THE ENLARGEMENT OF THE EU AND THE EUROPEAN CAPITAL MARKETS[1]

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I am delighted to be here in Berlin today to participate in this 7th Central European Covered Bond Conference. I should also like to thank the Association of German Mortgage Banks for their kind invitation.

Today I will offer you the ECB's view on the enlargement of the European Union and the European capital markets. In this context, the covered bond markets are a promising area for the future development of financial markets in Europe, albeit with significant differences in importance from one country to another.

As the title of my speech indicates, I will first consider the enlargement of the European Union and will thereafter make some comments on the financial sector in the accession countries.

At this relatively early stage in the development of financial markets in the accession countries, it seems more appropriate to refer to the financial sector rather than the capital market, since the latter is not yet very well developed.

The functional culmination of European Economic and Monetary Union (EMU) came on 1 January 2002, when euro banknotes and coins entered circulation. Now all that remains is the geographical or spatial completion of our Monetary Union. The process of enlargement is the most decisive step towards finalising this geographical whole, not forgetting those countries that are already members of the European Union but are outside the euro area.

Enlargement will benefit both sides. Economic integration is not a zero-sum game in which for there to be winners, there have to be losers. As economic theory has shown, surpluses can be generated from economic and financial exchange. Consumers, savers, business people, workers, investors…each and every economic agent can benefit from the accession process. The European Union (EU) itself, its institutions and its currency, the euro, will emerge stronger as a result of welcoming

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ten new Member States, as long as the integration process is handled well and is completed successfully.

The enlargement of the European Union and the Economic and Monetary Union poses many challenges to the European Central Bank (ECB) and the Eurosystem as a whole. Practically every area of the ECB's business is affected by the preparations for enlargement, ranging from the future production of euro banknotes to the compiling of monetary, banking and European financial market statistics, the organisation of the Eurosystem's payments system and, of course, the common monetary policy. While the total gross domestic product (GDP) of the ten countries joining the EU next year will not substantially increase the total GDP of the European Union or of the European Monetary Union, accession will pose serious challenges and will require the full commitment of all of us who are involved in this process. Some idea of the great efforts being made in this respect can be gained from the fact that, to date, more than 1,000 technical cooperation activities have been launched between the ECB and the acceding country central banks (ACCBs), helping them to prepare for membership.

It should be made clear from the outset that EU enlargement is a political process. Indeed, it is such a large undertaking that I think it is difficult to grasp its full impact. We lack the necessary time perspective in the same way that we still lack the historical distance needed to understand the full implications of having more than 300 million people using the euro for their accounts and payments.

The economic – and, it goes without saying, also the technical – is in the service of the political. It is the ECB's duty, along with other economic institutions and as far as its powers will allow, to define the criteria and create the economic and technical conditions needed to ensure that this vast political process is a success.

Despite the difficulties it involves, there are good reasons to believe that enlargement will be completed successfully. The creation of a monetary union, the launch of the euro and the establishment of a common monetary policy was a much harder task, and yet we managed it. Moreover, it is always easier to enlarge an institution than it is to create a brand new one. The Eurosystem already has solid foundations since it took on the relevant tasks of its national central banks (NCBs). Common operating criteria, from monetary policy strategy to IT standards, have been put in place and are now fully tried and tested. The Eurosystem was established using a strategy of creation; its enlargement will now follow a strategy of adaptation. The Eurosystem, and the ECB in particular, must facilitate this adaptation, while the strategy will require the ACCBs to make the greatest effort.

There is one fundamental reason for optimism that must not be underestimated, namely the high degree of economic interdependency already existing between the European Union and the acceding countries. Enlargement will therefore formalise or institutionalise something that already exists something that is already a fact of economic life. However, I don’t mean to suggest by this that the accession process will be easy. On the contrary, I repeat that it will run into difficulties, and these will have to be resolved. Progress will be made, but there will also be some setbacks along this road. My point is simply that, despite everything, the seeds of membership are being sown on already fertile ground.

In any process of monetary and financial integration, there are three key areas: legal-institutional, logistical-technical, and economic. Allow me to refer to these three aspects before concentrating on the relevance of the financial sector and the equity markets for the accession countries.

There can be no enlargement of the European Union or the Economic and Monetary Union without the prior legal and institutional convergence that allows the accession countries to adopt the Community acquis. It is essential that this *acquis* be applied in the financial sector in general, and to central banking activities in particular, in order to ensure a solid legal context. For its part, the Eurosystem has focused on: the financial legislation of the accession countries (especially with regard to the free movement of capital and payments); regulation of the financial markets with regard to the provision of banking, securities and investment services; rules governing eligible assets; and legislation paving the way for an internal financial services market.

