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Monetary Policy in a Union of 27: Enlargement and Reform Options

It is to be expected that by early 2006 the European monetary union will be enlarged by up to 10 countries. This poses the question as to whether the current decision-making structure in the common central bank is adequate for such a large membership. Not only will such a large number of national representatives impair the efficiency of decision-making, but monetary policy will have to deal with a much more heterogenous group of members. The following article addresses the problem of enlargement and discusses reform options for the central bank.

Recently Ireland, at its second attempt, has voted in favour of the Nice treaty on enlargement of the European Union. At the moment, it is expected that up to 10 countries will join in early 2004, while Bulgaria and Romania will follow a couple of years later. With Turkey, another candidate, negotiations have not yet begun.

Having joined the EU, it is expected of all candidates that they also join the monetary union – formally they are all countries with a derogation, which means they must join EMU. None of them has been granted an exception, as was the case for the UK and Denmark. While this does not necessarily mean that they could not deliberately fail to fulfil the entry criteria, most have expressed their desire to join EMU. Some have already done so implicitly through a currency board (Bulgaria, Estonia, Lithuania), while others have a formal peg to the euro (Hungary) or operate a managed float with respect to the euro (Czech Republic, Slovakia, Slovenia). Since one of the entry criteria is membership of the so-called ERM II for two years, it can be expected that EMU will be enlarged in early 2006.[1] As Table 1 demonstrates, most of the candidates are not so far away from fulfilling the entry criteria laid down in Maastricht.[2]

Currently, the organ responsible for formulating monetary policy, the Governing Council of the European Central Bank (ECB), is composed of 18 persons: six members of the executive board and twelve national representatives, namely the governors of the national central banks of EMU members. The board is selected jointly by the Heads of State and Government, while the 12 national representatives are chosen by their respective governments. Assuming that the current non-members of EMU and all new members will ultimately join, this council will be enlarged to 33 members: six board members and 27 national representatives. This would imply that 33 members have to decide on monetary policy for the euro area, with each member having one vote. What are the implications of such an enlargement, is reform needed and what are the reform options?[3]

Before entering the discussion of problems and reform options, it should be made clear that the whole issue would be of little relevance if the members of the council all had the same preferences and if they all cared only for the euro area as a whole. If all the members of such a council wanted the same and if all of them looked at the same aggregates, there would be little room for disagreement and it would consequently make little difference whether there was one person making the decision or if there were 30 making the same decision. The problem arises as soon as preferences begin to diverge or if members are concerned with different aggregates.

Unfortunately, it can be expected that exactly these differences would play a role in the ECB Governing Council. While it is usually taken for granted that the ECB board is mainly concerned with developments in the whole euro area and tries to formulate a monetary policy that is most adequate for the whole area,

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[1] R. Baldwin, E. Berglöf, F. Giavazzi and M. Widgren: EU Reforms for Tomorrow's Europe, CEPR-Discussion Paper No. 2623, 2000, even argue that entry could be as early as mid-2005 if such a political decision were taken. There are several examples of political will taking precedence over the economic criteria. The interest of the present members might be to avoid loss of competitiveness through exchange-rate devaluations by the accession countries.

[2] D. Gros: How Fit are the Candidates for EMU?, in: The World Economy, Vol. 23, 2000, pp. 1367-77, argues that the candidates are actually closer to the EMU average than former candidates were at the time of their entry into the ERM.

[3] Curiously, in the public debate much more attention is paid to the question of who the successor of the current president, Wim Duisenberg, will be than to the question of how to reform the ECB structure – a question of much greater importance.

