

The Eurosystem's dialogue with EU accession countries

The process of accession to the European Union (EU) has entered its final phase for a first group of countries, which are expected to complete negotiations by the end of this year. It is currently envisaged that, following the ratification of the accession treaties, these countries could enter the EU in 2004. Upon accession, the countries will join Economic and Monetary Union (EMU) with the status of "countries with a derogation" and their central banks will become part of the European System of Central Banks (ESCB). Once the countries have achieved sustainable convergence, assessed on the basis of the Maastricht criteria, they would also adopt the euro and their central banks would become part of the Eurosystem.

The Eurosystem has been involved in the accession process in its areas of competence, i.e. with regard to issues related to central banking. The involvement has taken the form of an ongoing dialogue – comprising both a policy and a technical dimension – that aims to prepare for the integration of the new central banks into the ESCB and, later on, the Eurosystem. The dialogue covers policy issues that are of relevance to central banks, such as macroeconomic developments, monetary and exchange rate strategies, financial sector structure and central bank independence. In addition, it entails technical co-operation activities with accession countries' central banks in a wide range of areas, such as payment systems, legal issues and statistics.

This article describes the structure and contents of the Eurosystem's dialogue with accession countries' central banks. It shows that the accession countries have made impressive advances on the path to the EU and future euro area membership, and highlights some of the remaining policy challenges.

I Introduction

The 12 countries that are currently negotiating accession to the EU are Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia. Turkey is also an official candidate for EU membership, but has not yet started negotiations and is therefore not referred to in this article. Accession negotiations have made considerable progress during the past year, and the Laeken European Council in December 2001 confirmed the intention to complete negotiations with as many as ten countries – all except Bulgaria and Romania – by the end of 2002.

The accession countries have to adopt the entire legal framework of the EU – the so-called *acquis communautaire* – upon EU membership, although negotiations can lead to an agreement on transition periods, implying that countries may be required to adopt certain provisions only some time after becoming EU members. So far, however, transition periods have been agreed on only in a limited number of areas. For the purpose of negotiations, the *acquis communautaire* is subdivided into

31 chapters. From the viewpoint of the Eurosystem – i.e. the ECB and the national central banks (NCBs) of the euro area – the two most important chapters are the EMU chapter, which includes the principle of central bank independence, and the chapter on the free movement of capital. Other chapters that are particularly relevant relate to the Single Market, such as those concerning the free movement of goods, services and persons respectively, and competition policy. By mid-June 2002 about three-quarters of the chapters had been provisionally closed for the accession countries as a group. The EMU chapter and the chapter on free movement of capital had been closed with all countries except Romania.

The Eurosystem is not directly involved in accession negotiations, although it is consulted on central banking issues. In addition, it has embarked on an in-depth dialogue with accession countries' central banks to prepare for an orderly integration process. The following sections describe the structure of the dialogue and give an overview of some of the issues involved.

2 Structure of the dialogue with EU accession countries

The dialogue with the accession countries is based on two main elements: a policy dialogue at Board and management level, and a technical dialogue at expert level. The main purpose of the policy dialogue is to exchange views on topics that are of common interest and to exchange first-hand information on economic and central banking issues. At the centre of this dialogue are annual high-level seminars, which are organised by the ECB in co-operation with one euro area NCB and which bring together Governors and Board-level representatives of the Eurosystem and accession countries' central banks. The first of these annual seminars took place in Helsinki in 1999, organised together with Suomen Pankki – Finland's Bank and laid the foundation for the regular policy and technical dialogue. The subsequent seminars were held in Vienna and Berlin, organised with the Oesterreichische Nationalbank and Deutsche Bundesbank respectively. This year's seminar is scheduled to take place in Brussels in December 2002 and will be organised with the Nationale Bank van België/Banque Nationale de Belgique.

In addition, meetings between Governors and managers from individual accession countries' central banks and the ECB have taken place on a regular basis. During these meetings, discussions have focused on policy issues similar to those addressed at the high-level seminars, such as monetary policy and exchange rate strategies, the disinflation process, implications of real income convergence and the implementation of central bank independence. These meetings have allowed a more in-depth exchange of views on the accession process and, in many cases, have also paved the way for technical discussions at expert level.

The technical dialogue is meant to support – from a technical and operational viewpoint – the preparatory work of accession countries' central banks to ensure their smooth integration into the framework of the ESCB. It is also aimed at familiarising the central banks with the functional and operational framework of the

ESCB. The technical dialogue takes various forms: expert seminars and workshops, bilateral meetings at expert level, training courses, internships and specific technical assistance activities. In this context, the ECB has put particular emphasis on multilateral activities involving all accession countries' central banks (e.g. in seminars), while NCBs have mostly focused on bilateral, tailor-made technical co-operation with individual central banks. All NCBs are involved in the technical dialogue. Some of them take part in highly resource-intensive multi-year “Twinning programmes” with a few counterpart central banks, while others conduct a large number of workshops and training programmes.

