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Too big, too small: Why the size of the FOMC does matter

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Abstract

The present article discusses the effectiveness of the decision-making body of the Federal Reserve System (Federal Open Market Committee, or FOMC for short) in the context of management. It focuses on the size of the FOMC as a group larger than the optimum of the group's effectiveness (depending on the study, the optimum size of the group should be three to eight or five to seven people). The article also discusses the potential negative consequences of too large a group and ways to improve group decisions. The last part of the paper includes an explanation of the decision-making structural composition, and thus partially answers the question of why the FOMC consists of seventeen members, and its decision-making composition of twelve.

Introduction

The contemporary architecture of central banks is based on collegial decision-making bodies. According to the data of the Bank for International Settlements report from 2009, out of 47 surveyed central banks, only 15% had a non-group decision-making system (usually in such cases the decision-maker was the president of the central bank). In the remaining 85% cases, collective bodies were decisive, with an average of seven committee members. The report also states that the Federal Open Market Committee (FOMC) has 19 members and ranks second (after the General Council of the European Central Bank) in terms of the largest number of members (Bank for International Settlements, 2009). The purpose of this article is to discuss the effectiveness of the FOMC (as a group) in the light of management science. Previous empirical studies on the impact of the decision-

making process by the decision-making body of the Federal Reserve System were conducted by Ehrmnann, Tietz and Visser (2021, 1).

Management in central banks is quite a niche field of study. This topic was investigated by Vandenbushe (2006) who, basing on subject literature, tried to answer the question regarding the optimal number of a Monetary Policy Committee members. The functioning of the FOMC was described in books written by Kwiatkowski (2014) and Blinder (2001). Group efficiency was researched by Wheelan (2009) as well as Liker and Meier (2006). The article was based on a literature review from the fields of management and economics.

Exploring the topic of the efficiency of the FOMC, the article raises and investigates two issues:

1. the efficiency and construction of the Federal Open Market Committee as a team,
2. explanation of construction of Federal Open Market Committee.

1. Architecture of the Federal Reserve System

To better understand the issues relevant to this article, it is worth presenting the structure of the Federal Reserve System. The system is made up of twelve regional branches known as the Federal Reserve Bank — the de facto executive and control body of the Federal Reserve System. The primary tasks of the twelve regional branches of the Federal Reserve Bank include, among others: issuing and withdrawing cash, settling interbank transfers, and organizing public debt auctions in a given district. The Federal Reserve System is also based in Washington, where meetings of the main decision-making body of the Federal Open Market Committee are held. The FOMC was established under the Banking Act of 1935. Its final shape was specified in 1942, in an act amending the Federal Reserve Act. The FOMC has three main goals:

1. maximum employment,
2. price stabilization,
3. maintaining the stability of interest rates in the long term (Board of Governors of the Federal Reserve System, n.d.-a).

Formally, the committee decides on open market operations, but de facto also makes choices regarding discount rates, which are then officially regulated by the Board of Directors of every bank in the Federal Reserve System, and the required reserves, which are set by the Board of Governors (Kwiatkowski, 2014, 105). The FOMC is made up of nineteen members (seven members of the Board of Governors and all the governors of the twelve regional branches of the Federal Reserve System), with a restricted voting of twelve. Members of the Board of Governors are nominated by the President of the United States with the consent of the Senate for a fourteen-year non-renewable term and have permanent voting rights, while

the governors of the regional branches of the Federal Reserve System gain voting rights alternately every two to three years (the governors of the Federal Reserve of Cleveland and the Federal Reserve of Chicago gain voting rights every two years, while the presidents of other banks every three years), the only permanent member of the group of presidents of the regional branches of the Federal Reserve System is the president of the New York Federal Reserve System (Kwiatkowski, 2014, 105). Under the Federal Reserve Act, the FOMC meets at least four times a year at the request of the President of the Board of Governors or three members of the Committee on Open Market Operations. In practice, meetings are held more than four times a year (in 2017–2021, there were a total of 46 two-day meetings, including three unscheduled ones) (Board of Governors of the Federal Reserve System, n.d.-a). The agenda of the FOMC meeting is, in principle, always the same.

