‘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 $\rightarrow$ Liquidity Premium (LP) falls by 2-35 basis points

• ‘HANK’ model
  • Short run:
    • 1% debt $\rightarrow$ LP falls by 14 basis points
    • Fiscal multipliers higher because of LP channel
  • Long run:
    • 10% debt $\rightarrow$ 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?
  • Heterogeneity of sovereign bonds with single monetary policy a defining feature of the euro area
    → What can the model say about this?