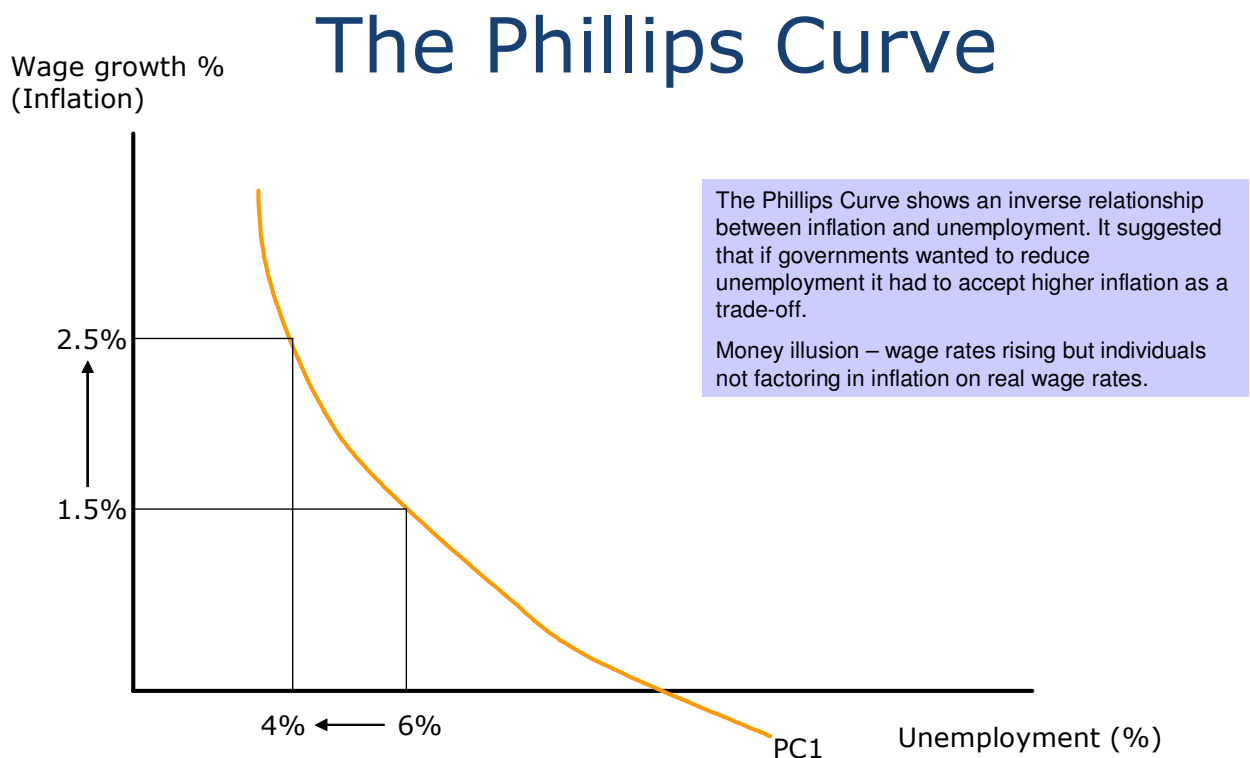


9

Opportunism and the Political Business Cycle

1. The Philips Curve
2. Political Business Cycle
3. Partisan Models of Monetary Policy
4. Partisan Theory
5. Some Empirical Evidence

The Phillips Curve



Helmut Schmidt: “I’d rather have five percent inflation than five percent unemployed.”

Note that the Phillips curve is an empirical regularity.

Is it also a model of choice???

DISCUSS!

