Discussion

“Questioning the puzzle:
fiscal policy, real exchange rate and inflation”
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Inflation response to fiscal shocks hotly debated

...and similarly for the real exchange rate

<table>
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<tr>
<th>Fiscal Policy Study</th>
<th>Response of Prices/Inflation</th>
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<tr>
<td>Edelberg et al. (1999)</td>
<td>Prices increase</td>
</tr>
<tr>
<td>Fatas and Mihov (2001a)</td>
<td>Prices are insignificant</td>
</tr>
<tr>
<td>Fatas and Mihov (2001b)</td>
<td>Prices decline</td>
</tr>
<tr>
<td>Blanchard and Perotti (2002)</td>
<td>Not reported</td>
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<tr>
<td>Canzoneri et al. (2002)</td>
<td>Inflation declines</td>
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<td>Burnside et al. (2004)</td>
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<td>Galí et al. (2007)</td>
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<td>Caldara and Kamps (2008)</td>
<td>Inflation increases</td>
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<tr>
<td>Mountford and Uhlig (2009)</td>
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<td>Ramey (2011)</td>
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<td>Nakamura and Steinsson (2014)</td>
<td>Inflation is insignificant</td>
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<td>Dupor and Li (2015)</td>
<td>Prices decline or are insignificant</td>
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<td>Ben Zeev and Pappa (2017)</td>
<td>Inflation increases</td>
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<tr>
<td>Ricco et al. (2017)</td>
<td>Inflation declines or is insignificant</td>
</tr>
<tr>
<td>D’Alessandro et al. (2019)</td>
<td>Inflation declines</td>
</tr>
</tbody>
</table>

Source: Jorgensen and Ravn (2019)
Situation:

- Mostly, theory predicts inflation and the real exchange rate to increase/appreciate after expansionary government spending shock
- Empirical evidence mixed at best, with many studies finding falling prices and depreciation of the real exchange rate

This paper:

- Issue is the identification of fiscal shocks!
- Proxy-SVAR with military spending instruments produces IRFs in line with theory
Validity of instruments key for the paper

For cases with autocorr. present, 1964-2015 sample only provides weak instruments

Authors show that only $h = 0$ case with full controls has no autocorr.

→ allows the use of “easier” critical value

Questions:

- Which variable is crucial in lowering $ac$?
- Make it clearer in figure that critical value is different, not so much F-statistic
Are proxy-SVAR IRFs more sensible?

Bayesian Proxy-SVAR (1964Q1-2015Q4)

Figure 3: Proxy-SV AR narrative identification. Impulse responses from a one standard deviation government spending shock. Target variables are tax revenues, real GDP, real private consumption, PCE inflation, total factor productivity, trade balance, short-term interest rate and real effective exchange rate. The real effective exchange rate is defined as the weighted basket of foreign goods to domestic goods: a decrease stands for a depreciation. The impulse responses are obtained in a proxy-SVAR framework in which government spending is instrumented with the military narrative series of Ramey (2016a). Shaded bands denote the 68% pointwise credible sets.

In line with Mussa (1986), Inflation increases on impact and becomes not significant after a few quarters. The fall in trade balance supports the twin deficit hypothesis, coherently with the appreciated real exchange rate, and contrasts the alternative twin divergence hypothesis (Kim and Roubini, 2008). Consumption decreases, in line with Ramey (2011),

- GDP quickly turns negative (albeit insignificantly)
- **Strong** and **persistent** decline in consumption
Output multiplier positive
Difference to BP response mostly in non-durables and services → similar here?

Generally: Go slower! Maybe first closed-economy proxy VAR with Ramey sample. Then shorten sample. Then go open economy.
# 3: How generalizable are the results?

...let’s look at international evidence

Estimate effect of fiscal shocks (dataset based on Born et al., 2019)
- Unbalanced quarterly panel data observations from early 1990s until 2018Q4 for 38 emerging and advanced economies

Two-stage approach
1. Two alternative measures of government spending surprises/forecast errors
   - Conventional BP-VAR model
   - Professional forecast from Oxford Economics
2. Run local projections on forecast error
# 3: International evidence - not as clear cut

Left: Blanchard-Perotti identification; right: Ramey-type forecast errors
From the introduction:

According to standard theoretical frameworks, whether Real Business Cycle or old and new-Keynesian theories, inflation should increase and the real exchange rate should appreciate in response to an increase in (unproductive) government spending.

So we know that most international business cycle models will be able to match the empirical evidence. But then what’s the point of the model exercise?

Is it specific parameters you are after that could not be estimated before? But then you should also motivate the specific setup more clearly.
Inflation response crucial question of the paper
→ but model cannot speak to this
→ no hope in matching it!

If you think that the model is important, why not use a NK model?

More technical (no details in the paper):
- Do you match up to 12 periods for all variables?
- Weighting is done with the empirical covariance matrix?
To sum up

- Interesting paper that tackles an important but divisive question
- Enjoyed reading it very much
- Main recommendations:
  - Pick the reader up at Ramey’s results and then go step by step to your full setup
  - Explain/investigate how general your results are
  - Think about ditching the model