Fiscal Devaluations: The Role of Government Expenditures *

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Abstract

The devaluation of the exchange rate using fiscal policies has become a noteworthy policy option in recent crises in the Euro area given that these countries do not have access to conventional policies that can affect exchange rate. Existing literature on exchange rate devaluations using fiscal policies has mainly focused on the revenue side of fiscal policy; particularly, the composition of taxes. Surprisingly, literature on fiscal devaluation overlooks the other side of government policy, composition of expenditures. Productive government expenditure (e.g. expenditure on infrastructure) and non-productive expenditure (e.g. redistributive expenditures), impact the tradable and non-tradable sectors of the economy differently. In this paper, using a computable representative agent model, we investigate the macroeconomic consequences of exchange rate devaluations through changes in the composition of government expenditure. We calibrate the model to the French economy and conduct a quantitative analysis examining how economic variables respond to international and domestic shocks when a country has the option to devalue the exchange rate using fiscal policy through the expenditure channel.

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