Yves Mersch: The reform of the Governing Council of the ECB

Panel statement by Mr Yves Mersch, President of the Central Bank of Luxembourg and Member of the Governing Council of the ECB, at the Central Bankers' Panel, European Banking & Financial Forum Prague, 25 March 2003.

*　　*　　*

Ladies and Gentlemen,

It is a pleasure for me to participate once again in the European Banking and Financial Forum and to be back in Prague in order to speak before such a distinguished audience.

My brief presentation will perhaps not directly cover the topic "When and how Europe can again become the global superpower" but is nevertheless closely related to both Europe and power. It will deal with how power, and more specifically voting power at the ECB's Governing Council, will be reallocated in order to cope with the ongoing expansion of the EU. It is also an excellent example of how the EU works: decisions are taking after a vigorous democratic debate, and a consensus is sought whereby the interests of all those involved are taken into account.

My presentation is structured as follows:

1. I will start by briefly describing the Governing Council and how, as a result of enlargement, it was considered necessary to reform its voting procedure.
2. Subsequently, I will analyse how the discussions in the Governing Council led to the approval of a dynamic rotation model and the utilisation of a composite indicator, made up of both an economic and a financial variable. I will also go in some detail in the formal ECB recommendation, notably in terms of group composition and voting frequency.
3. Before concluding, I will look at the reactions of all the institutions involved in the enabling clause procedure: the Council, the Commission and the European Parliament (EP).

1. The need for reform

1.1. The Governing Council

The Governing Council is the supreme decision-making power of the ECB. It comprises the members of the Executive Board of the ECB and the Governors of the national central banks or NCBs. The Executive Board has 6 members: the President, the Vice President and 4 other members. They are all nominated by a European procedure, contrary to the NCB governors who are appointed at the national level.

The Treaty and the Statute assign to the Governing Council the power to take the most important and strategically significant decisions for the Eurosystem. It defines and implements the monetary policy of the euro area. In particular when taking monetary policy decisions, the Governing Council normally acts by a simple majority of the votes cast by the members who are present in person. Each member has one vote. The principle of 'one member, one vote' reflects the status of all the members of the Governing Council, including the governors of the NCBs of the Eurosystem, who are appointed in their personal capacity and not as representatives of their Member States. For some decisions on financial matters relating to the status of the NCB as shareholders of the capital of the ECB, the votes of the Governing Council are weighted according to the NCBs' share in the subscribed capital of the ECB. On such occasions the votes of the members of the Executive Board are zero-weighted.

At the time of the Maastricht Treaty, the EU counted 12 Member States and the arrival of 3 new members was widely expected.Consequently the Treaty envisaged Governing Council eventually comprising 21 members: 6 Executive Board Members and 15 NCB Governors.

1.2. Enlargement

1.2.1. The enabling clause of the Treaty of Nice

In order to cope with the EU's current enlargement, the Treaty of Nice, which became effective on February 1 of this year, called for a revision of the decision-making procedures for, or composition of, several European institutions such as the Commission, the Council, the European Parliament and the ECB.

Indeed, many feared that the Governing Council's capacity for efficient and timely decision-making would be hampered if its membership expanded to up to 33 members, namely 6 Executive Board Members and, eventually, 27 NCB Governors. A solution therefore implies that the overall number of Governing Council members having voting rights would have to be smaller than the overall number of Governing Council members.

To this end, the Treaty of Nice contained a so-called enabling clause which, in essence, enabled the Council to amend Article 10.2 of the ECB Statute on a recommendation from either the ECB or the Commission. In case of an ECB recommendation, the procedure also involved consulting the Commission and the European Parliament. It should be emphasised that the reform of the Governing Council should in no way be compared to the reform of other institutions such as the Council. It is also remarkable that the Treaty of Nice included the possibility for the ECB to come up with a recommendation for its own reform.

It should also be underlined that the enabling clause is limited in scope. It concerns only the voting rights of the Governing Council and does not, for example, allow modifying the composition of the Governing Council or of the Executive Board. Similarly, it does not allow to restrict the membership of the Governing Council; or to some form of Monetary Policy Committee or Board. Moreover, the procedure is very complex. The ECB recommendation had to be taken by unanimity, and to be approved unanimously by the Council, meeting in its composition of Heads of State or Government, before ratification by all Member States according to their respective constitutional requirements.

Within these constraints and on 3 February 2003, only two days after the Nice Treaty took effect, the ECB adopted unanimously a recommendation, which I will explain and discuss in more detail. However, prior to doing so, I would like to turn a moment to the expansion of the Eurosystem, in order to clearly distinguish this from EU enlargement.

