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Introduction

It is widely accepted that enlargement requires reform of the highest decision-making bodies of the European Central Bank (ECB). In particular, there are concerns that the Governing Council, which is composed of the six-member Executive Board of the ECB plus the governors of the participating national central banks (NCBs), will grow too large to work efficiently. In the absence of reform, it could end up having over 30 members – resembling more a mini-parliament than a decision-making body that has to manage a global currency in fast-moving financial markets. Moreover, the accession of a number of small countries is often perceived as a threat to the "power balance" in the Governing Council.

The official proposal acknowledges the first problem of "numbers and efficiency", but it completely fails to offer a reasonable solution. It is apparent that the proposal was designed to address the second concern, i.e. the disproportionate representation of small countries. The proposed rotation in groups, however, is worse than the status quo. It is inefficient, opaque, internally inconsistent and arbitrary. Fortunately, it is not too late to stop it. The European Parliament has already expressed its opposition and the official proposal still has to be ratified by all member states before it enters into force. As the Convention on the Future of Europe is about to draft a new Treaty, a Constitution for the EU, there is still hope that alternatives can be considered.

1. The official proposal

Recognising that a Governing Council of over 30 members would be unwieldy, the European Council of Nice agreed on a simplified procedure to make some changes in the membership of the ECB governing bodies and asked the ECB to make a concrete proposal of how to change one paragraph in its statutes. This seems to have set in motion an acrimonious discussion within the European System of Central Banks (ESCB), that policy-making constellation comprising the ECB and the NCBs of eurozone members and about which very little is known outside central banking circles. At very last minute, i.e. in late 2002, the ECB came up with a proposal that had been elaborated in the strictest secrecy.

The essence of the official proposal is to divide all euro-area member countries into three groups measured by economic size, which, in turn, is determined by a new composite indicator: 5/6 GDP and 1/6 'aggregate balance of the monetary and financial institutions'. Each group would have only a limited number of votes, which would in practise mean that countries would have to rotate:

- Group 1: 4 votes (5 members, so voting frequency is 80%)
- Group 2: 8 votes (number of members varies, so voting frequency falls as the euro area expands, the maximum is 8/11 or 72.27%)
- Group 3: 3 votes (voting frequency falls as the euro area expands, the maximum is 50%)

* Director of CEPS. A revised version of this paper will be published in a forthcoming issue of *Intereconomics*.

Which countries would be in which groups? Table 1 gives a possible distribution for three different hypotheses about the membership of the euro area.

One of the reasons why it was felt that enlargement required a change in the composition of the decision-making organs of the ECB was that it is widely assumed that enlargement would increase the discrepancy between the relative economic and political weights within the Governing Council of the ECB. Most of the present candidates are relatively small in economic terms, but their representatives (the governors of the NCBs are often perceived that way) would have the same weight as that of Germany, whose economy is an order of magnitude larger.

Can this perception be quantified and verified? Economic weights could be defined as GDP shares and the political weights could be defined as being equal for all countries to 1/n, with the number of countries in EMU. Using this definition it is not evident that the discrepancies that exist at present will be worse in a larger EMU. Indeed, if one takes as a measure of discrepancies the sum of the squared differences between the economic and political weights, one arrives at the opposite result: the discrepancies between economic and political weights are lower in a larger euro area than in the current euro-12 club. Table 2 below provides the results of some illustrative calculations. It is apparent that all larger euro area compositions considered here actually lead to a lower discrepancy between economic and political weights than the current euro-12 grouping. (See the Annex 3 to *The Euro at 25*, Special Report of the CEPS Macroeconomic Policy Group, Gros et al., December 2002 for further details and additional calculations that take into account the Executive Board.)

