A Global Safe Asset for Emerging Market Economies

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[1] The views expressed in this discussion do not necessarily reflect the position of the Central Bank of Brazil.

What the paper does

- Proposes creating a Global Safe Asset (GSA) backed by a pool of EME's sovereign bonds.
  - GSA is the senior tranch of bond issued to fund that pool of assets.
- Argues that EME's would benefit from holding these assets as international reserves, instead of safe assets issued by AEs (e.g. US Treasuries).
- In the spirit of European Safe Bonds – ESBies (Brunnermeier et al. 2011):

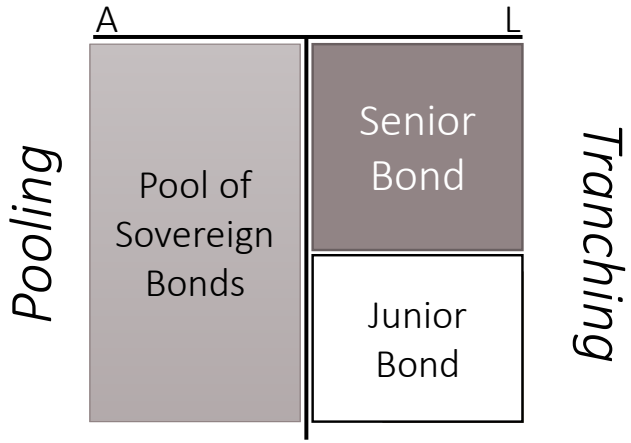

Figure 1: Structure of GSA

First reaction

- First reaction: Pooling + tranching = "Risk reshuffling".
- A Modigliani-Miller-type irrelevance result must come to mind:
  - Basic "CAPM intuition": adding portfolios of assets that already exist to menu of options doesn't change anything. How can this make a difference?
- Well, GSAs (ESBies) might make a difference in the presence of some frictions/distortions.
- Hence, a natural script for the analysis would be:
  - Build on a canonical setting in which a Modigliani-Miller-type irrelevance applies.
  - Bring in the relevant distortions/frictions that allow the "asset creation trick through risk reshuffling" to matter.
- Starting point: A look at ESBies.

ESBies (Brunnermeier et al. 2011)

- "The list of all of these virtues may at first seem almost magical... [H]ow can value be created by just re-packaging bonds? The answer to these questions is that eliminating the distortions brought about by bad regulation creates value. As we discussed earlier, the bank regulation practices of accepting national sovereign bonds as riskless for capital requirements, together with the ECBs generous haircuts, leads to a mispricing of sovereign bonds. By a government effort, this can be eliminated by directing the ECB interventions and the bank regulation risk weights towards ESBies. Value is thus created by moving to a different equilibrium, one that is supported by a pricing mechanism truly reflective of underlying risks...."

The Sovereign-Bank Diabolic Loop and ESBies (Brunnermeier et al. 2016)

- "A "sunspot-driven" repricing of the country's sovereign risk can result in bailouts of banks or other systemic financial institutions, which can lead to sovereign default ... In the absence of such repricing, the government never defaults. Effectively, the sunspot acts as a selection device among two equilibria – one with bailout and possible default, and another with no bailout and no default. A key condition for the first equilibrium to exist – and hence for the diabolic loop to arise – is that banks hold a sufficiently large fraction of the stock of domestic sovereign debt."
- OK. So ESBies can help solve a problem of multiple equilibria, where the bad equilibrium is made possible by bad regulation that creates distortions and makes room for the so-called "SBDL."

Back to the GSA, reasoning by analogy

- EMEs subject to "sunspot-driven" sudden stops
- Fragility: Households/firms currency mismatch.
  - Borrow in foreign currency at lower interest rate and run a carry trade.
  - Bad equilibrium outcome: Run on dollar debt and devaluation.
- Enough FX reserves eliminate sudden-stop equilibrium.
  - But costly (foreign currency borrowing rate $>$ return on foreign reserves).
- Proposal: Replace safe assets issued by AEs with GSA issued by EMEs.

(More questions than) Comments

- If enough FX reserves eliminate the risk of sudden stop and currency devaluation, why does insurance remain costly? In other words, how is $\bar{r}^{\$}$ determined and why $\bar{r}^{\$} > \underline{r}^{\$}$?
- Conditional on insurance cost remaining (i.e. given $\bar{r}^{\$} > \underline{r}^{\$}$), why are GSAs preferred? I.e., how do they eliminate/reduce the insurance cost?
  - I don't see how, because if they're senior enough to be a safe asset, then their return should equalize that of safe assets issued by AEs (i.e. should yield same return as FX reserves). Hence the insurance cost would remain the same.
- Other questions, likely due to exposition at this stage of the project.

Summing up

- Paper with an important, policy-relevant motivation: Role of global financial architecture in driving capital flows and sudden stops.
- Building on ESBies insight, thought-provoking proposal: GSA back by EME's sovereign bonds.
- Would encourage exposition based on basic script:
  - Start from canonical setting with irrelevance result.
  - Add frictions/distortions. Show inefficiency/problem to be solved.
  - Show how GSA can achieve this, why it dominates FX reserves.
- Looking forward to future vintages of the paper.