Lamfalussy Lectures Conference

'CAN THE SILK ROAD TUNE UP GROWTH? OPPORTUNITIES IN THE EUROPEAN-ASIAN ECONOMIC COOPERATION'

'THE FUTURE OF EUROPEAN INTEGRATION. WHAT ARE THE CENTRIFUGE FORCES THREATENING IT AND WHAT SHOULD BE DONE ABOUT IT?'

Conference logbook
on the fourth conference of the Magyar Nemzeti Bank's
Lamfalussy Lectures Conference series

Budapest, 23 January 2017

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Governor
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Foreword

In January 2017, the Magyar Nemzeti Bank organised the Lamfalussy Lectures Conference for the fourth time. The goal of this series is to provide a platform for prominent professionals to discuss and share their views on global economic policy, with a particular emphasis on international monetary policy. At the first three events, we discussed several stimulating topics related to international monetary policy and economics. This year's conference focused on two issues: European-Asian cooperation and the future of European integration.

I can summarise this year's conference in a simple, straightforward and crystal clear message: we need to build bridges, both within Europe – especially within the European Union – and between Europe and Asia – especially between the EU and China.

Europe is a strange continent. During the first half of the last century – in the course of the two world wars – Europe destroyed Europe. In the second half, we managed to rebuild Europe mainly by establishing very strong cooperation within the European Union. More recently, Europe introduced the common currency, which promised to be another great success. From 1999 until the outbreak of the global financial crisis, the euro proved to be a promising new endeavour, and it became one of the global currencies. However, since 2008 we seem to have lost our way, and many of us think that we made mistakes within the European Union and also in the euro zone. Although we did not destroy Europe, we may have destroyed the original European vision and our trust in it, and we definitely destroyed a lot of jobs and also the future of our GDP growth.

Our great friend Alexandre Lamfalussy emphasised several times the importance of financial stability. In this respect, our promising European currency went on a bumpy road mainly because of taking only half-measures; and all of these half-measures resulted in a somewhat weakened position of our currency.

There are many reasons for this, but let me mention just one of them which I view as a very important one. This is the economic policies of the European Union which many of us believe to be inappropriate. In particular, I blame the austerity programmes or austerity measures, because – by definition – austerity measures result in the loss of jobs, loss of GDP growth, loss of trust, and all these result in an unsustainable macro-economic path.

In the current situation, let us again take the advice of professor Lamfalussy: in order to re-build Europe, first of all we need financial stability. And with the help of financial stability, we can again build up growth, jobs and the future for Europe.

Let me repeat again the clear message that many of us proposed during the conference: we need to build strong bridges between the European Union and Asia, and especially with China. The European Union, the Central Eastern European countries, and especially Hungary can benefit a great deal from China's new "One Belt, One Road" concept. We would like to build up the new Silk Road, and Hungary is one of the 64 countries that is contributing to this project.

I do hope that this year's Lamfalussy Lectures Conference contributed to the ultimate success of this new endeavour, and also that our new approach, our new vision can re-build Europe, the European Union and the euro zone.

LAMFALUSSY LECTURES CONFERENCE

JACQUES DE LAROSIÈRE

former Managing Director of the IMF;
former Governor, Banque de France;
former President of the EBRD

The future of European Integration

What are the centrifuge forces threatening it? What should be done about it?

Unfortunately, there is no better time to deal with this subject.

A large member state – the UK – has chosen, by the Brexit referendum in June 2016, to leave the Union.

Prior to that, the immigration issue has been exacerbated by the pressures coming from the Middle Eastern turmoil and by the fact that no "European position" on the matter could be expressed.

On the backdrop of mounting terrorism and Islamic radicalism, not to mention weak economic growth as well as high unemployment, public opinions in Europe are getting more and more Eurosceptic. They are showing disenchantment with the EU as well as with national Governments. Extremist populistic parties are growing throughout Europe showing the magnitude of the lack of trust that affects the so called pro-European "elites".

These are some of the "centrifugal" forces at work.

We should not be surprised by such reactions.

In a way, Euroscepticism has always tended to have the upper hand.

We all know that Europe has been marred by lost opportunities, by a "democratic deficit", by the excesses of Brussels bureaucracy, by the extreme heterogeneity of its member States, by the lack of a long-term vision, by its inability to define a clear strategy and to carry it out...

All this reflects common perceptions, and, to some extent, reality. However, it seems to me that those criticisms do not put in question the essence of what Europe has achieved, in terms of its successes over the past sixty years. And they do not answer the question: what would happen to Europe and its members if it were to disintegrate?

Let me try to approach these issues under two major headings:

– What are the policies that are missing today and that would be required to make Europe more credible, in terms of achieving its own project?

– What would be the "additional", the "extra" elements that would allow Europe to become a "power" consistent with its fundamentals?

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I – What is missing today in Europe to achieve its basic intrinsic project?

1 – Better convergence in terms of economic policies

This has always been a fundamental – but often misconceived – issue. In a very diverse geographical framework with large productivity differentials as those that characterize the EU, there is a need to reach a sufficient level of homogeneity among member States in terms of economic performance and competitiveness. Such an imperative is all the more compelling for the members of the Euro-area which have given up, by definition, their freedom to devalue.

But we have to be clear on this subject. The EU has not been conceived nor established as an engine to equalize structural diversity among members States. Such a concept could have been the agreed path. But, in fact, that avenue has clearly been rejected from the very start.

The "no-bail out" rule is indeed at the core of the European architecture. The Union allows structural aid to help reduce major infrastructure discrepancies and therefore facilitate the catching up process of living standards throughout the continent. But such structural assistance is not intended to compensate – through permanent transfers of public money-persistent competitive weaknesses.
The consequence of the no bail-out concept is that each member State must make its own decisions – in terms of economic and structural reforms – in order to adjust its special conditions to a minimum level of "European consistency".

In other words, in the case of fundamental disparities (in fiscal or structural policies), it is the duty of the member State that "deviates" from the common – "sounder" – path, to embark on corrective measures destined to redress its lack of competitiveness.

This looks obvious and even tautological.

But, in fact, it is the most confused notion and also the most difficult objective to achieve, as past experience has abundantly shown.

Indeed, the path towards convergence has been mostly uneven.

Paradoxically, the "peripheral" members of the Euro have been really poor performers in terms of convergence. From 2000 to 2010, their inflation, unit labour costs, and current account imbalances significantly deteriorated in relation to the performance of the "core" members of the monetary Union.

It is worth noting that while German unit labour costs had gone up by 0,4% per annum on average from 2001 to 2010, the corresponding figures are 3% for Greece, 2,7% for Spain and Italy (i.e. 7 times more!).

In this regard, the indicators of competitiveness are:

Competitiveness indicators

From 1999 (1st Q)	100 (common base)			
Germany was at =	88.7 at end 2012		(gain :+ 11.3 points)	from 1999 to 2012
Greece was at =	103.7	"	(loss : - 3.7)	"
Spain was at =	107.3	"	(loss : - 7.3)	"
Ireland was at =	105.1	"	(loss : - 5.1)	"
Euro area average	92.9		(gain :+ 7.1)	"

Source: ECB

Which means that, in relation to Germany, the "peripheral" countries had seen their competitiveness indicators fall by a range of 15 to 19 points over the period 1999 to 2012.

But financial markets were slow to react to these discrepancies.

Actually, they took almost ten years to sanction, through higher interest rate spreads, the magnitude of these gaps in economic performance.

The 2009-2010 Euro sovereign debt crisis eventually forced a number of Eurozone countries to start correcting their imbalances.

Did the European "system" ring the bell early enough? The answer is: "no", in spite of the warnings given by the ECB. It was eventually the market signals that triggered overdue action. This does not speak in favour of EU's governance.

Actually, to be frank, this 10-year-long episode (2000-2010) casts an appalling light on the way the European States and Institutions dealt with the convergence of their economic policies and how much they disregarded the "minimum degree of consistency" that I was mentioning above as one of the main pillars of EU.

As far as the "new eastern" members are concerned, the process was much sounder: on most indicators of competitiveness these countries generally performed well and improved their fundamentals. Their business environment was, overall, friendlier. They thus benefited from significant capital inflows (notably from Germany and Nordic countries) not to mention EU funds, which facilitated their nominal and real integration to the EU.

Since the market wake-up call of 2010 and the deep sovereign debt crisis that it triggered, significant adjustment has taken place in countries like Greece, Ireland, Spain, Portugal and, to some extent, Italy.

Labour markets are being reformed in the South (from a level of (over) protection rated 3 by the OECD in 2008 to 2,6 in 2013). Fiscal imbalances are being gradually repaired, current account balances are almost all now in positive terrain, and competitiveness indicators are improving.

The case of Spain is rather remarkable: growth has resumed to more than 3% in 2015-2016, investment has picked up (5% on average) and exports are booming (+ 5,4%).

Here I should mention France which has only modestly started to deal with labour mobility and fiscal and retirement issues.

So, in summary, the convergence story of the EMU was a failure during its first ten years (2000 to 2010), a failure that is now being repaired at a high cost. The “Eastern” part of the story is much more rewarding.

Now let us look at growth.

2 – A return to growth?

We know that the EU performance has been lacklustre in this regard over the last seven years:

GDP growth (annualized)

	1998-2007	2010-2016
Euro area	+ 2,4%	+ 0,9%
US	+ 3%	+ 2,1%

There has been a slight rebound in 2015-2016 (+ 1,5%) but this is still fragile and is based more on consumption than on exports and investment.

This poor performance is in part the reflection of “secular” trends (ageing population, structural reduction of productivity gains ...). But it is also a “European made” problem. The outburst of the Eurocrisis in 2010 was followed by several years of recession (2012-2013) that heavily affected countries like Portugal, Greece, Spain.

Europe is striving to catch up and to heal the specific wounds that have accumulated as a result of ten years of divergences.

And average unemployment in the Eurozone has been hovering around 9% of the labour force with strong deviations from country to country (for example, unemployment in Spain reached 19%).

The question is: is it realistic to expect a significant increase in growth above the 1,5% average that is observed now?

I believe that such an expansion would necessitate a few important preconditions.

a) Fiscal adjustment: the weight of public debt and the size of Governments are hindering growth.

In spite of the recent fiscal adjustment that I have alluded to above (and that has, on the whole, reduced government spending to pre-crisis levels in the periphery), levels of spending are generally too high in many countries and debt sustainability is far from being established.

Therefore, I believe that, for the sake of higher growth and increased private capital inflows, public spending must be further reduced in a number of countries.

This is even more indispensable as ageing trends are pushing up pension imbalances and social protection spending.

b) I would add a number of structural remedies to slow growth:

– Reduction of administrative barriers on new business at entry;

– Elimination of too many thresholds on size of different categories of enterprises (SMEs);

– Boosting labour market mobility and training policies;

– Increasing initiatives to provide equity to enterprises instead of encouraging debt.

As long as Europe does not bite those bullets, I am afraid that – except for countries like Germany that have ingrained a culture of "mittelstand" of high quality industrial products and social cohesiveness – growth will be sluggish and unemployment will remain high.

When we look at the "Capital Market Union" project, we should be mindful not to add new layers of regulation to capital movements.

We need a Union open to capital inflows as well as to outflows, a Union where investors are eager to work, participate and make transactions. We do not need a Union that will focus on more regulation imposing additional constraints on investors.

If you look at Europe from a macro-perspective, the paradigm that I would favour is the following:

– Each country should see to it that the "minimum convergence" is in place, even if this entails constraints on revenues;

– Then, "surplus" countries (in the North) could be keener to export capital and to take advantage of the "catching up space" offered by those Southern countries as long as they are no more seen as the source of imminent financial crisis (because of unsustainable debt profiles).

Then we could reach "normally" functioning financial markets in Europe, where "excess capital" can move in a sounder way to countries in need of investment. This pattern is the one that works in countries like the US as well as in the Eastern part of the Union, but not in the South. In the South, the huge capital inflows that took place before the 2010 crisis were mainly bank to bank lending. Differences on yields favoured those purely financial movements that were immediately reversed when the crisis came.[1]

Against the description above, I often hear the "austerity" argument: « How can you ask more fiscal austerity from people who are unemployed and are at pains to make ends meet? »

The answer is that as long as productivity increases in the South are lagging behind the North (which is the case) there is no way to insulate and "protect" their revenues and wages. Actually the only way out (barring a devaluation that would make people even poorer) is to accept wage moderation and to focus on more structural reforms. One could add that the "austerity" measures of the past years have only reduced government spending to pre-crisis levels in the Eurozone periphery. So, the excesses of the "divergence frenzy" have been corrected but not any more.

The measures and orientations suggested above do not call for any Treaty change. They could be decided immediately by number of States. They are straight-forward and easy to understand even if they entail differences in political views.

In a way, this is the demonstration that the lack of convergence and the obstacles to higher and sounder growth are more the result of weak national policies than the manifestation of an EU institutional deficiency.

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[1] *Total lending by banks in the core Eurozone countries increased by 1,5 trillion Euros from 2000-2009 (+ 340% increase!). See "Europe's growth model in crisis" in "The Search for Europe" 2016 BBVA.*

But let us venture now in a more hypothetical and hazardous field: How could the EU play a more decisive role internationally?

II – What would be the "additional" elements that would allow Europe to become a "power" consistent with its fundamental strengths?

1 – Let us first give a quick view of the international importance of Europe.

Demographically, the EU is shrinking. The ratio of people aged 60 or more is increasing worldwide: from 19% in 1996 to 31% in 2030. But the ratio is moving faster in the EU. Therefore, the percentage of the European working age population in the world will continue to diminish (estimates are that the present proportion of 11,5% of working Europeans will be falling to 6,4% by 2050).

This means that Europe's influence will become weaker in the world.

In 2004, emerging countries accounted for 46% of world GDP compared to 54% produced by developed nations. Today they represent nearly 60% and in ten years the emerging markets may account for 75% of world GDP.

If we take into account the relatively weak economic growth and productivity gains in Europe, we can understand why the EU represents only 11,4% of the world economy (US: 16%) today. This trend is getting worse and in 2050, not a single European country will be able to justify its presence in the G7 on the basis of GDP.

So, the fundamental question is: What is our ambition for Europe? Are we resigned to see it getting marginalized in the community of nations or do we feel it is important to integrate it more so it can become one of the first actors in a world whose centre of gravity is drifting eastwards.

2 – If Europe wanted to live up to such a challenge a few "extra" decisions towards more integration would be called for. Let me just sketch a few of them.

Security and immigration policies

Member States would have to design a common policy. That policy, in my view, should not impose immigration quotas or measures of the like. Some members have already too many problems with their own labour force to be caught in an "immigration policy" of net inflows.

But it should allow some other countries, like Germany[2], whose fertility rate is one of the lowest in the world and is beginning to see its workforce dramatically reduce, – which is threatening the economy – to organize its own policies on immigration.

Instead of protecting "Schengen", the Union would focus on protecting its borders based on a strict – but not necessarily uniform – selective immigration policy (on the model of the US or Canada) in order to eliminate illegal movements. That imperative would have to prevail – for the time being – over openness and freedom of movements.

Foreign policy and defence

If Europe wants to become a significant world "player" (while it is merely today a "follower") it should raise the issue of a common foreign and defence policy (for external objectives). This is a subject fraught with difficulties, objections and past failures. But it could make sense in a world of enormous security tensions, of mounting external powers and where the continuous US "shield" becomes more problematic. The EU cannot remain on the sidelines as a mere spectator when rapid changes are affecting its own population.

A somewhat larger budget

In order to carry out common defence policies (that would go beyond the simple addition of present national forces and budgets), some increase in the present EU budget could be warranted. This should be very carefully limited, and certainly not conceived as a "general mutualisation or transfer effort". But a slight and well justified increase could present some advantages.

A common "convergence" ministry

The performance has been so dismal in this field, that a further step towards integration might help. If there were to be a sort of "Convergence Authority" it should have the power to act:

– To impose economic corrections when they are blatantly needed (peer pressure has shown its inefficiency);

[2] *Germany's population is estimated to fall from 81 million inhabitants today to 65-70 million by 2050 (70 million would need a net immigration inflow of 200 000 a year).*

– To dispose of a minimum of “dry powder” to manage the conditionality process with a modicum of flexibility that would provide more credibility.

A political setting that would be anchored in the populations themselves.

People would have to be comfortable with the above ambitions and feel able to share them.

In order to achieve such democratic ownership of the vision, it might be a good idea to elect European Parliament members directly from the people on a global continental basis (not country by country) and, perhaps, to elect its President by direct popular vote on a programme turned to the future.

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For such an ambition to be clearly conceived and proposed to the people Europe would require more leadership. And if democracy were enhanced, we could dream of a situation where each member State – big or small, rich or poor – could find in the new system: respect, collective discipline and a sense of security, in the face of present shocks and tensions.

Could the above ambition be carried out by a simple coordination between nations (Etats-Nations) and therefore not involve supra-national powers?

This might be more attractive to “nationalistic” circles. But it seems difficult to achieve the goals sketched above without some form of extra integration. The route of coordination between States is cumbersome and majorities are difficult to emerge. The danger, in this type of system, is that large members may have too large a say which could result in blocking decisions.

Therefore, some form of additional integration seems called for even if its probability today looks remote.

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I will finish by stressing the present paradoxical situation. We often hear the view that the Union has failed. But an objective analysis shows that it is governments – more than the EU institutions – that have been the major culprits in the lack of policy convergence and in slow growth. Is it therefore obvious to re-transfer powers to national governments that have displayed so much inefficiency? The danger is to further weaken the embryo of "collective discipline" provided by the EU and to go back to old fashioned habits and demagogy. Some extremist parties are asking for the right to "peaceful devaluations". But they do not recognize that, in a globalized and competitive world, devaluations are a recipe for trade retaliations and for the impoverishment of people.

The present model of integrated Europe – albeit limited – that we still enjoy may well be the fundamental bulwark to protect us from further decline.

TIAN GUOLI

Chairman
Bank of China

China-Europe Cooperation under the Framework of Belt and Road Initiative and its Impact on the World Economy

Abstract: The paper focuses on the cooperation mechanism between China and Europe under the framework of Belt and Road (B&R) and its impact on the world economic growth. As each other's most important trade partner, China and Europe can work to propel infrastructure interconnectivity, strengthen capacity cooperation, and speed up China-EU Bilateral Investment Treaty (BIT) negotiations to realize mutual prosperity with infrastructure, production and systems as the links on the basis of the existing economic and trade cooperation, so as to provide a new engine for the world economic growth. In such a process, financial institutions will play the role of guiding global funding to the B&R Initiative to provide support for the B&R projects through enhancing cross-border cooperation, innovating financial tools, improving risk management and developing RMB internationalization business.

Key words: Belt and Road Initiative, infrastructure interconnectivity, capacity cooperation

I Introduction

The financial crisis in 2008 has exerted a huge impact on the world and changed its political and economic landscape as well. According to the prediction of IMF (2017), the economic growth in 2016 was merely 2.4% (based on market exchange rate), hitting a new low in the past seven years; and global trade growth was 1.9%, the lowest since 2010. Despite the unprecedentedly low interest rates, investment and consumption demand remained dampened; and prices were at a low level in general globally, although commodity prices slightly bounced up.

The prospect of global economic growth will remain challenging in years to come, as population aging, lower productivity, more rigid financial regulation and lack of major technological breakthrough will continue to be obstacles for mid and long-term global economic growth. Trade protectionism and other "de-globalization" movements, plus rampant terrorism, will bring more policy uncertainties, widen the gap in the world's economic and political landscape and lead to more "black swan" events.

II Driving Force of the B&R to World Economic Growth

i. The B&R creates a new growth engine

According to the calculation by IMF data, from 2014 to 2016, the average growth rate of the real GDP of developed countries, or G7, was 1.7%, while the growth was much higher in emerging markets such as Asia, Europe, Middle East and North Africa along the B&R, standing at 6.6%, 3.2% and 2.7% respectively. That provides testimony for greater vitality of B&R-related countries.

