Real Interest Rates, Imbalances and the Curse of Regional Safe Asset Providers at the Zero Lower Bound*

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Abstract

The current environment is characterized by low real rates and by policy rates close to or at their lower bound in all major financial areas. We analyze these unusual economic conditions from a historical perspective and draw some implications for external imbalances, safe asset demand and the process of external adjustment. First, we decompose the fluctuations in the world consumption wealth ratio over long period of times and show that they anticipate movements of the real rate of interest. Second, our estimates suggest that the world real rate of interest is likely to remain low or negative for an extended period of time. In this context, we argue that there is a renewed Triffin dilemma where safe asset providers face a trade-off in terms of external exposure and real appreciation of their currency. This tradeoff is particularly acute for smaller economies. This is the 'curse of the regional safe asset provider.' We discuss how this 'curse' is playing out for two prominent regional safe asset providers: core EMU and Switzerland.

*Nick Sander and Maxime Sauzet provided outstanding research assistance. We thank our discussant David Vines, Ricardo Caballero, Barry Eichengreen, Philipp Hartmann, Òscar Jordà, Ralph Koijen, Martin Lettau, Richard Portes, Ken Rogoff, Andrew Sheng, Alan Taylor, David Thesmar and Gabriel Zucman for comments. All errors remain our own. Special thanks to Òscar Jordà, Moritz Schularick and Alan Taylor for sharing their data with us. Contact email: pog@berkeley.edu; hrey@london.edu;

1 Introduction

The current macroeconomic environment remains a serious source of worry for policymakers. Global real and nominal interest rates are at historical lows across advanced economies, both at the short and long end of the term structure. Policy rates are close to or at their effective lower bound in all major financial areas.[1] Figures 1 and 2 report the nominal policy rates and long yields for the U.S., the Eurozone, the U.K. and Japan since 1980. Increasingly large amounts of wealth are invested at zero or negative yields.[2]

Yet economic activity in many parts of the advanced world remains quite anemic, or insufficiently vigorous to sustain a normalization of monetary policy, as evidenced by the repeated delays in the U.S. Federal Reserve's 'lift-off'. Figures 3 and 4 report the output gap of advanced economies, as calculated in the April 2016 IMF's World Economic Outlook database. While output gap calculations are always imprecise, the figures indicate that, with the exception of Germany and the U.K., most advanced economies remain significantly below their potential level of output.[3]

That, despite the aggressive global monetary policy treatment administered, levels of economic activity remain so weak across the advanced world strongly suggests that the *natural interest rate*, i.e. the real interest rate at which the global economy would be able to reach its potential output, remains substantially below *observed* real interest rates. Far from being overly accommodating, current levels of monetary stimulus may well be insufficiently aggressive because of the Zero Lower Bound constraint on policy rates.[4]

Understanding whether natural rates are indeed low, for how much longer, and the source of their decline has become a first-order macroeconomic question. In a celebrated speech given at the IMF in 2013, five years after the onset of the Global Financial Crisis, Summers (2015) ventured that we may have entered an age of '*secular stagnation*', i.e. and era where output remains chronically below its potential, or equivalently real rates remain above their natural rate. Not coincidentally, the secular stagnation hypothesis was first voiced by Hansen (1939), ten years after the onset of

[1] This effective lower bound may well be negative. In this paper, and with a slight abuse of language, we refer to the 'effective' lower bound as the 'Zero Lower Bound' (ZLB). It should be clear that there is no conceptual difference between a small positive and a small negative lower bound on policy rates.

[2] According to FitchRatings (2016), the total amount of fixed-rate sovereign debt trading at negative yields reached $11.7 trillion at the end of June 2016.

[3] Potential output data from other sources, such as AMECO or the OECD are broadly consistent.

[4] Most central banks also deployed nonconventional monetary policy mostly in the form of asset purchases, or forward guidance. While the evidence suggests these policies have contributed to stabilize the economy, they may not have been sufficient to raise the natural rate above actual rates.

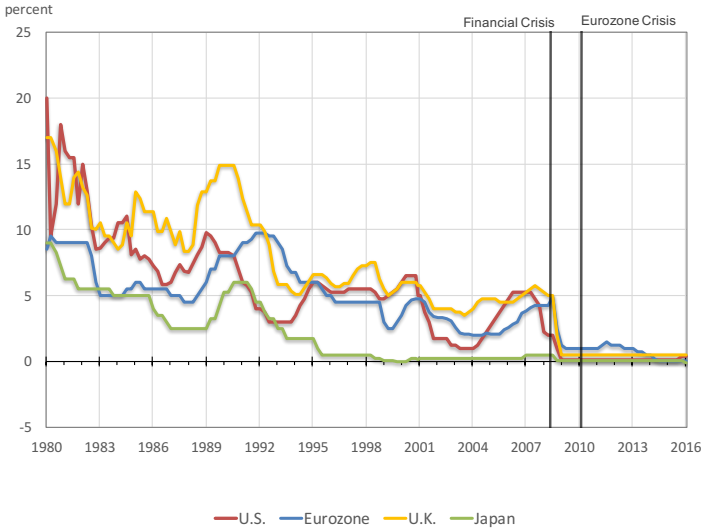

Figure 1: **Policy Rates, Eurozone, Japan, U.S. and U.K., 1980-2016**. Sources: U.S.: Federal Funds Official Target Rate; Eurozone: until Dec. 1998, Germany's Lombard Rate. After 1998, ECB Marginal Rate of Refinancing Operations; U.K.: Bank of England Base Lending Rate; Japan: Bank of Japan Target Call Rate. Data from Global Financial Database.

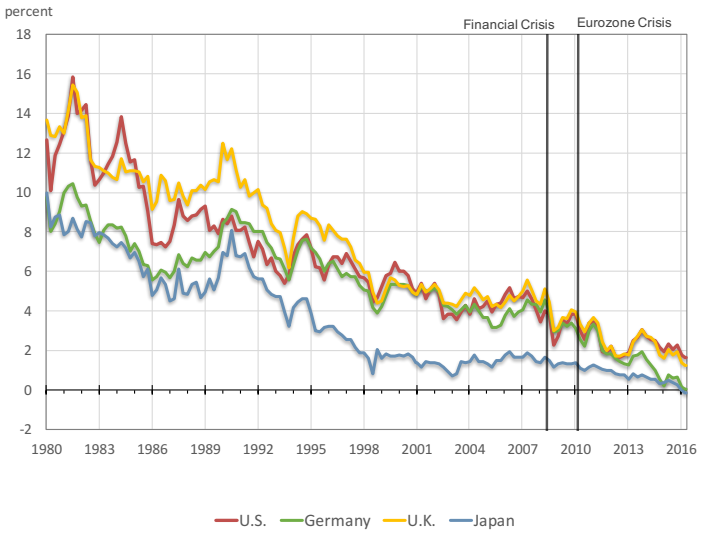

Figure 2: **Long yields, Germany, Japan, U.K. and U.S., 1980-2016**. Sources: U.S.: 10-year bond constant maturity rate; Germany: 10-year benchmark bond; U.K.: 10-year government bond yield; Japan: 10-year government bond yield. Data from Global Financial Database

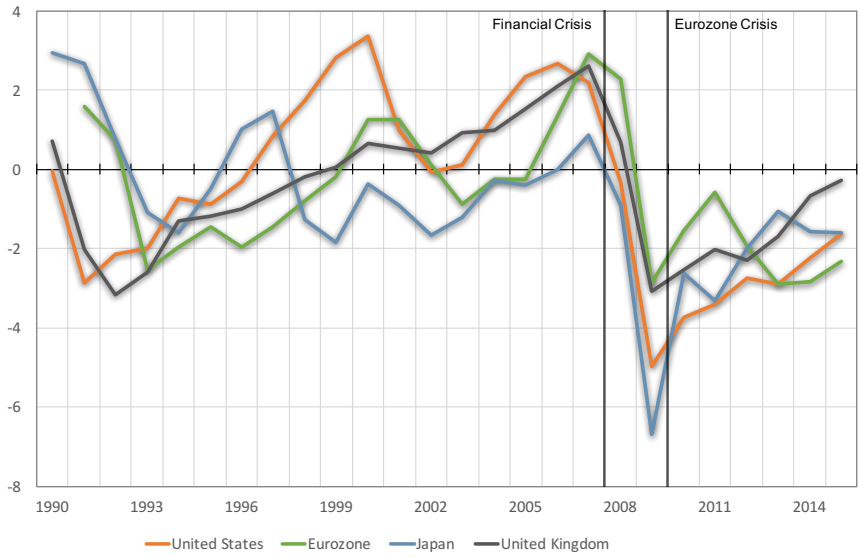

Figure 3: **Output Gap (percent of potential output), Eurozone, Japan, U.K. and U.S., 1990-2015**. Note: The graph shows the persistent decline in the output gap following the global financial crisis and European sovereign debt crises. Source: World Economic Outlook, April 2016.

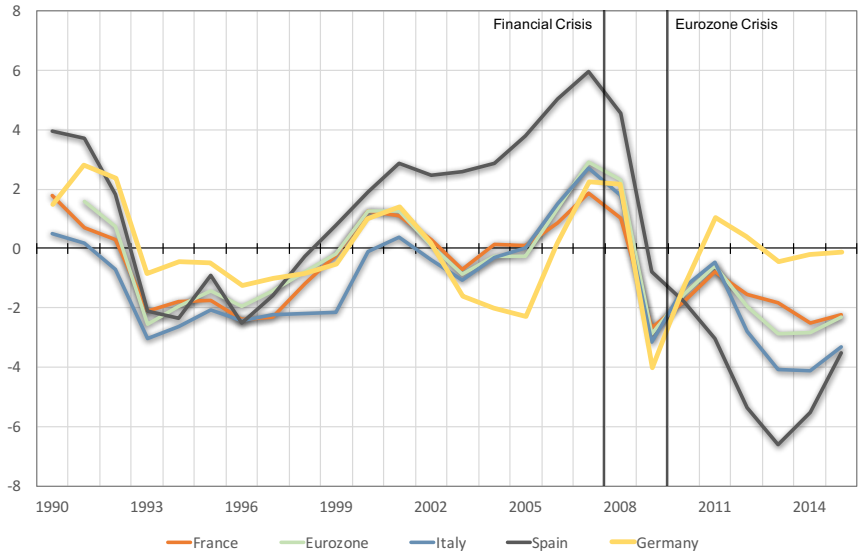

Figure 4: **Output Gap (percent of potential output), Eurozone, France, Germany, Italy and Spain, 1990-2015**. Note: The graph shows the persistent decline in the output gap following the global financial crisis and European sovereign debt crises. Source: World Economic Outlook, April 2016.

the Great Depression.

This paper contributes to this debate along three dimensions. We start by asking whether global real interest rates are likely to remain low and why. Using a novel empirical approach to this question, we conclude that they will, for an extended period of time, and that global economic activity is likely to remain muted. We argue that, as in other historical periods, most notably in the 1930s, this is the likely outcome of an extended and on-going process of deleveraging that creates a '*scarcity of safe assets*.'

Next, we consider the question of global imbalances. Previous studies have emphasized that the global imbalances of the 1990s and 2000s originated from a combination of low levels of financial development and rapid economic growth in emerging market economies.[5] If we enter an era of secular low growth, does it follow that global imbalances should recede? We answer this question in the negative: as argued in Caballero et al. (2015) and also in Eggertsson et al. (2015), global imbalances 'mutate' at the Zero Lower Bound from a benign phenomenon to a malign one.[6] At the ZLB, external surpluses propagate stagnation as countries attempt to grab a higher share of a depressed global aggregate demand via a more depreciated currency, increasing the potential for negative spillovers and the prospect of currency wars.

The last part of our analysis focuses on safe assets providers. We argue that safe asset providers must, in equilibrium, either be more exposed to global shocks with the incipient risk of large ex-post losses, or choose to let their currency appreciate with potentially adverse immediate real effects. Furthermore, we show that the terms of this trade-off worsen the smaller the safe asset provider is, a phenomenon we dub the '*curse of the regional safe asset provider*.' We document how this 'curse' has played out for two regional safe asset providers in recent years: Switzerland, and the core members of the European Monetary Union (EMU), including Germany, but also the Netherlands, Belgium and France. Looping back to our initial global focus, we argue that the curse of these EMU safe asset providers contributes significantly to the headwinds faced by the global economy and to the current pattern of global imbalances. We conclude by outlining some potential solutions.

Our empirical exercise begins by analyzing the consumption-to-wealth ratio in four advanced economies: the United States, the United Kingdom, France and Germany, for which we have

[5] See Caballero et al. (2008), Mendoza et al. (2009) and Bernanke (2005).

[6] Of course, there may be reasons linked to financial stability for which large imbalances might constitute a risk even outside the ZLB.

data going back at least to 1920.[7] We show that, at any point in time over the last century, the aggregate consumption-to-wealth ratio contained a great deal of information about *future* short term real rates. According to our empirical analysis, actual and natural real interest rates are likely to remain low for an *extended period of time*: our point estimates suggest that short term real interest rates could remain between -2% and 0% until 2021, with natural rates likely to be even lower. Our findings provide a bleak assessment of the medium-run growth prospects in advanced economies, and how difficult the return to prosperity may be for most advanced economies: we may well be stuck at the ZLB for the foreseeable future.

Our approach requires minimal assumptions, likely to hold under very general circumstances. In effect, we extract the historical information encoded in households' decisions to consume out of wealth. The consumption-to-wealth ratio tends to be abnormally low following periods of rapid increases in wealth, as is often the case during episodes of financial exuberance. In the aftermath of these booms, the return on wealth tends to be low or negative, and the consumption-to-wealth ratio reverts to equilibrium. Our empirical results indicate that this low return on wealth is traceable in large part to future low real risk-free rates.

We document two stark historical episodes where the consumption-wealth ratio was inordinately low. The first episode starts in 1929 at the onset of the Great Depression and lasts until the second World War. This is when Alvin Hansen first wrote about secular stagnation. The second episode starts in 1997 and is still on-going. It is during this period that Larry Summers revived the concept of secular stagnation.

