

Discussion of **Should the ECB be restructured,
and if so, how?** by Helge Berger, Jakob de Haan and
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The recent decision of the European Council to admit ten Eastern European countries into the European Union (EU), and by implication into the European Monetary Union (EMU), transforms the issue of reform of decision making institutions at the European Central Bank (ECB) from a pure academic exercise into a practical policy issue.

The paper by Berger et. al. presents a welcome systematic evaluation of the tradeoffs that will have to be faced at the ECB in view of enlargement. The basic problem is that under the current institutional structure the Governing Council of the ECB, which is composed of the six members of the Executive Board plus all the Governors of the National Central Banks (NCB) participating in the Euro area (currently eighteen members), may increase up to thirty three. Such a number appears excessive if one is to maintain the ability of the Governing Council to make efficient and timely decisions. Berger et. al., propose a Governing Council of fifteen members. This number appears to strikes a reasonable balance between the need for representation of different countries in the Euro area and the decision making efficacy of the Governing Council.

Given this number there is a basic tension between the, politically motivated, principle of equal vote shares to each of the Council members laid down in the Maastricht Treaty, and the need to reflect the fact that countries within the Euro area differ widely in terms of both economic and financial size. Under the current system the principle of equal vote shares leads to

substantial discrepancies between the voting rights of the NCB governors and the economic size of their respective countries. Berger et. al. refer to this discrepancy as a wedge between political and economic weights and quantify it by constructing a measure of the aggregate discrepancy between the vote share of each country in the Governing Council and its share in the combined GDP of the Euro area. Obviously, this discrepancy is sizable already today with only eighteen Council members. Some of the centrifugal forces exercised by the NCB Governors are currently mitigated by the non negligible voting share of the Executive Board (one third) amplified by the permanent presence of its members at the ECB headquarters in Frankfurt. But if and when the number of Council members increases to thirty three the share of votes of the Executive Board will decrease to less than twenty percent and the likelihood that economically small countries will have political weights substantially above their economic weights increases as illustrated by Figure 2 in the paper.

As the paper clarifies there are several options to bring economic and decision-making power at the Governing Council more in line with each other. One is to increase the vote share of the Executive Board, another is to create groups of countries with each group having one representative at the Council or to continue with the current system of one vote to each NCB governor in the Council and to achieve better balance between economic size and voting shares by means of rotation in voting rights. Although the first option is desirable on efficiency grounds it requires a fundamental adjustment in the Treaty of Maastricht. Such an adjustment is likely to lead to a reconsideration of other items in the charter of the ECB. This is politically unwise so soon after the creation of the ECB since it may endanger the hard won level of long run nominal stability in the Euro area.

After some discussion of the relative merits of those three systems the paper finally opts for the last method of sharing power and evaluates alternative rotation schemes. Weighted rotation appears as a reasonable compromise between maintaining the efficacy of the Governing Council decision making process and preservation of sufficient involvement of individual countries governors' in the decision making process at the ECB. Admittedly, under such schemes, large countries will have voting rights over longer periods than small countries will. But the fact that representatives of **all** countries, even if small, will occasionally be in positions of responsibility is likely to contribute to a feeling of collective responsibility and to enhance the culture of long

run nominal stability in the Euro area.

Besides the criterion of matching economic weight with decision making power the paper proposes two additional criteria for evaluating the desirability of alternative rotation schemes. One is the degree of business cycle coherence across the countries represented at the Governing Council and the other is the cross sectional distribution of inflation rates across countries. Although the simulations of the values of those two indicators for alternative rotation schemes are interesting and informative I doubt that they should be used as criteria for restructuring the ECB for a number of reasons. First, one of the objectives of the Maastricht Treaty, as reflected in the Maastricht criteria, is convergence of inflation rates. Taking the **existing** discrepancy of inflation rates between the Euro block and the ten Eastern European prospective members as a criterion for the choice of rotation scheme is in contradiction to the principle of inflation convergence. It may introduce, following enlargement, an inflation bias into the Euro area through the back door. Second, even if we abstract from this argument, the cross country correlation between inflation rates is likely to change **because** of enlargement. Hence using the pre-enlargement inflation correlations as a guide for the choice of rotation schemes is likely to carry little information for the post enlargement era.

To a lesser extent this argument also applies to the cross country business cycle correlations. Entry of the ten Eastern European countries into the EU is likely to change their patterns of production and of specialization, at least in the longer run. This will alter the cross country business cycle correlations as well. Under the presumption that it is undesirable to adjust the institutional structure of the ECB too often it appears, therefore, that the current business cycle correlations are largely irrelevant for the choice of rotation scheme.

The paper argues that since, due to the Balassa-Samuelson effect, the relative price of non tradeable in the prospective new members of EMU is likely to go up over time one should allow for the possibility of higher average inflation in those countries. Again, there is a risk in this approach since it implies that **relative price changes** that are expected to take place over the long run in the economies of the Eastern European prospective members might be accommodated to some extent by a general nominal expansion in the enlarged Euro area. I doubt therefore that this consideration should be allowed to have much effect on the choice of rotation scheme.

