Bank of England Tercentenary

Per Jacobsson Lecture

Central Banking in Transition

Baron Alexandre Lamfalussy

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Foreword

Baron Alexandre Lamfalussy, President of the European Monetary Institute, delivered the first of the two Per Jacobsson lectures held in 1994. The title of his lecture was "Central Banking in Transition." The lecture was held in conjunction with the tercentenary celebrations of the Bank of England and took place at the Barbican Hall, London, on June 8, 1994. Sir Jeremy Morse, Chairman of the Per Jacobsson Foundation, presided over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures are sponsored by the Per Jacobsson Foundation and are usually held annually. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.

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Opening Remarks

Sir Jeremy Morse

Good afternoon, ladies and gentlemen. On behalf of the Per Jacobsson Foundation, represented on the platform by Jacques Polak and myself, I welcome you to this latest lecture in our series, which is distinguished by its occasion, its audience, and its speaker.

The occasion is the midpoint in a week of celebrations for the tercentenary of the Bank of England. After three big gatherings of commercial bankers at the Forex Congress, the Bullion Conference, and the International Monetary Conference, we come now to the Bank of England's party and tomorrow's central banking symposium and dinner. I would like to thank the Bank warmly, and especially the Bank's Secretary, G.A. Croughton, and his assistant, C.R. Bennell, for their help in organizing this lecture.

When the lecture is held during the IMF's Annual Meeting in Washington or elsewhere, our audience consists largely of commercial bankers; and when it is held in Basle, largely of central bankers. In the circumstances of this week, tonight's audience combines both, and adds a third distinguished contingent from London.

If central banks are at the heart of national economies, their own international hub is Basle. Alexandre Lamfalussy has been with the Bank for International Settlements at the center of Basle for the past 18 years, including 8 years as General Manager, before taking on his present job as the first President of the European Monetary Institute. So we could not have chosen a more centrally placed speaker for this lecture, entitled "Central Banking in Transition." I now invite him to deliver it.

Central Banking in Transition

Baron Alexandre Lamfalussy

Central banking has never been a static business. Throughout its long history it has performed different tasks in different periods; at the same time, developments have been far from identical in the various national central banks. In a long and broad historical perspective, central banking has always been in transition—just like most of our institutions in modern times.

But there is another sense in which the title of my lecture is, I believe, justified. During the past twenty years or so the financial systems of the developed world have been involved in an exceptionally fast process of change, the end of which is, moreover, nowhere in sight. The expression "acceleration of history" surely applies to the contemporary financial scene. The novelty does not lie only in the pace of change; it has also to do with the fact that change is occurring everywhere in the developed world, and even beyond. We now operate within an internationally integrated, innovative, highly competitive global financial system.

It is in this genuinely new environment that, over the last few years, central banking seems to have acquired enhanced importance—perhaps not in relation to its role at the time of its founders, but surely in comparison with the perception of its role between the end of the Second World War and the early 1970s. Monetary policy has come to be regarded as the dominant element of macroeconomic policy, with the explicit mandate to ensure price stability. Central banks have been granted, or are in the process of being granted, a high degree of independence in the conduct of monetary policy. At the same time, they continue to be called upon to assume responsibilities in securing the integrity of the financial and payment systems. Not surprisingly in such circumstances, quite a few prominent central bankers have acquired a high public profile: regular readers of the economic and financial press will notice the

weight attached by journalists to the statements and actual or potential decisions of central bankers.

Being part of their world I should perhaps feel proud of these developments. My feeling of pride is, however, tinged with some unease. Independence goes hand in hand with accountability, yet achieving price stability and safeguarding the stability of the financial and payment systems is not going to be an easy task in the new financial environment. I nevertheless believe that, with careful policies (by which I do not mean only monetary policies) and with some luck, these are achievable objectives. This is the main point I should like to make in this lecture. My remarks will be grouped around four themes: the macroeconomic policy mix and the quest for price stability; financial innovation and the conduct of monetary policy; systemic stability; and the international dimension.

