# A Global Safe Asset for & from Emerging Economies

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# International: Flight to Safety

- Risk-on, Risk-off  Flight-to-safe asset

Safe asset:

- "Good friend analogy"  is around/valuable when you need it
- Safe asset tautology  is safe because it is perceived to be safe

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- Problem: Safe asset is *asymmetrically supplied* by AE

  Flight-to-safety ➡ cross-border capital flows

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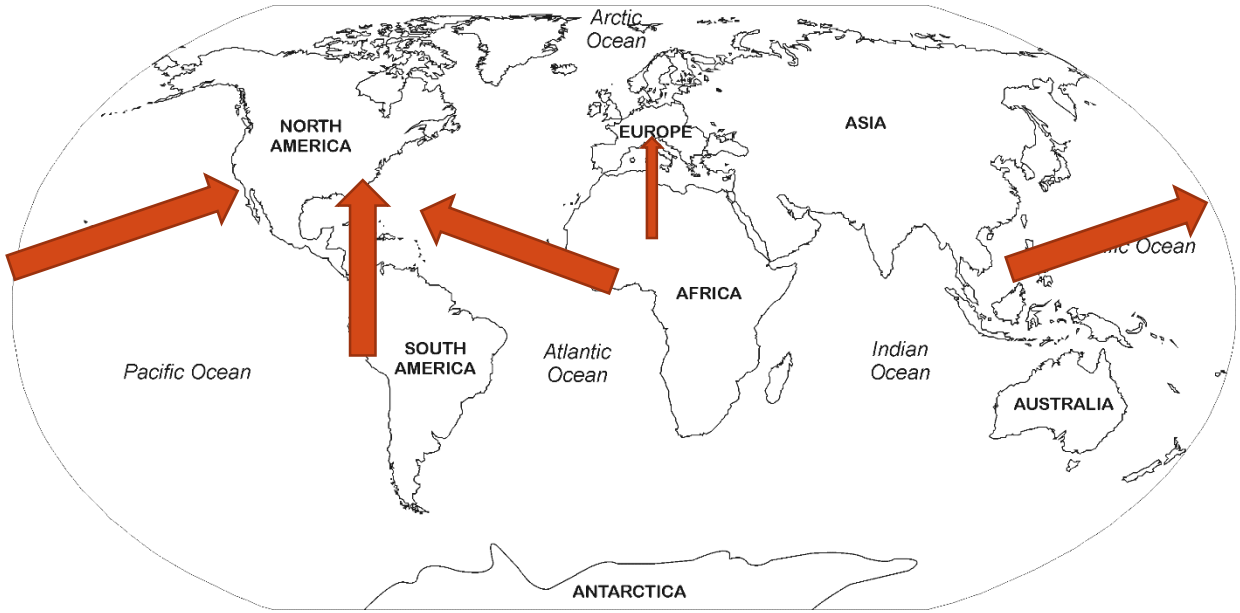

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  Flight-to-safety ➡ cross-border capital flows

- At times of global crisis, issuance of new debt
  - For AE  at inflated prices  eases conditions
  - For EME  at depressed prices  worsens conditions

- Question: Who insures whom? *"Poor insure rich Paradox"*
  - Correct insurance only if
    buffer is large and debt long-term enough
    so that no new debt issuance needed &
    sell safe asset/reserves instead

# Two Approaches

- Approach 1: "Buffer Approach" *(traditional)*
  - Lean against sudden stop (flight-to-safety) capital outflows

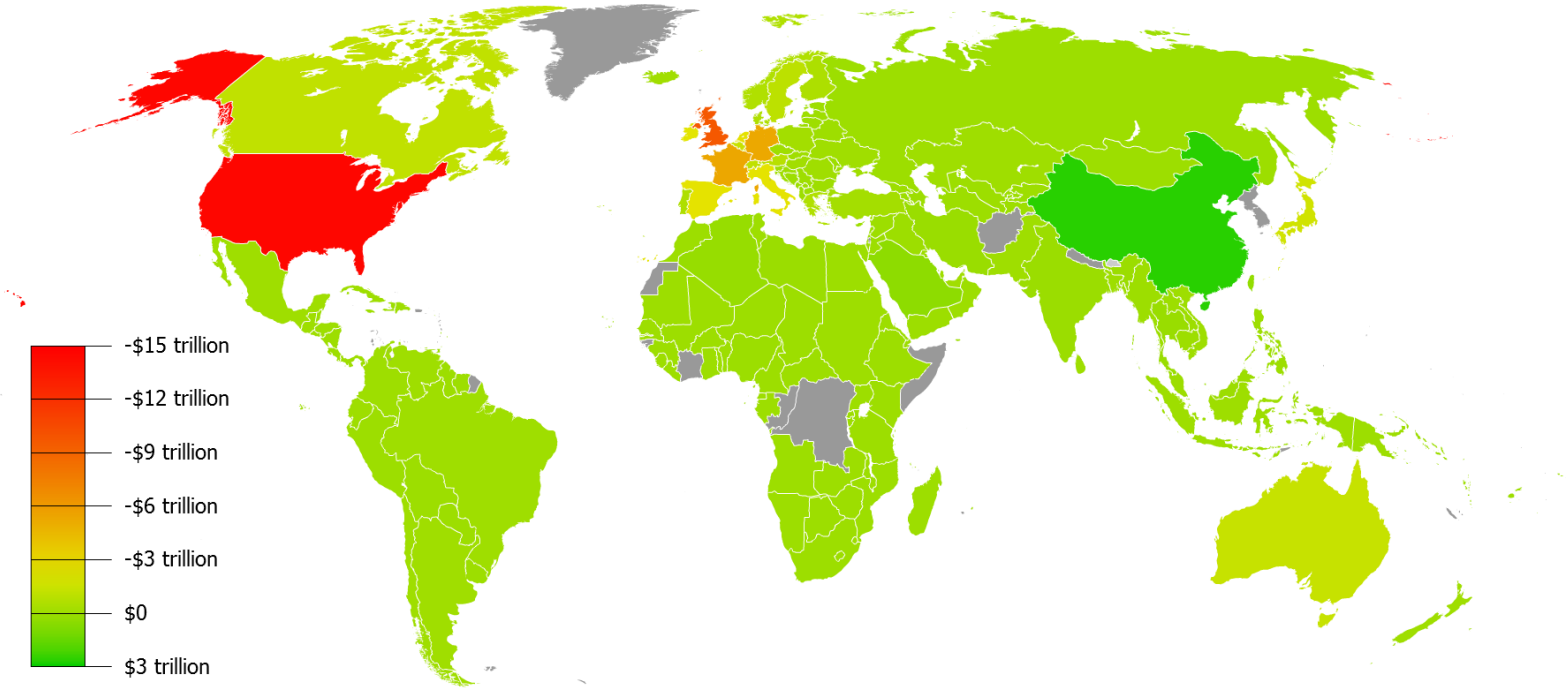
  - Precautionary Reserves
  - IMF liquidity lines
  - Central Banks Swap line arrangements

  } Official sector

- Approach 2: "Rechanneling Approach" *(new proposal)*
  - *"Global Safe Asset from & for Emerging Economies"*
    with Lunyang Huang
    (Central Bank of Chile Conference 2017)
    formal analysis

# 1. “Buffer Approach” via Reserves Holdings

- South East Asia crisis 97/98: Sudden Stop/Flight-to-Safety
  ⇒ precautionary reserves




Source: Kieran (Wikipedia)
CIA World Factbook data 2011

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  - As EME grows faster, it have to keep acquire foreign safe assets (export surplus required)
- Distorts exchange rates

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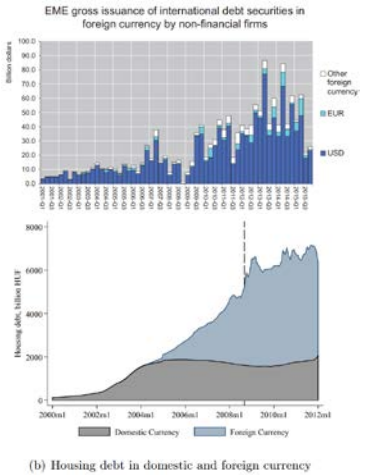
- Distorts exchange rates
- Subsidizes private carry trades
  - Carry traders undermine/undo official reserve holding
  - EME corporate sector $-borrowing
    - Bruno & Shin 2016
  - Hungarian/Polish household €-borrowing
    - Verner 2017



