Credibility & Stabilisation Policies in Ireland in the 1980's

The initiation of the exchange rate mechanism of the EMS in 1979 was a rare example of a policy regime change. The new policy rules for member countries were: (a) currencies were allowed to fluctuate only within a narrow band and (b) more fundamental changes in the value of a currency would entail a realignment of the entire system. It was hoped that the existence of this exchange rate discipline would lead to a convergence of Irish inflation and interest rates to German levels, in accordance with the predictions of purchasing power parity and interest rate parity theorems. Such a system of quasi- fixed exchange rates contains an inherent anti-inflationary bias as member countries compete to reduce their inflation rates to the level of the least inflationary member. In the EMS, Germany plays this anchor role so that the currencies of the other member countries are bound together in a DM- zone. It is in the context of this system that Ireland's attempts at stabilisation in the 1980s must be analysed. Between 1980 and 1985, the average inflation differential between Ireland and Germany was 9.4% and it is only in the last two years that the desired convergence has occured. This turnaround in economic fortunes is the motivation for this paper.

Recent evolution in macroeconomic research has been towards analysing the effectiveness of monetary and fiscal policies as the outcome of a dynamic game in which the government and the public are the players. The strategy chosen by each player is contingent on what it believes the other player will do. The existence of this strategic interdependence means that the effectiveness of policy cannot be predicted without reference to the response of the public to the announced strategy. This is important because of the existence of a time consistency problem. Consider the following scenario. The government regime announces in period t a sequence of policies it promises to follow in the next number of periods. The public responds by incorporating this new information into their decisionmaking concerning their consumption, investment and labour supply plans for the duration of the announced policy sequence. However, in period t + i the regime makes a surprise policy U- turn and the public realise it has been fooled. This ability of the regime to deviate from its announced strategy has the result that the public will heavily discount any announced policy sequence which it does not believe the regime will maintain. That is to say, is the regime trying to sell it a "lemon"?

In a number of economic situations, this problem of credibility presents serious difficulties. The most celebrated problem is the case of a disinflation strategy. If the announcement of a disinflation policy is not believed, reductions in the rate of inflation will entail a sacrifice ratio in terms of lost output and employment. On the other hand, a fully credible disinflation strategy can quickly reduce inflation with no output or employment costs as there will be a rapid downward revision of inflation expectations. This in fact creates a self- fulfilling prophesy dynamic which accelerates the speed of the disinflation. Sargent gives the example of the 1926 Poincaré disinflation "... as soon as he assumed control of the government, and even before his programme was enacted by the legislature, the Franc recovered and inflation stopped."(1)

The means by which credibility is established is for the regime to enter into precommitments which bind it to its announced policy time path. In the case of disinflation, one form of precommitment is to enact a constitutional limit on the growth rate of the money supply. Membership of the EMS may be regarded as offering a partial credibility bonus. However, the existence of the option to seek a devaluation does not make for a fully convincing anti- inflation reputation. In order that a precommitment be effective, it must contain a punishment clause if the regime deviates from its announced strategy. For example, the finance minister might promise to resign if inflation rose above a certain level, a real- life instance being Nigel Lawson's statement that inflation would be his judge and jury.

I wish to focus on the role of fiscal policy as an effective form of precommitment to a disinflation strategy. This can be understood as follows. A budget deficit may be financed by issuing bonds or by printing money. The higher is the deficit, the greater the likelihood that the regime will resort to money creation as a financing mechanism, which has obvious inflationary implications. Similarly, the larger is the level of public debt relative to national income and more quickly is this ratio increasing, the greater the likelihood that the regime will at some future date resort to an inflationary strategy in order to reduce the real value of debt servicing commitments. This strategy is termed seignorage, or an inflation tax. This account explains the paradox that tight money in the current period is not inconsistent with an increase in inflation expectations (2). A number of results follow from this analysis. Firstly, a stabilisation policy has to be wide- ranging, involving fiscal adjustment as well as monetary restraint. As some unknown Polish economist put it " you cannot cross a chasm in two leaps". Secondly, the existence of such policy inconsistency (or Stackleberg warfare) means that the current inflation rate is not a particularly good proxy for inflation expectations. The existence of a large differential in yields between short- term and long-term bonds will indicate pessimism concerning the expected future trend of inflation. Thirdly, the maintenance of stable exchange rate link is only possible with a convergence in fiscal policies as well as in monetary policies. Roubini argues that an EMS member must replace the old inconsistent trinity of monetary independence, perfect capital mobility and a fixed exchange rate with a new inconsistent trinity of fiscal autonomy, exchange rate stability and capital mobility. (3)

