

Monetary Policy-Making Bodies – An Overview

Monetary policy is one of the two macroeconomic tools used by the government to effectively impact the economy (*AIB Capital Markets*). This policy tool is primarily utilized to influence economic indicators like interest rates, inflation and credit availability by controlling the changes in the money supply available in the economy (Marchant and Snell).

Monetary policy is implemented in line with the economic goals set by government. The central bank of a particular country or economic bloc, as in the case of the European Union, formulates these monetary policies for the attainment of these identified objectives. Specifically, a core committee within the central bank is tasked to design and undertake monetary policies based on their assessment of economic conditions and objectives to be achieved.

This paper compares the operations and mandates of the three most influential monetary policy-making bodies, namely the US-Federal Open Market Committee, Bank of England-Monetary Policy Committee and European Central Bank-Governing Council.

US-Federal Open Market Committee (FOMC)

The FOMC is considered as the foremost policy-making body of the US Federal Reserve. Its primary function is to formulate monetary policies which serve to promote economic growth, full employment level, stable price level and sustainable pattern of international trade (*Federal Reserve Bank of Minneapolis*). This aim is achieved by making key decisions pertaining to the conduct of open market operations, i.e. the selling and purchasing of US Government and Federal Agency securities. Open market

operations mainly affect the provision of reserves to banks and other depository institutions. In this regard, open market operations impact the cost and availability of money and credit in the economy of the US (*Federal Reserve Bank of Minneapolis*).

As a background, the FOMC is composed of seven members of the Board of Governors and five Reserve Bank Presidents, who must meet at least four times a year in Washington D.C. as mandated by law. It is during these committee meetings that FOMC decides on the policies to be carried out through voting.

In view of the monetary decisions it has to make, the FOMC takes into account vital economic factors such as trends in prices, wages, employment, production, consumption, investments, foreign exchange markets, interest rates, and fiscal policies among others. It should be noted that the monetary policies are implemented with primary focus on supplying level of reserves which is congruent with the economic objectives of the US, both in the short-run and long-run (*Federal Reserve Bank of Minneapolis*). This means that the control of open market operations is FOMC's major tool to directly influence the money supply in the economy. The movement in money supply will then affect the other economic factors based on the economic objectives of the nation.

Bank of England-Monetary Policy Committee (MPC)

The MPC's main function is to regulate prevailing interest rates at an appropriate level in order to attain the inflation target over a period of two years. This committee primarily considers the economic performance of the country and determines whether this is accompanied by the risk of acceleration in overall price levels ("Bank of England").

The MPC, which is chaired by the Governor of the Bank of England, consists of five members from the Bank of England and four external members appointed by the chancellor (*Bank of England*). The setting of interest rates is decided based on the conditions of domestic monetary market, foreign exchange market, production market and labor market (“Bank of England”).

To curb inflation, the MPC’s primary tool is the setting of interest rates. Should the MPC determine that aggregate demand is expanding and exerting upward pressure on prices, the committee will decide to raise the interest rates in order to control the growth of investment and consumption spending in the economy. As such, the price stability is restored (“Bank of England”).

European Central Bank-Governing Council (GC)

The GC is the highest decision-making body of the European Central Bank. The main function of this body is to determine the monetary policy of the European bloc with primary focus on the fixing of the interest rates at which commercial financial institutions can obtain money from the European Central Bank (“European Union institutions and other bodies”).

This chief policy-making body is comprised of six members of the Executive Board and governors of all the national central banks of the twelve member-countries of the economic bloc. In particular, the GC is tasked to make decisions pertaining to key interest rates and supply of reserves in line with the monetary objectives of the Eurosystem (*European Central Bank*).

The GC usually conducts meeting twice a month. For the first meeting, it sets key interest rates for the euro area. For the second meeting, GC makes decisions

relative to the other tasks of the European Central Bank (*European Central Bank*).

These include decisions on payment systems, financial stability, statistics, banknotes and other legal affairs ("European Union institutions and other bodies").

Comparison of Monetary Policy-Making Bodies

Given the overview of the functions of the three monetary policy-making bodies, it can be said that one of the apparent difference is their strategies for achieving a given set of objectives (Meyer 2001). Based on the above discussion, the FOMC uses its control over open market operations to achieve the economic objectives of the US. On the other hand, the MPC and GC make use of its control over the setting of key interest rates to attain the economic objectives of the UK and European bloc.

The difference in the monetary policy strategy utilized by these committees is directly related the varying objectives of their respective central banks (Meyer 2001). For instance, the US Federal Reserve has a dual mandate of attaining both full employment and price stability. These two objectives are sought simultaneously. On the contrary, the Bank of England and European Central Bank have hierarchical mandates. This means that these central banks have a principal objective and secondary objectives. In the case of the given central banks, the main aim is to achieve inflation which is well within the target of the government (Meyer 2001). Once the main goal is achieved, only then will the other objectives be pursued. The three committees undertake a specific strategy which is in line with the achievement of their primary economic goals.

Another difference noted is the bodies' instrument independence. As a fundamental requirement, these committees have the final say on monetary policy

decisions and implementation. The committees are said to be independent, although at varying degrees, so as to insulate them from myriad forms of political interference (Meyer 2001). Independence of these monetary policy-making bodies are said to be reliant on the evolution of both informal and informal relationships between the central bank and the rest of the government (Meyer 2001).

Given its sphere of influence, the GC or European Central Bank as a whole is the one with the greatest degree of instrument independence. It participates in oversight hearings by the European Parliament, however, it has no authority whatsoever over the central bank (Meyer 2001).

In addition to the differences in monetary policy tools used, objectives and instrument independence, a study has been conducted by Ehrmann and Fratzcher (2005) on the divergence of these three policy-making bodies in terms of communication strategy relating to future monetary policy undertakings and manner of decision-making. Their conclusions are based on the analyzed statements of all committee members during inter-meeting periods.

The FOMC is said to pursue an individualistic communication strategy given that statements delivered by individual committee members exhibit a high degree of dispersion. The decisions of the FOMC is said to be generally made in a collegial manner as there is usually a unanimous vote on various monetary issues. (Ehrmann and Fratzcher 2005)

On the other hand, the MPC shows a collegial communication strategy since there is a high degree of consistency among the statements of the committee members. However, decision-making process is characterized as highly individualistic as majority

of the decisions they arrive at are not unanimously made. (Ehrmann and Fratzcher 2005)

The experts posit that the GC is the most consistent among the committees. This is because this policy-making body is highly collegial in both its communication strategy and decision-making process. Based on the assessment of inter-meeting communication, future policy decisions of GC show highest level of consistency.

As to the effectiveness of the communication strategy and decision-making of these committees, Ehrmann and Fratzcher (2005) concluded that there is no specific or standard approach to communication and decision-making strategies that should be adhered to by central banks.

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