Nicholas C Garganas: Regional financial stability around the Eurozone

Presentation by Mr Nicholas C Garganas, Governor of the Bank of Greece, at the conference on Regional Financial Stability Around the Eurozone, organised by the Euro 50 Group, Istanbul, 1 June 2006.

*   *   *

I am delighted to have been asked to participate in this conference on "Regional Financial Stability Around the Eurozone". This topic has gained importance as the economies - and particularly the financial systems - of South-Eastern European (SEE) countries have increasingly developed linkages both within their region and with the Eurozone. In recent years, SEE countries have generally experienced high rates of economic growth, improvements in macroeconomic fundamentals, and a significant transformation and growth of their financial systems. For sustainable future growth and development in the region, the maintenance of financial stability is an essential precondition. In turn, the existence of an effective legal and regulatory framework for the financial sector and the conduct of financial supervision in accordance with international best practices plays an important role in promoting financial stability. To this end, considerable efforts have already been made to strengthen the legal and regulatory frameworks of the financial sector in SEE countries and to improve supervisory practice. In what follows, I will briefly discuss the various channels through which external assistance towards regulatory and supervisory reform in South-Eastern Europe has been provided, identify some areas where further reform and expertise appears necessary, and suggest some co-operative arrangements that could contribute to this objective.

Over the past fifteen years or so, technical assistance to improve the legal and regulatory framework of the financial sectors of SEE countries and the implementation and enforcement capabilities of the competent national authorities has been provided in various forms by international organisations such as the IMF, the World Bank, and the BIS. Although a comprehensive discussion of all these projects is not realistic in my short presentation, it may be worthwhile to at least mention a few of them. Supervisory personnel from SEE countries have participated in training seminars offered by the Financial Stability Institute of the BIS and by the Joint Vienna Institute. Under the joint IMF-World Bank Financial Sector Assessment Program, international teams of experts have assessed the financial sectors of SEE countries and the degree of compliance with Basel Core Principles and have identified weaknesses and proposed corrective measures, many of which have since been implemented by the countries concerned. In coordination with international institutions, the United States Agency for International Development (USAID) has supported projects in many SEE countries to improve the regulatory framework for the financial sector and the conduct of supervision.

As SEE countries aspire to eventual EU membership, the European Commission has been particularly active in the region both in providing technical assistance and in monitoring progress in financial sector reform. As regards technical assistance, the European Commission's main instrument is the Twinning Programs financed by the PHARE and CARDS facilities. Twinning Programs are particularly useful since each beneficiary country determines its specific needs and is subsequently able to choose the one that best meets its requirements among the proposals submitted. Twinning Programs also help to establish close working relationships between the authorities of recipient countries and those of the EU countries which provide technical assistance. The ECB has also provided technical assistance to SEE countries through various channels such as short-term missions, conferences and internships. ECB assistance was given in the fields of money and banking statistics, payment and settlement systems and financial stability as well as in other fields which fall outside the scope of my presentation. Moreover, the ECB, acting as co-ordinator of Eurosystem projects, is currently working on a number of projects in the region, including the finalisation of plans for a 6-month CARDS funded project to Bosnia and Herzegovina. Apart from these Commission and ECB initiatives, technical assistance has been provided to SEE countries on a bilateral basis by the financial sector authorities of individual EU countries, usually through less formal ad hoc arrangements focusing on specific areas where particular SEE countries require expertise. Finally, the Memoranda of Understanding concluded between the banking supervisory authorities of EU countries and those of the SEE countries provide for regular meetings to discuss supervisory principles and practices and, in some cases, include specific provisions for co-operation in staff training.

In most SEE countries, the basic legal and regulatory framework for the financial sector is now in place and largely conforms with international standards. Nevertheless, there are differences between SEE countries as regards the state of development of financial sector regulation and supervision. Generally, there is a positive relationship between progress in these areas and how far each country has moved along the path leading to EU membership. As Bulgaria and Romania are acceding countries and Turkey, Croatia and FYROM are EU-candidate countries, they have generally made greater progress in adopting the acquis Communautaire in the financial sector compared to the remaining SEE countries, which are in various stages of the Stabilisation and Association Process.

