Sándor Lámfalussy

Financial crises in emerging markets

Vanishing tenets

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The first part of (*Alexandre Lamfalussy's*) book on the international financial crises was published in English in the wake of the Russian default, in 2000. The Hungarian version, published in 2008, was supplemented with a 2006 paper by the editors. According to the publisher's summary, Sándor Lámfalussy studied the correlation between financial globalisation and the vulnerability of the international financial system through the analysis of four major crisis experiences in emerging markets, as well as the dotcom bubble. The book consists of the papers read during the *Henry L. Stimson* lecture series at Yale University, as well as the paper read by *Xenophon Zolotas* in Athens upon the request of the National Bank of Greece.

Although according to the title the book discusses the history of crises that evolved in the emerging markets, it has a lot to say to the developed countries, what's more, to *present day people.* It is so topical that we can hardly believe that these sentences were committed to paper years ago.

I note here that I myself thoroughly discussed financial crises in the Hungarian literature. My paper titled Világméretű pénzügyi egyensúlyhiány (Global financial imbalance – KJK) analysed the debt crisis back in 1987. I repeatedly addressed this issue in the book titled Nemzetközi Pénzügyek (International Finances – 2006, Jatepressz), the co-author of which was *Péter Halmosi,* and in my coursebook with a similar title, which was published within the framework of the Human Resource Development Operational Programme (HRDOP) in 2007, and which is accessible via the internet. However, the subjects of Sándor Lámfalussy's analysis come not from literature, but from life itself.

The author's professional competence stands above all doubt. He possesses both theoretical

and empirical experience in bank management. He approaches issues from the practical side, but he also worked as a professor at the Catholic University of Leuven for many years. He was the president of the European Monetary Institute, the forerunner of the European Central Bank. He played a crucial role in the establishment of the European Central Bank, and is also called the "father" of the euro. He also received eternal acknowledgement in the field of international banking regulation, especially in the development and adoption of the so called Basel norms. In today's finances he is one of the most competent professionals, wherefore we can hardly question the substantiation of his critical remarks.

Lámfalussy could sense well in advance the problems of the international financial system. Naturally, there were other people – albeit not many – who also saw where the processes were leading (*As J. Stiglitz* wrote in one of his recently published essay: "It didn't take Nostradamus to foresee the string of events…") Yet, only few were brave enough to ask the proper questions. Sándor Lámfalussy did ask them.

According to mainstream finance, it was not proper to question certain tenets. Let us list a few of these disputed doctrines!

- The money and credit markets of the developed countries are sufficiently deep and developed to enable them to properly protect themselves against *risks.* Similar institutional systems must be established in the emerging countries, and then potential crises can be forestalled.
- The financial infrastructure of the Western economies is so developed that *there is no need for state regulation, self-regulation is sufficient,* since stability is in the very interest of this sector.
- Among the developed countries, those with more extensive securities based mediation are more efficient. These institutions – like the hedge funds – need no separate supervision, not even if they work with a high leverage ratio, since the banks, from which they borrow, are supervised. Higher profits can be yielded through capital market institutions, since costs are lower in this case.
- *Banks,* on the other hand, *must be bailed out* under all circumstances if they get in trouble, since they can launch a domino effect and drag the economy down.
- The spread of financial *innovations* is desirable, since they provide a large pool of tools for risk hedging and atomisation, and the expansion of profitable businesses.
- Debts must always be repaid to the last cent. Pacta sunt servanda. If this principle is not followed, borrowed money may get lost, and the trust in the financial institutional system will vanish in thin air.
- In the globalised world full liberalisation of capital movements is desirable. Incidentally, this is included in the IMF charter, too.

To tell you the truth, I myself have conducted research according to these principles, and relied on them in practice, too, as an undersecretary of state, as a minister, and as the president of the Hungarian State Banking Supervisory Agency. Yet, I had some faint doubts (which I did air in the past one and a half decades) about the shrinking role of the state; I doubted the encouragement of self-regulation in the banking sector, and the excessive use of financial innovations – which served more the purpose of profit-making than of risk mitigation. Yet, I basically accepted the tenets listed above. Since who in the former communist bloc could have been sufficiently prepared to criticise the theoretical foundations of the operation of the international financial system on the basis of *practical experience?* We made each decision following thorough discussions with the professional organisations. Basically, no one else had a different concept. The practical experience of the

