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# European Monetary Union: Past, Present and Future
# In Honor of Alexandre Lamfalussy

I am very glad to be here in Budapest again as a guest of the Hungarian central bank, with which the Austrian central bank – the Oesterreichische Nationalbank – has very close relations, not the least because both our central banks are in the same IMF constituency as our friends from Turkey, the Czech Republic and a few other countries.

I am a humble central banker and not a diplomat, so I may be frank and remind you that close relationships are not necessarily always easy relationships. In fact, our two central banks recently faced some difficult issues, revolving especially around some foreign-owned banks. But I also want to underline that both our central banks have always been committed to finding workable and fair solutions, and I am quite optimistic that at the end of the day, we – and our governments – will find such solutions. We all know very well that in matters of external and of internal affairs there may be situations of disagreement, but history teaches us that we should never go so far as to see each other as enemies.

The Hungarian central bank and especially my friend, Governor György Matolcsy, are to be commended for the brilliant idea of establishing the Lamfalussy prize and the Lamfalussy lecture: I gladly accepted this prize in honour of Baron Alexandre Lamfalussy, who perfectly exemplifies the model of the great liberal, open minded Hungarian that journalist and author Paul Lendvai impressively described in his brilliant book "The Hungarians". I recently gave my wife this book in recognition of her Hungarian roots. Baron Lamfalussy can also serve as a symbol of – and as a role model – for the personal and intellectual ties between Central Europe and Western Europe and therefore also for the relationship between the "Ins" and "Outs" of Economic and Monetary Union. Thus it

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is no coincidence that in two weeks, the Belgian central bank will also hold a special conference in honor of Alexandre Lamfalussy, a conference, by the way, where Lamfalussy will personally attend the presentation of a book on his life coauthored by his son.

Alexandre Lamfalussy lives in truly interesting times and has played an active part in these times in three capacities: As an eminent scholar in monetary economics, as a leading commercial banker and as a highly influential monetary policymaker And from my own experience I can assure you that being a commercial banker and a policymaker are – and should be – two very different experiences.

Alexandre Lamfalussy was born 85 years ago – in 1929 – in Kapuvár, Hungary. In 1949, when the Iron Curtain isolated Hungary and many other Central European countries from the rest of Europe, he managed to emigrate to Belgium, where he studied economics at the Catholic University of Louvain; he obtained his PhD from the University of Oxford.

It is quite fascinating to see that Lamfalussy developed his strong pro-European conviction already during these formative years, no doubt also because he personally experienced the barriers which divided Europe. And he found friends who shared his conviction and his values.

Let me give you a small, but interesting example of Lamfalussy's convictions: He became a member of "La Relève," which was both a political club and a weekly magazine close to the left wing of the Belgian Christian Democrat Party. It is noteworthy that the keynote speaker at the 30th anniversary of La Relève in 1975 was Jacques Delors (Maes, 2011, p.17). When I was Vice President of the European Investment Bank (EIB) in Luxembourg, I had the good fortune to gain an understanding of this set of ideas from my good friend Philippe Maystadt, the President of the EIB and the former Belgian Minister of Finance.

Alexandre Lamfalussy then worked for the commercial bank Banque de Bruxelles for 20 years, where he became a member of the Executive Board. Already during this time, Lamfalussy was active in a number of committees investigating the integration of European capital markets.

In 1976, Alexandre Lamfalussy underwent a major career change and went to the Bank for International Settlements, the BIS, in Basel, first gaining great respect as Chief Economist and from 1985 serving as the General Manager of the BIS. During this time, he became one of the leading figures in the preparatory work for European financial integration. Lamfalussy was a member of the Delors Committee, which played a central role in the preparation of the Maastricht Treaty and EMU. Thus he was the obvious choice to become the first president of the European Monetary Institute (EMI), which had the task of organizing the preparations for the introduction of EMU and the single monetary policy and which then evolved into the ECB.

