

UC Berkeley

Occasional Papers

Title

The Enlargement Challenge: Can Monetary Union be Made to Work in an EU of 25 Members?

Permalink

<https://escholarship.org/uc/item/38d2r4z1>

Author

Eichengreen, Barry

Publication Date

2002-02-01

Working Paper OP-1

*The Enlargement Challenge:
Can Monetary Union be Made to Work in an EU of 25 Members?*

by

Barry Eichengreen

February 2002

Abstract

This lecture considers how Europe's monetary union will evolve in the next five to ten years. It concentrates on what is likely to be the most important change in that period, namely, the increasing number and heterogeneity of participating states. By 2006, less than four years from now, it is virtually certain that EMU will be enlarged to include a number of Eastern European countries that have not yet been admitted to the EU itself. These new members will differ sharply from the incumbents in terms of their economic structures, their per capita incomes, and their growth rates. The analysis focuses on the implications of this momentous change for the structure, organization and operation of EMU.

Barry Eichengreen, George C. Pardee and Helen N. Pardee Professor of Economics and Political Science; Director, Institute of European Studies, University of California, Berkeley.

**The Enlargement Challenge:
Can Monetary Union be Made to Work in an EU of 25 Members?¹**

**Barry Eichengreen
University of California, Berkeley
February 2002**

In this lecture I consider how Europe's monetary union will evolve in the next five to ten years. I concentrate on what is likely to be the most important change in that period, namely, the increased number and heterogeneity of participating states. By 2006, less than four years from now, it is virtually certain that EMU will be enlarged to include a number of Eastern European countries that have not yet been admitted to the EU itself. These new members will differ sharply from the incumbents in terms of their economic structures, their per capita incomes, and their growth rates. I focus on the implications of this development for the structure, organization and operation of EMU.

I should start by defending my assumption that the accession economies will join the monetary union at an early date. There is no question that the European Union will have as many as 10 new members by 2004. But membership in the EU does not guarantee membership in the monetary union. Nonetheless, I see six reasons why the accession economies will become members at an early date, say, by the middle of 2006. (Assuming that they join the EU toward the beginning of 2004, this provides for two years for participating in the ERM-II and a six-month changeover period. In fact, the Italian precedent -- Italy was let in despite not having been back in the ERM for two full years -- suggests that this could happen more quickly still. And the

¹Fifth annual David Finch Lecture delivered at the University of Melbourne, 20 February 2002. This lecture builds on a paper written jointly with Fabio Ghironi for DGII of the European Commission.

changeover could take less than six months in countries like Estonia that are already pegged to the euro.)

First, the accession economies will not enjoy opt outs from the Maastricht Treaty. Unlike Denmark and the UK, who were able to negotiate opt outs as a condition for agreeing to the treaty, the accession economies will be obliged to accept existing EU treaty obligations. In particular, they will be obliged to prepare for monetary union and to enter as soon as they are deemed ready by their partners.

Second, the accession economies come at least as close as the existing EMU members to satisfying the optimum currency area criteria. They are small. They are open and trade disproportionately with the EU; hence they stand to gain from the additional trade and foreign investment that a common currency will confer. They already have gone a good way toward establishing independent central banks. Some, like Bulgaria and Estonia, have already demonstrated their ability to live with a monetary policy set by the European Central Bank, while others already formulate their exchange rate policies with reference to the euro.

