The Eurosystem and the EU enlargement process

There are currently 13 countries in central and eastern Europe and in the Mediterranean which are officially recognised as candidates for accession to the European Union (EU), 12 of which have formally started accession negotiations. Most of these are Central and Eastern European countries, as the new wave of enlargement ultimately stems from the dissolution of the Soviet bloc that followed the fall of the Berlin Wall 11 years ago. The majority can also be characterised as small open economies actively engaged in a process of catching up with the EU in terms of both real and nominal convergence. On joining the EU the new Member States will participate in Economic and Monetary Union (EMU) with the status of "countries with a derogation", that is to say with a clear commitment to join the euro area at a later stage. This ultimate step will depend upon their compliance with the convergence criteria required by the Treaty establishing the European Community (the "Treaty").

Even at this stage enlargement has implications for these countries in the monetary field. With a view to their accession to the EU, most of the countries negotiating entry have linked their currencies to the euro, although with varying degrees of closeness and through different unilateral arrangements. Furthermore, they are in the process of modifying or are planning to modify EMU-related legislation to ensure compliance with the requirements of the Treaty.

Against this background, the Eurosystem has a clear interest in establishing relations with accession countries and in being involved, in its areas of exclusive or shared competence, in the process aimed at EU accession and, eventually, at the adoption of the euro. The Eurosystem stands ready to support this process with a view to fulfilling its mandate and commitment to price stability in the euro area in a credible and lasting manner, even after enlargement.

1 Introduction

Relations between the Eurosystem and the countries currently recognised as candidates for accession to the European Union (EU) can be seen within the broader framework of the Union's relations with non-EU countries in Europe, and with Mediterranean and African countries. For each of the different country groupings – the European Economic Area (EEA), central and eastern Europe, the Balkans, the Mediterranean and the African, Caribbean and Pacific (ACP) countries – one or more institutional arrangements with the EU are currently in force. Clearly, accession to the EU is a distinct qualitative leap moving far beyond the traditional instruments of international co-operation.

As stipulated in the Treaty on European Union, European countries may apply to become a member of the EU and, subsequently, of Economic and Monetary Union (EMU). There are currently 13 countries in central and eastern Europe and in the Mediterranean which are officially recognised as candidates for accession to the EU. At present, the following 12 have already started negotiations with the EU: Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, the Slovak Republic and Slovenia. Furthermore, following a decision by the European Council in December 1999, Turkey is now also an official candidate for accession, but the conditions to be fulfilled before the start of negotiations have yet to be met. This article focuses on those 12 countries with which the European Council has decided to start formal negotiations for EU accession (hereinafter referred to as "accession countries").

The forthcoming EU enlargement, which will be the fifth to have taken place, has its ultimate origin in the dissolution of the Soviet bloc that followed the fall of the Berlin Wall. Since then, economic integration and political dialogue between the EU and accession countries have developed considerably. The transition process in which accession countries are currently engaged is a factor of potential growth and stability for the region as a whole. Some significant improvements have already been achieved, albeit in a rather diversified manner. The Eurosystem is monitoring these developments attentively, since accession to the EU ultimately means full participation in EMU.

2 The economic background

The main structural features of the accession countries are highlighted in Table 1. At the end of 1998 the total population of these countries was equal to around 36% of the euro area's population, but their combined GDP only represented about 6% of euro area GDP, with Poland accounting for 40% of this share. In fact, the other accession countries each had a GDP of less than 1% of euro area GDP. Moreover, per capita GDP ranged, depending on the country under consideration, from almost 7% to 61% of euro area per capita GDP. In terms of purchasing power standards, per capita GDP ranged from around 23% to 79% of that of the euro area; in particular, the per capita GDP of Cyprus, Slovenia and the Czech Republic reached levels similar to those of certain EU countries. On the whole, the aforementioned data are symptomatic of the asymmetry between the euro area and the countries currently negotiating EU accession in terms of both economic size and living standards.

