Lamfalussy Lectures Conference

THE EURO DILEMMA:
INSIDE OR OUTSIDE

Conference logbook
on the first conference of the Magyar Nemzeti Bank's
Lamfalussy Lectures Conference series

Budapest, 31 January 2014

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FOREWORD

by György Matolcsy

The professional conference entitled "Lamfalussy Lectures" was organised by the Magyar Nemzeti Bank for the first time in 2014. The aim of this annual event was to invite prominent speakers to Hungary to share their views on global economic policy with each other and the audience of professionals, with a special focus on current issues pertaining to monetary policy and the financial system. The figure of Sándor Lámfalussy – after whom the conference was named – symbolises the importance of Hungary's role in international economic processes.

The recent global financial and economic crises dealt a serious blow to the very foundation of economics and reopened questions which were previously considered to have been resolved once and for all. In this period of paradigm shift, it is particularly important that national and international economic policy makers at the highest level exchange their views on the challenges of the newly forming economic world order. High level economic and financial integration requires European decision makers and economic opinion leaders to discuss their views, synchronise their actions and strengthen their network of relationships. The Magyar Nemzeti Bank wishes to see the "Lamfalussy Lectures" series develop into a prominent forum of economic policy on a European and global scale.

The introduction of the European single currency, the euro, was one of the major milestones in the establishment of European unity, but the global crisis of 2008 revealed all of the structural issues and differences in development currently facing the euro area. A stable euro is needed, but financial stability also calls for further steps by euro-area member states. This presents a challenge for both crisis management and economic policy, as peripheral countries are in need of very different solutions compared to the most advanced euro-area member states. The main lesson we learnt was that extraordinary times require extraordinary solutions. From a European vantage point, one of the most important aspects of Lamfalussy's lifetime achievement is that the current level of integration of the European economic and monetary union, and the level of development of the financial system are the results of the sustained effort of individuals who, for decades, are able to construct theories based on seminal ideas and determined visions for the future and implement these through relentless empirical organisational work, adapting to challenges as they arise by setting up the necessary institutions. That is the spirit we need to follow in order to continue the European success story.

The presentations at the conference focussed on Europe's economic, monetary and financial integration and the future of this process. The four main topics discussed by the participants included the causes of the euro crisis, monetary policy challenges, euro accession strategies and the banking union.

The presentations were delivered by internationally recognised experts who are actively involved in the transformation of Europe's institutional framework. A total of six central banks were represented in the conference – no other central bank conference with media coverage held over the past ten years in Hungary has featured so many central bank governors at the same time. Among others, participants in the conference included Ewald Nowotny, Governor of the Oesterreichische Nationalbank, Christian Noyer, Governor of the Banque de France, and Ilmārs Rimšēvičs, Governor of the Latvijas Banka, along with representatives of the central banks of Spain and Russia. Prime Minister Viktor Orbán and Hungary's ambassador to Washington, György Szapáry also accepted our invitation. The presentations were followed by discussions on the most important issues, greatly contributing to the effective resolution of the issues raised.

The Prime Minister highlighted that Europe needs a strategy and must take unusual steps to preserve its competitiveness within the global reorganisation of world power which has taken place in recent years. Reforming the currently operating economic systems is not enough in itself; they must be radically renewed and totally reorganised. In the future, economic competitiveness will be determined by three things: political stability, a well-trained workforce and cheap energy. He also noted that Central Europe, together with some other countries, could be the new engine of the European Union.

In his speech, Ewald Nowotny emphasised that the basic problems in the early stages of the European Monetary Union were structural aspects which are still of relevance today and will remain so for the future. The historical experiences warn us that there cannot be a lasting monetary union without a closer political union. Now as then, a stronger political foundation would be preferable, but this is extremely difficult to achieve. However, now as then, an admittedly imperfect monetary union is still preferable to a situation without a monetary union and without a strong European Central Bank.

Mr Noyer explained why the banking union is an indispensable element of a monetary union. During the financial crisis, banking problems in certain participating countries threatened the fiscal sustainability of their respective sovereigns as the latter had to step in to stabilise the former. However, the transmission mechanism of the single monetary policy needs a healthy financial system to create uniform conditions in every part of the monetary union. Thus, the potential negative feedback loop between the national fiscal stance and banking sector stability must be disentangled. This requires a banking union as a complement to monetary union with more centralised banking supervision, a bank resolution mechanism and a unified deposit insurance system.

Mr Rimšēvičs gave a short overview of how Latvia coped with the deep recession by maintaining its currency board regime and managed to join the euro area. When the crisis hit his country, the central bank suggested sticking to the currency board, pointing to the risks of giving it up in the context of euro-denominated external indebtedness. The government implemented strict fiscal rebalancing, based mainly on cutting back expenditures, in what was called internal devaluation. As a result, Latvia today is back on the pre-crisis growth trend as the fastest growing European economy. By joining the euro area, Latvia got rid of devaluation speculations once and for all, which had caused so many problems during the crisis management period.

According to Mr Szapáry, what we are facing is a triple crisis, which explains why it has lasted so long: a financial crisis, a full-fledged economic crisis and a confidence crisis. Major central banks first responded using orthodox instruments, including lowering policy rates, sometimes quite rapidly, and providing liquidity for the financial sector. Later, when the financial crisis developed into a full-fledged economic crisis, central banks turned to unorthodox instruments, pursuing a policy called qualitative and quantitative easing. However, despite the tremendous increase in central banks' balance sheets, the credit flow to the economy has not yet been restored and long-term interest rates have remained low. Currently, central banks face the difficult problem of managing the transition to the normal mode of working, which means higher interest rates eventually that will inevitably cause losses for bondholders, including central banks.

Mr de Molina explained, with reference to the Spanish experience, that while the creation of the monetary union was a major milestone on the road towards a unified Europe, some problems were not foreseen, or if they were, effective remedies have not been found. Common money and market pressures did not force governments to implement ambitious structural reforms and exert fiscal discipline, while optimism in financial markets led to the elimination of risk differentials and excessive private and public indebtedness. As the Spanish case shows, these resulted in excessive imbalances and competitiveness losses. Institutional reforms, including the most important one, the banking union and rigour in implementing the old and new common rules are necessary to overcome the crisis and to prevent its recurrence in the future.

In his presentation, Mr Dmitriev focused on the increased trade and financial links between Russia and the euro area. Russia has extensive trading and financial ties with the euro area. Euro-area member states are far the most active direct investors in Russia and similarly are the most important FDI targets of Russian firms.

The euro has increased its role in the settlement of economic transactions between Russia and the euro area, although from a low level, due to the leading role of the US dollar in energy transactions in the global markets. However, recent developments in the Crimea and the ensuing tensions between the European leaders and Russian officials may result in a greater role for Asian countries in Russia’s economy and an increased use of the Chinese renminbi in Russia’s international settlements.

As Governor of the Magyar Nemzeti Bank, I believe it that it is in Hungary's interest for Europe to remain strong and the euro to remain in place. However, the crisis has shed light on the detrimental consequences of the premature adoption of the single currency. Hungary wishes to and will introduce the euro, but unless it is strong enough to do so, its best interest is to stay out of the euro area. My opinion is that in response to the recession, Europe was unable to think outside the box of traditional crisis management, and thus failed to place sufficient emphasis on restoring growth, which led to a further decline in its global economic weight. I believe that the crisis has also revealed that central banks and governments must cooperate, without violating the requirement of independence or the achievement of primary central bank objectives and find common solutions for the fastest possible recovery.

LAMFALUSSY LECTURES CONFERENCE

VIKTOR ORBÁN

Prime Minister of Hungary

Opening address

(Word-for-word transcript of the speech delivered at the Conference)

Good morning, Ladies and Gentlemen.

First of all let me express how privileged I am to have the chance to be here today. At the same time I have to tell you that we are proud of and have high respect for our outstanding professor of economy – professor Lamfalussy – to whom I wish all the best. Let me congratulate the winner, or should I say the awarded person who is with us today. It is always good to have a friend from Austria and especially one who is also highly respected at an international level. I really hope that this gesture, this friendship between the two National Banks, will serve to promote the continued good cooperation between Hungary and Austria that we greatly require both today and in the future. The fact is that in Hungary, a Hungarian Prime Minister must speak in Hungarian. So the point is that in Hungary the Hungarian Prime Minister is forced to speak the Hungarian language, which is a legitimate request on the part of the audience, not to mention the fact that there will soon be an election and it is better if the voters understand what the Prime Minister is talking about. And so, if you will allow me, I will now attempt to continue what I would like to say in Hungarian.

The question that the Governor of the Central Bank replied to with two short comments is a difficult one; the question of whether to join the eurozone or not. I am also one of those who prefer to play things safe and do not regard this as an ideological issue. This is a very practical issue. And when it comes to assessing practical issues, it is best to rely on experience. And so a false argument between pro-westerners, like the Russian "westernisers", and the pro-easterners or more nationally affiliated politicians, economists and philosophers should not be fabricated from the issue of whether or not to join the eurozone, but we should instead stick firmly to practicalities. We must examine in detail the example of Southern Europe, and we must understand why, following initial success, the countries of Southern Europe who joined the eurozone earlier then encountered such serious and hard to solve difficulties. If we have examined this, analysed it and understood the reasons behind it, then I think we will have found the answer to the question of when it would be wise for Hungary to joint the eurozone.

And the answer, I at least have drawn this conclusion, is roughly that if the gap in terms of the real economy between the zone and the country or group of countries that wants to joint it is too great, then that will have unavoidable negative consequences. And so we must move closer to the eurozone with regard to the real terms category of the economy before we can hold a rational discussion on monetary accession.

Ladies and Gentlemen,

And with that I have done my duty, meaning that I have given some sort of reply to the question set down in the invitation. But I thought long after receiving the invitation on whether it is in fact right for a Hungarian prime minister to attend this forum at all, because after all the European doctrine is that if a prime minister sees a governor of a central bank, then he should cross over to the other side of the street, because independence is so sacrosanct that it might even be endangered by a simple handshake. It was not silliness that led to the development of this doctrine in Europe, but experience. And so, while we may sometimes mock this way of thinking and, as Governor Matolcsy said, it is perhaps somewhat outdated, we should not forget that there was a good reason for the establishment of this doctrine in Europe. Because overly close cooperation between central banks and governments often led to bad economic policy, as expressed in budget deficits, being covered up with the help of the central banks. This is an unhealthy form of cooperation. And so, in addition to declaring the doctrine of cooperation, I feel that it remains justified to keep to the clear distribution of responsibilities that has always existed between central banks and governments, because it is no one's interests to try and cover up poor economic performance, the budget deficits that represent them and unsustainable budget practices using the tools available to the central bank. This would mean that we would be stripping the economy of an objective feedback system that political decision-makers will always require if they need to perform corrections to their own economic policies. And so the question isn't whether we should cooperate or not, but rather in what fields we should cooperate and in the interest of what objectives. And I believe than in view of the fact that increasing numbers of people have a similar viewpoint with regard to this issue in Europe, although I am certainly the odd one out among the list of extremely prestigious central bank governors present, I thought it would be perhaps better for everyone if I accept the invitation.

Ladies and Gentlemen,

Also included in this topic is the issue of base interest rates, with regard to which the Hungarian prime minister must be very careful to precisely determine the various scopes of authority, and despite the fact that the currencies of the emerging markets are currently rather volatile, it is my firm belief that governments must distance themselves from any public debating of questions concerning exchange rates. We can do one thing, and we must do so, and that is to practice an economic policy that is suitable for enabling our currency to be stable. And at this point I would like to draw your attention to a relationship that is obviously rarely the subject of debate in this regard, and that is that budget deficits in Hungary usually do well in the period between elections. There have been many examples of this. But what has never happened before is what we are preparing to do now. That the budget deficit will not increase in an election year. I recommend to everyone that you examine the figures for the budget deficit from 1990 until today, and you will see very interesting fluctuations, because prior to the elections, or rather in an election year, even the most rationally thinking government administrations have, for obvious political reasons, always allowed the budget deficit to increase unabated. What Hungary is attempting to make happen today is for there to be no such increase. And so if you examine the figures for the 2013 budget deficit and examine those for 2014, and you now also have available the opinion of the European Union on the subject, then you will see that similarly to 2013, the Hungarian budget deficit will also remain under 3 percent in 2014. This, in my view, is a huge, joint achievement on the part of Hungarian economists, people working within the Hungarian economy and the people working within the Hungarian Government, which is the result of their commitment towards the country, and which in my view is worthy of acknowledgement.

Ladies and Gentlemen,

The other thing we can do with regard to the forint is to practice an economic policy that results in a foreign trade balance, or rather a level of foreign trade that enables a stable financial policy. If you take a look at Hungary's export-import balance and at Hungary's current account balance, then you will clearly see that the Hungarian economy is extremely stable and has been producing outstanding results for many years even in international comparison. And if we keep the budget in order and our foreign trade and current account balance is in order, then we have done everything that we can in the interests of enabling good central bank policies with regard to currency exchange rate issues, and this is where we must stop.

Ladies and Gentlemen,

Naturally central banks, although as I have mentioned they are rightly sensitive with regard to their independence, are not isolated and cannot be separated from the environment in which we live, from an environment which in this case is the European economy. And for this reason I would now like to say a few words about the status and future of the European economy, and within that, with regard to the future of Hungary. First of all, I would like to choose as my starting point the fact that it is clear from here in Europe that unprecedented changes are occurring throughout the world; old vanguards and powers are slipping into mediocrity and new political, economic and military power centres are being established. What we in Europe are experiencing as an economic crisis is in fact the redistribution of world power. We rarely speak about this in this way and I will also refrain from getting into details, but I would like to draw everyone's attention to the fact that it is worth examining the current military spending of today's emerging powers, and there you will find growth and numbers behind which there clearly lie rational deliberations. It is not worth arguing this, although the rate of growth of these factors clearly indicates that this is not simply an economic transformation, but also a military transformation and a redistribution of power, or perhaps these primarily.

Ladies and Gentlemen,

Viewing the situation from here in Europe it is also clear, no matter how painful it is to admit it, but we must do so and it is better to face reality, that if we do not make changes to Europe's politics then our continent will be the loser in this great global realignment. Despite the occasional optimistic and positive political statements, Europe has been losing continuously within this global reorganisation in recent years. And if we cannot affect change, then what that means for Europe is that we must accept the changes that are going on throughout the world. It will mean that we will have no choice but to accept them and be pushed out of the group that is capable of affecting the decisions that determine the future of the world. The clearest indication of this fact, without wanting to transform today's conference into a narrative of events, is when European leaders display even publicly that the most important criteria for them is how the market will react to their statements. With regard to today's subject and from where you are sitting, you obviously regard this as a positive thing and as good news, because you interpret this as meaning that economic rationality has come to the fore in the manifestations of politicians. And there may be some truth in that. But the fact is that when leaders are only able to talk about adapting to circumstances and lose their capability for dictating the direction of events and of making the decisions that are required for change, and instead are satisfied with the dimension of survival, it shows that there are definitely serious problems with leadership, with Europe's democratic, political leadership.

Ladies and Gentlemen,

Hungary is part of the European Union and the continent of Europe. This has been the case for 1100 years, since we established the Christian State of Hungary, and it will remain so in the future. And so what is bad for Europe is also bad for us, and what is good for the European Union is also to our advantage. Do not forget that 80 percent of Hungary's foreign trade and exports are directed towards the European Union.

Ladies and Gentlemen,

In the language of numbers, which after all are always the most austere and pure things. Europe represents 8 percent of the world's population and we contribute about 25 percent of the world's global production, while at the same time we spend 50 percent of the world's total social expenditure. This raises serious dilemmas in itself. But if we go further, we can also see that the total debts of the 28 member states of the European Union equal around 11,000 billion euros. Its annually due repayment, including interest, totals more than 2,000 billion euros. Together, the member states of the European Union generate 1,200 million euros of new deficit every single day. This is the reality. In view of which the only question is: who is foolish enough to finance this unsustainable system? And who is foolish enough to finance an unsustainable system cheaply, a system that is, however, uncompetitive without cheap financing? And so, Ladies and Gentlemen, it is absolutely clear that the road we are travelling today cannot go on forever, because the ground is slowly running out from under our feet. The Europeans, that is we, must honestly face up to the problem that we are up against a conjunctural difficulty. The trouble, the challenge, the crisis, wherever we call it, is not simply a chapter in the usual, conjunctural phenomena of the global economy that just happens to be unfavourable at the moment. It is in fact a deep-rooted, structural problem that is not so much the end of a conjunctural period, but rather the end of an era. And accordingly, I am convinced that this structural crisis cannot as a result be managed using the usual, conjunctural crisis management methods. In our language, the language of politics, this means that we need a new strategy; the European Union needs a new strategy. I would like to describe a few elements of this possible strategy now. It is worth thinking about these, because if a certain level of public sentiment does not develop in favour of a new strategy, then as a result of political logic – as you know we have this hurdle every four years, the elections – even the most outstanding governments can lose their mandate. This appears as such a haze or horizon-blocker in the eyes of politicians, that if there is no public pressure behind a change in strategy, then we can hardly expect democratic politicians who are elected for four years to – as József Antall said – risk the fate of the kamikaze to perform a strategy shift in Europe. This can only occur if the European demos – which does not exist at the moment, but if all the national demoi come together to form a European demos – forces political leaders to affect change.

Ladies and Gentlemen,

I believe that we must take unusual steps to preserve Europe's competitiveness. In my view there are six things that we must do, introduce, undertake to perform, if we are to be successful in the global competition.

The first, cliché-like, globally accepted point is the financial stability of the euro; the issue of the monetary stability of the eurozone. If we do not succeed in stabilising the eurozone, then no strategy aimed at preserving European competitiveness can be successful. This is a serious statement. Since we are not members of the eurozone, we here perhaps do not sense the seriousness of this statement, although it means nothing less than the acceptance of the fact that it is impossible to maintain a common currency – especially in a time of economic crisis – if there is no common governance behind it. And common governance also means a common budget, a common tax system, a common social policy and a common distribution policy. It means creating perhaps not fully unified subsystems, but certainly subsystems that are extremely similar and compatible. And so when we say that we must stabilise the eurozone, then that poses a very great challenge to those nation-states who are today members of the eurozone. We rarely talk about it, but we all feel the disparity that exists between maintaining national scopes of authority and the common European governance that is required for the stability of the eurozone.

Ladies and Gentlemen,

The second pillar on which we may build a new era is the acceptance of the fact that in contrast, those countries who are not members of the eurozone must be given the fullest possible freedom to develop their own economic policies. This is not what we do in Europe today. Today in Europe we determine central requirements with regard to economic policies, with regard to the economic policies of countries that are not part of the eurozone, which are irrational. How can we determine the exact same recommendations regarding economic policy for, to mention just a few countries that are outside the eurozone, the United Kingdom, Sweden and Hungary? Where is the single economic policy that provides a global solution in all three of these countries, in which the situation is of course totally different? Clearly no such policy exists! And accordingly, the European Union must recognise and accept that the countries which fall outside the eurozone must be given the scope of authority, the opportunity, the right to self-determination and the independence to develop and practice their own economic policy mixes.

Ladies and Gentlemen,

My third thought is practically sacrilege in Europe today, because it concerns enlargement. The language of the European Union is extremely subtle. Where this leads could be the subject of a separate lecture. In this language, in this subtle language, there exists a phenomenon called enlargement fatigue. Meaning, in other words, that those who are already in the Union want the politics with which new members may be allowed into the EU like they want a sore thumb. And this is a mistake. I understand the political tension that enlargement entails. It is enough to think of the recent argument in England concerning the fate of foreign workers and immigrants, but having learnt from our own example we must nevertheless state that if in the mid 1990s, following the change in regime, when we could have been accepted into the EU; if Central Europe would have become part of the European Union in the early or mid '90s, instead of waiting until 2004, then Europe would have been much stronger than it was when the economic crisis hit. In other words, postponed and delayed enlargement is a waste of energy. It may go together with political conflict, but enlargement increases the strength of the European Union. Especially if it takes on new countries that have a significant potential for economic growth. Today, the Balkans is just such a region. And accordingly the postponement, delaying and deferring of the accession of the Balkan countries is not only bad for the countries of the Balkan region, but is also in conflict with the interests of the European Union, and so we European politicians must defeat our enlargement fatigue and the opposing winds of public opinion, and we must convince them that it is also in their interests for enlargement to continue.

Ladies and Gentlemen,

The fourth point of a new European strategy could be the free trade agreement with the United States. This is a difficult and complicated process. It is important to determine and protect national interests. But nevertheless, while maintaining all caution, I must say that if the European Union will be incapable of concluding an investment and trade partnership agreement with the United States as soon as possible, then we will hardly be able to retain our present position within the global economy. And so we Hungarians would like to see constructive and effective negotiations between the United States and Europe.

Ladies and Gentlemen,

The Hungarians have never shied away from free trade agreements, although we have always been aware that they sometimes pose internal difficulties for certain sectors of industry, but nevertheless, the fact that we have achieved a positive export-import balance of around 10 billion euros in each of the past three years is a clear example of the fact that the expansion of global free trade is on balance good for Hungary. The Hungarian economy is capable of exploiting the inherent opportunities and advantages.

The fifth thing that the Europe Union must face, and with relation to which it would be worth launching a new policy, is putting our existing relationships with Russia in order. This is a topic which must be handled with especially extreme care here in Hungary. And especially by my generation. As you all know, we are an anti-communist generation, and so our cooperation with Russia will always involve a certain element of suspicion and mixed feelings, but nevertheless – not to mention China, where political power is wielded by a communist party – if despite all understandable suspicion we are unable to rebuild our relationship with, now for reasons of geographical proximity, primarily Russia, if we do not find a way to incorporate the raw materials and energy resources that can be found there into the structure of the European economy, the I don't know from where Europe will be able to find resources to introduce into its own bloodstream. This is a "must", as the British say; it is something we must do, and re-planning [our relations with Russia] is unavoidable.

And finally, Ladies and Gentlemen, I would like to draw your attention to the report published this week by the European Union. It concerns the issue of energy. I will refrain from speaking about the difficulties faced with regard to introducing and protecting the reduction in public utility prices and in general energy regulation that affects families, and how the Hungarian Government is forced to stand its ground to achieve and protect these measures, because I am given more than enough podiums on which to do so already. What I would rather talk about is the contents of this report, which clearly states that energy supplied to industry in the United States is two to three times, that's right, two to three times cheaper than it is in Europe. And in the other, emerging regions too – including China, which otherwise has no energy sources, and not to mention Russia – energy is much cheaper than in Europe.

