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What determines Government spending multipliers?

Bruegel Economic Policy Seminar, 22 June 2012

One June 22nd, Bruegel hosted a policy seminar on the topic of government spending multipliers. The event was chaired by Jean-Pisani Ferry and featured as speaker Giancarlo Corsetti, of Cambridge Unviersity and CEPR, and as a discussant Rafael Wouters, of the National Bank of Belgium.

Following a brief introduction by Mr Pisani-Ferry, Mr Corsetti went on to present a paper co-authored with André Meier, from the International Monetary Fund, and Gernot J. Müller, from the University of Bonn and CEPR. Underpinned by the belief that there is no single multiplier capturing the impact of a fiscal stimulus, the paper looks into the effects of government spending given different economic environments. These include variations in the exchange rate regime, public indebtedness and the health of the financial system.

The authors use data for 17 OECD countries over the 1975-2008 time-frame and employ a two-step approach. In the first step, they identify a policy representation of the spending behaviour of government (policy shocks), while in the second stage the effects of policy shocks are estimated. They find that there is no clear cyclical pattern in spending, but there is a negative feedback from high debt, government spending adjusting downwards. More surprisingly they find that spending is also systematically cut during financial crises.

Looking at different economic environments, the authors find that under a flexible exchange rate regime, spending shocks mainly affect investment and the real exchange rate. These results hold in the background of low debt and the absence of a financial crisis. In a pegged currency framework, the impact of such a shock is a larger trade deficit, while the exchange rate does not depreciate. Furthermore, a spending stimulus in this scenario leads to a larger increase in output and a smaller fall in investment. Additionally, in the case of weak public finances (high debt and deficit) there is a lower output response.

The authors also consider the special circumstances of a financial crisis. In the latter case, they find a fiscal multiplier of up to two, meaning that output and consumption are extremely responsive to a spending increase. At the same time, a substantial fall in net exports and the real exchange rate is observed. Mr Corsetti went on to highlight that contrary to the Mundell Flemming model, which states that the multiplier is higher under a peg, things look very different in reality. He also stressed that there are many remaining gaps in the economist's toolkit. One of these shortcomings is a good model for a crisis. Furthermore, the crises considered in the paper differ from the one of today, in terms of both their nature, as well as in terms of their policy reaction.

Mr Wouters then provided his reflection on the paper. He argued that literature on fiscal shocks is relatively diffuse and that the new paper makes an improvement in this regard. The paper also provides a compelling argument for the importance of non-linearities. Mr Wouters went on to argue however that the paper does not control for the difference between the announcement date for a fiscal policy move and its implementation. Commenting on the results, Mr Wouters then asked to what extent financial crisis periods coincide with recession periods. He also suggested that the composition of public spending may be important for the analysis, and asked whether it would be possible to control for the interaction of high public debt and the presence of a financial crisis.

A question and answer session followed the presentation by the speakers. Several points were raised, such as the relation between stress in the financial markets and stress in public finances, the symmetry of the multiplier between expansions and contractions, the difficulties fiscal budget offices may encounter in proposing different multipliers for different economic conditions, the government approach to fiscal multipliers and differences across member states in this regard, among others.

Event notes by Dana Andreicut