Table 1. Distribution of countries into groups

	Euro-28	**Euro-25** (Euro-28 without BG, RO and TUR)	**Euro-22** (Euro-25 without UK, SW and DK)
Group 1	Germany	Germany	Germany
	United Kingdom	United Kingdom	France
	France	France	Italy
	Italy	Italy	Spain
	Spain	Spain	The Netherlands
Group 2	The Netherlands	Netherlands	Belgium
	Belgium	Belgium	Austria
	Sweden	Sweden	Ireland
	Austria	Austria	Poland
	Denmark	Denmark	Portugal
	Ireland	Ireland	Greece
	Poland	Poland	Luxembourg
	Portugal	Portugal	Finland
	Turkey	Greece	Czech Republic
	Greece	Luxembourg	Hungary
	Luxembourg	Finland	Slovak Republic
	Finland	Czech Republic	
	Czech Republic	Hungary	
	Hungary		

Group 3	Romania Slovak Republic Slovenia Bulgaria Lithuania Cyprus Latvia Estonia Malta	Slovak Republic Slovenia Lithuania Cyprus Latvia Estonia Malta	Slovenia Lithuania Cyprus Latvia Estonia Malta

Notes: Based on 2002 data. Due to limited availability of the data on the aggregate balance sheets of the monetary and financial institutions in the candidate countries the ordering is only approximate.

Source: Own calculations.

Table 2. Mismatch between economic and political weights

	Three alternative economic weights:		
	GDP	Population	ECB shares
Euro-12	9.5	10.3	8.9
Euro-15	7.4	7.8	7.1
Euro-25	7.0	9.2	5.4
Euro-27	7.2	9.4	5.7
Euro-25-UK	8.0	10.8	6.1

Source: Own calculations.

Note: Each entry represents the sum of the squared differences (times 100) between the political weights (defined as 1/n) and one of the different economic weights used here: GDP, population and ECB shares (the average of GDP and population weights).

2. A critique of the official proposal

The proposal of the ECB seems to combine the worst aspects of all approaches one might consider.

1. It gives up the principle of equality of member states,[1] thus potentially undermining the idea that all members of Governing Council should forget the particular interests of their home country and act only in the interest of the entire euro area.
2. It does not achieve a significant gain in efficiency: 21 members is much too large for the Governing Council. No modern central bank has a decision-making body this size. In Germany the composition of the decision-making body of the Bundesbank was reformed because it was considered that any number above 20 would be much too high.
3. Moreover, all members of the Governing Council (with and without voting power) will continue to sit at the table and have the right to participate in the discussion. The ECB's proposal thus does not solve the problem of the excessive size of the forum.
4. It is not even fully elaborated: The proposal does not say what is meant by 'sharing' a certain number of votes. By rotation? For example, it is not clear how the first group of five countries will share four votes. Will they rotate every meeting, every month,

[1] Although it asserts the opposite in its justification.

every year? By what order? Or will there be no rotation and they agree among themselves on how to vote together? What happens to new members of the euro area?

5. It is internally inconsistent:[2] The aim is to ensure better representation of the larger countries, but this will not be achieved if the rotation principle is applied immediately once euro area membership reaches 15.
6. Because of this internal inconsistency that needs to be addressed, it is not even clear when rotation will start because the ECB reserves for itself the right to postpone the rotation system until there are more than 18 members of the eurozone and hence 24 members of the Governing Council.
7. It is not transparent because it is too complicated.
8. It has arbitrary elements. The weight given to the indicator of the size of financial markets (1/6) is not justified in any way and seems designed to ensure a better position of one country (Luxembourg). Our calculations suggest that Luxembourg will have a larger weight than Finland (a country with about 10 times the population and 6 times the GDP). Table 1 above shows that notwithstanding the size of the euro area, the third group with the lowest voting power would consist exclusively of the new members. Was this the reason for the choice of the weight given to the indicator of financial markets? Why were the shares in the ECB not chosen as the measure of size?
9. It does not anticipate an even larger membership that should be considered as at least potentially imaginable given the candidacy of Turkey (and soon Croatia). As long as the UK does not join the euro zone, the group of the "big 5" will include the Netherlands (but not Poland).

For all these reasons the ECB proposal should be blocked. Almost any of the existing proposals would have been better. The Commission should prepare an alternative and the Council should be urged not to adopt the ECB proposal.

