Robust Design Principles for Monetary Policy Committees

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Note: The views expressed here are solely those of the authors and do not necessarily reflect the views of the Bank for International Settlements or anyone else.

Introduction

- Monetary policy influences borrowing costs for consumers and businesses, rates of return to savers and investors, and the foreign exchange value of the currency.
- Through those channels, monetary policy affects aggregate prices, economic growth, and the stability of the financial system.
- In many countries around the world, monetary policy frameworks have been subject to a rising degree of public scrutiny.

The Research Literature

- An huge number of analytical and empirical studies have investigated the characteristics of the monetary transmission mechanism.
- Many researchers have analyzed the design of monetary policy strategies, including optimal control, robust control, simple rules.
- A much smaller literature has studied the design of monetary policy institutions; cf. Romer & Romer (1997), Blinder (2004), Sibert (2006), Dincer & Eichengreen (2014).

The Design of Regulatory Agencies

- Over the past two decades, experts have collaborated with the World Bank to produce a "body of knowledge" about the design of agencies that regulate energy, transportation, and telecommunications.

  (http://regulationbodyofknowledge.org)

- That work has emphasized the role of operational independence, transparency, accountability, and legitimacy in establishing and sustaining an effective regulatory agency.

Parallels Between Infrastructure Regulation and Monetary Policymaking

- Producers & end-users make forward-looking decisions based on the expected path of rates.
- Policy must be insulated from undue influence by politicians and special interests.
- Intertemporal tradeoffs can pose challenges for making credible policy commitments.
- Policymakers face substantial uncertainty about key structural factors and about how policy adjustments may affect the evolving path of supply and demand.

The Goal of Our Paper

- Formulate a set of robust design principles for monetary policy committees (MPCs), that is, the decision-making body delegated with setting the course of monetary policy.
- These principles are intended to mitigate the risk of severe policy errors arising from two sources: (1) political interference and (2) excessive insularity ("group-think").
- This approach follows the spirit of Hansen and Sargent's work but focuses on the design of institutions rather than policy strategies.

Mitigating the Risk of Political Interference

- The risk of political interference cannot be eliminated merely by granting statutory independence to the central bank, because politicians may ignore or override those laws.
- The operational independence of the MPC fundamentally rests on the degree of public confidence in the legitimacy of the institution.
- These considerations provide a crucial rationale for ensuring the transparency and public accountability of the MPC.

Mitigating the Risk of Group-Think

- Delegating monetary policy to a committee is now standard practice across the globe.
- However, the benefits of having a committee can be severely undermined by group-think:
  - homogeneity of committee members
  - consensus-based decisions
  - lack of external reviews
- In light of those considerations, the MPC should comprise a diverse group of experts who are individually accountable for their policy decisions.

Outline of the Talk

- ✓ Introduction
- Case Studies
- Design Principles
- Outstanding Issues
- Conclusion

