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ECB Decision-making and the Status of the Eurogroup in an Enlarged EMU

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Abstract

This paper analyses the link between forthcoming EU enlargement and selected aspects of EU institutional reforms, namely decision making rules in the European Central Bank and the status of the Eurogroup. It argues that some earlier arguments calling for urgent ECB reform are based on unrealistic assumptions. It concludes that the reform recently adopted by the EU Council as well as the present system, while not free from shortcomings, could provide a workable environment for monetary policy in an enlarged EMU. Additionally, the paper claims that designing efficient institutional solutions for the EU Council is also important from the perspective of new member states as it might impact o their chances for early adoption of the common currency.

1. Introduction[1]

The upcoming 2004 wave of European Union enlargement and prospects of accession countries adopting the common currency in the following years have motivated the EU to undertake several important changes in its institutional design. The primary difficulty in adopting such reforms owes to the conflicting objectives of promoting greater efficiency in decision making at the EU level and securing the rights of sovereign Member States to decide themselves on matters they consider important. The dilemmas faced on the occasion of current enlargement of the Union are arguably greater than was the case in the past due to very large number of new entrants, their different characteristics compared to the current EU member states and the much higher level of political and economic integration that was achieved in the Union during the decade of the 1990s.

In particular, the enlargement of the EMU is often seen as a major challenge for the European Central Bank (ECB) deciding on common monetary policy in the euro-zone. The future of economic policy co-ordination and in particular of fiscal policies might also be affected. This is the starting point of analysis in this paper. The main claim is that the arguments calling for ECB reform tend to overestimate the potential negative impact of enlargement. Among proposed reform options there is little firm evidence clearly supporting one over the other, but several options appear reasonable. The change recently adopted by the EU Council, while not free from shortcomings should nevertheless provide a reasonable environment for efficient monetary policy making in the enlarged EMU. Secondly, the paper argues that the outcome of the current hot discussion on the future decision making procedures in the EU Council (Nice Treaty solution vs. the one proposed by the Convention) and the legal status of the Eurogroup might prove important in shaping the attitude of current EMU member states towards enlargement. Under the pessimistic scenario, incumbents might be willing to delay the process of enlargement to ensure efficient functioning of preferred co-operation mechanisms. The two main sections of the paper deal with the decision making mechanisms in the ECB and with the status of the Eurogroup.

2. Deciding on EMU monetary policy after enlargement

This section summarises the discussion on the need (or lack thereof) for a reform of decision making processes within the ECB after the Union enlarges from current 12 to above 20, 25 or more member states. As stipulated by Article 107 of the EC Treaty, the European System of the Central Banks (ESCB) is governed by the decision making bodies of the ECB, i.e. the Governing Council and the Executive Board. The Executive Board comprises six members (President, Vice-President and four regular members). As stated in Article 112 of the EC Treaty all Board members 'shall be

[1] I am thankful to Jacek Rostowski and Marek Dąbrowski for comments and remarks to the earlier draft of this paper. All remaining errors are my own.

appointed from among persons of recognised standing and professional experience in monetary or banking matters by common accord of the governments of the Member States at the level of Heads of State or Government, on a recommendation from the Council, after it has consulted the European Parliament and the Governing Council of the ECB'[2]. The Governing Council comprises members of the Executive Board and governors of the central banks of EMU member states. All members of the Governing Council have one vote and in most cases decisions are taken using the simple majority principle. In the event of a tie the President has the casting vote. In particular, interest rates decisions are taken using this principle.

As in the case of other EU institutions, enlargement of the Union was generally viewed as demanding a reshaping of decision making rules in the ECB. However, no consensus was reached during the Intergovernmental Conference leading to the Nice Treaty, which only stated that a change in ECB voting modalities was likely to take place and called for the ECB or the Commission to propose a reform 'as soon as possible'.

Two major arguments for reform are put forward in the context of enlargement. First, it is argued that the expected EMU enlargement will significantly increase the share of small fast growing economies in the union. It is further feared that the preferences of many Governing Council members might be affected by conditions in their home countries. If this was the case, the views of representatives of smaller catching-up economies might prevail in the Council and thus monetary policy might fail to reflect the needs of the biggest EMU economies (the 'core') and thus of the EMU as a whole. Second, it is claimed that the sheer size of the body deciding on monetary policy (the Governing Council) will become too large to secure efficient and meaningful discussion of economic development in the EMU and as a result the ability for able managing of the union's monetary policy might be affected. Indeed, within the 5-7 years horizon the EMU might well comprise 25 or so member states, which would bring the number of people in the Governing Council to above 30.

2.1 Evaluation of the small countries' bias argument

After enlargement the number of small economies in the union will increase significantly. Also macroeconomic diversity within the EMU will widen, with most of the acceding small countries expected to exhibit higher average growth rates than the EMU core economies and also higher average inflation rates. There is a distinct question on the expected sources of the inflation differentials and how they should be tackled by the ECB. Such issues are discussed in more detail by e.g. Honohan and Lane (2003) and ECB (2003). Here we only observe that such differences might under some circumstance turn out important in the decision making process, providing that GC members put more weight on the needs of the countries they come from than would be

[2] The term 'Member States' applies here only to countries that adopted the common currency. Only representatives of these governments appoint the Executive Board members (cf. EC Treaty, Article 122 (4)). While at present unanimity is required for appointment decisions, the Commission has recently suggested that the Intergovernmental Conference should introduce qualified majority voting in this instance (cf. Commission, 2003).

justified by their respective country's economic weight in the union. Such a phenomenon is referred to as a 'regional bias hypothesis'. The Article 108 of the EC Treaty demands that GC members act independently in fulfilling their duties. Baldwin et al. (2001) comment: '*A Panglossian observer would be satisfied with this; a Machiavellian observer would laugh. The truth is probably somewhere in between*'[3].

Since the discussion and voting results within the GC are kept secret, there is no direct way to test the regional bias hypothesis. A narrative approach, looking at the interests of which countries were best secured during the initial period of the EMU functioning, while subject to strong methodological critique, does not in any case provide decisive results (cf. Baldwin et al. (2001)). The US Fed represents an interesting object of study of voting behaviour of regional representatives. Most of the studies (see Meade and Sheets (2002) for a survey) found mixed and not very robust results. In a recent work Meade and Sheets (2002) illustrate a relationship between regional unemployment rates and attitudes to interest rate decisions by the FOMC members coming from respective regions. Regional influences are found among both regional Fed Presidents and Board members and turn out to be actually stronger among this latter group. It is interesting to note that this finding raises doubts about the popular view that Frankfurt-based ECB Executive Board members will tend to care about EMU-wide developments while national central bank governors may take a nationalistic perspective. Such an assumption underpins all the scenarios for hypothetical coalition formation in the GC presented by Baldwin et al (2001) or Eichengreen and Ghironi (2001).

