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## Credibility of government policy: Lessons for economies in transition

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totalled between 900,000 and 1.1 million a year. The level of immigration described above as being required in the coming years is therefore already met by the existing flow of immigrants.

The majority of immigrants now come from Eastern Europe (ethnic Germans and non-German Eastern Europeans); Turks make up only a small part of the present net migratory flow—just under 50,000 a year between 1989 and 1991. In the next few years the press of immigrants from Eastern Europe and the new Länder is expected to be considerable: between 300,000 and 400,000 people a year are expected to move West from the new Länder for the next four or five years, up to 250,000 ethnic Germans will arrive and at least another 150,000 non-Germans from Eastern Europe will come until the year 2000.

To summarise, this means that:

in this decade, there is no great scope for additional Turkish immigrants, even in the Community context, as for political reasons alone it would be difficult to turn away immigrants from Eastern Europe, especially ethnic Germans.

In the first decade of the next century a controlled immigration of people, including Turks, would be

conceivable in order to offset the decline in the potential labour force in Germany and the EC.

In the decade after that it might make sense to grant freedom of movement for Turkish workers, as the negative effects of the population decline would have to be offset throughout the Community. At the same time, the slowdown in population growth in Turkey should begin to affect the potential labour force in that country.

Finally, it should be noted that the employers of the future will be looking increasingly for skilled workers.<sup>16</sup> If Turkey wanted to actively enhance the emigration opportunities of its population, this factor would have to be taken into consideration, by improving the country's occupational training system, in particular, but also by teaching foreign languages. However, it is not likely that Turkey will make expensive investment in the educational system in order to give skilled workers a better chance in labour markets abroad. As mentioned above, there is a danger that the very people who would be interested in emigrating are those who are desperately needed for the economic development of their own country.

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<sup>16</sup> Friedemann Stooß and Inge Weidig: Der Wandel der Tätigkeitsfelder und -profile bis zum Jahr 2010, MittAB No. 1/1990.

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## SYSTEM TRANSFORMATION

Norbert Funke\*

# Credibility of Government Policy: Lessons for Economies in Transition

*Reforms have to be credible in order to fully reveal the intended positive effects. This important lesson for economies in transition is illustrated by recent experiences in developing countries. The following article discusses several possible ways of enhancing credibility.*

**T**he ongoing transformation process in Central and Eastern European countries still requires reforms in many areas. Although the challenges facing the post-socialist countries are somewhat unique, most of the individual tasks of socialist economy reform have been tackled before in many developing countries. One lesson

that can be learned from these experiences is that a lack of credibility of government policy may be a serious obstacle to successful reforms.<sup>1</sup> This paper shows that it is not the appropriate policy measure *per se* but only a credible government policy that is the source of efficiency gains.<sup>2</sup>

The analysis of the credibility of government policy has been a central topic in economic theory since the late 1970s.<sup>3</sup> In contrast to its theoretical importance, the credibility of policy measures seems to play only a minor role in everyday policy-making. However, based on theoretical insights, the fear is that the desired positive

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effects of government activities will not be fully revealed, will fail to appear, or will even cause the initial economic situation to deteriorate as long as these policy measures do not appear sustainable. This is true for single policy areas such as tax/debt policy, monetary/disinflation policy, exchange-rate policy, and trade policy, but seems to be even more relevant in the case of comprehensive reforms. In particular, the neglect of credibility aspects may have far-reaching negative consequences for economies in transition. The possible effects of a lack of credibility are manifold; a lack of credibility

- has effects similar to macroeconomic distortions. Thus, the effects are similar to those of regulations, subsidies or taxes that do not aim to correct a market failure;
- can cause additional costs for private agents to gather information; and
- stimulates the counterproductive activities of special interest groups.