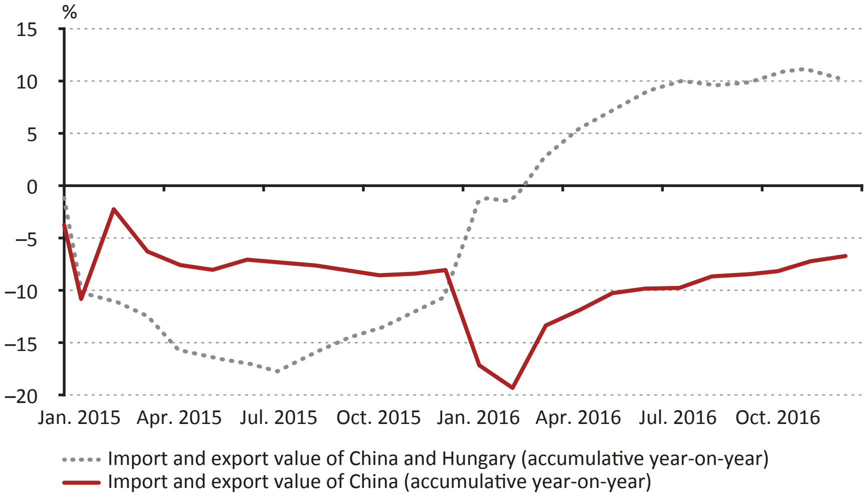
The B&R creates a new engine for world economic growth by connecting two distinctively outstanding markets. At one end is Europe boasting advanced technology and mature experience, and at the other is Asia featuring fast growth, vast demand and abundant labor. Mutually complementary and inclusive, the two markets, once integrated, will become the world's longest economic corridor with the greatest potential.

ii. China-Europe cooperation has fueled the economic growth of countries along the B&R

The B&R Initiative has been widely accepted in the world since 2013 when it was first proposed by Chinese President Xi Jinping. It was also highly praised by the United Nations and was included in the UN resolution in 2016. Over the past three years, more than 100 countries have shown endorsement to the Initiative, and more than 40 countries and international organizations have signed cooperation agreements and Memorandum of Understandings (MOUs) with China for implementing the Initiative (Xinhua News Agency, 2017). Among them, Hungary was the first European country that has signed the B&R MOU with China, which not only reflects the strategic vision of the Hungarian Government but also shows that the Initiative perfectly fits the country's "open-up-to-the-east" policy.

Since the implementation of the Initiative, the economic and trade cooperation between China and B&R-related countries show positive momentum, bringing new hope of economic growth to those countries. In terms of trade, despite China's foreign trade slowdown for two consecutive years, its bilateral trade with Hungary maintained sound growth, with the trade volume reaching USD 8.9 billion in 2016 at a year-on-year growth of 10.1% (see figure 1); besides, the China-Poland and China-Romania import and export volumes have exceeded USD 17 billion and USD 4 billion respectively. With regard to investment cooperation, from 2014 to 2016, Chinese enterprises invested more than USD 50 billion in countries along the B&R. Moreover, the new contract value of Chinese enterprises as contractors in 61 countries related to the Initiative hits USD 304.9 billion, more than half of China's total new contract value over the same period (Ministry of Commerce, 2017a).

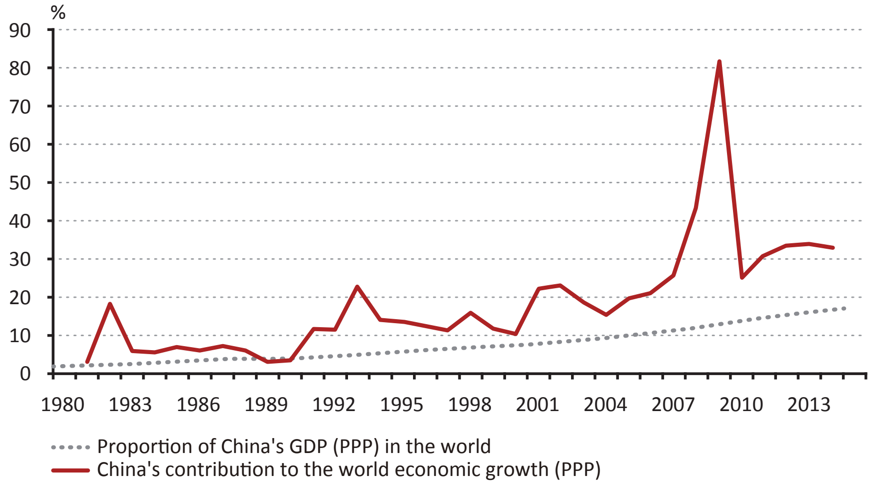
Figure 1: China's import and export growth and China-Hungary import and export growth



Data source: Wind database

The economy of countries along the B&R is expected to soar fueled by the aforementioned cooperation. China has worked wonders through the 30-year-plus reform and opening up. It has maintained economic growth at an annual average rate of above 9%, solved the problem of food and clothing for its people, reduced rural poverty-stricken population by 700 million, and become an important engine for world economic growth. According to the IMF statistics, the proportion of China's GDP in the world increased from 2.4% in 1981 to 7.5% in 2000 and then to 16.6% in 2014, and its contribution to world economic growth grew from 3.3% in 1981, 10.3% in 2000 and 33.2% in 2014 (see figure 2).

Figure 2: China's weight in the world economy



Data source: IMF WEO database

At present, many countries are confronted with insufficient demand, while China, thanks to its great market potential, is becoming a powerhouse for global economic growth. As per China's Thirteenth Five-year Plan, its GDP and per capita income of rural and urban residents will be doubled on the basis of 2010 and all rural population will get rid of poverty by 2020 (Xinhua News Agency, 2016). By 2022, more than 75 percent of China's urban consumers will earn 60,000 to 229,000 renminbi ($9,000 to $34,000) a year (McKinsey, 2013), which will create huge demand and bring great business opportunities to other countries. As reforms proceed in China, the Chinese economy is expected to grow at a speed above 6.5% in the coming years making her a leader in global economic development. Under the cooperation framework of the Initiative, more countries will get aboard the high-speed train of China economic growth, and B&R-related countries will reap more benefits.

III Three links under the cooperative framework of the B&R

Europe has set an example for the world with its economic and financial integration, and the creation of euro represents a great innovation in the history of the world economy. It is the unremitting efforts of all European countries to break the geographical and ideological confinement that makes all goods, services, employees and capital flow as freely as they do in the same country (Emmerson, etc., 2016). Similarly, the Initiative will create a new pattern, by connecting infrastructure, production and systems, to build a foundation for widely-shared development and to lift China-Europe cooperation onto a new stage.

i. Link of infrastructure, focusing on infrastructure interconnectivity

The top priority of the Initiative is to realize the eventual interconnectivity between Asia and Europe, which involves major infrastructure projects such as Trans-European Transport Networks, China-Europe Land-Sea Express Route and New Eurasian Land Bridge.

During the B&R implementation, China Railway Express (CR Express), the scheduled fast-speed railway cargo transportation between China and Europe, has been increasingly shown its unique value. So far, there have been 39 CR Expresses lines including over 1,700 trains (NDRC, 2016) in operation, such as Chongqing-Xinjiang-Europe and Yiwu-Xinjiang-Europe, gradually forming a transportation infrastructure network connecting sub-regions in Asia, as well as Asia and Europe. In China's Han Dynasty 2,100 years ago, the diplomat Zhang Qian, spent over two years to reach Central Asia from China's Xi'an, but now it only takes 12 days for Chinese goods to reach Duisburg in Germany from Chongqing in China through the Chongqing-Xinjiang-Europe International Railway, the transportation time of which is about one fourth of shipping, and the costs are about one fifth of air transportation (NDRC, 2016).

The construction of Budapest-Belgrade Railway as a key link in China-Europe Land-Sea Express Route commenced in 2015 and is expected to finish as soon as possible. Once completed, the new railway will not only benefit local people and help turn Hungary into a hub of regional transportation and logistics, but also bring benefits and new opportunities for economic growth to countries along the railway.

ii. Link of production, through capacity cooperation and establishment of economic and trade cooperation zones

Chinese and European leaders have reached consensus to align the B&R and the European development strategy with each other, and align China's international capacity cooperation and Europe's Junker Investment Plan with each other (Beijing News, 2015). On the one hand, the Junker Investment Plan is mainly designed to reinforce investment in strategic infrastructure, digital economy, high-end manufacturing, innovative R&D, human capital, etc. On the other hand, China has constantly made innovations and breakthrough in high-end technology in recent years, especially in equipment manufacturing. Some of China's industries have shown much remarkable advantage in international competition and gradually caught up with Europe. Given that, China and Europe enjoy great potential in capacity cooperation.

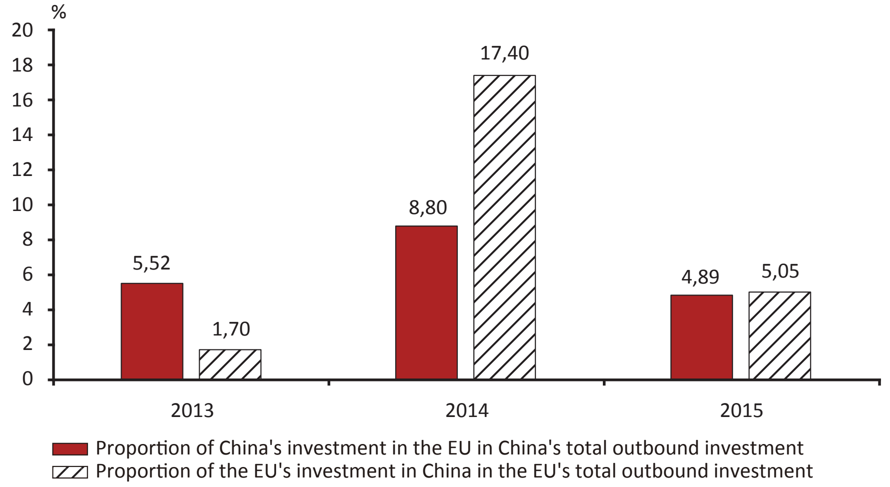
The economic and trade cooperation zone is an important vehicle for the capacity cooperation. By the end of 2016, China has invested USD 18.55 billion to establish 56 cooperation zones in B&R-related countries, which have created 177,000 jobs for local people (Ministry of Commerce, 2017b). Two of such zones are located in Hungary which is the bridgehead of European investment and gathers the most Chinese institutions and businessmen and overseas Chinese people in Central and East Europe. China has attached great importance to its economic and trade relationship with Hungary. As a matter of fact, the Coordination Centre for China-Central and Eastern European Countries' Tourism Promotion and Business Union, the most important coordination institution for China-Central and East Europe cooperation, is based in Budapest. So far, the two countries have made remarkable progress in improving the trade structure, increasing mutual investment, deepening financial cooperation. They have also found a new pattern for economic, trade and investment cooperation since the Central European Trade and Logistics Cooperation Zone in Hungary and Sino-Hungarian Borsod Industrial Park have been established.

For another example, let us take the Central European Trade and Logistics Cooperation Zone in Hungary for example. The trade center (China Goods Trade Center in Budapest) and two logistics parks (in Csepel and Bremerhaven respectively) in this zone have formed a fast, convenient and unblocked distribution network covering major cities in Europe and China. The annual export and import volume based on this network has reached USD 245 million, accounting for 6.5% of China-Hungary trade volume.

iii. Link of systems and regulations, towards facilitation of trade and investment

The European Union (EU) has been China's largest trade partner for 13 consecutive years, while the latter has been the second largest trade partner of the former for 15 years successively. However, compared with trade between China and Europe, their mutual investment remains low. In 2015, the EU's investment in China only accounts for 5% of its total outbound investment and vice versa (see figure 3). This low level of activity is partly attributed to differences in their rules governing market access and investment, but also implies great potential for investment cooperation by the two sides.

Figure 3: Bilateral investment between China and the EU



Data source: Wind database

Against the headwind of "de-globalization", to speed up negotiation on China-Europe Bilateral Investment Treaty (BIT) will help to consolidate and deepen achievements that have already been made in economic and trade cooperation between the two sides; but also, it can help the two sides tap economic growth potential, lead a new round of globalization and reshape the international economic landscape.

IV Innovate financial tools in the B&R implementation

Financial support is a must for the B&R implementation. Take infrastructure for example. A total of USD 6 trillion should be invested in infrastructure projects that have been planned in the Eurasian Continent, including railways, highways, electricity facilities and ports (Yin Hong, 2016). In recent years when global economic growth was dampened and the inventory of decent investment projects was low, hot money flooded international markets not promoting economic progress but gambling on short-term gain. This has impeded economic development of many countries. If such capital can be channeled into the B&R projects, relevant countries will enjoy substantial benefits, since production, investment and trade will be significantly boosted.

Several years ago, when the Initiative was just proposed, the author put forward the concept of building a financial artery for the B&R. If the people of different countries formulate a common vision, join hands to establish an innovative mechanism, and guide global capital to the real economy, the financial artery will blow fair wind to economic takeoff of B&R countries.

i. Expand financial sources for the B&R implementation

In the initial stage of the implementation, multi-lateral developmental financial institutions have played an important role in energy resource exploration and infrastructure construction. Over previous years, China has actively conducted cross-border financial cooperation with B&R countries and international financial institutions. The UK, France and some other European countries have joined the Asian Infrastructure Investment Bank (AIIB), and China has joined The European Bank for Reconstruction and Development (EBRD) in January 2016. At present, the AIIB has officially started operation and focuses on supporting energy, transportation and urban development projects in B&R countries. Three of the first four projects invested by the AIIB are based on cooperation with other multi-lateral development banks to bridge the gap of infrastructure investment.

However, the support from developing financial institutions alone cannot meet all the demand. As some projects have become feasible for market-based operation, commercial financial institutions should be mobilized to play a due role in cross-border cooperation. For example, commercial banks can support the B&R projects with trade finance, syndicated loan and project financing. European financial institutions have natural advantages in these fields. Therefore, Chinese and European financial institutions can conduct financing cooperation, by sharing information and jointly committing capital, to activate their joint strengths.

ii. Visualize the B&R investment returns

The B&R implementation is a complicated and systematic task. Its projects involve a long construction period and need complex instruments to finance them. While such projects are going to yield long term benefits in a broad sense, appropriate innovative financial tools are needed to turn such broader and longer term benefits into relatively short-term returns easily visible to investors and, thus, motivating more players to commit their resources. For instance, commercial banks can channel private capital into project financing by issuing bonds. In June 2015, Bank of China (BOC) made an attempt to issue the Belt and Road Initiative bond worth USD 4 billion.

iii. Diversify risks associated with the B&R projects

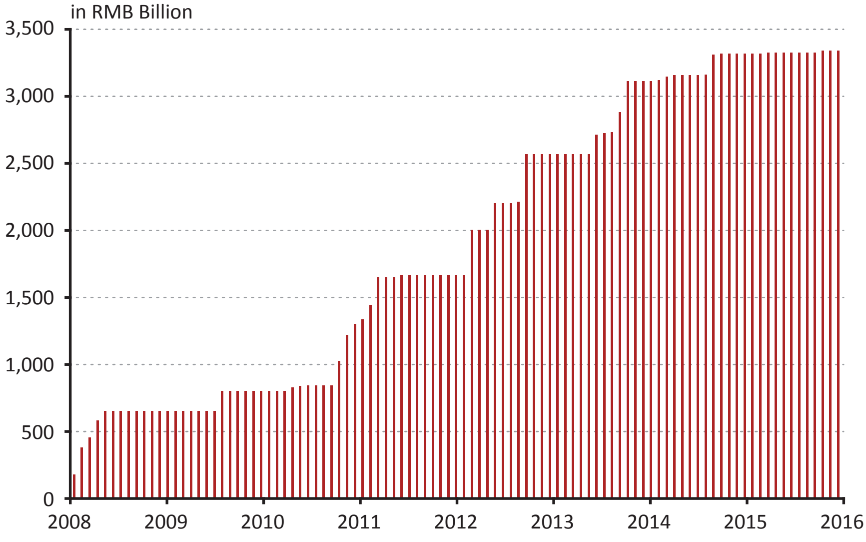
B&R countries, large in number, present unique and diverse risks. Given that, to carry out China-Europe capacity cooperation and expand markets, risks should be well managed. A new risk management structure should be established to safeguard the

B&R implementation. First, various credit guarantee institutions should be introduced and credit risk sharing functions should be developed. Second, financial derivatives, such as risk-swap products, should be developed to enable risks to be priced and traded. Third, the markets for international syndicated loan and asset securitization should be promoted to enhance the distribution of risks. Fourth, intermediary service providers should be introduced to promote risk transparency and information sharing.

iv. Open a new investment and financing channel for the B&R implementation

In recent years, the Renminbi business has been thriving in Europe, and become a new growth engine for financial institutions thanks to its increasing market size and diverse products. Meanwhile, China has been constantly increasing the payment and settlement efficiency and promoting product R&D and market development to press ahead with the offshore Renminbi business. PBOC, China's central bank, has signed MOUs for the Renminbi clearing arrangement with monetary authorities in 23 countries or regions, and designated a local Renminbi clearing bank in each country or region. In 2016, the US, Russia and the UAE have successively been covered by such arrangement for Renminbi clearing. The Renminbi swap agreements have covered 36 countries and regions worth RMB 3.3 trillion in total (see figure 4).

Figure 4: Size of PBOC's Renminbi currency swaps



Data source: Wind database

Renminbi is also quite popular in the Hungarian market and embraces increasing market depth. In October 2015, BOC held the inauguration ceremony for a Renminbi clearing bank in Hungary in Budapest, being the first Renminbi clearing bank in Central and Eastern Europe. In April 2016, the Hungarian Government issued Renminbi bonds worth RMB 1 billion in Hong Kong, and this is the first Renminbi bond by a sovereign issuer in Central and Eastern Europe.

BOC has surveyed annually 3,000 customers in the world since 2013, to formulate the White Paper on RMB Internationalization. According to the survey result in 2016, 74% of interviewed enterprises along the B&R were capable of easily obtaining Renminbi products and services from the local market, two percentage points higher than the previous year. Against the backdrop of Fed's interest rate increase, 78% of interviewed enterprises outside China expressed their willingness to use Renminbi as an alternative in case of tighter global liquidity, and this figure was as high as 87% among enterprises in B&R countries (BOC, 2016). This indicates the future boom of Renminbi business and the huge potential of financial cooperation between China and Europe, and Renminbi will surely blaze a new trail of investment and financing for the B&R construction.

V. Conclusion

In the case of sluggish global economic recovery, the B&R provides a new engine for the world economic growth. The Initiative establishes stronger connection between Europe and Asia. In the past, the ancient Silk Road recorded the fruitful Asia-Europe cooperation, while now the Belt and Road Initiative makes the cooperation between the two continents thrive again. China and Europe can work to propel infrastructure interconnectivity, strengthen capacity cooperation, and speed up China-EU BIT negotiations to realize mutual prosperity with infrastructure, production and systems as the links. In such a process, financial institutions should play the role of guiding global funding to the Initiative to provide strong support for the B&R projects through enhancing cross-border cooperation, innovating financial tools, improving risk management and developing RMB internationalization business.

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VIKTOR ORBÁN

Prime Minister of Hungary

Speech at the Lamfalussy Lectures Conference

We have heard English and Chinese spoken here today, so the time has come for a presentation in Hungarian.

Honourable Governor, Honoured Conference Guests,

I thought a great deal about whether to accept the invitation to this conference. There was no question that in itself the invitation was an honour, but recent events in world politics – some of which have already been mentioned here, such as Brexit, a new US president, and all their attendant consequences – are of such wide-ranging impact that one cannot speak meaningfully about the future without referring to their political significance. This approach comes with risks, and indeed it may steer the conference away from its customary harmony. So this was what I had to consider. But eventually I accepted the invitation. Firstly, this was because here in Hungary ever since the nineteen-eighties we have been following Mr. Larosière's thoughts; and so we are here with a true legend, with whom it is an honour simply to share the same table. Also here is Mr. Tian Guoli, who has been our friend for many years, but is a particular friend of ours in the policy of eastward opening. In our regular meetings he reduces our over-inflated sense of European pride to the correct size by supplying us with figures such as those you have also heard just now. So we are also grateful to him, and today it is an honour to be in his company.

Furthermore, China's rise draws our attention here, in Europe, to a psychological problem. There is a saying which goes roughly like this: "whatever exists is possible". Europeans do not understand this – at least they do not understand it when it comes to China. Instead of trying to learn from what is happening in China, we invest a considerable amount of energy in explaining that what exists in China is not really there. Or if it is, then it is only temporary and without foundations: this pace cannot be sustained, we say, and the internal tensions in Chinese society are such that eventually the whole thing will fail politically. So instead of learning, and understanding that whatever exists is possible, we want to explain to ourselves that this is not really the case. This is because everything that exists in China and is possible pushes us further down the rankings; and instead of accepting this fact and wanting to learn, we are busy trying to prove the opposite. Therefore meeting Chairman Guoli can perhaps shield us Hungarians from this European problem.

