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**Fiscal Policy, the Trade Balance,
and the Real Exchange Rate:
Implications for International Risk Sharing**

Discussion by

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**Discussion of “Fiscal Policy, the Trade
Balance and the Real Exchange Rate:
Implications for International Risk
Sharing” by Roberto Perotti and Tommaso
Monacelli**

Philip R. Lane, IIS-TCD and CEPR

IMF ARC, November 15th 2007

Introduction

- Ambitious paper, offering both empirical and theoretical contributions
- Part of very interesting empirical literature on international dimensions of fiscal policy
- One goal: evidence on impact of fiscal shocks
- Another goal: implications for design of open-economy models

Main Stylized Facts: Response to a Positive G Shock

For US, UK, CAN, AUS

- Increase in private consumption
- Real depreciation
- Decline in Trade Balance

Model Design

- Contribution here is to show how an open-economy version of Linnemann (2006) can consistently generate these stylized facts in a NOEM-type framework, while retaining complete financial markets
- Good discussion of how other standard models fail; also impact of various extensions

Complementarity between Working and Consumption

- Consume more to compensate for misery of working harder
- If elasticity of intertemporal substitution low enough / elasticity of work effort high enough, can lead to a positive consumption response
- Independent parameters?
- “Time to consume”?

Implications for International Risk Sharing?

- (C-C*, RER) relation massively violated in the data
- Manifest evidence of market incompleteness and limits to risk sharing
- Wealth effects under incomplete financial markets (eg work of Corsetti and collaborators)
- Fiscal evidence informative?

Modelling of Open Economy

- Law of One Price [alt. model: Schmitt-Grohe, Raven, Uribe (2007)]
- No nontraded sector
- Heterogeneity in Terms of Trade mechanism
- Variation in state of labour market
- Variation in Debt sustainability
- Variation in state of global economy

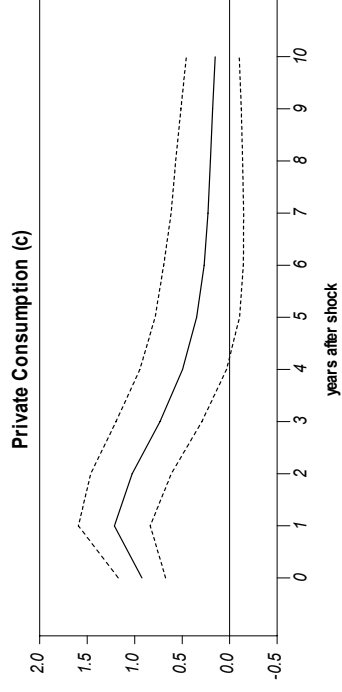
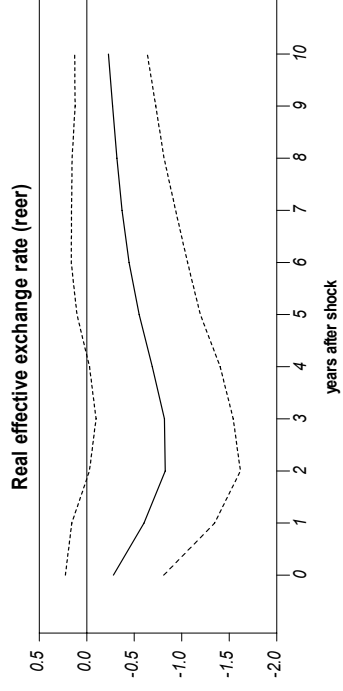
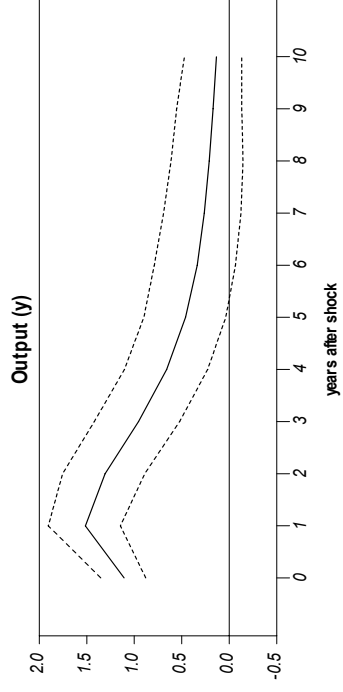
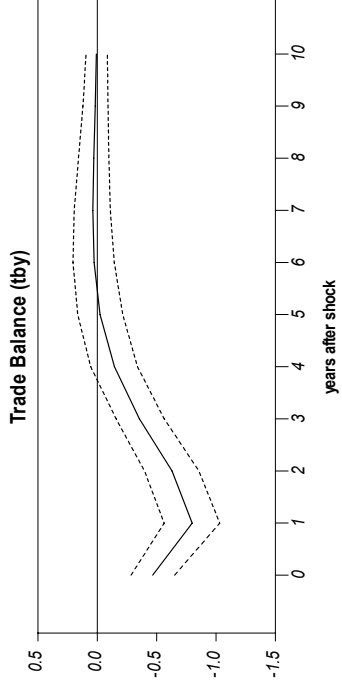
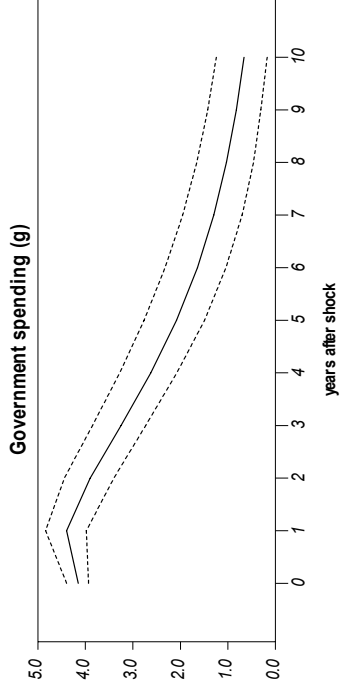
Monacelli and Perotti “Openness and the Sectoral Effects of Fiscal Policy (2007)

- US data, 1954.1 to 2006.2
- G shock leads to: (a) rise in relative price of nontradables; (b) terms of trade appreciation
- Reconciliation: deviations from law of one price (decline in markups on sales in US)?

Real Exchange Rate

- M-P: pos G shock induces real depreciation for US, UK, CAN, AUS
- (Also found by other studies for this group)
- Beetsma, Guidolin and Klaasens (2007): for EU-14, robustly obtain real appreciation [annual data]

Beetsma et al (2007): EU-14



Reconciliation?

- Differences in monetary regime: Floaters versus Peggers
- Lane and Perotti (Journal of Public Economics, 2003), Lane and Perotti (EER, 1998)

Fiscal Shocks?

- Duck test
- Forward-Looking Fiscal Policy

Final Remarks

- Valuable contribution to emergent literature
- Considerable open agenda on both theoretical and empirical modelling