I will return to the glorious past of EMU later, but first allow me to finish my short summary of Alexandre Lamfalussy's spectacular career by drawing your attention to the fact that he played a decisive role in European economic policy in later years as well: In 2000, Lamfalussy was appointed chairman of a committee called the "Group of Wise Men," a politically incorrect title, of course. This group laid the groundwork for the regulation of European financial markets and developed what became known as the Lamfalussy procedure on the regulation of European securities markets.

As my lecture is entitled "European Monetary Union: Past, Present and Future," let me return to the past briefly, namely to the foundation laid by the EMI under the presidency of Alexandre Lamfalussy.

Following the political agreement on the Maastricht Treaty, the EMI took up its duties in 1994. Alexandre Lamfalussy, then general manager of the BIS, was chosen to head this new institution. As David Marsh remarked in his outstanding account of the history of the euro, "Sharp of mind and way of manner, Lamfalussy was the most polished of monetary technocrats, commanding English, French and German with a cut-glass precision" (Marsh, 2009, p. 193). (Not untypically for an Englishman, David Marsh forgot Lamfalussy's knowledge of Hungarian). Lamfalussy started work in Frankfurt with a skeleton staff of 12 – today, the staff of the ECB numbers around 1,600, and the ECB is about to hire 1,000 more staff members to handle the Single Supervisory Mechanism.

The basic problems at this early stage of EMU were structural aspects that are still of relevance today and, as I will show later, will remain so for the future.

The first aspect concerns the relationship between political and monetary unification, or at least the coordination of both aspects. Especially in the German speaking countries, there were two opposing schools of thought at the time:

One view, rather grandiosely called the "coronation theory," saw a monetary union as the last step, the "coronation," of a political union. This reflects the experience of the unification of Germany in the 19$^{th}$ century and is based on the conviction that there has to be a common political system to guarantee a strict monetary policy.

The alternative view is the "locomotive theory," which reflects the experience of the Robert Schumann-Jean Monnet approach after World War II. In this view, economic cooperation projects starting with the European Coal and Steel Community in 1952 created an evolutionary process toward an "ever closer union." It is obvious that a political union using the coronation theory as a starting point is only realistic for a small, rather homogenous group of European states. After various rounds of EU enlargement this concept of a small, homogenous Europe was no longer realistic; moreover, it was no longer in Germany's interest. So Alexandre Lamfalussy reports in an interview with David Marsh how much he agreed with Helmut Kohl on a fast-track approach to monetary union. (Marsh, 2009, p. 191).

The Maastricht Treaty provided clear rules for EMU membership. But already at this time, there were controversies about "creative accounting" and statistical manipulation in some countries. In retrospect, it may be said however, that the ambition of entering EMU in combination with the Maastricht rules exerted a strong stabilizing influence in all future member states, so that – in accordance with benevolent political agenda setting – EMU could start as scheduled in 1999.

The question of the division of labor between the ECB and the national central banks had yet to be resolved, another topic which has remained relevant to this day. One important issue was whether the conduct of money market operations should be decentralized, as Jean-Claude Trichet, then governor of the Banque de France, advocated, or whether it should be centralized, as Alexandre Lamfalussy and Hans Tietmeyer, president of the Bundesbank argued. The ECB view prevailed, which proved to be extremely beneficial in the financial markets turmoil of 2007 and 2008: fast and strong liquidity provision by the ECB was vital for stabilizing the European economy.

To come full circle, we now move on to the present-day situation and to the challenges of EMU. The present situation is still dominated by the direct and indirect effects of the worldwide crisis that started in 2007 to 2008. In the years before the crisis, central banks lived in the glory – and as we now know the illusion – of the concept of "Great Moderation." The basic message was that a constellation of independent central banks following a strategy of tight inflation targeting is both a necessary and sufficient condition to ensure a benign combination of low inflation and high real economic growth. This combination had indeed been achieved in the first years of the new century. But as we now know, this positive outcome was the result of very specific circumstances, especially strong first-round globalization effects.

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

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

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

It is only this year that the euro area is expected to move out of recession to a constellation of positive, albeit still very weak, growth, and we still see substantial differences in the economic performance of various EMU member countries – and also of neighboring countries.