Third, there are few attractive alternatives. While several of the accession economies have moved toward greater exchange rate flexibility for lack of another mechanism for coping with capital flows, this is not a comfortable state of affairs. It will become less so as the accession economies join the European Union: their EU partners, concerned about low-wage competition from the east, are likely to press for measures to limit exchange-rate variability vis-a-vis the euro. They will insist on the provision of the Treaty of European Union that requires countries that are not yet part of the monetary union, and especially those seeking to qualify, to participate in an ERM II that will constrain the flexibility of their exchange rates. But exchange

rate bands are fragile and crisis prone; the accession economies will want to exit them as quickly as possible by entering the monetary union.²

Fourth, the accession economies will have little trouble satisfying the convergence criteria of the Maastricht Treaty that shape the entry decision. On the debt and deficit criteria that were the sticking points for countries like Italy, the candidates are in a favorable position since they possess limited non-inflationary options for financing deficits and since they inherited relatively light public debts. Most accession economies have relatively centralized fiscal institutions which give them the capacity to respond quickly to shocks. Although Eastern European populations are aging, which will increase fiscal burdens related to pensions and health care, demographic change is little faster than in the West. Complying with EU environmental standards will cost the prospective members at most one to two per cent of GDP. To be sure, they rate less favorably in terms of the inflation and interest-rate criteria. But experience suggests that these variables — interest rates especially — respond quickly and constructively to prospects for EMU membership.³

²One possible solution is to short-circuit the ERM-II stage by moving immediately to an Estonian- or Bulgarian-style currency board. But the incumbents have announced that they are unwilling to permit this option. In any case, this strategy, if adopted, is likely to be viewed as temporary; as a semi-permanent arrangement currency boards have no advantages relative to monetary union and the disadvantage that the country operating it has no voice in formulating the common monetary policy.

³And, in contrast to the situation after they enter the monetary union, the candidates will be able to appreciate their exchange rates to push down inflation to the requisite levels during the transitional period when they seek to qualify for EMU membership. To be sure, the fact that inflation tends to be high in relatively fast growing economies, reflecting the operation of the Balassa-Samuelson effect, suggests that satisfying the inflation criterion will be a challenge. The Balassa-Samuelson effect is likely to imply two additional percentage points of annual inflation in the accession economies. If this leads to an extra 4 percentage points of cumulative inflation between 2004 and 2006, then the exchange rates of the accession economies would have to

Fifth, the incumbents are unlikely to be able to do much to keep the aspirants out. The new EU member states will have blocking power in the Ecofin Council over a variety of matters requiring unanimous consent. (This will be true even if something resembling the Nice Treaty is eventually adopted.) They can use that power to block progress on other matters if the incumbents attempt to delay EMU enlargement. This was the situation, you may recall, that led the Maastricht entry criteria to be interpreted flexibly in 1997 and for all 12 EU member states wishing to join the monetary union to be deemed qualified either immediately or within two years of the inauguration of Stage III.

Sixth, and finally, a number of the accession economies -- most prominently Estonia and Hungary but prospectively others -- have largely solved problems of lax corporate governance, poor internal controls and open-ended public guarantees in their financial systems by selling off their banks to Western European financial institutions. This limits the danger of a banking crisis that could derail efforts to satisfy the convergence criteria.

For all these reasons, then, I see enlargement of the Europe's monetary union to 20 members or more by 2006 to be virtually a fait accompli.

Let me turn now to the implications, starting with those for prudential supervision.

* * * * *

appreciate by 4 per cent over this period in order to bring total inflation down to average EU levels. This is compatible with the plus-or-minus 15 per cent bands of the ERM-II (although it might have a depressing effect on these countries' traded-goods-producing industries, other things equal, which would be another cost of qualifying for EMU). And it is worth recalling in this connection that the convergence criteria do not require the new members to run the same inflation as the incumbents, only to come within 1 1/2 percentage points of their inflation rate (precisely, the rates of the three lowest inflation members) each year.

One of the most visible effects of monetary unification has been to encourage consolidation in European banking. The euro, in combination with the First and Second Banking Directives, has greatly reduced the barriers to cross-border banking. By fueling the growth of European securities markets and stimulating new alternatives to bank intermediation, it has forced European banks to contemplate mergers and strategic alliances in order to maintain their profitability.

