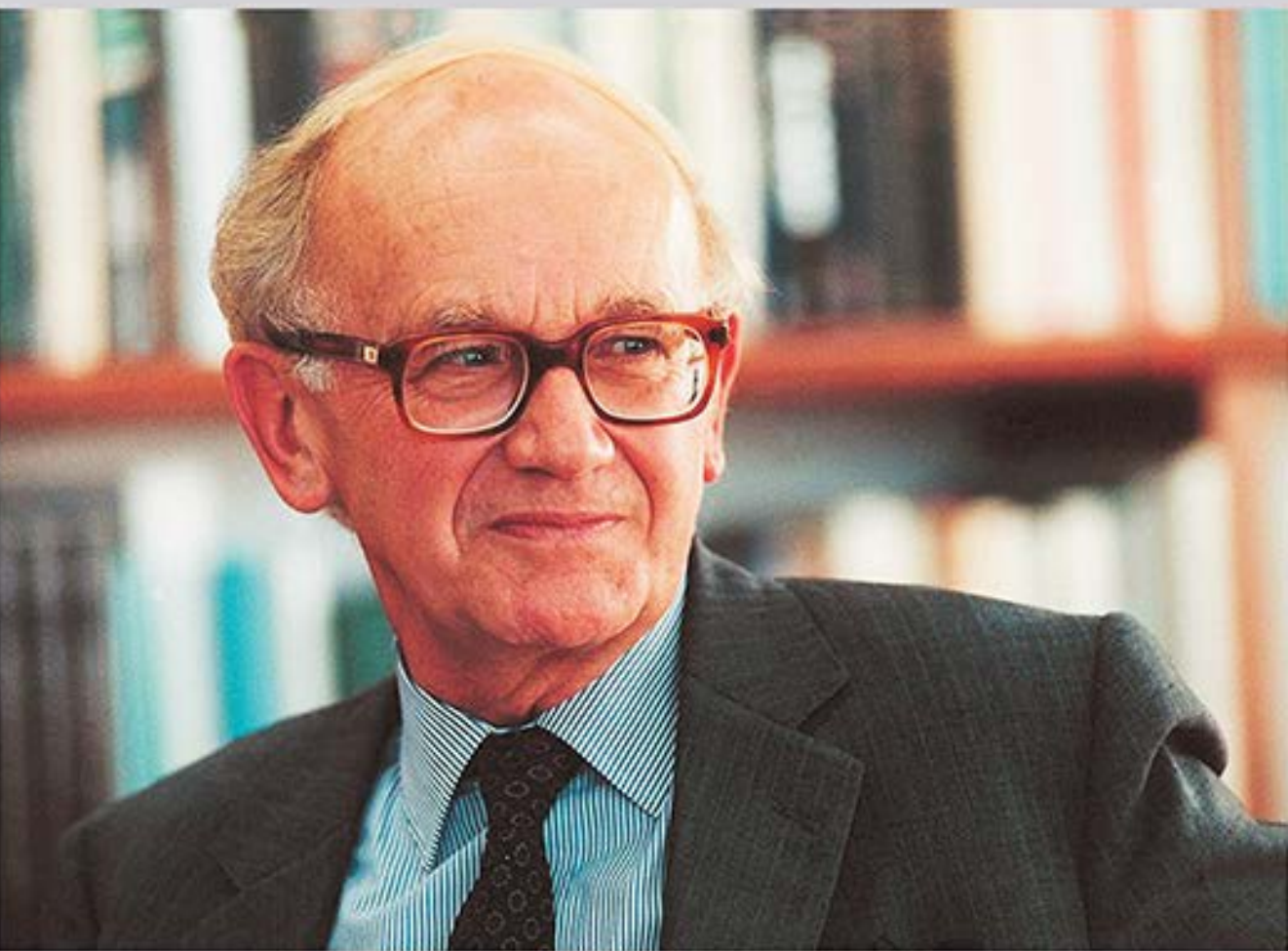


# Alexandre Lamfalussy Selected Essays

Ivo Maes (Editor)  
in cooperation with György Szapáry



MAGYAR NEMZETI BANK | NATIONAL BANK OF BELGIUM

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Alexandre Lamfalussy – Selected Essays

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in cooperation with György Szapáry

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# Foreword

Alexandre Lamfalussy was not only an eminent central banker and architect of the euro, but also a brilliant intellectual. This reprint of a careful selection of his essays is a fitting tribute to him as well as a way of preserving the intellectual heritage of this great European. It was a huge pleasure for the National Bank of Belgium to cooperate with the Magyar Nemzeti Bank on this project which brought together the central banks of the two countries which were close to Alexandre Lamfalussy's heart.

As Founding President of the European Monetary Institute, the precursor of the European Central Bank, Alexandre Lamfalussy will always be associated with European Economic and Monetary Union. Lamfalussy was a convinced European and he served Europe in many roles. From his earliest writings, he was an advocate of European monetary integration, but he was always careful to give the economic pillar its right place in Europe's Economic and Monetary Union.

Financial stability was a major concern for Lamfalussy and he was often a Cassandra warning of impending financial storms. At the Bank for International Settlements, he made a significant contribution to the creation of a "BIS approach", namely that one should be attentive to imbalances, debt build-ups and bubbles, which may sow the seeds of financial crises. These topics are very much to the fore in the essays in this book.

The book further highlights the young Lamfalussy's trenchant analyses of the Belgian economy. While they caused a furore at the time, some of them still ring true today. Lamfalussy showed that Belgian exports suffered from high domestic labour costs and an outdated composition, focused on traditional products. He developed the concept of "defensive investment", which mainly entails the reorganisation of existing factories, with short-term productivity increases, but much less potential for long-run economic growth.

Alexandre Lamfalussy's merits were widely recognised, in Belgium too. In 1993, King Baudouin conferred upon him the title of Baron for his efforts at the BIS to save emerging economies from bankruptcy. He was also awarded the honour



of Grand Officer of the Order of Leopold in December 1997 for his work on European monetary integration at the European Monetary Institute. The National Bank of Belgium decided to institute a keynote lecture named in honour of Alexandre Lamfalussy at its biannual international conference.

I would like to express my gratitude to everyone involved in the production of this volume. In the first instance, I would like to thank Governor György Matolcsy for the cooperation with the Magyar Nemzeti Bank, as well as György Szapáry, who coordinated the project on behalf of the MNB. A special word of thanks goes to Ivo Maes, who not only edited the volume, but who, through his initiative and hard work, has contributed greatly to preserving the intellectual heritage of Alexandre Lamfalussy.

Jan Smets

*Governor of the National Bank of Belgium*

# Foreword

This book is a tribute to the distinguished career of late Baron Alexandre Lamfalussy as an economist, academician, central banker and thinker, and to his outstanding contributions to the most important economic policy issues of his time: financial markets, exchange rates, debt crises, monetary policy and financial stability. Because of his dedicated work to promote European monetary integration and as Founding President of the European Monetary Institute, the predecessor of the European Central Bank, he is considered as the “father of the euro”.

Baron Alexandre Lamfalussy was born as Lámfalussy Sándor in 1929 in Kapuvár, a town in North-Western Hungary. He attended primary school in Lenti, a town in South-Western Hungary, and Sopron, a city on the Austrian-Hungarian border, where he completed his secondary education. In 1947, he started studying economics at the József Nádor University of Technology and Economics in Budapest. As the communist regime consolidated its power, he emigrated to Belgium in 1949 and continued his studies at the Catholic University of Louvain. Belgium became his home, but he maintained a very special attachment to Hungary.

This book is published in cooperation between the National Bank of Belgium and the Magyar Nemzeti Bank, the central bank of Hungary. Professor Ivo Maes from the National Bank Belgium, an eminent scholar of Lamfalussy and Editor of this book, sketches in his Introduction the extraordinary career and contributions to economic thinking of Alexandre Lamfalussy. Let me focus here on the close ties that Lamfalussy maintained to Hungary after the fall of communism.

Soon after the democratic elections in April 1990, Prime Minister József Antall invited him for consultations. He had travelled willingly to Budapest ever since then as his advice had been sought regularly by the Hungarian governments and the Magyar Nemzeti Bank. In September 1999, he became a member of the Hungarian Academy of Sciences. For his services rendered in the interest of Hungary, Alexandre Lamfalussy received several Hungarian State awards,

including the country's highest decoration, the Grand Cross of the Order of Saint Stephen of Hungary.

In 2014, the Magyar Nemzeti Bank launched the Lamfalussy Lectures Conference series held annually in Budapest. The purpose of the conference series is to invite distinguished lecturers to Hungary to share their views on the current issues of global economic policy, especially of monetary policy and the financial system. Along with the conference series, the Magyar Nemzeti Bank also established a Lamfalussy award to recognise outstanding professional contributions and lifetime achievements in economics, especially in the field of monetary policy.

Last but not least, I would like to express my gratitude to Governor Jan Smets for the cooperation of the National Bank of Belgium in making this book a joint publication and to Professor Ivo Maes for his editorial work.

György Matolcsy  
*Governor of the Magyar Nemzeti Bank*

*Alexandre Lamfalussy expressed himself with lucidity and often adopted controversial positions. In the light of subsequent events, we are compelled to acknowledge that his assessments were generally correct and far-sighted.*

Jacques de Larosière (2014: 7)

## Introduction

Alexandre Lamfalussy (1929-2015) has been highly influential in the process of European monetary and financial integration, especially as the Founding President of the European Monetary Institute, the predecessor of the European Central Bank. However, he pursued a very rich and varied career, not only as a central banker, but also as a commercial banker and academic. Throughout his life he was active in speaking and publishing. This made for an abundant number of beautiful essays of which a selection is presented in this book, from his first article in 1953 to his last essay in 2014. The essays are presented here in chronological order. The objective of this introduction is to put them into their historical and intellectual context, distinguishing between four major phases of Alexandre Lamfalussy's life and career. There is also a short introduction before each essay.

### 1. The Young Lamfalussy (1929–1975)<sup>1</sup>

Alexandre Lamfalussy was born on 26 April 1929 in Kapuvar, Hungary. He started his economics studies at the József Nádor University of Technology and Economics in Budapest. In January 1949, he left Hungary and came to Belgium, where he continued his studies at the Catholic University of Louvain. In his autobiography, Lamfalussy tells extensively about his early years in Hungary and his fleeing to Belgium (Lamfalussy, Maes and Péters 2014).

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<sup>1</sup> We draw here on the distinction made by Axel Leijonhufvud (1979: 525) between “Hicks the Younger” (like Lamfalussy, “That brilliant young man was extremely successful”) and the “Elder Hicks”.

The dominant figure in Louvain at the time was Léon-H. Dupriez, a prominent scholar in business cycle analysis. Two elements were typical of his approach (Dupriez 1947). Firstly, he based his analysis on extensive empirical investigations. Secondly, Dupriez was not in favour of Keynesian economics. He disliked the use of models, econometrics and national income accounts. Lamfalussy became Dupriez's assistant, although he adopted more "Keynesian" positions (Maes 2009). During his student days in Louvain, Lamfalussy was also active in the "Cercle Européen", together with several friends. For them, European integration was a very profound conviction, which had a special dimension for Lamfalussy personally, as he had just escaped from Hungary, on the other side of the Iron Curtain. In their view, it was necessary to break down the barriers which divided Europe. European integration should be a stimulus to haul the economy out of its stagnation. While the economic motive was important, there was also a clear cultural dimension, as one felt one belonged to a common cultural heritage. Lamfalussy, in 1953, also attended a meeting of the "Nouvelles équipes internationales" (the European Christian Democratic movement) in Saarbrücken, a symbolic city on the Franco-German border. Furthermore, Lamfalussy was influenced by his teacher Dupriez, who was involved in studies for the High Authority of the European Coal and Steel Community. So, it is fitting that the first article Lamfalussy published, in 1953, was on the Belgian steel industry in the European Coal and Steel Community (chapter I).

Lamfalussy went on to Oxford for his doctorate, with Philip Andrews as supervisor and Sir John Hicks as the main examiner. Lamfalussy focused on the weak investment and growth performance of Belgian industry. In 1958, he published an article on this theme in the *Journal of Industrial Economics* (chapter II) and, in 1961, a book entitled "Investment and Growth in Mature Economies. The Case of Belgium" (Lamfalussy 1961). A crucial theme for Lamfalussy was that investment was low in Belgium as compared to other Western countries. This was not only related to the slow growth of domestic expenditure, but also to a slower growth of exports than in most European countries. Belgian exports suffered from the high level of Belgian labour costs and an outdated composition (concentrated on traditional products of standard quality). When analysing investment in Belgian industries in more detail, Lamfalussy observed that there were significant increases in the capital stock (as well as in productivity and in output capacity) in declining sectors, such as textiles or firms producing railway

equipment and rolling stock. Lamfalussy argued that current theories did not seem able to explain this phenomenon. So, he developed the concept of “defensive investment”, which is carried out mainly as a protective device in stagnating or declining markets, “when profits are squeezed, when competition is active, when the lowering of costs becomes a matter of survival rather than of expansion” (Lamfalussy, 1961a, xvi). It entails mainly the reorganisation of existing factories. However, in the medium to long run, the scope for productivity increases of defensive investments is limited, restraining so also the growth potential of these economies, like Belgium.

In the following years, Lamfalussy broadened his research, going into the topic of why the countries of the European Economic Community had been growing much more strongly than the United Kingdom. It led to a short article in *Lloyds Bank Review* (chapter III) and a book, “The United Kingdom and the Six. An Essay on Economic Growth in Western Europe” (Lamfalussy 1963). In these publications, Lamfalussy emphasised virtuous (or vicious) circles, in which stronger export growth promotes higher investment, which in turn strengthens productivity and investment, further reinforcing exports. Broadly speaking, Lamfalussy’s analyses fit into the Keynesian tradition. His emphasis on vicious and virtuous circles clearly showed that the free market economy was not stable and self-adjusting. Lamfalussy is considered as one of the main protagonists of the Keynesian approach of export-led growth (Crafts and Toniolo 1996).

Lamfalussy returned to Belgium in 1955 and started working at the *Banque de Bruxelles*, Belgium’s second commercial bank, becoming Chairman of the Executive Board in 1971. In the 1960s, he was involved in the creation of mutual funds and played a role in international investment banking (chapter V). In 1961, under the influence of Robert Triffin, he went to Yale for a year. He also met James Tobin there, who was already critical of the functioning of the financial system. During his time at the helm of the *Banque de Bruxelles*, in 1974, Lamfalussy was to get his own first exercise in financial crisis management when some traders brought heavy losses for the bank through large open foreign exchange positions they had taken. At the end of 1975, he resigned from the bank.

Whilst at the *Banque de Bruxelles*, Lamfalussy’s research interests shifted to monetary and financial issues, both national and international (Maes 2011b). He was very close to the thinking of the Radcliffe Report, emphasising the importance

of money substitutes (chapter IV). In the 1960s, Alexandre Lamfalussy was also a member of certain committees which investigated the financial system. In 1963-1965, he served on the Segré Committee, appointed by the European Commission, which investigated the integration of the capital markets in the EEC (CEC 1966). The Segré report underlined the linkages between freedom of capital movements and progress in other areas, such as monetary and economic policies. Moreover, he took part in meetings of several groups on the reform of the international monetary system, one of the most famous being the Bellagio group together with Sir Roy Harrod, Harry Johnson, Peter Kenen, Fritz Machlup, Robert Mundell, Jacques Rueff, Robert Triffin, Tibor Scitovsky and Pierre Uri, among others. In 1969, at the age of forty, he delivered the prestigious Per Jacobsson lecture (chapter VII).

In The United Kingdom and the Six, Lamfalussy (1963) was optimistic about the future of the EEC. He was in favour of strengthening monetary integration, very much in line with Triffin's plea for a European Reserve Fund, "*A fortiori*, the organization of common monetary institutions could be of great help in coping with possible balance of payments problems of the Community. For instance, the pooling of gold and foreign exchange reserves would greatly strengthen the E.E.C.'s resilience to export-induced recessions" (Lamfalussy 1963: 131-132). However, Lamfalussy was not only in favour of monetary integration, but argued that also policy-coordination was necessary, "the prerequisite to a successful pooling of reserves is the effective co-ordination of economic policies".

## 2. At the Bank for International Settlements (1976–1993)

In January 1976, Alexandre Lamfalussy joined the Bank for International Settlements (BIS) in Basel as Economic Adviser and Head of the Monetary and Economic Department. He was General Manager from May 1985 until the end of 1993. The BIS was set up in 1930 and provided central bankers with three main services: research on issues relevant to international payments and prudential supervision, a venue for regular and discreet meetings, and a financial arm (particularly important in the gold market). At the BIS, Lamfalussy was in a first-rate position to observe the international and European monetary system. He took part in the meetings of the G10 governors, including the informal

dinners, with the most open and confidential discussions between the world's central bankers. As Economic Advisor of the Bank of International Settlements he participated also in the meetings of the EEC Committee of Governors, enriching the debates with trenchant analyses, based on careful empirical observations and new economic insights (Maes 2011 b).

During Lamfalussy's time at the BIS, three topics dominated the agenda: exchange rates, inflation and the Latin-American debt crisis. The strong appreciation of the US dollar, due to differences in the policy mix between Europe and the US in the early 1980s, would mark Lamfalussy profoundly. He felt this was a clear indication that flexible exchange rates could not be relied on to avoid serious exchange rate misalignments. Moreover, the period showed the dangers of exchange rate misalignments, especially strong protectionist threats (see chapter XIX).

The mid-1970s were the time of the great inflation. Among central bankers, monetary targets were a major issue of discussion. Lamfalussy (1985, reprinted as chapter XVI) took a balanced approach. He emphasised that policy-makers had to avoid succumbing to two opposite temptations. One temptation was to return to complete "ad hoc-ry". He argued that this would be a grave mistake: "Rules, be they monetary aggregates or an exchange rate target, are needed to provide some anchor for the wildly fluctuating expectations of market participants; to make monetary policy-makers accountable for their action, including their decisions to deviate from predetermined targets; and to give them leverage in their dealings with governments and parliaments" (Lamfalussy 1985: 412-413). However, he also argued against the temptation of retreating into a world of rigid rules: "I do not believe in a monetary policy based on mechanical rules. It is difficult to define such rules; it is sometimes impossible to apply them; and it would often be irresponsible to stick to them. The road to follow is somewhere in between: rules applied with a pragmatic sense of discretion." (Lamfalussy 1985: 412-413). For Lamfalussy, monetary policy, notwithstanding thorough research, remained an art, not a science.

Financial stability has always been an important topic for Lamfalussy. As early as the mid 1970s, he was warning about the debt build-up in Latin America (Maes 2011a). He also pointed up the interrelationship with loose US monetary policies and the US balance of payments deficit. In 1976, he proposed to set up a "risk office" at the BIS in order to collect crucial information on a limited number of



systemic banks. In 1979-1980, a Working Party which he chaired advanced a “macro-prudential” approach. Later, in the 1980s, Lamfalussy played a significant role in the management of the Latin American debt crisis (Maes and Clement 2016).

Lamfalussy very quickly took a cautious attitude towards financial innovations (Maes 2010). In a certain sense, he always kept a “Keynesian” *Weltanschauung*, with a certain scepticism about the functioning of financial markets. As observed by Keynes, “Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation” (Keynes 1936: 159). Like Tobin (1984), Lamfalussy had questions regarding the efficiency of the financial system and argued in favour of a research programme in the field of “normative financial economics”.

In his (aforementioned) presentation, Lamfalussy (1985) focused closely on the accelerating speed of financial innovation. This was leading to a flow of new financial instruments and techniques, as well as the blurring of dividing lines between institutions and between markets, an old concern of Lamfalussy who was steeped in the Radcliffe tradition. After discussing the monetary policy implications, Lamfalussy turned to prudential issues. His fundamental question concerned the effects on financial stability of the redistribution of risk by these new instruments: “You may argue that when risk-averse market participants shift risks associated with unexpected interest and exchange rate developments onto willing risk takers, everybody is going to be better off. This may well be the case, but increased collective happiness does not necessarily mean greater systemic stability. Or does it?” (Lamfalussy 1985: 411). Lamfalussy further greatly contributed to the creation of a “BIS atmosphere”, namely that one should be attentive to imbalances, debt build-ups and bubbles, which may sow the seeds of financial crises. Lamfalussy thus became the main architect of the BIS “macro-prudential” approach to financial stability with a focus on the financial system as a whole.

During his time at the BIS, Lamfalussy was also involved in European monetary integration issues. The highlight was his participation in the Delors Committee in 1988-1989, which played a pivotal role in the EMU process. As the meetings of the Delors Committee took place at the BIS in Basel, Lamfalussy, as General Manager of the BIS, was, *de facto*, the host of the Delors Committee.

While Lamfalussy was not one of the main protagonists in the Delors Committee, like Delors himself or Karl-Otto Pöhl, he nonetheless played an intellectually stimulating role (Maes 2016). He contributed three background studies, also with the help of collaborators at the BIS. There was a descriptive paper on the functioning of the ECU banking market and one on monetary policy operations in stage two. The third one concerned the coordination of fiscal policy (see chapter XX). He also tried to raise the issue of banking supervision, but it was not taken up in the work of the Committee (Coene 2014).

For Lamfalussy, the coordination of budgetary policy was a crucial issue (James 2012). Marked by his experience of the Latin American debt build-up, he questioned whether market forces were enough to ensure fiscal discipline. Lamfalussy advocated an EMU with a significant economic pillar. In his paper, Lamfalussy stated that fiscal policy coordination “appears to be a vital component of a European EMU” (Lamfalussy 1989: 93). He advanced two main reasons. The first one very much reflected his preoccupations with the policy mix on the international monetary scene: “the determination of a global fiscal policy in a way that is sufficiently responsive to evolving domestic and international requirements”. The second reason foreshadowed the “binding rules on budgetary policy” in the Delors Report itself, namely, the need “to avoid tensions arising from excessive differences between public sector borrowing requirements of individual member countries”.

### 3. Founding President of the European Monetary Institute (1994–1997)

On 1 January 1994, Lamfalussy, at that time nearly 65 years old, became the Founding President of the newly created European Monetary Institute (EMI). These were turbulent times for the EMU process, with the financial markets still in turmoil after the 1992-1993 EMS crisis and the difficult ratification of the Maastricht Treaty (Maes 2002). However, the second stage of EMU started on 1 January 1994 and the EMI was set up on schedule. Lamfalussy remained President of the EMI until 30 June 1997. The tasks of the EMI fell into two broad categories: strengthening the coordination of the monetary policies of the EU Member States and organising the preparations for the final stage of EMU,

especially the conduct of the single monetary policy and the introduction of the single currency. One of the main unresolved issues at the time concerned the precise scenario for the changeover to the single currency. This issue was very complex and delicate, as it affected the banking system, financial markets, enterprises, and the public at large. The European Commission issued a Green Paper in May 1995 and, in so doing, brought the issue to the fore. The EMI published its scenario for the changeover in November 1995 (EMI 1995). These two documents formed the basis for the scenario that was finally adopted by the European Council in Madrid in December 1995. The Madrid summit took some very important decisions: it confirmed the date of 1 January 1999 as the starting date of the third stage; it decided on the name “euro” for the future single currency; and it endorsed the scenario for the switchover to the single currency.

A crucial issue at the time was that the banking system was still very hesitant about EMU and reluctant to undertake the very heavy investment needed. Lamfalussy described the sentiment in banking circles as follows: “up until mid-1995, i.e. a year and a half after I took up my position, there was still profound pessimism in the markets and the banks. I had telephone conversations with 40 leading bankers and told them, ‘You need to get to work, we’ll send someone over to explain how to do it’. ‘Oh, but this kind of thing is terribly expensive’, came the response” (Lamfalussy, Maes and Péters 2014: 145). The EMI and the European Commission decided then that “the only way of convincing the banks – and, moreover, the participating central banks – was to pull out all the stops on the IT front and to have a precise timetable of what was going to happen as of 1 January 1999” (Lamfalussy, Maes and Péters 2014: 145).

In several speeches and articles, Lamfalussy also discussed the implications of EMU. Here, he was responding to an explicit request from Chancellor Helmut Kohl. As Lamfalussy wrote: “Kohl was explicit with me, he said, ‘I know that you have a lot to do, but please go and speak to the Germans. Explain the facts in different places, and especially in Bavaria.’” So, Lamfalussy went to Bavaria and, the following day, he got a phone call from Helmut Kohl who said, “You really won over those Bavarians, and they are a difficult lot” (Lamfalussy, Maes and Péters 2014: 147).

In Lamfalussy’s view, EMU would lead to major benefits, although there were also costs. He emphasised that, in order to reap these “large and lasting net

benefits”, countries had to enter EMU in a state of sustainable macroeconomic convergence and had to improve the working of their labour markets. In line with his earlier views on exchange rates, Lamfalussy argued that a crucial benefit of EMU would be to remove the risk of serious real exchange rate misalignments. In his view, EMU would stabilise real exchange rates because “the fixity of nominal exchange rates would be accompanied by an equalisation of inflation rates: a single monetary policy in a single market means that major inflation differentials between ‘regions’ are simply not sustainable” (Lamfalussy 1998). But the euro area experience showed this was a rather too optimistic view.

Lamfalussy also emphasised that significant policy adjustments were still necessary for EMU to function. One area was budgetary policy. But for Lamfalussy, the greatest challenge concerned the labour market, “I have already noted that wage and price flexibility is essential to facilitate economic adjustment to various kinds of shocks (...). With or without EMU, employment policies have to be in the forefront of attention of European policy-makers” (Lamfalussy 1997).

Wim Duisenberg, in his address at the occasion of the farewell of Alexandre Lamfalussy as President of the EMI, beautifully summarised Lamfalussy’s contribution: “Things have not always been easy for you when chairing the meetings of the EMI Council. But being a central banker, heart and soul, you have always managed to find compromises. I vividly remember a few meetings of the EMI Council which you eventually managed to conclude successfully, although they started off as a babel of tongues. Also whenever the atmosphere around the table started to become a bit tense, you always emphasised the need for cooperation and co-ordination (...). One of your greatest assets is that you have managed to combine this typical conservative and cautious nature of a central banker, always focused on substance, with your firm belief in European monetary integration. Having been a member of the Delors Committee for the Study of Economic and Monetary Union, you were at the cradle of European monetary union. You have never believed that a true single market is in the long run compatible with a quasi-floating exchange rate system. Over the past three and a half years, you have acted as a devoted missionary of EMU and European integration in general. In this capacity, you have managed to convert at least some incredulous European central bankers. And like any good missionary, you have also spread the message of EMU to the outside world.” (Duisenberg 1997).

## 4. The Elder Lamfalussy. A Growing Concern About Financial Stability (1997–2015)<sup>1</sup>

After retiring from the EMI, Lamfalussy took up an invitation from Yale University to deliver the 1998 Stimson Lectures. The theme, inspired by his BIS experience, was financial crisis in emerging markets (Lamfalussy 2000). Over the next few years, financial stability would increasingly become the main focus of his work.

In 2000, Alexandre Lamfalussy was appointed Chairman of the Committee of Wise Men, which developed a new approach for the regulation of European financial markets (see chapter XXXI). After the introduction of the euro in 1999, financial integration moved up the European agenda (Maes 2007). A key issue was the functioning of the securities markets, especially how to adapt the European regulatory framework to the continuously evolving financial markets. In July 2000, the ECOFIN Council appointed an ad hoc Committee, chaired by Lamfalussy, to analyse “practical arrangements for implementation of the Community rules” and “propose various approaches to adjusting the practice of regulation and cooperation between regulators”.

The Committee of Wise Men proposed a “four-level” approach, making a clear distinction between key political decisions and technical implementation. The crucial aim was to speed up changes in regulation. Moreover, it significantly increased the transparency of the regulatory process and extended greatly private sector consultation (Quaglia 2007). In 2002, the new governance structure was extended to banking, insurance and pensions. After the global financial crisis, the governance structure introduced by the Lamfalussy Committee would become an important cornerstone for Europe’s new supervisory architecture. In effect, the new so-called “Level 3 Committees” became the basis for the EU’s later supervisory authorities – the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA).

In his Pierre Werner Lecture in Luxembourg in 2004 (see chapter XXXII), Lamfalussy focused on the organisation of prudential supervision in the European

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<sup>1</sup> Axel Leijonhufvud (1979:527) characterises the “Elder Hicks” as: “Hicks has developed an economical and effective literary style (...). It gives one a sense – a privileged sense – of listening in on Hicks making up his mind on the issues and problems that have interested him through a long career.”

Union, which he described as a “mind-boggling patchwork”. Lamfalussy stressed that central banks had a crucial role in the management of financial crises, especially in “preventing a potential crisis from turning into a real one... In such a situation they should provide liquidity to the system, so as to avoid liquidity shortages pushing otherwise solvent banks into bankruptcy. They also have to care about the smooth functioning of the payments system”. Lamfalussy further argued that the timely provision of liquidity was very much a matter of judgment, which implied that central banks had to be intimately familiar with financial institutions. “They must possess direct information on banks’ risk-assessment methods and capabilities, on their decision-making processes and control mechanisms and, not least, on their expertise and skills in using innovative financial instruments. Such information cannot be acquired by reading second-hand reports, however lucid and transparent such reports may be” (Lamfalussy 2004:7).

For Lamfalussy the crucial issue was whether one should give some responsibility to the ECB for supervision of the large, systemically important, banks: “I would start from the assumption that the group of financial intermediaries whose regulation and supervision deserves to be reconsidered are a limited number of very large banks which have become actors at the global level and are key players in the European interbank market. Their problems could have directly systemic consequences (...). Should one not consider exploring the desirability and the feasibility of entrusting the ECB with an operational responsibility in the supervision of this limited number of banks?” (Lamfalussy 2004: 20). An early anticipation of the 2014 establishment of the Banking Union with the Single Supervisory Mechanism under the European Central Bank.

Later, in September 2006, a year before the start of the financial crisis, Lamfalussy turned to the threats which world-wide excess liquidity might pose. As in the 1980s, he was less concerned about potential inflationary dangers. He emphasised the “genuine, although unquantifiable, danger” for the stability of the financial system. In his view, the excess liquidity provided “a favourable breeding ground for developing bubbles in markets for asset and commodity prices, it erodes risk awareness and therefore encourages careless risk taking” (Lamfalussy 2006).

The financial crisis further induced Lamfalussy to adjust his opinions. In his “Dinner Address” to the Sixth ECB Central Banking Conference (see chapter XXXIII), he “meditated” on his 1997 EMI farewell speech, in which he had

warned not to “overburden monetary policy” and to focus on price stability. He now argued that the financial crisis had “confirmed something that was (or should have been) expected: that whether they like it or not, central banks are in the front line when it comes to keeping crisis manifestations under control” (Lamfalussy 2011). He then emphasised the severity of the crisis, “What is *new* in the current experience is that central banks have had to carry out their liquidity-boosting operations in an environment where the liquidity shortage turned rather quickly into solvency problems of frightening dimensions – for which there has been no precedent since the 1930’s. Nor has there been any precedent for the speed of contamination at the global level” (Lamfalussy 2011).

Given the severity of the crisis, central banks reacted with a variety of “non-standard” measures. This led not only to a spectacular expansion of their balance sheets, but also to a change in the composition of their assets, with more risky assets, “As a result central banks have started navigating in uncharted waters, in terms of both operational techniques and their relations with governments”. Lamfalussy did not expect a quick end to the crisis. Consequently, financial stability should remain an objective for central banks, just as price stability, making life more complex for central bankers.

In 1999, Lamfalussy became the Founding President of the Triffin International Foundation, now called Robert Triffin International, which seeks to enhance the debate on a necessary reform of the international monetary system. He was also, together with Michel Camdessus and Tommaso Padoa-Schioppa, co-chair of the Palais-Royal Initiative, which produced a report “Reform of the International Monetary System: A cooperative approach for the twenty first century”, which was submitted to the French G20 Presidency on 8 February 2011.

## 5. Conclusion

Alexandre Lamfalussy has been a highly influential central banker. He is perhaps best known as the Founding President of the European Monetary Institute, the predecessor of the European Central Bank. Before that, he was at the Bank for International Settlements, becoming General Manager in 1985.

At the BIS, Lamfalussy would become the main architect of the BIS macro-prudential approach to financial stability with a focus of the financial system



as a whole. The main reasons for his sensitivity to financial fragility were: a “Keynesian” *Weltanschauung* (that a market economy is not sufficiently self-correcting), the emphasis of Dupriez (his teacher) on cycles, his experience as a commercial banker, BIS involvement in financial stability issues, especially the Latin American debt crisis, and research on financial innovations. His vision of the financial markets also permeated his view of the foreign exchange markets, with a basic distrust of floating exchange rate systems.

The longevity of Lamfalussy’s involvement in the process of European monetary and financial integration is remarkable. As early as the mid-1960s, he was a member of the Segré Committee on a European capital market. During his time at the BIS, he was also a member of the Delors Committee. After his retirement of the EMI, in 2000-2001, he was Chairman of the Committee of Wise Men on the Regulation of European Securities Markets. Lamfalussy’s advocacy of European monetary integration had its origin in two main sources: a profound European conviction, marked by the devastations of the Second World War and the Iron Curtain, and a fundamental distrust of systems of floating exchange rates. Moreover, he was a strong defender of a symmetric EMU, with a strong economic pillar, and an early advocate of a banking union.

Alexandre Lamfalussy died in Ottignies, Belgium, on 9 May 2015, aged 86.

## 6. Acknowledgements

This study would not have been possible without the support of many people. A few words of gratitude, even if they remain imperfect and incomplete, are more than appropriate.

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I would further like to express my thanks to all the colleagues and friends of the Magyar Nemzeti Bank and the National Bank of Belgium who made many valuable contributions to this project. Special words of thanks go to György



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Naturally, there remains a dimension of individual responsibility, which I, of course, assume. Neither the National Bank of Belgium, the Eurosystem, the Magyar Nemzeti Bank nor any other institution is responsible for any of the views expressed in this volume.

Ivo Maes  
*Brussels, August 2016*

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Part One

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*The Young  
Lamfalussy*

1929–1975



## Chapter I

# The Steel Industry and the European Coal and Steel Community

1953

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*After his studies, Lamfalussy worked at the University of Louvain as an assistant to Léon-H. Dupriez, an authority on business cycles. Dupriez's work was concentrated on the different industrial sectors of the economy and he was also very involved in studies for the High Authority of the European Coal and Steel Community. In 1953, Lamfalussy published his first article, *La sidérurgie et la Communauté européenne du Charbon et de l'Acier*, in the *Bulletin de l'institut de recherches économiques et sociales* (Tome XIXII, NBB translation). Reprinted with kind permission of the Louvain Economic Review and the Lamfalussy family.*

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More than any other major branch of activity in the Belgian economy, the steel industry is heavily dependent on the international economic situation: more than 60% of production is exported in boom years. Its already high cyclical sensitivity due to the very nature of a capital goods industry is thus further reinforced, because foreign demand generally tends to be more sensitive to cyclical fluctuations than domestic demand. A study of the Belgian steel industry in the year 1952 therefore has to be preceded by an overview of international steel sector activity.



## I. – General Factors Determining the Global and Belgian Steel Production Cycle

### *International steel industry outlook*

The European steel industry played a part in the strong expansion of the capital goods industries, which was in stark contrast with the depression in consumer goods industries. Crude steel production by the member countries of the European Coal and Steel Community (ECSC) rose from 37.7 million tonnes in 1951 to 41.6 million in 1952, an increase of about 10%. Steel production in Great Britain also picked up, albeit at a slower pace.

The continued boom in the steel production cycle can be explained by several factors working together.

The key factor is obviously the rearmament effort that spans a long enough period to directly support steel activity. Its influence on the consumer goods market situation is only indirect and, consequently, less continuous.

The delay in the recovery of the German steel industry compared to West Germany's general industrial production and the steel sector expansion in other countries provides an equally important contributory factor. In 1951, German crude steel output was only running at 91% of 1936 production levels; by contrast, the general industrial production index was up to 136 compared with 1936. On the one hand, this lag acted as a stimulant for German steel output which rose from 13.5 million tonnes in 1951 to 14.8 million in 1952. On the other hand, it enabled West European steel industries, temporarily sheltered from German competition, to either continue their expansion as in France, Italy, the Netherlands and England, or maintain their activity at the high level reached in 1951, as in Belgium and Luxembourg.

The British steel industry had gone through a difficult patch, particularly in early 1952, due to poor supply of raw materials. It was not able to match the production figures foreseen in the plans.

The industrial equipment of less-developed countries of Latin America, the Near and Middle East, whose import markets were still quite active, was another expansionary factor for the European steel industry.

In the end, there was a completely random event; the US steel strike. It led to a relative loss of between 15 and 18 million tonnes of crude steel compared with the forecasts. This gap to make up was a major stimulant for the steel industry.

Despite the active presence of these stimulants, signs of a slowdown in activity first began to appear around the summer, and then became more obvious in October and November 1952. International competition was getting fiercer, foreign markets were better supplied, delivery times were getting shorter – all of which suggested that production capacities had adjusted to the stronger demand. Export prices started to fall from the third quarter and the price of scrap, a key index of the steel production cycle, began to collapse.

### *Belgian steel industry*

Activity in Belgium's steel sector, just like the Grand Duchy of Luxembourg's, has held up at the high level that it had reached in 1951.

The continued high level of activity is due to the stimulants listed above coming into play: exports to Great Britain, West Germany and the United States are evidence of the extent of their influence.

The high volume of Belgo-Luxembourg output should nevertheless not detract from the fact that it was the only cog in the European steel production machine to fail to exceed 1951 volumes. There was simply no growth in demand. Highly sensitive to cyclical fluctuations, demand in Belgium was the first to feel the signs of a slowdown in the global steel cycle, while production in other countries, geared towards more stable domestic markets, could still continue to expand. Besides, even if an increase in demand had called for higher output, Belgian production would have run into a physical barrier, since it had almost reached its maximum capacity in 1951. In 1952, the increase in production capacity was tiny, in contrast to what had happened in other countries.

## II. – Price Outlook

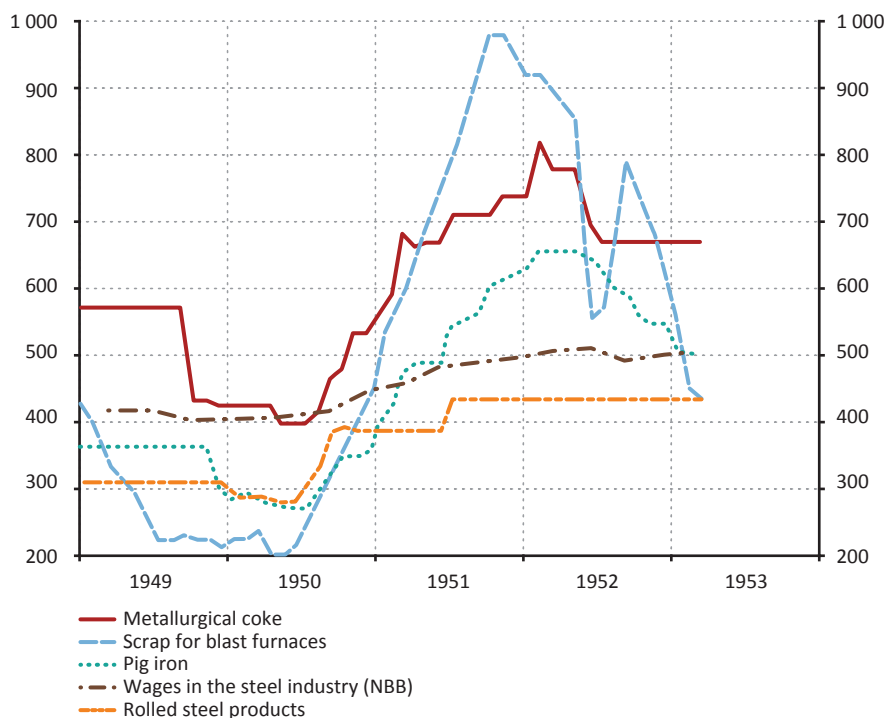
### *Change in prices*

Steel prices were stable during the course of 1952 (Chart I). Since the month of June 1951, merchant steel has been priced at 4 200 Belgian francs and heavy plate at Belgian francs 4 725. Prices of other steel products enjoyed the same stability.

However, 1952 was a year of strong activity while demand for steel products fluctuated wildly, so it is not the stable economic outlook that can offer an explanation for the stability of steel prices.

**Chart I**

**Prices in the Belgian Steel Industry (1936/38 = 100)**



Source: I.R.E.S.

### *Stability of steel prices*

This can be explained by the specific structure of the market for steel products.

First of all, it is worth noting the role played by the distinction between domestic prices and export prices. In the case of most products, foreign demand is more sensitive than domestic demand. This generally implies greater flexibility of export prices. This fact is of utmost importance for the Belgian steel industry, since it exports more than half of its output. In a period of buoyant activity, as in 1951 and at the beginning of 1952, strong foreign demand pushed up export prices, which greatly boosted the revenues of steel companies.

As far as domestic prices are concerned, different forces, both economic and political, were acting against a sharp rise that would have brought them up to a level that could still have been sustained by domestic demand. Faced with this opposing force, the steel industry did not insist on raising domestic prices, on the one hand, because it hoped that, in this way, it would make sure it had a loyal home market in the event of a depression and, on the other hand, because its domestic shortfall had been offset by extra revenues generated by exporting at excessively high prices. Despite the cyclical sensitivity of the steel industry, domestic steel prices had not responded with any great flexibility to the rise in 1951. Already observed before the war, this price behaviour became dominant during the two post-war periods of booming activity: in 1948/49 and 1951/52. Throughout these periods, export prices, expressed in indices as well as in absolute terms, are much higher than domestic prices.<sup>1</sup>

In conclusion, the practice of dual-pricing offers a partial explanation for the relative stability of domestic prices for almost two years of sustained levels of economic activity.

A second explanatory factor is also due to the specific structure of the market for steel products. The importance of the equipment and the special features of the production process have led to a strong concentration of the steel industry. The result is that, on a restricted market like Belgium's domestic market, price

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<sup>1</sup> This argument does not seem to be reversible and does not apply fully to the assumption of a depression. In fact, while domestic steel prices are subject to upward rigidity, they are much less so in the downward phase. They reflect the drop in export prices quite closely, albeit with a much smaller lag than during an upturn. In the first half of 1950, for example, domestic prices were at the same level as export prices, fluctuating around 2 600 Belgian francs for merchant steel.

formation does not follow the classic rules of perfect competition, which would assume that there is a large number of independent producers and consumers: this is the case, for instance, on the major international markets, in the absence of any cartel. Instead of being determined by spontaneous market forces, prices on the domestic steel market are the result of negotiations between representatives of producer and consumer organisations. As this process generally tends to be laborious, prices fixed in this way change only rarely. The presence of organised consumer groups also explains the pressure that they can exert on prices.<sup>1</sup>

Added to this was State control. A Ministerial Decree of 20 December 1950 made the price of merchant steel subject to the system of mandatory price increase declarations. Although this is not exactly the same thing as the maximum price regime, it nevertheless involves the obligation to justify any price rises by cost-price elements. Moreover, as the Minister can, if necessary, fix maximum prices, the regime really does imply price control.

It should also be added that the stability of domestic steel prices does not concern all output sold on the domestic market. Some “extras” may actually be added when steel – although sold to a domestic buyer – is exported at the following stage. This mitigates the importance of price rigidity for an appreciable proportion of domestic sales.

By way of conclusion, domestic steel prices, especially in periods of strong economic activity, are not a particularly good indicator of the real cyclical trend and certainly not of the intensity of demand for steel products.

### *Sensitive steel prices*

The case of export prices is completely different; they have retained their extreme flexibility and are still the most cyclically-sensitive indices (Chart III). After having reached their peak in the last quarter of 1951 and the first three months of 1952, export prices fell rapidly, indicating some saturation of international markets. They stopped falling in the third quarter of 1952 as the American steel

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<sup>1</sup> Consumers’ bargaining power varies with the economic situation. When demand is very strong, as in 1951 and 1952, it can put the brakes on the rise, but not prevent it altogether. When demand is weak – in times of recession – it can speed up the decline.

strike exerted its stimulating effects. But the decline resumed from the month of October.

Scrap price movements follow a very similar trend (Chart I). Having peaked at almost 4 200 Belgian francs in November 1951, i.e. the price of merchant steel, the price of scrap for blast furnaces suffered a rapid decline in the first half of the year, then enjoyed a marked upturn during the third quarter, as a result of the strike in the United States. Confirming the reversal in the steel production cycle, the decline continued during the last quarter of the year.

Pig iron and coking coal prices are on a downward trend.

### *Wages*

The pace of activity is reflected in movements in the index of average wages paid in the steel sector. A sharp fall was observed during the third quarter, then a slight recovery at the end of the year. This does not mean a change in wage rates, but a change in the number of overtime hours worked and in the production bonus.

## III. – Production

### *Trend in steel output*

In 1952, there was little change in the volume of Belgium's steel production on 1951 levels. Annual production held up at the exceptionally high level reached the year before; a small decline was barely detectable in certain sectors. Production of pig iron weighed in at 4 774 209 tonnes in 1952, compared with 4 847 164 tonnes in 1951, down by only about 1.5%. Production of crude steel in 1952 came to 4 995 414 tonnes, against 5 007 626 tonnes in 1951. The decline is hardly significant. Lastly, a drop of around 3% can be observed in output of finished steel products, which fell from 3 887 004 tonnes in 1951 to 3 762 727 tonnes in 1952.

However, a comparison of the two years cannot be made without taking account of monthly changes in output (Chart II). Throughout the whole of 1951, the trend in production was uniform. It only slowed down marginally at the time of paid holidays; moreover, an upward trend was observed from January to

December. The trend in output in 1952 is quite different. During the first three months of the year, monthly output figures reached an all-time high and factory output was close to its maximum capacity. From April onwards, a sharp slump in production can be noted. Together with the weakening of cyclically-sensitive prices at the time (Chart I), it clearly points to the beginnings of a better supply of steel products. The fall bottomed out in the summer. The strike in the US steel sector and orders from West Germany improved the situation in the autumn months. However, end-of-year production figures did not reach the levels seen in the previous year.

**Table I.**  
**Pig Iron Production in Belgium in 1952 (in tonnes)**

Month	Thomas iron	Other	Total
January	416 527	22 274	438 801
February	390 901	16 900	407 891
March	421 715	18 539	440 254
April	395 649	16 571	412 220
May	388 637	13 077	401 714
June	367 894	12 835	380 729
July	335 378	12 367	347 745
August	311 385	18 076	329 461
September	370 126	15 644	385 770
October	399 973	14 820	414 793
November	385 381	10 063	395 444
December	400 231	19 156	419 387
<b>Annual total</b>	<b>4 583 797</b>	<b>190 412</b>	<b>4 774 209</b>

*Source: I.N.S.*

**Table II.**  
**Ingot production in Belgium in 1952 (in tonnes)**

Month	Thomas	Martin	Electric	Total
January	388 924	49 163	11 567	449 654
February	361 914	51 607	13 145	426 666
March	387 069	59 537	13 132	459 738
April	365 456	50 759	14 342	430 557
May	356 035	52 039	13 707	421 781
June	329 219	48 394	13 351	390 964
July	292 237	42 770	11 347	346 354
August	278 107	47 511	12 592	338 210
September	352 842	61 220	15 006	429 068
October	377 697	59 444	15 702	452 843
November	345 932	46 250	14 550	406 732
December	374 589	55 792	12 466	442 847
<b>Annual total</b>	<b>4 210 021</b>	<b>624 486</b>	<b>160 907</b>	<b>4 995 414</b>

Source: I.N.S.

**Table III.**  
**Production of finished steel in Belgium in 1952 (in tonnes)**

Month	Finished iron and steel products
January	352 270
February	334 403
March	351 693
April	324 443
May	313 891
June	284 368
July	240 776
August	261 505
September	321 493
October	347 349
November	307 225
December	323 311
<b>Annual total</b>	<b>3 762 727</b>

Source: I.N.S.



**Chart II**  
**Belgian steel industry monthly output (in thousands of tonnes)**



Source: I.N.S.

### *Structure of production*

The stability of global crude steel production is only an average trend – the result of divergent trends in production of the various steel qualities. Production of Thomas steel dipped slightly from 1951 levels: it is the most accurate reflection of the general trend on traditional markets. Most probably under the influence of American orders, production of Martin steel, by contrast, expanded. Since US

steel production is largely composed of Martin steel, the brief shortage caused by the strike led notably to imports of it. The huge expansion of electro-steel stems from the strength of demand for special qualities (specialty steel).

The decline in production of finished steel products is by no means uniform. There has been a clear reduction in the case of production of steel wire rods and thin sheets, but it has been less pronounced for output of strips and bars. Production of merchant steel, sections, heavy and medium plate products has even expanded. Exports to Germany and England contributed to this.

### *Raw materials and factors of production*

The number of blast furnaces in operation has varied in line with fluctuations in output, reaching 50 at the beginning and at the end of the year, although shrinking to 46 during the third quarter. Adjustment of blast furnace numbers to the pace of activity and the use of richer types of ore have brought daily production of pig iron per blast furnace up to 271 tonnes in 1952, compared with 266 tonnes in 1951.

Consumption of coke has risen: the average yield rate in 1952 reached 870 kg of coke per tonne of pig iron, while it had been 843 kg the year before. This is due to the drop in consumption of scrap, which fell from 287 kg in 1951 to 247 kg in 1952. At the same time, consumption of ore has risen.

The drop in consumption of scrap metal can be partly explained by the fact that imports from Germany have fallen back sharply: the expanding German steel sector now needs domestic scrap metal; there is also a lot less scrap available.

Imports of iron ore by the B.L.E.U. have scarcely grown; in 1952, they weighed in at 11 383 015 tonnes, compared with 11 218 832 tonnes in 1951. However, the composition of the import trade has changed significantly: imports of the richer ore from Sweden increased by around 15%, while the volume of imported French declined. Belgium's imports of iron ore from Luxembourg rose considerably – from 1 780 000 tonnes in 1951 to 2 406 628 tonnes in 1952.

The number of workers employed in the steel industry has hardly changed. The annual average for 1952 is 49 528 compared with 49 798 in 1951.

## IV. – Luxembourg Steel Industry

In 1952, Luxembourg's steel production followed the same trend as that observed in Belgium. Activity was sustained at a still exceptionally high level, but about 2% below the figures reached in 1951.

**Table IV.**  
**The Luxembourg steel sector in 1952**

Month	Production (in tonnes)		Number of blast furnaces operating at end of the month
	Pig iron	Steel ingots	
January	274 851	266 314	27
February	270 416	264 640	27
March	267 752	260 456	27
April	245 547	241 248	27
May	254 701	247 416	27
June	239 104	232 943	27
July	245 900	241 399	27
August	243 504	230 249	27
September	256 915	254 179	27
October	269 920	267 597	27
November	251 045	240 910	27
December	256 331	254 354	27
<b>Annual total</b>	<b>3 075 986</b>	<b>3 001 705</b>	

*Source: Office de la Statistique générale, Luxembourg.*

Pig iron production fell back from 3 157 000 tonnes in 1951 to 3 076 000 tonnes in 1952. A decline of the same magnitude can be recorded for crude steel production, which came to 3 002 000 tonnes in 1952, compared with 3 077 000 tonnes in the previous year. Rolled steel production in 1952 was 2 172 000 tonnes, but had reached 2 248 000 tonnes in 1951.

The monthly fluctuations in Luxembourg's steel output showed a close parallel with Belgian production. Just like in Belgium, the drop in production over the summer months was larger than normal; then, from the autumn months onwards, there was some reversal due to general economic factors that we have already mentioned.

Since there had been a slight contraction in pig iron output, although the number of blast furnaces fired up remained at 27 throughout the whole year,

daily production of pig iron per blast furnace fell from 322 tonnes in 1951 to 313 tonnes in 1952.

## V. – Exports of Belgo-Luxembourg Steel Products

### *Steel exports by volume and value*

Although still very high, the volume<sup>1</sup> of exports in 1952 is 1.5% below the volume reached in 1951. Since output has dropped back by the same extent, the share of exports in production has remained virtually unchanged.

**Table V.**  
**Export of B.L.E.U. steel products**

Customs tariff number	Product description	1951		1962	
		tonnes	1 000 frs	tonnes	1 000 frs
699	Ingots	28 203	156 245	6 343	37 769
700 a	Blooms	42 961	220 774	71 424	368 483
700 b	Billets and sheet bars and tinplate bars	354 487	1 703 403	452 218	2 580 217
701 a, b	Hot-rolled bars	2 435 848	13 042 946	2 289 688	14 579 590
702 a	Hot-rolled wire	262 486	1 584 836	271 374	1 784 946
703 a	Hot-rolled sheet	691 229	5 321 448	642 721	5 840 685
703 b	Cold-rolled sheet	120 116	1 383 023	179 819	1 876 946
704 a, b, c, d	Worked sheet metal	71 590	1 060 380	60 420	872 138
705 a, b, c, d	Other sheet	143 740	2 136 229	101 363	1 267 887
706 a	Hot-rolled hoop	231 905	1 335 238	190 367	1 373 891
713 a, b	Rails	113 019	534 784	143 975	805 781
714	Metal sleepers	32 451	144 287	42 326	187 417
715	Soleplates	9 202	66 158	12 141	121 984
<b>Total</b>		<b>4 537 237</b>	<b>28 689 751</b>	<b>4 464 179</b>	<b>31 697 734</b>

Source: I.N.S.

<sup>1</sup> What we refer to as the “volume of steel exports” (4 537 000 tonnes in 1951 and 4 464 000 tonnes in 1952, see statistical Table V) does not actually correspond to the volume of exports as summed up by the *Bulletin mensuel du commerce extérieur* under the title “*Métaux communs – fer, fonte, acier*” (Common Metals – iron, pig iron and steel) which came to 5 212 425 tonnes in 1951 and 5 090 081 tonnes in 1952. The latter actually comprises products that do not usually fall under the category of steel products, as used in international or foreign statistics (see the *Bulletin de la Chambre syndicale de la Sidérurgie française*). Using the *Bulletin du commerce extérieur*’s terminology, the share of steel exports in total exports was 27.7% in 1951 and 32.2% in 1952. Growth remains of the same order of magnitude.

Exports in value terms grew by around 10.5%. Effectively, although export prices had started falling from the second half of 1952, the annual average of external prices remained higher in 1952 than in 1951. The growth of the value of steel exports reinforces the importance of the steel sector among the exporting industries: the share of steel product exports in the B.L.E.U.'s global export tally rose from 21.7% in 1951 to 25.9% in 1952. The growing importance of steel exports is an accurate reflection of the economic situation in 1952: continued buoyant activity in basic industries, decline of production in the consumer goods industries.

### *Structure of exports and markets*

Changes in the composition of exports are barely significant. One can observe an increase in exports of crude steel and rails, mainly due to the growth of exports to Germany. The rise in exports of cold-rolled sheet continue to reflect the installation of new technical units, in 1951, in the Liège industrial area. The export of other qualities of steel suffered a small contraction (statistical Table VI).

**Table VI.**  
**Export of B.L.E.U. steel products, by destination**

	1951				1952			
	tonnes	%	1000 frs	%	tonnes	%	1000 frs	%
The Netherlands	771 131	17.00	4 714 973	16.43	567 047	12.70	4 240 493	13.38
Italy	117 617	2.59	669 675	2.33	139 898	3.13	903 338	2.85
France	16 181	0.36	174 850	0.61	4 445	0.10	39 991	0.13
West Germany	3 154	0.07	13 653	0.05	470 542	10.57	3 065 712	9.67
Total ECSC	908 083	20.02	5 573 151	19.43	1 181 942	26.43	8 249 534	26.03
United States	493 646	10.88	2 787 701	9.72	347 715	7.79	2 098 474	6.62
Great Britain	154 210	3.40	811 725	2.83	430 782	9.65	2 813 654	8.88
Rest of the world	2 981 298	65.70	19 517 174	68.02	2 503 740	56.09	18 536 072	58.47
<b>Total exports</b>	<b>4 537 237</b>	<b>100.00</b>	<b>28 689 751</b>	<b>100.00</b>	<b>4 464 179</b>	<b>100.00</b>	<b>31 697 734</b>	<b>100.00</b>

Source: I.N.S.

But what was more important was the change, during the course of the year 1952, in the geographical location of markets.

Exports to traditional markets, such as the Netherlands, or overseas countries, are clearly contracting. This is reflected both in the absolute figures and in the share that these exports make up in the overall figure.

The growth of exports to Germany and Great Britain partly makes up for this decline. However, these markets are not traditional ones and their role as an outlet for Belgo-Luxembourg steel products can only be fleeting. Germany's share in global steel exports rose from almost nothing in 1951 to 10.5% in 1952. The growth was stimulated by the lag in German steel production behind the higher needs for the year 1952. The British market absorbed 9.6% of global exports in 1952, compared with 3.4% in 1951. This is largely due to the presence of numerous bottlenecks in the British production chain at the end of 1951 and the beginning of 1952, caused by raw material supply difficulties and by capacity shortfalls in the initial stages of production.

## VI. – The European Coal and Steel Community (E.C.S.C.)

### *Institutional aspects*

On 18 April 1951, the Foreign Affairs Ministers of six countries, Germany, Belgium, France, Italy, Luxembourg and the Netherlands, signed the Treaty establishing the European Coal and Steel Community. The draft laws ratifying the Treaty were put before the various national parliaments as early as the summer of 1951; they were approved during the first half of 1952. The Heads of State ratified the Treaty in July 1952 and it entered into force on the 25th of the same month.

On 10 August, the High Authority, the executive body of the E.C.S.C., was set up in Luxembourg. The other institutions of the Community, such as the Joint Assembly, the Court of Justice, the Special Council of Ministers and the Consultative Committee came into service during the second half of 1952 and at the beginning of 1953.

The common market for coal, scrap and ore was officially opened on 10 February 1953; the common market for steel opened on the first of May the same year.

## *Economic provisions of the Treaty*

Let us briefly recap some of the basic provisions laid down by the Treaty on economic matters.

1. The E.C.S.C. establishes a common market for coal and steel products whose competence covers the following: raw materials, such as iron and manganese ores and scrap; pig iron and a few ferro-alloys; crude, semi-finished and finished hot-rolled iron and steel products; and, lastly, certain end products made of iron or steel.<sup>1</sup>
2. The notion of a common market implies the removal of any institutional, public or private barrier that might hinder competition between production units. Also, the opening of the common market thus involved the abolition of customs duties, quotas, subsidies and any other measure designed to favour national industry. At the same time, it prohibits the formation of cartels<sup>2</sup> or business agreements and abolishes any discrimination between domestic and foreign buyers.
3. Price-setting has been abandoned, in principle, in favour of the operation of a competitive marketplace.<sup>3</sup> The High Authority may nevertheless intervene, in the event of a crisis, to set minimum prices, or in the case of major cyclical tension, to set maximum prices. The right of intervention is facilitated during the transitional period spanning the years 1953-57; it involves setting production quotas intended for the domestic market.
4. The Treaty makes provision for the High Authority to intervene to provide supplementary financing investment. It gives it full financial independence; by levying taxes directly from firms and without the intervention of national

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<sup>1</sup> Falling outside the competence of the E.C.S.C. are steel castings, forgings, steel tubes, certain categories of cold-rolled strip, wire and wire products, bright bars and iron castings.

<sup>2</sup> Only cartels concerning regulation of the internal market are abolished; producers are free to form cartels for operating on foreign markets.

<sup>3</sup> While insisting on competitive price-setting, the Treaty arranges this competition by requiring enterprises to publish lists of prices that may not be exceeded. In addition, the Treaty allows the “parity price” practice. Under this practice, prices are quoted from a geographical place, regardless of where the producer is located. With the High Authority’s approval, the constitution of several zones is provided for; “basing points” will be chosen among the main production centres. The “parity price” practice, referred to as Basing-Point Pricing in the United States, is regarded as a monopolistic method that hinders free competition. It falls under the competence of anti-trust law. See, for example, Machlup, Fritz, *The Basing-Point System*, Philadelphia and Toronto, The Blakiston Co., 1949 and Clark, J.M., *The Law and Economics of Basing Points*, *American Economic Review*, March 1949.

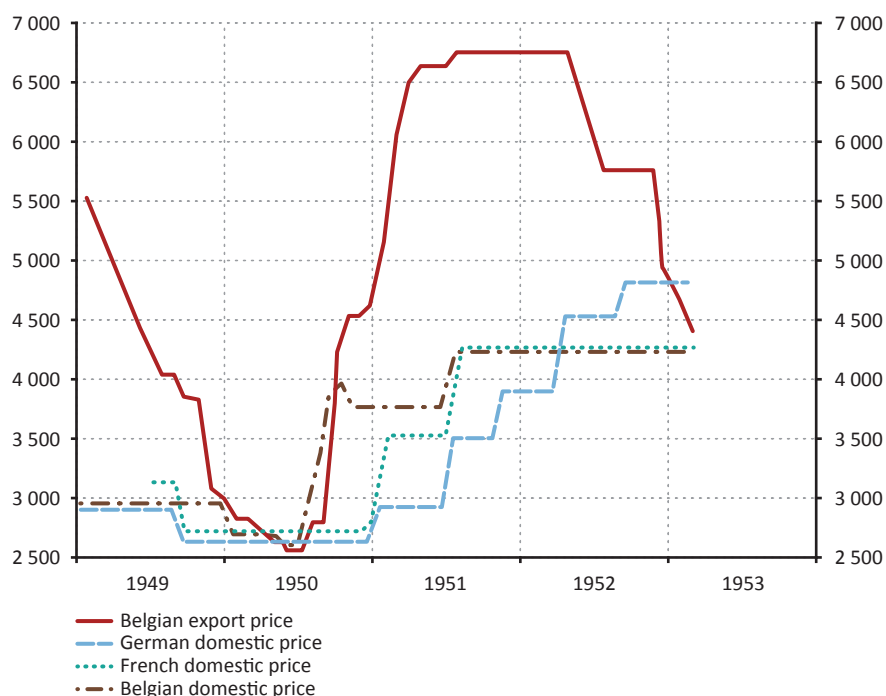
governments, the High Authority will have large funds at its disposal. It may use them either for servicing loans it has contracted itself or for guaranteeing loans contracted directly by enterprises.

### *The common market for steel and the outlook for the iron and steel cycle*

What are the problems raised by the opening of the common market for the Belgian steel industry? We shall first take a look at the current economic aspects of the question; the influence of the E.C.S.C. on longer-term trends is examined in the following paragraph.

**Chart III**

**Domestic prices in certain countries and merchant steel export prices  
(in Belgian francs per tonne)**



Source: I. R. E. S.



During the course of the year 1951 and in the first half of 1952, i.e. at the time of the negotiations, prospects for the immediate opening of the common market for steel had not been particularly good. The Belgian steel industry was riding on very high export prices in those days (Chart III). In 1951, roughly 20% of the B.L.E.U.'s steel exports – 908 083 tonnes – had gone to future member countries of the Community. In 1952, the figure had risen to 26%. But the common market implies the abolition of all forms of discrimination between national and foreign buyers; its opening would therefore have led to a sharp reduction in revenues from the sale of almost one million tonnes of steel at low domestic prices, at a time when raw material prices (coke, ore, scrap) were at their peak<sup>1</sup>. The same problem would obviously have arisen for other exporting member countries; the share of exports in their domestic production is nevertheless well below the Belgo-Luxembourg industry's. Consequently, the scale of the problem for the other nations was smaller.

Following the drop in export prices in the second half of 1952, the economic consequences of the market opening look rather different in the first quarter of 1953. At the end of March 1953, the price of merchant steel for export had fallen to around 4 300 Belgian francs. Since the profit margin derived from exporting was less than 100 Belgian francs, the fact that it was wiped out for a certain part of the volume exported no longer entails any great loss.

As far as production costs are concerned, the situation has not changed much. Although raw material prices have fallen, the Belgian steel sector is still working with much more expensive coke than its partner countries' iron and steel industries.

There were some immediate advantages, although very modest, to come out of the opening of the common market for coal. With a view to aligning the Belgian steel sector's production costs with those of the other Member States' steel industries, the Treaty provisions on the transitional period opened up the possibility of a regime of cross-subsidies had the Belgian coal market been kept in isolated conditions. Yet the Belgian coal market was open to competition; the result of this was a slight dip in coal prices, which makes application of the cross-subsidiation system questionable. High demand for coal made it possible to avoid an even

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<sup>1</sup> This large drop in revenues would only have been partly offset by a small rise in domestic prices.

sharper drop, making things easier for the coal mines. However, the excessively timid drop in coal prices is disappointing for the user industries, especially for the iron and steel industry, which thus find themselves at a disadvantage to the partner countries' industries.

Despite the unfavourable cost conditions, Belgian steel prices are lower than those in the Ruhr or France (Chart III).

The arguments that we have just put forward concern the present situation. What developments can be expected in the immediate aftermath of the opening of the common market?

Apart from economic factors, establishing the domestic price of steel depends on political and administrative decisions. It is thus impossible to accurately predict the level at which the domestic price for steel would settle after the common market was launched. But the price differentials are not very great. The adjustments to be made will not be very big either. As Belgian prices are the lowest, the alignments will be made either through a slight rise in Belgian prices, or a slight drop in foreign prices. In the current steel cycle, the second assumption is the most probable<sup>1</sup>.

All this concerns the immediate future. However, it seems to be more interesting to study the impact of the common market in the medium term. Whatever price adjustments are made immediately after the market is opened up to competition, we can expect an iron and steel economy that is slightly in recession (see Conclusions and Outlook). The problem that needs to be studied is thus the following: what are the likely effects that the common market will have on the Belgian steel sector in the event of a cyclical downturn?

In a cyclical contraction, there is a downturn in export prices, nevertheless followed quite closely by domestic prices. In this case, there is very rarely any distinction between foreign and domestic prices of the extent to that usually observed in periods of strong economic activity. Despite that, domestic prices may be marginally higher than export prices during the depression.

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<sup>1</sup> The short-term forecasts are nevertheless rather uncertain; the opening of the common market on the first of May will put an end to the uncertainty about this measure and could give rise, for instance, to a temporary firming up of demand.

Let us assume first of all that this price behaviour continues after the opening of the common market. The ensuing gain from the market opening for the Belgo-Luxembourg steel industry will probably be minimal: it will depend on the size of the gap between domestic prices and export prices. Effectively, the potential gain is based on the fact that part of the exports, sold previously at external prices, will from now on be sold at domestic prices, perhaps slightly higher, in the event of a depression.<sup>1</sup>

However, it appears to us that the opening of the common market will indeed affect price movements. It will have the effect, on the one hand, of slowing down the fall in export prices, and on the other hand, further slowing down the drop in domestic prices. This means that the price decline would slow and, at the same time, there would be a stronger uncoupling of the more rigid domestic prices from export prices. The end result would be a double advantage for the Belgian steel industry.<sup>2</sup>

For what reasons do we think this could be the case?

The brake on the fall in export prices would come from the fact that sales cartels for overseas markets, encompassing all E.C.S.C. producers, because of their clout on the international market, will have the possibility to impose their will on prices. Partial cartels or general, but less coherent, European cartels would have less bargaining power on the international market.

But there is an even great probability of seeing domestic prices become less flexible in the downward phase and move even further apart from export prices. In the event of a major crisis, the High Authority will effectively be able to set minimum internal prices which would rule out the likelihood of a price war between E.C.S.C. producers. Before the Community was set up, because of

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<sup>1</sup> As we have already pointed out, in boom periods, this same transformation of the structure of exports would involve some disadvantage, since the differentiation between domestic and export prices in this period of the cycle is both greater and more widespread. In fact, in an upturn, export prices generally tend to be higher than domestic prices.

<sup>2</sup> On condition, of course, that the price elasticity of demand is less than one, at least for the part of the demand curve in question. In this case, any loss resulting from the reduction in the quantities sold is more than offset by the gain from keeping prices rigid. American research work in this area unanimously confirms the inelasticity of demand for steel products, (see A.R. Oxenfeldt, *Industrial Pricing and Market Practices*, New York, Prentice Hall, 1951, p. 514). Given that the inelasticity of demand results from certain technical features of markets and production processes rather than from the specific characteristics of the American market, we have absolutely no reason to assume that it would be any different in Europe. If policies on cartels, seeking to keep prices rigid in the event of a downward trend, had not served the producers' interests, it would be difficult to understand their *raison d'être*.

foreign competition, whether actual or potential, national measures designed to shore up domestic prices often turned out to be ineffective, when they were not accompanied by any direct protection of the internal market. In the Community, things would be different: even in the absence of protectionist measures, setting minimum domestic prices could prove to be effective. There will, in fact, be less danger of competition from non-members, since the majority of producers, with competitive opportunities, are now in the Community and will thus be subject to any minimum price system.

We can conclude that, in the event of falling demand, the Belgian steel sector's position will stand to benefit from the opening of the common market, thanks to greater resistance of prices to a downward trend.

It is even likely that demand will contract less rapidly. Up to now, in the event of a recession, the marginal quantities bought from Belgium by the other countries have been the first to be dropped. But, from now on, buyers hailing from the E.C.S.C. Member States will regard Belgium as belonging to the internal market; the fall in their demand will thus be less strongly concentrated on the quantities purchased in Belgium.

There is one last favourable element that can come into play: the High Authority's competence extends to steel production costs. There have been some cases of prices, like coal prices, which have exhibited extreme downward rigidity under the system of compartmentalised national markets, thus weighing very heavily on steel production costs. The High Authority will certainly not intervene to help the steel sector at the expense of ore or coke producers; but it will make sure that production costs are kept at reasonable levels. The excessively small drop in coal prices is not a conclusive experience in this matter as it is due to keeping demand for coal very high. A decline could be envisaged later as soon as demand starts to weaken.

By way of conclusion: in the event of a slowdown of activity, the Belgian steel sector – just like that of the other participating nations – will benefit from the constitution of the Community. However, in return for the benefits drawn from the common market in a cyclical downturn, it will have to make do with more modest revenues in an upturn. It thus appears that the constitution of the common market will tend to act more in the sense of attenuating the strong cyclical sensitivity of Belgian steel sector activity.

### *The E.C.S.C. and the long-term evolution*

The benefits of the common market emerge clearly from the study of its longer-term effects.

The constitution of one vast outlet will facilitate specialisation of production, which would bring production costs down. Further pressure will be exerted on production costs as rationalisation also extends to the production of raw materials.

Secondly, there may be some advantage from the role played by the High Authority in providing supplementary finance for investment. The guarantees offered by the funds put at the disposal of the High Authority could attract US capital which had so far not been invested in Europe, owing to a few bad experiences in the past.

Thirdly, some economists insist that the constitution of the common market is likely to trigger further growth in global demand for steel products. The possibility of such growth should nonetheless not be underestimated. Something that is repeatedly cited is per capita consumption of steel in the United States which by far exceeds that of the Community. The American advantage effectively stems from the wider market: but here it is question of a bigger market for all products. The more rapid growth of steel consumption in fact comes from the faster expansion of global industrial production, stimulated by a larger general market. A larger market for steel products alone would therefore only have limited stimulus effects on the Community's overall demand for steel. The main benefit of the E.C.S.C. lies in the more rational satisfaction of this demand rather than expanding it.

## VII. – Conclusions and Outlook

The year 1952 was a year of buoyant activity for the Belgian steel industry: over the whole period, production and export volumes were sustained at the level reached in 1951. Thanks to high price levels, the total value of exports even exceeded the previous year's results. However, the pace of activity was less uniform than in 1951 and the cyclically-sensitive indices, like the price of steel for export and scrap prices, showed signs right from the start of the year of a better supply of the steel product markets.

The downward trend in sensitive prices continued into the first quarter of 1953; but as a sign of a cyclical downturn, in March 1953, European exporters set up an agreement aimed at regulating export prices and putting an end to disorganised competition on foreign markets. In the same month, the High Authority also set maximum prices for scrap: a few days later, some transactions were concluded at prices below the official ceilings. The weakness of the markets in the first quarter is partly due to the uncertainties in the run-up to the opening of the common market for steel, planned for the first of May. However, there are a whole host of facts that suggest the boom period in the steel sector is coming to an end.

This does not necessarily signal the approach of a major depression; besides, as we have seen, its effects would be likely to be slowed down by the establishment of the common market. Furthermore, demand can still be sustained at a satisfactory level: on the one hand, because military orders have not dried up yet, and on the other hand, because there are still many civil requirements, put on the back burner by rearmament, that have to be met. Finally, US economic policy is still expansionary. So, there is no threat of any collapse of demand.

The difficulties are more likely to come from the supply side, with the growth of supply made possible by a significant expansion of production capacity.

In the United States, production capacity is expected to be expanded by around 10 million tonnes during the course of 1953: at the end of this year, American production of crude steel could reach 108 million tonnes. Great Britain has already solved its early production stage bottlenecks: since the beginning of 1952, eight new blast furnaces have been started up, one after the other. In Germany, the month of July 1952 brought an end to the production ceilings that, up until then, had kept the country's steel output running below capacity. And, from the summer of 1952, French steel output kept the domestic market supplied quite comfortably; besides, its production capacity is in full expansion. The emerging economies are pressing on with building up their own iron and steel industry; new production units will shortly start up in South America and Canada. And finally, it is worth noting that Japan is moving increasingly towards expanding its heavy industry, instead of concentrating on the development of its consumer goods industries.

In conclusion, expanded production capacities, in 1953, will go hand in hand with rather stagnant demand.

## Chapter II

# The Pattern of Growth in Belgian Manufacturing Industry, 1937-1956

1958

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*In September 1953, Lamfalussy went to Nuffield College, Oxford, for two years as a research student. Lamfalussy focused his research on the weak investment and growth performance of Belgian industry. This would become the theme of his doctorate, with Philip Andrews as supervisor and Sir John Hicks as the main examiner. A revised draft of his Ph.D. thesis would be published in 1961 as a book entitled "Investment and Growth in Mature Economies. The Case of Belgium". The book immediately became a classic. Reproduced here is an article he published on this theme in 1958, "The Pattern of Growth in Belgian Manufacturing Industry, 1937-1956", in the Journal of Industrial Economics (Vol. 6, No. 2: 101-133). In the article, Lamfalussy develops a "vicious circle" argument, similar to Kaldor's, with low profits causing low investment and low investment leading to low profits, but Lamfalussy also brings international trade into the analysis. Reprinted with kind permission of John Wiley and Sons Inc. and the Lamfalussy family.*

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## Introduction

E.C.E. and O.E.E.C. reports have given a wide publicity to the assertion that economic growth has been proceeding at a slower pace since the war in Belgium than in nearly any other European country.

The purpose of this paper is to examine the validity of this proposition, and to explain it so far as it is true. It will be shown that, subject to some important qualifications, the statement may be accepted as valid. As regards the explanation, the main argument will centre around the volume and type of industrial investment, and it will be suggested that the factor mainly responsible for the low rate of growth is the inadequate level of profits, which in turn is related to the pattern of growth itself.

The paper falls into four parts. The first examines the available statistical evidence and describes the pattern of growth in post-war Belgium. The second consists of a theoretical digression the purpose of which is to discuss the various factors which determine the type and volume of fixed investment. The third works out an explanation of the Belgian development in terms of the theory outlined in part two. The fourth and final section deals with the impact of past development on the future prospects of the Belgian economy.

The analysis is restricted to manufacturing industry.

## I. Facts and Figures

(1) Growth is far from being a well-defined concept. It is often defined as an increase in total output, or in output per head of population, or in productivity; sometimes it is simply identified with capital accumulation.

How fast did the Belgian economy grow, as compared with other European countries, according to each of these definitions?

Table I shows quite clearly that, in terms of total manufacturing output, the rate of growth has been markedly slower in Belgium than in Europe in general. This is particularly true if the comparison is made with the U.K. for the immediate post-war years, and with the other European countries since 1948.

**Table I**  
**Indices of production in manufacturing industries**

	Belgium	United Kingdom	O.E.E.C. average
1937 <sup>1</sup>	100	100	100
1948	97 (101) <sup>2</sup>	110	95
1956	142 (146)	155	178

Notes:

<sup>1</sup> 1937 is a more appropriate base-year than 1938, since from 1937 to 1938 Belgian industrial production fell by 23 per cent, while that of other countries remained stable or declined only moderately. 1937 as well as 1948 and 1956 are cyclical peaks both in Belgium and in most European countries, and are therefore comparable.

<sup>2</sup> See Table III.

Source: O.E.E.C., General Statistics.



The picture is somewhat modified if the increase in population is taken into account. Owing to the rapid growth of population in Western Germany, Italy and in the Netherlands, the gap between Belgium and the O.E.E.C. average becomes narrower if growth is defined as an increase in output per head of population. It does not, however, disappear. In 1956, industrial output per head of population in Belgium was 33 per cent higher than in 1937, while the O.E.E.C. average increase was still 52 per cent. It was 48 per cent in the U.K.

If, on the other hand, growth is measured in terms of productivity, i.e. output per man-year of employment, Belgium's position is more enviable. No reliable employment figures are available for the prewar period, and therefore changes in productivity can be measured only since 1948.

**Table II – Productivity in manufacturing**

	<b>Belgium</b>	<b>U.K.</b>	<b>Netherlands</b>	<b>France</b>	<b>Italy</b>	<b>Germany</b>
1948	100	100	100	100	100	100
1950	150	125	147	153	200	243

*Source: O.E.E.C., General Statistics.*

If Germany is left out of account for obvious reasons, Italy is the only country where productivity rose substantially faster than in Belgium. France and the Netherlands are roughly in line with Belgium, while the British performance is considerably poorer. It may be mentioned that an even more favourable comparison for Belgium could be made by concentrating on the 1950-55 period. During that period productivity increased in Belgium by 40 per cent, against a 25 per cent increase in all the O.E.E.C. countries.

As regards capital accumulation, Belgium shares with Britain the doubtful privilege of having the lowest capital expenditures in Europe. Gross private capital formation, in per cent of the Gross National Product, has been moving, during the 1950-55 period (for which reasonably reliable estimates are available), in the neighbourhood of 15 per cent. There has been no trend of investment increasing substantially, except perhaps during the second part of 1956.