Ladies and Gentlemen,

The ultimate reason I finally accepted the invitation, however, was Professor Lamfalussy himself. This is because, as Mr. Larosière has already pointed out, today we are remembering a great man, who was a great friend of our country – and continued to be, even after the communists forced him to flee Hungary and escape as far as Belgium. Despite this, he remained a Hungarian and a good friend of Hungary throughout. He was able to distinguish between the political regime and his homeland – and this is a virtue which we should honour. He was also a good man, as you may have heard. In our culture there is a core principle: "…on earth peace, good will toward men"; Professor Lamfalussy was a man of good will, and therefore he received peace, love and respect from us all in return. If this were not enough in itself, I should also tell you that he was a colleague of mine. Forgive me this boast, but he worked with me as an advisor, and he was my supervisor, in an intellectual sense. He regularly warned me against my youthful excesses with these words of caution: "This will cause trouble, Viktor". He was also our emissary and scrutiniser in the Western financial world, so we owe him nothing but gratitude. We can also learn from him, and it is well worth taking certain aspects from his life as examples for ours. He was an open-minded man, and this has special significance in Western democracy. As Hungarians – or perhaps we can also say as Central Europeans – our mind-set is that good democracy is based on reasoning; we therefore support such a vision of democracy. This, however, requires open-minded people: it requires an open spirit and a forthright character. And Professor Lamfalussy had both an open spirit and a forthright character. We could say that he was one of us, and he embodied the Hungarian people's best traits. I had the chance to learn from him that in the end it is always character that counts – these may well have been his very words. There are difficult intellectual questions which must be considered, and for which a brain is very important. Incidentally, you can even buy brains – especially if you are prime minister – as you can hire the smartest people. And there you are: you have a brain. That is how simple it is in our line of business – easier than in other jobs. So you have the brain, and you have the difficult questions, and you have the intellectual challenge. But at the end of the day, Professor Lamfalussy said, when one has to make a decision it always comes down to one's character: "So Dear Viktor", he continued, " once a year you should go out for a week-long walk in the wilderness, just like I do". And this was the case: as long as his physical condition permitted, the dear Professor always kept to this habit. But the most important thing I learnt from him was the result of a provocative situation. The more mature among you may remember that at the beginning of the nineteen-nineties there were fierce – almost cut-throat – ideological battles about what the character of the post-communist political system should be: whether it should be liberal, Christian, or whatever. These were difficult times, full of provocation. On one occasion when the Professor, who was widely known to be a Christian, came home to Hungary, he could not have foreseen that an ill-mannered rude journalist would ask him if he was a Christian. This was a flagrant breach of the Christian rule that we don't ask each other such a question. Nevertheless he was asked this question, and I think his answer was the right one, and one which I have kept close to my heart ever since. With an air of perfect calm he said: "I try, but I don't always succeed".

Ladies and Gentlemen,

These are the memories, therefore, which I believe it is fitting to evoke at a Lamfalussy Conference. I do not believe, however, that these are the reason that this award has been named after Sándor Lamfalussy. Perhaps a more likely explanation is that in Hungary he is seen as the father of the euro. Once, when I nominated him for a state decoration, my supporting argument was that his global fame was not only known about in Hungary, but also around the world. Perhaps our guests do not quite understand what I was getting at, but I think we Hungarians understand. He was the Hungarian who was not only called "world-famous" in Hungary, and this was probably because of the role he played in the creation of the euro. I am not sure he would have agreed that this award should be named after him, because he did not see himself as the father of the euro. When I spoke to him about this, he said that naturally a great variety of work had to be done, but for the adoption of the euro, the skills of an economist were not the primary need; these were helpful, of course, but a strong political will was more important. Therefore, he said, one should not seek the father – or founders – of the euro among economists, but among the politicians of the time; and in this department, France and Germany were particularly distinguished. I asked him how he found the courage to tell politicians that they should create a monetary union without a fiscal and political union to back it up: whether he felt the risks involved were too great. His answer shocked me, because he said that in the end politicians will realise that it is necessary to create a fiscal and political union to back up the monetary union. This shocked me, because it is rather risky to entrust an enterprise of such historic proportions to the wisdom of politicians. Thus far, the intervening period has not proved the Professor right: it has rather vindicated my – or our – doubts. In essence, President Larosière's presentation was also centred on this doubt: whether European decision-makers will have the wisdom to make the decisions necessary for the survival of monetary union. I do not know the answer to this question – all I know is that this is the biggest question for the future, the biggest question for the future of Europe. The conclusion I can draw from all this is the following: we also learnt from Professor Lamfalussy that the basis of successful economic policy is politics, and its stability.

Ladies and Gentlemen,

A pre-condition for a strong economy – and we also learnt this from the Professor – is that financial and political actors should pull the cart in the same direction. If we look at the recent history of the National Bank of Hungary, we can see that time has vindicated this view: we can reasonably conclude that when the National Bank of Hungary was in opposition to the Government, politics and finance were heading in two distinctly different directions. We can remember this, as it was not so long ago, and the result was that Hungary went through a great deal of unnecessary suffering. Since the national bank stopped being in opposition and started seeking cooperation with the political leadership of the day we have observed economic growth: spectacular economic growth, which has also been mentioned by previous speakers.

Ladies and Gentlemen,

I should now talk about the situation since 2008, and what, if I understood correctly, our French guest referred to as the "wake-up call" we received. Since the 2008 financial crisis the world economy and world politics have experienced a paradigm change, and today the success of European countries is measured by how rapidly they have been able to implement this change: which ones responded immediately, which ones reacted more slowly, and which ones are still only in the process of waking up. The message of this change of paradigm – a somewhat pretentious term, of course, but it makes sense – is that the world had an old system, an old paradigm. Within this we framed our thoughts, and within this we had to find a place for them. And – to use another elegant linguistic innovation – after 1990 this paradigm was called "the unipolar world". This was a world order with a single centre, a single centre of power; and we lived in this world for almost twenty years. The world's lines of force were arranged in a system around a single centre of power. The essence of the new paradigm is that there are multiple centres; I would rather not use the term "multiple poles", because in the Hungarian language that mean two: a northern and a southern. That is not the same as what I am talking about, because here there will be more than two poles, and it is perhaps more accurate to use the term "multiple centres": multiple centres of power. A necessary consequence of this change of paradigm is that there is no consensus about it: among European political leaders today there is no consensus on whether it even exists, and whether the crisis afflicting Europe after 2008 is a cyclical on or a structural one related to competitiveness. If you were to interview the 27 EU prime ministers, you would see that there is no consensus on this. In other words, a necessary concomitant of any change of paradigm – today, just as in the past – is that the followers of the old order must engage in fierce debate with the followers of the new order. We Hungarians could talk about this at length, in relation to our economic policy since 2010.

Ladies and Gentlemen,

When one speaks at a conference such as this, the first question to be straightforwardly and openly asked is how to interpret the global situation in which the conference itself is taking place. And a corresponding attempt must be made to answer it this question. In addition to the economic figures which we heard earlier, the decisive element is, of course, the new president of the world's largest military power, the United States, his inauguration, and the policies that he is proposing. I have been listening to analysts and commentators: the followers of the old paradigm, if you like. Despite the fact that we have had Brexit, this US presidential election result and a referendum in Italy, they continually try to convince us that there is less to this than meets the eye, and that you cannot possibly bring about the sort of changes that the US president is aiming for, or that we usually permit US presidents to realise. I would like to point out that this is foolish. Whatever exists is possible – and this is true not only of China, but also of the United States. Naturally it is still too early to gauge the changes – their extent and magnitude – which the current shift in the character of the Western world will bring about. I would advise all of us – myself included – to exercise caution, but I think that last week we heard a key sentence, and we must take this key phrase seriously. If we understand this correctly, we shall understand everything that follows. This key phrase is not the one quoted by most people – "America First" – but this: "it is the right of all nations to put their own interests first". This represents a great change. These words could not have come from an earlier US president, but now they have come from this president. This means that the era of multilateralism is at an end, and the era of bilateral relations is upon us. For us this is good news, because it is an unnatural state of affairs when, influenced by external pressure, one dare not state that one's own country comes first when governing, making decisions, or considering what the central bank should do. This unnatural state of affairs is at an end, and we have been given permission, if you like, from the world's highest secular position, that we, too, can place our own interests first. This is a great thing; it is a great freedom and a great gift.

Ladies and Gentlemen,

I am convinced that the distinction between unipolar and multipolar systems necessarily means that in the world economy a single pole offers a single model, while multiple poles offer multiple models. One can see that it is very difficult to arrange a number of different models into a single system with multilateral agreements, and therefore new opportunities will emerge for bilateral agreements – including in military policy and economic policy issues. I am convinced about this. It follows that there is no single "one size fits all" economic policy which would be equally successful for nations which are extremely diverse. In fact today the world economy is growing – or at least this is my understanding, or the conclusion I drew from our Chinese speaker's presentation – and economic growth is being sustained around the world precisely because there are different models, and because there are different approaches to economic policy. If China were to imitate us, I find it hard to believe that the world economy would grow at its current rate. Consequently, we should welcome the rise of new poles or new centres, rather than see them as a threat. This is a decisive issue, because logically today's world leaders – we westerners, I mean – might perceive this as a threat, as a loss of status, and as a risk. If this is how we relate to the rise of multiple new centres, however, I am convinced that we shall doom ourselves to failure.

A world order with multiple centres has a great many inherent opportunities to offer. Here is China, which we've already spoken about. We can clearly conclude that it is not a comet, but a fixed star, that will have a determining role in the world economy for many decades at least. To bring up a light issue – an easy, safe topic – here is Russia. We have Russia, which – let us be honest – has survived Western attempts to quarantine it and attempts at regime change. It has survived low oil prices, it has survived sanctions, and it has survived the free, non-partisan, internal activities of NGOs – which can hardly be described as pro-government, and which obviously came about without external interference. It has survived all that, and there it is. It is therefore unreasonable – and particularly unreasonable in Europe – to ignore the power and the opportunity that Russia represents. This would naturally require more European self-confidence, and we should be able to honestly claim – but probably the reason we don't is because it's not true – that we Europeans can defend ourselves militarily, without external assistance. But we don't have the courage to say that, because it's not true. I would like to come back to this later, in connection with something one of our other speakers said. For now

I would just like to observe – and here I apologise for interfering in France's internal affairs – that we have good reason to welcome the fact that a man who is visiting Berlin today or tomorrow, and who I hope will be the next President of the French Republic, has stated that the most important issue he will raise in Berlin will be that of a common European defence alliance. This would be something that could open the way to self-confidence; and after self-confidence, to the ability to engage in talks as equal partners with everyone – including Russia. Perhaps this is not why we're here today, but we have not even mentioned India – which still has plenty in reserve, and which is performing at the highest global level in areas which will have a major impact on the world economy over the next twenty years.

Ladies and Gentlemen,

New centres are therefore emerging, and long-forgotten trade routes are coming back to life. With due respect we should mention that in 2013 it was President Xi Jinping who launched the *One Belt, One Road* initiative, which was the first in a series which I believe will follow in the period ahead. In a presentation such as this the second question we should touch upon is how Europe is perceived from a Central European perspective. The answer can be summed up in a single utterance: we can barely recognise it.

Europe is struggling with four major crises at once, and recently it has been unable to respond to any of them satisfactorily. It has a growth crisis – or, more precisely –, a competitiveness crisis; it has a demographic crisis; it has a security or terrorism crisis; and it has a foreign policy crisis, illustrated by the simple fact that we are unable to exert any influence whatsoever over events in the regions that directly affect our lives here. Here we could mention Syria, but equally we could mention Ukraine. This is a foreign policy crisis.

Europe is drowning in debt. Perhaps there is no need for me to quote the figures here, as you know them better than I do: the countries which form the European Union generate a deficit of some one thousand million euros every single day. As we've heard from Mr. Larosière, economic growth is slower than slow: over the past decade it has averaged just over one percent annually, with the eurozone's rate being under one percent; and since 2008 six million jobs have disappeared from the European labour market as a whole. Today I increasingly hear voices of resignation, as if experts – but decision-makers may slowly follow suit as well – were saying that also in the decade ahead European growth will barely exceed one – or perhaps two – percent. Europe is now nowhere near as safe as it once was. Living alongside us are hundreds of thousands of people from outside, but we do not know what they are doing here, why they came here, or exactly what they want. The following may sound uncharitable, but it is true all the same, and, rather than imagining what we would like to see, we must face up to a harsh reality. We must face up to the harsh reality that wherever immigrants have settled down in Europe in large numbers, crime rates have increased immediately: not later, but immediately. And we must take account of the consequences. In summary, the European continent is becoming ever weaker: it has been reduced from a global player to a regional player, and soon it will be forced to struggle even for the status of a regional player.

Ladies and Gentlemen,

In a presentation like this – and in particular when we talk about Lamfalussy and democracy based on open argument – we cannot avoid the question of how this could happen. Why is this so? There are as many answers as there are people. For my part, I do not demand that anyone accepts my answer as the only possible one – I would rather just contribute to the debate. I am convinced that Europe set some itself ambitious goals, and has failed to achieve a single one of them. I was Prime Minister for the first time back in 1998, when we had to make preparations for EU accession talks. So I have the advantage – or disadvantage – of remembering those talks with the heads of government at that time. Chirac and Kohl sat with us at the negotiating table, and we made grand plans for the euro to become the world's second reserve currency, alongside the dollar. That plan has failed. We said that we should create an independent European security policy. That plan has also failed. And we then set out to create a Eurasian economic zone, which, we said, should extend all the way from Lisbon to Vladivostok. That is now completely off the agenda, so that plan has failed as well. So in trying to identify the reasons I am not talking about some general decline, about which we would become involved in a never-ending debate on civilisation, but about the failure to achieve specific goals.

My explanation is that Brussels has become enslaved to a utopia, and the name of that utopia is a supranational Europe. Recently we have discovered that this is an illusion. There is no European people: there are only European peoples. And if there is no European people, you cannot build a system of European institutions on the foundations of such a non-existent European people. You have to accept the fact that in Europe there are nations, and a pan-European system can only be built upon the policies, intentions, will and cooperation of the nations. We got all this wrong. In recent times this distinction has been lost. Perhaps those with more experience than me can back up my view that if we look to the European continent's successful periods, we can see that Europe was never strong – or at least, not over an extended period – when it was directed from a single centre of power. We were strong when multiple centres of power existed within Europe. And today it is the policy of Brussels to transform these centres of power into a single centre of power. This, I believe, answers the question of how we got to where we are today.

And now, Ladies and Gentlemen, we must ask one last question. If things stand as they do, how can we make Europe competitive again? Mr. Larosière gave us an appealing and ambitious answer to this question. For my part, I shall also try to give an answer: a humble one, at the level of political reality. In my view, for Europe to be made competitive it must first abandon the illusion of federalism. We have been walking on the edge of a precipice, the ground under our feet has run out, and the world's fifth largest economy has left the European Union. This process will not stop if we carry on like this. So we must abandon the illusion of federalism. From this it follows that Europe itself must also be made multipolar. If you look at what the Visegrád countries are doing in this regard, you can see that we have set exactly that goal for ourselves. As a region the Visegrád countries want to become one of the poles of the European Union; we want to become a strong region that also competes with Europe's other regions or poles, and that increasingly contributes to Europe's overall performance.

Another milestone on the road to competitiveness is for us Europeans to enter into new types of cooperation. First of all we should seek a new arrangement with the US, instead of the doomed free trade agreement. There is no point in persisting with that: it's dead, it doesn't exist. Perhaps we shouldn't discard all the results of the work done so far, but nonetheless that agreement will not come into being. So instead we must enter into something different. We should find the appropriate form in which the United States and Europe can come to an agreement. We should develop and conclude an agreement. We should seek out opportunities and come to agreements with China, we should place the issue of Russia back on the agenda, and we should try to engage in a process which today can be described as a competition for concluding agreements – a competition which in the past we Europeans have been continually left out of.

On the path to competitiveness I think it is important for us to reconsider the financing of the individual European national economies. We have just heard an excellent presentation on this issue. I am convinced that we cannot fire up our economies if we have nothing to invest. In this respect Central Europe is not doing badly, as, first of all, I think there is a European bank which can see the right direction. This bank is the EBRD. It would be in our best interests to scale up its activities across the entire continent – but in Central Europe in particular. And we are in an advantageous position, because we have friends – including the Bank of China – who stand by us and support us on issues of financing. And finally, the last milestone I can see on the road to competitiveness is innovation: let us place more emphasis on innovation on a European scale. I would note that Hungary is in a fair position among Central European countries, and we are performing fairly well in terms of the sum our central budget devotes to innovation as a proportion of GDP. I think that this performance is commendable, but it is still not enough, and the amount the Hungarian budget invests in innovation should be increased.

And now, in the style of Mr. Lamfalussy, I would like to refer back to two important thoughts raised by Mr. Larosière. The first is the question of demography that he raised. Naturally I shall give a political answer, which is by its nature different from the answer of an economist. In my opinion a nation or a community that is unable to reproduce itself does not deserve to exist, and judgement will be passed on that nation in the highest place possible. This cannot be disguised with immigration, with migrants, with guest workers or with cunning tricks, because the problem is more deep-rooted. A community which is unable to sustain itself demographically does not believe in its own future, and therefore renounces its right to exist. This is also the gravest problem that we Hungarians face: our house is on fire, but so too is that of all Europe. I am convinced that if a community is unable to reproduce itself – if a nation cannot independently sustain itself, but seeks assistance and a solution from outside – it must give up its former national identity – in part, or perhaps in full. In such a case that nation is no longer the same nation. This is written in the book of fate – or at least, this is what I as a politician interpret from that book. I am convinced that Europe must find a solution to this, because this is its existential question. Hungary has a family policy which is already producing results, but let me repeat: our house is also on fire. Returning to demography, I say this to President Larosière: the reason I dare to use such forthright language on this matter is that we are a people with extensive experience on this subject: forced relocation, forced settlement, population exchanges, and all their consequences. This knowledge is in our genes. We know precisely that if we resort to such means this will end in a loss of nation, and a loss of our country – we can see this by, for example, looking back in Hungarian history to the period of Turkish occupation. This is why we have the courage to take such a firm stand on an issue that appears to be so theoretically complex; after all, politics is a practical pursuit, not a theoretical one.

As regards foreign policy, European foreign policy and security policy – as the President suggested – is also a serious question, which we must talk about in the frank style of Professor Lamfalussy. Here the question is the following: can we protect the continent against any – and, I repeat, *any* – external threat without America? Those who are brave enough to go further could also ask if we can do so without the English-speaking countries altogether. This is the great question for the future. The key to solving this question is something that appears to be the simplest thing in the world: German-French security and military cooperation. I am talking about a common army and a common security system – or whatever we choose to call it. This sounds simple enough, but when you think about it, this is something we have never had. And, despite its simplicity, this amply demonstrates the complexity of the matter. The question is whether we – or those concerned – will be able to create a defence alliance. Well, the talks that I have already mentioned in Berlin today or tomorrow will give us some guidance.

Ladies and Gentlemen,

Finally, standing here before you as the Prime Minister of Hungary, I should also say a few words about Hungary – primarily on account of our friends from China and France. They may find it strange that a country that accounts for just 0.2% of the world's population – that's us – states its opinion on issues of world politics in such wide-ranging terms. And I can understand your reservations, because in politics, too, the most important rule is that everyone should know their place. Just as in private life, a country must know its place – based on its defence capabilities, GDP, population and territory. And once it has occupied its appropriate place, it should know exactly which issues it is free to speak about, and which ones it is not free to speak about. So perhaps Hungary volunteering its own ideas on issues such as these requires some explanation. There is a piece of British wisdom, which may sound somewhat awkward when translated into Hungarian: "Nothing succeeds like success". This explains why the Hungarians have the courage to volunteer their opinions on these issues; if we look at the period from 2010 to 2016 – or to 2017 – we can see that Hungary has turned from a black sheep into a success story. Of course not everyone acknowledges this, but it is important that the facts and the truth be recognized – even when they favour us Hungarians.

Therefore – just to take two minutes of your time – we should recall that in 2010 we had no economic growth: virtually none. State debt had risen to over 85%. Inflation could not be forced below six percent. The budget deficit had soared to 7%, while unemployment stood at between 11.5% and 12%. Out of ten million Hungarians, fewer than 3.7 – three million, seven hundred thousand people – were in work; of these, only half – one million, eight hundred thousand – were paying taxes. So our revenue was next to zero, while our expenditure was fixed, given that the state, businesses and families were all deeply in debt. It is hardly surprising that the first country to seek a rescue package from the IMF was not Greece, but Hungary. This is where we started from. Today we can say that debt as a ratio of GDP is falling, the annual budget deficit is at a long-term level of around two percent, the economy is growing by approximately three percent annually, unemployment stands somewhere around four and a half percent, and we are very near full employment. Our foreign trade balance also repeatedly ends each year with a large surplus.

At times like this, the question is how this was achieved: how one can turn a country around 180 degrees in six years. Without trying to give advice to anyone, we would like to draw your attention to the following facts. The first and most important thing is political stability: if it is true that politics – stable politics – is the basis of good economic policy, one must create political stability. Without political strength and political stability there can be no successful economic reforms or successful changes in economic policy. Political strength is not always an appealing thing – particularly in intellectual circles. Analysts do not like it at all, and there are also some politically untutored financial experts who believe that the banking sector should have more room for manoeuvre. But the truth is that those who want a predictable business environment always have a vested interest in strong and predictable politics – not to mention 95% of the electorate.

The second important thing that led us to success was strict fiscal policy. All I would say about this now – referring back to the presentation of President Larosière, who said that either it is accepted or not – is that the people must accept that there are times when strict fiscal policy is necessary. My view is that the people will only accept strict fiscal policy if they find it just. A simple statement in a complex sentence. The people accept strict fiscal policy if they perceive it to be just. In this there will be a different recipe for every nation. In Hungary, for instance, it started with a fifty percent reduction in the political class. We did not introduce strict fiscal measures of any kind until we had reduced the number of politicians by half: a parliament with half as many MPs, and local councils with half as many councillors. This was just one thing, but I could list others as well. All I want to say is that an economic recovery programme based on strict fiscal policy is manageable and possible. This is why I am standing here, and this is why – having put the country's fiscal affairs in order – we did not lose the elections in 2014. Winning those elections is proof that this is possible; it is possible, but complicated, and should not be approached in a conventional manner. This means that the issue of justness cannot be left out of fiscal policy.

