Institutions and Cyclical Properties of Macroeconomic Policies*

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Abstract

Strong swings in business-cycle conditions in industrial and emerging economies alike have renewed the debate on the role and ability of stabilization policies. Traditionally it has been argued that emerging market economies (EMEs) are unable to pursue counter-cyclical monetary and fiscal policies due to financial imperfections and unfavorable political-economy equilibria. However, we claim that EMEs with institutional features similar to those of industrial countries may be able to conduct counter-cyclical policies. Using a sample of 20 EMEs and annual data for the 1990-2003 period, we find that the level of institutional quality plays a key role in the ability of these economies to conduct stabilizing macroeconomic policies. We show that EMEs with strong institutions are able to implement counter-cyclical macroeconomic policies, reflected in extended monetary-policy (Taylor) and fiscal-policy rules. In addition, fiscal-policy cyclicality is more sensitive to institutional quality than monetary-policy cyclicality

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