Monetary policy and liquidity constraints: evidence from the euro area

Abstract: In the context of the Eurozone, we investigate the relationship between country specific output responses to a common monetary policy shock and the share of liquidity constraint households in each country. We recover GDP impulse responses using local projections instrumental variables (LPIV) method with changes in overnight indexed swap rates in a narrow time window around ECB announcements as an instrument. We show that a monetary policy shock has heterogeneous effects on real GDP across countries, both in terms of timing and size. The effectiveness of monetary policy is closely related to the share of households with low levels of liquid assets: we find that a 10 percentage point increase in the share of liquidity constraint households is associated with a real GDP response that is 1 percentage point stronger. The results are driven by liquidity constraint households who hold positive illiquid wealth, i.e. the wealthy Hand-to-Mouth.