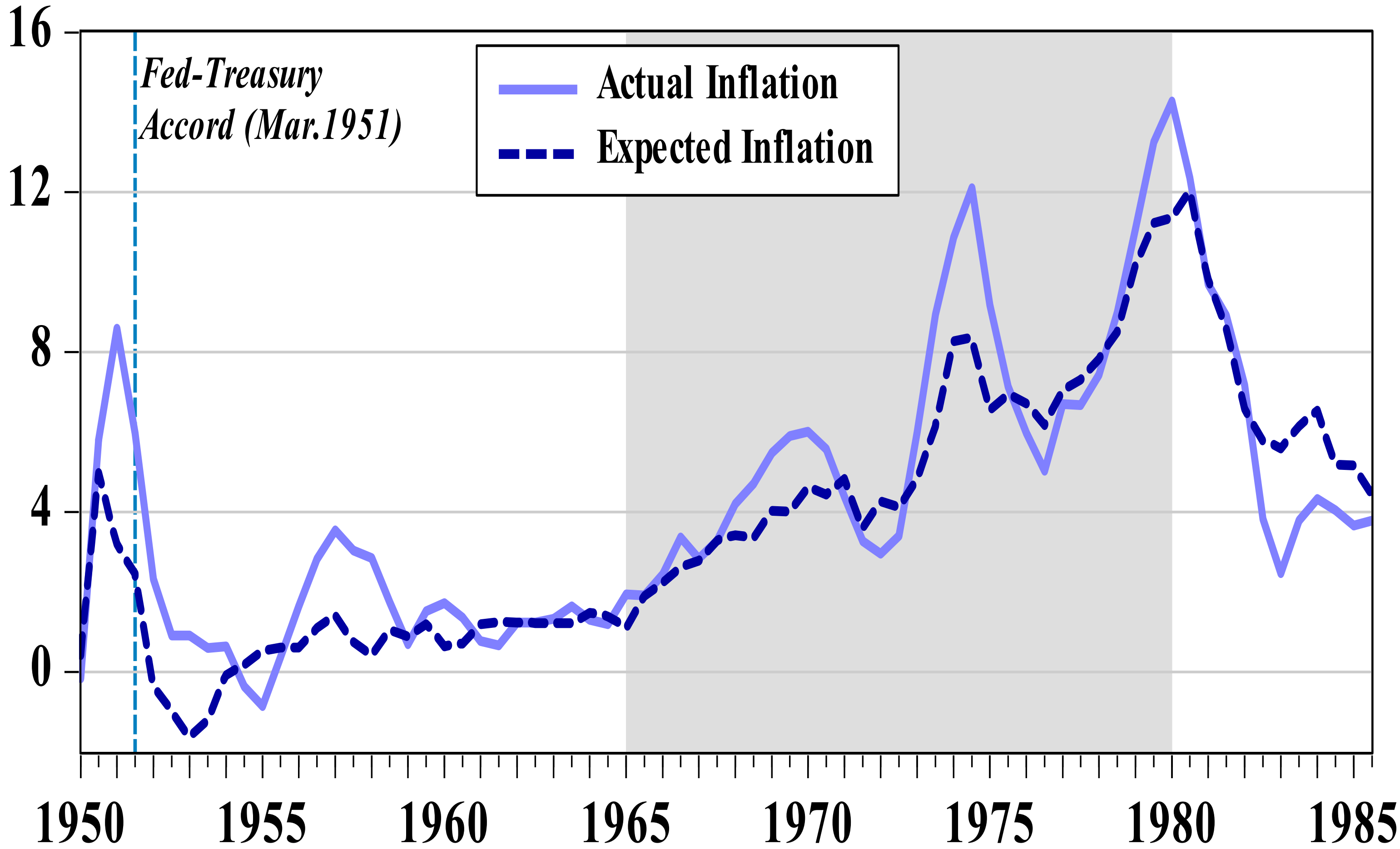
Case Studies

- **Political Interference**
  - **The Roots of the U.S. Great Inflation**
  - **Venezuela's Banking Crisis in 1994**
- **Group-Think**
  - **The FOMC in 2007-08**
  - **The Bank of England in 2007-08**

The Evolution of the FOMC, 1933-51

- The FOMC was established in 1933 with a high degree of statutory independence; its members serve long staggered terms and can only be dismissed for malfeasance.
- In practice, the FOMC remained subservient to the executive branch for nearly two decades.
- In March 1951, the FOMC gained operational independence through a joint accord with the US Treasury, *not* through any changes in law.

