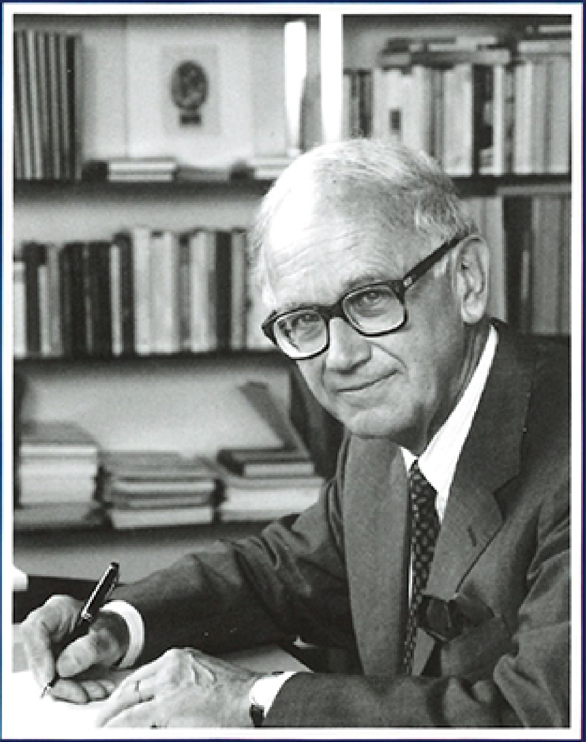
Lamfalussy Lectures Conference

PROFESSOR LAMFALUSSY COMMEMORATIVE CONFERENCE 'HIS CONTRIBUTION TO ECONOMIC POLICY AND THE BIRTH OF THE EURO'



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

Budapest, 1 February 2016

PROFESSOR LAMFALUSSY COMMEMORATIVE CONFERENCE ’HIS CONTRIBUTION TO ECONOMIC POLICY AND THE BIRTH OF THE EURO’

Conference logbook on the third conference of the Magyar Nemzeti Bank’s Lamfalussy Lectures Conference series

Budapest, 1 February 2016

Published by:
Magyar Nemzeti Bank
9 Szabadság tér, Budapest 1054

Responsible publisher: Marcell Horváth
Editor: Anna Ditta Lugosi
Cover design: Anna Ditta Lugosi
Photos: András Hajnal

All studies are paper based on the lecture given at the Conference.

Printed by: SPL–Prospektus Consortium
Budapest, 2016

CONTENTS

FOREWORD

by György Matolcsy

The global economic and financial community faces a difficult situation in 2016. The main pillars of the global economy – including the European Union, but also the US, China and Japan – have all seen their positions weakened in recent years. The main challenge for them is the lack of engines for global GDP growth. The global real GDP growth in 2015 was around 2.4% (1.8% in the European Union, 2.4% in the US, 6.9% in China and 0.6% in Japan), and according to forecasts, these figures are not likely to improve substantially in 2016. This moderate GDP growth comes together with persistently high unemployment rates and subdued lending activity.

As financial instabilities can lead to economic crises, one reason behind these relatively low GDP growth rates is financial instability in the aftermath of the financial crisis that began in 2007-2008. We know from Alexandre Lámfalussy that at the very heart of all successes in all economies, we can find stable finances. But financial stability is important not only for economic performance, because financial instabilities – due to the resulting decline in economic activity – can also lead to social and political turmoil.

There is a so-called magic triangle that the world economic and financial community has to overcome in order to improve its current situation. We badly need structural economic reforms in order to re-initiate growth and start creating jobs, and these will contribute to financial stability. But in the lack of financial, economic and political stability, it is difficult for countries to launch, and even more difficult to complete structural reforms. So we have to find a solution to break out of this magic triangle.

In trying to find a solution to the current situation, it is good news that we have the insights and thoughts of Alexandre Lamfalussy with us. The conference presentations made it obvious to all of us that we definitely need to discover and rediscover his messages. However, at the same time it is bad news that now we seem to face quite similar problems to those that Lamfalussy and his colleagues faced several decades ago.

We can perhaps say that the Euro and the Eurozone have survived the recent, second largest economic and financial collapse of the last one hundred years. In this respect, the Euro and the Eurozone have succeeded, and hence they are a political success. This is another good news. But at the same time we should also add that they are still in a very weak state, and there is still much to be done until the final recovery.

We have also benefitted a lot from trying to find solutions to the crisis. Along the way, we managed to find ways to actually use the crisis to improve some aspects of our economic and political structure. But we also have to see that we still keep marching under the umbrella of the old political structure of European integration. The main problem of the previous decades was that we failed to benefit from good times, but instead we have been accumulating more and more challenges. Now our task is to put together a new economic and political structure within the European Union, which make the benefits from the current crisis management sustainable, make it possible to avoid or prevent future crises, and are also suitable in the future to capitalise on good times.

There is a consensus between economists that we badly need new structural reforms. In the words of Alexandre Lamfalussy, we need *bold* reforms. But as bold structural reforms always need political, economic and financial stability, they are very difficult when we have double-digit unemployment rates, hardly sustainable public debt figures and tax systems in some member countries.

All in all, if we would like to break out of this magic triangle, we need a new mindset with which we should – at the same time – (1) put together "bold" structural reforms which enhance larger economic growth and job creation, (2) rebuild confidence, and (3) regain the trust of the voters in order to create or maintain political stability. I am sure that during the conference we have all come closer to finding a solution together to this challenging task.

LAMFALUSSY LECTURES CONFERENCE

LUIZ AWAZU PEREIRA DA SILVA[1]

Deputy General Manager
Bank for International Settlements

Revisiting Lamfalussy's insights regarding financial globalisation and the global financial crisis: the need to rebuild confidence[2]

One of the major waves of financial globalisation was being set in motion around the time Alexandre Lamfalussy came to Basel to join the Bank for International Settlements. The questions he started asking at the time – concerning, inter alia, the risks of excessive credit build-up and appropriate policy tools to contain them in a financially interconnected world – occupy us also today in the aftermath of the global financial crisis (GFC). We are mindful of his thinking as we look at the GFC and observe how the extraordinary monetary policy measures undertaken to counter its effects, though successful at averting a deep depression, failed to ignite a robust, sustainable economic growth cycle. We argue that the usefulness of cyclical policies such as monetary easing is declining while their costs are mounting. Hence, we need more structural reforms to reignite sustainable growth. In particular, we need to rebuild confidence and reconfigure social contracts.

1. Introduction

About 40 years ago, Alexandre Lamfalussy came to Basel to take up the position of Economic Adviser at the Bank for International Settlements. At the time, the world economy was moving from fixed exchange rates, strict capital controls and rigid financial regulations to a much more open, market-driven system, which set in motion a wave of financial globalisation.

[1] and Előd Takáts Senior Economist, Bank for International Settlements

[2] These remarks are personal and do not necessarily represent the views of the Bank for International Settlements (BIS). We thank Claudio Borio, Jaime Caruana, Piet Clement, Dietrich Domanski, Robert McCauley, Hyun Song Shin, Josef Tošovský, Philip Turner, Christian Upper and David Williams, who provided comments on an earlier version. We are grateful to Matthias Lörch and Diego Urbina for excellent research assistance. As usual, all remaining errors are ours.

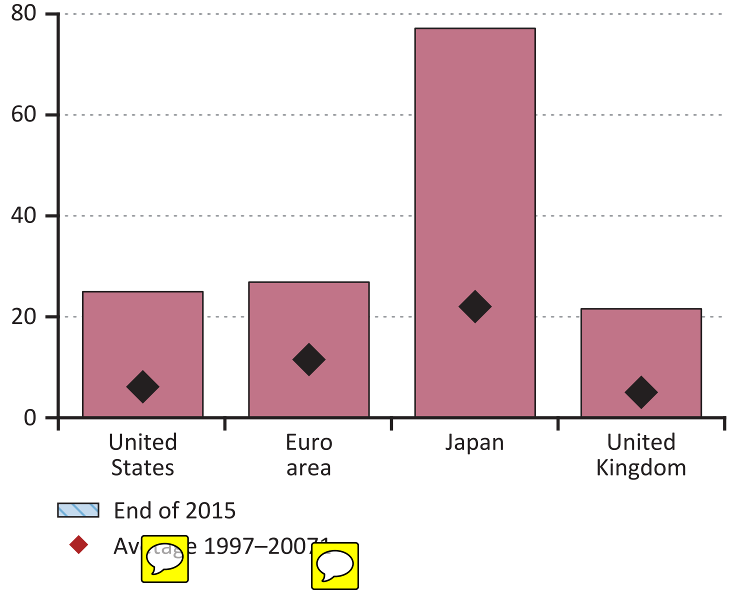
Alexandre Lamfalussy started to think about related questions that occupy policymakers today. For instance, he and his colleagues worried that the rapid build-up of debt would prove unsustainable, and a reversal of debt flows could expose the global financial system to significant risks. Moreover, Lamfalussy and his staff were, already in the late 1970s, exploring policies to limit such excessive debt build-up. We would recognise some of the measures they proposed as macroprudential tools today. For instance, they suggested requiring internationally active banks to make special balance sheet provisions or to increase their capital ratios to cover specific risks.

The Global Financial Crisis (GFC) of 2007-09 demonstrated that these challenges have not gone away. In fact, while earlier emerging market crises were often caused by excessive cross-border bank lending, in the case of the GFC a broader set of factors played a role, including excessive domestic public and private debt in advanced economies, the concentration of risks in some balance sheets, the interconnectedness of too-big-to fail global financial institutions and the opacity of certain financial instruments (Gourinchas and Obstfeld (2012)). Each one of these factors alone could produce larger systemic crises in the global financial system – and when they occur in combination, their impact is magnified. Fortunately, we also learned from past financial crises and we used old and new monetary policy tools to restore the functioning of financial markets after the Lehman bankruptcy – thereby managing to avoid a repeat of the Great Depression.

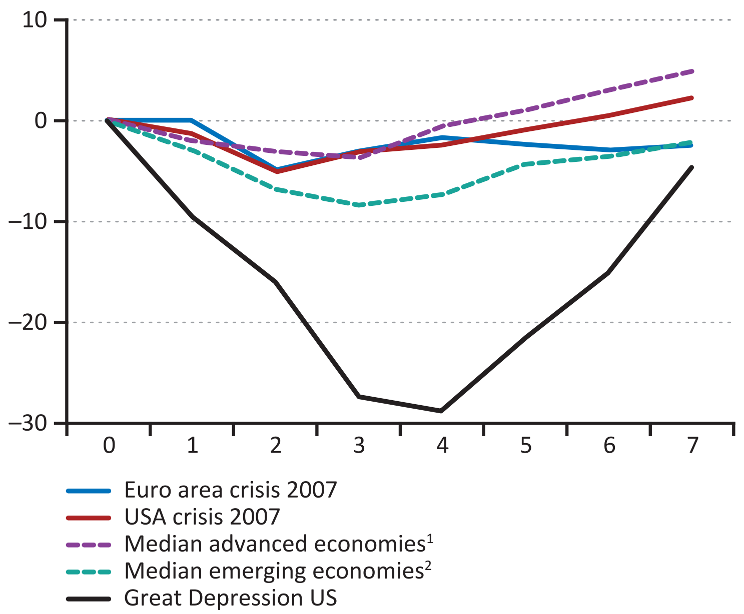
This is no small achievement. Yet, in 2015-16, we still seem to have been stuck in a relatively "mediocre" low-growth, high-volatility environment in spite of the massive initially fiscal and then monetary stimulus applied (Graph 1, left-hand panel). Although we avoided a repeat of the Great Depression, output recovery remained weak (Graph 1, right-hand panel). Further monetary policy easing, additional rounds of quantitative easing (including massive asset purchase programmes undertaken by central banks) and now negative interest rates are apparently failing to bring back a robust, sustainable and stable growth cycle and to steer inflation expectations back towards a reasonable non-deflationary trend, especially in the euro area and Japan.

Graph 1: In spite of unprecedented monetary stimulus, the recovery remains weak

Central bank total assets as a percentage of GDP



Real GDP per capita after the start of crises (in years)



1 *For the euro area, 1999–2007.*
2 *From the Reinhart and Rogoff (2014) crisis database.*

Sources: National data; BIS; BIS calculations.

So if, unconventional monetary policy tools are producing decreasing returns, what can we do to reignite stronger and sustainable growth? What do we need to do to reach a more robust upturn in the business cycle, in terms of both activity and inflation?

We argue that we need to restore confidence and that it needs to be done primarily by rebalancing the current policy mix, which has used monetary policy excessively. That is necessary, but not sufficient: confidence is not a simple dose of optimism that can be instilled without any real changes to the structure of the economy. We also need structural change that allows economic actors to form credible expectations about future growth and economic conditions. Currently, market participants and economic actors are very uncertain about a number of key economic parameters: the long-term sustainable growth rate, the benchmark return on safe assets and a sensible method for asset pricing and risk-taking. This uncertainty comes from the identification of actuarial imbalances between our liabilities and resources. Therefore, it is becoming increasingly clear that some of our old social contracts are unsustainable in a globalised and ageing world. However, it is much less clear how the new and hopefully sustainable social contracts will look. In addition, there are competing and equally plausible narratives about present recovery and the future, but they differ too much. Hence, markets remain unanchored, more than ever hostage to the smallest rumour, and, as we have seen in these first weeks of 2016, highly volatile. Further monetary easing can only boost asset prices in the short run, but it cannot resolve this fundamental uncertainty.

In order to re-establish sustainable long-term growth, we need to re-anchor these expectations. Simply put, we need to recreate "faith in the future". One element is to rebalance cyclical policies by relying more, when and where possible, on fiscal policy and, when and where adequate, continue working on and defining a clear roadmap towards a gradual normalisation of monetary and financial conditions. But this is not enough. We also need to implement structural reforms in the real economy to remove impediments to sustainable growth and make current arrangements more sustainable. And we need to consider all these elements simultaneously. The way out consists of building on existing progress and signalling a clear direction for change.

In the following, we develop this argument in more detail. The second section outlines the economic landscape that we face: the economic imbalances, how financial interlinkages amplify them and the key policy lessons we have learned so far. The third section looks at the low-growth environment after the crisis and delineates our structural suggestions for restoring sustainable growth. The final section concludes.

2. Economic landscape

2.1 Imbalances: credit booms and busts

After the crises of the 1990s, the past decade has seen several classical internal macroeconomic imbalances develop and erupt in crisis mostly in emerging economies. But in the 2000s the most extraordinary event was the Global Financial Crisis (GFC), which originated in advanced economies. Although it started in advanced economies, this type of crisis confirmed our understanding that excessively loose fiscal, monetary and credit policies can lead to a full-blown local crisis that can become global due to the systemic nature and size of advanced economies' financial sectors. In particular, in the period before and after the GFC, what we saw in advanced and emerging economies alike confirmed that credit booms and busts seem to be the most relevant risk for balanced growth.

While credit is necessary for development and for economic growth, it can also amplify shocks and can lead to accentuated boom-bust cycles. We know from the old and traditional literature that equity markets are prone to bubbles (Kindleberger (1978)) leading to asset and collateral overvaluation and always ending in inherent instability (Minsky (1986)).

Equity markets fed by excessively rapid credit growth can turn instability into a vicious cycle: credit finance can further inflate bubbles, which temporarily confirms inflated valuations, and overvalued collateral then enables even more credit growth and even higher asset prices – until the bubble bursts. Lax prudential and regulatory rules can further exacerbate this vicious cycle and contribute to self-feeding excessive credit growth (Blinder (2013)).

2.2 Interlinkages and spillovers

These domestic credit booms usually produce spillovers outside the domestic jurisdiction (see, for instance, Barata et al (2013) for the case of Brazil). Access to foreign credit can make the boom-bust cycle even more rapid and pronounced – and the eventual reckoning more difficult. International financing works through both banks and capital markets (see e.g. Ehlers and Villar (2015) and Hattori and Takáts (2015)). One clear channel works through foreign currency lending, where, in addition to credit risk, exchange rate risk is accumulated on balance sheets. But such an impact can also work through local currency-denominated bond markets.

The surges in dollar and euro lending from large advanced economies to emerging economies and smaller advanced economies often by-pass existing local prudential regulation and illustrate a "risk-taking channel" of monetary policy (Borio and Zhu (2008) and Bruno and Shin (2015a)). The novel part is that the funding currency – primarily the US dollar, but also the euro – became a key driver. This gave – and continues to give – these currencies great clout in driving global financial conditions. The immediate post-Lehman dollar appreciation provided indirect proof of the risk-taking channel view as European banks rushed to US dollar liquidity to unwind their financing round-trips.

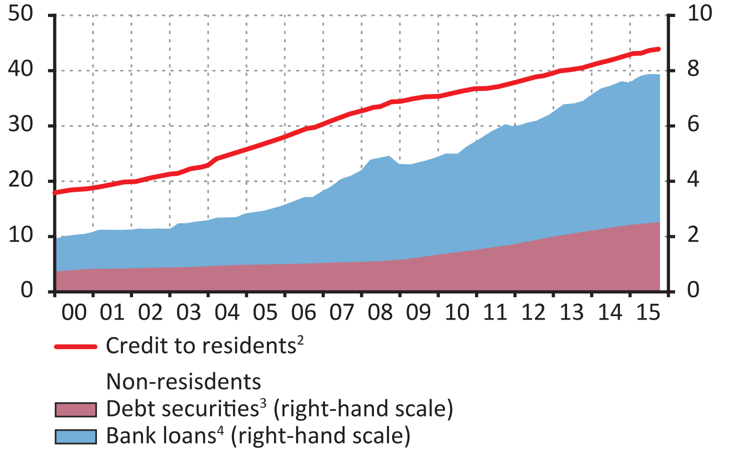
This feature occurred in many economies, emerging and advanced alike: periphery euro area countries have seen such massive inflows just before and after joining the euro area, and central Europe has also experienced such episodes. Moreover, in the wake of large programmes of liquidity injections by central banks after the financial crisis, rapid dollar credit flows, not only bank loans, but also debt securities, created an unprecedented amount of dollar exposures, of around US$ 9 trillion (McCauley et al (2015) and Graph 2, left-hand panel). Euro-denominated credit to non-residents has also increased, though much more slowly following the financial crisis (Graph 2, right-hand panel).

These international flows can indeed accentuate the vicious credit-asset price cycle. Excessive domestic credit flows can contribute to credit booms, which can trigger asset price booms. This provides additional incentive for international credit inflows, which can lead to currency appreciation and accentuate the decline in sovereign spreads. This is generally perceived as an improvement of macroeconomic fundamentals and financial stability. Hence, international investors' decisions to provide more credit are validated through temporarily stable returns and exchange rate gains. Consequently, international and domestic credit growth reinforce each other and lead to even stronger credit and asset price growth. All of this makes balance sheets look stronger. Risks of excessive debt and/or FX mismatches are downplayed – and often simplistic arguments arise on trend exchange rate appreciation, a misreading of the Balassa-Samuelson effect. The resulting excessive credit growth, buoyant economic activity and more permissive financial conditions facilitate the build-up of financial vulnerabilities.

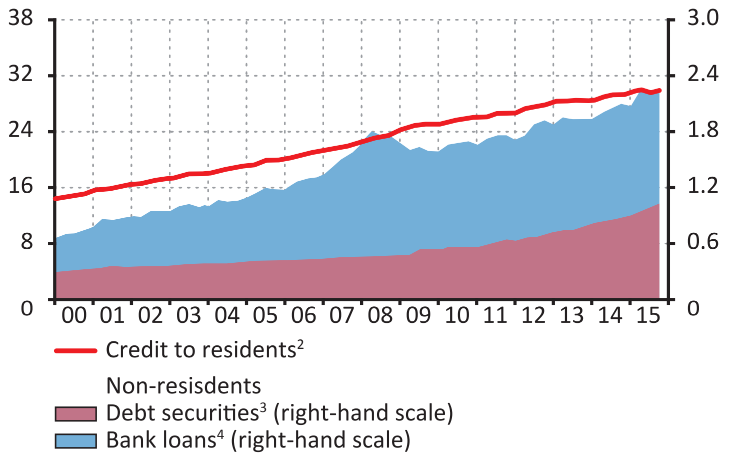
These international flows can be even stronger with the spillovers from ultra-easy monetary conditions in core advanced economies. Besides the pull factors described above, low interest rates in core economies can and did act as push factors to increase credit flows further.

Graph 2: USD- and EUR-denominated global credit has skyrocketed in recent decades

Dollar credit to the non-financial sector, in trillions of US dollars



Euro credit to the non-financial sector, in trillions of US dollars[1]



1 Amounts outstanding at quarter-end. Amounts denominated in EUR are converted to USD at the exchange rate prevailing at end-September 2015. 2 Credit to non-financial borrowers residing in the United States/euro area. National financial accounts are adjusted using BIS banking and securities statistics to exclude credit denominated in non-local currencies. 3 Excluding debt securities issued by special purpose vehicles and other financial entities controlled by non-financial parents. EUR-denominated debt securities exclude those issued by institutions of the European Union. 4 Loans by LBS-reporting banks to non-bank borrowers, including non-bank financial entities, comprise cross-border plus local loans. For countries that are not LBS-reporting countries, local loans in USD/EUR are estimated as follows: for China, local loans in foreign currencies are from national data and are assumed to be composed of 80% USD and 10% EUR; for other non-reporting countries, local loans to non-banks are set equal to LBS-reporting banks' cross-border loans to banks in the country (denominated in USD/EUR), on the assumption that these funds are lent to non-banks.

Sources: IMF, International Financial Statistics; Datastream; BIS international debt securities statistics; BIS locational banking statistics (LBS).

The confluence of the above factors – domestic credit booms, international credit inflows via financial interlinkages and ultra-easy monetary conditions in core advanced economies – created a huge wave or a "sudden flood" of financing.

Furthermore, the interlinkages in global financial cycles and the risk-taking channel can derail the normal stabilisation role of exchange rates. Normally, as for instance in the standard Mundell-Fleming framework, the exchange rate stabilises the real economy via the relative price of exports and imports. A negative shock elicits depreciation and a positive one appreciation – and even though the exchange rate can under- or overshoot, it works to facilitate the real adjustment and thereby stabilises the real economy.

However, the risk-taking channel in an interlinked world creates a destabilising exchange rate dynamic. In the initial phase, during good times, balance sheet risks accumulate through excessive foreign currency borrowing by firms and households. As discussed above, this creates a self-reinforcing dynamic, which works until the exchange rate depreciates. And when it does depreciate, the process seen in good times reverses sharply: as foreign exchange rate risks materialise, balance sheets come under strong pressure. Exchange rate depreciation thus destabilises balance sheets and can force exposed firms into bankruptcy, which weakens the local financial system. The new problem is the speed of adjustment: balance sheet risks can materialise much faster than the adjustment in the real economy through exports and imports. Although the exchange rate eventually corrects, as any unsustainable valuation by definition must correct at some point, this correction comes late and only after the exchange rate has contributed to the build-up of financial imbalances.

2.3 Policy lessons

Domestic policy is usually not an innocent bystander when imbalances build up because of credit growth. Unfortunately, the typical political economy cycle tends to reinforce local credit booms through wealth effects, expectations and policy complacency. Sometimes political demands add to the pressure on fiscal and para-fiscal policy and end up creating too much debt. Sometimes a genuine need for social equity and development rides on this euphoria to justify the pursuit of unsustainable fiscal policies. The political economic dynamics are so strong that these mistakes prove hard to avoid – even though we understand well how macroeconomic populism can lead to crisis and worsen the very social and development conditions that it seeks to remedy.

The GFC has shown that advanced economies are not immune to these risks: in the United States, the political economy, through quasi-fiscal guarantees, also encouraged unsustainable credit growth to facilitate home ownership, for instance. In the euro area, optimism about “convergence” fuelled credit flows from the core to the periphery – which then, during the euro area debt crisis, stopped suddenly with dire consequences. Financial institutions in the core countries took on complex balance sheet risks before the financial crisis, which had to be unwound through the complex construction of a unified system of bank supervision and resolution that was absent before the crisis.

Hence, the first policy lesson is to avoid the typical political economic mistakes that tend to fuel the bubble and deepen the eventual crisis – which is admittedly easier said than done.

Yet, policy can do more than just avoid exacerbating the crisis. Various models for currency crises (starting with Krugman (1979) and then Obstfeld (1986, 1996)) have explained the need for consistent exchange rate, fiscal, credit and FX reserve policies. Numerous historical and empirical studies have shown why fiscal prudence and low debt levels are key for stability. Incidentally, they have also demonstrated why the exceptional circumstances that politicians invoke to increase public spending and debt are almost never an exception.

Analytical work and practical rules have so far confirmed the effectiveness of conducting monetary policy aimed, at least, at a price stability goal, and in particular using inflation targeting frameworks. Central banks have combined interest rate policy with increasingly important and sophisticated communication (à la Blinder (1998)) to anchor inflation and inflation expectations at a low and stable level. And naturally, in part as a result of this, central banks raised their reputation and credibility, as illustrated by the Great Moderation.

And it was also shown that, under specific circumstances, stabilising inflation would keep unemployment at its “natural” level, stabilising output – a “divine” and very useful coincidence. Hence, many countries, including most pragmatic emerging market economies, adopted the current dominant macroeconomic policy framework: a (relatively) floating exchange rate regime, a (relatively) sustainable fiscal policy and a (relatively) open capital account – which, in turn ensure room for manoeuvre for a (relatively) independent monetary policy (Mishkin (2007), Frenkel (2011), and Agénor and Pereira da Silva (2013)). Finally, sufficient FX reserves and/or access to some multilateral liquidity provision are also necessary to withstand short-term shocks.

However, more is needed to counter credit boom-bust cycles. Central banks have also learned that the positive feedback loop between credit growth and asset prices can occur even if monetary policy keeps inflation at moderate levels. Hence, an open question is whether monetary policymakers might have to look beyond inflation to address financial stability risks directly – and incorporate financial cycles in order to lean against the wind in their policy setting. Moreover, monetary policy alone might not be sufficient: the problem with relying solely on monetary policy tightening to curb inflows is that it can actually trigger more, not less, short-term capital inflows. These potential inflows complicate running monetary policy in smaller economies completely independent from the monetary conditions prevailing in the largest advanced economies (Rey (2013 and Hofman and Takáts (2015)). Thus, there is a growing debate about combining monetary policy with macroprudential tools to smooth credit growth more directly and safeguard the stability of the financial system (using, for example, reserve and capital requirements or calibrating provisions through the cycle).

These macroprudential tools might sound new, but their predecessors were first proposed by Lamfalussy in the second half of the 1970s. Those proposals included the requirement for internationally active banks to make special provisions and increase their capital ratios to cover specific risks. Indeed, the term "macroprudential" was first mentioned during these discussions (for a review of subsequent usages, see Caruana and Cohen (2014)).

And these macroprudential tools are effective at limiting not only the domestic credit boom-bust cycle, but also the amplifying effect of global financial interlinkages. In particular, combining an adequate monetary policy with macroprudential tools can reduce excessive cross-border credit flows (e.g. by also using foreign exchange interventions). For instance, many emerging economy policymakers combined monetary policy with macroprudential policies to control consumer credit growth (e.g. asking for more capital for some consumer loans or by lowering loan-to-value ratios and hiking reserve requirements) during the large inflows in 2011-12 following the Federal Reserve's asset purchase programme. Macroprudential tools – which, incidentally, can be used in a symmetric and coordinated way – can be especially useful for, on the one hand, strengthening credit multipliers and avoiding leakages and, on the other hand, smoothing excessive currency appreciation and thereby dampening the international amplification of capital inflows into the domestic credit cycle (Agénor et al (2014)).

3. Policy options after the crisis

3.1 Unconventional monetary policies after the crisis

Monetary policy acted strongly and decisively to stabilise financial markets in the acute phase of the GFC. Central banks quickly brought the policy rate down to zero and also provided ample liquidity to unfreeze interbank markets.

Central banks also used unconventional monetary policy tools to stabilise the financial system. Balance sheet policies (such as quantitative easing or credit enhancing) boosted asset prices and financial conditions beyond the effect of the ultra-low short-term policy interest rate. Although these policy measures are not necessarily entirely unconventional (Borio and Disyatat (2009)), their size, intensity and persistence were certainly new. These unconventional measures improved the risk profile and composition of private sector balance sheets through the purchase of less liquid or even less risky assets.

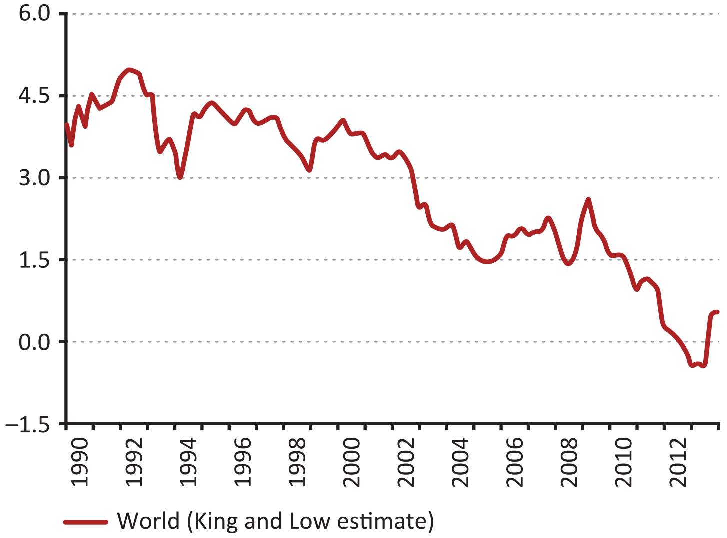
Furthermore, central banks communicated clearly that they were prepared to use their balance sheets to reduce yields and ease financing constraints if needed. This became a powerful tool for conducting quasi-fiscal policy and debt management. Finally, central banks started to communicate explicitly about the future direction of monetary policy: the new communication strategy of forward guidance (Woodford (2013)) helped to drive markets' expectations and thereby further lowered long-term rates and term premia (Graph 3).

