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Say you fix, enjoy and relax. The deleterious effect of peg announcements on fiscal discipline in emerging markets

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Abstract

This paper explores the impact of exchange rate pegs on the fiscal stance of emerging markets during the nineties. We empirically show that announcing the pegs had deleterious effects on fiscal discipline, while 'de facto' pegs which were not announced delivered superior fiscal outcomes. The evidence suggests that this was due to the initial positive credibility shock of the announcement, which allowed for easier and less costly access to the financing of fiscal deficits in emerging countries.

JEL classification: F33; H62

Keywords: Emerging markets; Exchange rate regimes; Fiscal deficits; International financing; Credibility

1. Introduction

Economic developments in emerging markets in the last 15 years have been characterized by the ebb and flow of capital flows in a period of financial liberalization. Their exponential growth in the first part of the nineties, in a context of high global liquidity, allowed for a period of high and robust growth. When the flows reversed in the second half of the nineties, a series of financial crises ensued, bringing havoc to many of these economies. The choice of exchange rate regime in

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[1] The views expressed in this article are those of the authors and do not necessarily reflect those of the Banco de España.

[2] This paper has benefited from the comments received at seminars in the Banco de España, Lisbon and LACEA 2004. All remaining errors are our own.

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emerging economies at that time was, in one way or other, closely related to the process of financial liberalization and access to the global supply of funds. Two cases stand out. In Asia, the outward oriented growth strategy implied – and still implies – a close, although not always declared, management of exchange rates that kept competitiveness high in spite of the upward pressure that capital inflows imposed on exchange rates. In Latin America, where recent history had made external financing hardly available and credibility was lacking, explicitly fixing the exchange rate became the cornerstone of the stabilization and reform programs setup in the aftermath of the 'lost decade' of the eighties.

Fixing the exchange rate was believed to foster not only monetary but also fiscal responsibility. By pegging the exchange rate, the monetary creation process is constrained, monetary financing of deficits becomes impossible and, in response, governments would be forced to discipline their fiscal decisions. However, empirical evidence of the positive impact of rigid exchange rate regimes on fiscal discipline has proven elusive. Using the IMF standard classification of exchange rate regimes, the first column in Table 1 shows that those emerging economies which limited the flexibility of their exchange rate during the nineties (whether through strict pegs or some other intermediate arrangement) displayed higher primary balances on average, but the difference relative to floating regimes was not statistically significant. Moreover, the average primary surplus under intermediate regimes was slightly lower than under floating regimes. Ghosh et al. (2003) sum up the empirical evidence concluding that "[...] greater monetary discipline does not translate into fiscal discipline". Gavin and Perotti (1997), Tornell and Velasco (1998) and Calvo and Vegh (1998) have also concluded that pegs do not provide higher fiscal discipline in emerging economies. These results are highly suggestive because insufficient fiscal discipline under pegged regimes may lie at the root of several recent crises in emerging markets. Ghosh et al. (2003) find that, for their sample of exchange rate based stabilization programs, profligate fiscal policy seems to be the most likely predictor of failure.

Previous efforts in explaining the irrelevance of exchange arrangements on fiscal policy have considered the possibility that the loss of seignorage associated to fixed exchange rates could lie behind these results. Since fiscal deficit figures include seignorage revenue, comparing low seignorage pegs to high seignorage floats may be biasing the results. However, Alberola and Molina (2003) arrive at similar conclusions after controlling for seignorage effects in the analysis.

In this paper, we explore a different venue. The reason why previous studies have failed to find an impact of exchange arrangements on fiscal policy is their use of the IMF's de jure classification of exchange rate policies. Using Reinhart and Rogoff (2004) de facto classification, we document statistically significant differences in fiscal policy outcomes across their taxonomy of exchange rate arrangements. We claim in this paper that the explanation for the apparent inconsistency between the

Table 1
Average primary balance (% of GDP). Emerging markets 1991–2001

	IMF de jure classification (a)	Reinhart–Rogoff Classification
Pegs	1.5	1.7***
Fixed	2.1	1.5*
Intermediate	1.2	1.8***
Free fall	–	0.6
Flexible	1.4	0.4

(a) 1991–1999 sample.
*, ** and *** denote statistically different from the Float control group at 10%, 5% or 1% confidence level. Comparison made on the basis of robust errors.