EURO ZONE EASTERN ENLARGEMENT AND ECB'S VOTING MECHANISM REFORM

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Abstract

The present paper analyses the issue of the voting mechanism reform within the ECB, as a consequence of the Eastern enlargement of the EU. Now it is known that beginning with the 1ˢᵗ January 2007 the euro zone will "go east" as Slovenia will be the first Eastern country the will join EMU's 3ʳᵈ stage.

The eastern enlargement raises more complex challenges for the ECB because of three main aspects: 1. the new member states have to "catch up" and this is very important when setting the interest rate, 2. the new member state's economic weight is very small comparative with their prospected position in the Governing Council, and 3. in the absence of the reform the ECB's Governing Council would become the body evincing the highest number of voters, as compared with other decision-making structures of other central banks, such as the FED, being very difficult for such a body to take monetary policy decisions.

Based on those challenges, the ECB will implement a new voting mechanism. Even so, this will not solve the problem of having large economies with weak representation, and small economies that have strong representation in the Governing Council.

1. The Eastern enlargement and the real convergence: why does it matter for ECB and its voting mechanism?

Real convergence means the reduction or even elimination of per capita GDP gap between the EU 15 and new member states or acceding countries. This challenge of real convergence needs economic growth for SEE countries greater than EU's, which implies the convergence of prices and wages. Eastern countries have a weak performance concerning per capita GDP.

Should real convergence be reached within the EMU, it is to be expected that poorer countries should have growth rates that are superior to the overall euro zone, until the levels of prices and productivity no longer substantially differ. This process will go on due to competitive markets, until the GDP per capita is the same all throughout the euro zone.

Before 1999, there used to be a trend stating that an enlarged monetary union including Portugal, Spain, Italy and Greece will pose difficulties to the ECB in implementing a restrictive monetary policy. Experience has shown that "poorer" countries register higher growth rates than the strongest, France and Germany. Moreover, the real convergence process involving "poorer" countries also entails higher prices hence higher inflation rates. Such countries would rather have a tighter monetary policy than the

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ECB's current one, addressing the overall interests of the euro zone.

Currently, even a fast convergence in the case of Portugal, Spain or Greece is not likely to pose problems for the Eurosystem to reach its inflation target. These countries are nonetheless close to the EU average, and their ratio in the harmonized commodity price index for the euro zone is and shall remain low.[1].

After EMU enlargement, things became more complicated because ECB will follow a monetary policy for the euro area interest, and it will not look at a specific country's inflation.

Anyway the Eastern countries will still have a low per capita GDP at the moment of EMU accession, when they will have voting rights in the Governing Council. This will complicate the voting process, in the context of more dynamic economies.

That means that an enlarged euro area will be more dynamic and will need higher interest rates. Are there any chances for higher rates to be in the interest of the euro area as o whole? Which are the challenges for the Governing Council voting system? How important will be the inflation rate in Eastern countries for euro area inflation? We can see a few more challenges that EMU members as well as Eastern Countries have to meet.

From this standpoint, we can see that both the ECB and the euro zone states would have reasons to fear new members acceding to the EM, even the more so if we take Great Britain's accession into account.

2. The necessity of a reform of the ECB's voting mechanism

As we know, the EMU institutional framework is underlain by centralized decision and decentralized implementation. The voting mechanism is extremely important since the participation of national representatives to decision-making is not to hold national interest into account. Even if the current mechanism is deemed adequate, the situation is likely to change following EMU enlargement by new members.

The prospect of EMU enlargement thus raises challenges for the ECB organizational structure. Starting from the assumption that the euro zone will be enlarged by 15 new members, and lacking an ECB reform, we would have a Governing Council comprising 33 members. The ECB Council would become the body evincing the highest number of voters, as compared with other decision-making structures of other central banks, such as the FED. Many analysts have proved that it will be very difficult for such a body to make monetary policy decisions.

