

Jean-Claude Trichet: Monetary policy in 2003

Introductory statement by Mr Jean-Claude Trichet, Governor of the Bank of France, at the Forum Institut für Management, Frankfurt, 2 December 2002.

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Introduction

Ladies and Gentlemen,

It is for me great pleasure to participate in this “International Forum on interest rates” and to exchange views with an audience of prominent players on financial markets. I welcome the initiative of the Forum Institut für Management. In promoting discussions on challenging issues between market practitioners and economists, this contributes to the attractiveness and spirit of financial markets in the euro area.

I would like to open these discussions with some remarks on structural issues that one should keep in mind when examining the prospects for financial markets in Europe.

Indeed, by achieving its primary objective of pursuing price stability in a medium-term perspective, the monetary policy defined by the Governing Council of the ECB lays the foundations of the success of euro. But these foundations are also embedded in a far-reaching structural dynamic involving notably three components:

- financial integration,
- financial stability,
- and the prospects of European Union enlargement.

I would like to make a few remarks on the challenges and opportunities arising from these three – interrelated– topics.

1 Financial integration

1.1 *As regards financial integration, the European monetary union has in many respects modified the way in which financial institutions organise their daily business in the euro area. This has influenced the integration pattern on the various segments of the financial market.*

European Union has modified the way in which financial institutions organise their daily business in the euro area:

It is true that financial integration in Europe started before January 1999, as banks and non-financial companies included, in their strategies, the setting up of the Single European Market, which occurred ten years ago. The expansion of their operations abroad has been notably the driving force. To illustrate that point, we can look at the stock of foreign assets held by companies. In the case of France, this stock has more than tripled between 1992 and 2000, from EUR bios 131 to EUR bios 465. As a result, non-financial companies gradually introduced more competition into the banking system, as they funded their expansion through non-domestic bond or commercial paper issues, or by centralizing their financing. As an example 40% of the external financial resources borrowed by French medium and large companies are being redistributed to their own subsidiaries, and 10 to 15% consists of commercial paper and bond issuance (figure as at end 2001)¹.

¹ Source : Banque de France – Central balance sheet data -

1.2 *These changes, and on top of them the introduction of the euro, have influenced the integration pattern on the money market, on the bond markets, on the derivatives markets and on the equity markets.*

Integration is certainly –and naturally– most developed on the money market. Interest rate differentials across regional deposit markets have vanished and the “law of one price” applies to all transactions within a deep and highly liquid pan-European market. Cross-border transactions –for unsecured inter-bank deposits and repos– now account for over 50% of all money-market cash transactions. EONIA and EURIBOR have within a very short time become the undisputed benchmarks for short-term interest rates. This is reflected for instance in the impressive development of the euro interest-rate swap market, where all but a few transactions are indexed on these benchmarks. This deep integration of the money market has prompted new organisational patterns in the banking sector, with a concentration of euro cash management activities making it possible to take advantage of higher liquidity levels on the secondary market. For instance, according to a survey by the International Securities Market Association in June 2002, the top ten banks in a panel of 77 accounted for 55% of the total reported business on the European repo market. As a result the price discovery mechanism on the money market is smoothed because trade decisions are based on information systems that capture the relevant parameters at euro-area level.

The integration of euro-area financial markets has also deepened on the bond market:

- Rapid internationalisation has taken place. Between 1998 and 2001, the relative share of corporate bonds issued by corporate borrowers in the euro area as a percentage of GDP has more than doubled, while it increased by one third in the United States².
- Competition between all issuers, corporate or sovereign, has intensified. For sovereign issuers, the disappearance of currency risk and the convergence process driven by the Maastricht Treaty have transformed government bonds into directly competing risk free assets. As a consequence, sovereign issuers have implemented strategies aimed both at differentiating their issuance profiles –in order to diversify the opportunities offered to investors– and at establishing benchmarks on a selection of maturities. This is reflected by the building up of an outstanding amount of at least 5 bios euros on the internationally important 10 years segment, in each euro area country, while issuance strategies on other segments –2, 5, 30 years– differ, some countries building up relatively larger outstanding amounts on 30 years maturities (Italy), some on 5 years maturities (Netherlands)³. Only a few large countries (Germany, France for instance) are able to provide a high level of liquidity on all the spectrum of maturities. This competition has provided market participants with a wider range of products that are also more standardised, which allowed for the development of electronic trading and enhanced the liquidity of the euro bond market.
- Internationalisation and competition between private issuers have been accompanied by an impressive surge in the amounts issued. Issuance of Euro denominated non-government bonds has more than tripled between 1998 and 2002⁴. It is quite difficult to isolate the specific impact of European Monetary Union, due to the fact that large issuances during the 1999-2001 period were also linked to the refinancing needs arising from intense merger and acquisition activity. Looking ahead over the medium-term, growth in the bond market is likely to be driven by such elements as the development of pension fund assets, while retail savers may move away from bank deposits to invest in other savings products. In turn, the design of savings products will benefit from the standardisation and diversification of fixed income issuance⁵.

The integration of interest rate markets in the euro area has been accompanied by a new phase in the development of derivative markets. The proportion of worldwide open interest contracts traded on

² BIS and IMF statistics – quoted in RAJAN and ZINGALES – 2002.

³ OECD – Debt management and Government securities in the 21st century – 2002.

⁴ from about EUR 100 bios in 1998 to about 300 bios in 2000, 2001 and 2002 – source Bondware.

⁵ RAJAN and ZINGALES – 2002 – Second ECB international banking conference.

European derivative exchanges went from less than 1% to more than 15% in 15 years⁶. As derivative markets enhance the ability to manage and trade risk, they are at the heart of modern finance and the backbone of financial innovation. Their development has enabled market participants to hedge risk, develop arbitrage, and, therefore, enhance the efficiency of price setting in financial markets. Of course, the other side of the coin is that derivatives are sometimes criticised as they may be regarded under some circumstances as a potential threat to financial stability. I will come back to this point later on.

The elimination of currency risk within the euro area has also had far-reaching effects on the equity markets. This is crystal clear when observing volatility patterns and portfolio allocation methods.

As regards *volatility patterns*, recent developments seem consistent with the predictions of economic theory, where stock prices should reflect expectations of future dividends, interest rates and risk premia. It follows that the introduction of the euro should be associated with a reduction in differences in volatility across markets. Indeed, a recent empirical study⁷ demonstrates that those countries whose stock exchanges had a structural high or medium volatility regime, converged towards those with a low volatility regime. From the point of view of the European stock market as a whole, this shows an improvement in global efficiency.

As regards *investment patterns*, sector-diversification strategies have been defined as an alternative to country diversification. Before EMU, it was common practice for institutional investors to make geographical diversification their first priority, and, secondly, to select securities in accordance with a sectoral diversification pattern. There is some evidence that the “home bias” has weakened since the introduction of the euro. For instance, assets held by pan-European investment funds represented 25% of total assets at the end of 2000, up from 12% in 1998⁸. The development of a genuine pan-European approach is also illustrated by the introduction of various European stock indexes. The turnover on options based on these indexes –for instance, the volume of options traded on the Eurostoxx50 contract– now matches the turnover of options based on well-established domestic indexes such as the CAC in France. This provides evidence that large investors are looking for – and actually have recourse to– hedging products that are suited to a cross-border oriented strategy.

However, this evidence of a strong impetus towards integration does not necessarily support the argument that a brand new asset allocation is overwhelmingly dominant. Let me emphasise two aspects.

First, pan-European sectoral strategies have also embraced non-euro area stocks in order to reach an appropriate level of diversification. This is the case in sectors such as pharmaceuticals, or telecom equipment, with stocks listed in non-euro area countries such as Switzerland, the United Kingdom and Sweden. This is in line with some theoretical assumptions, which are stating that currency risk is outweighed by the risk-return parameters, as far as investing in equities is concerned.