The main efforts both in Europe and across the world are now moving from crisis fighting to long-term crisis prevention. Two main approaches are being implemented: The first approach is to adjust the structures of the banking industry by implementing the Basel III process and the European banking union project. Christian Noyer, who plays a key role in both areas, will talk about this.

The second approach is to adjust public finances. As I have shown before, the founding fathers of EMU were already fully aware of the risks of having a single monetary policy without a centralized European fiscal policy counterpart. This awareness gave birth to the EU Stability and Growth Pact in parallel to EMU. As the crisis showed, the provisions of the Stability and Growth Pact were not strong enough to prevent a destabilizing accumulation of public or private debt in a number of countries before the crisis, so that the needed fiscal impulses were limited during the crisis.

At the EU level, we therefore see a whole set of new institutional arrangements to provide for long-term fiscal sustainability. There is a far-reaching consensus about the intentions of these arrangements: Public deficits and debt levels need to be limited and adequately supervised. This is all the more relevant for member countries of the euro area that do not have access to central bank financing and that are exposed to free capital movements. There are, however, divergent views about how fast to achieve the reduction of currently high, mainly crisis induced, levels of public debt. Whereas European institutions, including the ECB, advocate strict and tight timeframes, IMF and U.S. economists tend to prefer a more flexible approach. This discussion is not new and will remain a central issue of the political and economic debate in the near future – and it is a discussion where easy answers indeed tend to be misleading. The difficult political process of regaining fiscal sustainability must of course be strengthened and controlled without damaging the still very fragile process of economic recovery.

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

In this context, it is quite interesting to see that Alexandre Lamfalussy already at a very early stage referred to the problem that a lack of fiscal coordination could lead to substantial policy inefficiencies with regard to macroeconomic disequilibria – and could overburden a European single monetary policy in the long run: "The combination of a small Community budget with large, independently determined national budgets leads to the conclusion that, in the absence of fiscal coordination, the global fiscal policy of EMU would be the accidental outcome of decisions taken by Member States … As a result, the only global macroeconomic tool available within EMU would be the common monetary policy implemented by the European Central Bank" (Lamfalussy, 1989).

What about the future perspectives of the EMU? This, of course, is a huge field full of uncertainties, so let me concentrate on a single issue: future institutional perspectives.

We see a wide set of proposals to strengthen the political foundations of EMU. Basically, these proposals go into the direction of creating a "European economic government," a "fiscal union" with, as Jean-Claude Trichet emphasized, a European finance minister. All this would involve substantial transfers of national sovereignty and thus Treaty changes. We are all aware of the immense political problems involved in achieving such changes. This holds especially true if we look at the EU as a whole, where there is a strong ongoing discussion about leaving the EU in one major country, the U.K.

So any such institutional discussions have to concentrate on the Eurogroup countries, strengthening the already existing perspective of a two- or three-speed Europe. I am fully aware that this is a very sensitive issue not only for Europe in general, but especially also for the newer EU Member States. In the very long run, a Europe of different speeds may converge again, but at least for the medium term, I consider a closer cooperation of the EU members able and willing to engage in more advanced levels of political and economic integration the only way to achieve the desired future political foundations for

EMU. In fact, the present EU Treaty (Article 136 TFEU) may already allow for far-reaching changes of this type without the need to change the Treaty (Piris, 2012).

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

So in concluding my presentation, let me return again to Alexandre Lamfalussy and his principle-based, but pragmatic approach to economic and political affairs. In 2003, Lamfalussy gave a speech in Budapest on the unfortunately also now extremely relevant topic "Correcting Europe's dismal growth performance should be the EU's prime policy objective." In this speech, he warned against relying on the U.S.A. as "consumer of last resort" and made a number of proposals for "domestically propelled growth in Europe." And he ended his speech with some very characteristic remarks. The proposals, and now I quote: "will bring sizable benefits to most of us, but not without throwing up new challenges. You may say that this remark is just the usual manifestation of a central banker's innate caution. Well, it may be. But that does not mean that I am necessarily wrong."

I see this as a way of thinking with which every central banker can – and should – agree.

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