The U.S. "Great Inflation"



The Roots of the U.S. Great Inflation

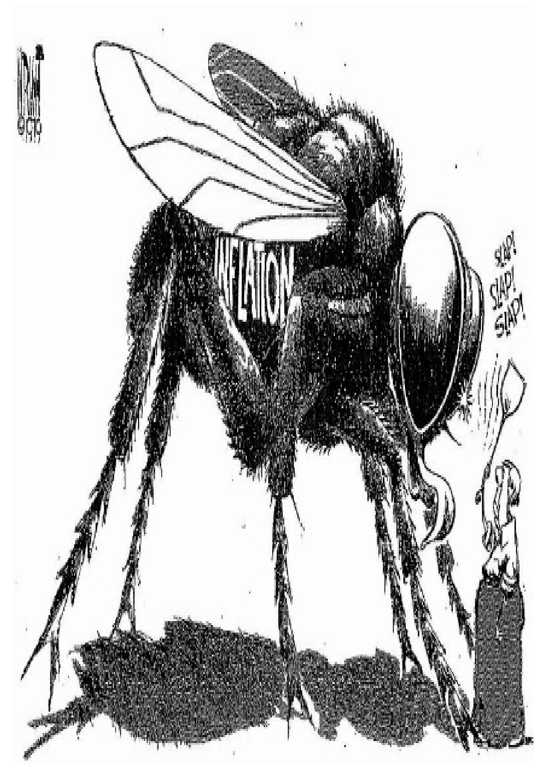
- After remaining low and stable in the 1950s and early 1960s, U.S. inflation began drifting upwards starting in the late 1960s and reached double-digit levels by the late 1970s.
- This policy failure reflected recurring episodes in which U.S. presidents exerted pressure on monetary policymakers (*Levin & Taylor 2013)*.
- An underlying problem was that the Federal Reserve was perceived as part of the executive branch rather than as an independent agency.

