Fiscal devaluations
Farhi, Gopinath and Itskhoki

Discussion

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The views expressed are my own and should not be attributed to the ECB.

Question asked

- This is an extremely careful and comprehensive study that asks a very specific question:
  - Can one mimic the effects on real allocations and prices of a nominal exchange rate devaluation through unilateral changes in fiscal instruments when prices/wages are sticky?
- It answers this question in the context of a standard, but quite elaborate two-country New Keynesian model with both PCP and LCP.

Questions not asked

- What is the source of the underlying shocks and structural problems that led to the loss of competitiveness and the need for an exchange rate adjustment?
- What is the optimal policy response to those shocks?

Selected findings (1)

- A small set of fiscal instruments can robustly replicate the effects of nominal exchange rate devaluations across all specifications.
- Which instruments need to be used depends on the extent of completeness of asset markets, the currency denomination of bonds and the expected or unexpected nature of devaluations…
- … but they typically involve either a uniform increase in import tariffs and export subsidies, or a uniform increase in value-added taxes and a reduction in payroll taxes (fiscal devaluation).
- For a one-time unexpected devaluation these are the only instruments needed (the relevant case?).

$$\mathcal{S}_t \equiv \frac{P_{Ft}}{P^*_{Ht}} \frac{1}{\mathcal{E}_t} \frac{1-\tau^v_t}{1+\tau^m_t} = \frac{P^*_{Ft}}{P_{Ht}} \mathcal{E}_t \frac{1+\varsigma^x_t}{1-\tau^v_t},$$

Selected findings (2)

- The required adjustment in taxes is only a function of the size of the required devaluation: easy implementation
- When all proposed tax instruments are used a fiscal devaluation is government revenue neutral
- The results hold under both PCP and LCP

Relevance

- Clearly a relevant issue for the euro area;
- Countries in distress need to regain competitiveness and close the current account deficit in order to ensure sustainability of external debt and reverse the sudden stop, but can not use nominal exchange rate depreciation;
- When prices and wages are sticky, the adjustment process will be slow and costly in terms of high and persistent unemployment.
- Rebalancing also requires an adjustment of the relative price of traded versus non-traded goods. This is not really covered. Does it make a difference?

Comments (1)

- Fiscal devaluation focuses mostly on the expenditure-switching effects of the terms-of-trade channel
- Changes in the exchange rate also affect the net-foreign asset position through valuation changes and provide risk-sharing opportunities. This will depend on the set of internationally held assets and the currency denomination of external debt.
- It is interesting that in the case of incomplete markets and local currency external debt, a partial default will be part of the set of fiscal instruments to replicate a nominal devaluation
- However, to the extent that net external debt is denominated in foreign currency, an exchange rate devaluation would have worsened the problem (see, e.g., Eastern Europe).
- To what extent can other asset prices (e.g. house prices) take over this risk-sharing arrangement.

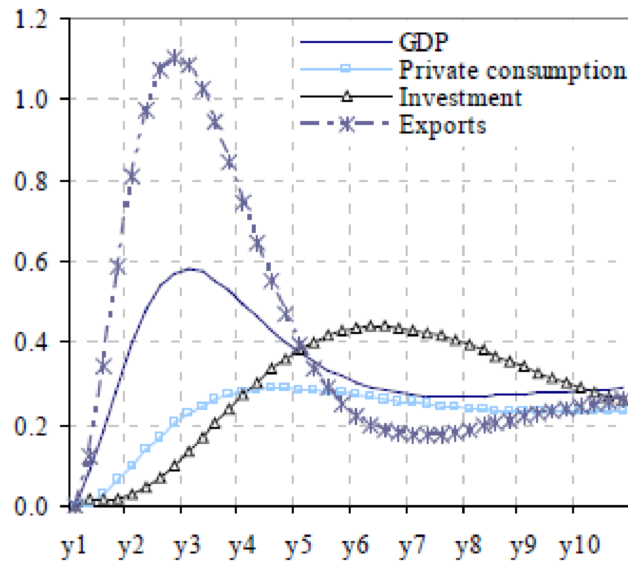
Comments (2)

