Lamfalussy Lectures Conference

NEW NARRATIVE FOR EUROPE AND FOR THE MONETARY UNION AFTER THE CRISIS

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

Budapest, 2 February 2015

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FOREWORD

by György Matolcsy

The global financial crisis that began in 2007 and intensified in the autumn of 2008 left its imprint on the economies of the world. More than six years after the bankruptcy of Lehman Brothers, global economic growth remains moderate, and among the most important economic regions particularly subdued economic performance can be observed in the EU. According to the latest GDP data, by the end of 2014 economic output had not yet reached pre-crisis levels in 13 out of the 28 Member States of the EU. In recent months, deflation has become an increasingly common phenomenon. The lending activity of the banking system is very moderate, while unemployment has stalled at a permanently high level and now threatens more and more serious long-term economic and social consequences. All in all, we can conclude that although Europe has passed the acute phase of the crisis, the subsequent recovery period remains slow and handling this still requires the special attention of today's economic policy-makers.

After the outbreak of the crisis, an extensive debate started among economists as regards to the composition of economic policy that should be followed in crisis management. A general consensus emerged in favour of loosening the monetary policy orientation, but positions varied widely in terms of the structure to strengthen the corrections in the extent, timing and structural reform of budgetary adjustments. As different countries followed different crisis management recipes, a detailed analysis of trends in the period since the crisis can provide useful information for developing a new narrative that can strengthen Europe in the context of global competition. Since I have been a part of this debate personally, first as Minister for National Economy and then as Governor of the central bank, by way of introduction allow me to mention a few perspectives based on the Hungarian experience that can address some of the central issues in our conference.

Now six years later, it is obvious that the world has passed through a unique, highly complex, or we could say a non-traditional depression. It has quite rightly been said in recent years that we fell into a synchronised debt crisis in 2008/2009, which was followed by a protracted balance sheet adjustment period. Synchronisation appeared in two dimensions: on the one hand, many economic agents in different economies were simultaneously struggling with an unsustainable debt crisis, while on the other hand most developed economies were forced to adjust their financing position at the same time. In addition to this synchronisation, an anaemic demand environment developed, which required particularly judicious and prudent intervention based on both real economy and social policy considerations.

In the case of Hungary, as in the case of many other European countries, the effects of the crisis resulting from the global environment and unsustainable debt situation were exacerbated by increasingly evident structural deficiencies in the economy. Following the crisis, in relation to the most dominant growth driver, the accumulated debt, Hungary more closely resembled the euro-area periphery economies rather than the economies of the countries of the Central and Eastern European region. Economic stabilisation started in 2010, and at the same time its aim was to address both the financial and structural problems in the economy.

Based on purely statistical data, Hungarian crisis management succeeded in stabilising the economy. The significant current account deficit as the previous cause of Hungary's vulnerability changed to a persistent surplus, and the budget deficit has consistently remained below the Maastricht threshold. The ratios of both general government gross debt and net external debt to GDP are on a downward path. Despite a significant, approximately 7% recession in 2009, economic output reached the pre-crisis level by the end of 2014, and the number of people in employment substantially exceeded the pre-crisis level. The investment rate has risen significantly in recent years, and consequently – in addition to the labour market – the increasing accumulation of capital also points towards a rebound in potential growth. In all areas, these indicators are more favourable than the data collected from other southern European economies using different forms of crisis management.

The key to success lies in decisive structural reforms, in coordinated behaviour of economic policies and sharing the burden resulting from crisis management. Launching structural reform programmes usually results in a slowdown in growth over the short term, which can easily lead to lasting economic losses in a generally demand deficient economy and weakening of the social support that is essential for the introduction of such reforms. Therefore, taking into account the characteristics of the crisis behind us, we only have a chance to achieve successful reforms when a method of sharing the burden of crisis management is implemented which takes into account the burden-bearing capacities. Furthermore, in our closely integrated world, in order to maximise the long-term benefits of reforms, it is necessary at the national and international level to harmonise the budgetary, monetary and regulatory policies, of course only within the framework of meeting primary mandates. Following these principles, in recent years Hungarian economic policy has reduced taxes on labour, increased labour market flexibility, restored monetary policy transmission and strengthened the effectiveness of supervisory activities.

Appropriate transformation of the institutional system of conditions in the medium term may help prevent future crises and possibly cushion the consequences. Drawing on experience from the crisis, reforms should target the fundamental transformation of the institutions in place before the crisis. I would like to draw attention to three of these areas. First, the balanced budget and fiscal stance, second the position of the labour market, and finally regulation of the financial system. As demonstrated by the Hungarian experience, in the absence of adequate fiscal room for manoeuvre in a crisis, it is almost impossible to support aggregate demand. Therefore, there is a need for new regulations during good times which will not allow excessive deficits, so that during a crisis they will provide adequate room for manoeuvre to support the economy.

In the labour market, it is essential to boost employment despite a weak demographic outlook. In addition to restructuring the tax and benefits system, strengthening productivity requires a renewal of the education system. Finally, as we have seen before the crisis, the financial intermediary system may suffer from serious systemic problems, despite stable growth and low inflation. These problems only can be prevented in the future by enhancing supervisory powers as well as applying micro- and macroprudential policies which are harmonised with monetary policy.

I hope that the valuable lessons learned from Hungarian crisis management can contribute to the design of the new narrative needed for the future of Europe. Of course, in contrast to national crisis management, the creation of a new institutional framework for the EU or the euro area requires cooperation between Member States, making this challenge even more complex, although the basic conditions will prevail at the international level. Europe is only able to successfully engage for the long term in increasingly fierce, global economic competition with an active approach, coordinated and pragmatic economic policies, the appropriate distribution of responsibilities and risks along with stable institutional systems.

LAMFALUSSY LECTURES CONFERENCE

BENOÎT CŒURÉ

Member of the Executive Board
European Central Bank

Lamfalussy was right: independence and interdependence in a monetary union

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

Summary

Decision-makers in different policy areas act independently and are at the same time interdependent. Managing interdependence requires a strong framework: "monetary dominance" is the framework in the euro area in which the central bank acts in independence and fiscal policies are constrained in the SGP.

The crisis in Europe has shown that policy interactions can be more subtle and also involve financial and structural policies. Monetary policy becomes more effective in impacting the real economy if other policies act in support. If not, it has less impact and expansionary policy has to last longer.

An example for interdependence between monetary and financial policies (micro level) is that if supervisors show too much forbearance to undercapitalised banks, central bank funding may end up being used to fill the gap. Fiscal policies can also become overburdened, if they need to smooth the economic cycle and at the same time stabilise the banking sector. Banking union has been one answer to the crisis. European supervision helps align the governance of the financial sector with the aims of monetary policy. And the resolution leg creates rules that limit the link between fiscal policies and the banking sector; bail-in replaces bail-out by governments and taxpayers.

The interaction between structural reforms and fiscal policies is clear: if product and labour markets are resilient and flexible, there is less need for fiscal intervention. Constantly refining fiscal rules while leaving structural policies at the national level makes little sense. If fiscal policies are to be freed from structural dominance, a strong framework for both is needed. Today, structural reforms are their own reward. Tomorrow, sovereignty over structural reforms should be shared between countries, allowing for symmetric risk sharing.

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Ladies and gentlemen,

Let me begin by reiterating my appreciation for receiving the award in honour of Alexandre Lamfalussy, and my pleasure to be here in Budapest today.

What I want to talk about this morning is a theme in which Lamfalussy himself took great interest, which is the interaction between policies in the euro area. In fact, in the Delors Committee, where he was an independent expert, Lamfalussy was one of the foremost proponents of the view that policy interactions in a monetary union had to be governed by a proper framework, and not just left up to ad hoc coordination and market discipline.[1]

My main argument today is that Lamfalussy was right – and in more ways than even recognised. A monetary union creates complex interactions which have to be governed by a strong and comprehensive framework. Many of these interactions we have only really understood thanks to the crisis. And in crucial areas, such as structural policies, we have still not adequately responded.

1. Independence and interdependence between policies

In any polity there is always a tension between economic policies. On the one hand, decision-makers in different policy areas act independently. But on the other, they inevitably have to take into account what the others are doing – they are interdependent. This is an inherent struggle which, if left to itself, can produce outcomes that no party really wants.

For example, central bank independence is a necessary condition for monetary policy to focus on its core price stability mandate. It is an essential feature of Europe's constitutional order and puts the onus on governments not to intervene in the policy-making, management and budget of central banks, including in those countries which have not yet adopted the euro, such as here, in Hungary.

But independence is not a sufficient condition to ensure that monetary policy calls the shots, as we know from literature on monetary and fiscal dominance.[2] Essentially what this literature finds is that if fiscal policy is not constrained by a rule which ensures the sustainability of debt, the central bank is ultimately forced into inflationary policies. At the same time, inflation can make output stabilisation through fiscal policy less effective, as workers' expectations adapt and prices rise faster than incomes. So all parties lose out.

The conclusion is that managing interdependence requires a strong framework. Policymakers must decide which aims they want to prioritise and construct a set of rules which promotes that and sets incentives right.

In the euro area, we consciously built our framework around “monetary dominance” – ensuring that the central bank could pursue price stability unconstrained by fiscal considerations. We did this by giving full independence to the central bank, while constraining fiscal policies through the rules of the Stability and Growth Pact, and now of the Fiscal Compact.

One can debate the details of this framework, but on its own terms it succeeded: in no cases have fiscal policies caused the central bank to lose its price stability focus.

Take the example of the ECB’s recent decision to extend its asset purchase programme. This has been taken in full independence to achieve our medium-term price stability mandate. And in our decision, we have taken into account the specificities of the euro area, meaning that we operate in an environment of decentralised national fiscal authorities, and the ECB has no mandate to engage in large scale pooling of fiscal risks.

But we have also learned from the crisis that policy interdependence has different dimensions. There are more subtle interactions between policies than our framework initially acknowledged. And these involve not just monetary and fiscal policies but financial and structural policies as well.

What is at issue is not the classic idea about one policy causing another to lose focus on its mandate. It is ex post coordination failure, where some policies miss their mandate, causing others to do more precisely to be faithful to their own – what one might call “weak dominance”.

For example, if financial supervisors do not encourage a fast and efficient clean-up of bank balance sheets, central banks’ interest rate cuts are less likely to be passed on to entrepreneurs. And this is exactly what we saw in the euro area until the Single Supervisory Mechanism was decided. And if at the same time governments do not make it easier to open a new business, those entrepreneurs are less likely to ask for a loan and take advantage of those low financing costs. And this is also what we have seen.

In short, monetary policy becomes more effective in impacting the real economy if other policies act in a supportive way; and if they do not, it has less impact and expansionary policy has to last longer to fulfil the mandate.

So, "weak dominance" is essentially about whether policies complement or compensate for each other. And what determines this is the framework – whether it is *strong* enough to ensure the right policies dominate, and whether it is *comprehensive* enough to achieve that along all the relevant dimensions of policy interaction.

While such a framework is important in any country, it is even more important in a multi-country union. In a single country coordination and policy adjustments involve a single treasury and economics ministry. But in a monetary union there are multiple different policy-makers and policies to align. A strong framework that constrains discretion is therefore indispensable.

2. Fiscal dominance

Though there is much that can be said about how fiscal dominance works in this context, I have discussed this elsewhere.[3] The risk of "weak" fiscal dominance was actually recognised by Lamfalussy. He noted that the lack of an appropriate aggregate fiscal stance for the euro area could lead to monetary policy having to bear too much of the adjustment burden:

"The combination of a small Community budget with large …. national budgets leads to the conclusion that, in the absence of fiscal coordination, the global fiscal policy of the EMU would be the accidental outcome of decisions taken by Member States. ... As a result, the only global macroeconomic tool available within the EMU would be the common monetary policy implemented by the European central banking system."[4]

There is much to learn from this comment. But in the remainder of my remarks I would like to focus on two other areas where we learned important lessons from the crisis for our future framework: financial policies and structural policies.

3. Financial dominance

For financial policies – that is, the governance of the banking sector – we saw clearly during the crisis how a weak framework can allow weak forms of dominance to take hold. Both monetary and fiscal policies can have their choices constrained by so-called "financial dominance"[5].

For monetary policy, the problem stems mostly from inadequate supervision.

At the micro level, if supervisors show too much forbearance to undercapitalised banks, they can end up effectively shifting the burden onto monetary policy – as when those banks lose access to market funding, or have to pay higher risk premia, they turn to central bank funding to fill the gap. Monetary policy has limited discretion here, as it cannot independently judge the solvency of its counterparties – and remember, we have 2,194.

At the macro level, if supervisory policies allow banks to grow too rapidly and then deleverage too slowly, it can also push the central bank into doing more.[6] Since monetary transmission becomes impaired, the monetary 'impulse' has to be strengthened to compensate for the diminished 'outpulse' coming out of banks. Many of our non-standard measures during the crisis, such as our Long-Term Refinancing Operations (LTROs), have essentially performed this function.

Moreover, weak micro-supervision and the resulting high level of non-performing loans can also trigger conflicts with other policy areas. For example, when bad banks or asset management companies are set up to deal with legacy asset problems, as happened for example in Slovenia and Spain, it is essential that the line between the duties of fiscal and monetary authorities is not blurred.

Central banking is about providing liquidity for solvent institutions, not about providing capital for insolvent ones. Thus, the capitalisation of asset management companies in any country should preferably be shouldered by the private sector, and if this is not possible, by the fiscal authority.

We have also seen in the euro area, however, that fiscal policies can face their own dominance problem related to financial policies. This stems less from supervision than from inadequate resolution frameworks.

The key issue is that if national fiscal policies are expected both to stabilise the business cycle and to bail-out the banking sector, incurred and contingent liabilities become unsustainable in a banking crisis. In the euro area, the total commitment to bank rescue packages amounted to 26% of 2008 GDP. Thus, fiscal policy can quickly become overburdened as well.

And here again, a too weak financial framework can trigger conflicts in other areas. If fiscal policy is forced to contract when it is needed to smooth the cycle, then obviously this will reduce aggregate demand. And insofar as this affects price stability, it has to be compensated for by the central bank. Monetary policy has the duty to respond to fulfil its mandate – as the ECB is doing today.

The lesson is that dominance is always a multidimensional problem. There is a triangle of monetary, fiscal and financial policies that requires a strong coordination framework. And the Banking Union has gone a long way to providing this.

To begin with, the move to European supervision helps align the governance of the financial sector with the aims of monetary policy – or put differently, it reasserts monetary dominance.[7]

The European supervisor has stronger incentives to uncover weak banks, which helps reduce the risk of financing so-called "zombie banks". And it is also able to use macroprudential policies to temper swings in the leverage cycle – for example through the release of countercyclical capital buffers. This means that monetary policy transmission should be more immune from disruption, and interest policy should not be overburdened over the cycle with the objective to avoid and then eliminate asset price bubbles.

At the same time, the resolution leg of Banking Union – the Bank Recovery and Resolution Directive and the Single Resolution Mechanism – creates a set of rules that will in principle provide separation between fiscal policies and the banking sector.

Bail-in of private creditors will replace bail-out by governments and taxpayers. And this will in turn mean that the public sector has lower contingent liabilities towards banks, creating more space for fiscal policies to act counter-cyclically alongside monetary policy in a downturn.

4. Structural dominance

Nevertheless, the loss of fiscal space that many countries have experienced during the crisis – and the knock-on effects for monetary policy – cannot solely be explained by bank bail-outs. As has long been recognised, going back to the literature on optimal currency areas,[8] there is also an important interaction in a monetary union between fiscal and structural policies at the national level.

If an economy has resilient product and labour markets and adjusts more quickly to shocks, there is less need for expansionary fiscal policies. But if inefficiencies are high and the economy adjusts more slowly, fiscal policies need to be more expansionary, and for longer, and this can in turn generate spillovers on other participating economies and on the single monetary policy.

To give an example of this interaction, Ireland and Spain were two countries that experienced relatively similar shocks emanating from the financial and construction sectors. Both saw their primary deficits deteriorate by around 13pp of GDP between 2007 and 2009. However, by 2012 Ireland had reduced that deficit by more than 7pp of GDP, whereas in Spain the primary deficit was less than 2pp lower.

This certainly reflected stronger consolidation efforts in Ireland as part of its adjustment programme. But it also reflected the faster adjustment in prices and wages in the Irish economy, which helped unemployment to begin stabilising in late 2010, while in Spain it rose until early 2013.

Of course, many other factors were at play as well, but the point is that economic flexibility matters for the size and duration of deficits. And what this implies is that, if structural reforms do not happen, there can be a form of "structural dominance" over fiscal policies. When a shock hits, fiscal policies are forced to do all the heavy lifting to stabilise the economy and, over time, fiscal space becomes progressively exhausted.

Indeed, this is one explanation for why the Stability and Growth Pact (SGP) rules have not been as effective as we hoped. There is a correlation between the ease with which countries comply with the rules and their progress on structural reforms. Effectively, through lack of reforms some countries have put themselves in a position of excessive deficit dependence, which then makes the difficulty and costs of meeting their obligations higher.

The conclusion, therefore, is that constantly tinkering with our common fiscal rules while leaving governance of structural policies entirely at the national level makes little sense. If fiscal policies are to be freed from structural dominance, then we need an equally strong framework in both domains. And it is fair to say in the EU context that the Macroeconomic Imbalance Procedure (MIP) has less teeth and has not benefited from the same level of ownership and political attention as the Stability and Growth Pact.

We could also envisage some complementarities between the two. For example, it does make sense to take into account structural reforms when assessing compliance with the SGP, as the Commission now intends to do.[9] This is because structural reforms not only reduce the amount of fiscal space needed for effective stabilisation, but they also increase future fiscal space via higher potential output and hence higher government revenues.

However, not all structural reforms are associated with fiscal costs, such as notably product market reforms. And some reforms, such as some social security reforms, may actually imply short-term fiscal gains. But most importantly, because we do not yet have a credible framework, we should only take into account reforms once they are implemented, not when they are simply announced – and seek an independent assessment of their cost and GDP impact.

These are all reasons for countries to press ahead with building a stronger framework. But above all, in the current situation, structural reforms are their own reward.

You may recall the not-so-old debate about introducing reform contracts with financial incentives. Well, those incentives are already there! I have discussed elsewhere how structural reforms make monetary policy more effective in a given country and how they help regain fiscal space.[10] Countries that reform now thus effectively receive, in return, a more expansionary monetary policy and a less contractionary fiscal policy.

In fact, our recent decision to expand our asset purchases, together with energy prices and an exchange rate more favourable to growth, have opened a unique window of opportunity for euro-area governments to act together, remove structural obstacles to growth, and pull our economy out of the low growth, low confidence trap.

In saying this, I am of course aware that structural reforms can have mixed effects on growth and inflation, and in certain situations can impact negatively on both in the short term.[11] But empirical evidence is mixed,[12] and the balance of effects depends crucially on designing reform packages well.[13] And indeed, many of the reforms that are on the table today – such as improving the business environment – have little disinflationary effect, but can provide a strong boost to investment demand.[14]

Looking further ahead, stronger governance of structural reforms is also in the enlightened self-interest of all countries that want to see a deepening of our monetary union.

It is now fairly clear that, in the long term, a union based on no risk-sharing will be vulnerable economically. Yet we also know that permanent transfers between countries cannot work politically.

The only way to resolve this paradox is if, behind the "veil of ignorance", risk-sharing is symmetric between countries. This is only possible if all countries share sovereignty over structural reforms so that they have equivalent growth prospects and shock absorption capacity. And this will in turn be made even easier if deeper cross-border market integration, starting with an effective Capital Markets Union, reduces in the first place the need to share risk through public balance sheets.

5. Conclusion

This brings me to my conclusion.

Alexandre Lamfalussy had great faith in the power of the EU institutional framework to enforce policy coordination and deliver a socially optimal outcome for the monetary union.[15] This, the crisis has shown, was overly optimistic. It is clear that the euro area needs stronger rules to regulate the many different forms of policy dominance that emerge due to interdependence.

That said, if over time those rules lead to more convergence, and more convergence leads to more common institutions with more common powers, then it may be that we need less rules down the road. This is not because complexity is less, but because a single central bank, a single treasury and a single economy ministry can manage it more effectively.

In other words, rules are a means to an end, which is a monetary union that creates jobs and growth in an environment of price stability. And until we decisively deepen our monetary union, they are the only way to achieve it.

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[2] The classic reference is Sargent, T., and N. Wallace (1981), "Some unpleasant monetarist arithmetic", Federal Reserve Bank of Minneapolis Quarterly Review, vol. 5. See also the discussion in Leeper, E. (1991), "Equilibria under 'active' and 'passive' monetary and fiscal policies", Journal of Monetary Economics 27, p. 129-147.

[3] See speech by Cœuré, B. on "Outright Monetary Transactions, one year on", Berlin, 2 September 2013.

[4] Lamfalussy, A. (1989), Macro-coordination of fiscal policies in an economic and monetary union in Europe, Collection of Papers. Committee for the Study of Economic and Monetary Union, Luxembourg, 1989, January, p. 101.

[5] Financial dominance is not a new concept. An early reference is Fraga, A., I. Goldfajn, and A. Minella (2003), "Inflation Targeting in Emerging Market Economies", Banco Central do Brasil Working Paper Series, 76, section 4.2.2.

[6] See for example Brunnermeier, M., and Y. Sannikov (2013), "The I Theory of Money", mimeo.

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[8] For a review see McKinnon, R. (2001), "Optimum Currency Areas and the European Experience", mimeo.

[9] See European Commission (2015), "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact", communication to the European Parliament, the Council, the European Central Bank, the Economic and Social Committee, the Committee of the Regions and the European Investment Bank, COM(2015) 12, 13 January.

[10] For more on how supply-side policies can empower demand-side policies see speech by Cœuré, B. on "Structural reforms: learning the right lessons from the crisis", Riga, 17 October 2014.

[11] For an illustration see Eggertsson, G., A. Ferrero, and A. Raffo (2014), "Can Structural Reforms Help Europe?" Journal of Monetary Economics, 61.

[12] Bouis, R., et al. (2012) find only weak evidence that reforms entail short-term losses in aggregate output or employment: see Bouis, R., et al. (2012), "The Short-Term Effects of Structural Reforms: An Empirical Analysis", OECD Economics Department Working Papers, No. 949.

[13] For more on this point, in particular the importance of getting the pace and composition of reforms right, see speech by Cœuré, B., Riga (Op. cit.).

[14] A similar argument is made in Fernández-Villaverde, J. (2013), "Discussion of 'Can Structural Reforms Help Europe?' by Gauti Eggertsson, Andrea Ferrero, and Andrea Raffo", Journal of Monetary Economics. Lane (2013) also emphasises the importance of calibration and timing in the reform package: see Lane, P. (2013), "Growth and Adjustment Challenges for the Euro Area", The Economic and Social Review, Vol. 44, No. 2, Summer.

[15] Lamfalussy believed in particular that this would help address asymmetric adjustment within the monetary union: "If surplus countries can be persuaded to expand their home demand at the same time as the deficit countries deflate their own economy, the balance can be restored without undue damage to the rate of growth of the Community as a whole. We do not know what will be the degree of success achieved by the Community authorities in their co-ordinating activity; but it is certain that the existence of an administrative machinery and of an institutional framework (already successful in other fields) will improve the ability of the area to deal with such problems." See Lamfalussy, A. (1963), The United Kingdom and the Six. An Essay on Economic Growth in Western Europe, London: Macmillan, p. 131.

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CESEE 25 years after the fall of the Iron Curtain – European integration remains a win-win strategy

(Paper based on the lecture given at the Conference)

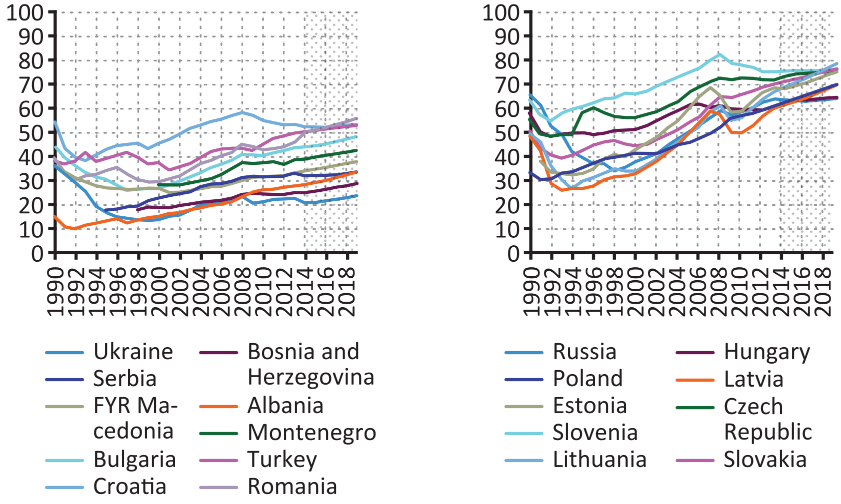
The fall of the Iron Curtain in 1989 marked the beginning of a new global era. Once the division of the world into East and West had been overcome, Europe evolved into an ever more integrated continent governed by the prospects of peace and prosperity. The EU enlargement round of 2004 was an important milestone: eight Central and Eastern European countries were firmly integrated into the European framework. Much has happened since then. Bulgaria, Romania and Croatia have also joined the EU, some of the newer Member States have introduced the euro, and many countries – especially in the Western Balkans – have moved closer to the EU. Economic transition, European integration and EU membership have spurred an unprecedented process of social, political and economic modernisation and catching-up.

However, today's tragic events and military confrontation in Ukraine should remind us that there are still deep and dangerous political divides on our continent and that wars not only destroy lives, but may take away opportunities for entire societies to live a prosperous life.

The transition process in Central, Eastern and Southeastern Europe (CESEE) was helped along by several unique features: (1) the geographical proximity of CESEE to advanced, high-income economies that facilitated the build-up of trade and production networks; (2) the fact that Western European countries had already embarked on a process of deep and comprehensive economic and political integration and were willing to extend the scope of this process eastward; (3) cultural, political and economic traits that partly date back to the pre-communist period that allowed for integration into a greater Europe; and (4) the relatively high level of education evident in CESEE. Paving the way for the rather successful transition process, these features supported an economic liberalisation of impressive speed and depth.

