

Robust Design Principles for Monetary Policy Committees

David Archer, BIS

Andrew Levin, Dartmouth College

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

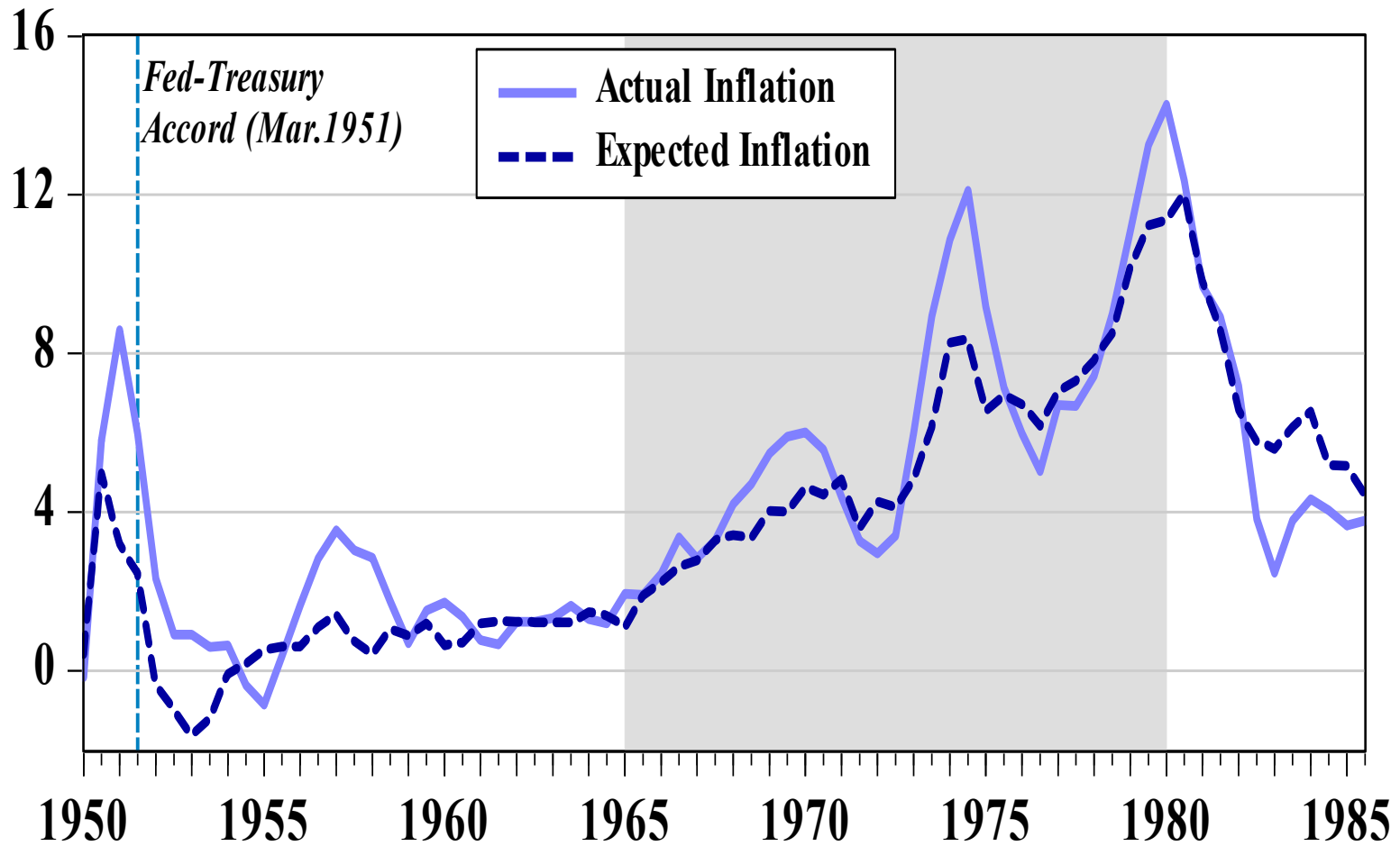
- **Political Interference**
 - The Roots of the U.S. Great Inflation
 - Venezuela's Banking Crisis in 1994

- **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.

