THE ENLARGEMENT OF EUROPEAN UNION AND THE ROMANIAN CAPITAL MARKET

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I. Introduction

At this relatively early stage in the development of financial markets in the accession countries, it seems more appropriate to refer to the financial sector rather than the capital market, since the latter is not yet very well developed. It is the same problem with the Bucharest Stock Exchange, re-openend after 50 years of socialism, which is totally engaged on fulfilling its mission to serve as an efficient, fair rule-based market which should be attractive and match European standards.

The functional culmination of European Economic and Monetary Union (EMU) came on 1 January 2002, when euro banknotes and coins entered circulation. Now all that remains is the geographical completion of the Monetary Union. The process of enlargement is the most decisive step towards finalizing this as a whole, not forgetting those countries that are already members of the European Union but are outside the euro area.

Enlargement will benefit all the sides involved. Economic integration is not a zero-sum game in which for there to be winners, there have to be losers. As economic theory has shown, surpluses can be generated from economic and financial exchange. Consumers, savers, business people, workers, investors, each and every economic agent can benefit from the accession process. The European Union itself, its institutions and its currency, will emerge stronger as a result of welcoming new Member States, as long as the integration process is handled well and is completed successfully.

It should be made clear from the outset that EU enlargement is a political process. Indeed, it is such a large undertaking that I think it is difficult to grasp its full impact. We lack the necessary time perspective in the same way that we still lack the historical distance needed to understand the full implications of having more than 300 million people using the euro for their accounts and payments.

II. The key areas of monetary and financial integration

In the process of EU monetary and financial integration, there are three key areas: legal/institutional, logistical/technical and economic. Considering the together fist two key areas of financial integration, there can be no enlargement of the European Union or the Economic and Monetary Union without the prior legal and institutional convergence that allows the accession countries to adopt the Community acquis and without an appropriate technical supporting system. It is important that the acquis must be applied in the financial sector in general, and to central banking activities in particular, in order to ensure a solid legal context. For its part, the Eurosystem has focused on: the financial

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legislation of the accession countries (especially with regard to the free movement of capital and payments); regulation of the financial markets with regard to the provision of banking, securities and investment services; rules governing eligible assets; and legislation paving the way for an internal financial services market.

At the economic level we can identify four main action areas: the accomplishment of the convergence criteria; exchange rate policy; the instruments and processes of monetary policy; and statistics. Most of these aspects provide the basis for understanding the functioning of capital markets in the accession countries and its interplay with the euro-area capital markets.

The most important economic aspect with regard to acceding Romania's membership of Monetary Union is the accomplishment of the nominal "Maastricht" convergence criteria. As was the case for the 25 current members, this is the economic key to the door. It is important to understand that the accomplishment of the convergence criteria by the acceding countries must be sustainable, as was set out clearly in Article 109J(1) of the Treaty of Maastricht and in Article 1 of Protocol no.6.

III. The impact EU integration for Romanian financial sector

For a better understanding of the impact of EU integration for Romanian financial sector, we have to look at what happened with the ten new joined EU states. At the time of their accession, in May 2004, there was a great diversity between the accession countries, talking about the economic situation also extends to their exchange rate strategies. Between them, the ten states had a wide variety of exchange rate regimes, ranging from independent floating (Poland and the Czech Republic), to currency boards (Estonia and Lithuania), managed floating, informally using the euro as the reference currency (Slovakia and Slovenia), pegging to a basket of currencies with a greater (Malta) or lesser (Latvia) weighting for the euro and, finally, pegging to the euro within fluctuation bands of ± 15% (Cyprus and Hungary), a practice reminiscent of that used by the Exchange Rate Mechanism II (ERM II).

Over the last decade, these countries have experienced remarkable transformations in their financial sectors. This was primarily driven by the transition process in Central and Eastern Europe and by the prospect of EU membership. In particular, considerable progress has been made in restructuring and consolidating the banking sector, thanks to the large-scale privatization of state-owned banks, the liberalization of markets and the extensive opening-up of the banking sector to foreign ownership.

In parallel, the accession countries' economies have been fundamentally transformed by the establishment of macroeconomic stability and the privatization of assets. Moreover, structural reforms have been made in many areas, and public institutions have been reformed and improved.