Perspectives on the U.S. Great Inflation

1966

1969

1979



Credits: Don Hesse, *New York Times,* Nov. 27, 1966; Bil Canfield, *NYT,* Dec. 7, 1969; Wright, *NYT*, May 1979.

The End of the U.S. Great Inflation

- **Under Chairman Volcker, the FOMC succeeded in bringing inflation back to low single digits. Since that time, the FOMC has remained fairly well insulated from political pressures:**
  - **Legislative reforms in 1977-78 strengthened the FOMC's transparency & accountability.**
  - **President Reagan and subsequent presidents have refrained from commenting on any specific FOMC decisions.**
  - **There has been broad public awareness that the Federal Reserve is an independent agency accountable to Congress, *not* the President.**

The Venezuela Banking Crisis of 1994

- In Dec. 1992, Venezuela's government granted statutory independence to the central bank:
  - board members with staggered 6-year terms, subject to dismissal solely for malfeasance
  - board control of central bank's own budget
  - prohibition on direct lending to the government
  - semi-annual monetary policy reports
- Unfortunately, this reform was part of a highly unpopular liberalization which triggered riots and coup attempts, and the president was later removed from office on corruption charges.

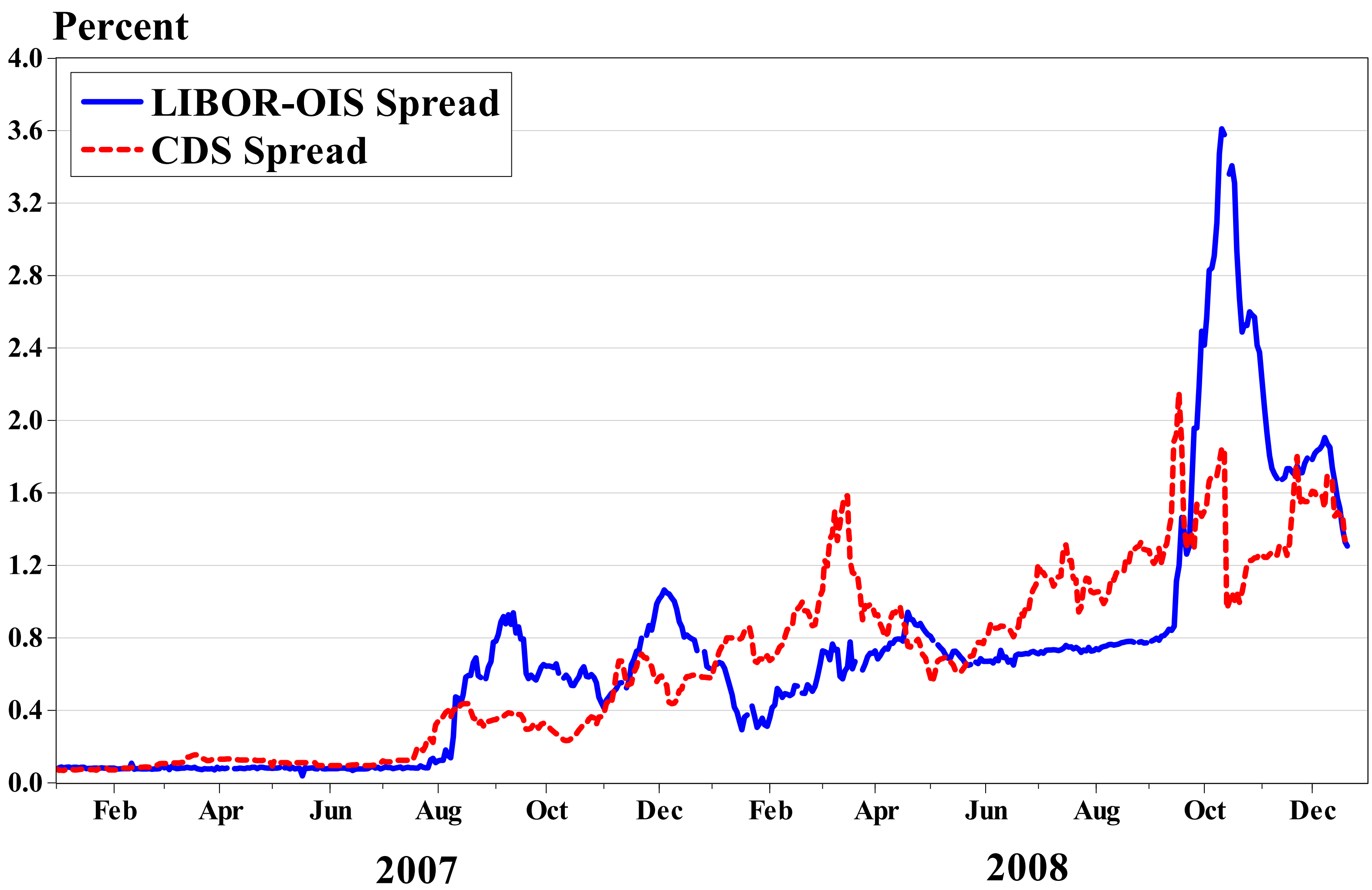
The Venezuela Banking Crisis (contd.)

