Fiscal Multipliers and Financial Crises

Miguel Faria-e-Castro *
New York University

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Abstract

How should the government spend an extra dollar during a financial crisis? I develop a macroeconomic model that provides a role for the use of common fiscal policy tools, such as government purchases and transfers, as well as of financial sector interventions such as bank recapitalizations and credit guarantees. Banks enable aggregate demand by intermediating funds between agents with different marginal propensities to consume. During recessions, borrowing constraints bind and aggregate demand is depressed. This effect is amplified during financial crises, as low bank capital hampers intermediation capacity. I use this model as a laboratory to study how the effects of fiscal policy vary with the state of the economy. Financial sector interventions generate negative fiscal multipliers during real recessions, but very high and positive ones during financial crises. Credit guarantees generate “lender-of-last-resort” effects: a fiscal authority that commits more resources to guaranteeing bank debt may end up spending less in equilibrium. In a quantitative exercise, I collect a rich data set on different types of U.S. fiscal policy interventions during the recent financial crisis. I use this data to filter a time series of policy-invariant credit risk shocks, which allows me to study the time series of fiscal multipliers for different types of policies during the recent financial crisis, as well as to study policy counterfactuals.

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