

## „Financial Development, Integration and Stability in Central, Eastern and South-Eastern Europe”

### CEEI 2005 – Opening Remarks

**Dr. Klaus Liebscher**, Governor

**Vienna, 14. 11. 2005**

Ladies and gentlemen!

It is a great pleasure for me to welcome you all to Vienna and to our annual Conference on European Economic Integration. Looking at the conference programme and the list of participants, I am very impressed that our conference has met with so much interest from so many distinguished participants both on the podium and among the audience. We are having with us well-known academics, economic policymakers and financial market practitioners, who – I believe – will guarantee for an interesting exchange of thoughts during the next two days.

This year’s conference deals with the issues of financial development, integration and stability in Central, Eastern and South-Eastern Europe. Thus, we will not only focus on current Member States, but also on the candidate and potential candidate countries for accession to the European Union.

The international aspect, which has always characterized our Conferences on European Economic Integration, or – as they were previously called – East-West Conferences, will be even more present this time. Not only do we have the honor of welcoming speakers and participants from all over the world, but we are proud to point out that this year, the Oesterreichische Nationalbank has organized this conference **together with the European Central Bank and the Center for Financial Studies**. I would like to seize the opportunity to express my special thanks to both of them, as without them, this conference could not have been realized in this form. I strongly believe that the additional coordination efforts have been worth taking, and that pooling the ideas, expertise and resources of our three organizations will bear fruit in the form of a successful and interesting conference.

This cooperation has left its mark also on the structure of the conference, as those of you who attended our earlier Conferences on European Economic Integration may have noticed. The main part of the conference – this afternoon and most of tomorrow – is essentially based on working papers prepared by researchers from central banks, research institutes and academia in the field of financial development and integration in Central and Eastern Europe. We have received a large number of excellent submissions to our call for papers. In order to be able to accept as many of them as possible for presentation and discussion, for the first time in the history of our conference we will have split sessions tomorrow. In some cases you will possibly find it difficult to make up your minds on which session to attend, but I am convinced you will make the right choice. The main part of the conference is set within a framework of keynote lectures and panel discussions aimed to provide an introductory overview and to give us a chance to hear the views of those who form and keep alive financial development and integration.

Let me explain why we chose financial integration as the topic for this year’s conference. The accession of ten new Member States to the European Union in May 2004 was a historical milestone and a major step toward the unification of Europe. Nevertheless, last year’s enlargement of the EU was not the end of European integration. For one, the process toward full integration of the new Member States will continue over the next few years. Then, the new Member States are expected to adopt the euro at some point in the future, which will mark another milestone in the European integration process. Full economic integration between the “old and new” Member States will presumably take longer than the monetary integration process. Nevertheless, I am confident that the catching-up process, if supported by coherent macro-economic policies, will be accomplished in the foreseeable future to the benefit of all Europeans.

Financial deepening in the new Member States and further financial integration within the European Union will be essential in promoting this catching-up process. The close relationship between financial development and integration on the one hand and economic growth on the other hand has been well documented in numerous academic studies in recent years. Although the direction of causality in this finance–growth nexus is not straightforward and has to be established by empirical analysis on a case-by-case basis, nowadays the weight of evidence overwhelmingly supports the view that financial development is capable of spurring economic growth.

Let me illustrate the impact of financial development and integration on economic growth by an empirical example. A study commissioned by the European Commission has found that raising the level of financial development in the EU to that in the U.S.A. would increase the growth rate of the manufacturing industry in Europe by slightly less than one percentage point per year.

According to this study, countries that currently have a comparably weak financial structure and countries with comparatively small firms would benefit most from such a step. With regard to the effects of financial integration, however, small and medium-sized enterprises are set to gain less from this process if financial integration simply brings improved access to international financial markets, since they are likely to be those that are least able to take advantage of improved external financing opportunities.

Financial integration in Europe began several decades ago, in 1957, with the Treaty of Rome, which already contained the basic principles for the creation of a single European market for financial services. In 1985, the Single Market Programme provided a general strategy based on minimum harmonisation, a single passport as well as mutual recognition. The adoption of the common currency in 1999 was a major impetus for further financial integration in the European Union. In the same year, the Financial Services Action Plan became a top priority of EU policy. In contrast to the unfortunately slow overall progress on the Lisbon strategy of the EU, the FSAP has proved to be a success story. Almost all of the measures contained in the FSAP to promote financial integration have been agreed on in time and are now being put into practice.

