Hysteresis and Fiscal Policy

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Abstract

Empirical studies support the hysteresis hypothesis that recessions have a permanent effect on the level of output. We analyze the implications of hysteresis for fiscal policy in a DSGE model. We assume a simple learning-by-doing mechanism where demand-driven changes in employment can affect the level of productivity permanently, leading to hysteresis in output. We show that the fiscal output multiplier is much larger in the presence of hysteresis and that the welfare multiplier of fiscal policy–the consumption equivalent change in welfare for one dollar change in public spending–is positive (negative) in the presence (absence) of hysteresis. The main benefit of accommodative fiscal policy in the presence of hysteresis is to diminish the damage of a recession to the long-term level of productivity and, thus, output.

Keywords: Fiscal policy, hysteresis, learning by doing, welfare

JEL classification: E62, F41, F44

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