Another issue of the enlarged euro zone would be an overemphasized representation of national central banks in the decision-making mechanism (as compared with Bundesbank or the FED, where the Executive Board members dominate decision-making bodies). Moreover, taking into account the low ratio of the new members' economies, they would have a political representation that surpasses by far the size of their national economies[2]. As an example, from the 1st January 2007 Slovenia will join the euro zone,

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[1] Spain and Portugal's ratios are 1,8 respectively 9,1, meaning that even in the case of rampant 10% inflation in these countries, the zone target can be reached if it is under 1% in the other countries. Anyway this situation could have negative effects by affecting the competitiveness of these economies.

[2] For a sound analysis, see Berger et alia (2003).

and its Governor (Mr. Mitja Gaspari) will have a voting right in the ECB's Governing Council. As long as Slovenia's GDP represents almost 0,4% of the euro zone GDP, Mr. Gaspari will have one vote, which will represent 7,6% of the governors voting rights, or 5,2% of the total 19 voting rights.

In this respect, the voting mechanism of the ECB decision-making bodies will change. There were a series of proposals for change in publications in the field, among which: setting up a limited participation Monetary Policy Council that would operate under the Governing Council; introducing constituents, as in the case of the IMF; increasing the Executive Board's number of votes or adjusting the national governors' vote rights function of the economic size of every country.[1]

Consequently, the reform issue has been seriously taken into consideration. In December 2002, the ECB Governing Council has unanimously decided on the content of the voting mechanism reform proposal, which is absolutely necessary when contemplating the euro zone enlargement prospects.[2]

Once the Nice Treaty was in force on February 1st 2003, the ECB has formally adopted a recommendation regarding the change of the Governing Council's voting mechanism. The ECB recommendation was passed on to the EU Council in February 2003. Based on this recommendation and taking into account the opinions expressed by the Commission and the European Parliament, The EU Council, convened at the level of state or government heads, has unanimously decided[3] to change article 10.2 of the SBEC statute. The decision was ratified by the 15 member states in order to be in force[4].

What does the decision comprise? According to it, all the members of the *Governing Council will continue to attend meetings*. Yet the number of national central bank governors having a right to vote will not be larger than 15, the 15 votes being covered by rotation based on a pre-set rule, whereas the Executive Board members will preserve their vote rights. In order to cover the necessity that governors with a right to vote should at all times be from countries that would represent together the euro zone interests, they will have the right to vote with a certain frequency, based on groups of countries.

Governors will thus be part of different groups, function of their economies' ratios in the euro zone, resulting by calculating an index that will comprise, apart from the GDP, the size of financial markets. When the number of countries in the euro zone reaches between 16 and 21, the rotation system will operate based on two such groups, and when the zone is made up of 22 members, the system will be based on three groups. Governors in each group will hold the right to vote for equal periods of time.

Let us now exemplify its operation with 21 and 27 members. According to the above-presented data, the proposal stipulates that once the EMU reaches 16 members, the number of national central bank governors with a right to vote in the Governing Council should be restricted to 15, based on the rotation system. Thus, in the case when EMU

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[1] Also see De Grauwe (2003), Berger (2003), European Commission (2004).

[2] The proposal was made based on the Nice Treaty provisions. European leaders have been unable to find a solution at the Nice meeting but they have inserted the empowerment clause, which has allowed the Council to change the voting system based on a proposal from the Commission or the ECB.

[3] On 21.03.2003.

[4] European Commission (2004).

comprises 21 members, the two group system will be used. Member states among the 5 large economies will have 4 votes, whereas the other 16 countries will hold 11 votes. In case the EMU is enlarged to 27 members, the three group system will operate, where the first 5 economies receive 4 votes, the following 14 have 8 votes, and the other 8 will have 3 votes. (See annex 2)

To conclude, the new voting system is characterized by soundness, being designed to adapt to the euro zone enlargement up to 27 states (the current EU states, which Romania and Bulgaria will join).

