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Report on the Online 'Lámfalussy Lectures Conference' Held in January 2021*

Ferenc Tóth

The Lámfalussy Lectures Conference – the most significant international event organised by the Magyar Nemzeti Bank (the Central Bank of Hungary, MNB), named after Alexandre Lámfalussy, the Hungarian-born economist and renowned European finance expert – was held for the eighth time on 25 January 2021, in an online format for the first time in its history with regard to the epidemic situation. The topic of the event was „The future of monetary policy after Covid-19 with a perspective for public debt evolution". The Lámfalussy Award and Popovics Award were presented during the conference.

In his opening remarks, *Barnabás Virág*, Deputy Governor of the Magyar Nemzeti Bank, noted that the Covid-19 epidemic had caused unprecedented economic and social disruption around the world. Several countries had experienced a decline in economic activities and been forced to impose strict lockdowns to curb the spread of the virus. The epidemic posed serious challenges for policymakers. To reduce the negative economic impact, fiscal and monetary authorities implemented large-scale measures such as job protection schemes and government securities purchase programmes to support the economy. The Covid-19 crisis changed the way the world operates with potential shifts that will outlasts the epidemic. In three main points, the Deputy Governor of the MNB summarised what central banks will look like in the future after the crisis caused by Covid-19: (1) There will be closer co-operation between fiscal and monetary policies. An optimal policy mix can only be achieved through continuous communication and cooperation between different branches of economic policy. In Hungary, for instance, the government introduced tax breaks and job protection measures to alleviate the situation of businesses and employees as the pandemic erupted, and simultaneously the MNB took a number of targeted, coordinated measures to provide the required amount of liquidity to all economic agents. As a result of the measures, no financial turmoil emerged at any point in any submarket. (2) The second feature is the expansion of central banks' balance sheets. Support for economic growth coincides with a dynamic increase in the balance sheets of central banks. Central bank balance sheets expanded to record levels due to asset purchases and other liquidity providing measures. In Western

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Ferenc Tóth is a Senior Economic Analyst at the Magyar Nemzeti Bank. E-mail: tothf@mnb.hu

Europe, this was rather necessary to secure stable financing of public budgets due to extraordinary measures taken by governments. By contrast, for Central and Eastern European central banks, this was more of an opportunity to support governments in crisis management. Between 2013 and 2019, the MNB maintained its monetary policy room for manoeuvre by keeping the size of its balance sheet low compared to many other central banks. This allowed the MNB to launch its government securities purchase programme in order to maintain a stable liquidity position in the government securities market and strengthen the effectiveness of monetary policy transmission. (3) The continued presence in the government securities market will mean a larger central bank balance sheet, which will be the new norm in the future. However, the objective of government securities purchase programmes is not to finance budget deficits, but rather to ensure the smooth functioning of the government bond market. This will improve monetary transmission, which in turn will contribute to the MNB's primary objective of price stability and keeping long-term interest rates relatively low. Central banks can also promote sustainability in two areas, by supporting green financing and digitalisation. In both cases, the MNB intends to play a pioneering role. He then indicated that there is a need for targeted money creation to address the most pressing challenges of the 21st century. This is more sustainable than general money creation and can ensure financial stability in a broader sense. Debt always remains debt, while deficits always become debt. The winners of the next decade will be those who draw the right conclusions and find creative, wise and courageous new solutions.

This was followed by the award ceremony of the Lámfalussy and Popovics Awards, as the Lámfalussy Gala, which traditionally preceded the conference, did not take place due to the pandemic situation. The Lámfalussy Award is bestowed on internationally outstanding professionals who exercise significant influence on monetary policy. This year, this prize was awarded to *Boris Vujčić*, Governor of the Croatian National Bank (CNB), who was a member of the Steering Committee of the European Systemic Risk Board, a member of the Financial Advisory Committee of the Federal Reserve Bank of Atlanta, a member of the Board of the Global Development Network and has been Chairman of the Steering Committee of the Second Vienna Initiative since October 2016. Mr Vujčić has played a key role in Croatia's accession to the European Union, in the reform of Croatia's monetary policy instruments and in keeping the kuna (the Croatian currency) stable, which has helped to bring the country to the brink of adopting the euro. The Popovics Award, named after the first Governor of the MNB, rewards outstanding professional work in the field of economics and finance. This year, *Gergely Fábián*, Executive Director of the MNB's Financial System Analysis and Statistics and CEO of the Budapest Institute of Banking, received the Popovics Award.

