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Government spending uncertainty and credit frictions

Abstract:

We investigate the effects of government spending uncertainty shocks in the Euro Area both empirically and theoretically. Empirically, a stochastic volatility model is used to extract a measure of uncertainty in the government spending to GDP ratio. This measure is then introduced in a structural VAR model to show that uncertainty shocks have recessionary, persistent and humped-shaped effects. We develop a dynamic New Keynesian model with financial frictions applying to a portfolio of equity and long-term government bonds where both assets are imperfectly substitutable to account for these effects. Key parameters of the model are then estimated using a mix of Simulated Method of Moments and Minimum Distance Estimation, and the effects of a government spending uncertainty shocks are correctly replicated. We discuss the various transmission channels and show that financial frictions in general and the portfolio channel -- the fact that both assets are imperfectly substitutable -- in particular, act as critical amplifiers of the usual transmission channels already discussed in the literature.

(with Anna Belianska, AMSE, and Aurélien Eyquem, University of Lyon 2)