THE MACROECONOMIC POLICY MIX AND THE QUEST FOR PRICE STABILITY

The assumption underlying the proposition that central banks should be given the explicit mandate to ensure price stability is that inflation is a monetary phenomenon. This assumption, I think, is basically true, but it needs to be spelled out. The late Henry Wallich, who cannot be suspected of having been complacent either about inflation or about the role of monetary policy in fighting inflation, used to say that inflation is a monetary phenomenon in the same way as shooting people is a ballistic phenomenon. This may have been, and indeed was, an after-dinner *bon mot*, but perhaps not only that.

Inflation is surely a monetary phenomenon in the sense that it cannot last without an accommodating increase in the money supply. Conversely, restrictive monetary policy is always able to put an end to the process of inflation. I would go even further. While, in the short run, monetary and fiscal policies have a joint impact on both activity and the price level, in the long run it is money that exerts a determining effect on prices. Finally, when market participants share these views (and I think that in today's world they actually do) their perception of what the central bank is doing, or will be doing, influences their price and wage setting behavior. This can shorten the time span elapsing between monetary policy deci-

sions and actual price behavior. In all these senses inflation is indubitably a monetary phenomenon. There are, however, several qualifications, of which I propose to mention only three. All three relate to the fiscal policy environment in which monetary policy operates.

First, take the case where as a result of a deliberate policy decision the fiscal balance suddenly swings into deficit. Even if monetary policy remains on course there will be an increase in aggregate demand, accompanied by a rise in interest rates. If resources are close to full utilization there will be an acceleration of price increases. Of course, in the end the fiscal policy move will exhaust its expansionary effects and the influence of higher interest rates will prevail. There will be a recession and inflation will decelerate. Conclusion: the stability-oriented monetary policy has in fact stopped the process of inflation, but it could not prevent either an initial inflationary slippage or a deeper recession than would have been warranted without the initial fiscal stimulus. Yet it would be strange to hold monetary policy responsible, first, for the acceleration in price increases and, second, for the depth or duration of the recession.

Second, a large and persistent public sector deficit is likely to trigger inflation expectations. Market participants may well be aware that what matters for inflation in the long run is the rate of monetary expansion and not the size of the fiscal deficit in itself. But they also have a long memory and remember how often in the past monetary authorities bowed to political pressure and ended up by financing the public sector's borrowing requirement through monetary expansion. By granting central banks independence from governments and by formally prohibiting central bank financing of the public sector (as is laid down in the Maastricht Treaty) we may help to defuse such expectations. But there is a genuine possibility that market participants will still want to insure themselves against the risk of inflation by adding an inflation premium to long-term interest rates. If central banks want to allay the markets' suspicion, they will have to underpin their credibility by demonstrating their determination to fight inflation. The resulting policy mix will not be optimal for economic growth. But through whose fault?

Finally, let me add to these two rather conventional observations a third that tends to be overlooked. The efficient conduct of a non-inflationary monetary policy can also be hampered by the *level* of

government spending even if it is adequately financed out of fiscal and social security revenues. A high level of transfer payments and the correspondingly high fiscal or wage cost burden weakens the kind of flexibility in price and wage formation that is essential to the smooth working of the transmission mechanism. In such an environment an anti-inflationary monetary policy will run into a zone of, so to speak, "diminishing returns." In other words, a given reduction in the rate of inflation will necessitate a higher degree of monetary restraint, and such restraint will affect not only prices but also output, and perhaps output more than prices. Again, the responsibility would seem to rest with fiscal policy.

My main conclusion is that monetary policy does not operate in a fiscal policy vacuum. The proposition that monetary policy can in the end achieve price stability is true. But it does not tell the whole story and the rest of the story is of quite some importance for economic growth. One cannot circumvent the need for an appropriate policy mix. Granting independence to central banks creates the condition for a balanced dialogue between monetary and fiscal authorities, but an optimum policy mix requires two correct decisions, not simply one.