There is little doubt that EMU enlargement to Central and East European countries will significantly increase the economic heterogeneity of the union. Nevertheless the conclusion that this poses risks to Governing Council voting outcomes if central bank governors exhibit regional biases is not straightforward. Below we analyse the historical inflation patterns among members of the euro-zone of today and future members. The main emerging finding is that while enlargement of the euro-zone is indeed likely to widen the inflation dispersion among member states, the median inflation is only affected to a limited extent. Moreover, once we assume six Executive Board members to guide their decisions solely on EMU-wide inflation developments, the outcome of majority voting appears to mimic very well the outcome of decisions based on EMU-average inflation only, *even* if we allow central bank governors to exhibit regional biases. While past inflation experience might not provide good predictions for future developments after new countries join the monetary union, this exercise at least raises some doubts with regard to alarmist views on the impact of regional biases.

[3] Also, the Treaties do not explicitly demand that central bank governors of member states take into account union-wide developments and not developments in their home economies. Governors are only banned from seeking advice or taking orders from EU or national bodies.

2.1.1 Modelling ECB Governing Council decision making in an EMU of 25.

Let us concentrate on the worst-case scenario, giving rise to the most alarmist calls for reform. We assume that members of the Governing Council are motivated by local conditions in their home economies and ask what difference this makes to monetary policy in the EMU.

Baldwin et al (2001) in their strong criticism on the one-man one-vote rule at the ECB Governing Council base some of their arguments on a model assuming that interest rates preferred by the country representatives (central bank governors) are uniformly distributed on the interval of possible interest rates (that is normalised to unity). More precisely, each central bank governor can derive the optimal (from the perspective of her home country) interest rate at any point in time but its future evolution is uncertain and equally likely to end up anywhere on the (0,1) interval[4]. It follows that, for any point in time, the expected ideal euro-area interest rate is 0.5. Authors then proceed to study the effects of shocks shifting the euro-area preferred rate and check the probability of the majority of voters being against adjusting the rates to the new optimum or only willing to accept a smallish adjustment. The reasoning is as follows. The Executive Board, taking the truly EMU-wide perspective is assumed to be controlling the agenda and making take-it-or-leave-it interest rate offers that are then decided by majority voting. The EB is assumed to foresee the preferences of central bank governors and thus to make interest rates offers that are (1) able to gain majority support and (2) as close to the EMU-wide optimum as possible. What turns out is that under their specific assumptions, Baldwin et al. (2001) find that whereas in the EMU12 the probability of finding the GC majority supporting the interest rate adjustment to the new optimum is very high, it decreases significantly in the EMU27. In the large union the most likely outcome is only a partial interest rate adjustment. Authors refer to this problem a 'status quo bias'. Below we take a closer look at this hypothesis.

We consider a one stage game in which the distribution of national inflation rates is given and the question is what interest rates will be decided by the majority voting rule. We make the following simplifying, though arguably not unrealistic assumptions:

a) the only parameter that ECB Executive Board members take into account to form their private preferences about monetary policy is the inflation rate in the euro-zone
b) the only parameter that central bank governors take into account to form their private preferences about monetary policy is the inflation rate in their home economy
c) the only monetary policy tool that the ECB collectively decides is the interest rate
d) there is a monotonic relationship between observed inflation rates and preferred interest rates

[4] This implies that there are no structural differences between 'core' and 'fast growing' countries – both groups are assumed to be equally likely to prefer high or low interest rates. Also, such an assumption neglects the spillover effects between countries – the evolution of optimal interest rate levels in each country is independent from developments in other EMU economies.

e) each member of the GC has its unique preferred interest rate level (bliss point) R*, and for any choice of two alternative interest rate levels either below or above R* he prefers the one closer to R*.

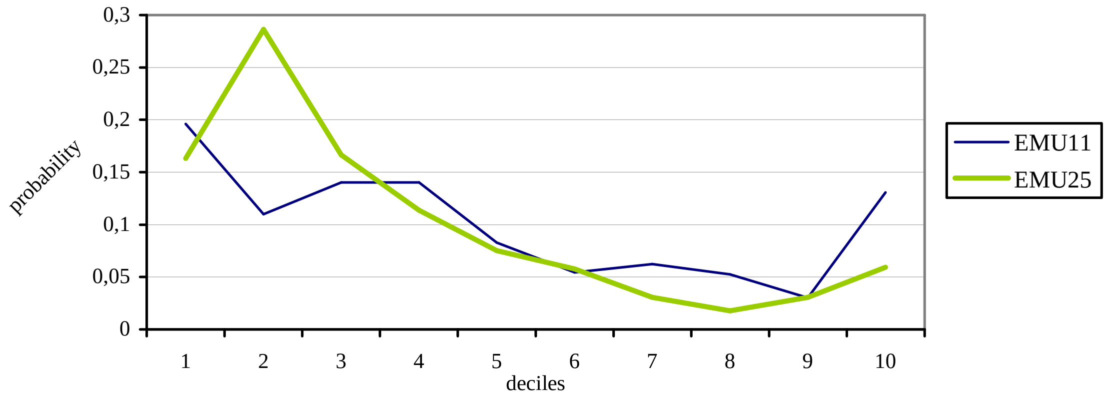
Assumption (e) is the so called single-peakedness assumption (Black, 1958; for an exposition see e.g. Myerson, 1996). It ensures that a version of the median voter theorem holds. Specifically, under such conditions, if the number of voters is odd, the median voter's bliss point is a Condorcet winner. This means that under normal conditions (i.e. excluding limitations to the voting agenda and manipulation of the agenda), the Governing Council would adopt the interest rate which is equal to the one preferred by the median voter.

In order to get more insights from this very simple result one needs to have some idea on the distribution of interest rates preferences among members of the Governing Council. In the discussed model this largely boils down to a question of the distribution of inflation rates in the monetary union.

Given that preferred interest rates are unobserved we concentrate on inflation rates that are arguably the main factor determining assessment of favoured interest rates. Below we present some descriptive statistics describing the evolution of inflation in the EMU11 and hypothetical EMU25 (comprising 25 countries that will form the EU after May 2004) during the period 1998-2002.