As a rule, in SEE countries the legal and regulatory framework and the implementation and enforcement capabilities of the supervisory authorities are more developed in the banking sector compared to other segments of the financial system. This is due to the fact that the capital markets are still underdeveloped in SEE countries, with the banking sector dominating the financial system in these countries. Accordingly, both the national authorities and the foreign providers of technical assistance place more emphasis on regulatory and supervisory reform in the banking sector. [Bulgaria and Romania have nevertheless made progress toward harmonization with EU regulations on capital markets.] Meanwhile, in all SEE countries except Turkey, foreign banks, mainly from EU countries, have acquired, through their subsidiaries and branch networks, a dominant position in local banking systems. This development has increased competition, facilitated the transfer of expertise especially in credit assessment and risk management and enhanced the ability of local banking systems to operate under more demanding supervisory standards.

In contrast with the banking sector, the insurance sector in SEE countries is still underdeveloped and tends to be characterized by weak governance and regulation, despite improvements in recent years, mainly in Bulgaria and Romania in connection with these countries' preparation for EU accession. Furthermore, reflecting the persisting problems in governance and regulation, the insurance sector in SEE countries tends to be undercapitalized.

In the banking sectors of SEE counties, it appears that the degree of progress towards achieving international best standards has not been the same in all areas of regulatory and supervisory interest, particularly as regards the implementation and enforcement capabilities of the competent authorities. In a number of countries, assessments on behalf of the European Commission and the IMF have revealed remaining weaknesses in such fields as anti-money laundering, consolidated supervision of financial conglomerates, implementation of International Financial Reporting Standards (IFRS), integrated assessment of risk management systems and the extent of co-operation with foreign supervisors. [As regards the IFRS, it is worth noting that Bulgaria, Romania, Croatia, and Serbia have already implemented these standards for companies and banks, while Turkey and Albania envisage their implementation by 2008.] Moreover, SEE countries face important medium-term challenges relating to the effective application of the principles of good corporate governance across the financial sector, the implementation of the Basel II capital adequacy framework and the development of a comprehensive methodology for financial stability assessment, including the design of a macro stress-testing framework, especially for credit risk. Although central banks in some SEE countries have already made progress in financial stability assessment, more work needs to be done and such assessments need to increasingly take into account potential repercussions from regional and wider European developments.

The above considerations indicate areas where further assistance may be required by particular countries. Apart from programs supported by international organisations, continuing recourse to bilateral co-operation arrangements between authorities of EU countries and those of SEE countries would be particularly useful. In this respect, the experience of the authorities of EU countries that have relatively recently completed the reform of their financial sector in accordance with international standards would be a valuable input to the authorities of SEE countries that currently face similar challenges. Also, peer group reviews by financial sector supervisors from other countries could play a useful role in periodically assessing the effectiveness of financial sector regulation and supervision in each SEE country and in offering advice on needed improvements. Finally, national Banking Federations of SEE countries can help to bring the operation of local banks up to EU standards through multilateral co-operation in the areas of staff training and convergence in the implementation of sound operating and risk management systems. To this end, the national Banking Federations participating in the Interbalkan Banking Forum have recently signed a Memorandum of Understanding.

It is important to recognize that, as the financial systems of SEE countries are liberalized and their economies become more open, the task of maintaining financial stability becomes more challenging. In meeting this challenge, I believe that arrangements for supervisory co-operation and the provision of technical assistance can continue to play a useful role in supporting national efforts for further regulatory and supervisory reform aimed at strengthening the resilience of the financial sector of SEE countries and achieving conformity with EU standards.

Let me conclude by stressing the importance of the financial system for economic growth. Why is the financial system so crucial? The answer is that the financial system can be thought of as a coordinating mechanism that allocates capital to building factories, houses and roads. If capital is misallocated, the economy will operate inefficiently and economic growth will be low (Mishkin, 2005)[1]. Effectively, just as a high level of human capital increases the productivity of labour, so an efficient financial system increases the productivity of *all* factor inputs. For this reason, a financial system can be thought of as the central nervous system of an economy. If it is stable and efficient, it coordinates the economy's activities, helping to improve the living standards of its citizens

Thank you for your attention.

1 Mishkin, S. Frederick (2005), "Is Financial Globalization Beneficial?" NBER Working Paper No. 11891 (December).