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Financial Market Integration in a Wider European Union

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Financial Market Integration in a Wider European Union

Corneliu Stirbu

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Financial Market Integration in a Wider European Union

ABSTRACT

EU enlargement rests on the proven success of European unification. European monetary integration and the introduction of euro are probably the best examples of integration. The EU financial sector has been going through a large restructuring program in the last decades. There was a continuous wave of deregulation since the late 1980s, when the Single Market programme with minimal harmonisation and home country control was implemented in successive periods for banking, insurance and the securities markets. The accession of new members poses huge challenges on the European Union and the countries from Central and Eastern Europe (CEEC). Similarities in economic histories and experiences, as well as comparable methods applied to build the market economies, led to creation of analogous structures and institutions in the CEEC. This was also true for the development of the financial sector. The paper will then investigate the most important characteristics of the financial architecture and will analyse the impact of closer integration of financial sectors in CEEC and EU countries. It will briefly review the developments which have taken place in the financial sector of both groups of countries to provide the background for the later analysis of the expected effects of integration in both old and new member states. Furthermore, it will make a formal assessment of the actual increase in financial market.

JEL Classification: F36, G2, G15, P34

Key words: Financial Aspects of Economic Integration, Financial Institutions and Services, European Financial Markets, Financial Economics

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List of abbreviations

CEEC	Central and Eastern Europe Countries
CESR	Committee of European Securities Regulators
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECOFIN	Council of Finance ministers of EU
EIB	European Investment Bank
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
ESC	European Securities Committee
EU	European Union
FDI	Foreign Direct Investment
FSAP	Financial Services Action Plan
GDP	Gross Domestic Product
IAS	International Accounting Standards
IMF	International Monetary Fund
ISD	Investment Services Directive
MS	Member States
OECD	Organisation for Economic Co-operation and Development
SEM	Single European Market
SEM	Small and Medium Enterprises
SMFS	Single Market for Financial Services

Countries' abbreviations:

A	Austria	BG	Bulgaria
B	Belgium	CY	Cyprus
E	Spain	CZ	Czech Republic
F	France	EST	Estonia
I	Italy	H	Hungary
L	Luxembourg	LT	Lithuania
P	Portugal	LV	Latvia
S	Sweden	M	Malta
D	Germany	RO	Romania
DK	Denmark	SLO	Slovenia
GB	Great Britain	SK	Slovakia
GR	Greece		
NL	Netherlands		
IRL	Ireland		
FIN	Finland		

"We must build the united Europe not only in the interest of the free nations, but also in order to admit the peoples of Eastern Europe into this community if, freed from the constraints under which they live, they want to join and seek our moral support. We owe them the example of a unified, fraternal Europe. Every step we take along this road will mean a new opportunity for them. They need our help with the transformation they have to achieve. It is our duty to be prepared."

Robert Schuman, 1963

1. INTRODUCTION

European Union (EU) enlargement rests on the proven success of European unification. Economic and political integration has helped ensure peace and prosperity in Europe and develop stable democracies across the continent. The process has yielded achievements that are tangible for all European citizens. A decade after the collapse of the command economy and restructuring towards a market economy ten countries from Central and Eastern Europe[1] have joined this process in order to benefit from, and contribute to, it. Table 1 reveals the way to EU membership.

Table 1. From application to EU accession

Country	Application for membership	Chapters closed of total 30	Likely EU membership
Poland	04/1994	30	2004
Hungary	03/1994	30	2004
Czech Rep.	01/1996	30	2004
Slovakia	06/1995	30	2004
Bulgaria	12/1995	25	2007
Estonia	11/1995	30	2004
Slovenia	06/1996	30	2004
Lithuania	10/1995	30	2004
Romania	06/1995	19	2007
Latvia	12/1995	30	2004
Cyprus	03/1990	30	2004
Malta	06/1990	30	2004

Source: RZB, EU Enlargement process, 2002

The accession of new members posed huge challenges to the European Union and the countries from Central and Eastern Europe (CEEC). Today, about 104 million CEEC citizens became EU residents. Similarly, the EU's population would grow by nearly 20%, when Romania and Bulgaria are admitted. More striking, perhaps, is the size of entrant economies in comparison to the EU. Together with Bulgaria and Romania the EU's total GDP is estimated to increase just 4.0% (Hildebrandt, 2002).

Therefore, from the point of view of the topic of this paper, the financial markets of all new member states are basically regarded as "*emerging markets*". The term emerging markets is commonly used in the literature to denote the financial market, in this case, of all developing countries and all economies in transition and is applied both to newly created markets and to the relatively long established ones (Kalotay and Alvarez, 1994). But if one thinks of the stock exchanges in CEEC that reopened their doors in the 1990's after many years of suspended activities, such as in Warsaw and Budapest, these can than be called "*re-emerging markets*".[2] In contrast with the "*re-emerging markets*", are the countries that were and still are no part of any group of the developed financial markets. Due to their delayed (compared to other countries in East Europe) entry into the transition, countries like Romania, Bulgaria or Latvia had in the recent past no access to private capital flows. Hence these markets are generally in a nascent stage of stock exchange development, even when compared with typical emerging ones (Emerson, Hall and Zalewska-Mitura, 1997). Those markets were termed as "*infant markets*" and characterised as being "*small, but steadily growing, with unpredictable movements*" (Emerson, Hall and Zalewska-Mitura, 1997). Since recently more important structural changes regarding their degree of liberalisation and foreign capital flows took place, the paper will refer them as being "*very young*" (Véron, 2003).

[1] These are: the Czech Republic, Estonia, Slovenia, Hungary, Poland, Slovak Republic, Latvia, Lithuania, Malta and Cyprus. Two other candidates, Romania and Bulgaria, are scheduled for 2007

[2] The origins of the Budapest Stock Exchange actually go back to 1864 when its predecessor was founded, only to be discarded by the post-war communist regime. The Warsaw Stock Exchange was first established in 1817 and re-opened in its new guise in April 1991 after a 52-year hiatus.

Similarities in their economic histories and experiences, as well as comparable methods applied to build the market economies, led to creation of analogous structures and institutions in CEEC. This was also true for the development of the financial sector. From the single-tiered banking system of the late 1980s, still ruled by the communist party, Eastern Europe's financial system has evolved towards one which EU countries have long been accustomed to. The CEEC accession negotiations required the implementation of the *acquis communautaire*, the set of laws that underpin the common market. As a result of adapting to the *acquis*, the CEEC financial systems are expected to be transformed to such an extent that the supervisory and legal framework will reach more or less the EU standards.

Financial sector liberalisation and integration not only imply adopting EU minimum rules and regulations, but more importantly, intensifying competition and structural changes in the financial sector. Most of the focus to date has been on the banking sector, although similar trends can be observed in the insurance sector and in the development of capital markets. Capital markets are only beginning to emerge. Unlike banking and insurance which existed during the communist era, they have been introduced to conform to European Union requirements.

Financial integration of EU is the fundamental cornerstone of EU's strategic goal taken by the Council of Europe at the Lisbon meeting in March 2000 to give the Union "*the most competitive, dynamic and inclusive knowledge-based economy in the world by 2010.*"[3] The Barcelona meeting in March 2002 gave a renewed boost to the integration by sending a message of confidence and showing the progress of structural reforms in the financial sector. "*Only through an integrated and efficient European capital market will consumers and businesses alike reap the full benefits of the euro*" (European Commission, 2002). Among the examples and benefits of a competitive and integrated financial sector for about 18 million businesses in Europe are: increased choices and lower prices for consumers, higher returns for individual investors, more venture capital available for innovation, better pensions. Such importance, critical to competitiveness and employment, is crucial since the financial markets are the catalyst between the supply and demand sides of the economy, a transmission mechanism by which savings are channelled into productive investments .

Reflecting their public good nature, financial markets were historically established on a national basis, with national authorities playing a significant role in their development, functioning, regulation and supervision. As markets started to develop internationally, the institutions and rules that govern the markets have gradually adapted. External pressures for integration have gone hand in hand with new policies. In EU significant policy developments - from capital account liberalisation to the launch of the internal market programme, the introduction of the euro and completion of more than half of the measures of the Financial Services Action Plan - have all promoted integration of the EU's financial markets. These are two fundamental and complementary objectives: harmonisation of general rules and principles at the level of the company, and close co-operation among market regulators, supervisors and central banks on technical and operational issues.

A very large part of EU financial integration is driven by market forces and sector's commitment to it. Indeed, a great deal of harmonisation process in Europe relies on private sector involvement given its practical and operational implications. Harmonised rules or operational standards, which are adopted after repeated consultations with the private sector, are only devoted to ensuring a level and integrated playing field. Once such a requirement is fulfilled, it is to private agents to play their role. As a result of mutual interactions between the political and sectoral, public and private forces, the European financial integration has been reinforced in a way which has never been seen before.

The EU's financial sector has been undergoing an almost continuous wave of deregulation since the late 1980s. The Single Market programme with minimal harmonisation and home

[3] European Council Lisbon declaration; March 2000

country control was implemented in successive periods for banking, insurance and the securities markets. By the end of the 1990s, however, under the impact of European Monetary Union, it was clear that this was not sufficient, and a Financial Services Action Programme set a schedule for the adoption of 42 directives to create a truly integrated financial market by 2005. Moreover, a Committee of Wise Men under the chairmanship of Alexandre Lamfalussy, made proposals to ease, stimulate and speed up the adaptation of EU financial regulations to market developments. Nevertheless, momentum towards these ideals has slowed. This has been mainly due to the huge volume of legislation, different interpretations of the detail of initiatives, and late night political horse-trading. "*It is not just the political will but also the sheer complexity of the exercise of uniting markets over such a huge and disparate area that is not only challenging but also unprecedented*" (Financial Times, 2002).

On the whole, recent years have seen positive progress towards financial integration in the old member states with the introduction of the euro and the implementation of single market legislation. The integration process has also been market driven, reflecting a trend towards more globalised investment strategies, made possible by technological advances and cross-border mergers and acquisitions. Yet, the transformation from a patchwork of 15 national financial systems to an integrated European Union financial system is not completed. Providers of financial services face numerous obstacles, described in later sections, to cross-border activity within the European Union. There are still a lot of protectionist pressures at work. The full benefits of financial integration can only be delivered if the main decision makers and actors forcefully implement a coherent and consistent policy for the integration of EU financial markets.

The paper will look into the financial sectors of old and new member states and will address key questions concerning the expected effects of integration and the ability of both groups of states to integrate. It will analyse; in particularly, the symmetries and asymmetries of integration and convergence following the FSAP, an obligatory target set for EU member states. Furthermore, it will discuss the conditions under which the integration should take place.

The paper is divided into five main sections. The first section will give the definition of integration and a short overview of historical development successes registered in the Europe of fifteen. Section II will focus on the architecture of the financial systems in CEEC. What was it like and how did it work in the centrally planned economy? What have been the reforms undertaken in the post-communist period? The vital challenges to the financial sector, related to the regulatory roadmap to integration, are the topic of chapter III. In a comparative analysis it will study the convergence in the banking sector and capital, bonds and derivatives markets. Section IV will look into issues and challenges of an imminent participation in the Exchange Rate Mechanism II and European Monetary Union. The regulatory framework, in particular, the implementation progress of FSAP measures by both groups of states will be addressed in Section V. The concluding chapter summarises key findings.

2. FINANCIAL LANDSCAPE IN THE EU

The financial sectors of CEEC economies are perhaps where the most intractable problems existed and where the most difficult reforms were forced to begin. Nowadays, the EU financial sector is also experiencing a profound change. The EU member states, and perhaps even more so those that have adopted the Euro, have become the standard of reference for many of the transition economies in the region. But, as many Western European countries are experiencing significant changes of their own, they, in fact, represent a rapidly moving target. First, forces as intense as deregulation, disintermediation, and technological change are, in general, shaping the financial systems. Second, the introduction of the euro has

provided a further impetus for change in the countries participating in the single currency. Hence, while the transition economies are in the process of building political and economic systems based an those in Western Europe, the financial systems in these "model economies" are evolving rapidly into new models. The financial landscape in Western European countries may well have undergone a major transformation by the time the transition economies reach their current goals or the objectives set for them as a condition of membership in the EU.

2.1. Conceptual Framework and Historical Developments

There is no unambiguous definition of financial market integration. Financial market integration is a gradual process and is defined by the transition from a completely segmented state of the market to a completely integrated market (Bekaert et al., 1998). However, the degree of financial integration depends on a number of country-owned factors, such as own country economic performance, the differences in the industrial structure between the global and the local markets, and on the degree of real and financial convergence with other economies. A perfect cross-market integration is understood as a situation in which there are no barriers (i.e. no capital controls and other institutional barriers) on any kind to cross-border financial transactions, such as taxes, tariffs, restrictions and information costs or any other costs that prevent investors from changing their portfolios instantaneously (Skipper, 2003). Financial integration, when defined as a state, refers to the extreme cases of perfect integration (absence of barriers) and no integration (presence of barriers). Financial integration, when defined as a process, refers to the degree of financial integration (Pagano, 2002). In the context of this paper, financial integration is understood as a matter of degree and perfect integration or the lack of such is of theoretical interest.

Greater financial market integration means higher financial market efficiency and an improvement in the risk-and-return combinations available to investors. Greater market integration, on the other hand, reduces the ability of domestically focused policies to deal with the new problems arising in financial markets. It might be argued that the closer we are to a single world market, the greater the need for world-wide supervision, particularly, if this greater integration is the result of solid structural trends, as seems to be the case. Whether such world-wide supervision should be provided by a single supervision or by a very-closely-linked group of supervisors, is, however, a different question.

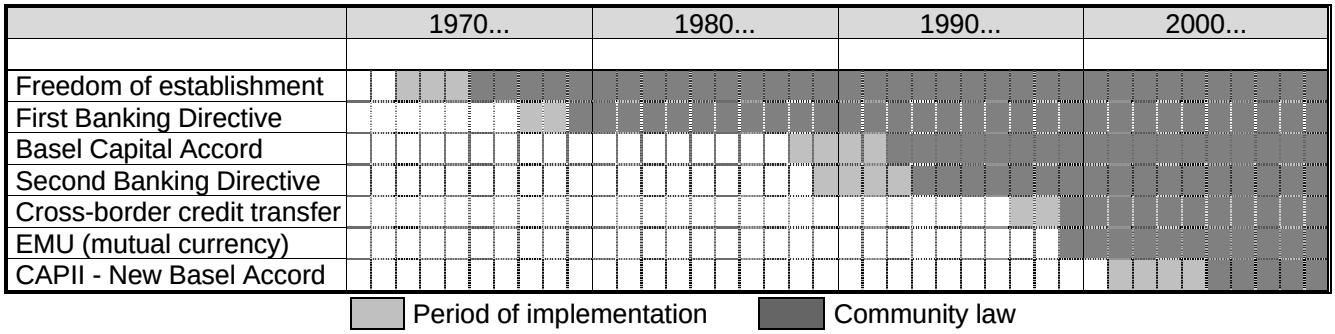
The main economic reasons that lead to the integration of different financial markets are the strive for efficient allocation of assets and the diversification of risk. When the marginal productivity of capital is different between countries, there exists a tendency for capital flows from those where the marginal productivity is lower to those where it is higher. This transfer of capital leads to the equalisation of the marginal productivity of capital of the different countries, and it also creates welfare gains in all the countries engaged in the process. Diversification of risk is also an important cause for financial integration as is shown with the help of the mean-variance model for financial decision of Markowitz. As the model of Markowitz shows, "*each portfolio of assets would have a given level of risk, and reward, but that for any level of risk, there was only one portfolio that would return an optimum reward. Conversely, for any level of reward, there would be only one portfolio that would minimize the risk*" (Markowitz, 1959).

