‘The liquidity channel of fiscal policy’ (Bayer, Born, Luetticke, 2021)

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Summary of the paper

- Studies effects of public debt on the economy, specifically via the ‘liquidity channel’
- Empirics: 1% debt → Liquidity Premium (LP) falls by 2-35 basis points
- ‘HANK’ model
  - Short run :
    - 1% debt → LP falls by 14 basis points
    - Fiscal multipliers higher because of LP channel
  - Long run:
    - 10% debt → Real bond rates increases by 25 basis points
    - Limited crowding out private capital

What to make of '*the liquidity channel*'?

- Paper:
  - Public bonds allow liquidity constrained agents *to better smooth consumption*, raising economic efficiency (Woodford, 1990)
- Distinct from another (more familiar?) notion: ability to trade swiftly at no price discount
  - DMOs very concerned on ensuring liquidity in this other sense
  - Two notions can a priori be found in the data
- To what extent do liquidity constrained households hold government bonds ?
  - Government bonds are held by wealthy households, who are not so likely to be liquidity constrained → Is heterogeneity adequately captured ?
  - Financial intermediaries value liquidity → Should they feature in the model ?

Specific clarification questions on the model

- Short term response to government spending shock (Figure 6 of paper)
  - How high is effectively the fiscal multiplier?
  - Inflation response: peak immediate response, then fades away: realistic?
- Households borrow at $R = A.R^b$, they lend at $R = A.R^b + P$
  - Who receives the penalty P? (doesn’t show in aggregate budget constraint)
- Nominal rate on public bonds set by monetary policy (smoothed Taylor rule, equation 19 of paper)
  - If inflation is anchored on target, how can (nominal or real) bond rate change in the long-term, in response to higher public debt?

A couple of broader questions

- To what extent does the premium that is measured capture ‘liquidity’ as opposed to ‘credit’ risk?
- How can the model be used to think about the present-day specific concerns, particularly in the euro area?
  - Evidence based on long time series, with lower debt levels than present. On the other hand, private wealth also much bigger

    → How to assess relevance of the liquidity channel in 2020s conditions?
  - Heterogenity of sovereign bonds with single monetary policy a defining feature of the euro area

    → What can the model say about this?