Eastern enlargement and ECB reform

Richard E. Baldwin, Erik Berglöf, Francesco Giavazzi and Mika Widgren*

Summary

■ The experience to date of the EMU suggests that newcomers will join the monetary union much sooner than generally assumed, perhaps as early as mid-2005 if accession takes place by January 2004. Our analysis suggests that enlargement to include five, let alone twelve, new members without reforming the European Central Bank (ECB) would seriously undermine the effectiveness of this critical institution and most likely lead to undesirable policy decisions. Even in the most optimistic view, the *status quo* bias in ECB decision-making would be strengthened. The outcome, however, could be worse. In one scenario a dozen or more high-growth, high-inflation "Irelands", accounting for only 20 percent of Euroland output, could in the Governing Council outvote a handful of "core" nations to set interest rates. We consider the merits and drawbacks of three possible solutions: rotation, representation and executive decisions. Finally, we suggest that the ECB may find it hard to propose any solution, so the Commission should act. Our recommendation is that decision-making power is assigned to the Executive Board, while non-voting central bank governors remain involved in monetary policy discussions in order to maintain accountability.■

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Reform of the European Central Bank (ECB) was not on the agenda at the 2000 Intergovernmental Conference in Nice dedicated to preparing the EU institutions for Eastern enlargement. Europe's monetary authorities had, at least until then, publicly denied the need for reform. We have in an earlier study argued that enlarging an unreformed European Central Bank (ECB) to include five, let alone twelve new members, would seriously undermine the effectiveness of this critical body and most likely lead to undesirable policy decisions (Baldwin et al., 2000). In this article we develop this analysis further and discuss solutions.

We argue that the experience to date of the EMU suggests that the newcomers will join the monetary union much sooner after EU enlargement than generally assumed, perhaps as early as mid-2005 if accession takes place by January 2004. We demonstrate that, even in the most optimistic view, expansion of the EMU without reform would further strengthen the *status quo* bias in ECB decision-making. The outcome, however, could be worse. In one scenario, a dozen or more high-growth, high-inflation "Irelands", accounting for only 20 percent of Euroland output, could in the Governing Council outvote a handful of "core" nations to set interest rates.

Although the EU leaders did not decide the nature of ECB reforms in Nice, they recognised the problem and opened the door to a solution by putting an "enabling clause" in the Treaty.[1] This allows

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[1] The Treaty of Nice opens the door to a "single issue" intergovernmental conference (IGC). The ECB institutional structure is set in the Treaty on the European Union, so changing it would normally entail another IGC. A full-scale IGC might have delayed enlargement, and it would have put the ECB structure into the bub-

the ECB's decision-making process, enshrined in the Maastricht Treaty, to be changed without convening a new intergovernmental conference (IGC). We consider the merits and drawbacks of three possible solutions: rotation, representation and executive decisions. Finally, we suggest that the ECB may find it hard to propose any solution, so the Commission should act. Our recommendation is that decision-making power is assigned to the Executive Board, while non-voting central bank governors remain involved in monetary policy discussions in order to maintain accountability.

1. Problems: enlargement and the ECB's "numbers problem"

When arguing for ECB reform, one of the first responses is that the problem is far into the future. For example, in responding to a question on ECB reform and enlargement, President Duisenberg told the European Parliament: "Fortunately, we still have some time to go before we come to a decision, or until the heads of state come to a decision on this" (5 March, 2001). This section argues that EMU enlargement will follow soon after EU enlargement. The admission decision is ultimately a political decision. Given the exceptions already made to the Maastricht rules for most of the twelve current EMU members, it will be hard to keep out the newcomers, especially since they will wield significant power in the Council of Ministers.

bling caldron of political trafficking. The Nice solution will, at least to some extent, ensure that ECB reform is considered in a politically uncluttered setting.

Article 5 of the Nice Treaty allows changes to Article 10.2 of the ECB statutes. This is the Article that specifies the voting rules of the Governing Council, i.e. that each Governing Council member has one vote, and that decisions are by simple majority with the president breaking ties. The procedure envisioned in Nice for changing Article 10.2 is almost identical to that required for any Treaty change. The European Council must decide by unanimity, the European Parliament must be consulted, and the change needs to be ratified by all member states. The only difference - but a critical one - is that the "IGC" that precedes the Council decision only needs to deal with a single issue.

Importantly, the Nice Treaty restricts changes to Article 10.2 of the ECB statutes. This may severely limit the set of feasible reforms, excluding perhaps the possibility of handing over monetary policy decisions to the Executive Board. The point is that Article 12 of the statutes specifies that the Governing Council as such is responsible for monetary policy decisions. However the matter is unclear since Article 12 also says "In addition the Executive Board may have certain powers delegated to it where the Governing Council so decides."

1.1. The membership timeline

The Maastricht Treaty lays down a very specific procedure for joining the EMU, which involves meeting specific targets over specified time periods, 'reporting periods' (illustrated in Figure 1). Once a country has joined the EU it can also join the post-euro Exchange Rate Mechanism (ERM2), and this starts the 'reporting period' clock running. The Treaty specifically requires that compliance with the Maastricht criteria on government debt, the government deficit, interest rates and inflation be evaluated based on data from the year preceding the evaluation. However, the reporting period for the fifth main criteria—Exchange Rate Mechanism (ERM) membership without devaluation—is two years. What this means is that the evaluation cannot be undertaken until a two-year track record exists. Of course, practice and theory have deviated (as we shall see below), but two years is what the Treaty says. This means that the convergence evaluation must wait at least until the second accession anniversary.

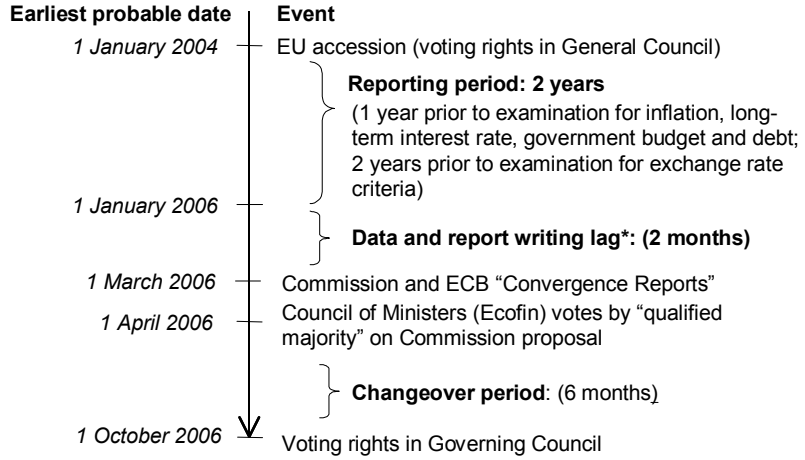
After the two years pass, the Commission and the ECB need about 2 months to produce the final data and write their "Convergence Reports." These documents assess the suitability of an EU member state for EMU membership based on compliance with the EMU-related *acquis* and the Maastricht economic convergence criteria. The relevant *acquis* mainly involves central bank independence, capital mobility, and banking and financial stability—things that the newcomers will have established by the time they join the EU. The Council of Ministers then deliberates the reports for at least a month.

Putting this all together suggests that the Council vote can come no sooner than 27 months after EU accession. If the answer is "yes" the EMU-members-elect may need some time to adopt the euro. The founding members took 8 months and Greece took 6, so voting rights in the Governing Council of the European Central Bank should come about 6 months after the Council decision. If the rules are followed to the letter, the process should thus take at least 33 months from the day of EU accession.

However, the Treaty-writers explicitly granted the entry judgement to a political body knowing that political pressure would make for exceptions. Historical precedence suggests that the EU-to-EMU delay will be much shorter. In 1998, great political pressure mounted to make Italy and Finland founding EMU members, despite their formal ineligibility. Italy had been in the ERM for only 15 months before the examination and Finland for only 16 months. The Commission and

the EMI (the ECB's precursor) more or less coalesced with politicians in overlooking the two-year ERM requirement. This exception was well reasoned and both countries had satisfied the two-year period before EMU's launch, but the exception was clearly stretching the Treaty rules. Given this precedent, it will be exceedingly difficult to hold a nation like Estonia to a two-year waiting period. Estonia has, after all, been tied to the euro (via its DM currency board) for longer than Greece. Once an exception is made for one new member state, how likely is it that the others will be denied?