(2) Two facts thus emerge from these data on the pace of economic development in Belgium.

The first is the rapid rate of increase in productivity, placing the country not only before the U.K. but also somewhat before the high-investment Netherlands. It is generally assumed that in the long run substantial increases in productivity can be induced only by capital investment. Nearly all the growth models are based on this assumption, which results not only from the theoretical convenience of such a functional relationship, but also from the genuine belief that it is an adequate simplification of reality. Now in so far as the 1948-56 period may be called a "long run" the Belgian pattern of development, where a low level of investment is associated with a sharp rise in productivity, contradicts this "classical" assumption. How and why this happened is precisely one point to be explained in this paper.

The second fact emerges from a comparison of the productivity, output and employment figures. From 1948 to 1956 manufacturing production rose by 46 per cent, while productivity went up by 50 per cent. This amounts to a 3 per cent fall in employment during the same period. It would be hard to find a period of eight years of economic development in the history of any country where such a substantial increase in output has been carried out without a net increase in the labour force. Economic growth has been proceeding on a similar pattern in France and in Italy, but even in these two countries there has been at least some increase in employment.

(3) Post-war economic development in Belgium displays a number of other peculiar features which distinguishes it sharply from the economic growth in the neighbouring countries.

One of these peculiarities is the lack of any basic change in the relative importance of the various industries. In this respect, the comparison between the U.K. and Belgium is most striking. There are a number of similarities between the two countries (such as the density of population, degree of urbanization, relative importance of agriculture and of foreign trade, the historical development of their coal, steel and textile industries, etc.) which suggest that if there is a sizeable difference between them as regards the changes in the pattern of industrial production, this difference has to be traced back to factors other than geography, demography or history.

Current economic factors may be held responsible, as will be shown later.

**Table III – Changes in manufacturing output, 1956 as per cent of 1937**

	<b>General</b>	<b>Steel</b>	<b>Met. Prods.</b>	<b>Textiles</b>	<b>Chemicals</b>
Belgium	+42 (+46) <sup>1</sup>	+67	+48 (+60) <sup>1</sup>	+24	+104
U.K.	+55	+60	+102	-13	+190
OEEC av.	+78	+71	+118	+19	+148

Notes:

<sup>1</sup> *There exists no reliable index of production for the metal products industry in Belgium. Uncertainty prevails especially for the 1937-47 period. The author gives two estimates, derived from various sources, such as the Institut de Recherches Économiques et Sociales, Louvain, the Ministère des Affaires Économiques and the Bulletin de Fabrimétal. If the estimate in brackets is adopted, the general index of manufacturing output has to be modified accordingly. As, in the author's view, the 48% increase comes closer to reality, the text has been written on the basis of this assumption. The general argument, however, would remain valid even if the higher estimate were true.*

Source: O.E.E.C, General Statistics.

As a whole, as shown by Table III, the structure of industrial production in Belgium has not undergone a marked change such as took place in other countries, and particularly in the U.K., in favour of engineering and at the expense of the textile industry. Engineering output has been increased not much faster than the national average, and the production of textiles has not fallen very far behind. Steel output, on the other hand, is well over the average, while it is in line with the general manufacturing output elsewhere. Only chemicals are in all cases over the average though the intensity of their development is widely different. It could be shown, moreover, on the basis of a more detailed statistical analysis, that both in the engineering and the chemicals group, the development of the more finished products has been slower in Belgium than elsewhere.

That no substantial change has occurred in the pattern of manufacturing is also shown by the employment figures. There has been practically no shift from textiles to engineering, as in Britain.

Another typical feature of post-war Belgium is the type and distribution of her (already limited) capital expenditures. There exist, unfortunately, no statistics of the distribution of investment by industries, but some estimates are available of the distribution of industrial investment by types of assets. Again, a comparison between Belgium and the U.K. may be useful (see Table IV).

How can these differences be interpreted? It may be safely assumed that both capital widening in the existing lines of production, and investment in entirely new lines require a higher building activity than investment in labour-saving devices. The figures therefore suggest that rationalization and labour saving (capital deepening) has played a more predominant role in Belgium than in the U.K.

**Table IV**  
Distribution of industrial investment by types of assets, average from 1950 to 1954 (in per cent)

	Building	Plant and Machinery	Vehicles	Total
Belgium	13.5	79.5	7	100
U.K.	27	66.5	6.5	100

Source: X<sup>e</sup> et XI<sup>e</sup> Rapports relatifs aux problèmes des Investissements, Ministère des Affaires Économiques, Brussels.

A second set of data on capital expenditures confirms this conclusion. According to tentative estimates, the share of capital consumption in total gross investment seems to be, extremely high in Belgium. In 1953, it amounted to 69 per cent, against 58 per cent in the U.K., 59 per cent in France, 56 per cent in the Netherlands and 39 per cent in Germany.<sup>1</sup> Whatever the statistical errors may be, the difference is too great to be ignored. Belgium spent obviously a higher proportion of her already low capital expenditure on renewing old plants and replacing old machinery than any of the above-mentioned countries. The renewal implied, of course, modernization, rationalization, labour saving. Capital widening in the existing line of production or the creation of new firms (and, *a fortiori*, industries) is carried out in the form of *net* rather than gross investment.

(4) To sum up. The rate of growth of industrial output from 1937 to 1956 has been slower in Belgium than in the other European countries, but the rate of increase in productivity, especially in the later years, has been rather on the high side. Capital expenditures have been among the lowest in Europe, and the little investment that took place was directed towards the modernization and the rationalization of the existing types of production, resulting in a highly successful

<sup>1</sup> *Économie Belge et Comptabilité Nationale*, Institut de Sociologie Solvay, Brussels, 1955.

process of labour saving. Accordingly, no substantial change occurred in the relative importance of the various branches of manufacturing industry.

This seems to be an accurate description of the pattern of growth in the Belgian manufacturing industry since the war. The remainder of the paper will attempt to explain it.

## II. The Factors Governing the Rate of Investment in Fixed Capital

Since the greater part of the argument will be in terms of investment decisions, it seems convenient to start the analysis by examining the factors which govern the rate of investment in a particular firm or industry and in the economy as a whole. This calls for a theoretical digression, the purpose of which is to enumerate the various factors which are likely to influence the level of investment.

There is no question of establishing a general theory of investment decisions. The object of this analysis is to outline a certain number of concepts, distinctions and functional relationships which may help us to work out a set of assumptions with particular relevance, to the Belgian growth problem. This involves, first, that the problems connected with the cyclical fluctuations of the volume of investment are left out of account and that attention is centred on the level and type of investment, over a more or less “long” period. This leaves aside, for instance, the problem of time-lags. Second, the factors which are supposed to determine the level and type of investment have to be statistically measurable, not only in principle but also in fact. Third, concepts and distinctions which do not seem to be relevant to the Belgian set-up are not discussed.

(1) According to economic theory, the firm’s investment decision at any moment of time, is the result of the confrontation of the marginal efficiency of capital schedule with the cost of finance. A limit to the volume of investment decided in this way may be set by the non-availability of finance, or the physical shortage of plant, machinery, building or fresh labour (if this latter is necessary to man the new equipment). Let us review each of these factors.

(2) The marginal efficiency of capital schedule may be defined as the series of the prospective rates of return over cost (other than the price of finance) related to

each additional pound to be invested. The word “prospective” has to be stressed: it shows clearly the importance of expectations. The problem, therefore, is to make some sensible assumptions about the factors determining the expectations themselves.

The *current* rate of return over cost depends on the, intensity and elasticity of the final demand on the one hand, and the current costs of production on the other. These latter are determined, in turn, by factor prices and by the state of production techniques. The *expected* rate of return is then clearly determined by the expected state of demand and the factor prices.

An analysis on these lines does not carry us very far for at least two reasons. First, because it seems unlikely that businessmen, when planning a capital expenditure, make independent forecasts about the future development of demand and the various components of production costs. Secondly, even if they did so, there are good reasons to disregard it, since it would lead us into considerable analytical difficulties. It would involve a separate analysis of the factors determining demand and factor cost expectations which would prove rather laborious: the position of a demand curve, expected or actual, is hardly measurable statistically.

There is another line of approach, which involves some arbitrary assumptions, but yields at least a significant result. Let us assume that the firm is in equilibrium: its capital stock is adjusted to the current rate of output. Then an increase in demand occurs. Output increases, and the volume of total profits, too: the firm reaches a new short-run equilibrium, but is working by now in conditions of long-run disequilibrium. If its capacity were adjusted to the new level of demand, the profits earned would be still higher. Investment will not occur, however, unless the entrepreneur believes that the rise in demand will be sufficiently lasting. One may speculate a lot about what will make him believe this; I am inclined to think that it will be his own experience, i.e. the length of time which elapsed since the increase in demand (and in profits) has taken place. The length of the “testing period” depends, of course, on the length of life of the piece of equipment, and on the entrepreneur’s general industrial experience as well as on his individual psychology.

This suggests that investment occurs in response to an increase in demand that has already been experienced and judged to be sufficiently “permanent”. The

amount of investment may thus be functionally related to an increase in the amount of profits and to the maintenance of profits on this higher level. This, however, is not enough, if the assumption of an initial equilibrium position is dropped. At the beginning, the capacity may be underemployed: a rise in output (and profits) in this case will not necessarily be the sign of a shortage of capacity and therefore will not necessarily call forth investment. How are we to measure whether the firm is working below, at or over the optimum capacity? The direct way is to look at every particular firm or industry and get some idea of the optimum capacities and the actual outputs. The indirect method is generally more practicable; it is based on the assumption that the volume of profits varies in proportion with the degree of utilization of the existing equipment. Thus underemployment produces lower profits than optimum capacity, and working at optimum capacity gives lower (total) profits than producing over optimum capacity. It is assumed that the increases in output occur in response to increases in demand, and may therefore imply a rise in prices. It follows that the *increase* of total profits will induce investment only in so far as it brings profits to a level which reflects the shortage of capacity.

Whether such a level is reached or not, cannot be guessed by looking at the total amount of profits. Here some use may be made of the profit ratios, relating profits to the value of the capital used (whatever this may mean). Exactly what profit ratio is sufficiently high to encourage investment depends on other considerations which will be discussed later on.

A “lasting” increase in total profits and a profit ratio which is high enough will bring about a definite amount of capital expenditure. This is comparative statics. On a dynamic level, the inducement to maintain a certain *flow* of investment over a longer period will be a function of the *rate* of increase of profits<sup>1</sup>, of the regularity with which profits are expanding<sup>2</sup>, and of the level of profit ratios<sup>3</sup>. These are the three main factors, all of them statistically measurable, which seem to govern the shifts in the marginal efficiency of capital schedule, or, in other words, the inducement to invest.

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<sup>1</sup> Real profits, i.e. money profits deflated by a price index.

<sup>2</sup> In this dynamic context, the regularity of profit expansion replaces the “waiting period” of the static analysis.

<sup>3</sup> This relationship does not imply that the capital expenditure decided in this way is used exclusively to re-establish the long-run equilibrium which has been lost during the previous “period”: capacity may be built in advance. All that it assumes is the existence of some shortage of capacity at the starting point.

This basic relationship needs to be restricted to capital expenditures the purpose of which is to increase capacity in the existing lines of production; let us call this type of investment capital *widening*, according to the motive of investing, though the increase in capacity may, in fact, entail as much “deepening” as “widening”. There are, however, two other types of investment, the volume of which does not seem to be directly related to the three variables we have arrived at: (a) investment, the purpose of which is to diminish the production costs by introducing a more efficient equipment or by substituting capital for labour, without necessarily widening the capacity (I shall call this capital *deepening*), and (b) investment in order to start producing a new product.

As regards (a), it is obvious that an investment of this type may be decided without any previous rise in profits. As a matter of fact, the inducement to proceed to capital deepening arises usually in a situation where profits are low and stagnating, or tend even to be squeezed, and where, therefore, the lowering of costs becomes a matter of survival rather than of expansion.<sup>1</sup> In some cases, capacity tends to rise simultaneously with the decrease of costs, producing thus a mixture of capital deepening and widening: but this arises as a sort of “by-product” of the main operation. It is the reverse of the previous case. Occasionally, two entirely different motivations may give very similar results. Usually, however, the difference in the “deepening” and “widening” mixtures is great enough to be operationally significant.

If the purpose of capital investment is the introduction of a new product (*b*), no direct past experience is available. However, new products are often improved substitutes of older ones, and some extrapolation may be made on this basis. Moreover, the trend and the rate of profits in other industries, or even in the economy as a whole, serve usually as an indicator for general business conditions, and may thus influence the innovator’s investment projects. The relationship will be nevertheless rather uncertain. It may even completely disappear.

(3) Having thus reviewed the various factors capable of determining the inducement to invest, we have now to clear up the role of the rate of interest in

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<sup>1</sup> This assumption will be made more plausible in Part III. It may seem unrealistic for those who remember that the lack of profits often prevented industrialists from proceeding to modernization. This may be true; I believe, however, that the inducement to modernize is still strong in these cases. The limiting factor may be rather the lack of finance which is related to the low level of profits.



the determination of the volume of investment. The classical diagram, derived from Keynesian theory, where the marginal efficiency of capital schedule is cut by the horizontal line representing the price of finance, tells us that at a given marginal efficiency of capital, the higher the rate of interest, the lower the volume of investment.

Translated into terms of the previous capital-widening theory, this amounts to saying that at a given rate of increase of profits, at a given regularity of profit expansion and at given profit ratios the flow of investment will be inversely related to the rate of interest.

This statement is questionable on several counts. Strong empirical evidence suggests that investment decisions in manufacturing industry are hardly affected by the cost of finance. There are two good reasons to believe that the findings of interviews and statistical inquiries correctly reflect reality. First, entrepreneurs do not compare as a rule the “net” marginal efficiency of capital with the pure rate of interest. The more widespread method is to compare a sort of “gross” prospective rate of return (including amortization charges) to the rate of interest *plus* the cost of replacement. The shorter the length of life of equipment, the lower the proportion of interest charges in the total capital cost. In those branches of manufacturing industry where technical progress is rapid, total capital charges may be as high as 25 per cent; the effect of a rise in the rate of interest from, say 4 to 6 per cent, increasing total charges to 27 per cent, will be negligible.

Secondly, uncertainty about the future course of events has to be taken into account. We have accounted for it previously by assuming the existence of a “testing period”, or in dynamic terms, by relating the shifts in the marginal efficiency schedule to the regularity with which profits have been expanding. There is another way of doing it which seems to be closer to business practice. The degree of uncertainty attached to any particular situation may be left aside by determining the position of the marginal efficiency of capital schedule: this latter is then solely determined by the rate of increase of profits and by the level of profit ratios. Uncertainty is then introduced into the analysis by adding an “uncertainty premium”<sup>1</sup> to the price of finance. This premium varies in proportion with the degree of uncertainty of the forecast which, in turn, may be functionally

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<sup>1</sup> Rather than “risk premium”; the investment decision is generally a unique event.

related to the regularity with which profits have been growing in the past. The “net” marginal efficiency of capital schedule is thus cut by a slightly upward sloping<sup>1</sup> line comprising the price of finance plus the marginal uncertainty premium. It follows that all other things being equal, the flow of investment will be inversely related to the degree of uncertainty, i.e. to the regularity of past business development. The uncertainty premium will be especially high in those circumstances where little or no past experience is available: in the case, for instance, of a new product. Therefore, in this case, and where the level of activity is strongly fluctuating, interest charges may be rather small compared with the uncertainty premium. The effect of a change of the rate of interest on the flow of investment will be small or negligible.

Adding up these two influences, it seems that in some industries, particularly in those branches of manufacturing where technical progress is rapid, and where the volume of activity is highly cyclical, the flow of investment will be insensitive to moderate changes in the rate of interest.

This throws also some light on the minimum profit ratio which is necessary to induce investment. The minimum is positively correlated with the degree of uncertainty, rate of obsolescence and the rate of interest.

(4) To sum up: the flow of planned investment in any particular firm (let us call it I) will be a function of the rate of increase of profits, on condition that the current gross profit ratio is higher than the total sum of the amortization charges (wear and tear *plus* obsolescence), of the uncertainty premium and of the rate of interest. The level of the uncertainty premium is primarily a function of the cyclical sensitiveness of profits. The *actual* flow of investment may be lower than the planned one if the supply of funds is inadequate, or if there is a physical shortage of producers’ goods or of labour.

(5) Experience suggests that if the rate of interest is rarely a factor of great importance in determining the level of investment, the non-availability of finance may often set a limit to planned capital expenditures. What are, then, the factors determining the supply of funds to the firm?

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<sup>1</sup> It may be assumed that the marginal uncertainty premium increases with the amount of capital expenditure, especially if it is financed by debt capital.

Four main sources of finance have to be distinguished: ploughing back of profits, issuing of shares, selling of debentures, and bank credit.

As regards the two first sources, the total amount of finance provided by them is limited by the level of current profits. The dividend policy of a firm may increase one or the other source: it is unlikely to influence the total. At a given level of current profits, higher dividends will make the capital market more easily accessible to the firm but will diminish self-financing, while lower dividends will achieve the opposite result.

The supply of share capital is not only a function of the level of profits, like self-financing, but also of the rate of increase of profits. Level and rate of increase of profits are the two factors which play a dominant role in determining expectations about future dividends and capital gains, and therefore in influencing the supply of share capital.

The supply of debentures and of bank credit is not directly related to profits. Individuals, insurance companies or banks responding to a firm will try to assess its general financial “health”, of which profits are only one aspect. They will probably attach more importance to the gearing ratio, i.e. the proportion of debts to the net assets of the firm, and be ready to lend up to a “critical” ratio. On the other hand, entrepreneurs themselves will have some idea of the maximum debt financing they are willing to accept. Their debt-aversion varies according to industries. Where the level of activity (and trading profits) fluctuates, aversion will be stronger, while in industries with a smooth development, the gearing ratio tolerated by the entrepreneur will be higher.

It follows that either the entrepreneur’s or the creditor’s critical gearing ratio will limit the amount of debt financing. The latter ratio will be presumably the lower: the degree of confidence of the creditor towards the firm is likely to be smaller than that which the entrepreneur places in his own success.

The supply of debentures or of bank credit, once the critical gearing ratio is reached, will increase only if the firm’s net assets start growing, or if there is an improvement in the firm’s future prospects. In both cases, profits have to increase; thus the “autonomy” of debt financing towards profits works only within the boundaries of the critical gearing ratios: beyond them the supply of both bonds

and of bank credit is closely related to the level (additions to the net assets) and the rate of increase (future prospects) of profits.

This amounts to saying that, apart from this limited “autonomy”, total supply of funds – just as the marginal efficiency of capital – is a function of the *level* and the *rate of increase* of profits.

(6) Up to this point the analysis has been conducted on the level of the firm or of a particular industry. A number of Belgian problems, however, have to be discussed on the level of manufacturing industry as a whole. The first question to be answered is about the reasons for the unusually low level of capital expenditures in manufacturing. This may be due, a priori, either to the low level of the planned investment, or to an inadequate supply of funds. These are aggregates, and the process of aggregation raises some questions.

There is no problem on the demand side. Total planned investment is the sum of the investments projected by every individual firm. One may therefore assume that it is determined by a sort of weighted average of the individual profit ratios, of the individual rates of growth of profits and of the individual degrees of stability.

On the financing side the situation is different. Here again the supplies of funds to every firm add up to the total supply of funds to industry. The total sum of funds available for the financing of industry – I shall call it  $F$  – need, however, not be equal to the total (ex ante) savings of an economy. The discrepancy may be due, first of all, to an obvious cause: savings are also required to finance Government investment and the capital expenditure of the non-industrial sector. But let us suppose for a moment that Government investment is financed by public savings and the non-industrial sector by self-financing. Now it is possible that the remaining saving (personal savings plus industry's internal saving) is higher or lower than the total supply of funds to industry. This is possible for two independent reasons. First, because capital funds may be exported or imported. Secondly, because one of the sources of funds, bank credit, is largely independent of current savings. Through the credit multiplier, and within the boundaries set by it, the banking system is able to determine the volume of bank money, and therefore the total supply of funds. If savings are lower than the supply of funds, the gap is filled by the creation of bank money or by capital imports, on

condition, of course, that the demand for funds be high enough to use up fully the supply. On the other hand, if savings are higher than the supply of funds, the volume of bank money will contract or capital will be exported.<sup>1</sup>

Both processes are familiar to the traditional saving-investment analysis. An excess of investment over saving calls forth an inflationary process, and the reverse produces deflation. There is, however, a distinct analytical interest in distinguishing between saving and the supply of funds on the one hand, and the supply of, and demand for funds, on the other. The utility of this double distinction may be shown by an example.

At a given moment of time the amount of planned investment by industry – and therefore the demand for funds – will be  $I$ . The total supply of funds to industry (after allowing for the financing of Government and non-industrial investment) is  $F$ , and current national *ex ante* savings  $S$ . Let us suppose that  $I < F < S$ . The traditional saving investment analysis, recognizing deflationary tendencies and a balance of payments surplus, will diagnose an excess of savings over investment. This will be true; nevertheless it misses the point that savings exceed the (potential) supply of funds too. Now let us suppose that for one reason or other planned investment increases, leaving  $F$  and  $S$  on their former level. The following situation may arise:  $F < I < S$ . The supply of funds being smaller than the demand, industry will be unable to finance the whole of its planned investment, in spite of the fact that the banking system is liquid and that capital outflows persist. The deflationary pressure will be somewhat smaller than beforehand – it will be due only to the excess of savings over the supply of funds, while previously it originated *both* in an excess of  $S$  over  $F$  and in an excess of  $F$  over  $I$  – but it will nevertheless be there, in spite of a shortage of finance.

Such a situation may arise in an economy where personal savings are of some importance and where the would-be individual “investors” (investment understood here in the sense of “placement”) or the bankers have an assessment of the future prospects of the home industry which is different from that of the entrepreneurs. Though both planned investment and the supply of funds are functions of the level, rate of increase and stability of profits, the impact may have a different intensity according to social habits or individual psychology.

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<sup>1</sup> Hoarding, or dis-hoarding, of banknotes may also be responsible for the discrepancy between saving and the supply of funds. However, this is unlikely to be more than a theoretical possibility.

Investment projects for a new industry may be viewed, for instance, with a greater optimism by entrepreneurs than by those who supply the funds.

A similar problem may arise in a country where – for institutional reasons – the credit multiplier is low.<sup>1</sup> If personal savers do not trust the home industry's expansion plans, capital exports will continue even after a sudden upsurge of planned investment. Now bankers, though maybe willing to finance the additional investment, will be unable to do so, since the credit multiplier is low. An increase in bank credit would, in this particular case, by no means be “inflationary” financing; it would only fill the gap left by existing, but “misdirected”, saving.

It is rather strange to notice that whereas the possibility of the supply of funds being smaller than savings is often overlooked, the reverse is admitted as the common case of inflationary financing. An *ex ante* excess of  $I$  over  $S$  brings about, according to the usual analysis, an *ex post* adjustment of  $S$  to  $I$ . This implies, however, that  $F$  has been large enough to meet  $I$ , since if the supply of funds had not been larger than savings (in form of bank credit or imported capital), entrepreneurs could have hardly made the expenditures that pushed up the income flow, and therefore savings, to the equilibrium level.

The conclusion is that, since the supply of funds is not necessarily equal to savings, the limiting factor of actual investment may be either of them, or, of course, planned investment. To estimate the actual relationship of these three aggregates to each other, a rough overall look at the balance of payments position is not sufficient. A more detailed, sometimes institutional analysis may be required, especially in the field of private capital movements and of the banking system.

(7) Besides finance or saving, the availability of plant, machinery, building or labour may also constitute a limiting factor. Current economic theory is usually silent about this possibility, because it assumes the upward flexibility of prices. Post-war experience has, however, clearly shown that physical bottlenecks have to be taken into account.

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<sup>1</sup> An example of this is given in Part III.

### III. The Pattern of Growth in Belgium

Part II examined, on a theoretical level, the various factors which in the long run determine investment decision in fixed capital. Let us now turn to Belgium and apply the model. It has to be explained, first, why capital expenditures were so low in Belgium, and secondly, how the Belgian economy still managed to grow and increase its productivity.

(1) Overall figures for the Belgian economy suggest that physical shortages of labour and equipment cannot be held responsible for the low level of capital expenditures. For the whole 1948-56 period, 1948 and 1956 were the only years of full employment, when unemployment amounted only to 3 per cent of the labour force. From 1949 to 1955 unemployment figures were fluctuating between 5 and 9 per cent.

The picture is similar as regards the availability of capital goods. From 1948 to 1956 the steel and engineering industries have experienced at least four years of heavy excess capacities (1949-50, 1953-54), and when they were working at or near full capacity, they did it for export orders. Home demand for both steel and engineering products has been slowly but regularly increasing during the period under review, but full employment of capacities could be ensured only by the sudden upsurges of foreign demand in 1951-52 and 1955-56. Competition between home and export markets, which has been so usual in post-war Britain, took place only occasionally. It has certainly not been a regular feature of the Belgian economy.

Moreover, nothing would have prevented Belgian manufacturers importing more capital goods, since physical controls were rapidly abolished, and import duties there have always been among the lowest in Europe.

(2) Balance of payments data show quite conclusively that an overall lack of savings cannot be held responsible either for the low level of investment. From December 1947 to December 1956 Belgium's gold and foreign exchange holdings have risen from 894 to 1194 million dollars, or by 34 per cent. The increase has been going on at varying rates, the periods of greatest surpluses being 1951-52, 1955 and the first half of 1956. Only in 1950, in 1953 and, in the second half of 1956 did reserves actually decline. The fact that the periods of full employment were precisely those of surpluses proves that the high level of activity was the

consequence of an increase in foreign demand, and that, therefore, even in boom periods there was an excess of savings over home investment.

Data on gold and foreign exchange holdings do not reflect properly the balance of payments surpluses which are relevant to the saving-investment equilibrium analysis. Statistics on capital exports show that the relevant balance of payments surplus was considerably higher than suggested by the increase in gold and foreign exchange reserves. During the period under review, net private capital exports amounted to approximately 27 billion Belgian francs,<sup>1</sup> i.e. to more than one year's total industrial investment in plant and machinery. There were net capital imports only in 1948 and 1949; since then there have been net capital exports every year, reaching the annual rate of 9 billions in 1955 and 1956. This confirms that savings have been abundant relatively to the volume of investment.

(3) The next point to examine is the relationship between the supply of funds and the volume of planned investment on the one hand, and the relationship between the supply of funds and the volume of savings on the other hand. The analysis outlined in Part II suggests that the supply of funds need not be equal to the flow of savings. Two questions have therefore to be answered: (a) has the supply of funds been smaller than planned investment? (b) what is the relationship between  $F$  and  $S$ ?

(a) There are two sets of evidence which show that there has been no shortage of funds in Belgium for manufacturing investment, except perhaps during the last months covered by the analysis.

The first evidence cannot be assessed numerically, but this does not diminish its strength. There is a general agreement in Belgium that there have been no failures in capital market issues since the war. Materially all the issues have been promptly and completely subscribed. This shows that at least this source of supply has been available for capital investment, and consequently those firms whose internal saving was inadequate, could have had recourse to the capital market.

This argument is not wholly satisfactory. Owing to the institutional set-up, it would be most surprising indeed to find partially subscribed capital issues.

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<sup>1</sup> 540 million dollars. The figure for 1956 is a preliminary estimate (National Bank of Belgium).



Preferential issues play an important role.<sup>1</sup> When the new shares are sold, according to a fixed ratio, to former shareholders, it may be safely assumed that their opinion has been tested beforehand, and that companies proceeded to actual issues only when they were certain to be successful. The existence and ubiquity of holding companies makes such a testing a great deal easier. A half-dozen companies control at least 80 per cent of Belgian manufacturing. Thus in most cases those people who decide to go to the market at the same time subscribe the greater part of the new issue. Hence the difficulty in assessing the significance of a successful capital issue.

A similar reasoning may hold for debentures. “Public” issues of debentures by manufacturing companies are not very frequent; indeed most of them are “private”, i.e. sold directly to insurance companies and other institutional investors. Here again it would be hard to assess whether the issue has been a success or not.

In spite of these qualifications, the capital market evidence retains some validity. One does not know what proportion of the industry’s capital market issues goes to private investors; but one does know that 45 per cent of total issues – comprising the bonds offered for sale by the State, the local authorities and public utilities – are bought by individuals. Thus the Belgian capital market is far from being completely institutionalized.

The second evidence centres around bank credit statistics. A recent inquiry into the sources and uses of funds by Belgian industry<sup>2</sup> shows that for three selected post-war years (1951, 1953 and 1955) only in one year – 1951 – did industry make a substantial use of bank credit. For this year bank advances provided 17 per cent of total industrial finance, while the banks’ contribution dropped to 5.5 per cent in 1953 and 1.5 per cent in 1955. During these two years industry’s liquid assets and its security portfolio increased substantially. It seems, therefore, that both in 1953 and 1955 industry’s demand for funds has been lower than the supply. In 1953 as well as in 1955 banks were in a position to increase their advances to industry. First, they held at that time Government securities

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<sup>1</sup> On the other hand, the great number of preferential issues proves that there is an abundant supply of funds, for there is little reason to make arrangements of this kind if funds are scarce.

<sup>2</sup> Banque de Bruxelles, Economic Research Department, May 1957.

in excess of the compulsory cover requirements;<sup>1</sup> secondly, the amount of bills re-discounted with the Central Bank was markedly below what it could have been.

One may therefore safely assume that during these two years the supply of bank credit to industry exceeded the demand for it. This was not true in 1951, but the increase in bank advances at that time was due to an increase in stocks, and not to an upsurge of fixed investment. Data covering two years are admittedly poor evidence for a nine-year period. It would be easy, however, to produce some fragmentary statistics, particularly in the field of banking ratios, which would show that the conclusion can be generalized for the period as a whole.

It is therefore suggested that neither the capital market resources nor the bank credit supply fell short of the industry's demand for them. This does not mean, however, that a lack of funds has been in no cases an obstacle to carrying out the volume of planned investment. One could argue that there might be industrial firms, of smaller size, which have no access to the capital market; that they have used up the total amount of bank credit available to them and therefore their only source of finance is internal saving. To these firms at least, the abundance of share capital or of debt financing available to *other* firms is irrelevant, for the total supply of funds to them is identified with the ploughing back of profits. This amounts to saying that no substitution is possible between the various sources of finance.

Individual cases of this kind may occur; I believe, however, that for the majority of manufacturing firms total supply of funds will not fall short of demand if the capital market resources and the bank credit are abundant, even if the sums available through self-financing may not be sufficient. This belief is derived from financing statistics in other countries, particularly in the United States.<sup>2</sup> They show that bank advances, and to a lesser extent capital market resources, play the role of "gap-fillers". When the difference between long-term finance requirements and internal saving increases, the gap is filled by a higher recourse to bank credit and/or to the capital market. On the whole, entrepreneurs do go to the market or apply for bank advances when the volume of their planned investment exceeds

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<sup>1</sup> Belgian banks are obliged to hold about 65 per cent of their deposits in Government paper.

<sup>2</sup> Statistics published in the *Survey of Current Business*.

internal resources. There is no reason why the average Belgian entrepreneur should not behave in this way.

(b) What about the relationship between the supply of funds and the volume of saving? The importance of this question lies not in its usefulness to explain past events – (the fact that neither  $F$  nor  $S$  has been a factor limiting investment projects is in itself sufficient) but because it may give some hints as to what would happen, should planned investment suddenly increase.

There are good reasons to believe that for the period under review the supply of funds to industry was below the level of current savings. This holds true even if the volume of savings is defined as savings disposable for private industrial development, i.e. after the financing needs of other sectors, namely of Government, are taken into account.

The strongest argument is derived from the fact of capital exports. An outflow of private capital is not in itself a proof for  $F$  being smaller than  $S$ , for it may take place as a residual flow. Funds may be invested abroad if there is no internal demand for them. It is reasonable to assume, however, that this was not the case in Belgium between 1950 and 1956, when, as already shown, private capital was exported for about 27 billion Belgian francs. A high proportion of this sum – some 16 billions<sup>1</sup> – was invested in the dollar area, mainly in Canada. The breakdown of this item is not available. According to scattered evidence, it comprised both direct investment by some important Belgian companies (oil, uranium, non-ferrous metals) and the purchase of shares, by individuals as well as by firms, in existing North American enterprises. However, whatever the form and sources of this 16 billion capital export might have been, the motivation was very much the same. It sprung not from the lack of investment opportunities in Belgium (although it coincided with it), nor from an analysis of prospective earnings, but from the general belief that North America's economic and particularly political future deserves a greater confidence than that of Belgium (or, for that matter, of western Europe). The opening of investment opportunities in Belgium could hardly have modified this opinion. There was nothing residual in the capital exports to the dollar area.

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<sup>1</sup> This is an estimate based on the balance of payments statistics published by the "Banque Nationale". The margin of error may be high, since the Banque Nationale data deal with transactions in Swiss francs as well as in dollars.

One could argue that an increase in bank credit supply could have made good the loss of funds. As has been shown previously, banks were in fact in a position to increase their advances to industry, and would certainly have been prepared to do so. However – owing to the peculiarities of the Belgian monetary system – the increase in bank credit would not have been large enough to offset the deflationary effect of capital exports.

The reasons for which advances to industry in Belgium are not likely to undergo a sizeable autonomous expansion, have been analysed in great detail elsewhere.<sup>1</sup> The conclusion of this analysis is that the credit multiplier in Belgium is extremely low. Though a reform of the banking system is under way, there are no signs of changes which would increase the multiplier. As a result, variations in the volume of bank money are closely correlated with balance of payments surpluses or deficits. Therefore banks will be able to increase their advances sufficiently to offset capital exports only if there is a sizeable surplus on the balance of payments. The trouble is that this offsetting process will be required precisely when the balance of payments shows a deficit; for an upsurge of investment which increases substantially the demand for funds will, at the same time, put a strain on the balance of current accounts. Consequently, the shortage of funds will slow down investment activity before current savings are exhausted.

Thus, answers to questions (a) and (b) suggest that for the period as a whole the supply of funds, though larger than planned investment, was below the level of savings:  $I < F < S$ .

This conclusion has been confirmed by the development of the Belgian economy which began in autumn 1956 and has been going on undisturbed since then. In the second half of 1956 the growth of home demand, stimulated by increasing consumption and an upsurge of planned investment, outpaced the rise of home production. As a result, a deficit appeared on the current account of the balance of payments, which was substantially aggravated by the accelerated outflow of private capital. The decrease in Belgium's foreign exchange holdings put a brake on the expansion of bank deposits at the very moment when industry felt a rising need for bank advances to finance its investment projects. The liquidity

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<sup>1</sup> A. Kervyn, «Les mécanismes monétaires belges», *Bulletin de l'Institut et Recherches Économiques et Sociales*, February 1956. The credit multiplier is low for two reasons: (1) Half of the total volume of money is held in the form of banknotes; (2) Belgian banks are obliged to hold about 60 per cent of their deposits in Government paper.

of the banks as well as that of the whole monetary system has experienced, as a consequence, a major squeeze. At the time of writing this article (June 1957) industrial investment plans are being revised downwards, and the investment boom which made a happy appearance is likely to be rather shortlived. The noticeable fact is that capital exports continue. The limiting factor is obviously the supply of funds, and not the volume of savings. This confirms that the supply of funds has been, and indeed still is, smaller than savings.

(4) The foregoing analysis makes it clear that neither physical shortages, nor lack of savings, nor a shortage of funds are responsible for the low amount of capital expenditures in post-war Belgium. The reasons must therefore lie in the weakness of the inducement to invest. The theory developed in Part II suggests that the volume of planned investment is a function of the rate of increase in real profits, on condition that the current profit ratio is high enough to cover the amortization charges, the uncertainty premium, and the rate of interest. Each of these variables of the investment function has to be examined now.

(5) As regards the rate of increase in profits, the relevant statistics would be those covering all manufacturing industry. Unfortunately they are not available. There are, however, data on the earnings of manufacturing companies which are organized as “sociétés anonymes”. They cover the greater part of Belgian manufacturing industry: in terms of labour force, the “sociétés anonymes” represent about 60 per cent of total manufacturing. The coverage is materially complete in steel, non-ferrous metals and cement, high in engineering and chemicals, and still representative in textiles and food. The figures are given in Table V.

The yearly figures are not strictly comparable. The number of companies included in the statistics went up from 5 306 in 1947 to 6 944 in 1955. It is absolutely impossible to make any quantitative estimate of the bias introduced in this way; for it results partly from the foundation of new enterprises, the results of which have to be included in the general statistics of the industry, and partly from firms changing over to the legal status of the “sociétés anonymes”, which ought to be excluded. Though its quantitative assessment is impossible, the bias does exist. The profit data should be interpreted correspondingly.

**Table V**

**Net profits of manufacturing companies in Belgium (in billions of Belgian francs)**

	1947	1948	1949	1950	1951	1952	1953	1954	1955	(1956)
At current prices	5.5	5.3	5.3	8.3	9.8	7.1	6.7	8.0	10.7	(12.0)
At 1953 prices	6.6	5.8	6.1	9.0	8.8	6.7	6.7	8.0	10.6	(11.7)

*Notes:*

(1) Years refer to years preceding the publication of the companies' annual statements. For instance, data under 1948 are derived from accounts published in 1949. In fact, 1948 should be interpreted as covering, for some companies, the second half of 1948 and the first half of 1949.

(2) The deflator is the price index of industrial wholesale prices. A deflator based on the consumers' price index would not modify substantially the trend of real profits.

(3) These data are the profits of the manufacturing "sociétés anonymes", net of amortization charges and of the taxes paid by the companies. The 1956 figures are estimates.

Source: *L'économie belge en 1949... etc.*, Ministère des Affaires Économiques (The Belgian Government's annual White Book).

The profit figures which are relevant to the investment decisions taken during the years 1948-55 may be roughly those of the 1946-53 period. The obvious fact is that from 1947 to 1953 there has been no systematic upward trend in company profits at all. Every sensible entrepreneur knew that the 1950-51 boom was very much a transitory phenomenon, due to a large extent to speculative stock-piling and a corresponding increase in prices. From the 1947-48 average profits to the 1952-53 average profits the increase was less than 10 per cent. This would be hardly a 1.5 per cent yearly rate of growth which can be qualified as negligible, if allowance is made for the increase in the number of companies registered.

It is therefore certain that in terms of our model, the Belgian manufacturing industry as a whole could have hardly found any stimulus, until 1953, in the development of real profits. Things have changed since then, however. In 1954 and 1955 there has been a substantial rise both in money and real profits. 1956 has also experienced an increase, though probably at a somewhat more moderate rate. This is the first time since the war that there have been increases for three consecutive years. The result is the investment boom which appeared in 1956, as has already been mentioned.

(6) Though the lack of increase in company profits itself explains the inadequacy of capital expenditures, it may be interesting to have a look at the other components of the investment function. The profit ratios have to be compared

with the replacement charges, the uncertainty allowance and the rate of interest. Statistics on gross profits are, however, not available, so the comparison has to be made between the net profit ratio on the one hand, the uncertainty premium and the rate of interest on the other.

**Table VI**

**Average net profit ratios in the Belgian manufacturing companies (net profits in per cent of capital plus reserves)**

1947	1948	1949	1950	1951	1952	1953	1954	1955	(1956)
7.0	6.3	5.7	8.6	9.7	6.5	6.0	7.1	8.8	(9.2)

*Source: See Table V.*

The average level of the profit ratios for the 1947-53 period is 7 per cent. The value of these statistics is, of course, subject to some doubt. Capital plus reserves, at their accounting value, measure only very imperfectly the value of the invested capital. But if there is any bias in the ratio, it is bound to be an upward one, since in numerous cases the companies' assets have not been sufficiently revalued to take into account the rise in prices. Thus the "real" rate of return is likely to be below 7 per cent.

Such a profit ratio seems to be rather low in itself. Its insufficiency appears only more clearly if the specific Belgian capital charges are taken into account. On the average, the long-term rate of interest on industrial debentures moved around 4 1/2 to 5 per cent. Short- and medium-term bank accommodations appeared to be more expensive, especially if overdraft facilities are taken into account. Thus a maximum of 2 to 2 1/2 per cent has been left, on the average, to cover the uncertainty premium.

An uncertainty allowance of this size looks wholly inadequate. According to our investment function, the level of the required uncertainty premium will be positively correlated with the sensitiveness of the industry to economic fluctuations. This may be measured most easily by the fluctuations in the volume and the ratio of profits. The real profits figures of Table V display a remarkable cyclical sensitiveness. The same is true as regards the profit ratios in Table VI.<sup>1</sup>

<sup>1</sup> As will be shown later, the cyclical sensitiveness of individual industries is considerably above the national average, for the timing of the cycles is not identical.

The cyclical fluctuations were not only wide, they were also rather short, with depression years in 1948-49 and 1952-53.

An additional element of uncertainty is contained in the fact that a high proportion of the Belgian manufacturing output is sold abroad. The percentage of exports ranks as high as 75 in steel, 60 in textiles and 38 in engineering. As the Belgian products are generally of standard quality, foreign customers are not permanent; they come to the Belgian market when their own internal demand runs ahead of home production. The best examples of this are the U.S. purchases of Belgian steel, glass or cement. A similar situation may occur in any exporting country, but in Belgium's case the heavy standardized products form a very high proportion of total exports. Thus, for instance, crude steel accounts for 25 to 28 per cent of total exports. The high sensitiveness of the Belgian manufacturing industry is due to a great extent to its position as a marginal supplier of semi-finished products. Entrepreneurs, under the present pattern of production, have no means of influencing the demand for their product.

As a result, Belgian entrepreneurs are apt to think of cyclical upswings as being of a short-lasting nature. Not only are their profit figures sensitive; this sensitiveness is of a fortuitous kind, over which they have no command. Thus both the actual behaviour of profit figures and the reasons for it make the Belgian industrialist extremely cautious.

Uncertainty premiums ought, therefore, to be high. It seems nearly impossible to arrive at a precise figure, 3 1/2 to 4 per cent would probably not be excessive. This represents the difference between the minimum and the maximum ratios experienced during the various cycles. If this is accepted as a fair guess, the minimum average profit ratio required to induce investment should fall between 8 to 9 per cent. In fact, as the breakdown of the profit figures per industry will show, the minimum is certainly higher, at least in those industries where the cyclical fluctuations are more violent.

The comparison of these minimum requirements with the actual average ratio – 7 per cent – makes it obvious that the level of the rate of interest cannot be held solely responsible for the low level of investment. Even if the long-term rate of interest had been around 3 per cent during the post-war year, this still would



not have brought down the minimum rate below the actual 7 per cent, or – if one disregards the breakdown by industry groups – it would have just done it.

The development since 1953 presents an altogether different picture. During the last three years, profit ratios have risen considerably. This rise has some particular characteristics which are new in post-war Belgium. First, it has been continuous and gradual. Second, it has not been due to a speculative upswing of prices. Third, it has lasted now for three years. As a result, entrepreneurial confidence has grown stronger and the uncertainty premium has fallen to a lower level. Thus the minimum required to induce investment is lower now than during the 1947-54 period, while the average actual profit ratio is higher. Moreover, as has been shown in Table V, real profits have been expanding satisfactorily. These are the factors which brought about the investment boom during the second half of 1956.

(7) Here is then an explanation of the low level of capital expenditures in post-war Belgium. The responsible factors are the stagnation of real profits, the low level of profit ratios, the high level of the uncertainty allowance and, to an extent which is debatable, of the rate of interest.

However, in spite of the low rate of investment, the Belgian economy still *did* grow, and even achieved a spectacular increase in its productivity. This is the next point to discuss.

To find the explanation, we have to go back to the theory outlined in Part II. As has been suggested there, stagnating profits and inadequate profit ratios discourage capital widening, but stimulate capital deepening. When an entrepreneur is afraid of being squeezed out of the market, he will do everything to increase his productivity and reduce production costs. This he can do either by rationalizing and reorganizing his firm (with little or no capital expenditures) or by investing in new machinery and equipment through which he will be able to obtain higher efficiency. It seems reasonable to assume, as regards the way this type of capital expenditure is reflected in business accounts, that some of it will go through the profit and loss account, particularly if it was used to buy smaller pieces of equipment.<sup>1</sup> Moreover, investment of this kind will be done generally in the form of replacement; it will not appear in the company accounts as net investment.

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<sup>1</sup> If this is done, profits will appear even lower than they really are. Thus this accounting practice will reinforce the correlation between low profits and capital deepening.

Behaviour like this seems to have been proper to the Belgian entrepreneur. This would explain why, in spite of low investment figures (and especially low *net* ones), productivity increased substantially in post-war Belgium. This conclusion is borne out by statistics which show, on the one hand (Table IV, Part I) that industrial building activity was relatively low, and on the other hand, that capital consumption figures, which are based on company reports, were relatively high (Part I).

An explanation on these lines suggests also that the increase in productive capacity occurred as a by-product of the rationalization and modernization process rather than as a result of deliberate capital widening. It makes it clear, moreover, why there has been no change in the pattern of Belgium's manufacturing output. The development of new firms, new industries and to some extent even of new products is hardly conceivable without the erection of new industrial buildings and without other types of capital expenditures which appear as *net* investment in the companies' capital accounts.

(8) Up to this point, the argument has been running in terms of the whole manufacturing industry in Belgium. Would data on particular industries confirm this overall analysis? There are surely differences between the various industries; and if the previous analysis is right, differences in profit trends and ratios should result in differences in the investment policies and the growth patterns. The following analysis deals with the three key industries in Belgium: steel, engineering and textiles. In terms of net assets, they are approximately of the same importance. The total net assets of steel, textile and engineering companies account for about 50 per cent of the net assets of all manufacturing companies.

**Table VII – Net profits in manufacturing: breakdown by industry (billions of francs, at 1953 prices)**

	1947	1948	1949	1950	1951	1952	1953	1954	1955
Steel	1.0	1.1	0.6	0.8	1.6	1.2	0.6	1.1	2.3
Textiles	1.5	0.9	0.7	1.8	0.9	0.0	0.3	0.5	0.5
Engineering	1.4	1.7	1.6	1.8	1.9	1.9	1.8	1.8	1.9

**Table VIII****Average net profit ratios: breakdown by industry (in per cent of capital plus reserves)**

	1947	1948	1949	1950	1951	1952	1953	1954	1955
Steel	5.3	7.2	3.1	4.3	10.3	7.5	3.4	6.9	11.5
Textiles	9.2	4.9	3.4	9.6	5.3	0.0	1.5	2.6	2.7
Engineering	12.0	13.5	11.5	11.8	9.0	8.3	9.7	9.3	10.0

*Source: See Table V.*

As regards the steel industry, there has been no rising trend in real profits. Moreover, the average profit ratio for the relevant 1947-53 period was lower than the national average: 6 instead of 7 per cent. Fluctuations in the profit ratios have also been extremely violent: boom years produced 10 per cent profits (or more), while during the recessions the percentage dropped to 3.

The textile industry's position is even less enviable. The trend of real profits goes clearly downwards; even the last two years, prosperous for other industries, are no exception to the general rule. The profit ratio is the lowest in the whole manufacturing industry – 4.8 per cent – for the relevant period, while the industry's cyclical sensitiveness is very high.

The profit pattern in engineering is markedly different. Though the trend of real profits is not rising either, the profit ratios have been well over the national average (10.8 per cent), and at the same time both real profits and the profit ratios displayed a fair amount of stability. This points to the uncertainty premium being lower than in the two other industries.

This analysis suggests that engineering is the only industry where there may have been a stimulus to growth, based on capital widening investment. There could have been hardly any stimulus at all in steel, while in textiles the stimulus is bound to work in the direction of decline rather than of growth. However, in both of these latter industries there must have been a strong encouragement to rationalization and to capital deepening investment.

**Table IX****Changes in fixed assets by industry; 1955 as per cent of 1948**

	<b>Steel</b>	<b>Engineering</b>	<b>Textiles</b>
Gross fixed assets	+ 67	+ 64	+ 14
Net fixed assets	+ 18	+ 41	- 3

*Source: Caisse Générale d'Épargne et de Retraite, Études Complimentaires au Rapport Annuel, 1956 (Sample of the main "sociétés anonymes").*

Table IX goes a long way to confirm this conclusion. If it is assumed that the growth of net assets is a good statistical indicator of deliberate capital widening, the figures clearly show that capital widening was strongest in engineering, considerably weaker in steel and negative in textiles.

The interesting evidence provided by these statistics is the considerable increase of gross assets both in steel and in textiles. This may result from a high level of gross investment as well as from the slow pace of scrapping: the lack of statistical information makes it impossible to assess the influence of each of these factors. The high level of gross investment – which coincides in both cases with little net investment – suggests that the squeezing of profits may be a powerful stimulus to proceed to modernization.

These differences in investment policies are reflected in the differential increases in productivity. Reliable employment figures by industry are available only since 1952, so the comparison covers only the 1952-56 period. During this period, the violently "squeezed" textile industry increased its productivity by 35 per cent, the "moderately" squeezed steel industry by 22 per cent, while in engineering, busy widening its capital rather than deepening it, productivity rose only by 15 per cent.

One last point has to be considered. What about the rates of increase of output? From 1948 to 1956 steel production went up by 52 per cent, while that of engineering only by 40 per cent. As regards textiles, their output increased by 42 per cent.

This means that the "by-product" effect of capital deepening may be very strong indeed. The expansion both of steel and textile outputs corresponds to increases in capacity, for none of them were working in 1948 below full

capacity. The explanation has therefore to be given in terms of investment policies. Paradoxically, the widening of capacities was strongest in the two industries where the stimulus to deliberate widening was weakest. This measures the extent to which the volume of output seems to have been geared to *gross* rather than to *net* investment.

## IV. Future Prospects

The purpose of this concluding part is to examine, first, why profits were low and stagnating in Belgium, and secondly, what are the implications of the present situation for the future prospects of the Belgian industry.

(1) The last pages of Part III revealed that the investment policies of the three main industries were responding to the behaviour of profits in conformity with the theory outlined in Part II. However, the analysis has also shown that the actual increases in capacity could be in no way related to different types of investment policies. In spite of wide differences in the investment pattern, capacity increased in engineering in the same proportion as in textiles. This means that – since there is no identifiable relationship between investment policies and increases in output – there can be no relationship either between this latter and the profit pattern. The disturbing conclusion is that in Belgium growth was stimulated by low profits as well as by high ones.

Were this conclusion right, the whole previous analysis would look rather silly. For what is the use of making subtle distinctions between investment policies, if the result, as regards increases in capacity, is the same? Such a conclusion would also prove disastrous from the point of view of economic theory: it would be hard to find any investment function which does not include the level or the rate of increase of profits among its main variables. It is therefore worth looking for some arguments which would preserve our peace of mind.

The first argument of this kind says that if the differences between steel, textiles and engineering are quite significant, they are not great enough to bring about a substantial change in the structure of manufacturing, by stimulating different rates of growth. Measured by Belgian standards, profit ratios were relatively high in engineering, and the cyclical sensitiveness of the industry was low; but real profits have followed a stationary trend since 1948 or at least 1950. It is reasonable

to assume that increases in the volume of real profits are as necessary a stimulus to capital expansion as are adequate profit ratios. The engineering industry's profit pattern shows therefore a mixed, intermediate position rather than that of a dynamic industry. It is favourable only as compared to the steel or textile industries, but not in absolute terms. As a result, though the pattern of growth included more capital widening than in the two other industries, the stimulus to deliberate expansion was not strong enough to increase the engineering output more than what the capital deepening and rationalization policies have achieved, under the struggle-for-life pressure, in the two other industries. In other terms, the engineering industry was stimulated neither to rationalize or modernize, nor to embark upon ambitious capital widening projects. Profit ratios were too comfortable to do the first thing, and the volume of profits was too stationary to do the second.

There is a second argument which completes the first. It may be argued that the period was not long enough to bring to the surface the (potential) differences in the rates of growth. It is certain that the expansion of capacity through modernization and rationalization has its limits. In badly organized industries working with out-dated machinery, rationalization and replacement can go a long way before reaching the optimum. This optimum, however, exists, and will be reached sooner or later, while capital widening may proceed undisturbed without any technically precise limits. Though this is difficult to measure, both the steel and the textile industries were far from optimum organization. The textile industry especially was also capable of renewing its old machinery, while in steel the technical progress since the war made some modernization necessary. Thus both industries could increase easily their capacity without making capital expenditures which would have appeared as net investment. The limit seems now to be reached, and further expansion will require in textiles as well as in steel deliberate capital widening. The fact that the pace of scrapping was lower in both of these industries than in engineering gives an additional weight to this argument. The old equipment has been obviously retained in some of the steel and textile firms; such a policy enabled them to meet the cyclical upsurges of foreign demand. This, however, cannot go on indefinitely.

These two arguments make it at least plausible that the distinction on which the greater part of this paper is based, is not entirely invalidated by the behaviour of industry groups in Belgium. Though the distinction loses some of its usefulness

when the profit patterns are not completely different, it seems still reasonable to believe that marked differences in profit patterns would lead not only to differences in investment policies, but also in rates of growth.

(2) After this digression, let us now turn to the main problem. Why are profits low and stagnating in the Belgian manufacturing industry as a whole?

It may be assumed that in a closed economy the share of profits in the national income and the volume of investment are closely interrelated. High profits encourage investment, and an increase in investment raises the level of profits. A theory of income distribution on these Keynesian lines has been recently outlined by Mr. Kaldor.

An explanation following strictly this reasoning cannot be valid in Belgium's case. The Belgian economy is wide open; an increase in investment, irrespective of its composition, will bring about an increase in imports which will not necessarily be offset by a proportional increase in exports. The resulting balance of payments difficulties are apt to bring about a drop in the industrial production. The multiplier mechanism through which an increase in the volume of investment produces higher profits is unlikely to work under these conditions.

It follows that what matters in an open economy like the Belgian one is the industrial distribution of investment as well as its overall level. If through an adequate distribution of capital expenditures growth takes place in those industries the products of which can be sold abroad at "normal" prices, exports will expand fast enough and an increase in profits will follow the rise in investment. If this condition is taken into account, the Keynesian theory of income distribution remains valid, and can be applied to Belgium.

It will be argued that the level and development of profits in the Belgian economy is chiefly responsible for the fact that the pattern of industrial output did not adapt itself to the changing requirements of international trade and that the rigidity of Belgium's manufacturing structure, in turn, prevents industrial profits from rising quickly and regularly to an adequate level. This is then something like a vicious circle, similar to the low profits – low investment argument, with the difference that international trade is taken into account. This argument is now to be developed in some detail.

Let us begin with the second half of the argument and make clear what is wrong with the structure of Belgian manufacturing. The “right” and “wrong” is measured here in terms of the changing pattern of international trade, which is clearly justified by the fact that about 45 per cent of total manufacturing sales are absorbed by exports.

Commodities in international trade may be broadly divided into three groups: those whose share in total trade is increasing, those whose share is stationary, and those whose share is declining. The “dynamic” group includes most of the engineering products and also chemicals, the “stationary” group comprises steel and the non-ferrous metals, while the “declining” group is composed mostly of textiles. This division is worked out in I. Svernilsen’s latest book<sup>1</sup> which shows also the composition of each important country’s exports in terms of this division (Ref. Table X). These data show strikingly that Belgian exports are based to an increasing extent on the stationary group, i.e. mainly on steel, while the share of the dynamic group has risen only moderately, and remains extremely small as compared with other countries.

**Table X**

**Exports by commodity groups in various countries (groups in per cent of total exports)**

		<b>Dynamic group</b>	<b>Stationary group</b>	<b>Declining group</b>
Belgium	1913	9	30	61
	1950	19	49	39
	1954	15	54	31
U.K.	1913	16	22	62
	1950	43	18	38
	1954	44	25	31
Germany	1913	17	34	49
	1950	33	47	21
	1954	46	32	22

*Source: A. Kervyn's article, op. cit.*

<sup>1</sup> I. Svernilsen, *Growth and Stagnation in the European Economy*, Geneva, 1954; cf. also A. Kervyn, «Quelques conditions d'une expansion économique en Belgique», *Société Royale D'Économie Politique de Belgique*, November 29th, 1955.



This seems to be the main explanation of the inadequate level of Belgian profits. The fact that only 15 per cent of Belgium's exports are composed of commodities whose share in international trade is expanding involves disadvantages from a double point of view. First, as regards prices: it seems likely that the price competition is stronger in the stationary group than in the dynamic one, not to mention the declining group where world market prices are certainly below long-run "normal" prices. Secondly, as regards the regularity of demand: the stationary group comprises mostly half-finished products, in Belgium's case crude steel. There is a general trend in most countries to build up a national steel industry which in normal times is able to meet home demand. These countries come to the international market only during periods of excess demand; during these years Belgian exports of crude steel are booming, and prices are relatively high. But according to post-war experience, boom years are not frequent, and during the other years exports fall very low, and prices are far below the long-run equilibrium level. The lack of symmetry between boom and recession years makes the average price level rather low.

This explains why the steel and textile industries' profits are low and stagnating or declining, and also why total manufacturing profits are inadequate: textiles and steel influence the average by their sheer weight. But it remains rather puzzling that the engineering industry's profits did not expand. Its exports are included in the "dynamic" group, and though this latter is small, and the share of exports in total sales of engineering lower than in textiles and steel, this fact should still have influenced the total volume of real profits earned by the industry.

There are several reasons why this did not occur. The first is a matter of classification. Transport equipment, for instance, is included in the dynamic group: but while this item is composed in the case of other countries mostly of really expanding commodities (aircraft, cars, etc.) Belgium's main exports in this field are railway equipment the demand for which is rather in decline, and where price competition is strong. It would be, therefore, a mistake to consider the Belgian engineering industry as producing mainly new products. If a detailed breakdown were possible, it might be shown that the reverse is true.

A second reason is that while a stationary or declining market is generally an effective handicap, particularly in the case of standardized products, the expanding market does not automatically produce high profits. The pressure is likely to be

more constraining than the stimulus to growth and profit. This is probably the main reason for stationary profits in those sections of Belgian engineering where new products are made. The size of these engineering firms is small; they have no means to adapt themselves to the increasing needs of an expanding market. For this market, though expanding quantitatively, requires a continuous adjustment in terms of quality; and this adjustment seems difficult for the small firms. The result is the profit pattern of engineering which reflects an intermediate position: relatively high profit ratios, but stationary real profits.

It follows that the structure of Belgian manufacturing is ill-adjusted to the present pattern of international trade; profits are therefore inadequate on the whole, though some differences exist between various branches.

Let us turn now to the other side of the vicious circle. How does the present profit pattern prevent any basic change in the structure of industrial output?

The process of "freezing" has already been outlined in Part III. In Belgian manufacturing industry as a whole profits are low and stagnating. Thus firms grow through rationalization and modernization; and since capital deepening and reorganization implies almost by definition the improvement and the extension of the existing lines of production, no radical changes are conceivable in the relative importance of various industrial branches. Admittedly, some changes may and do occur. The quality of a product may improve, and some diversification may also take place. This, however, remains very much weaker in its effects on the country's industrial structure than the ambitious capital investment projects which would be necessary to bring about a basic change. As has been shown previously, even the relatively prosperous engineering trade is lacking the necessary stimulus to set up large-sized new plants and to introduce risky new products.

It is therefore understandable that there is no initiative from within the industry to set up new industries. Few are the firms which created new plants and new products. The lack of diversification within the existing firms is thus explained.

One could, of course, argue that this is not a wholly satisfactory explanation. New industries could be created otherwise than by diversification within the old firms. Investible funds have been relatively abundant; "newcomers" and "outsiders" would have had ample opportunities to set up entirely new firms. That this happened only in very rare instances cannot be explained in economic terms

alone. Surely the overall profit situation, by creating a pessimistic atmosphere, bears some responsibility. But there must be other reasons, which ought to be analysed within the framework of a more sociological theory. This is beyond the scope of this paper.

(3) To conclude, I should like to give a tentative answer to two questions. Granted that this “vicious circle theory” contains some elements of truth, (a) how did the Belgian economy get into it? and (b) how could it get out of it?

The answer to the first question comes most probably from the analysis of the wage-cost figures. Before the war, Belgium was a low-cost country, with money wages 30 to 25 per cent below the British level. Immediately after the war there was a steep rise in wages which by 1947 brought the Belgian wages well over the level of the neighbouring European countries, in money as well as real terms. This was made possible by the quick recovery of Belgian industry whose traditional products – textiles, steel and railway equipment – could be easily sold in the post-war world. When the first difficulties appeared in 1948-49, wages were already pinned to a level which proved to be too high in comparison with the country’s possibilities. The fact that the Belgian franc was devalued less than the other currencies in autumn 1949 only worsened the situation. As in other countries, wages in Belgium are notoriously rigid if it comes to a downward movement.

Thus there is some justification in saying that high wages are responsible for the low profits; but this “responsibility” is far distant and stops to some extent at the starting point of the vicious circle.

This view is different from the opinion, widely held in Belgium, according to which the rapid rise of wages brought the greatest benefit to the country: the fast increase in productivity. It is true that the squeezing of profits pushed industrialists to rationalize and to substitute capital for labour. The price, however, of this fast increase in productivity seems rather high. For is it not this growth-through-rationalization which is chiefly responsible for the freezing of the country’s industrial structure?

As for the way out from the present vicious circle, the only “spontaneous” possibility seems to be a long-lasting prosperity outside Belgium, coupled with the stability of the internal wage level for a few years. This is what seemed to happen during the latest boom. The result is a marked upswing in investment projects

since summer 1956. It looks as if something had changed: planned investment has increased, the planning horizon has become longer and the projects comprise deliberate capital widening as well as the creation of new industries. In the summer of 1957 the problems facing Belgian industry are radically different from those of the 1948-56 period: the limiting factor has become the shortage of investible funds. It would be too early, however, to conclude that the investment pattern described in this article has merely an historical interest.

## Chapter III

# Europe's Progress: Due to Common Market?

1961

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*After his work on investment and growth in Belgium, Lamfalussy turned to the broader European scene. In this article, he asks the question whether the widening gap in the economic performance of the EEC countries and the United Kingdom was due to the creation of the Common Market (his conclusions are rather agnostic). During a sabbatical at Yale University, in the academic year 1961-62, he continued his work, which was published in 1963 as a book entitled, "The United Kingdom and the Six. An Essay on Economic Growth in Western Europe". The article here was published in Lloyds Bank Review, October 1961, No. 62. Reprinted with kind permission of Lloyds Banking Group and the Lamfalussy family.*

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It has now become quite fashionable to argue that the establishment of the European Economic Community (E.E.C.) has *already* had a stimulating effect on the rate of growth of the six member countries, and that the widening gap between the economic performance of the Six and that of the United Kingdom may have something to do with the fact that the latter has as yet remained outside the E.E.C. The purpose of this article is to discuss the validity of the statistical evidence which may be put forward in support of, or against, this argument.

To sum up the conclusion in advance, my own impression is that the weight of the evidence goes against the argument. There seem to be no obvious figures which would point to a causal relationship between the establishment of the Common Market and the rapid growth of its members. It seems, in fact, quite possible to argue the other way round and to suggest that it is the "inherently" high, rate of growth of Continental Europe which stimulated trade between members of the E.E.C. and made it possible to set up the Common Market, not *vice versa*.

We should, of course, bear in mind the rules of this kind of statistical game and resist the temptation to draw too many conclusions. First, we have to rely here on very general statistics; it is quite possible that the study of individual products or markets would reveal a different story. Second, one can never prove anything with statistics, for the reason that we cannot actually observe alternative courses of events. In this instance it means that we can only make assumptions about what would have happened *without* the Common Market, while it is possible to observe what has actually happened since the E.E.C. treaty was signed. Last, but not least, my concern here is exclusively with statistical evidence; and there can be a lot of important events which have not yet received confirmation in the growing flow of statistical material published by various European agencies.

This latter restriction creates an awkward problem: for one knows from first-hand experience that important changes are occurring in E.E.C. industries (in the form of joint ventures, agreements on product specialization, and so on), all of which tend to bring the actual size of production units nearer to the optimum and to speed up technological progress; yet one is unable to produce any figures which would as yet portray the effects of such developments. The result – as is usual in conflicts of this kind – is a good deal of scepticism, which may be considered healthy by some and deplorable by others.

These are important limitations to bear in mind when it comes to drawing conclusions; but the record since the signing of the Rome Treaty is well worth examination and raises many interesting questions.

## Production and Foreign Trade Since 1958

Let us begin by outlining, as fairly as possible, what seems to be the commonest argument put forward by those who believe that the E.E.C. has already had a marked impact on the pace of economic growth. The statistical background is summed up in Table I.

Between 1958<sup>1</sup> and the first three months of 1961 industrial growth has undoubtedly been much faster in the E.E.C. than in the E.F.T.A. as a whole or in the United Kingdom taken individually. The gap appeared in 1960, and

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<sup>1</sup> The first tariff cuts and quota increases within the Common Market took place on January 1st, 1959.

widened further in 1961. Total exports by the Six have also been growing much faster than those by the Seven. Between 1958 and the first quarter of 1961 the increase was 39 per cent, for the E.E.C, 20 per cent, for the E.F.T.A. and only 15 per cent, for the United Kingdom. Now, exports can safely be regarded in the case of all European countries as the decisive factor in encouraging expansion. For one thing, a satisfactory rise in export receipts improves the external balance of the country and enables the government to let home demand expand freely. On the other hand, exports usually represent a sizeable share of total demand and therefore exert a direct influence on home investment and on the level of activity of home industry.

**Table I**  
**Industrial growth and foreign trade: 1958-61 (1958 = 100)**

	1959	1960	1961 <sup>1</sup>
Indices of Industrial Production:			
E.E.C.	106	119	126
E.F.T.A.	107	113	115
United Kingdom	107	114	114
Merchandise Exports: <sup>2</sup>			
E.E.C.: Total exports	111	130	139
Intra E.E.C. trade	119	147	163
E.F.T.A.: Total exports	105	113	120
Intra E.F.T.A. trade	107	123	128
U.K.: Total exports	103	110	115
Exports to E.F.T.A.	108	120	129

*Notes:*

<sup>1</sup> *First quarter, seasonally adjusted, except for intra-area trade.*

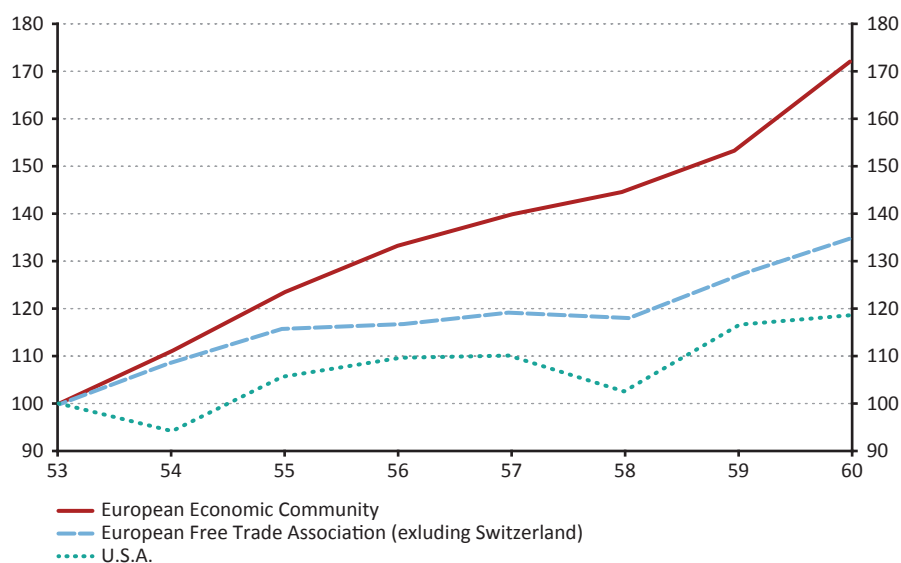
<sup>2</sup> *At current prices.*

It is through this second channel that the spectacular increase in trade within the E.E.C. – 63 per cent, between 1958 and the first quarter of 1961 – may have played an important part in stimulating over-all expansion. For the Six, trade within the area amounts to about one-third of total exports; and this third has been growing since 1958 at a yearly rate of almost 20 per cent. On the other hand, trade between the members of the Seven represents no more than one-sixth of their total exports; and even this small part grew at a yearly a rate of less

than 10 per cent. The “pull” effect of “intra-area” trade has thus been much more powerful for the Common Market countries.

This, of course, is not the whole of the story. The more sophisticated advocates of the argument are quite prepared to face two objections which are likely to be raised, even if the statistical evidence is accepted as a valid starting point for discussion.

**Chart I**  
**industrial production (1953 = 100)**



The first of these objections consists in pointing out that the two 10 per cent, tariff cuts (on January 1st, 1959, and on July 1st, 1960) and the limited increases in import quotas could hardly have produced sizeable changes in the trade flows as early as 1959 and 1960. This is especially doubtful as (1) in some cases the tariff reductions have been offset by an increase in compensatory taxes, (2) some of the tariff cuts and quota increases have also been applied to imports coming from third countries, and (3) the reductions were calculated by reference to the tariff level of January 1st, 1957, while in the case of Germany, in particular, some tariff cuts had already taken place in the course of 1957.



The answer given to this objection is that the expansion in intra-E.E.C. trade may have occurred as a result of advance planning. It does not seem unreasonable to assume that exporters would try to gain a foothold primarily in those markets where protective barriers are shortly to be removed. It may have seemed, for instance, more rewarding for a German motorcar manufacturer to invade the French market than to increase his sales in Britain. The reason is that it pays to get in first into a market which is to be opened gradually, even if the initial rise in sales is not profitable. This is likely to happen if the German manufacturer thinks of long-term profits and if he believes that the dismantling of trade barriers within the Common Market will proceed according to schedule. Both these views are in fact widely held.

The second objection runs on more theoretical lines. A somewhat arbitrary simplification of the main arguments of economic theory suggests that an increase in trade between the Six may have led to increased production only if one or more of the following conditions has or have been satisfied:

- (a) There has been a growing specialization of each country in those lines of production in which it has a comparative advantage over other countries. This has led to the disappearance of inefficient producers, has enabled the efficient ones to become even more efficient by reaching an optimum size, and has therefore led to a better allocation of resources and to a rise in production per head.
- (b) The actual or expected pressure of foreign competition has forced individual producers to rationalize and to invest, and thus to increase productivity by more than they would have done within the protected home markets. The result of this is not so much a better allocation of resources as their increase; but the final outcome is, anyway, an increase in productivity.
- (c) If the member countries were not fully employed when the first steps were taken towards the establishment of the Common Market, the increase in capital outlay as suggested in point (b) may have led to an increase in effective demand and therefore to a more complete utilization of resources.

To begin with (c), it can be easily argued that the Six were not fully employed in 1958. True, the European “pause” did not result in any substantial increase in unemployment; but the marked decline in the rate of growth in 1957-58

undoubtedly created excess capacity in most Continental countries. It was quite obvious, by the end of 1958, that output and productivity could be raised through a more complete and intensive utilization of labour and machinery. It can also be argued that the rise in fixed capital formation in 1959 and in 1960 played the role of a powerful driving force in accelerating economic expansion. Between 1958 and 1960, the gross national product of the E.E.C. member countries increased by \$17 200 millions in terms of 1954 prices. Gross domestic fixed capital formation alone rose by \$5 300 millions. As a result, the share of fixed investment in the gross national product went up from 20 to 21 per cent.

It would, of course, be impossible to prove statistically whether anything of the kind suggested under headings (a) and (b) has, or has not, taken place in the Common Market countries. One may, however, draw attention to the fact that labour productivity has been rising much faster in the E.E.C. taken as a whole than in the United Kingdom. A rough comparison of output and employment indices suggests that the productivity of labour may have risen between 1958 and the early months of 1961 by about 24 to 25 per cent, in Germany, France and the Netherlands, by 21 per cent, in Italy and by 16 per cent, in Belgium, compared with only 10 per cent, in the United Kingdom. The difference is the more striking as it appeared basically in 1960 and 1961. True, nobody would pretend that there has been a noticeable increase in the death-rate of inefficient firms; but then one would hardly expect such an increase to occur in the midst of a powerful boom. The lack of an increased mortality does not rule out the possibility that there has already been a shift of output from inefficient to more efficient producers; but such a shift will become apparent only when demand becomes less excessive.

## The Argument Reversed

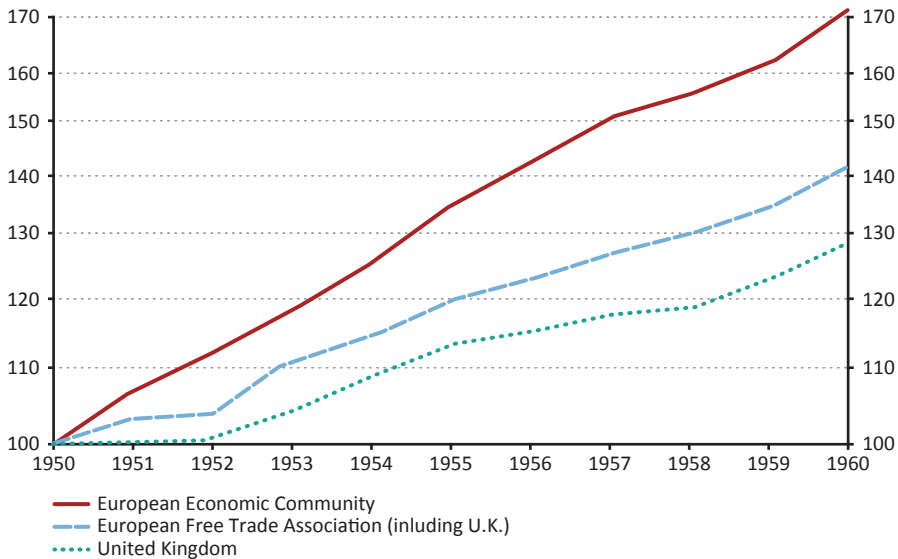
My doubts about the validity of the foregoing argument arise not so much out of any a *priori* reasoning, or because of the impossibility of "proving" any of the three points mentioned above. They stem from the feeling that the starting point for the whole train of argument is badly chosen. It is obviously not sufficient to look simply at what has happened since 1958. There would be a presumption that the Common Market was an important operative cause of the expansion during that period only if this indicated a marked improvement on previous

performance. And we should expect, too that any such increased momentum would be general, if perhaps varying in degree to all the countries participating in the Common Market. Yet in fact, if we take a longer perspective and examine the course of events since 1950, or at any rate 1953 we can find little evidence that this has been the case.

To consider first the comparison between E.E.C. as a group and E.F.T.A. as a group, it is apparent that the divergence of trends over the period 1958 to 1961 (as shown in Table I) was already apparent during the preceding years. In other words, if an economist from another planet looked exclusively at the most significant over-all statistical time series, without knowing anything about the E.E.C, the E.F.T.A. and the rest, he would hardly be able to detect a kink around 1958-59 which would induce him to ask questions about possible changes in the institutional framework of European trade.

**Chart II**

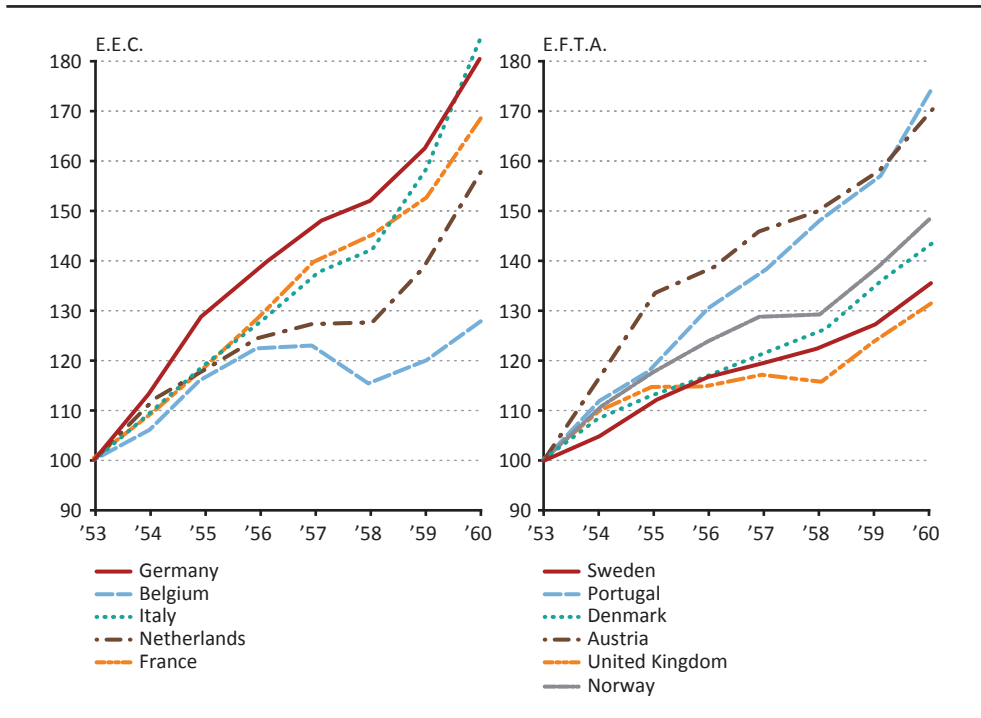
**Growth of gross national product (at 1954 constant prices, 1950 = 100, logarithmic scale)**



Take for instance Chart II, showing the trend of gross national products in the E.E.C., the E.F.T.A. and the United Kingdom between 1950 and 1960. It shows very clearly that the more rapid development of the Common Market countries

is not the product of the last two years. In fact there has not been a single year during the fifties when the United Kingdom recorded a faster growth rate than the E.E.C. Examining the trends in greater detail, the impression given is that the reason for Britain's slower rate of progress is connected with the two periods from 1950 to 1952 and from 1955 to 1958, rather than with the most recent years. This alone suggests that anyone interested in finding out what retarded the growth of the British economy should begin by asking questions about those two critical periods.

