Friedrich, Ingo; Belke, Ansgar; Gros, Daniel; Meade, Ellen E.

Article — Published Version

Reform of the decision-making rules of the ECB Council in view of EMU enlargement

Intereconomics

Suggested Citation: Friedrich, Ingo; Belke, Ansgar; Gros, Daniel; Meade, Ellen E. (2003) : Reform of the decision-making rules of the ECB Council in view of EMU enlargement, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 38, Iss. 3, pp. 116-131

This Version is available at:
http://hdl.handle.net/10419/41745

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Four years into Monetary Union, the euro-zone is about to be enlarged fairly soon. As things stand, ten new countries will join the EU on 1 May 2004. An enlarged euro-zone will also affect the work of the European Central Bank (ECB). Reforming the ECB decision-making procedure is far more than a purely technical matter of how best to develop a sophisticated voting procedure. But let me start by taking a look at the broader picture.

The Role of the Euro and the Single Market

In the first two months of 2002, we were all eyewitnesses of a unique event in history. Twelve independent nation states that had given up their national currencies and joined a common single currency three years previously were introducing the euro notes and coins. After having had the euro in the balance sheets for some time, the citizens of the euro-zone experienced the new money in their pockets. I think that even those people who had long considered the euro as a project of eurocrats not in touch with life on the ground did realise that the euro was much more.

First and foremost, the euro reinforces the Single Market in that it makes cross-border activities much more transparent and does away with exchange-rate volatility. So the economic benefits are there, not only for business, but also for the consumers. In this context I need to address a common misapprehension: it is sometimes argued from outside the euro-zone that it would make no sense to join the single currency as economic growth in Euroland is lower than elsewhere in Europe.

True, there is a great deal of room for improvement, but it is not the fault of the euro, but rather of those national governments which have missed out on tackling the much-needed structural reforms. I wish that my own government had been much more active over the last five years. They have made a promising move now and – in the interest of the euro as a whole – I cannot but hope for the best. At the end of May, the European Commission published a report on public finance in Europe and projected that, without reforms, Germany’s total debt would, by 2050, quadruple to 240 per cent of GDP!

The euro is not least a political project and we now hold it in our very hands. It is the daily proof of the success of European integration. The changeover to the euro worked unexpectedly well and it is now fully accepted as our everyday currency. Some may
say, “This is all good and well, but at the end of the day, who wants the euro?” As a matter of fact, all new Member States want to join as soon as possible after enlargement on 1 May next year. And also the three EU countries which have decided not to adopt the euro are considering – to various degrees, I must admit – joining in the not-too-distant future. I personally welcome the attractiveness of the euro and I am looking forward to the extension of monetary stability to the new Member States.

Priorities for EMU Enlargement

I believe that it is very important for every country to join at the right time. For economic and political reasons. There is no doubt that every new euro-zone member has to meet the Maastricht criteria in order to qualify for entry. Most economies in Central and Eastern Europe, however, still need to catch up with the level of productivity of the current euro-zone members. This would require fairly high growth rates coupled with “above-Maastricht” levels of inflation and a certain degree of flexibility of the national exchange rates. Therefore, I would think it economically sensible not to press for early entry at all costs, as this would hamper or even stifle the growth rates most of the new Member States still need.

Politically, too, premature entry would be dangerous. Lower growth rates would be perceived as an economic standstill and the benefits of euro-zone membership would be questioned. Indeed, the euro might even be seen as the reason for economic failure. “Euro candidates” can gain a lot more from powerfully catching up and adapting than from aiming at early entry at all costs, as this would hamper or even stifle the growth rates most of the new Member States still need.

The Merits of the ECB

The euro is a success. The main reason is that our common currency has the right architecture and is properly managed by an independent central bank. In retrospect, the ECB has done an excellent job so far. Its design has served well and the management has acted in a prudent, excellent and forward-looking manner. It could have been a lot worse.

I do not share the widespread criticism of the two-pillared monetary strategy. In my view it has served its purpose well despite the fact that it may seem somewhat too technical. I would say that the money supply target – together with the economic indicators – is a useful tool to meet the inflation target itself. Perhaps the ECB should explain this relationship between tools and goal from time to time.

I am glad that Wim Duisenberg was selected as the first President of the ECB. It is mainly due to his personal commitment, his experience and expertise and the respect he commands amongst his colleagues that we have enjoyed a stable euro from the beginning. If his post cannot be filled in time, I would very much welcome if Wim Duisenberg continued. We need to take care that only a personality with an undisputed track-record is in charge of the European Central Bank.

The ECB Reform Proposal

The current institutional design has served a monetary union of 12 members well. The ECB Governing Council – which includes the ECB Executive Board and the Heads of the national central banks – is a decision-making body of the right size. In an enlarged euro-zone, however, this institutional arrangement would soon reach its limit. The Treaty of Nice, insufficient as it may be in other fields, rightly includes a provision that foresees reform of the Statute of the ECB, namely article 10 paragraph 2 that deals with the composition of the General Council.

The ECB came up with a proposal at the beginning of February this year. In a nutshell, it suggested some sort of rotation system.

