Contingent Signals: Success and Failure of Stabilization Measures

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Introduction

When / why do governments fail to restore confidence?
Introduction

▶ When / why do governments fail to restore confidence?
▶ OUTCOME = f(Government; Market)
Introduction

- When / why do governments fail to restore confidence?
- $\text{OUTCOME} = f(\text{Government}; \text{Market})$
- Focus on $\text{MARKET EXPECTATIONS}$
When / why do governments fail to restore confidence?

\[ \text{outcome} = f(\text{Government}; \text{Market}) \]

Focus on market expectations \([\neq \text{outcome}]\)

Signal \(\rightarrow\) Expectations
\[ \uparrow \]

Polarization

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Contingent signals
SIGNALING

Standard model

- Uncertainty about commitment
**Signaling**

**Standard model**

- Uncertainty about commitment
- Signal provides information
**Signaling**

**Standard model**

- Uncertainty about commitment
- Signal provides information
- ‘Tough’ policy decreases $E[\text{Deval}]$
**Signaling**

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**Polarization**

- Variance of policy positions
Signalizing

Standard model
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Polarization
- Variance of policy positions
- Uncertainty about policies
Signaling

Standard model
- Uncertainty about commitment
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Polarization
- Variance of policy positions
- Uncertainty about policies
- Possibility of policy reversals
HYPOTHESIS

E[Deval] increases...

... the greater polarization in the political system
... the greater polarization within the government
Empirical analysis

European Monetary System

- $E[\text{Deval}] = IR^D - IR^F$
Empirical analysis

European Monetary System

- $E[\text{Deval}] = IR_D - IR_F$

Graph showing system credibility over time.
Empirical analysis

European Monetary System

- $E[\text{Deval}] = IR^D - IR^F$

Determinants of credibility

- Systemic credibility / European politics
Empirical analysis

European Monetary System

- $E[\text{Deval}] = IR^D - IR^F$

Determinants of credibility

- Systemic credibility / European politics
- Economic fundamentals
Empirical analysis

European Monetary System

$E[Deval] = IR^D - IR^F$

Determinants of credibility

- Systemic credibility / European politics
- Economic fundamentals
- Government characteristics
**Empirical analysis**

**European Monetary System**

- $E[\text{Deval}] = IR^D - IR^F$

**Determinants of credibility**

- Systemic credibility / European politics
- Economic fundamentals
- Government characteristics

**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

\[ E[\text{Deval}]_{i,t} = \beta_0 + \beta_1 E[\text{Deval}]_{i,t-1} + \beta_2 \text{Syscred}_{i,t} + \beta_3 \text{Infdiff}_{i,t} + \beta_4 \text{Unemp}_{i,t} + \beta_5 \text{Ideology}_{i,t} + \beta_6 \text{Govpolar}_{i,t} \]
Model

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Model

\[ E[\text{Deval}]_{i,t} = \beta_0 + \beta_1 E[\text{Deval}]_{i,t-1} + \beta_2 \text{Syscred}_{i,t} + \beta_3 \text{Infdiff}_{i,t} + \beta_4 \text{Unemp}_{i,t} \]
\[ + \beta_5 \text{Ideology}_{i,t} + \beta_6 \text{Govpolar}_{i,t} \]
\[ + \beta_7 \text{Unemp}_{i,t} \times \text{Ideology}_{i,t} \]
\[ + \beta_8 \text{Unemp}_{i,t} \times \text{Govpolar}_{i,t} \]
Model

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\[ + d_i + \epsilon_{i,t} \]
## Results

### General results

<table>
<thead>
<tr>
<th></th>
<th>Coefficient</th>
<th>Standard Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>$E[Deval]_{t-1}$</td>
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<td>(0.005)</td>
</tr>
<tr>
<td>$Syscred_t$</td>
<td>0.022***</td>
<td>(0.006)</td>
</tr>
<tr>
<td>$InfDiff_t$</td>
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</tr>
<tr>
<td>$Unemp_t*Govpolar_t$</td>
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## Results

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### Effect of unemployment

![Graph showing the effect of unemployment on government polarization](image-url)

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Contingent signals
CONCLUSION

- Signal effects contingent on political situation
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*Future work:*
- Measurement of policy
Conclusion

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*Future work:*
- Measurement of policy
- $E[\text{Depreciation}]$ vs. $E[\text{Revaluation}]$
CONCLUSION

- Signal effects contingent on political situation
- ‘Stabilization’ can be destabilising

Future work:
- Measurement of policy
- E[Depreciation] vs. E[Revaluation]
- Deviation from ‘natural unemployment’