One of the main factors affecting the integration of financial markets is exchange rate risk which, when it exists, affects negatively the opportunities for international investment and, in the same way, financial integration. Another important factor is the phenomenon of "*securitization*" of the assets and liabilities of banks, which makes easier to trade them both in national and international capital markets, and so contributes positively to financial integration for markets of otherwise non-tradable financial products. A third factor is the development of markets for financial derivatives (futures and options) which has created new opportunities for the management of financial risk, which lead to the intensification of

international movements of capital. By consequence, financial derivatives have also contributed strongly to the integration of capital markets.

The EU institutions and rules always considered the integration of the financial markets of the member countries as an important target. This is true since the Treaty of Rome, 1954, but more intensively, the restrictions on movements of capital imposed by European Union countries have been reduced significantly as a result of lengthy process that began in the early 1960s,[4] was set back by measures taken by member states during the economic difficulties of the 1970s, and was reactivated in the 1980s by major Commission regulation. Some of the milestones in the harmonisation of banking law have been the lifting of restrictions on the freedom of establishment and on the free movement of services in 1973 as well as the harmonisation of legislation on the provision of banking services as part of the first banking-law co-ordination directive of 1977 (Kern, 2002). The second co-ordination directive, which established EU-wide recognition of banking licences issued in any member state as well as the principle of home-country supervision with minimum standards at EU level was issued in 1989. Table 2 shows the time profile required for a directive to become community law with "*period of implementation*" standing for the period between the date of publication and the date of entry into force.

Table 2. EU Financial Services Directives



Source: Eppendorfer, Carsten et al., *Market Access Strategies in the EU Banking Sector Obstacles and Benefits towards an integrated European Retail Market*, University of Bochum, 2002

Stock market, investment and company legislation was initially harmonised with respect to stock market listings, 1979, listing prospectuses, 1980, prospectuses for public offerings of securities, and insider trading, 1989 (Kern, 2002). A further step towards a single market in financial services was finally taken on January 1, 1999 with the launch of the third stage of EMU. Since the irrevocable fixing of exchange rates and the introduction of the euro, the twelve current member states of EMU have enjoyed cross-border access to the euro zone's financial markets without the risks and costs caused by exchange rates.

2.2. The Current Stage of Integration

The shaping of the European financial area is the clearest contemporary example of how states, regulatory authorities, and networks of market interests can combine to redefine the boundaries of financial markets in terms of both space and characteristics. As the EU has become more integrated, as a result of market-led changes in industry structure, there has been a gradual, though persistent trend towards integration of EU financial markets. Although technological change and deregulation have reinforced these trends intensifying competition at the European level, an observation about the development of euro area financial services is that the pace of change has been slow (Heinemann and Jopp, 2002). One reason is that the measures to integrate markets take time to work and need to accumulate before the overall impact becomes visible. Cross-border mergers and penetration of national retail

[4] First Council Directive of 11 May 1960 for the implementation of Article 67 of the Treaty, 1952-1962 O.J. Eur Comm 49; Second Council Directive of 18 December 1962 adding to and amending the First Directive for the implementation of Article 67 of the Treaty, 1963-1964, O.J. Eur Comm 5

markets by competitors from other EU member states have been conspicuous more by their absence than by their frequency (Begg, 2003).

With regard to trade, the long track record of commercial relationships among European countries was the reason underpinning their move towards Union, which now, in turn, contributes to fuelling their reciprocal trade. Nevertheless, one should not neglect another very important aspect of this historical process, namely the fact that 15 countries decided to merge into a single economic area - and indeed achieved it - only recently within a very short period of time. The Single European Market (SEM) was created only 11 years ago[5], as the result of an initiative started in 1986.

By removing trade barriers, SEM expanded trade among EU Member States and thereby improved welfare. For the period between 1991 and 2001, the share of intra EU imports has increased on average by 6.7 percentage points. For services during the same period, the share of intra EU export has increased on average by 3.1 percentage points from 46.9% in 1985 to 54% in 2001 (Eurostat, 2002).

At present, labour, goods, services and capital circulate more or less freely within the Union's territory. European integration is the most ambitious supply-side reform attempted anywhere in the world. The introduction of the euro was enabled by economic convergence and contributes to reducing transaction costs and exchange risks. No other region in the world has been so successful in removing borders for labour, goods and capital over such a short period. These results are remarkable when one considers that now the euro area brings together 304 million citizens and represents more than 15% of world GDP. Given its sheer size, the Single Market enables significant economies of scale and offers huge business and investment opportunities. It boosts competition to the benefit of consumers.

Although strongly integrated (indeed, almost half of euro area countries' external trade is carried out within Monetary Union), the euro area is also very open to the rest of the world. It is actually more open than the world's other two major economies: its average external trade makes up around 17% of GDP (EuroStat, 2001). It also benefits from relatively integrated financial markets. Integration is certainly, and naturally, most complete in the money market (Ciampolini and Rohde, 2000). Interest rate differentials across regional deposit markets have vanished and the "*law of one price*" applies to all transactions within a deep and highly liquid pan-European market (Reszat, 2003). Cross-border transactions (for unsecured inter-bank deposits and repos) are developing rapidly and already represent more than 50% of all money market cash transactions (Schmiedel, Malkamäki and Tarkka, 2002).

- European Monetary Union

The creation of the European Monetary Union (EMU) is a unique event. Never before has a group of independent nation-states given up their national currencies to form a common monetary union on a new unit of account under the leadership of common monetary authority - while still remaining politically independent and accepting constrains in monetary and fiscal policy. It has certainly been the single most important event for international financial markets since the collapse of the Bretton-Woods system of fixed exchange rates. It opened the possibility for the creation of the world's largest domestic financial market in Europe.

The Treaty of Maastricht in 1992 laid down various conditions for Member States to qualify to join the single currency (this topic is detailed discussed in Chapter 3 of the present paper). In

[5] Established under the Single European Act, it was the core of the process of European economic integration, involving the removal of obstacles to the free movement of goods, services, people, and capital between member states of the EU. It covers, among other benefits, the elimination of customs barriers, the liberalisation of capital movements, the opening of public procurement markets, and the mutual recognition of professional qualifications. It came into effect on 1 January 1993 (Source: Internal Market Directorate-General of the European Commission).

May 1998 EU leaders confirmed which Member States were eligible to join the single currency. Of the fifteen member states, eleven which met the criteria have constituted the euro-zone. Three member states (Denmark, Sweden and the UK) chose not to enter EMU, while Greece failed to meet the Maastricht conditions at that stage. The euro was the official currency of the participating member states while the national currencies are sub-divisions of the euro, in effect two expressions of the one currency. From January 1st 2002, euro entered in general circulation, replacing the relevant national currencies.

- The Euro and Financial Integration

The successful launch of the euro, which is a key element in promoting economic stability and prosperity in Europe, has boosted the integration of financial markets in the euro area. Financial markets throughout the world are experiencing significant structural change. The process of integration in European financial markets coincided with a trend towards globalisation and securitisation, which, in turn, has been fuelled by the liberalisation of international capital movements, by widespread financial deregulation, and by advances in information and communication technologies. In the presence of so many different forces, it is not easy to isolate the impact of the euro. Nevertheless, the euro has several important effects, helping achieve a more efficient intermediation of savings into investment.

Even before 1 January 1999, the preparations for EMU had extended a culture of economic stability across the Union. This stability is a prerequisite for efficiently functioning pan-European financial markets. The economic policy framework that underlies EMU consolidates this with a clear set of objectives and a clear assignment of policy responsibilities (Quaden, 2000).

The efficiencies/inefficiencies of euro

Direct benefits of euro:

- reduction of transaction costs
- elimination of exchange rate risk
- increased price transparency, and
- creation of deep financial markets

Indirect benefits of euro:

- macroeconomic stability
- lower interest rates
- fundamental structural reform
- the creation of a new global reserve currency, and
- increased economic growth

Risks:

- susceptibility to economic shocks*/ asymmetric shocks
- political discord - not yet completed European political integration

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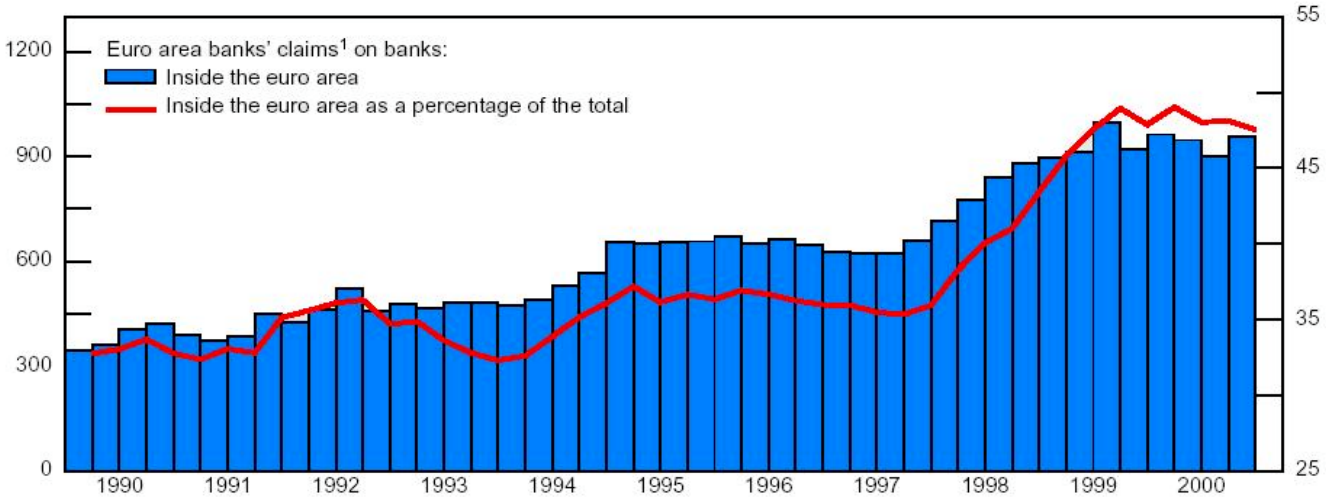
Note: *Economic shocks are unexpected changes in the macroeconomic environment of a country or region that disrupts the careful balance of production, consumption, investment, government spending, and trade. Source: http://www.wowessays.com/dbase/ac2/tda378.shtml

The euro provides greater scope for diversification of financial structures and the Union is now evolving from a relatively bank-oriented structure to a structure more reminiscent of the US, where markets play a greater role. A more diversified financial system promotes economic growth in the Union by offering wider opportunities for risk sharing. Greater competition and diversification in the Union's financial system should be reflected in more

innovation in terms of the financial products available and in the delivery of those products, for example, by electronic means.

The economies of, and the economic processes in, the countries currently within the euro area have become increasingly intertwined as they have moved towards more integration. This has naturally led to the development of more cross-border financial interconnections. At the same time, financial flows between the euro area and the rest of the world have increased rapidly in recent years. As far as euro area financial markets are concerned, the introduction of the euro acted as a catalyst for greater integration within the euro area, although this process is still far from complete (Duisenberg, 2002). The introduction of the euro is seen as strengthening these driving forces. It is important to emphasise that changes in market conditions vary considerably between different areas of banking activities. The most notable changes have taken place in wholesale banking, with the creation of a large and steadily-growing interbank market in the euro-zone (Figure 1). Changes in retail banking activities are seen to be much more gradual (Santillán et al., 2000).

Figure 1. Cross-border interbank activity
Amounts outstanding at end-quarter, billion USD



[1] Excluding Portugal.

Source: Galati, Gabriele and Tsatsaronis, Kostas; *The impact of the euro on Europe's financial markets*, BIS Working Paper no. 100, 2001

The improvement in efficiency which integration is bringing to financial markets in the euro area should be beneficial not only for euro area residents but also for non-resident borrowers and investors, who are able to access the financial markets of the euro area and take advantage of their breadth, depth and liquidity. In particular, even though euro area financial markets are not yet fully integrated at an area-wide level, they are larger and more accessible than any of the markets that were denominated in the legacy currencies of the euro (Liebscher, 2000).

As regards the bond market, the introduction of the euro created the second largest bond market in the world. While the corporate bond market was of limited importance in the euro area before 1998, the launch of the euro seemed to act as a catalyst for the development of a market in which corporations could issue debt securities of unprecedented size. The wave of mergers and acquisitions in the euro area corporate sector seen since the launch of the euro provides another example of the increased possibilities offered by the larger and deeper single financial market (Mira, 2001).

- The Financial Services Action Plan and the Lamfalussy Process

By eliminating investors' exchange risk in much of the Union, the euro has focused attention on the opportunity costs of residual market fragmentation and has highlighted the

imperfections in the present regulatory framework. Therefore, the main politically driven aim of the EU's **Financial Services Action Plan** (FSAP) was to create a more market orientated and competitive financial system through Europe by reducing cross-border barriers to trade in financial products and services and to reduce fragmentation across different product areas and markets and to ensure that the system is supervised to the appropriate standard (Casu and Girardone, 2002).

Behind this programme of regulatory reform, it was decisive for the success of this initiative to forge a powerful consensus at the political level on *"what the problems are and that they need to be tackled; broad consensus on the scale of the potential benefits, on the measures that are needed and on creating an integrated financial services market is an essential and central component of economic reform agenda*" (Bolkestein, 2002).

Just like in case of the European Single Market, where the "*implementation of half of 300 actions proposed in the 1985 White Paper will deliver much less than half of the total benefits*" (Cecchini, 1992), the integrated single EU market in financial services "*must capture all the benefits. The prize is, about half a percent of additional GDP growth per year*"(Bolkenstein, 2002). Therefore, the heads of states and governments pledged firmly in March 2000 at the Lisbon European Council to fully implement the Plan by 2005.

The strategic objectives of the Financial Services Action Plan are the following:

Objective 1: A single EU wholesale market.
Objective 2: Open and secure retail markets
Objective 3: Prudential rules and supervision
Objective 4: Conditions for an optimal single financial market

The first Action Plan's objective is to establish a common legal framework for integrated securities and derivatives markets. Hence, there is a need of completing a single wholesale market through dissolution of barriers to investment. The emphasis of the current measures are on clearing and settlement, financial reporting, auditing standards and practice, and revised investment services directives. One important issue now is the implementation of International Accounting Standards (IAS). By 2005, all listed EU companies active on a regulated market and having a public offer prospectus will be required to prepare their consolidated financial statements in accordance with the IAS standards.

The second strategic objective entails achieving an open and secure retail market. The communication on e-commerce and financial services is being followed up, and will ensure coherent implementation throughout EU. The action plan to combat fraud and counterfeiting in non-cash payments is another vital component. Building public confidence is key to progress in this field.

The third and fourth strategic objectives include prudential rules and supervision that will contribute to the stability of Europe's financial sector. The creation and reinforcement of an efficient and transparent legal system is an elemental tool on FSAP path. Concrete steps have been taken, in particular in securities markets, by reinforcing the EU's anti-money laundering policy and insurance solvency.

In the context of these developments, the EU faces the important decision about how to structure its financial system - whether on "*an Anglo-Saxon market-based model, a German style bank-based system or some combination of the two?*" (Allen, 2002). While the general tenet of the FSAP legislation veers towards a more market-based approach it is a fact that the bank-based system still predominates in most of continental Europe. It is likely. however, that the ongoing regulatory process is likely to result in the evolution of a more market-based system over time.