1.2.2. The expansion of the Eurosystem

The Eurosystem consists of the ECB and of the NCBs of all countries having adopted the euro. The timing of its expansion from the current 12 to the eventual "steady state" of 27 members is, however, highly uncertain.

Currently three EU countries are outside the euro area. The United Kingdom and Denmark have an exemption, while Sweden has the statute of a country with derogation.

All the new members will, upon joining the EU, automatically have the statute of countries with a derogation, that is to say with a clear commitment to join the euro area at a later stage. According to a position published by the ECB, the adoption of the euro is considered the result of a complex convergence process, rather than a mere exchange rate measure. Hence unilateral euroisation is considered unacceptable. The accession countries have to respect the converge criteria set by the Maastricht Treaty in terms of inflation, public finances and interest rates, and are expected to achieve high levels of real and nominal convergence, meaning that their economic structure and inflation levels have to converge to EU levels. In addition, they have to participate for at least two years in ERM II.

2. The ECB recommendation

2.1. Initial discussions

Initially a multitude of possible solutions were analysed. Relatively soon, a constituency model, a capital key inspired voting system and a double majority system, to name only the principal proposals, were all abandoned.

- A constituency model, based on regional groupings like in the IMF and the World Bank, was rejected as it was felt that this would violate the principle of total independence of the individual NCB governors because a representative of a constituency would probably feel obliged to defend the interests of his / her constituency in the Governing Council. This is contrary to the current system, whereby each NCB Governor votes with the interests of the entire euro area at heart, rather than on basis of national interests.
- A system of weighted voting which, by the way, is also used in the Bretton Woods institutions, is contrary to the "one member, one vote" principle of the EU Treaty. As we have seen earlier, the Statute of the ESCB foresees only this scenario for voting related to shareholdership, i.e. national central banks, issues. In these circumstances the Executive Board has, accordingly, a zero-weight.
- A double majority system, inspired by the revision of voting in the Council as decided by the Nice Treaty, was also rejected. First, the Council is not a relevant example for the ECB as the former is an intergovernmental body while the latter is a supranational institution. Second, many members felt this would result in a *directoire,* dominated by the largest countries. Under one version of this model, a proposal first requires approval by a majority of the Governing Council, including at least 3 of the 6 Executive Board Members. Moreover, any Governing Council member would have the right to request verification that a pre-set GDP level is represented. In case this representativeness level is set at for example 62%, Germany and France jointly could block any decision. Interestingly, as we shall see later, the European Parliament, with a German rapporteur, also made a proposal for a double majority, consisting of, first, the population and second, the total size of the economy and the financial sector.
- The creation of a Monetary Board, consisting of theExecutive Board and a few additional members, as sometimes suggested in the press or academia, was rejected for being incompatible with the model and the structure of the Governing Council. It violates the principle of decentralisation, on which the Eurosystem is based. When large areas of policy making are still national in the EU, the case for excessive concentration of decision making seems out of touch with political reality. As the EU is not a single nation, the structure from the ECB is different from the Fed's structure.
- An election system could appear appropriate but entails many practical difficulties in a body like the Governing Council. An unrestricted election might not fulfil the representativeness criteria and might lead to a "market" for votes and a less cooperative atmosphere in the Governing Council. Imposing certain conditions or safeguard clauses concerning representativeness, and maximum and minimum participation though simple in theory may well, in practice, present many drawbacks.

2.2. Dynamic rotation models and representativeness

In order to allay fears that decisions in the Governing Council might be taken by a majority not necessarily representative of the euro area's economy, discussions turned to a system of dynamic rotation models, whereby governors are allocated to different groups with varying voting rights on basis of a to be defined economic criterion. Such a system would maintain the principle of equal treatment for the NCB governors and ensure sufficient levels of representativeness.

2.2.1. Fundamental principles

A dynamic rotation system was considered the most equitable, efficient and acceptable way of assigning voting rights among the governors, particularly as the design of the rotation system was guided by a handful of guiding principles:

- 'One member, one vote' and '*ad personam* participation': All members of the Governing Council will continue to attend meetings in a personal and independent capacity, and the "one member, one vote" principle, as opposed to weighted voting, will continue to apply to those NCB Governors exercising a voting right.
- Representativeness: At any moment, the NCB Governors with the right to vote must, as a whole, be representative of the euro area.

