Commissioned Paper by Professor Markus K. Brunnermeier
Questions & Answers

1. One important aspect in the conversation of the interest rate and the corresponding risk premium vis-a-vis the so called "safe asset" is the proverbial elephant in the room, that is the eternal safe but non-interest bearing asset...gold. How would you prevent the obvious increase in the demand for gold in the absence of a good safe asset with the perceived lack of credibility of the respective central bank, particularly for emerging markets?
   --by ***Assistant Professor Aurobindo Ghosh, Singapore Management University***

   Yes, indeed, gold is the ultimate safe asset. In the analysis it should also be taken into account. However, it is not the ideal safe asset. First, the market liquidity of gold is not ideal. It is not so easy to trade physical gold. Also, the volatility of its value change is not always perfectly negatively correlated with the inflation of your domestic consumption basket. (Ideally, in a larger model one would like to include non-tradable goods as well, whose supply is shocked by local factors.)

2. If the policy prescription is to limit speculative capital inflows ex ante, do you reduce the safe asset characteristics of your asset in the first place? Value of service flows of assets (e.g. Their usefulness as collateral) might be diminished if there are restrictions in who can buy them...
   --by ***Professor Lutfey Siddiqi, Visiting Practice Professor, London School of Economics, UK***

   You are right but there are also other factors, which I didn't have time to get into. If you have open capital markets, then the local safe asset is also affected by foreign (exogenous) factors, like shocks to the global market, which the country would be isolated from if capital controls were on. That is, extra volatility is broad to the country, which can make the local safe asset more "risky" and hence a less ideal safe asset. Nevertheless, I am in principle for open capital market, since they promote competition and a fairer economy, but one has to be aware of some challenges that come along with it.