Euro Area Enlargement and European Central Bank Reform

David Howarth

Author's pre-print version. Please cite as:

'Euro Area Enlargement and European Central Bank Reform', in eds., L. Lacina, et al., *The Economic Performance of the European Union: Issues, Trends and Policies*, Basingstoke, Macmillan Palgrave, 2009, pp. 82-104.

Abstract

This contribution analyses the December 2002 reform of decision making in the European Central Bank's (ECB) Governing Council in terms of national economy size reflected in the bargaining power of the ECB Governing Council members and member state macroeconomic interest. The National Central Bank (NCB) governors of the largest member states were concerned about the impact upon ECB monetary policy making of equal representation being extended to future member states. By eliminating equal voting rights, the reform distorts the meaning of equality, representativeness and ad personam *participation as guiding principles of ECB decision making, moving from equal member state representation towards an emphasis placed upon Euro-zone economy representation. At the same time, two possible concerns watered down efforts to modify 'representativeness' and prevent enlargement contributing to inefficiency in Governing Council decision making. First, the current smaller member state NCB governors opposed a significant reduction of their 'voice' in ECB monetary policy making. Second, legitimacy concerns ensured persistent support for the maintenance of a large and 'decentralised' Governing Council.*

Introduction

On 19 December 2002, in preparation for the coming into force of the Treaty of Nice, the European Central Bank (ECB) Governing Council adopted a recommendation on new Governing Council voting procedures following the enlargement of the Euro-zone (formally approved on 3 February 2003).[1] Prior to this agreement, there was a

growing literature on the manner in which enlargement should / might affect ECB decision making institutionally including Berger (2002), Buiter (1999), Baldwin *et al*. (2001a, b), Bjorksten (2000), Eichengreen and Ghironi (2001), Fatum (2000) and de Grauwe (2000). This work contributes to the literature focusing on the efficiency of monetary policy making and the coherence of monetary policy making for economically diverse states – including Deutsche Bundesbank (2001), de Grauwe (2000), EP (2001) and Gros and Hefeker (2000). To this can be added the literature on the legitimacy of the existing decision making structures of the ECB, including Buiter (1999), de Haan and Eijffinger (2000), de Haan *et al.* (2005), ECB (2002), Issing (1999) and Leino (2001). Heisenberg (2003) attempts to bridge discussions about efficiency, transparency, enlargement and democratic legitimacy.

This paper analyses the recent agreement on ECB Governing Council reform in terms of national economy size reflected in the bargaining power of the Governing Council members and macroeconomic preference. The reform was subject to consensual decision making in the Governing Council and subsequently met the unanimous approval of national finance ministers in the Economics and Finance Council (Ecofin). While acting in an *ad personam* (that is, independent and personal[2]) capacity, the twelve NCB governors and six Executive Board members of the Governing Council agreed upon a reform that reflects national macroeconomic policy interests and particularly the interests of the member states with the largest economies. The reform conforms *barely* to the principles of *ad personam* participation,[3] equality[4] ('one governor, one vote') and representativeness[5] (all the Euro-zone is represented) set out in the Protocol to the TEC on the Statute of the European System of Central Banks (ESCB) and of the ECB. The reform also *inadequately* addresses concerns about Governing Council decision making

inefficiency. In order to prevent enlargement from contributing significantly to decision making inefficiency, the principles of ‘equality’ and ‘representativeness’ were distorted. Yet the reform was a ‘fudge’, stopping far short of the kinds of changes sought by many monetary economists and central bankers. Ultimately, the reform might also reflect the recognition by Governing Council members of the ECB’s problematic legitimacy.

This chapter in effect presents a loose intergovernmentalist explanation – ‘intergovernmentalism without governments’ – of the agreement on Governing Council reform. Not only does the reform adopted suggest that Governing Council members defended the macroeconomic interests of their home member states but also that the individual members had bargaining power that reflected the size of their home economies which likewise contradicts their *ad personam* status. Despite the official requirement that the ECB targets Euro-zone wide inflation there is suspicion – albeit not yet proven – that the ECB is also particularly preoccupied with the effect of its monetary policy on the largest national economies (Heinemann and Huefner 2004; Howarth and Loedel 2005).

The ECB reform process lacked transparency. The argument presented in this paper about Governing Council member and member state government preferences is thus speculative. The argument is based on an analysis of the preoccupations about monetary (and specifically ECB Governing Council) decision making that have been outlined by monetary economists and central bankers over the past decade. A small number of ECB officials involved either directly or indirectly with the reform have been interviewed and official justifications of the reform considered. The reform adopted is examined in relation to major reform alternatives that have been presented over the years as more effectively addressing particular concerns (efficiency and / or

representation) than others. Critiques of the reform by monetary economists and central bankers are also considered. Based on this analysis, the reform adopted appears to be a trade-off that reflects both 'intergovernmentalism without governments' and legitimacy concerns.

The difficulties posed by enlargement:
size matters but so too does representation

The 2000 Intergovernmental Conference which preceded the Nice Summit agreed upon the reform of several EU institutions to cope with a considerable increase in member state numbers yet largely ignored the impact of enlargement upon the operation of the ECB. Article 10.6 was introduced in the Statute of the ESCB and of the ECB calling upon the ECB Governing Council to present a recommendation 'as soon as possible' following the entry into force of the Treaty of Nice on the necessary institutional reforms in the bank to cope with enlargement. While the new EU member states were expected to respect most of the convergence criteria and, following accession, could potentially include their currencies in the Exchange Rate Mechanism (ERM) II, they could only participate in the Euro-zone at a later stage. At the time of writing (January 2007) six of the new member states are ERM II members: Cyprus, Estonia, Latvia, Lithuania, Malta and Slovakia. On 1 January 2007, Slovenia became the thirteenth Euro-zone member and the Governing Council expanded to 19 members.

