SESSION NO 2: ECONOMIC CONVERGENCE IN THE NEW MEMBER STATES: THE ROLE OF THE FINANCIAL SECTOR

(by Max Watson)

The session was chaired by Vicomte Etienne Davignon (Ministre d'Etat, Vice-President SUEZ-TRACTABEL, and former Vice-President of the European Commission)

Lars Heikensten (Governor of the Sveriges Riksbank) introduced the subject by underscoring the economic benefits of financial market integration – particularly for the new Member States. To ensure stability in an evolving financial market setting, he urged a greater attention to fiscal institutions and frameworks. But financial supervision also had a crucial role to play. He concluded by placing particular emphasis on three prudential pre-requisites to ensure stable and sustained real convergence: stronger cross-border supervisory co-operation; uniform deposit insurance, and sound understandings about the implicit fiscal burden of support; and a strengthening of the framework for crisis management – particularly where cross-border activities are concerned. In sum, supervisory coordination had a fair way to go to buttress the new Member States' financial systems effectively, given their unusually strong international integration.

Werner Riecke (former Vice-Governor, National Bank of Hungary) discussed Hungary's experience with market expectations – suggesting possible policy implications for other new Member States. Hungary had survived the Russian crisis unscathed – riding out market pressures with a prompt interest rate defence, in a setting of high fiscal credibility. The narrow band regime had functioned well, though policy had implicitly embodied something of a real exchange rate rule. Following a shift to inflation targeting (and a wide exchange rate band) in 2001, markets had carried the real exchange rate upwards. Meanwhile, fiscal tensions jeopardized the policy mix. After heavy intervention to limit appreciation, there was an unfortunate episode of communication with markets when a mini-devaluation over-achieved as a signal that the inflation target could not be maintained. This illustrated the importance of the policy mix, policy coordination, and full instrument independence for central banks as countries approached ERM II.

Vahur Kraft (Governor, Bank of Estonia) stressed that the positive experience, so far, of the new Member States did not imply immunity to adverse external developments. In the real economy, the key lay in sustained productivity gains and an environment attractive to investment. Flexible and efficient capital markets were also important, together with the well-judged use of fiscal policy as a stabilization tool. For Estonia, with its currency board regime, financial sector soundness was also crucial – this sector being the first line of defence against external or domestic shocks. In this setting, it was attractive to design regulatory regimes with cyclical considerations in mind – helping to moderate asset price bubbles and cyclical loan problems. Indeed, in bank-dominated systems this could help dampen fluctuations in domestic demand. Current challenges included a more efficient exchange of information among regulators; narrowing the scope for regulatory arbitrage; and ensuring uniform frameworks that reduced incentives to modify group structures for regulatory reasons. Finally, close links among Nordic supervisors might help when market behaviour became aggressive, as tended to be the case in Estonia.

Susan Schadler (Deputy Director, IMF) began by stressing the substantial boost to growth in the new Member States that could result from membership of the euro area. She then examined the implications for fiscal and financial policies in these economies, in terms of an optimal path toward adoption of the euro. A key feature of the economic and financial setting – in addition to an open capital account – would likely be a boom in domestic credit as financial deepening carried banking systems toward the scale of intermediation typical of existing euro area economies. To minimize the financial risks in this environment, bearing in mind the hazards of ERM II as an intermediate currency regime, it would be desirable to ensure that the economy was well on the way to meeting the essential conditions for euro area entry (the Maastricht criteria) before considering the entry to ERM II. That would entail significant fiscal consolidation in some of the new Member States – but this was in any case well warranted by the need to make room for a strong expansion of investment in the private sector. Strong banking supervision was also crucial – including to contain direct and indirect exposure to unhedged currency risk.

In the Panel Discussion the Chairman invited members to probe some of the more puzzling aspects of the financial sector outlook – particularly in the field of policy design and coordination. Max Watson (Economic Adviser, DG ECFIN) discussed potential risks of unhedged currency exposure, and a possible bias toward consumption and real estate lending; the question how far to build market infrastructure at the national level; the need to achieve a quantum jump in judicial system efficiency to help foster corporate lending; and the urgency of ensuring that prudential policy adequately safeguards macrofinancial stability – implying dynamic approaches to risk assessment, and strengthened cross-border co-operation. Herman Agneessens (CFO and Chief Risk Officer, KBC) also urged much stronger attention to the need for effective cross-border supervisory co-operation, noting that in some of the new Member States foreign ownership levels in banking exceeded 80 percent. Professor Alberto Giovannini (Unifortune Asset Management) emphasized firstly the many advantages these economies displayed – including financial systems that were not flawed by excessive government involvement; but, like previous speakers, he also stressed the need to improve the framework for enforcing collateral, and to reduce the time and costs of corporate bankruptcy procedures.