The Missing Political Link of the Argument

Version 1:

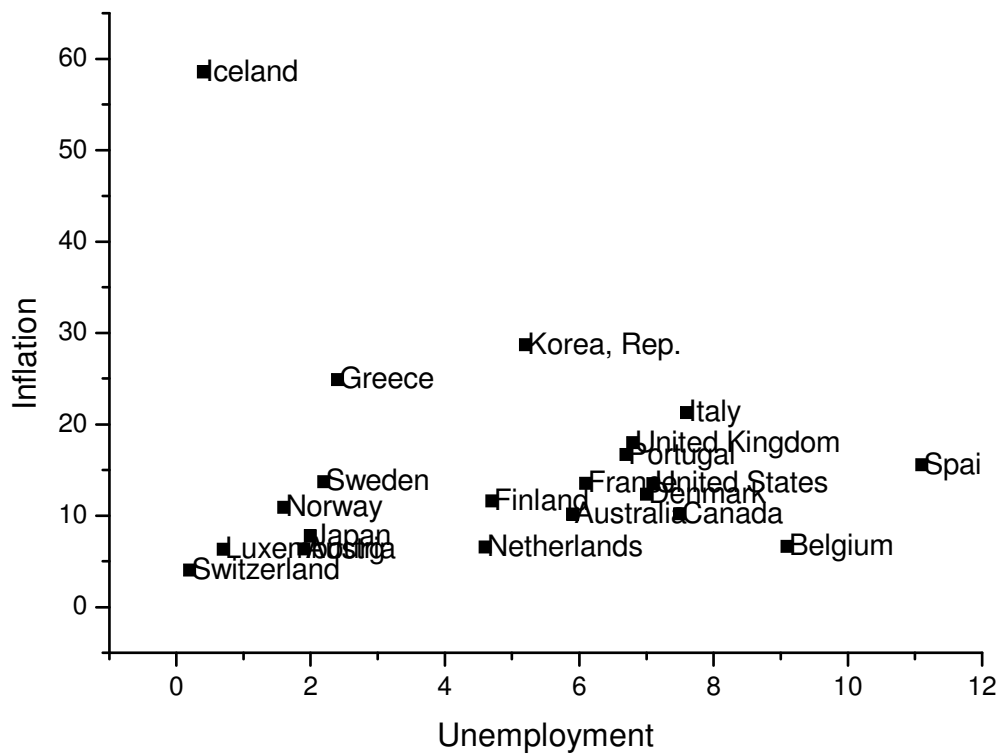
When unemployment is low, workers (unions) can demand relatively high wage increases. This pushes inflation upwards since corporations have to increase prices.

When unemployment is high, workers (unions) have less bargaining power and thus cannot push through high wage increases (regardless whether prices rise or not).

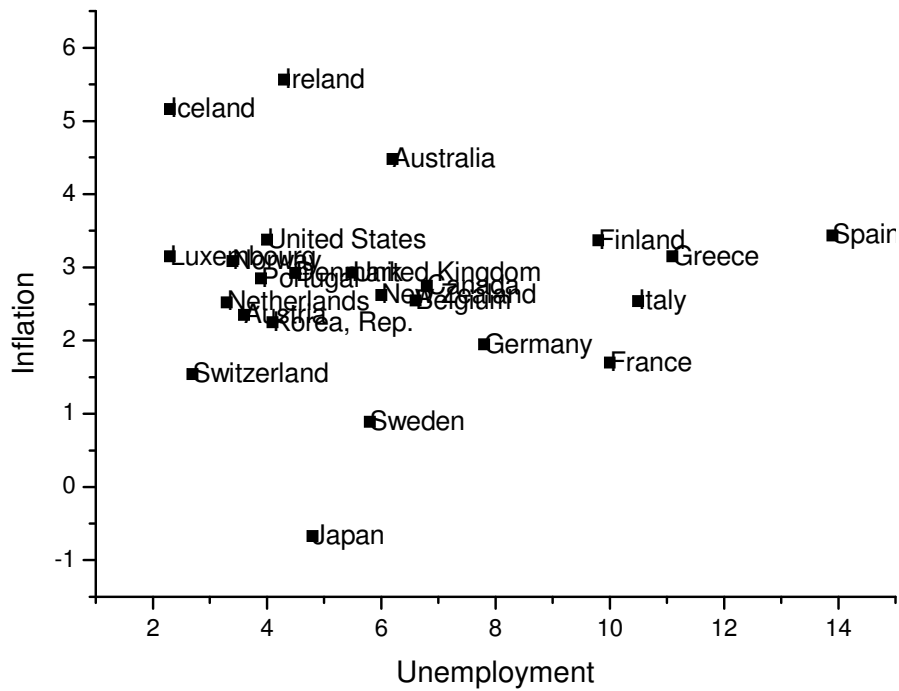
Version 2:

If inflation increases, because the government prints more money or cuts interest-rates, wages do not necessarily decline (that is what Keynes thought), nor does demand increase (that is what Phillips thought).