The impact of Euro-zone enlargement looms large for the ECB principally because it highlights existing problems with the operation of the Governing Council – problems that reflect the uneasy balance between equality, representativeness and decision making efficiency and effectiveness. The ECB Governing Council is already

the largest monetary policy committee of any central bank (the voting contingent of the Federal Open Market Committee (FOMC) of the US Federal Reserve has only twelve members). There is a growing body of work on optimal monetary policy committee (MPC) size to best ensure decision making efficiency and effectiveness (see Blinder 2004; Sibert 2003 and 2006). Sibert (2006) examines the economics literature on monetary policy making by committee and the literature on groups in the other social sciences – especially social psychology – focusing on the effect of size on group performance and decision outcomes. She concludes that the optimal number of MPC members is at least five and not much beyond this. On the basis of such studies, personal experience and observation, many other observers argue that the ECB Governing Council is too large. At 18 (now 19) members it is conducive neither to maximum efficiency nor to effectiveness in monetary policy making – in particular on technical as opposed to political aspects (notably, the specification of the ECB's operational goals) (see for example, de Haan *et al.* 2005; Eijffinger 2006; Sibert 2006). Future enlargements exacerbate such concerns. Amongst others, Willem Buiter, a former member of the Monetary Policy Committee of the Bank of England, complains of the Governing Council's size prior to Greek accession:

> A group of 17 is already too large for the serious and productive exchange of views, discussion and group decision making. … A squad of 21 will be quite unwieldy. Thirty would be a mob. … Based on my own limited experience, a policy making body with seven members would probably be optimal (Buiter 1999, p. 200).

The Governing Council was empowered to change (by unanimity) its own practices if it found problems or potential problems in its decision making subject to the approval of the Council. There is much scope for its procedures to evolve — such as the creation of more working groups — and the work of the Governing Council can involve more activity at the ECB level or through the NCBs. However, the size problem still matters. Some monetary economists have argued that the problem could be resolved by more centralised policy making along the lines of the FOMC of the US Federal Reserve. In the ECB this would involve increasing the power of the Executive Board in relation to the NCB governors and rotating a smaller number of Governing Council places among the governors (de Haan *et al.* 2005; Eijffinger 2006; Favero *et al*. 2000). Others see an entirely centralised system – the creation of a Monetary Board detached from the member state NCBs – as the only effective way to resolve the efficiency problem (Baldwin *et al* 2001a, b).

Such recommendations ignore the unique character of both the Eurosystem as a 'federal' banking system and the EU as a political entity. First, the centre (the ECB) is considerably less dominant in the Eurosystem than in the American system. The NCBs retain considerably more power than the US Federal Reserve District Banks and the governors have final say — thanks to their majority in the Governing Council — over the allocation of functions. Any reform to strengthen the Executive Board at the expense of the NCB governors would be challenged on grounds of legitimacy: despite their *ad personam* status (and *not* as national representatives), the strong presence of the NCB governors on the Governing Council was considered vital to selling the EMU project to sceptical national publics (de Haan *et al*. 2005; Howarth and Loedel 2005). The arrangements of the US Federal Reserve Board were developed just over 60 years ago, around 160 years after the creation of the United

States as a country and long after the conclusion of the Civil War successfully asserted federal government authority. There is obviously no parallel situation in the EU. The legitimacy concerns that the principles of equality and representativeness seek to address require a decentralised form of Euro-zone monetary policy making.

Verdun and Christiansen (2000) and Dyson (2000) argue that the independence of the ECB and the specific objectives assigned to it in the TEC and the Statute of the ESCB and of the ECB places importance upon 'output' rather than 'input' legitimacy. The 'output' legitimacy of the ECB and the EMU project involves providing low inflationary economic growth. The focus of most monetary economists and central bankers on improving the efficiency and effectiveness of ECB monetary policy directly concerns this form of EMU legitimacy. Although of secondary importance to overall ECB and EMU legitimacy, 'input' legitimacy is nonetheless of some relevance. The ECB's goal setting and operational independence means that democratic control via elected representatives is unable to provide this 'input' (apart from the unlikely possibility of treaty reform). Without direct democratic control, the make-up of the membership of the Governing Council assumes greater importance in providing 'input' legitimacy. The technocratic expertise of the members provides some (Dyson 2000). It is argued here that the presence of national representatives (even in an *ad personam* capacity) provides further 'input' legitimacy. EMU has normally been presented by the governments of member states participating in the Euro-zone as the *pooling* and *sharing* of monetary policy making powers. EMU is rarely presented as the transfer or loss of these powers. The presence of national representatives in the ECB confirms the former. The absence suggests the latter. The limited forms of interaction between the ECB and various EU institutions – the European Parliament, the European Commission, the Council of Ministers (Ecofin

and the Eurogroup) and the Economic and Financial Committee – further reinforces the importance of the bank's link to the member states. The ECB is poorly embedded in the contested political system of the EU which is, at present, unable to provide 'input' legitimacy (Amtenbrink 1999 & 2004; Banchoff & Smith 1999; Beetham & Lord 1998; Wincott 2004). The importance of 'input' legitimacy as a consideration was strongly suggested by the explicit emphasis placed upon 'decentralisation' as a 'core principle' by members of the Governing Council guiding their consideration of reform alternatives (Mersch 2003). A practical dimension to this emphasis on 'decentralisation' should also be mentioned. The continued importance of national macroeconomic policy making and the weakness of EU-level economic governance provides an additional reason to maintain the direct link with member states and member state governments via NCB governors.

