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Monetary policy committees and interest rate setting

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Abstract

This paper shows that it is preferable for monetary policy to be conducted by a committee instead of a single policy maker if there is uncertainty about potential output. We examine three decision procedures – an optimal procedure, averaging and voting – and find that the latter is the appropriate way to reach decisions if policy makers are not equally skilled. Finally, we demonstrate that efficient decision procedures reduce the persistence of shocks.
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1. Introduction

The responsibility for the conduct of monetary policy lies in many countries with a committee. Over the 1990s, a number of central banks, most notably the Bank of England, the Bank of Japan, and the Bank of Sweden, have established formal Monetary Policy Committees (MPCs). These MPCs are operationally independent from the government and consist of a small number of individuals – typically the governor, senior staff of the central bank and, in some cases, outside members as well – who meet on a regular and pre-announced basis to decide on the level of interest rates. Policy decisions are taken by voting, and the individual votes are published. One striking feature of these voting records

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is that disagreements regarding the appropriate level of the interest rate are the rule rather than the exception. For example, between June 1997, when the MPC was established at the Bank of England, and October 2002, disagreements occurred in forty-four of the sixty-six committee meetings held.

This paper provides a theoretical study of interest rate setting in MPCs. We address three questions. First, we investigate why it might be advantageous to have a committee set interest rates instead of a single policy maker. We argue that a group is better able than an individual to form a view of the appropriate policy action in the presence of uncertainty about the state of the economy. Blinder and Morgan (forthcoming) come to the same conclusion in an experimental study.[1]

Second, we study the performance of alternative decision making procedures. We consider three procedures, which we call "optimal", "averaging", and "voting". The first of these is unrealistic in practice since it requires policy makers' relative abilities to be known and implies that some MPC members should have a greater say than others. The averaging procedure assumes that the interest rate is set equal to the mean of the rates favored by the individual MPC members, while the voting procedure implements the median of these views as the policy rate.[2,3] We show that averaging coincides with the optimal procedure if the committee members are "equally skilled" (in the sense defined below), but that voting can lead to better decisions than averaging if abilities vary between policy makers.

Third, we ask how the economy reacts to shocks under these different decision making procedures. We demonstrate that procedures which use the available data inefficiently lead to delayed and prolonged responses of the interest rate, inflation, and the output gap.

The paper is structured as follows. Section 2 provides a selective survey of the related literature on MPCs, trial juries, and policy making under uncertainty, and describes the ways in which our paper extends the existing analyses. Section 3 presents the model. We assume that there is uncertainty about potential output, so that policy makers must form views of the state of the economy in order to set interest rates. After considering as a starting point a single policy maker, we explore how a committee of equally able policy makers sets interest rates under different decision making procedures. Section 4 relaxes the assumption of equal skills and considers the more plausible case in which some policy makers are better than others at divining the state of the economy. It is shown that voting can perform better than averaging if the committee is small, essentially because the median view of the appropriate level of interest rates is less affected by differences in skill than the average view. Section 5 concludes.

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[1] We do not model the speed at which decisions are taken. Experiments conducted by Blinder and Morgan suggest that a committee reaches decisions roughly as fast as a single policy maker. On the other hand, Koh (1993) and Sah and Stiglitz (1988) argue that decision taking in committees takes longer.

[2] Joanne Cutler has pointed out that decisions of the Bank of England's MPC are based on a majority vote which does not necessarily coincide with the voting procedure discussed here. At the time of writing, however, the two procedures have always implied identical policy actions.

[3] A referee suggested that in practice MPCs might use a more restricted version of voting than assumed here. In particular, policy makers might consider only the current level of the policy rate and one alternative. At least for the Bank of England, however, this does not seem to be true, as there have been several occasions on which the MPC considered three policy options (see Gerlach-Kristen, 2003).