• Up to 22 member states the euro-zone countries would be divided up into two groups.
• Once the number of countries exceeds 22 there would be three groups of countries.
• The Heads of national central banks would have rotating voting rights subject to the economic strength and the relevance of the financial sectors of their countries.
• The number of votes of central bank representatives would be limited to 15. The five biggest euro-zone countries would have 4 votes, the smaller ones would share 11 votes. Only the 6 members of the ECB Executive Board would keep their permanent voting rights.

Frankly, this model has a number of shortcomings.

• It abolishes the principle of “one man, one vote”. At present we have the psychologically crucial notion of equality among participating countries. This creates an atmosphere of mutual respect and facilitates...
decision-making. The principle of “group-setting”, however, involves a notion of a two or three-tier Europe which would not at all be true for countries all taking part in the same monetary union.

• The operational decision-making process would not be simplified at all. Every member of the Governing Council would have the right to speak in the debates on interest-rate decisions, for example. One could assume that representatives with no voting rights would use their speaking time intensively. The European perspective could be lost and there would be no time-gain whatsoever. Besides, the time needed for the voting as such would stay the same irrespective of the number of voting rights.

• Under the ECB proposal a situation could arise in which a coalition of smaller countries representing just ten per cent of the euro-zone economy prevailed. Also, Luxembourg would be entitled to vote more often than the far bigger newcomer Poland.

It seems to me that the ECB proposal is a very complicated and confusing one. It lacks transparency, creates inequality, saves no time and may disregard the economic realities in Euroland and disadvantage individual euro-zone states.

The Alternative

This is why, as European Parliament Rapporteur for the ECB statute, I have proposed an alternative two-step-solution to my colleagues:

• In a first step, we should keep the principle of “one country, one vote” for the time being. Every representative of a national central bank should keep his or her voting right. Likewise, the principle of majority voting, which applies under the present provisions, should also be maintained.

Only the Heads of the national central banks know precisely the conditions in their countries. This is all the more important as an enlarged euro-zone may be fairly heterogeneous. The voting system should be amended, however, so that a majority of the votes always commands an adequate majority with regard to population or economic power. Such a “double majority” could take up the criteria proposed in the Treaty of Nice for majority voting in the Council.

• In a second step at a later stage, when the euro-zone has reached the critical mass of 25 Members or more, the system would have to be changed more radically. There should then be a distinction between the operational level (interest rate decisions) and the strategic level (money supply issues).

The ECB Governing Council as a whole (i.e. the ECB Board and the Heads of the national central banks) should take the strategic decisions. The operational decisions should be left to the ECB Board which would be enlarged from 6 to 9 members. Operational decisions could then be taken very quickly in response to changes in the markets.

The European Parliament approved this alternative model on 12 March 2003. However, the Heads of State and Government did not even discuss the issue at their European Summit in Brussels on 21 March. They simply ignored the Resolution of the European Parliament and unanimously endorsed the ECB proposal. I am not sure whether that was a wise decision. But now the matter is left to the European Convention.

The Role of the Convention on the Future of Europe

My feeling is that the Convention – in which a number of representatives from the European Parliament and the national parliaments are involved – will be able to find an appropriate solution. I call on the Convention to take up the European Parliament model, which is far more practical and transparent than the proposal adopted by the Council.

The EU has committed itself to simplifying the Treaties and making them more transparent for the citizens. The ECB proposal definitely does not fit here. The Intergovernmental Conference (IGC) at the end of the Convention has the final say. But we all know that months of finger-waggling over proposals that have already previously been discussed in the Convention would not be a good sign for Europe. So I can see a scenario in which we would have a common-sense solution for the ECB Statute after the IGC. If the ratification process goes well, we would have the amended Statute ready for the first big round of euro-zone accessions. This would spare us the notorious Council regulation that we have on the table today.

There is, of course, a potential fly in the ointment. If the Convention were to look into the institutional provisions for the ECB, we would run the risk of the independence of the ECB and its paramount commitment to price stability being watered down. There are voices inside the Parliament, but also in the Council, which suggest that the ECB should also keep an eye on economic growth as much as it should on price stability. There are even calls to lift the inflation target to well
above 2 per cent. I cannot but warn against such voices! An independent ECB committed to price stability is an indispensable insurance against a weak euro. Unfortunately, a few Member States have become real liabilities for the fiscal stability a monetary union so desperately needs. With a single interest rate for the whole monetary union, we cannot have excessive budget deficits again like in the early and mid 1990s. I would advocate the strengthening of the Commission’s role in the Stability and Growth Pact (SGP). Early warnings to, or measures against, Member States with excessive budget deficits should no longer be subject to a qualified majority approval by the ECOFIN Council. We have seen damaging horse-trading emerging in ECOFIN at the first early warning to Germany last year. Lately we have even seen outright opposition against obligations to reduce an excessive deficit on the part of France.

The euro is a grand project, the long-term success of which is not automatically guaranteed. It is a unifying layer of European integration and also has enormous political potential. We must do everything we can to ensure the well-functioning of the monetary union. The reform of the ECB is a crucial one.