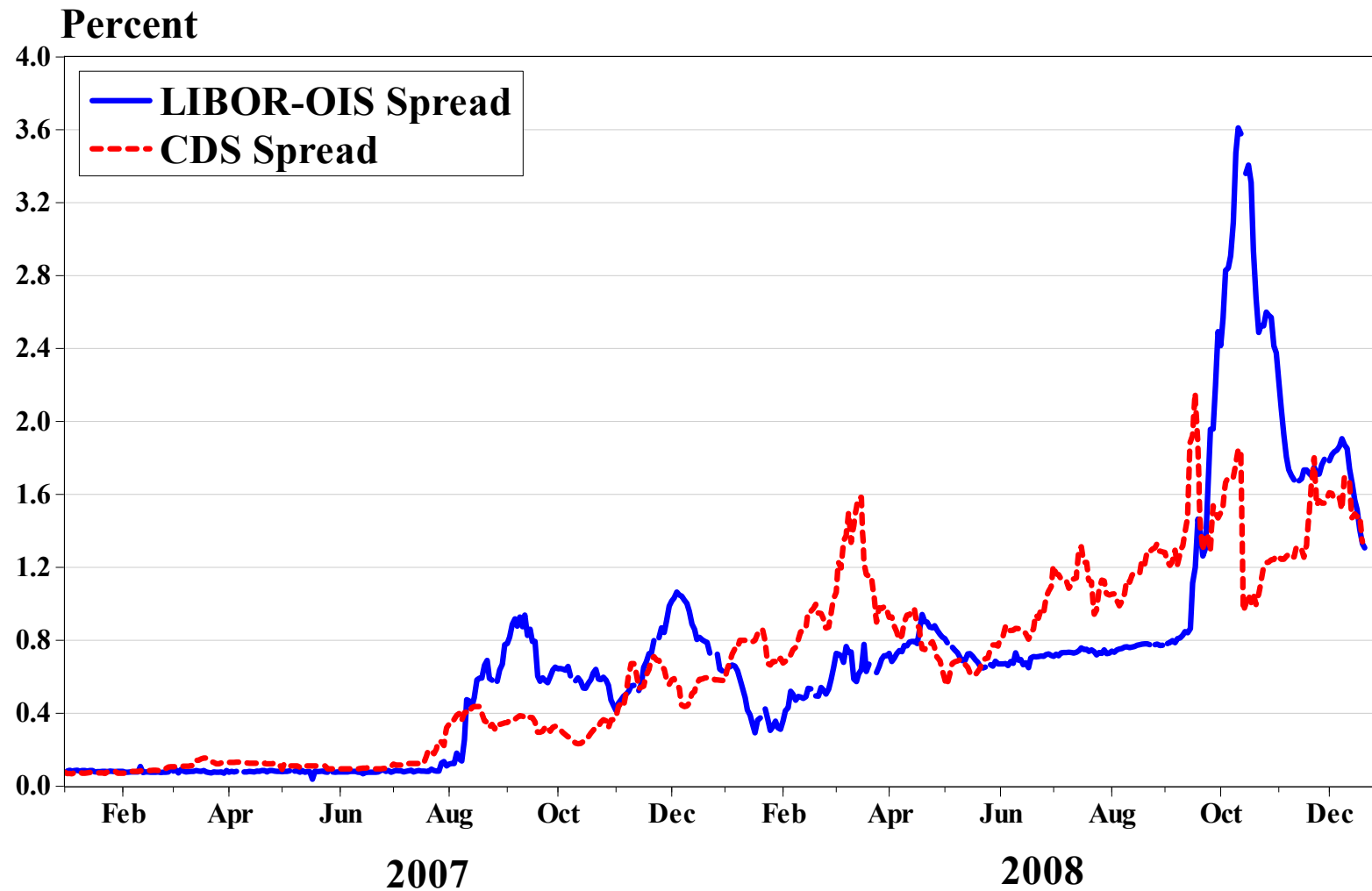
The Venezuela Banking Crisis (contd.)

