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DECISIONS OF MONETARY AUTHORITIES IN THE LIGHT OF MONETARY POLICY TRANSPARENCY

Summary: The analysis of the two approaches seems to favour collective decision-making as the approach that offers effective policy-making and the implementation of monetary decisions. The individual approach is, more often than not, charged with the burden of subjectivity since the policy-maker tends to form decisions based on individual value system and personal experience. Moreover, individual approach favours most obvious decisions, disregarding or neglecting alternative solutions to the problem at hand. By adopting the collective approach to decision-making, monetary authorities may augment the transparency of monetary policy in general, thus improving its efficiency and effectiveness.

Key words: strategy of direct inflation targeting (DiT), collective mind, individual approach to decision-making, collective approach to decision-making.

1. Introduction

Decisions of public authorities are a popular subject of research in many fields, due to the error of subjectivity frequently associated with decision-making processes. One particular group of public decisions is that of decisions made in respect to economic policy, especially decisions of monetary authorities.

The context of monetary authorities' decisions is highly complex, with the principal feature of uncertainty. Economic sciences attempt to address and evaluate the uncertainty factor and present it in the form of specific risk. Any attempts at quantification of macroeconomic phenomena for the purpose of optimizing monetary authorities' decisions may be burdened with error. However, the potential errors in forecasting the economic future cannot cripple the decision-making processes of monetary powers, but rather lead to improved methods of modeling the economic reality.

In theory and practical application, decisions of monetary authorities may come in the form of individual or group decisions. A good example of decisions made at individual level in the course of setting the parameters of monetary policy is the Reserve Bank of Australia, with pertinent judgments made personally by the

Governor. Most of the national central banks make their decisions collectively by the respective collegial bodies. Polish Monetary Policy Council is an example of such a collegial body.

In the above context, it is interesting to investigate which of the two approaches prove more optimal in the light of the adopted criteria of central bank's main objectives. Central banks, in the course of implementing their mission and obligation, must remain independent, responsible, reliable and transparent. All those attributes collectively constitute the reputation of the central bank as such.

This paper aims to address the question: which of the two approaches to monetary authorities' decision-making – individual or collective – is more optimal from the viewpoint of the principle of monetary policy transparency?

To address this issue, it is necessary to present this author's views on such subjects as:

- the strategy of direct inflation targeting (DIT) as the fundamental operational strategy of most central banks at present,
- the nature of monetary policy transparency,
- individual vs. collective approach to decision-making in various organizations.

Conclusions on the above analysis will help to establish the most optimal and most effective approach to monetary policy decision-making – individual or collective.

2. The direct inflation targeting (DIT) strategy

In all countries of the contemporary world, the central bank is a monetary authority established with the purpose of counteracting the inflation. In the modern world, the regulatory sphere can affect the real economy through a multitude of channels. Some of those channels offer immediate effects on small scale, others are designed to affect large-scale changes in a prolonged time frame. Decisions made by monetary authorities impact the real economy predominantly through the following channels:

- the channel of household expectations,
- the channel of expectations on the part of companies and institutions,
- the channel of exchange rate policy,
- the channel of balance,
- the channel of crediting,
- the channel of financial market assets.

In most countries, the fundamental mission of the central bank is to properly manage the expectations of all actors. Monetary authorities should state their goal unambiguously. Usually, the fundamental goal of a central bank is presented in the acts of supreme law, such as the constitution or a supreme act. Regulation of the fundamental goal may be expressed in various terms, such as 'price stabilization' or 'maintaining the value of domestic currency'. At present, central banks understand price stability in terms of inflation low enough to offer no negative impact on investment, savings and other important decisions made by the actors of the economic life, whereas maintaining the value of domestic currency is understood as the stabilization of its purchasing power.

Nowadays, central banks frequently adopt the strategy of direct inflation targeting (DIT) as their main objective. Also the Monetary Policy Council, a constitutional body of the Polish Central Bank, has adopted DIT strategy as its principal objective. The DIT strategy is applied either in terms of ultimate inflation targets or intermediary range of inflation targets. Poland has adopted the ultimate target approach. From the year 2004 onward, DIT is expressed as 2.5 % with symmetrical deviation range of (+ –) 1%. F.S. Mishkin describes the essence of direct inflation targeting strategy using five constituent elements of DIT:

- publicly announced medium-term inflation targets,
- institutional obligations to treat price stability as a fundamental objective of the monetary policy,
- decisions shaping the monetary policy instruments are based on a wide range of information (multiple variables), not only on the behaviour of monetary aggregates and exchange rates,
- increased transparency of the adopted strategy, based on communication with general public and the markets on plans, objectives and decisions of the monetary authorities,
- increased responsibility of the central bank before democratic institutions for completion of the adopted objectives[1].