Financial Innovation and the Conduct of Monetary Policy

There are two broad channels through which financial innovation can impede the efficient conduct of monetary policy. In both cases, the disturbance arises because elements of uncertainty are introduced either in the monetary authorities' decision-making process or in the transmission mechanism, that is, the way in which a monetary policy decision affects prices and the real economy.

I shall not dwell much on this second type of disturbance; not that I regard it a priori as unimportant, but because of ignorance. Little research has been undertaken into the possible influence of financial innovation on the transmission mechanism, and the results have been unimpressive. Take the example of just one, simple, almost "Stone Age," innovation: the use of floating interest rates. Economists long debated as to whether the wider use of floating interest rates accelerates or slows down the impact of monetary policy on the economy. In the end they concluded that a lot depends

on the asset/liability balance of households and corporations, on the structure of both assets and liabilities and, naturally, on interest rate expectations as well as on the influence of monetary policy on the rates at the long end of the market. Not a very clear conclusion. It is therefore not surprising that the potential influence of far more complicated devices, such as swaps, interest rate futures, or options, is still terra incognita. More systematic work is now under way among central banks. I hope that in the not too distant future someone will be able to report on this research.

I am, however, ready to stick my neck out on the first topic because we know more about it and also because I know it to be of crucial importance. The main point here is that financial innovation seems to have cast doubt on the usability of an intermediate money supply target. The jury is still out on this issue. On the one hand, the erratic behavior of the demand-for-money function in the English-speaking countries has led their central banks to downgrade whatever M they have used to the more modest position of an information variable or even to switch explicitly to the final target of price stability. The Bundesbank, on the other hand, has remained faithful to its M3 target on the grounds that the relationship between M3 and prices, when measured over the medium term, has in the past been reasonably stable. The Bundesbank also argues that it has never regarded M3 as the only guide for its monetary policy and that in any event the target has been a range rather than a single figure.

Only time will tell us whether the acceleration of financial innovation that is now under way in Germany will lead to the kind of unpredictable behavior in the demand-for-money function that occurs elsewhere in the developed world. It is also still too early to say whether the recent behavior of M3 in Germany foreshadows such a development, or whether it is just a passing aberration.

If Germany were to experience the kind of instability prevailing in the Anglo-American world, the Bundesbank would join the ranks of central banks that are already having a difficult time. Money supply targeting has indeed performed a highly useful role in the conduct of monetary policy, and may have been instrumental in enabling central banks to bring inflation under control.

The main advantage of a money supply target is that the "stance" of monetary policy is thereby clearly defined, which helps the formation of expectations by market participants. When the targeted

rate of growth of M remains unchanged, monetary policy can be said to be on an even course. While central banks still have to take decisions on operational interest rate targets, in a broader sense market interest rates are the outcome of changes in nominal GDP, and therefore of the demand for money, against the background of a steady expansion of the targeted M. The implications of this are substantial. Money supply targeting relieves central banks of some of the pressure that might be exerted on them by governments or parliaments. The decision-making body of the central bank is more easily able to avoid the temptation of "judgmental" adjustments to monetary policy. Finally—and this is perhaps the most important implication—a money supply target that is relatively well understood by the public at large gives a clear signal to market participants as to the range of price adjustments and wage settlements that is compatible with a stability-oriented monetary policy. Beyond this range, they would run the risk of pricing themselves out of the market.

If we were to cast aside money supply targeting altogether, the conduct of monetary policy would clearly become more difficult. For this would not simply mean a return to the judgmental type of monetary policy that had prevailed during the twenty-five years following the Second World War. It would mean carrying out a judgmental type of monetary policy in a new set of circumstances, in which central banks are entrusted with the explicit mandate to secure price stability and have no excuse for failure, because as independent entities they do not have to comply with the whims of their political masters.

While all this signals difficult times ahead, I am nevertheless not unduly pessimistic. Let us assume that it will be impossible to find in the future a specific, well-defined M that can be effectively controlled by the central bank and that displays at the same time a sufficiently stable relation to prices to make itself usable as a strictly interpreted intermediate target; and by "strictly interpreted" I mean that any departure from that target would have to be countered within a predetermined time by a change in monetary policy. I note, to begin with, that targeting of this kind has hardly ever been practiced. And central banks have always taken other considerations into account. The main point, however, is that it is a long way from this kind of targeting to decision making based purely on an ad hoc review of current economic circumstances.