(b) Housing debt in domestic and foreign currency

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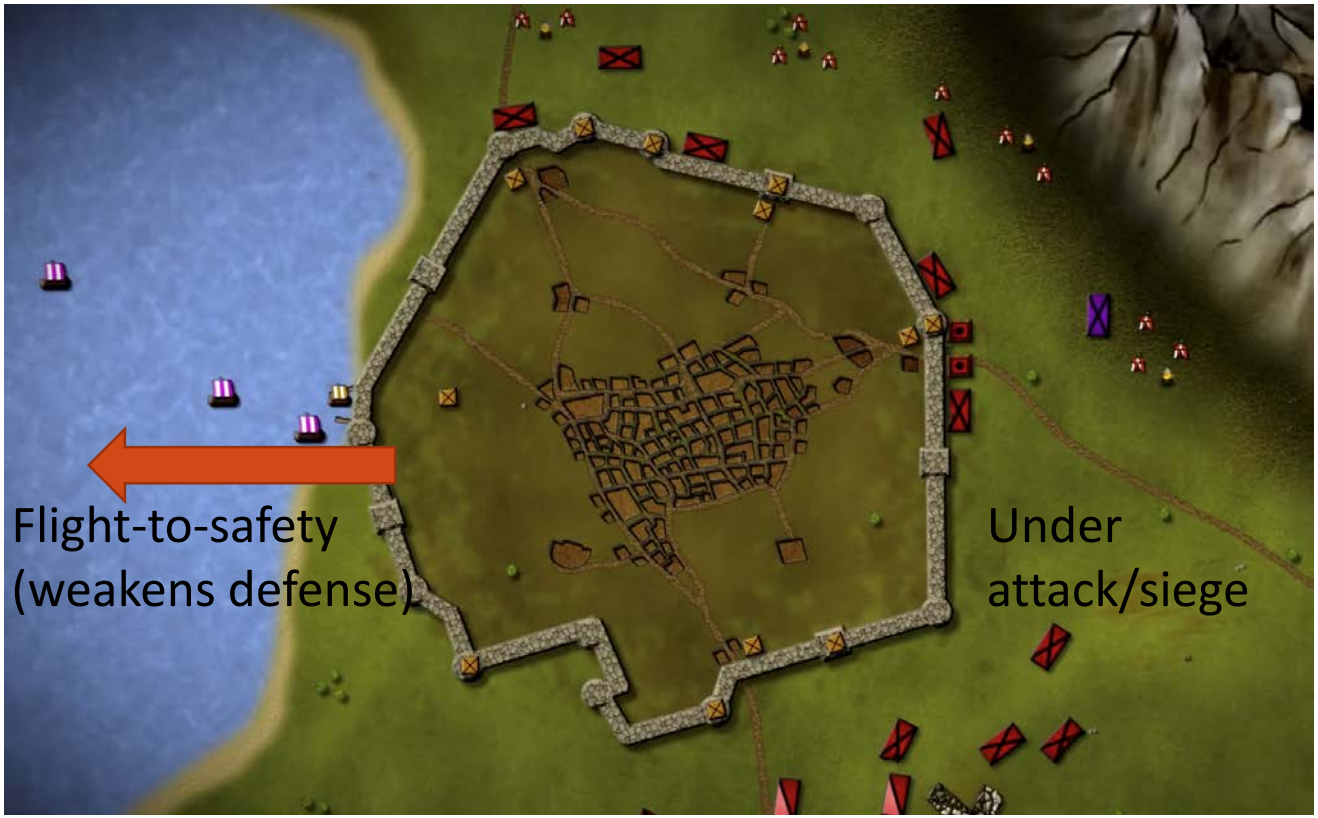
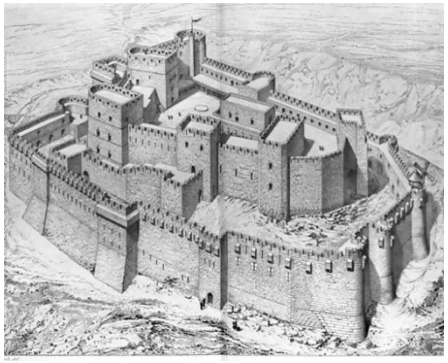


# 2. Approach: “Rechanneling”

- Address root cause: Safe asset is supplied asymmetrically

- Analogy
  - Two lines of defense
    - Stronger inner circle (keep)

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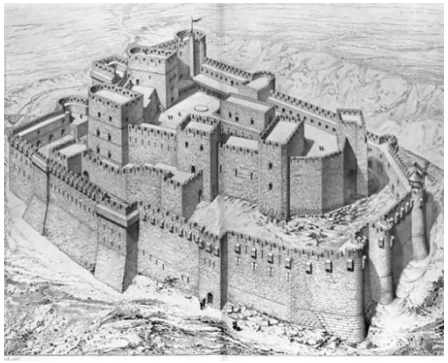

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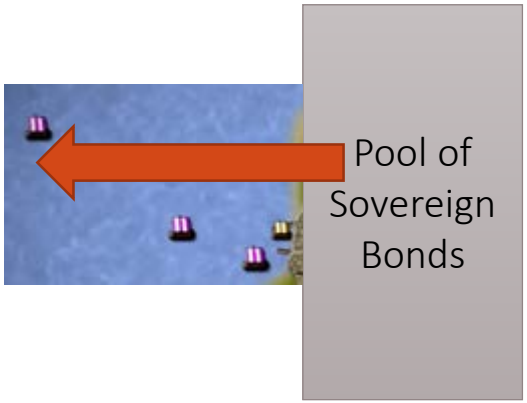
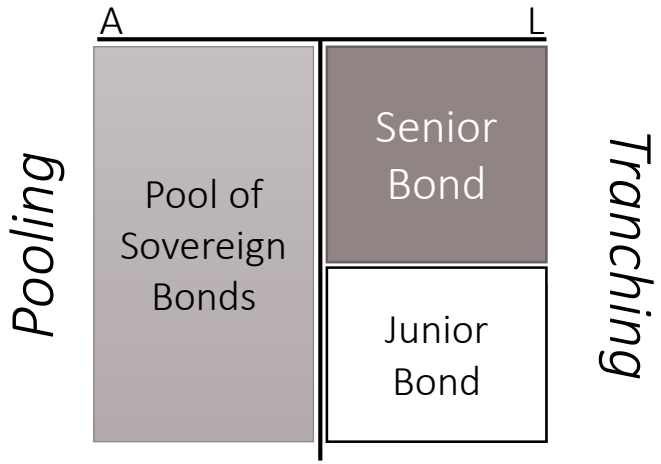


# 2. Approach: “Rechanneling”

- Address root cause: Safe asset is supplied asymmetrically

- Create globally supplied safe asset via pooling & tranching



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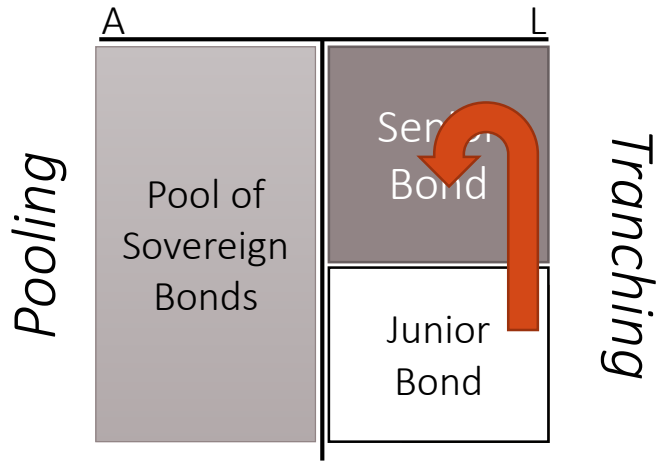



*Rechannel:*
Instead of cross-border
Across asset classes

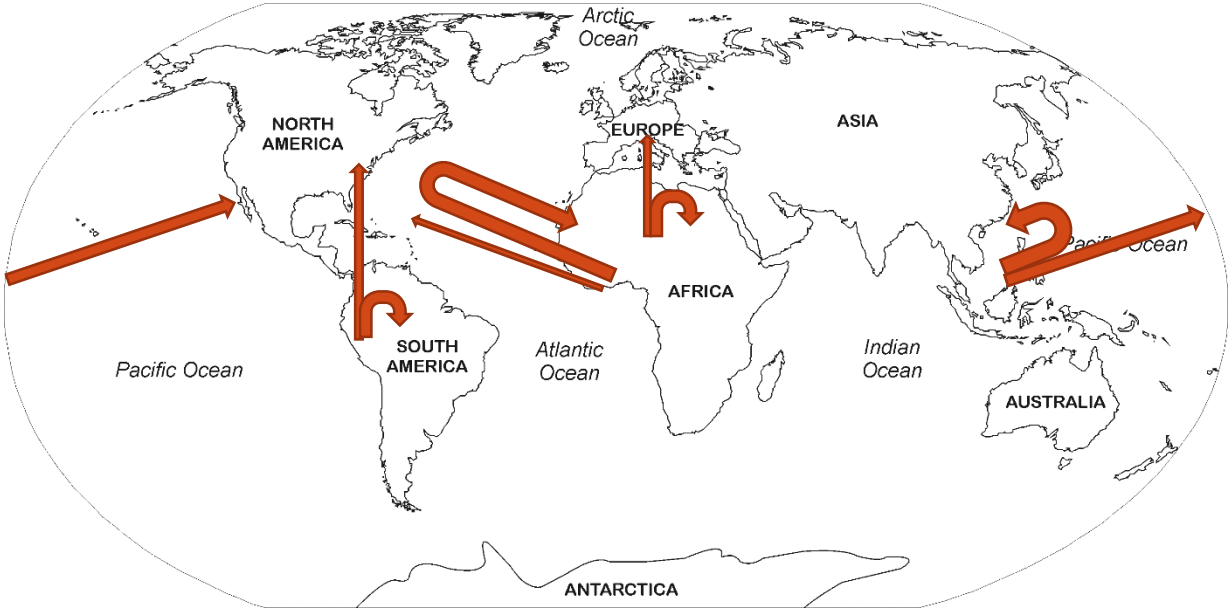
- Expand ESBies idea for euro area to EME:
  “SBBS (Sovereign-Bond Backed Securities) for the world”
  Euro-nomics group 2011, 2016, 2017