Of particular relevance here is the independence of the respective central banks. Their statutes must guarantee their institutional, personal, functional and financial independence, using the same criteria that were previously applied when assessing the legal convergence of the statutes of the current euro area NCBs.

In September 2002 the General Council of the European System of Central Banks (ESCB), which consists of the presidents and governors of *all* the NCBs in the European Union, invited their counterparts from the ACCBs to attend meetings of the General Council with observer status once their Accession Treaties had been signed. The signing ceremony took place in Athens on 16 April 2003. Consequently, history was made on 26 June 2003 when a total of 25 NCB governors met for the first time in Frankfurt for an ordinary meeting of the General Council, together with the ECB's President, Vice-President and other members of the Executive Board.

The solution implemented for the ACCB governors has been extended to include the experts of these banks, who can now attend ESCB committee meetings as observers. This process allows the ACCBs to familiarise themselves with the functioning of the ESCB and the working methods used in the various areas. This is a key requirement for the success of the adaptation strategy I referred to earlier.

The development of an ever-closer relationship between the Eurosystem and the ACCBs led to the signing of a Confidentiality Agreement to ensure that countries respect a set of minimum standards for handling confidential information.

The highest decision-making body of the Eurosystem is the Governing Council, which consists of the six members of the ECB's Executive Board plus the governors of those NCBs whose countries have adopted the euro. The future enlargement of the euro area and, therefore, of the ECB's Governing Council must not diminish the latter's decision-making speed and efficiency. To this end, the Nice Treaty introduced an "enabling clause" that makes it possible to amend the Statute of the ECB with regard to voting rights in the Governing Council. After a lengthy debate, in December 2002 the Governing Council unanimously approved the revision of the voting system (Article 10.2 of the Statute), and its proposal was adopted by the European Council in February 2003.

The new voting system is based on the idea of rotating the voting rights of the NCB governors, with only the six members of the Executive Board retaining a permanent vote. The frequency of rotation will not be the same for all governors, with different groups being created based on the GDP of the country concerned (corrected by a financial indicator). The system is such that at any given time the countries of those governors with the vote will, taken together, be representative of the euro area economy as a whole. However, this in no way alters the fact that governors exercising a voting right do so on the basis of the "one member, one vote" principle – they do not represent their respective countries but attend in a personal and independent capacity. This system will start with two groups as soon as the number of euro area countries exceeds 15. When it exceeds 22, the rotation system will operate using three groups.

Meanwhile, it should be recalled that in October 2002 the ECOFIN Council recommended the addition – by means of the Accession Treaty – of a new paragraph in Article 49 of the Statute, whereby the subscribed capital of the ECB and the initial transfer of foreign reserve assets by the NCBs will be increased as and when new Member States join. Such increases will be automatic and in proportion to the weighting of the new Member States in the adjusted capital key that was calculated on the basis of the GDP and population of each country. The subscribed capital of the ECB currently totals €5 billion, fully paid-up in the case of euro area countries, but only paid-up to the tune of 5% by those EU Member States that are not members of the euro group. This solution avoids having to refund some of the paid-up capital to existing members at what would be a particularly inopportune time, given that enlargement gives rise to more operational activities and therefore higher costs for the ECB. It also means that the ECB does not have to return to the Member States part of the foreign reserve assets that they had previously transferred, totalling €50 billion and allocated on the basis of the capital key.

I do not intend to refer at this conference to the economic situation of the accession countries and their degree of nominal or real convergence. Allow me simply to say that you cannot group all of these countries together and treat them as a whole. In fact, the labels “candidate countries” or “accession countries” hide ten or 12 different economic realities. Cyprus is very different from Estonia, Poland has little in common with Malta, and so on.

At the economic level – by which I do not mean the economic situation *per se* but those economic aspects relating to plans for membership – four lines of action can be identified: the accomplishment of the convergence criteria; exchange rate policy; the instruments and processes of monetary policy; and statistics. Most of these aspects provide the basis for understanding the functioning of capital markets in the accession countries and its interplay with the euro-area capital markets.

The most important economic aspect with regard to acceding countries’ membership of Monetary Union is their accomplishment of the nominal “Maastricht” convergence criteria. As was the case for the 12 current members, this is the economic key to the door. On this point I will only say that the accomplishment of the convergence criteria by the acceding countries must be sustainable, as was set out clearly in Article 109 J (1) of the Treaty of Maastricht and in Article 1 of Protocol no. 6.

The idea of the sustainability of nominal convergence goes hand in hand with the concept of real convergence insofar as any excessive real divergence could compromise the sustainability of nominal convergence. It all depends, of course, on what you consider to be “excessive real divergence”, since it is clear that different levels of income and employment, etc. are compatible with monetary union. But the message is clear: during the adaptation period, the acceding countries must move in parallel towards both nominal and real convergence.

