

# The Liquidity Premium of Government Debt under a Floor System of Monetary Policy

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## Abstract

Investors derive non-pecuniary benefits from the liquidity of short-term government debt. However, the central and private banks affect the supply of close substitutes (reserves and private deposits), which shows a strong positive collinearity with the supply of short-term public debt. How do they all interact to determine the convenience yield on government bonds? This paper claims that to disentangle the role of government borrowing from that of monetary policy, it is better to analyze the convenience yield when the central bank implements a floor system in which the supply of reserves is independent of the stance of monetary policy. I study the determinants of the convenience yield of government debt using data from New Zealand, whose central bank implemented a floor system in July 2006 and did not reach the zero lower bound nor conducted large-scale asset purchases until March 2020. The paper provides three novel results: (1) government debt issuance lowers the liquidity premium regardless of its degree of substitutability with other liquid assets; (2) raising the interest on reserves (IOR) under a floor system reduces the fiscal capacity of the government, via reducing the liquidity premium; and (3), under a floor system, the cyclical dynamics of the convenience yield dampen the transmission from the IOR to the intertemporal rate, impairing monetary policy transmission.

**Key words:** liquidity premium, monetary policy, treasury bills.

**JEL codes:** E43, E52, G12.

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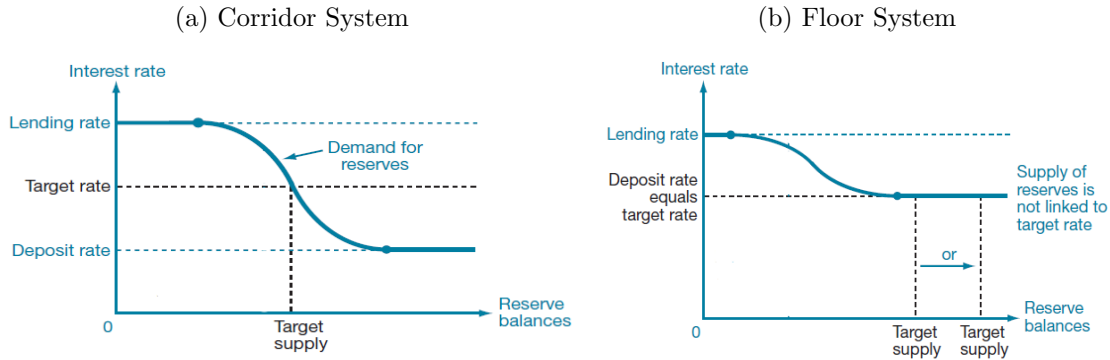
# 1 Introduction

Investors derive non-pecuniary benefits from the liquidity of short-term government debt, making public debt a near-money asset that carries a convenience yield. This increases the price of government bonds and thus expands the government's fiscal capacity. However, the supply of close substitutes (central bank reserves and private deposits) shows a strong positive collinearity with the supply of short-term public debt. What is the impact of each of them on the convenience yield? Is the convenience yield decreasing in the supply of government debt, or is it fully determined by the central bank's monetary policy decisions, regardless of how much the government borrows? Can there be interference between the two authorities? This paper argues that a floor system, where the supply of central bank reserves is not endogenous to the stance of monetary policy, allows one to isolate the effect of debt supply better and, in addition, helps to isolate the role of the monetary policy instruments set by the central bank. Results show that the liquidity premium is determined primarily by outstanding government debt supply and that the level of the interest rate paid on reserves negatively impacts the liquidity premium. These starkly contrast with previous results in this literature (see, for example, Nagel, 2016).

It is essential to understand the difference between a corridor system and a floor (or abundant-reserves) system. In a corridor system, the central bank targets an interbank rate at which commercial banks trade reserves they use to smooth their liquidity needs. Through open market operations, the central bank supplies the amount of reserves that achieve the target rate, which will be somewhere between the discount window rate and the interest paid on reserves (see Figure 1a). Therefore, the supply of reserves is endogenous to the stance of monetary policy. If there is an increase in demand for liquidity by banks, the central bank prevents the interbank rate from increasing by supplying extra reserves. The same would happen if the government issued more T-bills (which also provide liquidity to banks). The data strongly suggests that central bank reserves and the supply of T-bills have a strong positive correlation (crowding-in). Suppose reserves and T-bills are close substitutes and move together along the cycle. In that case, regressions of the liquidity premium on both the interbank rate and the supply of T-bills (as commonly used in this literature) suffer from multicollinearity, and the supply of reserves is a confounding factor for identifying the causal impact of Treasury supply.

To isolate the causal impact of the supply of government debt on the liquidity premium, one needs to look at instances where the central bank hits its monetary policy rate target without altering the supply of reserves. Monetary policy implemented through a floor system offers such an opportunity. The central bank supplies abundant reserves to the point where the demand for liquidity by banks no longer responds to the quantity of reserves (see Figure 1b; banks' demand for reserves becomes flat as in Poole's (1968) model). In this scenario, the interbank rate falls until it equals the interest paid on central bank reserves (the IOR). The supply of reserves ceases

Figure 1: Two Systems of Monetary Policy Implementation



Note: Figures taken from Keister, Martin, and McAndrews (2008)

to be endogenous to the stance of monetary policy, and along with the IOR, they are now two independent tools. Therefore, a regression analysis of the liquidity premium on the supply of T-bills uncovers the causal impact of the debt supply. Including the IOR in the regression exposes the effect of the monetary policy rate that works not through the quantity of reserves.

I implement this exercise empirically. Although the U.S. Federal Reserve has conducted something close to a floor system since late 2008 (when it increased the reserve supply and started paying interest on them), the U.S. data is unsuitable because the Quantitative Easing (QE) programs deployed in 2009-2014 endogenously altered the supply of reserves, and the IOR remained unchanged until December 2015. For this reason, I use data from New Zealand, whose central bank transitioned to a floor system in 2006 but did not reach the zero lower bound nor deploy QE until March 2020. The regression analysis shows that the supply of T-bills is a significant determinant of the liquidity premium and that the effect of the IOR is negative.

I propose a model to explain these results and show the implications for fiscal capacity and monetary policy transmission. The model highlights two sources of convenience yields. The first is at the household level: they benefit from holding liquid assets (private deposits or T-bills) to ease transactions. Therefore, the convenience yield will drive a wedge between these yields and the illiquid rate that governs intertemporal consumption. I assume that the households' demand for liquidity services is never satiated. The second one is at the banks' level: holding central bank reserves reduces the costs of issuing deposits. I refer to this as the *banks' cost of liquidity*, and I assume that above some level of reserves supply, this cost is zero and, at this point, banks do not respond to the supply of reserves (banks are in their flat portion of their reserves demand).

A central bank implementing monetary policy through a floor system supplies enough reserves to operate on these banks' flat demand portion, disentangling the level of reserves from the interest paid on them. The central bank must only set the interest rate paid on reserves to achieve its inflation mandate. However, intertemporal consumption is governed by the illiquid rate, which

trades above the IOR due to deposits’ convenience yield. Therefore, convenience yields are crucial to both the government (as they determine fiscal capacity) and the central bank (since they affect transmission from policy rates to intertemporal rates).

I use the model to show how monetary and fiscal policy interact in determining the liquidity premium of government debt. There are three novel results. First, I show that increasing government debt issuance lowers the liquidity premium regardless of its degree of substitutability with other liquid assets. Second, I show that monetary policy shocks under a floor system negatively impact the fiscal capacity of the government through its negative impact on the liquidity premium. The rise in the interest on reserves increases the interest paid on deposits; it reduces the households’ demand for liquidity (even though banks are not decreasing the supply of deposits), reducing the liquidity premium on government debt. Third, under a floor system, the cyclical dynamics of the convenience yield dampen the transmission from the IOR to the intertemporal rate, impairing monetary policy transmission. The model can have implications that are also potentially important for the U.S. The FOMC’s January 2019 statement says that the Committee intends to keep an abundant reserves framework in the future, where the IOR is the primary tool for its monetary policy goals and “in which active management of the supply of reserves is not required”<sup>1</sup>.

**Literature review.** The determination of convenience yields is relevant for fiscal and monetary policy. Convenience yields lower short-term equilibrium interest rates (Lenel, Piazzesi, and Schneider, 2019) and are at the center of unconventional monetary policy transmission in Krishnamurthy and Vissing-Jorgensen (2011) and Del Negro et al. (2017). I also contribute to the recent literature that uses convenience yields to estimate the government’s fiscal capacity (Mian, Sufi, and Straub, 2021; Reis, 2021; Jiang et al., 2022). The negative causal impact of government debt I estimate complements their models, which assume that larger outstanding debt reduces the “debt revenue” term. I also provide new insights into monetary policy’s role, highlighting the need for further research.

This paper contributes to the empirical literature on convenience yields by disentangling the role of the supply of government debt and monetary policy. While earlier articles found a negative impact of debt supply on convenience yields (Krishnamurthy and Vissing-Jorgensen, 2012; Greenwood, Hanson, and Stein, 2015), Nagel (2016) finds that the coefficient on the supply of debt loses all its significance once he adds the federal funds rate to the right-hand side of the regression. His model implies that this is due to the close substitutability of deposits and T-bills in providing liquidity services: the central bank can fully control the price of both assets by offsetting variations in debt issuance with the opposite variation of reserves. Building on this mechanism, Vandeweyer (2021) finds that T-bills supply becomes statistically significant in regressions using U.S. data after 2008. Based on this fact, he develops a model that explains why deposits and T-bills would no

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<sup>1</sup>Although in the last year, the Fed has committed to reducing the size of the balance sheet in its fight against inflation, there is no explicit intention to go back to the scarce-reserve system that prevailed before 2008.

longer be perfect substitutes.

I show that the positive correlation between reserves, deposits, and T-bills observed in the data does not support the crowding-out between reserves and T-bills at the center of these papers' mechanism. In addition, since New Zealand didn't reach the zero lower bound until 2020, the interest on reserves shows more variation than in the U.S. after 2008, which is the data used in Vandeweyer (2021). Theoretically, my model contributes by explaining the effect of the interest on reserves on the liquidity premium under an abundant reserve system. The model also complements Vandeweyer's (2021) by showing that under an abundant-reserve system, the supply of T-bills negatively affects the liquidity premium regardless of the degree of substitutability between debt and deposits.

More broadly, the idea that supply and demand effects can have significant consequences in the Treasury market is central to several recent papers, including Greenwood and Vayanos (2010, 2014), Krishnamurthy and Vissing-Jorgensen (2011), Hanson and Stein (2015), and Vayanos and Vila (2021).