The third thing that could explain Hungary's success is the creation of a workfare society, instead of a benefit-centred society. Naturally, it is not my place to tease, but

I would be intrigued to see the government of a Western European country – say of France – announce that the maximum period for which unemployment benefit can be claimed will be reduced to three months, after which there will be no benefit of any kind. Instead there is public employment: those who work receive a salary, while those who do not receive neither a salary nor benefits – and we wish them the best of luck. This is a very harsh statement to make – one that is almost inconceivable for most Europeans, but which is not far from fairness and justice. The Hungarian people took the view that they do not want their taxes to go towards supporting people who are capable of work, and they accepted that it is the duty of the state to arrange for these people to receive wages rather than benefits. And if the market cannot take care of this, then the state should devise some temporary bridging solutions. But the essence of the matter is that everyone should feel that the taxes they pay are well-spent. Following on from this, it was later possible to reduce taxes. I shall not mention them all, but in Hungary corporation tax is at 9% and we have a flat income tax rate of 15%.

The next path leading to success, and one on which we have a great many battles ahead, is the establishment of a dual training system. This means bringing an education system that is far removed from European economic reality closer to that economic reality. The aim is to ensure that at the end of their studies students do not discover that, while the knowledge we have given our children may well be fine, noble and valuable in theory, in reality it is utterly useless. Europe's school and higher education systems suffer in this regard. The only way to solve this problem is by descending somewhat from our refined intellectual heights, and bringing the school and training system closer to the oil and sweat of the real economy. This, perhaps, accounts for a major part of the Germans' success. In other words, jobs instead of benefits: every Hungarian must be given the opportunity to work.

And, finally, the policy of eastward opening also forms part of the Hungarian recipe, the Hungarian model. After 2008, we Hungarians took the view that Europe was unable to grow by itself: there would be no economic growth if we only trade with each other, without opening towards the East. This sounds fine, and it also sounds simple, but there is something here that the Europeans must understand. We cannot simply decide to open economically towards other countries to the East – say towards China –, and then every morning proceed to lecture them on human rights. That is not how it works. It is simply untenable to expect the kind of alliance in which we seek access to your market, and we want your economic cooperation, and we also ask you for investment, but we do not at the same time give you the very level of respect that is due to every single independent nation in the world. Such an approach only results in an opening towards the East which exists at the level of rhetoric, but not that of reality. At the heart of eastward opening lies respect, and those who do not accept that respect takes priority over ideology will never be able to open to the East, because they do not understand the peoples of the East. In this respect we are luckier, because we are an eastern people which was infused with Christianity; and this gives us a special perspective, enabling us to understand all that is happening in China. Furthermore, given that we are talking about a disciplined country, we also understand why they do not respond to criticism from the West, which should instead recognise the achievement represented by, say, the success and value of lifting masses of people out of poverty and hopeless economic situations. From a moral point of view, also, this is something which China can cite as the most important argument in its own favour. If we do not accept this, there will be no eastward opening; there will only be trade, which is not the same as eastward opening. Hungary strives to achieve eastward opening.

Ladies and Gentlemen,

The Hungarian model therefore comprises four elements: political stability, strict fiscal policy, a workfare society and eastward opening. With due modesty, but also appropriate self-confidence, this is what we can present to the world for consideration.

Thank you for your attention.

ZHIMIN CHEN

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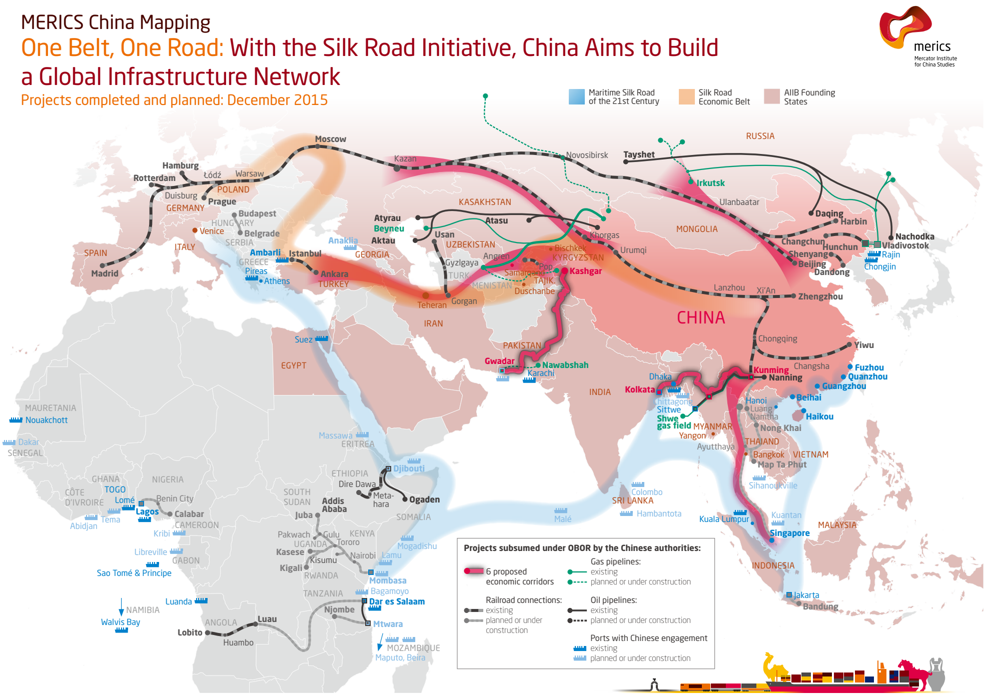
The New Silk Road and the Global China's Three-Level Engagement with Europe

Europe and China sit at the two ends of the vast Eurasian continent. However, the Silk Road connected us even two thousand years ago. With the revival of the idea of a new silk road, or the "One Belt and One Road" Initiative (OBOR), Europe and China have a new chance to deepen their cooperation and to contribute to the well-being of the people on this most populous continent in the world.

1. The New Silk Road Initiative: A New Approach to Inter-connected Development



The OBOR represents a new approach to achieve inter-connected development.

A) It is not about creating a new trade institution but an attempt to build an economic network. Countries have been engaging in creating global, regional and bilateral free trade arrangements in the past. However, OBOR does not have this as its main objective; it aims to find concrete ways to connect the economies along the Silk Road.

B) It is not mainly about the promotion of trade liberalization through lowering tariffs but mostly focusing on strengthening economic ties through connectivity projects particularly infrastructure projects between East Asia and Europe.

C) It focuses not just on transportation connectivity but also on connectivity in the fields of policy, trade, finance and people. With that, it can incorporate most aspects of a comprehensive relationship between China and countries along the OBOR, and through this repackaging and rebranding under the name of OBOR, these aspects of the relationship will be given higher priority in China's foreign policy towards the countries along the OBOR.

D) It is not about creating fixed rules or regulations but about identifying and building flexible arrangements so that China and its partners can find proper arrangements adapted to different national and local conditions to make things happen.

E) It is based not on one country's own interest or mere public goods, but on shared interests. OBOR is about win-win development, it could not just serve one party's interest. It is an open invitation, so if some countries did not feel that their interests could be served, they would not participate. OBOR has some elements of international public goods because when the connectivity projects are finished, they can offer benefits for many countries. For me, what is most important is that OBOR shall be based on shared interests, and bring benefits to all partners through jointly designed projects. It will be difficult but it is a good approach.

F) Last but not the least, it is not just about economic benefits but also about positive political spillovers. With deepened economic cooperation, China does hope that their political relations will also be strengthened, and their cooperation will bring more stability to the Eurasian continent.

2. China's Three-Level Engagement with Europe: State Level

Early in this century, Europe has become China's No.1 trading partner and China Europe's second trading partner. With the launch of this new silk road initiative from late 2013 we have seen that the cooperation between China and Europe has been strengthened at all three levels.

OBOR mainly focuses on cooperation with partner states in order to jointly develop projects of shared interests. At the moment, 6 European countries have signed bilateral MOU of cooperation with China. Hungary is the first country in Europe to do so and is becoming the best example with tangible results of cooperation. About $3 bn from Chinese companies have been invested in Hungary. According to your foreign minister, trade in the first seven months of 2016 saw a major increase, and the number of tourists from China increased 30% in that period. Hungary and China, in collaboration with Serbia, are in their final stage to start the 370-kilometer railroad link between Budapest and Serbia's capital, Belgrade, a €1.5 bn project.

3. China's Three-Level Engagement with Europe: Subregional Level

Apart from bilateral inter-state cooperation, China works with 16 CEE countries collectively to promote OBOR in the 16+1 mechanism. The first China-CEEC forum was launched in Hungary in 2011 when former Chinese prime minister, Wen Jiabao visited Hungary. We also know that this year's 16+1 summit will be hosted by Hungary, which goes to show the role Hungary plays in building this 16+1 process.

Under 16+1, a Chinese secretariat was set up within Chinese Foreign Ministry, with its members from various Chinese ministries including the National Development and Reform Commission (NDRC), which takes the leading role in project selection and implementation. The secretariat works with CEEC national coordinators to support the 16+1 cooperation. The 16+1 process now attracts various actors from outside of group, and it has witnessed a growing number of observers at the 2016 Riga summit: Austria, Switzerland, Greece, the EU, the European Bank for Reconstruction and Development and Belarus.

Every summit gives new impetus to the 16+1 cooperation. The Riga summit has formally endorsed the Adriatic-Baltic-Black Sea Seaport Cooperation. This Riga initiative aims to develop transportation hubs involving ports and industrial parks in the coastal areas of the Adriatic, Baltic and Black Sea and along the inland waterways, and works jointly to build industrial clusters in ports and establish modern road, rail and river corridors to connect them.

Another development in Riga has been the launch of a 16+1 financial holding company, which will be led by the Industrial and Commercial Bank of China (ICBC), the world's biggest commercial bank, to raise funds from global markets through commercial operations. According to prime minister Li Keqiang, the new holding company will mainly finance connectivity and production-capacity cooperation projects under the 16+1 framework.

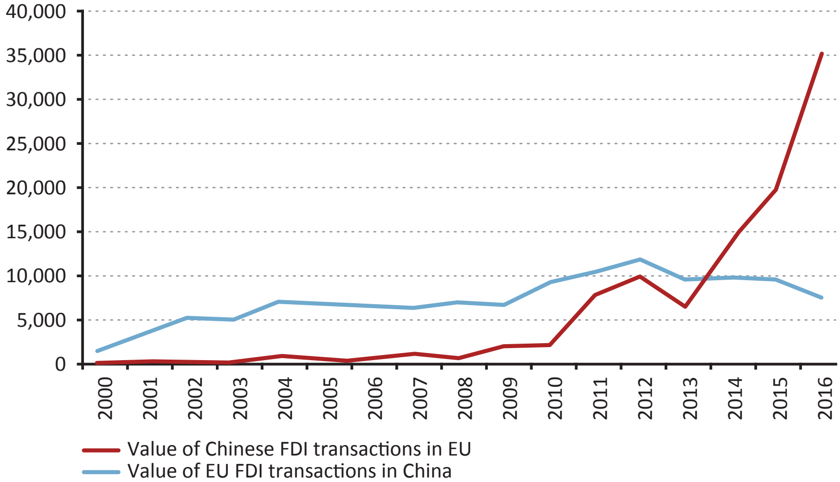
4. China's Three-Level Engagement with Europe: EU Level

Due to the inter-state origin and preference of the OBOR initiative, China was not very clear about how to engage with the EU institutions in the very beginning.

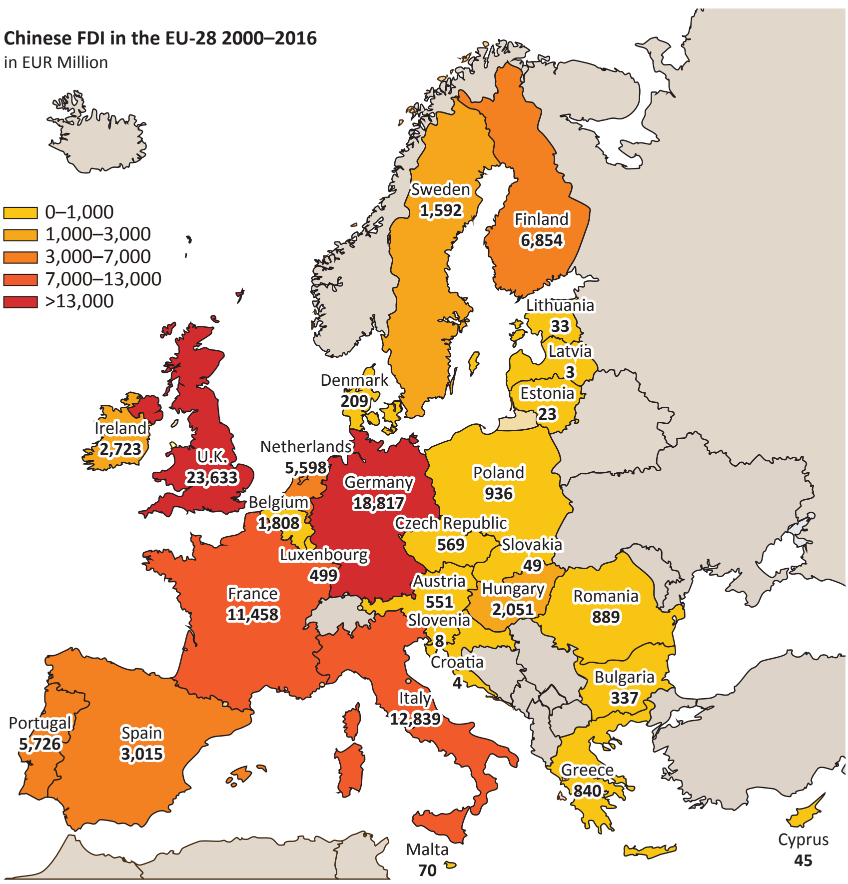
Serious engagement with the EU only started in June of 2015 at the 17th China-EU summit. By that time, China had adopted a formal visionary policy paper on OBOR in the spring of 2015 which identified Europe as the final destination of both the land and maritime Silk Roads and thus showed the willingness on China's side to engage with the EU. Also, the EU itself put forward the Junker Plan to create a European Fund for Strategic Investment, with its mission including investment in infrastructures. The Junker Plan provided a viable way for a partnership with OBOR, making cooperation possible at EU level. Furthermore, some Initial OBOR projects in the EU member states faced delays due to relevant EU regulations, which also led the Chinese side to realize that working with the EU institutions is also a matter of necessity.

Therefore, the EU and China set up a China-EU connectivity Platform, to identify possible partnerships and synergies in their infrastructure development plans. China made a commitment to invest in the EFSI and China gained member status in the EBRD, while around the same time, 14 EU member states joined the China-led AIIB as founding members. 2016 was also a year of surge of Chinese direct investment into the EU. According to a Rhodium Group report just released, in 2016, Chinese companies invested EUR 35 billion in the European Union, a 77 % increase from the previous year. This surge of Chinese FDI in the EU has made an ongoing bilateral investment treaty (BIT) negotiation become more urgent.

Chinese FDI in EuropeS Surges, While EU FDI in China Declines
Value of FDI transactions between the EU-28 and China, EUR Million



Source: MERICS | PAPERS ON CHINA No 3 | Update | January 2017, page 5.



Source: MERICS | PAPERS ON CHINA No 3 | Update | January 2017, page 10

5. Meeting the Challenges to Ensure Synergies

The Chinese side is very determined to ensure the synergy among the three levels of engagements: state, subregional and EU level. The EU is now an official observer at the 16+1 process; in all the documents adopted by 16+1, all parties have agreed to respect EU regulations. China has committed sizable investments through EFSI and supported the EU-endorsed Adriatic-Baltic-Black Sea Seaport initiative. To avoid state loans, China and CEEC have created a new commercial financing body: the 16+1 Holding Company.

Nevertheless, we should also notice that there are still a number of challenges ahead which require joint efforts in the future to make OBOR more successful. We must be aware that, the OBOR progress is not very obvious by far in a number of European countries that meeting various requirements from the EU side takes time, and that a more anticipated greenfield investment from China is just being started. We also need to be aware that there are still concerns in Western Europe and Brussels about the implications of China's engagements with member states. Furthermore, the difficulties in the China-EU relations in 2016 have also slowed the process of getting China into the EFSI.

6. Global China at the Time of Globalization Retreat

Having said that, looking beyond, we need to look at the broader picture in the world, and I believe there will be bigger incentives from both China and Europe to deepen their cooperation, and that may lead to more fruitful cooperation under OBOR.

The world is changing fast and is not becoming better these days. Global trade is not growing. Populism is turning countries inward-looking. Brexit is moving towards a hard version. The new US government is withdrawing from the liberal economic world order, and instead championing for America First. The New US President and his team have talked about a number of bombshells both for China and for the Europe.

For China, the US government has raised the possibility to abandon its long-held "One China" policy, the very foundation of US-China relations, and it has talked about a 45% import tariff imposed on products imported from China, to name just two. Although the first issue is removed after President Trump's phone call with President Xi recently, in which President Trump reaffirmed US adherence to its "One China" policy, China is still watching carefully the future moves of Washington. For Europe, the Trump government shows little interest in the TTIP negotiation, and has yet to affirm America's traditional preference for a more integrated Europe. On the security side, the new government in the US would push Europe to rely more on self-help.

On January 17th this year, President Xi Jinping went to Davos World Economic Forum for the first time as the Chinese president. In his keynote speech in Davos, President Xi made a strong case to defend the economic globalization. It might be confusing for many people in the world that this time it is a leader of a socialist country to champion globalization – Paris Agreement on Climate Change, and 2030 Sustainable Development Goals – while the leader of the West and the liberal international order turned his back on all these matters.

Xi's speech in Davos is also backed by a new decision from the State Council on the same day to open up further the Chinese service sector for foreign investment. In one word, while the US is moving away from free trade, China is adopting unilateral liberalization. I hope that the decision will be implemented soon with specific new regulations to allow easier access to the Chinese market for foreign business, in so doing to enhance the global confidence in a more inclusive economic globalization.

Under these circumstances, I see that both Europe and China will feel the new urgency to cooperate with each other further, not only for mutually beneficial cooperation between them in the framework of OBOR, but also to sustain the central features of the post-Cold War international order, join hands to reform and revitalize the global order, and to show the world that they will not give way to the unraveling forces in the world.

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Can the Silk Road tune up growth?
Opportunities in European-Asian economic cooperation

On 23 January 2017, I had the honor of addressing the Lamfalussy Lectures Conference in Budapest on the topic "Can the Silk Road Tune up Growth?".

The timing of this discussion could hardly have been better: While global growth is now recovering quite nicely, following the Great Recession of 2008-09, there is still a significant amount of catching up to be done, not least as productivity growth remains elusive throughout the industrialized world. Weak productivity in recent years is still not well understood, but the pronounced slowdown in global trade since 2012 is clearly part of the explanation. Initiatives to boost global trade and investment flows should, therefore, be welcomed.

This discussion is also timely because of the presence of disturbing signs of shifting political winds towards protectionism and against multilateralism in several parts of the world, including among those nations that have traditionally championed free trade. This is indeed an unfortunate irony because few things have contributed as much to wealth creation in the OECD area since the Second World War, or in China during the last four decades, as expansion in global trade and investment.

By most accounts, the crowning achievement of the period following the Second World War was the establishment of international organizations that promoted free trade and multilateralism within a rules-based setting. The General Agreement on Tariffs and Trade (GATT) from 1947 was at the core of this trend; it later evolved into the World Trade Organization (WTO) in 1994. The IMF and the World Bank also played critical roles in supporting policies around the world, that were aimed at encouraging private-sector-driven growth.

In Europe, multilateralism went even further, when the fore-runner agreements for the EU were agreed on in Rome in 1957. Within the multiple facets of European integration, nothing contributed concretely to trade and growth as much as the establishment of Europe's Single Market, which came into effect in 1993.

It was no surprise to see those nations of the world that had not benefitted from the start of these institutions and frameworks for economic interactions line up to become members as soon as their domestic politics allowed, and a minimum degree of convergence in institutional capabilities had been achieved. Hence, most of central Europe joined GATT in the late 1960s and early 1970s, followed by China joining the WTO in 2001 and Russia in 2012. Most of central Europe joined the EU in 2004.

As is now widely recognized, the overall benefits of these developments, as well as the challenges to traditional societies of the technological revolution, were not well managed in the United States and Europe and thus left large parts of their societies behind.

Still, it is disappointing to see political leaders misdiagnose these problems and turn away from multilateralism and the relatively free movement of trade, capital and people, which have contributed so significantly to growth, productivity and income in recent decades.

In November, Donald Trump won the US presidential election by running on a decisively protectionist platform, promising the withdrawal of the US from virtually all multilateral arrangements unless they could be renegotiated in the US's favor. In Europe, some countries have raised objections to the EU single market's linkage of the four fundamental free movements, namely of trade, services, capital and people. The most extreme manifestation of this occurred in June 2016, when the UK voted to leave the EU.