**Chart III**  
**Industrial production (1953 = 100)**



There seems to be no recent change, either, in the pace of the E.E.C.'s development looked at independently from any comparison with other areas. It does not require the use of refined statistical tools to discover that the trend line which best fits the Common Market figures comes very near to a straight line; and since the chart is drawn on a logarithmic scale, this means a steady percentage rate

of growth. True, there have been years with a higher-than-average performance: 1951, 1954, 1955, 1960. Others displayed a lower-than-average rate of growth: 1952 and 1958. On the whole, these deviations seem to fit in with traditional but very mild trade cycles; and if this assumption is adopted, the acceleration of the E.E.C. countries' expansion in 1959-60 may be regarded as a normal cyclical upswing comparable to the one that took place in 1954-55.

Much the same impression is obtained if we look not at the record of the two groups as a whole but at the performance of individual countries. Chart III shows that between 1953 and 1960 industrial production in Germany and Italy rose by 80 per cent, or more; but the rate of growth was about as fast in the earlier as in the later years of the period. By contrast, industrial production in Belgium rose on balance by no more than 27 per cent – and the greater part of this increase was achieved in the years before 1956.

Within E.F.T.A., on the other hand, Austria achieved an increase in industrial production over these years of nearly 70 per cent: not quite so spectacular an upsurge as that of Germany and Italy, but slightly greater than that of France. At the other end of the scale, the expansion in the U.K. was no more than 30 per cent. Even so, this was a little more than the Belgian increase. The pattern for the two countries is in fact remarkably similar: a reasonable rate of growth up to 1955, then some years of marking time (or in the Belgian case an actual decline), followed by renewed expansion after 1958.

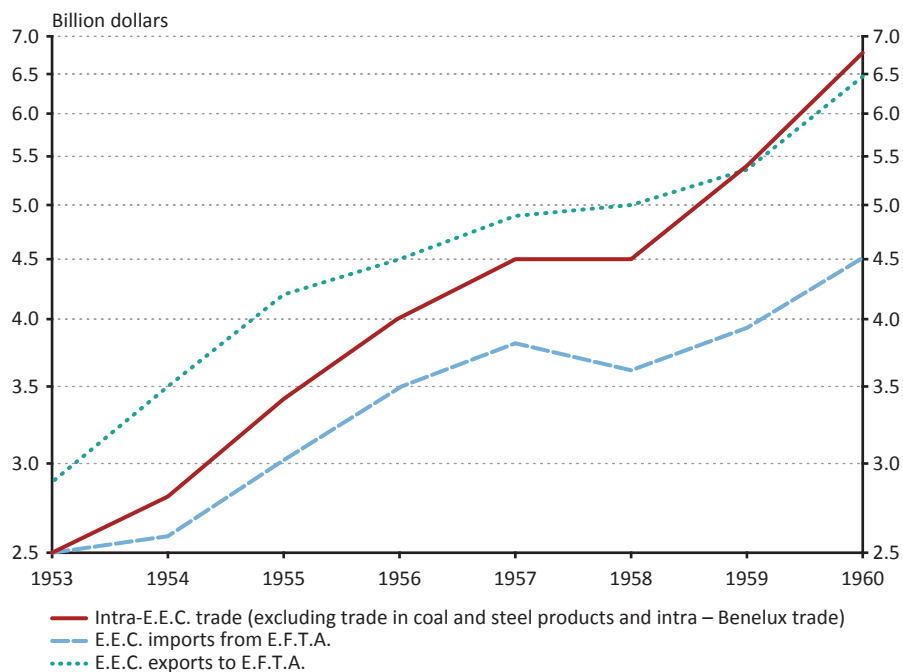
The Belgian example shows that membership of the Common Market does not automatically ensure exceptionally rapid growth. On the other hand, it may well be that the Belgian record would have been even less impressive without the Common Market. Incidentally, it is worth remembering that the U.K. is by far the largest member of E.F.T.A. (accounting for about three-quarters of that group's total industrial production), whereas Belgium is one of the smaller units of E.E.C. Hence the similarity of their performance is bound to be reflected, statistically, in a poorer showing for E.F.T.A. taken as a group than for E.E.C. taken as a group.

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Let us now turn our attention to the external trade of the two groups, as set out in Chart IV, which shows the development of trade within the E.E.C, and of trade between the E.E.C. and the E.F.T.A., for the period 1953 to 1960.

Chart IV

Development of E.E.C. countries' trade (at current prices, logarithmic scale)



It may be useful to say a few words about the reasons for selecting precisely these three sets of figures. The main reason is that, if the Common Market had already had an impact on the trade flows, one would expect to find this impact reflected mainly in a more rapid growth of trade between the members of E.E.C. than of trade between that group and E.F.T.A. Trade between Western European countries is composed mainly of industrial products; and although it would be a gross oversimplification to suggest that we can disregard the commodity composition of imports and exports, it seems reasonable to assume that there are numerous possibilities of substitution and hence great scope for trade diversion. There would be similar possibilities of substitution in trade between the Six and the United States. It seems wiser, however, not to attempt such a comparison, since the trade flows between Western Europe and North America were so greatly disturbed by the Suez crisis in 1956-57, and by the expansion of European automobile exports to the United States, that it is difficult to make valid generalizations about trends.

Development within Western Europe, as shown in Chart IV, has been more even and much less disturbed by chance occurrences.

As regards intra-E.E.C. trade, the figures shown on Chart IV exclude both intra-Benelux trade (which had become almost completely free at the beginning of the fifties) and trade in the products covered by the European Coal and Steel Community, which became free (with minor exceptions) in 1953. This precludes the objection that the rapid increase in intra-E.E.C. trade before 1958 may have owed something to the expanding merchandise flow between Belgium and the Netherlands and to the well-known stimulating effect of the E.C.S.C. treaty, which brought about a marked growth in the exchange of steel products, especially between 1952 and 1955.

Chart IV goes a long way to confirm the story told by Chart II. It shows clearly that the slower development of E.E.C. imports from the E.F.T.A. (compared with the expansion of trade between the E.E.C. countries themselves) did not begin in 1958. It had started in fact as early as 1954 and had become quite obvious in 1957-58. Between 1953 and 1958, trade between the member countries of the E.E.C. had already increased by 80 per cent, while imports from the E.F.T.A. had risen by only 44 per cent, or about half as rapidly. It is striking to see that between 1958 and 1960 intra-E.E.C. trade increased by 51 per cent, while imports from the E.F.T.A. rose by 25 per cent: i.e., again about half as fast.<sup>1</sup>

It is also worth considering the development of intra-E.E.C. trade by itself. The 51 per cent growth that occurred between 1958 and 1960 is no doubt spectacular;

<sup>1</sup> Looking at the same facts from a different viewpoint, the table below shows imports (excluding coal and iron products and intra-Benelux trade) drawn from other E.E.C. countries as a proportion of total imports from E.E.C., E.F.T.A. and North America. For E.E.C. as a whole, the proportion rose from 36 to 40 per cent, in the five years to 1958 and further rose to 44 per cent, in the succeeding two years; there were, however, striking differences in the trends for individual members:

**Imports from other E.E.C. countries as a percentage of combined imports from the E.E.C., the E.F.T.A. and North America (excluding trade in E.C.S.C. products)**

	1953	1958	1960
Importing Countries:	%	%	%
Germany	38	38	41
France	33	42	48
Italy	31	33	42
Benelux	44	50	54
E.E.C. total	36	40	44

but it so happens that there had already been another two-year period – from 1954 to 1956 – which registered a 44 per cent, rise, only a little less than that between 1958 and 1960. Since the period from 1954 to 1956 corresponds to the upward phase of the previous trade cycle in Continental Europe, it seems as likely as not that the rapid growth of trade between the E.E.C. countries in 1959 and 1960 was brought about by the normal cyclical upswing, rather than vice versa.

The plausibility of this way of thinking is enhanced if we look at the way the cyclical recovery took place in Europe as a whole. Fixed capital expenditure rose in the E.E.C. countries from \$29 900 millions in 1958 to \$35 200 millions in 1960, i.e. by 18 per cent. But there was also an increase in capital outlay in other O.E.E.C. countries, from \$16 800 to \$19 700 millions: i.e. by a little more than 17 per cent. There is no *prima facie* evidence suggesting that the 1959-61 investment boom in Europe should be attributed to the stimulating influence of the Common Market, unless we are prepared to argue that the British, Swedish or Austrian investment booms are the result of a reflex of self-defence. But this does not sound very plausible.

By analogy with the trade cycle argument, it would even be possible to turn completely upside down the reasoning set out in the preceding section. We could assume that, for a variety of reasons, the member countries of the Common Market have had a high “autonomous” propensity to grow. Germany, for instance, may have had large labour reserves, relatively low wages and only little military expenditure to carry; Italy and the Netherlands may have grown under the pressure of a rapidly expanding population and rather low wages; and so forth. Demography, wage levels, politics, a wider scope for industrialization – all these may have acted as stimuli to rapid growth. Once this growth started, it became quite normal for the countries concerned to increase their (imports from each other. And, the argument would continue, it is this “natural” tendency towards increased integration, coupled with a strong belief in further growth, that has made it possible to establish the Common Market, and to make the first tariff cuts and quota increases a more or less painless process. The *primum mobile* thus would be “autonomous” growth rather than the move towards a Common Market.



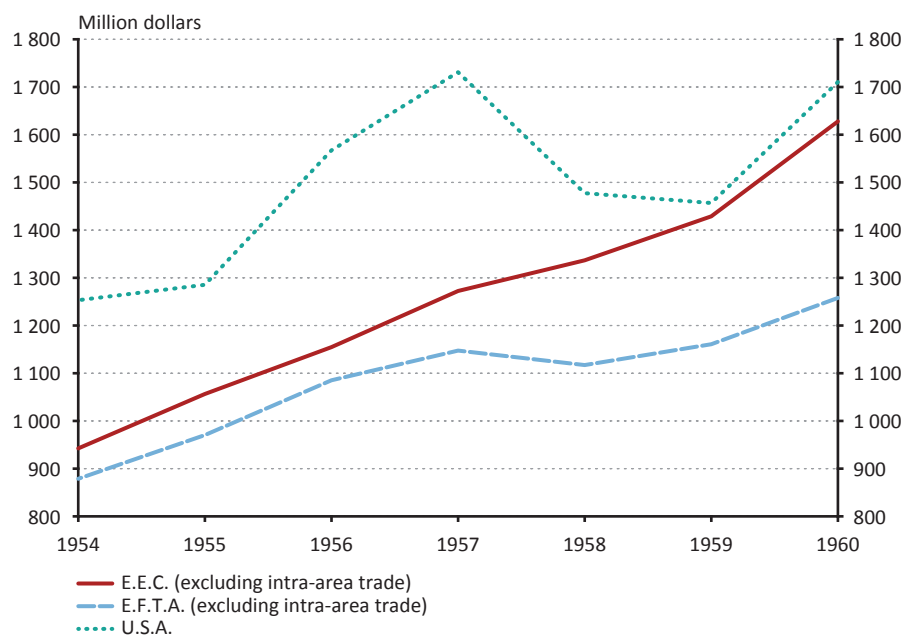
The main problem raised by this approach is to find out what the “natural” tendency towards greater integration may mean. The difficulty appears clearly in connection with the slower development of E.E.C. imports from the E.F.T.A. countries. If growth, calls for greater imports, why should the E.E.C. countries have increased their imports from the E.F.T.A. less rapidly than from each other long before 1958? Geography might perhaps provide part of the answer, although this would hardly fit in with the fact that E.E.C. exports to the E.F.T.A. have expanded more vigorously than E.E.C. purchases from the E.F.T.A. group. Nor does it appear that the reason should be sought in the commodity composition of E.F.T.A. exports. It would rather seem that something went wrong with the competitive position of the E.F.T.A. countries as a whole, or of the United Kingdom taken individually.

Now this is, of course, a highly debatable assumption. “Competitive position” is not a very precise phrase, and if we define it more precisely (by reference, for example, to the level of labour costs per unit of output, or the level of export prices), we find it extremely difficult to measure. It seems nevertheless fairly certain that the United Kingdom’s competitive position (relatively to the E.E.C.) worsened between 1953 and 1959, at least if we mean by this that British labour costs per unit of output or British export prices have risen more rapidly than those of the E.E.C. as a whole.<sup>1</sup> Worsening does not necessarily mean that the absolute level of the significant British prices became too high somewhere between 1953 and 1959; for no one really knows whether they had not been too low in 1953. The worsening has, however, been quite substantial in relation to France, Italy and Germany, i.e. to the three main Common Market countries; so that these three countries may by 1959 have achieved a competitive advantage over Great Britain.

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<sup>1</sup> Sir Donald MacDougall, *The Dollar Problem: A Reappraisal*, Essays in International Finance, Princeton, November, 1960, pp. 17-20.

**Chart V**  
**Exports (monthly average)**

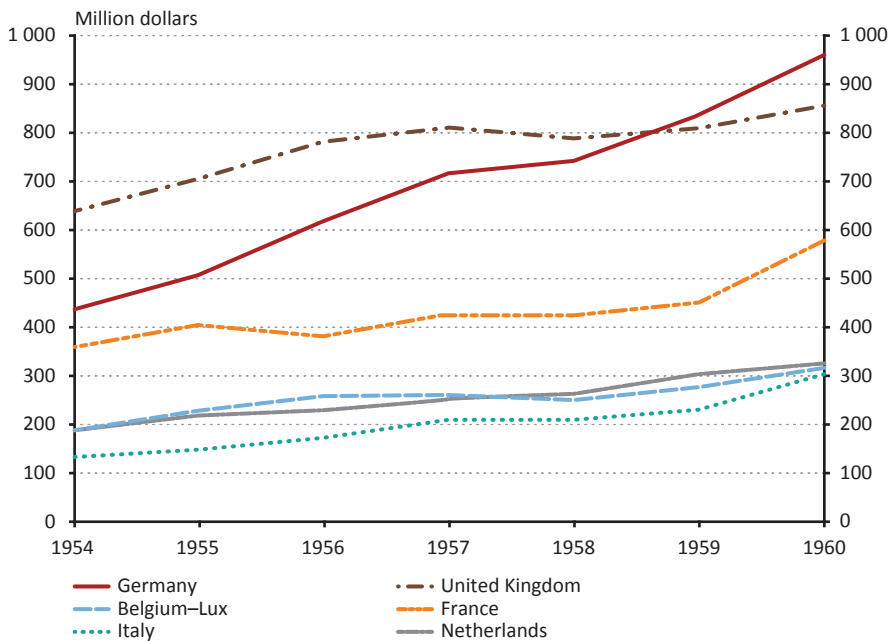


If this were so, the pieces of the puzzle would fall into a nice pattern. We could say that, for reasons proper to each of its member countries, the E.E.C. achieved both a faster economic growth and an improvement in its competitive position relatively to the main E.F.T.A. country, the United Kingdom. The faster growth brought about a rapid increase in imports, and these came naturally from those countries which were able to supply them more cheaply, i.e. from other member countries. The improvement of the E.E.C.'s competitive position vis-a-vis the United Kingdom resulted in a rapid expansion of the Common Market's exports to the E.F.T.A., in spite of the relatively slow expansion of this latter area. The improvement of the E.E.C.'s balance of trade with the E.F.T.A.,<sup>1</sup> and the rapid growth of trade between the member countries made the establishment of the Common Market attractive and an easy success.

<sup>1</sup> E.E.C. exports to the E.F.T.A. exceeded imports by \$400 millions in 1953. The surplus reached \$1 400 millions in 1958 and \$2 000 millions in 1960.

There can be little doubt that the favourable external position of the E.E.C. area as a whole had been an important factor in encouraging the Six to join forces and to establish an economic union. The combined current external balance of the E.E.C. countries has shown a surplus every single year since 1951. In periods of full (or over-full) employment, such as 1956-57 and 1960, the surplus fell below the average; but the balance has never run into the red since 1951, not even during the Suez crisis.

**Chart VI**  
**Exports (monthly averages)**



**Table II**

**External balance on current account of the E.E.C. In U.S. \$' 000 millions at 1954 prices and 1954 exchange rates.**

	1950	1951	1952	1953	1954	1955
Exports of goods and services	15.5	18.3	19.0	21.0	24.3	27.2
Imports of goods and services	16.0	17.0	18.2	19.9	22.7	25.3
Surplus (+) or deficit (-)	-0.5	+1.3	+0.8	+1.1	+1.6	+1.9
	1956	1957	1958	1959	1960	
Exports of goods and services	28.9	32.1	33.5	37.4	42.4	
Imports of goods and services	28.7	31.3	31.7	35.0	41.2	
Surplus (+) or deficit (-)	+0.2	+0.8	+1.8	+2.4	+1.2	

**Chart VII**

**Imports (monthly average)**



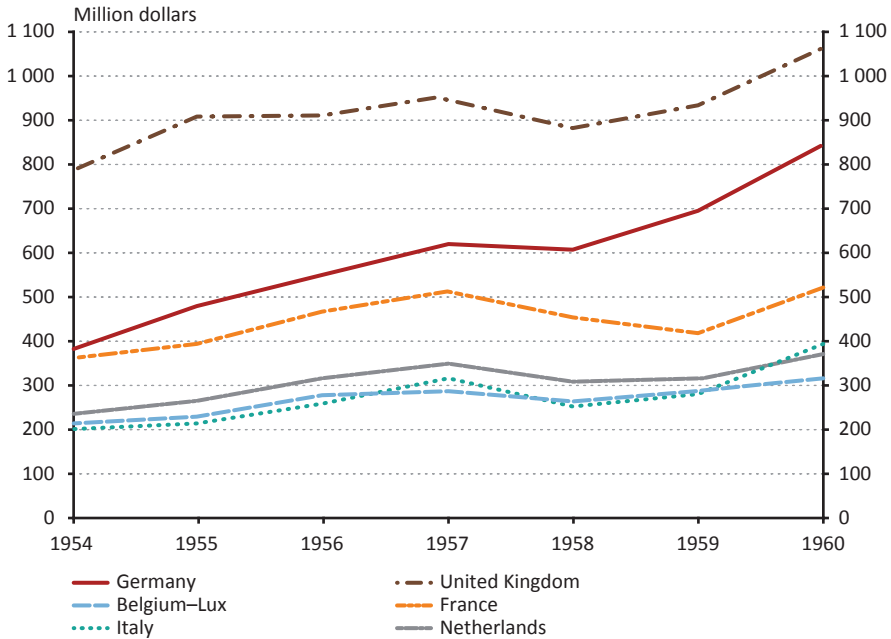
The fact that there has been a steady external surplus does not, of course, by itself prove that the E.E.C. countries as a whole have enjoyed a continuing competitive advantage over other industrial areas. Any country can have a surplus on current account, provided it is prepared to keep a sufficiently tight rein over internal demand; but for high-cost countries, or for countries with an unfavourable commodity composition of exports, an external surplus could be achieved only at the cost of some degree of unemployment. Now, the striking thing is that (except for some cyclical fluctuations) unemployment has been strongly declining within the Six. France and the Netherlands never had very much; but Germany's unemployment fell from an average of 1.4 millions in 1950-52 to 230 000 in 1960, that of Italy from 1.8 to 1.5 millions, and that of Belgium from 167 000 to 110 000. In spite of a severe labour shortage in 1960, the E.E.C. countries proved able to earn in that year a current external surplus of \$1 200 millions.<sup>1</sup> This strongly suggests that in one way or another the E.E.C. has been enjoying a competitive advantage vis-a-vis the rest of the industrial world as a whole. But unemployment had already begun to decline in Germany and Belgium around 1954-55, without any corresponding deterioration in the current balances of these two countries. Once again, therefore, there is no conclusive evidence that the establishment of the Common Market had anything to do with this favourable position.

On the contrary, the case of France confirms our earlier suspicion that it is much more fruitful to think the other way round. In 1956 and 1957 France ran into a big external deficit and, although the Treaty had been ratified by the national parliaments by the end of 1957, there was a great deal of uncertainty in 1958 about the actual application of the first trade concessions scheduled for the beginning of 1959. However, France managed to close her inflationary gap in the second half of 1958 and she restored her competitive position by devaluing at the end of the same year. This enabled her to reap the benefits of the rapid increases in productivity which had taken place between 1953 and 1957, but whose beneficial effects had been masked until 1958 by the inflationary pressure. As a result, the first tariff cuts were put into effect on January 1st, 1959, without causing the slightest disturbance.

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<sup>1</sup> At 1954 exchange rate and 1954 prices. At current prices and exchange rates the surplus was \$3 100 millions, as against 12 600 millions only in 1958, i.e. in a year of higher unemployment.

**Chart VIII**  
Imports (monthly averages)



It is doubtful whether this would have been possible had the improvement of France's competitive position hurt any other member country. But the competitive position of the rest of the Community seems to have been strong enough to support the revival of French competition in all markets. The vanishing of the French deficit thus did not bring about any marked deterioration in the current balance of the other E.E.C. countries. The impact, if any, could be exported outside the Community to other industrial areas; nothing happened to prevent the E.E.C. countries from continuing to expand and to increase their trade with each other.

## Conclusions

So far so good. The counter-argument looks neat enough and at least as plausible as the argument we set out to criticize. I should, however, be reluctant to conclude without once again calling attention to two limitations of this analysis, already mentioned at the beginning of the article.

First, the rather negative conclusion about the effects of the Common Market to date is not confirmed by direct experience in business. Anybody who has had the opportunity of closely watching the rapidly changing mentality of Continental industrialists, or to observe the flood of joint ventures and capital expenditure which in all cases are justified with reference to the Common Market, cannot but be unhappy about the apparent air of scepticism in previous sections of the article. It would, of course, be easy to argue that the recurring references to the Common Market in company reports or public speeches do not necessarily prove that the actual decisions have really been motivated by the establishment of the E.E.C., and that the effect of investment decisions taken in 1959 or 1960 is in any case unlikely to become apparent in published statistics before another couple of years. Yet industrialists seem to be so convinced that something new is emerging in Continental Europe that it would be foolish to project into the future the time series analyzed in this article without bearing in mind that the E.E.C. may bring about quite substantial changes in trade flows and in growth rates during the sixties.

This is the more relevant as one could not claim to have “proven” – even statistically – the validity of the conclusions suggested. There remains the eternal doubt raised by the *ceteris paribus* assumption, which in the present case means that we are unable to observe what would have happened without the establishment of the E.E.C. The “autonomous” stimuli to growth may have become exhausted by 1958-59, and that would have meant an actual slackening in the rate of growth but for the new stimulus provided by the opening of the Common Market.

This objection should not be dismissed light-heartedly. Even if we believe that it has not applied hitherto, it may well become of growing validity in the years ahead. Recently, important changes have taken place in some of the growth-leading Continental countries. After years of an easy labour market, Germany has entered since 1960 into a period of acute labour shortages. German labour costs have been rising since 1959 more rapidly than those of most other European countries, and there has also been a rise in German prices. There are signs that a similar development is on its way in the Netherlands and in Italy, while it becomes clear that France has for some time been losing some of the advantage secured by the devaluations in 1957-58.

If this trend continued, E.E.C. would be likely sooner or later to lose at least part of its competitive advantage vis-a-vis other industrial areas. While this would be a good thing for the sake of international equilibrium, such a development would lead the E.E.C. countries into rougher waters. If their combined external balance became less favourable, and if exports to third countries provided a weaker stimulus to expansion, we should soon begin to know whether the opening of the Common Market has, or has not, promoted the expected transfer of resources and so helped to raise productivity. So long as the present boom conditions prevail (combined with strong external surpluses), judgement must be suspended. It is the next pause or recession which will be the real testing time, both for the Common Market's success and for its internal cohesion.



## Chapter IV

# Money Substitutes and Monetary Policy

1961

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*In 1955, Lamfalussy started working at the economic research department of the Banque de Bruxelles, Belgium's second largest commercial bank. His research interests then shifted to monetary and financial matters. The monetary policy debates in the early 1960s were dominated by the 1959 Radcliffe Report (Report of the Committee on the Working of the Monetary System, UK). The report played down the importance of the money supply in favour of the "whole liquidity position". It soon became the topic of significant controversies. Lamfalussy strongly defended the report in an article in the Banker (January 1961, Vol. CXI, No. 419). In his view, the possibility of substituting near money for money in liquid balances, without affecting overall liquidity, implied that the dividing line between banks and other financial intermediaries would become blurred. This view would, more or less, remain a constant in Lamfalussy's work and shape his ideas, not only on monetary policy (scepticism regarding money supply rules), but also on financial stability (attention to financial innovations and shadow banks). Reprinted with kind permission of The Banker and the Lamfalussy family.*

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The Radcliffe Report, as a whole, has had a rather mixed reception; but no part of it has called forth more sceptical remarks than the one that insists upon the role played by the "whole liquidity position" (as opposed to the money supply) in checking the development of effective demand. Sir Dennis Robertson has been sarcastic,<sup>1</sup> Sir Roy Harrod highly critical,<sup>2</sup> and even those who seemed to acknowledge the growing importance of close substitutes for bank deposits felt

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<sup>1</sup> "A Squeak from Aunt Sally", *The Banker*, December, 1959.

<sup>2</sup> "Is the Money Supply Important?", *Westminster Bank Review*, November, 1959.

uneasy about the lack of clarity of the concept of overall liquidity.<sup>1</sup> Some later articles, however, have displayed a more favourable attitude.<sup>2</sup>

This essay discusses some theoretical problems raised by the Report's attempt to distinguish between overall liquidity and money supply. Let us, however, make it quite clear at the outset what the essay is not about. It does not wish to find out what the authors of the Report may have "really" meant; nor does it wish to assess, through a statistical inquiry, the practical importance of a theoretical distinction between overall liquidity and money supply. Its sole purpose is to show that this distinction is meaningful, provided adequate assumptions are made about the way non-banking financial institutions are working; and to show that, if these assumptions properly reflect "reality", the distinction is of major importance for monetary policy. Most of the ideas to be put forward have already been expressed by Mr Rose in his article in *The Banker*; the originality of this essay, if any, lies in a more formal and explicit discussion of the problem.

## Money Supply and Effective Demand

The British experience between 1954 and 1958 has shown that there may be a substantial and sustained growth in national expenditure in spite of the stability of the money supply. The relationship between the stock of money – cash plus bank deposits – and effective demand (which is assumed to be represented by the gross national expenditure) is the starting point of our analysis. Economic theory over the last fifty years or so has suggested two ways for establishing a link between the stock of money and the flow of expenditure.

The first group of theories – Fisher, the various subgroups of the quantity theory and the Cambridge school – work out a direct link. They start by assuming that people have an idea of the money balances they want to hold in any given set of circumstances, including among these "circumstances" the volume of spending transactions carried out (or planned) by the holders of the balances. It is obvious that these people will not be prepared to accept smaller money balances relatively

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<sup>1</sup> R. F. G. Alford and H. B. Rose: "The Radcliffe Report and Domestic Monetary Policy", *London and Cambridge Economic Bulletin*, December, 1959.

<sup>2</sup> H. B. Rose: "Another Look at Liquidity", *The Banker*, March, 1960; "New Light on Liquidity", *The Economist*, March, 1960.

to money expenditure – i.e. a fall in  $\frac{M}{D}$  (where  $M$  = the stock of money and  $D$  = total volume of spending) – unless they have some reason for becoming less liquid. Hence if all other things remain equal, a fall in  $\frac{M}{D}$  should exert a downward pressure on their readiness to spend. This way of reasoning is obviously that of the Cambridge school; and while Fisher and his followers work out their theories in terms of the velocity of circulation of money, Sir Dennis Robertson is right in stressing that “velocity, the ratio  $\frac{D}{M}$ , is simply the inverse of the ratio  $\frac{M}{D}$ , the desired ratio of money stock to money income”. The concept of velocity has logically the same motivational basis as the Cambridge theories up to Keynes. These theories could thus offer two explanations for an increase in spending despite the stability of the money supply. First, they could argue that at the beginning of the period people held money balances in excess of what they desired to hold; a fall in  $\frac{M}{D}$  has therefore been a welcome change in so far as it has brought their liquidity nearer to what they thought to be an ideal level. Now this sort of explanation can be valid only in an economy that is (or has been) subject to direct controls on spending: for it is only rationing (or building licences, or physical controls on imports) that can prevent people from adjusting rapidly their actual balances to the desired ones. In the sort of economic organization now predominant in Western Europe and in North America, which leaves spending decisions entirely free, I can see no reason why people should agree to hold excess balances for anything but a very short period. Secondly, the theories could argue that for some reason or other the desired ratio of money stock to expenditure has fallen; in other words, that people are quite happy about a higher velocity of circulation. The desire, for instance, for holding precautionary or speculative balances may have weakened. This explanation, of course, has a more general validity.

The second group of theories are associated with Keynes. The Keynesian approach is an indirect one. Here, too, people are assumed to have a definite preference for liquidity in a given set of circumstances; and though there are important differences between this concept and that of the desired ratio  $\frac{M}{D}$ , for the purposes of the present discussion we may treat the two concepts as being equivalent. In Keynes’s view, however, a fall in the stock of money when liquidity preference is unchanged will induce a fall in expenditure not directly but indirectly – by driving up the rate of interest. Hence the Keynesian explanation for an increase in spending in spite of a stable stock of money has to run on the same lines as that offered by the quantity and Cambridge schools: the increase could have occurred

only if the liquidity preference of the community had fallen; for had there not been a decline in their desire to hold money balances, people would have accepted a fall in the  $\frac{M}{D}$  ratio only at the price of an increase in interest rates which ought to have checked, sooner or later, the growth of expenditure.

Thus all current theories seem to be unanimous in explaining a fall in the  $\frac{M}{D}$  ratio by a decline in liquidity preference. I shall try to show in what follows that this is not the only possible explanation (although it may be the right one in some cases); that people may be induced to hold less money (relatively to the flow of expenditure) without desiring to become less liquid; and that they may do this because holding less money need not necessarily imply that they are going to be less liquid.

## The Role of Near-Money Assets

Let us begin by pointing out, in the most old-fashioned way, that being a medium of exchange is only one of the functions performed by money – and let us remind ourselves that we have defined money as cash plus bank deposits (by which we mean demand deposits). Money is also a store of value; it is also a bearer of option in that it gives the holder a unique freedom of choice. It may be held for precautionary or for speculative purposes.

Now it is clear that in normal circumstances nothing but money can be a medium of exchange. Time deposits and other sorts of near-money may be only a little less liquid than money proper; but they are radically different as regards the possibility of being used as means of payment. However liquid may be the shares of some building societies or term deposits with hire-purchase finance houses, they are not media of exchange; one cannot draw a cheque on a time deposit or on a building society account.

On the other hand, there may be a whole range of near-money assets that are highly liquid, in some cases as liquid as bank deposits. According to the Radcliffe Report, the liquidity of building society shares is very high indeed: “although one or more month’s notice is formally required, in practice withdrawals may be made at much shorter notice, small or urgently required sums being usually repaid on demand” (para 286). Similarly, savings deposits with the Belgian Caisse Generale d’Épargne et de Retraite (a Belgian savings bank) can be withdrawn,

in principle, in small sums once a fortnight; in fact larger sums are repaid on demand at the bank's central office in Brussels. And then, there are, of course, all sorts of time deposits repayable only at one or more month's notice – in fact as well as in principle. Even long-term assets, such as bonds or debentures, may be considered as highly liquid so long as they are marketable without a capital loss. It seems reasonable to assume that those near-money assets that are completely liquid (i.e. repayable, in fact, on demand) can perform all the functions of money but one: they are as good a store of value and as good a bearer of option as bank deposits; but they are not media of exchange. The less liquid near-money assets are less close substitutes for money; but for some (say, precautionary) purposes people may be prepared to hold them instead of bank deposits.

It follows that it may be possible to induce people to turn part of their money balances into appropriate near-money assets. How large a part will depend on why they want to hold money. If the only reason were to finance expenditure, no substitution could take place; but once we admit that part of the liquid balances will be required for other purposes, there is no reason why some substitution should not take place. Keynesian theory, of course, does not deny this possibility; but it stresses that such substitution involves a sacrifice of "liquidity" for the holder of the balances and that so long as his liquidity preference remains unchanged he will accept this sacrifice only if he can earn a higher rate of interest on the new assets. Now if the main line of argument of this article is correct, the requisite interest differential may be very small. So small indeed that a substantial part of money balances may be turned into near-money assets without requiring a rise in interest rates that would be large enough to have a significant effect on the rate of spending.

In terms of the quantity and Cambridge theories, this boils down to saying that a shift from money to near-money assets will call forth a change only in the composition of the total amount of liquid balances. This change in composition, in turn, should leave the holders' liquidity position unaffected so long as the balances needed for purely transactional purposes are completely covered by cash and bank deposits. As a result, actual balances will not fall short of the desired level and people will not be induced to slow down their rate of spending.

## Banks – No Clear Distinction?

The possibility of substituting near-money for money in liquid balances without affecting overall liquidity means that the dividing line between banks and other financial intermediaries has to be moved farther away from banks, so as to include among “banks” all financial institutions that are able to create adequate substitutes for money. Indeed, it is questionable whether this dividing line is useful at all as a tool of analysis in the present state of our knowledge about the money-holding habits of the public.

It is in the name of this dividing line that both Sir Dennis Robertson and Sir Roy Harrod in the two articles mentioned above accuse the Radcliffe Committee of faulty thinking. “Loans create deposits” applies to banks; banks, unlike other financial institutions, create the stuff they lend. All other financial institutions are pure intermediaries; they lend what they get; an increase in their assets has no direct impact on their liabilities.<sup>1</sup> If this were so, there would certainly be no reason to attack traditional thinking on the grounds that there are more and more financial intermediaries. The growing importance of these institutions could in no way make the economy more liquid; for if firm or private person A buys a financial asset for money, thus enabling a non-bank financial intermediary to lend money to another firm or individual (B), this would make no difference to the aggregate liquidity of the economy. Neither the “stock of money”, nor the “whole liquidity position” would change for the very reason that both of these phrases refer to the same thing. If the desire of both A and B to hold money balances remains unchanged, B would increase his rate of spending and A decrease it; even if the two changes in individual spending did not offset each other completely, the final effect on aggregate spending would be negligible. Keynesians would reach a similar conclusion by assuming appropriate change in interest rates. Of course, if meanwhile liquidity preference had fallen, spending would have gone up; but this would have happened because of a change in liquidity preference and not because of A’s lending money to B through a financial intermediary.

This neat reasoning, however, breaks down if we assume that (at least) some of the non-bank financial intermediaries provide the public with near-money assets

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<sup>1</sup> There may be an indirect impact through the ordinary investment-saving mechanism.

that are nearly perfect substitutes for the money held in excess of the strictly transactional balances. In this case there will no longer be identity between “stock of money” and the “whole liquidity position”. Let us think, for instance, of building societies offering shares repayable on demand. In this case, A may be induced – by a very slight interest differential – to buy these near-money assets. The building society will lend to B and B will be able to increase his spending. But A, in contrast with the example given in the previous paragraph, will not feel less liquid, and should therefore not reduce his flow of expenditure. The final result is likely to be a rise in the rate of aggregate spending. A slightly less clear-cut conclusion may be reached if we assume that the near-money asset is a less perfect substitute. In this case A’s spending may decline slightly, but this decrease is likely to be less than B’s increase, so that aggregate spending should still expand.

It follows that the flow of expenditure may grow although the stock of money (cash plus deposits) remains stable, even if liquidity preference is unchanged. The condition is that non-bank financial intermediaries should be able to create appropriate near-money assets. In doing this, they cease, of course, to be intermediaries: they become creators of near-money in just the same way as banks are creators of money.

Their powers of creation, which formally resemble the ordinary “pyramiding” of bank deposits, are, of course, subject to certain limits and conditions. First, there have to be near-money assets as liquid as bank deposits (or almost so), and people have to know this; but they are not supposed to ask simultaneously for massive repayment. This is the same condition as the one on which the pyramid of bank deposits rests: although bank deposits are repayable in cash on demand, the “creation” of bank deposits is possible because it can be taken for granted that only a small proportion of deposits will be withdrawn in cash in any given period. Secondly, the stock of money has to be higher than the total sum of money balances necessary for performing the function of means of payment. If the two are equal, nobody will be able to buy near-money assets without feeling less liquid and, hence, setting into motion the traditional equilibrating mechanism. Thirdly, financial institutions willing to create appropriate near-money must not be prevented from doing so by their own, internal, rules of management, or by state intervention. They will, presumably, want to hold a certain proportion of their assets in the most liquid form, i.e. in cash and in bank deposits. The level of this ratio will depend on the composition of their liabilities; the part of the

liabilities repayable on demand or at very short notice will not be allowed to grow beyond a certain proportion of the total. This “internal” limit to the process of near-money creation is, of course, similar to the brake put by cash and liquidity ratios on the creation of bank money.

## Implications for Monetary Policy

It appears, therefore, that if we make appropriate assumptions about the liquidity holding habits of people and about the way non-banking financial institutions are working, the total amount of liquidity held by an economy at any moment may well exceed the stock of money; and that the difference (made out of near-money) may increase through ordinary “pyramiding”.

An objection may be raised at this point. Why all this fuss about a second multiplier, adding its effect to the traditional pyramiding of bank deposits? It might seem much simpler to say that our analysis points to a widening of the definition of money; that the stock of money should include, besides cash and bank deposits, certain types of near-money. It is money that should be re-defined, not liquidity. The whole discussion would then boil down to an empirical inquiry into the types of near-money that are thought of by people as being perfect, or nearly perfect, substitutes for money.

Such a way of putting things may be misleading for several reasons. First, it would be embarrassing (from a purely definitional point of view) to include in the stock of money liabilities of financial institutions which, though highly liquid, are not media of exchange. This would go against the traditional use of the word “money”. Secondly, near-money is created by financial institutions that are very different from banks. Commercial banks in most western countries follow more or less homogeneous rules of management; they can be dealt with as a more or less uniform group of institutions. This does not apply to financial intermediaries which display a bewildering variety. There is no possibility of merging the creation of near-money with that of bank deposits into a unique pyramid. Thirdly, the distinction between bank deposits and near-money is of crucial importance for monetary policy. A check on the growth of bank deposits in itself will not slow down an increase in the rate of spending, for this increase can be “financed” by the creation of near-money. A fall in the  $\frac{M}{D}$  ratio will, of



course, put an end to the growth of expenditure indirectly, by weakening the liquidity position of the non-banking financial institutions; the brake will be similar to the one put on bank deposits by the stability of the volume of cash. But just as ordinary monetary policy remains ineffective so long as the actual cash holdings of commercial banks are above the normal (or legal) ratio, so the stabilization of bank deposits will check the lending (and near-money creating) operations of the financial “intermediaries” only if these institutions have no excess liquidity. In assessing whether monetary policy may have a chance to slow down expenditure it therefore seems important to look at the liquidity position of all financial institutions that may be involved into the creation of near-money.

## Shots in the Dark

All in all, this suggests that the stabilization of the stock of money by itself is a very clumsy weapon, the impact of which on the actual rate of spending is likely to be largely unpredictable. We already knew from established theories that liquidity preference may fall or – to put it into the quantity theory’s jargon – that the velocity of circulation may rise because of a weakening in people’s desire to hold liquid balances. And we also knew that it is very difficult to guess when and by how much liquidity preference may actually fall. Now it appears that the  $\frac{M}{D}$  ratio may decline without the holders of liquid balances feeling less liquid. In principle, of course, it ought to be possible to find the limit of the near-money pyramid in any given set of circumstances. But to do this in fact we must know the full list of the near-money assets that are regarded by firms and private individuals as suitable substitutes for money; we must know, also, the volume of transactional balances that has to be covered, in any circumstances, by cash and bank deposits; and, finally, we must know the rules of liquidity and the actual liquidity position of the financial institutions involved. Only with the aid of such data would it be possible to find out how far the  $\frac{M}{D}$  ratio would have to fall in order to curb expenditure. In the present state of our knowledge, no monetary authorities have such information at their disposal.

In an economy where there is a wide range of non-bank financial intermediaries (producing a wide range of near-money assets), the dividing line between “intermediaries” and creators of money or near-money may become so blurred as to become unhelpful as a tool of analysis. And without a dividing line of some kind, there seems to be little hope for predicting, with a reasonable degree of accuracy, the impact of monetary measures on the rate of spending.

## Chapter V

# The Euro-Bond Market: Problems and Prospects

1968

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*As a member of the Executive Board of the Banque de Bruxelles in the early 1960s, Lamfalussy was entrusted with responsibilities in the area of investment banking. He was involved in setting up certain mutual funds, which the Banque de Bruxelles introduced to the Belgian market. He also played a role in international investment banking, an area which was just emerging at the time. For instance, in July 1963, he represented the Banque de Bruxelles at the signing of the subscription agreement for the first Euro-bond issue, a \$15 million bond for Autostrada. Lamfalussy became an expert on the Euro-bond market and was invited to give a lecture at the Institute of Bankers in London on this theme in February 1968. Reprinted with kind permission of ifs University College and the Lamfalussy family.*

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I have delayed until the last minute the writing of my paper, because the devaluation of the pound, the speculation against the dollar and the measures announced by President Johnson upset the market, and there was a few days late December and early January when one could have serious doubts about its survival or at least its future growth.

I am glad that I did not write my paper earlier, as originally planned. For today, less than two months later, these doubts have vanished from my mind. The market is here to stay – indeed to develop. The volume of issues since the beginning of this year has come close to 600 million dollars, which is about three times as much as during the corresponding period last year and one-third of the total amount of public issues floated during the full calendar year 1967. Admittedly, there has been a drastic shift from straight bonds to convertibles,

and from borrowers of all nationalities towards U.S. issuers. This raises some thorny questions to which I am going to revert in the last part of my lecture. But whatever may be the nature of these new problems, they cast no doubt on the basic resilience and the growth potential of the market. The demand proved strong enough to absorb the flood of recent issues, without any drastic rise in interest rates.

We can therefore start discussing current problems and prospects with serenity and a degree of optimism which would have been hardly appropriate two months ago.

I intend to group my remarks under four headings. History – summary of recent trends in the European market. Economics – speculation about the economic impact of the market, basically on the U.S. balance of payments. Financial techniques – problems connected with the management, underwriting and placing of Euro-bond issues. Politics – discussion of the political implications of the market. I wish I could avoid this latter subject but, in view of what has happened over the last seven weeks, I do not think it would be fair to evade it.

## History

We have come a long way since a name was found [in 1962, I believe] for the floating of dollar bond issues on the so-called “European” market. I will not dwell on the origins of the market. We all know:

- that the strongest stimulus for its development came – on the issuing side – from the U.S. balance of payments position or, more precisely, from the set of measures taken by the U.S. administration in order to diminish the outflow of U.S. capital. These included the interest equalization tax, the guidelines for foreign investment by U.S. corporations, the loan ceilings for U.S. banks and, finally, the set of measures announced by President Johnson on January 2nd this year;
- that, on the other hand, the demand for bonds has been increased by the withholding taxes put into effect in some European countries, namely in Belgium and in Germany;

– and that the full development of the market could not have taken place without the high degree of liberalization reached by the main European countries in private capital movements, especially since 1958.

One may note, as an additional driving force, the growth of international corporations and the growing financial sophistication of company treasurers [and even of government officials] in their search for the cheapest source of finance.

With this background information in mind, let us point out the main changes which have occurred since the pioneering years of the early sixties.

1. The most striking fact relates, of course, to the development of the market. In 1963, aggregate gross loans issued publicly on the Euro-bond market amounted to the equivalent of 128 million dollars. During the same year, gross foreign issues on domestic markets [mainly in Germany and in Switzerland] reached the level of 332 million dollars. Two years later, in 1965, Euro-bond issues proper amounted to 735 million, against 528 million of foreign loans floated on domestic markets. Four years later – i.e. in 1967 –, the first figure came to 1 886 million, while the second fell below 200 million. It is difficult to make forecasts for the current year but it seems reasonable to assume that, unless there are drastic exchange controls or the collapse of the international monetary system, gross Euro-bond issues this year will be well above 2 000 million dollars and might even reach 3 000 million.

It may be worth reminding ourselves that the yearly amount of gross bond issues [as an average for the period 1960-65] on the domestic markets of the Common Market countries has been of the order of 9 000 million dollars<sup>1</sup>. If the other European countries are added to this latter figure – with the exception of the United Kingdom, whose bond market is at present cut off from the rest of the world –, the total for O.E.C.D. Europe might have been approximately 11 000 million dollars.

The obvious conclusion is that one cannot regard the Euro-bond market any longer as a marginal factor in European financial markets. This remains true even if it is assumed [rightly, I think,] that a substantial part of the Euro-bond

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<sup>1</sup> Étude sur le marché des capitaux, Rapport général, O.C.D.E., p.171.

is placed with non-European residents, "Europe" acting for these simply in an entrepot capacity.

2. There has been a significant change in the currency distribution of the issues. In 1963, out of a total of 128 million, 71 were denominated in dollars, 43 in units of account and 12 in Swiss francs. Since 1964, the share of unit-of-account issues has declined substantially and there have been no Swiss franc issues. The US dollar has become the dominant currency, accounting for 75 to 90 per cent of the issues since 1966. The rest has been taken up by loans denominated in D.marks.
3. The third important fact is the rising share of U.S. corporations among the borrowers. There were no U.S. borrowers until 1964. In 1965, their share jumped to about 40 per cent. It remained on that level in 1966. It was reduced to 30 per cent in 1967 but, in January and February this year, it reached more than 90 per cent. For all practical purposes, the Euro-bond market this year has become a market for U.S. corporate borrowers.
4. An interesting development has taken place since two or three years in the field of private placements. The growth of this market cannot be measured with precision in the same way as the public floating of Euro-bond issues. But there can be little doubt that its size has grown possibly even faster than that of the "public" market.

The implication of this is twofold. On the one hand, the dividing line between Euro-dollar credits granted by banks and private issues of notes has become less distinct; on the other hand, the line of demarcation between private and public issues has also become somewhat blurred. As a result, financing operations for international borrowers include now a full range of facilities, from simple Euro-dollar bank loans to the public issue of Euro-bonds or convertibles, passing through revolving lines of credit and the placing of short or medium term notes. These various forms of finance provide now such a variety of techniques, instruments and terms that it has become impossible to define any group of operations in a statistically watertight fashion.

This need not be regarded as surprising. "Public" Euro-bond issues have never been "public" in the way as domestic issues are in Continental Europe: i.e. by being sold on a retail level, or through an active "démarchage", in very small

denominations and by means of substantial publicity. They are public only insofar as they are quoted on one or more stock exchanges and as they are sold in denominations of 1,000 dollars [probably] to a large extent to private individuals. But we know that stock exchange quotations do not imply in themselves an effective market, and we also know that managers of private issues are maintaining a reasonable flow of secondary transactions in the paper which they sell. On the other hand, certificates of participation tend to open up the market of private issues for private individuals. Hence the inevitable overlapping between “public” and private issues.

On the other end of the market – that of short term Euro-dollar operations –, the connecting link with private issues of notes is provided to a large extent by banks. Banks have been lending to their customers in Euro-currencies since a number of years, and, since these lendings have often taken the form of notes, it was to be expected that the lending banks would normally seek possibilities of re-financing by selling these notes. Hence the result that part of the Euro-currency loans remain in the portfolio of the banks, part of it flows into institutional portfolios and another part even ends up [through the technique of certificates of participation] in the portfolios of wealthy private individuals.

A distinct stimulus to the merging and diversification of lending operations came from the wish of corporate borrowers to find the most flexible way of finance. In a market which is fairly capricious, this is only too natural: no operations can be planned months ahead in any specific way and, if the funds are to be available at a given time, the technique of finance has to be adapted to the changing requirements of the market. Hence the banks must look at various forms of finance as alternatives or complements rather than as entirely distinct operations.

5. On the management side of the bond issues, the most noticeable change has taken place in the increasing number of banks involved in management or co-management. The quasi-monopoly enjoyed by American [and to a lesser extent British] banks has come to an end, as European banks have learned how to operate in this market and as they have grown aware of the position they enjoyed in the placing of bonds. The management of bond issues has now become one of the most competitive businesses in the Western world.

It must be noted that while the recent upsurge of U.S. issues has tended to re-assert the strong position of U.S. investment banks, European banks have been acting as managers in a couple of important issues and have been associated as co-managers in others.

6. It is well known that one of the weak points of the market has been the placing of the bonds. The weakness still persists partly because there are relatively few institutional investors, partly because the retail sales do not follow the traditional European pattern. Hence the lack of transparency of the market and the difficulty how to assess the “quality” of a placement.

Three facts, nevertheless, have tended to improve matters in this field. The one is the formation of the Swiss syndicate, the second the increased ability of a number of European banks to sell bonds to their own private customers. The third is the increasing support provided by repayments, the amounts of which is becoming quite substantial.

7. The last fact I wish to mention is the multiplication of traders. A number of banks operate now in the secondary market. They have been prompted to do so partly because trading provides potential managers with a better insight into the state of the market, partly because it enables them to take better care of the issues in the after-sale market.

## Economics

The economics of Euro-bond issues are still to be written, and there is little hope that this will be done in the near future. The main reason for this is that while we know quite well who the borrowers are and why they borrow, we have no reliable general information on who are the final purchasers of the bonds and even less on what they would have done, had there been no Euro-bond issues. It is clear that without this double information there can be no clear conclusions as to the effects of the Euro-bond issues on the balance of payments of individual countries, nor on interest rates.

One can argue, however, that despite poor statistics we ought to make an effort to reach at least tentative conclusions. The growth of the Euro-bond market owes a lot to the U.S. policy of checking capital exports and it would clearly be highly



uncomfortable if we were unable to say anything sensible about the impact of the market on the U.S. balance of payments. At the same time [as I will mention this in the last part of my lecture], there is a growing political restlessness in some European countries about the size of U.S. issues and their alleged inhibiting influence on the ability of non-U.S. borrowers to find finance in the same market, or even in their own. Hence the need for some economic speculation.

Since almost everybody's main concern is with the U.S. balance of payments, we might perhaps start our speculation in a negative way, by asking the following question: what are the assumptions we ought to make about the sources of funds and the alternative investment policy of Euro-bond holders in order to reach the conclusion that the development of the Euro-bond market does not help the capital account of the U.S. balance of payments?

The measures taken by the U.S. administration since 1964 are obviously based on the assumption that they would help to improve the capital account of the balance of payments. Of course, there was never any doubt that a substantial part of the European issues floated in New York prior to the interest equalization tax had been bought by European residents; hence nobody expected a net improvement in the U.S. balance of payments of a size comparable to the amount of the issues the floating of which has now become impossible. But this does not mean that no net improvement was expected at all.

The main source of "balance-of-payments pessimism" lies in the assumption that the purchasers of Euro-bonds [denominated in dollars] have in fact forgone the purchase of U.S. dollar bonds or of other kinds of securities from U.S. holders. Hence the gain for the U.S. balance of payments resulting from a decline in capital exports is offset, partially or entirely, by a simultaneous decline in capital imports.

Now it is quite possible to develop this "pessimism" even further by arguing that the net effect of a developing Euro-bond market might be adverse. Let us assume that the widening of the Euro-bond market attracts borrowers who [all other things being equal] would not have floated, or could not have floated, an issue in New York. This, in fact, means that the dollar issues in Europe would become larger than the decline in dollar issues in New York. Hence if all these Euro-bonds were bought by investors who would have otherwise bought U.S.

dollar bonds, the fall in capital imports to the United States would be larger than the simultaneous decline in capital exports. In other words, the net effect on the balance of portfolio investment would be negative.

Applying this line of reasoning to events in January and February this year, one could argue the following way. Had there been no large Euro-bond market, U.S. corporations would have either given up their direct investments abroad or they would have sought for local finance in some other ways. But the existence of the market allowed them to float issues of more than 500 million dollars. On the assumption we have just put forward, this did not improve in any way the U.S. balance of payments by itself, nor did it have any adverse effect on it. But it might have had an adverse effect if the floating of these issues had triggered off sales of other U.S. securities, bonds or common stocks, by non-U.S. residents.

This, I think, is in a nutshell the logical framework for balance of payments pessimism. Although I have tried hard, I am not able to prove, or to disprove, its validity by referring to figures, U.S. balance of payments figures [or rather what I managed to make out of them] seem to give some support to the reasoning. During the years 1965 and 1966, there seems to have been no improvement in the portfolio account of the U.S. balance of payments [excluding from this account both short term capital movements and special government transactions]: the sharp decline of U.S. portfolio investment abroad has been matched by a similar decline of foreign portfolio investment in the U.S. I know, of course, nothing of what has happened since the beginning of the year.

Despite this *prima facie* evidence, I have serious doubts about the empirical validity of the balance-of-payments pessimism.

For one thing, the portfolio investment figure give no indication as to what would have happened to the outflow of direct investment capital from the United States in the absence of Euro-bond financing. It is quite possible that this outflow would have been bigger than the actual figures. Many of the investment projects financed currently may have been decided years ago. And one just cannot see how the U.S. Administration could have stopped this outflow if such prohibition had entailed the impossibility of carrying out capital expenditure which were essential for maintaining or improving the profitability of existing investment.

But I have another objection, too. The reasoning set out above assumes implicitly that the widening of the Euro-bond market has not attracted funds into the market which would not have been steered, all other things being equal, towards bond or equity investment in the U.S. The substitution argument is valid only if there has been no such net additional inflow into dollar bonds as a result of a larger Euro-bond market. In fact, I believe, there has been such an inflow; and I even believe that this inflow has increased over time. I can produce no statistical evidence to support this thesis but I derive it from my own professional experience. The substitution argument was probably valid so long as Euro-bonds were placed exclusively with insurance companies covering dollar risks, pension trust funds of international corporations, or the sophisticated wealthy private individual keeping an account in Switzerland. But as I have suggested above, this is no longer the only outlet [in some cases perhaps not even the largest outlet] for Euro-bonds. A number of European banks have made a considerable effort to attract investors in this market who otherwise would not have been interested in buying U.S. securities or at least not in amounts comparable with what they are buying now.

If I am right in this, the extension of the Euro-bond market could hardly have had an adverse effect on the U.S. balance of payments. All one can say is that its positive effects might have been smaller – or perhaps even much smaller? – than suggested by the mere superficial evidence of the shift from New York to Europe of bond flotation.

## Financial Techniques

The main problem I would like to raise under this heading is the relationship between underwriting [including managing underwriting] and the placing of bond issues in the European market. The point to be made is this: for a number of reasons – historical to a large extent –, this relationship has developed in a way which possesses neither the strength of the American-British type of relation between [domestic] underwriting and placing, nor the advantages of the Continental link between these two essential functions of bond issues.

The American [or British] pattern is based on the institutional character of placing. It is well known that since the late forties, American and British

households have not been net purchasers of securities; in fact, since a number of years, they have been net sellers. Issues of both equities and bonds are taken up to a very large extent by institutional investors, insurance companies, pensions funds, mutual funds. This, incidentally, explains the relatively low cost of issuing securities.

On the Continent, on the other hand, institutional demand for securities, even in the domestic markets, has remained relatively weak and the greater part of the primary issues is taken up directly by the household sector. The placing is performed by the deposit banks through their thousands of local branches. The fact that wholesale and retail sales coincide explains the seemingly higher direct costs for the issuer. This, of course, is only superficially so, for while Continental placings provide a direct link between issuers and the savings of the household sector, the U.S.-British type of placings go only half-way: to get the total social cost, one would have to include the costs involved in the second step, i.e. in the financial link between the institutional investors and households. And these latter are by no means negligible.

The interesting point is that, in both domestic systems, there is a close link between underwriting and placing. Whenever a Belgian, or French or German bank underwrites a domestic issue, it will ensure that the bonds [or stocks] are sold directly through its branches to its private customers and/or to its institutional clients. It is not customary to underwrite more than one directly places; and it is worth noting that underwriting in these domestic issues comes in most cases near to the concept of “managing” underwriting [as opposed to sub-underwriting] in the European issues. Hence the bank – or banks – form a direct link between the borrower and the final purchaser of bonds and perform simultaneously management, underwriting and selling, even though there might be separate commissions for each of these functions. Although the final purchasers are institutions rather than private households, there seems also to be a quite close link between management, underwriting and selling in the United States or in Britain. Investment or merchant banks have a number of “privileged” institutional or private customers and, whenever they handle an issue, they can make certain that a substantial part of it is sold to these customers. In this case, the link between underwriting and placing is not so strong as it is on the Continent, but it is still much stronger than in the Euro-bond market.

In the vast majority of Euro-bond issues, managing underwriters place only a small proportion of the total issue with their own “privileged” customers. The bonds are taken up by the selling group, which includes nowadays fifty to two hundred banks or brokers all over Europe. The much larger part of the issue is, in fact, sold to the customers of these banks rather than to those of the managing underwriters.

The reasons for adopting such a procedure are obvious. On the one hand, neither the American nor the British managers can actually sell in their home market, and while they do have institutional customers abroad, or even quite a few private customers, the size of these is in most cases inadequate to ensure the direct purchase of any sizeable proportion of the bond issues, German and Swiss banks are in a much stronger placing position, that of the Italian banks varies considerably over time and French and Belgian banks have also developed a substantial placing capacity with their own “privileged” customers. But even Continental managers of Euro-bond issues are at present unable to conform to the pattern of underwriting-placing relation which they follow in their own domestic market.

The result is that, for all practical purposes, the managing underwriter is cut off from the final purchaser of bonds by the interposition of one or, in most cases, several other banks. While he can use his past experience to assess the “proper” placing capacity of these latter, his judgement on the quality of the placement is bound to be based on guesses rather than on first-hand knowledge, if only because placing capacity is apt to change over time. On the other hand, members of the selling group can never be certain to be able to satisfy the demand of their own customers, and this leads both to ridiculously inflated demands for selling and at the same time to a lack of stimulus to develop systematically their placing power.

I consider this two-way uncertainty as the basic weakness of the Euro-bond market. So long as it persists, managing underwriters will always be in a difficult position to advise their customers about the optimum timing of bond flotations and to ensure that the quality of the placement will be up to the standards they usually promise to respect. Members of the selling group will also be in an awkward position to satisfy even the most genuine [and most “final”] demand for bonds coming from their own clientele.

The only way to diminish this uncertainty is to establish the closest possible link between management and “final” placing. Unfortunately, both competitive forces and the great spread of bond sales make a development in this direction difficult. It is regrettable that the experience of the last two months has shown a trend in precisely the opposite direction.

## Politics

The flood of U.S. convertible issues since the beginning of this year has raised two basically political [or at least policy] issues. One springs from the obvious fact that U.S. issuers have literally squeezed out of the market all, or almost all, other potential borrowers. The other stems from the feeling [rather from a fact] that the high degree of concentration of one type of issues within a very short period has resulted in an indigestion which could have been avoided, had we been operating in a more orderly way. Both issues point to the conclusion that the high degree of freedom enjoyed by banks in the Euro-bond markets has not only advantages. This conclusion is drawn in some circles on the Continent and I think banks must attach some weight to it.

I hasten to add that the political reaction is in fact much milder than one could have expected, but the reason for this is not particularly meritorious. Those who have suffered from U.S. issues are potential borrowers from smaller countries, outside the Common Market or even outside Europe, and most of these countries are not in a position to voice protest. On the other hand, all Common Market countries are relatively liquid at present, with interest rates not higher [and in most cases lower] than on the Euro-bond market. Even though this is the result of deliberate policies, the practical conclusion is that I know of no major Common Market borrower who could claim to have been put into a difficult position by the sudden rise in U.S. issues. In fact, from the point of view of the domestic markets within the E.E.C., and hence also from that of the potential Common Market borrowers in the Euro-bond market, these issues have gone almost unnoticed.

However, this need not remain always so and a time might come when powerful interest groups add their protests to the rather theoretical questions raised today by politicians or newspapers.

One could, of course, reply by insisting on the virtues of free competition. The high degree of freedom in this market has produced in a relatively short time an accumulation of know-how, financial techniques and speedy operations which can rarely be found in domestic markets, and this has been achieved despite the diversity of laws, regulations, customs and habits. In addition to this, it produced highly standardized and relatively low costs, again, despite difficult placing conditions. It is doubtful that any of these results could have been achieved in a climate of control, or even supervision.

One may add that the international flow of capital brought about by market operations has by and large been in conformity with the relative scarcity of funds in various countries and the objective of balancing international payments. Finland, the Scandinavian countries, Austria, Spain, Portugal, Mexico have been able to import substantial amounts of capital, while Germany, Belgium, Switzerland and more recently Italy have been exporting funds. It is only the most recent experience which has raised doubts about the ability of the market to create optimum capital flows.

Last but not least, we can point out that a free market of this kind is apt to provide us with information which can be valuable as information, even though some of us may not like it. Thus the last few weeks revealed that while many Europeans disliked dollar assets in December, they were ready to buy several hundred millions worth of them in January and February, with the incentive of some equity element attached to them. This is worth knowing.

While all this can, and should, be repeated, we must also bear in mind that the sheer quantitative development of the market – witness the figures quoted above – imposes obligations upon all institutions which would have been meaningless only a couple of years ago. There are no developed countries in the world where authorities do not exercise some sort of supervision on capital market operations. And there are quite a few large countries – especially in Continental Europe – where the regulation of the flow of funds is part and parcel of government policy. It would be unrealistic to expect that the very same governments which maintain a fairly tight control or at least a strong supervision of capital market operations in their domestic markets would tolerate, in the long run, the existence of a large entirely free, international market – especially in an era of free international

capital transactions, involving a high degree of interaction between the two markets.

Of course, no direct government interference should be forthcoming so long as the national interests of the large Continental countries are not at stake. But should these national interests be in danger, or – more precisely – should governments consider that such danger exists, policy measures might well follow. And the likelihood is not at all that an international supervisory body would be erected. Such authority is most unlikely to be created in the present state of political disintegration and conflicting policy objectives. Short of international [or supra-national] supervision, the only practical measures could then consist in the re-establishment of exchange controls, or of administrative controls of capital movements. This would annihilate years of progress achieved since the late fifties and undermine the very foundations on which the operations of the Euro-bond market are based.

To avoid this, banks ought to give serious consideration to measures of co-operation and self-imposed discipline.



## Chapter VI

# Towards a European Monetary Order?

1968

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*At the Sixth International Conference of the European League for Economic Cooperation, Brussels, 25-26 October 1968, Lamfalussy gave a presentation on the theme: “Vers un ordre monétaire européen?”. He argued for a “widening” of monetary cooperation to all financial operations, advocating the development of “genuine European financial markets”. Reprinted with kind permission of the European League for Economic Cooperation and the Lamfalussy family. Translated by the NBB.*

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## Introduction

This note has been written with a view to triggering a debate on the principles and arrangements for monetary cooperation in Europe. It puts forward a thesis – or theses – rather than a synthesis: experience with conferences suggests that this is the best way of achieving the desired goal.

First, to definite the scope of the topic. It is not about general international monetary cooperation problems, and even less about – more specifically – international liquidity. Of course, it stands to reason that a common monetary policy between European countries and especially the creation of common monetary institutions would influence international monetary organisation. However, this influence is beyond the scope of our investigation. Monetary cooperation between European nations is a sufficiently wide subject to justify being singled out for attention.

This caveat aside, I nevertheless propose to give as wide as possible a meaning to the notion of monetary cooperation.

The “classic” tradition is restrictive, although it does have two dimensions. First of all, it refers to monetary policy as essentially any economic policy act affecting changes in the monetary stock (with this also being defined in the strict sense of the term as the total means of payment in circulation) or, in the same way, the interest rate. To put it simply, in this conception, it is a question of coordination of policies pursued by the European central banks, with this coordination being likely to lead, in the final stage, to the creation of a single European central bank or at least a European federal system. Coordination would thus cover discount policy, mandatory reserve policy, open market policy (insofar as it actually exists), and possibly even more direct intervention in commercial banks lending, with the objective being, in any event, to influence monetary stock formation and interest rate movements.

Monetary cooperation, even in the narrow sense of the term, has a second dimension to it: that covering aid and assistance between countries in the event of balance of payments imbalances. Even with the assumption of perfect coordination of the aforementioned policies, the balance of payments can effectively move out of balance. Policy coordination is not the same as identity of policies: it can deliberately set itself the goal of differentiating between policies, which could have the consequence of creating or maintaining an external imbalance. Alternatively, even though the objective of policy coordination is to remove the imbalance, this generally tends to take time. Hence the need to help the deficit country, especially if its reserves are inadequate.

For reasons that are set out below and which constitute the very basis for the argument put forward in this note, I do not think it is possible to accept this rather restrictive conventional definition of monetary cooperation. I prefer to widen it to encompass the whole range of cooperation in the field of financial policy, the word “financial” being used here to describe the activity of all financial intermediaries (including the monetary organisations – central bank and banks – as well as all financial transactions made between non-financial economic agents (private individuals’ investment in State bonds, for example). Here, we are talking about coordination of all the activities described by the financial transaction tables in the national accounts.

## Taking Stock

So, where do we stand, in Europe, in 1968, on the monetary and financial cooperation front? Very briefly, this is how I see the situation.

### *A. The institutional framework*

1. The Western European countries are members of the International Monetary Fund system, which implies acceptance of fixed exchange rates, setting national currencies in terms of gold or dollars and the possibility of seeking assistance from the Fund in certain cases.
2. The majority of our countries have also accepted, since 1958, “external” convertibility of their currencies, that is, the right, for non-residents, to convert their assets denominated in each of the currencies in question into other currencies, including the dollar.
3. As for full convertibility – which applies to a country’s nationals as well –, this is only a *fait accompli* in a small number of cases, like for the Common Market and Switzerland. It must be stressed once again that this convertibility is not even entirely “full” in most of these countries. For example, certain exchange rate transactions, in Belgium, have to go through the “free” market where rates fluctuate freely (at least in principle). The result is that the freedom to make these transactions can be quite a lot more expensive: several percentage points above the official exchange rate. Another example: while exchange controls have been abolished in France, this does not mean that all transactions have been liberalised: and this is the case for direct investment by foreigners in France.
4. However, the possibility of converting assets from one currency into another does not in any way imply a concomittant freedom, for an institution or a private individual from a given country, to effect financial transactions in another country. The restrictions in this domain are many and varied; they defy any classification. More often than not they are fiscal or regulatory in nature; they tend to affect institutions more than private individuals, loan operations more than securities transactions. Their impact on actual capital flows is considerable. Suffice it to recall at this stage that the existence of these

restrictions is not incompatible with the absence of exchange controls in the strict meaning of the term.

So, let's briefly sum up this basic description of the institutional framework: fixed exchange rates, de facto primacy of the dollar as the channel or reference currency for settling foreign exchange transactions, near-general external convertibility, full convertibility limited to a small number of countries, persistence of a wide range of fiscal or administrative constraints.

### *B. The cooperation authorities*

1. Within the E.E.C., the main authority for cooperation, established by the Treaty of Rome, is the Monetary Committee. This was backed up, in 1964, by the Committee of Central Bank Governors whose more specific task is to encourage collaboration between issuing institutions. Lastly, a Budgetary Policy Committee was set up at the same time and is striving to create one of the basic conditions for the harmonisation of monetary systems in the Community by pooling Member States' fiscal policies.

These bodies play a key role in the prior consultation mechanism set up in 1964. On the one hand, provision has been made for consultations between Member States before any adjustment of exchange rates. On the other hand, the same system of consultation has been set up for international monetary relations, with a view to developing a joint attitude between member countries of the Community.

2. On the wider European level, monetary cooperation is being worked out, between central banks, at the Basel meetings. Moreover, a great many contacts and consultations are taking place through the appropriate bodies of the European Monetary Agreement and the O.E.C.D.

### *C. Facts and feats of cooperation*

Having never been involved in the work of any of these cooperation bodies, it is obviously impossible for me to make any informed "internal" judgement on how effective they are. One can nevertheless argue that it is only the results that count; and that, consequently, monetary cooperation must be judged by its achievements rather than by its internal workings.

This judgement, will of course depend on the criteria used. It nevertheless seems that it would be hard to present criteria that would not produce a positive opinion.

First of all, the European countries' economic growth has proceeded at a rapid pace since the end of World War II. It is virtually impossible to find such a long period of rapid, balanced and well-distributed growth (more than twenty years!) in modern history. For its high growth rate is not the only feature of Europe's development. It has also been remarkably consistent and all European countries have benefited from it. The fruits of growth have been fairly distributed: one can even say that it has contributed to levelling out living standards across Europe to some extent, by speeding up the development of the less rich countries (Italy) and slowing down, in relative terms, that of countries with a high standard of living (United Kingdom, Belgium, Sweden, Switzerland). Even though there are some exceptions to this general rule, Europe's economic history is nevertheless exempt from the charge that can be applied to global development, namely, the growing inequality between the rich and poor.

Second important factor: steady growth, that is, the absence of violent cyclical fluctuations. It is so true that we have got used to talking about recession as soon as the economy's growth rate dips. A mere slowing of development and, a fortiori, stagnation of gross national product automatically trigger economic stimulus policies in each of our countries. You can count on your hands the number of years since the end of World War II where there has been a decline, even marginal, in the main European countries' level of economic activity. Even quarterly periods are rare.

Third observation: full employment of resources, and labour in particular. The so-called "structural" unemployment in Germany and Italy, which was deemed to be virtually entrenched in the aftermath of the war, has disappeared and, in the absence of any strong cyclical fluctuations, cyclical unemployment has dropped to a low level. Certainly, there are some regional problems, just as there are problems with certain categories of workers failing to adjust to a changing vocational environment; but there is no comparison between these problems and those born out of the heavy unemployment of the inter-war period.

These observations may seem rather banal. They nevertheless need to be made in order to put things in an appropriate historical context and comment on the soundness and effectiveness of post-war economic policies. One only has to re-read the economic literature – both that produced by the professional economists and the writings of economic practitioners! – from the years 1944-1947 to realise the importance of the facts cited. The overriding concern of the time was to avoid widespread depression in the Western world, something that was regarded as probable or at least possible when hostilities ceased and the war effort came to an end. What country would still accept nowadays Lord Beveridge's 3% unemployment as a criterion of full employment?

This rapid, widespread and regular growth came at the same time as a gradual liberalisation of all kinds of trade. Liberalisation began in the area of goods trade: enough is known about its stages and the advanced levels that have now been reached to require any further comment. One only has to remember that the European countries' exports (or imports), in all directions, practically doubled in the space of eight years, between 1959 and 1967. At the same time, albeit with a few stop-starts and exceptions, a very high degree of liberalisation has been achieved for movements of services and capital. Whether this deregulation played a causal role in the growth phenomenon described earlier (which is probably partly true) or whether it is regarded as an objective worth pursuing for its own sake, their very existence is a tribute to the policies of coordination.

Of course, the achievements are not entirely positive. Among the negative elements, there is, firstly the more or less constant erosion of the currency's purchasing power. With the exception of a few short periods of virtual stability, the cost of living index has risen continuously throughout the post-war period in practically all European countries. Even in countries that have been the most resistant to rising prices (Switzerland, Belgium, Germany, and even Italy in certain periods), annual increases in the region of 2% are considered as quite normal. It is obviously regrettable that none of our countries have managed to stem the currency's loss of purchasing power but it does seem fair to me to pin the responsibility for this failure on the ineffectiveness of monetary policy and even less so on ineffective monetary policy coordination. It is a lot more reasonable to assume that the increase in prices is the inevitable consequence of pursuing a certain *type* of growth: the sort that does not tolerate any respite in the maximum utilisation of production capacities in terms of manpower

and tools, which does not allow a long enough cyclical *détente* and which thus starts a constant inflationary process. Monetary policy is not to blame for this. Responsibility lies in the political choice of an objective which, while desirable in itself, can only be achieved along with certain negative consequences.

A second liability (related to the first one as well) has been the adjustment of certain exchange rates. Even if we take recent European history as starting after the 1949 devaluations, we still have the French devaluations in 1957 and 1958, the revaluations of the German Mark and the Dutch Guilder in 1963 and the devaluation of the Pound Sterling (and certain other currencies) in 1967.

At the risk of laying myself open to the accusation of being a heretic, I do not consider these facts to be a demonstration of the failure of our coordination policies. In the first place, because monetary cooperation has recorded a number of undeniable achievements in this very same area. The most striking case is Italy which was able to overcome an extremely serious crisis in 1964 thanks to a radical and courageous internal policy and with external assistance. More recently, with the agreement and backing of its European partners, France, has followed a policy that seems to be highly successful (at least at the beginning of September 1968). And finally, it is worth remembering that the devaluation of the Pound in 1967 was preceded by several major crises that were all resolved thanks to international support.

Secondly, it could be argued that maintaining *set*<sup>1</sup> exchange rates is hardly a reasonable economic policy objective. In a world where the need for price changes is barely contested, it is hard to see any reason for accepting that this price – that the exchange rate constitutes – should remain irrevocably fixed. Besides, we know from the most elementary levels of thinking (just like the manuals at the same level) that simultaneous pursuit of three objectives (full employment, free trade and set exchange rates) is extremely difficult. It would take a series of exceptional circumstances for them to be achieved at the same time. But it is quite permissible to express the view (which of course implies a value judgement) that, in the event of any conflict between these three objectives, it is better to abandon the last one.

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<sup>1</sup> The term “figé” (set) is used here as opposed to the word “fixed”.

If this opinion is accepted, the adjustment of an exchange rate does not necessarily imply the failure of monetary cooperation. This is supposed to give a deficit country means of defence, insofar as this country has reasonable chance of restoring its balance of payments to equilibrium, without however jeopardising, in the long term, efforts to achieve other economic policy objectives. If we were to observe that restoring external equilibrium would involve a break in growth, persistent unemployment or the introduction of permanent controls, genuine monetary policy coordination would, in my view, command a devaluation (possible accompanied by external assistance) rather than sticking to the wrong parity and having to resort to repeated external aid. Likewise, I really do not see on what principle a country could be required to follow a domestic expansionary policy, in the event of a constant balance of payments surplus, if its resources are already fully utilised. In this case, a revaluation is perfectly compatible with the European monetary order.

So, these are the reasons why the track record of European monetary cooperation seems generally positive to me. Of course, it is not possible to demonstrate that the exceptional success in terms of growth and trade liberalisation is attributable to a policy of monetary cooperation. But it would not be rash to say that this cooperation has created a framework for the functioning of the European economy which, along with the contribution of other factors and especially a good measure of luck<sup>1</sup>, has enabled West European countries to achieve an exceptional economic performance since 1948.

Before concluding, this optimistic argument nevertheless needs qualifying or rather an important nuance should be added. This concerns the *geographical area* covering this cooperation effort. This area can hardly qualify as being European; by no means can it be reduced to the six countries of the Common Market. Those that take part in the E.E.C.'s cooperation bodies will probably tell us that there are numerous effective policy coordination measures within the Common Market. For an outside observer, this is not self-evident. On the contrary, great acts of cooperation can be seen coming from the United States (Italy, 1964) or initiated in Basel meetings (the various efforts to rescue the Pound Sterling). Is this the inevitable consequence of the current organisation of our international monetary

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<sup>1</sup> This piece of luck lies in the almost permanent cyclical lags between the main European countries, which has been good not only for growth but also from the point of view of balance of payments equilibrium.



system, based as it is on the gold standard and the *de facto* primacy of the dollar? Or should it be attributed to the Common Market's lack of internal cohesion? All these are questions that could make for useful debate at the Conference.

## Orientations

In which direction would it be desirable – or even possible – to develop monetary cooperation in Europe?

Two broad orientations can be envisaged, it seems. By their very nature, they are not an alternative; in principle, they could be followed simultaneously, because they complement one another. However, for political reasons, a choice will have to be made and priority given to one or the other.

- A. The first, strictly “monetarist”, option would put the emphasis on the deepening and institutionalisation of cooperation between central banks. Its outcome would be, whether implicitly or explicitly, the establishment of a common currency and a common central bank. As intermediate stages, it would involve a commitment by the countries concerned to no longer adjust exchange rates, the establishment of a “pool” of gold and foreign exchange reserves, the creation of a European “federal” reserve system.
- B. The second option would put the accent on *widening* monetary cooperation, by extending the consultation and harmonisation measures already accepted in the strictly monetary field to all financial operations. This second option would set a dual ultimate objective:
  - The removal of all fiscal distortions, all regulatory impediments that constitute an obstacle to the completion of a genuine European financial market, a term covering both the money market and the longer-term capital market, as well as the full range of operations of all financial intermediaries.
  - Full cooperation, definitive harmonisation of all policies or measures undertaken by the countries concerned on the financial market here defined.

This approach does not involve setting up a common currency. It can be followed by countries maintaining their monetary sovereignty but, in a way, it goes

much further, by covering an infinitely larger area than that of strict monetary cooperation.

If one of these options has to have priority over another, my preference definitely goes to the second one.

One of the first reasons is related to the political situation in Europe. Because of this situation, the first option hardly seems feasible. Rightly or wrongly – and, to some extent, wrongly rather than rightly –, the domestic currency and full autonomy of the central bank are considered as the most tangible signs of national sovereignty. An exceptional dose of optimism would be needed to believe that European States today would be prepared to give it up, when they were not in the least bit inclined to do so a few years ago, at a time when nationalism was a lot less active than it is now. In other words, there is very little chance of relations between central banks being able to go any further, in the coming years, than the present stage of cooperation based in the Committee of Central Bank Governors and Basel meetings. That is all the more so given that the results achieved in Basel may rightly seem, at least in the eyes of the stakeholders, to be quite substantial<sup>1</sup>. Why go any further and risk offending nationalist sensitivities?

A second reason, also negative, stems from quite different considerations. The main argument in favour of a common currency – apart from the insistence on its role as a symbol of European unity – is that the disappearance of national currencies and central banks would also sound the death knell for discordant and autonomous national policies. Deprived of its own currency and issuing institution, a national government's margin of manoeuvre would become very small.

This argument is a lot less convincing than it first seemed. It very clearly overestimates the contribution that a common currency would be likely to make to the progress towards economic policy cohesion, for two reasons.