Figure 1. Membership to EMU timeline, according to the Treaty

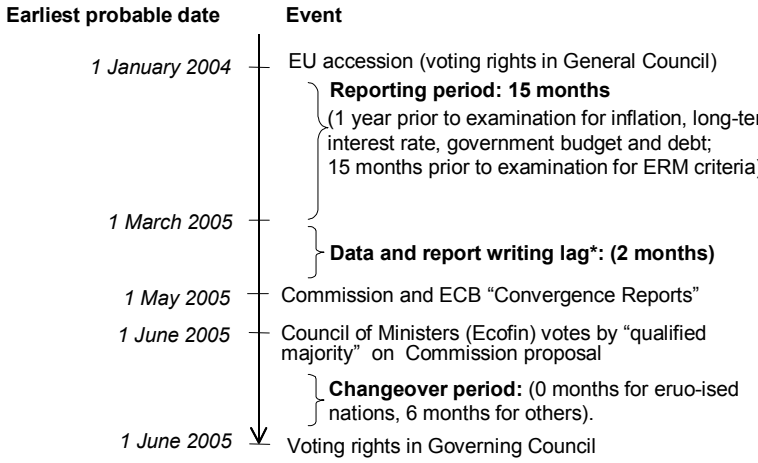


Note: Commission Report on first eleven members came on 25 March 1998 based on data up to March 1998; the Council voted on 2 May 1998; accession to EMU was on 1 January 1999. Commission and ECB Reports on Greece came on 3 May 2000 based on data up to March 2000; the Council accepted in June 2000; accession to EMU was on 1 January 2001.

In short, this Italian-Finnish precedent slices nine months off the *de jure* timeline. Euro-isation could take another six months off. Greece passed the convergence test in June 2000, and took up its seat in the ECB six months later. Not all of the applicant nations will face such a delay. With her currency-board peg to the DM, Estonia has effectively been using the euro since EMU started and Estonians have seriously contemplated adopting the euro as their national currency once banknotes have been issued in January 2002. This would mean

no delay, or a very short delay, between the Council's approval and voting rights in the ECB. Other applicants may follow this example.

Figure 2. Timeline with euro-isation and the Italian ERM period



Note: Italy's evaluation was based on 15 months of ERM participation, Finland's on 16 months.

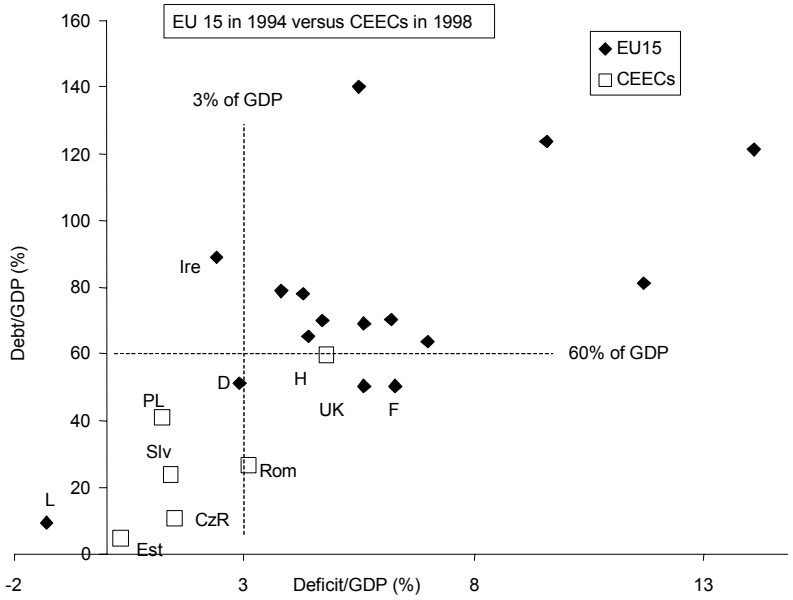
All of this implies, as shown in Figure 2, a minimum timeline that is 15 months faster than the 33 months suggested in Figure 1. The first new EMU members could, therefore, join as early as 1 June 2005, presuming the first EU enlargement happens on 1 January 2004. Of course, maybe only Estonia would be ready then, but given the astonishing Greek effort, it could well be more countries. Others, such as Gros (2000), estimate July 2006 as the earliest date, but this makes little difference. Whether it is 2005, or 2006, the EMU enlargement train is likely to pull away much sooner than many expect.

1.2. How many will be on board?

Some have argued that the newcomers will not be ready for EMU membership for quite some time, since they will not be able to fulfil the Maastricht convergence criteria. However, a glance at the data shows that on the difficult debt and deficit criteria, the frontrunner candidate nations are now better prepared for EMU membership than the current members were at a comparable stage. What did the current EMU members look like a comparable number of years be-

fore their entry, say in 1994? Figure 3 shows the facts for the debt and deficit targets. Except for Germany and Luxembourg, none of the current EMU members met the debt and deficit targets in 1994, and most of the others failed on both standards. The Central and Eastern European Countries (CEEC), by contrast, generally meet both criteria already.

Figure 3. Then and now: EU15 in 1994 vs. CEECs in 1998



Note: Estonia (Est), Czech Republic (CzR), Slovenia (Slv), Romania (Rom), United Kingdom (UK), France (F), Poland (PL), Germany (D), Ireland (Ire).
Sources: 1994 data, EMI Annual Report, 1994; CEEC data from Deutsche Bank Research (2000).

On the exchange rate criterion, the CEECs are again in better shape now than the incumbents were 5 years before they joined. Despite considerable variation in exchange rate regimes and strong underlying pressures, currencies have remained remarkably stable. The exchange rates in Europe, on the other hand, were a mess in the 1992-1994 period (with the exception of the traditional DM-bloc nations).

Table 1. Inflation and interest convergence criteria, then and now

	Inflation, 1994	Long-term interest rate, 1994		Inflation, 2001	Long-term interest rate, 2001
Belgium	2.4	8.3	Latvia	2.7	8.1[a]
Denmark	2.0	9.1	Lithuania	2.1	8.5[b]
Germany	3.0	7.8	Slovakia	6.0	7.9[c]
Spain	4.7	11.8	Slovenia	5.0	15.1–17.3[d]
France	1.6	8.3	Estonia	2.7	10.7[e]
Ireland	2.4	8.8	Czech Rep.	4.1	7.2[f]
Italy	3.9	12.3	Poland	6.9	10.9
Luxembourg	2.1	6.2	Hungary	6.5	7.7[g]
Netherlands	2.7	7.8	Bulgaria	4.5	6.7[h]
Portugal	5.2	11.7	Romania	19.4	n.a.
UK	2.4	8.9			
EU-12	3.1	9.6			
Austria	2.8	7.6			
Finland	3.7	10.1			
Sweden	2.2	10.7			
Greece	5.2	9.8			

Notes: a) 5 year gov. bonds; b) 7 year gov. bonds; c) gov. bonds; d) l-t loans; e) 5-10 year loans; f) loans > 4 years; g) 10 year gov. bonds; h) T-bonds.
Sources: ECB Monthly Report, various issues; IMF, World Economic Outlook, October 2000; national central bank websites.

The numbers on the inflation and long-term interest rate criteria are reported in Table 1. On inflation Romania is the only country to be in far worse shape than the current EMUers were four years before the start of EMU. In the three Baltic States, inflation is virtually identical to the euro average. For the rest, their 2001 inflation numbers are about twice the current euro average. As for long-term rates, many of the CEECs do not have ten-year government bonds, making the criterion problematic. Remember, however, the Italian and Greek examples: inflation and interest rates can be slashed over a period of, say, two or three years by a sufficiently determined government.

1.3. Historical exceptions to the Maastricht criteria

Although the Treaty is quite specific on the five sets of numbers (debt, deficit, inflation, interest rates, and exchange rates), political exceptions have been made, as Table 2 shows. In the year they were judged ready for EMU, only four of the current EMU members met

the debt/GDP threshold of 60 percent, with Belgium and Italy having more than twice this figure. On the exchange rate criterion, we have already seen that the rules were bent for Italy and Finland. For France and the other wide-band ERM members, the spirit of the Maastricht criteria was violated since "normal fluctuation" meant one thing to the writers of the Treaty and another thing after the 1992-1994 exchange rate crises that avoided a French devaluation or German revaluation by widening the exchange rate band.

