

Discussion of

“Government Spending, Downward Nominal Wage Rigidity, and Exchange Rate Dynamics”

By B. Born, F. D’Ascanio, G.J. Müller, and J. Pfeifer

CEBRA 2019 Annual Meeting, Columbia University, New York

Roberto M. Billi

Sveriges Riksbank

20 July 2019

What are the effects of government spending on the real exchange rate?

- The authors provide convincing evidence, both theoretical and empirical, suggestive that, under a currency peg, the response of the real exchange rate to government spending is “asymmetric.”
- A key reason, as they argue, is that *nominal wages are downward rigid*—in fact, empirically, wage declines are less frequent than wage increases.
- Generally, a *reduction* in government spending can be expected to imply a *depreciation* of the real exchange rate, which restores competitiveness and boosts aggregate demand.
- This real depreciation cannot take place, however, *if* the currency is pegged and *if* nominal wages don't fall enough to crowd-in private spending.

What are the effects of government spending on the real exchange rate?

- The authors provide convincing evidence, both theoretical and empirical, suggestive that, under a currency peg, the response of the real exchange rate to government spending is “asymmetric.”
- A key reason, as they argue, is that *nominal wages are downward rigid*—in fact, empirically, wage declines are less frequent than wage increases.
- Generally, a *reduction* in government spending can be expected to imply a *depreciation* of the real exchange rate, which restores competitiveness and boosts aggregate demand.
- This real depreciation cannot take place, however, *if* the currency is pegged and *if* nominal wages don't fall enough to crowd-in private spending.

What are the effects of government spending on the real exchange rate?

- The authors provide convincing evidence, both theoretical and empirical, suggestive that, under a currency peg, the response of the real exchange rate to government spending is “asymmetric.”
- A key reason, as they argue, is that *nominal wages are downward rigid*—in fact, empirically, wage declines are less frequent than wage increases.
- Generally, a *reduction* in government spending can be expected to imply a *depreciation* of the real exchange rate, which restores competitiveness and boosts aggregate demand.
- This real depreciation cannot take place, however, *if* the currency is pegged and *if* nominal wages don't fall enough to crowd-in private spending.

What are the effects of government spending on the real exchange rate?

- The authors provide convincing evidence, both theoretical and empirical, suggestive that, under a currency peg, the response of the real exchange rate to government spending is “asymmetric.”
- A key reason, as they argue, is that *nominal wages are downward rigid*—in fact, empirically, wage declines are less frequent than wage increases.
- Generally, a *reduction* in government spending can be expected to imply a *depreciation* of the real exchange rate, which restores competitiveness and boosts aggregate demand.
- This real depreciation cannot take place, however, *if* the currency is pegged and *if* nominal wages don't fall enough to crowd-in private spending.

The authors offer theoretical and empirical evidence

- Two “extensions” to the policy side of the small, open economy model of Schmitt-Grohé and Uribe (2016, JPE):
 - ① The *government* consumes a share of *nontradable* goods, financed with lump-sum taxes and a balanced budget.
 - ② The *central bank* can follow a range of exchange-rate regimes: pure peg, pure float, and dirty float.
- A number of estimates based on the *local projections* method by Jordà (2005) and the comprehensive database of *fiscal shocks* by Born et. al. (2019). Their database includes two measurements of *unanticipated* government spending:
 - ① Blanchard and Perotti (2002): forecast errors from a VAR.
 - ② Ramey (2011): errors with respect to surveys of professionals.

Some comments on the model extensions and responses

- The authors discuss two possible extensions to their baseline model, and the implications for the “asymmetric” response of the real exchange rate to government spending:
 - If also *upward* nominal wage rigidity, the asymmetry is *weaker*.
 - Nominal *price* rigidity (flex. wages), the asymmetry is *stronger*.
- Would the asymmetric response be reinforced by the simultaneous presence of both wage *and* price rigidity?
- Regarding the “generalized” impulse responses based on the method of Bianchi et al. (2016)—in the present model and parametrization, *uncertainty* plays a key role? Would a *deterministic* simulation look notably different or lead to different conclusions?

A quite useful “refinement” on the interactions between policy areas

- Fiscal policy is more potent as a stabilization tool precisely when needed the most—that is, when monetary policy is constrained—as argued by Farhi and Werning (2016) among others.
- This paper shows that, moreover, the response of output to government spending (i.e. the fiscal *multiplier*) is “asymmetric.”
- Hence the *fall* in output from a *cut* in government spending could be rather deep, if the currency is pegged and if nominal wages don't fall enough to crowd-in private spending.