And the train is rolling on. In May 2005, the European Commission put forward for public discussion a Green Paper on financial services policy for the next five years until 2010. While the FSAP has created the necessary decision-making and regulatory structure for financial integration in Europe, the major objective of the post-FSAP strategy is to complete unfinished business and finalise legislation.

All these efforts have brought measurable results for the euro area. Today, euro area money markets are nearly fully integrated. Also, the degree of integration in the government bond market has become very high since the introduction of the common currency. Euro adoption has also fuelled the development of the European corporate bond market, which has witnessed exceptional growth since 1999. However, despite a rising degree of integration and a considerable reduction in the home bias in equity portfolios of institutional investors, the euro area equity market remains the least integrated.

Integration of the euro area banking sector has also advanced since 1999. In this field, integration has largely taken the form of a considerable expansion of cross-border banking activity, such as cross-border holdings of securities and cross-border interbank loans. However, cross-border mergers and acquisitions between banks remain rare. Similarly, the volume and significance of cross-border loans to non-banks remain low in the euro area, accounting for less than five percent of all loans to nonbanks. Retail payment services, investment and insurance services remain highly fragmented as well and require further integration.

Let me now elaborate briefly on financial deepening and financial integration in the new Member States of the European Union. As I pointed out earlier, financial integration is a beneficial factor for fostering economic growth. In the case of the Central and Eastern European countries, economic growth should be understood in a broader sense, namely in the sense of closing the income gap between old and new EU Member States. By raising the living standard in Central and Eastern Europe and reducing the income differences between Member States,

financial integration should also foster the political integration process and bolster political stability in a wider Europe.

Given Austria's proximity to the new Member States and the significant involvement of Austrian banks in Central and Eastern Europe, the Oesterreichische Nationalbank has been closely monitoring financial sector developments in this region. The results of these analyses have regularly been published in the OeNB's Financial Stability Reports and in "Focus on European Economic Integration", the successor publication of our "Focus on Transition". Along with the regional expansion of Austrian banks into an increasing number of Central and Eastern European countries, the regional scope of this analysis has been gradually expanding.

The CEE countries continue to lag behind the old Member States by a large margin in terms of financial depth. On average, the ratio of domestic credit to the private sector as a percentage of GDP in the Central and Eastern European new Member States stood at slightly more than 30% in 2003, compared to the EU-15 average of around 120%. The gap in the intermediation levels is even larger for candidate and potential candidate countries. Favourably though, we were able to observe an improvement in the degree of financial intermediation over the past decade. Strong economic growth, structural reforms in the financial sector and progress in the privatization of banks benefited this process in most countries. Similarly, bond and equity markets continue to be relatively small in the new Member States in Central and Eastern Europe, both in absolute terms and in relation to GDP. Again, gaps are larger for candidate and potential candidate countries.

Notwithstanding their relatively small size, the CEECs form an active part of European financial integration. This participation started well before their formal accession to the European Union. Let me just mention the eminent role of foreign investors in the CEE banking sector, which is in clear contrast to what we can observe in the old Member States. Accession to the EU in May 2004 and the principle of the EU-wide single banking licence further promoted the integration of CEE banking sectors with that of the EU-15.

CEE banks have, however, not only been targets in this integration process. Since May 2004, several banks in the new Member States have notified the authorities of their intention to provide banking activities outside their home country, primarily in neighbouring EU countries, on the basis of the single EU licence. As a result, integration has begun also among CEE countries.

Furthermore, integration has advanced in the field of capital markets. In many of the countries in Central and Eastern Europe, foreign investors play a significant role in the equity and bond markets. In addition, capital market integration has also advanced at the institutional level. In this respect, stock exchanges in Central and Eastern Europe have intensified their cooperation in recent years. The most notable development in this respect has been the establishment of the Nordic and Baltic Stock Exchange through an alliance of the stock exchanges in Sweden, Finland, Estonia, Latvia, Lithuania and Denmark and there are similar considerations, led by the Vienna Stock Exchange, for Austria and some of its neighbouring countries.

In addition to the integration of financial intermediaries, non-financial sectors in the Central and Eastern European countries have gained better access to foreign financing over the past few years. This has been reflected by a steep increase in the ratio of foreign debt of the non-bank private sector to GDP over the past decade.

