Christian Noyer: Some ECB views on the accession process

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, on the occasion of The Central & Eastern European Issuers & Investors Forum, held in Vienna on 17 January 2001.

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Ladies and gentlemen,

I should like to thank the organisers for the opportunity to participate in this Conference in Vienna. This city has often been regarded, and rightly so, as a cultural bridge between the Member States of the European Union and the so-called candidate countries preparing for EU accession. Vienna already provided a stimulating backdrop to the discussion of issues related to accession about one month ago. In mid-December 2000, the Eurosystem (i.e. the European Central Bank (ECB) and the national central banks of the 12 Member States that have introduced the euro) held its annual high-level policy dialogue with the central bank governors of accession countries' central banks on the occasion of the "Vienna Seminar on the EU accession process".

I am looking forward to continuing this discussion not only with my colleagues from the central banking community but also with financial sector participants. From the specific perspective of a central banker, I can appreciate the important role which you play in the transition process, as leading investors and corporations that are active in this dynamic part of Europe. I am referring, in particular, to efforts to establish and maintain market discipline, to reinforce good corporate governance and business practices and - at the same time - to provide the highly valuable capital and transfer of "know-how" to these countries.

Transition has been challenging also from a central banker's point of view. Central banks - as we understand them - did not exist in the accession countries before the start of transition, and a society-wide consensus about price stability and the role of central banks was not an issue. At the outset of the transition, the conduct of monetary policy was complicated to an extent which might be hard to imagine for some of us in the ECB by far-reaching structural changes throughout the economy, the lack of a well-tested set of monetary policy instruments and, last but not least, high or even hyperinflation. Against this background, the achievements of the central banks in transition economies have been most remarkable.

Assessing current economic developments in accession countries, and putting them into perspective as regards their respective starting-points, I am pleased to note the considerable progress that has been made over the past decade. Undeniably, this progress, in particular structural adjustments, has also lowered vulnerability to external financial crises, as shown by the limited contagion effects during the Russian and - more recently - the Turkish crisis. A substantial reallocation of resources, a strong reorientation of trade links towards the EU, a complete institutional overhaul and a sizeable development of the private sector are the most obvious signs of systemic change. They have also contributed to the output recovery of these countries. Positive growth differentials with the euro area have also fostered real convergence, although this process is taking place - on average - at a more moderate pace than we had either wished or expected, but the economic outlook for practically all the countries is very positive.

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Despite all these achievements, we are well aware of the remaining challenges - and there are many of them - which lie ahead in this historic process for accession countries and their central banks. In order to support these reform efforts the Eurosystem is providing technical assistance - mainly via its national central banks - and is making use of a common platform for a close policy dialogue. Almost 300 activities, comprising bilateral visits, seminars and technical assistance activities, were conducted between the Eurosystem and accession countries in 2000 in all areas of central banking. In any event - and I should like to make this clear- all these activities are based on the unequivocal recognition that enlargement is ultimately a political decision which concerns first and foremost the Member States of the European Union.

That said, the Eurosystem's attention to accession countries also stems from a justified institutional and functional interest, namely the prospective inclusion of these countries in the euro area, provided that they fulfil the necessary conditions. In such a forward-looking perspective, we might consider the road towards the adoption of the euro as encompassing three distinct phases with different sets of criteria, namely: EU membership preceded by compliance with the Copenhagen criteria; participation in ERM II; and the eventual adoption of the euro, based upon the fulfilment of the Maastricht criteria. All these phases are equally important and help to create a solid basis for future non-inflationary growth. Just as in everyday life, though, where one should not put the cart before the horse, as it were, by taking the second step before the first, it is clear that accession countries' ability to cope with preparations for EU entry, that is, their success in adjusting to the conditions of the Single Market, will be crucial to determining the results and the timing of the two subsequent steps towards the euro.

Allow me to elaborate on the three phases in more detail:

1. In the first phase - prior to EU accession - candidate countries need to step up all their efforts to comply with the so-called *Copenhagen criteria*. As you are certainly aware, one of these criteria calls for the proper adoption of the *acquis communautaire*. This naturally also includes the provisions relating to Economic and Monetary Union. In particular, legislation will have to be put in place that ensures the full independence of central banks. In this respect, I noticed with some concern recent episodes in some countries which confirm the need for more stringent legislation on central bank independence.

Analysing candidate countries' monetary policy strategies, I find it rather encouraging that they are, in most cases, increasingly similar to that of the ECB. Centred on price stability, the conduct of monetary policy is built more and more around the use of indirect and market-based instruments to control liquidity conditions in the banking system. However, accession countries will need to further advance the process of bringing down inflation rates in the years to come. At the same time, they should not delay the much needed relative price adjustments within the economy which are part of the real convergence process.

