

J-liquidity Measure: the Term Structure of the Liquidity Premium and the Decomposition of the Municipal Bond Spread

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Abstract

We interpret the yield spread between government-guaranteed bonds and government bonds as market liquidity, and use this measure to decompose the municipal bond spread into credit and liquidity premiums in the Japanese market. 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. 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. The liquidity measure is provided publically for future applications.

JEL codes: G12, G13

Keywords: bond liquidity, liquidity risk, term structure of liquidity premium, municipal bond market.