Mr Wellink considers monetary relations between the euro zone and new member states

Speech by the President of the Netherlands Bank, Dr A.H.E.M. Wellink, at the European Finance Convention in Vienna on 23/11/98.

I should start with a warning to those who favour early accession of Central and Eastern European countries to the European Union. Somebody once said the following about the part of Europe I live in: "I do not find Northern Europe an ideal zone for human habitation. It is a fine place for industrial productivity, but its climate breeds puritans and the terrible dictates of the Protestant Work Ethic. The Romans were right to pull out when they did." So please be well aware of whom you seek to live with in a more institutionalized setting. But, let me add immediately that times have changed. For instance, the Romans have found it attractive to be reunited with us in EMU.

Today, I want to discuss the issue of monetary relations between Central and Eastern Europe and the European Union. Accession to the EU is understandably a hot issue in the countries concerned and it rightly guides their medium-term macroeconomic policy orientation. At the same time the turbulence in the global financial markets poses some immediate policy challenges. Two issues are particularly at stake: (1) to what extent is Eastern Europe hit by the consequences of the Asian and Russian financial crises? and (2) what is the best policy approach in the current international environment? I will first discuss these two issues. Later on, I will broaden my horizon and raise some issues related to the future accession of these countries to the EU.

Contagion? Economies in transition have not been shielded from contagion effects, which started after the Russian financial crisis. Financial market volatility increased sharply. Headline stock market indices significantly dropped in August and exchange rates were under downward pressure. However, the situation seems to have improved meanwhile. Although it is probably too early for a final assessment, until now the effects on the real economy have been relatively limited, also because trade relations have dramatically changed in the past and their focus is now much more towards the West. The countries that had made significant strides since the beginning of the 1990s in establishing a well-functioning market economy have weathered the financial storms rather well. This is ample proof that they are on the right track. Their main challenge is therefore to ensure that the ongoing stabilization and reform efforts continue even if, or should I say especially if, external conditions deteriorate further.

External conditions

Let me say a few words about these external conditions. I believe that we should not be overly pessimistic about economic growth in the industrial countries. The euro zone remains an area of stability, even though we have seen some downward adjustments to growth expectations for next year. Growth performance in the United States was quite strong in the third quarter, even stronger than had been expected. Interest rates in a number of countries – the US, the UK and several European countries – have been lowered. Signs are that the economic downturn in Southeast Asia has bottomed out. With the help of the IMF, Brazil has established a strong adjustment package. These are all hopeful signs that we might have reached a turning point and that things should now gradually show a turn for the better. But at the same time, given recent growth expectations, we should not be overly optimistic either.

Inside and outside the European Central Bank, there is much discussion about the level of interest rates in Europe. Supporters of interest rate reductions are pointing to the worsening

economic conditions in the world and to the lead given by the US central bank, the Federal Reserve System. Let me try to put things in perspective here. In the Governing Council of the ECB we are carefully considering developments in economic and monetary conditions in the euro zone. So far, the internal dynamics of the euro zone are still relatively strong. At the same time, we are certainly not blind to developments in the "outside" world. One should take into account, however, that for the euro area as a whole the average three-month market interest rate has come down from 4.2% early this year to 3.7% now. The current level is about 150 basis points lower than that in the US. In addition, we need to keep in mind that the US and Europe are at different stages of the business cycle. Therefore, monetary conditions seem easier here than in the US. I would stress that aggressive calls for lowering interest rates from politicians – apart from being against the letter and the spirit of the Maastricht Treaty – involve the danger of making the interest rate issue the acid test for the independence of the ECB. Europe and the world are better off with a monetary policy that is consistently oriented at the medium term than with efforts on our side to fine-tune the development of the business cycle.

