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The ECB in an Enlarged Monetary Union: How to Reform the Rotation Scheme

Wolfram Berger

Cottbus University of Technology

Rolf Knuetter

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The ECB in an Enlarged Monetary Union: How to Reform the Rotation Scheme

Abstract
The ECB recently announced the details of a rotation scheme for voting rights it will implement for its Governing Council as soon as the number of member states exceeds 18. However, skepticism remains regarding whether this model is appropriate to prepare the ECB for euro-zone enlargement. This study proposes, discusses, and evaluates possible amendments to this model from three perspectives (efficiency, European orientation, transparency) that deal with flexible majority voting, regrouping of countries, weighted voting, and centralised decision making. Each model improves on the rotation model in some respect, yet only a move toward more centralised decision making promises efficient, timely, and transparent decisions that avoid national biases. The widespread skepticism about the political acceptability of this approach is not shared in this paper. Instead, we note encouraging signs that a European identity is close to developing so that centralised policy making can be expected to gain more legitimacy and acceptability.

Keywords
ECB reform, rotation model, flexible majority voting, regrouping of countries, weighted voting, centralised decision making

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1. Introduction

In March 2009 the European Central Bank (ECB) decided to implement a rotation scheme for voting rights in its Governing Council to prepare for the challenges of the enlargement of the eurozone (ECB, 2009). The decision indicated this rotation scheme would be introduced as soon as the number of member countries of the European Monetary Union (EMU) exceeds 18, at which point EMU member states will be classified into two groups on the basis of a composite indicator of the countries’ financial and economic weights. The first five countries will constitute one group, while the remaining countries make up the second group. The first group will have four votes; the second group will be allocated eleven votes, independent of its total size (i.e. number of countries).

If the number of national governors reaches 22, the second step of the proposed model will launch, creating a third group and adapting the allocation of voting rights. That is, the first group will continue to be composed of the first five member states and have four votes; the second group, comprising half the remaining number of governors, will share eight voting rights; and the third group with all remaining countries will have three votes. All central bank governors always have the right to participate in the meetings and give their opinion and assessment, irrespective of whether they have the right to vote. The members of the Executive Board retain permanent voting rights.

However, it is far from clear that this approach will enable the ECB to cope with the challenges of EMU enlargement. Is this organisational change conducive to efficient monetary policy decisions, largely undistorted by national biases in a growing EMU? The ECB has already decided on this particular model, which suggests that a complete overhaul of the decision is unlikely. However, the rotation model could be amended by further organisational changes that do not demand the complete abandonment of the ECB’s model. As Berger (2006) puts it, central bank statutes are not cast in stone, especially if they prove inefficient.

Improper or belated monetary policy decisions represent a serious threat for the financial and economic stability of the eurozone. A lot is at stake when deciding on the optimal design of the ECB, so in this study we consider several proposals

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1 The rotation model was introduced in 2003, but details of the model and conditions for its implementation have been announced only recently.
for fine-tuning the ECB reform. First, we question whether the rotation model adopted by the ECB is suitable to enable efficient and transparent policymaking. In particular, we note the effect of the size of the Governing Council on performance. A larger committee has access to more resources and information, which may produce a better decision, yet common sense and academic literature both suggest large committees tend to suffer from free-riding and political bargaining, which impede timely and efficient decisions. Moreover, committees may actually polarise members and give rise to inopportune decisions (Sibert, 2006). Moreover, we also take into consideration that the efficiency of any organisational change for monetary policymaking depends heavily on its transparency. Since monetary policy is essentially about managing expectations rather than the control of overnight interest rates as argued by Woodford (2001), transparency is a prerequisite for an efficient conduct of monetary policy. Second, every reform and any measure proposed to improve the ECB reform must be conducive to fostering a European perspective among the ECB’s decision-making body. Third, political acceptability remains an important yardstick.

We argue that the ECB reform does not constitute an improvement on the status quo, in which governors of all EMU member states vote alongside the Executive Board. The reform renders the decision-making process less transparent. Fears that it may incite national representatives to follow regional instead of European considerations cannot be totally rejected. Yet the potential efficiency gains compared with the status quo seem negligible. We discuss several measures to ‘reform the reform’ (i.e. flexible majority voting, regrouping of countries, weighted voting, centralised decision making) and evaluate their potential impact on the workings of the ECB Governing Council in terms of its efficiency, European perspective and transparency. We also offer conclusions about their chances of being politically accepted.

This assessment leads us to conclude that stronger elements of centralisation should be introduced into the adopted ECB reform model to make the ECB ready for EMU enlargement. For example, the Executive Board’s decision-making weight might be increased by delegating the daily operations of monetary policy completely to it. The whole Governing Council then could meet less frequently, monitor the Executive Board, and decide on strategic questions according to the already adopted rotation scheme. Although the rotation scheme adopted by the ECB would remain in place, this amendment would enhance transparency and

3 Benassy-Quere and Turkisch (2009) analyse the impact of the rotation model on the Governing Council’s monetary policy decisions by comparing monetary policy under the rule to that under the “old” rule under the assumption that monetary policy is based on Taylor rules.
reduce tendencies for biased monetary policy decisions that reflect national interests.