In my view, economic competitiveness will be determined, for all countries and all economic communities, by three things over the next fifteen to twenty years. The first is political stability: order or chaos. Operating requires the maintaining of internal, if possible democratic order. The second is a well-trained workforce that is

available at rational prices and whose knowledge can be developed further. And the third factor will be energy. And the role played by energy in competitiveness will increase. In a little stronger term: those countries and economic entities that are incapable of supplying their economies with energy at a similar or cheaper price than their competitors will lose markets in the global economic competition. And so the question isn’t what is the right form of regulation with regard to energy systems in Europe, what is the ideal, the textbook method, but rather: how can we possibly succeed in establishing a system that enables us to supply energy at the same price as the United States? This is the question to which we must find the solution. And in relation to this, my view is that we must push aside several doctrines, one of which is the doctrine of resistance with regard to nuclear energy, and a second of which is the role of the state in regulating prices. These are all factors that must be rethought, and the European Union must construct an energy system that can compete with American prices, if it wants to remain competitive with its rivals.

Ladies and Gentlemen,

These are the six things that Europe would need to implement quickly over the course of the next few years to reprogram its own future. Whether we will be capable of doing so or not, the future will decide. I would encourage the Governors of the central banks, in view of the fact that you are well-respected throughout Europe, to occasionally put forward your standpoints on these issues and help us to enable the European politicians to come to rational decisions.

Ladies and Gentlemen,

Since we are in Hungary, and it is here that we are hosting the distinguished Governors of the world's central banks; I must also say a few words about Hungary. In order to be able to soberly assess Hungary's performance, the performance it has produced during the past few years, it is important that we remember where we started out from. Even we Hungarians often forget that the first economic collapse of the European financial crisis occurred in Hungary. Everyone talks about Greece and Cyprus, but the first financial collapse, when the grim moment arrived when payment is due in the morning, but the money is still not available the evening before, first occurred in Hungary. This then lead to a three-year big IMF agreement, and if the IMF had not rushed to our aid and connected us to its life support machine, then Hungary could hardly have survived this financial collapse. We should not forget this. In 2010, the situation was still such that in answer to the question of which country presents the most risk with regard to its monetary system, the two main contenders were still Greece and Hungary.

If we look at what category the countries that are in financial danger are talked about today, at how they are categorised, then it is very clear to what extent Hungary has moved forward. How it reduced its risks, how Hungary is today regarded as a country that, although often criticised and judged, has on balance nevertheless achieved fantastic progress over the past three to four years.

Ladies and Gentlemen,

It was a very difficult decision in 2010 whether we should achieve Hungary's financial stability through reducing the latitude of Hungarian administration and Hungarian sovereignty, or by instead increasing it. Both methods lead to success, but they each bear with them their own consequences. And in the autumn of 2010 we decided not to extend the expired agreement with the IMF. So we attempted to solve the situation not through reducing the scope of authority of the political and sovereign Parliament, which was elected with a two-thirds majority – and I will say a few words about how important this circumstance is later – and not through transferring powers to the IMF, but exactly the opposite: to achieve it through assuming responsibility and by extending the scope of national authority and influence.

Ladies and Gentlemen,

Our belief was that crisis management can only be successful if in fact the Government does not concentrate on crisis management. It is an interesting question, whether it is possible to manage a crisis while in fact not concentrating on crisis management. And what has happened in Hungary over the past four years leads us to say yes, it is possible. Because, although of course the crisis and its short-term manifestations must always be averted and remedied, the question is whether this is in itself our horizon, or if there is another horizon to which we must tailor the tools of crisis management, because there is always a choice. And in our opinion a horizon of this kind does exist, and in 2010 the Hungarian Government was already speaking of the fact that we must choose crisis management methods with which we at the same time also prepare the country for the post 2014 period, for the period following the crisis. And that we will handle the crisis in such a way that when we exit the crisis, our competitiveness in the world following the crisis can be much stronger that it used to be. This was our train of thought. And so we in fact used the crisis to enable us to reorganise the country. This is why we said, and continue to say, that with regard to crisis management, and in the case of this special kind of European crisis management, reforms are not enough. The EU is forever asking its member states to introduce reforms. That's not enough!

Reforming the currently operating economic systems is not enough in itself; they must be radically renewed and totally reorganised. I will refrain from going into detail now, but I would just like to note that a new Constitution, a new Civil Code, a new Penal Code, a new Labour Code, and many other new regulations; a new tax system and a new vocational training system: these all go beyond what one could call a simple reform. I wouldn't call it a regime change either, because that has a certain and precise meaning here in Hungary, but I could call it a radical renewal. This level of restructuring of our national economies and their reorganisation from head to toe may represent the solution to the crisis throughout Europe.

Ladies and Gentlemen,

By this, I do not mean to say that Hungary is now protected from all of the effects of the crisis, but I would risk saying that, although we still feel the waves of the crisis and they sometimes still make Hungary heave a little, but on balance we no longer have to deal with managing the crisis, but must instead prepare for a great era of growth. I am convinced that if this economic policy can be continued in Hungary – and this has primarily political prerequisites, since we live in a democracy and things depend on the elections after all, but if we are able to continue on this course, if I may call it that – then Hungary will be looking ahead to an era of growth and development.

Ladies and Gentlemen,

And now, please allow me to share a thought with you in closing. I am sure that you remember the heated debate that accompanied each decision of this nation-renewing policy. I would not like to put forward arguments about whether they were good or bad now, but instead I would simply like to draw your attention to the simple political fact that since then, others have also introduced these same measures. Hungary is a country of ten million. It can be regarded as perhaps middle sized within Europe, and as small in global comparison. And so it must know its place. Meaning we should take great care when talking about which of our measures have been transposed by others. The flea coughs, as they say in Hungary. It is better to avoid finding oneself in situations of this kind. But nevertheless, we can perhaps draw the political conclusion which is I think a French expression and which states: never tell the fountain you won't drink from its water. And I think this is also true of European economic policy. Because bank taxes were introduced in other countries too weren't they, and others have also made changes to the pension system, and the system of surtaxes on various sectors have also been introduced elsewhere.

It has also become clear that in time of crisis targeted regulatory systems are what is needed and not normativity. One need only look at the youth unemployment support packages authorised by the European Union, which are very similar to the Hungarian Job Protection Action Plan, and the list goes on.

Ladies and Gentlemen,

Central Europe has taken the lead in these innovations, these political and economic policy innovations recently. And in closing, I would like to say a few words with regard to this fact. I have been speaking about the European Union, and I would assume that the other speakers will also be talking about the EU. Nevertheless, here in Central Europe we must draw your attention to the fact that the opportunities for development within the European Union also do not follow similar horizons. And it is with suitable modesty, but with suitable self-assurance, that we must declare: here is this bloc of 80 million people, the Central European region. From the Baltic States, through Poland and down to Croatia. This is a bloc of 80 million people. That's almost the size of Germany. And this region has radically different opportunities for development in a positive sense compared to Europe's other regions. And accordingly, the people of Central Europe should prepare for a situation within the next few years, if our links to the German economy remain strong, which will be a great help, and if Austria sorts out a few issues, because we also need Austria here in Central Europe, and so as such the region can indeed be the engine of European economic growth in the upcoming period. This requires a concentration of power. I know that in modern, PC, democratic language, power has negative connotations, and so does concentration. And the two together certainly bring forth negative reflexes from the mind of many. But if you look at what, after all, is the prerequisite of successful economic policy in times of crisis, then you will see that it is the concentration of power. Austria is often criticised for having had a grand coalition government for the best part of forty years, of however long it is, apart from one or two, very short, adventurous intermissions. Austria is forever the subject of criticism because of this structure. But if one looks at the figures, the figures for the European economy since the Second World War, then Austria is the most successful country in Europe. And it is impossible not to bring up the question of whether this continuous concentration of power, the political concentration of power that has been established in Austria since the Second World War and which is practiced according to a grand coalition model, is not after all related to the fact that they are the country of the European Union with the most successful economic system.

And now that the Germans have also established a grand coalition, beyond the mathematical constraints, isn't is true that some form of power concentration in government is required if we wish to realise a large scale policy of renewal within Europe? And the answer is yes. This is what, in my opinion, the two-thirds majority in Hungary is really about. The Hungarian two-thirds majority brought about an unparalleled power concentration in Hungary not through a grand coalition, but through the supermajority system. Had this not come about, our policy of renewal could not have been launched in Hungary, let alone realised. And for this reason I would like to encourage the leaders of Europe, Europe's voters – there will be European Parliament elections soon, after all – and Hungary's voters to not to forget about factors such as political strength, the ability to govern and the concentration of power when weighing up their decision, because the question of whether our governments are able to practice a successful or an unsuccessful economic policy may depend on this later. It is my firm belief, based on the things I have mentioned, that Central Europe has a bright future ahead of it, and after very many years we Hungarians can once again state with joy: thank God we are part of Central Europe.

Thank you for your kind attention.

GYÖRGY MATOLCSY

Governor
Magyar Nemzeti Bank

Hungary on uncharted waters

(Paper based on the lecture given at the Conference)

1. INTRODUCTION

The creation of the euro was a major milestone on the road to European integration. Alexandre Lamfalussy, who is considered one of the forefathers of the single currency, played a pivotal role in this process.

Lamfalussy took part in the creation and fostering of European financial integration from the very outset of his career. Although he was not the main figure in the Delors Committee set up to examine the opportunities of an economic and monetary union and also to make recommendations on the introduction and phases of a single currency, he essentially hosted the committee sessions held at the Basel headquarters of the Bank for International Settlements (BIS) and made a substantial contribution to the committee's work.

Lamfalussy authored three background studies with the help of BIS staff to support the efforts of the Delors Committee. One study described the operation of the ECU system, the precursor to the single European currency, while the other two dealt with fiscal policy and monetary policy coordination. In these papers, Lamfalussy stressed the importance of fiscal coordination needed for a smoothly functioning economic and monetary union, and proposed the establishment of a European central bank. Lamfalussy was the first president of the European Monetary Institute (EMI) between 1994 and 1997, tasked with preparing the European Central Bank, which was established in 1997 as one of the outcomes of the process launched by the Delors Committee.

From a European vantage point, one of the most important aspects of Lamfalussy's lifetime achievement is that the current level of integration of the European economic and monetary union, and the level of development of the financial system are the results of the sustained effort of individuals who, for decades,

are able to construct theories based on seminal ideas and determined visions for the future and implement these through relentless empirical organisational work, adapting to challenges as they arise by setting up the necessary institutions.

This message is essential for us because the process of European integration and the development of the financial system have yet to come to a close, confronting us with new challenges to resolve and new opportunities often created by the results achieved.

The introduction of the European single currency, the euro, was one of the major milestones in the establishment of European unity. Above and beyond representing a new degree of economic integration, the euro was also instrumental in eliminating fragmentation in Europe and was Europe's response to the economic trends of globalisation and competition between the major reserve currencies. In the early 1920s the dollar began its global conquest, which was cut short by the 1929-33 crisis. After the Second World War, from 1945 the dollar replaced the pound sterling as the main global currency and its dominance was uninterrupted up until the 1970s. The US government responded to the rising strength of Japan and Western Europe in the early 1970s by devaluing the dollar. In 1971, the convertibility of the dollar to gold was terminated, which marked the end of the gold-backed dollar. An era of stable currencies was followed by one characterised by instability. Europe had to make a move. In response to a series of devaluations of the US dollar in 1972, the process of creating a monetary union began, followed by a recommendation in 1988 to set up a common European central bank. The Delors Committee created a three-staged strategy in 1988 for establishing the monetary union and introduced the euro not long after the signing of the Maastricht Treaty, in 1999, opening the era of euro vs. dollar rivalry. The age of currency wars has not ended by any means; on the contrary, it has since seen new protagonists emerge (such as the Chinese renminbi, the Indian rupee and the Brazilian real). In its current form, the euro area is not suitable for emerging as a winner from this rivalry, and still needs to undergo further development, but the importance of the initial steps is still incontestable.

To honour professor Lamfalussy's achievements, the Magyar Nemzeti Bank hosted the first instalment of the "Lamfalussy Lectures" conference series on 31 January 2014, providing a platform for speakers to present and share their views on global economic policy, specifically monetary policy and current topics affecting the financial system. Presentations at this year's conference covered European economic, monetary and financial integration and the future thereof, with a special

focus on the reasons behind the euro crisis, the challenges of monetary policy, euro introduction strategies and the banking union. The invited experts examined the issue of the introduction of a single currency in light of experiences drawn from the crisis. The main question they sought to answer was: to join or not to join?

Of course, the manner of adopting the euro is not open to debate for EU member states, and all of them (with the exception of the United Kingdom and Denmark) have an obligation to introduce the single currency sooner or later. Among the old member states, besides the two member states with opt-out clauses, only Sweden has not yet adopted the euro, but as it lacks the legal grounds to opt-out, it will in theory join the euro area at some point. The timing of introduction is a pivotal aspect which raises a number of dilemmas.

Hungary is no exception to this, and the crisis has even shed light on a number of hitherto unconsidered aspects. Based on an earlier overview of the Magyar Nemzeti Bank,[*] the main benefits of introducing the euro for Hungary were a reduction of transaction costs, the decline in real interest rates, the growth surplus stemming from higher foreign trade and the status offered by shedding its former status of an emerging economy. On the other hand, the adoption of the euro would entail a loss of revenues from the issuance of own currency and also mean giving up independent monetary policy. The analysis reveals that the costs and benefits would essentially offset each other in the short run, but the benefits outweigh the costs in the long run. In Hungary, the crisis has raised an additional argument in favour of introducing the euro in relation to the issue of foreign currency lending: finding a long-term solution to uncovered foreign currency positions and foreign currency debt. In addition to the above, a number of other events have occurred in the global economy, which must be taken into account when setting a date for euro introduction.

The global crisis of 2008 revealed all of the structural issues and differences in development that the euro area currently faces. There is no unified state or political union backing the euro. There is no budgetary union or common financial leadership among the member states. Despite being a common political endeavour, European institutions have not passed common political decisions to protect the euro, and thereby failed to set up the mechanisms necessary to handle emergencies.

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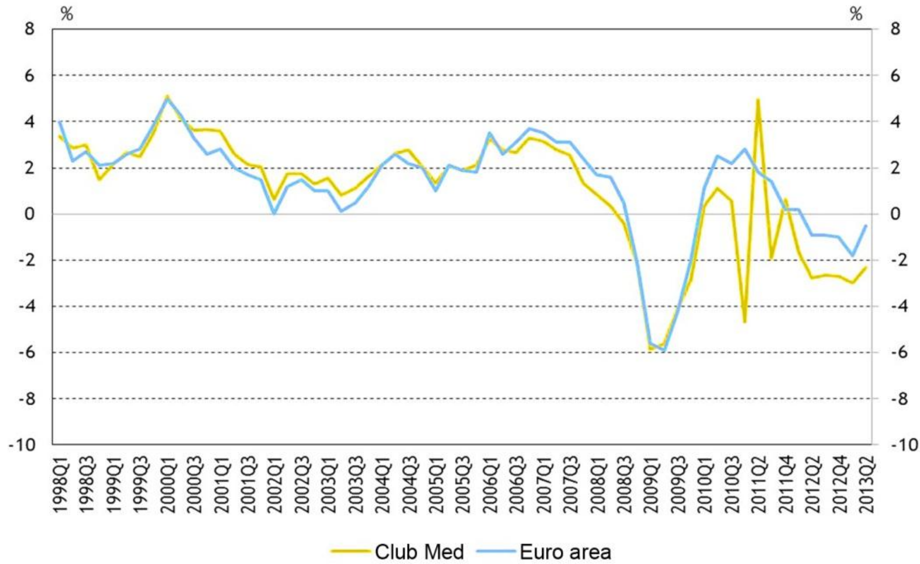
* Magyar Nemzeti Bank – Monetary Policy in Hungary 2006 (http://www.mnb.hu/Root/Dokumentumtar/MNB/Kiadvanyok/mnbhu_egyebkiadvanyok_hu/Monetaris_politika_2006/monetaris_politika_2006.pdf)

The recession highlighted the fault lines of a multi-speed Europe: the so-called Club Med countries (Italy, Spain, Portugal and Greece) only managed to emerge from the crisis with far deeper real economic and financial wounds.

Chart 1. – Year-on-year GDP growth

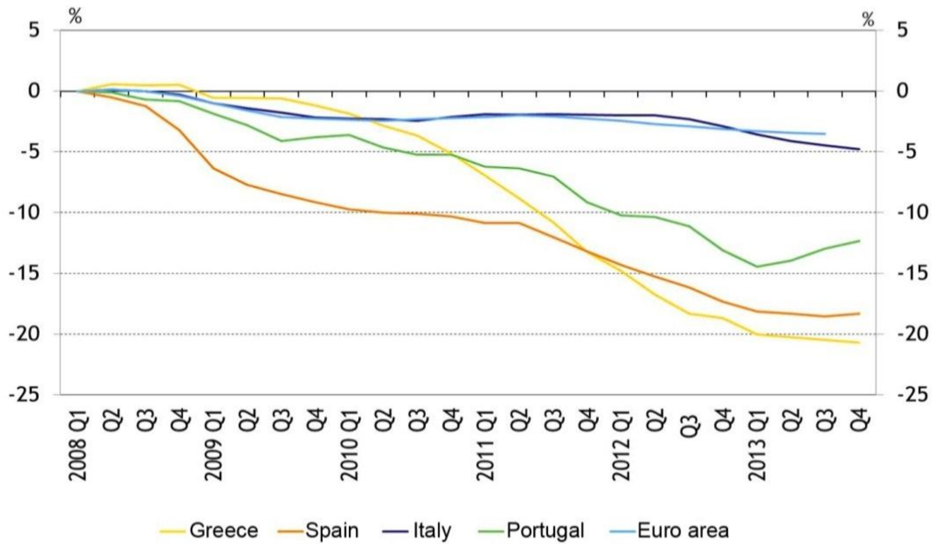


Source: Eurostat

Club Med countries posted similar growth rates as the euro-area average until the mid-2000s, but started falling behind even before the onset of the crisis. After the crisis, the differences that had emerged still prevailed, in part due to flawed crisis management mechanisms.

There are substantial differences between the euro-area average and these peripheral countries not only in terms of growth, but also employment. The number of individuals employed did not undergo any material change compared to the first quarter 2008 in the euro area, while this figure fell by 20 per cent in some cases up until the third quarter of 2013 in the Club Med countries.

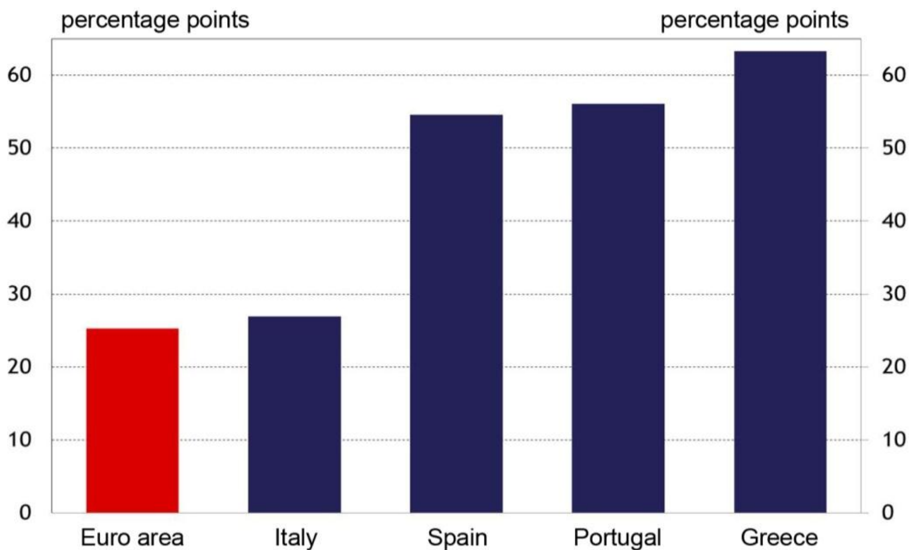
Chart 2. - Change in the number of individuals employed compared to 2008 Q1



Source: Eurostat

Employment trends were not the only area that suffered from the crisis and crisis management. The countries along the southern periphery of the euro area also saw a sharp deterioration in terms of their government debt.

Chart 3. - Changes in debt-to-GDP ratios between 2008 and 2013



Source: Eurostat

Government debt to GDP rose by 25 percentage points on average in the euro area between 2008 and 2013. This raises the question of whether the EU's responses to the recession were the right ones. The government debt of the Club Med countries also rose far more during the crisis compared to the euro-area average, explained in most cases by state-orchestrated bank bailouts, international financial loans and fiscal austerity measures with flawed structures, which excessively dampened demand.

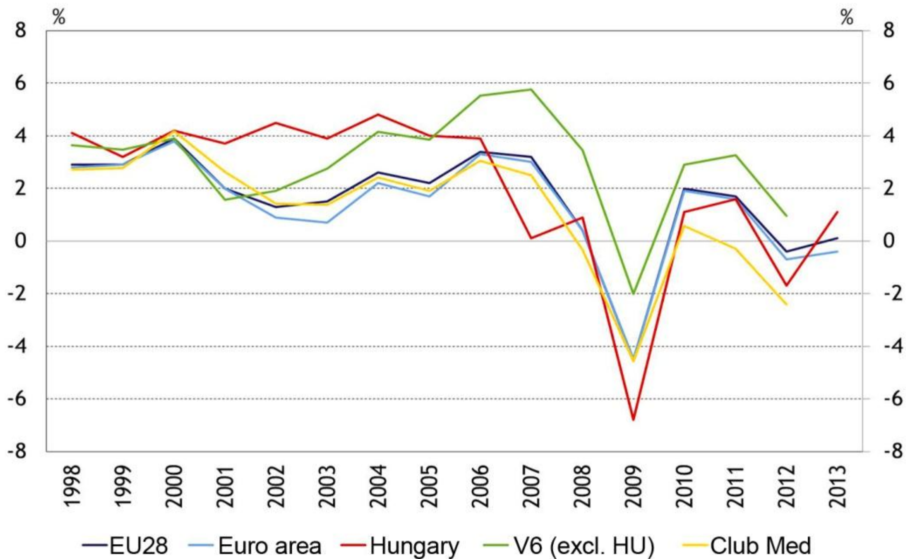
A multi-speed Europe is therefore not merely a theoretical category, but a very palpable reality. The above mentioned macroeconomic data clearly illustrate the risks of premature adoption of the euro. Hungary's interest at present is to prepare itself as best as possible for the introduction of the single currency, in parallel with the institutional reconstruction of the euro area. This will be a long road.