Unconventional monetary policies, along with ultra-low interest rates, did indeed work as intended in the immediate aftermath of the GFC. They helped to stabilise financial conditions and to reduce the expected large contraction in aggregate demand. In sum, all combined, these measures played their part in averting a 21st century repeat of the Great Depression.

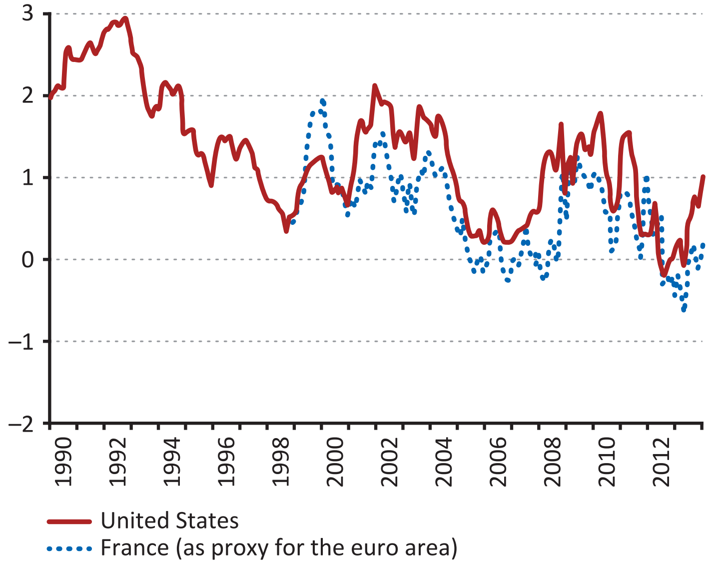
However, after more than seven years since they were first introduced, some of these unconventional monetary policies seem to be producing diminishing returns while their costs are mounting. Pushed to the extreme, some policy interest rates and some sovereign yields are now negative, not only in the short term, but also increasingly in the medium to longer term in several countries. However, growth is still weak and markets seem to be demanding ever increasing amounts of monetary stimulus.

Graph 3: Long-term interest rates and the term premium have plummeted

World real long-term interest rate (per cent)



Ten-year bond term premia (per cent)



Sources: King and Low (2014); Bloomberg; national data; BIS calculations.

3.2 Animal spirits, confidence and the new normal

Unconventional monetary policies aimed to restore confidence and risk-taking by keeping the cost of money low for a prolonged period of time. This seems to be slowly working in the United States, but less so in Europe and Japan – at least at the time of writing (February 2016). However, taking into account the slow rebound in the United States, the recovery after the GFC has been relatively weak – even after unprecedented policy stimuli. Reflecting this puzzle, it has often even been labelled a "new mediocre".

Furthermore, this weak growth environment is compounded by disinflationary pressures in some core advanced economies, which further complicate central bank strategies (Graph 4, left-hand panel). And inflationary expectations have fallen rapidly since mid-2015 following the decline in oil prices (right-hand panel). In addition, inflation is not only low, but its dynamics are also hard to reconcile with the more orderly processes seen in theoretical models (Faust and Leeper (2015)).

There are several narratives competing to explain low growth and low inflation, ranging from the cyclical to the more structural. The simplest cyclical explanation sees demand deficiency as a key impediment to restarting growth, and thereby would advocate stronger policy stimulus. Another cyclical view acknowledges that very high debt levels constrain growth, but argues that, after an admittedly painful but necessary deleveraging process, a new normal growth cycle will resume.

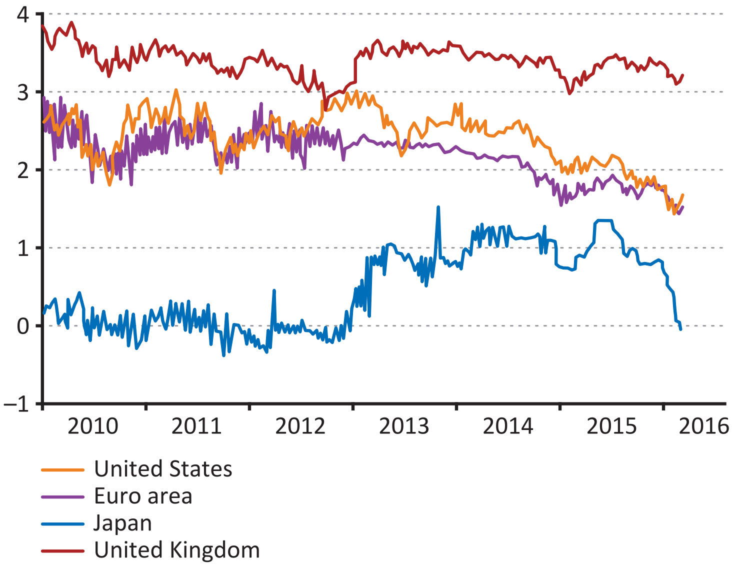
Others see a more structural reason for mediocre growth. According to the current version of the "secular stagnation" view (Summers (2014)): because of the new characteristics of advanced economies (ageing populations saving more, low productivity, etc.), real neutral rates are hovering at very low levels. Therefore, aggregate demand and especially investment remain weak even with the current ultra-low interest rates.[3]

[3] The secular stagnation hypothesis was originally put forward by Alvin Hansen (1939) as an illustration of the consequences of the Great Depression in the early 1930s, but it resurfaced in the post-crisis policy debate.

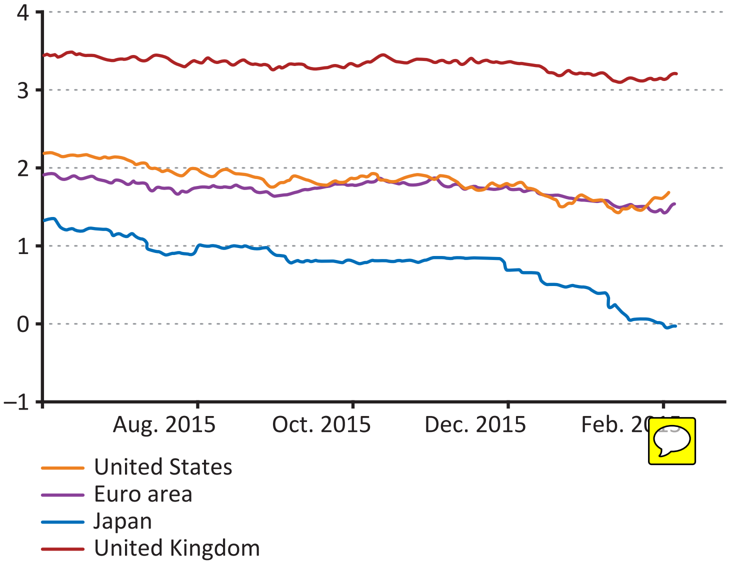
Graph 4: Inflation expectations remained weak

Five-years-ahead five-year inflation expectations (per cent)

Development since 2010



Development since mid-2015



Sources: Federal Reserve Bank of St Louis; Bloomberg; Datastream; BIS calculations.

Growth in emerging market economies is also slow. This again can be more cyclical: it could be simply "convergence to the mean" after a strong commodity-based boom (Pritchett and Summers (2014)). Given that growth rates are not persistent over the long run, the current growth rate has little predictive power for future growth. Hence, emerging economies might not be able to replicate the very high growth rates of the recent past in the coming years. Yet, the emerging economy slowdown can also be more structural. Emerging economies might be facing the middle-income trap, where pre-existing growth models are unable to further economic growth. In other words, they have reached a level where further growth depends on adjusting structural setups and improving the quality of institutions.

In any event, whatever the explanation for the current "mediocre growth" in both advanced and emerging economies, one common feature is that the "animal spirits" of entrepreneurs and investors remain numbed, i.e. these players are not yet ready to take risks and invest (Akerlof and Shiller (2009)). This might also explain why the usual multipliers (credit or financial) are still weaker than expected.

So what then? We think that one of the underlying problems is with confidence, more precisely the lack of it. Entrepreneurs facing uncertainty hold back investment. Consumers facing uncertainty and a bombardment of gloomy news from the press and sometimes subdued narratives from their policymakers hold back as much as they can, on consumption in particular. Seeing negative deposit rates and declining returns on their pension savings, they are naturally inclined to save even more. That is one of the many reasons why we are still experiencing low economic growth seven years after the financial crisis.

This lack of confidence is not a sunspot phenomenon that can be changed by simply adopting a more optimistic mindset. It is more structural in the following sense: confronted with several divergent narratives about what is long-term sustainable growth, agents and markets cannot form a definitive view. It is difficult for agents to price in a reasonable return on savings compared with the "safest" risk-free asset, i.e. they lack a reasonable benchmark. There are simply too many missing parameters, namely, among others, the absence of a consensus on sustainable long-term growth; on the non-accelerating inflation rate of unemployment; on the slope of the New Keynesian Phillips curve (Blanchard (2016)); and on the new neutral rate (Rachel and Smith (2015)).

In short, the difference between equally plausible narratives for the future is just too great. In this uncertain environment, market sentiment fluctuates according to short-term ups and downs of the latest news. Markets react to central bank action in the short term, but they cannot obtain long-term confidence and direction from short-term measures. Therefore, while financial markets may get animated or disheartened quickly, real economy investors prefer to wait and see. The "spirits" of the financial sector are stimulated, but not the "animal spirits" of the real economy.

3.3 Confidence and stable social contracts

Animal spirits (Akerlof and Shiller (2009)) need confidence, i.e. durable and firmly held views on the future growth of resources, on the return on savings, including a benchmark yield for a safe asset, and on the quality of policies and institutions. This confidence was present during the Great Moderation.

However, such confidence does not arise automatically. It springs from a complex interaction of economic factors (e.g., macroeconomic stability) with those that are non-economic (e.g., predictability of rules giving a sense of fairness in burden sharing, etc.). Both are usually included in what is called "social contract". One important component of it is stable rules and institutions (Drazen (2000), Acemoğlu and Robinson (2012)) and the associated rules and binding arrangements governing agents' behaviour. It also comes from viable, durable, sustainable "social-political contracts" (Fukuyama (2011)). Such contracts define, first and foremost, rights and responsibilities with regard to maintaining order and, much later on, in market economies, technical rules for keeping debt and inflation low. These social contracts were developed and enhanced in the decades preceding the financial crisis in both advanced and emerging economies.

However, the GFC has revealed that many of these current social contracts were no longer sustainable (Ferguson (2013)). The promises that were made are increasingly unsustainable. Some promises became unsustainable simply through social change – for instance, ageing rendered many commitments excessively expensive compared with the expected increase in revenues. Other promises were just based on excessively optimistic premises. In any case, tensions are arising as regards current and future budgetary allocations, and social security and pension systems. In other words, we have not really *earned* the welfare state based on our long-run sustainable total factor productivity growth – we may have merely *borrowed* it. And now this debt is coming back to haunt us (Reinhart and Rogoff (2011)). The case of fiscal stimulus illustrates the dilemma: in most advanced economies, policymakers rejected additional tax or debt-financed fiscal stimuli because of the anticipated constraints that would be imposed by these on old social contracts and the complications in renegotiating them. Instead, they resorted to asking for more monetary policy action, which required less scrutiny.

Other factors further weakened confidence. We see uncertainty about the economic transition to a more service-based economy in China and about the future trend of oil and commodity prices. Established regional currency arrangements have undergone stress, and regional separatism is flourishing in advanced and emerging economies alike. In addition, it has become painfully clear that we need to think about how to address some global issues, such as global warming or the waves of war refugees heading for Europe as we speak (February 2016). Unfortunately, progress on these global challenges remains more symbolic than effective – contributing to the uncertainty and loss of confidence.

In sum, confidence is weak today, and in order to restore expectations of a long-run growth path, the task is to strengthen that confidence.

First, we should aim to avoid further harm. In particular, we have to reflect on what exactly we are signalling about future policy directions through our own pessimism. Are we not reinforcing pessimism by systematically "talking down" the economy with our excessively gloomy analysis? What if reiterating that our recovery remains "mediocre" and needs additional monetary stimulus simply reinforces the perception that negative nominal interest rates might be here for much longer than we anticipated? What if this perception starts to affect savings behaviour and the balance sheets of large holders of safe, long-term assets such as insurance and pension funds (Pereira da Silva (2015))? While naive optimistic incantations are futile, we need to reflect on the possibility that our own actions might lead to a self-fulfilling negative expectations spiral. And that would call for a better communication strategy.

Second, and more positively, we should think about how to re-establish confidence by re-anchoring expectations about the future. Markets require more than just a vision; some tangible action is needed to re-anchor expectations. One avenue is to use structural reforms to draft new sustainable social contracts that would help economic actors to re-anchor their expectations. Consequently, we should pursue pro-growth policies and implement structural reforms that allow us to use innovations already present to boost total factor productivity (Rifkin (2014), Brynjolfsson and McAfee (2014)). We need structural reforms to unleash energies in some of our factor markets to improve efficiency and factor allocation. We need to help efficient entry and exit of firms too. And we also need to normalise monetary policy when and where this is possible. Finally, we also need to consider rebalancing our policy frameworks and using more fiscal policy when and where it can be used (e.g. in surplus countries with a good credit rating). Fiscal policy can be especially useful in the context of ultra-low interest rates and a strong need for infrastructure investments and public good provision.

In the end, confidence will return in a durable way only when agents perceive that the global financial crisis has bottomed out. Then, they might see that the upside in asset prices reflects more stable sustainable long-term growth rather than just ad hoc exceptional stimuli. That will be the time to "buy" for the long term.

Conclusion

We have gained a little more understanding of financial imbalances and how international linkages can amplify them. Policymakers distilled clear lessons from past crises to reduce financial risks, and dampen excessive financial exuberance by combining leaning-against-the-wind with macroprudential policies. We have also gained an understanding of how vulnerabilities can build up through the risk-taking channel of debt flows in international currencies.

Yet, even with all this understanding, the weak post-financial crisis growth poses a challenge. In spite of extraordinary stimulus, growth remains subdued. This might increase the temptation to pursue even further with more monetary stimulus, to expand the asset purchase programmes and/or to lower policy rates further below zero. While this additional stimulus might boost short-term financial sentiment, it seems unlikely to be capable of solving the long-term problem of weak growth if, as we argue, it is more deeply related to confidence factors. Would recreating large financial cycles – just another boom with some overpriced assets – lead to more sustainable growth?

We think that a more effective way to enhance growth prospects is not to increase short-term monetary stimulus. This might help short-term sentiment in some markets, but cannot contribute much more to create the preconditions for sustainable growth. We argue that we need to take active steps to rebuild confidence and rekindle animal spirits. This requires a different approach than talking up equity market sentiment. We need to rebalance our policy frameworks, i.e. consider a broader set of structural reforms, rely less on monetary policy and more on fiscal policy wherever there is sufficient room. In essence we need to go beyond cyclical policies: we have to pursue more pro-growth policies and as we indicated above, design new, sustainable social contracts.

Such re-anchoring of expectations and redrawing of social contracts has an international component. We need to work together to address global challenges, such as climate change or humanitarian catastrophes. We also need to cooperate to reduce the risks in the international financial system and ensure that it can work to allocate capital efficiently.

Lamfalussy in his essay *Financial crises in emerging markets* (2000) anticipated the increased risks that the global financial system would face:

However significant its contribution to efficiency gains, the process of globalisation makes our financial world a more rather than a less risky place to live in. […] Greater risk calls for less leverage, longer debt maturities, a stronger capital base, ample liquidity, and, most of all, risk-aware management for debtors and creditors alike.

And true to himself, he stressed the need for international cooperation:

The process of financial globalisation throws up problems of worldwide dimension which cannot be handled on an ad hoc basis. Even if all the preventive measures taken by national authorities work, their sum total may turn out to be dismally inadequate for reducing the risk of a systemic crisis. And there is a genuine risk that in the case of a major crisis, national policy reactions will tend to diverge rather than converge. […] Governments, central banks and regulatory agencies will have to meet the greatest of all challenges: setting up a well-structured and efficient cooperative framework at the global level.

Among other challenges, that one still faces us today.

REFERENCES

Acemoğlu, D and J Robinson (2012): *Why nations fail: the origins of power, prosperity, and poverty*, Crown Publishers, New York.

Agénor, P-R, K Alper and L A Pereira da Silva (2014): "Sudden floods, macroprudential regulation and financial stability in an open economy", *Journal of International Money and Finance*, vol 48, pp 68–100.

Agénor, P-R and L A Pereira da Silva (2013): *Inflation targeting and financial stability: a perspective from the developing world*, CEMLA and IDB, http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=38367231.

Akerlof, G and R Shiller (2009): *Animal spirits: how human psychology drives the economy and why it matters for global capitalism*, Princeton University Press.

Barata, J, L A Pereira da Silva and A Soares (2013): "Quantitative easing and related capital flows into Brazil: measuring its effects and transmission channels through a rigorous counterfactual evaluation", Central Bank of Brazil, *Working Paper Series*, no 313, July; forthcoming in *Journal of International Money and Finance*.

Blanchard, O (2016): "The US Phillips curve: back to the 60s?" Peterson Institute for International Economics, *Policy Brief*, no 16-1, January.

Blinder, A (1998): *Central banking in theory and practice*, MIT Press.

——— (2013): *After the music stopped: the financial crisis, the response, and the work ahead*, The Penguin Press, New York.

Borio, C and P Disyatat (2009): "Unconventional monetary policies: an appraisal", *BIS Working Papers*, no 292, November.

Borio, C and H Zhu (2008): "Capital regulation, risk-taking and monetary policy: a missing link in the transmission mechanism", *BIS Working Papers*, no 268, December.

Bruno, V and H S Shin (2015a): "Capital flows and the risk-taking channel of monetary policy", *Journal of Monetary Economics*, vol 71, pp 119–32.

——— (2015b): "Cross-border banking and global liquidity", *Review of Economic Studies*, vol 82(2), pp 535–64.

Brynjolfsson, E and A McAfee (2014): *The second machine age: work, progress and prosperity in a time of brilliant technologi*es, Norton, New York.

Caruana, J and B Cohen (2014): "Five questions and six answers about macroprudential policies", Bank of France, *Financial Stability Review*, no 18, April.

Drazen, A (2000): *Political economy in macroeconomics*, Princeton University Press.

Ehlers, T and A Villar (2015): "The role of banks", *BIS Papers*, no 83, November, pp 9–39.

Faust, J and E Leeper (2015): "The myth of normal: the bumpy story of inflation and monetary policy", paper prepared for the 39th Jackson Hole Economic Policy Symposium, *Inflation dynamics and Monetary Policy*, 18 August.

Ferguson, N (2013): *The Great Degeneration: how institutions decay and economies die*, The Penguin Press, New York.

Frankel, J (2011): "Monetary policy in emerging markets", *Handbook of Monetary Economics*, vol 3B, North-Holland, pp 1439–1520.

Fukuyama, F (2011): *The origins of political order*, Farrar, Strauss and Giroux, New York.

Gourinchas, P-O and M Obstfeld (2012): "Stories of the twentieth century for the twenty first", *American Economic Journal*, vol 4(1), pp 226–65.

Hansen, A (1939): "Economic progress and declining population growth", *American Economic Review*, vol 29(1), pp 1–15.

Hattori, M and E Takáts (2015): "The role of debt securities markets", *BIS Papers*, no 83, November, pp 41–64.

Hofmann, B and E Takáts (2015): "International monetary spillovers", *BIS Quarterly Review*, September, pp 105–118.

Kindleberger, C (1978): *Manias, panics, and crashes: a history of financial crises*, Macmillan.

King, M and D Low (2014): "Measuring the 'world' real interest rate", *NBER Working Papers*, no 19887, February.

Krugman, P (1979): “A model of balance-of-payments crises”, *Journal of Money, Credit and Banking*, vol 11, pp 311–25.

Lamfalussy, A (2000): *Financial crises in emerging markets: an essay on financial globalisation and fragility*, Yale University Press, New Haven & London.

McCauley, R, P McGuire and V Sushko (2015): “Global dollar credit: links to US monetary policy and leverage”, *BIS Working Papers*, no 483, January.

Minsky, H (1986): *Stabilizing an unstable economy*, McGraw-Hill Professional, New York.

Mishkin, F (2007): *Monetary policy strategy*, eg “The dangers of exchange rate pegging in emerging market countries”, Chapter 17, pp 445–63, MIT Press.

Obstfeld, M (1986): “Rational and self-fulfilling balance-of-payments crises”, *American Economic Review*, vol 76(1), pp 72–81.

——— (1996): “Models of currency crises with self-fulfilling features”, *European Economic Review*, 40, pp 1037–47.

Pereira da Silva, L A (2015): “’Sudden floods’ and sudden stops of capital flows in an environment of ultra-low interest rates: an equal opportunity menace for emerging market and advanced economies alike”, remarks at the 51st SEACEN Governors’ High-Level Seminar, Manila, 26 November.

Pritchett, L and L Summers (2014): “Asiaphoria meets regression to the mean”, *NBER Working Papers*, no 20573, October.

Rachel, L and T Smith (2015): “Secular drivers of the global real interest rate”, Bank of England, *Staff Working Papers*, no 571, December.

Rajan, R (2014): “Competitive monetary easing – is it yesterday?”, speech at the Brookings Institution, Washington DC, 10 April.

Reinhart, C and K Rogoff (2011): *This time is different: eight centuries of financial folly*, Princeton University Press.

——— (2014): “Recovery from financial crises: evidence from 100 episodes”, *American Economic Review*, vol 104(5), pp 50–5.

Rey, H (2013): ”Dilemma not trilemma: the global financial cycle and monetary policy independence”, paper presented at the 37th Jackson Hole Economic Policy Symposium, *Global dimensions of unconventional economic policy*, 24 August.

Rifkin, J (2014): *The zero marginal cost society: the Internet of Things, the Collaborative Commons and the eclipse of capitalism*, Palgrave MacMillan, 2014.

Summers, L (2014): “US economic prospects: secular stagnation, hysteresis, and the zero lower bound”, *Business Economics*, vol 49(2).

Woodford, M (2013): “Forward guidance by inflation-targeting central banks”, Columbia University, 27 May.

EWALD NOWOTNY

Governor
Oesterreichische Nationalbank

From the euro to banking union – what can we learn from Sándor Lámfalussy? [1]

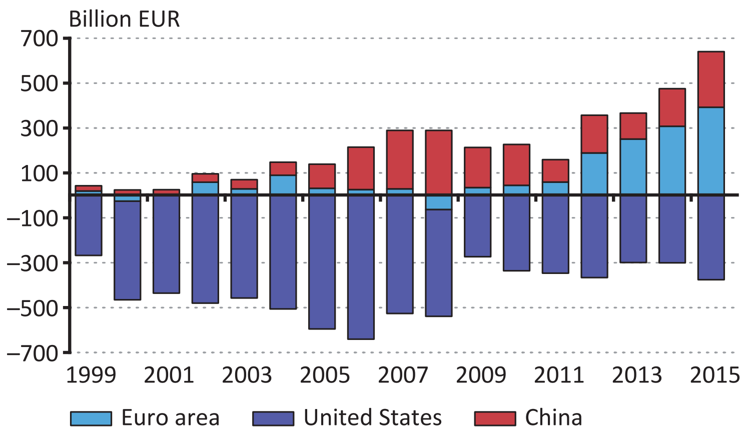
Regrettably, Baron Alexandre Lamfalussy is no longer among us. In view of this sad circumstance, it is even more important to join forces and, together, explore the rich intellectual legacy of "the wise man of the euro." With Sándor Lámfalussy we lost a unique personality who was a high-class economist, a first-rate commercial and central banker, as well as a skillful diplomat and politician. I hope to act in his spirit if I approach the topic of my contribution from the perspective of today's most pressing challenges. Luckily, we find advice from Lámfalussy himself, who addressed many of them, arriving at a message of general validity: Crises reveal the need for brave reforms. More precisely, as the inventor of the concept of macroprudential supervision, he would have made it clear that integrated financial markets must be confronted with integrated regulation.

Let me start with some comments on the current situation of the world economy. The most urgent issue here is the financial volatility and economic weakness in various emerging market economies, which is linked with two other big issues – stubbornly low commodity prices and the starting normalization of U.S. monetary policy. I cannot help but see all of these developments in the light of the financial crisis, even if the world economy as a whole is on a moderate recovery track. "Emerging Europe" or better: CESEE – with the exception of some non-EU countries – has weathered the recent turbulence comparatively well. Yet, most vulnerable countries in the euro area and CESEE still painfully feel the impact of the crisis in terms of high unemployment and incomes that fall short of pre-crisis levels. But even these countries report economic growth thanks to their improved competitive position, less contractive fiscal policies, lower oil prices and, last but not least, an accommodative monetary policy stance. For sure, the Eurosystem's quantitative easing has had a positive impact on economic growth; but of course, this nonstandard monetary policy would have been even more effective if fiscal policies had moved in the same direction.

[1] This contribution closely corresponds to a speech given at the Lámfalussy Lectures Conference in Budapest on February 1, 2016. The author would like to thank Andreas Breitenfellner (OeNB) for helpful comments and valuable suggestions.

Recent developments in China – since last year, the world's largest economy in terms of GDP based on purchasing power parity – are of particular concern. Most forecasts see Chinese GDP growth decline to 6.5% this year – a figure advanced economies can only dream of, but still meagre given China's demographic and social challenges. To be sure, China's economy is transforming from relying on export- and investment-led growth and manufacturing toward focusing more on consumption and services. This process, while improving the sustainability of the Chinese economy in the long run, impacts China's trading partners negatively in the short term. But let us not forget that China has also suffered from lower foreign demand; and the euro area has been a key driver of low global demand over the past few years. Chickens come home to roost. In other words, the emerging markets now bring the crisis back to us – and at the same time remind us of the interdependence in the global economy. We should not be astonished about dampened global demand and deflationary tendencies if the euro area posts a current account surplus way above 3% of GDP, dwarfing even the respective Chinese figures (above 2%). In this context, we might feel compelled to remember Lámfalussy's warning: "We should accept that in a worldwide depression the U.S. economy is called upon to act as the "consumer of last resort", but it cannot perform this function continuously."[2] He was convinced that Europe has to live up to its responsibility for global growth. Obviously, this task is still pending.

Chart 1: Current account balance of the three largest economies



Source: AMECO, SAFE (China), own calculation.

[2] Lamfalussy 2003a.

Lámfalussy was also aware of the trouble of distinguishing between international and domestic sources of vulnerability in emerging market economies. The fact that catching-up economies find themselves in a trap of short-term investment and asset price bubbles is a rather typical phenomenon. In a remarkable essay of 2000 on four major emerging market crises, Lámfalussy combined his experience as chief economist of the Bank for International Settlements and his great analytical skills to present his thought-provoking views. He wrote: "Bubbles in asset prices have rarely deflated slowly: soft landings have been the exception, sharp price declines the rule"[3]. While macroeconomic mismanagement has always played some role in aggravating financial, economic and fiscal predicaments, it usually only added to excessive short-time indebtedness – be it public or private. Lámfalussy was quite explicit about the responsibility of lenders and investors from the developed world for unsustainable capital inflows and asset price bubbles. While he was sure that the process of financial globalization made emerging markets more prone to financial crises, he only tentatively suggested that the same might be true for advanced economies. With the benefit of hindsight, we can confirm this last assumption with respect to the two crises (2001 and 2008) that occurred since he wrote these lines.

In this context Lámfalussy referred to the far-reaching influence of the newly introduced euro on European financial integration. He stressed that "banking and financial services supervision within the euro area (…)" was "(…) lagging desperately behind the challenges raised by the potentially revolutionary changes affecting European banking and financial structures"[4]. In stark contrast to centralized monetary policy, regulation and supervision was scattered among different national institutions. Lámfalussy held it "barely conceivable" that a cooperative framework of heterogeneous participants would be successful in harmonizing rules and practices or reconciling efficiency with stability. Prophetically, he saw a "genuine risk that this loose cooperative framework will be overtaken by events," as "successful crisis handling in our globalized world requires clout, speed and agreement on who is responsible for what initiative – precisely because the rules of crisis handling cannot, and should not be laid down in advance"[5]. So far, I have not come across a more pointed justification for a banking union.

Only a bit later, between 2000 and 2001, the "Wise Men's Committee" on EU Securities Regulation, chaired by Lámfalussy, took the first step toward harmonizing financial regulation and supervision across Europe, creating the so-called "Lámfalussy process"

[3] Lamfalussy, 2000, 163.
[4] Lamfalussy, 2000, p.170.
[5] ibid., p.170f.

– an elegant compromise of decision-making among various players at the national and supranational level. This process has reduced the transaction costs of bargaining over contested and technical aspects of policies[6]. It also initiated the establishment of three committees of supervisors – for banks, insurance companies and securities. Yet, Lámfalussy knew that this was not sufficient. The aim of the Wise Men was "to make legislation more effective, more modern and quicker, but one should not assume that quicker, more efficient markets would necessarily be safer markets. On the contrary." In 2000, Lámfalussy wrote to the ECOFIN Council: "Increased integration of securities markets entails more interconnection between financial intermediaries on a cross-border basis, increasing their exposure to common shocks"[7]. As a result, European finance ministers prompted the process of supervisory convergence, which eventually, although only after the outbreak of the financial crisis, led to the introduction of banking union in 2014, with the ECB at its center. So far, the banking union mainly comprises uniform supervision and consistent crisis management, particularly of large European banks. Now, the European Commission aims to complete the banking union by introducing a fiscal backstop and a deposit insurance scheme.