The technical dialogue covers a wide range of operational issues, such as payment systems, the legal framework, statistics, monetary policy and the operational framework, euro banknotes and information technology. In several cases, experts from the Eurosystem and accession countries' central banks have conducted joint analyses of important subjects, including the status of legal preparations for EU membership, issues related to payment systems and the statistical framework.

In addition to its own dialogue, the Eurosystem is involved in the “Economic Dialogue” between the EU and the accession countries, established in early 2001 by the ECOFIN Council and co-ordinated by the European Commission. Although the Economic Dialogue is not part of the negotiation process for EU membership, it aims to help the accession process move forward through an exchange of views between EU institutions and accession countries on macroeconomic policy and financial stability issues in the pre-accession phase. It is also intended to familiarise accession countries with the EU procedures of mutual surveillance as these countries will also become subject to this exercise upon EU entry. The EU Economic Dialogue takes place at ministerial and Economic and Financial Committee levels with respective meetings twice a year.

3 Selected issues from the dialogue

In the dialogue with the accession countries, a wide range of policy and technical issues have been discussed extensively. Of greatest importance have been: (i) real macroeconomic convergence, (ii) inflation developments, (iii) monetary policy and exchange rate strategies, (iv) financial structure and functioning, (v) central bank independence and (vi) technical co-operation. These issues are explored in the following sections.

Real macroeconomic convergence

Although large in terms of overall population (over 100 million altogether), the economic weight of the accession countries is small relative to the euro area (see Table I). In 2001, the combined nominal GDP reached about €460 billion, amounting to just under 7% of the euro area's GDP. Likewise, average

GDP per capita stood at around €4,400 when measured at current exchange rates and around €9,100 in purchasing power parity standards, which corresponds to about 20% and 40% of the euro area average respectively. As a comparison, the income levels of Greece, Portugal and Spain in purchasing power parity standards amounted to around 60-70% of the EU average at the time of their accession.

Considering the large income gap between the accession countries and the euro area, issues related to real macroeconomic convergence have been a key focus of the policy dialogue. Although different income levels as well as different economic structures can, in principle, be compatible with eventual participation in Monetary Union, advancing real macroeconomic convergence with the euro area – in terms of both per capita income levels and economic structures – is

Table I
Accession country key data (2001)

	Population (millions)	Area (1,000 km ²)	Nominal GDP (EUR billions)	GDP per capita ¹⁾ (EUR)	GDP per capita (% of euro area average) ¹⁾²⁾ 1995	GDP per capita (% of euro area average) ¹⁾ 2001
Bulgaria	8.5	111	15	6,087	25	26
Cyprus	0.6	9	10	20,028	83	88
Czech Republic	10.3	79	63	14,016	62	60
Estonia	1.4	45	6	9,406	30	40
Hungary	10.0	93	57	12,208	45	53
Latvia	2.4	65	8	7,021	24	30
Lithuania	3.7	65	13	7,517	27	32
Malta	0.4	0	4	13,372	49	58
Poland	38.6	323	197	8,905	36	38
Romania	22.4	238	44	6,050	32	26
Slovakia	5.4	49	22	10,995	46	47
Slovenia	2.0	20	21	16,240	64	70
All ³⁾	105.6	1,097	461	9,126	38	39
Greece	10.6	132	130	16,432	62	71
Portugal	10.4	92	123	16,622	57	72
Spain	40.0	506	650	19,964	70	86
Euro area ³⁾	303.0	2,508	6,811	23,227	100	100

Sources: ECB, European Commission, Eurostat, World Bank and IMF World Economic Outlook.

1) In purchasing power parity (PPP) standards.

2) For Greece, Portugal and Spain, the figure refers to the year of their EU accession, i.e. 1981 for Greece and 1986 for Portugal and Spain.

3) Weighted average, except for columns 1, 2 and 3.

Table 2
GDP growth rates

(in percentages)

	Bulgaria	Cyprus	Czech R.	Estonia	Hungary	Latvia	Lithuania
1995	2.9	6.1	5.9	4.6	1.5	-0.8	3.3
1996	-10.1	1.9	4.3	4.0	1.3	3.3	4.7
1997	-7.0	2.4	-0.8	10.4	4.6	8.6	7.3
1998	3.5	5.0	-1.2	5.0	4.9	3.9	5.1
1999	2.4	4.5	-0.4	-0.7	4.2	1.1	-3.9
2000	5.8	5.1	2.9	6.9	5.2	6.8	3.8
2001	4.2	3.7	3.6	5.4	4.6	7.6	5.9
Av. 1995-2001	0.2	4.1	2.0	5.1	3.7	4.4	3.7
2002 ²⁾	4.0	2.5	3.4	4.0	3.5	5.0	4.0
	Malta	Poland	Romania	Slovakia	Slovenia	All ¹⁾	Euro area
1995	6.2	7.6	7.1	6.7	4.1	5.6	2.2
1996	4.0	6.0	3.9	6.2	3.5	3.9	1.4
1997	4.9	6.8	-6.1	6.2	4.6	3.2	2.3
1998	3.4	4.8	-4.8	4.1	3.8	2.7	2.9
1999	4.1	4.1	-1.2	1.9	5.2	2.5	2.7
2000	5.2	4.0	1.8	2.2	4.6	3.9	3.5
2001	-1.0	1.1	5.3	3.3	3.0	3.0	1.5
Av. 1995-2001	3.8	4.8	0.9	4.4	4.1	3.5	2.4
2002 ²⁾	3.9	1.4	4.2	3.6	3.1	2.8	0.9-1.5

Sources: European Commission, Eurostat and ECB.

