Fiscal Policy in an Unemployment Crisis

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Pontus Rendahl[1,2,3]
[1]University of Cambridge; [2]Centre for Economic Policy Research; and [3]Centre for Macroecnomics

The aggressive fiscal response to the global financial crisis sparked a heated debate over the merits of expansionary government spending. Critics questioned the transmission mechanisms typically invoked to support the effect of fiscal policy, expressing concerns over their theoretical and empirical foundations. These concerns applied to both the traditional view, essentially inspired by the "Keynesian cross" linking current income to current spending, and the new Keynesian view, which stresses the need to sustain demand over time in order to reduce long-term interest rates by engineering a rise in expected inflation.

This paper takes a new approach into investigating the efficacy of government spending. In particular I explore a novel channel through which large fiscal multipliers can arise from simple equilibrium unemployment dynamics. The key mechanism stems from the interaction between two widely accepted and empirically grounded premises. First, at a zero rate of nominal interest, output is largely determined by demand. If households wish to consume more, firms will also produce more. Second, the labor market is frictional. Any change in current unemployment will therefore partly persist into the future.

To appreciate how the interaction between these two premises may lead to a large fiscal multiplier, consider the effect of a transitory spending hike at a zero nominal interest rate. Higher spending raises output (premise 1) and lowers the unemployment rate both in the present and in the future (premise 2). As forward-looking agents desire to smooth consumption over time, a rise in future output feeds back to a rise in present private spending, and the unemployment rate falls further. This interplay between present and future economic activity sets off a virtuous "employment-spending" cycle which propagates the effect of demand stimulating policies many times over. The fiscal multiplier associated with these dynamics is often around two, with an improvement in welfare roughly equal to 1.4 dollars of private consumption per dollar of government spending.