“GREAT TRANSFORMATIONS: EAST AND WEST”

Conference logbook
on the fifth conference of the Magyar Nemzeti Bank’s
Lamfalussy Lectures Conference series

Budapest, 12 February 2018

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GYÖRGY MATOLCSY

Governor
Magyar Nemzeti Bank

Foreword

Five years represent a short period in international history, but being equivalent to half a decade, this is an anniversary of an important milestone in our fast-changing world. We are proud of the fact that **the Magyar Nemzeti Bank has already organized the Lamfalussy Lectures Conference for the fifth time in February 2018** and by now we have managed to establish a tradition that attracts the attention of the world's professional community. Our annual conferences provide an excellent opportunity for leading central bankers and academic researchers to discuss current global macroeconomic and financial developments and to share their views on expected future trends.

The theme of this year's conference was the Great Transformation, which we have been witnessing all around the world in recent years. There is an ongoing transformation both within and between East and West, within the European Union, and within our region – the Visegrád countries of Central Europe – as well. **This quick and worldwide transformation definitely represents a new wave of globalization,** which is faster, deeper and unique compared to earlier changes of the nineteenth and twentieth centuries. We live in a new global age both at the individual and the country level and we are facing a brand new future in many respects: in terms of the structure of our economies and financial sectors, as regards information availability, and also in the abundance of technological advancements.

The distinguished speakers of the fifth Lamfalussy Lectures Conference provided us with an excellent overview of transformations united by new technologies, information and new geopolitics that have significant impact on all aspects of the global economic system.

Among global economic trends, the increasing prominence of Eastern economies and, as a consequence, **the emergence of a multipolar world economy merits special attention.** According to the World Bank's projections, about half of the global output growth between 2017-2019 will be produced in Asia, while the contribution of Western economies – and especially that of the European Union – to total output growth remains limited. A key element in this global realignment is certainly China, which is now considered as the largest investor in the world. The “One Belt, One Road” initiative, that was announced by China in 2013, continues to be a major factor. It comprehensively stimulates the economic relations between East and the West with the aim of rebuilding the ancient Silk Road.

The ongoing global realignment is also reflected in changes of technology hubs. Today, besides the United States, China is assuming a leading role in the field of technological development and digital technology, and has already outpaced the European Union in many areas.

Regarding the European continent, this transformation – as some of the distinguished speakers at the conference highlighted – **is further challenged by special circumstances, which, however, should not divert us from going forward without hesitation,** to stop the shrinking of the European Union and enhance our competitiveness. To achieve this, we have no time to waste and need to find new visions, new strategies and new structures right now.

I hereby invite all of you to come together again next year, for the sixth Lamfalussy Lectures Conference, with the aim of further analysing the way we proceed and finding those new visions that are necessary to ensure a sustainable future for the European Union.

LAMFALUSSY LECTURES CONFERENCE

MÁRTON NAGY

Deputy Governor
Magyar Nemzeti Bank

DÁNIEL PALOTAI

Executive Director and Chief Economist
Magyar Nemzeti Bank

BARNABÁS VIRÁG

Executive Director
Magyar Nemzeti Bank

Great transformation in Hungary

Introduction

It might not be an exaggeration to say that lately we have been experiencing a great transformation in every part of the world.[1] There is an ongoing transformation both within and between East and West, within the European Union, and also within many of the Central European countries in our region.

In this paper we discuss the case of Hungary and focus on the Hungarian economic and monetary transformations in the past, present and future. In doing so, first we shall provide a broad overview of the most important changes – or as we call them, the twelve turnarounds – in Hungarian fiscal and monetary policy and show their importance by highlighting some of the current trends that follow these policy changes. Second, since we are central bankers, we shall give a more detailed description about one of these, the monetary policy turnaround, and discuss the role that the Magyar Nemzeti Bank, the Central Bank of Hungary (MNB) has played in this – with particular attention to the targeted instruments it has introduced. Finally, we will discuss how monetary policy can contribute to sustainable convergence of the Hungarian economy, where we put equal emphasis on both the words "sustainable" and

[1] This paper is an extended summary of three presentations from the Lamfalussy Lectures Conference entitled "Great Transformations: East and West" organised by the MNB in February 2018. Manuscript has been submitted in April 2018.

"convergence". We shall also mention some of the possible traps one can experience during the convergence path, and also present some parallel global trends as well.

Twelve turnarounds in Hungarian fiscal and monetary policy

Apparently, the era of low global volatility in the developed world is over. In the preceding weeks of the fifth Lamfalussy Lectures Conference in February 2018, many major stock market indices suffered considerable losses, and long-term bond yields were rising significantly in both the US and the Eurozone.

In such an uncertain global economic environment, being vulnerable is equivalent to being weak: vulnerability limits the number of options a country can take when reacting to external shocks, and hence makes the country dependent on them. This is why it was essential to implement the twelve turnarounds in Hungarian fiscal and monetary policy: as they have helped the country to become less vulnerable, their importance and relevance cannot be overemphasised.

In this section we shall describe these twelve turnarounds in more detail.

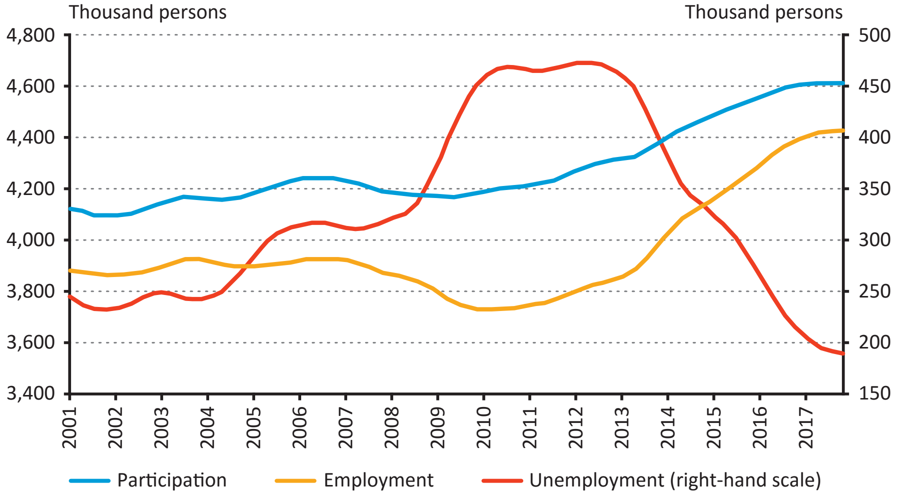
Turnarounds 1-3: Labour market, tax system and motivations

As is apparent from *Figure 1*, which demonstrates the *labour market turnaround*, the number of those employed in Hungary increased from 3.7 million in 2010 to 4.4 million in 2017. This increase contributed to a similar increase in labour market participation and resulted in a massive decrease in the unemployment rate. As a consequence, the *employment rate* has also steadily increased since 2010, and in 2017 it surpassed the average employment rate in the EU for the first time since joining the EU. Also, the current Hungarian unemployment rate is one of the lowest in the EU.

Which policy changes made it possible that the country experienced such a dramatic labour market turnaround since 2010? We shall mention two of these: the tax system turnaround and the motivational turnaround, which was a consequence of significant decreases in marginal tax wedges.

Regarding the *tax system turnaround*, the main goal of the tax reform was to decrease the taxes on labour income and increase it on consumption, or in other words, to shift the burden to consumption taxes. An important element of this tax system reform was the introduction of the flat personal income tax rate. As the unified rate was lower than the lower rate of the previous progressive tax system, this also meant a huge tax

Figure 1: Participation, employment and unemployment in Hungary between 2001 and 2017



Source: MNB, HCSO

decrease. Another important element of the tax system reform was the first targeted then general cut of social security contributions, which created extra incentives for the inactive population to enter the job market.

Furthermore, this shift in tax system turnaround resulted in a positive *motivational turnaround*. The implementation of the flat personal income tax system, and the cuts in contribution rates have been successful in multiple ways: they both decreased the previously very high tax wedge on labour income to a level that is comparable to that of the Visegrád countries. In sum, these measures enhanced employment by giving employees extra incentives or extra motivation to enter the labour market, by assuring them that extra work and extra performance do not increase tax rates. Overall, these measures led to a better general economic performance.

Turnarounds 4-6: Public finance, public debt and Excessive Deficit Procedure (EDP)

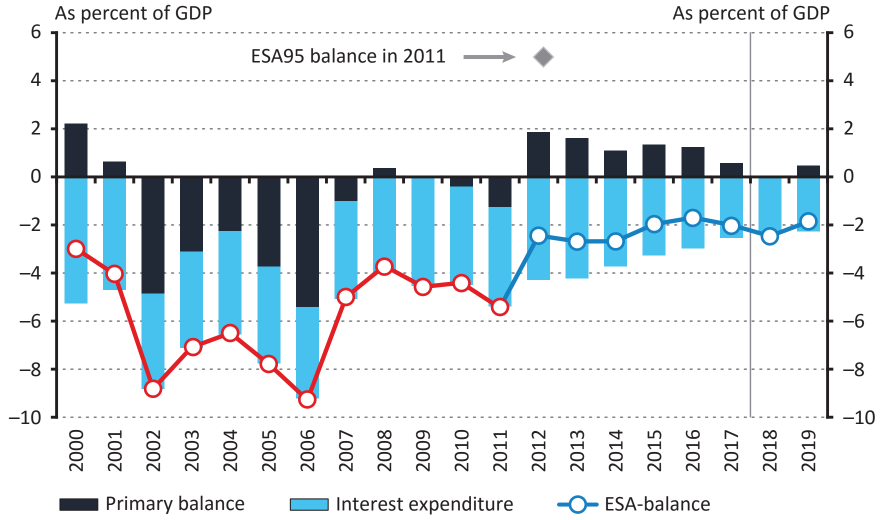
Figure 2 illustrates the *turnaround in public finances*, which date back to the years 2010-2013. As is apparent from *Figure 2*, there were three elements that contributed to this turnaround:

- The primary balance turned positive in 2012, and has remained positive since then (dark blue columns);

• The debt service burden has decreased massively as the interest expenditure has been decreasing since 2012 (light blue columns);

• As a consequence, the budget deficit fell to 2 % of GDP in 2017 compared to 4.5 % in 2010 (light blue dots).

Figure 2: Budget deficit in Hungary between 2000 and 2019



Source: Eurostat, MNB forecast

All these events led to a *public debt turnaround*: it decreased to 73.6 % of GDP in 2017, compared to 80.2 % in 2010.

These trends in budget deficit and public debt are significant achievements in an international comparison as well. Hungary is in the top 5 EU countries when one considers the overall decrease in the public debt (related to GDP) from 2010.

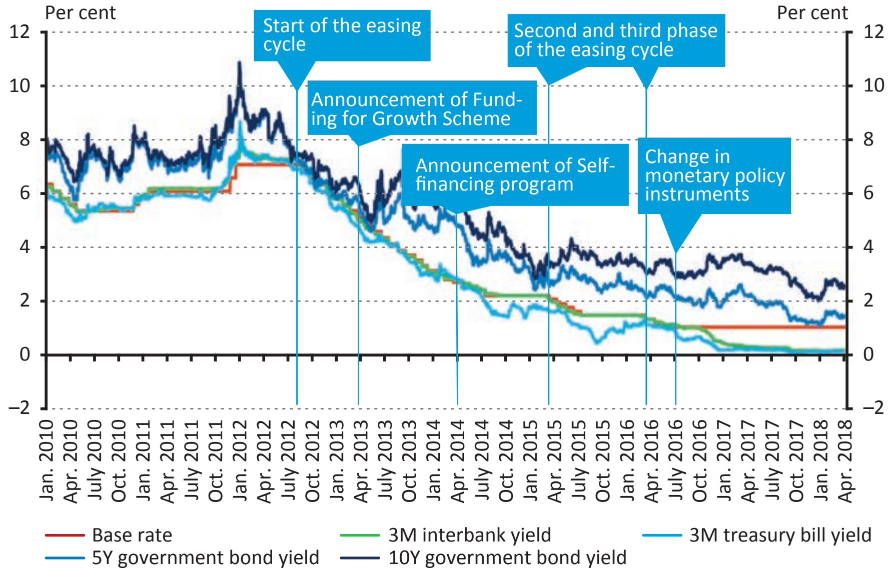
As a consequence of the previous two turnarounds, these achievements (in decreasing budget deficit and public debt) resulted in what we call the *EDP turnaround*, i.e. that Hungary has been removed from the EU's Excessive Deficit Procedure (EDP) – in contrast with many other countries who are still under the EDP.

Improving fiscal positions are not only important from the domestic stability point of view, but also if one considers the consequences of the current account. Presently, the current account is in surplus – which means that Hungary managed to get rid of the high budget deficit and of the current account deficit simultaneously. Thus, the era of twin deficit is over. This is very important now, in times of large global uncertainty, when countries might be highly vulnerable to future risks such as central banks in the developed world refraining from further quantitative easing.

Turnarounds 7-10 in monetary policy: interest rates, lending, households' FX loans, central bank balance sheet

Fiscal consolidation, which was discussed previously, opened the way for several turnarounds related to monetary policy. Probably the most important of these was the *turnaround in interest rates* from 2013. *Figure 3* illustrates the steady decline in the central bank's base rate – together with the corresponding declines in the government bond yields –, which brought about a significant easing in monetary conditions. The current base rate is 0.9 %; and other interest rates that are determined in the financial markets (e.g. money market rates, BUBOR, the interbank rate, treasury bills' rates) are around 0 %.

Figure 3: Base rate and government bond yields in Hungary between 2010 and 2018



Source: MNB, Government Debt Management Agency, Eurostat

These declines in market interest rates – as we discussed earlier – had a very positive side effect: they led to a significant decrease in the debt service burden, and eventually they resulted in large savings in the public debt. Altogether, these savings amounted to HUF 600 billion in 2017, and to HUF 1600 billion (or around 5 % of current GDP) since 2013. Therefore, this particular turnaround made the consolidation of public sector much easier. In this sense there is a two-way, mutually supporting interaction between the fiscal consolidation – which opened the gates for the possible monetary policy turnaround, and the monetary policy turnaround – which helped fiscal consolidation.

But the central bank did not only provide this favourable interest rate environment to the public sector, it also assisted the private sector – both firms and households. First, it initiated a *lending turnaround* by introducing the Funding for Growth Scheme (FGS). This instrument was launched by MNB in 2013 in order to improve the financing conditions of the SME sector through preferential central bank financing. Between 2009 and 2013, corporate lending declined steadily and dramatically. But from 2013, when the FGS started to operate, the declining trend in corporate lending has turned around, and Hungary avoided the credit crunch. Since then lending has been increasing. Now, lending for the SME sector and for the corporate sector are in the double-digit territories. Annual growth rate in corporate lending reached 10 per cent in 2017.

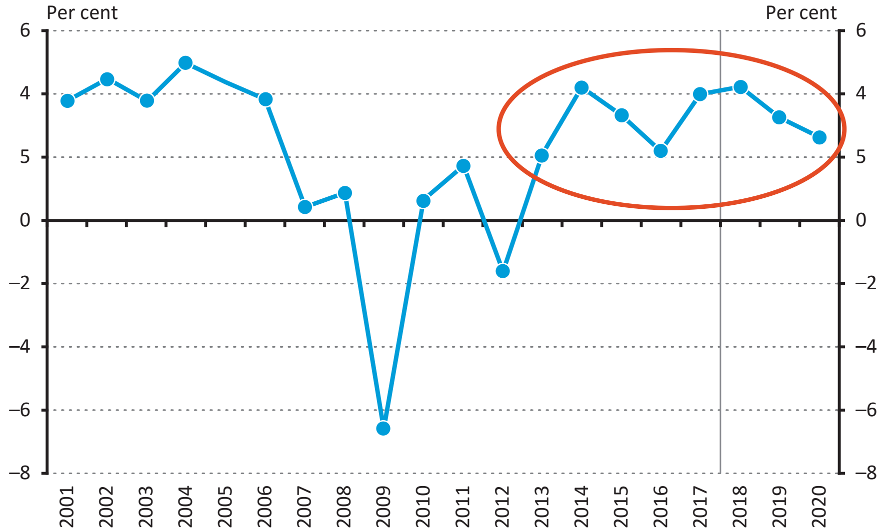
Second, the central bank initiated a *turnaround in households' foreign currency denominated loans*. These foreign currency denominated mortgage loans started to accumulate from 2002, when the households' forint-denominated mortgage loans were no longer subsidised, and due to the permanent and large differences in nominal interest rates, they gradually turned to foreign currency denominated loans. By 2010, the stock of such loans reached 10 % of GDP, and increased significantly Hungary's vulnerability to exchange rate volatility. By the conversion of households' foreign currency denominated loans, the central bank ceased this significant source of vulnerability. Today, there is essentially no foreign currency lending to the household sector.