1) Weighted average (weighted by 1995 GDP).

2) Projections (European Commission for accession countries and ECB for euro area).

desirable. This will foster economic cohesion within EMU, promote integration among Member States, and help in reducing the risks and effects of asymmetric shocks.

In this context, the Eurosystem has emphasised that advancing real convergence should be done in parallel with – and not at the expense of – nominal convergence, understood as the gradual lowering of inflation rates towards levels compatible with price stability. Indeed, by fostering real convergence through structural reforms – which improves growth prospects and the supply side of the economies through enhanced flexibility in goods and labour markets – the accession countries can support the nominal convergence process. Likewise, by further advancing nominal convergence, anchoring inflation expectations and reducing the inflation bias, the countries would improve prospects for economic growth and thus real convergence.

The process of real income convergence, however, has been rather slow in recent years. Since 1995 annual real GDP growth rates in the accession countries as a group have normally been higher than in the euro area, but the difference has typically been small (see Table 2). For example, in 2000 and 2001, it amounted to 0.4 and 1.5 percentage points respectively (and was even slightly negative in the two preceding years). This development reflects the unfinished reform agenda in some countries, such as Bulgaria and Romania, as well as the effects of domestic and external crises such as those in Bulgaria, the Czech Republic and Romania between 1996 and 1999 or the Russian crisis of 1998. The sheer size of the income gap suggests that even with wider growth differentials, the process of convergence in income levels may extend well beyond the date of EU accession or euro area membership.

It should be noted that the overall picture of income convergence masks considerable differences between the accession countries. The per capita income level in purchasing power parity terms ranges from 26% of the euro area average in Bulgaria to 88% in Cyprus in 2001 (see Table 1). Also, the pace of convergence varies substantially among the countries: Estonia, Hungary and Malta, for example, have narrowed the income gap with the euro area by around 10 percentage points since 1995, while other countries have not progressed in this regard, or even regressed.

However, real macroeconomic convergence means more than a catching-up of income levels. It also includes adjusting the structure of the accession countries' economies to bring them more into line with those in the euro area as well as setting up the appropriate institutions and adopting international best practices in a number of areas (competition policies, corporate governance, financial laws, etc). Encouragingly, the accession countries have made considerable progress in these areas. For example, the transition indicator of the European Bank for Reconstruction and Development (EBRD) shows that they have, by and large, come close to being well-functioning market economies (see

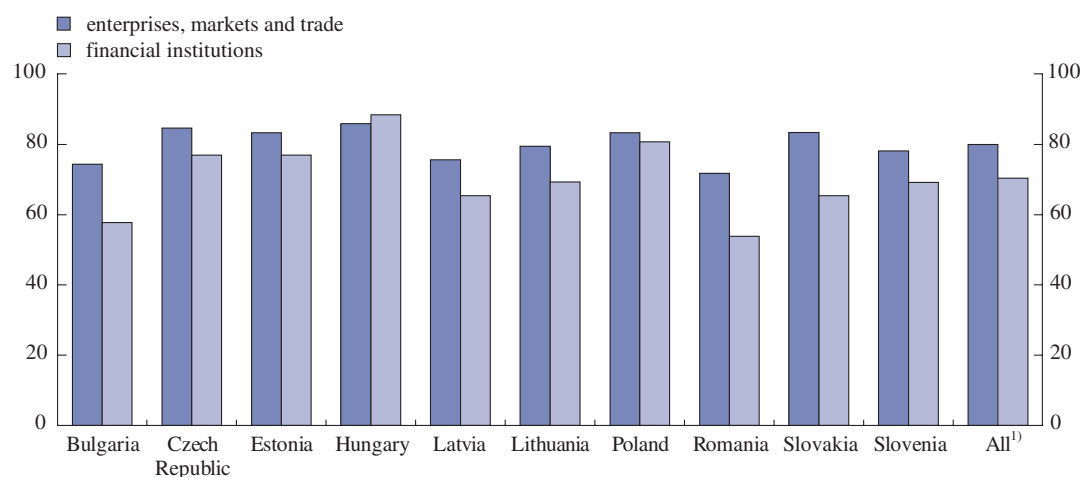
Chart 1). This indicator summarises the state of reforms in enterprise privatisation and restructuring, adjustments in markets and trade systems and financial institution upgrading. Accession countries are particularly advanced in the first two areas, as a result of privatisation, price liberalisation and reforms in the trade and foreign exchange system. In contrast, a reform agenda remains with regard to financial institutions, mainly on account of reform backlogs in the field of securities markets and non-bank financial institutions.