The four level approach of the Lamfalussy process is designed as follows:*

Level 1
Community legislation adopted by the Council and the European Parliament, upon a proposal by the European Commission, under the co-decision procedure: Legislation should be based only on **framework principles** and definition of implementing powers for the Commission.

Level 2
Community legislation adopted by the **Commission** to lay down the technical details for the principles agreed at Level 1 under the so-called Comitology Procedure. Particular features:

- **Technical advice** prepared by the Committee of European Securities Regulators (CESR); following mandates issued by the Commission and based on consultation with market users;
- Favourable **vote of Member States**(qualified majority) as represented in the European Securities Committee (ESC).
- **European Parliament** may adopt resolutions a) within three months on the draft implementing measure; b) within one month after the vote of the ESC if level 2 measures go beyond implementing powers.

Level 3
Committee of European Securities Regulators (CESR) in which the national supervisory authorities are represented, to facilitate consistent day-to-day implementation of Community law. CESR may issue guidelines and common, but non-binding, standards.

Level 4
Commission checks compliance of Member State laws with the EU legislation. If necessary, it takes legal action against Member States before the Court of Justice.

Source: First Interim Report Monitoring the New Process for Regulating Securities Markets in Europe, The Lamfalussy Process, 2003
Note: *See the Annex for detailed presentation of the four-level approach

On July 17, 2000 the Council of Finance ministers of EU (EcoFin) set up the Committee of Wise Man, chaired by Alexandre Lamfalussy, former president of the European Monetary Institute, to look at European securities markets, financial integration in EU and implementation of the FSAP. In its Final Report, the Committee identified shortcomings in the regulatory system as the major problem in integrating EU financial market (European Commission, 2003). In their view, the system:

- was too slow: the adoption of key Commission proposals often took many years;
- was too rigid and unable to react speedily enough to changing market conditions. Every change, however small or technical, required a full Commission proposal, to be negotiated by co-decision;
- failed to distinguish between core, enduring, essential framework principles and practical, day-to-day, implementing rules; and
- produced too much ambiguity. In addition, directives were often ambiguously implemented - partly due to the texts themselves, but also due to the lack of co-ordination by an effective network of European regulators.

Further, the Committee of Wise Men expressed the view that policy makers were not equipped with sufficient resources to fulfil their tasks. The degree of fragmentation in the European capital market still compares unfavourably with that of the US - the benchmark. The challenges lie mainly at two levels: firstly, the European financial markets are still marred by various inefficiencies. Secondly, there is an apparent unfamiliarity among consumers with regards to financial services.

In the past, securities markets legislation was adopted by the Council and (since 1997) by the European Parliament under the co-decision procedure. Thereafter, the Member States were tasked with transposing such Community legislation into national law. If Member States did not comply, the Commission would take, where necessary, legal action before the Court of Justice. The Report emphasised the need for more transparency and openness at all levels, throughout the legislative process. The essential novelty of the recommendations is the addition of two intermediary levels, supported by two committees - the European Securities Committee (ESC) in which representatives from finance ministries vote on implementing measures, and the Committee of European Securities Regulators (CESR), in which the national securities regulators have a seat.

The benefits from the Committee's four-level approach are a faster legislative process, a more democratic and more responsive legislative process and the benefit from the technical and regulatory expertise of European regulators. "*Openness, consultation and transparency will strengthen European financial policy making - by avoiding suspicion - building a stronger consensus - and involving more participants. It is also essential for democracy. We must break down, once and for all, the secrecy shibboleths of the past*" (Lamfalussy, 2000).

In order to attain the goal of a truly integrated financial market, the principles of the single market must be extended to all areas of the financial markets, exemptions must be eliminated, a consistent implementation of European legislation ensured and the EU's regulatory tools aligned with the rapidly changing structures and activities of the financial markets.

Progress in adopting the legislative measures to timetable has been impressive. All institutions have continuously shown their willingness to implement the complete plan on time. EU is close to creating a comprehensive legislative framework which enshrines effective single market freedoms and common regulatory objectives in principles- based rules - rules that are capable of responding to evolving market conditions and structures within a more efficient decision-making structure (European Commission, 2003).

3. FINANCIAL SYSTEMS IN CENTRAL AND EASTERN EUROPE

As Soviet communism collapsed in Eastern Europe in 1989, the countries of Central and Eastern Europe began the unprecedented transition from their highly centralised economies to market-dominated economies. After the World War II the countries of central and eastern Europe were forced to adopt the communist ideology and political system, they also were induced to adopt the Soviet system of centralised planning to achieve rapid industrialisation and accelerated levels of economic growth. As part of this process, they replaces the vibrant financial systems which existed across the region before the war with passive mono-banking systems modelled on the Soviet financial system.

3.1. The Legacy of Central Planning

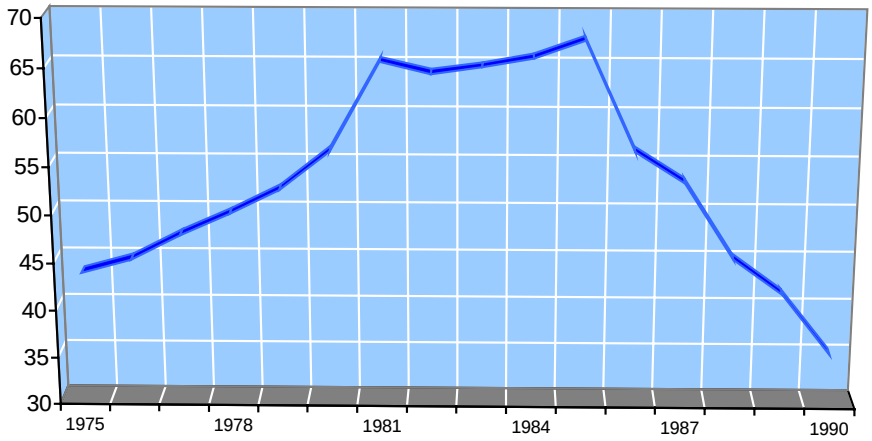
A crucial part of this transition is the decentralisation of the banking system, which underpinned the centrally planned Soviet society. Unlike most banking systems, "*the bank in the centrally planned economy was an administrative agency and had almost no common features with any commercial bank. Money was an accounting tool only and the central planner decided on capital allocation and production levels*" (Rostowski, 1995).

The role of the traditional Soviet-type banking system was to monitor behaviour directed by the central bank. A centrally-determined financial plan shadowing the state's production plan dictated credit and cash outlays. The financial plan determined how and how much credit the banking system would extend to enterprises. The state bank guaranteed enterprises the loan needed to carry out planned transactions and verified that loans and enterprises' deposits were used only for centrally determined transactions.

The state bank held a virtual monopoly over banking and credit. A small number of specialised banks, including a savings bank to serve the household sector, a development bank to finance long-term investment activities and a foreign trade bank to finance foreign trade enterprises, provided banking services to limited sectors in the economy, but there was no competition among banks. The lack of capital markets and foreign banks insured that enterprises and individuals would use only the state-run banking system.

Two separate and distinct financial circuits segmented financial flows. Enterprises received credit from banks and made payments to other enterprises and budgets entities through bank accounts. They paid wages in cash, but were forbidden from using cash to purchase goods. Aside from putting money under the mattress, households had no option but to place any excess cash they might have in the state savings bank (Bernstam and Rabushka, 2003). There were no possibility to invest in or lend to state enterprises. The state savings bank did not engage in transactions with state enterprises directly. Rather, it placed excess deposits with the central bank which transferred the funds to treasury accounts or to banks dealing with the enterprise sector. Figure 2 presents the dynamics of industry loans in the USSR.

Figure 2. Loans to the Soviet enterprises 1975-1990, (in % of GDP)



Source: Schrooten, Mechthild; *Geld, Banken und Staat in Sozialismus und Transformation*, DIW, 2000

The lack of historic relations between credit and enterprise profitability gave rise to soft budget constraints. The emphasis on enterprises' compliance with plan outputs led firms to be primarily concerned with obtaining the necessary material supplies to comply with plan outputs. Unconcerned with profitability or controlling costs, enterprises unable to meet their operating costs simply asked for more bank credit. Loans were disbursed without regard to whether they could ever be repaid under normal market conditions, and "*interest rates had no role in the allocation of credit*" (Pazarbasioglu and van der Vossen, 1995). Credits were granted to allow enterprises to cover losses and long-term financial short-falls when they failed to meet plan targets without sufficient economic justification. As their primary function was to ensure that firms complied with planned output targets and possessing no reason to consider the possibility of non-payments, banks passively accommodated enterprises' credit demands. "*This banking practice tolerated and encouraged economic mismanagement, eroded repayment discipline and clogged channels of money circulation with surplus payment funds*" (Woody, 1990). The existing loans then formed the first group of bad loans that the transition economies had to contend with while restructuring their banking system.

Moreover, there were no capital markets or wholesale money and interbank markets of any significance and few non-bank financial intermediaries, such as insurance companies and pension funds, managing portfolios of shares in private companies and holding government debt (bonds). The industrial and retailing sectors were state owned, the service and welfare sector was underdeveloped and tax revenues were derived largely from enterprises (Liebermann, 1993).

In the second half of the 80s, the transition economies took on board the two-tires model and tried to introduce market forces into a central planning framework. The first move was the granting of licences to joint ventures between the newly created commercial banks and foreign banks and/or establishment of numerous cooperative banks, thus, creating a third tier of banks. This developments accelerated with the establishment of numerous domestically owned private sector commercial banks, following the collapse of communism in the early 90s. The state-owned banks continued, however, to dominate the banking systems and privatisation of these banks only began in mid-1990s.

The mono-bank system was always a misnomer since most of these economies had a number of specialised banks (investment, agricultural and trade finance), as well as a national bank and also a savings bank, whose degree of independence from the national bank varied. When two-tier banking was introduced, not only were new commercial banks created, but the specialised and savings banks were usually also permitted to undertake commercial banking business. At the time of their creation the commercial banks clearly lacked experience, as well as facilities to collect deposits from the public and to provide modern money transmission services and the public was used to receiving rudimentary services from the state savings banks. More, the new banks were hampered by inherited bad debt. That is, as the post-communist countries moved away from the planned economic system and transformed their banking systems from the monobank to a two-tier banking system, their banks shifted from a situation in which all money is "*outside money*" to one in which most money is inside money, i.e. the liabilities of the banks instead of the state (Rostowski, 1995).

3.2. Initial Conditions and Common Features

The financial sector reform began with the separation of the banking sector into two tiers: central and commercials. The aim was to emulate the banking structure in western established economies. The difference, however, was that the banks remained largely state owned. As a consequence, individual transition economies have chosen quite distinct approaches in progressing with the reforms (EBRD, 2002).

Financial sector development has been rather slow compared to other areas of reform such as economic liberalisation and foreign trade. *"What determines the maximum speed of a process of institutional or economic change is ultimately the inherent human limitations of informational processing and learning*" (Balcerowicz, 1995). Thus, the development in the financial sector is closely related to the speed of economic and institutional changes. Nevertheless, the speed of microeconomic liberalisation and stabilisation in CEECs is much higher than that of institutional changes in the regulatory framework.

The shift from the state-owned monobank system to a market oriented banking system has proven difficult in all of the post-communist economies. Establishing a sound banking system, "*a process that took hundreds of years in Western Europe and decades in Japan is being telescoped into a few years in Central and Eastern Europe and the Former Soviet Union*" (Boot and van Wijnbergen, 1995). Though the approaches to bank reform have been varied, problems in making the transition from one banking system to another have been fundamentally the same in each of these countries. In retrospect, the early development strategies of several CEEC even come across as a bit naïve in their ambition to set up anglo-saxon style of banking and capital markets almost overnight (Maystadt, 2002). However, main priority at that stage was rather to establish a sound, stable and efficient financial system.

Basically, countries that started earliest the structural reforms and stabilisation processes have made considerable progresses (Borkos, 2001). Some countries started to reform their financial system even before the political changes. This has been the case of Poland and Slovenia, that launched their market-oriented reforms during the 1980s. Although in Hungary markets reforms were gradually introduced in the late 1960s, the pace of reform only

accelerated in the early 1990s, followed by currency devaluation, reduction of subsidies, price freeze. Yugoslavia, having had a formal, two-tier arrangement throughout the socialist period, started to liberalise banking regulation gradually in the second half of the 1980s.The large market oriented reform package was launched in the former Czechoslovakia in early 1991. Despite the break-up of the country in 1992-1993 and characteristics of a prudently and tightly controlled economy, both republics, were successful to adjust to the rhythm of reforms and are now among advanced and well-managed economies. Other countries, first of all, the former Soviet republics and Balkan countries were much less fortunate; financial sector reform could start only after the rather tumultuous political events and under the auspices of the first democratic governments. Among the Baltic countries, Estonia pioneered the reform processes in 1989. Latvia and Lithuania were relative late beginners, starting the reform wave in mid-1992, after the collapse of the former Soviet Union. Bulgaria and Romania were the latest to start the reforms, by postponing structural reforms as a result of political fragmentation during the early 1990s. However, in all countries regulation for the establishment and operation of banks and other intermediaries was quite liberal and this unleashed substantial initiatives leading to rapid growth in the number and size of these institutions.

Behind this opaque picture, there are huge and growing differences in financial sector development among CEECs, and these can be explained mainly by variations in the degree of government policies and the reforms implemented for modernisation. Grosso modo, the financial sector CEEC is characterised by the following common features (Bokros, 2001):

- A low level of financial intermediation in the range of 40 percent of gross domestic product
- Relatively poor asset quality and serious undercapitalisation
- A narrow range of services, especially in non-banking sector
- Largely immature external and internal governance structures
- Shallow implementation and enforcement capacity

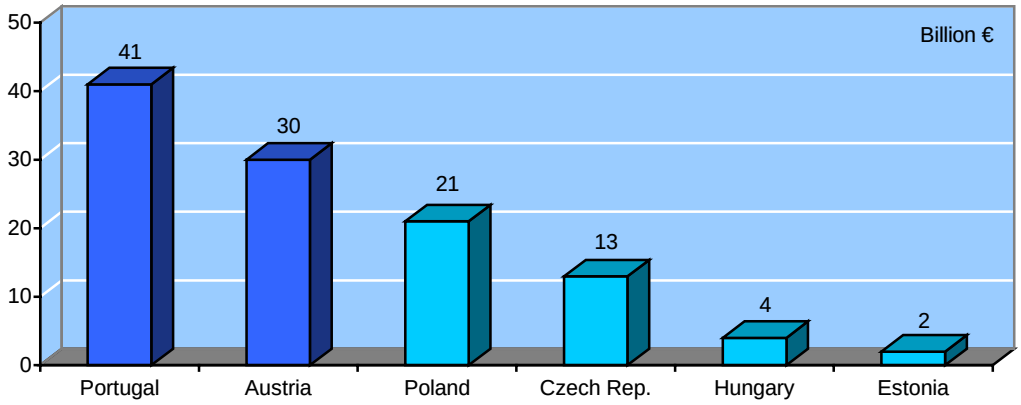
There is clear evidence, that the banking sector in transitional economies became the most important source of enterprise credit. However, the non-banking sector (stock markets, bond markets and all money markets) had also helped facilitate the objectives of transformation. For instance, the privatisation and mechanisms for corporate control had benefited from developed equity and capital markets. A greater variety of instruments, such as equities, bills and bonds increased the demand for financial services, thereby encouraging savings and mobilisation of funds. Tightened supervision, consolidation and liquidation of insolvent institutions as well as market entry of foreign banks, have ultimately led to stable commercial banking sector. At the same time, money and stock markets, have been set-up.

