News of defence spending changes the economic behaviour of people and firms

Announced changes in US public spending on defence have a significant impact on the economic behaviour of firms and households. In particular, anticipated increases in defence spending induce a significant and persistent increase in output, hours worked, the interest rate and inflation, as well as significant impact responses for consumption and investment.

In the light of these findings, we argue in our recent study that policy-makers should be cautious about announcing policy changes that can affect people's expectations about future government spending. Policy-makers can also use policy announcements as a tool for responding to the business cycle.

There has recently been renewed interest in theories of expectation-driven business cycles, focusing in particular on the effects of news shocks: shocks that are realised and observed before they materialise. These types of shocks are of particular importance for fiscal variables, where there is a natural lag between policy decisions and implementation.

To date, studies that attempt to measure the effects of news shocks empirically have used narrative identification of expectational shocks, which is particularly time-consuming to implement and requires the availability of detailed historical records. Our study proposes an alternative methodology to identify fiscal news in the data, one that is easier to implement and which can be used in situations where narrative evidence is unavailable.

By its nature, measuring news in the data can be difficult, but in recent years some studies have identified news using the timing of specific events, in particular in the context of fiscal changes. A 2011 study by Valerie Ramey constructs two measures of news about changes in defence spending: (a) The first uses narrative evidence, based on information in *Businessweek* and other newspapers, to construct an estimate of the change in the expected present value of government spending; (b) The second is constructed using the Survey of Professional Forecasters: changes in government spending are measured as the difference between actual government spending growth and the one-quarter-ahead forecast of government spending growth.

Our approach is different. It identifies defence news shocks as the shocks that best explain future movements in defence spending over a horizon of five years, and that are unrelated to current defence spending.

In other words, using the defence spending series, which are assumed to be uncorrelated with the state of the economy, we characterise as defence spending news any disturbances that can forecast defence spending movements in five years but do not relate to current movements in defence spending.

Clearly, defence spending is largely independent of the state of the economy, and the new methodology can be applied. Yet this is not true for other types of fiscal spending such as government employment or consumption, for which reason we do not apply our methodology to other non-defence components of government spending.

The identified defence news shocks are correlated with the news shocks of Ramey (2011), but explain a much larger fraction of the variability in all real variables at business cycle frequencies. They also generate more significant demand effects. Anticipated increases in defence spending induce a significant and persistent increase in output, hours worked, the interest rate and inflation, and significant impact responses for consumption and investment.

Moreover, the shock identified using this methodology significantly increases the excess returns of large defence contractors while Ramey's news shock does not. According to the estimates, news about future changes in defence spending account for a non-negligible share of US output fluctuations at business cycle frequencies.

These results are useful to both academics and policy-makers. Since anticipation effects are estimated to be significant and economically important; it is important to include them in empirical studies of the effects of fiscal changes.

Moreover, policy-makers should be cautious about announcing policy changes that can affect people's expectations about future government spending. Or, reversing this argument, policy-makers can use policy announcements as a tool for responding to the cycle when constrained by budgetary or other types of restrictions.

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Notes:

- *This blog post is based on the author's paper Chronicle of a War Foretold: The Macroeconomic Effects of Anticipated Defence Spending Shocks, The Economic Journal, August 2017.*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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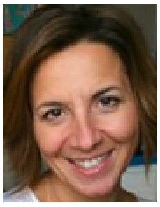
Nadav Ben Zeev I obtained my PhD from Hebrew University in 2012, after which I spent one year at European University Institute as a Max Weber postdoctoral fellow. Since 2013 I hold an assistant professor position in the department of economics at Ben-Gurion University of the Negev in Israel.



Evi Pappa is Professor of Macroeconomics at the European University Institute, and Associate Professor and Research Professor of Barcelona GSE at Universitat Autònoma de Barcelona. She was an assistant professor of economics at the LSE (2001-2006), Bocconi University (2004-2005) and UAB (2005-2006). Her main research interests are International Macroeconomics and Monetary and Fiscal Policy. Given Evi's interest in monetary policy analysis, she has been a visiting researcher in many Central Banks, like the Bank of England, the European Central Bank, the Federal Reserve Bank of Atlanta, and the Riksbank (Sweden). She is a member of the Applied Macroeconomics Network (Amen), is a MOVE (Markets Organizations and Voting in Economics) Research Fellow and a Research Affiliate of the Center for Economic Policy Research (CEPR). She received the IGIER Scholarship for Young Researchers in 2003-2004, the Paolo Baffi Fellowship in 2008 and the Ramon Areces scholarship in 2010. She has published in leading international journals.