Consequences of the modification of the Governing Council rules

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Executive Summary

EU enlargement requires a reform of the European Central Bank's decision-making procedures. The ECB Council has put forward a recommendation for this modification which sets a cap of 21 for the number of voting rights in the Council. Thus, with 6 members of the Board only 15 national central bank (NCB) governors would have a voting right. This is be realised by a complex rotating mechanism which in its final stage accords an intertemporal voting power to a governor that is determined by the size of his or her country: 80 % for large countries, 57 % for middle size countries, and 37.5 % for small countries.

In the Council's recommendation important guiding principles for this reform are mentioned: "the capacity for efficient and timely decision-making", the principles of "one member one vote", of "ad personam participation", of "representativeness", of "robustness and automaticity", and of "transparency". In this paper I additionally look at the principle of "accountability". An assessment of the recommendation along these lines leads to disappointing results.

- The new scheme does not improve the "capacity for decision making", since all NCB governors would always be admitted to all discussions. Thus, the main aim of reform, the creation of an effective decision-making body would not be realised. The reduction of voting powers is useless in this regard.
- The new scheme also violates the important principles of "one member one vote" and of "ad personam participation", since it creates a three-class voting scheme which treats the governors differently according to their national origin. This would threaten the independence of the ECB's decision-making processes from national considerations.
- Another major flaw of the new scheme is its lack of transparency which could additionally undermine the trust of Europe's citizens in the ECB and in Europe's institutions in general.
- Finally with a rotating scheme it could be difficult to hold NCB governors accountable for the ECB's overall policy stance.
- The only advantage of the new scheme over the status quo is a slightly improved "representativeness", i.e. the voting rights of the individual countries would correspond somewhat more with their GDP shares than under the present institutional set-up. Astonishingly this interpretation is not in line with the ECB's concept of representativeness, which simply means that the number of NCB governors with *a right to vote* should be representative of the euro area economy as a whole. In this regard the new scheme would not be superior to the status quo.

In sum, while the recommended scheme has many disadvantages compared to the status quo, it does not reach the main aim of reform, i.e. the creation of a more efficient decision-making body. Therefore, an alternative is urgently needed. In this paper, a model is presented which assigns the responsibility for operational decisions to an enlarged Executive Board (8 or 10 members) and accords the Council a veto power with 2/3 of its votes. Strategic and institutional issues would be decided by the Council where each NCB governor would always have a full voting power.

1. The ECB Council Recommendation

On 3 February 2003, the Governing Council of ECB unanimously approved the ECB Recommendation for a Council Decision on an amendment to Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank. The recommendation provides a new voting mechanism for the Council which aims at preparing the ground for the accession of new Member States to the euro area. The scheme is based on the proposition that the number of national votes in the Council should not exceed the present level of 15. Thus, with a growing number of member states, a cap for the sum of national votes is required. The core of the recommendation is a rotating voting mechanism with a two class voting scheme in an intermediate stage and three class scheme in the final stage, which is reached as soon as the Union includes 22 Member States.

- In the first class, the five most important countries are represented. Their importance will be determined by a ranking which takes into account national GDP shares (5/6) and the importance of the national financial sector (1/6).[1] The 5 countries will have 4 votes which implies that a "first-class" governor would be allowed to vote on 80 % of all meetings.
- In the second class, *initially* all other governors will be represented. In this stage they share 11 votes. With *22 and more members* the second class shall comprise half of the members (rounded up). I.e. with 27 members, 14 would be included in the second class according to their ranking. In the final stage the second class has 8 votes.
- In the third class, which would become effective in the final stage, the remaining countries are represented. They share 3 votes. With 27 members, 8 countries would participate in this class.

Thus, in the final stage with 27 members, the intertemporal voting power of a national governor would be 80 % in the first group, 57 % in the second and 38 % in the third.

2. Criteria for an assessment of alternative schemes

The Council has declared that its decision for this scheme was shaped by the following considerations:

- the capacity for efficient and timely decision-making
- the principles of "one member one vote principle" and "ad personam participation"
- the principle of "representativeness"
- the principle of "robustness" and "automaticity"
- the principle of "transparency"

Since these guiding principles are rather uncontroversial, I will use them in the following for my assessment of the Council's proposal. However, I will include the principle of *accountability* as an additional criterion.

[1] This ranking scheme was developed in order to guarantee Luxembourg a permanent seat in second class.

3. Capacity for efficient and timely decision-making

It is obvious that with a growing number of EMU members the present institutional framework would become more and more inefficient. A Governing Council with up to 33 members would not be suited for an efficient discussion of complex issues and a timely decision-making. Since this problem was the main reason for a modification of the ECB's institutional structure, it is somewhat astonishing that the proposed scheme does not provide a true solution. According to the Recommendation all NCB governors would be always admitted to all Council meetings and would always be entitled to participate in the discussion. In other words, the only modification concerns the final act of voting after the discussion has taken place. But in terms of efficiency this modification is useless. Thus, in spite of its complexity the Recommendation clearly fails to meet the main target of the ECB's institutional reform. The danger that the Council would be paralysed by too many participants is still there.