There are a great number of intermediate solutions. One that I could see gradually emerging is that an M would be announced as a target, but the target would be interpreted as an obligation for the central bank to publicly explain, if it wishes to disregard a deviation in the growth of M from the targeted path, why it does *not* intend to take corrective action. A somewhat looser commitment would consist in the designation of more than one M, which would of course give greater leeway for interpretation. Whether the announced M would still deserve in this case to be called a target or would have to be called just an indicator, is a matter of semantics. The substance is the commitment to explain the reasons why the decision is taken to disregard the signal given by a divergence from the target. Such an obligation would mean that the central bank is not free to undertake ad hoc decision making: the obligation to go public *is* a constraint. It would also imply that, while we may have trouble in finding the proper money supply figure, the role of money (indeed of money supply) in the inflationary process would remain firmly acknowledged. Finally, it would be very much in line with the doctrine of democratic accountability.

SYSTEMIC STABILITY

Preserving the stability of the financial system has been a traditional task of central banks—indeed, historically, very often they were entrusted with this task at the same time as with that of issuing banknotes. While today in many countries the micro-prudential function has been given to institutions distinct from central banks, there is little doubt that even in these countries central banks continue to be held responsible, or at least co-responsible, for securing the stability of the financial and payment systems as a whole. In fact, central banks *have* played a major role in recent years—and a successful one—in preserving systemic stability, even though they have not been the only players. The new financial environment is not going to make this macro-prudential task easier to carry out. Let me list briefly the main reasons for this.

First, there is the globalization of financial markets, by which I mean not only international financial integration but also the fading of demarcation lines between financial products as well as between different segments of the financial industry. Add to this the steady

progress in information systems and communications technology, and the result is the transmission, with lightning speed, of financial impulses originating in one country or in one market segment to other countries or the rest of the industry.

Second, all financial asset prices—the recent behavior of bond markets is a case in point—display a high degree of variability. This means both short-term volatility and large movements apparently disconnected from underlying fundamentals that, of course, are eventually corrected, but often only after a long time. There is no simple explanation for this price behavior, at least not one that would be obvious to me. Inappropriate policies or uncertainties surrounding policy decisions may in some cases have been responsible for excessive volatility or for misalignments, but I do not share the view of those who argue on a priori grounds that *all* erratic price movements are caused by policy mismanagement. Anyone who has operational experience in markets is likely to have come across very strange collective market behavior that would be hard to explain by reference to public policy blunders. But I do not claim to know why such market behavior occurs and still less why it occasionally persists sufficiently long to take on the dimensions of a genuine misalignment. The globalization of markets may be part of the explanation. Some derivatives may have increased volatility. The very large share of trading in total transactions may have played a role. But I suspect that this is not the whole story.

Third, globalization, in combination with financial innovation (in particular of the off-balance-sheet type), has significantly increased the opaqueness of the financial markets. This lack of transparency has two facets. One is the difficulty of assessing the creditworthiness of individual market participants on the basis of publicly available information. Imaginative financial structures, spreading across borders, add to the confusion. I suppose that everyone would agree that this does not help the smooth functioning of free markets, which requires adequate information. The other is that it has become exceedingly difficult, and in some cases almost impossible, to evaluate the interconnection between market segments either geographically or functionally. Gone are the happy days when central bankers, by looking at the Bank for International Settlements (BIS) statistics, could assess, for instance, the country risk exposure of individual banking systems. They can still do this as regards on-balance-sheet claims on individual countries, but no information

is available on off-balance-sheet links. This should be a matter for concern. For how could anyone, in this situation, make even an educated guess as to whether an initial major shock originating somewhere could develop into a global systemic problem requiring immediate action?

