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Disinflation and credibility in small open European economies in the 1980s: Parties, elections and the ERM *

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Abstract

This paper develops an open economy extension of the Alesina (1987) model of partisan electoral cycles. It links politics to the credibility of stabilization policies pursued. The partisan structure is very close to European politics where parties have well-defined differences. Empirical findings reveal the political (parties, elections and political instability) and economic (public debt, ERM membership) determinants of credibility of stabilization policies implemented in small European countries in the 1980s.

Keywords: Stabilization policies; Partisan theory; Small open economy; Credibility

JEL classification: E63; F41

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1. Introduction

The role of confidence in a stabilization policy as a reason for its successful implementation, has been extensively analyzed by the economists in the last years. The starting point for the credibility literature are the models suggested by Kydland and Prescott (1977) and Barro and Gordon (1983). From this point of view, policy making is considered as a game between policy makers and private agents. The recent theory of economic policy attempts to link politics and credibility problems in macroeconomic policy (Alesina (1988), Alesina and Sachs (1988), Alesina and Tabellini (1988)).

This paper develops an open economy extension of the Alesina (1987) model of partisan electoral cycles and empirically examines the political and economic factors that affect the credibility of traditional stabilization policies [1] pursued in small European countries in the 1980s.

The rise of conservatism in the 1980s concerns mainly the type of policies pursued (Cohen, 1988). Specifically, the shifts in policies are not necessarily associated with the changes of political parties in power. Empirical findings, however, reveal that political parties affect the credibility of stabilization policies they implement.

The most important feature of post-stabilization periods was the adoption of disinflationary policies. [2] However, the output cost of these policies appears to be very low. The reduction in the inflation differential relative to Germany (% of the initial level) was 8.3% for Denmark (1983–88), 88.9% for Ireland (1982–89), 47.2% for Greece (1986–88), 42.6% for Portugal (1985–89) and 39.3% for Spain (1985–89). The cumulative output loss [3] for almost every country in the sample was either small or even negative. Indeed, it was -5.6% for Denmark, 4.6% for Ireland, -0.1% for Greece, -7.7% for Portugal and -11% for Spain. It becomes apparent that in Denmark and Spain the cumulated output gains were very high. In these countries disinflation was accompanied by capital inflows and enhanced credibility after their entrance in the EMS and EC, respectively. In Greece, disinflation was accompanied by a short increase in business investment and, thus, the output loss was negative.

The paper proceeds as follows. Section 2 studies the credibility problems of stabilization policies in a small open economy in the context of a partisan model. Section 3 presents the econometric specification and the data. Section 4 provides empirical evidence on the credibility of stabilization policies. Finally, Section 5 presents some concluding remarks.

[1] The term 'stabilization policies' refers to policies that mainly aim at managing aggregate demand through fiscal or monetary measures.

[2] For a comparative presentation of the main features of stabilization policies in small open European economies in the 1980s see Kapopoulos (1993).

[3] Sum of deviations from trend GDP growth (linear trend: 1960-89).