

Paper 2: The New Triffin Dilemma

Author and presenter: Ann Davis, Marist College (URPE member)

Email of presenting author: Ann.Davis@marist.edu

ABSTRACT

According to Pozsar (2011), there is a new kind of "Triffin Dilemma." Due to rising inequality, a shrinking numbers of large banks, and a ceiling on FDIC insured deposits, there is a shortage of "safe assets" (Caballero 2010; Gorton 2016). The private supply of safe assets has occurred through the system of "shadow banks," and is based on repos, or Treasury Bonds. But the supply of US Treasury bonds is limited by the ceiling on public debt, and is constrained by neoliberal theories of limits to the size of government.

As a result, there is a presumed shortage of "safe assets," just when the levels of inequality have increased the order of magnitude of "assets under management" which are in need of protection. There are also large accumulations of cash pools by large multinational corporations, often held overseas to evade taxes. The private provision of safe assets tends to reduce liquidity and increase costs of information, potentially leading to financial instability.

Possible resolutions of this issue include 1) progressive taxes to reduce the size of the cash pools, 2) an increase in the ceiling for insured deposits, and 3) increasing support by the Fed for the role of "market-maker of last resort" (Mehrling 2010). This paper will conclude with the implications of each alternative.

JEL Code:

Key words

I. Money

Money is a social institution that is poorly understood. The pragmatic focus is on the “cash in hand,” as if that cash were a discreet object, while it actually has no meaning outside a social context. This pragmatic view of money is like focusing on the single neuron but forgetting the brain in which it is contained and interconnected (Seung 2012).

Theories of money are multiple and evolve over time (Brine and Poovey 2017), with no consensus at present (see other recent discussions, including Peacock 2017; Searle 2017; Lawson 2016; Deakin 2017). The study of the economic history of money can reveal the importance of the term itself, the institutions in which it is embedded, and the expertise which describes, explains, and rationalizes its function. In this sense, the study of money is accessible to the method of historical institutionalism (Davis 2015). Rather than viewing money as a convenient technology for managing time (Goetzmann 2016), the position here is that money is a social institution, subject to historical evolution, with multiple pressures, directions, and outcomes at stake.

By contrast, conventional economic theory describes money by its three most important functions, a means of payment, unit of account, and store of value. This approach provides a working definition, but forgets the people who enact those functions, a form of reification. The focus is on the object itself, even if there is no concrete object as in the case of electronic money, as if the characteristics of the object were of primary importance. This is typical of “commodity” theories of money. Alternative views, such as “endogenous” or credit theories of money, describe how money is generated within the economy itself. But again the focus is on the money itself instead of the institutional structures, relationships, and the associated expertise.

The view here is that money is a specific institution within a socio-economic system (Davis 2017a). It is generally understood that money is “conventional,” that the value of money depends on beliefs among the general public that it is valuable. In this sense, money is “performative” (Krippner 2017, 247-248; Brine and Poovey 2017, 324, 439, 441), a characteristic for which the meanings understood by the public determine how it is used, and vice versa. For example, a public backstop is often associated with safety of an asset, until the realization that nation states have fiscal limits as well, often in the context of a financial crisis. In fact, public assets, considered “safe,” have had lower and more volatile returns historically than private assets (Jorda et.al. 2017).

Money is paradoxical, in some ways (Davis 2017a). The goal of the financial circuit, $M - C - M$, is simply more money. This is an empty tautology without also understanding that this circuit is a source of discipline and control, regulating work as well as corporate performance by the simply metric of the “bottom line.” While the functions of money involve movement, such as means of payment in Smith’s “great wheel of circulation” (Smith 1994, 314-322), the store of

value function may involve hoarding, sudden stops, or “traps” (Caballero, Farhi, and Gourinchas 2017, 34-35, 42-43). Keynes understood the returns to money as involving liquidity, while also understanding that there is no such thing as “liquidity” for the economy as a whole (Keynes 1964, 151-155, 167-174). Further, the liquidity of various assets can ultimately involve “liquidation,” or asset sales, which may reduce the value of the asset category as a whole, setting off contagion. As Marx made clear, money must retain its value over the circuit, but the shortened circuit of $M - M'$ does not create value. The appearance of money’s capacity for automatic self-expansion value is a “fetish” (Davis 2017b).