This leads me to the second aspect: the sensitivity of stock market to general macroeconomic events suggests that domestic macroeconomic variables still influence stock prices. Therefore investors may still prefer to avoid being heavily weighted in a country with structural rigidities, or high public debt levels, and will on the contrary overweight their asset allocation in countries with well-designed fiscal and structural policies. In the same vein, this should suggest that the level of connection between stock exchanges in Europe and the US could be time varying, considering that the underlying factors are also driven by policies that are implemented independently. As a matter of fact, and not surprisingly, correlations of yields between European stock indexes appear to be higher than those between European and US indexes, and these correlations have increased since 1999. These results seem valid even taking into account the increase in correlations due to the increase in absolute volatility levels⁹.

⁶ RAJAN and ZINGALES – 2002 – Second ECB international banking conference .

⁷ MORANA, BELTRATTI – 2002 – The effects of the introduction of the euro on the volatility of European stock markets – Journal of Banking and Finance.

⁸ Source: FEFSI – Fédération Européenne des Fonds et Sociétés d'Investissement – in THE EURO EQUITY MARKET – ECB 2001.

⁹ Banque de France Research department calculations – . Correlations calculated as monthly averages. The impact of market shocks is neutralized by taking into account changes in long term interest rates. The correlation between Eurostoxx 50 and

2 Financial stability

2.1 ***Like every modern and independent central bank, the Eurosystem and its individual components, the ECB and the national central banks of the euro area, have to fulfil two main functions: firstly, ensuring price stability, and secondly, preserving financial stability. Discussions about the role that central banks should play in circumstances of illiquidity or financial distress are as old as central banks themselves.***

The involvement of central banks in financial stability issues stems from the superiority of central bank money in the final settlement of transactions on financial markets. Central bank money enables market participants to have risk-free and low-cost working balances – risk-free because the counterparty risk on a central bank is assumed to be zero, low-cost because, in the TARGET system, the cost of intraday credit is limited to the opportunity cost of depositing the appropriate level of collateral. Therefore, central banks are concerned with the robustness of payment systems and the financial positions of banks participating in the money market, in order to prevent systemic risk that could stem, for instance, from the potential “domino effect” if a participant fails to meet its settlement obligations.

Central banks are concerned also by financial stability from a monetary policy point of view. I would say that price stability can be regarded as the bedrock of financial stability, while financial stability is critical to the efficiency of monetary policy. Let me elaborate further on these two points.

First, why is price stability the backbone of financial stability? Financial stability can be achieved on a sustainable basis if financial resources are not misallocated. Past experience, as well as a large number of economic studies provide evidence that inflation brings about distortions in the allocation of resources. For instance, the calculation of returns is biased, due to the fact that the replacement cost of fixed assets is structurally underestimated. This may result in sub-optimal investment decisions, and over-optimistic credit risk assessment. Conversely, in the case of deflation, the solvency of indebted companies may be jeopardized, as the value of cash flows decreases over time, while the face value of debt remains stable.

Second, why does financial stability matter for the efficiency of monetary policy? The efficiency of monetary policy relies on the effectiveness of the transmission channels of monetary policy. Central banks have direct control over short-term interest rates only. The impact of monetary policy decisions on prices goes through various channels – acting directly on the anticipations of economic agents, influencing banking credit conditions, the exchange rate and other asset prices. Uncertainty may arise when these channels do not act in a predictable way nor with relatively stable time lags. In this respect, financial instability may affect the transmission channels of monetary policy. For instance, large fluctuations in asset prices may modify the behaviour of agents by decreasing the level of confidence. Such fluctuations can also expose bank portfolios to a higher risk of losses, inducing banks to compensate for these risks by restricting credit.

Let me stress that, although a price stability oriented monetary policy is conducive to financial stability over the long term, episodes of financial instability have been known to take place during periods of low inflation. Price stability must be therefore regarded as a necessary but not sufficient condition. Other parameters influence financial stability, among which financial integration is of particular interest from the point of view of a central bank in the Euro area.

