Paul Tucker: Remarks on "Making Monetary Policy by Committee"

Discussant remarks by Mr Paul Tucker, Executive Director and Member of the Monetary Policy Committee of the Bank of England, on "Making Monetary Policy by Committee" by Alan Blinder, at the Bank of Canada Conference "International experience with the conduct of monetary policy under inflation targeting", Ottawa, 22-23 July 2008.

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Central banking involves a lot of learning – by doing, by thinking, researching, and by comparing ourselves with our peers. At the core of that learning process is exchanges amongst central bankers themselves, much of it in Basel. The other rich seam is the academic literature. But relatively few turn (or return) to scholarly reflection after periods of alternatively practising and theorising about central banking.

Alan Blinder has therefore provided a signal service, since stepping down as Vice Chairman of the Federal Reserve Board, through his series of papers on monetary policy practice and how it both draws on and fuels theory.

Today's paper, on the role of committees in the making of monetary policy[1], places central banks into categories Blinder first set out a few years ago: single decision taker; autocrat-led college; genuinely-collegial; individualistic. It is especially interesting to the Bank of England, where for just over a decade we have operated a one-member/one-vote system for deciding our policy rate. As Blinder rightly says, comparatively speaking, this is clearly at the 'individualistic' end of the spectrum, and is a rare example of the species.

I have comments in three areas: the political economy genesis of the UK's system; how it bears on the communication of monetary policy or what Blinder called the 'cacophony problem'; and a plea for Blinder to widen his enquiries beyond interest-rate setting.

Political economy and one-member/one-vote

Modern Britain has no tradition of non-elected officials taking major executive decisions affecting the whole of the nation. This is in marked contrast to say the US where, at Federal level, the President is the only member of the executive to have reached office via the ballot box. Nor in the living memory of the UK people have we had any crises of democracy, so we have not developed national institutions, such as Germany's Bundesbank, whose place in society was not mediated via our democratic processes. In consequence, when debates about the possibility of central bank independence got underway in earnest from the mid-1980s, a widely perceived stumbling block was that central bank officials could not account personally for their decisions on the Floor of the House (of Commons). There was a democratic deficit.

Resolution came via the political cost of the failure of other approaches to monetary policy, in which Ministers running for re-election decided rates; the happenstance of the development during the 1980s and 1990s of influential committees of Parliament, before which central

1 See http://econ2008.bankofcanada-conference.ca/wp-content/blinder.pdf

bankers could (and frequently do) appear; and specific design features of the monetary regime itself.[2] Those included

- Parliament, in legislation, enshrining the goal of price stability, and requiring the Bank to publish a quarterly report on the outlook for stability
- the executive arm of government deciding the definition of price stability (2% CPI inflation target) and setting out requirements for the Bank to explain publicly what is going on if the target is missed on either side by more than 1pp
- the Committee comprising four 'external' members as well as five internal (or 'executive') members.

The external members were necessary to legitimise giving such an important function to the Bank. 'One person/one vote', with transparency, was a mechanism for attracting high-quality 'externals' and for ensuring that the introduction of 'new blood' made a difference – that it did let in 'fresh air' and bring useful expertise to the table. And, of course, the system of individual voting had to carry across to the 'internals' too. Indeed, as most studies show, there is no difference between internal and external members in our decision-taking.

The burden of that rehearsal of some UK institutional history is this: that, in comparing central bank practices, we should not think of our various decision-taking structures solely as technical solutions to the shared technical problem of deciding a path for rates. Rather, our varying structures are efforts to solve that shared technical problem in the context of varying histories and social and political structures. We should understand each other, and adopt and adapt what could usefully travel across borders, but not proselytise.

Communications, and forecasts

If, adapting Mike Woodford, monetary policy is nearly all about expectations, then communication matters hugely in real-world policy making (a world in which rational expectations don't hold and so one in which we cannot passively rely on households and firms just getting it right by observing our actions). I agree entirely with Blinder that what kinds of communication are feasible and effective will vary according to the type of decision-taking structure a central bank employs.

