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Check against delivery!

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

Speech at the Lámfalussy Lectures Conference

Ladies and gentlemen,

I feel highly honored to have once again been invited to this eminent conference series here in Budapest. Regrettably, this is the first time that the Lámfalussy Lectures Conference takes place without Baron Alexandre Lamfalussy himself 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 speech 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 seeing all of these developments in the light of the financial crisis, even if the world

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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.

Recent developments in China – since last year, 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 longer 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.

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

[2] Lamfalussy 2003a.

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 "(s)uccessful 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" – 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

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[3] Lamfalussy, 2000, 163.
[4] Lamfalussy, 2000, p.170.
[5] ibid., p.170f.
[6] Kudrna, 2011.

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, 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 to join 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 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.

Now we have the chance for a new start with substantially amended institutional preconditions. The banking union is one of them; the other one, capital markets union, has only yet started to take form. 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

[7] Lamfalussy et al., 2013, p.155.
[8] Lamfalussy, 2013, p. 169.
[9] Langfield and Pagano, 2015.

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.

Hence, the objectives of 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 detail. And regulators have to consider plenty of details, including information disclosure, corporate governance or consumer protection. More importantly, the 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 in 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

[10] Fuceri and Zdzienicka, 2013; IMF, 2013.
[11] Van Beers et al., 2014.
[12] James, 2012, p. 249.
[13] Lamfalussy, 2003b.
[14] Lamfalussy et al., 2013, p.133.

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.

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, a financial, a fiscal and a 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.

Ladies and gentlemen,

What strikes me most, recalling the achievements and insights of Alexandre Lámfalussy, 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.

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