Most of these countries are very open to international trade. With the exception of Poland and Romania, the degree of openness – the average of exports and imports of goods and services as a share of GDP – in 1998 was above 40% for all these countries and exceeded 80% in small countries such as Estonia and Malta (see Table 1). These figures are significantly higher than the corresponding figures for euro area countries in 1998. Trade integration is, so far, the most apparent effect of the process of integration with the EU. After COMECON ceased to exist in 1991, most accession countries belonging to this area underwent a major reorientation of their trade. Today only the Baltic states have a substantial share of their trade in Russia and the Commonwealth of

Table 1

Accession countries: structural indicators

(1998)

	Population (millions; annual average)	GDP in ECU (% of euro area GDP)	GDP in purchasing power standards (% of euro area GDP)	Per capita GDP in ECU (% of euro area per capita GDP)	Per capita GDP in purchasing power standards (% of euro area per capita GDP)	Share of industry in GDP 1) (%)	Share of agriculture in GDP 2) (%)	Degree of openness 3)	Exports to euro area (% of total exports)
Bulgaria	8.3	0.2	0.6	6.6	22.8	22.2	18.7	45.7	38.7
Cyprus	0.7	0.1	0.2	60.8	78.8	13.4	4.4	47.3	13.1
Czech Republic	10.3	0.9	2.1	24.3	60.1	32.2	4.2	60.7	58.5
Estonia	1.5	0.1	0.2	16.0	36.4	18.2	5.6	85.3	30.4
Hungary	10.1	0.7	1.7	20.6	47.7	24.9	5.2	45.7	67.7
Latvia	2.4	0.1	0.2	11.6	27.2	21.1	4.1	54.3	27.6
Lithuania	3.7	0.2	0.4	12.9	30.5	21.1	9.1	53.2	27.8
Malta	0.4	0.1	.	40.4	.	.	.	90.7	34.1
Poland	38.7	2.4	4.7	18.1	35.9	24.4	4.2	26.2	58.8
Romania	22.5	0.6	2.1	7.5	27.0	31.7	16.0	29.9	57.7
Slovak Republic	5.4	0.3	0.8	16.8	45.8	26.7	4.4	69.3	52.9
Slovenia	2.0	0.3	0.5	43.9	67.8	28.1	3.4	57.4	61.9

Sources: Eurostat; IMF (exports of goods to the euro area and all data for Malta).

1) *Industry, including energy and excluding construction. Data for Hungary refer to 1997.*

2) *Agriculture, hunting and forestry; fishing and operation of fish hatcheries and fish farms. Data for Hungary refer to 1997.*

3) *Average of exports and imports of goods and services as a share of GDP. Data for Hungary refer to 1997.*

Table 2

Accession countries: macroeconomic indicators

(1997-99; annual percentage changes, unless otherwise indicated)

	Real gross domestic product			Consumer price inflation			General government balance [1] (% of GDP)	
	1997	1998	1999 Jan.-June	1997	1998	1999 Jan.-June	1997	1998
Bulgaria	-7.0	3.5	0.5	1,082.0	22.3	.	-0.3	1.3
Cyprus	2.5	5.0	.	3.6	2.2	1.3	-5.3	.
Czech Republic	0.3	-2.3	-1.8	8.5	10.7	2.7	-2.1	-2.4
Estonia	10.6	4.0	-3.9	11.2	10.5	4.0	2.6	-0.2
Hungary	4.6	4.9	3.5	18.3	14.3	9.3	-5.4	-7.1
Latvia	8.6	3.6	-2.0	8.4	4.7	2.1	1.8	0.1
Lithuania	7.3	5.1	-4.8	8.9	5.1	1.2	-0.7	-3.4
Malta	4.9	4.1	.	3.1	2.4	1.6	-9.8	-11.1
Poland	6.8	5.0	2.3	14.9	11.8	6.1	-2.6	-2.1
Romania	-6.9	-7.3	-3.9	161.7	59.1	39.5	-4.4	.
Slovak Republic	6.5	4.4	2.4	6.1	6.7	6.9	-3.6	-4.8
Slovenia	4.6	3.9	4.5	8.4	7.9	4.9	-1.5	-0.8

Sources: Eurostat, except 1999 inflation for Cyprus (IMF) and all data for Malta (IMF and national sources).
1) Cyprus excludes local government.

Independent States (CIS). As a result of trade integration with western Europe, countries such as the Czech Republic, Hungary, Poland, Romania, the Slovak Republic and Slovenia placed around 50% to 70% of their total exports in the euro area in 1998.

Most accession countries have made significant progress towards macroeconomic stability. In particular, substantial decreases in the rate of inflation over the past three years have been achieved, with inflation falling below 5% in a number of countries (see Table 2). This mirrors the growing importance of price stability as a statutory objective of accession countries' central banks (see Table 3). On the other hand, this process has occurred in a period of crisis in the international financial system. The Russian crisis played a particularly relevant role in this context and might partially explain the deterioration in growth performance in the first half of 1999. However, there is some evidence that growth has recovered since then. Although final data for 1999 on the general government balance are not yet available, there are indications that deficits deteriorated compared with the 1998 figures shown in Table 2. In order to bring fiscal deficits closer in line with euro area standards, a continued effort is required on the part of most accession countries.

