LIQUIDITY AND INEFFICIENT INVESTMENT

Oliver Hart  
Harvard University  
Luigi Zingales  
University of Chicago

Abstract
We study consumer liquidity in a general equilibrium model where the friction is the non-pledgeability of future income. Liquidity helps to overcome the absence of a double coincidence of wants. Consumers over-hoard liquidity and the resulting competitive equilibrium is constrained inefficient. Fiscal policy following a large negative shock can increase ex ante welfare. If the government cannot commit, the ex post optimal fiscal policy will be too small from an ex ante perspective. The model throws light on the holding of foreign reserves in international markets. (JEL: E41, G21, E51)

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E-mail: ohart@harvard.edu (Hart); luigi.zingales@chicagobooth.edu (Zingales)

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