, even if not risk-free, assets alongside the U.S. Treasury. Australian or Canadian bonds? Commodities? Multinational corporate debt?… For now, global angst is driving people to buy U.S. Treasurys, but that may not last once the crisis abates, as it surely will. "We have time," Mr. El-Erian says. "We don't have infinite time." Producing the world's risk-free security has allowed the U.S. to exchange paper for goods and services….

Today, for the first time in generations, it is time to contemplate a world without a risk-free asset. The consequences of that are truly hard to fathom.

This is the point that Cardiff Garcia illustrates with the >unwanted mutant offspring of the most important chart in the world…

…on page 143 of the Credit Suisse 2012 Global Outlook, which we’ve stuck in the usual place. It shows how the world’s outstanding stock of safe haven assets denominated in either dollars or euros has evolved, adjusted to account for the Fed’s purchases of US Treasuries and other assets in recent years as part of quantitative easing.

You can see just how impressive the decline has been since 2007, and we’d also note that if Credit Suisse had been feeling uncharitable, they would have been justified in excluding French sovereigns.

The chart helps explain much of what’s happening….

Begin with the ongoing collateral crunch, and how the decline of safe assets is directly tied to the dramatic fall in the availability of high-quality collateral in European lending markets…. [I]f you’ve read your Manmohan Singh (or your Izzy Kaminska or your Tracy Alloway), you’ll know that this availability is the first of two parts of the collateral shortfall effect. The other part is the shortening of “re-pledging chains”, otherwise known as a reduction in the velocity of collateral…. Singh again…. "A security that is owned by an economic agent and can be pledged as re-usable collateral leads to chains…. [T]he first round impact on the real economy would be from the reduction in the “primary source” collateral pools in the asset management complex (hedge funds, pension and insurers etc), due to averseness from counterparty risk etc. The second round impact is from shorter “chains”—from constraining the collateral moves, and higher cost of capital resulting from decrease in global financial lubrication. When you hear… Draghi himself say that he’s cognizant of the “scarcity of eligible collateral” – this is why."

As was perhaps inevitable, the decline in safe assets has come at a time when investor demand for these assets has only climbed for them and as the deep freeze in European unsecured lending has meant a big shift towards collateralised lending. Hence the widening discrepancy in repo prices for different types of collateral….

There are future policy considerations here as well. Back to Singh…. "Recent regulatory efforts will require significant collateral on many fronts—Basel’s liquidity ratios, EU Solvency II and CRD IV, and moving OTC derivatives to CCPs. Unless there is a rebound in the pledgeable collateral market, the likely asymmetry in the demand and supply in this market may entail some difficult choices for the markets and the regulators…."

A somewhat obvious and related point here, but the loss of “safe” status for so much debt contributes to the deleveraging burden of European banks and their American subsidiaries; by definition it means higher risk weightings for these assets….

Another obvious and related point, which is that the ECB is now accepting everything but your dirty socks as collateral. Not much choice in the matter, we suppose, if it wants to ease the liquidity strains caused by the broken interbank market. What else can it lend against?

Historically, a Triffin Dilemma — and that’s kinda what this is — leads to funky innovations in the shadow banking system and all the complications that such innovations bring…

You can see in the chart that before the crisis, US Treasuries were an important but minority amount of the world’s stock of safe haven assets. Treasuries are now the vast majority of such assets. But this is because of the extraordinary decline in the other kinds of assets and because of quantitative easing by the Fed, not because the outstanding stock of Treasuries has increased by so much. Issuance in recent years hasn’t been nearly big enough to make up for the decline in other kinds of safe assets or, certainly, to correct the imbalance between investor demand for safe assets and outstanding supply…. [T]his further confirms how absurd it is that the US government has spent so much time this year bickering over deficits rather than economic growth, and that the US economy confronts a fiscal drag beginning next year…

In a way, it is a product of trust--or, rather, of the absence of same. Markets in which people do not trust each other are subject to adverse selection problems: they collapse, or function badly. It is the purpose of institutions, especially financial institutions, to substitute for the trust that does not exist. And when the financial underpinnings needed to substitute for trust are not present, the macroeconomy can go badly awry as well.

Consider something as simple as market exchange. My wife's and my earning power right now is not quite enough to exclude us from the 99%, but it is enough to exclude us from the 98%. We are not going to flee our domicile and change our names. Yet somehow we can't just go to the store, pick things out, and tell the cashier: "We'll owe it to ya. We're good for it." (Indeed, the only person in this Fallen Sublunary Sphere willing right now to lend us unsecured money for a more-than-30-day term is Tom Goldstein, and he is probably getting antsy about his $40 right now…) We have to show up with cash money to grease our transactions so that the cash can serve as a substitute for the trust that is not there. Thus an economy in which money is short--an economy in a liquidity squeeze--falls into a monetarist recession.

However, it is not just cash money that an economy needs to possess in sufficient quantities to substitute for the absence of trust in spenders. Spenders give you money in order to substitute for trust. But consider businesses seeking to borrow and invest. They can't give you money to make you trust them--the whole point is they want you to let them have your money now and for them to pay you back later after their ships have come in. What they need to give you, instead of the cash that you are giving them, is savings vehicles--bonds--of sufficient expected value. Economies can have a shortage of savings vehicles as well as of cash, and can suffer Wicksellian as well as monetarist recessions.

Last, there are a whole set of transactions in which what the counterparty wants is not your cash or your bond to substitute for nonexistent trust, but rather some safe and liquid collateral: a particular, peculiar bond that they are confident will maintain its (nominal, at least) value at maturity and that they are confident everybody else will be confident will maintain its (nominal, at least) value at maturity so that it will be useful as a means of raising cash in a hurry now. That's what AAA assets are good for. And when an economy is short of AAA assets, it can fall into a recession--but not a monetarist or a Wicksellian recession, rather an Minskyite recession--because in the absence of long-enough collateral chains the web of banking intermediation would have to run on trust that isn't there. Cash substitutes for trust to enable spenders to spend. Bonds substitute for trust to enable businesses with investment projects to raise financing for them from savers. Safe assets are needed (i) to make people averse to risk sleep soundly, and (iii) to substitute for trust in the complex intermediate transactions that sit between savers and borrowers and allow bankers to make their nut.

(Cf.: Jeremy Stein (2011), ["Monetary Policy as Financial-Stability Regulation"](Monetary Policy as Financial-Stability Regulation Jeremy C. Stein); Jeremy Stein (2010), "Securitization, Shadow Banking, and Financial Fragility"; Tracy Alloway (2011), "The AAA Bubble".)

This article is tagged with: Macro View, Market Outlook