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Measurement issues in political economy

Leertouwer, E.

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Chapter 8

Concluding remarks

The aim of this thesis is to provide valid measurements for a number of important variables in the field of political economy that do not depend on subjective judgement. Subsequently, these newly constructed measures have been applied in empirical models in order to assess the influence of the variables under scrutiny on economic and monetary policy outcomes. In this chapter, the results are summarized.

In chapter 2, we have discussed the methodology that is used throughout the chapters 3 to 7. An overview of latent variables models is given, as well as the procedures to estimate them. Corresponding issues such as correcting the underestimation of the coefficient and criteria concerning model selection and model fit are discussed. Also, an exact test that can be used to examine the presence of dynamics and unit root behaviour in panel data models is described.

In chapter 3, we have shown how the partial conflict between competing indicators of central bank independence can to a certain extent be resolved using latent variables modeling. We have disentangled the concepts of CBI and central bank conservativeness and constructed a measure of CBI proper in 22 OECD countries, for the period 1980–1989. The resulting ordering of countries by the degree of CBI is of interest by itself, but the results also allow for more satisfactory statistical inference in regression models in which CBI is an explanatory variable. In contrast to the results of the influential study by Campillo and Miron (1997), we find that the CBI indicator we have constructed is significantly related to inflation, also when various control variables as suggested by Campillo and Miron are included. Finally, the CALS estimator has been used to deal with problems concerning measurement error and underestimation of the coefficient of CBI. Use of this estimator leads to a reasonable increase of the estimated coefficient, while the significance of the results remains intact. We have

also created measures of CBI for other time periods.

In chapter 4, we have examined whether central banks can be held responsible for political business cycles in monetary policy outcomes. Using short-term interest rates to measure the monetary policy stance, we have tested whether central banks in 14 OECD countries have indeed created PBCs and whether the degree of CBI is crucial to prevent that. We have established evidence from two outcomes. First, we have conducted country-specific tests in which short-term interest rates are regressed on election dummies, variables describing national and international constraints and a number of control variables. The results of these tests show hardly any support for the PBC hypothesis. The second source of evidence stems from panel data regressions. After determining the correct model specification using exact tests to test for dynamics and unit root behaviour, we find that the estimation results provide more or less the same picture as the country-specific results. There is no evidence that central banks actively create PBCs. Overall, the implications are clear. If PBCs in macroeconomic variables such as unemployment show up, then the central banks should not be blamed. Either their actions have no effect, or they simply do not engage in short-sighted behavior.

In chapter 5, two new indicators for the institutional settings of the labour market in the 1970s and early 1980s have been constructed using the information provided by indicators for corporatism that have been suggested in the literature. Following a latent variables approach, two indicators that we label *coordination* and *organizational power of labour* have been obtained. For illustrative purposes, these measures are applied in the models of Hall and Franzese for inflation and unemployment. In contrast to their results, we find no evidence that interaction effects between the level of central bank independence and coordination play an important role with respect to unemployment. Also, the impact of organizational power of labour on inflation and unemployment, which has been reported in various previous studies, is not found in our regressions.

Chapter 6 returns to the conservativeness of central banks. The degree of conservativeness is measured using the rate and variability of inflation, variability of output and the conservativeness component that was isolated from one of the CBI indicators in chapter 3. For a sample of 14 European countries it is shown that, unsurprisingly, the rate of inflation is the most important indicator of conservativeness. The indicator of Cukierman, which has been designed specifically to measure conservativeness, does not seem to be of much use. Also, when results for the 1980s and 1990s are compared, the analysis shows that there have not been major changes in the degree of conservativeness. Further, the im-

pact of conservativeness on unemployment has been examined using the newly constructed measure. Only if trade openness is included as a control variable in the model, the coefficient of conservativeness is significant. Finally, CALS estimators that correct for the underestimation of the conservativeness coefficient have been used. This leads to a reasonable increase of the (absolute) coefficient values, while the (in)significance of the results is unaffected.

In chapter 7, finally, the relationship between economic freedom and economic growth is assessed. Instead of using a measure of economic freedom based on an (ad hoc) aggregation of various underlying components, as is often the case in the literature, we construct a measure of economic freedom using principal components analysis. We argue that the alternative aggregation procedure as recently suggested by Heckelman and Stroup (2000) - in which aggregation is directly based upon the relevance of each component for growth, as determined by multivariate regression analysis - has serious shortcomings. Using standard robustness analyses, we find that the level of economic freedom is not robustly related to economic growth.