What might cause a persistent decline in real interest rates? The literature emphasizes four candidate explanations (see Eichengreen (2015)): a slowdown in technological progress, demographic forces, a savings glut, and a decline in investment, possibly due to a decline in its relative price. The first force is well understood: a slower rate of technological progress reduces the marginal product of capital. Demographic forces, especially a slowdown in fertility, or an increase in life expectancy, also have the potential to increase savings, depressing equilibrium rates of return. The 'savings glut' explanation has multiple components. On the trend side, it originates from the combination of low levels of financial development in Emerging Market Economies and rapid economic growth

[7] Our measure of consumption consists of household's aggregate consumption expenditures. Our measure of wealth consists of households financial assets minus financial liabilities, plus housing and agricultural land. It does not include human wealth (the present discounted value of present and future non-financial income).

relative to Advanced Economies (see Bernanke (2005) and Caballero et al. (2008)). Low short term real interest rates can also result from an increased demand for 'safe assets' (Caballero and Farhi (2015)), especially in the aftermath of financial crises. An abundant body of empirical evidence documents how households, firms, governments simultaneously attempt to de-lever in order to repair their balance sheet after a major financial shock (see e.g. Mian et al. (2013) and Jordà et al. (2013)). Post-crisis weakness in the banking sector which often shuts out small businesses from credit markets, and the re-regulation of the financial sector which limits risk-taking and may involve some degree of financial repression also contribute to low real interest rates (Reinhart and Rogoff (2009)). A faster decline in the price of investment goods can also reduce natural rates of interest, if the elasticity of the volume of investment to the real interest rate is not too high.

Our empirical method does not allow us to separately test these four hypotheses. However it strongly suggests that the 'savings glut' explanation and de-leveraging dynamics played a large role in the decline in real rates both in the 1930s and now, as in Eggertsson and Krugman (2012) or Guerrieri and Lorenzoni (2011). Our findings are thus consistent with the view that the main low-frequency drivers of global real interest rates are cyclical movements in the demand for safe assets, in a context of limited supply, i.e. an environment of '*safe asset scarcity*'.[8]

The second part of our paper considers more closely the implications of our findings for global imbalances. Since the Global Financial Crisis, global imbalances have diminished but have not disappeared altogether. Figure 5 reports current account surpluses and deficits for countries or regions, scaled by world output since 1980. While U.S. current account deficits have decreased, they remain sizable, at -0.66 percent of world GDP in 2015, representing around a third of all current account deficits. On the funding side, two developments are noticeable. First, the surpluses of oil producers have disappeared. Second, the Eurozone has become a major source of surpluses, with a current account surplus of 0.61% of world output in 2015. Figure 6 reports current account balances and surpluses for members of the Eurozone since 1993, as a fraction of Eurozone output.[9] It is quite startling to observe that, since 2014, all Eurozone countries are running current account

[8]This terminology sometimes leads to some confusion. It should be clear that, in equilibrium, the supply of assets (safe or otherwise) always equals their demand. Instead 'scarcity of safe assets' refers to a situation where there is either an autonomous increase in the demand for safe assets, or an autonomous decline in their supply, leading to an endogenous adjustment in their price (outside the ZLB) or in output (at the ZLB) so as to restore equilibrium in these markets. See Caballero et al. (2016).

[9]In both graphs, the Eurozone consists of the 12 major members of the EMU for which we have consistent data over that period.

surpluses or have a balanced position, and are projected to do so in years to come.

In Caballero et al. (2015) and Caballero et al. (2016), one of us argued that current account imbalances mutate from 'benign' to 'malign' when the global economy hits the Zero Lower Bound. Excess savings of surplus countries cannot be accommodated any longer by a decline in global real interest rates. Instead, they push the global economy into a liquidity trap that depresses economic activity. Surplus countries *export* their recession, at the expense of deficit countries. Moreover, Caballero et al. (2016) argues that exchange rates become indeterminate at the Zero Lower Bound, yet play a key role in the adjustment process, by shifting relative demand for domestic and foreign goods. The analysis in that paper indicates a tight link between net foreign asset positions and exchange rates: countries or regions running current account surpluses have a more depreciated currency than under financial autarky, and correspondingly higher levels of activity, at the expense of foreign countries. A direct and immediate implication is that the exchange rate becomes a key variable to reallocate depressed global demand across countries, raising the prospect of 'currency wars'.[10] This analysis suggests that a period of secular stagnation does not necessarily imply that global imbalances should recede. Instead, imbalances at the ZLB have a greater potential to destabilize the global economy.

Indeed, Figure 7 illustrates that significant exchange rates movements have accompanied most major central bank attempts to stimulate their economy since 2008. The figure reports the cumulated rate of appreciation (+) or depreciation (-) of the euro against the US dollar, the Japanese yen and the Swiss franc since January 2007. The figure illustrates the large recent gyrations in exchange rates, especially in the dollar-euro rate after the implementation of the Federal Reserve's QE2 in October 2010 or the announcement of the ECB's public sector purchase program (PSPP) in January 2015; in the yen-euro rate following Abenomics in December 2013; or in the Swiss franc-euro rate after the Swiss National Bank decided to put a floor on the bilateral rate (September 2011) and to abandon it (January 2015). The figure also illustrates the significant depreciation of the Euro against the three other currencies since 2014, consistent with the surge in the Eurozone's current account surpluses.

In this context we ask how the growing demand for safe assets shapes external portfolios. Gourinchas et al. (2010) explored the implications of being a world insurer for the United States'

[10] See Eggertsson et al. (2015) for a similar argument.

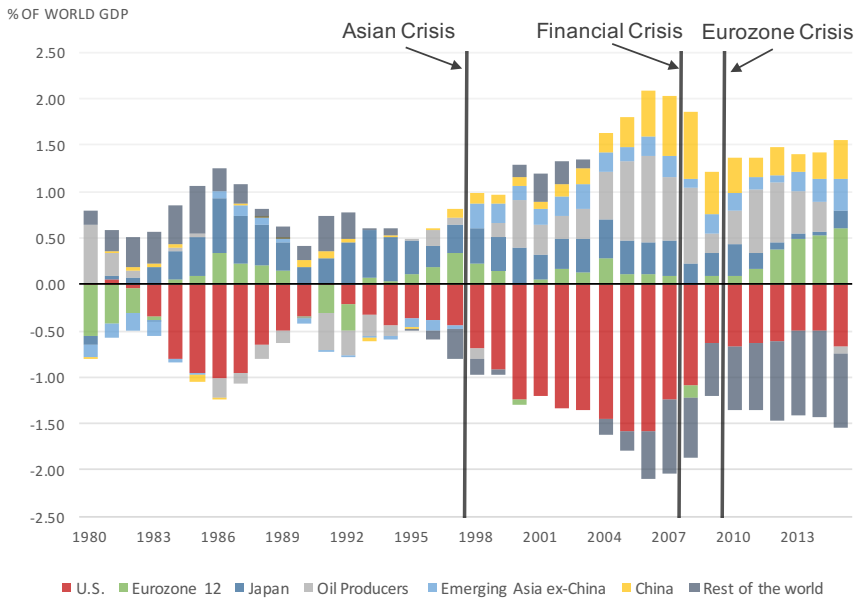

Figure 5: **Global Imbalances**, **1980-2015**. Note: The graph shows Current Account balances as a fraction of world GDP. Source: World Economic Outlook Database (April 2016), and Authors' calculations. WEO forecasts for 2015. Oil Producers: Bahrain, Canada, Iran, Iraq, Kuwait, Libya, Mexico, Nigeria, Norway, Oman, Russia, Saudi Arabia, United Arab Emirates, Venezuela; Emerging Asia ex-China: India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, Vietnam. Eurozone 12: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, Spain.

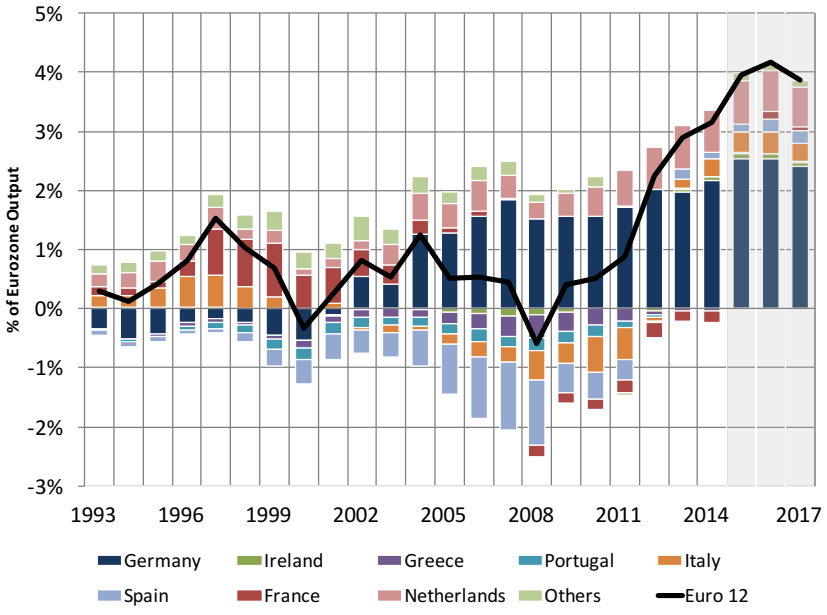

Figure 6: **Eurozone Imbalances**, **1993-2017**. Note: The graph shows the current account balances of Eurozone countries, relative to Eurozone output. Source: World Economic Outlook Database (April 2016) and Authors' calculations. WEO forecasts for 2015-2017. Euro 12: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, Spain.

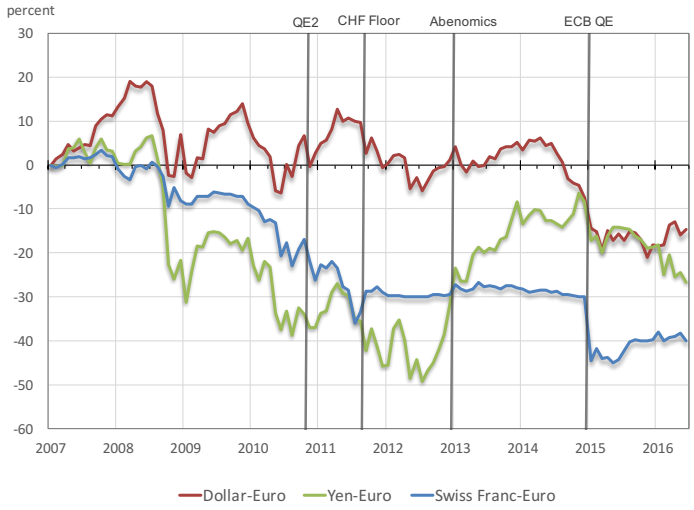

Figure 7: **Global Exchange Rates, 2007-2016**. Note: The graph shows the cumulated depreciation (+) or appreciation (-) of the dollar, the yen, and the Swiss Franc against the euro since January 2007. Source: Global Financial Database. The figure reports $\ln(E_{2007m1}/E)$ where E denotes the foreign currency value in euro.

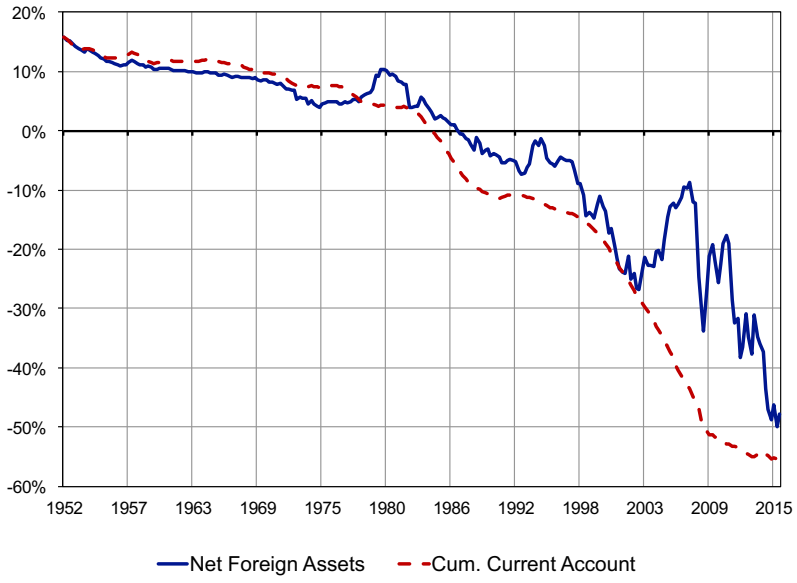

Figure 8: **United States Net Foreign Asset Position and Cumulated Current Account, 1952-2015**. Note: The graph shows the U.S. net foreign asset position as a fraction of U.S. output and the counterfactual obtained by cumulating current account balances since 1952Q1. Source: BEA, Flow of Funds and Author's calculations.

external portfolio. That paper argued that the structure of the U.S.'s external portfolio (gross assets and gross liabilities) reflects its capacity to provide safe assets. With integrated financial markets, asset prices and returns adjust so that, in equilibrium, the U.S. provides insurance to the rest of the world. This is reflected in the fact that (a) the U.S. holds a leveraged position long in risky assets and short in safe assets, relative to the rest of the world; (b) in normal times, the U.S. earns high returns on its gross assets relative to its gross liabilities (the 'exorbitant privilege' of the United States); (c) the U.S. experiences large capital losses in times of financial stresses (a phenomenon we called the 'exorbitant duty'). This last point is especially relevant in recent years. Figure 8 reports updated estimates of the U.S. net foreign asset position since 1952. Between 2007Q4 and 2015Q3, the U.S. external valuation losses represent $4.13 trillion, or a staggering 22.9% of 2015 U.S. GDP.[11] Three episodes account for the bulk of these adjustments: in 2008Q4, following the collapse of Lehman Brothers; in 2011Q3 during the Eurozone crisis, and in 2014Q4 when the dollar appreciated substantially against the yen and the euro. As a result, the bulk of the U.S. cumulated valuation gains since 1952, which reached 35% of US GDP at their peak in 2007, have dissipated.