Recently the ECB circulated a press release which outlines its official position on possible restructuring of its decision making institutions following enlargement.¹ Like Berger et. al. the ECB proposes to achieve a better match between voting and economic shares by means of rotation while preserving the principle of one vote to each voting Council member.² But the ECB proposal envisages a council of twenty one voting members - - fifteen NCB Governors plus the the six members of the executive Board. This number appears to be on the high side. A total of fifteen voting council members, as proposed by Berger et. al. appears as more appropriate for efficient committee work.

The ECB also proposes that **all** NCB Governors, including the members that do not exercise voting rights, will continue to participate in the discussions of the Governing Council and attend its meetings in a personal and independent capacity. This feature strikes me as a very good idea for several reasons. First, it is likely to facilitate the buildup of consensus and to enhance continuity in the decision making process in spite of rotation. Second, it is likely to contribute to a better internal flow of information and to generally strengthen the norm of collective responsibility to stability in the Euro area as a whole in spite of possibly divergent interests due to asynchronization in business cycles and other reasons. It may also contribute to a smoother transmission of the stance of monetary policy decided upon by the Governing Council to individual countries' levels.

A useful feature that might be added to the above stipulation is that all NCB governors (voting and non voting) should generally have free access to the research output of the ECB, as well as to those of the research departments of individual countries' central banks at all times. This type of information sharing enhances transparency within the system and is likely to increase the fraction of decisions that is based on professional considerations rather than on political motives. Effective decision making depends not only on the weight of the ECB center as represented by the Executive Board in comparison to that of the NCB Governors but also on the effectiveness of continuous internal communications, and on clear understanding and consensus about what monetary policy can and cannot do. Free mutual access to central bank research

¹ECB, Press Release (2002).

²Unlike Berger et. al. the ECB does not use either business cycle or inflation correlations across countries as criteria for the choice of rotation scheme.

departments in the Euro area can significantly contribute to the buildup and maintenance of such a long run consensus.

As a criterion for choice of rotation scheme the ECB press release gives a positive weight **also** to the relative size of financial development of each country as measured by total assets of the aggregate balance sheet of monetary and financial institutions. In my view this makes a lot of sense. The reason is that one of the main costs of inflation is proportional to the size of nominal financial assets in the economy. Thus if the ECB allows Euro inflation to increase by one percent the cost to countries with a higher share of financial assets is higher. The representatives of those countries should therefore be given an appropriately higher decision-making weight in the Governing Council of the post enlargement ECB. Such a strategy is also likely to have a positive externality for the entire Euro area for the following reason. Central bankers in countries with higher shares of financial assets are likely to be more conservative and to have, therefore, a lower inflation bias. Hence, the long run, post enlargement, Euro area inflation bias is likely to be smaller when decision making power in the Governing Council is allocated **also** on the basis of the share of financial assets.

Let me conclude this comment by voicing a warning. The Treaty of Maastricht makes the ECB responsible for achieving one **main** objective which is price stability but the Treaty **does not** require the ECB to engage in stabilization of output. Admittedly, the statement in the Treaty that, without prejudice to its main objective, the ECB should support the economic policies of the EC can be construed as opening the door for stabilization of output or "flexible inflation targeting". But many among the drafters of the Treaty might not agree with this interpretation. In spite of this, current consensus, as reflected *inter alia* in the Berger et. al. paper, appears to be that the ECB should make some contribution to the stabilization of output in the Euro area.³

Following enlargement, this point of view may put the primary objective of the ECB at some risk for at least two reasons. First, as discussed in the paper, due to the Balassa Samuelson effect, the ten or twelve new entrants are likely to be more inflationary than current members in the long run. Second, in spite of very substantial increases in legal independence in the former

³See for example the model in Appendix 1.

socialist economies during the nineties, the evidence about the effectiveness of this institutional device in bringing inflation down to the levels of EMU is still mixed.⁴ Excessive emphasis on stabilization of output may, therefore, raise the inflation bias, following enlargement, through the back door. This consideration is amplified by the fact that, following enlargement, the Euro area will be even more vulnerable than now to free rider problems inherent in its federative structure. Perhaps the time has come to think about shifting more of the burden of output stabilization to other instruments.

1 References

Cukierman A., G. P. Miller and B. Neyapti (2002), "Central Bank Reform, Liberalization and Inflation in Transition Economies - An International Perspective", **Journal of Monetary Economics**, 49, March, 237-264.

ECB Press Release (2002) "Governing Council Prepares for Enlargement", 20 December.

⁴One reason is that the discrepancy between actual and legal independence is higher in the former socialist economies than in the Euro area countries. Details appear in Cukierman, Miller and Neyapti (2002).