A commentary on “Does the Fed contribute to a political business cycle?”

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Abstract Abrams and Iossifov (2006) find that during 1957–2004, monetary policy turned significantly more expansionary prior to U.S. presidential elections when the Federal Reserve chairman and the incumbent president belonged to the same political party. However, their long sample period obscures changes in trends during the period stemming from advances in macroeconomic theory and in the implementation of monetary policy. Indeed, when one considers only the Volcker–Greenspan era (1979–2004), there is insufficient evidence to accept the notion of a political business cycle effect.

Keywords Monetary policy

Abrams and Iossifov (2006) find that during 1957–2004, monetary policy turned “significantly more expansionary” in the seven quarters preceding U.S. presidential elections, but only when the Federal Reserve chairman and the incumbent president belonged to the same political party. Their thesis is a refinement of what is known as political business cycle (PBC) theory (Nordhaus 1975) or, alternatively, political monetary cycle (PMC) theory (Meiselman 1986; Grier 1989). Abrams and Iossifov imply that a rules-based monetary policy regime is likely to lead to more socially desirable results than a discretion-based regime such as that employed, for example, by the Greenspan Fed (Friedman 2006).

Ordinarily it is not unreasonable to assume that the larger the sample size, the more robust the conclusions. But if the sample consists of a time-series, averages can be less than insightful if they obscure changes in trends during the sample period. Abrams and Iossifov use a sample period of nearly half a century (1957–2004). Clearly, during this time much has changed both in macroeconomic theory and in the implementation of monetary policy, especially over the most recent three decades.
I investigate the data of the last thirty years to see if the Abrams–Iossifov theory holds up for that period. Unlike the authors, who analyze implicit deviations from a theoretical federal funds target rate that is the outcome of a model employing various Taylor rules given deviations from an implicit inflation target and the output gap, I analyze the explicit policy record of actual changes in the fed funds rate along with the FOMC’s economic assessment, when available, as recorded in the announcements, minutes, and transcripts of the FOMC meetings during that time frame.\(^1\)

As the authors point out, seven presidential elections occurred during the Volcker–Greenspan years. During three of these, the party of the president and that of the president who had appointed the Federal Reserve chairman differed (1984, 1996, 2000), leaving four data points to which the Abrams–Iossifov theory can be put to the test: 1980, 1988, 1992, and 2004.

Prior to the 1980 election, there was some momentary easing in monetary policy during the spring of 1980, but otherwise the years immediately before and after the election are today remembered for the severe tightening in monetary policy under then newly installed chairman Paul A. Volcker, in an ultimately successful attempt to wring the so-called Great Inflation of the 1970s out of the system. Indeed, as Greider (1989, pp. 214–215) has observed,

> the events of the election year simply did not support the theory that the Federal Reserve always tries to help the incumbent party . . . . If the Fed was trying to re-elect Carter, it went about it in a very strange way. Volcker’s major policy shift in the autumn of 1979—undertaken despite the objections from the Carter White House—assumed the inevitable result would be an election-year recession, hardly designed to help the incumbent . . . . The close evidence, if anything, supported the opposite case—that the Federal Reserve was indifferent to Jimmy Carter’s fate and quite willing to let monetary policy contribute to his defeat . . . . In the fall of 1980, the Fed placed its own prerogative ahead of the President’s.

In the period before the 1988 election, monetary policy was generally restrictive. During the seven quarters before the election there were as many as ten tightening moves, briefly interrupted by three easing moves in the months after the October 1987 stock market crash. Thus, here, too, the data would appear to contradict the Abrams–Iossifov prediction.

Before the 1992 election, monetary policy was in a clear easing cycle. An Ockham’s razor type of explanation would be that monetary policy during that time was a response to the economic recession of 1990–1991 and its lingering effects. But, to be sure, in this case the data do conform to the Abrams–Iossifov prediction.

The 2004 election occurred near the beginning of a tightening cycle that consists, as of this writing, of 17 successive increases in the fed funds target rate. This tightening cycle began in June 2004, and by the time the election occurred three moves had already been made. During the seven quarters prior to the election, there had been only one easing move, back in June 2003. This was the last move in an easing cycle that stretched back all the way to January 2001, again in response to an economic recession during that time.

\(^1\)Historical changes of the fed funds target rate are widely available, e.g. on the public website of the Federal Reserve Bank of New York at http://www.ny.frb.org/markets/statistics/dlyrates/fedrate.html or from the Bloomberg information system at FOMC <GO> Historical Rates & Bias. Different proponents of PBC and PMC theories have used different methodologies to substantiate their case. Nordhaus (1975) finds election-cycle patterns in unemployment and inflation data. Meiselman (1986) and Grier (1989) find election-cycle patterns in money-growth data.

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