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II Keynes on Safe Assets

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Only the monetary authorities can create and issue a safe asset. A safe asset is not offset by any liability so it is outside the power of any private entity to issue such an asset. Only the Federal government can do so. Unless the government falls, such assets are not subject to risk of default. The rationale for the existence of safe assets stems from the factors that underlay the Keynesian Liquidity Trap. The nominal value of a safe asset is fixed. Its yield in nominal terms is usually zero. However, since 2008 the Fed has paid 0.25 percent on reserves held in deposits by its member banks. This program is known as 'quantitative easing.' It may have prevented collapse of the U.S. banking system. The reasons for its origin and the empirical effects are not discussed here.

Creation of a safe asset need not affect production, employment or any business activity. It may be a gift from government to a household, business, non profit or even a non federal government entity. The owner of a safe asset may give it to anybody without requiring compensation. If so, it need have no real effect on the economy. A real effect takes place if and only if the owner of the safe asset enters an economic transaction such as a purchase that causes employment of idle resources, workers or capital goods without offsetting other economic activity. The effect on the economy of a loan of a safe asset depends on how the borrower uses it. An increase in the stock of safe assets could enter the Keynesian liquidity trap and accomplish nothing.

Because loans depend on what happens in the future, they are vulnerable to unfavorable surprises. Safe assets can serve as reserves to protect against such unfavorable events. Heightened uncertainty can raise the demand for more safe assets that may simply lie idle but that do not stimulate more favorable business activity. How an increase in the stock of money affects business activity depends on what form the increase takes.

A lender gives up current acquisition of goods, services or securities in exchange for the hope that an equal amount of these concrete objects

will be available from repayment of the loan at the time agreed upon with the borrower. It simplifies the analysis and emphasizes the main problems to ignore interest payments, amortization and other details of terms usually included in loan agreements. A lender incurs two sources of uncertainty; i) part or all of the loan may not be repaid as agreed, ii) the amount of goods, services or other valuable assets that can be obtained from the amount repaid may differ from what could have been obtained with the amount loaned at the start of the loan. A lender incurs a loss in the first outcome, but the second outcome could be either a loss or gain. A safe asset is free of the risk of default but is subject to the effects of changes in prices prevailing when the loan is repaid.

There is a paradox. The monetary authorities increase the uncertainty surrounding the price effects described that may accompany their efforts to increase the stock of safe assets.