Moreover, real convergence also implies a stronger integration of the economies with the euro area. Here too, progress has been greater than the income gaps suggest: through trade and financial linkages as well as macroeconomic and financial stability, the economies are significantly more integrated with the euro area than they were just a few years ago. Partly for this reason, the accession countries were, for instance, largely unaffected by the recent emerging market crises in Argentina and Turkey.

However, further progress in structural reforms is still needed to complete transition and foster economic growth and

Chart 1
EBRD transition indicators – 2001

(index: 100 = well-functioning market economy)



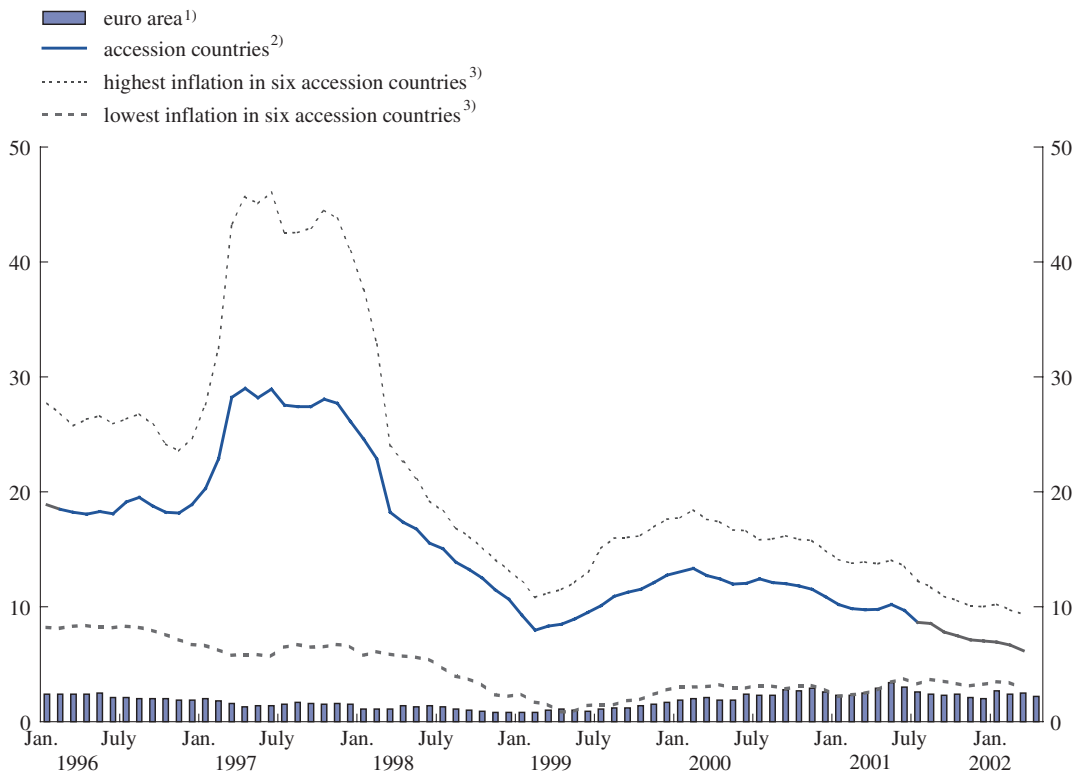
Sources: EBRD and ECB staff calculations.

1) Unweighted average.

Chart 2

CPI inflation

(percentage changes, year-on-year)



Sources: ECB, Eurostat and IMF International Financial Statistics.

1) HICP inflation.

2) Weighted average (weighted by 1996 GDP). Bulgaria excluded from January 1996 to January 1998.

3) Unweighted average of the six accession countries with highest and lowest inflation, respectively. Bulgaria excluded from January 1996 to January 1998.

convergence. In particular, the accession countries need to continue liberalising prices, guaranteeing property rights, improving corporate governance and enabling the transfer of decision-making responsibilities from government bodies to market participants. In addition, structural reforms in the corporate and financial sectors are instrumental in improving the investment climate, fostering sound business practices and entrenching financial stability. Finally, reforms in the labour market are needed to improve supply-side conditions, especially in light of the sharp increase in unemployment rates that has occurred in some countries during the past few years.

Inflation developments

The accession countries have made significant progress in disinflation over the past few years while the dispersion in inflation rates among countries has also markedly declined (see Chart 2). In some cases, inflation has come down from double-digit rates or even hyperinflation to relatively low levels, as macroeconomic stabilisation programmes – often involving the use of external anchors – have been successfully implemented. All accession countries except Romania managed to bring inflation down to single-digit levels in 2001 (see Table 3). Despite this progress, inflation rates – on average about 9% – remained significantly higher than in the euro area in 2001, although a further decline is projected for this year.

Since the beginning of the policy dialogue, price dynamics have been at the centre of the discussion. In view of the ultimate goal of adopting the euro and the need to fulfil the Maastricht criteria beforehand, inflation developments and nominal convergence with the euro area continue to be key issues.