At the end of a quite secretive discussion process the ECB Governing Council finally published its proposal for a reform of the ECB Council’s decision-making process in early 2003. The Heads of State of the EU member countries approved the proposal made by the ECB on the rotation model on March 21, 2003 in Brussels. For some analysts this unanimous decision came rather as a surprise in view of the heavy resistance to the proposal which was virulent until the middle of March in countries like Finland and the Netherlands, whose parliaments felt they had been treated at a disadvantage. However, political acceptance of the proposal is by no means certain as the 15 national parliaments must still ratify the modification of the EU Treaty. In the case of a rejection, any new proposal will be negotiated together with the EU constitution in the European convention. It seems as if in this case there may be a danger that politicians will be keen on even renegotiating the fundamentals of the two-pillar strategy of the Eurosystem or the independence of the ECB at the same time in a package deal.

As is well-known, the ECB’s reform proposal consists of a “minimum representation model” combining elements of rotation as practised by the Federal Reserve’s Board of Governors and elements of representation, i.e. the formation of country groups with group representatives following the example set by the IMF, the World Bank or the Bundesbank Council after German unification. In this context it is important to note that enhancing efficiency was not the main motivation for the introduction of the rotation principle in the Federal Open Market Committee (FOMC). Instead, the voting power of regional governors was restricted in order to be able to run a common monetary policy for a common region instead of a monetary policy driven by regional interests. Most remarkably, the delegation of decision-making competences in the ECB to a small committee with only a few national representatives (“delegation” and/or “centralisation”) was not regarded as an option at all. It was consistently argued by the President of the ECB, Wim Duisenberg, but questioned by the European jurisprudence, that the wording of Art. 5 of the Treaty of Nice, Art. 10.2 and Art. 10.6 (the so-called “enabling clause”) of the ESCB Statute prohibited a delegation or centralisation solution and limited the scope of the Council reform to a mere change in the voting procedures. Supporting this

Ansgar Belke*

The Rotation Model Is Not Sustainable

view would imply accepting that the “blueprint” of the Treaty of Nice was flawed and that the present “lopsided construction” was due to the lack of political power to correct the mistake. By speeding up the process of passing the reform, the ECB Governing Council met two strategic targets at once. First, its own proposal can now in principle be ratified just in time before EU enlargement and before the new members themselves participate in the decision. Second, it took the initiative for a proposal and did not leave it, for instance, to the EU Commission. How should the ECB proposal be assessed?

- Without any doubt, the coming extension of the euro area requires a reform of the highest decision-making body of the European Central Bank because without reform the ECB Governing Council is going to comprehend more than 30 members. This will raise efficiency problems in the body that is responsible for the stability of one of the most important world currencies (“numbers problem”).

- Unfortunately, the ECB proposal is even less preferable than the current decision-making procedure in the ECB Governing Council, which itself is by no means optimally prepared for the euro-zone enlargement. The rotation model suggested by the ECB violates the fundamental principle of “one member, one vote” that is intended to ensure that ECB Governing Council members participate in the Council’s meetings personally as well as independently and not as national stakeholders. The rotation model cultivates thinking in national categories, reduces the responsibility of the rotating members for monetary decisions and heightens intransparency. Furthermore, the limitation of the total number of rights to vote to 21 is far too generous by international standards and will cause additional inefficiencies in the decision-making process. In addition, the rotation model is inconsistent and contains arbitrary elements, such as the fact that the frequency of the voting rights’ rotation is not explained and that a very small country like Luxembourg will have a similar number of voting rights to Poland.

- Preferable to the status quo and the ECB model is a reform that delegates the authority to decide on operational monetary policy solely to the ECB’s Executive Board. Then, the ECB Council would determine monetary policy strategy and other fundamental questions in an unchanged formation. This two-stage system – the fundamental rules of the game are fixed by the Governing Council while the Executive Board makes decisions on daily political issues within this framework – is able to mitigate differences of interest. Such a reform would be both efficient and truly European. This would be of outstanding significance as the ECB is required to direct its monetary policy to the entire euro area and not to special interests of single member countries. The above proposal meets this requirement while the recently announced rotation model of the European Central Bank can hardly be brought into line with a continuous stabilisation policy.

**Minimum Representation: the ECB Reform Proposal**

A (price) stability oriented European monetary policy represents a collective good for the euro countries because a low and stable rate of inflation is the best precondition for investment, growth and employment. By contrast, a monetary policy prone to inflation may bring unemployment down in the short term but reduces medium and long-term growth and employment. It is the central task of any monetary policy constitution to assure that a central bank like the ECB is not tempted to jeopardise a reasonable stabilisation policy due to short-run demands by governments or organised lobbyists. In Europe, this constitution comprises, firstly, the anchoring of the goal of price stability in the EU Treaty, secondly a concept of monetary policy that allows a viable policy of price stability as well as the documentation and verification of the ECB’s willingness to maintain stability, and thirdly the organisation of the monetary decision-making. Particularly the latter item is of central importance, because this is where the framework for daily decisions is laid down.