Table 1
Accession Countries and Entry Criteria for Monetary Union
(in per cent)

	Price Stability	Interest Rates	Exchange Rate Stability	Fiscal Balance	Government Debt
Reference Value	3.6	7.0	+/- 15 %	-3.0	60.0
Bulgaria	7.9	6.4	-0.4	-0.9	69.7
Czech Rep.	4.7	4.3	-5.5	-3.8	19.4
Estonia	5.8	4.3	-1.5	0.4	5.4
Hungary	9.2	7.2	-5.1	-3.3	51.8
Latvia	2.5	9.3	6.3	-1.8	13.8
Lithuania	1.2	6.6	5.2	-1.7	29.1
Poland	5.5	6.4	-9.0	-5.6	42.9
Romania	33.5	29.7	-37.5	-2.5	27.5
Slovakia	7.3	7.4	-4.5	-1.6	42.7
Slovenia	8.5	10.0	-6.6	-1.4	28.4

it is just as likely that the national representatives are mainly concerned with developments in their own country. It is actually hard to imagine that the national representative of, say, Germany is just as much concerned with developments in Greece, Estonia, Poland or Spain as he or she is with inflation and economic activity in Germany.[4] Even if all central bankers have the same preferences for avoiding inflation, they may bring quite different concerns into a meeting deciding about monetary policy. If that is the case it will indeed make a difference who is entitled to vote and how many governors there are.

The Problem of Efficiency

The obvious problem is how to reach a decision in adequate time in a group of more than 30 members, even if some of them do share the same opinions. Consider the present situation of 18 members (six board members and 12 national governors). Assume that the president proposes an interest-rate change which is then voted upon. This requires that there are at least 9 members in favour of this decision (the president having two votes in case of a tie). If it is assumed that the members of the board all take the same position they need to find only three national representatives to share their opinion, i.e. only 25% of the governors. This will change dramatically with enlargement. If the EMU is enlarged by only five members the board must find 6 more governors to share their view (35.3%); with 12 new members they need the support of 9 governors (37.5%); and if 15 countries join the EMU (thus including the current opt outs) the board needs 11 governors on its side (40.7%).[5] In addition, it would take much more time to decide. Imagine that 27 governors and the president make an opening statement each of only 10 minutes so that nearly 5 hours have passed before discussion and voting can even begin. It will also make it much more difficult for the board to implement its preferred solution which implies that it will be more difficult in general to get any policy change accepted. And it implies that national influences will receive much more consideration after an enlargement than is currently the case.

The Problem of Heterogeneous Membership

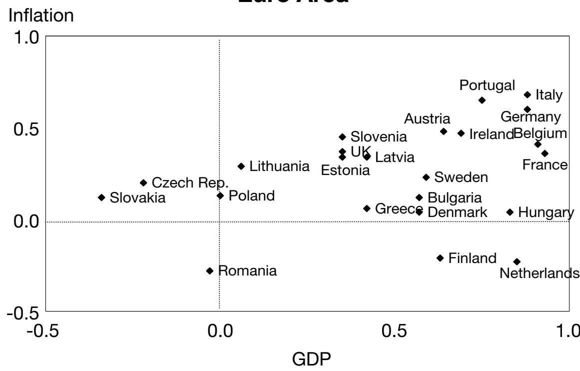
Membership in the current EMU is already characterised by significant differences. It is quite obvious that fast growing members like Ireland are in need of a different monetary policy than a country like Germany, which, in the view of some observers, is more in danger of deflation than anything else. Hence, one might already be of the opinion that the ECB is running into serious trouble by formulating one monetary policy for such a diverse union.

The problem is compounded if an enlarged monetary union is considered. A simple analysis of how inflation and GDP (Figure 1) and how demand shocks and supply shocks (Figure 2) have been correlated in the past for present EMU members and the candidates is revealing. The scatter diagrams establish a clear pattern of core and periphery for EMU members and accession countries. Present EMU members can be separated into a core comprising Germany, France, Belgium, Italy and the Netherlands and a periphery that is only weakly correlated with the core (Greece, Ireland, Portugal). The picture is even more diverse when looking at the accession countries. For most of them correlation is rather low, in several cases even negative. This implies that, if monetary policy is mainly based on economic shocks, the accession countries will show different preferences for monetary policy than the majority of the present members. While at present the board is likely to prevail with its policy proposals, because the members only need to convince a quarter of the governors, this will be more difficult in the future. It is to be expected that the course of monetary policy will shift in the direction of the smaller member states.