There are both real and nominal aspects of the economic convergence of accession countries; these are strategic elements that need to be pursued in parallel on the path towards sustainable economic growth and stability.

The need for real convergence implies, especially for central and eastern Europe, the completion of the process of economic transition towards competitive, market-based economies. Structural reforms – for instance privatisation, enhancing the legal and institutional framework to enable the functioning of a market economy, strengthening the banking system and developing domestic financial markets – are necessary to allocate capital and human resources more efficiently and to foster the development of the private sector. While this process is likely to take a long time, it will be accelerated by progress in integration with the EU. Moreover, the removal of inefficiencies is likely to attract further foreign direct and portfolio investment, feeding the virtuous circle between regional integration and real convergence.

Table 3

Monetary and exchange rate policies of accession countries

	Monetary policy
Countries	Statutory objectives *
Bulgaria	"The main task of the Bulgarian National Bank shall be to contribute to the maintenance of the stability of the national currency through implementation of the monetary and credit policy as provided for by this Law, and to assist in the establishment and functioning of efficient payment mechanisms."
Cyprus	"The main purpose of the Bank is to foster monetary stability and such credit and balance of payment conditions which are conducive to the orderly development of the economy of the Republic."
Czech Republic	"The primary objective of the Czech National Bank is to ensure the stability of the Czech national currency."
Estonia	"The main goals of the Bank of Estonia are: 1. Maintaining and ensuring the value of the Estonian kroon in fulfilling all the functions of money. 2. Improving the safety and stability of the Estonian banking system. 3. Furthering the efficiency and development of the Estonian financial system, particularly the payment and settlement systems. 4. Meeting the cash demand of the public."
Hungary	"The basic task of the National Bank of Hungary is to safeguard the domestic and external purchasing power of the national currency. The National Bank of Hungary supports the implementation of the economic policy programme of the government with monetary policy (money and credit policy) means available to it."
Latvia	"The main objective of the Bank of Latvia shall be to implement monetary policy by controlling the amount of money in circulation with the aim to maintain price stability in the State. The Bank of Latvia shall facilitate free competition, effective allocation and circulation of assets, and the stability, coordination and supervision of the financial system."
Lithuania	"The principal objective of the Bank of Lithuania shall be to achieve stability of currency of the Republic of Lithuania. Implementing the principal objective, the Bank of Lithuania must: 1. ensure the reliable functioning of the currency market and the system of credit and settlements; and 2. support the economic policy carried out by the Government of the Republic of Lithuania, provided said policy is in compliance with the principal objective of the Bank."
Malta	"It shall be the function of the Bank [inter alia] to maintain external reserves as to safeguard the international value of the currency; to influence the volume and conditions of supply of credit so as to promote the orderly and balanced economic development of Malta and a rising level of employment and income consistent with the maintenance of monetary stability in Malta and the external value of the currency; to promote a sound financial structure and to foster an orderly capital market in Malta."
Poland	"The basic objective of NBP (National Bank of Poland) activity shall be to maintain price stability, and it shall at the same time act in support of Government economic policies, insofar as this does not constrain pursuit of the basic objective of the NBP."
Romania	"The main objective of the National Bank of Romania is to ensure the stability of the national currency, for the overall purpose of price stability."
Slovak Republic	"The primary task of the National Bank of Slovakia shall be to ensure the stability of the Slovak currency."
Slovenia	"Bank of Slovenia shall take care of the stability of domestic currency and of general liquidity of payments within the country and with foreign countries."

* *Sources: Direct quotations from the central banks' acts, in the English translations prepared by the central banks themselves.*