In the Bank of England's case, given one member/one vote, the challenge is how to achieve a sensible balance of centripetal and centrifugal forces. How this plays out varies across the different dimensions of monetary policy: the objective, 'model' of the economy, reaction function, month-by-month decisions, and forecasts, and so on.

As already noted, the objective is laid down by the Chancellor of the Exchequer. As well as helping to fill the democratic deficit, this coheres with a one person/one vote committee. The structure would not work well if different members were free to form our own views on the objective. Amongst other things, that would mean that as the composition of the MPC changed, the objective could change. This also underpins the utility of the UK MPC's objective unequivocally giving primacy to inflation; in the jargon, the objective is lexicographic, with 'avoiding unnecessary volatility in output and employment' occupying a subsidiary role. This means that we can and do make judgments about the period over which we should return inflation to target in the wake of a cost shock, notably at present. But we are not in a position where individual members could choose to subordinate the achievement of price stability to that of stabilising output.

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[2] For a more extended discussion, see Tucker P M W (2007) 'Central Banking and Political Economy: the example of the UK's Monetary Policy Committee' speech at Inflation Targeting, Central Bank Independence and Transparency Conference, Cambridge, Bank of England Quarterly Bulletin Q3 2007, pp 445-452.

At the other end of the spectrum, our month-by-month votes on Bank Rate are individualistic in precisely Blinder's sense. And, as he says, that has clear implications for how we convey those decisions. The minutes take primacy. That is partly because it is more difficult for us than for some of our peers to release an informative statement immediately after the policy meeting: if you don't know what you're going to decide, it is pretty hard to prepare a draft in advance! Each individual member is obviously in a position to summarise their views. But we could not sensibly have nine individual statements without risking what Alan Blinder calls cacophony. Also, such statements would have to be prepared in advance, so there would probably be less listening and engagement at the policy meeting itself. At the other end of the spectrum, finding 'the average' for a collective Committee statement is tough in the short time available, except where a majority has decided to change Bank Rate, or where 'no change' is driven by some clear common factors that it would be unreasonable to withhold from the public sphere until publication of the minutes a fortnight later.

'Individualism' is also reflected in our public speeches and appearances before Parliament. Those individual exercises range widely – from assessments of the conjuncture, through examinations of particular parts of the transmission mechanism, to reflections on monetary-policy making more generally.[3] But whatever the subject or scope, we are each speaking for ourselves, not for the Committee as a whole.

Taken together, all this plainly sets up centrifugal forces, or Blinder's 'cacophony problem'. As put that matters, since it is of course the systematic component of monetary policy that is doing the work in stabilising nominal trends. Households, firms, the financial markets need to figure out what the Committee – or, somehow, its marginal member(s) – thinks is going on in the economy and how it will react in setting Bank Rate ('our' reaction function).

But there are centripetal influences too. I shall highlight two.

First, the aim of each member is not to be in a minority but for their preferred level of Bank Rate to be that chosen by a majority of the Committee. This means that, in addition to clarifying our own thoughts, we are up to a point in the business of persuasion. Ours is not a system of postal voting. It is a system of listening to and learning from each other.

Second, with qualifications, some of the MPC's communications are relatively more collective. In particular, our communications on a broadly shared 'model' of how the economy works, and our forecasts of the outlook for growth and inflation.

In 1998, the (then) Committee published a paper on the Monetary Transmission Mechanism; and, in a 2007 paper to the Treasury Select Committee of Parliament, we described our view of material changes in the workings of the economy during the Committee's first ten years. Both were agreed, collegiate-like documents, while not committing every member to every proposition.

Much the same can be said of our quarterly forecasts and Inflation Reports, which play a central role in the MPC's system. Our forecasts are the projections of the policymakers not the supporting analytical staff. It is striking that the 'individualistic' MPC publishes a common forecast, whereas the somewhat more-collegial FOMC has long published information (the central tendency and range) about the forecasts of its individual members (without the names). The FOMC's approach allows the range of central projections to be transparent. It is