The analogy between a lack of credibility and economic distortions can be easily demonstrated by looking at trade liberalizations.<sup>4</sup> Beside direct consumer benefits, trade reform aims at an efficient allocation of resources. It works only to the extent that it moves resources from one sector to another, typically from import-substituting industries to export-oriented sectors, according to international price signals. However, moving capital and labour in and out of sectors may entail considerable adjustment costs, such as labour-training costs or sunk costs due to sector-specific machinery. The willingness of entrepreneurs to bear these costs depends on the perceived sustainability of the trade reform. The private sector tends to postpone necessary and beneficiary adjustment in order to avoid a wasteful shifting of resources back and forth. The effects of a lack of credibility are comparable to a tax on new investment. Furthermore, the expectation that the trade reform will be reversed sometime in the future may lead to an intertemporal substitution of consumption towards the

present. Consumers have an incentive to stock up on imported consumer durables as long as their prices are cheap. These additional imports may result in an undesired reduction of savings and can put pressure on the current account balance. From an empirical point of view, the above description is not a bad explanation for what took place in Chile in the late 1970s and in Mexico in 1988. Although an incredible trade liberalization gets current relative prices right, it distorts intertemporal relative prices. The overall effect is at least ambiguous.

To reduce the uncertainty about future activities of the state, rational economic agents will gather costly information until the expected marginal benefits equal the marginal costs of obtaining an additional unit of information. Obviously, the reduction of uncertainties and therefore the enhancement of credibility could substantially reduce these costs.<sup>5</sup>

Beside these additional costs of gathering information, economic agents have an incentive to form new special interest groups or increase the activities of existing interest groups. The potential success of interest group activities is higher if the objectives of the government are unclear or its commitment to reform is low.

In contrast, the example of the newly industrialized countries (NICs) in Southeast Asia illustrates the advantages of credible policies. Compared to many Latin American countries, the NICs found it relatively easy to obtain external credits to diminish the negative consequences following the external shocks of the last decade (highly volatile interest rates, changing commodity prices and world demand)<sup>6</sup> (see Table 1).

Empirical analysis by Hiemenz, Nunnenkamp et al.<sup>7</sup> supports the argument that one objective of reforms, the promotion of investment activities, is better achieved if reforms are credible. Partial reforms in a highly distorted economy are not sufficient for a sustainable improvement of the economic situation.

The above analysis demonstrates that the credibility of any policy measure is of crucial importance. In order to analyze the possibilities of enhancing the credibility of

<sup>1</sup> After two finance ministers had resigned in the first half of 1992 in Poland, the Economist chose the symptomatic title "Poland loses credibility". The Economist: Poland loses Credibility, Vol. 323, No. 7758, May 9th 1992, p. 5.

<sup>2</sup> This paper follows to some extent Norbert Funke: Die Glaubwürdigkeit von Wirtschaftsreformen: Bedeutung, Ursachen und Ansatzpunkte zur Lösung von Glaubwürdigkeitsproblemen, in: Die Weltwirtschaft, No. 2, 1991, pp. 175-186. A paper that shares many of the themes of this paper is the recent article on trade reforms and credibility by Dani Rodrik: Credibility of Trade Reform – a Policy Maker's Guide, in: The World Economy, Vol. 12, 1989, pp. 1-16.

<sup>3</sup> Surveys of recent credibility literature include Torsten Persson, Guido Tabellini: Macroeconomic Policy, Credibility and Politics, Chur, 1990, and Pierre-Richard Aenor, Mark P. Taylor: Testing for Credibility Effects, International Monetary Fund, Working Paper 91/110, Washington, November 1991.

<sup>4</sup> Cf. Dani Rodrik: The Limits of Trade Policy Reform in Developing Countries, in: Journal of Economic Perspectives, Vol. 6, 1992, pp. 87-105.

<sup>5</sup> Cf. Holger Schmieding: Lending Stability to Europe's Emerging Market Economies. On the Importance of the EC and the ECU for East-Central Europe, The Kiel Institute of World Economics, Working Paper No. 481, 1991.

<sup>6</sup> Deepak Lal: The Political Economy of Liberalization, in: The World Bank Economic Review, Vol. 1, 1987, pp. 273-299.

<sup>7</sup> Cf. Ulrich Hiemenz, Peter Nunnenkamp et al.: The International Competitiveness of Developing Countries for Risk Capital, Kieler Studien, No. 242, Tübingen 1992.

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**Table 1**  
**Share of Asia and Latin America in Total Net Resource Flows to Developing Countries**  
(per cent)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Asia	19.4	22.4	24.0	33.7	31.9	34.8	33.1	32.7	37.6	33.3	33.7
Latin America & the Caribbean	44.2	46.1	42.6	29.2	34.9	27.2	22.5	23.6	22.1	24.3	28.2

Source: Organisation for Economic Co-operation and Development (OECD).

government policy, the main reasons why credibility problems may arise will be reviewed briefly in the following.

