Public Saving as Bubble Relocation*

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Abstract

This paper shows that public saving can relocate a public debt bubble from the government to households. Through this bubble relocation channel, public saving generates a stronger expansionary effect on economic activity than public debt issuance. In an economy with liquidity constraints, we first confirm that when the stock of public debt is sufficiently small, the government can finance persistent primary deficits through the issuance of bubbly public debt. We then show that when the government switches from a net borrower to a net saver, the same bubble is effectively relocated to the household sector, allowing households to borrow from the government at low interest rates. This relocation of the bubble relaxes private liquidity constraints, crowds in capital accumulation, and leads the economy to the Golden Rule level of capital that maximizes steady-state consumption. Dynamic inefficiency arises only when the government saves excessively beyond the Golden Rule level, in which case public debt issuance can help restore efficiency.

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