Fiscal Multipliers in Recessions

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Abstract

The Great Recession, and the fiscal response to it, has revived interest in the size of fiscal multipliers. Standard business cycle models have difficulties generating multipliers greater than one. And they also fail to produce any significant asymmetry in the size of the multipliers over the business cycle. In this paper we employ a variant of the Curdia–Woodford model of costly financial intermediation and show that fiscal multipliers can be strongly countercyclical and asymmetric. In particular, they may take values exceeding two during recessions, declining to values below one during expansions. This pattern obtains if the spread (the financial friction) is more sensitive to fiscal policy during recessions than during expansions, a feature that is present in the data.

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Introduction

Keynes advocated a fiscal stimulus during the Great Depression, and since then governments have routinely implemented fiscal expansions during recessions as a means of stimulating economic activity. Standard business cycle models offer scant support for this practice. Much of the criticism levelled at the Obama administration’s stimulus plan was based on the implication of these models that government spending is ineffective. In a nutshell, this implication rests on the argument that an increase in government spending raises consumers’ expected tax burden, and this negative wealth effect largely curtails the expansion of aggregate demand. The associated multipliers are small, hovering at best around one. Moreover, as we elaborate below, these models also imply that fiscal policy is ineffective even during very severe downturns.

The crowding out of private spending and the small multipliers are closely related to the popular assumption of smoothly functioning financial markets and the associated Ricardian equivalence. While it is well understood that the existence of financial frictions breaks Ricardian equivalence and has thus the potential to abate the negative aggregate wealth effects and contribute to large values for the multiplier, there exists no work that has shown this to be the case (at least in the context of a quantitative model). The objective of this paper is to fill this gap. In particular, we ask whether a model with financial frictions (in our case, the model of costly financial intermediation of Curdia and Woodford [2009, 2010]) can generate large, cyclically asymmetric multipliers. We find that it can if we require the spread to behave like its counterpart in the data. The key properties of the spreads that are responsible for both the size and the asymmetry of the multipliers are their countercyclicality and their greater sensitivity to changes in fiscal expansion during recessions. This feature allows fiscal expansions to support a stronger financial accelerator mechanism during recessions. We provide empirical evidence that the effect of changes in government spending on spreads is considerably more pronounced during recessions relative to booms, a fact that offers direct support to the main mechanism of the model.

1 The countercyclicality of financial frictions has been long recognized in financial economics, see, for instance, the detailed discussion in Mishkin [2001], Chapters 8 and 25, about how the cyclicity of firm net worth, of household liquidity etc. induce countercyclical variation in moral hazard and adverse selection problems. The possibility of asymmetric variation over the business cycle in the bite of financial frictions in response to policy interventions has not received any attention in the literature. Naturally, the popular practice of linearization in quantitative general equilibrium models precludes this possibility.

2 While models with financial frictions tend to give rise to a financial accelerator, they often fail to generate a strong and cyclically asymmetric one. For instance, Collard and Dellas [2008] calculate fiscal multipliers in the model of Bernanke et al. [1999]. They find that multipliers are small and exhibit limited cyclical asymmetry over the business cycle. Similarly, in a model with financial frictions, Fernández-Villaverde [2010] finds output multipliers of about 1.
Note that countercyclical fiscal policy can find little justification by the popular New-Keynesian models. Cogan et al. [2010] (CCTW hereafter) used the Smets and Wouter’s [2007] model to compute consumption and output multipliers. They consider several alternative experiments (such as permanent vs temporary government spending increases, the particular case of the Obama administration American Recovery and Reinvestment Act, different lengths of time for the zero bound constraint, etc.). They report that the maximum output multiplier is about unity (and typically much smaller) and consumption and investment multipliers are negative. More importantly from the point of view of this paper and in line with the findings of Collard and Dellas [2008], CCTW do not find any significant variation in the multiplier over the business cycle when solving the non-linear version of the model. In particular, using an output gap of 6.5%, and letting the zero bound become endogenous hardly affects the output multipliers; if anything, it made them slightly smaller.

There are two other models that can give rise to large multipliers: Models with deep habits (Ravn et al [2012]); and New Keynesian models with a binding zero nominal interest rate bound. It is not known whether the former can give rise to significant cyclical asymmetry in multipliers. The latter can do but the existing literature is not unanimous regarding the role of the zero nominal interest rate bound in making fiscal multipliers larger. While CCTW find no role, Eggertsson [2010] and Christiano et al. [2011] find that it can make a big difference for the multipliers. Erceg and Lindé [2010] fall in between CCTW and Christiano et al. [2011]. But independently of the effects of the zero bound on the fiscal multiplier, there seems to be a need for a supplementary or perhaps more general explanation of the large multipliers during recessions because nominal interest rates have not been at the zero bound for most of the recessions in the post World War II period.

In addition to generating large and cyclically variable fiscal multipliers, our analysis has other useful implications. For instance, it implies that the size of the fiscal intervention matters for the magnitude of the multiplier. In particular, while a 1% increase in government purchases during a recession produces a multiplier between 2 and 3, an increase of 5% or 10% gives rise to multipliers between 1.5 and 2. The reason large fiscal interventions are less effective than smaller ones is that the –negative– marginal wealth effect due to the higher tax liabilities is increasing in the size of the fiscal intervention while the –positive– marginal effect on the borrower from the reduction in the finance premium is decreasing.

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3 The mechanism is as follows. Normally, nominal and real interest rates would rise following an increase in government spending, chocking off the expansion. But if the nominal interest rate is stuck at zero, this channel does not operate.

4 Although the mechanism presented in this paper relies on the existence of financial frictions, it does not require financial shocks induced recessions. Most business cycle shocks will give rise to non-linear, countercyclical multipliers in our model.
in the size of the fiscal expansion.

Another implication is that multipliers during recessions remain greater than one even when the government finances higher spending through taxes. But as in the IS-LM analysis, the multipliers are even bigger for debt financed spending. The reason is that while higher government spending sets in motion the financial accelerator, higher taxes partly counter this by reducing the quantity of funds available to financially constrained individuals.