Hungarian banking sector was still rather insufficient. “Deposit, credit, foreign currency” – suggested the neon light advertising board of that time. The two-tier banking system came into being a mere three years before 1990, and the above cited work of mine (Világméretű pénzügyi egyensúlyhiány) also came out then, which, as far as I know, was the first publication to describe the essence of financial innovations on the basis of BIS information. We were hardly aware of the new types of financial transactions. At best we knew about the primitive innovations – as Lámfalussy put it – that were represented by variable-interest roll-over credits. This in part led to a drastic rise in Hungary's foreign currency debts. As far as the repayment of these debts is concerned, in 1990 I could draw the practical conclusion that the international money markets responded to the political changes with great mistrust. The Antall Government – which was just about to be formed – had to face the fact that state bankruptcy was imminent in a couple of days unless it was ready to declare its willingness to repay debts. However, naturally we new that loans are always signed by two parties: the lender and the borrower. (This is strongly emphasised by Sándor Lámfalussy in this work of his.) In theory, banks subscribing the securities could also be aware of the indicators of the Hungarian economy. However, the ultimate investors – who could even be ordinary people – had all the right to believe that the securities of the National Bank of Hungary were safe. Lámfalussy also confirms that it was generally held at that time that sovereign debtors could not go bankrupt.

Yet, we managed to get on the verge of collapse. With the given foreign exchange reserves, or rather, due to the lack of such reserves, and considering the balance of payments, the crisis could be overcome only by obtaining the goodwill and the standby credit of the IMF. On the other side, IMF extended the loan on the condition that Hungary agreed to repay the earlier loans.

A lot of – mostly political – criticisms were expressed in this issue in connection with the standpoint of the first government. However, domestic experts were in general of the opinion that we had to undertake the repayment of debts, since any other script would have triggered an even more tragic effect for the country. At least, this is what we thought would happen in the short and medium run. We had information according to which Latin and Central American countries that are much bigger than Hungary forced their creditors to reschedule their debts and attained certain discounts. (We can read about it in this book of Lámfalussy's.) However, this seemed to work only in countries the size of which is big enough to shake the financial and economic situation of the lending countries, or rather that of the lending institutions. The smaller countries could be cornered more easily. They do not meet the “too big to fail” requirement. Maybe confidential talks could have been organised for Hungary, too – certain talks were indeed conducted – but in the given political circumstances no real possibility existed for debt reduction. Since the economy was so dependent on imports, we could not risk the suspension of funding resources, not even temporarily. (See the comment on page 36 in Issue 1/2008 of Közép-Európai Közlemények)

Lámfalussy describes changes on the international money market since the crisis of 1982. He presents that as a result of price explosion the oil dollars inflated the credit supply in the developed countries. (This issue was immediately and most deeply studied in the Hungarian literature by *István Gyöngyössy* in his doctoral dissertation titled A mai nemzetközi pénzrendszer működése /The operation of the current international curren-

cy system/, which was published by KJK in 1982. In addition, in my 1987 work /Világméretű pénzügyi egyensúlyhiány – Global financial imbalance/ cited above I analysed the debt crisis that evolved in the developing and the socialist countries by the early 1980s relying on information from BIS. In search of the underlying causes I pointed out that in the developed countries the social programmes, in the developing countries the lavish investment projects, while in Hungary both factors contributed to excessive public spending. However, while the developed countries of Europe had enough savings, the developing – and the socialist – countries had to rely mostly on external resources. This became one of the major factors of the vulnerability of these countries.)

Sándor Lámfalussy thoroughly collected the different and identical features of crises. In addition to excessive public spending he also pointed out that the private sector also heavily relied on foreign currency influx several times. Due to liberalisation, incoming capitals pushed the exchange rates up, which often made the currencies overvalued – and thus contributed to the growth in the current account deficit of the balance of payments. The responsibility of the private sector is further increased by the fact that as a result of suspicious signs, excessive capital flights were carried out. Lámfalussy describes the characteristic features of the Russian crisis in a rather witty manner. It reminds me of the joke in which a creditor is not willing to lend to the former socialist large company, because it does not know it, while the other refuses to lend because it does know it... Being aware of the past, the Russians did not nourish any confidence in those in power, and took the money out of the country at a rapid pace. On the other hand, in the beginning foreigners were in euphoric fever – using Lámfalussy's words – and enthusiastically provided loans to the country. Then, when problems began to show, they fled the scene themselves.

An important finding of the author is that the reason behind the failure was not always the defective internal macroeconomic policy. And it happened several times that from among the available remedies the IMF applied the recipe of mandatory budgetary constraints in a stereotyped manner. Another important finding is that foreign currency indebtedness was always one of the main reasons. Including stock market financing. Since portfolio investors and fund managers often decide about the movement of capitals on the basis of large-scale indices. In the case of direct investments this would be less dangerous, however direct investments have always accounted for a minor share in securities investments. It is true that loss-bearing, which securities holders are compelled to accept, "comes in handy" for the system in preventing the spread of the crises, however, in less well-off countries the loss of wealth leads to massive impoverishment.

