Journal of International Money and Finance 40 (2014) 1–20

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Fiscal policy and external adjustment: New evidence☆

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JEL classification:
C32
E62
F41
H20
H50
H60

Keywords:
Current account
Exchange rate
Government spending
Structural vector autoregression
Taxes
Twin deficits

A B S T R A C T

Relatively little empirical evidence exists about countries' external adjustment to changes in fiscal policy and, in particular, to changes in taxes. This paper addresses this question by measuring the effects of tax and government spending shocks on the current account and the real exchange rate in a sample of four industrialized countries. Our analysis is based on a structural vector autoregression in which the interaction of fiscal variables and macroeconomic aggregates is left unrestricted. Identification is instead achieved by exploiting the conditional heteroscedasticity of the structural disturbances. Three main findings emerge: (*i*) the data provide little support for the twin-deficit hypothesis, (*ii*) the estimated effects of unexpected tax cuts are generally inconsistent with the predictions of standard economic models, except for the US, and (*iii*) the puzzling real depreciation triggered by an expansionary public spending shock is substantially larger in magnitude than predicted by traditional identification approaches.

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☆ We thank an anonymous referee for valuable comments and suggestions. We are also grateful to seminar participants at several institutions and conferences for helpful discussions. Financial support from SSHRC is gratefully acknowledged.

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http://dx.doi.org/10.1016/j.jimonfin.2013.08.019

1. Introduction

The latest financial crisis has revived interest in the macroeconomic effects of fiscal policy and its role as a stabilization tool, as nominal interest rates approached zero, leaving little room for monetary policy. However, while a large body of work has focused on assessing the effectiveness of tax and public spending policies in stimulating output and domestic absorption, relatively less effort has been devoted to studying the implications of those policies for countries' external adjustment and, by extension, for global imbalances. In particular, to our knowledge, only one paper, namely Kim and Roubini (2008), attempted to empirically evaluate the reaction of the current account and the real exchange rate to changes in taxes, and only a handful of studies attempted to measure the response of those two variables to changes in government spending (Corsetti and Müller, 2006; Kim and Roubini, 2008; Müller, 2008; Monacelli and Perotti, 2010; Enders et al., 2011). This is somewhat surprising given that the current account is commonly regarded as a barometer of a country's solvency, and that exchange-rate fluctuations critically affect a country's competitiveness on the world market and its trade balance.

Using structural vector autoregressions (SVARs) and focusing mostly on US data, the papers cited above find that unexpected tax cuts and increases in public spending unambiguously depreciate the real exchange rate. Kim and Roubini (2008) also find that a surprise tax cut worsens the budget deficit but improves the current account, a situation referred to as "twin divergence". On the other hand, no consensus has been reached regarding the effects of an unexpected increase in government spending on the current account, or whether it leads to twin divergence or twin deficits (i.e., positive comovement between the budget and external deficits).

Generally speaking, these findings are puzzling from a theoretical standpoint. A wide class of open-economy macro models indeed predict that an unexpected fiscal expansion should appreciate the currency in real terms and deteriorate the current account. In the case of a tax cut, the real appreciation occurs because there is a higher incentive to invest,[1] which raises the real interest rate. The rise in investment is typically larger than the increase in national saving, causing a current-account deficit. In the case of an increase in government spending, the appreciation results from the fact that public expenditures are relatively more intensive in domestically produced goods, which means that the increase in aggregate demand brought about by the increase in public spending will raise their relative price with respect to foreign goods. The rise in public spending also entails a negative wealth effect that induces households to borrow abroad to prevent a large drop in their consumption, thus worsening the current account.

The purpose of this paper is to provide new evidence on the effects of fiscal policy on changes in the net foreign position and on the real exchange rate in a sample of four industrialized countries, namely, Australia, Canada, the United Kingdom, and the United States. These four countries are known to have reliable non-interpolated quarterly data on fiscal variables. Our contribution to the empirical literature is threefold. First, we provide more comprehensive evidence on the response of the current account and the exchange rate to changes in taxes than Kim and Roubini, who focused exclusively on the US. Second, we use an estimation strategy that relaxes the identifying assumptions used in previous SVAR-based studies, which restrict the interaction of the variables of interest in a way that may or may not be consistent with the data. Third, we document the implications of imposing these restrictions for the response of the current account and the exchange rate to fiscal shocks.

Our empirical strategy builds on that developed in our earlier work (Bouakez et al., 2010). More specifically, we identify fiscal-policy shocks by exploiting the conditional heteroscedasticity of the shocks. When there is enough time variation in the conditional variances of the time series used in estimation, it becomes possible to identify the structural shocks and their effects without having to impose additional parametric restrictions, as would be the case under (the usually maintained

[1] This is the case as long as the tax cut is not lump sum.

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