Table 2. Historical compliance with the Maastricht criteria

	Inflation	Long term interest rates	Deficit ratio	Debt/GDP	ERM two-years membership
Austria	1.1	5.6	2.5	66.1	yes
Belgium	1.4	5.7	2.1	122.2	yes
Denmark	1.9	6.2	-0.7	65.1	yes
Finland	1.3	5.9	0.9	55.8	no
France	1.2	5.5	3.0	58.0	yes
Germany	1.4	5.6	2.7	61.3	yes
Greece	5.2	9.8	4.0	108.7	no
Ireland	1.2	6.2	-0.9	66.3	yes
Italy	1.8	6.7	2.7	121.6	no
Luxembourg	1.4	5.6	-1.7	6.7	yes
Netherlands	1.8	5.5	1.4	72.1	yes
Portugal	1.8	6.2	2.5	62.0	yes
Spain	1.8	6.3	2.6	68.8	yes
Sweden	1.9	6.5	0.8	76.6	no
UK	1.8	7.0	1.9	53.4	no
1998 reference values	2.7	7.8	3.0	60.0	
Greece (2000)	2.0	6.4	1.6	104.40	yes
2000 reference values	2.4	7.2	3.0	60.0	

The upshot of all this should be clear. Politics will determine the pace of EMU enlargement. After all, citizens of these countries view EMU membership as one of the main benefits that will come from EU accession. And as in the case of the initial EMU formation, a decision of membership based on the Maastricht criteria will be a political interpretation by a body of which the newcomers themselves are

full voting members. We turn next to considering what sort of political power the newcomers will have in the process.

1.4. Power politics and the convergence judgement

The evaluation duty falls to the Council of Ministers, acting by qualified majority with all member states voting, including those to be judged. How will the vote go? Even in the unlikely case that all current EU members (including those which are now outside the EMU) would resist early EMU enlargement, the newcomers could probably have their way. Much depends upon the size and timing of the EU enlargement. When twelve candidate nations are in, they will have 108 Council votes.[2] This is fewer than they would need to unilaterally vote themselves into EMU (a qualified majority requires 255 votes), but qualified majority voting is not the only source of power in the EU.

The EU typically operates in a very gentlemanly manner. In part, this is due to the good will of members, but more concretely, it is because each and every member has the ability to single-handedly block progress on many important issues—things like the budget, Treaty reforms and accession decisions. EU members do not use their veto power in a frivolous manner, but they have often used it to achieve ends that they felt were justified, even when this involved severe conflict with other members. The French "empty chair" policy and Prime Minister Thatcher's trenchant demands for a budget rebate are but two examples. Why should not the newcomers use a veto threat to get into EMU early?

The Estonians, Slovenians, Hungarians, Czechs, Slovaks, Latvians, Lithuanians and Poles all have made major domestic sacrifices to meet the criteria. What could they do if accession were nevertheless delayed? One can envisage all sorts of scenarios in 2005 and 2006 when the EU will be working on a new long-term budget plan ("Financial Perspective"). According to the timeline in Figure 2, this is exactly when the Council will have to vote on EMU enlargement. Is it unreasonable to suggest that that the CEECs might implicitly trade

[2] Will the new members vote as a block or not? The lack of cooperation in the process leading up to EU accession is not really a good guide to behaviour once these countries are full members. Their interests would then be much more aligned. Moreover, given that many important decisions will be taken by unanimity, including Treaty changes and important budget issues, even individual members can create problems and seriously slow down the decision-making process.

their vetoes over the budget to gain EMU membership? Another scenario involves ECB reform. If the EU fails to reform the ECB before enlargement, the CEECs will have a veto over ECB reform. They might, in this case, feel perfectly justified in threatening to veto reform unless they are assured that all the exceptions applied to the EMU's twelve current members are also applied to them.

The sort of exchange rate crises that marked the first ERM would further strengthen the argument for early EMU entry. Indeed, asking the new members to join the ERM2 and at the same time give up capital controls would expose them to speculative attacks. Moreover, anticipating the risk of having to join an ERM2 for two years, some of them may decide to jump into the euro *de facto* by following Estonia and adopting a currency board, or even unilaterally euro-ise against the wishes of the European Commission and the ECB.

2. Decision-making in a big unreformed ECB

National central bank governors will inevitably have some degree of national-perspective bias (after all, the governors sit in the Governing Council to bring diverse, real life experience to the table). The fact that the new entrants are very different economically and the Baltic States are slated to have more ECB votes than Germany and France combined poses an obvious problem. In this section, we first detail the ways in which the newcomers' economies differ as far as inflation is concerned. We then ask whether central bank governors do care about their homelands when voting. Finally, we discuss what all this would mean in an unreformed EMU with more members.

2.1. Applicant nations are different and this matters

How much macroeconomic diversity would the new members of the EU add to the monetary union? The IMF has recently computed output and inflation correlations for ten Central and Eastern European countries and Germany, and compared these numbers with the corresponding correlations within the present EMU.[3] These figures suggest that the newcomers are not too different when it comes to business cycles (as measured by *changes* in inflation and growth rates). Specifically, the growth and inflation correlations between the CEECs and Germany are not dramatically different from their correlations with

[3] World Economic Outlook (2000).

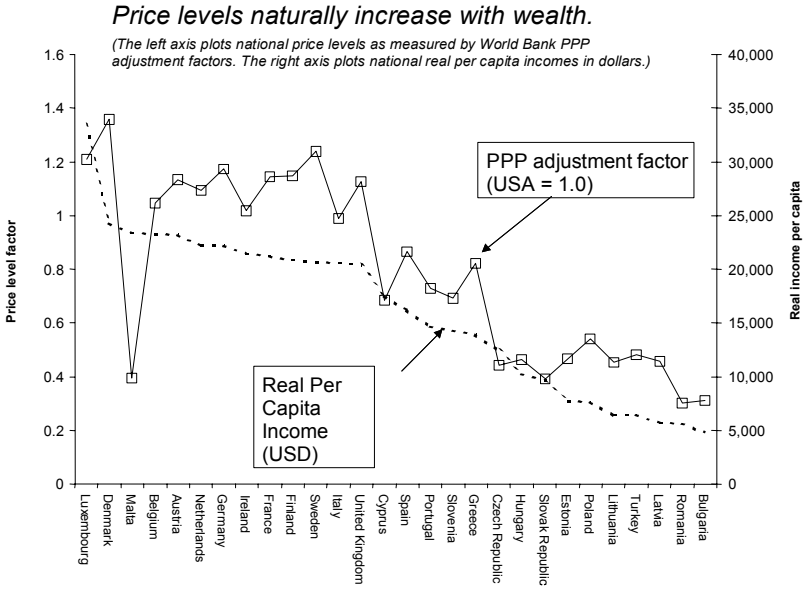
Poland. The IMF notes that the CEECs currently face somewhat different macro shocks, but note that "it is hard to predict how exposed these economies will remain to asymmetric shocks by the time they are fully integrated into the EU."

Business cycles, however, are not the only source of differences over monetary policy. The twelve applicant nations are much poorer and more agricultural than the incumbent members, and this has long-lived implications for their macroeconomic performance. In particular it means that they are likely to experience higher growth and higher inflation for decades. If all goes well, the CEECs will grow two or three times faster than the West Europeans countries for decades as they catch up with Western European productivity and thus income levels. As first suggested by Balassa and Samuelson, higher "non-monetary" inflation is a corollary of this.[4] This point is made graphically for the CEECs in Figure 4.

The Balassa-Samuelson effect is perhaps the most commonly used argument against early EMU accession for the CEEC newcomers. Is there anything the ECB could do to mitigate the problem? We argue that since this inflation in the new EMU members will be a symptom of growth, the Bank should step back, and simply let relative prices adjust. Euroland inflation would be higher, but this would have nothing to do with output exceeding potential output. This advice, however, does require a slight adjustment of the ECB's self-imposed inflation target of less than 2 percent to allow for this phenomenon.

