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# Do asymmetries matter for European monetary policy?

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## Abstract

In this paper we analyze the impact of economic and institutional (ECB decision rules) asymmetries on the effectiveness of monetary policy in Euroland. We consider a model where asymmetric shocks and divergent propagation of shocks in output and inflation are potential causes of tensions within the ECB concerning the conduct of common monetary (interest rate) policy. Welfare implications of the alternative decision procedures are discussed. © 2002 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

The European Central Bank (ECB) has the sole responsibility for the conduct of monetary policies in Euroland. The Maastricht Treaty provides some general principles about the objectives to be pursued by the ECB and has set the institutional framework within which the ECB will take its decisions. More precisely, the statutes of the ECB were enshrined in the Maastricht Treaty. The principles underlying these statutes are, first, that the primary objective of the ECB is the maintenance of price stability (art. 105), and, second, that in order to achieve this objective, the ECB should be politically independent (art. 107). The Treaty also formulates other objectives to be

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pursued by the ECB (e.g. high employment) but always adds the proviso that this should not interfere with the primary objective which is price stability.

The decision making body is the Governing Council (GC), which consists of the Governors (Presidents) of the National Banks of the Euro-countries, and of the President, the Vice-President and the four Directors of the ECB. Each of the members have one vote. Although the statutes of the ECB mandate the members of the ECB-Council to represent the interests of Euroland as a whole, it is quite likely that there will be occasions when the national representatives will pursue national interests.<sup>1</sup>

One major question that arises in this context is the following. Will the national representatives in the ECB-Council take a union-wide perspective when deciding about monetary policies, or will they give a high weight to national economic conditions when taking these decisions? The question is important. For, if asymmetric shocks and/or adjustment speeds occur frequently in the future EMU, a nationalistic attitude of the ECB Council members, triggered by divergent economic conditions, may lead to frequent conflicts about the appropriate policies to be pursued. One can expect that, although each of the Governors will share similar preferences about inflation and output stabilization, these divergent economic conditions may lead them to take different positions on the desirable stance of monetary policies. When that happens, national viewpoints will loom large in the decision making process. As a result, the decision making process within the ECB will be made difficult.

At the end of the day, however, a common monetary policy must be implemented. The issue of divergent optimal (national) monetary policies thus leads to a need for decision procedures. These procedures will determine the way country-specific desires about monetary policies are aggregated into one common monetary policy. Obviously, the modalities of the decision procedure will matter in this aggregation problem and will also affect macro-economic performance and welfare of the individual countries.

This paper provides a first step in analyzing the effects of decision procedures in the GC on effectiveness of monetary policy and macro-economic stabilization.<sup>2</sup> The paper proceeds in two steps. First, in Section 2 we assess empirically the magnitude of the divergence in 'national interests' that may arise and their effects on the desired monetary policy reactions. This

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<sup>1</sup> For a more detailed description of the statutes of the ECB see Gros et al. (1999). See also Begg et al. (1998) and Gros et al. (1999) for a discussion of the decentralised nature of the European System of Central Banks.

<sup>2</sup> Recent papers have analyzed similar issues relating to workings of the European Central Bank. See Bindseil (1996), Bottazzi and Manasse (1998), Brueckner (1997) and Von Hagen and Suetzel (1994). See also Dornbusch et al. (1998) who study problems of voting in the ECB.

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