A model of the confidence channel of fiscal policy

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There is a widespread perception among policy makers, the business community and the media that governments should intervene to induce 'confidence' in the economy. However, this 'confidence channel' is met with skepticism among economists owing to the lack of theoretical backing. This paper proposes a simple model where fiscal policy affects the economy directly and indirectly, through an expectational channel.

There are three important elements in the model: first, private goods and public goods are imperfect substitutes. That implies that government spending has a direct positive effect on demand for private goods. Second, there are fixed adjustment costs for investment, which generates an "inaction" zone: investment needs to be sufficiently attractive for the firm to choose a positive level of investment. Last, information about the economy to the agents is noisy, which means agents try to forecast what other firms will do based on their own information.

Expectations that other firms will not invest translates into low demand expectations and little demand for a firm's products. That reduces incentives for leaving the "inaction" zone. When the economy is in a situation where firms are refraining from investing owing to low demand expectations, government spending has not only a direct effect on demand but also an indirect positive effect through the expectations of a firm about other firms' actions. Knowledge that other firms will react to an increase in government spending and increase their production might tip an individual firm to leave the inaction zone and invest to increase its production capacity. Hence, in times of low demand, government spending might lead firms to more positive expectations and more investment. We dub this effect the confidence channel of fiscal policy.