The lack of political acceptability is commonly identified as the biggest obstacle to such an organisational change. We are optimistic though. First, the ratification of the Lisbon Treaty seems to indicate that the development of a European identity is underway; second, inefficient decision-making structures that prevent timely and adequate policy adjustments can exert enormous reform pressures, as other central bank reforms demonstrate. A new division of tasks between the Governing Council and the Executive Board might not be likely in the very near future. However, the first steps in this direction (e.g. higher vote share for the Executive Board, less weight for the national central bank governors) should seem less far-fetched.

The remainder of this article is organised as follows: In Section 2, we develop our criteria to evaluate the ECB’s reform model and the proposals to reform the reform. In Section 3 we briefly describe the ECB reform. In Section 4, we discuss ways to refine the reform to make it more efficient and transparent, as well as more resilient against national biases in decision making. Section 5 concludes.

2. Monetary Policy in an Enlarged Monetary Union

The ECB claims that reform would allow the Governing Council to make decisions in a timely and efficient manner, even in an enlarged eurozone (ECB, 2009). The efficiency and transparency of policymaking remains the most important yardstick to assess any reform proposal for the ECB, though decision-making reform in the Governing Council also must ensure that monetary policy in the EMU follows a European perspective and is not biased toward any national interests. We therefore evaluate the ECB reform, as well as our and other reform proposals, in light of these criteria. Before that, however, a brief introduction into the organisation and objectives of the ECB will be provided.

2.1. The European Central Bank and Monetary Policy in the Eurozone

The ECB was established on 1 June 1998 as the European institution that bears responsibility for monetary policy in the EMU, i.e. in the member countries of the European Union that have introduced the Euro as their common currency. More
specifically, decision on the preparation, conduct and implementation of the single monetary policy are taken by two bodies of the ECB, the Governing Council and the Executive Board.\(^5\) The former is the supreme decision-making body of the ECB and consists of the Executive Board and the governors of the national central banks in the euro area. The responsibility for the formulation of the single monetary policy (including decisions on key interest rates, open market operations, etc.) lies with this body that is chaired by the President of the ECB.\(^6\)

The Executive Board, which consists of the President and the Vice-President of the ECB and four other members\(^7\), prepares the meetings of the Governing Council, implements its decisions and assumes responsibility for the day-to-day management of the ECB. The national central banks in the euro area are subordinated entities. While the decision making on monetary policy lies with the ECB, the implementation and conduct of monetary policy decision taken by the ECB’s Governing Council lies in the competence of the national central banks.

To achieve its objectives the founding fathers of the ECB sought to equip it with full independence from political influence. Neither the ECB nor the NCBs, nor any member of their decision-making bodies, “are allowed to seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body” (Treaty establishing the European Community, Article 108).

In contrast to, for example, the US Federal Reserve System, the ECB only has one primary objective. The objective of the ECB is to maintain price stability, which is operationalised as keeping inflation below but close to 2 per cent. However, as long as there is no prejudice to this overriding monetary policy objective the ECB “shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community” (Treaty establishing the European Community, Article 105). In this respect, objectives of the Community include a high level of employment, sustainable and noninflationary growth, a high degree of competitiveness and convergence of economic performance.

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\(^5\) A thorough and detailed description of how monetary policy in the EMU is organised and conducted can be found in ECB (2004).

\(^6\) Other tasks of the ECB comprise the conduct of foreign exchange operations, the management of the foreign exchange reserves and the operation of payment systems.

\(^7\) The office term of the members of the Executive Board is eight years. A re-appointment is not possible.
2.2. Efficiency and Transparency

The ECB’s Governing Council currently has 23 members, 6 in the Executive Board and 17 national central bank (NCB) presidents. When all current EU members have joined the EMU and the third stage of the rotation scheme has been initiated, 33 people will meet in the Governing Council, sharing 21 voting rights. Compared with other major central banks such as the Fed in the United States, the Bank of England, and the Bank of Japan, the ECB has by far the largest decision-making committee. To Gros (2003), it looks more like a small parliament than an efficient decision-making body.

Assuming that the ECB president proposes a change in monetary policy that the other members of the Executive Board accept, and given the present composition of the ECB’s Governing Council, six additional positive votes from the NCB governors would be necessary for a simple majority of votes, because the president’s vote tips the balance (i.e. 23 members = 6 Executive Board members + 17 governors). With the launch of the rotation scheme, the number of votes will be fixed at 21, so that five more positive votes from national central bank governors would be needed in our example.

Reaching a decision on an effective proposal in a timely and efficient manner - which is the ECB’s stated reform objective - will not become easier under the rotation scheme compared with the pre-reform situation, especially considering that the ECB Governing Council prefers to make decisions by consensus.

The size of the committee matters, as most economists would agree (e.g., Blinder and Morgan, 2005; Meade, 2003; Sibert, 2006). However, there is no simple relationship between committee size and the quality and efficiency of monetary policy decisions. Overwhelming evidence indicates that full centralisation of decision-making power in a single person is not optimal (e.g. Sibert, 2006), though this scenario also occurs in reality (Bank of Israel, Reserve Bank of New Zealand).8 The critical question is how and why the performance of a committee depends on its size.

