The Macroeconomic Effects of Fiscal Policy and Rule-of-thumb Households

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Abstract

This paper aims to ascertain whether the macroeconomic effects of fiscal policy are affected by existence of rule-of-thumb households. This is motivated by the theoretical findings shown by Galí et al. (2007), in which they incorporate the households faced with liquidity constraints (i.e., rule-of-thumb households) into New Keynesian model and replicate the positive response of consumption to government spending shock.

Our estimation procedures are as follows. First, we extend the consumption function presented in Campbell and Mankiw (1991) to Markov Switching model, and estimate it to divide the sample period into two regimes according to the share of rule-of-thumb households. Then, the VAR model is estimated for each divided sample period. For identifying structural shocks, this paper use the sign restriction and identify the two types of fiscal policy shocks; unanticipated and anticipated fiscal policy shock.

As a result, we obtain the following findings. For the full sample period 1970Q1–2011Q1, it is estimated that the periods when the share of rule-of-thumb households is high are the early 1970s, the early 1980s, and the early-1990s. And, these periods roughly correspond with the recessions dated by Cabinet Office, Government of Japan. Moreover, consumption reacts more greatly to unanticipated fiscal policy shock at the regime of rule-of-thumb households being high, while significant differences are not observed in the response to anticipated fiscal policy shock. In sum, Galí et al. (2007)'s model is empirically supported by our results.

Keywords: Fiscal policy; rule-of-thumb household; Markov Switching model; MCMC

References

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