At first, however, the fall of the Iron Curtain heralded tremendous disruptions, in particular in the formerly centrally planned Eastern European economies, including an extensive reallocation of resources. Real incomes fell and living standards deteriorated right after the long-awaited opening-up of the borders. GDP per capita bottomed out in the early 1990s in most CESEE countries (see Chart 1). Yet, after some years of real income losses, a process of catching-up set in very rapidly. Between 1992 and 2008, average real per capita income measured in purchasing power parities in today's Central, Eastern and Southeastern European EU Member States rose continually from 35% to 55% of the level of the euro-area Member States. By comparison, per capita GDP in Portugal remained constant at 69% of the euro area average, while average incomes in Greece and Spain increased moderately from 72% and 82%, respectively, to 83% and 89% over this 16-year period. By contrast, average per capita income in the most successful cohesion country, Ireland, rose from 80% to 127% in the same period.

Chart 1. GDP Per Capita (at PPP) of Selected CESEE Countries in percent of the euro area Average



Source: IMF

Of course, such figures mask considerable cross-country heterogeneities. Slovenia, for example, had already started from a per capita income level of 64% of the euro-area average in the early 1990s, and overtook one of the initial euro-area countries, Portugal, in 2004. The Czech Republic followed suit in 2007. In the Baltic states, the turnaround to positive growth rates occurred around the mid-1990s, entailing extremely high growth rates and thus steep convergence. Yet, the Baltic countries walked a fine line between a steep convergence path and an overheated economy, as growth rates proved to be unsustainably high and triggered a deep recession even before the shockwaves after the Lehman bankruptcy. Some other countries (especially in the Western Balkans, but also Ukraine) showed no signs of convergence until the late 1990s (in the case of the Western Balkan countries, this was clearly related to the violent disintegration of Yugoslavia). Their growth performance also lacked the momentum observable in the Central European countries in the subsequent years.

One important explanation for this gap relates to institutional quality. Both the Central European and Baltic countries benefited from the perspective of EU accession and their gradual adoption of the EU body of law (acquis communautaire) as push factors for institutional modernisation. The EU accession process also proved an anchor for political and economic agents by aligning expectations and providing a stable and secure general framework for investments and the transfer of know-how.

CESEE economies, however, were not only politically integrated into greater European structures, but also reoriented their trade structures toward Western European markets.

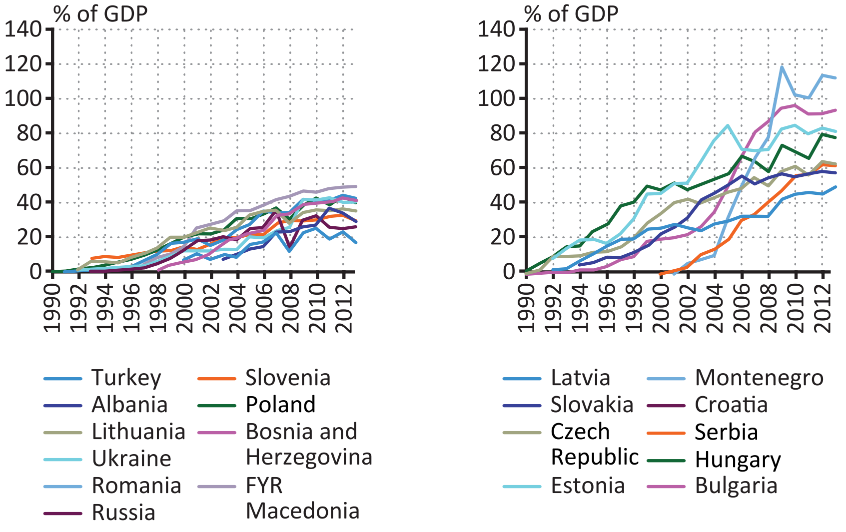
During the communist era, trade flows were coordinated within the framework of the Council for Mutual Economic Assistance, a tightly-knit trading bloc commonly known as Comecon that administered trade and production patterns. Its breakdown put an abrupt brake on the exchange of goods and services among CESEE countries, depriving them of a secure market position in the other Comecon member states. On the upside, it brought an increased degree of freedom for managerial decisions as to what goods to produce and where to sell them. Hence, trade was reoriented very quickly – mostly toward Western Europe – and trade openness increased strongly, also partly due to the Central European Free Trade Agreement (CEFTA), which was signed in 1992. To quote just a few figures: Exports and imports of the group of CESEE countries that are now members of the EU (as a % of GDP) climbed from 34% to 39% in the decade up to 1989. In 1990, the trade-to-GDP ratio jumped to 65% and, by 2007, had reached 116%, substantially outperforming the average ratio observed for Western European countries.

More recently, CESEE economies' trade among themselves recovered as well, on the back of (1) higher growth rates in the region, boosting demand; (2) the build-up of production capacities in CESEE, promoting (and also improving the quality of) supply; and (3) the development of international production networks across the region, boosting trade in inputs for the further production process.

It is important to stress here that the increasing trade openness of the CESEE countries was not only attributable to rising exports amid strong international demand, combined with a sound competitive position given the countries' moderate wage levels and productivity catching-up. It was also driven by higher demand for imports, with households increasingly able to afford consumer goods thanks to mounting income levels and employment rates. Moreover, consumer credit became widely available and companies imported capital goods to upgrade and expand production.

Investment and production upgrading was supported by massive foreign direct investment (FDI) flows from the very beginning of transition (see Chart 2). By the end of 1990, almost all countries had already passed privatisation laws and accompanying legislation encouraging FDI inflows into Eastern Europe. While FDI had initially been concentrated in the manufacturing sector, it soon started to be directed toward services too, in particular communications and financial intermediation. The contribution of FDI to subsequent economic growth is manifold and substantial. It was much more than just a means of financing: by also promoting knowledge, managerial and technological spillovers, FDI gave impetus to productivity growth.

Chart 2. Inward FDI Stock

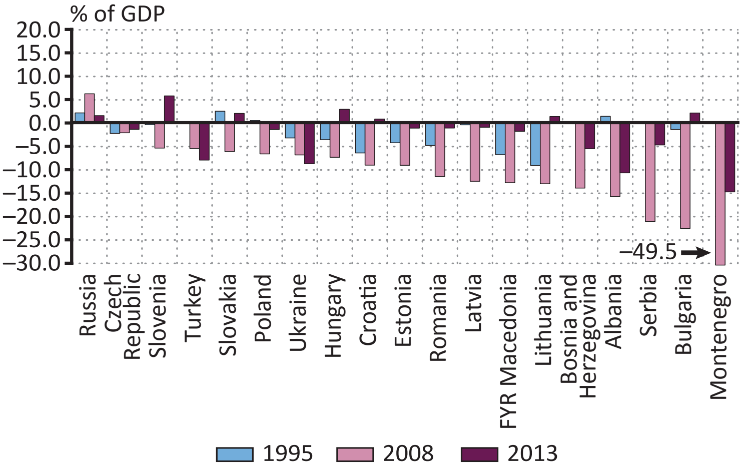


Source: The Vienna Institute for International Economic Studies (wiiw)

Increasing trade openness and strong capital inflows, however, also caused macroeconomic vulnerabilities to build up. Substantial gaps in the current account were one of the most distinctive features in the CESEE region before the recession. By 2008, double-digit current account deficits had become widespread in Eastern Europe (see Chart 3), with only one country – Russia – reporting a surplus (which was substantially driven by energy exports).

Current account deficits are to a large extent a natural by-product of catching-up processes: transition countries seek capital for investment and international investors seek high-yielding investment possibilities for portfolio diversification. Capital inflows and the related current account deficits are, moreover, to some extent unproblematic/ no cause for concern as they allow transition economies to access funds from abroad instead of having to raise them at home.

Chart 3. Current Account Balance



Source: The Vienna Institute for International Economic Studies (wiiw)

Consistent current account deficits can, however, also pose problems both in the short run (capital flows might be very sensitive to shocks) and in the longer run (countries may build up foreign debt positions that might become unsustainable). Unsustainable debt positions might in turn be a function of changes in external scenarios (e.g. a change in general risk perception or a general shift in global interest rates) and of external shocks, as witnessed during the crisis.

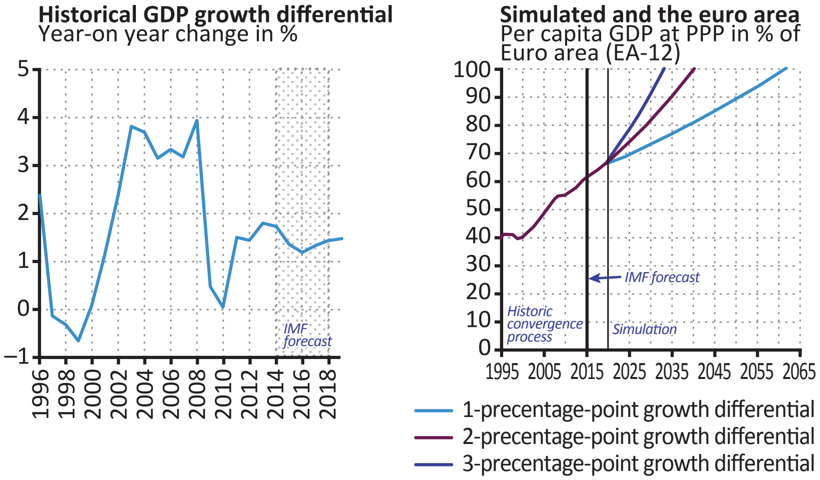
With regard to the build-up of vulnerabilities, attention also has to be paid to banking sector developments. Financial intermediation and private sector debt in CESEE increased markedly during the process of transition. To a certain extent, this was clearly a desired catching-up phenomenon. In many countries, however, credit growth became excessive. One distinctive feature of the CESEE region is the strong presence of foreign (especially Western European) banks. Foreign banks promoted credit expansion in light of higher profitability in CESEE markets, the great future profit potential as well as the prevalence of fixed exchange rate regimes in many countries and a path toward

EU and euro-area membership, which diminished the danger of devaluation. In fact, the trend expectation following the Balassa-Samuelson argument was that the CESEE currencies would appreciate. This – in connection with interest rate differentials, easy access to cross-border borrowing in the form of credit lines from parent institutions and competitive pressure for market shares – also prompted banks to build a substantial stock of assets denominated in foreign currency. When the international financial crisis hit, the high growth of private sector debt and the risks related to foreign currency credit in (at least some) CESEE countries led to a sharp change in sentiment. Significant devaluations took place in countries which maintained flexible exchange rates, while countries with fixed exchange rate regimes came under extreme disinflation pressure. In any case, GDP growth declined strongly, pushing most of the region into (partly severe) recessions in 2009.

The financial and economic crisis that unfolded in 2008 and still very much influences the general economic environment today, however, only put a temporary brake on the catching-up process. Most countries had again started to converge to Western European levels by 2011, after the growth differential between the CESEE EU Member States and the euro area had declined to close to zero in 2009 and 2010 (see Chart 4, left panel). Some qualifications, however, apply: First, not all countries managed to restart the convergence process. For example, GDP per capita has yet to reach its 2008 level in Croatia and Slovenia. In several other countries, GPD per capita in relation to the euro area has stayed essentially flat since the financial turbulence of 2008. This deserves special attention because, second, growth dynamics in the euro area have also lost substantial steam, which should, in principle, facilitate more rapid catching-up. Third, since the outbreak of the crisis, the speed of convergence has clearly been falling short of historical standards (1 percentage point to 1.5 percentage points compared with 3 percentage points to 3.5 percentage points during the boom years in the mid-2000s). This is in part related to lingering crisis legacies that dampen economic performance throughout Europe. The crisis also seems to have impacted on potential growth rates, however, and with that on longer-term trends.

Against this background, it is safe to assume that the convergence process will be delayed substantially. Simulations show that under the assumption of a growth differential of only 1 percentage point (a level that we currently observe), full convergence would not be reached before 2062 (see Chart 4, right panel). This contrasts with the target date of 2033 under the assumption of a 3-percentage-point growth differential – a level that was observed in the mid-2000s. Some CESEE countries will reach full convergence considerably later than others, given the large differences within the region.

Chart 4. Convergence between CESEE EU Member States and the euro area



Source: OeNB, IMF

To revitalise the convergence process, policy measures need to focus on building economic momentum and on removing structural barriers to stronger economic growth. Hence, measures are called for that rein in persistent deficits and debt, address high stocks of non-performing loans (NPLs) in banks' balance sheets and boost investment and sustainable credit growth. Structural problems should be tackled in areas such as governance, labour markets, access to financing, business and investment climate, tax administration and public expenditure prioritisation. Last, but not least, an aging society poses a challenge also for CESEE countries, as for most other countries in Europe. With the right policies in place, the convergence process should again pick up speed and lift income levels further in the countries of the region, just as it did in the past.

European integration and transition were, however, not only beneficial to the countries of Central, Eastern and Southeastern Europe, but also for all European countries. It is important to note that, even today, potential output growth in the CESEE region continues to be higher than that in the euro area. Many CESEE countries have not yet reached the income levels seen in most euro-area countries. These differentials imply a great potential for above-average growth, not only for the CESEE region, but also for the countries with which the region maintains close relations.

Austria is a case in point in this respect. In 1989, Austria's position shifted almost overnight from the dead end of what was then called the West right into the centre of the "new" Europe. Given its central location, but also its strong historical and cultural ties with Central, Eastern and Southeastern Europe, it was a natural step for Austria to intensify its bilateral links with the region. Austrian businesses and banks were among the first to identify the economic potential of the CESEE region and to expand activities into these new markets.

This strategy has clearly paid off. As studies have shown, the political and economic integration of Eastern Europe – in connection with Austria's accession to the EU in 1995 and subsequent adoption of the euro – has served as a stimulus for the Austrian economy to grow by an additional 0.5% to 1% per year and has resulted in up to 17,000 additional jobs per year. Furthermore, the Austrian current account turned positive in 2002, and the degree of internationalisation of the Austrian economy increased strongly as foreign direct investment was channelled into the CESEE countries.

To a substantial extent, this development was driven by the banking sector. Austrian banks have become key players in CESEE markets and have achieved substantial market shares in many countries of the region. Their long-term commitment to CESEE is also reflected in their total exposure to the region, which has been broadly maintained in the past years. It amounted to EUR 197.5 billion in mid-2014. Austrian banks, which operated a total of 62 subsidiaries in CESEE in June 2014, continue to rank among the major players in the region and contribute to a stable flow of credit to the local economies.

However, CESEE operations also come with higher risks: Higher NPL ratios, goodwill write-downs and political uncertainty in some countries pose challenges to Austrian banks operating in the region. These risks have translated into higher risk costs over the past few years. The most recent geopolitical crisis and economic turmoil in Ukraine and Russia also underline both the fragility of the current earnings situation and the permanent necessity to re-evaluate and rebalance risks in Austria's dynamic, but challenging eastern neighbourhood.

To sum up, Europe has undergone tremendous changes in the past 25 years that have profoundly shaped/transformed its political and economic landscape. The countries on the continent have reached an unprecedented stage of integration and economic well-being – a situation that proved broadly sustainable also against the background of the biggest economic crisis since the 1930s. However, risks and vulnerabilities have obviously increased. To fully capitalise on the further potential of European integration, unconventional thinking and bold reforms both at the national and at the European level are imperative. If the right steps are taken, the coming 25 years can be just as successful as the past 25 years.

ERDEM BAŞÇI

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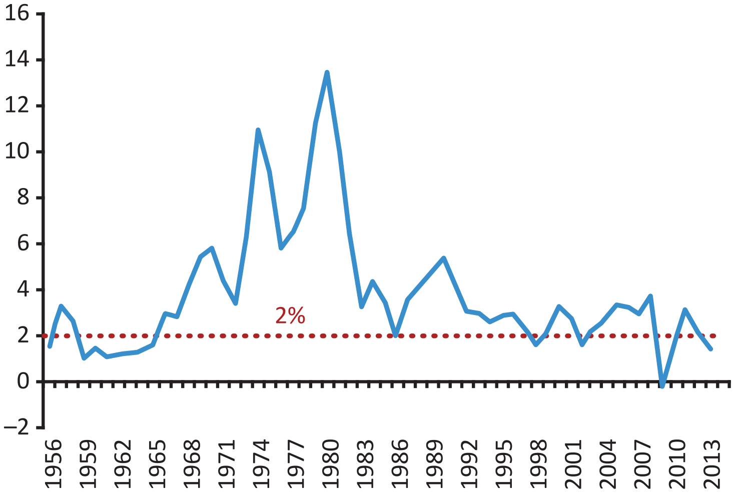
On the Value of Price Stability

(Paper based on the lecture given at the Conference)

Price stability was an important part of the vision of Alexandre Lamfalussy, a well-known advocate of monetary and financial integration in Europe. Indeed, before the global financial crisis, the euro area had achieved price stability, with inflation rates close to 2 percent. The dynamics, however, have changed since the crisis. The risk of deflation has emerged for the euro area. While the necessary policy measures to fight high inflation are well known, fighting deflation is challenging and central banks are in relatively uncharted territory with regard to this problem.

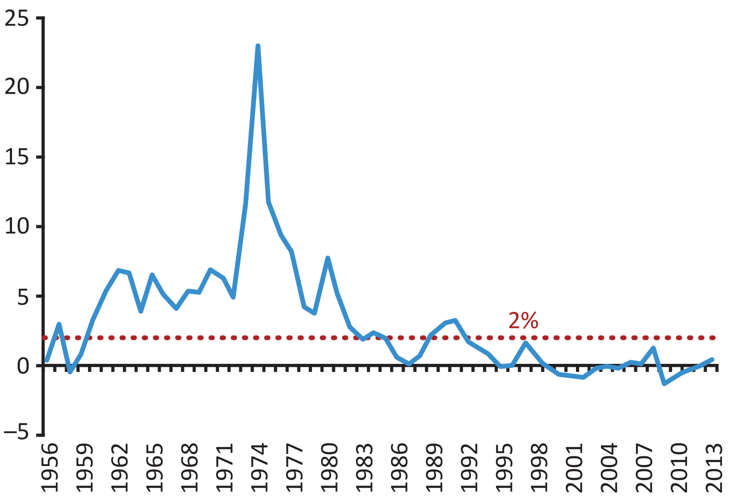
Historical data illustrates that the inflation rate accelerated in the US during 1970s and reached its peak level of 12 percent in 1980 (Figure 1). Paul Volcker, who was the governor of Federal Reserve at the time, cured this problem with very strong, front-loaded monetary tightening. He allowed interbank overnight rates to rise up to 19 percent, a rate significantly above the inflation rate. Although the US economy experienced a mild recession during that time, the long-run benefits of the measures were very high. Inflation came down, and both nominal and real interest rates declined. As a result, the US economy started growing quite robustly following the monetary tightening episode. This is a typical textbook example of how you stop runaway inflation. Currently, the rate of headline inflation is below the target of 2 percent in the US. Japan also experienced excessively high inflation rates, even exceeding 20 percent, mainly due to the oil price shock of the 1970s. Nevertheless, after decisive monetary tightening, throughout the Great Moderation the inflation rate declined sharply, dropping even to negative territory (Figure 2). Since 1995, Japan has occasionally experienced deflation and has taken various measures to revert deflation. Recently, the central bank of Japan has shown a strong will to increase inflation back to reasonable levels, in particular to the new target of 2 percent.

Figure 1. Annual Inflation in the US (percent)



Source: FRED.

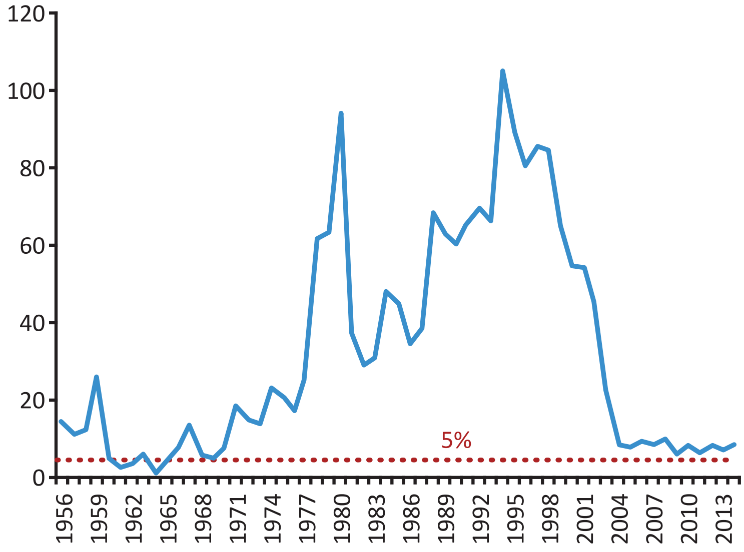
Figure 2. Annual Inflation in Japan (percent)



Source: FRED.

Turkey is a textbook example of high inflation, experiencing 10 to 100 percent inflation rates for almost 30 years (1973 to 2003), while never witnessing hyperinflation. This period was extremely costly for Turkey, as real interest rates and inflation risk premia were hovering at extremely high levels, which created allocational efficiency problems. As a result, aggregate investment was not able to reach levels that could have been possible under a low inflation regime. During the last decade, however, significant steps were taken. A combination of central bank independence and fiscal discipline solved the high inflation problem to a large extent. The inflation rate followed a path that is mostly in the single digits with a minimum of 6.2 percent at the end of 2012.

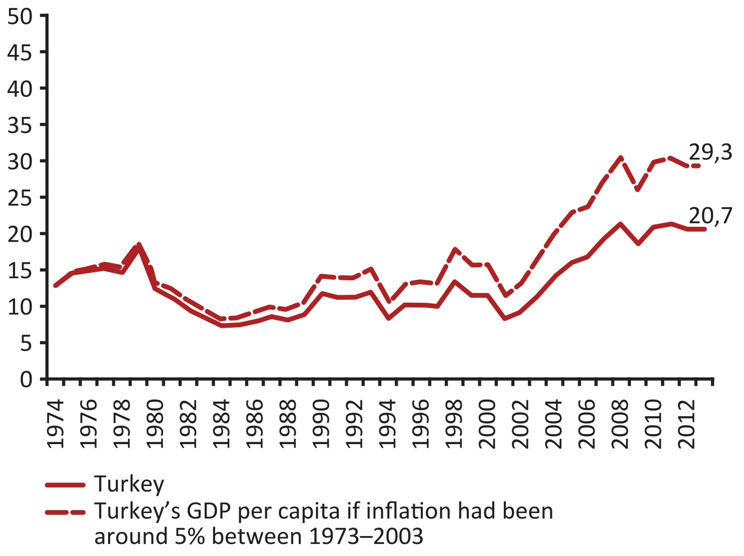
Figure 3. Annual Inflation in Turkey (percent)



Source: FRED.

Figure 4 illustrates GDP per capita in Turkey as a ratio of GDP per capita in the US, which can be seen as an indicator of the convergence process. As of 2013, this ratio is 20.7 percent which means GDP per capita in Turkey is approximately one fifth of the GDP-per-capita level in the US. In order to estimate the cost of high inflation Turkey experienced in the period between 1973 and 2003 during which annual inflation was 54.5 percent on average, we carried out a counterfactual analysis: "What if average inflation in Turkey were 5 percent in that period?". Based on related estimates of Barro (1995), the result reveals that in 2013 Turkish GDP per capita would have been 29.3 percent of the US GDP-per-capita level rather than 20.7 percent. In other words, as of now, Turkey's GDP per capita would have been one-and-a-half times higher, i.e. 15,000 US dollars instead of 10,000 US dollars. This example clearly shows that keeping the inflation rate at 5 percent in Turkey is very crucial and would improve welfare significantly.

Figure 4. Per Capita Income with respect to the US (percent)



Average inflation in Turkey between 1973 and 2003 is 54.5 percent.

According to growth regressions every 10 percentage points higher inflation leads to a reduction in GDP growth rate by 0.25 percentage points on average.

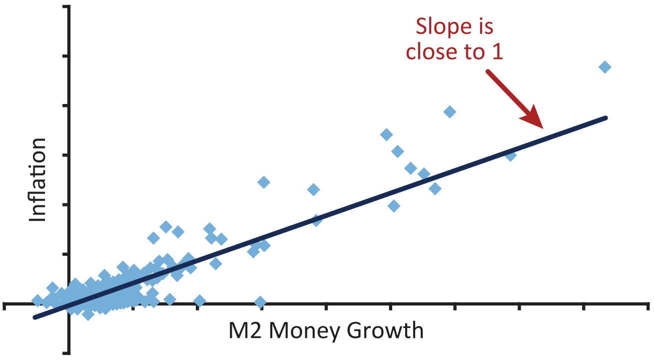
Source: UN, CBRT.

Returning to the problem of deflation, there are various reasons why it is more difficult to deal with. First of all, the zero lower bound prevents central banks from cutting interest rates sufficiently to stimulate demand and raise inflation expectations. Interest rates can go to negative territory only mildly because holding cash is always there as an alternative. Even if interest rates can go below zero, the monetary transmission mechanism is not well known in this region. Hence, it is uncertain whether cutting interest rates to negative rates will raise inflation expectations. For instance, when the ECB cut the deposit rates from -0.10 percent to -0.20 percent, inflation expectations did not immediately respond. Consequently, the ECB announced the quantitative easing programme in January 2015. Taken together with negative rates, the new policy mix is expected to help the fight against deflation. While the EUR/USD exchange rate has reacted to this policy mix, impacts on money and credit are yet to be seen.

The basic quantity theory of money equation M*V = P*Y is very useful to understand recent developments in the world economy including the current state of the Turkish economy. Despite the fast money growth in Turkey, the velocity of money and output growth have not changed much over time. As a result, the price level has grown in line with the money growth. The quantity theory of money suggests that there are three conditions for price stability in the long-run: stable money growth, stable output growth and stable velocity change.

The first condition for long-run price stability is stable money growth. Regressions of inflation on M2 money growth reveal that the slope coefficient is close 1. We carried out this exercise with 131 countries for the period between 1980 and 2013 (Figure 5). Estimation results confirm that the quantity theory of money still holds in the long run. Before going forward with the velocity of money, I would like to touch on the tools for controlling money and credit growth. If there is excessively high money growth resulting from private credit growth, macro-prudential measures could be effective tools to slowdown the credit growth. On the other hand, if the credit growth is low, central banks can use quantitative easing policies to accelerate credit growth, hence money growth. A third approach is cutting (hiking) interest rates to revive (contain) credit growth and hence money growth.