HENCE: the Phillips curve describes a purely functional logic, that cannot be exploited strategically.



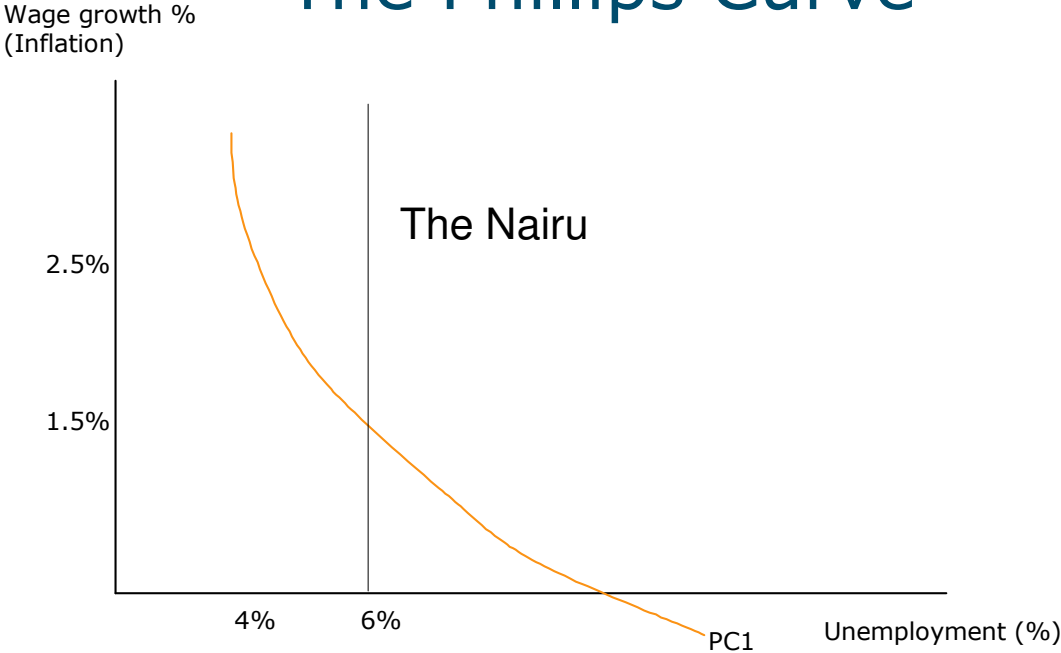
1980



2000

The NAIRU

The Phillips Curve



Opportunistic Government with Adaptive Voters

A1: Phillips curve

A2: Inflation expectations are adaptive

A3: Politicians are purely opportunistic

A4: Two Parties

A5: Voters prefer low unemployment and low inflation.

A6: Policymakers can stimulate demand, thereby reducing unemployment.

A7: Timing of elections is fixed.

