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Comment on Baldwin, Berglöf, Giavazzi and Widgren: Eastern enlargement and ECB reform

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The authors have produced a timely and thoughtful paper on where EMU might proceed after enlargement. They have focused on the monetary arm of EMU and the decision-making process within the ECB. Their arguments in short are that

- there is a historical bias in short-cutting the treaty provisions;
- thus EMU may well encompass 25 member states as early as mid-2005;
- this will make monetary policy more inflexible;
- which is detrimental to Eurozone policy efficiency;
- and that only an Executive-Board-led monetary policy, thus devoid of national interests, can ensure a true Eurozone monetary policy.

The authors conclude by arguing that a policy blockage within the ECB Governing Council will enable or force the Commission to act by presenting its proposal for a treaty revision, based on the Nice enabling provision.

My comments focus on the following aspects: entry aspects into EMU; the independence of the ECB and the implications for "exogenous" change; the role of the national central banks (NCBs) in the Eurosystem; and an evaluation of the authors' optimal solution to the problem.

As regards entry into EMU, the authors have taken the Finnish-Italian precedent of a shortened period of formal membership in the ERM as a benchmark against which future evaluations of this Maastricht criterion will be measured. They take it for granted that new member states will actually desire to enter EMU as early as possible. While this could be arguable on economic grounds, politics will reign supreme on this issue: this will be the ultimate proof of having "arrived".

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A benchmark that the authors have not been able to consider is that of the UK. There have been some speculations that the British authorities will—as in numerous other areas—argue on economic and not on legalistic grounds: what counts, so goes the argument, is de facto exchange rate stability, no matter whether in the "straightjacket" of an exchange rate mechanism or outside. Depending on how British timing evolves, this might actually accelerate the hypothetical schedule for an EMU of 25 members.

The actual economics is naturally a different story. Consider the British economy, with a high degree of flexibility in comparison to mainland economies. Here, we should not consider the ability to withstand the competitive pressures of a monetary union, but merely the entry rate. Conversely, the economy of Poland—to take an arbitrary example—is much less flexible, as demonstrated by the experience of the last years. This country might actually need to retain the potential use of the exchange rate instrument for some time, and would thus not benefit from early EMU membership.

Thus, the authors' arguments might shortcut a few corners, and their "calendarial reasoning" might, with the benefit of hindsight, have proved to be accelerated. However, all this is immaterial to the final conclusion: there is a high probability that, within the next few years, EMU will have close to 20 members.

Does this make monetary policy more inflexible? It certainly makes the ECB's task more difficult. The higher the dispersion of underlying inflation rates, the higher the potential for a monetary policy that does not fit the individual member state. Does this affect how monetary policy is pursued? In theory no, but in practice policy will have to rely more than ever on sound and differentiated economic analysis and reasoning in order to factor out the differing driving forces of price increases. A single-digit driven institution will have a harder job than an institution with a more holistic view of economic processes.

What about voting in the Governing Council? Will the potential inundation of the Governing Council by new members actually hinder an effective policy, as the authors suggest? I shall give a few comments on this problem in a general EU context.

The EU as such, not only the European Central Bank, faces the dilemma of an increasing need to reconcile two issues that lead to diametrically opposite institutional solutions in an ideal world: efficiency versus representativity. This was one of the central questions that brought heads of government to the European Council in Nice. They left without an answer.

The aim of the Nice Treaty revision was (among others) to bring the EU closer to its citizens. It is highly doubtful whether the resulting reform of the voting system in the Council is a contribution in this direction. When politicians start bargaining, outcomes tend to become even more complicated and less transparent.

From the viewpoint of efficiency, the extension of majority voting is, of course, more decisive than the weighting of votes—the fact that a member state can be overruled puts pressure on finding a compromise. In this respect, the ECB theoretically has an advantage in its voting system. In practice, as voting does not play a role in ECB policy formulation, this advantage is voided.

My conclusion with respect to the authors' hypothesis is that they would appear to draw the right conclusions, but possibly not based on the correct premises: voting behaviour is not the problem in the ECB context, but the shaping of actual decisions. In an ECB context, the efficiency argument of the EU as such relates less to voting considerations than to the actual unwieldiness of handling a council of more than 30 people.