Compared to other papers that study floor systems, the model is closer to Cochrane (2014), Lenel, Piazzesi, and Schneider (2019), and Afonso et al. (2020). However, these models do not feature convenience yields except for Lenel et al. (2019). Floor systems have also been studied in New Keynesian models (see Curdia and Woodford, 2011; Canzoneri, Cumby, and Diba, 2017; Arce et al., 2020; Piazzesi, Rogers, and Schneider, 2021; Benigno and Benigno, 2021), although their focus is instead on optimal policy and its impact on real activity. These models differ in how they account for the interbank reserves market, which allows for a role of the supply of reserves. Finally, in my model, the supply of real debt will impact equilibrium inflation, a feature shared by models of the fiscal theory of the price level (Cochrane, 2023). Unlike FTPL, however, my model ensures budgetary solvency, and bonds provide transaction services.

The paper proceeds as follows. Section 2 explains the empirical strategy and its results, while Section 3 presents a model to explain those results. Section 4 shows how monetary and fiscal policy interact in determining the liquidity premium of government debt. Section 5 concludes.

## 2 Empirical analysis

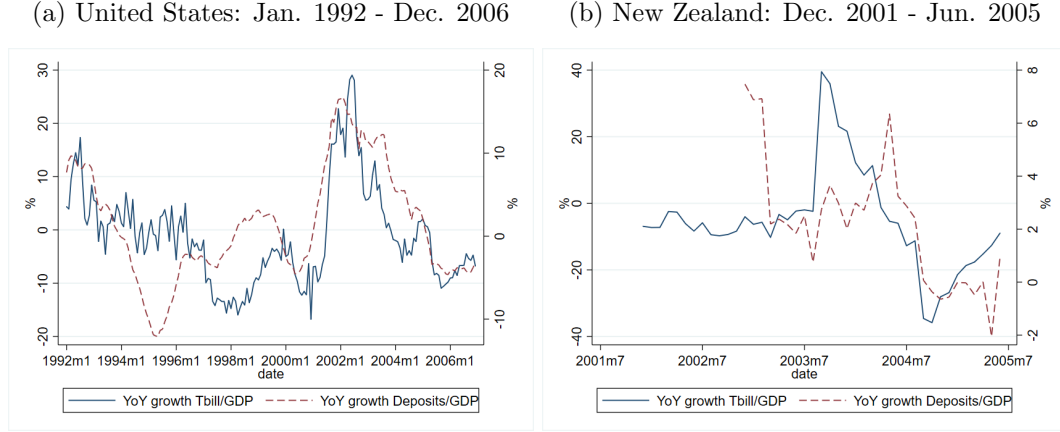
### 2.1 Empirical model

I begin by explaining my empirical strategy. A good starting point is to consider the following regression (see Nagel (2016) for a model-based interpretation of this regression):

$$LP_t = \beta_0 + \beta_1 FFR_t + \beta_2 (Tbills/GDP)_t + \epsilon_t \quad (1)$$

where  $LP_t$  is the liquidity premium of T-bills,  $FFR_t$  is the level of the monetary policy rate set by the central bank under a corridor system (the federal funds rate in the case of the United

Figure 2: Correlation between T-bills and deposits (scarce-reserve system)



States), and  $(Tbills/GDP)_t$  is the total supply of T-bills. Nagel (2016) estimates this regression for the United States with data from 1991 to 2011 when the U.S. Fed mostly used a corridor system of monetary policy (until late 2008). His results show that  $\hat{\beta}_1 > 0$  and  $\hat{\beta}_2 = 0$ . This leads Nagel (2016) to conclude that the supply of T-bills does not affect their liquidity premium, which would only depend on the level of monetary policy rate set by the central bank. The explanation would go as follows: under scarce reserves, the level of the federal funds rate is linked one-to-one with the supply of reserves, which in turn determines the cost of issuing deposits by banks. Deposits and T-bills must be very close substitutes in providing liquidity services. Therefore, by elastically supplying new reserves, the central bank can fully control the price of both assets. For example, if the government suddenly supplies fewer T-bills, the central bank can step in by supplying more reserves, and private banks increase their supply of deposits. This implies a central bank continually offsetting new issuance of T-bills by an opposite change in the supply of deposits. Ultimately, the central bank defines the liquidity premium on all liquid assets (deposits and closer substitutes like T-bills), and the composition between the two is irrelevant.

However, data for periods when central banks implemented a corridor system shows that T-bills and deposits do not crowd out each other but are crowded in. In Figure 2a, I show the correlation between T-bills supply and deposits supply for the United States between 1992 and 2006. The correlation between the yearly growth rates of T-bills and Deposits is 0.62, significant at the 1% level. The sample for New Zealand is shorter, but a positive correlation still emerges (0.44, significant at the 1.4% level, from December 2001 to June 2005, before the floor system). This result is robust to using reserves-to-GDP instead of deposits <sup>2</sup>.

<sup>2</sup>The crowding-in is also consistent with the result in Krishnamurthy and Vissing-Jorgensen (2015), who estimate the extent to which Treasury debt crowds out short-term liabilities by the financial sector. They find an economically significant crowding out, but it works through Treasury supply crowding out non-checkable short-term debt (savings deposits) rather than liquid deposits like checking accounts.

Figure 2 suggests that the supply of reserves and T-bills are endogenous and respond similarly to the business cycle. Since the federal funds rate is closely linked to the supply of reserves, the strong positive correlation between the supply of reserves and T-bills implies that the regression in (1) suffers from multicollinearity. Therefore, to isolate the causal impact of T-bills on their liquidity premium, one needs to look at instances where the central bank does not alter the supply of reserves to achieve its target.

In what follows, assume the following decomposition for the federal funds rate:

$$FFR_t = \gamma_1 i_t^m + \gamma_2 M_t^s + \gamma_3 (Tbill/GDP)_t + \nu_t \quad (2)$$

where  $M_t^s$  is the supply of central bank reserves, and  $i_t^m$  is the interest paid on these reserves (IOR) by the central bank. The federal funds rate is the rate at which banks borrow reserves from other banks. Under a scarce-reserve system, banks are willing to pay a premium (above the interest on reserves) for the liquidity of reserves. As they operate in the downward-sloping portion of their demand for liquidity, a larger supply of reserves lowers the willingness to pay for them, and so  $\gamma_2 < 0$ . T-bills also work as liquid assets. If the government increases the supply of T-bills, this will increase their yield and be a more attractive source of liquidity to banks. This will increase the equilibrium rate in the interbank market, forcing the central bank to issue more reserves to prevent money market rates from going over the target. As a result, the expected sign of  $\gamma_3$  will also be negative.

The true model for the liquidity premium would then be:

$$LP_t = \beta_0 + \beta_1 \gamma_1 i_t^m + \beta_1 \gamma_2 M_t^s + (\beta_1 \gamma_3 + \beta_2) (Tbill/GDP)_t + \epsilon_t + \beta_1 \nu_t \quad (3)$$

Equation (3) shows that the effect of the supply of debt on the liquidity premium can be decomposed into a direct impact (for which Nagel (2016) estimates  $\hat{\beta}_2 = 0$ ), and an effect working through their substitutability with reserves ( $\beta_1 \gamma_3$ , and we know  $\hat{\beta}_1 > 0$ ). The error term,  $\epsilon_t + \beta_1 \nu_t$ , highlights that one should use instrumental variables for the monetary policy rate.

I claim that a floor system offers the opportunity to analyze the liquidity premium in instances where the central bank does not need to alter the supply of reserves to achieve its target. Under a floor system, the central bank issues abundant reserves beyond the point where reserve demand by banks becomes flat (and does not respond to supply). This can be understood through the banks' reserve demand model in Poole (1968) or Afonso et al. (2020). In these models, banks demand reserves only to meet reserve requirements, and there are no frictions in the interbank market. Demand is flat at high levels of aggregate reserves, with banks indifferent among a wide range of reserve holdings as long as market rates (including the interbank rate) equal the interest rate paid on reserves. Since, in this case, central banks operate on the flat part of the banks' demand for reserves, they, in practice, have two independent instruments: the policy rate (the interest on reserves) and the supply of reserves. The former is used to meet its mandate on inflation, and the

latter can be used for another goal. Notably, the supply of reserves is no longer endogenous to the conduct of monetary policy and clears up this confounding factor of the impact of debt supply.

As monetary policy implemented through a floor system does not work through the supply of reserves, I assume that  $\gamma_2 = 0$  in (3). Therefore, I estimate the following regression:

$$LP_t = \alpha_0 + \alpha_1 i_t^m + \alpha_2 (Tbill/GDP)_t + v_t \quad (4)$$

In this equation, coefficients will have a different interpretation as in (1).  $\alpha_1$  captures the effect of the level of interest rates stripped from its effect through the supply of reserves. A monetary policy tightening (an increase in the IOR) no longer involves a decrease in the supply of reserves. What is the expected sign of  $\hat{\alpha}_1$ ? If the central bank pays a higher yield on its reserves, banks will ask for a higher yield on T-bills to be willing to hold them. A lower liquidity premium translates into a higher yield on T-bills. Therefore, we should expect  $\hat{\alpha}_1 < 0$ . The coefficient  $\hat{\alpha}_2$  will capture the causal effect of the supply of T-bills, no longer confounded by the collinearity with the supply of reserves.  $v_t = \epsilon_t + \beta_1 \nu_t$  will be the error term, which captures shocks that affect both the liquidity premium and the stance of monetary policy. Therefore, the empirical section will use instrumental variables.

The U.S. Federal Reserve has managed something very close to a floor system since October 2008, when it expanded the supply of reserves and started paying interest on them. However, for most of the time since then, this policy coincided with the conduct of QE (where reserve supply becomes endogenous) and didn't alter the IOR for seven years. Therefore, I study the liquidity premium under a floor system with data from New Zealand. In July 2006, the Reserve Bank of New Zealand (RBNZ) began transitioning from a symmetric channel system to a floor system (see the Appendix for a detailed description of this transition and its main elements). The level of reserves went from NZ\$20 million to around NZ\$8 billion in a few months. This level was kept steady until March 2020. At the same time, the interest on reserves (called the Official Cash Rate) was set equal to the interbank rate. Notably, New Zealand did not reach the zero lower bound nor conducted QE until the Covid crisis in March 2020 (when the reserves supply was raised to almost NZ\$30 billion). So, it is an ideal scenario to study a floor system.

Data for New Zealand supports the assumption that reserve supply is no longer endogenous to monetary policy under a floor system. The correlation between the interest on reserves and the supply of reserves is not significantly different from zero (for comparison, under a scarce-reserve system, the correlation between the federal funds rate and the supply of reserves is very negative). At the same time, in New Zealand, the correlation between T-bills and reserves is also not significantly different from zero, showing the disconnection between the two under a floor system. The Appendix shows these correlations graphically. It also addresses two specific episodes in which the RBNZ injected liquidity into the banking system, most likely driven by liquidity concerns and,



therefore, endogenous.