An important message of Gourinchas et al. (2010) is that the status of safe asset issuer inevitably comes with increased exposure to global shocks. In the current paper, we move away from the U.S. and consider instead what the implications of our analysis are for *regional* safe asset providers. As we argued in Gourinchas and Rey (2007a), net safe asset providers face a variant of the old 'Triffin dilemma' (Triffin (1960)): faced with a surge in the demand for their (safe) assets, regional safe asset providers must choose between increasing their external exposure, or letting their currency appreciate. In the former case, the increased exposure can generate potentially large valuation losses in the event of a global crisis, as documented in the case of the U.S.. In the limit, as the exposure grows, it could even threaten the fiscal capacity of the regional safe asset provider, or the loss absorbing capacity of its central bank, leading to a run equilibrium.[12]

Alternatively, a regional safe asset provider may choose to limit its exposure, i.e. the supply of its safe assets. The surge in demand then translates into an appreciation of the domestic currency which may adversely impact the real economy, especially the tradable sector. The smaller the

[11] In 2007Q4, the U.S. net foreign asset position was -$1.28 trillion. By 2015Q3, it reached -$9.03 trillion, a $7.74 trillion decline, $3.61 trillion of which represents cumulated current account deficits, and $4.13 trillion (22.9% of U.S. GDP) valuation losses.

[12] See Maggiori et al. (2016) and Amador et al. (2015) for recent related analyses of the Triffin dilemma or the potential for 'reverse speculative attacks'. See also He et al. (2015) for a discussion of the issue of the determination of the status of reserve assets in a world with competing stores of value.

regional safe asset provider is, the less palatable either of these alternatives is likely to be, a phenomenon we dub the '*curse of the regional safe asset provider.*'

In light of these considerations, we revisit the recent experience of two European safe asset providers: Switzerland, and core EMU, consisting of Germany, France, the Netherlands and Belgium. The case of Switzerland illustrates nicely the terms of the basic trade-off: After fixing its exchange rate against the euro in September 2011, the Swiss National Bank grew increasingly worried about its external exposure and the potential for future losses in the wake of the ECB's PSPP. In January 2015, in a surprise announcement, the Swiss National Bank chose to let the currency float, a move that was followed by a sharp appreciation of the Swiss currency (see Figure 7).

The case of the core EMU is equally fascinating. In the run-up to the financial crisis, it acted as a safe asset provider, with an extra twist. As documented by Hale and Obstfeld (2016), core EMU countries invested in risky projects in peripheral Eurozone members, but also intermediated foreign capital from outside the Eurozone into these countries, thereby increasing further their exposure. Most of that increased exposure occurred via an expansion in core EMU banks' balance sheet and leverage (Miranda-Agrippino and Rey (2015)) and cross-border loans instead of portfolio holdings. In the run-up to the Eurozone crisis, core EMU banks borrowed globally and lent to peripheral Eurozone countries, earning small but positive excess returns in the process. With a common currency, core EMU countries could not let their real exchange rate appreciate in response to a surge in the demand for safe assets, except via gradual domestic inflation. Instead, they have tended to absorb the increased exposure onto their national balance sheet.[13]

When the Eurozone crisis materialized, as in the case of the U.S. and other safe asset providers, core EMU stood to realize substantial capital losses on its net external position, a combination of losses on its gross external assets and capital gains on its external liabilities. With an exposure structure similar to the U.S., rough calculations indicate that the valuation losses could have reached a staggering 40% of output for Germany alone. Unlike the U.S., however, where the valuation losses were immediately realized via changes in asset prices and currency price movements, resulting in the sharp decline in the U.S. net foreign asset position documented in Figure 8, the protracted resolution process of the European Sovereign Debt crisis mitigated the losses of the core EMU

[13]Some of that increase in financial sector exposure may also reflect risk shifting and expectations of bailouts using tax payers money. This emphasizes the need for a very careful monitoring of financial fragilities and imbalances, especially for EMU safe asset providers.

countries but profoundly hampered the economic recovery of the region. Without a Eurozone debt resolution mechanism for banks or sovereigns, and with the fear that markets might turn on them, most peripheral eurozone members embarked on multiple rounds of private and public deleveraging. The result has been a massive shift from current account balance in 2007 for the Eurozone, to a current account surplus of 0.5% of world GDP in 2014, predicted to rise to 0.6% in 2015, as illustrated on Figures 5 and 6.[14] If the Eurozone had been a closed economy, the resulting deflationary forces may well have proven self-defeating, just like attempts to deflate one's economy at the expense of one's trading partners were ultimately self-defeating during the Great Depression under the Gold Exchange Standard. At the global Zero Lower Bound, the shift towards external surpluses has lessened the burden of adjustment on the Eurozone, at the expense of the rest of the world.

In summary, our analysis suggests that core EMU countries have not performed their role as regional safe asset providers. Unlike the U.S. which saw its net foreign asset position deteriorate substantially during the crisis, as U.S. Treasuries appreciated while external assets plummeted in value, core EMU economies have not absorbed the banking losses that were on their balance sheet. Instead they pushed back the losses onto the peripheral countries public sector balance sheet ex-post which forced them to de-lever aggressively. This aggregate delevering, and the corresponding surge in saving continues to have deleterious effects on the global economy. Given our finding that real interest rates will remain low for an extended period of time, we consider that it would be wise to steer away from policies that make us teeter on the edge of a global liquidity trap. Being a regional safe asset provider may prove to be a curse not only to the core EMU, but to the Eurozone at large, and to the global economy.

2 The Dynamics of Global Real Interest rates

As illustrated in Figures 1 and 2, both long and short rates have declined dramatically over the last thirty years. A growing literature has attempted to understand the source of this decline and

[14] Figure 6 demonstrates that the bulk of the increase in the Eurozone current account surpluses does not come from core EMU. Core EMU current account surpluses increased modestly from 2.3% to 2.6% of the region's output between 2007 and 2015. Over that period, the rest of the Eurozone's current account improved from -1.9% to 0.5%, representing 87% of the improvement in the Eurozone's current account.

concludes that the decline in global real rates is likely to be quite persistent.[15] In this paper, we borrow from Gourinchas and Rey (2016) and propose a novel approach based on the low frequency movements in the global consumption-to-wealth ratio.

2.1 The Global Budget Constraint: Some Elements of Theory

To fix ideas, denote beginning-of-period world private wealth W_t. W_t consists of private financial wealth (assets minus liabilities) as well as private non financial assets such as housing, non incorporated businesses, land etc...[16] The accumulation equation for the global economy is:

$$W_{t+1} = R_{t+1}(W_t - C_t), \tag{1}$$

where C_t denotes world private consumption expenditures and R_{t+1} is the gross return on wealth between t and $t+1$. In this equation, all variables are in real terms so R_{t+1} denotes the real return on total wealth. Equation (1) is simply an accounting identity: it has to hold exactly period by period. We add some structure on this equation by observing that, in most models, private agents aim to stabilize the ratio of their consumption to their wealth.[17] If the average propensity to consume out of wealth is stationary, equation (1) can be log-linearized around the steady state consumption-total wealth ratio $C/W \equiv 1-\rho_w$, where $\rho_w < 1$.[18] Denoting Δ the difference operator, $\mathbb{E}_t$ the expectation operator, $r_{t+1} = \ln R_{t+1}$ the continuously compounded real return on wealth and following some simple manipulations as in Campbell and Mankiw (1989), Lettau and Ludvigson

[15] Barro and Sala-i Martin (1990) explores the converse question of why real interest rates were so high in the 1980s. More recently, Laubach and Williams (2003, 2015) and Pescatori and Turunen (2015) attempt to measure the (unobserved) natural rate. Following Wicksell, they define the natural rate as "the real short-term rate consistent with the economy operating at its full potential once transitory shocks to aggregate supply or demand have abated" (Laubach and Williams (2015), p 2). Hamilton et al. (2015) adopts a similar definition but a different estimation method, relying on a bivariate error correction model for U.S. and world interest rates.

[16] In the following discussion, we ignore human wealth, i.e. the present value of current and future labor income. We focus on *private* consumption and wealth, as opposed to *national* consumption and wealth, which includes public consumption and net wealth. Our results are largely unchanged if we use either concept, except during wars where public consumption surges, while private consumption declines.

[17] For instance, if consumption decisions are taken by an infinitely lived representative household with logarithmic period utility $u(C) = \ln C$, then the consumption wealth ratio is constant and equal to the discount rate of the representative agent.

[18] In steady state, C/W satisfies the following relation: $\frac{\Gamma}{R} = (1 - \frac{C}{W}) \equiv \rho_w$, where Γ denotes the steady state growth rate of total wealth and R the steady state gross return.

(2001) and Gourinchas and Rey (2016) we can derive the following fundamental relationship:

$$\begin{aligned} c_t - w_t \backsimeq \mathbb{E}_t \sum_{s=1}^{\infty} \rho_w^s r_{t+s}^f + \mathbb{E}_t \sum_{s=1}^{\infty} \rho_w^s rp_{t+s} - \mathbb{E}_t \sum_{s=1}^{\infty} \rho_w^s \Delta \ln C_{t+s} \\ \equiv cw_t^{rf} + cw_t^{rp} + cw_t^c, \end{aligned} \tag{2}$$

where c_t and w_t denote respectively (log) real consumption (resp. real wealth) per capita, r_t^f is the real short term risk-free return, rp_t is the excess return.[19] Equation (2) states that today's aggregate consumption to wealth ratio (the left hand side) is high if either (a) expected future rates of return on wealth are high so that the denominator of C/W is expected to increase or (b) expected future *aggregate* consumption growth is low, so the numerator of C/W is expected to decline.

It is important to emphasize that the assumptions needed to derive this relation are minimal: we started from the law of motion of private wealth, which is simply an accounting identity. In particular, it holds with or without investment or production – these are simply factors that affect the return on wealth. We then performed a log-linearization under mild stationarity condition.[20] This simple equation conveys the message that today's average propensity to consume out of wealth encodes information about expected future consumption growth $\mathbb{E}_t \Delta \ln C_{t+s}$, expected future safe rates $\mathbb{E}_t r_{t+s}^f$, or future risk-premia $\mathbb{E}_t rp_{t+s}$. It also indicates how to construct the contributions of each component, cw_t^{rf}, cw_t^{rp} and cw_t^c as the expected present discounted value of each variable. Since it is well-known that aggregate consumption is close to a random walk, so that its growth rate $\Delta \ln C_{t+s}$ is largely unpredictable, and excess returns are also volatile and difficult to predict, we expect from equation (2) that the aggregate consumption to financial wealth ratio will provide us with significant information about the expected path of future real risk free returns r_{t+s}^f.

[19] The return on wealth can always be decomposed as $r = r^f + \left(r - r^f\right)$, the sum of the real risk-free rate r^f and an excess return $r - r^f$. We don't observe the excess return on wealth $r - r^f$, so we proxy it with the excess equity return rp, adjusted with a noise parameter which we estimate to maximize the empirical fit of equation (2). See Gourinchas and Rey (2016) for details.

[20] We also impose a transversality condition that simply rules out paths where wealth grows without bounds in relation to consumption.

2.2 Interpretation

Equation (2) does not provide a causal decomposition: in general, the risk free and risky returns as well as consumption growth are endogenous and interdependent. In Gourinchas and Rey (2016) we discuss how different shocks are likely to impact the various terms on the right hand side of equation (2) and summarize this discussion here:

- **Productivity Shocks**: persistent negative productivity shocks decrease future aggregate consumption growth $\Delta \ln C_{t+s}$, which pushes up $c_t - w_t$ (direct effect). There is an indirect effect that goes in the opposite direction since lower productivity growth tends to reduce equilibrium real interest rates, which pushes $c_t - w_t$ down. The relative strength of the two effects depends on the intertemporal elasticity of substitution (IES). With a low IES, real rates respond more than consumption growth, hence the indirect effect is likely to dominate and $c_t - w_t$ will decline. If instead the IES is high, consumption growth responds more than real rates, the direct effect dominates and $c_t - w_t$ increases. More generally, we expect the return component cw_t^{rf} and the consumption growth components cw_t^c to have opposite signs if productivity shocks are a main source of fluctuations: low future interest rates would coincide with low per-capita and total consumption growth.

- **Demographics**: a slowdown in population growth has a direct effect on the consumption-wealth ratio via the decline in total consumption growth $\Delta \ln C_{t+s}$. This direct effect is the same as that of productivity and pushes up $c_t - w_t$. Population growth may also have an indirect effect on the consumption-wealth ratio via its effect on savings and global real returns. If the lower population growth induces higher saving rates among currently alive generations, the real interest rate will decline and this will tend to push down $c_t - w_t$. Similarly, increases in life expectancy that reduce the ratio of workers to retiree may stimulate savings, as households need to provide for a longer retirement life, pushing down real rates and reducing $c_t - w_t$. Again, we expect opposite movements in the return and the consumption growth components: low future interest rates would coincide with low total consumption growth (but not per-capita consumption growth).

- **Deleveraging shock**: A deleveraging shock can be interpreted as an increase in the saving propensity (see Eggertsson and Krugman (2012); Guerrieri and Lorenzoni (2011)). There

is ample evidence that saving propensities increase in the aftermath of financial crises, as households attempt to repair their balance sheets (see e.g. Mian et al. (2013)). In equilibrium this needs to be offset by a decline in the equilibrium real rate. The response of future total consumption depends on whether the economy operates outside the Zero Lower Bound or not. Outside the ZLB, investment is likely to increase. While current consumption growth would be low initially, it would increase later as output increases. If the economy is at the ZLB, aggregate demand may remain depressed, which would keep investment low and consumption growth muted. Most of the impact of financial shocks is therefore likely to be reflected in the return component cw_t^{rf} .

- **Demand for safe asset**: A surge in the demand for safe assets should lead to a decline in the real risk-free rate, and an increase in the risk premium, i.e. expected excess returns. The first effect tends to reduce $c_t - w_t$ while the second increases it. The overall effect on consumption growth is unclear. We therefore expect to see the impact of an increase in the demand for safe assets in a decline of the return component cw_t^{rf} and an opposite movement in the risk premium component.

We conclude that different primitive shocks have different effects on the various components on the right hand side of equation (2) which we will exploit later to help us identify the relevant source of the variation in the data.

2.3 Empirical implementation

We implement our empirical strategy in two steps. In the first step, we construct estimates of the consumption-wealth ratio over long periods of time. We then evaluate the empirical validity of equation (2) by constructing the empirical counterparts of cw_t^{rf}, cw_t^{rp}, cw_t^{c} in that equation and testing whether they accurately capture movements in the consumption wealth ratio (i.e. whether $c_t - w_t = cw_t^{rf} + cw_t^{rp} + cw_t^{c}$). In a second step, we directly evaluate the forecasting performance of the consumption-wealth variable $c_t - w_t$ for future risk-free interest rates, risk premia and consumption growth.

