Supranationalism in Monetary Policy Decision-Making

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Central bank designs vary considerably around the world. Central banks differ, for instance, in their degree of institutional independence, their range of tasks and competencies, the size, composition and voting procedures of their decision-making bodies, and their communication and transparency policies. In view of the large differences in various organizational details of central banks, a growing body of literature aims to identify what can perhaps be described as best practice in central banking.

The European Central Bank (ECB) deviates from the majority of central banks in various respects. An obvious example is the size of the monetary policy decision-making body, the ECB's Governing Council, which currently consists of the six members of the Executive Board plus the governors of the national central banks of the 17 euro area countries. A council size of 23 (voting) members is clearly at the upper end of the distribution; most of the 82 central banks surveyed by Fry et al. (2000) operate a monetary policy committee with about 5-10 members. Another notable difference concerns the composition of the Council. Only few central banks require that decision-makers have a specific regional background; in the ECB's Governing Council, by contrast, the majority of seats are allocated by country, with each euro area member country having exactly one representative.

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When the ECB was established, many of these features of central bank design were probably chosen for good reason. The membership size of the Governing Council, for instance, can perhaps be justified by the size and heterogeneity of the economic area; Berger, Nitsch, and Lybek (2008) find that larger and more heterogeneous countries tend to have larger central bank boards. Having (at least) one representative from each member country in the Governing Council also seems to increase the central bank's credibility since it allows the council to communicate central bank decisions directly to the national public in each country in its native language.

After more than a decade in existence, however, it has become increasingly clear that some design features of the ECB are potentially problematic, because they strongly rely on the unrealistic assumption of an 'ideal' central banker (often accompanied by a hypothetical role model of a European policy-maker). The most critical assumption for the current organizational structure of the ECB is that all ECB-related decisions by central bankers and politicians are made with a purely European (or, more precisely, euro area-wide) perspective in mind. As the ECB (2004, p. 12) itself describes its procedures: "Monetary policy decisions in the euro area must be based on a euro area perspective. [...] When taking decisions, the members of the Governing Council do not act as national representatives but in a fully independent, personal capacity." If such benevolent behavior were indeed the case, the national background of ECB Governing Council members would be irrelevant, both for appointment and decision-making.

In practice, however, as will be argued below, it is obviously illusionary to expect that individuals (even central bankers) are completely ignorant as to their personal background, experiences and influences. As a result, national representation may, in fact, matter a great deal. This insight, if true, is of particular importance since the basic idea of national independence (and effective supranationalism) motivates a number of other critical (in fact, often unique) organizational features of the ECB.

Features of ECB design based on supranationalism

To illustrate this point, we consider the following four aspects of central bank design in turn: the membership size of the decision-making body, the taking of votes, the publication of votes and the weighting of votes.

A sizable body of literature examines the costs and benefits of small and large committees. While it is generally agreed that committees make better decisions than individuals, the exact number of members on the committee basically reflects a trade-off: on the one hand, a larger committee should be better able to process, analyse, and interpret large amounts of economic information; on the other hand, as the number of board members increases, the exchange of ideas becomes more complicated and the power of an individual to influence decisions (and, thus, his/her incentives to prepare for discussions) decreases. In fact, Berger and Nitsch (2011) estimate that monetary policy committees with an intermediate size of five to nine members have shown the best performance in the past.

The hypothesis of a supranational European central banker now seems to imply that the costs of increasing membership size are limited since all council members look at the same type of (euro area aggregate) data. Enlargement of the euro area, although potentially increasing diversity, hardly affects averages from economic data and, thus, does not necessarily lengthen discussions within the circle.[1] As a result, the benefits of admitting new national central bank governors to the council were initially viewed to outweigh the costs. In 2003, only a few years after the establishment of the ECB, a rotation model for voting rights was adopted, although this has not yet been implemented.[2]

The idea of 'taking a European perspective' has also led to some obviously distorted views and practices regarding decision-making in committees, with the ECB sending, for a long time, an artificial signal of consensus. Basically all central bank laws include a rule on voting procedures. In this respect, the ECB is no exception. Article 10 of the Statute of the ECB stipulates that: "The right to vote shall be exercised in person. [...] Save as otherwise provided for in this Statute, the Governing Council shall act by a simple majority of the members having a voting right. In the event of a tie, the President shall have the casting vote."[3]

Initially, however, the ECB did not even implement the simplest measure of individual accountability in decision-making, the taking of votes. As the first President of the ECB, Wim Duisenberg, explains (Barber, 1999): "I won't say that there never will be a vote, but in such a discussion, when it comes to a specific proposal, a consensus emerges over time. A consensus doesn't indicate in all cases that, if there had been a vote, it would have been unanimous. But if you see in a circle of [then] 17 people that there is a very large majority moving in the same direction, then nobody asks for a vote." Although it is not publicly known whether and when this procedure was changed, Duisenberg's successor as President, Jean-Claude Trichet, has long insisted that the Governing Council is a consensual body, in which members basically share similar views. Trichet's frequent claim that "we are a team" has become legendary in this context.

