ECB decision-making reform and EMU enlargement

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The expected enlargement of the EMU stimulated the discussions on the need for reforming the decision making process at the ECB. In late December 2002 the long-awaited ECB recommendation on the reform was revealed. This article discusses some features of the proposal and evaluates it from the perspective of current and prospective EMU member countries. It argues that a Union-wide perspective is best for assessing any changes in the EMU monetary policy making. The ECB recommendation seems to represent not an ideal but a realistic and workable solution and is thus worth supporting.

On 3rd February the European Central Bank published its official recommendation for the European Council 'on an amendment to Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank'. The recommendation suggests that after the EMU will enlarge to 16 or more member states, not all central bank governors will have a vote on interest rates decisions at all times. Instead, voting right will rotate within groups formed in a manner reflecting the economic weight of countries in the Union. Despite critical voices it is likely that the recommendation will soon be adopted by the Council and thus a lively debate on the need for the ECB reform will (perhaps temporarily) come to an end.

Why reform?

The Treaty of Nice, among other things, established decision making rules in the European Council of an enlarged Union. While this was clearly a welcome outcome from the perspective of candidate countries, it is fair to say that Nice rules might seriously affect the ability of the most important EU decision making body to make decisions. The problem has nothing to do with the allocation of votes but with the threshold level set for the procedure of the so-called qualified majority voting (QMV). As the threshold is set extremely high, it will

be possible for a small number of countries to block Council decisions[1]. The Treaty did not change the voting rules of the ECB Council, but explicitly stated that such a change was likely to take place and that it was expected that the ECB or the Commission would propose a reform ‘as soon as possible’. It took the ECB two years to come out with a recommendation suggesting that a matter was very difficult to agree upon[2].
In discussing the effectiveness of existing decision making rules or proposals for reform one needs to ask appropriate questions. Article 105 of the *Treaty Establishing the European Community* very clearly states that “*the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community*”. The conduct of monetary policy is the most important task of the ECB and most of the discussions concerning the reform of the Governing Council have rightly concentrated on this aspect of ECB activities. Clearly, the functioning of the euro area payment system, issues pertaining to supervision of credit institutions and in general to the stability of the financial system are also essential and the EU enlargement might eventually promote some changes in these fields[3]. Still, the ESCB role in these spheres is not expected to be most affected by the enlargement as such but rather by the general factors such as globalisation, evolution of the financial markets, etc.

EMU enlargement - what matters?

There are two major issues in the context of the entry of the current EU candidates to the EMU. Firstly, given their relatively lower level of output per capita compared to the current EMU member states some fear that the inflation differential might widen further in the EMU making the common monetary policy an even more difficult task. Secondly, there is a widely shared view that the decision making process in the Governing Council might become less efficient. One reason for this is simply the size of this body after enlargement (up to above 30 members). The other reason is the possible divergence of views on monetary policy within this body. As far as this last issue is concerned, it is unclear whether central bank governors from new member states will be more likely to support ‘loose’ monetary policy, given their short experience with a low inflation environment or rather whether they will tend to be more ‘hawkish’ supporting higher interest rates, given the expected higher inflation rates in the catching-up countries[4].

Most of these arguments hinge on the assumption that the members of the Governing Council might be influenced in their decisions by local conditions in their home countries[5]. The

[1] Another problem pertains to apparent inconsistencies in rules for the QMV threshold level found in various places in the Treaty (see e.g. D.S Felsenthal and M. Machover , Enlargement of the EU and Weighted Voting in its Council of Ministers, London School of Economics and Political Science, Centre for Philospohy of Natural and Social Science, www.lse.ac.uk/votingpower (2001) for a more detailed discussion on this).
[2] Wim Duisenberg admitted that reaching the consensus was extremely difficult during the questions and answers session following his testimony before the Committee on Economic and Monetary Affairs of the European Parliament on 17 February. The delay in the ECB recommendation was possible since Ireland only recently ratified the Nice Treaty.
[3] Eichengreen and Ghironi (2001) discuss some of these issues. B. Eichengreen and F. Ghironi, EMU and Enlargement, mimeo, May 2001.
[4] Bratkowski and Rostowski (2000) refer to this first explanation as the ‘price-stability culture problem’. A. Bratkowski and J. Rostowski, Unilateral Adoption of the Euro by EU Applicant Countries: the Macroeconomic Aspects, in *Ten Years of Transition*, ed. L. Orlowski, Edward Elgar 2000.
[5] Baldwin et al (2001) assume that national biases might be a problem in the decisions of central bank governors, while Executive Board members are assumed to take into account EMU-wide developments only (R. Baldwin, et al., Eastern enlargement and ECB reform, *Swedish Economic Policy Review*, 8 (2001) 15-50). Meade and Sheets (2002) based on evidence from Fed claim that a distinction between central bank governors and