On the one hand, because the existing constraints already substantially limit the autonomy of national policies. A government that commits itself to maintaining the exchange rate of its national currency (and what government has not made such a commitment, even if it has to cave in at the last moment) and has

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<sup>1</sup> These lines were written on 9 September, after the new measures to help the United Kingdom were announced.

liberalised its external trade in goods, services and capital has quite clearly given up its freedom of action: effectively, any discrepancy in its economic situation and its economic policy is automatically and extremely rapidly reflected in its balance of payments. Yet, the high degree of liberalisation makes the balance of payments of virtually all European countries highly vulnerable. Even in the absence of complete free movement of capital, fluctuations in the trade alone are liable to trigger (via the “leads and lags” channel) violent changes in reserve levels. That boils down to saying that European governments’ freedom of action is already fundamentally curtailed. The unification of currencies consecrate and consolidate this state of affairs (which would obviously be an important step); it would not bring the additional constraint of new coinage.

On the other hand, while sanctioning the loss of governments’ autonomy in short-term economic policy matters, it would not add any decisive element to the process of unification of financial markets. This process is held back by fiscal, regulatory and administrative rigidities far more than by the lack of a common currency. For a long time, we would have thought quite the opposite and, having shared this view myself until a few years ago, I would not hesitate now to express a revised opinion in the light of the financial trends seen over these last few years.

The inhibiting factor of the multiplicity of currencies was attributed to the refusal by companies, political bodies or private individuals to lend (or take out a loan) in a currency other than their own. Yet, what have we seen since 1963-64? Excessively rapid growth of transactions above all in dollars, often in German marks or Swiss Francs, but almost always in a currency other than that of the lender or the borrower. As long as they are transactions on the (short-term) euro-currency market, it was still conceivable that the exchange rate risk was zero or minimal (for financial intermediaries at least). Since the spectacular increase in Euro-bond issues and the equally impressive expansion of private investment, it has become quite clear that neither borrowers, nor lenders, nor even some financial intermediaries are covered for exchange rate risk. This – well-assessed – risk does not seem to frighten them any more than other risks (like, for instance, the loss of their own currency’s purchasing power) and they may well be right. In any case, the facts speak for themselves: by the end of 1968, total Euro-bond issues (comprising private investments and medium- and long-term loans granted by banks in foreign currency) will probably have reached the five-billion-dollar mark.

The surprisingly rapid expansion of these transactions is due to a multiplicity of causes, but some of them have played a decisive role. One reason is that euro-markets financing has developed outside domestic markets, in a way on a “parallel” market, that is not subject to the multiple fiscal constraints and different sets of national regulations. If company X in country A wants to invest privately in country B, current experience suggests it may be advisable to set up a subsidiary company in country C and make the loan in country D’s currency. In a good many cases, this makes it possible to get round the administrative barriers, while accepting, at several different stages, foreign exchange risks.

This conference is not the place for making normative judgements, or indeed any judgement at all, positive or negative, on these transactions. Their very existence, their nature, and their scale nevertheless point to one conclusion: the exchange rate risk should not be over-estimated as an obstacle on the road to unification of financial markets; while the role of fiscal, regulatory, administrative constraints should not be under-estimated.

So, to sum up, that is the argument defended in this note, as announced in the Introduction. If monetary policy is defined as an instrument for controlling the short-term economic cycle and if monetary cooperation is taken to mean both coordination of cycles and mutual assistance, we can be satisfied enough with the results obtained in this area so that we do not have to focus, as a priority, on establishing closer and more permanent ties between central banks. Instead, it would be better to concentrate efforts on widening the scope of monetary and financial policy coordination, with a view to promoting the development of genuine European financial markets. This would affirm the validity of a dual consideration: on the one hand, the overriding importance of coordination of domestic policies for financing European growth; on the other hand, the deep interdependence of financial mechanisms that make monetary management just one part of a country’s financial policy. This second consideration is in line with recent experience in the field of monetary policy and the development of modern economic thinking.

## Chapter VII

# The Role of Monetary Gold over the Next Ten Years

1969

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*On 28 September 1969, as a 40-year-old commercial banker, Alexandre Lamfalussy was invited to give the Per Jacobsson Lecture, established in honour of the late Managing Director of the International Monetary Fund. Following Lamfalussy's presentation, comments were presented by Wilfrid Baumgartner, former Minister of Finance and former Governor of the Banque de France, Governor Guido Carli of the Banca d'Italia, and Governor L. K. Jha of the Reserve Bank of India. Lamfalussy's lecture was based on a longer essay on "The Role of Monetary Gold Over the Next Ten Years". In the paper, Lamfalussy comes to the conclusion that greater flexibility of exchange rates cannot be avoided. Reproduced here is the text of his lecture in Washington. Reprinted with kind permission of the Per Jacobsson Foundation and the Lamfalussy family.*

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I would like first to sum up very shortly the thesis which I developed in my paper and then to restate it; because, despite some recent developments, I have not changed my views; yet I think it might be worthwhile to reformulate the various points I developed in a slightly different way and then perhaps to spell out a certain number of policy conclusions by being more explicit than I was in my paper.

I started off by observing recent trends in monetary history and I have come to the conclusion that we have been moving towards a gradual demonetization of gold. Why this conclusion? We can observe that gold has not contributed to the growth of international liquidity any longer since about ten years. We have watched the establishment and the functioning of the dual gold market.

We have seen, moreover, that the gold price on the “free market” did not rise to a level which had been expected by many people and that, after having reached a maximum of about 45 dollars, it has in fact tended to decline over the last few months. Finally, we are now approaching the creation of SDRs which is also, in a certain way, a further step towards the demonetization of gold.

The question which I then raised in my paper was whether this was likely to continue, for I think that the facts which I have just mentioned can hardly be questioned. My answer was very explicitly no: we will not make further progress on the road towards demonetization until we succeed in improving, and very substantially improving, the adjustment mechanism and, at the same time, in creating in an orderly way an adequate amount of new international liquidity.

Now on both these points, but especially on the first one – on the adjustment mechanism –, I was and still am rather pessimistic. I do not think that the adjustment mechanism, as it has been working over the last five or ten years, has improved. On the contrary, I think it is becoming less and less effective. I quoted a certain number of facts to that effect in my paper. The reasons I saw were basically of three kinds:

- One, the necessity to maintain the domestic responsibilities of governments in a changing institutional framework.
- Second, the doubts about the gradual adjustment in the current account through relative changes in unit costs.
- And third, the growing importance of capital flows and their interconnection with flows in trade and services.

As regards the second condition, I have pointed out a certain number of signs of a shortage of international liquidity. I know this is not a very fashionable view, but I tried to support it by quoting two series of facts: First, the spreading of controls all over the world, especially controls on capital flows, which certainly can be regarded as a sign of shortage of international liquidity. Second, the war of escalation in interest rates. I do not doubt that the increases in interest rates have been motivated to some extent and in some cases by purely domestic considerations – the fight against the overheating of the economy – but I simply cannot believe that the rise in interest rates would have been of the

size and of the speed which actually occurred had it not been for balance-of-payments considerations or, more exactly, because of the governments wanting to preserve their foreign exchange reserves. This, I think, is a clear indication of an insufficiency of international liquidity.

The upshot of all this is that unless we get a fundamental improvement on both these counts, we will not move towards a gradual and orderly demonetization of gold but much more towards more controls, or towards the dollar standard, or probably towards both at the same time. I suggested some good or bad reasons which made me dislike both of these alternatives and especially their simultaneous occurrence. This led me, quite logically I believe, to the suggestion that the only way out is to improve the flexibility of exchange rates.

May I perhaps now restate this thesis in a slightly different way? When I re-read my own paper after three months, I asked myself the question which probably many of you are tempted to ask: if our present monetary system is so deficient, how could it function so well for the last twenty-five years? For there is little doubt that the system has been quite successful. Economic growth has rarely been so strong, so sustained, and so regular as over the last twenty-five years. We have had a tremendous expansion in international trade, and this continues. And we do have – even after the reimposition of certain controls – a fair degree of freedom in international capital transactions. So, by all three of these criteria, the system proved to be successful.

Nevertheless, I am ready to argue that some very fundamental changes have taken place in the world economy which create entirely new conditions. Hence, the fact that our present system has worked well until recently does not imply that it will work well in the future.

Which are these changes? I try to sum them up without attaching any importance to the order in which I will mention them.

The first of these changes is the very substantial increase in domestic liquidity, first of all in the sheer actual volume of domestic liquid assets. You can take any of the developed countries over the last ten or fifteen years and you can see that the total amount of domestic liquidity as expressed in national currency has been multiplied by two, three, four, five, depending on the definition that you use. This is due partly to the stock of money and partly to the stock of quasi-money

and of other semi-liquid financial assets. But, in addition to the sheer quantitative expansion of liquidity, you must take into account the qualitative changes within domestic financial organizations: the increased intermediation which creates greater flexibility and hence a greater degree of liquidity within the economy. I think this is something absolutely fundamental if you compare today's position with what existed twenty or twenty-five years ago.

A second equally important point is the liberalization of capital movements. When the present system was created, the liberalization of capital movements was considered as a very, very distant objective, the main objective being the liberalization of trade. Since 1958, we have acquired a fair degree of freedom in capital transactions. This freedom has now been curtailed to some extent but it still exists and it does exist in some new form through the Euro-currency market.

The third point which is worth mentioning is the speed and the spread of financial information. With the development of a new type of journalism, with the speed of information in general, we have reached a sort of financial integration through radio, telex and television which was absolutely unheard of a few years ago. I remember watching television over the last few months, and the kind of financial information they give bears no comparison with what existed twenty years ago.

The fourth major change which I would like to point out is the growing interpenetration of the Western economies. This applies quite obviously, of course, and I hardly need to mention it, to trade flows, but it also applies to direct investment through the substantial development of the multi-national corporations and, last but not least, to tourist trade. Millions of people traveling from one country to another, knowing the price structure of each of the countries, comparing the national standards of living – all of these factors really have created a degree of interpenetration of the Western world which was totally nonexistent twenty years ago.

Now consider all these facts at the same time: growth of domestic liquidity, hence the growth of the funds which can be shifted quickly from one country to another in case of capital movements; second, the freedom to do so directly or indirectly through the Euro-dollar market; third, the degree of information on whether this happens and through which channels; and fourth, the degree of interpenetration



of our economies. You come obviously to the conclusion that we have much greater potential and real capital movements than a number of years ago. Hence I think that the old philosophy of balance-of-payments adjustment alone or principally through trade adjustment is really something which is entirely out of date and has nothing to do with current economic conditions. I also think that an institutional framework which built primarily on a sort of “current account philosophy” is also out of date.

This is one set of facts which explain why the problem did not exist ten, fifteen or twenty years ago and why it has grown gradually into the situation which we experience today.

There are, however, a second series of facts which we have to take into account: we have been moving away from the synchronization of economic trends in a number of countries, especially within Continental Europe. When you look today at the European economies, you find that national trends become stronger and stronger and the sort of harmonization of economic development which we did have between 1959 and 1963-64 has absolutely vanished. We have special problems in France, we have special problems in Italy, we have special problems in Germany, in Belgium. You cannot point out one single country which is moving really in unison with the others.

Should one regard this as a consequence of the lack of coordination of economic policies? To this very important question, my answer would be rather dubitative. It may be that we did not manage our economies well enough or that we did not succeed in coordinating economic policies in an efficient way; but my suspicion is rather that we are in the presence of strong political and social trends in each of our countries, which go against the growing internationalization of the economy. I suggest that a large part of our problems have been brought about by this divorce between the fundamental interpenetration of our economies and the persistence and strengthening of social and political trends in individual countries. I do not know whether these trends are something fundamental, or whether they are purely accidental or whether they are due to sheer bad luck. Whatever their nature or causes, one cannot doubt their existence. This is why I believe so strongly that, in order to reconcile these two fundamental trends, both of which are facts of life, we have to find some sort of compromise, and I cannot see any other compromise than a greater flexibility in exchange rates.

But what kind of flexibility? I do not intend to answer this question fully because I do not know the answer. Nevertheless, I might perhaps spell out very shortly my own prejudices or policy preferences. In theory, I would have a preference for the IMF kind of flexibility, in other words, for fixed exchange rates with periodic adjustments in case of basic imbalance. If the countries which in fact incur basic imbalances decided to devalue or revalue when it was needed, I think the IMF system could function perfectly well. It did function in some instances, especially in the cases of smaller countries, but we have had at least two or three major cases over the last few years when devaluations did not take place or took place only too late, and we have at least one major case where a re-evaluation, at least until today, has not taken place. Hence the conclusion that, despite all the advantages of the IMF system, we may have to find something else, because the experience seems to suggest that the countries are unable or unwilling to make the system work. This is why we may have to fall back on some sort of second-best, perhaps on a widening of the band plus some sort of dynamic and crawling changes in the band itself. I think this is probably the direction we ought to take. This sounds fairly pessimistic, because the technical feasibility of such a system is still questionable, and yet I think that, by necessity, we will be driven to a solution of this kind.

However, I would not like to end my talk simply by being so acutely pessimistic. I think we have two reasons for being somewhat optimistic. The one is that all these problems are those of a growing society of a growing economy. These are not problems of a declining world. We tend to forget it sometimes, but this is a very important fact. Our problems are the result of conflicting trends: national independence and growing internationalization. Both these conflicts and their solution are part of the process of growth.

My second reason for hope is that we are beginning to understand the mechanics of international payments and that our own minds are also changing. The proof for this is the SDRs are on the verge of being accepted and that the idea of a greater flexibility of exchange rates meets an increasingly positive reception.

May I conclude by reading you a few sentences which I found in a preface written by John Maynard Keynes to his *Monetary Reform* in October 1923? I quote: "Nowhere do conservative notions consider themselves more in place than in currency, yet nowhere is the need of innovation more urgent. One is often

warned that a scientific treatment of currency questions is impossible because the banking world is intellectually incapable of understanding its own problems. If this is true, the order of society which they stand for will decay. But I do not believe it. If the new ideas now developing in many quarters are sound and right, I do not doubt that sooner or later they will prevail. Hence I dedicate this book humbly and without permission to the Governors of the Bank of England who now and for the future have a much more difficult task entrusted to them than in former days”.

I would like to paraphrase this and say that I dedicate this talk very humbly and entirely without permission to the Governors of the International Monetary Fund.

Part Two

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*At the Bank for  
International Settlements*

1976–1993



## Chapter VIII

# Will Improved Reporting Requirements Lead to a Safer Euromarket?

1976

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*In January 1976, Alexandre Lamfalussy joined the Bank for International Settlements as Economic Adviser and Head of the Monetary and Economic Department. The Euromarkets would become one of his main preoccupations. Lamfalussy was quick to warn about the Latin American debt build-up. In December 1976, he gave this presentation asking the question “Will Improved Reporting Requirements Lead to a Safer Euromarket?” at a conference in London on the theme “World Economic Expansion and the Euromarkets”. He focused closely on country risks arising from international bank lending. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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Let me begin by reminding you of the main financial problems raised by the sharp increase in the oil price in late 1973.

The gloomy forecasts made at that time have turned out to be excessive. This happened partly because the oil surplus was much smaller than forecast in 1974, and actually declined in 1975. The explanation lies in the recession which cut the demand for oil by the consumer countries and simultaneously prevented a new rise in the oil price. To some extent, of course, we have also had the surprise to see that the capacity to import was much bigger than expected in many oil producing nations.

But the gloomy forecasts proved wrong also for another reason: the financing of the international imbalance took place surprisingly smoothly. Some of the financing was done through the official channels, of which the most important

was the I.M.F. oil facility. To a very large extent, however, the financing took place through the intermediation of the international private banking system. In this latter case one has to make a distinction between two phases, of which the first was perhaps less unexpected than the second. In 1974 and until early 1975 banks lent on a large scale to the oil consuming industrial countries: you may remember the major borrowings by Italy, France, the United Kingdom. This was not totally unexpected because the banks considered the risks to be acceptable, although the speed with which the major financing schemes had been set up surprised most of the observers. Then came the second phase which started in 1975 and still continues now, and this consists in the extension of lending to lesser-developed oil consuming countries.

There is no doubt that the major role played by international bank lending in the recycling of the oil surplus was largely beneficial to the world economy. One shudders at the thought of what would have happened had the banks not performed this balance-of-payments financing function. It is quite clear to my mind that official organisations could not have lent the same amounts at the same speed. You remember perhaps the failure of the Common Market negotiation with some of the Arab surplus countries.

This is not to say, however, that the acceleration in international bank capital flows has not created problems. One problem is that the generation of international liquidity escapes the control of national or international monetary authorities. This is an important question, but it falls outside the subject of my talk. I will concentrate on the second question: the country risks arising out of international bank lending.

I suggest to deal first with the sources of information on the size of these risks. You may find a full description of the various statistical sources in the I.M.F. Survey of September 6, which describes them in detail and which sets out the degree of overlapping.

The first source of information is produced by the World Bank. It is called the Debtor Reporting System (D.R.S.). This is based on a reporting system by the debtor countries to the World Bank and includes data on the outstanding long-term public debt of the debtor countries. Public debt is defined either as a direct

debt by a public organisation or as one guaranteed by a public institution. It has, therefore, two limitations: it does not cover debt incurred by the private sector and it does not include short-term debt at all.

The second source is called the Capital Market System and this again is organised by the World Bank. The World Bank collects the figures on the publicised medium-term Euro-currency loans and on the publicised bond issues. These figures are published on a quarterly basis and then broken down according to the currency distribution, to debtor country and to lending institutions. These figures do not include private bond issues nor do they comprise bank lending which has received no publicity in tombstones. Moreover, the publicised figures relate to loan commitments with no mention of what is actually used up.

The third source of information is provided by the Development Assistance Committee of the O.E.C.D. These are very comprehensive data covering the complete flow of financial resources to individual developing countries. The D.A.C. tries to cover public and private debts and they draw on various sources of information, that is both on figures by the debtor countries as well as on those coming from creditors. The main problem here is that there are considerable delays in collecting this information; therefore, the last full figures are available only for the end of 1974.

The fourth set of statistics are produced by my own institution, the B.I.S. Being personally involved in the attempts made at trying to improve them, I would like to go into some details.

The B.I.S. started collecting these figures more than 10 years ago and the original interest was not in country risks. At that time the central banks were interested mainly in the general development of the Euro-currency market, in its mechanics and in its impact on international liquidity creation. It is only since a few years that the interest had shifted towards country risks and when it did so, it became clear that we had to extend our inquiry from the Euro-currency market narrowly defined to international bank lending in general. The result of this is that we now publish a full table giving the debts of individual countries to banks in the original reporting area plus the United States, Canada and Japan. The figures cover both foreign currency lending and lending in domestic currencies. They are collected



by the central banks from the commercial banking system and transmitted to the B.I.S. on a quarterly basis. We sum them up and publish them with a delay of about 3 to 4 months. Those relating to the end of June are just about to be published.

Now, what are the weaknesses of these figures? What is it that you cannot find in our statistics and that has prompted central banks as well as a number of commercial banks to try to improve the reporting system?

First I must stress the fact that we do not have a fully detailed country breakdown: if you look at our tables you will see that there are non-allocated items which can be quite substantial. This is simply due to the fact that in some of the countries banks do not supply the full details to the central banks.

The second weakness in our figures relates to the striking development of the offshore centres. You know, as practising bankers, that a growing volume of bank loans is channeled through these centres, of which the most striking examples are the Bahamas, the Cayman Islands, Panama, Hong Kong, Singapore and Bahrain. We have information on the lending coming out of these centres only for the branches of the US banks simply because only the Federal Reserve collects these data. They are incidentally published in the Federal Reserve Bulletin. But we have no information whatsoever on the loans booked by non-American banks in the offshore centres. All we know is that a growing number of non-American banks are setting up branches in these centres. Not only do we not know what the claims of these banks are on individual countries, but we do not know either what the deposits are. In order to get these figures we would have to include the monetary authorities of the offshore centres into our reporting system. This may be an effective way of handling the matter in some cases but not in some others, simply because some of these authorities do not collect the figures. A possible short cut could be the reporting of the head offices to their own central banks in the way the reporting is done to the Federal Reserve by the US banks.

The third weakness of our figures lies in the fact that they give only actual claims, but provide no information on unused credit commitments.

Last but not least, the B.I.S. data contain no maturity breakdown. The Bank of England collects these figures for the banks located in London, but no systematic

information is available for banks operating in other countries. This is a very serious weakness since it makes the assessment of a country risk quite shaky.

Finally I must remind you that the B.I.S. figures relate only to bank claims and therefore do not give a full picture of a country's indebtedness. They do not include inter-company loans, nor do they comprise loans by government agencies unless these latter happen to be banks. Therefore, in many cases long-term export credits are not included in our statistics.

I apologize for all these technical details, but they explain the growing dissatisfaction with the available information on country risks. Both the supervisory authorities and the commercial banks are anxious to get better and simpler figures and this is the reason why the central banks of the Group of Ten and Switzerland have decided to try to improve the B.I.S. figures. Work on this improvement is still in progress and many tricky problems are still to be settled. It has become clear, however, that we are aiming at improvement in three directions:

1) We will try to cover the lending figures in the offshore centres by obtaining information from the head offices of the commercial banks; 2) we will try to get a simple maturity breakdown of the claims; 3) we would like to have figures on unused credit commitments.

If everything goes well we will collect this additional information for the end of December 1976 to be available sometime during the spring of 1977. At the latest we will collect data for the end of March 1977 to be published by the early summer of next year. The process of reporting will be the same as the one so far used. Central banks collect the data from commercial banks, channel them to the B.I.S. which in a consolidated form send them back through the central banks to the reporting commercial banks. By consolidation I mean data on the debt figures for individual countries. Once we will have reached this stage, the B.I. S. will contact other international organisations – mainly the World Bank and the O.E.C.D. – with the purpose of reconciling the improved bank lending figures with the data collected by these other institutions.

Now let me come to the next questions: Should the role of central banks and international organisations stop at this stage? Should we simply act as a sort of central statistical office or should we go further? I would like to submit to you

a couple of possible answers to these questions on a personal basis, but I would like to make it clear that these are my own views which do not necessarily reflect those of the B.I.S. or the central banks with which the B.I.S. is connected.

The first point I would like to stress is that I do not detect any strong desire for an increased international official supervision on commercial bank lending. This does not preclude, of course, that the national supervisory organisations may wish to have better control or at least better information on what commercial banks do. What I have in mind is a co-ordinated international control on bank loans.

There may be two distinct reasons for this lack of interest on the international level. The first is the recognition that bank loans have played a useful role in balancing international payments and that a sudden break on international capital flows might create substantial problems for international payments in 1977. The second reason is an even more practical one: international control can be efficient only if it covers the whole world. This has been demonstrated by the growing number of offshore centres and by the increasing share they play in channeling international capital flows. Now I do not believe, although I very much regret it, that we can hope for an international cooperation on a world-wide basis.

However, while I am therefore rather sceptical about the usefulness or the feasibility of controls by international organisations, I do not think that the role of official institutions should stop simply at providing better figures. I think there is room for effective cooperation between international lending institutions and the commercial banking system. There is scope for joint ventures in two stages. First, at the time when the loans are granted. This is clearly in the interest of official institutions like the I.M.F. or the World Bank because of the increase in the availability of resources. But this would also be in the interest of the commercial banks since international organisations are better equipped to get detailed information on the borrower's financial position and they are in a better position to negotiate policy conditions. Then there is a second stage which hopefully will be reached only occasionally and that is the negotiation of a rescheduling of loans. Joining forces at that stage would increase the bargaining power both of the official institutions and of private lenders.

## Will Improved Reporting Requirements Lead to a Safer Euromarket?

I would like to conclude by summing up my answer to the question raised in the title of my talk. The improvement of reporting is under way. Better figures will lead to better information, and therefore will enable commercial banks to make their decisions in the light rather than in the dark. This is a pre-requisite for a safer Euromarket, but safety does not flow automatically from better information. I do not believe either that safety will come from international control; it may come, however, from active cooperation between official and private lenders.

## Chapter IX

# The Future of the Euro-Currency Market

1978

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*The rapid expansion of international bank lending and its prudential implications remained a crucial preoccupation of Alexandre Lamfalussy in the second half of the 1970s. It was the main issue of this presentation at a meeting of the Conference Board Europe in Brussels on 14 December 1978. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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The rapid expansion of international bank lending and the similarly fast growth of foreign exchange reserves held by central banks, coupled with the widespread unrest which has characterised the currency markets until recently, have revived both official and private criticism of the Euro-markets. The sizable increase in the aggregates is supposed to foreshadow a resurgence of worldwide inflation (as it did in the early 1970s); the large volume of “uncontrolled stateless money sloshing around” is thought to bear a heavy responsibility for the recent disorders on the foreign exchange markets and to limit the ability of monetary authorities to pursue conservative domestic policies; no efforts should therefore be spared – so the argument concludes – to bring the growth of the Euro-markets under some sort of co-ordinated international control.

I share a great deal of the concern thus expressed, and would even add some of my own – especially as regards the prudential implications of the borrowers market prevailing today in international bank lending. But I have serious doubts about the wisdom of the policy conclusions drawn from these concerns, namely that the authorities should attempt to control by “macro-economic” means the growth of the Euro-currency aggregates. Any such attempt is likely to fail; and even if by a stroke of good luck a brake could somehow be put on the development of these aggregates, this would be unlikely to change the supply-led growth of

international bank lending as a whole (of which Euro-currency credits are only a part) as long as the US balance of payments remains what it is today and as long as bank lending from the United States is a close substitute for Euro-dollar operations. Let me spell out these points in some detail.

## The Facts

The figures are undoubtedly impressive. The external assets of banks in the main industrial countries (including the principal offshore branches of US banks) have multiplied by almost 2.5 between end-1973 and mid-1978, to reach a total of \$730 billion at end-June 1978. Of this total \$400 billion are accounted for by Euro-currency claims – i.e. assets held in foreign currency by banks in Europe –, the rest being external claims in domestic currencies by these same banks, external claims by Canadian and Japanese banks, and last but not least foreign assets held by US banks and their offshore branches (the latter amount to \$196 billion).

Admittedly, these figures include a lot of double-counting, due mainly to redepositing among the reporting banks. However, even the net figures are substantial. The BIS estimates that during the same period net international bank credit may also have multiplied by nearly 2.5, to reach \$465 billion at end-June 1978. Thus, both gross and net external claims have been growing during the past four-and-half years at the average yearly rate of 22 per cent, without there being much variation from one year to another. Even if account is taken of the depreciation of the dollar and of worldwide inflation, these are growth rates rarely reached elsewhere in the world economy.

Except in one other area: foreign exchange holdings by central banks. These have risen from \$123 billion at end-1973 to \$256 billion at end-June 1978. Should one not therefore conclude (a) that the growth of international liquidity has become excessive and (b) that since this growth is thought to have been made possible by that of international bank credit, the responsibility lies with the latter?

## Interpreting the Facts

I shall try to answer these questions by cutting the last four-and-half years into two sharply different periods: the first covers the full years of 1974 and 1975, as

well as the first half of 1976; the second, the two years extending from mid-1976 to mid-1978.

The first of these periods supported the full disruptive impact of the oil price explosion. As a counterpart to the sudden, sharp increase in the OPEC surplus, major deficits emerged in the current accounts of both industrial countries and LDCs. Simultaneously, the western industrial world experienced its deepest recession since the war under the combined influences of the OPEC imbalance and the earlier inflationary boom.

International bank lending – both lending by US banks and through the Euro-market – played a highly beneficial role during this period in preventing the recession from getting even worse than it actually did. The story was quite simple: a large part of the financial assets acquired by the OPEC countries took the form of bank deposits in the Euro-market and in the United States, and banks used these funds to finance the balance-of-payments deficits of the oil-consuming world. They thus accepted to carry sovereign risks as well as the risks of maturity transformation. While this part of the story is by now well known, some people still do not fully realise that the inevitable counterpart of this recycling process was the increase in officially held reserves: the OPEC countries gained exchange reserves on a substantial scale (about \$40 billion), while the oil-importers just about managed to marginally increase theirs (+\$6.4 billion) by borrowing from the banks. It should be noted, moreover, that this last figure comprises the reserve gains of the traditional surplus countries of Europe.

Neither the growth of international bank lending nor the reserve increase which took place during this period could be regarded as anything but beneficial to the world economy, with no potential inflationary dangers attached to them. There are several reasons for this. Firstly, the international recycling process occurring at that time could be compared to a sudden increase in savings in a closed economy: the “recycling” of these savings for the benefit of domestic investors (or dis-savers) increases the total amount of financial intermediation, thus leading to a rise in the assets and the liabilities of the domestic financial system. The economic impact of any such increase in the aggregate amount of liquid assets is to be regarded as counter-deflationary rather than inflationary. Secondly, the very nature of global reserve creation through international bank lending implied that there was no net creation of international liquidity. True, net reserves in the hands of the OPEC

and of a few industrial countries increased, but the other countries incurred heavy debts, and therefore by simply maintaining the level of their reserves in fact accepted a decline in their net reserve positions. Thirdly, the gainers of net reserves were either unwilling or unable to spend their foreign exchange holdings at a rate which would have raised their imports to such levels that the world would have been pushed towards inflationary over-full employment.

In sharp contrast to this first period, the second presents a number of distinctive features, which lead me to the conclusion that the fears expressed about excessive liquidity creation, when applied to more recent developments, are better founded. I would add, however, that the blame should be laid on the state of the US balance of payments, rather than on any excessive Euro-market lending.

The basic change that has occurred in the world economy during this period concerns the pattern of external imbalances. Firstly, the global current-account surplus of OPEC has been gradually eroded: by the beginning of this year it may well have become smaller than that of Japan, and by now it may have altogether vanished. The second major fact concerns the complete reversal of the US balance-of-payments position. While during the first period the current account of the United States registered a surplus of about \$25 billion, during the second period it ran into a deficit of about the same size. Moreover, since capital outflows continued, the official settlements balance of the United States during this second period displayed a deficit approaching \$50 billion. Thirdly, through appropriate demand management and thanks to the depreciation of their currencies, a number of deficit countries, both industrial and LDCs, have brought back their external balances into equilibrium or surplus. They have done so, of course, with the help of the offsetting shifts in the OPEC and US external payments situations. Two series of consequences have flown from these balance-of-payments developments.

1. The first concerns officially held international liquidity. Global exchange reserve creation has accelerated (+\$88 billion, as against +\$46 billion during the first period), while the rate of growth of international bank lending (and within that total, of the Euro-currency market) has not. This is just another way of saying that the origin of reserve creation has moved away, relatively speaking, from international lending towards the US current account, and within international lending, from the Euro-markets towards US capital exports. This can clearly



be seen from the fact that non-US central banks have acquired during this period additional claims on the United States for about \$50 billion, while their additional deposits in the Euro-currency market may be estimated to have been \$22 billion, i. e. about the same figure as during the first period. The emergence of the sizable US current-account deficit, in turn, meant that the world outside the United States has acquired a substantial amount of net liquidity. Last but not least, reserve gains have been concentrated among the oil-consuming countries (+\$76 billion), OPEC adding only about \$12 billion to its official foreign exchange holdings.

2. International bank financing has turned into a borrowers' market. On the demand side, there has been a drastic reduction in the balance-of-payments financing needs, as a result of the sharp fall in the current-account deficits of the oil-using world outside the United States. On the supply side, the continued sluggishness of the world economy, coupled with the liquidity-creating effect of the official financing of the US deficit, meant that banks have had to seek foreign markets as an outlet for their excess liquidity. This supply-led growth of international bank credit has led to the reduction of bank margins to the pre-Herstatt levels, to the lengthening of the maturity of bank loans and to the increase in the size of individual syndicated lending operations. It has also made it easy to borrow dollars for hedging or speculative purposes: witness the net outflow of bank funds of about \$10 billion from the United States between mid-1977 and mid-1978.

## Policy Issues

I do not want to jump from the preceding analysis to the conclusion that we are facing today a potentially inflationary situation similar to that of the early 1970s. That would certainly be exaggerated. The world outside the United States is still far from full employment; moreover, while many formerly major deficit countries – Italy, the United Kingdom, some large LDCs – have indeed improved their net external position by building up reserves and paying back part of their external debt, it would be mistaken to believe that the global net reserves of the world outside the handful of low-absorbing OPEC countries, Germany, Switzerland (and perhaps Japan) have become excessive. Nonetheless, we would be well advised to recognise that the US current account does pump net liquidity into

the system and that in conjunction with some other factors at work, this has led to a potentially dangerous borrowers' market for international bank lending. If one adds to this the disruptive influence of currency unrest on the world economy, "financed" through this borrowers' market, there appears to be a good case for trying to moderate the growth of both public and private international liquidity. How to achieve this? I venture to make three points, one negative, two positive.

1. Not by trying to control through macro-economic measures the growth of the Euro-currency market. There are two good reasons for making this clear-cut statement. The first is that it stands out clearly from the previous analysis that what has changed since 1974-76 is not any acceleration in the growth of the Euro-markets, but a drastic swing in the US balance-of-payments position from surplus to deficit. Is it not remarkable that concern about the excessive growth of the Euro-market arises always when the US balance of payments is weak? The second reason is of a more pragmatic nature: I can hardly see how macro-economic measures can in fact be effective. A ceiling on G-10 central bank deposits in the Euro-currency market would have a very limited effect on the aggregates since these deposits are only a fraction of worldwide central bank Euro-currency holdings, and a still weaker fraction of total Euro-deposits. The imposition of uniform reserve requirements on banks operating in the financial centres of the G-10 countries would simply push out banks towards the offshore centres whose vitality has been abundantly demonstrated over the last few years. Last but not least, since January 1974, bank funds have been flowing freely between the United States and the Euro-markets. Unless US monetary policy is further tightened, Euro-bank lendings would by and large be replaced by bank lending from the United States.
2. This brings me to my first positive point. What the world needs today is a drastic decline in the US current-account deficit, accompanied by tight US domestic monetary policy. US policy has in fact already been moving in the right direction and might well continue its restraining stance. In addition, most forecasters agree that next year's current-account deficit will be much smaller than that of 1978. If both these assumptions turn out to be right, the United States will feed the world with much less unwanted net dollar balances, banks in the United States will cease to be net exporters of funds, the international banking market will cease to be a borrowers' market and speculators will find it harder to borrow dollars and to take up short positions. And, following the

historical pattern the Euro-currency market will play its traditional role of amplifying the impact of US monetary policy on the rest of the world – except that the amplification would this time go in the right direction.

It has, of course, to be borne in mind that neither the world nor the United States would want to see the American economy being pushed into a deep recession. Measures aiming at domestic restraint need therefore to be gradual and have to be accompanied by the kind of “bridging” measures announced on 1st November.

3. The second positive point I would like to suggest is that both the banks engaged in international lending and their supervisory authorities should continue to take appropriate prudential measures to make the international credit market a relatively safe place to live in. If the growth in international lending continues at the rate experienced over the last few years, the external exposure of the banks is likely to widen, although probably at a lesser pace than during the last few years. Bank managements should make sure that they draw the proper conclusions from this historical transformation of the banking industry, and supervisory authorities should help them to reach such conclusions. This should imply a consolidated approach, on a worldwide basis, of risk management – a path already followed by many banks involved in international business. This should also imply that careful consideration be given to the degree of maturity transformation involved in international lending. While such prudential measures would not be tantamount to an attempt at any macro-economic steering of worldwide aggregates, they may well exert a restraining influence on their growth.

## Chapter X

# Problems and Techniques of Monetary Management

1978

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*The Bank for International Settlements provided a venue for central bankers for regular and discreet meetings. One of these groups was the Working Party on Domestic Monetary Policy, which Lamfalussy chaired. He compiled the "Annotated agenda" for the meeting of 23 October 1978. The note not only gives insight into monetary policy problems faced by the central banks at the time, but also in Lamfalussy's own style, asking questions to identify the crucial issues at stake. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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The purpose of the meeting is to encourage an entirely informal exchange of views on matters of interest to the participants on the basis of the problems and experiences of individual countries. In the limited time available this will probably be more fruitful if we can agree on a general framework for the discussion. This note suggests possible topics and raises some of the principal issues which seem to be confronting central banks. In preparing it, I have tried to strike a difficult balance between different degrees of generality, technicality and topicality. I have been greatly helped by personal notes sent by the participants, for which I am most grateful. Participants should by no means feel that they have to confine themselves to the topics listed; nor would I expect all of us to speak on all topics.

I suggest that the discussion should move from broad policy issues (in the morning session) towards more technical problems of monetary management (during the afternoon):

- I. The role of, and the limitations on, monetary policy in current economic circumstances.

## II. The experience with “intermediate” targets; technical and institutional problems encountered in meeting them.

### I.

The role of monetary policy has to be set against widely differing country backgrounds in terms of both macroeconomic conditions and structural factors. The United States is far more advanced in cyclical recovery than the other countries; inflation rates, although less widely spread than a couple of years ago, still range from 1 to 12 per cent; rates of unemployment also differ; and whereas some countries are experiencing balance-of-payments surpluses and upward pressure on their currencies, others are subject to external constraints on monetary policy from the opposite direction or are somewhere between the two extremes. I believe, however, that in spite of these unquestionable differences there are also strong similarities between countries.

1. One general feature is the persistence of inflation at a high average rate or, more precisely, the fact that several years of unemployment and underutilisation of capacity has not succeeded in eradicating inflation altogether.

This statement must, of course, be qualified in some respects. One is that the recent acceleration of inflation in the United States should perhaps be attributed to the classical overheating of an economy which has reached a very advanced stage of cyclical upswing. But even in the United States there is an underlying inflation rate of 6 to 7 per cent, which seems to have little to do with excess demand of any kind. Another qualification concerns the fact that in Switzerland, Japan, Germany and the Benelux countries price increases are now below the average inflation rates of the late sixties. However, this has been achieved with the help of sizable appreciations in effective exchange rates – in other words the potential, internally-induced inflation rates are higher than the actual ones and are liable to come to the surface if and when exchange rates are stabilised.

What can be the role of monetary policy in fighting this kind of underlying, cost-price inflation? Conservative, and a fortiori restrictive monetary policies might possibly prevent a renewed acceleration of inflation; but on what grounds can we hope that they will ever bring about a further reduction in

inflation rates? And if there are reasonable doubts about this happening, is it in the central banks' interest to make the public believe that it is their responsibility to move their countries at all costs towards price stability and that it is within their power to do so? Or, conversely, do you share the view that after a time lag of perhaps several years a deceleration in the growth of monetary aggregates is bound to produce a satisfactory slowing down of prices with no more "real" cost to the economy than that which would have had to be incurred anyhow as a result of inflation?

2. It is also a common feature of most countries represented at the meeting that in trying to answer these questions we have to bear in mind the historically high level of the public sector's borrowing requirement. Part of this represents the cost of not operating at full employment; another part is due to deliberately expansionist fiscal policies; and a third part to a kind of historical drift towards higher public-sector spending and financing needs. The size of the borrowing requirement varies considerably from one country to another, but everywhere it limits the degree of freedom of monetary policy.

Even if some of us may be tempted to believe that restrictive monetary policies alone cannot ensure a return to adequate price stability, probably all of us will feel that the persistence of inflation calls for various degrees of "conservatism" in monetary policies, either to support the credibility of incomes policies or simply to prevent price increases from accelerating again. What are the effects of such monetary conservatism when combined with high public-sector borrowing requirements? Are there any signs that private expenditure is being "crowded out"? Is there the risk of an outright recession in the United States (as opposed to a soft landing)? Is there any danger that the desirable expansion of the other economies will be held back?

3. Some of the countries have recently been experiencing downward pressure on their exchange rate. Assuming that they do not wish this to persist, what forms of intervention are being undertaken and with what consequences for the domestic money supply, liquidity and interest rates?

The experience of the Benelux countries might be considered relevant in this respect. In the past two years both the Netherlands and Belgium have successfully resisted several speculative attacks on their currencies. They did

so by allowing interventions to have their full liquidity-reducing effect on the domestic money markets and on occasion by tightening monetary policy even further. Do they consider that these policies have played a determinant role in stabilising their exchange rates? Have they experienced any adverse impact on domestic demand and employment? If not, could this be explained by the short duration of the liquidity squeezes and their limited influence on long-term rates? What lessons could much larger countries and, in particular, the United States draw from these experiences?

4. Some other countries have had the opposite experience, with strong upward pressure on their currencies which they have thought appropriate to combat through exchange market interventions. The liquidity-creating effect of these interventions cannot in all cases be offset by domestic money destruction, and when technically it can be offset, the result is that the upward pressure on the currency continues. The authorities are therefore obliged to accept a rate of increase in the money supply which otherwise they would have judged excessive.

Is their concern justified? It could be argued that in these countries the actual inflation rate has fallen to quite a low level, that there is unused capacity and in most cases unemployment, that the appreciation of the currencies will continue to exert downward pressure on domestic prices for a while and that a temporary acceleration in the rate of growth of the money supply should therefore be accepted. It could even be added that the greater part of the excess money supply thus created will be in the hands of holders who in the foreseeable future are unlikely to use these balances for the purchase of domestic goods and services. Alternatively, should one believe that an acceleration in the growth of the money supply will inevitably store up inflationary trouble for the future, even if only with a time lag of two or three years?

## II.

1. Since targets for the growth of the money supply have been at the centre of monetary policy in most of the larger countries, I propose that we begin the second part of our meeting with a discussion of recent targeting experiences. The following points seem to deserve special consideration:

- Countries that have set monetary targets have had difficulty in meeting them. Moreover, in most of these countries the actual rate of monetary expansion has been on average only slightly lower and less variable than in the critical 1971-73 period of monetary explosion and substantially higher and more variable than in the mid 1960s. Can we detect any common reasons for these disappointing performances or should we accept ad hoc explanations appropriate to each individual country? In particular, what role has been played by changes in the pattern of financial intermediation?
  - The broad problem of conflict between targets and exchange market interventions will have been discussed during the first session (point 4). What has been the experience of the countries represented with regard to potential and actual conflicts between money supply targets and interest rate policies? What grounds can be given to justify the apparent shifts of emphasis from quantitative targets to interest rate objectives and vice versa?
  - Quite a few countries have tried to reconcile money supply targets and interest rate objectives by imposing limits on bank lending. Have these experiments been successful?
  - The frequent publication of money supply figures and comparison of these with published targets have given rise to sudden changes in expectations and have therefore led to great instability in interest rates. Should this be regarded as an inevitable cost of otherwise successful targeting, or should this experience induce central banks to reconsider targeting techniques or perhaps even targeting itself?
2. The difficulty of reconciling conservatively-biased monetary policies with large public-sector borrowing requirements will have been discussed during the first session (points 1 and 2). Some of the more technical implications of large, possibly monetary, financing needs could be discussed at this stage:
- The larger the public sector's financing requirements and/or the stock of public debt outstanding, the more probable it is that the shifting liquidity preferences of the public will create unstable markets for government securities. Thus, quite apart from any longer-term conflict between the level of interest rates and monetary targets, there might arise the problem of sharp changes in interest rates attached to government securities, an occurrence



which is liable to create a good deal of uncertainty. Are there any technical ways of dealing with this problem?

- The management of the public debt raises the traditional problem of interest rate structure. Central banks have long been confronted with the question of their responsibility, regarding the level of long-term interest rates in relation to short-term ones. Have there been any recent developments in this field? Do you accept the view that long-term rates are largely a reflection of inflation rate expectations?
3. As regards the desirable level of interest rates, two broad questions seem to be of direct interest to central banks:
- Is it possible to find any reliable measure of real interest rates at any given moment in time? Should policy be aimed explicitly at an adequate real rate? What are the problems of reaching such a level of real rates in the current inflationary environment?
  - What has been the experience of those central banks which have accepted that interest rate differentials should play a significant role in exchange rate management? Have they been able to ascertain the size of interest rate differentials that tends to stabilise exchange rates?
4. While it can perhaps be accepted as a general rule that exchange rate interventions undertaken in order to hold down the external value of the currency will be effective only if their liquidity-creating effect is not offset domestically, there may be circumstances in which central banks will want to mop up the domestic liquidity created by the purchase of foreign currency.
- What techniques have been used for this purpose?
  - Have they been effective?
5. One very specific problem for monetary management is that posed by the “international” elements in money supply. Diversification of currency balances occurs because economic agents want to use foreign currencies for transactions or hold them for precautionary or speculative motives. This might take various forms, of which perhaps the most important are that (a) a country’s currency is held by non-residents with domestic banks, (b) a country’s currency is held by

residents or non-residents with foreign banks and (c) that a country's residents hold foreign currency balances with domestic or foreign banks. Once these international elements in the money supply have reached certain proportions the relationship between domestic monetary policy and the real economy or the domestic price level becomes highly unpredictable.

How has central banks' thinking evolved with regard to (a) the purely definitional problems involved in this internationalisation of the domestic money supply and (b) its policy implications?

## Chapter XI

# The Possible Consequences of the Establishment of the European Monetary System (EMS) for the Working of the International Monetary System

1979

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*Alexandre Lamfalussy was very active in different international groups. This is a paper he prepared for a meeting of the Consultative Group on International Economic and Monetary Affairs, or Group of Thirty (of which he was a member) in Bermuda, 17-19 February 1979. Lamfalussy goes into the possible consequences of the establishment of the European Monetary System for the international monetary system, and especially the effects on international liquidity. The annex is not reproduced. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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This is an unconventional blend of an annotated agenda and a discussion paper: its purpose is to raise questions as a framework for our discussions in Bermuda, suggesting answers to some, leaving others unanswered. It might also serve as a basis for further research if the Group decides to pursue its work on this subject.<sup>1</sup>

Any attempt to evaluate the possible consequences of the EMS for the working of the international monetary system runs up against several difficulties. The first is that a number of the provisions so far agreed upon apply only to the two-year transitional period.<sup>2</sup> Little has yet been decided about some of the

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<sup>1</sup> I chaired a one-day meeting on this subject on 15th January, attended by Mr. P. Oppenheimer, Dr. W. Rieke, Prof. H. B. Rose, Prof. N. Thygesen, Prof. R. Triffin and Prof. R. Vaubel, as well as Mr. M. G. Dealtry, Dr. H. W. Mayer and Dr. G. Baer from the BIS. The discussions have been of great help to me in preparing this note.

<sup>2</sup> A summary of these provisions, widely reported in the press, is attached as an annex to this paper.

main features of the EMS beyond this period especially as regards one of its central elements, the European Monetary Fund (EMF). Whatever is said about its possible impact on the rest of the world is therefore bound to remain highly speculative. The hypothetical nature of the discussion is heightened by the fact that at the time of writing this note even this modest, transitional, EMS has not yet started operating. Moreover, the reason why it has not – the sudden re-discovery that the monetary compensatory amounts create or preserve distortions between member countries – raises new questions about the ability of the EMS to function smoothly if and when a compromise is reached on the phasing out of the compensatory payments. Indeed, it is hard to imagine any compromise that would not make adjustments of the central rates more difficult.

## The EMS During the Transitional Period

As a starting point for the discussion let me make two broad negative assumptions about the working of the EMS during the transitional period.

The first is that there will be no, or little, creation of international liquidity since central banks will merely swap part of their dollar and gold holdings against ECUs. One reason for the qualification “little” is that gold will be valued at, or close to, the market price, while at present gold holdings can be mobilised only at a significant discount. Without this special EMS provision, a central bank could mobilise its gold assets either by pledging its gold against external borrowings, in which case gold would certainly be valued at a discount, or by selling its gold on the market, in which case it would be running the risk of depressing the market price of gold. If liquidity creation is defined broadly, one may add as a second reason for the qualification “little” the enlargement of the credit facilities under the short-term monetary support and the medium-term financial assistance arrangements. It should be added, however, that the enlargement of the latter is unlikely to enter into force before one or two years.

The second negative assumption is that in all probability the role of the ECU will remain limited. Only EEC central banks will hold “real” ECUs (i.e. claims on the EMCF) as reserve assets; moreover, for reasons spelled out below I consider it highly unlikely that the private use of the ECU will spread. By private use I mean here the large-scale acceptance by private banks of ECU-indexed deposits and the

acquisition by the same banks of ECU-indexed claims. Thus third-country central banks will be in no position to acquire real ECUs; moreover, if I am right in my belief about the limited private success of the ECU, they will also be unable to make sizable ECU-indexed deposits with commercial banks.

The upshot of these two negative assumptions is that during the transitional period the EMS is very unlikely to exert any strong influence on the rest of the world either by creating international liquidity or by developing a new kind of reserve asset available for third-country central banks.

How, then, could the EMS affect the rest of the world? The short answer is that it could do so through its intervention and exchange rate policies, and the possible impact of these on domestic policies.

Three questions might be worth discussing in this respect.

- a) Will the EMS lead to a greater stability of intra-European exchange rates than would otherwise be the case? My own answer is positive: intervention will itself smooth out exchange rate fluctuations; after some time, and if speculative movements are successfully resisted expectations are likely to be calmed down; the intervention rules are bound to exert at least some converging influence on domestic policies. In this case, such greater stability could hardly have anything but beneficial effects on the rest of the world.
- b) Assuming that there will in fact be some convergence of policies, will this result in a higher or a lower “average” inflation rate than would otherwise be the case? In other words: will the EMS emit inflationary or, on the contrary, deflationary impulses towards the world economy? The answer to this question has been passionately debated and was more or less explicitly at the centre of the discussions on the use of the ECU as an indicator of divergence. I find it difficult to give any closely reasoned a priori support to either of the two views. One reason for this is the ambiguity underlying the question: those who fear “inflation” have in mind price increases, while those who talk of a potentially deflationary impulse think in terms of real income effects; at the same time, monetary expansion is assumed to push up prices, while restrictive monetary policy is supposed to depress in the first place the level of activity. Another reason is that the expansionary or contractionary effects of EMS-induced

interventions on the monetary aggregates may in fact be either offset or simply swamped by much larger interventions vis-a-vis the US dollar, as actually happened during the fourth quarter of 1978. Last but not least, how can anyone make sensible predictions regarding the outcome of policy convergence when it is much more likely to be influenced by external shocks, internal political developments or the balance of power between countries than by the sheer mechanical effects of intervention rules?

- c) Will there be any common intervention policy towards the US dollar? The need for a minimum of policy co-ordination will emerge as a by-product of intra-marginal dollar interventions. A common policy may also be triggered by major downward or upward pressure on the dollar. For reasons similar to those mentioned above, predictions in this field seem to be equally hazardous; but the Group may want to discuss the desirability or otherwise of such a common European policy.

## The EMS After Two Years – The “Weak” Assumption

Let me assume that at the end of the transitional period the European Monetary Fund is established, the swaps are replaced by the outright sale of dollars and gold to the EMF and the various credit facilities are consolidated in the EMF. Let me assume, moreover, that the consolidation of the medium-term facilities takes the form of drawing arrangements of the IMF type, i.e. of conditional sales of national currencies against the acquisition of ECUs. Finally, let me assume – as I did above – that only EEC central banks are authorised to hold claims on the EMF and that there is no real “take-off” in the private use of the ECU.

What would be new in this situation compared with the transitional period?

- a) As a result of the transfer of ownership of dollars and gold, the EMF would now be in a position to conduct its own investment policy in regard to its dollar holdings. Would it buy US Treasury bills? Invest its dollar balances with US banks? Place them in the Euro-dollar market? Any change in relation to the investment practices of the individual EEC central banks could affect US Treasury financing conditions, relative interest rates and – depending on the

assumption made regarding the degree of freedom of capital flows between the United States and the Euro-dollar market – the aggregates of the Euro-market.

- b) According to the degree of conditionality attached to the sale of ECUs against national currencies, the EMF would be a greater or lesser creator of international liquidity. At the same time it would “compete” more or less strongly with the IMF and the international bank lending market. If the degree of conditionality were weaker than that of the IMF, the liquidity-creating effect of the EMF might be quite powerful; but even if European conditionality were stronger, there would probably still be some additional liquidity creation. In any event, there would be both policy and operational problems to be solved between the two Funds if neither were to risk undermining the contribution of the other’s credit operations to a better worldwide adjustment process. It must be added, however, that if international bank lending were to remain as supply-led as it has been since 1977, the real competition would arise between bank lending on the one hand and lending by both Funds on the other.

## The EMS after Two Years – The “Strong” Assumption

Let me assume here that the ECU really takes off within the Community—meaning by this that EEC central banks would become willing holders of “real” ECUs over and above their contractual obligations and that at the same time commercial banks would be willing to accept ECU-indexed deposits on a large scale as a result of their ability to acquire ECU-indexed claims. How might this come about?

Bearing in mind that the ECU is defined as an average of fixed quantities of EEC currencies, the critical question is what would induce holders of financial claims and issuers of debts to consider that their interest is best served by agreeing on ECU-denominated contracts rather than by selecting, as a result of their relative bargaining positions, one of the EEC currencies in isolation. I suggest that this is most unlikely to happen as long as intra-European exchange rates are set on a predictably divergent course. On the other hand, once the currencies on which the ECU is based are expected to maintain a “basically” stable relationship, only to be occasionally disturbed by unpredictable random “shocks”, the average

becomes a reasonable choice for both debtors and creditors, and its use would presumably spread. Market participants would form such expectations only if they had observed an effective convergence of both policies and performances and experienced exchange rate stability for some time. This seems to be a more important condition for the voluntary use of ECUs than market-related interest rates or a high degree of usability by central banks; and this is why I have some difficulty in conceiving of any extension of the use of the ECU in the short run. To put it provocatively, the use of the ECU cannot spread until the major objective of the EMS – exchange rate stability – will have been reached, rather than vice versa.

Be that as it may, if and when this happens, the door is opened wide for the use of the ECU as an international reserve asset by non-EEC central banks. This may take place through two channels, the use of each reinforcing that of the other.

For the use of the “official” channel, the institutional precondition is, of course, that third-country central banks are allowed to hold claims in ECUs on the EMF. Once this condition is satisfied, the acquisition of ECUs could take place in two ways: by the EEC area as a whole running a balance-of-payments deficit on an official settlements basis, and the EMF issuing ECUs in settlement of the deficit; or else by the EMF selling ECUs against dollars held by third-country central banks – thus responding directly to a possible desire for reserve diversification by setting up a substitution account. (A special case, mentioned for the sake of completeness, would consist of a substitution account established also for EEC currencies.) Both would steer the world towards a multi-reserve currency system. The desirability or otherwise of such a development, as well as the conditions in which a multi-reserve currency system could be stable, might form part of our discussions in Bermuda.

Reserve diversification could also take place through the private banking system, with which third-country central banks could deposit their currency reserves, indexed to the value of the ECU. If US dollars are deposited in this way and the banks simply “split up” these deposits among the EEC currencies represented in the ECU, the dollar will, of course, come under pressure. But if the banks find borrowers willing to take in dollars indexed to the ECU there will be no sale of dollars – at any rate, not at this stage. The same would apply if banks were



in a position to “create” ECU-denominated deposits by lending in ECUs. This could, of course, only happen if banks were able to hold base money in ECUs – in other words, if the EMF were to play the role of a genuine European central bank.

## Chapter XII

# Introductory Remarks by the Chairman. Working Party on Domestic Monetary Policy

1980

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*This chapter reproduces Alexandre Lamfalussy's introductory remarks for the meeting of the Working Party on Domestic Monetary Policy on 27 October 1980. The key theme is the fight against inflation and whether one should follow a "monetarist" strategy. Lamfalussy comes out in favour of a "conservative Keynesian" approach. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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The purpose of these brief remarks is to introduce our "tour de table" on current problems of monetary policy. To stimulate discussion I should like to lay a few general, background questions on the table, with some tentative answers of my own – leaving, of course, the members of the Working Party entirely free to present their own views with or without reference to my framework.

1. As you will recall, you agreed to focus your remarks on the part that you consider monetary policy can play in your country in continuing the fight against inflation during the present phase of economic slowdown. This, of course, raises a broad preliminary question: should the fight against inflation still be regarded as a target of first priority, despite the more widespread economic slowdown and the noticeable deceleration in observed inflation rates in most industrial countries?

There are at least two reasons for which my own answer is "yes". First, because I regard the current decline in observed inflation rates as somewhat deceptive, just as I thought that their fast acceleration during last winter was itself

somewhat misleading. Setting aside the special factors affecting the retail price indices in the United States – fluctuations in mortgage rates – and the United Kingdom – the shift towards heavier indirect taxation – all industrial countries have been strongly influenced first by the sharp rise and now by the weakness of international commodity prices. My impression is that if the “bulge” caused by this element of inflation were taken out of the domestic indices, the underlying – or domestically induced – inflation rates would still appear unacceptable in most (although perhaps not all) countries represented around this table. One indication to this effect is the behaviour of the GNP deflator.

The second reason is rooted in my growing scepticism regarding the wisdom of trigger-happy demand management – i.e. of a demand management responding to very short-run fluctuations in aggregate demand. This is not to say that I would wish to rule out demand management in all circumstances. I do not share the monetarists’ preconceived belief in the basic stability of the private economy. What is more important, I do not even believe that this is the primary issue: in the real economy, periodically shaken by domestic and international political crises, external shocks may well create a prolonged depressive impact on economic activity. Situations may therefore emerge in which stimulation of global expenditure, or of some of its specific components, may become fully justified. But I do not believe that we find ourselves in such a situation today. The recessionary experiences are very recent; some components of aggregate demand seem to be still quite strong; finally, it is very much an open question whether the recession will deepen further, whether it will bottom out or indeed whether we can expect a revival in the near future. Given our very poor record in short-term forecasting, it would seem to me highly premature to change policy priorities at this juncture. The future development of the business cycle is open to debate – the fact of inflation, unfortunately not. My scepticism is reinforced by a look at past experience: in many, probably in most, instances anti-recessionary demand management was set in motion far too early, and therefore bears much responsibility for the present inflationary trends.

2. This leads into the more specific question concerning the role of monetary policy. Assuming that the fight against inflation should still be regarded as a target of first priority, how could, or should, monetary policy be managed so as to contribute to achieving this target in present circumstances?

The answer to this question will probably depend on the degree of monetarism contained in the analytical framework that is used for examining the proper role of monetary policy. Let me develop this point by outlining two “stylised” positions.

3. The first is that of an adherent of “conventional” or Keynesian economics. According to this school of thought monetary policy is one of the main tools of demand management, the other being fiscal policy. If monetary policy is supposed to curb inflation, it can do so only by adopting a restrictive stance – i.e. by exerting restraint on the level, or the rate of growth, of total expenditure.

Beyond this agreement on broad principle, there are different views, within this group, on two distinct matters. First, on the choice of the best monetary control technique that the authorities can use for achieving demand restraint. There is a dividing line between those who favour the use of market-oriented techniques and those who prefer recourse to administrative measures, such as credit ceilings. Secondly, there are divergent views as to the appropriateness of trying to deal with inflation by restraining demand in a period of slack in the economy. Admittedly, almost everyone would agree that there is a level of unemployment which would bring inflation to an end. But according to some, where inflation is deeply embedded in a country’s way of life, this approach may imply a very substantial social cost; therefore, restrictive monetary policy should be replaced, or at least complemented, by incomes policies.

If I were to state my own preference “in abstracto”, without the necessary qualifications applying to individual countries, I would be inclined to favour a policy stance which would still be moderately restrictive – even now. The reason for this conservative-Keynesian attitude is not that I ignore the existence of excess supply and of unemployment, or that I underestimate the cost-push origin of current inflation in most countries, but that I believe in the importance of the “signal” given by monetary policy to price and wage setters, businessmen and trade unionists alike. How can one attach credibility to the monetary authorities’ determination to fight inflation in the long run unless monetary policy remains (at least moderately) tight in the short run? And how can one hope to break inflationary expectations and thus put an end to the cost price spiral unless credibility is ensured?

Such a proposition, of course, raises the tricky question of how to define and measure restrictiveness in monetary policy. In terms of availability of finance? In terms of real interest rates? In terms of exchange rate behaviour? Or in a suitable combination of all three criteria?

4. Now let me turn to the more clear-cut, but equally “stylised”, monetarist approach. Monetarists do not regard monetary policy as an appropriate tool of demand management. They refuse to do so because they do not believe in the effectiveness of demand management (except in the very short run) and because they see a direct medium-term link between the rate of increase in prices and the growth of the money supply. Their prescription, therefore, is to set a target for monetary policy which would be defined as a gradual, across-the-cycle decline in the rate of growth of the money supply, leading in the end to an equally gradual squeezing out of inflation.

Beyond these fundamentals, there are also divergent views among monetarists, although perhaps less so than among Keynesians. As regards the control technique, the majority seems to be in favour of the monetary base approach, leaving interest rates to find their own level as a result of the constellation of market forces. They may disagree about the most appropriate money supply figure, or about the time-span over which the decline in the rate of growth of the money supply should take place. But they dismiss the non-monetarist contention that the various components of total liquidity are shifting so unpredictably as to make the choice of any of the specific money supply figures worthless as a target.

They do not ignore the social cost inherent in their policy prescription, but argue that the firmer the authorities’ commitment to a medium-term target, the more quickly market participants will adjust their own pricing policies, and therefore the shorter will be the period of transition to price stability.

5. There are two features common to the conservative-Keynesian approach and the monetarist one which are often missed. One is that both acknowledge the inevitable short-term social cost inherent in their prescriptions. The other is that both insist on the credibility factor which, through the formation of expectations, may directly influence the behaviour of prices and wages and therefore decisively shorten the period of transition to price stability.

Two substantial differences remain. At first sight the most important would seem to concern their attitudes towards incomes policies. I have some doubt as to whether this difference should really be regarded as substantial, except for adherents of the extreme views. Can one not say that any monetary policy that insists on the need to break inflationary expectations, and therefore on credibility, contains an element of incomes policy?

There is a second difference, however, which seems to be insurmountable, and this relates to the choice of the variable through which the credibility effect is supposed to be transmitted. To be quite specific, the greatest difference lies in the importance attached to the short-run level of, and fluctuations in, interest rates as well as to the perception of abundance or shortage of loanable funds. The conservative Keynesian would argue that even in a period of slack, interest rates should remain positive in real terms and credit should not be abundant. The monetarist would argue that full respect of the money supply target is a necessary (and sufficient) condition for ensuring credibility. In a downward phase of the economy, his proposition may well entail declining, or perhaps even sharply falling, interest rates, and an abundance of loanable funds. Or, alternatively, in a period of institutional innovations, real tightness in the credit market may go hand in hand with an apparently excessive rise in the specific money supply figure selected as an intermediate target.

I feel that in this field there is much room for debate. The sharp volatility of interest rates implicit in the monetarist approach raises problems of its own even from a strictly domestic point of view. It raises even bigger ones internationally. If the monetary authorities of some countries continued to view interest rate levels as intermediate targets for achieving internal and/or external balance, while others were determined to follow the strictly monetarist prescription, difficult problems could appear for the monetary management of several countries.

Let me finish where I began. You should feel in no way constrained by these remarks in presenting your own views. I intended merely to raise some broad, background questions so as to avoid that our continuing technical discussion concerning the use of instruments and operational techniques takes place in a vacuum.

## Chapter XIII

# Fighting Inflation Through Monetary Policy: Success or Failure?

1981

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*With inflation receding, but only slowly, the fight against inflation remained an important topic for Lamfalussy and the central banking community in the early 1980s. Reproduced below is a presentation he gave at the International Herald Tribune Conference on “The Management of Foreign Exchange Risks” in Paris on 23 November 1981. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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My short answer to this highly topical question is: a moderate success – so far. This is an unenthusiastic answer, and a qualified one. The lack of enthusiasm stems from the observation that success has been far from universal and that, where there has been success, it has been modest – the only major exception being Japan. The qualification “so far” reflects my fear that the high current levels of unemployment may trigger political and, therefore, policy reactions which would in effect throw out the baby with the bath water, i.e. commit the major mistake of abandoning conservative monetary policies altogether. This is a fear, not yet a forecast; my purpose today is to put to you some thoughts about the ways and means of preventing this apprehension from becoming reality.

The three large countries which have witnessed an improvement in their visible inflation performances over the last year or so are the United States, the United Kingdom and Japan. The yearly rate of increase in consumer prices declined between September 1980 and September 1981 from 12.7 to 11.0 per cent, in the United States, from 15.9 to 11.4 per cent, in the United Kingdom, and from 8.9 to 3.9 per cent, in Japan. On the other hand, the performance of continental European countries has been, to say the least, more mixed. Over the same time

span the German, Swiss and Belgian inflation rates increased, although they remained lower than the OECD average, while French inflation was running at the same relatively high level of 13.7 per cent. On both dates, Italian inflation moderated somewhat from 21.3 to 18.3 per cent, but remained the highest among the G-10 countries.

Part of these differences can be ascribed to exchange rate developments: for instance, Germany, Switzerland and Belgium have clearly suffered from the price-raising impact of the decline in their effective exchange rates, while Japan has derived some benefit from the renewed strength of the yen, just as the United Kingdom has continued to benefit from the earlier strong appreciation of sterling. When one tries to look behind the “veil” of exchange rate changes, some comfort can be derived from the fact that the underlying inflationary pressures of domestic origin have abated in most countries, though not on any striking scale. This can be seen from the relatively reassuring money and real wage developments in quite a few countries and from the smaller rise in unit labour costs in some of them, as well as, more broadly, from the comparative evolution of GNP deflators.

I have little doubt that this moderate success in the fight against inflation owes a lot to the more conservative turn taken by monetary policies in the context of the second oil shock. This somewhat woolly term “more conservative” is used deliberately since I cannot here enter into the academic debate on how to measure the degree of tightness of monetary policies. Let me simply note that whatever indicators you care to pick out – rates of growth of nominal or real monetary aggregates, the level of nominal or real interest rates – there is fairly clear evidence that monetary policy has been exerting a restraining influence in most industrial countries. While credit has perhaps nowhere been really tight, in the sense of rationing expenditure directly, it has certainly not been cheap, nor over-abundant.

Let me now turn to the much more controversial issue of how monetary policy is supposed to put a brake on inflation. As I have just said, I believe that monetary policy has performed a useful role in this respect. But how has it done so? And how can it continue to play an active and useful role in fighting inflation?

This raises the tricky question of how the transmission mechanism (to use economists’ jargon) operates. On the answer to this question naturally depends all policy judgement and it is therefore central to any articulate debate. Mine is



an eclectic answer. I certainly share the monetarists' view that an "appropriate" monetary policy is an absolutely necessary condition for achieving success in the fight against inflation. In saying this I oppose those who hold the view that price increases originating from upward cost pressures should be fought primarily by means of incomes policies and administrative regulations. But I part company from the monetarists when they define the "appropriateness" of monetary policy exclusively in terms of the rate of growth of the money supply, and when they turn a blind eye to the considerable social costs involved when, in a world that has grown accustomed to living with the cost/price spiral, inflation is fought uniquely by means of monetary policy. Of course, in adopting a more eclectic position I expose myself to criticism from both sides – but this is a professional risk I have become used to taking. Let me spell out my position in these matters with three propositions.

The first is that the main channel through which monetary policy affects the rate of increase in prices and incomes is by exerting restraint on expenditure, either by reducing its level or by depressing its rate of growth: in other words, by maintaining, or creating, some slack in the economy. The natural corollary to this proposition is that monetary policy, if it is to be anti-inflationary, should be conducted in such a way as to effectively restrain spending. This will have to involve a slowdown in the rate of growth of the money supply, but also positive real interest rates and, depending on the institutional framework, which varies so much from country to country, possibly some direct action on banks' credit-granting ability or even, in some isolated instances, credit rationing.

The second proposition is that, owing to rigidities in price and income formation, this will not be enough. Or, to put it somewhat differently, most economies would have to endure very high unemployment of men and machines for a very long period if inflation were to be brought down to tolerable levels exclusively by means of expenditure-restraining monetary policy. It could be argued that, even so, the objective of price stability is unlikely to be reached within any socially or politically acceptable time span. Today's inflation is not the result of post-war disorganisation, or of a sudden, brutal expansion of money expenditure, of the kind that on two occasions in the past led to hyper-inflation in central Europe. It is not a business cycle phenomenon either. In most of our western industrial countries the experience of regular price increases goes back not just to the early 1970s, but to the 1950s. With few exceptions, the golden 1960s were

not that “golden” in terms of price stability. The tendency of prices and incomes to continue to rise even in a period of slack is the natural outcome of the fact that a whole generation of businessmen, government officials, house-owners and labour-market participants has become accustomed to living with inflation and at the same time gaining in their living standards. Given such rigidities, a policy relying exclusively, for the fight against inflation, on the underemployment of labour and capacities would have to carry very high social costs; and even the acceptance of such costs will not bring certain success.

Let me repeat once more: expenditure-restraining monetary policy is unavoidable if we want to put an end to inflation; and so are its costly effects in terms of lost employment and lost real income. But surely we should seek to alleviate this social cost by trying to speed up the process of disinflation. Broadly speaking, there seem to be three possible approaches towards this objective: trying to defuse inflationary expectations, implementing an effective policy of competition, and having recourse to incomes policies. I suggest that consideration should be given to trying all three of them.

The first of these approaches is to attempt to defuse inflationary expectations and, by doing so, to moderate price and wage developments directly. Monetary authorities can contribute to achieving this by taking a credible commitment to fight inflation, i.e. by announcing policy measures and by sticking to them. But what policy measures? Contemporary economists of the monetarist family have rendered great service in calling attention to the importance of inflationary expectations and to the possibility of combating them through credible, coherent and persistent policies; unfortunately, some of them have rendered a political disservice of even greater proportions by disseminating their belief that, to defuse inflationary expectations quickly and effectively, it is sufficient to announce conservatively calculated money supply targets and to adhere to them on a short-term basis. I am inclined to believe that the minds of men work in a rather more complicated way; that, given the length and diversity of our inflationary experiences, it will take a whole set of policy signals (and not just one), as well as an anti-inflationary policy stance of some duration, to persuade market participants that by putting up their prices they will price themselves out of the market. And my guess is that they are likely to pay greater attention to those policy signals that affect their life directly – interest rates or credit shortage – than to money supply figures which, after all, are mere statistical abstractions.

An example may show you what I have in mind. When in a period of recession the demand for money falls, adhering to a target of steady growth in the money supply may entail a sharp drop in short-term interest rates. Is there not a risk that such a decline in interest rates will be considered by many as a sign that the anti-inflationary stance of the monetary authorities has been abandoned? If there were a risk of this kind the authorities would be fully justified in accepting a temporary undershooting of their money supply target in order to strengthen the credibility of their commitment to fight inflation. This could moderate the drop in interest rates. That such a policy course will not help to counteract the emerging recession only underlines the fact that there is no painless way out of a long period of inflation.

Since I do not believe that there are any magic tricks by which inflationary expectations could be quickly and decisively defused, I have reluctantly come to the conclusion that either we accept a long period of high unemployment in the hope that this will best serve the cause of price stability, or we have to explore the two other approaches: namely, that of an effective policy of fostering more competitive markets, and that of a policy of incomes restraint.

The purpose of an effective policy of competition is to remove market imperfections, i.e. obstacles to the actual price and income declines which would normally be produced by the slack resulting from expenditure-restraining monetary policy. Good positive examples of such measures are deregulation or the promotion of professional and geographical labour mobility. Negatively speaking, assistance given to declining industries, encouraging cartel agreements, enforcing minimum prices, raising tariff barriers or otherwise limiting imports are all measures in direct conflict with an effective anti-inflationary policy. Why should the authorities create a slack with their left hand if with their right hand they prevent prices from effectively falling? No argument in favour of practical politics can justify such inconsistency.

As for the third approach – incomes policies – it should in no case be regarded as an alternative, but rather as a complement, to conservative monetary policies. I have been criticised for having advocated this view in the recent past. I can readily see that the consensus that is needed in order to implement an incomes policy that does not get lost in the labyrinth of bureaucratic mismanagement and can be applied with some flexibility is simply not available in all countries. What

I do hope is that my critics will admit that it is available in some others. In this particular field, just as in that of monetary policy signals, we must accept the fact of diversity among our western industrial countries and refrain from facile and unjustified generalisations – which should not exclude that on occasion we may learn from each other's experiences.

Now let me come to my third proposition, which I left to the end because it is the most important one in a longer perspective. It is by no means irrelevant, from the point of view of future growth, what kind of expenditure is restrained by applying tight monetary policies. It seems to me inevitable that monetary restraint puts some brake on investment as well as on consumption. But the point is that when a tight anti-inflationary monetary policy is accompanied by a fiscal stimulus, i.e. by a high or rising public-sector borrowing requirement, the chances are that this combination will lead to unduly high real interest rates, as can be seen just now in several countries. The brunt of the restraint will then fall on the corporate sector and, therefore, on business capital formation rather than on consumption. I have some difficulty in seeing how such a policy mix, which, I should like to stress, is common to all industrial countries, could allow our economies to adjust themselves to the second oil shock and prepare the ground for the resumption of non-inflationary growth and the resorption of unemployment.

These, then, are the reasons for the unenthusiastic and qualified answer given to the question raised in the title of my address. My only hope is that the disappointing experiences of all our countries in the difficult fight against the twin ills of inflation and unemployment will gradually pave the way both for a better understanding of how our economies work and for more balanced policy approaches. There are some encouraging signs that a learning process is under way among both economists and policy-makers. It should be speeded up to prevent the pendulum from swinging back towards the policy mistakes of the early 1970s.

## Chapter XIV

# The Role of Banks in Balance-of-Payments Financing

1981

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*The debt build-up, especially in Latin America, was a major concern for Lamfalussy in the second half of the 1970s and the early 1980s. In this address, at the Inaugural Annual Meeting of the Euromarket Institute in Vienna, 14-16 May 1981, he publicly warns against a “sudden stop” in lending by commercial banks to countries with balance of payments deficits. Furthermore, he argues for gradual adjustment of balance of payments imbalances, with the IMF having a role in the process. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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International bank lending has so far played a decisive role in financing the external imbalances which have increased so significantly since 1973 under the impact of the two successive oil shocks. On balance, this role has been beneficial to the world economy and, it is to be hoped, profitable to the banks. It is therefore in the interest of both that international bank lending should continue – if only because demand for balance-of-payments financing is likely to remain strong and other capital flows may prove too small and insufficiently flexible to replace it adequately. Whether it can continue will depend not only on the orders of magnitude involved – which do not seem to be such as to create insuperable problems for the banks – but also on the kinds of policies pursued by the authorities and the banks themselves.

This, in a nutshell, is the line of argument I propose to put to you.

Let me begin by reminding you how banks have helped to finance the deficits of a few groups of countries. During the seven-year period 1974-80 the developed countries outside the Group of Ten ran a cumulative current-account deficit of

over \$100 billion. During the same period about one third of this amount may have been covered by their net borrowings from the international banking system. For eastern Europe and the Soviet Union the two figures are almost the same: both come close to \$30 billion. The non-oil LDCs' total cumulative current-account deficit was about \$210 billion; their net borrowings from banks came close to \$100 billion, with the proportion rising during the last two years, and gross borrowings being of course much greater, since many of these countries have also built up their deposits with banks during this period. During the last quarter of 1980, net borrowing by non-oil LDCs was around \$12 billion. Finally, a substantial proportion of the current-account deficits of the Group of Ten countries was also financed by bank credit.

Should these developments be regarded as a good thing or a bad thing? I will not answer this question from the point of view of the banks – although I suspect that, had they not found the profit/risk trade-off acceptable, they would not have become so heavily involved in international lending – but from the point of view of the broader interest of the world economy.

There are two obvious grounds for saying, almost instinctively, that the banks' role in balance-of-payments financing has been beneficial to the world economy. The first is that without the recycling of the oil surplus by the banks, especially in 1974-75 and in 1979-80, the world economy would be in even worse shape than it is today. Neither other types of private capital flows nor official financing could have performed this function fast or efficiently enough. Therefore, in the absence of intermediation by banks world economic activity would have been depressed to much lower levels. This point hardly needs to be elaborated further.

The second reason is that, contrary to widely-held beliefs in the 1960s, in more recent years capital flows through banks have hardly ever aggravated current-account imbalances. As we have just seen, they had exactly the opposite effect in the case of the oil deficit. But this is also true, admittedly with a few exceptions, of the non-oil imbalances.

Leaving the realm of the obvious, let me now turn to three areas of concern in regard to international bank lending. In discussing these, I shall have to qualify my "instinctive" answer somewhat.

One area of concern is international liquidity. There can be little doubt that the significant increase since 1973 in total foreign currency reserves held by central banks has largely been the direct outcome of international bank lending. There can also be no doubt that this process of reserve creation is not “controlled”, in the sense that it is not the result of concerted government action, nor is it supervised by international organisations. Both these statements are correct, and may justify some longer-term concern over the working of our present international monetary arrangements. I do not think, however, that there is cause to worry just now about the inflationary potential of these reserve increases. Firstly, in real terms the rate of growth of international trade declined to about zero in 1980. Secondly, the current oil-induced balance-of-payments deficits are still very big. Thirdly, a number of countries have been actively using their reserves to finance such deficits. Lastly, it should be borne in mind that international bank lending cannot lead to a net increase in international reserves.

Another area of concern is the banks’ role in the efficient allocation of international savings – or, to be more specific, their ability to judge whether it is really in the world interest that countries should be allowed to run persistent current-account deficits. According to ordinary economic theory such deficits are, broadly speaking, acceptable provided that the funds which finance them are put to better use in the capital-importing countries than they would be in the capital-exporting ones. This would be the case if the counterpart to a current-account deficit were increased investment rather than consumption, and if such additional investment were to yield a higher real return than in the saving countries. This is the typical justification for LDCs running current-account deficits. I would be ready to subscribe to the view that ideally these kinds of deficits ought to be financed by long-term capital flows – direct investment, project loans, bond issues and so on – in order to ensure a direct link between finance and investment and at the same time to provide the borrowing country with a more manageable pattern of debt service charges. All this is fine; I am very much in favour of stimulating such capital flows. But what if they are not forthcoming in sufficient quantities? Should developing countries be forced to adjust, and by so doing depress world activity? Clearly, medium-term bank lending is a workable alternative, even if only a second-best solution, for development finance. But we do not live in a perfect world.

The third problem area is the role played by bank lending in balance-of-payments financing, including the financing of consumption in deficit countries. There are two points to be made here. Firstly, as long as the oil imbalance persists, large-scale financing will be needed for oil-induced deficits. Secondly, however, deficits also arise as a result of inflation differentials, cyclical de-synchronisation between countries, or simply mismanagement of the domestic economy. In most of these cases adjustment is desirable, and the question arises as to whether bank lending helps or hinders the process of adjustment.