- Transparency: The language of the revised Article 10.2 of the Statute has to be reasonably accessible and meet the requirements of primary Community Law.
- Consistency. During the transition phase, great care should be taken in order to avoid that governors of certain NCBs move randomly up and down between certain groups.

2.2.2. Number and Composition of Groups, voting rights, composite indicator and representativeness

- Two-group versus three-group models. A long debate went on concerning the number of groups and their composition. Three-group models for the steady state were favoured from the outset, although a two-group model, consisting of 15 and 12 countries was also considered. In the final event, preference was given to a three-group model, which allows, roughly speaking, to rank countries according to whether they are large, medium or small. However, in an intermediary phase a two-group model will be used.
- Voting rights. At one stage it was discussed to limit the number of votes to the current 18. A consensus was eventually reached to set the number of votes at 21, (6 for the Executive Board and 15 for the NCB Governors). It was also decided to grant the 6 Executive Board permanent voting rights, as they are appointed by a special European procedure.
- Representativeness indicator. As the ECB is an economic and not a political body, the use of the population criterion appeared as inappropriate, even if it is used for the capital key together with GDP, and initially using exclusively GDP was favoured. However, it was increasingly found that the contribution of the financial sector, through which the ECB steers liquidity and interest rates, should also be taken into consideration. Moreover, the financial criterion, in contrast to GDP or population, is not purely national, but reflects the effective contribution of the various central banks to the Eurosystem. It is also in line with the experience of the American Federal Reserve System where no reference has been made to the relative weight of the various US states. Instead, according to section 2 of the Federal Reserve Act, the criteria are based on convenience and "customary course of business". Reflecting their importance as financial centres, the Presidents of the New York and Chicago Federal Reserve Banks enjoy respectively a permanent voting right and a 50% voting right in the Federal Open Market Committee (FOMC), against a 33% voting right for virtually all other Fed Presidents. Several financial indicators such as the monetary aggregate M3, capital of credit institutions, bank deposits / loans and the Total Aggregated Balance Sheet of the Monetary Financial Institutions were analysed. Preference was given to TABS-MFI for conceptual, legal and statistical considerations. From a conceptual point of view, TABS-MFI is the broadest measure for the size of the financial sector. A legal definition exists in Community law and the statistical framework is well established and consistent.
- Concerning the relative weights for the composite indicator, the ECB proposed in its official recommendation to give GDP a weight of 5/6 th, against a relative weight of 1/6 th for TABS-MFI

2.3. Technical elements of the ECB recommendation

In its recommendation, the ECB proposed a dynamic rotation model which, in the steady state, will have 21 voting rights. The Executive Board will have 6 permanent voting rights while the 27 governors, allocated to three groups on basis of the composite GDP-TABS indicator, will have 15 voting rights. In an initial phase, the model will consist of 2 groups.

The detailed implementation provisions, including the possible decision to postpone the start of the rotation system so as to avoid the situation that governors within any voting group have a voting frequency of 100%, are to be adopted by the Governing Council, acting by a two-thirds majority of all its members, with and without a voting right.

The ECB recommends introducing a two-group rotation system when the number of euro area Member States ranges from 16 to 21 Member States. Once the number of euro area Member States exceeds 21, a rotation system based on three groups will start operating.

Group composition in the steady state

In a euro area with 27 Member States, and on basis of the available figures for GDP and TABS-MFI, the first group would consist of the 5 Governors of Germany, the United Kingdom, France, Italy and Spain. NCB Governors in this group would have a voting frequency of 80%.

The second group would consist of 14 members, namely the NCB Governors of the Netherlands, Belgium, Sweden, Austria, Denmark, Poland, Finland, Greece, Portugal, Ireland, Luxembourg, the Czech Republic, Hungary and Romania. These Governors would vote 8 times out of 14, equivalent to a voting frequency of 57%.

The third group would consist of the remaining 8 NCB Governors and have a voting frequency of 3/8 or 37,5%. This can be compared to their cumulative share in the composite GDP-TABS indicator of less than 1 %.

In the steady state, the 3 groups of NCB governors will thus be made up of respectively 5, 14 and 8 members. This is the result of a pragmatic and empirical approach, which attempted, to the extent possible, to have clear separations between the different groups. Thus, the first member of the second group, the Netherlands, has a composite indicator which is 41% inferior to the indicator for the last country of the first group, Spain. The corresponding figure for the separation between the last country of the second group -Romania- and the first country of the third group -the Slovak Republic- is an even more striking 80%.