Finally, another factor that contributed to the monetary policy turnaround was the *turnaround in the central bank's balance sheet*. Despite the expansionary monetary policy stance and the loose monetary conditions in the country, the balance sheet of the central bank shrank to 26.5 % of GDP in 2017 from 40.8 % in 2010. This unusual result (among developed countries) was achieved by a central bank policy that did not operate with the size of the balance sheet, but with the asset and liability structure of it.

Turnarounds 11-12: Growth and convergence

As a result of the previously discussed turnarounds related to the labour market, and to fiscal and monetary policy, there has been a *growth turnaround* since 2009. As is apparent on *Figure 4,* Hungary recently has been increasing its GDP by more than 3 % on average. GDP growth rate increased to 4 % in 2017 from 0.7 % in 2010.

Figure 4: Real GDP growth in Hungary between 2001 and 2019



Source: HCSO, MNB forecast

These relatively high growth rates ensure that there is an ongoing *convergence turnaround* as well. As Hungary's GDP growth rate has been larger than the EU average since 2013, the Hungarian economy growth permanently faster than the EU average and continues to converge to the European Union.

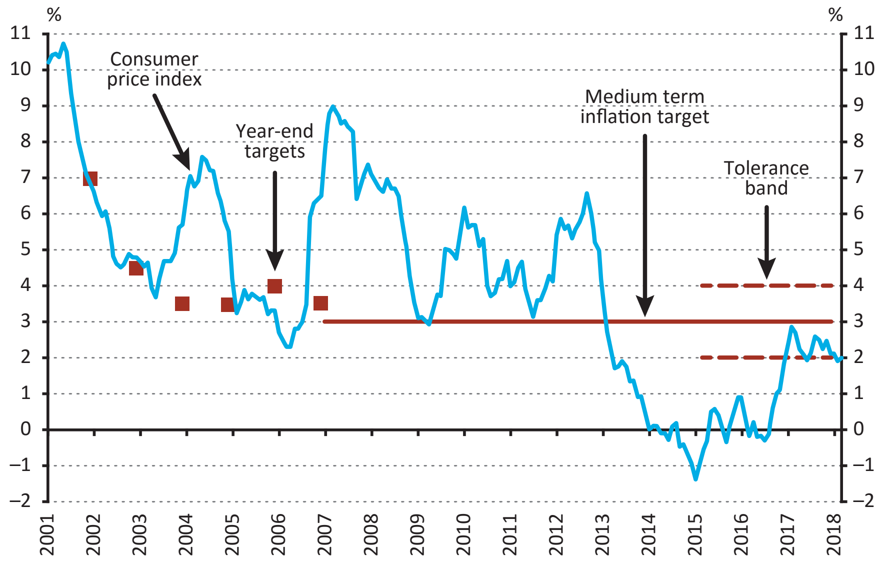
Central bank policy in Hungary

In this section we discuss in more details the elements of monetary policy turnaround – which were briefly mentioned before – and shall emphasise their targeted nature.

As discussed, the 2010-2013 turnaround in fiscal policy was followed by a monetary policy turnaround from 2013. Until then, monetary policy was mainly focusing on stabilising inflation, but the new central bank management and the new members of the Monetary Council took a different approach and started to focus on all three legal mandates of the central bank: price stability, financial stability and economic growth. These goals were achieved by mostly non-conventional, targeted, innovative measures in monetary policy, which affected various segments of the economy. Although some of these instruments were briefly mentioned before in turnarounds 7 to 10, in this section we provide a more detailed description of these and their effects.

First and most importantly, monetary conditions were eased. Interest rates in Hungary have been decreasing since August 2012, when the Monetary Council – with the votes of its newly elected members – started to cut rates. The central bank has eased monetary conditions in three phases, or three easing cycles. By now the base rate in Hungary reached a historical low level of 0.9 %, and it is expected to be maintained for an extended period. When the easing cycle started, there was a lot of scepticism from outside experts and commentators; but we can confidently say that the easing cycles turned out to be the right step to make.

Figure 5: Inflation rate in the inflation targeting system in Hungary between 2001 and 2018



Source: MNB

One of these positive consequences is illustrated in *Figure 5.* We can see from *Figure 5* that monetary easing was not only possible, but also necessary, as in this way the central bank managed to avoid deflation. When headline inflation dropped to near zero and even turned to slightly negative between 2014-2016, the central bank implemented further monetary easing, and Hungary managed to raise the headline inflation rate back up towards the 3 % medium-term target (which has a plus-minus 1 % ex ante tolerance band since 2015). According to our estimations, without the interest rate cuts the headline inflation would have been in negative territory even longer, and with that we would probably have run the risk of dipping into a debt-deflation spiral. This was certainly avoided by the central bank's easing cycle, but we should not be over confident: the headline inflation is still somewhat below our 3 % target (but already within the tolerance band), thus maintaining loose monetary conditions is still warranted.

The introduction of some further targeted non-conventional measures contributed to the loose monetary conditions. These measures are the following:

- overnight deposit rate reduction, asymmetric interest rate corridor;

- putting upper limits on sterilisation instruments (cap);

- increasing the role of central bank swaps and thereby having an impact on reference yields and lending rates;

- forward guidance, by which market expectations have been influenced in a quite successful manner.

MNB also has two relatively new tools, which have just been introduced, to achieve loose monetary conditions for a prolonged period. These are the unconditional monetary policy interest rate swaps (MIRS), and the mortgage bond purchasing programme. Out of these, the latter affects longer term market yields and thus can have the positive side effect of helping the household sector to get more fixed-rate, long-term financing – which might in turn help to mitigate future vulnerabilities in the economy due to possible increases in interest rates.

Besides the new instruments that we have listed so far, the Self-Financing Programme of MNB also merits attention. This is a good example of how monetary policy tools have been used to also address the macro-financial vulnerabilities of the economy. It is also a good example of efficient cooperation between the banking sector and the different institutions of the state. The central bank modified its toolkit which represented new incentives for the banking sector, and via this mechanism the MNB helped indirectly the government sector to reduce its foreign currency exposure. With the foreign-exchange reserves of the central bank, the government managed to repay its maturing foreign currency bonds and accumulated domestic currency funding instead, essentially from the banking sector. As a result, the foreign currency share within the government bond portfolio declined from around 50 % to around 20 %, which contributed to a further decrease in Hungary's external vulnerability. According to both MNB and European Commission forecasts, this decreasing trend in foreign currency exposure of the government is expected to continue, in parallel with the declining trend in public debt.

The Funding for Growth Scheme – which has been briefly described in the previous section – is also a prime example of a monetary policy tool used by the central bank that has a positive impact on the real economy as well. Hungary faced the possibility of a credit crunch in 2013: in the preceding years, lending growth rates were negative in the corporate sector, and in particular in the SME sector. The latter was especially worrying, given that the SME sector provides more than two thirds of the employment in the economy. This means that there can be no economic recovery in Hungary without the SME sector. Realizing this, the central bank launched a major SME lending scheme – the Funding for Growth Scheme. According to this, the central bank provided financing to commercial banks at a 0 % rate, and, in turn, commercial banks could give new credit to the SME sector at a maximum of 2.5 % interest rate.

The Funding for Growth Scheme was implemented in three waves: in the first wave it provided loan redemptions for SMEs to help them get rid of their more expensive previous loans and/or of their foreign currency exposure – which essentially helped them to recover from the crisis. Then, in the second and the third waves the program provided loans for new investments. These loans thus helped to increase the amount of fixed capital in the economy, and the overall productive potential of the economy. The result of the Funding for Growth Scheme was a massive increase in the credit growth rate of the SME sector. Further, the scheme reached 7.5 % of the total SMEs in the economy, it increased the level of GDP by more than 2 % with a total outstanding loan amount of 8 % of GDP; and its estimated impact on the employment rate was at least 0.5 %.

As we mentioned before, by focusing on all three of its legal mandates, the central bank has also put increasing emphasis on financial stability. Before the crisis, and before 2013, the central bank and the Financial Supervisory Authority operated separately and had their own individual goals without much coordination between each other. The outcome of this institutional setup was suboptimal, and this might have contributed to the unfolding of the financial crisis in Hungary. Since 2013, the year when the Financial Supervisory Authority was integrated into the central bank, these policies have been coordinated inside MNB. The Financial Stability Council, which now operates within the central bank, coordinates central bank policy in a way that finds balance between the different goals of the institution: (1) price stability (the goal of traditional monetary policy); (2) financial stability (the main objective of financial supervision); (3) sustainable growth.

A very good example of such coordination was the conversion of the households' foreign currency denominated mortgages to domestic currency. This was a major operation, initiated by the central bank together with the government and the banking sector. Since 2015, the household sector has basically no foreign currency exposure. The timing was also perfect, since all these exposures were converted just before the Swiss National Bank lifted the exchange rate cap on the Swiss Franc. Thus, with this measure Hungary has avoided a major economic, financial, and social crisis.

As a summary about recent advances in monetary policy, *Figure 6* illustrates how broad the instruments are used by MNB in international comparison. The central bank is equipped with broad macro-prudential and micro-prudential mandates, and it is using them actively. But it is also equipped with a resolution authority. In a regional comparison, there are very few central banks that operate with such a broad mandate. All these tools together helped MNB not only to achieve its traditional goal of price stability, but in addition it could also address the macro-financial challenges of the economy, could support the Hungarian economic recovery, could increase the growth potential and thus it could also help economic growth.

Figure 6: Changes in the Hungarian regulatory policy over time in an international context

	Macroprudentaial policy		Micropridentaial policy		Resolution authority	
	2011	2015	2011	2015	2011	2015
USA	⊘	⊘	✓	✓	⊘	⊘
Euro area	⊘	✓	✓	✓	⊘	⊘
Switzerland	⊘	⊘	⊘	⊘	⊘	⊘
Norway	⊘	⊘	⊘	⊘	⊘	⊘
Sweden	⊘	⊘	⊘	⊘	⊘	⊘
United Kingdom	⊘	✓	⊘	✓	✓	✓
Japan	⊘	⊘	✓	✓	⊘	⊘
New-Zealand	⊘	⊘	✓	✓	✓	✓
Poland	⊘	⊘	⊘	⊘	⊘	⊘
Czech Republic	⊘	✓	✓	✓	⊘	✓
Romania	⊘	⊘	✓	✓	⊘	✓
Hungary	⊘	✓	⊘	✓	⊘	✓

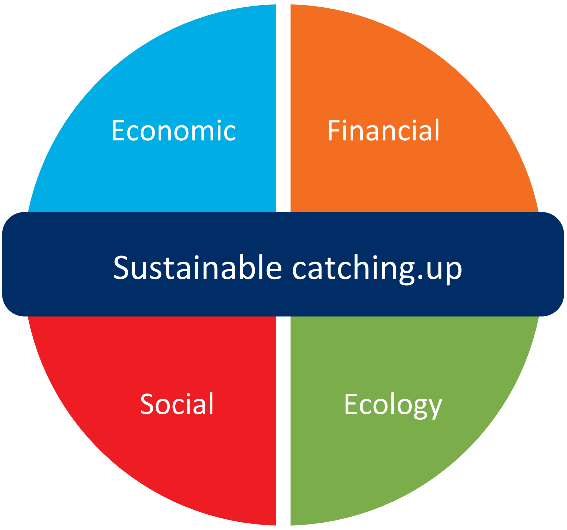
Source: MNB

Sustainable convergence

As discussed in the previous sections, the twelve turnarounds in the Hungarian economy created grounds for a prolonged period of economic growth and presented an opportunity for sustainable convergence towards the EU average. The next challenge is thus to ensure a sustainable growth trajectory. This calls for a broad shift in competitiveness.

Sustainable convergence has become a complex process. A trajectory characterised by stable and high growth needs to be achieved without being coupled by mounting debt (in fact, it should entail a contraction in outstanding debt), that will distribute the income generated within society equitably, and will support the protection of the natural environment. Therefore, as is illustrated on *Figure 7*, this issue has to be examined from an economic, financial, social and ecological perspective. Despite multiple attempts, neither the CEE region nor Hungary has been able to demonstrate sustainable convergence.

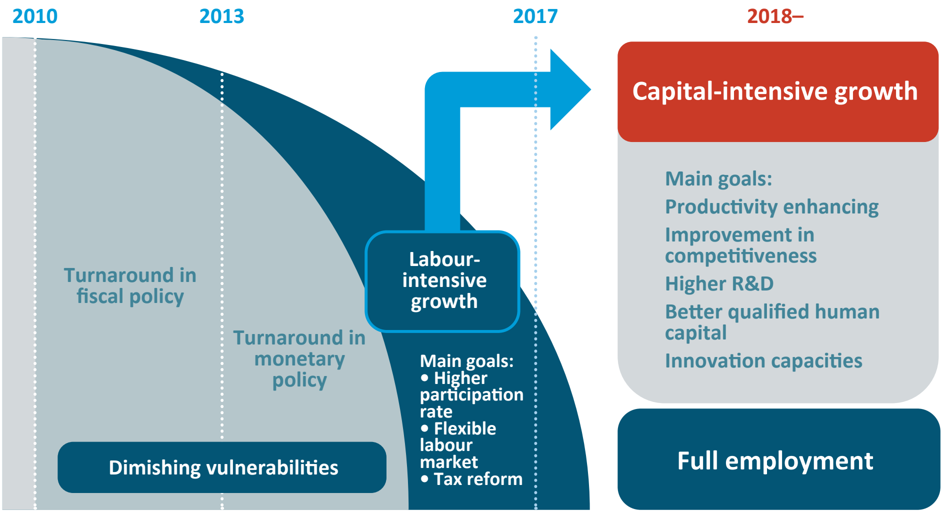
Figure 7: The components of sustainable catching up



Source: MNB

After 2010, the goal was to reduce the country's vulnerability, which required – as we have already discussed – first a fiscal turnaround, and then a monetary and lending turnaround as well. This was followed by a period of labour-intensive growth, with the main aim of boosting employment, developing a flexible labour market and reducing taxes. In 2018, the country has to enter on a capital-intensive growth trajectory, focusing on expanding productivity, improving competitiveness, promoting R&D, enhancing human capital and fostering the development of creative industries (*Figure 8*).

