Christian Noyer: The ECB and the accession process

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the European Federation of Finance House Associations (EUROFINAS) conference, Warsaw, 15 October 2001.

*   *   *

Ladies and gentlemen,

Let me begin by saying that it is a great pleasure for me to participate in this conference, and that I appreciate the invitation of the "European Federation of Finance House Associations" (EUROFINAS). The Federation's effort to bring together finance and credit institutions throughout Europe deserves full merit. The choice of the city of Warsaw for this year's conference seems particularly interesting to me, as this city is witnessing the far-reaching links that are currently being developed between the countries represented by EUROFINAS' members and the so-called accession countries preparing for EU membership.

As a representative of the European Central Bank (ECB), I welcome the EUROFINAS members' objective to jointly tackle the challenges faced by the European financial industry at an international level. Not only is this remarkable in such a competitive industry, but it is also key to support the development of the financial sector in the economies of central and eastern Europe. Despite the achievements of the past decade, the accession countries still need to devote effort both to the reinforcement of prudential policies and business practices and to the development of highly valuable capital and "know-how" in the financial sector. For this reason, I would like to focus my presentation today on the integration of these countries into the EU and, more specifically, on how the ECB sees the so-called accession process.

Let me start by saying that the ECB's attitude towards accession is a positive one. In fact, the ECB is conducting a fruitful and constructive dialogue with the central banks of the accession countries at many levels and in many areas. Once a year, the Governors and Deputy Governors of the central banks of the accession countries and the Eurosystem meet to discuss policy issues related to EU accession. This year's meeting will take place in Berlin in December. In addition, these meetings have been complemented with multilateral seminars to support the preparatory work for the final adoption of the euro in fields such as statistics, payment systems or legal issues. Central banking co-operation between the Eurosystem and the central banks of the accession countries has also been enhanced through the organisation of bilateral visits and seminars.

To give you an idea of the significance of this co-operation, let me mention that, only last year, around 300 central banking co-operation activities, including technical assistance, were organised throughout the Eurosystem. The main areas of co-operation have thus far been payment systems, legal issues, and statistics, as they entail the longest lead times. These activities are continuing apace also this year. Furthermore, the ECB is involved in the recently established "Economic dialogue with accession countries", launched by the European Council, which includes issues highly relevant to the ECB such as monetary and exchange rate policies and financial sector developments.

The road towards EU integration and, later, euro area participation is not a single one and, therefore, a plurality of approaches may well be pursued by accession countries, not only before EU accession, but also after it. It is true that, upon accession, countries will enter the EU with the status of "Member States with a derogation", that no "opt-out" clauses will be granted and that countries will therefore be expected to follow macroeconomic policies consistent with the ultimate adoption of the euro. Indeed, accession countries will have to comply with the well-known convergence criteria, before they can adopt the euro.

It is also true that, with this objective in mind, countries will be expected to join ERM II at some point in time, and to participate in this mechanism for at least two years, without devaluation of the exchange rate of their currency vis-à-vis the euro, before they join the euro area. However, ERM II membership does not need to happen immediately after EU accession, neither need ERM II membership to be limited to only two years (this is a minimum for adoption of the euro). In fact, the length of the period of ERM II participation has also varied among current euro area countries; this may be similar for new Member States. Hence, although the process of EU accession consists of three different phases, namely EU accession, ERM II membership and the adoption of the euro, a single common trajectory cannot be prescribed for all countries.

Such a plurality of approaches also applies to the economic experiences of accession countries over the past decade. After the rather abrupt developments at the beginning of the transition, the accession countries have generally attained macroeconomic stabilisation, and they have done so despite pursuing different policies and strategies. A remarkable process of disinflation, structural reforms and relatively sound fiscal policies have supported positive growth – which is still moderate in some cases. Despite the worldwide economic slowdown, GDP in accession countries is expected to grow at, on average, around 3.2% this year. The stabilisation success has been confirmed by the accession countries' resilience to the Asian and Russian crises in the past and, more recently, to the developments in Turkey and Argentina. No doubt, the prospect of EU accession has helped to trigger reform in the accession countries and provided an umbrella to shield them from financial turmoil.

