

How big (small?) are fiscal multipliers?

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Abstract for *No Way Out: Government Response to the Fiscal Crisis*

As fiscal stimulus packages were hastily put together around the world last spring, one could not have been blamed for thinking that there must be some broad agreement in the profession and policy circles regarding the efficiency of fiscal policy as a stabilization tool. While a consensus seemed to emerge regarding monetary policy, with central banks reducing interest rates close to zero and several pursuing additional, less-conventional stimulative approaches, the fiscal response differed greatly across countries. In fact, some of the deepest rifts in the economics profession emerged around the question of the desirable fiscal response to the crisis.

In a January 2009 *Wall Street Journal* op-ed piece, Robert Barro argued that peacetime fiscal multipliers are essentially zero, implying that the use of fiscal policy was not only ineffective, but enormously wasteful. At the other extreme, Christina Romer, Chair of President Obama's Council of Economic Advisers, used multipliers as high as 1.6 in estimating the job gains that will be generated by the \$787 billion stimulus package approved by Congress last February, implying that the fiscal stimulus would more than pay for itself in terms of stimulated output. The difference between Romer's and Barro's views of the world amounts to a staggering 3.7 million jobs by the end of 2010.

If anything, the uncertainty regarding the size of fiscal multipliers in developing and emerging markets is even higher. A history of fiscal profligacy and spotty debt repayments calls into question the sustainability of any fiscal expansion. How does this financial fragility affect the size of fiscal multipliers? Does the exchange regime matter? What about the degree of openness? These are all critical policy questions that remain largely unanswered.

A big hurdle in obtaining precise estimates of fiscal multipliers has been data availability and reliability. To address this shortcoming, we have put together a novel, quarterly dataset for 45 countries (20 high-income and 25 developing). The coverage, which varies across countries, spans from as early as 1960 to as late as 2007. We scrutinized the data carefully to ensure its quality, and that the data was reliably reported at quarterly frequency. Using this unique database, we have estimated fiscal multipliers for different groups of countries in our sample. Our hope is to go beyond the heated and endless debate as to the effectiveness of fiscal policy in general, to a discussion of the conditions under which fiscal policy has a greater or lesser chance of success.

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Our results indicate that such an approach sheds light on some important differences in the effectiveness of fiscal policy, depending on countries' specific contexts, and the types of measures employed. The main results can be summarized as follows:

- In developing countries, the response of output to increases in government spending is smaller on impact and considerably less persistent than in high income countries.
- The degree of exchange rate flexibility is a critical determinant of the size of fiscal multipliers. Fiscal multipliers are much larger in economies operating under predetermined exchange rate regimes than under flexible exchange rates. In fact, the multiplier for countries with flexible exchange rates is indistinguishable from zero. This is, in principle, consistent with a standard open-economy macroeconomic model (Mundell-Fleming).
- The degree of openness to trade is another critical determinant. Relatively closed economies have much larger multipliers than relatively open economies. Multipliers in open economies are essentially zero. This is consistent with the theory that expansionary fiscal policy in an open economy may be crowded out by deterioration in the trade balance, so what is gained in output due to increased government spending is lost in a decline in net exports.
- In highly-indebted countries, the output response to increases in government spending is short-lived and much less persistent than that in countries with a low debt to GDP ratio. This finding is consistent with the idea that, in highly-indebted countries, the sustainability of any rise in government spending will be quickly called into question by market participants. The resulting increase in financing costs will not only make it more difficult to keep up the fiscal expansion but also dampen the output effects of current government spending.
- The multiplier for the United States in the post-1980 period is small both in the short and long-run and is smaller than the multiplier in the pre-1980 period. This finding may be explained by some of our cross-sectional findings. While for most of the pre-1980 period the United States operated under the Bretton Woods system whereby the value of the dollar was officially fixed to gold, during the post-1980 period the United States has operated under a fairly flexible exchange rate regime. Higher exchange rate flexibility has allowed a greater emphasis on controlling inflation since the Volcker disinflation in the early 1980's. The focus on price stability has left little scope for monetary accommodation during fiscal expansions. Second, the United States has become a much more open economy, as evidenced by the fact that its ratio of exports plus imports (as a proportion of GDP) has increased from 12 percent in the the 1960-1980 period to 22 percent in since 1981.
- In contrast, multipliers for government investment in the United States are larger. This is a first indication that the composition of a government-spending stimulus is a crucially important determinant for it success in expanding output.