Since 1998, Hungary has taken significant steps towards convergence with the euro area, albeit with mixed results at times. The financial sector has undergone substantial development and deepening. Significant changes have occurred in respect of macroeconomic indicators as a result of the economic policies of various administrations and of the crisis. In terms of the Maastricht criteria, Hungary was subject to an excessive deficit procedure for many years after its accession to the EU. It was also far from meeting the inflation criteria given its weak fiscal indicators. These facts, coupled with the impact of the recession, called for a sharp change in economic policy. The new crisis management approach applied by Hungary and the strategic steps based on it have stood the test of the European challenge as confirmed by macroeconomic indicators and could propel Hungary towards once again becoming one of the most dynamically growing regions within the European Union along with its Central and Eastern European peers. The following chapter gives insight into this process.

2. ACHIEVEMENTS OF HUNGARIAN ECONOMIC POLICY IN VIEW OF EURO-AREA ACCESSION

Political cycles have fundamentally shaped Hungary's convergence with the average level of development in the European Union and even the euro area over the past decade and a half. Summarising the prevailing tendencies, Hungary made great achievements in the field of economic policy as a forerunner among Visegrad countries until the early 2000s, but then accumulated a substantial lag by 2010 due to the flawed economic policies of subsequent periods. Thanks to its novel economic policy and crisis management, Hungary has returned to the path of convergence with Europe.

Chart 4. - GDP growth

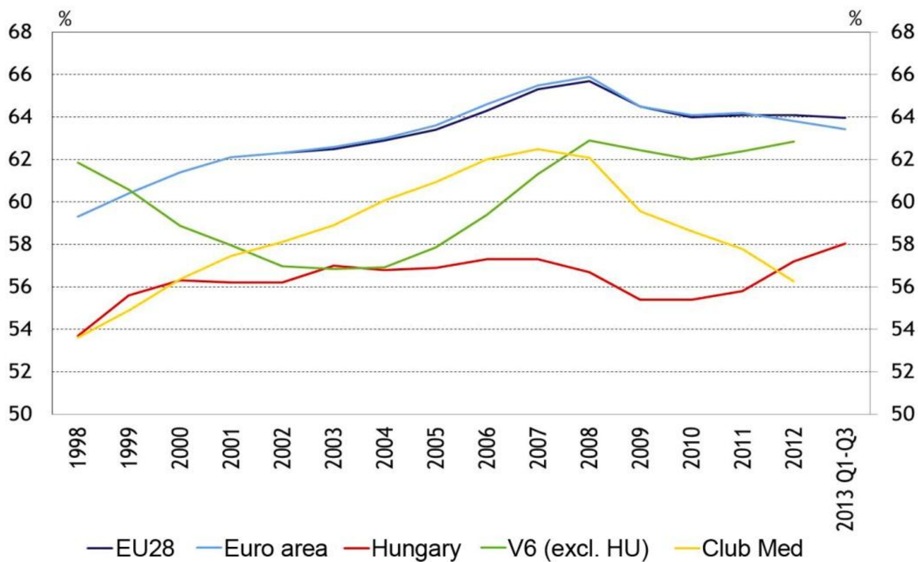


Source: Eurostat

Until the mid-2000s, Hungary showed a rate of growth and convergence to the European Union unseen ever since, outperforming its regional rivals. In 2002, Hungary's rate of growth was 3.6 per cent higher compared to the euro area and 3.2 per cent higher compared to the EU-28 average. By the mid-2000s, the country's structural problems had become more clearly outlined and the Hungarian economy's previously accumulated competitive advantage progressively wore down. By this time, Hungary's growth advantage compared to the Visegrad five (Austria, Poland, the Czech Republic, Slovakia and Slovenia) had disappeared.

Hungary was already on a path of deceleration from 2006, even before the onset of the crisis due to delayed fiscal consolidation, having been unable to take advantage of the opportunities offered by the positive international economic climate. The traditional crisis management applied between 2007 and 2010, based on austerity measures and the lack of many essential structural reforms, further exacerbated Hungary's lag behind the European average and its regional competitors. From 2010, a new approach to crisis management was adopted, placing the emphasis on structurally transforming the economy and on structural reforms, which enabled Hungary to attain growth once again in 2013 and outperform the European average.

Chart 5. - Changes in the employment rate in the 15-64 age group



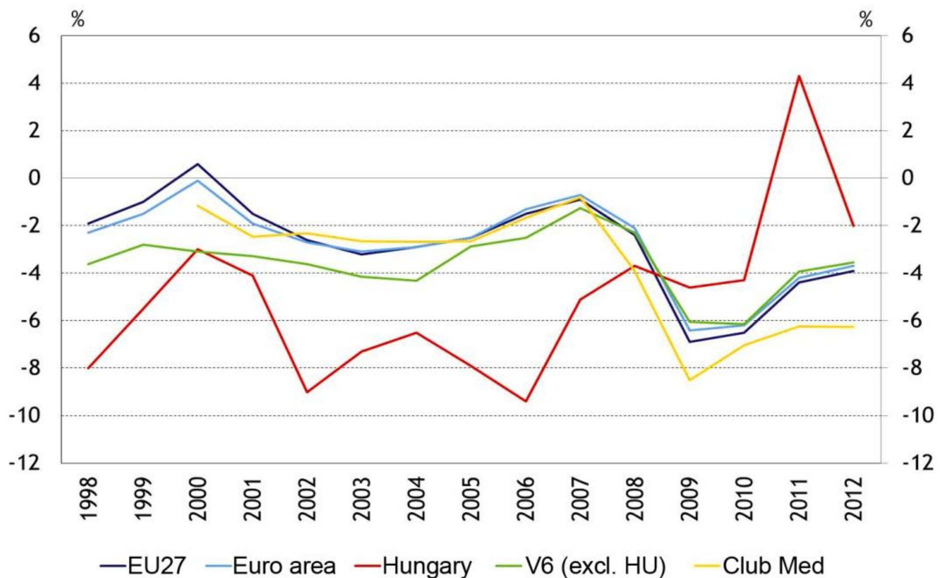
Source: Eurostat

Employment data reflect a similar tendency towards growth. The employment rate essentially stagnated in Hungary in the years leading up to the crisis, while the European Union and the euro area were able to take advantage of the global economic climate to increase their employment rate, along with the Visegrad five and Club Med countries. The crisis and the initial crisis management measures brought the Hungarian employment rate down to below 56%. The dip in employment was smaller on average in the European Union and within the region, and far sharper in the Club Med countries, which were the most severely affected by the crisis.

Besides restoring growth, improving the employment rate was one of the cornerstones of Hungary's untraditional crisis management, which also resulted in a turnaround on the labour market, as reflected by the historical peak in the Hungarian employment rate.

The tendencies displayed by growth and employment and the achievements in these areas are somewhat nuanced by the impact on Hungary's balance position.

Chart 6. - Fiscal balance as a percentage of GDP

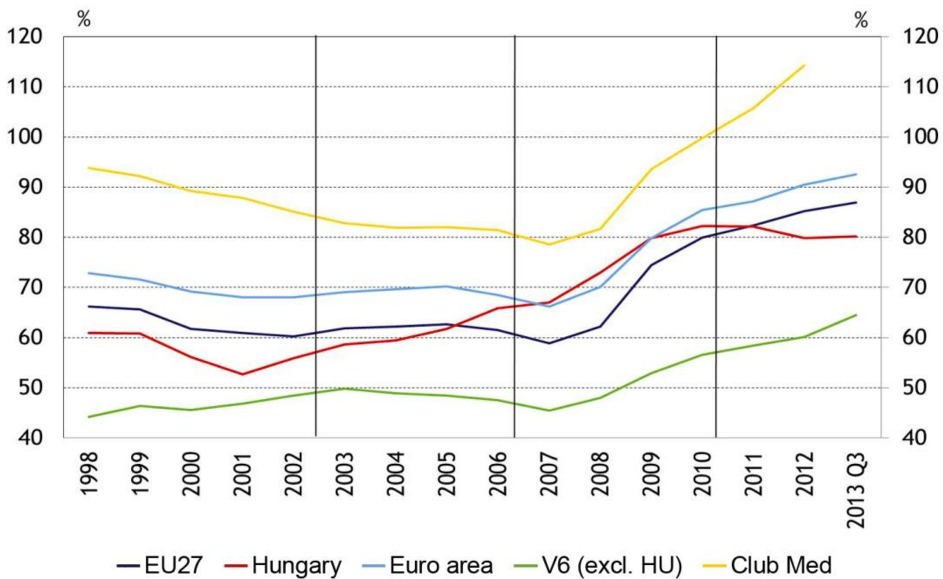


Source: Eurostat

Prior to 2011, Hungary was only able to meet the 3 per cent budget deficit criterion, defined as a percentage of GDP, in 2000. Hungary's fiscal position between 2000 and 2008 was worse compared to other country groups, but did show improvement starting from 2008 and was brought sustainably below 3 per cent during the period of unorthodox crisis management, enabling it to exit the excessive deficit procedure. This achievement is all the more significant in light of the fact that the other countries within the region, along with those along the euro-area periphery, are still subject to the procedure. In addition, core countries such as Belgium, Denmark, the Netherlands and even France have also been under the procedure.

The various political cycles in Hungary can be clearly delineated based on the developments in the fiscal balance and debt-to-GDP ratio. Hungary saw its debt rise substantially in the 2000s due to lax fiscal policy. Economic growth was accompanied by a sharp increase in government debt, which was neither sustainable nor in line with international trends. All country groups show that debt did not rise during this period, thanks to the positive global economic climate. In Hungary, the debt ratio had risen to 66 per cent prior to the onset of the crisis in 2008 and had increased to 85.3 per cent by the second quarter of 2010, due to the economic slump and the weaker exchange rate resulting from traditional crisis management and the loan agreement concluded with the EU and the IMF. Unorthodox crisis management brought the debt-to-GDP ratio back to 80.2 per cent by the third quarter 2013. None of the country groups under review managed to achieve similar results in the period following 2010.

Chart 7. - Debt-to-GDP ratio



Source: Eurostat

This non-exhaustive list of macroeconomic indicators presented above shows that the crisis management measures implemented in Hungary following 2010 were a success, not only because of their impact on the Hungarian economy, but also based on their unrivalled positive results compared to European countries and country groups opting for traditional crisis management measures.

Overall, contrary to the other country groups under review, Hungary managed to decrease its debt-to-GDP ratio, keep its fiscal balance below 3 per cent in a sustained and stable manner while seeing its employment rate rise and economic growth pick up in the period following 2010, the latter exceeding both the European Union, the euro area and the Club Med growth rates. European economic policy therefore failed to give the best responses to the challenges of the crisis. A London banker stated the following opinion in 2013: "If the unorthodox crisis management is successful in Hungary because the deficit is below 3 per cent, public debt declined, employment is on the rise, growth commenced and Hungary was removed from the excessive deficit procedure, while the Southern euro-area countries basically failed to achieve any of this with their traditional crisis management, then they [the Hungarians] were right, and the European Union is on the wrong track...".

During the crisis, it became clear for economic policymakers and economic opinion leaders that sustainable GDP growth, high employment and financial balance cannot be achieved without structural reforms. At the same time, structural reforms do not yield immediate results. Moreover, structural reforms present the paradox of swallowing more money during the initial years than yielding benefits, so sufficient funding must be found. This can come from three different sources: borrowing, austerity measures or the distribution of burdens, the expansion of the system of public dues.

The first solution was out of the question, as the crisis of the Western world had been caused by the substantial debt accumulated because of cheap credit. This left Hungary with the options of austerity measures or the distribution of burdens. That is where the difference in approaches occurred, with European countries opting for traditional crisis management measures and Hungary opting for unorthodox ones. The issue with austerity programmes is that they dampen domestic demand, which exacerbates the recession and triggers internal resistance, which creates political instability, hindering the implementation of structural reforms. By contrast, the sharing of burdens by a broader range of players lays the financial foundations for structural reforms while retaining political stability, thereby allowing governments to implement reforms and thus achieve a sustainable financial balance.

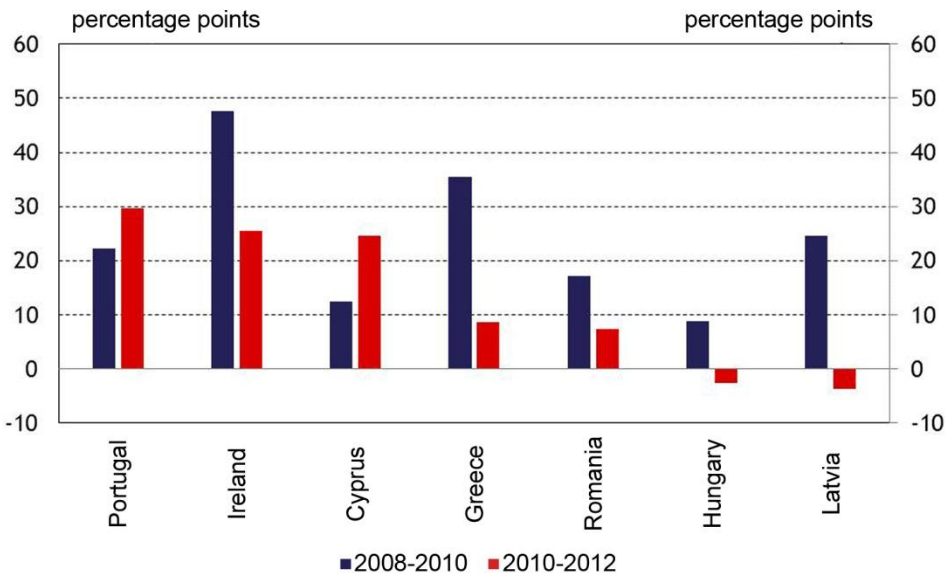
Hungary therefore crafted a successful response by combining structural reforms with the sharing of burdens. The latter consisted of introducing sectoral extra taxes, along with the financial sector bank tax and transaction charges. Although these measures were initially contrary to prevailing crisis management dogma and thus triggered an onslaught of criticism for Hungary, their results subsequently made them a model later followed by other countries.

Since the introduction of the Hungarian banking sector tax in August 2010, Slovenia, the Netherlands and Slovakia have followed suit with similar measures, and in January 2013 Poland adopted the finance ministry's proposal for introducing a supplementary bank tax. Romania and Slovakia also introduced sectoral extra taxes, and the European Commission decision opened the way for introducing a financial transaction tax in 11 countries.

By distributing public burdens across a broad spectrum of players, Hungary was able to radically reform its tax system in order to foster employment, improve the competitiveness of SMEs, and overhaul the educational system, the social welfare system and the pension system. It did all of this while decreasing tax centralisation, going against European practice.

The European Union's and the IMF's recipe for tackling the crisis proved ineffective due to its emphasis on reducing spending, while putting the stimulation of growth on the back burner. The European Commission only started communicating a need for supporting growth alongside fiscal stringency to its crisis management measures from spring of 2012. The biggest issue is the fact that the measures recommended by the EU and the IMF were unable to achieve even their declared objective of reducing debt and keeping the budget deficit in check. Between 2010 and 2012, only Hungary and Latvia managed to decrease their debt-to-GDP ratio among IMF programme countries.

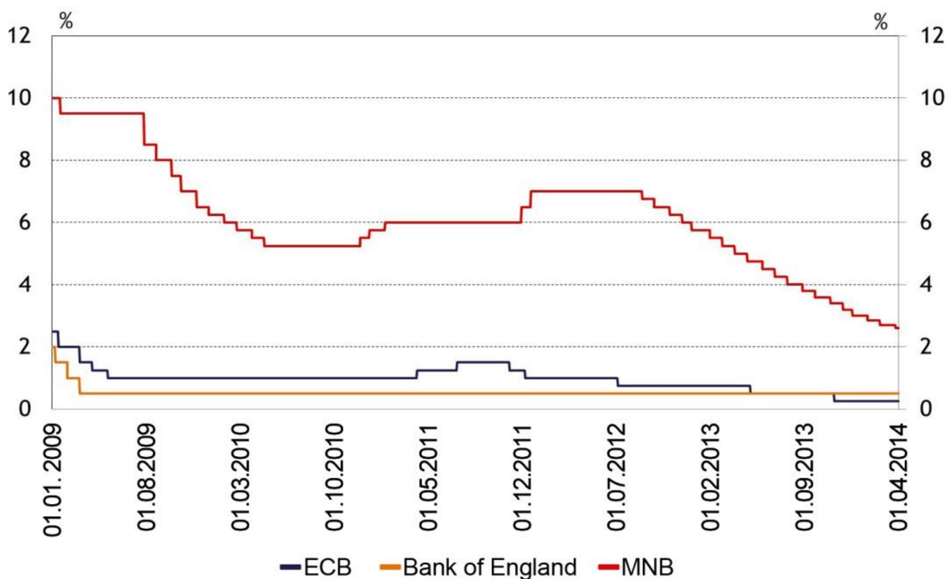
Chart 8. - Government debt only decreased in two IMF programme countries (GDP% change)



Source: Eurostat

The crisis resulted in major challenges not only for fiscal policy, but also for monetary policy. The stability of the financial system's operation and the stimulation of economic growth became increasingly important, alongside achieving the primary central bank goal in developed countries. In order to stimulate the economy, central banks first started quickly cutting interest rates, which rapidly fell to a point referred to as the zero lower bound. This depleted the arsenal of traditional monetary policy tools. New solutions were needed and central banks soon turned to unconventional tools that had not been used in the past. Some of these included providing liquidity, while others aimed to restore liquidity within the banking system through direct credit market intervention or government bond purchases, and to achieve monetary easing to spur economic growth. It also became clear that the relationship between central banks and governments needed reinterpretation in order to effectively and successfully address the crisis – their cooperation was needed, without jeopardising central bank independence, needless to say.

Chart 9. - Substantial Hungarian interest rate cuts

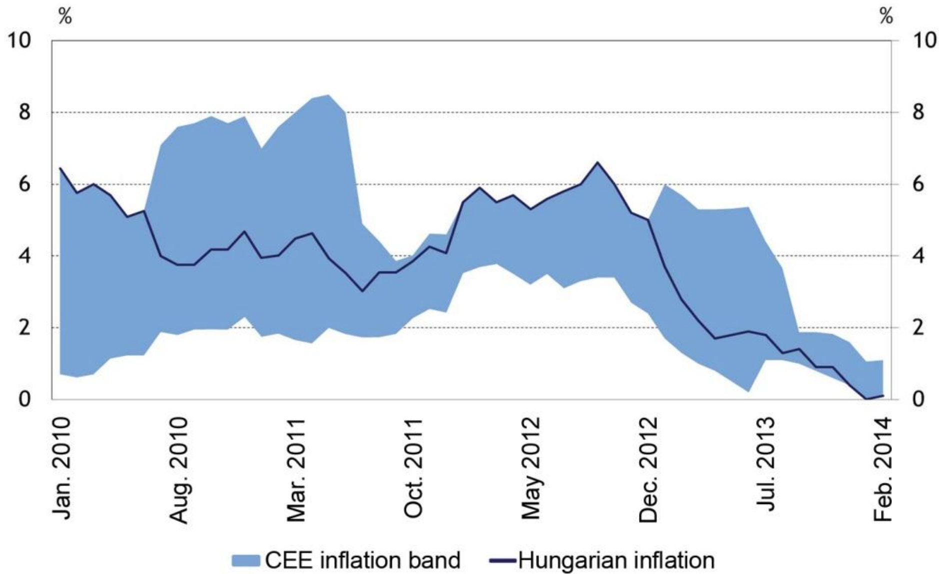


Source: Bloomberg

The fiscal policy reform and successful crisis management in Hungary have enabled a reform of monetary policy as well. Mid-2012 was marked by moderate inflationary pressure from the real economy coupled with suboptimal domestic economic activity. The progressive improvement in Hungary's risk perception warranted the gradual monetary easing implemented by the MNB.

The Magyar Nemzeti Bank's monetary policy based on interest rate cuts fostered growth within the Hungarian economy without jeopardising the achievement of its primary goal. The easing brought the central bank base rate from 7 per cent in August 2012 down to 2.6 per cent in April 2014.

Chart 10. - Hungarian inflation is also low in a regional comparison



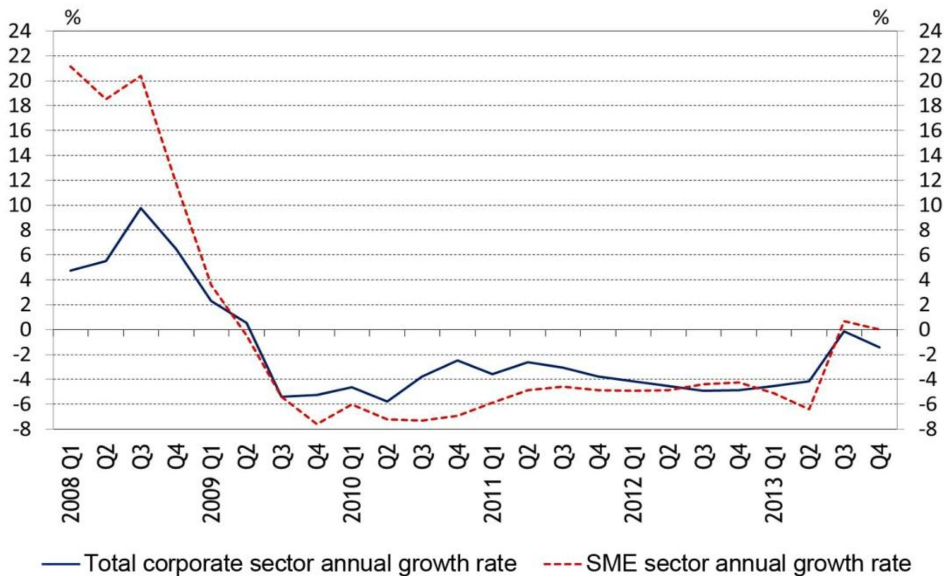
Source: Magyar Nemzeti Bank

A new feature of Hungary's renewed monetary policy is the fostering of sustainable growth, along with maintaining sustained expansive monetary conditions, due to low medium-term inflationary pressure. In the spirit of this objective, the MNB announced the Funding for Growth Scheme (FGS) in April 2013 in an effort to foster lending to the small and medium-sized enterprise sector. Under the scheme, the MNB provides collateralised, zero-interest refinancing loans to credit institutions which can be used for lending to small and medium-sized enterprises at an interest rate margin of maximum 2.5 per cent and for terms of at most ten years. The first phase of the programme ended on 30 September 2013 and saw the conclusion of agreements with SMEs in a total value of nearly HUF 701 billion from the total allocated amount of HUF 750 billion.

New investment loans accounted for over 60 per cent of the loans disbursed in the context of the first pillar of the FGS, a clear indication of the fact that the scheme achieved the central bank's goal of stimulating the economy.