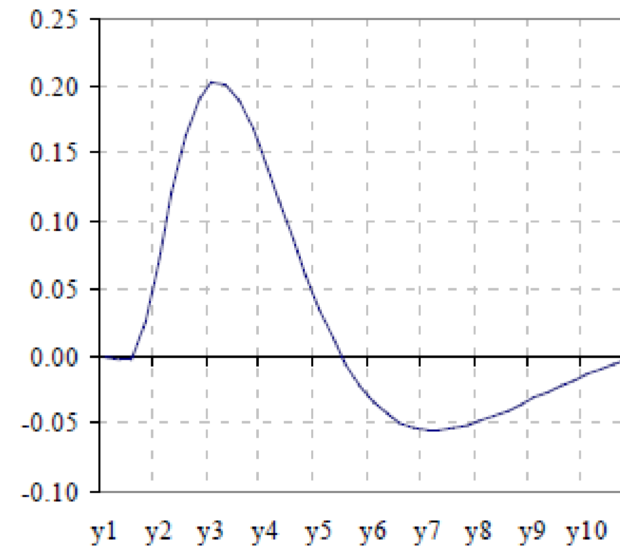
- The paper assumes that there is no reaction in the foreign economy. In practice we have seen increases in VAT in many euro area countries. These may offset the expenditure-switching effects of a domestic increase in VAT.
- More generally, there is a need for cooperation to have the desired effects.
- One of the benefits of a currency union is that a single currency supports the single market and the exchange rate can not be used to pursue beggar-thy-neighbour policies, which may endanger the single market.
- An active use of fiscal instruments (including import tariffs and export subsidies) could undo these benefits and distort the single market.
- Finally, the first-best is still to make wages and prices more flexible.

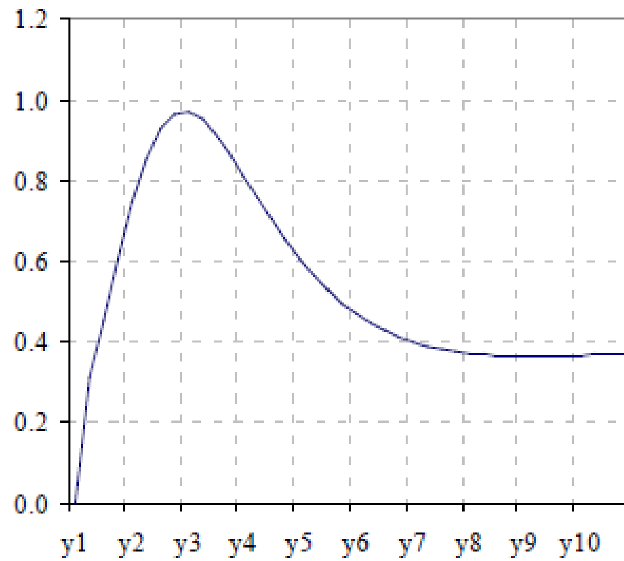
Comments (3)

- How large are the effects of reasonable fiscal devaluations and what is the room for manoeuvre?
- In Portugal, VAT revenues are already relatively high (23% vs 20%), whereas social security contributions are relatively low (29% vs 33%) compared with the euro area.
- Simulations by Jacquinot and Pierluigi using the EAGLE model calibrated to Portugal

Chart 1 – Macroeconomic impact of an ex ante budget neutral tax change obtained with an increase in VAT
(percentage deviation from baseline scenario, trade balance in percentage points)







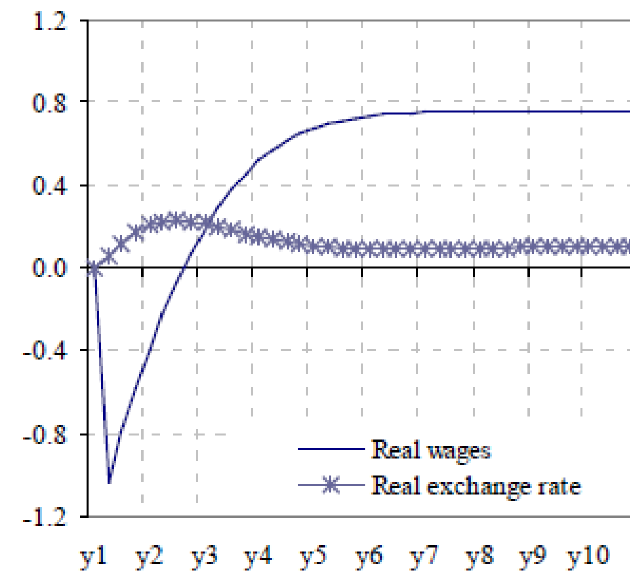


Chart 4: Ex-post dynamics of the taxes and spending