How do these theoretical implications square up with the existing empirical evidence on multipliers? As is well known, the empirical estimation of fiscal multipliers is a hazardous affair due to identification and data problems. No consensus view exists in the profession regarding their size. Nonetheless our calibrated model gives rise to multipliers that, for increases in government spending of the order of 1%, are very close to those recently estimated by Auerbach and Gorodnichenko [2010] and Bachmann and Sims [2011]. Auerbach and Gorodnichenko [2010] use regime switching SVAR’s to show that output multipliers are countercyclical. They find that the point estimates of the maximum output multiplier (over the first 20 quarters) are 0.57 during expansions and 2.48 during recessions. When they ignore the distinction between recessions and expansions they obtain an estimate of 1.00, which is typical of estimates in the more recent empirical literature. Our results are also consistent with the empirical findings of Tagkalakis [2008] who finds that, in the OECD, fiscal policy has a larger effect on consumption in recessions than in expansions; and that this effect is more pronounced in countries that have a less developed consumer credit market.

The rest of the paper proceeds as follows: In Section 2, we outline the model, and describe its calibration; at the end of the section, we discuss a financial accelerator that is created by our countercyclical intermediation friction. In Section 3, we present our results for consumption and output multipliers. We show that they involve multipliers falling short of unity during expansion and exceeding unity during recessions. In Section 4, we conclude.

1 The Model

Our model adopts the Curdia and Woodford [2009, 2010] framework of financial intermediation. Our main point of departure from that model is that we allow credit market frictions to be countercyclical and cyclically asymmetric. We present below empirical evidence that offers support to this specification, as it is crucial to our results. And we use our empirical findings to calibrate the parameters of the function describing the financial

\footnote{It should be noted that the standard errors of the estimates are rather large.}
friction.
It is not easy to formulate a dynamic general equilibrium model with private borrowers and lenders. Keeping track of the wealth of heterogeneous agents can be a daunting task. So, Curdia and Woodford devise a rather ingenious insurance scheme to make the solution tractable. In the Curdia-Woodford framework, households have access to complete financial markets, but only on a random and infrequent basis. During the intervening periods, the household only has access to limited – and costly – financial intermediation: savers can deposit funds at a bank (or hold government bonds) and borrowers can obtain loans from the bank. Banks are competitive, and they maximize profits period by period. But more importantly, banks incur a cost when making a loan. It turns out that households’ infrequent access to complete financial markets makes wealth dynamics tractable, while costly financial intermediation adds the financial friction that is at the heart of our results.

1.1 Households
In each period \( t \) an individual agent, \( i \), has a type \( \mu(i) \in \{b,s\} \). The household’s type may vary over time in a manner that is described below. Household \( i \)’s preferences in period \( t \) are represented by

\[
E_t \left[ \sum_{j=0}^{\infty} \beta^{t+j} \left( u^{\mu(i)}(c_{t+j}(i);\xi_{t+j}) - \int_0^1 v^{\mu(i)}(h^{\mu(i)}(i,f);\xi_{t+j}) \, df \right) \right]
\]

(1)

where \( u^{\mu}(\cdot,\cdot) \) is the utility of consumption of type \( \mu \) household. The consumption good is a CES aggregate of the outputs of a continuum of firms, indexed by \( f \). Members of household \( i \) work at all of these firms, and \( v^{\mu}(\cdot,\cdot) \) is the type \( \mu \) household’s disutility for the hours worked at each firm. \( \xi \) is the vector of preference shocks: specific preference shocks for borrowers and savers, and aggregate shocks to the disutility of hours worked. The difference between type \( b \) and type \( s \) agents lies in the fact that type \( b \) agents have a higher marginal utility of current consumption, that is,

\[ u^b_c(c,\xi) > u^s_c(c,\xi) \]  

(2)

for all \( c \) and all \( \xi \). In equilibrium, the type \( b \) agents will borrow while the type \( s \) will save. We will also refer to type \( b \) (resp. \( s \)) agents as impatient (resp. patient).

1.1.1 Evolution of Household Types
As explained previously, the type of an agent can change from one period to the next\(^6\) The type change is governed by a simple stochastic process. In each and every period an

\(^6\)The setting is identical to Curdia and Woodford, and the reader is referred to their paper for a more detailed presentation.
agent either keeps his type with probability $\delta \in [0, 1)$ or redraws a type with probability $1 - \delta$. In the latter event, the agent draws type $b$ –becomes a borrower– with probability $\pi_b$ or type $s$ with probability $\pi_s = 1 - \pi_b$. The law of large numbers implies that $\pi_b$ and $\pi_s$ will be the –unchanging– fractions of borrowers and savers in the economy. The type drawing process for somebody who is at present a saver is described in Figure 1 (a similar process applies to a current borrower). Given that agents can switch type with probability $1 - \delta$, the number of household histories goes to infinity, potentially generating formidable heterogeneity in wealth. Curdia and Woodford [2009] develop an insurance scheme that makes it possible to aggregate across agents in a tractable way. Agents can sign state contingent contracts that allow them to transfer to or receive resources from an insurance agency when and only when they have been selected to draw a new type. These contracts –which are optimal in the context of the Curdia-Woodford model– have the property that they eliminate all history dependence for those drawing a new type. In particular, wealth is redistributed in such a way that all agents who end up drawing the same type after visiting the insurance agency are identical. Curdia and Woodford then show that the consumption and employment decisions within each type is the same, independent of individual history. The distribution of wealth across agents at any point in time becomes irrelevant.

1.1.2 The Household’s Budget Constraint

The net wealth of household $i$ at the end of period $t$ is

$$B_t(i) = A_t(i) - P_t \delta_t(i) + \int_0^1 W_t(f) h_t(i,f) df + \Pi_t^f(i) + \Pi_t^b(i) + T_t(i) - P_t \tau^q_t(i)$$  (3)

where $\Pi_t^f(i)$ and $\Pi_t^b(i)$ are the profits received by the household as the owner of firms and banks, $T_t(i)$ is a transfer from the insurance fund (0 unless the household had access to the agency at the beginning of the period), $\tau^q_t(i)$ is a real lump sum tax, and $A_t(i)$ denotes
agent $i$’s nominal assets at the beginning of period $t$; that is,

$$A_t(i) = (1 + i^d_{t-1}) \max(B_{t-1}(i), 0) + (1 + i^b_{t-1}) \min(B_{t-1}(i), 0)$$

(4)

$i^d_{t-1}$ is the nominal interest rate on bank loans and $i^b_{t-1}$ is the interest rate on bank deposits created in period $t-1$. Note that government bonds compete with bank deposits, and the government bond rate, $i^g_{t-1}$, is equal to the deposit rate in equilibrium.