Nonetheless, one can appreciate that in time, the rotation system might prove difficult even if sound and robust, and *that it is likely to lead to decision-making gaps when the euro area comprises a high number of members.*

Anyway, even in the event that the reform does not fully eliminate the difficulties in the decision-making system, it nonetheless represents a step forward. We should not forget that Bundesbank or the Federal Reserve System (FED) have improved the operation of their bodies in time. It took years for these institutions to learn how to combine the benefits of a regional structure with the effectiveness of a centralized decision[1].

### 3. Will the new voting mechanism eliminate the problems?

Thus, the reform of the ECB Governing Council's vote system is of special importance to eastern enlargement, and as we have shown, entails a limited number of 21 votes[2], regardless of the number of members the euro zone will comprise.

The proposed ECB reform will not fundamentally respond to enlargement challenges. With a total number of 21 members with a right to vote, the Governing Council will be smaller than without a reform but larger than, for instance, the similar FED body.

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[1] See also Berger 2002.
[2] 15 of the Governors + 6 of the Executive Board
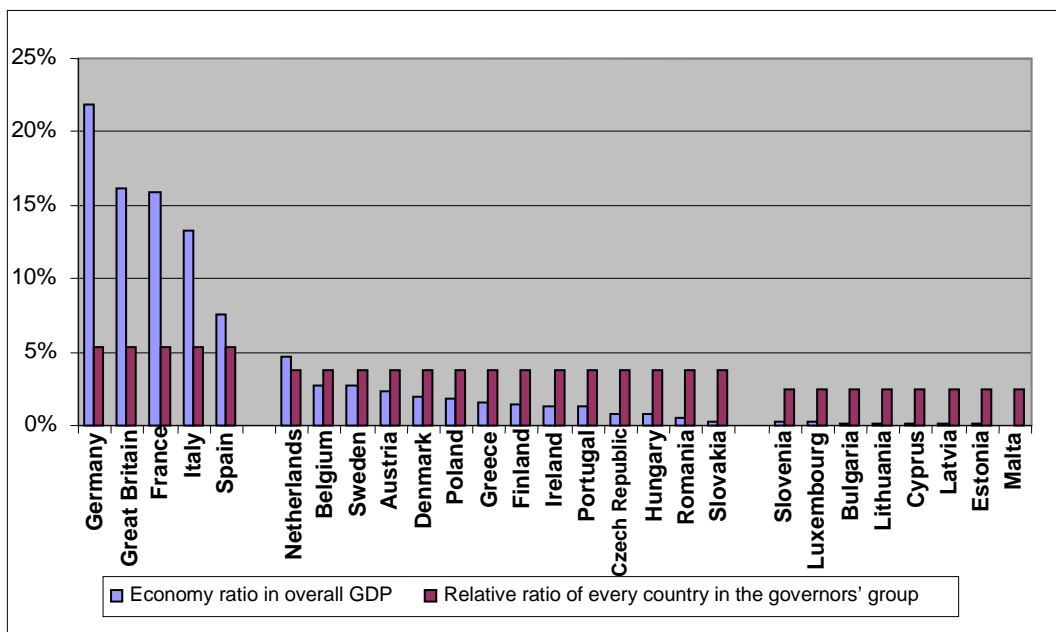
Graph 1   Economic importance and each country's weight in the governors' group

Source: according to the annex, own calculations[1]

Moreover, the reform will not do away with the issue of member state representation. Even in the case of the proposed reform, states such as Italy, France or Germany will be insufficiently represented, whereas states such as Malta, Latvia or Estonia will have a larger ratio than the size of their economies. There are fears that a "tyranny" of minority might emerge even with a reform.

Graph 1 proves the lack of symmetry between the economic importance of every country and the part they will play in an EMU enlarged to comprise 27 members.

The lack of correlation between economic importance and the role of national governors is even better outlined by graph 2, where one can see that the first group has a 74.63% economic participation and 4 votes, whereas the second group would have just a 24.21% GDP ratio and 8 votes!

