The Naked ECB

The central bank's voting arrangements are in need of reform.

BY HOWARD DAVIES

The crisis in the eurozone remains far from resolution. Investor worries are now concentrated on the health of European banks, many of which have large exposures to Greece and the other southern European countries with severe fiscal problems.

Europe's leaders have so far applied only plaster to the wounds. A stabilization fund has been established, but on a temporary basis. New arrangements for monitoring member states' budget balances have been introduced, but they can do nothing about the stock of debt outstanding. And the European Central Bank has begun to buy government bonds, including those of Greece, at prices well above those that would prevail in a free market.

The latter move by the European Central Bank has underscored a number of unresolved questions about the structure of the Bank and how it makes its decisions. Some issues that Europe's decision makers have wanted to keep under the carpet have now been rudely exposed.

The decision to buy Greek bonds directly was not unanimous. The world now knows that Axel Weber, the president of the Bundesbank, voted against it. His was one vote out of twenty-two, but he represents 27 percent of eurozone GDP, so he cannot be dismissed as an insignificant outlier. It was the first time that the president of the ECB has had to reveal that a decision was not unanimous.

In theory, we have always known that the ECB would, if necessary, make decisions on the basis of majority rule. But until now, no such case

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had arisen, and there were no procedures for disclosing votes. This stands in marked contrast to the U.S. Federal Reserve, and also the Bank of England, where individual votes on the Monetary Policy Committee are routinely revealed.

The argument against transparency has been that, in the unusual circumstances of the ECB, to expose the votes of individual members of the Governing Council would put pressure on them as representatives of member states. The governor from a country in recession might feel almost bound to vote against an increase in interest rates, or for a cut, regardless of overall conditions in the eurozone.

But can an absence of clarity about the ECB's voting arrangements last forever? Nout Wellink of the Dutch central bank has explicitly said that more disclosure would one day be needed as the ECB reaches maturity. Weber's dissenting voice on Greek bond purchases brings that day dramatically closer.

It also exposes a more fundamental problem. The voting structure in the ECB is flawed. In any federal system, a balance must be struck between those who are charged with assessing economic conditions in the whole monetary area and those who represent the interests of particular regions.

This problem has been addressed before, in both the Federal Reserve and the Bundesbank. In the case of the Fed, seven members of the Board in Washington have a federal remit, and twelve presidents of regional reserve banks vote in rotation, with only the New York president having a permanent voice. So the ratio of central to regional votes is 1:0.7. The Bundesbank had a similar arrangement with a central/regional balance of 1:1.1.

The ECB is different, for some good reasons. It is the monetary authority of a federation of sovereign states. The weight of individual national members of the Governing Council is much greater. In fact, the ratio of federal to national votes in the ECB is 1:2.5. And, since each member state has one vote, there is a massive imbalance between the voting weight and the GDP weight of individual countries. Germany has the same weight as Malta.

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The ECB has thought about this problem, but all that has been agreed (in the Nice Treaty) is some modest rotation of voting membership as the federation grows further. This will not correct the imbalances that exist today.

So far, this problem has attracted little attention. But Weber's dissent opens up the possibility that small countries could vote down the center and the large members. It is theoretically possible that the six Executive Board members plus France, Germany, and Italy, representing 65 percent of the eurozone's GDP, could be outvoted by a coalition of small countries.

That could matter a lot in relation to interest rate decisions. It could also be relevant to purchases of debt from distressed member states. It is highly likely that the Greek debt that the ECB has acquired is not worth what it has paid. If Greece were forced to restructure its debt and impose a "haircut" on holders of its bonds, the ECB would incur a sizeable loss. That loss would be borne by eurozone member states in proportion to their share of eurozone GDP, even though the votes are one per country.

This peculiar arrangement is a further major risk for economic and monetary union, to add to those of uncoordinated fiscal policies and the lack of a European equivalent of the International Monetary Fund. Especially in nervous markets, which we certainly have today, any perception that the ECB's decisions might not take into account the interests of the whole eurozone, or could commit the major countries to significant losses, could itself be destabilizing.

This points to a clear need to revisit the terms of the Nice Treaty. That will be tough to do for political reasons. But it is increasingly clear that the eurozone needs a major overhaul if it is to survive. And the ECB's voting arrangements are one further element in need of reform. ◆

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