Figure 8: Transition to the capital-intensive growth area in Hungary



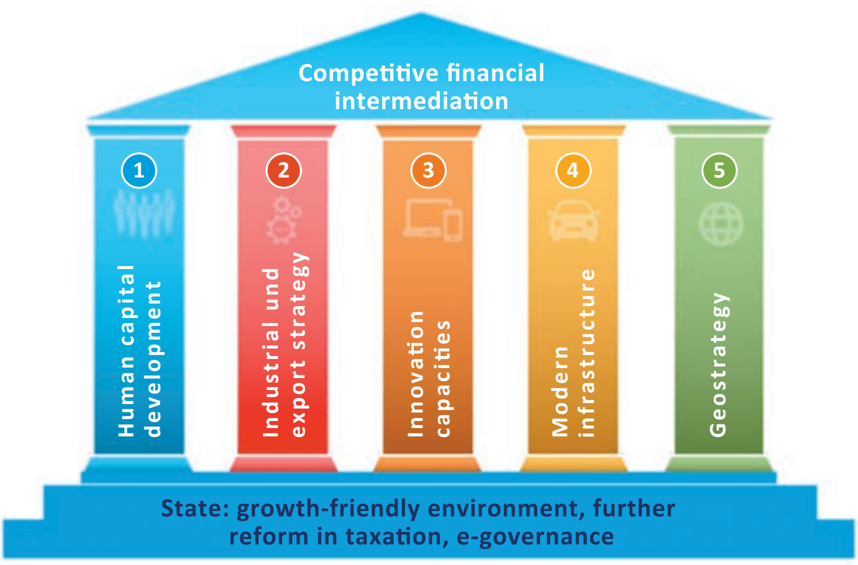
Source: MNB

At the same time, it needs to navigate some traps, even in the short run. One such example is demographic developments. In the next decade, the number of the economically active is expected to fall, while the share of pensioners will increase. Meanwhile, the lack of skilled labour, inhibiting growth, is increasingly becoming a problem not only in Hungary but also globally. In spite of the huge amounts of FDI in Hungary, the share of domestic value added is low, which hampers convergence. This is because Hungarian firms enter production at a low-value added phase of the production chain (i.e. assembly). The Hungarian economy continues to be characterised by a high degree of duality: productivity is unfortunately quite low in the case of the SMEs employing most workers, and much lower than in the large-enterprise sector. With respect to financing, the Hungarian economy has to be prepared that after 2020, the availability of EU funds might be lower, and new funds have to be found to finance the investments driving growth. It also has to be borne in mind that the current ultra-loose monetary policy of globally dominant central banks may gradually normalise, which will lead to the gradual increase in the currently historically low interest rate level. Finally, the value system of society has to be transformed to eliminate the barriers that help the shadow economy or hamper entrepreneurship, for example.

In addition to the traps, the next decade will bring about new global megatrends, which are also opportunities for breakthrough. Examples include the rise of the global middle class (especially in high-growth Asian economies), the shortage of basic resources (such as water or agricultural staple products) and strengthening urbanisation. The sweeping transformation of existing technologies (Industrial Revolution 4.0 and 5.0), the new trends in globalisation, stronger regional ties and the heavy globalisation of the services sector should also be mentioned here. Fundamental changes are expected in the energy mix, which result in a strong focus on renewables. Infrastructure will be overhauled, and a new global map will emerge, where the expansion of the Asian economies will be more substantial. Finally, financing may be characterised by persistently low real interest rates.

The coming period will require a new growth structure. Convergence may hinge on the continued reforms in administration and governance. The launch of a second tax reform, the establishment of e-government, further cuts to red tape and the improvement of the investment climate are key aspects of this. Major pillars of this new growth structure include the enhancement of human capital, the formulation of a new industrial strategy, the promotion of innovation, the development of infrastructure and the implementation of a new geostrategy. On the financing side, the backbone of the reforms may be a competitive financial system (*Figure 9*).

Figure 9. The potential main pillars of the medium-term growth strategy



Source: MNB

Within the framework of the new geostrategy, Hungary has to act as a bridge between East and West, especially in the "One Belt One Road" initiative devised by China. This geopolitical moment holds great potential for the CEE region and may entail practical consequences, such as reversal of the trend of industrial production moving from Europe to China. In the future, high-tech industrial production may relocate from China into this region.

Industrial production is relatively central in Hungary's GDP, but in order to get from the traditional industrial status to the vanguard, greater economies of scale, faster application of new technologies, better management skills, the fostering of R&D activities and better cooperation with universities are required.

The 21st century creates new nodes, such as biotechnology, electromobility, digitalisation, robotisation, fintech, waste management, tourism and the healthcare industry. Genuinely sustainable convergence can only be achieved if Hungary connects to all these nodes in time and in the appropriate manner.

ADAM GLAPIŃSKI

President of Narodowy Bank Polski

Ladies and gentlemen,

Let me begin by thanking Governor Matolcsy and the Magyar Nemzeti Bank for their kind invitation and hospitality. I am honoured to deliver this keynote speech at the Lamfalussy Lectures Conference 2018.

The title of this year's conference is "Great Transformations: East and West". I think this is a very timely perspective and there is certainly a lot to discuss. In the West, among the many transformations, we have Brexit, a recent tightening of German-French cooperation, and an increased likelihood of a deepening of the two-speed Europe which might pose a threat to European unity. On the other hand, in the East, we are witnessing changing models of growth and competitiveness across Asia, and new diplomatic endeavours such as the "one belt, one road" initiative, which underscores China's push to take a larger role in global affairs. It would be a Herculean task to comment on – not to mention fully analyse – all these topics. But when looking for a common denominator among them, we could safely say one thing: political and economic equilibria as we know them are shifting and institutional arrangements are undergoing deep changes.

Since I come from Central and Eastern Europe, my perspective is naturally oriented to the West, and that is also where I see these processes most clearly. In fact, when preparing these remarks I could not escape the thought that the West, once considered an anchor of stability for the world, is becoming less and less stable. One might even say that in some cases various forms of instability are originating in the West. Witness the recent discontent around political representation demonstrated in the broad-based collapse of the political centre in most advanced economies. Or consider the rise in anti-European attitudes which the patron of this conference, Alexandre Lamfalussy, would surely lament. According to the Pew Research Survey, the favourability of the EU has dropped markedly in most countries. In France and Italy, the split between those satisfied and dissatisfied with the EU is dangerously close to 50-50. In Britain the situation is even more difficult and Brexit can be seen as an extreme expression of these tendencies. Ironically, according to Pew Research, societies in Hungary and

Poland – often portrayed as the most euro-sceptic countries – tend to view the EU most favourably.

These developments are most likely driven by deep social and political currents. I am not a politician, nor a political scientist, so I am not going to offer any political commentary. But as a historian of economic thought and a central banker, I wonder how the central banks fit into this picture. What is the role of central banks amid ongoing political and economic changes?

My view on this is, quite simply, that central banks should be the anchors of stability in this destabilized environment. This means that, on the one hand, we should stand ready to absorb various shocks, but on the other, we should be careful not to become the source of disturbances ourselves. We should project stability and confidence, but without promoting complacency and hubris.

Some might say that what I propose is uneventful and boring. I fully agree, but I do not necessarily see it as a bad thing. I happen to represent an old-school view of monetary institutions and finance, according to which these things are not supposed to be exciting. They are public utilities, much like waterworks or electricity. Nobody wants to be surprised by unexpected changes in the provision of hot water or electric energy, and similarly, when it comes to the provision of money. If people want excitement, they are free to visit a casino. When it comes to central banking, boring can be a virtue, not a vice. Especially, given that boring monetary policy does not mean ineffective. On the contrary, a boring and conservative monetary policy can be the most effective course of action. Let me illustrate this point by reference to an example I know best – Polish monetary policy.

For almost 3 years now, the main policy rate in Poland has remained unchanged at the historically low level of 1.5 %. Some observers might take this to mean that our Monetary Policy Council is on an extended leave of absence. However, nothing could be further from the truth. In fact, the MPC meets on a regular basis each month to discuss the level of interest rates. Our meeting frequency is higher than in most central banks. And while we are well aware of the costs in terms of central bank resources, we think this is actually money well spent. Frequent meetings provide us with monthly updates on the state of the economy reflected in activity and inflation indicators, which helps us conduct a more informed, data-dependent monetary policy. And – from a macroeconomic point of view – our decision not to change interest rates at a particular meeting is just as important as a decision to change them.

Over that entire period, we heard sirens calling for us to be more active: first, to cut rates further and then, more recently – to begin raising them. Some have even urged us to start asset purchases or other unconventional measures. We did not give in, though. But it is important that I explain why.

Obviously, there is nothing in principle wrong with unconventional monetary policies, and QE programs in particular. They have all had great merit in overcoming the aftermath of the crisis. However, in our case there was simply no need to apply them as the Polish economy and financial sector weathered the global crisis quite well. To be clear, our conservative approach does not mean that we do not stand ready to react, if needed, or with no-standard tools once it is required to stabilize the economic cycle or secure financial stability. We are just cautious. We do not want to overreact, as medicine can sometimes be worse than the illness itself – a point I will return to later.

I am not naïve, I don't blame the commentators for exerting pressures on us. To some extent this was to be expected. Market participants and reporters covering our decisions thrive on volatility. With no major changes in monetary policy parameters, and clear central bank communication, placing market bets or writing headlines can actually be quite difficult. However, for the general public and the economy as a whole our decisions have actually been beneficial, and I think recent macroeconomic performance has vindicated our policy.

Take, for example, the deflationary episode in Poland, which lasted from mid-2013 to the third quarter of 2016. When NBP cut interest rates for the last time in March 2015, price dynamics had been the lowest on record. Although that did seem unusual for the Polish economy, and certainly far below our target, there was no reason to panic.

Firstly, deflation at the time had been driven mostly by external factors – mainly the unexpected large fall in oil and other commodity prices, but also weak demand pressure in the global economy. Let me remind you that between mid-2010 and mid-2014 the price of oil had been around $100, before it rapidly fell to below $50. This fall in the price of oil reflected not just an increase of supply coming from the United States, but also a considerable amount of slack in the global economy at the time. Note that output gaps in both the US and euro area were negative and the euro area itself experienced an extended period of very low inflation.

Secondly, there was some evidence that the previous interest rate cuts – which had reduced the main policy rate by 325 basis points over 3 years – were actually working and sustaining economic recovery. We were also "importing" some monetary policy accommodation from the euro area. Indeed, government borrowing costs had been close to historically low levels at the time and only a part of that was due to NBP interest rate cuts. The remainder of the fall in yields was associated with the ECB's asset purchase programme, which spilled over to the Polish government debt market.

Finally, the ongoing deflation didn't seem to be having any negative impact on households, corporates or economic growth. Real GDP growth was already accelerating, driven by strong domestic demand, and the situation in the labour market was improving.

Taking all that into account, the Polish MPC decided that further monetary policy accommodation was not needed and could actually be counter-productive, as it might put financial stability at risk. Thus, we exercised "strategic patience" and it paid off. Towards the end of 2016 inflation was back in positive territory and for most of 2017 it has hovered around 2 %, just below the NBP's target of 2.5 %.

Ironically, just when price dynamics began slowly approaching our definition of price stability, the pressure started to build to begin raising interest rates. However, just as before, these calls to action do not seem justified given the available information.

It is true that economic performance of late has been very favourable. GDP increased by 4.6 % in 2017, driven by a healthy balance of consumption, a gradual recovery of investment and a positive contribution of net exports. The labour market continues to improve, with unemployment falling to historical lows of below 5 %. And indeed, perhaps 10 years ago I would have been a little concerned myself about such a situation. The reason is simple: the last time the labour market was heading in this direction, in 2007-2008, the economy was clearly overheating. We had double-digit wage growth, massive credit expansion – most of it in FX – and a widening current account deficit.

But this time is quite different. Wage growth is moderate and has not yet translated into significant price pressure as core inflation remains low. Our current account is balanced and credit is growing in line with nominal GDP, while the level of indebtedness is low when compared not only to advanced economies, but also to our regional peers. There are no signs of bubbles in asset markets – real house prices, though gradually rising, remain much lower than before the global financial crisis. This good performance is confirmed by the European Commission Macroeconomic Imbalance Procedure Scoreboard, where Poland comes second out of 27 countries in terms of the lowest number of thresholds breached since the introduction of the procedure.

Against such a background, there really is nothing at the moment to suggest that monetary policy should be tightened. Especially taking into account that nominal and real interest rates in Poland are already much higher than in most peer regions, particularly the euro area. Since price developments in Poland are driven increasingly by global factors and inflation in most advanced economies seems to be “missing” from the overall macro picture, I actually expect interest rates in Poland to remain flat throughout 2018.

Of course, stability of interest rates is not an end in itself for us. Our monetary policy is data-dependent and oriented towards maintaining price stability in the medium term. So, we will act if there is a substantial risk of inflation overshooting – or undershooting – the target in the medium term. So far, however, this is not the case, and I believe interest rates should stay where they are.

Some would say: even more boring monetary policy. But so what? As I have tried to explain, boring is not necessarily a bad thing when it comes to monetary policy. Of course, we don’t have a counterfactual and it is difficult to say what would have happened if we had been more pro-active over the past 3 years. But one thing is certain – more interest rate cuts during the deflationary episode would most likely have meant quicker hikes now. As a result, we would be adding to the overall uncertainty and financial market volatility, rather than suppressing them. Instead, our policy of keeping interest rates stable has anchored the expectations of market participants and contributed to a predictable business environment.

Moreover, the “inertia” in our interest rates has also been a way for us to deal with the uncertainty involved in monetary policymaking. As I have made the case above, our reading of the macro picture did not support more interest rate cuts during the deflationary period and does not support hikes now. That being said, monetary policy is not just about reading the incoming data or following any number of simple rules. Moreover, monetary policy is about recognizing and dealing with the uncertainty involved with incoming data and policy rules. Note, for example, that measures of output and inflation tend to be revised several times following the initial data release. Hence, it is generally untrue that data can be taken for granted and observed without error in real time. The problem is even more pronounced for measures of potential output and employment, which are not directly observable, must be estimated using a model, and can be revised even years later. To make matters worse, policymakers are often not only uncertain about the exact state of the economy, but also about the transmission mechanism of monetary policy decisions, which is likely to change over time. Weighing all these factors and incorporating them into the decision process is what makes monetary policy more of an art than a science. But this perspective also provides some deeper justification for a stability-oriented, conservative policy. Because when data and policy parameters are uncertain, aggressive moves are more likely to have unpredictable – and potentially even unintended – consequences for the economy.

Let me conclude. I have advocated humility before, so I am hesitant to offer any general lessons from our experiences. But one thing that struck me over these 3 years of interest rate stability in Poland is how much people sometimes expect the central bank to just "do something". Clearly, there are situations in which acting forcefully is appropriate. But sometimes in monetary policy, just as in life, "better is the enemy of good". In such circumstances, "staying the course" and being conservative can actually be the optimal policy. Although boring, such a policy can contribute by providing stability and confidence. These two qualities are much needed in these times of great transformations – in East and West alike.

Thank you.

ALICIA GARCÍA-HERRERO

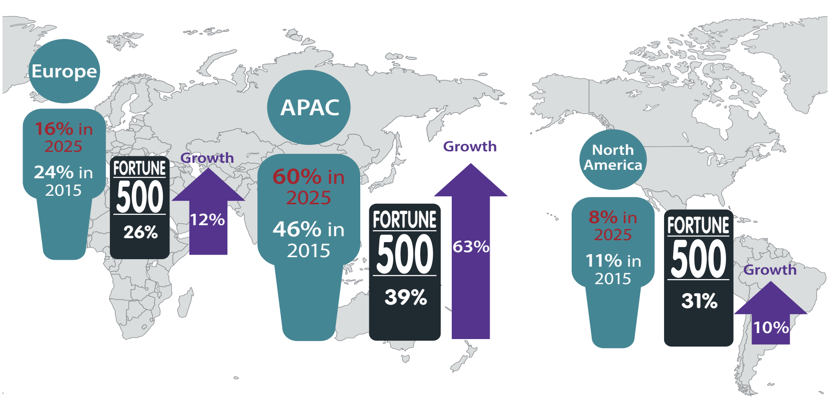
Senior Fellow, Bruegel

How can the EU shift East in the Century of Asia

1. Asia's global relevance rising…Europe's shrinking

Asia is dominating in contribution to global growth, middle-class population and even the corporate world while Europe's global relevance is shrinking. China and India have contributed and will contribute much more to global growth than the US and even more than Europe. It is expected that China will contribute 14 % more to global growth in 2025 in addition to the 2015 rate of 21 %. India also substantially fuels the global economy in terms of growth and is expected to add 8 % to its 2015 rate of 18 % in terms of contribution to global growth by 2025. More importantly, 60 % of the middle-class population worldwide will come from Asia in 2025, an increase of 14 % from its 2015 position. The rising middle class in Asia has momentous implications in terms of future consumption patterns and global value chain. It is expected that not only will Asian consumers continuously upgrade their consumption basket but also Asian producers will climb the ladder at the same time and more and more global goods and capitals will flow into Asia. If that is not yet enough, Asian corporates are increasingly competitive in the global arena. In 2017, Asian companies made up 46 % of Fortune 500 while 143 of European companies made the list.