The necessity of reforming the decision-making process in the ECB Governing Council is beyond question. Under the prevailing body of rules, an expanded euro area would lead to a large ECB Governing Council which is hardly capable of acting. Including the six members of the Executive Board, the Governing Council would consist of more than 30 members. Guided by national interests, the latter would as a rule tenaciously struggle to arrive at day-to-day decisions. This absolute increase in the number of members of the ECB Council would in the end lead to efficiency problems. Another dimension of the problem is that coalition formation among smaller euro member countries could lead to interest rate decisions which are not optimal for the euro area as a whole. The period of natural coalition between the governors of the larger...
member countries and the Executive Board, which in the first four and a half years of monetary union enabled consensus decisions, would be terminated.

Finally, the discrepancy between the economic and the political weight of the euro member countries in the Council would even increase due to the fact that the new members tend to be (in economic terms) smaller in size. A too strong representation of the acceding countries, which are characterised by higher inflation due to the Samuelson-Balassa effect, might lead to additional economic costs for the euro-zone. According to some critics, these costs would consist either of higher inflation in the euro area (although the latter should not be rated to be very high, i.e. above 0.2 percentage points of total euro area inflation) or of higher nominal and real interest rates in the euro-zone than otherwise (if the ECB reacts to this inflationary bias). Of course, this argument heavily depends on whether there really are differences in motivation between the old member countries of the euro-zone and the newcomers. However, one should not be so confident that the EMU core countries endanger the stability mandate of the ECB to a lesser extent than the CEECs will do later on (see, for example, the erosion of the stability and growth pact by Germany itself).

The central question raised in this contribution reads as follows: is the ECB’s reform proposal able to handle and to dissolve these future problems?

Based on the assumption of a future euro area with 27 member countries (the current twelve members, plus the United Kingdom, Sweden and Denmark, plus the ten Central and Eastern European countries which will join the EU in 2004 plus Bulgaria and Romania) the ECB’s Governing Council would consist of 27 national central bank governors and 6 directors. According to the ECB’s rotation model the voting rights would then, i.e. if euro area enlargement is completed, be divided as follows.

- The six directors would possess a permanent right to vote.
- Eight votes are assigned to the central bank governors of 14 middle-sized member countries. Thus, the participants of this group are entitled to vote only in 57 per cent of all decisions (Group 2).
- The remaining eight central bank governors only account for three voting rights which implies that these representatives are suspended from 62.5 per cent of the voting dates (Group 3).
- Irrespective of their specific voting right all national central bank governors always participate in the discussions on monetary policy of the ECB Governing Council.

The implication of the ECB proposal in terms of the distribution of the voting rights between the Executive Board on the one hand and the national bank governors from big, medium-sized and small euro member countries on the other hand can best be summarised as follows. A simple visual inspection of Figures 1 and 2 reveals that the ECB proposal lowers the voting shares of the new euro member countries to the benefit of the current member countries and that the position of the Executive Board will in fact be strengthened by the reform, which is intended by the ECB with an eye to its “greater independence and competence”.

An Assessment of the ECB Proposal

Despite the claims by the ECB, the rotation model will not make it possible for the Governing Council to make monetary decisions efficiently and in a timely manner within an enlarged euro-zone (although exactly this was a central motivation for the ECB proposal). The inflation of the effective ECB Governing Council (i.e. those who vote at a particular time on interest rates) leads to a board that is far too voluminous as compared to any modern central bank and thus hardly efficient. Non-voting governors are accredited to all meetings of the Council and have the right to take part in monetary discussions at any time. Hence consensus decisions, which have been the tradition of the ECB up to now, will be less probable in the future. Even if recommended, changes of, for example, the refi rate will become less frequent. Even more important, the ECB’s own central principles for any reform of the voting system are significantly violated, as argued below.

- The rotation procedure violates the central principle of “one person, one vote” as the latter will only apply to those national central bank governors who are allowed to vote. The principle is violated in two ways. First, the countries are weighted, and second,
the rotation takes place with different frequencies for each group. Thus, the reform proposal does not meet the rationale of an integrative monetary policy. The renunciation of this tenet at best foments national thinking. In other words, it re-nationalises European monetary policy. Moreover, the rotation model leads to an unequal treatment of large and small countries from an inter-temporal perspective. On the one hand, the representatives of small and medium-sized countries could easily outvote both the representatives of the large countries with their dominant economic weight and the Executive Board. On the other hand, the third group with the lowest number of votes will only consist of acceding countries. Hence, both large and small countries in fact argued that the principle of representativeness, i.e. that the NCB Governors with a right to vote have to be from member states which, taken together, are representative of the euro economy as a whole, is violated by the ECB proposal. Ironically, the resulting critique from both sides finally led Wim Duisenberg to conclude that the rotation model is the best reform under the given jurisdictional constraints.1

• Also, the principle of a personal and independent participation in the Governing Council, the “ad personam participation”, is impeded. Safeguarding this principle, which was eminently successful in the case of the German “Landeszentralbanken” was the main motivation for and legitimation of the principle “one person, one vote”. In this bloated Council, each governor will experience that it is mainly his national provenance which will play a role in the monetary decision-making and not his personality as a monetary policy expert. This experience will most probably induce him to decide more from a national perspective. This incentive will finally challenge the independence of the decision-making process in day-to-day operations within the ECB. Hence, a rational monetary policy in line with the stability goal becomes vastly complicated.