The challenges ahead, however, are still formidable: the transition agenda has not yet been completed, reforms have seen major setbacks and substantial structural differences with the euro area remain both in the real economy and in the financial sector.

Today, I would like to highlight three of these challenges, which are of particular relevance to the ECB. First, the need for further convergence in real and nominal terms, second, the need to advance on the compliance with the Treaty in the field of central bank and other relevant legislation and, third, the need to strengthen the financial and banking sectors. In addition, I would like to finish my presentation by briefly recalling how the entry of new Member States into the euro area is likely to impact the monetary policy of the ECB.

Advancing convergence in real and nominal terms

Advancing real and nominal convergence with the euro area in a parallel manner should take top place on the agendas of accession countries' policy-makers. This means that the need to catch-up with the EU in terms of both the real economy structures and income levels and the need to advance disinflation should be pursued as a "dual track". Let me explain why I like to stress the need for this parallelism.

Very often, higher inflation rates in accession countries have been partly explained by their need to catch-up with the real income and price levels prevailing in the euro area. This empirical phenomenon has been observed in many fast-growing economies and is often referred to as the Balassa-Samuelson effect. Although the magnitude of this effect and, thus, its impact on inflation is difficult to quantify, most empirical studies for the accession countries have estimated it at around 1 to 3 percentage points of inflation.

For monetary policy, this has a double meaning. On one hand, it implies that the speed of the disinflation process may need to take the "catching-up" component into account and that the monetary policy objectives in accession countries might need to be different from those applied to high-income countries or to the euro area for some time.

On the other hand, it also means that other macroeconomic and microeconomic factors (including a relatively loose policy-mix, wage inertia, stubborn inflation expectations) as well as transition-related factors (price liberalisation, privatisation) continue to play a key role in explaining inflation outcomes in many accession countries and that, therefore, the persistence of inflation differentials with the euro area cannot be attributed to the Balassa-Samuelson effect alone.

Also with regard to real convergence, the challenges are significant. Income levels in accession countries are far below the levels of the euro area, and discrepancies of this magnitude have never been observed in previous EU enlargements. Moreover, the process of catching-up in terms of real incomes will be very slow, likely to take many years, if not decades.

Hence, even if different income levels are compatible with Economic and Monetary Union (EMU), it is desirable that the real convergence of accession countries towards the euro area increases further, particularly as real convergence will foster economic integration with the euro area and minimise the risks and effects of asymmetric shocks in an enlarged euro area.

Against this background, the central banks of accession countries should simultaneously be concerned about the need to further advance disinflation and to catch-up with real income and price levels in the euro area. The strict respect of the Maastricht inflation criterion should be seen as a medium-term objective and not as an immediate goal, if progress towards the achievement of this criterion would jeopardise the catching-up process. Nevertheless, the ultimate fulfilment of the Maastricht criteria over the medium term should provide monetary policy with the appropriate framework for gradually lowering inflation rates, thereby contributing to macroeconomic stability and sustainable growth.

Together with the maintenance of inflation differentials with the euro area, catching-up in terms of real per capita income and price levels may also imply an appreciation of the real exchange rate. In this fashion, exchange rate policy should support the convergence process without any constraint to real sustainable growth. Again, neither the Eurosystem nor the ECOFIN Council can recommend a single exchange rate policy as the appropriate one to be pursued along the road towards the adoption of the euro. It is clear, however, that some accession countries will have to modify their exchange rate strategies to make them compatible with ERM II requirements. This applies mainly to the existing free floats (e.g. Poland) and pegs against anchors other than the euro (e.g. Latvia and Lithuania); in these cases, it will be crucial to identify the optimal timing of the revision of the different regimes. In this context, I should also highlight that ERM II membership should not be seen as a mere "waiting room" prior to the adoption of the euro, but rather as a meaningful and flexible framework for the achievement of further real and nominal convergence with the euro area.