## 2.2 Data

I follow the literature’s convention and measure the liquidity premium of T-bills by taking their spread against other assets of similar maturity and credit risk. The intuition is that since the maturity and credit risk are the same, the remaining spread must be due only to their liquidity services. The spread, then, is a measure of the extra price investors are willing to pay for the liquidity of the T-bills. For New Zealand data, I use two assets comparable to T-bills: 3-month bank bills and 6-month term deposits.

Bank bills are a common investment in Australia and New Zealand: it is a promise by the borrower to pay the face value at maturity. It is considered a safe investment because they are “accepted” (guaranteed) by a bank. In accepting the bank bill, the bank makes the payment at maturity, regardless of the borrower’s repayment ability. Investors can buy bank bills from a bank for an agreed face value, an agreed term, and a quoted interest rate. The bank then endorses the bank bills to acknowledge the change in ownership. Upon maturity, the bank will pay the full face value, which includes the initial purchase price and the interest receivable. An additional feature of investing in bank bills is that should you require funds before the due date, the bank will purchase the bank bill at the prevailing interest rate. Although this last feature might make them as liquid as a T-bill, they have consistently traded at yields above T-bills, with the spread spiking during the turmoil of 2008.

On the other hand, the spread between term deposit rates and T-bill rates is one of the measures used in Krishnamurthy and Vissing-Jorgensen (2012) for U.S. data. Like the U.S., term deposits in New Zealand are a safe investment where investors lock in a competitive interest rate for a fixed term. Investors are usually not allowed to redeem their money before the term’s expiration. Some banks allow it in specific circumstances and require early notifications. Therefore, the spread should account for the liquidity provided by the T-bill.

The liquidity premium measured with these two assets is sizable. The bank bill has a yield of 28 basis points above T-bills on average for January 1996-July 2021. The term deposit has a larger spread of 63 basis points on average. The larger spread for the term deposit might come from two sources. First, its maturity is six months rather than three. Second, this might be due to the higher liquidity of the bank bill, which makes it more similar to the T-bill. Recall that the bank bill can be sold any time during the instrument’s term, while the investment in the term deposit is locked in for the whole period. Standard deviations are high: 24 and 80 basis points, respectively.

## 2.3 Results

I estimate Equation (4) via instrumental variables. The dependent variable is the spread between the 6-month term deposit and the 6-month T-bill. Data starts in March 2009 (the month the New Zealand Treasury started auctioning 6-month instruments). The independent variables are the interest on reserves, the VIX index -to account for demand shifts due to uncertainty-, the supply of government debt (which I proxy by using the supply of T-bills or the supply of debt of all maturities), and the supply of deposits or reserves. The latter accounts for the few instances where the RBNZ injected reserves for endogenous reasons. I use two measures of the supply of deposits: the total amount taken from the banking system's balance sheet and the total amount taken from the households' balance sheets. Newey-West standard errors correct for autocorrelation.

For robustness, I run the regressions in the Appendix using the spread between the 90-day Bank Bill and the 3-month T-bill to measure the liquidity premium. It also shows robustness to estimating the regression in first-differences and to dropping the Covid pandemic months.

Instrumental variables for the monetary policy rate are essential since an unobserved liquidity demand shock (correlated with interest rates or the supply variables) may induce the central bank to lower interest rates in the same month, leading to reverse causality. This would result in a downwardly biased estimate of the interest rate coefficient.

I use futures prices to instrument the interest on reserves, like Piazzesi and Swanson (2008). In particular, I use the generic future contract for the 3-month bank bill, available in Bloomberg. These futures contracts settle at the end of each month based on the average rate that prevails during that month. The futures price before expiration is a risk-adjusted forecast of the average rate during the expiration month. As an instrument, the futures price in months before the expiration month should be highly correlated with the average policy rate during the expiration month.

I use nonlinear functions of the total debt to GDP ratio to instrument the supply variable. Greenwood, Hanson, and Stein (2015) and Nagel (2016) use month dummies to exploit the strong seasonality in T-bill supply in U.S. data. This arises from seasonal fluctuations in tax receipts that are plausibly exogenous and immune to the reverse causality problem. This does not seem to work for New Zealand data. Nonlinear functions of total debt to GDP exploit the positive correlation between total debt and its maturity structure. For example, this instrument has been used by Krishnamurthy and Vissing-Jorgensen (2012).

Table 1 shows the results. Columns 1 and 2 use the supply of T-bills as a measure of the supply of government debt. The coefficient on T-bill supply is negative and significant. A one percent increase in the supply of T-bills reduces the liquidity premium by 41 and 46 basis points. This result is robust to the measure of the supply of deposits used. The magnitude is lower than in Krishnamurthy and Vissing-Jorgensen (2012) but is much larger than the non-significant effect found by Nagel (2016) for the U.S. data.

Table 1: New Zealand: Determinants of the liquidity premium - 2SLS

	(1)	(2)	(3)	(4)
$ior_t$	-0.323*** (0.1213)	-0.387*** (0.111)	-0.214* (0.122)	-0.217*** (0.055)
$\log(\frac{Tbill}{GDP})_t$	-0.446*** (0.162)	-0.405*** (0.154)		
$\log(\frac{Debt}{GDP})_t$			-0.653* (0.340)	-0.498* (0.276)
$\log(\frac{HHDeps}{GDP})_t$	-4.628*** (1.058)			
$\log(\frac{Deps}{GDP})_t$		-5.881*** (1.259)	-1.386 (1.559)	
$\log(\frac{Reserves}{GDP})_t$				-0.953*** (0.190)
$vix_t$	-0.00106 (0.0118)	-0.00108 (0.0128)	-0.0098 (0.0106)	0.0164 (0.0117)
Constant	4.348*** (0.996)	8.779*** (1.741)	3.7411 (2.377)	-0.459 (0.525)
Instruments for:				
IOR	Y	Y	Y	Y
Tbill/Debt supply	Y	Y	Y	Y
Deposits/Reserves	Y	Y	Y	Y
Weak instruments test				
CD stat	22.1	26	22.88	40.35
SY critical value	8.5	8.5	8.5	8.5
Observations	149	149	149	149
R-squared	0.254	0.287	0.2711	0.357

Notes: Data are at monthly frequency. Units are hundredth of basis points. The dependent variable is the 6-month Term deposit/Tbill spread.  $\log(\frac{Debt}{GDP})_t$  includes outstanding government debt of all maturities.  $\log(\frac{HHDeps}{GDP})_t$  are total deposits in households' balance sheet.  $\log(\frac{HHDeps}{GDP})_t$  are deposits in the monetary base. Instruments for debt supply are nonlinear functions of the total debt-to-GDP ratio. Instruments for the supply of deposits are nonlinear functions of the ratio of T-bills to GDP. A CD stat greater than the Stock and Yogo critical value rejects weak instruments (with bias greater than 10% of OLS bias). Newey-West standard errors in parenthesis (3 lags).

Interestingly, the coefficient of the interest on reserves is significantly negative. This is the effect of the monetary policy rate stripped from its connection with the supply of central bank reserves. It represents the effect of tightening monetary policy under an ample reserve system. This is a complete switch of the sign in the impact of the monetary policy rate on the liquidity premium estimated in Nagel (2016) under a scarce-reserves system. The Appendix shows that this negative coefficient also shows up for data in the U.S. after 2008, even though, in that case, the caveat of an endogenous supply of reserves still applies.

Columns 3 and 4 replicate the first two columns but include the supply of debt of all maturities as a proxy for the supply of government debt. Both the coefficient on the IOR and the negative effect of government debt are robust. A one percent increase in the supply of total debt reduces the liquidity premium by between 50 and 65 basis points.

Notably, the instruments in Table 1 are strong, as shown by the relatively high Cragg-Donald statistics. A statistic greater than the critical values from Stock and Yogo (2005) -also shown- rejects the hypothesis of weak instruments (with bias greater than 10% of the OLS bias) at a significance level of 5%.

### 3 Model

In this section, I set up a model to explain the empirical results and characterize fiscal and monetary policy implications. This is an endowment economy-representative agent model comprised of households, who derive transaction services from liquid assets (deposits and T-bills); banks, who provide deposits by accumulating central bank reserves and other assets; a fiscal authority who sets the supply of T-bills; and a central bank that conducts monetary policy. The model is set with flexible prices, but most implications would also hold in a version with endogenous income and sticky prices.

In the model, the liquidity premium arises at the household level, which derives convenience services from either deposits (issued by banks) or T-bills. This slightly differs from the discussion in Section 2.1, where the premium showed up at the banks' level, which derived liquidity from reserves or T-bills. This will allow me to compare the implications with those of Nagel (2016) and Vandeweyer (2021). In addition, reserves are one of the determinants for the supply of deposits, and it is reasonable to assume that banks are intermediaries who want to serve households. Moreover, the households combine liquidity preferences with consumption-saving decisions, which are central to monetary policy.

#### 3.1 Households

There is a single perishable consumption good with endowment stream  $\{Y_t\}$ . The endowment follows an exogenous process:

$$\log Y_{t+1} = \rho_y \log Y_t + \epsilon_{t+1} \quad , \epsilon_t \sim N(0, \sigma^2) \quad (5)$$

The representative household seeks to maximize the objective:

$$\mathbb{E}_0 \sum_{t=1}^{\infty} \beta^t [u(C_t) + \alpha \log(Q_t)] \quad (6)$$

where  $C_t$  is consumption, and  $Q_t$  is a real stock of liquid assets from which the household draws service flows. Liquidity services are supplied by money in the form of deposits and near-money in the form of T-bills issued by the government. The stock of liquidity is the CES aggregate:

$$Q_t = \left[ (1 - \lambda) \left( \frac{D_t}{P_t} \right)^\rho + \lambda \left( \frac{B_t^h}{P_t} \right)^\rho \right]^{\frac{1}{\rho}} \quad (7)$$

where  $\frac{D_t}{P_t}$  denotes real balances of deposits and  $\frac{B_t^h}{P_t}$  indicates the real value of the household's T-bill holdings.  $P_t$  is the nominal price of the consumption good. These liquidity benefits arise from some unmodeled use in intra-period transactions. A model period is one quarter, and deposits and T-bills have a one-period maturity.

The parameter  $\rho$  controls the elasticity of substitution between T-bills and deposits. With  $\rho = 1$ , T-bills and deposits are perfect substitutes, and the composition of the aggregate liquidity supply is irrelevant. If they are imperfect substitutes, then  $0 < \rho \leq 1$ . The parameter  $\lambda$  allows for differences in the relative contribution of T-bills and deposits to the liquidity stock.

Households optimize subject to the flow budget constraint:

$$\begin{aligned} D_t + B_t^h + k_t A_t - L_t + P_t C_t &= D_{t-1}(1 + i_{t-1}^d) + B_{t-1}(1 + i_{t-1}^b) \\ &+ k_{t-1}(A_t + P_t Y_t) - T_t - L_{t-1}(1 + i_{t-1}) + \Omega_t \end{aligned} \quad (8)$$

where  $B_t^h$  are the holdings of T-bills,  $k_t$  denotes the share of total endowment stream that the household owns at the end of period  $t$ ,  $A_t$  is the price of the claim to the endowment stream,  $T_t$  denotes transfers/taxes from the government,  $i_t^b$  is the T-bill yield,  $i_t^d$  is the interest rate on demand deposits,  $L_t$  denotes loans,  $\Omega_t$  is the flow of profits from banks to households, and  $i_t$  is the nominal interest rate applicable to assets and transactions that do not produce a liquidity service flow.