When no votes are taken at the meetings, voting records can also not be made public. However, whether votes are published or not is, in principle, a conscious design decision. For example, the Federal Reserve, the Bank of England, and the Bank of Japan, among others, release detailed minutes of the monetary policy meeting, including individual voting records. The ECB, in contrast, has decided to refrain from this form of transparency. Specifically, it is argued that this opacity helps to ensure supranationalism. Since members are likely to be associated with their country of origin by the public, the fear is that publishing votes may invite pressures by national politicians or interest groups. As the ECB's inaugural chief economist Otmar Issing (1999, p. 513) puts it: "Members of a committee with a clearly defined mandate should concentrate on making their individual best judgement and their best contribution to the collective decision-making process. Anything that focuses attention on personalities or nationalities, rather than on issues, is likely to distract from this task, to encourage attempts to 'play to the gallery' and thus, ultimately, to compromise

[1] In contrast, regional quotas (i.e., an assignment of seats by regional background) are typically adopted in order to explicitly allow for different regional perspectives.
[2] In 2008, the Governing Council decided to postpone the start of the rotation system until the date on which the number of governors exceeds 18; see ECB Decision ECB/2008/29, available at http://www.ecb.int/ecb/legal/pdf/l_00320090107en00040005.pdf.
[3] Available at http://www.ecb.int/ecb/legal/pdf/en_statute_from_c_11520080509en02010328.pdf.

personal independence." This reasoning, however, is again based on the implicit assumption that Council members always act fully according to mandate. If, in contrast, voting behavior is (partly) colored by national frames of reference, the argument completely turns around. Since no public assessment of individual voting behavior is possible, votes may be shaped in strong disproportion by national considerations. In the extreme, this intransparency may lead to situations in which council members themselves make their votes public (especially if they take a minority position).

As a final example of potential difficulties associated with supranationalism, we briefly discuss the weighting of votes in the ECB. For decisions on monetary policy, the ECB applies a 'one member, one vote' rule.[4] While this procedure offers some (mainly) practical advantages (e.g., by allowing easy determination of a quorum and majority, and giving the President the casting vote in case of a tie), the crucial assumption behind this decision rule is that nationality is irrelevant for decision-making. Since all Council members have the same mandate, weighting of votes by nationality seems to be unnecessary. As soon as this assumption is violated, however, the rule becomes highly problematic, since countries are heavily misrepresented. More generally, it seems hard to understand why nationality matters (often decisively) for appointment, but then becomes completely irrelevant immediately after appointment.

Does regional background matter for decision-making?

Yet, is supranationalism, the common belief of committee members on an overarching goal, indeed an illusion? Are votes influenced by the personal background of a decision-maker (including the decision-maker's regional affiliation)? There is not only strong direct and indirect empirical evidence pointing in this direction, European policy-makers also seem to be sensitive to this issue, often eagerly seeking to place national candidates in the ECB's Executive Board.

The most convincing piece of evidence is probably provided by analyses that examine individual voting records in central banks with regional quotas. Since there are few such constellations, most research focuses on the United States. These studies often strongly conclude that members of the Federal Open Market Committee are influenced by economic conditions in the regions that they represent; see, for instance, Gildea (1992), Meade and Sheets (2005), and Chappell, McGregor and Vermilyea (2008). In similar fashion, Berger and De Haan (2002) analyze individual voting behavior in the Bundesbank Council (Zentralbankrat), in which all German state central banks held voting rights, over the period from 1948-1961, finding that the probability of dissent voting is partly explained by regional economic developments. In sum, the assumption that an individual's regional background is irrelevant for decision-making has no firm basis in the data. Policy preferences of members of the ECB Governing Council, especially national central bank governors who live and work in their home country, are likely to be affected by local conditions.[5]

The role of lower management levels for decision-making

Finally, in Badinger and Nitsch (2011), we highlight the importance of national representation in the management of the ECB. Specifically, the paper builds on a recent literature in management science which analyzes corporate design, organizational hierarchies, and the functions of top executives (such as CEOs), board, and firm management in general. This literature typically emphasizes the effects of individuals in organizations. For instance, Bertrand and Schoar (2003) note that executives from earlier birth cohorts seem to be more conservative on average, while managers with an MBA degree tend to follow more aggressive strategies. For corporate boards, Schwartz-Ziv and Weisbach (2011) find that board activity chiefly involves supervising management, with board members often being presented with a clear recommendation as to which proposal the CEO/management preferred.