Compliance with the Treaty in the field of central bank independence and other legislation of concern to the ECB

The ECB is not formally associated with the negotiations on accession, and we have no intention to compete with the European Commission and the other entities involved in this process. On the other hand, the timely implementation of the *acquis communautaire* within the ECB's field of competence is of crucial interest to the ECB for a number of reasons. One reason relates to the new status of the central banks of accession countries from the date of EU accession. At that point in time, these central banks will become members of the European System of Central Banks (ESCB). Moreover, commercial banks of accession countries will also be affected by accession, and we need to know that they operate in a sound and stable legal environment.

For instance, the rules of the internal market and the "single financial passport" will allow credit institutions established in an accession country to obtain indirect access to Eurosystem facilities – such as monetary policy operations and payment systems – through branches located in the euro area.

The interest of the ECB in this process therefore relates especially to the independent status of central banks of the accession countries and to the implementation of sound legal regimes in the area of financial law.

At a later point in time before an accession country adopts the euro, further legislative amendments will be required in order to integrate the central bank into the Eurosystem and to enable it to fulfil its part in our monetary policy and other operations.

So, what has been achieved in terms of legislative amendments in accession countries and what remains to be done before accession? The ECB co-operates with the legal experts of the national central banks of the accession countries in order to follow the legislative developments, and I can therefore give some indications of the degree of progress. Turning first to the requirement of central bank independence, several accession countries have amended their central bank legislation, although further adjustments are generally required. The drafters of the Treaty placed a strong emphasis on central bank independence as a reflection of the generally held view that the achievement of price stability is best served by an independent institution with a precise mandate. In line with this Treaty principle, the precursor of the ECB, the European Monetary Institute, established a list of features of central bank independence, which will form the basis for the assessment of the compliance of the accession countries with the requirement of central bank independence.

In financial law, the accession countries need to satisfy a number of provisions of the Treaty which have been applicable to the EU Member States since before the establishment of the ECB and the start of the third stage of EMU. In particular, statutory provisions providing credit facilities for public entities with a national central bank have to be revoked, together with provisions providing access for public entities to funds from credit institutions on terms which are not market-oriented. Moreover, capital movements need to be liberalised and statutory obstacles to the freedom of capital movements removed.

Some of these changes may be difficult to introduce before accession, and several accession countries will only achieve full compliance at a later stage when accession is imminent. In the area of banking law, more immediate progress has been achieved.

For instance, several accession countries have introduced completely new banking legislation, aiming at compliance with the standards for EU financial markets in accordance with EU Directives relating to credit institutions. A similar need for legal implementation pertains to the areas of capital markets and payment and securities settlement systems, but in these fields further changes are required. Finally, the reduction of risks related to central bank operations also requires a legally sound collateral regime, which provides legally effective arrangements not only for repurchase and pledge transactions, but also in relation to insolvency proceedings.

Again, this is a technically difficult area where the accession countries still need to catch-up with EU standards. All in all, our initial findings demonstrate impressive efforts on the part of the accession countries to achieve satisfactory regulations with regard to their central banks and financial systems in conformity with EU requirements, even if further work is still needed. At the same time, a sound financial legal system requires not only the adoption of the "right" financial laws, but also the support of an infrastructure – and, indeed, a culture – that ensures that the relevant laws can be effectively applied.

The strengthening of the financial and banking sectors

Although the restructuring process in accession countries has made substantial progress, the financial sectors of accession countries still need to be further developed in terms of size, depth and functioning. This applies, in particular, to the banking sector that largely dominates the financial sector of these economies. The challenges ahead are numerous: inter alia, the weakness of banking intermediation, reflected in the low level of credit to the private sector, the relatively large proportion of bad loans in banks' balance sheets in some countries or the exceptionally high spreads between lending and deposit rates that will progressively vanish in the next years.

