Abstract

We present a theory in which the key driver of short-term debt issued by the financial sector is the portfolio demand for safe and liquid assets by the non-financial sector. This demand drives a premium on safe and liquid assets that the financial sector exploits by owning risky and illiquid assets and writing safe and liquid claims against those. The central prediction of the theory is that government debt (in practice this is predominantly Treasuries) should crowd out the net supply of privately issued short-term debt (the private supply of short-term safe and liquid debt, net of the financial sector's holdings of Treasuries, reserves and currency). We verify this prediction in U.S. data from 1914 to 2011. We take a series of approaches to address potential endogeneity concerns and omitted variables issues: Testing additional predictions of the model (notably that checking deposits should be crowded in by government debt supply), including controls for the business cycle, exploiting a demand shock for safe/liquid assets, and exploring the impact of government supply on the composition of consumption expenditures. We also show that accounting for the impact of Treasury supply on bank money results in a stable estimate for money demand and can help resolve the "missing money" puzzle of the post-1980 period. Finally, we show that short-term debt issued by the financial sector predicts financial crises better than standard measures such as private credit/GDP.