This restructuring process in both the financial sector and the real economy is well advanced and a new phase of financial and economic development is now under way in all the accession countries. EU enlargement and the prospect of the eventual adoption of the euro implies the need for the countries concerned to consolidate economic practices and enforce financial regulations and operational procedures in the euro area. This calls for the further refinement of the concept of a "functioning market economy and the ability to cope with competitive pressures", one of the so-called Copenhagen economic criterion for EU accession. Actual compliance with this criterion requires the accession countries to further strengthen their financial sectors as the linchpin for balanced and sustainable economic growth.

The traditional role of the financial sector in underpinning investment and realizing growth potential through its intermediation and governance functions is still very limited in most accession countries. For example, with the exception of Cyprus and Malta, which display a ratio comparable with that of the euro area, the level of financial intermediation in central and eastern European countries is relatively low and the provision of bank financing represents a much smaller share of GDP than in the euro area. To give you some figures, bank assets in the euro area amount to about 265% of GDP, whereas the bulk of accession countries' banking systems have asset volumes amounting to between 30% and 100% of GDP. At the mid-year 2004, the level of financial intermediation in Romania was approximately 50%, compared with the 75% in central European countries in the same period. The forecast for the next three years is that financial intermediation will reach 100% of GDP.

Due to the relatively prominent role of the banking industry in accession countries' financial sectors – or the correspondingly limited development of capital markets – the low level of financial intermediation has become an obstacle for credit institutions to channel financial savings into investment.

In some countries, specific features of the corporate sector alleviate this constraint through extensive recourse to the international financing provided by multinationals. By contrast, the role of capital markets as a source of financing is not sufficient to offset the activity of the banking sector. As regards stock markets, the total market capitalization of acceding countries combined stood at around 52% of GDP in the euro area. Turning to bond markets, unlike in the EU, their role has traditionally been limited in terms of accession country financing, mainly as a result of low levels of outstanding government securities. Even though the levels of fiscal deficit have been high in some countries, the average general government debt outstanding at end-2002 amounted to only around 40% of GDP, compared with an average of 70% of GDP in the euro area.

Although the banking industry in accession countries is widely considered as stable and sound, it has its structural weaknesses and inefficiencies – for example, those reflected in the continued high spreads between lending and deposit rates or the relatively large proportion of bad loans in some countries. These weaknesses require that an extra effort be made to consolidate the financial sector and to avoid adverse future implications.

IV. Romanian capital market and European Union membership

Overall, enhancing the efficiency of the financial sector in accession countries is relevant in order to achieve full integration in the euro area's financial sector. Important steps towards this integration have already been taken and are clearly visible. In the banking sector, for example, the strong presence of foreign banks has already had significant implications, accelerating concentration, increasing competition and enhancing efficiency.

However, the adjustments still to be made in order for the financial sector in accession countries to reach euro area standards remain significant. In this context, the changes occurring in the euro area's financial sectors imply that the accession countries have a moving target to catch up with. Some euro area indicators, such as degrees of efficiency in financial intermediation, are relevant for the accession countries' financial development, while other elements are not necessarily meaningful benchmarks because the euro area is highly heterogeneous and its financial markets are still subject to profound changes.

This means that further integration with the euro area – which will be mainly market-driven – will also need to be supported by considerable action on the part of the authorities. The adoption of the EU's legal framework, a greater integration of the financial infrastructure with that of the euro area and strong cross-border collaboration between supervisors are the main elements of this process.

For example, in the specific case of covered bond legislation, this entered into force in a number of accession countries some years ago, for instance in the Czech Republic (1995), Slovakia (1996), Hungary (1997), Poland and Latvia (both in 1998), Romania (1999) and Bulgaria (2000).

However, the development of this particular segment of the capital market is still at an early stage, reflecting the above discussion on the dominance of the financial system by the banking sector. To illustrate this in figures, at the end of 2002, the outstanding amount of euro-denominated covered bonds was EUR 1,497 billion – around 20% of the total amount of the euro bond market. This compares with roughly EUR 3 billion in accession countries. Moreover, this relatively low volume is concentrated in only two countries, Hungary and the Czech Republic. However, although these differences are significant, they should not be overstressed. In fact, in the rest of Europe, the German covered bond market is by far the dominant one, since it accounts for 73% of the total euro-denominated covered bond. In the light of the substantial differences remaining in the structure of the national European financial systems, we should not prematurely judge the current status of convergence of capital markets in accession countries, particularly at this early stage.