Exchange rate regime		
Features	**Remarks**	**Countries**
Currency board, pegged to the euro/Deutsche Mark.	Formally introduced on 1 July 1997. National legislation provides that the euro will replace the Deutsche Mark upon the introduction of the euro banknotes in 2002 at the latest.	**Bulgaria**
Pegged to the euro, with a ±2.25% fluctuation band.	The Cypriot pound was pegged to the ECU between June 1992 and December 1998. It has been pegged to the euro since 1 January 1999 with the same central parity as was previously adopted for the ECU.	**Cyprus**
Managed floating (the euro is used informally as a reference currency).	In May 1997 the peg, with a ±7.5% fluctuation band, to a currency basket (Deutsche Mark (65%) and US dollar (35%)) which had been introduced in February 1996 was abandoned; the peg to a currency basket had been introduced in 1991.	**Czech Republic**
Currency board, pegged to the euro/Deutsche Mark.	Introduced in June 1992.	**Estonia**
Crawling fluctuation band, pegged to the euro. ±2.25% pre-announced crawling fluctuation band, currently with a 0.4% monthly depreciation rate.	Introduced in March 1995. The monthly rate of depreciation of the central rate and accordingly that of the crawling fluctuation band have been frequently reduced over time.	**Hungary**
Pegged to the special drawing right.	De facto peg to the special drawing right since February 1994, formalised in 1997.	**Latvia**
Currency board, pegged to the US dollar.	Introduced in April 1994. The Bank of Lithuania has announced its intention to re-peg the litas to the euro in the second half of 2001.	**Lithuania**
Pegged to a currency basket: euro (56.8%), US dollar (21.6%), pound sterling (21.6%). ±0.25% fluctuation band.	Currency basket peg in effect since 1971. The euro was substituted for the ECU, with effect from 1 January 1999.	**Malta**
Crawling fluctuation band, against a currency basket: US dollar (45%), euro (55%). ±15% pre-announced crawling fluctuation band currently with a 0.3% monthly depreciation rate.	The currency basket peg was introduced in May 1991, with the basket weights remaining unchanged until 31 December 1998 (US dollar 45%, Deutsche Mark 35%, pound sterling 10%, Swiss franc 5%, French franc 5%). The crawling band around the peg was introduced in May 1995. The rate of the crawl has since been gradually reduced and the band has widened. Since 1 January 1999 the basket has comprised only the euro and the US dollar.	**Poland**
Managed floating (the euro is used informally as a reference currency).	Since August 1992. In recent months the exchange rate has become the prevailing anchor for monetary policy. A change of strategy has not, however, been announced.	**Romania**
Managed floating (the euro is used informally as a reference currency).	Between 14 July 1994 and 1 October 1998 the Slovak crown was pegged to a basket of two currencies (60% Deutsche Mark and 40% US dollar). In 1996 the fluctuation band was widened from ±1.5% to ±7%. On 2 October 1998 the system of pegging was abolished and replaced by managed floating; on 1 January 1999 the Deutsche Mark was replaced by the euro as a reference currency.	**Slovak Republic**
Managed floating (the euro is used informally as a reference currency).	Since 1992 the exchange rate has remained within an unannounced narrow band against the Deutsche Mark (the euro since 1 January 1999).	**Slovenia**

Even though the fulfilment of the "Maastricht convergence criteria" (including price stability, the sustainability of public finance, exchange rate stability in the framework of participation in the exchange rate mechanism and the convergence of interest rates) is not mandatory for EU accession, accession countries should have macroeconomic programmes consistent with those prevailing in the euro area in their medium-term policy agenda. In particular, it should be highlighted that price stability has a positive impact on real economic performance, especially on output and employment prospects. It does so by increasing the transparency of the relative price mechanism, which is a precondition for the efficient allocation of resources by markets; by avoiding large and arbitrary redistribution of wealth and income; and by reducing uncertainty, which will be reflected in an overall reduction in long-term interest rates.

As detailed in Table 3, monetary policies and exchange rate regimes adopted by accession countries are very different, with exchange rate arrangements ranging from tightly fixed to flexible ones. Currency board arrangements are in place in three countries, implying a fixed peg to the euro/Deutsche Mark in Bulgaria and Estonia, and to the US dollar in Lithuania. Other countries are operating fixed pegs (Latvia to the special drawing right (SDR)), crawling fluctuation bands of different widths (Hungary to the euro, Poland to a currency basket) or adjustable pegs (Cyprus to the euro, Malta to a currency basket). Both Malta and Poland assign a weight higher than 50% to the euro in their currency baskets. The Czech Republic, Romania, the Slovak Republic and Slovenia have adopted a system of managed floating with the euro unofficially used as the reference currency.

