Europe needs a new social contract – Lessons from the Lámfalussy Lecture Conference of 2016*

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The Lámfalussy Prize and the Popovics Prize, both established by the Magyar Nemzeti Bank, were awarded on 1 February 2016 at a Gala Concert in the National Theatre in Budapest.[1] The purpose of the Lámfalussy Prize is to recognise outstanding professional contributions to progress in international monetary policy. The Popovics Prize, commemorating the first Governor[2] of the MNB, is an award given by the central bank to outstanding professional achievement in the field of economy and finances.

This year, the recipient of the Lámfalussy Award is not an individual, but a deservedly recognised institution, the *Bank for International Settlements (BIS)* seated in Basel. Since its establishment, in several areas, the BIS has pioneered the reform of monetary policy and the approach to financial stability, thereby promoting new concepts on the functioning of modern economies. Alexandre Lámfalussy (1929-2015) played a significant role in the operation of the BIS for 18 years, and thus this year's award and the conference after the event – apart from acknowledging the outstanding and internationally acclaimed activity of the BIS staff – is also a kind of commemoration of Mr. Lámfalussy's contributions as the "father" of the euro.

The Popovics Prize was awarded to *Ádám Balog*, the Chairman and CEO of MKB Bank and former Deputy Governor of the central bank, who played a dominant role in the implementation of the successful monetary turnaround, and in the launching of the Funding for Growth Scheme, one of the key drivers of the Hungarian economy. Upon presenting the award, *György Matolcsy*, the *Governor of the MNB* emphasised that the MKB, reformed under the leadership of Ádám Balog, has now re-established its operation in the domestic financial market as a competitive, profitable bank.

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[1] The press release issued on the event is available at: http://mnbintranet/hirfolyam/2016/kommunikacios-es-penzugyi-ismeretterjesztesi-igazgatosag/lamfalussy-konferencia-es-gala-2016 and http://www.mnb.hu/sajtoszoba/sajtokozlemenyek/2016-evi-sajtokozlemenyek/atadasra-kerult-a-lamfalussy-es-a-popovics-dij

[2] Sándor Popovics (1862–1935) was Minister of Finance in the Wekerle government in 1918. From the establishment of the Magyar Nemzeti Bank in 1924 until 1935 he was the Governor of the MNB, and was an Academy member, and Vice President of the Hungarian Academy of Sciences in 1933–1934.

The Award Gala was followed by the Lámfalussy Lectures Conference on 2 February. The widow of Alexandre Lámfalussy and several members of his family, prominent representatives of the government and the Hungarian banking community, as well as a number of outstanding representatives of financial and economic sciences and the banking profession were among the more than 400 participants of the conference. Presentations were made by Luiz Awazu Pereira da Silva – Deputy General Manager of BIS, Ewald Nowotny – Governor of the National Bank of Austria, Benoît Coeuré – Board Member of the European Central Bank, Edmond Alphandéry – former Minister of Economy of France and by Klaus Regling – Managing Director of the European Stability Mechanism.

The focus of this year's Lámfalussy Conference, organised for the third time, was on the reform of the euro area. Revival is conditional upon drawing the lessons from the crisis. The lecturers of the conference have done a great deal to foster the elaboration of solutions that facilitate sustainable convergence in the EU, based on financial stability and structural reforms.

In his opening address to the guests of the conference *György Matolcsy*, Governor of the central bank, emphasised the timeliness of Alexandre Lámfalussy's work. The engine of global economic growth is faltering. These days, new signs of weakness have re-emerged in each of the countries which were the pillars of the global economy. The United States, the European Union, China and Japan face new difficulties, in addition to the legacy problems from the past. The maintenance of financial stability is critical amidst this deceleration. Lack of financial stability would jeopardise economic recovery, while the absence of jobs would destabilise politics. Structural reforms are necessary to reinforce the triple, intertwining pillars of economic, financial and social security and stability. "We could learn from Alexandre Lámfalussy that economic instability easily leads to crisis. Sustainable growth may be achieved through financial stability underpinned by structural reforms."[3] emphasised the Governor of the Magyar Nemzeti Bank.

