Yves Mersch: In the run-up to an enlarged Europe

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the 6th European Congress of the Association des Cambistes d'Internationaux (ACI) (Financial Markets Association), Luxembourg, 25 May 2002.

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Ladies and Gentlemen,

I should first like to thank the organisers for having invited me to the 6th European Congress of the ACI. It is a real pleasure to address today's audience. I had been tempted to speak about the Luxembourg central bank which in the meantime is the second largest provider of liquidity to the European banking system, second only to the Bundesbank. But I think it is more important being in Luxembourg to show you that we can only decline our national identity in relation to European integration.

European integration is an ongoing dynamic process. Enlargement is not something threatening Europe. It is not something new. We have had experience with enlargement in history, and we also should not consider enlargement as only limited to the institutional sphere and the immediate neighbourhood of Europe. I think you should know that with the introduction of the euro, Europe has now relations with more than 56 countries in the world, which use the euro to some extent as an anchor currency. These countries represent about 20% of world population, but barely represent 5% of world GDP. There are a number of relations with those countries through the euro or through association arrangements. Basically, we can say that in all cases Europe is the largest creditor to those countries: this applies to the European banking system, but also to the status as an official creditor. In some of those countries the euro is only used as a private mean of transactions, mainly as an investment currency; in some other countries the link exists through exchange rate policy. In some other countries, the euro has been introduced as a de facto currency (euroisation).

My subject today is focusing more closely on the accession countries of which you had some representatives speaking to you in the previous days, and I would like to recall that the first six countries which tried to build up an European integration process from 1951 on did not think of integration until the 60's.

It was in Luxembourg in 1970 that we decided to open negotiations with four countries: the UK, Denmark, Ireland and Norway. When the accession decisions were concluded in 1973, one country, Norway, decided through referendum to step back, and we only enlarged for the first time to three new countries. The next enlargement was in 1981 when Greece joined Europe, Spain and Portugal both following in 1986. When we started the Maastricht negotiations, we knew already that there would be three additional candidates which joined Europe in 1995: Finland, Austria and Sweden. Even though the Maastricht Treaty was ratified in 1992, you ought to know that during the discussions and negotiations, we already tried to take into account the enlarged Europe when we designed the built-up of the institutions that were to run the single currency.

It is of course this time a little bid different insofar that the block of countries which are on the way to access Europe is much larger. Thus, thirteen countries are standing ready to join the new European area and later on the European currency zone as well. Where do we stand as of today? We defined thirty-one chapters to be discussed with twelve countries. With one country, Turkey, negotiations have not yet started. Progress has been encouraging, but, as you know, you always start with the easiest chapters and you leave the most difficult ones to the end. So, as of end of April 2002, 73% of total chapters were concluded. The most advanced country had still four open chapters, one of them being agriculture of course.

The European Summit last year decided that the negotiations ought to be concluded by the end of this year. Now, with two elections looming in the two largest countries of the European Union, it is sometimes a little bid difficult to come to common positions especially on the most difficult chapters that are still open. I can only express hope that the objective of concluding the negotiations by the end of this year will be fulfilled, and that it will not be due to a lack of common positions of the existing European Member States that we are not able to come to final conclusions.

If we would not come to final conclusions by the end of this year, it would become too tight to have any new accession country participating in the next European Parliament elections to take place in 2004.

But let us not forget that even at this stage, part of the internal preparations that the EU has embarked on is not yet finished. I speak about the so-called Nice Treaty which is to prepare partly the European institutions for the enlargement and which has not been ratified in all of our countries. But on the other hand, we have also in the meantime started a new exercise, the Convention, which also has to come to an end and to be ratified in order to prepare the European Union for enlargement.

But I don't want to dwell too much on the political aspects and give you the view of the Eurosystem in the monetary field.

Even if we are not taking part in the official negotiations, the Eurosystem is tightly involved in cooperation with the central banks of the candidate countries. This process started in 1999 with a high-level seminar organised in Helsinki, which defined the five principles on which the European system of central banks would approach its cooperation:

1. First, the principle of competence. That means the Eurosystem is involved in all fields falling in its exclusive or shared competence: monetary policy, exchange rate policy, payment systems and financial stability meaning not only oversight of payment systems where the Eurosystem has not a shared responsibility, but an exclusive one, but also banking supervision where the Eurosystem is of the opinion that it has a shared responsibility just as it is stated in the Maastricht Treaty;

2. The second principle is to preserve the Eurosystem's primary objective. The Eurosystem's involvement in the accession process must be without prejudice to its independence and its primary objective to preserve price stability;

3. Third, the principle of openness. The Eurosystem has a positive attitude to the prospect of accession of new EU Member States;

4. Fourth, the principle of equality of treatment. The criteria on which we will assess the ability of countries to join the European Union and later on the euro should be implemented in a strict and effective manner while also avoiding any discrimination;

5. Finally, the principle of plurality of approaches which means the possibility to choose different paths and ways to join the European Union without compromising equality of treatment.