Thus, the MNB played an active role in the turnaround in Hungarian economic growth which materialised in 2013. Building on the success of the first phase of the Scheme, the MNB's Monetary Council launched the second phase, with a framework amount of HUF 500 billion (with the option of increasing this to HUF 2 trillion based on the prevailing macroeconomic, money market and lending trends) valid until the end of 2014. The most recent data show a material increase in the HUF loans outstanding of small and medium-sized enterprises, mainly driven by the first phase of the FGS; further gradual expansion can be expected from the second half of 2014.

Chart 11. - The FGS increased corporate loans outstanding in the SME sector



Source: MNB, CCIS

The third cornerstone of the new Hungarian monetary policy is stronger harmonisation of monetary policy and financial regulation. The crisis has revealed that the prevention and management of one-off and systemic financial crises calls for the harmonisation of macro- and micro-level supervision. Until mid-2013, these functions were separate in Hungary: the Magyar Nemzeti Bank was in charge of macro-prudential supervision, while the Hungarian Financial Supervisory Authority was in charge of micro-level tasks. This structure proved ineffective during the crisis, which led to the integration of the Supervisory Authority into the Magyar Nemzeti Bank, creating a central bank capable of ensuring the stability of the entire financial system. Experiences so far have confirmed the viability of this model: the conditions of macro-level decision preparation have improved and the contradictions plaguing authority action have been eliminated.

In addition, integration also allows the reinforcement of the set of tools for supervising the entire financial intermediation system.

The MNB achieved these results while closing 2013 with a surplus of HUF 26 billion, instead of the forecast deficit of HUF 203 billion (which would have been financed from the budget). Falling interest losses stemming from the lower base rate played a role in this.

Hungary has thus embarked in a new direction in terms of monetary policy as well, alongside its fiscal policy. At the same time, the new monetary policy approach would not have been possible if fiscal policy had not adequately addressed the crisis and created a stable macroeconomic and financial background. Monetary policy reform was therefore allowed by the turnaround in economic policy, with these processes building upon each other. It is also apparent that structural reforms brought about both economic and financial change in the Hungarian economy. By contrast, European countries opting for traditional measures proved less effective in the crisis management competition. What is the message of the Hungarian model for Europe? What are the most pressing tasks and challenges of euro-area and Hungarian economic policy in the future? The following chapter attempts to answer these questions.

3. CHALLENGES AND VISIONS FOR THE FUTURE

The lessons learned from the recession have highlighted the difficulties and structural flaws plaguing the euro area. A stable euro is needed, but financial stability also calls for further steps by euro-area member states. Europe was unable to think outside the box of traditional crisis management in response to the recession, and thus failed to place sufficient emphasis on restoring growth, which led to a further decline in its global economic weight. As illustrated by Hungary's case, a turnaround in monetary policy requires a turnaround in economic policy. Europe must concentrate on growth in its recovery from the crisis. In this context, it must define and reinterpret its role in global competition and find ways to take advantage of the opportunities and creative industry and research and development, and to bolster its competitiveness. In addition, it must also identify the role of CEE countries within the European economy, as they could potentially be the future drivers of European development. A multi-speed Europe is not the problem in and of itself, however member states and their decision-makers must adapt to the situation and elaborate economic strategies tailored to a multi-speed Europe. Financial balance cannot be achieved without a stable real economy.

Further steps are needed in the area of monetary policy to enhance the euro’s stability. The euro was devised during times of peace and for periods of sound economic health. For this reason, crisis management mechanisms were not thoroughly elaborated. Although the European Central Bank played a pivotal role in mitigating the negative impacts of the crisis, it has become clear that there is room for improvement. The creation of a European banking union could be a great step forward in preventing and managing future crises. A banking union would allow the supervision of an integrated banking system based on common standards and independent from governments, thereby enhancing financial stability not only within the euro area, but also in the European Union member states with close financial ties to it. Clear and transparent regulation must be created from the outset.

The crisis has also revealed that central banks and governments must cooperate without violating the requirement of independence or the achievement of primary central bank objectives and find common solutions for the fastest possible recovery. The competitors of the European Union take advantage of the opportunities of coordinating the state and central banks. By contrast, there is no unified state or political union backing the euro, as mentioned previously. Euro-area member states lack a budgetary union and there is no common financial management or common sharing of burdens. For these reasons, in case of the euro it is difficult for fiscal and monetary policy measures to help member states overcome the crisis by reinforcing each other. Nevertheless, the European Central Bank could foster economic growth within the euro area through targeted lending schemes.

One of the most pressing and most severe issues for the euro area today is the large discrepancy in the development of its member states. This presents a challenge for both crisis management and economic policy, as peripheral countries are in need of very different solutions compared to the most advanced euro-area member states. A quick solution is likely to remain an illusion on account of the complexity of the issue.

It is Hungary's interest for Europe to remain strong and the euro to remain in place. However, the crisis has shed light on the detrimental consequences of the premature adoption of the single currency. Hungary wishes to and will introduce the euro, but unless it is strong enough to do so, its best interest is to stay out of the euro area. Until a level of development of 80-90 per cent of the European average is achieved, adopting the euro will entail significant risks.

Even during crisis management, Hungary made significant steps to move forward rapidly in the convergence process. Hungary's unorthodox crisis management measures have put it back on a growth trajectory and improved its external and internal balance position. The budget remained under control, government debt was reduced and the current balance shows a surplus. In addition, Hungary also made great improvements in the field of employment. But this is no time to ease up. In order to become a driving force of the European Union as a member of the CEE region and achieve convergence in terms of development, new jobs are needed, investment must be reinforced, competitiveness increased and productivity fostered. Hungary has already found the right path, but it still has a long way to go.

EWALD NOWOTNY

Governor
Österreichische Nationalbank

European Monetary Union: Past, Present and Future

In Honor of Alexandre Lamfalussy

(Paper based on the lecture given at the Conference)

The Hungarian central bank is to be commended for the brilliant idea of establishing a Lamfalussy prize and a Lamfalussy lecture: I have gladly accepted this prize in honour of Baron Lamfalussy, who is the perfect epitome of the great liberal, open-minded Hungarian so impressively described by journalist and author Paul Lendvai in his brilliant book "The Hungarians". Baron Lamfalussy may be seen to symbolize the personal and intellectual ties that Central Europe shares with Western Europe, and therefore may perhaps also serve as a role model for the relationships between the "ins" and "outs" of Europe‘s Economic and Monetary Union. In these truly interesting times into which Alexandre Lamfalussy was born he has played an active part in three capacities: as an eminent scholar in monetary economics, as a leading commercial banker, and as a highly successful and influential monetary policymaker.

Alexandre Lamfalussy was born 85 years ago in Kapuvár, which is not so far from Hungary's border to Austria. In 1949, when the Iron Curtain cut off Hungary and many other Central European countries from the rest of Europe, he managed to emigrate to Belgium, where he studied economics at the Catholic University of Louvain, and later obtained his PhD from the University of Oxford.

Lamfalussy developed his strong pro-European conviction already during these formative years, no doubt also because he personally experienced the barriers which divided Europe. And he found friends who shared his conviction and his values. Consider a small but quite remarkable detail: he became a member of "La Relève", which was both a political club and a weekly magazine close to the left wing of the Belgian Christian Democrats – honoured by Jacques Delors as the speaker invited to mark the 30th anniversary of "La Relève" in 1975. In this club, Lamfalussy also became acquainted with people like Philippe Maystadt, later Finance Minister of Belgium. Alexandre Lamfalussy then worked for the commercial bank Banque de Bruxelles for 20 years, where he became a member of the Executive Board. And already during this time, Lamfalussy was active in a number of committees investigating the integration of European capital markets.

In 1976, Alexandre Lamfalussy underwent a major career change and went to the Bank for International Settlements, the BIS, in Basel, first gaining great respect as Chief Economist and from 1985 serving as the General Manager of the BIS. During this time, he became one of the leading figures paving the way for European financial integration. Lamfalussy was a member of the Delors Committee, which played a central role in drafting the Maastricht Treaty and designing the European Monetary Union (EMU). Thus he was the obvious choice for the position of the first president of the predecessor of the European Central Bank: the European Monetary Institute (EMI), which was tasked with laying the groundwork for EMU and for a single monetary policy of the participating EU Member States from 1994 onward. He played a decisive role in European economic policy in later years as well: in 2000, Lamfalussy was appointed chairman of a committee called the "Group of Wise Men", today of course a politically incorrect title. This group laid the groundwork for the regulation of European financial markets and developed what became known as the Lamfalussy procedure on the regulation of European securities markets.

In the context of the topic of this text, "European Monetary Union: Past, Present and Future", it is tempting to refer to the foundations laid by the EMI under the presidency of Alexandre Lamfalussy, characterized by David Marsh in his outstanding book on the history of the euro as "sharp of mind and way of manner, Lamfalussy was the most polished of monetary technocrats, commanding English, French and German with a cut-glass precision". Not untypically for an Englishman, David Marsh forgot to mention Hungarian as one of the languages that Lamfalussy is able to speak. So Lamfalussy started working in Frankfurt with a skeleton staff of 12; today, in early 2014, the staff of the ECB numbers around 1,600 and it is just about to hire 1,000 more to handle the Single Supervisory Mechanism. The basic problems at this early stage of the European Monetary Union were structural aspects that are still of relevance today and will remain so for the future.

The first aspect concerns the relationship between political and monetary unification or at least the coordination of these two aspects. Especially in the German speaking countries, there were two opposing schools of thought at this time. One view, heralded as the "coronation theory", saw a monetary union as the last step, as a "coronation" of a political union. This reflects the experience of the unification of Germany in the 19th century and is based on the conviction that it takes a common political system to guarantee a strict monetary policy. The alternative view is what became known as the "locomotive theory", which reflects the experiences of the Robert Schumann-Jean Monnet approach after World War II.

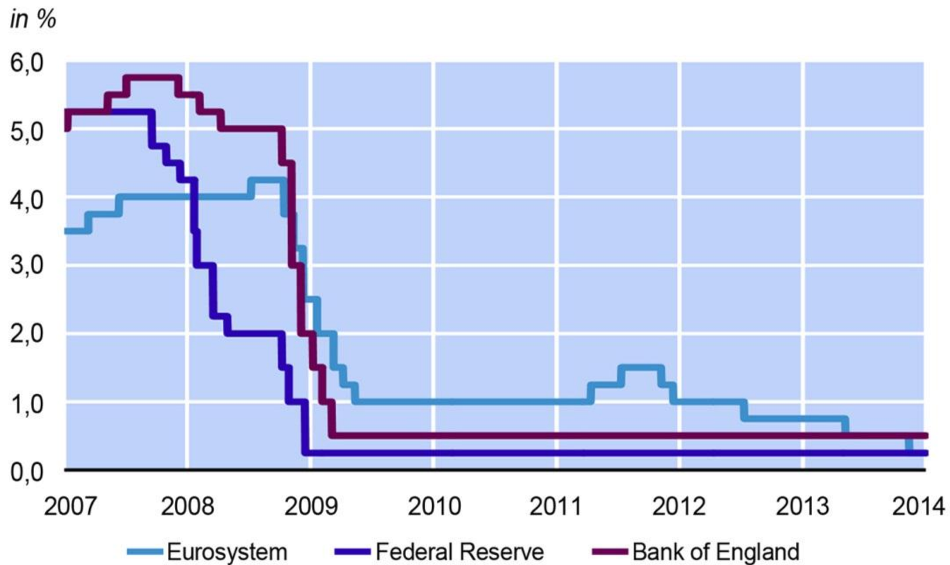
In this view, economic cooperation projects, for instance, like starting with the European Coal and Steel Community in 1952 created an evolutionary process toward an “ever closer union”. It is obvious that a political union using the coronation theory as a starting point is only realistic for a small, rather homogenous group of European states. After various rounds of EU enlargement, this concept of a small, homogenous group was no longer realistic; and, by the way, was also no longer in the German interest. So Alexandre Lamfalussy reports in an interview with David Marsh how much he agreed with Helmut Kohl on a fast-track approach to monetary union (Marsh, 2009, p. 191).

The Maastricht Treaty provided clear rules for EMU membership. But already at that time, there were controversies about what is called “creative accounting” and statistical manipulations in some countries. Yet in retrospect, it may be said that the ambition of entering EMU in combination with the Maastricht rules exerted a strong stabilizing influence in all future member states, so that – of course in accordance with benevolent political agenda setting – EMU could start as scheduled in 1999. The question of the division of labour between the ECB and the national central banks had yet, of course, to be resolved and this is another topic which has remained relevant to this day. One important issue was whether the conduct of money market operations should be decentralized, as Jean-Claude Trichet, then governor of the Banque de France, advocated or whether it should be centralized, as Alexandre Lamfalussy and for instance Hans Tietmeyer from the Bundesbank argued. The ECB view prevailed, which proved to be extremely beneficial in the financial markets turmoil of 2007 and 2008: fast and strong liquidity provision by the ECB was vital for stabilizing the European economy.

So to come full circle, we now move on to the present-day situation and to the challenges for the European Monetary Union. The present situation is still dominated by the direct and indirect effects of the worldwide crisis that started in 2007 and 2008. In the years before the crisis, central banks lived in the glory – and as we now know the illusion – of what then was called the “Great Moderation” (Bernanke, 2004). The basic message was that a constellation of independent central banks following a strategy of tight inflation targeting is both a necessary and a sufficient condition to ensure a benign combination of low inflation and high real economic growth. And this combination had indeed been achieved in the first years of the new century. But as we now know, this positive outcome was the result of very specific circumstances, especially strong first-round effects of globalisation.

Thus central banks were not well prepared for the upcoming financial and economic tsunami. This also holds true for the ECB, which in the summer of 2008 still raised interest rates. But when the tsunami arrived, central banks, including the ECB, reacted fast and forcefully, thus preventing a world-wide crisis of the dimensions of the Great Depression of the 1930s (see Graph 1).

Graph 1. - Monetary Policy Rates



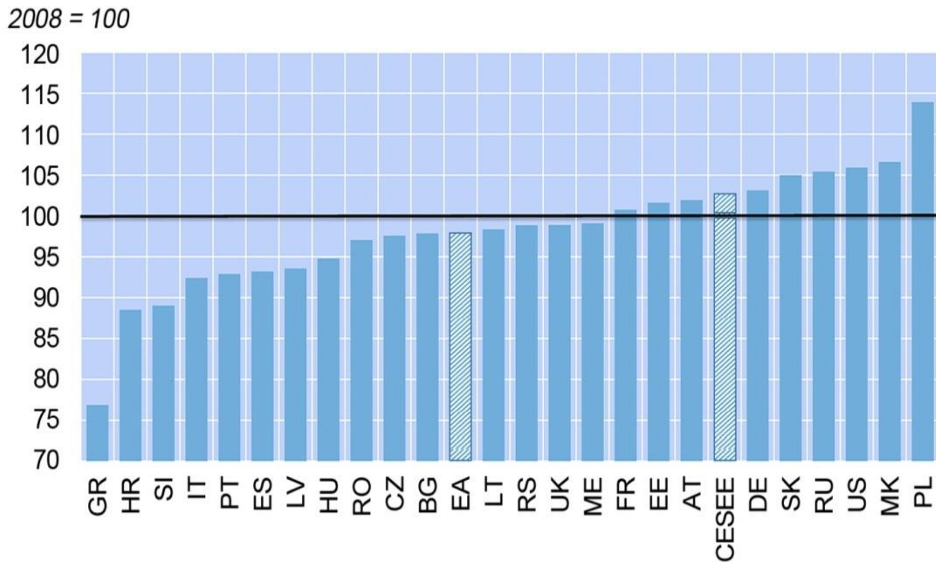
Source: Thomson Reuters

Looking at these developments from a European perspective, it is fair to say that without the European Central Bank, the impact on Europe of the worldwide crisis and especially of the de facto breakdown of money markets would have been much stronger and indeed catastrophic not only for the member states of the EMU but for all of Europe.

No national central bank, not even the central bank of a large country, would have been able to provide banks in liberalized capital markets with as much crucially needed liquidity as fast as the ECB. And only the big central banks, like the ECB, the Fed, the Bank of Japan and the Swiss National Bank were able to form the strong network of swap agreements that proved of utmost importance for the banking industry and has come to be one of the most important institutional innovations. All these innovations, by the way, benefited not only the banks – and thus the economies – of the euro area but in an indirect way also the countries in which euro area banks are active, such as Hungary (Nowotny, 2010).

It is only this year, in 2014, that the euro area is expected to move out of recession to a constellation of positive, albeit so still very weak growth and we still see substantial differences in the economic performance of various EMU members – and also of neighbouring countries (see Graph 2).

Graph 2. – Economic Output: 2013 vs. 2008



Source: IMF, Eurostat

The main efforts in Europe and across the world are now moving from crisis fighting to long-term crisis prevention. Two main approaches are being implemented. The first approach is to adjust the structures of the banking industry by implementing the Basel III process and the European banking union project. The second approach is to adjust public finances. As mentioned before, the founding fathers of the European Monetary Union were already fully aware of the risks of having a single monetary policy without a centralized European fiscal policy counterpart. This awareness gave birth to the European Stability and Growth Pact in parallel to the EMU. As the crisis showed, the provisions of the Stability and Growth Pact were insufficient to prevent a destabilizing accumulation of public or private debt in a number of countries before the crisis, causing the fiscal impulse needed to be limited during the crisis.

At the EU level, we therefore see a whole set of new institutional arrangements to provide for long-term fiscal sustainability. There is a far-reaching consensus about the intentions of these arrangements: public deficits and debt levels need to be limited and adequately supervised. This is all the more relevant for member countries of the euro area which do not have access to central bank financing and that are exposed to free capital movements. There are, however, divergent views about how fast to achieve the reduction of currently high, mainly crisis induced, levels of public debt.

Whereas European institutions, including the ECB, advocate strict and tight timeframes, the IMF and U.S. economists tend to prefer a more flexible approach. Of course, this discussion is not new and will remain a central issue of the political and economic debate in the near future – and it is a discussion where easy answers indeed tend to be misleading. The difficult political process of regaining fiscal sustainability must of course be strengthened and controlled without damaging the still fragile process of economic recovery.

It is true that future economic growth will depend on a number of supply-side structural reforms of the labour and products markets. But in the present situation of still low capacity utilization in many fields of the economy, of low investment and especially of alarming rates of unemployment in many countries, it seems obvious that the demand side of the economy is also of relevance and that additional demand cannot be expected to come from ever-increasing current account surpluses of the European Union.

In this context, it is quite interesting to see that Alexandre Lamfalussy already at a very early stage referred to the problem that a lack of fiscal coordination could lead to substantial policy inefficiencies with regard to macroeconomic disequilibria and could overburden a European single monetary policy in the long run: “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 European Monetary Union would be the accidental outcome of decisions taken by Member States. As a result, the only global macroeconomic tool available within the EMU would be the common monetary policy implemented by the European Central Bank” (Lamfalussy, 1989).

So now, what about the future perspectives of the EMU? Concerning institutional perspectives, we see a wide set of proposals to strengthen the political foundations of EMU. Basically, these proposals suggest creating a “European economic government” or a “fiscal union” with, as Jean-Claude Trichet emphasized, a European finance minister. All this would involve substantial transfers of national sovereignty and thus Treaty changes. And we are all aware of the immense political problems involved in achieving such changes.

So any such institutional discussions have to concentrate on the Eurogroup countries, strengthening of course in this way the already existing perspective of a two- or three-speed Europe. There is general awareness that this is a very sensitive issue, not only for Europe in general but especially also for the newer EU Member States. In the very long run, a Europe of different speeds, of course, may and should converge again but at least for the medium term, a closer cooperation of the EU members able and willing to engage in more advanced levels of political and economic integration is the only way to achieve the desired future political foundations of the European Monetary Union. In fact, the present EU Treaty (Article 136 TFEU) may already allow for far-reaching changes of this type without the need to change the Treaty (Piris, 2012).

In other words, we have in fact not advanced very far since the discussion we had before starting EMU described above. This historical perspective should make us wary of frequent warnings that there cannot be a lasting monetary union without a closer political union. Now as then, a stronger political foundation would be preferable. But now as then, this stronger political foundation is extremely difficult to achieve. And now as then, an admittedly imperfect monetary union is still preferable to a situation without a monetary union and without a strong European Central Bank – a European Central Bank that has proved to be one of the most important and efficient European institutions.

In this situation, there is still something to be learned from Alexandre Lamfalussy and his principle-based but pragmatic approach to economic and political affairs. In 2003, he gave a speech in Budapest with the uncannily topical title "Correcting Europe's dismal growth performance should be the EU's prime policy objective". In this speech, he warned against relying on the U.S. as – as he called it – "consumer of last resort" and made a number of proposals for "domestically propelled growth in Europe". And he ended his speech with a very poignant message, indicating that the proposals "will bring sizable benefits to most of us, but not without throwing up new challenges. You may say that this remark is just the usual manifestation of a central banker's innate caution. Well, it may be. But that does not mean that I am necessarily wrong".

This is a message with which every central banker can – and should – agree.

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CHRISTIAN NOYER

Governor
Banque de France

Why the Economic and Monetary Union needs a banking union

(Lecture given at the Conference)

Mister Prime Minister,
Dear Governors,
Ladies and gentlemen,

Before I begin with my address, I would like to thank very warmly Governor Matolcsy for having invited me. I would also like to congratulate him and the Magyar Nemzeti Bank for the very prestigious and interesting conference you have organized.

My address is about the latest step of European integration, namely the banking union.

As you are aware, these past 14 years of monetary union have brought huge benefits: the purchasing power of more than 300 million users of the single currency has been more protected than ever thanks to stable and moderate inflation; the currency risk between euro area countries has been eliminated, helping to foster growth and maintain stability; and the single currency has simplified and stimulated both trade and labour mobility.

However, even with all these benefits, the euro area still did not manage to escape the crisis, and one of the most important lessons from this period was that monetary union was insufficiently complete and coherent.

In 2012, a consensus was reached over how we could resolve this failing. The answer was crystal clear: Europe needed to move towards a banking union.

Let me go over some of the reasons why we chose this path.
The euro area crisis, and in particular the more acute episodes of banking turmoil, revealed a number of basic weaknesses at the heart of the monetary union.

- First, the problems encountered by some of the big banks severely damaged the fiscal stance in certain countries, where the state had to step in to save these banks. This, in turn, undermined market confidence in the sustainability of the resulting fast growing public debts, which led to sharp rises in the rates at which those countries could borrow on the market, as, for example, in the case of Ireland.