Fourth, central banks have to face up to the dual challenge of the relative decline in the role of banks in the financial system and the fading specificity of banking itself. Some thirty years ago banks, that is, commercial banks, were the privileged market interlocutors of central banks—because banks were monetary institutions and stood at the center of the financial system by supplying liquidity, distributing credit, and managing the payment flows. By safeguarding the stability of the banking system as a whole, central banks could be reasonably sure that they were protecting, indirectly but effectively, the stability of the financial system as a whole. This still remains true to some extent, but that extent is diminishing.

Finally, we have witnessed a spectacular surge in the volume and average size of financial transactions, resulting in an unprecedented rise in the volume of payments. Intra-day settlement exposures, and with them liquidity and credit risk, have reached a new dimension, putting a premium on the efficiency and soundness of clearing and settlement arrangements.

I should not like to sound alarmist. All this does not necessarily add up to a basically unstable worldwide financial system in the sense that the likelihood of a financial crisis has demonstrably increased. Many of the features of our new system have two facets: while they may be a source of instability, they often contain built-in shock absorbers. Financial innovation has put at the disposal of market participants powerful hedging devices that enable the wise ones to protect themselves precisely against asset price instability. Globalization itself has increased the depth and liquidity of markets. Securitization has led to a wider distribution of risks throughout the system. Market efficiency, in a number of senses of this term, has increased. The point, however, is that in the unlikely event of a financial crisis the crisis could take on genuinely global dimensions. Central bankers will have to bear this in mind. In fact, I think they do.

What sort of preventive measures can they take?

The most important one is the conduct of a monetary policy directed, in a medium-term perspective, toward the attainment of

price stability. The lack of a credible commitment to that objective could seriously aggravate the risk of market overreaction and therefore that of systemic instability. Or, to put it more bluntly, the best way to avoid asset market "bubbles" is to stick to a cautious monetary policy. This may not eliminate all misalignments or significantly reduce short-term volatility, but it would at least mean that monetary policy ceased to be a contributory factor to both types of disturbance. The fact that central banks are now recognizing this is good news.

A more difficult task is to ensure that market participants attach full credibility to the central bankers' commitment to ensure price stability. The difficulty arises in connection with the downgrading (and, a fortiori, the phasing out) of intermediate targets. To the extent that the setting of a money supply target no longer provides an unambiguous indicator of the resolve of central banks to pursue a stability-oriented monetary policy, central banks will have to find other ways and means of conveying their message to the markets. This will necessarily entail better and more detailed information on the economic analysis forming the basis for monetary policy decisions. The initiative of the Bank of England to publish its quarterly reviews of the outlook for inflation is surely a step in the right direction.

As a second measure, central banks should do everything in their power to make the financial system more transparent. More complete and comparable disclosure by all market participants—and not only by banks—should be a priority objective. This will require cooperation not only between regulatory agencies but also with the accounting profession and with market participants themselves. We also have to improve the statistical information on market linkages—even if this turns out to be a tedious and costly exercise.

Third, central banks should contribute to enhancing the safety of both domestic and international payment, settlement, and clearing systems, since these are the transmission mechanisms that could amplify crisis manifestations and turn a local or sectoral crisis into a genuinely global one. The "Report on Interbank Netting Schemes," to which I contributed in my previous capacity, was a beginning, but not more than that.

Last but not least, a controversial question. Should central banks be directly involved in supervision? Those who give a negative an-

swer to this question base it on considerations relating to moral hazard: there is the risk that supervision may arouse destabilizing expectations of support from the central bank. This, indeed, is a powerful argument. But so is the opposite, which says that it is difficult to draw a practical distinction between systemic and micro-prudential responsibilities. The prevention of systemic risk can hardly be effective without intimate knowledge of the participants in the market and the linkages between them. Given the kind of financial world in which we operate, the second argument would seem to me to outweigh the first. But it is perhaps not inconceivable for a central bank to acquire this intimate knowledge without a "line responsibility" in supervision.

THE INTERNATIONAL DIMENSION

"Globalization" means that cross-border capital flows, be they actual or potential, have created a very high degree of interdependence between countries. This has a bearing on all three topics I have discussed so far.

