

Money-Based versus Exchange Rate-Based Stabilization with Endogenous Fiscal Policy*

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July 1995

Abstract We present a standard intertemporal model in which fiscal policy is determined by an optimizing but non-benevolent fiscal authority. If the fiscal authority is impatient, a money-based stabilization provides more fiscal discipline and higher welfare for the representative agent than does an exchange rate-based stabilization. Data for Latin American stabilizations in the last quarter-century seem to confirm the notion that stabilizing by using money rather than the exchange rate helps induce politicians to reduce the fiscal deficit.

*Earlier versions of this paper were presented at Dartmouth, MIT, Yale, the International Monetary Fund and the Inter-American Development Bank. We are grateful to seminar participants and to A. Alesina, R. Barro, R. Dornbusch, M. Gavin, R. Hausmann, E. Helpman, L. Leiderman, R. Perotti, J. Sachs, and M. Tommasi for comments and/or discussions. All errors are our own. Early work on this paper was done while both authors visited the Research Department of the Inter-American Development Bank, whose hospitality is gratefully acknowledged. Velasco's work was supported by the C.V. Starr Center for Applied Economics at NYU, and by the Harvard/MIT RTG in Positive Political Economy while he visited Harvard in 1994-95.