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Explaining the Cross-Country Variation in Fiscal Multipliers: A Bayesian Approach

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Abstract

The effectiveness of fiscal policy is subject to crowding out. For nearly thirty years of annual economic data, we find that the crowding out of fiscal policy occurs through interest rate and exchange rate channels. The three most important determinants affecting the size and sign of fiscal multipliers during recessions worldwide are: (i) exchange rate regime, (ii) monetary policy, and (iii) current account balance. We find statistically significant results that these accompanying policies are the most influential sources of the cross-country variation in fiscal multipliers. Similarly, using an OECD dataset examining both economic expansions and recessions, we find that the three most statistically significant variables affecting fiscal multipliers in this case are: (i) exchange rate stance, (ii) private investment, and (iii) monetary policy. We find that the coefficient of the private investment variable is significantly negative, which is in line with the theoretical predictions. This finding is consistent with the hypothesis that expansionary government spending financed by debt crowds out private investment through rising interest rates.

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