3 Questions: Ricardo Caballero on the search for safe investments

October 25 2011, by Peter Dizikes

What caused the financial crisis of 2008? MIT economist Ricardo Caballero has posited that a key structural factor was a massive global imbalance between the demand for safe investments, especially bonds, and the supply of safe places to put new capital.

Because this “insatiable demand for safe debt instruments,” as Caballero has called it, was not wholly absorbed by the traditional safe haven of U.S. Treasury notes, it helped spur the growth of the mortgage-backed bond market. But these bonds, backed by subprime loans, turned out to

be unsafe despite their AAA ratings, exploding en masse. Financial markets are still feeling the aftereffects.

As a solution to this imbalance, Caballero — an expert on global capital markets, financial panics and risk who is among the 100 most-cited economists worldwide — has proposed the idea of government-issued investment insurance meant to help spur financial activity. Without such policies, he has warned, we could see the "recurrent emergence of bubbles," as capital chases emerging investment areas.

MIT News recently queried Caballero, MIT's Ford International Professor of Economics, Macroeconomics and International Finance, about the shortage of safe investments.

Q. In recent months, the fiscal crisis in Europe has intensified and core European countries such as France are now at risk of having their credit ratings downgraded. What is the status today of this global imbalance between the demand for, and the supply of, safe investments?

A. Worse than ever. People do not realize how many odd things are happening as a result of this shortage. The most recent one is a sharp decline in the currencies of emerging market economies, following the peg (floor) set for the Swiss Franc against the Euro. All of a sudden, one of the key safe assets in currency markets disappeared, and now holding emerging-market currencies became much riskier, as a natural hedge is no longer available. As the safe assets' relative supply shrinks, investors become less willing to invest in riskier assets, banks become more reluctant to lend and so on.

Q. In the mortgage-backed bond market, when the economy dipped, whole classes of securities blew up. Given this problem, why is an insurance-based solution your preferred policy choice, and how would it function?

A. Unfortunately, we may be beyond that point. I proposed that governments provide, for a fee, guarantees to banks against extreme macroeconomic risk so that banks could go back to the production of safe microeconomic assets — which they can generate through mortgages, loans and other growth-enhancing activities — without having to absorb macroeconomic risk, which is too capital-consuming. These types of measures are politically unfeasible at this time, so we will have to continue muddling through.

Q. What do you think of other ideas that might address the problem? For example, wouldn't the proposed issuance of joint Euro-bonds, backed by the whole European Union, provide a new source of safer debt for investors?

A. It would, but this would effectively mean a transfer of German collateral to periphery countries. Germany could certainly issue more Bunds [their bonds] since they have plenty of credibility to do so. But I don't think safe-asset production per se is an argument to justify these transfers. I suspect a better way to do it is to have the European Central Bank (ECB) provide some guarantees for marginal countries' debt, either directly or indirectly. I have in mind Spain or Italy, not Greece, which is clearly bankrupt and not the business of the ECB.

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