The development of equity markets in the selected CEEC was driven mainly by the privatisation process. Equity markets developed quite quickly initially in countries where mass privatisation schemes were initiated (Figure 3). Market infrastructure and regulation often was put in place after the establishment of a rudimentary market. This approach proved to be more successful than the others, which is reflected in higher liquidity and better performance of stock indices in selected countries. On the other hand, the equity markets exhibit a more fragmented structure with a comparatively large number of small companies with low liquidity.

The development of stock markets has been closely related to the privatisation strategies of individual countries. The first stock markets in CEEC appeared in Czech and Slovak Republics (1992), as a consequence of mass privatisation, followed by other countries. Stock markets quickly comprised a large number of companies, but widespread ownership actually limited the development of sound corporate governance structures and restrained liquidity (Claessens, 2000). The mass privatisation via vouchers failed as the bulk of enterprises initially listed turned out not to be viable. This had a negative effect on the public confidence in stock markets - until today - and massive delistings of ailing enterprises. In Czech

Republic, for example, 83% of companies were delisted between 1996 and 1997 (Thimann, 2002).

Figure 3. Equity market capitalisation



Source: Klolias, Sotirios; *Capital movement liberalisation and financial sector reform in the accession countries*, European Commission, 2003

There are several reasons why stock markets play a much smaller role in CEEC than in euro area. First, markets have a much shorter history of development, about 10 years. The setting-up of the stock market required long-run processes and reforms: privatisation, enterprise restructuring, elaboration and establishment of appropriate legal and regulatory framework. Second, foreign direct investments have been an important element in the transition process and often served as an alternative to domestic financing. Third, almost all countries have experienced a renewed recesssion after the initial output decline, following the collapse of the planned economic system. However, helpful as foreign direct investments have been, they cannot forever substitute for domestic savings and domestic financial intermediation. Making CEEC companies too dependent on foreign financing risks exposing them to excessive foreign liabilities and exchange rate risks and the damages of a withdrawal of funds in times of crisis. Moreover, the access to foreign capital is basically given only to blue-chip companies and subsidiaries of non-CEEC firms, small and medium enterprises are restricted to domestic finance.

In the process of macroeconomic stabilisation in CEEC the securisation of loans denominated in local currency went in parallel to the declining role of the central bank as a creditor to the public sector. Rapid increases in stocks of non-performing loans led to banking crises in many transition countries during the 1990s. In fact, transition made banking sectors vulnerable in several respects. Many crises arose out of insolvencies in state-owned or formerly state-owned banks caused by bad loans inherited from the Soviet era. Moreover, transition cut enterprise profitability in certain sectors, thereby reducing the ability of companies to service their loans. The operating environment for banks deteriorated in conjunction with severe output contractions in the early part of transition. Finally, regulatory frameworks and supervisory structures for the banking system in most transition countries were inadequate (Tang, 2000).

3.3. Reforms and Progresses Made

Over the past 10 years financial systems in transition countries have undergone dramatic changes as a result of the successes and failures of macro- and micro-economic reforms and changes in the institutional framework. Today, the shape of financial sectors in transition economies varies significantly as far as relative size, structure, health and efficiency are concerned. With the elimination of monobank systems, most countries experienced a rapid expansion of the banking sector with the entry of a large number of new banks and corresponding declines in state ownership in the sector

During the first decade of transition, inflows of foreign capital has provided extensive financing for investment and thus allowed the CEEC to grow faster than would otherwise have been possible. It has been a notable characteristic of the transition period that investment needs have exceeded domestic saving in the CEEC, which implies that the balance of payments of Eastern Europe has been characterised by persistent current account deficits. "*Around 90 percent of the external financing to CEEC have come from private sources, with the rest coming from institutions such as the IMF, the World Bank, the EBRD, the European Commission, and the EIB*" (Maystadt, 2002). The role of private capital increased over time. In particular, in the more advanced CEEC such as Poland, Hungary and Czech Republic, private flows make up virtually all of the external financing. This is not surprising, since progress in economic reforms tends to improve the attractiveness for private capital.

A country's approach to privatisation has direct implications for the development of its financial sector. "*Privatisation through vouchers and investments funds stimulates securities markets. Privatisation by management buy-outs reinforces the role of the banking sector as the main creditor of industry*" (Lannoo, 2001). Large bank privatisation programs were undertaken in almost all countries during the early 1990s. While some countries (Hungary, Poland and Slovenia) were successful in stabilising their banking systems with the help of these programs by the second half of the 1990s, other countries faced continuing problems. Thus, by 2001 foreign banks had more than half of deposits in all of these countries, and in some of the larger ones (e.g. Poland, Hungary, Czech Republic) the share of foreign banks is around two thirds (Gros, 2003). In Slovakia and Slovenia the banking sector is dominated by 3 and 2 banks respectively, which are mainly state-owned and dominate the market. Privatisation is least advanced in Bulgaria and Romania (Padoa-Schioppa, 2001).

Foreign ownership of the banking sector is most developed in the Baltic states, where more than 80% of total bank assets are in majority foreign-owned bank.[6] It is rather exceptional, since most countries have preferred to keep banks locally owned and foreign ownership has averaged below 20%. Many governments have managed to keep foreign bank entry and ownership low by, for example, remaining a shareholder, a caveat not liked by many investors (Hampel, 2002). This is a sensitive issue not only for European transition countries (Table 3), but for many countries in Westerns Europe as well.[7]

Table 3. Share of majority foreign-owned banks in total assets (%), 2001

AC	%		EU	%
Estonia	97,5		United Kingdom	52,1
Czech Rep.	90,1		Belgium	36,3
Latvia	83,9		Greece	21,9
Slovenia	81,0		Portugal	10,5
Bulgaria	75,0		France	9,8
Poland	68,4		Netherlands	7,7
Hungary	65,5		Italy	6,8
Lithuania	62,6		Germany	4,3
Slovakia	55,0		Austria	3,3
Romania	55,0		Sweden	1,6

Source: From the presentation "Capital Movements Liberalisation and Financial Sector Reform in the Accession Countries" made by Sotirios Kollias, Head of Unit, European Commission, at the seminar on "The economic impact of EU enlargement on the Mediterranean partners: opportunities and challenges" Brussels, 2003

[6] Figures taken from the Latvian Development Agency: http://www.lda.gov.lv/eng/inner/le/financial/

[7] In Germany, half of bank assets are state-owned and further privatised is not currently on the political agenda. In France and Italy the proportion is closer to a third. (Source: Finel-Honigman, Irene; *Reconfiguration of US/EU Financial Competitiveness: the bank, the state and the shareholder*, from EU/US Relations: A Partnership in Transition Conference, University of Georgia 2000)

The level of financial intermediation in CEEC remains relatively low. This is reflected in a low penetration of both banking assets and capital market securities in the economy. Although banks are by far the most important pillar in the CEEC financial sectors, the degree of financial penetration through assets and loans is much lower than in other emerging markets and the euro area. There are a number of reasons for the low levels of bank intermediation. All countries experienced a sharp economic downturn upon transition. These severe recessions led to massive bad-debt problems in the corporate sector, widespread defaults and a substantial reduction of banks' loan portfolio. In many cases, these developments triggered rounds of banking crises, which, in turn, reduced banks' assets further and, moreover adversely affected their lending behaviour and induced a shift towards government securities or liquid assets on their balance sheets. For many economies, it took several years to break free from this circle of banking and macroeconomic crises (Winkel, 2002).

At the current stage, the CEECs have already achieved a high degree of transformation of their financial systems and substantial convergence toward the EU financial sector and the world financial markets. The requirements to fully liberalise the capital movements and to adopt the EU regulatory norms and prudential rules, have been the driving force and the key instruments for bulging an efficient financial system and for financial convergence with the EU.

4. INTEGRATION OF EUROPEAN FINANCIAL MARKETS

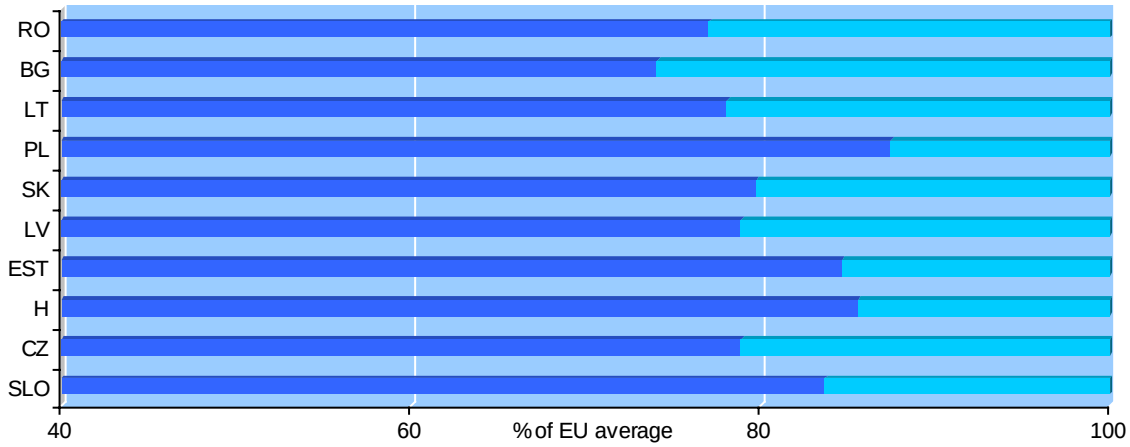
A single market in financial services in the EU has been under construction since 1973, underlying its importance as a motor for growth and job-creation in the union. If Europe wants to achieve the objective of becoming the most competitive and dynamic economy in the world capable of sustainable economic growth, as defined at the Lisbon European Council in 2000, it needs more efficient and competitive financial markets.

The completion of the EU's single market in financial services is a key target along the way. The benefits of reaching the target are real and substantial: completing the single market in financial services may boost EU growth by as much as 1.1% and total employment by up to 0.5% (European Commission, 2002). Further integration of retail financial markets might yield potential gains in terms of interest rates of 0.7% of EU GDP. The elimination of the present inefficiencies in the banking sector could result in potential gains of about 1.4-1.6% of GDP. A reduction of the costs of cross-border credit transfers aligned on the most "cost efficient" one would yield no less than 41% in savings (European Commission, 2002).

Financial sector development was also considered an important feature in the CEEC's convergence process with the present EU Members (Caviglia, Giacomo et al, 2002). The later have made strong headway above all in the field of institutional and structural reform, and have thus secured the key precondition for sustainable growth. In the accession process real convergence, i.e. convergence with EU standards in terms of output growth as well as concerning the structural and institutional framework, were going hand in hand with nominal convergence, that is the gradual fulfilment of the Maastricht criteria, i.e. reduction of inflation rates, interest rates and fiscal deficits. Several observers argue that real and nominal convergence are conflicting objectives and cannot be pursued together. "*Real convergence is more than the catching up in income levels; it is the adjustment of the real economies towards structures that allow the countries to participate in a monetary union without contributing to, or suffering from, significant asymmetric shocks ... If the horizon for full compliance with Maastricht criteria is chosen in line with the starting conditions and the economic environment, nominal convergence will not be disruptive to real convergence*" (Padoa-Schioppa, 2002). However, pursuing overly ambitious goals within a very short period of time could hamper economic growth and the implementation of the necessary structural reforms (Gugerell, 2001).

As Table 4 shows the convergence at the general level and at the level of economic policy and institutions had made strong headway in all CEECs and the leading ones joined the EU at the same, if not higher, level as the *ClubMed.* For comparison, Spain and Portugal, joined the EU with the general convergence level of 76,2% and 74,4%, respectively (Hildebrandt, 2002).

Figure 4. Convergence indicator, real vs. general



Source. Deutsche Bank Research, 2002
Note: *Deutsche Bank Research uses 16 variables of convergence indicator that are broken down into five main groups: real economy, growth dynamics, institutions, external factor, monetary policy

When talking about integration of CEEC economies into EU and degree of convergence, the main question remains: convergence on what? It is not a secret that the ultimate shape of the EU financial sector is itself unknown (Mullineux and Murinde, 2000) and subject of profound changes (Thimann, 2001). On the other hand, the CEEC countries have officially declared their willingness to belong to the European Union and their financial system should be prepared for such a step. So, to estimate the convergence, this chapter will look at the financial sector and compare the data among the old and new member states. Thus, it will provide a clear picture of the sort of ultimate structure upon which EU member states, and the accession states as well, will converge.

4.1. Banking Sector

According to traditional microeconomic theory, under perfect competition, less efficient bank will be driven out from the market normally via consolidation. Although it is clear that this is not always the case and often consistently non-efficient banks are allowed to survive the market, it is also known that the increase in competition in Europe brought about by deregulation would lead to further consolidation, normally in the form of less efficient bans being taken over by more efficient ones. Hence also from the political point of view, the concept is also of great importance, as it will affect the long-term viability of the banking sector in individual countries (Bikker, 1999).

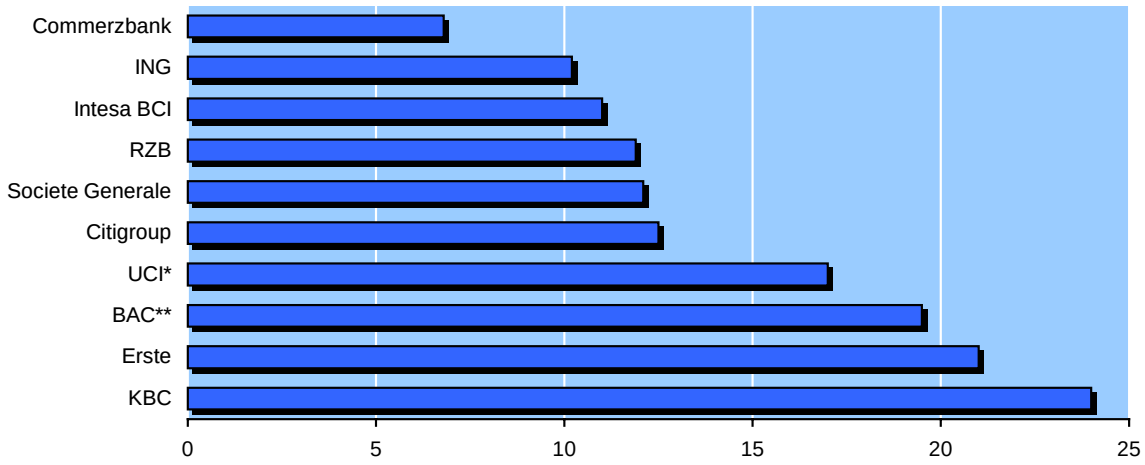
The introduction of the euro has intensified competition in an already competitive environment for banks, by enhancing price transparency, reducing foreign exchange revenues and competitive advantage for domestic players associated with the existence of national currencies. Already existing competitive pressures in the financial services industry reflect among other things technological change, which tends to lower the costs of both information and transactions and facilitates securitisation.

As a response to these competitive pressures the banks started seeking higher margin power either through mergers and acquisitions or through cross-shareholding. So far, most of consolidation in the EU has taken place mainly within national boundaries. Even though the trend has been towards a more concentrated banking sector in all EU countries, the degree of concentration still varies considerably from one member to the other.