- In January 1994, the failure of a major bank led to a massive crisis, and the central bank lent funds to the deposit insurance agency (roughly 4 percent of GDP) on the premise that those funds would be repaid via bond issuance.
- In April 1994, the central bank's head and two other board members resigned when faced with a government ultimatum to monetize the bailout.
- In effect, the central bank's independence was curtailed by executive order less than two years after it had been granted by statute.

FOMC Group-Think, 2005-2008

- During 2005-06, officials at the Federal Reserve and other agencies overlooked warning signs regarding the risk of a collapse in house prices.
- During autumn 2007 and early 2008, Fed officials misattributed the widening of interbank spreads to liquidity factors rather than counterparty risk.
- The FOMC met on Tues. 16 Sept. 2008, two days after Lehman’s failure, but still did *not* perceive that the U.S. might be heading into a financial crisis and a severe economic downturn.

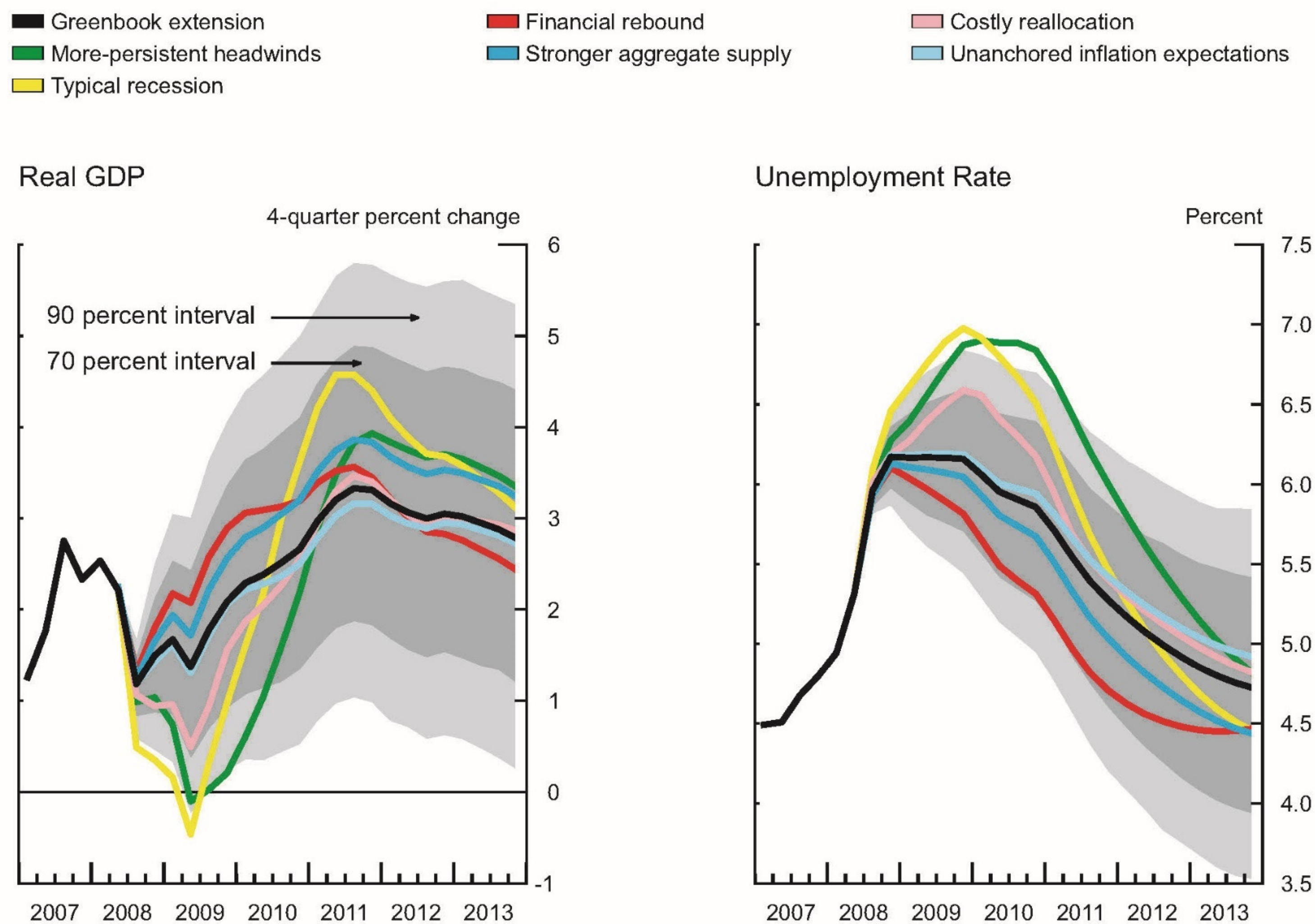
Strains in U.S. Interbank Markets



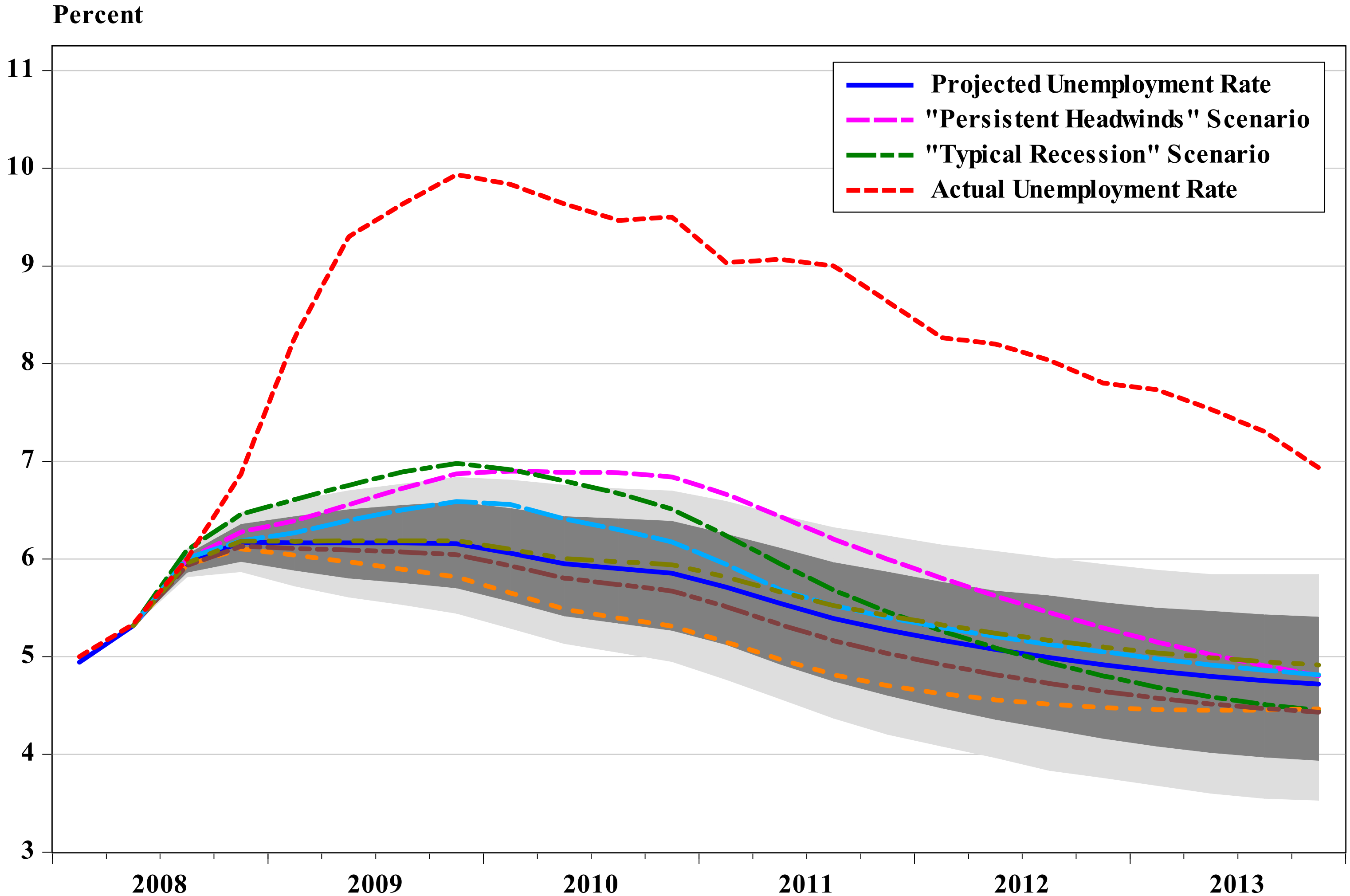
FOMC Statement, Tuesday 16 Sept. 2008

"Strains in financial markets have increased significantly and labor markets have weakened further....Tight credit conditions, the ongoing housing contraction, and some slowing in export growth are likely to weigh on economic growth over the next few quarters....The Committee expects inflation to moderate later this year.... The downside risks to growth and upside risks to inflation are both of significant concern."

