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The monetary policy consequences of enlargement

Carsten Hefeker*

Most real effects of the extension of European Monetary Union (EMU) to new member states have arguably already been realized. EMU might increase trade because uncertainty from changing currency values disappears, and for the same reason it might also increase investment. But given that many of the candidates for enlargement are already de-facto members of EMU, as several operate currency boards or have other forms of more or less tight pegs to the euro, one should be forgiven for not expecting tremendous changes in these areas. However, enlargement is likely to have an impact on the way monetary policy is set. With enlargement of the common currency area there will also be an enlargement of the council which sets the policy of the European Central Bank (ECB). New members in the council could change the policy stance of the larger institution. Moreover, a larger currency area might imply changes in the optimal policy with enlargement. Both changes could have substantial influence on the way monetary policy is set and how the private sector in member countries reacts to these changes.

Changes in the ECB council

The new member countries are characterized by shock structures that are different from those of the older members. Especially the larger current members often exhibit a low if not negative correlation to supply and demand shocks in the new member states (Fidrmuc and Korhonen 2003). This implies that new members will often prefer a different monetary policy compared to that of current members, reinforcing the problem that one-size common monetary policy does not fit all. Moreover, some of these countries are still characterized by higher growth rates and therefore often have stronger price pressures due, among other factors, to the Balassa-Samuelson effect. This again might imply that new board members bring different preferences to the ECB council meetings. It does not mean, however, that new members will favor more inflation as is often feared. It is just as likely that they will push for a tighter monetary policy in order to stem price pressures in their national economies (Kenen and Meade 2003).

Of course, all this would mean nothing if all ECB members were to represent only the European interest and if all of them would have the same preferences concerning the trade-off between inflation and stabilization of the real economy. In this case, additions to the monetary union would hardly influence the common monetary policy stance, as new member states are economically small and thus unlikely to influence the European average by much. However, this interpretation is probably too benign. More and more evidence belies the officially voiced position that decisions are taken by consensus and that the ECB council decides solely with a truly European perspective. This is not surprising as the whole point of having regional representatives on the council is to have someone representing regional perspectives. Regional representation is meant to ensure that more adequate information on regional developments is available to the council and also to ensure that regional interests influence the common decision. Accordingly, empirical evidence suggests that regional delegates vote with a distinct regional perspective, something that is also found in other federal central banks, such as the US Federal Reserve System and the German Bundesbank before EMU. There is also suggestive evidence that this is not different in the ECB council (Meade and Sheets 2002, Heinemann and Hüfner 2004).

Regional representatives to the ECB vote with a regional perspective

This being the case, one might expect that the whole monetary stance of the ECB could change if new members were to bring different preferences or needs for monetary stabilization to the council meetings. To avoid too big a shift in monetary policy, a

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plan has been accepted by the European Council that mandates a change in the ECB board once the number of member states reaches 15 (European Central Bank 2003). The ECB proposed a two- stage reform, depending on the number of members. In a first step, applicable for a monetary union of 15 to 21 members, two groups would be formed, the first comprising the five largest economies (measured in terms of GDP and the size of the banking sector). This group would have between four and five votes, the rest being rotated among the second group of smaller economies. The overall number of votes for national representatives would be restricted to 15. A third group of countries would be formed once the number of member states exceeds 21. In this case, the first group would have 4 votes (so that members in this group will be entitled to vote 80 percent of the time), the second group, comprising half the member states, would rotate through eight votes, and the smallest economies would share three votes (see Table). Since members in the respective groups rotate through the assigned voting rights, larger countries are more often entitled to vote than smaller ones. However, at any given time, all countries that do vote have the same weight and all members are invited to discuss policy decisions, so that non-voting countries are not excluded and could contribute their opinion and expertise. The members of the board, however, will retain full voting rights, so that the overall number of voting members on the council will remain at 21.

