

Fixed versus Flexible Exchange Rates: Which Provides More Fiscal Discipline?*

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Abstract

In recent years the conventional wisdom has held 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 this 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 Sub-Saharan countries supplies some preliminary evidence that matches the predictions of the model.

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