In Romania, the positive performance of the real economy also entailed favorable changes in the financial sectors, the capital market included, which did not go unnoticed by investors, the outcome being a more intense trading in the last few years. There was a combination of factors that exerted a favorable impact on the capital market, such as sustained GDP growth, declining inflation, the appreciation of the national currency and the fall in banking interest rates. It is important to mention the end of the demutualization process of Bucharest Stock Exchange (BSE), with financials intermediaries becoming shareholders of the commercial company Bucharest Stock Exchange SA.

The demutualization of BSE, the merger with the RASDAQ electronic exchange and with the Sibiu Financial Monetary and Commodities Exchange, opens the possibility of creating a powerful exchange in this region, These mergers were planned with a view to creating, which in 2007 to be able to cope with international competition. This development strategy means that BSE has to reposition itself regionally and look equally attractive to Romanian and European investors.

The indices of the Bucharest Stock Exchange posted remarkable growth rates in 2004, this placing the BSE in the category of European stock markets that offered investors the highest returns on their financial placements. In 2004 the BET-C composite index grew by 114.13%. The CESI index of the Central European stock exchanges grew by 65.40% in 2004, while EUROSTOXX50 grew by 5.49%. Such rises in stock exchange indices occurred against the background of intensified trading, the total value (shares and bonds) traded in 2004 on the Bucharest Stock Exchange standing at EUR 667.81 million. The favorable market tendencies also showed in the greater market capitalization by over 194.84% as expressed in EUR which by end 2004 stood at EUR 8.82 billion.

The same positive evolution of BSE was observed in 2005. The composite index of BSE (BET-C) grew by 46.16%, compared with EUROSTOXX50 which grew only by 20.50%. Total value (shares and bonds) traded on the BSE standing at EUR 2.15 billion, a remarkable 360% growth from the total value traded in 2004, sustained by a market capitalization of EUR 15.3 billion.

V. Conclusions

Looking back to the early years of the BSE, the progress is obvious and substantial. In the context of a comparison to neighboring countries, we will realize that while in 2002 BSE ranked sixth, with a market capitalization of EUR 2.6 billion, in 2004 it ranked fourth with EUR 8.8 billion. At the end of 2005 the market capitalization was over EUR 15 billion, approximately 20% of GDP.

In transition economies, stock market evolution gives very clear signals determining the way investors perceive the economic environment of a country, and also as major signals for economic policymakers. Thus, a stock exchange that holds a good regional position can serve the country's image, especially in view of the European Union membership looming ahead. It is very important for BSE to participate, and become the promoter of a regional virtual market which to serve the important Romanian listed companies as the necessary channel to regional capital in flows without losing the domestic one.

It is essential that Romania create a modern financial market infrastructure. Preparatory work in this field is subject to very long lead times and, therefore, needs to be implemented years before the adoption of the euro. Moreover, the target of this preparatory work is a moving one, and it may be moving faster than other targets. Certain components of the euro area financial infrastructure may need to be dynamically adapted before Romania can be integrated into the euro area.

In any case, development of the financial systems in Romania needs to be consistent with economic convergence. In this respect we can mention the case of fixed-rate bond markets: without convergence of inflation towards euro-area levels, it will be difficult, if at all possible, to promote the bond market. This also applies to the covered bond market in particular. The relevance of such development is based on the fact that the financial sector plays a key role in strengthening and broadening economic growth, as well as fostering stability. In order to promote financial development, without compromising hard-won financial stability, it seems crucial at this stage to complete a number of structural reforms. Moreover, a fully integrated capital market in Europe, including the accession countries, may be considered an aim in itself and an ultimate hard test for a truly successful enlargement.

In conclusion, although a new era of financial development in Romania is now in full swing, the challenges ahead are still considerable. Despite the remarkable progress made in recent years and the ongoing adjustment to euro area standards, the Romanian financial sectors need to undertake further significant changes in the future.