Irrespective of the particular exchange rate arrangement chosen by any of these countries, the aim should be to ensure a stable economic environment, inter alia, by avoiding real exchange rate misalignments and excessive nominal exchange rate fluctuation. In these countries, exchange rate and monetary policies also have to cope with the challenges presented by factors related to the catching-up process, such as large foreign direct investment inflows due to, inter alia, large-scale privatisation programmes and the potential for real appreciation owing to productivity gains. As the exchange rate vis-à-vis the euro generally plays a fundamental role for these countries, the faster the process of integration moves towards a single market and economic convergence with the EU/euro area, the stronger the case for the stability of the nominal exchange rates vis-à-vis the euro will become.

3 The institutional background

While the Copenhagen European Council in June 1993 marked the political start of the current enlargement process, by approving the principle of enlargement and defining the criteria for membership (the "Copenhagen criteria", which are further described in Box 1), the Luxembourg European Council in December 1997 marked the start of the process more formally by broadly endorsing the strategy for enlargement presented in the Agenda 2000 (a document detailing the need to reform EU policies in order to prepare for enlargement). Following that decision, negotiations were launched on 30 March 1998 with six of the then 11 accession countries, namely Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia. The same Council requested that the other five countries, Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic, make further progress towards satisfying the conditions for launching accession negotiations. More recently, the enlargement process was given additional impetus at the Helsinki European Council on 10 and 11 December 1999. On that occasion it was decided to launch accession negotiations in February 2000 with the five remaining countries and Malta, which

Box 1

The Copenhagen criteria

The overall criteria which applicant countries should meet as a prerequisite for becoming members of the European Union (EU) were defined in general terms by the Copenhagen European Council in June 1993. The "Copenhagen criteria" require:

- "the stability of institutions guaranteeing democracy, the rule of law, human rights, and the 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 EU"; and
- "the ability to take on the obligations of membership, including adherence to the aims of political unification, as well as Economic and Monetary Union (EMU)".

joined the list of accession countries in February 1999.

On their way towards EU membership, all 12 countries are benefiting from a pre-accession strategy which was formulated at the Community level and which consists of the treaties of association (the "Europe Agreements"), as well as pre-accession aid through the Phare programme and a set of co-operative arrangements (the "Accession Partnerships"). Within that framework, key provisions of the EU legal system already apply to the accession countries in some areas (e.g. extensive trade liberalisation and competition rules). The Accession Partnerships also constitute a forum within which the European Commission and the governments of the individual accession countries jointly carry out assessments of medium-term economic policy priorities.

Also in Helsinki, a political commitment was made to carry out the necessary institutional reforms to ensure that the EU would be in a position to accept new Member States as from the end of 2002. To this end, an Intergovernmental Conference aimed at resolving the institutional issues "left over" by the Treaty of Amsterdam has been convened and is expected to produce a new Treaty by the end of this year, designing the new European Union which accession countries will ultimately join. These institutional issues refer to the "size and composition of the European Commission; the weighting of votes in the EU Council and the possible extension of qualified majority voting in the Council; as well as to any other amendment to the Treaties arising as regards the European institutions" in connection with the implementation of the Treaty of Amsterdam (Presidency conclusions of the Helsinki European Council). An "efficient and credible enlargement process" remains a priority, as confirmed in Helsinki and recently reiterated by the Portuguese EU Presidency.

There is no exact timetable for the accession of new Member States, nor will the timetable need to be the same for each of them. Some candidate countries have indicated that they intend to be ready from a technical point of view in 2002 or 2003. Negotiations are carried out separately by the EU with each of the 12 accession countries and will be finalised by means of individual accession agreements which may contain transitional arrangements. The ratification of the individual accession agreements by the relevant accession country and by the current 15 EU Member States will need to be concluded before the respective accession country becomes de jure a member of the EU.

In the monetary field it has already been decided that no "opt-out" clauses, such as those negotiated by the United Kingdom and Denmark, shall be granted to new Member States, thus implying that, when joining the EU, new Member States will be committed to finally adopting the euro. However, they will not be expected to transfer their monetary sovereignty upon accession to the EU, but instead to participate in EMU with the status of Member States with a derogation. Nonetheless, they will still have to prepare themselves for full participation in EMU. Upon accession to the EU, the respective central banks will consequently be integrated into the European System of Central Banks (ESCB).

Meeting the Maastricht convergence criteria does not constitute a prerequisite for joining the EU. In the Copenhagen criteria, reference is only made to the ability of applicant countries to adhere to the aims of EMU – rather than to their fulfilment of the criteria for adopting the euro – at the time of accession. Indeed, progress towards adopting the euro is part of a continuum encompassing three stages: pre-accession to the EU, EMU membership with a derogation and full EMU membership. There are thus two different steps to the accession process: EU accession and final adoption of the euro. As is also the case for EU accession, there is no preset timetable for the final adoption of the euro and countries need not enter the euro area at the same time. The Treaty only foresees an assessment of convergence at least once every two years, or at the request of a Member State with a derogation.