So far, most consolidation has been at the national level, although we have now seen the first of what will surely be a rising tide of cross-border mergers and acquisitions. The part of Europe where cross-border acquisitions have been greatest is, of course, precisely the accession economies. Many newly-established and reconstituted private banks have been acquired by Western European financial institutions. This has created a two-tier banking system combining a tier of well-capitalized, well-managed, foreign-owned private financial institutions with a second tier of banks still in government hands and saddled with an overhang of nonperforming loans.

These characteristics of the banking sector pose a challenge for prudential supervision and its coordination with monetary policy. Public banks are not subject to market and shareholder discipline. Their owners are often sensitive to the condition of their customers as much as of as the banks themselves, resulting in mixed motives and excessive forbearance. Private, foreign-owned banks can skim off the most profitable business. International comparisons have shown that this is an environment ripe for financial instability.⁴

⁴The limited administrative capacity of newly-established regulatory agencies in many accession economies suggests that early privatization, which shifts the burden of disciplining bank management to the market, should be a high priority. Unfortunately, the costs of removing nonperforming loans from public bank balance sheets and recapitalizing these institutions are likely to be significant.

The fact that a large number of private banks have been acquired by foreign financial institutions raises questions about the compatibility of the single currency with a single, integrated banking system characterized by 20 or more distinct national systems of supervision and regulation. Although the “reg” part of “sup and reg” will be harmonized by mutual recognition and EU directives defining minimum requirements for the regulation of banking systems, prudential supervision is another matter. Different supervisors can and do interpret EU directives differently. There is little to prevent them from averting their eyes when their national champions take on additional risk in the attempt to get a leg up in international competition. The incentives to react in this way will of course strengthen as competition intensifies. (More intense cross-border competition, in banking as generally, is of course part of the *raison d’etre* for the Single Market and the single currency.) In any case, assigning supervision and regulation to the home-country authorities becomes increasingly problematic as banks come to do a growing share of their business internationally.⁵

These are all reasons why national supervision is problematic in a financially-integrated Europe. They suggest that the advent of the euro will create pressure for the EU to establish a centralized supervisory agency, either within the ECB, as suggested by Tomaso Pado-Scioppa, or independent of it, as argued in the Lamfalussy Report. Will enlargement to the east accentuate this tendency to centralize supervisory functions? The fact that the new members will have the EU’s least experienced supervisory authorities points in this direction. That monetary unification, by further reducing transactions costs and making it easier to finance mergers and

⁵For example, it becomes difficult for the home-country supervisor to evaluate counterparty risk, given the difficulty of assembling information on foreign counterparties.

acquisitions by enhancing the liquidity of European bond markets, will accelerate acquisition of Eastern European banks by their Western European counterparts work in the same direction.⁶

Will those functions be housed in the central bank, as the ECB itself has proposed, or in an independent agency, as favored by the German government? Arguments for housing the supervisory agency in the central bank include that supervisory information is valuable for the conduct of monetary policy, and that the monetary authority should act as lender of last resort in times of crisis, an activity that must be informed by facts that only a supervisory authority can possess. The main argument for an independent agency is that housing this function in the central bank creates the potential for conflict with the monetary-policy function. (There is some evidence that central banks responsible for prudential supervision are more susceptible to inflationary pressures.)

In fact, Europe's new monetary authority is ideally structured to square this circle. It is a "European System of Central Banks" made up of the ECB and the national central banks, which are in constant communication with one another (in principle, anyway) and tied together by the participation of national central bank presidents on the ECB's governing board. Why not then give more supervisory power to the national central banks? They are closest to their national

⁶On the other hand, the banking systems of the accession economies are small relative to the countries in question and even more relative to Europe (as noted above). Financial distress will therefore create less pressure for bailouts on too-big-to-fail grounds and less scope for contagion through the interbank market than in the event of the failure of a large Western European institution. Moreover, to the extent that the further integration and consolidation of European banking causes banks in the new member states to be acquired by larger institutions from elsewhere in the EU, this will automatically remedy some of the weaknesses of Eastern European financial systems and export key supervisory functions to more experienced agencies in the west. Thus, while monetary union has already added to the pressure for centralization of some supervisory functions at the EU level, enlargement to the east will lend only a bit of additional momentum to the inevitable movement in this direction.