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[1] See also Berger (2004).
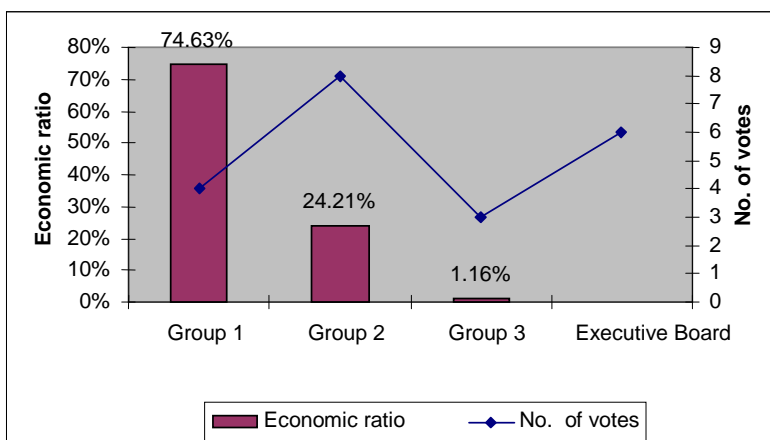
Graph 2   Economic ratio and number of votes per group of countries
Source: calculations in the annex

If we are to refer to the last group as well, it will represent just 1,16% of the GDP yet it will hold 3 votes in the Governing Council. If in the case of the current euro zone composition, the Executive Board could vote for an average interest rate, in case of enlargement it is highly likely that the desired interest rate distribution should be asymmetrical. Therefore the voting process will be difficult, running the risk that certain countries with major economic importance should be unsatisfied with the interest rate decided by the Governing Council. In this sense, the ECB and large states' apprehension might be, again, grounded.

Consequently, even if prone to controversies, the reform is a step forward. One should not forget that it took years to the Bundesbank or the FED to perfect the operation of their bodies.

Conclusion

The EU's Eastern enlargement means the possibility of euro zone eastern enlargement as well. In this sense we can imagine how hard will be to implement a monetary policy for 25 or 27 members.

Based on this assumption that the euro zone will be enlarged by 15 new members, and lacking an ECB reform, we would have a Governing Council comprising 33 members, being very difficult for such a body to make monetary policy decisions.

Moreover, an enlarged euro zone would be an overemphasized representation of national central banks in the decision-making mechanism (as compared with Bundesbank or the FED, where the Executive Board members dominate decision-making bodies).

This is why the ECB's viting mechanism is a reform subject. The voting syetem will change when the euro zone will comprise more than 15 members. From this point on the national governers total number will not exceede 15.

The 15 votes will be covered by rotation based on a pre-set rule, whereas the

Executive Board members will preserve their vote rights. Governors will be part of different groups, function of their economies' ratios in the euro zone, resulting by calculating an index that will comprise, apart from the GDP, the size of financial markets. When the number of countries in the euro zone reaches between 16 and 21, the rotation system will operate based on two such groups, and when the zone is made up of 22 members, the system will be based on three groups. Governors in each group will hold the right to vote for equal periods of time. Thus the new system is designed as a robust one, in order to assure the functioning of the euro zone comprising even 27 members.

Anyway, if we look at the ECB's voting mechanism, the proposed reform will not fundamentally respond to enlargement challenges: the Governing Council will be smaller than without a reform but larger than, for instance, the similar FED body.

Moreover, reform will not do away with the issue of member state representation. Even in the case of the proposed reform, larger economies such as Italy, France or Germany will be insufficiently represented, whereas smaller economies states such as Malta or Estonia will have a larger ratio than the size of their economies.

