Government Spending Multipliers and Imperfect Asset Substitution

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Abstract

There has been a renewed interest in the ability of fiscal policy to play an active role in stabilizing economies since the Great Recession. We illustrate in a tractable New Keynesian model that imperfect asset substitutability in the bond market can serve as an important channel for fiscal policy away from the effective lower bound on interest rates. Specifically, in the presence of imperfect asset substitution, government spending shocks can generate a positive consumption multiplier if the fiscal authority finances the shock by issuing bonds of a relatively shorter maturity. This channel works through the imperfect pass-through from short- to long-term bonds, inducing fluctuations in the interest rate spread. This spread is shown to have a substantial impact on consumption decisions. Policy-wise, this implies that the Treasury can play an active role in economic stabilization, an idea commonly relegated to monetary policy, by actively managing the maturity structure of its debt portfolio.

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