Within the historical institutional framework, this paper will proceed by examining the notion of “safe assets,” and the dilemma posed by the presumed shortage of safe assets. Beginning with a working definition, followed by a description of the financial institutional structures, the dilemma will be explored as an expression of the contradictions among various views of money. We will conclude with an analysis of the connections between the pragmatic conventional view of money, its operation, and feasible policy alternatives. That is, recommendations are conceptions within the existing paradigm, both political and ideological. Within alternative paradigms, new possibilities for institutions and policies emerge.

II. Definition of Safe Assets

From a historical institutional approach, there is a long institutional evolution of the treatment of public debt as a safe asset, beginning in the Italian city-states of the fifteenth century and the “financial revolution” in England in the early eighteenth century. The collective nature of this debt, pooling risk and representing strong public commitment, was an important determinant of its safety. Later private business corporations enabled the pledging of capital to a collective project, with some ownership rights to supervise management, and liquidity to reduce risk through diversification in secondary markets. With the shift from trade to production, nation states internalized the function of public finance and focused more on leveraging the future (Boldizzoni 2017). The typical nation state shifted from hereditary monarchy to the form of the “liberal state,” creating a sovereign currency, intentionally issuing and managing public debt and allocating public credit to increase military capacity and extension of markets. Markets became “free,” and individuals more mobile, in pursuit of the “wealth of nations.”

By contrast, the pragmatic approach to money, which is typical of mainstream economics, is evident in a recent discussion of safe assets, which are defined by their function.

A safe asset is a simple debt instrument that is expected to preserve its value during adverse systemic events...This operational definition captures the ‘information insensitivity’...[and] an essential strategic complementarity: an asset is safe if others expect it to be safe” (Caballero, Farhi, and Gourishchas 2017, 29-30).

The authors proceed to explain that safe assets are “produced” by the financial sector (private) and the government (public) (See the list of safe assets in Caballero, Farhi, and Gourishchas 2017, 32). Advanced countries have greater capacity to produce safe assets, in their account,

because they have enhanced financial development, fiscal capacity, and a reputation for exchange rate and price stability. The growing demand for safe assets is from emerging countries, who have faster growth rates and higher saving rates (Caballero, Farhi, and Gourishchas 2017, 30). Because of this growing demand, the price of safe assets has increased, and the resulting falling interest rates are associated with Bernanke's "savings glut" hypothesis.

Other accounts (Pozsar 2011) attribute the increasing demand for safe assets to the rise in income inequality (Palma 2009), and to the increase in assets under management by large institutions such as pension funds, insurance companies, and money market funds. The resulting global economic stagnation is attributed to the zero lower bound of nominal interest rates (Caballero, Farhi, and Gourishchas 2017, 31, 34-35), rather than the lack of effective demand or the low anticipated rate of return to additional investment. Large cash pools are held by non-financial corporates like Apple, as well, due to high profit rates and lack of attractive investment opportunities, or a "profits glut" (Milberg and Winkler 2013). Such an investment shortfall could also be attributed to increasing concentration of markets globally, managed by oligopolies and state industrial policies.