• The important precept of protecting the constancy and transparency of the Council’s decision-making is not supported adequately by the ECB model. Of course, the rotation proposal apparently enables an automatic adjustment to the process of euro area extension. However, the same is valid in the status quo ante. As the model is rather complicated and therefore not transparent, the decision-making process will become less comprehensible to the public. Also, mutual control is hampered. All this diminishes the people’s confidence in the ECB and its policy and therefore makes a continuous and time-consistent policy aiming at price stability more difficult.

• Moreover, in the scenario of 27 euro member countries, 12 NCB Governors will no longer have a right

to vote at any point in time. Hence, the principle of accountability which demands that all central bank governors are included in the interest rate decisions is clearly violated. Under the rotation model, it might be difficult to make all governors accountable for all interest rate decisions.

Moreover, the rotation model contradicts the principle of consistency and clarity as it contains arbitrary elements. For example, a small country like Luxembourg will dispose of a similar number of voting rights to Finland and Poland due to its large share in the euro zone’s balance sheets of MFIs. However, this does not seem to be justified since Luxembourg’s high rank is the result of a spurious correlation. Its banks mainly attract “parked” money from EU institutions. Hence, Luxembourg is certainly not comparable to the New York district as a real financial centre in the US Fed system. Why not substitute the financial market indicator by a population indicator measuring the potential of convergence? Likewise, it is not explained how often the voting rights are to rotate. It is up to the ECB’s monetary politicians themselves to decide on the rotation rhythm. At present there is no clear strategy on this issue. Most governors of large countries prefer short phases (three to six months) while others favour yearly changes in the voting groups.

Delegation and Centralisation as the Alternative

The best alternative one can think of to the ECB’s proposal is based on a new definition of the division of labour between the Executive Board and the Governing Council. According to this scenario, the Executive Board has to be developed into an independent Council. According to this scenario, the Executive Board’s work. In this case, the representation of all member countries in this body would provide the Governing Council with a sufficient legitimisation for this alternative. Again, the number of members within the Council could keep on growing with new countries joining – like under the status quo. The advantages of this alternative lie above all in a much more efficient voting process and the prevention of the breaching of the above-mentioned five principles as the personal configuration of the Governing Council would not change. It takes into account the important insight that competence and not nationality should be the key qualification for deciding about European monetary policy. Furthermore, this model is oriented towards the objective comparative advantages of the national central banks’ governors on the one hand and the Executive Board members on the other. The latter put the emphasis of their work on the formulation of monetary policy’s orientation toward European aggregates and focus on the development of the euro financial markets. The NCBs’ governors contribute country-specific knowledge on the development of goods and services markets. In addition, they supervise the national banking system and participate in economic debates.

This two-stage system is capable of mitigating conflictive interests and of maintaining the monetary competence of the ECB. Strictly speaking, a change in the ECB’s statute in line with this proposal would not be necessary as the ECB Governing Council could easily delegate competences to the Executive Board according to Art. 12.1 ESCB Statute. It seems as if this proposal is the only type of delegation/centralisation proposal which potentially is of more than purely academic interest. All other proposals which imply changes of the ESCB Statute not covered by the Nice Treaty are currently not feasible in the political sphere.

However, from a politico-economic perspective it seems fair to concede that, within the institution responsible for the reform proposal, the ECB Governing Council, the acceptance of this model is not very realistic because the governors would of course not be able to cope with the associated loss of importance. This view is corroborated by a quote from a German newspaper which – in spite of its irony – is quite representative for the public reception of the ECB proposal: “For some of them, even the idea of no longer travelling once a fortnight to the meetings in Frankfurt would be intolerable”. Furthermore, it is not even certain that members of the Executive Board do not take the


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regional economic situation in their home country into account. The contrary has been shown for the Fed. Moreover, even this concept of centralisation is not immune to criticism; it must be admitted that it does not solve the legitimisation problems. In cases of strategic decisions (namely those that affect the Governing Council as a whole) the bigger member countries would represent a smaller share of the total number of euro member countries and could again easily be overruled by the smaller ones. Under the very plausible assumption that this would not be accepted by the bigger members for long, a real breaking test for the ECB and the economic and monetary union would not be far away. Perhaps this proposal would even lead to a complete loss of power for the ECB Governing Council as the model does not foresee a penalty if the Executive Board does not stick to the Governing Council’s guidelines. Finally, all reform options of the delegation type have the inherent tendency to lead to labour-shedding by the oversized national central banks due to their loss of importance. Since the number of employees in euro-zone national banks following the enlargement of the euro-zone will be three times as high as that of the Fed system, this is almost certainly a realistic scenario.