For the first step, we use historical data on private wealth, population and private consumption for the period 1920-2011 for the United States, the United Kingdom, Germany and France from

Piketty and Zucman (2014a) and Jordà et al. (2016).[21] We identify the risk-free return with the ex-post real return on three-month Treasuries minus CPI inflation (both series obtained from Jordà et al. (2016)), and the real return on risky assets as the total equity return for each country minus CPI inflation (obtained from the Global Financial Database- see Appendix A for a detailed description of the data). Over the period considered, these four countries represent a substantial share of the world's wealth. Moreover London, New-York and to a lesser extent Frankfurt are major financial centers.

The dotted blue line in Figure 9 reports $c-w$, demeaned, for our 4-country aggregate since 1920 (G4).[22] As expected, historical time-series on the consumption wealth ratio show little long run trend but significant serial correlation. These long swings in the consumption-wealth ratio justify the use of long time series.[23]

We identify two periods during which the consumption-wealth ratio was significantly depressed: the first one spans the 1930s starting around the time of the Great Depression and ending at the beginning of the 1940s. Interestingly, it is in 1939 that Professor Alvin Hansen wrote his celebrated article about 'secular stagnation' (Hansen (1939)). The second episode of low consumption-wealth ratio starts in the late 1990s with a pronounced downward peak in 2007 that is reversed during the financial crisis. As this paper is being written, the consumption-wealth ratio remains depressed for the G-4 aggregate. Not coincidentally, in the Fall 2013 at a conference at the International Monetary Fund, Larry Summers, revived the idea of secular stagnation (Summers (2015)). From an accounting point of view, a low consumption wealth-ratio can follow periods of low consumption growth or periods of rapid wealth growth. In both cases (in 1928-29, then in 2007-08), the consumption-wealth ratio decreases dramatically right before a financial crisis, then rebounded during the crisis (1930 and 2009). This suggests that the movements in the consumption-wealth ratio are driven mostly by the dynamics of wealth during boom-busts episodes.

We estimate each of the components on the right hand side of equation (2) using a reduced form Vector Auto Regression (VAR).[24]

[21] The wealth data prior to 1920 for these three countries is somewhat imprecise. There appears to be a strong break in data before the 1920s, most likely due to the first World War.

[22] The appendix presents the raw data.

[23] Over shorter time periods, $c_t - w_t$ may exhibit a marked trend. For instance, over the 1970-2011 period, we observe a large decline in $c_t - w_t$.

[24] Note that our approach does not need to identify the various structural shocks driving the variables. Equation (2) only requires that we construct present discounted forecasts of real rates, excess returns and consumption growth.

2.4 VAR Results

Figure 9 shows the consumption wealth ratio as well the components of the right hand side of equation (2) for the G4.[25] We further decompose total consumption growth $\Delta \ln C_t$ into per capita consumption growth Δc_t and population growth Δn_t and report separate components for the expected present value of future population growth (cw^n) and per-capita consumption growth (cw^{cp}).

The results are striking. First, we note that the fit of the VAR is very good.[26] The grey line reports the predicted consumption-wealth ratio, i.e. the sum of the four components $cw_t^{rf} + cw_t^{rp} + cw_t^n + cw_t^c$. We find that our empirical model is able to reproduce quite accurately the annual fluctuations in wealth over almost a century of data. This is quite striking since the right hand side of equation (2) is constructed only from the reduced form forecasts implied by the VAR estimation. Second, most of the movements in the consumption-wealth ratio reflect expected movements in the future risk-free rate, i.e. the cw_t^{rf} component. By contrast, the risk premia cw_t^{rp}, population growth cw_t^n and per capita consumption growth cw_t^{cp} components are often economically insignificant. it follows that the consumption-wealth ratio today contains significant information on future real risk-free rates, as encoded in equation (2). As discussed above, periods of low consumption-wealth ratios are following periods of rapid asset price increases. Our empirical results indicate that these are followed by extended periods of low (or negative) real risk-free interest rates. Moreover, we find only weak evidence for the view that productivity growth or demographic forces are key secular drivers of the real risk free rates since neither per capita consumption growth nor population growth seem to matter much. Recall that if productivity or population growth were the main drivers of the consumption wealth ratio, we would expect to find significantly negatively correlated direct contribution of each of these (cw^c and cw^n) with the real interest rate contribution (cw^{rf}). While we find a negatively correlated contribution, it is economically small -and also not very robust.[27]

We assume a discount rate $\rho_w = 0.96$. Recall that $\rho_w = 1 - C/\bar{W}$. This implies an average propensity to consume out of wealth of 4%. Our calculations also estimate a 'noise' parameter for potential mismeasurement of the excess return on private wealth. We estimate this noise parameter by regressing $c_t - w_t - \hat{cw}_t^{rf} - \hat{cw}_t^c$ on our estimate of $\mathbb{E}_t \sum_{s=1}^{\infty} \rho_w^s rp_{t+s}$. While this maximizes the overall fit of the decomposition, it does not affect the risk-free and consumption growth contributions. See Gourinchas and Rey (2016) for details.

[25] We use a wealth-weighted average of the riskfree rate of the U.S. and the U.K. for the risk-free rate, and of the equity excess returns for the global excess return. Substantial price instability in the 1920s in Germany and France prevent us from using these countries' real returns.

[26] The lags of the VAR are selected by standard criteria.

[27] As discussed above, for the interest rate component to dominate the productivity or population growth terms would require a very low intertemporal elasticity.

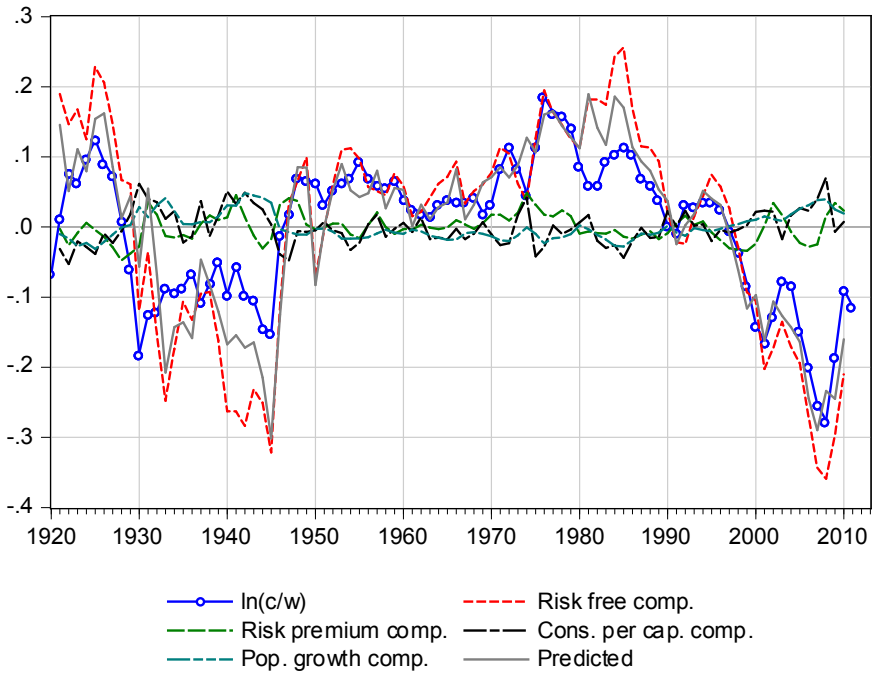

Figure 9: **Consumption Wealth: Real Risk-free rate, Equity Premium, Consumption per capita and Population Growth Components. United States, United Kingdom, Germany and France, 1920-2011**. Note: The graph reports the (log, demeaned) private consumption-wealth ratio together with the riskfree, risk premium, consumption per capita and population growth components. Estimates a VAR(2). Source: Private wealth from Piketty and Zucman (2014a). Consumption, population and short rates from Jordà et al. (2016). Equity returns from Global Financial Database.

Similarly, our estimates indicate that the consumption-wealth ratio contains little information about future equity risk premia. This is perhaps a more surprising result in light of Lettau and Ludvigson (2001)'s findings that a cointegration relation between aggregate consumption, wealth and labor income predicts reasonably well U.S. equity risk premia.[28]

Table 1 decomposes the variance of $c_t - w_t$ into components reflecting news about future real risk-free rates, future risk premia, and future consumption growth. It is immediate that the bulk of the variation in $c - w$ is accounted for by future movements in the real short term risk-free rate. The fact that total consumption growth contributes negatively is consistent with the view that the productivity slowdown may play a role: the contribution of consumption growth per capita is

[28] A number of factors may account for our result. First and foremost, $c_t - w_t$ is stationary in our sample, hence we do not need to estimate a cointegrating vector with labor income. Second, we consider a longer sample period, going back to 1920. Thirdly, as argued above, our sample is dominated by two large financial crises and their aftermath, unlike theirs. Lastly, we view our analysis as picking up low frequency determinants of real risk-free rates while Lettau and Ludvigson (2001) seem to capture business cycle frequencies.

#	percent	G4
1	β_{rf}	1.406
2	β_{rp}	0.025
3	β_c	-0.336
	of which:	
4	β_{cp}	-0.168
5	β_n	-0.168
6	Total (lines 1+2+3)	1.094

Table 1: **Unconditional Variance Decomposition of $c_t - w_t$**

Note: β_{rf} (resp.β_{rp}, and β_c) represents the share of the unconditional variance of $c-w$ explained by future risk free returns (resp. future risk premia and future total consumption growth); β_{cp} (β_n) represents the share of the unconditional variance of $c-w$ explained by per capita consumption growth (population growth). The sum of coefficients $\beta_{cp}+\beta_n$ is not exactly equal to β_c due to numerical rounding in the VAR estimation. Sample: 1920-2011

negative. However productivity growth or population growth are unlikely to be the main drivers of $c-w$ unless they have a disproportionate effect on real risk free returns.

2.5 Predictive regressions

Our decomposition exercise indicates that the consumption-wealth ratio contains information on future risk-free rates. We can evaluate directly the predictive power of cw_t by running regressions of the form:

$$y_{t+k} = \alpha + \beta cw_t + \epsilon_{t+k} \tag{3}$$

where y_{t+k} denotes the variable we are trying to forecast at horizon k and cw_t is the consumption-wealth ratio at the beginning of period t. We consider the following candidates for y: the average real risk free rate between t and $t+k$; the average one-year excess return between t and $t+k$; the average annual real consumption growth growth per capita between t and $t+k$; the average annual population growth between t and $t+k$.

Tables 2 presents the results. We find that the consumption-wealth ratio always contains substantial information about future short term risk free rates (panel A). The coefficients are increasing with the horizon and become strongly significant. They also have the correct sign, according to our decomposition: a low $c-w$ strongly predicts a period of below average real risk-free rates. By contrast, the consumption-wealth ratio has almost no predictive power for the equity risk premium and very limited predictive power for per capita consumption growth. The regressions

U.S., U.K., France and Germany				
Forecast Horizon (Years)				
	1	2	5	10
A. Short term interest rate				
$c_t - w_t$	**.07**	**.10**	**.19**	**.22**
	(.06)	(.06)	(.06)	(.04)
R^2	[.03]	[.07]	[.27]	[.43]
B. Consumption growth (per-capita)				
$c_t - w_t$	**.06**	**.05**	**.02**	**.01**
	(.04)	(.04)	(.02)	(.02)
R^2	[.06]	[.06]	[.02]	[.00]
C. Equity Premium				
$c_t - w_t$	**.27**	**.20**	**.01**	**-.06**
	(.25)	(.18)	(.11)	(.11)
R^2	[.02]	[.02]	[.00]	[.01]
D. Population Growth				
$c_t - w_t$	**.02**	**.02**	**.02**	**.02**
	(.01)	(.01)	(.01)	(.01)
R^2	[.07]	[.13]	[.18]	[.24]

Table 2: **Long Horizon Regressions**. Note: The table reports point estimates, Newey-West corrected standard errors and the R^2 of the forecasting regression.

indicate some predictive power for population growth: a low $c-w$ predicts a low future population growth which suggests that the indirect effect (via changes in real risk-free rates) dominates the direct effect, since the direct effect of a lower future population growth (and total consumption growth) would be to increase $c-w$ according to Equation (2).

Figure 10 reports our forecast of the risk free rate using the G-4 consumption-wealth ratio at 1, 2, 5 and 10 year horizon. For each year t, the graph reports $r^f_{t,k} = \frac{1}{k}\sum_{s=0}^{k-1} r^f_{t+s}$, the average of the one-year real risk-free rate between t and $t+k$ where k is the forecasting horizon. The graph also reports the predicted value $\hat{r}^f_{t,k}$ based on predictive regression (3). While the fit of the regression is quite poor at 1-year, it becomes quite striking at 10-year. Our point estimates indicate that short term real risk free rates are expected to remain around -2% for an extended period of time. The last forecasting point is 2011, indicating a forecast of -2% until 2021 (bottom right graph).

2.6 Interpretation.

Taken together, our results suggest that boom-bust financial cycles are a strong determinant of real short term interest rates. Wealth increases rapidly during the boom, faster then consumption. Increased leverage, financial exuberance, and risk appetite fuel asset prices, bringing down $c-w$.