Figure 5. Inflation and M2 Money Growth
(Pooled Data, 1980-2013, 131 Countries)



Source: IMF

Within the context of the quantity theory of money, the second condition for price stability is stable output growth. Historical data indicates that output growth does not deviate too much from the long term average. At this point, stability of the change in velocity, which is the third condition for price stability, becomes critical. The velocity of the M2 money aggregate, which consists of bank money and cash, has been on a declining trend. While the velocity of M2 has been decreasing for a long time in Japan, (Figure 6), it was on the rise in the US until about 1997, and has come down quite rapidly since then (Figure 7).

Figure 6. Velocity of M2 in Japan

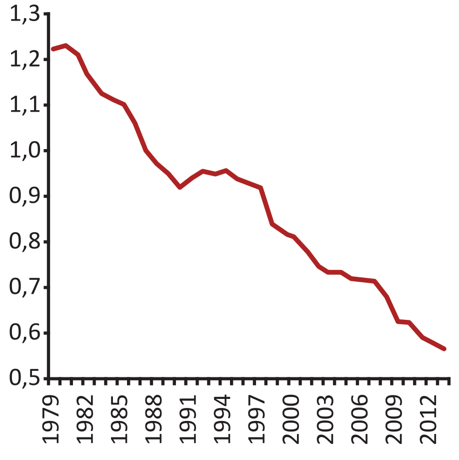
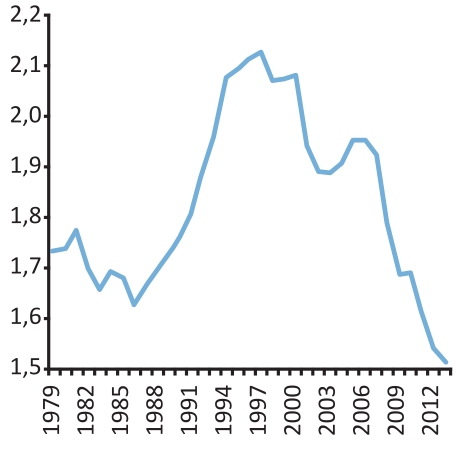


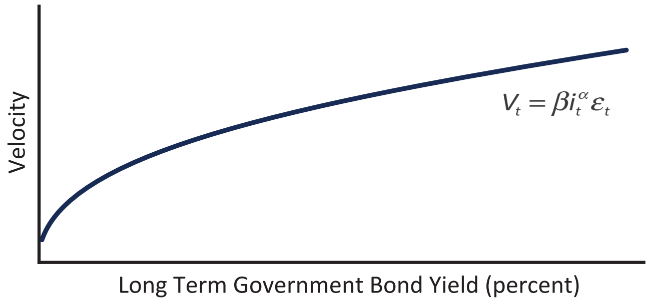
Figure 7. Velocity of M2 in US



Source: FRED

Why has the velocity of money been declining for a long time? One reason might be the decline in long term government bond yields. It is well known that there is a positive relation between the velocity of money and government bond yields (Figure 8). Therefore, if long term government bond yields approach to zero the velocity of money has to decline. Hence, there would be downward pressure on price level. As a result, long term government bond rates have an indirect impact on price stability. Therefore, stability of long term interest rates is also a crucial element for price stability.

Figure 8. Velocity Function



Source: FRED

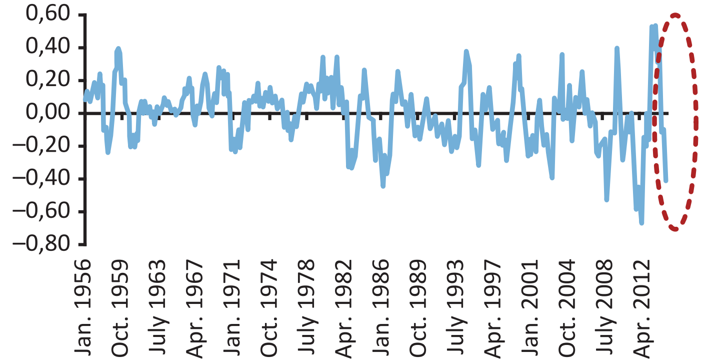
Negative nominal interest rates on money balances may have a potential to increase the velocity through a sharp reduction in the real money demand. However, due to the fact that this is an uncharted territory, this instrument has to be used very carefully and its impact on the velocity and on the economy should be analyzed in detail. For instance, the initial effects of the ECB's negative policy rate are quite promising. According to data regarding expectations and actual outcomes on economic activity and sales, negative nominal interest rates affected economic surprise indices positively which strengthened expectations for recovery in Europe. Negative nominal interest rate, as a new instrument, is also used by central banks in Switzerland and Denmark. We will wait and see what is going to happen to the velocities and other economic variables in these countries before making a conclusive evaluation.

The volatility of long term interest rates in the US has been quite high for some time now. More recently, there has been a significant downward trend in long term interest rates which pushes down the velocity in the US (Panel 1). This can be one of the reasons behind the downward pressure on prices in the US. Similarly, German bond yields have been coming down strongly. This decline might be quite deflationary, unless it is neutralized by a negative nominal deposit rate. Japan also seems to be in a similar situation.

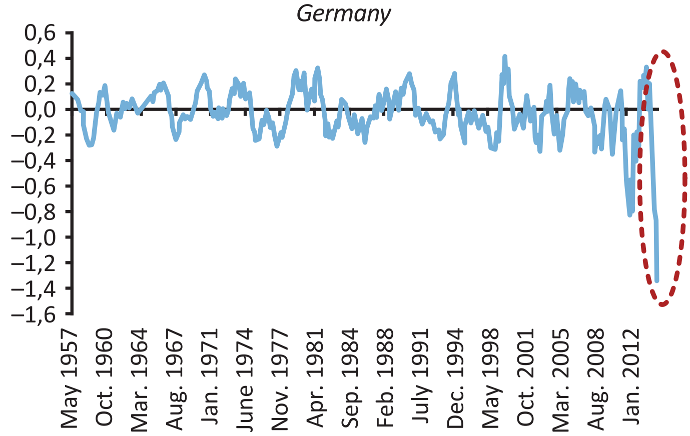
To sum up, high inflation is very costly in terms of allocational efficiency, thus maintaining a low and stable inflation would be the best contribution to growth from the perspective of a central bank. On the other hand, deflation seems like a disequilibrium phenomenon which may lead to a liquidity trap. Both deflation and inflation are detrimental to growth and therefore, need to be avoided decisively.

Panel 1. Annual Change in Long Term Interest Rates
(10 Year Government Bond Yield, Difference of Natural Logarithm)

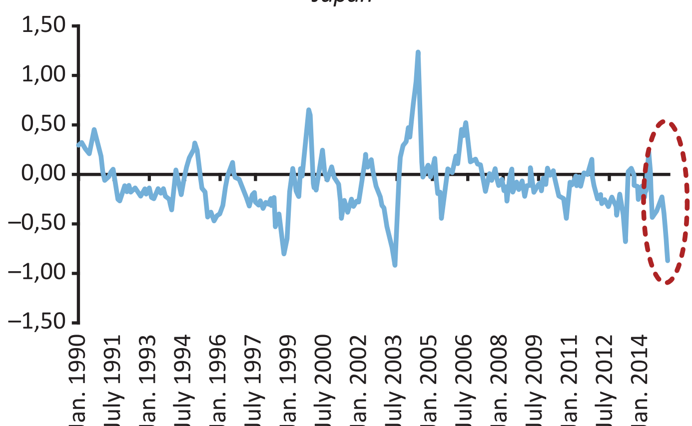
United States



Germany



Japan



Source: FRED, Bloomberg

Last Observation: January 26, 2015

CARLOS DA SILVA COSTA

Governor
Bank of Portugal

Reform and Prosperity in the Monetary Union

(Paper based on the lecture given at the Conference)

"In all things which have a plurality of parts, and which are not a total aggregate but a whole of some sort distinct from the parts…"

Aristotle, Metaphysics, Book VIII

I. Introduction

A common misconception about the European Union is that there is a trade-off between the Monetary Union and economic growth. In my view, this reflects a misunderstanding of what both monetary union and sustainable economic growth means.

Sustainable economic growth means improving per capita incomes with acceptable levels of inequality. If a country's growth rate and distribution falls short of people's aspirations, the fittest will tend to leave, further undermining prosperity.

Fiscal sustainability, external balance and job creation are all necessary – and mutually reinforcing – conditions for sustainable growth in any individual country; they are also necessary conditions for a sustainable monetary union.

Policies that ensure fiscal and external balance sustainability at the national level will also promote the sustainability of monetary union; however, these policies are not sufficient to ensure the cross-country optimisation and sustainability of economic growth in a monetary union such as the euro area.

So, the policy question that we should all be addressing is how to promote balanced and sustainable growth in a monetary union where a single monetary policy co-exists with national fiscal sovereignty.

This question inevitably brings us to the reforms needed both at national and the European level to ensure prosperity in the Monetary Union, which is precisely what I propose to address in this talk.

II. Reform at national level

The potential benefits from joining a monetary union such as the euro area are huge. However, for these benefits to be reaped, countries need to adapt their institutions and policies to the new environment and constraints arising from belonging to the single currency area.

For countries with long histories of macroeconomic instability, the monetary union is a way to reduce the sovereign risk premium, ensure nominal stability and create trust among investors. At the inception of the euro area, we witnessed a significant improvement in these Member States' financing conditions, with a decline in interest rate spreads and an increase in the availability of credit. However, this has not led to a sustainable real convergence among euro-area countries as might be expected in a context of lower and more stable interest rates.

Why? Because some implications of the monetary union were overlooked in the first years of the euro area.

The first overlooked implication is that the credibility induced by the creation of the euro delays the perception of risk and, consequently, the need for adjustment, resulting in the persistence and amplification of imbalances due to the adoption of unsustainable fiscal and economic policies. In a country outside the monetary union, the perception of the risk of unsustainability and the corresponding correction would have occurred earlier.

The second overlooked implication is that in the context of the euro area the conflict between the sustainability of public finances and safeguarding financial stability is exacerbated. This is due to the fact that it is impossible for individual countries to monetise bank bailouts, meaning that financial repression cannot be used to help absorb public costs with recapitalisations of the banking system.

The third implication follows from having limited mechanisms to deal with idiosyncratic shocks and the asymmetric effects of common shocks. Internal adjustment through relative prices is slower than when countries can use the exchange rate as an instrument.

What was the outcome of this? In the absence of the right policies in some euro-area countries we witnessed:

- a rise in the indebtedness of households and firms,
- a private expenditure boom financed by credit,
- an increase in the relative price of non-tradables,
- an increase in the share of the non-tradables sector in the economy,
- upward wage pressure,
- a deterioration in competitiveness,
- a deterioration in the current account, and
- an accumulation of a substantial negative net foreign asset position.

The consumption boom fuelled by abundant and cheap credit led to a shift of supply from tradables to non-tradables as higher prices in the non-tradable sector attracted labour and capital. The impediments to competition and heavy protection in the non-tradable sector pushed up costs and encouraged rent-seeking activities in the sector. Thus, for over a decade unsustainable policies led to bias in the allocation of resources towards the least productive sectors of the economy. When the financial crisis emerged it became evident that the levels of debt of all economic agents were at the limit of sustainability. The need for deleveraging became imperative, revealing the unsustainability of the levels of demand in the non-tradable sector and therefore of many of the jobs that had been created in this sector. The misallocation of resources for such a long period of time resulted in structural weakness in these countries. Redirecting resources towards the more productive tradable sector is one of the biggest challenges these countries currently face.

Indeed, a coherent strategy for the economic recovery and prosperity of these Member States requires not only a change in economic policies, but also the implementation of significant structural changes. And in this regard we have to be aware that it is quicker and easier to change policies than to solve structural imbalances. The misallocation of resources implies a significant waste of capital and huge job losses from the redirection of production to the tradable sectors. This is evident in the high levels of structural unemployment in several countries. Many unemployed people are in their forties and do not have the skills needed to move from one sector to another. As regards companies, some need to close and at the same time others in the tradable sector need to open. However, capital is not transferable from one sector to another, meaning that we have a significant waste of capital in the non-tradable sector and a need for capital in the tradable sector.

This issue leads me to a point that I find of utmost importance: the social responsibility of policy-makers. Bad economic policies create high microeconomic costs because they generate a misallocation of resources – capital and labour – and eventually give rise to the insolvency of economic agents that have been guided by the wrong signals. Indeed, from an intertemporal perspective, inconsistent economic policies lead to inconsistent responses, particularly in terms of investment, resulting in very high costs to individuals and to society. This means that policy-makers need to consider the implications of the various options in the decision-making process, not only at macro level but also at micro level.

In this regard, it is essential to implement national economic policies that perform a stabilisation role; compensating the effects resulting from an environment where a common monetary policy coexists with national fiscal and income policies. This means:

• a countercyclical fiscal policy stance;
• a macroprudential policy that helps prevent the build-up of credit risks on the private side; and
• an institutional framework for incomes policy that safeguards competitiveness, implying that wage developments are in line with productivity.

III. Reforms at European level

Let me now turn to the EU level.

One thing that was clear from the current crisis was that the reaction of the European Union suffered from two biases, which have endangered the survival of monetary union:

• a reactive bias, in the sense that problems were acknowledged too late and the reaction tended to be rather timid; and
• a national bias, meaning that countries tended to look at the problems from their own national angle and failed to take the perspective of the group.

This suggests that the sustainability of the monetary union also requires the implementation of reforms at EU level which equip the euro area to prevent or cope better with future crises.

In the short term, the surveillance and monitoring of the sustainability of national policies, namely fiscal and incomes policies must be reinforced. This means ensuring compliance with the rules and procedures already established (such as the European Semester) and using correction mechanisms effectively.

While we need to apply the rules forcefully we should not discard the possibility that a country will follow an unsustainable policy. It is unrealistic to assume that everybody will behave in the right way at every moment. Thus, the euro area needs to have a financial adjustment mechanism to provide technical and financial support to individual Member States facing unsustainable situations. This mechanism must be based on a commitment to an economic and fiscal adjustment path with financial assistance conditional on the adjustment progress. The governance of such a mechanism could be organised in the context of the establishment of a 'European Monetary Fund', independent from national governments, endowed with skills and financial capacity that allow quick and informed action when needed.

Another reform that must be implemented follows from the need to have mechanisms to share the costs of shocks. Indeed, while many shocks can be avoided with the implementation of the right policies, others cannot. We need to put in place mechanisms that allow some sort of cross-border risk-sharing to help reduce adjustment costs for the countries affected and prevent disruptions in social cohesion. This means that we have to establish a common approach to dealing with both the idiosyncratic effects of common shocks and with idiosyncratic shocks not resulting from bad national policies.

A well-functioning Monetary Union requires an institution that is responsible for the economic policy of the whole, commands the game from the centre and is accountable for the whole. This institution must be able to explain what it is doing to set the group on the path to sustainable development and a sustainable monetary union. This is a big challenge for the institutional framework of the European Union: it implies creating the culture, values and the political empowerment and accountability to ensure that the group objectives are met. It is a political challenge.

We need an integrator power for national economic policies that takes into account the path of potential output and employment in the area as a whole. This integrator power needs to have at its disposal direct and indirect (via Member States) ways to steer aggregate demand, investment and potential output. This means that the sustainability of the Monetary Union depends on the nature and integrative capacity of the mechanisms that ensure the coordination of national policies, which includes the economic integration stage (the robustness of the EMU economic arm) and the corresponding institutional framework.

In addition, we need to improve private risk-sharing in the euro area by deepening financial markets. This would allow investors to spread the risks through portfolio diversification and would facilitate consumption smoothing. We have already implemented the Single Supervisory Mechanism and the Single Resolution Framework (Single Resolution Mechanism and Single Resolution Fund) and we have to move towards a Single Deposit Guarantee Scheme. The Banking Union is a very important step, complementing the monetary union, but falls short of the full financial integration needed to ensure the proper functioning of the euro area. We have to create European financial markets, with instruments that enable institutional investors (such as insurance companies and pension funds) to invest funds in Europe, in securities issued by the European banking system. These funds are being channelled into investments outside the euro area markets, especially to the US, increasing the exposure of the European economy to exogenous shocks.

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On the effectiveness of non-standard monetary policy measures in Slovenia

(Paper based on the lecture given at the Conference)

Summary

Following the global economic and financial crisis, Slovenia is facing a decoupling of real and financial cycles, which is symptomatic of a balance-sheet recession. Such a recession impairs the traditional transmission channels and limits the effectiveness of monetary policy. The wide array of nonstandard monetary policy measures introduced by the Eurosystem has had only a limited effect on the synchronisation of the two cycles in Slovenia. The economic recovery in now underway, but net bank credit continues to decline in Slovenia.

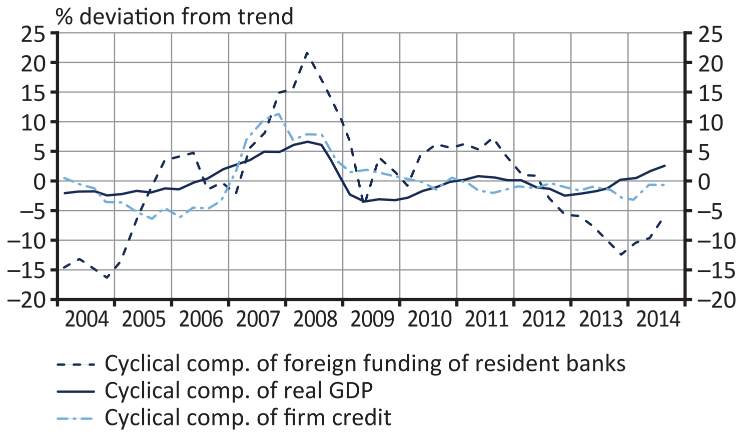
There are several impediments to the effectiveness of non-standard monetary policy measures in Slovenia. The main ones are continued high credit risk, slow enterprise restructuring and an undeveloped market for alternative assets. As in most small, open economies, the exchange rate effect and other indirect effects of non-standard monetary policy measures are likely to dominate the direct effects. Monetary policy will need to be complemented with structural policies to reinvigorate economic and credit growth.

Balance-sheet recession and the decoupling of real and financial cycles

The global financial crisis has hit Slovenia particularly hard and, notwithstanding recent signs of economic recovery, the country continues to face difficult times. The protracted decline in economic activity and a relatively weak recovery have their roots in the pre-crisis boom period.

Economic growth during the pre-crisis period was fuelled by excessive borrowing and risk taking by banks and firms, and there was considerable degree of misallocation of credit. The onset of the crisis in late 2008 caused a sudden stop in external financing and contributed to the impairment of the balance sheets of banks and enterprises. Slovenia was caught in a cycle of reduced credit availability, deleveraging by both banking and corporate sectors, a cutback in corporate investment and output, and rising non-performing loans. Thus, a typical balance-sheet recession ensued, and the real and financial cycles became decoupled (Figure 1). In this environment, the transmission mechanism of monetary policy became dysfunctional. Research by Bank of Slovenia staff shows that a decrease in the share of bank funding from abroad by 1 percentage point reduced domestic lending to non-financial corporations by about 2.5 percentage points and GDP by 1 percentage point with a one-year lag.[1]

Figure 1: Real activity cycle and financial cycles



Source: Bank of Slovenia staff estimates

Eurosystem's response to crisis: introducing non-standard monetary policy measures

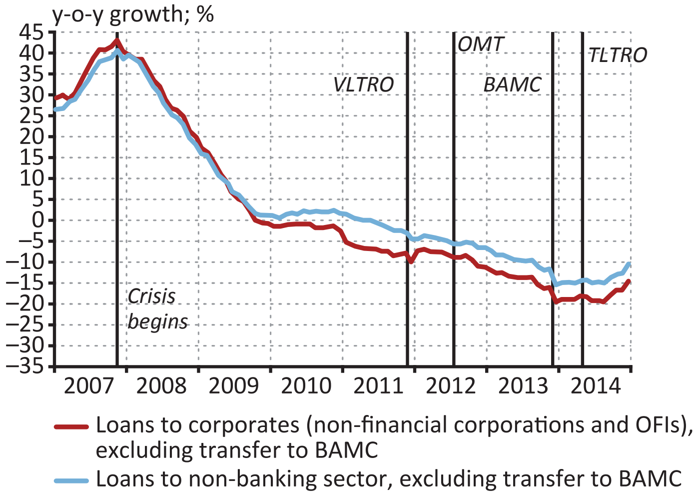
In response to the crisis, the Eurosystem, like other major central banks around the world, expanded its monetary policy instruments to include a variety of non-standard measures. These measures were motivated by a need to ensure the continued effectiveness of the transmission of the monetary policy stance in an environment where the financial system was subject to considerable stress. These non-standard measures can be classified into five groups: (i) extension of maturity of liquidity-providing operations at fixed rate full allotment; (ii) foreign currency swap arrangements (in US dollar and Swiss francs); (iii) easing collateral requirements; (iv) engaging in securities purchase programmes; and (v) introducing negative deposit rate and forward guidance to signal monetary policy orientation.

[1] Jazbec, Herman and Lozej, 2014, and Herman and Lozej, 2014.

The objectives of the non-standard measures varied over time as the environment in which the Eurosystem was conducting monetary policy was also changing. During the first stage of the crisis in the euro zone, following the shutdown of wholesale markets, the priority of monetary policy was to fill the liquidity and funding gaps of the banking sector. In the second phase, non-standard measures aimed at addressing market segmentation and restoring the impaired functioning of the monetary policy transmission mechanism. In the third phase, against a backdrop of de-anchored expectations and a zero lower bound environment, the goal of non-standard measures was to increase monetary stimulus.

Although the common monetary policy in the euro zone was executed with a view of developments in the euro zone as a whole, the impact was not uniform across countries, because of differences in the structural features of the economy and in the starting positions at the beginning of the crisis. A striking feature of Slovenia's experience is that net bank credit to the corporate sector has contracted throughout the crisis period, notwithstanding the various non-standard policy measures (see Figure 2). This outcome is symptomatic of the continued impairment of the transmission channels of monetary policy.

Figure 2: Loans to private sector

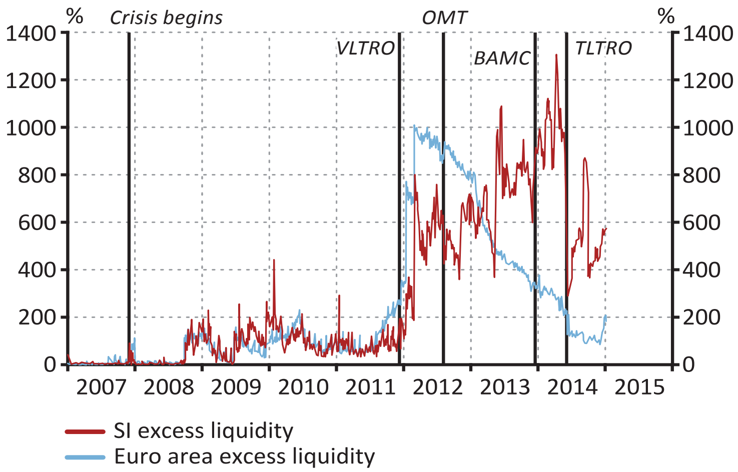


Vertical lines in the figure represent the timing of an introduction of important Eurosystem non-standard measures (VLTRO, OMT, TLTRO) and measures taken in Slovenia (BAMC): VLTRO – Very Long Refinancing Operations, OMT – Outright Market Operations, BAMC – Bad Asset Management Company, TLTRO – Targeted Long Term Refinancing Operations.

Source: Bank of Slovenia. Note: OFI – other financial institutions.

Slovenian banks have used the long-term refinancing instruments (especially LTRO and VLTRO) extensively. The share of liabilities of the Slovenian banking system to the Eurosystem increased strongly in early 2012 to hover at 8-9%, before falling markedly in 2014 to reach around 2% at end-2014. However, the liquidity provided by the Eurosystem was not used to support higher lending to the real sector. In the initial phase of the financial crisis, the ECB's refinancing measures were of immense importance as they helped to partially fill the funding gap left by the sudden stop in access to the wholesale market.[2] In subsequent periods, banks used the refinancing options to accumulate liquidity and facilitate deleveraging. The hoarding of liquidity has continued even in the environment of ECB's negative deposit rates. Since 2013, the excess liquidity of the banking sector has been higher in Slovenia than in the euro zone (Figure 3). The excess liquidity of the banking sector is one of the reasons for the less-than-allocated take-up in the auctions of the TLTRO in 2014. It is particularly notable that a large part of the liquidity acquired in the first two auctions of the TLTRO was used for early repayments of liabilities stemming from VLTRO, instead of credit extension.

Figure 3: Excess liquidity



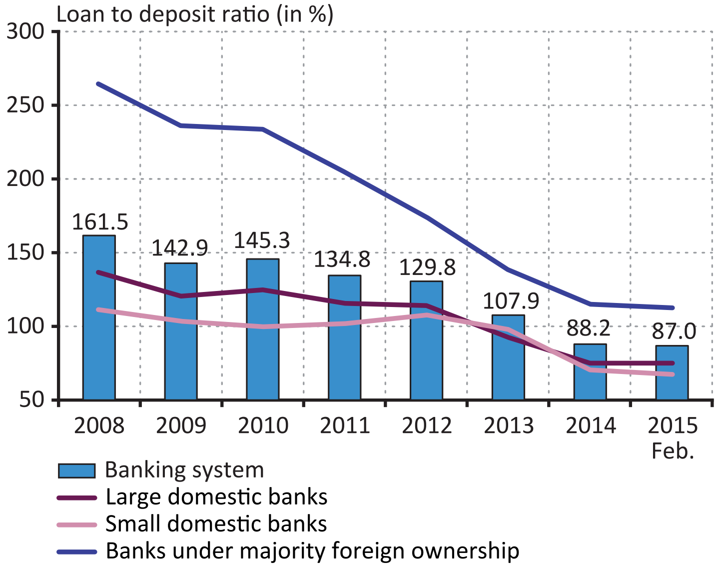
Excess liquidity is defined as bank reserves at the Eurosystem in excess of minimum required reserves + deposit facility + liquidity absorbing operations. Vertical lines in the figure represent the timing of an introduction of important Eurosystem non-standard measures (VLTRO, OMT, TLTRO) and measures taken in Slovenia (BAMC): VLTRO – Very Long Refinancing Operations, OMT – Outright Market Operations, BAMC – Bad Asset Management Company, TLTRO – Targeted Long Term Refinancing Operations.