In their turn, the transition economies of Central and Eastern Europe have become integrated into international financial markets at an impressive speed over the past decade. Market shares of foreign banks are far above averages for the typical EU country, cross-border capital flows have grown, and the countries rely on international bank lending to a substantial degree. An important aspect represents the development of the banking sector and the convergence of regulations to European Union standards. A common feature in CEEC is the increasing involvement of foreign banks in the banking sector.

As a result of an increased presence of foreign banks has been seen through the opening of branches and increasingly through takeovers of, or participations in, domestic banks (Figure 5). The entry of foreign banks into a domestic banking sector makes financial intermediation more efficient if the sector is underdeveloped and if there is little non-bank financial intermediation (Dickinson and Mullineux, 2002). Both conditions apply to Eastern Europe and, not surprisingly, the presence of foreign banks has been found to improve the quality, pricing, and the availability of financial services. Nevertheless, the degree of financial intermediation in CEEC along the reform process remained low. The remaining challenges will include further consolidation, efficiency improvement and increasing the menu of financial services, such as mortgages, consumer credit, small and medium enterprises (SME) finance, measures that will reduce the costs of bank intermediation to the benefit of both borrowers and lenders. Conversely, given the widespread presence of foreign banks in CEEC there is the possibility that certain sectors of the banking activity will be effectively taken over by foreign banks.

Figure 5. International Banks in CEEC, total assets

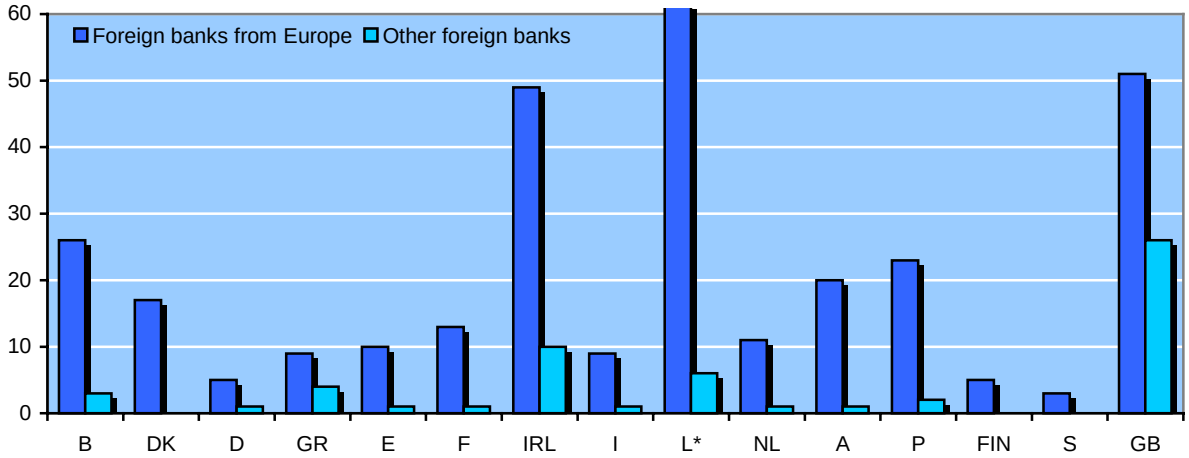


Source: Financial Times, Special Report Central and Eastern Europe, October, 2003
Note: * UniCredito Italiano; ** Bank Austria Creditanstalt

It is important to stress here that foreign ownership of local banks does not imply increased borrowing from abroad. Just like domestically owned banks, foreign-owned local banks are involved in intermediating in the local currency. Hence they do not contribute to increased foreign indebtedness. Indeed the opposite may well be true. If foreign ownership helps generate a more functional, liquid and stable financial sector, then this would attract more domestic saving and encourage more effective intermediation into local investment, thus reducing the dependency on cross-border capital flows (Maystadt, 2002). This trend is less popular in the European Union, as Figure 6 illustrates.

As regards the degree of internationalisation of European banking sector, the progress has been registered so far on the retails market sector. Cross-border provision of retail banking services has been relatively more limited and much of it has occurred within relatively homogeneous regions such as Benelux or Scandinavia. The limited cross-border activity is reflected in a relatively low share of foreign banks in most European Union countries. This share, except few countries, does not exceed 10 per cent of total assets of domestic credit institutions in most European Union countries.

Figure 6. Share of foreign banks in EU country banking sector



Source: OECD financial market trends, no 84, march 2003
Note: *For Luxemburg, the share of foreign banks from Europe equals to ca. 93

The CEECs have put in place the core elements of a legal and regulatory framework for the banking sector. In general, these frameworks are in line with what is being applied in the EU. However, difficulties remain in implementing this framework. But it is also because it is sometimes politically sensitive to take corrective measures when banks get into trouble. In light of the disparity between the design and the implementation of the legal and regulatory framework it is tempting to say that banking sector reforms in Eastern Europe have been extensive but not yet very effective - at least in some countries (ECB, 2001).

Although the banks create by far the most important pillar of financial intermediation in CEEC, the degree of financial penetration through assets and loans is much lower in these countries than in the EU and also in other emerging markets. However, the Czech Republic has - in comparison with other countries - a relatively large banking sector, about 132% of GDP (Cech, 2003). On the other side of the spectrum, the countries like Lithuania and Romania with banking assets of less than one fourth of the Czech Republic. Total banking assets in CEECs are half of the GDP, whereas in Euro area these are over 200 per cent as a whole (Thimann, 2001).

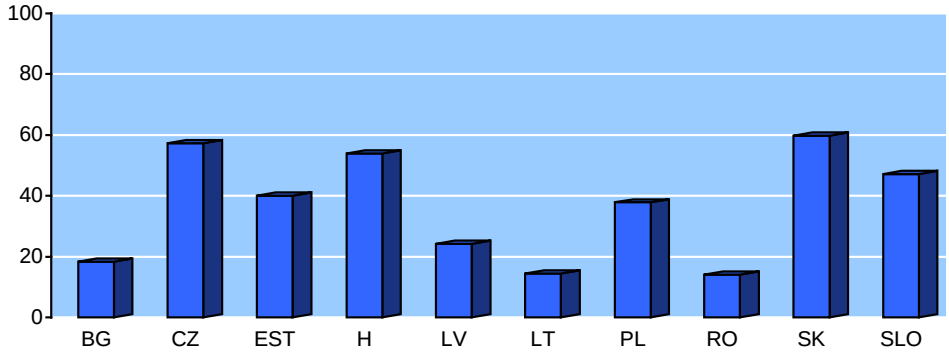
An idea of the size of CEEC banking sector can be offered by further comparisons and characteristics (Bielecki, 2003):

- Total CEEC banking assets are equivalent to those of Portugal
- Total CEEC banks are smaller than Deutsche Bank assets, loans and deposits
- Banking confidence is still low (e.g. 45% of Poles do NOT have a bank account)
- Bank deposits are all well below EU levels

The gap is more evident in the degree of monetisation[8] which is clearly lagging behind the EU standard (Reszat, 2005). On average the monetisation ratio in CEEC region reaches ca. 45 per cent while in the Euro area it stands at almost 1000 per cent (Economic Commission for Europe, 2000). Looking at domestic credit, and even more to the credit to the private sector, which is inadequate, an outstanding difference emerges, as Figure 7 shows (Berglöf and Bolton, 2002).

[8] Monetisation is the ratio of money plus quasi money (M1+M2) over GDP (Morrison, Andrea; *Financial Development and Growth: Evidence from Latin America*, AISSEC, 2001)

Figure 7. Domestic credit provided by CEEC banking sector (% of GDP)



Source: World Development Indicators 2002

Relative to GDP, the CEEC financial system provides only 1/5 of the credit provided by its European analogue. The ratio for credit to the private sector stands at only 37 per cent of GDP, against over 100 per cent in Europe (Gomel, 2002). In the last five years the share of total domestic credit over GDP decreased from 45 to 38 per cent whiles the credit to private sector increased from 19 to 23 per cent. On average the share of private sector credit over total domestic credit has reached 70 per cent (in the Euro area is 10 points higher). Therefore it could be said that credit intermediation towards private clients is showing signs of progress but, even in the more advanced countries, it still quite fragile.

Moreover, the convergence of the lending rates in the Eurozone and CEEC shows some structural breaks. With the introduction of the single currency there is some evidence of an "*emerging uniform Eurozone banking market. This tendency is more pronounced for the corporate lending market, while consumer lending markets are still fragmented*" (Sander and Kleimeier, 2002). Moreover, lending is still very much a localised business. There is also little evidence to support the view that pass-through of interest rate changes resulting from policy changes is uniform or smooth.

4.2. Capital Markets

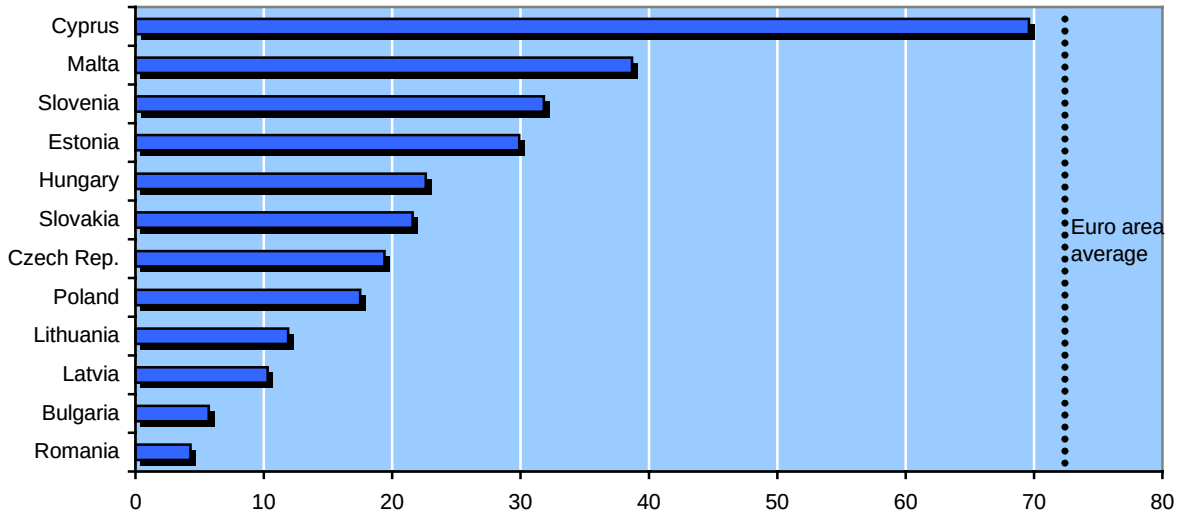
European stock markets have become more integrated over time, as evidenced by the observations that returns in different European markets have become dominated more by EU-wide factors rather than factors specific to the country of that specific market (Hadouvelis et al, 2000). However, the development of domestic capital markets turned to be a difficult issue for most CEECs. Eastern and Central Eastern enterprises and firms got the opportunity to tap increasingly the emerging EU-wide capital markets. Hence exploitation of direct financing opportunities by the larger firms in CEEC is likely to accelerate as the accession date approaches. The process could be accelerated further by the linking of their domestic exchanges, to the emerging euro-exchanges, as has already occurred in a number of cases within the EU.

The stock exchanges in CEEC are relatively small markets and little used as a source of finance. The largest of them, the Warsaw Stock Exchange, has approximately 46% of the capitalisation of the whole region, is comparable in size and market turn around to the smallest Western European Exchange, the Vienna Stock Exchange. Most of the other CEEC stock exchanges belong to the smallest in the world (Schröder and Köke, 2002). For comparison, all CEEC exchanges together amounted 2001 to:

- 0,2% of the world stock market capitalisation
- 9,2% of the German Stock Exchange
- 95,2% of the Athens Stock Exchange

More, the annual turnover of all CEEC stock exchanges together is roughly equivalent to ten days of turnover in the DAX shares at Deutsche Börse. Given the relatively low levels of GDP per capita in these countries, market capitalisation in absolute terms is particularly low, as Figure 8 demonstrates.

Figure 8. CEEC stock market capitalisation (% of GDP)



Source: ECB, International Federation of Stock Exchanges and Accession Countries' National Banks and Stock Exchanges, 2001

As mentioned in previous chapters, most CEEC countries, like in many other cases, went through similar experiences with the domestic stock markets: after an initial rise, the number of listed firms stocks listed on CEEC exchanges has generally declined. As a result an increasing number of domestic firms were looking for cross-listing (here defined to include dual-listing, using depository receipts, or listing only on an international exchange) in international financial centres (Table 4). For comparison: for all emerging markets combined, the ratio of market capitalisation listed abroad to total market capitalisation jumped from only a few percent in 1989 to about 50% currently, with a peak of over 62% in 1999.

Table 4. Degree of migration/cross-listing

	Value (%) traded abroad/domestically	Number of cross-listed firms	Percentage (%) of cross-listed firms
Czech Rep.	11.8	40	36.0
Estonia	84.7	9	44.4
Hungary	14.6	52	74.3
Latvia	0,6	2	12.5
Lithuania	37.3	5	11.4
Poland	62.5	30	28.6
Slovakia	N/A	6	23.1
Slovenia	5.9	2	10.0
Average total	73.9	145	35.4

Source: Corporation of London; *Future of stock exchanges in EU accession countries*, 2003

Although the degree of listing of firms in CEECs on international stock exchanges varies considerably among individual countries, it is on average more extensive than in Latin America and East Asia. In some cases more than two-thirds of stock market capitalisation is listed abroad as well as domestically. Relative to some other regions, internationalisation in the CEECs also occurred earlier. Whereas for most emerging markets, cross-listing really accelerated in the mid-1990s, for CEECs there was considerable cross-listing already in the early 1990s as local markets were being established, followed by some further cross-listing up until 1995/96. This reflects, in part, the transition process of these economies to market economies where many large firms already existed, but which, following the onset of

transition, were being privatised and listed both on local and foreign markets quickly. The dual listings added credibility to the privatisation process, and in that way had positive feedback on the incipient local markets at that time.

Being a region with relatively new stock exchanges, the evidence for Eastern Europe is still limited and sometimes ambiguous. For Polish companies listed on a foreign exchange, turnover on foreign stock exchanges is often smaller than domestic turnover on the Warsaw Stock Exchange. Trading in Polish firms listed in London, for example, generally had little effect on local market turnover. This is consistent with the home market preference found for many developed countries. The modest performance of NEWEX, a special stock exchange with a Central and Eastern European focus, founded jointly by Deutsche Börse and Wiener Börse, also demonstrates how difficult it is to generate foreign trading volume in CEEC stocks (see Box 2 in the annex).

The CEEC stock exchanges are diverse and small, both internationally and domestically. Even the most successful ones face the problem of how to survive after the accession. There are several "*survival options*" (Claessens; Stijn et al., 2003):

- *Self-Survival Strategy*: seek to prosper by themselves by reducing costs and increasing revenues;
- *Linkages*: try to build larger virtual markets by establishing some form of cross-border linkages with other exchanges;
- *Mergers & Acquisitions*: merge with, or be taken over by, one or more other exchanges.

Option 1 is sustainable, although the increase of revenues may be limited. One way to reduce costs is by outsourcing major expenditures. A good example in this sense is the strategic alliance between Tallin and Helsinki Stock Exchanges (see Box 3 in the annex). Option 2 seems to be viable without a merger or acquisition. Costs savings may arise from many different sources (economy of scale, sharing standards, etc.). Potential candidates for an institutional cooperation are the Deutsche Börse, Euronext, HEX, the London Stock Exchange (LSE), and NOREX. However, option 2 is working mostly theoretically. Very few cooperation proposals between exchanges have been implemented and even realised, most of them failed. Reasons are the technological issues as well as governance structures. Option 3 was not very popular in the last time. Though it holds clear advantages of merger over any linkage (irrelevancy of gain distribution, higher credibility, solid and sound cooperation, etc.), there have been only a few mergers and acquisitions between exchanges. An example of a merger is Euronext (see Box 4 in the annex).