- Second, there was a perception that countries with impaired public finances would have difficulty bailing out their respective financial systems in the event of a problem. This resulted in a widespread loss of confidence and pushed up borrowing costs for banks and sovereigns, as in the case of Italy.
- In response to these tensions, the European Central Bank took unprecedented steps to lower the cost of bank refinancing, cutting its key policy rates to historically low levels and providing unlimited 3-year liquidity. But even this proved insufficient to calm market tensions. In some countries at least, monetary policy measures were simply not being fully transmitted to the real economy.

What was the reason behind these three phenomena, which were largely responsible for the escalation of the crisis in the euro area? It was the vicious circle that developed between the state of a country's banking sector and its perceived sovereign credit quality. And why did this vicious circle emerge? Because of the lack of banking union:

- In a monetary union, capital can circulate freely and rapidly from one country to another, which can amplify the potential fallout from "banking panics", unless there are effective supranational mechanisms in place for supervision, resolution and the guarantee of deposits;
- As long as the financial health of the euro area remains at the mercy of the difficulties encountered by one of its member countries, there is a threat that negative interactions may develop between sovereign credit risk and banking risk;
- In reality, the lack of a banking union allowed a high degree of fragmentation to develop within the euro area banking system and this, in turn, nourished doubts about the "singleness" of the euro.

The crisis thus made it clear that a uniformly healthy financial system was vital to safeguard the stability of the euro area and ensure the effective transmission of a single monetary policy.

Once we had agreed on this reasoning, we had to come up with a concrete solution. The key to banking union can be summed up as follows: the aim is to find a way to ensure that banks in the euro area are considered precisely as that, as "euro area banks", and not as "Irish", "German" or "Italian" banks. In other words, the goal is to ensure that credit conditions in the euro area will not depend on where you are but on who you are, which is what should be expected of an efficient financial market.

To achieve this, we need to have three things in place:

- Federal bank supervision, to guarantee that all institutions are subject to the same rules and same methods of control. A supra-national supervisor is in fact better placed to assess the risks of cross-border activities and therefore to protect and encourage such activities; it is not subject to national biases that can lead to the temptation of economic introversion. It is therefore more credible and strengthens stability and confidence in the area;
- A unified mechanism for the resolution of banking crises, so that individual countries no longer have to shoulder the burden of major upheavals on their own;
- A unified deposit-guarantee mechanism to avoid banking panics.

Over the past year, these ideas and words have translated into concrete actions, and Europe has demonstrated that it can carry out rapid, in-depth reforms, to ensure it emerges stronger from the crisis. I would just like to tell you where we stand currently in the move towards banking union.

As you know, the area in which we have made the most progress is in supervision.
European heads of state agreed to the principle of a single supervisory mechanism at the end of 2012, and we are in the process of actively preparing its implementation.
By November, the main banks in the euro area will be supervised by a federalized system headed in Frankfurt. A Supervisory Board will be established to plan and carry out the ECB’s supervisory tasks, undertake preparatory work, and propose complete draft decisions for adoption by the ECB’s Governing Council.
Moreover, the entire European banking system, including Hungary of course, will be supervised on the basis of a single set of principles – the Single Rulebook – which has been compiled by the European Banking Authority. This is a huge step towards a more unified and consistent European banking system, and one that is therefore more robust and efficient.

The move towards a Single Supervisory Mechanism is firmly on track. Last October, we reached another important milestone with the announcement by the ECB that European banks will be subject to a Comprehensive Assessment prior to the set up of the SSM in November 2014.
This exercise is now underway. We must be aware that the exercise is an unprecedented one: about 130 participating banks - including 13 French banking groups – representing 85% of the total assets of European banks, will simultaneously undergo a thorough asset quality review (AQR) using a common methodology, and this will be followed up with stress tests this summer.

The purpose of this rigorous exercise is threefold:

- to foster transparency about the condition of the European banking system;
- to take the needed corrective actions;
- and finally to restore confidence.

Of course, this exercise is a challenge. But I think that it is also a great opportunity for European banks to show that they have cleaned up their balance sheets and that they are trustworthy.

As you can see, the SSM is well on track and I am fully confident that it will be operational at the end of this year, as expected. But this good result should not lead to forget that for the banking union to be fully successful, the SSM needs to be completed with the adoption of a Single Resolution Mechanism.

Indeed, in line with my colleagues at the ECB, I consider the Single Resolution Mechanism to be another essential pillar of the banking union, alongside the SSM. Ideally, the SRM should consist of three main elements: a single system, a single authority and a single fund.
This is why the ECB has constantly been encouraging all the relevant parties to make further progress in adopting the SRM, which should be in place by the time the SSM becomes operational. You know that a political debate is taking place currently between the European Council of Ministers and the European Parliament.

The version of the SRM that has been agreed among European governments at the end of last year is not ideal, notably because it requires a long transition period which could fuel uncertainties. But what matters most is that we have clear and common set of rules concerning banks resolution. For the mechanism in itself, Europe has proven in the past that, confronted to acute crisis, it was able to accelerate the processes and deepen its solidarity.

Ladies and gentlemen, I hope I have managed to give you a clear and up-to-date picture of the advance towards banking union. I would like to conclude by stressing just how crucial this development is in order to strengthen our economic and monetary union.
I think that the ECB proved, in the darkest moments of the crisis, that it was completely committed to the euro. Our actions were driven by a profound belief that the single currency is our most valuable shared asset and that it brings enormous economic benefits. Today, with the construction of a banking union, we aim to demonstrate that this is a long-term commitment.

Thank you for your attention.

ILMĀRS RIMŠĒVIČS

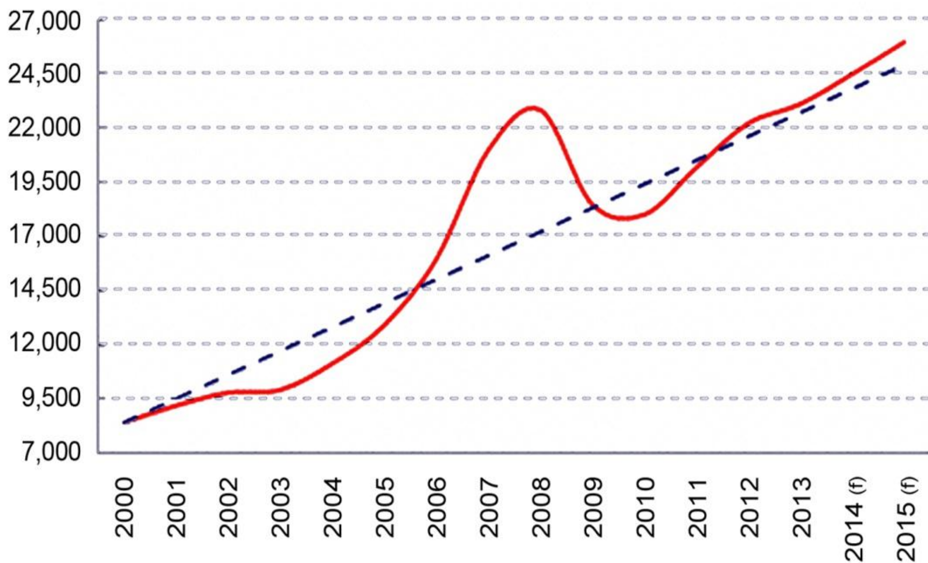
Governor
Latvijas Banka

Latvia and the Euro

(Lecture given at the Conference)

Good morning Ladies and Gentlemen, it is really my pleasure to be here today. In or out, that is the question, to be or not to be. I think Alexandre Lamfalussy probably would be the right person to ask this question, since we have heard very interesting memories, since he is also being one of the co-founding fathers of the euro. Before we really tackle this one million euro question, I believe the conference organisers have really attempted to stir a discussion about to cut or not to cut, to print or not to print, in other words, to devalue or not to devalue or maybe to devalue internally. Otherwise, Latvia probably would not be mentioned and the experience of Latvia would not be presented here today. Indeed, I believe it is an interesting story, there were lots of thought and food for the brain. Therefore, I would really like to thank the organisers and the central bank of Hungary, let me say, for bringing me here today, and giving me the opportunity to share our views and see and remind ourselves of Latvia towards the euro.

Chart 1. – Pre-crisis level of GDP reached in 2013
Gross Domestic Product in Latvia (millions of euro), 2000-2015



Source: Eurostat, (f) – BoL forecast

I would divide my presentation into three parts: maybe the word 'austerity' sounds a little bit rough, but that is probably the most picturesque one; then, how did we do that, and why it really is good to adopt the euro. Needless to say that Latvia is the fastest growing economy again, and it is not only for the third quarter of 2013. Latvia has been the fastest growing economy in Europe for the last three consecutive years, and, according to the European Commission, will be the fastest growing economy for another three years as well. Many times the sceptics and critics have been saying: “well yes, but you have paid a very dear price, and you have still not recovered from the crisis, and really the method whereby you did it, is probably very controversial”. No, I think Latvia is one of the few countries which have reached the pre-crisis level and I think it is very important that we paid dearly for it and we recognise mistakes, but we are out of the loop.

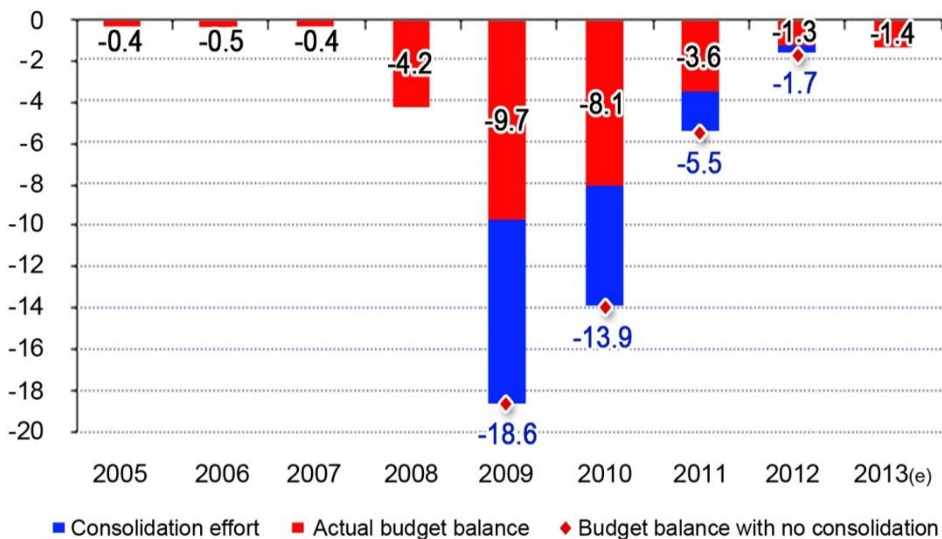
Needless to say, this growth had to come from somewhere, and we heard this morning from Prime Minister Orbán that competitiveness is really the key. And one of the success stories or arguments, or factors, definitely comes from the capability of a country to export, and Latvia’s exports have been among the fastest growing in Europe. I think it is important to mention that there are still many arguments here, like: "in order to improve your competitiveness, you devalue and that drives your exports and you are the winner". Of course, many of us know that you could devalue twice a day but that would not help your economy, and, therefore, we are very pleased to show to you that even without devaluation a country can be the fastest growing economy, with the fastest growing exports. It is important to note that many people believe – by cutting down expenditures you downsize the demand, you decrease the consumption and basically you lose jobs. But we have reduced the unemployment rate from 19% to 9.5%. As you can see from the pre-crisis time when the Latvian economy was clearly overheated, the current account deficit reached 22%, and many people said “well, this is just a matter of days when the country will be forced to devalue the currency”, and it never happened. And today we see that the current account balance has been completely restored and has been completely or fully covered by foreign direct investment inflows.

When preparing for this conference I was reflecting on a question – how could a country be the fastest growing economy with the lowest inflation? But Latvia’s inflation was exactly zero last year. So maybe this is a very blunt statement about Latvia’s prescription, we are definitely not trying to say that this is the one and only way out of the crisis, and if you follow this particular prescription, you are going to succeed. But at least when asked how we did that, we allow ourselves to share these views with our friends and our colleagues. Well, first of all, usually during the crisis there is extremely little time and you have to make decisions very quickly in order not to regret them afterwards. And, of course, the first thing which came to our minds was “OK, now, what should we do?” Of course, devaluation was the number one option. The number one option had been exercised in many countries before and had worked pretty well. And Latvia said "no". Latvia said "no" for the very good reason that we saw that public finances were

not in order; public finances were expanding at a very fast rate and, as Prime Minister Orbán said, the central bank and the government had to work together, and that was an interesting case when the central bank convinced the government that devaluation was not an option and that government expenditures had to be cut. Of course, as we will see later on, there have to be other elements as well, flexible labour markets, and high degree of openness to foreign trade. And speed. Speed is definitely important. If somebody would ask me what the most important thing was, what the most crucial factor was which guaranteed the success of Latvia in overcoming the crisis, I would say that it was the speedy and very decisive action. As you can see, these are the numbers that show the result, the consolidation effort.

How much the Latvian government and parliament did adjust during 2008, 2009, 2010, and 2011? The total number comes to 17% of GDP. One could always ask: could it be done differently? And the answer is definitely yes, and as we have seen in many countries, the preferable way has been, of course, raising revenues instead of cutting expenditures. In Latvia, two thirds of the 17% came from cutting the expenditures and one-third from raising the revenues. Of course the central bank's preference might be a little bit different; we probably would wish that more expenditure would have been cut, but surely there are certain limits. But believe me, very thorough, very precise inventory or revisiting of every single expenditure position was made. Let me remind you that central banks can still be quite vocal in advising what to do and, at the same time, safeguard our independence. The central bank also, in solidarity, cut its wage-bill and, on average, wages in the public sector were cut between 25% and 30%, in the private sector between 10% and 15%, and in the central bank around 40%.

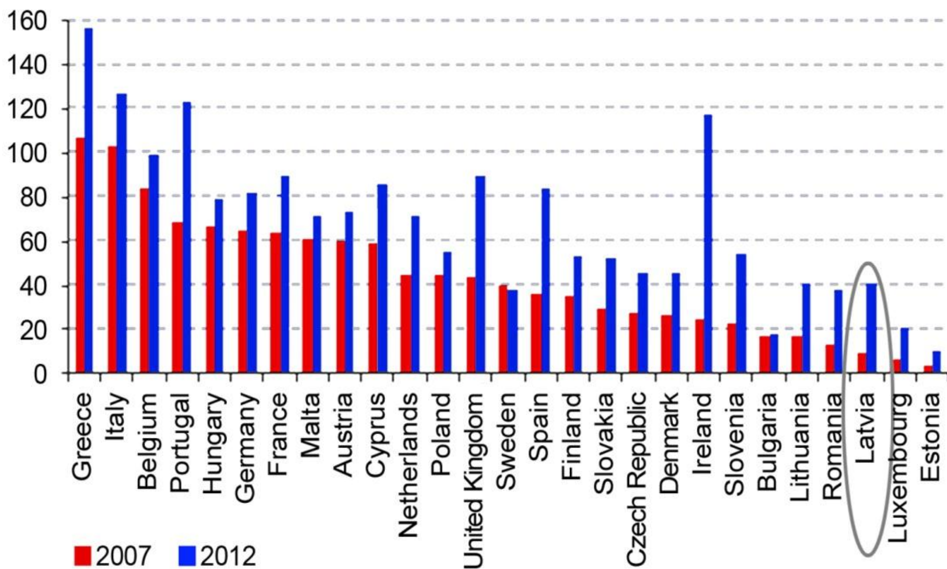
Chart 2. – General government budget balance (ESA'95), % of GDP



Source: Eurostat, Bank of Latvia, e - estimate

Speaking of the speed of consolidation, my colleagues have always told me not to use any strange examples, for usually we were talking about cutting the dog's tail, and doing it all at once, but they advised me to use a nicer picture. So we are also gardening, we have an apple orchard, and then those of us who do gardening know that if you are cutting out the unnecessary branches, then next year's harvest will definitely be much better, and the same thing goes for revisiting an expenditure ladder of the government. Believe me, in Latvia there were many unnecessary expenditure positions. Because in good times, you know, you just enjoy extra money which comes in the economy that is growing better than expected, and you just distribute extra revenue and do not think about crisis. Now, speaking of perspective. I think, definitely one of the crucial factors which I have to mention when Latvia entered the crisis in 2008-2009, our debt to GDP was one of the lowest – it was second or third lowest in Europe, somewhere around 11-12%. Today it is 40%. By and large we were helped by this unused space in potential borrowing. But needless to say, I think this is now the government's number one task to bring borrowing back to the previous low figures in order to prepare for a possible future crisis. Although we are not expecting that, I think that debt levels are really crucial because we know markets are smart, intelligent and they know when exactly the problems will come. And they, believe me, they analyse this type of graphs very closely and follow the developments.

Chart 3. – Government debt to GDP ratio in an international comparision



Source: Eurostat

As a matter of fact, this morning we heard statements that the IMF came, the IMF was dictating, the IMF was telling this and that. But that was not the case in Latvia. In Latvia, the Latvian government and the Latvian parliament really recognised that there is a problem and we have to do things on our own, and the IMF will not dictate to us what to do. So we grabbed the whole position to control it ourselves, there was a full commitment to get out of the woods as soon as possible. And there was also a wide and very broad involvement of all government branches and all society levels. So basically speed, commitment, ownership and solidarity; these are the four crucial elements. And speaking about competitiveness, you can see that the competitiveness gap, which developed in the very good years preceding the crisis, that gap has been closed and I think it is crucial that despite all good things, despite our euro area membership, that is very dear to us and will always be kept in mind as something which we have to watch and never lose.

Why the euro? To my mind, and also to the Latvian central bank's mind, there has never been any doubt about why the euro. I think you may have a different situation here in Hungary where there was an involvement with the Swiss franc. In Latvia, already from the early days of 2004 when Latvia became an EU member, there were a lot of loans in euro because people naturally expected that one day there will be euro membership, so 82% of the loans were already in euro, and almost half of the household deposits were in euro. And settlements too, almost 60% were in euro. So, I think it was just a natural move towards the currency which had already been widely used inside the country. I always ask the question: being pegged to the euro, what sense does it make to be outside the Eurozone? So therefore we clearly believe we have fully understood what it means to be a member of the euro club. We checked to see that this ship is very stable before stepping onto it so I would like to say that there were no doubts whatsoever. Those people who would like to see some doubts probably would agree that the year 2010 was indeed difficult and there was much nervousness around, but there is absolutely no doubt in my mind that Latvia's decision clearly shows that the Eurozone is the way to go.

Sometimes people would like to see potential benefits in figures. They would like to be very rational, in addition to being European, in addition to being just good European citizens. Simply a question – but what is there for me? Then in very simple terms I would say that not just because of the euro, but keeping the finances in good order and bringing not only your economic and financial ratios in line with the Maastricht criteria but maybe doing even better, and, on top of everything else, your eurozone membership gives you immediate effect; even the announcement that you are going to join, brings credit rating upgrades, at least two notches in a period of one year before and one year after, which is immediately reflected in the price of borrowing and the country itself could save a lot of money just on servicing the foreign debt.

And budget savings are important. I think knowing that a lot of loans were already in euro but payments and salaries were made in the local currency, many banks definitely profited from currency exchange operations. Thus, the banks were not too keen to join the euro as they would lose a lot of money, although sometimes people think that the banks and their interests were the driving force behind joining the Eurozone.

But of course, in crisis times, when we were just by ourselves in a small boat, the European Central Bank funding would definitely have helped us in 2008 and 2009. So now we are in the Eurozone and do not have these problems, but it is good to know that if something happens, the ECB is always there, as you have heard also this morning. And, of course, devaluation rumours are killed once and for all and neither businesses and politicians, nor bankers, central bankers in particular, are any more attacked and made nervous about what they have to do, like maybe they should resign in order to keep the currency stable or not.

Ladies and Gentleman, once again, thank you very much for inviting me here! That was all I wanted to say, and if there are questions I will be very pleased to answer them.

GYÖRGY SZAPÁRY

Ambassador of Hungary,
Former Deputy Governor of the Magyar Nemzeti Bank

Central bank responses to the crisis and what are the challenges of exit

(Paper based on the lecture given at the Conference)

THE TRIPLE CRISIS

The unfolding of the current crisis reminds one of an iceberg: first only the part that is above the water is seen, without noticing the big junk of ice that is hidden under the water. At the beginning of the crisis, only the tip of the iceberg was visible. Nobody would have thought that the subprime crisis will eventually turn into the most severe economic crisis in the post WW II period. We first just saw the tip of the private sector indebtedness: the mortgage boom and the serious leverage of the banking industry. We did not immediately see the bottom of the ensuing consequences, the extent of household indebtedness and of the financial sector's structural weaknesses and how much the private debt would be socialized and become the burden of governments, thus the burden of current and future taxpayers.

The current global crisis had a special distinguishing characteristic of being a triple crisis. It started as a financial crisis ("subprime crisis") and then turned into a full-fledged growth crisis. The low growth and high unemployment environment had a devastating impact, leading to the third leg of the crisis: a confidence crisis. This meant that even people who had the means to spend did not spend, exacerbating the fall in domestic demand across the advanced economies. The confluence of financial, growth and confidence crises explains the deepness of this crisis and is one of the main reasons of the slow recovery. Another reason for the languor of recovery is that the initial policy responses addressed the problems that were immediately visible (the tip of the iceberg). Only in a later stage did policy makers try to reestablish confidence by tackling the issues of strengthening the financial system and trying to deal with the debt vs deleveraging dilemma. In the following, I will briefly review the policy responses to the crisis of major central banks.

MONETARY POLICY RESPONSES OF FOUR MAJOR CENTRAL BANKS

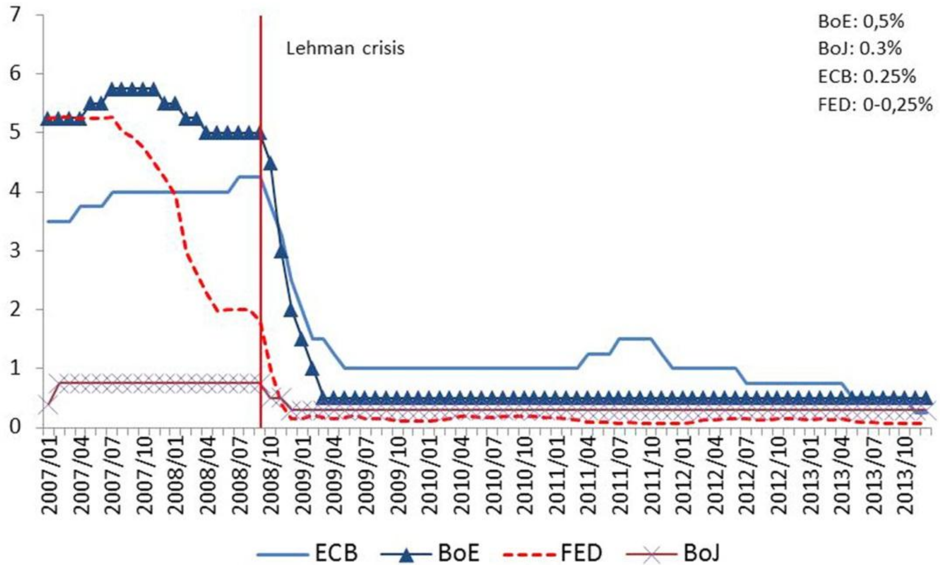
The responses of monetary policy authorities reflected the above mentioned characteristics of the crisis. During the first phase of the crisis, when only the tip of the iceberg was visible, central banks used conventional policy tools, including significant interest rate cuts and injection of liquidity into the most troubled parts of the financial system. In addition, central banks established FX swap lines in cooperation with other central banks to decrease currency volatility. Longer term swaps and repo operations were launched to address liquidity pressures in the mortgage and other asset backed security markets.

