Is Fiscal Policy More Effective in Uncertain Times or During Recessions?

CFM-DP2016-31

Mario Alloza

Bank of Spain and Centre For Macroeconomics

How do uncertainty and the state of the business cycle affect the effectiveness of fiscal policy? Economic models incorporating non-convex adjustment costs suggest that high levels of uncertainty make agents more cautious when taking investment/hiring decisions, thereby reducing the effect of fiscal policy. In this paper I attempt to shed light on this question by empirically characterising how uncertainty and the state of the business cycle influence the effects of government spending.

The empirical strategy is based on a nonlinear structural vector autoregression (SVAR) that allows for differing effects of government spending shocks during times of high (HU) and low (LU) uncertainty, or during times of recession (R) and boom (B). I identify periods of HU as those with unusually high stock market volatility, and define periods of R and B following the NBER's recording of the dates of business cycles. Exogenous shocks to government spending are identified using two alternative strategies. In the first case, the shocks are identified as the residuals in a SVAR that imposes the restriction that government spending cannot react within one quarter to shocks to output and tax revenues. In the second case, I follow a narrative approach and identify government spending shocks using news about future defence. The narratively identified shocks are then classified according to whether they occur during times of HU or LU or, alternatively, during times of R or B. This second framework addresses issues related to the anticipation effects of the shocks, and offers an alternative assessment of the exogeneity of the shocks. I apply this methodology to post-war US data.

The results suggest that the response of output to a positive government shock is negative during times of HU or R and positive during times of LU or B. Interestingly, the two identification strategies achieve very similar results. These results can be understood in the light of a framework where information is scarce or noisy during times of HU. In this context, agents are concerned that the economy may take a downturn and reduce their future levels of income. A government spending shock during times of heightened uncertainty may then simply confirm these pessimistic views, in turn producing a decline in consumption and activity. I find evidence of measures of household-sector confidence reacting negatively to a government spending shock during times of HU, together with consumption and prices.

Importantly, the results I obtain contrast with previous literature that finds government spending shocks to be more effective in stimulating the economy during periods of R than B. I reconcile the two views and conclude that these differences arise from the information used to define periods of R.