Monetary-Fiscal Interaction and the Liquidity of Government Debt

CFM-DP2024-06

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This paper investigates the interplay between fiscal and monetary policies and how they influence individuals' savings behaviors and, as a result, the aggregate economy. By constructing a model with heterogeneous agents—with varying abilities to save and invest—the study sheds light on the effects of policy mixes on economic stability and individual financial decisions.

At the core of the analysis is the concept of the "liquidity premium," which refers to the difference in returns between more liquid assets (like government bonds) and less liquid investments (such as physical capital or stocks). The study reveals two main forces at play: the "self-insurance" channel, where households save more in liquid assets to protect against personal financial shocks, and the "supply" channel, where government policies influence the availability and attractiveness of different types of assets.

Through a series of simulations, the paper demonstrates how these dynamics shift in response to economic shocks and policy changes. For example, when a technology shock occurs, the balance between saving in liquid assets for self-insurance and investing in illiquid assets for potential growth depends heavily on the government's fiscal and monetary stance. Interestingly, the research finds that the option to invest in capital as a form of insurance is limited by the lack of complementarity between capital and other assets in the current setup of the model economy.

The paper also delves into the effects of fiscal stimulus under various policy scenarios. It shows that the impact on households' portfolio choices—whether they prefer to hold more liquid assets or invest in capital—varies significantly based on the combination of fiscal and monetary policies in place.