[4] The so-called Balassa-Samuelson effect stems from the fact that poorer nations typically have lower price levels than rich nations. Although the prices of traded goods do not differ much from those in rich nations, the prices of non-traded goods, especially construction and labour-intensive services, are typically lower because wages are lower. As productivity, incomes and wages catch up, so do the non-traded goods prices. Given the initial income gap between the average applicant nation and the EU15, this catch up could take two or three decades. During these decades, the newcomers will have higher inflation rates if they attain the higher growth rates necessary to converge. Note that this inflation simply reflects rising living standards. It is very different from inflation driven by too much money chasing too few goods.

Figure 4. Structural "Balassa-Samuelson" inflation in applicant nations



Note: As CEECs' incomes catch up, they too will become high-priced European nations, and during this process they will have an inflation differential. Germany's price level is 1.17 while Poland's is 0.54 (a level of 1.0 would indicate prices, measured in dollars equal to US prices). To close the gap, Poland needs a cumulative inflation differential of 63 percentage points. Even if this were spread over 20 years, the annual Polish inflation rate would be roughly 3% higher than Germany's for purely structural reasons. As the chart shows, the Balassa-Samuelson effect seems to matter less beyond a certain level of income.
Source: The IFS dataset.

To see this, consider a very simple EMU made up of two countries, one rich and one poor, with the rich country's GDP being four times that of the poor one. Furthermore, assume that inflation is zero in the first nation, but—because of Balassa-Samuelson—it is 10 percent in the second. Using GDP weights, average inflation in this simplified EMU would be 2 percent ($0 \times 0.8 + 10 \times 0.2$). Now consider the situation facing the ECB. To keep inflation below 2 per cent, the ECB must do one of two things: force deflation in the rich country via a recession, or force poor-country growth below its long-term potential. Most likely, the application of the tools available to the ECB, viz. monetary tightening, would lead to some of both. Plainly, neither

outcome is desirable; the proper reaction to Balassa-Samuelson inflation is cautious tolerance. The aim should be to keep the GDPs growing in line with their long-run potential. This will inevitably create higher inflation in the faster growing economies. If, say, 1 percent inflation was the best policy for Euroland as we know it, a figure above 1 percent will be optimal for an Euroland that includes many fast growers. How much higher?

2.2 What should the ECB do about Balassa-Samuelson inflation?

The combined nominal GDP of the twelve new entrants is less than one twentieth of Euroland's current nominal GDP. Now if the Balassa-Samuelson effect induced an inflation gap of, say, 5 percent, the necessary increase in the Euroland inflation target would be 0.25 per cent. Given the current 0-2 percent target range the required adjustment would be very small.

Balassa-Samuelson inflation, however, poses a tougher problem—what might be called the "assignment problem." As recent experience with Ireland and Spain suggests, it is not straightforward to determine precisely the extent to which inflation is induced by healthy growth and the extent to which it is induced by an overheating economy. In the first two years of the EMU, inflation in Spain and Ireland was, respectively, 1.7 and 2.2 percent above the EMU average. In Ireland about one third of this can probably be attributed to higher productivity growth (see Alesina et al., 2001); in Spain, however, productivity growth has been below the EMU average since the start of EMU, so that excess inflation can only have come from a growth of demand in excess of the economy's potential growth in output. Still, both countries argued that their excess inflation was structural. This led to a showdown with the Ecofin Council and the ECB who were asking them to tighten fiscal policy to slow down domestic demand. Difficulties of this kind will be common in an enlarged EMU.

2.3. Do national governors vote with home conditions in mind?

The ECB was designed to be very independent, but the actual structure is not the most natural to meet this goal. Technocrats would run a completely independent central bank. Instead, the ECB's decision-making body includes members who are politically appointed in their home nations—the central bank governors. Of course, oaths are

sworn and decrees are signed stating that the governors are independent experts when sitting on the Council. A Panglossian observer would be satisfied with this; a Machiavellian observer would laugh. The truth is probably somewhere in between.

We do not know how much the votes of national central bank governors are influenced by economic conditions at home. The ECB does not publish the individual votes of Council members—and there are understandable reasons for not doing this in a body whose members are national representatives. Yet the extent to which individual votes reflect domestic conditions, rather than Euroland averages matters enormously.

What we can do is to look for evidence elsewhere. Some indirect empirical evidence is available from the US. The Fed has a structure comparable to that of the ECB, with a technocratic board and regional representatives, but the homogeneity of American states suggests that regional representatives on the Fed are less likely to have a regional perspective than would European regional representatives. The evidence is mixed, although some work has identified a home bias in the voting pattern of regional bank presidents (see, Havrilevsky and Gildea, 1992, 1995; and Tootell, 1991, 1997; for different findings). The lack of clear evidence in favour of a home bias in the US may be due to the system of rotating seats, which may affect the voting dynamics. Presidents of the district banks are also in a minority: since Board members always win the day, there is no point for Bank presidents to vote having home conditions in mind.

The relative weight of national governors in the ECB Governing Council may be an important factor in determining the outcome of the vote. Currently they are 12 out of 18. How is the dynamics of voting affected by this particular composition of the Council, and how might it change the day the Council were to enlarge? Before we turn to this issue, it is useful to note one piece of evidence on ECB decisions.

The analysis of ECB decisions during the first two years of operation of the Bank, reported in CEPR (2001), suggests that the Council may have pursued an interest rate policy more attuned to inflationary developments in three countries (France, Germany, and Austria) than to those in the Euro area as a whole. During the first few months of EMU (January to March, 1999) monetary policy was somewhat tight relative to the needs of Germany and France. With the April 1999 cut, euro interest rates moved closer to those that France and Germany

would have chosen if the Banque de France and the Bundesbank still existed and acted independently. This evidence is consistent with a Governing Council in which the prevailing majority was the result of the 6 Executive Board members joining the governors from France, Germany and Austria (remember, at the time there were 12 + 6 members in the Governing Council).

Later, however, as economic conditions in France, Germany and Austria started improving, the ECB did not raise interest rates as fast as an ECB that looked only at these three countries would have done. Thus the evidence of a regional bias in the current ECB is mixed at best.

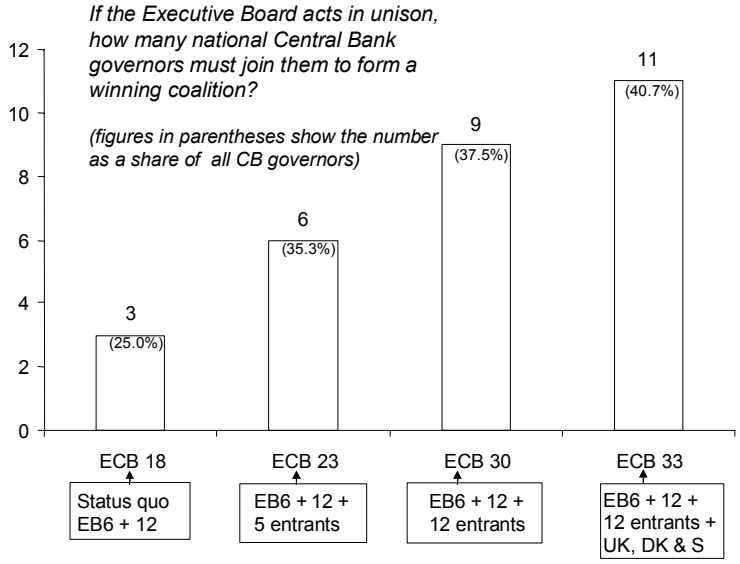
2.4. Voting in an unreformed Governing Council

Assuming that the voting rules in the Governing Council do not change, how would it function with a large number of members? Unfortunately, we know very little about how the current procedure for changing interest rates works, but we suppose that the following is not grossly at odds with actual practice. The ECB President (who chairs the Executive Board and the Council) proposes an interest rate change, and, if the proposition is contentious enough to require a vote, a simple majority of Council members is required to adopt the proposition. The Council currently includes 18 voters—6 Executive Board members and 12 Central Bank Governors—each with one vote. With this group, the simple majority rule means 9 votes are needed for the President's proposal to be adopted (the President decides in the case of a tie). Supposing that its six members act in unison, the President currently needs to find only three more votes to get his/her way. With 12 national governors at the table, it is relatively easy. Enlargement will change this.

