

# Central Banks: Regulation, Monetary Policy, and Independence

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## PLAN OF THE TALK

- Delegation of policy to independent bureaucracies: What is special about Central Banks?
- Central Bank Independence: Does it work?
  - Monetary policy
  - Regulation of banking sector

## DELEGATION OF POLICY

- Career concerns model for top bureaucrats.
- Electorally motivated politicians.
- Normative vs positive model: Central Bank independence both a “positive” and “normative” result.

## MODEL (sketch)

- Policy outcome:

$$y = \theta + a \quad (1)$$

- Utility of representative individual:

$$u(y) = y \quad (2)$$

- Net benefits of policy maker:

$$R(a) - C(a) \quad (3)$$

- Reward for the bureaucrat:

$$R^B(a) = \alpha E(E(\theta|x)) = \alpha E(y - a^e) = \alpha E(\theta + a - a^e) \quad (4)$$

- Equilibrium effort:

$$\alpha = C_a(a^B) \quad (5)$$

- Reward for the politician:

$$R^P(a) = \beta Pr(u \geq w) = \beta[1 - P(w - a)] \quad (6)$$

$$P(w - a) = Pr(\theta \leq w - a) \quad (7)$$

$$w = \theta + a^e \quad (8)$$

$$\beta n(\bar{\theta}) = C_a(a^P) \quad (9)$$

## **NORMATIVE QUESTIONS**

- Who puts more effort?
- Which tasks should be assigned to politicians and to bureaucrats in order to maximize social welfare?

## POSITIVE QUESTIONS

- If a politician could choose which tasks to delegate and which tasks to keep, what would he do?
- Generally not the optimal choice.

## NORMATIVE ANALYSIS

- Imperfect monitoring:  $y = \theta + a + \epsilon$ 
  - The comparison between  $a^P$  and  $a^B$  is ambiguous. Imperfect monitoring (high  $\sigma_\epsilon^2$ ) reduces effort for both types of policy makers. Higher  $\sigma_\theta^2$  increases  $a^P$  but decreases  $a^B$ .



- An increase in  $\sigma_\theta^2$  increases the signal-to-noise ratio and implies that observed performance ( $y$ ) is a better indicator of ability ( $\theta$ ). This makes the bureaucrat work harder, since by assumption he fully internalizes the benefit of higher expected ability. The politician, instead, only wants to overcome the re-election threshold. If ability is more uncertain, then re-election prospects are less sensitive to effort, since more of the outcome is due to randomness. Hence his incentives are weakened.

## UNCERTAIN PREFERENCES

- Voters not sure about the evolution of their preferences; all voters still have the same preferences, but subject to some “shock”
  - The politician, unlike the bureaucrat, always chooses the right policy from the voters’ perspective. This advantage of the politician is more important the more risk-averse are the voters, and the more uncertain are their ex-post preferences.

## REDISTRIBUTIVE POLICIES

- Splitting a cake:  $y = \theta = a = c_1 + c_2 + c_3$ 
  - Politician builds minimum winning coalitions (two voters): dilutes incentives.
  - What would a bureaucrat do?
  - “Fair” versus “unfair” bureaucrats.

## **SPECIAL INTERESTS, LOBBYING POLITICIANS AND BRIBING BUREAUCRATS**

- Normative prescription: Minimize influence of special interests;
- Allocation of tasks depends on strength of legal systems in enforcing bribe-free equilibria.

## **POSITIVE RESULTS**

- Key assumption: What voters know and understand about who does what, and how they place “blame” and reward.
- Rational expectations and full knowledge of delegation structure.

- **Result 1:** If voters are risk-neutral, then in equilibrium the probability of re-electing the incumbent politician is always  $\frac{1}{2}$ , irrespective of the constitutional choice. Hence, the politician chooses the constitution that maximizes equilibrium rents of being in office.
- **Result 2:** Politicians will keep for themselves tasks that are useful for extracting bribes and campaign contributions.

- **Result 3:** (“Blaming the bureaucrats”) The choice between the safe and the risky task entails a trade-off between votes and rents (or effort). By keeping the safe task and delegating the risky one, the politician increases his incumbency advantage but decreases equilibrium rents (increases equilibrium effort).
- **Result 4:** Politicians will always want to keep redistributive tasks, because they can build minimum winning coalitions and will need to work less hard to expand the size of the pie.

## CENTRAL BANK INDEPENDENCE: HAS IT WORKED?

- Monetary Policy: OECD countries, yes; Developing countries, unclear.
- Causality issues: Which countries choose to have independent Central Banks?
- European Central Bank



- Regulatory capture of Central Banks.
- Banking supervision, regulation, and competition: Issues in cross-border acquisitions in Europe.
- Move competition policy to Brussels.