3. An alternative

The problem of the size of the Governing Council of the ECB is real. How should it be solved? The approach proposed here (see *The Euro at 25*, op. cit.) is quite simple: do not change the composition of the Governing Council, but ensure that it meets less often and thus re-define the division of labour between it and the other governing body of the ECB, the Executive Board, which has six members, including the President and Vice President. The tasks of the Governing Council should be to set the direction for monetary policy, decide on proposals from the Executive Board, constitute a platform for the exchange of views on the eurozone economy and monitor the work of the Executive Board. These tasks can be performed efficiently even by a rather large body and the representation of all member countries in the Governing Council provides the appropriate legitimacy for such a controlling function. The Executive Board should equally develop into a decision-making body in its own right, but so far its actions have been tightly controlled by the Governing Council.

The Governing Council can be regarded as the "sovereign institution" in European monetary policy. It derives its sovereignty from the fact that it represents all the member states and pools expert knowledge from the national central banks. All powers within the ESCB can

[2] The justification says "In order to avoid the situation that governors within any group have a voting frequency of 100% the Governing Council may also decide to postpone the start of the rotation system until the number of governors exceeds 18." But if the rotation principle is postponed, the voting frequency remains 100%.

eventually be traced back to the Governing Council. This also applies to the Executive Board, all of whose powers at present are directly delegated by the Governing Council.

This proposal does not affect the primacy of the Governing Council – all powers would continue to emanate from it. It does, however, reduce the right of the Governing Council to control every single act of the Executive Board. Thus the Executive Board could come to enjoy a certain degree of discretion, which is justified by the fact that it represents not just the aggregation of individual state interests but rather a "general European monetary interest".

The division of labour proposed here is based on one key difference between NCB presidents and members of the Executive Board that is "objective": i.e. their respective information bases. Board members concentrate on area-wide aggregates in their daily work and are likely to be in closer contact with global financial markets than the NCB presidents. The latter perform a wide variety of functions at the national level: they supervise the national banking system and are influential participants in national debates about almost all economic policy issues. By contrast, the remit of the members of the Board is more focused and narrowly defined, allowing them to concentrate almost exclusively on issues related to the formulation of the common monetary policy stance.

This information advantage of the Board members is likely to be most pronounced in the area of financial market developments. Area-wide data on real economic variables, such as output, result essentially from the summation of national data that become available at different points in time and most of which contain small national idiosyncrasies. Financial markets are much more integrated than the markets for goods and services so that an observer at the centre does not need to have detailed local knowledge. Some national idiosyncrasies persist in financial markets at the retail level, but the movement towards a unified market is stronger for financial services than for goods and most other services.

By contrast, the markets for most goods and services retain some distinctive national characteristics. For example, the average area-wide inflation rate might be influenced by a change in indirect taxes or a re-basing in one member country, which can at times produce an effect that might not even be known outside the country and whose importance is difficult to judge unless one knows the local situation in some detail.

This view implies that there might well be a natural division of labour between the NCB presidents and the Executive Board members: the latter can contribute their knowledge about the state of financial markets whereas the former can contribute local knowledge about the real economy, including prospects for output and employment. This division of labour has one immediate consequence: financial markets move much more quickly than the markets for goods and services, which in the final analysis determine output and employment. Interest rates and stock markets can collapse or soar in a matter of weeks, if not days, but a fall in consumer demand usually takes months to develop (and to be recognised as such). Supply-side shocks, such as an acceleration of productivity, take place over an even longer time horizon.

The different comparative advantages of NCB presidents and members of the Executive Board suggest a simple approach to the reform of the ECB in view of enlargement. As the number of euro-area member countries increases, the Governing Council, which would continue to comprise all the NCB presidents, would meet less often and concentrate on strategic decisions. To be concrete, the Governing Council might meet only once every quarter. These meetings could involve a longer exchange of views on the state of the economy, which would then allow the Governing Council to formulate general, strategic guidelines for monetary policy, leaving the day-to-day execution to the Board in Frankfurt.

