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Redefining asset classes using default risk is a robust approach

Modern Monetary Theory offers a useful framework for defining assets, physical or financial, by assessing their default risk

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Traditionally, there are four asset classes broken down into sub-classes: equities, fixed-income securities (debt), cash and cash equivalents like fixed deposits.

Highlights

- *Traditionally, asset classes are divided into buckets such as equities, fixed income, cash and so on*
- *However, these classifications overlook the fundamental nature and underlying reasons for risks of these assets*
- *Modern Money Theory (MMT), by revealing the essence of modern money, offers a robust basis to redefine asset classes according to their inherent risks.*

While developing investment or savings strategies for clients, financial advisors recommend diversification between risks and returns associated with asset classes, that is, assets with similar characteristics and subject to similar regulations. Savers have, however, come under severe pressure in times of crisis as during the 2008 global financial crisis, the COVID pandemic, stock market or even cryptocurrency market collapses when risks of assets are exposed, which triggered panic in markets and eroded the wealth of millions. It is, therefore, important that savers fully recognize the possibility of default risk across asset classes. Modern Money Theory (MMT), by revealing the essence of modern money, offers a robust basis to redefine asset classes according to their inherent risks.

Traditionally, four asset classes have been demarcated, sometimes broken down into sub-classes: equities, fixed-income securities (debt), cash and cash equivalents like fixed deposits and money market mutual funds (MMMFs), and alternative investments that consist of commodities including precious metals, real estate, collectibles like art, intellectual property, derivatives and futures, and emerging-technology assets like cryptocurrencies. Although dividing assets into such

groups does provide a practical and convenient profile of assets, it is arbitrary and overlooks the fundamental nature of and underlying reasons for differences in the riskiness of these assets.

From an MMT standpoint, assets must, at the broadest level, be separated into physical and financial assets. The prime characteristic of a physical asset is that it appears in the balance sheet of only a single entity. For instance, gold held by an individual will appear only in that individual's balance sheet as an asset and in no other entity's balance sheet. Real estate and collectibles are also physical assets. The same is true of **digital assets** like cryptocurrencies (but not central bank digital currencies or CBDCs) and intangible assets (although they lack physical substance) like intellectual property. We include all these assets in our broad categorization of physical assets.

Physical assets may or may not yield an income stream or cash flow for owners but their market price, which then determines capital gains or losses, depends on the market forces of supply and demand. Expectations of future prices or speculation could be a key variable in the demand and supply functions of these assets and not merely their use value, which makes their prices volatile and elevates risks. Consider gold once again. Although gold may find usage in industry and for jewelry, its price volatility arises more from speculation.

Similarly, cryptocurrencies like Bitcoin, may have a certain usefulness as a medium of exchange although its high price cannot be from this feature alone. It arises from speculation. Physical assets are also susceptible to wear-and-tear and deterioration over time. Some physical assets like land are fixed in supply and likely to appreciate with time but there is no guarantee that this will indeed happen since demand for any given piece of land remains uncertain. Physical assets are also subject to loss from theft, damage and/or encroachment.

The key characteristic of financial assets, which distinguishes them from physical assets, is that they appear in the balance sheet of at least two entities, in one as a financial asset and in another as a financial liability. A further separation is required here to isolate risks of different asset classes: financial assets (and liabilities) which are backed by physical assets and those which are not. As mentioned above, the price of physical assets is determined by the forces of demand and supply and therefore their realizable value at the time of liquidation in case of default or bankruptcy is uncertain. **Equities and fixed-income** securities issued by the private sector are both backed by physical assets of the issuer.

Although the preference in order of repayment from the proceeds from liquidation of assets are different, there is essentially no difference in the nature of riskiness of these assets. The financial liabilities of mutual funds or non-bank financial companies (NBFCs) and even those of MMMFs that hold private sector equities or debt instruments are ultimately backed by physical assets owned by the issuer of those securities. Public sector undertaking (PSU) debt, if not backed by the government, may also be exposed to this risk given that they are backed by physical assets.

Up the hierarchy (lower on the riskiness scale) come financial liabilities of commercial banks or deposits, both savings and current account. These correspond to financial assets held by the non-bank private sector including households and the corporate sector. However, demand deposits held in a commercial bank are backed by loans (financial assets of the commercial bank), which when they turn 'bad', result in liquidation of collateral. Such collateral may either be a physical asset or backed by a physical asset (equity or bonds) and is therefore essentially risky. Demand deposits held at banks are insured only up to Rs 5 lakh and anything beyond that, legally speaking, are prone to risk. The same is true when it comes to assessing riskiness of fixed deposits held at commercial banks. Given the systemic failure associated with bankruptcies, bailouts are becoming more common; however,

such bailouts are not mandatory. The proposed Financial Resolution and Deposit Insurance (FRDI) Bill, 2017 to facilitate bank bail-ins clearly revealed this intrinsic risk of bank deposits.

Nonetheless, a unique advantage of commercial banks over other financial institutions is that they hold accounts at the central bank, in India's case, the Reserve Bank of India (RBI). While this does not guarantee a commercial bank from solvency risks, it does protect them from liquidity risks arising from maturity mismatches, a facility that may not be available to NBFCs directly.

At the top of the hierarchy, or at least risk from default, are financial liabilities of the government, and in particular, the central government. Cash and debt of the government – from GoI bonds to Public Provident Fund (PPF) accounts – are risk-free because they are *not* backed by physical assets. Instead, they are backed by the state's constitutional power to issue modern money, or in other words, fiat money which is legal tender. In the case of India, this is the Indian rupee, which is also the unit of account in which all books of accounts must be maintained and taxes paid in. The financial liabilities of the government are settled only by issuing its own (new) liabilities. This is the basis for MMT's claim that a government that is issuing its own sovereign currency can never go bankrupt in that currency. CBDCs are also financial liabilities of the state and are not backed by physical assets, which make them risk-free. There is no liquidity or solvency risk associated with financial liabilities of the state. However, this does not imply that a government *must* issue unlimited liabilities, only that it *can*.

State government and municipal corporation debt are not risk-free unless they are backed by the central government since they, like the private sector, are *users* and not issuers of currency. However, it is unlikely that central governments will allow state governments or local government agencies to default on their debt.

Foreign currency denominated debt issued by the central government is, however, not risk-free. Default on such debt cannot be ruled out. A country going broke or bankrupt usually refers to situations when its foreign currency liabilities (sovereign debt) exceed foreign currency assets (reserves). An option is for the government to issue its own currency to buy foreign currencies in the forex market. This, however, inevitably leads to a depreciating domestic currency and soaring (imported) inflation as many countries have experienced including Venezuela, Zimbabwe and more recently, Sri Lanka.

Allocation of savings in default-risk free assets also has important macroeconomic implications. Private sector entities look for a reasonable allocation of their portfolio in risk-free instruments. Non-availability of adequate risk-free savings opportunities in central government debt, especially when fiscal austerity policies are vehemently implemented, could result in an increased savings rate to compensate for higher risks in other assets arising from default and/or loss in value. The increased propensity to save can consequently result in lower aggregate consumption and slower rates of growth as John Maynard Keynes proposed in his theory on the "paradox of thrift".

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