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TABLE 1.1

Crt. No.	Country	Wheight in overall GDP (2003)	Each country's relative ratio related to the overall number of governors' votes
	GROUP 1		
1	Germany	21.84%	5.33%
2	United Kingdom	16.08%	5.33%
3	France	15.83%	5.33%
4	Italy	13.30%	5.33%
5	Spain	7.58%	5.33%
	GROUP 2		
6	The Netherlands	4.63%	3.81%
7	Belgium	2.72%	3.81%
8	Sweden	2.71%	3.81%
9	Austria	2.28%	3.81%
10	Denmark	1.93%	3.81%
11	Poland	1.88%	3.81%
12	Greece	1.56%	3.81%
13	Finland	1.46%	3.81%
14	Ireland	1.36%	3.81%
15	Portugal	1.36%	3.81%
16	Czech Republic	0.76%	3.81%
17	Hungary	0.75%	3.81%
18	**Romania**	**0.50%**	**3.81**%
19	Slovakia	0.29%	3.81%
	GROUP 3		
20	Slovenia	0.25%	2.50%
21	Luxemburg	0.24%	2.50%
22	Bulgaria	0.18%	2.50%
23	Lithuania	0.16%	2.50%
24	Cyprus	0.12%	2.50%
25	Latvia	0.09%	2.50%
26	Estonia	0.08%	2.50%
27	Malta	0.04%	2.50%
Total		**100%**	**100%**

Table 1.2

	1	2	3	4	5	6
	No. of countries	Votes	Group frequency (**2/1**)	Country frequency	Group weight	The relative weight of each country
Group 1	5	4	80.00%	16.00%	26.67%	5.33%
Group 2	14	8	57.14%	4.08%	53.33%	3.81%
Group 3	8	3	37.50%	4.69%	20.00%	2.50%
	27	**15**			**100.00%**	

Source: Eurostat, ECB - Monthly Bulletin 05/03*; own clculations*
Notes:

1. The division per groups (table 1.1) is performed function of the GDP weight only;

2. In table 1.2, columns 1 and 2, groups and number of votes comply with the ECB proposal;

3. In column 5, the group weight in the overall governors' votes is calculated by dividing the number of votes (4, 8 or 3) to the whole number (15);

4. In column 6, every country's ratio/weight matches the group ratio to the number of countries in the group;

Table 2.1 The euro zone having between 16 and 21 members: two-group rotation system (first stage)

		Number of governors in the Governing Council						
		16	**17**	**18**	**19**	**20**	**21**	**22 and more**
1st group	No. of voting rights/ No. of governors	**5/5**	**5/5**	**5/5**	**4/5**	**4/5**	**4/5**	*Second stage: rotation system with three groups (table 2.2)*
	Voting frequency	*100%*	*100%*	*100%*	*80%*	*80%*	*80%*	
2nd group	No. of voting rights/ No. of governors	**10/11**	**10/12**	**10/13**	**11/14**	**11/15**	**11/16**	
	Voting frequency	*91%*	*83%*	*77%*	*79%*	*73%*	*69%*	
The sum of voting rights		**15**	**15**	**15**	**15**	**15**	**15**	

Table 2.2 The euro zone having more than 21 members – three-group rotation system (second stage)

		Number of governors in the Governing Council						
		16-21	**22**	**23**	**24**	**25**	**26**	**27**
1st group	No. of voting rights/ No. of governors	*First stage: rotation system with two groups (see Table 2.1)*	**4/5**	**4/5**	**4/5**	**4/5**	**4/5**	**4/5**
	Voting frequency		*80%*	*80%*	*80%*	*80%*	*80%*	*80%*
2nd group	No. of voting rights/ No. of governors		**8/11**	**8/12**	**8/12**	**8/13**	**8/13**	**8/14**
	Voting frequency		*73%*	*67%*	*67%*	*62%*	*62%*	*57%*
3rd group	No. of voting rights/ No. of governors		**3/6**	**3/6**	**3/7**	**3/7**	**3/8**	**3/8**
	Voting frequency		*50%*	*50%*	*43%*	*43%*	*38%*	*38%*
The sum of voting rights		**15**	**15**	**15**	**15**	**15**	**15**	**15**

*Source: **The adjustment of voting modalities in the Governing Council,** în ECB, Monthly Bulletin, may 2003*