III. Production of Safe Assets

There are several sources of safe assets. The public debt of advanced countries is the prime source, such as US Treasury bonds. There is a global market for US Treasury bonds, constituting one of the most liquid assets. The shortage of US Treasury bonds could be easily eliminated by the creation of more public debt, through fiscal policy, for example. This is an example of a new "Triffin Dilemma" (Pozsar 2011; Caballero, Farhi, Gourinchas 2017, 38-39), nonetheless, due to the avoidance of public debt and any increase in tax capacity that is typical of modern macroeconomics practice (Brine and Poovey 2017). The US public debt is considered "safe" in relative terms, compared with other financial assets, rather than based on any current ranking by rating agencies, or any prospect of government shutdown due to political gridlock in the US. Rather than "information insensitive," US public debt is considered safe by assumption, and by popular beliefs rather than informed analysis. The assumption that public debt is safer also conveniently forgets the history of national debt defaults, as well as the increasingly frequent global financial crises since the end of the Bretton Woods arrangement. The origin of the Great Recession in the leading capitalist country, presumably the "safest," undercuts the reliability of the public/private distinction.

Other sources of private safe assets are the financial sector. One reason for the shortage of safe assets is the ceiling on insured deposits by the Federal Deposit Insurance Corporation (FDIC), a product of the New Deal financial legislation. There is also a decline in the number of banks (Pozsar 2011, 8-9), while the assets under management have continued to increase (Kahle and Stulz 2017, 74-75). As a result, a "shadow banking" system has emerged, to provide additional safe assets. The structure of shadow banking is to lengthen the number of steps in the intermediation chain, with specialized institutions at each step. This process of specialization increases liquidity, but also fragility of the system as a whole (Adrian 2014).

With the advent of shadow banking, the size of the financial sector as a share of GDP has grown (Greenwood and Sharfstein 2017). These specialized institutions, such as brokerage firms, securities dealers, mutual funds, and structured investment vehicles (SIV), invest in long term liabilities based on short term assets.

Figure 1. here

There is frequent trading of short term assets, such as repurchase agreements (repos) and Asset Backed Commercial Paper (ABCP), to maintain liquidity (Copeland, Duffie, Martin, McLaughlin 2012). The repurchase agreement often uses the US Treasury bond as collateral, but the ability to fulfill the “repurchase” contract depends on the liquidity of the counterparties, which are highly leveraged (Adrian and Shin 2010). The collateral is often “rehypothecated” or pledged to several entities at once, with no equivalent of a reserve requirement (Pozsar and Singh 2011). The ABCP is issued by SIVs, often backed by large investment banks, but off-balance sheet, and risking unforeseen financial liabilities should the SIV itself require backstop (Covitz, Liang, and Suarez 2013).

The large size and highly diversified financial institutions were judged sufficient to stabilize financial markets, along with sophisticated theory and high powered information technology (Brine and Poovey 2017). This was the rationale for the progressive deregulation of the financial sector from the 1980s. While there were lower interest rates (or “haircuts” on repurchase agreements) based on quality of asset, even the large sophisticated institutions were subject to sudden loss of confidence during the financial crisis of 2008 (Krishnamurthy, Nagel, Orlov 2014, 2402, 2405-2409).

This shadow banking sector aimed to provide safe assets, while also the product of regulatory arbitrage (Covitz, Liang, and Suarez 2013, 815). That is, these institutions were created to evade capital requirements that are intended to increase safety. As such, the shadow banking sector is subject to sudden collapse of perceptions of “safety,” when short term securities are no longer liquid, and existing short term debts cannot be rolled over.

In summary, the private financial sector produces “safe assets” for profit, increasingly short term and leveraged, evading the regulatory oversight of the central bank, and consequently ever risking the margin of safety. The moral hazard of “too big to fail,” or the “Greenspan put” (Roubini and Mihm 2010), means that the growing size, profitability, and risk of the financial sector is at public expense.

IV. Multiple Dilemmas

Public finance is increasingly associated with the goal of stabilizing financial markets, and focused on providing safe assets for the accumulation of wealth, rather than financing public and private investment. The risks of this role of money as a store of value has been long noted, including by Keynes and Marx.

Once the safety of money is assured, with the presence of “riskfree” assets like Treasury bonds, there is less incentive to undertake the risk of actual real investment and production. Keynes advocated the “euthanasia of the rentier”, having foreseen the motive of wealth preservation, and the function of money as a store of value, instead of money as a tool for active investment. He also recommended progressive taxes and an increasing role for public investment (Keynes 1964, 221, 320-324, 376).

