Public versus Private Provision of Liquidity: Is There a Trade-Off?

Christoph Winter*

Abstract

To what extent is public debt private liquidity? Much policy advice given in the aftermath of the financial crisis rests on the assumption that increasing public debt relaxes borrowing constraints of private households. This is the case for ad-hoc debt limits, which are exogenous to public policy. Instead, if debt limits are fully endogenous, as e.g. in the case of the natural borrowing limit, public debt has no impact. We assume that borrowing limits arise because of limited contract enforceability and are therefore determined as equilibrium outcomes. Using an incomplete markets economy in which households are subject to uninsurable earnings shocks, we show that public debt provides some liquidity, but less so than it would if constraints were imposed ad-hoc. We show that generating borrowing constraints as an equilibrium outcome substantially alters the answers to other important questions, such as for the welfare effects of government debt or its impact on real economic activity.

**University of Zurich*

(joint with Sigrid Röhrs, Goethe Universität Frankfurt)