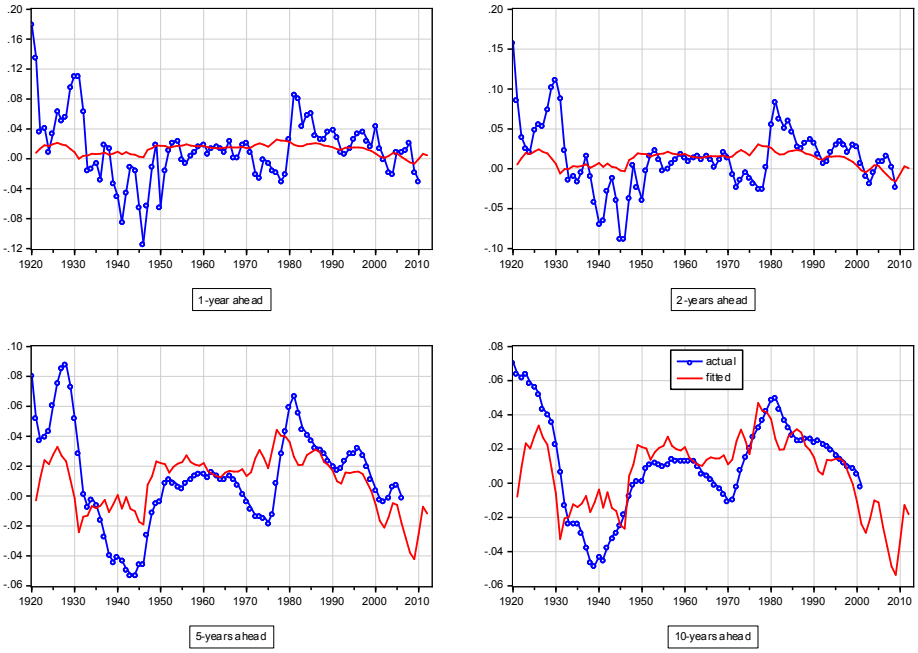

Figure 10: **Predictive Regressions: Risk Free Rate, 1920-2010.** Note: The graph reports forecasts at 1, 2, 5 and 10 years of the annualized global real risk free rate from a regression on past $\ln(c/w)$. Each graph reports, for each time t, the average short real interest rate between t and $t+k$ where k is the forecasting horizon, together with the forecast at time t, based on cw_t.

Two such historical episodes for the global economy are the roaring 1920s and the 2000s. In the subsequent bust, asset prices collapse, collateral constraints bind, and households, firms and governments attempt to simultaneously de-leverage, as risk appetite wanes. The combined effect is an increase in saving that keeps future safe real interest rates low. An additional force may come from a weakened banking sector and financial re-regulation or repression that combine to further constrain lending activity to the real sector. Our estimates indicate that short term real risk free rates are expected to remain low or even negative for an extended period of time. Since current rates are constrained by the Zero Lower Bound, natural real interest rates might be even lower!

Our empirical results do not support directly the view that low real interest rates are the result of low expected future productivity –since we don't find much predictive or explanatory power for future per capita consumption growth- or demographic forces. Instead, it points us towards the global financial cycle boom/bust cycle, both in the 1930s and now. Under this interpretation, it is the increased in desired savings, and the move away from risky asset that drive real interest rate determination. Therefore, we view these empirical results very much in line with interpretations

of recent events that emphasize the global financial cycle (Miranda-Agrippino and Rey (2015), Reinhart and Rogoff (2009), as well as the scarcity of safe assets (Caballero and Farhi (2015)).

3 Imbalances and The Curse of the Regional Safe Asset Providers.

If the scarcity of safe assets can drive equilibrium real interest rates down -potentially into a global liquidity trap, with most advanced economies at the ZLB, their geographical distribution will determine the pattern of global imbalances. As described in Gourinchas et al. (2010), the country at the centre of the international monetary system acts as the world insurer and global liquidity provider. As such, its external balance sheet is particularly remarkable, featuring large amounts of liquid gross external liabilities and large gross mostly illiquid external assets. It follows that the center country typically has a large long net position in risky assets and a large short net position in safe liabilities. As shown in Figure 11, U.S. net exposure to risky assets amounts to about 10% GDP in 2015Q4 after having reached 37% of GDP in 2007 Q4, while U.S. short net position in safe liabilities amounts to around 58% of GDP in 2015Q4, having undergone a trend increase (in absolute value) since 1984.[29]

This asymmetric composition of assets and liabilities explains largely the excess returns that the US earns on its external position. But this *exorbitant privilege* (see Gourinchas and Rey (2007a)) comes with an *exorbitant duty* (Gourinchas et al. (2010)). In times of global stress the value of the external assets of the U.S., dominated by risky investment, plummets while the value of its liabilities remains stable or even appreciates. As the centre country provides insurance to the rest of the world, its gross liabilities can be large relative to its own economic size. The properties of the external balance sheet of the centre country therefore imply massive wealth transfers to the rest of the world in troubled times. Since at least the summer of 2007, financial markets have been in turmoil. The subprime crisis, followed by the default or near default of several investment banks, insurance companies and nation states has driven volatility to levels not seen in the last two decades. Inspection of the data on the net foreign asset position of the United States during the period of the recent crisis is very revealing. As discussed earlier, Figure 8 reports updated

[29] Net exposure to risky assets is defined as FDI assets+ equity assets+ loans and portfolio debt to emerging markets and euro area periphery - (FDI liabilities+ Equity liabilities). Net safe liability position is defined as Net Foreign Asset position - net risky asset position. The net safe liability position consists therefore of loans and portfolio debt assets to advanced economies (except euro area periphery) + gold and reserves - portfolio and bank liabilities.

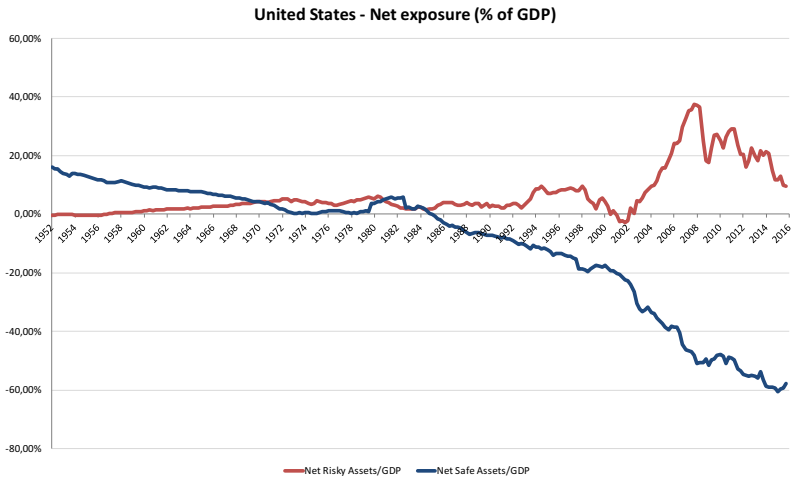

Figure 11: **US net exposure to risky assets and net position in safe liabilities as a % of US GDP, 1952Q1-2015Q4.** Net exposure to risky assets is defined as (FDI assets+ equity assets+ loans and portfolio debt to emerging markets and euro area periphery) - (FDI liabilities+ Equity liabilities). Net safe liability position is defined as Net Foreign Asset position - net risky asset position (the net safe liability position consists therefore of loans and portfolio debt assets to advanced economies (except euro area periphery) + gold and reserves - portfolio and bank liabilities)). For portfolio debt we use the geographical breakdown of the Coordinated Portfolio Investment Survey (IMF). For bank loans and liabilities we use the US TIC data geographical distribution (https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/ticlaim.aspx). We compute geographical shares from those two data sources and apply them to the IIP data.

estimates of the U.S. net foreign asset position since 1952. We observe three dramatic collapses of the U.S. international asset positions as a fraction of GDP during the crisis: between 2007Q4 and 2009Q1 as the US investment banking world sank and the U.S. net foreign asset position declined by about 24% of GDP; it initially bounced back but between 2011Q1 and 2012Q2, it declined again by 20.5% of GDP as the Eurozone crisis was unfolding; finally between 2013Q3 and 2015Q3 it decreased by another 19% of GDP as the dollar appreciated substantially against the yen and the euro, decreasing the dollar value of external assets. All in all, between 2007Q4 and 2015Q3, we estimate that U.S. valuation losses represent $4.13 trillion, or a staggering 22.9% of 2015 U.S. GDP.

3.1 Scarcity of Safe Assets and the Exorbitant Duty

Periods of turmoil come with massive movements in net foreign asset positions, especially that of the center country providing insurance to the rest of the world. In the current configuration of the International Monetary System, the U.S. is the main world insurer. There are however a number

of smaller or more regional safe asset providers such as Switzerland, or Germany and other core eurozone economies. An important message of Gourinchas et al. (2010) is that the status of safe asset issuer inevitably comes with increased exposure to global shocks.

As pointed out in Section 2 of this paper, one plausible interpretation of the current very low real rates is that the world economy is characterized by a large demand for safe assets, driven in part by post-crisis deleveraging dynamics. Indeed we found that low consumption-wealth ratios, symptomatic of periods of financial exuberance and rapid wealth growth predict low future real interest rates for an extended period of time. This sequence of events occurred at the time of the Great Depression, as well as in the more recent period.[30]

Faced with a large demand for safe assets, safe asset issuers are confronted with an important tradeoff. They can either choose to provide insurance to the rest of the region or world and thus let their external balance sheet grow, together with their external exposure to global risk. Or they can choose to limit the issuance of safe assets, letting the value of domestic asset rises and their currency appreciate, thereby increasing the value of their limited supply of safe assets.

Gourinchas et al. (2010) argue that this trade-off is a variant of the old '*Triffin dilemma*' (Triffin (1960)): on the one hand, limiting the supply of safe assets can have contractionary effects on the economy as the currency appreciates; on the other hand, the increased external exposure to macroeconomic risk can generate potentially large valuation losses in the event of a global crisis, as described above in the case of the United States. In the limit, as external exposure grows, it could even threaten the fiscal capacity of the regional safe asset provider, or the loss absorbing capacity of its central bank, leading to a run equilibrium.[31]

For small regional safe asset providers, the tradeoff between real appreciation of their currency and net external exposure to global risk is likely to be even less appealing: the smaller the country is, the larger is the quantity of safe assets it has to provide to the rest of the world, in relation to the country's economic size– or the larger the appreciation of its currency has to be in order to boost the value of these safe assets. The smaller the regional safe asset provider is, the less palatable either of these alternatives is likely to be, a result we dub the '*curse of the regional safe*

[30] Shifts in the composition of institutional investors, increased size of the asset management industry (pension funds for example) and/or changes in financial regulation can also play a role in fostering higher demand for assets and in particular safe assets.

[31] Gourinchas and Rey (2007a) already suggested the possibility of a run of international investors on the gross liabilities of the centre country in the case where its fiscal capacity would be put into question by international investors, stressing the parallel with the old '*Triffin dilemma*'. See also Obstfeld (2011).

asset provider.'

Figure 12 illustrates the argument.[32] The solid lines (blue) represent the trade-off curves between net exposure to global risks (in units of domestic output) and the appreciation of the domestic currency, for a large and a small safe asset provider. The *curse of the regional safe asset provider* is simply illustrated by the fact that the trade-off curve for the smaller country lies above that for the larger one: the former faces a larger exposure (relative to its own size) and/or a larger appreciation.[33] The dashed (red) lines represent illustrative indifference curves: they capture the notion that countries prefer both less net exposure and less appreciated currencies: utility increases as we move towards the lower left part of the figure. Each country chooses a different optimal point at the tangency between the indifference curve and its size-specific trade-off curve: point A for the larger country and point B for the smaller one. As is clear from the figure, depending on the shape of these indifference curves, countries may pick different 'habitats' on the trade-off curve. For instance, as we have drawn the figure, the smaller country prefers less exposure and more appreciation, relative to the larger country.[34] There are good reasons to believe that larger economies will be content with supplying the safe asset elastically and absorb the (comparatively smaller) exposure, while smaller countries may prefer to let their real exchange rate appreciate more, in order to avoid excessively high levels of external exposure. Smaller countries may be particularly unwilling to let their external exposure grow too much, if this would threaten their solvency in case of a bad enough shock. This could in turn potentially endanger their status as safe haven. In the realistic case where small countries are competing with other safe asset providers (including potentially large ones), they could easily lose their share of the *exorbitant privilege* to their competitors by excessively expanding their exposure. Strategic complementarities between investors could even open the door to run equilibria, to which smaller safe asset providers might be more vulnerable.[35] What this suggests is that there are some potentially non-linear responses once exposure levels become too elevated. Smaller safe asset providers are more likely to reach these levels if they attempt

[32] This discussion builds on Gourinchas et al. (2010).

[33] A simple example illustrates the point starkly. Suppose the global net demand for safe asset is inelastic and equal to $\bar{S}$. For the country supplying the safe asset, it follows that $\bar{S} = E.d.Y$ where d is the net exposure, i.e. the ratio of the domestic value of safe assets held abroad to domestic output, Y, and E is the value of the safe asset currency, with an increase reflecting an appreciation. This defines a trade-off curve $d.E = \frac{\bar{S}}{Y}$ that is higher for smaller economies (lower Y).

[34] This is only a relative statement. Since the smaller country faces a worse trade-off, point B features a more appreciated currency and more exposure compared to point A. But the relative share of the adjustment changes towards more exchange rate flexibility.

[35] See Calvo (2013) for related arguments.

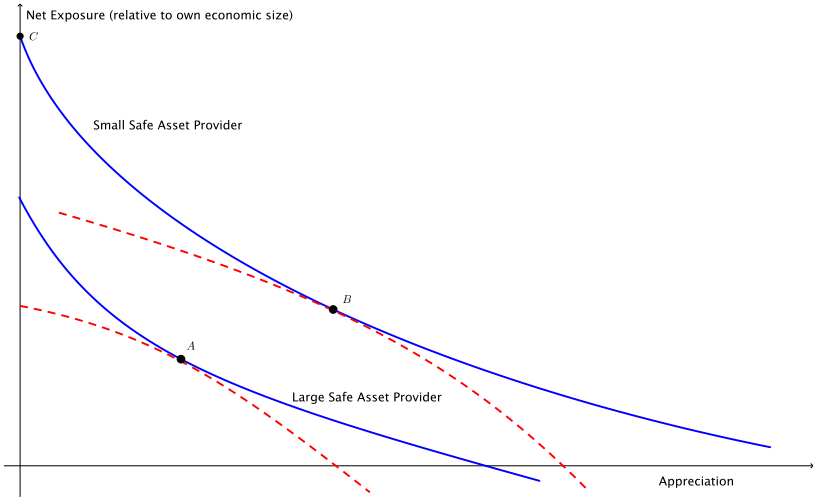

Figure 12: **The Curse of the Regional Safe Asset Provider.** Note: The solid (blue) line reports the trade-off between net exposure (relative to own output) on the vertical axis and the appreciation of the domestic currency on the horizontal axis. The dashed (red) line reports illustrative indifference curves when countries prefer less external exposure and less appreciated currency. Point A corresponds to the optimal choice of exposure and currency appreciation for a large safe asset provider. Point B is the corresponding point for a small safe asset provider. A small safe asset provider under fixed exchange rates would end up at point C instead.

to prevent an appreciation of their currency. A small safe asset provider may therefore subject itself to a 'value-at-risk constraint', to avoid excessively risky exposure levels, and prefer to let its currency appreciate.[36]

According to this analysis a small economy such as Switzerland (point B) will tolerate a more appreciated currency than the U.S. (point A). If instead the small economy attempted to fix the value of its currency, it would face very elevated exposure levels (point C). Such high levels of exposure may eventually threaten the solvency of the country. For a small asset provider, this discussion suggests that it seems optimal to retain some flexibility in the real exchange rate.