Another challenge is to convince non-euro area Member States of the advantages of joining the banking union. The advantages of a banking union opt-in would be access to the future common fiscal backstop mechanism, better information on parent banks, an improved quality of supervision, and more effective home-host coordination. Of course, there are no benefits without costs; yet I believe that these costs are rather of a symbolic nature. In any case, joining the Single Supervisory Mechanism and the Single Resolution Mechanism would help non-euro area countries prepare for future euro introduction.

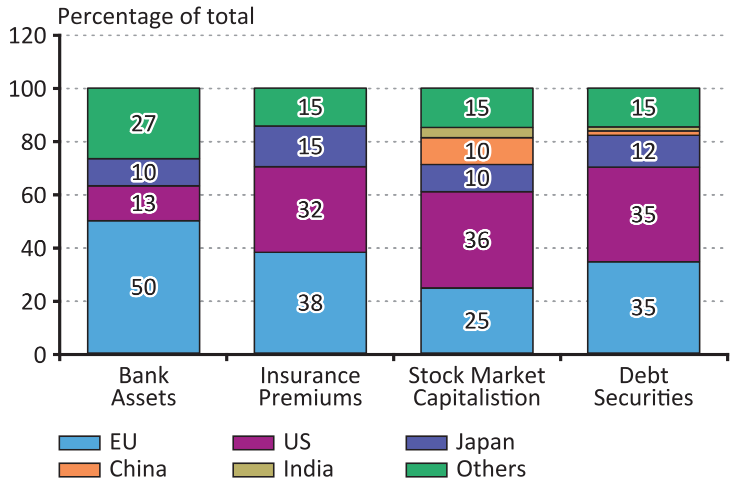
Even while Lámfalussy was steering the process toward the single currency in his capacity as the president of the European Monetary Institute (EMI), i.e. the predecessor of the ECB, he still did not swallow his doubts. When asked to quantify the probability of euro introduction being a success, his answer was "about 50%"[8]. The euro's eventual success was accelerated by an unexpected convergence trend from 1996 onward, where inflation, fiscal deficits and interest rates fell and converged. Although this might have been encouraging, it also laid the foundations for complacency in the early period of EMU. Not only did these various indicators reinforce each other, their benign tendency was also partly facilitated by a spurious global trend called the "Great Moderation." More importantly, convergence reflected EMU-specific market failures

[6] Kudrna, 2011.
[7] Lamfalussy et al., 2013, p.155.
[8] Lamfalussy, 2013, p. 169.

which Lámfalussy had already known from his long experience with emerging market crises: first, underestimated risks fostering debt accumulation and second, irrational exuberance inflating asset values.

In view of those deficiencies we might be tempted to ask: Was the establishment of EMU premature? I don't think so. Let me explain why. Initially, in both, the EMI and the Delors committee, which prepared the Maastricht treaty EMU, debates oscillated between two poles: On the one hand, there was the "coronation theory" (advocated by Germany), according to which a monetary union should be the final step in economic and political integration. On the other hand, the "locomotive theory" (held by France) rather saw monetary union as a milestone triggering the process of further integration. The only feasible compromise was the approach finally taken: While the Single Market and the Maastricht criteria assured important progress in economic convergence, the establishment of EMU would make sure that the process of integration – beyond monetary policy – would continue. Indeed, this is the route things turned out to take, although we have lost any illusion that it would be a smooth and easy route. It is true that the logic behind EMU has led to one-sided financial market integration, which was partially reversed with the financial crisis. Now, however, we have the chance for a new start with substantially amended institutional preconditions. The banking union is one of them; the other, capital markets union, has only yet to start to take form.

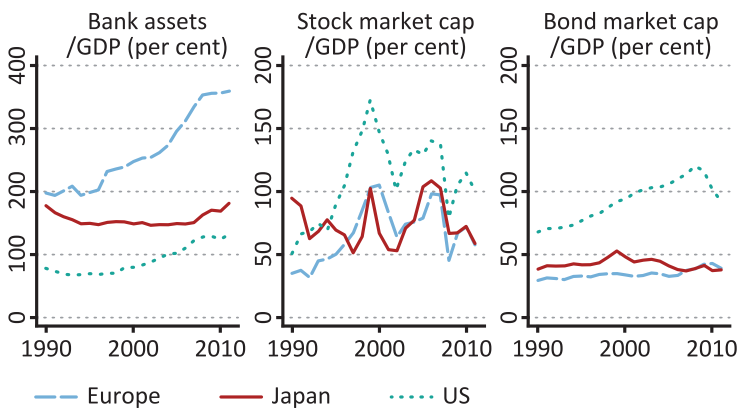
Chart 2: Contribution to world financial activity (2008/2009



Source: World Federation of exchange (2009), IMF (2008), BIS (2009) and SwissRe (2009).

The need for a capital markets union builds on two elements of economic analysis that mark a considerable change from the times when Lámfalussy steered the establishment of EMU: First, the euro area has become over-reliant on banking relative to equity and private bond markets; this so-called bank bias is associated with more systemic risk and lower economic growth[9]. We can see that the increase of the bank bias coincided with the establishment of EMU. In contrast, in the U.S.A. stock and bond markets are much better developed than they are in the euro area. Second, cross-border risk-sharing mechanisms are significantly less effective in smoothing incomes in the euro area than in the U.S.A., and even more so in severe downturns – just when they are needed most[10]. Although cross-border asset ownership grew strongly between the establishment of EMU and the beginning of the crisis, much of this growth was attributable to banks[11]. Since the euro area crisis, however, financial fragmentation has weakened the possibility to share economic risks across borders in EMU.

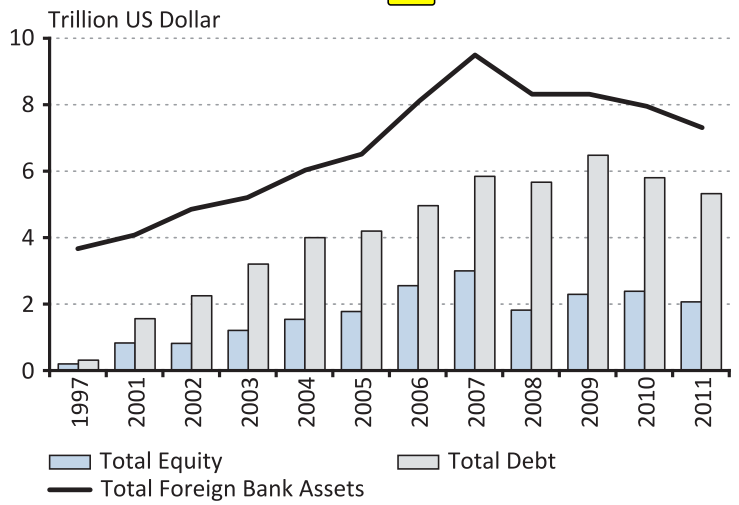
Chart 3: Financial structure since 1990 in Europe, Japan and U.S.A.



Source: World Bank various (central) bank statistics. In: Lengfield and Pagano. 2015. p. 38.

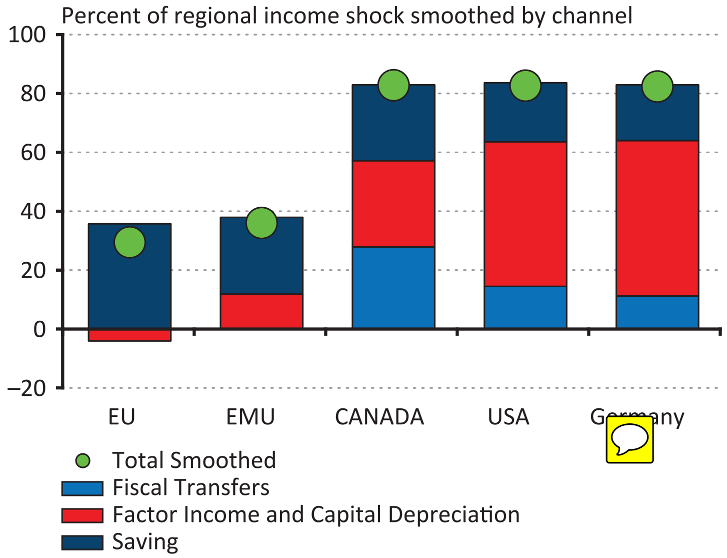
[9] Langfield and Pagano, 2015.
[10] Fuceri and Zdzienicka, 2013; IMF, 2013.
[11] Van Beers et al., 2014.

Chart 4: Evolution of intra EMU total cross border holdings of equty and debt



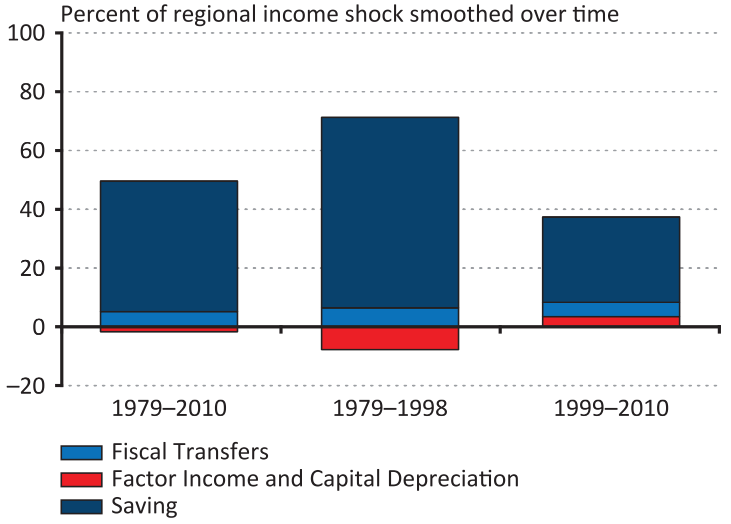
Source: IMF, BIS. In Van Beers and Zwart, 2014, p.26.

Chart 5: Overall risk sharing in EU, EMU, Canada, U.S.A. and Germany



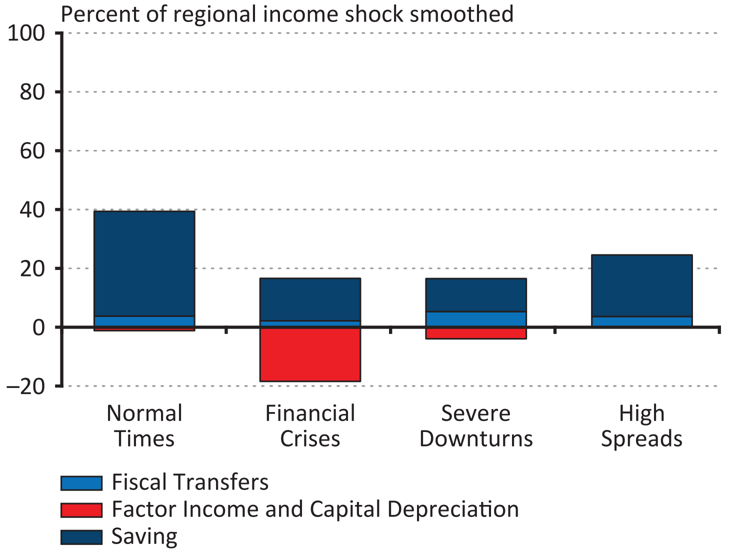
Source: Various Sstudies. In IMF, 2013, p.8.

Chart 6: Overall risk sharing in the euro area before and after euro introduction



Source: Fuceri and Zdzienicka, 2013 In: IMF, 2013, p.10.

Chart 7: Overall risk sharing in the euro area times of stress (1979–2008)



Source: Fuceri and Zdzienicka, 2013 In: IMF, 2013, p.10.

Hence, the objectives of a capital markets union are to broaden the sources of finance beyond banking, to deepen the Single Market for financial services and to promote growth and financial stability. As is often the case, however, the devil is in the details. And regulators have to consider plenty of details, including information disclosure, corporate governance or consumer protection. More importantly, comparison with the U.S.A also suggests an important role for fiscal risk-sharing mechanisms in supplementing market-based risk-sharing.

From the very beginning, Lámfalussy was conscious about the consequences the introduction of a single currency would have on other policy fields. As early as in 1988 and 1989, during the meetings of the Dolors committee he repeatedly emphasized the need of a more effective policy coordination process. He was not convinced that market discipline was enough to ensure fiscal convergence and proposed the creation of a center for macrofiscal coordination. This new institution would limit national budgetary deficits, urge budgetary consolidation, coordinate EMU's fiscal policy stance and exert peer pressure on noncompliant countries. It is worth noting that Lámfalussy had not only fiscal discipline in mind; he also aimed for flexibility in the policy mix. He regarded EMU as "part and parcel of the world economy (…) with a clear obligation to cooperate with the United States and Japan in an attempt to preserve (or restore) an acceptable pattern of external balances and to achieve exchange rate stability"[12].

As early as 2003, Lámfalussy said in an interview with the Guardian[13]: "The greatest weakness of EMU is the E. The M is institutionally well organized. We have a solid framework. We don't have this for economic policy." In the middle of the euro area crisis, in 2013, he said: "We can see today, with the Stability and Growth Pact, the extent to which that element of the preparations of Monetary Union was badly designed. We focused not on the level of debt, but on the level of deficit. And we neglected the most important thing of all: the competitiveness of the member countries"[14]. A few pages further on, he put it even more precisely: "The fiscal criterion should not have been considered as the most important criterion." Rather, he would have preferred to highlight the real effective exchange rate as key criterion, which essentially results from changes in wages and productivity. In this context, he commended the post-crisis introduction of the macroeconomic imbalance procedure.

[12] James, 2012, p. 249.
[13] Lamfalussy, 2003b.
[14] Lamfalussy et al., 2013, p.133.

All this makes clear that Lámfalussy would certainly have welcomed the Five Presidents' Report "Completing Europe's Economic and Monetary Union," which was published just one month after he passed away. The report proposed a strategy for the further deepening of EMU that rests on four pillars: an economic, financial, fiscal and political union. I am sure Lámfalussy also would have liked the stepwise approach adopted in the report, which prudently envisages two different stages toward completing EMU. In the first stage, changes would build on existing instruments within the current legal framework. Only the second stage, scheduled to culminate by 2025 in the establishment of a euro area treasury – ideally with its own fiscal capacity, requires fundamental Treaty changes. Lámfalussy would have known that reaching a compromise takes time, particularly when every single Member State could veto against a reform. He also would have tirelessly endeavored to convince all participants that by sharing sovereignty they would gain sovereignty rather than lose it.

What strikes me most, recalling the achievements and insights of Alexandre Lamfalussy, is his disarming modesty. Despite his multiple talents and his power of self-assertion, he always maintained a healthy sense of self-reflection and even self-criticism. He always saw the glass not only as being half full, but also as being half empty. This prudence might have motivated him to sustain his efforts and not to rest on his laurels. Let us try to adopt his cautious attitude when vigorously continuing his oeuvre and working toward an "ever closer union" in the interest of all citizens.

REFERENCES

Furceri, D. and A. Zdzienicka. 2013. The Euro Area Crisis: Need for a Supranational Fiscal Risk Sharing Mechanism? IMF Working Papers.

James, H. 2012. Making of the European Monetary Union. The Role of the Committee of Central Bank Governors and the Origins of the European Central Bank. The Belknap Press of Harvard University Press. Cambridge and London.

IMF 2013. Toward a fiscal union for the euro area. Technical background note, September.

Kudrna, Z. 2011. Financial market regulation: A 'Lamfalussy exit' from the joint-decision trap. In G. Falkner (Ed.), The EU's decision traps: Comparing policies. Oxford: Oxford University Press.

Lamfalussy, A. 2003a. Introductory remarks: Correcting Europe's dismal growth performance should be the EU's prime policy objective. World Science Forum. Budapest.

Lamfalussy, A. 2003b. Europe's financial architect. Interview Mark Milner, Guardian, 16 August.

Lamfalussy, A. 2000. Financial Crises in Emerging Markets: An Essay on Financial Globalisation and Fragility.Yale University Press, New Haven and London.

Lámfalussy, Ch., I. Maes and S. Péters. 2013. Alexandre Lamfalussy – The Wise Man of the Euro. LannooCampus, Leuven.

Langfield, S. and M. Pagano. 2015. Bank Bias in Europe: Effects on Systemic Risk and Growth. ECB Working Paper.

Van Beers, N., M. Bijlsma and G. Zwart. 2014. Cross-country insurance mechanisms in currency unions: an empirical assessment. Bruegel Working Paper.

BENOÎT CŒURÉ

Member of the Executive Board
ECB

Time for a new Lamfalussy moment

In February 2001, Alexandre Lamfalussy and his Committee of Wise Men submitted their Final Report on the Regulation of European Securities Markets to the Commission.[1]

To deepen integration in the Union's financial markets, they proposed to distinguish between the political choices and the more technical measures in the area of financial legislation; the former would be made by the legislators themselves, while the latter would be left to technical bodies. The intention was to significantly streamline the legislative process in order to ensure that the Union's legal framework for financial services was keeping up with the rapidly changing realities on the ground. The offspring of the Lamfalussy Report is today's European System of Financial Supervision, comprising the EBA, ESMA, EIOPA and ESRB.

Lamfalussy and his colleagues had realised that there are moments when one has to shift gears and change the method in order to progress. It was the right time, an auspicious moment – or kairos, as the ancient Greeks called it – to make a change.

This article argues that we have reached another such kairos, that we are at a point where we should consider changing our method again. Economic and Monetary Union (EMU) needs a Lamfalussy moment, a moment when we realise that our current approach to moving European integration forwards is no longer good enough, and that we should seek new solutions.

In 2000, aiming for new solutions meant developing new ways of tackling technical standards. This time, our goal should be to design a political strategy to broaden the scope of integration so as to make EMU truly sustainable; to achieve this, we will need new political convergence to accompany new economic convergence.

[1] Lamfalussy, A. *et al.*, "Final Report of the Committee of Wise Men on the Regulation of European Securities Markets", Commission of the European Communities, 2001.

The remainder of this article lays out this argument in two steps, starting first with economic recovery and how to consolidate it; second, it will show how shifting gears with regard to completing the Economic and Monetary Union could help to improve the situation in which we currently find ourselves.

A challenging time for Europe

Lamfalussy claimed early on and rightly that Economic and Monetary Union implied interdependencies which needed to be governed robustly. Yet Economic and Monetary Union has not reached that point.[2]

Indeed, recent years have provided us with numerous examples of the deficiencies of our governance framework. For instance, negotiations with the Greek government in 2015 went on for months, exposing the shortcomings of our institutional architecture in addressing collectively what was a collective problem – securing Greece's future in the euro. In parallel, the economic and fiscal policies of individual Member States did not do enough to complement the impulse coming from our very accommodative monetary policy stance, leaving euro area growth until recently far below its potential, and far below what would be needed to secure the future of our unemployed young people.

More recently however, our countries' focus shifted away from the unresolved economic issues and towards the global challenges that Europe is facing.

On the one hand, many of the challenges with which the Union is confronted – be they refugees, terrorism, climate change, or the state of the economy – point to the fact that we need to strengthen our capacity to work together in a spirit of joint responsibility. What frightens the public and markets alike is that Europe seems too often unable to act in a unified manner. On the other hand, if we can advance in one area and show that we can act jointly this will help us to work together in other policy areas as well.

Therefore, the fact that Europe is facing pressing challenges in other policy areas should not discourage us from progressing as regards Economic and Monetary Union. On the contrary, an economically successful euro area is crucial for a successful European Union.

[2] See Cœuré, B., "Lamfalussy was right: independence and interdependence in a monetary union", lecture at the Lamfalussy Lecture Conference, Magyar Nemzeti Bank, Budapest, 2 February 2015.

Ingredients for a structural recovery

The ECB has always made it clear that it is ready and able to play its part in the recovery. This means ensuring stable prices – which means inflation being below, but close to, 2% in the medium term. Price stability acts as a foundation on which the economy can grow. This was the rationale behind the ECB embarking on large-scale public sector purchases.

The euro area numbers clearly show that the ECB's monetary policy is having the intended effect.[3] It represents a major contribution to the ongoing cyclical recovery. But for the recovery to become structural – and thus to increase growth potential and reduce structural unemployment – monetary policy does not suffice.

Rebalancing in the euro area has come a long way since the start of the crisis, but is not finished yet.[4] The challenge now is to further consolidate the recovery and the rebalancing of the economy. Three ingredients could make a difference here:

First, more flexible economies to ensure that adjustments can take place via market mechanisms.[5] This means making the most of a low-interest rate environment to embark on structural reforms. These will not only increase growth tomorrow by boosting productivity and employment, but also will send a signal of confidence and unleash investment opportunities today[6].

Second, higher levels of investment. Since the beginning of the crisis, investment has shrunk markedly. Of course, we should be careful not to assume that investment levels right before the crisis were desirable, as they partly reflected exuberant behaviour. But despite the current low interest rate environment, we are still well below the average numbers for the period 1995 to 2005 for both public investment and private investment.[7] This shows that an essential ingredient for sustaining the recovery is still missing.

[3] See ECB, "The transmission of the ECB's recent non-standard monetary policy measures", Economic Bulletin 7/2015, pp. 32-51, December 2015.

[4] See Cœuré, B., "Rebalancing in the euro area: are we nearly there yet?", speech at Danish Economic Society in Kolding, 15 January 2016.

[5] See Cœuré, B., "The future of Europe: building on our strengths", speech at the plenary session on "The Future of Europe" during the fifth German Economic Forum in Frankfurt am Main, 6 December 2013.

[6] See Cœuré, B., "Structural reforms: learning the right lessons from the crisis", speech at the Economic conference organised by Latvijas Banka in Riga, 17 October 2014.

[7] Public investment in the euro area was 3.2% of GDP for 1995-2005 compared with 2.6% projected for 2016, while private investment in the euro area was 18.7% of GDP for 1995-2005 compared with 17.3% projected for 2016. See European Commission, Annual Macroeconomic Database, 2015.

Third, coming back to the call for a Lamfalussy moment, a strong political commitment to complete an Economic and Monetary Union so as to give the public, businesses and markets a strong signal that we are serious about making the euro a lasting success. The remainder of this article will focus on this last point – completing the EMU.

The Five Presidents' Report published in summer 2015 provides a very useful roadmap for moving ahead. And while not everyone may agree on the need to complete the EMU, consensus might still be reached on three principles. These principles could guide future work towards a complete Economic and Monetary Union and would strongly reinforce the proposals made in the report. They include a parallel approach to risk reduction and risk sharing, more joint decision-making within common institutions and political convergence as a necessary accompaniment of economic convergence.

Risk reduction and risk sharing – a parallel approach

First, risk reduction and risk sharing should go hand in hand – both as regards strengthening the banking union and as regards economic and fiscal policies.

The logic behind a parallel approach to risk reduction and risk sharing is similar to safeguarding a house. Of course the owners will want to take all the necessary precautions to prevent fires, and they will want their neighbours to do the same, thus jointly reducing the overall risk of a fire in the neighbourhood. But even with the best precautions, the owners will probably still want to buy fire insurance, and rightly so. And if they buy it together with all their neighbours, it will be much cheaper.

The same logic applies to the EMU. Risk reduction on its own will not be sufficient; we will need to better share the remaining risk as well. The two are complementary.

For a banking union, this means reducing risks in banks in parallel to establishing a common deposit insurance scheme and a robust fiscal backstop. This is the approach proposed by the European Commission and supported by the ECB.

As regards fiscal and economic policies, combining risk sharing and risk reduction means that more pooling of fiscal resources – ultimately necessary to provide better insurance against shocks – will have to be accompanied: (i) by a new convergence process which ensures that all economies have a similar resilience to shocks; and (ii) by initiatives to restore the credibility of our fiscal rules. These two elements are all about preventing risk sharing from becoming a one-way street, in other words preventing risk sharing from turning into risk shedding.

Joint decision-making on matters of common concern

The second principle on which consensus might be reached is that there are policy domains where coordination via rules has run its course and is no longer a viable substitute for joint decision-making within common institutions. This argument has two parts:

On the one hand, there should be no doubt that the rules that are in place have to be respected. This is not some kind of theological dogma. This is because it is economically and politically the right thing to do – not only to avoid the macroeconomic instability stemming from excessive imbalances, but also to re-establish mutual trust, which is the precondition for progress. The high public debt levels of many Member States are a case in point. If we want to be able to tackle the next crisis and have sufficient fiscal room for manoeuvre, strictly applying the rules of the Stability and Growth Pact today is both logical and imperative.

But, on the other hand, there are political limits of the rules-based framework. Every time the rules are set to bite, national interests prevail over those of the euro area. This dilemma is built into the framework: as long as economic and fiscal policies are in the end a matter of national competence and as long as commonly agreed upon rules are perceived as an intrusion into policies that are seen as genuinely national, the interests of the euro area as a whole will probably not be strong enough to carry the day unless a country is forced to enter a financial assistance programme.

Therefore, in the end, certain economic and fiscal policies in the euro area will have to become truly shared competences, as the internal market already is; other policies, which are not essential for the smooth functioning of the EMU, should remain solely a national competence. Hence, more joint decision-making in the economic and fiscal realm should certainly not mean centralisation at the European level for each and every policy. But it should mean that in those policy areas that are crucial for the functioning of the EMU, common legislation and policies should be adopted where appropriate and warranted to ensure the primacy of the common interests of the euro area.

Such legislation and policies will in turn necessitate the further development of the institutional architecture of the Economic and Monetary Union. One element here will be to strengthen the euro area executive with a euro area treasury, be it within the Commission or as a separate body. Another element will be to build up a genuine legislative capacity at the euro area level and to make institutions acting in the euro area's interest, such as the European Stability Mechanism, accountable to it.

The Lamfalussy moment – making the debate on EMU political

The third principle is that sustainable economic convergence is possible only if accompanied by political convergence. Economic convergence requires political convergence because discussions on economic governance in the euro area in recent years have revealed that we still have no common understanding in Europe of what economic and fiscal policies should look like in a monetary union.

A common understanding of the aim of monetary policy did develop when the monetary union was being set up; there is now a clear and broadly shared consensus that the ECB should first and foremost pursue price stability. A similar approach and attitude is increasingly taken to financial regulation.

But such a common understanding is not necessarily the case for those policies which remain largely in the national domain, but subject to European coordination. This is no coincidence. Monetary policy and banking supervision are inherently technical and seemingly distant from the lives of ordinary people. Labour market institutions, product market regulations or the quality of a country's administration, on the contrary, are less distant as they affect the everyday lives of individuals.

The diversity of opinion on economic policy is a sign of a healthy, pluralist democracy and certainly not a problem. At the national level, institutions and procedures exist which permit divergent views to be channelled into political decisions that leave little room for ambiguity.

In contrast, there are, as yet, no procedures or sufficient incentives to facilitate a consensus at the European level on the design of economic policies in a functioning economic and monetary union. This is a root cause of why the spirit of the common rules is not sufficiently respected – as there is no consensus on what this spirit ought to be.

The methods of advancing European integration have so far not been sufficient to foster such a consensus – hence the need for a Lamfalussy moment and a shifting of gears; putting the debate on European integration back where it belongs – in the political arena.

We are at a point where integration cannot and should not continue as a technical and technocratic exercise. It is now time for political leaders to take up the baton, because only they will be able to convince their electorates of the need for further deepening.

Therefore, new economic convergence will need to be complemented by political convergence. Such a process would, in an inclusive and democratic way, ensure that, in parallel to converging economically, there develops a common understanding of economic policies in the euro area that would underpin the common rules.[8]

While it would be up to political leaders to structure the process towards political convergence, citizens, too, need to be engaged in the debate on the right economic policies for the euro area.

Such a political process might not lead to the best outcome from an economist's point of view. But this would be a price worth paying if, in return, the outcome is a consensus that is fully democratically legitimised.

[8] See Cœuré, B., "Towards a political convergence process in the euro area", speech at the Interparliamentary Conference "Towards a Progressive Europe" in Berlin, 16 October 2015.

JAN SMETS

Governor
National Bank of Belgium

"Navigating in uncharted waters": Alexandre Lamfalussy, the euro and a genuine economic and monetary union[1]

It is a great honour for me to take part in this "Professor Lamfalussy Commemorative Conference" highlighting "his contribution to economic policy and the birth of the euro".

Let me first of all congratulate my colleagues from the Magyar Nemzeti Bank for organising, since 2014, these high-level conferences on issues of global economic policy. By using Lamfalussy as an eponym for these meetings, they rightly honour a Hungarian born outstanding personality in the history of European integration. As a matter of fact, we in Belgium used to consider Alexandre Lamfalussy as a *Belgian* economist and banker. By 1996, the Belgian King had granted him the nobility title of baron. Now, honestly speaking, I believe that we, Hungarians and Belgians, should not quarrel about who is entitled to claim the intellectual legacy of Baron Lamfalussy: his merits are large enough to be shared by both of us; I would even say, to be shared by all Europeans.

I'm using Alexandre Lamfalussy's patented expression "Navigating in uncharted waters" in the title of my exposé. In my opinion, it is an adequate way to depict our present situation in the euro area. And it is a great pity that Alexandre Lamfalussy, whose memories have been published under the very apt title, "The Wise Man of the Euro", is no longer with us to share his ideas and opinions (Lamfalussy, Maes and Péters 2014).