In Badinger and Nitsch (2011), we focus on the composition of the ECB management team below the Governing Council. Analysing the nationality of

[4] Article 10 of the Statute of the ECB describes two deviations from this rule. Firstly, for decisions concerning the capital of the ECB, the votes shall be weighted by the capital subscription key (with zero weight for Executive Board members). Secondly, once the rotation model is established, the number of governors with a voting right will be restricted to 15, with voting rights being assigned on a rotating basis.

[5] Euro area-wide indicators may nevertheless have a larger weight for decision-making; see Chappell, McGregor and Vermilyea (2008). Hayo and Méon (2011) provide interesting evidence for the ECB.

over 200 individuals who have been appointed to a management position since the establishment of the ECB, we ask whether country features matter for employment? We also search for evidence of networks among staff members along national lines. Finally, we examine whether the national composition of central bank staff has a measurable impact on policy-making.

In contrast to the principle of equal representation among national central bank governors in the Governing Council, we find that the national share of managers in the ECB varies strongly from country to country. A sizable fraction of the observed variation is, not surprisingly, explained by country size; countries with a larger capital share in the ECB and (often) a larger staff size at the national central bank tend to have more representatives in the management of the ECB, possibly reflecting a greater supply of able central bankers. Moreover, membership in the euro area is positively associated with shares of national representation, although the association becomes weaker as the management level declines. Interestingly, for the core business areas of the ECB, membership in the euro area seems to be an important precondition for appointment, while knowledge of the German language is less relevant than in the full sample.[6]

To explore the possible existence of national networks in the ECB, we analyse whether national presence at top management levels also affects national representation at lower management levels. While it could be argued that, following appointment of a new top executive, nationals of other countries are targeted for lower-level positions in order to achieve broad geographical representation within a given business area, nationals at the top level may also act as a door-opener for fellow nationals. Specifically, given that in the day-to-day business, personal interaction is often crucially important, there may be even a tendency to select subordinates who share the same language and culture. In our empirical analysis, we indeed find consistent evidence for the networks hypothesis; strong national representation at a particular management level is typically associated with similarly strong national presence at the subordinate management layer.

In a final exercise, we examine the association between national representation in the ECB's top management and monetary policy decision-making. To analyse this issue, we estimate Taylor-type interest rate rules; Taylor rules specify the nominal interest rate as a function of inflation and the output gap and are typically found to describe actual monetary policy reasonably well. For the ECB, we now make use of the fact that monetary policy is targeted at the euro area, such that the key macroeconomic variables of interest are weighted averages of national data from euro area member countries. As a result, we are able to compute euro area aggregates and estimate corresponding Taylor rules, based on alternative weighting schemes for national data. More precisely, it is argued that if monetary policy is directed more strongly towards the macroeconomic conditions in countries that are well represented in the ECB management, Taylor rule specifications that use national representation as weights to aggregate national data should provide a superior empirical fit than the default specification based on economic weights. Based on this approach, monetary policy decisions seem to be most closely linked to national representation in the core business areas of the ECB. Our estimates indicate that the ECB's interest-rate setting behavior is best described by a Taylor rule that uses national representation weights in the management of the ECB's key business units.

Policy conclusions

The decision rules of the ECB crucially depend on the assumption of supranationalism. In other words, the voting behavior of members of the Governing Council is exclusively shaped by their mandate and remains completely unaffected by local conditions. In practice, however, a sizable body of literature suggests that this assumption is seriously flawed.

As a solution, the asymmetry in the treatment of nationality for appointment and decision-making in the ECB should be reduced. A possible option to achieve this goal is to make national background irrelevant for membership of the Governing Council, as there is no need to have a committee that includes a national representative from each euro area member country. In terms of its implementation, this solution may imply strengthening the

[6] The ECB has defined as its core business areas: Banknotes; Economics; Financial Stability; International and European Relations; Legal Services; Market Operations; Payments and Market Infrastructure; Research; Statistics; the Target2-Securities Program; and the ECB Permanent Representation in Washington, DC. Supporting business areas are: Counsel to the Executive Board; Administration; Communications; Human Resources, Budget and Organization; Information Systems; Internal Audit and Secretariat and Language Services. See http://www.ecb.int/ecb/educational/facts/orga/html/or_005.en.html.

power of the Executive Board. Another option is to accept the importance of national background to decision-making and to weight votes accordingly. This rule could be implemented immediately since a similar procedure already applies to other ECB policy decisions.

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