FOMC Greenbook Alternative Scenarios as of 10 Sept. 2008



FOMC Greenbook Alternative Scenarios as of 10 Sept. 2008



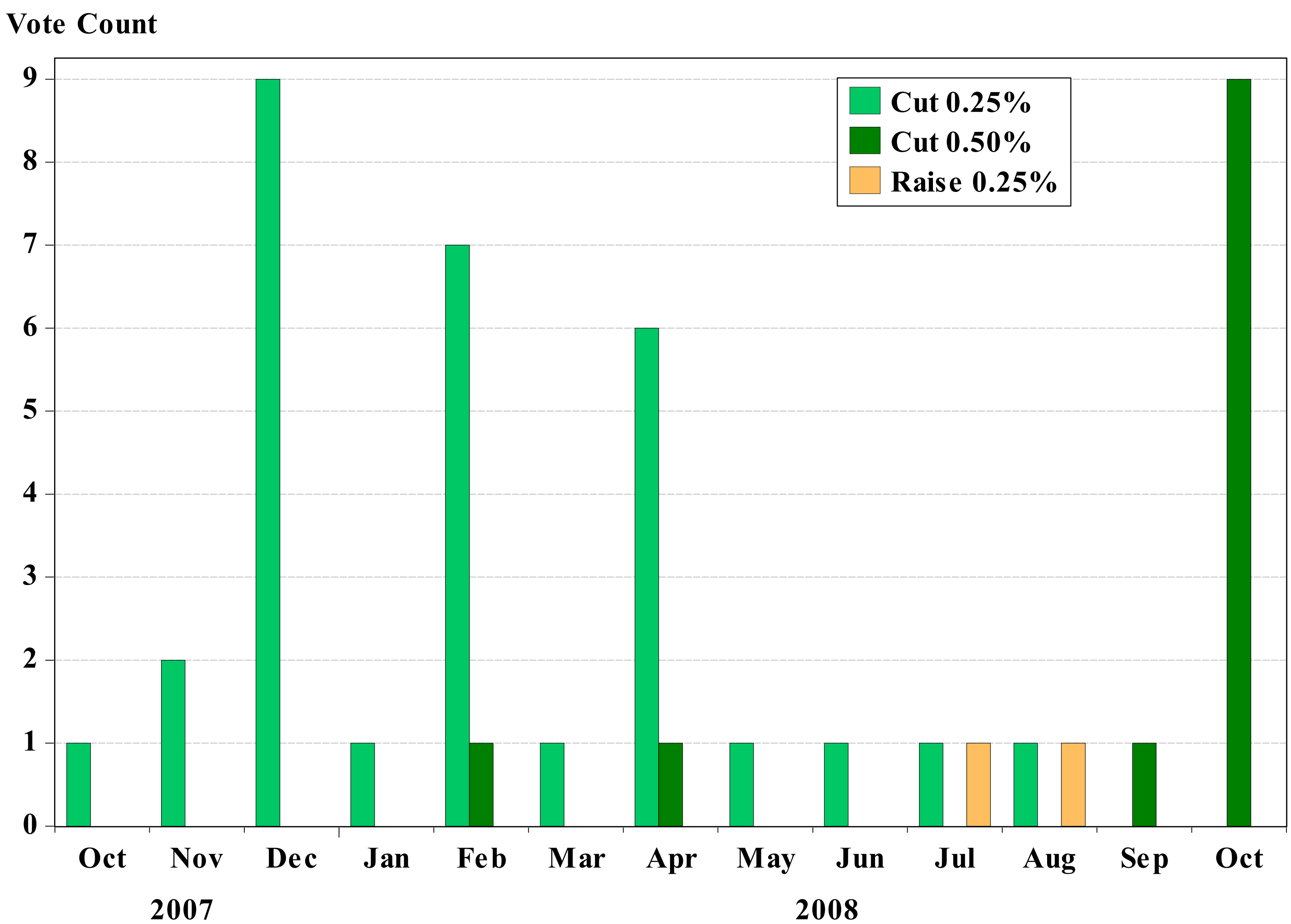
Note: Dark shading and light shading denote confidence intervals of 70 percent and 90 percent, respectively, based on stochastic simulations of the FRB/US model.

A Lone Voice at the Bank of England

“For some time now I have been gloomy about prospects in the United States, which now seems clearly to be in recession. Developments in the U.K. are starting to look eerily similar....My biggest concern right now is that the credit crisis will trigger a rapid downward spiral in activity. Now it is time to get ahead of the curve.”

David Blanchflower, MPC Member
Speech to the Royal Society
29 April 2008

Bank of England MPC Votes, 2007-08



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MPC Governance

- Ownership
- Size
- Composition
- Selection procedures
- Terms of office
- Voting rules
- Accountability

Principle #1: Fully Public

The MPC should be a fully public institution whose members are accountable to elected officials and the general public.

- Many central banks were originally conceived as private institutions, but the vast majority are now public.
- The Bank of Canada and Bank of England became public more than a half-century ago.
- The European Central Bank and 16 of the 19 national central banks are fully public.

Principle #1 (contd.)

- In Belgium, Japan, Turkey, and Switzerland, the central bank has shares outstanding, but a majority are held by public institutions.
- The central banks of Greece, Italy, and South Africa have private shareholders.
- The Federal Reserve's Board of Governors is public. By contrast, each regional Federal Reserve Bank is owned by private banks that select two-thirds of its directors—half of whom select its president, who sits at the FOMC and votes regularly on monetary policy.

Principle #2: Composition

The selection of MPC members should ensure diverse perspectives and forms of expertise.

- Earlier studies of MPCs were mostly focused on hetereogeneous preferences (hawks/doves) or the hetereogeneity of anecdotal information.
- In contrast, this principle combats group-think by appointing experts with diverse educational backgrounds and professional experiences.
- Geographical diversity may also be crucial for fostering & maintaining public legitimacy.

Principle #3: Selection Procedures

The process of selecting MPC members should be systematic, transparent, and consistent with democratic legitimacy.