The above discussion presents the methods of defining the objective of monetary authorities. In order to address the main question of this paper, it is essential to present the issue of transparency in respect to monetary policy. Only then, one may attempt to point out the most efficient approach to monetary policy decision-making from the viewpoint of the monetary policy objectives.

3. Transparency of the monetary policy

Only the central bank, with its privileged position of independence, may effectively guard the price stability and protect the value of domestic currency. Independence of central banks, liberated from the negative political influences, is safeguarded in the European Union Treaty. Such functional, institutional, personal and financial independence offers proper conditions for them to fulfill their central monetary objective.

As an independent institution equipped with the above competences related to price stabilization and currency protection, a central bank is responsible for shaping and carrying out the national monetary policy. Like any other public institution, the independent central bank is obliged to clarify their decisions to the public. In other words, its actions and activities should be transparent.

[1] F.S. Mishkin, *Inflation targeting for emerging market countries*, "American Economic Review" 2000, No. 2.

Responsibility of the central bank should be understood as accountability for its autonomously set objectives. On the other hand, transparency is a much narrower term referring to the obligation to provide general public with information on any of its internal decision-making processes carried out in the course of its duties. In a wider sense, transparency also refers to the process of clarifying the use of monetary policy as an instrument for carrying out the mission of the central bank. The strategy of monetary policy contributes to transparency of actions in the sense that it creates stable environment for both the internal decision-making processes and for external communication[2]. Increased transparency is reflected in better understanding of monetary policy by the general public, and, as such, offers better potential for improving the reputation of monetary authorities.

The notion of 'transparency' in relation to monetary policy is widely discussed in professional literature. For example B. Winkler observed that monetary policy can be regarded as transparent if the following attributes are met:

- *openness* in relation to quantity and precision of information provided by the central bank,
- *clarity* in presenting and interpreting information. Information provided should not introduce informational 'noise',
- *common understanding* – information and processes should be viewed and interpreted in the same fashion by both the central bank and the general public; this is a precondition for proper communication and, in consequence, for transparency,
- *honesty* – referring to the degree of accord between perception and interpretation of information for internal purposes of the central bank and that of information presented to the general public in the process of external communication[3].

The definitions and attributes of transparency presented in professional literature, despite certain differences, clearly show that the transparency of monetary policy should be regarded both from the viewpoint of monetary policy objective as well as from the perspective of instruments and procedures employed to that effect[4].

From the viewpoint of this paper, the most important aspect in preparation and realization of monetary policy by the monetary authorities is the attribute of *common understanding* – the accord between monetary authorities and general public in interpretation and understanding of information and processes communicated. Monetary authorities and general public must have access to the same information, although the significance of respective information and its potential impact on future economic processes will, naturally, be different. Such differences will show not only at the level of relations between monetary authorities and general public, but also

[2] F.S. Mishkin, op. cit.

[3] B. Winkler, *Which kind of transparency? On the need for clarity in monetary policy making*, "ECB Working Papers" 2000, No. 26 (August).

[4] U. Ziarko-Siwek, *Ocena efektywności informacyjnej wybranych segmentów rynku finansowego w Polsce*, "Materiały i Studia" nr 178, NBP, Warszawa 2004.

among particular members of the monetary body. In this context the approach to decision-making processes of the monetary authorities seems of particular importance.

4. Individual vs. collective approach to monetary authorities' decision-making process

Decisions made by monetary authorities reach their full point of impact after 5-8 quarters of their issuance. Two important considerations apply in this context:

– firstly, the impact of a monetary decision upon real economy will be immediate, e.g. through the channel of inflation expectations of market participants and the exchange rate channel, while the peak of such influence will be observed after 5-8 quarters;
– secondly, globalization processes result in prolonging the real economy effects of monetary decisions from 5-7 quarters up to 8 quarters or more.

Moreover, it should be noted that decisions made by monetary authorities are also influenced by the following:

1) monetary authorities have access to precise information on past economic processes, while the future trends are always uncertain and can be forecasted only to a certain degree of probability, i.e. less than 1;

2) monetary authorities are well aware of the fact that effects of their decisions will be delayed in time. This is also important, inasmuch as the decisions of monetary authorities 'overlap' with other changes beyond their influence, such as globalization processes, asymmetric shocks, unforeseen circumstances of political, social and cultural nature etc.

Monetary authorities may take their decisions single-handedly through a delegated individual, as in the proceedings of the Reserve Bank of Australia, or collectively, as in many other countries, including Poland, the USA, England, Sweden, Denmark and the European Central Bank (ECB). Before embarking on the analysis of these two approaches to decision-making, it may be useful to evaluate these processes as applied to a typical business environment.