3. Follow up to the ECB recommendation

The Council unanimously accepted the ECB's recommendation on 21 March, after a positive opinion from the European Commission and a non-binding rejection by the European Parliament. The Council also confirmed that the model for voting modalities in the Governing Council of the ECB should not be seen as a precedent for other EU-institutions. It is now up to the Member States to ratify therecommendation according to their own constitutional procedure. Let me add that, as the Treaty of Nice was already ratified, there seems to be no need for national referenda, something which should facilitate this gratification process.

It is noteworthy, however, that both the Commission and the EP favoured a more comprehensive revision of the functioning of the Governing Council in the framework of the upcoming Intergovernmental Conference. I will analyse the position of these two institutions in more detail.

3.1. The Commission's opinion

On 19 February, roughly two weeks after the ECB made its recommendation, the Commission issued a press release in which it indicated that, and I quote, "…the proposed model constitutes a step towards securing the continued efficiency of decision-making within the ECB in the perspective of enlargement."

The Commission also emphasised that, and I quote, "…the severe limitations of the enabling clause of Art.10.6. of the ECB statutes…More fundamental and comprehensive reform of the ECB's governance structures could not be envisaged on this basis, but can only be achieved in the wider framework of the Convention and the upcoming IGC."

On the same occasion, the Commission reiterated also the importance it attaches to the "population" criterion, a matter I have dealt with above.

3.2. The European Parliament's opinion

The EP rejected on 11 March the ECB's recommendation, notably on the grounds "that it has been widely criticised for being excessively complex".

In the short term the EP "…reaffirms the existing rule whereby all central bank governors of Member States in the eurozone have full and unrestricted voting rights, and whereby the Governing Council of the ECB takes decisions by simple majority."

In the longer term, however, the EP "…Calls for the adoption of a solution at the next Intergovernmental Conference, after consulting the EP, which would distinguish between operational decisions, to be taken by an enlarged Executive Board of nine Members, adequately representing the euro area economy, and strategic and general monetary policy decisions, to be taken by the Governing Council acting on a double majority, based on the population of the Member States, the total size of the economy and the relative size within it of the financial services sector;"

The essential points of the EP consist therefore of:

- maintaining the *statu quo* in the short term, meaning that each NCB Governor has a vote;
- requesting the Intergovernmental Conference to create an enlarged Executive Board of nine members. Such an enlarged Board may well turn out be similar to the Monetary Board some academics and journalists have in mind;
- Most interestingly, the EP accepts the use of a composite indicator, based partly on a financial criterion.

4. Conclusion

Please let me finish my presentation with a few concluding remarks. One of my fellow countrymen, Member of the European Parliament, stated during the recent debate in this institution, less than 2 weeks ago, that the debate about the enabling clause seemed to result from the fact that larger countries suffer from a Gulliver syndrome: they fear to be bound and tied up by the Lilliputians who outnumber them and, by definition, act in an irresponsible manner. Interestingly, this MEP reminded the Parliament that most blockages to European integration originated from the large, rather than from the small nations. Similarly, the small nations are the ones who abide punctiliously by the Growth and Stability Pact. Nevertheless, the fear seems to exist among larger Member States that the smaller ones might impose a lax monetary policy, even though it is generally accepted that NCB governors vote in the Governing Council on an *ad personam* basis and in the interest of the entire euro area. To this MEP, the whole debate about the enabling clause seemed therefore somewhat artificial and taken under unnecessary time pressure.

All this was two weeks ago and in the meantime the Council approved the enabling clause. Particularly important and heartening, in my eyes, is the fact that a handful of guiding principles which the ECB considered of particular relevance were respected such as 'one member, one vote', *ad personam* participation, representativeness and transparency.

Moreover, the ECB recommendation managed to avoid several perilous pitfalls:

- As I mentioned, the 'one member, one vote' principle is maintained, even though all governors do not vote all of the time. However, whenever they are entitled to vote, the votes of all Governors carry the same weight and this is an important element of fairness between large and smaller countries.
- There is no re-nationalisation of monetary policy, as would have been the case if the Governing Council had moved to a system of IMF-style regional constituencies.
- Similarly, the fact that no Governor member of the Governing Council has a permanent voting right, and that they are all subject to a rotation scheme, is another important element of fairness between large and smaller countries.
- Finally, in the steady state, 4 new member countries are expected to become member of the second group while many of the remaining countries will gradually move from the third to the second group as real convergence, or "catching up" in plain English, progresses. In this respect, the ECB proposal also strikes a fair balance between current and new members, an important point I wish to emphasise here in Prague.