The household first-order condition for consumption yields the intertemporal Euler equation

$$1 = \beta \mathbb{E}_t \left[ \frac{u_c(C_{t+1})}{u_c(C_t)} \frac{1 + i_t}{\Pi_{t+1}} \right] \quad (9)$$

where  $u_c$  denotes the first derivative of  $u(\cdot)$  and  $\Pi_{t+1} = P_{t+1}/P_t$ . The illiquid rate  $i_t$  in Equation (9) governs the household's intertemporal decisions; thus, this is the rate the monetary authority looks to affect. However, as explained below, the central bank's policy rate is the rate on deposits,  $i_t^d$ , which will carry a convenience yield and trade below the  $i_t$ .

The first-order conditions with respect to real liquid asset balances are:

$$\frac{\alpha(1 - \lambda_t)(\frac{D_t}{P_t})^{\rho-1}}{(1 - \lambda_t)(\frac{D_t}{P_t})^\rho + \lambda_t(\frac{B_t^h}{P_t})^\rho} = u_c(C_t) \frac{i_t - i_t^d}{1 + i_t} \quad (10)$$

$$\frac{\alpha\lambda_t(\frac{B_t^h}{P_t})^{\rho-1}}{(1 - \lambda_t)(\frac{D_t}{P_t})^\rho + \lambda_t(\frac{B_t^h}{P_t})^\rho} = u_c(C_t) \frac{i_t - i_t^b}{1 + i_t} \quad (11)$$

Equation (10) reflects households' valuation of inside money or deposits. Since households derive transaction services from deposits, they are willing to accept an interest rate on deposits  $i_t^d$  below the intertemporal rate. The households' cost of liquidity,  $i_t - i_t^d$ , reflects the value of money for making payments. It is declining in real balances: the marginal benefit of payment instruments is declining in the overall quantity held. Equation (11) has an analogous interpretation for T-bills and their yield,  $i_t^b$ . In this equation,  $i_t - i_t^b$  corresponds to the *liquidity premium* of T-bills.

### 3.2 Banks

A model characterizing a corridor or a floor system needs to include an interbank market where the supply of reserves plays a role (or not) in determining equilibrium interest rates. The literature has attempted this through different modeling choices: from a representative bank facing real intermediation and liquidity costs (Lenel et al., 2019; Curdia and Woodford, 2011) to a mass of banks facing idiosyncratic liquidity needs (Arce et al., 2020; Piazzesi, Rogers, and Schneider, 2021). In this section, I build on the framework of Curdia and Woodford (2011) because it nests a corridor and a floor system in the simplest way. However, the implications are similar if I use, for example, the framework in Piazzesi, Rogers, and Schneider (2021).

The representative bank in this economy exists because households cannot access the central bank's reserves directly. The bank, therefore, originates liquid deposits, on which they promise to pay a riskless nominal return  $i_t^d$  one period later, by either holding reserves at the central bank,  $M_t^d$ , that receive a nominal yield of  $i_t^m$  or having other assets such as loans,  $L_t^s$ , on which they earn a nominal interest rate of  $i_t$ . The bank takes all these interest rates as given. In what follows, lower-case variables denote real variables.

The representative bank faces an intermediation cost when issuing loans. In particular, the origination of  $l_t$  real loans requires costly information in the amount of  $\chi_t(l_t)$ , with  $\chi_t', \chi_t'' \geq 0$ . In addition, the bank consumes real resources in managing liquidity,  $\theta(l_t, m_t^d)$ ,  $m_t^d \equiv M_t^d/P_t$ , where the cost is a positive function of the scale of operations and a decreasing function of central bank reserves held,  $\theta_{lt} > 0$ ,  $\theta_{mt} < 0$ . These costs can be thought of as coming from unexpected deposit withdrawals from households. Importantly,  $\theta_{mt} < 0$  means that reserves are more useful for handling liquidity costs than other assets: if they are sufficiently scarce, banks are willing to pay a higher price.

I also assume that for any scale of operations  $l_t$ , there exists a finite level of reserves  $\bar{m}(l_t)$  for which  $\theta_{mt} = 0$  for all  $m_t^d \geq \bar{m}(l_t)$ . This assumption resembles the banks' demand for reserves in the models of Poole (1968) and Afonso et al. (2020). This tries to capture that liquidity costs are increasing in the scale of operations (for example, a higher chance of unexpected withdrawals and greater precautionary liquidity demand), decreasing in reserves (for instance, as they meet regulatory requirements and facilitate intraday operations) and that with a sufficiently large amount of reserves, reserve demand by banks becomes flat once they are above their precautionary demand level,  $\bar{m}(l_t)$ .

Each period, the representative bank decides a scale of operation,  $l_t$ , and the level of reserves to hold at the central bank,  $m_t^d$ . It then issues real deposits to households in the maximum quantity that it can repay, taking all rates as given:

$$(1 + i_t^d)d_t^s = (1 + i_t^m)m_t^d + (1 + i_t)l_t \quad (12)$$

The bank maximizes the earnings to its shareholders (the household) each period, equal to the deposits not used to pay for loans and reserves. Therefore, the bank maximizes:

$$\Omega_t = d_t^s - m_t^d - l_t - \chi_t(l_t) - \theta(l_t, m_t^d) \quad (13)$$

The first-order conditions concerning loans and reserves are thus:

$$\frac{i_t - i_t^d}{1 + i_t^d} = \chi'_t(l_t) + \theta_{lt} \quad (14)$$

$$\frac{i_t^d - i_t^m}{1 + i_t^d} = -\theta_{mt} \quad (15)$$

The left-hand side of Equation (14) is the marginal benefit of an extra loan. The right-hand side shows the marginal cost: a higher intermediation cost. Similarly, Equation (15) equates the marginal cost of an extra reserve with its marginal benefit: a lower liquidity cost (as  $\theta_{mt} < 0$ ).

The rate  $i_t^d$  resembles the interbank rate central banks target when implementing a corridor system (more on this later).  $i_t^d - i_t^m$  in Equation (15) represents the *bank's cost of liquidity*. For  $m_t^d < \bar{m}_t$  and a given  $i_t^m$ , Equation (15) delivers a one-to-one relationship between the supply of reserves and the interbank rate,  $i_t^d$ . For a given  $i_t^m$ , an increase in the supply of reserves reduces the liquidity cost of banks (right-hand side of the equation) and thus reduces the premium on reserves, reducing  $i_t^d$  (in the left-hand-side). If  $m_t^d \geq \bar{m}_t$ ,  $\theta_{mt} = 0$ , banks face no liquidity cost, and the interbank rate equals the interest paid on reserves, independently of the supply of reserves. Intuitively, since reserves are abundant, banks no longer pay a premium on them.

Banks' liquidity costs are not essential for obtaining the liquidity premium. It is useful, however, to contrast the scarcity of liquid debt that gives rise to the liquidity premium on government debt

to the shortage of central bank reserves that ended when the RBNZ implemented the floor system (in the case of the U.S., it ended with quantitative easing programs).

### 3.3 Government and Central Bank

The government is comprised of a fiscal authority and a central bank. The fiscal authority's flow budget constraint is given by:

$$B_t^s = (1 + i_{t-1}^b)B_{t-1}^s + G_t - T_t - T_t^{cb} \quad (16)$$

where  $B_t^s$  is total debt issued,  $G_t$  is fiscal spending,  $T_t$  are tax/transfers to the household, and  $T_t^{cb}$  are transfers from the central bank.

The central bank buys government bonds and pays with the issuance of new reserves to the banking system. Its budget constraint is:

$$M_t^s + (1 + i_{t-1}^b)B_{t-1}^{cb} = B_t^{cb} + M_{t-1}^s(1 + i_{t-1}^m) - T_t^{cb} \quad (17)$$

where  $M_t^s$  is the supply of reserves and  $B_t^{cb}$  are its holdings of government bonds. Notice that  $B_t^s = B_t^h + B_t^{cb}$ , and therefore the budget constraint for the consolidated public sector is:

$$B_t^h + M_t^s = (1 + i_{t-1}^b)B_{t-1}^h + M_{t-1}^s(1 + i_{t-1}^m) + G_t - T_t \quad (18)$$

Letting  $U_t = B_t^h + M_t^s$ , the consolidated budget constraint becomes  $U_t = U_{t-1} + Z_t$ , where  $Z_t = i_{t-1}^b B_{t-1}^h + M_{t-1}^s i_{t-1}^m + G_t - T_t$  is the total deficit, inclusive of interest payments.

In real terms, the budget constraint becomes:

$$u_t = \frac{u_{t-1}}{\Pi_t} + z_t \quad (19)$$

where lower case letters denote real variables and  $\Pi_t = P_t/P_{t-1}$ . I assume that fiscal policy is governed by a rule for setting the real deficit:

$$z_t = \zeta_t - \rho_g u_{t-1} \quad (20)$$

where  $\zeta_t$  will be assumed to follow an exogenous path. The parameter  $\rho_g$  captures the response of the current deficit to the outstanding debt. A positive value resembles a government that follows a sustainable path, as Bohn (1998) describes. For simplicity, I assume  $G_t = 0$ . In this model, bonds' transaction services will affect equilibrium inflation. Therefore, the fiscal and monetary policy will interact in a way absent in standard models where bonds do not provide transaction services. Canzoneri and Diba (2005) show that, in this framework, the government needs to set fiscal policy in real terms to achieve local determinacy in the inflation rate.



### 3.4 Monetary policy implementation

The monetary authority conducts monetary policy to meet an interest rate operating target,  $i_t^{d*}$ , according to the policy rule

$$i_t^{d*} = \psi \Pi_t^{\psi\pi} e^{\xi_t} \quad (21)$$

where  $\xi_t$  is an exogenous monetary policy shock. Equation (21) rules out the possibility of a zero lower bound, as the calibration for New Zealand in the period before 2020 will not involve such episodes.

The choice of  $i_t^d$  as the central bank's policy rate can be justified as follows. In the real world, most central banks set the interbank rate at which banks trade reserve balances intraday among themselves. The interbank rate can, therefore, be seen as the rate at which banks can obtain liquid funding whenever needed. Although there is no interbank market in the model, the policy rate  $i_t^d$  captures the same idea: it is the rate at which banks can obtain liquid funding, but, in this case, from households. There are alternative ways of modeling an interbank market that gives a role to the supply of reserves (see, for example, Arce et al. (2020)), but introducing a more formal interbank market would complicate the model without improving the exposition of the underlying mechanisms.