As far as the co-operation of stock exchange from CEEC is concerned, the establishment of the CESI group (Central European Stock Exchanges Group) is the only initiative undertaken and realised so far in the region. The main activity of this group is publishing of CESI index of biggest listed companies in the region. CESI is the Central European Stock Index which the Budapest Stock Exchange began publishing on 1 February 1996. The index is composed of blue chip company shares, which are listed on the five stock exchanges of Central European countries: Budapest stock exchange, Bratislava stock exchange, Warsaw stock exchange, Prague stock exchange and Ljubljana stock exchange. Its value is calculated as the price-weighed daily average of official prices of individual shares and encompasses selected Polish (44%), Hungarian (17%), Czech (30%), Slovenian (7%) and Slovakian (2%) equities.[9] The weigh used is the market capitalisation of individual shares expressed in USD equivalent.

[9] Ljubljana Stock Exchange, Trading Information, Indexes

4.3. Bonds and Derivatives Market

Government bonds were the first capital markets to emerge in CEEC. Sales of government bonds directly to the public have resulted in a fairly active government securities market, which is providing a relatively safe and homogenous asset with a range of maturities. The governments thus managed to build up investor's experience with trading financial assets (Table 5) and at the same time, facilitating pricing of longer term instruments (Nieto Carol, 1996).

Table 5. Issues of government bonds in CEEC, 1997 (million USD)

Country	Amount
Bulgaria	28.2
Croatia	483.2
Czech Rep.	236.1
Estonia	48.8
Hungary	409.4
Lithuania	169.3
Poland	380.3
Romania	410.4
Slovenia	232.3
Total	2,395.5

Source: Securities Data Corp., 2000

Nonetheless, the development of the debt financing in CEEC was limited due to the low level of outstanding government securities. The low level of liquidity, which is also relevant for the government bond market represents another important issue. It has also constrained the development of the corporate bond market, where the outstanding volume of corporate bonds is particularly small. CEEC bond markets are equivalent to 5 to 20 percent of GDP; this compares to a figure of approximately 50 percent in the euro zone (Hampel, 2002). In many countries, government bonds are mostly bought and held until maturity with liquid secondary markets existing only in the Czech Republic, Hungary and Poland. In addition, in recent years, foreign currency-denominated bonds have gained significance as spreads on these instruments have fallen considerably against the background of reforms and the prospects of EU accession (Reszat, 2005).

In general, it is fair to say that the commercial paper and corporate bond markets remain underdeveloped, even in the EU member states (Mullineux and Murinde, 2001). The bond market was mostly subject to changes in the structure of issuers. While in earlier years primarily foreign credit institutions were the issuers, in 2002 the volume of their issues shrank, against the background of broadly sound institutional and structural reforms as well as policies well entrenched in the framework of European Union accession. Table 6 illustrates the above said.

Table 6. Debt securities in CEEC and EU member states
Amounts outstanding at the end of December 2000 (EUR millions, nominal value)

CEEC	€	EU	€
PL	47.522	D	2,278.45
H	30.619	GB	1,510.06
CZ	28.579	I	1,465.66
SLO	5.97	NL	685.052
RO	3.691	E	400.534
CY	3.449	S	272.361
M	2.433	DK	261.651
LT	1.639	P	91.212
LV	0.657	IRL	21.784
EST	0.123	GR	15.889

Source: ECB long-term interest rate convergence statistics in EU and CEEC.

The derivative market in CEEC are in their infancy. Currently only Budapest and Warsaw are CEE exchanges that offer derivatives trading, though Prague obtained the permission to organise derivatives trading in August 2001. Both in Hungary and in Poland, futures trading got off to a jump-start after its introduction. However, futures trading in Budapest peaked in 1998 but has declined steadily since then.

The derivative market in Europe became the world's largest exchange, Eurex, following the merger of the German DTB Deutsche Terminbörse and the Swiss Exchange Soffex in the autumn of 1998. It is the world's largest futures and options exchange and accounted for 18% of the world volume, as it traded 365 million contracts in 2000. That year also bore witness to the creation of Euronext, a pan European "one company, three centres" structure merger between Amsterdam Exchanges, Brussels Exchanges and Paris Bourse, which created the first totally integrated cross-border single currency derivatives market. There are also commodity exchanges of a more traditional kind (Santana-Boado, 2000), oriented towards physical trade in these countries, notably the French Rungis market for trade in fruits and vegetables, and the Dutch flower auction in Aalsmeer.

Trade in all emerging futures exchanges and new futures contracts have been quite limited so far. However, the Budapest Commodity Exchange, created in 1989, which trades in grains and livestock, has been quite successful and ranked in 2000 as the world's 37th commodity exchange, whereas the Budapest Stock Exchange was the world's largest 42nd. Other commodity exchanges, not trading futures contracts, have been created since 1990 in Romania, Bulgaria, Ukraine, Lithuania and Estonia. Most of them focus on organising trade for immediate physical delivery. However, in some markets, futures contracts are traded on foreign currencies (euro, dollars, etc) as in the Sibiu Monetary Financial and Commodities Exchange, founded in 1997, and the Romanian Commodities Exchange, opened in 1992, which also trades in grains and oil by-products. In Poland, the Warsaw Commodity Exchange, founded in 1995, deals in futures options in agriculture and currency .

However, due to a relatively small size of the bond and derivatives market in most CEECs and European Union, it is difficult to forecast the degree of their convergence (Mullineux, Andrew and Murinde, 2001).

5. PARTICIPATION IN THE EUROPEAN MONETARY UNION

In 1993, at the Copenhagen European Council, the Member States took a decisive step towards enlargement, agreeing that the associated CEEC countries that so desire shall become members of the European Union. The declaration set political, economic, legal and administrative criteria that need to be fulfilled by the candidate on their path to accession. As stated in Copenhagen, membership requires that the accession candidate

has achieved: stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union; the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.

and has created : the conditions for its integration through the adjustment of its administrative structures, so that European Community legislation transposed into national legislation is implemented effectively through appropriate administrative and judicial structures.[10]

The economic criteria cover a broad spectrum of indicators, among which are:

[10] European Commission, Copenhagen summit conclusions, December 2002

Functioning market economy	Capacity to withstand the competitive pressure and market forces
■ Equilibrium between supply and demand is established by the free interplay of market forces; prices, as well as trade, are liberalised	• A functioning market economy and a sufficient degree of macroeconomic stability, so that economic agents can make decisions in a predictable and stable climate
■ Legal system, including the regulation of property rights, is in place; laws and contracts are enforceable	■ A sufficient amount of human and physical capital, including infrastructure, education and research - at an appropriate cost
■ Macroeconomic stability has been achieved, including adequate price stability and sustainable public finances and external accounts	■ Extent to which government influences competitiveness through trade policy, competition policy, state aids, support for SMEs, etc.
■ Financial sector is sufficiently well developed to channel savings towards productive investment	■ Volume and nature of goods already being traded with Member States
■ Barriers to market entry and market exit are absent	
■ Broad consensus on economic policy principles	

Source: European Commission, 2002

Thus the only condition in these criteria that address the question of monetary regimes is that any entrant into the EU will also make every effort to join the European Monetary Union (EMU) in the medium term (Buiter and Grafe, 2001). The logic behind is that, in signing up to the accession treaty the EU candidates accepted the goal of monetary union as part of the *acquis*. Whether and when the Maastricht criteria are satisfied is a different question.

In the Europe of fifteen this used to be left a significant extent at the discretion of the candidate members. Sweden, for instance, did not have an EMU derogation but has thus far evaded the obligation to join EMU by choosing not to satisfy the exchange rate criterion (Buiter and Grafe, 2001). These rules have changed radically, so that, the future EMU participants are no longer granted an opt-out clause as in case of the current EU members, i.e., those who join the EU are expected to join EMU as well, as soon as the Maastricht criteria are fulfilled (Krawczyk, 2004). The future member states are thus legally forced to introduce the common currency.

The full set of macroeconomic Maastricht criteria for membership in EMU is as follows:

- *Price stability*. Over a period of one year before the examination a country's inflation rate may not exceed the average rate of the three best performing EU member states in terms of price stability by more than 1.5 percentage points
- *Interest-rate convergence: The average long-term interest rate (10Y) must not exceed that of the three EU countries with the best inflation performance by more than two percentage points*
- *Budget deficit: The ratio of general government deficit to GDP must not exceed 3%*
- *Government debt: The ratio of general government debt to GDP must not exceed 60%*
- *Exchange-rate stability: A country must observe the normal fluctuation margins of the ERM II (15% on either side of the central rate against the euro) for at least two years without devaluing*

An important point is that, while the achievement of each of the targets implied by the Maastricht criteria is more or less under the control of the national monetary authority and the national government, the whole set of targets together is not (Buiter and Grafe, 2001). For instance, the targets on (nominal) interest rates and inflation put constraints on real interest

rates; and the target on nominal exchange rates and inflation put restrictions on real exchange rates. Real interest rates cannot be controlled by the national authorities if there is a high degree of international capital mobility, although they may be able to influence national (default) risk premia. The real exchange rate (the relative price of traded to non-traded goods) is affected by fiscal policy and other structural measures, but also depends on how quickly productivity in the traded and non-traded goods sectors rises to Western European levels. This is something the authorities can control only indirectly and imperfectly (EU Enlargement Monitor, 2003). Thus, the likelihood and timing of entry will depend on the degree and speed of convergence of CEEC economies with the existing EU members. Until the former fulfil the convergence criteria and join EMU they will be treated as "*countries with a derogation*" (Hefeker, 2002).

Now the EMU, actually the Stability Pact, itself faces great criticism. What has forced matters to a crisis was the statement made by French and German finance ministers to run a deficit of more than 3%, the third year in succession, following the cut in the government's economic growth estimates (Munchau, 2003). More, Greek revised deficit figures appear to be ballooned and set to reach 5,3 percent of GDP, far above the pact's threshold (Parker, 2004). Silvio Berlusconi, the Italian prime minister, called for a loose interpretation of the rules of the pact. Austria, Netherlands and Finland are among hardline supporters of the stability pact and warned that they would not back any rewriting of the pact. The European Commission made recently a proposal that eurozone governments be given a more flexible timetable for cutting big deficits, according to national circumstance. The ECB President, Jean-Claude Trichet, called "*the so called "national circumstances" very dangerous. We need a fair and equal treatment of all*" (Parker, 2004). So, if the Stability Pact is a game of equals, why some of its players are allowed to slide away from the common rules? More, why without being fined for breaching the rules of the pact? Looking back in the history, the Portuguese were censured under the pact and the others, including the Central and Eastern European countries, have made and are making enormous efforts to comply with it (The Economist, 2003). In the latest clash with the eurozone's political leaders, the ECB rejected the idea floating among EU finance ministers that responsibility for the euro could be shared. "*We have a clear mandate on the euro, responsibility for the stable euro lies in the hands of the ECB governing council. The ECB is an independent body and independence is very highly valued good... It is not the pact itself which has failed. It is the missing will of several governments to fulfil their responsibilities and obligations.*" (Atkins and Schieritz, 2004). It seems, that the ECB's appeals were having an impact. EU finance ministers at their recent meeting (September 2004) in Scheveningen, seemed to have listened to the warning voice.

5.1. Challenges of EU Accession

Following the EU accession in May 2004, the new member countries have joined the exchange rate mechanism of the European Monetary System. Although the first of the new members are unlikely to join EMU before 2007 or 2008, the prospect of joining the euro area is already affecting market expectations, as long-term bond rates are converging to euro area levels. Moreover, the policy environment has also been affected, as macroeconomic policies have to satisfy the Maastricht criteria and to manage large capital inflows at the same time.

What are the advantages of a rapid adoption of the euro in CEEC? The early EMU participation will bring considerable advantages:

- Basically all CEEC countries have relatively small, open economies that are heavily dependent on foreign trade
- On average, almost 60% of their foreign trade is with the euro area. It is therefore to their advantage to eliminate the currency risk in trade with the euro area and reduce transaction costs

- They will also gain from being domestic players in the large, liquid EMU capital market. Interest rates for creditworthy borrowers will be low, particularly for government debt
- Finally, submission to the discipline of the monetary union will strengthen the credibility of the economic and fiscal policies of the CEEC

One major problem in the run-up to EMU is the large budget deficit and, in some countries, relatively high inflation. Although the medium-term goal is to reduce the budget deficits below the Maastricht norm of 3% in two years, entering ERM II with a budget deficit of 5-6% of GDP would put pressure on central banks to keep short-term interest rates higher than in the euro area. Experience shows that this differential would attract short-term capital inflows and could well increase exchange rate volatility. A particular concern is what might happen if the ambitious fiscal deficit reduction strategies were to go off track. Since non-residents are expected to become major buyers of newly issued public debt, given the promise of medium-term sustainability, such an event could lead to a sudden reversal of portfolio capital flows, causing the currency to depreciate sharply.

Another fundamental problem is the inflation criterion. Central banks of CEECs will be asked to pursue monetary policies in such a way as to match the average inflation rate - adjusted for the 1,5 percentage point margin - in the three lowest-inflation countries. As inflation in the UK, Sweden and Denmark, three EU members outside the currency area, is higher than the average eurozone rate and is projected to stay so, the criterion in effect requires CEECs to match the average inflation in three eurozone countries.

To minimise the associated risks, the new EU members might find it advantageous to try to satisfy the Maastricht criteria as soon as they join ERM II. However, the experience of countries such as Italy and Spain in the early 1990s indicates that convergence can prove most difficult when it appears most within reach. Achieving nominal convergence in the next two to three years may thus prove more challenging for policymakers in CEEC than is suggested by the current data (Table 7). This highlights the need for continued prudent macroeconomic policies.

Table 7. Maastricht convergence in CEEC

Criterion	Inflation % 2002	Interest rate 10Y*	Fiscal deficit 2002**	Public debt 2002**	FX rate deviation***
Bulgaria	5,8	6,8	0,2	60,9	-0,4
Czech Rep	1,8	3,8	-4,6	22,4	-5,0
Estonia	3,6	2,9	1,2	5,4	-1,5
Hungary	5,3	6,5	-9,6	50,4	-6,0
Latvia	1,8	7,8	-2,7	13,9	-14,4
Lithuania	0,3	6,4	-2,8	25,0	-5,8
Poland	1,9	5,4	-5,4	48,0	-15,5
Romania	22,5	29,7	-1,7	25,7	-32,7
Slovakia	3,3	5,0	-1,9	32,0	-5,0
Slovenia	7,5	7,2	-1,1	32,2	-5,6
Reference value	3,0	5,5	-3,0	60,0	+/-15%

Source: EU Monitor 3, Deutsche Bank Research, 2003
Notes: * if available, shorter maturities: Bulgaria, Estonia, Latvia, Lithuania, Romania, Slovenia; ** Definitions could differ from those f the EU and of the accession countries; *** Parity here: Average rate of exchange of the last 3 years against EUR

5.2. Exchange Rate Mechanisms

Discussions on optimal dynamics of CEEC inclusion in the eurozone conventionally start from the analysis of exchange rate regimes of these countries. In the process of joining the EU and the euro area their present exchange rate arrangements will at some point in time have to go through some changes before their final adoption of the euro. The sequence and

timing of adaptations of their exchange rate regimes shed some light on the issue of optimal as well as on realistic dynamics of inclusion of CEEC in the eurozone.