In the second phase, when the full scale of the crisis became visible, central banks started to use unconventional policy tools. First came qualitative easing by widening the collateral base through lowering the acceptable ratings of several securities and accepting illiquid instruments as collaterals (for example, municipality bonds). This was soon followed by quantitative easing, such as purchasing mortgage backed securities and government bonds in the secondary market.

In the US, the Federal Reserve even purchased mortgage backed securities directly from the mortgage agencies (Fannie Mae, Freddie Mac). In Japan and in the UK, the program was supplemented with other unconventional tools, such as offering direct loans to the banking system with the aim of increasing business investments, mostly in the SME segment (Bank of England’s Funding for Lending or Bank of Japan’s Loan Support Program). A similar loan support program (Funding for Growth Scheme) was launched by the Magyar Nemzeti Bank in 2013.

The Fed, the BoE and the ECB all sharply cut interest rates as turbulences hit the financial system and economic growth dropped. The BoJ also cut its policy rate, but from an already much lower level (Figure 1). By the first quarter of 2009, with the exception of the ECB’s main refinancing rate, central bank interest rates have practically reached the zero lower bound.

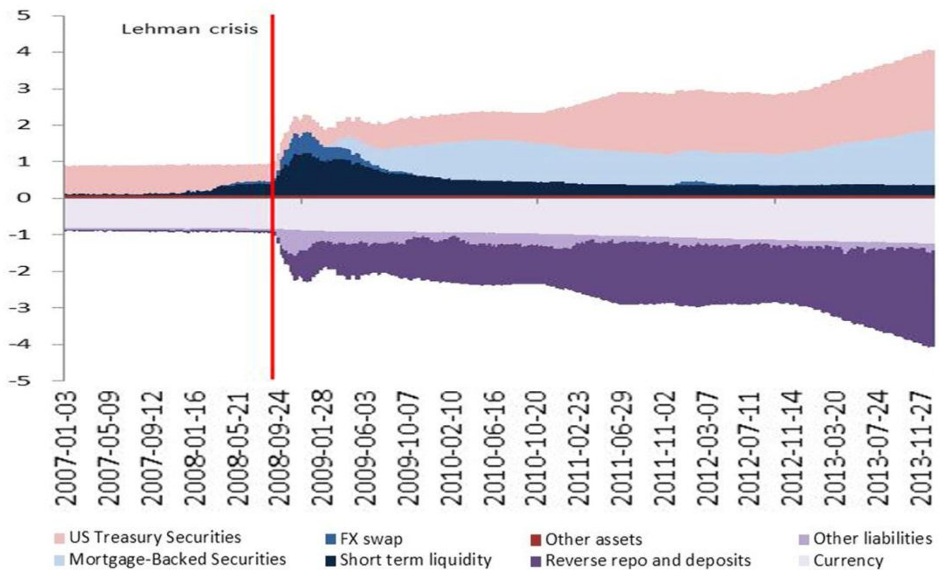
Figure 1. - Aggressive cuts in central bank policy rates (percent)



Source: central banks

As mentioned, when central banks realized the limits of conventional monetary policy tools, they started to use unconventional measures. The story of major central bank crisis responses can be analyzed by looking at their balance sheets.

Figure 2. - Fed balance sheet (trillions of dollars)

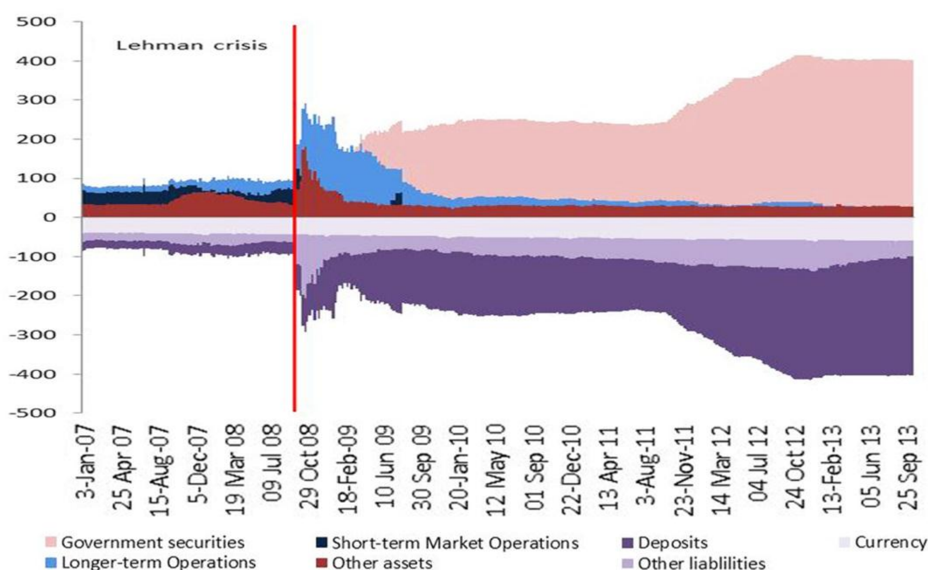


Source: FED

As shown in Figure 2, first the liquidity schemes, later the unconventional measures significantly increased the balance sheet of the Fed. US Treasury bonds became the largest component on the asset side followed by mortgage backed securities. The asset side increases were mirrored by an increase in commercial bank deposits.

The BoE's balance sheet reveals the same pattern (Figure 3). Government securities represent the largest increase on the asset side, while on the liability side an increase in deposits mirrored this change.

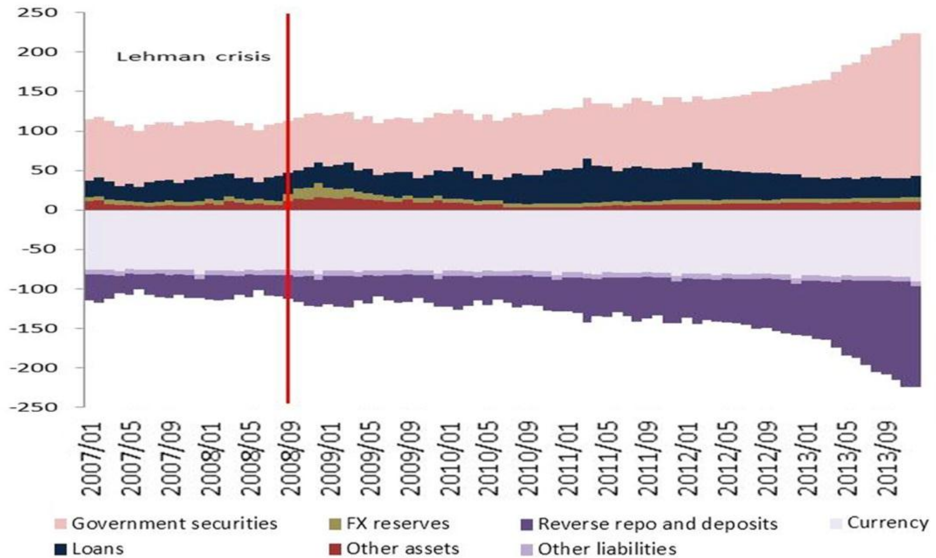
Figure 3. - Bank of England balance sheet (billions of GBP)



Source: BoE

The BoJ's balance sheet shows a similar development, but Japan's monetary authorities entered the crisis with a different starting position. The BoJ had already embarked on quantitative easing policies before the 2008 crisis. During the 2001-2006, after reaching the zero lower bound, the BoJ had already started asset purchases and had finished the program just before the outbreak of the subprime crisis. As illustrated in Figure 4, on the asset side of its balance sheet, government securities were the largest component even before the outset of the crisis. Its balance sheet remained relatively flat during the first years of the crisis and started to increase gradually and then more significantly after a massive quantitative and qualitative monetary easing was launched in April 2013.

Figure 4. - Balance sheet of the Bank of Japan (trillions of JPY)



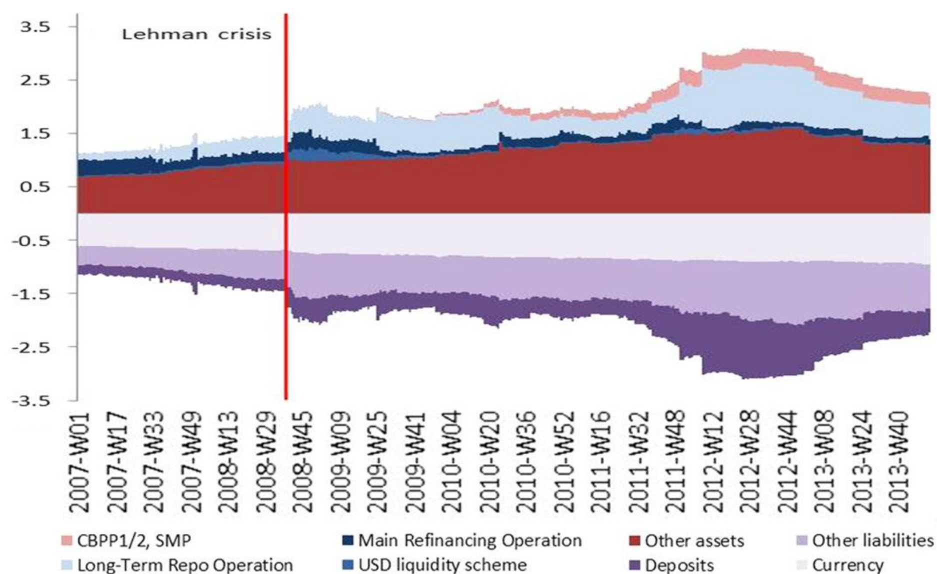
Source: BoJ

The case of the ECB was somewhat different. It did not use its balance sheet in a way the three other central banks did to deal with the crisis. Only during the second phase did the ECB introduce some quantitative easing with the aim of saving the government bond markets of periphery countries such as Greece, Spain and Portugal. In May 2010, following significant increases in the longer-term government bond yields in periphery countries, the ECB announced its Securities Markets Programme (SMP). The programme was aimed at addressing the inadequate functioning of securities markets and restoring the monetary transmission mechanism without changing the elements of the standard instruments. Under SMP, the ECB started to buy government bonds and other securities in the secondary markets. However, the program proved unsuccessful in avoiding further turbulences. As the Securities Markets Program was not efficient in decreasing periphery country government bond yields, the ECB started two 3-year long term refinancing operations. This was a crucial step to avoid a credit crunch in Europe in late 2011 and early 2012. Although these loans were mostly longer term, some of them have already been repaid to the ECB and thus its volume in the balance sheet has been shrinking since the end of 2012. Despite the 3-year LTROs and the asset purchases, South European countries, in particular, still had to face unprecedented high and increasing government bond spreads. The ECB aimed to correct the unreasonably high periphery yields and restore the impaired monetary transmission channel with a new instrument, the outright monetary transactions (OMT).

The program was announced in August 2012 - following the famous “whatever it takes” speech by Mario Draghi - and was launched in September 2012, concurrently with the termination of the SMP. For the time being, OMT should be considered as a verbal intervention only, as up until know the ECB has not bought any assets. Still, the intervention was very effective as short-term and medium-term government bond spreads of periphery countries decreased significantly after the announcement.

As Figure 5 shows, the ECB’s balance sheet also expanded, although to a lesser extent than those of the three other central banks examined. However, in the case of the ECB as well, the increase in the asset side led to an increase in deposits.

Figure 5. - Balance sheet of the European Central Bank (trillions of Euros)



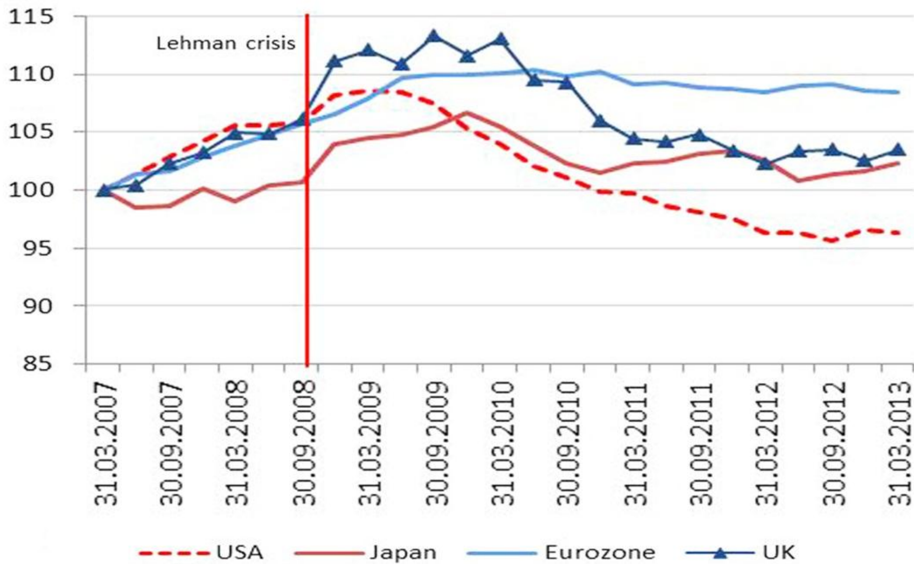
To sum up, between 2007 and 2013, as a result of the activist monetary policies, the Fed’s and the BoE’s balance sheet increased by almost 400 percent, while the BoJ’s and ECB’s balance sheets have approximately doubled. Overall, these measures together increased the global liquidity during this period by around USD 6,100 billion, equalling 16 percent of the regions cumulated GDP (USA, Eurozone, Japan, UK). The low inflation environment supported central banks to undertake this massive liquidity injection.

CREDIT GROWTH WAS SLOW

Despite the tremendous injection of liquidity, commercial bank lending to the private sector remained subdued (or falling in the US and the UK, Figure 6.), as most of the liquidity returned to the central banks as deposits of financial institutions. Stagnant credit growth has posed a difficult problem. The deleveraging of households, the weak position of financial institutions due to the losses incurred during the crisis, together with the weak confidence in the recovery all contributed to the sluggishness of credit. The actions of the central banks were nevertheless crucial because in their absence the credit would have shrunk more significantly.

Figure 6. - Credit growth remained slow

(Total credit to private sector in terms of GDP, relative change 2007Q1=100)

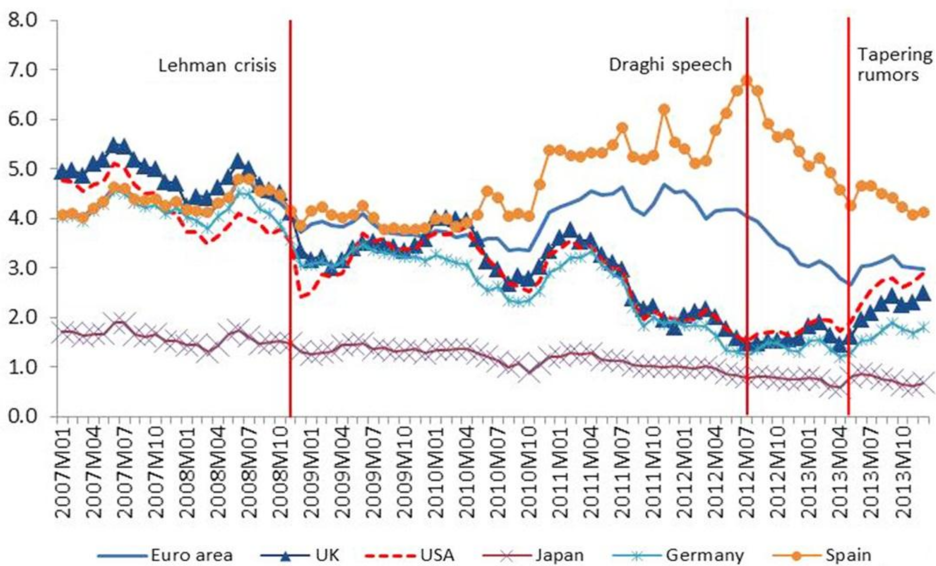


Source: BIS, Eurostat

LONG-TERM YIELDS REMAINED LOW

One measure of achievement of the policies of the central banks is that they were successful in keeping longer-term yields low. This was partly due to the fact that markets believed in the forward guidance policies of the Fed and BoE. In the case of the ECB, the OMT program's announcement had significant signaling effect that lead to the decrease of periphery bond yields. However, in May 2013, when the Fed first indicated that it might taper (slow down the rate of monthly injection of liquidity), long-term interest rate immediately increased. This experience underlines the importance of communication as central banks exit from monetary easing.

Figure 7. - 10-year government bond yields (percent)



Source: Eurostat

ISSUES OF THE EXIT STRATEGY

There are a few challenges worth mentioning that central banks may face while exiting from quantitative easing. One is how to avoid a sudden drawdown of bank deposits at the central banks which would fuel inflation when the economy rebounds. For central banks, the liability side management of the interest rate channel is technically more challenging than managing through the asset side. Central banks have of course the necessary instruments in their toolkit, but it is still a challenging question how to most effectively use them. Unforeseen relative asset price adjustment as liquidity is withdrawn is another challenge. In periods of abundant liquidity, economic agents are ready to invest in riskier assets, but when the perception is that liquidity might be reduced, they tend to return to less risky markets.

Recent episodes of emerging market exchange rate depreciation and reversal of capital flows following the first announcement of tapering by the Fed show what are the dangers when exiting from quantitative easing.

High levels of central bank balance sheets will likely remain with us for an extended period of time since only a gradual exit can be safely contemplated. Sooner or later interest rates will have to increase, however. As rates increase, asset prices fall, creating losses on the central banks' holdings of government bonds. Given the large holdings of government bonds, these losses can be very big for some of the central banks.

CONCLUSIONS

Central banks took risks by resorting to unconventional measures that led to a very large expansion of their balance sheets, but the risks related to inaction were even greater. It proved to be of crucial importance that the central banks examined could build on the credibility capital earned by the successes of the rule-based policies followed by them in the years prior to the crisis. Their credibility has been kept as economic agents believe that the central banks will eventually go back to some form of rule-based policies. There are new types of policy tools introduced, such as forward guidance that helps to anchor market expectations. The practice of better explaining future actions is crucial to a successful exit. When the time is right, central banks should go back to rule-based inflation targeting or some other sort of targeting regimes that are transparent.

JOSÉ LUIS MALO DE MOLINA

Director General for Economics, Statistics and Research
Banco de España

Convergence and Adjustment in the European Monetary Union

(Lecture given at the Conference)

Good morning ladies and gentlemen, and thank you to the Magyar Nemzeti Bank for having invited me to participate in this conference in honour of Alexandre Lamfalussy. I feel deeply honoured at having been asked to share with you some thoughts on the current situation of European monetary and economic integration. There are two powerful reasons why I accepted the invitation immediately.

Firstly, I sincerely believe that the monetary integration project would have been less vulnerable to the international financial crisis, if the pro-Europe momentum of the early European leaders – including most notably Alexandre Lamfalussy – had been maintained. Alexandre Lamfalussy as President of the European Monetary Institute (EMI), played a prominent role in making possible such a bold project. In the current critical times, it is more necessary than ever to recover the pro-European spirit and the analytical rigour of the advocates of the European project in order to address and to overcome our current complex problems.

Secondly, I thought I could contribute to this event by sharing with you some thoughts on the economic policy lessons that may be drawn from the experience of the Spanish economy within EMU. Our experience may be of use to other economies aspiring to join the euro.

The creation of the Economic and Monetary Union was one of the most ambitious steps of the European integration project. The introduction of a single currency and a single monetary policy and the institution of the European Central Bank, were true milestones in the project to create an integrated Europe.

At the national level, countries also had to undertake far-reaching changes in their economies to meet the nominal convergence criteria established.

The result of all these efforts was the successful launch of the euro. The first eight years of the euro saw a long phase of very intense growth across all the economies that started from a lower level of per capita income.

The success of the European project was particularly visible in real convergence, which progressed more rapidly than expected. However attention was not paid to the imbalances building up and to the weaknesses in the structure of European governance, which emerged abruptly as the crisis broke. These weaknesses were as follows.

First, national authorities did not take into account the fact that EMU was not a goal, or a final destination, but merely an intermediate stop on the road to a new reality that would require far reaching changes in the rules and in the institutional framework at both the national and European levels. Everyone was aware that when EMU was set up, the member countries did not fulfil the characteristics required to be an optimal monetary zone. But it was thought that the functioning of the Union would ultimately generate the incentives to move in that direction. It was expected that the disappearance of monetary policy and the exchange rate as adjustment instruments, would stimulate the introduction of structural reforms that would increase flexibility and adjustment capacity in the participant economies.

But the reality was very different. In most countries there was a lack of ambition regarding ongoing structural reform. And that, against a background of abundant financial capital and underpriced risk across the board, resulted in distortions in resource allocation and in the adoption of inappropriate models of growth.

Second, there were also flaws in EMU governance, which meant that the signs and warnings about the build-up of imbalances and divergences within EMU were ignored. Naive confidence in market mechanisms as the drivers of structural change finally resulted in a framework for the EMU governance with very limited mechanisms of monitoring and lacking of any real coordination.

The founding fathers of monetary unification were aware of the destabilising potential that fiscal imbalances posed within EMU. However, the difficulties that might emerge from persistent divergences in spending patterns and from current account imbalances and shortfalls in competitiveness were underestimated. The coordination of structural and macroeconomic policies was organized around a minimalist framework, based on the principle of mutual learning and peer pressure, which ultimately proved to be very ineffective.