Continuing this argument, *Luiz Awazu Pereira da Silva*, Deputy General Manager of the Bank for International Settlements (BIS) (formerly the Deputy Governor of the central bank of Brazil), also talked about global challenges.[4] He emphasised that in order to reinforce the stability of the ailing global economy the key task of the decision-makers is to calm the markets by focusing on the solution. He pointed out that the measures first proposed by Lámfalussy are suitable for creating stability. According to da Silva, the world has made enormous progress in stabilisation in recent decades. He emphasised that the structural reforms in the economy must

[3] http://magyarhirlap.hu/cikk/46638/Nincs_gazdasagi_bovules_penzugyi_stabilitas_hijan#sthash.RVdr8Lq2.dpuf

[4] Title of his presentation: Old and new challenges for 2016 and beyond.

be implemented such that people accepted it as a new social contract. "We see now what causes vulnerabilities in certain situations: this may include excessive credit growth or the insufficient supervision. We also know that credit-driven growth complicates the challenges of central banks, especially in the case of an open economy. Taken together, with the use of models, today we already know much better how a crisis may be prevented" he noted.[5]

Ewald Nowotny, Governor of the National Bank of Austria and recipient of the Lámfalussy Award in 2014, emphasised in his presentation ("From Euro to Banking Union – What can we learn from Mr. Lámfalussy?") that in the work of Lámfalussy the efforts to have the concept of macroprudential supervision accepted and implemented played a key role in paving the way for the euro. Lámfalussy saw clearly that integrated financial markets must be accompanied by integrated regulation. Governor Nowotny mentioned Hungary as a good example, where the single supervision in close cooperation with the central bank helped the country survive the years of the crisis with relatively smaller shocks, which enabled it later to benefit from ECB's quantitative easing at an early stage. The monetary policy of the ECB also contributed to the relatively strong performance of the Hungarian economy. A stable banking regulatory environment is an important condition for the economic stimulus arising from the monetary policy stance of the Community to become efficient. Governor Nowotny emphasised that the accession to the banking union in the future could be a similarly important breakthrough as the development of the single macroprudential supervisory mechanism in the recent past. The strengthening of the banking system's stability is an important precondition for placing the financing of the economy on stable foundations.

Benoît Coeuré, Board Member of the European Central Bank and recipient of the Lámfalussy Award in 2015, discussed the issues of the central banks' independence and interdependence in the EU in his presentation entitled "Time for a new Lámfalussy moment".[6] He emphasised that the efficient cooperation of the central banks in the EU required strong institutional frameworks. This framework has two pillars. One of the pillars is the Stability and Growth Pact (SGP), which keeps fiscal policy under control. The cooperation between the European Central Bank and the independent central banks of the Member States in the area of monetary policy takes place within the framework of so-called monetary dominance. This framework facilitates cooperation, which is an important precondition for ensuring that the monetary policy measures of the ECB achieve their goals. However, the efficiency of monetary policy largely depends on the timing and the way of implementing the

[5] *http://magyarhirlap.hu/cikk/46638/Nincs_gazdasagi_bovules_penzugyi_stabilitas_hijan#sthash.RVdr8Lq2.dpuf*

[6] The presentation is available at the following link: https://www.ecb.europa.eu/press/key/date/2016/html/sp160201.en.html

measures necessary in the area of fiscal and structural policy. In the wake of the crisis, it was necessary to tighten banking regulation, but the consequences of these measures would have severely curbed lending had the ECB not offset this impact by the marked expansion of the liquidity supply. The increase in banks' risk would have undermined the sustainability of government debt. The regulatory initiatives of the central banks and the establishment of the banking union tried to mitigate this effect by elaborating a single framework at the EU level for the restructuring of banks which were facing difficulties. The ECB regulated the participation of the private sector in the settlement of the bank crisis (bail-in) in a precise manner and determined the relevant circumstances and the scope of the application of the central bank instruments. With these measures, it mitigated the risks burdening government debt. In addition to the interactions of monetary policy and fiscal policy, structural policy may reduce the burdens of both fiscal and monetary policies, as better functioning product and labour markets also reduce the risks of the crisis. However, the single banking regulation raises the need for further measures in the securities markets as well. The key step toward the single regulation of the securities markets was taken 15 years ago by the report of the Committee of Wise Men led by Alexandre Lámfalussy (Final Report on the Regulation of European Securities Markets to the Commission[7]). Today, Europe faces a similar challenge in several respects, which can only be resolved with yet another breakthrough, i.e. a new "Lámfalussy moment". By now we are past the temporary solution of the most pressing problems of the crisis; Europe today must focus on the global challenges. The management of the global challenges such as the refugee crisis or climate change, require definite measures and the necessary changes must not be postponed. With the cooperation of Alexandre Lámfalussy, the European Union managed to overcome several similar obstacles, and integration often gained a new momentum through the measures taken in the crisis. Today, similarly brave political solutions are necessary, while the technical issues can be solved by the existing institutions in the specialised fields, but this alone is not enough for making progress. The statement made by Alexandre Lámfalussy in 2000 is still valid: "either to dawdle aimlessly along in our slowcoach, in the slow lane – with … the world passing us by, or to change and capture the benefits".[8]