The topic of *Boris Vujčić's* award recipient speech was non-traditional monetary policy in emerging countries. He explained that central banks were expected to respond to almost all problems these days: achieving inflation targets and addressing the lack of economic growth or credit, even inequality and environmental protection issues, or now, for example, in Croatia, dealing with the consequences of the earthquake. Looking back at interest rate developments in recent years, few would have thought that a negative interest rate environment would be more than a temporary phenomenon in economies. Today, however, extremely low interest rates seem to remain a constant feature of the economy. Recent research suggests that the downward trend in interest rates spans a much longer period, at least seven centuries. Falling interest rates seem to predate even the establishment of the first central banks. Over time, the frequency at which negative real rates appeared has increased, and that happened regardless of the dominant monetary regime such as fiat money issued by a central bank, or some form of species monetary standard such as gold or silver. It is an interesting twist of fate that it is the reduction of investments, as population growth slowed and the nature of technology changed, that is pushing interest rates down, rather than an increase in savings. Savings rates have remained robust due to the rising "rich savings glut", rather than due to any increase in general living standards. In addition, a growing portion of the world's surplus savings are generated by Far Eastern economies, with capital flowing towards richer economies. Furthermore, the impact of low interest rates on inequality is far from straightforward. Various channels work in different ways and many blame them for the increase in inequality, especially the inequality in wealth. Low interest rates interact with the economy in a complex way, with some evidence of its negative impacts on productivity growth, commonly known as the "zombification of the economy". Due to the problem of the lower bound on policy rates, in the major advanced economies, central banks pursued asset purchase policies in the context of quantitative easing and forward-looking guidance. Until recently, such policies were definitely limited to a small number of large central banks that issue reserve currencies. However, since the Covid-19 crisis, some 20 emerging market central banks have launched asset purchase programmes. Such policies have reduced bond yields and improved financing conditions for the domestic economy. In emerging economies, the main objectives of asset purchase programmes are much more related to stabilising markets and less to pushing up inflation. Last year, the Croatian National Bank conducted one of the largest asset purchases among the emerging economies, accounting for about 5.5 per cent of GDP. Although the CNB did not opt for the purchase of domestic securities, but rather for the accumulation of international reserves, the bank's liquidity channel operated in the same way. The foreign exchange swap agreement with the European Central Bank (ECB) and subsequent accession to ERM-II have also contributed to the stabilisation of markets and the success of the asset purchases. Asset purchases used so far in emerging economies do not appear to generate major risks to the

domestic economy. At the same time, the unconventional policies of major central banks, which drive capital flows and credit cycles at the global level, are likely to continue to be an immediate source of risk to the financial stability of emerging economies.

Subsequently, *Yi Gang*, Governor of the People's Bank of China (PBOC), gave a keynote speech. The Covid-19 pandemic left its mark on the last year. The PBOC took a number of measures to give a strong impetus to the economic recovery, with the objective of stabilising employment. In China, most workers are employed in the private sector, especially at SMEs. Therefore, the PBOC has – via its credit policy – encouraged commercial banks to increase their funding to micro and small enterprises. Two loan instruments were introduced to support micro and small enterprises, with deferred loan repayments and preferential borrowing facilities without collateral. By the end of last year, banks had provided about USD 1,000 billion in deferred capital and interest rebates, and micro and small businesses had received soft loans worth about USD 500 billion. This provided support for more than 31 million businesses entities. Lending decisions are made by commercial banks, as they are responsible for the credit risk, but the PBOC provides some incentive tools. Banks that provide loans for at least six months are eligible for a lump sum subsidy equal to 1 per cent of the principal, and the PBOC provides refinancing up to 40 per cent at zero interest rate for those lending without collateral. The base rate was reduced by 50 basis points last year, while the 10-year government bond yield is about 3.1 per cent, the overnight repo rate is less than 2 per cent and the consumer price index is currently about 2.5 per cent. The RMB exchange rate is at USD/RMB 6.5, having appreciated by around 7 per cent versus USD last year. Monetary policy will continue to adjust to new economic developments in a timely manner, but will strike a balance between stabilising economic growth and preventing risks. The PBOC will keep the growth rate of money supply in line with the nominal GDP growth rate. The PBOC will use its two monetary instruments this year, as well. In this way, it helps and encourages banks to use their loans to support the development of the real economy, especially agriculture, as well as micro and small enterprises and private businesses. President Xi Jinping announced that China would reach its peak carbon emissions before 2030 and become a carbon-neutral economy before 2060. Therefore, the PBOC is focusing on promoting the development of green finance. In China, green loans worth USD 1.7 trillion were issued, ranked first globally. In addition, more than USD 154 billion worth of green bonds were issued, making China the second largest green bond market in the world. In order to achieve the green goals, the 5 pillars of the green financial system need to be further improved:

1. the system of green financial standards,

2. the supervision of financial institutions and disclosure requirements for green finance related information,

3. on the regulatory side, financial institutions should be encouraged to provide soft loans by reducing CO_2 emissions,

4. continuing to develop products such as green credits, green bonds and green funds. A carbon market and a market for green futures need to be developed, and

5. strengthening international cooperation in green financial standards, and in particular the finalisation of the China-EU common ground taxonomy as soon as possible.

The next part of the conference was the panel discussion, moderated by *György Szapáry*, Chief Adviser to the Governor of the MNB, on the topic of the future of monetary policy in the post-coronavirus epidemic period, in particular with regard to the development of public debt. *Philip R. Lane*, Member of the Executive Board of the ECB and former Governor of the Central Bank of Ireland, *Jacques de Larosière*, former Managing Director of the IMF and former Governor of the Banque de France, *Yang Yao*, Professor at Peking University, and *William B. English*, Professor at Yale University, former Director of the Division of Monetary Affairs and Secretary to the Federal Open Market Committee, participated in the panel discussion. In his introduction, György Szapáry said that while no one questioned the need for monetary and fiscal expansion to restart economies, there is a need to look beyond the short term and think about the monetary policy framework for the coming years. He presented three charts as thought-provoking:

1. The first chart showed the balance sheets of the main central banks in terms of GDP from 2007 onwards. The two crises led to the expansion of balance sheets as central banks pumped huge amounts of money into their economies. In the case of the Fed, the Bank of England and the Bank of Japan, the central bank balance sheets as a ratio of GDP have risen up to five to six times. (In the case of the ECB, this indicator has more than tripled.) The question arises as to whether this foreshadows a resurgence of inflation.

2. The second chart presented developments in financial assets and real wages in the USA and Germany. The discrepancy is striking, as the money injected led to a rapid increase in the value of financial assets, far outpacing real wage developments. This resulted in a significant increase in income inequality. How much should central banks worry about this?

3. The third chart illustrated the rapid growth of government debt in 2007 and 2020. Can we assume that the "r-g", i.e. the difference between real interest

rates and growth, will remain negative for a long time and that debt servicing will not be a problem?

Philip R. Lane noted that the current configuration of macroeconomic policies around the world was striking. The large-scale, but temporary nature of the global epidemic requires an oversized fiscal response that takes into account the shortfall of income for workers and companies, the asymmetric effects across industries and the need to finance extensive fiscal support over a very long period. The optimal contribution of monetary policy is to provide ample liquidity to maintain credit supply and stabilise markets, combined with an accommodative monetary stance to counter the negative pandemic shock. To achieve these goals, the ECB has developed a wide range of tools. Of these, the pandemic emergency purchase programme plays a particularly important role, given that it is expressly designed as a means of responding to the shock caused by the epidemic. Looking beyond the pandemic period, the future orientation of macroeconomic policies will face a number of challenges. The implications of low equilibrium real interest rates on fiscal and monetary policy is a key issue. It is equally important to review the conditions for fiscal sustainability and the appropriate role of fiscal policy in macroeconomic stabilisation. In relation to monetary policy, the decline in the equilibrium real interest rate is a central topic in the ongoing strategic review of the ECB.

Jacques de Larosière expressed the view that first, central banks deserve praise for their swift and massive action, as economic agents were provided with the necessary liquidity after the outbreak of the global epidemic. Thus, they managed to avoid an economic collapse, and central bankers were once again seen as heroes. Second, the former head of the IMF emphasised a critical view on the pre-pandemic loose monetary policy conditions. This resulted in indebtedness of the economies over the past 15 years. In the pre-epidemic period, adherence to the 2 per cent inflation target led to unnecessary quantitative easing. Third, with the current massive purchase programmes for sovereign securities, central banks have become *de facto* agents of fiscal policy. The long-term effects of central banks becoming quasi-direct financiers of budgets can only be seen years later. Low and excessively low levels of negative interest rates for too long have significant disadvantages in the long run, causing a liquidity trap. Great care must be taken not to jeopardise growth by setting interest rates too low. This could lead to yield hunting and the appearance of asset bubbles, weakening the stability of the financial system and increasing the chances of crises. Extremely loose central banking policies are hampering the introduction of government reform measures, discouraging long-term investors, and shifting savings toward short-term and speculative investment directions. In his opinion, the lack of inflation is misleading, since the increase in the value of

financial assets and real estate is also a kind of inflation, which in itself can lead to a crisis at any time.