To avoid too big a shift in monetary policy, a reform of the ECB board was agreed

This reform, accepted by the European Council and ratified in all members states, is a combination of rotation, like it is practiced in the US Federal Reserve System where some districts are not entitled to vote all the time, and the system of representation used in the International Monetary Fund, where smaller countries form groups. Of course, the reform implicitly leads to a higher centralization of monetary policy, because relative power is shifted to the board, and a slight correction of the under-representation of larger countries that currently exists in "the one country, one vote" setup is achieved. The change in the council incidentally follows the example of the extension of the German monetary union to the former GDR. Then as well, every federal state (Bundesland) was no longer represented in the council of the German Bundesbank which would have meant 16 regional representatives in addition to nine board members. Instead, groups of federal states where formed and the total number of regional representatives was reduced to nine, while the number of board members was restricted to a maximum of nine (of which not all are filled). This implicitly gave more power to the Bundesbank board just like the ECB reform gives more power to the ECB board (Hefeker 2003).

Increased divergence of monetary transmission

A more important change will probably follow from the fact that the new board, taking decisions in consensus or voting on them, will face the fact of an increased divergence of economic structures among member states after enlargement. Different indus-

Rotation System in the Enlarged Euro-Area Central Bank Governing Council

Euro Area composed of 15 or more members							
		Number of governors in the council					
		16	**17**	**18**	**19**	**20**	**21**
1st group	Votes/governors	5/5	5/5	5/5	4/5	4/5	4/5
	Voting frequency	100%	100%	100%	80%	80%	80%
2nd group	Votes/governors	10/11	10/12	10/13	11/14	11/15	11/16
	Voting frequency	91%	83%	77%	79%	73%	69%
Votes		**15**	**15**	**15**	**15**	**15**	**15**
Euro Area composed of 22 or more members							
		Number of governors in the council					
		22	**23**	**24**	**25**	**26**	**27**
1st group	Votes/governors	4/5	4/5	4/5	4/5	4/5	4/5
	Voting frequency	80%	80%	80%	80%	80%	80%
2nd group	Votes/governors	8/11	8/12	8/12	8/13	8/13	8/14
	Voting frequency	73%	67%	67%	62%	62%	57%
3rd group	Votes/governors	3/6	3/6	3/7	3/7	3/8	3/8
	Voting frequency	50	50	43	43	38	38
Votes		**15**	**15**	**15**	**15**	**15**	**15**

Source: Monthly Bulletin of the ECB, May 2003.

trial structures, different banking systems, and different degrees of labor market centralization imply that the transmission of monetary policy will become more unequal than in the existing monetary union where a considerable convergence of transmission seems to have been taking place in recent years (Angeloni and Ehrmann 2003). Because of this convergence, starting even before the introduction of the euro, monetary policy tends to have largely similar effects in most euro-zone countries. However, the convergence among the candidates for new membership is less advanced. Monetary policy works differently in these countries and it is asymmetric within the group of candidate countries (Ganev et al 2002, de Haan et al. 2005, Egert and McDonald 2006). What does this imply for the monetary policy of the ECB?

A stronger divergence in the transmission of monetary policy should lead the ECB to give more attention to those countries which diverge from the average (Gros and Hefeker 2002, Benigno 2004). This recommendation simply follows from the fact that more variability in output and inflation results in increasing losses in any country. The more a country diverges from the average, the less adequate is a policy tailored to the average of the member countries, and hence the more risk there is that these countries will suffer from inflation and output variability. Hence, more weight should be placed on developments in countries which are further away from the average and for which transmission of monetary policy is highly asymmetric.

This, of course, presumes that differences in transmission are well known and can be adequately addressed by the central bank. But this need not be the case in the larger EMU, at least in the immediate and foreseeable future. The transmission of monetary policy is not only asymmetric, it will also be uncertain because the ECB might not fully know about how monetary policy translates into real variables in new member states, not least because many of these countries are still in a process of restructuring (De Grauwe and Senegas 2004). The sensible response of a central bank to increased uncertainty is to react less aggressively to economic shocks, simply because it is prudent to be less active when the outcomes of one's actions are uncertain (Brainard 1967). A highly asymmetric and uncertain transmission of monetary policy hence implies that the ECB will pursue a less active monetary policy than it has been doing in the past. While the ECB has been frequently criticized for pursuing a less active strategy than other central banks such as the US Fed, this criticism is not justified once one realizes that monetary policy in the eurozone is inherently much more difficult than in other currency areas. The logic for this is of course grounded in the fact that EMU member states are more diverse than those of other single currency areas, and that the ECB, at least initially, was faced with uncertain territory. This problem is reinforced by enlargement of EMU and so even more prudence can be expected from the ECB.

