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PRESS RELEASE

On the origins of the BIS macro-prudential approach to financial stability: Alexandre Lamfalussy and financial fragility

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While the financial crisis has left many reputations in tatters, the Bank for International Settlements (BIS) is receiving more and more attention for its analysis of financial stability issues. The BIS is renowned for taking a broad approach to financial stability, "marrying" the micro- and macro-prudential dimensions of financial stability. In this paper, it is argued that Alexandre Lamfalussy, who was at the BIS from 1976 to 1993, played a crucial role in shaping the BIS view of financial stability.

Lamfalussy's early academic work was very much in the Keynesian tradition. Gradually, he would move towards the ideas of Dupriez, his teacher in Louvain, acknowledging that cycles should be moderated, but not suppressed. However, Lamfalussy retained a certain scepticism about the stability of the financial markets. This mix of business cycle theory and a Keynesian *Weltanschauung* is also very much the vision behind the BIS macro-prudential approach.

In 1955, Lamfalussy started working at the Banque de Bruxelles, Belgium's second biggest commercial bank. While there, he developed an awareness for the financial markets. Later, he became the Chairman of the bank. However, in 1974, some traders took large open foreign exchange positions, causing significant losses and leading to Lamfalussy's resignation in 1975. It evidently had a strong impact on his view of the financial system, with risk and financial fragility becoming important concerns.

In the mid 1970s, the BIS was going through a fundamental transformation. The collapse of the Bretton Woods system led to a shift in the objectives of central bank cooperation. With the advent of floating exchange rates and financial liberalisation, cooperation shifted towards financial stability issues. Lamfalussy became Economic Adviser at the BIS in 1976. With his academic background and his profound knowledge of the financial markets, he was well suited to navigate the BIS through this new environment of financial instability.

Two of the main challenges during Lamfalussy's time at the BIS were the Latin American debt problem and the rise of financial innovations. As early as 1976, Lamfalussy was warning about the debt build-up in Latin America. Moreover, he stressed the interrelationship with loose US monetary policies and the US balance of payments deficit. In 1976, he proposed to create a "risk office" in order to collect crucial information on a limited number of systemic banks. In 1979-1980, a Working Party which he chaired advanced the term "macro-prudential". In the Working Party, there was also a heated debate on the use of prudential instruments (like capital ratios) to moderate credit growth.

In the early 1980s, central bankers paid more and more attention to financial innovations, mainly for monetary policy reasons. Lamfalussy quickly turned to the impact on financial stability. In 1985, he questioned whether financial innovations, and the redistribution of risk which they entail, do actually contribute to greater systemic stability. Moreover, he emphasised that financial innovations reduce the transparency of the financial system and they can lead to new types of systemically important institutions.

Lamfalussy thus combines a broad macroeconomic view with a focus on the systemically important financial institutions. His fundamental vision is that the micro- and macro-prudential dimensions of financial stability overlap considerably. In his policy conclusions, he follows a two-track approach, being attentive to cases of strong debt build-up and strengthening the financial system. Lamfalussy greatly contributed to the creation of a "BIS atmosphere", namely that one should be attentive to imbalances, debt build-ups and bubbles, which may sow the seeds of financial crises.