[4] This is in violation of the official rhetoric, which purports that all council members are "true Europeans", concerned with the whole euro area. This official rhetoric is hard to believe. Apart from pure cosmetics there is no reason to have national representatives if not in order to voice the interests of their region. It could be argued that their main function is one of transmitting information about their region to other council members, but it is not clear that there are no better and more efficient ways of transmitting information than sending governors to Frankfurt. If its members are not "true Europeans", the council should be as large as possible; see P. Gerlach: The Interest Rate Setting Behavior of Central Banks, Doctoral Thesis, University of Basle, 2002.

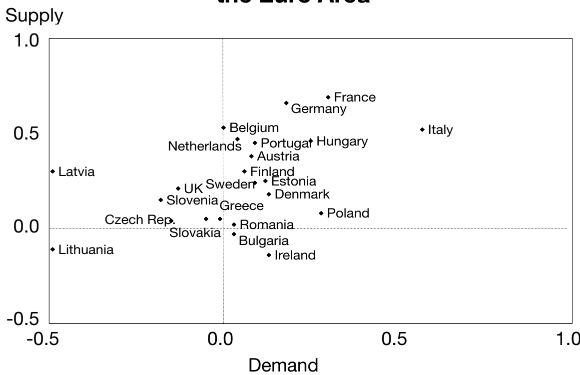
[5] See Baldwin et al., op. cit.

Figure 1
Correlation of GDP and Inflation with the Euro Area



Note: Correlations with the aggregate of the euro area. Data are for 1991-2000. Based on: J. Fidrmuc and I. Korhonen: Similarity of Supply and Demand Shocks Between the Euro Area and the CEECs, Bank of Finland Discussion Paper 14, 2001.

Figure 2
Correlation of Supply and Demand Shocks with the Euro Area



Note: Correlations with the aggregate of the euro area. Data are for 1991-2000. Based on: J. Fidrmuc and I. Korhonen: Similarity of Supply and Demand Shocks Between the Euro Area and the CEECs, Bank of Finland Discussion Paper 14, 2001.

Apart from demand and supply shocks, different monetary policy preferences can be due to structural differences in the accession countries. On the one hand, it has been argued that accession countries might have a preference for higher inflation because of higher unemployment, fiscal problems or problems with their banking sectors.[6] Others instead point to the influence of the so-called Balassa-Samuelson effect. According to this empirically validated theory poorer countries will have a higher rate of inflation. The reason is that initially the price level in poor countries tends to be lower than in high income countries. As these poorer regions will grow faster than the advanced regions in the process of convergence, they have higher rates of inflation.[7] This inflation is purely structural and not due to expansive money creation. Given higher growth rates and inflation, accession countries have need of a tighter monetary policy than most of the older members. This would imply that the newcomers would vote for a more restrictive policy. Whether the first or the second effect is stronger is not clear – but it seems obvious that preferences will diverge more strongly in the council than they do today.

As indicated above, all this would be no problem if the present members and the new governors voted on monetary policy with a view to the Euro-wide aggregates. Experiences with the US Federal Reserve System (where votes are published so that individual positions can be identified) however suggest otherwise. In the United States, a much less diverse monetary area than the present EMU or an enlarged EMU, regional representatives tend to vote consistently with a view to their own regions. For the ECB such a test is more difficult, but here as well observed policy decisions are compatible with the interpretation that national governors have a national bias in their votes.[8]

The Problem of Size

Currently, every country has one vote in the council (assuming that the board members do not adopt a partisan position). This implies that larger members are under-represented while the smaller members are over-represented with respect to their economic size. This imbalance will become more significant if new members join the union. Given that most of them are rather small entities (with the exception of Poland and Hungary), smaller members can easily determine a monetary policy that is in contrast to the interests of the larger members. While the one country, one vote principle may be regarded as democratic, it also poses a significant problem. What grounds are there for supporting the fact that the smaller members could overrule the interests of two thirds of the entire population within the EMU?

