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The Monetary Policy Committee Five Years On – Speech by Mervyn King

In a speech delivered to the Society of Business Economists in London today, Mervyn King, Deputy Governor of the Bank of England, poses four questions about the role and record of the MPC.

"First, why give the power to decide interest rates to a committee rather than an individual? Second, does it matter that the MPC frequently disagrees about its decision? Third, has the Committee communicated clearly the reasons for its decisions? Fourth, does the MPC require reform?"

He notes that Alan Blinder - a former Vice-Chairman of the Federal Reserve Board - and his colleague John Morgan at Princeton carried out two 'laboratory experiments' using groups of Princeton students to test whether groups do indeed make decisions differently. Last year, a team from the Bank of England attempted an exercise very much like Blinder and Morgan's monetary policy experiments using a sample of just under 200 economics students from the London School of Economics.

Reporting on the results, Mr King says that three features were striking:

- (i) The significant upward trend in the results. Players clearly learned how to play the game as time went on.
- (ii) The large upward movement in scores when players moved to committee decision-making.
- (iii) The large downward move in scores when participants returned to playing as individuals.

He says "These results support the idea that committee decisions represent a significant improvement over those of the individuals that comprise them. What might account for these results?"

The Blinder and Morgan and Bank studies suggest two main reasons. "First, collective decision-making appears to give more weight to the better and less weight to the worse committee members, as judged by their scores when playing the game as individuals, than would be implied by taking the mean of individual performance."

"Second, there was also evidence from the experiments consistent with the hypothesis that committees enable all members to improve their performance by sharing information and learning from each other. And it

was striking that the performance of committees was on average somewhat better than that of the performance of the single best player on the committee when playing alone. So in terms of group decisions, it appears that the whole is different from - and generally better than - the sum of its parts."

Discussing differences of view among MPC members Mr King says: " On only four occasions has the difference between the highest and lowest interest rate voted for exceeded 25 basis points, and, interestingly, all four were between August 1998 and April 1999, a period of great uncertainty about whether there would be a downturn in the world economy that did not in fact materialise. Since then differences of view have never exceeded 25 basis points. The average difference between the interest rate cast by the member voting for the highest average level of rates and the member voting for the lowest average level of rates is less than 15 basis points! Such a small difference hardly corresponds to a major difference of view about the outlook for inflation."

Turning to the MPC's explanation of its decisions, Mr King says: "Commentators and others may form their own views about the likelihood of various economic shocks occurring, and in that respect it is more important for them that the Committee explains its policy reaction function than attempting to provide guidance on the likely future path of interest rates."

He believes that there is "an inherent tension between a system of nine individually accountable members, with their associated views, and a Committee from which a single decision emerges that requires a clear explanation each month. The former produces, as I have argued, better decisions; the latter is important for the predictability and thus the efficiency of monetary policy. The communication strategy of the MPC must provide a balance between these two objectives, a point acknowledged in the report by Don Kohn on the procedures of the MPC."

He adds: "This tension between the need to explain the diversity of members' views, and the need to provide a clear rationale for the single decision, suggests that the Committee may need to explore further ways of putting across its collective view." He concludes "The avoidance of confusion requires some forbearance by individual members of the Committee, and a clear understanding of which forms of communication are appropriate to explain individual views and which forms are suitable for explaining the reasons for a collective decision. I am sure that the Committee will learn more about how best to achieve this balance as time goes by."

Finally, on the question of whether the MPC requires reform, he says: "The precise definition of the inflation target, and its numerical value, can be debated at length. What is important is that the target is for inflation and not additional objectives that would lead to confusion about the Committee's aims."

He adds "The Committee has had more problems in trying to explain that there is no mechanical link between the central projection of the forecast for inflation two years ahead and the policy decision. This is for several reasons. First, the view of inflation both prior to and after the two-year horizon is important too. The

optimal horizon over which to bring inflation back to target depends on the shock which moved inflation above or below target. Second, the risks to inflation around the central projection (defined as the mode of the distribution of inflation at future points) are also relevant to the policy decision. Third, there may be some risks to which the Committee does not wish to respond until they have materialised. But the Committee will continue to explain how its outlook for inflation relates to the policy decision, and, over time, we hope that this educational effort will pay off."

He concludes: "During its short life-time the MPC has made changes in its procedures and remains open to the possibility of further improvements. But unnecessary tinkering would be a distraction from its main purpose."

Key Resources

The Monetary Policy Committee Five Years On - Full Speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2002/speech181.pdf>