My answer to this question is similar to the one I have just given to the previous question. As a rule, official organisations are better equipped than banks to grant conditional loans and it is conditional loans that are needed in these circumstances. There are not many examples of successful conditional lending by the private-sector banking system; and in the absence of a pre-negotiated programme of gradual adjustment, the only way private-sector banks can set domestic adjustment policies in train is by stopping lending. This has happened in some cases; and when it did happen, it did so fairly abruptly. Gradual adjustment, undertaken at a relatively early stage under the wisely-dosed pressure of conditional lending by the IMF, would clearly be preferable to such drastic, but belated, medicine. But, again, it is unrealistic to expect the IMF (or, for that matter, any other international organisation) ever to be endowed with resources sufficient for it to take over a high proportion of balance-of-payments loans from the private-sector banks. And I might even add that I would have some misgivings about a utopian world in which one central organisation – and only one – was responsible for negotiating adjustment policies with individual governments. My answer, then, is this: let the private-sector banking system continue balance-of-payments financing even if the result is only less than optimum adjustment; and let the IMF be given adequate resources so as to enable it to bring sufficient pressure to bear on borrowing countries to make them effect the necessary adjustment.

The upshot of all this can be summed up quite briefly. Yes, banks do create international liquidity without control, i.e. in the sense that the market mechanism works without “control”. Yes, the international allocation of savings would be better handled by long-term capital flows. Yes, private-sector bank lending is not always conducive to optimum adjustment, since it has in some major cases led to “over-financing”. But there is no practical alternative to large



scale balance-of-payments lending by banks: the current and prospective payments imbalances are such that the world economy could not function without the continued participation of banks in the recycling process.

Now let us assume that international bank lending continues at its current rate. What might happen in such a case to the balance-sheet structure of the private-sector banking system?

In trying to answer this question, I have made some very rough extrapolations concerning the US banking system. Not that the other banking systems do not matter, but simply because the US figures are easier to collect. Even so, please take these figures with a pinch of salt and keep in mind only the very broad orders of magnitude. At end-1973 the share of external assets in the US banks' balance sheet on a worldwide consolidated basis (i.e. including their foreign branches) was probably somewhere around 13 per cent. Their international exposure measured in this way rose to about 19 per cent, at end-1976, and may have reached 22 per cent by mid-1980. In absolute figures, this represented average yearly additions to their external assets of \$25-30 billion. Trendwise, these additions have been fairly steady over time (although they sharply fluctuated from one year to another), which is another way of saying that the yearly percentage increase in external assets has decelerated. Now, assuming that this pattern of growth continues during the next four years, and that at the same time domestic assets grow by 7-8 per cent, per year, by end-1984 the share of external assets in the consolidated balance sheet of the US banking system will probably not be above 25 per cent – a not insignificant but far from dramatic change from the present situation. As for European banking systems the percentages are in some (but not all) cases higher, but the increase in these higher percentages would not be dramatic either.

The tentative conclusion I draw from this exercise is that continued substantial participation by the western banking system in balance-of-payments financing would not produce drastic shifts in balance-sheet structures, and would therefore not pose unmanageable problems for banks from this particular angle.

It is, of course, true to say that since the second oil shock the world has become a more dangerous place to live in, and, accordingly, the same figures of international involvement may in fact entail a higher risk. Between the end of

1978 and the end of 1980 non-oil LDCs more than doubled their net debtor position vis-a-vis the international banking system from \$44 to 102 billion. As a result of the sharp rise in interest rates, the real burden of this debt probably increased faster. And, clearly, more is to come: the recycling process has been relatively easy so far, since a high proportion of the oil deficits this time has been located in the financially strong Group of Ten countries. This will not last, and part of the deficit will be shifted over to the LDCs, or to the weaker developed countries. Last but not least, claims on specific individual countries have reached in some banks – even in some banking systems – levels that are too high in relation to their equity. And, more generally (but with a few healthy exceptions), the banks' capital base has been gradually eroded over the last ten years.

What should be done, in these circumstances, to alleviate the riskiness of international lending?

As far as the authorities are concerned, the main step that has to be taken is to ensure that the IMF's resources are effectively, and significantly, enlarged. The agreement that has just been signed with Saudi Arabia is a welcome move in this direction, and both the Fund and the Saudi authorities deserve praise for this successful negotiation. Other agreements, and perhaps borrowing from the market, should follow, but in the longer run the best route is that of quota increases. It should also be recognised that the likely persistence of the oil surplus will make new kinds of adjustment policies necessary in order to maintain the viability of the international financial system. Greater emphasis should be placed on structural or, to use the fashionable term, "supply-side" policies. At the same time, the old recipes of global macro-economic adjustment – demand-restraining fiscal and monetary policies – should not be forgotten. Clearly, global demand restraint cannot adjust away the whole of the oil deficit, except at the cost of a world depression which, I trust, I can rule out. But demand restraint should be allowed to play an important role in the case of individual deficit countries, if only to "shift around" the oil deficit and thus prevent the emergence of protracted, stubborn, deficits which are the really dangerous ones from the point of view of the safe functioning of the international financial markets.

What about the banks' angle? It is not within my remit, nor am I competent, to tell the banks how they should adapt their management structure, administration and policies in order to take account of their heightened international exposure.

But it is my job to call the banks' attention to the need for them to participate more constructively in the adjustment process. There have been at least two major instances in the recent past, and several minor ones, of banks offering far too much credit to deficit countries. They did so at a time when information was available both about the degree of indebtedness and the economic situation of the countries concerned. The IMF's role cannot and should not be restricted to situations in which the borrowing country has no other alternative left but to solicit official financing at the price of drastic adjustment measures. For adjustment to be early, banks will have in all cases to accept a more cautious lending policy and, I may perhaps add, governments should not prevent such efforts by involving them in large-scale export-credit financing at times when this may also lead to over-lending and the emergence of "sticky" deficits.

Last but not least, countries at the receiving end of balance-of-payments financing have to adapt their own policies to improve the transfer process of real resources. Even the best combination of bank and official financing will be a poor substitute for long-term capital flows; and the responsibility for promoting these flows lies as much with the capital-importing countries as with the exporting ones.

## Chapter XV

# Concluding Session on Monetary Control Considerations

1983

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*In the early 1980s, central bankers became more and more concerned about financial innovations. Initially, this concern was strongly focused on the implications for monetary policy, especially monetary targeting, as financial innovations led to “missing money” in money demand functions. In this paper, written for a Bank of England Conference on the Implications of Developments in Monetary Systems on 20 May 1983, Lamfalussy takes a cautious attitude towards financial innovations because of their potential implications for the conduct of monetary policy. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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Mr. Chairman, may I begin by apologising for having been absent for the greater part of the meeting, as a result of which I am in the fortunate or unfortunate position of not being able to sum up the discussions in the proper sense of the term. You will have, I am afraid, to put up with some rather impressionistic and certainly biased observations.

I would like to begin with a general remark which I have already made at a number of other meetings but which is worth repeating here. I am struck by the sharp contrast between the legitimate concern expressed in the United States about the difficulties encountered in the conduct of monetary policy because of the flow of financial innovations and by the lack of concern in this respect in most other countries the United Kingdom being, perhaps, the sole major exception. This old story raises the intriguing question of what it is that makes the United States so different from the rest of the world. Is it that the monetary policy technique used in the United States creates particular incentives for innovation?

Or is it that for some other endogenous reasons financial innovations there are more widespread, are developed faster and affect the financial institutions more broadly than elsewhere? I somehow have the impression that both these explanations have to be taken into account. The particular type of monetary control technique which is used in the United States does lead to innovations of certain kinds; and it may well be that financial entrepreneurs have in fact been more innovative in the United States than elsewhere for some other reasons. But I also feel that financial innovations may have been taking a different course in some other countries than in the United States. My point is that, in fact, a number of innovations do occur, say, in continental Europe, but somehow we fail to recognise them.

I should like to give two examples underpinning this belief. One is that in a number of countries, especially smaller European countries with widely “open” economies, financial innovations, especially in the banking field, have taken the international route. This certainly applies to Belgium and Switzerland, two countries with which I am familiar. The development of international connections between their banks and the external world through the Euro-currency market has played a very active role in changing banking practices; and if you overlook this, you get the false impression that there have been no financial innovations in the banking industry. Major changes in wholesale banking practices, such as the generalisation of floating rate bank lending, have occurred via the international route. The same applies to active liability management, or to the management of banks’ liquidity positions via foreign exchange transactions. A second reason why we may have the impression that innovations do not occur in some countries is that many innovations take place within institutions. Take the case of universal banking in Germany and Switzerland but also in Belgium or France: innovations take place within the banks themselves. To give you just one example: the development of mutual funds (or of unit trusts) was sponsored by the banks. As a matter of fact, fixed-interest mutual funds, taking in their portfolio bonds denominated in foreign currencies and in domestic currency, originated in these countries and in these banks. I speak from experience, since in my earlier incarnation, I played a role in putting one of these funds on the market.

My second general remark reflects my intellectual discomfort derived from my lack of understanding of what are the driving forces behind financial innovations. The little I have heard in this discussion and what I have read in the papers have not relieved this discomfort. Ideas have been put forward: deregulation has often been mentioned as a possible cause, growing competition (partly as a result of deregulation or for other reasons) and technological changes in payment systems as well. But I must say this leaves me somewhat dissatisfied – I don't think that we have the whole story. I have no general theory to propose to you, but let me just try out a few broad ideas.

One causal factor which seems important (and that was mentioned in Mr. Corrigan's paper right in the introduction) is inflation. The rise in inflation rates has certainly played an important role in at least three ways. Firstly, by raising the nominal level of interest rates and therefore the opportunity cost. Secondly, by spreading the habit of floating rates, either on securities or on bank lending and thirdly, it certainly had something to do with the shortening of maturities. To complicate things, of course, a new experience is that many of our countries have now entered a period of disinflation. How this will affect financial innovation I simply don't know, but I am ready to bet that it will have some sort of effect. Will it simply wash away earlier innovations or will it create new ones? Only time will tell.

A second major causal factor behind financial innovations might well be growing uncertainty. One uncertainty I have just mentioned clearly relates to the future course of inflation: are we in the process of winning the war, or just a battle, in the fight against inflation? Fluctuating inflation rates undoubtedly create a great deal of uncertainty for both lenders and borrowers, who may well perceive them quite differently, i.e. asymmetrically. Another uncertainty is that surrounding the development of corporate profitability, with its effects on stock prices. A third area in which uncertainty has increased over the last ten years is that of currency fluctuations. The development of ECU-denominated financial transactions on a surprisingly large scale may be due to this. Finally, sharp fluctuations in interest rates have clearly been a driving force behind the development of the financial futures market.

The third motivation to undertake financial innovations, especially in the large labour-intensive financial institutions, is sheer cost-consciousness. Cost control

in the major banks is a very important factor in the propagation of technological innovations.

As an introduction to my comments on how innovations might affect the conduct of monetary policy, let me just make one iconoclastic remark triggered by an observation made by Peter Cooke this morning. He said that supervisors never question that financial innovations are a good thing. Well, in some of my more courageous moments, I do. It doesn't seem to me intuitively obvious that on balance financial innovations are a good thing. They lead, or are supposed to lead, to increased efficiency; they help market participants to protect themselves against inflation, disinflation, uncertainty and so on; I don't doubt that this is a good thing. But they also create a few problems. If you are protected against inflation you may feel able to live with it – this is the familiar German concern with the indexation of securities, or even with floating rates. But, even more importantly, (and now I am coming to monetary policy) innovations may make the life of those who manage monetary policy much more difficult. You may say that this is just too bad for them – they should try to live with these difficulties – but if the result is that we end up in a monetary policy mess, and therefore major policy mistakes, (and not simply with professional discomfort for the practitioners of monetary policy), then I begin to have doubts about the balance of pros and cons.

Turning now to the potential effects of innovations on the conduct of monetary policy, I shall limit myself to suggesting a sort of framework for discussion, by regrouping these influences under three broad headings. These distinctions are, of course, somewhat arbitrary; the influences, in fact, overlap.

The first way in which innovations may create difficulties for monetary policy is by aggravating what I would call the identification problem in a narrow sense. This is the typical current US problem concerning the definition of the various aggregates. I am not saying that this is not a serious problem – it is a very serious problem – but it can conceivably be solved with experience by redefining the aggregates.

Secondly, there is an identification problem in a much broader sense which does not arise simply in those countries that rely (or have been relying – I do not know which tense I should use) on targeting precisely defined monetary aggregates. The question is how to identify the stance of monetary policy. Taking the example

of a desired monetary policy restraint, how do we know that monetary policy is actually “biting”? I think our hosts are familiar with this problem. Should one look at the aggregates? Which ones? At interest rates? Real or nominal ones? How should one interpret the level of interest rates in a world of generalised floating rates? Should one look at the exchange rate, at the rate of growth of nominal GNP or – horrible dictu – at the degree of slack in the economy? Is it at all possible to identify the impact of monetary policy on the economy by taking monetary policy in isolation from fiscal policy?

Thirdly, there is the most fundamental problem of the efficiency of monetary policy, and by efficiency I mean how particular actions of the central bank in the end affect nominal GNP. To put it more precisely: do financial innovations affect the transmission mechanism, and if so, how? The answer to this question is clearly connected with the one you give to the previous ones.

Let me conclude by taking up a point that was made in John Fforde’s paper and was reverted to this morning. Would it be justified, in the kind of world in which we live, to use supervisory or prudential controls as a “macro tool” for monetary policy? The question was raised with reference to experience in the United Kingdom, where better supervision or stronger prudential controls could possibly have had a constraining influence on final spending. I recall some meetings we had three or four years ago in Basle on a similar problem, but which arose in the international context. As a result of a US initiative, the idea was put on the table of controlling the growth of Euro-market lending by applying to the Euro-banks non-interest bearing compulsory reserve requirements, i.e. a special monetary policy tool. The result was a lengthy and very interesting discussion which ended with the US proposal being rejected. However, since many of the participants felt concerned about the very fast growth of international bank lending, and since no generally acceptable monetary policy tool could be found to control this growth, the problem was passed on to the supervisors, with the idea that they could possibly devise means of moderating the enthusiasm of the banks for international lending by applying prudential pressure, i.e. by calling the banks’ attention to the need for applying proper prudential standards to international lending. That was even said in a public communique. I am quite sure that all supervisory organisations transmitted that message to their banks. And what happened? International lending continued to expand at the rate of 20 to 25 per cent, per annum – until its radical slowdown last year, in circumstances



we all know about. If analogies are of any good, we should not derive from this experience any great encouragement for the use of prudential measures for monetary policy purposes. With this melancholic warning I conclude my remarks.

## Chapter XVI

# The Changing Environment of Central Bank Policy

1985

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*In December 1984, Alexandre Lamfalussy addressed a joint luncheon of the American Economic Association and American Finance Association. It was published in the American Economic Review, May 1985, Vol. 75, No. 2. Here, Lamfalussy takes a broad look at the challenges confronting central bankers. He discusses four interconnected evolutionary processes: disinflation, internationalisation, innovation, and deregulation. He focuses a lot on financial innovations, going not only into the consequences for monetary policy, but also into the prudential implications. He raises the issue of the impact of the redistribution of risk by financial innovations on financial stability. Reprinted with kind permission of the American Economic Review and the Lamfalussy family.*

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It was more than a year ago that Charles Kindleberger extended to me his flattering invitation to address this joint meeting of the AEA/AFA. At that time we discussed various possible topics, but eventually decided to leave the title as vague as possible, on the grounds that this should allow me to take up the intellectual challenge of speaking on whatever financial crisis might have conveniently cropped up by the time of the meeting. Well, much in line with the fate besetting current economic forecasting, our timing was amiss: no crisis seems to be at hand.

I do not want to take the easy way out by frightening you with possible future crisis scenarios, only to end up by trying to persuade you that (despite the numerous wrongdoings of governments and even the occasionally silly behavior of market participants) the naturally enlightened and effective cooperation between

central banks will either avert the crisis or at least contain it. As an alternative to this somewhat uninspiring approach, I propose to offer you a few reflections on some of the more fundamental problems that monetary policy makers are facing today, both domestically and internationally, and for the handling of which they would be delighted to receive from the academic community some operationally usable advice – the stress being on “operationally usable”.

I should like to focus my comments on two points. The first is that the financial systems of the main Western industrial countries are in the midst of not one but, in some cases, as many as four interconnected evolutionary processes: disinflation; internationalization; innovation; and deregulation. The second point is that unless I am hopelessly behindhand in my reading economic theory provides us with only limited guidance for managing our monetary affairs in such a complex process of structural adjustment and institutional change; nor can the observation of history give us much help towards understanding a situation which seems to be without precedent.

Let me begin with a few remarks on the management of the disinflation process. Under the impact of concerted anti-inflationary monetary policies initiated in 1979-80, inflation rates have over the last few years been declining more or less rapidly in all industrial countries. With the exception of a few countries they are, however, still at levels which would have been considered alarmingly high during the early 1960's. Moreover, what we know both from survey data and by inference from the level of interest rates suggests that inflationary expectations have been even slower to move downwards. The crux of the matter is that a slow process of disinflation of this kind carries with it, almost by definition, a good deal of uncertainty regarding future inflation rates – otherwise inflation could not be so sticky. This, in turn, implies that a considerable number of market participants are entering into contracts on terms that will inevitably prove costly for them; in other words, we are far from having seen the last of the casualties, either in the field of international lending or domestically, that are the normal corollary of disinflation. At the same time, the very slowness of the process also implies a continued high cost in terms of unused resources and unemployment. For both these reasons, there is the risk of a political reaction against the process of disinflation itself. On the other hand, an anti-inflationary shock treatment might well have been even more painful, with heavy costs being implied in both the short and long run.

These developments raise at least two sets of questions for policymakers. First, is there any practical alternative to slow disinflation? Is “shock treatment” a genuine alternative? Note that history provides us with good examples of quickly successful disinflation only after phases of hyperinflation, not after the sort of long-lasting, creeping inflationary process which has permeated and distorted most of our Western industrial countries over the last fifteen years or more. In the absence of historical precedents, can theory provide any guidance? There have been a few interesting pieces of analysis of the question of shock treatment vs. gradualism, but the academic debate has remained remarkably scant.

Second, on the assumption that the current policy course is the only practicable one, what are its implications for the prudential side of central banking policies? Can manifestations of financial fragility be taken care of by the normal market mechanism, or does their containment require specific lender-of-last-resort intervention by central banks in order to prevent domino effects? Here, too, I would much welcome a wide-ranging theoretical debate on the mechanics of financial adjustment during a slow process of disinflation, as distinct from crisis manifestations at cyclical turning points.

While I could imagine convincing answers to these questions when viewing the process of disinflation within one closed economy, my imagination begins to falter when I look at this process within the framework of the growing internationalization of domestic banking systems. Whatever ratios you care to consider – the share of external claims or liabilities in the total balance sheet, the relative importance of balance-sheet items in foreign currency, the size of income flows derived from international operations – they all point to a large and increasing international exposure of the domestic banking systems. The story of financial integration is also reflected in the cross-border transmission of interest rate developments. Interest rate parity holds almost instantaneously in the Euro-currency market; but, what is more important, there is growing statistical evidence of strong interconnections, even under floating exchange rates, between interest rate developments in the major domestic markets. Moreover, the fact that a number of countries, and within these countries private firms, are indebted in foreign currencies means that interest rate developments in these currencies can have a totally unexpected impact on the financial ratios of such debtors. In general, financial impulses emanating from the United States are transmitted remarkably quickly to other financial centers, despite fairly generalized floating.

Interest rate “de-coupling” has been possible only within certain limits and by certain countries. Similarly, floating has not prevented strong international transmission links via the “real” side of the business cycle either.

In the best academic tradition, much recent research has gone into analyzing the implications of this state of affairs for exchange rate determination and for the international transmission effects of shifts in the policy mix of a large country, in particular of the United States. This research confirms the day-to-day experience of policymakers, namely that in a financially integrated world no country can isolate itself from the others, no matter what its exchange rate regime. To mention just one example, even determined domestic anti-inflationary policies can be thrown off balance by a real effective exchange rate depreciation induced by capital flows. This clearly raises major policy issues to which there are no unequivocal answers, but I certainly have no grounds for accusing academic researchers of any benign neglect of these problems.

I do, however, have the uneasy impression that insufficient academic work has been devoted to analyzing some other implications of international financial integration. One specific problem area concerns the question of whether the growing across-the-border interdependence increases, or on the contrary, diminishes the fragility of the Western countries’ banking systems. More perfect competition would seem to point to greater resilience, that is, to the ability of the system to take care of itself without any lender-of-last-resort intervention. On the other hand, it does not seem evident to me that more active competition in some fields (i.e., internationally), coupled with continued market imperfections in others (i.e., domestically), add up globally to more perfect competition. I shall return to this question shortly, when reflecting on the subject of deregulation. Another much broader area concerns the normative evaluation of the effects of greater financial integration (i.e., of speedier and much larger financial flows) on a world economy in which international direct investment flows remain limited and which at the same time is exposed to increasing trade barriers or to new types of trade distortions (for example, countertrade). This is Bretton Woods turned upside down – a kind of topsy-turviness which, in my physiocratic simplicity, I view with some suspicion.

The third evolutionary process has to do with the accelerating speed of financial innovations, particularly in North America and the United Kingdom, but also in quite a few other countries, though there, perhaps, attended by less publicity. This process is fueled by market participants' desire to hedge against the uncertainty generated by interest and exchange rate volatility (and is thus partly a reflection of inflationary developments), to circumvent regulations or to avoid taxes, to take up opportunities offered by deregulation or new technology, or simply to respond to market pressure. The result is a flow of new instruments and new techniques, and the blurring of dividing lines between institutions as well as between markets.

Central banks operating in such a fluid environment encounter a variety of problems. There is the problem of identifying suitable targets among the monetary aggregates, broad and narrow, and of recognizing circumstances when it seems appropriate to deviate from these targets. At a time when almost all bank liabilities are beginning to carry interest, I fear that the concept of transactions balances itself may be becoming elusive. Then, second, there are problems related to the narrowly defined monetary control techniques, that is, to the operational methods by which central banks try to hit their targets. Third, central banks would like to know whether and, if so, how the transmission mechanism from these targets to nominal income is affected, for example, by the proliferation of new instruments, the spreading use of floating interest rates or of financial futures.

Fourth, there are the prudential implications of innovation. What should be done, for instance, on a purely technical level, with (a number of balance-sheet items listed as contingent liabilities, or with the host of intermediary balance-sheet items classed somewhere between equity and "traditional" liabilities? How should minimum capital ratios be established? Should such ratios be established at all? Are they not going to produce "evasive" innovations? What are the macroeconomic implications of assigning greater control responsibilities to the supervisory authorities? More fundamentally, we should try to assess the systemic effects of the redistribution risk realized by means of some of these new techniques and instruments. You may argue that when risk-averse market participants shift risks associated with unexpected interest and exchange rate developments onto willing risk takers, everybody is going to be better off. This may well be the case,

but increased collective happiness does not necessarily mean greater systemic stability. Or does it?

The difficulties in analyzing these problems and, therefore, in establishing policy-oriented value judgements are aggravated by two aspects of the current trend in innovations. One is that many of them also have an international dimension. Take the example of swapping a fixed interest claim in one currency on a foreign debtor against a variable interest claim in a different currency on a domestic borrower. Note, at the same time, that the legal obligations attached to a swap are so difficult to define, even within one legal system, let alone when several systems are involved, that the word itself cannot be translated unequivocally into the legally very precise French language. The point is that I am far from sure that all participants in these swaps fully appreciate the commitments they take on. Second, and more importantly, we are confronted here with a continuous process, rather than occasional discrete steps followed by a lengthy pause. There is no time for market participants to adjust themselves fully; the process is truly a dynamic one. Take, for instance, the gradual merging of the Euro-bond market with international bank lending, which is progressively eroding the usefulness of traditionally defined international banking statistics and removing the little transparency which we have managed to create in this particular field. What could be the consequences of this vanishing transparency for the decision-making process of market participants or for policymakers?

Let me now say a few words about deregulation – a topic of great interest in this country as well as in others. This, too, is an ongoing process, rather than a quantum jump from a fully regulated to an entirely free financial system. And if we consider the worldwide financial system, it becomes evident that we are condemned to live with a hybrid system even if the legislature of any single country were to accept such a quantum jump – a remote possibility anyway.

What guidance can theory offer to central banks managing their monetary policy or discharging their prudential duties in this environment? Note that the question is not only whether an entirely free financial system is more efficient (whatever that may mean), or more stable, or more easily “controlled” (in the sense of monetary control) than a regulated one. That is an interesting question but one of little immediate practical relevance. What I should like to know is, first, how the process of deregulation, with its inevitable lopsidedness and uncertainties as to

the next steps, is working out in practice and, second, how it could be improved. A deregulated world might be better than a fully regulated one, but a lot can happen on our way from the latter to the former.

I apologize for having presented such an indigestible menu of what might look like institutional trivialities, but I think that quite a lot is at stake. I have in mind in particular the need to preserve the useability of monetary policy as the main macroeconomic policy instrument.

The practical or fundamental limitations of fiscal policy have become obvious: with government expenditure absorbing a very high proportion of resources, few Western European countries have any margins of maneuver for stimulatory fiscal policies, while, for reasons that you know only too well, the United States seems to have got stuck in the opposite direction. In such circumstances, impaired useability of monetary policy would surely have to be counted as a social cost to be set against the benefits of innovation and of deregulation in any global cost-benefit analysis.

Those of you who are familiar with ancient writings will by now have discovered my nostalgia for one of Schumpeter's main themes, namely that economic analysis should concern itself with the process of change, with its succession of cumulative or compensating imbalances, rather than with movements around some identifiable state of equilibrium. When I read his writings, more years ago than I care to remember, I hardly understood what he had in mind and dismissed it anyhow because I could not convert it into equations. As a professional participant in the current process of change affecting financial markets, and having to advise central banks on how to operate in such an environment, I am beginning to have an inkling of what he was driving at although I am less able than ever to put these thoughts into a rigorous theoretical framework. If some of you could, I am sure that practitioners of monetary policy would appreciate it.

In the meantime – “en attendant” as we would say more appropriately in French – practitioners will have to continue to practice. They cannot simply resign and take up gardening, much though some of you might wish them to. For my part, in my advisory capacity, I try to prevent them from succumbing to two opposite temptations.



One temptation is to return to complete “ad hoc-ry”, that is, to what the French would call “naviguer à vue”. This would be a grave mistake. Full discretion cannot counteract uncertainty; in all likelihood it increases it. Rules, be they monetary aggregates or an exchange rate target, are needed to provide some anchor for the wildly fluctuating expectations of market participants; to make monetary policymakers accountable for their action, including their decisions to deviate from predetermined targets; and to give them leverage in their dealings with governments and parliaments.

The other temptation is to retreat into a world of rigid rules. I hope that I have made it abundantly clear why in the present world environment I do not believe in a monetary policy based on mechanical rules. It is difficult to define such rules; it is sometimes impossible to apply them; and it would often be irresponsible to stick to them.

The road to follow is somewhere in between: rules applied with pragmatic sense of discretion. Admittedly, this is more easily said than done, but then monetary policy, like all other policies, remains an art not a science.

## Chapter XVII

# Structural Change in International Financial Markets

1986

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*On 21 January 1986, Alexandre Lamfalussy gave the Sir Purshotamdas Thakurdas Memorial Lecture in Bombay on the theme, "Structural change in international financial markets". In this presentation, he discusses the decline of barriers between national financial markets and financial innovations, focusing closely on the prudential implications. He also goes into the effects of these structural changes for developing countries. The statistical tables in the original article are not reproduced. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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I propose to deal with two distinct, although interconnected, aspects of structural change in international financial markets: the steady crumbling of barriers between national financial markets, which, for the sake of simplicity, I shall call "global financial integration", and the remarkable upsurge of financial innovation that has been spreading of late to the international financial markets from some major financial centres, notably in the United States and in the United Kingdom. My paper first surveys recent evidence. It goes on to consider the reasons for such changes in the international financial environment. Thirdly, it points to some of their implications for the international economy. In my concluding remarks, I intend to make some observations on these structural changes from the point of view of the developing countries.

## I. Global Financial Integration and International Financial Innovation: Some Recent Evidence

There have been three major phases of structural change in international financial markets; it is against this changing background that global financial integration and innovation must be considered. The first phase – the emergence and development of the traditional Euro-markets, which lasted until the late 1960s – was characterised by short-term Euro-dollar deposits which were onlent at an agreed spread over a reference rate. There was also a small but active Euro-bond market. The second phase was introduced by the launching in the late 1960s of medium-term syndicated bank credits at variable interest rates linked to LIBOR and adjusted every three or six months. Such instruments were to dominate international financial markets until the 1982 international debt crisis. The third phase – the “financial revolution” – was triggered by the international debt crisis and by the growing uncertainties – interest and exchange rate volatility – against which market participants have been trying to seek protection. It has been characterised by a rapidly decreasing volume of new bank lending and a significant expansion of capital-market activity in traditional as well as new instruments.

Let us consider first the evidence of global financial integration.

There is no unquestionable and unique definition, and therefore no simple measure either, of international financial integration, but fortunately all the available evidence points to the same conclusion: namely that linkages between national financial markets have become much closer.

A first indicator is the size of international financial flows. Medium-term syndicated bank credits rose from \$27.5 billion in 1976 to \$100.5 billion in 1982 before falling back to only \$36.6 billion in 1984 and \$12.5 billion in the first half of 1985. In terms of world exports they rose from 3.0 per cent, in 1976 to a peak of 5.9 per cent in 1982 before dropping to only 2.1 per cent, in 1984. A similar pattern is to be seen in the growth rates of external assets and liabilities of banks in the BIS reporting area. In contrast with bank credits, international bond issues generally stagnated between 1976 and 1982 – both in absolute terms and in relation to world exports. However, since 1982 there has been an exceptionally rapid expansion of volume. Whereas in 1981 they totalled \$44.0

billion, they rose to \$108.1 billion in 1984 and amounted to \$80.6 billion in the first half of 1985. In terms of world export they rose from 2.4 per cent, in 1981 to 6.1 per cent, in 1984. At the same time new facilities – note issuance facilities, revolving underwriting facilities, multiple-component facilities and other Euro-note facilities – have established themselves as a major vehicle for international financial flows. They rose in value from \$1.0 billion in 1981 to \$18.9 billion in 1984 and \$22.4 billion in the first half of 1985. Overall, new lending facilities – a measure of total financial market size – rose from 5.7 per cent, of world exports in 1976 to 9.3 per cent, in 1984.

Another indicator which reflects the closer links between national banking systems is the huge increase in the size of the interbank market between countries in the BIS reporting area. Between 1976 and 1984 the interbank market quadrupled in size, and at end-June 1985 it amounted to over \$1 300 billion.

A third indicator is the larger number of countries actively involved with the international financial markets. Whereas the traditional Euro-market essentially concerned only developed countries, the first oil shock in 1974, backed up by the second five years later, led to broader participation in the international financial markets. OPEC surpluses were deposited at short term with the banks, which recycled them to deficit countries – developed and developing alike. Indeed, the breadth of the international financial markets after the first oil price shock was well illustrated by the fact that bank lending to developing countries continued even though these countries' deficits had been reduced. Some developing countries were actually building up their reserves at the same time as they were borrowing. Even now, after the international debt crisis, the number of countries drawing on the markets is impressive, and only heavily indebted countries which have lost their creditworthiness are unable to borrow new money.

Fourthly, there has been a progressive implantation of banks worldwide – an “institutional internationalisation” of banking. Banks have continued rapidly to increase their branches and representative offices abroad, even though the international debt crisis has dampened growth in offshore banking centres and the impressive advances in worldwide telecommunications and transport have reduced the need for local physical presences. Furthermore, foreign banks have continued to expand their share of total bank business.

A fifth indicator has been the growing importance to banks of international business. This was particularly true up to 1982 and the onset of the international debt crisis. Thereafter there was some retrenchment of activities and a shift to less high-risk business, as will be discussed later in the sub-section on financial innovation. The two phases are particularly well illustrated in the data on US banks' foreign and domestic assets and liabilities. Although the ratios of foreign assets to domestic assets and of foreign liabilities to domestic liabilities grew substantially from 1978 to 1982, they then fell back to levels which, in June 1985, were below those of 1978. In contrast, however, these ratios more than doubled for Japanese deposit money banks between 1978 and 1984, and there were significant increases also for banks in the United Kingdom, although the UK figures are perhaps not as significant as those for Japan and the United States on account of the role of London as an international market-place.

Last but not least, the strongest evidence, of international financial integration is furnished by the behaviour of interest rates. In the Euro-markets, covered interest parity holds almost instantaneously. More significantly, interest rate changes – nominal and real – originating in the United States are more and more quickly transmitted to other financial centres, despite the floating of the main currencies.

Let us now turn to financial innovation.

As already mentioned, the chief vehicle for international financial flows has changed on a number of occasions. The first major innovation was the introduction of syndicated medium-term bank credits in the late 1960s. This allowed banks to meet the challenge posed by the OPEC surpluses of the 1970s and the need to recycle funds globally. The use of adjustable interest rates as a hedge against unforeseen movements in inflation and the cost of borrowed deposits was another important innovation in the 1970s. Nevertheless, the international debt crisis shattered the equilibrium that had been established between savers and borrowers through the international banking system. Banks discovered that they were exposed to considerable loan risks, while depositors began to doubt the stability of the financial intermediaries. The consequence was a sharp fall in syndicated medium-term bank lending, as mentioned earlier, and a wave of innovation affecting both the banking market and the international capital market. I do not intend to give a full list of new instruments and techniques; I shall limit my observations to four major instruments, all of

which have contributed significantly to structural change and global financial integration.

The first of these are the note issuance facilities (NIFs), which enable a borrower to issue a stream of short-term notes (generally known as “Euro-notes”) over a medium-term period, occasionally up to ten years. The success of the technique derives from the fact that it combines an off-balance-sheet commitment by banks with the sale of the notes to non-banks. The first NIF was arranged in 1981 for New Zealand, and up to mid-1985 a total of \$48 billion in NIFs had been arranged, overwhelmingly for developed countries, although a number of developing countries, notably South Korea, Singapore, India and Indonesia, have begun to arrange facilities, mostly for small amounts.

The second instrument is swaps, in which two parties agree to exchange a stream of payments over time. There are two categories of swaps: currency swaps and interest rate swaps. Currency swaps normally involve the exchange of specific amounts of two different currencies with repayment over time according to a predetermined schedule encompassing both interest payments and capital repayments. Normally fixed interest rates are used for each currency. The volume of currency swaps is difficult to gauge but is currently estimated to correspond to about 20 per cent, of all international bond issues. Interest rate swaps involve no exchange of principal at any time, but interest payment streams of differing character are exchanged according to predetermined rules and based on an underlying notional principal amount. In mid-1985 outstanding interest rate swaps were estimated to total between \$100 and 150 billion of notional principal.

Options – that is contracts conveying the right, but not the obligation, to buy or sell a specified financial instrument at a fixed price before or at a certain future date – have also led to greater global financial integration. Firstly, European banks are able to cover options written for their customers with options bought on exchanges in the United States. Secondly, the need to adjust the hedging of options positions 24 hours a day has made it necessary for banks to deal continuously around the world.

Forward rate agreements are arranged between two parties wishing to protect themselves against a possible future movement in interest rates. They agree on an interest rate for a specific period of time for a specified future settlement date

and based on an agreed principal amount. These instruments are more efficient and cheaper to use than interbank transactions, which they largely duplicate.

The reasons for the development of these new instruments will be dealt with in the following section, but it is important to note that these financial innovations have two common characteristics: they provide banks with fee income at a time when the traditional source of bank income – the intermediation margin – has been curbed by the fall in the volume of bank lending; and they draw an increased number of non-bank borrowers and lenders into the flows of international financial transactions.

## II. Structural Change in International Financial Markets: The Role of the Economic Environment

The previous section on developments in the international financial markets has shown two trends. Firstly, there has been a growing volume of financial transactions, spreading throughout the international economy, and, secondly, a fundamental change has taken place in the techniques and instruments employed to handle the growing flows. The factors which have brought about these two trends fall into two categories: those that stimulated global financial integration and the growth of international markets, and those that set the appropriate conditions for financial innovation. Let us examine both categories, bearing in mind, however, that they overlap to a certain extent, since a flourishing, integrated market will provide fertile ground for innovation, while innovation itself will sustain the expansion of the markets.

The first set of factors may be termed macro-economic developments, the main component of which is the changing pattern of balance-of-payments surpluses and deficits. The distribution of balance-of-payments surpluses and deficits has changed dramatically since the mid-1970s. The two oil price shocks of the 1970s had resulted in a massive build-up of surpluses by OPEC countries and correspondingly large deficits in particular in the industrialised countries heavily dependent on imported energy, but also in some large LDCs. As a result of the preference on the part of OPEC countries for indirect recycling of their surpluses via short-term deposits with the banking system, a major stimulus was given to banking intermediation. Medium-term syndicated bank credits became

the predominant vehicle for lending. As the OPEC surpluses were gradually whittled away, other sources maintained the supply of funds to the banking system and lending continued at a high level until the international debt crisis broke in 1982. The crisis was marked by the virtual halt of bank lending to heavily indebted countries, especially in Latin America; although lending to other countries continued, the total volume of international bank lending was severely curtailed. At the same time, some creditworthy borrowers shifted to the international capital markets, where non-bank lenders, who have grown averse to the risk of depositing with the banking system, have been willing to provide finance at lower interest rates.

The most creditworthy of these borrowers, of course, has been the United States. The oil surpluses have disappeared, many formerly deficit countries have reached external balance, or have even started building up surpluses, while the United States has started attracting massive capital flows, largely from Japan and Germany, but also from some developing countries in the form of flight capital. The factors that have generated these spontaneous capital flows into the United States are well known. Firstly, the US economy entered into a period of sustained growth well before other countries. This led to growing investment opportunities in the United States. Secondly, the combination of buoyant growth and a policy mix including a firm monetary stance but a large public-sector deficit kept US interest rates up, despite decelerating inflation. Just as the oil price shocks had created a suitable environment for the growth of banking intermediation, the capital flows into the United States stimulated the development of international capital-market transactions, since they created an eminently creditworthy group of borrowers. At the same time, the substantially improved profitability and liquidity position of the corporate sector in most industrial countries has provided the supply response from non-banks to this credit demand.

A second set of factors contributing to the development of international financial markets in recent years has been the changing regulatory environment. In many countries the national authorities have taken steps to liberalise regulations affecting international capital movements and, in particular, exchange controls. Some countries have removed or reduced barriers to the full participation of residents in international financial markets. For instance, the United Kingdom and Japan have both freed outward capital movements from control, setting



in motion a process of adjusting financial portfolios to include external assets. Furthermore, a number of countries have reduced or eliminated barriers to foreign competition on domestic financial markets, leading to increased activity by foreign banks on their own markets.

Financial innovation has been stimulated by a number of developments. The main influence has been the pervasive sense of uncertainty in the international economy. The surge in inflation rates, partly associated with the oil price shocks, the great variability in interest rates, especially at the short-term end of the market, which has led at times to an inverted yield curve, and the volatility of exchange rates have increased the risks associated with financial transactions. There has therefore been a strong incentive for banks, other financial intermediaries and their customers to seek new techniques that would effectively hedge against the risks by re-allocating the risk burden to willing risk-takers.

A further influence has been the worldwide tendency to deregulate and to reduce structural rigidities and barriers to competition. The main deregulatory measures have included the phasing-out of interest rate ceilings on the deposit and lending activities of key financial intermediaries, tax reductions and the blurring of demarcation lines between the activities of specific financial intermediaries. The effect has been to create a climate of competition between institutions and markets which has fostered the search for innovative techniques and instruments.

As a corollary to these more liberal policies, there has been a marked tightening of prudential controls, especially as regards capital adequacy, which has also stimulated financial innovation by encouraging market participants to look for ways to circumvent such controls. I do not wish to push the paradox too far, but it is tempting to argue that innovation has been stimulated simultaneously by deregulation and by new prudential controls.

### **III. Benefits and Risks Associated with Structural Change in Financial Markets**

In the previous sections I have considered the developments in international financial markets in recent years and the factors accelerating the pace of financial change and innovation. This section looks more closely at the numerous

advantages of global financial integration and of financial innovation and points to areas where market participants and national authorities must be prudent in dealing with a fundamentally different environment.

A priori, there should be three positive consequences of greater global financial integration. Firstly, it implies keener and wider competition between financial intermediaries, with the consequent benefits of improved quality, quantity and choice of financial services for both investors and savers and a reduction in the cost of financial intermediation. Secondly, the greater mobility of capital should tend to ensure better allocation of global savings, with countries and sectors with the highest marginal return on capital receiving the largest inflows. Thirdly, the greater interdependence of national financial markets would tend to encourage governments to align their policies more closely with those in the dominant economies.

However, all these advantages have to be qualified both from a theoretical angle and in the light of recent experience. Greater competition between financial intermediaries may reduce operating margins to the point where they no longer cover the risk involved and so potentially threaten the stability of the financial system; capital flows may not be determined exclusively by the marginal return on capital, with the risk of sub-optimal allocation of resources; and the desirability of alignment of national policies with those in the dominant economy presupposes that the policies in that economy are appropriate, which may not always be the case.

Furthermore, increased capital flows can have two other negative consequences: they may lead to exchange rate levels which could pose a threat to the balance of the “real” economy, and they may finance current-account deficits for an extended period, offering countries the chance to postpone the adoption of desirable adjustment policies. Such consequences have already been encountered. For example, the United States has attracted massive capital flows in recent years and the dollar has risen to record levels. The effects on the real economy have been a major loss of international competitiveness of large sectors of the US economy and the disproportionate expansion of the services sector. This sectoral shift has had two results: social upheaval and human sacrifices and an upsurge in protectionist pressures which threaten to disrupt international trade. At the same

time, other countries have been expanding their export industries, gearing them to the US market on the assumption of unchanged exchange rates, which also creates a misallocation of resources. The second example is the rapid expansion of international bank lending between 1974 and 1982 which allowed many countries to finance their balance-of-payments shortfalls. Some countries took the opportunity to postpone the adoption of appropriate policies until the burden of servicing the debt became intolerable, partly as a result of the emergence of positive real interest rates. The consequence has been the international debt crisis, which we are still far from having solved.

It would, of course, be unwise to blame the freedom of capital movements either for exchange rate misalignment or for excessive current-account financing. The common feature of both examples is that inappropriate economic policies were being pursued in the countries concerned. The persistence of a major structural budget deficit in the United States, with the resultant high level of real US interest rates, clearly bears a major responsibility for what happened to the dollar. Similarly, “overlending” cannot take place without “over-borrowing” – there are always two partners in an unwise credit contract. Indeed, global financial integration is unforgiving of such policy errors in that it allows capital flows to react rapidly, and often excessively, to all shifts in economic policy, eventually forcing the adoption of appropriate policies – but “eventually” may well be a long way off, and appropriate policies undertaken too late may well turn out to be very costly.

Experience therefore points to two general conclusions. Firstly, global financial integration increases the need for wisdom in the pursuit of economic policies in all countries of the world. This is being acknowledged only slowly. Secondly, in a financially interdependent system, the pressure to coordinate national policies is stronger. Even if a policy is apparently in the best interests of a given country, it may nonetheless have serious, negative consequences for that country if it is out of step with policies elsewhere. This is a very important and burdensome conclusion.

As with global financial integration, financial innovation has positive effects in that it reduces market rigidities, introduces a healthy climate of change and reduces the segmentation of markets. Both savers and borrowers are offered greater choice of financial instruments, leading to a better allocation of resources.

At the same time, downward pressure on banks' intermediation margins is increased, to the advantage of borrowers and lenders alike. Most importantly, financial innovation is offering greater possibilities for borrowers, lenders and the financial intermediaries to hedge against the risks and uncertainties in the economic environment.

Nevertheless, these changes may also carry risks. These stem from the fact that financial innovation breaks down the distinctions between money and other financial assets, between banks and other financial intermediaries, and between bank intermediation and direct lending by non-banks. Yet, at the same time banks remain the "nerve centre" of financial markets and the group of institutions through which central banks carry out monetary control as well as their prudential duties. Let us look more closely at some of the areas of concern that arise from this situation.

Firstly, at the macro-economic level, an important component of bank liabilities – money – is a key economic variable influencing economic performance. Its control is an essential objective of economic policy. Financial innovation, by altering the leverage that the monetary authorities can exert on the economy through the banking system, will make monetary control more difficult and in a sense less direct. Control can still be maintained, however, through increased attention to interest rates and exchange rates. It should be noted, nonetheless, that it is because of the difficulties of interpreting the signals given by interest rate and exchange rate movements and because of the need for an easily understood medium-term framework that quantitative targets were adopted by most countries from the late 1960s onwards and especially in the 1970s. To the extent that the broad thrust of monetary policy becomes less visible because of the effects of financial innovation, this must be seen as a serious drawback.

Secondly, banks are unconventional businesses: they have little capital compared with the size of the total balance sheets, they have little hold over their liabilities, which can be easily transferred to other banks or non-bank financial intermediaries, and they are totally interdependent through the interbank market. These characteristics justify, on the one hand, the lender of last resort facility from central banks and, on the other hand, the banks' obligation to submit themselves to banking supervision. However, this specially nurtured stability may be endangered by financial innovation. Let me give a few examples.

The first aspect is the impact of innovation on the “transparency” of both individual bank activities and the global financial system. The greater the degree of financial integration, the greater the need for full and detailed information on the balance sheets of the individual banks, since the free flow of financial assets and liabilities must be based on an objective assessment of risks. Recent financial innovation, however, has obscured the “transparency” of banking operations. This is especially true of commitments in the form of interest and currency swaps, options, the increasing amount of other banks’ liabilities held by banks, and the growth of NIFs, which do not appear on banks’ balance sheets and which leave unclear who bears the individual risks. The proliferation of different types of assets and liabilities, both on and off banks’ balance sheets, clearly obscures their activities – for the banks’ own management, for bank supervisors and for the market.

Innovation may also reduce the “transparency” of the financial system as a whole. As mentioned earlier, one of the main advantages of innovation is that it offers scope for hedging risk. This implies, however, that another market participant is prepared to share the risk at a price. But the risk does not disappear for the system as a whole: it is redistributed. Theory says that if this redistribution implies that risks are shifted on to willing and strong risk-takers, the net result will be positive. Experience with the Latin American banking debt does not support this conclusion. Why? The move to a generalised use of floating interest rates in medium-term bank credits allowed banks to protect themselves against the erosion of their margins of intermediation and the danger of negative margins. However, it also had the effect of transmitting short-term market interest rate movements to borrowers. With negative real interest rates for a prolonged period, credit demand was unduly stimulated. The return to positive real interest rates, following a prolonged period of over-expansion in lending, and borrowing, then placed a crippling burden on many debtors, leading to the international debt crisis. In effect, innovation allowed banks to transform margin risk into capital risk which, in this case, was probably a greater threat to the stability of the international banking system – not to mention its rather disastrous effects on the borrowers themselves.

Further concerns arise from the process of “securitisation” the growth of negotiable instruments in international financial transactions. This process involves several

important developments. Firstly, the growing disintermediation of banks, as borrowers and lenders deal directly with each other, is underpinned by a greater financial sophistication in many international companies. It is no exaggeration to regard these companies' activities – at least on the asset side of their balance sheets – as verging on banking operations. Secondly, “securitisation” has also brought important changes also to the banks. It has reduced the proportion of banks' international business actually on their balance sheets, as off-balance-sheet items – typically NIFs – have gained importance. Furthermore, a growing proportion of banks' balance sheets – both assets and liabilities – has become negotiable. These developments are clearly advantageous in some respects. In addition to stimulating competition, they have redistributed – away from banks and towards non-banks – both country risk and the burden of recycling balances. Furthermore, the growth of negotiable instruments in banks' balance sheets reflects attempts by banks to increase the liquidity of their international portfolios. On the other hand, the advantages of “securitisation” may have been overstated. The better distribution of country risk between banks and non-banks may be illusory. “Securitisation” has overwhelmingly affected quality borrowers attracted to the financial markets by the prospect of borrowing more cheaply than through the banks. Problem debtors, however, are still unable to tap the financial markets, and their liabilities remain on banks' balance sheets in a non-negotiable form. Indeed, banks will increasingly be restricted to dealing with prime borrowers only off their balance sheets, unless these claims are transformed into bank loans if the borrower's standing deteriorates. In effect, banks are being excluded from the market for prime international borrowers.

Another potentially negative consideration regarding “securitisation” is the difficulty of managing a crisis in an international credit market based on negotiable instruments. Past experience is not reassuring in this respect. In the 1930s the large share of international debt in the form of bonds prevented the kind of restructuring of debts that has taken place with bank lending in recent years. On the other hand, it may be argued that international lending based on negotiable instruments would not have led to the over-indebtedness of certain countries because most of the Latin American countries could not have sold bonds to the same extent that they could overborrow from banks. This may be so, but I have the uncomfortable feeling that with the current development of negotiable instruments, not all bond issuers are prime borrowers. We have not

yet had an issue of “junk bonds” on the international market, but who knows what could happen in these highly inventive markets? Whatever the conclusion might be, it is clear that the shift towards “securitisation” of international lending will expose both lenders and borrowers much more to the unpredictable forces of a freer market.

What sort of policy conclusions should be drawn from this cost/benefit analysis? Let me begin by stating quite firmly that, even though there may be concerns over the “financial revolution” that is taking place, it would be undesirable for the authorities to attempt to halt its progress and, a fortiori, to reverse the changes that have taken place. On the one hand, the advantages of innovation, in terms of market efficiency, are substantial and would be lost. On the other hand, since world financial markets have become so integrated, any attempt to restrict activities in one market would result in business moving elsewhere as long as there was demand for the financial service concerned.

However, both the banks and the authorities should face up to the challenges presented to them by financial innovations. Banks will have to manage their affairs with much more prudence in this new environment. This does not mean that they should shun innovation, but that they should not follow the innovative trend blindly: every decision should be taken on the basis of a careful assessment of the actual risks and realistically viewed returns. This being the case, there should be little reason to conceal information on their activities. Accordingly, details on balance-sheet and off-balance-sheet positions should be made available to help the smooth functioning of the markets. Furthermore, it would be in the general interest to make the new instruments more homogeneous: standardisation of the various products would be of considerable value.

With regard to the national authorities, I would venture to make four points. In the first place, the process of financial deregulation, which has opened the door to innovation and consequent institutional changes, should be handled with care. Deregulation should not be stopped but should continue at a pace allowing the markets to adjust to the new techniques and supervisors to sharpen their supervisory tools. Both adjustments will take time. In the second place, the national authorities are committed to gathering and publishing information. At present they are falling behind progress in innovation and must make an effort to catch up. The third aspect is that prudential control must be updated:

domestic supervision of each financial market must be coordinated, so that a comprehensive view of activities is guaranteed; and prudential control must be harmonised internationally. Without international cooperation, business will shift out of more regulated markets to others which are less regulated. The fourth challenge to national authorities is to pursue macro-economic policies that are both sound and compatible with the policies in dominant economies. Failure to do so will lead, as noted earlier, to disruptive capital movements in ever more sensitive international financial markets.

#### IV. LDCs and the Changing International Financial Environment

Turning now briefly to the implications of global financial integration and financial innovation for developing countries, I should like to make two series of remarks.

Firstly, let me make a point that often goes unnoticed but is of considerable importance. The banking systems of many developing countries are themselves quite active on the lending side. This appeared clearly on the occasion of the Latin American debt crisis: in addition to borrowing from the banking systems of the G-10 countries (directly, or via some of the offshore centres), Latin American countries also borrowed from each other's banks, and from banks in Asian developing countries. As a result, the banking systems in many developing countries, and therefore their authorities, have an interest in the prudential and macro-prudential implications of the changing international financial environment that is perhaps quantitatively less important than (but nevertheless similar to) that of the traditionally lending G-10 banking systems.

This would point to the need for closer, worldwide cooperation between all banking systems involved in international lending activities. One area for potential cooperation is in the field of statistics; another is between the supervisory authorities.

This having been said, it remains true, of course, that the main question about the implications of innovation and global integration for the developing countries concerns their borrowing activities. What have been the facts in this respect?



During the 1970s – indeed up to the summer of 1982 – most of the developing countries, with the exception of the very poor African ones, drew substantial benefits from the then prevailing borrowers' market and from financial innovation in the form of syndicated bank credits. Of course, as I mentioned earlier, we know with hindsight that these benefits turned out to be a mixed blessing for those developing countries which built up an external debt in excess of their longer-term growth and debt-servicing potential. But this was not a general phenomenon, although I would suggest that the surprises caused by the floating rate techniques deserve to be kept in mind and should incite all borrowers to scrutinise carefully any new financial techniques presented to them.

In the period of “financial revolution” and growing securitisation that has characterised our world since 1982, the position of the developing countries as borrowers has changed markedly. Those which have lost their creditworthiness in the wake of the debt crisis – almost all of Latin America, plus one or two isolated cases elsewhere (while, of course, Africa's position has not improved) – have been cut off from spontaneous bank lending. Whenever net new lending occurred, it took the form of IMF-“engineered” loan packages, linked with rescheduling exercises. Needless to say, these countries have not gained access to the capital market either; nor could they make use of the new types of instrument.

On the other hand, developing countries elsewhere – in particular in Asia – have not suffered from the break that occurred in 1982. Admittedly, the rate of growth of claims on Asian developing countries by the banks reporting to the BIS has slowed down markedly since the debt crisis, although it remained higher than vis-a-vis other LDCs. But my impression is that this slowdown resulted much more from the demand side than from any unwillingness of banks to lend to them. The moving force was these countries' ability to adjust their external accounts and their desire to safeguard their financial integrity. At the same time, some of the Asian countries have also started using the new instruments, although the amounts have remained extremely small in an expanding market. In 1984, for instance, they arranged less than \$500 million in NIFs, compared with a total of almost \$19 billion. In the first nine months of 1985 the figure rose to \$600 million, but the total advanced to more than \$28 billion.

While the Asian developing countries are thus little involved in the use of new instruments, they are nonetheless present in the market. Whether they will be able to increase their share significantly depends first and foremost on the pursuit of appropriate and credible policies which will safeguard their creditworthiness. Indeed, the need for suitable policies is reinforced by global financial integration, since countries losing their standing would not only lose access to the markets but could also become increasingly vulnerable to adverse capital movements made easier by the closer links between financial markets.

## Chapter XVIII

# Globalization of Financial Markets: International Supervisory and Regulatory Issues

1988

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*In August 1988, Lamfalussy gave the luncheon address at the Jackson Hole symposium of the Federal Reserve Bank of Kansas City. The theme of the symposium was "Financial Market Volatility" and Lamfalussy discussed the international supervisory and regulatory issues of the globalisation of financial markets. He first discussed the rationale for supervision of financial institutions, as well as for international cooperation, and then went into current issues both for banks (capital adequacy) as securities markets. Reprinted with kind permission of the Federal Reserve Bank of Kansas City and the Lamfalussy family.*

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I was delighted to accept your invitation to come to Jackson Hole. To economists and specialists in financial markets, Jackson Hole is, of course, firmly on the map of conference centers for the excellence of its seminars; but Wyoming is not a territory with which I can claim great familiarity. When I looked at the map to get my bearings, the schoolboy in me was intrigued to observe our proximity to such famous names from the Wild West as the Big Horn River and Fort Custer. General Custer might not have cared much about instability of the financial variety, but he would surely have made a forceful contribution as a discussant for a seminar devoted to policy responses to disorder and instability of a different kind.

My subject today is international supervisory issues and I propose to divide my remarks into two parts. First, I should like to use (or abuse) the privilege of a luncheon speaker to make some very general observations on the rationale for

official, supervision of financial institutions, and for international cooperation in this field, in today's world; and second, I shall look at some current issues facing supervisors. A good deal of what I shall have to say will be about the supervision of banks, but I shall also refer to supervision of securities markets.

To begin, then, with the question as to the rationale for supervision in today's world. The traditional goal assigned to the supervision of the financial industry in general, and of banking in particular, is to ensure the stability of the system as a whole by promoting sound management of individual institutions. The reason for caring more about stability in the financial, and especially the banking sector, than about that in any other industry appears to be twofold: first, the failure of individual institutions can lead to chain reactions within the system because of the strong links tying institutions to each other, because of the speed at which funds can be shifted and because of the overwhelming role of expectations; and, second, as a result of its central place in the mechanism of credit allocation and in the payments and settlements system, whatever happens within the banking world can have far-reaching consequences for the real economy. It is for these reasons that central banks have been entrusted with the lender-of-last-resort function, of which bank supervision – so runs the argument – would seem to be the natural corollary.

I have not noticed anyone seriously challenging the view that the pursuit of stability in banking is a worthwhile objective, nor, indeed, that the achievement of this objective presupposes that central banks should be able and willing to perform (at least in a global sense) their lender-of-last-resort function. What has been questioned, however, by a number of observers and analysts in recent years is whether supervision has become largely unnecessary to the achievement of systemic stability and also whether it may not actually be counterproductive. I propose to look briefly at both these views.

Those who argue that supervision has become largely unnecessary are, in effect, saying that nowadays bank failures are no more harmful economically than failures of firms in other sectors of the economy. This assertion is based on the existence of retail deposit insurance schemes, which mean that most bank depositors now run no risk of losing their money if a bank fails. From this it is argued that the threat of systemic runs on banks leading to a multiple contraction of bank money and credit is now a thing of the past. This view would seem to be supported by the

observation of what has, or rather has not, happened in recent years. In contrast to events in the 1930s, the numerous and, in some instances, very severe shocks that have affected individual banks or even the whole industry in the 1980s have not produced large-scale disturbances that could be called a genuine banking crisis. The second of the two views I mentioned, namely that bank supervision may actually be counterproductive, is based on the argument that supervision has costs in weakening the efficiency with which banking functions. This is not a new view and it has several interconnected facets. Regulatory prescriptions governing, say, minimum capital or liquidity ratios are accused of inviting bank managements to suspend their own judgment on the risk involved in certain bank activities and/or to try to evade the cost they imply. At the same time, supervision, especially if carried out by the central bank, may induce the latter to bail out individual institutions more or less systematically. The argument that supervision is the natural corollary of the lender-of-last-resort function is therefore turned upside down: supervision carries with it the temptation to be lender of last resort to individual institutions in a fashion and with a predictability that would tend to distort management behavior. The result would be a weakening of market discipline, reinforcing the supposedly perverse influence of deposit insurance. Banks may take greater risks than they otherwise would with their depositors' money and, at the same time, depositors may be less attentive to the quality of bank management. The efficiency of market discipline would be impaired. Note that the logical implication of this view is that individual banks should be allowed to fail, or at least that no single institution should be able to operate on the assumption of a bailout – a principle I would find hard to contradict.

I would not want to deny that banking supervision, or retail deposit insurance, may in general involve some costs. These costs may be characterized as interference with the workings of the market. They include some loss of efficiency in banking and, of course, costs to the taxpayer to the extent that the bailout is financed by the state. I would not dispute either that some specific aspects of individual countries' supervisory regimes may be unnecessary, or even perhaps, counterproductive. Nor do I wish to hide my mixed feelings on observing the frequency of bailouts. But I believe that both the supervisory and the rescue techniques are improvable, so that these costs can be reduced, although not completely eliminated. More important, however, to my mind is the question about the balance between the costs and benefits of official supervision.

To that question I would give the traditional answer that the benefits of supervision clearly outweigh the costs, for two reasons. First, I think it is an exaggeration to say that retail deposit insurance schemes have largely extinguished the risks of systemic runs on banks. Quite apart from the fact that not all countries provide deposit insurance, the main thing wrong with this argument is that insurance does not cover wholesale deposits, nor deposits placed in foreign branches. In saying this, I am well aware that in the United States there is an active brokerage trade engaged in cutting up wholesale deposits into retail slices. But insurance is not, indeed should not be, complete, and I would add that it is in the field of wholesale banking in the Euromarkets that competition has been keenest in recent years, and that banking has become more integrated worldwide.

I am familiar with the argument that wholesale (i.e. corporate) depositors are supposed to be able to judge the quality of bank managements, and therefore, to look to the safety of their deposits, better than the man in the street. Recent experience does not suggest that this is always the case. For instance, it was not true of the wholesale depositors at Continental Illinois Bank, particularly those in the Euromarkets from which Continental drew a large part of its funding.

My second reason, or set of reasons, for holding the traditional view has to do with the structural changes that have taken place in banking over the past decade and with some of their consequences. The main features of these changes have been international financial integration, the wave of financial innovations and the deregulation of banking. Their most important consequence has been a very marked increase in competition between financial intermediaries, both in their home markets and, even more so, internationally.

There are three points to which I would draw your attention to this connection. First, greater competition in banking is supposed to improve the allocation of resources through banks. I am ready to accept this as a general proposition, but I have some difficulty in forgetting the lessons of the debt crisis. The present external over-indebtedness of many sovereign borrowers – one of the largest contemporary macroeconomic imbalances, and one that continues to give a lot of headache to the banks themselves – emerged at a time when bank credit was provided by banks which were not only competing freely with each other but were doing so with very little regulatory impediment. The Euromarket of the 1970s and early 1980s came as close as possible to the model of a free, unregulated

market. It is, of course, true that “overlending” could not have happened without “overborrowing”, and that it was not easy to foresee a combination of world slump with very high interest rates. Nevertheless, anyone who had the experience of seeing bankers queuing up in front of the offices of lesser developed country (LDC) finance ministers at that time cannot help feeling that the highly competitive environment had something to do with the emergence of the problem.

Second, in recent years, there has been a very large increase in corporate and household debt ratios, particularly here in the United States but also in some other industrial countries, carrying obvious risks in the event of a cyclical downturn. One cannot rule out, in my view, the influence of financial innovations, notably leveraged buyouts, on the increase in corporate debt ratios.

Third, and more generally, competition works partly through the elimination of weaker units from the system – the process that Schumpeter described as “creative destruction”. If, like me, you cannot accept the view that the risk of systemic runs on banks is now a thing of the past, you feel that such destruction can be more dangerous in banking than in any other sector of the economy. Moreover, the worldwide integration of banking has given this risk a dimension that it never had before.

My purpose in making these points is not to argue that the costs of increased competition in banking outweigh the benefits. I do not believe that they do; nor do I wish to underestimate those benefits. My argument is simply this. The rapid evolution toward a more and more competitive environment in banking exerts tremendous pressure on bank management to outperform rival banks or simply to fight for survival. This means not only cost cutting but also finer pricing for deposits, a search for higher-yielding investment, new ventures, the use of innovative techniques and new products. In other words, it is likely to imply an incentive to greater risk-taking. Add to this a very uncertain and basically imbalanced global macroeconomic environment leading to wildly fluctuating exchange rates, interest rates, stock prices, real estate values and commodity prices, and it is hard to avoid the impression that the risks in banking have been set on a rising trend. I do think that in order to preserve the stability of the banking system, which is a valuable aim in its own right, bank management needs the

support of the restraining influence of supervision even at the cost of some loss of efficiency, whatever the definition of efficiency may be. And it is obvious that in today's globalized banking market, supervision has to be as far as possible globalized, both in the geographical and in the inter-industry sense of the term.

I now turn to some current supervisory issues. Capital adequacy lies at the heart of sound banking. For some years, therefore, the efforts of supervisors to help banks meet the challenges of the more competitive environment in which they now operate have been concentrated on strengthening banks' capital positions. The accord reached last month by the G-10 central banks on capital adequacy represents the culmination of those efforts. I know that the agreement has not been universally acclaimed by all sections of the banking community in the United States, but it has also been criticized, from different angles, in other countries. This is, perhaps, the sign that it is a good agreement, well-balanced and distributing the strategic adjustment efforts evenly across the world. I would like to spend a few minutes considering the importance of this landmark in supervisory cooperation.

It has two aims: to strengthen bank capital standards in the G-10 countries where the core of the international banking system is located; and to do so in a way that tends to equalize the impact of supervision on the competitive positions of banks in different G-10 countries.

Disparities between national regulations with respect to the measurement of capital and the assessment of capital adequacy can have a number of harmful consequences. First, banks in countries with high capital standards are less able than their opposite numbers in countries with lower standards to compete for new business. Second, as a consequence, banks with lower capital and larger balance sheets will be able to lend on substantially lower margins with the result of diminishing returns for all. Third, some banks may, therefore, take on riskier, higher-margin lending in an effort to boost their earnings. And, fourth, the combination of these factors can make it harder for banks, and for supervisors, in a given country to raise their capital standards in isolation from what is happening elsewhere.



It may be argued that over the long run the market might do the job that the new accord on capital adequacy is designed to do. The market would, without any help from supervisors, pass its verdict on weak and inadequately capitalized banks and would reward strong banks for their prudence. But the history of banking does not suggest that the market can do this sort of thing and, *at the same time*, preserve the system's stability. This is a practical illustration of the general point I made earlier, namely that whatever costs supervision may imply, they are likely to be offset, especially in today's world, by the advantages such supervision produces in terms of the preservation of financial stability.

Turning now to the securities markets, last October's stockmarket crash, and the events that followed it were remarkable for two features, the first having been the speed at which other markets reacted to the fall in prices on Wall Street. That was the most dramatic illustration we have yet had of the degree to which financial markets are now integrated worldwide. Moreover, this reaction occurred despite quite marked contrasts between different countries, both in economic conditions and in price/earnings ratios for equities.

The second feature was the resilience that the markets displayed after the crash. There was no cumulative decline of share prices which, in fact, stabilized rather quickly (except in Japan) at lower levels.

This resilience of markets was no doubt partly the result of the rapid and efficient way in which the Federal Reserve and other central banks supplied extra liquidity to their markets. Given that the authorities took those actions, we shall never know to what extent there were also market forces at work that prevented a tailspin of prices which would certainly have had deflationary effects on the real economy. Probably there were such forces at work. But, in my view, it was a good thing that the central banks did not wait to see how effective they would have been, on their own, in stabilizing the situation.

One consequence of the post-crash resilience of markets was that no really large-scale problems emerged in the financial markets, either for individual institutions or, still less, for the system itself. This means, in my view, that there is no reason in the light of last year's events to consider drastic changes in the ways that markets work and, in particular, to try and put into reverse the structural changes of the

past decade. At the same time, however, the crash certainly pointed up issues for market participants and for supervisors in both the banking and securities markets.

Those who supervise securities markets have had brought home to them, more clearly than before, the extent to which the cash securities markets and the markets in derivative instruments are linked to one another. Effective supervision of the securities markets must cover all their different parts.

Those responsible for supervising banks have realized more clearly than before the implications of the banks' increased involvement in the securities business. In fact, the losses sustained by banks on equity holdings were, in most instances, substantially offset by gains on their bond portfolios. The full implications of the banks' participation in the securitization phenomenon of the 1980s will only become apparent when we next experience a period of rising interest rates and falling bond prices – when there might well be no offset from rising equity prices to banks' losses on their bond portfolios.

Last year's events have also alerted bank supervisors and securities market supervisors to the necessity of cooperating with one another, both nationally and internationally. Action is now being taken to organize such cooperation. Even at the national level this may not always be easy, for institutional and other reasons. Internationally, it is likely to prove even more difficult, since the greater the number of countries that attempt cooperation the harder it becomes to reach an agreement that is both worthwhile and workable. But the worldwide character of financial markets and the geographical mobility of both financial transactions and financial institutions mean that cooperation between supervisors in different parts of the financial system needs to be put on the widest practicable basis.

Let me conclude by expressing my conviction that one of the great challenges policymakers are facing today is to encourage market participants to behave in a way that maximizes the advantages of free global competition without exposing the system to greater instability. They can do this by creating an appropriate regulatory framework and by implementing stability-oriented macroeconomic policies. I have tried to make the point several times that the adjustment of supervisory practices and their coordination internationally have an essential

part to play. It was not within my remit today to insist on the role that must be assumed by macroeconomic policies – and their coordination – but it is clear to me that the high capital mobility implied by free competition will not be tolerant vis-a-vis policies that lead to, or appear to be unable to correct, large financial imbalances, be they domestic or international. And this intolerance would express itself in continued exchange rate and financial asset price volatility – the very topic of this symposium.

## Chapter XIX

# The Danger: A Protectionist Backlash

1989

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*This was Alexandre Lamfalussy's contribution to a Special 20th Anniversary Supplement of Euromoney in June 1989. He gives a broad overview of the development of the financial markets over the preceding twenty years and offers some "crystal ball-gazing" for the next ten years. Typical for Lamfalussy is the attention he pays to macroeconomic imbalances and their potential interactions with the financial markets and policy responses in different countries. Reprinted with kind permission of Euromoney and the Lamfalussy family.*

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Even though the risk of being remembered and quoted in 10 years' time may not seem too great, crystal ball-gazing is a perilous exercise. It is also a difficult one when the object is an activity – financial market activity – that has been undergoing radical changes since the 1970s. There is a strong temptation to extrapolate recently observed trends into the future, in the way many market participants do when forecasting exchange rates or financial asset prices. In both cases the danger lies in failing to recognise turning-points, or at least a slackening of the rate at which changes are occurring.

What have been the dominant features of the current financial revolution? I should like to single out five of them.

- To begin with, international financial integration – that is, the growing interconnection between domestic markets.
- Secondly, in the banking segment of international finance, the replacement of US banks by the Japanese banking community as the leading international banking group.
- Thirdly, the generalisation of innovations.

- Fourthly, the blurring of distinctions between institutions, between types of financial assets and liabilities, between balance sheet and off-balance-sheet items, between intermediation and the market, and even to some extent between financial and non-financial firms. This blurring of dividing lines can perhaps be described, somewhat loosely, as a trend towards despecialisation.
- Last but not least, the very fast growth of the financial “superstructure”, that is of the volume of transactions carried out between financial market participants that have no apparent links with transactions involving final lenders or borrowers.

There have been many driving forces behind these overlapping and interconnected developments. Integration in the “real” world started much earlier – in the 1950s – as a result of the rapid expansion of international trade and created fertile ground for the development of international banking. The more recent major payments imbalances, starting with the first oil shock and culminating today in the large-scale current account disequilibria within the industrial world, have involved a substantial increase in net cross-border capital flows in many directions.

Japan’s strong and persistent creditor position has without doubt been a major factor in the rise of Japanese banking to international prominence.

Exchange rate and interest rate volatility, itself a product of both domestic and international macro-economic imbalances, has given a powerful stimulus to financial innovations of the hedging type, which are responsible for at least a part of the explosive growth of financial trading and of interbank transactions.

Technological progress has played its role, not only in allowing innovations to be implemented swiftly and efficiently, but also in speeding up the transmission of asset price fluctuations between markets and countries.

This manifestation of international integration could not have taken place without the progressive and widespread removal of external capital controls, just as despecialisation could not have occurred without domestic financial deregulation – both policies being part and parcel of the re-emergence of free market philosophy. And, undoubtedly, high financial rewards and the prospect of working in an exciting and dynamic environment have attracted people with outstanding entrepreneurial talent into an industry which could not have grown as it has, and in the way it has, without their contribution.

Now what about the next 10 years?

My main question mark concerns the pace and the future shape of worldwide financial integration. The reason for my hesitation here is the size and apparent persistence of the large current payments imbalances within the western industrial world.

The existence of these imbalances means further progress towards financial integration, since the persistence of the US current account deficit is tantamount to a continued accumulation of claims of the rest of the world on the United States. Or, looking at it from the opposite angle, Japan cannot go on running a current account surplus without acquiring a growing stake in the wealth of other countries.

My concern, however, arises from the belief that current account imbalances on the present scale are not sustainable in the long run and that in the unavoidable process of unwinding there may be elements that could act as a brake, or have a distorting effect, on international financial integration.

The Latin American experience of the western banking system provides an example of an integration process undergoing shock treatment – although this shock treatment should certainly not to be taken as an example of what could conceivably happen within the western industrial world.

The extension of bank loans to Latin America on a large scale in the late 1970s and early 1980s could be regarded as a manifestation of international financial integration. It transformed both the banks' balance sheets and the external asset and liability structure of the borrowing countries. But the payments imbalances it financed were unsustainable and have indeed been unwound.

And what is the present situation? While most lending banks still have a stake in Latin America's future, and while a few of them do in fact view their investments as a long-term commitment, which they hope will remain profitable, the prospects of a resumption of spontaneous net banking flows to Latin America are, to say the least, dim. The process of financial integration between Latin America and the western industrial world has come to a halt.

It is obviously not this sort of halt to financial integration that I could imagine happening within the western industrial world. No one in his right mind would

maintain that there is a transfer or credit risk attached to the claims held by foreigners on the United States as a country, it is even arguable that the United States can go on for quite some time running a sizeable current account deficit; while the absolute figure is without historical precedent, its size in relation to the US domestic aggregates, to world savings or world financial portfolios, is much more modest. But it seems clear to me also that the persistence of the imbalances on the present scale will in the end trigger an adjustment process.

I do not know how this adjustment process will unfold; but what I fear is that the unwinding of the intra-OECD payments imbalances could entail two developments that could inhibit further integration by inflicting damage on those who have been actively engaged in it or by deterring those who would like to become so.

The first, more probable and potentially more damaging development could be a protectionist backlash, specifically in the financial area, just as large and persistent current account deficits, coupled in particular with an overvalued currency, breed protectionism in trade, so large-scale capital inflows breed protectionism vis-à-vis foreign ownership or even foreign creditors.

And the danger of such a backlash is all the greater, the stronger the concentration of foreign owners or creditors in one particular country. The danger must therefore be seen as deriving equally from persistent deficits and surpluses. To extend this observation to the nationality structure of international banking, I find it difficult to imagine that the share of Japanese banks in international banking businesses, which between the end of 1983 and the end of 1988 rose to 38% from 21% of the total reported to the BIS, could continue to expand at such a pace without provoking reactions from other countries which, to put it mildly, would be unhelpful for the further development of intra-OECD financial integration. Protectionist measures have a nasty habit of spreading, through retaliation.

The second adverse development that might be part of the adjustment process is sudden, large movements in exchange rates and/or financial asset prices. Perhaps as a result of the relative stability of exchange rates and long-term interest rates and the recovery of world equity prices over the last 12 months, the crash-landing scenario has less support today than it did some while ago.

I have always regarded, and continue to regard, a violent crash-landing, involving ruinous losses for holders of dollar-denominated claims on the United States, as improbable, but for other reasons; because of the rather low relative figures referred to above; because of the breadth and sophistication of US financial markets; and, because of the crisis-handling ability demonstrated on several occasions by the authorities.

What I do, however, regard as quite probable is that the persistence of the payments imbalances and their subsequent unwinding will go hand-in-hand with a good deal of instability in exchange rates and financial asset prices.

Hedging devices may protect well-insured market participants from the consequences of such instability. They do not protect the system as a whole, but simply redistribute the risk in the same way as insurance does. Someone is bound to lose. Prolonged exchange rate instability would hardly promote international financial (or for that matter, trade) integration.

This leads me to a broader observation. The emergence and the persistence of the major intra-OECD payments imbalances are not an act of God. They reflect differences in patterns of savings and investment in the countries in question, which may themselves look persistent but which nevertheless are also not immutable. Policy, especially (but not only) the fiscal/monetary policy mix, can certainly influence them.

The problem, however, is that international policy cooperation has conspicuously lagged behind the pace of private market integration in both the real and financial spheres. We are much better at crisis handling than at crisis prevention.

The combination of a high degree of integration with rapid technological change, deregulation, the explosive growth of the financial superstructure and the spread of management techniques which react with lightning speed to news has created a situation for which there is no historical precedent.

Admittedly, markets were quite free for a few decades around the turn of the century, and the gold standard then functioned without global policy coordination.

But what, during that period, was the relative size of internationally mobile financial assets? How large was the interbank market? What was the state of



information technology and of financial management techniques? Were nominal wages rigid? Did governments care about massive emigration or immigration?

I do not believe that in today's environment we can do without a relatively high degree of international policy co-ordination, whatever our exchange rate arrangements. The fact that international policy cooperation has remained slow and deficient probably reflects a much less advanced harmonization of social and political values between our different societies than that which has taken place in the economic and financial fields.

I have the uncomfortable feeling that, with policies remaining geared almost exclusively to the attainment of domestic objectives, and with fiscal policies remaining bogged down, we run the risk of witnessing the emergence of conflicts in which the losing party will be integration – real or financial, or perhaps both.

A return to protectionism would be unlikely to occur within smaller individual countries, but I could imagine pressure for protectionism building up within regional groupings or, simply, large countries. In this context, the danger of Fortress Europe (and why not Fortress United States or Fortress Japan?) should not be underestimated.

Now for three points concerning despecialisation and mergers and acquisitions within individual countries or across borders in the financial industry.

First, I would not expect any large-scale return to re-regulation, although there may be attempts in this direction in one country or another, whenever segments of the financial industry get into trouble. Free-market philosophy will remain a powerful force. Moreover, international financial integration, even if it were to become constrained by protectionism or by unstable asset markets, will continue to be sufficiently effective to limit the practical scope for large-scale domestic reregulation.

Secondly, however, market forces themselves will tend to re-establish a fair degree of specialisation. This process has already started in the securities industry but it will also spread to banking, with most banks rediscovering the virtues of specialisation, leaving it to only a few very large ones to expand in all directions. This does not mean that many banks will not try to expand into, or at least consolidate their position in, the securities markets, or in other financial areas

which are not traditionally part of the primary business of commercial banks. But these linkages will vary considerably from bank to bank.

Thirdly, I also see limits to mergers and acquisitions in the banking industry, especially of the cross-border variety, not only within the OECD as a whole but even within regional groupings, such as the European Community.

I say this for several reasons. Large multinational banking units may be more efficient in serving large multinational customers, but the profitability of wholesale banking will remain constrained by the financial expertise of corporate treasurers and the continuing momentum towards disintermediation. The scope for restoring profit margins through size is limited. As the same time, there is a great deal of inertia in the markets for retail customers and small enterprises; moreover, the investment required to penetrate these markets from abroad can be prohibitively large. Finally, differences in the banks' corporate cultures will discourage mergers, as will incompatibilities in such capital-intensive areas as electronic data processing.