Why was this issue not addressed properly in Nice, and which conclusions can be drawn for the near future? The ECB issue became a topic of the IGC only at a very late stage and led to controversial discussions. The main question was whether anything should be changed at all. The well-known compromise was a revision of the ESCB Statute, entitling the Council to change a certain paragraph of the statute—where the ECB or the Commission were and are expected to make a proposal in good time.

Why did this happen? This apparent policy failure of not preparing the issue for decision by Heads of State stems from systemic factors. The independence of the ECB has been so deeply impressed upon policy makers that in the months preceding Nice, it was inconceivable—and politically incorrect—to actually discuss these issues as a non-central banker. This policy inertia was fostered by the agenda-setting large countries. Thus, everybody averted his or her eyes from what needed to be done for bad reasons. In the meantime, internal discussions in the ECB could only go around in circles, highlighting the policy dilemma of the national central banks. While the necessity for reform was and is clear to everyone concerned, it will imply a political "loss" for some or all countries. This was a decision by which even the most farsighted national central bankers were as overburdened as the politicians meeting in Nice.

Will this change in the near future, in time for enlargement? The gut reactions that politicians are not allowed to discuss central bank matters have not abated, which does not bode well for reform. The urgency has, of course, increased, and the enabling clause of Nice has actually provided a catalyst for decision-making. Will this, as the authors suggest, be hindered by the same forces that were already at work before Nice? My presumption is that this will indeed be the case, and that a forward-looking endogenous reform proposal can take place only under certain circumstances: that the presumed loss for individual countries from an unreformed Governing Council is higher than the certain loss of representational power. This is a highly unlikely outcome.

This would mean that no proposal on reform would be forthcoming. Actually, the main driving force despite this constellation for reaching a decision, is that the ECB and the Eurosystem face a clear threat, which the authors have actually identified as their preferred outcome: an "outside" proposal. This would increase the risks for the national central banks to such a degree that they might actually be able to reach a decision as a preventive action against outside interference. The presumption here is that in drafting such a proposal, the Commission would lean towards a (centralistic) executive model that would limit the powers of the periphery of the system.

What does this imply for the outcome of this game? Restructuring the ECB decision-making system is a difficult and highly sensitive issue. Externally this is due to the fear of politicians to appear to meddle with an independent, albeit highly political, institution. The internal trade-off in the ECBS between the efficiency of decision making and representation of national central banks puts a further brake on the process.

The authors examine the range of solutions in search of efficiency. The problem, of course, is that the efficiency of the system is not the sum of nationally preferred outcomes. This, it is argued, shows that there is no such thing as a truly independent national central banker. From a national perspective, this is obviously not the case, as the NCBs profess to merely want to ensure that national conditions find an adequate reflection in ECB decision making (see the above reasoning on better and more differentiated economic analysis in a situation of a wider dispersion of national inflation rates). Thus, representation and rotation are judged as sub-optimal outcomes, which is exactly the reason why there will be solutions of this type.

Is this as bad as we think? In terms of the paper, the answer is yes. In reality, the ECB is, of course, much more of a political institution than it wishes to be. It must therefore be judged against the yardstick of other European institutions, and here the efficiency/representativity dilemma is a long way from being resolved. As long as member states retain national identities, they will also wish to retain certain symbols: a voting central bank governor is such an example. In politicians' minds, this increases the acceptance of supra-national institutions. It is unclear, however, whether the populations concerned are actually in need of these symbols to the extent that politicians presume.

Central bankers, in turn, can afford to be more rational than myopic policy-makers, so that the actual outcome will be somewhere in between myopic and farsighted ones. The number of people around the table will increase, the number of people being able to vote will increase to a smaller extent, and the question of representation will play quite a strong role. The larger member states will take this as being merely a problem of the smaller member states. This, in turn, increases the chances that this issue will be brought to the political level after all, as the large member states have a comparative advantage in these fora. Europe is, not even at the technocratic level of monetary policy making, ready for institutions devoid of “national content”. This may lead to efficiency losses, but to a medium-term gain in acceptance, and thus ultimately to the accountability of the European Central Bank.

The medium-term outlook will depend on whether the centrifugal or centripetal forces in ECB decision making will prove stronger: there is a strong presumption that the Executive Board will ultimately increase its power at the expense of NCBs. This will increasingly be driven by the question of the raison d'être of 25 fully equipped NCBs. With declining inflation spreads within EMU, the power of the NCBs will show a parallel decline.