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Capital inflows, fiscal discretion, and exchange rate policy

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Abstract

Many writers have argued for the benefits of a credible fixed exchange rate (a hard peg) as a commitment device in an open economy. But historically, fixed exchange rates have often been associated with large current account deficits and episodes of 'over-borrowing'. This paper develops a model of capital inflows that are linked to the exchange rate regime because of endogenous fiscal policy. The key message of the paper is that a hard peg is undesirable in the absence of commitment in fiscal policy. In face of a credible fixed exchange rate, the fiscal authority subsidizes capital inflows. The economy will engage in inefficiently high international borrowing, and in welfare terms may end up worse off than under capital market autarky. To eliminate the incentive to subsidize borrowing, the monetary authority must follow a *flexible exchange rate rule* in which capital inflows lead to exchange rate appreciation. If fiscal policy must be financed by money creation rather than direct taxation, then a fixed exchange rate rule may cause both over-borrowing and a subsequent exchange rate crisis.

JEL classification: F320; F400; F410

Keywords: Capital inflows; Fiscal policy; Exchange rate regime; Pre-commitment

0. Introduction

Many writers have argued for the benefits of credible fixed exchange rates (hard pegs) in providing a nominal anchor for monetary policy in an open economy. 'Hard pegs' are seen

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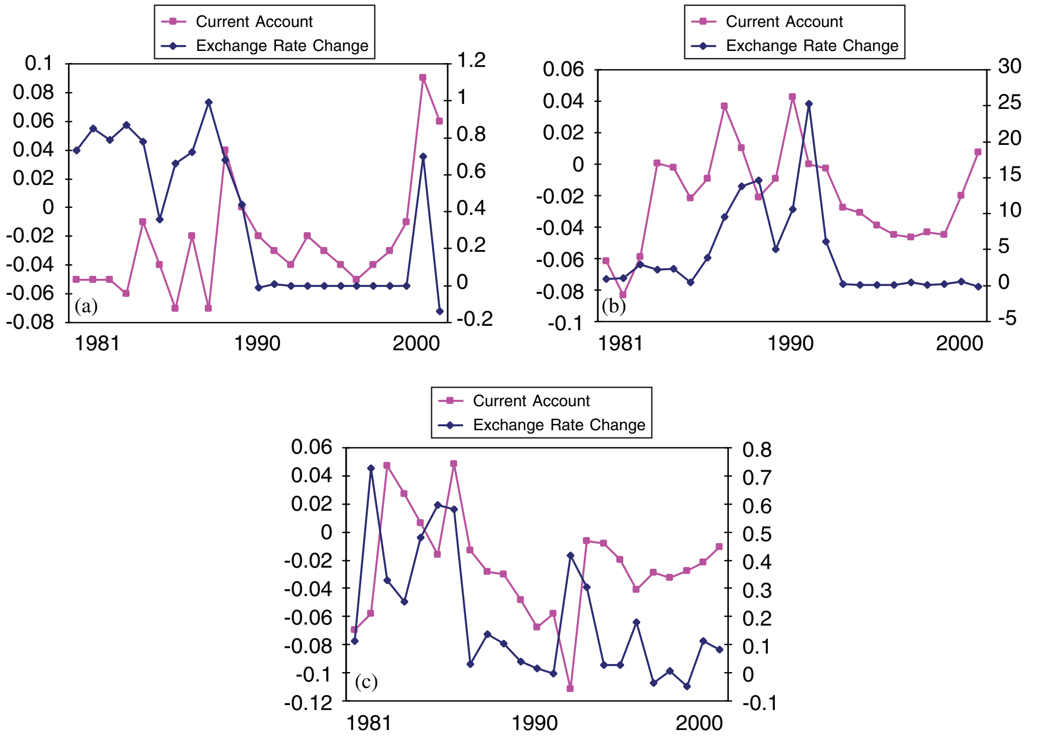

Fig. 1.

as instilling a commitment in monetary policy (e.g. Calvo, 2000 for emerging markets and Giavazzi and Pagano, 1989 for Europe), particularly in countries with a record of high inflation. But the historical record of hard pegs is mixed. Many countries that have fixed their exchange rates have experienced very large current account deficits, and in some cases, subsequent exchange rate crises. In fact, most of the significant capital inflows into emerging market countries have taken place under fixed exchange rates. This is true of both the Latin American and East Asian economies. Fig. 1 shows that for Argentina, Brazil, and Mexico, episodes of exchange rate stability have typically coincided with large and sustained current account deficits.

This paper explores the linkage between the fixed exchange rate regimes and capital inflows in environment of endogenous fiscal policy.[1] The essential message of the paper is that the incentive for government interference in capital markets (through implicit or explicit borrowing guarantees or subsidies) will generally depend on the exchange rate policy. If there is credible commitment in both monetary and fiscal policy, then the exchange rate policy is irrelevant. But, absent commitment in fiscal policy, a credible fixed

[1]The link between fixed exchange rates and capital inflows has been noted in many previous contexts. See Edwards (2000) for discussion of the exchange rate based stabilization literature. For discussion of overborrowing, see McKinnon and Pill, (1999), Burnside et al (2001a) among others. We discuss this references more fully below.