Lámfalussy analyses the role of the exchange rate systems, since it can be seen that pegged exchange rates played a role in each crisis, as a result of which foreign exchange reserves soon melted away in crisis situations. We could also see that the size of the crises – and consequently the size of the remedy actions -has gradually grown. The author draws attention to the problem of "moral hazard", for lenders and investors increasingly relied on the fact that they would be bailed out by their governments or international organisations.

For today's readers the most exciting details of the book are those referring to the current crisis.

Lámfalussy describes how strong the credit boom was in the U.S. economy, what bubbles were caused by the lax budgetary policy, and at the end of his work – as he gets closer to our days – he highlights the role of China, too. By

maintaining its undervalued exchange rate, China accumulated huge exchange reserves, which contributed to the global oversupply of liquidity. This was one of the reasons of lax monetary policy in the U.S., which has lead to the growth in mortgages and thus to the current crisis.

The author, as we have shown, does not confine himself to the emerging markets. He also raises the question whether the self-confidence with which the developed countries described the level of development and strength of their financial markets was justified or not. Did they have the right to claim that the emerging countries should do nothing but adopt their techniques and institutions, and then – applying proper macroeconomic policies – they can avoid crises? Was it a sound idea to leave the regulation of risk-taking practically to the banks on their own developed markets?

The life of banks is regulated by three basic principles: liquidity, solvency and profitability. Liquidity means the ability of prompt payments, while solvency means that the value of the bank's assets is always higher than that of liabilities, wherefore the bank is creditworthy at all times. It can obtain resources from other financial institutions, including, ultimately, the central bank, since it has *assets to back* borrowings… Thus, liquidity, too is likely to be ensured at all times. However, profit motivation may blur vision. Especially at a time, when abundant resources are available. Due to the level of regulation, money mediation through the banks is relatively expensive. Profits can be yielded on the capital market, which is *much less regulated* than the banking sector. The large financial funds and hedge funds operated practically without being regulated despite that fact that their investments were often based on large amounts of borrowed assets. It can be said that this is the responsibility of the lending banks. However, this does not change the fact that through the irresponsible banks they can drag down masses of innocent depositors.

Lámfalussy firmly criticizes bailout actions that fully get creditors out of the mess under the excuse of public interest. He emphasises that a l*oan contract always involves two parties:* a lender and a borrower. What professional contempt was formerly shown for people who cited the responsibility of lenders, too, in relation to the debt crisis, and who called for a sort of debt acquittance! Maybe this does not seem completely absurd from a man of such eminence. The author pointed out: the hunger for profit led to excessive risk-taking. Therefore, it would be a mistake if those responsible passed on the negative consequences exclusively on debtors. Then they would still be interested in maintaining this type of “moral hazard”.

It is not necessarily a good thing either that preference was given to capital market mediation, primarily in the Anglo-Saxon countries. Investors excessively relied on the judgement of securities rating institutions, which were far from being on the ball. They rated the repackaged versions of the current mortgages in a manner which made the investors' models suitable for buying. Financial innovations have made the market less and less transparent. Excessive confidence in the mathematical models produced a strong bandwagon effect among investors and made the current day crisis unavoidable. But if this is really the case, why do developed countries inflict their own systems on the emerging countries? It is clear that finance techniques cannot yield a solution by themselves. This is especially so in countries with large external debts.

Lámfalussy bravely approaches other, formerly taboo subjects, too, such as the liberalisation of speculative capital flows. This is one of the issues in which we ranked among the 'top-grade students'. The author clearly states – in fact, stated several years ago! – that the pre-

mature liberalisation of such capital flows is not advisable. What is more, he says that we should simply forget that this is included in the IMF charter.

I agree with all sentences of his. I wish I had read them earlier! Lámfalussy would have reinforced me in what I thought and said. But it would have been advisable for other people, too, to consider the viewpoints of this outstanding expert. Fundamentalist market advocates should ponder about what has led to the current crisis. One thing is sure: the course of changes that took place in the past two decades under the Washington Consensus has broken. Privatisation, liberalisation, deregulation: these terms need to be reviewed. *A new era is imminent.* But shall we not swing to the other extreme? Do people who take regulation in their own hands have sufficient moral backing? This is something that we also need to think about.

Katalin Botos

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