Hence, seen on the whole it seems as if the “first best” is not feasible for politico-economic reasons. Why then not dispense with such a complicated reform proposal which was intended to lower the discrepancy between the political and economic weights of the member countries, but enhances the voting share of Germany by no more than one percentage point compared to the status quo, i.e. why not leave the decision rules unchanged? The suspicious haste in pushing through the proposal and the choice of an economically unjustified financial market indicator represented clear evidence not only in the eyes of Finland, the Netherlands and the CEECs in favour of the hypothesis that the reform was directed at unduly benefiting the large member countries. Instead, the preferable solution would have been to stick to the status quo as a “second best”. In this case, the open power struggle between the EU, represented for instance by the European Parliament, and the group consisting of the Heads of State of the EU member countries and the representatives of the national central banks could have been avoided. Instead, it now seems to be a not unrealistic scenario that due to the initiative of, for example, the European Parliament, Pandora’s box will be opened within the highly politicised European convention and some indispensable foundations of European monetary policy like the primary focus of the ECB on price stability will come under scrutiny and will possibly be modified.

Daniel Gros*

An Opportunity Missed!

It is widely accepted that enlargement requires reform of the highest decision-making bodies of the ECB. Especially, there are concerns that the Governing Council will grow too large to work efficiently. Without a reform it could end up having over 30 members – more like 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 “balance of power” 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. However, the proposed rotation in groups is worse than the status quo. It is inefficient, opaque, internally inconsistent and arbitrary. But 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

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is about to draft a new Treaty, a Constitution for the EU, there is still hope that alternatives can be considered.

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 on how to change one paragraph in its statutes. This seems to have set in motion an acrimonious discussion within the Eurosystem, about which very little is known outside central banking circles. At the very last minute, i.e. in late 2002, the ECB came up with a proposal which had been elaborated in strict secrecy.

The essence (for details see other contributions in this Forum) of the official proposal is to divide all euro-area member countries into three groups measured by economic size, which, in turn, is measured 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 practice 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 %).

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 requires a change in the composition of the decision-making organs of the ECB was that it is widely assumed that enlargement will increase the discrepancies between 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 “n” 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 eco-

<table>
<thead>
<tr>
<th>Distribution of Countries into Groups</th>
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<tr>
<td>Euro-28 (BG, RO and TUR)</td>
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<tr>
<td>Germany</td>
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<tr>
<td>United Kingdom</td>
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<tr>
<td>France</td>
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<td>Italy</td>
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<td>Spain</td>
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<td>The Netherlands</td>
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<td>Turkey</td>
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<td>Latvia</td>
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<td>Malta</td>
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</table>

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>
<thead>
<tr>
<th>Table 2</th>
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<tbody>
<tr>
<td>Mismatch between Economic and Political Weights</td>
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<tr>
<td>---------------------------------------</td>
</tr>
<tr>
<td>Three alternative economic weights:</td>
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<tr>
<td>GDP</td>
</tr>
<tr>
<td>Euro-12</td>
</tr>
<tr>
<td>Euro-15</td>
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<tr>
<td>Euro-25</td>
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<tr>
<td>Euro-27</td>
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<tr>
<td>Euro-25-UK</td>
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</tbody>
</table>

Source: Own calculations. 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).
nomic 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.1

A Critique of the Official Proposal

The ECB’s proposal seems to combine the worst aspects of all approaches that might be considered.

• It gives up the principle of equality of member states,2 thus potentially undermining the idea that all members of the Governing Council should forget the particular interests of their home country and act only in the interest of the entire euro area.

• 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.

• Moreover, all members of the Governing Council (with or 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.

• It is not even fully specified: 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, every year? In 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?

• It is internally inconsistent:3 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.

• Because this internal inconsistency needed 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.

• It is not transparent because it is too complicated.

• It has arbitrary elements: the weight given to the indicator of the size of financial markets (1 sixth) is not motivated in any way and seems designed to ensure a better position for 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 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 financial markets indicator? Why were the shares in the ECB not chosen as the measure of size?

• It does not consider an even larger membership although 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 the group of 5 large countries 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 national parliaments should be urged not to ratify the ECB proposal.

An Alternative

The problem of the size of the Governing Council of the ECB is real. How should it be solved? The approach proposed here4 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 the Executive Board and the Governing Council. 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 euro-zone economy and monitor the work of the Executive Board. These tasks can be performed effi-

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1 See the Annex 3 to Daniel Gros et al.: Fiscal and Monetary Policy for a Low-Speed Europe, 4th Annual Report of the CEPS Macroeconomic Policy Group, Brussels 2002, CEPS, for further details and additional calculations that take into account the Executive Board.
2 Although it asserts the opposite in its motivation.
3 The motivation 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%.
4 See Daniel Gros et al., op. cit.
ciently even by a rather large body and the representa-
tion of all member countries in the Governing Council
provides the appropriate legitimacy for such a control-
ling function. The Executive Board should 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 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 Board that is “objective”, i.e. their re-
spective information bases. Board members concen-
trate 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, they are influ-
ential participants in national debates about almost all
economic policy issues, etc. By contrast the members
of the Board can concentrate almost exclusively on
issues related to the formulation of the common mon-
etary 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 eco-
nomic 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 serv-
ces 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 un-
less 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 out-
put 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 ever longer time horizon.

The different comparative advantages of NCB pres-
idents 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 Govern-
ing 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 back-
ground: as argued above, local information is essential
to fully understand the economic situation even at the

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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 a more profound impact on the economy.