- 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



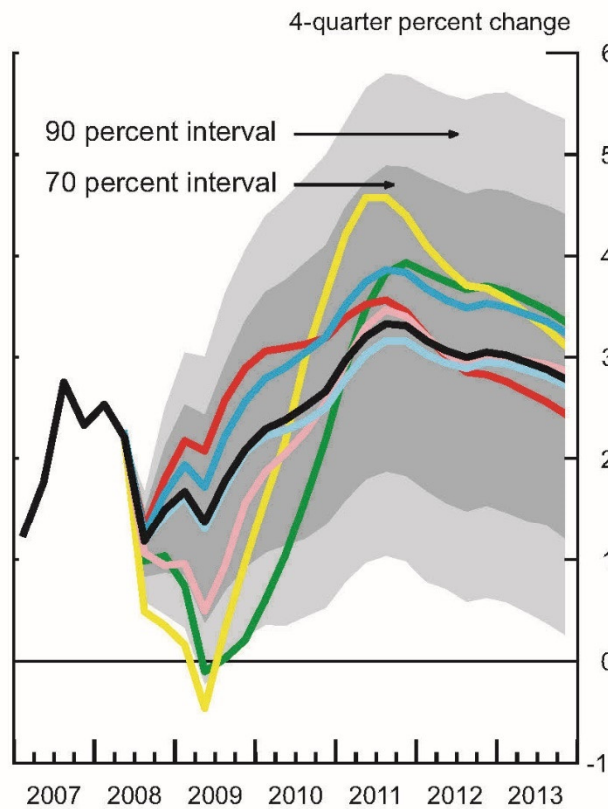
FOMC Statement, Tuesday 16 Sept. 2008

“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.**”

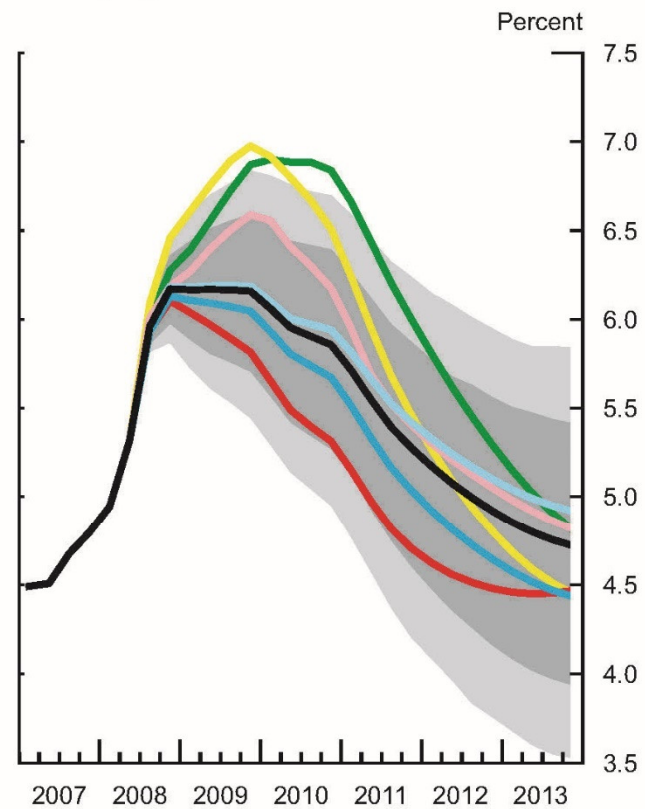
FOMC Greenbook Alternative Scenarios as of 10 Sept. 2008

- Greenbook extension
- More-persistent headwinds
- Typical recession
- Financial rebound
- Stronger aggregate supply
- Costly reallocation
- Unanchored inflation expectations

