DISCUSSION: "Liquidity, Government Bonds and Sovereign Debt Crises" by F. Molteni

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- **Important analysis**: during European sovereign debt crisis decreasing funding liquidity [‘rising haircuts’] on peripheral government bonds affected systemic risk;
- In particular, author:
  1. uses **sophisticated DSGE model** with financial frictions to show that ‘issuing more (ST) public liquidity’ can alleviate adverse shocks to funding liquidity;
  2. shows **empirically** that adverse liquidity shocks had a negative effect on the price of government bonds.

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- Introduction of **important risk channel** to DSGE framework: different degrees of asset liquidity;
- Model **results intuitive**: rise in haircuts results in rise in liquidity spreads and a fall in output, investment, and consumption;
- Particularly **interesting**: zirp less effective than nirp in face of strong adverse financial shock.

Comments

1. Entire analysis motivated with financing issues on the interbank market partly due to sovereign bond haircuts, yet **model does not feature banks/interbank market**.
   Related: **Jakab and Kumhof (2015) critique** on loanable funds assumption.
2. Model features **'risk-free equity and bonds'**: While it helps to tease out funding liquidity risk channel, not realistic an assumption (for Irish/Greek case).
   Can the default risk channel be included in model? How would this affect results?

Comments (ctd.)

3. Unclear if model fits specific **Irish case**: SOE and part of a currency union (better take UK?).
4. Policy suggestion makes sense in market based economy ('**operation twist**'): flatten yield curve to increase investment. However, in bank-based systems, there may be collateral effects.
5. Related to previous point: What if banks need to hold LT bonds (e.g. to minimize investment risks: maturity mismatch, funding risk, interest rate risk)? Abstracting from banks and their risk management might lead to flawed (macroeconomic) policy conclusions.

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2. **Better connect** empirical and theoretical parts: Empirical analysis somewhat detached...what is the relation to your theoretical analysis? Does it validate it or is it just an additional empirical finding?
3. **Clearly distinguish** between government and central bank in your model descriptions: p. 19 'gvmt reacts to haircuts by issuing more public liquidity...' $\rightarrow$ it is the central bank exchanging ST against LT bonds.

Literature

Del Negro, M., G. B. Eggertsson, A. Ferrero, and N. Kiyotaki (forthcoming): The great escape? A quantitative evaluation of the Feds liquidity facilities, American Economic Review.

Jakab, Z. and M. Kumhof (2015): Banks are not intermediaries of loanable funds – and why this matters. Bank of Egland Working Paper Series, 529.

Reis, R. (2015): QE in the Future: the central bank's balance sheet in a fiscal crisis. Centre Centre for Macroeconomics Discussion Paper Series, 2016-20.