# International: Flight to Safety

- Risk-on, Risk-off  Flight to safe asset

- Channels back some of flight-to-safety capital flows

  ➡ fewer cross-border capital flows

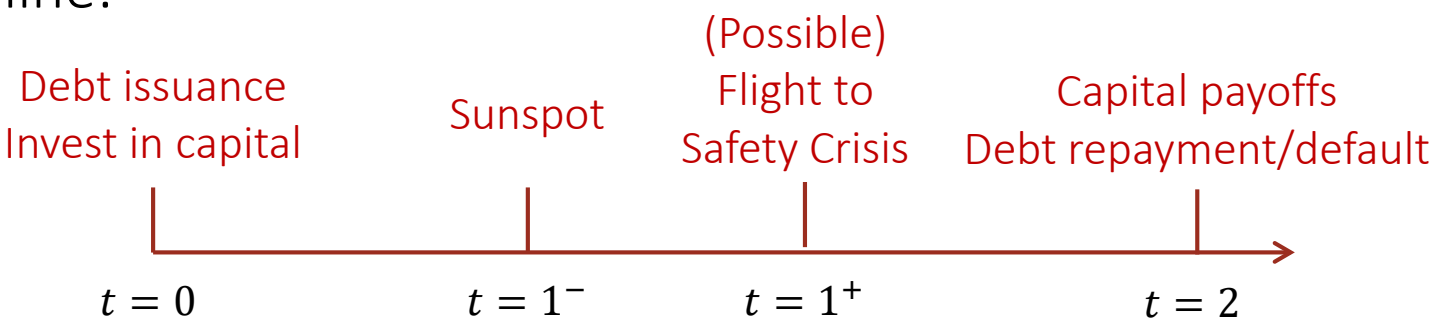


# RoadMap

- Motivation
  - International: Flight to Safety
- Model Setup
  - Ilustration
  - More detail
- Policy Analysis
  - Foreign Reserves: Buffering Approach
  - Tranching: Rechanneling Approach
- Global Safe Asset *from & for* Emerging Market Economies

# Model Setup

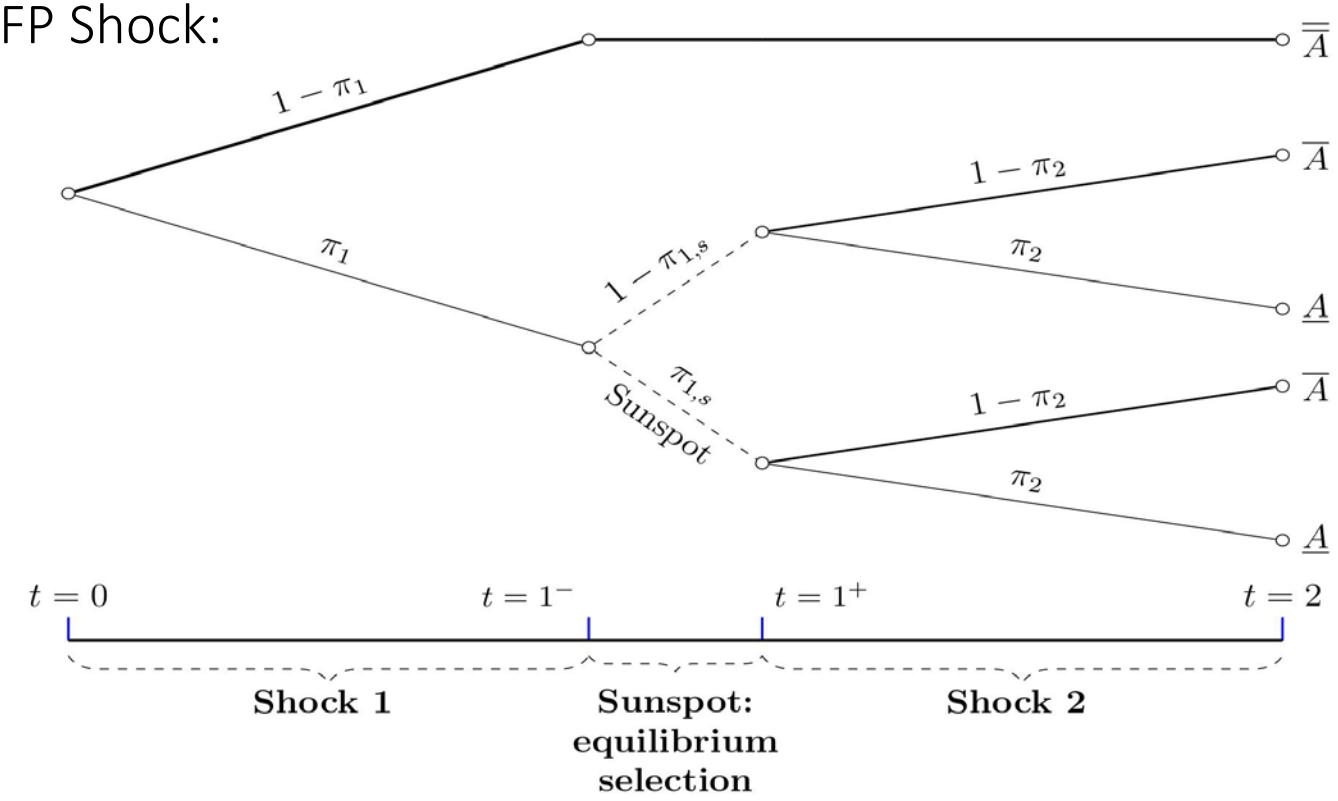
- 3 Dates: t = 0,1,2
- Agents: entrepreneurs, households and foreigners
- Assets: Productive capital, domestic bonds and dollars
- Timeline:




More Detail

# Assets

- Capital:
  - Only entrepreneurs can invest at $t = 0$
  - Output only at $t = 2$:
    - Entrepreneurs: $y_2^E = \tilde{A}K_1^E$; Foreigners: $y_2 = \eta\tilde{A}K_1^*$ $(\eta < 1)$
  - From $t = 1$, capital can be traded among agents, price $q_t$
  - TFP Shock:



# Assets con't

- Domestic Bonds:
  - The government issues zero coupon bonds at $t = 0$
  - Mature at $t = 2$ with a total face value $B_0$
  - Traded at $t = 0,1$ at price $p_t$
  - The government can repay up to a maximal lump-sum tax

$$T_2 = \tau \tilde{A} K_1^E$$

i.e., $Repayment = \max\{B_0, T_2\}$

  - Is perceived "safe" when bonds are not expected to be default
- Dollars/ Treasuries:
  - Outside storage technology offers return $R^{\$}$ per period
  - Low risk-free yield

# Agents

- Domestic Entrepreneurs
  - Risk-neutral preferences:
    $$\max \mathrm{E}_0[C_0 + \beta C_1 + \beta^2 C_2]$$
  - The only agent that can invest in capital at $t = 0$
  - (Exogenous) Safe asset demand/constraint :
    $$S_t^E \geq \beta^{2-t} \alpha K_t^E$$
  - Possible safe assets:
    - dollars, domestic bonds when they are nearly default free
  - Prefer to invest minimal dollars: $\frac{1}{R^\$} > \beta$
  - Low Initial wealth $W_0^E$, not enough to buy all domestic bonds

# Agents con't

- Domestic households
  - The same preference as entrepreneurs
  - Can not hold capitals
  - Initial wealth $W_0^H$, buys the rest of domestic bonds at $t = 0$
- Foreigners
  - Similar preference: $\max \mathrm{E}_0[C_0 + \beta^* C_1 + \beta^{*2} C_2]$
  - Less patient than entrepreneurs: $\frac{1}{R^\$} > \beta > \beta^*$
- Additionally:
  - For simplicity, crisis is unanticipated at $t = 0$
  - Debt-capital ratio $d = \frac{B_0}{K_0}$ , $b^E = \frac{B_0^E}{K_0}$, $b^H = \frac{B_0^H}{K_0}$