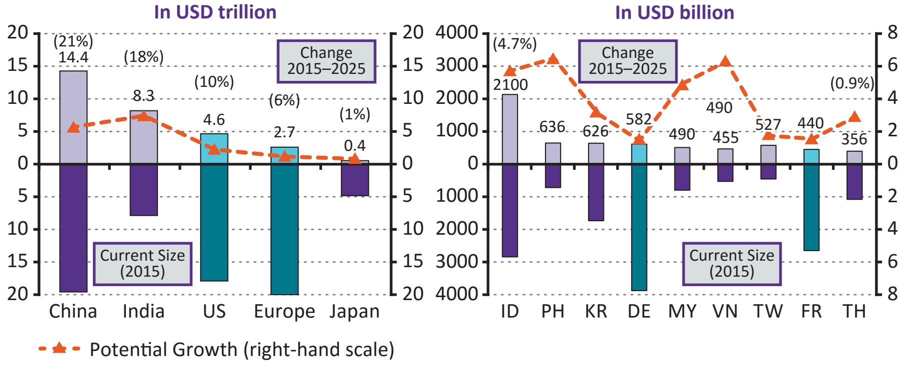
Contribution to global growth, middle class and corporate world



% middle class in 2015 and middle class in 2025. Middle class: GDP per capita above USD5,000 per year
% Fortune 500 companies in 2017
% contribution to global growth from 2015–2025

Source: Natixis, BBVA EAGLEs

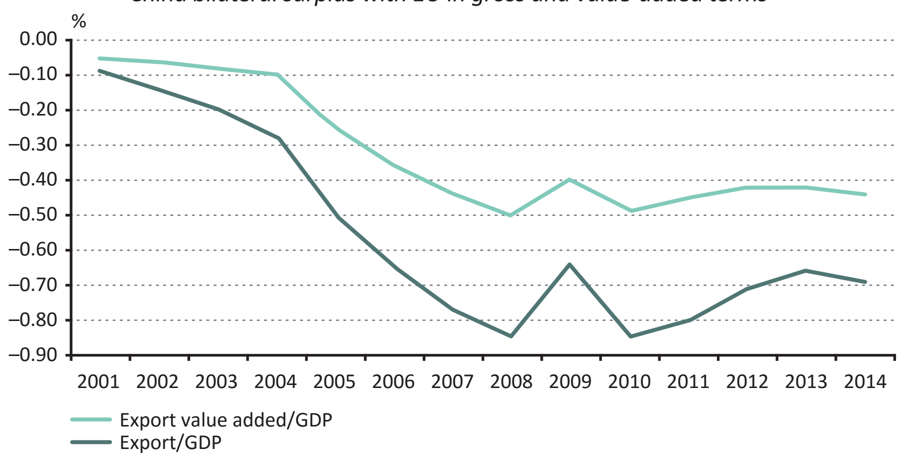
Contribution to global growth



Source: Natixis, BBVA EAGLEs, IMF

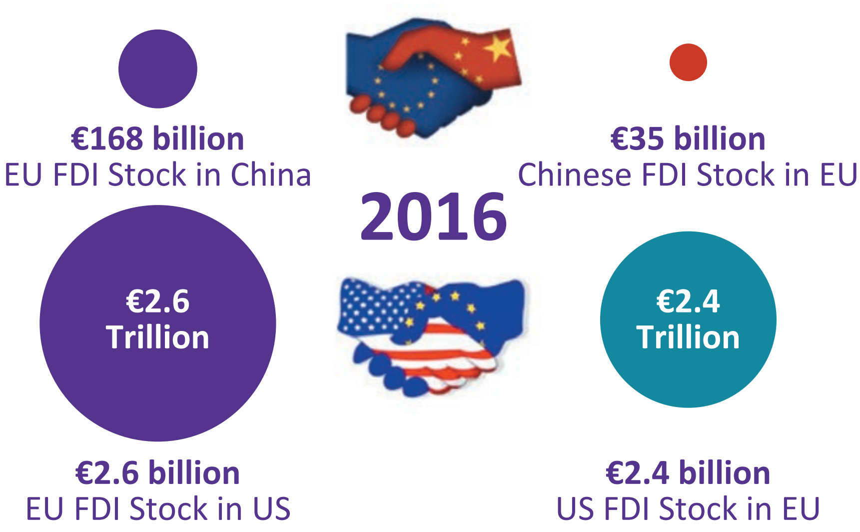
Beyond the fact that Asia is leading the world to growth in the 21st century, improving EU-China trade and investment relations is key for the EU to benefit from the century of Asia. The EU-China trade remains unbalanced and works in favour of China. According to EU statistics, China exported 16.1 % of its total exports to the EU and imported 13.1 % from the EU. However, the EU heavily imports from China (20.2 % of total imports) but exports little to China (9.7 % of total exports). The situation improves with value-added analysis of trade flows. China's trade surplus versus the EU would be substantially lower (reducing to about 0.4 % of GDP from the unadjusted estimate of 0.7 % of GDP) if we take into account value added of exports. It is indeed the case as about 35 % of China's exports to the EU were processing and assembly trade. However, the value added of China's exports has grown noticeably since 2007 as it is climbing the ladder. Looking forward, services trade is likely to grow faster than trade in goods. At present, more than 80 % of trade between China and the EU is comprised of goods. But there is massive room for growth as China further opens up imports of services.

China bilateral surplus with EU in gross and value-added terms



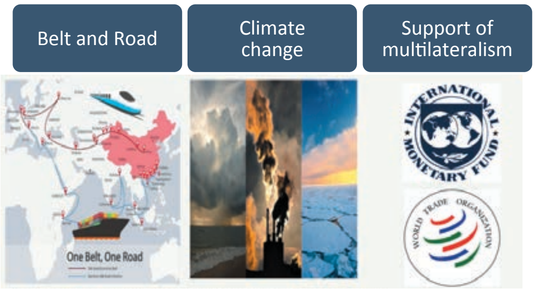
As for investment, the EU's FDI stock in China (€168 billion) is small compared to its stock in the US (€2.6 trillion) and Chinese FDI stock in the EU is even smaller and valued at about €35 billion. Clearly, with a sounder and more stable framework, there are good reasons to expect further growth in both directions. From the perspective of China, excessive savings, overcapacity, and the scarcity of opportunities for domestic investment will push Chinese corporates to step outwards. As for the EU, the opening-up of Chinese consumption and service sectors would bring potential opportunities to European investors. The best way would be to reach a Bilateral Investment Agreement (BIT) between the EU and China to take the lead in a US-China BIT. In addition, to make successful deals, several issues will stand out in between. For example, the EU would expect Chinese SOEs to follow common business practice in their outbound investment. Furthermore, there should be a mutual recognition of standards between the two. In addition, a common mechanism is needed to deal with investment disputes. Although it is impossible to expect major convergence in terms of an economic model, the role of the State, in particular, agreement should be reached on closer FDI relations.

Foreign Direct Investment stocks



Looking ahead, there are other possible venues for collaboration between the EU and China, like the Belt and Road Initiative (BRI), combatting climate change and support of multilateralism. The BRI addresses the pressing needs of infrastructure in Asia, but there is a limit to how much China can finance. The slowdown of the Chinese economy and limited lending capacity of Chinese banks, and the official multilateral development agencies placed European banks (the largest cross-border lenders in the world) in a good position to step in with their already large financing to Belt and Road countries. Europe's proximity to some of these countries also makes some of these projects more appealing for Europe. Thus, we should expect private and public European co-financing of Belt and Road projects to increase over the next few years and, with it, European interest in Xi Jinping's grand plan. This should bring Europe closer to China.

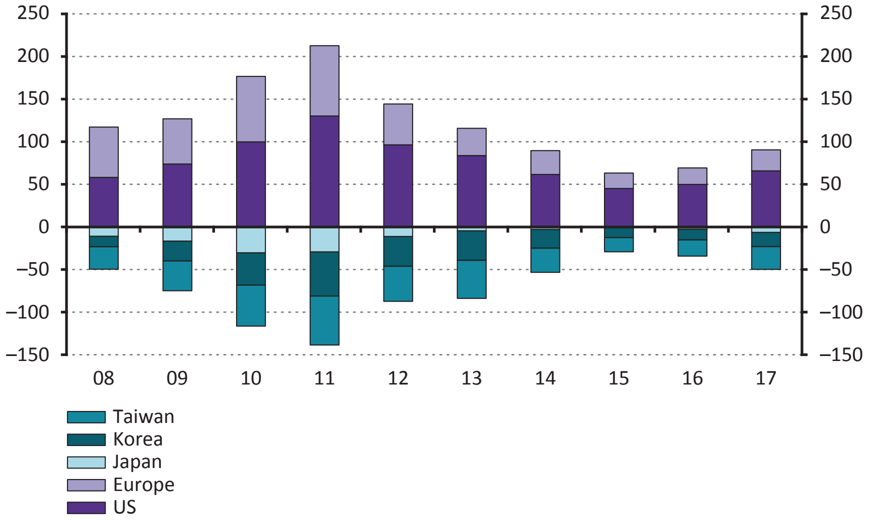
Possible venues for collaboration



2. US potential isolation makes the EU's shift eastwards all the more urgent

The Trump administration is leading the US to potential isolation, which makes the EU's shift eastwards all the more urgent. Since the beginning of 2017, the US administration has not toned down but only escalated its protectionist actions against China. The new round of Tic-Tac-Toe between the US and China has stirred up wide-spread fears of a global trade war. Although contribution of external demand to China's growth has waned, it is still relevant and very dependent on the US, followed by the EU. Moreover, we could tell from the recent targeted Chinese exports by the US, the US strategy has evolved from one in which the purpose was to reduce the bilateral trade deficit to a much more targeted strategy to prevent China from moving up the value chain. In other words, the US has shifted its focus to defending US companies' intellectual property rights. In addition, Chinese corporates are increasingly reliant on overseas revenue due to overcapacity, heightened domestic competition and weaker local demand from decelerating investment. As the US is closing its door to China, China will inevitably be looking for potential substitutes for its massive exports and outbound investment, which makes the trade and investment relations between the EU and China more relevant than ever. As discussed above, against the backdrop of an Asia-led century, the EU cannot afford the status quo where it is in a large trade deficit with China and the FDI is small in size. In the presence of a more isolated US, it is good timing for the EU to shift eastwards, especially towards China.

US and EU: major sources of China's trade surplus (% of Total Trade Balance)



3. Conclusions

This century will be Asia-centric, as shown by contribution to growth, middle-class population and corporate dominance. The EU cannot afford the status quo but needs to look East, much more aggressively. China is clearly the elephant in the room, so improving EU-China relation becomes the key. In terms of trade, more focus on services trade will help the EU to improve its position. For investment, consensus on the rules of the game is urgent. The Belt and Road Initiative, combatting climate change and support for multilateralism are also relevant venues for cooperation. However, without a clear move on trade and investment, it will be hard to reap gains in other areas.

PARK IN-KOOK

President, Korea Foundation for Advanced Studies

The "New Normal" of Global Transformation in Asia

1. "A World in Disarray"

The world is in disarray. Sweeping changes throughout the world have rendered ineffective the very rules and norms that once governed much of it. The ascendancy of China is the single most conspicuous factor that contributes to a world in disarray. This is the "new normal". We must accept that change head-on and adapt accordingly.

Richard Haass, the President of the Council on Foreign Relations, argues in his latest book *A World in Disarray*: "There is a widespread rejection of globalization and international involvement and as a result, a questioning of long-standing postures and policies". What is most alarming about this global "disarray" is that the phenomenon may be permanent rather than being transient.

In 2017, Larry Diamond goes one step further and talks about the crises of democracy and decay of democratic values. "We are in a new era. The global democratic recession is at a very serious risk of becoming a depression, a genuine crisis." However, there have been various definitions on democracy.

2. Rise of China

1) Assertiveness of China

After joining WTO in December 2001, China demonstrated its willingness to open its market to the outside world. This form of cooperation with the international community seemed to have peaked during the 2008 Beijing Olympics.

However, after the 2008 global financial crisis, China has been observed to be more assertive, beginning to challenge its neighbours in the South and East China Seas. Deng Xiaoping's strategy of "韜光養晦 (tāoguāng yǎnghuì)" [meaning, "biding its time, keeping a low profile and never claiming leadership"] seems to have been cast aside around 2009.

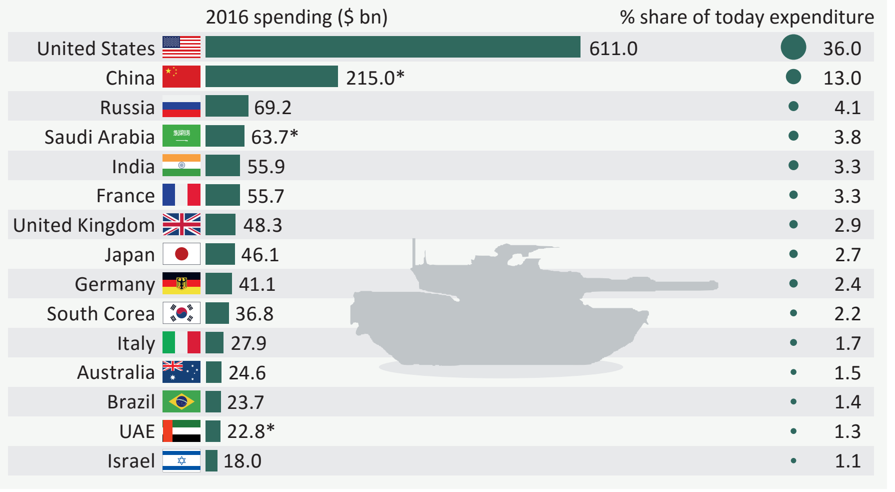
2) Rivalry with the United States

There are two schools of thought when assessing the rise of China. The liberalists argue that the current international order is defined by economic and political openness, and such openness can accommodate China's peaceful rise. In short, unprecedented economic success of China will eventually lead the way for a more open society. A democratised China will contribute to durable peace in Northeast Asia and the world. Realists argue that China's rise cannot be peaceful because its growing strength will lead China to pursue its interests more aggressively. John Mearsheimer, one of the most vocal realists, argued in his recent lecture in Seoul that the US, which is determined to remain the only regional hegemon in the world, will try to form a balancing coalition against China and that it will in turn lead to intense security competition in East Asia.

In his 2017 book *Destined for War*, Graham Allison predicted that if things keep going the way they are and no one does anything about it, the possibility of war increases. Mearsheimer likewise warns that China's growing dominance will lead to very intense security competition between the US and China, a development that would nudge China's neighbours to align themselves with the US.

I'm not in a position to side with liberalist ideas nor realist predictions of a future conflict in whatever form, but we must pay attention to two basic facts. First, the existing US-Korea alliance and the US-Japan alliance will continue to serve as a linchpin for the peace and security of Northeast Asia. Second, the rise of new emerging markets such as ASEAN will have an impact in balancing against any shift of power relations in Asia.

