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A convenient truth: The convenience yield, low interest rates and implications for fiscal policy

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When government bonds carry a positive convenience yield, meaning they are valued for things other than their pecuniary return, counter-cyclical fiscal policy becomes more successful in stabilizing output. This is because the convenience yield implies a positive link between government bond holdings and private consumption which counter-cyclical fiscal policy effectively exploits. While governments face a tradeoff between output stabilization and debt sustainability, the convenience yield renders this tradeoff more favorable. Optimal fiscal policy under a positive convenience yield prescribes a large weight on output stabilization and a small weight on debt stabilization.

When government bonds carry a positive convenience yield, counter-cyclical fiscal policies become more successful in stabilizing the economy. The *convenience yield* captures the value of holding government bonds that is related to things other than those bonds' pecuniary return. For instance, investors may value government bonds because of their superior safety and liquidity attributes, and for their use as collateral in financial transactions (see Krishnamurthy and Vissing-Jorgensen, 2012).

In a recent paper, Bonam (2020), I study the implications of this convenience yield for fiscal policy using a standard New Keynesian model. The only non-standard feature of the model is that households have a preference for holding government bonds for reasons beyond merely consumption smoothing. This preference gives rise to the convenience yield (see also Fisher, 2015; Michaillat and Saez, 2019; Rannenberg, 2020).

The main mechanism that drives the results is a positive link between government bond holdings and private consumption which is present only when the convenience yield is positive. Intuitively, the more government bonds are held by households, the lower becomes the marginal utility of holding government bonds. This causes households want to save less and consume more. Therefore, the government can stimulate household consumption by issuing more bonds.

Counter-cyclical fiscal policies can deliver more favorable macroeconomic conditions, because they effectively exploit this positive co-movement between government bond holdings and private consumption. For instance, let's say a negative demand shock drives the economy into recession. If fiscal policy is *counter-cyclical*, the government will respond to the crisis by raising its budget deficit (e.g. by increasing its expenditures or cutting taxes). To finance the deficit, the government issues more bonds which end up being held by households. The rise in government bond holdings reduces the marginal utility of holding government bonds, which motivates households to save less and consume more. The rise in private consumption offsets the initial bad shock which, ultimately, helps stabilize the economy. Note that, under a *pro-cyclical* fiscal policy, the opposite occurs: in that case, the government responds to the crisis by reducing its budget deficit, which leads to a reduction in households' holdings of government bonds. Consequently, households wish to save more and consume less, which exacerbates the recession. Therefore, the convenience yield renders counter-cyclical fiscal policies stabilizing and pro-cyclical fiscal policies destabilizing.

The stabilizing effects of counter-cyclical fiscal policy get weaker, the more effort the government puts into ensuring debt sustainability. Put differently: the government faces a *tradeoff* between output stabilization and debt sustainability. A larger weight on debt sustainability effectively makes fiscal policy more pro-cyclical: in times of recession, when the budget deficit rises automatically due to automatic stabilizers, the government will pro-cyclically tighten its budget if it cares strongly about debt sustainability. Such actions offset the output-stabilizing effects of the part of fiscal policy that counter-cyclically moves with the economy. Conveniently, however, the greater is the convenience yield, the more favorable this tradeoff becomes. A larger convenience yield implies a stronger link between government bond holdings and private consumption, which makes counter-cyclical fiscal policy more successful in stabilizing the economy. This allows the government to focus more on output stabilization without jeopardizing debt sustainability. In fact, the model shows that the greatest welfare gains for households can be achieved if the government adopts a strongly counter-cyclical fiscal policy while, at the same time, puts the least amount of weight on debt sustainability as possible.

Policy Implications

The results outlined above have clear implications for the design of fiscal policy in an environment characterized by positive convenience yields that keep interest rates persistently low. The secular decline in (safe) interest rates, observed since the 1980s, increasingly limits the scope for central banks to engage in accommodative monetary policy. This has prompted policymakers to look to fiscal policy to do its part in stabilizing the economy. This paper shows that not only does the convenience yield strengthen the stabilizing properties of counter-cyclical fiscal policy, it also (conveniently) ensures that such policies do not threaten debt sustainability.

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