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Fixed versus flexible exchange rates: Which provides more fiscal discipline?[☆]

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Abstract

Conventional wisdom holds that fixed rates provide more fiscal discipline than do flexible rates. In this paper we show that this wisdom need not hold in a standard model in which fiscal policy is endogenously determined by a maximizing fiscal authority. The claim that fixed rates induce more discipline stresses that sustained adoption of lax fiscal policies must eventually lead to an exhaustion of reserves and thus to a politically costly collapse of the peg. Hence, under fixed rates bad behavior today leads to punishment tomorrow. Under flexible rates bad behavior has costs as well. The difference is in the intertemporal distribution of these costs: flexible rates allow the effects of unsound fiscal policies to manifest themselves immediately through movements in the exchange rate. Hence, bad behavior today leads to punishment today. If fiscal authorities are impatient, flexible rates — by forcing the costs to be paid up-front — provide more fiscal discipline and higher welfare for the representative private agent. The recent experience of

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1. Introduction

Should countries adopt fixed or flexible exchange rates? One way to tackle this age-old question is to consider which exchange rate regime provides more discipline — be it discipline against loose monetary policies, unnecessary fiscal spending, or excessive wage demands. The recent conventional wisdom within the economics profession holds that fixed rates provide more discipline.[1] In this paper we concentrate on the issue of fiscal discipline, and show that the conventional wisdom need not hold in a standard intertemporal optimizing model in which fiscal policy is endogenously determined by a maximizing fiscal authority. On the contrary, we show that under flexible rates there are mechanisms which can provide more fiscal discipline and higher welfare for the representative agent.

There has been little work comparing the properties of exchange rate regimes since the classic paper by Helpman (1981). And while there is a great deal of informal discussion on the connection between exchange rate regimes and fiscal discipline, we are aware of no formal analysis of this link. We attempt to remedy this relative neglect by studying a simple dynamic general equilibrium model within which the properties of exchange rate regimes can be systematically compared. We are able to obtain closed form solutions for the equilibrium of this model under both fixed and flexible exchange rates. As a result, we can carry out unambiguous positive and welfare comparisons of the two exchange rate regimes.

According to the conventional wisdom, fixed rates induce more fiscal discipline because adopting lax fiscal policies must eventually lead to an exhaustion of reserves and an end to the peg. Presumably, the eventual collapse of the fixed exchange rate would imply a big political cost for the policymaker — that is to say, bad behavior today would lead to a punishment tomorrow. Fear of suffering this punishment leads the policymaker to be disciplined. If the deterrent is strong enough, then unsustainable fiscal policies do not occur in equilibrium.

[1] See Frenkel et al. (1991) and Aghevli et al. (1991) for statements of this view. See also Giavazzi and Pagano (1988) for an analytical treatment.

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