Gradually reducing inflation towards rates closer to those prevailing in the euro area remains crucial, in particular as a way to entrench an economic environment of price stability. However, moving from moderate to low inflation rates remains a challenge, as exemplified by the brief interruption to the disinflation path in 2000. A number of factors have contributed to the persistent inflation differentials between the accession countries and the euro area. Several of these factors are related to the transition process, mainly stemming from the effects of ongoing price liberalisation and deregulation. In addition, nominal wage growth based on backward-looking indexation, stubborn inflation expectations as well as expansionary monetary and fiscal policies have at times also contributed to inflationary pressures. In

this respect, fiscal slippages recently recorded in the Czech Republic, Hungary, Poland and Slovakia give rise to concern, as they could put the hard-won stabilisation achievements at risk.

In addition to the effects mentioned above, the Balassa-Samuelson effect has often been cited as an important reason for the inflation differentials, as relatively higher productivity growth in the accession countries than in the euro area has translated into higher inflation, especially in the countries with fixed exchange rates.¹ There is indeed evidence that such an effect operates in accession countries and its significance could increase if future productivity growth were to rise, aided, for example, by EU accession. However, most empirical studies indicate that the Balassa-

1 The Balassa-Samuelson effect occurs if productivity growth is faster in the tradable than in the non-tradable sector, as is usually the case, resulting in a rise in the relative price of non-tradables. A rise in productivity in the tradable goods sector will tend to drive up wages in this sector and, as labour is assumed to be mobile across sectors, push up wages in the non-tradable sector. As the latter increase is not matched by a productivity increase, it will raise costs and prices in the non-tradable goods sector and thereby lead to a rise in the overall price index.

Table 3
CPI inflation

(percentage changes, period average)

	Bulgaria	Cyprus	Czech R.	Estonia	Hungary	Latvia	Lithuania
1995	62.1	2.6	9.2	28.8	28.3	25.0	39.7
1996	121.6	3.0	8.8	23.1	23.4	17.6	24.6
1997	1,058.4	3.6	8.5	10.6	18.3	8.4	8.9
1998	18.7	2.2	10.6	8.2	14.2	4.7	5.1
1999	2.6	1.6	2.1	3.3	10.0	2.4	0.8
2000	10.3	4.1	3.9	4.0	9.8	2.7	1.0
2001	7.4	2.0	4.7	5.7	9.2	2.5	1.2
2002 ²⁾	7.5	3.1	3.9	4.1	5.2	3.0	2.7
	Malta	Poland	Romania	Slovakia	Slovenia	All ¹⁾	Euro area ³⁾
1995	4.0	28.1	32.2	9.9	12.6	24.3	2.4
1996	2.5	19.8	38.8	5.8	9.7	22.7	2.2
1997	3.1	15.1	154.8	6.1	9.1	68.5	1.6
1998	2.4	11.7	59.1	6.7	8.6	16.1	1.1
1999	2.1	7.3	45.8	10.6	6.6	10.5	1.1
2000	2.4	10.1	45.7	12.0	10.8	12.5	2.3
2001	2.9	5.5	34.5	7.3	9.4	9.1	2.5
2002 ²⁾	2.6	4.0	26.0	4.1	7.5	6.7	2.1-2.5

Sources: ECB, IMF International Financial Statistics and European Commission.

1) Weighted average (weighted by 1995 GDP).

2) Projections (European Commission for accession countries and ECB for euro area).

3) HICP inflation.

Samuelson effect can only account for a limited share of inflation differentials vis-à-vis the euro area in recent years.²

Monetary policy and exchange rate strategies

Monetary policy and exchange rate strategies are regular subjects in the dialogue between the Eurosystem and accession countries' central banks. The discussions focus on, for example, the role of monetary and exchange rate policies in achieving macroeconomic stability and the handling of large and volatile capital flows. The dialogue also centres on issues related to future participation in the exchange rate mechanism (ERM II), including the compatibility of current exchange rate regimes with ERM II.

As all the accession countries can be regarded as small open economies, the dialogue has largely focused on exchange rate strategies. In general, exchange rate strategies have taken into account the overall economic policy framework and economic conditions prevailing in the respective country. Most transition economies opted for a fixed or tightly managed external anchor in the early stages of the transition process, as fixed regimes were regarded as an effective device to anchor inflation expectations. Since the mid-1990s, a number of countries have gradually moved towards greater exchange rate flexibility. With the exceptions of the Czech Republic and Slovakia in 1997/98, these regime shifts have not been related to currency crises, but have rather been the result of a forward-looking policy approach, taking account of changes in economic conditions and circumstances, including rising capital flows.

At present, the accession countries are following a variety of exchange rate strategies, covering the full spectrum from currency boards to free floats (see Table 4). Bulgaria, Estonia and Lithuania have a currency board pegged to the euro, Latvia and Malta maintain a conventional peg to a currency basket, Cyprus and Hungary unilaterally shadow

ERM II (with an officially announced central rate and fluctuation bands of $\pm 15\%$), while Romania, Slovakia and Slovenia follow a managed float, and the Czech Republic and Poland a free float regime.

