Available online at www.sciencedirect.com
SCIENCE DIRECT®
Journal of Monetary Economics 53 (2006) 659–669
Journal of MONETARY ECONOMICS
www.elsevier.com/locate/jme

One monetary policy and 18 central bankers: The European monetary policy as a game of strategic delegation☆

Rasmus Fatum*

School of Business, 4-30H Business Building, University of Alberta, Edmonton AB, Canada T6G 2R6

Received 18 February 2003; received in revised form 28 February 2005; accepted 3 March 2005
Available online 17 April 2006

Abstract

This paper employs a multi-country delegation monetary policy model and argues that a decision-making mechanism based on the median voter theorem where intensity of preferences cannot play a role does not capture important aspects of policy setting in the European Monetary Union. Replacing the median voter mechanism with a less restrictive "weighted mean mechanism", it is shown that strategic delegation can lead to a surprising degree of central bank inflation aversion. This finding supports the "The Twin Sister Hypothesis" and the perception of the European Central Bank implementing the policy of the Bundesbank rather than a more inflationary monetary policy.

JEL classification: C72; D72; E58; F33

Keywords: Monetary union; Decision making; Strategic delegation

☆I gratefully acknowledge financial support from Social Sciences Research Council of Canada (SSHRC) and from a J.D. Muir Grant. An early version of this paper was presented in September 2001 at the EMU conference held at the University of Milan-Bicocca. I thank conference participants for comments, in particular Alex Cukierman and Mario Gilli. I also thank Michael Hutchison, Henrik Jensen, Barry Scholnick, Christian Schultz, Constance Smith, Carl Walsh, Donald Wittman and an editor of this Journal, Robert King, for very helpful comments.

*Tel.: +1 780 492 3951; fax: +1 780 492 3325.
E-mail address: rasmus.fatum@ualberta.ca.

0304-3932/$ - see front matter
doi:10.1016/j.jmoneco.2005.03.010

1. Introduction

Within a multi-country, one-period strategic delegation framework, this paper shows that strategic delegation can lead to a surprising degree of central bank inflation aversion. The paper provides further theoretical support for why the European Central Bank (ECB) might be the twin sister of the Bundesbank, i.e. why the monetary policy of the ECB mimics that of the Bundesbank rather than constituting an average of the optimal monetary policies of all the member states.

Several papers have made contributions towards creating a better understanding of the single monetary policy and its implications. Debrun (2001) uses a two-country two-good model and a bargaining game to show that the ECB is minimizing a loss function biased towards German preferences, thereby proponing "The Twin Sister Hypothesis". Aksoy et al. (2002) analyze the optimal policy-setting rule under four decision scenarios (each characterizing whether the ECB Executive Board and/or the national central bank presidents have national or EMU-wide interests or whether policy is set in accordance with a European Monetary System-rule) and find that different member states have different views as to what is the optimal policy rule. In an early contribution, von Hagen and Süppel (1994) use a multi-country model with incomplete information to show that national interests can lead to inefficient choices. Meade and Sheets (2002) also point to the importance of viewing the ECB Council as a group of delegates with conflicting interests. They find that the majority of ECB Council members typically voted on monetary policy changes in a manner that can be justified by the differential between their national inflation rate and the EMU average, thus suggesting that national interests or biases—of all 18 council members and not just the national central bank presidents—may play a role in deciding on the single monetary policy.[1]

The delegation framework seems particularly well-suited for capturing the implications of a French delegate being French and a German delegate being German rather than both being merely Europeans. Within such a framework, this paper points to the importance of how the decision-making mechanism of the Council is modeled and argues that a mechanism based on the median voter theorem is overly restrictive, since focusing on the median neglects the importance of the intensity of preferences.

The political economy literature incorporates several alternative decision-making mechanisms.[2] One oft-used alternative mechanism is the probabilistic voting model.[3] A straightforward application of the probabilistic voting model to a fixed set of Council members deciding on the single monetary policy—in the absence of strategic delegation—would set policy according to the average preferences of the ECB Council. However, by replacing the median voter mechanism with a "weighted mean mechanism", consistent with the probabilistic voting view, it is shown that allowing for strategic delegation may

[1]As pointed out by Dornbusch et al. (1998): "The issue is not that bank presidents take or solicit direct instructions from their patrons, but whether they are cloned and then sent on their mission. When an issue of difference arises, a French appointee would vote in the style of France, and a German, as predictably, in the way of the Bundesbank."

[2]See Persson and Tabellini (2000) for a detailed exposition of various decision-making mechanisms. See also Gerling et al. (2003) for a recent survey of alternative decision-making models and Bullard and Waller (2004) for a discussion of the advantages of alternative decision-making models.

[3]See Lindbeck and Weibull (1987, 1993) for frequently referenced applications of the probabilistic voting model in the context of (expected) plurality maximization with two political parties.