There is no uniform trend that could characterise the exchange rate regimes in the CEEC. At present, the latter have very different exchange-rate arrangements, covering practically the whole spectrum from rigidly fixed to free floating exchange rate arrangements (Table 8). This substantiate the view that no single currency regime is right for all countries at all times (Frankel, 2000). The exchange-rate strategies in CEEC differed greatly throughout the transition phase of more than ten years, and they still differ today. At the outset of the transition process in early nineties the CEEC opted for different exchange rate regimes.[11] In line with conventional wisdom at that time, which emphasised the role of the fixed exchange rate as a nominal anchor for macroeconomic stabilisation, majority of CEEC decided for some form of a fixed exchange rate regime. Others, like Slovenia, against conventional wisdom, opted for more flexible solutions, even for a managed floating exchange rate regime. As all exchange rate arrangements basically performed well and fulfilled their main task of stabilising the economy and bringing down inflation rate of the CEEC to the range of single digit figures, one can conclude that no single optimal exchange rate regime exists for CEEC and that their choice of an appropriate exchange rate regime should be tailored according to their specific characteristics and priorities. Their choice of the exchange rate regime therefore reflects the main alternative focuses of their exchange rate policies - bringing down inflation, sustaining balance of payments equilibrium, dealing with large and volatile capital flows, stabilising the real exchange rate etc. Anyway, the view that the optimality of the exchange rate arrangements for the CEEC can not be generalised mirrors in the position of the EU on the current exchange rate arrangements of the CEEC.

Table 8. Exchange rate regimes and capital movement liberalisation

Country	Regime	Target	Band	Anchor	Degree of capital movement liberalisation*
Bulgaria	Currency board	EUR		external	C
Czech Rep.	Management float	EUR		Inflation target	A
Estonia	Currency board	EUR		external	A
Hungary	Crawling peg	EUR	+/- 2,25	external	B
Latvia	Fixed peg	EUR	*/- 1	external	A
Lithuania	Currency board	USD		external	A
Poland	Crawling peg	EUR/USD	*/- 12,5	inflation target	B
Romania	Management float			monetary aggregate	C
Slovakia	Management float			monetary aggregate	C
Slovenia	Management float	EUR		monetary aggregate	C

Source: European Commission, 2001

Note: *Status of capital movement liberalisation:

A Exchange controls removed; B Long/medium term controls removed, short-term controls remain;

C Exchange control still rather comprehensive

Interestingly, there is no clear correspondence between the status of liberalisation and the choice of monetary and/or exchange policy (Ems, 2001). For comparison: both Estonia and Bulgaria have a currency board combined with exchange controls. Latvia is pegging its currency without exchange control, whereas Hungary applies a crawling peg together with control of short-term capital flows. The Czech Republic has a floating currency without exchange controls and Slovenia applies a managed float with exchange control.

[11] Typically, the D-mark has been chosen as an important or even the only anchor currency. In Estonia, the exchange rate was fixed at a parity of 8:1 to the D-mark until the beginning of 1999 when the euro replaced the D-Mark. In Hungary, the basket to which the forint is pegged currently consists of 70 percent euro and 30 percent US-dollars. In Poland, the basket comprises five currencies altogether, with the US-dollar and the euro having the greatest weights. The Czech Republic maintained a fixed central parity to a basket of US-dollar and D-mark between 1990 and spring 1997, and Slovenia has been following a strategy of dirty floating with the D-mark (euro) serving as a reference currency. Institutional convergence and exchange rate targeting have both accompanied and facilitated a substantial re-orientation of trade relations.

As far as the liberalisation of capital movements is concerned one should keep in mind that the EU is requesting an orderly liberalisation of capital movements and not a liberalisation with the greatest possible speed. This leaves the new member states with some lee-way to decide when it is time to abolish the last ramparts of exchange controls. In the run-up to membership all candidate countries have declared that they are prepared to abolish all exchange controls by the date of accession at the latest. Thus the recent financial crises have not led them to apply for a postponement of that commitment. however, the issue remains, whether it would be worthwhile to keep some restrictions in order to guard the domestic economies from undesirable monetary influences from abroad. This issue raises the question on the degree of liberalisation achieved, the CEEC differ in this respect. Estonia, Latvia, Lithuania and the Czech Republic have removed practically all exchange controls. Poland and Hungary maintain restrictions basically only on short-term capital transactions. The remaining countries are less advanced, but all of them have partially liberalised. Still, as members of EU they will all have to apply a regime of free capital movements.

Most of CEEC countries used to press for rapid acceptance as members of EMU. Over the time this has been given way to a more considerate stance. As already pointed out, few years ago, almost all EU-10 countries wanted to join EMU as soon as possible. Over time, most of the countries are reticent with official statements on the matter. But in the Czech Republic, for example, 2009 is now being cited as entry date. The reason for this change of heart is that the countries have to weigh up nominal and real convergence.

The Commission declared that it would rejected any demands to water down the convergence criteria, for instance, or shorten the examination period. The period is two years for the exchange-rate criterion and one year for the other conditions. Two years is in fact a pretty short time in which to establish whether a country can really manage with absolutely fixed exchange rates (Lavrac, 2002). Of the initial EMU members, though, Italy and Finland did not participate in the ERM I for a full 24 months before the convergence test, but only for 15 and 16 months, respectively. Prior to that their currencies had floated more or less freely. If, contrary to expectations, the United Kingdom were to decide in the near future to join EMU, it would no doubt also insist on a much shorter test period in the ERM II. It would then be quite understandable if the CEEC demanded equal treatment. From the economic point of view, a country such as Estonia, which has operated a currency board successfully for over ten years,[12] has already proved it can live with a fixed exchange rate. However, countries should appreciate that the EU does not want to permit any exceptions.

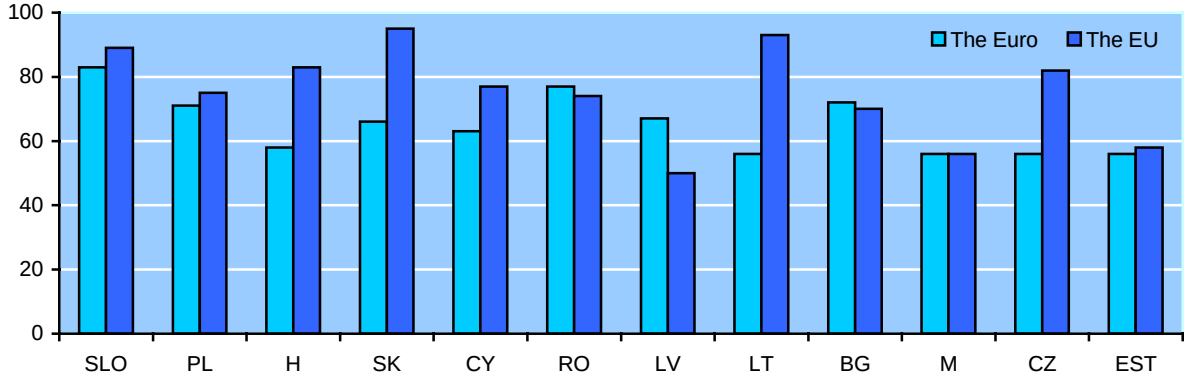
"*The ten new Member States could damage the single currency and themselves if they rush to join the euro. They need to ensure their economic straight before joining the single currency. Decisions to admit the countries to eurozone, already beset by high deficits and internal divisions, would be based on tough economic criteria and the soundness of the economies in the applicant countries would be monitored very closely.*"[13]

Despite all the above said, the support for joining the EU and euro is CEEC is very high (Figure 9). Across the central and eastern Europe, eight candidate countries voted by large majorities in favour of joining the EU. Romania had voted last year the amendments to the constitution, that are meant to ease the way to EU. Bulgaria and Turkey are in queue to come next and all three are as enthusiastic as the most pro-EU of current members, such as Luxembourg, the Netherlands and Ireland.

[12] Estonia has had an absolutely fixed exchange rate initially against the D-mark and since 1999 against the euro

[13] From the interview with Mr. Caio Koch-Weser, chairman of the EU's economic and financial committee published in Financial Times, September 5, 2003

Figure 9. Support for joining the EU and euro in CEEC (%); 2003



Source: Eurobarameter; Reuters. Data based on actual referendum results and latest opinion polls

6. INSTITUTIONAL DEVELOPMENT

Institutional development is of central importance to the proper functioning of financial markets. The existence of an independent central bank, competent supervisory authorities , a regulatory framework and market infrastructure are crucial components for the maturation of financial markets. Many of these elements still need to be developed before the EU accession can proceed as membership presupposes the capacity to withstand competitive pressures from within the Union. In practice, this means CEECs must approximate the regulatory and institutional framework as established by the *acquis*.

Most are advanced in establishing the necessary framework, as far as financial markets are concerned. In this sense, it could be argued that the transition is over (Lannoo, 2000). Clearly, the prospect of near-term membership provided a strong incentive to CEEC to move forward with implementing the *acquis*.

But progress in implementing the *acquis* does, however, not mean that the regulatory framework is functioning. Table 9 has therefore been completed by using EBRD legal regulatory transition ratings on the *effectiveness* and *extensiveness*[14] of legal reforms governing banking and financial markets. The benchmark is thus not only the *acquis*, but also the efficiency of the regulatory framework. For commercial law, extensiveness measures the impact of the jurisdiction's pledge, bankruptcy and company low in commercial transactions. For financial markets, extensiveness assesses whether banking and capital market legal rules approach minimum international standards (IOSCO, Basel Committee).

The legal regulatory transition had improved for the majority of CEEC countries in both commercial law and in financial markets. A greater improvement was achieved in the regulation of capital markets than in the banking sector in 2002. However, in many countries this improvement in capital market perceptions was not enough to offset the general decline in banking rating.

[14] The EBRD has developed measures to assess the extent to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and the degree to which these laws are implemented and enforced (effectiveness). These method can also be used to analyse the perceived role of legal reform in promoting investment and growth in the region.

Table 9. Legal transition indicators: financial regulations

Country	2002			2001		
	overall	extensiveness	effectiveness	overall	extensiveness	effectiveness
Bulgaria	3	3	3	3	3	3
Czech Rep.	3	3+	3	3+	3+	3
Estonia	4-	4	3+	4-	4	3+
Hungary	3+	3+	4-	4-	4-	4-
Latvia	4-	4	4-	3	3	3
Lithuania	3+	4-	3	3+	3+	4-
Poland	3+	4-	3+	3+	4	3
Romania	3+	4-	3	3+	4	3
Slovakia	3-	3	2+	3	3	3
Slovenia	3	3+	3	4-	4	4-

Source: EBRD Transition Report 2002, Annex 2.2.: Legal transition Indicators

With respect to the financial sector and financial regulation in particular, the adaptation of the acquis raises two questions. First, how quickly can the acquis , which reflects the norms of a sophisticated financial sector, be transposed into the relatively underdeveloped financial sectors of the CEEC? Is the Commission flexible to grant, for example, transition periods, or will it require that the acquis be fully in place following the accession? Second, once these norms are put in place, will they inhibit their further development in some way and encourage the further penetration of these markets by well-established financial players? (Lannoo, 2001).

The European Commission had the view that the aspirant countries must be in position to apply the *acquis* and wants the news members to exercise full rights and responsibilities. This does not mean that the *acquis* will play everywhere immediately. Most likely, transitional periods will be used, if appropriate. This was the case in the previous accession negotiations. Examples in this sense are the southern European countries and Finland. Another problem is that the *acquis* is a moving target (Kraft, 2003). New EU legislation or amendments to existing legislation will become *acquis* upon adoption. The Financial Services Action Plan is a the best reference in this case.

Together, the FSAP and the Lamfalussy process (LP) are two invaluable instruments for pushing ahead with EU financial-market integration. They represent a pragmatic approach towards achieving an ambitious objective: a clearly defined set of measures to be implemented along a pre-defined time-table and - in the case of securities-market legislation - by means of a more efficient legislative process.

A significant distance has been travelled since the adoption of the FSAP in 1999. Progress in adopting the legislative measures to timetable has been impressive. All institutions have continuously shown their willingness to implement the complete plan on time. Up to now 39 of the 42 i.e. neally 93% of all original legislative measures have been finalised (European Commission, 2004). This progress has been made possible by a clearly defined objective and timetable, a carefully planned strategy, high quality resources, systematic monitoring, and the goodwill of Member States, the European Parliament and market participants. However, it is too early to make a final evaluation of the extent to which the FSAP has achieved its objectives. Many of the key FSAP measures have only just entered into force; others still need to be written into Member States' national laws (European Commission, 2004). Furthermore, some of the more technical implementing measures of key securities Directives have yet to be adopted.

The new Member States should have implemented from the date of accession all FSAP measures with an implementation deadline before 1 May 2004. Where implementation deadlines of FSAP measures are later than May 2004, deadlines apply to all twenty five Member States alike. To facilitate this process, delegates from the new Member States have been included as observers in EU meetings and committees over the last year and the

Commission has maintained an intensive dialogue with the new Member States, aiming to ensure effective implementation of EU financial services legislation (European Commission, 2004).

With the complete implementation of the Action Plan, the EU will have made a big leap towards the goal of a single European market of financial services, but it is unlikely to arrive there yet. The FSAP does not - and cannot - tackle all of the causes of the fragmentation of the EU's financial market. So, what are the next steps following the successful implementation of FSAP and LP?

After FSAP deadline in 2004, the EU will have to consider the next steps. This does not mean that the EU should rush into a new round of financial-market legislation, disregarding the effects and effectiveness of its past actions. Quite to the contrary, a thorough evaluation of the state of development of the single financial market, the performance of the installed legislative, regulatory and supervisory framework as well as a careful analysis of those areas where market fragmentation continues to inhibit the activities of consumers and companies, including a cost-benefit analysis of legislative and regulatory action in these areas, should necessarily precede any detailed planning of the post-FSAP agenda. In pursuing a thoughtful approach, the EU will nevertheless find it useful to maintain the pace set by the FSAP and use the political momentum it has created (EU Enlargement Monitor, 2003).

The single EU financial market would benefit greatly from an even more coherent approach, and therefore ultimately needs a single regulatory and supervisory authority. Such a European Financial Services Authority (EFSA) requires a strong and autonomous position within the legal order, rooted in the EU Treaty. At present, an EFSA is not on the political agenda, nor would a political majority in support of it be attainable. Still, its establishment requires immediate action today: in the forthcoming revision of the EU Treaty provision needs to be made for the necessary institutions and procedures so as to enable the establishment of an EFSA at a later stage of the unfolding internal market in financial services. The insertion of an enabling clause into the new Treaty for the establishment of an EFSA later on should therefore be an important item on the EU agenda if Europe wants to avoid a major constitutional revision which would otherwise most probably become necessary.

7. CONCLUSIONS

The CEEC have made great progress in the reform of their financial sectors. The difficult process of restructuring the banking sector show its results and continued focus on EU accession had helped with governance, management, efficiency, service provision and overall financial performance. Capital markets emerged with a high level of correlation between stock market development on the one hand, and commitment to both macroeconomic stability and privatisation on the other. Where macroeconomic stability has been undermined and/or privatisation has been slow, bond markets tended to emerge. Most importantly, the CEEC have moved to market-based criteria and requirements as they developed their market infrastructure, which has the added benefit of increasing financial flows by diversifying the range of instruments and increasing the breadth and depth of financial institutional capacity.

