The Fiscal Multiplier

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Abstract

We measure the size of the fiscal multiplier using a heterogeneous-agent model with incomplete markets, capital and rigid prices and wages. The environment encompasses the essential elements necessary for a quantitative analysis of fiscal policy. First, output is partially demand-determined due to pricing frictions in product and labor markets, so that a fiscal stimulus increases aggregate demand. Second, incomplete markets deliver a realistic distribution of dynamic consumption and investment responses to stimulus policies across the population. These elements give rise to the standard textbook Keynesian-cross logic which, and unlike conventional wisdom would suggest, is significantly reinforced in our dynamic forward looking model.

We find that market incompleteness is key to determining the size of the fiscal multiplier, which is uniquely determined in our model for any combination of fiscal and monetary policies of interest. The multiplier is 1.34 if deficit-financed and 0.61 if contemporaneously tax-financed for a pegged nominal interest rate, with similar values in a liquidity trap. If monetary policy follows a Taylor rule, the numbers drop to 0.66 and 0.54, respectively. We elucidate the importance of market incompleteness for our results and contrast them to models featuring complete markets or hand-to-mouth consumers.

Keywords: Fiscal Multiplier, Incomplete Markets, Sticky Prices, Liquidity Trap

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