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Voting on monetary policy in the Council of the European Central Bank

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Abstract

This paper challenges the received view that, from the monetary policy standpoint, EMU is a sure loss since participating countries relinquish a useful stabilisation instrument with no credibility benefit if they are equally averse to inflation. The single European monetary policy is decided by majority voting within the Council of the European Central Bank—a collegiate body consisting of the members of the Executive Board and the governors of the participating countries who are assumed to entertain Union-wide and national stabilisation objectives, respectively. The incentive structure originating from repeated voting and conflicting national interests provides an effective commitment device that reduces the inflationary bias and can offset the welfare loss due to the poorer stabilisation performance of the single monetary policy. However, this common advantage may well be accompanied by a very unequal distribution across countries of the stabilisation benefits from the single monetary policy, despite the presence of the members of the Executive Board.

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1. Introduction

The long-running debate on the costs and benefits of Economic and Monetary Union in Europe, EMU (see Feldstein, 1997 and Wyplosz, 1997 for a vivid

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synthesis) has always taken for granted that EMU is a sure loss from the point of view of monetary policy since participating countries relinquish an instrument of macroeconomic stabilisation useful in the event of asymmetric, country-specific shocks. Only countries with a track record of high inflation could hope to assuage this welfare loss through a gain in credibility. In analogy with the 'advantage of tying one's hands' that motivated participation in the European Monetary System (Giavazzi and Pagano, 1988), credibility gains could be reaped by delegating monetary policy to an institution that, according to the Maastricht Treaty, is at least as independent and committed to price stability as the Bundesbank. Yet, the remarkable convergence to low inflation rates that has taken place in Europe[1] undermines the relevance of this argument, reasserting the validity of the standard verdict that EMU is a sure loss from the monetary point of view. Benefits have to be searched in other areas: from strategic geo-political interests to the mundane, but more tangible, gains from reduced transaction costs.

As the analysis of this paper shows, the conventional line of reasoning neglects an important gain from EMU that can offset the welfare loss due to the poorer stabilisation performance of the single monetary policy and reverse the above verdict, strictly from the point of view of monetary analysis. The decision-making process within the Governing Council of the European Central Bank (ECB)—the collegiate body in charge of the European monetary policy—provides an effective institutional arrangement to generate a credible commitment that can substantially reduce, albeit not eliminate altogether, the inflationary bias that plagues discretionary monetary policy. Thus, all participating countries, even if they are by now endowed with equally credible central banks, stand to gain from EMU in the monetary field.

The politico-economic approach to monetary policy in the wake of Kydland and Prescott (1977) and Barro and Gordon (1983) has long established the two factors ultimately lying at the root of the inflationary bias: the policy-makers' inclination to engineer inflation surprises in the futile attempt to stimulate output above its natural level and the non-availability of a 'commitment technology' capable of restraining this inclination while preserving an active stabilisation role for monetary policy. The first-best monetary rule contingent on the realisation of the relevant macroeconomic shocks is not time consistent and, therefore, in the absence of a credible commitment, price and wage setters anticipate a higher inflation rate that prevails in equilibrium without any benefit in terms of average level or variance of output. The appointment of independent central bankers less prone to output stabilisation than the public at large (Rogoff, 1985; Lohmann, 1992)—possibly complemented with contracts providing appropriate incentives to central bankers (Walsh, 1995; Svensson, 1997)—is the institutional arrangement to address the issue that has received the broadest support in theory and practice. This type of arrangements improves welfare not by eliminating the time-consistency problem, but rather by shifting it with reference to the personal preferences and incentives of (appropriately selected) central bankers.

[1] For example the inflation differential between Italy and Germany shrank from 15.8 percentage points in 1980, to 3.4 in 1995, to 0.3 in 1997.