Source: ECB, Bank of Slovenia; and Bank of Slovenia staff calculations.

[2] In addition, Slovenian government adopted measures to mitigate the drain of foreign funds by borrowing abroad and placing part of the funds raised in banks as deposits.

Total repayment of foreign liabilities by Slovenian banks during 2009-2014 amounted to about one third of GDP. Total liabilities of the banking sector to foreign banks represented peaked at more than 35% of the balance sheet in mid-2008, and this share subsequently dropped to around 13% at end-2013 and 11% at end-2014. The deleveraging process was also manifested in a very fast decrease in the loan-to-deposit ratio from its peak at over 160 in 2008 to 88 in 2014 (Figure 4). With the aim of slowing down the pace of deleveraging in the banking sector and encouraging banks to moderate the contraction of lending to the non-banking sector, the Bank of Slovenia introduced limits on the annual change in ratio of gross loan-to-deposit of the non-banking sector (GLTDF) in 2014.[3]

Figure 4: Deleveraging of the banking sector



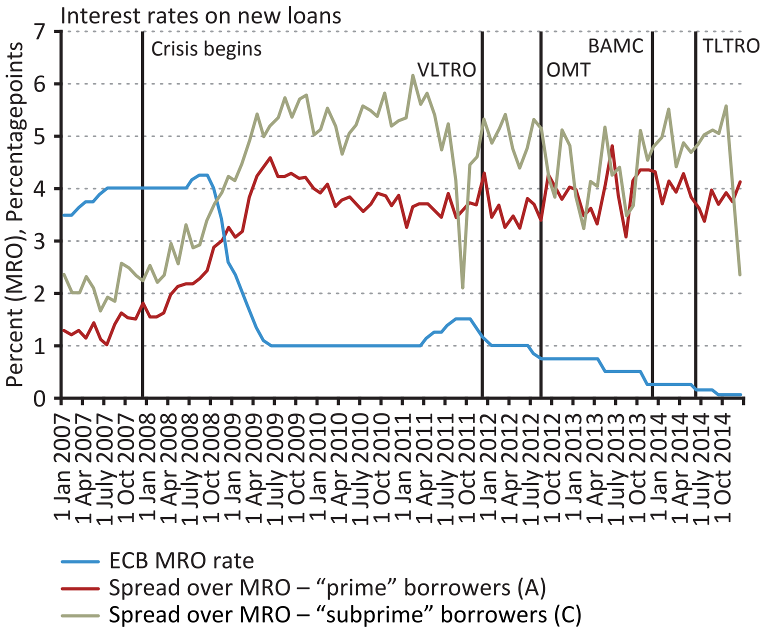
Source: Bank of Slovenia

[3] For more, see http://www.bsi.si/en/financial-stability.asp?MapaId=1192.

Lending conditions of Slovenian banks

Despite the lowering of the main refinancing rate of the ECB and the considerable excess liquidity in the banking sector, lending rates remain high in Slovenia. Slovenian banks increased their mark-up on lending interest rates at the beginning of the crisis, but did not decrease lending rates in line with the decreases in ECB policy rates, even for prime borrowers (Figure 5). Interest rates on loans to non-financial corporations have been constantly higher in Slovenia than the average of the euro area. One main reason for this is heightened credit risk as manifested in a high proportion of non-performing loans. Following the onset of the crisis, the share of non-performing loans in total bank claims increased from 3 per cent in 2008 to a peak of about 18 per cent at end-2013. Despite a significant transfer of non-performing loans to the Bank Assets Management Company, the volume of non-performing loans on the balance sheets of banks remains high (Figure 6).

Figure 5: Interest rates on loans in Slovenia



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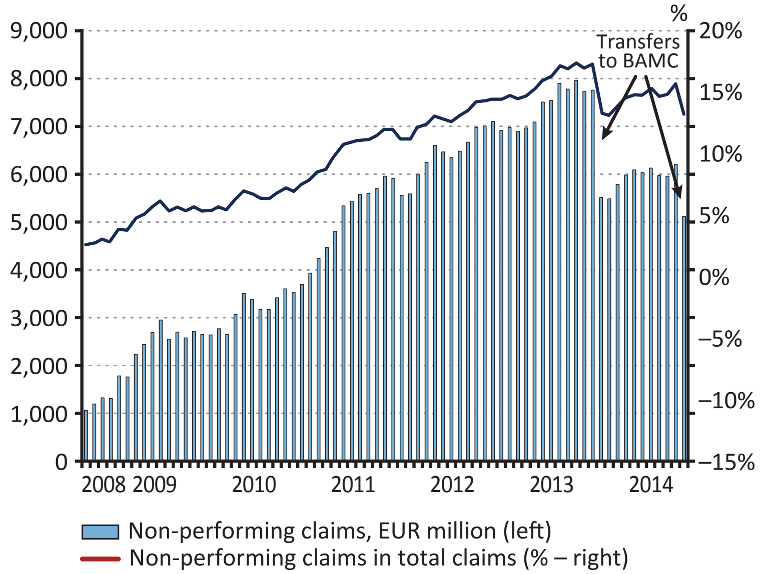
Source: ECB, Bank of Slovenia, and Bank of Slovenia staff calculations

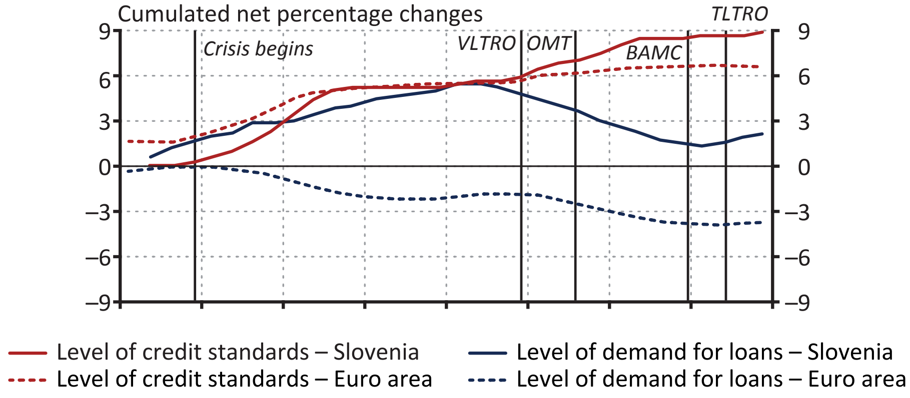
Figure 6: Non-performing loans in Slovenia



Source: Bank of Slovenia

After the crisis hit, Slovenian banks became very cautious in providing loans to the corporate sector and increasingly tightened lending standards. While the tightening of credit standards eased in 2014 in the euro zone as a whole, Slovenian banks continued to tighten standards despite their recapitalisation and transfer of non-performing loans from their balance sheets (Figure 7). There are several possible explanations for such behaviour: (i) better risk management practices in banks; (ii) stronger supervisory oversight; (iii) large debt overhang in some parts of the corporate sector; and (iv) with better clients tapping alternative financing abroad, the demand for loans was mainly from weaker and more risky borrowers.

Figure 7: Demand and supply conditions for loans to non-financial corporate sector in Slovenia



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Source: Bank Lending Survey and Bank of Slovenia.

Will the expanded asset purchase programme be effective in Slovenia?

The direct effects of the expanded asset purchase programme of the ECB are likely to be limited in Slovenia. ABS and covered bond programmes face obstacles. ABSs and covered bonds do not exist in Slovenia owing to the small amounts of underlying assets, first mover disadvantage and, to smaller extent, due to legal uncertainty and tax issues. It may also be noted in this context that the diversification of risks by means of securitisation is weaker because the pool of underlying assets that can be securitised is small. Banks which are losing their best clients magnify these problems as they may not have a sufficient volume of eligible loans.

The direct effects of quantitative easing via purchasing sovereign bonds also may be limited in Slovenia. It is uncertain that banks will pass on the additional provision of liquidity to the private sector. Although yield curves are flattening, these effects are not expected to be transmitted to loan pricing conditions for several reasons. One dominant reason is that the purchase programme itself does not guarantee that banks will be willing to sell bonds at all, given that they are risk-averse and face very low-yield (or even negative-yield) alternative assets.

The main effect of quantitative easing on Slovenian economy is likely to be indirect, via a more depreciated euro exchange rate and via demand spill-overs from other countries where the beneficial direct impacts are strong.

Conclusions

The global and financial crisis has shown that monetary policy alone cannot resolve the deep structural imbalances that resulted from the pre-crisis model of unsustainable economic growth. The initial liquidity providing non-standard monetary policy measures of the Eurosystem following the onset of the crisis performed a critical positive key role. They successfully filled the funding gap of the banking sector when the wholesale markets were shut down abruptly. However, the provision of credit to the economy by banks was seriously hampered by the impairment of the balance sheets of banks and enterprises. Notwithstanding decisive policy action to repair the balance sheets of banks, the monetary transmission channel remains dysfunctional, because the necessary balance-sheet repair of the corporate sector is yet to be completed. Enterprises continue to suffer from large debt overhang and are still deleveraging. Priority needs to be given to speeding up corporate sector restructuring.

The latest expanded asset purchase programme of the ECB is likely to have a limited direct effect on the Slovenian economy. The main reasons are that the instruments to be purchased by Eurosystem do not exist in Slovenia, and that banks are already loaded with liquidity. However, indirect effects are expected to prevail, mainly via a lower euro exchange rate and higher demand from large trading partner countries where the quantitative easing may have stronger effects.

BORIS VUJČIĆ

Governor
Croatian National Bank

Crisis and central banking paradigm

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

Ladies and Gentlemen,

Today, the issue of a new central banking paradigm is intensively debated. At the heart of this debate are questions such as how globalisation affects monetary policy, monetary policy spillovers, zero lower bound, and issues of unconventional monetary policy, etc. Deflation is another highly ranked topic.

Global financial cycle

Does increasing globalisation affect monetary policy? There is quite a lot of evidence, convincing evidence, on the existence of the global financial cycle. The global pool of liquidity, through the interconnected financial sector, leads to monetary policy spillover throughout the world, and the areas for shock propagation and amplification are now more open than ever before. Financial fragility linkages are getting stronger, through the banking system, amongst other channels. This is particularly the case in Central and Eastern Europe, which is now deeply integrated through the banking sector with the rest of Europe.

Even prior to the crisis it was difficult for the central bankers of small, open economies to operate independent monetary policy with a banking sector integrated with the rest of the Europe through foreign parent banks. For example, if the central bank of Croatia wanted to tighten monetary policy conditions, while the ECB was doing the opposite, the ECB won. Banks could simply get financing from the ECB, through their parent banks. However, although difficult, there are ways for a small open economy with a banking sector implicitly integrated with a large central bank, to achieve a decent degree of independent monetary conditions. Doing that implies using a wide array of macroprudential tools. Prior to the crisis, the Croatian National Bank went all the way to introducing capital inflow controls.

Globalisation and inflation

How much has globalisation moderated inflation? Globalisation has increased trade integration and greatly reduced barriers to market access. There is a lot of reallocation of production through FDI, which puts downward pressure on tradable goods and on overall inflation. Firms today are faced with increasing competition, and so it is more difficult for them to raise prices. At the same time, it is more difficult for workers to ask for higher wages because of the increased competition. Over the last 15 years, we have seen broad productivity gains particularly in the emerging markets. That growth has increased supply, and even created what slowly appears as excessive capacity, which continues to weigh down on price developments.

Today, monetary conditions in emerging markets are more exposed to world conditions than ever before. As a result, the strength of cyclical response of inflation to domestic output fluctuations is reduced. Prices of many items that are produced or consumed in our countries are now increasingly determined by foreign demand and supply factors rather than by local factors.

Financial integration has allowed the weakening of the relationship between domestic output and demand. This happened through the easy financing of the current account deficits, facilitated by the strong foreign bank presence, particularly in Central and Eastern Europe. That was, however, also the case in the Eurozone, where many countries have enjoyed very easy access to deficit financing. There is clear evidence that international capital flows today transmit monetary conditions to other countries even under floating exchange rate regimes. In the past, the assumption was that the floating exchange rate regimes protect the real economy, but that is hardly a case today. Particularly not so for small open economies.

Croatia has used many unconventional monetary policy tools, later dubbed macro-prudential policies. It is very difficult, from the perspective of a central banker in a country such as Croatia, to draw the clear line between the macro-prudential and monetary policy measures. The question for was: “Is it possible to run a countercyclical monetary policy in a small open economy with a stable exchange rate regime?” Conventional wisdom would suggest that it is not. Yet, while it was difficult to conduct an independent countercyclical monetary policy under such circumstances, a wide space for manoeuvre actually existed. The fact that financial market imperfections limit perfect capital mobility, and that Croatia was not a member of the EU, which allowed us to introduce capital controls at the time of the peak of excessive credit growth, were both helpful.

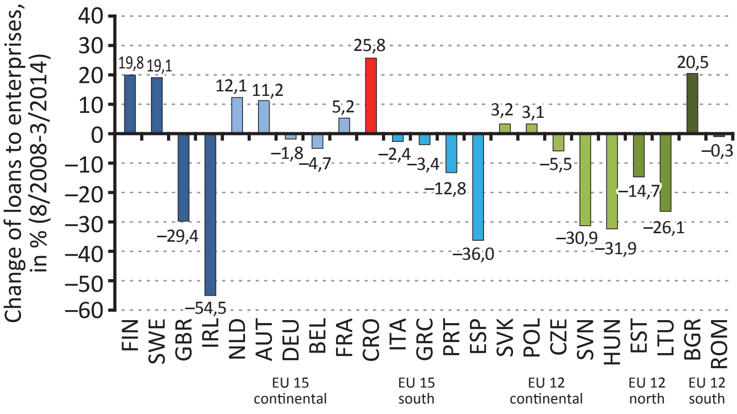
It is of crucial importance to act in time, as it is impossible to make up for a delay. But it is better to act belatedly than not to act at all. In order to be effective, one should often try to think "out of the box", while looking back into history can also be of much help. In Croatia, prior to the crisis, a number of unorthodox, unconventional measures, such as a capital inflow tax, were used. As Croatia at the time was not part of the EU, it was possible to use a capital inflow tax of 55 per cent. This measure proved very beneficial in providing independence to monetary policy making. In additions, credit growth was implicitly taxed in a very harsh manner. Also, banks were asked to hold a large amount of foreign exchange liquidity. Capital requirements were higher for foreign exchange lending to the unhedged borrowers.

By putting in place a number of such macro-prudential and monetary policy measures, credit growth and the banking sector's foreign indebtedness were moderated. A huge foreign exchange liquidity buffer was created before the crisis and the tier-one capital of the banks was doubled, making the capital adequacy ratio highest in Europe. At the time of the start of the crisis, it was 16 percent, and today it is more than 21 percent.

Now, when the crisis-induced policies were reversed – capital inflow control was removed, foreign exchange liquidity requirements were reduced, as was the reserve requirement, thus creating a huge liquidity surplus in both foreign and domestic currency. Also, that reduced regulatory cost impact on interest rates by two thirds. That demonstrates that a small open economy, with a stable exchange rate, can do much in order to run countercyclical monetary policy. The liquidity surplus created at the beginning of the crisis was so huge that the repurchase agreements in domestic currency became unnecessary, due to lack of demand. The structural liquidity surplus remained high throughout the crisis.

In the 2008-2014 period, Croatia recorded the highest cumulative growth in corporate lending in Europe. However, on the other hand, GDP recorded the second strongest decline after Greece. Even if monetary policy was appropriately countercyclical, and created monetary policy space, if other policies, primarily structural policies are not in place, and fiscal policy is procyclical, monetary policy cannot do very much.

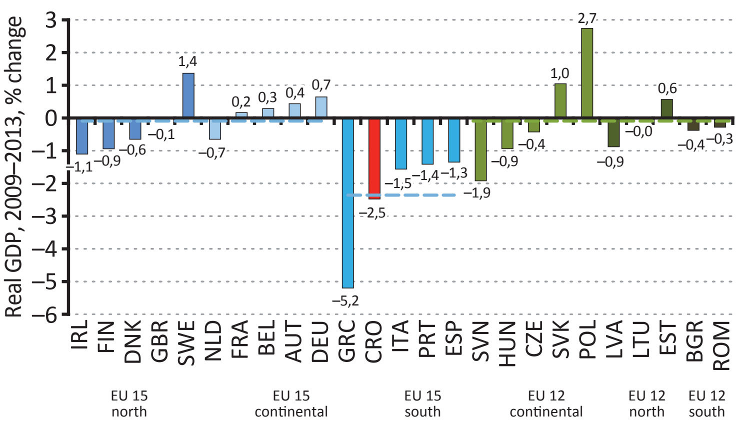
Graph 1: Changes of loans to enterprises, in % (8/2008 – 3/2014)



Note: EU15 = Finland, Ireland, Sweden and United Kingdom (north), Austria, Belgium, France, Germany and Netherlands, (continental), Greece, Italy, Portugal and Spain (south). EU 12 = Estonia, Latvia(north) Czech Republic, Hungary, Poland, Slovakia and Slovenia(continental), Bulgaria and Romania (south)

Source: ECB and national central banks

Graph 2: Real gross domestic product (GDP change, average 2009-2013)



Note : EU15 = Denmark, Finland, Ireland, Sweden, and United Kingdom (north), Austria, Belgium, France, Germany, and Netherlands, (continental), Greece, Italy, Portugal, and Spain (south). EU 12 = Estonia, Lithuania, Latvia (north), Czech Republic, Hungary, Poland, Slovakia, and Slovenia (continental), Bulgaria and Romania (south)

Source:Eurostat

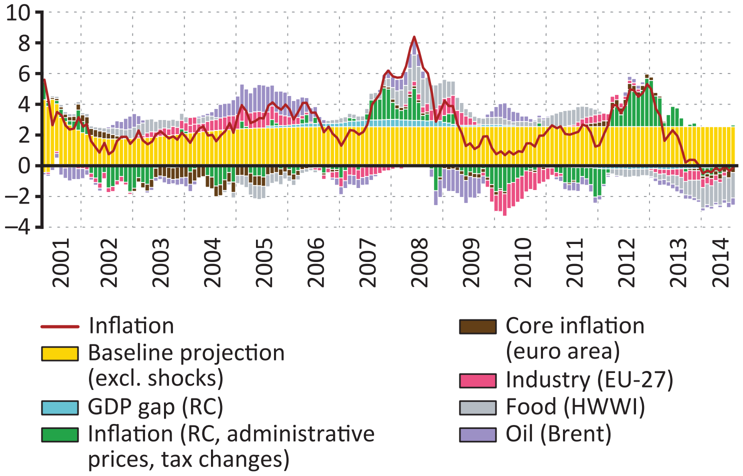
Our lessons from the crisis

The first lesson is that even a small open economy which is euroised, with almost a fixed exchange rate, can conduct a countercyclical monetary policy, if it uses unconventional /macro-prudential monetary policy tools. The second lesson is that if other policies are not in place, monetary policy alone cannot achieve a lot. The question is whether accommodative monetary policy back in 2009 was actually counter-productive, by allowing the government to access financing from the domestic banking system when the foreign markets closed down. Would it have been better if the monetary policy had done less and, therefore, pushed the government to do more? Whether that would have produced more structural or fiscal reforms and the country as a whole would have done better? Maybe. Because of strong countercyclical monetary policy, the pressure was relieved from the government to press forward with the adjustment. But then, central bankers are unelected officials with a clear mandate, and in such circumstances it is very difficult to assume that others will not do their part and, subsequently, not do whatever one can do. It is very difficult for central bankers to think and act in that way, although, ex-post, it might turn out that such policies help create more risks.

Inflation

At the moment, the Croatian central bank's main objective of price stability is mainly externally driven. In 2014, the inflation was -0.2 per cent, very mild deflation. As for the drivers of deflation, domestic output gap has almost no effect. The whole effect of the price decline is the result of the decline in food and energy prices. If, for example, food and energy prices were at their 5-year average before 2014, inflation in Croatia would have been 2 per cent in 2014. Instead, it is -0.2 per cent. Looking at the inflation diffusion index, it shows that every month 22-30 per cent of the prices are declining, which is in line with the 5-year average. Data from household surveys do not point to the existence of deflationary expectations in the real sector, as there is no indication that consumers are postponing purchases of durable consumer goods. Indebtedness and the debt service ratio of the household sector are declining in spite of the mild increase in the real interest rate. Finally, the decline in the energy commodities prices produces significant positive terms of trade shock for the Croatian economy.

Graph 3: Inflation decomposition into baseline projection and domestic and external shocks in a small open economy (Croatia)



* *Baseline projection, i.e. a scenario which does not take economic shocks (whether domestic or external) into account*

Note: Data as of April 2001.

Source: CNB.

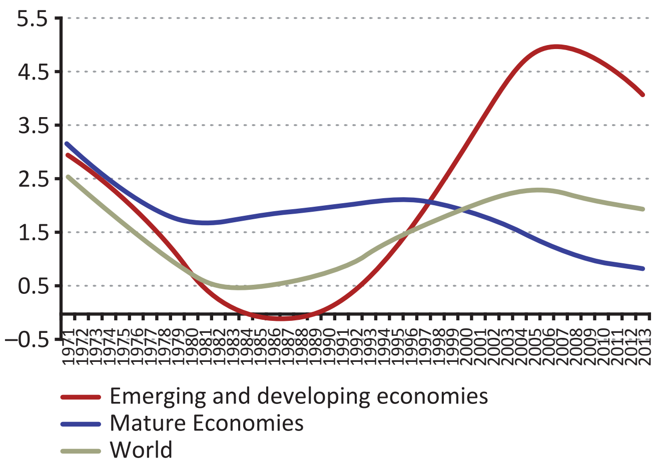
Deflationary episodes through history

Past deflationary episodes are still not understood well enough. There is little conclusive evidence in the literature about deflation in general, with too few deflationary episodes, and almost no recent ones. Historical example of "good" deflation, during the late 19^{th} century in the US is relatively well known. It was the time of the classical gold standard and the second industrial revolution in the US. For a quarter of a century constant deflation was coupled with high GDP growth.

On the other hand, an example of "bad" deflation is associated with the Great Depression. Earlier papers link deflation with the depression. But the new ones actually put in doubt the early findings of, among others Bernanke and James (1991). Atkeson and Kehoe (2004) looked at the data for 17 countries for more than 100 years. Except for the Great Depression, they did not really find evidence of a negative link between deflation and GDP growth. On the contrary, they found many more periods of deflation with reasonable growth than with depression, and more periods of depression with inflation, than with deflation. The issue about the link between deflation and growth is, I would say, very much open, in spite of the strong conclusions that have often been drawn recently.

In some sense, one can also draw a parallel, between the late 19th century USA, and the early 21st century global economy. The late 19th century was a period of rapid productivity growth. There was a deep workforce pool, and the productive resources were being reallocated away from agriculture or from less productive industries to more productive ones. It was the time of the second industrial revolution. More recently, not such a different process is happening in emerging Asia. There was rapid productivity growth over the last 15 years (see graph), deep reservoirs of labour force and no wage pressures. The waves of inflation moderation have been transmitted throughout the global economy. The question is whether the depletion of these productivity gains and the deep pool of work force in Asia will be coupled with the reappearance of inflation and wage pressures? Or will the build-up of excess capacity that has accompanied rapid growth, continue to put downward pressure on global prices?

Graph 4: Productivity gains



Source: The Conference Board

Bad deflation vs. good deflation

Declining long-term inflation expectations are indicators of bad deflation. A prolonged period of very low inflation might destabilise inflation expectations. Central banks are expected to react to the temporary shock, which might spread through the economy and induce a decline in long-term inflation expectations. It is clear that the more indebted economy is, the more likely the deflation will be "bad". But in the Monetary Union, or more generally in a fixed exchange rate regime, due to the lack of the exchange rate instrument, some deflation is necessary for adjustment. This so-called internal devaluation creates a deflation paradox. In a vicious circle, more indebtedness, a consequence of lost competitiveness, requires more deflation in order to regain competitiveness, and thus reduce indebtedness, while on the other hand more inflation would help make debt more sustainable.

Since deflation necessary to regain competitiveness is relative, some positive rate of inflation of, between, for instance, 1 and 2 per cent, *relative* to others, would help make debt more sustainable. That is possible in positive inflation territory only if others have significantly higher inflation than 2 per cent for a prolonged period of time. How realistic that is, is really a structural and institutional issue. As countries with higher competitiveness have little incentive to change their policies, that seems to be quite an unlikely outcome. Therefore, competitiveness should be regained via structural reforms aimed at increasing productivity levels.

New central banking paradigm

Before the crisis, perceived output gaps were neutral, inflation was very mild, and the prevailing opinion was that this was enough to provide financial stability. As became painfully clear after 2008, financial instability was accumulating through the lending and asset price booms. After the crisis, the new consensus emerged that low inflation and perceived neutral output gaps are not enough to ensure financial stability and macroprudential policies in developed economies were widely adopted. Central banks are now explicitly given the financial stability mandate. This new consensus may eventually lead to a new paradigm. But so far, this notion opens new questions to which there are no clear answers. For example, how to reconcile the financial stability mandate with the monetary policy goal? Who plays the second fiddle and when?

At the moment, it seems that monetary policy is still primarily concerned with a narrow price stability mandate, but the central banks are increasingly looking at the financial stability issues and asset prices through macro-prudential regulation. Some say that “only the interest rate goes to all the corners”, as it is often heard from Basel. But it is very difficult to draw a clear line between the monetary policy and the financial stability mandate. In addition, some recent work (Mihaljek et al., 2015) shows that interest rates were historically of little use in preventing housing price booms.