Over the past few years, the euro has increasingly gained importance as the main reference currency in both the pegged and managed floating regimes, either because the pegs have shifted to the euro or because of shifts towards managed floating regimes with the euro as the predominant reference currency. These shifts have been in line with the accession countries' rising trade and financial integration with the euro area as well as with the institutional requirements associated with the ultimate objective of adopting the euro. The most recent example of a greater role for the euro was given by Lithuania, which re-pegged its currency board from the US dollar to the euro in February 2002.

The accession countries' monetary policy strategies also differ widely. Countries with fixed exchange rate regimes obviously have to gear monetary policy towards the exchange rate target. Other countries operate fully-fledged inflation targeting frameworks (Poland and the Czech Republic), while Hungary combines an inflation targeting framework with an exchange rate regime that shadows ERM II. Slovenia's monetary policy strategy includes targets for monetary aggregates.

In general, the accession countries' monetary and exchange rate policies have significantly contributed to macroeconomic stability and disinflation, anchored inflation expectations and thereby provided the necessary conditions

² See, for example, O. Arratibel, D. Rodriguez Palenzuela and C. Thimann (2002), "Inflation dynamics and dual inflation in accession countries: a new Keynesian perspective", ECB Working Paper 132; M. De Broeck and T. Slok (2001), "Interpreting real exchange rate movements in transition countries", IMF Working Paper WPI01/56; R. Corker and R. van Elkan (2000), "Exchange rate regimes in selected advanced transition economies", IMF, SMI/00/43; A. Simon and M. Kovacs (1998), "Components of the real exchange rate in Hungary", National Bank of Hungary Working Paper 1998/3.

Table 4**Monetary and exchange rate strategies in accession countries**

	Exchange rate regime ¹⁾	Currency	Features
Currency board			
Bulgaria	Currency board to the euro	Bulgarian lev	Introduced in 1997
Estonia	Currency board to the euro	Estonian kroon	Introduced in 1992
Lithuania	Currency board to the euro	Lithuanian litas	Introduced in 1994; re-pegged from the US dollar to the euro in February 2002
Conventional fixed peg			
Latvia	Peg to the SDR	Latvian lats	Exchange rate band $\pm 1\%$
Malta	Peg to a basket	Maltese lira	Currency basket (euro, US dollar, pound sterling): exchange rate band $\pm 0.25\%$
Unilateral shadowing of ERM II			
Cyprus	Peg to the euro, with $\pm 15\%$ fluctuation bands	Cypriot pound	
Hungary	Peg to the euro, with $\pm 15\%$ fluctuation bands	Hungarian forint	Exchange rate regime combined with inflation targeting: 2.5-4.5% by end-2003
Managed float			
Romania	Managed float	Romanian leu	Currency basket (US dollar, euro) is used informally as reference
Slovakia	Managed float	Slovakian koruna	
Slovenia	Managed float	Slovenian tolar	Monetary targeting: the euro is used informally as reference currency
Independent float			
Czech Republic	Free float	Czech koruna	Inflation targeting: 2-4% by end-2005
Poland	Free float	Polish zloty	Inflation targeting: 2-4% by end-2003

Sources: IMF and national central banks.

1) IMF classification.

for sustainable economic growth. Nevertheless, all strategies have had their drawbacks, including risks to external competitiveness, difficulties in managing rising and volatile capital flows and meeting inflation targets. In this context, structural shocks have further complicated the conduct of monetary policy, including the operating of inflation-targeting frameworks.

Moreover, some accession countries have experienced difficulties in finding the appropriate balance between monetary, fiscal and structural policies. For example, the Czech Republic, Hungary, Poland and Slovakia experienced serious fiscal slippages in recent years, and several of these countries also incurred setbacks in their structural reform programmes. These episodes have at times called for a more restrictive monetary policy

stance than would otherwise have been warranted.

Most countries have already adjusted their exchange rate regimes ahead of their future participation in ERM II, which has the euro as its sole reference currency. Crawling pegs, free floats and pegs to currencies other than the euro are incompatible with ERM II. With regard to currency boards, the ECB does not consider them to be a substitute for participation in ERM II, implying that countries operating a currency board will be required to participate in ERM II for two years before adopting the euro. However, countries that operate a euro-based currency board deemed to be sustainable might not be required to go through a double regime shift, i.e. of floating the currency within ERM II and then re-

pegging it to the euro later. Thus, such countries may participate in ERM II with a currency board as a unilateral commitment, enhancing the discipline within ERM II. However, the ECB has stressed that such an arrangement will be assessed on a case-by-case basis and that a *common accord* on the central parity against the euro will have to be reached.

Financial sector structure and functioning

Although the financial sectors of the accession countries have undergone major changes during the last decade, they are still less than fully developed. With the exception of Cyprus and Malta, which are not transition countries, most countries started from monobank systems and practically non-existent capital markets. Even today, most financial systems are characterised by low levels of financial intermediation, a dominance of the banking sector over capital markets, a high degree of foreign ownership, and a limited degree of liquidity in many market segments.