Household $i$ maximizes (1) subject to (3) and (4).

1.2 Bank Intermediation

Banks issue one period deposits to households that save and make one period loans to households that borrow. Unlike the operation of the insurance agency, bank intermediation is costly: a bank expends real resources to make loans. Its costs are given by

$$\Psi_t(b_t, y_t) = \xi \Psi, t b_t \eta \exp \left(\alpha \tilde{y}_t\right)$$

(5)

where $\tilde{y}_t = \frac{y_t - y^*}{y^*}$ denotes the relative deviation of output from its steady state level. $\xi \Psi, t$ is a cost shock. Like Curdia and Woodford, we assume that the cost is convex in the (real) amount of loans made, $b_t$. But, in addition, we assume that banking costs vary as a function of the business cycle (the output gap). We use this as a proxy for agency problems (default risk) in credit markets that become more severe during recessions. When $\alpha > 0$ loan rates have a countercyclical spread over deposits rates. There are compelling theoretical reasons for this countercyclicality and also strong empirical support.

While in principle it is always desirable to have micro-foundations for important features such as this, the short cut we take here does not compromise the answer we seek to the question we are interested in, namely, how spreads must behave in order for this model to generate large, cyclically variable multipliers and whether the required behavior of spreads is consistent with that observed in the date.

Banks are competitive – they take the deposit and lending rates, $i^d_t$ and $i^b_t$, as given – and they maximize profits period by period. Real bank profits in period $t$ are

$$\frac{\Pi^B_t}{P_t} = d_t - b_t - \Psi_t(b_t, y_t)$$

(6)

7Using the loan to GDP ratio in place of $b_t$ does not affect the implications of the model. See the technical appendix.
8The worsening of agency problems may require greater screening/monitoring efforts on the part of the intermediaries.
9See Mishkin [2001], for a detailed discussion of how reductions in net worth and cash flows exacerbate adverse selection and moral hazard problems in lending to firms. Unfortunately, the existing ways of modelling these agency problems in macroeconomics do not easily apply to models with heterogeneous agents. Curdia and Woodford use the shock to the cost of banking to represent exogenous variation in the probability of default. We adopt their approach and use the endogenous output gap in place of their exogenous shock to capture the same variation in default (agency problems).
10See, for instance, Gilchrist and Zakrajsek [2011], Figure 1.
and it chooses \( d_t \) and \( b_t \) to maximize profits subject to

\[
(1 + i^d_t)d_t = (1 + i^b_t)b_t
\]

Let us define the spread between the lending and the deposit rate, \( \omega_t \), by

\[
1 + i^b_t = (1 + \omega_t)(1 + i^d_t)
\]

then the bank’s first order condition is

\[
\omega_t = \frac{\partial \Psi_t(b_t, y_t)}{\partial b_t}
\]

The cost of making an additional dollar loan (the RHS) is equal to the benefit (the LHS). Using (5), the bank’s first order condition can be written as

\[
\omega_t = \eta \xi y_t b_t^{\eta - 1} \exp(-\alpha \tilde{y}_t)
\]

### 1.3 Firms

A continuum of monopolistically competitive firms, indexed by \( f \), produce intermediate goods using the technology

\[
y_t(f) = \xi_{y,t} h_t(f)^{\frac{1}{\psi}}
\]

where \( h_t(f) \) is a CES aggregate of the households’ labor and \( \xi_{y,t} \) is an auto-regressive aggregate productivity shock. Competitive retailers buy the intermediate goods at price \( P_t(f) \) and bundle them into the final good, \( y_t \), using a CES aggregator with elasticity \( \theta \). The final good is then sold, at price

\[
P_t = \left( \int_0^1 P_t(f)^{1-\theta} df \right)^{\frac{1}{1-\theta}}
\]

to households and the government.

Wages are flexible, but prices are not. In particular we employ the popular Calvo price setting scheme. In each period, an intermediate good firm gets the opportunity to re-set price optimally with probability \( 1 - \gamma \). As is well known, a dispersion of intermediate good prices distorts household consumption patterns and the efficient use of labor. So, aggregate output is

\[
y_t = \xi_{y,t} \int_0^1 h_t(f)^{\frac{1}{\psi}} df
\]

where \( \Delta_t = \int_0^1 \left( \frac{P_t(f)}{P_t} \right)^{-\theta} df > 1 \) when \( \gamma > 0 \). When \( \gamma = 0 \), prices are flexible and there is no price dispersion; that is, \( \Delta_t = 1 \).

In equilibrium

\[
y_t = \pi b_t b_t + \pi_s c_t + g_t + \Psi_t(b_t, y_t)
\]

\footnote{Following Curdia and Woodford we let banks select deposits and loans subject to this equation. As \( i^d_t \) is smaller than \( i^s_t \), \( d_t > b_t \). The difference between the volume of deposits and loans is used to pay for the intermediation costs and is the source also of bank profits.}
### 1.4 Government

The consolidated government flow budget constraint is

$$
\tau^g_t + b^g_t = \frac{1 + i^g_t}{\pi_t} b^g_{t-1} + g_t
$$

(13)

where $i^g_t$ is the interest rate on government bonds; it will be recalled that $i^g_t = i^d_t$ (since savers are indifferent between holding bank deposits and public debt). Government spending follows an auto-regressive process

$$
\log(g_t) = \rho_g \log(g_{t-1}) + \xi_{g,t}
$$

(14)

where $\xi_{g,t}$ is an innovation. Increases in government spending are initially bond financed, but lump sum taxes increase over time to stabilize the debt

$$
\tau_t = \tau^* + \theta \frac{b^g_{t-1} - b^*}{y^*}
$$

(15)

Note that Ricardian equivalence does not hold in our model. In particular, borrowers discount future liabilities at a rate that exceeds the interest rate on public debt. A tax cut financed by an increase in government debt generates a positive wealth effect for them. A similar role is played by transfers from households with low to households with high marginal propensity to consume in the model of Oh and Reis, 2012.

