The financial crisis and the heightened concerns about sovereign debt sustainability in many advanced economies have reinforced the notion that no asset can be viewed as truly safe. Recent rating downgrades of sovereigns previously considered to be virtually riskless have reaffirmed that even highly rated assets are subject to risks. The notion of absolute safety—implicit in credit rating agencies’ highest ratings and embedded in prudential regulations and institutional investor mandates—can create a false sense of security, and it did prior to the crisis.

In this context, the chapter examines the various roles of safe assets; the effects of different regulatory, policy, and market distortions; and potential future pressure points that these distortions may create. Safe assets have varied functions in global financial markets, including as a reliable store of value, collateral in repurchase and derivatives markets, key instruments in fulfilling prudential requirements, and pricing benchmarks. In the absence of market distortions, safety is priced efficiently, reflecting sustainable demand-supply dynamics. However, heightened uncertainty, regulatory reforms, and crisis-related responses by central banks are driving up demand. On the supply side, the number of sovereigns whose debt is considered safe has fallen, which could remove some $9 trillion from the supply of safe assets by 2016, or roughly 16 percent of the projected total. Private sector production of safe assets has also declined as poor securitization in the United States has tainted these securities, while some new regulations may impair the ease with which the private sector can produce safe assets.

Demand and supply imbalances in global markets for safe assets are not new. Prior to the crisis, global current account imbalances encouraged safe asset purchases by official reserve managers and some sovereign wealth funds. Now, attention has focused on safe assets’ capacity to meet new prudential requirements, increased collateral needs for over-the-counter (OTC) derivatives transactions or their transfer to centralized counterparties, and the increasing use of such assets in central bank operations. The shrinking set of assets perceived as safe, now limited to mostly high-quality sovereign debt, coupled with growing demand, can have negative implications for global financial stability. It will increase the price of safety and compel investors to move down the safety scale as they scramble to obtain scarce assets. Safe asset scarcity could lead to more short-term volatility jumps, herding behavior, and runs on sovereign debt.

To mitigate the risk to financial stability from a potentially bumpy, uneven path to a new price for safety, policy responses should allow for flexibility and be implemented gradually enough to avert sudden changes in what are defined as safe and less-safe assets. In general, policymakers need to strike a balance between the desire to ensure the soundness of financial institutions and the costs associated with a potentially too-rapid acquisition of safe assets to meet this goal. Specifically, careful design of some prudential rules could help increase the differentiation in the safety characteristics of eligible safe assets and would thus decrease the likelihood of cliff effects or runs on individual types of assets. On the supply side, desirable policies include improving fiscal fundamentals in countries subject to concerns about their debt sustainability, encouraging the private production of safe assets—such as well-conceived and regulated covered bond structures and placing securitization on a sounder footing—and building up the capacity of emerging economies to issue their own safe assets. These efforts can help to remove some of the impediments that may inhibit safe asset markets from moving to a new price for “safety.”