markets, and there already exist channels for communicating their findings to Frankfurt. The ECB will then get the information it needs for the conduct of monetary policy and lender of last resort operations. The moral hazard for monetary policy will be limited because national central banks no longer make monetary policy. Because supervisory authority will rest with the national central bank, which will have only one voice out of more than a dozen in the formulation of monetary policy, the danger that fears for the stability of a national financial system will push ECB policy in a more expansionary direction will be limited. This approach would avoid giving yet additional powers to an already powerful and only weakly accountable European institution. (National central banks, in contrast, are still accountable to their national parliaments.) If these arguments don't convince you, there is the additional fact that the national central banks no longer have anything else to do!⁷ This arrangement won't solve the problem of coordinating home and host country supervision, but the scope for regulatory coordination will surely be greater within the European System of Central Banks, which -- after all -- is a system, than amongst 12 or 20 independent national regulators.

* * * * *

Let me turn next to fiscal policy. On joining the EU, the accession economies will become subject to the "reference values" for deficits of no more than 3 per cent of GDP that help to determine whether they qualify for EMU. After they qualify, they will still be subject to the Growth and Stability Pact (GSP) that requires all EU members to aim for "medium-term

⁷*The Financial Times* recently speculated that the driving force for ECB proposals for a larger role in bank supervision "may be pressure from eurozone central banks, which have lost their control of monetary policy and are looking for tasks to justify their existence."

objectives of budgetary positions close to balance or in surplus.” For most EU member states, budgets close to balance or in surplus in normal times will give automatic stabilizers sufficient room to respond to ordinary recessions without exceeding the reference value of 3 per cent, above which questions of budgetary sustainability and financial stability may arise. The worry is that the accession economies may experience unusually large shocks. They will therefore require larger “medium-term” surpluses in order to reconcile the 3 per cent reference value with the need to avoid procyclical changes in discretionary fiscal policy. It follows in this view that the accession economies should be subject to particularly stringent application of the GSP.

In fact, I would draw a different conclusion from these observations. What should be changed to accommodate the accession economies is not the requirement that medium-term budgets must be close to balance but rather the requirement that deficits cannot exceed 3 per cent of GDP except in exceptional circumstances. The 3 per cent ceiling was a political compromise, but to the extent that it had an economic rationale it was chosen to reconcile real growth rates, real interest rates, and inherited levels of debt with a nonexplosive path for the debt. But the EU’s new members should be able to grow considerably faster than the incumbents, given that they are starting out behind, enabling them to run larger deficits without risking explosive growth of their debts. That their debts start out low works in the same direction. What should be reinterpreted on their behalf therefore is not the “close to balance” clause in the GSP but the 3 per cent reference value.

Another implication for fiscal policy derives from the fact that the new member states will rely more heavily on discretionary changes in their budgets. The EU’s new members will rely less on progressive income and corporate taxes and more on the essentially proportional

VAT. Their deficits will therefore be less elastic with respect to the cycle. Since they will derive less support from automatic stabilizers, they will have to rely more on one-off changes in fiscal policy.

The response of the political system being difficult to forecast, such discretionary changes in fiscal policy are more difficult to project than automatic ones. This complicates the coordination of fiscal policies. Member states will have to provide information on national budgetary discussions more promptly. This raises concerns about sovereignty: the Dutch, French and British governments have already made clear their reluctance to share more information on policy actions prior to their implementation. The more demanding nature of fiscal coordination in an enlarged monetary union also points to the need to streamline the process whereby recommendations for fiscal adjustments pass from the national authorities to the European Commission and then to the Ecofin Council and the European Council, and to the importance of strengthening the Commission's capacity to process and evaluate the incoming information.⁸

To put these concerns in context, it is important to remember that the budgets of the