During normal times the general public is unlikely to 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 restrictive to achieve price stability? These are the issues that concern the general public rather than the question of whether the appropriate neutral stance implies an interest rate half a percentage point higher, or whether rates should be cut in a month 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 rotation 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 by the ECB could then quickly be perceived as illegitimate because the ECB “does not even know what our problems are”. An asymmetric rotation 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 USA 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 into different categories. The importance of a financial centre is not determined by the size of balance sheets but by the complexity of the 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.

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 counterbalance the cost arising from 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 go against 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) thus ensuring an important gain in efficiency.

This contribution has also presented an alternative to the ECB proposal, but the main point is not that this particular alternative proposal (to maintain the
composition of the Governing Council but restrict the large Governing Council to determining the guidelines for monetary policy and leave their execution to the 6-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.

Ellen E. Meade*

A (Critical) Appraisal of the ECB’s Voting Reform

In March 2003, the European Council approved an amendment to the voting procedures of the Governing Council that was formally proposed by the European Central Bank (ECB) in February. It has long been acknowledged that a revision to the Governing Council’s voting procedures would be necessary in order to streamline the central bank’s decision-making process in the context of the widening of the euro area to the east. With a prospective size of the euro area of 25 countries,1 decisions of the ECB Governing Council would depend on a vote of 31 officials (six members of the Executive Board and 25 heads of national central banks) in an unrevised system. The Treaty of Nice provided for an amendment to Article 10.2 of the Maastricht Treaty’s Statute of the European System of Central Banks and of the European Central Bank – the provision that specifies the “one man, one vote” procedure currently used. Because the Nice decision focuses on Article 10.2, it does not permit a change to the size of the Executive Board or an alteration of the responsibilities of the Executive Board relative to those of the Governing Council.

The ECB amendment, which has been approved by the Council but awaits ratification by the member states, does not provide an adequate long-term solution for the voting problem. The reasons for this are as follows and are discussed in sequence in this article:

• First, despite the reform, decision-making procedures will become more unwieldy and inefficient with each new addition to the euro area.

• Second, the reform is unnecessarily complex, not fully specified, and unlikely to be transparent even when all the details are enumerated.

• Third, the new voting procedure gives some weight to financial size when sorting countries into groups – a laudable approach, except that the financial variable used is not the appropriate one.

In light of these reasons, it seems likely that the new voting scheme will be operative only for some interim period. A simpler alternative is available and appears to have wide support.

Efficiency

One of the main reasons – if not the main reason – for reform of the Governing Council’s voting structure owes to concern over the efficiency of monetary policy decision-making in an enlarged euro area. In its recommendation, the ECB (p. 2) pointed to the need to “maintain the Governing Council’s capacity for efficient and timely decision-making,” suggesting that efficiency can be measured in two ways. Having too large an official body risks that meetings will be unnecessarily long and that policy will not respond actively enough to the economic situation at hand.

The reform proposal caps the number of voters at 21, about one-third smaller than an unreformed 31-member Governing Council in a euro area of 25 members. The reform maintains the number of Executive Board voters at six, and limits votes cast by national central bank (NCB) heads to 15. NCB voters are determined by sorting countries into three groups (based on a weighting scheme that is discussed below) and rotating a pre-specified number of votes within each group.

Thus, 31 policy officials (21 with voting rights) will attend meetings of the ECB’s Governing Council. The mere thought of the tour-de-table is exhausting! Among 18 central banks surveyed by Wyplosz,2

1 The current 12 countries, plus Denmark, Sweden, the United Kingdom, and ten accession countries in eastern Europe (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic and Slovenia).


* Senior Research Fellow, Centre for Economic Performance, London School of Economics, UK.

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the Fed’s FOMC is the largest decision-making body with 12 voters. Nineteen policy officials participate in the discussion of economic conditions and policy alternatives when the FOMC meets eight times per year.\footnote{The Fed uses a rotation system to allocate votes so that only 12 of the 19 officials have voting rights at any given meeting.} Needless to say, participation by 31 officials at bi-monthly meetings of the Governing Council hardly seems streamlined by comparison.

It is difficult to know how the size of the official body affects the timeliness of policy action, but it seems certain that, at least for very large bodies, an inverse relationship is the case. In a series of monetary policy experiments, however, Blinder and Morgan\footnote{Alan S. Blinder, John Morgan: Are Two Heads Better than One?: An Experimental Analysis of Group vs. Individual Decisionmaking, Working Paper No. 7909, 2000, NBER.} found that committees of five voters do not require more information when enacting policy than does an individual decision-maker. While this finding is both interesting and surprising, it seems unlikely that their result would hold were the size of the voting committee in the experiments expanded to 21.

The ECB has indicated that “transparency” is one of the “five fundamental principles” that has guided the design of its voting reform. Upon reading the proposal, it is clear that the rotation of votes within the three country groupings is complex, perhaps even intricate – suffice it to say that “transparent” it is not.

Countries in the euro area will be assigned to one of three groups based upon a measure of size, and votes will rotate across countries within the three groups according to some as-yet-unspecified system. Over time, the groups may be adjusted to take account of changes in relative size among countries. The voting rights will rotate within each group such that officials will vote with equal frequency, but the proposal leaves open the possibility that the rules for rotation may differ across groups.