In the past decade, many central banks have moved to monetary policymaking by committee, a move widely endorsed by economic theory. Many articles show, whether theoretically or experimentally, that monetary policymaking by committee is superior to centralisation in a single decision maker.9 The famous

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8 Although the governors have sole authority to make decisions, they are advised by committees.
Condorcet jury theorem implies that multimember committees are better suited for decision making because they have access to more resources, can pool information, and cooperate in their information processing and evaluation (Gerling et al., 2005). This capability is especially relevant for monetary policymaking, because individual knowledge about transmission channels and the state of the economy is invariably incomplete. This view has been corroborated by experimental results too (Blinder and Morgan, 2005; Lombardelli, Proudman, and Talbot, 2005). Moreover, as Sibert (2006, p. 16) remarks, monetary policymaking has elements of a “disjunctive task”, that is, a task for which an exceptionally competent group member could have a more than proportionate influence on the group’s overall performance. Increasing group size increases the probability of finding such a member.

Another beneficial element of committees may be overstated though. Blinder (1998) and Waller (2002) both argue that committees tend to moderate the more extreme views of single members, because the extreme views have little chance of prevailing in the face of group compromises. Yet recent research suggests committees may have exactly the opposite effect (Sibert, 2006); members grow polarised and opt for extreme solutions. Conformity norms and fears of being regarded as a group deviant exert so much pressure on individual group members that their initially moderate views develop into rather extreme positions through reinforcement and repetition.

Despite the clear benefits to monetary policy of decision making by committee, these benefits do not increase concomitant with group size. Rather, persuasive arguments suggest decision-making costs increase with group size, such that they eventually offset the beneficial effects of increasing committee size further. Free-riding and shirking typically increase as the decision-making body grows larger, which implies the need for an upper limit on any group size from an efficiency point of view (Sibert, 2006). People behave differently for a group decision compared with an individual decision. Every committee member likely agrees that the committee should be well informed, which means having access to sufficient, timely, high-quality information. However, because information collection and processing is costly and information is a public good in a committee, it may be optimal for each individual group member to shirk the information-gathering effort and choose to free ride. In turn, withholding and varying levels of effort are

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10 This characterisation of monetary policy suffers from the possibility of classifying a solution as best only after the fact. When the decision must be made, the “best” solution is rarely clear to all the committee members. However, over time, greater expertise should lead to a greater influence of these committee members in the decision making.
common practices. Overall, we establish that group performance does not increase in parallel with the capabilities and competence of its members.\(^{11}\)

In addition, Berger (2002, p. 9; 2006, p. 211) points out that larger committees spend considerably more time “sounding out” various members before proceeding to actual decision making. For the same reason, a large decision-making body implies greater decision-making costs, particularly if a consensus-based approach is preferred, such as for the ECB and the Fed (see Blinder, 2006). Compelling evidence thus indicates that the benefits of enlarging a decision-making body are U-shaped. The crucial question, of course, is when the costs start to outweigh the benefits. That is, what is the optimal committee size? Not surprisingly, opinions on the answer diverge; Sibert (2006) argues strongly that the optimal committee size is five, whereas other researchers consider a committee twice as large still efficient in terms of policymaking (Berger 2006; Lybeck and Morris, 2004).

We follow Goodfriend (2005), who suggests there is no single size that is optimal for all countries (see also Berger, Nitsch, and Lybek, 2008). Yet the (future) ECB Governing Council, with its 21 voting members, appears far too large from any efficiency perspective,\(^{12}\) and a substantial size reduction seems in order.

In addition to its size and composition, the efficiency of any organisational change for monetary policymaking depends heavily on transparency. To avoid jeopardising the credibility of the ECB and common monetary policy, the decisions and their underlying procedures must be transparent and minimally complex. Expectation formation in the market will thus be facilitated, which is key for effective monetary policy decisions. Transparency therefore provides an important yardstick to assess the quality of any reform proposal.

2.3. The European Perspective

Any reform proposal should be assessed with regard to whether it is conducive to a common monetary policy or instead leads to a strengthening of national interests. A stronger representation of regional interests likely causes inefficiencies and a dilution of the European perspective in policymaking. Even if

\(^{11}\) Clear and easy to monitor objectives, as well as the publication of individual votes, are possible measures to counteract these tendencies. The goal must be to increase the accountability of every committee member.

\(^{12}\) With its 22 current members, the ECB Governing Council is the largest monetary policy committee in the industrialized world. The decision-making body of the Bundesbank, the Zentralbankrat, was reduced in size because it considered more than 20 members too many.
we were to disregard divergent degrees of inflation aversion (e.g. de Grauwe, 2002) and different monetary policy transmission mechanisms across current and future EMU member countries, varying national preferences regarding monetary policy may result from idiosyncratic shocks that are not perfectly correlated across the eurozone member countries.