* * *

Let me for a moment go back in time, to the process of European monetary integration and Alexandre Lamfalussy's role and ideas.

European integration really started back in the 1950s, when such visionaries as Robert Schuman and Jean Monnet put forward plans for a new Europe, united, democratic and based on solidarity. Alexandre Lamfalussy, as a young student at the University of Louvain, took part in this movement too. The ideas of these founding fathers of

[1] Thanks to I. Maes and H. Geeroms for preparation.

European integration had their roots in the traumatic events of World War II and the threat of the Cold War escalating into a full-blown war. "There must never again be war in Europe", was the *leitmotiv* of a generation of convinced European federalists. The argument had a special significance for the young Alexandre Lamfalussy, who had escaped the communist regime in Hungary after an epic journey.

Alexandre Lamfalussy has always been a convinced pro-European. In his 1963 book *The United Kingdom and the Six*, he clearly admits this "value judgment". He wrote: "I do believe that the Common Market is a good thing, that 1 January 1958, is a turning point in Western European history". As early as that, Lamfalussy was arguing in favour of strengthening monetary integration. Very much in line with Robert Triffin's ideas for a European Reserve Fund, he argued that "common monetary institutions could be of great help in coping with possible balance of payments problems of the Community. For instance, the pooling of gold and foreign exchange reserves would greatly strengthen the E.E.C.'s resilience to export-induced recessions". Indeed, Alexandre Lamfalussy always believed in the need for strong European institutions. But he took a balanced position, emphasising policy coordination as well. I quote again: "The prerequisite to a successful pooling of reserves is the effective coordination of economic policies". His arguing in favour of symmetry between the monetary and the economic dimension of integration would become a constant feature in Lamfalussy's work.

When, at the 1969 The Hague Summit, an Economic and Monetary Union came for the first time really onto the European agenda, leading to the well-known "Werner Plan", Alexandre Lamfalussy was quite favourable to it. Pierre Werner gave indeed due respect to both the economic and monetary pillars of EMU, with two new supranational bodies: a Community system of central banks and a centre of decision for economic policy. However, the 1970s and the growing economic divergences during that decade did not prove good soil for the EMU.

From the mid-seventies of the last century onward, Lamfalussy played a discrete but important role in the process leading to a genuine monetary union, first as Economic Advisor of the Bank for International Settlements, and later as its General Manager. The establishment, in 1979, of the European Monetary System, under the inspiration of Valéry Giscard d'Estaing and Helmut Schmidt, was an important step. Despite considerable difficulties, especially during the first years, the EMS indeed contributed to monetary stability and economic convergence. By means of the eminent job Lamfalussy did at that time in the Committee of Governors of the Central Banks of the European Economic Community, he shored up this broadening of the *acquis communautaire* that became the basis for a real monetary union.

It was obviously not a surprise that Alexandre Lamfalussy became a member of the famous Delors Committee, set up in 1988 by the European Council under the leadership of President François Mitterrand and Federal Chancellor Helmut Kohl, after European integration had gained renewed impetus in 1985, with the launch of the Single Market programme. Within the Delors Committee, Lamfalussy argued for a “Centre for Economic Policy Coordination”, an idea which was nevertheless not reflected in the Report. Eventually, the ensuing Maastricht Treaty established an asymmetric EMU, as ceding sovereignty for economic policy was not acceptable to the Member States (Smets, Maes and Michielsen 2000). This would prove to be a serious flaw in the design of the EMU, making it a “good weather” system, extremely vulnerable to internal and external shocks.

It is always easy to criticise major projects such as the single currency with hindsight, but as to Alexandre Lamfalussy, it is obvious that he was well aware of the shortcomings of the construction and he repeatedly compared the single currency, without economic and political union, with “navigating in uncharted waters”. Lamfalussy predicted problems due to as well the lack of fiscal and macro-economic coordination and the lack of financial integration and harmonisation of the prudential supervision. As a matter of fact, Lamfalussy saw *in tempore non suspecto* the need of a reinforced economic and fiscal pillar and of a real financial union, in order to get a genuine Economic and Monetary Union.

Where do we stand now on the road to a genuine EMU? And what were Lamfalussy’s contributions and opinions? Let me first highlight the views on banking and financial union before moving to the area of economic and fiscal coordination. Already at the time of the discussions on the Delors Report, Lamfalussy argued in favour of giving the European Central Bank a role in the field of banking supervision. And in 2004, Lamfalussy focused further on the organisation of prudential supervision in the European Union, which he described as a “mind-boggling patchwork” (Lamfalussy 2004). He stressed that central banks had a crucial role in the management of financial crises, especially in “preventing a potential crisis from turning into a real one”. For him, the crucial issue was to give the ECB responsibility for the supervision of large, systemically important banks.

In the meantime, we have lived the financial crisis of 2007-2008 and the subsequent sovereign debt crisis. These crises evidenced the fragmentation of Europe’s financial markets and especially the vicious nexus between banks and sovereigns. It became crystal clear that further progress in European financial integration, a real banking union, was needed.

Soon after the start of the financial crisis the European Commission tabled proposals to reinforce financial legislation in the European Union. As to the governance of financial institutions the crux of the proposed legislation was the need of a *single rule book*, to be applicable throughout the whole EU. But this was definitely not enough in order to reinforce the single currency. That's why the Commission, fully backed by the President of the European Council Herman Van Rompuy, proposed in September 2012 "a roadmap towards a Banking Union". This Banking Union would be built upon three pillars: the Single Supervisory Mechanism, the Single Resolution Mechanism and a harmonised deposit guarantee system.

The first pillar, the Single Supervisory Mechanism, introducing supervision at the European level, became effective from November 2014 onward. The SSM has already shown itself to be an effective system, and, more importantly, the ECB and the national supervisors continue to work together to improve the effectiveness of the system. Our experience so far will feed the European Commission's first regular review of the SSM later this year. In this respect, I would like to recall that Lamfalussy argued for the twin peaks model, whereby central banks exercise banking supervision, as it would allow them to use that knowledge when deciding on liquidity provision to banks. Since liquidity provision is a matter of judgement, central banks would benefit from being intimately familiar with financial institutions, as Lamfalussy put it. I'm convinced that, while both policies should indeed not interfere with each other, we should allow for the exchange of knowledge and analysis between these two strands of work. Central bankers need to act independently, but not isolate themselves from vital sources of information. By the way, precisely this argument, but also the insights of central banks in systemic development risks as well as their being part of different international cenacles allowing them to monitor more efficiently the financial interlinkages convinced the Belgian government back in 2011 to move to a twin peaks model, on the basis of a report by Lamfalussy.

As the crisis has shown, we also need to work on the European management of bank crises for just such a case, an area which was somewhat out of scope of Lamfalussy's daily activities. In this respect, the second and third pillars of the Banking Union are crucial. On banking resolution, the second pillar, it is particularly important that banks have the required level of bail-in-able liabilities as foreseen in the minimum requirement for own funds and eligible liabilities, the so-called MREL.

A third and essential pillar of a complete Banking Union is a European Deposit Insurance Scheme – or EDIS. The European Commission is right to stress the equilibrium between risk sharing and risk reduction in its proposal of November last year. Reducing moral hazard is a precondition for risk sharing and to start the EDIS. A key element of risk reduction is to weaken or even cut the doomed loop between banks and their sovereign which is more a problem in the euro area than elsewhere. In that respect, recognizing the fact that no exposures, including sovereign exposures, are risk free, should be the starting point. Europe needs to develop its own preferred formulae in this respect, but a solution requires global coordination at the Basel level, possibly developing a formula with a well calibrated combination of large exposure limits and non-zero risk weights. A sufficiently long transition period will be necessary in view of the large and concentrated stocks of sovereign debt at certain banks.

Lamfalussy did not only have clear views on the governance and resilience of financial institutions, he was likewise visionary when it comes to macro-prudential supervision (Maes 2009). Long before the macro-prudential concept became a hype, he stressed the importance of looking at the risks caused by the financial sector as a whole, and its systemic parts in particular. It is clear that indeed we still have to strengthen further the macro-prudential authorities.

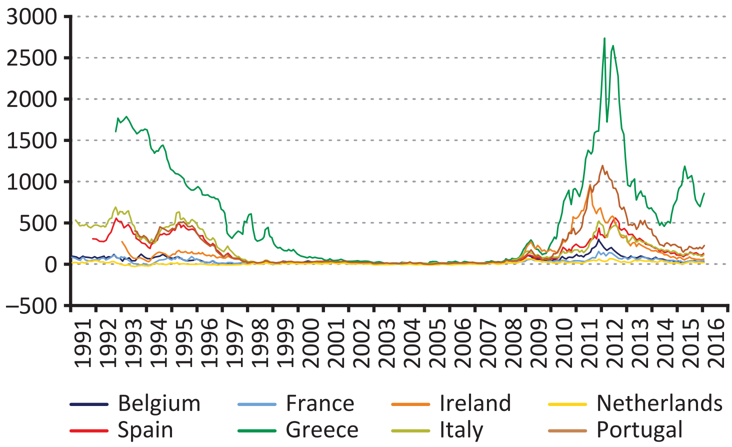
That is, in my opinion, part of the financial policy agenda for the near future, together with the development of the Capital Markets Union as proposed by the European Commission last September. A well-functioning Capital Markets Union is not only important to deepen the internal market and thus to be a source of economic growth and extra benefits from our common currency. It will also strengthen crossborder risk-sharing through deepening integration of bond and equity markets, strengthening the euro area's resilience in the face of asymmetric shocks. A CMU is an ambitious project and it will take a very long time to transform the bank-based euro area economy to one closer to the American model where 75% of investments are financed by the capital markets, while in the euro area this is done at 60% by banks. While everybody shares the ambition to establish a Capital Markets Union, the risk exists that progress will stop after harvesting some low hanging fruit – be it important – such as modifying the Prospectus directive and Securitisation. However, to realise a true Capital Markets Union it is also important to tackle thorny issues, but even more importantly, issues such as harmonisation of insolvency law and taxation.

* * *

As I said before, Professor Lamfalussy not only anticipated problems because of a lack of financial integration, he also stressed the need for a reinforced economic and fiscal pillar of the monetary union.

The track record of the euro illustrates the limits and excesses of market forces. In the first ten years, markets hardly responded to the growing macro-economic imbalances (see chart 1). Their subsequent reaction came too late and was clearly overblown, disrupting the economy even further, as unprecedented contagion swept through European financial markets in 2011 and 2012. Lamfalussy had already been warning about these dangers back in the Delors Committee days. At that time he seriously questioned whether “it would be wise to rely principally on the free functioning of financial markets to iron out the differences in fiscal behaviour between member countries” (as quoted in James 2012). He used two arguments to support his doubts; I quote: “(a) the interest premium to be paid by a high-deficit member country would be unlikely to be very large... and (b) to the extent that there was a premium, I doubt whether it would be large enough to reduce significantly the deficit country’s propensity to borrow”. End of quote.

Chart 1: Yield differentials on ten-year public loans in relation to the German bond (monthly date, basis points)



Sources: BIS, calculations BNB.

The financial crisis and even more the sovereign debt crisis became a watershed in the European integration process. European economic policymakers responded with a range of measures, not just emergency assistance and fiscal consolidation programmes, but also substantial reforms in European economic governance. In a couple of years' time, significant reforms in economic governance were introduced in the euro area. They included the so-called "Six-Pack" and "Two-Pack" legislation, the improved macroeconomic coordination with the new Macro-economic Imbalance Procedure, and the euro area's Fiscal Compact Treaty.

The euro area crisis indeed highlighted the fragility of the EMU's institutional set-up. The crisis made clear that the euro area needed a quantum leap towards a stronger and more efficient institutional architecture, making the EMU more resilient and remedying its fragilities. A major weakness is that the ECB does not have a strong political counterpart. At the time of the negotiations of the Maastricht Treaty, Jacques Delors and several finance ministers, including Philippe Maystadt, were very much in favour of a parallelism of the monetary and economic pillars of EMU. Not without reason the EMU means *economic* and monetary union.

As a convinced pro-European, Lamfalussy believed that due to monetary integration, Europe would be "condemned to succeed" in building a successful economic union. Looking at it from the present situation, this belief seems somewhat over-optimistic: a sizable gap remains between, on the one hand, the consensus that we have to strengthen the economic pillar of the EMU, as already identified by Lamfalussy, and, on the other hand, reaching an agreement on the practical measures to solve the remaining weaknesses.

There can't be any doubt that we have to share economic policy decisions within common European institutions, combined with democratic oversight at the European level. The history of the ECB illustrates the merits of such an institutional approach. But establishing the economic pillar of the EMU in the way Pierre Werner envisaged it in his report in 1970 is complicated in Europe where different economic paradigms frame political choices: the ordo-liberalism of the Freiburg School which inspired Adenauer, the Mercantilism of Vauban and Colbert in France and the inspiration of Smith and Keynes in many other member states.

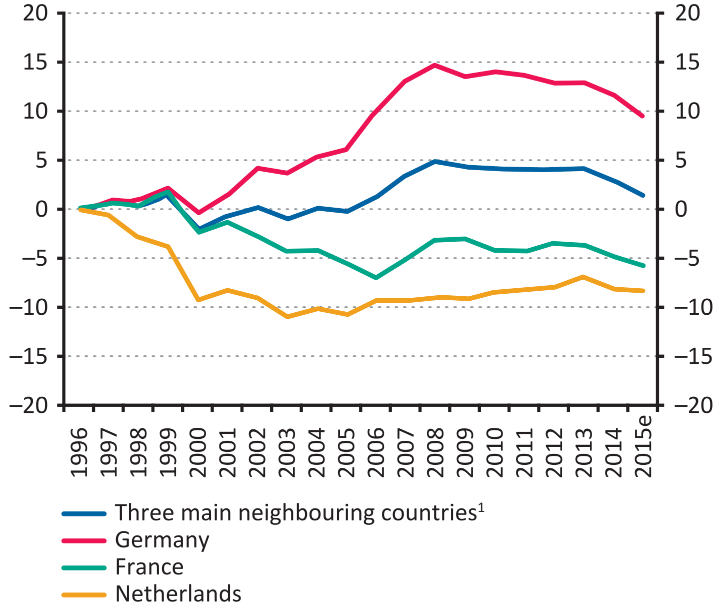
The consensus to be found for deepening the EMU – and as you know consensus building is of the essence in the EU – will be based on the right equilibrium between more risk sharing and further risk reduction, two processes that need to move hand in hand. The building blocks of the necessary political compromise can also be found in the theory on Optimal Currency Zones: increased flexibility of labour and product markets and structural economic reform reduce the risk and consequences of asymmetric economic shocks, but the impact of certain shocks should be shared by all members via public or private risk sharing mechanisms. This requires a budget for the euro area and deeper financial integration via the Banking Union and a Capital Markets Union.

It is striking how many of Lamfalussy's ideas are reflected in both the Report of Herman Van Rompuy and the report of the Five Presidents: his views about having macroeconomic and fiscal coordination, as well as his emphasis on working towards a single financial market and common supervision are all at the core of these reports.

Lamfalussy already insisted on the implementation by national governments of crucial structural reforms to their economies, while also endeavouring for better European economic coordination. The idea to enhance competitiveness of member states via the creation of national competitiveness councils, as suggested by Commission President Juncker in his Five Presidents report, is a recent specific proposal to implement that idea. I really hope these national councils will support member states and national stakeholders to implement the required structural economic reforms and to make their economies more resilient.

In Belgium, we have a long lasting tradition of consensus building on competitiveness. The so called Central Economic Council is a meeting place for both employers and trade unions to monitor competitiveness on the basis of analysis provided by the Council's experts and especially to monitor whether wages and labour costs in Belgium are staying in line with developments in our main trade partners, Germany, France and the Netherlands and whether corrective measures should be taken (see chart 2). This analysis is used by social partners to fix a wage norm for wage negotiations. Even if this wage norm is in a way imposed as a counterpart of the indexation mechanism, it provided Belgium with a framework – well before the introduction of the euro – which helped it guide its relative competitive position – an instrument which would have been very useful in other countries.

Chart 2: Belgium's wage handicap decreased during recentyears
(hourly labour costs in the private sector, cumulative percentage differences vis-à-vis the three main neighbouring countries since 1996)



[1] *Weighted average based on relative size of GD*

Source: Central Economic Council.

National fiscal policies also need to be better coordinated and the rules of the several times changed Stability and Growth Pact need to be better respected and enforced. The Pact allows for sufficient flexibility and the Commission accepts that member states use this flexibility margin for a growth friendly fiscal policy, and, recently, to accommodate the exceptional spending resulting from the refugee crisis. If member states respect their Medium Term Objective or MTO, a concept based on the structural balance, they have an important fiscal buffer to apply a countercyclical policy in times of recession.

In order to further improve fiscal coordination, the Five Presidents report proposes setting up a European Fiscal Board with an advisory function. Again referring to a Belgian experience, we have such a Fiscal Council since 1989. At that time Belgium was transformed into a federal state whereby regional authorities acquired more powers and more autonomy. In Belgium regional authorities are not subordinated to the central government! One of the consequences is that the federal government is accountable to the EU regarding the country's respect of the SGP, while the regions and local authorities decide autonomously on about half of public spending for the country. The Belgian Fiscal Council was meant to reconcile the different interests and to develop a kind of Belgian Stability and Growth Pact within the European framework. Even if the Council has only advisory powers, both the federal government and the regional and local governments follow, to a large extent, its policy advice. I think that part of the success of this Belgian Fiscal Council has to do with its composition. The composition is such that the regional authorities are represented by senior experts and are able to contribute to a policy line for the country as a whole. Internal debates at the Fiscal Council are based on objective data and scientific analysis. Economic logic and shared analysis, not political opinions, guide it in its advice and result in an independent consensus, irrespective of the composition of the federal government and regional authorities. I believe that this is one of the factors that make the yet complex Belgian institutional model workable.

It is important that the proposed new European Fiscal Board is really independent and will also provide advice about the appropriate fiscal stance at the level of the euro area as a whole. In his days, Lamfalussy was already stressing the benefits of agreeing on the appropriate fiscal stance of the Monetary Union as a whole, beyond different national policies. In his contribution to the Delors report Lamfalussy states in a somewhat sarcastic way 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" (Lamfalussy 1989).

Even if European economic governance gets reinforced, the need for a public euro area stabilisation function to help cushion exceptional asymmetric shocks will remain. Again, the absence of a budget for the euro area was already a concern of Lamfalussy. Of course, a euro area budget should not lead to permanent or one-way transfers and should not undermine the incentives for sound economic policymaking. Moral hazard should be avoided and the incentives to conduct a sound and sustainable national budgetary policy should be kept intact.

* * *

Let me conclude. While re-reading the works of Alexandre Lamfalussy, I was struck by how forward looking he was: basically all elements for a stable EMU, as developed in the reports of Herman Van Rompuy in 2012 and of the Five Presidents last year, were in his writing decades ago. That's also the case for Lamfalussy's views on the EMU's role in the world. His ideas are in line with current efforts to work towards a more common external representation for the euro area, notably at the IMF.

His motivation is, however, different from the currently often-repeated argument that individual euro area countries are becoming too small to play an important part on the global scene. Paul-Henri Spaak, the first president of the UN General Assembly and a former Belgian prime minister, used to say that there are only two kinds of countries in Europe: small countries, and small countries that have not yet realised they are small. The argument voiced by Alexandre Lamfalussy is different: he states that sharing a common European currency forces us to play a more prominent role on the global scene, so as to contribute to the soundness of the global monetary system. Personally, I subscribe to both these lines of reasoning: individually we are becoming too small to have a leading role, yet together we are too big not to take up that role.

On the portal website of the European Union, you can find under the lemma "founding fathers" a list of eleven visionary leaders who inspired the creation of the European Union we currently live in. Today, here in Budapest, nine months after his passing away, I formally stand up for adding Baron Alexandre Lamfalussy to this list of founding fathers of the European Union.

The challenge in the next years will be to translate into reality the ideas voiced by Alexandre Lamfalussy and his fellow founding fathers. With his work, Lamfalussy has provided us with the direction ahead. Clearly pointing to vortexes and sandbanks, Lamfalussy indeed charted the waters for us.

REFERENCES

James, H. (2012), *Making the European Monetary Union. The Role of the Committee of Central Bank Governors and the Origins of the European Central Bank,* The Belknap Press of Harvard University Press, Cambridge – Massachusetts, London – England.

Lamfalussy, A. (1963), *The United Kingdom and the Six. An Essay on Economic Growth in Western Europe*, London: Macmillan.

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, pp. 91-126.

Lamfalussy, A. (2004), *Central Banks and Financial Stability*, 2nd Pierre Werner Lecture, Luxembourg: Banque Centrale de Luxembourg.

Lamfalussy, C., I. Maes and S. Péters (2014), *Alexandre Lamfalussy. The Wise Man of the Euro. A conversation with Christophe Lamfalussy, Ivo Maes and Sabine Péters.* Preface by Jacques de Larosière, Leuven: LannooCampus, February 2014.

Maes, I. (2009), "On the origins of the BIS macro-prudential approach to financial stability": Alexandre Lamfalussy and financial fragility, Working Paper no 176, National Bank of Belgium.

Smets J., I. Maes and J. Michielsen (2000), EMU from a Historical Perspective, Ooghe H. et al. (eds.), *The Economic and Business Consequences of EMU*, New York: Kluwer, pp. 53-92.

EDMOND ALPHANDÉRY

President
Euro 50 Group

Greece and the Euro Crisis: Lessons from confidence

It is an honour for me to speak at this Professor Lamfalussy Commemorative Conference and I wish to thank Governor Matolcsy for his invitation.

I will focus my presentation on Greece which has been at the heart of the euro crisis, and also on the notion of confidence, a feeling which has been and still is playing a major role not only in Greece, but also in the unfolding of events that have punctuated the Eurozone since the creation of the European currency. This approach will help me make some comments on the challenges presently facing the European construction. But it also brings me first to speak of Alexandre Lamfalussy.

Alexandre was first and foremost a trustworthy man. As such, he had the highest quality required for a central banker. I have had the privilege to work closely with him. Some of you may remember the informal Ecofin council of May 1995 which I chaired where, thanks to Alexandre Lamfalussy, we designed the roadmap for the launch of the euro. In 1999, he helped me create the Euro 50 Group, which is still active today. While I was chairing CNP Assurances, the leading life-insurance company in France, Alexandre joined its board and chaired its audit committee.

I have learnt a lot from Professor Lamfalussy in these various circumstances. One of the most important lessons which I received from him was that sudden change in people's sentiments are always at the heart of major economic disruptions, and when distrust is spreading among investors then we are heading towards a financial crisis.

Let me first use this tenet for the analysis of the European economic and monetary union.

When economists speak about the underpinnings of the euro crisis, they usually start from the fact that the Eurozone is not an optimal currency area, which is certainly true. We can find nevertheless many examples of currency areas which are not optimal, but which are "domestically" stable, in the sense that there are no forces inside the currency area which may lead to a crisis and put the common currency in jeopardy: Italy, before the euro, was not an optimal currency area between North and South, nor were East and Western Germany after the reunification. The "zone franc" has remained fairly stable since the last devaluation of the CFA franc which I had to carry out from Bercy in 1994; and contrary to the Eurozone, despite its heterogeneity, it has not been destabilised by the global financial crisis.

We need therefore more insight into the Eurozone dynamic; and an evolution in confidence is probably in this respect a good parameter to look at.

A book has just been published in France on Jacques Rueff which is prefaced by Wolfgang Schäuble. Three times during the 20th century, Jacques Rueff played a major role in the design of successful recovery programmes of the French economy: in 1926, when Raymond Poincaré stabilised our currency, the famous so-called "franc Poincaré", in 1938 with Paul Reynaud just before the Second World War, and most famously in 1958 when the "plan Rueff" put in place by Général de Gaulle laid the foundations of the prosperity of the French economy for a full decade. With hindsight, it appears that return of confidence has always been at the heart of each of these recoveries. Each time, politicians who were implementing the programmes were trustworthy and courageous, return to fiscal balance and current accounts equilibrium has always been their priority. And they used to profess a free-market approach which aimed at letting French entrepreneurs freely make business, invest and innovate.

Confidence is key and its evolution has a lot to say about the events that have happened in the euro area.

Countries living in a fixed exchange-rate system can post lasting current account balance of payments disequilibria. As long as investors keep their confidence in a country in deficit, equilibrium is maintained through capital flows coming from the rest of the world. In a "fully- fledged currency area" such as the US or post-reunification Germany or the "zone franc", thanks to the inflow of financial capital underpinned by the trust bestowed by financial markets participants, we don't have to care about "domestic" current account imbalances, either because they are considered as without significance (as between California and the State of Washington), or because they are under control (like the zone franc).

In the euro area, in the first ten years of the EMU, market confidence[1] in the new European economic and financial framework allowed peripheral countries to live beyond their means, and therefore to accumulate current account deficits which were financed by savings coming from the core of the euro area (mainly Germany).

But when there is a shock like the "great recession", investors start to realise that countries in deficit are vulnerable and confidence starts to vanish. In these circumstances, it is no wonder that the first country under attack was Greece which was not only living beyond its means, but had cheated about the true amount of its fiscal deficit.

Member States in deficits are then hit by the mechanisms at work in a fixed exchange-rate system when a country loses the confidence of markets, i.e. by the complex interplay between sales of currency, capital outflows, contraction of the stock of money, reduction of domestic aggregate demand and deflationary pressure on wages and prices.

In a fixed exchange-rate system where a country has its own currency, the first market to be under attack is the forex market. Hence depreciation of the currency, etc. But in a currency union like the Eurozone, the market under attack is the financial market itself and first and foremost, the most vulnerable part of it which is the sovereign bonds markets.

In order to allay the pressure on these markets, one can raise the demand for public securities or the capacity for doing it. The set-up of the EFSF and the ESM, which have been cautiously and wisely managed by Klaus Regling who will speak after me, and later on the launch of quantitative easing[2] led to alleviating tensions and reducing the fragmentation along national borders, as can be seen through the impressive drop in interest rate spreads.

But if they intend to fully restore confidence, Member States under attack have to put their houses in order. If the country does it voluntarily, investors then more easily acknowledge that the country is aware of its own disequilibria and understands how to correct it. This is the best scenario for calming down the markets. As a second best, other Member States which have an interest in the stabilisation of the country under attack may incite it to implement the necessary reforms. But when its government acts reluctantly, then trust hardly comes back and the economy remains fragile.[3]

[1] Probably, I am afraid, excess confidence!
[2] Which was badly needed and I fully subscribe to the analysis made by Benoît Coeuré.
[3] See annex.

This analysis provides a good framework for describing the sequence of events that hit Greece since its adoption of the European currency in 2001: before 2009 too much trust conducing the piling up of imbalances, then a sudden surge of distrust and the necessity to take steps to restore confidence, the resilience of Greek politicians to implement structural reforms leading to rising mistrust among financial markets participants which entailed higher spreads on Greek sovereign bonds followed by a haircut on bonds held by the private sector; later on a more reform-oriented policy led Greece in the end of 2014 towards a return to slow and mild economic growth.

Success of Syriza at the parliamentary election of 25 January of last year opened a new phase of the euro crisis whose heart shifted from economics to politics. It had been the consequence of harsh economic and social degradation that had accumulated in this country, raising the prospect that sooner or later, other countries attracted by populist platforms would follow suit.

As a matter of fact, confidence has two facets: one is financial, the other is political. The first rests on the sentiments of investors, the second of citizens. And for politicians, who put in place the necessary reforms to restore confidence, given that these programmes are frequently economically and socially painful, they may lose the following elections, and when the opposition wins on a platform based on their rejection, at the end of the day reforms are put in jeopardy…

Over the last 12 months, the turn of events in Greece has been astonishing. It deserves to be recalled since it sheds light on the political dimension of the EMU and on its resilience and may help give some clues on the current challenges facing the European construction.

Syriza had been elected on a platform which comprised two hardly compatible objectives: on the one hand, it wanted to turn its back on the so-called "austerity". But on the other hand, it pledged, according to the wishes of the vast majority of the Greek people, to stay in the Eurozone and keep the euro.

On 30 June the previous bailout programme expired and Greece became the first developed economy to default to the IMF. By calling a referendum urging Greek voters to reject the deal with creditors under the argument that the "no" vote would strengthen its bargaining power, Tsipras overplayed his hand. Instead of improving his position, the referendum dramatically weakened it, and with it the Greek economy: the Greek bank depositors realising that "Grexit" was becoming a major risk, rushed to the banks to withdraw as many euros as they could, forcing the government to close the banks and impose capital controls. Economic activity forecasts dropped dramatically.

The problem for Greece today brings us back to the question of confidence. What Greece obviously needs most is a return to economic growth, and the sooner the better. Tsipras has to regain investors' trust if he wants to kick-start the Greek economy. To be fair, significant progress has been made on various fronts: a successful bank recapitalisation, the resumption of the privatization programme. He now has to deliver on the most socially and politically difficult part of the programme which is pension reform.

He has to create as well the conditions for lifting capital controls and for including the Greek public securities market into the ECB quantitative easing purchasing scheme in order to lower the interest rate spread which is a major obstacle to productive investment take-off.

Return of confidence could be greatly enhanced by the respect of the Greek government to independent authorities, by a more courageous fight against vested interest and by a comprehensive fiscal reform which phases out all existing loopholes.

