COORDINATING MACROECONOMIC POLICIES:
A Rejoinder to Alberto Alesina (the Case of Colombia)

(Abstract)

The overview of Colombian institutions provided by Alesina et.al. has the virtue of a well-argued and well-integrated set of proposals. However, its major weakness stems, paradoxically, from not having set clear priorities. This brief rejoinder is devoted to stating agreements regarding some central bank reforms that should be tackled at some point in the future, including bank supervision, release of board minutes, and board members' tenure. We also explain our disagreements on the proposals aiming at removing the minister of finance from the board, reducing the number of board members to three, or adopting congress ratification for appointees.

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Professor Alesina and his collaborators have devoted precious time re-thinking institutional arrangements in Colombia (Alesina, et.al. 2000), including the partial independence of the Central Bank of Colombia (Banco de la República, BR for short). They advocate in favor of consolidating fiscal and political decentralization, while adopting revenue-sharing rules that could enhance efficiency on the expenditure side. They also propose new electoral procedures and vote-casting rules that aim at fortifying well organized political parties, so that Executive and Congress relations build more on the desire to achieve good quality legislation, than on proceeds coming from the so-called pork-barrel-funds.

Although most of these initiatives had been previously discussed (Comisión de Gasto Público, 1997), the overview of Colombian institutions provided by Alesina et.al. has the virtue of a well-argued and well-integrated set of proposals. Perhaps its major weakness stems, paradoxically, from not having set clear priorities, at times when Colombian governments have scant "political capital" to spare, due to the internal conflict and the fragility of the current socio-economic arrangement.

One would have expected that those who lead the economic profession on "the political economy of institutional reforms" would have set such a ranking of reforms as the core of the proposals. *After all, if governing is the art of bringing political-desires into the frontier of real-world possibilities, economic policy should be the art of turning academic recommendations into draft-laws that can be approved in Congress¡*

In fact, Alesina's et.al. (2001, p.39) recent response in *Central Banking* acknowledges that "the need to amend the central bank charter (in Colombia) is much less urgent than the need to introduce many other economic, institutional and political reforms".

Having agreed with Mr. Alesina on the reform priorities for Colombia, let me briefly state my agreement regarding some Central Bank reforms that should be tackled at some point in the future (i.e. Bank Supervision, Release of Board Minutes, and Board Members

Tenure). I will also explain my disagreement on other proposals (e.g. removal of the minister of finance from the board, reduction of the board members from seven down to five, and ratification of board members by congress).

Bank Supervision. Several emerging economies have moved towards granting the central bank also the role of banking supervision, but in most cases such reform took place at the time of the constitutional reform that conceded independence. Interestingly, Minsky (1999) has explained that it is extremely difficult for an independent central bank to gain access to banking supervision, once society has taken the toll of giving independence to an institution that is perceived as causing pain in the short-term (while disinflating the economy). The benefits of expecting better supervision under the central bank command is related not only to having the "political stamina" for a second generation of reforms, but to solving the potential problems of moral hazard for the central bank. Would an independent central bank turn a "blind-eye" on a "too-big-to-fail-bank" for fear of conflicting with its obligations as "a lender-of-last-resort"? The practical answer seems to be ambiguous; it will depend on the concrete circumstances.

In the particular case of Colombia, the argument that builds upon the need to strengthen bank supervision by means of providing the status of a well-reputated central bank does not really apply. The bank superintendence not only has well-prepared and relatively well-remunerated staff, but one should not forget that the recently instituted Law 510 of 1999 actually granted its budgetary independence (a fact apparently disregarded by Alesina et.al.). However, it is fair to recognize that the potential benefit of approving a reform like the one proposed by Alesina would mainly emerge from the net gain in political independence, although recent experience tell us that there is more *the facto* independence than outsiders usually perceive.

Release of Board Minutes. We are in agreement with Mr. Alesina about finding a good middle ground between board members voicing thorny issues through the media to make a point and maintaining the public well informed about policy actions and their rationale.

The current practice in Colombia of instant press releases strikes in my view a good balance. Most likely, generous and quick release of the board minutes could finally lead to auto-censorship among board members, defeating the purpose of providing useful information.

Board Member's Tenure. Currently, the minimum tenure in the BR is four years, but reelection could bring tenure up to 12-years (three periods). Alesina's proposal is to bring the minimum up to seven years and to fix the personal period of each member as to avoid the arbitrary removal of any-two members every four years (at the mid-point of every government).

As I had mentioned it in the *Quarterly journal of Central Banking* of November 2000, this minor reform could help in promoting tenures for longer periods. However, one should keep in mind that under the current arrangement any member accomplishing the limit of 12 years would automatically be removed. This implies that the room for the imaginary "complacency of the board members towards the Executive" is actually shrinking. In fact, this will actually occur in late 2003, leaving the new administration with just one choice of whom to remove, while appointing two new members to the board (the other one leaving would be the one with the 12-year tenure).

Just to remind Mr. Alesina that good institutional arrangements are desirable, but are never a guarantee, I invite him to screen the outcome of the Federal Reserve Bank in Washington D.C. (the FED, for short) under the new Bush Administration. Under his current governing period (2001-2004), Mr. Bush will have the opportunity of appointing five out of seven members, while appointing also the successor of Mr. Greenspan (effective 2006). See details in *Central Banking* of May (Berry, 2001 p.6). Was not the FED the "blue print" to follow in order to avoid government having majority at board meetings?

Removal of the Finance Minister from the Board. The main argument in Alesina´s response is that if fiscal policy and, at the same time, monetary policy are kept on track then there will not be any need of policy coordination. Why then have the minister at the board if coordination should not be required?