Divergent business cycle developments already exist across the current EMU member countries. If we consider a core of countries such as France, Germany, and the Benelux nations and a periphery of, say, Portugal and Greece, the ‘core’ group represents a rather homogenous entity, but the comparison between the ‘core’ and the ‘periphery’ paints a different picture (see Fidrmuc and Korhonen, 2004). Whether the business cycles among member countries start to correlate after their EMU entry seems particularly relevant in light of the number of countries that plan to introduce the Euro in the near to medium-term future. Most studies find an element of endogeneity in the fulfillment of the Optimal Currency Area (OCA) criteria (see Belke and Heine, 2007; Fidrmuc and Korhonen, 2004, 2006; Goncalves, Rodrigues and Soares, 2009). According to this popular view, correlated business cycles are a consequence of rather than a prerequisite for economic integration.

However, these studies also indicate that an overly optimistic view about the tendency for endogenous business cycle synchronisation is not warranted. Substantial differences mark central and eastern European countries. On the one hand, countries such as Hungary, Poland, and (EMU member) Slovenia display increasingly synchronous business cycles with other current EMU members. On the other hand, countries such as Slovakia (which recently joined the EMU) and Lithuania lack convergence. Artis, Fidrmuc, and Scharler (2008) conclude that synchronising and desynchronising factors, including varying labor market institution and regulations, would work in concert in an enlarged EMU. Furthermore, even if some countries exhibit an increasing degree of convergence with current EMU members, the extent of synchronisation typically matches that of smaller, peripheral current EMU members, and substantial diversity remains between ‘core’ and ‘peripheral’ EMU countries.

Prior literature therefore indicates that, despite possible declines, business cycle asymmetries and economic heterogeneity will persist, at least for the subset of central and eastern European countries. Because the ECB relies on the ‘one member, one vote’ principle, it seems wise to consider the possibility of national rather than European preferences by some countries. Heinemann and Huefner
(2004) also offer empirical evidence that regional differences in the EMU affect monetary policy.\textsuperscript{13}

This tendency is particularly worrisome if the economic and political weight within the ECB Governing Council deviates substantially.\textsuperscript{14} Currently, the ‘one member, one vote’ principle causes smaller countries to be overrepresented, while bigger countries suffer from a sub-optimally reduced political weight. This misrepresentation problem will be somewhat moderated but still not solved by the proposed rotation. Only if the weight of the vote that a national central bank governor casts perfectly matches the economic size of that represented country can the committee decision accurately replicate the decision of a single policymaker concerned solely with area-aggregated data. A misrepresentation of economic size creates the possibility that, in certain circumstances and depending on the rotation rhythm, decisions for the whole EMU would be pushed through the monetary policy committee by a group of member countries that does not represent a majority in terms of either economic or population size.

Berger (2006) calculates an index of misrepresentation, equal to the sum of the squared difference between regional vote shares in the monetary policy committee and relative economic size in a given year for the ECB. This index allows for a comparison with two other federal central banks, the U.S. Fed and the German Bundesbank. The extent of economic size misrepresentation in the ECB is already extreme; it will stay at a level unmatched by other central banks, even with the rotation scheme.

3. The ECB Reform

On March 19, 2009, the ECB Governing Council decided on the implementation of a rotation scheme for voting rights in the Governing Council (ECB, 2009). This scheme is based on a proposal of the Governing Council that was adopted by the

\textsuperscript{13} Empirical studies show that economic policy decisions on the federal level are influenced by regional considerations (e.g., Meade and Sheets 2005, 2006, regarding the U.S. Fed). Regional affiliations likely are stronger for EMU countries than for Fed districts; however, as long as the ECB does not publish information about individual voting behaviors, the question of whether members of the ECB Governing Council follow their national interests or act in the interest of the whole EMU will continue to be debated.

\textsuperscript{14} The ECB usually downplays the problem of political misrepresentation by pointing out that members of the Governing Council do not act as national representatives (\textit{ad personam} members) and that it follows a consensus-based approach without formal voting. However, the allocation of votes to groups of NCB presidents indicates that the ECB understands this approach likely is not sustainable when more countries enter the EMU and participate in meetings.
European Council on March 12, 2003 (ECB, 2003). The main features of the proposal are as follows:

- If the number of NCB presidents is greater than 18, a rotation system will be introduced for NCB presidents, limiting the total number of votes allocated to them to 15. In all, 21 votes then will be cast in the ECB Governing Council (6 members of the Executive Board with 1 vote each + 15 votes by NCB representatives).\textsuperscript{15}

- The NCB presidents will be divided into groups according to the position of their countries, which is based on the so-called composite indicator index. Countries’ gross domestic product enter this indicator with a weight of 5/6 and 1/6 of the indicator weight is allocated to the share of the aggregated balance sheet of their monetary financial institutes.