Current monetary policy challenges in Eastern Europe

This brings me to the issue of current monetary policy challenges in Eastern Europe. In a general sense, key words are credibility and transparency. These words are used quite often, but they are all the more relevant in turbulent times. The overall aim should be to create "sound money". This implies (1) price stability and (2) a sound financial and payments system. For a central bank to attain the goal of price stability, it must have not only full power to formulate and implement monetary policy but also the confidence of the general public and financial markets. That is where transparency comes in. Being transparent is essential in order to educate people and make them understand the reasons for policy changes.

The current monetary policy approach in most Eastern European countries recognises the importance of the basic principles of credibility and transparency. Through July of this year, we have seen the "costs of success" in several countries. Improved confidence on the part of foreign investors led to capital inflows that were very large compared to the size of the economies of the recipient countries. Coping with the inflationary pressures created by these capital inflows was the main challenge facing monetary policy. Following the aggravation of the crisis in Russia, however, the countries experienced significant capital outflows. Obviously, such sudden shifts in investor behaviour do create severe strains for the day-to-day management of monetary policy. The authorities from these countries have skilfully reacted by adjusting their monetary strategy in a practical manner. In Poland and Hungary, for instance, the central banks have provided clarity about the medium-term development of the exchange rate, thus contributing to anchoring expectations. Most laudably, the countries in Eastern Europe have refrained from imposing new restrictions on capital movements. This is very important indeed and it seems to have been rewarded in financial markets.

Accession to the EU

Let me now turn to the future relationship between the European regions, more specifically to the intended enlargement of the European Union towards the East. Many years ago, fathers in the United States would tell their sons to go West in search of fortune. Perhaps fathers in Western Europe may in the not too distant future tell their sons: "Go East, young man."

The countries of Central and Eastern Europe are catching up quickly and may one day become the most dynamic economies and societies in Europe. In the meantime, it is clear that Eastern Europe is looking towards the West.

The so-called “fast-track” countries of Central and Eastern Europe will hopefully be ready to join the European Union some time from now, although a number of further reforms still need to be implemented. This is especially true for financial markets and the banking sector. There have been many political statements on the most likely year for accession. It is of course, for the politicians to decide on this. In my view, the countries of Central and Eastern Europe should be given enough time to prepare themselves properly for becoming part of the Single Market. Moreover, given the substantial differences among them, the candidate member states should be looked at on a case-by-case basis.

Some transitional provisions are likely to be necessary for new member states after joining the European Union. Without such provisions the expansion of the European Union may need to be postponed for many years, which is clearly undesirable. Moreover, in the past such provisions have also been applied to new entrants, including Spain, Portugal and Greece.

It is essential to strike a proper balance. The acquis, the body of legislation which applies to all EU member states, must remain the common denominator. Member states can decide to work more closely in some areas, but they cannot detract from the acquis. Member states must satisfy certain requirements in the monetary and financial sphere, even those member states that have a derogation with respect to monetary union. These requirements are essential for the functioning of the single market. Transitional provisions may be required. However, permanent exemptions or lengthy transitional periods would be inappropriate as they could threaten the internal cohesion of the Union.

Monetary relations

Let me be a bit more specific about monetary relations and let me start with the period before membership. In the run-up to the accession to European Union, prospective member states should take a pragmatic approach to the implementation of monetary policy. It seems only logical that the exchange rate against the euro will gradually be assigned an increasing importance in the monetary policy considerations of candidate member states. An implicit or explicit orientation of monetary policy towards the exchange rate against the euro can also be justified by the relative importance of trade relations between the two regions. Some 50–60% of foreign trade of the countries of Central and Eastern Europe is with the European Union.

Where pragmatism is called for, it does not make sense to establish all kind of institutional bells and whistles in the monetary field. Rather than participating in any formal exchange rate mechanism with the euro before EU membership, countries in Central and Eastern Europe should focus on economic reform. During such a period, monetary and exchange rate policies should provide for sufficient flexibility and should take account of the specific circumstances of the country concerned. For instance, given the current levels of inflation, it may be wise for some countries to maintain a crawling currency peg for the time being. For other countries a stronger commitment – a fixed peg or a currency board – may be more appropriate. Before accession, this can only be a unilateral decision. Only after joining the European Union can new member states participate in ERM-II, as indeed they are expected to, assuming that a credible peg against the euro can be established at that time.