In line with the principle of limited rationality, policy-makers need to cope with limited time and limited resources for systematic research of information and optimal approach to a problem at hand. As a result, decisions in companies are often taken individually[5].

What problems may arise when decisions are taken individually? Below is an overview of such effects:

– firstly, policy-makers often take up the most obvious decision that, to some extent, relates to the problem at hand;

[5] J. Stankiewicz, *Kryzys decyzji jednostkowych i grupowych – uwarunkowania,* [in:] *Zachowania organizacji wobec zjawisk kryzysowych*, ed. J. Skalik, Cornetis, Wrocław 2003.

– secondly, the choice of solution is often based on intuition, as opposed to a detailed analysis of costs and benefits in the affected area. By taking decisions individually, policy-makers should anticipate problems and limitations that may arise in their implementation. Outrunning the competition requires a mindset of institutional thinking, not merely that of logical and linear reasoning;
– thirdly, by taking up an individual approach, policy-makers will primarily draw from own business experience that does not necessarily coincide with the best line of action[6].

As already stressed, individual decision-making may lead to decision-making crisis, since decisions taken in this manner may in practice prove ineffective. To make informed decisions, it is necessary to:

a) engage self-awareness of the policy-maker, i.e. knowledge of one's strengths and weaknesses,

b) anticipate problems and limitations that may arise as a result of the decision taken,

c) prepare detailed analysis of alternative solutions of the problem at hand[7].

The above fundamental aspects of individual decision-making allow to address the question whether such an approach to decision-making may be regarded advisable and suitable in the proceedings of monetary authorities. It is this author's belief that the answer here is negative. The primary argument is that monetary authorities do not operate under time-restricted conditions. Furthermore, monetary authorities should in no way be restricted in resources needed for gathering information and arriving at optimal solutions to problems faced by this body.

Naturally, the issue of time in relation to monetary decisions has always been fervently disputed. Changes of monetary policy parameters are often labeled by the public as 'premature' or 'overdue'. However, this is not equivalent to the typical notion of time available to arrive at an informed decision. Moreover, each monetary authority should act in a forward-looking manner, since dousing the already existing effects of inflation is much more expensive than any preventive measures in this respect.

Based on analyses of central bank functioning, as presented in professional literature, as well as own research, it is this author's belief that there are no premises for advocating individual approach to decision-making in respect to monetary policy decisions.

Let us now analyze collective approach to decision-making in the world of business, which will be the basis for evaluation of this approach and its suitability for monetary policy decisions.

[6] J.P. Nioche, M. Ghertman, H. Laroche, *Decyzje w zarządzaniu firmą. Strategie, struktury, decyzje, tożsamość*, PWE, Warszawa 1995.

[7] J. Stankiewicz, op. cit.

Collective decision-making in business is a concept widely discussed in the literature on the subject[8]. This approach to decision-making has its merits, but also certain inherent flaws that may lead to crises in collective decision-making. At this point, it is noteworthy to cite the classic work of G. Le Bon 'The Crowd: A Study of the Popular Mind' (1895). In the author's view, '…on the fact alone that individuals are able to form the crowd, they apparently share a kind of collective soul. This soul orders them to think, act and feel in a manner that any individual alone would not attempt to think, act and feel'. Further on, Le Bon observes that the crowd is not a sum and average of its components, but rather 'forms a new substance, with completely new properties'[9].

The concept of 'collective soul' introduced by G. Le Bon was later replaced by the analogous term of 'collective mind', commonly used in the management theory. In 1997, H. Simon proposed the term 'collective mind', based on the argument that any information-processing, reacting and self-regulating entity, be it individual or collective, has a 'mind' of its own[10]. Collective approach to decision-making has its benefits and flaws. According to K. Bolesta-Kukułka, benefits of collective decision--making include the following:

- each participant of the decision-making process contributes his or her share of unique and varied competences, knowledge and skills – the information base expands and professional bias may be avoided,
- collective approach tends to generate more variants of solutions to the problem at hand,
- collective approach allows for more insightful and multidimensional analysis of the variants generated, as well as competent assessment of the variants based on a larger number of criteria,
- as early as during the negotiation phase, collective approach may eliminate any potential conflicts that might arise in the course of implementing the chosen solution,
- collective approach increases the probability that the chosen solution will be accepted by those affected by its implementation,
- collective approach offers the potential for eliminating extremities resulting from individual influences (in the individual approach, cognitive attitudes, value systems and emotions of the policy-maker may distort rational judgment),
- decisions taken collectively are more final and binding (as opposed to decisions made individually, that may be perceived as arbitrary and biased)[11].