Figure 1: Top 15 Countries for Military Expenditure in 2016



The US still has a decisive edge over China militarily as it spends vastly more per year on its military. The US has spent $611 billion in 2016 compared to $215 billion by China. Joseph Nye has pointed out that there is no country today that can match American military power: "At current rates, China's military expenditure may be half that of the US by 2020 and it may come close to parity in mid-century, but in accumulated stocks of modern military equipment, the US retains at least 10:1 advantage over China without even counting American allies." Even by the 2050s, the US will maintain absolute predominance in naval power.

I believe there is much room for the United States and China to navigate uncharted paths for coexistence and mutual engagement. China today is not the Soviet Union of the Cold War. China is much more dependent on trade than the USSR. Such dependency foreshadows a more intimate interdependency, something the US and USSR never had.

China is and has been for almost a decade the largest foreign buyer of US treasury securities. PRC holds nearly $1.2 trillion of US treasury securities, which accounts for 19 % of total foreign holdings. China's soybean import has also been accelerating since 1994, with more than one-third coming from the United States. The country is America's largest trading partner, the fastest-growing market for US exports, and the third-largest market for US exports in the world. Lastly, as of December 2017, China holds the largest foreign exchange reserves of $3.2 trillion.

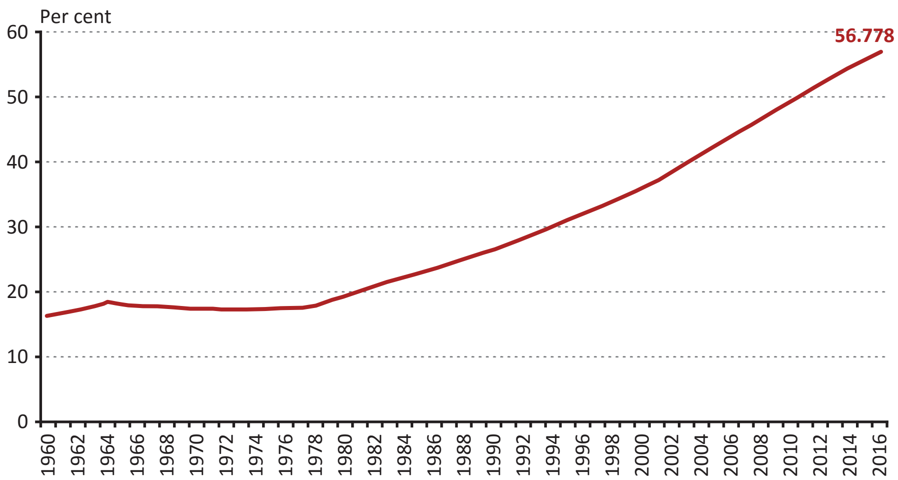
3) The Future of the Chinese Economy

During the Central Economic Work Conference in December 2017, President Xi Jinping stated that China would pursue 'high-quality' growth instead of 'high-speed' growth, focusing on tackling financial risks, curbing pollution and reducing poverty. How he could achieve these unique goals deserves our special attention. This is the first time a Chinese leader on the public stage emphasised quality rather than quantity or speed of economic growth.

In 2017, China's sovereign credit rating was downgraded twice - by Moody's in May and by S&P in September. China rebutted that Moody's and S&P ignored the country's solid fundamentals. Some scholars were of the view that Moody's and S&P were limited by data and lacked a deep understanding of the Chinese economy. The market seems not seriously worried about China's credit rating downgrade. For instance, Karishma Vaswani, the Asia business correspondent of BBC, asserted that the downgrade was not serious, because most of the debt was held by Chinese state-owned enterprises or ‘quasi-state’ like entities. Luc Froehlich, head of investment directing for Asian fixed income at Fidelity International, argued that China’s central bank and its regulators were firmly in control of the situation.

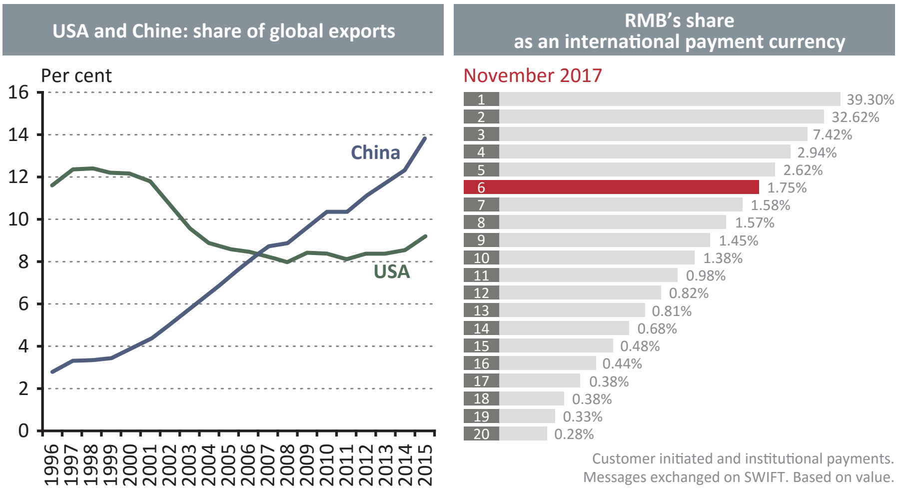
To avoid falling into the middle-income trap, China has pushed hard on urbanisation. China intends to maintain the momentum of growth by generating a large base of middle class. The Chinese urban population has now crossed the 50 % threshold. In the *2016 Government Work Report*, Premier Li Keqiang declared that it was China’s goal to achieve 60 % urbanisation by 2020. Why is this so important? If one looks back at the history of Western societies, most countries reached a 70-80 % urbanization rate when they attained per capita GDP of US$10,000, which means that there is much room for China to be more urbanised. If China continues to move upward in its urbanisation, at least 300 or 400 million people are projected to join the new middle class. Addition of this magnitude of new consumers will prove indispensable for the continued development of the Chinese economy.

Figure 2: China’s Urban Population (% of Total)



In 1 October 2016, the IMF finally accepted the Chinese currency, RMB, in its SDR basket. The event can be interpreted as the global affirmative appraisal of China's economic development and recent reform efforts in the Chinese financial sector. While the inclusion of the renminbi into the SDR basket is a significant milestone in the internationalisation of the Chinese currency, the Chinese side contends that there is still a serious gap between China's global export share and RMB's share as an international payment currency.

Figure 3: Gap between China's global export share and RMB's international payment share



China's "Belt and Road Initiative" (BRI) involves almost 70 countries connecting Europe, the Middle East, Africa and Asia. To realize the blueprint of BRI, some \$900 billion worth of investments are being planned. So far, only \$200 billion is pledged. Another major concern is the safety and security of the BRI projects. Political instability is increasing in a growing number of countries along the passage of BRI.

Technological innovation is another locomotive of China's future growth. As Figure 4 shows, China has already become the world's second largest investor in R&D, spending almost \$240 billion (over 20 % of the global R&D spending) in 2016. Its R&D-to-GDP ratio was 2.11 %, on par with that of European countries. China increased R&D spending by about 10 % annually even during the 2008-2009 recession, which demonstrates China's determination and commitment.

Figure 4: Share of Total Global R&D Spending

	2015	2016	2017
North America (12 countries)	27.9%	27.8%	27.7%
United States	25.8%	25.6%	25.5%
South America (10 countries)	2.7%	2.5%	2.4%
Europe (34 countries)	21.6%	21.2%	20.8%
Germany	5.8%	5.6%	5.4%
Asia (24 countries)	41.3%	42.3%	42.9%
Japan	8.5%	8.6%	8.4%
China	**19.4%**	**20.1%**	**20.8%**
South Korea	3.9%	4.0%	4.1%
India	3.5%	3.6%	3.8%
Africa (18 countries)	1.0%	0.9%	0.9%
Middle East (13 countries)	2.5%	2.4%	2.5%
Russia/CAS (5 countries)	3.0%	2.9%	2.8%

Source: R&D Magazine (2017)

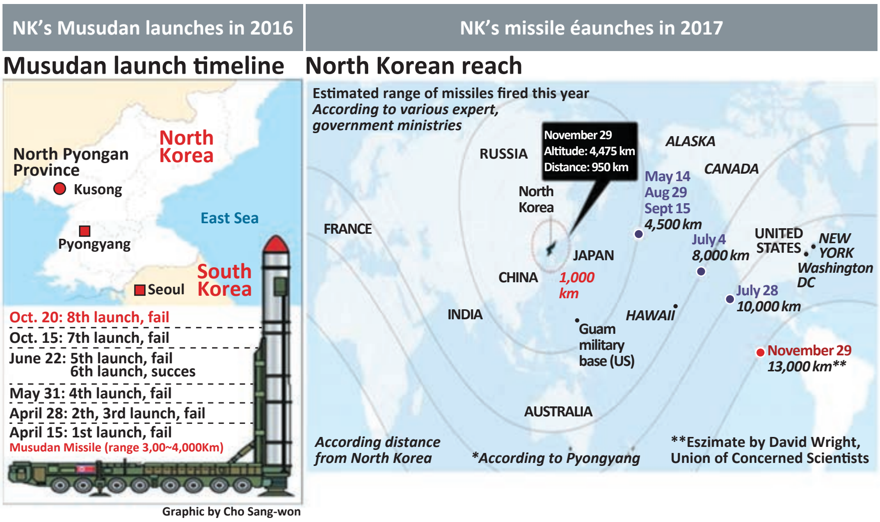
With heavy investment in R&D, Chinese start-ups have been successful in attracting capital. Among the 57 global 'unicorns' (a privately held start-up company valued at over $1 billion) in 2017, 18 were Chinese companies, second only to the US. China's Toutiao (now valued at $20 billion) topped the list.

During the last decade, China has made an impressive achievement of covering 25,000km (16,000 miles) of *gaotie* (高铁), high-speed railways, within China. Enhanced nation-wide inter-connectivity is expected to propel China's economy to the next stage.

3. Proliferation of WMD : North Korea Nuclear Threat

The single most critical geopolitical risk for China and Asia is the North Korean nuclear threat. North Korea has made significant progress in its intercontinental ballistic missile (ICBM) technology especially in 2017.

Figure 5: North Korea’s Missile Launches in 2016 and 2017



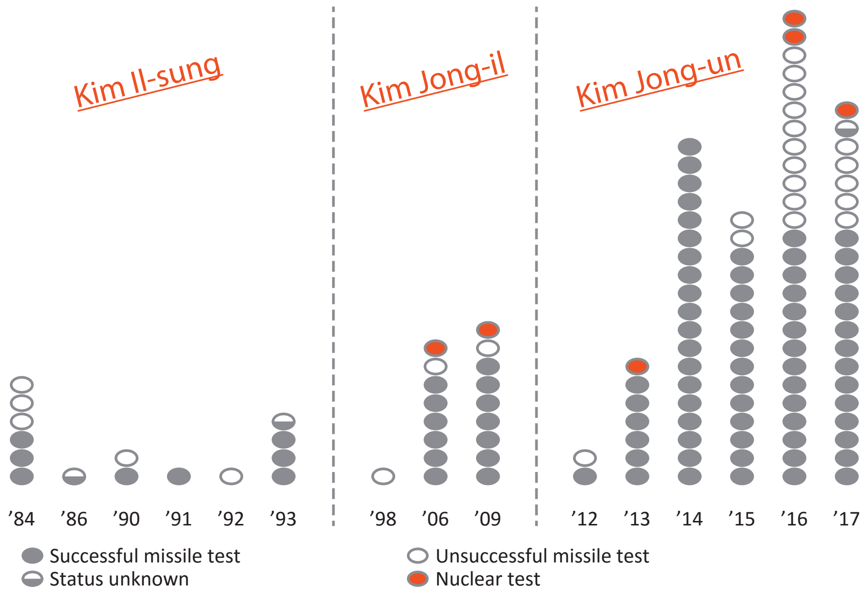
In 2016, North Korea launched eight Musudan missiles. All but one failed. Then, in 2017, North Korea made a technological leap in both their success rate and distance. Such technological advancement culminated in the two ICBM-level missile launches in July. We can assume that North Korea’s nuclear development was not fuelled by indigenous technology. It is widely presumed that there has been help from the outside.

Kim Jong-un has carried out four of North Korea’s six nuclear tests, including the biggest one in September 2017 with an estimated yield of 100 to 150 kilotons (the atomic bomb dropped on Hiroshima, Japan, during World War II was estimated to be 15 kilotons). North Korea has tested nearly 90 ballistic missiles since Kim Jong-un took power in late 2011, three times more than his father and grandfather.

The “strategic patience” policy of the US and the Chinese Communist Party’s Foreign Affairs Leading Group (中央外事领导小组) 2009 decision to prioritise peace and security over denuclearisation of the Korean peninsula both had the effect of giving North Korea a blank check that allowed it to accelerate its nuclear and missile programmes with a sense of impunity. Even after the US government declared its ‘Pivot to Asia’ policy in 2011, little was done to signal its intension to follow through with full implementation. Intending to withdraw its military involvement in the Middle East but finding itself unable to quickly enough, the US could not secure adequate room to properly pivot to Asia and address the mushrooming nuclear weapons programme of

North Korea. Fortunately, the Trump administration grasped the urgency of the situation when it took office and began sending a clear message to North Korea and China.

Figure 6: North Korea's Nuclear Test



If North Korea successfully proves completion of its ICBM technology to send a nuclear tipped missile to the US mainland, South Korea will likely question the reliability of US extended deterrence and worry about de-coupling of the US-South Korea alliance. Furthermore, if North Korea proves that it has enough second-strike capability, there will be more serious questions on the reliability of the US nuclear umbrella because many people doubt that the United States will sacrifice Seattle or New York for Seoul or Tokyo. If North Korea does prove it could hit Washington or New York, South Korea and Japan may face the same dilemma that Europe dealt with since World War II. At the time, the Europeans doubted that the US would sacrifice Washington or New York for Paris or London in the face of the Soviet Union's powerful second strike capability. Europe addressed the problem by having US tactical nuclear weapons combined with NATO's unique nuclear sharing arrangements. Unlike Western Europe, however, there are no tactical nuclear weapons deployed in Korea and Japan.

South Koreans are rightfully concerned by these portentous developments. According to a Gallup Korea research conducted in September 2017, 60 % of South Koreans support going nuclear. YTN reported in August 2017 that 68 % of South Koreans support redeployment of US tactical nuclear weapons to South Korea. In such a case, there will be a terrible cascade of nuclear chain reaction in Northeast Asia. That is a horrible catastrophe which the international community should avoid.

Since the two ICBM tests in July 2017, the international community has ratcheted up sanctioned measures against North Korea. The measures were assessed to be the true beginning of real sanctions to inflict pain effectively on North Korea. I personally believe that China has played a central role in implementing such robust UN Security Council resolutions. At the same time, the newly evolving discourse on the so-called 'contingency plan' on North Korea, which entails concerted effort by the US, China, and South Korea, deserves the international community's attention. Henry Kissinger argues that "An understanding between Washington and Beijing is the essential prerequisite for the denuclearization of Korea."

4. Inflection of Global Economy

In addition to the disarray in the world economy, the rise of assertive China, and proliferation of WMD, there are several other far-reaching economic factors that epitomise the inflection of the global economy: dominance of Information Technology (IT), decline of multilateralism, resurgence of protectionism, rise of new emerging economies, and demographic transition. These factors may pose a severe threat to the stability of the global economy by intensifying the ever increasing digital disparities.

1) Dominance of IT

Among elements of the new disarray, IT has emerged as the most formidable social change in the past decade. Google and Facebook have grown so gigantic that they de facto monopolise the global IT sector. In China, IT sectors are dominated by three local IT giants, Baidu, Alibaba, and Tencent, often collectively referred to as "BAT", while foreign access has been prohibited.