Under current rules, the central bank governor of each new Euroland member gets a vote on the Governing Council. Figure 5 considers what decision–making would look like when five (say Estonia, Hungary, the Czech Republic, Slovenia and Poland) of the applicants are in the monetary union, when all twelve of the current applicants are in, and when all twelve applicants plus Denmark, Sweden and the UK are in. These ECB enlargements imply Governing Councils of 18, 23, 30 and 33 voters respectively. The bars in Figure 5 show how many governors would need to join the Executive Board in order to pass any particular interest rate change. Enlargement thus seriously weakens the relative power of the Executive Board. The number of

central bank governors that must be lined up almost quadruples from 3 to 11 when EMU membership rises from 12 to 33. Even as a share of the governors sitting at the table, enlargement raises the bar, from just 25 percent in the current ECB 18, to over 40 percent of them in the ECB 33. Plainly, the Executive Board will find it much harder to guide monetary policy.

Figure 5. Enlargement and the rising difficulty of ECB decision-making



Source: Authors' calculations.

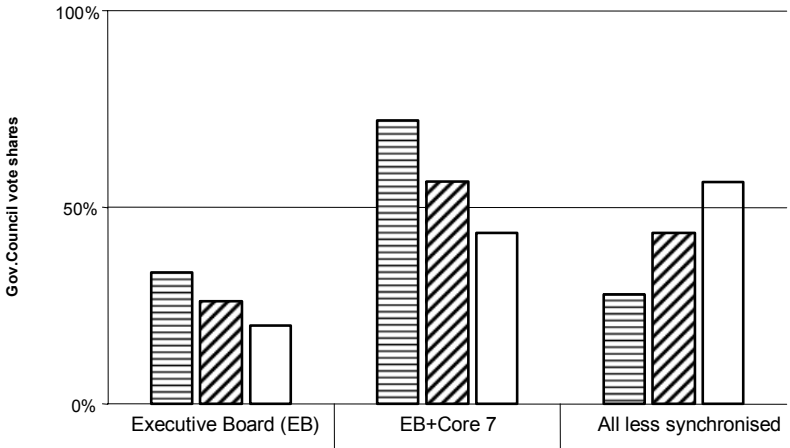
Of course, if the Governing Council attempts to make decisions by unanimity, the problem is much more severe. Getting 12 governors to agree is hard; getting 27 to agree will be very, very hard.

2.5. Hypothetical alliances in an enlarged Governing Council

Another way to make this point is to look at hypothetical coalitions that might form in the Council post-enlargement. To do this, however, we need to address the issue of the Board's and the governors' positions on monetary policy. Let us assume that the six Board members only care about Euroland inflation, i.e. that they have no national bias. Euroland inflation is the average of national inflation rates,

where the averaging uses weights that are related to the economic size of member nations (here we take GDP weights to be specific). Also for the sake of argument, let us adopt the extreme Machiavellian view that the central bank governors care only about their national inflation rates.

Figure 6. Possible coalitions in the Governing Council



	Executive Board (EB)	EB+Core 7	All less synchronised
ECB 18	33%	72%	28%
ECB 23	26%	57%	43%
ECB 30	20%	43%	57%

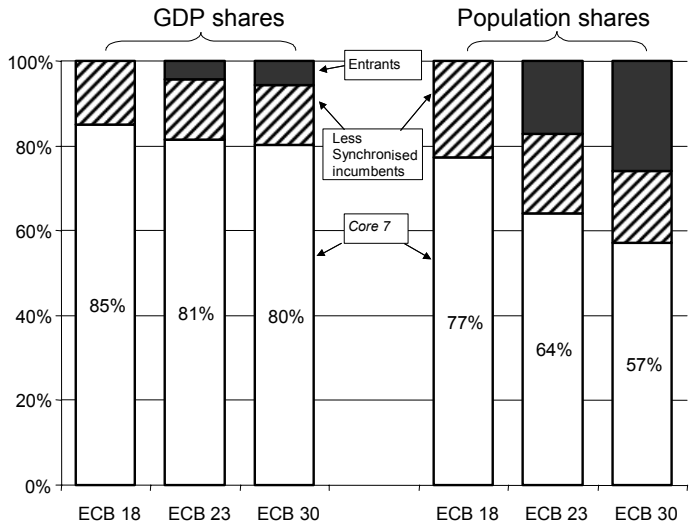
Note: The last two columns add to 100 percent. The three sets of bars are the ECB18, ECB23 and ECB30, respectively. Core 7 = Austria, Belgium, France, Germany, Italy, Luxemburg and the Netherlands. Less Synchronised = Finland, Greece, Ireland, Portugal and Spain & Entrants in ECB23 & 30
Source: Authors' calculations.

Now given that a fistful of "core" nations dominate the EU GDP (France and Germany alone account for more than half of EU GDP), the national inflation rates of these same nations also dominate the Euroland inflation average. What all this means is that the Executive Board will find natural allies among these "core" economies—even if all governors take purely national perspectives. Under this analysis, Governing Council decision-making now is relatively smooth because the Euroland average is dominated by six nations whose macroeconomies are relatively synchronised.

Now comparing Figures 6 and 7, we see that the ECB 30 would find itself in a very unhappy situation. The 16 non-core nations, who

together account for only 20 percent of the Euroland economy would have enough votes to set monetary policy for the whole area.

Figure 7. EMU GDP and population shares under current and future memberships



Source: Authors' calculations (MEI11.xls).

Again enlargement will change this. The applicant nations are now, and will remain for decades, different from the core nations when it comes to inflation and growth, as Figure 4 showed. What this means is that it will be harder for the Executive Board to get its way. The problem is that coalitions of non-core nations may have a blocking majority and thus frustrate the Board's efforts to pursue the Euroland averages.

Figure 6 shows the evolution of a blocking coalition made up of the "less synchronised" nations among EU incumbents and applicants. To be concrete, we consider enlargement in two waves and assume that all 12 entrants want to join, but the UK, Sweden and Denmark stay out. This gives us the current ECB 18 and the future ECB 23 (6 Board members plus 12 incumbent governors and 5 governors from the Czech Republic, Estonia, Hungary, Poland and Slovenia), and the ECB 30 (the ECB 23 plus the other applicants, leaving Turkey aside). Notice that the Board's voting weight shrinks significantly, from one third to one fifth, and the coalition of the Board plus the

Core-7 (Austria, Belgium, France, Germany, Italy, Luxemburg, and the Netherlands), shrinks from a dominant 72 percent to just under the critical 50 percent mark. The flip side of this coin is that the total voting weight of the "less synchronised" economies rises to over a half, enough in theory to dictate Euroland interest rates.

2.6. Status quo bias in an enlarged and unreformed ECB

The simple counting of votes, though very transparent, belies the complexity of ECB decision-making. According to informal accounts, the President, backed by the Executive Board, sets the agenda. This matters a great deal, as anyone who has tried to oppose a chairman knows. To be more specific, we consider an alternate view of the ECB decision process. This discussion is somewhat more technical, but we believe the analysis captures better how decisions are actually taken. Obviously, it does not claim to incorporate all the complexities of decision-making within the Council and the ECB

We assume that Euroland's ideal interest rate can be described on an interval that, for convenience, is normalised to be between zero and one. EMU members' ideal interest rates are uniformly distributed on the interval in the sense that while each nation knows its ideal interest rate at any moment, it also knows that its ideal rate will change in the future. For simplicity, we assume that the members believe that their ideal rate at a randomly chosen time in the future has an equal probability of laying anywhere in the interval. The Executive Board is interested in the Euroland average, so if the EMU members have correctly calculated their ideal rates, the Executive Board's ideal interest rate is a weighted average of member states' ideal interest rates. Now, probability theory tells us that since the members' ideal rates are uniformly distributed, the Executive Board's ideal policy is approximately normally distributed with the centre of the distribution on ½ (this is called the Central Limit Theorem).

