Effects of Fiscal Stimulus on Credit Constraints and the Role of Firm Dynamics

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Abstract

During the 2007-09 contraction, the credit crunch in the U.S. economy coevolved with a dramatic and persistent decline (27%) in firm entry. The massive monetary expansion pursued by the U.S. Federal Reserve during the crisis had limited success in tackling these two phenomena. This study examines whether and to what extent fiscal policy can deal with them. First, a VAR model, covering the period 1993Q3-2019Q4, documents empirically that the expansionary fiscal policy can stimulate both the credit supply and the new business formation. Second, we develop a New Keynesian DSGE model combining endogenous firm entry and firm-level financial constraints to explain this finding. The model implies that a fiscal expansion can relax credit constraints faced by firms, leading to a gradual and persistent rise in firm numbers. We also demonstrate that firm entry dynamics are a crucial dimension for fiscal policy analysis in the presence of financial frictions. We find that firm entry substantially affects the persistence of the impact of fiscal shocks on the aggregate economy and the size of fiscal multipliers, especially in the long run.

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