The Mandate

The question of how much actually should central banks worry about asset price inflation remains open. The evidence seems to be that the central bank policies currently have more direct impact on the exchange rates and asset prices than on the CPIs, which are their main mandate. And could unconventional monetary policy do more harm than good by trying to push through the closed door? Especially if the structural conditions in the economy limit productivity and GDP growth? Is monetary policy already overstretched? When structural and fiscal policies are not in place, more pressure is put on monetary policy to compensate. This might lead to the overstretching of monetary policy and endanger, in the end, the central bank independence.

There are also legitimate questions of whether inflation and output gaps are measured properly, or what should be the exact proper target for inflation. These, essentially old issues, are now reopened with an argument for new, for example path-dependent monetary policy targets. And also, some old medicines are invoked – for example, capital controls to insulate small, open economies from the global financial cycles on which they have no influence.

To conclude, is there a new central banking paradigm appearing? Except for the issue of the financial stability, on which there is now a clear consensus, and it has already being assigned to the central banks as an explicit mandate, there are still too many open questions. The crisis opened more questions than it has given answers, and thus it would be too early to talk about a new central banking paradigm emerging from the crisis. Actually, it looks that now, given all these open questions, monetary policy is even more an art than a science, than was the case before. And, as usual, when it comes to art, the beauty is in the eye of the beholder. At least, until we get better evidence to build a new central banking paradigm. Thank you.

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Independence of Monetary Policy and the Banking Union

(Paper based on the lecture given at the Conference)

Check against delivery

One of the lasting lessons we have learned from the monetary policy experience of the last decades is the value of the independence of central banks. What does this independence mean today? Why should we have it? What are the current problems involved?

The modern idea of central bank independence was born from the lessons learned in the fight against the high inflation of the 1970s and the 1980s. The Bundesbank became the role model which has not been forgotten. The supporting theory was later developed by the great economists of the day: Stanley Fischer, Kenneth Rogoff, Carl Walsh and others.

The fight against inflation was successful, and the lessons learned from this fight inspired great reforms in the central banks. In Europe, those lessons inspired the writing of the statutes of the ECB. Securing central bank independence and preserving the hard-won price stability were key ingredients.

Today's monetary problems are very different. In some respects, they are almost a mirror image of the problems of the great inflation era. But I am convinced that central bank independence is equally important in today's environment.

Still, it is interesting to think once more what exactly this independence means and what it requires in today's different context.

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In research, it is usual to distinguish two types of central bank independence: goal independence and instrument independence.

Just a few comments on goal independence.

Goal independence would mean the ability of the central bank to formulate the ultimate objectives of its policy. In democratic systems, goal independence is typically quite limited, and the objectives of central bank are given by elected bodies. This is how it should be. It gives the central bank's activities the necessary democratic legitimacy.

The ECB has been given price stability as its primary objective. The Treaty left to the Governing Council to give an operational definition of what price stability means. As you know, the current definition, unchanged since 2003, is that inflation should be "below but close to two percent over the medium term".

The words "close to" were added to the ECB's definition of price stability in 2003, after a serious and thorough consideration. These words have now gained increasing weight, as inflation in the euro area has been clearly below 2 per cent for quite some time.

We have been forced to think carefully what the expressions "close to" and "over the medium term" mean. The Governing Council has remained committed to the definition of 2003, and with a good reason. The definition of price stability in the medium term must provide a credible anchor to expectations. So we must follow it to the letter.

Now on the other level of central bank independence, instrument independence, before I return to price stability.

Instrument independence means that the central bank has a great deal of freedom to use its monetary policy instruments in order to achieve its policy goals. Without such freedom, the ability of monetary policy to achieve its objectives would not be credible and the policy itself could become ineffective.

Modern central banks have had a very high degree of instrument independence since the 1990s. This was taken for granted, and remained so, as long as the main instrument was the interest rate. Now, after the central bank interest rates have reached their lower bound – close to zero – monetary policy has had to turn to other means. This is now a global phenomenon in the advanced countries.

The use of "unconventional monetary policy tools" such as large-scale bond purchases has restarted the discussion of instrument independence. What can the central bank do under its instrument independence? For example, there have been some, however not many, critics who claim that the ECB's bond purchase programmes could go beyond the definition of monetary policy.

The ECB's case for the legality of its various bond purchase programmes has been argued elsewhere and I will not go into that here. I just want to reiterate that in the Governing Council, we all agreed that the Extended Asset Purchases Program decided on 22 January is a monetary policy tool.

But instrument independence is not only about what the law allows the central bank to do.

Independence also requires that the environment in which monetary policy operates is such that a successful monetary policy is possible and viable. And this is where it becomes really interesting and where the present very low inflation environment makes a difference.

We usually distinguish two such threats to independence. They are called "fiscal dominance", and "financial dominance".

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Fiscal dominance is the older concept of the two. Fiscal dominance would arise if the government financing constraint were to become an overriding influence on monetary policy.

The idea that tight monetary policy may become impossible without accompanying fiscal adjustment was well understood when the blueprints for the EMU were being prepared. This is why the Maastricht treaty had its fiscal policy clauses and also why the Stability and Growth Pact was concluded. Also the famous prohibition of direct central bank credit to the government, and the institutional independence of the central banks, are in effect protections against fiscal dominance.

Now we know that the fiscal framework as put in place before the start of the EMU was not strong enough to prevent fiscal problems from emerging. Some have been worried that fiscal dominance has taken hold when the central banks have used government bond purchases, both to stabilise the markets and to produce additional monetary stimulus with "Quantitative Easing" when the interest rate instrument has already been used to the maximum. The Extended Asset Purchase Programme of the ECB announced in the week before last is an example.

As for the euro area, there is no evidence of fiscal dominance. The acid test for fiscal dominance is: does monetary policy violate its price stability objective for the sake of maintaining the solvency of the government sector. This is not the case. The price stability objective has not been and will not be abandoned.

The bond purchases of the Eurosystem are directed to make monetary policy more effective, not less. In particular, we want to move closer to our definition of price stability, and the bond purchases are contributing to that end.

We have had well known fiscal problems in some of the euro-area countries. Still, the traditional symptom of fiscal dominance, accelerating inflation has not materialised, nor have inflation expectations risen. Inflation expectations remained well in line with the price stability objective until last summer, when they started to show signs of declining, not increasing.

Does this mean that the risk of fiscal dominance has become obsolete? Certainly not. The idea that monetary policy should be able to concentrate on its primary objective is relevant also now. But it manifests itself in a slightly different way than in a high inflation environment.

The solvency of governments is a self-evident condition for sustainable policies. But striving for our definition of price stability now requires a very accommodative monetary policy, which includes exceptionally low interest rates, and also bond purchases. There have been worries that such a policy could make it too easy for governments to engage in excessive deficits and fiscal irresponsibility. Is the ECB, for its part, making life too easy for governments which should continue their consolidation efforts?

It may well be that the financing of government deficits is made easier by an accommodative monetary policy. But the primary goal of monetary policy is price stability, which includes avoiding the threat of deflation. The responsibility for fiscal discipline is with the governments, and in the EU also with the Council and the Commission in their particular roles.

Prudent fiscal policy and abiding by the fiscal rules is essential, but we cannot have a trade-off between fiscal discipline and price stability. We can and must have both. The division of responsibilities between the ECB and the governments is clear, and each must do their part.

We should beware of the danger that problems which are fundamentally political could be pushed to central banks to solve. A division of responsibilities between appointed officials and elected politicians should be preserved. That division of responsibilities is one of the forms that the central bank's instrument independence takes today.

Monetary policy can neither micromanage the needed structural transformation in the real sector of the economy nor solve excessive deficit problems of governments.

In the euro area, the countries which have their public finances in order will benefit more from the accommodative policies of the ECB. The experience of the last years shows clearly that if there is any doubt about the long-run solvency of a government, monetary policy will not be transmitted fully to that country's private sector either.

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Let me turn next to consider the other potential threat to the independence of monetary policy, the threat of financial dominance.

Financial dominance means the possibility that the condition of the banking system could become a constraint, or dominant influence, on monetary policy. The idea is that a weak banking sector could force the central bank to pursue second- or third-best monetary policies in order to prevent a banking crisis.

In theory it is easy to see how this could happen. One can imagine a central bank which would have to tighten its monetary policy for price stability reasons, but is prevented from doing so for the fear that the value of the assets of the banking system would decrease and a financial crisis could ensue.

Episodes which fit that kind of financial dominance have been observed in the past, especially in the emerging economies. And in my own country, the severe crisis in the banking system was one of the main reasons which forced a devaluation of the currency in 1991.

But looking at the more recent experience, this has not really been the case in the advanced economies. The bust in 2008 of the last credit boom did not lead monetary policy to tolerate a higher-than-mandated rate of inflation. Instead, in the large advanced economies at least, the bursting of the bubble coincided with a contraction of private demand and a deep recession.

The negative effect of the crisis on economic activity actually reduced inflationary pressures. The main problem since then has been how to prevent the deleveraging process from starting a deflationary spiral. In such conditions, monetary policy which eases the strain on the banking sector has at the same time supported price stability.

Now, almost five years later, do we have a trade-off between price stability and financial stability? By conducting a monetary policy of extremely low interest rates, combined with exceptional measures such as bond purchases, are we stoking asset price bubbles and encouraging too risky lending practices by banks?

Very low interest rates may encourage risk taking by the investors. This is actually one of the objectives. Our economies need more productive investments.

The low interest rate environment will also affect bank lending. This is also desirable, and it is hoped that business lending to job-creating SMEs will be stimulated.

However, we hear worries that the incentives could be too strong. This is based on the fear that banks will finance investments which are too risky, or the stimulus could be unduly concentrated on, say, the real estate sector.

Of course, successful monetary policy requires a stable financial system. If stability is not there, the transmission of monetary policy can hardly work smoothly. This is one of the lessons of the financial crisis.

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Here we see how the problem of possible financial dominance is manifested in today's economic environment. Now it is not the question of whether the banking system can endure a hard, disinflationary monetary policy. We must pose the question in another way: how can we make sure that the banking system is able to operate prudently under a monetary policy that seeks to maintain price stability "from below", with an accommodative, even expansionary stance?

There was a famous discussion on how monetary policy should relate to credit booms and asset prices at the Jackson Hole conference of 2007. At that time, the prevalent thinking in central banking circles was what it is better for monetary policy only to "clean" (up after the bursting of the possible bubbles) than to "lean" (against the wind).

The strategy of the ECB includes the so-called second pillar of monetary analysis, which focuses on signals from money supply and credit creation. This means we are committed to consider the sustainability of the developments in the banking sector and their compatibility with price stability.

After the hard lessons we have learned over the last five years, the case for benign neglect of asset booms and only picking up the pieces afterwards is not very attractive. The crisis experience supports the idea that financial excesses are better prevented as they happen rather than only be managed after they have caused a recession.

One option is leaning against the wind. That would mean taking the price stability objective in a more flexible way and paying more attention to asset prices in monetary policy formulation. But there are difficulties with that:

One difficulty is the problem of detecting the credit cycle in time, and correctly timing the monetary policy response. Another problem is that price stability might get too little attention. If the price stability objective had to be compromised because of the developments in the banks and in the financial markets, we would actually have a case of financial dominance.

How can this be avoided? Naturally, it is the quality of commercial bank management and the internal incentives built into the banks' management systems that are the first line of defence. But we have also learned that prudent management practices need to be supported by good and effective regulation.

This leads to my other main point today. In today's environment, the effective independence of monetary policy requires good regulation which ensures that the banking system as a whole remains stable and solid through the interest rate cycle, not only in times of tight monetary policy but also in times of very accommodative monetary policy.

Like the fiscal discipline of governments, which protects monetary policy from forms of fiscal dominance, effective banking regulation protects monetary policy from financial dominance. We can see how these prerequisites for independent monetary policy are as important for today's accommodative monetary policy as they were for a disinflationary monetary policy when the concept of independence was developed.

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Fortunately, major progress has been achieved in the field of banking regulation, not least in the euro area with the banking union.

There are three aspects of the developing banking regulation that I want to mention in this connection.

First, the prudential regulation of banks is now stronger and more uniform than before. Banks' capital ratios have been strengthened a lot since the crisis, and the responsibility for supervision has been centralised at the ECB. This has already made banks more resilient in the face of any future shocks.

The new bank recovery and resolution framework is also part of the banking union. Its purpose is to reduce the moral hazard problems which are linked to the problems of explicit or implicit government guarantees and the too-big-to-fail. It strengthens the incentives for prudent risk management and the correct pricing of risks. It will make banks more resistant to the temptations which the low interest rate environment may entail.

Second, the EU and the member states are now implementing new macro-prudential instruments which are designed to improve the stability of the financial system as a whole. Macro-prudential policies are very closely related to the problem of ensuring the independence of monetary policy from financial dominance.

Especially interesting are those macro-prudential tools which can be adjusted according to the situation in the asset markets and the credit markets. Such instruments include, in particular, the countercyclical capital requirements, as well as the adjustable restrictions on Loan-to-Value ratios.

The connection between macro-prudential policy and monetary policy is so intimate that central banks must be closely involved in macro-prudential analysis and decision making. In the banking union, macro-prudential policy is a shared competence between the member state authorities and the ECB. Member states can react to national developments with national measures, and the ECB has an option to require additional restrictive measures where it deems that necessary. The national component is important and valuable since especially the real estate markets behave often differently in different countries.

Third, while macro-prudential policy is important, it would benefit from the kinds of structural reforms which would make the banking system more resilient, and – I emphasise – less prone to unstable behaviour.

By separating the most risky securities and derivative activities from deposit banking, the spill-overs from deposit protection to speculative risk taking in the securities markets would be prevented. This would reduce any distorted incentives to expand trading activities in the universal banking groups. Several European countries have already implemented legislation which seeks to separate some parts of the securities business from deposit banking. The EU level proposals are under discussion between the Council and the European Parliament. I hope that a solution will emerge which ensures as level a playing field within the EU banking market as possible, while contributing to the resilience and stability of the financial system.

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A New Narrative for Europe (and for the monetary union after the crisis)

(Paper based on the lecture given at the Conference)

All regions of the world were hit unexpectedly by the current crisis. Policy-makers everywhere, especially in the developed world, had to turn to non-standard instruments after exhausting the potential of standard tools. The particularities of central bank reactions reflected the structural and other specific features of each jurisdiction. While similarly surprised, some regions fared better in terms of dampening the impact of the crisis and helping their economies to find a new growth path, whereas others were less successful. Notably, those areas where the level of indebtedness – either that of the public or the private sector or of both – was lower, and the credibility of economic policy was higher, suffered a lighter blow. By contrast, countries where indebtedness was higher, especially when a significant portion of it was denominated in foreign currency, were hit harder. Those countries which followed stability-oriented economic policies for a shorter period and had less resilient institutional systems became even more vulnerable.

1.1. Gross capital flows not global imbalances may help to understand the crisis

Before the crisis, much ink was spent on global imbalances. Most of the analyses pointed to the current account deficits and surpluses, and capital flows were explained in terms of differences between domestic savings and investments. The polar cases in global terms were the US and China, while the euro area as a whole, having a roughly balanced external balance, was seen as not significantly contributing to the global imbalances. At the same time, Hungary, and some other Central and Eastern European countries (CEECs), showed significant external deficits. This contrasted strongly to other emerging market economies, which refrained from allowing negative trade balances and also were keener on fiscal discipline. The attitude of the latter group was explained by the legacy of the Asian crisis.

It is interesting to recall that at the time the main narrative was relaxed about imbalances. Although the size of the imbalances was unprecedented, in one way or the other these constituted a 'kind of equilibrium' in the sense that they were in line with the expectations. At that stage of development (so it was said), it was in the long-term interest of the countries involved to rely on foreign funds to modernise their economies. A new term 'Bretton Woods II' was coined to give a new context for the prevailing imbalances as an acceptable development. In the case of CEECs, importing external savings, i.e. capital inflow, was seen as desirable to facilitate convergence ('inter-temporal optimisation'). Within the European monetary union, a similar development took place, leading to internal imbalances between the 'core' and the 'peripheral' countries. Although countries differed in many important ways, the common feature between them was high indebtedness, largely financed from outside the country, but from within the monetary union. It was unclear at the time how much this indebtedness counted as an 'external' or 'internal' imbalance from the point of view of a particular euro-area country.

While there were some (while not very sanguine) comments characterising these imbalances as unsustainable, even these views expected a 'classic', gradual current account adjustment, which would be supported by a significant realignment of the EUR/USD exchange rate, in the event that confidence in the value of USD-denominated assets was shaken. As we all know now, the crisis unfolded quite differently. The US dollar did not lose its value, and USD assets served as safe haven assets. First and foremost, the crisis was a financial or banking crisis, and it started in the US interbank market. European banks – which were heavily exposed to the US subprime market – were also hit hard, despite the fact that the euro area's current account was balanced vis-à-vis the rest of the world. It turned out that we should have looked more closely at *gross capital flows*, rather than focusing on current account imbalances (net flows). The stock of indebtedness of the private and public sectors and their currency denomination was also much more important than it appeared at that time. It turned out that the indebtedness of the private sector in several CEEC countries was more or less unrelated to their current account positions and resulted from capital inflows mediated by commercial banks (i.e. 'other capital flows').

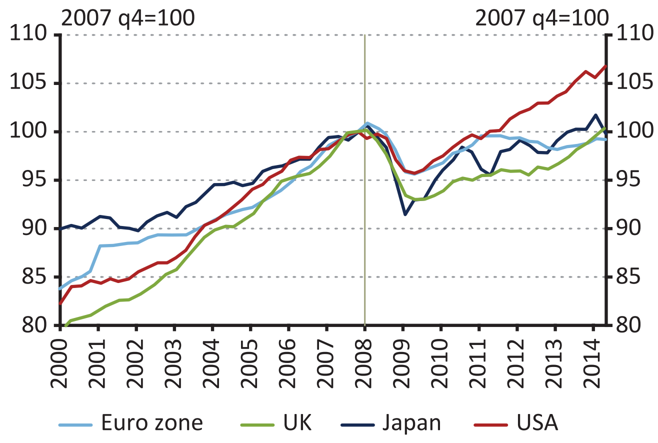
The developed world was surprised, because both historical experience and economic theory suggested that such financial crises belong to the past, or to the less developed world nowadays. The prevailing view held that price stability and responsible fiscal policy would result in macroeconomic stability under competitive market conditions. Stability-oriented price and wage developments would follow. Financial stability would be provided by macroeconomic stability as a by-product with sufficient prudential regulation of the financial sector. The framework of macroeconomic policy-making, including mandates, rules and institutions, was based on both these principles in the euro area as well as other jurisdictions including non-participating EU countries.

The consensus view has been seriously shaken by the financial crisis. Macroeconomic stability in itself did not guarantee financial stability. Gross capital flows, quite independently from current account balances and domestic saving and investment differences, facilitated the build-up of vulnerabilities and significantly affected the financial conditions of the countries. Policy-makers were not sufficiently prepared to handle a full-scale global financial crisis. In hindsight, those countries which were regarded as safe havens could allow larger fiscal deficits to dampen the downturn in the real economy, while others had limited fiscal space and had to recourse to fiscal consolidation procyclically. Thus, in the case of the latter group, which included Hungary too, fiscal consolidation was difficult and had to involve burden sharing across economic sectors, with limited room for alleviating the negative effect on economic activity caused by the ongoing balance sheet adjustment of the private sector, notably the heavily indebted household sector (MNB Growth Report, 2014).

1.2. Recovery is lagging in the Euro area

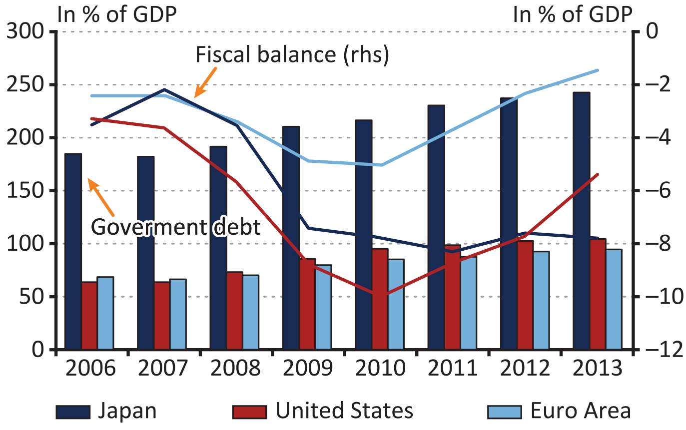
A cursory comparison of the recovery patterns of developed economies reveals a surprising divergence between the euro area and the other leading economies (Figure 1). In the world's developed regions, which were most strongly affected by excessive lending, both the economic downturn and the recovery between 2009 and 2011 exhibited a similar pattern in the years following the crisis. The nearly simultaneous movements in the downturn stemmed from the global nature of the crisis, while the similarities in the recovery can be traced back to the globally coordinated fiscal and monetary easing. Although more significant discrepancies in economic performance have emerged in the period since 2011 between the Japanese and US economies, the real outlier here was the euro area. The US economy's recovery in the past years has essentially continued steadily, while Japan's recovery exhibited more erratic developments. After an initial promising start, euro-area growth, however, basically came to a halt in 2011 and remained trapped in a gradual slide back.

Figure 1: Similarities and divergences in the recovery in the euro area and other developed economies



This observation raises the question of why the crisis is more serious in the euro area? Does it reflect problems with policy design or institutional rigidities that hinder adjustment, or both? The financial crisis caught every region by surprise with serious imbalances and exposed to contagion. In such a situation, it made a big difference that other regions were able to come up with more efficient responses and a better policy mix. In principle, the euro area could have replicated such policies only if national fiscal policies were tightly coordinated in tandem with the centralised monetary policy of the ECB. One can say that the monetary union is incomplete without fiscal (or political) union, which rendered the euro area especially prone to the global financial crisis. It is true that crisis management was more successful where fiscal policy and monetary policy was coordinated to form an appropriate policy response. This does not necessarily mean, however, that the euro area was left with insufficient means. In fact, the euro area followed a very similar path and did effectively loosen policies to help recovery at the beginning of the crisis. But the euro area reversed the accommodative fiscal policy too early (around 2010), (Figure 2).

Figure 2: Insufficient fiscal accommodation in the euro area, reversed too early



This turn of events needs an explanation. One might think that the design of the monetary union's rules and institutions were misguided and led to limited political appetite for risk sharing. This was aggravated by institutional rigidities embodied in rules, which were inefficiently implemented and rarely observed completely, and consequently tolerated undesirable behaviours. However, it is one thing is how we got there, and quite another how can we mend things after the crisis already struck. Handling a financial crisis, or to use Richard Koo's expression, a balance sheet crisis, needs a strong and credible fiscal framework to avoid a destructive fiscal adjustment. In addition, monetary sovereignty or a substitute for it, such as international financial cooperation or integration, is important for stabilising the financial system and avoiding extreme negative events. In jurisdictions where these features and international arrangements were not in place, effective economic policy response was hindered. It turned out that euro-area countries were undecided about what the best way to stabilise the situation was: immediately after the outbreak they implemented coordinated fiscal expansion, but later, probably too early, they turned to fiscal consolidation. This was probably seen as being unavoidable, because of the limited fiscal space of the euro-area countries under market pressure on the on hand, and fears of the excessive potential fiscal costs of contagion from peripheral countries on the part of the core countries on the other. This is a remarkable development, because the euro area as a whole was less indebted than any other major global region – including the USA, UK or Japan – and had a neutral external position. This suggests that the euro area had the necessary resources to better handle the crisis. What was missing in the euro area that proved to be crucial for a sustained recovery?

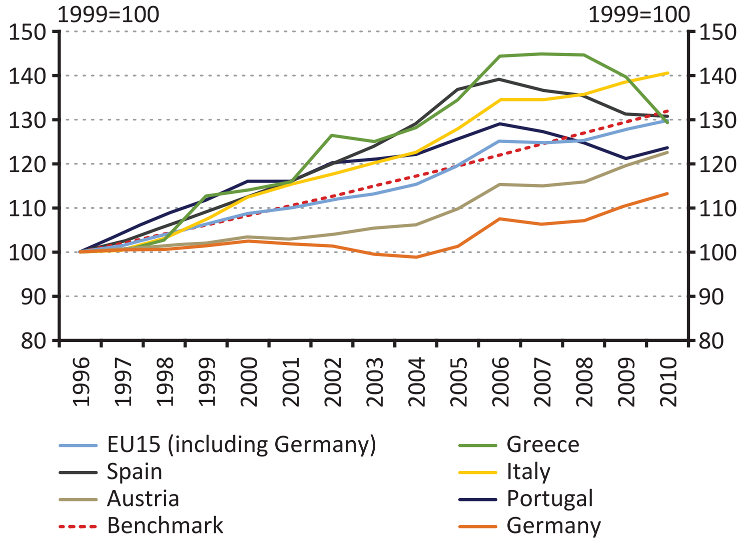
1.3. The Brussels-Frankfurt-Washington consensus – a too narrow perspective

The shortcomings in the resilience of the euro area's crisis preparedness were exposed by the events of the crisis and its consequences. The origins of these shortcomings are deeply rooted in the intellectual or ideological world views of the day, which were based on the economic knowledge of the time. In hindsight, that view proved to be based only on partial knowledge and an insufficient understanding of how the modern, liberalised financial markets work. Today, the name of *Hymen Minsky* is often mentioned, because his warnings were heard well before the crises hit, but remained mostly unnoticed and disregarded. Instead, the dominant view can be framed by the intellectual basis of the Brussels-Frankfurt-Washington consensus which held the narrow proposition that maintaining fiscal discipline and price stability would guarantee macroeconomic and financial stability. A corollary of this view was the assertion that there was no need for full fiscal union in a monetary union. Although fiscal policies have to be coordinated because of the potential moral hazard and spillover effects on other countries, full fiscal union – i.e. a genuine European welfare state – was not envisaged. Weak fiscal coordination coupled with a lightly coordinated (micro-) prudential regulation was believed to be sufficient mainly on the grounds of political convenience. More ambitious unification would have called for public support for a full fiscal union, which was adamantly opposed by public sentiment. In the early stages of the preparations for establishing the monetary union, the majority held the view that if all the countries follow stability-oriented policies, including price stability and disciplined fiscal policies, then monetary union can work without full fiscal union. This consensus resulted in a euro area, which represented a historically unique design of centralised monetary policy coupled with several national fiscal authorities. The uniqueness of such a union was emphasised by Charles Goodhart and others who noted at the time that historically monetary union and fiscal authority used to cover the very same geographical area; and the stability of the money and the financial sector ultimately relied on the fiscal capacity of the union's area, that is, its taxing capacity (Fitoussi-Saraceno, 2004).