Now we assume that the ECB President makes take-it-or-leave-it interest rate offers to the Governing Council and that the Board members all support the proposal. The President only proposes a rate change that he/she thinks will win the vote (i.e. attract a simple majority). While he/she would prefer to propose his/her ideal (by assumption the ideal for Euroland), the President proposes the rate that is as close as possible to this ideal and would command a majority of the votes. But if the President anticipates being unable to win a ma-

jority on this, he/she will propose something that is as close as possible to this ideal.

This set-up enables us to consider the impact of enlargement on the *status quo* bias. To this end, we first establish what would happen in the case of a completely random macroeconomic shock that disturbs the initial situation, i.e. where the *status quo* interest rate is at ½ and this is the ideal rate for Euroland. Now, suppose that there is a random shock, which shifts the weighted average of ideal interest rates to the right (by symmetry it does not make a difference whether we move to the right or left). The President controls the agenda, so he/she would never propose a lowering of the interest rate after such a shock. The key question is then: "Can the President garner enough votes to increase the interest rate towards the new ideal point for Euroland?" In the current ECB this means that he/she needs three central bank governors to support the proposal (still assuming that the members of the Executive Board votes as the President).

Since the President needs only three votes, it is quite likely that any sort of macro shock that leads to an increase in the Euroland average will entail national ideal positions such that the Executive Board can find at least three allies for its policy to increase interest rates. To look at this in another way, note that it is extremely unlikely that the ideal (i.e. Euroland weighted average) interest rate has increased, and yet ten out of the twelve central bank governors would prefer the status quo to some interest rate increase. Using actual GDP weights of the EMU 12, our simulations for the *status quo* outcome is quite low, about 4 percent. What this means is that in the current ECB, the balance of power between the Executive Board and the governors is such that the Euroland ideal rate will typically be pursued, even if the central bank governors vote along purely national lines.

What does EMU enlargement do to the *status quo* bias? In the case of the ECB 27 (using current GDP weights), our simulations show that the bias increases enormously, more than fourfold. Our simulation suggests that a big, unreformed ECB would suffer from such a bias in as much as one-sixth of its decisions.

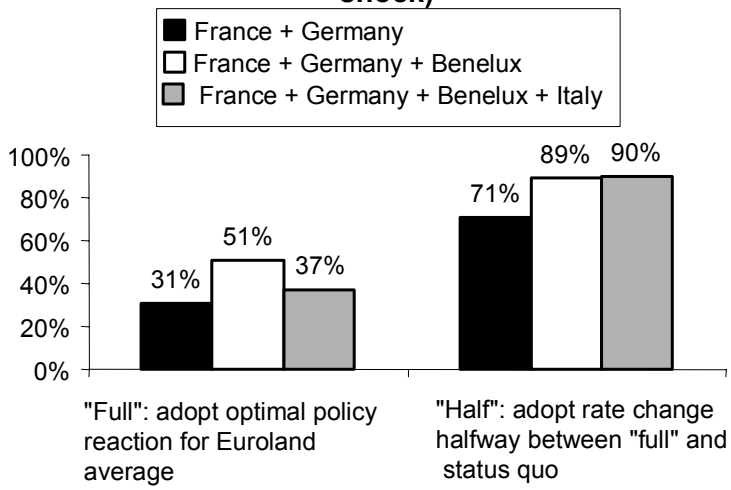
2.7. Reaction to big asymmetric shocks affecting large members

Another question is how well the ECB 27 can react to changes in the EMU-wide weighted average if there is a more specific need to react. To consider this question we study three scenarios. First, it is assumed that France and Germany are hit and their ideal policies jump to the

far right of the interval, i.e. they need a big interest rate increase. Second, it is assumed that Benelux countries follow the same pattern, and, third that also Italy joins this group. In all cases, we assume the ideal interest rates for the other EMU members are uniformly distributed on the zero-to-one range. Of course, all three shocks will raise the Euroland weighted average ideal above the initial status quo level of ½.

Again we calculate what each of these shocks does to the Euroland and Executive Board's ideal interest rate policy. And again we calculate the probability that the Board can win a vote to raise interest rates. To be more specific, however, we consider the probability that the Board would win a vote on raising the rate all the way to the Euroland ideal, and we consider the probability that it would win a proposal to raise the rate to half way between the *status quo* and the Euroland ideal.

Figure 8. How the ECB 27 would react to a shock in Euroland's core economies (passage probability and size of shock)



Source: Authors' calculations.

In Figure 8 it has been assumed that the Executive Board tries to pass the full policy reaction first in the ECB 27. The respective bars of "Full" give the passage probabilities of this proposal. It can be clearly seen that in the case of such asymmetric shocks, the ECB's capacity to act is quite limited, with the probability of passing an op-

timal policy in the ECB 27 falling close to or below half in all three scenarios. By contrast, the figures for the ECB 12 (not shown in the diagram) are quite high, exceeding 95 per cent. The bars showing the passage probabilities for a halfway policy are higher, but the main message of this figure is that the probability of passing an optimal policy in the ECB 27 may fall below one half.

2.8. Summing up

An enlarged and unreformed ECB would run into severe difficulties that would hinder its ability to make tough decisions fast and in Euroland's best interest. Enlargement would weaken the relative power of the Executive Board, the body most likely to vote with Euroland conditions in mind. Enlargement would create the opportunity for coalitions formed by non-core EMU members to win the day, and set interest rates for the whole area. Finally, enlargement might induce a status-quo bias, making it more difficult to come to a decision. In short, we have argued that the ECB will have a big "numbers problem", so ECB reform is imperative. We turn now to considering the form it should take.

3. Solutions: reform options and a recommendation

Politics and national jealousies will play a huge role in determining the ultimate solution to the ECB's 'numbers problem', and we shall address these in turn. We start, however, by considering what would, in our opinion, be the best way to manage Europe's monetary policy in a world without political constraints.

3.1. Monetary policy management in the best of all possible worlds

The perfect monetary policy keeps inflation low and stable, while simultaneously stabilising aggregate demand fluctuations, providing monetary stimulus in downturns and monetary restraint in upturns. This is a tricky business for both economic and political reasons. The economics of it is hard since the relationships between monetary policy, output, and inflation are subject to long and variable lags. One thing is clear however. A loose monetary policy stimulates output and boosts inflation, but the output boost usually comes sooner than the inflation. It is this fact that makes the politics tricky. A central bank that cares both about unemployment and inflation will try to exploit

this short-run/long-run trade-off in an attempt to reduce unemployment. A government may also be tempted to exploit this trade-off to win elections. If a monetary stimulus is timed right, the political benefit of higher output will appear before the election with the political cost of higher inflation appearing only afterwards. Of course, investors and workers are aware of these temptations, so the typical results is higher than desired inflation and a lack of central bank credibility.

There is a solution to this quandary and it is now almost universally adopted. Make sure the central bank is: (1) independent of the elected government, and (2) clearly focused on keeping inflation low and stable. Of course, this solution poses problems of its own: Legitimacy and democratic accountability are the main ones. No central bank can operate without the public's trust and here some sort of democratic accountability is essential. Yet, the balance between accountability and independence is a fine one. Ultimately, accountability means that sufficiently poor performance will lead to some sort of sanction. Without this, citizens may suspect that the central bank could drift "off mission", perhaps pursuing some pet monetary theory or favouring one particular social group. With sanctions, the citizens can rest assured that the central bank will do its job, or else. The problem is that it can be difficult to distinguish between warranted and unwarranted use of such sanctions. Indeed there is no consensus on the best form or means of control of such sanctions. Nations across the world have adopted a wide range of solutions.

An ideal monetary decision-making body would consist of experienced and highly competent individuals who are primarily concerned with keeping Euroland's inflation rate low and stable. Competency, not nationality, should be the key qualification (more on this below). This body should have enough members to provide a healthy debate and a robust representation of different points of view, but it should be small enough to make tough decisions quickly. The members should not represent elected governments; they should be independent. Yet they should be democratically accountable in the sense that in the unlikely event of extraordinarily poor performance, they would eventually face some form of sanction.

Going from the ideal to the real is the next topic.

3.2. Reform options

Looking ahead at an ECB Council comprising 30+ members, there are essentially three options for keeping the number of decision mak-

ers at a reasonable number—all of which involve a reduction in the number of central bank governors who are allowed to vote. The options are:

- rotation,
- representation,
- executive decisions.