Firstly we analyse the distribution of inflation rates between countries. Using monthly data we construct the intervals [minimum annual inflation rate, maximum annual inflation rate], normalise them to unity and calculate the number of countries in each decile. Averaging over time we can plot an approximation of the implied density function of inflation dispersion.

Graph 1. Implied 'density functions' of inflation rates distribution in the EMU11 and EMU25

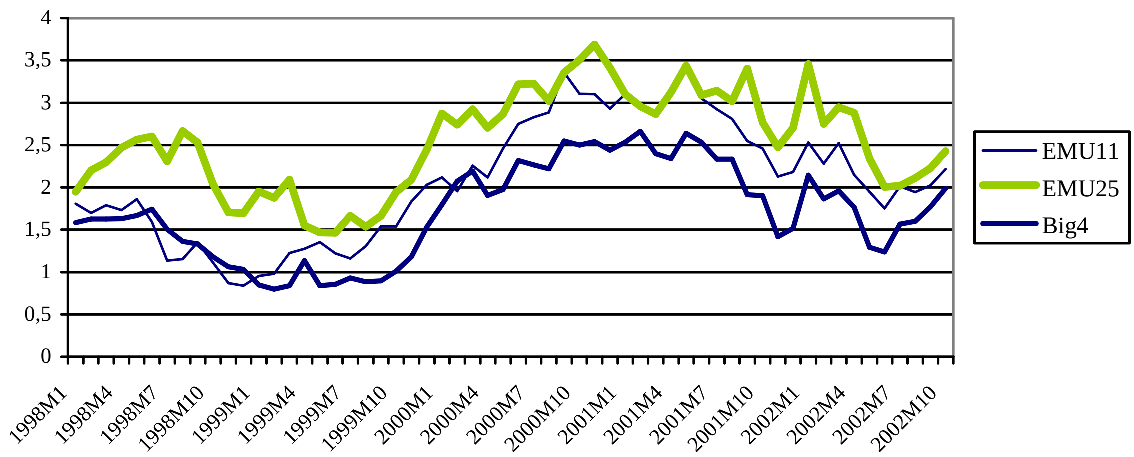


Note: Due to data availability January 1998-October 2002 period was used for calculating EMU11 histograms and January 2000-January 2002 period was used for EMU25. See main text for more explanations.
Source: Own calculations based on IMF, International Financial Statistics CPI data.

Graph 1 reveals that the distribution is heavily biased to the left. More specifically, inflation rates in above 50% of countries in the analysed period were in the three (EMU25 during 2000-2001) or maximum four (EMU11 during 1998-2002) lowest deciles of the distribution. The distribution of inflation rates among 25 countries turns out very similar to the distribution for 11 countries that initially adopted the euro in 1999. If anything, there appears to be even stronger concentration in the lowest deciles in a larger set of countries. These patterns have remained broadly unchanged over time. Calculating implied inflation dispersion densities in EMU11 separately for each year between 1998-2002 one finds that over 50% of all countries had inflation rates in the lowest three deciles during two years (2000 and 2002), in the lowest four deciles in a further two years (1998 and 2001) and only in 1999 did they have inflation rates in the lowest five deciles. The general picture is thus one of a majority of countries recording low inflation figures and several outliers with significantly higher inflation figures.

Another interesting insight is provided by comparing median inflation rates in EMU11, EMU25 and the median of the four largest economies of the hypothetical EMU25, i.e. Germany, UK, France and Italy (Graph 2). The EMU25 median remained above EMU11 median throughout most of the period, although the difference rarely exceeded 0.5 percentage points (apart from 1998). Also, the EMU11 median remained slightly above Big4 median throughout most of the period.

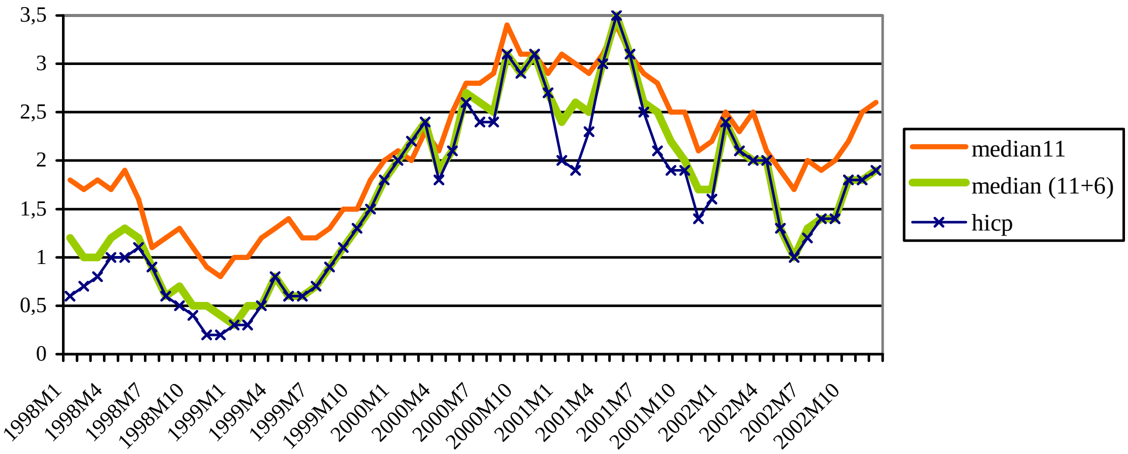
Graph 2. Median inflation rates in EMU11, EMU25 and in four largest EMU25 economies, January 1998- October 2002 (% points)



Notes: Big4 group includes Germany, UK, France and Italy.
From mid-1999 HICP dynamics (not shown) was relatively close to median Big4 dynamics.
Source: Own calculations based on IMF, International Financial Statistics CPI data.

An interesting question is whether the presence of six Executive Board members might make the difference to the outcome of voting in the GC. We maintain our assumption that central bank governors only look at domestic inflation rates and Executive Board members look at the HICP for the EMU as a whole. Graph 3 plots the results of an exercise in which median inflation value is calculated in the set of 17 'entities', consisting of 11 EMU countries and 6 'euro-zones' (with inflation rates set at HICP value). An analogous exercise is carried for EMU25, where in the absence of officially calculated historical inflation series a GDP weighted average is taken as an approximation of the EMU-wide HICP (see Graph 4).