This approach has the advantage that it maintains the representation of all member countries in the highest decision-making body of the ECB. There is a strong political demand for full representation, which should not be dismissed. It also has a rational background: as argued above, local information is essential to fully understand the economic situation even at the area-wide level. This same perception is also shared by the wider public. Tough decisions by the ECB are thus more likely to be accepted as necessary and legitimate if all countries are represented in the governing body of the ECB that takes strategic decisions. In this context, strategic means those decisions that have a longer-run and more profound impact on the economy.

During normal times the general public is unlikely to even notice the week-to-week, or even month-to-month changes in monetary policy interest rates. Monetary policy becomes an issue only when tough decisions have to be taken. This is most likely to happen when output falls and unemployment goes up but inflation remains high (as at present). In such a situation, the choice takes on great political importance. Should monetary policy become accommodating to sustain employment or become restrictive to achieve price stability? These are the issues that concern the general public rather then the question whether the appropriate neutral stance implies an interest rate half a percentage point higher, or whether rates should be cut in one month hence instead of today. This type of decision can be left to a smaller group even if it is not perceived to be currently representative of all countries.

All rotational schemes face the same dilemma: while they may be fair on average, this fact is irrelevant at any given moment in time. If a country that is hit by a crisis does not have a representative on the ECB Governing Council, the public is unlikely to magnanimously accept its bad luck. Unpopular decisions of the ECB could then quickly be perceived as illegitimate because the ECB "does not even know what our problems are". An asymmetric rotational scheme that differentiates, for example, between larger and smaller countries would reduce the likelihood that this would happen for a large country, but it would raise the general suspicion that ECB policy is being determined by the interest of the restricted group of countries that happens to be represented at any one time in the Governing Council.

The example of the US Federal Reserve Board, where there is an asymmetry in the sense that the Governor of the NY Federal Reserve District is the only one to have a permanent seat in the Open Market Committee, does not constitute a counter argument. This asymmetry is due to the importance of New York as a financial centre, not because the New York District is in a different league in terms of population or GDP. This implies also that the NY Fed Governor is more likely to represent the interests of the US financial sector (witness the rescue of LTCM) rather than the interests of the Federal Reserve District of New York, which encompasses a number of quite different states. In the case of the ECB, the Board, based in Frankfurt, would subsume the role of the NY Fed Governor. Moreover, Governors of Federal Reserve Districts do not have the same prominent role in regional politics as do the presidents of NCBs in Europe, partially because their constituencies encompass several states (some Federal District boundaries even cut across states).

The example of the US also does not justify the inclusion of the total aggregate balance sheet of monetary financial institutions in the indicator of size that should be used, according to the ECB proposal, to classify countries in different categories. The importance of a financial centre is not determined by the size of balance sheets but by the complexity of operations that are undertaken. The huge amounts of savings deposits in Luxembourg banks on their own do not constitute a reason to put this country in a different category. Most of these deposits come from other member countries and are often controlled directly or indirectly by other EU financial institutions. Luxembourg cannot be compared to New York; it is not the financial centre of the euro area.

4. Concluding remarks

The main theme of this contribution has been that the official proposal to reform the composition of the Governing Council is so flawed that the status quo would be preferable. It does not make much difference whether 21 or 25 (or 30) have the right to vote when everybody continues to participate in the discussion anyway. The negligible gain in efficiency cannot compensate for the cost that must be paid as a result of the fact that the ECB's proposal undermines the principle of equality among member states, thus making it more probable that governors of national central banks will actually put the perceived interests of their home country before the interests of the euro area as a whole. To undermine the principle of equality of member states would have been justified only if the size of the Governing Council had been reduced to a manageable level (e.g. around 10 members), thereby ensuring an important gain in efficiency.

This contribution has also presented an alternative to the ECB proposal. The main argument, however, is not that this particular alternative proposal (to maintain the composition of the Governing Council but to confine its purview to setting the guidelines for monetary policy, thereby leaving their execution to the six-member Executive Board) is much better than the ECB proposal. The main point is that almost anything (including the status quo) would be better than the official proposal that is now in the process of being ratified at the national level.