4. "One member – one vote" and "ad personam participation"

Especially from the experience of the Bundesbank one can see that it is of decisive importance for the political independence of a federatively structured central bank system that all regional/national representatives are treated equally in all respects. This insight is expressed by the principle of "ad personam participation". It implies that a NCB governor is not regarded as an agent of its specific region/country but as an expert on monetary policy which takes part in the discussions and decisions in personal and independent capacity. The German experience shows that such an institutional set-up leads to a "Thomas Becket" effect according to which governors from very different political and regional backgrounds soon feel a responsibility for the currency area as a whole. So far, the ECB experience seems to confirm this finding.

Again the Recommendation is difficult to reconcile with its declared principles. While it is true that each NCB governor is treated equal *if* he or she is entitled to vote, the three class system creates an obvious differentiation according to the national origin: During e.g. 16 years of tenure, a first-class governor will have a voting right for about 13 years, while the third class governor can vote only during 6 years. In other words, from an intertemporal perspective the new scheme is clearly incompatible with the "one member – one vote" principle and thus also with the principle of "ad personam participation". Under the new rules a NCB governor would permanently experience that his national origin plays a role in the decision-making process. This could make him prone to decide from a national perspective which threatens the independence of the ECB's decision-making process from national considerations. Such an introduction of a nationality bias is especially dangerous if the principle of "representativeness" is not very well developed.

5. Representativeness

The Council defines this principle as follows: "At any moment in time, the NCB Governors with the right to vote will have to be from Member States which, taken together, are representative of the euro economy as a whole". This principle is regarded as the basis for the rotating system. While the new scheme is compatible with this principle, it is also obvious that the status quo solution (i.e. a Council with a full voting right for all members) would lead to the same result.

As the new scheme is also not superior in terms of the main principle, i.e. the "capacity for efficient and timely decision-making", there must be another important rationale for this complicated framework. If one asks for the main difference between the status quo and the recommendation, one can see that it is related to the share of large, intermediate and small countries in the ECB's voting mechanism. This is shown by Table 1.

Table 1: Voting shares with 27 members under status quo and under the Council Recommendation

	Recommendation	Status quo	*GDP share*
Largest country	*0.04*	*0.03*	*0.22*
5 largest	0.19	0.15	*0.75*
14 middle	0.38	0.42	*0.24*
8 small	0.14	0.24	*0.01*
Smallest country	*0.02*	*0.03*	*0.00*
Executive Board	0.29	0.18	

Compared with the status quo the new scheme increases above all the voting power of the Executive Board (from 18 % to 29 %) while it reduces the share of the small countries from 24 % to 14 %. Somewhat smaller changes can be seen for the large countries which would gain 4 percentage points under the new scheme while the middle countries would loose the same amount. The rationale of the voting scheme is obvious: It reduces the voting power of the new entrants to the benefit of present members. Due to the ranking which includes the size of financial markets not even Luxembourg would be included in the third class.

This change in the voting shares is certainly the most important feature of the new voting scheme. Since the Council does not address this issue explicitly, one has to try to identify the reasons for such a reform. From the aspect of "representativeness" one could argue that the Recommendation brings the voting shares more in line with the economic importance of individual countries. However, the discrepancy between the GDP shares and the voting shares remains huge. For instance, in the case of Germany it seems questionable whether the increase in its voting share from 0.03 to 0.04 would really justify the introduction of such a complicated voting scheme. An additional effect is a strengthening of the position of the Executive Board. This can be regarded as a positive feature if one assumes that the Executive Board is more independent and/or more competent as far as the euro area as a whole is concerned. Thus, from the perspective of a redefined principle of representativeness, the Recommendation has some advantages over the status quo.

6. Automaticity/Robustness

This principle refers to the need to create an institutional framework that is capable of dealing with an increasing number of EU members during the enlargement process. With the two-stage scheme provided in the Recommendation the Council has no doubt developed a very adaptable framework. However, the status quo would also be open for a gradual expansion of the EMU member countries.

7. Transparency

In his letter to President Cox (19 December 2002) the ECB's President emphasises that "the Governing Council sought to design a rotation scheme which is transparent so that its main features and functioning can be communicated relatively easily." While this might be true for experts of central bank constitutions, it would be very difficult to explain the new scheme to European citizens. Its two-stage introduction looks as complicated as the whole three-class rotating system. This is major drawback compared with the status quo which rests on the simple principle that each country is represented equally by its central bank governor. Such a lack of transparency is especially dangerous in the case of a very independent and powerful institution like the ECB. Since from time to time the common monetary policy will exert negative effects on certain areas, it requires an broad and ongoing public support in Europe and this requires that the citizens can easily understand the working of this system.