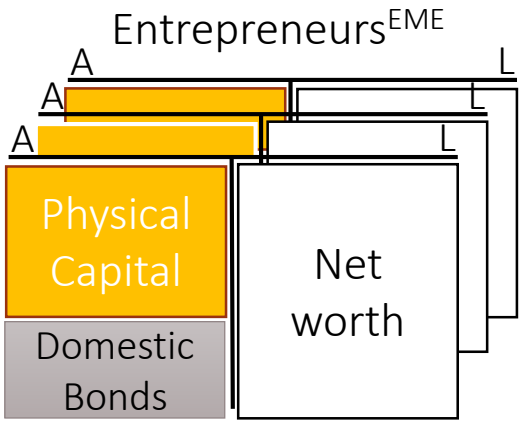
$$d = b^E + b^H$$

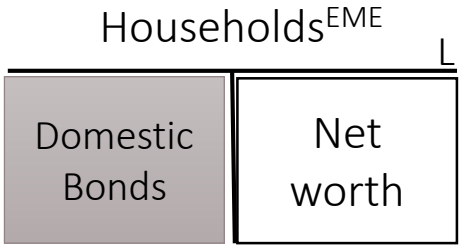
# Equilibrium at $t = 0$

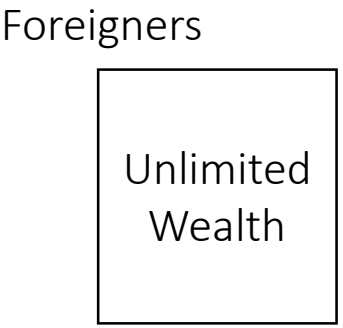
- Entrepreneurs:
  - For sufficiently high $\tilde{A}$ , prefer

Capital > Domestic bonds > consumption > dollars

  - Hold domestic bonds for safe asset constraint: $b^E = \frac{B_0^E}{K_0} = \alpha$
- Households:
  - Buy all residual bonds supply
  - Indifferent between consumption and bonds: $p_0 = \beta^2, b^H = d - \alpha$
- Foreigners:
  - Holding nothing due to impatience (low valuation)
- Equilibrium going forward depends on realization of TFP shock

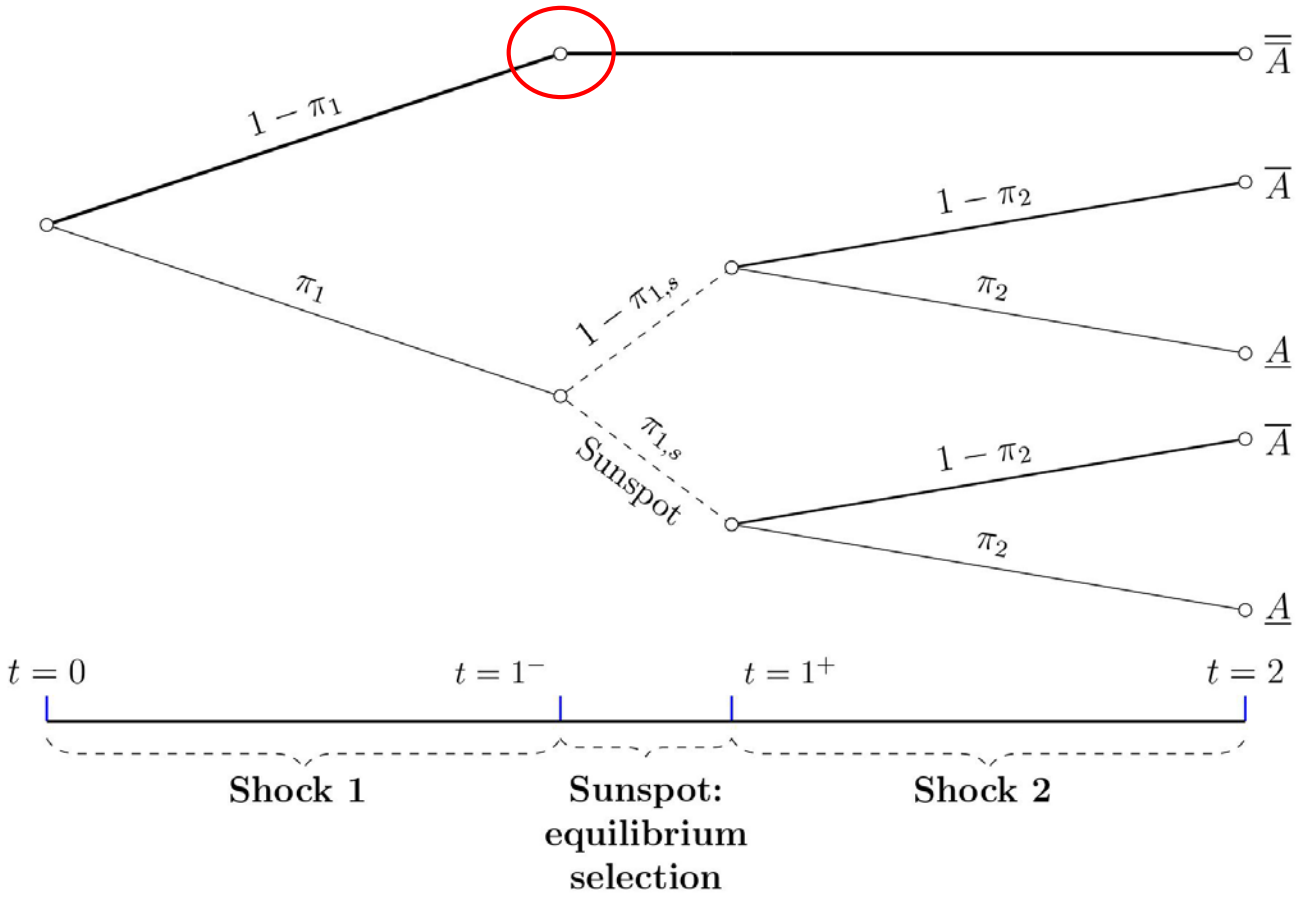


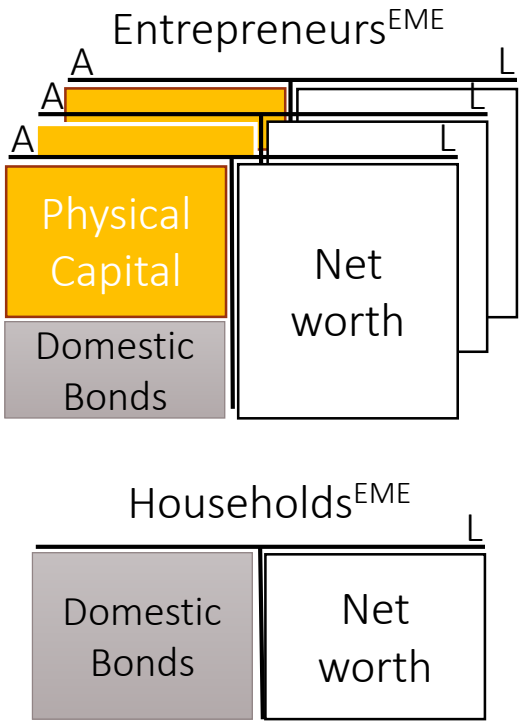
# Equilibrium at $t = 1$

- Three possibilities:
  - $\bar{\bar{A}}$ subgame equilibrium:
    - Fundamental is strong, no crisis



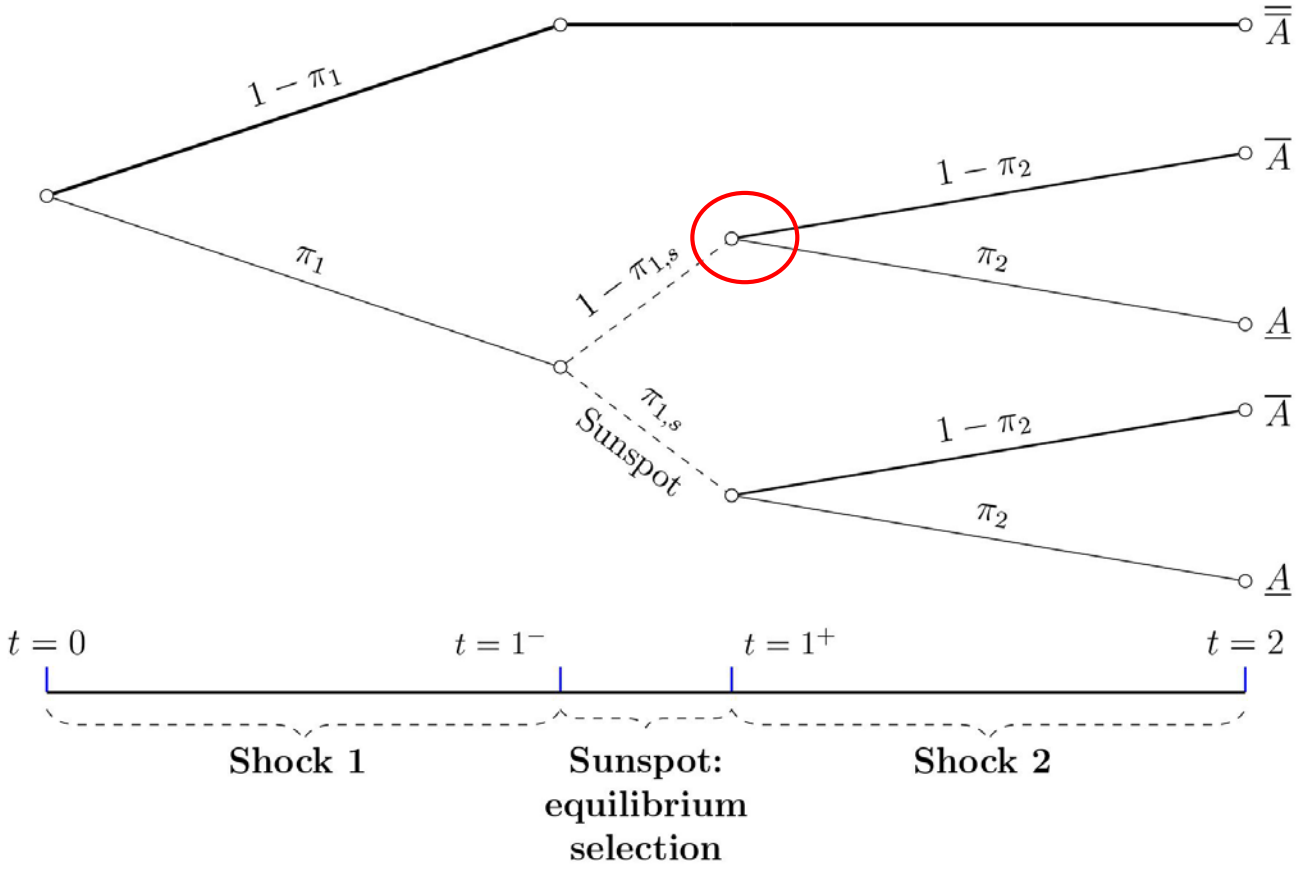
# $\bar{\bar{A}}$ subgame equilibrium at $t = 1$

