

WHAT DOES REALLY DISCIPLINE FISCAL POLICY IN EMERGING MARKETS?

THE ROLE AND DYNAMICS OF EXCHANGE RATE REGIMES (*)

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Abstract

Fixing the exchange rate stabilises inflation and reduces monetary seigniorage, a key source of financing under the fiscal dominance hypothesis. However, the link between fixed exchange rate regimes and fiscal discipline in emerging markets has been found to be weak. This paper thoroughly reviews the issue through three venues. First, an alternative measure to gauge fiscal discipline –the so called shadow balance, inclusive of seigniorage revenues- is proposed, since the traditional one, the primary balance, does not convey monetary financing; notwithstanding this modification, no robust relation is found either. Second, we sustain and then prove the hypothesis that fixing the exchange rate may have offsetting effects on fiscal discipline through the relaxation of the fiscal constraint of the government. In particular fixing the exchange rate is expected to reduce the cost and burden of debt and to enhance the ability to obtain revenues through a higher level of activity. The empirical test of this hypothesis follows a two-stage approach. First, we test the impact of the fiscal constraints on discipline: as advocated, a higher fiscal burden induces higher discipline; higher activity does not clearly relax discipline, although expenditures grow and the burden of debt is shown to diminish. The second stage tests the impact of fixed regime on the considered determinants. Again, the relation between fixed regimes and the reduction of the burden is robust, but not so the impact of fixed regimes on the cycle. Finally, we explore the dynamics related to the pegging of the exchange rate, uncovering that at its inception exchange rates trigger an expansion and reduce the debt burden. This final outcome does not only strengthen our hypothesis but illustrates how the peg sows the seeds of its own destruction, also at the fiscal level.

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