- The rotation system will be launched in two steps: When the 19th member state joins the EMU, two groups will be created. The first group consists of the NCB presidents of the five largest countries (with 4 voting rights). The remaining NCB presidents form the second group with 11 votes. However, the NCB presidents of the first group may not have fewer (relative) voting rights than the NCB presidents of the second group. When the 22nd member state joins, a third group will be created. The first group will still contain the five largest countries (with 4 voting rights), according to the composite indicator; the second group will assemble half of all member countries according to their country ranking (with 8 voting rights); and the third group will consist of the remaining (small) countries (with 3 voting rights). As Figure 1 shows, if there were 27 members, the voting frequency in the first group would be 80 per cent, that in the second group 57 per cent, and that in the third group 38 per cent. However, all NCB presidents are allowed to take part in the meetings of the Governing Council.\textsuperscript{16}

\textsuperscript{15} Belke and Styczynska (2006) analyse the allocation of power in the ECB Governing Council as it increases in size to accommodate new EMU members.

\textsuperscript{16} Further information about the rotation scheme, including the rotation period (one month), rotation rate, and other details, can be found in ECB (2009).
Figure 1: Voting Rights of Groups, Depending on the Size of the Governing Council

Source: ECB (2003), (2009) and own construction.

Does this reform help the ECB live up to its aspiration to create an organisational structure that allows for timely and efficient decision making, even in the enlarged eurozone? Regarding efficiency and timeliness, skepticism seems at order. As we noted previously, the effect of the rotation scheme, compared with the pre-reform situation, will be negligible. No other central bank in advanced economies relies on such a large decision-making body; the next largest decision-making group is the Federal Open Market Committee (FOMC), with ‘only’ 12 members.

By introducing the rotation model, the ECB implicitly accepts the national orientation of NCB presidents. Moreover, despite its claims to the contrary, the ‘one member, one vote’ principle gets substantially diluted by the rotation model. Even if everyone allowed to vote has only one vote, the rotation scheme makes it inevitable that not all NCB governors who participate in Governing Council meetings will vote. In addition, the details of the rotation mechanism and the number of votes allocated to each group differ across the groups of national representatives. The original ‘one member, one vote’ idea thus becomes one member (who is allowed to vote), one vote (with varying frequency across groups).

17 NCB presidents likely will recognise that their European influence depends on their origin, rather than their competence, which may encourage national behavior.
However, we also acknowledge that the widely criticised ECB reform offers a first step in the consideration of economic size in voting. Even if it is insufficient from an efficiency point of view, it may slightly moderate the potentially negative impact of the rotation scheme on the European orientation of the Governing Council. Yet the ECB reform is clearly and unavoidably a step back in terms of transparency. The rotation scheme is too complicated and not sufficiently transparent. A simple and clear decision-making process is critical for broad support in the EMU and eventually for the credibility of the ECB.

4. How to Improve the ECB Model

The ECB reform leads to an improvement only in terms of efficiency compared with the pre-reform situation, and even the extent of that improvement must be qualified as marginal at best. The ECB reform thus seems to create more problems than it solves. So the obvious question becomes how to amend the model without overthrowing it completely (see Table 1 in the Appendix for an overview).

4.1. Grouping Member Countries into Districts

Heisenberg (2003) considers transparency the key means for democratic legitimacy, which the current ECB reform lacks.18 The reform model chosen should depend on the level of transparency about internal decision making that the ECB is willing to offer. The rotation model, coupled with the ECB’s refusal to publish minutes, “create[s] an incompatible institutional framework from a democratic accountability standpoint” (Heisenberg 2003, p. 415).19

Therefore, Heisenberg (2003) suggests grouping countries into homogenous ‘districts’, along the lines of the U.S. Fed or German Bundesbank, such that each district casts one vote. This solution could enhance the democratic legitimacy of the ECB and its policy decisions, because every citizen in the eurozone would feel represented. Although Heisenberg does not specify the number of districts to be created, which makes it difficult to judge the regrouping in efficiency terms, democratic legitimacy sets an upper limit on the geographical or population size

18 For example, prior to now, the ECB has always refused to publish any minutes of its meetings.
19 Allowing only some national representatives to vote requires confidence on the part of the public in non-voting countries that votes will not be biased toward national interests, possibly to the detriment of the non-voting country’s economy. This confidence can be achieved only if the discussions and voting by the decision-making body are made public.
of such districts. An overly strong dilution of a country’s vote, and thus the representation of its citizens, would need to be avoided. From an efficiency point of view, this model might not solve the number problem if it still aims to respect democratic legitimacy.

Moreover, the regrouping of countries into districts may incite NCB presidents to focus more on national data rather than encouraging a European orientation. However, the regrouping of countries into groups of similar economic weight would help alleviate the misrepresentation problem inherent to the rotation model, thus contributing to a monetary policy that matches that achieved by a single policymaker focused on euro-zone data.

The Heisenberg proposal suggests something like ECB districts, and it would require a complete overhaul of the rotation reform, which is unlikely. Even though this proposal would improve transparency and democratic legitimacy compared with the complicated rotation model, its chances of implementation seem marginal.