1. Reading the summary (FOMC minutes) of the previous meeting.

2. Speeches by the directors of the Department for Open Market Operations and the Department for Information and Statistics.

3. The presidents of the federal reserve gather their votes in the committee. Governors present the state of their district and express their position. The presentation is an introductory one.

4. The presidents of the federal reserve gather their votes in the forum of the committee. Governors present the state in their district and express their position. The presentation is informative for the rest of the FOMC members.

5. The issues of economic data forecast are discussed, followed by a discussion on the direction of future activities.

6. The President has the final vote, specifies the implementing directives, and the vote on the directive is also put to the vote.

7. The last stage before the publication of the meeting results is discussing the banking sector issues.

The governing body comprises the six-member Board of Governors, and the chairperson of the Board of Governors serves as the chief executive of the Federal Reserve System. The position of the Board of Governors chairperson is dominant. Their competencies include setting the agenda or summing up the FOMC meeting; they also have a decisive vote in the FOMC in case of a tie (Kwiatkowski, 2014, 107) and, above all, they are the "face" of the Federal Reserve System. The chairperson is the keynote speaker at press conferences and represents the Federal Reserve System outside the organization.

2. Group decisions in the central bank

2.1. Economic theory and group decisions in the central bank

The studies conducted so far indicate some economic benefits related to collective decision-making in central banks. Firstly, as Blinder (1998, 21) points out, collec-

tive decision-making bodies in the central bank create a check-and-blank system of their own accord. In this concept, the president or chairperson of the monetary policy board/committee is "anchored" by the rest of the board members not to use their dominant position, and they do not stand out in terms of views from other members. Secondly, group decisions eliminate extreme views (Blinder, 1998, 21). Thirdly, collegiality enhances independence. In a collegiate body, it is more difficult to exert pressure on individual members of the group, and the members themselves are most often elected by various centers of power. Alesina and Summers (1993, 151), among others, wrote about the economic benefits of central bank independence.

2.2. Management theory and group decisions in the central bank

As a rule, the academic literature shows that group decision-making is better than single-person decision-making due to the lower probability of making a mistake (Griffin 2014, 302). Among the advantages of making group decisions affecting monetary policy, the following can be mentioned:

— Different views. The group most often consists of members with different experience and education. Thanks to this diversity, a group can identify a larger number of problems and propose more solutions than a single person (Koźmiński and Piotrowski, 2009, 98). In the case of a direct goal, different views have an impact on the immediate goal of monetary policy, as the collegial decision-making body includes supporters of both "hawkish monetary policy" and "dovish monetary policy." However, in the case of intermediate targets, an example may be the decision on the "side" of the short-term Philips curve, which "illustrates the negative correlation between unemployment and inflation" (Krugman and Wells, 2012, 538). The short-run Philips curve is widely used in central banks for decision-making as well as by the Federal Reserve System (Hooper, Mishkin and Sufi, 2019).

— The mistakes of a single decision-maker can be noticed and removed by the group (Koźmiński and Piotrowski, 2009, 98).

— The group entails mutual influence of people. Thanks to free discussion, decision-makers inspire one another (Griffin, 2014, 301). Nowadays, central banks use discussions during meetings as a form of creating monetary policy. However, the analysis of the discussion may be difficult, as only 28% of 44 surveyed central banks affiliated with the Bank for International Settlements published minutes of meetings, and it is common practice to publish reports with a delay of several years (Bank for International Settlements, 2009).

Group decisions also have their drawbacks. Among these imperfections, one can mention the syndrome of group thinking, which consists in refraining from expressing dissenting views to provide the appearance of compatibility. Group

thinking has a negative impact on the critical thinking process, which deteriorates the quality of the final decision (Griffin, 2014, 304).

