Abstract (summary):

There is a long held view that fixed exchange rates can provide an important source of discipline for monetary and fiscal policies. This study shows, however, that such discipline effects are often much weaker than advocates assume. Discipline effects are a result of incentive and constraint effects. Most of the discipline literature addresses only the constraint aspect. Since the two effects often work in opposite directions, pegged exchange rates may not always be an effective source of discipline. While several studies treat hard fixes and soft pegs as being one and the same, the two regime types are very different in their incentive and constraint structures. One should expect hard fixed-rate regimes to be a much stronger source of discipline.

The empirical results in the current literature tend to be mixed due to differences in methodology. This study addresses these problems by separately analyzing fiscal and monetary discipline and accounts for potential differences in the effects exerted by hard fixes and soft pegs. The study also looks at effects for developing and emerging market countries, since the two groups differ not only in their institutions, but also in their degrees of capital mobility. The results confirm that hard fixes are the most effective source of monetary discipline of all the different exchange rate regime types for both developing and emerging market countries. Soft pegs are clearly less effective than hard fixes in delivering monetary discipline. The results for fiscal discipline show more variability, but none of the estimates support the view that fixed or pegged exchange rates have a strong positive effect on fiscal discipline. The results also show that effects of particular types of exchange rate regimes often have opposing signs for emerging and developing economies, and thus these two types of economies should be analyzed separately.

In addition to distinguishing between hard and soft fixes, this study also improves on the previous literature by investigating the role that politically unstable and divided governments may play in affecting the discipline effects, but also allows for the possibility of interaction effects between these political variables and exchange rate regimes.