4.2. Flexible Majority Rules

Gersbach and Pachl (2009) instead propose flexible majority rules as a means to increase decision-making efficiency by committees and foster a European monetary policy. They argue that simple majority rules (50 per cent plus one vote) lead to an inefficient provision of public goods, or in this case an inefficient interest rate reaction to (potentially) asymmetric shocks. With flexible majority rules, the size of the majority needed to implement an interest rate change is linked positively to the interest rate change itself. Small variations in the interest rate require a comparatively small share of all votes (possibly less than 50 per cent) for adoption. Imagine a regional shock that only affects a small subset of countries. The NCB governors of these countries could mitigate its economic consequences by voting for a small interest rate change, without the consent and approval of the other members of the ECB’s Governing Council. Significant changes must be approved by a significant majority, perhaps far above a simple majority. Truly significant interest rate changes would require larger majorities, possible only if many countries are hit by the same shock and thus favor the same policy. Total unanimity may even be required in particular cases. Gersbach and Pachl (2009) show that voting according to such a flexible majority rule leads to welfare-superior outcomes compared with simply majority rules.

The adoption of flexible majority rules would lower the communication and coordination costs associated with small interest rate adjustments. The tendency to ‘sound each other out’ also would abate, as long as the consequences of the shocks were narrowly confined. However, the problem of an overly large decision-making body is not addressed with this proposal. Even if a minority of votes is enough to adopt an interest rate change, all members of the Governing Council still would participate in the discussion and voting. Moreover, an unambiguous identification and distinction of regional or area-wide shocks is hardly straightforward in practice. Therefore, from an efficiency point of view, a flexible voting scheme (or any similar voting scheme that does not substantially reduce the number of decision makers) cannot make the ECB ready for EMU enlargement.

The model developed by Gersbach and Pachl (2009) implies that the common monetary policy in the EMU could lead to better outcomes. The model also implies that regional considerations would affect monetary policy in the EMU to an extent that corresponds with their overall meaning for the EMU. However, this influence is not unwanted but rather desired and necessary from a European point of view.

Integrating flexible majority voting into the adopted ECB reform need not be associated with a (further) loss of transparency, if the majority requirements were linked to normalised interest rate changes (e.g., 25, 50, 75 basis points), according to a simple step function. The step function could be reviewed and revised every time a new member state enters the EMU. Thus, the biggest obstacle to a majority voting system in practice seems to be its modest chances of implementation in the short and medium terms. The scheme runs counter to the experience and organisational principles in all current and future EMU member countries and has not been used by any major institution, to the best of our knowledge.

4.3. Reduction in Misrepresentation

Another way to ‘reform the reform’ would be to change the weighting of votes that underlie the rotation scheme to align the political and economic weights in the ECB Governing Council. As we argued previously, the misrepresentation of economic and population size in the Governing Council far exceeds that in other federal central banks (though some theoretical work shows that a certain degree of over- or underrepresentation can be optimal). Empirical evidence also strongly

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21 Benigno (2004) demonstrates that a bias toward countries with higher degrees of nominal rigidity can be optimal. Gros and Hefeker (2002) argue that as long as there are substantial
suggests a regional bias among national representatives, which makes it hard to reconcile the extent of economic and population size misrepresentation with a truly European perspective.

An obvious way to synchronise these weights would be to alter the number of votes allocated to the groups of NCB governors. However, this revision would need to change not only the balance across the different groups of national representatives but also the relative share of votes given to the national governors and the Executive Board. Strengthening the Executive Board should help reduce the impact of regional biases on monetary policy, though it does not address the problem of aligning economic and political weights for regional representatives. This approach should result in a weighted voting scheme. To account for economic size, the votes could be weighted by a country’s share of the EMU GDP. A role model for this approach is the decision-making process adopted by the Council of Ministers (‘qualified majority rule’). The number of votes cast by the national representatives of the member countries depends on the member countries’ economic and population size and ranges from two (Luxembourg) to ten (France, Germany, Italy, and the United Kingdom).

From an efficiency point of view, however, changing the voting weights across all groups would not improve on the ECB reform because the ‘number problem’ persists. However, the common monetary policy would benefit, because a perfect representation of economic weight in the Governing Council avoids regional biases and favors a truly European perspective.

This model also violates the one member, one vote principle that is sacrosanct for the ECB. Therefore, it may be difficult to find sufficient political support for such a reform. By the same token, however, the current rotation scheme is not fully innocuous with respect to this principle, as discussed previously.

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22 An adaptation of the composite indicator according to grouped member countries might also help alleviate the misrepresentation problem. Including financial market size in this indicator has prompted serious criticism though, because it would be biased toward countries with a large banking sector (e.g. Meade, 2003). However, a fully GDP-based indicator would have only marginal effects on the country ranking (i.e. Luxembourg would move down).

23 See Article 9 C of the Treaty of the European Union.
A weighted voting model could be implemented without impairing transparency compared with the status quo. The application of weighted voting (‘qualified majority rules’) in the Council of Ministers should also help allay fears and raise its chances of being politically acceptable. Moreover, weighted voting already has been applied to some decisions by the ECB Governing Council; namely, those taken under Article 10.3 of the Statute of the European System of Central Banks (ESCB) [see ECB, 2009].