I find it particularly hard to make guesses about the future pace of financial innovation. On the one hand, one has the impression that all that could be invented, in particular in the way of hedging devices, has already been invented and applied widely. Innovations move in waves. Are we not now entering a trough? This view is supported by the observation that genuinely new financial innovations have tended to become rare in the last couple of years; what has been passing for novelty is often not much more than an ingenious refinement or a combination of techniques that had been invented some time previously.

On the other hand, there are no signs of any slowdown in technological progress; the young generation entering the financial industry today has an educational background and, in particular, a mathematical grounding that were still quite exceptional when the wave of innovation began some 10 years ago; and management has become accustomed to absorbing and even encouraging innovation.

Moreover, if the fears I have expressed are confirmed, financial asset price instability, generated by the combination of continued macro-economic imbalances and weak international cooperation, is not about to disappear. Then

why should the pace of innovation slow down – beyond a perhaps inevitable, but temporary, period of digestion? Why, indeed.

All in all, I would expect a continuation in the current growth pattern of financial activity, with a possible slow down (although not a reversal) of the international integration process.

## Chapter XX

# Macro-Coordination of Fiscal Policies in an Economic and Monetary Union in Europe

1989

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*In 1988-1989, Alexandre Lamfalussy was a member of the Delors Committee, which played a pivotal role in the EMU process. In line with his earlier work for the Committee of EEC Governors, he played an intellectually stimulating role. For Lamfalussy, a crucial issue was the coordination of budgetary policy, to which this contribution was devoted. Marked by his experience of the Latin American debt build-up, he questioned whether market forces were enough to ensure fiscal discipline. Lamfalussy concluded that fiscal policy coordination “appears to be a vital component of a European EMU”. Of Annex I of the paper, only the Introduction is reproduced. Reprinted with kind permission of the Office for Official Publications of the European Communities and the Lamfalussy family.*

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## I – Introduction<sup>1</sup>

This note attempts to provide a basis for the discussion of the degree of macro-fiscal coordination that might be needed after the establishment of economic and monetary union (EMU) in Europe and during the period of transition towards it.

The note examines several arguments that have been put forward in support of fiscal coordination. Their assessment is based partly on theoretical considerations and partly on lessons drawn from the experience of federal states. As the

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<sup>1</sup> I would like to thank Claudio Borio for valuable assistance in the preparation and drafting of this paper.

arguments overlap somewhat, the conclusions bring together the various strands of the analysis.

The note is complemented by two appendices. The first contains a brief review of fiscal arrangements and coordination in federal states, compares the fiscal structure of these states with the current and prospective situation in the EEC and assesses the relevance of their experience for the Community. The second appendix discusses in more detail the question whether market forces can be expected to exert disciplinary effects on fiscal policy and thereby lessen, at least in part, the need for explicit fiscal policy coordination.

The main conclusion of the analysis is that fiscal policy coordination appears to be a vital component of a European EMU. Such coordination would have to be conceived and implemented with two objectives in mind:

- to allow the determination of a global fiscal policy in a way that is sufficiently responsive to evolving domestic and international requirements; and
- to avoid tensions arising from excessive differences between the public sector borrowing requirements of individual member countries.

## II – Why Coordination?

Basically three partly overlapping arguments have been put forward in support of macro-fiscal coordination in a European EMU, while a fourth one focuses on the difficulties during the transition period:

- the need for an appropriate fiscal policy for the union as a whole;
- the need to avoid disproportionate use of Community savings by one country;
- a possible bias towards lack of fiscal restraint;
- the need for convergence in budgetary positions during the transition period.

### *Argument 1: An appropriate fiscal policy for the EMU*

*Description.* An economic and monetary union transforms the Community into a single economy. Both for the purpose of internal macroeconomic objectives and in order to be able to participate in the process of international policy coordination, the Community will require a framework for determining a coherent mix of monetary and fiscal policies. The creation of a single currency area implies, by definition, the adoption of a single monetary policy for the Community as a whole. By contrast, if it is assumed that fiscal policy is not centralized, the Community's fiscal stance would merely be the result of the aggregation of unilaterally decided budgetary positions in individual member countries. Consequently, without an explicit coordination of fiscal policies, the Community would not be able to formulate a common fiscal policy, be this with a short-term or longer-term orientation. Monetary policy would be the only instrument available for pursuing macroeconomic objectives.

*Assessment.* The essential theoretical foundation of this argument is that policy coordination is beneficial to countries whose economies are closely intertwined. Strong linkages between real and financial markets across countries imply that the policies pursued by one country have significant repercussions on economic developments in others. If this interdependence is not taken into account in the policy setting, there is a danger that independent national policy decisions lead to an outcome inferior to that which could have been achieved by a cooperative approach.<sup>1</sup>

A simple illustrative example of the desirability of a jointly decided policy stance in an EMU could run as follows. Even if domestic conditions in the Community called for a fiscal stimulus, each country (region) on its own might have little

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<sup>1</sup> The benefits deriving from coordination in the presence of interdependence are in general supported by the theoretical literature. This is what in game-theory terms is known as the "cooperative" solution, where every player (e.g., a country) can be better off relative to the "non-cooperative" solution where each one acts in isolation. For some examples see P. R. Krugman (1987), "Economic integration in Europe", Annex A to Efficiency, stability and equity (Padoa-Schioppa Report), EC, especially page A-19; or, with particular reference to the present EMS arrangements, P. De Grauwe (1985), Fiscal policies in the EMS: A strategic analysis. International economics research paper No 53. These studies also make it clear that, while establishing the need for coordination is relatively simple, specific rules depend critically on detailed assumptions about national objectives, the workings of the economy and, implicitly, the ability to control budgetary variables. While the existence of benefits is beyond dispute, there has recently been some scepticism about their magnitude – see, e.g. G. Oudiz and J. Sachs (1984), "Macroeconomic policy coordination among the industrial economies", Brookings papers on economic activity. Note also that the specific question of fiscal policy coordination in an EMU has not as yet been examined within this analytical framework.

incentive to shift to a more expansionary fiscal policy (for instance through tax cuts). Each would fear that the policy change would lead to a deterioration in its budgetary position with little gain in output, since a large part of the induced income effect would be transferred via higher “imports” to other Community countries. If, by contrast, all countries decided jointly to lower taxes, the expansionary income effects would reinforce each other and stimulate economic activity with smaller adverse effects on budgetary positions. The creation of a single market and a single currency area greatly strengthens the linkages between individual member countries, thereby heightening the importance of such common decisions within the Community.<sup>1</sup>

The above example illustrates how the need for coordination in a European EMU would arise from a possible misalignment of national (i.e. regional) fiscal policies. There are in principle two types of solution. One would be to use the Community budget to correct any distortions in the aggregate fiscal policy resulting from independent national decisions; the other would be to intervene at the source, by limiting the scope of national discretion in determining budgetary positions.

The problem is clearly analogous to that faced by federal states where regional governments have sizeable budgets.<sup>2</sup> With the exception of Australia, all the federal states examined have tended to discard the second solution. Their macro-fiscal policy is conducted in the context of their sizeable federal budgets, while budgetary policies of individual states are left primarily to the discretion of their governments. This type of solution seems to avoid unnecessary friction with regional authorities. This solution, however, is out of the question for a prospective European EMU because its central budget is not expected to exceed 3% of GDP. This compares with federal expenditures that range from around 10 to 30% of GDP. The size of the Community budget would clearly be too small to provide for an adequate *masse de manoeuvre* for an effective macro-fiscal policy. As a result, in an EMU an appropriate aggregate fiscal policy could not be determined without impinging on the autonomy of national budgetary positions,

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<sup>1</sup> It is clearly also possible to construct examples with opposite biases, by pointing to crowding-out effects through increases in interest rates in other countries or to the possibility of higher inflation. The precise results will always depend on the specific assumptions made about the objectives of the authorities and the transmission mechanisms involved. The general point, however, remains valid: greater interdependence in principle raises the potential benefits of coordination.

<sup>2</sup> The implicit recognition of the existence of a coordination problem among regional governments has been the basis for traditional arguments that in a federation the stabilization function should be conferred on the federal government – see R. A. Musgrave and P. B. Musgrave (1973), *Public finance in theory and practice*, McGraw-Hill.

whether for purely domestic reasons or for the purpose of international policy coordination.

***Argument 2: Undue appropriation of EMU savings by one country***

*Description.* There is a danger that without coordinated fiscal policies individual member countries might run excessive national deficits and absorb a disproportionate proportion of Community savings. This lack of convergence would impose unwelcome costs on other countries.

*Assessment.* A similar argument has traditionally been made in support of capital restrictions designed to ensure that domestic savings are invested in the national economy. Obviously, in a Community with a single market where goods, services and capital can move freely, the “earmarking” of domestic savings for domestic use would not be a meaningful concept. With fully integrated financial markets any government borrowing would be financed voluntarily, though at a price determined in the market. Only if markets persistently underpriced their lending to governments, or if the fiscal authorities could tax other countries’ citizens, directly or indirectly, could there be a danger of one country “unduly exploiting” the savings of the Community.

Since it can be ruled out that even upon completion of EMU individual governments will be able to tax residents outside their borders directly, an inappropriate (i.e. involuntary) use of private non-resident savings could only occur if circumstances forced all, or at least some, citizens of other Community countries to bear some part of the required financing costs.

One way that this could happen would be if a particular government encountered refinancing difficulties. Since a certain part of claims on that government might result from earlier voluntary lending by residents of other Community countries, there could be strong political pressure throughout the Community to bail out the government in financial trouble. Such pressure might be difficult to resist, especially if the country facing refinancing problems was relatively large and if the EMU implied stronger solidarity ties. Through these bail-out arrangements, citizens of other member countries would effectively be taxed and their savings “exploited” by the national government concerned.



Another possibility might be that excessive borrowing by one country would raise the interest rate level throughout the Community and crowd out investment in countries where the interest rate would otherwise have been lower.<sup>1</sup> Finally, an “exploitation” of savings might also occur if one country’s borrowing either exerted pressure for a more accommodative monetary policy (resulting in a higher rate of inflation throughout the Community) or led to a depreciation of the Community’s exchange rate vis-à-vis third currencies (entailing terms-of-trade losses for all Community residents).

The strength of these arguments largely depends on whether, without policy coordination and explicit constraints on national budgets, market forces could exert sufficiently strong disciplinary effects on national governments’ fiscal behaviour. There is reason to be sceptical about the adequacy of sanctions imposed by the market mechanisms (see Appendix II). Rather than operating directly (through the higher borrowing cost to the government, partly associated with credit risk differentiation),<sup>2</sup> market forces tend to operate indirectly (through political pressures resulting from the perceived costs of the fiscal stance on the economy) (see Appendix II). Their effectiveness could be enhanced, however, by explicit no-bail-out provisions, which would encourage greater prudence on the part of both borrowers and lenders.

The general absence of constraints on the budgetary policies of regional authorities in federal states would seem to suggest that there is little concern about an excessive use of savings by one region at the expense of the others. Nevertheless, the experience of federal states may be of relatively limited guidance in this respect (see Appendix I). Not only have EEC Member States historically shown markedly divergent attitudes towards the merits of fiscal orthodoxy, but the Community is also unique in having a major fiscal imbalance in one of the large regions.

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<sup>1</sup> This argument implicitly assumes that markets do not work efficiently in this case in the sense that the private return on such financing flows exceeds the social return because of the displacement of potentially more useful investment spending, i.e. the market “underprices” such financing from the social viewpoint.

<sup>2</sup> Evidence from Canada and the United States suggests that markets differentiate between the various regions as regards credit risk.

### *Argument 3: Bias towards lack of fiscal restraint in an EMU*

*Description.* It is sometimes argued that in an EMU constraints on national budgets would be needed to avoid an excessively lax fiscal stance for the Community as a whole. A tendency towards fiscal expansion could lead to pressures on the monetary authorities to adopt a more accommodative monetary policy. If this pressure was not resisted, it would jeopardize control over the price level. If resisted, interest rates would rise, thereby crowding out investment and undermining longer-term growth prospects. In either case, monetary policy would be unduly compromised.

*Assessment.* This argument, which has never been spelled out in detail, appears to be essentially a variation of Argument 2. There would seem to be at least three theoretical reasons for less fiscal restraint in an economic and monetary union.

The first has to do with the fact that the EMU would rule out changes in intra-union exchange rate parities. To the extent that the threat of a depreciation of the domestic currency as a result of excessive fiscal expansion had acted as a constraint under the EMS arrangements, its disappearance would encourage financial indiscipline.

The second is that, as outlined above, expectations might arise that the union would tend to make assistance from other member governments more likely in the event of debt-servicing problems. Counting on this assistance, a government might feel less constrained and markets might not properly signal the emergence of difficulties through appropriate risk premiums.<sup>1</sup>

A third reason might be that a move to EMU could entail additional demand for government spending. In the poorer regions in particular, claims could emerge for comparable levels of government services and, more generally, comparable living standards. Quite apart from political pressures, in a situation of greater capital and labour mobility there would be clear limits to the possibility of raising tax revenue as higher tax rates would lead to a loss in the regional tax base. Similarly, the possible negative output and employment effects associated with the more competitive environment in the EMU and the disappearance of exchange rate

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<sup>1</sup> A situation of this kind would seem partly to explain the difficulties in restraining regional government expenditure in Italy. As noted earlier, in Canada and the United States markets differentiate among the various regions in terms of credit risk, suggesting that bailing-out is not perceived as automatic.

adjustments could give rise to demands for specific assistance over and above what is at present allowed for in the calculations of future Community transfers. Resistance to the implied higher tax burden at the Community level would result in a larger deficit.<sup>1</sup>

On the other hand, fears of a bias towards lack of fiscal restraint may be exaggerated. A move to EMU might in fact increase the constraints on fiscal expansion precisely for national governments with a track record of excessively expansionary fiscal policies. For these are the governments that have tended to monetize their deficits and had recourse to direct controls on domestic and international financial transactions with a view to keeping financing costs artificially low (e.g. Italy, Spain, Greece and Portugal). They therefore stand to lose most from the creation of a union.<sup>2</sup> The abolition of restrictions on residents' purchases of foreign assets would reduce the demand for domestic securities. Similarly, with the liberalization of financial services in the Community the battery of domestic controls which directly or indirectly increase the demand for government liabilities and/or reduce their rate of return would need to be largely dismantled.<sup>3</sup> The abolition of these restrictions, whose link to the deficit is sometimes only vaguely perceived, would be equivalent to the elimination of a "hidden tax". By pointing to the true costs of the deficit more clearly, it might tend to encourage discipline.

The available evidence from federal systems would not seem to suggest a bias towards lack of fiscal restraint. Over the period examined, in all cases except one there has been no apparent medium-term problem of control of regional expenditures and deficits, which have not tended to grow relative to their federal counterparts. Moreover, beyond the provisions defining the areas of responsibility of federal and regional authorities in the expenditure and tax spheres, there are no federally imposed constraints on regional government borrowing. A key aspect of all the federal systems considered is the denial (or strict limitation) of access to central bank financing to regional governments in an attempt to subject them

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<sup>1</sup> The creation of an EMU could also lead to pressures for reductions in the average level of tax rates in the absence of effective tax rate coordination, as countries with higher than average tax rates may face an erosion of their tax base in favour of those with lower than average rates.

<sup>2</sup> The implicit tax levied through controls on domestic financial holdings alone may be quite large. See, for example OECD Economic Survey, Spain, 1986.

<sup>3</sup> Otherwise, quite apart from any legal obligations, the domestic financial industry, notably banks, would face serious cost disadvantages in the face of increased competitive pressures. *Ibidem*.

to the discipline of the market. It remains unclear, however, what are the factors ultimately accounting for the apparent lack of a bias in the states examined. This raises doubts about the extent to which their experience can be of guidance for foreseeable conditions within a European EMU (see Appendix I).

#### *Argument 4: Convergence during the transition period to EMU*

*Description.* A certain degree of convergence in the budgetary positions of member countries is a prerequisite for the transition towards a monetary union. Only if fiscal policies are better aligned among Community countries will it be possible to reduce the need for exchange rate realignments and gradually prepare the ground for an irrevocable fixing of exchange rates. The desirability of a financially disciplined and prudent fiscal stance calls for convergence towards the budgetary positions of the more fiscally conservative countries.

*Assessment.* The need for convergence (and hence, implicitly, for some form of fiscal coordination) depends on the degree to which divergent fiscal policies are thought to affect exchange rate relationships. Unfortunately, economic theory and empirical research do not provide unequivocal answers on either the size or, indeed, the direction of the pressure that fiscal shocks can exert on exchange rate parities. They merely suggest that factors such as the impact of fiscal policies on interest rates and on the current account are important, and that neither of these can be determined without knowing whether the monetary authorities will monetize the deficit or not. Thus, for instance, expectations of monetization of an increase in government borrowing can lead to a depreciation of the currency, whereas a non-accommodative monetary stance could cause an appreciation by increasing the interest rate differential in favour of domestic assets.

If economic theory emphasizes that the precise effects of divergent fiscal policies can only be analysed with reference to actual circumstances, it also indicates that changes in fiscal policy will in general have important repercussions in asset markets. This view is confirmed by practical experience within the Community and, perhaps even more clearly, by the discussion of the role of fiscal policy in the context of G-7 efforts to achieve a greater degree of exchange rate stability among the main currencies. Thus, measures to coordinate fiscal policies within the Community and to enhance their compatibility with a view to exchange rate cohesion would greatly facilitate the Community's approach to EMU.

While the importance of such measures is beyond doubt, it is more difficult to define in practice what the appropriate degree of fiscal policy convergence should be. As long as countries differ considerably in the structure and relative size of their budgetary expenditure and revenue, in their sectoral saving/investment propensities and in their central banks' ability to resist pressures for monetization, there would be no economic justification for broadly uniform budgetary positions.

As far as the direction of convergence is concerned, the shift towards fiscal consolidation for domestic purposes in a number of countries suggests that convergence towards the position of the more fiscally conservative countries would be desirable.

### III – Conclusions

A review of fiscal arrangements in federal states and of their experience with fiscal coordination suggests that there generally exist few constraints on the budgetary policies of sub-federal governments and that concerns about fiscal coordination have not ranked highly. At the same time, there are at least two major differences between conditions in these countries and in the EEC which call for caution in deriving possible lessons for appropriate fiscal arrangements in the Community.

Firstly, with the possible exception of Canada, there have been no large and persistent differences in the fiscal behaviour of the member states in the various federations. This is in marked contrast to the widely divergent "propensities to run deficits" prevailing in the EEC, Secondly, the Community budget will, in the foreseeable future, remain a much smaller proportion of total public spending in Europe than the federal budget as a percentage of total public expenditure in other contemporary systems.

Much of the fiscal convergence achieved in federal states is probably the result of tradition and history – factors which in Europe appear to favour divergence. Nor would it be wise to rely principally on the free functioning of financial markets to iron out any excessive differences in fiscal behaviour between member countries. It is unlikely that the interest premium to be paid by a high deficit member country would be very large, since market participants would tend to act on the assumption that the EMU solidarity would prevent the "bankruptcy"

of the deficit country. In addition, to the extent that there was a premium, it is doubtful that it would reduce significantly the deficit country's propensity to borrow. There is, therefore, a serious risk that, in the absence of constraining policy coordination, major fiscal imbalances would persist.

This raises two concerns which differ according to the stage reached in the progress towards a fully-fledged EMU. During the transition period (stage two), the greater part of the burden of trying to respect the stricter intra-Community exchange rate commitments would have to be borne by the monetary policies of individual member countries. This task would be harder to fulfil than under the present ERM arrangements and failure to succeed would have more devastating consequences for the whole integration process than it would today.

If the stage of irrevocably locked exchange rates had been reached (stage three), the emergence, or the persistence, of a significant public sector borrowing requirement in one or more of the member countries would mean that real interest rates would be higher in the other member countries than they would otherwise have been. Private investment in these countries would thus be "crowded out" by the fiscal policies of the deficit countries. This could lead not only to the emergence of intra-EMU political tension, but also to pressure on the federal monetary authority to relax monetary policy.

The combination of a small Community budget with large, independently determined national budgets leads to the conclusion that, in the absence of fiscal coordination, the global fiscal policy of the EMU would be the accidental outcome of decisions taken by Member States. There would simply be no Community-wide macroeconomic fiscal policy.

As a result, the only global macroeconomic tool available within the EMU would be the common monetary policy implemented by the European central banking system. Even within a closed economy, this would be an unappealing prospect as it would imply the serious danger of an inappropriate fiscal/monetary policy mix and pressures tending to divert monetary policy from the longer-run objective of preserving price stability. But such a situation would appear even less tolerable once the EMU was regarded as part and parcel of the world economy, with a clear obligation to cooperate with the United States and Japan in an attempt to preserve (or restore) an acceptable pattern of external balances and to achieve exchange

rate stabilization. To have even the smallest chance of reaching these objectives, all cooperating partners will need flexibility in their policy mixes.

On the basis of these arguments, fiscal policy coordination would appear to be a vital element of a European EMU and of the process towards it. Appropriate arrangements should therefore be put in place which would allow the gradual emergence, and the full operation once the EMU is completed, of a Community-wide fiscal policy. Such arrangements should also aim at avoiding disruptive differences between the public sector borrowing requirements of individual member countries.

## Appendix I

### *The experience of federal states and the EEC*

I – Introduction and summary of factual findings

When searching for some empirical evidence to assess the various arguments for coordination, it seems natural, for want of a better alternative, to turn to the experience of federal states. This might provide some, albeit crude, parallels with possible conditions within a European EMU. What follows considers five countries (the United States, the Federal Republic of Germany, Canada, Australia and Switzerland) before looking at the present situation in the Community and assessing the relevance of the comparison.

The key findings that emerge from the factual analysis are the following:

- federal states differ markedly with respect to the degree of autonomy enjoyed by sub-federal governments in the fiscal sphere; it is particularly great in Switzerland, Canada and the United States and much less in Germany and Australia;
- federally-decided limits on the borrowing of regional governments exist only in Australia, though in both Germany and the United States there are restrictions imposed by the states themselves;

- with the exception of Germany, where it is in any case of negligible importance, in no country do regional authorities have access to direct central bank financing;
- except for Australia, over the period examined no country appears to have experienced serious problems with, or been much concerned about, medium-term control over sub-federal budgetary positions;
- concern has at times been expressed, however, about an inappropriate overall fiscal policy stance arising from independent decisions taken at the regional level;
- the size of the federal budget has generally allowed these conflicts to be resolved with a minimum of interference in sub-federal budgetary policies.

From a structural viewpoint the main differences between the EEC and the federal states are the following:

- the much smaller size of the Community (central) budget;
- greater concentration of expenditures and, especially, borrowing needs in a few “regions”;
- greater dispersion of net borrowing and indebtedness in relation to regional variables;
- much smaller inter-regional transfers.

[...]



## Appendix II

### *Market forces and budgetary discipline*

This brief appendix considers in more detail whether there exist market mechanisms which can encourage prudent fiscal behaviour on the part of governments.

For a private firm, the ultimate market threat which penalizes imprudent borrowing is the danger of bankruptcy and liquidation. Market forces signal this risk by incorporating a default premium into the cost of funds and/or by rationing them. In addition, lenders may curtail the decision-making autonomy of the enterprise when a position of financial stress is approached. As in a competitive environment there exist strict limits to the extent to which revenue can be obtained by simply raising prices, the borrowing and expenditure decisions of firms tend to be relatively responsive to market pressures.

Whether similar market pressures can be brought to bear on governments is less clear. One may distinguish here between the situation of a single State and of one which is an EMU member. In a single State, a government may be less responsive in the short run to an increase in the cost of its borrowing resulting from market anticipations of future debt problems because it might feel that higher debt service payments can be met by raising taxes and/or, perhaps, by monetizing the deficit. It is only in the longer run that the costs of such actions become apparent, either in the form of resistance to the implied tax burden or higher inflation.<sup>1</sup> At that point, political pressure may be exerted to cut expenditure. As the experience of a number of countries illustrates, however, the lag with which such pressures tend to emerge is considerable.

When a State is a member of an EMU, at least two contrasting forces would seem to be at work. On the one hand, the exclusion from access to central bank credit may make governments more sensitive to signals coming from the market in the form of higher costs of funds. On the other hand, the closer economic and solidarity ties implied by membership of the union may generate market expectations that the country concerned would ultimately be bailed out by other EMU members. That would mean fewer pressures on fiscal consolidation and

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<sup>1</sup> They can also show up, probably earlier, as resistance to any perceived crowding-out effects associated with the fiscal policy stance.

less differentiation in the cost of funds. The country would effectively benefit from the credit rating of others. The case of New York City may be taken as an example. It is clear that in that instance market mechanisms were not effective in preventing the financial crisis and that central government assistance was indeed forthcoming.

## Chapter XXI

# Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries

1990

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*Alexandre Lamfalussy not only paid attention to the big themes of monetary policy and financial stability, but he was also involved in “plumbing” matters. In 1989-1990, he was the Chairman of the Committee on Interbank Netting Schemes of the central banks of the Group of Ten countries. The committee provided, in the first instance, an analysis of the policy implications of cross-border and multi-currency netting arrangements. Thereafter, in its policy recommendations, it laid down minimum standards for netting schemes as well as principles for co-operative central bank oversight. Reproduced here is Part A, Introduction and summary, of the report. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family. The original text of the Report is available on the BIS website, [www.bis.org](http://www.bis.org), free of charge.*

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## Section 1 – Introduction

1.1 In February 1989 the Report on Netting Schemes prepared by the Group of Experts on Payment Systems of the central banks of the Group of Ten countries (the Angell Report) was published by the BIS. At that time the G-10 Governors agreed to establish a high-level ad hoc committee to analyse further the policy implications of cross-border and multi-currency netting arrangements identified by the Angell Report as being of particular concern to central banks collectively. Promoters of interbank netting schemes had been requesting the views of central banks individually on projects which appeared to have implications for a number of countries and it was hoped

that the collective consideration of the issues raised by these schemes might provide a basis for common responses by the G-10 central banks. This Report contains the analysis of netting conducted by the Committee on Interbank Netting Schemes together with the Committee's policy recommendations.

- 1.2 The Angell Report presented an analysis of the credit and liquidity risks experienced by participants in bilateral and multilateral netting arrangements for both interbank payment orders and forward-value contractual commitments, such as foreign exchange contracts. The Report also identified a number of broader policy issues. These included the effects of netting on the integrity of interbank settlement arrangements, on the conduct of monetary policy, and on trading behaviour in interbank markets. Particular concern was expressed for the complications posed for the allocation of supervisory responsibilities and the effective oversight of cross-border netting systems.
- 1.3 The Committee's work has confirmed the general analysis of the credit and liquidity risks associated with netting schemes that is contained in the Angell Report as well as the main policy concerns for central banks which the Report identified. In general terms, the Committee has recognised various advantages that netting can have in terms of improving both the efficiency and the stability of interbank settlements, by reducing costs and risks, provided that certain conditions are met. However, the relative lack of experience with different types of netting arrangements – particularly proposed systems for multilateral netting of foreign exchange contracts – has made it difficult for the Committee to analyse all of their likely consequences. Nevertheless, the Committee has concluded that the shared policy objectives of central banks do provide a sufficient basis for common policy responses to the development of cross-border and multi-currency netting systems.
- 1.4 The Committee's analysis and policy recommendations are summarised in this Part A of the Report. Part B describes the policy objectives that central banks have in common with respect to these netting systems, presents the Committee's analysis of the impact of netting on credit and liquidity risks and on the level of systemic risk and describes the broader implications of netting arrangements for central banks and supervisory authorities. Part C presents the Committee's recommended minimum standards for the design and operation of cross-border and multi-currency netting and settlement

schemes. Part D presents principles for co-operative central bank oversight of these schemes. A list of the members of the Committee is contained in an annex.

## Section 2 – Summary of Analysis

- 2.1 Central banks have shared policy interests both in the efficiency and stability of interbank payment systems and, more generally, in the efficiency and stability of the financial system as a whole. In particular, all central banks have an interest in limiting the level of systemic risk in the banking system while encouraging improvements in the efficiency of interbank markets and the settlement systems which support these markets. Central banks also seek to maintain the effectiveness of the policy instruments used to pursue their ultimate objective of the stability of their currency and to ensure their continued ability to oversee developments in the markets through which monetary and exchange rate policies are implemented.
- 2.2 By reducing the number and overall value of payments between financial institutions, netting can enhance the efficiency of domestic payment systems and reduce the settlement costs associated with the growing volume of foreign exchange market activity. Netting can also reduce the size of credit and liquidity exposures incurred by market participants and thereby contribute to the containment of systemic risk.
- 2.3 Effective reductions in exposures, however, depend upon the legal soundness of netting arrangements in producing binding net exposures that will withstand legal challenge. The concept of netting, in the broadest sense, is given effect under the law of all G-10 countries. But binding net exposures may not be achievable by all banks in all circumstances. For example, cross-border netting arrangements raise choice-of-law and conflict-of-law questions that cannot be easily resolved. Establishing a sound basis for the assertion of net exposures will, therefore, require thorough legal preparation by the participants in netting schemes and by netting providers.
- 2.4 If, instead of achieving reductions in actual credit and liquidity exposures which participants would experience in the event of a counterparty default, netting merely obscures the level of exposures, then netting arrangements

have the potential to contribute to an increase in systemic risk. Moreover, even when actual exposures are reduced, multilateral netting systems can shift and concentrate risks in ways that could increase systemic risk by increasing the likelihood that one institution's failure will undermine the condition of others. The degree of systemic risk in multilateral systems depends on the strength of the incentives for the netting provider and the participants to manage and contain their exposures and on their capacity to absorb losses in the event of a default.

2.5 The Committee considered different possible risk-management procedures for multilateral netting systems, particularly in relation to proposals now being developed by bankers to establish multilateral systems for foreign exchange contracts. At one end of the spectrum are arrangements under which all risks would be borne and managed by the provider of the netting service or central counterparty. Participants in such systems might be required to post collateral or margin to secure fully the system's exposure to them. At the other end of the spectrum are completely decentralised arrangements under which, in the event of a participant's default, credit losses associated with its net position vis-a-vis the central counterparty would be allocated on a pro-rata basis among the surviving participants. Under such arrangements the principal risk-control mechanism would be participants' bilateral limits on their exposures to other participants.

2.6 In principle either centralised or decentralised arrangements, or some combination of the two, should provide credit and liquidity safeguards that would ensure the systems' abilities to manage exposures and complete settlements. A centralised, collateral-based approach appears likely to provide somewhat greater protection against systemic risk but it would do so at the cost of the use of the necessary collateral, which would then become unavailable for other purposes. A purely decentralised approach would avoid that cost and would maintain incentives for participants to manage their own exposures but without the same level of assurance of the system's ability to ensure the completion of settlement. A decentralised approach to the allocation and management of risks, however, could be combined with a collateral facility to ensure the satisfaction of participants' loss-sharing obligations in the event of a crisis.

- 2.7 By altering settlement costs and credit exposures, these proposed multilateral netting systems for foreign exchange contracts could alter the structure of credit relations and affect competition in the foreign exchange markets. But the lack of any actual experience with such systems makes it difficult to predict the impact which any particular system would have on activity in the foreign exchange markets or on the stability of the financial markets generally.
- 2.8 The principal concern for monetary policy with respect to netting systems results from the possibility that a system's risk-management procedures may be inadequate and, thereby, contribute to systemic risk or financial fragility in a way that would impede the attainment of monetary policy objectives. Netting per se, however, is unlikely to impair the effectiveness of the instruments of monetary policy in the long run, although the operation of netting systems could, at certain times, complicate the daily conduct of monetary management in some countries. In particular, it may be difficult for a central bank to oversee effectively the liquidity-management practices of a cross-border or multi-currency netting system that is located abroad but the operation of which affects settlement practices in its domestic, interbank funds market.
- 2.9 More generally, the development of truly trans-national interbank settlement arrangements, made possible by the application of advanced communications and data-processing technologies, has permitted a separation of the netting or clearing process among a group of banks in one financial centre from the final settlement of their net positions in another. This geographic division of functions which have traditionally been integral parts of domestic payment and settlement systems complicates the task of assessing the impact of particular systems on market practices and systemic risk.

## Section 3 – Summary of Policy Recommendations

- 3.1 Based on its analysis, the Committee believes that the common interests of central banks in the development of internationally-related netting arrangements demonstrate a need for collective policy responses. Specifically, the Committee has identified shared interests in ensuring, firstly, that netting schemes are designed and operated with adequate attention to the prudent

management of credit and liquidity risks and, secondly, that there is effective central bank oversight of the impact of netting schemes on market behaviour and systemic risk.

### *Minimum standards for netting schemes*

3.2 A direct means of achieving central banks' common objectives of containing systemic risk and moral hazard, while encouraging improvements in the efficiency of interbank settlements, is to ensure that private interbank netting and settlement systems are designed and operated so that the participants and the service providers have both the incentives and the ability to manage the associated credit and liquidity risks. As a first step toward ensuring the adequacy of the risk-management practices of private interbank netting arrangements, the Committee has agreed upon minimum standards for the design and operation of cross-border and multi-currency netting schemes. These minimum standards are set forth below and are repeated in Part C of this Report with supporting explanations.

- I. Netting schemes should have a well-founded legal basis under all relevant jurisdictions.
- II. Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process.
- III. Multilateral netting systems should have clearly-defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant.
- IV. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position.



V. Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access.

VI. All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements.

3.3 The primary responsibility for ensuring that netting and settlement systems have adequate credit, liquidity, and operational safeguards rests with the participants. The presentation of these minimum standards by central banks in no way diminishes this responsibility. On the contrary, it is the Committee's intention to heighten awareness of the risks associated with netting and settlement systems and of the need for their prudent management by market participants. Moreover, these are minimum standards that all schemes should meet; they are not a statement of best practices to which schemes should aspire.

3.4 There are clearly several ways of prudently managing the risks associated with netting and settlement mechanisms. The standards are intended to be sufficiently flexible to permit market participants to adopt different risk-management techniques. Their presentation is designed to indicate both the issues that market participants should address and the standards against which their different approaches should be measured. The Committee's intention is to encourage market participants to develop systems that can contribute both to improving efficiency and reducing risk.

3.5 The Committee's work has focused on netting and settlement arrangements for interbank payment orders and for foreign exchange transactions and the suggested minimum standards have been drafted with these particular instruments and netting systems for them in mind. But these standards may also provide a useful starting point for the consideration of risk-management procedures for funds settlements associated with clearing arrangements for other financial instruments.

3.6 In establishing minimum conditions, the Committee's intention is to preserve the freedom of individual central banks to apply higher standards where necessary. This should help to contain moral hazard and provide flexibility for central banks to ensure that interbank settlement arrangements in their

own currency are consistent with the central bank's market practices. For example, the Committee believes that it would be highly desirable for systems to be able to withstand multiple defaults and that such structures should be encouraged by central banks whenever possible.

### *Principles for co-operative central bank oversight*

- 3.7 Central banks oversee developments in their domestic interbank markets and in the payment and settlement systems that support these markets. In their capacities as the ultimate providers of interbank settlements and as lenders of last resort, central banks have a special interest in the credit and liquidity management practices of banks, as well as the settlement arrangements that link their credit and liquidity exposures within the domestic banking system, in order to assess banks' abilities to withstand adverse developments without the need for recourse to extraordinary central bank support. This "oversight" of the domestic payment system serves to co-ordinate the various functions of the central bank and may also involve a co-ordination of the responsibilities of the monetary and supervisory authorities.
- 3.8 The development of cross-border and multi-currency systems demonstrates the need for a similar oversight function to be performed with respect to these systems which directly link the credit and liquidity exposures of banks in different countries. "International" financial trading activities traditionally have been settled through the correspondent services of "domestic" clearing and settlement systems. Although interbank payments in a given currency are still ultimately settled through accounts with the central bank of issue, the private sector is now developing truly trans-national interbank settlement systems which separate the netting or clearing process among a group of banks in one financial centre from the final settlement of their positions in another. Cross-border and multi-currency netting systems are examples of these developments that are of special concern to central banks because of their potential influence on the overall credit structure of financial markets and, particularly, of the foreign exchange and interbank funds markets.
- 3.9 The Committee recommends that central banks respond to this situation by agreeing to act in accordance with the principles set forth in Part D of this Report. In summary, these principles provide that:

- Netting systems should be subject to oversight by an authority that accepts primary responsibility to do so;
  - There should be a presumption that the “host-country” central bank (in whose market the system is located or operating) will undertake this responsibility but that, in certain cases, it could be mutually agreed that another authority would undertake the primary responsibility;
  - The responsible authority should review the design and operation of the system as a whole and consult with other central banks and supervisory authorities that may have an interest in the system’s prudent operation;
  - Determination of the adequacy of the settlement arrangements should be the joint responsibility of the central bank of issue and the authority with primary responsibility; and that
  - In the absence of confidence in the soundness of the design or management of a cross-border or multi-currency netting or settlement system, a central bank should discourage use of the system by institutions subject to its authority.
- 3.10 These principles apply to any netting or clearing system for payments or currency obligations that is located outside the country of issue of the relevant currency or currencies and are designed to serve at least three objectives. Firstly, their application should ensure that cross-border systems are subject to review “as systems” by a single authority with responsibility to consider the system’s impact in different countries. Secondly, they should provide a co-operative approach to ensure that the interests of different central banks and supervisory authorities are reflected in the oversight of any one system. Thirdly cooperation between central banks should, in particular, help to preserve the discretion of individual central banks with respect to interbank settlements in their domestic currency.

## Chapter XXII

# Priorities for Eastern Europe

1991

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*The fall of the Iron Curtain brought about tremendous changes in Europe. At the BIS, Lamfalussy too was confronted with the issue of the transition of the central and eastern European countries into market economies. In this paper, he goes into three issues: the broad directions which all eastern European countries should follow; areas in which countries should be allowed to make their own choices; and the way the West could help these countries. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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The deepening of the slump in eastern Germany has prompted comments to the effect that if things can take such a nasty turn there, how much worse will be the fate of the other reforming eastern European countries. Well, yes and no. Admittedly, eastern Germany will continue to benefit from the financial resources and the entrepreneurial and administrative skills of western Germany on a scale that is bound to bring recovery in the end. On the other hand, eastern Germans expect to catch up with the standard of living of their western fellow countrymen within a few years at a time when their industry has become exposed to the full vigour of international competition and has lost the adjustment weapon of the exchange rate. This has made gradual restructuring impossible and has led inevitably to the collapse of output. Prospects for the other reforming eastern European countries are different: less disastrously disruptive in the short run, but less promising in a longer perspective.

This is a good reminder that, when making policy recommendations to eastern European countries, one should be careful to keep the right balance between general prescriptions and country-specific recommendations. While the difference between the former German Democratic Republic and the other eastern European countries is the most striking, differences among the latter abound. My feeling

is that, as time goes by, the need to be country-specific becomes increasingly obvious.

There remain, of course, a few broad directions which all eastern European countries would be well advised to follow if they want to achieve a successful transition to a properly working market economy.

Firstly, the political and social foundations of a functioning democracy have to be laid and consolidated. This requires a great deal of legislative and institutional work but also two practical developments which have little to do with drafting laws. One is the emergence of a strong and effective parliamentary opposition that keeps the policies of the majority under constant scrutiny and can offer potential alternatives. The other is the revival and strengthening of organised civil society: the representation of the interests of various social groups, be they professional, sectoral, cultural, regional or ethnic. The elimination of such organisations was one of the more vicious crimes of the communist regimes. Both these developments are indispensable for the successful outcome of an explicit debate on the crucial policy issues faced by these countries, as, indeed, for the implementation of tough policy decisions.

Secondly, there is an obvious need to develop the institutional framework of a market economy: a system of western-type taxation; corporate law, in particular bankruptcy law; an independent central bank; a banking system; accounting and auditing; and capital market institutions which include not only stock exchanges but also institutional investors, such as pension funds and insurance companies. Finally, I would place special emphasis on the rapid and, if unavoidable, even unfair settlement of property rights. Ethical perfectionism in this field is not only hopelessly impracticable; it also puts a major brake on genuine capitalistic developments.

Thirdly, all countries need to pursue a basically orthodox macro-economic policy with the objective of keeping – or bringing – inflation under control. Rising inflationary expectations provide the worst possible environment for the optimum allocation of resources.

Now let me turn to a list of policy issues on which I would find it questionable to make recommendations applying to all countries. The process of dismantling a total command economy based on all-pervasive state ownership is untested to

such a degree that there is room for divergent views. Countries should be allowed to make their own choices and even to make their own mistakes. The list is not exhaustive.

1. The pace and technicalities of privatisation. I start from the premise that privatisation should be regarded both as an objective worth pursuing in itself (spreading ownership to promote a balanced society) and as a means of achieving a properly functioning market economy. The first of these objectives is best served by privatising housing, retail trade, services and small firms. The achievement of the second objective, especially in the case of larger firms, is not such a straightforward matter. It requires two different things: on the one hand, effective control by owners over management and, on the other, the development of a market for assets. Giving priority to the one or the other may imply a preference for very different routes. The spreading of ownership by issuing vouchers may lead quickly to a broad market in ownership rights, but it is far from evident that it will allow owner control over management. Even in our western countries scattered shareholding ownership does not ensure a proper control over management. Perhaps the mutual fund sub-option could help. But who will control the management of these funds? On the other hand, the gradual process of outright sales of state assets is much more likely to lead to effective control by owners over management (in particular via foreign ownership), but at the same time there will be much slower growth in the market for assets. This second route has, however, the added advantage of forcibly accelerating the pace of development in such crucial areas as accounting, auditing and property rights, without which there will not be many sales.
2. Convertibility. Convertibility for the current-account operations of the enterprise sector should be considered an indispensable ingredient for the proper working of a market economy, as has been recognised in the western industrial world since the end of the war. But there is room for very divergent views on whether convertibility should be extended to households and to capital-account operations of both households and the enterprise sector, and if so, at what pace. Total convertibility of the kind that has only recently been reached by some of the major industrial countries cannot be made an operational objective on the basis of the same robust arguments as those used in favour of full import liberalisation and the right of foreign investors to repatriate capital and dividends.

3. The exchange rate regime. There are not many protagonists of absolutely free floating, except for what could be a transitional experimentation with foreign currency auctions at the very beginning of the reform process. The real choice lies between pegging the exchange rate with more or less frequent adjustment and pegging it to a single currency or to a basket. The second choice can be argued out technically, while the first is a matter of degree not of kind. The degree can of course be crucial, but the size and frequency of adjustments to the pegged rate will have to be decided with due regard for the pace and nature of inflationary developments as well as for the type of available anti-inflationary policy instruments (see next point).
4. Wages and incomes policy. Curbing a strongly imbedded inflationary process without some sort of wage control – for instance by taxing wage increases in excess of a certain percentage of the increase in the consumer price index – requires not simply monetary orthodoxy, but very tough fiscal and monetary restraint and very high unemployment. On the other hand, it is difficult to prevent such wage controls from leading to bureaucratic excesses, inducing fraud and, most importantly, impeding the flow of labour from inefficient to profitable firms. Should structural adjustment, be delayed in order to keep inflation under control without resorting to mass unemployment? I believe that the answer to this question will have to depend on considerations such as the intensity of inflationary expectations and the efficiency of traditional monetary policy means in fighting inflation. The development of inter-enterprise indebtedness – the infamous “queuing” – has in many instances blunted the anti-inflationary impact of an orthodox monetary policy.
5. External debt. The argument for debt forgiveness is fairly obvious: a high debt service ratio imposes stringent limits on the capacity of a poor country to invest and, therefore, on its ability to start on the path of balanced growth. But even if one were to forget about questions related to the practical feasibility of large-scale debt forgiveness, the counter-arguments are very weighty indeed. The disincentive to the inflow of the right kind of foreign equity or direct investment (that with a genuinely long time horizon) can prove fatal for an economy which badly needs to restructure its industry. This could perhaps be even more damaging than renouncing access to new external debt-creating finance. The price to be paid for a wrong decision could be very high indeed.

Apart from good or bad advice on how to deal with the policy issues just listed, in what way can the West help those countries of eastern Europe which have decisively opted for political democracy and the market economy? I see four broad ways, in sharply increasing order of importance and/or urgency.

Firstly, by providing technical assistance in setting up the institutional framework and the technical infrastructure needed for a smoothly functioning market economy. Such assistance is already well under way, thanks to the work of multilateral institutions, various government organisations and private think-tanks. Well-focused, specific assistance is probably more useful and less liable to be misdirected than broad “strategic” advice, although the latter is not without importance, especially for those countries which have been late in embarking on the reform process, it could also be of help even for the early reformers wherever it can break the deadlock of internal debate – in much the same way as management consultants can help put an end to interminable board discussions on strategic issues faced by corporations.

Secondly, by helping to bridge external financing gaps with loans that are strictly conditional on the pursuit of reform and macro-economic adjustment programmes. In this field, too, progress has been made under the leadership of the IMF, with the cooperation of the World Bank, the EC and the G-24. The danger here is a certain “financing fatigue”, which has emerged at a time when neither domestic adjustments nor the inflow of direct or equity investment have yet advanced sufficiently to enable these countries to dispense with official lending.

Thirdly, western countries should provide political, technical and possibly financial assistance to help mitigate the effects of the abrupt collapse of the Comecon trade mechanism and the additional shock deriving from the shrinking import capacity of the Soviet Union. Without western help, the individual eastern European countries are left to their own devices and bilateral bargaining both among themselves and with the Soviet Union – not a particularly promising prospect. Almost nothing has been done in this area, rather the contrary: credits granted by western countries for their own exports to the Soviet Union are in the process of crowding out eastern European exporters who cannot count on credits from their own governments.



Fourthly, and by far most importantly, western countries should grant eastern European exporters open and secure access to their own markets. This would be helpful in the short run and more than helpful – absolutely vital – in a longer perspective. There is no way in which rational investment decisions can be reached within individual eastern European countries unless they know where they can export to and on what conditions. How can these small and open economies take their place in the international division of labour unless they are able to specialise in fields in which they enjoy a comparative advantage? And how can western corporations be encouraged to invest in countries whose internal markets are far too small to warrant any sizable investment, unless they see their investment as part of their own international deployment of production capacities? Hence the decisive importance of the early conclusion of generous association treaties with the EC and of clear prospects for longer-term EC membership.

## Chapter XXIII

# What Kind of Independence for Central Banks?

1993

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*Central bank independence gained in popularity in the 1980s and was also enshrined in the Maastricht Treaty. In this subtle paper, Lamfalussy goes into the reasons why central banks should be granted independence. He develops the (traditional) argument about price stability. However, he also argues in favour of a dialogue between the central bank and the government for “shared responsibilities”, especially the monetary/fiscal policy mix. Moreover, he cannot accept that central banks would opt out of banking supervision. Reprinted with kind permission of the Bank for International Settlements and the Lamfalussy family.*

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The case for central bank independence cannot be argued convincingly in purely abstract terms – for instance, by saying that for reasons of principle, and in all circumstances, the central bank should be as independent of the government in the conduct of monetary policy as is the judiciary in dispensing justice. Monetary policy is one of the most important tools of economic policy, and it would seem rather strange to argue on a priori grounds that in a democratic society one specific part of economic policy should be removed from the control of a constitutionally elected government, responsible to its electorate directly or via parliament. What is so exceptional about monetary policy that would warrant such special treatment?

The answer, of course, lies in our concern with inflation. To the extent (a) that the fight against inflation is considered as having high priority on the policy agenda, (b) that governments and parliaments can be legitimately suspected of systematically indulging in over-expansionary policies in general, and in fiscal

laxity in particular, and (c) that inflation is regarded as a basically monetary phenomenon, a good case can be made for granting independence to the central bank in the design and conduct of monetary policy, on condition, however, that the central bank receives an explicit mandate to preserve the purchasing power of the currency and is held accountable for carrying out this mandate. These are important conditions which need to be examined more closely.

There is little doubt in my mind that price stability – by which I mean a rate of change in the general price level that does not materially affect saving and spending decisions – should rank high on the list of policy objectives. Admittedly, the degree of concern with inflation can, and should, vary over the cycle. At present, for instance, the rate of inflation has declined in the majority of industrial countries to a level which can be equated with price stability on the definition just given. The trouble is, however, that on the basis of past experience an acceleration of inflation from the current 2½ to 3½% rate of price increase can happen very quickly. At the same time, it seems highly improbable – if only because of the growing services component of the consumer price index – that the rate of price increase would fall permanently below current levels. This is just another way of saying that while a major battle has been won in the war against inflation, the same cannot be said of the war itself. Now what about the role of governments or parliaments as engines of inflation? While there are instances in which governments have been pursuing staunchly conservative fiscal policies – think of Japan –, there are unfortunately many more cases in which fiscal laxity, and the subsequent monetary financing of public sector deficits, have exerted strong inflationary pressure.

If this is accepted as a valid description of reality, it can be argued that the responsibility for pursuing the objective of price stability should be given to an institution with an explicit mandate to seek its attainment. Assuming that inflation is a monetary phenomenon, this institution would be the central bank. But can this assumption be taken for granted? If not, or even if only with qualifications, how can its governing body be held accountable in the event of failure? And if it were not accountable on this ground, then for what should it be held accountable, and to whom? Without well-defined accountability, the case for central bank independence cannot be made convincingly in a democratic society.

The nature of the process of inflation is therefore at the very heart of the debate. A short paper of this kind clearly cannot do justice to a matter of great complexity, but let me put forward a few propositions. The starting-point is probably not really controversial: in a broad but fundamental sense, inflation is a monetary phenomenon. The late Henry Wallich used to say that inflation is a monetary phenomenon in the same way as shooting people is a ballistic phenomenon. There can be no inflation without money, and (almost) all economists would agree that no inflation can persist, and in particular accelerate, without an accommodating increase in money supply. No economist would deny, even if he (or she) does not adhere to the strict formulation of the quantity theory of money, that money, indeed the quantity of money, matters a lot in the process of inflation.

There would probably be similar agreement on the proposition that restrictive monetary policy, be it defined in terms of a brake on the growth of the money supply or as an increase in short-term interest rates, will in the end have an effect on prices. In other words, the central bank possesses the ways and means of pushing down price inflation to tolerable levels.

At this point, however, unanimity, or quasi-unanimity, of views ceases. Opinions diverge in three key areas. Firstly, as regards the working of monetary control techniques, i.e. the channels through which central banks, by using the operational tools at their disposal, can affect the money supply and/or a wide range of market interest rates. Secondly, there are quite important differences of view as to the transmission mechanism, i.e. the sequence and timing of the impact of changes in  $M$  or in interest rates on prices and the real economy. And, thirdly, partly depending on the views held on the working of the transmission mechanism, economists differ in their assessment of the cost/benefit analysis of an anti-inflationary monetary policy.

At the risk of sounding dogmatic, my views on these three areas of controversy can be summed up as follows. I have no doubt that central banks possess the ability to influence a wide range of short-term interest rates and also a number of potential money supply targets – although financial innovation, governments' money market operations and capital flows may for relatively long periods constrain the capacity of central banks to attain their targeted  $M$ . But, broadly speaking, central banks are masters of their monetary stance, as long of course

as they do not give up their policy independence for the sake of complying with an exchange rate commitment.

I see greater difficulties with the understanding of the transmission mechanism and the assessment of the potential cost of an anti-inflationary policy based exclusively on the use of monetary weapons. The impact of a restrictive monetary policy stance on prices may take quite a long time to work through, and the first effect is likely to be on output. You may put the blame on inflexible prices, labour market rigidities, poor supply-side responses – but the point is precisely that all these imperfections are pretty widespread. If you then consider a situation in which monetary tightening occurs in response to fiscal expansion (as is often the case), it will at once be apparent that this kind of policy mix, while ultimately still conducive to slowing inflation, will do so through quite a strong “real” shock: recession and the crowding-out of private investment. The matter is further complicated when an anti-inflationary monetary policy is expected to operate at relatively low inflation rates where, arguably, the role of market rigidities is proportionately more important and, therefore, the anti-inflationary effectiveness of monetary policy will be running up against decreasing returns.

This, of course, is not an argument against central bank independence. Rather the contrary, it is precisely because of the likelihood of inflationary pressures arising out of potentially large fiscal stimuli or market rigidities that central banks should be given the specific mandate to pursue a monetary policy geared to price stability, and the means to carry out this mandate without interference from government or parliament. (Parliamentary pressure may be even more dangerous than pressure from the executive branch.)

The point I should like to make, however, is that in a world of market rigidities and high public sector borrowing requirements, the success of central banks’ anti-inflationary policy will at best be slow to materialise and at worst appear so costly in the eyes of the public that the resulting pressure on the governing bodies of central banks could well jeopardise the final outcome. There can be no absolute institutional protection against such pressure. For these reasons, in this kind of world, central banks cannot be held accountable, in any simplistic way, for the imperfect success, or perhaps even the failure, of their policy action. How to respond to such a dilemma?

I see no obvious answer to this question. Countries – even those which decide to opt clearly for central bank independence – will have to find their own solution, appropriate to their traditions and the institutional environment in which public policy operates. As a matter of fact, differences already exist between countries with a long tradition of central banking independence. The mandate given by US law to the Federal Reserve System is not the same as that given to the Bundesbank; and, quite significantly, the Federal Reserve is often thought of as having independence within the US Government, while the Bundesbank is regarded as being independent of the German Government.

Two broad propositions could be made, however. The first is that since the implications of an anti-inflationary monetary policy stance for the real economy are strongly influenced both by fiscal policy and by market imperfections, there should clearly be a dialogue between the central bank and the government, with a shared responsibility for the resulting policy mixes, in particular for the monetary/fiscal policy mix. The dialogue should take place between equal partners – otherwise there can be no dialogue. The principle of “shared responsibility” is, of course, not easy to implement. But ways and means have to be found to make it a reality, for it is a reality. No government should be allowed to escape responsibility for a recession which is brought about by a mix of fiscal laxity and monetary restraint; but nor should a central bank pretend that it has no part in such a policy mix. Whether the principle of shared responsibility should lead to a policy mandate to the central bank which somehow qualifies the priority attached to the pursuit of price stability, or whether the government should also operate under a constitutional obligation to put a cap on the fiscal deficit, would of course have to be considered.

The second proposition, which underpins the first, is that the dialogue should receive appropriate publicity. Both parliament and the public at large should be made aware of the views held by both parties, should receive adequate information on the facts and figures held to support these views, and should be informed of the outcome of the dialogue. Such publicity goes a long way towards ensuring genuine accountability. Any such information should of course relate to the policy stances, not to the day-to-day operations of the central bank, which could destabilise the functioning of the money markets.

Central bank independence, even if redefined in the way just suggested, raises one more tricky question, that of the range of activities of the central bank. Contemporary central banks tend to carry out a number of activities, admittedly to varying degrees in different countries, in addition to the key function of conducting monetary policy: management of the public debt, intervention in the foreign exchange market, active participation in the payment and settlement system and banking supervision are the most frequent examples. Is it desirable that a central bank which has been granted independence specifically for the purpose of conducting a non-inflationary monetary policy should continue to exercise such additional responsibilities? The answer to this question should be given in the light of two considerations.

Firstly, central banks should be entrusted only with those additional activities that can be carried out more effectively by themselves than by other agencies – and this would normally be the case when the simultaneous exercise of two activities leads to some added value. This is the main argument in favour of entrusting central banks with banking supervision: supervising the payments system, ensuring the integrity of the financial system as a whole and supervising the banking system are basically complementary activities. Secondly, however, some of these activities may be regarded as a source of potential conflict with the conduct of an anti-inflationary monetary policy. When these two considerations point in opposite directions – as is the case with banking supervision – the choice will have to be made according to the relative importance attached to the pursuit of price stability and to the preservation of the integrity of the financial system. My own view is that given the formidable challenge posed by financial globalisation to systemic stability, central banks should not opt out of the business of banking supervision.

Part Three

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*Founding President  
of the European  
Monetary Institute*

1994–1997





## Chapter XXIV

# Central Banking in Transition

1994

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*This is the text of Alexandre Lamfalussy's (second) Per Jacobsson Lecture, given in London, on the occasion of the Bank of England's tercentenary, on 8 June 1994. In this very careful and nuanced essay, Lamfalussy discusses the main policy challenges faced by central banks: the macroeconomic policy mix, financial innovations, systemic stability and the international dimension. Reprinted with kind permission of the Per Jacobsson Foundation and the Lamfalussy family.*

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Central banking has never been a static business. Throughout its long history it has performed different tasks in different periods; at the same time, developments have been far from identical in the various national central banks. In a long and broad historical perspective, central banking has always been in transition – just like most of our institutions in modern times.

But there is another sense in which the title of my lecture is, I believe, justified. During the past twenty years or so the financial systems of the developed world have been involved in an exceptionally fast process of change, the end of which is, moreover, nowhere in sight. The expression “acceleration of history” surely applies to the contemporary financial scene. The novelty does not lie only in the pace of change; it has also to do with the fact that change is occurring everywhere in the developed world, and even beyond. We now operate within an internationally integrated, innovative, highly competitive global financial system.

It is in this genuinely new environment that, over the last few years, central banking seems to have acquired enhanced importance – perhaps not in relation to its role at the time of its founders, but surely in comparison with the perception of its role between the end of the Second World War and the early 1970s. Monetary

policy has come to be regarded as the dominant element of macro-economic policy, with the explicit mandate to ensure price stability. Central banks have been granted, or are in the process of being granted, a high degree of independence in the conduct of monetary policy. At the same time, they continue to be called upon to assume responsibilities in securing the integrity of the financial and payment systems. Not surprisingly in such circumstances, quite a few prominent central bankers have acquired a high public profile: regular readers of the economic and financial press will notice the weight attached by journalists to the statements and actual or potential decisions of central bankers.

Being part of their world I should perhaps feel proud of these developments. My feeling of pride is, however, tinged with some unease. Independence goes hand in hand with accountability, yet achieving price stability and safeguarding the stability of the financial and payment systems is not going to be an easy task in the new financial environment. I nevertheless believe that, with careful policies (by which I do not mean only monetary policies) and with some luck, these are achievable objectives. This is the main point I should like to make in this lecture. My remarks will be grouped around four themes: the macroeconomic policy mix and the quest for price stability; financial innovation and the conduct of monetary policy; systemic stability; and the international dimension.

## The Macroeconomic Policy Mix and the Quest for Price Stability

The assumption underlying the proposition that central banks should be given the explicit mandate to ensure price stability is that inflation is a monetary phenomenon. This assumption, I think, is basically true, but it needs to be spelled out. The late Henry Wallich, who cannot be suspected of having been complacent either about inflation or about the role of monetary policy in fighting inflation, used to say that inflation is a monetary phenomenon in the same way as shooting people is a ballistic phenomenon. This may have been, and indeed was, an after-dinner *bon mot*, but perhaps not only that.

Inflation is surely a monetary phenomenon in the sense that it cannot last without an accommodating increase in the money supply. Conversely, restrictive monetary policy is always able to put an end to the process of inflation. I would go even

further. While, in the short run, monetary and fiscal policies have a joint impact on both activity and the price level, in the long run it is money that exerts a determining effect on prices. Finally, when market participants share these views (and I think that in today's world they actually do) their perception of what the central bank is doing, or will be doing, influences their price and wage setting behavior. This can shorten the time span elapsing between monetary policy decisions and actual price behavior. In all these senses inflation is indubitably a monetary phenomenon. There are, however, several qualifications, of which I propose to mention only three. All three relate to the fiscal policy environment in which monetary policy operates.

First, take the case where as a result of a deliberate policy decision the fiscal balance suddenly swings into deficit. Even if monetary policy remains on course there will be an increase in aggregate demand, accompanied by a rise in interest rates. If resources are close to full utilization there will be an acceleration of price increases. Of course, in the end the fiscal policy move will exhaust its expansionary effects and the influence of higher interest rates will prevail. There will be a recession and inflation will decelerate. Conclusion: the stability-oriented monetary policy has in fact stopped the process of inflation, but it could not prevent either an initial inflationary slippage or a deeper recession than would have been warranted without the initial fiscal stimulus. Yet it would be strange to hold monetary policy responsible, first, for the acceleration in price increases and, second, for the depth or duration of the recession.

Second, a large and persistent public sector deficit is likely to trigger inflation expectations. Market participants may well be aware that what matters for inflation in the long run is the rate of monetary expansion and not the size of the fiscal deficit in itself. But they also have a long memory and remember how often in the past monetary authorities bowed to political pressure and ended up by financing the public sector's borrowing requirement through monetary expansion. By granting central banks independence from governments and by formally prohibiting central bank financing of the public sector (as is laid down in the Maastricht Treaty) we may help to defuse such expectations. But there is a genuine possibility that market participants will still want to insure themselves against the risk of inflation by adding an inflation premium to long-term interest rates. If central banks want to allay the markets' suspicion, they will have to underpin their credibility by demonstrating their determination to fight inflation.

The resulting policy mix will not be optimal for economic growth. But through whose fault?

Finally, let me add to these two rather conventional observations a third that tends to be overlooked. The efficient conduct of a non-inflationary monetary policy can also be hampered by the level of government spending even if it is adequately financed out of fiscal and social security revenues. A high level of transfer payments and the correspondingly high fiscal or wage cost burden weakens the kind of flexibility in price and wage formation that is essential to the smooth working of the transmission mechanism. In such an environment an anti-inflationary monetary policy will run into a zone of, so to speak, “diminishing returns.” In other words, a given reduction in the rate of inflation will necessitate a higher degree of monetary restraint, and such restraint will affect not only prices but also output, and perhaps output more than prices. Again, the responsibility would seem to rest with fiscal policy.

My main conclusion is that monetary policy does not operate in a fiscal policy vacuum. The proposition that monetary policy can in the end achieve price stability is true. But it does not tell the whole story and the rest of the story is of quite some importance for economic growth. One cannot circumvent the need for an appropriate policy mix. Granting independence to central banks creates the condition for a balanced dialogue between monetary and fiscal authorities, but an optimum policy mix requires two correct decisions, not simply one.

## Financial Innovation and the Conduct of Monetary Policy

There are two broad channels through which financial innovation can impede the efficient conduct of monetary policy. In both cases, the disturbance arises because elements of uncertainty are introduced either in the monetary authorities’ decision-making process or in the transmission mechanism, that is, the way in which a monetary policy decision affects prices and the real economy.

I shall not dwell much on this second type of disturbance; not that I regard it a priori as unimportant, but because of ignorance. Little research has been undertaken into the possible influence of financial innovation on the transmission mechanism, and the results have been unimpressive. Take the example of just

one, simple, almost “Stone Age”, innovation: the use of floating interest rates. Economists long debated as to whether the wider use of floating interest rates accelerates or slows down the impact of monetary policy on the economy. In the end they concluded that a lot depends on the asset/liability balance of households and corporations, on the structure of both assets and liabilities and, naturally, on interest rate expectations as well as on the influence of monetary policy on the rates at the long end of the market. Not a very clear conclusion. It is therefore not surprising that the potential influence of far more complicated devices, such as swaps, interest rate futures, or options, is still terra incognita. More systematic work is now under way among central banks. I hope that in the not too distant future someone will be able to report on this research.

I am, however, ready to stick my neck out on the first topic because we know more about it and also because I know it to be of crucial importance. The main point here is that financial innovation seems to have cast doubt on the usability of an intermediate money supply target. The jury is still out on this issue. On the one hand, the erratic behavior of the demand-for-money function in the English-speaking countries has led their central banks to downgrade whatever M they have used to the more modest position of an information variable or even to switch explicitly to the final target of price stability. The Bundesbank, on the other hand, has remained faithful to its M3 target on the grounds that the relationship between M3 and prices, when measured over the medium term, has in the past been reasonably stable. The Bundesbank also argues that it has never regarded M3 as the only guide for its monetary policy and that in any event the target has been a range rather than a single figure.

Only time will tell us whether the acceleration of financial innovation that is now under way in Germany will lead to the kind of unpredictable behavior in the demand-for-money function that occurs elsewhere in the developed world. It is also still too early to say whether the recent behavior of M3 in Germany foreshadows such a development, or whether it is just a passing aberration.

If Germany were to experience the kind of instability prevailing in the Anglo-American world, the Bundesbank would join the ranks of central banks that are already having a difficult time. Money supply targeting has indeed performed a highly useful role in the conduct of monetary policy, and may have been instrumental in enabling central banks to bring inflation under control.

The main advantage of a money supply target is that the “stance” of monetary policy is thereby clearly defined, which helps the formation of expectations by market participants. When the targeted rate of growth of  $M$  remains unchanged, monetary policy can be said to be on an even course. While central banks still have to take decisions on operational interest rate targets, in a broader sense market interest rates are the outcome of changes in nominal GDP, and therefore of the demand for money, against the background of a steady expansion of the targeted  $M$ . The implications of this are substantial. Money supply targeting relieves central banks of some of the pressure that might be exerted on them by governments or parliaments. The decision-making body of the central bank is more easily able to avoid the temptation of “judgmental” adjustments to monetary policy. Finally – and this is perhaps the most important implication – a money supply target that is relatively well understood by the public at large gives a clear signal to market participants as to the range of price adjustments and wage settlements that is compatible with a stability-oriented monetary policy. Beyond this range, they would run the risk of pricing themselves out of the market.

If we were to cast aside money supply targeting altogether, the conduct of monetary policy would clearly become more difficult. For this would not simply mean a return to the judgmental type of monetary policy that had prevailed during the twenty-five years following the Second World War. It would mean carrying out a judgmental type of monetary policy in a new set of circumstances, in which central banks are entrusted with the explicit mandate to secure price stability and have no excuse for failure, because as independent entities they do not have to comply with the whims of their political masters.

While all this signals difficult times ahead, I am nevertheless not unduly pessimistic. Let us assume that it will be impossible to find in the future a specific, well-defined  $M$  that can be effectively controlled by the central bank and that displays at the same time a sufficiently stable relation to prices to make itself usable as a strictly interpreted intermediate target; and by “strictly interpreted” I mean that any departure from that target would have to be countered within a predetermined time by a change in monetary policy. I note, to begin with, that targeting of this kind has hardly ever been practiced. And central banks have always taken other considerations into account. The main point, however, is that it is a long way from this kind of targeting to decision making based purely on an ad hoc review of current economic circumstances.

There are a great number of intermediate solutions. One that I could see gradually emerging is that an  $M$  would be announced as a target, but the target would be interpreted as an obligation for the central bank to publicly explain, if it wishes to disregard a deviation in the growth of  $M$  from the targeted path, why it does *not* intend to take corrective action. A somewhat looser commitment would consist in the designation of more than one  $M$ , which would of course give greater leeway for interpretation. Whether the announced  $M$  would still deserve in this case to be called a target or would have to be called just an indicator, is a matter of semantics. The substance is the commitment to explain the reasons why the decision is taken to disregard the signal given by a divergence from the target. Such an obligation would mean that the central bank is not free to undertake ad hoc decision making: the obligation to go public is a constraint. It would also imply that, while we may have trouble in finding the proper money supply figure, the role of money (indeed of money supply) in the inflationary process would remain firmly acknowledged. Finally, it would be very much in line with the doctrine of democratic accountability.

## Systemic Stability

Preserving the stability of the financial system has been a traditional task of central banks indeed, historically, very often they were entrusted with this task at the same time as with that of issuing banknotes. While today in many countries the micro-prudential function has been given to institutions distinct from central banks, there is little doubt that even in these countries central banks continue to be held responsible, or at least co-responsible, for securing the stability of the financial and payment systems as a whole. In fact, central banks have played a major role in recent years – and a successful one – in preserving systemic stability, even though they have not been the only players. The new financial environment is not going to make this macro-prudential task easier to carry out. Let me list briefly the main reasons for this.

First, there is the globalization of financial markets, by which I mean not only international financial integration but also the fading of demarcation lines between financial products as well as between different segments of the financial industry. Add to this the steady progress in information systems and communications technology, and the result is the transmission, with lightning



speed, of financial impulses originating in one country or in one market segment to other countries or the rest of the industry.

Second, all financial asset prices – the recent behavior of bond markets is a case in point – display a high degree of variability. This means both short-term volatility and large movements apparently disconnected from underlying fundamentals that, of course, are eventually corrected, but often only after a long time. There is no simple explanation for this price behavior, at least not one that would be obvious to me. Inappropriate policies or uncertainties surrounding policy decisions may in some cases have been responsible for excessive volatility or for misalignments, but I do not share the view of those who argue on a priori grounds that all erratic price movements are caused by policy mismanagement. Anyone who has operational experience in markets is likely to have come across very strange collective market behavior that would be hard to explain by reference to public policy blunders. But I do not claim to know why such market behavior occurs and still less why it occasionally persists sufficiently long to take on the dimensions of a genuine misalignment. The globalization of markets may be part of the explanation. Some derivatives may have increased volatility. The very large share of trading in total transactions may have played a role. But I suspect that this is not the whole story.

Third, globalization, in combination with financial innovation (in particular of the off-balance-sheet type), has significantly increased the opaqueness of the financial markets. This lack of transparency has two facets. One is the difficulty of assessing the creditworthiness of individual market participants on the basis of publicly available information. Imaginative financial structures, spreading across borders, add to the confusion. I suppose that everyone would agree that this does not help the smooth functioning of free markets, which requires adequate information. The other is that it has become exceedingly difficult, and in some cases almost impossible, to evaluate the interconnection between market segments either geographically or functionally. Gone are the happy days when central bankers, by looking at the Bank for International Settlements (BIS) statistics, could assess, for instance, the country risk exposure of individual banking systems. They can still do this as regards on-balance-sheet claims on individual countries, but no information is available on off-balance-sheet links. This should be a matter for concern. For how could anyone, in this situation, make even an educated

guess as to whether an initial major shock originating somewhere could develop into a global systemic problem requiring immediate action?

Fourth, central banks have to face up to the dual challenge of the relative decline in the role of banks in the financial system and the fading specificity of banking itself. Some thirty years ago banks, that is, commercial banks, were the privileged market interlocutors of central banks – because banks were monetary institutions and stood at the center of the financial system by supplying liquidity, distributing credit, and managing the payment flows. By safeguarding the stability of the banking system as a whole, central banks could be reasonably sure that they were protecting, indirectly but effectively, the stability of the financial system as a whole. This still remains true to some extent, but that extent is diminishing.

Finally, we have witnessed a spectacular surge in the volume and average size of financial transactions, resulting in an unprecedented rise in the volume of payments. Intra-day settlement exposures, and with them liquidity and credit risk, have reached a new dimension, putting a premium on the efficiency and soundness of clearing and settlement arrangements.

I should not like to sound alarmist. All this does not necessarily add up to a basically unstable worldwide financial system in the sense that the likelihood of a financial crisis has demonstrably increased. Many of the features of our new system have two facets: while they may be a source of instability, they often contain built-in shock absorbers. Financial innovation has put at the disposal of market participants powerful hedging devices that enable the wise ones to protect themselves precisely against asset price instability. Globalization itself has increased the depth and liquidity of markets. Securitization has led to a wider distribution of risks throughout the system. Market efficiency, in a number of senses of this term, has increased. The point, however, is that in the unlikely event of a financial crisis the crisis could take on genuinely global dimensions. Central bankers will have to bear this in mind. In fact, I think they do.

What sort of preventive measures can they take? The most important one is the conduct of a monetary policy directed, in a medium-term perspective, toward the attainment of price stability. The lack of a credible commitment to that objective could seriously aggravate the risk of market overreaction and therefore that of systemic instability. Or, to put it more bluntly, the best way to avoid asset market

“bubbles” is to stick to a cautious monetary policy. This may not eliminate all misalignments or significantly reduce short-term volatility, but it would at least mean that monetary policy ceased to be a contributory factor to both types of disturbance. The fact that central banks are now recognizing this is good news.

A more difficult task is to ensure that market participants attach full credibility to the central bankers’ commitment to ensure price stability. The difficulty arises in connection with the downgrading (and, a fortiori, the phasing out) of intermediate targets. To the extent that the setting of a money supply target no longer provides an unambiguous indicator of the resolve of central banks to pursue a stability-oriented monetary policy, central banks will have to find other ways and means of conveying their message to the markets. This will necessarily entail better and more detailed information on the economic analysis forming the basis for monetary policy decisions. The initiative of the Bank of England to publish its quarterly reviews of the outlook for inflation is surely a step in the right direction.

As a second measure, central banks should do everything in their power to make the financial system more transparent. More complete and comparable disclosure by all market participants – and not only by banks – should be a priority objective. This will require cooperation not only between regulatory agencies but also with the accounting profession and with market participants themselves. We also have to improve the statistical information on market linkages – even if this turns out to be a tedious and costly exercise.

Third, central banks should contribute to enhancing the safety of both domestic and international payment, settlement, and clearing systems, since these are the transmission mechanisms that could amplify crisis manifestations and turn a local or sectoral crisis into a genuinely global one. The “Report on Interbank Netting Schemes,” to which I contributed in my previous capacity, was a beginning, but not more than that.

Last but not least, a controversial question. Should central banks be directly involved in supervision? Those who give a negative answer to this question base it on considerations relating to moral hazard: there is the risk that supervision may arouse destabilizing expectations of support from the central bank. This, indeed, is a powerful argument. But so is the opposite, which says that it is difficult to draw

a practical distinction between systemic and micro-prudential responsibilities. The prevention of systemic risk can hardly be effective without intimate knowledge of the participants in the market and the linkages between them. Given the kind of financial world in which we operate, the second argument would seem to me to outweigh the first. But it is perhaps not inconceivable for a central bank to acquire this intimate knowledge without a “line responsibility” in supervision.

## The International Dimension

“Globalization” means that cross-border capital flows, be they actual or potential, have created a very high degree of interdependence between countries. This has a bearing on all three topics I have discussed so far.

The pursuit of price stability through monetary policy can be helped, or hindered, by exchange rate developments. By saying this I clearly dissociate myself from the orthodox monetarist view according to which freely floating exchange rates would secure individual countries full freedom to pursue their domestic policy objectives, and, first and foremost, the objective of price stability. I have two quarrels with this assumption. First, because it implies that monetary policies directed toward domestic stability will also stabilize the exchange rate. While I would fully agree that diverging stances of policies have a destabilizing effect on exchange rates, stable monetary policies by themselves will not secure exchange rate stability. Fiscal policies also matter, either because of their possible influence on inflation expectations, or by creating current account imbalances and therefore a shift in financial portfolios. Admittedly, monetary policy will always be able to offset the undesirable impact of fiscal policy on exchange rates, but at a cost, that is, by resorting to changes in short-term interest rates that could be unjustified in terms of domestic balance. Second, exchange rate changes, whatever their origin, will affect domestic prices, and will therefore have an impact on price expectations.

The practical conclusion is twofold. In their quest for price stability, central banks cannot disregard exchange rate developments. But neither are they able to influence exchange rates, in the case of a fiscal imbalance, solely through monetary policy means, or through exchange market intervention, without running the risk of deviating from the pursuit of their domestic policy objective. The need for

an appropriate policy mix is even more important in an open economy than in a closed one. However, the problem is compounded by the fact that in a world of rigid fiscal policies international agreement on a correct configuration of policy mixes will be even harder to come by than agreement on the appropriate domestic policy mix.

The international dimension has implications for the use of money supply targeting as well. On the level of definition and measurement there is the intellectually not very exciting but practically quite tricky question of including or not in the targeted M such items as nonresidents' holdings of assets denominated in domestic currency or residents' holdings of foreign currency assets. Then there is the associated question of how to deal with assets held in offshore centers. More fundamentally, the combination of changes in interest rate differentials with shifting exchange rate expectations may induce portfolio movements that can significantly destabilize the behavior of the targeted M. Further, the large-scale use of derivatives certainly has a major impact on the treasury and liquidity management of corporations and is therefore likely to have an impact on the behavior of M. I do not claim to know what this impact is going to be.

By definition, systemic stability cannot be preserved without active cooperation between central banks. Measures directed toward fuller disclosure and better statistical information, improvements in the payment, settlement, and clearing systems and, naturally, effective banking supervision – all these preventive measures must be taken within the framework of international cooperation. Central banks are keenly aware of the need for such cooperation, and have demonstrated this in the work carried out under the aegis of the BIS.

They have also displayed a clear willingness to fight manifestations of financial crisis by the concerted provision of liquidity to markets whenever they feared that a generalized retrenchment by market participants could lead to a liquidity crisis. With hindsight, some of us might think today that the liquidity creation in the autumn of 1987 was excessive. Maybe. There might in any case have been market developments preventing a tailspin of prices leading to a general financial crisis. Possibly there were such market forces at work. But despite a feeling of dissatisfaction that our intellectual curiosity was not satisfied, I believe it was a good thing that the central banks did not wait to see how effective the built-in

brakes of the market mechanism would have been if they had been left to operate on their own.

The story of 1987, just like the more specific fire-fighting activities that were undertaken on several occasions within a cooperative framework, shows that we can count on international cooperation between central banks to preserve systemic stability. What these experiences have also demonstrated is that, to be successful, this cooperation has to embrace on a very wide basis all central banks whose financial systems are part and parcel of our global system. There may be scope for somewhat tighter regional cooperation in this area, but the interconnections between the regions are such that at the end of the day systemic stability can be secured only by cooperative endeavors on a worldwide scale.

When it comes, however, to the pursuit of price stability (the other major task of central banking), which also requires cooperation, I would put the emphasis in the reverse order. Admittedly, situations may arise in which cooperation on, say, the Group of Ten level is called for with a view to coordinating monetary policies and trying to influence the behavior of exchange rates. But any systematic coordination of monetary policies requires an institutional framework that is just not available on a worldwide basis, and I doubt that it could become available in the foreseeable future. A firm institutional framework is needed for ensuring that the endeavors of individual central banks to reach price stability are helped, rather than hindered, by the policies of neighboring central banks. It is also needed for securing a minimum of fiscal policy coordination and for attaining exchange rate stability. Such a framework does exist in Europe: prospectively a very strong one, if and when we reach Stage Three; a more flexible one, within which we operate at present. It was not my remit today to talk to you about the work of the European Monetary Institute (EMI) or about the prospects for European Monetary Union (EMU), but I do not want to conclude without reminding you that the European Union does exist, and without conveying to you my conviction that this is a firm framework within which central banking policies (still in the plural today) will evolve in the right direction.