We consider these in turn, keeping the best for last.

Rotation

Rotation means that not every central bank governor would have a right to vote at each meeting. There can be many forms of this. The main parameters are the number of central bank governors with a vote and their tenure as vote-casters.

At one extreme, there could only be a few central governors on the Governing Council, say three, with long appointments of, say five years. This would result in a small number of voters on the Governing Council and a highly stable composition. However, in an EMU with 24 members this would mean at any one time 21 central banks would be without a vote, and with perfectly even rotation, a typical central bank would have to go 35 years without its governor voting. At the other extreme, there could be many voting central bankers, say 12, with short tenures of, say six months. This would leave only 12 of the 24 central banks without a vote and no central bank would be without a vote for more than six months. Such a Governing Council, however, would have a membership that varied frequently—not something that boosts credibility and predictability—and at 18 voting members it might be at the limit of as far as decision-making expediency is concerned.

Note that non-voting central bank governors could still participate in the discussion preceding a vote, or at least be present during the discussion. Indeed, in the rapid rotation model, it would be essential for all central bankers to stay continually abreast of events and the evolving discussion. The downside of having the central bank governors participate in the discussions is, of course, that the level of the debate, and ultimately the effectiveness of the Council, may deteriorate.

Table 3. Rotation in an ECB 30: maximum number of years without a vote

	Number of governors casting votes			
	3	8	12	24
Voting-casting term: 0.5 years	3.5	1	.5	0
1 years	7	2	1	0
2 years	14	4	2	0
5 years	35	10	5	0

Note: It is assumed there are 24 central bank governors on the Governing Council.
Source: Authors' calculations.

The European Commission has a similar "numbers problem", and this was "solved" in Nice with the rotation option (actual decisions on the rotation details were postponed until the 27th member joins). The fact that this proved politically acceptable to the European Council in Nice is important since the same EU leaders will decide how to solve the ECB's numbers problem. Moreover in March 2001, ECB President Wim Duisenberg told the European Parliament (5 March 2001): "I think that the rotation model, but now I am speculating, will be the most likely outcome of that discussion [on ECB reform]." It is important to note, however, that the premise of nationality-based rotation belies the assertion that central bank governors are independent experts, not national representatives. Partial rotation is also the system adopted by the US Federal Reserve Bank (the 'Fed').[5]

[5] In the US Federal Reserve Bank the body responsible for taking monetary policy decisions, the Federal Open Market Committee, includes the seven members of the Board of Governors—a body which corresponds to the ECB Executive Board—the president of the New York Fed, and, on a rotating basis, 4 out of the remaining 11 Federal Reserve Bank presidents. The remaining 7 regional Bank presidents attend the meeting but do not cast a vote. This system guarantees that the majority always lies with the 7 members of the Board of Governors. As mentioned above, this feature may be crucial in avoiding the possibility of a regional bias in Fed decisions. One should note that the Fed model is specific to the history and the characteristics of the US. Unlike the European case, 11 out of the 12 US Federal Reserve Banks are relatively equal in terms of the size and importance of the regions they represent and this makes rotation more palatable. The permanent seat of the New York Fed is justified by the very special role that this Bank has historically occupied

Representation

Representation reduces the number of voting central bank governors by grouping central banks together and giving them only one vote per group. As with rotation, many forms of representation are possible. The main parameters are the number of groups and the grouping criteria.

One form of this solution would require the members of each group to constitute a sufficiently large fraction of the Euroland economy. Given the enormously uneven distribution of GDP among the EU 27, the five largest Euroland economies, Germany, France, Italy, Spain and Netherlands—whose GDPs each exceed 400 billion euros—could have one vote each with the remaining 7 votes divided among the smaller economies. Using current GDP figures, the Euroland GDP without the big five (assuming Sweden and Denmark join but the UK does not) divided by 7 is about 400 billion euros, so the typical group should represent approximately this amount of GDP.

Alternatively, the groups could have an equal number of members with membership determined on a geographical or other basis. Votes would then be allocated based on GDP weights. While the GDP-based group might seem to treat small members unfairly, it might actually end up giving them a greater say. For instance, if Slovakia got bundled with Germany, it would be unlikely to ever have much influence on the group's stance, but if it were part of a large group of small Central European members, its voice might on occasion be heard. It is also conceivable to combine representation with rotation. For instance, with 24 EMU members, one could envisage eight groups of three with each group's voting right rotating automatically among the three members of each group. If the vote-casting tenure were one year, each nation would find itself without a direct vote for two years.

One problem with representation is the politically daunting task of deciding on groupings and on the decision-making mechanism within groups. Representation is the system used in the IMF Board of Directors.[6] This was also the solution adopted for Bundesbank reform after

in the Fed System. The financial market is disproportionately located in New York and all open market operations are undertaken through the New York Fed.

[6] Large countries have their own Director (the US, Germany, Japan, France and the UK), while smaller countries form groups with a single Director representing each constituency. Some of these constituencies include, along with smaller countries, a

unification.[7] The solution to the German numbers problem was to merge the 16 regional banks into 9 and reduce Board members by one as well. The Council now includes the 9 regional presidents and 6 Board members. This has the merit of roughly maintaining the Board's vote share at 40 percent and limiting the number of decision makers to 15.

Executive Boards and Monetary Policy Committees

A third solution is to delegate monetary policy to a group of independent experts chosen for their competency, experience and reliability. The main parameters are the number of voters, the length of their tenure and the form of democratic accountability. This is the system adopted in many nations—though, as we have seen, not in Germany with its highly decentralised structure. Under this arrangement, monetary policy is delegated to a board, or a committee, whose composition is unrelated to the regional structure of the country. In some countries monetary policy decisions are delegated to a board that includes only full-time executives of the central bank. Elsewhere, in the UK for instance, the committee includes both executives and non-executives appointed for fixed terms.

Leaving aside politics for the moment, the delegation to experts clearly corresponds most closely to the ideal monetary decision-making body we discussed above. It would consist of experienced and competent individuals concerned mainly with keeping Euroland's inflation rate low and stable. If it had, say, 15 members, 6 in the Executive Board and 9 others, it would be large enough to represent most

few which are of relatively similar size. One, for instance, includes Belgium, Austria, the Czech Republic, Hungary, Turkey, Slovenia, the Slovak Republic, Belarus and Kazakhstan. The Executive Director for this group rotates between Belgium and Austria. Others are grouped around a relatively larger country that appoints the Executive Director. Such is the case of the group that includes Italy, Greece, Portugal, Albania and Malta.

[7] Prior to unification the Bundesbank Council included the 7 members of the Board (Direktorium) and 11 Landeszentralbanken presidents. Under the old rules, the addition of five new Länder would have boosted the Council to 23, which was viewed as being too unwieldy for serious central banking. Moreover, the extra Landesbank presidents would have seriously shifted power away from the Board. The relative weight of the Board was 39 percent of Council votes prior to unification. To maintain it at that level with one vote per Landesbank, the Board would have had to have 11 members, yielding a Council of 27, which was perceived as being clearly too big.

of the different points of view likely to arise in Euroland, but be small enough to act decisively when events call for action. The members would not represent elected governments and with non-renewable 8-year terms they would be largely insulated from political pressures. One problem though is that such a Governing Council would lack accountability (more on this below).

Table 4. Size and composition of monetary policy committees

	Size of the committee	No. of executives	No. of Treasury officials	No. of non-executive Inde-pendent experts
UK	9	5	0	4
Sweden	6	6	0	0
New Zealand	1	1	0	0
Australia	9	2	1	6
Canada	7	7	0	0

Note: The table shows the size and composition of the monetary policy committees in two European nations who are not members of EMU—the UK and Sweden—and three non-European nations—New Zealand, Australia and Canada. With the exception of New Zealand, the size of such committees varies between 6 and 9 (see Svensson, 2001, for a criticism New Zealand's arrangement). In two cases, the UK and Australia, the committee includes outside experts. In the UK case, the independent experts are a minority of voters, but in Australia they are in a majority, having 6 of the 9 votes. The Australian body also includes a Treasury official.
Source: National central bank web sites.