2.2 ***The relationship between financial integration and financial stability is twofold:***

- First, the liquidity redistribution function has taken on a new dimension as participants in the market are dealing with a wider range of counterparties, and actually trade larger unit amounts. Some bank treasurers in Paris mention that the average face value in euro of single transaction today is equivalent to the face value of a transaction in French franc in 1998, that is, more than six times higher.
- Second, financial market integration is related to the trend towards the greater share of markets in the allocation of assets. At the end of 2000 financial assets in the euro area were

Dow Jones is 70% over the period January 1999- October 2002 (70% when the measure is based on SP500), and 100% between CAC and Eurostoxx50 (97% between DAX and Eurostoxx 50).

split almost equally between intermediated and non-intermediated assets¹⁰. Although credit still plays a prominent role in the allocation of financial resources, credit institutions themselves are relying on the financial markets to manage their balance sheets.

These two points suggest that the benefits of enhanced liquidity entail the management of a new range of risks. This should not lead us to conclude that financial integration has necessarily negative side effects from the point of view of financial stability.

Financial integration may help to foster financial instability. I would like to put forward three reasons for this:

- First, the setting up of a large currency area eliminates disruptions arising from currency risk that would otherwise prevail between the participating countries. Domestic economies are immune to currency misalignment episodes that disturb regional trade. Currency risk premia are eliminated from interest rates.
- Secondly, the setting up of a large currency area implies an overhaul of market infrastructure. In this respect both public bodies, such as national central banks and market participants, have a unique opportunity to pool best practices. Indeed, this has been the case in the euro area where, for example– the TARGET system, interlinking domestic real-time gross settlement systems, has demonstrated its ability to absorb large volumes of cross-border flows, and to perform well even in critical circumstances such as September 2001. The TARGET system processes today around EUR 1500 billion per day, 50% more than the average in 1999 and an estimated three times the amount that all the large-value payment systems in the 12 euro area countries processed together in 1990¹¹.
- Thirdly, a large currency area means deeper and more liquid financial markets. This allows market participants to diversify their risks on a wider basis; moreover, as currency risk is eliminated, they can focus on the analysis of credit risk. A large currency area also provides more scope for specialised institutions to develop. All in all, market efficiency and liquidity help to cushion external shocks¹².

2.3 Taking into account these benefits, one could question why financial stability issues are still important in the euro area.

In my view financial stability issues need to be re-visited today against the backdrop of the far-reaching changes observed on the financial markets in the last decade, and taking into account the succession of market instability episodes. Just to name a few, the Asian crisis, the Russian/LTCM crisis in 1998, the “Tech-bubble” as of 2000. These episodes were characterised by situations of liquidity stress, market volatility, and the late discovery of risks that had spread widely through complex hedging and financial innovation devices.

In this respect the complex relationship between volatility, financial innovation and financial stability deserves attention.

Clearly, volatility levels primarily reflects the degree of uncertainty of market participants. From a general point of view, volatility is a kind of genetic signature of the price setting mechanism in a competitive market. Prices hover around the equilibrium through successive adjustments. When market participants express widely different views on this equilibrium price, or when the volume of transaction shrinks, volatility usually increases. In this respect, there is a close correlation between the occurrence of crises –such as the revealed insolvency of an emerging country, supply shocks on commodity prices, bursting of equity bubbles– and excessive volatility. Volatility is not an indicator of market inefficiency. However, excessively high volatility has adverse effects on the behaviour of market participants and the real economy. From a corporate management point of view, volatility on capital markets lowers the predictability of the cost of capital. When reviewing investment

¹⁰ Source : Report on financial structures – ECB - 2002

¹¹ estimation in « Central banks and financial stability – exploring an intermediate land » – Second ECB central banking conference - 2002

¹² BRI – Economic aspects of regional currency areas and the use of foreign currencies – 2002 – document non publié.

opportunities, managers may want to avoid relying too heavily on external finance because of the uncertainties surrounding the cost, or even the sheer availability, of financing. This may lead companies to postpone or downsize investment projects. From a financial management point of view, large investors may give priority to companies with a low risk profile, in order to bring back their own asset portfolios to levels of volatility matching their requirements. Therefore listed companies will have an incentive to adjust their risk profile and avoid more hazardous –which may also be more innovative– investment projects. Therefore, “entrepreneurship” may be curbed and the growth potential may be influenced adversely.

