
Fiscal Policy and Exchange Rate Regimes

Anyone who lives within their means suffers from a lack of imagination.

—Oscar Wilde

Fiscal policy is not well-suited for stabilizing inflation and output in most circumstances, with the exception of automatic stabilizers such as unemployment benefits. Unsustainable fiscal deficits lead inexorably to fiscal crises under all exchange rate regimes. However, such crises tend to come earlier and more abruptly in currency unions or for governments that have borrowed in foreign currency.

Fiscal Policy for Economic Stabilization

This book focuses on monetary policy as the primary tool for domestic economic stabilization—that is, for the stabilization of inflation and output—both for simplicity and in concert with the widely held view that this is a reasonable prescription for economic policy in most circumstances. Nevertheless, there is a long tradition—dating back at least to Keynes (1936)—that accords fiscal policy a major role in economic stabilization. Fiscal policy operates through government spending, taxation, and transfer programs such as unemployment insurance and medical coverage. All these elements of fiscal policy can affect economic output and inflation.

The convention in economic textbooks is to assert that fiscal policy is more potent with a fixed exchange rate and monetary policy is more potent with a floating exchange rate (Krugman and Obstfeld 2000, Feenstra and Taylor 2008). But this assessment depends critically on the assumed behavior of monetary policy. With a fixed exchange rate and international capital mobility, the interest rate must remain fixed at the world level at all times, and

so monetary policy is tautologically impotent.¹ With a floating exchange rate, there is no such constraint on monetary policy, and that is the sense in which monetary policy is more potent with a floating exchange rate. Whether fiscal policy is less potent with a floating exchange rate depends on how monetary policy responds. If the central bank does not raise interest rates in response to a fiscal expansion, then fiscal policy is equally potent with either a fixed or a floating exchange rate.

However, during most of the past two decades many economists have presumed—as described by Blanchard (2009)—that under normal circumstances monetary policy is, or should be, set continuously to stabilize inflation and output over the medium term, leaving no role for activist fiscal policy stabilization. Indeed, under this presumption, fiscal policy actions are inherently destabilizing and need to be counteracted by monetary policy, a conclusion that is supported by numerous episodes of harmful fiscal actions. The textbook conclusion that fiscal policy is less potent with floating exchange rates essentially reflects the view that monetary policy tools already have the situation well in hand and will offset any effects of fiscal policy on inflation and output.

The Great Recession of 2008–09 shocked this simple macroeconomic consensus. Even aggressive monetary actions were insufficient to adequately stabilize inflation and output. The impossibility of lowering nominal interest rates below zero posed a novel dilemma for central banks seeking to fight a collapse in aggregate demand.² The International Monetary Fund (IMF 2009) urged governments in many economies to adopt large fiscal stimulus programs in response to the crisis. Blanchard, Dell’Ariccia, and Mauro (2010, 9) acknowledge the helpful role played by fiscal policy, stating that the crisis had “returned fiscal policy to center stage as a macroeconomic tool.” But they also argue that the crisis “further exposed some drawbacks of discretionary fiscal policy for more ‘normal’ fluctuations.” Moreover, recent studies show that monetary policy may not necessarily be hobbled by the zero bound on nominal short-term interest rates when there is scope to reduce longer-term interest rates (Joyce et al. 2010, Gagnon et al. 2011, Hamilton and Wu 2011).

The presumption that monetary policy is the main stabilization tool is relevant mainly for floating exchange rate regimes. But for economies with pegged exchange rates, the textbook conclusion of fiscal policy potency and monetary policy impotence remains valid. These economies need to make countercyclical fiscal policy as automatic as possible, in order to avoid the legislative and managerial delays associated with discretionary fiscal policy. Examples of automatic fiscal stabilizers include unemployment benefits and progressive tax systems that increase spending and reduce revenues automatically when

1. As elsewhere in this book, the home economy is presumed insufficiently large to affect interest rates in the rest of the world.

2. Japan’s experience at the so-called zero interest rate bound a decade earlier had been a warning call for new policy analysis that was not heeded by many outside, or even inside, Japan.

economic output slows. Automatic stabilizers can be greatly enhanced when a currency union has a unified fiscal system that provides for automatic transfers from regions that are performing well to those that are not.

Fiscal Crises under Fixed and Floating Exchange Rates

Economic stability ultimately requires fiscal stability. When a government borrows more than it is able to repay, the result is damaging under any exchange rate regime. However, the nature of any fiscal crisis, and the options for dealing with it, do differ under different regimes.