The Greek government needs also to show that it has faith in the measures which it is implementing. The best political environment in this respect should be the enlargement of the current majority which would foster political stability, a pre-requisite to any durable recovery.

Let me now try with you to draw some lessons from this Greek odyssey for the European Union. I will deal briefly with three issues: the resilience of the EMU, the Eurozone integration process, and I will end up with a few remarks on the so-called "Monnet method".

Last year, Tsipras' metamorphosis was impressive. He came to power to overthrow austerity policies and called the IMF policies "criminal". The same man has fought against his own political pals to put in place precisely the type of reforms they had together so vigorously rejected.

Now, when it comes to Germany and many countries in the Eurozone, their U-turn on "Grexit" was no less amazing. Wolfgang Schäuble was forcefully pledging for a "temporary" five-year exit of Greece from the euro and many countries (Finland, Slovenia…) had publicly declared their hostility to Greece remaining in the euro area.

In a matter of days they gave up the idea of letting Greece leave the euro and they unanimously accepted to contribute to its bailout.

How to explain not only Tsipras' turnaround, but also why all European institutions, all governments and parliaments, despite the frustration and distrust they had accumulated, at the end of the day chose the option that seemed in the eyes of many the less straightforward and the most expensive?

It is not the first time that the magic wand of Europe's construction has achieved such a transformation. In 1983, while I was a young member of the French Parliament, I witnessed the yet unbelievable "*tournant de la rigueur*" (austerity turn) imposed by Mitterrand to his majority (which included elements coming from the radical left), which was the consequence of the participation of France in the exchange-rate European Stability Mechanism. For Tsipras today as for Mitterrand yesterday, the choice was between sticking to their ideology and taking the responsibility of the subsequent backlash for their own people of leaving the path of Europe's construction, or accepting an economic and political U-turn with the price of giving up their populist platform.

For Greece, it is clear that the Greek people were willing to keep its destiny anchored in the European Union at any price. As for its Member States partners, Volker Kauder the leader for the CDU in the German Parliament provided the clue to their reversal. He explained the CDU vote for the bailout with this statement: "*One thing is clear, it is not about making Greece an offer, but it is a question of holding this Europe together*".

Once again, the lesson to be drawn from this crisis is that the European construction is an overwhelming force which has been deeply enshrined in the collective psyche of Europeans for decades, if not centuries. It started to get into motion after the Second World War with Robert Schuman and Jean Monnet, but its origin goes back to the 19th century where the ideas of European common values and destiny can already be found in the writings of Goethe, Heine, Nietzsche[4] or of the French poet Victor Hugo[5].

It is also telling that today in Portugal, the leftist coalition does not call into question the commitment of the previous government towards Europe. In Spain, Pablo Iglesias, the leader of Podemos, declared that it was out of the question for his country to come back to the peseta[6].

---

4 Dieter Borchmeyer, « Beethoven, Goethe and Europe », 2000
5 Victor Hugo, Speech at the Peace Congress, Paris, August 1849
6 François Musseau, « Podemos, une autre voie pour l'Espagne? », Politique Internationale n°148

Thanks to the confidence still bestowed on the European construction, if the EMU and the euro remain more resilient than Anglo-Saxon economists, media or politicians have constantly professed, it does not mean that we should not remain wary nor be less eager to carry on the integration process of the Eurozone.

Has the object lesson from Greece been fully learnt? One can have some doubt when looking at what has been recently happening in Portugal when spreads on Portuguese public bonds brutally increased after a law had been passed to introduce the 35-hour working week for civil servants.

We certainly have to go ahead in the integration process of the Eurozone which will foster confidence. In this respect, the Five Presidents' report released in June of last year is a good starting point: a better integration of markets and policies would provide more a favourable environment for economic prosperity and employment. In order to enhance confidence, I even think that we should not hesitate to be more ambitious, by trying for example to put our defence expenditures in common which will acknowledge the fact that defence of EU Member States has become a matter of common interest.

This leads me to a final remark about the "Monnet method" whose foundation is encapsulated in the famous sentence of Jean Monnet: "*Europe will be forged in crises, and will be the sum of the solutions adopted for those crises*".

Many times in the past, Europe had to face violent shocks: the breakdown of the Bretton Woods system, the fall of the Berlin Wall, the Great Recession… Each time, these shocks, instead of weakening the European construction, worked as a lever for Europe to move forward and progress. But each time, the European response took time and has been hard to implement. It has been punctuated by Eurosceptic doomsayer predictions that the European Union would fall apart. But at the end of the day, European construction eventually was strengthened.

Europe is presently confronted with major issues. While the economic and financial crisis is not over, it has to simultaneously face the terrorist threat and the migrant crisis, at a time when centrifugal forces in Great Britain are putting the integrity of the European Union under pressure.

Once again, the European construction is under stress and the "Monnet method" is on trial. In this respect, the only relevant question is to know whether each country should rather face these problems by itself, or whether we had better find a European collective response.

Who can seriously claim that jihadism could be better defeated by each European country following its own security policy? An answer to terror rests on action in the Middle East and Africa which requires European collective action. In this respect, we should listen carefully to the recent pledge of Wolfgang Schäuble for a more integrated European defence policy.

As for migrants, there is clearly a need for a strong European answer as well. It is not sufficient to say that national borders should be closed and the Schengen Treaty be dropped. European citizens cherish the freedom of circulation across their countries. But European authorities need to find a compromise between the respect of our values to give shelter to the people who are persecuted in their countries, and the necessity to protect European citizens and therefore to make the Union's external borders safer.

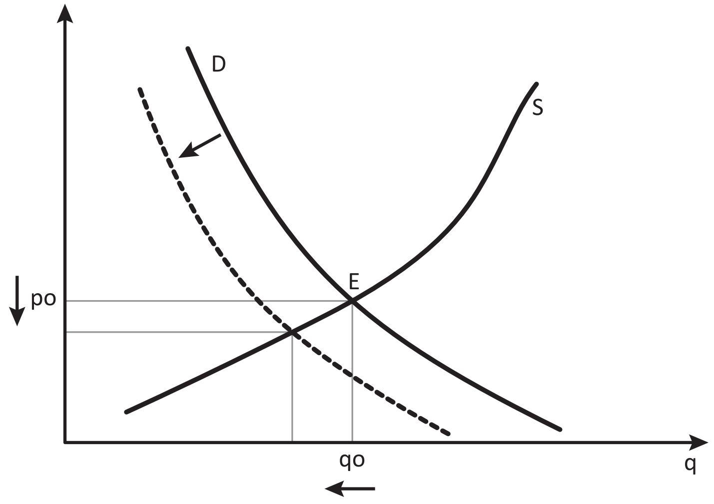
It would be foolish to bet that each country is better equipped to face by itself these huge twin problems[7], or to imagine that we will find the answers at once. Fostering confidence which is the most solid ground to arouse support of citizens fundamentally rests on our capacity to find solutions to these new issues.

Europe is led to move forward through crises. This has been its history. Will it again overcome these huge challenges? Let me guess that as in the past, once again, hopefully it will succeed.

[7] Sylvie Kauffmann, « Europe's new normal », International New York Times, January 23-24, 2015

Annex

Confidence can be simply introduced in price equilibrium of demand and supply:



A sudden drop in confidence shifts the demand curve downwards, price decreases (for an asset its return increases accordingly). One can come back to equilibrium by raising demand. But in order to obtain a durable equilibrium, the upward shift of the demand curve requires a return of confidence.

KLAUS REGLING

Managing Director
ESM

"Lessons from the euro crisis"

Governor, members of the Lamfalussy family, ladies and gentlemen,

It is a great pleasure and honour to be here at the Lamfalussy Commemorative Conference. Hungary is not a member of the euro zone – yet. Nonetheless, the country has made an important contribution to the single currency through the person of Alexandre Lamfalussy.

In 1949, Alexandre fled this country, walking through fields covered in a metre of snow. This adventure paid off well – for all of us. He became a founding father of the euro. As a young man, he witnessed the devastation brought about by the Second World War. And, in his own words, he was horrified by it. It made him decide to help rebuild Europe. His life has been closely tied to our history ever since. There are many examples of how Europe has benefited from his insights.

Alexandre was once asked whether his war experience was the reason for his personal conviction that Europe needed a single currency. His answer was: "Yes, no question, because it was clear that the European Union couldn't exist without monetary union." That early vision was paired with the ability to forge a consensus among people who often love to disagree, and his determination and intellectual power to find workable solutions.

I had the pleasure of working very closely with Alexandre during my years at the European Commission. When I look at his biography, I see some similarities in certain phases of our lives. He became the head of the European Monetary Institute, the precursor of the ECB. When I read how Alexandre personally recruited the first 100 people at the EMI – first in Basel, then in Frankfurt – I am reminded of my first days at the EFSF in Luxembourg. It was created in 2010 and we reached a staff of 100 three years later. The EMI, like the EFSF, was an innovative new institution that represented a key step in European integration. In both cases, there were many who said the institutions wouldn't succeed. But they did. Moreover, both were bodies with a temporary lifespan. The EMI's goal was to prepare the ground for the ECB, and then be terminated. Likewise, the EFSF has now been succeeded by the ESM.

There is another story about Alexandre that reminds me of my own experience. He once spoke in a small town in Bavaria. As you know, Germany went through two currency conversions, one after each world war. In both cases, people lost considerable amounts of money. So an elderly man was eager to know if this was going to happen again with the euro. Alexandre convinced the audience it wouldn't. This earned him the praise of Chancellor Helmut Kohl, who called him up and said: "You really won over those Bavarians, and they are a difficult lot". I'm also spending some of my time on the road to tell people about the benefits of the euro. Although I don't think I've convinced each and every Bavarian just yet, like Alexandre, I firmly believe that one of the important tasks of policymakers is to explain the benefits of the single currency to citizens.

Ladies and gentlemen, Europe has come out of the worst crisis since the Great Depression. There were many who said the single currency wouldn't survive. They were wrong. The euro area is emerging from the crisis stronger than before. Of course there is no room for complacency. The road ahead will require more work, difficult decisions, and above all a clear vision. A vision such as the one Alexandre Lamfalussy had. So, in all modesty, let me follow in his footsteps and give you my own vision of the lessons Europe has learned from the crisis.

Europe went through two crises in recent years. First, the financial and economic crisis was triggered in the United States in 2007. Markets had ignored credit risk in subprime mortgages. This was aggravated by a lack of financial supervision, which had allowed a proliferation of opaque financial instruments. The behaviour of certain bankers, supervisors, central bankers, and credit rating agencies all contributed to the crisis. It led to the dramatic bail-out of the U.S. banking system in September 2008. European banks also suffered. Two years later, this was followed by a crisis in the euro area – a crisis of our own making. Years of irresponsible fiscal policies had caused unsustainable budget deficits and debt burdens in some countries. Others had become uncompetitive, pricing themselves out of markets with wrong wage policies. Housing bubbles contributed to the imbalances. Institutions for crisis management were lacking. All this finally came home to roost between 2010 and 2012, when several countries lost access to bond markets. A scenario whereby a country inside the monetary union lost market access had been unthinkable at the time the euro was set up. Now, sovereign defaults loomed. At the height of the crisis, the risk that the euro would break up was real.

That was six years ago. Since then, policymakers have taken decisive action and their response to the crisis has been fairly comprehensive. I believe – like former French economy minister Edmond Alphandéry – that this experience has demonstrated once again the ability of Europeans and of our systems to deal with crisis. The euro area is now more integrated and less vulnerable. Let me mention five lessons that one can draw from the crisis.

First, countries must avoid excessive macroeconomic imbalances. Second, we needed closer economic policy coordination in the euro area. Third, in a crisis one needs an active or unorthodox monetary policy. Fourth, we had to strengthen the banking system, and five, we had to close institutional gaps and create firewalls against the crisis, the EFSF and ESM.

Let me say a few words about each of these five points. Some countries had to work hard to keep fiscal deficits and public debt manageable. You can ask yourself why Finland was never attacked by markets despite a relatively poor economic performance in recent years, and why it managed to keep its AAA rating. The answer is clear: Finnish debt and deficits remained fairly low. The countries that lost market access during the euro crisis in some cases had really excessive deficits, particularly in Greece of course, but also Portugal, Ireland and Cyprus.

The good news is that a lot has happened over the last few years. There is a lot of noise about the speed of fiscal consolidation. But there is no disagreement about bringing deficits below 3 percent of GDP, and then towards a structural balance. In the aggregate, the euro area has made good progress. The deficit of the euro area overall last year was 2 percent of GDP. In the U.S. and the UK, it was twice as large, and in Japan even three times.

Competitiveness is another area countries have to watch closely to avoid macroeconomic imbalances. During the first decade of the EMU, a number of countries very clearly lost competitiveness. At the peak of the crisis, unit labour costs in Greece had increased 45 percent faster than in Germany, or other northern European countries. The current account deficits of these countries became very big, 10 to 15 percent of GDP, which again was not sustainable.

Through what is now called internal devaluations – direct cuts in wages, salaries and pensions – unit labour costs have come down drastically within a short period of time. The competitiveness gap has now been closed to a large extent. That can be very painful for the population, but the benefits can also materialize relatively quickly. The decline in the current account deficits that we have seen is not just the result of collapsing GDP, export growth is also playing an important role. Ireland and Greece, two countries that had substantial internal devaluations in recent years, had the strongest export performance of all EU countries in 2014. So the strategy is working.

Countries that lost market access are implementing more reforms than many people are aware of. It is very difficult to summarize this in one indicator. Adding up labour market reforms with the opening of product markets is like comparing apples and oranges. But the OECD tries to do this, and the World Bank with a different methodology tries something similar as does the World Economic Forum. The result for all these institutions is that these countries do indeed implement more reforms than anyone else. Every year, Greece comes out on top. That does not mean that everything is fine in Greece, because it came from a low level. Still, countries that implement reforms grow faster than others after a number of years. That is the experience from IMF programmes, and I believe the same will happen in southern European countries.

The second lesson is that economic policy coordination in the euro area was not close enough. Of course this is an old issue, during the 90s and up to today there were many academics – particularly in the Anglo-Saxon world – who told us monetary union will never work. Because we have centralised monetary policy, and everything else is decentralised. The answer to that criticism is: it can work, if we coordinate well enough. Obviously, that was not the case before the crisis. Since then, we have tightened the surveillance of fiscal policies with a stricter Stability and Growth Pact, with the Fiscal Compact and more powers for the European Commission.

In the context of the European semester, the Commission gives recommendations to every country – not just crisis countries – on how to remove obstacles to growth. Importantly, there is a new procedure, the so-called Macroeconomic Imbalances Procedure, with the aim to avoid excessive divergences and imbalances. There is even the possibility of sanctions. The crisis showed that problems can happen not only due to wrong fiscal policies but also when for instance competitiveness diverges too much. The new procedure looks at that. All this must now be implemented in a credible way, but the framework has been strengthened considerably.

The third lesson is that one needs a very active monetary policy. Mervyn King once said that monetary policy should be boring in normal times, and he was right. But during a crisis, it cannot be boring. The ECB has risen to the occasion. It was the first of the large central banks to take measures against the crisis as it began to emerge in 2007. It was also early on that the ECB introduced negative deposit rates. The results are there, because the credit cycle has turned and we see some credit growth.

The fourth lesson is that Europe needed a stronger banking system. Again, a lot has happened in this respect. We have introduced and created new institutions, like the European Systemic Risk Board with a mandate to monitor and identify macroprudential risks. This institution did not exist before the crisis. Macroprudential tools were not very fashionable. Other countries like the U.S. and the UK have also created such bodies with a mandate to monitor macroprudential risks. We also have the new supervisory bodies for banks, securities markets and insurance companies.

The Banking Union began in November 2014, with a single supervisor overseeing the 130 largest and systemically relevant banks. Since the beginning of this year, we have the Single Resolution Mechanism, and the Single Resolution Fund, which is building up its capital over the next eight years. European banks have massively raised their capital, adding €600 billion since 2008, so basically doubling their capital. The progress made over the last six years would have been unthinkable before the crisis. When the Maastricht Treaty was negotiated, there was no consensus on a single European supervisor. During a crisis, things happen that seem impossible before.

The final lesson is that we built a firewall to protect countries that lose market access. These are the EFSF and later the ESM, the two institutions that I manage. They were not foreseen in the initial design of monetary union, because like I said, it was unthinkable that a country could lose market access once it joined. Together these institutions – which are managed by one staff – have a lending capacity of €700 billion. Financing is only provided against conditionality – which explains why you often hear that certain disbursements have been delayed. That is because we operate like the IMF, and we check that agreed policy reforms are implemented before we disburse any money.

During the last five years, we have disbursed €254 billion to five countries, which is about three times as much as the IMF has disbursed globally. There were five programme countries: Ireland, Portugal, Spain, Cyprus and Greece. Four of these five have become success cases by now. That was far from clear two or three years ago. Ireland, Portugal and Spain exited their programmes successfully, they are able to refinance themselves again at relatively low interest rates. Cyprus will exit its programme in March, and that programme is going very well. Greece is still a special case. We entered a new programme in the summer of last year after very difficult negotiations in July and August. The new programme allows the ESM to disburse up to €86 billion.

The EFSF and the ESM have many benefits. First, we were able to keep the euro area together. Others have played a role, like the ECB. But if the EFSF had not been created in 2010, not only Greece, but probably also Portugal and Ireland would have been forced to leave the euro area. Europe would be a different place today if that had happened.

The second benefit of the approach by the EFSF and the ESM – which is basically the IMF approach – is that conditionality is enforced on countries. I already talked about the OECD reform statistics. Reforms help countries to return to growth. Spain and Ireland, two of the countries that benefited from our loans are having the highest growth rates today in Europe, Ireland with 7 percent growth and Spain with 3 percent. That is probably well known. What is not so well known is that by providing our financing very cheaply we also help countries to return to debt sustainability. Our funding is much cheaper than IMF funding. One main difference between us and the IMF is that we finance ourselves in the market, by issuing bills and bonds. The IMF gets its refinancing from central banks, and adds relatively large margins. Given that our operations are guaranteed by our strong member states, the EFSF and ESM have a high credit rating. This means we have low funding costs, which we pass on directly to borrowing countries. And this in turn leads to significant savings for the respective countries.

If you look only at Greece, using reasonable assumptions Greece saved almost €8 billion in its debt service payments from its budget in 2014. That's 4.4 percent of the GDP, every year. Then, if the country continues to implement reforms and reaches a higher potential growth rate, this can add up and the country can return to debt sustainability. Another important element of the EFSF and the ESM is that we enhance risk sharing in the monetary union, which is underdeveloped.

The final element is that we do now have a lender of last resort for sovereigns in the euro area. I believe that not everyone had fully understood that with the creation of a monetary union, there was no lender of last resort. In a country that has its own currency, the central bank obviously is the lender of last resort not only for the banks, but in a crisis also for the sovereign. In EMU, that is not possible. Because if the ECB were to play that role we would shift risks between countries. That is one reason for the prohibition of monetary financing in the Treaty. There was no lender of last resort, but with the EFSF and ESM that gap has been closed.

I hope to have demonstrated that Europe has come a long way. At the same time, it is important to remind ourselves that we must not stop here. Last year's Five Presidents report is a good starting point for further integration. It includes many good proposals for economic union, banking and capital markets union, and fiscal and political union. Completing banking union is essential, and it requires one big step: a European Deposit Insurance Scheme. This may take a while, but I'm convinced we will get there. Capital Markets Union would be another important step to make the economy more resilient. More financial market integration would lead to more capital flows, and would promote risk sharing via markets. Creating the Capital Markets Union will not be an easy process, because it requires harmonising insolvency, taxation and company law. In the United States, shocks are smoothed out across the 50 states through markets to a much greater degree than across the euro area. That's an area where we need to catch up. Fiscal transfers can complement that, but there's a trade-off: the more we succeed in getting to share risk via markets, the less we need to share risk via fiscal mechanisms.

One should remember that we do already have fiscal transfers in Europe, through the EU budget. The budget is small overall, but the transfers that poorer countries can receive are quite sizeable, up to 3 percent of their GDP. More is not really needed for the good functioning of EMU. However, a limited fiscal capacity as suggested in the Five Presidents report could be useful to act against asymmetric shocks. Importantly, such a fiscal capacity could be designed so that it does not lead to permanent transfers or debt mutualisation. And there may be ways to do this without EU Treaty change. The Five Presidents report also mentions the possibility of a euro area Finance Minister. This could support policy coordination, external representation, visibility and, therefore credibility of EMU.

Let me conclude here. Monetary Union has come out of the crisis stronger than it was before. A host of measures saved the euro: economic adjustments at the national level, greater economic coordination between countries, unorthodox monetary policy, a stronger banking system, and substantial financial solidarity between euro area countries via the EFSF and the ESM.

Further steps would make the monetary union more robust. When I look at what is still on the agenda, I think again of Alexandre Lamfalussy. If he were still with us, we would simply ask him to start another Lamfalussy process, and to move us closer to fiscal and political union. No doubt, he would deliver, and Europe would be better off.

GYÖRGY SZAPÁRY

Ambassador of Hungary and Chief Adviser
to the Governor Magyar Nemzeti Bank

Introduction to the panel discussion: food for thought

By way of introducing the discussion of the panel featuring three outstanding economists – Daniel Gros, Director of the Centre for European Policy Studies, Niels Thygessen, Professor Emeritus of the University of Copenhagen and Daniel Palotai, Executive Director of the Magyar Nemzeti Bank, – I would like to show and briefly comment on four charts that could provide some food for thought for the panel discussion.

Chart 1 shows the government debt as a ratio of GDP in the EU member countries in 2007, i.e., prior to the crisis, and in 2015. In 2007, only 3 countries exceeded substantially the 60 percent Maastricht threshold – Greece, Italy, and Belgium – while 6 countries exceeded it by less than 10 percentage points. In 2015, on the other hand, 14 countries exceeded substantially the 60 percent threshold, while 3 countries by less than 10 percentage points. As a result of the crisis, the debt levels in the EU have ratcheted up mainly through a combination of bank bail-outs, a rise in unemployment benefits and a decline in tax receipts as a consequence of a slow recovery of growth, following an outright decline in GDP in most countries. The slow recovery prevented the debt levels from declining despite efforts to reduce deficits since 2009. As we have seen, in a situation of balance sheet adjustments when banks, households and, to a large extent, also firms are deleveraging, the effectiveness of monetary policy in reinvigorating growth is limited. Because of the high levels of public debt, most countries do not have the fiscal space to boost growth. The questions then are: Have EU countries become more vulnerable to future crises? How much longer will it take to reduce the debt to sustainable levels? Will the current high-debt-slow-growth situation weaken investment confidence so much that it paves the way for the next financial crisis?

Chart 2 shows various key indicators of economic performance in the United States and the euro area: GDP, consumption, investment and unemployment. All indicators show that since the outbreak of the crisis, the US economy has performed much better than the euro area. There are many reasons that explain the differences, not the least the poor performance of southern euro area economies. One reason for the better performance of the US economy that needs to be pointed out in this context is that the US has been less fiscally constrained than the euro area countries and could therefore resort more freely to expansionary fiscal policy to stimulate growth. Are we therefore going to see in the long run a widening gap in the economic performance between the new and the old continents? What type of changes on the geopolitical scene would bring about an economically weakened Europe vis-à-vis the United States? This question is certainly worth considering, and all the more so since the European economy and the political unity of Europe are also stressed by such issues as the possibility of Grexit and Brexit and the flow of immigrants from the East.

Chart 3 shows the evolution of real GDP per capita in the United States, Germany, the euro area excluding Germany, and Greece. In the US and Germany, the per capita real GDP is already above its pre-crisis levels. In Germany, the per capita numbers shown on the Chart are distorted by the fact that the 2011 population census revealed that the actual population was 1.4 million lower than the path projected on the basis of the previous census (*see Chart 4*). However, even adjusting for this, the level of per capita real GDP exceeds its pre-crisis level, but not to the extent shown on the Chart. In the euro area excluding Germany, the per capita real GDP is still below the pre-crisis level and it is projected to reach it only in 2017. In Greece, the fall in incomes has been dramatic, with per capita real GDP in 2015 standing more than 25% below its pre-crisis level. This Chart is a good illustration of the large discrepancies in economic performance among euro area countries. The question is how long can such large discrepancies persist before they pose a threat to the political support for the single currency.

Chart 4 shows projected demographic trends in the United States and the EU. On both sides of the Atlantic, the rate of population growth is declining, but in the EU the population is projected to actually decrease after 2027 based on projected birth and death rates. It seems very unlikely that this trend can be reversed by an increase in the birth rate alone, given the generally observed fact that birth rates decline with the increase in income levels. This brings to the fore the issue of immigration which has recently become a dominant feature of the political discourse in Europe, as a consequence of the large influx of refugees and economic immigrants from the East. With decreasing population, only robust productivity gains could assure overall growth of the economy. It is very unlikely that productivity increases alone could offset the effect on overall growth of a falling population at the European level. Are we seeing here yet another factor that will weaken Europe's geopolitical role in a globalized world?

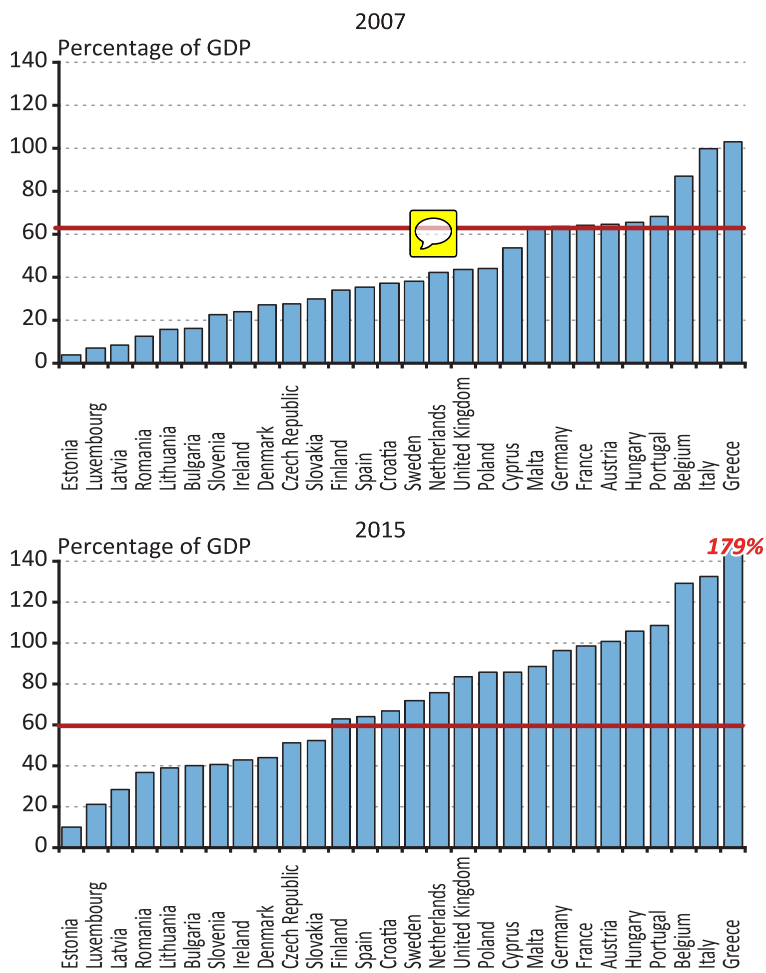
Let me finish my introductory remarks with a quote from Barry Eichengreen from his recently published book *Hall of Mirrors*, in which he discusses the policy responses during the two great financial crises of the 20th century, the Great Depression of the 1930s and the financial crisis which began in 2008 (Oxford University Press, 2015, p.382):

"The single greatest failure to learn appropriate lessons from this earlier history was surely the decision to adopt the euro. The 1920s and 1930s illustrated nothing better than the dangers of tying a diverse set of countries to a single monetary policy [the gold standard](...). It highlighted the economic pain and political turmoil that would result when the only available response was austerity. That history should have given European leaders pause before moving ahead with the euro."

Must we agree with this opinion? Is there a better answer that supports the creation of the euro?

I hope that the points made and the questions raised in my brief introductory remarks will be addressed by the panel and will stimulate an interesting discussion.