Another impact of volatility on financial management is related to recourse to hedging, namely derivative products. As I mentioned earlier, derivatives are a driving force behind mature financial markets, and their strong development in the last two decades is merely consequence of the benefits they have generated.

More precisely, derivatives and related financial innovations have enabled companies to transfer the impact of interest rate and currency fluctuations to financial institutions or investors that were ready to manage it, whereby facilitating international trade or project financing.

Meanwhile, the pricing of derivatives is closely linked to volatility. As volatility is indeed difficult to predict, market practitioners have developed models, which are constantly being refined. Over time, market participants, –especially banks,– have become more competent in managing risk, while being left that residual risks which are more complex and harder to control.

These consequences would not be a major concern, if the episodes of excessive volatility were only accidental. Peaks of volatility clearly reflect macroeconomic imbalances, as soon as market participants take into account the relevant information. This has been evidenced in studies reviewing factors behind currency crises in emerging countries. Macro data –such as balance of payment or fiscal policy indicators– prove to be discriminant-leading indicators from this point of view¹³.

However, I cannot affirm that the resolution of market imbalances would result in a reduction of volatility to levels that prevailed before these imbalances were taken into account by market participants. In my view one should not underestimate the part played by technical factors in the persistence of volatility peaks. This persistence in volatility is fuelled by technical features that facilitate the build up of mimetic behaviours (amplifying effects), or that reinforce the links between the various market segments (diffusion effects).

Mimetic behaviour is of course by no means a new phenomenon on financial markets. However benchmarking, index management, and risk management techniques may have gradually reinforced this type of behaviour, as participants are under increasing pressure to follow their peers through matching the performance of a benchmark.

There is no doubt that the spread of benchmarking allows fund managers and clients to better assess their performance against that of other funds. But, in a context of growing competition within the sector, it may well have increased mimetic behaviour. Some market participants (whose own compensation is closely linked to the relative, rather than absolute, profit and losses they generate) may indeed have come to the conclusion that it would be better to be wrong along with everybody else, rather than to run the risk of being right alone. A striking example of rational mimetic behaviour is the influence that hedge funds possess as “opinion leaders” and trend setters. By its nature, trend following amplifies the imbalance that may at some point affect a market, potentially leading to vicious circles of price adjustment and liquidation of positions. Moreover, increasing numbers of participants are able to access financial markets directly, while the expertise to deal with a wide range of technical information is not evenly distributed. This may also reinforce the role of “gurus”.

Index management, as a fund management technique, has proven very popular on equity markets and may have contributed to exacerbating fluctuations in financial asset prices. Because their goal is to mimic the performance of indices, “passive managers” constantly strive to match the composition of their benchmark. They thus help to amplify market trends, buying more as the market rises and increasingly liquidating as the market drops. It can be argued that index funds distort the prices of the targeted indices and that, as a result, the indices end up creating rather than measuring performance.

¹³ Leading indicators of currency crisis in emerging countries – BURKART, COUDERT – Notes d'Etude et de Recherche – Banque de France – 2000.

The impact of risk management techniques on market dynamics is particularly enlightening with regard to the question of asset price overshooting. Value-at-risk calculations have become a crucial element of the standard approach used by market participants to evaluate the risk inherent in their market activities and to set up exposure limits. Of course, central banks and financial institutions should continue to encourage the use of these instruments. But, in times of financial turmoil, the growing use of sophisticated risk management techniques by financial intermediaries might have the paradoxical effect of amplifying the initial shock, exhausting liquidity and contributing to contagion phenomena. Regardless of the intrinsic qualities of these risk management tools, we see that their growing use in the same fashion by all market participants may have produced pernicious effects. When market players rely on converging risk evaluations, they tend to take the same decisions at the same time, thus amplifying initial shock to prices and trading volumes.

