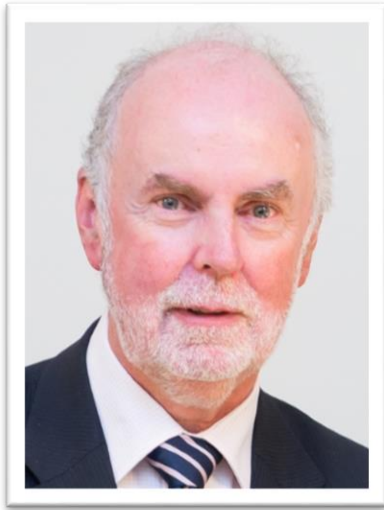
Belgian Financial Forum

Central banking in times of uncertainty, is Lamfalussy still relevant?



Jan Smets – Governor National Bank of Belgium

Ladies and gentlemen,

It is a great honour for me to speak at this conference which pays tribute to Alexandre Lamfalussy, the quintessential central banker. However, while Alexandre Lamfalussy, as General Manager of the Bank for International Settlements and Founding President of the European Monetary Institute, clearly belonged to the core of the central banking establishment, he always kept a somewhat iconoclastic, slightly rebellious, intellectual trait. He was always questioning accepted doctrines and always had a great attention for the permanent changes that characterize our world.

Alexandre Lamfalussy was fond of the expression “navigating in uncharted waters”. And indeed, throughout his life and career as a central banker he has been living through considerable changes, not to say turmoil, in the world economy and financial markets. Today I would like to focus on the question: what lessons can we draw from Lamfalussy for present day central banking, considered in a broad way, encompassing both monetary policy and financial stability?

The collapse of the Bretton Woods system, in the early 1970s, marked a profound regime change for monetary policy and central banking. The exchange rate lost its anchor function and central bankers started the search for a new reference framework for monetary policy. However, also under the influence of the oil price shocks, inflation derailed and "stagflation" became the new reality in the Western economies. In these times, in January 1976, Alexandre Lamfalussy became the Economic Adviser of the Bank for International Settlements.

The stagflation of the 1970s showed the limits of active demand management policies. Gradually, a consensus developed towards a medium-term economic policy orientation, emphasising structural, supply-side oriented policies, while macroeconomic and monetary policy was geared towards medium-term objectives. A core ingredient of this new strategy was that monetary policy should focus on price stability, and should be conducted by an independent central bank.

These changes in economic policy conceptions were supported by new economic theories. The "Monetarist counter-revolution" had questioned the Keynesian framework. With the rational expectations hypothesis, the possibilities of policy-makers to steer the economy were even more strongly questioned. According to this approach, and although the future is not predictable, agents' expectations are assumed not to be systematically biased and that they would use all the relevant information in forming expectations of economic variables and behaving accordingly. The literature on time-inconsistency pointed further to the inflationary bias of a discretionary monetary policy. To retain flexibility, while dealing with the inflationary bias of a discretionary policy, central bank independence quickly topped the research agenda. Moreover, empirical studies indicated that central bank independence went together with a better inflation performance with no significant increase in unemployment or volatility. As a result, Central bank independence not only became a key theme of German ordo-liberalism, but also an important element of mainstream Anglo-Saxon economics.

This new model of central banking, based on an independent central bank pursuing price stability, became also enshrined in the Maastricht Treaty and in the Statutes of the European Central Bank. Noteworthy is that financial stability was rather absent in this model. There were discussions about asset prices and monetary policy. However, there was a rather broad consensus that the best contribution monetary policy could make towards financial stability was to ensure price stability.

As the essays in the book here presented illustrate, Alexandre Lamfalussy evolved towards “conservative” Keynesian positions during these years. A key issue for him was the establishment of the credibility of anti-inflationary policies, which was "a protracted, long-term affair in which success will be achieved only by consistently resorting to a broad set of anti-inflationary policy measures".

However, for Lamfalussy the world was more complex. Three elements always come back in Lamfalussy’s analyses: globalization, debt and financial innovation.

Lamfalussy never lost sight of the internationalisation process. For Lamfalussy, a crucial implication was that no country could isolate itself from other countries, whatever its exchange rate regime. Lamfalussy was always warning for international imbalances which might lead to exchange rate instability and protectionist threats. A theme which has obviously not lost its relevance.

A second issue concerned debt. From the mid-1970s, Lamfalussy focused on the debt build-up in the international financial markets. Lamfalussy presented a “macroprudential” approach. He said, more than 35 years ago: "focusing on problems that bear upon the market as a whole as distinct from an individual bank, and which may not be obvious at the micro-prudential level". He also proposed to introduce prudential measures to slow down credit growth. Later, in the early 1980s, Lamfalussy and the BIS played a key role in the management of the ensuing Latin America debt crisis.

