Christian Noyer: Challenges ahead - the accession process

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the Foreign and Commonwealth Office, London, 12 November 2001.

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Ladies and gentlemen,

It is a great pleasure for me to be able to be here today at the Foreign and Commonwealth Office to share with you some thoughts on the process of EU accession and the challenges that this process poses for the accession countries. While recognising that this process raises challenges for the EU itself, I will not elaborate on those in my speech today.

Undoubtedly, the enlargement of the European Union to embrace a number of countries from central, eastern and southern Europe and the Mediterranean constitutes, after the changeover to the euro banknotes and coins, one of the main challenges currently faced by European policy-makers. However, I would be giving a somewhat misleading impression if I devoted my speech today solely to the "challenges ahead" without first mentioning the very foundations of the European structure. The latter form the basis for our capacity to actually meet those challenges.

EU enlargement rests on the proven success of European integration. The European Union constitutes an unprecedented framework for the successful development of regional co-operation. Not only have the original objectives of European integration been achieved, namely to ensure peace and prosperity in a historically conflict-ridden part of the world, the European Union has also shown its ability to overcome the various economic and political challenges with which it has been confronted throughout its almost 45-year history. Such is the attractiveness of the European integration project that, since the Treaty of Rome was signed in 1957, nine countries have joined the original six, and a host of others are keen to do so. A key accomplishment of this progress towards "ever closer union" will become truly tangible in a few weeks' time, on 1 January 2002, when most of the citizens of the European Union will finally have the euro, our money, in their pockets.

In many ways, the prospect of EU accession has also been instrumental in triggering reform in the 12 countries currently negotiating entry into the EU, namely five Central and Eastern European countries, the Czech Republic, Hungary, Poland, Slovakia and Slovenia; three Baltic States, Estonia, Latvia and Lithuania; two southern European countries, Bulgaria and Romania; and Cyprus and Malta in the Mediterranean. Following some troublesome years at the beginning of the transition process, the accession countries have made substantial progress in building institutions and designing appropriate policy. The accession countries have now generally achieved macroeconomic stability. The significance of these achievements can be demonstrated by the resilience shown by the accession countries to the Asian and Russian crises in 1997-1998 and, more recently, to the adverse developments in Argentina and other emerging market economies.

However, a number of important challenges remain. The years to come will be crucial to ensure that the current significant momentum of the accession process is maintained, and that the remaining difficulties are dealt with effectively in order to permit the smooth integration of accession countries into the EU and, later on, into the euro area.

The forthcoming enlargement of the EU will, no doubt, increase the diversity and complexity within the Union in an unprecedented way. In economic terms, the discrepancies in real per capita income and price levels between the accession countries and the euro area are of a magnitude that has never been observed in previous enlargement rounds. In this regard, however, it should be borne in mind that the combined GDP of all the accession countries accounts for only around 5% of that of the EU. The enlargement also confronts European policy-makers with enormous challenges in political and institutional terms. The sheer increase in the number of Member States that the current enlargement represents renders the functioning of decision-making bodies more difficult. As we all know, substantial institutional reforms are needed to ensure that the EU can continue to function effectively after enlargement.

From the Eurosystem's perspective, there are five economic issues that appear to be of greater relevance at the current juncture: real convergence, inflation developments in the accession countries, monetary policy and exchange rate strategies, capital account liberalisation, and the structure and functioning of the financial sector. Let me elaborate briefly on each of these.

1. Real convergence

Sustainable rates of GDP growth will be a key challenge for accession countries in the years, and even decades, to come. 2000 was the first year since the beginning of the transition process in which all accession countries experienced positive growth. The degree of real convergence with the euro area, that is, the catching-up of the per capita income and price levels of accession countries with those of the euro area, has remained limited. Looking ahead, it appears unlikely that the overall growth differential between the accession countries and the euro area will be significantly higher than a few percentage points. Overall, the gap between the average GDP per capita of the accession countries and that of the euro area remains large. On average, GDP per capita in the accession countries is, in terms of purchasing power parity, around 44% of that of the euro area, and this figure is even lower when current exchange rates are taken into account. The size of the gap, combined with the limited growth differentials, suggests that the process of real convergence will be a very slow one, likely to continue far beyond the tentative dates for EU accession and for the adoption of the euro.

Hence, although differences in income levels are compatible with membership of EMU, it is important for accession countries to progress in the process of real convergence with the euro area. In particular, real convergence can help to create economic cohesion within EMU and promote integration between Members States. Further real convergence will also help to minimise the risks and the effects of asymmetric shocks. Against this background, it seems crucial that accession countries pursue structural policies that enhance the potential output growth of their economies.

2. Inflation developments

With regard to inflation developments, I should like to stress that, on the whole, the accession countries have made remarkable progress in bringing inflation down to single-digit rates. Inflation in the accession countries is expected to average around 6%-7% by the end of this year. However, reducing inflation from relatively low levels to even lower ones is clearly a difficult task. Evidence points to a number of micro and macroeconomic factors which affect current inflation rates in the accession countries. These include ongoing price liberalisation, privatisation processes, relatively expansionary fiscal policies and stubborn inflation expectations. Inflationary pressures stemming from high productivity growth in the tradable sector of fast-growing economies – known as the Balassa-Samuelson effect – have also been cited as one of the main reasons for higher inflation in catching-up economies, such as those of the accession countries.

