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Regime Switches in Japanese Fiscal Policy: Markov-Switching VAR Approach

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Abstract

This paper empirically investigates the changing dynamics of fiscal policy shocks to the macroeconomy in Japan. By estimating a Markov-switching vector-autoregressive (VAR) model, regime switches in both automatic fiscal responses to output and discretionary fiscal shocks are investigated. The main findings are summarized as follows. First, the best-fit model is a version with four regimes that allows time variation in both coefficients and disturbance variances. Second, the structural changes occurred in the mid-1970s, the early 1990s, and the late 1990s. Third, in contrast to the other regimes, expansionary fiscal shocks depress output and consumption in the third regime. Fourth, fiscal shocks crowd out investment only in the fourth regime. Fifth, the twin-deficit hypothesis holds in all regimes.

Keywords: fiscal policy, twin-deficit hypothesis, Markov-switching, VAR
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