### Reasons for a Lack of Credibility

A lack of credibility mainly arises because of inconsistent reforms, doubts about political sustainability, unclear government motives, the time-inconsistency of reforms and negative experiences with earlier policy measures.

One of the simplest reasons for a lack of credibility is when the announced reform violates *ex ante* budget constraints and accounting identities. The announcement of a drastic stabilization programme is hardly credible as long as the state still relies on revenue from inflation tax and no other new sources of revenue or expenditure cuts are available. The experiences of the Southern Cone countries during the 1970s demonstrate that inconsistent policies largely contribute to the ultimate failure of economic reforms.<sup>8</sup> In particular, the inappropriate policy mix of fixing the exchange rate to the US dollar without stopping the monetization of budget deficits and abolishing backward wage indexation schemes caused the programmes to fail. The 1986 Cruzado Plan in Brazil was similarly inconsistent. In an attempt to fight inflation, the government introduced a new currency, the Cruzado, and froze prices for goods and services without tackling the underlying problem, namely the high budget deficit. For economies in transition, a lack of credibility may result from the continued existence of "soft budget constraints".<sup>9</sup> As long as individual income streams appear flexible, because the state directly subsidizes potential loss-makers, increasing pressure on the state budget may ultimately lead to the re-emergence of inflation.

Even if reforms are consistent, doubts about their political sustainability may create credibility problems. At least in the short run, nearly every comprehensive reform is accompanied by undesired distributional effects. The expectation of considerable political opposition makes entrepreneurs reluctant to adjust immediately and may increase pressure to revert reforms. Zambia's ambitious reform programme is a primary example.<sup>10</sup> The government cut public expenditure, reduced subsidies to urban consumers, and started to auction foreign exchange. The induced depreciation of the domestic currency increased prices for imports, as well as the general price index. Urban unrest followed and the government ultimately reversed the reforms.

Unclear government motives may also contribute to a lack of credibility. Under rapidly deteriorating economic conditions, governments may tend to accept any conditionality simply to satisfy large creditors (e.g. World Bank, International Monetary Fund) temporarily. If the public anticipates that the reform is likely to be reversed soon because the government itself is not convinced of the necessity of substantial changes, a reform can hardly be credible. This scenario seems to be a reasonable description of the situation in many African countries or of the Philippine trade reform under President Marcos.<sup>11</sup>

Even if there are no doubts about the government's general willingness to reform, the time inconsistency of policy measures may present a serious obstacle to success. A policy is time inconsistent when policy decisions that are optimal from the current viewpoint will no longer be optimal in the future, even though no relevant new information has been available in the meantime. This concept can easily be applied to comprehensive

<sup>8</sup> Cf. Ulrich Hiemenz, Rolf Langhammer: Liberalisation and the Successful Integration of Developing Countries into the World Economy, in: Geoffrey T. Renshaw (ed.): Market Liberalisation, Equity and Development, Geneva 1989, pp. 105-139.

<sup>9</sup> Cf. János Kornai: Economics of Shortage, Amsterdam 1980.

<sup>10</sup> Cf. The World Bank: World Development Report 1991, The Challenge of Development, Oxford 1991, pp. 115-116.

<sup>11</sup> Cf. Dani Rodrik: Credibility of Trade Reform ..., op.cit.

<sup>12</sup> Cf. Horst Siebert: The Transformation of Eastern Europe, The Kiel Institute of World Economics, Discussion Papers, No. 163, January 1991.

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economic reforms. Under the assumptions that comprehensive reforms follow the pattern of a J-curve<sup>12</sup> in production and employment and governments want to cushion the temporary decline in production and employment, a typical time inconsistency problem may arise.<sup>13</sup> It is ex ante optimal for the government to announce a comprehensive stabilization-cum-liberalization programme. Rational private agents, however, anticipate the government's incentive to renege on earlier announcements and form expectations accordingly. After the private sector has formed its expectations, it is indeed no longer optimal for the government to stick to its previous announcement. The government's actual adjustment efforts will be smaller than socially optimal. The adjustment efforts will be

weaker, the stronger the government's inclination to cushion the short-run decline in production and employment, the smaller the expected long-run benefits of the reform (and the less weight the government attaches to long-run effects), and the less the government's concern about its reputation. Reform efforts would be stronger if the government were credible or able to commit itself to comprehensive reforms.