1.4. Cracks in the wall

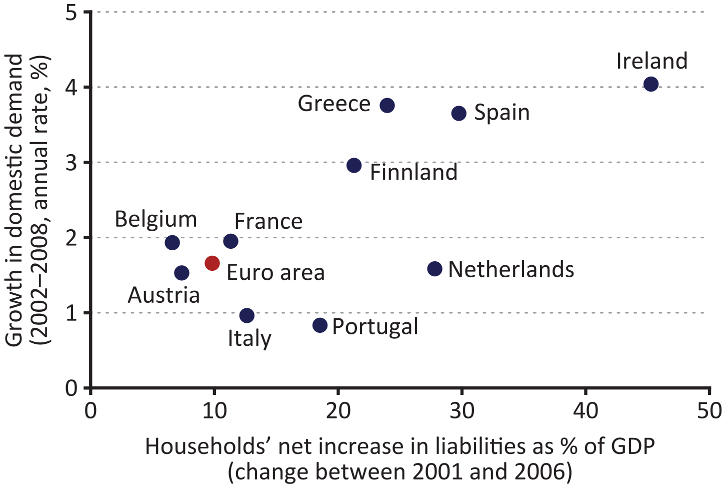
The shortcomings of the euro area eventually became overwhelming, but the first signs of divergence were immediately apparent. To see this, it is enough to look at wage developments. Divergent wage trends initially were defended on the grounds of converging living standards. However, the matching side of living standards is competitiveness, which failed to support these developments. Unit labour costs grew faster in the countries of the periphery. Non-inflationary and non-deflationary wage growth is equal to a roughly stable (stagnant) unit labour costs plus expected inflation. Figure 3 shows the development of unit labour costs in relation to the ECB's inflation target represented by the red dashed line. Countries below the red dashed line (core states) have competitiveness advantages compared to those that are above the red dashed line (periphery states).

Figure 3.: Nominal unit labour costs and the inflation target



Countries in the union diverged remarkably in term of unit labour costs until the crisis in 2007, and there was a marked correction afterwards in those countries (except Italy), where competitiveness fell during pre-crisis years. Increasing wages led to increased domestic demand. Figure 4 indicates that consumer demand was also boosted by credit.

Figure 4. Domestic demand boom and household credit



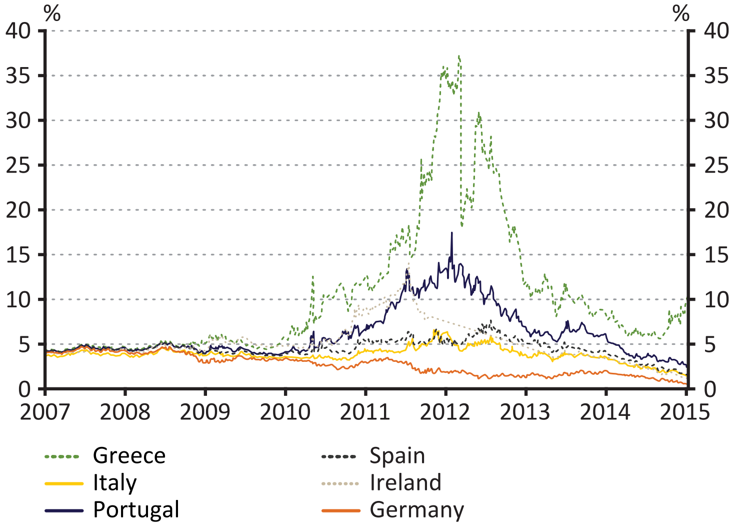
1.5. Burden sharing to maintain stability

A fuller monetary union and sufficient fiscal capacity is needed at the level of the integration as a fiscal backstop, but full fiscal integration, including centralised welfare state functions are still not needed to establish the efficiency of fully functioning fiscal stabilisers to do their part.

In the USA, the centralised welfare state provides such a backstop which acts as a cyclical stabiliser as a side product of the transfer system: regional shocks are dampened by the centralised unemployment provisions. However, cyclical stabilisation in the European monetary union does not require transfer among countries or social groups. It would be sufficient if there was fiscal flexibility with a credible fiscal framework at the country level. In technical terms, stabilisation needs inter-temporal fiscal policy actions, instead of intra-temporal one. So there is no need for permanent transfers. The fiscal framework was not flexible enough before the crisis, and did not foresee such a large scale shock, and in addition, the initial fiscal positions of some of the countries were inappropriate in leaving enough room for sufficient accommodation during the crisis.

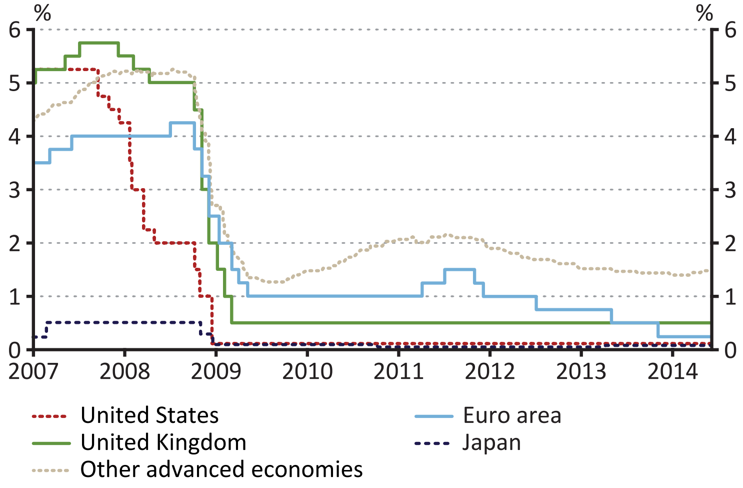
In Europe, there is also a need for improved monetary policy framework in order to maintain macroeconomic and financial stability in addition to price stability. The mandate of monetary policy needs to be extended to cover financial stability. Unless financial stability is sufficiently guaranteed we cannot even speak of a monetary union. In a unified money and capital market there should be a single currency and a single price. Bond prices did not exhibit such "singleness" during the years of the crisis (Figure 5).

Figure 5: 10-year benchmark rate: the lack of "singleness" in the monetary union



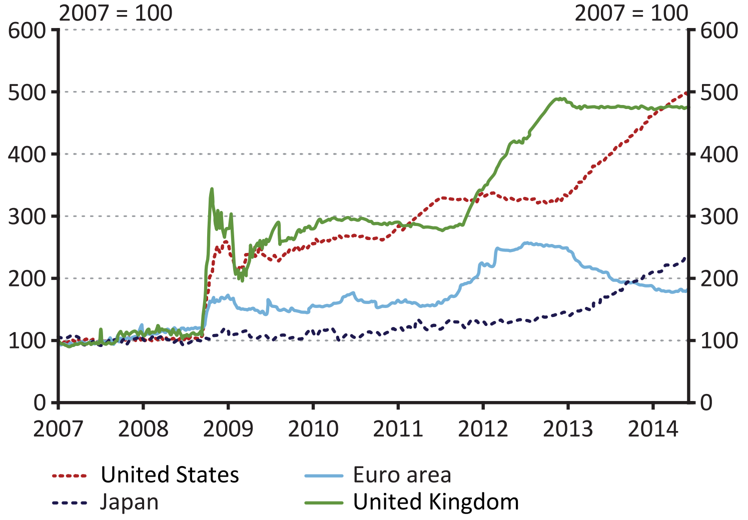
The crisis fragmented the single financial system in the euro area and there was an urgent need for intervention and stabilisation. Countries all over the world responded with all available tools according to their individual needs. The need for intervention in the euro area was not universal, as individual countries required different approaches with different magnitudes of monetary and fiscal measures (Ali Al-Eyd and S. Pelin Berkmen, 2013). The ECB's response was lagged somewhat behind. Rate cuts were large, but came later than in most other countries (Figure 6).

Fig 6: Slower rate cutting by the ECB



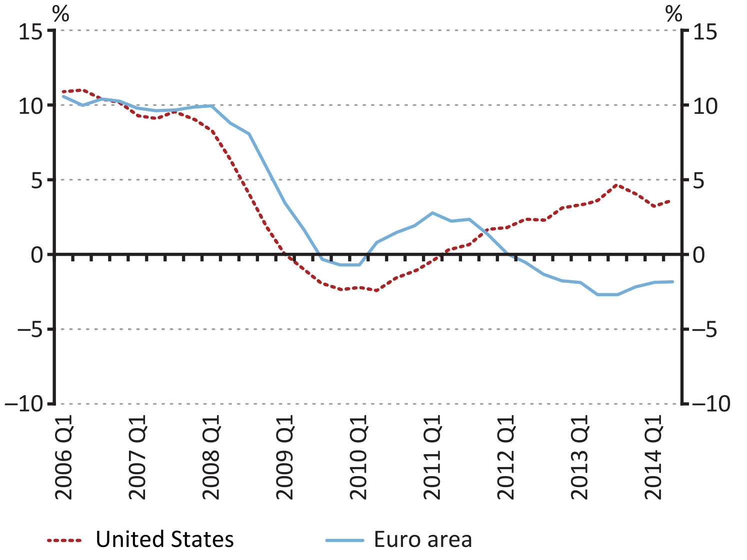
The central banks of large regions continued to maintain an extraordinarily accommodative stance. They have used unorthodox measures widely, as the tools commonly used during normal periods to stimulate the economy and stabilise financial sectors became ineffective at near zero rates. The ECB was relatively more reluctant to cut and even prematurely reversed some cuts in 2011. As for other measures that led to the increase in central bank balance sheets, the ECB was also more "cautious" (Figure 7).

Figure 7: The ECB: less sizeable balance sheet increase and a premature correction



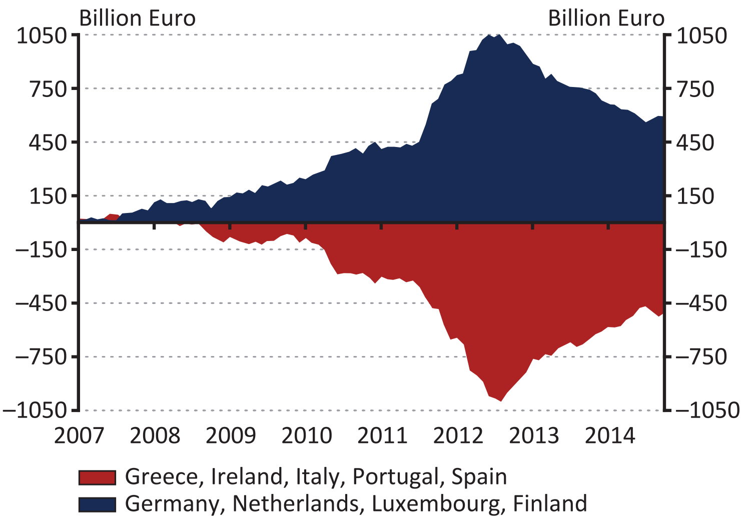
In Europe, the central bank's balance sheet shrank by one third after a quick and firm initial easing period from 2012. This correction was not the original intention of the ECB, but banks decided to repay their balances with the ECB early. These developments hurt credit growth (Figure 8) which would have been vital for recovery (ECB, 2014).

Fig 8: Credit growth to the non-financial private sector became negative after the correction



In general, an effective response by the euro area was hampered by the lack of ex-ante arrangements for burden sharing among countries. The lack of such an arrangement was a direct consequence of the "consensus" that explicit arrangements would have opened the door for "moral hazard" creating incentives to misuse it. Relegating the issue to ambiguity was considered a "constructive ambiguity" which turned destructive during the crisis. The market's sudden fear that core countries are not committed to (or unable to) save all banks and sovereigns in the euro area aggravated the problems triggering a flight to safety as represented in the diverging escalation of flows reflected in the development of Target2 balances (Bosomworth, 2012), (Figure 6).

Figure 9: Target2 balances: in panic euro funds fly to the core



In normal times Target2 balances are negligible: banks located in the periphery and core countries could lend to each other with little risk directly. Sufficient amounts of risk-free collateral – including government bonds – make such a relationship even less risky. This is the case when all government bonds, independent of the issuer within the euro area are seen as virtually risk-free. When interbank relations are hindered by elevated counterparty risk and government bonds lose uniform acceptance as collateral, banks must turn to the central bank for liquidity. The large Target2 balances show the tensions and uncertainty in the interbank market among the core and periphery countries (Cecchetti et al., 2012). As the latter are seen as risky and the amount of risk-free collateral on the markets diminished, banks tended to relocate their funds to the core countries and place them with core national banks. These had to be borrowed by periphery banks from the centre, mainly via the ECB. Without this lending and borrowing, the euro banking and financial markets would be broken, and the single monetary policy would be impossible to implement. The tensions abated only after the announcement of the OMT ("whatever it takes" speech by Mario Draghi in 2012), but balances still did not return to the pre-crisis levels yet. To cope with the remaining tensions, new measures, rules and institutions were needed. Among these, the creation of the banking union, the European Stability Mechanism, and revamping the ECB's banking supervisory capacities were pivotal.

1.6. Need for a new narrative

Having stabilised their economies, policy makers are currently working on guiding their respective economies towards a new growth path.

The legacy of the balance sheet recession makes this hard to do, because economic agents are still engaged in balance sheet adjustment, which means aggregate demand is weak due to the high rate of savings. This results in unacceptably high unemployment and underutilised production capacities. It is notable that current account and fiscal deficits could be corrected more quickly under the pressure of the crisis, albeit at significant cost. In this respect, demand compression and fiscal consolidation yields results relatively quickly. With balance sheet recession, by contrast, the case is not so straightforward. While demand compression and fiscal adjustment reduce debt, they can significantly affect incomes as well, which are the sources of debt service. Debt ratios are thus hard to reduce, and the structural reforms, which are advocated on the basis of their long-term growth benefits, often have negative effects on aggregate demand in the short term. The easiest way to tackle the legacy of the financial crisis would be to promote economic growth, but precisely this is the hardest to achieve given the circumstances. Central banks have tried their best to provide attractive financing conditions, but without growth prospects, agents are reluctant to add further debt to their existing stock. This is similar to a coordination problem, when each agent is waiting for the other to take the first step.

Taking a longer-term perspective, a new narrative is required which would involve more robust macroeconomic frameworks and supporting rules and institutions. The still rather narrow focus on price stability should be amended by adding financial stability considerations to all central banks' mandates. This should take into account the reality of the pro-cyclical behaviour of the macroeconomy, not least due to the excessive elasticity of the financial sector. Institutions capable of preventing and handling financial crisis should be put in place with sufficient regulatory and resolution authority. Appropriately calibrated fiscal backstops for financial stability, either nationally or collectively, also seem to be needed.

In addition, better designed cyclical stabilisation frameworks are needed. It seems more complicated to create them in the euro area, where there will be no full fiscal union involving welfare state functions, and thus cyclical stabilisation will not come from automatic stabilisers at the euro-area level. More robust, but at the same time more flexible fiscal frameworks are needed, supported by 'shared sovereignty' in several additional fields of economic policies to reinforce confidence. This could provide a basis for more risk and burden sharing among the participating countries. In this way, a better policy mix could be formed between centralised monetary policy and national economic policies in the euro area, replicating the ones seen in full fiscal and political unions, but without additional permanent transfers between countries. More effective cyclical stabilisation frameworks are needed in non-participating countries as well, which coordinate between monetary, macroprudential and fiscal policies, and which are able to secure a stable, sustainable development path, taking into account the interaction of financial and real cycles.

In this paper, we are only able to indicate the possible avenues where future changes in the institutional system and general economic thinking might influence the development of the future macroeconomic framework. The origins of the crisis and the effectiveness of crisis management are still the subject of heated debates. However, policy-makers do not have the luxury of having time to wait around until a new consensus is formed. The distinguished speakers of this conference are also influential decision makers, who are actively forming these new frameworks in practice at the global, European and national levels.

We have every reason to expect that, building on the results of last year's conference, the 'Lamfalussy Lectures' conference series has come one step closer to its goal of becoming one of the leading fora for European and global economic policy thinking.

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GYÖRGY SZAPÁRY

Ambassador of Hungary
Former Deputy Governor of the Magyar Nemzeti Bank

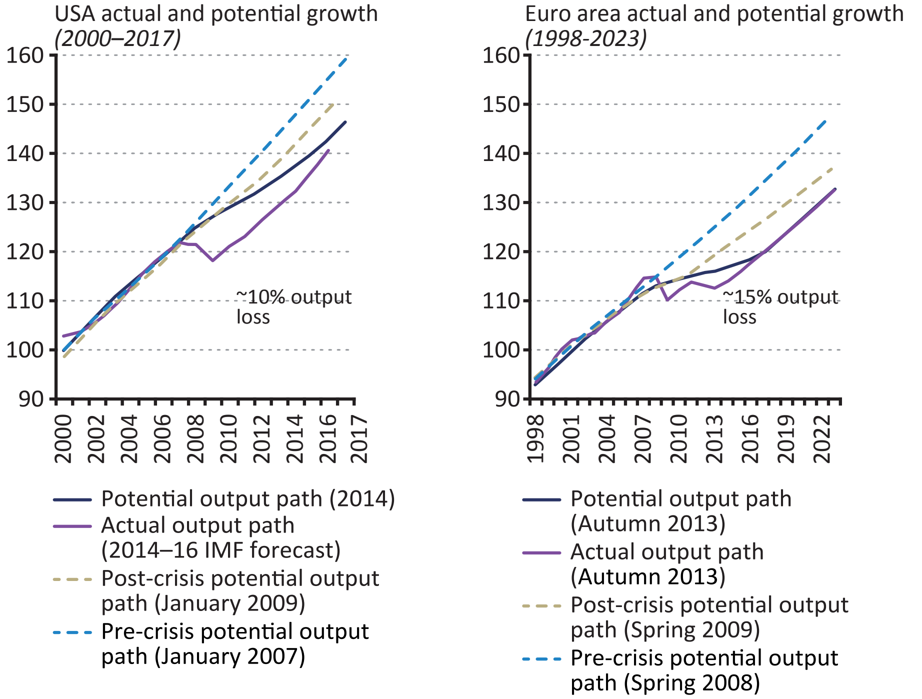
A brief comparison of policy responses to the crisis in the United States and the euro area and the challenges lying ahead

(Paper based ont the lecture given at the Conference)

In my presentation, I would like to make a few points about the policy responses to the crisis in the United States and Europe, so as to highlight some of the challenges faced by the economies of the two continents during the years ahead. Before the financial crisis of 2008, the global economy was believed to be in a solid growth cycle. Estimates of potential output growth were stable both in the US and the euro area, while output gaps were marginal and temporary. It seemed that the output growth fluctuations had been smoothened. However, the pre-crisis estimates of potential output levels turned out to be vastly overestimated, once the long-term effects of the financial crisis took hold.

We know now that during the pre-crisis period, significant imbalances had built up in both the financial markets and the real economy. The recession highlighted that financial booms can induce supply side shocks in response to unsustainable demand expansion. As a result of the crisis, aggregate demand decreased and actual output fell far behind the pre-crisis estimates of potential output, creating a substantial output gap. As shown in Chart 1, the output gaps have been closing on both side of the Atlantic since 2010, but not because of a hoped-for healthy recovery of growth, but because downward revisions of potential growth estimates. In other words, *the bar to clear has been lowered.*

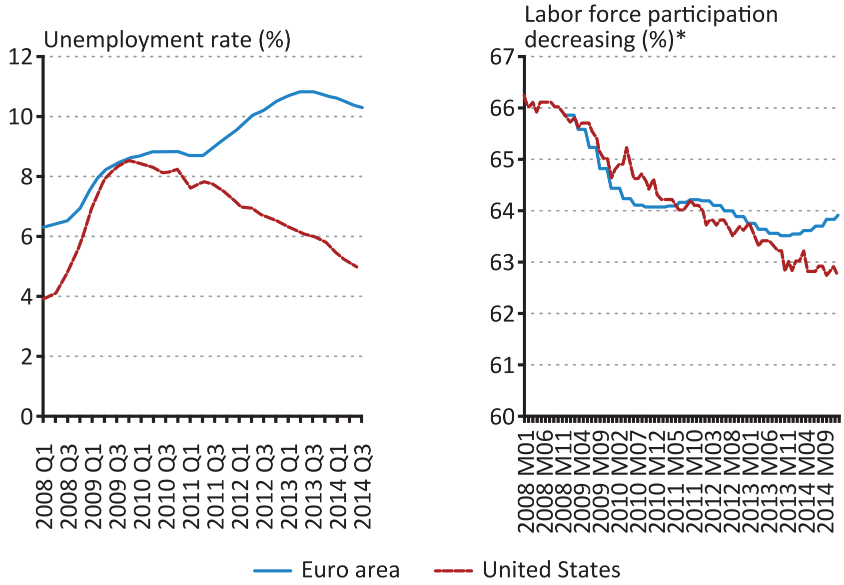
Chart 1: Output gap is closing by a reduction of potential output estimates



Source: CBO, IMF, European Commission 2013, Quarterly report on the euro area, vol. 12, issue 4. Graph I.5.

Here is now the challenge for monetary policy: output gaps are closing (US) or have practically been closed (EU), which would dictate neutral monetary policy, but the employment situation is dismal. Although in the US the unemployment rate is approaching its long-term target of 5 percent, this number masks a sharp fall in labour force participation (Chart 2). In the euro area, there has been a roughly similar decline in labour force participation, but at the same time the unemployment rate has remained dramatically high, particularly in the Southern countries. Accordingly, the closing of the output gap cannot provide comfort for monetary policy-makers, or for any policy-makers for that matter. Before discussing what room for manoeuvre still exists for monetary policy in such circumstances, let us briefly look at some of the reasons behind the fall in labour force participation in the US, as this can shed some light on what measures beyond monetary policy are necessary to tackle the low labour force participation problem.

Chart 2: *US unemployment approaching long-term target, but labour force participation decreasing*



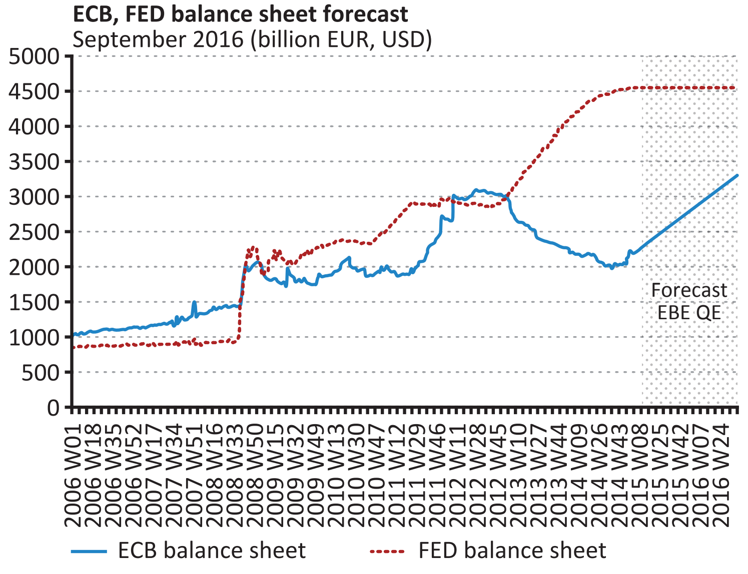
**USA statistics 16 years over, EU statistics 15-64 years*

Source: Eurostat, BLS

At the annual meeting of the American Economic Association in January 2015, US economists cited the following causes of the low labour participation: a) expansion of benefit programmes such as food stamps. Even though social benefits in the US are much lower than in Europe, people who lost their jobs tend to stay on social benefits instead of seeking employment. For instance, in construction activity among men of 45 years or older, more people are on disability benefits than are working; b) the college drop-out rate in the US is the highest among OECD countries, reflecting, among other causes, social issues: children born out of wedlock rose sharply and children with mothers below 40 years who still live with both parents dropped dramatically (from 95 percent in 1960 to 34 percent in 2014); and c) with stagnating real wages and/or reduced hours of work, working couples are seeking two jobs, which reduces labour mobility. I do not have comparable insights for Europe, but similar factors, even if not exactly of the same magnitude, must be at work in many of the euro-area countries as well. What this tells us is that in order to return to a healthy growth path that will increase labour force participation and reduce unemployment, i.e. get people back to work, one must look for reforms which go beyond the traditional macroeconomic tools of monetary and fiscal policies. A discussion of such reforms is not the topic of this presentation, so let us go back to a comparison of how macroeconomic tools were used after the crisis in the two continents under consideration.

The responses of fiscal and monetary policy were strikingly different, reflecting the differences in the economic situations and political frameworks. In the US, monetary easing and fiscal stimulus were used simultaneously to a significant degree right after the outbreak of the crisis. In the euro area, policy-makers were concerned about the high level of public debt, particularly in the periphery states. In the latter, the scope for fiscal stimulus was constrained by the unsustainable debt levels. Monetary easing was much more timid in the euro area than in the US, since policymakers advocated austerity measures because of the heterogeneity of member states' indebtedness. They were primarily concerned that the unsustainable debt levels will impede a sustainable recovery of economic growth. As can be seen from Chart 3, the balance sheet of the Fed expanded about fivefold since 2008, while that of the ECB grew much less, and even declined between 2012 and 2014. Only now, with the launch of the bond purchase programme, is the ECB's balance sheet projected to strongly expand in the next two years. Whether the ECB should have eased monetary policy faster and more substantially is likely to be debated by economists for years to come.

