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Alexandre Lamfalussy and the origins of instability in capitalist economies

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ABSTRACT

In this paper the vision of the "Young" and "Elder" Lamfalussy on the origins of instability in capitalist economies will be contrasted. The young Lamfalussy found the origins of instability in medium-term cumulative processes in the real sector of the economy, very much inspired by the vicious circles in the British and Belgian economies in the postwar period. The Elder Lamfalussy focused on financial innovations and the short-term myopic behavior of financial markets, very much inspired by his experience of the Latin American debt build-up and ensuing crisis in the early 1980s. The Euro area crisis showed the importance of both processes, as it was the consequence of both short-term myopic behavior in financial markets and medium-term cumulative processes in the real sector.

1. Introduction

As the General Manager of the Bank for International Settlements and the first President of the European Monetary Institute (the precursor of the European Central Bank), Alexandre Lamfalussy was one of Europe's most eminent central bankers in the postwar period. Moreover, Lamfalussy, also pursued an academic career. As an economist, he remained conscious of the limits of his knowledge and he was always trying to get a better understanding of the crucial policy issues, combining academic theories (in plural) and different types of empirical material (a selection of Lamfalussy's articles was published in Maes 2017).

While being a distinguished central banker, close to the empirical reality, Lamfalussy remained faithful to a strongly Keynesian *Weltanschuung*, which he had already acquired as a young economics student. In Lamfalussy's view, the market economy was inherently unstable. However, over time his view on the origins of the instability of the economy shifted. In this contribution the vision of the "Young" and "Elder" Lamfalussy on the origins of instability in capitalist economies will be contrasted (Maes 2023). The young Lamfalussy found the origins of instability in medium-term cumulative processes in the real sector of the economy, very much inspired by the vicious circles in the British and Belgian economies in the postwar period, in contrast to the virtuous growth processes of the

German and Italian economies. The Elder Lamfalussy focused on financial innovations and the short-term myopic behavior of financial markets, very much inspired by his experience of the Latin American debt build-up and ensuing crisis in the early 1980s. The Euro area crisis showed the importance of both processes, as it was the consequence of both short-term myopic behavior in financial markets and medium-term cumulative processes in the real sector (especially the real estate sector and competitiveness).

2. The young Lamfalussy: Cumulative processes in the real sector of the economy

Alexandre Lamfalussy was born in Hungary and started economics studies at the Budapest Polytechnic. In January 1949, he succeeded in leaving Hungary and came to Belgium, where he continued his economics studies at the Catholic University of Louvain (Lamfalussy, Maes and Péters 2013). Lamfalussy went to Oxford for his PhD and, thereafter, he returned to Belgium, as an economist at the Banque de Bruxelles.

In 1961, Lamfalussy published *"Investment and Growth in Mature Economies. The Case of Belgium",* a revised draft of his Oxford doctorate. A crucial theme was that investment was low in Belgium as compared to other Western countries (Maes 2009). This was not only related to the slow growth of domestic expenditure, but also to a slower growth of exports, which suffered from the high level of Belgian labour costs and an outdated composition. At the core of the book is the concept of defensive investment, investment which is carried out mainly as a protective device in stagnating or declining markets, "when profits are squeezed, when competition is active, when the lowering of costs becomes a matter of survival rather than of expansion" (Lamfalussy 1961: xvi). Defensive investment entails mainly the reorganisation of existing factories. Its distinctive characteristic is its “exclusive reliance upon minor innovations, upon the improvement of existing capital goods and upon rationalization" (Lamfalussy 1961: 114). The dominance of defensive investment in Belgium had serious consequences for economic growth. Defensive investment can, in the first instance, result in quite substantial increases in productivity. However, there will be no (or very little) growth in new industries. Over time, this will have major consequences as the potential for productivity increases in declining industries is limited. "Opportunities for increasing productivity within the existing plants will have been exhausted, and as the profit pattern does not stimulate major innovations and a substantial rise in capital spending, the rate of increase in productivity will slow down. For the same reason, there will be no major shift ... in the composition of exports. It follows that the cost disadvantage of the country will worsen and that there will be no improvement, either, on account of a change in the commodity composition of exports" (Lamfalussy 1961: 165). A vicious circle then becomes inevitable: "The slow growth of home demand and the competitive disadvantage on foreign markets reduce profit rates; this, in turn, favours the widespread use of defensive investment which puts a brake on home expenditure as well as on exports. The pressure on profit rates is therefore maintained, and the circle remains as vicious as ever" (Lamfalussy 1961: 165).

In the following years, Lamfalussy would extend his analyses to the other main European economies (Maes 2009). In "*The United Kingdom and the Six. An Essay on Economic Growth in Western Europe*", Lamfalussy (1963) provided an analysis of the divergence in economic performance between the countries of the European Community and the United Kingdom. Lamfalussy showed the virtuous circle of the EEC growth performance, "competitive advantage in world markets, leading to faster growth of exports; export-oriented growth, raising the share of investment in the national product; higher investment ratio, calling forth a faster growth in the productivity of labour and leading, therefore, to renewed competitive advantage in world markets" (Lamfalussy 1963: 116-117). The virtuous circle of the EEC countries contrasted naturally with the vicious circle of the United Kingdom (or Belgium).