My rebuff is that the rule in emerging markets (where you do not know how to emerge when markets fail for lack of development) is that fiscal, monetary, and exchange rate policies are rarely on track.

Hence, coordination inside the Board might be a plus, specially when dealing with financial crises that could trigger systemic risks, while supervision is performed by the government, and the central bank defines and implements the exchange rate policies (the case of the BR). Japan and Chile, among others, also use different forms of inside coordination. USA escapes the need for inside coordination, since exchange rate policies are defined directly by the Treasury and supervision of the financial system is performed by the Central Bank.

Political scientists have argued that since a conservative central banker would actually receive the *highest* degree of political pressures, board appointees (like the minister of finance in the case of Colombia) that better reflect the preferences of society may then face less political pressure, diminishing rent-seeking practices (Piga, 2000 p.583). Obviously, this view has to be weighted against those that are technically capable and willing to avoid inflation.

Hence, the current scheme that permits internal coordination between central bank and the executive is one way to tackle this issue; another way is to use the FED arrangement, where the confirmation of Congress is required, specially when those being appointed come directly from the government. What is difficult to acknowledge are the benefits of Alesina's proposal in which no internal coordination is permitted, nor appointments of

any government officials (not even under Congress ratification), unless a year has elapsed. Such proposal looks inconvenient, impractical, and academically stubborn.

I can not speak for other countries, but in the case of Colombia the presence of the minister of finance has helped in consolidating fiscal adjustment and a successful flotation of the exchange rate over the period 1998-2001. Such process remains to be tested on more turbulent waters, since the two consecutive years of one-digit-inflation have taken place under a slump of the real sector. Alesina is right to point out that such coordination failed during most of the 1990s, but I am resisting his view that it was the minister of finance's fault, since there is no veto-power nor tie-breaking vote at the BR. In some cases, the analysis has to go beyond institutional arrangements.

<u>Reducing the Number of Board Members and Searching for Congressional Ratification</u>. On technical grounds, this is Alesina´s weakest proposal. The current arrangement foresees five board members (appointed by the President), who in turn elect the general manager of the central bank, plus the minister of finance, for a total of seven-board member, with equal-voting powers. Their proposal is to reduce from five down to three the board members, while expelling the Minister out of the Board, and granting tie-breaking vote to the general manager. Not to repeat my arguments (Clavijo, 2000 p.77), let me quote instead what Charles Goodhart (2001 p. 12) thinks about the "optimal size" of a central bank policy committee:

> The reason (for the median number of a central bank policy committee being) eight is that it is half way between seven and nine. Seven and nine are in fact roughly the appropriate size. That goes back to the operation of committees. If it is three you don't get enough variety of views and very likely somebody with a dominating personality runs the show. If it is as large as 17 (like in the European Central Bank) you can't really give everybody a chance to participate within a process that lasts a short time.
> The maximum number for reasonable interchange is possibly around 11. The Minimum number to give a reasonable discussion and exchange of views is possibly around five. And, low and behold, add five and 11 and divide by two and you get your magic number again (eight).
> Depending on the size of the country, on average a committee of eight also manages to incorporate most of the leading outside macro-monetary economists (…).

So much for the voice of the experienced, which I reckon will not make much sense, unless you have been at board meetings. But the academia has also tackled the issue in an interesting manner. In the figure below we reproduce the argument made recently by Lindner (2000 p.645), while assessing the board position, according to the number of members. In his model, "b" measures the degree of polarization (as opposed to moderation), where the variance of the government position is given by ϕ_g . Lindner notes that under $\sigma^2_{\phi g} = b^2$, monetary policy would be under control of the current government, while "a" measures randomness. The [*] depicts the median of the board tenure in each case, which in this example happens to be at length "b-a".

Central Bank Preferences for Term Length: Case for Nine and Three Members

Preferences for Term Lengths:	-b-a	-b	-b+a	0	b-a	b	b+a
Members: Nine	*	* *	*		[*] *	* * *	
Members: Three		*			[*]	*	

Lindner also shows that if the electorate changes their preferences in unpredictable way (zeitgeist shocks), *there will be a trade-off concerning member's term length: a longer term (indeed) entails more moderation, but it enhances the likelihood of detachment from contact to the electorate's current preferences*.

Now, provided that Alesina's proposal also entails ratification of board members by congress, there will clearly be a case for a trade-off between tenure and accountability. Put differently, longer tenure under Congress ratification entails larger probability of accountability failure, which is a paradox, since the proposal aims at enhancing accountability. Furthermore, Alesina's complementary proposal of reducing membership down to three not only entails severe problem of "swinging votes" (higher instability), but works against the potential benefits of extending tenure. The interested reader is invited to further track the so-called "accountability critique" (Piga, 2000 p.566-70), dating back to David Ricardo (1824), which somehow Alesina downplays.

That said, I reckon that "academic" arguments could go either way, so I allocate higher weight to historical and operational experience in line with Mr. Goodhart.

In sum, the seven-member board of the Colombian Central Bank, with no veto-power from any of its members, has many virtues in terms of ideological representation, which, in my opinion, turns inconvenient to change its current composition. Furthermore, Alesina should re-think his complementary proposal of not having any member of the current government being appointed to the Board. In fact, appointing former civil servants to the Board (without any waiting period) will enhance policy coordination, as currently occurs in Germany and USA (among others). More details can be found in the recount of the successful Greenspan era (Woodward, 2000 p.18ss), when several high-ranking officials from the Treasury were appointed to the board of the FED.

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