Monetary policy follows a standard interest rate rule

$$
i^g_t = \rho_i i^g_{t-1} + (1 - \rho_i) \left[ i^g_t + \kappa_i (\pi_t - \pi^*) + \kappa_y \left( \frac{y_t - y^*}{y^*} \right) \right] + \xi_{i,t}
$$

(16)

where $\pi_t$ is the rate of inflation and $\xi_{i,t}$ is a policy shock.

### 1.5 Model Calibration

The baseline calibration of our model’s parameters closely follows Curdia and Woodford [2009, 2010] and is reported in Table 1. In what follows, we let

$$
u^\mu(c^\mu, \xi) = \frac{\xi c^{\frac{1}{\sigma}} c^{\mu} e^{\sigma - 1}}{1 - \frac{1}{\sigma}} \quad \text{and} \quad \nu^\mu(h^\mu, \xi) = \psi c^{\frac{\xi - \nu h^{1+\nu}}{1+\nu}}
$$

(17)

The curvature parameters of the utility functions, $\sigma_b$ and $\sigma_s$, are set so that the average

12Savers also discount the future at a rate exceeding that on public debt because of the possibility of switching type.

13More precisely, the parameters are set using the same methodology as in Curdia and Woodford. However, since our model departs slightly from theirs in several minor ways (for example, we do not have sales taxes) some of our parameters differ from theirs.
## Table 1: Parameters

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Household</strong></td>
<td></td>
</tr>
<tr>
<td>Discount Factor ($\beta$)</td>
<td>0.9874</td>
</tr>
<tr>
<td>Intertemp. Elasticity (Borrowers) ($\sigma_b$)</td>
<td>12.2209</td>
</tr>
<tr>
<td>Intertemp. Elasticity (savers) ($\sigma_s$)</td>
<td>2.4442</td>
</tr>
<tr>
<td>Inverse Frischian Labor Elasticity ($\nu$)</td>
<td>0.1048</td>
</tr>
<tr>
<td>Disutility of Labor param. (Borrowers) ($\psi_b$)</td>
<td>1.1492</td>
</tr>
<tr>
<td>Disutility of Labor param. (Savers) ($\psi_s$)</td>
<td>0.9439</td>
</tr>
<tr>
<td>Probability of Drawing Borrowers type ($\pi_b$)</td>
<td>0.5000</td>
</tr>
<tr>
<td>Probability of Keeping Type ($\delta$)</td>
<td>0.9750</td>
</tr>
<tr>
<td>Debt Share ($b/y$)</td>
<td>$4 \times 0.8$</td>
</tr>
<tr>
<td>Preference Shock (Average, Borrowers) ($\log(\xi^b)$)</td>
<td>8.0133</td>
</tr>
<tr>
<td>Preference Shock (Average, Savers) ($\log(\xi^s)$)</td>
<td>0.8123</td>
</tr>
<tr>
<td><strong>Production</strong></td>
<td></td>
</tr>
<tr>
<td>Elasticity of Subst. btw. goods ($\theta$)</td>
<td>7.6667</td>
</tr>
<tr>
<td>Inverse labor Elasticity ($1/\varphi$)</td>
<td>0.7500</td>
</tr>
<tr>
<td><strong>Financial Costs</strong></td>
<td></td>
</tr>
<tr>
<td>Elasticity of Loans ($\eta$)</td>
<td>5.000</td>
</tr>
<tr>
<td>Output Gap Elasticity ($\alpha$)</td>
<td>23.0000</td>
</tr>
<tr>
<td>Constant ($\xi_\psi$)</td>
<td>1.2720e-06</td>
</tr>
<tr>
<td><strong>Nominal Aspects</strong></td>
<td></td>
</tr>
<tr>
<td>Annual Premium (Gross) ($1 + \omega$)</td>
<td>1.0200</td>
</tr>
<tr>
<td>Degree of Nominal Rigidities ($\gamma$)</td>
<td>0.6667</td>
</tr>
<tr>
<td>Persistence (Taylor Rule) ($\rho_i$)</td>
<td>0.8000</td>
</tr>
<tr>
<td>Reaction to Inflation (Taylor Rule) ($\kappa_\pi$)</td>
<td>1.5000</td>
</tr>
<tr>
<td>Reaction to Output (Taylor Rule) ($\kappa_y$)</td>
<td>0.0500</td>
</tr>
<tr>
<td><strong>Shocks</strong></td>
<td></td>
</tr>
<tr>
<td>Government Shock (Persistence) ($\rho_g$)</td>
<td>0.9700</td>
</tr>
<tr>
<td>Government Share ($g/y$)</td>
<td>0.2000</td>
</tr>
<tr>
<td>Persistence (Other shocks: $x$) ($\rho_x$)</td>
<td>0.9500</td>
</tr>
<tr>
<td>Debt feedback ($\varrho$)</td>
<td>0.0200</td>
</tr>
</tbody>
</table>
The curvature parameter is 6.25 and the ratio of the curvature parameters is $\sigma_b/\sigma_s = 5$. The levels of $\xi_b^c$ and $\xi_s^c$ are set in a way that guarantees that borrowers always have a higher marginal utility than the savers (see equation \[2\]). The value of the labor elasticity parameter is as in Curdia and Woodford. The discount factor, $\beta$, is set so that the nominal deposit rate is 1% per quarter. Households’ access to the insurance agency is infrequent: $\delta = 0.975$. But once there, the household has a 50–50 chance of changing type: $\pi_b = \pi_s = \frac{1}{2}$.

On the firm side, the inverse labor elasticity is set to $\psi = 0.75$, and the elasticity of substitution between intermediate goods is set so that the markup rate is 15%. The Calvo parameter and the production parameters are standard in the literature. Setting $\gamma = 2/3$ means that price settings last 3 quarters on average. The parameters of the interest rate rule and the process for government spending are also representative of those used in the literature.