4.4. Strengthening the Executive Board

Redefining the division of labor among the six permanent members of the Governing Council, the Executive Board, and the rotating NCB presidents could correct some of the more serious flaws of the rotation model. The basic idea is to let the Executive Board decide on day-to-day monetary policy operations, such as interest rate adjustments, while the entire Governing Council provides a platform for exchanging views about the Euro and takes charge of strategic decisions, such as the overall monetary policy or the policy instruments. All issues related to the implementation of monetary policy decisions would be debated under the Governing Council’s authority, which includes the NCB governors. Moreover, it would be the task of the Governing Council to monitor the Executive Board. Thus, the Governing Council could meet less frequently.

This model would not require the ECB to abandon its rotation model; rather, the Governing Council would delegate daily operations of monetary policy to the Executive Board, without giving up any of its overall responsibility. The overarching power would continue to lie with the Governing Council, and the Executive Board would enjoy a certain degree of discretion. A full delegation of decision-making power to a committee of apolitical experts is explicitly not advocated, for legitimacy and accountability reasons (e.g. Heisenberg, 2003).

With a small body in charge of the daily operations of monetary policy, this reform responds to the main criticism of the rotation model. This organisational structure would enable the ECB to live up to its self-proclaimed objective to make decisions in a timely and efficient manner, even after the EMU enlargement. Furthermore, decision making in the ECB would improve considerably in terms of transparency compared with the pure rotation model.

24 A similar idea has been presented by Gros (2003) and CEPS (2002). Similar considerations also can be found in European Parliament (2003).
25 For a different opinion, see Baldwin et al. (2001). The monetary policy committee of the Bank of England consists of four external members who are appointed directly by the Chancellor.
Although members of the Executive Board might take a national perspective (see Meade and Sheets, 2005), the European perspective of the monetary policy committee could be secured through its more centralised approach to policymaking. The process of nomination would help ensure a balance of interests across EMU member countries and the selection of experts with a European identity (i.e. heads of government must agree unanimously).

The biggest obstacle to implementing this more centralised decision-making structure in the ECB seems to be its obvious contrast with the federal character of the ECB. Smaller EMU member countries that currently enjoy overrepresentation should be expected to object to this redefinition of the prerogatives of the Executive Board and the Governing Council. However, this view of the likely political acceptance of stronger centralisation in the ECB is debatable; it hinges on the assumption that a European identity in the EMU member countries is not present or at least is underdeveloped. This perception certainly held true when the Euro was first introduced, as well as when the ECB opted for the rotation model in 2003; it is questionable if it persists today. The adoption of the Lisbon Treaty in all EU member countries (despite the complicated ratification process in some countries) and the acceptance of more qualified majority voting system for the Council of Ministers both signal progress in the development of a European identity.

5. Discussion

Given the number problem inherent to ECB decision making under the rotation model and the discrepancy between political and economic weights, a new division of tasks between the Executive Board and the Governing Council goes farthest in terms of reforming the reform in a way that still allows the ECB to reach its objectives. None of the other models is able to provide for efficient decision making while simultaneously ensuring an EMU-wide perspective by the decision-making body.

The practical implementation of more centralised policymaking could follow a step-by-step approach. Before introducing the new division of tasks formally, the ECB could adapt the allocation of votes to the different groups in the Governing Council (i.e. Executive Board plus the two or three groups of NCB governors). A greater share of votes for the Executive Board would not solve the number problem but instead strengthen its position in the Governing Council further.

26 The Lisbon Treaty entered into force on December 1, 2009.
Coupled with a move away from the consensus-based approach toward formal voting on policy propositions, this approach could prepare the way for a formal introduction of more centralised decision making.

Two arguments usually arise in response to centralised decision making. First, the information accuracy available for monetary policy decisions could deteriorate (Berger, 2006) and, second, the political legitimacy and accountability of the ECB may suffer to the point that its independence is questioned (Servais, 2005). Both points are, at least, debatable. The timely provision of accurate data is inevitable for the formulation of monetary policy. Because national central banks have stronger regional anchors than the ECB, they are in a better position to provide national data. However, even if information must be aggregated from the regional level, it is not obvious why the flow of relevant, timely, accurate information should be subject to serious barriers. Moreover, NCB presidents would still be members of the Governing Council, able to provide additional information to the Executive Board if it is necessary from a European perspective.

The legitimacy gap that many observers attribute to a more centralised ECB presupposes that a European identity in the EMU member countries exists in weak form at best, as we noted previously. Not only do signs suggest that a change in attitude is underway, but the Executive Board would be monitored and controlled by the Governing Council, so the accountability of the ECB and its legitimacy should not be seriously affected. We might also argue that the ECB, with a more centralised decision-making structure, could become more resilient to political pressure, because the far-reaching rules of European treaties and the ECB statute would apply to all members of the decision-making body, which is responsible for the day-to-day management of monetary policy.\(^{27}\)

All the proposals summarised herein could improve the ECB’s decision-making structure but can also be criticised for their apparently minimal chances of being implemented in practice. We therefore stress the need to consider enhancements to a sense of European identity, even if the process is admittedly fragile.