Financial techniques can also reinforce the links between the various market segments. A striking feature of recent developments on financial markets is the quick spreading of disruptions from one market segment to another, especially between equity and credit markets.

For example, the short selling of equities is sometimes used to hedge credit risk. The underlying reasoning is that if there is a credit default, the value of the equity will decrease symmetrically, and an equity gain will compensate the lender for the credit loss. As a result, the fall in the equity value, which is triggered by the credit default, is amplified by the short selling operation.

Credit risk derivatives constitute another financial innovation which has played an increasingly important role in the last years. It has contributed to avoiding credit institutions to be heavily impacted by the large credit defaults that have occurred recently. Credit risk derivatives have also enabled banks to fine-tune the risk-return profile of their loan portfolios. From a macro point of view, credit risk derivatives are helping diversify and spread risk, under the assumption that buyers of risk will deliberately alter their own risk-return profile. But the ultimate risk remain and as a result, some sectors, such as insurance companies or pensions funds, which hitherto did not feel the direct pressure of a worsening in credit quality, may now find themselves directly impacted, had they sold such derivatives at an earlier stage.

Against this background, and beyond the primary objective of achieving price stability over the medium-term, which part should central banks play to improve the functioning of financial markets and promote financial stability?

Apart from their operational tasks –such as the management of money market liquidity and the monitoring of large value payment systems– central banks must endeavour unremittingly to create the conditions for the international economy to minimize misalignments in asset prices, excessive volatility, purely speculative phenomena and dangerous herding behaviour. This is the underlying message in central banks' repeated calls for prudence and caution.

I would like now to address my third point, that is, the prospects of the European Union enlargement.

3 *European Union enlargement*

At first glance, the link between this topic and the two issues I have been dealing with up to now appears quite tenuous. Yet, while the issues arising from market integration and financial stability are of concern for many Central Banks, managing the EU enlargement is a distinctive concern of the Eurosystem. I would like to share views on how the Eurosystem will act to address this concern, while performing their task regarding price and financial stability.

Ten countries from Central, Eastern and Southern Europe –comprising 75 million inhabitants – are to join the EU, thus completing European reunification. Although their combined GDP is rather small (equivalent to that of the Netherlands for instance), in terms of population' size they will propel the EU (450 millions inhabitants) largely ahead of the combined population of both the US (population: 275 millions) and Russia (population: 145 millions). This testifies again, if need be, to the attractiveness of the European Union framework, which has provided us with economic prosperity and political stability for almost half a century.

Accession countries have accomplished important progress in stabilizing and strengthening their economies and their institutions. Observing the accession countries, recent history shows the major improvements those countries have made, in hardly 10 years, on the road towards convergence with the EU. Let us keep in mind, the sometimes rather slow pace the current Member States took, regarding for example trade openness, price liberalisation, or macro economic discipline.

Nevertheless, there is also general agreement on the fact that the gap, in terms of average GDP per capita, between the accession countries and the euro area, although diminishing, remains still quite significant. The size of the gap, combined recently with a rather limited growth differential between the two groups of countries, suggests that the process of real convergence will be very gradual and will have to continue much beyond the tentative dates for EU accession.

Although differences in income levels are not incompatible with EU and even EMU membership, it is extremely important for accession countries to increase real convergence. Indeed, real convergence is essential to create economic cohesion within EMU and promote integration between Members States, thereby helping to minimize the risk and the effects of asymmetric shocks, in the best interest of accession countries themselves.

Let me stress seven points of particular relevance for the Eurosystem, and for accession countries themselves on the road towards achieving catching-up and convergence with the EU.