Thus, the accession process, painful as it may be in terms of legal, institutional and political adjustments, shows already its beneficial effects. Both the progress achieved (Table 15) and the way that progress is being monitored, by bodies under the Europe Agreement and by the Commission, contribute greatly to the build-up of credibility in the economic systems of Eastern and Central European countries and an increasing trust from the part of the international financial community (Claessens et. al., 1998).

The collective results of the EU and CEEC tests of financial integration are highly illustrative. They show clearly a picture of two groups of countries going on the same road towards yet unattained full financial integration. Compared with the new member states, the old EU members appear so much more advanced towards its goal, but high differences across countries persist in both groups. Nevertheless, the achievements of Central and Eastern European countries can not go unnoticed or unappreciated. The EU and CEEC continue to persevere towards harmonisation and integration on different levels, thus, the success is more luckily to be achieved.

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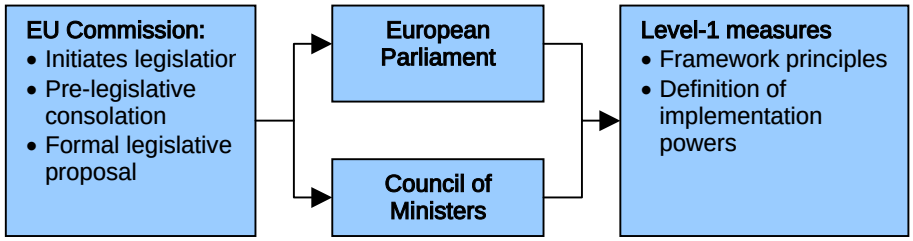
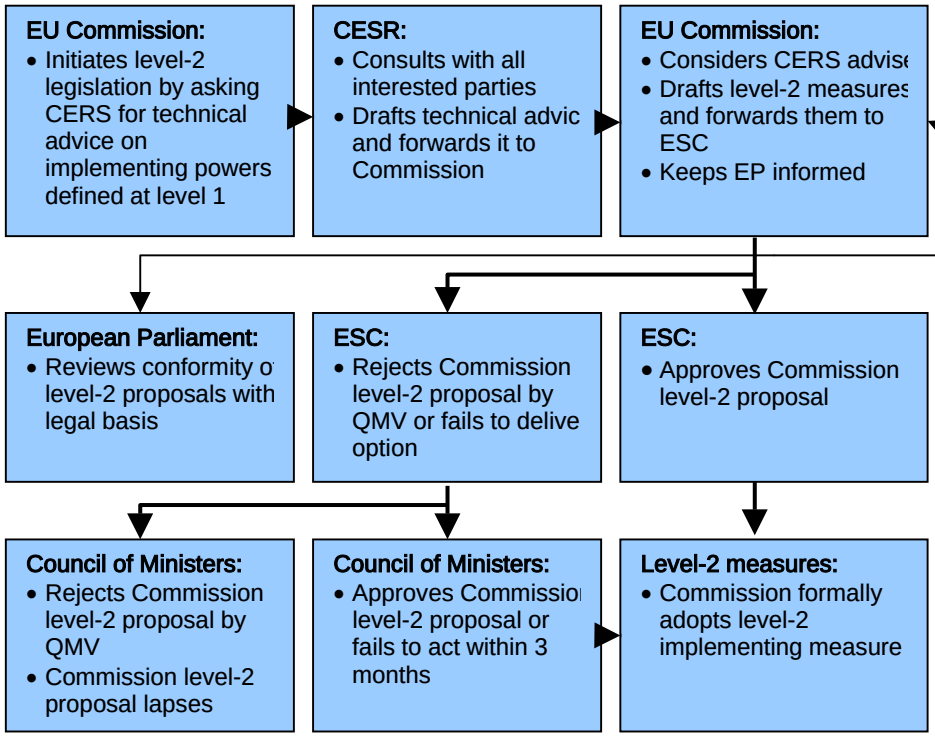
The Lamfalussy process in practice

LEVEL 1: Framework Principles



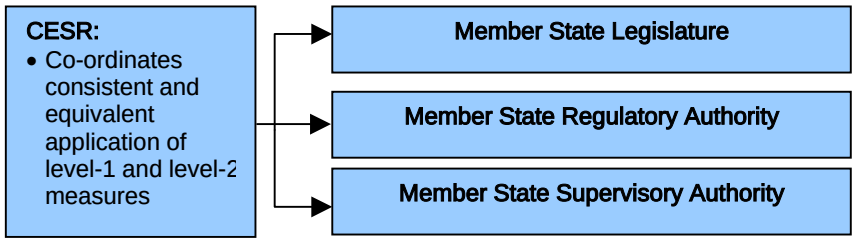
- Level-1 measures designed as framework legal acts
- Adopted by conventional co-decision procedure
- Fast-track: institutions are encouraged to work towards adoption of level-1 measure after first reading in EP
- Level-1 measure contains definition of Commission's powers is enacting level-2 measures
- After adoption by EP and Council, level-1 measures have to be transported into national law by EU member states and applied in regulatory and supervisory practice

LEVEL 2: Implementing Measures



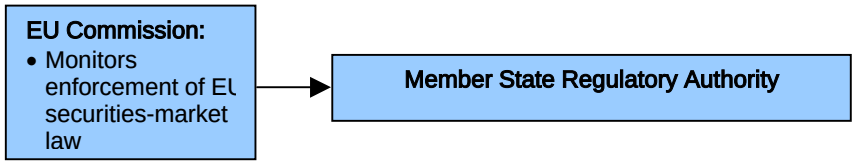
- Level-2 measures designed as implementing measures on the basis of scope defined in level-1 acts. Lelel-2 measures adopted on basis of modified comitology procedure, i.e. so-called Lamfalussy process (LP)
- Commission mandates Committee of European Securities Regulations (CESR) to give technical advice on level-2 measures
- Commission proposes draft level-2 implementing measures
- Commission formally adopts level-2 implementing measures, unless European Securities Committee (ESC) and Council of Ministers reject draft by qualified majority (QMV)
- Commission mandates Committee of European Securities Regulations (CESR) to give technical advice on level-2 measures
- After adoption by Commission, level-2 measures have to be transported into national law by member states and applied in regulatory and supervisory practice

LEVEL 3: Consistent Application of level-1 and level-2 measures



- CESR co-ordinates consistent and equivalent transposition and application of level-1 and level-2 rules by the member states
- CESR's instruments: administrative guidelines, recommendations on joint interpretation, common standards, comparison of regulatory practice, peer reviews
- Level-3 activities apply to EU security-market law irrespective of whether legal acts have been enacted under LP or not

LEVEL 3: Consistent Application of level-1 and level-2 measures



- Commission takes measures to enforce EU securities-market law in case of infringement
- Level-4 activities apply to EU securities-market law irrespective of whether legal acts have been enacted under LP or not

Source: Deutsche Bank Research, EU Monitor No. 4, Financial Market Special, 2003

Classification system for transition indicators: financial regulations

Extensiveness

1 Legal rules concerning banking and securities regulation are perceived as very limited in scope. For example, capital adequacy standards and restrictions on affiliated lending in banking appear non-existent. There may be no functioning stock exchange in this jurisdiction, or the capital markets' legal infrastructure may be in its earliest stage of development.

2 Legal rules governing financial markets are perceived as limited in scope. Although regulations in banking may have been amended to accord with international principles, at least one important area of regulation is perceived as deficient - for example, capital adequacy, use of international accounting standards or use of consolidated comprehensive supervision. Oversight of securities markets appears limited and regulation of securities intermediaries and investment funds, for example, are either non-existent or rudimentary.

3 Legislation for financial markets is perceived as reasonably comprehensive but could benefit from further refinement in some areas. Banking regulations appear generally to conform with the Basel Committee's Core Principles, although regulations concerning bank insolvency and deposit protection may not have been adopted. Further refinement to regulation of securities intermediaries and/or investment funds and creation of shareholder depositories and registers may be needed to achieve conformity with minimum international standards.

4 Comprehensive financial market legislation is perceived as conforming generally with minimum international standards. However, refinement appears to be needed in at least one important area of either banking or securities regulation. For example, many jurisdictions in this category may need to enact rules concerning money laundering or bank insolvency. Legislation concerning shareholder depositories and registries seems to be in its early stages of implementation.

4+ Banking and capital markets legislation and regulation are perceived as comprehensive and conform to minimum international standards.

Effectiveness

1 Legal rules governing financial markets are perceived as usually unclear and often contradictory. The regulatory support of the laws is rudimentary. Supervisory mechanisms seem to be either non-existent or poor. There appear to be no meaningful procedures to make financial laws fully operational.

2 Legal rules are perceived as somewhat unclear and sometimes contradictory. Supervision of financial institutions appears to exist only on an ad hoc basis. There appear to be few, if any, meaningful procedures in place to enforce the law. There may be a lack of adequately trained staff in either banking or capital markets regulatory authorities.

3 Although legal rules governing financial markets are perceived as reasonably clear, regulatory and supervisory support of the law may be inconsistent, creating a degree of uncertainty. Although regulators may have engaged in corrective actions against failing banks and securities market practices, enforcement problems still appear to exist.

4 Legal rules governing financial markets are perceived as readily ascertainable. Banking and securities laws appear to be well-supported administratively and judicially, particularly regarding the efficient functioning of enforcement measures against failing institutions and illegal market practices. For example, the regulator has taken corrective action to liquidate failing banks. Enforcement actions against individuals and securities intermediaries are evident, but might still benefit from more systematic and rigorous enforcement. Courts appear to have adequate authority to review enforcement decisions or other corrective actions for banks and/or securities firms.

4+ Regulators appear to possess comprehensive enforcement powers and exercise authority to take corrective action on a regular basis. Examination of securities intermediaries and licensing of intermediaries seems to be frequent, as is the use of corrective action, such as prosecution for insider dealing, revocation of bank licences and liquidation of insolvent banks.

Overall score

The overall score is the average of the scores given for the two indicators rounded up where the average did not fall exactly into the existing categories. A "+" after a number is used to indicate countries that have just made it to the highest tier of one category and are within a few points of reaching the next category in the scale. A "---" indicates countries that are at the bottom of a category where a significant improvement is required for that jurisdiction to fall more comfortably within the middle range for that category.

Source: EBRD Transition Report 2002, Annex 2.2: Legal transition Indicators

Box 2

NEWEX Stock Exchange

In order to create a more liquid and homogeneous market for CEE stocks, on November 2000, Deutsche Börse AG and Wiener Börse AG jointly founded NEWEX, a stock exchange offering a special trading platform for CEE stocks. Trade initially took place on a slightly adapted version of Deutsche Börse's trading system, XETRA, with an open order book under the supervision of a broker/market-maker. Trades were executed in euros and settlement occurred via Clearstream, the subsidiary of Deutsche Börse. All listed firms had to apply either IAS or US GAAP accounting standards, publish quarterly reports, hold conferences for analysts and accept certain disclosure requirements.

Although approximately 150 stocks were initially traded on NEWEX, trading volume was much lower than expected. Therefore, in 2001 trading in the NEWEX listings was transferred from Vienna to Frankfurt. NEWEX is now a special Deutsche Börse segment for CEE equities.
Several factors are thought to have contributed to the limited success of NEWEX.

First, even after the introduction of NEWEX, the market in CEE stocks remained fragmented. Floor trading of CEE stocks continued at several German exchanges, including Frankfurt and Berlin. Thus, NEWEX was only able to attract a fraction of the total foreign trading volume of CEE stocks. Some Austrian institutional features, such as penalty payments for late delivery, contributed to the migration of volume to the trading floors of German exchanges.

Second, domestic resistance to listings or cross-listings of CEE stocks on NEWEX may have hindered performance. Clearly NEWEX was unable to overcome the opposition by CEE stock exchanges and other CEE institutions to NEWEX listings or cross-listings. There seems to have been less concern from CEE financial institutions about perceived competition from cross-listings of their blue chip firms in London or New York.

Third, the NEWEX members did not include any of the leading investment banks. Also Scandinavian banks did not participate in the market, so the Baltic states were lost as potential constituencies for NEWEX.

Fourth, NEWEX seems to have started with a sub-optimal market microstructure. Technical access was rather complicated. Also, the permanent auction model did not fully exploit the liquidity potential for the biggest stocks. More recently, different trading models have been introduced for different NEWEX segments.

Source: Claessens; Stijn et al.; *The future of stock exchanges in European Union Accession Candidates*, Corporation of London, 2003, pp. 20

Box 3

HEX Stock Exchange

HEX is the Finnish stock exchange group that operates the stock exchange and central securities depository in Finland, Estonia and Latvia. In order to achieve growth and profitability through internationalisation, a key goal of HEX is to be the best place to trade Baltic securities. In order to do this, HEX has pursued a policy of purchasing strategic stakes in the market infrastructure institutions in the Baltic countries. The reasons for the Baltic exchanges joining HEX are illustrated by the Riga Stock Exchange's main objectives, which were to attract a strategic partner or join an alliance, in order to obtain a solid investor base, and to transfer the know-how of an experienced partner to the Latvian market. When the Riga Stock Exchange saw that NOREX was not going to deliver these objectives, it decided to join HEX.

In Estonia, HEX acquired strategic ownership of the Tallinn Stock Exchange (TSE) in April 2001, and now owns 61.6% of the exchange. The Estonian CSD is owned 100% by the TSE. In Latvia, HEX bought 92.98% of the Riga Stock Exchange in August 2002, which in turn is the sole owner of the Latvian Central Depository. HEX has also been in negotiations with the National Stock Exchange of Lithuania.

The Tallinn Stock Exchange and the Riga Stock Exchange still operate independently, but under the brand of HEX. The intention is to provide trading and settlement facilities on a single electronic platform. On February 25, 2002 the TSE and its member firms adopted the trading system of HEX, thus creating a common trading environment for securities listed on the Tallinn and Helsinki exchanges. The official trading currency is the euro, but investors can still pay for transactions in Estonian kroons.

Source: Claessens; Stijn et al.; *The future of stock exchanges in European Union Accession Candidates*, Corporation of London, 2003, pp. 30

EURONEXT

Euronext is the result of a merger which was carried out on September 22, 2000 between Société des Bourses Françaises SA (SBF), Amsterdam Exchanges NV (AEX), and Société de la Bourse de Valeurs Mobilières de Bruxelles SA/Effectenbeursvennootschap van Brussel NV (BXS).

The three stock exchanges became wholly-owned subsidiaries of Euronext NV, a newly created Dutch holding company, and changed their names to Euronext Paris, Euronext Amsterdam and Euronext Brussels. Following the merger, Euronext NV became 60% owned by former SBF shareholders, 32% owned by former AEX shareholders and former holders of participating certificates issued by AEX, and 8% owned by former BXS shareholders.

Although companies remain listed in their original market, all financial instruments are to be traded on a single integrated trading platform, and listing and trading rules will eventually be harmonized, resulting in a single market rulebook. Issuers are subject to supervision and monitoring rules, information obligations and public offer obligations set by the regulators in the country in which they are listed.

Following the merger, the three exchanges retained their separate legal status from a regulatory point of view. Following its creation, Euronext subsequently bought up the London International Financial Futures Exchange, and also merged with the Lisbon Stock

Source: Claessens; Stijn et al.; *The future of stock exchanges in European Union Accession Candidates*, Corporation of London, 2003, pp. 29