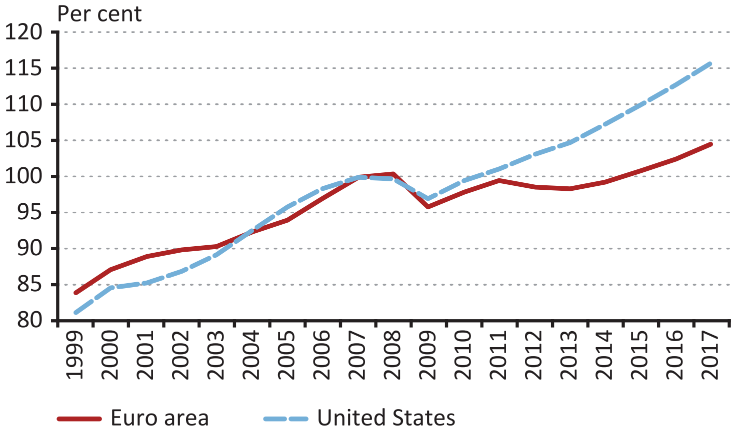
Chart 1: General government debt, 2007 and 2015



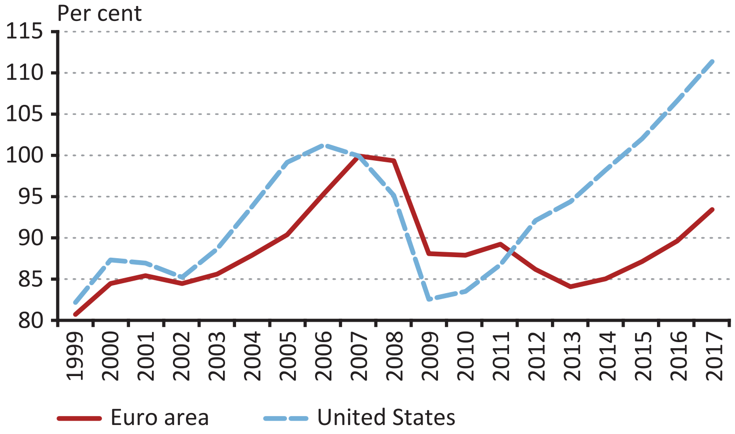
Source: AMECO

Chart 2: Economic performance: United States and euro area

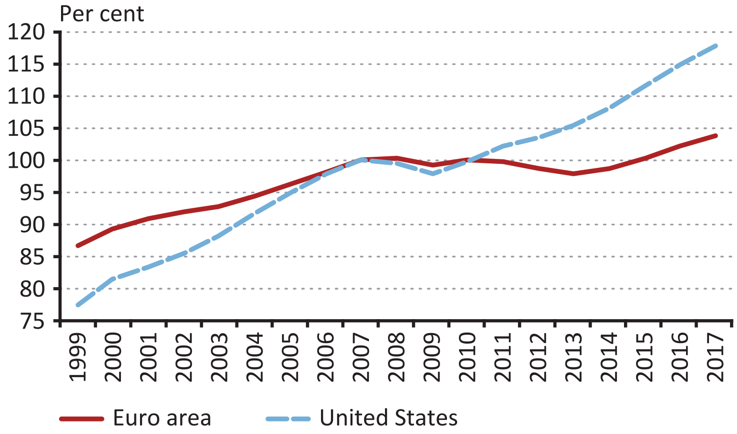
GDP at constant price (2007 = 100)



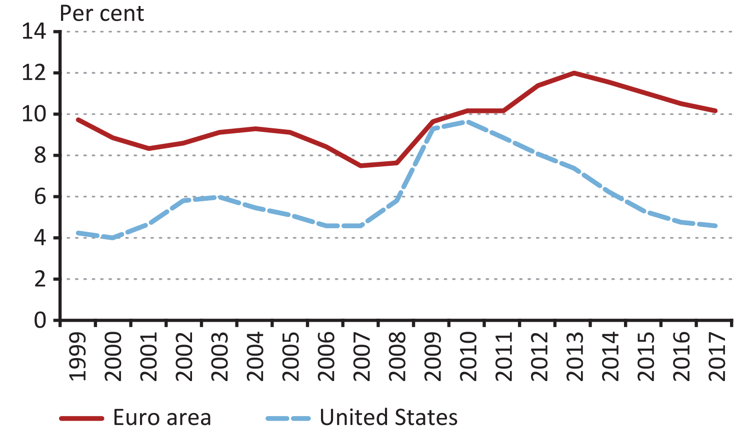
Gross fixed capital formation (2007 = 100)



Private final consumption expenditure at constant price (2007 = 100)



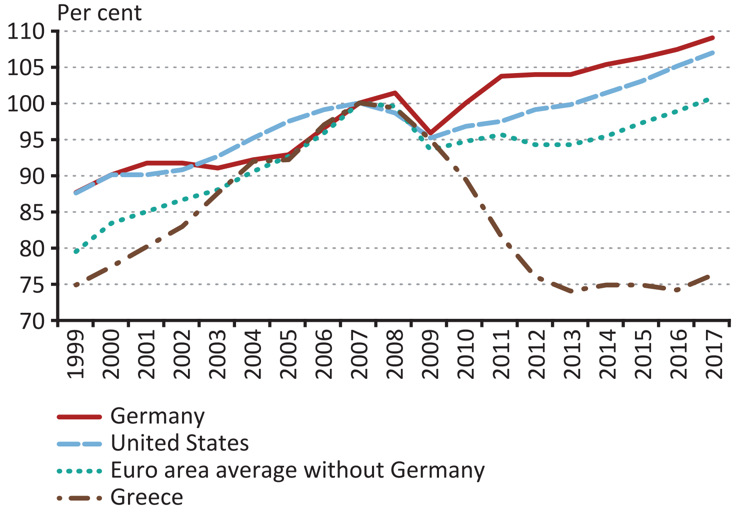
Unemployment rate (as percent of civilian labor force)



Note: Data for 2016-2017 are projections.

Source: AMECO

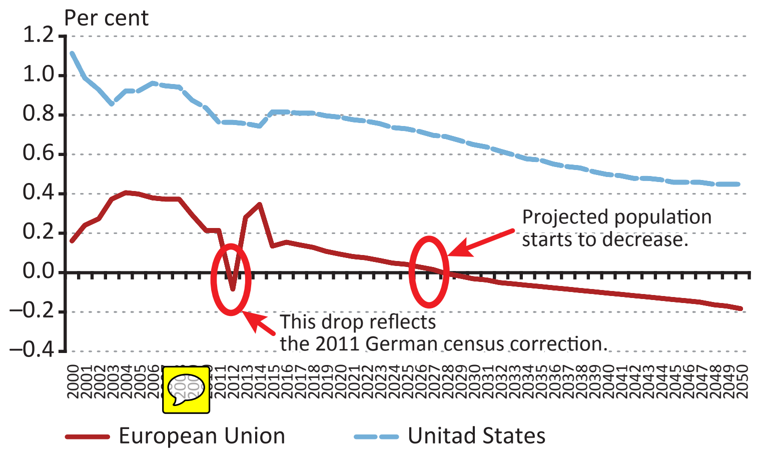
Chart 3: GDP per capita (2007 = 100)



Note: Data for 2016-2017 are projections.

Source: AMECO

Chart 4: Growth rate of the total population in the European Union and the United States



Sources: World Bank, United States Census Bureau. Projections in the case of US are data from the US Census Bureau. WB statistics are calculated with mid-year data.

DANIEL GROS

Director
Centre for European Policy Studies

Quantitative Easing in the Euro Area: Fiscal or monetary policy? National or common?[1]

The basic themes addressed in this conference embrace the big questions: Has increased public debt made the EU more vulnerable and is there a risk of losing political support for the euro? These are very complex issues which other speakers will address in a more general way. My contribution will be more modest, zeroing in on one particular aspect of the EU's monetary policy, namely quantitative easing in the euro area. Although this is a rather specific and technical issue, it can show with more clarity how these broader issues affect concrete policy-making.

This paper will explore two key underlying questions raised by quantitative easing. Firstly, do large bond purchases by central banks actually constitute fiscal or monetary policy? And secondly, does the euro area's QE qualify as a common policy or a collection of national policies?

This difficult intersection between monetary/fiscal and national/common policy is a recurring theme in the European integration process.

This is also the reason why large purchases of (national) government bonds by the central bank have proven highly controversial in Europe. In short, QE, as it is called, put central banks in the grey zone between monetary and fiscal policies. And, given that fiscal policy remains in national hands, it is politically very delicate for the European Central Bank (ECB) to undertake actions that have clearly identifiable fiscal implications.

Some of the fears concerning QE, especially those related to its monetary impact, quickly turned out to have been exaggerated. There has been no increase in inflation, although central banks have expanded the monetary base to unprecedented levels.

[1] This contribution draws on D. Gros (2015), "QE 'euro-style': Betting the bank on deflation?" and D. Gros (2016), "QE infinity: What risks for the ECB?", both of which were written at the request of the European Parliament.

This contribution thus concentrates on some other, longer-term issues.

First it considers some implications and risks for the balance sheets of the central bank when it buys government bonds. In the specific case of the euro area, one then needs to distinguish between the balance sheet of the ECB (as a separate legal entity) and those of the national central banks of euro area countries (which together form the Eurosystem). This leads to the question of whether the government bond-buying programme of the ECB – officially called the Public Sector Purchase Programme (PSPP), which is part of a broader Expanded Asset Purchase Programme or EAPP – represents a common policy. Finally, this contribution argues that bond-buying by the central bank reduces the effective maturity of public debt; and that the countries that are the most exposed to potential problems are the same ones that are most deeply engaged in this risky business.

1. Balance-sheet risks

The discussion about the fiscal risk inherent in any quantitative easing in the euro area was first dominated by concerns over possible default risk, obviously inspired by the Greek case[2]. The decision by the ECB to engage in a large-scale bond buying programme became possible only when it was decided in December of 2014, that the national central banks (NCBs) would be allowed to buy the bonds of their own governments and that there would be no risk-sharing on the 80% of the bonds purchased under this programme.

Basically the ECB told the central national banks: "Buy the bonds of your own government." Viewed from this perspective it is not surprising that the opposition to QE was so muted. There has been a lot of discussion about why Germany did not object more strongly to QE in 2015, which is after all counter to the fundamental principles held by the German government. But if you tell the Bundesbank to buy its own government bonds, why should Berlin object? Rare is the country where the financial minister objects to the central bank buying its own bonds. The ECB had been made super independent to ensure that it would not succumb to the pressure from finance ministers to do just that. Now, it is insisting on buying bonds against the wishes of some finance ministries (but with the tacit, very strong approval of others).

The risk-sharing debate also passed quickly since Greek bonds would not be included for the time being in the bond-buying. But other risks, notably the interest-rate risk,

[2] The ECB did not suffer any losses in the so-called private sector involvement (PSI) operation in 2012, because its bonds were exempted from the hair cut thanks to some last-minute accounting tricks. This shows that if there is a political will to exempt the central bank from any losses resulting from a government's insolvency, a legal way can always be found to ensure that this happens.

should be considered. When central banks buy longer-term bonds, they obviously run the risk that the price of these bonds will fall when (long-term) interest rates increase. Moreover, a simple aspect has often been forgotten in the debate about risk-sharing: 'no risk-sharing' also implies 'no profit-sharing'.

1.1. Interest-rate risk not avoided

The ECB has stated publicly that bonds whose yield to maturity is less than the official deposit rate should not be bought, implying that buying them would constitute a loss-making operation.[3] But this justification has weak foundations.

Whether or not the central bank ultimately makes a loss buying long-term bonds does not depend on the difference between the deposit rate and the interest rate (or to be more precise the yield to maturity) of the bond at the time the purchase is made, but rather on the difference between the yield to maturity and the average of future deposit rates during the lifetime of the bond.

This applies of course both to the purchases made by the ECB, and the 80% implemented by the NCBs on their own account.

The main reason why this lower bound was adopted was probably political: the Governing Council likely wanted to avoid giving the impression that it was forcing the Bundesbank to buy bonds on which it would be making an accounting loss during the first few years. The restriction on a central bank from buying a long-dated bond yielding less over its life (say 10 years) than the one-day deposit rate on the day of purchase amounts to populist posturing. What matters is the average of the deposit rate over the remaining maturity of the bond. The following sub-section will provide some illustrative calculations in this respect.

The aim of central banks in implementing their monetary policy is not to make a profit, but rather to influence monetary and financial market conditions in the direction of price stability. Hence pure profit and loss considerations should be of a secondary concern for central banks. But the ECB should still acknowledge that its bond-buying programme unavoidably leads to some risks to its balance sheet.

[3] In principle, purchases of nominal marketable debt instruments at a negative yield to maturity are permissible as long as the yield is above the deposit facility rate. See https://www.ecb.europa.eu/mopo/implement/omt/html/pspp.en.html

Another way to look at QE is that in buying longer-term securities, the ECB is undertaking a maturity transformation not unlike commercial banks: it borrows at the short-term rate by issuing deposits to commercial banks, to invest in long-term paper.

Long-term interest rates are usually higher than short-term rates because longer-term securities are more risky as their market price varies inversely with the interest rate. It is important to distinguish between market risk and default risk: the latter should be practically equal to zero for highly rated securities like most government bonds, but the former, the market-price risk, is unavoidable. Consider the following concrete example: if the 10-year interest rate increases by one percentage point, the price of a 10-year bond will normally fall by about 10%.

This difference between the average of long-term and short-term rates (of securities with similar default risk) is called the 'term premium'. It can only be indirectly estimated, but under normal circumstances it is thought to be positive and substantial. If this were the case today, one could expect that the Eurosystem would make a profit on the EAPP. However, some estimates suggest that under today's market conditions, the term premium is negative for some countries. It is thus not a foregone conclusion that in the end the Eurosystem will make a profit on the bonds it is buying today.

1.2 No risk-sharing = No profit-sharing

An important element of the EAPP is that $4/5^{th}$ of the bonds bought under this programme should be bought by the national central banks in the Eurosystem and that any profits or losses on these securities should remain with the NCB that bought them. This represented an important departure from the general rule under which all profits and losses resulting from 'ordinary' monetary policy operations are shared within the Eurosystem. That is, normally, all profits and losses on these ordinary operations are pooled in the so-called 'monetary income' of the Eurosystem, which is then shared among the NCBs according to the capital key (with a small share going to the ECB, which in turn is again owned by the NCBs).

Moreover, in another departure from standard procedure, NCBs are expected to buy the bonds of their own government.

The departure from this basic principle of risk (and profit/loss) sharing has important implications because the central banks of those countries where interest rates are still higher will also earn a higher return on their investment (while the 'cost' of funding is the same, namely minus 25 bps., at present.). A concrete example can illustrate the importance of this point: The difference between what the Banca d'Italia would have earned under full risk-sharing and the current arrangement is substantial. At present the rate of return on 10-year Italian government bonds is about 0.8 percentage point higher than the average euro -area rate (on 10-year government bonds). The Banca d'Italia will buy about €150 billion of Italian government debt under its own account. If one assumes that it will buy only 10-year bonds, it will earn on this investment €1.2 billion per year more than it would have under full risk-sharing. Based on a rough calculation, over 10 years, this would amount to more than €10 billion, or about 0.75% of Italy's GDP (provided, of course, that Italy has not defaulted by then). The converse is naturally also true: those national central banks whose national government bond rates are lower than the euro -area average will have lower seigniorage revenues than they would under full risk-sharing. This is the price they must pay for not wanting to share the risk of default.

The table below provides some details of the calculations assuming that the average remaining maturity of the purchases under the EAPP is 10 years for each country. In the case of Germany, the weighted average of the remaining maturity of the bonds eligible under the EAPP is very close to 10 years.[4]

Table 1. ECB QE-EGBs purchase impact of no-risk sharing (selected countries)

Country	Risk spread	Difference yield national – EA average	Gain/loss from no risk-sharing 10 (average maturity) years	% of GDP (10 years)
AT	0	-0.00522	-1.2	-0.4
BE	0.003	-0.00222	-0.7	-0.2
DE	0	-0.00522	-11.4	-0.4
ES	0.013	0.007776	8.3	0.8
FI	0	-0.00522	-0.8	-0.4
FR	0.003	-0.00222	-3.8	-0.2
IE	0.007	0.001776	0.3	0.1
IT	0.013	0.007776	11.6	0.7
NL	0	-0.00522	-2.5	-0.4
PT	0.02	0.014776	3.1	1.8

Note: *The calculations shown in the table are based on prices/rates of a certain day, so results are subject to certain daily variation. Yet, this does not imply that the message is no longer valid.*
Source: *Own calculations based on ECB data.*

[4] For more details, see Gros (2015).

2. Maturity transformation with low long-term rates: Betting the bank on deflation

In order to understand the balance-sheet effects of QE, a comparison with foreign exchange market interventions is instructive. A central bank sells foreign exchange if it thinks that the domestic currency is undervalued in the market. If the currency then strengthens in the long run, the central bank will have made a profit.

In the case of the EAPP (as with any QE operation), the link between the aim of the operation (to avoid deflation) and the profit-and-loss account of the central bank is less direct. But an indirect link exists: if inflation increases, it is likely that the central bank will have to increase its interest rates (i.e. the rate at which it lends money to commercial banks). This implies that the central bank is more likely to make a loss on QE if it is successful: Assume that in a couple of years inflation goes back to about 2% (the rate the ECB charged on its deposits on average until 2008) and financial market conditions normalise. In this case, the ECB will likely have to increase its deposit rate to the average level of the first decade of monetary union, which was about 2%.

To be more concrete, one can imagine that monetary conditions normalise in 2018 and revert to the average of 1999-2008. Assuming that the deposit rate has not moved until then, one can calculate the average deposit rate as the simple average of three years at minus 0.4% and seven years at (plus) 2%, or 1.34% (-0.4*3+2*7=-1.26+14=12.8). This implies that under these circumstances the Bundesbank would make a loss by buying 10-year Bunds at much less than half this break-even rate. By contrast, the Banca d'Italia might still make a modest profit from buying BTPs at the present yield of around 1.4%.

The Bundesbank can break even on its purchases of 10-year Bunds at a yield of 0.2% only if the deposit rate remains negative for a long time; and then never rises above 2% after policy rates have been normalised. In financial market terms, one must conclude that the ECB (or rather the Eurosystem, including its constituent central banks) are offering financial markets a bet that monetary conditions will remain lax for a very long time. The private-sector investors selling the bonds are implicitly betting that monetary conditions will remain lax even longer than central banks seem to be thinking.

3. Is QE fiscal or monetary policy: Consolidating the public sector

In a country with its own currency, the central bank and the Treasury can be consolidated for fiscal purposes, at least in the long run. Any gains or losses the central bank makes over time are transferred to the (national) Treasury. Monetary and fiscal policy thus cannot be kept completely separate under extreme circumstances, but from a political point of view, this matters less in a national context when the country has its own currency. Within the euro area, one could consolidate the sum of all national Treasuries with the accounts of the ECB, as the Eurosystem, sooner or later, transmits most of its profits to national Treasuries, according to the capital key, which determines the respective shares of each country in the ECB.

However, this applies only to ordinary monetary policy operations.[5] Apparently the public sector purchase programme (PSPP) was not regarded as a 'normal' monetary policy operation since it was decided that 80% of the asset purchases would be undertaken by the NCBs under their own responsibility. The reason for this was obviously that the NCBs from creditor countries, such as Germany or the Netherlands, were worried that they might have to share in the losses if there was a default on the bonds bought under this programme. Moreover, these purchases, which remain only on the books of the individual NCBs, will be confined exclusively to national bonds.

The fact that 80% of the purchases under the PSPP will be undertaken by NCBs means that (to 80%) the EAPP will mainly have the effect of shortening the duration of the existing national public debt. The deposits of banks with the NCB represent effectively public debt with a zero duration (these deposits can be withdrawn daily). When the Bundesbank buys a German government bond with a residual maturity of 10 years, it reduces the maturity of that part of the German public debt from 10 years to zero (one day, to be precise). If short-term interest rates increase, the Bundesbank would make losses on its investment, but these losses should be offset against the gains the German Finance Ministry made by selling the bond.

This shortening of the effective duration of government debt could be substantial given that the Bundesbank is likely to buy about one-quarter to one-fifth of all the (publicly traded) German government (federal) debt over the lifetime of the EAPP. If the average maturity of the purchases of the Bundesbank is about six years, the effective duration

[5] Another special case is emergency liquidity assistance (ELA), which is granted by national central banks and all the losses or gains from ELA operations remain with the national central bank that granted it.

of German government debt (at least that which takes a publicly tradable form) would be reduced by 1.2 to 1.5 years.[6]

The weighted average (residual) maturity (WAM) of the bonds bought by the NCBs under the PSPP shows large cross-country differences. The WAM of the PSPP holdings of the Bundesbank is only about 7 years, whereas that of the Banca d'Italia is about 9.3 years. For Italy the reduction in average maturity would be even longer, about 1.75 years (0.25*9 years). Moreover, the extension of the asset purchase programme decided in December of 2015 by the ECB, implying that it potentially could buy up to one-third of the outstanding debt, would lead to an even larger effective reduction in the maturity of public debt.

In principle the ECB was supposed to conduct a unified monetary policy under which the short-term interest rate would be identical throughout the euro area. During the acute phase of the euro crisis, large and variable risk premia arose even on short-term rates across countries (i.e. banks and governments in different countries faced different short-term borrowing costs), but the policy was still unified in the sense that the terms under which 'normal' monetary policy instruments were implemented were the same across the euro area. This is no longer the case today, with 80% allocated to NCBs under the PSPP. This means that de facto each country (or rather each NCB) conducts its own QE programme, only broadly coordinated across the Eurosystem and under the guidance of the Governing Council.

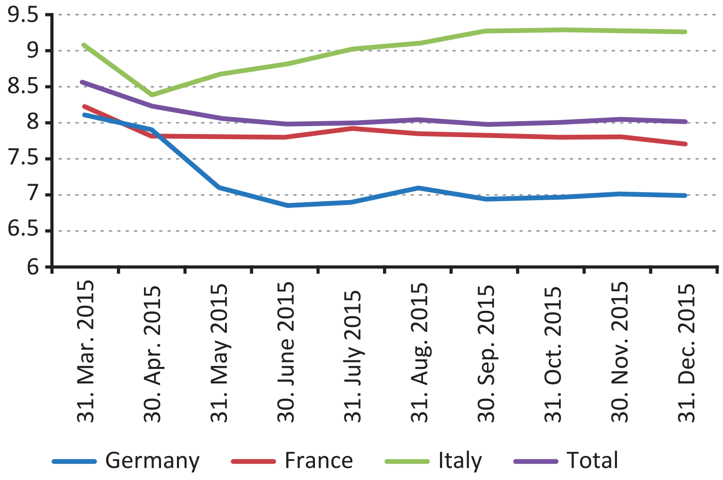
The de facto result is that monetary policy is no longer unified in the euro area.

QE is supposed to work by forcing the private sector to reduce its holdings of longer-term paper. What matters for the portfolio balance of the private sector is not just the amount of bonds, but also their average maturity. One measure would be the 'ten-year equivalent' or more simply just the product of the amount of bonds times their WAM. Under this measure one could argue that the purchases of the Banca d'Italia should have a much stronger impact on the market than those of the Bundesbank since the WAM of the purchases of the Banca d'Italia is about one-third longer than that of the Bundesbank (9.3 versus 7 years).

[6] The analysis of Greenwood et al. (2014) can thus also be applied in the context of the euro area. The authors argue that monetary and fiscal policies in the US have been pushing in opposite directions, with debt management policies offsetting partially the impact of monetary policy. However, this does not seem to have happened so far in Europe.

The difference in maturities bought by different NCBs can only partially be explained by the differences in the maturity structure of the outstanding debt, which, at about 5.5 years, is lower for Germany than for other euro -area countries. However, the average maturity of Italian government debt is about 6.5 years, only about 1 year more than that of Germany, and much less than the average maturity of the bonds bought by the Banca d'Italia under the PSPP. All NCBs are thus buying bonds with a WAM larger than the outstanding stock. But this is unavoidable given that only securities with a remaining maturity of more than two years are eligible under the PSPP.

Figure 1. Eurosystem holdings under PSPP – Weighted average maturity



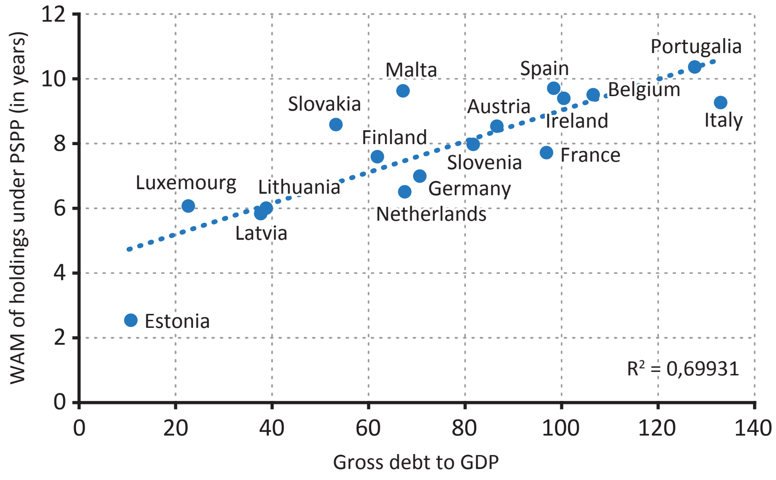
***Source**: Own elaboration on ECB data.*

As an aside, one has to note that the fact that 80% of the bond buying executed by NCBs on their own profit-and-loss account can be consolidated with the national public debt also implies that there is no economic justification for the 25% limit on each issue, which the ECB has set for the programme. The rationale for this limit was that the ECB (or rather the Eurosystem) should not have a blocking minority in case a government goes into default. Since 2013, all government bonds issued by euro zone members have collective action clauses under which a super majority of bond holders (75%) can decide to accept an offer of rescheduling or a haircut on the nominal value in case of a default. If the Eurosystem held more than 25% of any one bond issue, it could obstruct such a restructuring, which it would be obliged to do since, according to many, accepting a restructuring of its bonds would constitute 'monetary financing' of a government.

However, this reasoning does not make sense for a national central bank from an economic point of view. Whether or not a national central bank agrees to a restructuring of the debt of its own government makes no difference at all for the consolidated fiscal accounts of the country, as one can consolidate the NCB with the national Treasury.[7]

What is more worrying is that the WAM of the purchases made by NCBs of high-debt countries is high. The NCBs of countries with a high public debt (as a ratio to GDP) and those countries still facing a substantial risk premium are buying more at the longer end.

Figure 2. Gross debt to GDP (in %, x-axis) and WAM of holdings under PSPP (in years, y-axis)



Note: Cyprus omitted.

Source: Own elaboration on ECB and IMF data.

A priori there is little one can object to central banks buying large amounts of government (or indeed other) bonds during a period when inflation is too low and expected to remain so for a long time. The underlying assumption is that central banks will be able to sell these bonds with the same ease with which they bought them. However, this might not be the case.

[7] Moreover, the ECB has given itself a lot of leeway on this limit, which it seems to apply only to those issues that do contain a CAC. However, since the CACs were introduced only in 2013, the bulk of the outstanding bonds are still without a CAC. This will change gradually over time, at different speeds in each country given that the maturity distribution differs enormously. By the end of 2017 (four years after 2013), most government bonds available on the market will have these CaCs, given that the average maturity is in most countries around 6-7 years. But for the time being there are still substantial amounts of bonds without them.

Moreover, when the time comes to sell, the maturity of the bonds bought originally will matter. The longer the maturity of the bonds that central banks will have to throw on the market at some point in the future, the larger will be their exposure to changing market conditions. This applies of course in particular to countries where risk premia could return quickly, given that public debt remains elevated.

There is thus a clear danger that deep conflicts of interest will arise within the Governing Council when the attainment of the goal of price stability will warrant the unwinding of the purchases undertaken today.

4. Conclusions

Starting in early 2015, the ECB embarked on 'euro-style' QE, with its Public Sector Purchase Programme (PSPP). The ECB has been at pains to underline that it was formally just extending an existing asset purchase programme to government bonds. And ECB President Mario Draghi has emphasised that "asset purchases are unconventional, but not unorthodox" (Draghi, 2015). Given the limited impact these bond purchases have had so far on inflation the ECB then extended the scope and magnitude of its bond purchases the following year. But the parameters were not changed. In particular, most (80 %) of the bond purchases are undertaken by national central banks at their own risk.

A first key point is that given the low share of asset purchases subject to risk-sharing, the risks largely fall on the national central banks, not the ECB nor on the Eurosystem as an entity. This is a first indication that the PSPP is not a unified policy, but only a framework within which national central banks in the Eurosystem can, and do, pursue slightly different policies and aims.

A second point is that there are real risks, but they do not arise from default risk. The latter appears to have been overestimated. The key balance-sheet risk is that the purchases are financed by deposits whose rate is currently so low (minus 0.4% at present) that it can only go up in future. When this happens, in particular once monetary conditions normalise and the deposit rate return to its pre-crisis average of (plus) 2%, some national central banks might make large losses on their EAPP purchases. These losses will probably only materialise far off in the future, when the deposit rate has returned to more normal levels, since the purchases would be held at 'amortised cost'. If they were valued at market prices, the losses would become apparent as soon as long-term interest rates increased.

The Bundesbank in particular is paying a high price for avoiding the default risk on the bonds of other countries. It is only buying German government debt whose yield is on average more than half a percentage point lower than that of the euro area average. Conversely, the central banks of high-yield countries, like Italy, Spain and Portugal, will be much better off because the bonds they buy have a yield that is about 0.8-1% higher than the euro area average. Provided their governments do not default, they will thus earn about 10% more over the next ten years than they would have under full risk-sharing. This difference amounts to potential gains of €12 billion for Italy alone and a gain of about €3 billion or 1.8% of GDP in the case of Portugal.

A closer look at the fiscal implications of quantitative easing shows that it is actually (national) debt-management policy. In essence, the national central bank buys longer-dated government bonds in exchange for short-term deposits with the national central bank. This reduces the effective maturity of public debt. Countries with the highest public debt ratios are also those that buy the longest dated bonds, thus ensuring the largest reduction in the maturity of the public debt still outstanding with the public. This increases their risk should monetary conditions normalise or risk premia return.

A closer look at the economics of QE in the Eurozone thus suggests that it has resulted in reality in quasi-fiscal public debt operation with considerable differences across countries which might lead to considerable problems should financial market tensions return or if monetary policy had to be normalised rapidly. But these problems are abstract and might not materialise for a long time. This is why they have had so little impact on policy making today.

REFERENCES

Draghi, M. (2015), speech at the ECB and its Watchers XVI Conference, Frankfurt am Main, 11 March (www.ecb.europa.eu/press/key/date/2015/html/sp150311_content.en.html).