With the US and parts of Europe beginning to question the benefits of global trade and investment flows, Chinese President Xi Jinping travelled to the World Economic Forum in Davos, Switzerland, (less than a week before the conference in Budapest) to deliver a welcome defense of globalization, free trade and cooperation. He said that "we must remain committed to developing global free trade and investment, promote trade and investment liberalization and facilitation through opening-up and say no to protectionism." Mr. Xi also used the opportunity to promote China's bilateral trade and investment proposals, noting that "over three years ago, I put forward the 'Belt and Road' initiative. Since then, over 100 countries and international organizations have given warm responses and their support to the initiative".

As if on cue, three days later (on 20 January), President Trump doubled down on his campaign pledges in one of the most nationalistic inaugural addresses in US history, asserting that "protection will lead to great prosperity and strength" so "from this day forward, it's going to be only America first", and "America will start winning again, winning like never before". The world's reaction to the speech varied from near-enthusiasm – in, for example, Russia and a small number of other countries, whose leaders strangely did not consider who the losers might be in a game, in which the US president promises to make the US the winner – to quiet concern in most of western Europe and China.

Of course, as experienced people joined the Trump administration and helped shape the thinking of the new president, a good deal of verbal back-pedaling has since taken place with regard to trade. However, the US did manage to remove its traditional pledge to refrain from protectionism from the G7 communique.

The question in front of us is whether China can become a global leader in trade and finance and specifically whether the Silk Road can play a constructive role in this respect.

In this article, I argue **1.** that China has a natural leading role to play in the global economy – its success in developing its domestic economy during the last four decades and the resulting size of the Chinese economy today both dictate this, but China still faces huge structural issues, which, if left unchecked, will lead to less investment capabilities in the future; **2.** that the Silk Road initiative is a natural component of China's own development and the global role China would like to play in the years ahead; but **3.** that key questions remain with respect to China's future ability to be the leading yardstick for international investment flows, its adherence to policies to promote the necessary free capital flows as well as its commitment to transparency in investment, which are necessary to secure gains in competition and, hence, productivity.

1. China's right to assume a leading global role in trade and finance

Following China's long and glorious (but at times painful) history, the last four decades have brought unprecedented progress to China's population and have led the country from being a troubled, poor emerging market to becoming a respected global power.

China's meteoric rise came about via an abrupt shift from being a largely agrarian society to becoming an industrial powerhouse. With a GDP of USD 11tn, China is now the second-largest economy in the world. At home, these impressive economic achievements have translated into the lifting of 800 million people out of poverty, the emergence of a burgeoning middle class and a literacy rate of 96%. Abroad, Beijing has shaken the workforces of its Western partners by attracting offshore manufacturing production and by helping Asian economies integrate themselves into complex global value chains.

Yet in many respects, China remains a developing country: Its GDP per capita amounts to just 15% of that of the US; its interior remains heavily underdeveloped, compared to its coastal regions and its industries are still too reliant on importing technologies from the West.

China's rise, which happened as Europe and the US were capitalizing on the compounded return of the three industrial revolutions that the Middle Kingdom missed, is the quintessential example of how a free market and an intrusive state can coexist and reinforce each other, at least for a time. There are three defining moments in this success story.

First, the third plenary session of the 11th Central Committee of the Communist Party of China in December 1978 started the process of market liberalization, and the opening up of China's economy to trade. Collective farming was replaced by a household responsibility system. Price controls were eased, foreign capital was allowed in to boost regional economies and investment in education was increased.

Then came the reopening of the Shanghai Stock Exchange in December 1990, after a 40-year hiatus and, ultimately, China's accession to the WTO in 2001. Respectively, these two events contributed to attracting investment from abroad and consolidating China's role as a top global exporter.

While pre-1978 China had seen average, but highly volatile, annual GDP growth of 6%, post-1978 China saw growth rates rise to levels that were at or above 10% in the aftermath of WTO accession, as China reaped the so-called WTO-dividend. As a result, China's GDP per capita today stands at 26 times the level it was when prominent former leader of China Deng Xiaoping adopted his reform plan.

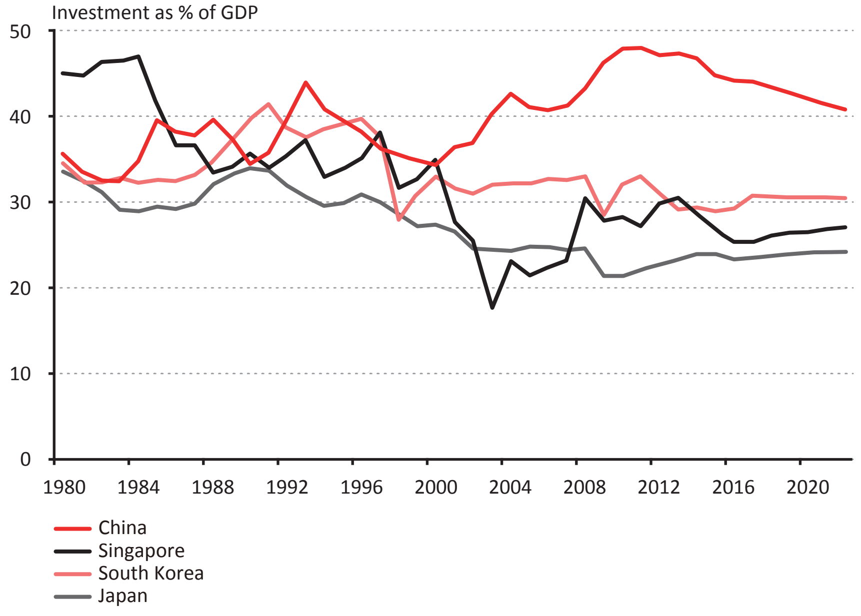
Starting from scratch and dependent on a massive workforce, as well as the (induced) willingness of foreign companies to share their know-how, China's growth miracle has been the result of three key factors: radical institutional changes, capital accumulation and urbanization, which have all combined to generate huge productivity gains.

Yet, for most of this time, the central government has played a dominant role in combining these factors within the context of an export-led, investment-driven growth model, albeit often creating major distortions. For a long time, investment was fuelled by cheap credit provided by state-owned banks, subsidized land provided by local governments and energy prices administered by public officials.

From an expenditure-based GDP approach, Beijing has been trying to gradually reduce its dependence on growth that is based on investment and the export of goods and services – a policy that has been considerably more successful with respect to the latter than to the former.

Investments currently represent about 44% of China's GDP, down from 48% in 2011. Exports represent 22% of GDP, down from its 2006 peak of 37%. When imports are subtracted, net-exports account for 3% of total Chinese economic activity, down from the 8.6% recorded in 2007. As a result, private consumption represents just 38% of China's GDP.

Despite all of China's major achievements, the completion of China's transition from its old to its new economy, with a more "normal" distribution of growth between investment and consumption, is still a long way off. To illustrate, at the end of the 1980s – after four decades of exceptional growth performance in Japan and the rise, twenty years earlier, of the Four Tigers (Singapore, Hong Kong, Taiwan and South Korea) – investments' share of GDP was, on average, slightly less than 30%, which is almost 15pp less than China's current level. At the same time, consumption was already close to 50%.



Source: IMF, UniCredit

Masterminding the necessary shift in the Chinese economy from investment-led growth to consumption-led growth will be a challenge of an order of magnitude never seen before – even in relatively similar economies and in smaller ones, which would have been easier to manage. Even if China is successful in this endeavor, the obvious result will be a Chinese economy with a smaller external surplus to invest abroad and an economy that is less fixated on investment more generally.

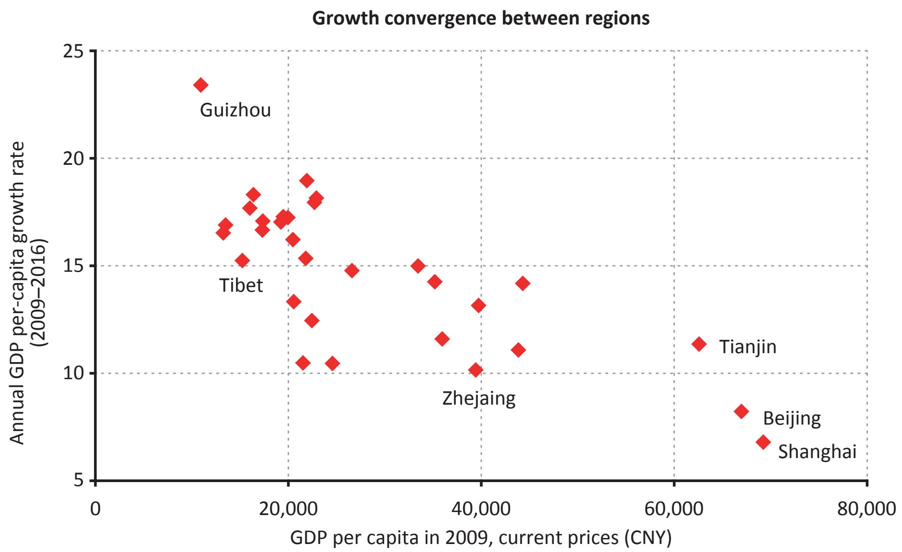
2. The domestic importance of the Silk Road and how it fits into China's vision of its future global role

China's population is aging fast, and the availability of skilled labor (to be moved from the countryside in western China to the urban industrial centers) is drying up. As a result, the so-called Lewis turning point – i.e. the point at which an economy shifts from having a vast supply of low-cost workers to experiencing a labor-shortage and, therefore, a potentially sharp reduction in growth – is approaching.

According to research by the IMF, China's glut of labor peaked in 2010, and China is likely to reach the Lewis turning point between 2020 and 2025. When firms struggle to fill their factories with new employees and wages go up, competing globally becomes more difficult without innovating, and the manufacturing sector inevitably shrinks. As an order of magnitude, this could shift GDP growth down to about half of the present annual growth rate of 6.7%.

Partly as a result, the New Silk Road has been designed to induce industries to move inland. For the first time in China, a powerful middle class is emerging, and new technologies are transforming consumption patterns.

Beijing's move towards a more balanced growth model is not just a matter of resource-re-allocation. It also requires a process of growth-convergence among regions. This is necessary to stem pressure on real estate prices in urban areas, to promote social inclusiveness and to optimize the use of resources – especially considering the massive income disparities between the west and east of China (GDP per capita in Guizhou province is just 30% of that recorded in Beijing and Shanghai). There are signs that the convergence process is underway: In 2010, all Chinese regions recorded growth rates of above 10%. Now, GDP in the poorest areas, those mostly concentrated in the southwestern part of the country, has tended to expand at double-digit rates, outperforming China's richest regions.



Source: NBSC; UniCredit

Several manufacturing activities have already been moved from the coast to China's inner regions thanks also to the hopes created by the New Silk Road. This ambitious infrastructural project will not only spread growth across the country, connect its most remote areas, absorb overcapacity in heavy industry and increase Beijing's geopolitical influence in Eurasia and the Middle East through, respectively, new land and maritime routes. It will also contribute towards keeping alive the globalization process by facilitating and intensifying connectivity between countries that are geographically distant from each other, with positive spillover effects on global value chains.

As such, the Silk Road initiative fits into China's longer-term strategy to become a global power – namely that of securing raw materials (by heavily investing in key sectors and transportation links in, for example, South America and Africa) and securing access to future key markets (via its Belt and Road initiative, in which it invests in infrastructure hubs via land and sea to Europe).

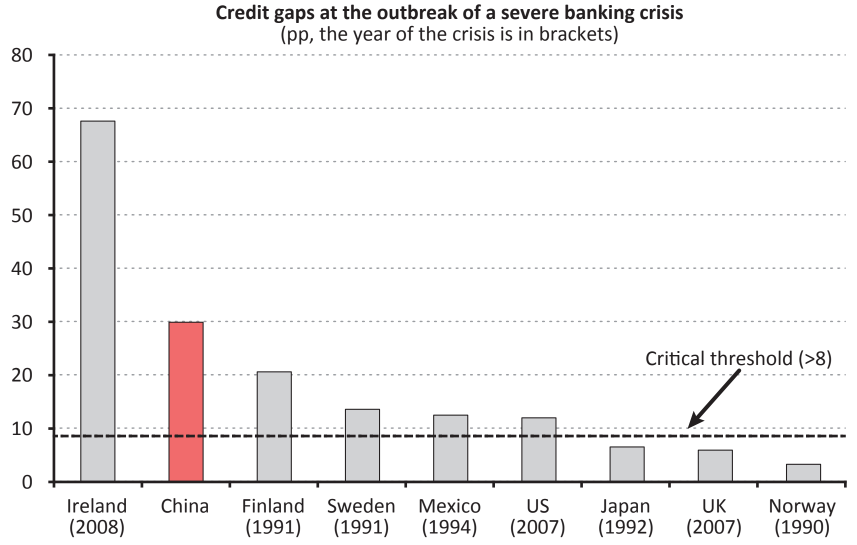
China's huge external surpluses of past years and the resulting cash pile have come in handy to help finance these external investments. This sets a clear limit for what is likely to be an acceptable reduction in China's current account surplus, let alone the politically undesirable possibility of running a deficit. It opens up the likely possibility of China developing a more-integrated bond market (one that is likely to be included in key indices) to attract "captured" inflows. It also explains part of the anxiety in government circles caused by the sight of capital outflows.

3. Important questions remain: Can China become the natural leader of free trade, and is the Silk Road a good initiative in this respect?

Although China is very likely to be successful in the long term, there are clear signs that it is set to encounter some serious bumps in the road, and its policy reaction has not been very reassuring.

In recent years, growth in China has been boosted by an excessive amount of monetary activism. In particular, credit growth of above an annual rate of 15% has kept alive many highly inefficient state-owned enterprises, has stimulated industrial and residential investments and has boosted earnings. This has contributed to the enlargement of already-sizable corporate debt, which, at 171% of GDP, is more than twice as high as that of the US.

Via extensive historical research, the Bank for International Settlements (BIS) has identified a credit gap – broadly defined as the difference between the credit-to-GDP ratio and its long-run trend – of 8% as a critical sign of a looming crisis. According to this measure, China's credit gap is 30%, a level second only to that experienced in Ireland in the years leading up to the financial crisis.



Source: BIS, UniCredit

Whether a systemic banking crisis can be avoided or not depends critically on the policy response of the Chinese government. Debt-for-equity swaps, bank recapitalization and the establishment of a market for NPLs are all options on the table. Such restructuring of China's banking system would result in a period of slower growth due to credit contraction but would lead to the establishment of a more-sustainable growth model in the medium term. If, instead, the government continues to promote rampant credit growth, forcing banks to keep alive struggling state-owned enterprises, to misallocate resources and to defer necessary structural rebalancing, then a crash would seem unavoidable.

A strained banking sector could undermine the New Silk Road project itself. Building ports, highways and railroads requires a huge amount of money. If Chinese banks and the government struggle to significantly contribute to the project, it will also be difficult for the Asian Investment and Development Bank to raise funds from foreign countries, which, on average, face rather binding fiscal constraints. Moreover, a sudden credit crunch would threaten the lifeblood of heavy industry, particularly the one producing raw materials, whose overcapacity is key for such an infrastructure project as the New Silk Road.

This is where the issue of capital outflows returns to the debate. China's foreign reserves have dropped from about USD 4tn to about USD 3tn, but this wealth will be critically important both for China's investment ambitions and as a cushion if (or when) a credit bubble bursts.

In order to avoid capital flight or even legitimate capital outflows, Beijing has adopted a number of measures aimed at restricting these. Banks trading FX forwards must hold a certain amount of foreign currency in reserve, whereas offshore banks offering an FX deposit must adhere to a reserve-requirement ratio. Moreover, Beijing has placed tighter limits on the amount of money individuals can transfer abroad via bank transfers. Among other measures, it has cut payment limits on purchases of insurance products in Hong Kong, set restrictions on retail USD FX purchases and capped the amount of money individuals can withdraw when on holiday abroad using credit cards. It has also increased surveillance to ascertain whether certain transactions are authentic.

Curiously (and of considerable concern), these measures are rarely communicated consistently and transparently. Rather, they have often been implemented as simply stricter enforcement of existing regulation, thereby adding to uncertainty and confusion in the business community.

A very plausible scenario is one in which China maintains a highly controlled capital account for years to come – in contradiction with its pledge to the IMF to include the

Renminbi in the Swap Data Repository basket and in contradiction with China's broader aspiration of seeing its currency develop into the leading economy and reserve currency in global trade and finance.

As financial constraints start to build up, the political feasibility of the New Silk Road could become questionable. This will probably depend on the long-term loyalty to Beijing of those countries that will be the recipients of investment and on the willingness of other great powers (like Russia) to allow China's influence to grow within their own spheres of influence.

In Europe, the "end station" of the project, the Silk Road has also run into issues. The EU is insisting on adherence to European standards for tenders and bidding on projects. This is critical to competitiveness issues, to the benefits to productivity and (critically important) to reducing the risk of corruption gaining a foothold.

These issues contradict, at various levels, China's aspirations to become the beacon of the liberal world order, as outlined by Mr. Xi's remarks at the latest World Economic Forum in Davos in response to Donald Trump's apparent intention to withdraw the US from this role. It calls into question the role the Silk Road might play in developing global trade and investment flows in a way that would stimulate long-term, inclusive growth.

YAN XUETONG

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Tsinghua University

Cooperation between China and Hungary

Globalization is causing problems and difficulties and is likely to continue doing so in 2017. My understanding is that the problem is not globalization itself – since it moves forward automatically, without any external assistance. The problem is how countries perceive it. It has two sides, of which the negative side seems to become stronger and stronger, while the positive side – welcomed by liberal governments – is no longer that favourable.

In fact, globalization is a double-edged sword, as it indeed has both its positive and negative sides. If you want to have free capital flows, you probably cannot avoid financial crises. If you want to have free flow of goods, you probably cannot avoid trade circles. And if you want to have free movement of people, you probably cannot avoid the problem of immigration and the resulting conflicts between different peoples. So these things, the positive and negative things, go together.

Unfortunately, liberalism and its advocates believe that globalization only brings the positive parts for people, without having any negative effects. That is why when these negative effects occur and become stronger, many people get worried about globalization. Liberalists tend to believe that regionalization, like the EU, is a part of globalization. But for a realist like me, regionalism is actually an effort to counterbalance globalization, when some countries try to unite and stand together as a power in order to resist the negative impacts of globalization – rather than encouraging or helping or moving forward it.

Since some liberalists deny the negative sides of globalization, they are never concerned with how to prevent these negative effects from occurring. The international system is an anarchical system, and it will remain anarchical until a world government is set up. But before we have this world government, the nature or the character of the international system will remain anarchy. That is because until we have an unanimously recognized global military force that exercises monopoly power in enforcing contracts, all sovereign governments have the right to have their own military forces – and you cannot have a world government.

In the absence of a world government, we then created a new term: global governance. Who governs whom? Who carries out the task of a government? In my view, without a world government there cannot be any world governance. The result is that we still rely on the sovereign states, the nation states, which still rely on their national governments to govern their own country. One cannot rely on any international organizations to govern these independent states. So this is why without a world government there is no world governance.

So, what kind of globalization are we living in? Many people think that globalization is so strong that one cannot resist it. But if the world continues to evolve on its current path, then it will still be countries or independent states that are working together and cooperating with each other – but ultimately it will be national governments that govern their own countries. And all that means that globalization is still based on individual governmental governance, rather than on world-wide global governance.

What does this imply for developing cooperation between China and Hungary? In my understanding, we need two principles or guiding rules for our cooperation. The first is the principle of sovereignty. We still need sovereignty as the basis of cooperation between our two countries. As both China and Hungary are sovereign states, we can make decisions together, we can sign bilateral agreements and we can agree on many projects without the approval of third parties. We do not need other states' approval for doing what both of us agree on.

What does that mean? It means that it is very difficult for China to look for cooperation under the concept of One Belt One Road (OBOR) between China and the EU. It is very difficult to rely on multi-lateral cooperation when establishing cooperation between China and Hungary. Therefore, cooperation on OBOR between China and Hungary will be mainly carried out on a bilateral basis, rather than in a multilateral form. We have just heard about the concept of the "Visegrad group". I think that even the Visegrad group, a sub-regional cooperation, can only be complementary. We cannot even rely on this sub-regional cooperation as we need to re-define the means of cooperation between China and Hungary under the general plan of the OBOR.

The second thing, or the second principle in our bilateral cooperation between China and Hungary is a two-way principle – where the term "two-way" means that you cannot rely on either imports or exports. In order to introduce Chinese capital, goods and technology to Hungary, we also need to do that in the opposite direction. This means that actually the concept of OBOR is not a one-way plan, but a two-way plan. In the one direction we export capital, technology and products, and in the other direction we absorb foreign capital, foreign technology and foreign goods. So we need to have this cooperation between our countries on a two-way basis, rather than just in one direction.