The flip side of the dominant banking sector is an underdeveloped non-bank financial sector in most accession countries. Domestic capital and equity markets are often limited, with low levels of liquidity and secondary market activity. For example, stock market capitalisation amounted to about 16% of GDP in 2001 in the accession countries, compared with 72% of GDP in the euro area (see Table 5). The banking sector is, in turn, predominantly foreign-owned in most countries and, for example, in Bulgaria, the Czech Republic and Estonia almost entirely so. Foreign investors also play a key role in other market segments, including foreign exchange, stock and bond markets, and large domestic firms often resort to foreign banks and capital markets abroad for their financing.

While the banking sector in most countries can be considered as generally stable and well capitalised, the level of financial intermediation remains quite low, even in those countries with the most developed financial markets (the Czech Republic, Hungary and Poland). The ratio of bank assets to GDP and domestic credit to GDP are only about one-quarter and one-third respectively of that in the euro area. The

Table 5
Financial sector structure in accession countries

	Banking assets ¹⁾	Domestic credit ²⁾	Credit to public sector ²⁾	Credit to private sector ²⁾	Stock market capitalisation ¹⁾
	% of GDP	% of GDP	% of domestic credit	% of domestic credit	% of GDP
Bulgaria	44	21	29	71	4
Cyprus	249	137	13	87	69
Czech Republic	126	61	20	80	16
Estonia	72	43	4	96	27
Hungary	61	42	22	78	19
Latvia	77	25	21	79	9
Lithuania	32	18	34	66	10
Malta	224	147	20	80	37
Poland	66	39	34	66	14
Romania	30	13	40	60	3
Slovakia	96	67	54	46	19
Slovenia	79	56	30	70	30
All	76	44	29	71	16
Euro area	265	135	21	79	72

Sources: ECB, IMF International Financial Statistics, national authorities and International Federation of Stock Exchanges.

1) Data as at end-2001.

2) Data as at end-2000.

liquidity levels in other market segments, such as the foreign exchange, money, bond and stock markets, are also relatively low.

The dialogue with accession countries' central banks has focused on the importance of further developing the financial sectors, including payment systems, without jeopardising the achievement of financial stability. Sound and well-functioning banking sectors, capital markets and payment systems are crucial for the effectiveness of monetary policy, as they help to strengthen the monetary policy transmission process. Further development of the financial sector could also contribute to the real convergence process, as the availability and efficient allocation of a broad range of financing instruments could facilitate economic development and structural change. In particular, small and medium-sized enterprises – which are often the main engine of economic growth and job creation – typically depend on the domestic financial markets for raising capital, and may therefore benefit most from the enhanced development and efficiency of the financial sectors.

Issues related to the financial sector structure and functioning are expected to remain at the core of the policy dialogue with the accession countries. With a view to their eventual entry into the euro area, it will also be important to develop the banking sector and money markets so as to improve the transmission of monetary impulses. Moreover, to ensure the preservation of financial sector stability, it will be crucial to further strengthen the institutional and legal frameworks and foster corporate governance. Finally, it will be essential to establish cross-border co-operation among supervisory institutions of the euro area and the accession countries.

Central bank independence

Central bank independence is an essential component of a sound economic policy framework for the achievement and maintenance of price stability. Indeed,

membership of the EU requires the accession countries to ensure that central bank legislation is in compliance with the Treaty, implying full institutional, personal, functional and financial independence for the central banks.

The ECB has been regularly consulted by accession countries' central banks on the compatibility of their respective draft laws with EU requirements. All the accession countries have either revised their central bank acts in the past few years or are amending them so as to meet the EU requirements. So far, progress has been considerable. In particular, Cyprus, the Czech Republic, Latvia, Lithuania, Slovakia and Slovenia are well advanced with their legal preparations. Most other countries have also made progress in this regard, although they still have to refine some parts of their central bank laws or constitutions – often in the area of personal and financial independence – to fully comply with the Treaty. In addition to the revision of the respective central bank statutes, it is also important to ensure that the revised laws are indeed fully implemented and that central bank independence is not only ensured formally but also respected in the day-to-day conduct of policy.

The process of adjusting the central bank statutes has not been smooth in all cases. Amendments to the Czech National Bank Act were initially resisted in Parliament in 2001, before the matter was finally resolved in early 2002. More recently, the parliaments in Hungary and Poland have discussed draft amendments to their respective central bank statutes that could de facto limit the degree of central bank independence. The passage of amendments that, in substance, weaken central banks in their pursuit of price stability would cause serious concerns in the accession process.

Technical preparation

Future membership of accession countries' central banks in the ESCB and the Eurosystem requires not only a strengthening of central banking policies but also needs significant

technical preparation. As the lead time covers a period of several years, accession countries' central banks have already started their preparatory work in many areas. The ECB and the NCBs have assisted in this process by familiarising accession countries' central banks with the functional and operational framework of the ESCB and the Eurosystem, and by providing expert-level support in various fields. Technical preparations and central banking co-operation between the Eurosystem and accession countries' central banks are extensive, covering the whole range of central banking functions, and also draw heavily on NCB resources. Since 2000, some 800 co-operation activities have taken place. An overview of some of the main technical co-operation activities conducted in recent years is given below.