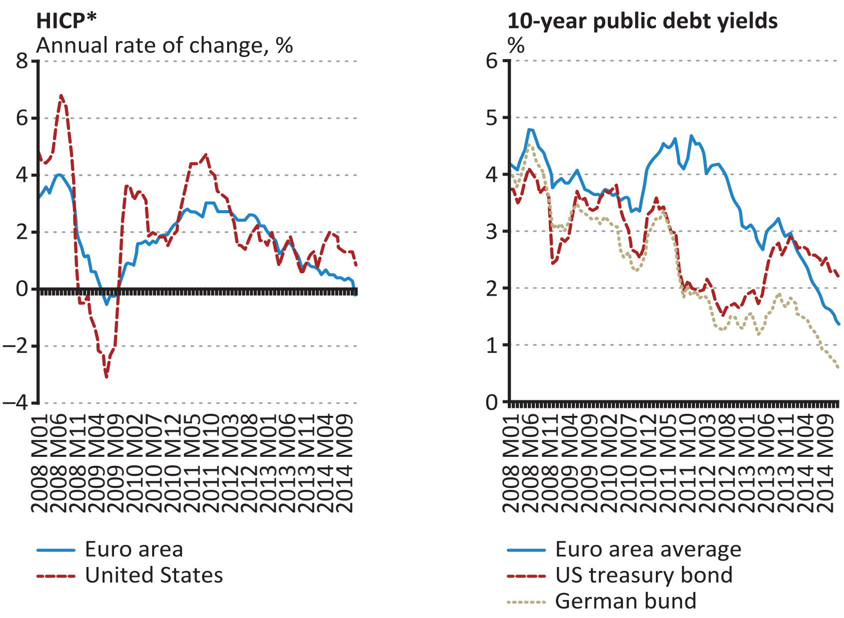
Chart 3: New wave of QE in Europe, gigantic central bank balance sheets all across the Atlantic



Source: ECB, FED, BIS Global liquidity selected indicators, October 2014

The crisis-led shrinking of aggregate demand led to a fall in inflation, which has made the substantial reduction in policy interest rates and quantitative easing less risky in terms of fuelling price increases (Chart 4). However, in the euro area, output growth remains sluggish, labour force participation is low and unemployment is very high in some of the countries. The policy rate has reached the zero-lower bound and quantitative easing is now under way. Are there any other possibilities for monetary policy to stimulate the economy? One possibility is to find a way beyond the zero-lower bound. This can be the targeted funding for growth pioneered by the Bank of England and later also applied by the Hungarian central bank. The targeted funding for growth bypasses the weakness of asset purchase programmes, since it funnels liquidity directly into the real economy. The targeted funding for growth schemes can be a viable possibility, but it has to be well targeted so that it reaches the sectors that face real demand and therefore have long-term growth potential in the new post-crisis environment.

Chart 4: Inflation well below central bank comfort zone, long-term interest rates at historic lows



*Source: Eurostat, *USA: Nov, Dec 2014 data for CPI*

This brings me to the concluding thoughts of my brief presentation. The issue that we are faced with is both a demand and a supply side issue. On the demand side, I have discussed what monetary policy has done and can still do. Here I would like to insert a footnote. If inflation would remain as low as it is today, i.e. close to zero percent both in the US and the euro area, monetary policy will be helpless in stimulating growth when the next recession comes, as they always do. The sooner the target inflation of about 2 percent is reached, the sooner the economies will be ushered back into the safety zones. When it comes to fiscal stimulus, the question is whether the governments have the fiscal space to stimulate. In the euro area, there is no common fiscal authority and, as mentioned, some member states are fiscally constrained. In those countries, fiscal policy cannot take advantage of the currently cheap funding to adopt a simulative stance, for example by developing infrastructure as would otherwise be a logical thing to contemplate. Even though the fiscal deficit is high in the United States as well, it has easier access to funding and many well-known economists (e.g. Larry Summers) are strong advocates of spending on infrastructure to take advantage of the low cost of borrowing. As Summers has put the question: when will it be the right time to renovate JFK airport in New York if not now when the long-term cost of borrowing by the government is about 2%?

On the supply side, I would like to highlight only a couple of things. The reasons for the low labour force participation in the United States noted above point toward two areas where structural reforms have to be undertaken. First, the social benefit systems have to be shaped in such way that they do not encourage people to leave the labour force and live on benefits. Since the benefit systems vary a great deal among countries, each country has to determine what reforms may be needed. Second, the education systems have to be reformed so that school leavers at different levels of education have the skills to satisfy the technological demands of tomorrow. The information technology revolution is far from over. The IT application has so far mostly affected the services and the retail sectors, but it will increasingly spread to other sectors of production. The challenge then is twofold: on the one hand, to create the skills necessary to innovate, develop and apply the new technologies, and on the other hand, create enough jobs to absorb the working-age population in the new technology-driven environment.

GYÖRGY MATOLCSY

Governor
Magyar Nemzeti Bank

A new narrative for Hungary

(Paper based ont the lecture given at the Conference)

This years' Lamfalussy Lectures Conference confirmed that Europe has arrived at a crossroad. The integration of the euro area faces significant challenges. The participants of our meeting, the governors of the National Bank of Austria, the Central Bank of the Republic of Turkey, the Bank of Slovenia, the Croatian National Bank, and the Bank of Finland, addressed relevant policy issues that concern European policymakers. Benoît Cœuré, member of the Executive Board of the European Central Bank and recipient of the 2015 Lamfalussy Award, emphasised that while central banks have powerful tools, the ECB alone would not be able to lift the euro area out of the current recession. Europe needs a new narrative today. Here in Hungary, we faced similar challenges and responded decisively with new and often unconventional measures. We reduced the cost of financing, increased the availability of credit, while at the same time halting the accumulation of debt. We converted households' foreign currency mortgages into cheaper forint mortgages. We took steps to reduce foreign currency exposure by increasing the domestic component in government debt. In the following pages, the main messages of the European debt crisis and our experience with policies in Hungary based on new understanding and applying new approaches are discussed.

1. Renewal in Europe: Main messages

In his keynote address, Benoît Cœuré, member of the Executive Board of the European Central Bank and winner of the 2015 Lamfalussy Award, reminded us that significant advances have been made in the euro area since the beginning of the crisis. The European Stability Mechanism (ESM/EFSF) has been established, which is now capable of participating in the management of the debt crisis, along with and similarly to the International Monetary Fund. The creation of the banking union and the strengthening of the banking supervisory role of the European Central Bank promoted the efficient operation of the European banking system by facilitating the timely identification of problems and addressing them promptly. The Magyar Nemzeti Bank welcomed the progress made in these areas and on our part we contributed by stabilising finances in the Hungarian economy. This process of stabilisation in Hungary utilised novel approaches in policy-making.

Benoît Cœuré noted that the euro area is built on monetary dominance. Decision-makers in different policy areas act independently. However, they are also interdependent, and thus they have to take into account what the others are doing. This is an inherent characteristic of any policy-making process. Without proper rules it may lead to conflicts and can produce outcomes that no party really wants. Central bank independence is a necessary condition for monetary policy to focus on its primary price stability mandate. That is why central bank independence is an essential feature of Europe's constitutional order which instructs governments not to intervene in the monetary policy-making, refrain from intervening in the daily management and budget operations of central banks even in those countries that have not yet adopted the euro, such as Hungary. But independence is not a sufficient condition to ensure monetary policy autonomy, as we know from literature on monetary and fiscal dominance. If fiscal policy was not constrained by a rule which ensures the sustainability of debt, central banks would ultimately be forced into inflationary policies.

Benoît Cœuré rightly stressed that managing monetary and fiscal policy interdependence requires a strong framework and "policymakers must decide which aims they want to prioritise and construct a set of rules which promotes that and sets incentives right. In the euro area, we consciously built our framework around "monetary dominance" – ensuring that the central bank could pursue price stability unconstrained by fiscal considerations. We did this by giving full independence to the central bank, while setting up a strong fiscal framework which is in line with the Stability and Growth Pact, and now with the Fiscal Compact. This has efficiently served the maintenance of price stability."[1]

After the crisis, Hungary had to recognise that monetary policy needs to be adjusted to be able to effectively contribute to increasing employment and stimulating growth. Benoît Cœuré also mentioned that monetary policy may become more effective in impacting the real economy if other policies are coordinated to support it. If not, it has less impact and expansionary monetary policy has to last longer.

While we tend to focus on the coordination between monetary and fiscal policies, we should not forget about the conditions in financial markets. One important message in Cœuré's lecture is that "both monetary and fiscal policies can have their choices

[1] Cœuré (2015): http://www.ecb.europa.eu/press/key/date/2015/html/sp150202.en.html

constrained by so-called *financial dominance.* For monetary policy, the problem stems mostly from inadequate supervision."[2] This challenge defines important actions. The changes we initiated in Hungary by merging the banking supervision into the central bank served the same purpose that Cœuré highlighted. We had first-hand experience on how weak micro-supervision and the resulting high level of non-performing loans can trigger conflicts with other policy areas. For example, banks burdened by bad debt are not able to provide sufficient lending to support a recovery. In Hungary, confronted with this problem we initiated the Funding for Growth Scheme.

Revamping growth in the Central and Eastern European region was the topic of the lecture by *Ewald Nowotny,* Governor of the central bank of the Republic of Austria (Österreichische Nationalbank). Ewald Nowotny analysed the catching-up processes of the region in the past 25 years and its prospects for the near future. Although the impact of the crisis on output was still very much felt in 2014, the catching-up process was substantial despite the repercussions of the crisis. Living standards have been increasing in all countries and growth potential has remained largely intact.

So far, most of the countries in Central, Eastern and Southeastern Europe (CESEE) have weathered the pullback of capital rather well. Since 2008, current account and fiscal imbalances have decreased, and most CESEE countries have become less reliant on foreign capital. As a result of this increased resilience, these CESEE countries most likely will not be forced to abruptly raise interest rates to fight currency depreciation. For those CESEE countries with well-capitalised banking sectors which do not rely on capital inflows, a slight weakening of their currencies could even give some momentum to economic recovery.

As a result of the changes that have taken place, the region has advanced on the development scale. This development could open up new opportunities for these countries. Unfortunately, rating agencies' risk ratings do not always reflect the significance of changes. Although many major investors followed their own better judgement, but some of them remained dependent on ratings and continued to assign the region to the "emerging European" portfolio, which may have limited financial flows. Governor Nowotny correctly highlighted that, despite the general progress, important disparities among the countries involved did not disappear. Very significant differences remained still even between two neighbouring economies. Concerning the upcoming period, Ewald Nowotny indicated that new opportunities should open up for development. He also carefully identified the main risks, namely that there was also

[2] Cœuré (2015): http://www.ecb.europa.eu/press/key/date/2015/html/sp150202.en.html

a high geopolitical risk that Hungary would be relegated to the periphery exposed to geopolitical tension. These looming risks made it imperative for the MNB to take the lead and address the main stability concerns. One such concern was low growth, which was addressed by the Funding for Growth Scheme. The other concern was exposure to foreign currency debt, which was reduced by converting household foreign currency debt to loans denominated in domestic currency.

The experience of monetary policy in Turkey is very relevant for Hungary, because of the similarities in the philosophy of both central banks. Accordingly, the contribution of *Erdem Başçı*, Governor of the Central Bank of the Republic of Turkey,[3] (Türkiye Cumhuriet Merkez Bankasi) deserves special attention. In both cases central bank policies are geared to achieve stability in a complex manner. Erdem Başçı assessed price stability and highlighted that central bank actions against inflation had a wide-ranging, well-known toolset. However, the tools available to counter deflation – which is a current phenomenon threatening several European economies – are not that well-known. Governor Başçı expressed the view that the best a central bank can do for the benefit of the economy of its country is to maintain price stability in any case. Our practice in Hungary also reflects this idea. The policy framework and the tools in Turkey are somewhat different from ours, as we complemented the traditional measures with new instruments to cope with our new challenges mentioned above.

Carlos da Silva Costa, Governor of the Bank of Portugal (Banco de Portugal), emphasised sustainability at the national and community level. He noted that the nature of national economic policies and the coordination of these policies across the EU as a whole determine the sustainability of the development model.[4] He highlighted that every step in economic policy is based on the assessment of risks. We need an outcome that contributes to the permanent solution of the problem instead of one that looks promising in the short run, but would lead to social conflict 6 or 8 years later. In Hungary, we learned that in order to improve the integrative capacity of European cooperation, national economic policies must also make sacrifices to be able to strengthen resilience against external and internal shocks.

[3] http://www.tcmb.gov.tr/wps/wcm/connect/tcmb+en/tcmb+en/main+menu/announcements/press+releases/2015/ano2015-09
http://www.tcmb.gov.tr/wps/wcm/connect/19ab7e30-6ed6-45dc-a874-cec42e896484/Budapest.pdf?MOD=AJPERES

[4] https://www.bportugal.pt/en-US/OBancoeoEurosistema/IntervencoesPublicas/Lists/LinksLitsItemFolder/Attachments/89/intervpub20150202.pdf

Boštjan Jazbec, Governor of Bank of Slovenia (Banka Slovenije), assessing the experiences of the introduction of the euro in Slovenia in 2007 noted that this step generated a large influx of capital and to use it efficiently not just monetary policy needs to be prepared, but the whole financial system has to adjust quickly. Slovenia as a new member of the euro area was able to benefit from the ECB's unconventional measures, but this might be limited by the fact that financial markets in Slovenia are not deep enough, and instruments such as asset-backed securities (ABS) and covered bonds are not widely used for financing yet.

Boris Vujčić, Governor of the National Bank of Croatia (Hrvatska Narodna Banka) talked about the paradigm shift of central bank policies. The experience of Croatia indicated that despite the textbook example, exchange rate stability can be sustained in a small, open economy as well, while pursuing an autonomous, anti-cyclical monetary policy. Although the methods applied prior to the crisis to moderate lending and capital inflows, including a high required reserve ratio and capital controls, were of questionable efficiency and "rough regulatory tools" in themselves, they still had the advantage that when the crisis broke out, there was a latitude that enabled the easing of monetary policy. Boris Vujčić also elaborated on the fact that in the global economy the efficiency of monetary policy has changed and externalities play an increasingly important role. Prices are shaped by global factors for an every wider array of products. The cross-border relationships of financial and capital markets facilitate larger swings in the balance of payments, and the price-shaping effect of the demand and supply characteristics of the national economy has weakened. Capital flows transmit global monetary conditions, and these conditions have a mounting influence on monetary conditions in the national economy, even if the exchange rate is flexible. Central banks must pay attention to this change and draw conclusions accordingly. One such conclusion is that their opportunities to decrease external vulnerability have narrowed significantly. The other important conclusion is that monetary policy is only able to boost growth efficiently if other policies (fiscal, institutional, and structural policies) change in line with it in a coordinated manner.

Erkki Liikanen, Governor of the Bank of Finland (Suomen Pankki)[5] warned that the measures of the European Central Bank and quantitative easing cannot replace the need for adaptation in national economic policies, although they may temporarily mitigate the pressure for such adaptation. There is a need for improvement in the European institutional system, in order to avoid the risk that additional liquidity resulting from quantitative easing would feed speculative bubbles leading to a new crisis.

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[5] http://www.suomenpankki.fi/en/suomen_pankki/ajankohtaista/puheet/Pages/150202_EL_puhe.aspx

The panel discussion which followed the presentations gave a convincing framework for the ideas heard during the Lamfalussy conference. The discussion was moderated by *Csaba Lentner* (National University of Public Service). The participants – *Agnès Bénassy-Quéré* (University of Paris I Panthéon Sorbonne), *Dániel Palotai* (Magyar Nemzeti Bank), *André Sapir* (Université libre de Bruxelles) and *György Szapáry*, (former Deputy Governor of MNB and former ambassador of Hungary to Washington) – assessed the new challenges and the efficiency of monetary policy responses to these challenges. Many open questions remained concerning the efficiency of monetary policy measures. The participants agreed that many of these questions could only be answered ex-post, by their impact on growth. Participants joined André Sapir in arguing that the euro area's institutional governance reform must go beyond the banking union. What is missing is a mechanism or an institution that could help preventing divergence in wages and productivity. He proposed[6] two new institutions: setting up a European Competitiveness Council (ECC) and establishing a Eurosystem of Fiscal Policy to revamp fiscal coordination to maintain fiscal debt sustainability. Because labour mobility is limited and fiscal policy is currently decentralised, the function of the new fiscal institution would go beyond the implementation of current rules by guiding national policy makers in countries that can afford it to borrow more so that the euro-area fiscal stance remains appropriate. Participants agreed, that maintaining fiscal debt sustainability also hinges on maintaining competitiveness. In the absence of nominal exchange rate adjustment by member countries and without fully integrated labour markets, the euro area needs a system to prevent large divergences between the unit labour cost developments in member states. Such an institution would help real convergence, or at least prevent the recurrence of past mistakes. Instead of supporting real convergence, in the past the single currency built up imbalances between core and periphery countries, while the latter was not prepared to deal with the posed imbalances. The establishment of the macroeconomic imbalances procedure (MIP) implemented in the European Union was a response to these shortcomings. MIP is a new mechanism to monitor and offset macroeconomic imbalances. Divergent wage and productivity developments led to the build-up of macroeconomic imbalances, but the MIP alone is not efficient enough to prevent such a divergence. It is unable to "ensure that wage developments are in line with productivity, which means that serious competitiveness problems can and do occur within the euro area" (Sapir – Wolff, 2015, p. 4).

André Sapir pointed to the fact that asset price booms are mostly associated with an overheating economy and tight labour markets. However, preventing asset price booms would not be sufficient to restore competitiveness in periphery countries,

[6] See Sapir – Wolff (2015) for a detailed discussion of Sapir's proposal.

especially if labour market regulations and welfare systems are not compatible with the membership in a monetary union. Maintaining fiscal debt sustainability and restoring competitiveness are both pressing challenges. Coping with these challenges requires political consensus between governments. The central bank has powerful tools, but the ECB alone would not be able to achieve these objectives. Europe needs a new narrative today, after the European Central Bank launched its monetary policy programmes.

In 2010, the new Hungarian government had to face the dilemma of choosing between orthodox or unorthodox measures to address the crisis. I believe that Hungary would have failed if only conventional measures had been applied. There are three pillars of the success of the crisis management. Job creation is one of them. Structural reforms represent the second pillar. They have crucial importance in paving the way to creating new jobs. At the same time, without political stability little could have been accomplished.

2. Policy turnaround in Hungary and the policy challenges in the European Union

Last year, the participants of the Lamfalussy conference looked at the origins of the crisis and discussed how monetary and financial integration, including the prospects of the convergence process, would be affected. It was pointed out that the crisis caused setbacks to the convergence process or even reversed it. A recent study published on the benefits and challenges of euro adoption concluded that while "countries adopting the euro in the 2000s benefited from a sizeable premium in the perception of investors, this premium has mostly vanished"[7] now.

A recent assessment of the response to supply and demand shocks revealed deep asymmetries between individual countries of the euro area. Jen-Yilmaz (2015) revisited the model calculations of Bayoumi-Eichengreen (1992) and confirmed their scepticism about the desired convergence in member countries responses to shocks. Jen-Yilmaz (2015) noted that the euro-area countries had indeed exhibited economic convergence prior to 1999-2000, but they have significantly diverged since then. "The members of the euro area are more diverged now than they were in 1982."[8] There are several implications of this fact, including that the "combination of a common monetary policy, fixed exchange rates, and limited scope for member countries to

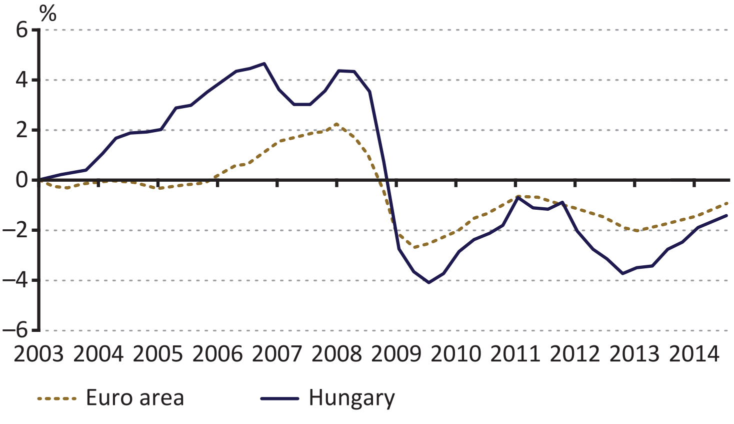
[7] J. Podpiera – J. Wiegand – J. Yoo (2015): Euro adoption – benefits and challenges. forthcoming, p. 1.
[8] Jen-Yilmaz, 2015, p.1

conduct their own fiscal policies may have led to weak economies weakening further and strong economies strengthening further."[9]

Externals shocks are often propagated by globalisation, but the growing interconnectedness resulted in vastly different effects on the performances of the euro-area member states. The heterogeneity of the economy and specialisations in production and services favoured more competitive sectors and countries (such as Germany), while peripheral countries may have been marginalised in the process of globalisation.[10]

Demand and supply shocks may have been intensified by globalisation, while differentiation in the resilience and shock absorption capacity of Member States widened. Meanwhile, countries not yet participating in EMU such as Hungary were able to use their monetary policy autonomy and exchange rate flexibility to support adjustment during and after the crisis. Monetary easing supported domestic demand and helped to offset imported disinflationary pressures. Although Hungary has not adopted the euro yet, the correlation of Hungary's output gap with that of the euro area is apparently rather strong as illustrated in Figure 1. The larger fluctuation of the output gap in Hungary underscores the greater importance of monetary policy autonomy in stabilisation of the Hungarian economy.

Figure 1: Output gap in Hungary and in the euro area (per cent of GDP)



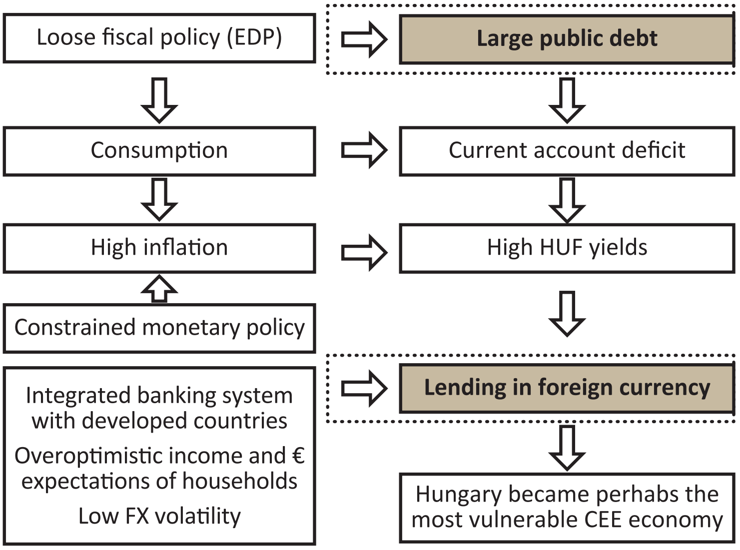
Source: MNB, Podpiera, J. – J. Wiegand – J. Yoo (2015)

[9] Jen-Yilmaz, 2015, p.1
[10] For more details see Jen-Yilmaz, (2015).

2.1. The legacy of the imbalances in the 2000s for monetary policy

Since 2001, inflation targeting has been Hungary's monetary policy framework. In this respect, Hungary followed the international best practice, similarly to other developed and emerging economies. Although the framework has not been changed significantly, its policy content has changed more substantially. Comparing the developments in monetary and fiscal policy in the past and now, the dividing line is 2010, when fiscal stabilisation took a new turn which was later underpinned by an interest rate cutting cycle starting in 2012. Monetary policy was under fiscal dominance during the first decade, limiting the room for monetary policy manoeuvres. Hungary was on the edge of the abyss in 2008, and only managed to hold on with international assistance, and also could not move away from there until 2010. The economic problems which existed in 2010 affected almost all segments of the economy. There were problems with increasing unemployment (falling activity rate), unsustainable fiscal policies (including an overstretched social safety net) and increasing external indebtedness. In this environment, the central bank kept interest rates high, with the unfortunate side effect of elevated costs of financing. This resulted in costly financing both for the state and the corporate sector and also for households. The disconnection between domestic monetary conditions and the increasing liquidity on the foreign financial markets where the banks operating in Hungary had an access to relatively cheap funding, resulted in a distortion. Corporate and household credit demand turned to apparently cheaper alternatives and banks' behaviour changed accordingly, to reap huge profits from galloping lending. Figure 2 gives a schematic summary of the causes and consequences of the monetary policy followed in the past. Low employment destroyed economic performance, while demand was boosted by public spending. Loose and irresponsible fiscal policy on the one hand postponed the urgent need to tackle the structural problems while public debt ballooned. The most dangerous aspect of debt dynamics was fuelled by foreign currency loans to households. Abrupt changes in monetary conditions raised financial stability risks later.

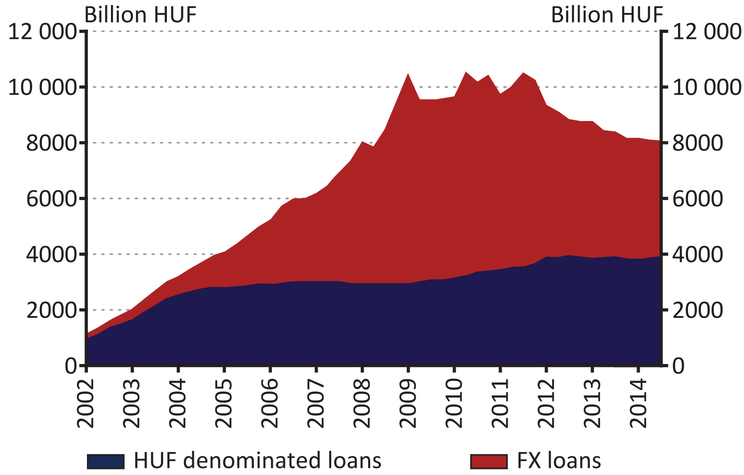
Figure 2: Monetary policy dilemma in the 2000s



Source: MNB

Lending in foreign currency was profitable for banks and seemed attractive for households. Funding costs for banks with access to foreign financing was lower than domestic funding. Households – also motivated by banks' aggressive campaigns – largely neglected exchange rate risk. The government in the mid-2000s did not restrain FX lending to households as it offset the negative effects of the halted subsidised housing loan scheme. Lending in foreign currency (euro, yen, and mostly Swiss franc) boomed, at least until the global financial crisis sent exchange rates flying and funding sources hiding. Figure 3 depicts credit developments in Hungary, showing the protracted adjustment since 2011.

