Journal of Macroeconomics 39 (2014) 171–184

Contents lists available at ScienceDirect

Journal of Macroeconomics

journal homepage: www.elsevier.com/locate/jmacro

# Conflict inflation and delayed stabilization

Elena Seghezza[a,*], Pierluigi Morelli[b]

[a] Dept. of Economics, University of Genoa, Via Vivaldi 5, 16121 Genoa, Italy
[b] Associazione Bancaria Italiana, Piazza del Gesù 49, 00186 Rome, Italy

ARTICLE INFO

*Article history:*
Received 24 April 2012
Accepted 2 October 2013
Available online 28 October 2013

*JEL classification:*
E31
E42
E63
E65
N1

*Keywords:*
Delayed stabilization
Political exchange
Rentiers
Inflation

ABSTRACT

There are numerous political economy approaches to the question of delayed stabilizations. However, all these approaches regard inflation as the unintentional result of the behavior of interest groups. In this paper we take the opposite view, namely, that when there is polarization of financial wealth, inflation is used as a tax to transfer the burden of stabilization onto some interest groups. In countries characterized by financial polarization, stabilization can occur only when there is a change in the political and economic equilibrium, and when parties which represent interest groups adverse to inflation support a new government coalition. The estimates of a Probit model support this hypothesis: the stabilizations after World War I and after the Great Inflation of the 1970s in several European countries showed remarkable political regularities. In fact, generally, these stabilizations occurred when there was a reversal of the political-economic equilibrium and government coalitions including rentiers' representatives took power.



## 1. Introduction

Stabilization processes often occur with some delay and several explanations have been offered to explain this fact. Among these explanations, political economy models seem better able than others to account for the fact that policy-makers often pursue inefficient policies. Actually, the stabilization processes require measures that affect the distribution of income and wealth of different interest groups. There may, therefore, be a conflict between the groups in shifting the adjustment costs onto others (Fernandez and Rodrick, 1991; Alesina and Drazen, 1991; Labán and Sturzenegger, 1994). This is the basis of the *war of attrition hypothesis* (Alesina and Drazen, 1991): any delay in stabilization may be attributable to the deadlock that results from the conflict between interest groups trying to avoid the adjustment costs associated with stabilization. The deadlock is overcome when the loser (i.e., the interest group most damaged by inflation) surrenders.

However, as shown in Section 2, this conclusion does not square up with the experience of industrialized nations in the periods following the two world wars and after the Great Inflation of the 1970s. The fact is that stabilizations in these periods were introduced in almost all cases by political coalitions where the interest group most impoverished by inflation, the rentiers, played a prominent role.

An explanation for this fact can be found in the *political exchange hypothesis* outlined in Section 3. As in Beetsma and Van der Ploeg (1996) this hypothesis assumes that in economies with a high degree of financial polarization and fixed-interest-rate financial portfolios, inflation is primarily a tax burden on the holders of financial wealth.

* Corresponding author. Tel.: +39 3337955185.
*E-mail addresses:* seghezza@unige.it (E. Seghezza), p.morelli@abi.it (P. Morelli).

0164-0704/$ - see front matter © 2013 Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.jmacro.2013.10.002

In a democracy, equilibrium inflation (or deflation) is the result of matching up the demand for different forms of taxation (including inflation) coming from interest groups, and the supply coming from political parties. Thus, as shown in the model put forward in Section 3, inflation results from the policy choices of the political majority that holds power.

In this context, the decision to stabilize does not arise, as in the war of attrition hypothesis, from the removal of the veto on stabilization by the weaker interest group, but rather from the dominance of an alliance between interest groups adverse to inflation. This helps to explain why in the government coalitions that carried out stabilization policies in several industrial countries after the two world wars and after the Great Inflation, the parties representing the interests of the middle class (i.e., the rentiers) generally played a leading role, while the left-wing parties, representing working class interests, were excluded or marginalized from these coalitions.

Section 4 provides an empirical test of the main conclusion of the model. The test was conducted on the stabilizations that occurred in European countries in the 1920s and the 1980s. The choice of these periods was motivated by the fact that during those periods several industrialized countries had a high level of financial deepening, a large public debt and high polarization between creditors and debtors.

In Section 5, on the basis of the political exchange hypothesis and the empirical results presented in this paper, we offer some recommendations as to how to prevent situations of high inflation and how to reduce delays in stabilization in economies with a high level of financial polarization.

## 2. Political economy approaches to stabilization delay

Most political economy literature attributes stabilization delays to a conflict between interest groups: the best-known approach in this type of literature is the war of attrition hypothesis put forward by Alesina and Drazen (1991). According to this model, the conflict between different interest groups arises from the attempt by the individual interest groups to shift the cost of realignment onto other interest groups. This struggle leads to deadlock, a war of attrition; no interest group wishes to bear the cost of public finance adjustment.

This deadlock is due to the existence of information asymmetries in the ability of rival interest groups to bear the effects of inflation caused by the adjustment delay. Stabilization takes place when it becomes clear which interest group is least capable of withstanding inflation. This group is the one bound to bear most of the burden resulting from adjustment.

The war of attrition hypothesis makes it possible to build a bridge between a country's economic and social structure, on the one hand, and its political regime, on the other: in regimes fragmented from an institutional point of view, it is easier for interest groups to exercise their veto power. Despite this, the hypothesis under consideration, albeit fascinating, can be criticized from several angles.

First, it sees inflation as the result of an unresolved conflict between interest groups, none of which in principle wants inflation. In actual fact, in an economy with a large financial system and fixed-interest-rate bonds, inflation will damage some interest groups, creditors, while benefiting others, debtors.

Secondly, the war of attrition hypothesis makes the assumption that interest groups are unable to establish ex-ante which of them will suffer the greatest losses from inflation. Nonetheless, these interest groups, if they are heterogeneous in terms of forms of income and in terms of their financial assets and liabilities, will necessarily know in advance who will gain and who will lose by inflation.

Thirdly, the historical experience of industrial countries shows that in many cases, in particular after the post-war stabilizations and the Great Inflation of the 1970s, stabilizations occurred when political coalitions where the interest group most impoverished by inflation, the rentiers, played a prominent role. This fact disproves the main conclusion of the war of attrition hypothesis, according to which deadlock is overcome when the loser (i.e., the interest group most severely damaged by inflation) surrenders.

Following on from the above observations on the war of attrition models, this paper maintains that high inflation, at least in some circumstances, is not the unintentional consequence of deadlock but rather the outcome of a political exchange between interest groups and political parties.

This political exchange occurs mainly in situations characterized by extreme polarization between debtors and creditors and where creditors hold portfolios exposed to the risk of inflationary erosion. This is the case when the state has taken on debt by issuing fixed-interest securities,[1] national debt is high, and the distribution of financial wealth is unequal.

A significant amount of recent literature on the redistributive effects of inflation has focused on the incidence of inflationary tax on cash holdings. However, studies on this kind of tax, notably by Erosa and Ventura (2002) and Albanesi (2007) look solely at expected inflation, while disregarding the effects of inflation on stocks of financial assets.

This paper, in contrast, looks at recent contributions, such as those by Doepke and Schneider (2006a,b), that emphasize the importance of the redistributive effects that result from the inflationary erosion of financial wealth. These effects can occur only in an economy characterized by a high level of financial deepening, in other words where there is a highly developed banking system and/or financial market. In this kind of context individuals are heterogeneous in terms of their

[1] The first indexed public securities were introduced by United States in 1780. This was, however, an isolated attempt, taken up again in Germany in November 1923 when hyperinflation made it impossible for the state to place its bonds.