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Does government ideology matter in monetary policy? A panel data analysis for OECD countries

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A B S T R A C T

This paper examines whether government ideology has influenced monetary policy in OECD countries. We use quarterly data in the 1980.1–2005.4 period and exclude EMU countries. Our Taylor-rule specification focuses on the interactions of a new time-variant index of central bank independence with government ideology. The results show that leftist governments have somewhat lower short-term nominal interest rates than rightwing governments when central bank independence is low. In contrast, short-term nominal interest rates are higher under leftist governments when central bank independence is high. The effect is more pronounced when exchange rates are flexible. Our findings are compatible with the view that leftist governments, in an attempt to deflect blame of their traditional constituencies, have pushed market-oriented policies by delegating monetary policy to conservative central bankers.
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1. Introduction

Many scholars have investigated how government ideology influences monetary policy instruments such as interest rates in OECD countries (e.g., Alesina et al., 1997; Boix, 2000; Clark, 2003; Sakamoto, 2008). Politicians, however, do not have a direct influence on interest rates, but are

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subject to institutional restrictions, most notably central bank independence. Ideology-induced politicians can therefore manipulate interest rate policies only when central banks are not independent and subject to directives of the government. Some previous empirical research has dealt with this interaction between central bank independence and government ideology. In contrast to the predictions of the partisan theories, it transpires that leftist governments do not always conduct expansionary monetary policies: when central bank independence was high, interest rates have rather been higher under leftist governments. These previous studies have, however, several shortcomings such as: (1) employing annual data although interest rates are remarkably volatile, (2) choosing ad-hoc econometric frameworks, (3) not considering exchange rate regimes and (4) not considering that government ideology may also influence inflation and the output gap (Berger and Woitek, 2005). This paper deals with these shortcomings to re-examine whether leftist governments have implemented more expansionary monetary policies than rightwing governments.

Our empirical strategy is to include government ideology, central bank (in)dependence and their interaction in a Taylor-rule specification. We use a dataset containing quarterly data from 1980.1 to 2005.4 for 23 OECD countries excluding EMU countries, the government ideology index by Potrafke (2009), the new time-variant index on central bank (in)dependence by Arnone et al. (2007) and Klomp and De Haan (2009), and the exchange rate regime data proposed by Reinhart and Rogoff (2008). The results show that leftist governments have somewhat lower short-term nominal interest rates than rightwing governments when central bank independence is low. In contrast, short-term nominal interest rates are higher under leftist governments when central bank independence is high. The effect is more pronounced when exchange rates were flexible. Our findings are compatible with the view that leftist governments, in an attempt to deflect blame of their traditional constituencies, have pushed market-oriented policies by delegating monetary policy to conservative central bankers.

The paper is organized as follows. Section 2 discusses theoretical considerations of the influence of government ideology on monetary policy and reviews the empirical literature. Section 3 presents the data and specifies the empirical model. Section 4 reports the regression results and investigates their robustness, and Section 5 discusses the implications of the results.

2. Theoretical background and empirical evidence

2.1. Partisan approach

The partisan approach is based on the assumption that politicians provide policies that reflect the preferences of their clienteles (partisans).[2] Leftist parties appeal more to the labor base and promote expansionary policies, whereas rightwing parties appeal more to capital owners and are therefore more concerned with reducing inflation. This characterization holds for both branches of the partisan theory – the classical approach (Hibbs, 1977) and the rational expectations approach (Alesina, 1987).[3] The traditional partisan theory contains that leftist governments produce higher inflation and lower unemployment. The rational partisan theory, on the other hand, predicts upward (downward) post-election blips in unemployment for rightwing (leftwing) regimes due to wage rigidities in an environment of electoral uncertainty.

The implications of the partisan theories have been tested empirically by investigating various policy instruments. Several studies – mainly undertaken in the late 1980s and the early 1990s – have focused on money growth, fewer studies have analyzed political manipulations of interest rates. Central bank independence has been ignored in this literature. For encompassing surveys on empirical tests of the partisan theories till the mid 1990s see, for example, Belke (1996).

[2] By contrast, the political business cycle theories imply that politicians – independent of their respective party couleur – will implement the same expansionary economic policies before elections. In other words, before elections political ideology retires to the background, and policies converge (see, for example, Alesina et al., 1997 on the different approaches). On monetary political business cycle in open economies see, for example, Dreher and Vaubel (2009).

[3] For a survey of the literature see, for example, Alesina et al. (1997), Belke (1996) or Drazen (2000).

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