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Overconfidence, monetary policy committees and chairman dominance

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ABSTRACT

Monetary policy decisions are typically characterized by three features: (i) decisions are made by a committee, (ii) the committee members often disagree, and (iii) the chairman is almost never on the losing side in the vote. We show that the combination of overconfident policymakers and a chairman with agenda-setting rights can explain all these features. The optimal agenda-setting power to the chairman is a strictly concave function of the degree of overconfidence. We also show that the quality of advice produced by the central bank staff is higher in a flat organization than in a hierarchical one.

1. Introduction

Overconfidence is arguably the best established cognitive bias in the psychology of judgment.[1] DellaVigna (2009, p. 341) compactly summarize the bias, arguing that people tend to "...over-estimate their performance in tasks requiring ability, including the precision of their knowledge." Overconfidence has been documented among decision makers in many professions, including physicians, investment bankers, engineers, lawyers and managers.[2] In this paper, we investigate the consequences of possible overconfidence among decision makers involved in monetary policy decisions.[3] We show that overconfidence yields predictions about monetary policymaking that is consistent with a set of stylized facts that cannot

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[1] Researchers have documented many other biases in information processing (see, e.g., the surveys by Rabin, 1998 and DellaVigna, 2009), but according to DeBondt and Thaler (1995, p. 389) overconfidence is perhaps the most robust finding in the psychology of judgment.

[2] See Odean (1998, p. 1892) for references to studies of these and other professions.

[3] To our knowledge, there are no investigations of monetary policymakers targeted directly at testing overconfidence, but it would be hard to argue that they are exempted from such a common cognitive bias. Apel et al.'s (2010) questionnaire survey evidence from Swedish monetary policymakers contains information that is clearly consistent with overconfidence. More generally, the low-predictability, fluid environment in which monetary policymakers typically operate is exactly the type of situation where overconfidence can easily prevail (see, e.g., Odean, 1998). We discuss these and other studies in more detail in Section 2 below.

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be easily explained with existing theories. These facts include (i) disagreement within monetary policy committees (MPCs) after deliberations, (ii) provision of decision power to MPC members, and (iii) that chairmen of MPCs are (almost) never on the losing side when the committees vote.

According to our model, the typical decision structures in contemporary central banks can be seen as an example of "Behavioral Institutional Design" (DellaVigna, 2009). The structures are designed to counteract the effects of cognitive biases and thereby improve welfare.

An important trend in practical monetary policy is the move from individual decision making to committee decision making. The main explanation for this trend in the literature is simple: "two heads are better than one". Monetary policy committees (MPCs) improve decisions by pooling members' information and knowledge (see, e.g., Blinder, 2007). Although information pooling within the committee is relevant to understand the transition from individual decision making, it cannot alone explain the use of MPCs. To see this, it is useful to distinguish between two types of information pooling, which we will denote 'pooling by talking' and 'pooling by voting'. 'Pooling by talking' refers to the sharing of views and information among MPC members during deliberations. 'Pooling by voting' refers to the implicit pooling that takes place after deliberations when the MPC votes, or use some other aggregation mechanism, to aggregate the different opinions into one decision. Following Condorcet's famous jury theorem, a huge literature on 'pooling by voting' ('Condorcet effects') has emerged. This literature describes under what conditions voting improves on decisions, see, e.g., Koriyama and Szentes (2009) and references therein. Gerlach-Kristen (2006) uses a theoretical macroeconomic model to study Condorcet-effects in MPCs when there is uncertainty and disagreement about the size of the output gap.[4]

If there are no frictions in 'pooling by talking', each member should take the other members' information and arguments into account, and full agreement would result.[5] As Blinder (2007) also points out, then you do not need a decision-making committee to achieve the pooling benefits. The pooling gains can be achieved by having independent board members serving as mere advisors to the chairman (as is the arrangement at the Reserve Bank of New Zealand). Alternatively the pooling benefits can be captured by the central bank staff on behalf of the central bank governor. If there are frictions in 'pooling by talking', the MPC members may end up disagreeing also after the deliberation round. We observe extensive disagreement among MPC members in practice, suggesting that 'pooling by talking' is not frictionless. This creates a potential role for 'pooling by voting'. MPC members are distinguished from central bank staff members in that they have *decision power*, whereas staff members have only *advisory power*. The staff can contribute to decisions through 'pooling by talking', while MPC members can contribute through both 'pooling by talking' and 'pooling by voting'. The common institutional setup in central banks is that there is an MPC where each member has decision power, but where the chairman (and other internal members) has access to a staff.[6] An additional stylized fact is that the chairman is almost always in the majority coalition.[7]

How can overconfidence help explain the use of MPCs? Consider a central bank chairman who receives information and judgments from his staff, but who also has a private signal about the unknown "optimal" interest rate. If he is an unbiased information aggregator, he will optimally weigh the staff's advice and his own signal. To the extent that more people should be involved in the monetary policy decisions, these can be hired as advisors because the chairman will take their views properly into account. If, however, the chairman is overconfident, he will place a too high weight on his own signal and underweight the advice from his staff. Thus, an overconfident chairman does not extract all potential pooling gains inherent in his staff's advice. This increases the risk of bad policy decisions if he alone decides. An MPC with decision power can reduce the risk induced by overconfidence not only because it can intervene against extreme policy proposals, but also a chairman who has to bring his views to a committee will moderate his proposals. Giving decision power to the MPC is a necessary condition for such moderation to take place. These results hold even though all committee members are subject to the same overconfidence bias. Our approach suggests a different understanding of the role of MPC members: rather than thinking of MPCs primarily as tools for information pooling, we interpret them primarily as an insurance mechanism against extreme actions from a single policymaker.[8]

Overconfidence precludes agreement about policy in a committee, and it has consequences for the optimal allocation of decision power in the MPC. Through the chairman's unique access to the central bank staff (and perhaps superior competence), the chairman's policy view should on average carry a higher weight than rank-and-file members'. However, overconfidence gives him a suboptimal influence on policy if it is set through simple majority voting. Giving the chairman the agenda-setting right (i.e., the right to propose a policy action that other members must vote for or against) yields an extra layer of decision power, and is a mechanism for restoring (or approaching) his optimal influence.

[4] Blinder and Morgan (2005, 2008) and Lombardelli et al. (2005) provide experimental support for pooling by talking and pooling by voting in MPCs.

[5] We assume that the differences in preferred policy decisions before 'pooling by talking' reflects different judgments and information and not different preferences. This is a reasonable assumption, as most MPCs today consist of economic experts and not (former) politicians.

[6] Ordinary MPC members may also have some access to the staff, or have a small private staff, but staff resources are generally unequally distributed between the chairman and the ordinary members.

[7] The only known example of the chairman being outvoted is the MPC at the Bank of England where the Governor has been in minority twice (out of 157 meetings, see Section 2).

[8] In a rather provocative paper, Romer and Romer (2008) empirically show that the FOMC has not added any value to the forecasts made by the Fed's staff, by adding their own judgments. This result clearly calls into doubt the importance of the MPC as an information pooling device, and thus points to other reasons for having committees (formally) in charge of monetary policy (see also Ellison and Sargent, 2009).