According to Benoît Cœuré, Europe faces a similar dilemma today. Deepening integration requires a new political strategy. In order to manage the economic

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

[8] Lámfalussy argued in 2000 that the Union had a clear choice: "either to dawdle aimlessly along in our slowcoach, in the slow lane – with … the world passing us by, or to change and capture the benefits". Source: Summary of remarks made by Alexandre Lámfalussy, Chairman of the Committee of Wise Men on the Regulation of European Securities Markets, to the Press concerning the Committee's initial report published on 9 November 2000 (http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/lamfalussy-summary_en.pdf)

problems jointly, the framework of cooperation should be also changed. Today, economic integration may be carried further by political decisions facilitating stronger political cooperation.

According to *Jan Smets,* Governor of the National Bank of Belgium, Alexandre Lámfalussy navigated the euro to safe ports in uncharted waters and thereby laid the foundation for a real economic and financial union. Governor Smets suggested that it would make sense to increase competitiveness at national levels, by setting up national competitiveness councils – if so required – that coordinate, for example, the conflicts of interest between the trade unions and other economic agents. The fiscal council, the goal of which is to preserve the fiscal balance and control central spending, works efficiently in Belgium. In addition to the government, the autonomous regions and local governments also participate in this work, ready to make compromises. The Governor of the central bank of Belgium closed his presentation by noting, "Countries of Europe, we are dependent on each other!"[9]

In his presentation[10] *Edmond Alphandéry,* former Minister of Economy of France and currently Chairman of the *Euro50 Group*, dealt with the lessons learnt from the Greek crisis. He emphasised that the Greek crisis could become also a crisis for the euro area due to the severe disparities between the countries in the euro area. In the first years after the creation of the monetary union, there were strong hopes for fast convergence by the less affluent countries and this trust also attracted investors to these regions. When the crisis erupted, strong capital inflows reversed into strong capital outflows, generating severe tensions in the debt financing of these countries. Financial difficulties soon generated social and political tensions, further exacerbating the problems that arose due to the shaken trust of investors. Further escalation of the crisis can only be stopped by reinforcing the economy's shock absorbing capacity by joint efforts. This places a duty upon both the countries of the Union and Greece. Success can only be achieved by deepening integration. Alphandéry recalled that the Union had faced challenges before as well, and a breakthrough could only be achieved by the political deepening of integration. He reminded the audience of the words of Jean Monnet: "Europe will be forged in crises, and will be the sum of the solutions adopted for those crises."[11] He recalled that Monnet had managed to convince both France and Germany to take the steps necessary for the creation of the European Union, despite the numerous opponents to political integration.

[9] *http://magyarhirlap.hu/cikk/46638/Nincs_gazdasagi_bovules_penzugyi_stabilitas_hijan#sthash.RVdr8Lq2.dpuf*

[10] Title of his presentation: What lessons from Greece can be drawn for the EMU?

[11] "Europe will be forged in crises, and will be the sum of the solutions adopted for those crises." Jean Monnet

Having drawn the lessons from the crisis of the euro area, *Klaus Regling*, Managing Director of the European Stability Mechanism (ESM), started his presentation by stating that although Hungary is not a member of the euro area, it has already made a major contribution in the person of Alexandre Lámfalussy. Regling interpreted the fact that Europe managed to recover from the shocks, which was undeniably the most severe one since the 1929–33 crisis, and that the euro survived the crisis, as the sign of the viability of the euro. In his view, there are probably not too many other common currencies that would have been able to achieve this. Regling emphasised that, on the whole, the consequences of the crisis were managed successfully.[12]

The moderator of the panel discussion in the afternoon of the conference was *György Szapáry*, Ambassador, Chief Advisor to the Governor of the MNB. The discussion was attended by Dániel Palotai, Executive Director and Chief Economist of the MNB, Daniel Gros, Director of the Centre for European Policy Studies, and Niels Thygesen, Professor Emeritus, University of Copenhagen.