In the time span of a decade, the global map of the top ten most powerful companies has undergone a drastic change. Only three companies from the 2006 list survived to the 2016 list. Six out of the top ten in 2016 are IT-related companies, whereas only Microsoft made it on the list back in 2006. Absolute dominance of IT in the global economy is causing growing concerns and fears, ranging from suppression of innovation, privacy, security and so on. There is no guarantee that the use of Internet technology will always be benign. Marriage between authoritarian governance and data-rich IT monopolies may give rise to another nightmare.

Figure 7: Comparison of Top Ten Companies in 2006 and 2016

2006 Top 10 Companies

Rank	Company (Industry)	Market Value (US billion)
1	Exxon Mobil (Energy)	451
2	GE (Industrial Machinery)	386
3	Microsoft (IT)	295
4	Citi Group (Finance)	275
5	Gazprom (Energy)	272
6	PetroChina (Energy)	257
7	Bank of America (Finance)	241
8	Toyota (Car)	241
9	IND&COMM (Finance)	240
10	Royal Dutch Shell	228

2016 Top 10 Companies

Rank	Company (Industry)	Market Value (US billion)
1	**Apple (IT)**	612
2	**Google (IT)**	539
3	**Microsoft (IT)**	443
4	**Amazon (IT)**	370
5	**Facebook (IT)**	369
6	Berkshire Hathaway (Finance)	358
7	Exxon Mobil (Energy)	342
8	Johnson & Johnson (Consumer goods)	323
9	GE (Industrial Machinery)	266
10	**Tencent (IT)**	255

2) Multilateralism in Crisis

The Bretton Woods system of global governance showed its limitations in dealing with the global financial crisis in 2008. The G20 summit, an ad hoc global economic steering group, has played an active role in leading the world economy to timely manage the unprecedented challenges. From the onset, the G20 members pledged to resist protectionism in all its forms and to roll back their existing protectionist measures. The G20 summit has also greatly contributed to the improvement of the global financial governance by addressing chronic disparity in the voting share. For example, the 2010 G20 Seoul Summit decided the 6 % shift of quota shares in the IMF from Western economies to emerging economies.

Despite the UN system's limitations, its intrinsic functions cannot be overlooked: namely, its agenda-setting capability, convening power, and legitimacy. Instead of overhauling the existing multilateral system, it would be wise to find ways to complement it. For example, G20 summit does not impose legally binding measures but builds common understanding and encourages voluntary cooperation. With G20 not on its own, but as a complementary mechanism to the UN system, we may open a new horizon for the better management of unexpected global challenges.

After the failure of COP15 in Copenhagen in 2009, the success of COP21 in 2015 was marked as a great achievement in the international community's fight against climate change. The United States' threat to withdraw from the Paris Agreement under President

Trump, however, has dealt a serious blow to international cooperation. It remains to be seen how steady the agreement will hold in the face of the flip-flop of the US.

Many critics also talk about the steady decline of the WTO system. The failure to complete the Doha Round after 17 years of negotiations has crippled the credibility of the WTO. To make matters worse, its dispute settlement system has been under growing stress: The US has been blocking the selection of senior arbitrators. The latest WTO Ministerial Conference in December 2017 failed to even adopt a joint Ministerial Statement, due to irreconcilable disagreement among major members.

In fact, the crisis of the WTO is not something new. Bilateral and regional Free Trade Agreements (FTA) had been on the rise. Now, with the election of Trump as the US President, the US became more dismissive of the WTO, the very organization it has championed to create and strengthen.

3) Resurgence of Protectionism

Under the Trump administration, dealing with trade deficit became policy priorities. Trade deficit, in the opinion of President Trump, means US job loss to foreign countries. Under this rationale, he has increased pressure on China, and demanded renegotiations of FTA with Korea, and North American Free Trade Agreement (NAFTA) with Canada and Mexico.

Figure 8: Top Trading Partners of US – November 2017

Country	Exports	Imports	Total Trade	Trade Balance	Percent of Total Trade
China	116.7	461.1	577.8	-344.4	16.3%
Canada	259.2	274.5	533.7	-15.3	15.0%
Mexico	223.3	289.0	512.2	-65.7	14.4%
Japan	61.3	124.6	185.8	-63.3	5.2%
Germany	48.6	107.0	155.6	-58.4	4.4%
South Korea	43.8	65.4	109.2	-21.6	3.1%

Source : United States Census Bureau

In his first week in office, President Trump took the US out from the Trans-Pacific Partnership (TPP), which was negotiated under his predecessor and waiting for domestic ratification. The TPP had many significant rules for the data-driven digital economy. And the US wanted to write the rules for the coming era. Trump's throwing out of the TPP was highly controversial for this reason.

In dealing with the trade issue, Trump resorts to both conventional and unconventional measures. Not only trade remedy measures such as anti-dumping, countervailing duty and safeguards are used. Trump has gone to the length of using Section 232 ("security exception) of the 1962 Trade Expansion Act in levying tariffs on steel and aluminium from all over the world.

President Trump has intensified his critique of China. In April 2018, the US announced a list of trade retaliation on China and demanded radical reduction of China's trade surplus against the US. The US has issued several prohibitive measures to deter Chinese' firms acquisition attempts in the US through the CFIUS. China appears non-conciliatory. On-going conflicts have a potential toward a full-blown trade war between the US and China.

With Trump resorting to aggressive unilateralism, fear is mounting that the global economy may repeat the colossal mistake of the past. The spectre of the Smoot-Hawley Act looms large. In 1930, the United States enacted a tariff law called the Smoot-Hawley Act to discourage consumers from buying imports and to promote domestically produced goods. With this law, US tariffs were raised to 53 % on average. What ensued was a massive retaliation by other nations that traded with the US. The consequences were detrimental. The international trading system broke down and world trade reduced to one third of what it was. Competitive erection of trade barriers eventually lead to the protraction of the Great Depression.

4) Demographic Transition

Another factor that will shape the future of the world with far-reaching impacts is sea change in demographic transition in Asia. Northeast Asia region is undergoing unprecedented speed and scope of ageing, coupled with critically low birth rate. As for China, experts have warned that China's next bomb would be its ageing population. By year 2100, China's total population is projected to be just under one billion while its 65 and over-aged population is estimated to reach about 30 %. China's total birth rate is below the world average and has become similar to that of Korea and Japan, which happen to be the lowest among OECD countries.

Another conspicuous emerging phenomenon in demography is India's ever increasing population and its future impact. Many investors and scholars are taking notice of India's demographic advantage, compared to China. India's population is growing twice as fast as China's: India's population is growing at 1.55 % a year while China's is growing at 0.66 %. According to a UN study conducted in 2017, it is expected that India and

China will be equal in population of about 1.5 billion by 2024. Around the year 2100, the population of India is predicted to be 1.5 billion while that of China is projected to be under 1 billion. A more pessimistic outlook by an authoritative Chinese demographic sociologist predicted that the population could drop to 500 million, unless the Chinese government implements successful intervention.

What must be carefully monitored in terms of the drastic demographic change is its potentially sweeping impact on Asia's future economy and geopolitics, which could become the most profound facet of the new normal.

5) Rise of New Emerging Economies

Since its foundation in 1967, ASEAN's integration process has been modest at best, as it focused more on building regional peace and stability rather than economic integration. However, with the remarkable growth of its member countries, the regional community has stepped up its integration agenda in recent years. The establishment of the ASEAN Economic Community (AEC) in 2015 is one such milestone. South China Sea maritime disputes are also fuelling the members to seek a united front, though it has not always been easy to bridge different interests.

Back in 2001, the combined GDP of ASEAN countries was $599 billion, similar to that of South Korea ($533 billion). In 2016, ASEAN countries' combined GDP amounted to $2.5 trillion, almost twice as big as South Korea's GDP of $1.4 trillion (World Bank current US$). If counted as a single entity, ASEAN's economy would rank sixth in the world, behind those of the United States, China, Japan, India and Germany. Furthermore, the combined population of ASEAN creates the world's third largest market with more than 630 million people.

What has driven ASEAN's fast growth is its rapidly expanding middle class, young labour forces, buoyant infrastructure spending, and strong global demand. According to the IMF forecast in 2018, the five countries of ASEAN are expected to grow to 5.3 %.

Notably, the region is experiencing a rapid growth in internet, digital technology, social media and mobile activity. With more than 320 million internet users as of January 2017, the digital sector is booming and attracting a lot of interest. Internet penetration, which measures internet users to the total population, was 53 % in Southeast Asia as of January 2017. Mobile connectivity, which is the number of mobile connections compared to population, was 133 %. These numbers point to a great potential for continued growth in the region's IT industry.

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LAWRENCE J. LAU[1]

Ralph and Claire Landau Professor of Economics,
Lau Chor Tak Institute of Global Economics and Finance,
The Chinese University of Hong Kong

The Great Transformation–East

Abstract

The objective of this paper is to identify the common factors that enable East Asian economies to become developed in the post-World War II period. East Asian economies have been able to take advantage of the open global economy. They all have sound economic fundamentals – a high domestic savings rate, the existence of abundant surplus labour, and investment in intangible capital – which provide the necessary domestic conditions for an economy to grow and prosper. They have also been able to maintain domestic macroeconomic stability and a relatively low rate of inflation, which are essential for the stability of the exchange rate and the success of an export promotion policy. They have all adopted an export promotion, as opposed to an import substitution, economic development policy, capitalising on their comparative advantages and using the exchange rate as one of the instruments. Exports also provided the initial growth in the aggregate demand for these economies. Finally, the continuity of governance has been an important factor in the early stage of development of these economies as it facilitates not only long-term planning but also faithful implementation of the plan once adopted.

1. Introduction

Today, East Asia as a whole accounts for close to 30 per cent of world GDP. Professor Angus Maddison (2006) estimated that China accounted for 30 per cent of world GDP in the 18th Century. In 1970, China accounted for approximately 3 per cent of world GDP. In 2017, China accounted for approximately 15 per cent of world GDP. Japan

[1] The author is Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong and Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University. This is a revised version of a presentation made at the Lamfalussy Lectures Conference, Budapest, 12 February 2018. The author wishes to thank the Central Bank of Hungary for inviting him to the Conference and Mrs. Ayesha Macpherson Lau and Prof. Yanyan XIONG for their helpful comments and suggestions. All opinions expressed herein are the author's own and do not necessarily reflect the views of any of the organisations with which the author is affiliated.

accounted for 18 per cent of world GDP at its peak in the mid-1990s. China and India are the two fastest-growing large economies in the world today.

In the post-Second World War period, quite a few East Asian economies, beginning with Japan, reached developed status. They include the "newly industrialised economies (NIEs)" of Hong Kong, South Korea, Singapore and Taiwan, also referred to as the "four little dragons". They were followed, in turn, by the other Association of Southeast Asian Nations (ASEAN) economies and by Mainland China,[2] which are still in the process of becoming developed. In the early 1950s, the Philippines was widely tipped to be the economy that was most likely to become developed. In fact, at the time, the Philippines had the highest GDP per capita in all of East Asia, higher than even that of Japan. Today, the Philippines still has the lowest GDP per capita among the five founding members of the ASEAN (the other four are Indonesia, Malaysia, Singapore and Thailand).

The objective of this paper is to answer the question: How did the East grow rich? We begin by examining what successful East Asian economies have in common. All of these East Asian economies, beginning with Japan, adopted and implemented the economic development policy of export promotion. Export promotion turned out to be a successful policy for the then developing economies of East Asia because of trade liberalisation around the world, beginning with the Kennedy Round (1964-1967) of trade negotiations under the General Agreement on Tariffs and Trade (GATT), the predecessor to the World Trade Organisation (WTO).

Taiwan was among the first, if not the very first, developing economy to explicitly adopt and implement the economic development policy of export promotion instead of import substitution. It proved to be highly successful in enhancing domestic savings and investment, attracting foreign direct investment, increasing employment and stimulating economic development. Subsequently, these policies were also widely and successfully emulated by many other developing economies such as South Korea, the ASEAN and Mainland China.

[2] In this paper, China and "Mainland China" are used interchangeably.

2. The Shifting Centre of Gravity of the Global Economy

In 1970, the United States and Western Europe together accounted for almost 60 % of world GDP. By comparison, East Asia (defined as the 10 Association of Southeast Asian Nations (ASEAN)–Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam–+ 3 (China including Hong Kong, Macau and Taiwan, Japan and the Republic of Korea)) accounted for only approximately 10 % of world GDP. By 2016, the share of United States and Western Europe combined in world GDP had declined to approximately 41 % whereas the share of East Asia had risen to around 28 %. The Japanese share of world GDP declined from a peak of almost 18 % in the mid-1990s to 6.7 % in 2016 while the Mainland Chinese share of world GDP rose from 3.1 % in 1970 and less than 4 % in 2000 to over 15.1 % in 2016. See Charts 1 and 2.

Chart 1: The Distribution of World GDP, 1970

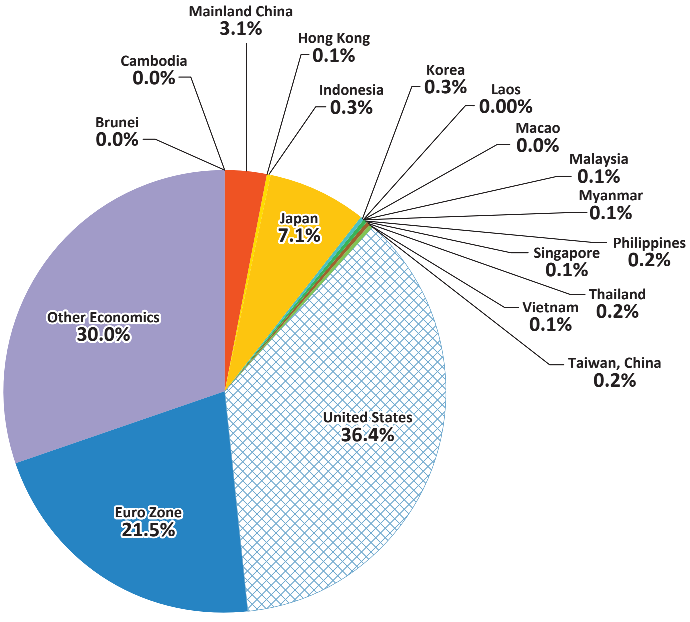
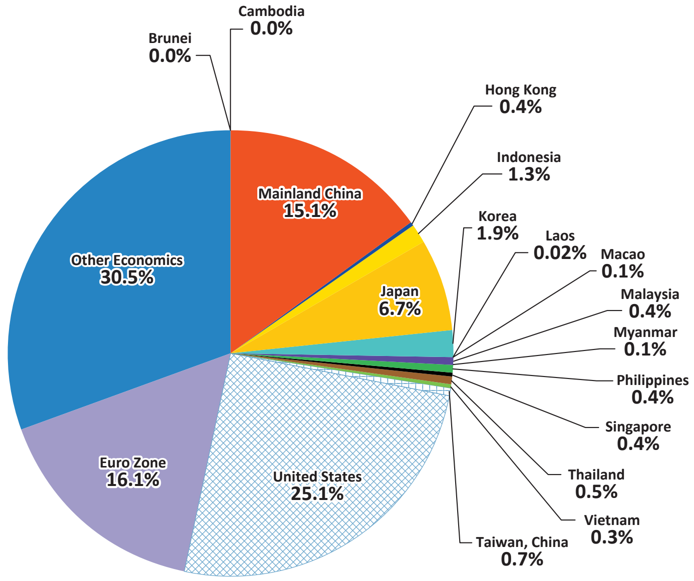


Chart 2: The Distribution of World GDP, 2016



In 1970, the United States and Western Europe together accounted for 47 % of world trade in goods and services. By comparison, East Asia accounted for 9.5 % of world trade. By 2016, the share of United States and Western Europe combined in world trade had declined to 37.1 % whereas the share of East Asia had risen to 28.1 %. The Mainland Chinese share of world trade rose from 0.6 % in 1970 to 10.1% in 2016. The growth in Chinese international trade may be attributed in part to adoption of current-account convertibility of the Renminbi by China in 1994, accompanied by a significant devaluation of the Renminbi, and to Chinese accession to the World Trade Organisation in 2001. Since 2015, Mainland China has also been the largest trading partner country of the U.S., surpassing Canada. See Charts 3 and 4.