## Chapter XXV

# Address on the Occasion of the Tenth Anniversary of the Establishment of the New Hungarian Banking System

1997

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*During his stint as President of the European Monetary Institute, Alexandre Lamfalussy retained his interest in developments in his native Hungary, especially in the monetary and financial sphere. Reproduced below is his address on the occasion of the tenth anniversary of the new Hungarian banking system, given at a conference organised by the Hungarian Banking Association in Budapest on 7 February 1997. After discussing the macroeconomic and monetary policy environment, he goes into the challenges facing Hungarian banks. Reprinted with kind permission of the European Central Bank and the Lamfalussy family.*

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For at least three reasons, I have accepted with pleasure the invitation to share some thoughts with you on the occasion of these tenth anniversary celebrations.

First, for obvious personal reasons, I enjoy spending some time in Hungary – even if it is only for less than a day.

Second, I am absolutely convinced that an efficient financial system in general, and an efficient banking system in particular, together comprise an indispensable precondition for the proper functioning of a market economy and, indeed, for economic growth. Not a sufficient condition, but a necessary one.

Third, I note that Hungary has made substantial progress in this direction in four key areas. The larger part of the Hungarian banking system is now in genuinely private hands; the financial health of most banks (which, not so long

ago, was – to put it mildly – precarious) has improved; the legal, accounting and regulatory framework has been consolidated, and, last but not least, there is now an interbank payment system in place which can no longer be qualified as prehistoric. Admittedly, in all these areas progress is still possible and desirable, but what has been achieved so far now enables you to address a number of institutional issues for the solution of which Western experience is fast becoming increasingly and directly relevant.

But before considering some of these issues, allow me to make some remarks about the macroeconomic situation of the Hungarian economy and about the new framework within which the National Bank of Hungary will be operating. Both these areas are of key importance for the management of your banks. At the same time, both have a bearing on Hungary's declared intention to join the European Union (and within this, probably at a later stage, also EMU). Last but not least, both are important areas in themselves, irrespective of considerations relating to European integration.

## The Macroeconomic Situation

That there has been a significant improvement since mid-1995 in Hungary's macroeconomic situation is beyond doubt. Here are a few facts and comments on some of the features of this improvement.

1. The current account deficit reached \$3.5 billion in 1993 and almost \$4 billion in 1994, i.e. more than 10% of GDP – an obviously unsustainable situation by any standards, but even more so for a country with a high debt ratio. Some of this deficit was covered by direct foreign investment, but the greater part of it was financed by borrowing, as a result of which by the end of 1994 the net external debt had reached 46% of GDP and the exceptionally high level of more than 160% of exports of goods and services and unrequited transfers.

2. I have not yet seen the full 1996 figures, but estimates based on the first eleven months suggest a current account deficit of around (or even less than) \$1.5 billion. This looks much more reasonable, not only because it was more than covered by foreign direct investment but also because of what lies behind this improvement. The \$2.5 billion drop in the current account deficit between 1994 and 1996 was made possible (a) by a 35% increase in exports, accompanied



by a modest increase in imports of about 14%, and (b) by the steady and rapid increase in services income, mainly (but not exclusively) derived from tourism.

3. Since there was also a sizable inflow of foreign direct investment in 1995 and 1996, the country's net external debt dropped from \$18.9 billion at end-1994 to about \$13.3 billion at end-1996. Net external debt declined to 31.2 expressed as a percentage of GDP, and to 71.6 as a percentage of exports of goods, services and unrequited transfers. I have also noted that by 1996 net interest payments on the external debt had dropped to 6.7 as a percentage of exports of goods and services. The comparable figures were 12% in 1994 and as high as 17% in 1990. It is useful to point out that the sizable decline of the net external debt was made possible by the substantial decline of the public sector deficit from 8.2% of GDP in 1994 to 4% in 1996, while at the same time the share of public sector expenditure in GDP declined from 62% to a more bearable 51%. "Growing out" of the debt service burden is no longer wishful thinking, it is beginning to become a reality.

4. The fact I find most noteworthy is that the \$2.5 billion switch of resources towards external use, amounting to some 7% of GDP, took place without a recession, which is unusual for such a large switch. It was even accompanied by a small increase in GDP. This would not have been possible without the fast growth of exports. The remarkable growth of labour productivity in industry – of close to 60% between 1992 and 1996 – played a major role in this respect. This growth, together with the changing composition of exports, suggests that the structural transformation of the Hungarian economy has gone quite far. The growth of net services exports points in the same direction.

5. So much for the bright side of the picture, which is a good thing but should not be overstated.

First, these are improvements in comparison with the unsustainable imbalances which characterised both the situation prevailing in 1988-89 and that of the years 1993-94.

Second, the price paid by the majority of Hungarians was very heavy indeed: a drop in net real earnings of 12% in 1995, followed by another of 4% last year. Even if this was arguably unavoidable, given the size of the imbalances which had to be corrected (and which themselves had been caused, to some extent at

least, by the premature rise in real earnings in 1994), the size of the sacrifices remains a fact. Against this background, any further erosion of average living standards would be just as unsustainable as were the macroeconomic imbalances in 1993-94.

Third, the rate of inflation is still far too high. Admittedly, since the post-devaluation peak reached in the late spring of 1995 – of more than 30% – the rate has been declining steadily, to stand by December last year at a shade below 20%. But I am seriously worried by the fact that the Hungarian rate of inflation, while never moving towards three digits, has remained stuck within the 18-35% range over the past seven years. The worst was avoided by maintaining positive real interest rates during the greater part of this period, but the distorting effects of such inflation rates on the economy remain substantial, not to mention their socially unacceptable impact on those people whose earnings cannot be adjusted to inflation.

6. Looking ahead, I hope that you will bear with me if I become a little philosophical. All knowledgeable observers of Hungarian history, ancient as well as contemporary, agree that Hungarians possess the very rare ability to pull back at the last minute from the brink of disaster or at least to extricate themselves from a seemingly hopeless situation. They unfortunately also note that once the Hungarians have done so, they miss the opportunity offered by their own success to carry out policies with a long-term perspective in mind. I do hope that history will not repeat itself.

Admittedly, any further decline in the average living standard would be unacceptable. The standard of living should be allowed to begin to rise – but only to the extent that this does not upset the basic balance of the economy again. At the same time, the reduction in inflation must continue at a pace which puts the attainment of single-digit inflation in sight. You must break out – downwards – of the 18 to 35% range. And, last but not least, the country will have to begin to tackle earnestly the major structural problems related to the pension, health care, education and social security systems. These are daunting challenges. Two reminders may help when tackling them. The first is that Hungary has managed major breakthroughs in the recent past which were just as difficult as these future challenges: over the past five years, real privatisation accompanied by a fundamental shift in the structure of industry and services; and, more recently,

the handling of a macroeconomic crisis situation. The second is that most of these challenges are akin to those encountered by modern Western societies. For these challenges Hungary is in good company.

## The Monetary Policy Environment

Two recent changes have occurred regarding the institutional environment in which the National Bank of Hungary is operating. I welcome both of them.

1. The possibility of the direct financing of the budget deficit by the NBH has been eliminated. This is in conformity with the provisions of the Maastricht Treaty, and is a measure which has already been implemented by all fifteen member countries of the European Union and which the EMI closely monitors. To remind you, this provision of the Treaty applies to the member countries at this stage, prior to effectively entering EMU. It would seem to me impossible for Hungary to join the European Union without this change in the law governing the operations of the NBH, even if Hungary's participation in the euro area were to come at a later stage.

But this is only an institutional or political argument. There is more to it. Maastricht or no Maastricht, eliminating the direct monetary financing of budget deficits is simply economic common sense. In the long run, inflation is a monetary phenomenon: it cannot happen without an (at least) accommodating expansion of the money supply. And we know from historical experience that more often than not the major source of any such inflationary increase in the money supply has been the direct financing of government by the central bank. Hungary has not been an exception to this general rule – rather its confirmation. And once inflation is established, interest rates go up. Except for very short periods, it is impossible to keep market interest rates below the rate of inflation: who would be ready to undertake financial savings the remuneration of which would imply a loss in real financial wealth? To try to keep interest rates low by monetary financing of the government is a self-defeating device. It may work for a few months, but would end up producing more inflation and higher, not lower, interest rates – certainly higher nominal interest rates, but very likely also higher real rates. The simple reason for this is that people are not fools – at least

not for a long time. Monetary financing of the government is therefore likely to combine two evils at the same time: inflation and high interest rates.

2. The accumulated and potential future losses of the NBH on account of its borrowings in foreign currency have been taken over by the government. This is a salutary cleaning-up operation which ought to have been carried out long ago. It has no consequences for the “real” economy. These borrowings have been undertaken in the past on government instruction and with government approval, with the NBH acting solely as an intermediary. The NBH’s only shareholder is the Hungarian State; the real burden of the State’s direct or indirect external borrowing has to be borne by the present or future taxpayers. This real burden was to some extent hidden by the “seigniorage” profits of the NBH, which had two consequences: they hid the size of this burden from public view; and they distorted the NBH’s accounts. As all experts know, the size of this double distortion was proportional to the rate of inflation, and was aggravated by the NBH’s sterilisation policy of large capital inflows, without which, however, inflation would not have been brought down from 30 to 20% within the past eighteen months. Sterilisation was therefore a wise policy; the real culprit is the rate of inflation, which is much higher in Hungary than in the countries whose currencies were used for borrowing. In a sentence: this long overdue measure serves both public transparency and democratic accountability (of both the government and the NBH) – even if the general public, or politicians, may be excused for not fully understanding the intricate interconnection between accounting procedures in a country with high inflation and the processes of the real economy. This is a good example of the generalised mess created by inflation.

## Challenges for the Hungarian Banks

As I said right at the outset, it is now time to look ahead and begin to address some major issues for the Hungarian banks – issues which, thanks to the progress made over the past few years, are no longer totally dissimilar from those facing banks in western Europe. I intend to make a few comments on these, since they are issues on which I can possibly throw some light on the basis of my own professional experience.

1. The first is about the specificity of banking, i.e. about the possibility or desirability of clearly distinguishing banks, through rules and regulations, from other financial intermediaries. I noted that the recent changes in Hungarian banking law have implied a movement towards the de-specialisation of banks, notably in the field of securities transactions. I believe that a development towards the universal banking model is justified – on certain conditions. It is justified for two groups of reasons.

First, because financial innovation in general, and securitisation in particular, are breaking down the traditionally neat distinction between banks and other financial intermediaries, indeed even between financial intermediation and financial markets, all over the world. Some time ago, banks were defined as financial intermediaries whose liabilities (mainly sight and short-term deposits) were equivalent to the money supply, and the money supply was defined as the total sum of bank liabilities. This nice circular definition kept academics, bank regulators and central bankers equally happy until the moment when financial innovation started blurring the distinction between money and other financial assets, and securitisation began blurring the distinction between financial intermediation and financial market operations. The proliferation of derivatives, financial futures and the like added to the confusion between balance sheet and off-balance sheet items. The result is that it is becoming increasingly difficult to identify banking on the basis of the old equivalence of “banking liabilities = money supply”. This has now been recognised in the sweeping deregulation of banking activities affecting the whole of western Europe and, though more cautiously, also the United States. In some cases this has gone so far as to allow the emergence of consolidated banking and insurance activities.

Second, in a shorter Hungarian perspective, banks in Hungary have a head start on other financial intermediaries in collecting the financial savings of households and of the enterprise sector. Admittedly, Hungary badly needs the large-scale development of life assurance companies, pension funds, mutual funds and the like, i.e. all those institutional investors which can channel savings towards equity investment. But this takes time, since experience and human resources are rare and the reform of the pension system and of health services takes time. Banks should be allowed to fill the gap for the time being, by putting at the disposal of savers a wide variety of financial instruments.

2. Now let me come to the risks that a generalised move towards universal banking could entail, and the ways and means of containing them.

The main risk, of course, is the emergence of conflicts of interest. One such potential conflict of interest may arise within any bank, between the bank's own risk-taking activity and risk-taking for its customers. The classic example of this is the potential conflict of interest between credit-granting and securities underwriting, but this is only one example. The traditional way of avoiding the misuse of such conflict-creating situations is (a) to devise an organisational structure with clearly distinguishable lines of responsibility, (b) to avoid flows of "inside" information between the various activities, (c) to attribute to each activity costs, income and profits, and (d) to entrust external auditors with the surveillance of the systems put in place. The end-result will, of course, never be entirely safe. Moreover, the building of "Chinese walls" inside a multi-polar banking organisation may weaken, or even destroy, the synergy between those poles, i.e. it may undermine the rationale of a multi-polar organisation. I would not want, however, to overstate the internal conflict of interest argument. In the long run, the kind of conflict to which I have referred is unlikely to be very strong, in a longer-term perspective, no bank can afford to favour its own risk-taking activity at the expense of its customers – especially if auditing makes it certain that any misuse of the bank's powers would come to light.

3. Another much more dangerous conflict of interest could arise where the bank is capable of exercising a decisive shareholding power in another non-banking firm, of which it is at the same time a major creditor. This could have unacceptable consequences not only for the firm's other shareholders but, if the practice became widespread, could even lead to structural distortions for entire industries. To avoid this happening, I would favour rather strict regulations. For instance, mutual funds managed by banks should either have limits on the equity participation in individual firms or not have access to the firm's Board. The same should apply, a fortiori, to any bank's direct and permanent equity participation in a non-banking firm – unless, perhaps, the bank remains just a shareholder (as if it were, say, a pension fund), without direct banking operations with the firm in question.

4. Under the last point, I already touched on one particular aspect of corporate governance, namely when a bank can play a decisive role in a non-banking firm's life. But you will also have to face up to the reverse problem: when a non-banking

firm becomes a bank's key shareholder and could therefore potentially induce risk-taking by the bank in its favour, at the expense of the bank's other shareholders or of its depositors or customers. This is a particularly acute danger in countries where there are not many non-bank institutional shareholders, where the defence of minority shareholders has no tradition and where depositors are not properly protected. Such problems have been encountered in Western market economies. It is clearly in Hungary's interest to build up, or consolidate, the appropriate defences against the emergence of such problems.

5. In order to avoid any misunderstandings, I am not launching any appeal in favour of overregulation. In a market economy, the best regulator is the market itself. And when spontaneous market regulation fails – which does happen – the second-best solution is to use regulatory techniques which favour the emergence of market-led self-regulation. I am simply trying to make two points. First, that banking and finance have broader and more general implications for the economy as a whole than any other kind of activity. A crisis in, say, the steel industry creates hardship, but it does not create a general crisis. A banking crisis may well do so. Second, banking and finance are evolving at a very fast pace under the combined influence of technological progress, innovation and globalisation. This needs a careful adjustment of the regulatory framework, not its general weakening.

6. In a very different area, may I call your attention to the need to develop both retail banking in the narrow sense of the term and also banking services to the dynamic sector of small and medium-sized enterprises. In these fields, Hungarian banking is vastly underdeveloped, both in the number of consumer-friendly local offices and, even more importantly, in the range of high-quality banking services offered to these two groups of customers. This underdevelopment is particularly striking when it is compared with the sophistication of some of the wholesale banking activities being offered.

This is most regrettable and goes against the long-term interests of the banks themselves, not to mention those of the country. Households are, and will remain, the major source of the country's financial savings. They deserve to be supplied with appropriate, safe and diversified vehicles which allow them to find an outlet for their financial wealth. Some small and medium-sized firms are net savers; others desperately need financing for development purposes, which financial markets will not be able to provide for a very long time indeed. I have

known of a number of western European and even North American banks which derived great strength from their solid retail banking basis, which helped them considerably in situations in which some, if not many, of their cherished wholesale customers went bust.

You will also need the retail banking basis for another reason. Satisfied household and small enterprise customers provide you with the greatest public support. And I can assure you that you will need this support in a democratic society. Banking has never been, and is unlikely to become, a popular activity, especially when it relies exclusively on customers recruited from among large corporations and very wealthy individuals. Beware of the danger of political backlash.

In developing your retail activities, you will have to monitor western European experiences carefully. Many western European countries are overbanked in this field, and a good deal of discussion is focusing on the merits of customer proximity versus home-computer banking. My feeling is that you will be able to avoid some of the earlier western European excesses, and rely directly on the most recent communications and information systems technology. But for a long time to come, most of your customers will need close human proximity. The comparative assessment of the costs and benefits of these two approaches will be a very great challenge for the Hungarian banking system.

I hope that in ten years' time, if I am still around, I shall be able to congratulate you on having been able to successfully meet this challenge. Meanwhile, I wish you good luck – and the ability to help the emergence of good luck by hard work, skilful management and good strategic choices.



## Chapter XXVI

# The Changeover to the Euro

1997

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*A key task of the European Monetary Institute was preparation for the final stage of EMU, especially the conduct of the single monetary policy and the introduction of the single currency. For the changeover to be a success, it was important for everyone to be well informed about it, and that meant not just banks and financial markets, but also enterprises and the public at large. In his capacity as the President of the European Monetary Institute, Alexandre Lamfalussy had a crucial role in the communication process and gave many speeches on this topic. Reproduced here is his presentation at the International Monetary Conference, Interlaken, on 2 June 1997. Reprinted with kind permission of the European Central Bank and the Lamfalussy family.*

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Prompted by the evident commitment of the political authorities to the EMU project, the successful convergence of countries' performances in some key areas and genuine efforts to reduce fiscal imbalances, financial market indicators in particular suggest a great deal of optimism that Monetary Union will indeed come about, and will commence on time – on 1 January 1999. But it is not only financial markets that are showing such confidence. Banks and companies have also begun to make the investments in information technology that will be required to handle the future single currency. My theme today is the changeover to the euro, with a particular focus on money and capital markets.

## The Changeover Scenario: a Reminder

In the spring of next year, the Heads of State or of Government will make the initial choice of the countries that will participate in Monetary Union. They will also establish the European Central Bank (ECB). On 1 January 1999,

the exchange rates between the currencies of the participating countries will be replaced by irrevocably locked conversion rates and Monetary Union will become a reality.

On 4 January 1999, the European System of Central Banks (ESCB) will conduct its first repo. Repos will be the main instrument of the single monetary policy. They are flexible and market-oriented and, therefore, best suited to performing the functions of steering interest rates in the money market and of signalling the ECB's policy intentions. Following the adoption of the scenario for the changeover to the single currency in Madrid in December 1995, repos will be conducted in euro as from 4 January 1999. Two standing facilities will be made available to the counterparties of the ESCB: a marginal lending facility at rates normally above market rates and a deposit facility at rates normally below market rates. The interest rates applied on these two facilities will form a corridor within which will lie the repo rate and within which money market rates will move. Like the repo transactions, operations under the two standing facilities will be conducted in euro as from 4 January 1999. It is not yet clear whether the conditions that the ECB will face at the beginning of 1999 will warrant the use of reserve requirements as a complementary instrument of the single monetary policy and what the precise features of this instrument should be.

An essential feature of the operational framework for the single monetary policy is that it will operate in euro from the beginning, as agreed by the European Council in Madrid in December 1995. The European Council also decided in Madrid that governments will issue all new tradable public debt in euro as from the beginning of Monetary Union.

The starting date of Monetary Union will not bring about a full introduction of the euro immediately. The timing of the physical introduction of the European banknotes and coins and of the changeover of the current operations of public administrations will depend on what is technically possible. In Madrid, the European Council agreed that the European banknotes and coins will be introduced at the latest three years after the start of Monetary Union. Agreement was also reached that the spread of the use of the euro in the current operations of public administrations (for example, payment of civil servants' salaries and social security transfers, and collection of taxes) will take place in all participating countries at roughly the moment when the European banknotes and coins are

introduced. This chronological framework was adopted in order to promote the transparency and simplicity of the process of changing over to the single currency and its acceptance by the public.

A key feature of the changeover scenario is that, during the period between 1 January 1999 and the moment of the introduction of the European banknotes, the authorities will not intervene, via regulatory channels, to influence the speed at which the euro is introduced in banking activity and among non-bank users of money. This will be neither desirable nor possible. During that period, economic agents will be free to develop their own mechanisms to adapt to the introduction of the euro. They will be able to use the euro, but they will not be obliged to do so (the “no prohibition, no compulsion” principle).

At the latest six months after the introduction of the European banknotes, the changeover to the single currency will have been completed for all operations and all agents.

## Impact on Money Markets

There is little doubt, in my opinion, that a Monetary Union-wide money market in euro will develop very quickly.

First, the integration of the national payment systems, through TARGET, will allow banks in the euro area to deal directly with each other for supplying and accessing overnight funds in euro, irrespective of their location. The implementation of TARGET, which will be operational from the first day of Monetary Union, will quickly lead to the creation of a euro area-wide interbank market in which differences in “local” interest rates would only reflect differences in credit risk and/or differences in taxation and regulation. It is a possible next step for a private repo market to develop within the euro area, with instruments ranging from overnight to longer-term contracts. The fact that repos will be the main instrument of the single monetary policy will provide a strong incentive for the development of a Monetary Union-wide interbank market for repos and, maybe, at a later stage, for a private repo market, where financial and non-financial entities may engage in short-term collateralised refinancing operations for conducting day-to-day treasury management.

Second, an important consideration in our preparations for the instruments and procedures of the single monetary policy is to facilitate the development of an integrated euro money market. As I said, the single monetary policy will be conducted in euro from the beginning. Moreover, the interest rate corridor (set by the interest rates applied on the two standing facilities) is likely to be relatively wide. The larger the corridor, the more volatility is allowed and the more initiative is left to banks to manage their interest rate exposure. Compared with alternative ways of controlling volatility in the interbank market, the framework for the ECB's monetary policy assigns a central role to the market and does not require the central bank to intervene frequently in the market. This reflects a desire to gear the day-to-day conduct of monetary policy to the market and to use the interbank market as the principal means of allocating liquidity.

Third, the collateral policy of the ECB will be relatively liberal. Unlike most central banks (including the Federal Reserve), it is envisaged that the ECB will accept a wide variety of instruments that range from public to private paper. This has to be seen in the context of a desire to encourage the use of private paper and in relation to the prohibition on preferential treatment of public entities. At the same time, the proposed arrangement for the cross-border use of collateral will allow banks in the euro area to obtain liquidity from their home central bank against assets held anywhere in the area, with TARGET allowing them to transfer the liquidity to any place they wish. Banks will no longer need to hold securities traded at the national level to cover their liquidity needs.

Finally, the European Monetary Institute and, later, the ECB will provide assistance to market participants in the establishment of standards for market practices in the euro area-wide money market. Our recent publication on the operational framework for the single monetary policy has already provided interested market operators with elements of information that are naturally becoming a focal point for the adaptation of national standards or for the elaboration of new joint standards at the European level.

## Impact on Capital Markets

The issuance of new tradable public debt in euro as from the start of Monetary Union will provide an incentive for securities markets to change over to the single

currency at an early stage. However, the speed at which the euro will spread in securities markets will also depend on the speed at which public and private debt issued before 1 January 1999 will be redenominated in euro. The choices of public and private borrowers and the preferences of the banking and finance industry at large as regards the timing and modalities of redenomination will have a direct impact on the development of the euro-denominated segment of capital markets at the start of Monetary Union. Let me say a few words on this.

First, the legal framework will have to clearly establish that, for non-sovereign debt, redenomination will require the consent of investors whenever it goes so far as to modify the par value of the security and to affect the legal interest of investors. This is necessary to avoid any disturbances in financial markets. The legal framework is expected to be finalised before the meeting of the EU Council in Amsterdam.

Second, I see the enhancement of the liquidity and depth of capital markets as an important argument for bringing forward the redenomination of financial instruments. Financial market participants would not consider as full substitutes instruments denominated in euro and instruments denominated in the old national currencies, even where they were issued by the same entity. There is a risk that, until the end of the transition period, markets for the old national currency bonds will be de facto split from those for euro bonds and the liquidity of the one or the other segment will tend to fall. Non-redenominated securities would look like “orphan bonds” which would attract only local trading.

Public borrowers will also have an interest in promoting the liquidity of their debt during the transition period, so as to benefit from the lowest possible cost of funds. A number of governments within the EU have already announced plans for the redenomination of all or part of their outstanding debt in euro at the start of Stage Three, or shortly thereafter. Such announcements are driven by competitive considerations and, above all, the search for liquidity in the new euro markets.

Third, the currently envisaged modalities and techniques for redenomination are numerous. I am confident, however, that there will be a natural process of technical convergence towards similar approaches within the euro area. In my view, it is desirable that such a process be achieved via the identification by the

market of the best practices of sovereign borrowers, rather than by imposing common minimum requirements.

The spread of the use of the single currency in financial markets will contribute to further enhancing capital market integration in the euro area. In such an environment, credit risk is likely to become the most important component of securities pricing in the area, increased attention, however, will also be paid to other elements of risk: bonds denominated in the same currency and with identical credit risks may still be priced differently if issuing techniques, clearing and securities settlement procedures and legal procedures differ across countries. More uniform pricing of financial assets in euro will also depend on greater uniformity and transparency in issuing techniques and financial infrastructures.

## Conclusion

Following the political agreement in Madrid that the single monetary policy of the ECB will be conducted in euro and governments will issue their new debt in euro immediately from the start of Monetary Union, one should expect that money and capital markets will largely and quickly switch over to the single currency. The announcement by a growing number of EU governments that they will redenominate their outstanding debt in euro at the start of Monetary Union, or shortly thereafter, will provide a further incentive for financial markets to quickly adopt the single currency.

Meanwhile, most private individuals and most enterprises are likely to continue to operate in the old national currencies until the time when European banknotes are introduced and public administrations adopt the euro for their current transactions. One should, however, not exclude that large companies will wish to operate and open accounts in euro at an earlier stage. The challenge for banks individually will be to have completed – on time – their own technical preparations, in particular in the field of information systems, to be able to respond with flexibility to the wish of their customers to operate in euro and/or to keep their accounts in national currencies. Quite a challenge.

## Chapter XXVII

# Securing the Benefits of EMU

1997

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*Alexandre Lamfalussy frequently debated the economic consequences of EMU. In his view, notwithstanding certain costs, EMU would lead to large net benefits. However, he also stressed that ensuring sustainable convergence and better working labour markets were important to secure these net benefits. Reproduced here is his speech to the forum on “The Future of European Monetary Integration”, London School of Economics, 10 March 1997. Reprinted with kind permission of the European Central Bank and the Lamfalussy family.*

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It is a great pleasure to be with you today here in London, at this august institution and in this distinguished company. I am acutely aware that the topic we are to discuss today is one which has been addressed in great depth and with much passion in this country. I hope the panel will advance that debate further. The main focus of my remarks is the economic benefits that members of the European Economic and Monetary Union (EMU) can expect to achieve, an assessment of costs, and how we can construct the Monetary Union so as to be sure that the net benefits are achieved. First, however, I would like to remind you briefly of the role of the European Monetary Institute (EMI), and of the progress that has been made in the preparations for EMU.

## 1 The EMI and the Preparations for EMU

In a nutshell, the EMI is an organisation of the European Union, established under the Maastricht Treaty. Its members are the central banks of the EU Member States. Based in Frankfurt, it came into being on 1 January 1994, and currently has a staff of around 250. The EMI was established to contribute to the realisation

of the conditions necessary for the transition to EMU; it is a temporary institution which will be dissolved when the European Central Bank (ECB) is established, i.e. some time in the second quarter of 1998. Its three main functions are: first, at this stage, i.e. before the start of EMU, further strengthening co-operation among the national central banks and the co-ordination of national monetary policies with the aim of ensuring price stability; second, providing advice to the EU Council regarding the achievement of a high degree of sustainable convergence by Member States adopting the single currency; and, third, undertaking the necessary preparations required for EMU. I shall not deal with the first function; the second will enter my remarks later. For now, I would like to focus on the highly advanced state of preparatory work.

The preparations for EMU involve close collaboration between the EMI and the national central banks. Concerning preparatory work by the EMI, I would highlight, *inter alia*, that the scenario for the changeover to the euro after the beginning of EMU has been agreed; operational aspects of monetary policy for the ESCB, including instruments and procedures, have been specified in some detail, and the factors underlying the eventual choice of strategy by the ECB have been outlined; the foreign exchange relationship to be established between the Monetary Union and Member States which are not participants (ERM II) has been defined; and secondary Community legislation on the introduction of the euro (including the continuity of contracts after the start of Stage Three and technical rules for the conversion rates) will become effective this year.

There are a large number of other areas in which preparatory work for the establishment of the ECB and the ESCB is being carried forward by the EMI, including issues relating to the interlinking of national payment systems (the TARGET project); preparation of euro banknotes; foreign exchange reserve management; statistical requirements; securities settlement systems; harmonisation of accounting rules and standards; information and communications systems; and further legal issues.

A great deal of work remains to be done, notably the detailed specification of all of the technical features of the various monetary policy instruments and procedures, and more generally in respect of the implementation of the overall framework so that a single monetary policy can operate smoothly from the outset. This will undoubtedly reveal many hurdles – but I am confident that they will be



overcome. All things considered, the EMI is well on track to achieve its objective of ensuring that all of the preparations will be finalised so as to allow EMU to start on 1 January 1999.

## 2 Benefits of EMU

I begin with the realistic expectation that EMU will ensure price stability. Price stability is laid down in the Maastricht Treaty as the primary objective of the single monetary policy, to be explicitly incorporated in the statutes of participating national central banks. The European System of Central Banks (ESCB) will enjoy full independence to determine the appropriate level of interest rates in order to satisfy this requirement of the Treaty. Moreover, the members of the ECB's Executive Board and the Governors of the participating national central banks, who will together form the ECB Governing Council, will have long terms of office and will only be dismissible for serious misconduct or inability to perform their duties. These provisions imply that the concept of monetary stability will benefit from explicit legal protection. The ECB should also reap reputational benefits, inherited from its constituent central banks. We should bear in mind that as a result of generally conservative monetary policies for a number of years, the average rate of inflation in the EU is now just a little above two per cent.

The benefits of price stability are increasingly appreciated. Notably, there is growing awareness that inflation, and inflation uncertainty, lead to a misallocation of resources, and hence the maintenance of price stability is associated with significant efficiency gains, and longer-term benefits to growth. In this context, EMU will be a tool to consolidate the progress towards price stability already made and to firmly anchor inflation expectations. For some countries, where inflation expectations may still be higher due to their shorter track record in terms of monetary stability, EMU will also bring lower interest rates, both nominal (due to lower inflation) and real (as inflation – and exchange rate – risk premia fall), thus providing a stimulus to investment and to growth in the euro area as a whole. There should also be benefits from EMU in terms of a reduction in the costs of disinflation following inflationary “shocks”. For in the absence of EMU, maintenance of the option to alter the exchange rate may be taken as leaving open the possibility to devalue, thus giving credence to agents' expectations of higher future inflation.

A further important benefit of EMU is that it will remove the risk of serious real exchange rate misalignments. These may not only hinder economic growth and give rise to a misallocation of resources; they may also trigger protectionism and, hence, pose a threat to free trade. Such misalignments are particularly devastating in Europe given the level of economic integration; you will recall that sudden sharp falls in currencies such as the lira and sterling some time ago immediately led to – rather isolated – calls for protection and compensation. Such pressures, if unchecked, could put the survival of the Single Market, and all the benefits it brings to producers and consumers, at risk. Note, in this respect, two facts. We have achieved inside Europe a spectacular downward convergence of inflation rates. At the same time, the Single Market implies generalised competition and constant pressure on profit margins. In such a world – and this is a new world – even relatively small nominal exchange rate movements turn into real misalignments, with disruptive effects on trade flows and business planning.

Short-term intra-EU exchange rate volatility will, of course, also be eliminated. Such volatility can again have a direct effect on trade and investment, as is shown by most empirical studies. In any event, the argument that the increased use of hedging instruments makes such volatility a matter of indifference seems exaggerated. Such instruments are not available to all economic agents, nor are they of negligible cost. It may not even be optimal to fully hedge against a single type of risk, since it may leave the firm more exposed to other types of risk, as ably demonstrated in Professor David Currie's recent paper entitled "Pros and cons of EMU".

Furthermore, the benefits of economic integration afforded by the Single Market process will be enhanced once the transactions costs of exchanging different currencies are eliminated. These costs, which include commissions, the bid/offer spread and overall cash management costs, otherwise constitute a dead-weight loss for society as a whole and are far from insignificant – although I acknowledge that they are difficult to measure. Equally, they in effect form an additional layer of protection for domestic producers; a single currency will make prices across the euro area directly comparable, which should increase competition and hence efficiency and underpin progress towards a Single Market.

A number of further positive effects on growth will flow from the elimination of separate currencies. I have already referred to the potential for the reduction

of risk premia built into real interest rates, which in turn will stimulate productive investment. By facilitating the development of deep and integrated securities markets, the single currency should further reduce long-term rates via the elimination of an illiquidity premium. In addition, a wider and deeper capital market will improve intermediation between savers and investors. At a macroeconomic level, the savings/investment balance as reflected in the current account of the balance of payments will become much less of a constraint within the individual participating economies. An EMU country that shows valuable and attractive investment opportunities will be able to attract more capital without running into a balance of payments constraint. Moreover, foreign direct investment is sensitive both to exchange rate volatility and to the risk of lasting real exchange rate misalignments, and hence should benefit from EMU.

A number of the benefits enumerated above increase with the existing degree of integration. In this context, it is important to stress that the integration of the real economies and financial markets of the Member States has already reached a high level. According to a recent estimate, around two-thirds of EU trade is intra-EU, an unparalleled degree of real integration. But equally, the single currency should stimulate further economic integration, with efficiency gains. Such further integration will be beneficial also in that it may reduce the likelihood of so-called asymmetric shocks, one of the arguments used in the debate about the dangers of EMU, to which I shall now turn.

### 3 Criticisms of EMU

Although the case given is a sound one, the arguments put forward by the opponents of EMU cannot, and should not, be disregarded but should be considered seriously and their merits acknowledged, not least because they contain useful warnings about potential problems.

The main policy or even “political” argument often put forward against EMU is that it entails the loss of monetary sovereignty, i.e. the ability to use monetary policy to achieve domestic objectives. However, this argument only retains force if countries were to disagree on the final objective of monetary policy; instead, there has been a growing consensus over the last decade or more that monetary policy cannot influence economic activity and unemployment beyond the short

term. This has been the result of the experience of the 1970s, both in Europe and in the United States, which demonstrated the futility of attempts to trade inflation off against unemployment, as well as the growing awareness that inflation erodes growth potential. This has led to an intellectual and political conversion to the cause of price stability and to worldwide acceptance of it as the primary objective of monetary policy. At the EU level, since monetary policies have a common objective, and given the potential for spillovers of national policy decisions in this area, it is hard to see what is lost by sharing responsibility for the conduct of a single monetary policy – which is, in essence, what EMU means. I might add that the degree to which countries may adopt fully independent national monetary policies is itself limited by the power of the international financial markets, whose ability to punish perceived monetary laxity with rising bond yields and a failing currency has strengthened in recent years.

There are, however, other arguments which to my mind carry greater weight.

First, there will clearly be costs to the changeover, such as training, updating computer systems, and adjustments to cash dispensers and vending machines. These are, however, one-off costs, which should be weighed against certain permanently accruing benefits. Second, there may be differential effects of a single monetary policy on national economies, owing to differences in the monetary transmission process. However, such differences can be exaggerated. Moreover, the market forces unleashed by EMU should themselves promote convergence in this area, as, for example, sustained low inflation makes long-term fixed rate mortgage finance attractive.

Perhaps the strongest argument put forward against establishing EMU is that individual countries should retain the ability to change their exchange rates as a means of responding to adverse asymmetric shocks – shocks which affect the domestic economy but not the euro area as a whole. One preliminary remark, however. I do not believe that asymmetric shocks are likely to be frequent events in western Europe. First, our economies remain rather similar in structure and are relatively diversified, certainly in comparison with the United States. To take an example, the automobile industry plays an important role in practically all our countries. It is heavily concentrated in some areas of the United States. Second, whenever we had a genuinely asymmetric shock in the past – German unification or, to a lesser extent, the oil shock – what really mattered was not so much the

asymmetric nature of the shock, but the asymmetry of the policy reactions. This was evident in the case of the oil shock; and the impact of German unification on interest rates would have been significantly weaker if the Germans had not allowed their public sector borrowing requirement to rise by the equivalent of several percent of GDP. With the emergence of a genuinely converging “stability culture” in the conduct of monetary and fiscal policies the risk of asymmetric policy reactions during the coming years would appear to me to be much smaller than any time since the end of the last war.

Be that as it may, I do not deny that market rigidities in most EU countries are a source of concern. There is no doubt that labour and also some goods and services markets show insufficient flexibility. However, I disagree with the view that this is an argument against EMU. The source of the problem lies in structural rigidities that prevent timely adjustment in domestic prices and wages. The reduction of such rigidities, especially in labour markets, is an objective which has to be pursued irrespective of Monetary Union. Keeping the exchange rate option – which means, to put it bluntly, the devaluation option – may even foster the illusion in some circles that structural adjustments do not require immediate attention.

Moreover, in an environment of real labour market rigidities, changing the nominal exchange rate may not be effective against shocks. If real wage decline is needed to prevent a negative shock from raising unemployment, it has to be the case that wage setters are prepared to allow it through a depreciation of the national currency but at the same time are not willing to accept it through nominal wage restraint. This presupposes a degree of “money illusion”, which is present at most in the very short run.

What role might fiscal policy play in this context? As critics of EMU note, there is no provision under current fiscal arrangements for transfers between Member States of a magnitude sufficient to offset differences in labour market rigidities. Moreover, to minimise the risk of an adverse policy mix and an excessive burden on monetary policy, the countries participating in EMU have agreed to exercise a concerted discipline in the conduct of their fiscal management, with accepted sanctions in the case of excessive deficits. But even if such discipline reduces the scope for increasing fiscal deficits and public debts, the operation of automatic stabilisers should still be available to stabilise the economy, provided the structural

deficit is close to zero. This should be a worthwhile objective with or without EMU.

## 4 How Do We Ensure that the Net Benefits Are Achieved?

Two years ago, I would have cited a number of challenges still to be faced in ensuring that benefits of EMU are secured, notably a mutually satisfactory exchange rate relation between countries within and outside the euro area and an adequate system of control of fiscal deficits once EMU is up and running. Since these have been addressed, I would like to focus on the key remaining elements, which I have already foreshadowed, namely those of ensuring sustainable convergence among countries before they join EMU and, in the longer term, enhanced labour market flexibility.

The dangers of a lack of convergence when countries enter EMU are self-evident. If fiscal positions are not initially under control, there may be repercussions on the single monetary policy from large deficits, and adverse spillovers across borders affecting the Monetary Union as a whole from lax fiscal policies in individual Member States. These difficulties are far from theoretical. We must be aware that with such a unique enterprise as EMU, with no historical precedent, and operating in such an uncertain world environment, we will have to live with the possibility of teething troubles during the crucial “running in” period, putting considerable strain on the strategy and the technical capabilities of the ECB. Such strain could become unbearable or, to put it less dramatically, could lead to a dangerously unbalanced policy mix if it were compounded by the consequences of initially weak budgetary positions in the member countries.

The authors of the Maastricht Treaty were acutely aware of these dangers and, consequently, required entrants to show a high degree of sustainable convergence by reference to compliance with various convergence criteria. The EMI is assigned an important role in the assessment of such convergence.

As regards current performance, I would acknowledge that important progress has been made in respect of the downward convergence of inflation and bond yields, and exchange rate stability has to date been broadly maintained. In a welcome development, Finland and Italy are now ERM members. However, on the fiscal

side, deficits in 1996 substantially overshoot the benchmark laid down in the Treaty in most Member States, despite efforts aimed at consolidation. Debt ratios have continued to rise in the aggregate, despite favourable trends in some Member States. In my view, the composition of consolidation continued to rely excessively on high revenue ratios and less than is desirable on expenditure restraint. Moreover, there were measures with a one-off effect, which cannot contribute to sustainable convergence.

Given the crucial importance of the issue, let me outline how I would like to see the EMI's advice on the eventual assessment of fiscal positions being given. In essence, we should stick to both the spirit and the letter of the Treaty; and the Treaty says three things, not one. Firstly, it establishes the two reference values which should not be exceeded: the 3% deficit ceiling and the 60% debt ceiling. Secondly, it accepts deviations from these reference values on certain conditions which are described carefully, but are not quantified. Thirdly, it insists on the need to have sustainable positions – in fact, it even uses this expression twice: to cover all convergence criteria and, in addition, to refer specifically to the sustainability of budgetary positions. Consideration of the risks, as I have outlined, suggests two conclusions. First, deviations from the reference values should be granted sparingly by interpreting the words used by the Treaty in a carefully restrictive way; and, second, compliance with the reference values should be regarded as sufficient for eligibility only if the deficit and debt ratios observed for 1997 are genuinely sustainable. In short, in case of doubt when applying the second and third prescriptions of the Treaty, we should lean towards caution.

Beyond convergence, I consider that the greatest challenge that most EU countries face is in the labour market. I have already noted that wage and price flexibility is essential to facilitate economic adjustment to various kinds of shocks that may hit individual EU economies from time to time. With or without EMU, employment policies have to be in the forefront of attention of European policy-makers. The recent record of the Union in terms of job creation is dismal; employment has barely risen in the Union as a whole since the cyclical trough in 1993, and projections envisage little improvement. This points to the crucial need for continued labour cost moderation and enhanced labour market reforms – including attention to tax and social security systems – across the EU. For it is evident that the recovery of output growth alone will be insufficient to remedy deep-seated structural patterns of unemployment. A cause for optimism in this

respect is that the enhanced competition that EMU in combination with the Single Market will unleash will be fertile ground for those arguing in favour of measures of labour market deregulation and reform of bargaining structures.

## Conclusion

The preparations for EMU are far advanced. In combination with the strong political commitment to go ahead with EMU and with the remarkable downward convergence of inflation rates, this has led to enhanced – albeit volatile – expectations in financial markets that EMU will come about. I believe that EMU will lead to major benefits for participants, although potential costs should not be disregarded. To minimise these costs and therefore to ensure large and lasting net benefits, countries entering the Monetary Union should be in a state of sustainable macroeconomic convergence and ready to improve the working of their labour markets as well as to reduce the often very substantial indirect labour costs. This is needed anyhow if they are to achieve a reduction in the unacceptable current levels of unemployment.



## Chapter XXVIII

# The European Central Bank: Independent and Accountable

1997

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*The Maastricht Treaty enshrined the independence of the European Central Bank as well as that of the national central banks. In this presentation, Alexandre Lamfalussy first developed the main arguments underlying the general move towards the establishment of independent central banks with a mandate for price stability. He then went into the Treaty arrangements relating to the independence and accountability of the ECB. The presentation was given at the Oesterreichische Nationalbank, Vienna, on 13 May 1997. Reprinted with kind permission of the European Central Bank and the Lamfalussy family.*

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Against a background of both historical experience and the evolution of the policy debate, central bank independence has in many countries become the preferred means of providing an institutional framework for monetary policy. Reflecting this growing consensus, the Maastricht Treaty enshrines the independent status of the European Central Bank (ECB) and the EU national central banks – which together form the European System of Central Banks (ESCB) – as a bulwark for ensuring that the future euro area benefits from price stability. However, it must be conceded that despite the fact that the legal arrangements which have been made in this regard for the ESCB are clearly spelled out in the Maastricht Treaty, clarity does not always prevail concerning the scope of such independence. It is against this background that I welcome this opportunity to clarify the basic issues of central bank independence, both as I see them and as they are incorporated in the Treaty.

I would like to organise my speech in two parts. First, I shall take a backward-looking perspective by briefly describing the main arguments underlying the general move towards the establishment of independent central banks with a mandate for price stability. Since I assume that you are quite familiar with the arguments, I will not go into much detail. Second, I shall take a closer look at the Treaty arrangements relating to the independence and accountability of the future ECB. This includes the preparations which are currently under way to ensure that national central banks of Member States comply with the relevant Treaty obligations.

## 1. The Move Towards Central Bank Independence

Over the past decades, two significant changes have taken place in the approach to monetary policy-making, with important consequences for the way the institutional arrangements for the future ESCB were designed. One relates to the adoption of price stability as the primary goal of monetary policy, and the other to the mandate widely given to central banks to pursue this objective independent of political interference.

The first element of this sea-change was probably triggered by the negative experience of the 1970s, when inflation and unemployment rose in parallel, despite the efforts of macroeconomic policy-makers to generate renewed growth in the traditional “Keynesian” manner. This led to growing recognition of the fact that in the long term monetary policy can only systematically control the price level and not real economic variables such as output growth or unemployment. Admittedly, over shorter horizons, monetary policy does indeed affect both real and nominal variables. However, it is by now widely accepted among policy-makers and in the academic literature, that deliberate attempts to exploit any short-run trade-offs between output and prices are likely to result in a permanently higher and more variable rate of inflation, with significant adverse consequences for resource allocation, long-run output and productivity growth. Against this background, the primary goal of monetary policy should be to achieve and maintain price stability, with any other economic objectives receiving emphasis only to the extent that price stability is not endangered.

The second fundamental change which I would like to highlight is the widespread tendency to delegate the decision-making power over monetary policy to independent central banks. Modern economic theory emphasises the inflationary bias in economic policy, which relates in particular to the so-called time-inconsistency issue, i.e. the problem of convincing the public that the monetary authorities will resist the temptation to stimulate output growth in the short run by creating “surprise inflation”. Against the backdrop of negative past experience, the public is unlikely to have much faith in the authorities’ promises to maintain low inflation. Unless these promises are underpinned by a credible form of pre-commitment, the equilibrium inflation rate will be higher than needed, with no better performance in terms of output and possibly even a deterioration. As a solution to this problem, it has been suggested that responsibility for monetary policy be separated from political control and to enshrine this in legislation. According to this view, central banks should be given the freedom to formulate and execute monetary policy in line with their primary objective as determined by the legislator, to whom they are accountable. Accountability may involve either a legal obligation for the central bank to give reckoning for the conduct of monetary policy or a commitment to explain its actions, for example, in regular reports and to parliament. This allows central banks to take a medium-term orientation and not to be distracted by short-term political motives, an approach which benefits the credibility, transparency and efficiency of monetary policy.

In line with the foregoing analysis, more and more EU central banks have over time been assigned the task of guaranteeing price stability, either explicitly by national law, or more informally as a reflection of an underlying culture of stability. In many cases, these reforms went hand-in-hand with the move towards a greater degree of central bank independence. These changes in national monetary legislation or at least the practice of central bank independence were beginning to be implemented well before the start of the Maastricht process. They were, however, further promoted by the recommendations of the Delors Committee with regard to the institutional arrangements for Stage Three of Monetary Union. The Committee’s proposals culminated in the inclusion in the Maastricht Treaty and the Statute of the ESCB of the primary objective of price stability, the pursuit of which is delegated to an independent central bank system composed of the ECB and the national central banks of Member States.

## 2. The Independence and Accountability of the ESCB

The Treaty (in Article 107) and the Statute of the ESCB (in Article 7) both contain very clear provisions regarding the relationship with third parties, which leave no room whatsoever for misinterpretation. To quote a key sentence: “neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body”. Moreover, the aforementioned authorities shall also – and I quote again – “undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks”. To put it simply: the door to the single monetary policy is locked from both sides, and neither the ESCB nor third parties can open the door for political instructions. Even attempts to do so would already be in conflict with the provisions of the Treaty and the Statute of the ESCB.

For national central banks to become an integral part of the ESCB, Member States have to ensure that national legislation is compatible with the Treaty (Article 108) and the Statute of the ESCB (Article 14). This obligation of legal convergence does not require the full harmonisation of central bank statutes, but merely insists that inconsistencies with the Treaty be eliminated in respect of features such as institutional, personal, functional and financial independence. This requirement applies to all Member States, including those which may initially be unable to adopt the single currency owing to insufficient economic convergence. Exceptions are Denmark and the United Kingdom, which enjoy the right to “opt in” or “opt out” of EMU. Member States have made significant progress in recent years in amending their central bank statutes where needed in order to fulfil their Treaty obligations. For example, major reforms have taken place in Belgium, Spain, France, Luxembourg and Portugal, whilst in Germany, the Netherlands and Finland changes in legislation are pending. For those interested in further details, I would refer you to the EMI’s November 1996 Report entitled “Progress towards convergence 1996”, which contains a detailed account for each country of the provisions which would need to be adapted.

The importance of these institutional arrangements for creating an appropriate monetary policy setting in Stage Three of EMU cannot be underestimated. I would like to illustrate this by reference to the following two arguments. First, these arrangements underline the continuity with the experience of the EU central banks with the most successful track record in terms of price stability over the past decades. In fact, in legal terms the ECB will enjoy an even higher degree of independence than the most independent national central bank at present. Moreover, these legal arrangements are firmly anchored in the Maastricht Treaty and could thus only be changed by a Treaty revision. As you know, this is a very difficult and time-consuming procedure, involving both the European Parliament and all the national parliaments, which thus ensures that such a step is not lightly taken. This brings me to the second point, namely that initially the ECB will have no track record of its own, other than the average track record that it may inherit from the participating national central banks. This implies that financial markets and the general public will assess the performance of the ECB on the basis of the effectiveness of the monetary policy framework adopted and the ability to act in accordance with its primary objective.

Taken together, these two arguments make it clear that the independence of the ESCB underpins the credibility and effectiveness of the single monetary policy and is thus a key condition for the maintenance of price stability in the euro area. Given this legal framework, the Governing Council of the ECB will be able to decide on the basis of its own judgement on the scope and timing of monetary policy actions and how they should be executed. Naturally, in its assessment the Governing Council will take account of a wide range of relevant factors – including the state of the economy in the Monetary Union – but only to the extent that they affect future price developments. This does not imply, as is sometimes suggested, that the secondary objective of providing support to the general economic policies in the Community has no real meaning. Nevertheless, under its mandate the ESCB can only pursue this additional goal provided it does not prejudice the primary objective of price stability.

A natural complement to the independent status of the ESCB are the Treaty provisions which make the ECB accountable for its policy actions. Accountability is reflected above all in the fact that the President and the other members of the Executive Board of the ECB, at their own initiative or on request, may be heard by the competent committees of the European Parliament (Article 109b.3).

A further aspect of accountability concerns the requirement to publish an annual report covering the single monetary policy and other activities of the ESCB. The President of the ECB presents this annual report to the Council and the European Parliament, which on that basis could subsequently hold a general debate. Reports on the activities of the ESCB will also be published during the year, at least quarterly, in addition to weekly financial statements. All these provisions – to which I may add the wish to deliver speeches to the public and statements to the press – clearly promote the transparency of monetary policy objectives, intentions and actions. They thereby support the effectiveness of monetary policy. At the same time, the Treaty recognises that the ECB cannot be made responsible for outcomes in terms of inflation month-by-month, since there are lags involved between a change in the course of monetary policy and its effect on prices. Moreover, in the short term, the inflation outcome may reflect the incidence of temporary or external factors over which the ECB has no control.

At this point, critical observers often confront me with the fact that the door is not completely shut against political interference, as the Treaty may seem to make an exception to the independence of the ESCB with regard to the exchange rate policy of the euro area. The ECOFIN Council may indeed conclude formal exchange rate arrangements with countries outside the EU, or formulate general orientations for exchange rate policy in relation to the currencies of these non-EU countries. This essentially reflects the current situation in most Member States, where the government determines the exchange rate rules (if any) and the central bank is responsible for the execution of this policy. On closer inspection, however, I do not fear a potential overburdening of the single monetary policy via this route.

To begin with, the participation of the euro in a multinational system with non-EU currencies is, to say the least, not on the agenda. You may or may not like it, but I do not see the likely emergence of a Bretton Woods Mark II in the foreseeable future – and by this I do not refer to just a couple of years. And as regards the “general orientations for exchange rate policy”, while such orientations are indeed in the hands of the ECOFIN Council, they can be issued only either on a recommendation from the ECB or on a recommendation from the Commission – but after consulting the ECB. And Article 109 of the Treaty says explicitly that “these general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability”.

Overall, it appears that sufficient “checks and balances” have been built into the procedure. I am confident that the view of the ECB in these exchange rate matters will carry a very high weight indeed and that the independence of the ESCB will not be affected. My confidence also finds support in the fact that the EMI has played a crucial role in helping to design the new exchange rate mechanism (ERM II) for establishing links between the euro and the non-participating EU currencies. To our satisfaction, the arrangement contains an explicit safeguard clause for the ECB (and other central banks) with regard to automatic intervention and financing at the margin, and also assigns a key role to the ECB (and other central banks) in negotiations that may culminate in realignments.

So far, I have mainly concentrated on the two “monetary anchors” that should help to provide for a stable single currency: the objective of price stability and the mandate for an independent monetary policy. We all know that other economic policies have an essential supporting role to play in the effort to maintain price stability on a durable basis. In this respect, ensuring sound and sustainable budgetary positions would certainly make the ESCB’s task a lot easier. Fortunately, a series of Treaty provisions support a high degree of fiscal discipline – which is of course also very much in the interests of Member States themselves. Already since the start of Stage Two, Member States have no longer been allowed to engage in monetary financing of budget deficits (Article 104). Correspondingly, for Stage Three, it is explicitly forbidden for the ESCB to supply credit facilities to government bodies, or to buy government debt instruments in the primary market. In addition, financial institutions are not allowed to grant credit to public authorities under preferential conditions (Article 104a). Furthermore, a bail-out of one Member State with financial problems by another country is strictly excluded (Article 104b). Finally, the Treaty obliges EU countries participating in the single currency to avoid excessive budget deficits (Article 104c). Compliance with this obligation will be assessed in the context of an elaborate procedure which will ultimately lead to the imposition of sanctions if no effective action is taken to correct an excessive deficit. The preventive nature and effectiveness of this procedure has recently been strengthened by the adoption of a Stability and Growth Pact, which specifies both the time limits for the consecutive steps in the procedure and the size of sanctions. Moreover, it commits each Member

State to target a budgetary position that is close to balance or in surplus over the medium term.

## Conclusion

I have taken this opportunity to spell out in detail how the move to a single currency in the EU will be accompanied by the creation of a new Community institution, the European System of Central Banks, whose independent status is guaranteed by the provisions of the Maastricht Treaty. But I may perhaps conclude by saying that my confidence in the ability of the future ESCB to conduct in full independence a policy geared towards price stability is not based exclusively on my reading of the Maastricht Treaty. It is also based on our recent experience. EU central banks have been pursuing stability-oriented monetary policies for quite some time: otherwise it would have been impossible to achieve the downward convergence of inflation rates within the Community. As you know the most recent average rate of inflation is just a little above 2%. If this has become possible in Stage II, with central banks retaining their independence in conducting their own policies, why should this change when they will act jointly within the framework of the ESCB?



## Chapter XXIX

# Farewell Address at the EMI

1997

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*This is the text of the address given by Alexandre Lamfalussy on the occasion of his retirement from the European Monetary Institute, in Frankfurt am Main, on 30 June 1997. After words of thanks, he turns to the role of monetary policy. In his view, the key policy challenge facing Europe was strengthening economic growth and reducing unemployment. However, he saw only a limited role for monetary policy here, arguing that fiscal and structural policies have to assume the principal role. Reprinted with kind permission of the European Central Bank and the Lamfalussy family.*

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The moment has come for me to say a heartfelt “thank you” to you all!

I should like to express my gratitude, first of all, to the governors of the central banks of the European Union, who, in the autumn of 1993, chose me as their candidate for the presidency of the European Monetary Institute, thereby setting in train a process which has allowed me to play a part in a groundbreaking enterprise of exceptional scope and responsibility. I should like to thank them, secondly, in their capacity as members of the EMI Council, for their co-operation in this undertaking and for their wisdom, prudence, willingness to compromise but also their will to achieve results. They have invariably acted with the utmost professionalism. I should like to add that we should not have been able to achieve what has been done without the conviction – which each of us shares – that the first duty of a central bank is to maintain price stability. This fundamental principle has never been a matter of dispute.

My thanks go next to the political authorities. First, to the Heads of State or of Government, who did me the honour of putting their faith in me in appointing me President of the EMI. Second, to the Finance Ministers, who

resigned themselves gracefully to the existence of an institution which would be independent of the executive and who played their part, with consummate political skill, in establishing the good working atmosphere between the ECOFIN and the EMI, in the mutual respect of our respective competences. I hope that this will be an enduring legacy.

Thanks go, too, to the European Commission, with which we have been able – after a little trial and error, and with both sides demonstrating good will and a certain ability to listen – to draw up the rules of the game for the indispensable cooperation which is needed to enable the project of Economic and Monetary Union to go ahead.

The European Parliament – and several national parliaments – have given me the opportunity to report on the work of the EMI, in an atmosphere of constructive dialogue. Their questions and concerns, as well as those of the media and of the large number of associations from both the banking and financial sphere as well as society at large, have given me valuable insights into the expectations and concerns of our fellow citizens.

These thanks would not be complete without my expressing publicly what I have already had the opportunity to say in private to the members of the management and staff of the European Monetary Institute; without their personal commitment, their spirit of innovation, their boundless ability to find the happy medium – and not just a practical compromise between the concerns of our central banks – nothing would have been accomplished.

What can I say to you now by way of farewell? There is little point in giving you the “final score” at this stage – the match is not over yet... Recommendations on how to cope with the challenges which are looming on the horizon? You will deal with them effectively, I am convinced, without my advice. But perhaps you will accept some reflections on the ability – and the limits – of monetary policy to meet the expectations of our fellow citizens who, while appreciating the confirmation (or renewal) of price stability, are looking for stronger growth and, above all, more jobs. I share their concern unreservedly. The current level of unemployment in the majority of our countries is ethically unacceptable; it is leading to the erosion of the social fabric and, because of the waste it represents, it is a clear signal that the economy is not functioning properly. Reducing

unemployment must be the prime objective of action by the authorities. But what should be the role of monetary policy? In view of the short time available to me – plus the fact that you cannot contradict me – I shall be brief. You may perhaps feel that I am being dogmatic: if so, please bear with me. I should like to make four observations.

1. There is no doubt whatsoever that monetary policy can bring inflation under control. When monetary policy is not flanked by the appropriate budgetary policy, and when labour markets – but also goods and services markets – are not flexible, bringing inflation under control will take time, it will take time, and it can also entail costs – which could otherwise have been avoided. But even so, these costs would still be less than the (very high long-term) cost of not dealing with inflation. Let us not forget that while the rich and the powerful can protect themselves from any loss of purchasing power of their money – and in many cases can even benefit from such a loss – the weak and the not-so-rich will always be the losers. Inflation has always been a major source of social iniquity. In addition, it prevents the economy from functioning properly, by falsifying the signals which are given by prices. The speculative boom in the real estate markets in some of our countries at the end of the 1980s caused serious damage – and we are still paying the price.
2. Once inflation has been brought under control, and once this control has been confirmed, monetary policy can guide short-term interest rates to a level which contributes to balanced growth. Quite a number of EU countries are in such a situation already, with short-term interest rates at around 3%. In others, where inflation has been brought under control more recently, rates have not yet reached this level but are approaching it gradually. The confirmation that inflation has been brought under control does, unfortunately, take time. Finally, in one major country which has seen rapid growth for several years now and in which unemployment has fallen remarkably, short-term interest rates have been raised – applying the principle of preventive medicine.
3. Now, what can we say about long-term interest rates, which also have an important role to play in stimulating growth – perhaps an even more important one than short-term rates?

Monetary policy does have an influence on the level of these rates, but its influence is not exclusive and we cannot even predict the direction of its influence with certainty. At this particular point in time, in the first group of countries to which I referred a moment ago, nominal long-term interest rates are at a historically low level – they are well below 6% – but real long-term interest rates can be regarded, perhaps, as still being too high to put continental Europe on the road to more vigorous growth.

I am doubtful whether a further easing of monetary policy in this group of countries would be able to help move the yield curve in the desired direction. It could actually have the opposite effect – if investors perceived it as heralding a weak euro. In any event, given the current level of short-term interest rates, monetary policy's margin for manoeuvre is extremely limited.

It is possible that the level of real long-term interest rates in Europe reflects, partially at least, that of real interest rates world-wide. Europe has no influence over that effect.

Europe can, however, have an influence on the effect which comes from the constant increase in public sector indebtedness in our countries. As a reminder, between the end of 1991 and the end of 1996 the general government debt rose from around 56 to above 73% of GDP for the European Union as a whole. This development, together with the worry that it might not yet have run its course, are not likely – to say the least – to lead to a fall in real interest rates. Nor do they create the climate of confidence necessary for consumers and investors to modify their current prudent behavior. On the other hand, the certainty that governments are tackling the underlying causes of the public deficits which are responsible for the constant increase in the debt burden could well bring about such a change in behavior. “Faceless” markets are not the only ones looking beyond the immediate present to the future – our fellow citizens are, too. The prospect of self-perpetuating, ever-increasing deficits will not encourage them to spend more.

4. Stronger growth would certainly have a beneficial effect on employment. But it would not eliminate the largest component of unemployment – the structural component. This can only be done by means of measures which remedy labour market rigidities and reduce the burden of non-wage labour

costs. It is this latter channel that links efforts to create jobs with the task of bringing public expenditure under control. I observe, too, that in those countries where unemployment has fallen substantially, jobs have been created not by existing enterprises – and especially not by large enterprises – but by the setting-up of a large number of new enterprises, which have necessarily been small to begin with.

To conclude – allow me, if you will, to be quite blunt. Yes, once inflation has been brought properly under control, monetary policy can and must contribute to supporting balanced growth, but balanced growth will not depend on monetary policy alone. Both the acceleration and the viability of growth will rely on the contribution to be made by other policies. First, on that of a fiscal policy which does not crowd out private investment but, rather, fosters a climate of confidence by implementing a credible process of reforms. Second, on that of a policy which creates a favourable fiscal, financial and regulatory environment for the proliferation of new enterprises. And, so that the growth fostered in this way can create many jobs, structural policies will have to assume the principal role, while the role of monetary policy will then dwindle and fade away – alas – to nothing.

Part Four

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*Lamfalussy the Elder*

1997–2015



## Chapter XXX

# Structural Changes in European Financial Markets

1999

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*On 4 May 1998, Alexandre Lamfalussy became a member of the Hungarian Academy of Sciences. On 16 September 1999, he gave his inaugural lecture on the theme “Structural Changes in European Financial Markets” to the Academy in Budapest, paying significant attention to the effects of the introduction of the euro and financial globalisation on financial markets. In the conclusion, he discussed the impact of these developments on the Hungarian financial system. Reproduced here is the original English version by Lamfalussy (the address to the Academy was in Hungarian). Reprinted with kind permission of the Hungarian Academy of Sciences and the Lamfalussy family.*

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There can be little doubt that the introduction of the euro has sharply accelerated the process of structural change in European financial markets. These changes, however, have been under way for a few years as a result of financial globalisation which continues to exert its own influence. It is not easy to assess the precise direction of these structural shifts, nor indeed to forecast their pace, and certainly not their final outcome. However, events are speeding up – look at the monumental banking battle involving three large French banks, which would have been unthinkable only a year ago – and we are beginning to see some of the major issues that are likely to arise for market participants, public authorities and, indeed, public interest. These are challenges for the European Union as a whole, for the euro area and, sooner or later, for Hungary, too.



## A Reminder of Some Key Facts

Let me start by drawing your attention to some of the main characteristics of European financial markets in general, and of banking in particular, as they appeared in the second half of the 1990s – and comparing them with the situation prevailing in the United States.

The most striking fact is the dominant influence of banks in the European (and even more fundamentally in the continental European) financial system. As with all statistics, a lot can be distorted by definitions (which institutions can be classified under the heading, “banks”?). However, in this particular case, there can be no doubt about the validity of this assertion. In the European Union, at the end of 1996 banks’ total assets amounted to close to 200% of GDP. The figure for the United States was around 80%. Or, to make another significant comparison, the share of bank assets in the total assets of all financial intermediaries fell, in most European countries, within the range of 70 to 80%. It was as low as 26% in the United States. This means, incidentally, that there was no highly significant difference between the two areas in terms of the total financial assets/GDP ratio.

Second, note the relative weakness of equity markets in Europe (with the notable exception of the United Kingdom and the Netherlands). Stock market capitalisation in relation to GDP barely reached 33% in continental Europe. It stood at more than 100% in the United States. This is, in fact, a mirror image of the previous characteristic: non-bank financial intermediaries (mutual funds, investment companies, pension funds) are substantial holders of equity investments in the United States. Their importance is more limited in Europe and, on top of this, they are more biased in favour of fixed income securities.

The third fact is that European households are big savers. In 1996 net lending from European household savings was 6% of GDP, while it was close to zero in the United States. Moreover, European households channelled most of their (gross) financial savings towards the banking system or purchases of debt – mostly government debt. By contrast, American households became major holders of equity portfolios – either directly, or via mutual and pension funds.

Finally, securitisation has had a major impact on US banking but, so far at least, a much smaller impact on the way European banks operate. For banks, securitisation means that securities holdings acquire a growing importance among

their assets, that bank assets become more and more marketable, that such assets move from the balance sheet to off-balance sheet liabilities (thereby allowing a relative shrinking of the balance sheet without affecting total profits) and, more generally, that the lender – borrower relationship loses both its transparency and stability.

At the risk of oversimplifying matters, all these observations can be captured in one major proposition: namely, that the European financial structures have remained “bank-oriented”, while the United States has moved towards a “market-oriented” system. For a few years, the importance of securities’ markets in relation to traditional banking intermediation has, of course, progressed in Europe – but that happened in the United States, too. The contrast has so far remained striking.

## The Euro and the Single Banking and Financial Markets in Europe

It is against this background that we have to consider the potential impact of the euro on Europe’s financial structures. Where do we stand now – in the late summer of 1999 – with the euro?

European households will not experience the full reality of the single European currency until the early days of 2002. It is at that time that national currency units will have to be converted into euro and that all national administrations will start operating their accounting and payment systems in euro.

However, even today the euro is a reality both from a legal point of view and in terms of the practical life of financial market participants. Legally, the euro is the currency of the euro area member countries: on 1 January this year, national currency units became simply non-decimal components of the euro, in the same way as a pfennig is just one hundredth of a Deutsche Mark. (This does not prevent the national banknotes from remaining legal tender until their withdrawal at the beginning of 2002). The legally enforceable conversion ratios between the euro and the national currencies have been established by a monetary law and are therefore observed by courts all over the world.

With regard to banking and financial markets, the euro is also a very practical reality. The European System of Central Banks (ESCB) operates with banks

through euro-denominated assets and liabilities. As a result – not by decree but for practical reasons – the interbank and foreign exchange markets operate in euro. New government bond issues are effected in euro and the outstanding stock of government debt has been converted into euros. Last but not least, trading on organised exchanges – such as stock markets – takes place in euro.

The widespread use of the euro in these operations represents a significant – I should probably say, decisive – step towards the implementation of the single financial and banking market in Europe, since it removes one of the major non-tariff barriers distorting the functioning of this market. All capital account transactions have now been unrestricted for some time and together with the possibility of setting up branches or subsidiaries in other countries. Admittedly, the lack of full harmonisation of regulatory practices and of taxation still represents a substantial impediment to free competition, but these impediments can and will be dismantled gradually. The replacement of the national currencies by the euro in financial transactions is not a matter of gradual change, rather there has been a sudden, radical shift. Let me give you two examples which show why this is going to give a decisive push to the implementation of a genuinely single banking and financial market.

The first relates to banking. The existence of foreign exchange risk, however small, does represent an impediment to cross-border banking competition. This risk can, of course, be eliminated or reduced by the use of appropriate hedging techniques. But hedging involves costs and therefore banks operating in their home market, with full access to funding in domestic currency, have a competitive edge over banks lending from abroad. Once the intra-euro area foreign exchange risk is eliminated, this kind of competitive edge will disappear.

The second example concerns the government debt market. The redenomination of all outstanding government debt in euro opened up the possibility of developing a large, liquid and efficient secondary market in government securities. Trading costs are reduced for the benefit of issuers and purchasers of government debt, but this amounts to a sharp reduction in the profits of traders. This, however, is not a zero sum game. The disappearance of the foreign exchange risk enhances transparency. A yield differential between, say, 10-year Italian government bonds and their German counterparts no longer reflects a foreign exchange risk, but basically a credit risk or some other remaining market imperfections.

Both examples show that the introduction of the euro enhances competition, which is precisely what the single market in banking and financial services is expected to achieve. Competition is surely a good thing for the users of financial services, be they borrowers or investors, who will benefit from better service, a wider range of products and, last but not least, from innovation. But competition does not make life easier, to put it mildly, for financial intermediaries which have to cope with constant pressure on their profit margins. Even more importantly, when there is a sudden change in market conditions – and that is what the introduction of the euro amounts to – the pressure on profits will not be constant, gentle, or gradual, but potentially sudden and severe. It is the reality or the anticipation of this sudden impact which induces fast and deep structural changes. These changes are at the heart of the competitive process, which Schumpeter so eloquently described as the process of “creative destruction”. I shall touch upon the implications of this for systemic stability towards the end of my presentation. The key issue is that “destruction” in banking or financial markets can have far wider systemic consequences than in, say, manufacturing industry. Banks, even in a “securitised” or “market-oriented” system, remain at the heart of credit distribution, liquidity creation and, perhaps most importantly, the payment and settlement system.

## Financial Globalisation

A very major difficulty encountered when trying to assess the direction and speed of the structural changes induced by the euro derives from the fact that our financial systems are also affected by the more general, worldwide process of financial globalisation.

“Globalisation” is one of those inventive catchphrases in American English which convey a lot to the reader without attempting to be very precise. For the purposes of this presentation I shall use it in a very wide sense.

First and foremost, I take it to mean financial integration in the geographical sense: to be part of the world-wide global financial “village”. This means that capital is free to flow between countries belonging to the globalised part of the world, and that it does indeed flow. Controls on capital account transactions have on the whole been lifted; and current account transactions are naturally free.

But globalisation also means that these same countries have substantially liberalised or deregulated their domestic financial systems. This does not imply that a financial intermediary will buy or sell any financial product of its liking, but it does mean that there are few administrative restrictions in this respect. Deregulation also means that the authorities do not interfere with pricing decisions, nor do they set quantitative limits on specific lending, investment or funding decisions. Specialisation still exists, more by tradition and by free choice than as a result of regulation. But at the margin at least there is intense competition among institutions belonging to different groups of intermediaries.

The general trend towards lifting controls on capital account transactions (internationally) and deregulating financial markets (domestically) has coincided with revolutionary changes in communications and information systems technology. These changes are very much part and parcel of financial globalisation today. It is to a very large extent because of these changes, which have allowed the creation of highly complex new financial products and operating techniques as well as the instantaneous transmission of information that our global financial world today is so much different from the unrestricted banking and financial markets which existed before World War I.

To sum up in a couple of sentences the most striking outcome of these developments, one could say: (a) that they have resulted in an enhanced threefold financial interdependence – in the geographical sense (i. e. between countries of the globalised world), between markets (for instance between debt and equity markets) and between the various segments of the financial industry: and (b) that by the same token they have led to the creation of a highly competitive environment with competition across borders, between individual financial intermediaries and between groups of intermediaries.

## The Avenues of Structural Change

In what follows, I shall comment on (or, rather, think loud about) some of the main directions which structural changes in Europe's financial system are likely to take as a result of the dual impact of the euro and globalisation.

1. In banking the first, most visible change is towards concentration through mergers and acquisitions. This is a world-wide trend in which globalisation

is playing the major role, with the euro adding strong momentum to it. The striking fact is that until now mergers and acquisitions have tended to regroup banks within national borders. Cross-border mergers have been very rare; cross-border acquisitions (or minority participations) somewhat more frequent, but still insignificant in number and size. Several factors may have contributed to this outcome. National banking “cultures” or traditions are still strong: it is easier to merge with (or acquire control of) institutions which share such traditions. At the same time in a number of countries regulatory authorities have displayed a bias in favour of national rather than cross-border concentrations. Be that as it may, I am convinced that what we have seen so far is just the first stage of regrouping. Cross-border initiatives will be the next step. They are likely to involve both mergers between institutions of comparable size or acquisitions of smaller banks.

2. What about the nature of these regroupings? Will they be friendly or hostile? Until recent events in French banking, I was of the view that friendly initiatives would prevail. This is what has happened in the United States so far, and also in the United Kingdom. One reason is, I thought, that success in banking and, even more, the successful management of banking mergers crucially depend on people – not only on top management, but on a much wider group of people. A hostile takeover is likely to lead to a massive loss of talent: a targeted company is an ideal hunting ground for head-hunters. Another reason for friendly mergers may have been that regulatory authorities favoured them – partly because they kept a watchful eye on systemic risk, but often also because they feared that the acceptance of hostile bids at the domestic level would increase the chances of “foreign” invasion. It remains to be seen whether the French example will be followed by others, or will be regarded as an exception.
3. Assuming that cross-border regroupings become a reality, what sort of size configuration will European banking acquire? My guess is that the size structure will not be a simple one. A handful of Europe-wide megabanks are likely to emerge, some of which will aim to become “global” on a world-wide scale as well. But even not all of these banks will want to cover retail banking throughout Europe. At the other end of the spectrum, the number of small local banks will surely diminish, but I do not think that this species will become extinct. Customer proximity – either for households, or for small enterprises – will still count (I shall say more about this later, in connection with remote

banking). The intriguing question concerns medium-sized “regional” banks. Many of these will be swallowed up by the megabanks, but some of them may well survive, especially if they add to their geographical franchise the advantage of being efficient “niche” players.

4. The most difficult configuration to foresee concerns specialisation. The megabanks will do everything to encompass the full range of financial services, including investment banking. Will they succeed? The US evidence is not conclusive in this respect, since, despite recent successful inroads into investment banking by a couple of large “traditional” banks, the scene is still dominated by a few “genuine” investment banks. European megabanks will have to compete, both in Europe and elsewhere, precisely with these “first league” US investment banks, which have on their side not only tradition and accumulated expertise, but also the support of their US equity market base. Finally, the most open issue, on which I hold no views, concerns the links between insurance and banking. There is no doubt that potential synergies exist between banking and insurance in the area of asset management and in retail sales of banking and (some) insurance products. What is questionable, however, is whether the exploitation of such synergies is best dealt with through mergers or could be handled by inter-company agreements.
5. Let me now consider the impact on banking of one of the key components of globalisation, namely IT (information technology) developments.

The traditional channel through which IT developments have been, and will continue to affect banks’ operations is through cost reductions which occur in the management of information – typically, in the collection, storage, processing and transmission of information. Automated processes replace highly labour-intensive work methods and a lot of paperwork. After a very long waiting period (IT was used as early as the late 1950s!) the cost reductions and improvements in efficiency achieved in this way are now becoming substantial. Note, however, that IT has improved the quality of management – for instance, in terms of management control – for a much longer time. The influence on banking structures of these “traditional” IT developments has not been unambiguous. There is evidence that major investments in this field are subject to the rule of economies of scale and that they substantially enhance the ability of management to control efficiently large-scale and diversified companies.

But these investments do not pay off quickly; they are frontloaded in terms of costs while the benefits are associated with long time-lags. When banks with different IT systems (which have to be replaced or “harmonised” try to merge, the heavy initial cost implications and the prospect of delayed returns act as a deterrent to concentration.

The second, more recent channel through which IT developments may affect banking relates to the implementation of customers’ access to banking services through “remote banking”. There is no doubt that this development has the potential to radically change the operation (and therefore the structure) of retail banking in Europe. Europe is dominated by branch banking, with signs of overbanking and excess capacities in the majority of the European Union member countries. Remote banking is going to lead to the radical reduction of the number of branches, a change in the employment pattern of banks (shift towards marketing and sophisticated value-added services), interbank agreements on common standards, and increased competition from non-banks such as supermarkets, and so on. But I would caution against believing that all this will happen everywhere and at a very fast pace. My guess is that the rate of change will vary between geographical areas according to differences in the age pyramid, wealth, education and social structures, all of which have a bearing on the willingness and ability of retail customers to adjust to new habits. The winners will be those banks which are able to detect the time-scale of these new developments. If a bank were to implement prematurely radical changes in its organisation with the intention of switching over to generalised remote banking, the mistake could be very costly; if it were to do so too late, its market share would suffer heavily.

6. Structural changes in markets are likely to be as profound as, and probably faster than, those in banking – perhaps because in this field the introduction of the euro and technological progress interact swiftly and very powerfully. Electronic trading will dominate, I am quite sure, in all major secondary markets within a couple of years. This forecast is based on observations of what has already been happening. On the first pan-European wholesale secondary market for euro-denominated government securities (which started operating in April this year), the daily turnover in benchmark German, Italian and French securities has been around 30 billion euro, i.e. about 15 to 20% of total trading. The trading is now being extended to the benchmark securities



of other euro area countries as well as to the very large market in repos. At the same time new, competitive initiatives have been announced. As for the European equity markets, they will see the surge of online (Internet) trading, in the same way as has happened in the United States, as investors gradually recognise the speed, convenience and relatively low costs of trading on the Internet.

Such developments will lead over time to the gradual withering away of national financial centres – or, to be more precise, to their reduction to the kind of core activities on which developments in information and communications technology have a limited impact. Advisory services for mergers and acquisitions are a prime example of activities where interpersonal contacts (and therefore location) count. Location will become far less important for market-related activities, especially as regards secondary markets.

7. Will these developments (together with many others, on which I have no time to comment) steer Europe towards increasingly “market-oriented” financial structures – along the lines of the US model? Very probably, yes. But the pace of this change remains largely unpredictable.

## Challenges to European Supervisory and Regulatory Authorities

The organisation of banking and financial services, supervision and regulation within the euro area is, at present, more or less as it was a few years ago. I view this situation with some concern, because I fear that the current pattern of organisation will have difficulties in responding to the challenges raised by the potentially revolutionary changes affecting European banking and financial structures.