question whether there exist truly independent central bankers is open to discussion. Whether there is any merit in the EMU regional bias hypothesis is unclear, but quite clearly institutional arrangements reducing negative outcomes if it was true are welcome. However, in the long run it is convergence of macroeconomic conditions among member states that is needed to assure smooth and efficient functioning of the common monetary policy within the EMU.

The ECB reform proposal

The ECB recommendation states clearly that it is motivated by '*a need to maintain Governing Council's capacity for efficient and timely decision-making in an enlarged euro area, irrespective of the number of Member States that adopt the euro*'. It also explicitly argues that '*the design of the rotation system should be guided by five fundamental principles, i.e. 'one member one vote'; 'ad personam participation'; 'representativeness'; 'automaticity/robustness' and transparency'*[6].

The proposed solution is that while all central bank governors should continue to take part in the Governing Council discussions, some of them will temporarily not have a vote on the interest rate decisions. Six members of the Executive Board will retain their rights to vote, but governors of national central banks will be allocated not more than 15 voting rights. The rights will rotate within two groups (for an EMU of 16-22 countries) or three groups (if the EMU comprises of more than 22 member states). All countries will be ranked according to their share in EMU GDP (weight 5/6) and the share in the total aggregated balance sheet of the monetary financial institutions ('TABS-MFIs', weight 1/6). The five biggest economies will form the first group with four voting rights. In the scenario with two groups all other countries will be allocated 11 voting rights. When 23 or more countries participate in the EMU all but the five largest economies will be split into two groups of equal size according to the economic ranking and the group consisting of bigger countries will share 8 voting rights, whereas the smallest countries will have 3 voting rights at their disposal.

Such a procedure clearly introduces some 'breaking points' resulting from changes in the ranking (due to new economic data) and/or inclusion of new countries to the EMU. In many constellations the automatic application of the rule would produce outcomes unwarrantedly beneficial or detrimental to some countries or groups of countries. For example, problems would occur in the scenario of a gradual EMU enlargement, where at some stage there were 16-18 member states forming two groups, with the five biggest economies sharing four votes and the remaining 11-13 countries sharing 11 votes. This would indicate an even stronger preference towards the smaller member states than it is the case today. The authors of the ECB proposal were obviously aware of this issue and thus included a kind of a transitory escape clause arrangement stipulating that the introduction of the rotation system might in fact be postponed until the EMU is enlarged to comprise of at least 19 countries. In practice one should not expect the rotation system being implemented before there are 19 EMU member states, i.e. before seven new countries (out of 3 current EU members and 10 candidates) join. This seems rather unlikely to happen before 2006-2007. More generally, some degree of *ad hoc* decision making regarding the voting modalities cannot be avoided. These issues, according to the ECB proposal, will be decided by all Governing Council members –

Executive Board members might be irrelevant in this respect. (E.E. Meade and D.N. Sheets, Regional influences on U.S. monetary policy: some implications for Europe, IFDP No. 721, February 2002).

[6] European Central Bank, Recommendation, under Article 10.6 of the Statue of the ESCB and of the ECB, for a Council Decision on an amendment to Article 10.2 of the Statue of the ESCB and of the ECB, (ECB/2003/1), 3 February 2003.

irrespective of whether or not they hold a voting right at the time of the decision – by a two-thirds majority.

Discussion

It is not difficult to see that the proposed system is a compromise trying to address somewhat contradicting principles of 'one member one vote' versus 'representativeness' with an attempt to control for 'automaticity and robustness'. It seems fair to say that it reduces the 'small countries bias' present in the current setting (where the governor of the central bank of Luxembourg has the same impact on ECB interest rates as the Bundesbank governor). This perhaps does not go far enough to satisfy everyone in the biggest EMU economies but has already sparked voices of protests in some small countries[7].