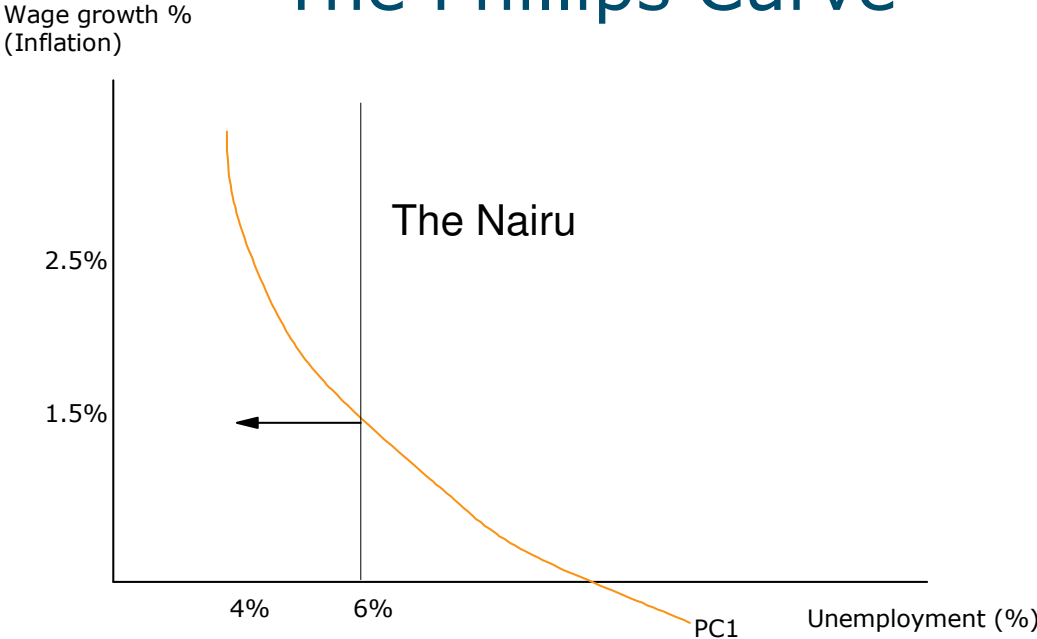
Results:

One period before elections, the incumbent stimulates the economy. Unemployment declines. In the period after the election, inflation rises and so does unemployment.