A closer examination of inflation developments in the accession countries shows, however, that the Balassa-Samuelson effect alone cannot explain the persistence of inflation differentials vis-à-vis the euro area. Moreover, notwithstanding its importance, the Balassa-Samuelson effect should not be overstated when explaining current inflation rates in the accession countries. Indeed, most empirical studies estimate the Balassa-Samuelson effect within a range of 1 to 2 percentage points. This does not mean, however, that the pursuit of real convergence conflicts with further progress on disinflation. On the contrary, the process of disinflation should be advanced in the accession countries, at a pace determined by the overall economic situation and in particular by the need for these countries to increase real convergence. The Maastricht inflation criterion, which will not be revised to take into account any possible Balassa-Samuelson effect, should not be seen as an immediate requirement for these countries, but rather as a medium-term objective for central banks. As the experience of some euro area participants shows, progress in nominal and real convergence can be, and should be, pursued in parallel. Indeed, the experience of countries such as Greece, Spain and Portugal confirms that a key element of their successful entry into the euro area was their success in controlling sources of inflation other than the Balassa-Samuelson effect. In particular, a balanced monetary and fiscal policy mix and the control of real wage increases have supported the disinflation process in these countries, and allowed them to advance in the process of nominal convergence without compromising the gradual catching-up in real incomes.

3. Monetary policy and exchange rate strategies

With regard to monetary policy and exchange rate strategies, most accession countries have already indicated their intention to join ERM II as early as possible after entry into the EU. The accession countries have also signalled their intention to adopt the euro as soon as possible, that is, after two years of ERM II membership.

The whole issue of the timing of ERM II membership, both as to *when* to join and *how long* to remain in the system, is dependent on a somewhat more complex question, namely whether the discipline which ERM II imposes on its members is advantageous for the accession countries. The answer, in our view, is “yes”.

Ladies and gentlemen, allow me to reflect on this question for a moment and explain why we hold this view.

Being small open economies, most accession countries cannot disregard exchange rate developments when making their monetary policy decisions. The exchange rate is generally a more potent transmission channel of monetary policy decisions than domestic interest rates, and it also plays a crucial role in explaining the pass-through to price developments in most accession countries. Thus, in order to achieve further disinflation and sustainable growth, excessive exchange rate fluctuations need to be avoided. In our view, and this view is supported by our previous experiences with the EMS/ERM framework, ERM II provides a useful mechanism to anchor exchange rate expectations. At the same time, ERM II, with its adjustable central rate and its current fluctuation band of ±15%, provides accession countries with the same degree of flexibility as the EMS/ERM following the decision to widen the fluctuation band in 1993. This may be suitable for accession countries. Given that accession countries still need to complete the process of restructuring their economies and catching up in terms of real income, the flexibility inherent in ERM II and its wider fluctuation bands provides accession countries with sufficient scope to accommodate these reforms. Bearing in mind that ERM II constitutes a multilateral arrangement, and that it is consistent with the regional integration process in which all accession countries are deeply involved, ERM II is likely to have fewer potential weaknesses than other alternative exchange rate arrangements have shown over recent years. Of course, as for any exchange rate arrangement, coherence between macroeconomic policies must be ensured for successful participation in ERM II.

With regard to the length of the period of ERM II membership, in view of the varying degrees of convergence of the accession countries, limiting the duration of ERM II membership to the minimum permissible time to qualify for the adoption of the euro – that is, two years – may not be an optimal choice for all accession countries. Longer membership of ERM II may, in some cases, be helpful since it would allow accession countries to retain the exchange rate as an instrumental policy variable during the catching-up process. Indeed, this option has proven useful for most of the current euro area participants. Again, it is worthwhile to recall the examples of Greece, Portugal and Spain. In the case of Greece, the final revaluation of the drachma on 17 January 2000 took place at the request of Greece, with the agreement of the EU authorities, to support the country's efforts to preserve sustainable price stability and progress in real convergence without jeopardising the competitiveness of the economy. Portugal and Spain, which participated in the EMS/ERM for a longer period of time, also used the option of realigning the respective exchange rates of the escudo and the peseta at several points along the road towards entry into the euro area.

Participation in ERM II should, therefore, not be seen as a mere “waiting room” prior to the adoption of the euro. Instead, it should be regarded as a meaningful and flexible framework for increasing nominal and real convergence with the euro area, and for tackling the challenges faced by the accession countries as they progress towards the adoption of the euro. Indeed, the experience of current euro area member countries in the fields of inflation and exchange rate developments strongly suggests that the existing institutional framework for accession to the euro area, including the convergence criteria as defined in the Maastricht Treaty, is sound. Furthermore, this framework should be sufficiently flexible to accommodate most of the challenges that accession countries will face on their path to the eventual adoption of the euro.