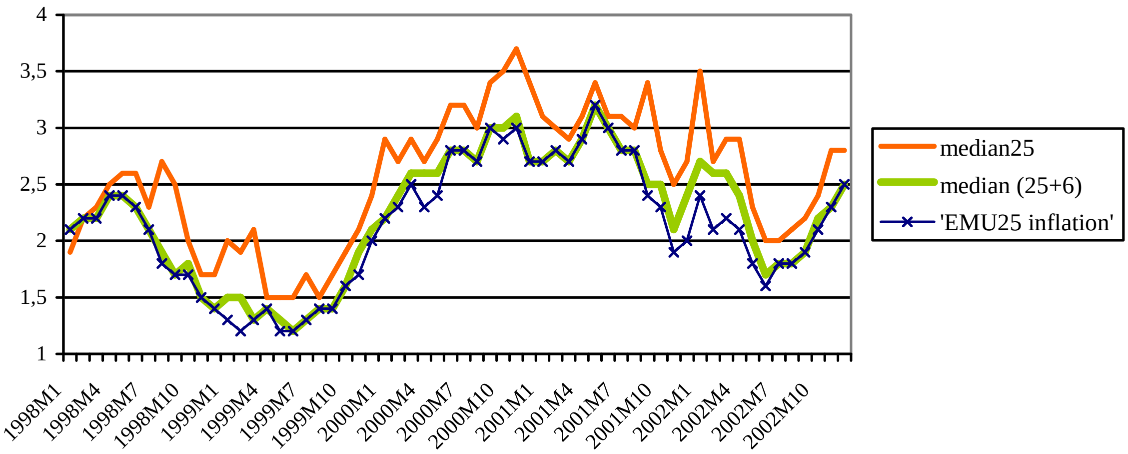
Graph 3. Median inflation rates in EMU11 and EMU(11+6) compared to HICP, January 1998- December 2002 (% points)



Notes: Median for EMU(11+6) is defined as a median value of the set including six time the HICP value and each of 11 national inflation rates.

Source: Own calculations based on IMF, International Financial Statistics CPI data and ECB HICP data.

Graph 4. Median inflation rates in EMU25 and EMU(25+6) compared to simulated EMU25 inflation rate, January 1998- December 2002 (% points)



Notes: Median for EMU(25+6) is defined as a median value of the set including six time the approximated EU25 inflation value and each of 25 national inflation rates.

EMU25 inflation rate is approximated by GDP weighted average inflation rate. Only OECD countries data were taken to the calculations. GDP data are current prices, current exchange rate 2000 data taken from OECD, Main Economic Indicators, October 2003 issue.

Source: Own calculations based on IMF, International Financial Statistics CPI data and ECB HICP data.

An interesting finding is that while in both cases median inflation is on average around 0.5 percentage points above aggregate inflation, the difference almost disappears while the median is calculated in the larger set, including six time respective aggregate inflation rate. While in the case of EMU11 this is not really surprising, the fact that much the same holds true for a much larger monetary union could be viewed as reassuring, as it might indicate that majority voting in the enlarged but unreformed ECB Governing Council could still produce outcomes close to EMU optimum. The pessimistic view of Baldwin et al (2001) is not really supported by this simulation based on real inflation[5].

The ECB Governing Council decides on interest rates rather than on inflation rates. While the link from one to the other is complicated, subject to uncertainty and varies between countries and over time it is likely that the dispersion of national preferred interest rates is smaller than the dispersion of observed national inflation rates. One argument is that a (perhaps substantial) part of differences in inflation rates might reflect natural adjustment processes (e.g. resulting from varying productivity growth rates) and to that extent should not be counteracted by economic policies[6].

Another observation is that due to strong economic linkages between the countries of the current and the future enlarged EMU, national preferred interest rates should incorporate the preferences of other partners in the monetary union. If an important trade partner badly needs lower interest rates this should impact domestic objectives – even if only for purely self-interested reasons. This mechanism should also act towards decreasing the dispersion of preferred interest rates[7].

In conclusion, we have illustrated that observed inflation differentials have not led to a substantial divergence of median inflation rates in EMU11 and EMU25. Six Executive Board members taking care of EMU-aggregate inflation should prevent the hypothetical ‘fast growing, high inflation’ group from gaining the majority in GC, also after EMU enlargement. Factors such as interdependence of preferred interest rates and lower dispersion of interest rates compared to inflation rates should further assure the optimal outcome of monetary policy in the enlarged EMU even if the one-man one-vote rule was to be maintained. The ‘regional bias’ pessimism in versions described by Baldwin et al (2001) and others does not appear to be justified.

2.2 Evaluation of the Governing Council size argument

The ECB Governing Council is already today a rather large. There are 18 members casting votes on interest rates decisions compared to 12 voting members of the US Federal Open Market Committee (FOMC), and between 6 and 10 in monetary policy committees of Sweden, Canada, Australia, UK and Poland. However, prior to German unification the Bundesbank Council also included 18 members (7 Board members and 11 presidents of regional banks). After unification, the reform was implemented amounting to merging some regional banks and slightly reducing the size of the Board to 15 people.

[5] A word of caution is however needed. HICP and GDP weighted inflation average do not closely coincide for the EMU group, with the latter usually remaining slightly above HICP. This means that a correct HICP for EMU25 members would differ from the CPI values used in the exercise, which could have affected the outcome of the exercise. HICP differs conceptually from CPI measures. For a discussion see e.g. Cecchetti and Wynne (2003).

[6] See ECB (2003) and references therein.

[7] Grüner and Kiel (2002) discuss the issue in more detail and derive some theoretical implications.

A further increase in the size of the ECB Governing Council (up to around 30 people) would clearly make it more difficult to carry open discussions on economic developments in the EMU involving all members of the body. The expected increase of the size of the Council was one of the reasons for the Bundesbank reform at the time of unification. One argument raised in this context is that there seems to be a culture of long discussions leading to 'consensus' decision making without using voting in the ECB Governing Council[8]. Clearly, even if decisions are taken without a formal vote it does not indicate that all members agree on a particular decision. Once positions of all members are known, the outcome of a potential vote is established anyway. While the ability of the Governing Council to carry on in-depth discussion would obviously be affected by enlargement, there would be no problems with the decision making procedure itself. Simple majority voting with the threshold set at 50% of all votes assures that there will always be a majority supporting some monetary policy decision.[9]

The problem of the optimal size of the committees deciding on monetary policy has also been studied from the more formal perspective applying the tools of game theory. This literature, while providing some interesting results under specific sets of assumptions does not come out with any clear cut recommendations. The optimal size of the committee can be affected, among other things, by factors such as costs of accessing private information and heterogeneity of objective functions among committee members. An up-to-date survey of relevant literature is provided by Gerling et al (2003).