Upon their entry into the EU, new Member States will have to "treat (…) exchange rate policy as a matter of common interest" (Article 124 of the Treaty, ex Article 109m). In their progress towards adopting the euro they are expected to participate in the exchange rate mechanism (ERM II), the features of which should allow sufficient flexibility for accession countries to reconcile price and exchange rate stability with the structural evolution of their economies, thereby accommodating their different needs. Throughout this process, the Eurosystem will act in accordance with its statutory objective of maintaining price stability in the euro area.

Furthermore, the new Member States shall "regard their economic policies as a matter of common concern" (Article 99 of the Treaty, ex Article 103) and will also take part in the EU policy co-ordination and surveillance procedures under the same conditions as current Member States with a derogation. This relates in particular to the relevant provisions of the excessive deficit procedure and the Stability and Growth Pact.

The aforementioned mechanisms should assist the new Member States in pursuing the stability-oriented policies necessary to foster economic convergence and properly integrate their economies into that of the euro area, with the ultimate aim of becoming full participants in EMU and joining the euro area once the Maastricht criteria have been met. Once a new Member State has adopted the euro, the central bank concerned will become a component of the Eurosystem.

4 The Eurosystem and the EU accession process

The Eurosystem stands ready to support the process of economic and monetary integration between accession countries and the euro area, based on the principles outlined in the Treaty. The progress of economic integration between accession countries and the euro area, the increasing links to the euro in the pre-accession exchange rate strategies, and the fact that, with EU accession, these countries will be committed to the final adoption of the euro, all illustrate the need for the Eurosystem to follow the accession process closely. Moreover, in order to fulfil the statutory mandate of price stability in an enlarged euro area, it is in the Eurosystem's best interest, even at this stage, to encourage current policies to be oriented towards stability and economic convergence in accession countries.

The Eurosystem is not formally involved in the negotiations on accession. However, it will be involved in such a way as to ensure that its views, when the issues in question relate to its areas of competence, are properly taken into account. This concerns, in particular, the adoption and the implementation of the EMU-related *acquis communautaire*, which will provide new Member States with the necessary background to pursue stability-oriented policies.

The implementation of the EMU-related *acquis communautaire*

From the perspective of the Eurosystem, the compliance and implementation of the EMU-related *acquis communautaire* are essential for establishing the appropriate conditions for stability-oriented monetary policies, sound banking systems and smoothly functioning market economies. In particular, this relates to the following three areas:

– legislation on *central banks*, to ensure that they are compatible with the independence of the ESCB and all the other requirements arising from the Treaty and from the Statute of the ESCB;

– legislation on *capital movements*; and

– legislation relating to the creation of conditions for *sound banking systems and financial stability*.

With the exception of the first of these areas, for which it will be possible to adopt some aspects of the legislation on joining the euro area, new Member States will have to comply, at the time of EU accession, with all requirements outlined in the *acquis communautaire* – unless transitional arrangements are made during the negotiations.

With regard to legislation on *central banks,* all features of central banks' independence should be effective at the time of accession to the EU, in accordance with Article 109 (ex Article 108) of the Treaty. This requirement implies that accession countries will have to take on the legal features of institutional, personal and financial independence, as laid down in the Treaty and in the Statute of the ESCB and as further elaborated by the European Monetary Institute (EMI) in its Convergence Report ("Report required by Article 109j of the Treaty establishing the European Community", March 1998). Furthermore, in order to enhance functional independence, central banks' statutory objectives ought to be brought into line with the primary objective of maintaining price stability, as laid down in the Treaty. These legal adjustments do not require full harmonisation, but they do imply that the relevant national legislation needs to be made compatible with the Treaty and with the Statute of the ESCB.

Moreover, a number of provisions contained in the Treaty will be directly applicable to the new Member States upon accession to the EU. For instance, this is the case for the provisions concerning the independence of the central banks, such as the prohibition of monetary financing of the public sector (Article 101 of the Treaty, ex Article 104) and that of privileged access by the public sector to financial institutions (Article 102 of the Treaty, ex Article 104a).