The pursuit of price stability through monetary policy can be helped, or hindered, by exchange rate developments. By saying this I clearly dissociate myself from the orthodox monetarist view according to which freely floating exchange rates would secure individual countries full freedom to pursue their domestic policy objectives, and, first and foremost, the objective of price stability. I have two quarrels with this assumption. First, because it implies that monetary policies directed toward domestic stability will also stabilize the exchange rate. While I would fully agree that diverging stances of policies have a destabilizing effect on exchange rates, stable monetary policies by themselves will not secure exchange rate stability. Fiscal policies also matter, either because of their possible influence on inflation expectations, or by creating current account imbalances and therefore a shift in financial portfolios. Admittedly, monetary policy will always be able to offset the undesirable impact of fiscal policy on exchange rates, but at a cost, that is, by resorting to changes in short-term interest rates that could be unjustified in terms of domestic balance. Second, exchange rate changes, whatever their origin, will affect domestic prices, and will therefore have an impact on price expectations.

The practical conclusion is twofold. In their quest for price stability, central banks cannot disregard exchange rate developments. But neither are they able to influence exchange rates, in the case of a fiscal imbalance, solely through monetary policy means, or through exchange market intervention, without running the risk of deviating from the pursuit of their domestic policy objective. The need for an appropriate policy mix is even more important in an open economy than in a closed one. However, the problem is compounded by the fact that in a world of rigid fiscal policies international agreement on a correct configuration of policy mixes will be even harder to come by than agreement on the appropriate domestic policy mix.

The international dimension has implications for the use of money supply targeting as well. On the level of definition and measurement there is the intellectually not very exciting but practically quite tricky question of including or not in the targeted M such items as nonresidents' holdings of assets denominated in domestic currency or residents' holdings of foreign currency assets. Then there is the associated question of how to deal with assets held in offshore centers. More fundamentally, the combination of changes in interest rate differentials with shifting exchange rate expectations may induce portfolio movements that can significantly destabilize the behavior of the targeted M. Further, the large-scale use of derivatives certainly has a major impact on the treasury and liquidity management of corporations and is therefore likely to have an impact on the behavior of M. I do not claim to know what this impact is going to be.

By definition, systemic stability cannot be preserved without active cooperation between central banks. Measures directed toward fuller disclosure and better statistical information, improvements in the payment, settlement, and clearing systems and, naturally, effective banking supervision—all these preventive measures must be taken within the framework of international cooperation. Central banks are keenly aware of the need for such cooperation, and have demonstrated this in the work carried out under the aegis of the BIS.

They have also displayed a clear willingness to fight manifestations of financial crisis by the concerted provision of liquidity to markets whenever they feared that a generalized retrenchment by market participants could lead to a liquidity crisis. With hindsight,

some of us might think today that the liquidity creation in the autumn of 1987 was excessive. Maybe. There might in any case have been market developments preventing a tailspin of prices leading to a general financial crisis. Possibly there were such market forces at work. But despite a feeling of dissatisfaction that our intellectual curiosity was not satisfied, I believe it was a good thing that the central banks did not wait to see how effective the built-in brakes of the market mechanism would have been if they had been left to operate on their own.

The story of 1987, just like the more specific fire-fighting activities that were undertaken on several occasions within a cooperative framework, shows that we can count on international cooperation between central banks to preserve systemic stability. What these experiences have also demonstrated is that, to be successful, this cooperation has to embrace on a very wide basis all central banks whose financial systems are part and parcel of our global system. There may be scope for somewhat tighter regional cooperation in this area, but the interconnections between the regions are such that at the end of the day systemic stability can be secured only by cooperative endeavors on a worldwide scale.

