Markus Brunnermeier

US Dollar, Deficits, and Safe Assets: Are We Entering a New Global Economic Order?

On Thursday, April 17, Markus Brunnermeier held a talk on "US Dollar, Deficits, and Safe Assets: Are We Entering a New Global Economic Order?" Markus Brunnermeier is the Director of the Bendheim Center for Finance.

A few highlights from the discussion.[1]

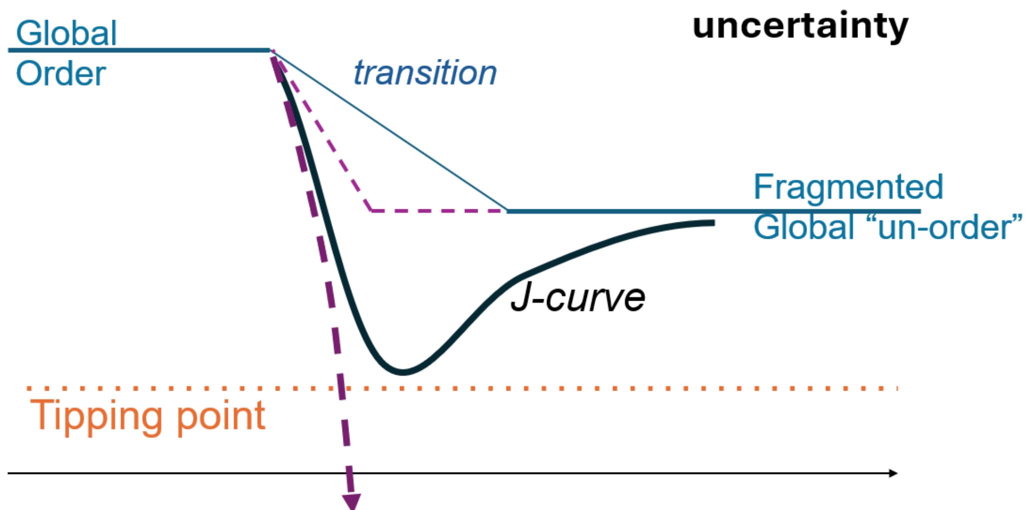
Key Questions

- How can we make sense about recent **geo-political shifts** and uncertainty?
- What role do the **dollar** and **U.S. Treasuries** play in the global financial architecture?
- Is the **safe asset status** at risk? Would tariffs help? What are the implications for exchange rates and term premia?
- How should we think about choke points in international trade?

[0:00] Geopolitical shifts: uni-, bi- or 5-polar world

- Technological shifts have led to increasing returns to scale in many sectors, with high fixed costs and low marginal costs. In these cases market size matters, so it may be beneficial to have a global market
- The global order is shifting from a multilateral, rules-based system (built on mutual interdependence) to a bilateral, bargaining-based transactional one
- In the old system, interdependence encouraged cooperation; chokepoints were mutually deterring. In the new system, countries prioritize national resilience. The shift favors large countries or trading blocs (and larger countries within blocks)
- Three scenarios for the new global order:
    - **(1)** Unipolar: U.S.-led, continuation of Pax Americana, USD/Treasuries remain core global assets
    - **(2)** Bipolar, where the U.S. or China becomes isolated from the rest, as we are seeing in technology
    - **(3)** Multipolar, but with how many poles? The global order after the Thirty Years' War (1648) and after Napoleon (1815) suggests the optimal number of poles is 5. There needs to be an odd number so that there are no even splits and any power is pivotal. It cannot be 3 because a 2:1 split is not sufficiently balanced. If there are 7 or more poles, the free-riding problem becomes too severe (Münkler, Morgenthau, Carr)
- Transitions between global orders are rarely smooth, and may follow a volatile and uncertain J-curve. If a tipping point is reached the entire transition could be derailed

[1] Summary produced by Pablo Balsinde (PhD student, Stockholm School of Economics)