Greenwood, R., S. Hanson, J. Rudolph and L. Summers (2014), "Government Debt Management at the Zero Lower Bound", Hutchins Center on Fiscal and Monetary Policy at Brookings, Working Paper No. 5, Brookings Institution, Washington, D.C.

Gros, D. (2015), "QE 'euro-style': Betting the bank on deflation?", paper prepared for the European Parliament's Committee on Economic and Monetary Affairs, June (https://polcms.secure.europarl.europa.eu/cmsdata/upload/b83faa84-0dea-4288-8ac7-086ca04a7b0f/CEPS_Bonds_Purchase_MD_June2015_FINAL.PDF).

Gros, D. (2016), "QE infinity: What risks for the ECB?", paper prepared for the European Parliament's Committee on Economic and Monetary Affairs, January (https://polcms.secure.europarl.europa.eu/cmsdata/upload/333c07ed-671f-41b8-b799-2ec64b2c4ee4/CEPS_%20FINAL.pdf).

DÁNIEL PALOTAI

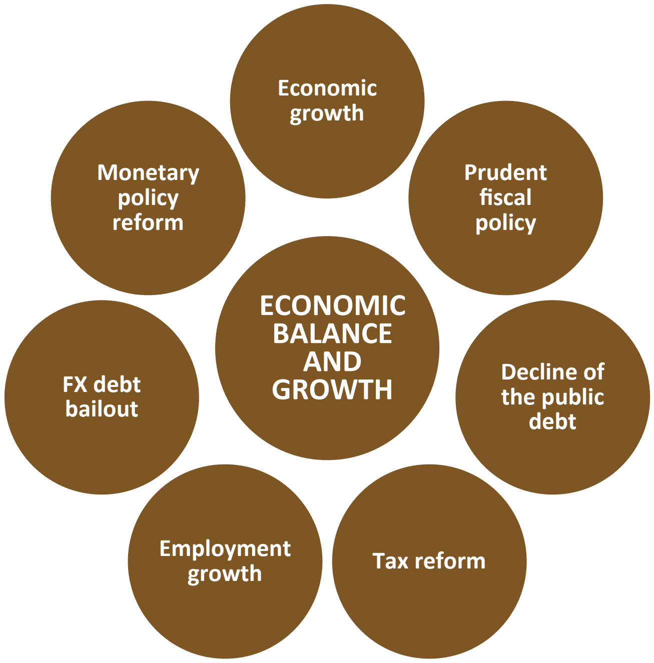
Executive Director and Chief Economist
Magyar Nemzeti Bank

A new approach to crisis management in Hungary

In this presentation I would like to briefly summarise some main factors of Hungarian economic policy and crisis management in the last 5-6 years. I would also like to highlight some of the challenges Hungary has faced regarding economic policy and point out how we have solved them. In my opinion, important lessons can be drawn from the Hungarian experience. First, I will briefly present the difficult starting position in 2010, then demonstrate the fiscal and monetary policy reforms, and finally emphasize the turning point in growth and employment.

We can say that the current crisis differed significantly from most other crises, except for the Great Recession, in at least one aspect. Most of the earlier crises hit only a single country or a group of countries, thus the affected country could rely on its exports and foreign demand helped to pull them out from the recession. But this crisis was global. We faced a **synchronised financial and debt crisis** accompanied by a plummet in potential growth all around the world, hence no country could rely on export markets. Also, due to inherited debt and fiscal imbalances, Hungary was forced to implement significant fiscal adjustment in spite of the negative output gap. **Conventional spending side measures were unavailable**, because if the government had tightened expenditures, then demand would have collapsed, which would have dragged on growth, and revenues would have decreased even more. This is a vicious cycle: more applied austerity is a drag on growth, resulting in a need for more austerity. To break the cycle, Hungary needed **innovative, unconventional measures to restore fiscal balance without having an adverse effect on growth**. The next part will highlight the fiscal and monetary reforms implemented in Hungary, and the results achieved.

Chart 1: Economic balance and growth



From 2010 the main goal of economic policy was **to achieve economic balance and growth** at the same time (realising goals presented on *Chart 1)*. What were the main characteristics of the starting point? Low growth, high indebtedness (partly in foreign currency), high taxes, low labour market participation rate, and before 2010 lack of political stability. A key realisation was that political stability had to be kept, as it seemed to be a prerequisite for successful crisis management in other countries. Furthermore, labour force participation rate had to be increased. Hungary had the second highest tax wedge in Europe, after Belgium, and one of the lowest labour force participation. Previously tax rates were increased to finance the cost of low activity, which led to even lower labour supply. In order to break this vicious circle and to foster employment and growth, the Government cut taxes on labour.

An additional trap in Hungary was foreign currency indebtedness. Normally, in a small and open economy, weak currency is good for exports, and supportive to growth. However, in Hungary it was the other way around because of the foreign currency indebtedness of both the government and household sectors. When the currency weakened the balance sheet, effects increased household monthly instalments on foreign currency mortgages, and that likewise dragged down consumption and growth. This trend had to be broken as well. Other key areas were handling of stock imbalances, high public debt, and high external debt, all of which could be unwound in a gradual manner only. Sectoral taxes were introduced, in order to involve those sectors in the fiscal consolidation which were in the healthiest shape after the crisis. Moreover, monetary policy was struggling with foreign currency indebtedness; also yields and risk premia required on Hungarian assets were high. These factors related to the situation that in those days the Hungarian government could not rely on the support of monetary policy.

The **fiscal reforms and their results** are well illustrated in the following charts. First of all, *Chart 2* shows the general government deficit since 2000. Even during the global boom in the 2000s, Hungary ran a primary deficit. Then when the crisis hit, even the interest expenditures of the government were more than the 3% Maastricht threshold as depicted by the blue bars. Only after 2010 did it seem the fiscal balance was on track, and since then the fiscal commitment of the government fructified and **primary surplus was sustained**. Moreover, as depicted by the blue bars, interest rate expenditure is declining likewise. This is partially due to the central bank's rate cuts, and also to that the MNB aimed to lower the long end of the yield curve supporting the government expenditures on the interest rate side.

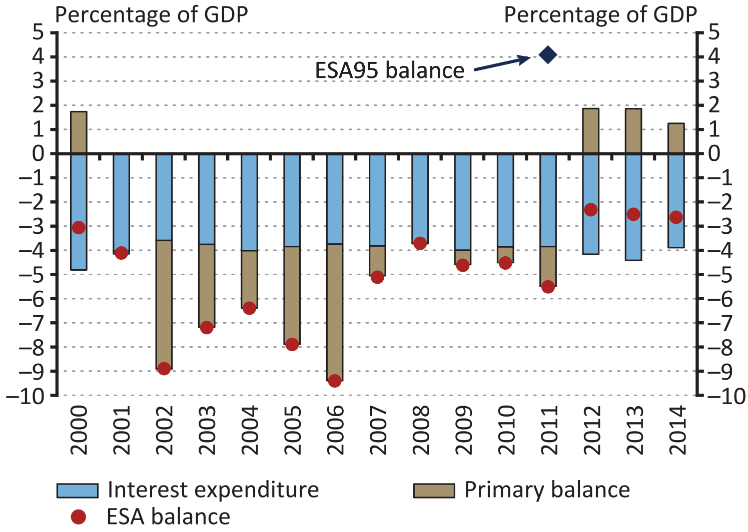
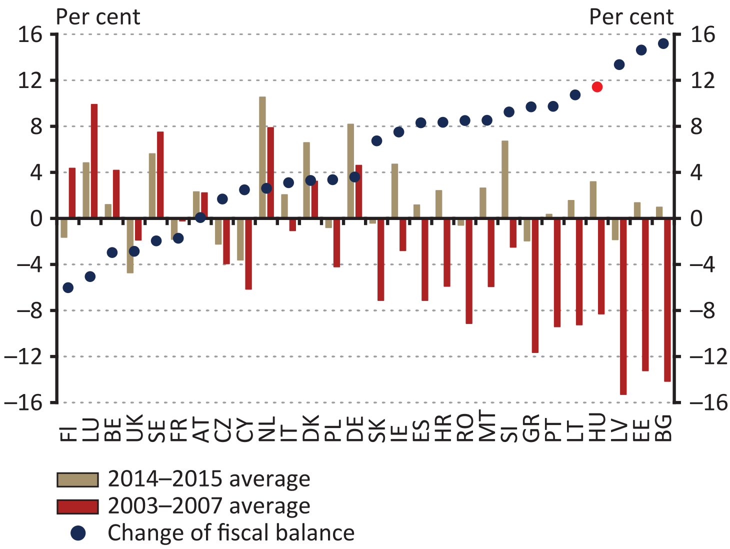


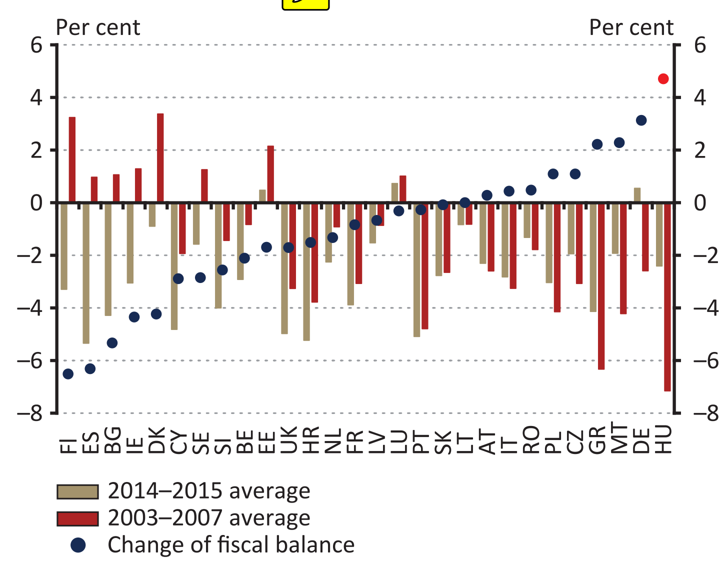
Chart 2: General government deficit had been reduced successfully

To put it into international perspective, as we can see in *Chart 3*, **Hungary has shown the most significant improvement in the European Union** in terms of external and fiscal balances. Regarding the current account balance Hungary accomplished the fourth largest adjustment in the EU. In terms of fiscal balance Hungary achieved the single largest fiscal adjustment after the crisis compared to pre-crisis period. As a result of the fiscal turning point, Hungary managed to get out of the excessive deficit procedure in which the country was since 2004 EU accession, meanwhile other member states are still struggling with getting their fiscal balances on track.

Chart 3: External and internal balances were improved substantially and permanently



Current account balance



Another new and innovative measure of the government was to make significant steps in order to **whiten the economy**. In Hungary the extent of the shadow economy was very significant (and despite the achievements, still is). The most significant measure in the fight against tax evasion was the introduction of electronic online cash registers in stores, which are connected directly to the tax authority. It increased the government's VAT revenue to an extent which previously had been achievable only by tax rate hikes. *Chart 4* shows that VAT revenue ratio to consumption expenditure increased in 2014 significantly without any increase in VAT tax rates, thus the additional revenue is fully attributable to the whitening effect of this measure. This measure also reduced distortions caused by tax evasion and helped to restore market competition among corporations.

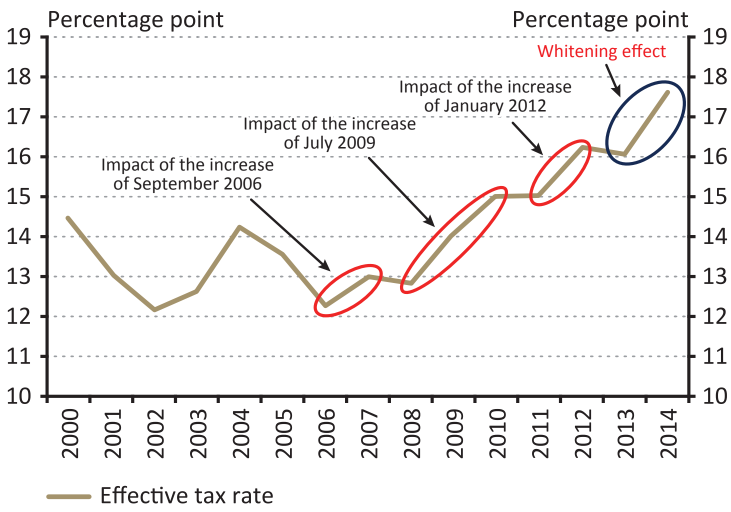


Chart 4: Effective VAT rate

All the aforementioned fiscal achievements (and the restoration of growth) led to a turning point in the public debt path. Public debt to GDP ratio increased significantly during most of the 2000s due to undisciplined fiscal policy. The debt to GDP ratio peaked in 2011 and started to decrease since then as a result of prudent fiscal policy and positive primary balance. *Chart 5* shows the public debt to GDP ratio on the left hand side scale that decreased to 75.3% in 2015, and is forecasted to decline even more substantially during the next years. At the same time, the foreign currency share within public debt evolved favourably too. During the crisis years the foreign currency share was exceptionally high, creating significant vulnerability in the economy. By this time the foreign currency share is declining towards 30% and forecasted to go below this figure next year. This favourable adjustment has been strongly supported by the central bank's self-financing program since 2014.

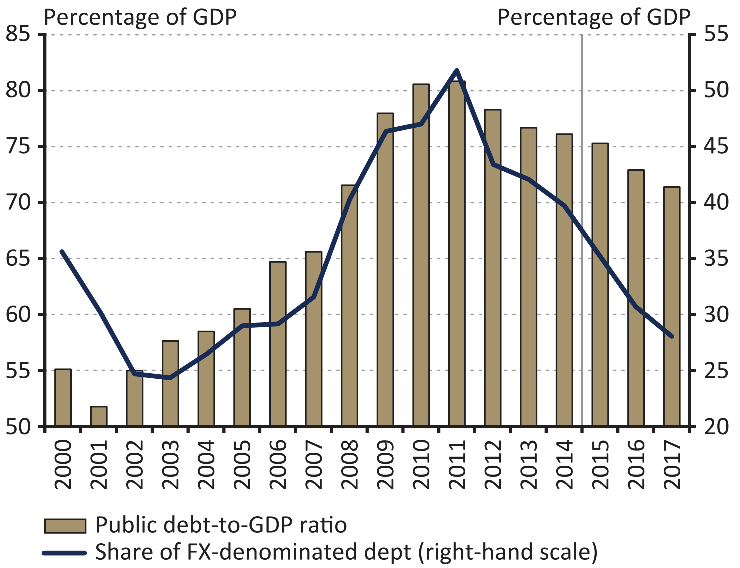


Chart 5: Debt-to-GDP ratio over the forecast horizon with falling share of FX debt

These changes culminated in an outstanding achievement displayed in *Chart 6*; Hungary **managed to reduce both public debt and interest expenditures** during the period of 2010 and 2015. On the contrary, in Club Med countries both interest expenditures and public debt increased significantly during this period. Public debt increased in the EU as well, however, interest expenditures decreased as a consequence of QE policies. Likewise, the six Visegrád countries followed similar trends as the EU.

Besides fiscal developments achieved in previous years, Hungary has also managed to implement successful **monetary policy reforms**. The central bank's easing cycle has substantially contributed to avoiding deflation in Hungary. The easing cycle started in 2012, and continued in two phases helping to lower yields in every sector of the economy. It has contributed significantly to the decrease of the government securities' yield curve both on the short and on the long end as displayed in *Chart 7*. Additionally, the self-financing programme has been also supportive in this adjustment.

Chart 6: Interest expenditures per GDP and public debt ratio

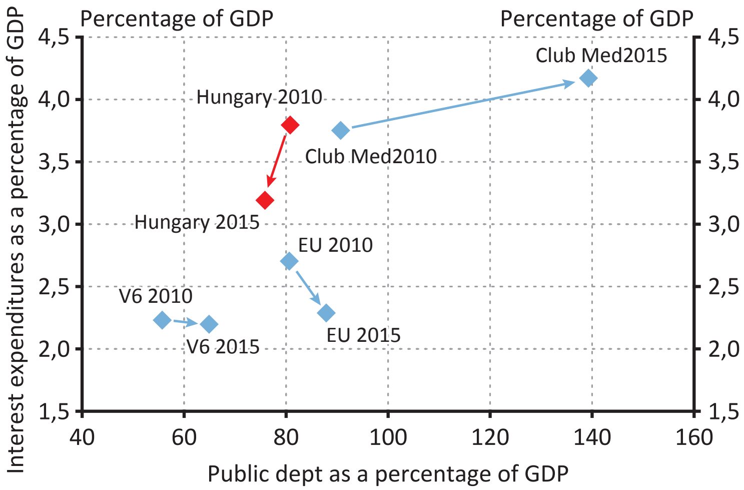
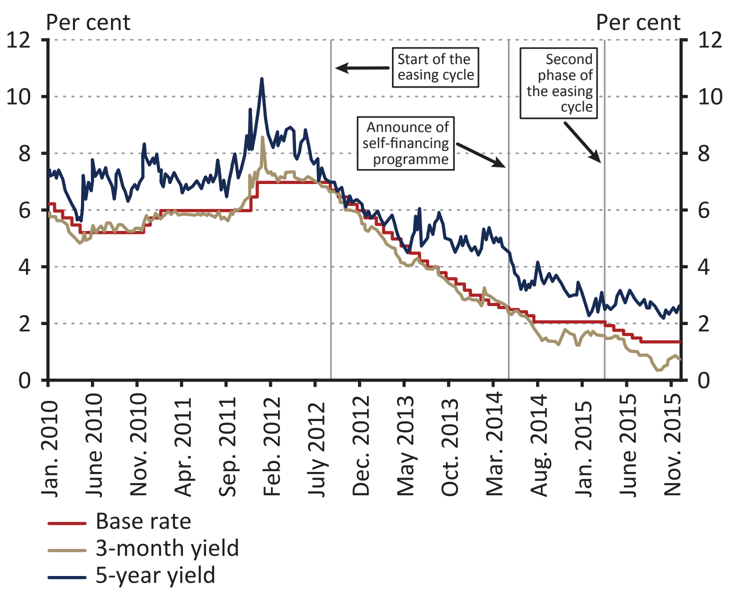
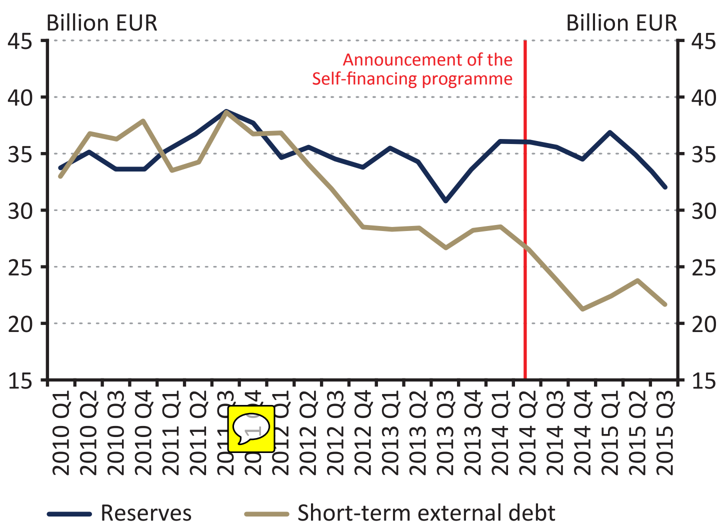


Chart 7: MNB self-financing programme's positive effect on government bond yields



Another new and unconventional measure introduced by the central bank was the **Funding for Growth Programme** that aimed at addressing bottlenecks in the SME sector. The program followed the Bank of England's initiative, but it was designed to deliberately target the SME sector. The MNB managed to get financing for 31,000SMEs, and thereby avoid the otherwise unavoidable credit crunch in this segment. In terms of the extent of its contribution to lending and economic growth it is probably the most successful programme of its type worldwide.

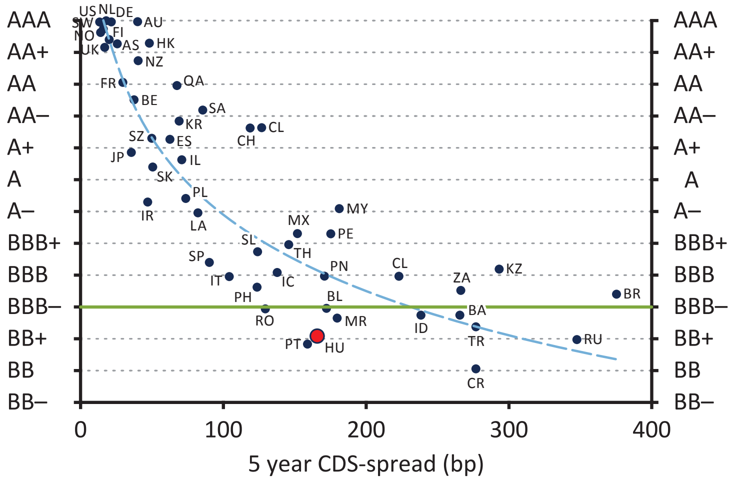
Chart 8: Self-financing plan reduced vulnerability



The **central bank's self-financing programme has also substantially contributed to reducing external vulnerability** in the economy. The programme intended to decrease gross external debt, meanwhile supporting the central bank's excess reserves reduction likewise. As displayed in *Chart 8,* the self-financing programme supported Hungary to be able to refinance its maturing external FX debt from domestic sources.

The central bank's balance sheet was also among the key achievements in Hungary during the last years. In 2012, when Hungary was just one step from the EDP (Excessive Deficit Procedure), the European Commission argued that the planned structural measures would not be sufficient, as they expected the central bank to make a loss close to 0.7% of the GDP. Therefore, the Commission recommended further structural adjustments, even though that would have curbed the fragile growth environment. Then even in this situation, the new management of the central bank succeeded in getting the bank's profit and loss statement back to positive territory.

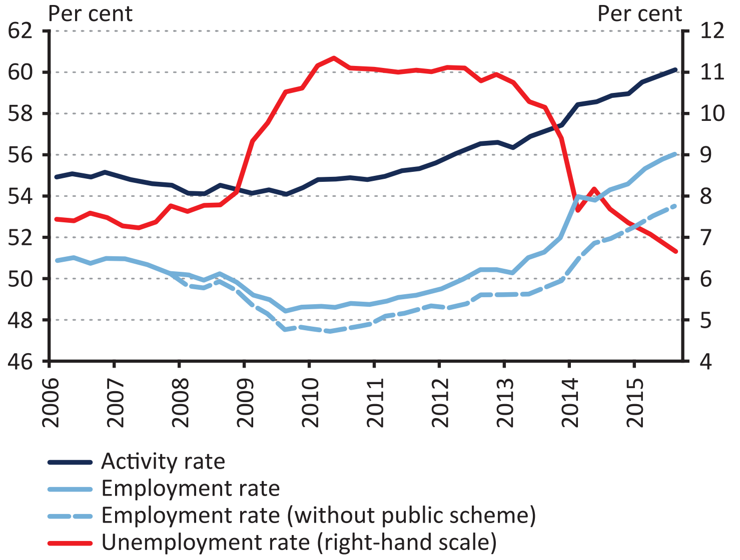
Chart 9: Hungarian CDS-spreads consistent with CDS-spreads of investment grade countries



The implemented reforms were acknowledged by markets, though, so far not by rating agencies. *Chart 9* presents the average rating of the three largest rating agencies and the 5 year CDS-spreads indicating the market perception of risk level. Countries along the curve have their ratings more or less in line with the market assessment of their risk level. Hungary lies far off the curve, which means that it is priced much more favourably by markets than rating agencies. The forward looking indication of this phenomenon is that rating agencies will probably follow the curve and upgrade Hungary to investment grade in the next quarter.

Last, but not least there was an exceptional **turning point in growth and employment** during previous years. Contrary to the previous trend, during the last three years growth in Hungary systematically exceeded the EU average that the MNB hopes to maintain for the following years as well. Moreover, a key reform of the government to cut taxes on labour and increase taxes on consumption, which is less distortionary, bore fruit. As *Chart 10* shows the **activity rate is going up significantly, while the unemployment rate has decreased below pre-crisis level**. Although Hungary is often criticized for the fact that employment is increasing because of the public work scheme, employment is going up steadily even when the public work scheme is excluded. Therefore, we can conclude that the private sector is also benefiting from the implemented structural reforms.

Chart 10: Growing activity, decreasing unemployment



The key to success is having economic growth and balance at the same time as opposed to the previous recipe, where one had to choose between economic growth and economic balance. Hungary managed to have growth, and the structural reforms achieved their goals which were also confirmed by the European Commission's latest assessment on vulnerabilities. We could celebrate, but it's too early as we have not arrived to the end of the road. Hungarian competitiveness still needs to be increased in the longer run in order to achieve sustainable convergence towards the European Union average. This is what Hungary is currently working on and we hope to present new results in the years to come.

NIELS THYGESEN[1]

Professor

University of Copenhagen

Was monetary union created too early?

Alexandre Lamfalussy and the timely preparations for EMU

It is an honor as well as a great pleasure to have been invited to the 2016 Lamfalussy Lectures, not least since the topic the organizers have assigned to me is one where the role of Alexandre Lamfalussy looms larger than those of any other individual. As a member of the Delors Committee on Economic and Monetary Union (EMU) in 1988-89 and the efficient host of its meetings, he made several significant contributions to the early outline of EMU, notably to its underpinnings in national budgetary policies, and to an understanding of the less than reliable role of financial markets in monitoring national policies. He argued for a rules-based procedure as a basis for this monitoring, but also for European policy coordination to achieve an appropriate aggregate budgetary stance – a proposal which has recently been revived in the Five Presidents' Report, Juncker *et al.* (2015).

Towards the end of our meetings in the Delors Committee Alexandre became concerned that the preparations for the EMU outlined by the Committee had focused too much on the final stage with a single currency and a central bank and not enough on the transitional stages. He feared we might never get to the final stage, finding it unlikely that one could move directly from a decentralized system in the transition to a well-functioning and fully centralized European System of Central Banks. To remedy this defect he proposed an ingenious scheme for sharing operational experience among the national central banks prior to the final stage, while leaving decision-making at the national level. His proposal did not find favor with several members, but by a strange twist of history, a few years later Alexandre was put in charge of the European Monetary Institute to prepare for the final stage. He performed this central task so well that the transition to the single monetary policy in the ECB went very smoothly, hence proving his own earlier pessimism excessive; his careful work in fact substituted for the shared operational experience. Alexandre made it possible to answer the question in the title

[1] Professor (emer.) of Economics, University of Copenhagen; Member of the Delors Committee of Economic and Monetary Union 1988-89, An earlier, preliminary version appeared in Thygesen (2016)

of my presentation with confidence: monetary union was started only after careful economic and monetary preparations – and not too early.

Nevertheless, many Europeans today ask the question why the European Community – as it was a quarter of a century ago – chose the bold and, in principle irreversible, strategy of going for an Economic and Monetary Union (EMU), at a time when a number of political and economic issues had not been resolved, or even anticipated. For someone like myself who had the privilege of being involved in the early efforts of preparing for the EMU, the answer is both simpler and more positive as regards the future than most inquirers imagine: I believe there was both a strong economic case for moving towards a single currency and a rare political opportunity for deciding on it around 1990; the combination was crucial and it is arguable that, had no decision and timetable been agreed on, the opportunity to decide and implement later would not have been available. I stick closely to the question posed to me by the organizers regarding the timing of the initiative, trying not to drift into the more general issue of whether the EMU should have started at all, but focusing largely on why it was decided to take the decision 25 years ago.

Many, probably most, economist colleagues who have been critical from the start and have sharpened their attacks over the last decade of disappointing experiences, think that the economic case in favor was also weak then and that the decision was taken strictly on political grounds, which would now have the appealing consequence of absolving the economics profession from direct responsibility. That would, in my view, be a serious misinterpretation of the basis for the decisions at the Intergovernmental Conference which prepared the Maastricht Treaty throughout 1991. I start with what I see as the main economic arguments at the time, see also Gros and Thygesen (1992) for a contemporary assessment, moving subsequently to the favorable political environment and, finally, to some issues related to economic union and to financial stability that were either unresolved or largely unanticipated in 1990. As to these latter issues, there was around 1990 a coincidence, fortunate for the realization of the EMU, that no strong economic case was made for taking steps that would in any case have been politically infeasible. This third set of factors, besides the economic arguments and the general political tailwinds favoring integration, reinforces, as I see it, my thesis that the process of planning for and implementing the EMU was not too early, but “just in time”.

Three main economic arguments for the EMU – important at the time

The *first* argument in favor of the EMU was the link to the single Internal Market. The European economies performed poorly with high inflation and low growth for more than a decade after the first energy crisis of 1973-74 had ended a long boom. That crisis, at the same time, undermined any hope that Europe could move towards advanced monetary and financial integration with strong elements of also fiscal integration — outlined in the 1970 Werner Report for implementation over the course of the decade up to 1980. But very gradually the preconditions began to come together in the course of the late 1970s and the first half of the 1980s: progress in stabilization was observed, admittedly from a low starting point, and monetary coordination was strengthened with the set-up of the European Monetary System (EMS) in 1978-79 which brought France and Italy back from their experiments with more flexible exchange rates; only the United Kingdom remained outside the EMS. Finally, comparisons with the United States, Japan and other successful parts of the world economy over the early 1980s regenerated European ambitions for growth.