Chart 3: The Distribution of International Trade in Goods and Services, 1970

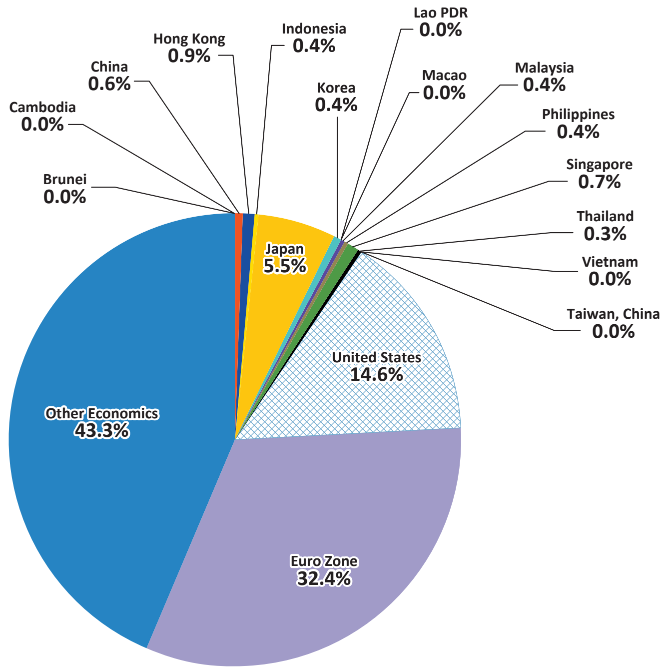
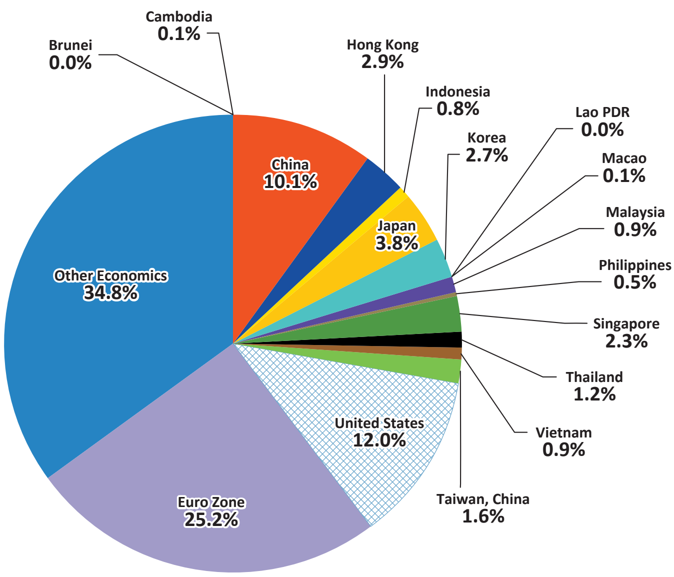
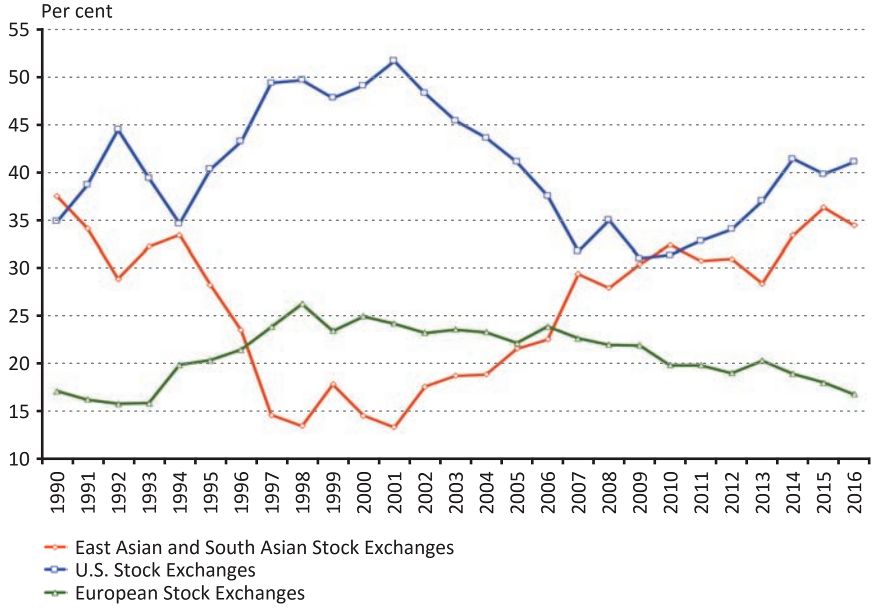


Chart 4: The Distribution of International Trade in Goods and Services, 2016



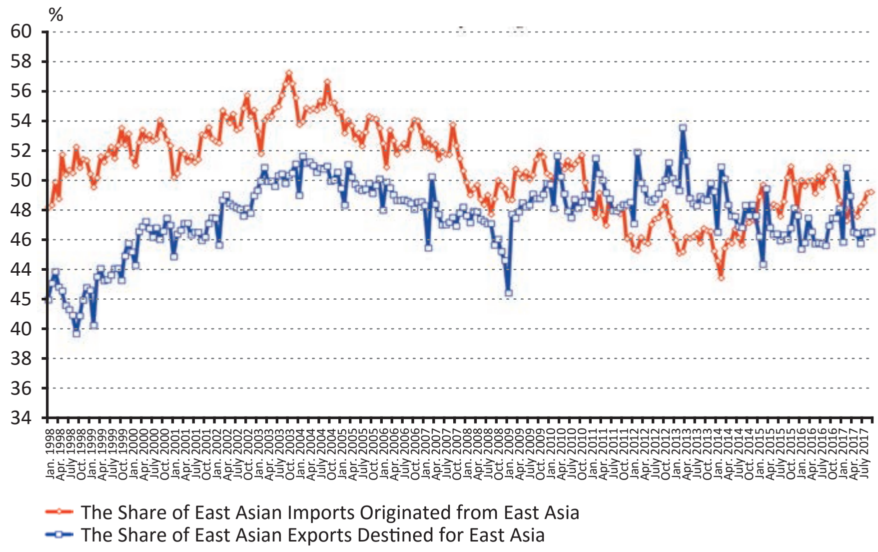
If we use the values of market capitalisation from the stock exchanges of respectively the U.S., Europe, East Asia and South Asia combined as a proxy of the values of their wealth (admittedly a crude one for many reasons), we can see that in 2001, the U.S. accounted for 50 per cent of the world's wealth, Europe not quite 25 per cent and Asia as a whole just above 10 per cent. In 2016, while the U.S. still accounted for approximately 40 per cent, Asia rose to almost 35 per cent and Europe fell to less than 20 per cent. See Chart 5.

Chart 5: The Regional Distribution of the Market Capitalisation of Stock Exchanges, per cent



Throughout the 2007-2009 global financial crisis, as well as the subsequent European sovereign debt crisis, East Asian economies continued to do reasonably well. Mainland China, in particular, has been able to maintain its real rate of growth above 6.5 % since 2007, lending credence to the "Partial De-Coupling Hypothesis", that is, East Asian economies can continue to grow, albeit at lower rates, even as the U.S. and European economies go into economic recession. This partial de-coupling can occur because of the shift of the economic centre of gravity of the world from the United States and Western Europe to Asia (including both East Asia and South Asia) over the past four decades. In terms of trade flows, thirty years ago, the trade flows were predominantly from East Asia to the United States and Western Europe. There was relatively little intra-East Asian trade. Today, intra-East Asian exports and imports account for approximately half of the total exports and imports of East Asia respectively (see Chart 6).

Chart 6: The Share of East Asian Exports Destined for East Asia and the Share of East Asian Imports Originating from East Asia



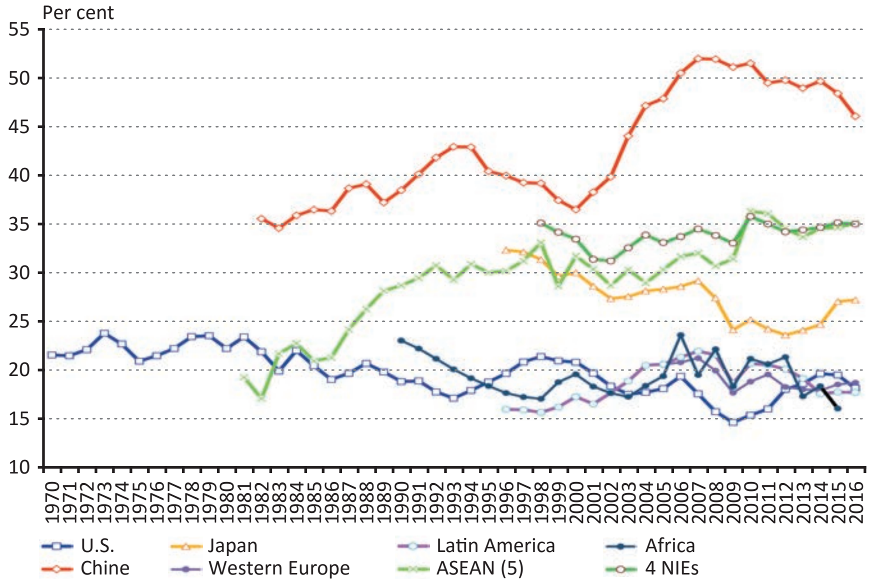
3. Economic Fundamentals

First, we consider the economic fundamentals of East Asian economies. Most of them turn out to have a high domestic savings rate, abundant surplus labour, and significant cumulative investments in intangible capital such as human capital and Research and Development (R&D) capital.

A High Domestic Savings Rate

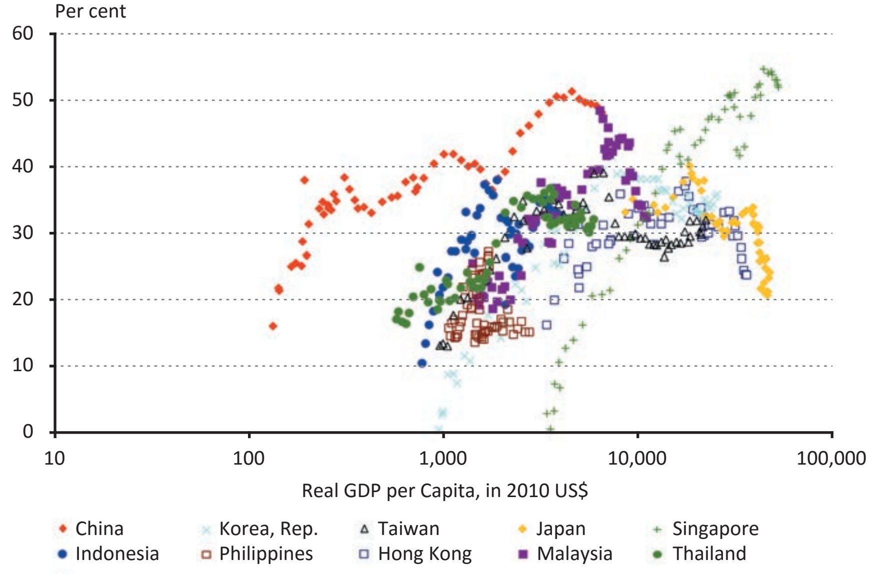
The domestic savings rates of East Asian economies have been consistently high, with the possible exception of the Philippines. Chart 7 shows that the savings rates of China, Japan, the East Asian NIEs and the ASEAN five are all significantly higher than those of not only African and Latin American economies, where the savings rates are typically low, but also those of the U.S. and Western Europe (see Chart 7). A high domestic savings rate means that it is possible for the economy to maintain and sustain a high domestic investment rate without depending on the more fickle inflows of foreign aid, credits, loans and direct and portfolio investment, enabling the tangible capital stock of the economy to grow consistently and continuously.

Chart 7: The Savings Rates of Selected Economies and Groups of Economies



In Chart 8, the savings rates of each economy are plotted against its real GDPs per capita. The savings rate of an East Asian economy typically started out low when its real GDP per capita was low and near the subsistence level. However, the savings rate rose quickly as real GDP per capita exceeded the subsistence threshold. It is, however, sometimes necessary for an economy to have a jump start with an initial supply of savings to support the initial investment – from, for example, a good agricultural harvest, land reform, foreign aid, credit or investment. The recent measured savings rates of Japan, Korea, Taiwan and the U.S. may appear low because of the traditional statistical practice of expensing educational and R&D expenditures, which properly speaking should have been recognised as investment expenditures rather than current expenditures and appropriately accumulated as stocks of intangible capital such as human capital and R&D capital.

Chart 8: The Relationship between Savings Rate and Real GDP per Capita: East Asian Economies



Abundant Surplus Labour

East Asian economies are also endowed with abundant surplus labour. Their economic development has proceeded along the lines of Professor W. Arthur Lewis's celebrated model of surplus labour, first introduced in his 1954 article, "Economic Development with Unlimited Supplies of Labour". In almost every successfully developed East Asian economy, from Japan to Taiwan to South Korea to Mainland China and Southeast Asia, development began with expanded employment of the surplus labour from the agricultural sector in the non-agricultural sector, enabled by the continuing investment in tangible capital in the non-agricultural sector.[3] Initially, the bulk of the additional output is exported.

During this surplus labour phase, tangible capital was accumulated in the non-agricultural sector and surplus labour moved from the agricultural sector to the non-agricultural sector as complementary tangible capital became available in the non-agricultural sector. For such movement of labour to be sustainable, a relatively high domestic savings rate would be needed, both as a source of wage goods (food) and as a source of investable funds in the non-agricultural sector, unless they could be

[3] The city-economies of Hong Kong and Singapore were different because they did not start with a large primary sector. However, even then, they had significant unemployed or under-employed labour.

supplemented by imports and inflows of foreign capital. However, it is important to realise that the principal source of economic growth during this phase is not the surplus labour itself, but the accumulation of tangible capital in the non-agricultural sector, which made it possible for the surplus labour to move from the agricultural to the non-agricultural sector to be productively employed.

In the following series of charts (Chart 9-16), we show the changes in the distributions of GDP and employment by the three production sectors: primary (which includes agriculture and mining), secondary (which includes manufacturing) and tertiary (which includes services) over time in Japan, Taiwan, South Korea and Mainland China. All of them started out with the primary sector accounting for the largest share of employment. With the growth of the economy and the secondary and tertiary sectors, the primary sector became progressively the sector accounting for first the smallest share of GDP and then the smallest share of employment.