The central bank can implement monetary policy along two dimensions. First, for a given  $i_t^m$ , it can influence the policy rate  $i_t^d$  by altering the supply of reserves,  $m_t^s$ . This resembles a corridor system. By Equation (15), in this case, the supply of reserves is not an independent policy tool, as there is a one-to-one relationship between the supply of reserves and  $i_t^d$ .

Second, for a given level of supply of reserves, it can influence  $i_t^d$  by altering  $i_t^m$ . I model the implementation of the floor system as the central bank setting  $m_t^s > \bar{m}_t$  at all times. Therefore, by equation (15),  $i_t^d = i_t^m$  and every period the central bank sets the interest on reserves,  $i_t^m$ . The supply of reserves becomes an independent tool as long as  $m_t^s > \bar{m}_t$ . To keep things simple, I assume the supply of reserves  $m_t^s$  follows an exogenous random path that never falls below  $\bar{m}_t$ . This exogenous shock tries to represent unanticipated demand by households due to unexpected liquidity needs (change in precautionary demand or unexpected liquidity withdrawals by households). Besides this shock, the central bank does not endogenously set  $m_t^s$ .

This represents how the Fed has conducted monetary policy since 2008. The interest rate on reserves and the federal funds rate are the tools used to reach its goals of inflation and unemployment, and the supply of reserves is not followed closely<sup>3</sup>. Indeed, the Fed's January 2019 statement reads: "*The Committee intends to **continue** to implement monetary policy in a regime in which an abundant supply of reserves ensures that control over the level of the federal funds rate and other short-term interest rates is exercised primarily through the setting of the Federal Reserve's*

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<sup>3</sup>Except for the period starting in the second half of 2022, when, due to the inflation surge, the Fed decided to run down the size of the balance sheet.

administered rates, and in which *active management of the supply of reserves is not required*” (emphasis is mine).

How is monetary policy transmitted to the intertemporal interest rate governing consumption/savings decisions,  $i_t$ ? There are two channels through which the central bank can induce an increase in  $i_t$ . First, by reducing the supply of reserves, it can increase the cost of liquidity of banks and, therefore, reduce the supply of deposits. This will increase the convenience yield of deposits and push  $i_t$  higher.

Second, raising the monetary policy rate,  $i_t^d$  or  $i_t^m$ , for a given level of the convenience yield will translate into an increase in  $i_t$ . If the change in  $i_t$  is more or less than proportional than the change in  $i_t^d$  or  $i_t^m$  will depend on the response of the convenience yield. This will be analyzed more carefully below.

While the corridor system combines these two channels, the floor system only works through the second one, as banks do not respond to the supply of reserves.

**Definition:** An equilibrium in this economy are prices  $\{i_t, i_t^b, i_t^m, A_t, \Pi_t\}$  and policy rules  $\{C_t, d_t, l_t, b_t^h, d_t^s, b_t^s, l_t^s\}$  such that:

1. Given prices, households maximize lifetime utility, banks maximize future cash flows,
2. All markets clear:  $k_t = 1$ ,  $D_t = D_t^s$ ,  $L_t = L_t^s$ ,  $B_t^h = B_t^s$ .

I solve the model using the global nonlinear method in Cao et al. (2023). The remainder of the paper has a predominantly qualitative goal: to show how fiscal and monetary policy interact in determining the liquidity value of government debt. The model is too simple to give a complete quantitative characterization of the New Zealand economy. However, to ensure that the analysis comes from reasonable values of the parameters, I calibrate the model to match the debt and reserves levels and the liquidity premium of New Zealand’s assets (see Appendix).

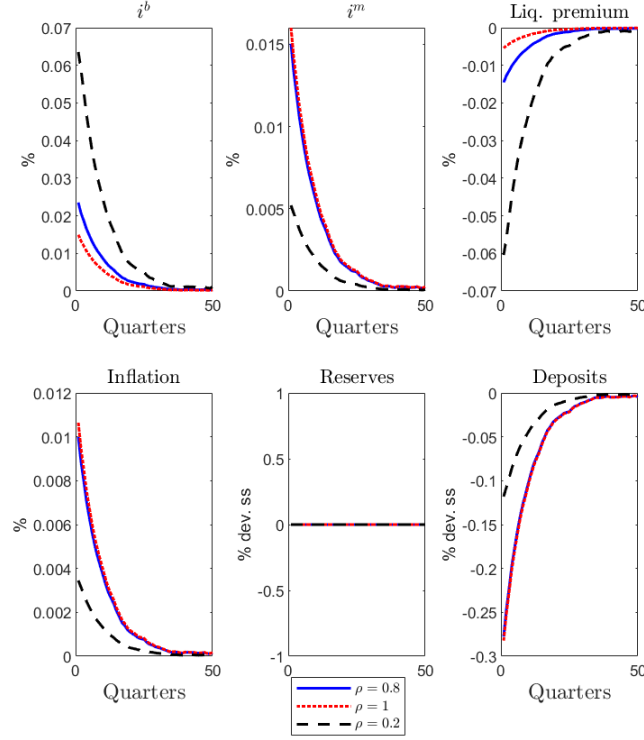
## 4 Monetary and fiscal policy interactions

### 4.1 Shock to the supply of debt

First, I consider an exogenous increase in the deficit financed by the rise in the supply of government debt. In New Zealand data, the annual growth rate of the supply of T-bills between January 2008 and February 2020 has a mean of 6.25% and a standard deviation of 79. The debt issuance in response to the global financial crisis influences this sizeable standard deviation. I consider an increase in  $\zeta_t$  of 1% over a year. The blue line in Figure 3 compares the impulse responses of the yield on T-bills, the liquidity premium, inflation, and central bank reserves for a value of  $\rho = 0.8$ .

The exogenous increase in the deficit is financed by an increase in government borrowing, which directly affects the liquidity premium as the marginal convenience yields of liquid assets decrease. In addition, it increases the inflation rate. The rise in current inflation calls for an increase in  $i_t^m$

Figure 3: Positive debt supply shock - floor system



via the central bank's rule. Notice that the rise in  $i_t^m$  does not imply a decrease in the supply of reserves, which is the main feature of the floor system. The supply of deposits falls because loan supply decreases, but the magnitude of this drop is small enough not to change the sign of the response of the liquidity premium.

These effects can be interpreted from a liquidity preference perspective. The increase in  $i_t^m$  by the central bank is fully passed into an increase in  $i_t^d$ . Since deposits provide liquidity and a higher return, bonds must adjust to stay attractive. This higher yield is necessary to induce the households to hold the new debt issued, and it is achieved through a drop in the convenience yield.

Under a corridor system, the central bank would also raise the interest rate ( $i_t^d$  in this case), but this would need a reduction in reserves and a much more significant drop in the supply of deposits. This drop in the supply of deposits would offset the increase in debt supply; if they are perfect substitutes, then there would be no change in overall liquidity supply and no change in the liquidity premium. This is how Nagel (2016) explains that the debt supply has no statistical significance in his regressions. However, this mechanism predicts a negative correlation between debt and reserves, which does not fit the data.

Figure 3 also shows the responses for different degrees of substitutability between deposits and T-bills. I plot the responses for  $\rho = 0.2$  (low substitutability between deposits and T-bills) and  $\rho = 1$  (perfect substitutability) along with  $\rho = 0.8$ . In line with intuition, the rise in inflation is

higher when the degree of substitutability is higher: the more T-bills can be used for money-like transactions, new issuance by the government will have a more significant impact on inflation. Accordingly, the rise in the IOR needed to counteract this shock is higher for higher values of  $\rho$ . At the same time, when bonds and deposits are imperfect substitutes ( $\rho = 0.2$ ), the impact of the shock on inflation and the IOR is lower, but on the other hand, the effect on the liquidity premium is higher.

Another purpose of Figure 3 is to show that, under a floor system, the debt supply has a causal impact on the liquidity premium regardless of the degree of substitutability between deposits and bonds. Vandeweyer (2021) extends the regressions in Nagel (2016) and finds that the debt supply has become statistically significant in the United States after 2008. This leads him to conclude that it must be because deposits and T-bills are no longer perfect substitutes. Figure 3 shows that debt becoming statistically significant once the United States transitioned to an abundant-reserve system cannot be used to conclude the degree of substitutability between T-bills and deposits.

## 4.2 Monetary Policy Shock

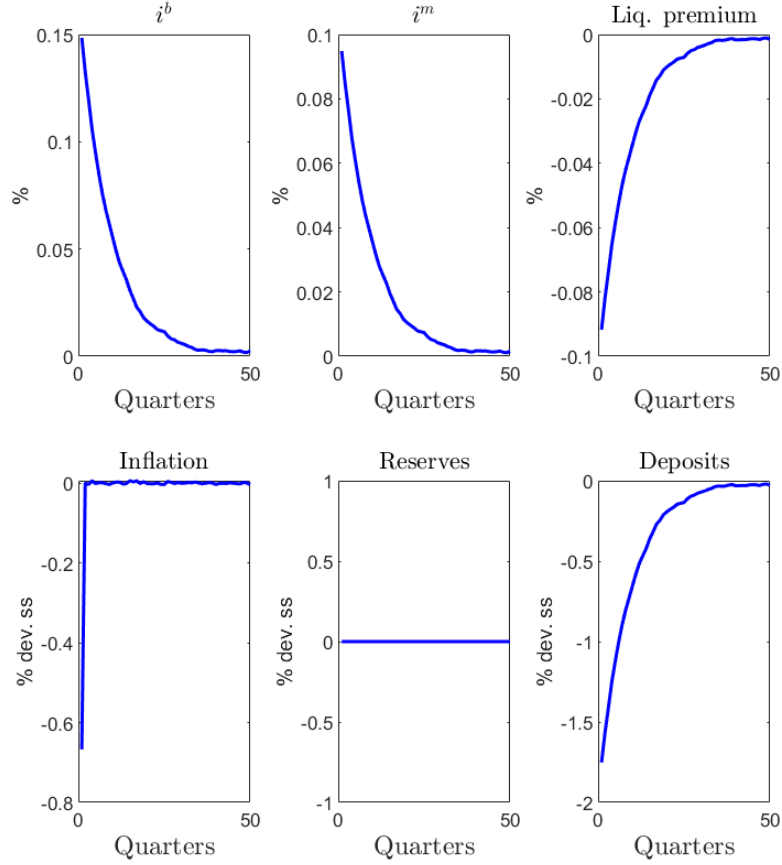
In this subsection, I consider a positive realization of  $\xi_t$  in the Taylor rule (21). The monetary policy shock in the model is assumed to follow an iid process. The 25 basis point shock increases the interest paid on reserves, with everything else equal, by 1% at annual rates. In Figure 4, I set the parameter  $\rho$  at 0.8, reflecting high substitutability.