- Similar to equilibrium at $t = 0$
- Strong fundamental ($\bar{\bar{A}}$) guarantees government repayment
- Asset positions unchanged
- Asset price changes due to time discounting:
  - $q_{1,u} = \beta \bar{\bar{A}}$ , $p_{1,u} = \beta$



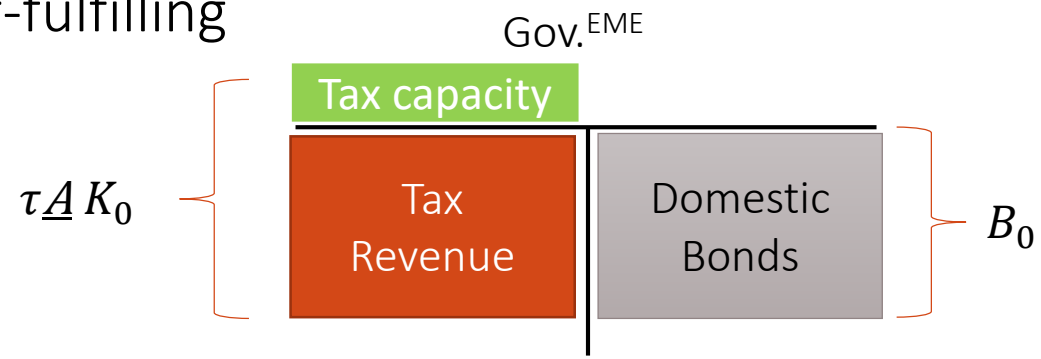
# Equilibrium at $t = 1$

- Three possibilities:
  - Fundamental $\mathrm{E}_1\bar{A}$ equilibrium:
    - Weak fundamental, but no sunspot triggers crisis

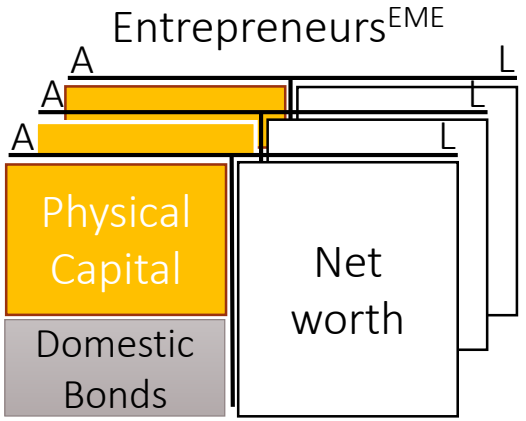


# Fundamental $\mathrm{E}_1[\bar{A}]$-equilibrium at $t = 1$

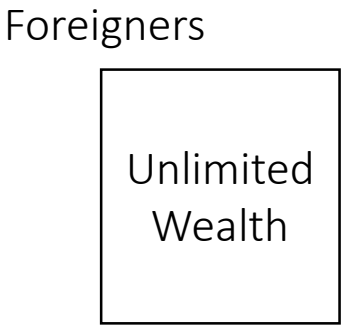
- Similar to equilibrium at $t = 0$
- Weak fundamental ($\bar{\bar{A}}$) but market confidence makes government repayment self-fulfilling




- Asset positions unchanged
- Asset price changes due to time discounting:
  - $q_{1,f} = \beta \mathrm{E}_1[\bar{A}], p_{1,f} = \beta$

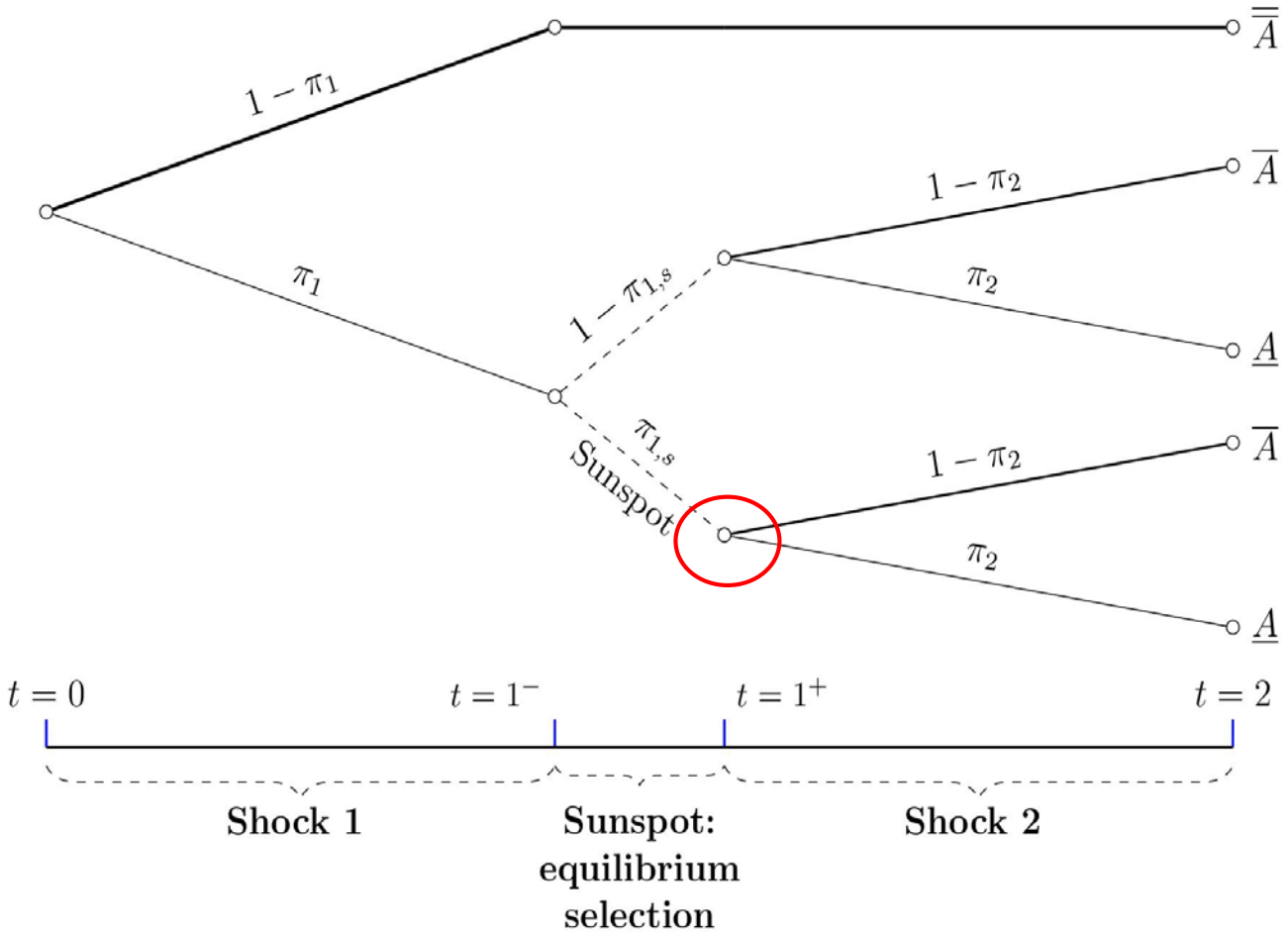






# Equilibrium at $t = 1$

- Three possibilities:
  - Flight-to-Safety equilibrium:
    - Weak fundamental, sunspot triggers crisis