At present this problem is less acute because, if one believes that the board takes the relative size of countries into account when determining its preferred position, the larger countries are more or less appropriately

[6] On the banking sector, see D. Gros, op. cit. On structurally higher inflation, see H. Berger: The ECB and Euro-Area Enlargement, IMF-Working Paper 02/175.

[7] This also casts doubt on the desirability of having a monetary union with those countries. Actually, they would have a need for flexible exchange rates to adjust to differences in structural inflation. That this effect can be considerable is documented in: D. Begg, B. Eichengreen, L. Halpern, J. v. Hagen and C. Wyplosz: Sustainable Regimes of Capital Movements in Accession Countries, manuscript 2002.

[8] E. Meade and N. Sheets: Regional Influences on U.S. Monetary Policy: Some Implications for Europe, Board of Governors of the Federal Reserve System, International Finance Discussion Paper 721, 2002.

represented even though they have only one vote in the board. If board and member preferences are not too far apart, the economic interests of the larger members are thus taken into account. But again, this would change with enlargement because the board members would find it much more difficult to implement their preferred policies. This means larger members would be less well represented in an unreformed enlarged union.

This problem could most easily be remedied if member states agreed on weighting the governors' votes by their respective relative sizes. The size could be derived from the number of inhabitants, which would probably be the most democratic form. Alternatively, the relative sizes of GDP could be taken as the pivotal factor. While the two are correlated, the latter would be based on economic importance and give more weight to small, rich economies in Europe (such as Belgium, the Netherlands and Austria). It would certainly imply that the larger accession countries such as Poland and Hungary would have less weight than when weighted by their populations.

While some weighting seems an intuitive solution to the problem, it is also clear that the smaller states would oppose this. And it would violate the principle, codified in the Maastricht treaty, of one country, one vote. Since such a solution would require that the treaty be revised, it seems to be an unlikely and impractical solution.

The Problem of Centralisation

One way out of the problem would be to follow the example of most national central banks and to centralise monetary policy in the hands of only a few trusted individuals. After all, according to the statutes of the ECB its policy should not take national considerations into account. This could best be ensured by delegating decision-making to the board alone.[9] The board would then appropriately weigh all the observations from the member states, take into account their relative size and importance for the euro area, and set policy such that the weighted average of inflation (and output) is close to its objectives.

There are several reasons why this obvious solution is not a likely outcome. First, one might argue that the dispersion of power to vote on monetary policy is also some kind of protection for the independence of the board and thus to be defended. It is conceivable that pressures from member states, interest groups, or the public at large can be less easily rejected by a small group. If voting power and responsibility is more diluted, it could be more difficult to exert pressure on the council.

Second, it is unlikely that member states will formally renounce their right to co-determine monetary policy by sending national central bank governors into the Governing Council. Influence could also be taken if the European Council set an inflation target for the board, which was then held responsible for implementing it. This would exert some government influence on monetary policy while at the same time ensuring that the efficient implementation of policy is possible. However, it is unlikely that this position will be taken by the European Council, not least because this would shift the problem of finding a solution from the central bank Governing Council to the European Council. Apart from that, a much fiercer fight would probably follow about whom to make a member of the board. Given the observed conflicts about the nationality of the president, this is unlikely to be a workable solution.

Third, as in the case of assigning voting weights to member countries, this solution would violate the one country, one vote principle. What other solutions are there to preserve the efficiency of monetary policy-making?

Reform Option I: Representation

Reform proposals that are currently being discussed fall under two headings: representation and rotation. Both are systems that are currently in operation.

Representation is the system operated by the International Monetary Fund (IMF). Here countries would be grouped with four or five countries having one vote. The chair would represent the position of the group. If countries in one group diverged in terms of inflation, growth, income level etc., the problem of finding a solution would be transferred from the council to the group. If the one country, one vote principle is kept this would imply that the chair's position is bound by the vote of the majority of his/her constituencies.