The cooperation activities between the Eurosystem and the accession countries are intense and have increased considerably between 2000 and 2001. In line with the principle of competence I just mentioned, the fields covered by the cooperation are the following: operational framework for monetary policy, operational framework for foreign exchange policy, economic analysis, internal control and procedures, payment systems, statistical systems, accounting, communication network architecture, legal issues, banknotes, prudential supervision, capital account liberalisation and of course the transition to the adoption to the euro. To give you an idea of the intensity of those joint efforts in all the fields I just have mentioned, let me quantify them by giving you two figures: since 2000, the Eurosystem has conducted (or plans to conduct) more than 800 activities accounting for around 19.000 working days in the accession countries.

Let me now say a word about the criteria. The criteria accession countries have to comply with are often thought to be constricted to the Maastricht criteria, which are nominal criteria, but we ought not to forget that there is another second set of Copenhagen criteria, by the number of three, which have been set up in 1993 already:

1. The first is a political criterion. It encompasses the stability of institutions guaranteeing democracy, the rule of law, human rights and, what is important in some of the new accession countries, the respect for protection of minorities as well.

2. The second Copenhagen criterion is of economic nature. Accession countries should demonstrate the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces which are the key rules in the European Union.

3. Finally, the third Copenhagen criterion relates to the acquis communautaire. We must be convinced that it can be implemented, that means the ability to take on the existing obligations of membership including adherence to the aims of political, economic and monetary union.

Let me now elaborate on three issues that I consider of importance: convergence, currency regimes as well as policy mix.

1. Convergence

- Nominal convergence is necessary but not sufficient. Thus, real convergence has to be pursued in parallel. Why also real convergence? Because the Maastricht Treaty very clearly spells out that the criteria must be fulfilled in a sustainable way and not result from a point lending at one day in the year;
- Real convergence is also the translation of the second Copenhagen criteria, which very clearly says that you have to demonstrate your capacity to cope with competitive pressure and market forces. That is why real convergence is also important and has to be pursued in parallel. This process will allow a closing of the gap between accession and euro zone countries as it is stated in the objectives of the Union as defined in Article 2 of the Treaty of the Union and Article 2 of the Community Treaty.

The recent economic policies have shown that this parallel convergence is possible and has been pursued and achieved in many existing European Union countries. On the nominal side, convergence to the bottom has occurred in long-term interest rates already in most accession countries, showing that financial markets pay some credibility to the current policy frameworks and consider the announced accession timetable as being credible.

Real convergence is proceeding further but I must say at a rather slow pace. Indeed, accession countries still show important gaps in terms of income levels versus the EU. So at the end of 2001, that are the latest figures I have come across, income levels in accession countries were 44% of the EU average in terms of PPP. With a growth rate scenario of 4% per year, all accession countries would reach by the year 2026 the same income level of Greece when it joined the EU in 1981, namely 62.4%. If I look at the level Greece had reached when it joined the euro zone twenty years later, then it would take the accession countries about to year 2033 before they would be at the level of the country with most catch-up need that has so far joined the euro zone. Therefore the right policies, concentrating on liberalisation and macroeconomic stabilisation, have to be implemented and pursued in order to foster growth and enhance the catching-up process.

2. Currency regimes

- First principle: There are no "one fits all" exchange rate strategies in the wake of accession. Different regimes are possible as long as they are supported by a stability-oriented policy stance;
- Second principle: An exchange rate regime should be assessed on its ability to contribute to a stable macroeconomic environment by supporting an exchange rate level consistent with underlying fundamentals and expectations;
- Third principle: For non-key currencies, corner solutions are not necessarily the best solution. Intermediate options may be a relevant alternative, especially for small open economies with a dominant trading partner that maintains price stability as it is the case for most accession countries.