3.2 European safe asset providers

3.2.1 Switzerland

In light of these considerations, we revisit the recent experience of two European safe asset providers: Switzerland and core EMU, which we will interpret here to mean Germany. The case of Switzerland

[36]Large safe asset providers may limit their issuance for a different reason, namely to manipulate their terms of trade. See Kindleberger (2013) for a discussion of the role of the 'benevolent hegemon' in that context.

illustrates nicely the terms of the basic trade-off: after fixing its exchange rate against the euro in September 2011, the Swiss National Bank grew increasingly worried about its external exposure. The decline in the Swiss net external position between 2011Q2 and 2015Q1 was very large: it went from 123% of GDP to 84% of GDP, with a peak of 143% in 2012Q3. In January 2015, in a surprise announcement, the central bank chose to let its currency float, a move that was followed by a sharp appreciation of the Swiss currency (see Figure 7). In Figure 13, we show the rapid growth of official reserves and of the external risky assets of Switzerland (in particular FDI) after the beginning of the global financial crisis. At end 2015, FDI and equity external assets amount to about three times the Swiss GDP. On the liability side, banking deposits account for the lion's share of the Swiss external position as evidenced in Figure 14. External debt liabilities are very small due to the lack of depth in the Swiss debt market, so that Swiss safe assets are effectively bank deposits. Gross bank deposits and trade credit (the "other liability" category of the balance of payment) reached almost 200% of Swiss GDP by end 2015. This is despite the fact that the Swiss Franc was allowed to appreciate substantially, suggesting that the increased exposure would have been even higher had the peg not been abandoned. Figure 15 shows the net exposure of Switzerland to risky assets and the net position in safe liabilities. Both are decreasing in absolute value in recent years though next exposure is still high (about 100% of GDP in net risky assets even if the net safe position is zero) in 2015Q4. This decline in net exposure is to some extent misleading however. The reason is that unlike for the U.S., the foreign exchange reserves of Switzerland are very sizable. We included them in the safe assets (hence they decrease the net risky position and increase the net safe position of Switzerland). But because of their currency composition, they carry significant exchange rate risk (in Q2 2016 for example the SNB portfolio investments in foreign currency bonds were dominated by euro investments (41%) and dollar ones (32%)).[37] Since total reserves grew from 39% of GDP to 88% of GDP during the period 2011Q2-2015Q1, taking the associated risk into account would increase very sizably the net risky exposure of Switzerland and decrease its net safe liability position in the recent years.

[37] Source: http://www.snb.ch/en/iabout/assets/id/assets_reserves

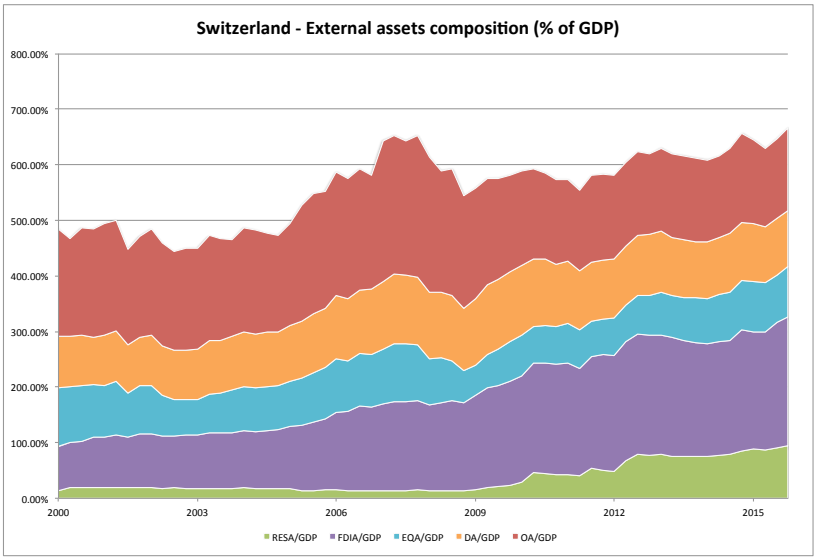

Figure 13: **Swiss Gross External Assets, 2000Q1-2015Q4.** Note: The graph reports the gross external asset position of Switzerland as a % of GDP . RES: Reserves; FDI: Foreign Direct Investment; O : bank loan and trade credit; D: Portfolio Debt; EQ : Portfolio Equity.

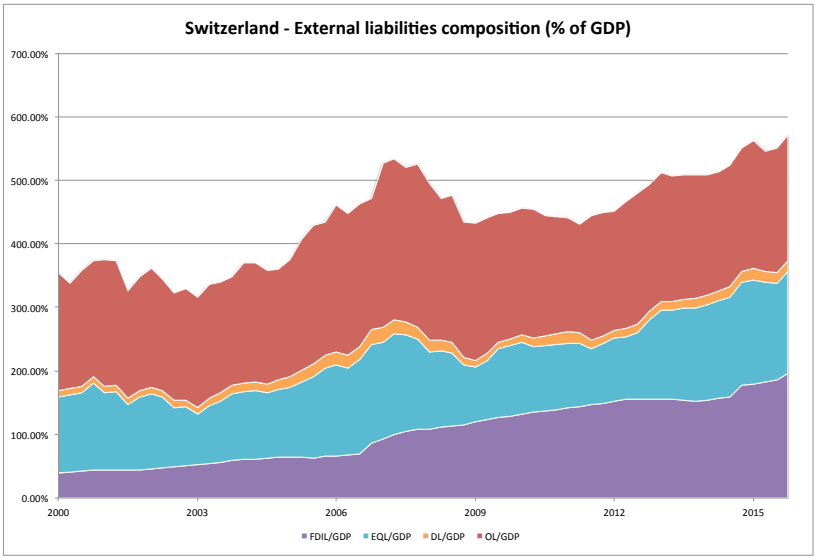

Figure 14: **Swiss Gross External Liabilities, 2000Q1-2015Q4.** Note: The graph reports the gross external liability position of Switzerland as a % of GDP . FDI: Foreign Direct Investment; O : bank loan and trade credit; D: Portfolio Debt; EQ : Portfolio Equity.

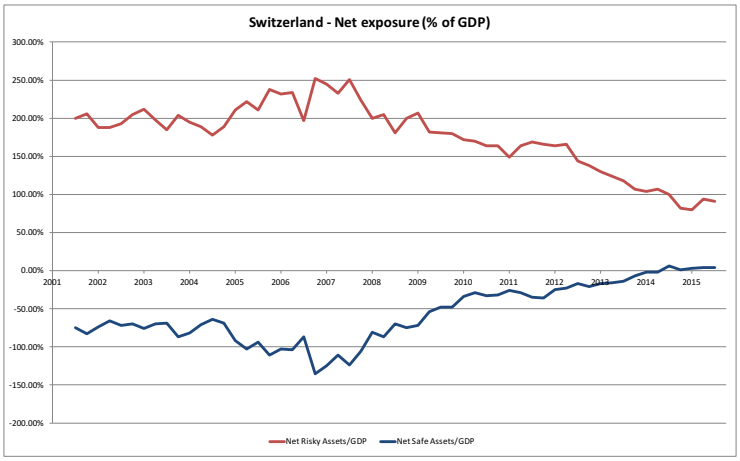

Figure 15: **Swiss net exposure to risky assets and net position in safe liabilities as a % of Swiss GDP, 2000Q1-2015Q4.** Note: Net exposure to risky assets is defined as (FDI assets+ equity assets+ loans and portfolio debt to emerging markets and euro area periphery) - (FDI liabilities+ Equity liabilities). Net safe liability position is defined as Net Foreign Asset position - net risky asset position (the net safe liability position consists therefore of loans and portfolio debt assets to advanced economies (except euro area periphery) + gold and reserves - portfolio and bank liabilities)). For portfolio debt we use the geographical breakdown of the Coordinated Portfolio Investment Survey (IMF). For bank loans and liabilities we use the Locational Banking Statistics (BIS) geographical distribution. We compute geographical shares from those two data sources and apply them to the IIP data.

3.2.2 Core EMU

The case of core EMU is equally fascinating. In the run-up to the financial crisis, it acted as a safe asset provider, with an extra twist. As documented by Hale and Obstfeld (2016), Germany alongside other core Eurozone countries such as France, Belgium and the Netherlands, invested in risky projects in peripheral Eurozone members, but also intermediated foreign capital into these countries, thereby increasing further their exposure. Most of that increased exposure occurred via an expansion in core EMU bank's balance sheet and leverage (Miranda-Agrippino and Rey (2015)) and cross-border loans instead of portfolio holdings. In short, core EMU banks borrowed globally and lent to peripheral Eurozone countries, earning small but positive excess returns in the process. Importantly, because core EMU shares a common currency with the rest of the Eurozone, it cannot let its currency appreciate in response to a surge in the demand for safe assets. Instead, it has to absorb the increased exposure onto its national balance sheet. We illustrate how this trade-off has

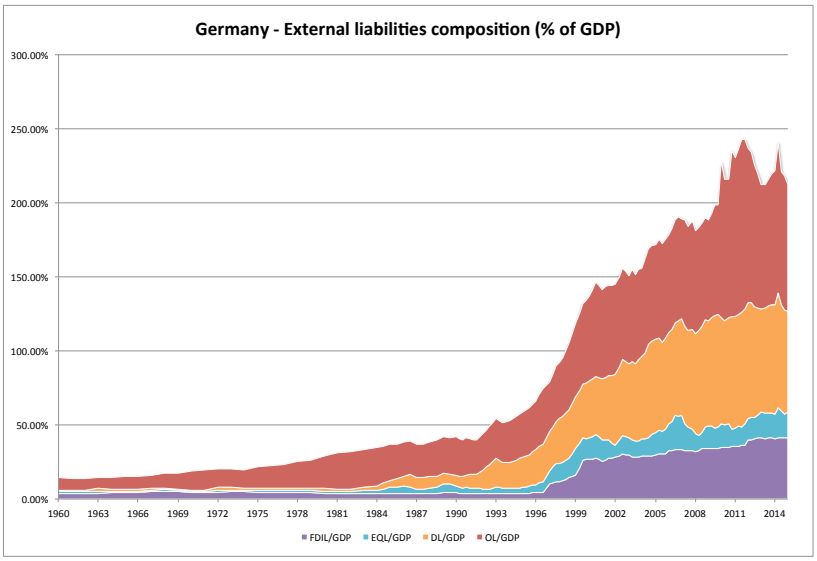

Figure 16: **German Gross External Liability Position, 1960Q1-2015Q4.** Note: The graph reports the gross external liability position of Germany disaggregated by asset classes, as a % of GDP. FDI: Foreign Direct Investment; O : bank loan and trade credit; D: Portfolio Debt; EQ : Portfolio Equity.

played out by considering in detail the external balance sheet of Germany.[38]

As can be seen from Figure 16, on the liability side the German external balance sheet has the definite characteristics of a safe asset provider with a very large share of its gross liabilities being either debt or bank liabilities (153% of GDP at end 2015). Over the period 1960-2015Q4, the share of safe liabilities in total liabilities is always above 60% and is sometimes above 80%. Portfolio equity and FDI account for a small share of liabilities. Interestingly the amount of safe assets held by foreigners has increased sizably with the euro area crisis in 2010. What is remarkable however is that on the asset side the portfolio is very symmetric in terms of asset classes, with the share of FDI and equity hovering around 20 and 30% of total assets in recent years (Figure 17). A very large proportion of German external assets are fixed income securities or bank loans. This is different from the US which is invested heavily in FDI and portfolio equity and exhibits a very asymmetric balance sheet structure in terms of asset classes. The riskiness of the bank loans and deposits may be very different on the two sides of the German balance sheet however. Indeed, German banks have extended large amount of credits to the euro periphery. At end 2003, the consolidated claims of German banks on the euro area as a whole was about 92% of German GDP. At their peak in July 2007 they amounted to an impressive 125% of GDP while the first warning shots of the global

[38]Similar trade-offs are present for the other core EMU members. However, Germany plays a prominent role in that group.

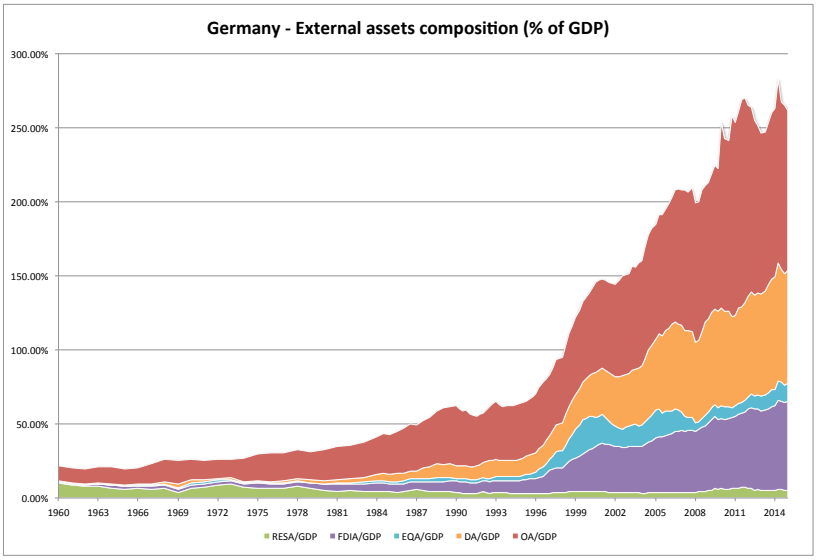

Figure 17: **German Gross External Asset Position, 1960Q1-2015Q4.** Note: The graph reports the gross external asset position of Germany disaggregated by asset classes, as a % of GDP. FDI: Foreign Direct Investment; O : bank loan and trade credit; D: Portfolio Debt; EQ : Portfolio Equity.

financial crisis were becoming more obvious.