Calls to restrict the total number of NCB governors in the Governing Council are thus problematic.[6] No other EU institution[7] currently denies member states representation (although the Treaty of Nice creates this possibility for the European Commission once the number of EU member states exceeds 27).[8] Officially, each NCB governor participates in the Governing Council in a personal capacity as an experienced expert on central banking not as a national representative *per se*. In theory, therefore, a rotation of governors (either all or only the less populated member states) would be an adequate resolution of the size problem: a particular group of them should be as representative of informed opinion as all of them. However, it would be difficult for the governors to present the perspectives of other member states as effectively as their own and thus highly problematic to exclude certain member states from voting on a permanent, let alone regular, basis. Moreover, the governors are de facto national representatives because they each come from one of the member

states and are most familiar with their own national economies and banking systems. De Grauwe *et al.* (1999) also note that there is nothing in the treaties to prevent NCB governors from prioritising the economic interests of their own member states (although it is unlikely that they would do so overtly as this would undermine the credibility of their commitment to the ECB's operational goals which target the entire Euro-zone).[9]

Alternative reform proposals

In addition to variants of the rotation system (discussed below), five alternative reform proposals were considered and rejected by Governing Council members: a constituency model, a system of weighted voting, a double majority system, the creation of a Monetary Board and an election system (Berger *et al.* 2004; de Haan *et al*. 2005; ECB 2003; ECB officials, interviews 2004; Mersch 2003). A constituency model, based on regional groupings as in the World Bank and the IMF, was rejected. Officially (ECB 2003; Mersch 2003) it was argued that this would violate the principle of independence of the individual NCB governors in that they would become *de jure* representatives of a specific constituency rather than operate on an *ad personam* basis (in a personal capacity). The extension of the system of weighted voting was deemed contrary to the 'one member, one vote' principle established in Article 10.2 of the Protocol to the TEC on the Statute of the ESCB and ECB. This Statute allows weighted voting (excluding EB members) only on matters pertaining to shareholdership, i.e., NCB capital. Governing Council members also rejected the kind of double majority system (number, population and / or GDP to be considered) adopted in the Nice Treaty for the Council which, 'concerning an intergovernmental body', was not seen to be a relevant precedent for Governing Council reform (Mersch

2003). The NCB governors from the smaller member states were concerned that the need for a double majority would result in a kind of *directoire* dominated by the largest member states. One variant of this model required a majority vote including at least 3 of the 6 Executive Board members, with any Governing Council member possessing the right to verify that a pre-set GDP level was represented, thus (if based on current figures) giving the French and German NCB governors the possibility of blockage if that level was set at 62 per cent. Another rejected model was a Governing Council consisting of a preponderance of Executive Board members and a few rotating NCB governors (akin to the FOMC of the American Federal Reserve). This model was seen as contradicting the 'core principles of decentralisation and representation' (Mersch 2003). Finally, an 'election system' in which NCB governors would elect a limited number of their colleagues to the Governing Council was rejected on several grounds: an unrestricted election might infringe the representativeness criteria, result in the creation of a 'market' for votes and undermine cooperation among Governing Council members.

Rotation system

The rotation system for voting in the Governing Council is impressively complex for the uninitiated. The lack of transparency in the preparation of the proposed reform – itself suggestive that considerations beyond the core principles and efficiency goals were influential in determining the system agreed upon – has been criticised by several ECB watchers, notably the well-known German monetary economist Daniel Gros (2003). According to the reform agreement, the number of NCB governors exercising a voting right would be capped at 15, while all governors would continue to attend meetings. When the number of NCB governors in the Governing Council

exceeded 15, voting rights would be exercised on the basis of a rotation system, designed to ensure that the NCB governors with the right to vote would be from member states which, taken together, were representative of the Euro-zone's economy as a whole. Consequently, the NCB governors would exercise a voting right with different frequencies depending on an indicator of the relative size of the economies of their member states within the Euro-zone. Based on this indicator, NCB governors would be allocated to different groups.

Initially, there would be two groups. The governors from the five member states with the largest economies (currently, Germany, France, Italy, Spain, Netherlands) would form one rotating group possessing four votes (thus only four of these five governors would have the right to vote at any one time with a voting frequency of 80 per cent). The governors from the other member states (numbering eleven to seventeen) would form the second rotating group, sharing eleven votes. Once the total number of member states in the Euro-zone increased beyond 22 (up to 27, i.e., the current EU member states and the 12 accession countries listed in the Protocol on enlargement annexed to the Treaty of Nice), three groups would be established. The first would remain the same. The second group would consist of the NCB governors from the countries with the next largest economies, sharing eight votes on a rotational basis. The size of this group would equal the total number of governors divided by two (then rounded up to a full number if necessary). The third group would consist of the governors from the countries with the smallest economies sharing three votes on a rotational basis. The members of the Executive Board would preserve their permanent voting rights.

