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The German political business cycle: money demand rather than monetary policy

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Abstract

Arguably, Germany had the world's most independent central bank. Surprisingly, however, recent work has found political business cycles in German monetary aggregates. It is hard to explain this with standard models of opportunistic government behavior. Instead, we show that the cycles originate from shifts in money demand tolerated by the Bundesbank. Such shifts occur because, when inflation preferences differ between political parties and election results are uncertain, rational investors avoid entering into long-term financial contracts before elections. Contrary to the Bundesbank's stated commitment to a monetaristic policy rule, it appears to have allowed these changes to have an impact on monetary aggregates.

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1. Introduction

There is a paradox in the literature on central banking. While it is generally believed that central bank independence is a means of preventing opportunistic Nordhaus-type monetary policy around elections, there is strong evidence that the

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German Bundesbank—repeatedly described as "one of the most independent central banks of the world" (Eijffinger and De Haan, 1996; Cukierman, 1998) and the European Central Bank's role model—tolerated a political business cycle in German monetary aggregates.[1] Results to that end were reported by Alesina et al. (1992) and confirmed by Berger and Woitek (1997a), who found an increase in the growth rates of various German monetary aggregates before elections and a matching decline afterwards. The cycle was small in quantitative terms ($\pm$0.2–0.4 percentage points) but extremely strong statistically. The result is robust with respect to the specific (real or nominal) monetary aggregate analyzed, the univariate or multivariate specification of the estimated time series model, alternative data frequencies, and different methods of modeling seasonality.[2] Including or excluding the turmoils of German unification after 1989 in the analysis also does not change the outcome.

There are two possible explanations for the discrepancy between the Bundesbank's reputation and a political business cycle in German money. One is that it is not a contradiction in the first place, but rather a consequence of the interaction between the Bundesbank and the German government. If the Bundesbank Council had partisan preferences, it might in fact (mis-) use its independence to either support or oppose an incumbent government depending on the ideological beliefs of the Council's median voter (Vaubel, 1997a; Sieg, 1997). If the partisan beliefs of the two actors coincide (do not coincide) before an election, the bank follows an expansionary (a contractionary) monetary policy stance, which it will then correct after the event. In other words, the opportunistic cycle might be an anomaly in the data. Obviously, this hypothesis can only be tested if the partisan preferences of the Bundesbank can (at least ex post) be known. Assuming the party preferences of a Council member to be identical with those of the government body that nominated the individual, Vaubel (1993, 1997a) was unable to refute the hypothesis. His results were questioned by Berger and Woitek (1997b) using data on the individual voting behavior of the Bundesbank Council.[3]

There is an alternative explanation for the coexistence of central bank independence and political business cycles in German monetary aggregates. If the

[1] Alesina et al. (1992) find a significant political business cycle in monetary aggregates in most OECD countries. For the theory of opportunistic political business cycles, see Nordhaus (1975) and Rogoff and Sibert (1988). The literature is surveyed in Nordhaus (1989).

[2] Most results are based on nominal monetary aggregates. See Table B.1 in Appendix B for evidence for a political business cycle in the growth rates of German real M3. Additional variables introduced in the literature include a proxy for the world business cycle (Alesina et al., 1992), the balance-of-payments, and the exchange rate (Berger and Woitek, 1997a). See Lang and Welzel (1992) for a critical view.

[3] The findings by both Alesina et al. (1992) and Berger and Woitek (1997a) of significant straightforward political business cycles in the data on monetary aggregates suggests that the partisan preference hypothesis is difficult to distinguish empirically from the simple opportunistic case. See, however, Vaubel (1997b).