As a second important step, at the latest before the adoption of the euro, the statutes of accession countries' central banks will have to be adapted in order to provide for smooth integration into the Eurosystem. In particular, measures need to be taken to ensure that the national central banks (NCBs) execute tasks as members of the Eurosystem and in accordance with the decisions of the ECB. The main areas for attention are those where statutory provisions may prevent an NCB from complying with the requirements of the Eurosystem, as well as those where statutory provisions do not respect the prerogatives of the ECB.

As part of the implementation of the EMU-related *acquis communautaire*, other legislation in the monetary field with a potential impact on the Eurosystem's operations will also have to be adopted in time for participation in the euro area, taking particular account of the long lead times involved. The monetary authorities of new Member States will, therefore, need to pay close attention to these provisions, which will directly or indirectly impinge on the conduct of the Eurosystem's monetary policy operations. Therefore, new Member States' central banks will have to take into account relevant legal instruments brought into effect by the Eurosystem since its establishment, and the overall civil and commercial law of their countries will have to be adjusted accordingly. The soundness of legislation on pledges and repurchase agreements, for instance, will have a bearing on the use of collateral. Finally, other financial regulations in the area of payment systems, securities settlement systems and stock exchanges will also need to be taken into account.

With regard to the second area mentioned above, *capital movements*, accession countries will have to liberalise capital flows before EU accession. This is important not only because free movement of capital is an integral part of both the internal market and EMU, but also because it constitutes one of the components which reflect the accession countries' ability to cope with competitive pressures and market forces within the EU.

As for the third area, the creation of conditions for *sound banking systems and financial stability*, accession countries will need to implement the EU Directives in the banking and financial area before EU accession. These involve, in particular, the need for appropriate legislation on capital adequacy, insolvency, the adoption of accounting standards, effective prudential supervision, settlement finality and the avoidance of moral hazard problems.

The Eurosystem's dialogue with accession countries' central banks

In order to engage, within its areas of competence, in a fruitful dialogue with accession countries' central banks, the Eurosystem has intensified its bilateral relations and is also developing a framework for multilateral relations with these institutions. As a first step, a seminar at a high policy level was held in Helsinki on 11 and 12 November 1999, which was jointly organised by the ECB and Suomen Pankki, the Finnish national central bank. It brought together representatives of the Eurosystem and governors and deputy governors of the 12 accession countries' central banks, with the objective of addressing central banking issues related to the accession process in order to identify the main areas where co-operation could be enhanced in the future. The main conclusions that emerged from the Helsinki seminar are highlighted in Box 2.

Since the Helsinki seminar, multilateral meetings have taken place with experts from a number of areas, in particular statistics and legal services. These meetings will gradually be extended to all central banking areas and develop into a regular activity.

Accession countries' central banks are already benefiting from different kinds of professional co-operation and technical assistance in a large number of areas. However, with regard to EU accession and the eventual adoption of the euro, a significant amount of additional preparatory work will be required in order to integrate the central banks of the accession countries into the ESCB and – later on – into the Eurosystem. The catalogue of issues to be addressed is, indeed, a substantial one. The areas involved include the adoption and implementation of the *acquis communautaire* (in particular, the adaptation of central bank statutes and other legal instruments), the enhancement of payment and securities settlement systems, the preparation of the necessary statistical requirements, the technical adaptation required to connect the central banks to the IT infrastructure of the

Box 2

Main conclusions emerging from the Helsinki seminar

- Central banks have a crucial interest in the timely adoption and implementation of the *acquis communautaire* in their fields of competence. Although they are not directly involved in accession negotiations, they will closely follow the process and express their views. This relates especially to the independent status of central banks and other legislation in the monetary field, as well as to the banking sector and financial market.

- **Nominal and real convergence** should be pursued in parallel. By modifying their economic structures in line with those prevailing within the EU and by implementing appropriate structural reforms, accession countries will speed up the process of "catching up", whereby their living standards will progressively move towards levels closer to those of the EU (real convergence). Historical experience shows that this process should go hand in hand with price stability and sound public finances (nominal convergence). Progress towards fulfilling the Maastricht criteria as a condition for the adoption of the euro is, therefore, fully compatible with structural reforms.

- Accession countries therefore need to continue to implement monetary policies geared towards achieving and maintaining **price stability**, and to support this process with prudent fiscal policies and adequate structural reforms.

- No common path should be prescribed for all accession countries with regard to the orientation of their **exchange rate policies** prior to accession, the inclusion of their currencies in ERM II or the later adoption of the euro. Against the background of different starting-points for the economic reform process and the difficulty of ascertaining the lead time for further headway towards nominal and real convergence, a plurality of approaches should be feasible without compromising the equality of treatment.