The financial cost parameters play a critical role in our analysis. We set $\eta$ equal to 5, following Curdia and Woodford (2010). The value of $\alpha$ is set such that the cyclical behavior of the spread—the difference between corporate bond (AAA) and 3-month Treasury Bill rates—in the model is in line with that in the data. In particular, the average spread during expansions (defined as periods where output is above trend, with trend computed with the HP–filter) over the period 1960:I–2008:IV is 1.65%. The annualized spread is 2.8% during recessions (defined as periods where output is below the HP trend). Combining this information together with the fact that, on average, output is 1.16% above (below) trend during expansions (recessions) allows us to calibrate the value of $\alpha$. With a value of $\alpha = 23$ the model generates a spread of 1.65 with a 1% output expansion and a spread of 2.38 with a 1% recession when the source of the business cycle is an intermediation shock (first row, columns 3-4, in Table \[2\]). Note that the model’s ability to mimic average, cyclical spreads in the data obtains for all types of shocks present in the model (compare across rows in Table \[2\]). And the same pattern obtains when computing the average spread during booms or downturns rather than the spread that corresponds to an individual 1% boom/recession (columns 1-2 in Table \[2\]). In the analysis below we study multipliers for even more severe business cycles (in particular, deviations of 2.5% from trend) so we also report in this Table the spreads during such severe cycles (columns 5-6 in Table \[2\]). The spreads are about 3.1% with an output gap of $-2.5\%$ and about 1.25% with a boom of the same magnitude.

The average value of the financial shock, $\xi_{\psi}$, is set so that, as in Curdia and Woodford, \[14\] This means that a 10 percent increase in the volume of lending increases the equilibrium credit spread by about 1 percentage point.
the steady state annual premium is 2% (which is in line with the values reported in the literature; see, e.g., Gilchrist and Zakrajsek, 2011). This also implies that steady state financial costs represent 0.24% of output. We conduct a thorough sensitivity analysis on these parameters.

<table>
<thead>
<tr>
<th>Shock</th>
<th>Average</th>
<th>1.0%</th>
<th>2.5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\xi_c^e$</td>
<td>1.54</td>
<td>2.55</td>
<td>1.60</td>
</tr>
<tr>
<td>$\xi_c^s$</td>
<td>1.53</td>
<td>2.56</td>
<td>1.59</td>
</tr>
<tr>
<td>$\xi_h^e$</td>
<td>1.55</td>
<td>2.54</td>
<td>1.60</td>
</tr>
<tr>
<td>$\xi_h^s$</td>
<td>1.41</td>
<td>2.72</td>
<td>1.48</td>
</tr>
<tr>
<td>$\xi_f$</td>
<td>1.55</td>
<td>2.54</td>
<td>1.60</td>
</tr>
<tr>
<td>$\xi_R$</td>
<td>1.53</td>
<td>2.56</td>
<td>1.59</td>
</tr>
</tbody>
</table>

Note: E (resp. R) denotes an expansion (resp. recession).

The model is solved under perfect foresight using the non-linear method proposed by Laffargue [1990] and Boucekkine [1995] as implemented in DYNARE.

2 Cyclical Fiscal Multipliers

We can compute multipliers over the business cycle for cycles generated by any of the shocks in the model. Let $\xi_x$ denote a shock to the exogenous variable $x$. Let us denote by $\xi_x^R$, respectively $\xi_x^E$, the value of the shock to the exogenous variable $x$ that triggers a recession, respectively expansion. In our benchmark experiment, we choose a $\xi_x^R$ that is large enough to make output fall by 2.5%; then, we choose a $\xi_x^E$ that will make output rise by 2.5%.\(^\text{15}\)

In order to evaluate the effectiveness of fiscal policy over the business cycle we generate an expansion or recession and then immediately induce a fiscal response to it by having the government spending shock, $\xi_{g,t}$, respond by one percent. Let $z \in \{c, y\}$, where $c$ refers to consumption and $y$ to aggregate output, be the multiplier, let $z_{t+i}(\xi_x, g)$ denote the path of $z$ when the shock to the exogenous variable $x$ is accompanied by a fiscal response, and let $z_{t+i}(\xi_x)$ denote the path in the absence of a fiscal response. Then the cumulative

\(^{15}\)Note that the two shocks need not be of the same size (in absolute value) since the model is not linear.
multiplier $h$ quarters after the shock is computed as

$$M_h^x(\xi_x) = \frac{\sum_{i=0}^{h} (z_{t+i}(\xi_x, g) - z_{t+i}(\xi_x))}{\sum_{i=0}^{h} (g_{t+i} - g^*)}$$

(18)

### 2.1 Financial Market Shocks and Multipliers

In our benchmark simulations, we study business cycles caused by the shock to the spread, $\xi$. Figure 2 shows impulse response functions (IRF) for output in the absence of a fiscal response. The dark (or black) IRF is generated by a positive shock that is large enough to cause a output to fall by 2.5%. The light (or red) IRF is generated by a negative shock that would cause a 2.5% expansion; the graph for an expansion has been inverted for easier comparison with the recession case.

The IRF’s are not symmetric. In particular, output reverts to its steady state value more quickly in the case of a recession; a fact which is consistent with the empirical evidence (see Hamilton [1989], Beaudry and Koop [1993], Acemoglu and Scott [1997]). This is due to the fact that any given change in output has a more powerful effect on the premium during recessions, which serves to accelerate the process of recovery during recessions. The reason for this lies in the existence of a powerful financial accelerator during recessions. An increase in output in a recession mitigates the financial friction, which further increases output, further ameliorates the financial friction and so forth. A large spread as well as a spread that moves strongly with the business cycle contribute to a large financial accelerator. At the depth of a recession, the spread, $i_b - i_d$, is large and more sensitive to improvements in economic activity (if $\alpha > 1$), and the accelerator speeds up the recovery; by contrast, at the peak of an expansion, the bank spread is smaller and its sensitivity
to output movements low, and hence the accelerator propelling output back to its steady
state is weaker.

Figure 3 reports the cumulative output multipliers generated when fiscal policy reacts con-
temporaneously to the financial shock. The dark line shows multipliers during a recession;
the light line shows multipliers during an expansion. For the recession, the first quarter

Figure 3: Output Multipliers (Benchmark Experiment)

(and maximal) multiplier is about 2.25; for the expansion, it is less than unity (0.89). These
multipliers are in line with the empirical results of Auerbach and Gorodnichenko
[2010].

Figure 4 reports cumulative multipliers for aggregate consumption, and for borrowers
and savers individually; it shows what the determinants of the output multipliers are.