In Figure 18 we look at the geographical composition of consolidated German Monetary and Financial Institutions (MFIs) external claims.[39] The share of German banks' claims on the euro area in total claims climbed by about 10 points (from 33% to 42%) between July 2007 and September 2009. The share of claims on the euro area periphery had been in constant rise from 2002 and up to 2009 while the share of claims on the core euro area countries, after dipping in 2005 and decreasing till 2007, resumed its growth from 2007 onwards. The years 2009-2010 constitute turning points with German banks decreasing massively their exposures to the periphery. In Figure 19 we calculate the net risky exposure of Germany, including not only FDI and equity assets but also portfolio debt as well as loans to emerging markets and to the periphery of the euro area (using the locational statistics -not the consolidated ones- for consistency with the IIP data). The German net risky position increased to reach about 100% of German GDP in 2015. At the same time, German's net safe liability position stabilized around -50% of GDP after having reached a peak of about -70% of GDP during the euro area crisis. Hence the net risky and net safe position

[39] We looked both at consolidated data and non-consolidated data. Non-consolidated data are consistent with the external investment position data which uses balance of payment (residency) definitions but do not cover the full exposure of Germany (based on a concept of ownership). A graph using non-consolidated data (data available since 1994) looks very similar however as far as the movements in shares are concerned. Expected levels of exposures of German banks to the euro area as a percentage of GDP are higher in the consolidated data however.

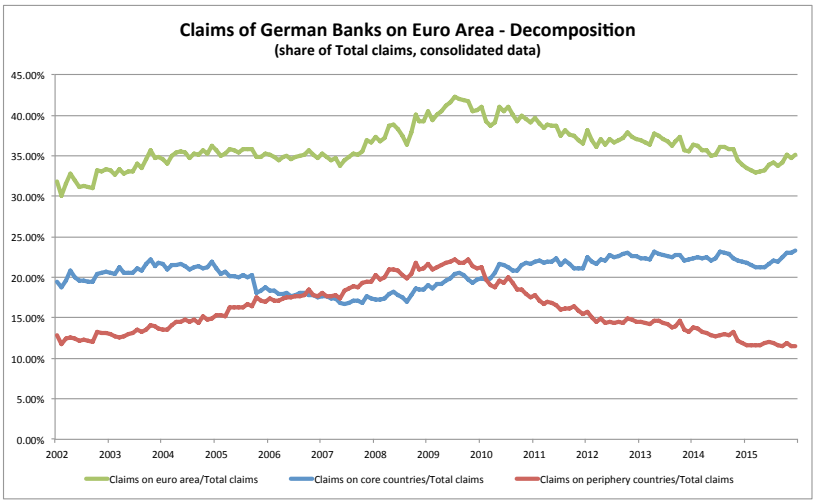

Figure 18: **Geographical composition of consolidated German MFIs external claims, 2002Q1-2015Q4.** Note: The graph reports the geographical composition of consolidated German MFI external claims on euro area countries. The core is defined as Austria, Belgium, Finland, France, Luxembourg, Netherlands. The periphery is defined as Cyprus, Estonia, Greece, Ireland, Italy, Latvia, Lithuania, Malta, Portugal, Slovak Republic, Slovenia, Spain.

of Germany have common features with the U.S. ones. One important difference however comes from the nature of the assets involved: in the case of the U.S., risky assets consist mainly of FDI and equity. In the case of Germany, a sizable share of external assets are bank loans and portfolio debt into risky markets, in particular into the periphery of the euro area.

German banks and investors were therefore loading up exposures on the countries of the periphery of the euro area so that the riskiness of their banking (and portfolio) assets and liabilities was very asymmetric. As a result, Germany was enjoying positive excess returns on its net foreign asset position for most of the period between 1995 and July 2007, since the net international investment position of Germany at market value exceeds the cumulation of current account surpluses or deficits albeit only modestly. These small excess returns appear to turn negative from the spring of 2007 onwards as risk started to be repriced in the global economy as shown on Figure 20.

The official statistics report a large cumulated valuation loss of about 19% of GDP or about €492 bn between the international investment position and the cumulated current account deficit of Germany between 2000 and 2015Q4. As pointed out by Busse and Gros (2016) however, there are reasons to doubt the accuracy of these numbers.[40] Using net investment income data, these authors estimate that returns on German external assets exceeded returns on German external

[40] See also Schipper (2015) and Deutsche Bundesbank (2014).

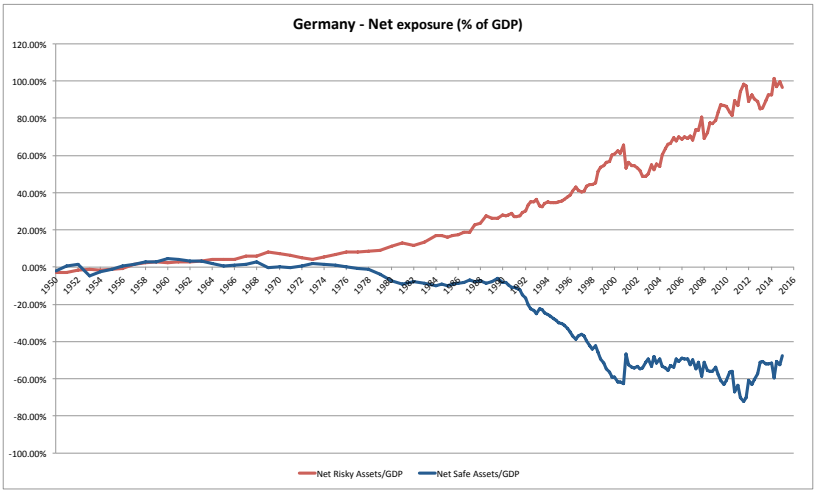

Figure 19: **German net exposure to risky assets and net position in safe liabilities as a % of German GDP, 1950Q1-2015Q4** Note: Net exposure to risky assets is defined as NFA-Net safe position i.e. (FDI assets+ equity assets+ loans and portfolio debt to emerging markets and euro area periphery) - (FDI liabilities+ Equity liabilities). Net safe liability position is defined as reserve assets +loans and debt to advanced economies (except euro area periphery)+ trade credit -(portfolio and other liabilities). For portfolio debt we use the geographical breakdown of the Coordinated Portfolio Investment Survey (IMF). For bank loans and liabilities we use the locational banking statistics (http://www.bundesbank.de/Navigation/EN/Statistics/Time_series_databases/External_sector/). We compute geographical shares from those two data sources and apply them to the IIP data.

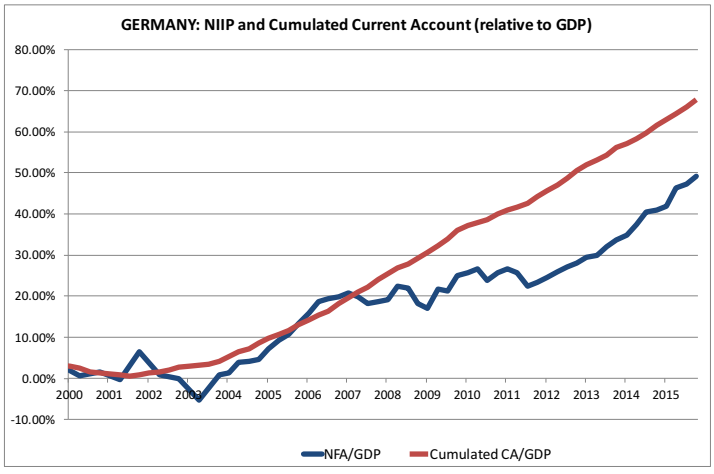

Figure 20: **Gap between the Net International Investment Position of Germany and the cumulated current account surpluses, 2000Q1-2015Q4.**

liabilities even after the onset of the euro area crisis. When the crisis materialized and hit the periphery of the euro area, Germany (and core EMU) stood to suffer substantial capital losses on its net external position, a combination of losses on its gross external assets and capital gains on its external liabilities.

Unlike the U.S. however, where the valuation losses were immediately realized via changes in asset prices and currency price movements, resulting in the sharp decline in the net foreign asset position (Figure 8), these losses do not seem to have materialized. With the crisis, risk was repriced throughout the periphery but there were no large realized losses.[41] Without a debt resolution mechanism for banks or sovereigns within the Eurozone, and with the fear that markets might turn on them, most peripheral eurozone members launched multiple rounds of private and public de-leveraging. The protracted resolution process of the European Sovereign Debt crisis profoundly hampered the recovery of the Eurozone.

Just for illustration purposes, we perform the following simple thought experiment. Imagine that Germany had had the same external balance sheet structure as the US with a large share of risky claims (FDI and equity instead of bank loans and portfolio debt) on the rest of world. We ask: what would have been the order of magnitude of valuation losses that Germany would have incurred between 2007Q4 and 2015Q3? German external assets stood at about 200% of GDP in 2007 while US gross external assets amounted to about 115% of GDP, out of which about 80% were risky. Between 2007Q4 and 2015Q3, our estimates indicate that U.S. valuation losses represented approximately $4.13 trillion, or 22.9% of 2015 U.S. GDP. Assuming a similar change in the value of liabilities in the US and in Germany - both countries benefitted from safe haven effects and have very similar net safe positions in 2007 Q4 (-50% of GDP for Germany and -47% of GDP for the US)-, German losses would have been of the order of 40% of German GDP. We can perform a perhaps less crude calculations by comparing the net exposures in risky assets for the US and for Germany. In the US, net exposure to risky assets stood at about 38% in 2007Q4 (risky exposure, just like that for Germany includes loans and portfolio debt assets to emerging markets and to the euro periphery). For Germany it was about 68% for the same quarter. If Germany had undergone a loss proportional to the US one, Germany would have had a valuation loss of about 41% of GDP, which is very similar to the previous estimates. Whatever disagreement one might have about the

[41] Except in Greece, but Greece was only a small share of German external exposure.

actual losses on the German net foreign asset position during that period, they are very far from 40% of GDP. According to the official statistics – which as mentioned above are probably biased upwards- German losses would be at most 19% of GDP.

Three points are important here. First, some of these valuation losses can ultimately be reverted as the global economy recovers and safe asset providers –via their exposure– stand to gain disproportionately from the subsequent recovery. Second, our point here is not to argue that Germany (or other core EMU countries) should have shouldered such a staggering amount of losses. Rather, it is that the external portfolio structure of regional safe asset providers can entail very large levels of exposure which should be properly understood and monitored. Third, this portfolio structure is an equilibrium phenomenon, emerging from market forces and expected returns. If German post-crisis external returns are not very low, German pre-crisis external returns do not appear inordinately large either: the yield difference between core and periphery investment appeared surprisingly low in the run-up to the Eurozone crisis. This may have been the result of massive risk shifting on the part of core-EMU financial institutions. It also suggests that safe asset providers are disproportionately vulnerable to periods of excessive risk appetite. Ultimately, this contributes to extremely elevated exposure levels that make it very difficult to achieve a speedy resolution.

The result of the protracted deleveraging in the euro area has been a massive shift from current account balance, to a current account surplus of 0.7% of world GDP, as illustrated on Figures 5 and 6. In terms of our earlier analysis, these deleveraging forces pushed the natural interest rate in the Eurozone far below the rest of the world. If the Eurozone were a closed economy, the resulting deflationary forces would have been self-defeating, just as attempts to deflate one's economy at the expense of one's trading partners were ultimately self-defeating during the Great Depression. At the Zero Lower Bound, instead, this shift towards surpluses has lessened the burden of adjustment on the Eurozone, at the expense of the rest of the world.

In summary, core EMU has not performed its role as a regional insurer. Unlike the U.S. which saw its net foreign asset position deteriorate a great deal during the crisis, as U.S. Treasuries appreciated while external assets plummeted in value, core EMU has not absorbed the banking losses on its balance sheet. Unrealized losses have been pushed onto the peripheral countries' public sector balance sheet, forcing them to delever aggressively. This aggregate delevering, and

the corresponding surge in saving continues to have deleterious effects on the global economy.[42] Given our finding that real interest rates will remain low for an extended period of time, we consider that it would be wise to steer away from policies that make us teeter on the verge of a global liquidity trap. Being a regional safe asset provider may prove to be a curse not only to core EMU, but to the EMU as a whole, and to the global economy.

4 Conclusion

Several implications can be derived from our analysis. First, we analyze the long run historical time series of consumption and wealth of four large economies accounting for much of international financial and economic activity between the end of the 19th century and today (the United States, the United Kingdom, France and Germany). We show that consumption wealth ratios tend to predict future movements in real risk-free rates. The strength of our analysis comes in particular from the fact that we do not superimpose any structural model on our data; all our results are obtained using merely the intertemporal budget constraint of the world economy proxied by these four countries. Economic common sense and our budget constraint say that low consumption-wealth ratios today have to be an indication of future low returns on wealth or high future consumption growth. After decomposing the return on wealth in a real rate component and an excess return component and constructing the relevant VARs, we obtain a first-order result: consumption-wealth ratios predict future real riskless rates. Furthermore, we identify two historical periods during which the consumption wealth ratios have been unusually low: those are the two "secular stagnation" periods (the 1930s and the current period). Both periods have been preceded by a period of "financial exuberance" (the 1920s and the 2000s) were wealth has grown quickly. Both periods have seen a major financial crisis followed by a period of deleveraging and low consumption. These deleveraging periods during which we observe low consumption to wealth ratios announce low future real rates. The bottom line is that our estimates indicate that the real rates should stay low for several more years. Such a long period of low real rates has consequences ranging from the sustainability of the business models of banks and insurance to the solvency of pension plans.

[42] Reinhart and Rogoff (2009) emphasize that besides deleveraging post-crisis weakness of the banking sector and in some cases post-crisis re-regulation of the financial sector (which may involve some degree of financial repression) are also important factors contributing to the weakness of the economy.