Adjustment under the NAIRU

Period 1

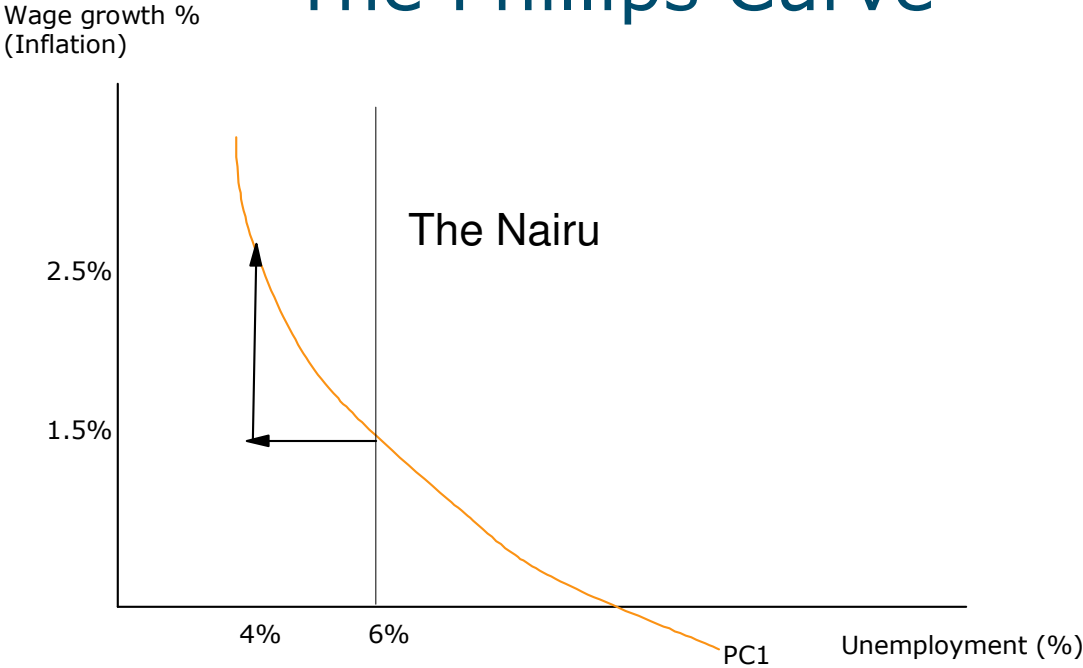
The Phillips Curve



Adjustment under the NAIRU

Period 2

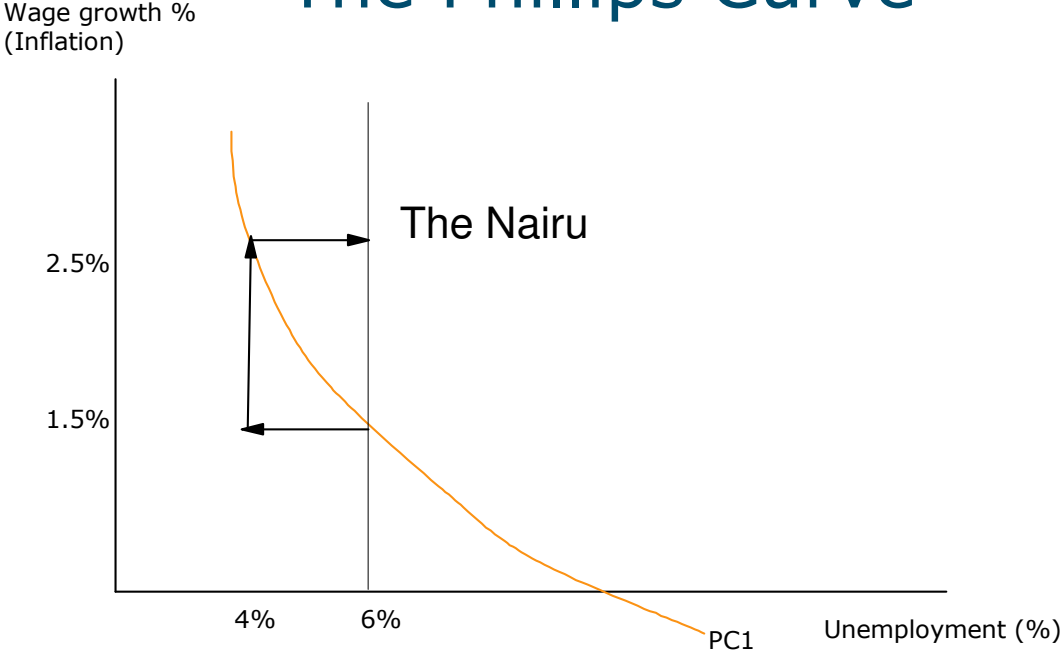
The Phillips Curve



Adjustment under the NAIRU

Period 3

The Phillips Curve



Accordingly, governments in the short run reduce unemployment, but in the long run and employment returns to the NAIRU, while inflation is higher.

A Rational Expectations Model of the Phillips Curve

Opportunistic Government with Rational Voters

A1: Phillips curve

A2: Inflation expectations are rational

A3: Politicians are purely opportunistic AND differ in skill

A4: Voters prefer skillful governments.

A5: Two Parties

A6: Voters prefer low unemployment and low inflation.

A6: Policymakers can stimulate demand, thereby reducing unemployment and rising inflation.

A7: Timing of elections is fixed.

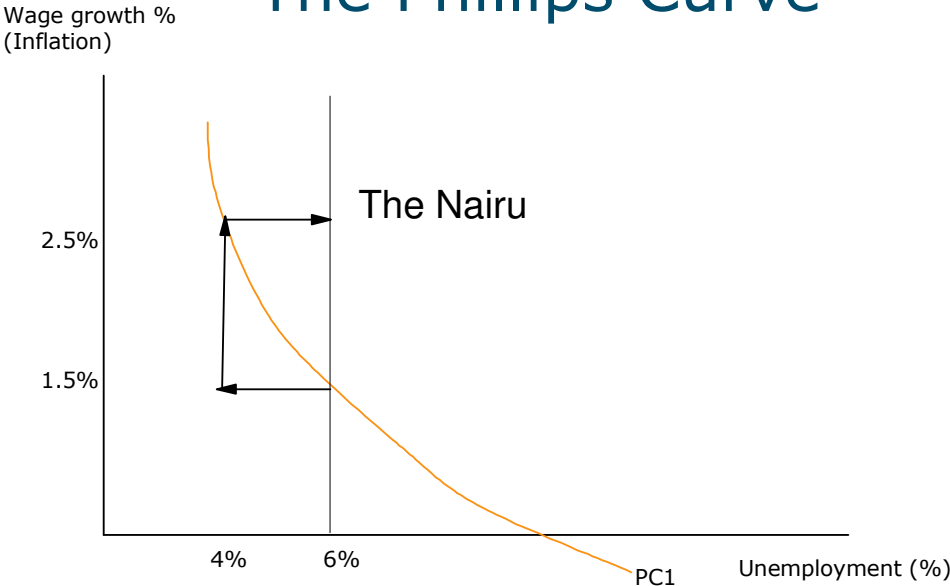
A8: Skillful governments have no effect on long-term inflation, less skilled governments increase inflation

