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Who creates political business cycles: should central banks be blamed?☆

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Abstract

Little attempt has been made in studies on political business cycles (PBCs) to separate the effects of fiscal and monetary policy. We assess the effect of monetary policy in a panel model for 14 OECD countries. To answer the question whether central banks actively create political business cycles, we focus on the short-term interest rate as a proxy for the use of monetary instruments. Our results indicate that central banks should not be blamed for creating political business cycles. We find no evidence of cyclical behavior in the short-term interest rate. This conclusion holds whether or not central banks are regarded independent or are constrained by the exchange-rate system.

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1. Introduction

There are two principal reasons why central banks are independent. First, the inflationary bias is reduced. Many empirical studies provide evidence for that.[1] Second, "the most obvious advantage a fully independent central bank has is that

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[1] See Eijffinger and de Haan (1996) for an overview. Posen (1998), however, challenges this view by providing evidence that a higher degree of central bank independence does not reduce disinflation costs.

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of not being influenced by electoral deadlines" (Muscatelli, 1998). That the incumbent government may be inclined to stimulate the economy before elections to enhance reelection probabilities is well-known.[2] Are central banks also influenced by electoral deadlines? Put differently, if we observe political business cycles (PBCs) in macroeconomic variables, such as unemployment and the growth rate, who is responsible for creating them—and who should or should not be blamed?

Surprisingly, the empirical literature has little to say about the exact role of governments and central banks when it comes to PBCs. Worse, in most previous studies, different institutional features have largely been neglected. Often, the scope for electorally motivated monetary policies is reduced, since national or international restrictions bind central bankers. In a regime of fixed exchange rates, for example, opportunistic policies are less likely to occur than in a flexible exchange-rate system. Similarly, independent central banks are less likely to be involved in electorally motivated policies than central banks that are under the spell of the government. The restricting effects of these institutional features are recognized in economic theory; yet, empirical papers on political business cycles do not explicitly control for them.

Clark et al. (1998) argue that common cross-country studies of PBC models may be seriously flawed since they do not account for institutional differences that constrain national policymakers.[3] However, these authors only examine economic outcomes (output growth and unemployment). Although these variables are likely to be influenced by monetary policy, there are a number of other influences that may offset or reinforce the impact of monetary policy. Furthermore, the rational political business cycle predicts that policymakers manipulate instruments, while the effects on outcomes are less certain.

This paper tends to fill this gap by focusing on policy outcomes for which the central bank can be held responsible, namely the short-term interest rate. We can thereby answer the question whether the central bank can be blamed for active opportunistic behavior. Our sample runs from the 1960s until 1997 and consists of monthly data for 14 OECD countries.

The results are simple and strikingly robust. The short-term interest rate shows hardly any sign of a political business cycle. We thus reject the hypothesis that central banks have actively engaged in opportunistic behavior.

The outline of the paper is as follows. In the next section, we explain the political business models in more detail and show how internal or external constraints can prevent politicians from using monetary policy for short-sighted purposes. Our estimation results are presented in Section 3. In Section 4, we summarize our findings.

[2] See Alesina et al. (1997) for an overview.

[3] Clark and Hallerberg (2000) formulate this idea in terms of a theoretical model.