Preface

The event on which this volume is based – the Oesterreichische Nationalbank's 2005 Conference on European Economic Integration, co-organized jointly with the European Central Bank and the Center for Financial Studies – touched a wide range of issues related to financial developments, integration and stability in the enlarged European Union and its neighbouring countries in Central and Eastern Europe.

The contributors to this book pay tribute to the impressive transformation process that the countries in Central and Eastern Europe have gone through over the past decade without overlooking the risks and negative side effects involved. Among other things, the process of European integration has led to an increase in the level of per capita income and financial depth. Yet despite this success, the Central and Eastern European countries continue to lag behind Western Europe in terms of their financial development level. Also, the market structure for financial services differs between the two country groups, with perhaps the most striking difference being the high share of foreign ownership in Central and Eastern Europe. Nevertheless, the Central and Eastern European countries do not represent a homogeneous region either. These differences need to be taken into account in an in-depth analysis of financial development and integration, and in particular in economic policy assessments. While it cannot be reasonably expected that these differences will completely disappear in the near future, as such differences have not disappeared within the euro area either, domestic and European policies should continue to aim at creating an integrated European financial market. In this respect, we would like to stress the need for 'better regulation', drawing on open, transparent and evidence-based policy-making, and the need to focus on the consolidation and consistent implementation of the legislative framework for financial services, as has been proposed by the European Commission in its Green Paper on financial policies for the years 2005–2010.

Why is this important? We have seen that financial development and integration are crucial factors for economic growth in Central and Eastern Europe, and should thus benefit the economic catching-up process. This is particularly true for the new member states of the European Union, but improvements in the quality of the financial system have also been beneficial for South-Eastern European countries over the past decade.

Thus, financial development and integration should also contribute to more economic growth in the euro area. In this respect, the involvement of foreign investors in the banking systems of Central and Eastern Europe, largely pioneered by Austrian banks, has been identified as a significant beneficial factor over the past few years, despite some negative side effects. Research in this field presented in this book not only highlights a number of interesting differences between domestic and foreign banks' lending behaviour and profitability, but also shows that the entry mode of foreign banks matters for the level of interest rates they charge. Let us add here that the provision of cross-border banking services to non-bank clients is likely to have welfare-enhancing effects as well. However, this type of activity remains underdeveloped in the EU, reflecting the importance of proximity of banks to their clients.

Given relatively low financial development levels, financial sector growth in Central and Eastern Europe can be expected to remain strong over the next few years. In this respect, strong credit growth, especially of loans to households, is one of the central topics currently being discussed by policy-makers and academia. New literature presented in this book suggests that while credit growth in some countries may be characterized as excessive with signs of adverse macroeconomic effects, the financial systems have preserved overall stability in the region. Moreover, the monetary authorities are aware of the connected risks and in most countries have already moved to address the situation. However, close monitoring of the developments to detect early signs of financial sector distress and to maintain financial sector stability remains an issue. As the contributions to this volume show, important empirical research has been undertaken to identify such early warning indicators for banking crises, which should assist policy-makers in their decisions.

Financial integration in the euro area has advanced over the past few years but is not yet complete. The establishment of a legislative and institutional framework for financial integration in the European Union as a whole has been a major success. Now it is up to us all to fill this framework with life to promote European financial integration to the benefit of our economies. As evidenced by this book, the integration of Central and Eastern European financial markets with the euro area remains low, although significant cross-country differences remain. However, we believe that this situation will improve over the next couple of years. We all know that integrated and efficient financial markets enhance the smooth and effective transmission of monetary policy impulses throughout the monetary union. Financial integration is also important for the frictionless functioning of payment, clearing and settlement systems, and it also enables the banking sector to manage and diversify risks better. For all these reasons, the integration of the financial system of the new member states with that of the current euro area must be promoted already in the run-up to euro adoption. This process will continue beyond that point as well, as the developments since the start of the third stage of the economic and monetary union in 1999 have shown us.

Commercial banks and stock exchanges play a significant role in promoting financial development and integration in Central and Eastern Europe. Complementing the academic views presented in this book, the closing chapters document impressively that banks are clearly aware of the business potential which lies in the financial services sector in the region, and even banks operating on a global scale have been attracted to Central and Eastern Europe. At the same time, banks are also aware of challenges which they will likely face down this road, and they are ready to take them on. Having said this, the banking industry's natural self-interest in pursuing its business activities while keeping risks on a manageable scale will have to be complemented by adequate regulation and supervision practices. In this respect, solving outstanding issues, such as the effective supervision of financial conglomerates and of the non-bank financial sector, and finding an optimal solution to the supervision of cross-border financial institutions, will require further efforts.

Summing up, financial development and integration in Central and Eastern Europe is a key element for growth and stability not only in the region, but also for Europe as a whole. A measurable deepening of financial markets in Central and Eastern Europe has happened already, but more has still to come. This will provide an even broader variety of financial instruments to those who have been driving the catching-up process so far and will drive it further down the road. Further financial deepening is also a precondition for more stable prices for all kind of goods and services. This is where the stabilization of expectations comes in, something quite important for central banks. Therefore we do judge the ongoing integration process as vital, being an important stabilizing element for the upcoming economic and social change.

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