In addition, I would like to make one personal remark on currency boards arrangements, which has become fashionable at one point in the time:

- Euro-based CBAs are not a substitution for participation in the European Exchange Rate Mechanism, ERM II. Like all countries having entered EMU, the ERM II passage is compulsory and I would give three reasons:
    1. To be able to assess on the basis of equal treatment whether the fulfilment of the exchange rate criterion is satisfied, it has to be done in an equivalent multilateral environment, namely ERM II;
    2. In full respect of the principle of equal treatment we cannot assess exchange rate stability inside ERM II for past accessions and outside ERM II for new accessions;
    3. I think the ERM II and the assessment of the exchange rate stability criteria is also part of the second Copenhagen criteria.
- However, under certain circumstances, an unilateral CBA can be a suitable option in order to enhance the commitment to foreign exchange stability deriving from ERM II, but I would like

to underline that this will not and cannot impose any unilateral obligation on the ECB besides those that are related to ERM II participation per se;

- The discipline entailed by CBAs may be a good incentive to pursue stability-oriented macroeconomic policies in order to enhance convergence efforts before EMU participation. Nonetheless, this stability is not automatically warranted, the cause being related to complex adjustment mechanisms through which accession countries being in a market economy transition phase have to go;
- Accession countries operating a sustainable CBA would not necessarily have to face a double regime shift. However, if a CBA would prove to be weak and not adapted to the ERM II framework, the ECB has made it very clear it would speak up and tell this country its opinion and make its concern known;
- And finally, I think the fashion of CBA has also to be viewed within the recent experiences as for example in Argentina. The exit strategy is key.

3. Policy-mix

- On average, fiscal deficits have widened in 2001 in accession countries. The sustainability of the budgetary situation in some countries is at stake. The forthcoming parliamentary elections in some countries, as well as large accession-related expenditures, are subject to amplifying this situation. Monetary policy should be supported by an adequate fiscal policy in order to avoid a large risk of overburdening monetary policy. This is not only true for accession countries however. Some concern already has been expressed towards some Member States of the present euro area and I would like to voice it again.

  I want to stress that the strict compliance with the Stability and Growth Pact is important just in order to give back to the political sphere the margin of manoeuvre to do policy in the fiscal area and record it is key to the credibility of the policy-mix and therefore also to the orderly functioning of EMU. This understanding has been steady from its inception and now it is crucial to keep EMU perennial;
- In the framework of the policy-mix, the ECB has accepted to be involved in an informal dialogue with governments and other political actors. This institutional setting has however been questioned recently. Some voices have been heard advocating a reinforcement of the policy-mix coordination, even in this country, in view to achieve overarching recommendations applying to all areas of policy-mix. I would like to underline that from the point of view of the ESCB there should not be any ambiguity. The implication of the ECB in this informal dialogue has as sole purpose to share information. Any form of ex-ante coordination would undermine the ECB's credibility in fulfilling its mandate and would be considered to be in opposition to the terms of the Treaty;
- Let me come back to the accession countries now. In the monetary sphere, continuous efforts are necessary in order to bring down inflation. Inflation has been brought down from 12.4% in the accession countries in the year 2000 to 8.8% in 2001. In the present year, inflation is expected to be around 6-7%. This track record is quite encouraging and ought to be pursued. Some challenges however remain, likely to generate pressure on prices: the liberalisation of administered prices in many accession countries, the so-called Balassa-Samuelson effect, which on average has been considered to represent between 2 and 4 % of inflation for accession countries, as well as the sliding fiscal policy stance in some countries. All are upward risks to price stability. In addition, the weight of energy-related items in most accession countries' HICPs is higher than in European countries. In accession countries they vary between 22% and 31%, while the average in the euro area is only 11%. The rising oil prices hence add a further element to the balance of risks for inflation inside the accession countries.
- The catching-up process will bring inflation rates above those prevailing in the euro area before they will converge slowly. Let me stress in this respect that no additional criteria will be added for accession countries but that, as for the actual members, the entry in the euro area will be based on the strict fulfilment of the existing convergence criteria as they have been applied in the past, without new interpretations.

The run-up to an enlarged Europe also is an opportunity to stress what I would call two core principles for the functioning and the strategy of the Eurosystem.

4. Independence

In Europe, independence is a quite recent principle. Today it is also acknowledged that it is an indisputable one. Independence is one of the key items to be implemented in the framework of the acquis communautaire. But this issue does not only relay to accession countries. As you have seen in the recent convergence report of Sweden, we consider that the present Swedish law is still not compliant with the requests needed for the Swedish central bank to enter the euro. The same of course holds true for the UK. Some mixed signals emerged from some accession countries, the most lately being the Czech Republic and most alarmingly Poland.