An increase in government spending that is partly financed by higher taxes raises the
present and future tax burden on all agents. This by itself has a negative wealth effect on
households. In the standard model, this is the only effect, and the Ricardian households are
induced to work harder and/or consume less in order to meet their higher tax obligations.

In our model, however, there is an additional effect that operates through the credit
friction. The reduction of the spread caused by higher government spending has a positive
effect on the consumption of the credit constrained agent. If this effect is large enough
relative to the negative wealth effect associated with the higher expected taxes, then the
borrowers end up increasing their consumption (while the savers’ consumption drops).

An expansion in government spending during a severe recession (a period of high spreads)
has thus the potential to lead to an increase in the consumption of borrowers that exceeds

16 More precisely, they find that the maximum output multiplier (over the first 20 quarters) during a
recession is 2.48, with the 95% confidence interval given by [1.93;3.03]. Note, though, that our IRF cannot
match the shape of theirs. Naturally, as we show in the technical appendix, adding real rigidities such as
habit persistence delays the peak in the multiplier.
Figure 4: Consumption Multipliers (Benchmark Experiment)

Cumulative Multiplier (Borrowers’ consumption) vs. Periods

Cumulative Multiplier (Savers’ consumption) vs. Periods

Cumulative Multiplier (Aggregate Consumption) vs. Periods

- Expansion
- Average
- Recession

Figure 5: Financial Markets (Benchmark Experiment)

Aggregate Borrowings vs. Periods

Annualized Spread ($\omega$) vs. Periods

Annualized Rate on Borrowings ($i^b_t$) vs. Periods

Annualized Rate on Savings ($i^d_t$) vs. Periods

- Expansion
- Recession
the reduction in the consumption of the savers. Aggregate consumption rises. This is sufficient to produce output multipliers that are greater than one. But in expansions, the increase in the consumption of the borrowers is smaller, and in our calibration, aggregate consumption falls; output multipliers are less than one. The reason for this result lies in the asymmetric cyclical variation of the spread. As can be seen in Figure 5, the spread, \( i^b_t - i^g_t \) (\( =i^b_t - i^d_t \)), widens disproportionately during a recession while it contracts in an expansion. That is, any amelioration in the financial friction is much more stimulating for the borrowers—who play the crucial role for the multiplier— in bad than in good times.

Interestingly, the relationship between spreads and government spending exhibited by the model seems to be present in the data. Figure 6 provides direct supporting evidence. In the Figure, each period is classified as either a ”contraction” or as an ”expansion” depending on whether output in that period is above or below the H-P trend. The red dots in the graph correspond to contractions and the black ones to expansions. The figure exhibits three features. First and consistent with the empirical findings reported in section 1.2, spreads are on average higher during recessions than during expansions. Second, spreads are negatively related to government spending. And third and more importantly from the point of view of the properties of the model discussed above, there is cyclical asymmetry. In particular, the effect of any change in government spending (as a share of GDP) on spreads is considerably more pronounced during recessions relative to booms (the slope of the red line is steeper than that of the black line). Related information on correlations between \( g/y \) and spreads is reported in Table 3.

### Table 3: Correlation Spread–Share of Government Spending

<table>
<thead>
<tr>
<th></th>
<th>AAA-FFR</th>
<th>BAA-FFR</th>
<th>AAA-TBILL</th>
<th>BAA-TBILL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boom</td>
<td>-0.2244</td>
<td>-0.2631</td>
<td>-0.2795</td>
<td>-0.3136</td>
</tr>
<tr>
<td>Recession</td>
<td>-0.4888</td>
<td>-0.5041</td>
<td>-0.6493</td>
<td>-0.6017</td>
</tr>
</tbody>
</table>

### 2.2 Debt vs Tax Finance of Government Spending and Multipliers

In our benchmark simulations, the lump sum tax rule (15) stabilizes debt dynamics. This means that the increase in government spending is partially bond financed. Figure 7 shows how Figure 3 would change if the debt-tax rule were replaced by a balanced budget rule.

The cumulative multipliers in Figure 7 are now smaller than those shown in Figure 3. The reason is that the increase in the consumption of the borrowers is lower (See Figure
Figure 6: Spreads and Government Expenditure

Note: Dark plain line (marks): Booms, Red plain line (marks): Contractions. A “contraction” (“expansion”) is identified with periods during which the cyclical component of output (obtained from the HP filter) is negative (positive). Period: 1960Q1-2008Q1.

Figure 7: Output Multipliers (Balanced Budget)
As in the case with partly debt financed spending, government spending expands output and closes the output gap, which makes the credit spread decrease and generates a positive wealth effect for the borrowers. But unlike the case of debt financed spending, the borrower is taxed in the current period and so has fewer funds to spend on consumption. This implies a weaker consumption response and a smaller multiplier.

In contrast, the savers’ consumption drops by less under a balanced government budget. This is due to the difference in interest rates across the two schemes of financing government spending. When no debt is issued the deposit rate is lower than when debt is issued (due to the violation of Ricardian equivalence). With a lower interest rate there is less of an incentive to reduce current consumption. Nonetheless, the differential effect on the consumption of the savers is much smaller than that on the borrowers, so total consumption increases by less, leading to lower multipliers.

While the mechanisms are different, this result is reminiscent of a similar result in the traditional IS-LM, Keynesian model, namely, that the size of the multiplier varies with the method used to finance government spending. And that the greater the reliance on debt, the greater the multipliers.
2.3 The Size of the Fiscal Shock and Multipliers

Does the size of the multiplier vary with the size of the fiscal expansion? Graph 9 shows that the multiplier is decreasing in the size of the fiscal intervention. For instance, the impact multiplier for a 5% or 10% intervention is lower that for 1% (1.85, 1.65 and 2.25 respectively). The reason that large amounts of government spending may prove less effective than smaller amounts is that the –negative– marginal wealth effect due to the higher tax liabilities is increasing in the size of the fiscal intervention while the –positive– marginal effect on the borrower from the reduction in the premium is decreasing in the size of the fiscal expansion.\footnote{Note that our model is silent on normative issues such as the optimal size of the fiscal intervention.}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure9}
\caption{Output Multipliers: Size of Fiscal Shock}
\end{figure}

2.4 Multipliers and the Source of the Business Cycle

Expansions and recessions can have a variety of origins and the size of multipliers may well depend upon the source of the business cycle.\footnote{Hereafter and unless clearly specified, we will refer to output multipliers as multipliers} Table 4 reports cumulative output multipliers for various types of shocks: the first three are preference shocks (to the marginal utility of the impatient and patient households and the disutility of labor), the fourth is the financial shock used in the benchmark scenario above, the fifth is a productivity shock ($\xi_{y,t}$), and the sixth is a monetary policy shock ($\xi_{i,t}$). In all cases the size of the shock is such that it generates a recession (resp. expansion) of 2.5%.