The majority of the Central and Eastern European Countries (CEEC) will not likely join the EMU before 2015 (Backé, 2009, see also Table 2 in the Appendix). As stressed regularly by the ECB, there will be no ‘speed-up’ in the entry process; it is still necessary to achieve a sustainable level of convergence and take part in the exchange rate mechanism II (ERM II) for at least two years (Tumpel-Gugerell, 2009a). Moreover, because the recent financial crisis has had negative

\(^{27}\) See Article 127-133 of the Treaty on the Functioning of the European Union and the Statute of the ESCB and the ECB.
impacts on most of the accession countries, Euro adoption may have moved farther into the future (Tumpel-Gugerell, 2009b). By the time the rotation system is implemented, the development of a European identity may have reached a level that makes a centralised approach to monetary policymaking politically acceptable. This view is well supported by developments in other fields of European integration (e.g. Lisbon Treaty).

Moreover, Berger (2006, p. 227) anticipates that efficiency requirements will exert pressure on the ECB, such that “there is little reason to expect that any central bank statute is cast in stone especially when potential inefficiencies are looming.” The reforms of the U.S. Fed and the German Bundesbank offer clear proof that organisational dynamics emerge if the efficiency of monetary policymaking is at stake. Therefore, a further, albeit slow, move of the ECB toward more centralised decision making seems at least possible in the future.

6. Conclusion

Any change in the ECB Governing Council decision-making process should increase efficiency compared with the pre-reform situation and reduce or even eliminate national biases. However, the number problem is far from being solved by the rotation model that the ECB plans to launch as soon as a 19th country enters EMU. It will continue to be a serious threat to the efficiency of monetary policy decisions in the eurozone. The rotation model cannot solve the problem of the serious wedge between the political and economic weight for most member countries either.

With these considerations in mind, how might the reform adopted by the ECB be improved in light of its obvious drawbacks? We explicitly acknowledge that the adoption of a completely new model must be ruled out for political reasons; more realistically, we focus on how to fine-tune the existing ECB reform. The proposals we discuss all have the potential to align member countries’ economic and political weights better, but only a more centralised decision-making structure also reduces the size of the decision-making body to lead to the necessary efficiency gains. Flexible majority voting, regrouping countries into districts, and reducing misrepresentation through new vote allocations are clearly inferior in this respect. Yet we do not advocate the total centralisation of monetary policy to a committee of apolitical experts. Rather, we suggest a redefinition of tasks for the Governing Council and the Executive Board within the rotation model.
An abrupt move toward more centralised decision making by the ECB cannot be expected in the near future. However, we are less skeptical than the conventional wisdom about its political acceptability and eventual implementation. A European identity seems to be growing in many EMU member countries, preparing the ground for a more centralised approach. Moreover, the history of central bank reforms has shown that inefficiencies and unsuitable decision-making structures that result in less-than-optimal monetary policies create significant pressure for reform. In the meantime, the first steps in this direction could include a reduction of the regional weight through a decrease in the governors’ vote share, in favor of the Executive Board.
Appendix

Table 1: Alternative Reform Proposals

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Efficiency</td>
</tr>
<tr>
<td>Regrouping (medium (size problem could be alleviated))</td>
<td>high</td>
</tr>
<tr>
<td>Flexible majority rules (low (size problem persists))</td>
<td>high</td>
</tr>
<tr>
<td>Reduction in misrepresentation (weighted voting) (low (size problem persists))</td>
<td>high</td>
</tr>
<tr>
<td>Strengthening the Executive Board (high)</td>
<td>high</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations

Table 2: CESEE 7: Current Exchange Rate Regimes, ERM II, and Euro Adoption Plans

<table>
<thead>
<tr>
<th>Country</th>
<th>Exchange rate regime</th>
<th>ERM II: Actual or planned date of entry</th>
<th>Target date for Euro adoption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lithuania</td>
<td>Euro-based currency board</td>
<td>June 28, 2004</td>
<td>As soon as criteria are met (2013 at the earliest, according to EDP deadline)</td>
</tr>
<tr>
<td>Latvia</td>
<td>Peg to Euro, unilateral ± 1% band</td>
<td>May 2, 2005</td>
<td>As soon as criteria are met (2014 at the earliest, according to EDP deadline)</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Euro-based currency board</td>
<td>As soon as possible</td>
<td>As soon as possible</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Managed float, inflation targeting</td>
<td>2.5 years before Euro adoption</td>
<td>Currently no target date</td>
</tr>
<tr>
<td>Hungary</td>
<td>Managed float, inflation targeting</td>
<td>Not specified</td>
<td>Currently no target date (2013 at the earliest, according to EDP deadline)</td>
</tr>
<tr>
<td>Poland</td>
<td>Float, inflation targeting</td>
<td>Not specified</td>
<td>2015 (expected)</td>
</tr>
<tr>
<td>Romania</td>
<td>Managed float, inflation targeting</td>
<td>2012</td>
<td>2015 (in line with EDP deadline, i.e. not before 2013)</td>
</tr>
</tbody>
</table>

Notes: CESEE=Central, Eastern and Southeastern European; EDP=excessive deficit procedure; ERM=exchange rate mechanism.
Source: Backé (2009) and own comments
References