Financial deepening is expected to continue over the next few years, along with the expected closing of the income gap between new and old Member States, and will lead to a rapid expansion of banks' balance sheets. This process of financial deepening will not only affect the banking industry, but is expected to extend into bond and equity markets and comprise also non-bank financial intermediaries, such as pension funds and insurance companies, as these are underrepresented in the new Member States when compared to the old Member States.

At the same time, the rapid expansion of domestic credit and bank balance sheets will require close monitoring, to preserve both macroeconomic and financial stability. The integration of financial sectors will bring more

complexity to the Central and Eastern European financial markets. Financial products become more sophisticated, making the assessment of their risk profile more complicated. Similarly, financial integration makes financial institutions, and the relationships between them, more complex and thus facilitates the shifting of risk exposure not only between individual banks, but also between economic sectors within a country and even across countries. Strong ownership links between CEE and EU-15 countries may exacerbate these channels, giving rise to a risk and crisis transmission channel.

Increased integration is likely to boost competition in the banking sector, which is undoubtedly beneficial for structural progress and efficiency. By contrast, higher competition may lead to a reduction in interest rate margins and without a compensating rise in cost efficiency might adversely influence banks' profitability. As a result, banks may be tempted to loosen their credit policies and take on more risk in search for maintaining profitability. Ensuring that banks' risk monitoring capacities keep up with this process and additional risk is properly priced is a major challenge.

Similarly, the international integration of capital markets may give rise to portfolio capital flows and bring about more complexity. On the one hand, portfolio capital flows may be necessary for the financing of large current account deficits in some countries, or may be beneficial for the deepening of domestic capital markets. On the other hand, they also leave countries more exposed to sudden changes in investor sentiment and to global factors. Through these channels, portfolio capital flows can exert direct influence on exchange rate and interest rate developments and hence on monetary policy in the small and open economies of Central and Eastern Europe.

Financial market supervision, risk prevention and risk management, in which national banks are actively involved, have to live up to all these challenges. Monitoring the stability not only of commercial banks, but also of non-bank financial intermediaries and capital markets is therefore essential. It requires a comprehensive supervisory framework on the national level, and in those countries where financial sector supervision is not performed by a single agency, the proper flow of information between the institutions that are responsible for monitoring financial stability must be ensured.

The cross-border character of financial integration and the emergence of large, potentially systemically relevant entities under host country jurisdiction require cooperation between national supervisory agencies to ensure an effective exchange of information both from a home country and a host country perspective. In this respect, upon accession to the EU, the central banks of the new Member States have joined the European System of Central Banks and thus adopted its financial stability monitoring, crisis prevention and crisis management framework. Their legislative and supervisory frameworks have been largely aligned with EU regulations, with the most important European banking directives having been implemented.

The new Member States also joined the 2003 Memorandum of Understanding between EU banking supervisors and central banks, which accomplishes a broad set of unilateral Memoranda of Understanding. The new Member States have become objects of analysis of several publications prepared by the Banking Supervision Committee of the ESCB, like the "EU Banking Sector Stability Report," the "Report on EU Banking Structure" or the report on the "Banking Structures in the New EU Member States."

Naturally, they participate in the Committee of European Banking Supervisors and are involved in all stages of decision-making processes at the EU level.

Financial development and integration are important for CEE central banks from a narrower monetary policy perspective. In order to achieve their major monetary policy goal of price stability, central banks in the region benefit from financial deepening. As we have learned, financial integration may contribute to financial deepening. In addition, since the new and future Member States of the European Union are ultimately heading toward euro area membership as well, their financial sectors will have to reach a sufficient level of integration with the current

euro area countries by the time the new Member States wish to adopt the euro in order to ensure the smooth functioning of monetary policy in an enlarged monetary union.

Financial deepening and financial integration are complex issues. I hope that our conference – by providing a forum for both the presentation of the latest analytical research and discussion – will contribute to a better understanding of all these issues, with a particular focus on the integration of the relatively young financial markets in Central and Eastern Europe.

I wish all of us an interesting and successful conference.

Now I would like to leave the floor to Mr Cesare Calari, Vice-President of the Financial Sector of the World Bank, to share with us his views on the benefits and risks of financial integration. Mr. Calari, the floor is yours.

Verleger, Herausgeber und Hersteller:

Oesterreichische Nationalbank

Sekretariat des Direktoriums / Öffentlichkeitsarbeit

Mag. Günther Thonabauer

Tel.: (+43-1) 404 20-6666