⁸The proposals to strengthen fiscal coordination tabled by the Commission in 2001 are consistent with this quest. They include (i) creating a working group of senior treasury officials within the Economic and Financial Committee to prepare the meetings of the Euro Group finance ministers (the Euro Group being made up of the finance ministers of member states participating in the monetary union), so that fiscal issues can be more thoroughly discussed, (ii) requiring EMU members to inform one another and the Commission prior to adopting policies that are likely to impose externalities on other member states (rather than simply submitting the budget once this has been agreed by national authorities), and (iii) having the Commission evaluate the euro-zone policy mix twice a year (rather than annually, as at present). Predictably, support for these recommendations has been mixed. Member states that do not yet participate in EMU have warned that de facto shifting coordination functions to the Euro Group would create a feeling of exclusion among countries that have not yet joined the monetary union and sow divisions within the Ecofin Council. And whether the Commission has the capacity to engage in the essentially continuous policy reviews implied by a biannual schedule can reasonably be questioned.

accession economies, like their economies and financial systems, will be small relative to those of the EMU incumbents following accession. Hence the cross-border spillovers of their fiscal policies will be small. Insofar as their debts similarly will be small relative to European financial markets, this will limit the pressure on the ECB to backstop their public debt markets so as to prevent debt-servicing problems from infecting European financial markets and institutions.

Thus, the problem is not so much that fiscal imbalances in the new Central and Eastern European members threaten to place financial and economic stability in Western Europe at risk, something that is unlikely given the disproportion in the economic and financial size of the two regions. Rather, it is that a Growth and Stability Pact and procedures tailored to the circumstances of the EU's high-income incumbents will not be compatible with growth and stability in the accession economies. If even more diverse growth performance results, the strains on the common monetary policy will be greater still. To put the point colloquially, if fiscal policy is not part of the solution, then even greater pressure will be placed on the monetary authorities to provide it.

* * * * *

Let me turn next to labor markets. Admitting ten Central and Eastern European candidate countries will expand the EU's population by a third, which is equivalent to the increase in German population due to reunification. Not only are wages in the accession economies a fraction of those in the monetary union (half of EMU levels in the 1998 Accession Group, a third of EMU levels in the 2000 Accession Group), but unemployment rates are uniformly higher in the accession economies. Thus, enlargement will provide Western Europe with a reservoir of

labor with incentives to move.

Will these incentives to relocate produce the more mobile labor force needed to smooth the operation of the monetary union? Will the greater elasticity of labor supply at the national level that results from this mobility ratchet up the pressure for the reform of labor market institutions? The answer to both questions is likely to be “yes, but to a limited extent over the time frame relevant to this paper.” For one thing, it is likely that the incumbents will attempt to limit the access of the citizens of the new member states to jobs in the western countries for a transitional period. The Commission has proposed that labor mobility should be limited for a period of 5 to 8 years, echoing the German line.

I would note in passing that whether such restrictions can be enforced is questionable. A similar transitional period applied to Greece, Portugal and Spain when they entered the European Community. But this predated the creation of the Single Market. If the new members are to receive the other rights and privileges of countries participating in the Single Market, then it will become difficult to restrict the movement of their citizens across its internal borders. Stopping workers from moving will require halting trucks, trains and barges at the border, in turn raising transport costs (and transactions costs generally), and slowing the process of commodity-market integration. Conversely, allowing the trucks to roll will make it harder to stem labor flows and to prevent migrant labor from participating in the informal sectors of the high-income countries. Given that there is likely to be strong resistance to denying the accession economies the other benefits of the Single Market, efforts to limit labor mobility for this transitional period may be less successful than historical precedent suggests.