I can tell you a story why it's so difficult for China to establish cooperation within Central Asia. The reason is because the existing cooperations are mostly one-way cooperations. We cannot import enough goods from these countries, so the train can carry goods to these countries, but they have nothing to send back to China. So, it is always a one-way transportation, and it does not work. That is why I think that we need two-way cooperation, rather than one-way cooperation.

This also means that we do not need economic cooperation alone: we also need to cooperate in politics, security, culture, etc. So, if we extend the cooperation from the economic sector to other sectors as well, that will make this two-way cooperation more feasible. Otherwise, it will be limited. Furthermore, if we want to develop two-way cooperation between two countries, we cannot only rely on state-owned businesses. Certainly, the states should be major players in this cooperation, but we also need private companies, the private sector, because they are growing very fast in China. They now account for 75% of GDP and are ever more powerful, and in China they have much more capability to generate wealth than state-owned businesses. So private businesses can certainly do more than governments in this kind of cooperation between China and Hungary.

My final point is something that someone has just suggested: that you have to learn from China. I would remind you to be very careful about that. In China, we have learned a lot from others, but we often say that we do everything with a Chinese character. I also think that in your country, you should have everything with a Hungarian character.

What does that mean? It means that you cannot simply copy our model. You cannot even copy our experience, since you are so different. But you are not only different from China, you are very different even from your neighbours. So, you should try to find your unique way, a unique approach and then you can make your growth faster, and you can make your country unique in cooperating with China. We have cooperated with so many European countries. So, you need to make this cooperation, this bilateral cooperation between Hungary and China, a unique one so that no other countries can replace it outright. By doing this, you can make this cooperation important and durable.

One of our most important experiences is that we develop our own model by ourselves, we never copy any others. We just learn from them and then we synthesise them into a Chinese way. I do hope that you can do something similar: while borrowing some ideas from us, you can still stick to your own characteristics and transform these ideas into something very, very Hungarian, just like your food.

IVO MAES

Senior Advisor, National Bank of Belgium
and Robert Triffin Chair, Catholic University of Louvain

Presentation of the book 'Alexandre Lamfalussy – Selected Essays'

It is a great honour for me to address the prestigious Lamfalussy Lectures Conference and to present the book 'Alexandre Lamfalussy – Selected Essays'.

It is common knowledge that Alexandre Lamfalussy has been highly influential in the process of European monetary and financial integration. He is perhaps best known as the first president of the European Monetary Institute, the predecessor of the European Central Bank, and as the Chairman of the Committee of Wise Men, which developed a new approach for the regulation of European financial markets. However, he was also a brilliant intellectual and an eminent academic who published widely.

Alexandre Lamfalussy and his contributions to economic thought, the European integration and financial stability occupied a large part of my research efforts over the past decade. Therefore, I am very grateful to have been asked by the Magyar Nemzeti Bank to collaborate on this volume 'Alexandre Lamfalussy – Selected Essays'. I would especially like to thank Governor György Matolcsy of the Magyar Nemzeti Bank for this initiative and for kindly inviting me to present the volume at this renowned conference.

Belgium and Hungary were the two countries close to the heart of Alexandre Lamfalussy. Lamfalussy was born on April 26, 1929 in Kapuvár, Hungary. He started his studies in economics at the József Nádor University of Technology and Economics in Budapest. In January 1949, he left Hungary and came to Belgium where he continued his studies and where his career took off.

This book is a compilation of selected articles and speeches by Alexandre Lamfalussy, starting with his first article in 1953 on 'The Steel Industry and the European Coal and Steel Community' and ending with his last lecture, his 'Concluding Remarks' delivered at the conference commemorating the 20th anniversary of the European Monetary Institute in February 2014.

The essays in the book are presented in chronological order. The volume is divided into four broad parts: (1) 'The Young Lamfalussy', covering the period from 1929 to 1975, encompassing his initial work on industrial economics and growth as well as his early writings on monetary and financial issues; (2) ‘At the Bank for International Settlements’, the period from 1976 to 1993. During Lamfalussy’s time at the BIS, three topics were predominant: exchange rate instability, inflation and the Latin-American debt crisis; (3) ’Founding President of the European Monetary Institute‘, the period from 1994 to 1997. The main task of Lamfalussy and the EMI was to prepare the final stage of European Monetary Union, especially the single monetary policy and the introduction of the euro; and (4) ’Lamfalussy the Elder‘ covering the final period of his life, from 1997 to 2015, highly focusing on financial stability.

Let me say a few words on two crucial issues in Lamfalussy’s career and intellectual life: financial stability and European monetary and financial integration. Financial stability was probably Lamfalussy’s major concern. As early as the mid-1970s, he warned about an unsustainable debt build-up in Latin America. Lamfalussy also took a cautious approach towards financial innovations. He was particularly concerned with the effects on financial stability of the redistribution of risk by new financial instruments. In this respect, Lamfalussy made a significant contribution to the development of the ‘BIS approach’, namely that one should be alert to imbalances, debt build-ups and bubbles, which may sow the seeds of financial crises.

Lamfalussy further stressed that central banks had a crucial role to play in the management of financial crises. Therefore, already in 2004, he argued that the European Central Bank should be given responsibility for the supervision of the large, systemically important banks. This was an early argument in favour of a European banking union, which would only take shape in 2014 in the aftermath of the financial crisis.

Lamfalussy’s advocacy of European monetary integration had its origin in two main sources: a profound European conviction, marked by the devastations of the Second World War and by the Iron Curtain, as well as a fundamental distrust of systems of floating exchange rates, in line with his general views on the functioning of financial markets.

I really enjoyed working on this book project. A major stimulus was the enthusiastic support of so many people. Thus, some words of thanks are in order, even if I may miss out on some persons.

First of all, I would like to express my gratitude to Governor György Matolcsy of the Magyar Nemzeti Bank and Governor Jan Smets of the National Bank of Belgium who strongly supported the undertaking. I trust Alexandre Lamfalussy would have appreciated the cooperation between the central bank of his 'native' country and the central bank of the country which became his 'home', for this type of truly European project.

Furthermore, I owe many thanks to all colleagues and friends at the Magyar Nemzeti Bank and the National Bank of Belgium, who made many valuable contributions to the project. I especially recognize the cooperation with György Szapáry, who on behalf of the Magyar Nemzeti Bank coordinated the project with me.

I would also like to express my gratitude to the Lamfalussy family and the various publishers and institutions, especially the Bank for International Settlements and the European Central Bank, which kindly allowed me to reprint various essays.

Finally, I would like to say that I very much hope that this book may contribute to preserving the intellectual heritage of Alexandre Lamfalussy. In these times of financial instability and doubts over the European project, it is worth reading, or rereading, Alexandre Lamfalussy's work. As Jacques de Larosière pointed out, '*Alexandre Lamfalussy expressed himself with lucidity and often adopted controversial positions. In the light of subsequent events, we are compelled to acknowledge that his assessments were generally correct and far-sighted.*'

PAUL DE GRAUWE

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How to ensure the long-term survival of the Eurozone

Despite the fact that the Eurozone crisis seems to have abated recently, the question of the future of the euro remains on the agenda. How can we make sure that the Eurozone will survive? This is the question we wish to address here.

In order to answer this question it is important to start from the design failures that have been identified by economists (see in particular Baldwin and Giavazzi (2015)). We stress two of these here. This will allow us the opportunity to discuss possible solutions to the two problems.

1) The Eurozone is not an optimal currency area

The European monetary union lacks a mechanism that can deal with divergent economic developments (asymmetric shocks) between countries. These divergent developments often lead to large imbalances, which crystallize in the fact that some countries have built up external deficits and other external surpluses.

When these imbalances have to be redressed, it appears that the mechanisms to redress the imbalances in the Eurozone ("internal devaluations") are very costly in terms of growth and employment, leading to social and political upheavals. Countries that have their own currency and that are faced with such imbalances can devalue or revalue their currencies. In a monetary union, countries facing external deficits are forced into intense expenditure-reducing policies that inevitably lead to rising unemployment. This problem has been recognized by the economists that pioneered the theory of optimal currency areas (Mundell (1961), McKinnon (1963), Kenen (1969)).

2) Fragility of the sovereign in the Eurozone

As stressed by De Grauwe (2011), this fragility arises from the fact that member countries of the monetary union issue debt in a currency they have no control over. As a result, the governments of these countries can no longer guarantee that cash will always be available to roll over government debt. This lack of guarantee provided by Eurozone governments in turn can trigger self-fulfilling liquidity crises (a sudden stop) that can degenerate into solvency problems. When this occurs it leads to a massive outflow of liquidity from those problem countries, making it impossible for the governments of these countries to fund the rollover of their debt at a reasonable interest rate.

This dynamic can force countries into a bad equilibrium characterised by increasing interest rates that trigger excessive austerity measures, which in turn lead to a deflationary spiral that aggravates the fiscal crisis.

1. How to deal with the OCA problem

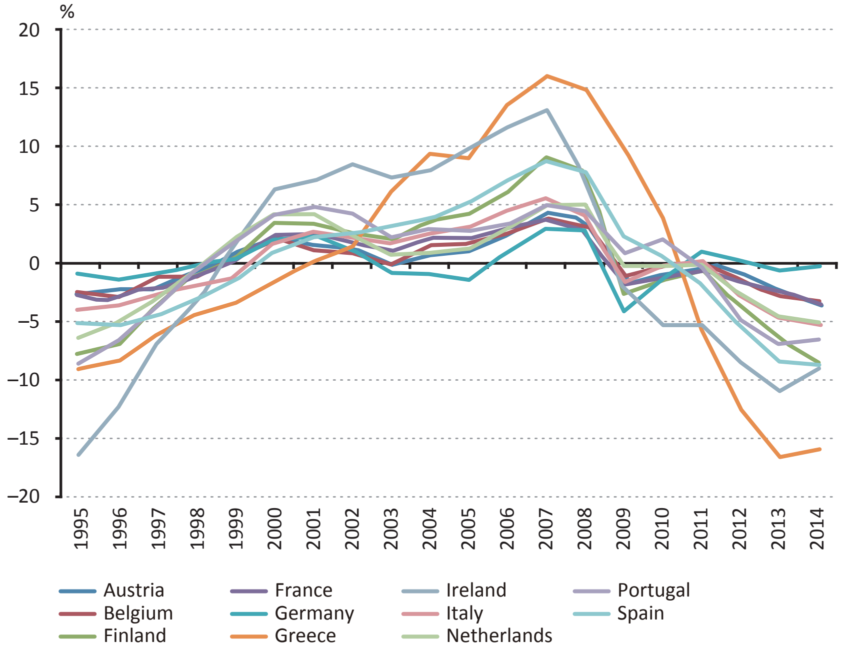
The standard response derived from the theory of optimal currency areas is that member countries of a monetary union should do structural reforms so as to make their labour and product markets more flexible. By increasing flexibility through structural reforms the costs of adjustments to asymmetric shocks can be reduced and the Eurozone can become an optimal currency area. This has been a very influential idea and has led Eurozone countries into programmes of structural reforms.

It is often forgotten that although the theoretical arguments in favour of flexibility are strong, the fine print of flexibility is often harsh. It implies wage cuts, less unemployment benefits, lower minimum wages, easier firing. Many people hit by structural reforms, resist and turn to parties that promise another way to deal with the problem, including an exit from the Eurozone. From an economic point of view, flexibility is the solution. From a social and political point of view, flexibility can become a problem. Stressing flexibility as the way out of the conundrum risks creating enemies of the monetary union that, as time moves on, leads to an increasing political momentum favouring an exit from the union.

There is a second reason why the structural reform path should be taken with caution. This is that the nature of asymmetric shocks has been quite different from the traditional asymmetric shocks analysed in OCA literature. In fact, business cycles in the Eurozone have been relatively well synchronised. This is shown in Figure 1.

We have observed that most Eurozone countries were booming in the period of 2000-2007 and have experienced a downturn since then. If there was asymmetry it was in the amplitudes of the same cycle. Some countries (Ireland, Spain, Greece) experienced a very strong boom and later a deep and protracted recession. Other countries (Belgium, Germany, France, Italy, Netherlands) experienced a much more modest period of booming conditions followed by less intense recessions. Germany stands out as having experienced booms and busts with the lowest amplitude.

Figure 1: Business cycle components of GDP



Source: Eurostat

Note: the business component is obtained by applying a HP-filter to the growth numbers.

Table 1 shows the bilateral correlations of the business cycle components of GDP growth in the Eurozone. It leads to the same observation that business cycles in the Eurozone were highly synchronised. Again Germany stands out as having the lowest correlation coefficients, although these are still quite high, exceeding 0.5 in most cases (see De Grauwe and Ji (2015b) for more detail).

Table 1: Correlation coefficients of cyclical components of GDP growth (1995–2014)

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Netherlands	Portugal
Austria										
Belgium	0,97									
Finland	0,97	0,98								
France	0,93	0,95	0,97							
Germany	0,69	0,57	0,55	0,59						
Greece	0,73	0,82	0,84	0,74	0,09					
Ireland	0,85	0,89	0,92	0,95	0,41	0,81				
Italy	0,91	0,96	0,98	0,96	0,50	0,86	0,93			
Netherlands	0,93	0,94	0,93	0,91	0,60	0,75	0,86	0,90		
Portugal	0,98	0,89	0,89	0,87	0,37	0,82	0,87	0,90	0,94	
Spain	0,85	0,91	0,94	0,87	0,27	0,97	0,90	0,95	0,86	0,90

Source: Eurostat and authors' own calculation using Hodrick-Prescott filter approach.

If there is asymmetry in the business cycle movements of the Eurozone, it is in the amplitude of these cycles. This asymmetry led to a situation in which countries in the group experiencing the highest amplitudes were hit very hard when the recession came, leading to an explosion of government debt. That is when the second problem of the Eurozone stepped in. Markets singled out these countries, leading to massive capital outflows from the first group of countries to the second one. The whole of the Eurozone was destabilised. This problem risks popping up each time the Eurozone is pushed into a recession. Each time some countries will be hit harder than others. As a result, large internal capital flows risk further destabilising the system.

The implications for the governance of the Eurozone from the finding of the overwhelming importance of cyclical and temporary components of output growth is that efforts at stabilising the business cycle should be strengthened relative to the efforts that have been made to impose structural reforms. We are not implying that structural reforms are unnecessary, but rather that efforts at creating mechanisms aimed at stabilising Eurozone business cycles should be strengthened.

Inter-country versus inter-temporal smoothing

There have been many proposals made to create a fiscal space at the Eurozone level in the form of a common unemployment insurance system (see e.g. the Four Presidents report (2012), Enderlein, et al. (2012), Beblavy, et al. (2015), Alcidi and Thirion (2015))[1]. The proposals for such an insurance system have very much been influenced by the standard assumption made in the OCA-theory that shocks are asymmetric, i.e. when one country experiences a recession, and thus increasing unemployment, the other country experiences a boom, and declining unemployment. This facilitates the operations of the common unemployment insurance system. The booming country transfers resources to the country in a recession and thereby smoothens the business cycles in the two countries. Technically and politically such a system encounters relatively few problems.

Problems arise when business cycles are relatively well synchronised but of very different amplitude in the different member countries. In that case most countries will tend to experience a recession at about the same time, but in some countries the recession will be mild while in others very intense. This creates both an economic and a political problem. First, countries with a mild recession are asked to transfer resources to countries experiencing a stronger recession. This tends to reduce the intensity of the recession in the latter country at the expense of making it more intense in the former country. It is not clear whether this is welfare improving. Second, it is likely to create important political problems in the former country that is asked to transfer resources although the economy is not doing well.

Another way to formulate the previous insights is the following. The traditional proposals for a Eurozone unemployment insurance mechanism are predicated on the view that there is a need to smooth differences in unemployment changes *across* countries. The insurance mechanism is intended to balance these inter-country differences. We have noted, however, that this is not the typical asymmetry in the Eurozone. Most countries are likely to experience a boom and a recession at about the same time, with different intensities and amplitudes. Hence there is relatively little need for inter-country smoothing of business cycle movements. The more pressing need is to smoothen volatilities over time.

The previous analysis suggests that common unemployment insurance schemes should put emphasis on smoothing over time and not so much on inter-country smoothing.

[1] There is older literature stating similar proposals. See e.g. Italianer and Vanheukelen (1992), Hammond and von Hagen (1993) and Melitz and Vori (1993).

This can be achieved by allowing the common unemployment insurance scheme to accumulate deficits and surpluses over time. The fiscal rule that could be imposed is that the insurance scheme balances the business cycle.

In principle, inter-temporal smoothing could be done at the national level, by allowing national budgets to do the job. However, large differences in the amplitude in business cycle movements makes such a purely national approach problematic, as it leads to large differences in the budget deficits and debt accumulation between countries. These differences quickly spill over into financial markets when countries that are hit very hard by a downward movement in output are subjected to sudden stops and liquidity crises. This is likely to force them to switch off the automatic stabilisers in their national budgets (De Grauwe and Ji (2015)). In addition, these liquidity outflows are inflows in some other countries in the monetary union, typically those that are hit least by the recession.[2] Their economic conditions improve at the expense of others. Stabilisation of common business shocks with different amplitudes at the national level makes the system unstable.

National stabilisation efforts do not work and introduce an element of instability in a monetary union, mainly because it leaves the countries most hit by the business cycle shocks unable to stabilise. Thus, when business cycle shocks dominate, it will be necessary to follow a common approach to the stabilisation of business cycles. This can be provided by a budgetary union. By centralising part of the national budgets into a common budget managed by a common political authority, the different increases in budget deficits following from a (common) recession translate into a budget deficit at the union level. As a result, the destabilising flows of liquidity between countries disappear, and the common budgetary authority can allow the automatic stabilisers in the budget to perform their role in smoothing the business cycle. In fact, because a common budget also generates implicit inter-country transfers, the countries with the deepest recession will profit the most from the automatic stabilising features of the common budget. As a result, a common budget provides the most effective way to stabilise the business cycle.

It is clear, however, that a budgetary union in which a significant part of national taxation and spending is transferred to a European government and parliament is far off. It cannot, therefore, be invoked today to solve the lack of stabilisation at the European level.

[2] This is confirmed by the empirical work of Furceriand Zdzienicka (2013) and Hoffmann and Nitschka (2012) who found that during recessions risk sharing through financial markets declines dramatically.

2. How to deal with the fragility problem

Let us now turn to the question of how to deal with the second problem of the Eurozone, its fragility.

The ECB has a central role to play here. By promising to provide unlimited support in the government bond markets in times of crisis, it can stop liquidity crises that are likely to emerge each time the Eurozone experiences a recession; liquidity crises that destabilise the system leading to large capital outflows from some countries to other countries in the same monetary union.

The ECB recognized this problem when it started its OMT programme in 2012. This certainly helped to pacify financial markets at that time and avoid a collapse of the Eurozone.

The issue arises of how credible the OMT programme is for future use. The credibility problem arises from the fact that when using the OMT programme the ECB will have to decide whether the crisis it is facing is due to a liquidity or a solvency problem. If it determines it is a liquidity problem it should step in; if it decides it is a solvency problem it should not. In the latter case, the other governments should decide whether or not to support the troubled government.

This creates huge political problems that the ECB cannot take on. It is generally very difficult to determine whether the problem is due to lack of liquidity or to insolvency. This complexity makes it difficult for the ECB to step in without creating political controversy. In the latest Greek crisis, the ECB decided that the Greek problem was one of insolvency of the Greek government and therefore it refused to support the Greek government bond market, provoking the crisis and leading to intense political conflicts in the Eurozone.

All this will lead to doubts about the willingness of the ECB to provide liquidity to future governments in times of crisis. As a result, the credibility of OMT is limited, which means that it is not an insurance mechanism that will stabilise markets in future crises.

This problem does not exist in standalone countries. The commitment of the central bank to support the sovereign of a standalone country in times of crises is unconditional. As a result, its credibility is at 100%. This may come at a price though, because it also implies that the credibility of the central banks' commitment to price stability is less than 100%. Paradoxically, one may argue that the commitment of the ECB towards price stability is stronger than in standalone countries precisely because the commitment of the ECB to the support of the 19 different national governments is weak.

The only way to solve the lack of credibility of the ECB as a lender of last resort in the government bond market is to create a budgetary union that includes the consolidation of a significant part of national debts. Such a consolidation mimics the relation between the central bank and the government that exists in standalone countries. It makes the credibility of liquidity support of the sovereign watertight and eliminates the danger of destabilising capital flows within the union. Clearly such a consolidation can only occur if it is embedded in a political union, characterized by a central government that has the power to tax and to spend.

Conclusion

We have identified the conditions under which the Eurozone's fragility can be eliminated making it possible for the monetary union to survive. But these conditions are politically very intrusive, requiring a very large transfer of sovereignty from nation states to a central Eurozone authority. The conclusion can only be that this is politically impossible today.

History teaches us that what one considers politically impossible at one moment in time can quickly change and become possible when conditions become extreme. Nevertheless, today a political union such as the one we have spelled out appears for most of us to be out of reach.

There are two possible reactions to this situation. One is to despair and to conclude that it would be better to dissolve the monetary union. It will never work anyway. The other reaction is to say, yes it will be very difficult, and the chances of success are slim, but let's try anyway. That is the position we are taking.

