"The Euro-Area Government Spending Multiplier at the Effective Lower Bound" (joint with M. Fragetta)

Abstract

We build a factor-augmented interacted panel vector-autoregressive model of the Euro Area (EA) to estimate government spending multipliers. The multipliers are contingent on the overall monetary policy stance, captured by a shadow monetary policy rate. The econometric approach deals with several technical problems highlighted in the empirical macroeconomic literature, including the issues of fiscal foresight and limited information. We find that the output response to a government spending shock when the monetary policy rate is at the effective lower bound (ELB) is significantly higher than during normal times. Depending on the specification, while in normal times the average medium-term cumulated multiplier ranges between 0.9 and 1.2, in the ELB period, the range is between 2.5 and 3.4. More generally, the multiplier is inversely correlated with the level of the shadow monetary policy rate. While we verify that EA data give support to the view that the multiplier is larger in periods of economic slack, we show that the shadow rate and the state of the business cycle have an autonomous impact on its size.