Lamfalussy took a cautious attitude towards financial innovations, not only because of their impact on money demand functions and monetary policy, but also because of their effects on the stability of the financial system. In a certain sense, Lamfalussy always kept a "Keynesian" Weltanschauung, with a certain scepticism about the functioning of financial markets. In January 1985, at a joint luncheon of the American Economic Association and American Finance Association, Lamfalussy discussed the accelerating speed of financial innovation. This was leading to a flow of new financial instruments and techniques, as well as the blurring of dividing lines between institutions and between markets. An important concern for Lamfalussy was that, with financial innovations, the transparency of the financial system was waning. His most fundamental question concerned the effects on financial stability of this redistribution of risk enhanced by these new techniques and instruments, "You may argue that when risk-averse market participants shift risks associated with unexpected interest and exchange rate developments onto willing risk takers, everybody is going to be better off. This may well be the case, but increased collective happiness does not necessarily mean greater systemic stability.

Or does it?". It was a perfect analysis of the US subprime mortgages market, which would be at the origin of the Great Recession, but he did it with a foresight of 20 years.

During the years 2000, Alexandre Lamfalussy was consistently one of the few Cassandra's, warning for the debt build up, which would lead to the Great Recession. In 2004, he raised the issue of giving the ECB a responsibility in the supervision of large, systemically important banks, an early anticipation of the Single Supervisory Mechanism, which was launched in November 2014.

The "Great Recession", which started in 2007, seriously questioned the dominant central banking model. It clearly showed that central banks had a crucial responsibility for financial stability. As observed by Lamfalussy in 2010:

> "Our current experience has confirmed something that was (or should have been) expected: that whether they like it or not, central banks are in the frontline when it comes to keeping crisis manifestations under control. They have the resources, and their traditional banking operations plus their oversight responsibilities in payment and settlement systems give them a proximity to the money and financial markets that finance ministers or supervisors not connected with central banks do not possess."

The Great Recession further led to significant changes in the operational framework of monetary policy. Indeed, with financial markets in turmoil, central banks were confronted with three major problems:

- They found it more difficult to control the interest rate which functioned as their operational target;
- The relationship between short-term policy rates and longer-term rates became unstable. This was especially the case in the euro area, where the sovereign debt crisis led to significant financial fragmentation with heterogeneous financing conditions across countries for both households and corporations;
- The ability of the central banks to lower interest rates was impaired when these reached the zero lower bound.

Confronted with these challenges, central banks responded with significant changes in the operational framework of monetary policy, with a major role for the management of their balance sheet. The result has been an increasing variety of "non-standard" central banking interventions, with longer maturity

terms for their liquidity support as well as quantitative easing. This led not only to a significant expansion of the balance sheets of central banks, but also to changes in the composition of their assets, sometimes with the acquisition of more risky assets and the emergence of leverage risk, inherent to excess liquidity created to fund these assets and remunerated at the policy rate, exposing their balance sheet to a squeeze in case of intense rate increase.

While central banks now increasingly pay attention to financial stability, they also have to take care of their price stability objective. As inflation in the euro area, during the last years, was below the objective of price stability – an inflation below but close to 2% over the medium term – the ECB has been pursuing a more accommodative monetary policy. The basic objective of the ECB was to steer nominal interest rates lower, towards the real equilibrium rate, the rate for which savings and investment are in equilibrium.

However, the issue at stake is that the real equilibrium rate is far too low. This is the consequence of structural factors, like an ageing population and a declining productivity leading to a structural saving surplus, as well as more cyclical factors, like the debt deleveraging process and uncertainty. However, monetary policy has only limited effects on the real equilibrium rate. Structural measures, either labor market reforms, fiscal policy reforms or product market reforms, have the impact to boost productivity and stimulate potential output.

Let me return to central banking, especially the concept of central bank independence. The new world of central banking, with a greater responsibility of the central bank for financial stability and a greater emphasis on balance sheet policy, might lead to risks for central bank independence as we have enjoyed it so far. As observed by Alexandre Lamfalussy in the conclusions of his last essay, at the 2014 conference for the 20th anniversary of the European Monetary Institute:

> "The risk arises from the obvious fact that having to comply with two distinct mandates pushes the central banks into a much more complex world. The modalities of their independence in their monetary policy function (…) can be reasonably well defined. But in the case of macroprudential independence this is much more difficult. Once it appears that the initial liquidity problem is shifting toward a solvency problem, and especially when the latter implies the risk of systemic meltdown, the central bank has to operate hand in hand with the government (...) The macroprudential mandate requires for the central bank a type of

relationship with - and therefore a type of independence from - the government that is different in substance from the one governing monetary policy. The rules of the game on both sides have to be spelled out. The complexity of the current situation – and the likelihood that it will remain such – means that central banks will have to continue their navigation in uncharted waters. There is no way of opting out of this complex world."

Ladies and gentlemen,

The National Bank of Belgium is very proud of its contribution to preserve the intellectual heritage of the great European and central banker Alexandre Lamfalussy. Beyond today's conference and in memory of Alexandre Lamfalussy, the National Bank of Belgium has decided to institute a keynote lecture in honour of him at its biannual international conference. It will be inaugurated at the next conference, in the Autumn of 2018.