Independent of concrete government objectives, the credibility of government policy may depend, to a large extent, on country-specific economic and political history (cf. Table 2). In an extremely volatile political environment, where changes in government occur frequently, a perpetual lack of confidence is created. Political instability often goes hand in hand with economic instability (Table

**Table 2**  
**Changes in Government, 1970 to Present, Argentina, Bolivia, Brazil**

Country/Date	Head of Government	Form of Government
<b>Argentina</b>		
6/1966- 6/1970	Juan Carlos Onganía (deposed)	Military
6/1970- 3/1971	Roberto Levingston (deposed)	Military
3/1971- 5/1973	Alejandro Lanosse	Military (transitional)
5/1973- 8/1973	Héctor Cámpora	Directly elected
8/1973- 7/1974	Juan Perón	Directly elected
7/1974- 3/1976	Isabel Perón (deposed)	Succeeded Juan Perón on his death
3/1976- 3/1981	Jorge A. Videla	Military
3/1981-12/1981	Roberto Viola	Military
12/1981- 6/1982	Leopoldo Fontunato Galtieri	Military
6/1982-12/1983	Reynaldo Bignone	Military (transitional)
12/1983- 7/1989	Raúl Alfonsín	Directly elected
7/1989-	Carlos Menem	Directly elected
<b>Bolivia</b>		
9/1969-10/1970	Ovando Candia (deposed)	Military
10/1970- 8/1971	Juan José Torres (deposed)	Military
8/1971- 7/1978	Hugo Bánzer Suárez	Military-civilian(1971-1973); military (1973-1978)
7/1978-11/1978	Juan Pereda Asbún (deposed)	Directly elected
11/1978- 8/1979	David Padilla	Military (transitional)
8/1979-11/1979	Wálter Guevara Arze (deposed)	Civilian-interim
11/1979	Natusch Busch	Military
11/1979- 6/1980	Lydia Gueiler (deposed)	Civilian-interim
6/1980- 8/1981	Luis Garía Mesa (deposed)	Military
8/1981- 9/1981		Military junta
9/1981- 7/1982	Celso Torrelio Villa (deposed)	Military
7/1982-10/1982	Guido Vildoso Calderon	Military (transitional)
10/1982- 8/1985	Hernán Siles Zuazo	Indirectly elected
8/1985- 8/1989	Paz Estenssoro	Directly elected
8/1989-	Jaime Paz Zamora	Directly elected
<b>Brazil</b>		
10/1969- 3/1974	Emilio Garrastazu Medici	Military
3/1974- 3/1979	Ernesto Geisel	Military
3/1979- 3/1985	Joao Baptista Figueiredo	Military
3/1985- 3/1990	José Sarney	Indirectly elected <sup>1</sup>
3/1990-10/1992	Fernando Collor de Melo	Directly elected
10/1992-	Atamar Franco	Assumption of office <sup>2</sup>

<sup>1</sup> Sarney was chosen vice-president, and assumed the presidency on the death of the presidential candidate, Tancredo Neves.

<sup>2</sup> After the impeachment of Fernando Collor de Melo, Atamar Franco was only interim president until his predecessor resigned at the end of December 1992.

Source: Update of Stephan Haggard, Robert Kaufman: The Politics of Stabilization and Structural Adjustment, in: Jeffrey Sachs (ed.): Developing Country Debt and Economic Performance, Vol. 1, The International Financial System, Chicago 1989, pp. 240 f.

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**Table 3**  
**High Inflation and Stabilization, 1970-1989**  
(monthly percentages and numbers of months and years)

	Average monthly inflation rate <sup>1</sup>			Peak monthly rate (date)	Number of months with rate > 50 % (> 25 %)	Number of years with annual rate > 100%	
	1970-79	1980-85	1986-90			'70-'79	'80-'89
Argentina	6.8	11.9	19.0	197 (7/89)	5(18)	5	10
Bolivia	1.4	18.5	2.1	182 (2/85)	9(16)	—	5
Brazil	2.4	7.9	19.7	84 (2/90)	4(18)	—	8

<sup>1</sup> Monthly averages refer to periods from January of the first year to December of the last year except for 1990, for which most data reach only up to January-February.

