

Who should bear interest rate & liquidity risk?

■ Financial sector

- Holds long-term government bonds
- Issues short-term deposits
- If “well capitalized”, insures government against rollover risk

■ Government sector

- Issues short-term bonds (debt management)
(financial sector focus on private credit extension)
rollover risk depends on “fiscal capacity”

- Split gov. sector into:

Fiscal authority

issues long-term bonds →

Independent central bank

buys it & issue short-term money
CB can “costly signal” future i
backed by seignorage

Large CB balance sheet