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[8] J. Penc J., *Decyzje i zmiany w organizacji. W poszukiwaniu skutecznych sposobów działania*, Difin, Warszawa 2008.

[9] G. Le Bon, *The Crowd. A Study of the Popular Mind* (download: Microsoft Reader), Amazon. Com, 2001, p. 2 (free translation from the Polish edition).

[10] H. Simon, *Administrative Behavior: A Study of Decision Making Process in Administrative Organizations*, Free Press, New York 1997.

[11] K. Bolesta-Kukułka, *Decyzje menedżerskie w teorii i praktyce zarządzania*, Uniwersytet Warszawski, Warszawa 2000.

Flaws of the collective approach, in Bolesta-Kukułka's opinion, include the following:

- prolonged negotiations,
- the danger of barriers in communication among participants of the decision--making process,
- discussions of the collective body may be dominated by hierarchically privileged individuals or those that are more active and eloquent,
- there is an increased probability of 'blurred responsibility' for decisions taken,
- considerable danger of failure in reaching a compromise in the face of conflicting individual interests,
- the group may be manipulated by those skilled in the art of influence,
- the danger of 'group thinking' syndrome that may lead to:
– illusion of omnipotence,
– false belief that the best decision has been taken,
– unquestioned belief that group members share the same ethical and moral premises, leading to rejection of guilt for dubious decisions,
– strong tendency for stereotyping, i.e. simplification of opponents' views and arguments.
- excessive tendency to take risks, i.e. arriving at more risky decisions[12].

The above benefits and flaws of collective decision-making in business settings may – in this author's opinion – apply to decision-making processes employed by monetary authorities. There are, however, some important considerations that make this process distinct from the one observed in business settings:

– firstly, decisions of monetary authorities reach their peak of impact after 5 quarters and their influence may be observed for 8 or more quarters altogether. There are also certain delays and adjournments inherent in the process, whereas business decisions (e.g. a decision to purchase) may be effected immediately;
– secondly, monetary authorities, in their attempts at regulating real economy with the prospect of price stabilization, have little or no influence on certain elements of the price basket, such as prices of imported goods, oil etc.;
– thirdly, decisions of monetary authorities shape inflation expectations of all market participants. The reactions of market actors may be varied (adaptive, rational). Thus, the effect anticipated by monetary authorities may not always be met;
– fourthly, decisions of monetary authorities in practice affect the whole society, while business decisions impact only a certain part thereof.

Based on the above considerations, collective approach to decision-making as applied to the operation of monetary authorities seems more suitable, since decisions taken collectively tend to be more rational, efficient and effective than those taken individually. Uncertainty and complexity of economic processes offer premises for

[12] Ibidem.

employing collective decision-making in the operation of monetary authorities, provided that the self-consciousness of the deciding body allows for elimination of the 'group thinking' syndrome.

5. Conclusions

Decisions of monetary authorities take the form of public decisions. As such, they are often laden with certain degree of subjectivity. To face this dilemma, economic and social sciences have developed a range of concepts for objectivization of public authorities' decisions. This paper analyses benefits and disadvantages of collective and individual approach to decision-making as applied in the operation of monetary authorities. The conclusions are unequivocal – monetary authorities in their policy-making should employ collective approach to decision-making processes. Individual approach, apart from disadvantages presented herein, may also introduce the danger of subjectivity, since the policy maker tends to take decisions based on own experience and individual system of values. In practice, collective decisions of monetary authorities should be taken in the atmosphere of transparency to fully meet the qualities inherent in the definition of 'collective mind'. Transparency of monetary policy will be the more pronounced, the more rules of conduct are observed, as opposed to discretionary activities. Only then, decisions of monetary authorities may be regarded as an effect of 'collective thinking'.

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DECYZJE WŁADZ MONETARNYCH W ŚWIETLE PRZEJRZYSTOŚCI POLITYKI MONETARNEJ

Streszczenie: Artykuł poświęcony jest problemowi wyboru najlepszego sposobu przygotowania decyzji władz monetarnych. Zawarta jest w nim analiza dwóch ujęć: indywidualnego podejmowania decyzji i zespołowego (zbiorowego) podejmowania decyzji przez władze monetarne. W artykule przedstawiono argumentację dotyczącą przewagi zbiorowego podejmowania decyzji przez władze monetarne. W konkluzji autor stwierdza, że w świetle zwiększania przejrzystości działania władz monetarnych stosowanie zbiorowego podejmowania decyzji jest zdecydowanie bardziej efektywne w porównaniu z decyzjami podejmowanymi indywidualnie.