A precedent for this procedure can be found in the process of German monetary unification where the integration of the East German regions reflects this strategy.[10] Given that the economic structure of the formerly communist regions was completely different from West Germany, it was feared that monetary policy would be influenced too much by giving these regions full voting rights. Integrating the five Länder of East Germany into the unreformed institutional structure of the Bundesbank

[9] A less radical proposal would be to assign double voting weight to the members of the board. This is likely to run into the same problems, if in weaker form, as making the board alone responsible for monetary policy.

[10] See C. Hefeker: Federal Monetary Policy, manuscript 2002.

would have meant that the share of board members would fall from 9/11 to 9/16, reducing their influence significantly. Given that it was expected that the preferences of the new Länder would be more expansionary, this would have implied a shift to a more expansionary monetary policy. To counter this effect, the western regions of Germany decided that the relative share of the board needed to remain high. This was achieved by merging the new territories into the older ones and reducing the number of regional central banks to 9, increasing the relative weight of the board to 8/9.

While intriguing in principle, there are several problems with this solution: how would the groups be formed, how would the chair be determined (would it rotate? would one country always hold it?), and how would the members determine their joint position (would they vote or find their position by "consensus"?)[11]

To minimise transaction costs, it would probably make sense to group countries according to their expected economic position, i.e. one based on close similarities in business cycles or in economic structure. But a two-step decision-making process need not necessarily be more efficient than one where all members and the board come together jointly. Decision costs could be just as high.

Reform Option II: Rotation

The alternative solution is one that would follow the system of the Federal Reserve Board in the US. In addition to a group of seven permanent board members (the president, the vice-president and five other persons), there is a group of twelve regional federal reserve banks' governors who take turns to fill the other five seats in the council. New York, as the financial center, has a permanent seat and Chicago and Cleveland (historically minor financial centers) take turns to fill one other seat. The remaining nine banks rotate through the remaining three seats.[12]

If this example were to be followed, obvious questions would be whether there should be permanent seats for some countries and which ones those would be. Germany and France would be obvious candidates for permanent seats, but what about Italy and Spain, or later the UK and maybe Poland? Should countries be formed into groups that are allocated one seat so that this solution would comprise elements of the alternative discussed above? If not, should countries rotate randomly or according to some mechanism that gives larger members more time in the seats? If the relative sizes of the countries were not taken into account, situations could arise in which no large member was holding a seat, bringing us back to the problem of the over-representation of small members.

Following a recent proposal, the size of the groups would depend on the relative sizes of countries that are members of the group.[13] This would imply that a group would be assigned a number of seats according to the size of its member countries. A group consisting of Germany, France, the UK and Italy might receive 3 seats, as would the group consisting of Spain, Netherlands, Sweden, Belgium, Austria and Poland. Two seats would be allocated to Denmark, Finland, Greece, Portugal, Ireland, Czech Republic and Hungary, while one seat would be allocated to the remaining ten countries. Accordingly, the big countries would have a 75% chance of being present in the council at any point in time, falling to 10% for the last group, with probabilities of 50% and 29% for the intermediate groups.

The advantage of this system would be that it tries to bring together as closely as possible the relative sizes of countries and their voting power, while at the same time preserving the principle of one country, one vote, since each country entitled to vote would have equal voting power. At the same time, it would avoid the problems of representation and aggregation of preferences, while being relatively efficient because the number of governors on the council would be restricted to nine.

Nice and practical as this solution is, it is not without problems. Forming the groups exclusively with respect to the size of the economies represented in each group begs the question of economic foundation. Just because countries are of similar sizes, this does not imply that they have similar preferences or similar needs regarding monetary policy. A group comprising such diverse countries as Poland and the Netherlands, Denmark and Hungary, or Luxembourg and Romania indicates that rotation does nothing to ensure that the interests of these smaller countries are taken into account. The smaller the countries get, the more diverse the groups become, which would imply that the larger members clearly benefit from such a system. It is true, however, that for the smallest group the chances of being represented in actual policy decision is always small if a voting mechanism is sought that reflects relative sizes.

[11] In the IMF, the chair is not bound to represent the position of members, i.e. this is not an "imperative" system; cf. H. Berger, op. cit.