# Flight-to-Safety equilibrium at $t = 1$

- Flight to Safety:
  - Entrepreneurs seek dollars
  - Sell capital and bonds to foreigners at discounted price

$$q_{1,s} = \underbrace{\beta^*}_{\text{Impatience}} \quad \underbrace{\eta}_{\text{Inefficiency}} \quad \mathrm{E}_1[\tilde{A}] < q_{1,f}\mathrm{E}_1[\tilde{A}],$$

$$p_{1,s} = \beta^*(1 - \pi_2 \quad \underbrace{h}_{\text{haircut}} \quad )$$

  - Entrepreneurs hold capital

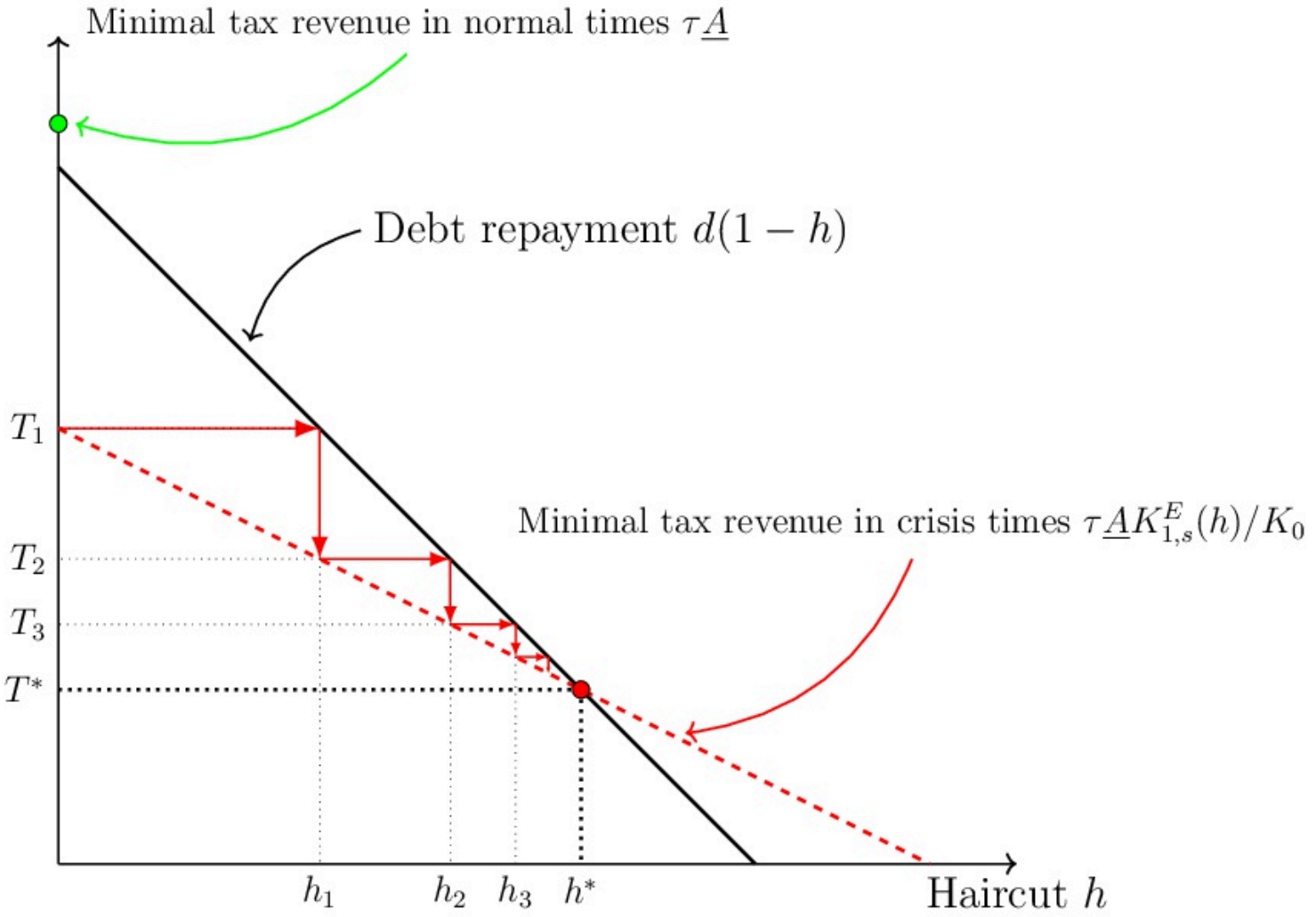
$$K_{1,s}^E = \frac{q_{1,s}K_0 + p_{1,s}B_0^E}{q_{1,s} + \alpha\beta} = \frac{\beta^*\eta E_1[\tilde{A}] + \beta^*(1-\pi_2 h)b^E}{\beta^*\eta E_1[\tilde{A}] + \alpha\beta} K_0 = K_{1,s}^E(h)$$

- Self-fulfilling default:
  - Assume default happens only if $\underline{A}$ realizes (No default for $\overline{A}$)
  - Endogenous debt haircut:

$$B_0(1-h) = \tau\, \underline{A}\, K_{1,s}^E \leftrightarrow d(1-h) = \tau \underline{A} \frac{K_{1,s}^E(h)}{K_0}$$

  - Crisis existence condition: $h > 0$
  - In Fundamental $\mathrm{E}_1[\bar{A}]$ equilibrium: $d < \tau\, \underline{A}$

# Self-fulfilling Debt Crisis



# Crisis vulnerability and Severity

- Let $x$ be the policy parameter
- Crisis vulnerability:
  - The area of $d$ (indebtedness) where a flight-to-safety crisis exists
  - Intuition: For sufficiently low $d$, implied $h(d) < 0$
  - In the baseline model:

$$V^B(x) = [\max\{\alpha, \underline{d}^b\}, \tau\underline{A}\,],$$

$\underline{d}^b$ solves $h(\underline{d}^b) = 0$

- Crisis Severity:
  - The fraction of capital fire sold in a crisis
  - Output loss is linear in this measure
  - In the baseline model:

$$S^B(x) = \max\{0, \frac{\beta^*\eta E_1[\tilde{A}] + (1-\pi_2)\beta^*\alpha}{\beta^*\eta E_1[\tilde{A}] + \beta\alpha - \tau\underline{A}\beta^*\pi_2\frac{\alpha}{d}}\}$$

- Later analyze how policies affect these measure

# RoadMap

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  - More detail
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  - Tranching: Rechanneling Approach
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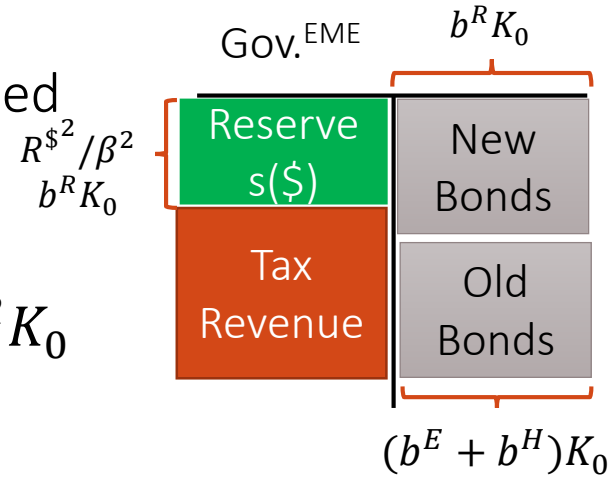
# Foreign Reserves

- Implementation:
  - The gov can issue additional bonds (purchased by households) for purchasing reserves
  - Face value of additional bonds: $b^R K_0$
  - Since $p_0 = 1/\beta^2$, reserves worth $R^{\$^2}/\beta^2 b^R K_0$




- Benefit-cost analysis:
  - Given debt hair cut $h^R$,

$$\frac{R^{\$^2}}{\beta^2} b^R K_0 - (1 - h^R) b^R K_0 =$$

$$\underbrace{\left(\frac{R^{\$^2}}{\beta^2} - 1\right) b^R K_0}_{\text{negative carry}} + \underbrace{h^R b^R K_0}_{\text{debt forgiveness}}$$

# Equilibrium

- Subgame equilibriums without crisis is similar

- Focus on flight-to-safety crisis with reserves
  - Fire-sale of capital the same as in baseline

$$K_{1,s}^{E} = \frac{q_{1,s}K_0 + p_{1,s}B_0^E}{q_{1,s}+\alpha\beta} = \frac{\beta^*\eta E_1[\tilde{A}] + \beta^*(1-\pi_2 h^R)b^E}{\beta^*\eta E_1[\tilde{A}]+\alpha\beta} K_0 = K_{1,s}^{E}(h^R)$$

  - Endogenous haircut $h^R$:

$$(b^e + b^h)(1-h^R) + b^R(1-h^R) = \tau \underline{A} \frac{K_{1,s}^{E}(h)}{K_0} + b^R(\beta^2 R^{\$^2})$$