If one takes this attitude, one quickly comes to the conclusion that success can only occur by following a strategy of small steps. A revolutionary approach will simply not work.

What are these small steps?

We see essentially two. One is to create some fiscal space at the level of the Eurozone. An example is a common unemployment insurance scheme that would insure the cyclical component of unemployment (so as to minimize moral hazard problems). This insurance scheme should have a large component of insurance over time.

Another small step is to start with a limited programme of debt consolidation. It must take care of moral hazard issues that naturally arise with such schemes. The best way to achieve this is by introducing an element of co-insurance. This can be done by limiting the common issue of government bonds to a given % of GDP, e.g. 60%. What exceeds this limit must be issued by the individual government (see Delpla and von Weizsacker (2010)).

These are small steps. Even these small steps, however, encounter severe hostility and will be difficult to take. Yet these steps will have to be taken if we want to avoid the future disintegration of the Eurozone.

Our task as economists is to make this choice clear to the rest of the population: we should tell them that if they want to keep the euro, steps towards more political union are inevitable. If they do not want to take these steps, they will have to say goodbye to the euro.

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European (dis)integration

In Johann Wolfgang von Goethe's drama "Faust" Mephistopheles, the devil, declares that he is part of the force that always wants the evil but always ends up creating the good – because everything that comes into being is worth being destroyed. It seems to me that European integration follows the logic of Mephistopheles: as it progresses, it grows its own seeds of destruction. Only those, who are driving it forward would claim that they are pursuing the good, while actually they are spawning the opposite. The European Union was created to secure freedom, the rule of law, and democracy in Europe after half a century when the opposite was the norm. Integration was the means to the end. Over time, it has become the end itself and now risks destroying what it was meant to achieve. In the following I shall discuss the problems created by driving integration too far with reference to the Schengen project, which promised the abolition of internal border controls in the EU, and to the single European currency, which promised economic benefits and more political integration. I come to the conclusion that we are in danger of losing the values Europe has stood up for when there will not be more restraint on integration.

The overstretch of Schengen

The agreement of Schengen promised to get rid of border controls among its member states. Many members of the European Union joined so the Schengen area now stretches over 23 EU countries (plus 3 countries that are not members of the EU). Almost 420 million people living in the Schengen area and all foreigners after entry into the area can travel within the area without being controlled at the internal borders. The external border spans over 50.000 kilometers, of which 80 percent run in the sea and 20 percent on land. For the Schengen Agreement to work, common rules for the entry of foreigners as tourists, immigrants, refugees or seekers of political asylum have to be followed and the cooperation of legal and security entities across borders has to be ensured. The agreement allows states experiencing a threat to their inner security to reinstate border controls temporarily, but no longer than 30 days.

The agreement entered into force in 1995. However, more than two decades later, the basic requirements for it to work have not been fulfilled. Countries with external borders especially to North Africa and the Middle East were not able to properly control, register, and process immigrants seeking political asylum, fleeing from war, or looking for a better life in Europe. Countries with predominantly internal or external borders to other safe and wealthy areas were not prepared to help their partners with external borders to troubled regions. The cooperation among legal and security entities has remained patchy. The inability to enforce the rules of the Schengen Agreement (and the associated Dublin Regulation dealing with the distribution of asylum seekers and refugees) has contributed to a loss of control over immigration. Moreover, the absence of internal border controls has allowed residents of poorer states to migrate to wealthier ones to claim higher welfare benefits there.

In response to the failure of the Schengen Agreement, several member states have reinstated border controls – at least in sensitive areas – beyond the official duration of at most 30 days. The highly visible loss of control over immigration into such a vast area has helped to tilt the public vote against EU membership in the UK. And the loss of control over immigration has also contributed to the perception of a loss of control over domestic security in several EU countries.

Developments in Germany are a case in point. When masses of immigrants that should have been processed at their entry point into Schengen, but moved on uncontrolled and congregated in Budapest in the summer of 2015, German Chancellor Angela Merkel decided to open the German border to Austria and to allow hundreds of thousands of people to enter Germany without any control. Of almost 2 million immigrants in 2015 in total, 890.000 were seekers of political asylum. The initially positive attitude towards the newcomers turned into ever greater skepticism as the problems associated with immigration became clearer and several of those who came to seek asylum committed high profile terrorist attacks and serious crimes in the course of 2016. During the election campaign of 2017 the issue of internal security moved up in the list of concerns of the electorate.

The bad execution of the Schengen Agreement has not only severely damaged the project of border free travel in Europe but also tarnished the European Union itself. For the EU to be appreciated by the peoples of its member states it needs to deliver what it promises. And what it cannot deliver it must not promise. For the Schengen Agreement this implies that it will have to be downsized to a smaller area of more homogenous countries. These countries must be capable of effectively controlling their external borders, able to commit to common procedures for immigration management, and in a position to cooperate closely on security and law enforcement issues. Moreover, Schengen, like other EU agreements, cannot be a one-way street. There must be an exit clause for countries unable to deliver on the commitments made for the common project.

The half-baked single European currency

Money is an insufficiently understood social instrument, created by human societies more complex than families or tribes, to facilitate economic transactions. In the course of history, money has acquired several functions. It has been used as a means of exchange, store of value, and unit of account on the one hand, and as a measure of debt on the other. Where money is used as a means of exchange, store of value and unit of account it can exist without a state. Even when anarchy rules and people do not trust each other, money will emerge spontaneously (i.e., without being planned) to allow people to transact. Since money in this function was generally derived from a suitable commodity, it has been called commodity money.

Things are different when economic transactions are based on credit and debt. In this case, every more complex society needs an authority to enforce creditor-debtor relationships when needed. Hence, the function of money as a measure of debt tends to emerge in societies that organize themselves as states. States tend to take advantage of their role as enforcers of creditor-debtor relationships expressed in monetary terms by monopolizing the issuance of money.[1] This allows them to issue new money to appropriate goods, services and assets of their citizens to themselves. Thus, money becomes "legal tender" or, as I call it, "state money".

The euro as a single currency for European states received two characteristics at birth. On the one hand, it was designed as a commodity money so as to be able to function without a single European state as enforcer of creditor-debtor relationships in its back. It was to be issued by an independent central bank (ECB), mandated to secure only price stability without regard to other economic policy objectives. In a commodity money system, money supply is inelastic and the central bank does not intervene if states and banks are in danger of going bankrupt. On the other hand, the euro was also given the characteristics of state money. The ECB was allowed to create money by acquiring government debt. Moreover, debt of member states of the European Monetary Union (EMU) were treated as "risk free" in banking regulation by exempting it from

[1] On this see also Murray Rothbart, „What has Government done to our money?" Ludwig von Mises Institute, Auburn 2008.

the securing it with banks' equity and single credit limits. In a state money system, the supply of money is elastic and designed to achieve multiple policy objectives, and the central bank acts as a lender of last resort to both banks and states.

The single European currency enjoyed a happy childhood in the first decade of its existence. Its 10th birthday at the beginning of 2009 was overshadowed by the financial crisis in the wake of the bankruptcy of Lehman Brothers, but this was seen as a problem created by the US banking system. EMU was considered to be a haven of stability in the stormy weather on global financial markets. In retrospect, this view was completely wrong. In reality, the happy childhood of the euro was made possible by the era of cheap credit. Private household, company and government debt could be easily funded, no matter how high, at rock bottom interest rates. Private and public debtors in several EMU member countries availed themselves excessively of this opportunity. Cheap credit was the glue that held the euro together in its first decade, and when the era of cheap credit ended, the euro came unglued. To avert the collapse of EMU, the gap created by the sudden disappearance of private credit was filled with public credit from stronger states and the ECB.

To return EMU to a stable base, the authorities had two choices. They could either strengthen the characteristics of the euro as a commodity money, and accept that some member countries would have to leave EMU as their governments and banks lacked the means to repay their debts in euro. This would also have meant a strengthening of the "No Bail-out" clause enshrined in the Maastricht Treaty, which had intended that each member state be held fully responsible for its financial decisions. Or they could emphasize the irreversibility of EMU membership, keep all member countries in the Union, and give the euro the characteristics of state money with the ECB as lender of last resort to banks and states.

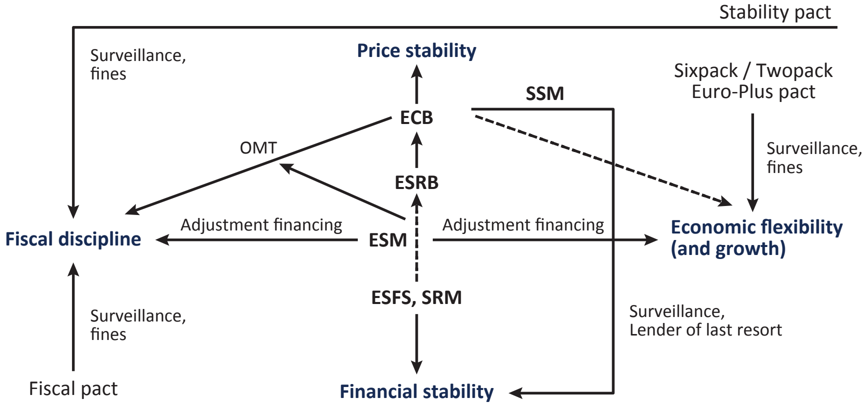
At first, broadly from the beginning of 2010 to the first half of 2012, efforts of EMU governments, led by Germany, concentrated on keeping the euro's characteristics as commodity money. Adjustment funding was supposed to be temporary, a restructuring of Greek public debt was engineered, and it was seriously considered to let Greece exit EMU. However, the efforts to emphasize the nature of the euro as hard commodity money only deepened the crisis. Markets speculated that other countries than Greece were also unfit to operate in a commodity money standard and drove up risk premia on their government and bank debt. Italy turned out to be a specially exposed country as its debt was seen to be too high for being supported by the newly established European Stability Mechanism.

After a change in the Italian government at the end of 2011 and a turbulent first half of 2012, ECB President Mario Draghi put an end to market speculation about a break-up of the euro by promising that the ECB would "do whatever it takes" to defend the single European currency. He conditioned this promise by adding "within its mandate", but markets understood that Draghi was in effect positioning the ECB as a lender of last resort for banks and governments without market access. Draghi's promise was later formalized in an ECB program dubbed "Outright Monetary Transactions" (OMT), which was challenged by the German Constitutional Court but subsequently found to be within the mandate of the ECB by the European Court of Justice. Market tensions eased, but with this move ECB President Draghi now defined the euro clearly as state money. This was a bold move with far-reaching consequences as efforts to create a European Political Union to back up monetary union had failed some 15 years earlier.

With market forces as an instrument for disciplining governments' inclination to amass debt suspended by Draghi's guarantee and without a European state enforcing financial discipline by political means, European policy makers – at the initiative of German Chancellor Merkel – built a system of pacts and contracts to ensure financial discipline this way. Table 1 gives a stylized view of this system. Initially, the ECB was only tasked with achieving price stability, while the pursuit of other objectives important for establishing a solid monetary regime was left to national authorities. To nudge them towards fiscal discipline, a "stability pact" (on French insistence changed to Stability and Growth Pact during the negotiations) was concluded as an addendum to the original Maastricht Treaty.

In the course of the euro crisis, the European Stability Mechanism (ESM) was created as a tool for emergency funding and crisis management. To strengthen crisis prevention, numerous legal acts were passed at the EU level intended to push countries towards fiscal discipline, budget coordination and structural reforms (Sixpack, Twopack, and Euro-Plus Pact). The top-down approach was complemented with a bottom-up effort to strengthen fiscal discipline by concluding so-called Fiscal Pacts at the country level. To round off crisis management the OMT program empowered the ECB to act as lender of last resort to governments, provided that they had concluded an adjustment program with the ESM. In the context of Banking Union, a Single Supervisory Mechanism (SSM) (under the roof of the ECB), a European System of Financial Supervision (ESFS) and a Single Restructuring Mechanism (SRM) for banks were established. Surveillance procedures were set up, and – in case of violations of the agreements – fines were envisaged to make the system work. Thus, to make up for the missing state as a back-up for the euro, a shadow state was built.

Table 1: A shadow state for the euro without a state



Source: Own exposition

Almost immediately after it had been rolled out, it became clear that the system does not work. Commitments made have not been respected, rules have been broken, and fines have been dodged. National governments have failed to respect the shadow-state and have continued to show a lack of financial discipline and willingness to adjust to the requirements of the single currency regime. The original architecture of the euro was faulty, and the amendments to it have failed to correct the faults. If EMU were a building, civil engineers would have to conclude that it will collapse sooner or later. Thus, in its present set-up, EMU can be expected to follow its historical predecessor, the Latin Monetary Union, which was founded in 1865 and in effect ended in 1914.

In fact, to save it, the euro would have to be rebuilt with the characteristics of commodity money, the only form of money that can exist without a central state backing it. EMU would have to be re-designed as a super gold standard, with strictly inelastic money supply (enforced by 100 percent reserve requirements for bank accounts held in euros). In addition to the bank restructuring and resolution mechanism, a regime for government debt restructuring and governments' exit from EMU would have to be established. Thus, the euro could become a common instead of a single European currency, with private and public currencies existing in parallel. Competition from private parallel currencies would exert a disciplinary influence on the ECB to steer money issuance to the benefit of money users and not of governments seeking cheap funding to please their political supporters. And public parallel currencies could be issued by governments unable to cope with the requirements of a hard commodity money standard.

Conclusion

The European Union suffers from overstretch. Freedom, democracy, and the rule of law were supposed to be achieved by ever greater integration. But people have not been ready for the degree of integration required by such ambitious projects as border-free travel and a single currency. With these projects failing, to which eminent politicians such as German Chancellor Angela Merkel have tied the fate of Europe, the EU itself is in danger of failing.[2] The only feasible way to save the EU is to respect the will of the peoples to retain the core of sovereignty within the nation states. This does not exclude the delegation of parts of national sovereignty to the European level in order to be able to pursue specific projects. But the delegation of sovereignty must be limited, clearly defined in binding provisions of the European Treaty, and be reversible by national parliaments. In other words, the EU must be organized as an association of states, based on international treaties, with national parliaments being the masters of these treaties. Integration must be confined to these clearly defined areas. In all other areas, the principle of the Peace of Westphalia, i.e., the principle of non-interference in the internal affairs of other nations, must be upheld.

[2] In a speech to parliament in 2010 Chancellor Merkel said „If the euro fails, Europe fails."

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Centrifuge Forces in Europe

In February 2016, when the National Bank of Hungary decided that the topic of today's conference should be the centrifuge forces threatening the European integration, Brexit was not yet on the agenda. Today, Brexit is a reality and talking about the forces that divide Europe is more important than ever. The divisive issues are not only economic but, more importantly, political in nature. Issues such as preserving national sovereignty or dealing with immigration are driven by social and political, rather than simply economic considerations. If we economists turn a blind eye on these issues, we will not help to find the answers of how to strengthen Europe and European integration. This is why I have deliberately chosen to address some of the issues of a more social and political character.

In the past, technical economic issues, such as the definition of the Maastricht criteria, the Stability and Growth Pact and its reforms, financial regulations, etc. generated complicated and time consuming discussions between Member States, often going into the wee hours of the day before reaching agreement. Today, multidimensional political issues divide the European Union that cannot be differentiated along dividing lines such as, for instance, new Member States versus old Member States, or Northern Member States versus Southern Member States, a differentiation that had some meaning when it came to issues, such as providing financial help to Eurozone countries in the Southern hemisphere or to convince Western banks not to withdraw capital from Central and Eastern Europe following the outbreak of the financial crisis in 2008. Migration, Brexit, the viability of the euro and protectionism, issues that I am going to address in my brief remarks, cut across the geographic divides.

The European founding fathers envisioned an ever closer Europe with strong political integration. Their driving motivation was to prevent once and for all the devastating wars between European nations. That motivation as a glue of European integration has diminished as the second and third generations have had no experience of wars. Instead, the Great Financial Crisis brought to the surface new problems that are currently preoccupying the populations in Europe: low growth, large unemployment and increased income inequality, which fuel the anti-establishment and nationalistic feelings. The several waves of enlargement, particularly those of the former communist countries of

Central and Eastern Europe, also contributed to the weakened attractiveness of an "ever closer" Europe as an answer to these countries' particular concerns.

The Central Eastern European (CEE) countries were not part of, and did not have a say about the gradual integration process and thus they lacked the tiresome and sometimes stressful experience of how to build up an integrated Europe from scratch. They joined a club, where they sometimes felt that they have not been treated as equal partners, their specific concerns have not received the due recognition they deserved. The rightly emphasized "70 years of peace" that the EU brought about in Europe sounds different to the 100 million people of the CEEs who were under the yoke of Soviet-imposed communist dictatorship for more than forty years out of those seventy years. They rightly feel that it was their resistance to communism that brought down the iron curtain and opened up new markets and new perspectives for the European integration. These countries' expectations of rapid convergence of incomes toward western levels were clearly unrealistic, but the financial crisis and its economic consequences dealt a serious blow to those expectations.

Migration is one of the most serious political issues which currently fuel discontent with the EU, diverting the focus from the economic reforms needed to strengthen the European integration. Two issues need to be considered. First, one cannot ignore the different attitudes of societies in those countries which had colonies (the UK, France, Italy, Spain, Portugal, Belgium, the Netherlands) and those which did not have, such as the CEE countries. The former had sometimes centuries of close contacts with people of very different cultures from their own and, after World War II, decades of experience of *gradual* integration of *legally* admitted immigrants from their former colonies. This experience has helped them to integrate people with different cultural background who were not necessarily coming from their former colonies, although tensions remain where integration has remained uneven. The CEEs, on the other hand, had no colonial experience and some of them have been suddenly confronted with the massive arrival of immigrants from the East with different culture, customs and religion. The CEEs are also a melting pot of a sort, but not with people of such different cultural and religious background as those now coming from the East. Their fears are understandable and not a sign of lack of compassion.

That brings up the second issue. The current wave of migration is a stock-flow problem. One has to find a way of controlling the flow of migrants, separating the refugees from economic immigrants before finding an acceptable and durable solution to take care of and integrate the immigrants who already entered the EU. Uncontrolled migration threatens to wrack Schengen, a key element of the smooth functioning of the single market and a most popular feature of European integration that is perceptible by the populations at large. Imposing compulsory quotas on accepting migrants without controlling the flow of migrants will be strongly resisted by some countries, creating resentment and deepening the divisions in Europe. Understandably, front countries facing the arrival of migrants are more pressed to find a common solution than the countries further away. Coastal front countries like Italy and Greece are more defenceless to stem the flow of illegal immigrants than land-route front countries like Hungary which erected a fence, much criticized by some countries, which are relieved nevertheless that they don't have to deal with the massive inflow of illegal immigrants seen before the fence was put up. Even so, border controls within the Schengen zone are multiplying to stop the entry of illegal immigrants. Leaders of Germany, Sweden and Italy have already called for stronger defence of the European Union's external borders. Europe is rich and defenceless, which is not an enviable situation to be in.

Brexit is the most evident case of how migration can unravel the European integration project. Most observers agree, supported also by opinion polls, that migration was a key issue that motivated the leave vote. Migration had a positive effect on growth in the UK, but a negative distributional effect by keeping wages low in low-skill jobs. While the political discourse turned around the immigration from the EU, especially from the CEEs, the fact is that the largest part of the immigrants to the UK is from outside the EU (Table 1). The TV images of the "jungle" in Calais and of the daily arrivals of migrants in rubber boats on the Mediterranean Sea no doubt contributed to the fear of immigration and boosted the leave vote.