[12] For a comparison of the Federal Reserve System with the Eurosystem, see K. Ruckriegel and F. Seitz: Zwei Währungsgebiete – Zwei Geldpolitiken?, Frankfurt2002, Bankakademie-Verlag.

[13] See H. Berger, op.cit., pp. 40-42.

Moreover, a mere rotation model is probably less adequate for the euro zone than it might be for the USA, which exhibits less regional divergence than the enlarged EU. Rotation does not take into account that the structure of shocks might be very different. At any point in time there is thus the possibility that the affected member is not a member of the council and thus its shocks are only imperfectly taken into account (by the board). This, as said, is particularly of concern for the smaller (and accession) countries.

An alternative would be to try to form groups not based on size but on economic similarities. This would require the identification of countries whose economic structures and whose exposure to economic shocks are close together. Then it would presumably matter little what particular country were to cast the vote since all would be more or less in the same position in the business cycle. While economically much more convincing than groups based on size, it is less straightforward to regulate how the groups would actually have to be formed.

Finally, the biggest hurdle to the implementation of such a solution is political. The larger member states would probably argue that they deserve a permanent seat on the council but the smaller members would object to this. The smallest countries in particular would be the ones which would lose most from a reform of the current system.

An Imperfect Solution

The preceding discussion has shown that there is no magic solution to the ECB's structural problem. All possible solutions have significant weak spots but the current system is even weaker than the alternatives. It is hard to understand why this complex has found so little public and political interest so far.

One possible explanation for this could be that the assumptions underlying this analysis are unrealistic. Do we believe that all members of the ECB council are true Europeans, irrespective of whether they are board members or national governors? If that is the case, the reform exercise is superfluous and the whole structure of having national representatives is pure cosmetics. But this is not very likely and clearly refuted by the available literature on central bank behaviour. Thus, we have to deal with the possibility that all members take foremost their nation as a reference point for their monetary policy decisions, implying that some care should be taken to rule out long and protracted discussion of monetary policy.

It is also necessary to be clear about what one wishes monetary policy to do. The basic question in judging the reform proposals is our perception of the task of monetary policy. The answer will be very different depending on whether we believe that the ECB exists to address the Union's average aggregates or to address the needs of the member states. If the former is the major task of the ECB, as the statutes say, and which makes sense, the answer is a very different one than if it is argued that the ECB exists to maximise the welfare of member states. The reform options discussed above should be evaluated in the light of the type of monetary policy which is regarded as desirable. If we are mainly interested in efficiency while preserving national influences, rotation or representation are appropriate. If, however, we mainly aim at strengthening the board, more centralisation would be appropriate.

Finally, one also has to make up one's mind about the capacity of, especially, the larger member states to adjust to the changed environment in monetary policy. The set-up of monetary policy-making loses importance if it can reasonably be assumed that labour markets will become more flexible, rendering monetary policy less important. Experience in Germany, France and Italy is not very encouraging here though. If it has to be assumed, however, that monetary policy will continue to remain a powerful instrument, the discussion of the ECB reform is important.

Unfortunately there is no easy answer and European governments will have to make decisions and set priorities. And the decision needs to be taken rather quickly. It is extremely unlikely that any meaningful reform can be achieved after the EU has been enlarged. Since reforming the ECB's structure is a decision which must be taken by all EU members, the prospective EMU members' support for reform would be essential. It is unlikely, though, that the accession countries will have an interest in reforming the system. On the one hand, they might be considered as gaining most from delegating their monetary policy to the ECB. This should be accompanied by a huge increase in credibility and a concurrent fall in interest-rate risk premia. This increase in credibility would be largest if they have the least influence in the ECB. On the other hand, this is a group that is likely to be characterised by monetary needs different to those of the present core countries. It should thus be in their interest and correspond to their needs if the current monetary policy takes them into account as much as possible. For this reason it is not clear that the accession countries would consent to a reform of the system once they are members of the EU. Hence, reform has to be decided upon before 2004.