2.3. The FOMC as a group — analysis

The FOMC takes advantage of the benefits resulting from group decisions. First, the group is diverse. The Federal Reserve Act 10.1 explicitly states that FOMC members must represent the interests of different regions and industries. The current FOMC squad (as of April 2022) and previous squads met the legal requirements of Article 10.1. Moreover, the diversity of the FOMC manifests itself not only in the fields of "geographic" and interest representation, but also in education and professional career. Additionally, FOMC members have the right to express themselves and discuss freely, as well as to dissent during voting (dissenting votes). Each president of a regional branch of the Federal Reserve must also present the state of the economy in his district during the FOMC meeting and express their opinion. They also contribute to the Beige Book presenting economic data from individual regions.

The size of the FOMC is questionable. The results of research on the relationship between group size and group effectiveness are inconclusive. Research by Susan A. Wheelan (2009, 151) indicates a size of three to eight people as the most effective. In the case of groups of nine or more members, the efficiency does not increase (or even decreases) with successive members. At the same time, research conducted by Liker and Meier (2006, 154) shows that the optimal team size is within the range of five to seven people. However, it can be assumed that the upper limit of the group size is twenty-five — in larger teams, problems arise in terms of coordinating the body and dispersing responsibility (Pyszka, 2015, 13). Research proves that group size has an influence on the so-called bystander effect. A study by Darley and Latany concludes that the more people are present, the slower the response to an emergency and the lower the likelihood of intervention. The problem of the "bystander effect" is explained by the diffusion of responsibility — that is, "weakening in each member of the group the sense of duty to act, when he perceives responsibility as shared with all members of the group or it is believed that the leader assumed it" (Zimbardo, Johnson and McCann, 2010, 56).

Conclusions

From the presented analysis, we can conclude that the structure of the FOMC is in some respects an effective team. First of all, the group is diverse, the members have different professional experiences and education, and represent various regions and sectors of the economy. This means that the body can theoretically create more ideas and solutions. Furthermore, FOMC representatives have the opportunity to freely discuss issues — each member presents their point of view

and represents the interest of their district. Discussion and presentation create more opportunities and build the broader picture of the US economy as well as improve group decision-making as they overcome the pressures to group compliance that limits creative thinking. The size of the FOMC as a team, which may be ineffective and far beyond the group size optimum, remains a controversial issue. The consequences of too large a body may be low motivation and diffusion of responsibility, which could potentially delay the appropriate reaction of the central bank's decision-making committee in an emergency where intervention is required in a very short period. It is worth considering and undertaking further research on whether and how the Federal Committee for Open Market Operations tries to improve group decision-making, for example, whether it is struggling to apply nominal group techniques or brainstorming. A study could be carried out through a questionnaire addressed directly to FOMC members.

Despite reservations about the size of the group, it is important to remember the specific structure of the Federal Reserve System. Such a construction of the FOMC is anchored in the legal-historical order in which the Federal Reserve System operates, and it manifests itself in two areas. The first one is a mechanism called "check and balance." This institution is widely known in the American political culture; institutions control one another and none of them is dominant. In the case of the FOMC, "check and balance" works between the chairperson of the Board of Governors and the rest of the FOMC members. The president as a dominant figure is partially counterbalanced by other FOMC members.

The second area is federalism. The United States is a federal country where each region (state) has a high degree of autonomy. Within the construction of the FOMC, each president of the regional federal reserve system is automatically a member of the FOMC and is tasked with representing each district of the country. It is worth noting, however, the asymmetricity of the districts in the Federal Reserve System. The twelve districts are not evenly divided in terms of economy, population, or area (the largest district by population and territory is the twelfth district called the Federal Reserve Bank of San Francisco), while some states, such as Wisconsin, fall into two districts of the Federal Reserve System (Board of Governors of the Federal Reserve System, n.d.-b). This asymmetry creates doubts as to the adequate representation of individual regions.

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