Fiscal Policy in a Liquidity Trap

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Abstract

One of the major issues of the expansionary fiscal policy is that, even if it is effective in alleviating economic slowdowns, it increases the government's budget deficit and hence raises the debt-to-GDP ratio. This paper shows that fiscal expansions can suppress the increase in the debt-to-GDP ratio if the short-term nominal interest rate is zero and if a negative economic shock is temporary. This is possible because fiscal stimulus raises the inflation rate.