Using Stock Returns to Identify Government Spending Shocks: New Insights

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ABSTRACT

The existing instruments of government spending using accumulated stock returns of military contractors generate vastly different consumption and investment impulse responses when compared to the narratively identified war news shocks as per Ramey (2011). I show that a reason for this difference is because of the persistence in the accumulated stock returns. Instead, a return spread between diversified portfolios of defense firms minus private consumption and investment good firms (DMP) renders persistence and generates responses akin to war news shocks. DMP return spread is a relevant instrument for post-1963 period and the spread Granger-causes government spending shocks identified using standard VAR approach.

REFERENCES


CONCLUSIONS

• This paper is an attempt to reconcile the differences between the two narrative based measures of government spending shocks.
• Differences in the responses arise due to persistence issues in the log of accumulated stock returns instrument.

• I propose two ways to get around to mitigate the persistence issues.
  1. Use a value-weighted return spread between defense good minus private consumption and investment good producers (DMP) with approximately the same weighted average market equity.
  2. Use local projections (LPs) as per Jorda (2005).
• Consumption responses become negative when LPs are used to generate responses following a shock to government spending.