In the current model of exogenous endowment and flexible prices, the positive realization of  $\xi_t$  lowers current inflation and raises the interest on reserves. The lower inflation increases the real supply of government debt, and, therefore, it reduces the marginal value of liquidity services. At the same time, the higher IOR increases the yield earned by banks on holding reserves, which they pass through to a higher yield on deposits. This lowers the cost of liquidity for households and, therefore, their willingness to pay for the liquidity provided by T-bills. The combined effect of these two forces lowers the liquidity premium on T-bills, as shown in Figure 4.

In a model with endogenous income and sticky prices, the shock would increase  $i_t^m$  with little effect on the price level and the real value of government debt. However, it would reduce the demand for consumption and, therefore, still reduce the convenience yield through lower need for liquidity.

Before I turn to the policy implications of a floor system, I validate the model by showing it matches the relevant correlations if one assumes the Central Bank implements a corridor system. Although the focus of this section is on the floor system, I show that the model under a corridor system can match the positive correlation between the interbank rate and the liquidity premium (as found in Nagel, 2016) and the positive correlation between the supply of deposits and the supply of T-bills (seen in Section 2). To perform this exercise, I assume a functional form for  $\theta(l_t, m_t^d)$  and

Figure 4: Monetary Policy Tightening - Floor System



let it respond to the supply of reserves ( $m_t^s < \bar{m}_t$ ). In addition, I assume that the Central Bank fixes  $i_t^m = 0$ ; therefore, there is a one-to-one relationship between the supply of reserves and  $i_t^d$ .

Table 2 shows the relevant correlations among the variables. Since this is not a quantitative exercise, I pay attention to the sign and significance more than their magnitude. Notice that the supply of deposits and T-bills positively correlates with the cycle. Facing a positive realization of the endowment process under a corridor system, the hike in  $i_t^d$  now needs a decrease in the supply of reserves, which reduces the supply of deposits. The increase in current inflation, in turn, decreases the real burden of the government, and the fiscal rule allows for a reduction in the debt supply. As a result, the overall supply of liquid assets decreases, and the liquidity premium increases. Therefore, a clear positive correlation exists between the interbank rate,  $i_t^d$ , and the liquidity premium, as shown in the last row of Table 2.

Table 2: Second moments under a Corridor System

Moment	Value
$\text{corr}(Y_t, b_t)$	0.401
$\text{corr}(Y_t, m_t)$	0.9517
$\text{corr}(Y_t, d_t)$	0.9603
$\text{corr}(i_t - i_t^b, i_t^d)$	0.781

Note: Values calculated from  
simulating 50,000 periods and  
dropping the first 10,000.

### 4.3 Implications for fiscal capacity

Standard fiscal capacity analysis tells that higher interest rates reduce the expected present discounted value of primary surpluses and thus reduce the sustainable debt-to-GDP ratio. However, the model implies the existence of an additional channel: higher interest rates can reduce the fiscal capacity through their negative effect on the liquidity premium.

To see this, take the government’s budget constraint in (19), ignoring for now the role of reserves as a liability for the government. Iterate it forward, and impose the transversality condition  $\lim_{n \rightarrow \infty} E_t[q_{t,t+n} b_{t,t+n}] = 0$  to get:

$$b_t = \mathbb{E}_t \left[ \sum_{j=1}^n q_{t,t+j} s_{t+j} \right] + \mathbb{E}_t \left[ \sum_{j=1}^n q_{t,t+j} (i_t - i_t^b) b_t \right] \quad (22)$$

where  $q_{t,t+j} = \mathbb{E}[\beta^j (u'(C_{t+j})/u'(C_t))]$  is the model-based stochastic discount factor. The left-hand side in Equation (22) corresponds to the current debt-to-GDP ratio (recall that steady state endowment has been normalized to one). The first term on the right-hand side is the expected discounted present value of future primary surpluses. The second term is the expected discounted present value of future liquidity services.

What Equation (22) shows is that the fiscal capacity of the government increases when government debt provides safety and liquidity services to investors: the current value of debt-to-GDP can be above the present discounted value of primary surpluses thanks to the second term on the right-hand side, which depends on the magnitude of the liquidity premium,  $i_t - i_t^b$ . This term is what Reis (2021) calls the “debt revenue” term. Fiscal capacity analysis for the U.S. by Mian, Sufi, and Straub (2022) and Jiang et al. (2022) assumes the debt revenue term depends negatively on the debt supply.

Equation (22) can give an idea of the economic magnitude of the convenience yield in New

Zealand’s data. An average liquidity premium of 1.2% over the period coupled with a mean debt-to-GDP ratio of 0.42 gives a flow debt revenue of 0.5% of GDP. Discounting at the mean illiquid rate of 2.44% (4.44% nominal rate minus 2% inflation) and ignoring risk or uncertainty in calculating the present value over a long time horizon implies that debt revenue can sustain  $0.5/0.024 = 20.8\%$  of GDP in public debt. This number is lower than the ones obtained by Reis (2022) for the U.S. and other G7 countries.

A few caveats to this magnitude. First, of course, it assumes that all debt is short-term and, therefore, enjoys the convenience yield of T-bills. A more complete analysis would consider debt at different maturities and consider that longer maturities are less money-like than T-bills. Second, it does not consider central bank reserves as a potential debt obligation for the Treasury.

What is the impact of monetary policy on the fiscal capacity of the government? In the model, a monetary policy shock increases the debt burden of the government in real terms (due to the fall in inflation), which increases borrowing and reduces deficits in the future (per the fiscal rule in (20)). This impact is qualitatively the same regardless of how monetary policy is conducted.

The floor system will have a distinctly negative impact on the “debt revenue” term in (22). Figure 5 below shows the response of the “debt revenue” term to the same monetary policy shock analyzed in Section 4.2. The fiscal capacity of the government drops along with the debt revenue term. There is a sharp decrease during the first two quarters as the drop in inflation raises real rates. After that effect, fiscal capacity recovers only slowly because of the slow dynamics of the liquidity premium.

This result can bring new insights into the sharp tightening cycle on which advanced economy central banks have embarked since early 2022. This tightening coincided with high debt-to-GDP levels due to the fiscal response to the Covid-19 crisis. Although more research is needed, it might be a relevant element in the discussion on the optimal size of the central bank’s balance sheet.

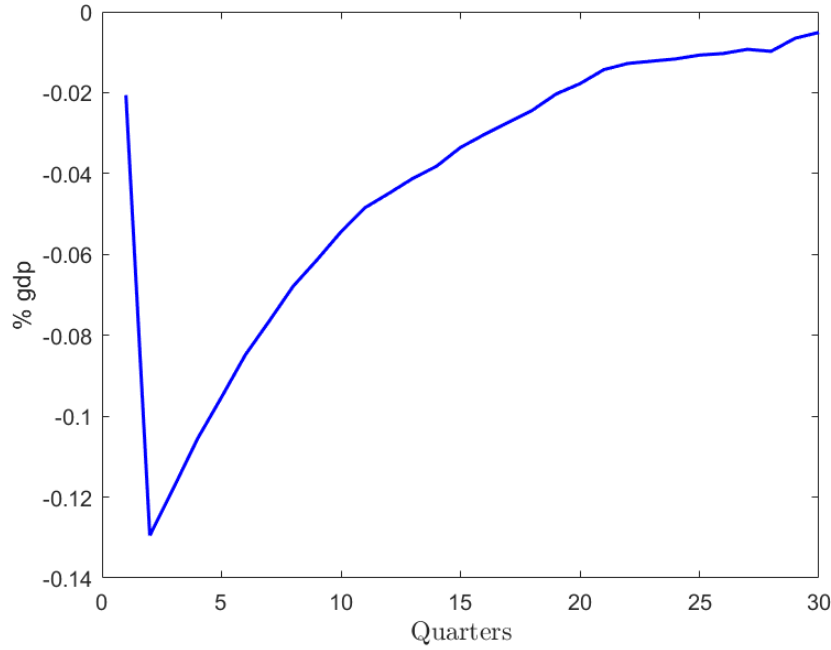
#### 4.4 Implications for monetary policy transmission

A feature of the model in Section 3 is that convenience yields drive a wedge between the rate that the central bank controls and the rate that the central bank wants to affect (the intertemporal rate). Therefore, the transmission from the policy rate to the intertemporal rate will depend on the response of convenience yields. Since the corridor and the floor systems manage liquidity differently, they will have different outcomes regarding monetary policy transmission.

**Proposition 1** *In response to a business cycle shock, under a floor system, the reaction of the convenience yields dampens the transmission of changes from the interest on reserves to the intertemporal rate.*

*Proof:* see the Appendix.

Figure 5: IRF of Debt Revenue to a Monetary Policy Shock



To see the intuition of this result, consider a good realization of the exogenous endowment process,  $Y_{t+1}$ . This increases the demand for consumption and, therefore, the need for liquid assets. Ultimately, this shock will result in a higher intertemporal rate,  $i_t$ , and a higher liquidity premium (because of the increased demand for consumption).

The central bank will accommodate this by an increase in  $i_t^d$  (under a corridor system) or the interest on reserves (under a floor system). However, the interest on reserves under a floor system will require a more significant increase in magnitude. The reason is that, under a corridor system, the reduction in the supply of deposits and the consequent increase in the banks' cost of liquidity will do most of the work in adjusting a higher illiquid rate and a higher convenience yield on liquid assets. As a result,  $i_t^m$  in a floor system will need to rise by more than  $i_t^d$  in a corridor system<sup>4</sup>.

Consequently, under a floor system, a central bank will need to adjust its response function to business cycle shocks compared to a corridor system. A central bank transitioning from a corridor to a floor system and not considering this runs the risk of running inflation persistently above its target.

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<sup>4</sup>The implication that the proportional magnitude of the response of  $i_t$  is different in a corridor versus a floor system can also be found in the model of Piazzesi, Rogers, and Schneider (2021).



## 5 Conclusions

This paper has shown that fiscal and monetary policy interact in determining the near-money properties of government debt. Contrary to previous results in the literature, I have shown that the supply of government debt negatively impacts its liquidity premium. I have isolated this effect when a central bank operates under a floor system, and it does not need to alter the supply of reserves to hit its rate target. This clears up the confounding factor of the supply of reserves. This result mainly implies that a government that borrows too much can reduce the premium and eventually exhaust it. From the perspective of fiscal policy, too much borrowing can lessen the debt revenue term in the government’s budget constraint, which confirms previous assumptions that a government cannot indefinitely exploit the seignorage revenue coming from the safety/liquidity of its debt (Mian, Sufi, and Straub, 2021; Reis, 2021).

At the same time, the floor system allows one to estimate the impact of interest rates, stripped of their link to the supply of central bank reserves. This has provided new insights into the interaction of the short end of government bonds with monetary policy. The interest on reserves has a negative impact on the liquidity premium. This implies that increases in the monetary policy rate can have further adverse effects on the government’s fiscal capacity. As the number of advanced economies implementing an abundant-reserves system has grown in the past decade, it is even more critical to understand how this new system has changed this and other linkages between monetary and fiscal policy. One fruitful avenue for future research will be to consider the endogenous debt maturity decisions by the budgetary authority, considering that long-term bonds have less liquidity value than T-bills.