- Firstly, we should never forget that nominal convergence must be sustainable and therefore not only constitutes an objective that must be met at a given point of time but rather a goal that must be achieved continuously. Strict compliance with the Maastricht criteria will be key for joining the euro area. Indeed, the EU Treaty calls, as a prerequisite for adopting the euro, for a high degree of sustainable convergence in the fields of price stability, government fiscal position, stability of the exchange rate, and long-term interest-rate levels. The sustainability of nominal convergence itself presumes that sufficient preliminary progress has been made towards real and structural convergence (and namely having set a fully-fledged market economy, catching-up in income and productivity levels, as well as economic and social infrastructures, upgrading of the legal system...). Conversely, a sustainable catching-up process requires macroeconomic stability. Therefore, nominal and real convergence should be pursued in parallel, and are not antagonistic.
- Secondly, I noted that several accession countries have already expressed their intention to join ERM II rapidly after EU entry. This intention is to be welcomed, although it should be clear that ERM II membership needs neither to happen immediately after EU accession in all cases, nor to be limited to only two years, which is the minimum before adopting the euro. It would be totally misleading to consider ERM II as a mere "waiting room" before the euro. On the very contrary, ERM II membership allows countries to retain some limited exchange rate flexibility during the catching-up process and offers a meaningful, flexible and credible framework for increasing nominal and real convergence with the euro area, and for helping determine the appropriate level for the eventual irrevocable fixation of parities, in the best interest of candidate countries themselves. To enter the Eurozone is a very important, very grave and irrevocable act. Neither the accession country concerned nor the Eurozone could afford the risks associated with a mistaken decision.
- Thirdly, accession countries must strengthen their fiscal and external positions. Given the aim of attaining real convergence over time, accession countries will have to devote significant public resources to funding investment. However, candidate countries' weighted average public deficit amount to 3.6% of GDP in 2001. The fiscal consolidation currently planned by some accession countries is welcome and likely to require sizeable expenditure cuts or tax increases. Looking ahead, accession countries will have to implement fiscal consolidation very credibly with a view to avoiding the risks associated with the existence of high "twin deficits", i.e. fiscal and external.
- Fourthly, a sound and efficient banking and financial system is key. Significant progress has been made over the past few years in rehabilitating the banking sector and encouraging foreign ownership. The latter has also contributed to greater integration into the EU financial system. Nevertheless, adapting the legal and regulatory framework is a process entirely in the hands of the accessing countries. The intermediation role of the banking sector remains fundamental for the efficient use of capital and sustained growth. Progress in corporate governance, the enhancement of the legal and supervisory frameworks that support the banking sector, and an efficient fight against money laundering, are also crucial. These improvements are conducive to achieving the macroeconomic objectives of the accession countries.
- Fifthly, central bank independence is of the essence. It is an integral part of the *acquis communautaire*, which is laid down not only in national legislation but above all in the

Maastricht Treaty. The effective implementation of the *acquis communautaire* is not only a legal prerequisite for accession to the EU. It also implies the effective transformation of accession countries' economic framework, which should facilitate their integration into the EU and, later, the euro area. In this context, it should be ensured that there is no discrepancy between the central banks' formal status in the legislation and the implementation of that legislation. It is of utmost importance that all present and future Member States respect this economic and institutional ground rule of the European framework.

- Sixthly, let us not forget the present and future contribution of Central and Eastern European countries to the economic prosperity of Europe at large.

It seems that this contribution might be sometimes *underestimated*, while the relative influence of the US economy, for instance, might be sometimes *overestimated*. In fact, transition economies, as a whole, are as important as the US in terms of external demand addressed to the euro area: they both enjoy the same share, i.e. 13% of our exports. And, during the last two years, transition economies contributed for two-thirds to the overall growth of our total external demand, while the US contributed for less than 0.1%.

More generally speaking, Central and Eastern Europe countries are already major contributors to the overall growth on the European continent. In 2001, despite the international context, they remained at quite high a level of growth, around 2.8%. This contribution is bound to further increase given these countries' considerable potential for growth.

I thank you for your attention.