Communicating Monetary Policy when the MPC Members Believe in Different Stories

by

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Objective of paper

- Analyze monetary policymaking made by committees (MPCs)

- How should decision-making structure of the MPC be designed?

  - Should MPC members vote on the interest rate decision?
    (Conclusion-based voting.)

  - Should MPC members vote on factors that form the basis for the interest rate decision?
    (Premise-based voting.)

- Relevant and interesting issue with non-trivial answers and social-choice based insights

Modelling approach

- MPC members agree on a decision rule:

$$i = f\left(p_1, p_2, ..., p_k\right)$$

- The n MPC members have different premises, or, stories:

$$S_j = \left(p_{1,j}, p_{2,j}, ..., p_{k,j}\right), \qquad j = 1, 2, ..., n$$

- Given these different perceptions about the economy, what to do?

- Authors focus on interest rate settings backed by *consistent* stories:

$$i' = f\left(S'\right) \tag{3}$$

- Authors assume that each member's preferred interest rate is *consistent* with his/her premises:

$$i_j = f\left(S_j\right)$$

General results

- Two main scenarios are compared:

  - Voting on i, and subsequently finding a consistent story
  - Voting on elements in S, and then determine the consistent i

- The scenarios may differ significantly:

  - Voting on i gives i_m, but a consistent story, S_m, may differ from a story wining the vote among S_js, S_{mpc}, leading to the consistent interest rate $i_{mpc} = f\left(S_{mpc}\right)$

- Hence, conclusion- and premise-based voting procedure deliver different stories and interest rates — this follows from an *aggregation inconsistency called the "discursive dilemma"*

Specific results, 1

- So, what to choose?

- It is found that under a conclusion-based procedure the "winner interest rate" (by median voter), are associated with a unique consistent story: that of the median voter

- It is found that under a premise-based procedure, MPC members should vote on each premise to get a unique story:
$$S_{p_m} \Longrightarrow i = f\left(S_{p_m}\right)$$

Specific results, 2

- These two specific procedures are compared, and the premise-based procedure is *the winner*!

  - In simulations with linear decision rule it entails lower RMSE of the premise variables (when compared to the true ones); a "committee gain" is present (the RMSE of i are the same)

  - With a non-linear decision rule, even with only one premise variable, a premise-based procedure is the winner.

General comments

- Well motivated analysis, with some clear and intriguing examples

- Relevant for thinking about appropriate decision structure in MPCs

- Nice application of social-choice theory to monetary theory

- Clear policy recommendations:

  – Introduce premise-based decision procedures to obtain less surprises in consistent stories

  – Use central bank's "core" models to facilitate premise-based decision making

Specific comments: Reasonable assumptions?

- Stringent analysis given the assumptions, but many assumptions are strong and *ad hoc*

- *Any* story S_j is exogenously given

- *Any* story $S_j = \left(p_{1,j}, p_{2,j}, ..., p_{k,j} \right)$ is internally consistent (no structure on any relationships between p_js)

- *Any* story S_j gives member j's preferred *and* consistent interest rate $i_j = f\left(S_j \right)$

- *All* members agree on the decision rule (form and arguments)

- . . . any scope for real conflicts (or just information sharing) are absent

Specific comments: Reasonable assumptions?

- What *is* the magic of consistent stories?
  Why focus only on $i' = f(S')$

  - When voting on interest rates, and it is known there is dissent, it is not surprising if two stories are around; it may be helpful to know them!

  - It is simply an assumption that consistency is "good" — in models in this vein, I prefer such things to be a *result*

- What *is* the magic of small RMSE of stories? Only that assumed in the paper. A very weak welfare criterion for a normative analysis (in the main example the nominal interest rate has identical RMSE under either procedure)

  (And can one, e.g., have *wrong* preference-based premises?)

Very specific comment:
The one-premise example and non-monotonicity?

- Example uses New-Keynesian two-equation model, with optimal discretionary policy

- Decision rule becomes *non-linear* in structural variable $\kappa > 0$:

$$i_t = \frac{\kappa}{\kappa^2 + \lambda} u_t \tag{10}$$

  - κ is slope of Phillips curve (low κ means high degree of nominal rigidity)

  - λ is relative weight on output versus inflation stabilization in loss function

- Application of model to economic structures, and a better welfare assessments are just around the corner

Very specific comment:
The one-premise example and non-monotonicity? (cont'ed)

- But, with welfare function specified properly, λ is function of κ

- More nominal rigidity in the economy makes inflation more costly

  - So, $\partial\lambda/\partial\kappa > 0$

  - Actually, it is the case that $\lambda = \kappa\theta^{-1}$

- Hence,

$$i_t = \frac{\kappa}{\kappa^2 + \lambda}u_t = \frac{\kappa}{\kappa^2 + \kappa\theta^{-1}}u_t = \frac{1}{\kappa + \theta^{-1}}u_t$$

  which is *monotonous* in κ

- So, slightly disappointing example (another could very likely be dug up)

General remarks

- The issue of central bank institutional design has been on the agenda in monetary macro for decades now

- Fruitful and lively area with enormous interaction between academics and practitioners

- The independent central bank, and to some extent inflation targeting, are robust recommendation of the large literature

General remarks (cont'ed)

- The size of the (positive) welfare implications are yet to be assessed firmly

- The sub-literature on transparency, communication, decision-making structure, etc. has yet some way to go before *firmly rooted* quantification of costs and benefits are established

- So, more work and fewer mantras are needed!

General concluding comments on paper

- Very interesting paper

  - Clearly and well motivated

  - Clearly and well presented

  - Clear policy implications

- Lots of "food for thought." Still, I am not fully convinced

  - More "beef" is needed on the bones:

    * Find Nash equilibrium behavior under different procedures in a fully speficied extensive-form, non-cooperative game

    * Any welfare gains of suggested policy reform must be much more evident