4. Capital account liberalisation

Ladies and gentlemen, the fourth economic issue I would like to refer to is capital account liberalisation. In several accession countries, capital movements are still subject to a number of restrictions. The most relevant restrictions, from a monetary policy perspective, apply to short-term portfolio investments. Although transitional periods may be allowed under the Treaty in the early years of EU membership, as well as prior to accession under the Europe Agreements, thus far, only a few countries have requested them. In those few cases, transitional periods mainly relate to areas that are not particularly relevant from a monetary policy point of view (e.g. real estate purchases).

Despite the generally positive impact of capital liberalisation on the growth prospects of the accession countries, one should bear in mind that the speed of capital account liberalisation may carry risks for countries with underdeveloped financial sectors, especially in a context of fixed or tightly managed exchange rate regimes. If not carefully sequenced and supported by consistent macroeconomic and structural policies, capital account liberalisation could pose some risks to macroeconomic or financial stability in the accession countries. It is therefore crucial that the right policies are put into place before EU accession.

5. Financial sector structure and functioning

The last issue I would like to elaborate on concerns the structure and functioning of the financial sector in the accession countries. Partly for historical reasons, the financial sector in the accession countries is largely dominated by the banking sector, whereas other financial sector intermediaries still need to be further developed. Over the past few years, significant progress has been made in restructuring and consolidating the banking sector. This progress has been accomplished through the large-scale privatisation of state-owned banks and through the extensive opening-up of the banking sector to foreign ownership. Undoubtedly, this process has contributed to greater integration with the EU and significant efficiency gains. It has also supported the strengthening of financial stability and provided the banking sector with know-how and capital.

However, the degree of financial intermediation remains rather low and the challenges ahead are considerable. Given the major implications that the structure and functioning of the financial sector may have for macroeconomic developments, a strengthening of the accession countries' financial markets, including the enhancement of legal frameworks and prudential supervision, is needed. The principal reasons for this are twofold. First, the weakness of the financial sector has been partly responsible for the relatively modest growth rates observed in some accession countries during the last decade. In spite of substantial structural reforms in the real sector of the economy, the as yet insufficient development of the financial sectors may have made the transition to a fully functioning market economy more costly in many accession countries. Financial sector development is, therefore, crucial if potential economic growth is to be increased and real incomes are to catch up with those of the euro area. Second, financial stability in the accession countries is of great relevance to the ECB, since it is a central aspect of ensuring the smooth conduct of monetary policy in an enlarged euro area. Financial sector vulnerabilities have to be avoided as they may complicate the efficient working of the monetary policy transmission mechanism. They may also pose great challenges for the conduct of monetary policy, for central banks' credibility and for the maintenance of price stability.

Finally, accession countries have embarked on the process of developing a modern financial market infrastructure. This is essential in order to facilitate the transition from a planned to a market economy and, at the same time, to support the conduct of a single monetary policy in an enlarged euro area. Setting up such a financial infrastructure is, however, a difficult task. First, preparatory work in this field is subject to very long lead times and, therefore, needs to be implemented years before the adoption of the euro. Second, the target of this preparatory work is a moving one: certain components of the euro area financial infrastructure may need to be adapted before new Member States can be integrated into the euro area. Furthermore, there is an ongoing debate in international fora about the optimal structure of modern financial markets in an increasingly integrated global financial system. More and more, market pressures, economies of scale and efficiency gains point to the need for further consolidation of the financial infrastructure. In the context of EU entry, and taking into account the relatively small size of the financial sectors in the accession countries, plans to develop the financial market infrastructure may need to bear in mind the specific conditions applying to accession countries. Indeed, there is a risk that accession countries may now be investing considerable efforts and resources to develop infrastructures similar to those that some euro area countries are trying to rationalise.

Concluding remarks

Ladies and gentlemen, I shall conclude with a few brief remarks of a more general nature. The ultimate goal of entry into the euro area is an ambitious one and, for this reason, it is necessary to start preparing for this prospect well in advance. Broadly speaking, the prospect of EU membership should encourage accession countries to make all the macro and microeconomic adjustments necessary to join the euro area. In this way, EU accession may set in motion a virtuous cycle of long-term

sustainable economic growth. As the experience of current euro area participants shows, accession countries may encounter difficulties, and even sometimes feel frustration, during the different stages of this process. However, these difficulties should not discourage accession countries from going ahead with the project of entry into EU and, later on, the euro area.

Undoubtedly, EU enlargement poses great challenges to both the accession countries and to the European Union itself. Creating the right economic and political conditions and adjusting the European institutions for the eventual integration into the EU of all accession countries is certainly an enormous task. However – and here I come back to what I mentioned at the beginning of my speech – the project of European integration should not be regarded just as a stimulating exercise of facing up to never-ending “challenges ahead”, but rather as a historic opportunity to deepen and extend the idea of Europe. I am confident that we, as Europeans, and more specifically in our central banking function at the ECB, will be able to master the “challenges ahead” and, in this way, to contribute to the completion of the European project through the successful integration of the future Member States into the euro area.

Thank you for your attention.