

CONTINGENT SIGNALS: SUCCESS AND FAILURE OF STABILIZATION MEASURES

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INTRODUCTION

- ▶ When / why do governments fail to restore confidence?



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- ▶ $\text{OUTCOME} = f(\text{Government}; \text{Market})$
- ▶ Focus on MARKET EXPECTATIONS [\neq OUTCOME]
- ▶ Signal \longrightarrow Expectations
 - ↑
 - Polarization

SIGNALING

Standard model

- ▶ Uncertainty about commitment

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Polarization

- ▶ Variance of policy positions
- ▶ Uncertainty about policies
- ▶ Possibility of policy reversals

HYPOTHESIS

$E[\text{Deval}]$ increases...

- ... the greater polarization in the political system
- ... the greater polarization within the government

EMPIRICAL ANALYSIS

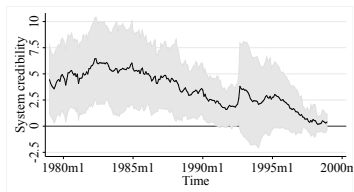
European Monetary System

▶ $E[\text{Deval}] = IR^D - IR^F$

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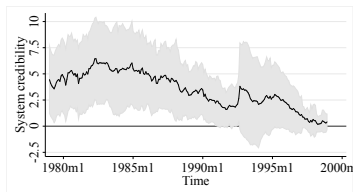
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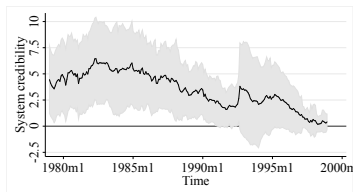
Determinants of credibility

- ▶ Systemic credibility / European politics

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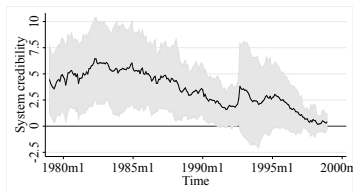
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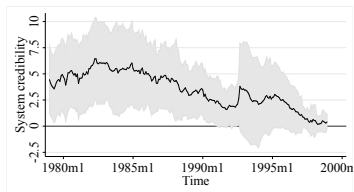
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⏟
Cointegrated series

Model

$$E[Deval]_{i,t} = \beta_0 + \beta_1 E[Deval]_{i,t-1} + \beta_2 \text{Syscred}_{i,t} + \beta_3 \text{Infdiff}_{i,t} + \beta_4 \text{Unemp}_{i,t}$$

Model

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RESULTS

General results

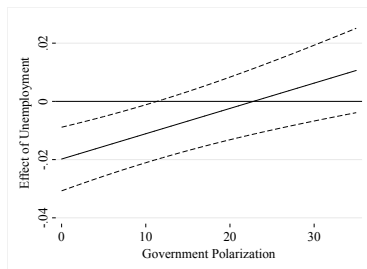
$E[\text{Deval}]_{t-1}$	0.959*** (0.005)
Syscred_t	0.022*** (0.006)
InfDiff_t	0.019*** (0.003)
Unemp_t	-0.020** (0.007)
Ideology_t	-0.009 (0.064)
Govpolar_t	-0.006 (0.004)
$\text{Unemp}_t * \text{Govpolar}_t$	0.001*** (0.000)
Constant	0.158** (0.060)
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Effect of unemployment



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- ▶ Signal effects contingent on political situation
- ▶ 'Stabilization' can be destabilising

Future work:

- ▶ Measurement of policy
- ▶ $E[\text{Depreciation}]$ vs. $E[\text{Revaluation}]$
- ▶ Deviation from 'natural unemployment'