Dániel Palotai, Executive Director of the MNB, emphasised that it made one major difference between the present financial crisis and previous crises was that the small open economies of Europe were not in a position to “export themselves out of the crisis”, as the growth of the export markets abruptly slowed down globally. He recalled that the Hungarian central bank recognised this in due course and announced the Funding for Growth Scheme to boost growth. The high level of government debt was another major problem that hindered the development of the Hungarian economy, and the government applied innovative, unconventional solutions to manage this problem. The most important measure taken to stabilise and reduce the debt was the improvement of the budget balance. For the first time in a long while, in 2001 the budget closed with a surplus in Hungary as a result of the pension reform. By the end of 2015 Hungary achieved a positive change also in the debt structure, by reducing the ratio of foreign currency debt in the total debt from roughly 50 per cent close to 30 per cent. In the past, the high tax burden on labour had a negative impact on economic performance and employment. In order to remedy this problem the government cut taxes to reduce the tax wedge on labour. He emphasised that monetary policy gradually reduced interest rates to a level that nobody would have imagined a couple of years ago. He remarked that the Monetary Council thought this level can be maintained until the end of 2017. He also noted that the growth performance of the Hungarian economy has outstripped average European growth for a considerable time, and investors’ perception of Hungary has improved, although this improvement had not yet been reflected in the reports of the international credit rating agencies.

[12] http://magyarhirlap.hu/cikk/46638/Nincs_gazdasagi_bovules_penzugyi_stabilitas_hijan#sthash.RVdr8Lq2.dpuf

According to *Niels Thygesen*, Professor Emeritus of the University of Copenhagen, the creation of the European Union and the smooth introduction of the euro were attributable to fortunate timing, as at those times the employers, the politicians and the trade unions all supported it because they envisaged the advantages of the integration and the larger market. This helped to overcome the great political uncertainties that surrounded the process.

Daniel Gros, Director of the Centre for European Policy Studies (CEPS), noted that corporate finance in Europe relied on bank financing, while in the United States capital market funding played the primary role in corporate funding. As a result of this difference, the stability of European banking systems has a critical impact on the conditions of economic growth. Keeping interest rates at a low level on a permanent basis is another important factor of growth conditions. He pointed out an interesting duality in the quantitative easing policy of the European Central Bank (ECB), insofar as the separation of the nation states once again appears here, since the asset purchases are managed by the nation's central banks and they buy the government securities of their own countries within the quantitative limits specified by the ECB. He noted that in the individual countries the average duration of the government securities acquired by the central banks in the course of the asset purchases was different. The countries deemed riskier by the markets are usually characterised by longer residual maturity of the central bank's portfolio. In these countries, investors make efforts to shorten the maturity of their portfolio and thereby reduce their potentially large capital loss on long-term securities, which would occur if the papers were repriced due to an anticipated interest rate increase. Gros pointed out that through this tendency the maturity of the state's liabilities shortens, which reduces the risk of their government debt. This government debt risk mitigating impact of quantitative easing differs from country to country. In the countries with higher risk the maturity, and thereby the risk, decreases to a greater degree. He believes that this is an undesirable phenomenon, as it becomes easier to increase debts particularly in those countries where the opposite of that would be desirable.

In his closing speech *György Matolcsy*, Governor of the Magyar Nemzeti Bank, thanked the participants for their contribution to the success of the conference. This year's conference – in addition to addressing the most important problems of Europe – was a commemoration and a tribute to Alexandre Lámfalussy, who passed away in May 2015. The lecturers all highlighted the importance of Lámfalussy's intellectual legacy and the usefulness of the guidance provided thereby in the management of current problems. They agreed that the strengthening of political stability in the euro area required urgent structural reforms and further progress in the development of the monetary union. The management of today's problems, the reduction of high unemployment and the reform of the unsustainable tax regimes must be implemented in a particularly difficult situation, facing new global challenges exacerbated by climate change and the migration. To accomplish this Europe needs a new social contract.