8. Accountability

This criterion has not been listed in the Council's guiding principles for ECB reform. Nevertheless, it seems obvious that a new institutional design has to contribute to the ECB's accountability. Thus, it seems paramount that all national central bank governors remain involved in the decisions on interest rates. In the words of Wellink (2002):

"[I]t may be particularly 'reassuring' for the public in countries where economic developments diverge from the euro area average if 'their' NCB governor is seen to participate in the formulation of the single monetary policy."

While the status quo arrangement is ideal in this respect, under the new scheme the responsibility for interest rate decisions rests on only 56 % of the governors. 12 governors are temporarily exempt from voting and thus also from the overall responsibility for monetary policy decisions. This makes it also difficult to hold NCB governors accountable for the monetary policy of the ECB since one has to know at which concrete decisions they had a vote and since they have no permanent say in the decision process.

Thus, in terms of accountability the status quo is superior to the scheme proposed by the Council.

9. Interim assessment

If one compares the new framework with the status quo using the ECB's guiding principles, the overall assessment is very mixed. In terms of

- an "*efficient and timely decision making*" both schemes are identical but inadequate, since the new scheme affects the voting process only,

- the "*ad personam participation*" and the "*one member one vote*" principle the status quo is clearly superior since the new scheme introduces a differentiation of the governors according to their national origin,

- the "*representativeness*" principle both schemes are identical, if one uses the Councils concept of "representativeness". If "representativeness" is understood in terms of a correspondence of voting shares with the GDP shares of countries and country groups, the new scheme has an advantage over the status quo since it reduces the disproportionate influence of the small countries, especially in an EMU with 27 members.

- the "*robustness and automaticity*" principle, the status quo is per se not inferior to the new scheme,

- the principles of "*transparency*" and "*accountability*" the new scheme is worse than the status quo.

In sum, the new scheme does not solve the primary problem of how to create a new decision-making body which allows an efficient and timely decision-making. It violates the principles of "ad personam participation" and "one member one vote" and it leads to a very intransparent institutional structure. Since the only advantage is a somewhat reduced lack of "representativeness", it seems very questionable whether this framework should be adopted even in comparison with the status quo.

10. An alternative solution

In the literature different alternative solutions have been developed. While they differ in detail there seems to be a consensus that it is useful to differentiate between

- *operational* decisions, i.e. on interest rate and exchange rate policy, and
- *institutional* and *strategic* decisions, i.e. on the overall strategy or the use of monetary policy instruments.

For the first group of decisions a fast and very confidential decision process is required which calls for a relatively small decision making body. For the second group more time for discussion is available and they are of a less confidential nature. The discussion of such issues can also take place by an exchange of papers. Thus in this area, a larger decision-making body is much less problematic.

This could call for a solution where the *Executive Board* decides on all operational decisions. Given this increased responsibility the number of its members should be increased from 6 to 8 or even 10. This would above all reduce the risks a "dominant in-house view that is intolerant of challenges to local orthodoxy" (Willem Buiter). For the institutional and strategic decisions the *Governing Council* would be responsible. Its voting scheme would remain unchanged.

Such a framework would be superior to the recommended scheme in terms of all criteria. It would allow for a fast and efficient decision process, all governors are treated equal, its transparency is high. The principle of representativeness would lose its importance since operational decisions would be made by a group of experts without a national institutional affiliation. The only flaw of this approach is lack of accountability at the national level which is due to the fact that the NCB governors would no longer be involved in the ECB's interest rate policy.

This could call for a synthetic approach which additionally gives a *veto power* to the Governing Council in operational issues. Thus, if the Board decides on a certain interest rate level, the Council could override this decision with a majority of two thirds. As the members of the Board are included in the Council, a veto would require a large support by national governors, especially if the Board takes a decision unanimously (Table 2). Thus representativeness would always be guaranteed.

Table 2: Number of NCB governors required for a veto of a Board decision (27 member countries, 8 member Executive Board)

Dissenting Board members	3	0
Required number of NCB governors	21	24
Quorum of NCB governors	78%	89 %

11. Summary

The institutional reform of the ECB is an extremely important and wide-ranging issue which requires a very careful analysis and preparation. In my view, the recommendation that has been put forward by the ECB Council shows serious flaws. It violates several principles that the Council itself has regarded as essential. These flaws are so serious that it would even be better to maintain the status quo. It is much more compatible with these principles and only under one aspect inferior to the proposed scheme.

But since the EMU enlargement calls for an efficient decision-making body in the field of monetary policy, it is unavoidable to develop an alternative to the Council proposal. In this short paper a blueprint is provided that meets all guiding principles. But given the enormous importance of the task, more analysis is urgently needed.

Reference:

Wellink, Arnout (2002), The role of national central banks within the European System of Central Banks", in: Wettbewerb der Regionen und Integration in der WWU, Editor: Wolfdietrich Grau, P. 189-195.