As for exchange rate regimes - I understand that this issue may be of particular interest since many foreign investors are present - there are no formal requirements in the pre-accession phase. Each country remains responsible for the chosen exchange rate regime, and a plurality of approaches seems feasible. Such a variety could also be observed with respect to existing Member States prior to their entry into the EU. In brief, in this phase the consistency of economic policies and their appropriateness for the individual economic situation appear to be more important than the specific choice of an exchange rate regime.

The Eurosystem also has a vital interest in the proper functioning of financial and payment systems in accession countries. In the context of EU accession, we expect candidate countries to adopt EU legislation in the area of financial services, including those related to banking, insurance and investment firms. In this context, allow me to recall an expression used by that famous Viennese economist, Joseph Schumpeter, who once contended that the only important institution in capitalism is the bank.

The establishment of an efficient and competitive banking sector as well as a smoothly functioning capital market ensures the stability of financial systems and supports the convergence process in these countries. It is also an essential requirement for the proper conduct of monetary policy and therefore also for successful future participation in the euro area - once the necessary conditions have been fulfilled.

The creation of deep and liquid capital markets is an important factor enabling an efficient use of indirect and market-based instruments in the conduct of monetary policy. It furthermore strengthens compliance with the rules relating to the prohibition of privileged access to the financial system. Finally, structural weaknesses in the banking sector could also have severe implications for the monetary policy transmission mechanism, affecting the responsiveness of banks to changes in the monetary policy stance.

Efforts to strengthen the financial sector and the banking system need to be undertaken in the years ahead, not least in fulfilment of the so-called "economic" Copenhagen criterion. This criterion requires the existence of functioning market economies and the capacity to cope with competitive pressures. While it is undoubtedly a difficult task, compliance with this criterion is an essential step towards integrating into the Single Market and, in this way, towards creating a solid basis for future non-inflationary growth.

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2. In the second phase of the aforementioned three-stage process - starting immediately upon accession into the EU - the new entrants will, as far as EMU is concerned, have the status of "Member

States with a derogation". No "opt-out" clauses will be available for the future new members. As from their entry into the EU, the new Member States will be obliged to treat their exchange rate policy as a matter of common interest. This implies, for example, that competitive devaluations are not allowed, since they would interfere with the smooth functioning of the Single Market.

Bearing in mind the final objective of adopting the euro, we expect accession countries to join ERM II, when they have achieved a sufficient degree of convergence with the euro area. This mechanism can accommodate different exchange rate regimes including euro-based currency board systems, provided that they are compatible with its key features and that the policy objectives are in line with those of the mechanism and with participation in the Single Market. The only clear incompatibilities with ERM II that can be identified at this stage are the cases of free floating, crawling pegs, and pegs to reference currencies other than the euro.

Most accession countries have already indicated their intention to join the mechanism as soon as possible after entry into the EU. In this context, I should like to stress that the experience of current Member States reveals that the time between EU accession and entry into ERM II can vary considerably. Taking into account only the six countries that joined the EU after the establishment of the European Monetary System (EMS) and the ERM in 1979, only one country, namely Austria, joined the ERM immediately following its accession to the EU in 1995.

In this second phase we also expect candidate countries ultimately to satisfy the Maastricht criteria, which - I think - require no further elaboration. Nominal convergence will become a key requirement and regular convergence reports, both by the European Commission and the ECB, will assess whether the convergence process has progressed sufficiently to qualify for the adoption of the euro. The Treaty requires the strict and sustainable fulfilment of these criteria, which we will apply to future euro area entrants in the same way as we have done to past ones.

3. As a final step, based upon the fulfilment of these criteria, the new Member States will then be expected to enter the third phase and to exchange their national currencies for the euro and, thus, to become full participants in EMU.

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Before concluding my remarks, I should like to stress an important constraint that will guide all our actions in relation to the three above-mentioned steps. Whatever the intensity of the Eurosystem's involvement in the enlargement process, we will always focus on the maintenance of price stability *in the euro area*. Hence, any arrangements or other forms of co-operation with accession countries will be without prejudice to the Eurosystem's independence and our primary objective.

A number of years - I shall not venture to guess how many - lie ahead of us before the first candidate countries will join the EU. Some more years will elapse before the best-prepared countries will adopt the euro. This period will offer an opportunity for these countries to combine sound macroeconomic policies, much needed structural reforms and robust institution building. In this sense, the overall period in the process depends on the candidate countries' individual efforts in advancing reforms and it may, of course, vary from country to country.

I should like to end my remarks here. As I hope I have made amply clear, the Eurosystem is fully aware of the future implications of the ongoing accession process for the fulfilment of its own statutory objectives. Preparations, on all levels, for a smooth integration into the European System of Central Banks (ESCB) and - some time later - into the Eurosystem are well under way. As the historic process of reunifying Europe unfolds before our eyes, let me assure you that the ECB is ready and looking forward to playing its part.