In summary, the issue of the size of the Governing Council indeed constitutes a potential problem for this body's ability to take swift policy decisions. There is no experience of other central banks with such large decision making bodies. On the other hand, the ECB itself is a unique institution in global economic history. Proposals to limit the size of the GC would be welcome, providing they fulfil other criteria discussed below. Whether the GC of 30 or so people could well organise its work remains uncertain but cannot be ruled out.

There is even less direct evidence concerning the validity of the regional bias hypothesis. Again, any reform proposal truly limiting its potential impact (i.e. not just appearing to do so by merely increasing the size of the Executive Board) would be welcome, but failing to address this issue need not turn out to be damaging. In the end, the general public and market perception functioning of the GC will likely be a decisive factor. The lesson is, therefore, that political chaos surrounding any reform projects should be avoided.[10]

[8] No information is available on the Governing Council discussions and voting. This assertion rests on some public comments made by GC members. For instance, during the ECB press conference on 3 February 2000 Wim Duisenberg said: '*there was no formal vote. Again, as I had hoped and as it was, it was a consensus decision*'.

[9] This stands in contrast to the situation in the Council of Ministers, where the threshold for majority voting is above 50%. We return to this issue while discussing the functioning of ECOFIN.

[10] If the Governing Council is perceived as inefficient in managing the EMU monetary policy and subject to regional biases, the prospects for the union would turn negative irrespective of the actual abilities of the GC. By the same token, even if internal discussions are difficult and some members overemphasise local conditions, but the credibility of the ECB is maintained, it would not necessarily have significant negative impact on the functioning of the union. Recall that no details of internal discussions and voting are revealed to the public.

2.3 Possible solutions

Several solutions were proposed that could solve one or both of the above problems. These mainly reflect the experience of existing arrangements in other institutions facing similar challenges. The major ideas implemented (in various combinations) are rotation, representation (forming constituencies) and executive decisions (delegation to technocrats).

Firstly one can think of systems where the composition of the Governing Council remains unchanged, but the rights to vote on policy decisions are given to a subgroup of GC members at any one time. Voting rights would rotate among GC members according to an agreed schedule. This demands that a number of voting members is decided and a period for which they retain voting rights. The advantage of such an approach is that it can limit the problem related to the number of people at the discussion table. However, this is only possible when non-voting members are excluded from discussions, which in turn would have some negative consequences. For instance members just starting their voting period would not know what was the state of discussion in previous months or years.

Another solution would be to form groups of central bankers with each of the group delegating its representative for voting (and possibly also discussion). Such a system is used in the IMF Board of Directors[11]. Under such arrangement the number of people at the table could be reduced (again, providing that non-voting GC members do not participate in discussions). On the other hand, it would seem natural to treat representatives of groups as standing for interest of their groups rather than being independent experts on EMU monetary policy. It could therefore actually worsen the regional bias problem.

One could combine any of the above systems with a weighting of countries' votes by, say, shares in the ECB capital[12]. This would make ECB decision-making rules similar to the ones in operation in some other EU institutions, in particular the qualified majority voting in the EU Council. Such a solution would have the advantage of making irrelevant the regional bias hypothesis, since even under purely nationalistic behaviour of GC members voting would still on average be close to the EMU-wide optimum[13]. On the negative side, it might strengthen the *perception* of monetary policy decisions as the outcome of a game between national representatives rather than one motivated by the aggregate needs of the euro-zone. It is interesting to note that a weighted voting scheme for the ECB Governing Council was one of the possibilities discussed during the 1990 IGC on monetary union. The proposal from the European Commission advocating such a solution was at that time opposed by the Bundesbank and the German Ministry of Finance, who feared that it

[11] Note, that there are above 180 countries at the IMF so the scale of the 'number problem' is of different nature. Also, for most countries, decisions taken by this body are of much lower relevance in normal economic times than is the case of Governing Council decisions in the European Monetary Union.

[12] ECB capital shares are in turn determined as a sum of half of the share in EMU GDP and half of a share in EMU population (cf. Article 29, Protocol on the Statue of the ESCB and of the ECB).

[13] See Aksoy et al. (2002) for discussion on how does weighed average of countries' optimal policies correspond to EMU optimal policy.

would '*encourag[e] a damaging spirit of compromise amongst national interests*'. (Heisenberg 2003).

Yet another possibility is to delegate running monetary policy to a small monetary policy council consisting of experts, without looking at their nationalities. Such a move would be more radical as it would constitute a departure from the original ESCB architecture put into the EC Treaty. It is however an actually applied solution in a number of countries, such as the UK which is commonly perceived as an example of extremely successful monetary policy making (see Begg et al., 2003). This solution would solve both the 'numbers' and regional bias problems, provided that members of this body could indeed be regarded as fully independent and not influenced by developments in their home countries. The major disadvantage is that it could possibly undermine the accountability of the ECB. The point is that governors of central banks of member states can be perceived as playing the role of national 'listening post' ensuring the ECB is accountable to someone with strong credibility in the home country (Baldwin et al, 2001).

Also, there are some potential gains from having national representatives in the decision making body which would be lost by delegating the policy to a small council of experts. Central bank governors may have better information concerning their economies and better understanding of the policy transmission channels. Indeed, in the US regional board governors sitting in the Open Marker Committee of the Fed are regarded as experts on local developments. In the words of Alan Greenspan: '*As keen observers of local economies, the directors here and elsewhere contribute vitally to the formulation of monetary policy by offering important insights absent, by definition, from even the most careful analysis of aggregate data. Often they know what is happening in the various regions of the country well before the hard data are collected by national statistical agencies*'[14].

Developments at the level of countries are clearly not irrelevant, despite the ECB focus on euro-zone aggregate performance. De Grauwe and Sénégas (2003) find that the uncertainty about the transmission process increases the need to take into account information about national economies (and not only aggregate data) in the formulation of optimal monetary policies in a monetary union. Earlier studies cited there found that asymmetries in the transmission mechanisms (even in the absence of uncertainty) also call for considering national data.

