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ON CENTRAL BANK INDEPENDENCE AND POLITICAL CYCLES

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Using a large panel data set, I find that political budget cycles are significantly smaller in countries with *de facto* central bank independence (CBI). To explain this result and its consequences in the economy, I develop an extended New Keynesian model that incorporates a political economy model of career concerns. I find that CBI mitigates the incumbent's fiscal decisions. Intuitively, since increases in the interest rate have a negative effect on the reelection probability due to consumption postponement, this discourages expansionary fiscal policies.

JEL classification codes: E52, E58, D72
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I. Introduction

An independent central bank is thought as an autonomous institution that ensures that its policies will not be politically influenced. The main achievement and desirability of central bank independence (CBI) is that it is considered to be a crucial factor in controlling inflation and bringing down stabilization costs putting therefore suitable foundations for sustainable, noninflationary economic growth. Political budget cycles are, on the other hand, driven by political interests that beyond sustainable, noninflationary economic growth, are aligned with a shorter

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horizon objective: to remain in power. These two goals will generally be in conflict. This is why the institutional structure governing monetary decisions should not be indifferent to politicians and in particular, to those who care about the size of political budget cycles. As a matter of fact, any given country might be willing to rest on an independent central bank because, as Fisher (2008) states, it "protects a democratic government from its own worst instincts": inflationary bias and political budget cycles.

The CBI literature has tackled the existing relationship between CBI and inflation and its causality. While Eijffinger et al (1998) find that CBI lowers inflation in industrialized countries, Sturm and de Haan (2001) find no relationship between *de facto* CBI and inflation in developing countries, except when high-inflation countries are considered. Furthermore, Hayo (1998), Jácome and Vázquez (2005) and Hayo and Hefeker (2010) document the negative but not causal relationship between CBI and inflation.[1]

On the other hand, correlation between the size of political budget cycles (PBCs) and a country's institutional characteristics is empirically documented by the political economy literature. Gonzalez (2003) shows that PBCs in Mexico are bigger the higher the country's degree of democracy. Persson and Tabellini (2003) relate PBCs to different types of electoral rules and government forms. They find that PBCs are bigger in majoritarian countries and in parliamentary democracies. Shi and Svensson (2006) show that PBCs are positively related to politicians' rent of being in office and negatively related to the share of informed voters (voters that can distinguish politicians' competence level).

Furthermore, Drazen (2000 and 2001) argue that PBCs are not based on monetary surprises as the driving force but rather explained by a monetary policy that accommodates fiscal impulses in election years (active fiscal and passive monetary model). This paper is placed in an active fiscal and monetary environment due to a specific institutional characteristic, CBI. It tackles the issue of whether CBI affects or not PBCs and which is the mechanism underlying this effect.

[1] See Berger, de Haan and Eijffinger (2001) for a survey about theoretical foundations of CBI and empirical regularities.

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