The evidence from German unification is that the very most- and least-skilled workers

have the greatest tendency to move. Western Europe will therefore import unskilled workers for low-paying, physically-demanding jobs when their labor markets are tight, a tendency that already manifests itself, for example, in the legions of Albanian and Bulgarian workers engaged in harvest labor, legally and illegally, in Greece. University graduates also will have a disproportionate tendency to move, reflecting the fact that they possess the linguistic and social skills to thrive in another country. As the mutual recognition of technical credentials is extended to the accession economies, they are likely to show up in Western European countries with tight labor markets. If the EU attempts to limit labor mobility for a transitional period, their relocation will be slowed, since the need for workers to present their technical credentials to employers and professional associations provides an additional threshold at which the policy of preventing immigration can be enforced. This suggests that the informal sector will be the main beneficiary of more elastic labor supplies in the short run, while manufacturing will be least affected.

Thus, while increased labor mobility is likely to be one of the positive side-effects of eastward expansion for Europe's monetary union, the extent of the change should not be exaggerated, especially in the short run when migrant networks are underdeveloped and manufacturing continues to play a large role in the European economy.

* * * * *

I have reviewed a number of arguments for expecting a larger, more heterogeneous monetary union at an early date. But the real stumbling bloc to granting admission to these additional members may be the ability of ECB decision-making processes to handle larger numbers.

Enlargement to include a significant number of accession economies increases the danger that the six Executive Board members, whose decisions are presumably guided by conditions in the euro zone as a whole, could be outvoted by a coalition of national representatives who prefer a policy suitable for only a small part of the EMU economy. One might imagine nine new members, each enjoying catch-up growth while suffering from relatively high inflation, teaming up with Finland, Ireland, Italy, Portugal, Spain and Greece, where conditions are similar, to demand anti-inflationary interest rate hikes that choke off expansion in the rest of Euroland, whose six national representatives, together with the six members at large, can command only a minority of votes. Countries accounting for less than a third of euro-zone economic activity could thus dictate the common monetary policy.

Even if this is not the case, there is still the danger that such a large number of Governing Council members will succumb to gridlock as a result of increased decision-making costs. Six Executive Board members plus anywhere from 17 to 28 national central bank governors will create large-numbers problems for the Governing Council. The U.S. Federal Open Market Committee has 12 voting members; the Bank of England's and Bank of Japan's policy boards have 9. In the case of the ECB, it will take a very large conference table to even seat the members. Imagine that every member is allowed to make a 15 minute opening statement. It would then take a day to dispense with preliminaries. It will be difficult to build consensus with such a large board. An ECB that was slow to raise interest rates when inflation was accelerating or to cut them when growth was slowing, reflecting its inability to make quick decisions, would enjoy neither policy credibility nor political support, as we learned when the institution was slow to react to the slowdown last year.

This large-numbers problem suggests reducing the number of voting members of the Governing Council. EU leaders took a first step in this direction at the Nice Summit by inserting in their draft treaty a clause allowing for changes in the ECB's decision-making procedures without calling another inter-governmental conference. The proposals under discussion include:

- Having national central bankers rotate on and off the Governing Council.
- Forming countries into constituencies, as at the IMF.
- Empowering the Ecofin Council to set inflation targets and limiting the ECB's mandate to achieving them.
- Delegating decision making power to an independent committee of experts. The national central bank governors could still retain some kind of advisory role for monetary policy, and they would report to the Board on economic conditions in their country, but they would not have the power to set interest rates.

The fourth option is popular in the UK, where the formulation of monetary policy is heavily shaped by an independent committee of non-official experts -- professors, in other words. (This solution is always popular among professors...) But the UK does not have much say in reshaping the ECB, and it is unlikely to gain more insofar as it will be the last existing EU member state to join. Moreover, the ECB already has an accountability deficit. The accountability of Europe's monetary policy makers would be further weakened if national central bankers, who are ultimately accountable to their domestic polities, were effectively removed from the Governing Council.

Empowering the Ecofin Council to set an inflation target and broad guidelines for monetary policy would streamline ECB decision making by providing a framework for its interest-rate decisions. In addition, it would go some way toward solving the problem of political accountability. The Council's guidelines would provide an agenda-setting function for the deliberations of the ECB. To put it in scholarly jargon, the ECB would then have instrument independence but not goal independence. But this reform would not change the fact that in an expanded monetary union there would still be an unprecedented number of Governing Council members who would have to agree on these strategic decisions, nor would it address the danger of an overly slow response or inaction in the face of rapidly changing conditions.