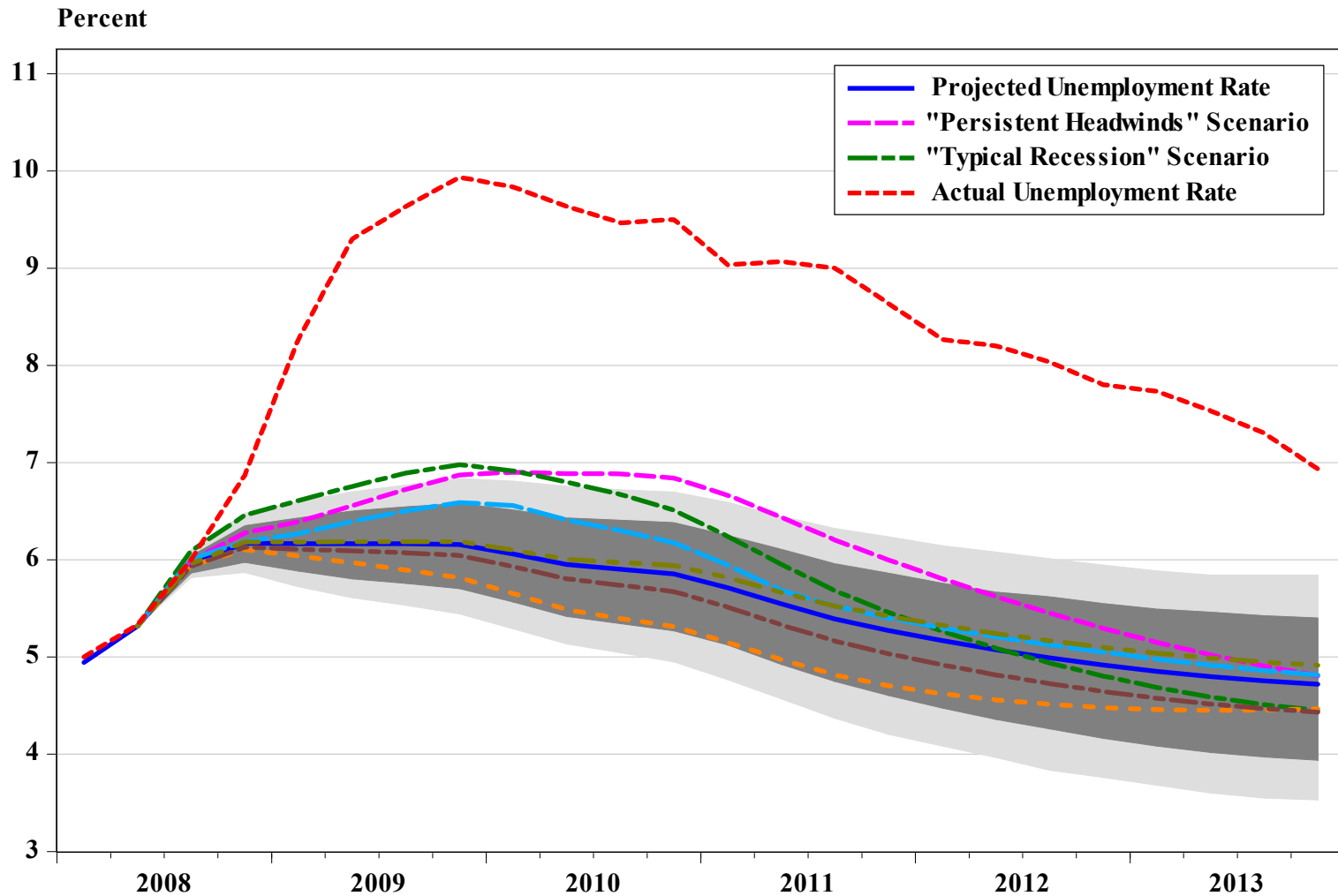
Real GDP



Unemployment Rate



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.