There is some variation in the impact multipliers; our benchmark shock gives the largest impact multiplier. Importantly, no matter the source of the business cycle, multipliers are larger in recessions (about 2) and smaller (around one or less) in expansions. After the first year, the cause of the business cycle does not seem to matter any more.
Table 4: Multipliers: Sensitivity to the Source of the Business Cycle

<table>
<thead>
<tr>
<th>Shock</th>
<th>1 Quarter</th>
<th>1 Year</th>
<th>2 Years</th>
<th>5 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E</td>
<td>R</td>
<td>E</td>
<td>R</td>
</tr>
<tr>
<td>$\xi_{c,t}$</td>
<td>1.10</td>
<td>2.04</td>
<td>0.78</td>
<td>0.94</td>
</tr>
<tr>
<td>$\xi_{s,t}$</td>
<td>1.03</td>
<td>2.17</td>
<td>0.75</td>
<td>0.97</td>
</tr>
<tr>
<td>$\xi_{h,t}$</td>
<td>1.01</td>
<td>2.13</td>
<td>0.74</td>
<td>0.97</td>
</tr>
<tr>
<td>$\xi_{\psi,t}$</td>
<td>0.97</td>
<td>2.34</td>
<td>0.75</td>
<td>0.98</td>
</tr>
<tr>
<td>$\xi_{y,t}$</td>
<td>1.01</td>
<td>2.13</td>
<td>0.74</td>
<td>0.97</td>
</tr>
<tr>
<td>$\xi_{i,t}$</td>
<td>1.16</td>
<td>2.01</td>
<td>0.82</td>
<td>0.92</td>
</tr>
</tbody>
</table>

Note: This table reports the cumulative multipliers of output obtained in a 2.5% expansion (E) and in a 2.5% recession (R) generated by each of the shocks considered.

3 Sensitivity to Parameters

In this section we examine whether the size of the multipliers implied by our model is sensitive to the calibration used. We consider variation in: i) the degree of price rigidity, ii) the amplitude of the business cycle, iii) the parameters of the monetary policy rule and, iv) the parameters in the bank lending cost function. In no case do small perturbations make a big difference for the size of the multipliers. The sensitivity analysis is conducted only under the benchmark bank lending cost shock as we established in the previous section that the source of the cycle did not make much of a difference.

3.1 The Degree of Price Rigidity

Figure 10 shows that cumulative output multipliers rise as the degree of price rigidity, $\gamma$ (the Calvo parameter), increases and that they reach their maximum at about $\gamma = 0.8$. Our benchmark setting is $\gamma = 0.67$, that is, prices are reset on average every 3 quarters. In the New Keynesian literature, common values for $\gamma$ are 0.67 and 0.75. In this range the multiplier are large in recessions and small in expansions, and of a magnitude consistent with the findings of Auerbach and Gorodnichenko [2010]. The reason that the multiplier is increasing in the degree of price rigidity is that, the more rigid the prices, the bigger the effect of government spending on closing the output gap and hence the larger the decline in the spread. Under our calibration, this effect peaks at about $\gamma = 0.8$ and then it declines somewhat (but remains large). The reason for this non-monotonicity seems to be that under extreme degrees of price rigidity, monetary policy is more potent and it closes more of the output gap by itself, leaving less room for the fiscal stimulus to manifest its

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19 An appendix that is available upon request reports additional robustness checks are empirical evidence as well as a discussion of whether and how the model can generate hump shaped multipliers.
Figure 10: Multipliers: Degree of Nominal Rigidity

Figure 11: Multipliers: Amplitude of the Cycle

potency.

3.2 Amplitude of the Business Cycle

The model being non-linear, the size of the multiplier ought to depend on the amplitude of the business cycle. Figure 11 shows that this is indeed the case: the size of multipliers in a recession grows with the amplitude of the cycle, while the size of multipliers in an expansion falls with an increase in the amplitude. In our benchmark case, we chose shocks that made output rise or fall by 2.5%, which may be deemed a normal amplitude for business cycles. The impact multiplier during a recession was 2.17. But for a deeper recession of say 3.5%, the impact multiplier would be about 3. The multipliers rise quickly with the magnitude of the recession.

The reason for this can be found in, yet again, the cyclical variation of the spreads. The deeper the recession the larger the interest rate spread, $i_t^b - i_t^g$, and also and more
importantly the larger the elasticity of the spread to a variation in \( \bar{y} \). Hence after an increase in fiscal expenditures, the amelioration of the financial friction will be larger in deeper recessions. The potential output gains from a fiscal stimulus are therefore magnified. On the contrary, the greater the expansion, the smaller the elasticity and hence the smaller the gains from the mitigation of the friction.

### 3.3 Multipliers and the Conduct of Monetary Policy

As the literature on the zero bound has shown, multipliers are not independent of the conduct of monetary policy. Figure 12 shows how monetary policy, through its concern for inflation and output fluctuations, can affect cumulative multipliers.

![Figure 12: Multipliers and Monetary Policy \((\kappa_y, \kappa_\pi)\)
(a) Reaction to Output Gap \((\kappa_y)\)

Panel(a) suggests that an increase in the reaction of monetary authorities to the output gap lowers the size of the multiplier. This is because a stronger reaction means that monetary policy closes more of the output gap and hence lowers the spread by more. As we have shown before, fiscal policy is less effective when applied to a smaller spread, so the multipliers are decreasing in the level of \( \kappa_y \).