[12:39] What is a Safe Asset? - Three Exorbitant PrivilegeS

- A safe asset is **like a good friend**: "a friend in need is a friend indeed" - it is a good precautionary store of value also in times of idiosyncratic and systemic setbacks.
- A reserve asset is a specific safe asset that governments or central banks hold for precautionary reasons
- The price of a safe asset is not just the expected present value of its cash flows. It also includes the expected present value of the service flows the asset provides
- Brunnermeier, Merkel and Sannikov (2024) formalize the mechanics of safe assets: when, due to frictions, agents cannot write contracts to diversify idiosyncratic shocks away, holding a shared asset (even if it has zero cash flows) allows them to implicitly insure each other by "retrading" it in response to shocks
- The value of this insurance rises in bad times—when risk is high, the demand for safe assets increases, driving up their value, and making the safe asset a negative (CAPM) beta asset
- **"Safe asset tautology":** For an asset to be safe it must be perceived as safe—this requires that we coordinate on which asset we agree is safe.
- The safe asset is "bubbly" in that the model has multiple equilibria: one where the safe asset is valuable and facilitates insurance; one where it is worthless and insurance is impossible ("safe asset tautology")
- The U.S. issuing the global safe asset gives it two structural exorbitant privileges:
  - **(1)** it earns a convenience yield that reflects the value of the service flows,
  - **(2)** as long as $r<g$ (with economic growth increasing the demand for safe assets) the U.S. can issue Treasuries without ever having to pay them back
- But during crises the U.S. also enjoys a third benefit:
  - **(3)** because of the flight-to-safety into Treasuries (as they become more valuable), the U.S. can more easily borrow during crises to implement fiscal stimulus

[23:10] Deficits, Dollar Overvaluation, Triffin Dilemma 2.0

- From this perspective, one may worry that we are **mismeasuring** the current account, as it misses the value of service flows: neither the value from retrading nor the flight-to-safety value

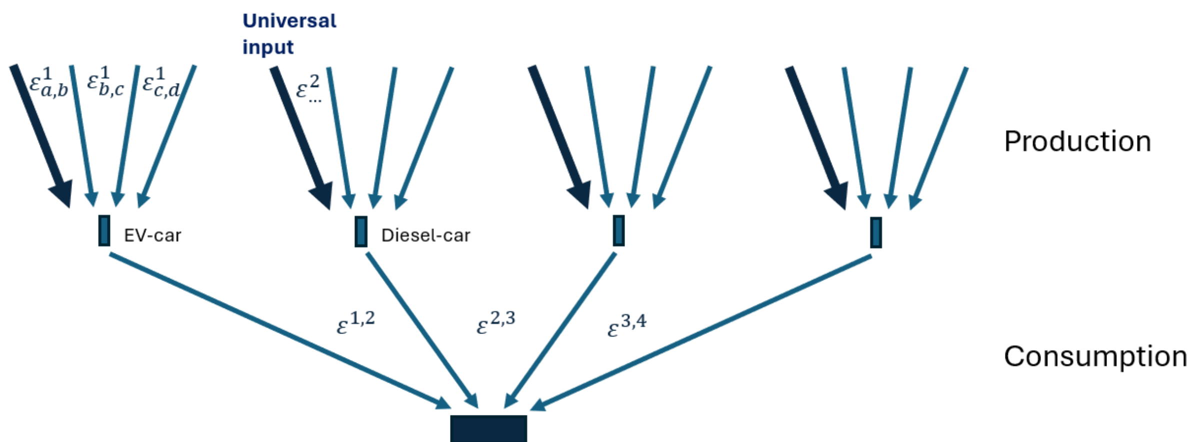
- The political debate often focuses on trade deficits. The trade deficit however ignores the convenience yield (which is in the current account), and ignores the services the U.S. provides through the safe asset
  - The net foreign asset position, which is based on the assets the U.S. holds abroad net of the liabilities it owes to foreigners, may also be mismeasured. It is measured at market prices, where the prices of Treasury liabilities include both the present value of cash flows and service flows
  - However, the U.S. doesn't need to pay for the service flow it provides—so the liabilities are overstated, and the U.S. might be in a stronger position than it seems
  - This helps explain why the U.S. "income statement" remains stable—what the U.S. pays and receives in interest is roughly balanced
- There are **Two Tales of Trade Deficit**.
  - (1) Under the first, the U.S. buys Chinese products to consume, for which it has to accumulate debt that it will eventually have to pay back. However it need not ever pay it back, running a permanent trade deficit (as measured traditionally)
  - (2) Under the second Tale, the U.S. trade deficit results from it being an attractive investment destination: foreigners invest due to high expected returns. As foreigners invest they create jobs in the U.S., and the U.S. increases its imports. In the future when investment returns materialize the trade deficit would decline (but this may never materialize if there are high service flows)
- Many want to **devalue the dollar**, but a strong dollar, due to its safe asset and reserve currency status, is in the U.S. interest as it can enjoy the exorbitant privilege
  - A strong dollar may hurt the US export sector only in certain circumstances of increasing returns to scale and "learning by doing" technologies. Global demand for U.S. safe assets drives up the dollar, making imports cheaper and boosting U.S. consumption. This leads to a trade deficit and shifts resources toward non-tradable sectors, raising their prices and wages. Over time, U.S. manufacturing declines while countries like China gain from scale and learning, leaving the U.S. at a long-run disadvantage despite the short-run benefits from being the global reserve currency
  - Tariffs (without retaliation) can improve the U.S. terms of trade—meaning the U.S. gets more value per unit of exports, as foreign exporters lower prices to retain access to the U.S. market
  - As foreign wealth declines, so does their demand for U.S. safe assets. The trade deficit would decline, but so would the exorbitant privilege: the net welfare gain would be small. If foreign countries retaliate, these effects vanish and everyone is worse off
- **Uncertainty** around the U.S. safe asset status could trigger a flight from Treasuries, weakening the dollar and raising term premia (even if there is still no default risk).
- The classic **Triffin Dilemma**, formulated under the Bretton Woods system, warned that as the global economy grew, demand for dollars would exceed U.S. gold reserves, creating tensions that could lead to a run on the dollar or gold.
  - Now that there are flexible exchange rates, there is a new Triffin Dilemma 2.0. There are tensions from the growing demand for safe assets, the Treasuries. If there is a run away from the bubbly US Treasury, the U.S. government

