Different Liquidity Substitution between Money and Government Bonds across Households and Banks in Japan

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Abstract

This paper studies whether Japanese government bonds are substitutes for money-like assets, and whether this substitutability differs between households and banks. Government bonds are usually viewed as interest-bearing assets, but they can also provide liquidity services because they are safe, actively traded, and useful as collateral. The results have three main implications. First, government bonds and money-like assets are substitutes, but they are not perfect substitutes. Second, the elasticity of substitution is much higher for banks than for households. Banks' relative holdings of government bonds to money respond more strongly than those of households to changes in the supply of government bonds through the liquidity channel. Third, the liquidity channel can lower long-term government bond yields during quantitative easing, but its contribution is small.

Keywords: Liquidity premium; Japanese government bonds; Bond demand; Quantitative easing