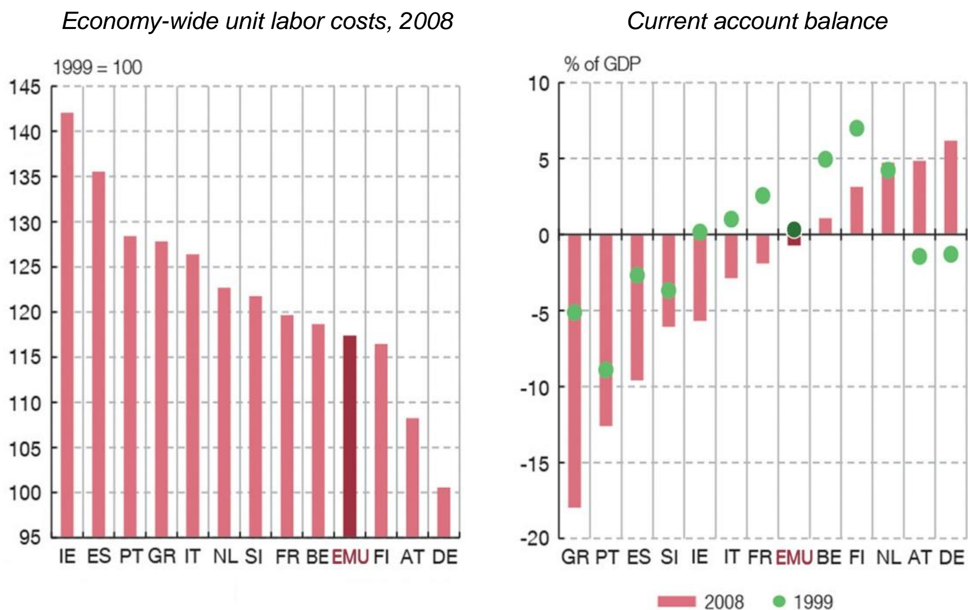
Lastly, the financial markets failed to exert the expected disciplining effect. The global underpricing of risk prevailing during the early years of EMU meant that funds flowed generously and without sufficient discrimination among the different borrowers. Despite the imbalances building up, risk premia remained at historically low levels in all the EMU economies. And also the macroprudential financial regulation and supervision mechanisms were lacking.

Once again Baron Lamfalussy, who constantly maintained a degree of scepticism about the functioning of the financial markets, was a pioneer in this area. He was the main architect of the BIS macro-prudential approach to financial stability.

As a result of the foregoing, the euro area countries accumulated imbalances in various areas that left them exposed to a perfect storm following the Lehman Brothers collapse. What began as a financial crisis soon was transformed into a competitiveness and balance of payments crisis in the economies evidencing the biggest structural shortcomings, while it left deep damage to public finances and private-sector balance sheets. Let me focus on each of these aspects.

As regards competitiveness, the reduction in funding costs for certain euro area economies following the creation of the euro and the enhanced expectations of growth boosted an expansion in private spending that was easily financed through external funding, against a background of generalised underpricing of risk. A large portion of these capital flows was not channelled towards productive investment, but to financing construction and real estate projects which had a very modest impact on the growth potential of the economy.

In this setting, the excessive expansion of expenditure led to continuing positive inflation differentials and to an increase in unit labour costs relative to the euro area average, as can be seen in the graph on the left hand side. The intensity of these mismatches was accentuated by the weakness of spending and the containment of costs and prices in some of the euro area economies with higher per capita income.



The case of Germany is relevant in this respect. The outcome was notable divergence in the current-account balances, as can be seen on the right. In those economies running deficits –including my own country – the prevailing interpretation was benign, playing down the importance of these imbalances, and considering them as a natural consequence of headway in real convergence. One example of this was the recurrent use of the Balassa-Samuelson hypothesis to justify the inflation differentials. This interpretation was in contradiction with the weakness of productivity in all these countries.

In the fiscal arena, the fiscal rules of the Stability and Growth Pact were absolutely insufficient to ensure the budgetary discipline needed in a monetary union. Most euro area countries did not take advantage of the economic boom years to properly redress public finances. In most cases, debt levels remained far above the reference value of 60% of GDP. And in those countries such as Spain and Ireland, which had low levels of debt in the early years of EMU, the improvements proved to be ephemeral, because they were based on an increase in extraordinary revenue from the real estate boom which was used to increase public spending instead of improving the underlying fiscal position.

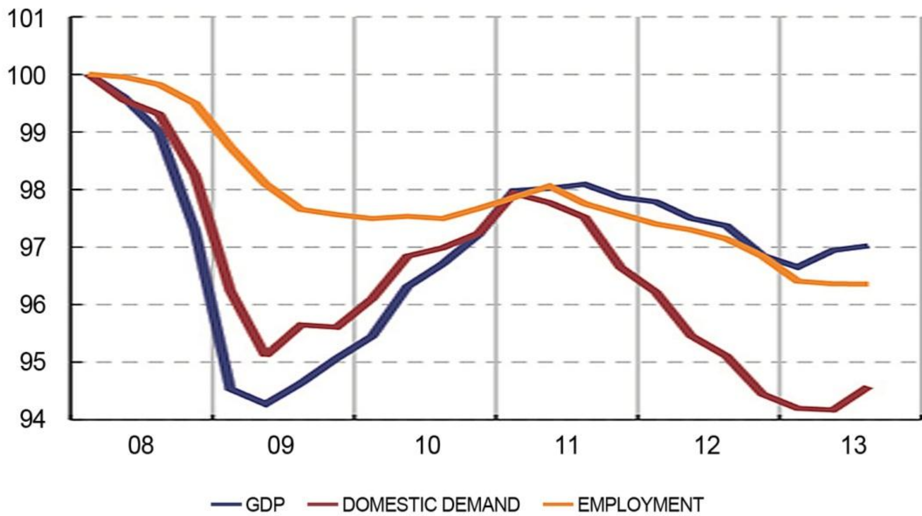
Lastly, private-sector debt levels also increased notably.

With the outbreak of the international financial crisis and the shortfall in financing, the high level of indebtedness became an important factor of vulnerability.

The correction of the imbalances was urgent but very difficult. Their scale and the inappropriate institutional setting favoured the emergence of negative feedback loops between economic growth and the necessary reduction in high debt levels and the clean-up of the banking system. In particular, the fact that supervision and regulation remained in national hands, meant that governments had to bear individually the restructuring and resolution costs of the financial institutions located within their borders. And that amplified the "diabolical loop" between sovereign and banking risk.

As the chart shows, the adjustment of the imbalances has severely impacted economic activity and unemployment in the euro area, and only in recent months has this begun to be reversed. The climate of mistrust led to the fragmentation of financial markets and triggered a balance of payments crisis in countries reliant on external funding. The situation was so serious in mid-2012 that it reached the point of calling into question even the continuity of the euro in its current form and introducing the so-called “redenomination risk”.

Euro area, GDP, Domestic demand and employment



Against this background, the economic authorities deployed all the tools at their disposal. Specifically, three major packages of measures were launched.

First, the ECB contributed to easing financing conditions both by the use of conventional tools, implementing a gradual reduction in rates down to practically zero and, above all, through the application of a broad set of non-conventional measures. From the outset of the crisis, the ECB applied a generous liquidity-provision policy for banks and, in 2012, when circumstances worsened to the extent that the continuity of the euro was in jeopardy, the ECB introduced the possibility of intervening in the public debt markets using Outright Monetary Transactions (OMT). This new instrument proved to be a powerful deterrent against speculative processes and tail risks.

In the absence of mutual insurance mechanisms to repair financial market fragmentation, the ECB had to assume such a heavy responsibility in defending the stability of the single currency. Nevertheless, it should be borne in mind that these measures were not able to tackle the true causes of the crisis and the imbalances; rather, they merely provide some time to be gained in order to allow the activation of the appropriate instruments by national governments and European authorities.

In this respect, European governments have deployed measures on two fronts.

At the euro area level, crisis-management mechanisms have progressively been introduced to provide financial assistance for the countries in most difficulty. The process has been long and complex but the entry into force of the European Stability Mechanism was a milestone in the ongoing design of the new European institutional architecture.

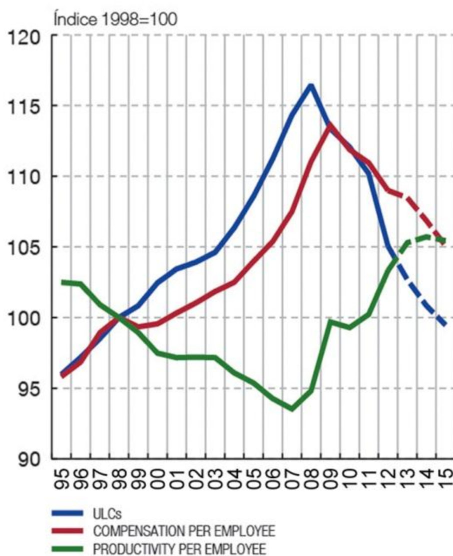
At the same time, European authorities have strengthened economic policy surveillance mechanisms. The key steps here have been: (i) strengthening of the Stability and Growth Pact, introducing the possibility of imposing sanctions on countries; (ii) widening of the supervision perimeter to encompass macroeconomic imbalances, with the introduction of the Excessive Imbalances Procedure; and (iii) the reform of micro and macroprudential policies, to remedy the flaws that had allowed excessive accumulation of risk.

But perhaps the most important step in order to curtail the negative feedback loops between sovereign and banking risk was the decision taken by the European leaders to address the construction of the Banking Union. The first pillar of this banking union has been the adoption of the Single Supervisory Mechanism, under the roof of the ECB. The SSM will be fully operational in November 2014. The relevant regulation has already been approved, and the ECB is very busy these days with the preparatory work needed. Initial steps have also been taken to establish the Single Resolution Mechanism.

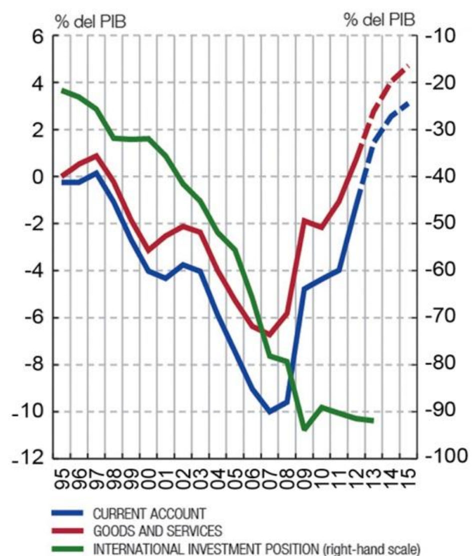
In any event, although making progress towards a more complete economic union at the European level is an important ingredient in the solution of the current problems, governments must be clear that, in a monetary union, national policies must be geared unambiguously to increasing productivity and ensuring the necessary flexibility. And that requires sustaining the public finances consolidation effort and greater ambition regarding the structural reforms needed.

Without the necessary flexibility, the adjustment costs that the correction of the imbalances in a monetary union entails are extremely high. The recent experience of the Spanish economy clearly illustrates this.

Spain: Relative ULCs compared with the euro area



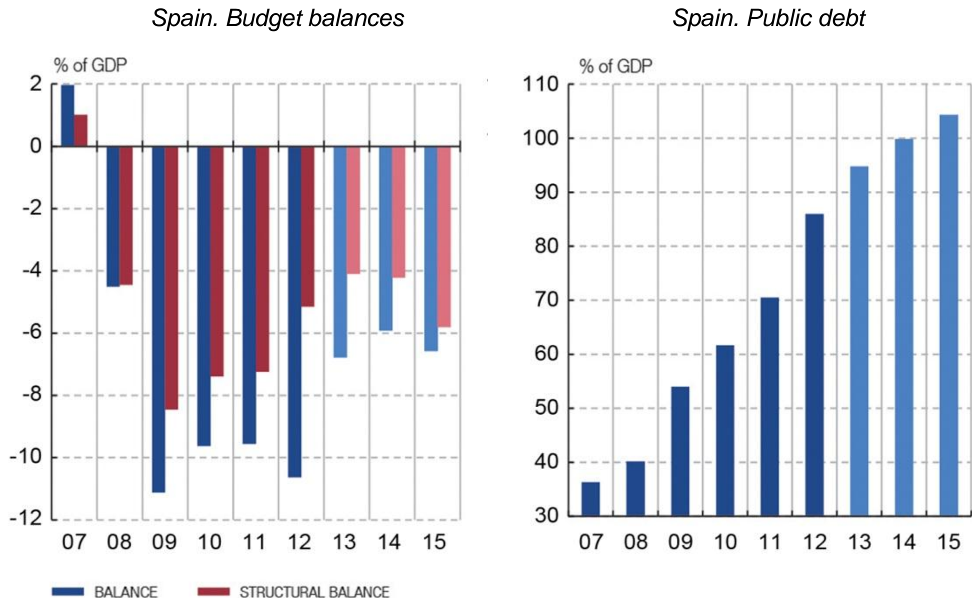
External balances and international investment position



As this slide shows, the Spanish economy is intensively pursuing the correction of its current account and competitiveness imbalances. Real exchange rates, measured by unit labour costs, have shown an improvement that practically offsets the deterioration suffered since the start of EMU, and the current-account balance has run a surplus, after posting deficits of close to 10% of GDP in the years prior to the crisis.

Following an initial phase in which the adjustment was mainly underpinned by a fall in domestic demand, there are visible signs of a genuine readjustment of competitiveness and considerable export buoyancy. Moreover, unlike events in past crisis episodes, when the improvement in competitiveness was based on a readjustment of the nominal exchange rate, the Spanish economy is undergoing an internal devaluation process based on wage and profit margins moderation. That said, the sharp correction in unit labour costs also reflects a pick-up in productivity resulting from ongoing job contraction.

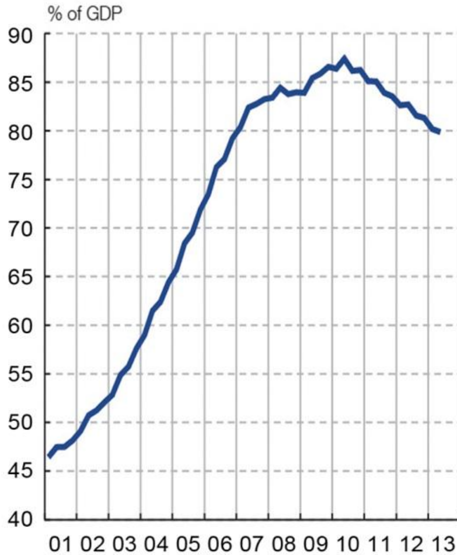
Yet the economy continues to show high levels of external debt, illustrating the challenges ahead in the coming years.



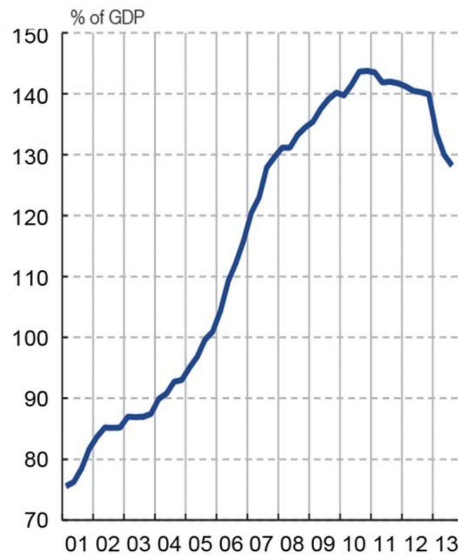
In the case of public finances, this slide depicting the general government balance in structural terms reveals the considerable fiscal consolidation effort made since 2009.

Even so, the deficit is still high, and debt levels have risen to over 90% of GDP as a result of the recessionary environment and the recording of the assistance to financial institutions.

Spain. Household debt



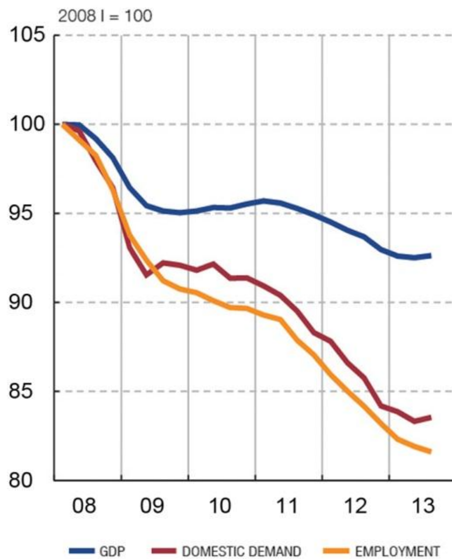
Spain. Non-financial corporations debt



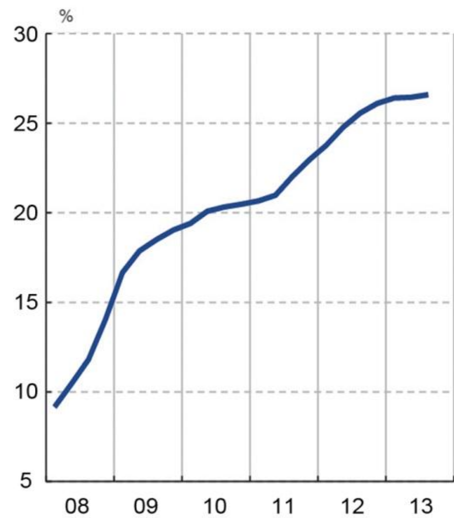
The ongoing deleveraging of the private sector is moving ahead at a moderate pace against a background of weak household and corporate income. A reduction in the real debt burden can be seen, but to make progress in the deleveraging process a period of credit contraction seems unavoidable. The clean-up, restructuring and recapitalisation of ailing Spanish banks was tackled under the financial assistance programme requested from the European institutions, which was successfully completed in late 2013. The healing undertaken by the Spanish banking system establishes a sound base for the continuity of the required external financing of the economy.

In any case, the significant adjustment made has been achieved at high costs in terms of growth and in terms of unemployment. After an unprecedented double-dip recession, the level of real GDP is now 7% below the level before the crisis. A clear difference would have been seen in Latvia. The level of employment has suffered a contraction of 17% during the crisis and the rate of unemployment has reached 26% of the labour force.

Spain. GDP, Domestic demand and employment



Spain. Unemployment rate



The Spanish experience is very telling. Macroeconomic divergences may have serious consequences if they are not addressed in time.

Accordingly, if, with a view to new monetary union members joining in the future, I had to summarise the lessons learnt in the case of the Spanish economy, I would highlight the following.
Firstly, the importance of a sustained convergence drive, beyond the efforts needed to meet monetary union entry requirements.

Secondly, it is crucial that countries should see the need for more disciplined fiscal policies and to progressively overcome structural rigidities in order to achieve an appropriate level of flexibility and capacity of adjustment.

Finally, the mechanisms being designed for the early detection and correction of imbalances must be rigorously implemented. The difficulties of correcting accumulated stocks of debt and restoring sustained growth underline the need to prevent the situation recurring in the future.

To conclude, I would like to offer you a Lamfalussy quote reflecting his conviction in European integration: "I don't accept the status quo, ... I think it is in Europe's destiny to be unified, and that it will be a good thing for Europeans and also for the rest of the world. It is a fact that is hard to prove, but in any case, it is an act of faith on my part" (Lamfalussy, 1971)". Hopefully, in the coming years it will be less of an act of faith and start becoming a reality.

IGOR DMITRIEV

Director of the Monetary Policy Department
The Central Bank of the Russian Federation

The euro from the Russian perspective

(Paper based on the lecture given at the Conference)

The single European currency has a great importance for the Russian economy, especially taking into account our close trade and financial links with European countries, and for the economy in the whole continent as well.

Since 1999 the euro has played a significant role in the development of economic relations both within and outside the eurozone. The euro's introduction led to a considerable reduction of foreign exchange risks, which had previously affected trade and capital flows between European countries. Since European economies are highly interdependent, this shift in risk perception was followed by a surge in cross-border investment within the region, which in turn resulted in faster GDP growth rates. The elimination of currency exchange fees contributed to a steady rise in cross-border trade volumes and accelerated the pace of electronic payment systems development in the EU.

Another benefit brought by the currency union was the creation of more stable and more efficient financial markets. The higher degree of competitiveness has brought down the costs of market operations, reduced financing costs and made financial services more common and affordable for ordinary citizens of the Union. It has also boosted economic activity in the region, since the access to cheap financing has become easier for businesses and their capability of attracting capital via IPOs has increased accordingly.

It should also be noted that one of the positive consequences of euro introduction has been the reduction in price differentials between various countries in the region. This should also lead to a reduced rate of inflation throughout the eurozone as companies increasingly compete with each other, and to increased quality of final goods and services.

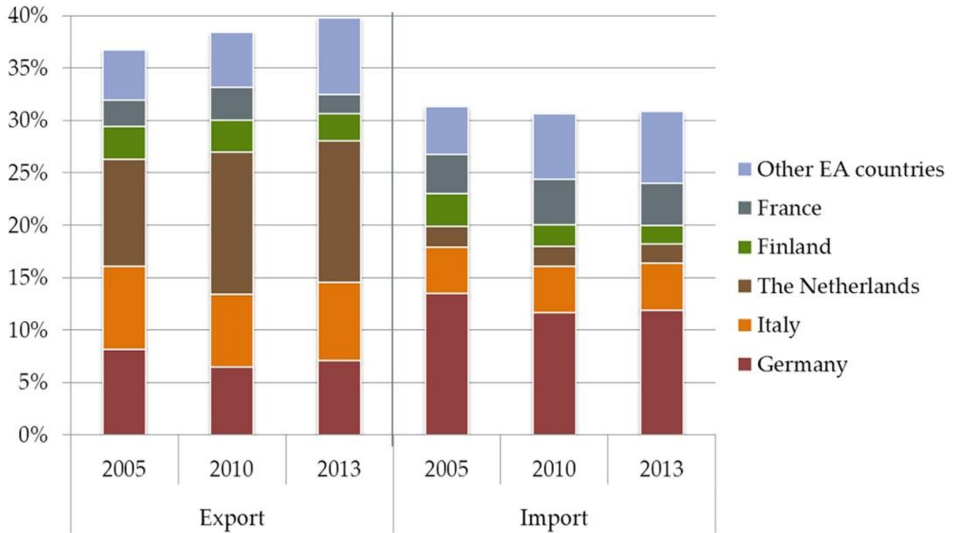
A reduced cost of financing for many companies and even whole countries-members of the eurozone has also been observed. This stemmed from the fact that sovereign and corporate bond issues offered lower yields and more liquid markets to their investors compared to the period when they were issued in the national currencies of the euro countries. Companies benefited from the creation of the single currency as they had access to cheaper external financing without any foreign exchange risks.

Moreover, banks found themselves in much more favourable conditions after the creation of the euro area since they were permitted to operate in a number of new areas and markets without the need to follow previous capital flow limitations.