- The smooth functioning of banking and financial markets is of utmost importance for successful integration of the accession countries, first, into the Single Market, and, at a later stage, into the euro area. Compared with developments in the euro area in recent years, the **financial sector** in accession countries has been characterised by intense restructuring (mergers, acquisitions and privatisation). Central banks will make an important contribution to ensuring that such developments occur within a general framework of stability.

Eurosystem, work to ensure full compliance with the Eurosystem's accounting and reporting framework, as well as activities in the area of banknote production, the post-issuance handling of euro banknotes and efforts to combat counterfeiting.

The provision of technical assistance will require substantial resources and adequate co-ordination within the Eurosystem. This will present a significant challenge to the Eurosystem, requiring adequate planning and the necessary instruments to address a number of objectives. First, these instruments will have to draw on the expertise and resources of the different components of the Eurosystem, notably the NCBs, which have already been active in this field for some time. Second, they will have to ensure that all accession countries receive the necessary support. Finally, they will have to guarantee a consistent approach, not only in terms of the treatment of the accession countries' central banks, but also within the Eurosystem.

The Eurosystem, under the co-ordination of the ECB, will provide accession countries' central banks with the required technical assistance in the above-mentioned areas. More generally, the aim will be to develop a close and fruitful professional working relationship in areas of common interest for the central banking community.

Box 3

The General Council of the ECB

As stated in Article 45 of the Statute of the ESCB, the General Council "shall be constituted as a third decision-making body of the ECB".

Composition: the General Council comprises the President and the Vice-President of the ECB and the governors of all the Member States' national central banks (including, therefore, the four current non-participating countries). The other members of the Executive Board may participate, without having the right to vote, in the meetings.

Responsibilities: the General Council performs the "transitional tasks", namely those tasks of the European Monetary Institute (EMI) which, because of the derogation of one or more Member States, still have to be performed in Stage Three of EMU. These tasks mainly include the strengthening of the co-operation between the ECB and the national central banks of Member States with a derogation, the monitoring of the functioning of the exchange rate mechanism, and the regular consultations concerning the course of monetary policies.

Moreover, the General Council gives advice on the preparations for the abrogation of the derogation and, when a decision is taken by the EU Council that a Member State with a derogation fulfils the necessary conditions for the adoption of the euro, it contributes to the necessary preparations for irrevocably fixing the exchange rate of the currency of this Member State vis-à-vis the euro.

Finally, the General Council contributes to a number of advisory functions (for instance, those related to acts proposed by Community institutions or national authorities in the fields of ECB competence, including prudential supervision) and other activities (including the collection of statistical information and the reporting activities of the ECB).

Upon EU accession, accession countries' central banks will become members of the ESCB and their respective governors will join the General Council of the ECB, the decision-making body responsible for carrying out the tasks related to the central banks of Member States with a derogation (see Box 3 for the composition and responsibilities of the General Council). The General Council will become, from that point onwards, the primary forum for co-operation between the Eurosystem and the central banks of the new Member States.

5 Concluding remarks

As can be seen from the increase in trade interdependence, the economic links of the 12 accession countries with the EU are intensifying. This development is lending substance, from an economic point of view, to the enlargement process itself. This process, which consists of three different stages (namely pre-accession, participation in EMU as a "country with a derogation", and full participation in EMU), forms a *continuum* which is already conditioning the medium-term policy framework of these countries.

The Eurosystem has a major interest in the monetary aspects of the EU enlargement process. While the Eurosystem is not officially party to the accession negotiations, it will need to be involved in such a way as to ensure that its views – in its areas of competence – are properly taken into account.

The Eurosystem attributes particular importance to the adoption and implementation of the necessary provisions to ensure compliance with the EMU-related *acquis communautaire*. Prior to entry into the EU, central banks need to be made independent, capital movements liberalised and legislation adapted to guarantee the necessary conditions for sound banking systems and financial stability.

Upon entry into the EU, the central banks of the new Member States will join the ESCB and their governors will become members of the General Council of the ECB. The General Council will therefore play a key role in the co-operation between the Eurosystem and the new Member States' central banks.

Before this point is reached, i.e. in the pre-accession stage, the Eurosystem will increase its co-operation with accession countries' central banks, with a view to extending it to all relevant central banking areas and to assisting them in their preparations for integration into the ESCB and, later, into the Eurosystem itself.