Source: Michael Bruno: Introduction and Overview, in: Michael Bruno, Stanley Fischer et al. (eds.): *Lessons of Economic Stabilization and its Aftermath*, Cambridge, Mass. 1991, p. 4.

3). Brazil, for example, initiated 9 different reform programmes between 1979 and 1991. Price policy was changed 24 times, wage policy 20 times, and the exchange rate policy 16 times.<sup>14</sup> Obviously, another announcement would just be met with substantial scepticism.

### Enhancing Credibility

Having analyzed the importance of and main reasons for a lack of credibility, the possibilities of coping with this serious obstacle to success should be discussed. In general, a lack of credibility seems to be of less importance in more flexible economies, where the shifting of resources in and out of sectors is less costly. The removal of rigidities that hinder the adjustment process, as well as an economic policy that encourages mobility (e.g. labour training programmes), may help to reduce the possible negative effects of a lack of credibility. Furthermore, a government can increase its credibility by:

- clearly signalling its willingness to reform,
- "tying its own hands", and
- sticking to previous announcements, thereby increasing public confidence gradually.

<sup>13</sup> Cf. Peter Nunnenkamp, Norbert Funke: *Woran scheitern Stabilisierungs- und Liberalisierungsprogramme? Lehren aus Entwicklungsländern für den Transformationsprozeß in Osteuropa?*, in: Roland Herrmann, Friedrich L. Sell (eds.): *Wirtschaftliche Liberalisierung in Industrie- und Entwicklungsländern*, Schriften des Zentrums für regionale Entwicklungsforschung der Justus-Liebig-Universität, Hamburg 1992, pp. 153-174.

<sup>14</sup> Cf. Norbert Funke, *op.cit.*

<sup>15</sup> Cf. Dani Rodrik: *Credibility of Trade Reform ...*, *op.cit.*

The less credible the government or its reform programme is in the beginning, the more important it is to signal the commitment to reform clearly. Radical action as in Turkey in 1980 and in Bolivia in 1985 is one way to signal commitment. In Turkey, Deputy Prime Minister Özal undertook a devaluation in 1980 that was far beyond previous expectations and three years later he abolished most quantitative import restrictions practically overnight.<sup>15</sup> The inflation rate in Bolivia reached its peak in 1985 (above 20,000% p.a.) The new government under President Paz Estenssoro voted for shock therapy. Money supply was stabilized, import restrictions abolished, subsidies and the budget deficit reduced, and the tax system redesigned. After the inflation rate had fallen to roughly 10% in July 1987, it remained relatively stable in the range of 10% to 20%.<sup>16</sup> Although the credibility of the programme appeared to be low in the beginning,<sup>17</sup> clear signals elucidated the government's commitment.

The recent Polish experience at the beginning of 1990 shows that a simultaneous stabilization and liberalization strategy is also one crucial element of providing coherent and credible market signals to economic actors in the transformation process. The initial success in stabilizing the economy has been quite impressive, although the initial price shock was higher than generally expected. The monthly inflation rate fell rapidly from 79.6% in January

<sup>16</sup> Cf. Miguel A. Kiguel, Nissan Liviatan: *Inflationary Rigidities and Orthodox Stabilization Policies: Lessons from Latin America*, in: *The World Bank Economic Review*, Vol.2, 1988, pp. 273-298.

<sup>17</sup> Cf. Jeffrey Sachs: *The Bolivian Hyperinflation and Stabilization*, National Bureau of Economic Research Working Paper, No. 2073, Cambridge, Mass. 1986.