Overall, the introduction of the euro as a new single currency has facilitated internal competition in the euro area and intensified capital flows, which gave an impulse for further economic and financial integration. Currently the euro is the third global currency servicing the trade and financial turnover, surpassed by the US dollar and the yuan. The use of single currency provides European countries with certain advantages such as: elimination of foreign exchange risk related to exchange transactions, lower transactional costs of international trade operations, convergence of inflation and interest rates' levels among the countries. Moreover, common currency and removal of technical and legal barriers in the euro area allowed the creation of a single large and liquid financial market. The measures currently being undertaken to intensify further financial integration and establish the Banking Union in the eurozone will strengthen the above-mentioned positive trends.

Nowadays, the eurozone is Russia's most important trading partner. The share of the euro area countries comprises about 40% of total exports and about 30% of total imports, which exceeds the share of the Commonwealth of Independent States (CIS) and Asia-Pacific Economic Community (APEC) countries. Russia's main trading partners among the Eurozone countries are Germany, the Netherlands, Italy, and France. EU exports to Russia are dominated by machinery and transport equipment, chemicals, medicine and agricultural products. The Russian Federation supplies a significant volume of fossil fuels and is the largest exporter of oil and natural gas to the European Union. According to the data compiled by the Bank of Russia, about 66% of Russia's crude oil exports and 63% of its natural gas exports come to the EU. Germany is the single largest importer of Russian oil and gas, while the UK imports about 6% of Russia's gas. Other raw materials are also widespread among Russian export to the EU. According to the European Commission, over 54 percent of the EU's total regional energy consumption in 2010 was imported from outside the EU, and a large percentage of this imported energy, including about one-fourth of the oil and gas used in Europe, originates in Russia. The EU's energy dependency rate is set to rise to 80 percent by 2035 from the current 60 percent, according to the International Energy Agency. Gas from Russia accounted for almost 32 percent and oil for about 35 percent of the bloc's imports in 2010, according to EU data. Undoubtedly, entry of new members into the economic and monetary union forms the basis for further expansion of the euro's role in Russia's foreign economic relations, but a lot must be done for this relationship to be further strengthened and special attention should be paid to resolving any diplomatic and trade tensions which may arise.

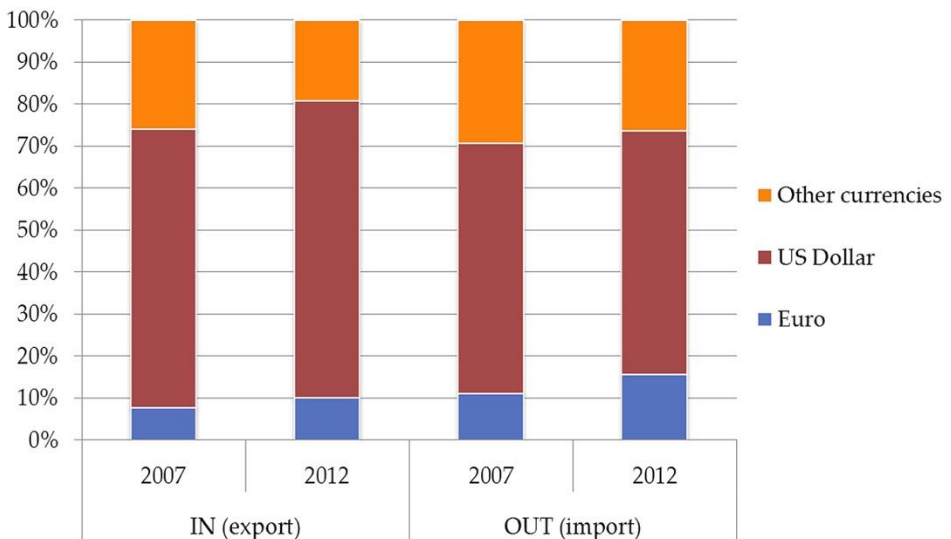
Chart 1. - Share of European countries in Russian foreign trade



Despite close trade and financial links, a major part of Russia's foreign trade contracts is still largely denominated in US dollars. This can be attributed to the significant share of energy in Russian exports to the European countries. Standardized energy contracts in the global market are traditionally settled in US dollars.

The share of the euro as a means of payment in Russia's international operations has increased over time, but remained low in general compared to the US dollars.

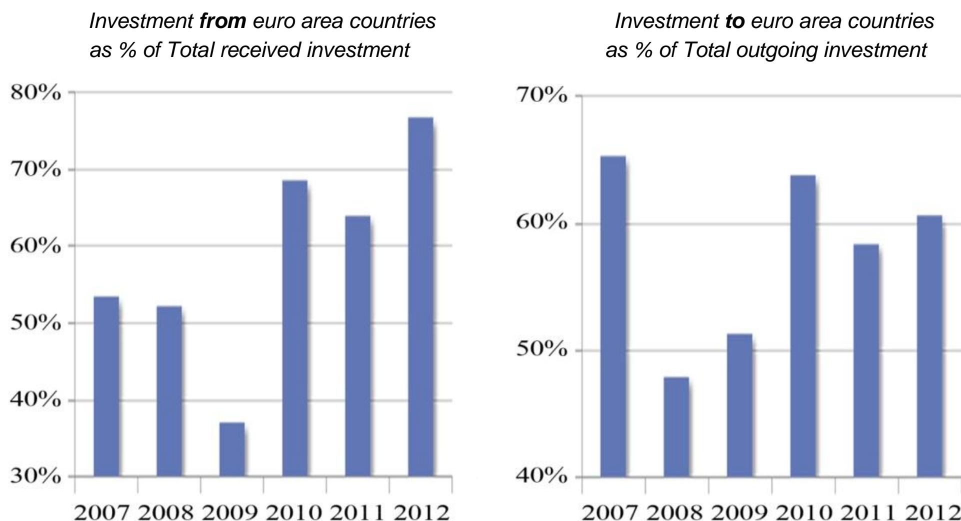
Chart 2. - Currency structure of Russian foreign trade and financial operations



It is important to note that euro is not the only currency which has good chances to become world's most used in international trade and finance. Actually, according to the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the Chinese yuan surpassed the euro in October 2013 and became the second most widely used currency in the world. The share of the yuan in trade finance operations grew to 8.7% in October up from 1.9% in January 2012. The renminbi is now ranked behind the US dollar, which had a share of 81.08 percent, while the euro's share dropped to 6.6% in October from 7.9% in January 2012. The yuan itself appreciated 2.3% against the US dollar in 2013 and was the best performer among Asian currencies. The recent Crimean crisis and the possibility of sanctions being introduced makes it more likely for the yuan to replace the euro as a second most important currency in Russian external trade operations. If a number of European countries decide to introduce severe sanctions curbing Russian external trade and investment flows with Europe, Russia will have to readjust its export operations and focus mostly on Asian countries. This may lead to the yuan squeezing the euro out of Russian trade settlement and adversely affect demand for the single currency.

The European Union is not only Russia's most prominent trading partner, but it is the most important investor in Russia as well. The geographical structure of foreign direct investment inflows and outflows reflects the importance of the Eurozone countries, which account for over 75% of total FDI to Russia and about 60% of investment from Russia. Nevertheless, a large part of investment goes to offshore or semi-offshore countries.

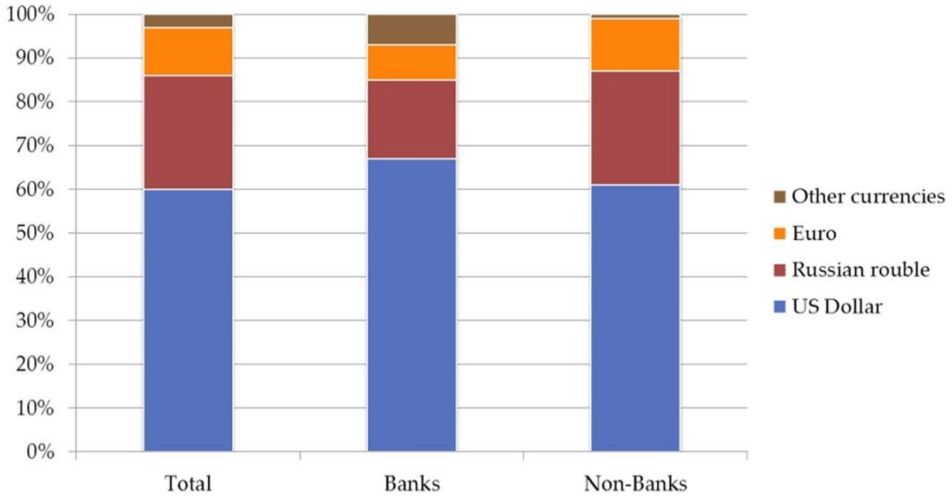
Charts 3. and 4. - Investment ties with euro area countries



The euro also has a significant share in Russia's external debt currency structure. The share is larger for non-financial organizations, but the dynamics of the currency structure of Russian banking sector's foreign assets and liabilities reflects increasing

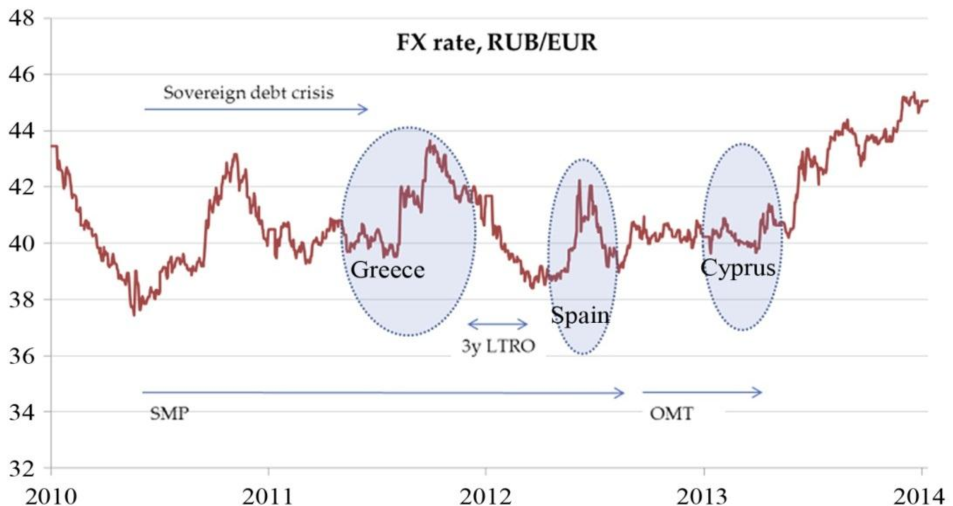
importance of the euro: the share of euro-denominated assets increased from 7% in 2002 to 17% in 2011 and the share of euro-denominated liabilities – from 5% to 11%.

Chart 5. - Currency structure of Russia's external debt



The recent developments in European financial markets, related to the sovereign debt crisis, have had a considerable impact on the Russian financial market and the economy as a whole. Instability in the European market led to massive capital outflow from Russia and downward pressure on the rouble exchange rate. In this context, measures taken by the ECB helped to restore market confidence, stabilize financial markets, lower global investors' risk aversion, and reduce volatility in the forex market.

Chart 6. - RUB/EUR exchange rate dynamics

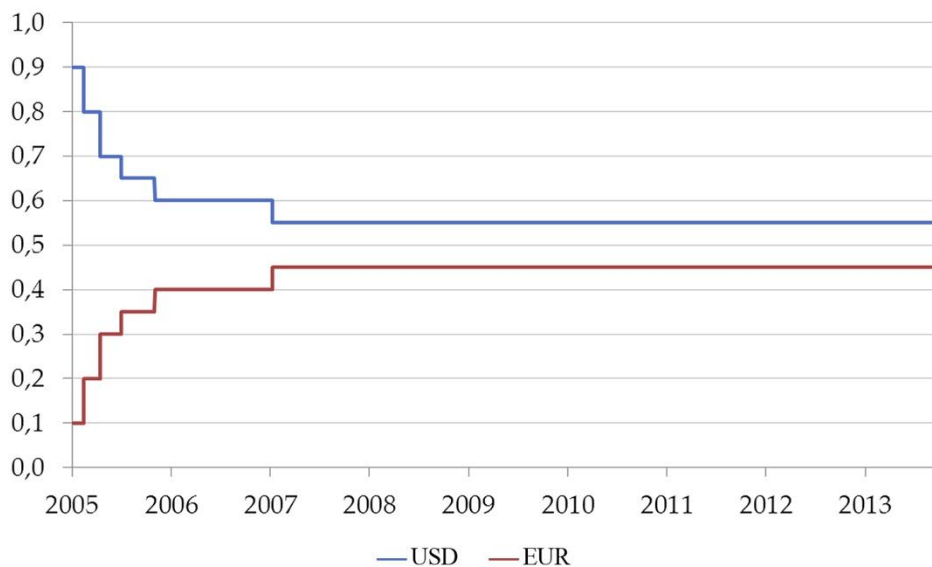


Starting from 2005, the Bank of Russia has been using the rouble value of the dual-currency basket, which consists of the US dollar and the euro, as an operational indicator of its exchange rate policy. Previously, foreign exchange interventions were conducted only in the ‘rouble-US dollar’ segment. The share of the euro in the dual-currency basket expanded over time, reflecting the growing importance of the euro in foreign economic operations and the development of the euro-segment of the domestic forex market. Since February 2007, the dual-currency basket has comprised of 0.45 euros and 0.55 US dollars.

The euro and euro-denominated assets play a significant role in the Bank of Russia’s foreign exchange reserves management. The euro accounts for about 40% of Bank of Russia’s foreign exchange assets, exceeding 130 billion euros in absolute terms.

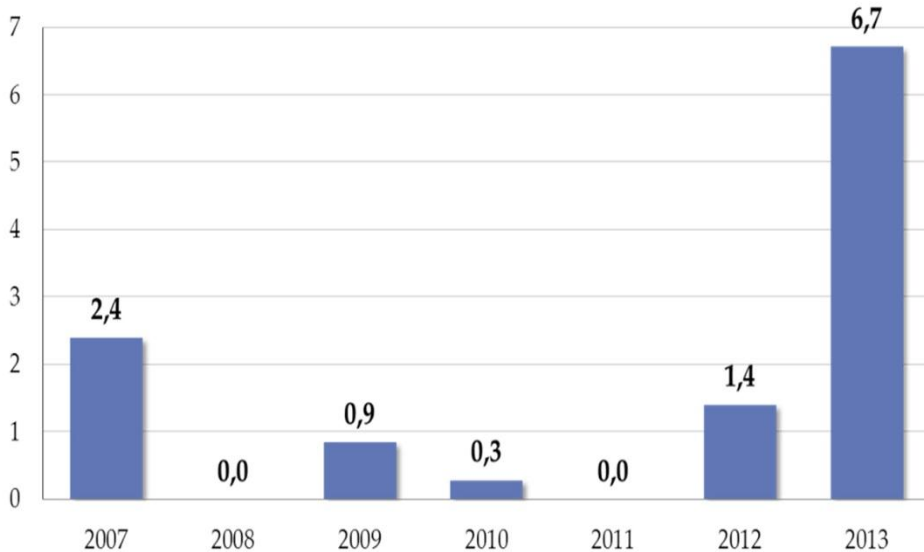
Dual-currency basket: share of the euro increased from 10% to 45%. Share of EUR in FX reserves structure as of 31/03/2013 was about 40%.

Chart 7. - Dual-currency basket composition



After a considerable reduction of euro-denominated debt issuance by Russian companies in 2008-2012, the European market opened again for Russian borrowers last year. Total euro-denominated bond issuance by Russian companies in 2013 stood at 6.7 billion euros, while the government’s borrowings amounted to 750 million euros.

Chart 8. - Role of the euro area capital market
Value of euro-denominated eurobonds issued by Russian companies



Recent developments in Crimea pose a threat to economic stability in the region. After Crimea voted to join the Russian Federation, many western countries, and some European states among them, started talking about implementing political and economic sanctions against Russia. Some of them have actually introduced modest sanctions already, which include visa bans, suspension of talks on a number of international treaties and skipping the G8 summit, which was to be held in Sochi.

If they are actually imposed, further western sanctions on Russia may have a serious impact on the economic stability both in Russia and in the EU. The EU ranks as Russia's number one trading partner, accounting for 41% of all trade. Russia is the third most important trading partner for the region behind the USA and China. Trade between the two economies has been growing steadily and reached record high levels in 2012. In case of sanctions Russia will have to switch to other trade partners on the other side of the globe.

The Russian economy accounts for approximately 3% of the world's gross domestic product. Russia generates a considerable volume of demand for European products from such countries like Germany, Italy and France. The absence of normal trade and economic relations with Russia essentially means losses for these countries.

Russian external long-term debt amounted to $632 billion in the third quarter of 2013. $250 billion of debt is owned by foreign banks, of which $180 billion pertains to European banks. Approximately $184 billion of debt was issued in the form of Eurobonds, 35% of this is owned by American investors and most of the remaining part falls to the share of European investors.[*]

Since Russia has close trade and financial ties with the EU, economic sanctions of any kind will likely hurt both sides. However Russia can be deemed to be in a comparatively more advantageous position because as a supplier of goods and resources it can readjust its trade and finance operations towards Asia and the rest of the BRICS. The EU in turn will have to find a replacement for Russian energy imports, which can be hard and costly taking into account the considerable share of Russian-originating resources in total European consumption. This may considerably diminish the role of euro in foreign trade settlement and curb investments coming to Europe as well.

Overall, the euro's role for Russia is quite significant at the moment. However, it probably still does not fully reflect the depth of economic ties between our countries. This situation indicates that there is high potential and prerequisites for expanding the use of the single European currency in our foreign economic relations.

We also attach great importance to the close cooperation, which exists between the Bank of Russia and the ECB. Since as early as 2003, we have been implementing a number of joint programmes of staff training and experience sharing. In 2012, the Bank of Russia and the ECB signed a three-year Memorandum of Understanding, which implies a number of seminars on monetary policy, banking supervision and financial stability, as well as holding annual meetings and conducting joint research projects.

[*] Morgan Stanley estimates

THE
LAMFALUSSY AWARD
2014

Lamfalussy
Award

MAGYAR NEMZETI BANK

THE LAMFALUSSY AWARD

The Lamfalussy Award was established by György Matolcsy, Governor of the Magyar Nemzeti Bank, in 2013 to recognise internationally outstanding professional achievements and life works with a profound influence on both the operation of the MNB and on international monetary policy. The award ceremony also offers an opportunity for the MNB to draw the attention of the community of international economists and economic policy makers to Hungary and its role in transforming economic attitudes and economic policy itself. The figure of Sándor Lámfalussy – after whom the Award was named – symbolises the importance of Hungary's role in international economic processes.

The Award was first awarded by the MNB's Governor on 31 January 2014.

The Lamfalussy Award is given to persons of international acclaim, whose outstanding professional achievements in economics and finances, scientific publication or training activities have a major and lasting influence on the development of monetary policy, economic sciences and the professional community – both in Hungary and on a global scale.

In 2014, the Lamfalussy Award was presented to Ewald Nowotny, an authority on economics of international renown, who is currently Governor of the Oesterreichische Nationalbank and a member of the ECB's Board of Governors, and former professor and deputy rector of the Vienna University of Economics. Having precisely understood the emergence of problems leading to the global crisis, and the imbalances in the EU's peripheral countries, Governor Nowotny made serious efforts through his public appearances and way of thinking to actively shape the paradigm shift occurring in European economic policy, in the course of which he became one of the most prominent figures in the European financial system. Ewald Nowotny is a true role model for the universal, responsible economist. He is an excellent practical expert and a responsible decision maker, one who can and will properly govern and influence the financial future of his country and the European Union as a whole. However, in addition to being a financial expert and central bank governor, he is also an economic policy maker who dares to say what he thinks even if it goes against the grain. Last but not least, he is both an author and a scholar, a thinking scientist and a university professor teaching future generations, whom he truly cares about.

2014 AWARD RECIPIENT

EWALD NOWOTNY
Governor
Oesterreichische Nationalbank

Ewald Nowotny is the Governor of the Oesterreichische Nationalbank (OeNB) and a Member of the Governing Council of the European Central Bank (ECB).

Before taking on his current position in September 2008, Ewald Nowotny held a number of high-level positions in financial institutions. He was CEO of the Austrian BAWAG P.S.K. banking group from 2006 to 2007, served as Vice-President and Member of the Management Committee of the European Investment Bank (EIB) in Luxembourg from 1999 to 2003, and, between 1971 and 1979, was first a Member and then President of the Governing Board of Österreichische Postsparkasse (P.S.K.). Moreover, from 1992 to 2008, Ewald Nowotny served on the supervisory boards of several banks and corporations and was a member of the OeNB's General Council from 2007 to 2008.

Ewald Nowotny was born in Vienna, Austria, in 1944. He studied law and political science at the University of Vienna and economics at the Institute for Advanced Studies (IHS) in Vienna. In 1967, he received his doctorate in law from the University of Vienna.

Ewald Nowotny becomes a Member of the Board of University Board of the Vienna University of Economics on the 2nd of April 2013.

THE
POPOVICS AWARD
2014

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MAGYAR NEMZETI BANK

THE POPOVICS AWARD

The Popovics Award is named after Sándor Popovics, the first outstanding Governor of the Magyar Nemzeti Bank. It is awarded to young Hungarian economists who through their achievements in both academia and industry have made an outstanding contribution to achieving the MNB's objectives and its success, both domestically and on the international stage.

In 2014, the Popovics Award was awarded to Márton Nagy, Managing Director of the MNB, who played a major role in the shaping and development of the Hungarian financial system. As a central banker, he greatly contributed to the success of the Funding for Growth Programme and was actively involved in the integration of the Hungarian Financial Supervisory Authority into the MNB. Mr Nagy also became one of the key opinion leaders affecting public thinking regarding the nationwide issue of household foreign currency loans.

2014 AWARD RECIPIENT

MÁRTON NAGY
Executive Director of Financial Stability and Lending Incentives
Magyar Nemzeti Bank

Mr Márton Nagy has been Executive Director of Financial Stability and Lending Incentives of the Magyar Nemzeti Bank since March 2013. He is a member of the Financial Stability Board and the European Banking Authority.

He earned his degree in economics at Corvinus University of Budapest in 1999. Between 1998 and 2000, Mr Nagy worked as an analyst at the Government Debt Management Agency. In the following two years he was chief economist of ING. He joined the MNB team in 2002.

The main fields of his research are bank competition and efficiency, pricing of bank products, sustainable lending and the U.S. subprime mortgage crisis. His professional publications regularly analyse challenges to the financial system. His professional activity is mainly focussed on the easing of SME's financing difficulties and the solution of households' foreign currency problems.