Finally, one might still be sceptical about the possibility of first finding and then selecting in a political process of monetary policy experts able to fully forget about their national attachments. The Meade and Sheets (2002) finding of regional biases among FOMC Board members could be interpreted as giving support to such scepticism. One could note that in a small monetary policy committee a large proportion (or even exclusivity) of members are very likely to come from the large countries. This is for two reasons: (1) what one might call the "Trichet effect", i.e. simple bullying by the governments of the large countries, to make sure that their nationals get selected; (2) a "demographic effect", resulting from the fact that, with talent being distributed democratically,

[14] Alan Greenspan, December 2000. Cited in Meade and Sheets (2002).

council members are likely to come from countries roughly in proportion to their population (or GDP if that is taken to reflect the "human capital" available to train top economists). Thus, this can lead to a monetary policy committee becoming *excessively* dominated by large countries even in the presence of appointment purely by merit.

Table 1. Pros and Cons of various ECB reform options

	Rotation of member states	Representation (forming of constituencies)	Weighted voting	Delegation to a monetary policy council
Solving the 'number problem'	Yes [a]	Yes [a]	No	Yes
Solving the 'small countries' bias'	Yes [c]	Yes [c]	Yes	Yes
Building sense of common European identity	No	No [b]	No	Yes [d]
Can be viewed as democratically legitimate	Yes [c]	Yes [c]	Yes	No

Notes:

a – providing non-voting members do *not* participate in discussions.

b – unless one regards building identity within smaller groups as a step to European identity building. This point could be debatable. Heisenberg (2003) claims that grouping of member states might help in building the common European identity.

c – debatable, might depend on details.

d – unless the MPC is excessively dominated by large countries.

Source: own elaboration. Compare Heisenberg (2003).

2.4 An evaluation of the ECB reform proposal

In line with the Nice Summit, in December 2002, two years after the signing of the Treaty, but soon after its acceptance by a second Irish referendum, the ECB revealed its proposal for reforming the voting modalities of the Governing Council. On 3rd February, 2003, just after the Nice Treaty entered into force, the ECB published its official recommendation for the European Council 'on an amendment to Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank'[15]. The recommendation proposes to introduce a rotation system in a manner taking into account the economic weight of member states.

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

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

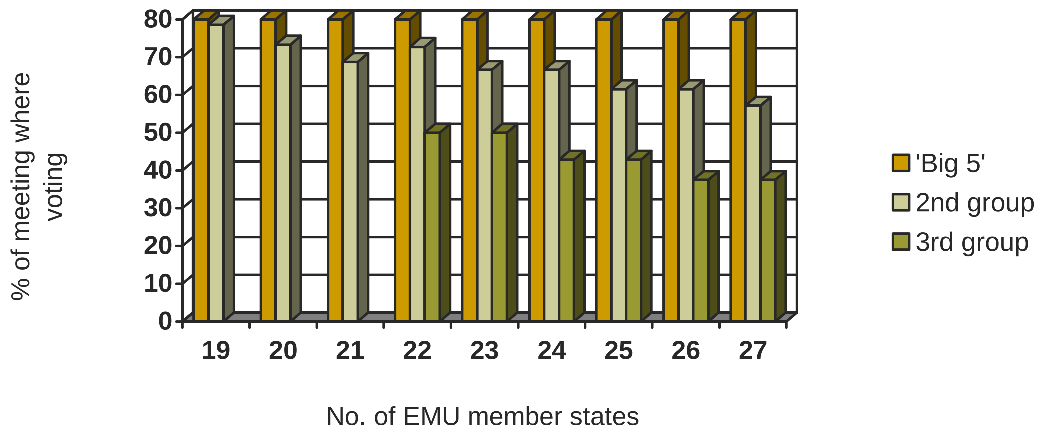
The proposed solution is that while all central bank governors should continue to take part in Governing Council discussions, some of them will temporarily not have a vote on interest rate decisions. Six members of the Executive Board will retain their rights to vote at all times, but governors of national central banks will be allocated not more than 15 voting rights. The rights will rotate within two groups (for an EMU of 16-21 countries) or three groups (if the EMU comprises of more than 21 member states). All countries will be ranked according to their share in EMU GDP (weight 5/6) and the share in the total aggregated balance sheet of monetary financial institutions ('TABS-MFIs', weight 1/6). The five biggest economies according to this ranking will form the first group with four voting rights. In the scenario with two groups all other countries will be allocated 11 voting rights. When 22 or more countries participate in the EMU, the allocation of voting rights to the 'Big 5' group will be unchanged (i.e. 4 rights). The second group will comprise half of all EMU member states (coming after the 'Big 5' in the ranking) that will share 8 voting rights. Remaining countries will have 3 voting rights at their disposal.

Such a procedure clearly introduces some 'breaking points' resulting from changes in the ranking due to new economic data and/or inclusion of new countries to the EMU. In many constellations the automatic application of the rule would produce outcomes unwarrantedly beneficial or detrimental to some countries or groups of countries. One such scenario, where at some stage there were 16-18 member states forming two groups, with the five biggest economies sharing four votes and the remaining 11-13 countries sharing 11 votes is explicitly excluded by the additional requirement that '*The frequency of voting rights of the governors allocated to the first group shall not be lower than the frequency of voting rights of those of the second group.*' Also, a kind of a transitory escape clause arrangement is included stipulating that the introduction of the rotation system might in fact be postponed until the EMU is enlarged to comprise at least 19 countries. It is likely that the rotation system will not be implemented until there are 19 EMU member states, i.e. until seven new countries (out of 3 current EU members and 10 candidates) join. This seems rather unlikely to happen before 2007-2008. More generally, some degree of *ad hoc* decision making regarding the voting modalities cannot be avoided. These issues, according to the ECB proposal, will be decided by all Governing Council members – irrespective of whether or not they hold a voting right at the time of the decision – by a two-thirds majority.

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

The proposal does not address the issue of the large number of persons participating in monetary policy discussions and decisions. It is hard to believe that the difference between: (a) having around 30 members participating in the discussion followed by a vote of 21 and, (b) allowing all members to vote, is substantial for the efficiency of the process. The hope is that the simple majority decision rule should assure reasonable results in any case[16].

Graph 5. The size of the EMU and the distribution of voting rights



Note: The distribution of voting rights is presented only for EMU of more than 18 member states. See text for discussion.

The complexity of the proposed solution is in itself a reason for criticism. Indeed, the proposed algorithm cannot be described as simple and it will demand some degree of *ad hoc* modifications. This might be bad for the transparency of the ECB and public perception of its functioning. On the other hand, it should not come as a real problem for financial markets that deal with much more complicated issues.