Figure 3: Currency composition of loans (domestic currency and foreign currencies)



One direct consequence of the increased risk was that the economy became extremely vulnerable before the crisis. When the financial crisis hit Hungary, the economy fell into depression for years. GDP decreased by 7 per cent, while unemployment rose above 10 per cent in 2009. The trend of debt to GDP, which was increasing since 2002, soared between 2008 and 2010, reaching 85 per cent of (nominal) GDP. Meanwhile, the gross external debt of the national economy surpassed 120 per cent of GDP in the first quarter of 2009, in which household foreign debt amounted to one-fifths of GDP.

2.2. Stabilisation by changing monetary policy in Hungary

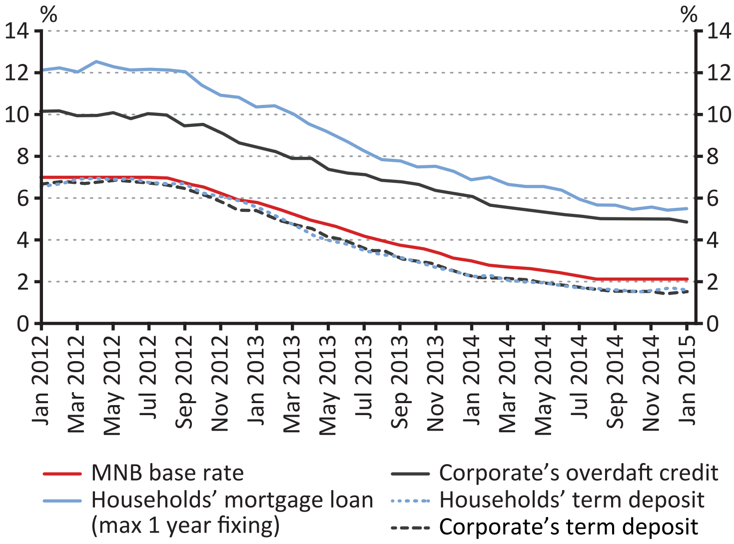
The economic policy goal of the new government which came to power in 2010 was to stop and reverse these negative trends. The results are telling. Prudent fiscal policy maintained for several years brought the fiscal deficit under the threshold set by the European Union. Growth in public debt was stopped, and – looking at the trend – it has been set on a downward path. Employment increased and not only through the public employment programme, but also in the private sector. Finally, the economy is growing steadily. In addition to exports, domestic investment and consumption also contributed to GDP growth.[11]

[11] Matolcsy– Palotai (2014) gives a detailed assessment of the turnaround in economic policy.

This year, our conference focused on the challenges to monetary and economic policies in helping boost economic growth and on the evolving new framework of macroeconomic policy making, hence the title "New Narrative for Europe (and for the monetary union after the crisis)". There is a new narrative evolving for Hungary's policy management, indeed.

Monetary policy was effective in enhancing growth and recovery. The MNB started its easing cycle in August 2012 and, following a cautious approach, the interest rate was reduced from 7 per cent to 2.1 per cent in two years (Figure 4).

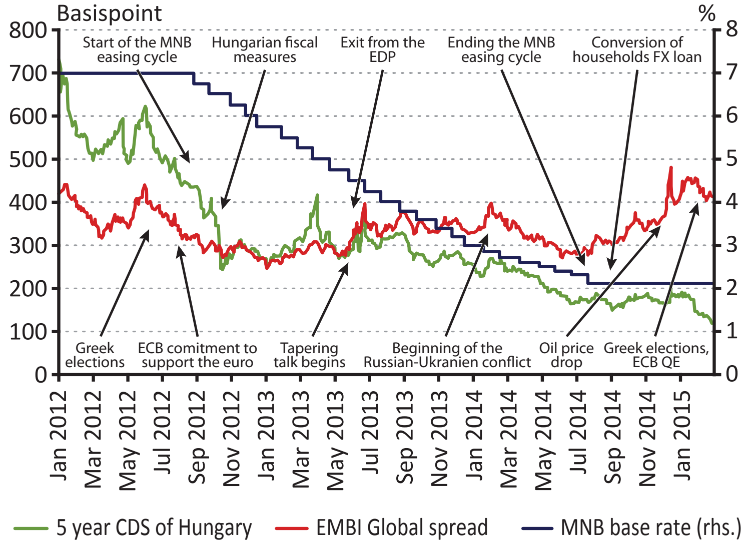
Figure 4: Interest rate path



Source: MNB

The easing cycle was facilitated by favourable trends in global liquidity as a result of the quantitative easing policies of several major central banks. However, the rate cuts were implemented in a cautious manner keeping in mind possible volatile changes in global monetary conditions influenced by changing political risks (Greek election, Russian-Ukrainian conflict) and changes in the quantitative easing policies of leading central banks, including the Fed and the ECB. Interest rate cuts supported by fiscal measures contributed to the success of stabilisation in the Hungarian economy. This is reflected in the fall of Hungary's CDS spread in a period when emerging market global spreads did not fall. They continued to fluctuate between 300-400 basis points without an apparent falling tendency (Figure 5).

Figure 5: Interest rate, EMBI and CDS spread



Source: Bloomberg, MNB

In August 2012, inflation was above the inflation target. However, the price level increase that exceeded the central bank target was mainly supported by unique and transitional effects. Following the disappearance of one-off factors, strong disinflation started, and inflation declined to below 3 per cent. Disinflation resulted from a wide range of external and internal factors. It was supported by muted domestic consumption, international inflation trends, the more disciplined fiscal policy and gradually reducing inflation expectations. In line with these effects, the Bank's measures of underlying inflation gradually fell in 2013 and remain at historically low levels. According to the MNB's estimates, the interest rate cuts increased the level of average inflation by 1.1 percentage points in total in two years.

Cutting the base rate contributed directly or indirectly to coping with the most serious macroeconomic problems. Between the beginning of the easing cycle and the end of 2014, the expected return on newly issued government securities dropped by 4-5 percentage points, and was thus more than halved. This reduced the interest expense of the budget by half a per cent of GDP per year, and this effect can increase to 1.5 per cent in the long term according to central bank's estimates. The interest rate cut stimulated the real economy by reducing lending rates and through other channels, which accounted for half of the economic growth in 2013-2014. Following the easing cycle, residential mortgage interest rates have also declined, which made the conversion of foreign currency loans even more favourable and more attractive.

2.3. Measures to support growth by increased lending

Building on the success of this stabilisation, Hungarian monetary policy took additional measures to help indebted households and enterprises. Corporate lending declined as a result of tighter credit conditions and falling demand in the wake of the financial crisis.[12] Tight credit supply hinders economic growth, while falling asset prices and the declining value of available collateral further reduces credit available for corporations. To avoid this vicious circle, the MNB launched the Funding for Growth Scheme (FGS) in 2013. As a result of the FGS and other monetary policy tools, interest costs were reduced to reasonable levels, and credit conditions improved. While the fall in lending was reversed (Figure 6), the measures also improved the efficiency of the monetary transmission.

As a favourable side effect of the FGS, increased investments generated additional demand for working capital loans. As a result of the central bank's easing cycle, the interest rate even on market-based loans started to approach the maximum rate of 2.5 per cent available under the FGS. But so far spreads have not changed substantially and the difference in the cost of credit for FGS clients SME's and those outside the eligibility (medium-sized and larger corporations) is still substantial. In 2014, the average interest rate of contracts below a credit line of EUR 1 million fell to around 4 per cent.[13]

When the risk-taking channel[14] functions well, banks increase their lending more than what normal transmission channels would justify in a low interest rate environment, thus helping the recovery from the crisis. In our case, this would mean that as a result of cuts in interest rates between 2012 and 2014, the willingness of the banking system to take risks should have increased. Following a financial crisis, however, the risk appetite of banks often remains low, owing to the high ratio of non-performing loans and loan losses suffered during the crisis. This fact leads to tight credit conditions and prevents monetary easing from stimulating growth. To overcome this barrier, the MNB also took additional measures, including the extension of the FGS and FGS+.

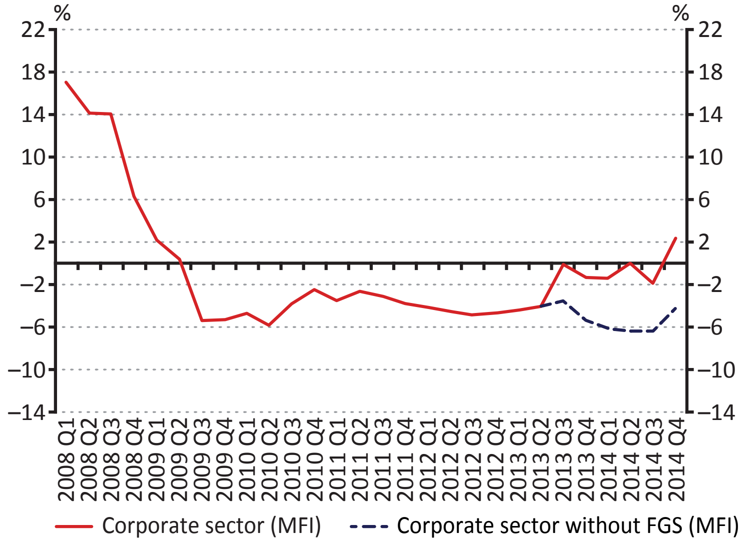
[12] Atoyan (2010) demonstrated that the cornerstone of the future growth model in emerging Europe is greater reliance on tradable sectors. Enhancing domestic sources of bank credit funding would contribute to mitigation of external vulnerabilities and make domestic financial system more resilient to global financial shocks. Prudential and macroeconomic policies will have to be more proactive in managing capital inflows, including funnelling these inflows into investment in the export-oriented industries.

[13] What are the reasons behind the launch of FGS+? p. 3. http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Monetaris_politika/fgs/2015/Hatterelemzes_final_ENG.pdf

[14] For empirical evidence on the importance of the risk-taking channel see Altunbas, Y, L Gambacorta and D Marqués Ibañez (2009) and Jiménez, G, S Ongena, J Peydrò and J Saurina (2009).

Furthermore to support banks' portfolio cleaning and to reduce corporate NPLs, the MNB is establishing an asset management company (MARK Zrt.).

Figure 6: Lending to SMEs helped by the Funding for Growth Scheme



Source: MNB

Endrész – Oláh – Pellényi – Várpalotai (2014) estimated the impact of the FGS on corporate investments up to the end of 2014 applying different estimation methods. They concluded that the level of corporate investments was increased by an average of 1.2-4.1 per cent annually, depending on the approach used for the assessment. The median of the point estimates based on the methods used for the calculations shows an investment impact of around 2.2per cent. To assess the impacts on GDP and on employment, two more factors were taken into account in addition to the direct investment impact. On the one hand, the interest rates of non-investment FGS loans were approximately 300 basis points lower than the average rate on the market. This resulted in a long-term income transfer of approximately 0.1 per cent of annual GDP to the enterprises that participated in the scheme. On the other hand, the investment loans in the FGS not only had similarly low interest rates as non-investment FGS loans, but – compared with the previous SME loans – they also have a significantly longer maturity (around 7 years on average), resulting in a lower repayment burden for SMEs. These two effects may have improved cash flows annually by 0.2 per cent of GDP in comparison to the scenario without the FGS (Endrész – Oláh – Pellényi – Várpalotai 2014, p. 84). Increasing investments improved domestic aggregate demand which also contributed to GDP growth. On the income side, the growth in GDP boosted wages and corporate profit, with the latter also increasing dividend-type incomes paid to households. The effects of the rising cash flows of enterprises are exerted through the same channels. The increase in households' income would improve their consumption through second-round demand effects. Employment would be higher due to additional capacities resulting from investments and the overall rise in demand. The strengthening of economic activity increases the tax base related to wages, consumption and profit and will therefore generate additional budget revenues.

Based on the demand side estimates of Endrész – Oláh – Pellényi – Várpalotai (2014), the Funding for Growth Scheme resulted in a total GDP surplus of 0.3-0.9 per cent in 2013-14. Employment increased by about 3,000-9,000 jobs. As a result of the additional investments, the capital stock also increased, and thus the level of the potential output might have increased by 0.1-0.3 per cent in the medium term (Endrész – Oláh – Pellényi – Várpalotai, 2014, p. 85.).

2.4. Self-Financing Programme increases domestic funding of debt

All sectors of the Hungarian economy (government, corporations and households) accumulated foreign currency debt before the crisis. To reduce the share of external debt in total debt, debt management has now shifted to a higher share of forint issues to finance maturing public foreign currency debt. The administration repaid the IMF loan and took over all municipal debt, while the majority of the municipal sector's foreign currency debt was prepaid by the central budget. Since 2010, each year the debt issuance was lower than the current expiring foreign currency debt, and thus in four years the foreign debt ratio has decreased from about 50 per cent to nearly 38 per cent. This was largely achievable thanks to demand supported by the household sector, while foreign investors also significantly increased the share of HUF-denominated government bonds in their portfolios. Exclusively for households, a number of new government bonds were introduced with different maturities, conditions and favourable rates of interest. As a result, the amount of government securities directly owned by the population tripled in four years and their share in total public debt increased from 3 to over 8 per cent. It became favourable for households to invest their savings in government bonds, which were secure and offered high yield.

To support this trend by central bank measures, the Self-Financing Programme was launched by the central bank in the spring of 2014. Some of the central bank's instruments have changed in line with this programme to support the domestic funding of the national debt, and to reduce the economy's external vulnerability. The main element in this transformation was that an important instrument, the two-week central bank bill, was replaced by a two-week deposit facility. This deposit facility is offered to banks only, so the move closed out direct access for non-residents and non-banking entities. While the MNB bills were eligible collateral, the two-week deposits are not used as collateral in central bank operations. Other assets, such as government securities may be more attractive for banks' liquidity management purposes. The programme resulted in a more stable market for government securities. Yields on Hungarian securities have decreased since the start of the programme. On the day of its introduction, yields began to decrease immediately. Government securities became more attractive for domestic participants, including banks, and there was a shift in the structure of debt towards domestic sources.

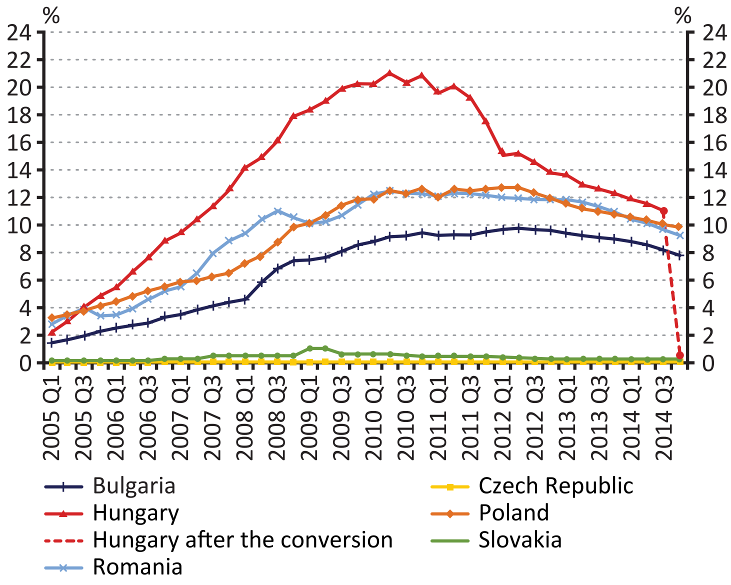
2.5. Conversion of households foreign currency mortgage loans to forint loans

Household lending in foreign currency reached epidemic proportions in all countries in the region, but was especially serious in Hungary (Figure 7). Consequently, households' demand for financial instruments such as government bonds was seriously handicapped by the high and increasing burden of their own existing (foreign) debt. The residential mortgage loans amounting to 19 billion euros were the most serious economic and social problem of the period. Apart from the hundreds of thousands of directly affected families, foreign currency loans threatened the stability of the whole financial system through spillover effects. Moreover, it fuelled an irreconcilable conflict between exporting businesses and indebted households in terms of interests. In 2010, the government basically put an end to foreign currency lending by prohibiting the registration of foreign currency credit related mortgage rights. Subsequently, it took the first step to terminate the outstanding foreign currency loan portfolio in 2011 with the discounted final repayment option. Thanks to the final repayment scheme, households repaid 170,000 foreign currency loans, and consequently the total foreign currency loan portfolio decreased by 1,350 billion forints, of which 370 billion represented savings due to the favourable conditions by discounted exchange rates. Bankrupt foreign currency borrowers were supported by the moratorium on eviction and the foundation of the National Asset Management Company to buy houses and lease them back, while the exchange rate limit helped those who were still able to pay monthly instalments.

Foreign currency mortgage loans were partially converted to forint loans in 2012, but only a very limited number of borrowers were able to benefit from that scheme. Later, however, a systematic solution of total conversion to forint was initiated in one step as recommended by the MNB and de facto executed on 9 November 2014 at market exchange rates based on an agreement signed between the Government and the Banking Association, before the date the Swiss National Bank decided to unpeg the Swiss

Franc. In late November 2014, the Parliament passed the law on this issue, according to which foreign currency mortgage loans were also de jure converted into forint loans as of 1 February 2015. The conversion applied corrections based on earlier decision of the Supreme Court. Applying these corrections, the principal amount of total loans was reduced by nearly 1,000 billion forints. There was another favourable factor affecting the instalments in the conversion process: forint interest rates are at a historical low and so foreign currency loans can be changed into the least expensive forint credit.

Figure 7: Household debt in foreign currency (in per cent of GDP)



Source: ECB, MNB

The risks related to households' FX loans were handled by the Hungarian legislation by nullification of the exchange rate spread, settlement of the unfair interest rate and fee increases, the transition to a "fair banking system", and conversion of the FX mortgage loans into forints. These measures may have a substantial impact on all aspects of the banking sector's operations and significantly enhance competition in the banking sector.[15]

Settlement may result in a significant burden for the banking system, the total cost could amount to almost HUF 950 billion, the overwhelming majority of which – nearly HUF 700 billion – was generated on the FX-denominated mortgage loan portfolio.[16]

[15] Financial Stability Report, 2014. November, p. 12-13.
[16] Financial Stability Report, 2014. November, p. 12-13.

Based on settlement, consumers' claims (the amount of overpayment) will be offset against the outstanding debt for contracts which are still in force in 2015. As a result of settlement, the portfolio of household FX loans will fall by about an estimated 16 per cent on average. Given that lending rates will also drop to a fair level with an interest rate moratorium of one and a half years, the charges payable by performing debtors may fall by nearly 25 per cent on average. The settlement will be followed by conversion to a "fair banking system" and the planned FX loan conversions into forints in 2015 (hence the drop in Figure 7). In the fair banking system, pricing policies of banks are constrained by regulation and the interest rates charged to debtors may only be raised objectively within the framework of the regulation.

The MNB provided both technical and financial support for the conversion of foreign currency loans to Hungarian forint loans. The conversion came along with an almost 8 billion euro demand for foreign currencies, which then would have meant a significant depreciation pressure on the forint exchange rate. Therefore, the central bank promptly signalled – in September 2014 – that it is ready to provide the necessary amount from its foreign exchange reserves. The banks received the whole amount – a total of 7.9 billion euros – in November. The central bank intends to prevent the re-emergence of foreign currency loans by encouraging the so-called fair banking system, and with the introduction of new macroprudential regulation, including the use of PTI (payment-to-income) and LTV (loan-to-value) ratios in January 2015.

3. summary of the results of policy changes in improving economic conditions

Favourable trends have been observed in the past four years. The government budget deficit between 2012 and 2014 was 2.4 per cent of GDP on average: since the transition, the balance of the government sector has never before been this favourable. Moreover, Hungary finally exited the Excessive Deficit Procedure, the first time since joining the European Union. Employment increased by 400,000 between 2010 and 2014, with 240,000 of these jobs created in the private sector. Meanwhile, the number of the active labour force also increased by 300,000, and the rate of unemployment decreased from 11.8 per cent to 7.4 per cent. The gross external debt-to-GDP ratio, which was as high as 120 per cent during the crisis, decreased to below 90 per cent by 2014. In recent years, economic growth has been sustained, and in 2014 it was the second highest among the EU member states.

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THE
LAMFALUSSY AWARD
2015


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. 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.

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.

Honouring the oeuvre of the eponym, the Lamfalussy Award is awarded to outstanding financial and economic professionals who have internationally acclaimed contributions in economics and monetary policy, in 2015 as well. Benoit Coeuré, this year's recipient of the Lamfalussy Award, is such a professional.

Benoit Coeuré is a prominent European academic and empirical macroeconomist, with unrivalled innovative ideas. He is an excellent practical professional and a responsible decision-maker, who – in addition to being able and willing to manage the monetary policy of ECB and the finances of Europe – is also an innovative economic policy-maker, who has been urging the necessity of using new monetary policy instruments more intensely from as early as 2011, well ahead of their implementation in this form.

Furthermore, he emphasised that during the crisis management of the European countries with high government debt, efforts should be made to distribute the burdens more evenly rather than putting the entire load on less protected classes of society.

BENOÎT CŒURÉ
Member of the Executive Board
European Central Bank

Benoît Cœuré has been a member of the Executive Board of the European Central Bank since 1 January 2012. He is responsible for International and European Relations, Market Operations and the Oversight of Payment Systems. He is the Chairman of the Committee on Payments and Market Infrastructures (CPMI, formerly the Committee on Payment and Settlement Systems) of the Bank for International Settlements, and has held this position since October 2013.

Prior to joining the ECB, he served in various policy positions at the French Treasury. He was the Deputy Chief Executive, then Chief Executive, of the French debt management office, Agence France Trésor, between 2002 and 2007. From 2007 to 2009, he was France's Assistant Secretary for Multilateral Affairs, Trade and Development, co-chair of the Paris Club and G8 and G20 Finance Sous-Sherpa for France. From 2009 to 2011, he was Deputy Director General and Chief Economist of the French Treasury.

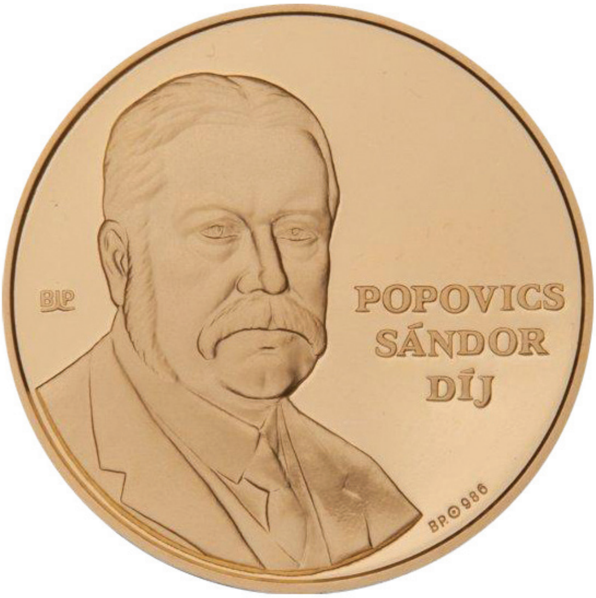
Mr Cœuré co-chaired the G20 working group on reforming the World Bank and the other multilateral development banks in 2009, and the G20 sub-working group on global liquidity management in 2011.

Mr Cœuré is a graduate of the École polytechnique in Paris. He holds an advanced degree in statistics and economic policy from the École nationale de la statistique et de l'administration économique (ENSAE) and a B.A. in Japanese. He is an affiliate professor at Sciences Po in Paris. He has authored articles and books on economic policy, the international monetary system and the economics of European integration, including *Dealing with the New Giants: Rethinking the Role of Pension Funds* (CEPR, 2006, with Tito Boeri, Lans Bovenberg and Andrew Roberts) and *Economic Policy: Theory and Practice* (Oxford University Press, 2010, with Agnès Bénassy-Quéré, Pierre Jacquet and Jean Pisani-Ferry).

THE

POPOVICS AWARD

2015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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. In 2015, the Popovics Award was awarded to Dániel Palotai, Executive Director and Chief Economist of the Magyar Nemzeti Bank.

Dániel Palotai has been interested in issues related to macroeconomic balance and imbalance since the very start of his career. He was one of the first to point out in 2005 that with the then-current performance of the private pension fund scheme (low real yield and high costs), the system might provide its members with a lower level of pensions than the social insurance system. In the same year he was also one of the first to warn about the risks of household foreign currency lending, when most economists still touted the benefits of cheap Swiss franc interest rates.

After mastering European crisis management in the ECB, he returned to Hungary in 2010 and joined the team of the Ministry for National Economy, where he worked on the elaboration of the Structural Reform Programme. In addition, he was a resolute bargaining partner with the European Commission and IMF, always representing the Hungarian position consistently and very efficiently, helping to foster the turnaround in economic policy.

He returned to the Magyar Nemzeti Bank and entered the service of monetary policy in 2013, providing support – amongst others – in accomplishing the easing cycle.

2015 AWARD RECIPIENT

DÁNIEL PALOTAI
Executive Director and Chief Economist
Magyar Nemzeti Bank

Dániel Palotai is an economist. He earned his Masters degree in 2004 at the Faculty of Economics (Finance Major, Actuary Minor) of the Corvinus University of Budapest. He began his professional career at the Magyar Nemzeti Bank, working as an analyst in the Monetary Strategy Division of the Bank's Economics Department between 2004 and 2007. One of the developers of the MNB pension model, he is a recognised expert on pension systems. From 2007, he went on to work at the European Central Bank where, as an economist responsible for selected non-euro area EU Members States, he gained insight into financial crisis management. From November 2010, he was Head of the Macroeconomic Policy Department of the Ministry for National Economy and was actively involved in the development of Hungary's Structural Reform Programme. As a member of the Economic Policy Committee of the European Union, he contributed to economic and financial stabilisation in Hungary.

Dániel Palotai has been Executive Director responsible for monetary policy and also Chief Economist of the Magyar Nemzeti Bank since March 2013. He has a key role in shaping monetary policy and in strengthening the credibility of the MNB's forecasts. He is a member of the Monetary Policy Committee of the European Central Bank and an alternate member of the Economic and Financial Committee of the European Union.