The changed central bank reaction should obviously have consequences for financial markets and the private sector as well. Private agents will realize a lower ability and willingness of the common central bank to respond to economic shocks or to intervene to compensate for the negative effects of too generous wage and price increases. While the ECB has always emphasized that it is not attempting to stimulate employment or output with the help of monetary policy, it has nevertheless intervened to stabilize the economy in response to economic shocks (albeit preserving the primacy of a low inflation rate). Wage and price setters should realize that monetary policy will be even less available as an instrument of adjustment in a larger monetary union than before. This should result in less aggressive wage setting by unions and more careful price setting by enterprises (Hefeker 2005). In a sense, this might have beneficial effects, as wage and price setters should place no expectations on the central bank concerning a possible bail-out and instead should make greater efforts themselves to become less vulnerable to economic shocks. While this had been the case for the smaller member countries in the European Monetary System even before the introduction of the euro, where countries like the Netherlands, Austria and Belgium had long ago given up their independent monetary policy and pegged their currencies closely to the deutschmark, this was less the case for the larger countries in the EU. The same applies to the new member states; there are some, like the Baltics and Slovenia that gave up independent monetary policy from the beginning, while others, like Poland and Hungary, will have to do so upon entering EMU. Enlargement of EMU will imply at least for the larger countries that they will also have to adjust to a less active monetary policy which is no longer able to address national needs.

Differences in transmission mean that ECB policy must be more cautions with all the consequences for financial markets and the private sector

Increased uncertainty about central bank behavior

But uncertainty will not only increase for the central bank. One can also expect the larger ECB council to become less predictable for financial markets and the private sector, at least initially, than the smaller council had been. This has to do with the fact that new members with potentially different preferences will enter the council which might shift the monetary policy of the ECB. More members can shift the majority on preferred monetary policy in comparison to the previous situation because systematically different preferences influence the median position that determines policy (Hefeker 2003). Some observers, in contrast, claim that the ECB council is dominated by some members, and that the official 'one country, one vote' system does not adequately reflect the de-facto power distribution (Fatum 2006). However, even in this case it is well possible that a larger group might effect a different outcome as relative powers in the council could change. In fact, even observers from national central banks argue that the envisaged change in the council's decision-making system will lead to more uncertainty, as nobody so far has any idea on how exactly decisions are going to be taken in the larger council (Servais 2006).

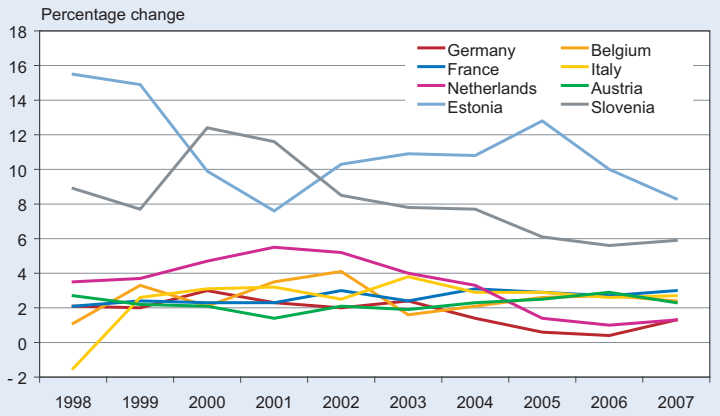
When markets are more uncertain about the ECB's reaction function, wage setting will be less aggressive and governments will undertake more reforms

This at least is what happened in the early years of the newly created ECB (Goldberg and Klein 2005). It took financial markets a considerable time to decipher the position of the new institution and to form an adequate perception of what the position, behavior and reaction of the ECB to any given development would be. Only over time did markets and the private sector learn what type of reaction could be expected from the new central bank to real developments in member states. There is little reason to expect that there will not be a more or less prolonged period of uncertainty this time as well.