One more important criticism regards the criteria for the ranking of member states and consequently the division into groups. The inclusion of the indicator of the size of the financial sector indicator (TABS-MFIs) with a weight of 1/6 on top of GDP (weight 5/6), without taking into account population shares must be viewed as arbitrary. There seem to be no convincing arguments for choosing such a set of indicators and ignoring the benchmark provided by the shares in the ECB capital that is applied in many decision making procedures in the Bank[17]. It is hard to avoid the conclusion that this set of indicators was tailored to favour the interest of Luxembourg (very small economy with large financial sector) and in general of the incumbent EMU member states at the expense of prospective new entrants from Central and Eastern Europe (whose share in EMU aggregate GDP and TABS-MFIs is much below the share in population). As illustrated by Gros (2003), the adoption of these criteria results in the third rotating group being composed of only CEE countries and leaves Poland out of the 'Big 5" group even if the UK chooses not to enter the EMU before Poland does (see Table 2). Also, estimations based on 2002 data would put Luxembourg (population of 0.45 million) in group 2, while Romania with a

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

[17] For instance all GC decisions concerning issues such as capital of the ECB, policies with regard to foreign reserve assets, allocation of profits and losses of the ECB, etc. are taken by the qualified majority voting with weights equal to the shares in the ECB capital and the threshold set at two thirds (cf. ECBS Statute, Article 10.3). The shares in the ECB capital are equal to the sum of half of the share of a respective member country in the union's population and half of the share in the union's GDP (cf. ECBS Statute, Article 29).

population of 21.7 million would be in group 3. On the other hand the same table also reveals that adopting the shares in ECB capital as a basis for the ranking would not change the allocation to groups radically. Still, this system is likely to be perceived as frustrating in CEE, particularly as these countries had no say on the reform, and will have no impact on whether it is ratified by current member states or not. This could pose risks for the democratic legitimacy and accountability of the ECB.

Table 2. Estimated allocation of countries to groups (according to the methodology proposed by the ECB and the ranking based on shares in ECB capital)

	Euro-22 (current euro-zone plus 10 countries expected to join the EU in 2004) – without the UK, Sweden and Denmark (ranked using the ECB methodology)	Euro-25 (current EU plus 10 countries expected to join the EU in 2004) (ranked using the ECB methodology)	Euro-25 – ranked by share in ECB capital
Group 1 (4 voting rights)	Germany France Italy Spain Netherlands	Germany UK France Italy Spain	Germany UK France Italy Spain
Group 2 (11 voting rights)	Belgium Austria Ireland Poland Portugal Greece Luxemburg Finland Czech Rep. Hungary Slovakia	Netherlands Belgium Sweden Austria Denmark Ireland Poland Portugal Greece Luxemburg Finland Czech Rep. Hungary	Poland Netherlands Belgium Sweden Austria Greece Portugal Denmark Czech Rep. Hungary Finland Ireland Slovakia
Group 3 (3 voting rights)	Slovenia Lithuania Cyprus Latvia Estonia Malta	Slovakia Slovenia Lithuania Cyprus Latvia Estonia Malta	Lithuania Slovenia Latvia Luxembourg Estonia Cyprus Malta

Note: Classification is based on estimated 2002 data (2001 data in the last column). EU candidate economies on average are growing faster than most of current EU countries so as times passes one should expect gradual changes in the ranking.
Source: Gros (2003) and Lommatzsch and Tober (2002).

The ECB proposal was accepted by the EU Council on 21 March 2003, which indicates that once it is ratified by all member states it will enter into force[18]. However, the discussion is by no means over, since some other reform options might be brought to the agenda again either during

[18] Decision of the Council was published in the *Official Journal of the European Union*, L83, Vol. 46, 1 April 2003, pp. 66-68.

the Intergovernmental Conference that started in October 2003 or at some later date[19]. As it stands now, the Central and Eastern European accession countries will have nothing to say about the current round of the ECB reform, unless the Council decision is not ratified or the reform discussion will re-open before the currently agreed system is implemented (approximately 2007-2009).

3. The Eurogroup in an enlarged EU

The Eurogroup is an informal grouping of the finance ministers of the countries that adopted the common currency. It is not based in any Treaty provisions and does not have any decision making powers. It serves as a forum for consultation and discussion. Lack of any formal powers does not mean that it is not an important body. On the contrary, it could be argued that it is the Eurogroup's informal setting that makes is particularly influential and relevant in the functioning of the EU (Puetter, 2003).

A brief historical excursion might be helpful in understanding the current discussion on economic policy co-ordination in EMU, the positions of various actors and how EU and EMU enlargement matter in this context. The Maastricht Treaty assumed that EMU economic policy (apart from monetary policy delegated to the independent ECB) would be carried at the intergovernmental level with the Economic and Financial Affairs Council of Ministers (ECOFIN) being the central institution. ECOFIN groups ministers from all EU countries, including those that do not adopt the euro. Until 1996-1997 the discussion on EU economic co-ordination largely concentrated on building of the set of rules that would guarantee the stability of the monetary union. In 1995, Germany put forward the Stability and Growth Pact to prevent inflation fuelled by fiscal expansion and to assure mechanisms of efficient implementation of Article 104 of the Treaty (banning excessive deficits). During the 1997 Luxembourg Summit it was agreed that the introduction of a common currency makes closer co-operation between EMU member states necessary and thus the Eurogroup was established. Its first meeting was held in mid-1998 and since then ministers gather regularly, in parallel to ECOFIN meetings.

The Eurogroup has some specific features that make it distinct from other EU institutions. First, it is a very small body with only two persons (the minister and one advisor) representing each country. Second, the informal character of the group, the confidentiality of the discussions and lack of decision making powers arguably make it much easier to debate difficult and sensitive issues in a more open manner. The atmosphere of co-operation and compromise might be easier to achieve than at the ECOFIN forum where rivalry might be more natural[20]. This feature of the Eurogroup is particularly valuable since these same ministers meet later in the ECOFIN, where many decisions are taken by qualified majority voting. This implies that in the current setting a compromise worked

[19] While the Council took the decision unanimously, there was opposition coming particularly from Finland and the Netherlands. The opinion of the European Parliament was largely critical, while the European Commission supported the broad idea but voiced its preference towards including the population parameter in constructing the ranking.

[20] See the discussion and references in Puetter (2001).

out by the Eurogroup can be easily imposed on the ECOFIN or in any case earlier round of Eurogroup discussions might be helpful in reaching some deal in the ECOFIN.