Marx foresaw the division between productive and financial capital (Davis 2017b), with the latter representing the interests of the capitalist class as a whole. The goal of accumulation is thwarted, nonetheless, by the misunderstanding of the origin of surplus, not from holding money, but from maintaining the continuous circular flow of money in the production of commodities. The desire to produce profit from money itself, $M - M'$, has led to increasing rate of turnover, increasing leverage, and the extension of financial markets into novel aspects of life and work. The expansion of the reach of financial markets, often called “financialization” (Krippner 2011; Lapavistas 2013), presumably reduces and redistributes risk. The system as whole, nonetheless, is built upon a false foundation, leading to claims of greed and fraud, rather than ideological blinders and misunderstanding the nature of money.

There is some recognition of the systemic “public good” nature of “issuance of safe assets,” with risk to fiscal capacity due to fiscal stimulus and coordination failure (Caballero, Farhi, Gourinchas 2017, 39). That is, fiscal stimulus is effective on the global level only if pursued by all countries at once. The mainstream discussions of “safe assets” still do not focus on the complex inter-relationships of the global financial markets, made more unstable by deregulation and global capital flows, or “hot money”. Rather, in the mainstream view, globalization presents more opportunity for the diversification of risk and arbitrage opportunities. The conception of money and markets as voluntary misses the drive to evade or “disintermediate” regulated financial institutions, which are a form of control. Mainstream theorists do not perceive the inadequacy of unregulated financial markets as global governance mechanism, and the presumed role of money in the automatic self-expansion of value. The promise of ever-greater profits from ever reduced role of government misreads money as a form of independent private property, rather than a symbol of the whole managed by the “sovereign” (Davis 2017). The view of the whole is replaced by the “faith” in the freedom of markets.

V. Recommendations:

The so-called dilemma of the production of safe assets is the outcome of the view of money as a discrete object, rather than a key organizing feature of an entire socio-economic system. The shortage of safe assets can be remedied easily by Keynesian policies, such as progressive taxes, fiscal policy, and increased financial regulation.

The problem is not only in competing theories but also in politics. First, the modern macro approaches do not focus on the role of money, but still see money as a veil, having no real effect on economic dynamics. Even when money is incorporated into macro models, there is

still an assumption of equilibrium, even with ever more comprehensive sets of equations in Dynamic Stochastic General Equilibrium (DSGE) models. Risk is still assumed to be associated with various known probability distributions, with ever more complex distributions increasingly tractable with modern information technology. There is no conceptual foundation for financial regulation (Brine and Poovey 2017). For those theorists who do value the provision of liquidity (Mehrling 2011), their recommendation is to extend the role of the Fed to include shadow banking, as “market maker of last resort.” Since the goal of the shadow banking system is to evade regulation, this seems like an endless game of cat-and-mouse.

Second, the political influence of the financial sector still restricts the feasibility of regulation and progressive taxes. With financial deregulation under the Trump administration, private risks will again be associated with public backstop, even as the central bank still retains the bloated balance sheet of the responses to the Great Recession, such as Quantitative Easing.

Even with the historical institutional approach, the state is not an impartial mediator among different sectors of the economy. Money has a special role, in the form of a sovereign currency, in extending purchasing power, issuing debt at lower cost, and gaining increasing network externalities as a global key currency. Regulation of finance plays a role in managing the circular flow and the process of accumulation, with the goal of stable production and extraction of surplus in domestic and global financial circuits. Such a nation state will provide a backstop to debts denominated in its own currency, to maintain its reputation for power, as well as allow risk-taking in the pursuit of profits, up until the point of risk of collapse.