Again, it is reasonable to expect that the private sector will adapt its behavior to any increase in the uncertainty about the type of central bank it faces. Just as the central bank becomes less active when setting monetary policy in reaction to uncertainty, the private sector will become less aggressive in terms of wage and price setting in response to increased uncertainty about the monetary authority's reaction function. Theoretical work has shown that an uncertainty reaction function of the central bank will lead to more restraint in unions' wage setting (Grüner 2002), and there is empirical evidence as well to show that for certain types of national labor markets a disciplinary influence of increased uncertainty on wage setting behavior of labor union can indeed be found (Grüner et al. 2005). Preliminary evidence for the eurozone accordingly shows that wage setting in the common currency area has become less aggressive in response to the introduction of EMU (Posen and Gould 2006). This is reflected in the moderate development of nominal wages in recent years (see Figure) . The positive effect on employment should be reinforced when EMU is enlarged.

Not only the private sector should be influenced by the increased uncertainty about the reaction function of the central bank, government policy should adapt as well. Losing monetary policy as an alternative adjustment instrument in response to economic shocks should increase the willingness of governments to implement politically undesirable structural reforms in labor and product markets. (Hefeker 2006). Governments, which are usually averse to reforms in product and labor markets because of the political cost of reforms, will usually rely on the central bank to help stabilize the economy in case of economic shocks. When monetary policy can no longer provide this service, more efforts have to be undertaken by the private sector, and the government might itself be forced to help make the economy less vulnerable to shocks by increasing product and labor market flexibility. A loss of monetary policy will thus even pressure reluctant governments to

NOMINAL WAGES IN EMU AND ACCESSION COUNTRIES



Source: Eurostat.

undertake more reforms. An increase of uncertainty about the central bank's behavior will reinforce this process as it is, from the point of view of government, akin to a loss of monetary policy as an instrument of adjustment or a shift to a more conservative central bank.

Incidentally, this result has also implications for the debate about central bank transparency (Geraats 2002). Observers often criticize the ECB for being not open enough and being less transparent than other central banks, like the Bank of England or the Swedish National Bank. While there are many good arguments for high central bank transparency, the argument introduced above suggests that not having full transparency can have beneficial effects on wage setting and government reform policy.

Enlargement is likely to have positive effects

While conclusions about the likely effects of an enlargement of EMU are highly speculative and subject to a large degree of uncertainty, one conclusion at least seems quite clear: There is no indication whatsoever that the monetary policy of the ECB will become more active than it is currently. As argued above, it is likely that the larger central bank's policy will become less active because of higher transmission uncertainty and because economic divergences among member countries will increase, making it even less likely that the ECB will tailor its policy to the need of any particular group of countries. This confirms the old conclusion that monetary policy in a monetary union is less of a ready-to-use instrument than national monetary policy implemented by a national institution.

While this situation is relatively new for Germany, it is well known for the smaller members of the old EMU, where countries like Belgium, Austria and the Netherlands were used to having a monetary policy aiming mainly at stabilizing exchange rates so that national adjustment had to come from other areas and policies. And it is also a well known principle in the Baltic countries and Slovenia. Germany, and possibly Poland and Hungary, will have more problems with acknowledging that monetary policy is lost for good as an instrument for stabilization. More adjustment will instead have to come from the labor markets and the deregulation of product markets and the service sector.

Enlargement is therefore likely to be a continuation and reinforcement of a process in which member states increasingly realize the loss of an economic policy instrument which had been used more or less freely before monetary union. Larger states will have more problems adjusting to this situation than smaller ones, but eventually they will also have to do so. In the best case, enlargement can work to speed up reforms. Enlargement is thus as much in the interest of the older members as it is in the interest of the candidates. If, however, larger members fail to realize the implications of enlargement, there will be transitory adjustment costs.

Monetary policy in a monetary union is less active than that of a national central bank

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