The division of member states into the two / three groups would reflect their share in the Euro-zone according to a composite indicator of 'representativeness'

consisting of principally the member states' GDP at market prices (five-sixths weight in the indicator) and its total assets of the aggregated balance sheet of monetary financial institutions (TABS-MFI) (one-sixth weight). The data on GDP would be provided by the European Commission, while the rules for the calculation of the key for subscription of the ECB's capital would apply (article 29.2 Statute of the ESCB). The data on TABS-MFI would be defined on the basis of an existing Council Regulation (No. 2533/98 of 23 November 1998) concerning the collection of statistical information by the ECB. This data would be updated every five years. The Governing Council proposed that a two-thirds majority of *all* its members would be required to decide on the initial adaptation of the voting rights in the two-group system as the number of Euro-zone member states increased. The same procedure of a two-thirds majority of *all* members would apply to the definition of the precise implementing provisions for the rotation of voting rights within each group (for example, the time interval between the rotation of voting rights).

The official justification

The agreement on the rotation system reflects the concern of many Governing Council members (especially Executive Board members and NCB governors from the larger participating member states) with regard to the potential inefficiencies of an excessively large Governing Council. A principal concern was that one form of representativeness (namely, one member, one vote) would override representation of the actual Euro-zone economy as simple majority voting could (see also Berger 2002; de Haan *et al*. 2005; Eijffinger 2006). Such a possibility currently exists in the system of representation and voting in the Governing Council. However, the possibility would increase considerably if all the accession NCB governors obtained voting

rights. The official ECB position was that a system of rotation with varying voting rights on the basis of reasonable economic criteria ensured the true equal treatment of the NCB governors and 'sufficient' levels of representativeness. The design of the rotation system was, according to the ECB, guided by the following principles (ECB 2002b):[10]

The '*equality*' of NCB governors ('one member, one vote' principle) is maintained in three ways. Even though all the governors do not vote all the time, the votes all carry the same weight regardless of the size of national economies. No NCB governor retains a permanent vote. Furthermore, all governors are allowed to attend all Governing Council meetings.

The principle of '*ad personam participation*' (allowing all Governing Council members to attend all meetings in a personal and independent capacity rather than as representatives of a specific member state *per se* or constituency) is preserved.

Representativeness is preserved in the sense that voting NCB governors will be representative of the entire Euro-zone (even though some NCB governors are not voting) yet there is no 'renationalisation' in the sense of governors being required to represent specific regions.

Consistency is to be maintained during the transition from two to three phases by avoiding that governors of certain NCBs move randomly up and down between certain groups.

The rotation system was defended also in terms of not discriminating against the NCB governors of countries acceding to the Euro-zone in the future. Four of the new member states were expected to enter the second rotating group – assuming the continued non-participation of the UK, Sweden and Denmark – while the strong possibility exists that several of the other new member states would move eventually from the third to the second group because of their relatively strong economic growth (on average much higher than the Euro-zone 12).[11]

Debates on the Number and Composition of Rotating Groups, Voting Rights, Composite Indicator and Representativeness

Two or three rotating group models. The number of rotating groups was debated at length in the Governing Council. Numerous alternative proposals of two group models of different sizes were proposed (interviews, ECB 2004). These were likely rejected because of the concerns expressed by several of the current NCB governors of being placed in a rotating group with governors from member states with much smaller economies. The NCB governors from the largest member states also sought to create a small group with relatively high voting frequency. Thus the three group model – with NCB governors from large, medium and small member states respectively – was the preferred option from the start of discussions with the intermediary phase of a two-group model.

18 versus 21 votes. The concern for decision making efficiency encouraged the governors from the largest member states to favour maintaining the existing 18 votes, while several governors from the smaller member states defended a higher number of voting members to ensure greater voting frequency in the second and third groups.

The compromise reached was 21 votes: 6 permanent votes for the Executive Board members and up to 15 rotating votes for the governors.

Representativeness indicator. The NCB governors from several of the member states (notably the Netherlands) preferred to avoid the use of population criteria given that this would allow several of the NCB governors from Central and Eastern European Countries (CEECs) to replace existing member state governors in the second group and allow Poland to replace the Netherlands in the first group. The official logic for excluding the population criterion (ECB 2003; Mersch 2003) is curious: this was seen as inappropriate as the ECB is ‘an economic and not a political body’, even though the population criterion is already used in addition to GDP for determining member state capital contributions to the ECB and voting on these contributions. Most NCB governors and member states preferred just using the GDP criterion. However, the NCB governors from some of then Euro-zone member states (notably Luxembourg) also sought to include recognition of the financial sector. This was defended (ECB 2003; Mersch 2003) on the grounds that central banks are charged (de jure and/or de facto) with observing financial sector stability. The bankers also made explicit reference (ECB 2003) to the experience of the American Federal Reserve System which takes into consideration financial sector size by granting only one Federal Reserve District Bank president – the president of the New York Federal Reserve Bank – permanent voting rights in the Federal Open Market Committee (FOMC).[12] TABS-MFI was adopted on the grounds that it was the broadest measure of the financial sector, with an existing definition in EU law and an established and consistent statistical framework.