Results:

One period before elections, the incumbent stimulates the economy. Unemployment declines. In the period after the election, inflation rises and so does unemployment.

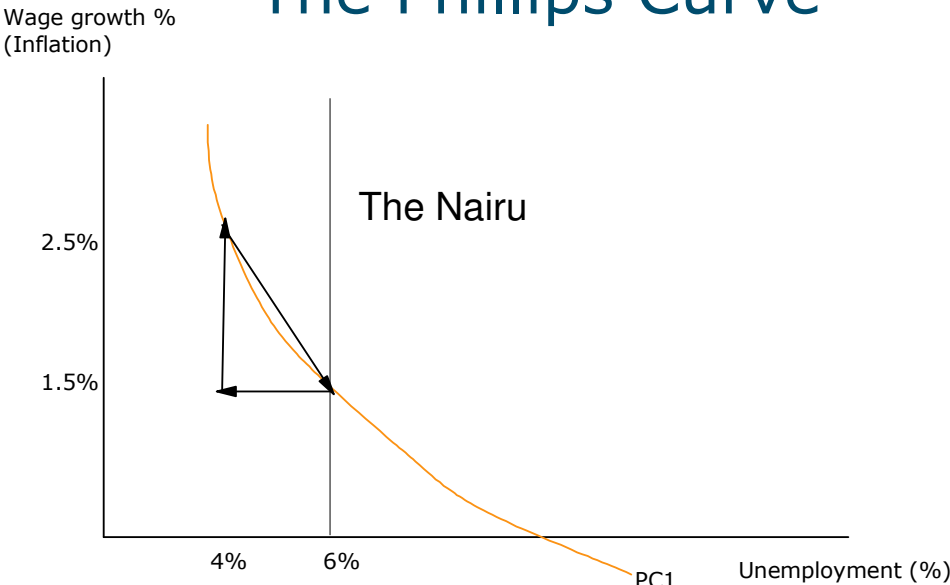
The Less skilled Government

The Phillips Curve



The Skilled Government

The Phillips Curve



Alternatives...

Partisan Theory

right parties favor low inflation

left parties favor low unemployment

partisan cycles

Empirical Evidence

```
xtregar govcon_per~p pop65 unemp_wdi leg_el_keefer, fe
```

```
FE (within) regression with AR(1) disturbances   Number of obs   =       711
Group variable (i): id                          Number of groups =        26
```

```
R-sq:  within = 0.0681          Obs per group: min =         5
        between = 0.2731          avg =       27.3
        overall = 0.2546         max =        30
```

```
corr(u_i, Xb) = 0.2996          F(3,682)         =       16.61
                                Prob > F             =       0.0000
```

```
-----+-----
govcon_per~p |      Coef.   Std. Err.   t    P>|t|   [95% Conf. Interval]
-----+-----
      pop65 |   .2259168   .1120895    2.02  0.044   .0058349   .4459987
    unemp_wdi |   .1501774   .0230728    6.51  0.000   .1048751   .1954796
leg_el_kee~r |   .0671419   .0314061    2.14  0.033   .0054775   .1288062
      _cons |   15.0407    .186011   80.86  0.000   14.67548   15.40592
-----+-----
      rho_ar |   .88359461
    sigma_u |   3.8626894
    sigma_e |   .59186301
    rho_fov |   .97706048   (fraction of variance due to u_i)
-----+-----
```

```
F test that all u_i=0:      F(25,682) =      14.60          Prob > F = 0.0000
```

Alesina/ Roubini/ Cohen