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## Appendix A Data sources

**Yields:** the interest on reserves, the 3-month bank bill rate, and the 6-month term deposit rate are from the Reserve Bank of New Zealand (RBNZ) statistics. See Wholesale interest rates, table B2 monthly, for the OCR and the bank bill, and Retail interest rates, table B3, for the term deposit rate. The 3- and 6-month yields on T-bills are calculated from auction results published by the Debt Management Office of New Zealand’s Treasury. When more than one instrument is offered, I take the weighted average of successful yields.

**Supply of T-bills and deposits:** the amount of T-bills outstanding is published monthly by the Debt Management Office of New Zealand’s Treasury. Series are at market value. The supply of reserves by the central bank is obtained from the RBNZ’s balance sheet (see statistics, table R2). The two proxies for the supply of deposits correspond to households’ deposits at registered banks, available at the RBNZ’s statistics (see Household balance sheet, table C22), and total deposits calculated as broad money minus currency in circulation (from the RBNZ’s balance sheet).

All these variables are scaled by GDP, available at FRED (current price Gross Domestic Product in New Zealand, New Zealand dollars, Quarterly). The series was brought to monthly frequency through interpolation.

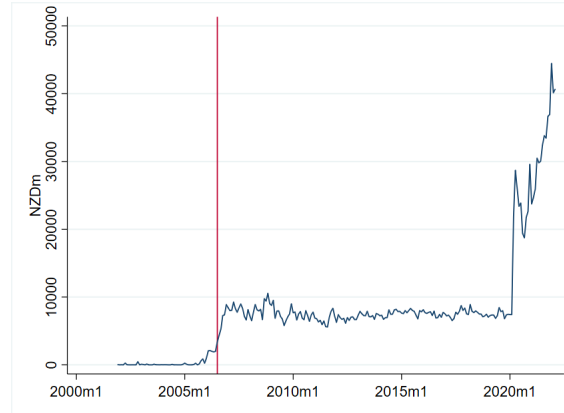
**Other:** the VIX index and the U.S. federal funds rate were obtained from FRED (series VIXCLS and EFFF). Data for bank bills’ futures contracts prices (the instrumental variable for the IOR) was obtained from Bloomberg, tickers ZB1 and ZB2. Supply for U.S. T-bills (see Figure 1 in the main text) was obtained from TreasuryDirect. U.S. deposit supply in the same Figure corresponds to the sum of checking and savings accounts in Table 4 in H.6 release (see FRED).

## Appendix B Monetary policy in New Zealand

This section relies on Keister et al. (2008) and Selgin (2018) to describe New Zealand’s transition to a floor system. From 1999 until July 2006, the Reserve Bank of New Zealand (RBNZ) implemented a symmetric corridor system in which the benchmark policy rate, the Official Cash Rate (OCR), was kept 25 basis points above the rate paid on reserves and 25 points below what was charged for overnight loans. Because banks’ overnight settlement balances (i.e., reserves) bore an opportunity cost in such a regime, banks held very few such balances, relying instead on intraday credits from the RBNZ to meet their ongoing settlement needs.

Along with its corridor system, the RBNZ implemented a Real Time Gross Settlement (RTGS) system for wholesale payments, in which interbank payments are settled bilaterally and immediately, thereby becoming final and irrevocable as transactions are processed, rather than at the end of the business day only. This allows payments to be made final as soon as they are processed. If a bank faced any real-time liquidity need in the remainder of the day, it would rely on credit from

Figure 6: Reserve supply in New Zealand



the RBNZ instead of waiting to settle its net balances at the end of each day.

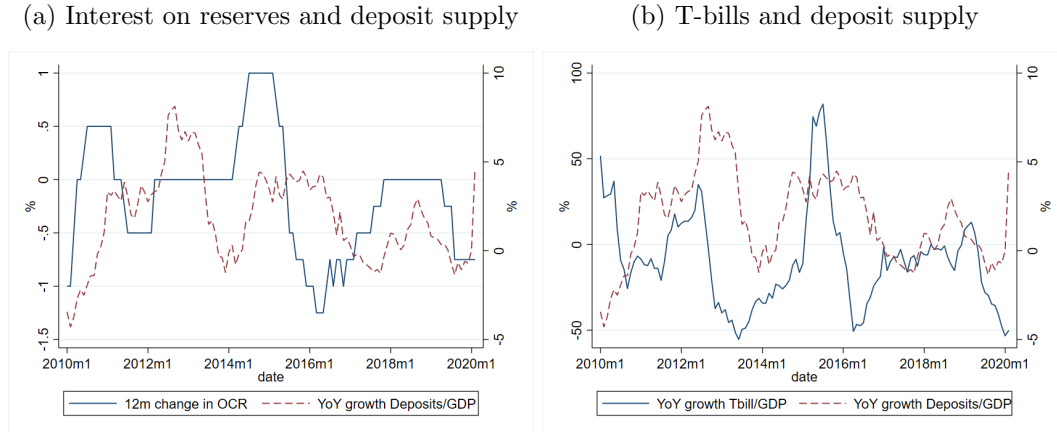
The disadvantage of the RTGS is that it exposes the central bank to credit risk. The RBNZ chose to supply intraday credit through fully secured reverse repo agreements to avoid that risk. However, the Government of New Zealand had been running a fiscal surplus for a few years, and government bonds had become scarce. Since these bonds were the preferred collateral, the scarcity produced broad volatility in the interbank market and often resulted in rates significantly above the target desired to implement monetary policy. The RBNZ had to accept municipal and corporate paper as collateral, which did not eliminate the risk of losses.

The RBNZ reviewed its liquidity management regime in 2005 and announced a new system in early 2006. Recognizing the danger of losses, the RBNZ encouraged banks to rely on overnight settlement balances (reserves) instead of intraday repos to meet their settlement needs. With that end in mind, in July 2006, the RBNZ began its program of “cashing up” the banking system. The first step was to create an additional NZ\$7 billion reserves between July and October. Concurrently, it increased the interest paid on those reserves by 25 basis points (made in five-point increments) to encourage banks to hold them. Next, the RBNZ stopped providing intraday repos. In the end, the RBNZ achieved the two critical components of a floor system: the interest rate on reserves was equal to the policy rate, and banks were well supplied, if not satiated, with liquidity.

Figure 6 plots the evolution of the supply of reserves. The vertical red line marks the official start of the floor system. The level of reserves went from a negligible amount (NZ\$20 million approx.) to around NZ\$8 billion. This level remained steady until March 2020, when QE raised the supply to almost NZ\$30 billion.

Figure 7 suggests that deposit supply is no longer endogenous to monetary policy under a floor system. Banks hold enough reserves, and the liquidity cost of creating new deposits no longer depends on the availability of reserves. In Figure 7a, the correlation between the interest on reserves and the supply of deposits is not significant. This correlation would be significantly negative under

Figure 7: Correlations for NZ: Jul. 2006 - Feb. 2020



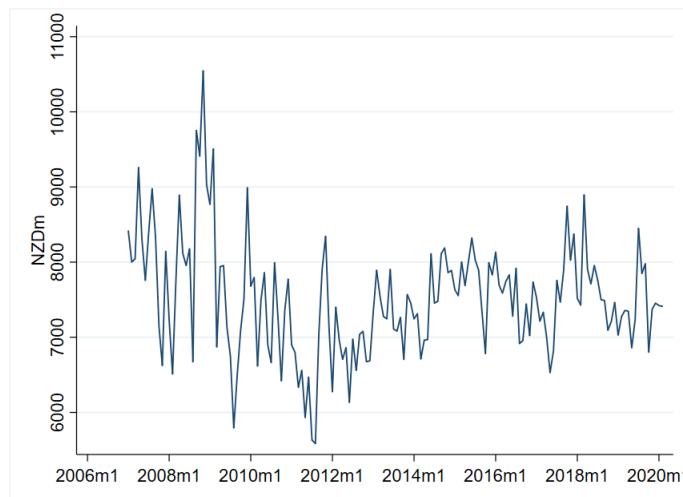
a corridor system like the one in the United States before 2008. In Figure 7b, the correlation between T-bills and deposits is also not significantly different from zero, showing the disconnection between the two under a floor system.

Can we be sure to rule out any endogenous variation in reserve supply? There are two episodes in which the RBNZ injected further liquidity into the banking system, both during the financial turmoil of 2008 (in August 2007 and the Fall of 2009). These are the most likely to be driven by liquidity concerns and thus be endogenous. Figure 8 provides a closer inspection of the evolution of reserve supply. Although the RBNZ occasionally found it desirable to inject some extra reserves into the banking system -as in the two episodes mentioned- those cash additions were modest and transitory. As an extra precaution, I add the supply of reserves or deposits in the regressions to control for any out-of-order variation in their quantities.

Finally, one crucial reform happened in August 2007. A common issue with supplying too many reserves is that banks no longer need to rely on one another to access reserves, effectively ending active trading in the interbank market. This has happened in the US since 2008 in the federal funds market, where the number of transactions has been minimal for the past decade. The RBNZ concluded that it was a good idea to avoid this outcome, as an active interbank market provides information on the health of the banks. However, once the floor system was up and running, it became clear that it encouraged some banks to hoard reserves, accumulating them without incurring any opportunity cost and, thus, without the need to go to the interbank market.

The solution to the reserve hoarding problem was a “tiering system”, with reserves up to a bank’s assigned tier limit earning the interest on reserves and reserves beyond that level earning 100 basis points less. The tier levels were based on banks’ apparent settlement needs but collectively still amounted to the aggregate target of NZ\$7 billion. The overnight interbank lending market remained active thanks to this switch to a tiered system. Banks continued to rely upon one another as lenders of first resort, turning to the RBNZ for overnight funds only as a last resort.

Figure 8: Reserve supply in New Zealand: Jul. 2006 - Feb. 2020



It is important to notice that this tiered system does not affect my identification strategy. Even though an active interbank market might suggest that banks are not fully satiated with liquidity, my strategy only needs that the overall supply of reserves is not correlated with the monetary policy rate, as they are in a scarce-reserve system. Figure 7 shows that this is the case. In contrast, the same graph for a corridor system -like the one in the US before 2008- would show a significant negative correlation between the federal funds rate and the supply of reserves/deposits.

## Appendix C Robustness for results in section 2

Table 4 estimates equation (4) with data for New Zealand from July 2006 until July 2021. The dependent variable is the spread between the 3-month bank bill and the 3-month T-bill. I differentiate the dependent and independent variables to avoid concerns with stochastic trends. This avoids spurious correlations between the levels of these variables by removing random walk components in these series. All columns are estimated using OLS, with the standard errors adjusted for autocorrelation using the Newey West estimator.