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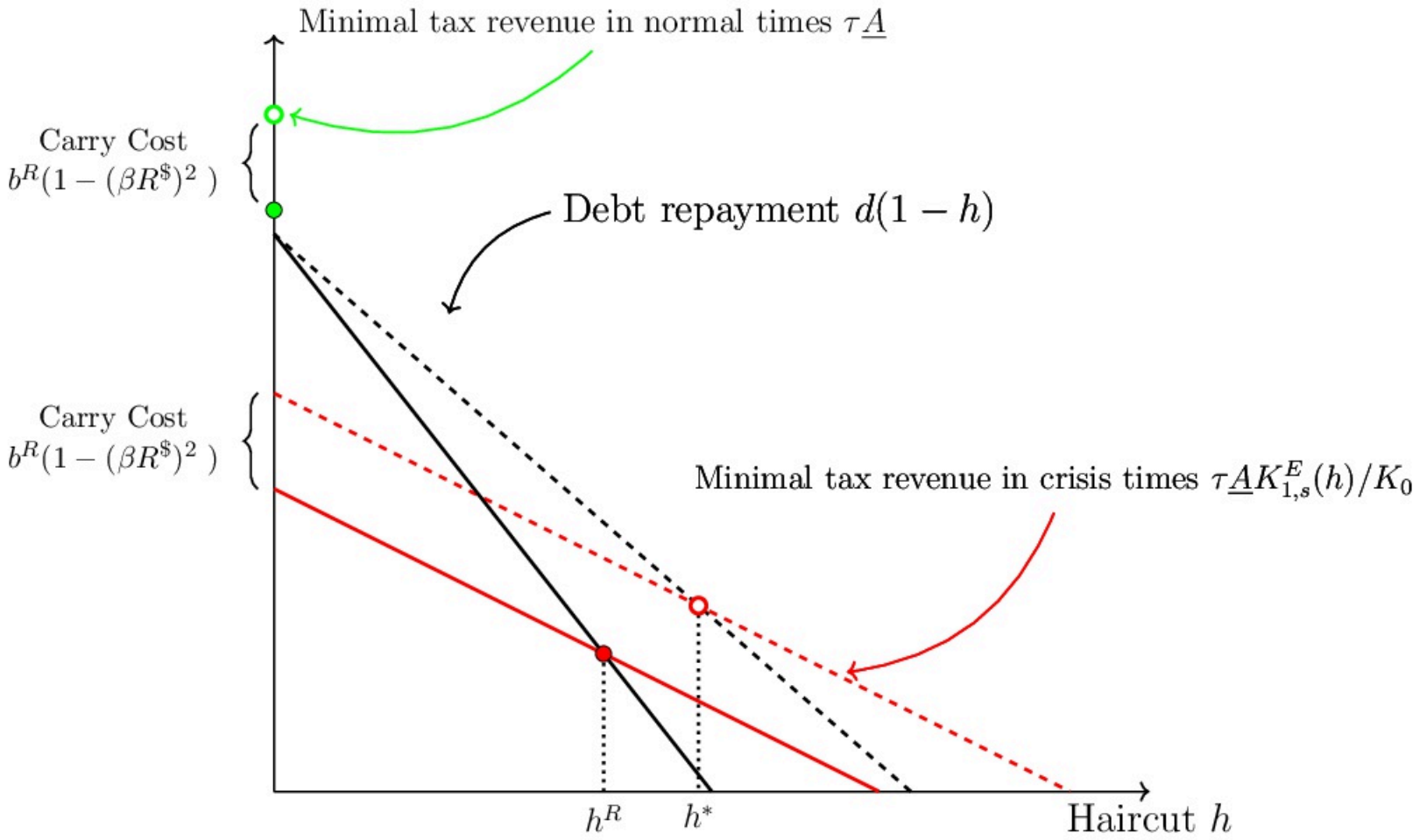
  - Endogenous haircut $h^R$:

$$(b^e + b^h)(1-h^R) + \underbrace{b^R(1-h^R)}_{\text{New Debt Repayment}} = \tau \underline{A} \frac{K_{1,s}^{E}(h)}{K_0} + \underbrace{b^R(\beta^2 R^{\$^2})}_{\text{Reserves}}$$

  - Crisis existence condition: $h^R > 0$

# Self-fulfilling Debt Crisis (With Reserves)



# Crisis vulnerability and Severity (With Reserves)

- $b^R$ is the policy parameter here
- Crisis vulnerability:
  - Compare to baseline:

$$V^R(b^R) \supset V^B$$

  - Intuition: At $h^R = 0$, no debt forgiveness but negative carry

- Crisis Severity:
  - Compare to baseline:

$$S^R(b^R) \leq S^B \Leftrightarrow h^R \geq 1 - \left(\beta R^{\$}\right)^2 \Leftrightarrow h \geq 1 - \left(\beta R^{\$}\right)^2$$

  - Intuition: If crisis is severe enough, debt forgiveness creates gain that exceeds negative carry

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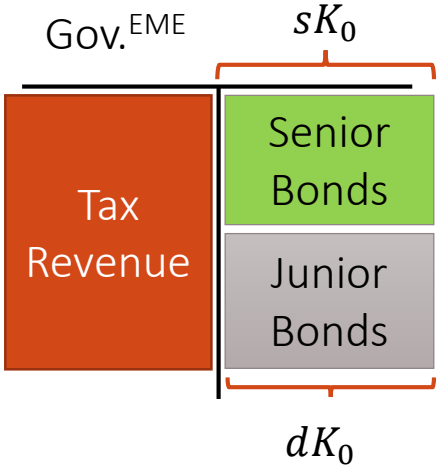
# Tranching

- Implementation:
  - Set up a SPV that purchases government bonds and issues a senior and junior bond.
  - Default loss is first absorbed by junior bonds
  - Total face value of senior bonds:$sK_0 < dK_0$
  - Assume $s > \alpha$, entrepreneurs are fully protected
  - Notations: $b^{S,E}, b^{S,H}, b^{J,E}, b^{J,H}$




- Benefit-cost analysis:
  - No cost within the model
  - Senior bonds are less likely to lose safe-asset-status
  - Owners of senior bonds (E) recover larger value even in defaults

# Equilibrium

- Subgame equilibriums without crisis is similar
  - At $t = 0$, junior bonds and senior bonds are perfect substitutes
  - Assume entrepreneurs slightly prefer senior bonds
- Focus on flight-to-safety crisis here
  - Senior bonds haircut $h^S > 0 \Leftrightarrow h^J = 1$(Junior bonds wiped out)
  - Fire-sale of capital the same as in baseline

$$K_{1,s}^E = \frac{q_{1,s}K_0 + p_{1,s}^S B_0^{S,E}}{q_{1,s}+\alpha\beta} = \frac{\beta^*\eta E_1[\tilde{A}] + \beta^*(1-\pi_2 h^S)b^{S,E}}{\beta^*\eta E_1[\tilde{A}]+\alpha\beta} K_0 = K_{1,s}^E(h^S)$$

  - Endogenous haircut $h^S$:

Baseline: $$(b^E + b^H)(1-h) = d(1-h) = \tau \underline{A} \frac{K_{1,s}^E(h)}{K_0}$$

  - Crisis existence condition: $h^S > 0$

# Equilibrium

- Subgame equilibriums without crisis is similar
  - At $t = 0$, junior bonds and senior bonds are perfect substitutes
  - Assume entrepreneurs slightly prefer senior bonds
- Focus on flight-to-safety crisis here
  - Senior bonds haircut $h^S > 0 \Leftrightarrow h^J = 1$(Junior bonds wiped out)
  - Fire-sale of capital the same as in baseline

$$K_{1,s}^E = \frac{q_{1,s}K_0 + p_{1,s}^S B_0^{S,E}}{q_{1,s}+\alpha\beta} = \frac{\beta^*\eta E_1[\tilde{A}] + \beta^*(1-\pi_2 h^S)b^{S,E}}{\beta^*\eta E_1[\tilde{A}]+\alpha\beta} K_0 = K_{1,s}^E(h^S)$$

  - Endogenous haircut $h^S$:

    Tranching: $(b^{S,E}+b^{S,H})(1-h^S) = s(1-h^s) = \tau \underline{A} \frac{K_{1,s}^E(h^S)}{K_0}$

    - $h^S$ can be solved from baseline model assume $d = s$
  - Crisis existence condition: $h^S > 0$
    - Tranching is equivalent to eliminate $d - s$ debt burden in crisis

# Crisis vulnerability and Severity (With Tranching)

- $s$ is the policy parameter here
  - But $\alpha \leq s \leq d$
- Crisis vulnerability:
  - Compare to baseline:

$$V^T(s) = V^B|_{d=s} \subset V^B$$

- Crisis Severity:
  - Compare to baseline:

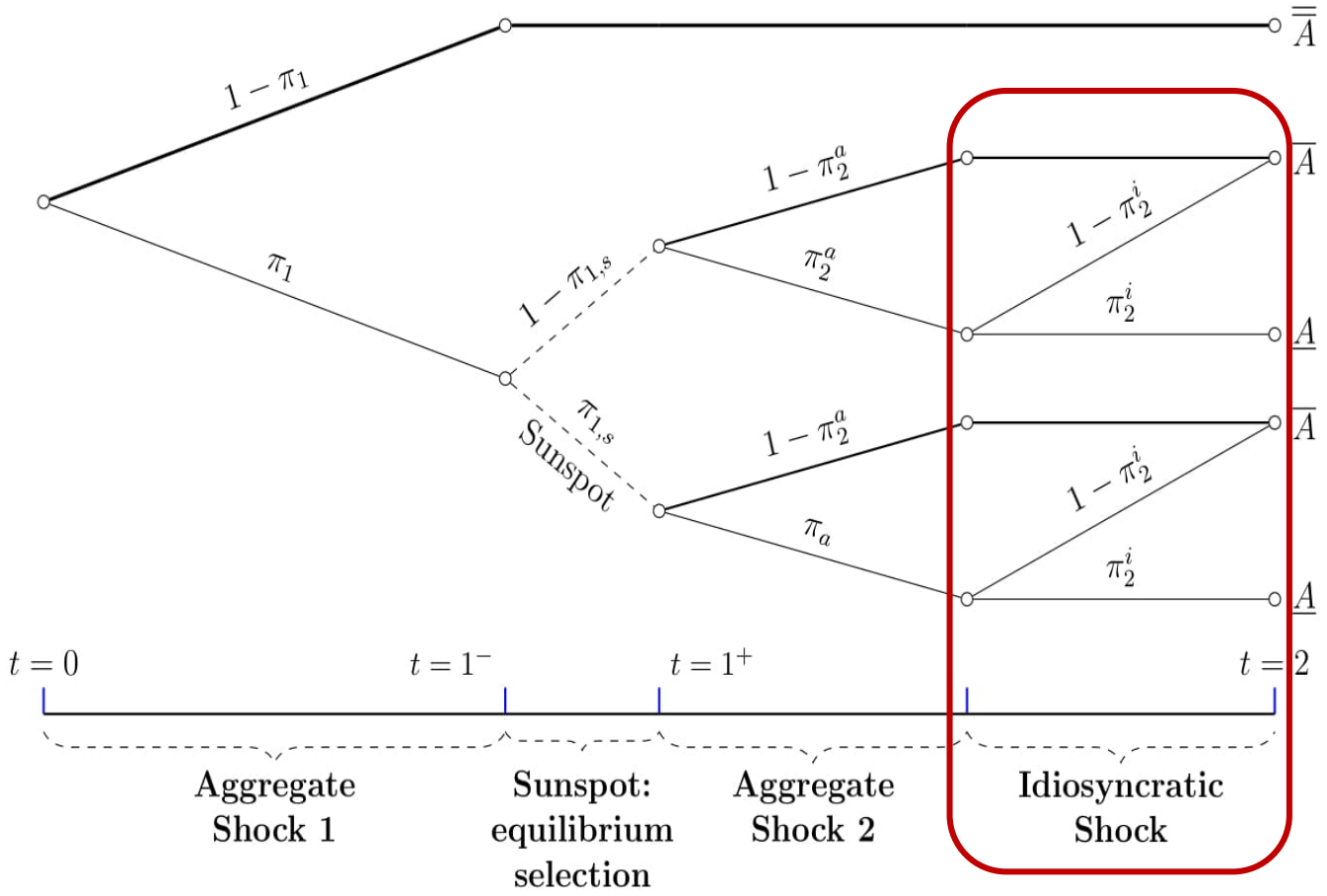
$$S^T(s) = S^B|_{d=s} \leq S^B$$

# RoadMap

- Motivation
  - International: Flight to Safety
- Model Setup
  - Illustration
  - More detail
- Policy Analysis
  - Foreign Reserves: Buffering Approach
  - Tranching: Rechanneling Approach
- Global Safe Asset *from & for* Emerging Market Economies

# Tranching and Pooling

- Tranching can be strengthened via diversifying local shock
  - generalize the model to a continuum of ex-ante identical countries
- Set up international SPV to implement *GloSBBies*



# Policy Analysis (Tranching & Pooling)

- $s$ (senior bonds/capital) is the policy parameter
  - But $\alpha \leq s \leq d$
- Crisis vulnerability:
  - Crisis exists iff

$$\underbrace{s}_{\text{Issued safe asset}} > (1-\pi_2^i) \underbrace{d}_{\text{repyment of default free country}} + \pi_2^i \underbrace{d^B}_{\text{repyment of defaulted country}}$$

  - For national tranching, crisis exists iff

$$s > d^B$$

- Crisis Severity:
  - Compare to national tranching:

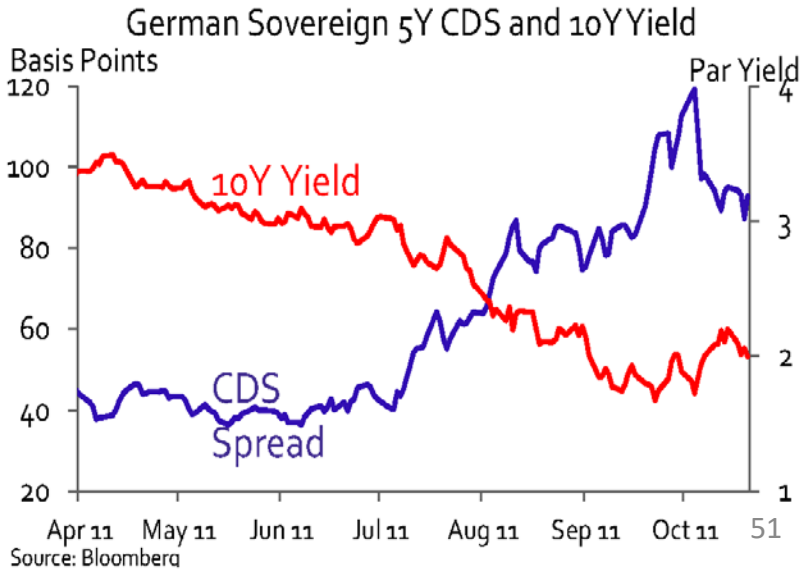
$$S^{GloSBies}(s) < S^T(s) = S^B|_{d=s} \leq S^B$$

# Conclusion

- High Debt Level
  - Domestic Challenge: Central Bank independence
  - International Challenge: Flight-to-Safety
- Global Financial Architecture
  - Buffer approach: interventionistic
    - Reserve holding: costly due to cost of carry & distortionary
    - IMF support: very limited
    - Swap lines: Limited (not all IMF member countries)
  - Rechanneling approach: self-stabilizing (autonomous)
- Tranching completes the market
  - Allows catering to investors groups with different risk attitudes
  - Makes EME less crisis prone
- International pooling and tranching
  - SBBS/ESBies for the world
  - Expands IMF's fire power

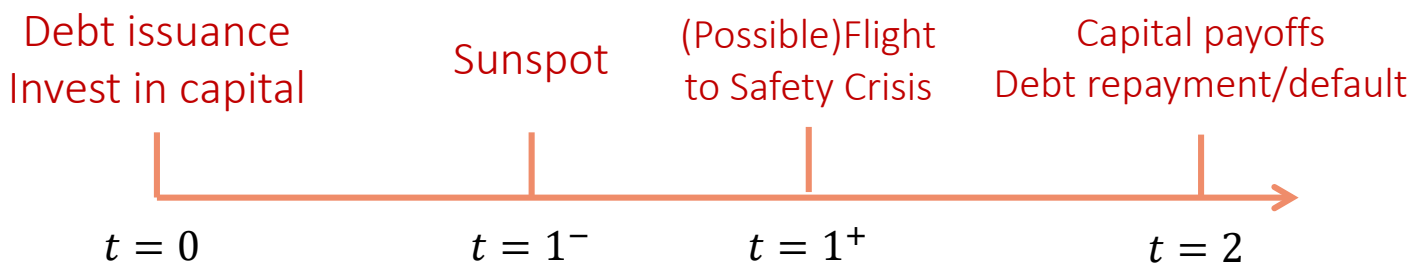
# Extra Slide: Safe assets

- "Good friend analogy" - like reserve assets
  - Safe/available at any horizon - "when it counts"
  - Precautionary buffer
    - held in addition to more risky assets
    - Risk ↑ ⇒ demand for safe assets ↑
- "Safe asset tautology"
  - Safe because it is "perceived to be safe"
  - Safe independent of fundamentals
    - US Treasuries downgrade by S&P in 2011 ⇒ yield ↓
    - German CDS spread ↑ ⇒ yield ↓ during Euro crisis
  - Multiple equilibria
  - Bubble



# Model Setup

- Three Dates: t = 0,1,2
- Time 0:
  - The government issues bonds maturing in date 2
  - Domestic agents invest capital and buy domestic bonds
- Time 1:
  - Potential flight-to-safety crisis
  - Capital and domestic bonds are fire sold to foreigners
- Time 2:
  - Capital produces output
  - The government partially defaults if tax revenue < maturing bonds

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