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3 See Tucker, P M W, 'Reflections on operating inflation targeting', speech at the Graduate School of Business, University of Chicago, July 2006, Bank of England Quarterly Bulletin Q2 2006, pp 212-224.
Kate Barker, 'Monetary Policy in the UK – The Framework and current issues' delivered at the National Association of Business Economics Policy Conference, Washington DC, March 2005, Bank of England Quarterly Bulletin Q2 2005, pp 276-282.
Rachel Lomax 'The MPC comes of age', a speech delivered at De Montford University, February 2007, Bank of England Quarterly Bulletin Q1 2007, pp 106-111.
Charlie Bean 'Inflation Targeting: the UK experience', speech at the Annual Congress of the German Economic Association, October 2003, Bank of England Quarterly Bulletin Q4 2003, pp 479-494.

quite different in kind from the fan charts we publish in the UK, showing the band of uncertainty around central projections for output growth and inflation. Our 'fans' are not, as is sometimes suggested, a way of encompassing the central view of each of the nine individual members; they reflect collective discussion and agreement. Mutual engagement would not be needed if we were in the business of publishing nine individual fan charts. Frequently, we do indicate in the Inflation Report that different members assign different weights to the various risks around the central projection. And to be clear, individual members are not constrained to be part of the collective forecast; if our differences were sufficiently material, we could make that clear quantitatively in the Inflation Report. But, if at any point, all nine members did so, the centrifugal elements of our individualistic system could, it seems to me, lead to genuine cacophony. In the interests of effective policy, the Committee as a whole therefore has an interest in setting up some centripetal influences, without making them a binding constraint on individual members.

Thus, the publications on the transmission mechanism and on the economic outlook provide a broad, common platform for readers to use when making sense of our individual pronouncements. My hunch is that this gives us greater scope for articulating our individual views without creating misleading impressions. For example, a paper I delivered last year on Money and Credit[4] went into more detail on those parts of the transmission mechanism than any collective statement, or than my colleagues might wish to go.

I have found that helpful in recent months, as a few comments on the current conjuncture might illustrate. My take at our recent July meeting was, broadly, that since the May Inflation Report, the near-term outlook for inflation had deteriorated, underlining the risk that the rise in commodity prices will feed through to wage and price setting. The outlook for demand and output had also deteriorated, which in degree should help to contain those upside risks to inflation. Going forward, a key judgment will be whether the prospective slowdown will be sufficient to bring inflation back to target with the current level of Bank Rate, taking into account the tightening in some broader measures of monetary conditions. The final point is what I want to highlight in the context of my remarks today. Given a marked increase in credit rationing in capital markets and bank lending, the conventionally measured short-term risk-free real rate may not be the same summary statistic of monetary conditions as before the turmoil. It is currently necessary to undertake a richer analysis of monetary and credit conditions, which had been the broad theme of my earlier paper. But those remarks about money and credit were nested within a broadly common approach to the transmission mechanism and policy.

To recap, the MPC's more collective statements make us free to do our duty in revealing our individual thoughts without creating a misleading perception of cacophony when it is not really there.

The challenge for central banks with different decision-taking structures would seem to be the opposite: (i) how to allow a range of views to be explored seriously so as to avoid intellectual or analytical inertia – or how to let in fresh air; and (ii) in terms of communications, how to demonstrate that there is true debate without individual pronouncements being confused with the collective pronouncements on policy made typically by the Chair.

I think forecasts are central to this. And I would encourage Alan Blinder and his collaborators to extend their work on the production and role of forecasts in the decision-making of different central banks; and how the communication of forecasts interacts with the communication of other elements of the policy process.

4 See Tucker, P M W, 'Money and credit: banking and the macroeconomy', speech at the Monetary Policy and the Markets Conference, 13 December 2007, Bank of England Quarterly Bulletin Q1 2008, pp 96-106.

Other bits of central banking

Finally, and briefly, I would observe that Blinder's work on decision-taking processes and structures has so far focused entirely on the setting of interest rates. We have been living through a decade or more in which, at many although not all central banks, other decisions affected the financial landscape and risks to stability. Again drawing on his experience as the Vice Chairman of the Fed Board and again comparing and contrasting different approaches, I think we would all benefit enormously if Alan Blinder took his scholarly apparatus and spirit of enquiry into other corners of central banking and how they fit together.