When it comes, however, to the pursuit of price stability (the other major task of central banking), which also requires cooperation, I would put the emphasis in the reverse order. Admittedly, situations may arise in which cooperation on, say, the Group of Ten level is called for with a view to coordinating monetary policies and trying to influence the behavior of exchange rates. But any systematic coordination of monetary policies requires an institutional framework that is just not available on a worldwide basis, and I doubt that it could become available in the foreseeable future. A firm institutional framework is needed for ensuring that the endeavors of individual central banks to reach price stability are helped, rather than hindered, by the policies of neighboring central banks. It is also needed for securing a minimum of fiscal policy coordination and for attaining exchange rate stability. Such a framework does exist in Europe: prospectively a very strong one, if and when we reach Stage Three; a more flexible one, within which we operate at present. It was not my remit today to talk to you about the work of the European Monetary Institute (EMI) or about the prospects for European Monetary Union (EMU), but I do not want to conclude without reminding you that the European

Union does exist, and without conveying to you my conviction that this is a firm framework within which central banking policies (still in the plural today) will evolve in the right direction.

Questions and Answers

Following the formal presentation, Baron Lamfalussy answered questions from the audience.

What indicators should central banks watch in order to take preventive measures against inflation—bearing in mind that consumer price indices, or GDP deflators, are lagging indicators?

BARON LAMFALUSSY: Although I have doubts about the reliability of any single M, I still think that the money supply *does* matter. Since the definition of money supply has become uncertain, central banks should certainly monitor a set of Ms, and also credit flows. Second, the level of and changes in long-term interest rates, and the behavior of bond markets in general, provide a useful indicator of market participants' inflation expectations. Third, I would watch labor market developments domestically, and, internationally, commodity prices. Finally, a comparison between the actual rate of growth and the growth of productive capacity can also be useful.

Do you approve the position taken by the report of the Bretton Woods Commission [chaired by Paul Volcker] regarding the desirability of setting up target zones for exchange rates, or should any such approach be reserved only for the European Union?

BARON LAMFALUSSY: I have not yet read the report, and therefore do not wish to make specific comments on its recommendations. But I am rather skeptical about the feasibility, and therefore the desirability, of a target zone approach. Exchange market intervention can be useful only if it signals a change in domestic policy stances, and any such signal will have to be credible. I doubt that credibility can be established without an institutional framework, which does not exist on a worldwide scale. On that level there might be circumstances in which concerted action can be useful, but these will be the exception rather than the rule. I think the reverse applies to Europe.

The power of public sector borrowers appears to be waning: governments that overborrow simply see the money flow out. Does this make monetary policy management easier or more difficult?

BARON LAMFALUSSY: The "globalization" of markets, of which the free flow of funds and instantaneous communication are the chief ingredients, imposes the same constraint on monetary management as on fiscal policy or on debt management: policies that are not credible—in the sense that they do not appear sustainable—lose their effectiveness.

Does the more extensive coverage of central bank activity by the financial press make central banking easier or more difficult?

BARON LAMFALUSSY: That depends very much on the kind of coverage!

A recent EMI ruling would like to see the use of prepaid cards confined to commercial banks. Will this conservatism not inhibit innovation?

BARON LAMFALUSSY: I hope not, but the possibility cannot be ruled out. But we should accept this risk if the EMI proposal can help ensure greater efficiency in the conduct of monetary policy.

You emphasized the role of monetary and fiscal policies in the pursuit of price stability. Would not an incomes policy also be relevant?

BARON LAMFALUSSY: I certainly do not deny that wage increases exceeding the growth of productivity give a cost-push impetus to inflation that can be contained by monetary policy only at the cost of restraining the level of activity. Experience suggests, however, that generalized incomes policies fail to prevent the emergence of cost-push inflation and create, moreover, major imbalances in relative wages. I would, however, not rule out a wages policy, for a short time, in some rare situations: for instance, when hyperinflation has to be brought under control.

Would you agree that international cooperation should not be confined to such groups as the Group of Seven but encompass a much wider group of countries, including developing nations?

BARON LAMFALUSSY: Yes, I agree, but the geography of cooperation should vary according to the subjects covered. Trade relations cannot be handled on a restricted basis: GATT was a global institution, and so will be its successor. At the other end of the spectrum, matters relating to macro-prudential policy are best dealt with by countries whose financial industries are part of the global system.

Will central banks be able to control the coming disaster in derivatives trading?

