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Optimal Money and Debt Management: liquidity provision vs tax smoothing[*][†]

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Abstract

Conventional wisdom on public debt management says that liquidity demand should be satiated and that tax rates should be smoothed. Conflicts between the two can arise when government bonds provide liquidity. Smoothing taxes causes greater variability in fiscal balances, and therefore in the supply of government liabilities. When prices are flexible, and can jump to absorb fiscal shocks, the tradeoff between liquidity provision and tax smoothing is eased; when they conflict, optimal policy subordinates tax smoothing to satiating liquidity demand. When price fluctuations impose real costs, conflicts necessarily arise and optimal policy gives primacy to neither goal.

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