could respond by fiscally backing the safe asset. However, this would require sufficient fiscal capacity—potentially including unpopular tax increases.

- **Loss of Safe Asset Status:** Brunnermeier, Merkel, Sannikov (2023) studies how the flight away from the global safe asset could lead to a world without a global safe asset or to a jump towards other assets
- In a 5-pole world, Europe might decide to issue **ESBies** (securitizations of its sovereign bonds, Brunnermeier et al., 2016), hoping that the world coordinates on seeing the safe tranche as the global safe asset
- Emerging markets could do the same with **GloSBies** (Brunnermeier and Huang, 2019), during crises incentivizing capital flight across tranches rather than away from countries
- China cannot offer a safe asset as long as it has capital controls; it would also need to shift from "rule-by-law" to "rule-of-law"

[45:33] Trade Chokepoints 101

- Before recent geopolitical shocks, the global system was based on mutual interdependence—each country had numerous chokepoints over others
- In response to shocks like the Russian invasion of Ukraine, which have challenged the assumption that mutual harm prevents aggression, countries are now reshoring, friend-shoring, and multi-sourcing to reduce exposure to chokepoints
- Chokepoint analysis starts with the elasticity of substitution: how easily can a good or input be replaced?
- The intertemporal elasticity of substitution matters too: it might be hard to substitute in the short run, but much easier (and cheaper) over the course of a year
- In supply chains, the location of the chokepoint matters. Consider the following chain:



- If consumers can easily substitute across consumption goods, upstream elasticities are irrelevant. The more dowsteam the chokepoint the more relevant it is
- However, if there is an universal (upstream) input the elasticities in production will become more important, regardless of the elasticity of consumption across goods

Timestamps:
[0:00] Geopolitical shifts
[12:39] What is a Safe Asset?

[23:10] Deficits, Tariffs, and the Exorbitant Privilege
[45:33] Trade Chokepoints 101