Compromising representativeness and efficiency

The reform proposed by the ECB Governing Council has been widely criticised by academics, journalists, non-Euro-zone central bank officials and politicians. Gros (2003: 1) has been particularly outspoken in his criticism arguing that 'the solution proposed by the ECB is worse than the status quo. It is inefficient, opaque, internally inconsistent and arbitrary'[13] (see also Bofinger 2003). After several debates and expressions of expert opinion, the reform proposals were rejected by the European Parliament's Committee on Economics and Monetary Affairs on the grounds of their 'complexity' – although this rejection was not binding upon the Council. The parliamentary committee voted to retain the 'status quo', that is the preservation of votes for all NCB governors, with an enlarged Executive Board of nine members, thus challenging the validity of claims of a size-efficiency trade-off. However, if rotation was to be adopted, the parliamentary committee accepted the use of a composite indicator, based on the criteria of economy and financial market size *but also* population, thus challenging the legitimacy of the ECB's more restricted criteria (European Parliament 2004).

On efficiency grounds, the proposed reform does not address the concerns that the ECB Governing Council is already too big: the Governing Council is set to grow to 21 members from the present 18. Preventing some NCB governors from voting is not the same as preventing them from speaking and they will continue to attend all Governing Council meetings. Thus the potential for cacophony, that concerns Buiter (1999) and others remains. The nod in favour of efficiency was managed only in the context of a great distortion of the principle 'one member, one vote' with the new rotation system reflecting national economic size. The reform – in order to ensure representativeness – moves in the opposite direction to the preference of those

observers who advocate a more centre-heavy US Federal Reserve model (de Haan *et al.* 2005; Eijffinger 2006; Favero *et al*. 2000) or the Monetary Board proposed by Baldwin *et al*. (2001). The reform places increased emphasis on representation of the Euro-zone economy rather than member states but all NCB governors can continue to attend Governing Council meetings and there is an increased number of voting members.

The new form of representativeness reflected in the rotation system and the failure to meet efficiency objectives reflects the macroeconomic preferences of the five Euro-zone member states with the biggest economies more than the other current and future member states. The establishment of two / three groups for rotation, with the NCB governors from the five member states with the biggest economies assured more frequent voting rights than the other governors seems to contradict the *ad personam* status of the NCB governors. The reform officially recognises that the status of the NCB governors should vary and this in turn suggests that the governors are not to be treated as truly independent people operating in a personal capacity. The reform demonstrates that the governors' home member state is of relevance and determines their status, at least by guaranteeing governors from member states with larger economies a more frequent vote than governors from member states with smaller economies.

Of course, one might see the proposed reform as 'politically reasonable' and legitimate in that it appears that the governors have recognised that economy and financial market size do in fact matter: if there must be rotation why should the governors of the banks of Malta and Slovenia be treated the same as the Bundesbank President? Clearly, the member states with the biggest economies have already lost out in terms of a 'representativeness' that reflects economic size. Officially, their

central bank governors possess the same vote as the others on all decisions except those having to do with the capital of the ECB. The adoption of the new rotational scheme is a way of potentially strengthening this kind of 'representativeness', if only to a limited degree. Put another way, the 'representativeness' of one governor one vote has been qualified by a 'politically reasonable' 'representativeness' that accepts the relevance of economy size. This qualification reflects the reality that most Euro-zone citizens are preoccupied, first and foremost, with conditions in their national economy rather than the Euro-zone economy as a whole. While this qualification no doubt reflects the power concerns of NCB governors from the largest member states, it might also reflect a concern with regard to public perception in these member states of the legitimacy of Euro-zone monetary policy making.

Crucially, the two / three rotating group system and the agreed cap of 21 for Governing Council voting members reflects the macroeconomic preferences of the largest member states (especially Germany and France). The voice of the five largest member states is hardly diminished by the proposed reform, dropping from five out of eighteen to four out of twenty-one (in a Euro-zone of 22 member states or more). It might also be argued that de facto over-representation of the large member states in the Governing Council is set to continue. Howarth and Loedel (2005) show that the underlying objective of equal national representation was undermined with the first appointment of the Executive Board in 1998 and the (almost) constant representation of the four largest member states on the Executive Board.[14] These Executive Board members are expected to maintain a focus on the entire Euro-zone, as required by the Statute of the ESCB and of the ECB. Nonetheless, the overrepresentation of large member states does challenge the principles of equality and representativeness. At the very least, it can be argued that having served most, if not all, of their career in their

member states of origin, the Executive Board members are more familiar with their home economy than other national economies. As explained below, this familiarity can have an impact on monetary policy making preferences. If Executive Board members are to be considered potential national representatives in disguise, the twenty-one maximum membership of the Governing Council established in 2003 only slightly diminishes the weight of the largest five member states from currently nine out of eighteen to eight out of twenty-one. It is very likely (interviews, ECB 2004) that the French and German NCB governors (and perhaps even the Italian and Spanish ones) preferred a double majority system of GDP size and voting members – or a voting system weighted according to GDP – which would have given two or three of these governors an effective veto on all monetary policy making. Clearly, such a system would have been unacceptable to the large majority of NCB governors. It would also have posed considerable risks for the public's perception of the legitimacy of Euro-zone monetary policy making – especially, in the event of a future move to greater transparency in the Governing Council.[15]

The economic danger of 'equality'

In the context of enlargement, one principal consideration linked to the different economies and economic needs of the future Euro-zone member states likely contributed to the reform preferences of the largest member state NCB governors (interviews, ECB 2004). Given the more rapid expansion of their economies over the medium to long term, the future member states would have much higher inflation on average than existing member states and considerably higher inflation than France and Germany (and even Italy and Spain). Completely equal member state NCB governor representation on the Governing Council in an enlarged Euro-zone would

result in the over-representation of inflation-prone member states and the possible establishment of an entrenched bias in favour of higher interest rates. This over-representation arguably already exists in the current Governing Council, where inflation differentials between the member states have spilled over to private and public differences between ECB Governing Council members on interest rate changes, and vociferous criticism by certain Executive Board members of certain member states with higher inflation (Howarth and Loedel 2005).