Independence of central banks is, as you know, declined at least in two different forms. On the one hand, the independence of the institution, but also the independence of the people working in the institution, the so-called personal independence. The institutional independence has again two functions. One is the operational independence. Each central bank must have all the instruments at its disposal and at its free disposal in order to execute all operations related to a central bank's core activity, in particular in the area of monetary policy, foreign exchange, as well as payment systems. On the other hand, I think the financial independence is also increasingly attracting attention. It means that a central bank ought to rely on a robust balance sheet in order to underline its independence. But financial independence also applies to the personal independence of the people running the central bank. I think that as a Luxemburger I should not give anyone a lesson in this respect.

The Treaty has made the ECB responsible and accountable for the maintenance of price stability over the medium term. That is why it also has been shielded from political pressures. Medium term price stability should not be sacrificed to meet short-term objectives linked to political and electoral considerations, risking to weaken the stability of the currency.

5. Consensus building

The second important element in the functioning of the European monetary institutions is the underlying principle of decision-making, namely consensus building. The approach of seeking a broad consensus rather than to resort to voting in my opinion has the following advantages.

- It is shielding from pressures arising from national authorities;
- It allows continuous, multilateral check of time consistency and policy direction within the Council, thus imposing a discipline on monetary policy and
- It is countering any public suspicion that national bias may inform policy decisions.

I think this approach has been a key element in the efficient functioning of the Governing Council of the European Central Bank up to now. It is representative of an European culture of decision-making which has served us well until now. Therefore I think it ought also to be pursued in the perspective of accession countries adopting the euro in the medium term.

Now finally a word about monetary policy strategy.

The monetary policy of the Eurosystem, as well as the set-up of its operational toolkit, has been designed as to accommodate the specific environment in which it evolves and this is an environment of hugely diversified financial structures and cultural diversity as well. This gives me the opportunity to underline once more that the designing of our strategy is and should not be a transposition of other models like for instance that of the Federal Reserve System which is designed by a different historical development. But I think I ought not too much dwell on the difference between the FED and the Eurosystem, although that is a very interesting subject in itself. Let me just limit myself to say a few words concerning the inter-relation between our primary objective and the question whether there is a so-called second objective.

You know that without prejudice to our overriding objective, the Eurosystem supports the general policies of the Community according to the Treaty. This support of economic policies in our opinion is fully encompassed in the overriding objective of the ECB. Monetary policy is neutral on output and employment in the long run and there should be no short-term trade-off between output and prices.

The marginal gains on the output-side in the very short-term have to be weighted against the building of inflationary pressures and unrealistic expectations about the monetary policy's impact on output. This approach would entail incoherent monetary policy decisions and be detrimental to the ECB's credibility in fulfilling its mandate. However, this does not mean that the Governing Council does not take into account the economic sphere, all to the contrary. When we assess every month the risk to price stability over the medium term, we do not only take into account the information from the first pillar, the so-called monetary pillar, we also look into the second pillar. The shape of the yield curve, exchange rate, oil prices or labor market developments, are examples of the variables analysed in the second pillar. As a consequence, the two parts of the mandate enshrined in the Treaty should not be considered separately but in conjunction. Let me add on this point that the maintenance of price stability as such over the medium term is the best contribution to fostering an environment favourable to sustainable growth in the longer run.

Price stability is to be achieved in the medium term and in the whole euro area. First, this mandate is based on the fact that short-term, volatile factors cannot be controlled by monetary policy and that monetary policy acts within long and variable lags. Second, the mandate underlines that price stability is assessed euro area wide, the Governing Council not reacting to national or regional developments. The ongoing accession process will have no impact on this underlying philosophy.

Our will to be as transparent as possible so as to allow agents to internalise stable price developments in their expectations is key to accountability and will remain so with accession.

In order to underline that we pay great attention to developments in the real economy, I am very glad that I am able also now to invite a representative of the real economy to this rostrum, namely the chief financial officer of the largest steel company in the world. I am very glad to count him among the supervisory board of the Luxembourg central bank. I think very appropriately that he will also dwell on something which is similar to my mind, namely that you also have to see globalisation from Luxembourg and not go the other way around and start with globalisation and then try to come back to your national attitude. We only can realise our aims in the context of the international environment and therefore I am very glad and interested to hear now what Mr. Michel Wurth will have to tell us.

Thank you very much for your attention.