In Column 1, the coefficient on the supply of T-bills is negative and significant. A one percent increase in T-bills to GDP reduces the liquidity premium by 28 basis points. The coefficient on the IOR is negative, although not statistically significant. Column 2 adds the supply of reserves as a percentage of GDP, which serves as a robustness check to the intuition that under a floor system, reserve supply is exogenous in determining the liquidity premium. The estimation shows that it does not have a significant effect, and the coefficient on the supply of T-bills is similar in magnitude and significance.

In columns 3 and 4, I add the current and lagged values of the independent variables. I do this to consider the possibility that the coefficients in columns 1 and 2 only capture a transitory

Table 3: New Zealand: Determinants of liquidity premium - OLS

	Sample: 2006m7-2021m7				Sample: 2006m7-2020m2			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
$\Delta ior_t$	-0.0826 (0.0520)	-0.0835 (0.0529)	-0.187*** (0.0629)	-0.187*** (0.0630)	-0.0941* (0.0558)	-0.101* (0.0542)	-0.206*** (0.0685)	-0.227*** (0.0697)
$\Delta ior_{t-1}$			0.265*** (0.0763)	0.269*** (0.0749)			0.273*** (0.0774)	0.295*** (0.0812)
$\Delta vix_t$	0.00352*** (0.00133)	0.00256 (0.00166)	0.00157 (0.00149)	0.000450 (0.00203)	0.00477** (0.00193)	0.00459** (0.00175)	0.00353 (0.00216)	0.00370* (0.00203)
$\Delta vix_{t-1}$			0.00134 (0.00449)	0.000670 (0.00480)			-0.000563 (0.00641)	-0.000823 (0.00629)
$\Delta \log(\frac{Tbill}{GDP})_t$	-0.278** (0.124)	-0.290** (0.119)	-0.193** (0.0922)	-0.195** (0.0767)	-0.371** (0.188)	-0.349* (0.184)	-0.299** (0.117)	-0.284*** (0.108)
$\Delta \log(\frac{Tbill}{GDP})_{t-1}$			-0.0475 (0.0901)	-0.0419 (0.0885)			-0.0676 (0.119)	-0.0538 (0.109)
$\Delta \log(\frac{Res}{GDP})_t$		0.119 (0.0855)		0.139 (0.114)		0.180 (0.135)		0.218 (0.145)
$\Delta \log(\frac{Res}{GDP})_{t-1}$				-0.00894 (0.0795)				-0.129 (0.0927)
Constant	-0.00646 (0.00810)	-0.00786 (0.00833)	-0.000266 (0.00599)	-0.00158 (0.00624)	-0.00864 (0.0101)	-0.00947 (0.0103)	-0.00253 (0.00716)	-0.00259 (0.00704)
Observations	181	181	181	181	164	164	164	164

Notes: Newey-West standard errors in parentheses (6 lags). Units are hundreds of basis points. The dependent variable is the first difference of the 3-month Bank bill/T-bill spread. Independent variables are the same as in Table 1 in the main text.

effect on the liquidity premium. This is especially relevant in this case where I am using 1-month differences. It can be the case, for example, that new debt issuance by the government has a short-lived impact that fades away soon after (this is what Nagel (2016) finds for the supply variable in the US). Results show that the supply of T-bills still has a negative and significant impact, although of a smaller magnitude. Importantly, unlike the results in Nagel (2016), the lagged value is insignificant, suggesting it has a more persistent effect. The results for the IOR are the opposite. The current value of the IOR has a significant negative impact that almost entirely reverts in the following month. The negative effect of the IOR and its transitory nature is the opposite result as the one in Nagel (2016).

In columns 5-8, I replicate the first four columns but with the sample ending in February 2020. Recall that the RBNZ embarked on large-scale asset purchases after March 2020. Large-scale asset purchases involve purchasing assets in exchange for newly issued reserves. Therefore, we should no longer expect the supply of reserves to be exogenous in this situation. The estimation in columns



5-8 is a robustness check as it should be free of any effect of QE and the possible endogeneity of the supply of reserves. The results show that the impact of the supply of T-bills and the IOR is still significant.

## Appendix D Regressions with U.S. data after 2008

Is the negative effect of the interest on reserves robust to using data for other countries? The following Table shows regressions of the liquidity premium for the U.S. after November 2008. The dependent variable is the spread of 3-month AA financial commercial paper and 3-month T-bills. Data for T-bill and reserve supply are from TreasuryDirect and FRED, respectively. The caveats pointed out in the main text still apply, mainly that the supply of reserves is likely to be endogenous to the different QE programs carried out by the Federal Reserve between 2009-2014. However, it is interesting to see the coefficients for the IOR, and the supply of T-bills are of the same sign as in Table 4. In particular, both the interest on reserves and the supply of T-bills have a negative effect on the liquidity premium. These results are robust to using IVs (not shown).

## Appendix E Calibration of the Model

The model is calibrated with data for New Zealand at a quarterly frequency, using the sample 2006:III to 2021:III. Panel A of Table 5 shows the parameters calibrated externally. I pick a value of risk aversion of 1.5 and assume a Taylor rule parameter for inflation of 1.5, as it is common in the literature.

The rest of the parameters are calibrated under a deterministic steady state. Table 5, Panel B, shows the values for the five parameters. The targets are the illiquid rate, for which I use the yield on 6-month term deposits, the average yield on T-bills, and the OCR during the sample period. I complement this with two quantities: government debt and banking deposits. I define a supply of government debt to GDP of 0.42 (OECD data, General Government debt), and for deposits, I set reserves to GDP at 0.12 and other assets to GDP at 1.4. The ratio of reserves to GDP is obtained from the RBNZ, and the supply of other assets matches domestic credit by the banking sector from OECD statistics.

The calibration exercise gives a discount factor of 0.994, which is somewhat lower than usual. However, this difference accounts for the illiquidity of the intertemporal rate in the model. The liquidity preference in the household's utility function,  $\alpha$ , takes the value of 9.617e-04, and the relative usefulness of government debt,  $\lambda$ , equals 0.4783. This implies that deposits are only slightly more liquid than T-bills.

Table 6 shows how the model matches the targets for prices and quantities. The last row computes the liquidity premium on government debt.

Table 4: U.S.: Determinants of liquidity premium, 2008m11-2020m6 - OLS

	(1)	(2)	(3)	(4)
$\Delta \text{ioer}_t$	-0.363*** (0.124)	-0.604*** (0.158)	-0.361** (0.157)	-0.511*** (0.124)
$\Delta \text{ioer}_{t-1}$			0.449*** (0.131)	0.403*** (0.103)
$\Delta \text{vix}_t$	0.0131*** (0.00293)	0.0119*** (0.00246)	0.0113*** (0.00284)	0.00813*** (0.00198)
$\Delta \text{vix}_{t-1}$			0.00561*** (0.00184)	0.00453** (0.00181)
$\Delta \log(\frac{Tbill}{GDP})_t$	-0.895*** (0.223)	-0.755*** (0.195)	-0.498*** (0.139)	-0.625*** (0.154)
$\Delta \log(\frac{Tbill}{GDP})_{t-1}$			0.266 (0.167)	0.371*** (0.123)
$\Delta \log(\frac{Res}{GDP})_t$		-0.932*** (0.343)		0.0747 (0.167)
$\Delta \log(\frac{Res}{GDP})_{t-1}$				-0.495*** (0.169)
Constant	-0.0127 (0.0137)	-0.00209 (0.00935)	-0.00442 (0.00516)	2.91e-05 (0.00464)
Observations	140	140	139	139

Notes: Newey-West standard errors in parentheses (6 lags). Units are hundreds of basis points. The dependent variable is the first difference of the 3-month AA financial commercial paper/T-bill spread.

## Appendix F Proof of Proposition 1

Rewrite Equation (10) in the model to get:

$$1 + i_t^d = (1 + i_t)(1 - v_{dt}) \quad (23)$$

where  $v_{dt} = \frac{\alpha(1-\lambda_t)(\frac{D_t}{P_t})^{\rho-1}}{u_c(C_t)[(1-\lambda_t)(\frac{D_t}{P_t})^\rho + \lambda_t(\frac{B_t^h}{P_t})^\rho]}$  is the marginal convenience yield of deposits for the household.

In response to an endowment shock,  $(1 + i_t)$  responds directly from the intertemporal Euler equation, and Equation (23) makes clear that the response of  $i_t^d$  will be less than one-to-one with

Table 5: Calibration

A. Externally calibrated			
	Description	Value	Source
$\gamma$	Risk aversion	1.5	Standard
$\psi_\pi$	CB's response function	1.5	Standard
$\rho_G$	Gov's deficit	0.1	Bohn (1998)
B. Calibrated			
	Description	Value	Target
$\beta$	Discount factor	0.994	mean( $i_t$ )
$\alpha$	Liq. preference	0.0013	mean( $i_t^b$ )
$\lambda$	T-bill preference	0.4783	mean( $i_t^m$ )
$\psi$	CB's response function	1.0008	Inflation target
$\chi$	Loans' cost	7.6831	Gov debt/GDP
$z$	Gov's deficit	6.7164e-04	Reserves/GDP

Notes:

the response of  $i_t$ , and the difference will be proportional to the reaction of the convenience yield. The response of the convenience yield will be given by (take the case of  $\rho = 1$  for simplicity):

$$\frac{\partial v_{dt}}{\partial Y} = -\alpha(1 - \lambda_t)(\partial Q_t / \partial Y) / Q_t^2 \quad (24)$$

where recall that  $Q_t$  represents the liquidity aggregate. T-bills' real supply responds to current inflation, so their supply drops. In turn, as given by Equation (12) in the model, deposits will respond depending on the change in reserves and loans. Under a corridor system, the central bank responds by reducing the supply of reserves, which will reduce deposits, and therefore  $\partial Q_t / \partial Y < 0$ . Under a floor system, there is no change in the supply of reserves, and the drop in deposits is smaller. Therefore,  $\frac{\partial v_{dt}}{\partial Y}$  is larger under a corridor system, and the adjustment needed in  $i_t^d$  will be smaller than under a floor system.

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Table 6: Model moments and Targets (Annualized)

Variable	Description	Data	Model
$b_t$	Gov debt/GDP	0.42	0.42
$m_t$	Reserves/GDP	0.12	0.12
$l_t$	Loans/GDP	1.4	1.4
$i_t$	Illiquid rate	4.44%	4.44%
$i_t^b$	Debt yield	3.25%	3.25%
$i_t^m$	Interest on reserves (OCR)	3.34%	3.34%
$i_t - i_t^b$	Liquidity premium	1.19%	1.19%

Notes:

Keister, Todd, Antoine Martin, and James McAndrews, 2008. “Divorcing Money from Monetary Policy”, FRBNY Economic Policy Review, September 2008.

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