1990 to 4.3% in March 1990. The collapse of output, the increasing unemployment and the persistence of inertia inflation which followed, however, indicate that stabilization and liberalization need to be complemented by other measures. More detailed analyses have pointed to the importance of hardening budget constraints and comprehensive financial market reforms early in the transformation process.<sup>18</sup>

Beside signalling its commitment, a government can try to "tie its own hands" and thereby reduce its ability to reverse reforms. Rodrik<sup>19</sup> uses the illustrative analogy of Ulysses, who had himself tied to the mast of his ship so that he could not be trapped by the Sirens' call. The creation of independent institutions, such as an independent central bank, backed by a constitutional or less fundamental law may reduce the government's ability to follow a short-sighted policy. Moreover, the policymaker can appoint a conservative central banker, who places a higher weight on inflation-stabilization than the policymaker himself (the public).<sup>20</sup> Furthermore, entering into agreements with international organizations or institutions may help to increase credibility. Typical examples refer to IMF-programmes or joining the General Agreement on Tariffs and Trade (GATT). Mexico seems to have used entry into the GATT to reduce the uncertainty associated with its recent trade liberalization.

In addition, using an exchange-rate policy has been suggested as a means of "tying one's hands". The theory of comparative advantage provides this proposal with an appealing basis. Developed market economies are supposed to have a comparative advantage in providing credibility. Consequently, developing countries or Central and East European countries could benefit from importing that credibility. By assigning all monetary functions to one or more Western economies or by joining a currency union credibility could be enhanced.<sup>21</sup>

Although credibility will be increased if the perceived political costs of exit rise, all these examples demonstrate that the literature on credibility is still in its infancy. Laws can sometimes be changed easily, institutions dismantled, exchange-rate regimes abandoned, and politicians (central bankers) removed from office.

Furthermore, the attempt to increase credibility by "tying one's hands" is not without costs. The

policymaker's flexibility in responding to external shocks is artificially reduced. As a result, the *ex ante* optimal policy commitment would be contingent on the state of the world. However, in practice, it is impossible or prohibitively costly to foresee and specify all possible contingencies. Recently, Lohmann<sup>22</sup> has demonstrated that escape clauses or the ability of policymakers to override the decisions of an independent central banker, for example, may improve welfare. In her analysis, a partially independent conservative central banker dominates a number of other institutional frameworks. The perceived trade-off between credibility enhancing commitments and a loss of flexibility clearly deserves further research.

Finally, governments can enhance their credibility by sticking to their announcements, thereby gradually improving their reputation. In this context, it seems to be of special importance that the potential beneficiaries of the reform are identified and organized in order to prevent counterproductive political opposition.<sup>23</sup>

### Concluding Remarks

It is argued that government policy has to be credible in order to lead to the desired positive effects. Theoretical analyses, as well as the experiences of many developing countries with stabilization and liberalization programmes, support the importance of credibility aspects.

To increase the credibility of a comprehensive reform governments should signal commitment. Even a simple announcement may be informative, because the public knows that a policymaker who reneges on promises incurs a cost. Hence, a statement may convey some new information about the likelihood of a specific policy measure.<sup>24</sup>

Furthermore, governments can tie their own hands in order to reduce uncertainty about their political decisions. "Tying one's hands" is not without its costs, but it seems to be necessary for enhancing credibility. With increasing confidence in government policy, improved reputation may be a valuable substitute for self-imposed ties.

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<sup>18</sup> Martin Raiser: *Soft Budget Constraints: An Institutional Interpretation of Stylised Facts in Economic Transformation in Eastern Europe*, The Kiel Institute of World Economics, Working Papers, No. 549, December 1992; cf. Norbert Funke: *Timing and Sequencing of Reforms: Competing Views*, The Kiel Institute of World Economics, Working Papers, No. 552, January 1993.

<sup>19</sup> Cf. Dani Rodrik: *Credibility of Trade Reform ...*, op.cit.

<sup>20</sup> Kenneth Rogoff: *The Optimal Degree of Commitment to an Intermediate Monetary Target*, in: *Quarterly Journal of Economics*, Vol. 100, 1985, pp. 1169-1190.

<sup>21</sup> Cf. Holger Schmieding, op.cit.

<sup>22</sup> Cf. Susanne Lohmann: *Optimal Commitment in Monetary Policy: Credibility versus Flexibility*, in: *American Economic Review*, Vol. 82, 1992, pp. 273-286.

<sup>23</sup> Cf. Peter Nunnenkamp, Norbert Funke, op.cit.

<sup>24</sup> Alex Cukierman, Nissan Liviatan: *Optimal Accommodation by Strong Policymakers under Incomplete Information*, in: *Journal of Monetary Economics*, Vol. 27, 1991, pp. 99-127.