

Flight-To-Quality in Advanced Exchange Rate Markets during Covid-19 Pandemic: Which currency is the hardest?

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Abstract:

The phenomenon of flight-to-quality has long been an area of interest and an implicit tool to distinguish advanced and developing markets. Caballero and Krishnamurthy (2008) points out that fact that most flight to quality episodes are triggered by unusual or unexpected events, which in turn forcing investors to re-evaluate their [credit] risk models. This study provides a fresh look at this financial phenomenon amongst advanced economies, rather than the distinct group of developed and developing economies under the severe stress period of Covid-19 pandemic. Moreover, the evidence for a flight to quality is mostly tried and tested from returns and yields perspective. This study utilizes daily international currency traders' position data to capture investor preference under the phases of Covid-19 pandemic. We use Du (2017) algorithm based on Phillips and Sul (2007) approach based on a nonlinear time-varying factor model. This approach is also a first application in this field of research. The statistical findings indicate a distinct bifurcation between so-called hard currencies following the Covid-19 pandemic threshold. The results suggest that global investors shift their positions to another subset of quality currencies regardless of sole price developments.

Keywords: FX trade, flight to quality, social network analysis.

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