The great diversity between the accession countries I referred to earlier when talking about the economic situation also extends to their exchange rate strategies. Between them, the ten new states have a wide variety of exchange rate regimes, ranging from independent floating (Poland and the Czech Republic), to currency boards (Estonia and Lithuania), managed floating, informally using the euro as the reference currency (Slovakia and Slovenia), pegging to a basket of currencies with a greater (Malta) or lesser (Latvia) weighting for the euro and, finally, pegging to the euro within fluctuation bands of ±15% (Cyprus and Hungary), a practice reminiscent of that used by the Exchange Rate Mechanism II (ERM II).

At the current stage of the EMU convergence process, any exchange rate strategy is valid in principle, with the exception of euroisation. This is because the euro must be the final aim of monetary integration after the necessary adjustments have been made; it should not be the point of departure, making additional adjustments impossible.

The monetary reference framework for accession countries wishing to join the euro is ERM II, as defined in the “European Council Resolution on the establishment of an exchange rate mechanism in the third stage of Economic and Monetary Union”. ERM II is a voluntary mechanism that involves a central euro exchange rate for the currency of the accession country; a standard fluctuation band of ±15% around the central rate; obligatory, automatic and unlimited intervention at the margins; and the availability of short-term financing.

The principal function of the ERM is to act as an instrument for consolidating economic policies designed to promote stability and convergence, both nominal and real. Membership of ERM II is itself a criterion for membership of Monetary Union, and should last for at least two years. There is also a qualitative requirement: this minimum period of membership must be completed without excessive tensions arising and without the currency concerned being devalued [during this period] by the participating country. ERM II is often said to play a dual role since it acts as an instrument of convergence and as a membership criterion in its own right.

Despite the criticisms that were levelled at the ERM of the European Monetary System and which will no doubt now be levelled at its successor, ERM II, I have no hesitation about claiming that the ERM was a key factor in the successful monetary unification of Europe: it avoided excessive exchange rate volatility and competitive devaluations at the same time as acting as an external shock absorber. ERM II must not be seen as an uncomfortable two-year waiting room for accession countries, but instead as a mechanism that combines compromise and flexibility and that facilitates stability and adaptation to a new environment. I would stress that I use the word “facilitates” and not “guarantees” or “ensures”, for example, because exchange rate discipline alone, without a consistent economic policy, is unable to create stability and will finally prove unsustainable.

Turning to the specific issue of the relevance of the financial sector in the enlargement process, I will focus on the accession countries as a whole and refrain from country-specific assessments and conclusions.

Over the last decade, these countries have experienced remarkable transformations in their financial sectors. This was primarily driven by the transition process in central and eastern Europe and by the prospect of EU membership. In particular, considerable progress has been made in restructuring and consolidating the banking sector, thanks to the large-scale privatisation of state-owned banks, the liberalisation of markets and the extensive opening-up of the banking sector to foreign ownership.

In parallel, the accession countries’ economies have been fundamentally transformed by the establishment of macroeconomic stability and the privatisation of assets. Moreover, structural reforms have been made in many areas, and public institutions have been reformed and improved.

This restructuring process in both the financial sector and the real economy is well advanced and a new phase of financial and economic development is now under way in all the accession countries. EU enlargement and the prospect of the eventual adoption of the euro implies the need for the countries concerned to consolidate economic practices and enforce financial regulations and operational procedures in the euro area. This calls for the further refinement of the concept of a “functioning market economy and the ability to cope with competitive pressures”, one of the socalled Copenhagen economic criterion for EU accession. Actual compliance with this criterion requires the accession countries to further strengthen their financial sectors as the linchpin for balanced and sustainable economic growth.

The traditional role of the financial sector in underpinning investment and realising growth potential through its intermediation and governance functions is still very limited in most accession countries. For example, with the exception of Cyprus and Malta, which display a ratio comparable with that of the euro area, the level of financial intermediation in central and eastern European countries is relatively low and the provision of bank financing represents a much smaller share of GDP than in the euro area. To give you some figures, bank assets in the euro area amount to about 265% of GDP, whereas the bulk of accession countries' banking systems have asset volumes amounting to between 30% and 100% of GDP.

Due to the relatively prominent role of the banking industry in accession countries' financial sectors – or the correspondingly limited development of capital markets – the low level of financial intermediation has become an obstacle for credit institutions to channel financial savings into investment.

In some countries, specific features of the corporate sector alleviate this constraint through extensive recourse to the international financing provided by multinationals. By contrast, the role of capital markets as a source of financing is not sufficient to offset the sluggish activity of the banking sector. As regards stock markets, the total market capitalisation of acceding countries combined stood at around 52% of GDP in the euro area. Turning to bond markets, unlike in the EU, their role has traditionally been limited in terms of accession country financing, mainly as a result of low levels of outstanding government securities. Even though the levels of fiscal deficit have been high in some countries, the average general government debt outstanding at end-2002 amounted to only around 40% of GDP, compared with an average of 70% of GDP in the euro area.

