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Government Spending News and Surprise Shocks in Open Economy VARs

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Abstract

By using the Survey of Professional Forecasters, we provide new evidence on the open-economy effects of government spending, focusing on a well-known puzzle in the literature, that the real exchange rate depreciates in response to a fiscal expansion. Much of government spending is well anticipated over a one year horizon. Once news and surprise shocks are treated as different shocks, there is no depreciation puzzle for news shocks while it is still there for surprise shocks. Fiscal foresight seems to lie at the heart of the different exchange rate responses to news and surprise shocks, depending on the timing of the anticipated budget adjustment following the shock. Indeed, the results are broadly consistent with the prediction of a DSGE model with spending reversals.

JEL classification: C32, E32, E62.

Keywords: government spending, Survey of Professional Forecasts, fiscal foresight, non-fundamentalness, news shocks, spending reversals.

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