WHEN IS THE GOVERNMENT TRANSFER MULTIPLIER LARGE?

ERIC GIAMBATTISTA AND STEVEN PENNINGS

Abstract. Transfers to individuals were a larger part of the 2009 US stimulus package than government purchases. Using a two-agent New Keynesian model, we show analytically that the multiplier on targeted transfers to financially constrained households is (i) larger than the purchase multiplier if the zero lower bound (ZLB) binds, and (ii) is more sensitive to the degree of monetary accommodation of inflation. Targeted transfers provide the same boost to demand as purchases, but lower aggregate supply relative to purchases, as those receiving transfers want to work less. When the aggregate demand curve inverts — such as when the ZLB binds — the extra inflation from lower supply boosts the multiplier. We show this result also holds quantitatively in a medium-scale version of the model.

1. Introduction

In the years preceding the Global Financial Crisis, the role of macroeconomic management had largely fallen to central banks, with fiscal policy playing a secondary role. But with the magnitude of the global recession, and the Zero Lower Bound (ZLB) on nominal interest rates binding in the United States and other countries, fiscal policy has now taken a more prominent role in policymakers’ attempts to stimulate the economy. This has led to a renewed interest in the response of output to an increase in government purchases: the government purchase multiplier.
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