An FOMC-style solution, in which a subset of national central bank governors serve, say, staggered 12 month terms on the Governing Council, allowing all regions to be represented but solving both the large numbers and regional-dominance problems, seems like the intuitive solution to an American observer. While European countries would resist moving to such a system because they are accustomed to continuous representation on the Council, it is worth recalling that neither was rotation the initial arrangement for the Federal Reserve committee charged with making monetary policy; rather, it was phased in after several years in response to evidence of the unworkability of earlier arrangements.

A final possibility is reform along the lines of the IMF constituency system. The 20-plus countries participating in the monetary union could be assembled into constituencies, say, four or five in number, each having a single vote. The reorganization of the Bundesbank following German reunification provides a precedent. Absent reorganization, reunification would have expanded the Bundesbank Council to 26 members (10 members of the directorate and 16 *land*

central bank presidents). This number being considered unworkable, the decision was taken to merge a number of *land* central banks, reducing their number to nine.

But where Germany's post-EMU reorganization abolished the affected *landers'* separate regional representatives, under a constituency system the separate national representatives would remain. This would imply the need for pre-negotiation among those national representatives, whose chair would then have to represent their collective view in the deliberations of the Governing Council. If the point of reorganization is to speed and simplify decision making, a constituency system that replaced negotiation with pre-negotiation and shifted the haggling to before the actual Council meeting would achieve little.

On balance, I would favor rotation over constituencies as a more effective way of streamlining decision making and promoting frank discussion, and thereby information revelation, within the ECB Council. My guess is that this is the direction that Europe is heading. Rotation was the solution adopted at Nice to deal with the size of the European Commission. Wim Duisenberg has described it to the European Parliament as "the most likely outcome." France will accept it, since it will have the presidency of the ECB. Germany will accept it, because it will see rotation as the price that has to be paid for EU enlargement to the East, something that it wants more than any other member state. To be sure, the large member states (France, Germany, Italy, Spain and the UK -- if and when it joins) will want permanent seats while having the small countries rotate. The small ones will want all countries to rotate on and off the board. One can imagine a compromise where the four large countries rotate on and off every second period, while the 16 small ones rotate on and off every four, making for an Governing Council of 12 members.

* * * * *

I have argued that membership in Europe's monetary union will be radically different as soon as four years from now. This will pose serious challenges. But nothing I have said implies that EMU will be unable to accommodate this expansion. The wide monetary union created in 1999 has been able to handle members with different structures, growth rates and per capita GDP. Enlargement will enhance labor mobility within the monetary union and thereby ease its member's adjustment to shocks. But it also will heighten the need to strengthen procedures for mutual surveillance of national fiscal policies and to coordinate the supervision and regulation of financial institutions at the EU level. These are things that the European Union will have to address in any case, however, expansion of its monetary union or not. That is to say, expansion will only intensify the pressure to do what is already necessary.

Politically, the most formidable challenge will be to reorganize decision making within the ECB. Agreement will not come easily; large countries will be reluctant to rotate off the Council, and small countries will hesitate to take seats at the back of the bus. But, as the Nice Summit reveals, these are directions in which decision making in the European Union is headed anyway. The European Central Bank can be no exception.

While none of the options on the table meets every objection, there are nonetheless compelling arguments for some kind of reform. It is important to set these changes in motion prior to enlargement of the monetary union. The larger the numbers, the more difficult it will be to agree on changes; status quo bias will grow stronger. The evolution of the U.S. Federal Reserve System suggests that such reforms can be pushed through over the objections of regional

interests after the fact, but that it may then take a crisis to galvanize the authorities into action. In the United States this meant the Great Depression. These are not circumstances under which Europe should prefer to modernize and streamline decision making in its monetary union.