Dealing with the Flight to Quality

In the current financial crisis a common question is: “where has all the money gone?” Actually, it hasn’t gone anywhere. Asset values (wealth) have gone south, but not money.

A simple explanation of a complex issue runs as follows. The “flight to quality”, investors selling shares or fleeing managed funds for banks, has depressed asset values and destroyed perceived wealth.

But selling shares and banking the cheque doesn’t increase the amount of money (bank deposits) in the economy. The buyer of those shares pays by drawing a cheque on their bank account. Buyer and seller might use different banks (and the transaction may be electronic rather than paper based), but the banks settle up by transactions on their Reserve Bank accounts (or asset sales between themselves), with no subsequent significant consequences for the economy.

Thus asset (house, share, bond) prices can fall without there being any loss of “money” (bank deposits) - unless cash is withdrawn and put under the mattress. We all feel poorer, because investors have lowered their valuations of future income expected from those assets.

A flight from other investment vehicles (eg unlisted managed funds) creates even more problems for two reasons. First, they also use bank deposits as money, to meet redemption demands by investors. There is a “layering of financial claims”. Second, investors believe their investments are liquid, even though the funds hold illiquid assets which cannot be easily sold to meet redemptions without loss.

The flight to quality from managed funds to banks plays out (in a simplified fashion) as follows. First, managed funds draw down bank balances to meet redemptions. Bank deposits of managed funds decline and are transferred to those fleeing to quality.

Second, managed funds attempt to sell assets, driving prices down. Purchasers of those assets pay by drawing down bank deposits. Managed funds’ bank deposits increase temporarily, until reduced by transfers into bank accounts of investors making redemptions.

The only “automatic stabilizer” of asset prices is that some investors ultimately find lower asset prices make an attractive buy and hold proposition. Unfortunately, falling asset prices and mass redemptions give investors in managed funds incentives to get out quick, thereby making a bad situation worse.

For many unlisted managed funds the option exercised is to freeze redemptions to allow a more orderly sale of assets or to let panic subside.

Policy responses can ameliorate this problem, but create other longer term problems. If banks, rather than other investors, purchase the assets being sold, an increase in bank

deposits occurs. Banks credit the deposit account of the asset seller when acquiring the asset and the scale of bank balance sheets is increased. In this way, banks have increased the amount of money (deposits) in the economy.

But for banks to be willing asset purchasers they need balance sheet capacity. That involves having sufficient liquidity and capital adequacy. Thus, RBA injections of liquidity into the banking system provide a potential solution, although recent bank desires for higher liquidity have limited its effectiveness. Similarly, new issues of equity increase banks' ability to expand balance sheets – but depressed bank share prices tend to inhibit this response.

But in these responses lie the longer term concern of growth in the banking sector relative to non bank financial institutions. A highly concentrated banking sector, with bank dominance extending well beyond traditional banking, exacerbate the "too big – too important to fail" problem.

It is difficult to prevent a "flight to quality" in such troubled times as these. But a second policy response of quickly winding back bank guarantees, but carefully so as not to induce further nervousness (and a flight of wholesale depositors to "international" quality available from other national guarantees) is vitally important.

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November 7, 2008