It also makes it more likely that several countries fall or stay in a liquidity trap. In a world where many countries flirt with the ZLB, it is the reallocation of demand across geographical areas that determines global imbalances as shown by Caballero et al. (2015) and Eggertsson et al. (2015). There is therefore a large risk that countries pursue non-cooperative policies. Another important message of our paper is that a world of low real rates also comes with unequal burdens. Safe asset providers and in particular regional or small safe asset providers face a large demand for their assets in times of turmoil. Building on Gourinchas et al. (2010), we show in section 3 of the paper that such countries face a tradeoff between letting their exposure to world risk increase or allowing their currency to appreciate in real terms. The tradeoff is starker for smaller economies (such as Switzerland or core EMU countries) than for the United States as their exposure can rapidly rise to several multiple of GDP. We dub this the '*curse of the regional safe asset providers*.' The recent experience of Switzerland comes to mind. Unlike the United States whose net foreign asset positions has massively declined since 2007 (as insurance has been provided to the rest of the world), core EMU countries have postponed or avoided losses on their external assets, forcing euro area economies of the periphery to delever to make good on their external debt. Euro area periphery countries' deleveraging has translated into a large aggregate current account surplus of the euro area, effectively exporting recession abroad.

What are the implications of our analysis? The issue of post-crisis deleveraging leading to low levels of the real interest rate is central to the difficulties of the world economy. Hence our econometric analysis supports the part of the "secular stagnation" literature which assigns the current economic weakness to the post financial crisis debt hangover and overhang. Increased public spending in particular seems likely to decrease the risk of falling into a liquidity trap. But our analysis also suggests a particular role for countries issuing safe assets. Overcoming the "curse of the regional asset provider" seems to be one of the most challenging issue.

First, if the Eurozone were to issue safe assets on a larger scale instead of relying only on Bunds, French OAT, or on Swiss deposits, this would increase the supply of safe assets and presumably increase the real rate. This should give impetus to a number of initiatives aiming at developing euro-area safe assets, whether red/blue bonds (see Von Weizsäcker and Delpla (2010)); ESBies (see Brunnermeier et al. (2011)); or CDOs (see Corsetti et al. (2016)). Relying on a broader supply of safe assets, whose safety is not aligned with geographical boundaries but rather spans the entire

euro area would avoid the destabilizing portfolio shifts occurring during periods of high risk. In periods of volatility, endogenous market segmentation increases, hindering the proper transmission of monetary policy and capital flows towards safe haven countries pushing them to either supply insurance and increase their risk exposure or to real appreciation with recessionary risk. Overcoming the curse of the regional asset provider can therefore be done by delinking the supply of safe asset from a particular economy.

Second, having a mechanism which allows orderly loss-taking within the euro area would help overcome the curse of the regional safe asset provider. When losses are not realized and deleveraging drags on, recession takes hold and becomes self-defeating in a closed economy. In an open economy, recession is exported abroad via current account surpluses. One could think of institutionalizing a sovereign debt restructuring mechanism within the euro area to make sure that the current situation does not reproduce itself in the future. By enabling an orderly write-down of debts, a sovereign debt restructuring mechanism avoids long periods of deleveraging and resolves the problem of debt overhang (see Corsetti et al. (2016) for a possible implementation). Paying particular attention to the treatment of non-performing loans (NPLs) in the portfolios of banks could help avoid the well-known phenomenon of zombie lending. Sovereign debt restructuring and NPLs write down could in some cases lead to financial instability and contagion across the area. Safeguards in terms of banking union (including deposit guarantees) if in place would help decrease the likelihood of contagion.

Third, developing the Capital Markets Union would allow a quicker write down of losses. Were risk to be shared through contingent assets -such as FDI and equity-we would not be facing the protracted current period of recession associated with a long and painful deleveraging of the periphery. In that respect much remain to be done and in particular some major rethinking of the legal infrastructure (bankruptcies).

Lastly, increased monitoring of core EMU banks and financial intermediaries would enable regulators and supervisors to avoid boom-bust cycles in financial markets. In this crisis, international banks have borrowed globally and lent to peripheral Eurozone countries, earning small but positive excess returns in the process. Core EMU countries have not let their real exchange rate appreciate in response to a surge in the demand for safe assets. Instead, they have tended to absorb the increased external exposure onto their national balance sheet. Some of that increase in financial

sector exposure may well reflect risk shifting and expectations of bailouts using tax payers money. A very careful monitoring of financial fragilities and imbalances, especially for EMU safe asset providers woudl decrease the probability of financial instability.

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Appendix

A Data Description

The data used in Section 2 were obtained from the following sources:

1. **Consumption:**
   Real per-capita consumption going back to 1870 and covering the two world wars was taken from Jordà et al. (2016) who in turn took the data from Barro and Ursúa (2010). As this consumption series is an index rather than a level, we convert it to a level using the consumption data from Piketty and Zucman (2014a). To convert to a level we could use any year we have level data for but chose to use the year 2006 (the year that the index of consumption was 100). In addition, the consumption data was adjusted so that instead of being based on a 2006 consumption basket, it was based on a 2010 consumption basket to match the wealth data.

2. **Wealth:**
   Real per capita wealth data was taken from Piketty and Zucman (2014b). The wealth concept used here is private wealth. As such it does not include government assets but includes private holdings of government issued liabilities as an asset. Where possible, wealth data is measured at market value. Human wealth is not included. Private wealth is computed from the following components: "Non-financial assets" (includes housing and other tangible assets such as software, equipment and agricultural land), and net financial assets (includes equity, pensions, value of life insurance and bonds). Prior to 1954 for France, 1950 for Germany, 1920 for the UK and 1916 for the USA, wealth data is not available every year (see Piketty-Zucman's appendix for details on when data is available for each country or refer to Table 6f in the data spreadsheets for each country). When it is available is is based on the market value of land, housing, other domestic capital assets and net foreign assets less net government assets. For the remaining years the wealth data is imputed based on savings rate data and assumptions of the rate of capital gains of wealth (see the Piketty-Zucman appendix for details of the precise assumptions on capital gains for each country. The computations can be found in Table 5a in each of the data spreadsheets for each country).

3. **Short term interest rates:**
   These were taken from Jordà et al. (2016) and are the interest rate on 3-month treasuries.

4. **Long term interest rates:**
   These were taken from Jordà et al. (2016) and are the interest rate on 10 year treasuries.

5. **Return on Equity:**
   This data is the total return on equity series taken from the Global Financial Database.

6. **CPI:**
   CPI data is used to convert all returns into real rates and is taken from Jordà et al. (2016).

7. **Population:**
   These were taken from Jordà et al. (2016).

   Figure 21 reports consumption per capita, wealth per capita, the consumption/wealth ratio as well as the short term real risk free rate for our G4 aggregate between 1920 and 2011.

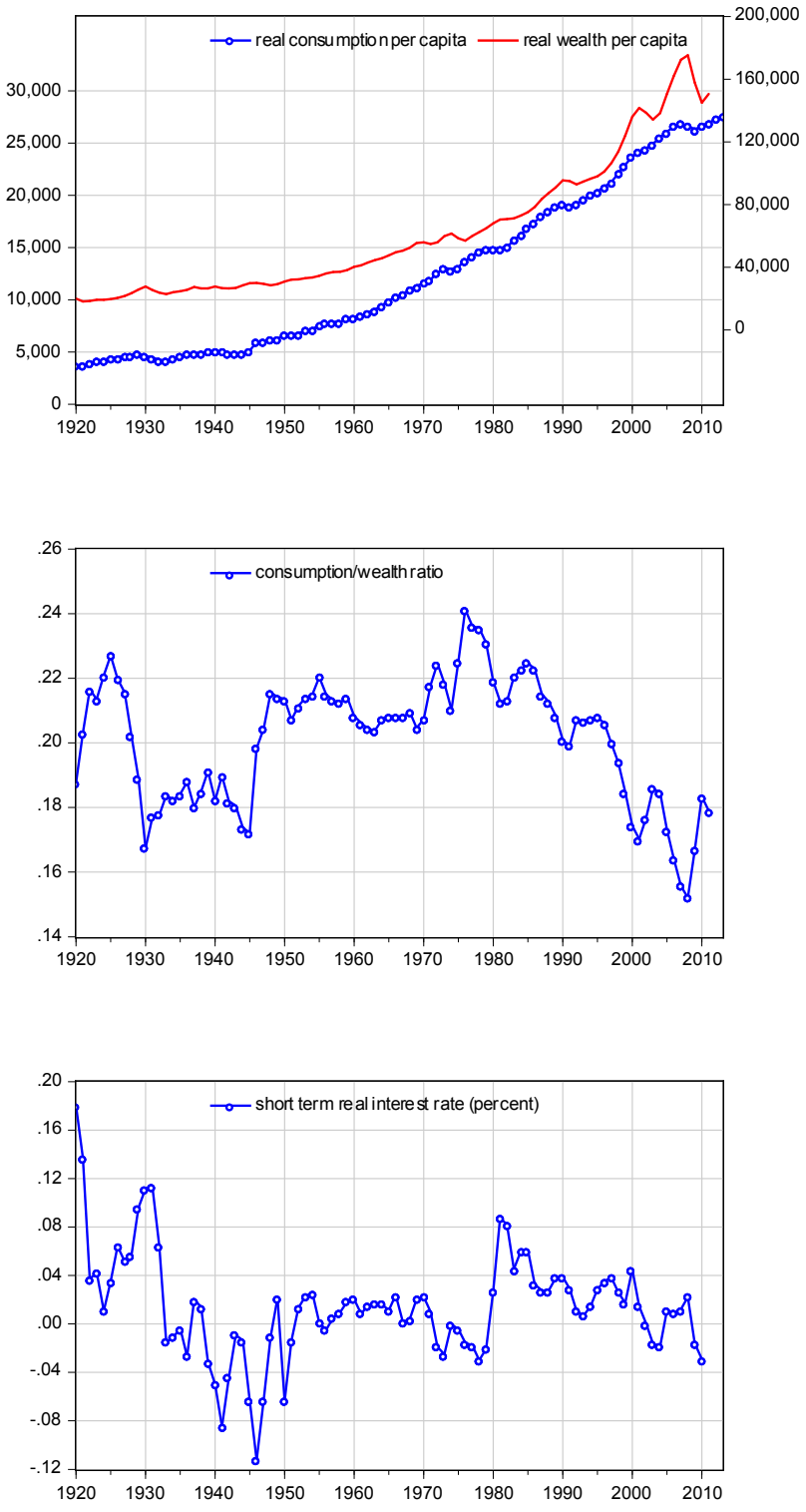

Figure 21: **Real Consumption and Wealth per capita (2010 USD), Consumption Wealth Ratio and Short term real risk free interest rate, U.S., U.K., Germany and France, 1920-2011.**

The data used in Section 3 were obtained from the following sources:

1. **United States:** For the United States, the framework of Gourinchas and Rey (2007a,b),is used to construct net and gross foreign asset positions at market value. Data is available from two sources: the U.S. Department of Commerce's Bureau of Economic Analysis (BEA), and the Federal Reserve Flow of Funds Accounts (FFA). The BEA is the main source for recent data. It reports its *International Investment Position of the United States* (IIP) annually since 1976, and quarterly since 2006. In addition, the BEA reports quarterly flow data in the U.S. International Transactions (USIT) tables since 1960 for some flow series, and 1982 for others. Following official classifications, we split the foreign portfolio into four categories: debt (corporate and government bonds), equity, foreign direct investment (FDI), and other. For assets, reserves are also presented as a separate category. The "other" category includes mostly bank loans and trade credits. It also contains gold reserves. U.S. GDP data are obtained at the quarterly frequency on an annualized basis from the BEA's National Income and Product Accounts (NIPA), Table 1.1.5. - Gross Domestic Product, Line 1. Current account data are from NIPA Table 4.1, Line 33. Appendix B of Gourinchas and Rey (2007a), and Appendix A of Gourinchas and Rey (2007b), provide a complete description of the data construction.

2. **Germany**: For Germany, net and gross foreign asset positions, as well as Current Account data, are obtained from the Deutsche Bundesbank's International Investment Position and Balance of Payments series. Complete series are based on Euros, including for historical data, and are available at the annual frequency from 1949, and the quarterly frequency from 2003Q4. We follow the same decomposition as for the United States into debt, equity, FDI, and other (as well as reserves assets). "Other" is taken as the difference between total external assets (liabilities) and the other 4 (3) categories. It contains mostly bank loans, trade credits, as well as currency and deposits (which include Target 2 balances). Quarterly GDP data on an unadjusted current-prices basis is from the Bundesbank as well as the Federal Statistical Office of Germany (Statistische Bundesamt), and is annualized on a rolling 4-quarter window. Data are linearly interpolated over very short periods of time when needed. Risky assets include FDI and equity assets, while safe liabilities contain debt and "other investment liabilities" (from the official nomenclature, which is slightly more restrained than our "Other" category).German banks data are obtained from the Deutsche Bundesbank as well, specifically the External position of banks series. Those series provide details on the currency and geographical composition of banks' balance sheets. The Bundesbank follows the BIS in providing two main types of classification: locational banking statistics, which are based on the location of banks' offices Banks in Germany (MFIs) series, and consolidated banking statistics, which are based on the nationality of banking groups Claims of German banks, including their foreign branches and subsidiaries vis-a-vis non-residents series. Consolidated data provide a perhaps more accurate picture of the foreign and currency risk exposure of German Banks (concept of ownership), while locational data are more consistent with Balance of Payments data (concept of residency). Finally, Target 2 balances data, which are part of the "Other investment asset" category, are also obtained from the Deutsche Bundesbank, External position of the Bundesbank series.

3. **Switzerland**: Data for the International Investment Position and Current Account of Switzerland are available at the quarterly frequency from 2000Q1 from the Swiss National Bank (SNB), International Economic Affairs division (*Cube ID: auvekomq*). We follow the same decomposition as for the United States and Germany into debt, equity, FDI, and other (as well as reserves assets). "Other" is taken as

the difference between total external assets or liabilities and the other categories. It contains mostly bank loans, trade credits, as well as currency and deposits. Quarterly GDP data is obtained from the State Secretariat for Economic Affairs (SECO) of the Swiss Confederation. Non-adjusted data are used, to be consistent with current account and net investment position data. We use data based on the *production approach*, but figures are similar to expenditure and income-based approaches. GDP is annualized using a rolling 4-quarter window.