Yang Yao suggested that the huge expansion of liquidity will result in a crisis and the "superfinancialisation" of the world, which will have long-term consequences. If the financial sector is to grow forever, it will require the real economy to move towards higher-yielding sectors. The link between the financial sector and the real economy is becoming weaker. This also means that the financial sector itself will become a kind of self-sustaining economy. Central banks are expanding liquidity, believing they can take it back in the future. However, historical experience says that in practice it is very difficult for central banks to reduce their expanded balance sheets, and therefore the excess liquidity will persist for a long time. One good example of this is Japan, where it will be very difficult for the government to ever repay its debt, which is close to 300 per cent of GDP. In Japan, there is virtually no inflation, and the central bank cannot use the instrument of monetary stimulus. In his view, in such a case, fiscal policy should probably play a much bigger role. In China, the monetary policy of the central bank was judged to be rather cautious, while on the other hand, the government increased spending quite aggressively. About half of last year's 2.3 per cent growth was related to public investment, while the other half was related to exports, which means fiscal policy played a significant role in recovering from the crisis.

According to *William B. English*, the Covid crisis will not change the outlook for monetary policy in the United States and other advanced economies, but it is clear that the actual lower bound will limit anti-cyclical monetary policy in the foreseeable future. This is because equilibrium real interest rates are low. Actual inflation and inflation expectations have remained stable and at equally low levels. Central banks have been successful – at least for the most part – in forecasting inflation. It is possible that inflation will rise in the future. In the future, a rise close to the inflation target would even be welcomed, but inflation expectations will probably remain low and stable. Post-epidemic monetary policy needs to focus on unconventional monetary policy, as traditional monetary policy is already limited, but it is not yet clear how effective non-traditional policy is. Many countries have already introduced unconventional instruments such as forward-looking guidelines or asset purchases, but such policies also have limitations. There are a large number of other possible programmes to encourage lending to businesses and households, such as low-cost central bank financing to encourage banks to lend more or, directly, the central bank may purchase corporate securities and thus improve financing conditions. However, these programmes are also subject to certain constraints, unless they are transformed into substantially support-only programmes, which are already more fiscal measures than monetary ones. The Fed has already made some changes to the inflation targeting system and other central banks will follow

this in the future, adjusting the monetary framework. Overall, the benefits of the new monetary policy framework need to be considered. In addition, strengthening monetary-fiscal cooperation should also be considered. It can be seen that a more active counter-cyclical fiscal policy will be needed to keep the economy on track. By maintaining low interest rates, monetary policy can continue to help provide room for fiscal manoeuvre and avoid expected crises. One important issue is the possible direct monetary financing of the budget deficit. There is a horrible experience of this from wartime. This can result in very high and persistent inflation and the situation would be worse rather than better. To avoid this, institutional arrangements may be needed to preserve central bank independence.

At the end of the conference, *Barnabás Virág* concluded that the speeches and panel discussions once again demonstrate that difficult situations inspire innovative thinking and that we can benefit from the experience of the recent period. The thoughts and ideas that were shared during the conference confirm that a new era of central banking is on the doorstep. We should take the opportunity and start building a better future now. Central banks can mainly contribute to this in three ways:

1. Closer cooperation between fiscal and monetary authorities ensures that the right policy mix is applied at all times.

2. A larger balance sheet will also enlarge the monetary policy room for manoeuvre. To mitigate the adverse financial effects of the pandemic, central banks intervened quickly and decisively. Potential negative repercussions can be handled in the same manner should further crises arise.

3. Continuous presence in the government securities market improves monetary transmission and ensures that interest rates remain persistently low. Maintaining sustainable government budgets will receive greater attention. Once economic growth is restarted, the focus needs to be shifted on restoring balance. Central banks can support the issuance of green bonds. This incentivises businesses to conduct greener practices. Implementing digital innovations can greatly improve efficiency, and central bank digital currencies might be the basis of our payment systems in the future.

In addition, a new era of thinking has begun worldwide. Events such as the Lámfalussy Lectures Conference provide a platform to share and further develop such ideas.

The entire conference can be viewed on the MNB's YouTube channel: The future of monetary policy after Covid-19 | Lámfalussy Lectures E-Conference.