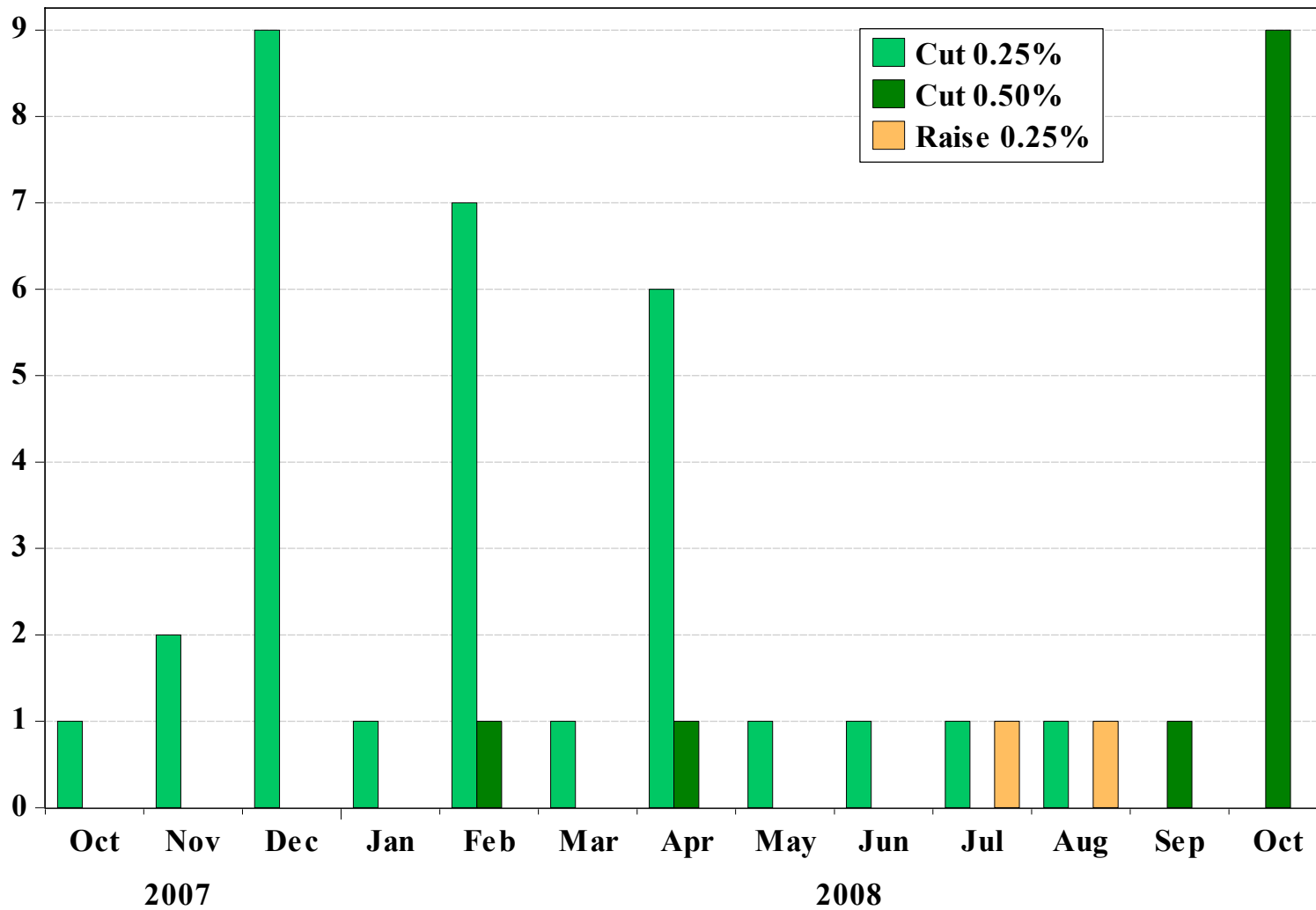
A Lone Voice at the Bank of England

“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

Vote Count



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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 heterogeneous preferences (hawks/doves) or the heterogeneity 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!**