The fear of over-representation is linked to two related concerns. The first is the extent to which national policy preferences shape the governors' (and even the Executive Board members') positions. The second is the structural differences of the national economies. Regarding the first concern – as already noted – no explicit provision in the TEC and the Statute of the ESCB and of the ECB prevents a NCB governor from presenting policy positions based on domestic data and national needs (de Grauwe *et al*. 1999; Meade and Sheets 2002). There have been a small number of studies which attempt to differentiate between policy making on the basis of national preferences and policy making on the basis Euro-zone-wide preferences and the low inflation target of the ECB (e.g. de Grauwe *et al.* 1999; Heinemann and Huefner 2004; Sanchez-Santos and Varela 2003). The jury is out on whether or not national preferences have had a 'distorting' effect on ECB monetary policy making and this chapter does not attempt to enter into this debate. However, it is important to emphasise that the presence of a much larger number of NCB governors from small and medium sized national economies with relatively high inflation creates additional pressure for a monetary policy which focuses less on the interests of the biggest member state economies (Heinemann and Huefner 2004).[16]

The likelihood of a considerable inflation differential in the future enlarged Euro-zone is due to the Balassa-Samuelson effect: inflation rates in the poorer ten CEECs will be systematically higher than in wealthier current member states and will likely remain so for some time (Baldwin 2001b; Bjorksten, 2000; Égert *et al*. 2003; Égert 2005; Eichengreen & Ghironi 2001). In 2004, for example, there was an inflation rate of 3.7 per cent for the ten future member states and 4.4 per cent for the twelve (the ten, Romania and Bulgaria) versus an average of two per cent for the current Euro-zone (ECB 2005). If we are to assume that all NCB governors view inflation risks similarly – despite the ECB's overall inflation target of or close to two per cent over the medium term – those governors from the future member states would tend to prefer tighter monetary policy while those from many of old member states would prefer a looser policy. Baldwin *et al*. (2001b) thus complain of a strong potential for a disjuncture between the requirements of the economy of the entire Euro-zone (more than 70 per cent of which is made up of the five largest member states) and the preferences of the smallest 14 (16) member states which will form a majority of members in the Governing Council of an enlarged Euro-zone of 22 (24) member states. The economic situation of the 10 (12) accession countries thus creates difficulties for the entire Euro-zone and problems for monetary policy making. Without the 2003 reform to Governing Council voting procedures, member states with only six per cent of the Euro-zone GDP (2000 figures) (but 35 per cent of the population) would have controlled 10 voting positions on the Governing Council. In the future enlarged Euro-zone of 24 member states, Germany, France and Italy would comprise 67 per cent of the GDP yet – according to the old voting system – would have held only three of the NCB governors' 24 votes or 12.5 per cent (assuming Sweden, Denmark and Britain stay out but all the new accession countries, Romania

and Bulgaria come in). In a monetary union of 27 member states, the smallest 17 would represent only ten per cent of the Euro-zone's economy yet would form a majority of votes in the Governing Council (Berger 2002). Without reform, all newcomers to the Euro-zone – with the exception of the United Kingdom – will have greater political than economic weight.

In addition to the concern about inflation differentials between the larger and future poorer member states, the largest member states also had other economic reasons to seek to preserve their relative voting power in the Governing Council. The differences in monetary transmission mechanisms due to national economic structural differences and different national banking systems – see Angeloni *et al*. (2003), Bank of England (1999), Corsetti & Pesenti (1999), de Grauwe (2000) and EP (2001) – can result in different monetary policy preferences. Interest rate changes have significantly different effects on the national economies of the Euro-zone (although understanding the precise impact is an inexact science given the complexity of variables in the national economies). Therefore, while NCB governors might agree on the need for an interest rate change, a consideration of the impact of the change on national economies might encourage them to push for varying levels of change. Several variables can be mentioned. There are different levels of consumer and public debt: thus interest rate changes will have a considerably different impact on consumer and public spending in different member states. The maturities of debt also vary considerably: for example, because firms in Italy and France have shorter-term loans than the firms in other Euro-zone member states, they are more affected by ECB interest rate changes. Furthermore, the degree to which interest rate changes are buffered by national banks varies (Angeloni *et al.*, 2003). The economic structures of the future new member states of the Euro-zone will likely vary as much as the current

member states. Thus, the concern of the current large member state NCB governors regarding new member state voting is not only related to their economic differences as a group but rather the further dilution of large member state concerns regarding the impact of interest changes.