- **The process should have “checks and balances”, i.e., multiple steps involving different sets of decision-makers.**
- **Transparency mitigates the risk of undue influence by special interests.**
- **The process should foster public confidence in the integrity of the institution.**

Principle #4: Size and Voting Rules

The MPC's size and voting rules should foster genuine engagement among members and diminish the influence of any single individual.

- **This principle mitigates the risks of autocracy, which has pitfalls like those of group-think.**
- **Previous analysis prescribed a fairly small size as optimal for engagement (e.g., 5 members), but a somewhat larger size may be needed to encompass sufficiently diverse perspectives.**

Principle #5: Terms of Office

Terms should be staggered, non-renewable, and last longer than the political cycle, with removal only in cases of malfeasance.

- Staggered terms are fairly conventional but only effective if members serve out a full term.
- Foreclosing the possibility of reappointment mitigates risks of political interference and avoids the entrenchment of power bases.
- The heads of many MPCs serve terms of 7-10 years, whereas the Federal Reserve Chair has a renewable 4-year term.

Principle #6: Individual Accountability

Each MPC member should be individually accountable to elected officials and the public.

- Individual accountability is crucial for mitigating the risk of group-think.
- Such accountability should occur through MPC communications, speeches & interviews, and hearings before elected officials.
- To avoid cacophony, the MPC must clearly explain the rationale for its decisions as well as elucidating the range of individual views.

Principle #7: External Reviews

The MPC should be subject to periodic external reviews of its strategy and operations, but not its specific policy decisions.

- **External reviews can be invaluable in identifying and mitigating group-think.**
- **Such reviews should occur on a regular schedule rather than triggered by political motives or idiosyncratic factors.**
- **These reviews should focus on assessing past & prospective performance, *not* on evaluating individual policy decisions.**

The Policymaking Process

- Statutory Mandate
- Medium-Term Framework
- Near-Term Strategy
- Specific Decisions

Principle #8: Legal Mandate

The MPC should have a legal mandate that sets forth its governance, goals, and tools.

- Some previous analysts have advocated that the MPC's objectives & priorities should be clarified in its statutory mandate.
- With pervasive & persistent model uncertainty, the appropriate specification of those goals and priorities may be complex & time-varying.
- Thus, the mandate should set forth the MPC's responsibilities & tools in fairly broad terms to minimize the need to amend that statute.

Principle #9: Medium-Term Framework

The MPC's medium-term policy framework should be approved or endorsed by elected officials roughly once every 5 years.

- **This framework should provide a quantitative description of the MPC's objectives, priorities, intermediate targets & operating procedures.**
- **The approval or endorsement of elected officials is crucial for the legitimacy and credibility of the policy framework.**

Principle #10: Near-Term Strategy

The MPC should formulate a systematic and transparent strategy that guides its specific policy decisions over the coming year or so.

- **This near-term strategy effectively clarifies the MPC's "policy reaction function."**
- **The strategy may be characterized using model-based forecasts, simple rules, and/or scenario analysis & contingency plans.**
- **The MPC should be free to determine its near-term strategy (operational independence) and held accountable for that determination.**

Principle #11: Policy Decisions

The MPC should regularly publish reports explaining the rationale for its specific decisions in terms of its policy framework and strategy.

- This principle presumes that the MPC promptly announces each policy decision.
- The MPC's reports should be published on a fixed schedule, roughly once per quarter.
- These reports should explain the rationale for the majority's decision along with concurring and dissenting opinions that clearly convey the range of individual views.

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Delegation of Responsibilities

- Interactions between monetary policy and macroprudential supervision & regulation
- Delegation to multiple agencies vs. multiple decision-making bodies in the central bank
- Roles of MPC members in overseeing and managing permanent staff and operations
- Appointment processes for officials with major public policy roles (e.g., chief counsel)

Insiders & Outsiders on the MPC

- Full-Time vs. Part-Time
- Executive vs. Policymaking Roles
- Differential Terms of Office

Concluding Remarks

- The MPC has responsibility for a critically important task.
- The institutional design of the MPC is crucial for mitigating the risk of severe policy errors due to political interference or group-think.
- The principles formulated here are framed with that purpose, but the specific application necessarily depends on the particular context of any given central bank.
- Comments welcome!