Magyar Nemzeti Bank

Lamfalussy's speaking notes for the 11/12/2009 Conference

- Presentation in two parts: (1) The three problem areas of the exit scenarios; (2) Are we on the right track for the prevention of future systemic crises? - interconnection/overlapping between these two topics. So let us take the first part first.
- *The first problem area* has to do with central banking policies: absorption of excess liquidity and return to "normal" in monetary policy.
- Excess liquidity: between June 2007 and December 2008 the balance sheet of the Fed grew by 160%, that of the Eurosystem by 90%. Mention the asset-side differences (quantitative easing versus supply of liquidity to banks).
- The three risks implied by maintaining this "overhang": (1)inflation (medium term); (2)bubbles or simply sharp real and financial asset price increases (already now); (3)return of a dangerously rising "appetite for risk"(already now). Additional observation: sharp rise in banks' profits (intermediation margin) – not a bad thing if banks use these resources properly, which does not seem to be always the case (understatement).
- Two arguments against speedy exit: (1)while the interbank market seems to function normally, and there is more than "normal" activity in other markets (bond issuance and equity raising), the credit market (especially for small-medium sized firms) still far from normal; (2) There are doubts, in particular in Europe, about a sustainable, and sufficiently strong recovery capable of leading to an increased demand for labour.

- My assessment/advice to central banks: they should announce the beginning and describe the technicalities of the exit, but refrain from committing themselves to a precise time-table. On the whole I trust the ability of the major central banks to do this reasonably well (refer to recent experience) – hence no major concern on my part.
- This is not the case with the *second problem area:* how and when to engineer the withdrawal of the demand-stimulating fiscal policy measures. Here I have serious concerns. Let me spell them out.
- There can be no doubt that this withdrawal *has* to take place: not doing it would lead to a literal explosion of public debt. When to begin engineering this withdrawal? Answer: when it appears that private sector demand (consumption and investment, and for Europe export to developing countries) is clearly beginning to pick up. This does not seem to happen (yet), but hopefully it will within one or two years. But in contradistinction with monetary policy, we have to face up to two difficult challenges.
- The first is that with fiscal policy you cannot comply with the proposal I have outlined for central banks: monetary policy decisions can be implemented at lightning speed – for fiscal policy to "bite" in 2011, you have to act *now.* At the same time, within the euro area there is only one monetary policy, and the ECB (much to the surprise of anglo-american pessimists)has amply demonstrated its capability of taking decisions.
- The second is that for the member states of the Eurosystem quite clearly (explain why), but (because of the growth and stability pact) also for all EU member states there is an obligation to accept that fiscal policy decisions have to be coordinated – or even taken by common accord.

- Is there going to be a sufficient political will – at the highest level – to act in this way? We very much need this, since there are growing differences between the size of public sector deficits. The problem is the most serious inside the Eurosystem, which demonstrates what many of us have been fearing: the demonstration that within EMU (*E*conomic and *M*onetary Union) the M-leg is likely to function quiet well, but not so the E-leg.
- *The third problem area:* how to engineer the withdrawal of governments from supporting specific financial institutions, predominantly banks? This touches the full range of "bail-outs": guaranties of all shapes and sizes and more or less hidden equity participation of public funds – reaching up to quasi (or not so quasi) nationalisation.
- This withdrawal process has already started either by the initiative of banks (Goldman Sachs) or, as it has become more frequent in Europe (ING, KBC) by the pressure of the Commission to reestablish level playing fields.
- Fine, but such scattered initiatives are liable to affect fundamentally the concerned banks' business models *without connecting explicitly such moves to the more general debate about the ways and means of preventing the failure of systemically significant institution.*
- This brings us to the heart of the debate on the way out from the current financial debacle: Excessive size of the financial system as a whole? If so, what to do? Excessive size or excessive complexity of individual banks? If so, what to do? Back to the old model of specialization? If so, specialization according to what criteria? And, most important: if we want to avoid that no bank (or any financial institution) should consider itself as being "to big to fail" – the only radical way out of the now prevailing

moral hazard pitfall – how could the winding down of such large businesses be ensured in a way which would prevent systemic crisis? (Mention living will etc). Insist on the importance of controlling moral hazard).

- In our globalised world there is no credible way on answering such queries at the national level – and even not at the European level. We need a global solution, which means in agreement in the first place (but not exclusively) with the United States. But to have a balanced dialogue with the US we need first an agreement among ourselves in the EU, which should enable Europe to speak with one voice. Short of doing this we run the risk of having to take for a fact initiatives coming from the other side of the Atlantic.
- Now let me switch to my second topic of my presentation: Are we on the right track for the prevention of future systemic crises? My answer is in three parts. I have just given the *first* part of my reply: we shall not be on the right track as long as we are not decided to get us out of the moral hazard pitfall. *Second,* we have to finalise and implement a list of specific reforms which deal with the specific failures identified in the current crisis {to mention the areas: Originate-and-distribute business model; Credit default swap (CDS) market; credit rating agencies; risk management models and practices; compensation schemes; and procyclicality}. There is hope, but beware of violent lobbying by specific business interests. The *third* part is about the reform of the supervisory institutional framework, which is a key condition precondition for successful crisis prevention.
- In this field I shall focus my remarks on one important proposal under discussion/implementation: the establishment of a European Systemic Risk Board (ESRB)……..