Any voting system based on a weighting that will be periodically updated (such as the measure of size in the ECB case) is by definition going to be less transparent than one in which the weighting is fixed. In the case of the Fed, for example, four seats on the FOMC have rotated among eleven Federal Reserve districts since 1943. Four groups of Federal Reserve districts share a vote that rotates annually according to a 1942 amendment to the Federal Reserve Act.\footnote{One voting seat is rotated among: Cleveland and Chicago; Atlanta, Dallas, and St. Louis; Boston, Philadelphia, and Richmond; Kansas City, Minneapolis, and San Francisco.} The rotation system is highly transparent and predictable, and it is so precisely because the rotation does not evolve over time.

It is hard to see how the ECB can reconcile the need to update the weights periodically with the desire for simplicity and transparency. At the core, these objectives are in conflict.

The Weighting Scheme

The Maastricht Treaty established voting rights on the basis of the individual without regard to country importance: Article 10.2 of the Statute states that “each member of the Governing Council shall have one vote” and that the Council “shall act by simple majority.” NCB presidents were to participate on the Governing Council “in a personal and independent capacity.” Qualified majority voting, the hallmark of European decision-making, was not to be part of the central bank.

The voting reform sorts countries into groups based on their shares in area-wide nominal GDP (with a weight of 5/6) and in the total aggregated balance sheet of monetary financial institutions (with a weight of 1/6). The first group will contain the five largest countries and have four votes. In a euro area of 25 members, the second group would contain the next largest 13 countries and have eight votes. The final group would consist of the remaining seven countries and cast three votes. Thus, countries in the first group will register a vote at 80 percent of the meetings, compared with 62 percent for the second group and 43 percent for the third group.

This system produces an unabashedly nation-based sorting scheme, which will tend to encourage – rather than reduce – any pressure on officials to vote in the interests of their countries. In the four years since the introduction of the euro, have Governing Council meetings been so filled with nationally biased NCB governors that this reform is an attempt to better align their vote with their size? One can only wonder.

Still, the choice of weights leaves many questions unanswered. Some commentators – notably the European Commission – have asked why country rankings are not computed using 50-50 shares in GDP and population, the weights used in the Maastricht Treaty to determine country contributions to subscribed capital of the ECB. The data in Table 1 suggest that this
weighting would rank Belgium and Poland the same, in a tie for seventh place. Moreover, a 50-50 weighting of GDP and population would put the Slovak Republic in the second group (with a ranking of 18) and Luxembourg in the third (with a ranking of 22).

If the intention behind the second component in the ECB's weighting scheme is to capture the importance of the financial sector, then the variable used to measure this is the wrong one. Given a central bank's responsibility for financial stability, it is easy to argue that a representative weighting should look at the overall financial sector. In fact, an attempt to align Governing Council votes with the economic and financial sector. In fact, an attempt to align Governing Council votes with the economic and financial importance of countries in the euro area would be an enlightened approach.

However, the variable used to measure the financial sector (TABS-MFI) is akin to banking assets, and bears only a limited relationship to the breadth, depth, and scope of overall capital markets. This variable will give too much weight to a country with a large banking sector relative to one with highly diversified financial markets. One could imagine, for instance, that an appropriately structured measure would rank the United Kingdom first in light of the breadth, size, and importance of its financial markets. However, as shown in my table, the United Kingdom is the fifth largest country among the 25 when evaluated in terms of bank assets as a share of GDP. Has this component been included, as some have suggested, only for the purpose of boosting Luxembourg into the second group? The ECB proposal offers us no answer whatsoever to this question.

**Merely an Interim Solution?**

The ECB's reform creates more problems than it solves. It might best be regarded as an interim solution, one that reveals the complexities involved in setting monetary policy for a large and diverse euro area. A number of commentators – including importantly the European Commission and the European Parliament in their official opinions of the reform proposal – have called for a re-structuring of the decision-making bodies of the ECB. The Executive Board would be turned into a monetary policy committee and its membership would be increased (from six to perhaps nine or a few more); it would be a "small, efficient decision-making body" similar in size to policy committees of other central banks. Importantly, this enlarged Executive Board would set short-term interest rates for the euro area. The Governing Council would have authority over broader issues, such as the monetary policy strategy and instruments, and so would continue to play a key role in overall policy. Such a reform is broader than what the Nice Treaty permits and, as such, would require an intergovernmental conference to negotiate the requisite changes.

In the European context, an enlarged Executive Board with sole authority over the day-to-day setting of interest rates would likely reduce (perhaps greatly) any pressures for national bias. Interestingly, in the United States, such a reform might yield concerns of exactly the opposite! This is because the officials at the Fed's center are political appointments of the US President and, rightly or wrongly, have at times been thought to share a political party perspective on monetary policy. For the ECB, however, appointments to the Executive Board are seen as technical experts with the backing and perspective of the European Community as a whole.

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**FORUM**

**Table 1**

<table>
<thead>
<tr>
<th>Nominal GDP</th>
<th>Population</th>
<th>%GDP +½Bank Assets (% of GDP)</th>
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</tr>
<tr>
<td>UK</td>
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