

# The Term Structure of the Liquidity Premium and Its Application

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## Abstract

We interpret the yield spread between Japanese Government Guaranteed Bonds (JGGB) and Japanese Government Bonds (JGB) as market liquidity, and use this measure to decompose the municipal bond spread and evaluate the BOJ policies. Our model-free approach not only provides the term structure of the liquidity premium, but also captures the impact of illiquidity events and the illiquidity condition of the fixed-income market. Based on this measure, we show the liquidity factor plays an important role in the municipal bond spread, which suggests local governments have the opportunity to reduce their financing costs through enhancing market liquidity. We also show the spread between JGGB and JGB has drastically increased after the widespread emergence of negative JGB's yields, finding the yield of JGGB strongly hit the zero lower bound and the market segmentation effect has strengthened.

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