Conclusion

Disenfranchising a significant number of the smaller member states was thus considered vital to the preservation of the macroeconomic preferences of the largest member states but also the perception of the legitimacy of Euro-zone monetary policy making for the citizens of these member states. However, the only way that the NCB governors from the existing smaller member states would agree to this reduction of total votes was if rotation was to apply to all the member states and if the established principles of equality ('one member, one vote') and representativeness were respected officially. These treaty-based principles were distorted to become, in effect: 'one member, one vote only some of the time with varying frequency determined by economy and financial market size'.[17] For the full Euro-zone of 27 members including all current EU member states, Romania and Bulgaria, the total number of votes and frequency of voting will vary considerably: 4 out of 5 and 80 per cent frequency for the first group; 8 out of 14 or 57 per cent for the second; and 3 out of 8 or 37 per cent for the third. Even with fewer Euro-zone members, the preferences of the smallest (and crucially the future poorer) member states are much less likely to prevail and those of the larger member states more likely to be asserted. The insistence that economy and financial market size matter over population size (however reasonable from the perspective of monetary policy making) was also reflected in the preferences of the smallest of the current large member states (notably

the Netherlands) and other current small member states, few of which would end up in the third rotating group. With the possibility (however remote) of future Turkish entry into the Euro-zone, even German, French and Italian NCB governors had a clear interest in establishing group selection by economy and financial market size as opposed to GDP and population size.

Given the lack of transparency surrounding the intra-ECB discussions and negotiations on Governing Council reform, the precise policy positions of the different NCB governors and the precise nature of internal debates are impossible to determine for the time being. However, the reform agreed upon suggests that the NCB governors of the largest member states defended policy positions conforming to national macroeconomic interests, even though compromise was necessary that took on board the concerns of other current Euro-zone NCB governors and respected – albeit only in a highly distorted manner – treaty-based principles and legitimacy concerns. The distortion reflects possible efforts to weaken the representation of the NCB governors from the future CEEC member states in order to diminish a structurally determined bias in favour of higher interest rates. The distortion also reflects the interests of the NCB governors of the largest member states to maintain their disproportionate representation in the Governing Council in order to ensure their relatively strong influence on interest rate changes affecting their economies in a particular way due to specific national economic structures. The reform of Governing Council voting procedures transforms the underlying concept of 'representativeness' in the Euro-zone. It undermines the principle of member state representation that has been (and remains) vital to the legitimacy of ECB policy making (and EMU more generally), while strengthening the relevance of national economic size and the representation of the entire economy of the Euro-zone (rather than its member states

and their populations). The official ambition to avoid enlargement contributing *significantly* to decision making inefficiency can arguably be said to have been met. However, inefficiency was, nonetheless, potentially worsened and the core concerns about size raised by many monetary economists were not addressed.

Some monetary economists have granted qualified praise to the agreed reform of the ECB Governing Council and the creation of the three rotating groups. They do so on the grounds that this reform moves in the right direction towards a truly desirable voting system that aligns 'political power and economic weight' of national central bank governors as closely as possible (de Hann *et al.* 2005; Eijffinger 2006; see also Berger *et al.* 2004). Such a system is, according to these authors, 'the best way' – short of the centralisation of operational policy making in the Executive Board – 'to ensure that national interests will not unduly influence ECB policy-making' (Eijffinger 2006: 97). Their argument doubts the *ad personam* participation of NCB governors and the possibility that they can make monetary policy decisions without specific reference to their own national economies. If NCB governors can in effect represent national economic concerns over those of the Euro-zone as a whole, the alignment of voting power in the Governing Council with economic weight negates the possibility of reflecting this bias in ECB monetary policy. These observers are concerned with the policy making inefficiencies created by emphasising NCB governor equality and member state representativeness. They also believe that treating NCB governors equally in terms of voting rights in the Governing Council results in the over-representation of the smaller national economies of the Euro-zone which in turn damages effective ECB monetary policy. The problem will worsen with enlargement.

The analysis adopted in this paper accepts that these considerations might well have influenced the reform agreed by the Governing Council members. However, it is argued here that the move in the direction of aligning political (voting) weight and economic weight runs contrary to the 'equality' and 'representativeness' principles in a manner which undermines ECB and EMU legitimacy. The argument that political weight should reflect economic weight responds to the legitimacy and power concerns of the governments of the largest Euro-zone national economies. However, the way in which this argument denies the equality and *ad personam* participation of NCB governors – by emphasising that they represent member state economies – undermines the legitimacy of the ECB and in turn the EMU project. Rooted in a contested EU political system, ECB and EMU legitimacy relies to an unclear extent on equal member state representation, however indirect and qualified by the principle of *ad personam* participation. The agreed Governing Council reform of December 2002 and February 2003 fudges the principles of equality, representativeness and *ad personam* participation of the Governing Council members. Yet the reform does not entirely discard these principles. The reform is potentially damaging to ECB and EMU legitimacy but it is considerably less so than the reform proposals driven solely by either efficiency concerns or the recognition of member state economic weight or both. The monetary economists who advocate such proposals would do well to consider 'input' as well as 'output' legitimacy.

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Notes

[1] This ECB recommendation, under Article 10.6 of the Statute of the European System of Central Banks and of the European Central Bank, for a Council Decision on an amendment to Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank (ECB/2003/1; 2003/C29/07) was submitted by the European Central Bank to the Council on 3 February 2003. The decision of the Council, meeting in the composition of the Heads of State or Government, was taken on 21 March 2003 (Council 2003/223/EC) after taking into consideration the opinions of the European Commission and the European Parliament. The agreed amendment was then recommended to the member states for ratification in accordance with their respective constitutional requirements.

[2] Article 108 TEC and Article 7 of the Statute of the ESCB and of the ECB establish the independence of Governing Council members. They cannot 'seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body'.