3. The elder Lamfalussy: Myopic financial markets

Being at the Banque de Bruxelles, Lamfalussy's research interests shifted to monetary and financial issues. Lamfalussy was intellectually close to the Radcliffe Report. He defended it against criticism from Dennis Robertson and Roy Harrod who argued that the principle of "loans create deposits" applies only to banks. In their view, all other financial institutions were pure intermediaries, who can only lend what they get. Lamfalussy claimed that this argument breaks down if non-bank financial intermediaries provide near-money assets which are quasi-perfect substitutes for money held in excess of transaction balances. One can see Lamfalussy’s early attention to financial innovation and shadow banking systems.

In January 1976, Lamfalussy joined the Bank for International Settlements (BIS) as Economic Adviser. The BIS was set up in 1930. It provided central bankers with three main services: research on issues relevant to international payments and prudential supervision, a venue for regular and discreet meetings, and a financial arm (particularly important in the gold market). In the postwar period, Basel was one of the main centres of international monetary cooperation, contributing to the longevity and success of the Bretton Woods system (Toniolo 2005). The collapse of Bretton Woods, in the early 1970s, contributed significantly to a shift in the objectives of central bank cooperation. With floating exchange rates, increasing capital mobility and financial liberalisation (also inside countries), cooperation shifted away from monetary stability towards financial stability. The high-profile collapse of certain banks, especially Herstatt, reinforced this tendency.

During his time at the BIS, Lamfalussy was very much involved with international debt issues (Maes 2010). In the mid-1970s, with the oil price shock and the recycling of the petrodollars, Lamfalussy became concerned about the strong increases in lending to developing countries and the consequent increase in country risks of the international banks. Moreover, financial innovations became a topic of discussion among economists and policymakers. Lamfalussy very quickly took a cautious attitude towards financial innovations, not only their impact on monetary policy, but also their effects on the stability of the financial system.

In a 1985 speech, Lamfalussy focused very much on financial fragility, paying special attention to 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. His most fundamental question concerned the effects on financial stability of the redistribution of risk 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?" (Lamfalussy 1985: 411).

Later, Lamfalussy gave a negative answer to the question whether the redistribution of risk improved financial stability. His argument was strongly influenced by his analysis of the Latin American debt crisis. In his view, the shift to a generalised use of floating interest rates in medium-term bank loans, during the petrodollar recycling, allowed banks to protect themselves against the erosion of their margins of intermediation. However, it also had the effect of passing on short-term market interest rate movements to borrowers. With negative real interest rates in the 1970s, credit demand was stimulated, leading to a period of over-expansion. The return to positive real interest rates in 1979 placed a "crippling" burden on many debtors. The ensuing debt crisis threatened the world financial system. Lamfalussy concluded: "Innovation allowed banks to transform margin risk into capital risk which, in this case, was probably a greater threat to the stability of the international banking system - not to mention its rather disastrous effects on the borrowers themselves" (Lamfalussy 1986: 14).

4. The euro area crisis: Combining the young and elder Lamfalussy

Alexandre Lamfalussy always held a strongly Keynesian *Weltanschuung*, that the market economy was inherently unstable. However, over time his view on the origins of the instability of the economy shifted. In this contribution the vision of the “Young” and “Elder” Lamfalussy were contrasted. The young Lamfalussy emphasised medium-term cumulative processes in the real sector of the economy, very much inspired by the vicious circles in the British and Belgian economies in the postwar period, in contrast to the virtuous growth processes of the German and Italian economies. The Elder Lamfalussy focused more on financial innovations and the short-term myopic behavior of financial markets, very much inspired by his experience of the Latin American debt build-up and ensuing crisis in the early 1980s. This distinction remains relevant. During the first decade of the euro, structural divergencies between the countries of the euro area increased (Buti 2021). There were growing trade, financial and fiscal imbalances as well as competitiveness problems. The credibility of the monetary union had induced the financial markets to finance much larger external imbalances than in earlier periods. In some countries, such as Ireland and Spain, economic expansion – especially in the property sector – was initially bolstered by the convergence of nominal interest rates within the monetary union, as spreads with Germany more or less disappeared. This convergence was also due to increasing cross-border banking activity in a large Euro Area without exchange-rate risk, with the markets disregarding credit risk. The ensuing boom further fuelled wage and price increases, which largely surpassed those in other countries like Germany, impairing the competitiveness of these countries. Notwithstanding these competitiveness losses, domestic demand further increased through the combined effects of strong wage increases and very low real interest rates (given the combination of low nominal rates with high inflation). This situation further added to the trade, financial and fiscal imbalances, with excessive lending and debt, property market bubbles, and current account deficits. The result was a severe boom-bust cycle with a subsequent harsh and prolonged process of deleverage. The cycle was caused by myopic behavior in the financial markets, as emphasized by the Elder Lamfalussy, and by dynamic processes in the real economy, as emphasized by the Young Lamfalussy.

5. References

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