Momentum in the European debate was restarted by the initiative of the incoming Delors Commission in 1985 to move towards a Single Internal Market for goods in the European Community (EC) over the following seven years. Returning to the ambition of two decades earlier to push for monetary integration seemed to many a natural complement to building the Single Market. Obviously, free trade does not require the full elimination of national currencies, but there was a widespread perception that it would be unrealistic to go through detailed implementation of hundreds of pieces of legislative initiatives to deepen the Single Market while retaining the possibility of a sizeable sudden shift in competitiveness associated with occasional realignments between European currencies. Large industrial enterprises in Europe strongly supported the perceived complementarity of market and currency unification, pointing to sizeable expected efficiency gains in their pricing policies and financial strategies. And most governments were supportive of the positive impact of a single currency on competition through greater transparency.

Acceptance of these arguments went well beyond the ranks of policy-makers and industrialists. Organized labor in Germany as elsewhere, keen on assuring a smooth rise in real wages, disliked the uncertainties for wages and jobs associated with shifts in competitiveness due to exchange-rate changes vis a vis close European trading partners. A much superior protection of real wages would be within reach if exchange-rate movements were constrained more firmly than in the past — and ultimately eliminated.

Some success in this direction had been achieved within the EMS, which had narrowed exchange-rate movements considerably by the late 1980s. After a shaky start in 1979-83, associated with the policy experiments in the first two years of the Presidency of Francois Mitterand in France, convergence of major macroeconomic indicators, notably price and cost trends, had become observable — more advanced in France and some of the smaller member states than in Italy or in the then three newest member states (Greece, Spain and Portugal). Eliminating exchange-rate adjustments among the now twelve member states (since the start of 1986) no longer looked totally infeasible over a medium-term horizon.

Second there was also an external argument in favor of the single currency which commanded broad support among policy-makers: the EMS had not protected the participating currencies well against the massive disturbances over the 1980s from swings in the oil price and in the dollar. As the US economy was exposed to sharp monetary tightening and expansionary fiscal policies early in the decade, the dollar appreciated strongly, and that in turn required brutal adjustment when the dollar had, by 1985, become overvalued to an unprecedented extent. When the dollar was weak (strong), the Deutsche Mark (DM) became excessively strong (weak) within the EMS, leading to pressures for realignments that were unwarranted by developments within Europe.

The year 1987 can, in retrospect, be seen as watershed; in January of that year a (small) realignment – the last one prior to the decision on the EMU – was triggered by international financial market pressures, not by genuine disequilibria within Europe. In November renewed pressures once more exposed the vulnerability of the Franco-German currency relationship, but it was saved by the two countries moving interest rates in opposite directions. I remember Alexandre's surprise and positive assessment of this achievement, but also his concern that it was unlikely to be repeated. An evolution beyond the EMS would be needed to preserve stable exchange rates within the area, which remained an aspiration for Europe.

This type of widely shared acknowledgement of the coming to the end of a useful, but increasingly fragile EMS, was reinforced by a change in German perceptions which has often been overlooked. In global fora Germany was increasingly seen by the late 1980s as *the* European voice due to her leading role in the EMS, but Germany was becoming less and less comfortable with exposure to strident admonishments, notably from the United States, and more ready to consider sharing the role of whipping boy ("Prügelknabe") with other Europeans. France, in particular, was anxious to seize this opportunity, long sought at the bilateral level, but now apparently realistic at the level of the EC.

A *third* economic argument played a role in supporting the idea of moving beyond the EMS : orderly management of realignments of central rates in particular, had been facilitated by residual capital controls, still in existence in France, Italy and Belgium. But the Single Market was also designed to create a unified European financial market in which national currencies and the policies underpinning them would be competing and hence exposed to "market discipline". When the "weaker" economies finally agreed, in June 1988, that they would eliminate all remaining restrictions on short-term flows in the near future, Germany (and the Netherlands) acknowledged that the EMS would become (even) more difficult to manage. It was no accident that two weeks after the decision to scrap residual capital controls by 1990, there was agreement at the Hanover European Council in June 1988 to set up a Committee to study how an Economic and Monetary Union with a single currency could be implemented in stages – named after Commission President Jacques Delors, nominated jointly by Germany and France, to direct the study. The financial dimension of the Single Market also helped to clear the path for the single currency.

The combination of the three above arguments, based on (1) a perception of complementarity to the ongoing implementation of the Single Market, (2) a desire to diminish the vulnerability of the structure of national currencies, experienced over most of the preceding decade and a half, to external disturbances, and (3) a realization that free capital flows within the EU could better be handled by a unified currency area, made a strong economic case for the project of a single currency — and one generally accepted by both France and Germany. This was the common economic rationale for a broader compromise on how to proceed; without this basis we could not have seen an agreement to move towards the EMU, no matter how desirable that may have seemed on strictly political grounds.

Looking at the three economic arguments with the benefit of hindsight, they still appear largely convincing – at least to me. A counterfactual analysis of where the EU would be today without the single currency can never be counted as evidence, at best as suggestive. But try to reflect on the most likely counterfactual scenario by raising a couple of questions: Would the Single Market have survived the turmoil of German unification and speculative attacks on the EMS — which all happened shortly after the Maastricht Treaty had been signed — without the prospect of a single currency on the horizon? And would the Single Market have proved resilient in the face of the crises from 2008 onwards?

The current UK referendum debate on EU membership regards monetary unification as an unfortunate distraction for Europe, unnecessary for and unrelated to the fate of the Single Market. But surely the answers to both questions are closer to a No than to a Yes. Similarly, monetary union with a single currency and central bank has made participating countries less vulnerable to centrifugal external disturbances than they would have been even under a well-functioning EMS. Finally, eliminating national currencies has reduced the capacity of capital flows within the area from driving member states apart, though not to the extent hoped for – as the experiences of the reversibility of such flows between creditor and debtor countries in 2010-12 showed.

The argument that the Maastricht Treaty on the EMU had no valid economic rationale is, in my view, highly questionable. But arguments of the kind just made would not have been enough to trigger the process of moving towards a single currency. There was significant help from political tailwinds in favor of more integration around 1990 to which I now turn.

Political tailwinds and the role of German unification

Among those who see the decision to move towards the EMU as an almost entirely political project with limited economic justification there is a great affection for the thesis a "grand political bargain" at the origin of the Maastricht Treaty. This presumed bargain was a German acceptance of giving up the national currency in return for support from European partners for unification. The thesis is especially popular in political circles in France and among political scientists; both groups are attached to the notion of the primacy of politics over economics. No one could dispute that the massive political changes in Central and Eastern Europe, of which German unification was the fastest and most dramatic manifestation, had important implications for other developments within Europe at the time. But there are two problems with the thesis of the grand bargain.

The first problem is a simple one of timing, see also James (2012): planning for the EMU had started well before even the most imaginative observers had anticipated political upheaval to the East. The European Council had clearly stated its intention of moving towards the EMU at the June 1988 meeting in Hanover, and it accepted one year later the outline prepared in the Delors Report (1989) of how to proceed in stages.

When the Berlin Wall suddenly fell in November of that year, EC governments had done further technical work on the outline to assure that Ministers of Finance were also in agreement; these preparations were the essential precondition for announcing in December 1989 that an Intergovernmental Conference on EMU – the final operational proposal in the Delors Report — would be called at the end of the following year.

The second problem with the grand-bargain thesis is the more fundamental one that German unification did not need the support of Germany's EC partners. The process had too much momentum and support where it mattered the most – from the US and the Soviet Union –for the Heads of State and Government of the three largest members states after Germany, President Mitterand and Prime Ministers Thatcher and Andreotti, or other EC skeptics to even slow it down. Chancellor Kohl and Foreign Minister Genscher could be confident that this was the case, but they did show understanding that the perceptions of their partners that a unified Germany might become more dominant required confirmation of Germany's commitment to Europe.

While the notion of the grand political bargain lacks credibility, there was a more subtle and drawn-out impact of German unification on the speed with which the EMU was implemented to start less than seven years after the signing of the Treaty, highly surprising to even the best informed, such as Alexandre. This impact came through two channels.

First and, contrary to the assumption of France and other EC countries, unification added a massive burden to German public finances and international competitiveness. For more than a decade unified Germany had an external as well as a public sector deficit, turning Germany into a softer guardian of budgetary orthodoxy and an advocate of easier monetary policies than had been expected. The fears of France and others of German dominance proved exaggerated – for some time.

Second, in addition to this important channel, another one opened via the political debate in Germany. Attention was absorbed by all the challenges of unification, even more significant and urgent than those related to future European integration. Debate on the *pros* and *cons* of the EMU has to wait. Chancellor Kohl was criticized, towards the end of his term in 1998 and after, for not having engaged in this debate, particularly since he had signed up for automatic start of the EMU by 1999, regardless of how many participants were ready. Concerns were voiced by senior officials when it became likely in 1996-97 that there might be several more members in the final stages than expected, but at that point it was too late to tighten the admission criteria. The really critical debate on the EMU came in Germany only after 2008.

Hence strong political tailwinds, facilitating the decision to launch the EMU and then to implement it fast, came both from Germany's economic performance and from the domestic debate; an emergence of economic imbalances and a domestic focus which made it more difficult to raise the bar for admission to the EMU beyond what had been signed up for at Maastricht.

But there was an even stronger political tailwind inherent in the compromise on the EMU, struck in the Treaty. It was an outcome that allowed both of the main protagonists, Germany and France, while agreeing on the main economic arguments in favor listed above, to claim they had won. It is natural to focus on the two, since the other EC countries either lined up behind one of them or were amenable to any compromise that had the support of both. The conflicting, though not irreconcilable, differences of emphasis embodied in the Treaty can be illustrated from two complementary perspectives.

First France, could present the EMU as the way to "share monetary leadership in Europe with Germany". The core of truth in this ambition is that the overt past leadership of the Bundesbank in the EMS would disappear; this became even more obvious when the principle of "one man, one vote" for monetary policy decisions in the future ECB was adopted – on the recommendation of the President of the Bundesbank during the Maastricht negotiations. France can claim that this "sharing" has become very visible, not least in recent years when German views have on several occasions been outvoted in the ECB Governing Council.

In *Germany* the future single currency was presented as the inheritor of the Deutsche mark, embodying the qualities of German economic policies, notably a "stability culture" of low and stable inflation. Not all German officials were convinced that such an outcome had been assured, but they were sufficiently flattered that their principles of an independent central bank, guided by medium-term price stability as the primary objective, had, finally, been explicitly recognized, that they did not oppose the positive approach of their government. Such considerations certainly prompted the President of the Bundsbank to sign the Delors Report in 1989.

These national perspectives were overstated vis a vis the general public in the two countries. President Mitterand omitted two inconvenient facts: "shared monetary leadership" implied looking only at the collective, not the national interest and France would be represented by its national central bank, not subject to instructions from the government; the notion of an independent central bank never appealed to France, as statements from leading politicians have continued to illustrate right to this day. And the German government, in presenting the case that the EMU was fully compatible with the German Constitution at the time of their belated ratification of the Treaty in 1993 used very idealistic terms. Indeed, the differences of emphasis in national presentations made one wonder whether the two countries were joining the same club.

My main point remains that the compromise was a constructive one by allowing both of the main protagonists to claim some form of victory, hence generating political tailwinds. Unfortunately, the compromise was twisted into incongruent shapes in early presentations to national electorates, and this has lingered on since.

Second, the EMU tried to reconcile the different positions on sequencing – the right order in which to advance European integration – and on the proper balance between national responsibilities and European solidarity. Well-known positions from two decades earlier reappeared: the German preference for delaying monetary unification until a late stage in economic and political — though not fiscal/budgetary — unification, the so-called "economist" view, versus the French preference for using monetary unification as a catalyst early in the process, the so-called "monetarist" position. The Werner Report of 1970 had fudged the issue to some extent by referring to the need for parallelism, and there are traces of the same in the Delors Report, though the latter was a bit more precise in describing some characteristics of an economic union – the Single Market, regional policies, intensified competition policy, and minimalist rules for national budgetary policies. At least the latter could be seen as part of a political union, though Germany did not obtain the firmness of rules and the attached sanctions it asked for. At Maastricht it would be fair to say that France won the point that monetary union would come relatively early; the firm date of 1999 for starting the EMU settled that, although the admission criteria to the final stage also had to be met by prospective participants.

The price of this French "victory" with respect to sequencing was, however, a largely German design of the EMU, in particular as regards the balance between national responsibility and European solidarity. EMU is, as its founders were fond of saying, *sui generis,* unlike any existing national federation. Only monetary policy was to be centralized; all other instruments of economic policy were to be left in national hands, though, in the case of national budgets subject to (relatively lax) rules. This extensive freedom for national actions was seen as a fair and operational package: assuring monetary stability while observing the principle of subsidiarity, i.e. that all important non-monetary decisions should be taken as close to national electorates as possible. The EMU was to rest more on national responsibility for conducting stable policies than on appeals to European solidarity.

Whichever way one looks at the outline of the EMU embodied in the Treaty, it bears the mark of a genuine compromise. It was an optimistic one in the sense that it assumed much of the cohesiveness among participants who would be sustained via the greater transparency and discipline of sharing their currency. That would make firms, unions and governments more aware of the need to keep national prices and costs on trends parallel to those of partners in the EMU; and it would make governments anxious to avoid the risk of losing access to international financial markets in the absence of a safety net, though some critics found such anxiety too remote to substitute fully for the disappearance of the risk of facing a traditional foreign exchange crisis. Hence rules on upper limits to public sector deficits had to be part of the framework and reinforce or guide market discipline, but they could be relatively mild; the EMU would require some room for maneuver in national budgets, as changes in the interest and in the exchange rate were no longer available for stabilization.

On the whole, this compromise could not be dismissed as unworkable; that was a change from the Werner Report of 1970 which contained a politically unrealistic and economically unnecessary degree of centralization of all macroeconomic policies. This time both the economics and the politics looked more propitious for implementation. The impression of a promising mixture of political tailwinds for European integration in general and a well-crafted compromise vision for the EMU in particular added momentum to planning and implementing the EMU.

Omissions and weaknesses in the original vision of EMU

There was no shortage of criticisms of the EMU when it started, and there has been a crescendo since 2008 of analyses concluding that there were serious fault lines which should have been corrected before the single currency appeared. From this perspective, monetary union was certainly started too early. It will be clear from the above that I do not share that view; European and national policy-makers seized the opportunity of a coincidence of good economic arguments and generally positive political views about what had once more become achievable in Europe. Had the original intentions and compromises been strictly observed, the EMU would have withstood the crisis from 2008 onwards, and, in particular, the sovereign debt crisis from 2010, in much better shape. But the design proved too weak to withstand divergent pulls from national policies; in hindsight it is clear that both rules and institutions should have been strengthened by more forceful, but also more flexible, fiscal rules, by a wider monitoring of imbalances — macroeconomic, and not only fiscal – by a public safety net for crises, and by more emphasis on joint responsibility for financial stability; the relatively narrow – "purist" – mandate for the future central bank should have been extended into some of these areas.

Should the founders of the EMU have waited to settle at least some of these issues? I would argue that some of the challenges that have arisen were genuinely impossible to foresee, and that others were best dealt with on the basis of accumulated experience, though in some cases more speedily than actually occurred.

The previous section dealt already with what has become the headline for most of the subsequent criticism: the EMU was a lopsided construction, centralizing only monetary policy, while leaving national governments in charge of fiscal/budgetary as well as structural policies. This was, as hinted at, quite a deliberate omission; there was and is no convincing economic case for centralizing these other macroeconomic policies, though a member state which loses its access to international financial markets will have to accept a clear loss of sovereignty, also in the sense of finding itself unable to fundamentally modify agreements made with its creditors. Some of those who were initially the most critical of the absence of EU authority over the aggregate stance of fiscal policy, have begun to accept that here is an area where a questionable economic case coincides with maximum political resistance, see Eichengreen and Wyplosz (2016), and that it will have to be accepted that fiscal policy will remain almost entirely national. The monitoring of national non-monetary policies has become more intense, trying hard to combine rules for longer-run sustainability of public finances with some short-run flexibility, changing the firm rules of the Treaty into an ongoing negotiating process between the national and EU levels and relying increasingly on the structural (cyclically-adjusted) rather than the actual deficit. This shift was already discussed 25 years ago; it could only be brought about in the light of experience and improvements in the tools of analysis.

There was no doubt excessive emphasis on public finances as the only, or at least, main source of imbalances. Current account imbalances were seen as less significant in a monetary union, if they were largely due to imbalances between private investment and saving in a country. The latter type of imbalances proved to be very important in a few cases in the recent decade; arguably the main improvement in monitoring since 2010 has been the so-called macroeconomic-imbalance procedure – though the latter requires more of the firmness built into the monitoring of public sector imbalances to become effective as intended.

A more permanent public safety net for governments that have lost access to external finance has only become necessary because – so far – four EMU participants had that experience by allowing imbalances to grow very large. Even members of a monetary union may need longer-term financial support; in the Treaty it was envisaged that this could only happen to EU countries outside EMU. The European Stability Mechanism (ESM) is another example of a reinforcement of the framework, the need for which could not have been foreseen by those who drafted the Treaty.

Joint responsibility for financial stability at the European level is another addition to the EMU in recent years. At the time the Treaty was written, banking activities in Europe were largely national and no banking crisis had been experienced recently by any of the 12 EU Member States. To the extent concerns about financial instability were discussed, they were seen to have arisen at the global level and to be the responsibility of international regulators; the Basel I guidelines were being drafted at the time. Most EU countries were in the process of buiding up national supervisory authorities and saw EU initiatives as an undesirable complication. The central banks were not anxious to take on supervisory tasks, and they felt generally well informed. Nevertheless, a small window of opportunity was – fortunately as it turned out – left in the Treaty for the ECB to take on more of a role in supervisory activities than a purely advisory one, should the need arise. This was the opportunity seized in 2012 when the banking union reached the EU agenda. Having a single supervisor, harmonized rules for bank recovery and resolution, and hopefully some elements of joint deposit insurance is the major step towards risk sharing that was lacking for a financially integrated EMU, a step that can be seen as more important than the steps toward fiscal union which have come under discussion.

The final criticism of the Treaty provisions has centered on the narrow, almost "purist" mandate for the ECB which reflects the concerns that dominated at the time it was formulated: keeping inflation low and stable in the medium term, and protecting the coming central bank from pressures to depart from a prudent policy. Such pressures might come from three sources: the rest of the world, the government and the financial sector; so the Treaty built up defenses against all three. The exchange rate of the single currency was to be flexible, liberating the ECB from intervention obligations, effectively giving the ECB a veto on the development of an exchange-rate strategy; there were prohibitions on direct financing of public sector entities and no lender-of-last-resort function vis a vis governments to protect monetary policy against the risk of a resurgence of "fiscal dominance"; and the ECB was to have only an advisory role in financial supervision and an arms-length position in rescues of banks and other financial institutions, requiring important injections of liquidity. The ECB was to become an exceptionally focused institution, more firmly isolated than other central banks from events that could throw a steady, medium-term monetary policy off course.

On the whole, the design has in my view proven to be more durable than impressions may suggest. One protective mechanism remains intact: currency interventions have been very rare; the ECB has not had to face serious conflicts between internal and external dimensions of monetary policy because the euro did not undergo the long cycles of major amplitude of the Deutsche Mark before the EMU.

But the other two perceived threats to monetary autonomy have materialized. The crippled state of national public finances and the consequent absence of scope for national fiscal policies after the crisis have given the ECB a major role in sustaining demand and that role has been assumed through major purchases of public bonds, but, in the latest and largest version, the Asset Purchase Programme since January 2015, carefully avoiding actions in special favor of individual countries – an important reason why the ECB mandate was made restrictive. The ESM, the need for which was unforeseen under the smooth policy scenario envisaged at Maastricht, was set up in 2012 to take the ECB out of the front line in crises. This step and the attention to creating a banking union allowed the ECB to announce Outright Monetary Transactions (OMT), a commitment to purchase sovereign bonds with exceptionally high interest rates — provided the issuer had negotiated an adjustment program with the ESM. Not a single bond has been purchased by the ECB as part of OMT, but the impact on interest rate spreads proved decisive in reducing them to levels more compatible with long-run sustainability of public finances than the panic-levels observed, as redenomination risks developed.

Finally, the ECB has become heavily involved in the supervision of individual financial institutions, as this proved the only way in which a single supervisor could be set up, as already mentioned above, one might take the opening for this institutional solution in the Treaty as a rare example of foresight by the signatories. But the ECB has, to a large extent, remained fully protected against engaging in major rescue operations partly by higher capital and liquidity requirements for banks, partly by the principle of "bail-in", i.e. that major losses will be met by creditors, possibly by large depositors, of a failing financial institution. The residual responsibility for restructuring will be funded through the Single Resolution Mechanism which is part of banking union.

My main point is that the ECB has preserved, or even reinforced, its strength as an independent central bank which has been a badly needed asset in the responses to the crisis since 2008. To an even larger extent than foreseen when the Treaty was drafted, the ECB has emerged as the only operational institution at the European level, as a consequence of the inability of the participating countries to agree on the proper use of other, notably fiscal, policies. That is not a situation which the ECB has aspired to; independence is not another term for being alone on the policy stage, as Padoa-Schioppa (2004) put it.

Conclusions

This article began by asking why it became possible a quarter of a century ago for the then 12 Member States of the European Community to agree on moving towards a single currency for most of them. In contrast to a number of other observers, I argue that there were solid economic arguments, and that grand political bargains played a subsidiary role – but that the political circumstances for implementation were (unusually) propitious in the late 1980s and, particularly, in the 1990s, during the run-up to the introduction of the single currency.

There were clear omissions in the framework agreed upon, some deliberate, some due to an understandable lack of foresight. There was excessive optimism regarding the ability or willingness of national governments to accept the constraints of being part of a single currency area and more basic disagreements of what kind of fiscal underpinnings were required. Some omissions have been repaired, though not the fiscal issues. The ECB was set up as a remarkably independent central bank – and it has remained so, despite the major role it has taken on in sovereign bond markets and as the single supervisor of Europe's major banks; new features in the institutional set-up have preserved its central monetary role. But too many tasks have been left to the ECB in the very prolonged recovery from the financial and sovereign debt crises.

Was monetary union created too early? I have tried to argue why I do not think so. It was not possible at the time of the Maastricht Treaty negotiations to anticipate the challenges that became clearly visible only over the past decade and the associated fault lines in the original construction. There are, in my view, few indications that the

EMU could have been created later, or that, if that had been achieved it would have been built in a more fool-proof way; starting from the institutional structure that had been agreed upon made it easier, rather than more difficult to add on the features that have helped to make it more solid.

REFERENCES

Committee for the Study of Economics and Monetary Union in the European Community (1989), *Report on Economic and Monetary Union in the European Community* ("Delors Report"), Office of Publications of the European Community, Luxembourg.

Eichengreen, Barry and Charles Wyplosz (2016), "Minimal Conditions for the Survival of the Euro", *Intereconomics* Vol. 51, 1, pp.24-28, Hamburg.

Gros, Daniel and Niels Thygesen (1992), *European Monetary Integration –From EMS to EMU*, Addison Wesley Longman, London and New York.

James, Harold (2012), *The Making of Europe's Monetary Union*, Princeton University Press, Princeton N.J.

Juncker, Jean-Claude, Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz (2015), *Completing Europe's Economic and Monetary Union* ("Five Presidents' Report"), European Commission, Brussels.

Padoa-Schioppa, Tommaso (2004), *The Euro and its Central Bank*, MIT Press, Cambridge Ma.

Thygesen, Niels (2016), "Why did Europe Decide to Move to a Single Currency 25 Years Ago?", *Intereconomics* Vol. 51,1, pp. 11-16.

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. Benoît Cœuré, this year's recipient of the Lamfalussy Award, is such a professional.

Benoît Cœuré is a prominent European academic and empirical macroeconomist, with 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 to lighten the burden on the most vulnerable social groups.

2016 AWARD RECIPIENT

BANK FOR INTERNATIONAL SETTLEMENTS (BIS)

The Basel-based Bank for International Settlements (BIS), the longest standing international financial organisation of the world, was established on 17 May 1930. The BIS functions as the bank for central banks, with 60 central banks being its members. Its mission is to foster the pursuit of price and financial stability in different regions of the world, and to contribute with its research to the development of economic theory. In addition, the BIS offers a wide range of financial services specifically designed to assist central banks and other international organisations, particularly in the management of foreign exchange reserves.

In order to help realise global financial stability objectives, the BIS actively supports the work of several committees and associations involved in financial regulation, supervision and in the operation of the financial infrastructure, and promotes efficient communication among the responsible bodies. In addition, the BIS carries out in-depth monetary policy and financial stability analyses, and operates an international statistical database related to the functioning of the financial organisations and financial markets.

The BIS pioneered the reform of monetary policy and financial stability thinking. The term „macroprudential" first appeared in its publications. It established a radically novel concept and analytical framework for the operation of modern economies, which better reflects the realities of our days. By giving due consideration to the processes that were underestimated by the prevailing monetary strategies, it warned about the build-up of financial imbalances already when the mainstream economists, having seen the Great Moderation, contemplated whether business cycles would disappear and what types of securities may take over the role of government securities after the vanishing of government debts.

Following the crisis, the foresight of the BIS has been acknowledged and its proposed approaches have been followed by an increasing number of economists. The latest examples of this are the methodological innovations initiated by the BIS, such as the estimate of finance-neutral potential output or the recognition of the importance of financial cycles, in addition to that of business cycles, for stability and monetary policy. In its publications the BIS has demonstrated that, due to the real nature of the modern financial system and global imbalances, the traditional approach leads to the misinterpretation of the crisis.

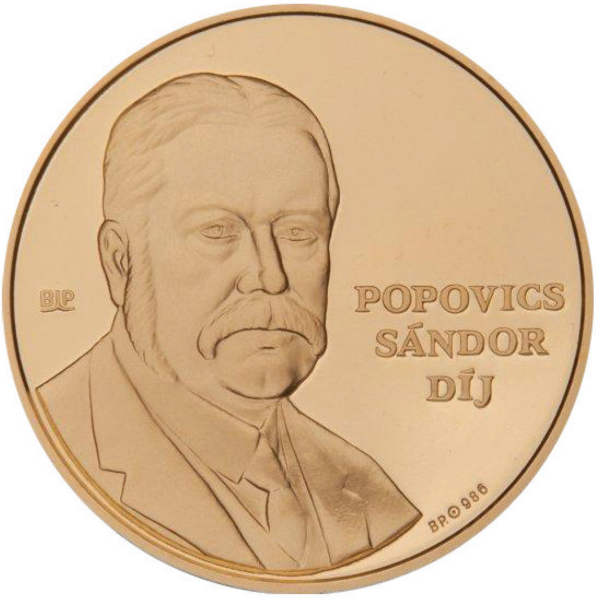
It is an integral part of the BIS's consistent reform work, pursued for several decades, that it goes back, in a manner worthy of an institution with solid and strong roots, to such, once prestigious traditions and theories that were pushed into the background during the decades, but under the new realities once again became important and inspire useful new insights.

The BIS proved that the continuity of thinking and keeping previous tradition alive is not at all contrary to forward-looking thinking, which helps us shed light on new challenges and have better chances to find solutions for them.

THE

POPOVICS AWARD

2015


POPOVICS
SÁNDOR
DÍJ


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 promoted the benefits of low Swiss franc interest rates.

After having been deeply involved in European crisis management in the ECB, he returned to Hungary in 2010 and joined the Ministry for National Economy, to head the Macroeconomic Policy Department, a key policy area. He made a significant contribution to crisis management in Hungary, then over indebted and subject to the Excessive deficit procedure (EDP). In addition to his major role in elaborating the Structural Reform Programme of Hungary, he proved to be an effective negotiator with international stakeholders.

In 2013 he returned to the Magyar Nemzeti Bank, building on his earlier experience, to become Executive Director for monetary policy. He played a significant role in the preparation, design and communication of the MNB's easing cycle and other monetary policy measures. His contribution to the credibility and reputation of the central bank has been widely appreciated.

20[illegible] AWARD RECIPIENT

ÁDÁM BALOG
Chairman and CEO
MKB Bank Zrt.

Ádám Balog is an economist and lawyer.

He graduated at the Budapest University of Economic Sciences and Public Administration, Faculty of Business Administration in 2003. He earned a master's degree at the Community of European Management Schools International Management in 2005, and went on to obtain a law degree at the Pázmány Péter Catholic University, Faculty of Law and Political Sciences in 2007.

From 2002 he worked at the Financial Controlling area of GE Tungsram Lighting Ltd and at the Tax Department of Pricewaterhouse Coopers Hungary Ltd from 2003 (as Manager from 2008).

From the summer of 2010 until his appointment as Deputy Governor of the Magyar Nemzeti Bank, he continued his career as Deputy State Secretary responsible for taxation matters at the Ministry for National Economy.

He was appointed Deputy Governor of the Magyar Nemzeti Bank and member of the Monetary Council on 6 March 2013.

He has participated in Hungary's fiscal and monetary stabilisation since 2010.

Since 23 July 2015, he has been Chairman and CEO of MKB Bank Zrt.

He has been a member of Heller Farkas College since 1999 and a senior member since 2003.

He is a member of the Presidium of the Hungarian Economic Association.

He is Chairman of the Board of Editors of the Economic and Financial Review.

He is Chairman of the Board of Trustees of the Pallas Athéné Domus Scientiae Foundation and a member of the Board of Trustees of the Pallas Athéné Domus Animae Foundation.

He has published several professional articles on taxation and monetary policy.

Ádám Balog is holder of the Order of Merit of the Republic of Hungary, Officer's Cross.

He is married with four children.