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Essays on the Great Recession and the Austerity Period

"A Welfare State-based Fiscal Multiplier"

Empirical evidence from the IMF suggests that fiscal multipliers associated with episodes of fiscal consolidation were significantly larger during the austerity period of 2010-13 than in previous times. A common explanation of this phenomenon is that the spending multiplier can be larger than usual in the context of new-Keynesian models when the Zero Lower Bound binds. However, a critical feature of these models is that changes in government spending must be temporary to achieve a large multiplier. Here we argue that current theory cannot explain the evidence if spending cuts during the austerity period were expected to be permanent. To overcome this puzzle, we build a simple new-Keynesian model with incomplete markets, heterogeneous households exposed to health shocks, and welfare state spending in the form of public healthcare to show that permanent welfare spending cuts do lead to a larger-than-normal multiplier when the Zero Lower Bound binds. The intuition behind this result has to do with the insurance aspect of welfare spending, as an anticipated cut of this fiscal component makes future individual income riskier, thereby increasing incentives to save and leading to a Paradox-of-Thrift type of recession.

"On the Estimation of the Relative sizes of Fiscal Multipliers"

In this paper we exploit cross-sectional variation in the composition of fiscal adjustments for a sample of developed countries during the austerity period of 2010-2013 to recover information about the relative sizes of the multipliers of different fiscal components (welfare spending, non-welfare spending, and taxes). We address endogeneity concerns by developing a simple theoretical framework and showing that if governments' choices are optimal, and if the observed joint distribution of the weights measuring the composition of fiscal adjustments satisfies certain conditions, it is possible to determine whether the weights are exogenous with respect to output shocks. In our empirical analysis we verify that the sample joint distribution of the weights satisfies the theoretical conditions and conclude that our estimates provide strong empirical support for the hypothesis of a multiplier of welfare spending significantly larger than the others during the austerity period.

"The Great Recession: Divide between Integrated and Less Integrated Countries" (joint with Eric van Wincoop and Gang Zhang) IMF Economic Review 64.1 (2016): 134-176

No robust relationship has been found between the decline in growth of countries during the Great Recession and their level of trade or financial integration. Here we confirm the absence of such a monotonic relationship, but document instead a strong discontinuous relationship. Countries whose level of economic integration (trade and finance) was above a certain cutoff saw a much larger drop in growth than less integrated countries, a finding that is robust to a wide variety of controls. We argue that standard models based on transmission of exogenous shocks across countries cannot explain these facts. Instead we explain the evidence in the context of a multi-country model with business cycle panics that are endogenously coordinated across countries.

JEL Codes: E62, E63, F14, F44

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