Financial Flow Variables and the Short-Run Determination of Long-Term Interest Rates

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Abstract

Because transactions costs are smaller for allocating new cash flows than for reallocating existing asset holdings, financial flow variables are important determinants of investors' short-run asset demands. The demand-for-bonds equations implied by the resulting "optimal marginal adjustment" model of portfolio behavior constitute the demand side of a structural supply-demand model of the determination of the long-term interest rate. Empirical results, based on demand-for-bonds equations estimated using U.S. data for six major categories of bond market investors, support the optimal marginal adjustment model and show that the associated structural model of interest rate determination, which is restricted by the underlying demand-for-bonds equations, fits the data about as well as do previously developed unrestricted reduced-form term-structure equations.