Domestic-Currency Debt and Flexible Exchange Rates

Fiscal crises under flexible exchange rate regimes are generally relatively slow-moving. As government debt rises, the central bank gradually raises interest rates to keep output close to potential levels and to keep inflation stable. Higher interest rates divert capital from productive projects to unproductive government debt, thereby slowing the potential growth rate of the economy. To pay interest on the debt, either the tax burden must continually rise or the government must force the central bank to abandon its inflation target in order to print money to service the debt. There is no clearly defined tipping point. Eventually, the public concludes that ever-slower growth with either ever-higher taxes or ever-higher inflation is unacceptable. Mild examples of this pattern occurred in Australia and Canada in the early 1990s. Extreme examples led to hyperinflation in Austria, Germany, Hungary, and Poland in the 1920s and Argentina and Brazil in the 1980s.³

Domestic-Currency Debt and Fixed Exchange Rates

The early stages of a profligate fiscal policy are especially expansionary under a fixed exchange rate regime because interest rates do not rise. Eventually, however, markets begin to push up domestic interest rates out of concern that the government will be forced to choose between defaulting on its debt and abandoning the exchange rate peg in order to print money. These concerns break the tight link between domestic and foreign interest rates. As interest rates rise, the government's debt service costs rise. When the government becomes unable to raise more taxes or cut enough spending to service the debt, it must choose between default and depreciation. Default imposes large immediate losses on domestic and foreign investors and shuts the government out of capital markets, thereafter forcing it to live within its means. Abandoning the fixed exchange rate is the more common choice. This starts a transition to the flexible exchange rate regime described in the previous section, with high and rising inflation.

3. Sargent (1982) provides a good account of the hyperinflations during the 1920s.

Domestic-Currency Debt and Currency Unions: The Euro-Area Debt Crisis

A currency union is distinct from a fixed exchange rate regime because government debt in a currency union is denominated in a currency beyond the government's control. This means that the government is not free to devalue its debt by abandoning the exchange rate peg. Any break with the currency union that involves a conversion of debt into the new local currency would be considered a default. Moreover, exiting a currency union is considerably more difficult than abandoning a fixed exchange rate because of the need to immediately establish a new currency. For these reasons, default—or restructuring, as it is more politely called—is a more likely policy choice for countries in a currency union.

A noteworthy feature of fiscal crises in a currency union is that they are more sudden and sharp than in countries that have the option of printing money to service their debts. As markets begin to fear default, investors demand higher interest rates on the debt to compensate for this increased risk. However, the higher interest burden makes it harder for the government to service its debt. This sets up a vicious cycle in which bond yields soar.⁴ At some point, higher interest rates become meaningless because they raise the probability of default by more than they raise the expected future payoff for bondholders. At this point, the country is immediately shut out of the capital markets.⁵

This vicious cycle is readily apparent in the euro-area sovereign debt crisis that began in 2010. Greece, Ireland, and Portugal were effectively shut out of the capital markets. They were rescued from default by the European Union and the IMF, which provided large loan packages.

Foreign-Currency Debt

Many developing economies have experienced fiscal crises after their governments borrowed heavily in foreign currencies. Because these governments lack the option of printing money to service their foreign-currency debts, the dynamic pattern of fiscal crisis resembles that in the euro area beginning in 2010. Responding to foreign-currency debt crises has been the mainstay of IMF lending programs since the founding of the institution after World War II.

For economies with a floating exchange rate—and for those that are prepared to abandon their fixed exchange rate—easy monetary policy may provide some offset to the contractionary economic effects of the necessary fiscal tightening. But easy money causes the currency to depreciate, and currency depreciation increases the burden of the debt and the cost of interest payments in terms

4. De Grauwe (2011) describes this process in greater detail with a focus on the euro area.

5. When the government has the option of printing money to service its debt, higher interest rates do not have such a direct effect on the probability of default, and there is no sudden break in the ability to borrow.

of local currency. This increased debt burden further increases the needed fiscal adjustment, which can be especially harmful if the private sector also has borrowed in foreign currency (Allen et al. 2002, Arteta 2005).

Even in the absence of a fiscal crisis, the existence of a large stock of foreign-currency liabilities—issued either by the government or by the private sector—greatly reduces the stabilization benefits of a floating exchange rate (Bergin, Shin, and Tchakarov 2006; Acosta-Ormaechea and Coble 2011). The dangers of foreign-currency borrowing, and currency mismatches in general, have been more widely acknowledged in recent years (Goldstein 2002). The Committee on the Global Financial System (CGFS 2007) documented the significant growth of—and increased policy emphasis on—local-currency borrowing in developing economies as a superior alternative to borrowing in foreign currency.

Conclusions

Fiscal policy is more potent—and potentially more disruptive—in a currency union or a pegged exchange rate regime than in a floating regime. When the exchange rate cannot move, the burden of macroeconomic stabilization falls on fiscal policy, preferably through automatic stabilizers. But excessive fiscal deficits also precipitate crises that are more abrupt and severe under firmly fixed exchange rate regimes than under flexible regimes.