\footnote{This elasticity is given by \(-\alpha \bar{y}_t\).}
Panel (b) depicts the multiplier as a function of the reaction to inflation, $\kappa_\pi$. In order to facilitate the exposition we employed a policy rule with $\kappa_y = 0^{[21]}$. An increase in the weight placed on price stability means a smaller multiplier. The reason is as follows. Consider a negative financial shock. Both output and inflation decrease. The central bank cuts interest rates as inflation is below target, and the cut is larger the larger $\kappa_\pi$. A more expansionary monetary policy means a smaller –negative– output gap and thus a smaller spread. But with a smaller spread, the effects of fiscal policy on output are smaller. That is, a more aggressive countercyclical monetary policy limits the contribution of countercyclical fiscal policy.

We have also considered a policy rule in which the monetary authorities also target the spread
\begin{equation}
      i_t^g = \rho_i i_{t-1}^g + (1-\rho_i) \left[ y_t - \pi_t^* + \kappa_\pi (\pi_t - \pi^*) + \kappa_y \left( \frac{y_t - y^*}{y^*} \right) - \kappa_\omega (\omega_t - \omega^*) \right] + \xi_{i,t} \tag{19}
\end{equation}
and computed the multipliers as a function of $\kappa_\omega$, letting $\kappa_\omega$ vary from 0 to 1. As with the reaction to the output gap and inflation, an increase in the policy reaction to the spread also reduces the value of the fiscal multipliers.

### 3.4 The Role of Banking Parameters

As argued before, the existence of a sizable multiplier lies in the presence of the “financial accelerator mechanism” described at the end of section 3.2. One measure of the degree of financial friction is $\omega = i^b - i^d$, the steady state level of the spread between borrowing and deposit rates. Figure 13 shows that the cumulative output multipliers in a recession vary significantly with perturbations to the steady state spread. For instance, while in our benchmark calibration—an annual spread of $2\%$—the recession multiplier is about 2.2, raising the spread by just 20 basis points increases the recession multiplier by about 50% (around 3.25).

The reason is that a larger steady state spread corresponds to a larger gap between the rates used to discount future consumption streams and tax liabilities. Hence the potential positive wealth effects for borrowers—and hence the multipliers—are larger the greater is the spread.

The elasticity of bank lending costs to the output gap, $\alpha$, is a parameter that is fundamental to our quantitative results. A larger $\alpha$ means that the spread is more sensitive to the state of the business cycle, and thus that fiscal policy is more effective: An increase in aggregate demand during a recession has a large impact on the spread, generating large

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21 As expected in light of the previous discussion, this leads to much larger multipliers.
positive wealth effects on borrowers and driving the size of the multiplier up. Figure 14 shows that even small perturbations in $\alpha$ can have a big effect on the cumulative output multipliers. We chose $\alpha = 23$ on the basis of the calibration exercise described in Section 1.5. This value produced multipliers consistent with the multipliers found by Auerbach and Gorodnichenko [2010] in the data. Higher values of $\alpha$ give even larger multipliers.

One can similarly analyze the role of $\eta$ for the multiplier. In general, a higher $\eta$ means a larger spread for any given level of debt. Hence its implications for the multiplier are quite similar to those discussed above for the steady state spread.

One may wonder how much of the gain in output that follows expansionary fiscal policy comes directly from the savings in intermediation costs? Table 5 shows that the not only the direct contribution to the output increase is quite small but it is also negative (note also that intermediation costs are a small share of output; 0.24% of steady state output). For instance, consider a 2.5% recession. In this case, intermediation costs are 0.48% of output. And because the reduction in the spread induced by higher spending leads to
higher borrowing, direct intermediation costs increase, subtracting from output \((-0.20)\) and reducing the multiplier.

### Table 5: The role of Intermediation Costs

<table>
<thead>
<tr>
<th></th>
<th>1% E</th>
<th>1% R</th>
<th>2.5% E</th>
<th>2.5% R</th>
</tr>
</thead>
<tbody>
<tr>
<td>(\Psi_t(b_t, \tilde{y}_t)) (%)</td>
<td>0.18</td>
<td>0.32</td>
<td>0.11</td>
<td>0.48</td>
</tr>
<tr>
<td>Multiplier (\Psi_t(b_t, \tilde{y}_t))</td>
<td>-0.04</td>
<td>-0.10</td>
<td>-0.02</td>
<td>-0.20</td>
</tr>
<tr>
<td>Multiplier (y)</td>
<td>1.12</td>
<td>1.57</td>
<td>0.89</td>
<td>2.27</td>
</tr>
</tbody>
</table>

Note: E denotes an expansion and R denotes a recession.

## 4 Conclusion

Countercyclical fiscal policy represents a puzzle. Policymakers routinely fight economic downturns by using budget deficits, presumably because they think that fiscal multipliers are large. While this is in line with Keynes’s original recommendation and is consistent with traditional IS-LM type of thinking, there exists preciously little in terms of modern economic thinking that supports multiplier values exceeding unity during recessions.

Some recent work has suggested that the zero nominal interest bound may make multipliers large during recessions (exceeding one) even when they are quite small during expansion. But, except for the latest recession, countercyclical policy does not seem to coincide with the presence of such constraint on monetary policy, so the zero bound cannot be the full story.

In this paper we have proposed an alternative, more general explanation for large and cyclically variable multipliers that is not dependent on the conduct of monetary policy. Our proposal is based on the following premises: Financial frictions matter for the business cycle, they vary countercyclically and they can be influenced by policy. And the degree to which they can be influenced by policy depends on the state of the business cycle. We show that the behavior of spreads in the data is consistent with these premises. Spreads vary countercyclically and are more sensitive to changes in fiscal policy during bad times. Under these circumstances, the model has a property present in the old-Keynesian model. Namely, that providing financially strapped agents with funds creates a positive wealth effect for them even when they take into account any increase in their future tax liabilities. The more severe and widespread the financial constraints, the larger this wealth effect and thus the higher the likelihood of a positive aggregate consumption response to a fiscal stimulus. Our analysis relies on spread movements rather than on the relaxation of...
quantitative borrowing constraints but we believe the logic is the same.
References


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”Targeted Transfers and the Fiscal Response to the Great Recession,” *Journal of Monetary Economics*, 59 (supplement), S50-S64.


### A Data Sources

• Moody’s Seasoned Baa Corporate Bond Yield (BAA): http://research.stlouisfed.org/fred2/series/BAA?cid=47