3.3. General problems with representation and rotation

The rotation and representation models appear to have been discussed in the ECB and so far both have come up against strong resistance. The potential loss of votes appears to have been the main stumbling block.[8] However, any objection to losing a vote on the Governing Council is a testimony to the lack of independence of the

[8] As President Duisenberg told the European Parliament (5 March 2001), "You could use rotation, which is the most likely outcome, but then immediately the question arises—would it be for any country acceptable not to take part in the decision making on monetary policy for some time? Or do you treat countries differently? These are questions which are very sensitive … Another model would be for example to form constituencies to group countries together, but then you would violate the principle of total independence of the individual participants, because a representative of a constituency would have to defend the interests of his constituency in the governing council. That would run counter to the total personal independence as it is presently formulated and experienced."

central bank governors. If, for example, the Spanish governor is absolutely independent of Spain, Spain loses nothing by not having their governor on the Council. Or does she?

Is it possible that the governors are completely independent and yet still serve a national role? The answer is yes. Under current rules the central bank governors serve one explicit and one implicit role. They are independent monetary experts, according to the law, who know a lot about the nation whose central bank they serve. They are the "ears" of their nation in this closed but hugely important decision-making body.

That is, the central bank governors are important, not only for their monetary expertise, but also since they are the Governing Council's only significant democratic accountability. Central bank governors are political appointees in each and every member state—since this appointment process is a key element of democratic accountability. Of course, under the terms of the Maastricht Treaty their advice on monetary policy must be insulated from national daily politics, but they are very clearly a way for the member state to ensure that the ECB stays on-mission; to be sure that a whistle gets blown if something starts to go terribly wrong.

To see this point, suppose that the ECB made a huge, but honest policy mistake (as happens to all decision-makers at one point or the other). Think about which of the following would be more reassuring to, say, German citizens: (i) The Bundesbank President states that he was there when the decision was made and he can testify that 'due diligence' was done; or (ii) A highly competent and experienced technocrat from a Latin nation assured the Germans that he was there when the decision was made and he could assure them that the decision-makers had "done their best." Plainly, Germans would find the first more assuring and this suggests that the presence of the central bank governors is a form of accountability.

To put it differently, a central bank governor on the ECB is both a monetary policy expert *and* a national 'listening post,' that ensures that the ECB is ultimately accountable to someone with credibility in the eyes of the various national electorates. Taking this as given, any rotation or representation scheme may undermine the credibility/accountability of the ECB in the eyes of Europe's citizens. The ECB has been amazingly effective at avoiding what might be called football-match-headlines. When the ECB failed to cut interest rates in

March 2001, we did not see the various national presses crying that this meant that their central bank governor had won or lost.

But it need not have been like this. If, for example, the governors had GDP-weighted votes and the whole vote and pre-vote debate were made public, the national presses of various euro members would have surely reported interest rate decision in 'us versus them' terms. For example, suppose there were an explicit rotation scheme that this year meant there was no Spaniard in the voting loop and the decision was to tighten when Spain's economy would have been best served by a loosening. The Spanish press might well have a field day at the expense of the ECB's good name.

3.4. A recommendation

We suggest that the preferred solution is delegation to a committee. This could coincide with 6 Executive Board members, or could also include, as in a few countries non-executive members. The main trade-off here is effectiveness versus political acceptability. In the political-acceptability extreme, the Committee could consist of 30 members thus allowing, on average, each likely EMU member to have a committee member; this, however, would fail on effectiveness grounds. In the effectiveness extreme, it would consist of the six members as in the current Executive Board. It is hard to know where the line should be drawn, but when faced with a similar problem, the Bundesbank decided on 15 members, with 6 in the Executive Board, but as Table 4 showed many nations have opted for a number between 6 and 9, and 9 strikes us as appropriate. Needless to say, there is little science in this number. For example, the current number of ECB decision makers is 18 and according to the latest research this seems to function well enough (for example, Alesina et al., 2001). Such a set-up has obvious merits.

- It limits the number of individuals responsible for taking monetary policy decisions.
- It de-nationalizes monetary policy, by removing interest rate decisions from a group controlled by national central bank governors and assigning it to individuals clearly identified with the euro area; and
- It enhances the individual accountability of Board or committee members.

What about the politics of it? If the central bank governors sit on the Governing Council in a personal capacity, and if they do not represent their countries and if they are forbidden to seek or accept instructions from any private or public body, then they are completely independent. If so, the Governing Council already is a committee of independent monetary experts. In this case, no one should object to nominating the finest experts in the world, even if he or she does not come from a Euroland member.

This misses the point made above about the governors' role in terms of accountability. Central bank governors do have some credibility in the eyes of their fellow citizens. If nothing else, they are typically viewed as eminent citizens in touch with national sensitivities. What all this goes to say is that cutting the governors out of the ECB process entirely might seriously weaken the ECB's accountability and political acceptability.

To redress this, and ensure that the full range of monetary conditions have a voice, we suggest that the views of central bank governors could still enter the process but only as information that Board or committee members use to reach their decision. The central bank governors would continue to be part of the Governing Council, but this would become, as far as monetary policy decisions are concerned, a consultative body. To mitigate the potential problem of the group being too large for meaningful debate, discussions could be restricted. The essential objective is to ensure that the governors can continue to function in the role as national "listening posts".

Selection of the committee members would be another important component of the ECB's accountability. The current process used to select Executive Board members seems to be appropriate to the task. The EU has clear supranational executive power in both competition policy and monetary policy. In the case of competition policy, the power is delegated to a committee—the Commission. Decisions are made without formal consultation with either the Council of Ministers or EU members in general. Thus the idea of delegating monetary authority to a committee does have precedence in EU practice.

3.5. Modalities: ECB deadlock and the Commission's opportunity

The ECB Governing Council has a clear incentive to move fast in proposing a change in the Statutes.[9] If it waits, it may be put in the uncomfortable position of having to respond to a proposal tabled by the Commission.[10] Although the Council of Ministers will certainly consult the ECB on whatever proposal was put forward by the Commission, and vice versa, there will be a clear first-mover advantage. The role of agenda setter can be powerful: if the Commission proposes a workable solution, opposing it would be an uphill battle for the ECB.

Could the ECB move first? The Nice Treaty requires the ECB to act unanimously in making its recommendation for such a proposal, so the incentive to move fast is not enough to produce a decision. None of the solutions outlined above (rotation, representation, executive decisions) is likely to gather unanimity among national central bank governors. As in the case of the composition of the Commission, many governors will balk at giving up the vote in the Governing Council, even temporarily, as would be necessary in a rotation system. Wim Duisenberg's view (expressed in a March 2000 testimony to the European Parliament) that "rotation in a relatively small Governing Council is the most likely outcome" is wishful thinking. Delegating monetary policy to a committee would, in essence take the vote away from *all* governors. In one way this would cause even bigger problems, but at least all the governors would be in the same boat.

This likely deadlock offers a unique opportunity to the Commission. The Commission has the incentive to table a proposal along the lines suggested by us.[11] Article 5 of the Treaty and the surprising

[9] We do not consider here the increasingly significant role of the European Parliament or the larger issue of the legitimacy and accountability of the EU-wide institutions. Clearly, the legitimacy of the ECB is at some level tied to these institutions, not least through its accountability to the European Parliament.

[10] Remember that Article 5 of the Nice Treaty specifies that the Council of Ministers can modify the voting rules of the Governing Council acting on a proposal of the ECB or the Commission; presumably it would act on whoever moves first.

[11] The independent committee solution would require a somewhat larger Treaty change than the one enabled by the Treaty of Nice. A change in Article 10.2 of the ECB statutes may not be enough to strip voting rights from the Council assigning them to the Executive Board, to say nothing of creating a new body "the monetary committee" made up of the Executive Board and several other independent ex-

agenda-setting power it gives to the Commission are unlikely to have been drawn up by chance. It was very clear to the European Council that the ECB might not be able to produce a consensus plan; hence the possibility for the Commission to step in and table a proposal. We expect that the Commission will do this rather soon.

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perts. A new drafting of Article 10.2 to this effect is likely to clash with Article 12 which can only be interpreted in the sense that the Governing Council as such is responsible for taking monetary policy decisions. However, as we have argued above, there is really nothing that stops a single-issue IGC from extending the changes to the ECB statutes beyond Article 10.2.