VI. Conclusion

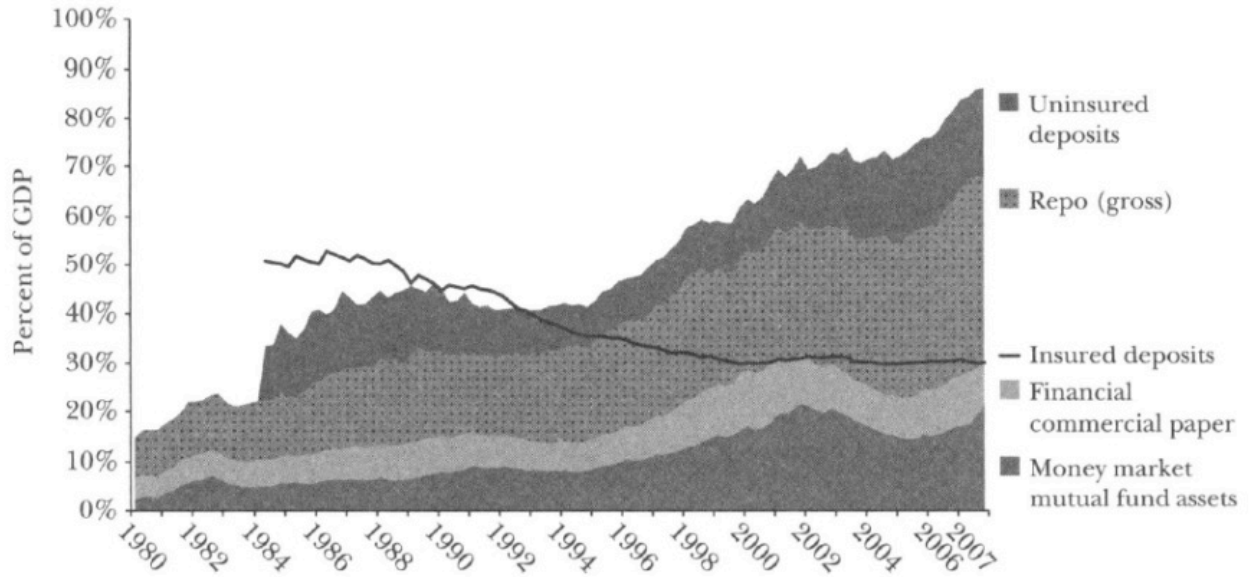
On the one hand, Trump’s tax cuts of December, 2017, can solve the shortage of safe assets. The projected increase in the government deficit will lead to an increase in the supply of US Treasury bonds, facilitating the use of this public asset as a store of value. On the other hand, higher interest rates and increased value of the dollar could exacerbate global instability, much like the Plaza Accord in 1985. Further, budget cuts could contribute to political gridlock and social unrest. The diminished fiscal capacity may lead to downgrading of US government debt, potentially threatening the role of the dollar as key currency. The lack of any coherent plan for economic growth, other than deregulation and inequality, may reduce US competitiveness when faced with the China juggernaut. President Trump’s ostensible goal of “America First” would be undermined by neglect of the actual sources of US strength, such as global leadership of trade and finance, as well as public goods like infrastructure, innovation, and education.

Like previous historical periods (Marx 1967; Keynes 1964; Polanyi 1944), there are various commentators at present who worry about the future of capitalism (Posner 2010; Rajan and Zingales 2003; Reich 2015). There is a risk of fascism as well as possibility for progressive transformation (Fraser 2015). The ironies of the rentier economy contributing to stagnation have been noted at other periods in history, as well (Arrighi 1994; Adams 2005; Palma 2009). This is the ultimate irony of money and accumulation for its own sake. In its performative

dimensions, if people believe that money is valuable, they will pursue money, rather than build the community which it symbolizes, and which is the source of its value and meaning.

Figure 1. Size of Short Term Funding Relative to GDP (Greenwood and Sharfstein 2013)

Figure 5
Short-term Funding of the Financial Sector



Source: Author using data from the Flow of Funds Accounts of the United States.
Note: Insured deposits and uninsured deposits are only available starting in 1984.

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