Although the banking industry in accession countries is widely considered as stable and sound, it has its structural weaknesses and inefficiencies – for example, those reflected in the continued high spreads between lending and deposit rates or the relatively large proportion of bad loans in some countries. These weaknesses require that an extra effort be made to consolidate the financial sector and to avoid adverse future implications.

In this context, a prominent role could actually be played by the current members of the EU. The predominance of foreign owners in the banking sector, in particular from the EU, ensures an effective control of over half of the 300 or so commercial banks in the region and is heavily geared towards the larger institutions. This feature is generally seen as a positive factor in terms of financial sector stability, as it tends to foster strong corporate governance, the adoption of high-standard management practices, etc. while facilitating access to parent banks' financial resources.

Overall, enhancing the efficiency of the financial sector in accession countries is relevant in order to achieve full integration in the euro area’s financial sector. Important steps towards this integration have already been taken and are clearly visible. In the banking sector, for example, the strong presence of foreign banks has already had significant implications, accelerating concentration, increasing competition and enhancing efficiency.

However, the adjustments still to be made in order for the financial sector in accession countries to reach euro area standards remain significant. In this context, the changes occurring in the euro area’s financial sectors imply that the accession countries have a moving target to catch up with. Some euro area indicators, such as degrees of efficiency in financial intermediation, are relevant for the accession countries’ financial development, while other elements are not necessarily meaningful benchmarks because the euro area is highly heterogeneous and its financial markets are still subject to profound changes.

This means that further integration with the euro area – which will be mainly market-driven – will also need to be supported by considerable action on the part of the authorities. The adoption of the EU’s legal framework, a greater integration of the financial infrastructure with that of the euro area and strong cross-border collaboration between supervisors are the main elements of this process.

In the specific case of covered bond legislation, this entered into force in a number of accession countries some years ago, for instance in the Czech Republic (1995), Slovakia (1996), Hungary (1997), Poland and Latvia (both in 1998), Romania (1999) and Bulgaria (2000).

However, the development of this particular segment of the capital market is still at an early stage, reflecting the above discussion on the dominance of the financial system by the banking sector. To illustrate this in figures, there is some data which is well known to many of you: at the end of 2002, the outstanding amount of euro-denominated covered bonds was €1,497 billion – around 20% of the total amount of the euro bond market. This compares with roughly €3 billion in accession countries. Moreover, this relatively low volume is concentrated in only two countries, Hungary and the Czech Republic. However, although these differences are significant, they should not be overstressed. In fact, in the rest of Europe, the German covered bond market is by far the dominant one, since it accounts for 73% of the total euro-denominated covered bond. In the light of the substantial differences remaining in the structure of the national European financial systems, we should not prematurely judge the current status of convergence of capital markets in accession countries, particularly at this early stage.

Finally, it is essential that accession countries create a modern financial market infrastructure. 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. Moreover, the target of this preparatory work is a moving one, and it may be moving faster than other targets. Certain components of the euro area financial infrastructure may need to be dynamically adapted before new Member States can be integrated into the euro area. In the context of EU entry, and given the relatively small size of the financial sectors in the accession countries, plans to develop the financial market infrastructure will need to take into account the specific conditions applying to accession countries. Indeed, there is a risk that these economies may now be investing considerable efforts and resources to develop infrastructures similar to those that some euro area countries are trying to rationalise.

In conclusion, although a new era of financial development in accession countries is now in full swing, the challenges ahead are still considerable. Despite the remarkable progress made in recent years and the ongoing adjustment to euro area standards, the financial sectors of accession countries need to undertake further significant changes in the future.

In any case, development of the financial systems in these countries needs to be consistent with economic convergence. In this respect I can mention the case of fixed-rate bond markets: without convergence of inflation towards euro-area levels, it will be difficult, if at all possible, to promote the bond market. This also applies to the covered bond market in particular. The relevance of such development is based on the fact that the financial sector plays a key role in strengthening and broadening economic growth, as well as fostering stability. In order to promote financial development, without compromising hard-won financial stability, it seems crucial at this stage to complete a number of structural reforms. Moreover, a fully integrated capital market in Europe, including the accession countries, may be considered an aim in itself and an ultimate hard test for a truly successful enlargement. However, we should allow market forces and policy makers sufficient time to achieve this long-term goal. Conferences like the one today are an excellent opportunity to promote a common understanding of the intended design of the European capital markets among practitioners of policy markets.

Thank you for your attention.