Large-Scale Bond Purchases in a Currency Union with Segmentation in the Market for Government Debt

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Large-Scale Bond Purchases in a Currency Union with Segmentation in the Market for Government Debt

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Abstract

The literature on large-scale purchases of government debt emphasises the importance of bond market segmentation along the maturity dimension for their transmission. This study investigates how another form of segmentation that we observe, the segmentation of government bond markets across countries, can be exploited by the central bank of a currency union in which fiscal coordination is not attainable. It is shown first that, under general conditions, government bond purchases which lower bond yields have first-order effects on demand and hence inflation through a fiscal channel, even in the absence of the heterogeneity in investment opportunities assumed by Chen et al. (2012). The total effect on aggregate demand can be broken down into an "income-from-debt-issuance effect" and a "primary-surplus effect". As a result, the central bank is able to use government bond purchases to control the terms of trade and achieve asymmetric degrees of stimulus across the members of the currency union without a transfer of resources if there is cross-country segmentation in bond markets and home bias in government spending. The paper characterises the welfare-optimising mix of conventional interest rate policy and bond purchases in this scenario and gives an upper bound on the welfare benefits from using the additional tool.

Keywords: Large-Scale Asset Purchases, Quantitative Easing, Policy Coordination, Monetary Union, Market Segmentation
JEL-Classification: E50, E52, E58, F45

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