[3] All Governing Council members are independent from both national and other EU bodies and cannot take instruction from these bodies (Article 7 of the Statute of the ESCB and of the ECB). They are also officially committed official to Euro-zone goals (Article 2 of the Statute of the ESCB and of the ECB) which suggests that these goals over-ride specifically national concerns. However, it should be noted that no TEC or Statute provisions explicitly prevent a NCB Governor from representing specifically national concerns.

[4] The 'one member, one vote' principle is established in Article 10.2 of the Protocol to the TEC on the Statute of the ESCB and ECB: '… each member of the Governing Council shall have one vote' except on a limited range of matters concerning the capital of the ECB where votes are weighted according to the national central banks'

shares in the subscribed capital of the ECB (Art. 10.3) and the terms and conditions of employment of the members of the Executive Board (on which Executive Board members have no right to vote (Art. 11.3)).

[5] The principle of 'representativeness' can be said to be established in TEC Article III-382 and Article 10.1 of the Protocol to the TEC on the Statute of the ESCB and ECB which confirm that 'the Governing Council of the European Central Bank shall comprise … the Governors of the national central banks of the Member States'. This provision is further reinforced by the equality provision of Article 10.2 of the Protocol to establish 'representativeness'.

[6] Buiter (1999) for example recommends — even without Euro-zone enlargement — restricting the size of the Governing Council to nine members and the Executive Board to four.

[7] The ECB enjoys a special status and is not a Community institution in the legal sense.

[8] The Nice Treaty (Article 4(2)) requires the Council to adopt a rotation of European Commission places totalling below the number of member states once this number exceeds 27. The Draft Treaty Establishing a Constitution for Europe (Article I-26(6)) specifies this further, allowing – after one full Commission term under existing rules – for the number of Commissioners to equal two-thirds the number of member states (subject to possible modification by the European Council acting unanimously).

[9] In terms of the ECB's operational goals, the Euro-zone wide inflation target should effectively force individual governors to disguise specifically national concerns. Furthermore, to adopt an explicitly national perspective in the Governing Council would discredit a NCB governor as an 'objective' analyst of Euro-zone wide inflation.

[10] The fifth principle was transparency (of the wording of the text outlining the rotation system). ECB Press Statement, 20 December 2002.

[11] See the section below on 'The economic dangers of equal representation'.

[12] The other eleven Federal Reserve District Banks presidents rotate into four voting positions on the FOMC. The US Federal Reserve Act makes no reference to the relative weight of Federal Reserve districts, while section 2 of the Act establishes the criteria of convenience and 'customary course of business' to determine voting weights.

[13] In addition to the points made in the text, Gros challenges the lack of clarity and the arbitrariness surrounding the rotation of NCB governors with voting rights. He provides an alternative for the reform of the ECB developed by the CEPS Macroeconomic Policy Group — which involves the Governing Council meeting less often and setting the guidelines for monetary policy, while the Executive Board assumes more control over the execution of monetary policy — and urges the European Commission to propose an alternative reform for adoption by the Council.

[14] Three replacements since June 2004 demonstrate the continuity of large member state representation: the Spanish Executive Board member, Eugenio Domingo Solans, was replaced by another Spaniard, Jose Manuel Gonzalez-Paramo; the Italian Tommaso Padoa-Schioppa by Lorenzo Bini Smaghi; and the German Ottmar Issing by Jürgen Stark. France was not represented on the Executive Board for only a brief period following the replacement of Christian Noyer as ECB Vice President and the accession of Jean-Claude Trichet as president. However, this was an inevitable interruption given that Noyer's departure was part of the controversial compromise allowing Trichet to take office. The extent to which the French President went in 1998 to ensure the appointment of the Bank of France Governor, Trichet, as the ECB

president, further suggests the importance attached to securing Executive Board places by the largest member states.

[15] There is disagreement among legal scholars whether primary Community law prohibits the publication of minutes of the meetings of the Governing Council. It has been argued by some that Article 10.4 of Statute of the ESCB and of the ECB limits transparency in this regard (Amtenbrink 1999). Article 10.4 states: 'The proceedings of the meetings shall be confidential. The Governing Council may decide to make the outcome of its deliberations public.' Although no provision in the TEC (and specifically Article VII or the Protocol on the Statute of the ESCB and of the ECB) necessarily blocks transparency, the ECB Governing Council members justified their 1998 decision to prevent disclosure of Governing Council minutes as a necessary evil to prevent the exertion of domestic political pressures on national central bankers (ECB 1999). In effect, non-transparency might also the decrease the appearance of NCB governors advocating monetary policy changes that conform to national preferences (Howarth and Loedel 2005).

[16] Heinemann and Huefner (2004) apply different economic approaches to determine if national preferences rather than a Euro-zone focus determine ECB interest rate decisions. Using the ordered probit approach, these authors conclude that national preferences (based on controlling national inflation rates rather than the Euro-zone inflation rate) do affect monetary policy – although they accept clear limitations to their study. Given the increased divergence in the economies, and inflation rates, among member states in a future enlarged Euro-zone. These authors argue that …

> If for EMU-12 there is some evidence that divergence is not irrelevant in the Governing Council this should be even more pronounced for EMU-27. In this sense our first results back the case for adjusting the

representation and/or voting weights in the Governing Council in favour of the countries with large GDP shares as recommended by the ECB (556).

[17] Author's own words.