In the area of payment and security settlement systems, infrastructures and procedures have been or are being adapted to ensure a seamless entry into the EU environment. To identify priorities for preparation, the ECB published a report in 1999 entitled "Payment and settlement systems in countries that have applied for membership of the European Union". Significant progress has been made since then in upgrading these areas. Most infrastructures and procedures – including the underlying regulatory framework – have been or are being brought into line with EU requirements, often requiring substantial investments. As for payment systems, real-time gross settlement systems are being introduced, and in the field of securities settlement progress has been made with procedures allowing the introduction of delivery versus payment mechanisms and the effective management of collateral. A follow-up report on the progress made in these areas will be published in the second half of 2002.

In the legal domain, the most important preparation from a Eurosystem point of view – in addition to the implementation of central bank independence – has been the amendment of financial laws in line with the *acquis communautaire*. This includes, for

example, legislation on the free movement of capital and freedom of payments, the provision of banking, securities trade and investment services, collateral rules, and legislation aiming at an internal market for financial services. In order to establish a regular exchange of views on these areas, the Eurosystem has organised several seminars for officials of the national central banks of the accession countries. In addition, country rapporteurs have been appointed within the Eurosystem (both at the ECB and NCBs) to closely monitor legal developments, provide advice and prepare informal opinions on draft laws.

In the field of statistics, the focus of co-operation has been on areas for which the ECB is responsible or shares responsibility with the European Commission and Eurostat, in particular relating to money and banking statistics and balance of payments statistics. Activities have centred on preparations that allow the accession countries to ultimately produce high-quality data in a manner consistent with that of the euro area Member States. As part of the co-operation, the ECB has published several technical manuals regarding the development of statistics in accession countries. These countries have made considerable progress towards aligning their statistics with ESCB requirements. The current situation varies from area to area depending on the required lead times and respective priorities. Regarding balance of payments statistics, all countries have adopted the standards of the relevant IMF Balance of Payments Manual. Most of them compile a monthly balance of payments, all of them compile international reserves at least on a monthly basis, and all but one compile a regular full international investment position. Regarding money and banking statistics, work is currently under way relating to data on Monetary Financial Institutions (MFIs) and some non-monetary financial intermediaries. Several accession countries are already well prepared regarding MFI balance sheet statistics, and preparations are also far advanced for the exchange of statistical information in ESCB-compatible formats.

As regards operational issues in support of monetary policy – including monetary policy instruments and the operational framework – co-operation activities have intensified markedly in the recent past. Some accession countries have already adopted monetary policy instruments and procedures similar to those of the Eurosystem, and the harmonisation of open market operations, standing facilities and minimum reserve systems in line with Eurosystem practices is taking place in many countries. Concerning the investment of foreign reserve assets, accession countries have started to actively familiarise themselves with the Eurosystem practices.

Until recently, co-operation on banknotes issues mainly focused on the cash changeover, including technical preparations as well as communication aspects. This issue was of particular interest to many accession countries because of their substantial holdings

of euro legacy currencies. Intensive discussions, which were held both bilaterally and at seminars organised by the ECB, contributed to a smooth cash changeover in these countries. In parallel, co-operation work in the field of preventing and combating euro counterfeiting is taking place.

Finally, preparatory work has started on information technology in order to make accession countries' central banks familiar with the technical adaptations required to eventually connect their central banks to the information technology (IT) infrastructure of the ESCB. Of particular importance at this preparatory stage is the need to establish a secure electronic communication infrastructure so that, by the time of accession, data and confidential documents can be exchanged between the ECB and accession countries' central banks. The relevant technical preparations are already under way.

4 Concluding remarks

The accession countries have made remarkable progress over the past few years in macroeconomic stabilisation, in transforming their economies into market economies and in integrating them through trade and financial relations with the euro area. The prospect of EU accession and future euro adoption has thereby already served as a powerful anchor for economic, monetary and exchange rate policies and has guided policy-makers as well as market participants.

In particular, progress has been made with regard to disinflation and financial stability. The economic structures are continuously being brought closer to those prevailing in the EU through transformation, privatisation and liberalisation, and trade and financial integration are also well advanced. However, progress has been more hesitant in the area of real income convergence. Nevertheless, the achievements in the areas of macroeconomic stabilisation and

structural reforms have been important steps towards laying the foundation for sustainable non-inflationary growth. The challenges ahead include further inflation convergence, entrenchment of macroeconomic stability even amid possibly stronger and more volatile capital flows, and further economic and financial development. In this context, it is important that remaining structural reforms are implemented and that regressive steps – such as those concerning central bank independence – are avoided.

For the ECB and the Eurosystem, managing the accession process from a central banking point of view has become an institutional priority, and significant resources are committed to this task. In the period ahead, preparations will be intensified to ensure the smooth integration of accession countries' central banks into the ESCB and, at a later stage, into the Eurosystem.