After the 2004 wave of EU enlargement (and before enlargement of the EMU) this might become slightly more complicated. Twelve current euro-zone countries will have 60% of votes in the ECOFIN of 25 states, i.e. below the qualified majority threshold[21]. Still, nothing can be decided at the ECOFIN without the support of the euro-group countries (assuming they act together) and they will need the support of only a few other countries to get their way. On the other hand, ten EU accession countries will also become quite powerful in the ECOFIN (and other Council of Ministers bodies) since their cumulative share in votes will be above 26% of the total (in the EU-25), around the blocking minority threshold. In other words the position of new EU member states might actually be stronger in the Council of Ministers than in the ECB Governing Council (if one sees the latter as a place where national interests are represented).[22]

Such a situation is potentially dangerous from the perspective of the effectiveness of the functioning of the most important EU institutions. There is a risk that the Council is paralysed by being unable to take decisions on certain issues. If this black scenario materialises, there will be strong incentives for the creation of smaller more efficient bodies facilitating integration within the EU (subgroups of countries). In particular the Eurogroup might become one such institution, challenging the role of the ECOFIN by gaining some formal powers. If the Eurogroup indeed becomes a remedy for inefficient economic policy dialogue and co-ordination within the EU, because of ECOFIN's size and difficult Nice Treaty decision making rules, the natural reaction of current euro-zone member states might be to try to slow the EMU enlargement process (Rostowski, 2003).

Current euro-zone countries indeed appear interested in giving Eurogroup ministers the key say on EMU matters, without involvement of the non-euro countries[23]. The draft EU Constitutions proposes that only euro-zone member states will vote (applying the qualified majority rule) on economic policy guidelines and surveillance of them and excessive deficits. Also, euro-zone countries are to be allowed to co-ordinate actions and take common positions within international institutions, where they might also be represented in a unified manner[24]. The *Protocol on the Euro Group* that was annexed to the draft Constitution confirms the current practice of informal meeting of the euro-zone ministers but introduces one new element, by proposing the establishment of a euro area president elected for two years by a majority of EMU member states. This proposal would clearly further strengthen the international position of the euro-zone, possibly at the cost of

[21] According to the allocation of votes agreed in the Nice Treaty. The draft EU Constitution proposes a reform of that system which, however, even if accepted, is not envisaged to enter into force before 2009. After this date current non-EMU members will have a majority of states in the ECOFIN and will therefore still be able to block decisions (assuming they act together).

[22] The explanation of this phenomenon rests in the difference in the voting rules – simple majority rule in the ECB Governing Council does not allow a small group of representatives to block the proposal of the majority, whereas this is relatively easy in the European Council due to the very high majority threshold.

[23] See 'Eurozone bids to limit voting of non-euro countries', Financial Times, 13 May 2003.

[24] European Convention (2003), Article III-85.

weakening the position of EU non euro countries. The European Commission is also a strong advocate of giving formal powers to the Eurogroup and enabling closer policy co-ordination within the euro-zone. European Commission (2003) clearly states that '*the Ministers of Finance of the euro zone must be able to meet and take decisions as the Ecofin Council for the euro zone*'.

The question of the legal position of the Eurogroup in the enlarged EU is strongly linked to two other issues. Firstly, the qualified majority voting rules and more generally the decision-making rules of the Council are important. The draft Constitution proposes a significant simplification of the Nice Treaty regulations that also strengthens the relative position of the largest and – to a lesser extent – the smallest EU member states relative to the Nice rules[25]. Also, there is tendency for reducing the number of areas where unanimity is required[26]. The outcome of current debates on these proposals will ultimately shape the allocation of power between various EU actors. Secondly, the prospects of closer economic policy co-ordination in the EMU, particularly with respect to budgetary policies play a role. For instance, there are widely divergent views on the functioning of the Stability and Growth Pact, the credibility of which is in any case being tested with France and Germany likely to breach the 3% deficit ceiling for the third year in a row in 2004[27]. At the same time there is strong pressure from the Commission to strengthen its role in economic policy co-ordination (e.g. Commission, 2003).

4. Conclusions

There is very little one can say with certainty on the optimal design of the monetary policy decision making processes in a large and heterogeneous monetary union such as the EMU. The presented evidence indicates that several different solutions might work well, despite their potential shortcomings. The currently applied one-man one-vote, simple majority procedure in the ECB Governing Council appears to be performing well, if judged from numerous reports monitoring the ECB performance in its early years. This paper argues that EMU enlargement would not necessarily undermine the effectiveness of the current rules. The reform proposed by the ECB itself, currently at the stage of ratification by member states, also provides a reasonable framework for monetary policy making in the larger monetary union. Its major drawbacks are rooted in the sphere of intra-EU politics, rather than in economic effectiveness.

The design of the current ECB architecture was influenced by the experience of the functioning of the Bundesbank. Since the UK stayed outside the euro-zone, there was much less impact from the practice of direct inflation targeting frameworks steered by a small monetary policy council consisting of monetary policy experts[28]. Such 'policy culture' influences arguably have a strong

[25] For an exposition see e.g. Baldwin and Widgren (2003).

[26] Commission (2003) proposes to further widen the area in which qualified majority voting rather than unanimity is applied.

[27] Recent papers presenting different views on the Stability and Growth Pact include Eichengreen (2003), Fatas and Mihov (2003), Wyplosz (2002) and Gali and Perotti (2003).

[28] Begg et al. (2003) argue that countries staying out of particular EU arrangements have limited impact at the stage of building respective institutions.

impact on institutional design. Consequently, one should not expect a major revolution in the decision making rules of the ECB in the near future.

The prospects of EMU enlargement clearly have some impact on the discussion of the future of the Eurogroup and ECOFIN, and on economic policy co-ordination at the level of the euro-zone and of the EU as a whole. However, these discussions are largely driven by other considerations and the positions of major actors are determined by their specific experience and goals. The analysis of the optimal level of economic policy co-ordination lies outside the scope of this paper. From the perspective of accession countries, assuming they are willing and able to quickly adopt the euro, the risk is that the functioning of ECOFIN becomes inefficient and the Eurogroup emerges as a way to overcome this problem. In such a scenario, there might be opposition from incumbents to let new members into EMU, as this could undermine the efficiency of the functioning of the Eurogroup and thus the monetary union as a whole. Designing efficient institutional solutions for economic policies in the enlarged EU is thus in the best interest of all EU members, though this task is much complicated by the sheer size of the union and diverging views on the optimal balance of checks and powers between actors involved.

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