POLITICAL ECONOMY ISSUES

The problems encountered by some OECD countries in implementing fiscal adjustment programmes during the 1980s (e.g. Italy, Belgium and Ireland) has led to a realisation that representative agent models, such as the tax- smoothing approach, are not always helpful in understanding the determination of the levels of the budget deficit and the public debt. In the case of stabilising the debt to GNP ratio, a conflict exists between different groups in society as to what corrective action is required. Workers who do not hold government bonds will favour a capital levy on bondholders. Bondholders on the other hand prefer a programme of fiscal adjustment. Some, may advocate outright repudiation. As it turns out, membership of the EMS overrides these conflicts. With capital mobility, a capital levy is impractical, and the reputational impact of repudiation would be inconsistent with continued membership of such an organisation. The only consistent choice is that of a fiscal adjustment programme.

The problem of terminating a sequence of high budget deficits should also be addressed using a conflict- scenario analysis. Strong associations have been found between high deficits and (a) short- term regime tenures and (b) coalition-type structures of government (4). The former correlation may be explained as follows. If a regime knows its likely time- span is short it has no incentive to cut the deficit, as it will not have the time to make up the resulting loss in popularity before the next election. This lack of incentive may be construed as the absence of a punishment clause, the regime being "forgiven" due to its short term of office. A coalition- type governing structure creates a classic prisoner's dilemma situation. Each party in the coalition has an incentive to maintain its own spending programme and seek cuts in the other's programme. Again the problem is the absence of a punishment clause, as each party may blame the other for the failure to cut the deficit. This creates a stalemate situation with no action being taken to reduce the deficit. The outcome of this analysis is that, firstly, political stability is a requirement for a successful fiscal adjustment programme.

Secondly, political cooperation is highly desirable. It has been a noteworthy feature of successful stabilisations that they have often been preceded by a period of great political crisis, as it was only in such dire circumstances that such a political consensus could be formed.

IRELAND'S STABILISATION.

The Irish macroeconomic experience has in the 1980's has become something of a case study in the literature (5,6). The large premium on long-term bonds over German yields prior to 1987 may be interpreted as a case of the policy inconsistency problem outlined earlier, as the FG- Labour coalition's anti-inflation objective coexisted with a sequence of high deficits and an escalation in the debt problem. In this way, reductions in inflation were achieved at the cost of large output and employment losses. The failed devaluations and large capital outflows, together with growing despondency, at the end of 1986 created the required crisis conditions. Thus, the incoming FF regime faced the task of constructing a credible stabilisation programme. It was helped by the emergence of a parliamentary consensus and the Programme for National Recovery agreement with the unions and employers created a more general social consensus.

These conditions enabled the regime to implement a successful fiscal adjustment programme. A credibility bonus was achieved by the removal of the policy inconsistency problem so that yields have converged to German levels. The anti- inflation objective was no longer incredible, with further reductions in inflation having no adverse impact on output and employment in the last two years. To some, this evidence suggests that a rational expectations approach can be a very useful policy analysis technique on occasion. Mr. Haughey has claimed that Keynes was the only decent economist; but his strategy since 1987 might suggest that he is a closet admirer of Messrs. Lucas and Sargent!

My conclusion, then, is that the credibility paradigm offers valuable insights into the problem of stabilisation. The importance of credibility should be thought of as a highly democratic state of affairs, as the outcome of government policies is dependent on the decisions of the public rather than being a matter of dictat.

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