BARON LAMFALUSSY: I see no coming disaster, rather the possibility of specific problems arising in connection with the very fast development of the derivatives markets. But these problems will be manageable if central banks, supervisory bodies, and, most importantly, market participants follow a few lines of action: wider and better disclosure; standardization of products; speedy flow of information; stability-oriented monetary policy; and, last but surely not least, prudent risk-aware management by market participants.

* * *

SIR JEREMY MORSE: Those of you who have looked closely at your program will have seen that our speaker has given the Per Jacobsson lecture once before. He is in fact the only speaker to have been our main lecturer twice, and the first occasion was fifteen years ago. So this is a personal anniversary for him, as well as an institutional one for the Bank of England. Alexandre, we thank you most warmly for your lecture and answers to questions.

That concludes our proceedings, ladies and gentlemen. Our next lecture will be on October 2 in Madrid, and it will be given by Sr. Guillermo de la Dehesa.

Baron Alexandre Lamfalussy

Biography

Baron Alexandre Lamfalussy has been President of the European Monetary Institute since January 1994. He was born in 1929 in Hungary and is a citizen of Belgium. During 1949-53 he studied at the University of Louvain, Belgium, where he received his degree (*Licence en sciences économiques*). Subsequently, he was a research student at Nuffield College, Oxford, where he was awarded a D.Phil. degree in economics in 1957. He has been a Visiting Lecturer at Yale University (1961-62) and at the University of Louvain—first as Lecturer (*Maître de conférences*) during 1965-75 and since 1975 as Professor. He is at present on leave from the university.

In the course of his distinguished career, Baron Lamfalussy has held a number of positions in Belgium and abroad. During 1955-65, he was an economist with, and then became an Economic Adviser to, the Banque de Bruxelles. He was Executive Director and Chairman of the Executive Board of that bank during 1965-75, and in 1975 became Executive Director of Banque Bruxelles Lambert. In 1976 he joined the Bank for International Settlements in Basle, where he served as Economic Adviser and Head of the Monetary and Economic Department (1976-81), Assistant General Manager (1981-85), and General Manager (1985-93). In 1988-89 he was a member of the Committee for the Study of Economic and Monetary Union (Delors Committee).

Baron Lamfalussy is the author of numerous books and articles. Among these, mention may be made of the following: *Investment and Growth in Mature Economies: The Case of Belgium* (London, Macmillan, 1991); *The U.K. and the Six: An Essay on Growth in Western Europe* (London, Macmillan, 1963); *Les marchés financiers en Europe* (Paris: Presses Universitaires de France, 1968); *"Rules versus Discretion": An Essay on Monetary Policy in an Inflationary Environment*, BIS Economic Papers, No. 3 (Basle: BIS, April 1981); "International Financial Integration: Policy Implications," in *Employment and Growth: Issues for the 1980s*, edited by Alfred Steinherr and Daniel Weiserbs (Dordrecht: Kluwer Academic Publishers, 1987); "International Cen-

tral Bank Cooperation: What It Can—and Cannot—Achieve," in *Evolution of the International and Regional Monetary Systems*, edited by Alfred Steinherr and Daniel Weiserbs (London: Macmillan, 1991); and *The Restructuring of the Financial Industry: A Central Banking Perspective* (Tilburg: Société Universitaire Européenne de Recherches Financières (SUERF), 1992). Baron Lamfalussy is also coauthor of *Economic Policy for Europe* (London: Macmillan, 1975) and delivered the 1969 Per Jacobsson Lecture entitled "The Role of Monetary Gold over the Next Ten Years."

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Copies of the Per Jacobsson lectures in English, French, and Spanish are available without charge from the Secretary, the Per Jacobsson Foundation, International Monetary Fund, Washington, D.C. 20431. Photographic or microfilm copies of all out-of-print lectures may be purchased from University Microfilms International, 300 North Zeeb Road, Ann Arbor, Michigan, 48106, U.S.A., or from Information Publications International, White Swan House, Godstone, Surrey, RH9 8LW, England. Site of the lecture is Washington, D.C., unless otherwise shown.