Gap-Filling Debt Maturity Choice in the Government Bond Market: Evidence from the ECB's 3-year LTRO

Frederik Eidam*

University of Mannheim and Centre for European Economic Research (ZEW)

February 8, 2017

Abstract

I study cross-country linkages in governments' debt supply to manage the aggregate demand for government debt across maturities. For this purpose, I explore the ECB's three-year LTRO in 2011-2012 as a quasi-natural experiment, as peripheral banks resulting 'carry trades' stipulated peripheral governments to temporarily decrease their supply of long-term debt. Using a difference-in-difference approach based on a novel panel data set, I find that core governments responded by temporarily increasing their supply of long-term debt to fill the resulting gap. The empirical results are consistent with my theoretical prediction of gap-filling debt maturity choice, in which preferred habitat investors demand debt with a specific maturity. My results suggest that governments decide on their debt maturity not in isolation, but in interdependence to one another. This has important implications for the design of monetary policy and the financial architecture.

Keywords: sovereign debt, maturity structure, unconventional monetary policy, sovereign-sovereign linkages, preferred habitat, difference-in-difference, natural experiment

JEL Classification: E58, G11, G15, H63

* Address: L7 1, DE-68161 Mannheim, Germany, Phone: +49 621 1235330, frederik.eidam@uni-mannheim.de. I thank Viral Acharya, Klaus Adam, Martin Brown, Matteo Crosignani, Karolin Kirschenmann, Luc Laeven, Johannes Pfeifer, Jan Riepe (discussant), Sergio Schmuckler, Farzad Saidi, Sascha Steffen, Christoph Trebesch, Michael Weber, participants at the 2016 Muenster Banking Workshop, and seminar participants at the University of Mannheim, Deutsche Bundesbank, and the Centre for European Economic Research for their helpful comments and suggestions. I also thank Nils Melkus for excellent research assistance.