Preconditions for stable monetary relations

Of course, linking the currency to the euro cannot be a substitute for conducting stability-oriented macroeconomic and structural policies. Rather, any formal link to the euro should be preceded by policy measures which make the intended currency link a credible one. Given today’s importance

of capital flows to exchange rates, such policy measures should also cover areas that are important to capital flows.

Allow me to say a few words on the approach towards capital movements. Undoubtedly, hot money is a hot issue at the moment. Restrictions on capital flows have proven less than effective in times when investor confidence turns sour. Introducing controls to limit capital outflows in the middle of a crisis is doomed to fail. They may afford some temporary relief, but when people want to get their money out of the country, they will succeed in doing so in the end. What remains is long-term damage to investor confidence. Liberalizing the capital account further is the more promising route.

Adequate sequencing of short-term capital inflows may be required in order to gain time for adjusting the domestic financial sector to the competitive pressures that follow from capital liberalization. It should be realized, though, that such an approach should go hand in hand with an improvement of supervision and a strengthening of the financial sector. This should be high on the policy agenda in Eastern Europe. There has been considerable progress on capital liberalization in these countries and it is expected that, under OECD rules, capital movements will be free of restrictions pretty soon. The major challenge now is to ensure that the restructuring of the financial sector keeps pace, an area where there is still much to be done.

It is well-known that in the communist past many banks used to be a part of, or closely related to, the central bank. In addition, many of the borrowers used to be companies with close ties to the government. As a result, there were few incentives for risk control and return enhancement. Instead, some banks used to generate profits by exploiting certain privileges which no longer exist.

What is necessary, and what has been done to some extent in some countries, but not all, is privatizing state-controlled banks and promoting free market entry. This will provide bank managers with the right incentives to make risk/return assessments. Adequate bank supervision and financial markets oversight are required to ensure that sufficient weight is given to risk control. Foreign ownership may help to transfer certain specific banking skills to candidate member states, even though I do not favour a big January sale of financial institutions in the countries concerned.

The current problems in certain Asian countries show that a bad loan overhang can severely impede the functioning of the economy. Balance sheet restructuring in countries in Central and Eastern Europe may require intervention by the competent authorities in some cases. It may be necessary to let some banks fail. It may be necessary for governments to take over bad loans inherited from the communist era. This would enable some credit institutions to conduct business more effectively. In order to prevent moral hazard, the rescue of selected credit institutions can only take place under certain conditions, most likely including the lay-off of those responsible for making these loans.

Importantly from a macroeconomic point of view, any debt restructuring involving government money should find expression in official figures for government debt. This would provide a better insight into the actual financial situation in the countries of Central and Eastern Europe. Reducing uncertainties in this respect is likely to build up confidence and attract rather than deter foreign investors.

Concluding remarks

I have spoken on the monetary relations between the euro zone and the countries of Central and Eastern Europe. Let me conclude by presenting some ideas about the relations between the European System of Central Banks (ESCB) and the central banks of the candidate member states. Although candidate member states obviously cannot take part in ESCB meetings before their accession to the European Union, it could be useful to invite the governors of the central banks of the “fast-track” countries once a year to attend a special meeting of the General Council of the ECB. This would be similar to the current practice for the Council of Economics and Finance Ministers (Ecofin). Apart from that, the ECB staff could be asked to make a yearly assessment of the state of progress in applicant countries.

Finally, the Governing Council of the ECB will be requested to give its opinion on the expansion of the European Union towards the East. For now, I would like to conclude that the authorities of the candidate member states seem to be very capable of taking the right decisions in providing their people with a stable economic environment.