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Political shocks and public debt: The case for a conservative central bank revisited

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Abstract

We explore the dynamics of public debt and optimal institutions in the presence of political shocks arising from electoral uncertainty. Under commitment, optimal stabilization is established by combining an inflation target with a debt target. The inflation target should be contingent on the political shocks while the debt target forces the government to fully absorb the political shocks in the period in which it occurs. In the absence of such inflation and debt targets but with monetary commitment, a conservative central bank enhances stabilization. An even more conservative central bank is optimal if monetary policy cannot commit.

JEL classification: E52; E58; E61; E62

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1. Introduction

Research into political monetary cycles goes back to Hibbs' (1977) work on the relationship between the inflation-unemployment trade off and the political color of

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the government. Later work includes Alesina (1987), as well as a number of papers that suggest institutional reforms to alleviate politically induced cycles in monetary policy (see, e.g., Alesina and Gatti, 1995; Muscatelli, 1998; Al-Nowaihi and Levine, 1998). More recent work links political monetary cycles to fiscal policy (see, e.g., Demertzis et al., 1999; Ozkan, 2000; Pina, 2000; Drazen, 2001).[1]

The current paper extends the work on political monetary cycles and fiscal policy by incorporating public debt. The existing literature either employs a single-period setting or assumes a balanced government budget in each period. The introduction of public debt raises both positive and normative issues. Positive questions are how shocks should be spread out over time and whether the intertemporal transmission of political shocks (the news that a new government has been elected) differs from that of standard supply shocks. A normative issue involves the way public debt affects optimal institutional design, including that of the central bank. Are also fiscal restrictions called for and, if so, how do political shocks affect these optimal restrictions?

To explore these issues, we extend the standard Barro and Gordon (1983) framework with both fiscal policy and political shocks arising from electoral uncertainty. The political structure is characterized by two political parties that differ in their preferences about the level of government spending. This type of conflict has received only little attention in the literature on political monetary cycles, even though in reality political parties often differ strongly in their views on the desirable size of the public sector.[2] Our formulation of the conflict extends Pina (2000) by formulating a dynamic two-period model in which public debt is endogenous.[3]

We start the analysis with the case in which the central bank can commit to monetary policy. While commitment is less realistic than discretion, it enables us to gain insights into the impact of the distortion of political shocks before moving on to the more complicated situation in which discretion yields additional distortions. In this way, we conduct the normative analysis of welfare-enhancing institutional adjustments in several steps, in which we progressively strengthen the case for a conservative central banker (à la Rogoff, 1985), who attaches a larger preference weight to price stability than the rest of society does. Indeed, in contrast to the existing literature on central bank conservatism, we show that a conservative central bank may be optimal even if monetary policy can commit.

The case of monetary commitment yields the following results. As regards the positive results, supply shocks and political shocks affect public debt in different

[1] Electoral cycles in fiscal policy have been studied by Rogoff (1990).

[2] An important branch of the literature (going back to Nordhaus, 1975) points to opportunistic (re-election) motives as the main source of political business cycles. However, ideological differences (e.g., on the extent to which intervention in the market system is desirable) typically drive changes in political preferences about the government's size. Therefore, our partisan model of political parties characterized by different preferences (see also Alesina, 1987) is most suitable for our purposes.

[3] The current model extends Beetsma and Bovenberg (1999, 2005) by including political shocks. Beetsma and Bovenberg (2005) focus on fiscal discretion while nominal wages are determined two periods ahead. Here, we abstract from this complication.