The basic responsibility for supervision and regulation lies, at present, with national authorities. Some of these are part of (or closely tied to) the national central banks, while others are separate agencies – mostly, but not always, under some sort of government control. The heterogeneity is enhanced by the fact that while in some countries many segments of the financial industry are regulated by one authority, in others the responsibility is shared among different institutions. Admittedly, all these authorities are co-operating between themselves under the auspices of the European Commission, while the European Central Bank

is expected to “contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system” (Article 105 (5) of the Maastricht Treaty). But will this be sufficient?

I do not rule out the possibility that this loose co-operative framework may enable such a large, heterogeneous group of participants to harmonise the national rules and practices so as to lift the remaining non-tariff barriers to the development of an efficient single banking and financial market. This is conceivable, although not very likely. I would make the same remark with regard to the chances of reaching a consensus view on what kind of financial structures will reconcile efficiency and stability. Given the pace at which market structures – for instance, the degree of concentration or the emergence of financial services giants – are likely to evolve, there is a genuine risk that regulators will be overtaken by events. This risk is even greater when it comes to the crisis handling ability of the authorities – especially in a truly “market-oriented” system. The LTCM experience in the United States is worth keeping in mind. Successful crisis-handling in our globalised world requires clout, speed and agreement on who is responsible for what initiative – precisely because the rules of crisis handling cannot, and should not be laid down in advance. It is not obvious, to put it mildly, that the current arrangements meet these requirements.

## Concluding Remarks on Hungary

What could, or will be the implications of all these developments for the Hungarian financial system? There is good news and bad news.

First, the good news. As regards financial markets and institutions in general, and banking in particular, Hungary has achieved an enviable position among the countries of Central and Eastern Europe. The road leading to this relatively satisfactory situation has been bumpy. The restructuring of banks has been costly, as successive governments have exhausted the full range of policy errors, while bank managements made their own contributions. But this happened in all other former communist countries as well, without their being able to achieve what Hungary has now achieved, namely a banking system that has real owners, efficient operational methods, and with an, on the whole, sound balance sheet structure. But banking is not alone in this respect. The stock exchange is by far

the most liquid among the area's stock exchanges; the reporting obligations and practices of the listed corporations ensure accurate information and a high degree of transparency; the reform of the pension system – a good thing in itself, even if allowance is made for its teething problems – contributes to the development of strong institutional investors; the payment, settlement and clearing system functions smoothly; and last but surely not least, the National Bank of Hungary has a sophisticated set of policy tools. I do not claim that this is perfect (it is just less imperfect than what you can see in some other countries), nor that (with the benefit of hindsight) it would not have been possible to achieve the same results at a lower cost to the Hungarian taxpayer, but the fact is that in the area of banking and finance, Hungary has successfully approached western standards. And that is no mean feat.

But what, then, is the trouble? Well, the bad news is that these “western standards”, as I have tried to show you today, are a moving, indeed a very fast moving target. The Hungarian banking industry cannot avoid a wave of mergers of regroupings – if only because some of the key western shareholders in Hungarian banks will have merged among themselves. “Remote banking” raises a strategic question for many Hungarian banks: should they expand their branch network – in terms of branches, Hungary still has a shortage of banks, and banking services to the crucial small and medium-sized enterprises are still unsatisfactory – given that in the none-too-distant future branches may become redundant? How will the Hungarian securities industry respond to the challenge of online Internet trading of equities? More generally: which banking and financial services will continue to require customer proximity? I trust that their inventiveness and entrepreneurship will enable Hungarian financial market participants to respond to these challenges, for the greater benefit of Hungarian savers, investors and borrowers (as well as for their own benefit). But the road ahead will not be an easy one. This, indeed, is the general challenge facing the whole of the Hungarian economy: to integrate itself into European economy which has entered, in terms of all its components and in every aspect of its *modus operandi*, a period of radical structural change.

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## Chapter XXXI

# Reflections on the Regulation of European Securities Markets

2001

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*In 2000, Alexandre Lamfalussy became the Chairman of the Committee of Wise Men, which developed a new approach for the regulation of European financial markets. The Lamfalussy Committee proposed a “four-level” approach, making a clear distinction between key political decisions and technical implementation. The crucial aim was to speed up changes in regulation. In 2002, this new governance structure was extended to banking, insurance and pensions. After the global financial crisis, it became the crucial building stone for Europe’s new supervisory architecture, with the Level 3 Committees being transformed into the EU’s supervisory authorities – the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). Reproduced below is an extended version of Lamfalussy’s SUERF lecture at the Bank of England on 3 May 2001. The annexes are not included. Reprinted with kind permission of SUERF (Société Universitaire Européenne de Recherches Financières) and the Lamfalussy family.*

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When some time ago I accepted the invitation to deliver the 2001 SUERF Lecture I did not suspect that I would have to start my lecture by apologising for addressing my chosen topic from a rather special angle. Originally, my intention was to share some thoughts with you on the major challenges facing securities regulators in our global financial markets and to think aloud about the ways and means of meeting these challenges. However, I imagine that today most of you would find this detached academic approach somewhat disingenuous on my part. My objective is to discuss five main issues. Firstly, to review the Committee’s mandate and the way it conducted its investigation. Secondly, I will discuss the

shortcomings of the current legislative and regulatory process with respect to securities markets' regulation, and therefore why the Committee was established in the first place. In the process, I will discuss some of the reasons why the current system works so poorly. This will be followed by a consideration of the main reform proposals the Committee recommended. I will then address three particular queries and objectives that have been raised about our proposals. Finally, I will briefly outline some of the developments since the Committee reported. [...]

The Committee of Wise Men on the Regulation of European Securities Markets, which had been set up by ECOFIN in July 2000 and which I was asked to chair, released its final report on 15 February of this year. On 23 March the Stockholm Summit approved 90 to 95% of our recommendations and requested that the new regulatory structure should become operational by the end of this year. I will say more about the residual 5-10% in a later section.

Implementation of our recommendations is now underway. While I am confident that it will be carried out according to schedule, it is nevertheless raising problems, and may well raise additional problems in the future. These problems will have to be solved if the new regulatory process is to produce a significant improvement over current practice. A commendable feature of the Stockholm Resolution was that it set out a series of clear principles for the reform of securities markets regulation. Bad habits, however, do not fade away gently. It is important, therefore, that investors, issuers of securities and all market participants keep a watchful eye on the implementation process, and speak up whenever they detect deviations from the principles so clearly agreed in the Stockholm Resolution.

So my paper will be far from detached. I would like to persuade you to lend your support to the realisation of our Committee's recommendations.

## Major Problems: An Overview

The central problem can be summarised quite simply: the current regulatory system is not working; it is too slow and too rigid, produces too much ambiguity and fails to make a distinction between core principles and detail. Insufficient consultation and transparency, plus uneven transposition and erratic implementation by Member States of agreed Community rules, are real handicaps.

The development of the EU financial market is hindered by a plethora of barriers such as:

- the absence of clear Europe-wide regulation on a large number of issues;
- an inefficient regulatory system;
- inconsistent implementation of existing rules;
- a huge number of transactions, clearing and settlement systems;
- the inadequate development of funded pension schemes.

Other factors slowing market integration are: differences in legal systems and taxation; and political, external trade and cultural barriers.

The lack of basic European rules is a major handicap. This is recognised and became the heart of the reason for the Financial Services Action Plan, which should be delivered by 2005 at the latest. The most important gaps are:

- lack of agreed principles covering all financial services legislation;
- failure to make the mutual recognition principle work;
- outdated rules on listing requirements;
- ambiguity over the scope and application of conduct of business rules;
- no appropriate rules to deal with alternative trading systems;
- inconsistencies between the E-commerce Directive and financial services Directives;
- no comprehensive market-abuse regime;
- no cross-border collateral arrangements;
- no set of common accounting standards;
- outdated investment rules for UCITS and pension funds;
- no agreed take-over rules; etc.

## The Committee's Mandate and Working Method

Let me remind you of what we considered to be our core mandate: to identify the shortcomings of the current European legislative and regulatory process in the field of securities markets and to make recommendations on remedies for these shortcomings. In other words, this was an action-oriented mandate.

We had to start, of course, with fact finding, analysis and assessment. It did not take us much time to persuade ourselves that significant gains could be derived from building genuinely integrated, liquid, transparent and efficient securities markets in the European Union. At the micro level, such benefits include a more efficient allocation of capital, enhanced liquidity which will benefit all companies and most especially SMEs, a lower cost of capital, higher net yields for consumers, and cheaper cross-border (clearing) settlements. At the macro level a more efficient capital market should enhance the productivity of capital and labour and contribute to stronger growth and employment.

Such markets would help raise the productivity of both labour and capital, and thus contribute to faster growth and job creation. Although this contribution could be substantial, we fully realised that the radical improvement of Europe's growth and employment performance hinged on a number of other developments as well. Nevertheless, our judgement was that the completion of the single market programme will bring substantial benefits across the board. We also judged that an integrated and well-functioning European capital market is an integral part of the overall single market programme. We believe that the implementation of the Financial Services Action Plan cannot in practice be completed by 2004 without the type of reforms our Report recommends. Reform of capital market regulation is an integral part of fulfilling the ambitions of the single market in financial services.

We also quickly came to the conclusion that, in contrast with markets for goods and many services, the single market for financial flows and services was very far from being a reality, despite progress in some areas. There was no doubt either that the identified weaknesses or even failures of the European legislative process bore a major responsibility for the inadequate degree of financial integration – hence the justification for remedial action.



Quite clearly, however, it was not part of our mandate to make recommendations on what should, or should not be regulated via European law-making, and even less on the content of specific Directives or Regulations. On the other hand, as our work progressed we gradually realised that the Financial Services Action Plan was a highly ambitious exercise requiring considerable legislative work during the coming years. For the sake of speeding up the process it was essential that priorities be established. Hence our recommended list of priorities – a sort of by-product of our core report, albeit an important one.

The priorities within the Financial Services Action Plan which must be adopted by the end of 2003 are:

- single prospectus for issuers;
- modernised admission to listing;
- home-country control for all wholesale members and a definition of professional investors;
- modernised investment rules for UCITS and pension funds;
- the adoption of international accounting standards;
- a single passport for recognised stock markets.

The Committee of Wise Men also argues that attention needs to be given to three crucial parameters:

- convergence of regulatory and supervisory structures;
- restructuring of clearing and settlement led by the private sector in order to reduce the huge European costs compared to those of the US. If the private sector fails to deliver an efficient system, a public policy lead will be needed. A smooth functioning of clearing and settlements is essential for efficient securities markets and for the infrastructure for monetary policy;
- the management of prudential implications implies the need to strengthen co-operation at the EU level between regulators and institutions responsible for micro and macro supervision.

Throughout this initial work of fact finding, analysis and assessment we always kept in mind that our final report should come up with recommendations on how to improve, as speedily as possible, the legislative process and, by implication, the regulatory structures. In short, we felt ourselves drawn into an exercise in European Governance.

A very substantial part of our work was taken up by consultations. We consulted investors (“consumers”), end-users (issuers of securities) and the full range of intermediaries, as well as regulators, and the three main actors of the legislative process, i.e. the Commission, the Council and Euro MPs. These consultations took the form of organised hearings and/or receiving written submissions in response to our questions posted on the Internet.

The first wave of consultations took place in September and October 2000, leading up to our Initial Report released in November. My original inclination was to draft a rather anodyne, factual and analytical interim report, suggesting perhaps alternative courses of action, yet leaving explicit recommendations to the final report. But we soon came to the conclusion that the shortcomings of the current system were so obvious, and that there was such a wide consensus on what these weaknesses were, that we would just waste our very limited time by digging out more and more evidence confirming the initial findings. Rather, we judged that we should focus our attention on potential remedies. As a result I joined those of my much wiser colleagues who had argued from the outset that we should stick our neck out as early as possible with a view to provoking genuine reactions from all interested parties: market participants, regulators, government and Commission officials, Euro MPs and, indeed, media and the public at large. This is what led us to outline already in our initial report our four-level reform approach (including the setting up of the two new committees) which did, indeed, produce widespread reactions.

We received these reactions during the second wave of consultations in December 2000 and January 2001 and they were summarised in an annex to our final report. [...] This helped us to refine and adjust our initial proposal and to make it more explicitly operational. It also led us to put a much greater emphasis on the need for consultation and transparency throughout the whole of the legislative process. This was the result of our own genuine learning process. In a world of

accelerating innovation, changing structures, in matters so technical yet having so broad implications for so many people, enterprises and institutions – let alone for real or perceived national interests – no one can make sensible recommendations without carefully listening to arguments and being ready to enter into a genuine dialogue.

## Shortcomings of the Current Legislative and Regulatory Process

The basic principles of the current system are quite simple – but the way it functions in practice is not. The right and duty of taking legislative initiatives belongs exclusively to the Commission which drafts either a Directive or a Regulation. This proposal is submitted for co-decision to the Council (i.e. to Ministers of the Member states – in the area of financial services, to ECOFIN) and the European Parliament. These legislative bodies approve, amend or reject the proposal. The practical complexity is due in part to the fact that the interaction between these three institutions – for instance the amendment process – is governed by a set of pre-agreed rules known as the “comitology” process. Herein lies one of the problems; these rules are neither simple nor unambiguous. They are the result of historical developments accompanied by protracted negotiations. To varying degrees all three institutions dislike them and try to interpret them according to their own perceived interest. Another cause of complexity is that the implementation of the legally binding Directives rests with the administrations of the Member states; and whenever a Directive contains ambiguous passages these administrations interpret them to their liking. And, of course, these interpretations may be different between different jurisdictions which, in some cases, means that, what was originally designed as a laudable exercise in harmonisation and having markets in different centres subject to equal regulatory requirements, ends up with a complex and sometimes differentiated set of rules and procedures.

We have identified a series of major shortcomings of the current system. I will emphasise three in particular.

To begin with, the legislative process is far too slow. In a number of instances it has taken three to four years between the time the Commission started working on a draft Directive and its effective implementation by the Member states. The worst example is provided by the horror story of the cross-border take-over proposal which was initiated by the Commission as long ago as 1989 and yet has still not been approved (let alone implemented). However, everyone would agree that relying on widely differing national legislations in this crucial area is the best recipe for preventing optimal financial integration in the European Union.

Second, the legislative process is also far too rigid – by which I mean that existing Directives (or Regulations) cannot be swiftly adjusted to evolving market conditions. Every change, however minor or technical, requires a full-blown Commission proposal to go through the complexities of the lengthy and creaking co-decision process. Yet we all know that one of the dominant features of our global financial system is an accelerating pace of change. Innovation produces almost daily new products and operating techniques; and under the combined impact of deregulation and competition nothing can be taken for granted in terms of financial structures and practices. The fact is quite simply that we have a decision-making and implementation process in the area of securities markets regulation which is quite unsuited to a world of fast-moving innovation and market practices. The process needs to be reformed to reflect the current environment of substantial and rapid change.

Third, the current system has produced legislation which is of poor (some would even say appallingly poor) quality. In the course of our hearings and in the written submissions we were given numerous examples of Directives which display a lack of understanding of how financial markets actually work in practice. Moreover, the texts are of legendary ambiguity which, as I have just said, opens the door to inconsistent implementation. There seems to be no co-ordinated effort to eliminate these inconsistencies, and neither is there effective enforcement on the part of the Commission.

All these weaknesses and deficiencies are compounded by a plethora of other complexities, such as clearing and settlement systems that fragment liquidity, increase costs and present a real barrier to financial market development in the European Union. Add on to this differences in legal systems (such as bankruptcy

laws), taxation, different cultural approaches to corporate governance and a lack of identified regulatory priorities, and you have a remarkable cocktail of Kafkaesque inefficiency that serves no-one – not consumers, SMEs, large corporations, or governments. It was not within the remit of our Committee to address these additional complexities although we could not prevent ourselves from voicing our concern over some of them. As a result, we focussed our attention on the legislative and regulatory process. But before outlining the core of our proposals I would like to spend some time on trying to identify the reasons for the obvious shortcomings of the current system.

## Why Does the Current System Work So Poorly?

It is evidently the case that the current system works very poorly and inefficiently and is in serious need of reform. There are several reasons for this.

1. The first, and arguably the most important reason is that the current system ignores the distinction between primary and secondary legislation or, more precisely, between core principles approved by the legislator and implementation technicalities defined by the executive or specialised agencies – within the confines of the delegation granted to them by the legislator. Such a distinction exists in practically all our national legislative systems, although the terminology used to make the distinction differs from country to country. In Belgium, for instance, a law voted by the Parliament is implemented via an “arrêté royal d’exécution”. Because there is no such distinction in European law, the Commission has to draft frighteningly long and exceedingly detailed Directives, of which every element has to be agreed by the Council and the European Parliament.

The consequences are dramatic. They derive, first, from the fact that the two legislative bodies are prevented from concentrating on what should be their primary task and for which they are qualified: to decide, after careful debate, what are the core political principles – the “essential elements” – of each Directive or Regulation. These basic principles are lost in the swamp of details and technicalities. Second, the Commission itself is drawn into drafting such details without possessing the expertise for efficiently carrying out this task.

May I come back for a minute to the story of the unfortunate cross border take-over Directive? This Directive has now got stuck because – after almost twelve years – it appeared that the European Parliament (under the leadership of its German members) wanted to retain the right of the management of a targeted company to reject a hostile take-over bid without consulting its shareholders (for instance, by using the “poison pill” defence tactic). The question of whether or not the ultimate decision lies with the shareholders is very much a matter of “core principle”. Had this issue, together with the other core principles, been put squarely to the two legislative bodies right at the beginning of the legislative process, the conflict would have emerged with clarity from the outset. Although it would not necessarily have been solved with ease, at least the legislators would have had to assume their political responsibility for making their choice between conflicting principles at the outset – not after a decade of haggling. In other words, a clearer focus on “core principles” at the outset of the process would enable disputes to be identified early on, and the nature of the important decisions would be transparent at the beginning of the process. We need to make a clearer distinction between primary and secondary legislation because the present lack of a clear distinction provides an optimum breeding ground for poor legislation, confusion and a slow legislative process.

It also bears the major responsibility for the rigidity of the system. Speedy adjustment to the evolving financial scene means adjustment of the implementation technicalities – not of the core principles. But none of the three institutions is qualified to handle this adjustment within the present system. The Commission is far too removed from the practicalities of the market place to be able to detect the need for a change; and even if it happened to make the right proposal at the right time, the two legislative bodies would be ill-equipped to pass judgement on the appropriateness of the proposal.

2. The second reason for the shortcomings of the current system is its basically “top down” approach, The initiative to legislate is taken by the Commission whenever it considers, from a broad European angle, that there is a need to legislate and that there is a constitutional basis for doing so. The proposal it makes is then debated by government representatives – officials from finance

ministries – and Euro MPs, mostly the active members of the European Parliament’s Economic and Monetary Affairs Committee.

I have no doubt that when core principles are at stake representatives of the three institutions must play their full role, as I have argued just a few minutes ago. That is their right and duty. But even here I feel that they should make ample use of advice coming from “below”, i.e. from practitioners close to the realities of the market – be they regulators or market participants. To set in motion a legislative process requires information: on the pros and cons of legislating at all at the European level; on the main elements of such legislation; and on the guiding principles. And when the debate starts on a draft from the Commission, both legislative bodies would be well advised to listen to the reactions of all the interested parties. This consultation process is important because it should at least minimise the risk of making serious errors, and should alert the law-makers to some of the likely consequences of their rules and legislation. This does not, of course, mean that the law-maker should respond to all the comments made: indeed, that would be impossible given their sometimes contradictory nature. It does, however, mean that law-makers should have access to informed comment. This means that there would be advantage in having explicit mechanisms for public consultation.

When it comes to secondary legislation, the deficiencies of the “top down” approach become even more obvious. The very nature of implementing technicalities, and their timely adjustment to changing market circumstances, requires a type of organisation in which those capable of giving advice should be entitled to take the initiative. By doing this, “top down” would begin to closely resemble “bottom up”.

The information gathered from our hearings, and also from the written submissions we received, suggests that consultation has so far been inadequate. In most instances market participants have been offered the opportunity to make their voice heard only after the publication of a draft proposal. Moreover, only very rarely does such consultation turn into a genuinely interactive dialogue.

3. The current legislative process is remarkably opaque. This does not apply to the part played by the European Parliament, which deserves praise for practising full transparency. But it does apply to the role of the Commission and even more to the activities of the Council, This lack of transparency has two deplorable consequences.

One is that, even when there is consultation, this cannot yield optimal results: for how can the consulted practitioners form an operationally useful view on matters under discussion when they do not know how the discussion is progressing among member states and inside the Commission as well as between the Council and the Commission? And how can they defend what they perceive to be their legitimate interest without knowing who defends what argument? Consultation and transparency are twin requirements. Genuine consultation requires transparency; but how can there be transparency if there is no consultation?

Second, the lack of transparency has a debilitating effect on the quality of the legislative process. It encourages behind-the-scene compromises in which participants in the decision-making process accept a deal in the hope of deriving a benefit from a reciprocal concession in a field totally unrelated to the working of securities markets. Politics (or simply human nature) being what they are, it would be unrealistic to hope that such across-the-border concessions could be eliminated, but it is worth trying to reduce their frequency. Transparency can contribute to achieving this objective.

## The Main Components of Our Regulatory Reform Proposal

The Committee believes there is a need for all financial services and securities legislation to be based on a conceptual framework of overarching principles.

The most important could be:

- to maintain confidence in European securities markets;
- to maintain high levels of prudential supervision;



- to contribute to the efforts of macro and micro prudential supervisors to ensure systemic stability;
- to ensure appropriate levels of consumer protection proportionate to the different degrees of risk involved;
- to respect the subsidiary principles of the Treaty;
- to promote competition and ensure that the Community’s competition rules are fully respected;
- to ensure that regulation is efficient as well as encouraging, not discouraging, innovation;
- to take account of the European, as well as the wider international dimension of securities markets.

The core of our proposal centres around a four level approach to the regulation of European Securities markets.

The Level 1 legislative acts should concentrate on the core political principles: the “essential elements” of each Directive or Regulation. The Council and the European Parliament, acting on a proposal from the Commission, would agree on the key political Directive and orientation for each subject. Most important, the Council and the European Parliament would agree on the nature and the extent of the implementing measures to be decided at the second level. The split between Level 1 framework principles and Level 2 implementing measures will have to be determined on a case-by-case basis.

Let me emphasise again how important I believe it is that the Commission should consult, in a very open, transparent and systematic way, before making its Level 1 proposal. [...]

Level 2 is composed of an actively functioning network of national securities regulators, the Commission and a European Securities Committee to define, propose and decide on the implementing details of framework Directives and Regulations which have been determined by the co-decision procedure in Level 1.

This implies the setting up of two new committees:

- An EU Securities Committee (ESC) whose central role would be to act as a regulatory committee under Article 202 of the Treaty, in which the Commission's proposal would be voted on with a short, fixed deadline. The Member states should nominate members to the ESC, which the Commission would chair.
- An EU Securities Regulators Committee (ESRC) which in Level 2 would act as an advisory committee to the European Commission. Its members should be the heads of the competent national authorities for securities regulation designated by each Member state – building on the structure already successfully established by FESCO.

The role of the ESC would be to:

- act as a Regulatory Committee where the Commission's proposal would be voted within a fixed deadline of 3 months;
- act in an advisory capacity to the Commission for the Level 1 legislation;
- advise the Commission on Level 2 mandates for the ESRC.

The membership of ESC has to be at a high level. Collegiality and “esprit de corps” are considered as very important. The role of the ESRC would be twofold:

- in Level 2, to be an independent advisory group to the Commission;
- in Level 3, to act as a fully independent committee of national regulators to ensure a more consistent implementation of Community Law.

The ESRC must be composed of national regulators. Four basic procedures must be followed for ESRC consultation:

- consultation on the basis of a concept release (3 months);
- consultation with markets and end-users on the basis of a draft proposal (3 months);

- hearings, roundtables, internet;
- public comments should be appended to each of the ESRC’s final recommendations.

The working method in Level 2 could be summed up as follows. In the light of the Level 1 co-decision process, the Commission would ask the ESRC to begin work on the implementation details and agree a timeframe for the work to be carried out. After having consulted market participants, the ESRC would forward its advice to the Commission, which would consider this advice and forward its proposal to the ESC, which would then vote on the proposal.

I would like to insist on three important points made in our Report:

- The European Parliament must be kept fully informed throughout the process, in line with inter-institutional agreements;
- The consultations carried out by the ESRC should be open, transparent and inter-active; [...]
- Both the ESC and ESRC must be high level committees.

In order to maintain institutional balance and involvement of the European Parliament it is proposed:

- to keep the European Parliament fully informed;
- to give the European Parliament time to check the proposal before ESC votes;
- to ensure that the Commission takes utmost account of any European Parliament resolution against the proposal;
- to give an adequate role to the European Parliament.

Now let me come to Level 3 in which the Levels 1 and 2 European legislation is transposed and implemented in the Member states. At this stage the ESRC puts on a different hat: it acts no longer as an adviser to the Commission, but assumes the more “independent” role of ensuring consistent transposition and implementation. The fact that the ESRC plays a key role in the process of defining

the Level 2 component of the Directives is likely to go a long way towards ensuring that it can be an efficient co-ordinator of the transposition process.

In Level 3 the objective is to improve day-to-day transposition and implementation. ESRC is more independent and voting by unanimity is necessary. The role of the ESRC is:

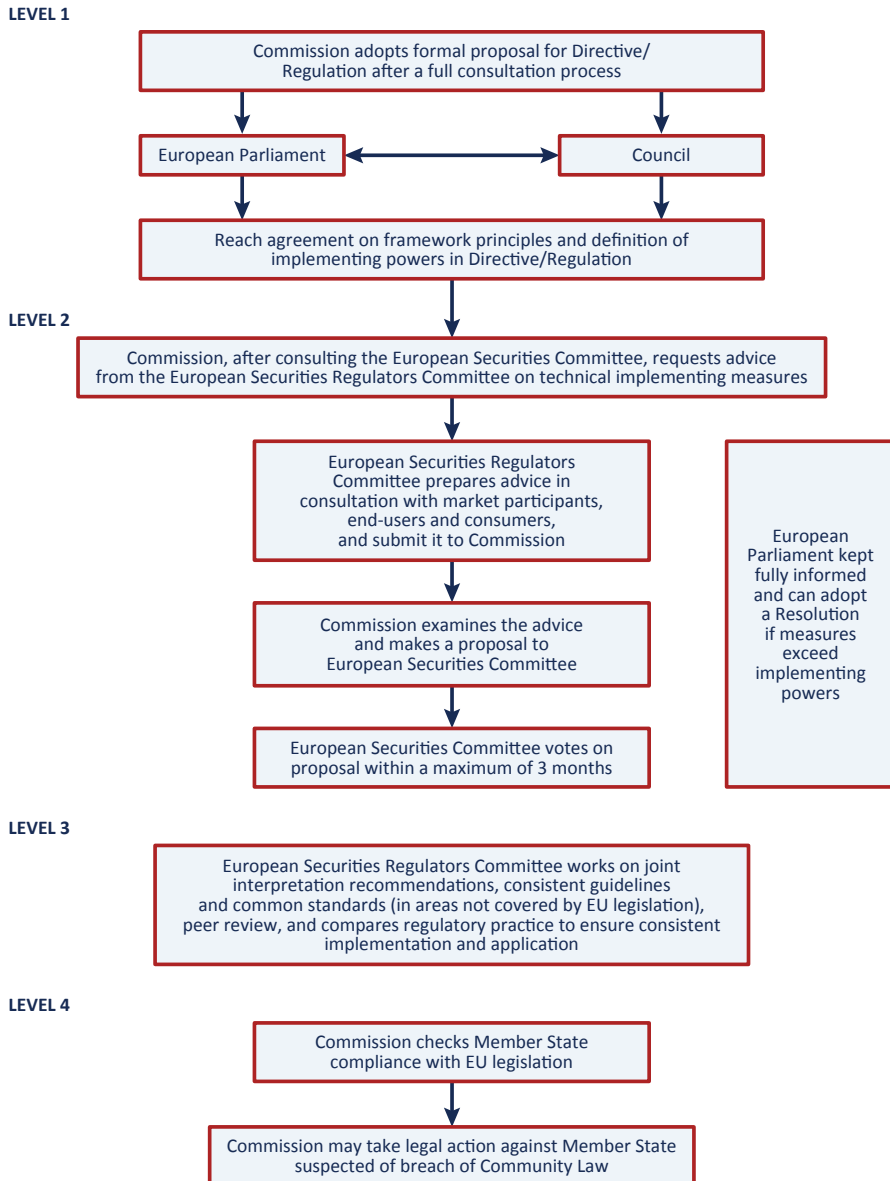
- to produce consistent guidelines for administrative regulations;
- to issue joint interpretative recommendations and common standards;
- to compare and review regulatory practices;
- to carry out peer reviews.

An important and immediate condition of the ESRC to be able to perform its dual role is that those mandated by the national regulatory authorities should have both the knowledge to carry out their work and the ability to deliver from the very outset the undertakings on which they have agreed. In the longer run, a more fundamental convergence is necessary among European regulatory structures – for the simple reason that differences in these structures make it cumbersome for the national authorities to co-operate within the ESRC. At the moment there are several important differences in these structures: the areas covered; the degree of autonomy of regulators; and not least the way in which market participants are involved in the regulatory process. These issues need to be addressed.

Level 4 is that of enforcement. We propose to strengthen the enforcement of Community rules. All actors have a part to play here, but the major responsibility falls on the Commission, which has the legal duty to act as guardian of the European treaties.

This four-level approach is represented by a chart taken over from our Report, and reproduced below.

**Chart 1**  
**The four-level approach recommended by the committee**



## Queries and Objections

After its release on 15 February, our Report received a broadly positive welcome. However, there have been quite a few queries and some objections have been raised. Let me try to respond to three of the major concerns that have emerged:

1. The proposed framework is far too complex – especially as regards the interaction between the Commission, the ESC and the ESRC.

To some extent the complexity of our design is more apparent than real. In writing our final report we responded to ECOFIN's request to "clarify and refine" the regulatory framework suggested in our initial report and "propose operational recommendations". Describing in some detail the operation of any system is bound to appear complicated, even if the operation can in fact be quite simple. A manual summing up instructions of how to ride a bicycle may look frighteningly complex, yet five-year-olds can be expert bicycle riders.

At the same time I do not deny that, in some respects, our proposed reform is not simple. But there are reasons for this. We are not dealing here with some broad guidelines governing gentlemen's agreements but with a legislative process. Any such process requires careful and precise description, and has to find its place in an existing legal environment. Moreover, this is European law-making; and whether we like it or not, the European Union is a highly complex organisation.

2. Why does the Report refrain from recommending the setting up of a single European securities regulator?

The Report refrained from recommending it in the present circumstances, for two good reasons. First, because no such regulator could operate today without the gaping holes in the European financial legislation being filled-in in the first place. It is conceivable that a single regulator would be endowed with the authority to interpret core principles or to define Level 2 implementation technicalities, but it is unthinkable that it could become a legislator deciding on Level 1 framework principles.

The second reason is that setting up a single European regulator would require a new Treaty (in the same way as the European Central Bank could not have been set up without the Maastricht Treaty). The negotiation, drafting

and ratification of a new Treaty would take several years – yet the reform of the current system is of the utmost urgency. Without such a reform the implementation of the Financial Services Action plan cannot be completed by 2004, and even less brought forward, partly at least, to 2003. We saw no alternative to submitting, reform proposals within the confines of the existing Treaty.

Some might object that this need not have prevented our Committee from outlining the profile of a potential single regulator. This would have been in line with the very last sentence of our Report which says that if the full review were to confirm in 2004 (or earlier as the case may be) that the approach did not have any prospect of success, it might be appropriate to consider a Treaty change, including the creation of a single EU regulatory authority for financial services generally in the Community. We did not volunteer to outline any such profile. This would have required a careful and very thorough analysis for which we simply had no time. I also believe that such an exercise, however carefully qualified by liberally using “if” and “when”, would have derailed the constructive discussion of our reform proposal.

3. Why should the proposed regulatory framework be able to function properly when success hinges on the change of behaviour of the very same actors – Commission, Council, European Parliament – who bear a shared responsibility for the shortcomings of the present system?

It is recognised that simply changing institutional structures does not in itself guarantee the right policies. In the final analysis, it is what regulators, legislators, etc. do that is important rather than which agencies do it. So I accept that this question is, indeed, a major concern which should not be dismissed lightly. Hence our repeated insistence throughout our Report to:

- give a clear mandate to the two key Level 2 committees;
- ensure full transparency of the system, coupled with deadlines in the decision making bodies;
- throughout the whole legislative process to consult regularly with market participants and consumers;

- implement strong monitoring and reporting to the Council, Commission and Parliament, and to the public at large.

## Developments Since the Release of the Report

In its Resolution on 23 March 2001, the European Council endorsed the essential features of our proposal, including our call for a “full an open review in 2004”, and requested that the new regulatory structure should be operational from the beginning of 2002 at the latest.

On one specific point, however, the Resolution did not follow our recommendation. We suggested that the Securities Committee (ESC) should vote by qualified majority on proposals coming from the Commission, and that the votes should be weighted in the manner set out in the Treaty for the votes in Council. This implied that it would be highly unlikely that a proposal emanating from the Commission and based on the advice received from the ESRC would be rejected by the ESC. In my discussions with Euro MPs I argued that this would demonstrate the willingness of governments to grant concessions in order to make the proposed system effectively operational.

In Stockholm, however, the Commission watered down our proposal regarding the voting procedure, mainly under pressure from the German government. As a result, in its resolution the European Council noted that “the Commission has committed itself, in order to find a balanced solution for those cases of implementing measures in the field of securities markets acknowledged in the light of discussions to be particularly sensitive, to avoid going against predominant views which might emerge within the Council, as to the appropriateness of such measures”. What are “predominant views”? It presumably means less than qualified majority, since otherwise there would have been no reason for asking the Commission to make this commitment. Does it therefore mean a simple majority? Or the views of one or several “predominant” countries? And how will the interested investors, issuers and market participants learn about the emergence of such views?

This departure from our original proposal has not created a healthy climate for finding a solution to the Parliament’s request to be granted a “call-back” or “parliamentary override” provision relating to the Level 2 measures. We were



persuaded by the legal advice we received that a formal call-back provision would be incompatible with the current institutional arrangements. I believe, on the other hand, that if our Committee's recommendations are properly implemented, the Parliament will be able to have a significant impact on the Level 2 decision-making process. Let me spell out (as we did in our report) what should be the three main features, in this respect, of a "proper" implementation:

- full transparency at all times;
- sufficient time for the Parliament to check that the decisions are in line with the scope of the implementing measures it agreed to;
- if the Parliament believes that the Commission is exceeding its implementing powers it should be able to pass a resolution. Were it to do so, the Commission would be required to re-examine its proposal and should take the utmost account of the Parliament's position. It would be inconceivable if it did not.

Acceptance of these recommendations would give the Parliament – de facto though admittedly not de jure – something that comes very close to a parliamentary override. For we should keep in mind that Level 2 decisions are to be decided on a case-by-case basis. This means that if the Parliament were dissatisfied with the Commission's reaction, the consequences would be felt next time a request for Level 2 implementing powers were made.

Given the importance of reform of securities markets regulation, my own wish (and hope) is that the proposed framework is given a fair chance to function during the next two years which are so crucial for the implementation of the Financial Services Action Plan. This implies that the Parliament does effectively play the delegation game at the same time as governments refrain in practice from reminding the Commission that it has accepted the "predominant views" concession. For the rest, the commitment to undertake a "full and open review" in 2004 should be interpreted to imply the willingness to address with an open mind whatever concerns may have remained in the minds of Euro MPs regarding the functioning of the new system. Most importantly, it should also imply that consideration will be given to the formal introduction of a two-level legislative procedure.

## Concluding Remarks

I have noted that our legislative and regulatory approach has been received with interest, well beyond the world of finance, by all those who find the present system of governance in the European Union unsatisfactory. I am not qualified to argue that our approach should be extended to other areas of European legislation and regulation – for the simple reason that the approach which we proposed is not the result of putting into practice pre-conceived ideas about the generally desirable features of European governance. Rather, it emerged – admittedly quickly – from the observation that in the specific field of financial services the current system was working very poorly indeed. The impression of dysfunction in this field has however been so strong and the identified shortcomings – no distinction between primary and secondary legislation, “top down” procedures, lack of transparency and consultation – so blatant that the prevalence of similar weaknesses seems to me likely to be widespread. Whether this is true or not should, however, be checked by looking into the working of the legislative and regulatory practices in other areas as well. The debate about the global reform of governance in the European Union badly needs the support of empirical evidence.

This is the more so since the balance of power between the three institutional poles – Council, Commission, Parliament – is in a state of flux. Part of these uncertainties is understandable and probably unavoidable, given the unique features of the European integration process. But with 2004 on the horizon, these uncertainties are now reaching a degree that can become genuinely detrimental to any legislative and regulatory initiative. The possibility, indeed the likelihood, of changes in the balance of power induces defensive reactions on the part of all three institutions. Whatever deal is made today can serve as a precedent for more systematic changes in 2004. This is vividly illustrated by the fact that the European Council resolution on the Commission’s commitment regarding the “predominant views” goes on to say that “this commitment shall not constitute a precedent” – while we all know that the commitment itself was requested on the basis of a former precedent (the so-called “aerosol” clause).

Again, we cannot hope to eradicate these defensive reactions; but their deleterious consequences could perhaps be limited by introducing more factual evidence into the important debate on governance. And again, I emphasise the need for active consultation at all stages.

## Chapter XXXII

# Central Banks and Financial Stability

2004

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*Throughout his career, Alexandre Lamfalussy has been a more or less constant advocate of giving the central bank a role in the prudential supervision of banks. In his Pierre Werner Lecture in 2004, he returned forcefully to this theme. He focused on the organisation of prudential supervision in the European Union, which he described as a “mind-boggling patchwork”. Lamfalussy stressed that central banks had a crucial role to play in financial crisis management, especially in preventing a potential crisis from turning into a real one. He then raised the issue of whether the ECB should be given some responsibility for supervision of the large, systemically important, banks. This would eventually happen with the Single Supervisory Mechanism launched in November 2014 under the auspices of the European Central Bank. This is the text of his Pierre Werner Lecture, delivered at the Banque Centrale du Luxembourg on 26 October 2004. Reprinted with kind permission of the Banque Centrale du Luxembourg and the Lamfalussy family.*

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## Introductory Remarks

Why did I pick this topic for my Pierre Werner Lecture? First, because (for reasons I propose to develop later) serious consideration should be given to enhance our crisis prevention capabilities. Not that I would attach a high degree of probability to the outbreak of a systemic crisis; but should such an unlikely event nevertheless materialise, its consequences would be devastating both for our financial system and for the “real” economy. Second, because the present institutional set-up in Europe regarding crisis prevention (and potentially also crisis management) looks to me, to put it mildly, sub-optimal. Finally, because the relative calm prevailing today in financial markets provides a favourable climate

for discussing the issues raised in this lecture without undue haste. A crisis would provide a strong incentive for reforms, but not necessarily for good reforms.

By “financial stability” I mean systemic stability – not the stability of individual institutions, nor even that of segments of the financial industry. Note, however, that the demarcation line between a systemic crisis and specific crisis manifestations is very uncertain. By the same token it is equally difficult to define when crisis prevention stops and crisis management – or, more precisely, implementation of emergency measures to avoid an open crisis – begins. Macro- and microprudential responsibilities have the irritating habit of overlapping. These observations underpin most of the arguments I intend to present.

My lecture deals with the role and responsibility of central banks in preserving the stability of the financial system as a whole. First, it does so in general terms; in the second part it refers to specific European issues.

## I – Emergency Measures to Avoid a Systemic Crisis

1. When there are converging signs of a potential systemic crisis, central banks have a key role to play in preventing a potential crisis from turning into a real one. I think we would all agree that in such a situation they should provide liquidity to the system, so as to avoid liquidity shortages pushing otherwise solvent banks into bankruptcy. They also have to care about the smooth functioning of the payments system, which is the main channel through which contagion may spread – not to mention the fact that a payment gridlock, whatever its proximate cause (9/11, breakdown of IT or CT systems), may be at the origin of a systemic crisis.
2. The timely provision of liquidity to the system is very much a matter of judgement, moreover of a judgement which in most instances has to be made at very short notice. In order to be able to make a sound judgement, central banks have to be intimately familiar with the working of financial intermediaries in general, and of banks in particular. They must possess direct information on banks’ risk-assessment methods and capabilities, on their decision-making processes and control mechanisms and, not least, on their expertise and skills in using innovative financial instruments. Such information cannot be acquired

by reading second-hand reports, however lucid and transparent such reports may be.

3. There are two “macro” problems associated with liquidity creation as a crisis-avoidance action. One is the potential conflict with a price-stability oriented monetary policy. If the central bank’s liquidity creation is not warranted by monetary policy considerations, it has to be reversed as soon as the crisis manifestations are brought under control.

This is technically feasible, but – again – the right decision has to be based on sound judgement. The other one is moral hazard: pre-emptive liquidity creation is likely to have, as a side-effect, the “bailing out” of holders of risky assets. If a radical relaxation of the monetary policy stance takes place when equity prices are plunging, the central bank’s action is likely to be interpreted as a support for the equity market.

4. Additional complications may arise when it appears that the provision of liquidity to the banking system as a whole does not eliminate the risk of a systemic crisis. When it becomes clear that direct liquidity assistance to a specific institution is required, an emergency credit granted by the central bank is only one of several options. Moreover, this is an option which has to be handled with care: in a crisis situation it is close to impossible to know whether the illiquid bank is also insolvent. Yet we would all agree, I believe, that a central bank should not lend to insolvent institutions. One other option is a lifeboat arrangement whereby a group of banks come to the rescue of a specific institution. The central bank may play a role in organising such rescue operations. This could, however, imply the risk of moral hazard, i.e. precisely what lifeboat arrangements are supposed to minimise. Another option is the explicit use of taxpayers’ money to bail out an insolvent institution. The primary responsibility in this case will have to shift to governments.
5. Recourse to emergency measures will always be a messy business: the nature of a crisis is unpredictable, and so is the sequence of events leading to a crisis. To sum up: (a) it is exceedingly difficult to identify if and when there is a need to undertake emergency action; (b) decisions have to be taken at short notice; (c) since the demarcation line between general liquidity creation, which is a central banking responsibility, and bail-outs committing taxpayers’ money,

which is a government responsibility, may well become fuzzy, there is need for well-designed, simple procedures for communication and cooperation between these two main actors; (d) emergency measures always imply, albeit in various degrees, the risk of moral hazard. Hence the obvious conclusion that to avoid being driven to the implementation of emergency measures, we would be well advised to put in place a broadly-based policy of prevention.

## II – Prevention

6. Central banks often argue that their most effective contribution to crisis prevention is the conduct of a monetary policy whose primary objective is the preservation of price stability. This implies the avoidance of both inflation and deflation – for the obvious reason that both provide a favourable breeding ground for crisis manifestations (not to mention that this is especially true when inflation is followed by deflation). I have no doubt that a stability-oriented monetary policy significantly reduces the risk of a systemic financial crisis, but it does not eliminate it. A problem may indeed arise from the fact that price stability is usually defined (and I don't see how it could be done otherwise) as, say, an X percent rate of increase in the index of consumer prices (or of the GDP deflator). Achieving price stability thus defined does not imply, however, that nothing could go wrong with asset prices. May I refer to a “stylised” summary of the recent US experience? An unexpected increase in the rate of growth of labour productivity, combined with a decline in the “natural” rate of unemployment, may well keep a lid on the prices of goods and services (and do so lastingly), even though the rate of increase of broad money points to the development of excess liquidity. If this excess spills over into asset markets and creates asset price bubbles, and if this is accompanied by a rise in corporate and household indebtedness, the bursting of the bubbles is apt to create a propitious environment for the emergence of a systemic crisis. Hence the awkward question: should central banks worry about bubbles, and if not, who could or should? My short answer is that they should – but I acknowledge that this is more easily said than done. Identifying an asset price bubble, while never an easy exercise, may be the easier part of the assignment. The genuine difficulty lies in the fact that it would seem hopeless to try to agree on what should be the right level of an asset price. We may agree that the current price is by far too high, but this does not mean that we can pretend

to know by how much. Hence the obvious conclusion that, as opposed to the rate of inflation, an asset price cannot, and should not be targeted. But, in that case, what happens to the accountability of a central bank? Add to this that fighting an asset price bubble is unlikely to win popular support in the same way as inflation fighting can. But what is the alternative? If a central bank does not try to discourage “irrational exuberance”, it may well fall into the trap of asymmetrical policy reactions, with obvious moral hazard implications. For how could it not undertake policy relaxation when the bursting of the bubble raises the risk of a systemic crisis?

7. The traditional recipe for prevention is the micro-prudential regulation and supervision of financial intermediaries. But which intermediaries? The focus should clearly be on banks. The specificity of banking deserves a few comments, especially in the light of two developments which could be interpreted as leading to the erosion of this specificity. One is the blurring of demarcation lines between traditional commercial banking and other financial intermediaries, even including non-financial enterprises. The other one is the declining importance of banking intermediation relative to the role played by market transactions. However, despite these developments, banks have continued to play a central part in the potential emergence of a systemic crisis as much as in its prevention. There are several reasons for this. By their very nature, they are highly leveraged institutions. Via their deposit base and credit-granting activities, they are the providers of liquidity to the system: it is through the banks that the central bank's ultimate liquidity creation affects the full range of financial intermediaries as well as the real economy. Moreover, they play a key role in the payments mechanism, which is the channel through which specific crisis manifestations are liable to develop into a full blown general crisis. Because of these specificities crisis management means, in essence, preventing the collapse of the banking system, and crisis prevention means taking prudential measures with a two-fold objective in mind: to keep a rein on banks' crisis-generating proclivities and to enhance their crisis-resistance capability.

This, of course, is an oversimplification. We have to watch carefully the development of financial structures and the steady flow of financial innovation which may compel us to extend prudential supervision to new segments of the financial industry. One major, worrying, example pointing in this direction

occurred in September 1998 when LTCM, a prestigious hedge fund, came close to bankruptcy but in the last minute was rescued by a banking consortium under the auspices of the Federal Reserve Bank of New York. LTCM was not a bank, yet the US authorities decided to “facilitate” the rescue operation because “fire sales” of the fund’s government bond portfolio could have created a major upheaval in the US Government debt market. There had indeed already been signs of a potential liquidity crunch: remember the dramatically increased demand for liquidity protection, well illustrated by the surprising surge in the illiquidity premium for the off-the-run Treasury securities. The rescue was successful, and markets returned to business as usual. But we cannot take it for granted that the stream of financial innovations will not throw up other “surprises”.

8. The role of central banks in bank regulation and supervision is a highly controversial topic. To the best of my knowledge there is no clear empirical or historical evidence, nor conclusive theoretical arguments, in favour or against their operational involvement in this activity. Those who favour such an involvement point out (a) that central banks, by being banks themselves, are eminently well equipped to fulfil such function; (b) that they need the operational experience of bank supervision for being able to discharge their unquestionable duty in undertaking emergency crisis-avoidance measures; and, not least, (c) that they are capable of looking not only at a bank in isolation – but also at the broader picture of the interbank market and of relations between segments of the financial industry which gives them insight into both macro and micro prudential issues. Those who are against fear (a) the “pollution” of monetary policy decisions by prudential considerations as well as (b) the likelihood of enhancing the risk of moral hazard (how could a central bank, which is acting as supervisor, resist a request for emergency lending?).

### III – Beyond Generalities: The Case of Europe

9. The queries and concerns raised so far in general terms have to be set against an institutional set-up in Europe, which is very peculiar indeed. Here are its most striking features:



- (a) The ECB's role and responsibility in global liquidity creation is well defined; its other responsibilities in crisis management and prevention are not;<sup>1</sup>
  - (b) Regulation of the financial industry (including banking) is carried out mostly at the European level, but with the active participation of national authorities;
  - (c) Supervision, including that of banks, is carried out at the level of member states;
  - (d) As regards banking supervision, some NCBs have a clear operational role, others have some operational involvement, a few have practically none;
  - (e) In some countries the whole financial industry is supervised by one single authority, in others there are authorities with sectoral responsibilities, while some countries follow the "twin peaks" model;
  - (f) Euroland ≠ EU – and Europe's main financial centre is not in Euroland;
  - (g) There is no single "federal finance minister" – although commendable efforts are under way to endow the so far "informal" Eurogroup with an institutional status, including a President with a mandate going well beyond the traditional six months.
10. Looking at this mind-boggling patchwork one might be tempted to suggest a global overhaul. A rational mind would begin by trying to answer the following questions:
- (a) Should there be a single supervisor for Euroland? the EU?
  - (b) If so, should this single supervisor bring together under the same roof all the sectoral responsibilities?
  - (c) If not, should we at least try to harmonise the national supervisory structures?
  - (d) In case of centralisation what role should be left to the national authorities?

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<sup>1</sup> Article 105/5 of the Maastricht Treaty: "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system".

(e) How would the ECB and the NCBs fit into a new structure?

Given the observations made above under 9, I would find any such global approach hopelessly unrealistic – at least at this stage of Europe’s history.

11. Yet at the same time I do believe that there are good reasons for enhancing our crisis-prevention and crisis-fighting capabilities. Let me elaborate.

Why worry when we have just witnessed the remarkable resilience of our financial systems at the time of the stock markets’ meltdown between early 2000 and the spring of 2003? Between March 2000 and March 2003 the P/E ratio of S&P 500 declined from 38 to 20, and that of US technology stocks literally dived from 65 to 18<sup>1</sup>. That this did not produce a systemic crisis can be explained to a large extent by the resilience of the developed world’s banking systems which in turn can be attributed to three facts. To Basel I, which enabled our banks to enter this period of turbulence with a very strong capital base; to the widespread and skilful use of risk-hedging techniques by bank managements in general; and, in particular, to the transfer of credit risks, via the market for credit derivatives, to non-bank intermediaries and institutional investors. These have undoubtedly been reassuring developments, but they do not tell the whole story. For one thing, another – perhaps even more important – key influence was also at play; household consumption and investment held up remarkably well, especially in the United States. The decisive factor in this respect was the simultaneous administration to the US economy of a powerful dose of monetary and fiscal stimulus, the speed and size of which was without historical precedent. As a result, the “real” economy suffered only a short and shallow recession and then entered into a fast recovery. There is, however, a question mark hanging over the sustainability of this recovery, which has to do with the level and with the unpredictability of asset prices. The late 1990s were dominated by the steady deepening of “flow” imbalances in the US economy: a growing public sector deficit, a rising current account deficit and a very low rate of saving by the household sector. None of these imbalances were corrected by the recession; and with the recovery they have continued to deepen. Sooner or later, however, they have to unwind. This unwinding has so far

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<sup>1</sup> BIS. 73rd Annual Report. June 2003. p. 105.

been prevented by the high level of real estate prices, combined with low interest rates: property wealth has as a counterpart a significant debt burden in households' balance sheets, of which a non-negligible part is based on adjustable interest rates. This asset-price domination of the US economy constitutes a major challenge to the Federal Reserve's monetary policy – especially if the public sector deficit continues to deepen. I also have some broader, less “cyclical” or macro-policy concerns. They have to do with the consequences of the steady flow of highly sophisticated financial innovations. As I just have said, by using these innovations as hedging devices, banks have managed to come out of a period of market turbulence without much damage. But the system as such cannot insure itself against the meltdown of asset prices or the bankruptcy of large non-financial firms which represent a genuine, global, loss. All that insurance does is to redistribute this loss, by transferring risks from risk-averse market participants to willing risk-takers. To the extent that these risk-takers know what they are doing, and properly assess their risk-resistance capabilities, the system as a whole gains in stability. But the assessment of risks in financial markets is a tricky business. The instruments may be of the highest sophistication, but the empirical evidence is often very recent and therefore may turn out to be unreliable. Regularities observed in the asset price behaviour – co-variances – may easily break down in a world subject to radical changes. There is a world of difference between these kinds of insurance contracts and those based on mortality tables reflecting information provided over centuries. Finally we have to bear in mind that those in charge of maintaining systemic stability possess only incomplete information on which segments of the financial industry act as risk-takers, and even less on the intricate set of interconnections established through the use of derivatives. Our highly innovative financial system has not gained in transparency. It has become remarkably opaque. Let me give you just one example. In 1982, at the beginning of the Latin American crisis, we were reasonably well informed about the external claims and liabilities of western banks, thanks to the statistics collected by the BIS. These statistics still provide useful information, but their importance is dwarfed by the risk-interconnections created by the derivatives markets, for which, for obvious reasons, no such “simple” information is available.

All this boils down to saying that we are navigating in waters uncharted by reliable historical experience. Given this situation, strengthening our crisis prevention capabilities deserves to be regarded as a worthwhile undertaking. Could we not make progress in this direction by being less “globally” ambitious, but rather more pragmatic?

12. I would start from the assumption that the group of financial intermediaries whose regulation and supervision deserves to be reconsidered are a limited number of very large banks which have become actors at the global level and are key players in the European interbank market. Their problems could have directly systemic consequences. Conversely, to the extent that these banks do not encounter major difficulties, the likelihood of a systemic crisis is substantially reduced. Some of them have already undertaken intra-European cross-border ventures; others are considering it. Their cross-border integration could have a beneficial influence on the broader integration process – but such integration is surely not helped by the complexity of our current regulatory supervisory arrangements.

Should one not consider exploring the desirability and the feasibility of entrusting the ECB with an operational responsibility in the supervision of this limited number of banks?

There are some weighty arguments in favour of such course of action. First and foremost, this would go a long way towards providing the ECB with the first-hand information it needs to discharge its unquestionable macroprudential duties in the case of an impending systemic crisis. Second, it would not need to imply by necessity the overhaul of the banking supervisory arrangements at the national level: the ECB would have to share its responsibility with the national authorities – be they the NCBs or other agencies. Third, it would simplify the procedures for communication and cooperation between the main actors in two respects: at the global level (in relation with the US and the UK authorities) and within Euroland (with the Eurogroup of finance ministers).

Finally, cumbersome treaty changes could be avoided by having recourse to Art. 105/6 of the Treaty or to a similar disposition of the draft Constitution.<sup>1</sup>

Some may object that submitting a limited number of very large banks to a special supervisory regime would amount to a revolutionary innovation. I do not think that this would be a valid objection. The distinction does exist in the United States. Moreover Basel II makes a clear distinction between banks with relatively simple operations and banks with more complex activities; and even more important, it picks out of this second group “advanced” banks which will be in a special position.

One final remark: the effectiveness of any such mandate given to the ECB would only be enhanced by the Eurogroup moving towards a solid and efficient institutional structure.

13. Could the advantages of such course of action not be outweighed by its disadvantages? They could indeed. These disadvantages are those implied, in general, by the operational participation of central banks in banking supervision (see 8. above). To which I may add that in the case of the ECB it would be regrettable if the clarity of its mandate for running monetary policy – “the primary objective of the ESCB shall be to maintain price stability” – would be diluted. The balance of the argument critically hinges on the answer given to two questions. First: how serious is the risk that we would have to deal with a systemic financial crisis? May I repeat my answer: it is hopefully not very high, but in the unlikely event of such a crisis nevertheless materialising, its consequences could be devastating. We should therefore err on the side of prudence. Second, what sort of practical and credible alternative could be envisaged?

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<sup>1</sup> “The Council may act unanimously on a proposal from the Commission and after consulting the ECB, and after receiving the assent of the European Parliament confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings”.

## Chapter XXXIII

# Dinner Address. Sixth ECB Central Banking Conference

2010

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*In his “Dinner Address” to the Sixth ECB Central Banking Conference, on 18 November 2010, Lamfalussy “meditated” on his 1997 EMI farewell speech (see chapter XIX), in which he had argued not to “overburden monetary policy” and to focus on price stability. He now argued that the financial crisis had “confirmed something that was (or should have been) expected: that whether they like it or not, central banks are in the front line when it comes to keeping crisis manifestations under control”. He emphasised the severity of the crisis and did not expect a quick end to it. Consequently, financial stability should remain an objective for central banks, just like price stability. Naturally, having to comply with two distinct mandates makes life more complex for central bankers. The essay was published by the ECB in “Approaches to monetary policy revisited – Lessons from the crisis”, Jarocinsky, M. et al. (eds). Reprinted with kind permission of the European Central Bank and the Lamfalussy family.*

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At the farewell ceremony of the change of EMI presidency – on 30 June 1997 – I made a speech in which I said, not literally but in substance: “Don’t overburden monetary policy with tasks it cannot accomplish” – by which I meant – “keep it targeting and achieving price stability, and let other policies, and policy makers, carry the responsibility for failing to achieve, or being proud for having achieved, other respectable policy objectives”.

In the first part of my remarks this evening I propose to look backwards and set this recommendation in its historical context. This is the relatively easy part of my remarks. In the second part I shall stick my neck out and meditate (I apologize

to Jean-Claude [Trichet, editor's note] for borrowing his patented expression) whether today I would still make such a recommendation.

When I made this recommendation, only eighteen months left before 1 January 1999 which was the latest date at which the single monetary policy was supposed to start operating. There were still doubts, especially across the Channel and the Atlantic, whether this was going to happen, but the view of the markets and of all those familiar with the progress of the preparatory work were shifting towards a cautious optimism. The single most important event in shaping this view was the outcome of the crucial informal autumn ECOFIN meeting in Valencia and the formal 1995 December Summit in Madrid which agreed on the main ingredients of the changeover scenario to the single currency.

While there remained still a lot to do during the next eighteen months, in terms of institution building the groundwork was not very far from having been completed. I have often been asked: why did the pessimistic forebodings prove unfounded? I must confess that until Madrid I had my own share of forebodings. In fact while the road leading to the beginning of Stage III was on occasion somewhat bumpy, there were no major conflicts of the kind that could have fatally jeopardized the implementation of the single currency: neither between the EMI Council and the governments, nor among governments, nor inside the EMI, nor between any of these and the Commission – and this, despite the many vested interests against the introduction of the single currency. A lot of things could have gone wrong in the process of institution building. How is it that they did not go wrong?

My favourable explanation is that we have been well served by the exceptional convergence of several facts and influences. Let me list some of them – without going into longish explanations: (1) The initiators of the project were the governments themselves, and at the highest level: the heads of State or of Government, who acquired a vested interest in a successful implementation process; (2) These political leaders were shrewd enough to entrust the central bankers with a major role in the preparation of the Maastricht Treaty (Jacques Delors deserves a special mention in this respect); (3) The Maastricht Treaty set out a roadmap in great detail, described reasonably clearly the division of labour between the Council, the Commission and the central bankers of the EMI and of the ECB, and most important, set 1 January 1999 as a crucial date to be

respected. Time constraint, as Wim Duisenberg and I had the privilege to learn, turned out to be a barbarian but most effective instrument for finding in time constructive compromises in matters which were not regulated by the Treaty (such as the changeover scenario); (4) In terms of the internal management of the EMI, an institution which had to be speedily built up from the small secretariat of the Committee of Governors into a fully operational enterprise, the EMI Council granted me an almost complete authority (which was particularly helpful for staff recruitment and allowed the number of staff to jump from 15 to close to three hundred at the time I was leaving).

External circumstances also played a helpful role. Perhaps the most important was the fact that after the stagflation experience of the 1970s Keynesian demand management went out of fashion and anti-inflationary monetary policy began acquiring, or regaining professional (and political) respectability. This led to the sharp decline in inflation rates well before the EMU initiative. Average EU inflation declined successively from a horrifying peak of 14% in 1974 to 10% in 1980-84 and then to 4% in 1985-89. Even more significant, there was a marked downward convergence of inflation rates. The standard deviation of CPI inflation, which was a very high 6% during the late 1970s, fell to 2% by 1995. This goes a long way of explaining the relatively serene atmosphere prevailing in the ECOFIN meetings I attended.

To all this, we have to add the fact that the regained respect for both inflation fighting, and the inflation fighting capability of monetary policy, has been accompanied by a gradual, but general move towards granting policy making independence to central banks – and this too, began well before Maastricht. It is of course true that the Federal Republic played a major role in shaping the definition of the ECB's independence – which in fact was defined more strictly than that of the Bundesbank, although not more strictly than what had become over time the German practice – but these requests fell on receptive ears in the case of most Member States. The time was ripe for moving collectively in this direction.

With these favourable developments in mind, what prompted me to make my recommendation? Well, quite simply my deep concern about the inherent weakness of the “E” leg of EMU – and by weakness I mean the prospectively highly probable incapability of the intergovernmental decision making process to



deliver the “right” kind of fiscal (as well as other, non fiscal) policies. Admittedly, I had to acknowledge that the debt levels growing out of control (General government gross debt, which in 1991 stood at 56% of GDP, reached 73.5% by 1996) would have prompted the governments to take action in any case – but this action received the additional, welcome, help by the constraint of the convergence criteria which emerged at the right time. I nevertheless sensed a gaping contrast between the likely capability of the future ECB to deliver price stability and the built-in risk that an intergovernmental process will not be able to deliver the right kind of policies.

But beyond this broad problem, we were beginning to perceive at the EMI specific reasons for concern. Both in the 1996 Convergence report published by the EMI and in the Institute’s 1996 Annual report you may find numerous examples of concern expressed regarding several developments: the slowness of the pace of reduction of fiscal deficits; the recourse to one-off measures; the temptation to raise taxes rather than reducing expenditure; and, most important, the little attention paid to the sustainability of deficit-reduction measures. Moreover, the Convergence report contained a detailed analysis of a development which received at that time far less attention than today: the growing fiscal burden of social security old-age pensions.

Now let me turn to the second part of my remarks – would I make the same recommendation today? Well, yes and no, or no and yes. Let me spell out the reason for this cryptic answer.

Our current experience has confirmed something that was (or should have been) expected: that whether they like it or not, central banks are in the frontline when it comes to keeping crisis manifestations under control. They have the resources, and their traditional banking operations plus their oversight responsibilities in payment and settlement systems give them a proximity to the money and financial markets which finance ministers or supervisors not connected with central banks do not possess.

What is new in the current experience is that central banks have had to carry out their liquidity-boosting operations in an environment where the liquidity shortage turned rather quickly into solvency problems of frightening dimensions – for which there has been no precedent since the 1930s. Nor has there been any

precedent for the speed of contamination at the global level. The result has been an increasing variety of “non-standard” central banking interventions, ranging from the lengthening maturity of liquidity support to quantitative easing of all shapes and sizes. In a number of instances this has led not only to the spectacular expansion of the balance sheets of central banks, but also to the change in the composition of their assets, which implied the acquisition of risky assets. As a result central banks have started navigating in uncharted waters, in terms of both operational techniques and their relations with governments.

Looking ahead, it is difficult to avoid raising the question whether these problems are going to fade away once we have the current crisis behind us. I regret to say that I doubt it. I have three major reasons for my doubts.

First, because our globalised, competitive and highly innovative financial markets have an unlimited capacity to breed financial disturbances of a size and nature that could lead to systemic meltdown. I note with preoccupation the speed with which new, complex and bizarre innovations appear at the slightest relaxation of financial stress. Hopefully, the severity of the current crisis will not be promptly forgotten by *all* market participants. But how long will moderation last?

Second, while acknowledging that the numerous reform processes, if properly implemented, will enhance our prevention capability, I have to note that precious little is being done in the crucial field of structural reforms. Mergers and acquisitions are leading to concentration, with the result of increasing the size of banks qualifying for being considered as systemically important. The widespread belief that such banks will always be bailed out has two devastating consequences: it encourages reckless risk-taking by such institutions, and provides them with an unfair competitive edge over the rest of the financial industry by ensuring cheaper financial resources for them. To avoid this unappealing moral hazard trap, it has to be made clear that no financial firms, and especially banking firms, should count on being protected from failure. But no such statement will appear credible unless ways and means are found to ensure that the absence of bail-out has no systemically disruptive consequences. Trying to find, and agree “globally” on such crisis resolution processes should rank very high on the political agenda. This does not seem to be the case.

Finally, despite the encouraging statements made by the G20, it is questionable whether we have the ability to deal with those macroeconomic imbalances which played an instrumental role in the development of the crisis, and therefore are likely to continue to nurture a “crisis-friendly” environment. I refer, of course, to the savings/investment imbalances and their capacity to contribute powerfully to the creation of excess liquidity.

It is for these reasons (and for some others as well) that I would expect that systemic fragility will remain a source of concern for years to come. If so, central banks should not regard their macro-prudential duty as being less important than their mandate to preserve price stability. But nor do I believe that their duty to prevent a systemic meltdown should lead them to forget their mandate to preserve price stability. Price stability is just as much a public good as the stability of the financial system, or vice-versa. Does this amount to squaring the circle? I do not think so, but I do not deny that situations may arise where decisions have to be taken which represent a risk for the realization of one of the objectives – a risk which is difficult to measure, and therefore can lead to conflicting assessments. To minimize such risks, techniques have to be found to preserve the capability of the central banks to reabsorb the excess liquidity created by “non-standard” liquidity-boosting interventions: this is feasible, but may on occasion be quite a challenge.

Does this put central banking independence at risk? Yes, it does. The risk arises from the obvious fact that having to comply with two distinct mandates pushes the central banks into a much more complex world. The modalities of their independence in their monetary policy function may be debatable, but once agreed, the content of independence can be reasonably well defined. In the case of the macro-prudential independence this is much more difficult. Once it appears that the initial liquidity problem is shifting towards a solvency problem, and especially when the latter implies the risk of a systemic meltdown, the central bank has to operate hand in hand with the government. But hand in hand can mean very different things – hence my plea for a reasonably well defined operational framework. The macro-prudential mandate requires for the central bank a type of relationship with, and therefore a type of independence from, the government that is different in substance from the one governing monetary policy. The rules of the game on both sides have to be spelled out.

The complexity of the current situation, and the likelihood that it will remain such, mean that you have to navigate in uncharted waters. There is no way of “opting out” of this complex world. Wishing that we could go back to the professional and intellectual comfort of the pre-crisis years is a pipe-dream.

A short remark by way of conclusion. A potential conflict between the two mandates is most likely to arise in the various stages of managing an open, or almost open, crisis. If you want to avoid this happening, the emphasis should be put on crisis *prevention*; and, in particular, on working out crisis resolution processes that would make it possible to let financial institutions fail without triggering a systemic crisis. I realize that such reforms are difficult to design, and even more difficult to implement, but this is a price to pay for financial stability and for a somewhat quieter life for central banks.

Well, this is where the text I drafted ahead of this dinner has come to an end. Having re-read it after today's fascinating discussions I feel that my remarks should be completed, by trying to answer the following question: will the ECB be able to respond with efficiency to the challenges of this complex new world? Looking over the Bank's past performance, five facts stand out which to my mind warrant quite some confidence that *it will*:

- (1) It fulfilled its core mandate by ensuring price stability over the past eleven years – and this happened despite the fact that a number of member countries were relative newcomers to the club of those countries which had a long period of price stability behind them.
- (2) It has displayed a capacity to adjust to new circumstances. I refer here to the gradual changes in its “two pillar” monetary policy strategy.
- (3) It has displayed an unquestionable capacity to take swift decisions, of which the prime example was the Eurosystem's massive intervention on 9 August 2007. I still vividly remember that a certain press regarded the Bank as a sleepy organization, whose oversized Governing Council, operating on the basis of consensus, would be unable to reach prompt decisions in case of a crisis situation.

(4) It has displayed imagination and inventiveness: anybody who doubts this should take the trouble of taking note of the steady changes in the Bank's monetary policy tool-box.

(5) Finally, it has managed to preserve its independence.

Let me now really conclude by expressing the hope that the ECB will play an active role in the work of the newly created European Systemic Risk Board – an institution which must become the key macro-prudential player in the new European financial regulatory and supervisory architecture.

## Chapter XXXIV

# Concluding Remarks. EMI 20<sup>th</sup> Anniversary Conference

2014

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*This is Alexandre Lamfalussy's last essay. On 12 February 2014, the European Central Bank and the National Bank of Belgium co-hosted a conference in Brussels to commemorate the 20th anniversary of the establishment of the European Monetary Institute at the beginning of 1994. In his concluding remarks, Lamfalussy goes into the issue of why, notwithstanding significant scepticism in the early 1990s, European monetary union was established as scheduled in the Maastricht Treaty. In his conclusion, Lamfalussy reflects on the future of central banks which, because of the financial crisis, now have to comply not only with their traditional monetary policy mandate, but also a macroprudential one. The essay was published by the ECB in "Progress through crisis? Proceedings of the conference for the 20th anniversary of the establishment of the European Monetary Institute", Ivo Maes and Frank Moss (eds.). Reprinted with kind permission of the European Central Bank and the Lamfalussy family.*

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To be called “the wise man of the euro” – and to be remembered as such in the title of one’s biography – is a great honor but a mixed blessing: flattering, yes, but also a little frightening, because it means I’ll have to watch my words even more carefully than when the president of the EMI addressed the European Parliament. This is especially true now that the euro has remained in the eyes of some, and has become in the eyes of others, a dubious if not downright unwise undertaking.

Fortunately I have not been asked to comment on current or even recent events, since what we are celebrating today happened twenty years ago, and I definitely feel on safer ground trying to draw lessons from the past than analyzing the

present or – unwisely! – attempting to forecast the future. This – drawing a few lessons from the past and from my experience at the helm of the European Monetary Institute – is what I propose to do in the next few minutes.

The bold venture called EMI could indeed, from the start, seem a dubious undertaking. In an article I wrote in 2005 and which came out in a book published in 2008, I recalled that the EMI's beginnings provided “a propitious environment for bitter conflicts. Specifically, for conflicts between the central banks operating within the EMI structure (...) on the one hand, and the member governments of the European Union on the other. But also for conflicts within the central banking community as well as among governments, and for conflicts with the Commission, guardian of the Treaties”.<sup>1</sup>

So a lot of things could have gone wrong in this process but, amazingly, they did not. “I myself was not excessively optimistic about the outcome when I was appointed president of the EMI, but I became gradually more and more confident, and by the winter of 1995-96 I had acquired the conviction that we were on the right track. Market sentiment was also beginning to change at that time; witness the downward convergence of long-term interest rates”<sup>2</sup> that was observed: “considering the initial EMU participants, the mean yield spread over the German yield fell from 218 basis points in 1995 to 111 in 1996, 39 in 1997, and 19 in 1998”.<sup>3</sup>

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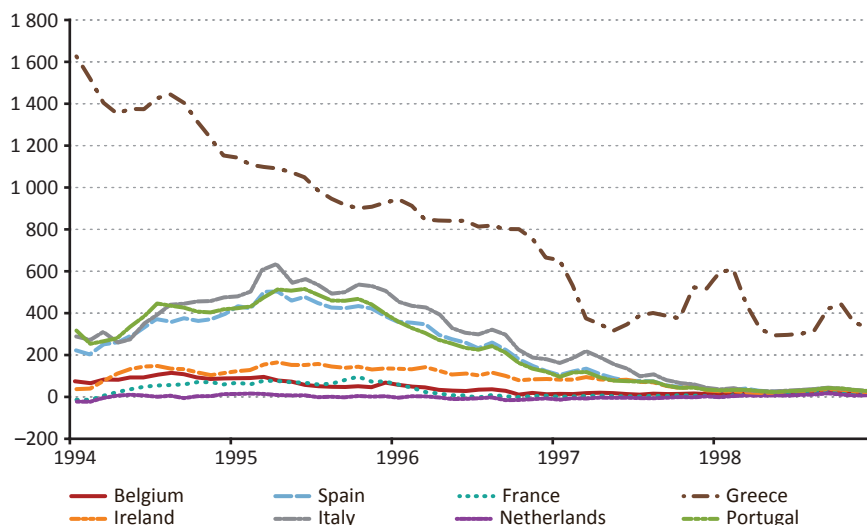
<sup>1</sup> “Central Banks, Governments, and the European Monetary Unification Process”, in *Past and Future of Central Bank Cooperation*. Edited by Claudio Borio, Gianni Toniolo and Piet Clement. Cambridge University Press, 2008, pp. 155-156.

<sup>2</sup> Ibid. p. 156.

<sup>3</sup> Pagano, M. and von Thadden, E. “The European Bond Market under EMU”, *Oxford Review of Economic Policy*, Vol. 20, n° 4.

Chart 1

Yield differentials on ten-year public loans in relation to the German bund  
(monthly data, basis points)



Source: BIS, calculations NBB.

How was it that Murphy’s Law (“If anything can go wrong, it will”) was so blatantly defeated? In the same article I referred to an “exceptional convergence of several facts and influences”, which I described. I will not repeat them all here, but single out four which seem to me to have been especially important because they were part of what was quite clearly an institution-building process and as such were perhaps less dependent upon the vagaries of the economic or political environment.

The first factor – not necessarily in importance – was the fact that the initiators of the EMU project as well as those who, at crucial moments, propelled it forward, were the governments themselves, and this at the highest level: the heads of state or of government. This was the case at The Hague summit in December 1969, in Copenhagen in April 1978, in Hanover in June 1988, and in Maastricht in December 1991, just to name a few important milestones on this “long and winding road”. So the initiative was clearly a political one, not simply because the initiators were heads of government but also because, at



decisive moments, the political motivation played a major role. “With such a political commitment, the highest political authorities acquired a vested interest in a successful implementation process”.<sup>1</sup>

Reflecting now on a more recent past, one may wonder whether all the political leaders in the Eurozone at present are in a similar frame of mind with regard to EMU: to the extent that, when they came to power, they no longer had to make, or to renew, vis-à-vis their public opinions, a similar political commitment, I think they are unlikely to have so strong a vested interest in the successful continuation of a project that was initiated by their predecessors.

Another factor which played a part in preventing conflicts from arising, both between the central banks and member governments, and within the central banking community, was the fact that political leaders entrusted the central bankers right from the start with a major role in the preparation of the Maastricht Treaty; this already began when they decided to set up the Delors Committee, the membership of which was overwhelmingly of central banking extraction. In addition, “Jacques Delors was not only a good Chairman, but he also possessed the political wisdom to accept that the majority of the meetings, and practically all the preparatory work for the meetings would take place at the BIS, with both rapporteurs being central bankers. Subsequently, the Dublin Summit (June 1990) mandated the Committee of EC Governors to draft a statute for the European System of Central Banks to be submitted to the Intergovernmental conference on EMU”.<sup>2</sup>

A third factor is to be found in the fact that “the institution-building process was governed by the Maastricht Treaty, which set out a roadmap in great detail, clearly described what should be the division of labor between the Council, the Commission and the central bankers of the EMI and of the ECB, and, most importantly, set 1 January 1999 as the latest date on which the single monetary policy should start operating. Time constraint – as I, and later Wim Duisenberg, had the privilege to learn – turned out to be a barbarian but most effective instrument for finding compromises in matters that were not regulated by the Treaty”.<sup>3</sup> One such matter was, of course, the scenario of the changeover

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<sup>1</sup> “Central banks, Governments....” op.cit.. p. 158.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid. pp. 158-159.

to the single currency, the story of which provides a good illustration of how it was possible to achieve decisive progress in an area which the Treaty had left undecided, while avoiding spectacular conflicts between the Council, the Commission, and the EMI, which all had their part to play.

The fourth factor, and this was decisively important in avoiding major disruptive conflicts among the central banks participating in the EMU process, was the institution called the EMI itself. The discussions both among central banks and between them and the governments, as well as the search for constructive compromises, received increasingly powerful support from the EMI staff, which grew from about two dozen members taken over from the secretariat of the Committee of EC Governors when we began to more than four hundred by the time I left EMI in mid-1997. “Most of the staff, and all those in key positions, came from the member central banks, but within months they had acquired the *multilateral* frame of mind so indispensable for making realistic proposals to reconcile conflicting views held by member central banks (...). Achieving progress would have been impossible if, instead of a solid institutional structure, the work had had to be carried out within a cooperative framework”.<sup>1</sup>

This last observation gives me the opportunity to praise, and to thank, all those who took part with me in this adventure as members of the EMI staff and who quickly acquired the pioneering frame of mind and the team spirit which made it succeed. Quite a few of them are here tonight, and I wish all of them were present to hear the expression of my admiration and of my deep gratitude for their personal commitment. I remain extremely proud to have sailed, for three and a half years, as commander of such a fine ship as the European Monetary Institute, with such a fine, well-trained, competent, committed and responsive crew, from the lowliest ship's boy to the first mate.

Although it belongs to the same class of vessels as the EMI, the European Central Bank is a different ship, bigger than the EMI, with great firepower and plenty of ammunition. It has also proved, in the treacherous waters of the international economic environment these past six or seven years, highly responsive to swift changes of course. It has fortunately been blessed with a succession of highly skilled commanders. However, their job has become even more difficult since, as

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<sup>1</sup> Ibid. pp. 159-160.

an outcome of the financial crisis, central banks have received, in addition to the traditional mandate governing their monetary policy, a macroprudential mandate as well, and this, I believe, may even put central banking independence at risk. Allow me to quote here, by way of conclusion, a remark I made in October 2011 at the conference celebrating the 100<sup>th</sup> anniversary of Robert Triffin.

“The risk arises from the obvious fact that having to comply with two distinct mandates pushes the central banks into a much more complex world. The modalities of their independence in their monetary policy function do not follow necessarily the same model, but once agreed, the content of independence can be reasonably well defined. In the case of macroprudential independence this is much more difficult. Once it appears that the initial liquidity problem is shifting toward a solvency problem, and especially when the latter implies the risk of systemic meltdown, the central bank has to operate hand in hand with the government (...). The macroprudential mandate requires for the central bank a type of relationship with – and therefore a type of independence from – the government that is different in substance from the one governing monetary policy. The rules of the game on both sides have to be spelled out. The complexity of the current situation – and the likelihood that it will remain such – means that central banks will have to continue their navigation in uncharted waters. There is no way of opting out of this complex world.”<sup>1</sup>

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<sup>1</sup> Alexandre Lamfalussy, “Introduction”, in *À la recherche d'un nouvel ordre monétaire mondial-In Search of a New World Monetary Order*. Jean-Claude Koeune & Alexandre Lamfalussy (dir./eds.), P.I.E. Peter Lang, 2012.

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