The proposal proves the weakness of the argument that the number of persons having voting rights in the Governing Council is a serious issue (or, alternatively, that nothing can be done about it for political reasons). It is hard to believe that the difference between having around 30 members participating in the discussion followed by a vote of 21 and allowing all members to vote is substantial for the efficiency of the process. The simple majority decision rule should assure reasonable results in any case[8].

Current EU member states will need to quickly decide whether they see the reform proposal worth supporting. The Council will have the last say about it and the changes will be subject to ratification by all member countries. The Central and Eastern European candidate countries will most likely have nothing to say about the ECB reform. While this might possibly provide additional arguments to those opposing EU (and EMU) accession just before the accession referenda, the complicated and technical nature of the issue should keep it far from the centre of the pre-accession debates. On the other hand asking whether the proposed reform model is good for CEECs in practice boils down to asking whether it is good for EMU as a whole before and after enlargement. The decision to join the EMU remains voluntary to the extent that each candidate country can delay applying for membership for an unspecified period. At the same time none of the CEECs (just as none of the current EU member states) could plausibly expect that it could gain 'stronger' impact on ECB decisions or that it would be possible to influence interest rates such as to best suit local conditions. Even if the latter was theoretically feasible (as a part of the 'ECB number problem' literature suggested in portraying a coalition of fast growing countries winning the vote against the 'core' block) it would be extremely unwise and short-sighted to use such a possibility. What good could it be to keep interest rates too high in trying to fight inflation in the 'fast growing block' (arising mostly due to productivity gains vis-à-vis the EMU core) thus eroding the environment allowing for a catching-up of output levels and living standards and at the same time inducing recessionary tendencies in, say, Germany and other big EMU economies? The latter are the destination for 40-70% of CEECs exports, so altogether such a strategy would boil down to slowing down growth in the whole enlarged EMU (both 'core' and 'fast growing' countries).

To this end the ECB recommendation on the adjustment of the voting modalities seems in line with CEECs interests. What might turn out to be more important from these countries' perspective is the eventual adjustment in monetary policy strategy of the ECB. The review of

[7] Compare for instance the debate in the Finnish Parliament. Financial Times, 17 February 2002.

[8] It is instructive to compare this with the QMV decision making rule for the European Council agreed in Nice that allocates the voting rights more fairly to member countries but sets the qualified majority threshold at a prohibitively high level.

the strategy, results of which might be revealed within the coming few months, is not expected to bring substantial changes. However, the ongoing discussion is likely to result in gradual modifications of the ECB's approach over the longer horizon. Several significant issues could be addressed, including the relationships between the two pillars and more explicit definition and/or modification of the inflation target. In light of enlargement one of the most important spheres where more research effort should be concentrated is the sources and causes of regional inflation differentials and the ways in which monetary or other policies should handle this.

Conclusions

The ECB proposal for amending voting procedures in the Governing Council is not ideal, but workable and probably able to gain political support. It should solve the (somewhat theoretical) problem of overrepresentation of small EMU economies in their potential impact on interest rates decisions. In the future (probably not very soon) some simpler institutional designs are likely to come back to the agenda as candidates for another reform. Among such solutions one should mention the idea of a small monetary policy council taking over responsibility for interest rates where no reference to the members' citizenship would be made.

It would be advisable to devote some effort to the information campaign explaining the adjustment of voting modalities to the public in current and potential EMU member states. This could strengthen the support for the ECB mandate, strengthen its legitimacy and lead to its more efficient functioning.

No EMU member country can reasonably hope that its influence on the Union-wide monetary policy is stronger than its position within the EMU. Consequently, for each current and prospective EMU member the appropriate topic for the discussion is whether changes at the ECB would result in better functioning of the Union. This does not mean that the heterogeneity of the Union's members should be disregarded. On the contrary, this constitutes a real problem and one of the most difficult challenges to the monetary policy. This notes stresses that substantial research effort should be devoted to this field, so that the design of monetary policy will be able to properly account for regional differences.