Table 1: Immigration to the United Kingdom

Immigrants in the United Kingdom (in percentage of total immigrants)

1985		2014	
Ireland	16,50%	India	9,40%
India	13,50%	Poland	8,20%
Pakistan	6,90%	Pakistan	6,00%
Jamaica	5,10%	Ireland	5,00%
Germany	4,60%	Germany	4,30%
Total	**46,60%**	**Total**	**32,90%**

Newly arrived immigrants (in percentage of total arrivals)

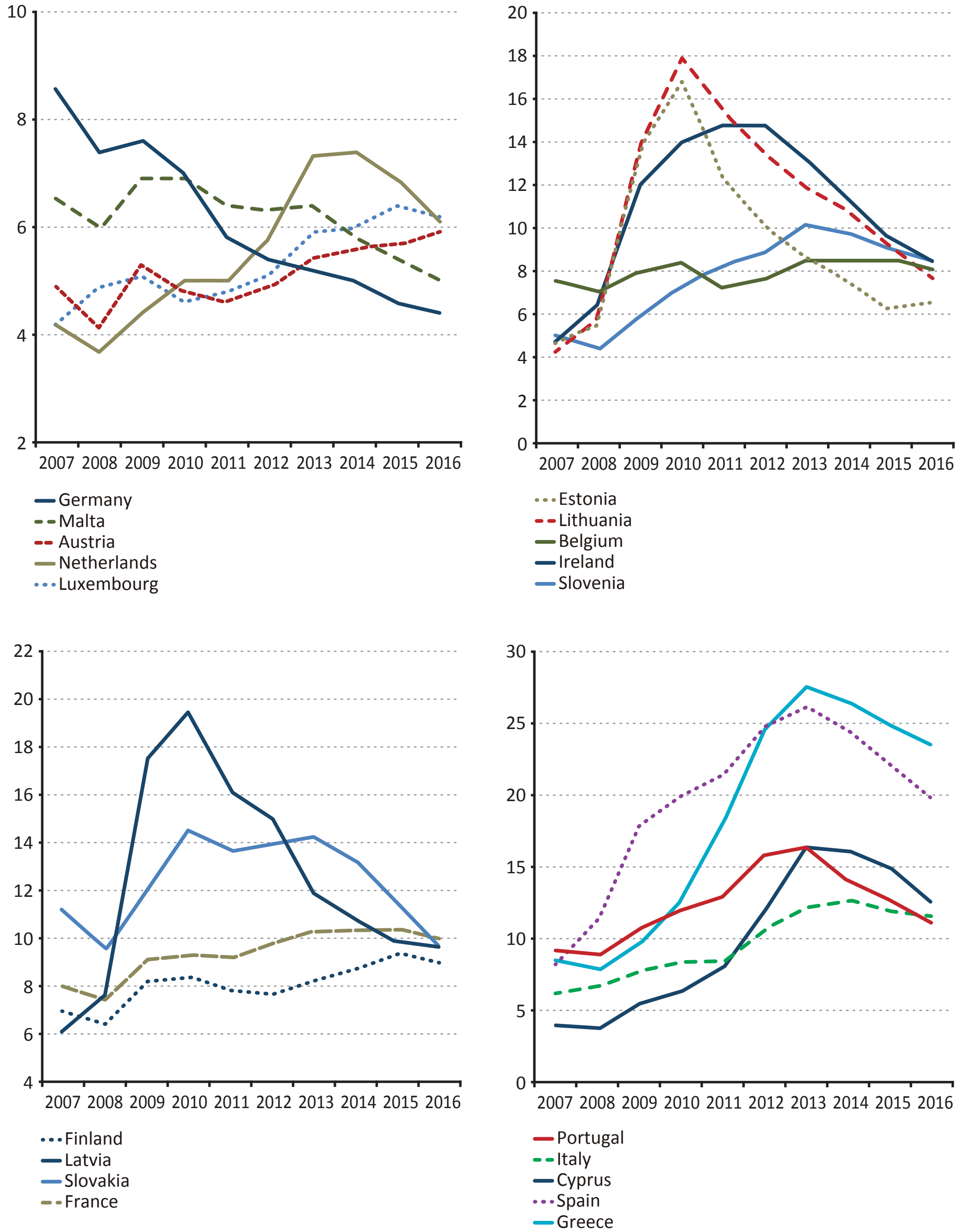
1985		2014	
United States	20,60%	India	9,80%
Ireland	10,60%	United States	6,70%
India	5,20%	Romania	6,20%
Pakistan	4,10%	Poland	6,10%
Germany	3,90%	China	5,70%
Total	**44,40%**	**Total**	**34,50%**

Source: Centre for Economic Performance (2014)

The UK announced that it will go for a clear Brexit, but wants to have an agreement that assures her something close to the current market access for goods and services in the EU. Some countries take a hard line and oppose anything that can be perceived as cherry-picking, which could encourage others to follow the UK example. Others warn that any “punishment” of the UK should be avoided, since it is in the interest of both sides to come to a mutually beneficial solution. No one knows for sure what the outcome of the negotiations will be. What is sure, however, is that scores of bureaucrats in Brussels and in the national capitals will be tied down for years with the task of ironing out a deal. Some might argue that Brexit is not such a bad thing after all, since the UK has been a bit of an outsider, never putting her full weight behind the European integration project. True, the UK has managed to negotiate for herself many opt-outs and exceptions from the common rule, but the positive aspects of her participation in the single market and in the discussions of how to shape the future of Europe has not been questioned, even when she represented a counterweight to the arguments of a more rapid move toward a political union advocated by others. Brexit has prompted some countries to advocate a multi-speed Europe which others strongly reject, illustrating the centrifuge forces that Brexit has created. This is why Brexit is, in my view, the most negative development that has inflicted so far the European integration project.

Besides the single market and Schengen, the euro is the other flagship project of the European integration. The cohesion of the euro area is put under stress by the very unequal growth performance and unemployment levels among its members. Unemployment levels range from 20% or more in Greece and Spain, to 10% or more in Italy, Portugal and Cyprus, barely below 10% in France, Slovakia, Finland and Latvia, while it is only 6% or less in Germany, Austria and the Netherlands (Chart 1). If such levels of unemployment as seen in some Member States and such differences in them persist, the attractiveness of the common currency might be increasingly questioned. The uneven levels of public debt is another area where the cohesiveness of the monetary union is put to test. In 2007, prior to the crisis, the public debt significantly exceeded the Maastricht threshold of 60 percent of GDP only in four EU countries, while in 2016, already thirteen EU countries exceeded that limit. Now that the contribution to growth of unconventional monetary policy is increasingly reaching its limits, this ratcheting up of the debt constraints the fiscal space in countries with high unemployment, where fiscal stimulus could provide some help. Productivity growth and the pace of structural reforms also diverge importantly among EU members.

Chart 1: Unemployment in the Euro Area (2007–2016)
as a percent of active population

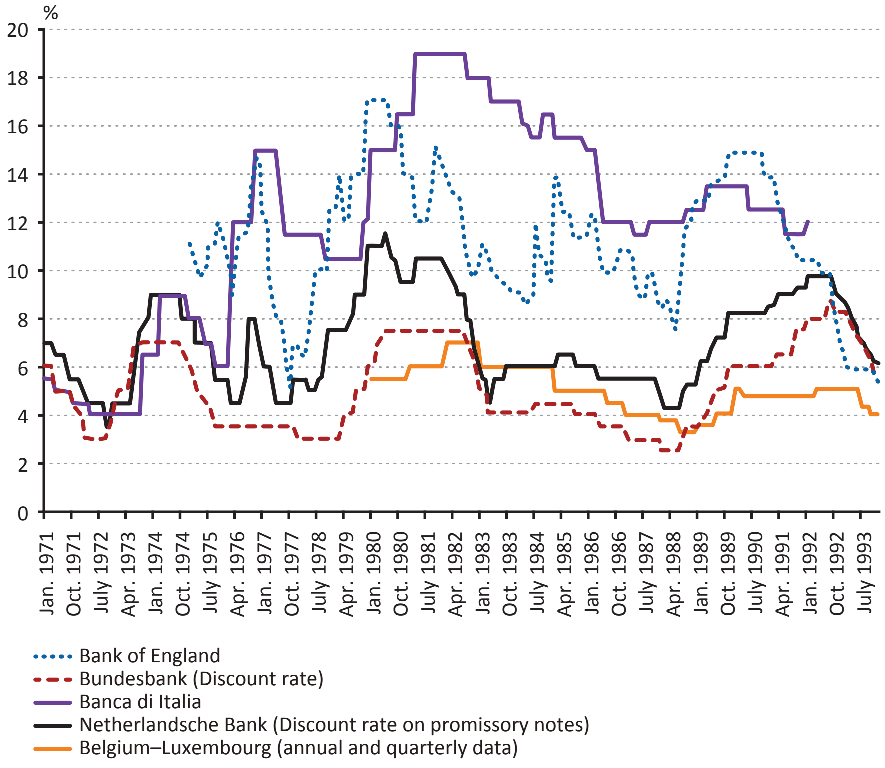


Source: AMECO Database (2016 data are estimates)

Despite all these differences and the problems they create in managing the single currency area, the alternative to the euro is worse. During the twenty-year period of 1973-1993, 36 exchange rate adjustments took place in the European common market countries of that time. As shown in Chart 2, domestic interest rates have widely diverged, prompting capital flows that put pressure on the exchange rates. If the currency union were to break up, Europe will likely to go back to the frequent exchange rate adjustments of the past, with their harmful impact on trade and economic growth. Thus, the only good solution is to improve and strengthen the functioning of the eurozone.

Chart 2: Policy interest rates (1971–1993)

in percent



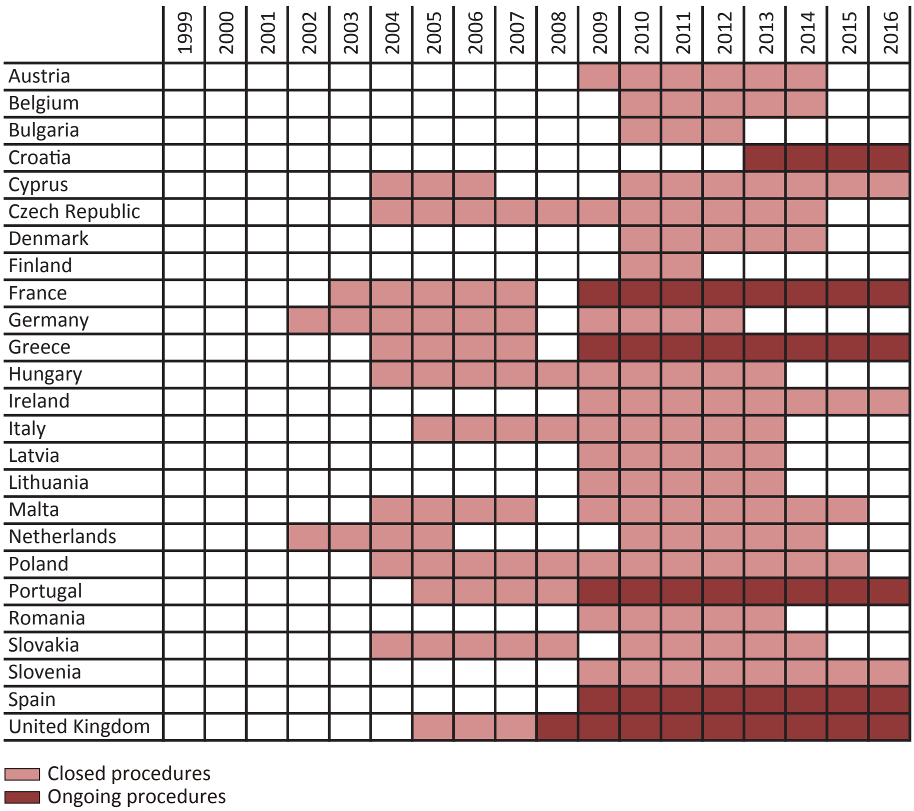
Source: BoE, Bundesbank, Banca di Italia, Netherlandsche Bank

Following the financial crisis, some important measures have already been taken. The setting up of the European Stability Mechanism established a much needed firewall to limit the spillover effects if a eurozone member faces a confidence crisis. The establishment of the European Systemic Risk Board, the Single Supervisory Mechanism and the Single Resolution Mechanism are important steps toward strengthening financial supervision at the European level. It now needs to be seen how effectively they will work in practice. Further steps are needed to develop the banking union, such as to set up a European deposit insurance scheme and a credible common backstop to the Single Resolution Fund. A capital markets union with single European capital market supervision will need to be set up sometime in the future.

Fiscal union, as envisioned by some economists and EU leaders, does not seem to be feasible in the foreseeable future – at least for the EU as a whole – considering the resistance in many member states of giving up sovereignty over taxation and spending matters. At the same time, experience has shown that fiscal policy coordination based on rules alone does not work. Table 2 is a good illustration of that if we consider how long some countries have been or still are under the excessive deficit procedure. Some rules are necessary though, but they have to satisfy two important criteria. First, they should be simple and transparent. Charles Goodhart noted that if a numerical indicator becomes a policy rule, it loses its reliability[1]. Simplicity and transparency can help to prevent this from happening. Second, people have to believe that sticking to the rules is worthwhile because of its economic benefits. That is not an easy task to demonstrate and communicate because the negative effects of disregarding the rules show up only years later, often only when a crisis hits the economy. Ultimately then, only strong and responsible governments will respect the rules. Nation-states are not a threat to democracy, on the contrary, the wars and the resistance to communist dictatorship is a testimony to the necessity of strong European nation-states, the best entity conceived so far that can muster the thrust, commitment and sacrifice to defend freedom and democracy.

[1] George Kopits, IMF, Independent Evaluation Office, BP/16-02/07, p. 7.

Chart 3: Excessive Deficit Procedure in the European Union (1996–2016)



Source: Ameco, European Commission

Finally, a word about the recent tendencies of protectionism. Trade has contributed tremendously to economic growth, but it is also seen by many as a threat to job security. Free trade is not there to address the redistribution of wealth. Other measures are needed to mitigate the possible negative distributional effects. Trade agreements have to be transparent, demonstrating the positive effects and, if needed, accompanied by measures compensating those who might be at the losing end of the deal. If one concentrates on the negative effects without emphasizing the positive ones, an engine that has powered world economic growth for decades will be lost.

Henry Kissinger, at the Nobel Peace Prize Forum held in Oslo on December 11, 2016, observed *"a continuing weakening of European strategic relevance because of Europe's loss of a sense of global mission"*. This is a warning that needs to be taken seriously if Europe wants to remain a global player and give a positive perspective to its citizens.

THE

LAMFALUSSY AWARD

2017


Lamfalussy
Award


MAGYAR NEMZETI BANK

THE LAMFALUSSY AWARD

The Lamfalussy Award was established in 2013 by György Matolcsy, Governor of the Magyar Nemzeti Bank, to recognise internationally outstanding professional achievements and life works with a major and lasting influence on the development of monetary policy, economic sciences and the professional community – both in Hungary and on a global scale. The award ceremony also offers an opportunity for the MNB to draw the attention of the community of international economists and economic policy makers to Hungary and its role in transforming economic attitudes and economic policy itself. The figure of Sándor Lamfalussy – after whom the Award was named – symbolises the importance of Hungary's role in international economic processes.

The Award was first awarded by the MNB's Governor on 31 January 2014. In 2014, the Lamfalussy Award was presented to Ewald Nowotny, an authority on economics of international renown, who is currently Governor of the Oesterreichische Nationalbank, a member of the ECB's Board of Governors, and former professor and deputy rector of the Vienna University of Economics.

In 2015, the Award was presented to Benoît Cœuré, who is a prominent European academic and empirical macroeconomist, with unrivalled innovative ideas. He is an excellent practical professional and a responsible decision-maker, who – in addition to being able and willing to manage the monetary policy of ECB and the finances of Europe – is also an innovative economic policy-maker, and who has been urging the necessity of using new monetary policy instruments more intensely from as early as 2011, well ahead of their implementation in this form.

In 2016 the awardee of the Lamfalussy Award was not an individual, but a deservedly recognized institution, the Bank for International Settlements (BIS) seated in Basel. The BIS, established in 1930, is the longest standing international financial organisation of the world, with sixty member central banks, representing countries from around the world that together make up 95% of world GDP. As a bank for central banks, the BIS supports its members in their persuit of monetary and financial stability and fosters international cooperations. Since its establishment, the BIS has pioneered the reform of monetary and financial stabilty thinking in several areas, thereby establishing new concepts for the functioning of modern economies.

The recipient of this year's Lamfalussy Award is Jacques de Larosière, whose career intersected with Alexandre Lamfalussy's career in many instances. Jacques de Larosière was the Managing Director of the International Monetary Fund (IMF) between 1978 and 1987. During his leadership the IMF played a key role in finding solutions to the Mexican crisis and thus preventing wider international contagion. Between 1987 and 1993, he served as the Governor of the Banque de France, which was followed by his presidency at the European Bank for Reconstruction and Development (EBRD) between 1993 and 1998. During his presidency, the EBRD vastly expanded its financing in the CEE region. In 1992, he became a member of the financial advisory body, the Group of Thirty (G30). In the wake of the financial crisis of 2007-2008, he became the chairman of the high level committee on the reform of the European financial supervisory architecture. Many of their recommendations – today known as the de Larosière report – have already been implemented, including the establishment of the Single Supervisory Mechanism (SSM) and the European Systemic Risk Board (ESRB).

2017 AWARD RECIPIENT

JACQUES DE LAROSIÈRE
former Managing Director of the IMF;
former Governor, Banque de France;
former President of the EBRD

Entered the French Treasury in 1958 as Inspecteur des Finances.

Undersecretary of Monetary Affairs: French Treasury (1974–1978).

Managing Director of the IMF (1978–1987).

Governor of the Banque de France (1987–1993).

President of the European Bank for Reconstruction and Development (1993–1998).

Chairman of the high level committee on the reform of the European financial supervisory architecture (2008–2009).

Advisor to the Chairman of BNP Paribas (1998–2008).

Chairman of Eurofi (2000–2015).

Member of the G30.

Chairman of the "Observatoire de l'Epargne Européenne" (1999 –).

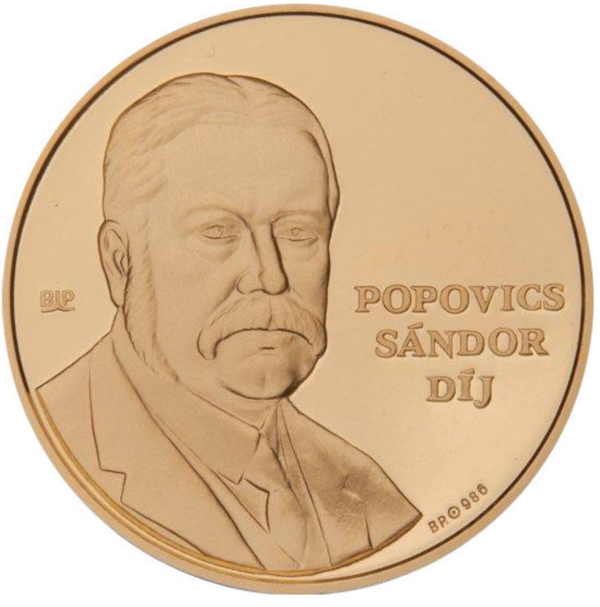
Chairman of the Strategic Committee of the Agence France-Trésor (2004–).

Member of the „Académie des Sciences Morales et Politiques" of the Institut de France.

Grand Officier of the Légion d'Honneur, KBE.

Member of the French Society of the Cincinnati.

THE
POPOVICS AWARD
2017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MAGYAR NEMZETI BANK

THE POPOVICS AWARD

The Popovics Award is named after Sándor Popovics, the first outstanding Governor of the Magyar Nemzeti Bank. It is awarded to young Hungarian economists who – through their achievements in both academia and industry – have made an outstanding contribution to achieving the MNB's objectives and its success, both domestically and on the international stage.

In 2014 the Popovics Award was awarded to Márton Nagy, Executive Director of the MNB, who played a major role in the shaping and development of the Hungarian financial system.

The following year, in 2015, the Popovics Award was presented to Dániel Palotai, Executive Director and Chief Economist of the Magyar Nemzeti Bank, who has played a significant role in the preparation, design and communication of the MNB's easing cycle and other monetary policy measures.

In 2016 the Popovics Award went to Ádám Balog, Chairman and CEO of MKB Bank and former Deputy Governor of the MNB. Ádám Balog played a determinant role in the implementation of the successful turnaround in monetary policy, and in the elaboration of the Funding for Growth Scheme, one of the main engines of the Hungarian economy, which helped the MNB make a substantial contribution to Hungarian economic growth. MKB Bank, reformed under the leadership of Ádám Balog, continues to operate in the domestic financial market as a competitive and profitable bank, fostering the stability of the financial intermediary system.

This year's awardee of the Popovics Award is Barnabás Virág who has been the executive director of the Magyar Nemzeti Bank responsible for monetary policy, financial stability and lending incentives since 2015. It has been nearly 15 years that Barnabás Virág started working at the Magyar Nemzeti Bank. As a central banker, he has become a recognised expert in economic analysis and forecasting. He plays a key role in shaping monetary policy and in strengthening the financial intermediary system. He is a member of the Financial Stability Council of the Magyar Nemzeti Bank and the Monetary Policy Committee of the European Central Bank.

2017 AWARD RECIPIENT

BARNABÁS VIRÁG
Executive Director, Magyar Nemzeti Bank

Barnabás Virág is an economist. He earned his degree at the Faculty of Economics, Finance Major, of the Corvinus University in 2000. He began his professional career at the Ministry of Finance in 2001. He joined the Magyar Nemzeti Bank as an analyst in 2003. He has been managing the forecasting work carried out by the staff of the Bank since 2009. Since September 2015 he has served as Executive Director responsible for monetary policy, financial stability and credit incentives.

He publishes regularly in the domestic financial press. His analyses focus, in particular, on economic growth, inflation, monetary policy and competitiveness. He has played an important role in the development of the Magyar Nemzeti Bank's monetary policy and in building its policy credibility. His analyses, interviews and lectures explain complex economic issues in easy-to-understand language, thereby shaping domestic public thinking.

Barnabás Virág is a member of the Magyar Nemzeti Bank's Financial Stability Board and the Monetary Policy Committee of the European Central Bank. He has been Chief Editor of the Financial and Economic Review since 2016. He was Co-Editor of the book 'Competitiveness and Growth'. He won first prize at the ECB's forecasting competition for central banking professionals.