The Flight *to* Quality

By J. Bradford DeLong

Why U.S. Treasury bonds are so beloved.

In late May, the yield to maturity of the thirty-year U.S.Treasury bond was 4.07 percent per year—down a full half a percentage point since the start of the month. That means that a thirty-year Treasury bond had jumped in price by more than 15 percent. So a marginal investor was willing to pay more than 15 percent more cash and more than 30 percent more equities for U.S. Treasury bonds at the end of the month than at the beginning. This signals a remarkable shift in relative demand for high-quality and liquid financial assets—an extraordinary rise in market-wide excess demand for such assets.

Why does this matter? Because, as economist John Stuart Mill wrote in the first half of the nineteenth century, excess demand for cash (or for some broader range of high-quality and liquid assets) is excess supply of everything else. What economists three generations later were to call Walras's Law is the principle that any market in which people are planning to buy more than is for sale must be counterbalanced by a market or markets in which people are planning to buy less.

We have seen this principle in action since the early fall of 2007, as growing excess demand for safe, liquid, high-quality financial assets has carried with it growing excess supply for the goods and services that are the products of ongoing human labor. This is true to such an extent that there is now a 10 percent gap between the global economy's current output and what it would be producing if it were in its normal relatively healthy state of near-balance.

And global financial markets are now telling us that this excess demand for safe, liquid, high-quality financial assets has just gotten bigger.

To some small degree, a change in investor sentiment has induced the rise in excess demand for such assets. After all, we can assume that the ani-

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J. Bradford DeLong, a former U.S. Assistant Secretary of the Treasury, is Professor of Economics at the University of California at Berkeley and a Research Associate at the National Bureau for Economic Research.

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mal spirits of investors and financiers has been further depressed as a psychological reaction to the exuberant belief just a few years ago in the powers of financial engineering.

But most of the recent shift has come not from an increase in demand for safe, liquid, high-quality financial assets, but from a decrease in supply: six months ago, bonds issued by the governments of southern Europe were regarded as among the high-quality assets in the world economy that one could safely and securely hold; now they are not.

The argument six months ago in favor of those bonds seemed nearly airtight. Yes, the liabilities of southern Europe's private sector were speculative and potentially insecure; but the region was part of the eurozone, and thus its governments' debts were backed by the European Central Bank, which in turn was backed by the governments of France and Germany, which in turn were backed by the willingness of French and German taxpayers to pay for the long-run project of closer European integration. Neither the French nor the Germans, obviously, want to contemplate any possibility of a return to the days when every generation they would kill each other over the question of which language should be spoken by the mayor of Strasbourg (or is it Strassburg?).

Now things are not so certain.

When there is excess demand for safe, liquid, high-quality financial assets, the rule for which economic policy to pursue—if, that is, you want to avoid a deeper depression—has been well-established since 1825. If the market wants more safe, high-quality, liquid financial assets, give the market what it wants.

After all, as a social-resource planning mechanism does, a market tells us which things are valuable and thus gives us the signal to make more of them. Markets are now signaling that U.S. Treasury bonds are much more valuable assets than they were a month ago. So those governments whose credit is still unshaken and whose assets are still the benchmarks of quality for the world economy should be creating a lot more of them.

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Creditworthy governments around the world can create more safe, liquid, high-quality financial assets through a number of channels. They can spend more or tax less and borrow the difference. They can guarantee the debt of private-sector entities, thus transforming now-risky leaden assets back into golden ones. Their central banks can borrow and use the money to buy up some of the flood of risky assets in the market.

Which of these steps should the world's creditworthy governments take in response to the asset-price movements of May? All of them, because we really are not sure which would be the most effective and efficient at the task of draining excess demand for high-quality assets.

How much should they do? As long as there is a clear global excess supply of goods and services—as long as unemployment remains highly elevated and inflation rates are falling—they are not doing enough. And the gap between what they should be doing and what they are doing grew markedly in May.

This isn't rocket science or capping deep-sea oil blowouts. These are problems that we have long known how to solve. ◆