Intelligence MEMOS

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To: Canadians Concerned about Financial Markets

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Re: **Why Safe Asset Shortages Matter (When They Occur)**

Safe assets – debt instruments that are expected to preserve their nominal value during both good times and bad, and have ample liquidity – play a vital role in the financial system. Institutions use them to store wealth, meet regulatory requirements and provide collateral in financial transactions.

In the decade leading up to COVID-19, the world experienced a global safe asset shortage as supply did not keep pace with demand. Governments have boosted the supply of safe assets in Canada and abroad as a result of pandemic support programs, and continued spending. But such shortages will occur again, and it is important to understand their impacts when they do.

Between the Great Financial Crisis and the beginning of the COVID pandemic, the supply of high-grade government bonds in advanced economies was limited by declining budget deficits. At the same time, demand for these assets increased due to aging populations, more restrictive regulations on financial institutions (requiring them to hold more safe assets) and the rapid growth rates in high-saving emerging markets that have underdeveloped financial markets, notably China.

Such an imbalance between the demand and the supply of safe assets – when it occurs – can have important macroeconomic consequences.

As an example, they have been associated with financial instability and crises, as shortages increase the price of safety and create an incentive for investors to move down the safety scale where there is more volatility.

The scarcity of safe assets has also been identified as a key element of the so-called secular stagnation in advanced economies since the 2008 financial crisis, characterized by low capital investment, slow GDP growth and low interest rates. And this negative impact on GDP can be more pronounced when monetary policy is operating close to central bank effective lower bounds, typically nearing zero-percent policy interest rates.

At the effective lower bound of nominal interest rates, real rates on safe assets have limited room for downward adjustment, leaving the economy with higher rates relative to the rate that would restore balance between demand for savings and investments. When safe interest rates are above this equilibrium value, households prefer to save and delay consumption. As a result, businesses delay investments as they are faced with lower demand for their products and services. Aggregate demand, therefore, weakens, and the economy can find itself operating below potential.

Our recent C.D. Howe Institute Working Paper examined three important questions related to safe asset shortages:

First, we tested and found that between the financial crisis and the pandemic there was clear evidence of a safe asset shortage in Canada, with flat supply of safe assets alongside a widening equity risk premium (excess return investing in a risky versus safe asset), indicative of excess demand for safe assets, which puts unilateral downward pressure on safe interest rates;

Second, we tested whether our domestic safe asset shortage hurt real GDP, an effect magnified when interest rates are at the effective lower bound, and found that it did; and

Third, we tested what drives such a shortage, and found that the dominant factor was the global asset shortage itself.

These results tell us a number of things. First, increasing the supply of Canadian safe assets by issuing more government debt to meet excess demand for those assets is not a viable option to eliminate a shortage.

We found that the higher debt would mostly come at the expense of Canadian output, and would have only a limited impact because it would not affect the global safe assets imbalance to which we are tied.

Second, there was no clear evidence the shortage would disappear if Canada relaxed its financial institution regulation, which was significantly tightened to align with new international standards after the financial crisis. But even if they were tightened too much, feeding the asset shortage thereby, any unilateral Canadian move to unwind or ignore those standards would be destabilizing and counter-productive.

Given the current level of interest rates and government debt there is little imminent threat of a return to the effective lower bound. Nonetheless, we need to watch out for its possible return. Such an event could keep real rates too high relative to their equilibrium.

As a result, Canadian policymakers should work with other large demanders and suppliers of safe assets in settings such as the G7, the G20 and the Bank for International Settlements to avoid future shortages, which would exacerbate the stagnation of productive investments.

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