Fortunately, the privatisation process and the increasing participation of foreign investors in the banking system have supported the rehabilitation and transformation of formerly state banks into efficient and profitable banking institutions.

Efforts to strengthen the financial and banking systems need to be made in the next years, also for the fulfilment of the so-called "economic" Copenhagen criterion, which requires the existence of functioning market economies and the ability to cope with competitive pressures. Compliance with this criterion for EU accession will require the adoption of EU legislation in the area of financial services, including those related to banking, insurance and investment firms, as I have mentioned before. All in all, in order to fully comply with the *acquis communautaire*, it would be necessary to further advance institutional reforms related to the applicability and enforcement of laws, in particular as regards the enhancement of corporate governance and legal frameworks.

Finally the development of a stable and well-functioning financial sector in the accession countries is also key to the smooth conduct of monetary policy in an enlarged euro area. Efficient and competitive banking sectors as well as smooth functioning capital markets are needed to ensure macroeconomic and financial stability in the accession countries and to support the convergence process of these economies. They are also needed for the proper conduct of monetary policy and, thus, for the successful participation of accession countries in the euro area. Indeed, deep and liquid capital markets are key to enabling an efficient use to be made of monetary policy instruments, since structural weaknesses in the banking sector could have severe implications for the monetary policy transmission mechanism and could affect the responsiveness of banks to changes in the monetary policy stance.

The impact of enlargement on the monetary policy of the ECB

Enlargement will imply important new challenges for the monetary policy of the ECB. Nevertheless, there is no doubt that the ECB will be able to ensure the continuation of price stability, even in an enlarged euro area, in a credible and lasting manner. At the technical level – as was the case when Greece joined EMU – it will be necessary to employ new monetary and non-monetary aggregates.

Looking at the broader picture, however, there are other types of challenges that one should also consider. These challenges are closely related to what are the fundamental differences between the accession countries and the current euro area members. I have already mentioned what is, perhaps, the most striking difference: the divergence of per capita income levels and, related to this, the difference in price levels. Other important factors, however, may also be worth investigating, such as the different potential vulnerabilities to external shocks.

Some of these 'features' of the new Member States will probably not have fully disappeared, when these countries will join the euro area.

The successful implementation of structural reforms and the acceleration of the catching-up process of the accession countries would definitely facilitate the task of integrating these countries into the euro area. Indeed, the deepening of the integration process between current and new Member States is likely to reduce the risks associated with the effects of asymmetric shocks.

Against this background, it needs to be stressed that monetary policy in an enlarged euro area would not – and could not - include, as an own objective, the promotion of the catching up process of any participating country. Notwithstanding that catching up is desirable, it is our conviction that the best contribution the ECB can make to enhancing the growth prospects of current and new participants in the single currency area is to guarantee stable prices.

Moreover, it should also be realised that the entry of new Member States into the euro area will neither lead the ECB to redefine the scope for monetary policy, which is the formulation of a monetary policy for the euro area as a whole. If individual countries are faced with an asymmetric economic development, national economic policies should be used to tackle the problems that might be the result of such an asymmetric development.

Concluding remarks

I should like to close my presentation here. Yet, before concluding my remarks, let me stress that we at the ECB, as well as at the Eurosystem level at large, are fully aware of the magnitude of the political, economic and institutional challenges faced by accession countries along the road towards the adoption of the euro. As central bankers, we are not isolated from the reality surrounding us, and we are committed to play our role in this historical process, particularly with regard to the smooth integration of the central banks of accession countries into the European System of Central Banks and, later , into the Eurosystem. Through ongoing co-operation, the central banks of the accession countries are being given an opportunity to familiarise themselves with the Eurosystem's mode of operation, and the Eurosystem can gain a better understanding of how these central banks operate under their respective regimes. This exchange, and the resulting establishment of a common terminology and understanding of each other's environments, will facilitate the pursuit of a common objective in the future.

Thank you for your attention.