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Fiscal policy and stock market efficiency: Evidence for the United States☆

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Abstract

This paper examines the extent to which fiscal policy actions affect the stock market's behavior for the US during 1968–2005. The findings are consistent with the hypothesis that past budget deficits negatively affect current stock returns thus suggesting that the market is inefficient with respect to information about future fiscal policy actions. One interpretation of this 'disturbing' result is that market participants do not place much faith on news about the budget deficits as they do not believe that deficits could adversely impact the stock market. Instead, what the market considers most important is news about monetary policy.

JEL classification: E62; E52; G1

Keywords: Fiscal policy; Monetary policy; Budget deficit; Stock market; Efficiency

1. Introduction

There is an overwhelming empirical literature on the issue of monetary policy and stock market efficiency (SME) for the United States (e.g., Bernanke, 2004; Davidson & Froyen, 1982; Ehrmann & Fratzscher, 2004; Mishkin, 2001). In its semi-strong form, the SME hypothesis postulates that stock prices fully reflect all past and current publicly available information. In other words, there

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should not be any statistically significant lagged relationships between money growth and stock returns given that stock prices fully incorporate all available information on monetary policy changes.

By contrast, there are only a handful of studies in the financial literature that have focused on the relationship between fiscal policy (budget deficits) and stock market efficiency. Darrat (1987, 1988, 1990), in a series of papers, tests the efficiency of fiscal policy actions on three countries' equity markets namely, Germany and the United Kingdom, and Canada, respectively, and finds that in all three cases past federal budget deficits impact the stock market. Ali and Hasan (2003), on the other hand, re-examines Darrat's (1990) finding for Canada and finds that the country's stock market is not inefficient with respect to fiscal policy. Lee (1997a,b) tests the SME hypothesis for four Pacific Basin countries (Hong King, Singapore, South Korea and Taiwan) and reports that the stock markets in all four countries are inefficient with respect to fiscal and monetary policies. Rezessy (2005) and Ewing (1998) also report inefficiencies of the stock market to deficits for the cases of Hungary and Australia, and France, respectively. Hancock (1989) tests the efficient hypothesis with respect to expected and unexpected monetary and fiscal variables and finds support for the hypothesis for both policies for the US. Finally, Singh and Talwar (1982) investigate the causal linkages between monetary and fiscal policy (variables) and the stock market for Canada, within bivariate and multivariate modeling approaches, and report conflicting results that often run contrary to economic reasoning.

Although the theoretical motivation on the effects of fiscal policy on the stock market (or asset prices) has been laid out more than 30 years ago (Blanchard, 1981; Shah, 1984; Tobin, 1969), the empirical front on the issue has been lagging. Perhaps this was due to the assumption of Barro's (1974) Ricardian Equivalence (or debt-neutrality) Proposition, but subsequent investigations have produced mixed results. For instance, while some studies have shown that budget deficits do not matter, that is, they support the proposition (Boothe & Reid, 1989; Evans, 1987a,b), other studies have produced results to the contrary (Darrat, 1986; Frenkel & Razin, 1986; Zahid, 1988).

In view of the scant and mixed evidence, the aim of this study is to fill the gap in the empirical financial literature by investigating the extent to which stock prices (returns) incorporate all publicly available information on fiscal policy moves (as measured by federal budget deficits). Variations in the deficits can, in general, be considered to affect all stocks and since such a risk cannot be eliminated by diversification (like market risk), it should then be priced by a rational equity market. The sensitivity of the stock market to changes in the deficit will be examined for the United States for the period from 1968 to 2005. To avoid any bias in the estimation and to abide by sound economic theory, we will also incorporate some monetary variables (namely, an interest rate and/or the inflation rate) in the estimation of the models. Besides, the relationship between fiscal policy and stock returns even when the path via the interest rate is excluded will also be investigated.

The significance of the study is threefold. First, it is important to find out whether the stock market offers an important channel for transmitting the impact of fiscal policy to the real side of the economy. For example, continuing federal budget deficits can exert a significant impact on long-term growth and production capacity as the market participants recognize the government's inability to restore fiscal balance discouraging them, in turn, to invest in real assets and expand real economic activity. Second, from the perspective of investors, large budgetary deficits undercut stock and bond market activity by driving interest rates higher. In other words, in addition to affecting national income, saving and investment, federal deficits also affect interest rates, exchange rates and stock market values. Specifically, higher interest rates depress investment, tend to attract foreign capital (which then put an upward pressure on the domestic currency), and reduce stock