Chart 9: The Distribution of Japanese GDP by Sector Since 1955

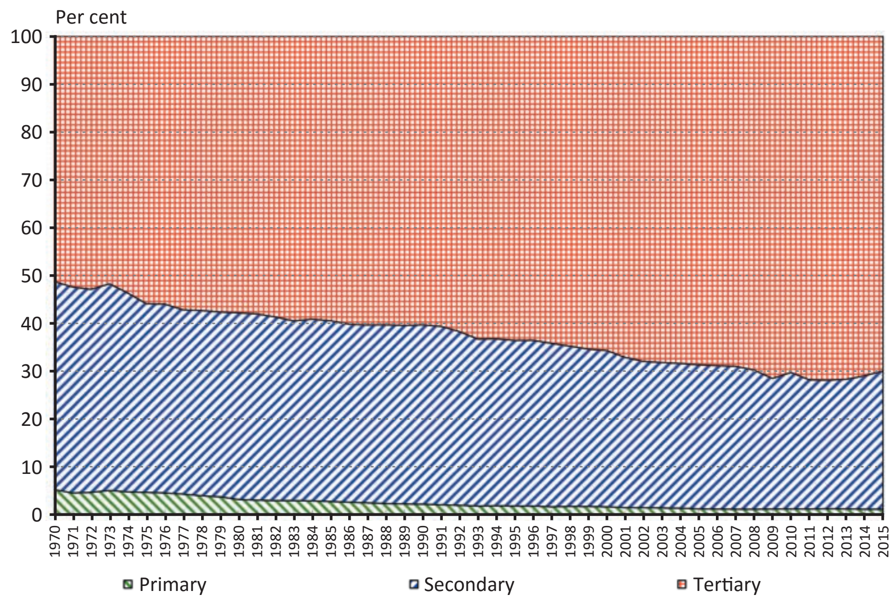


Chart 10: The Distribution of Japanese Employment by Sector Since 1953

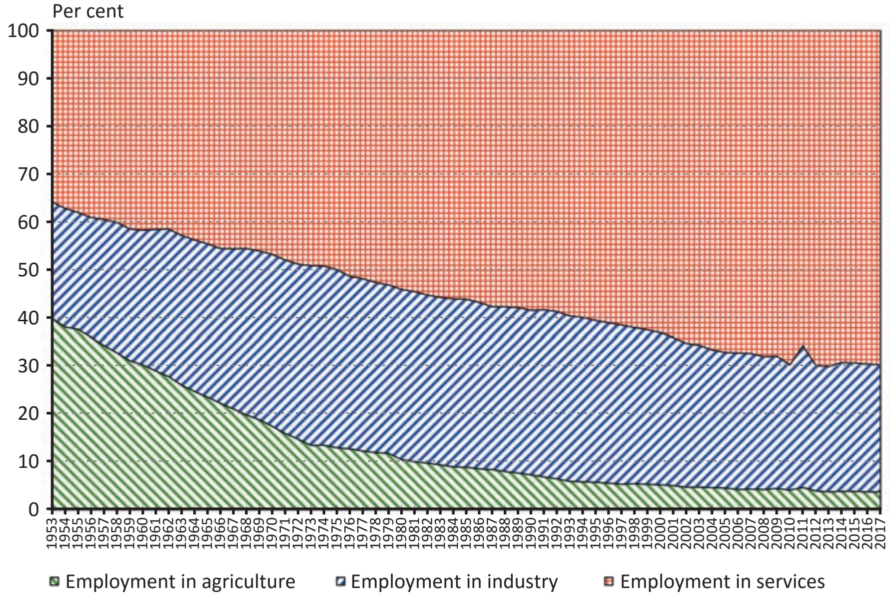


Chart 11: The Distribution of Taiwan GDP by Sector Since 1951

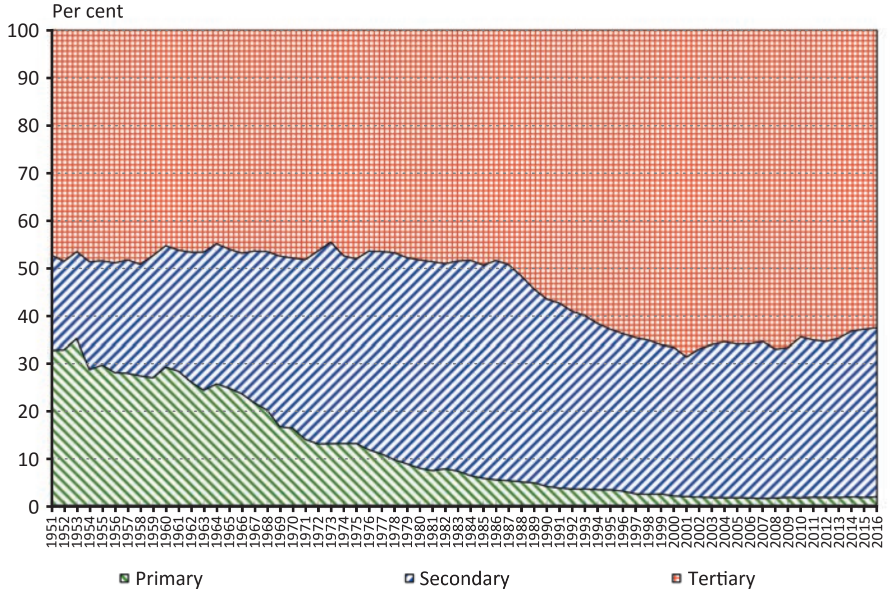


Chart 12: The Distribution of Taiwan Employment by Sector Since 1951

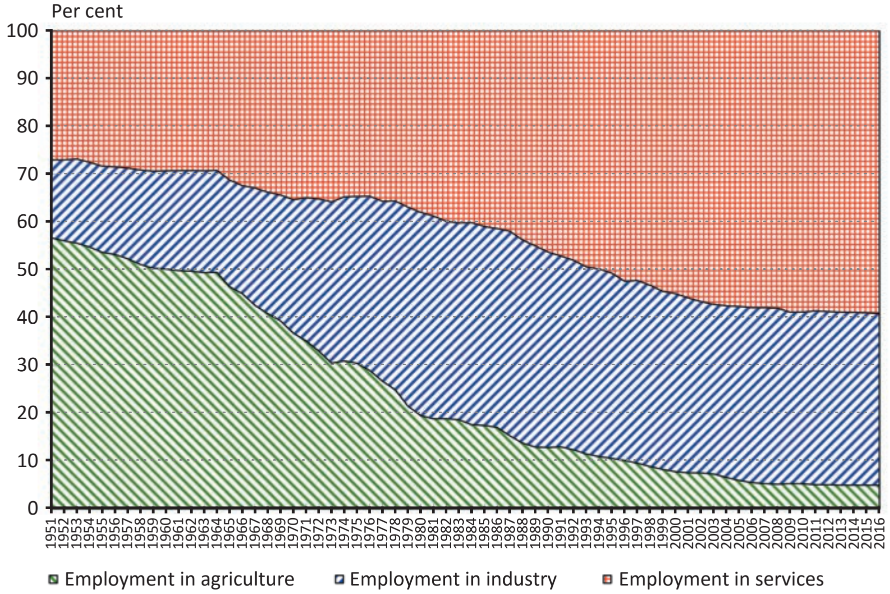


Chart 13: The Distribution of South Korean GDP by Sector Since 1965

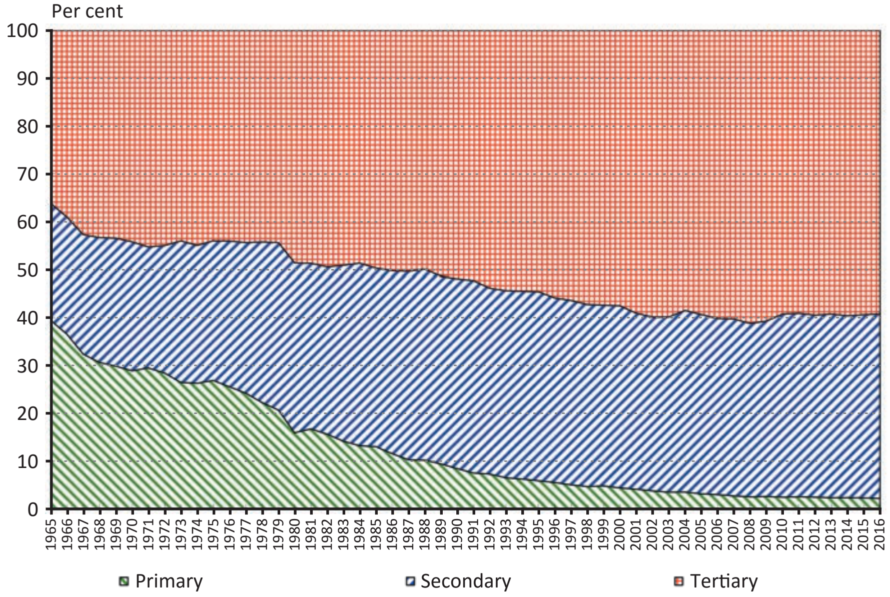


Chart 14: The Distribution of South Korean Employment by Sector Since 1970

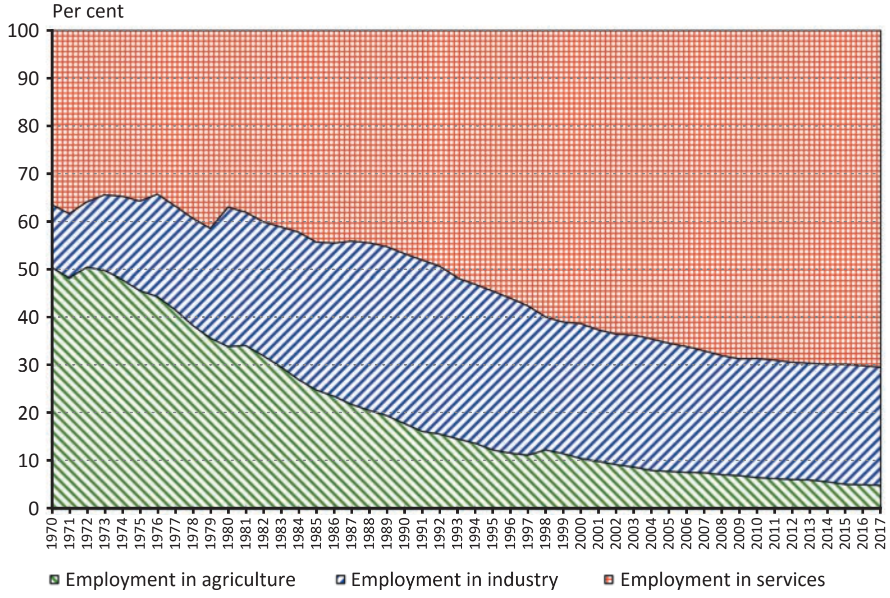


Chart 15: The Distribution of Chinese GDP by Sector Since 1952

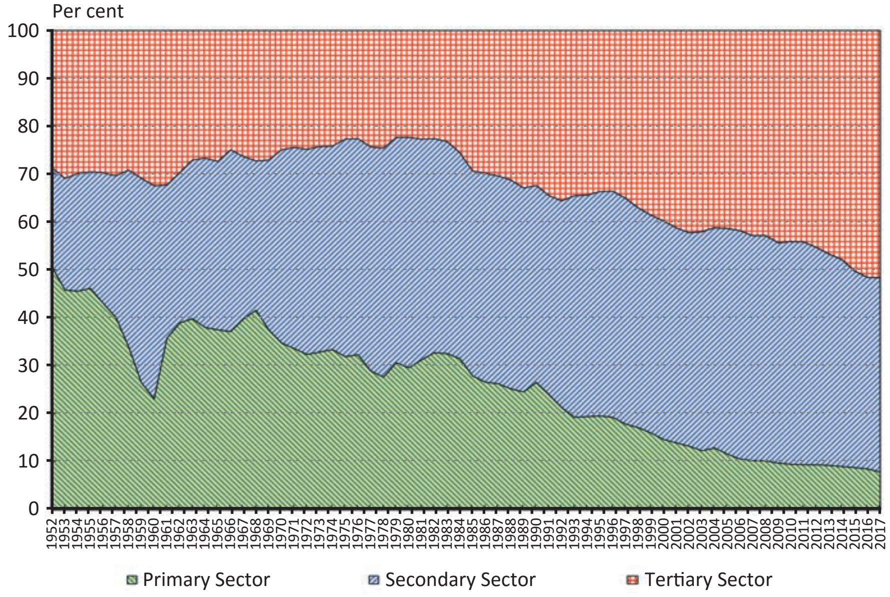
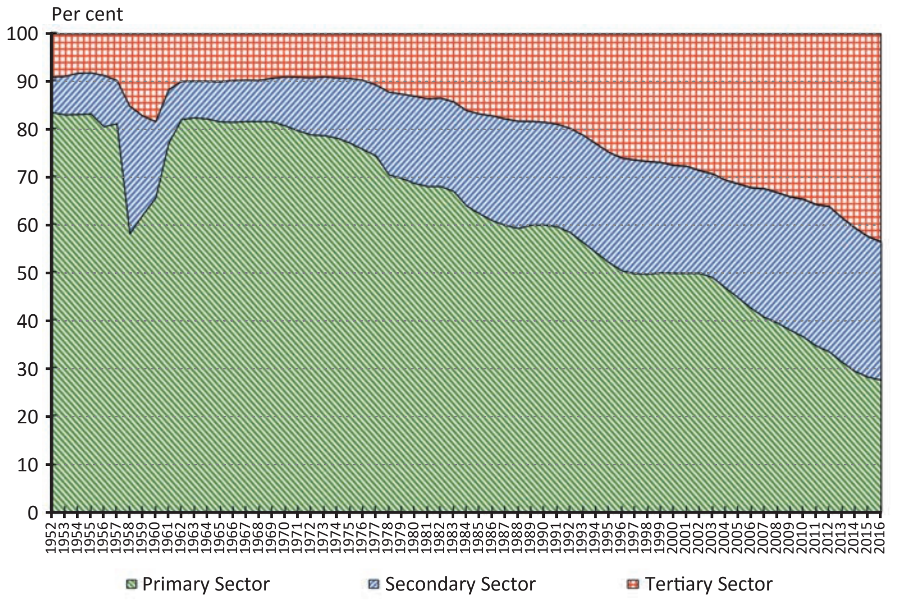


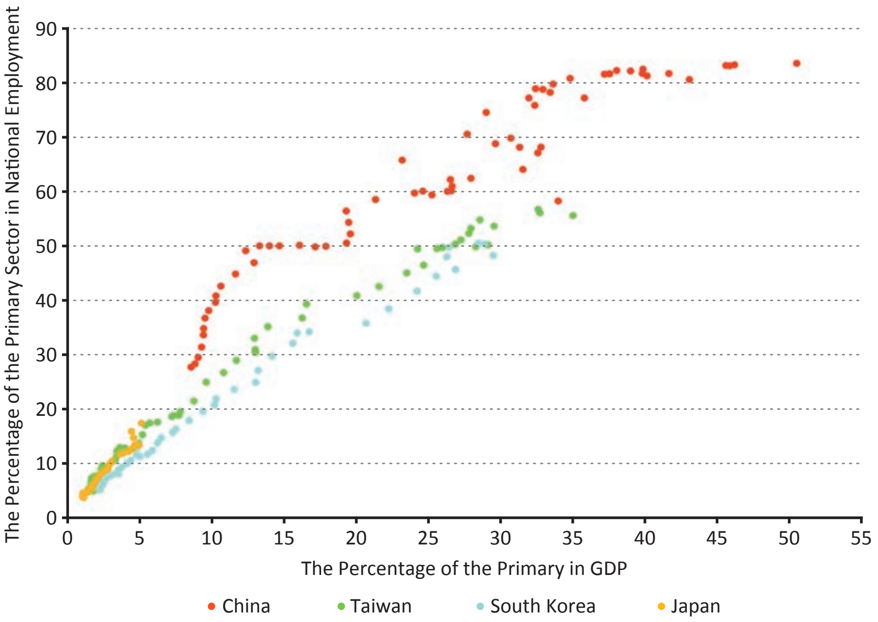
Chart 16: The Distribution of Chinese Employment by Sector Since 1952



Several common features may be identified from these charts. First, as economic development proceeded, the share of GDP originating from the primary sector would decline continuously to below 10 per cent. This has occurred in every single one of the economies of Japan, Taiwan, South Korea and Mainland China. Second, the share of employment of the primary sector would also decline, but not to the same extent as the share of GDP. It has also fallen below 10 per cent except in Mainland China, the economically least developed of the four economies. Third, the tertiary sector in all four economies, including even Mainland China, have grown to be the largest sector in terms of the share of GDP. Fourth, the tertiary sector has also become the largest sector by employment.

In Chart 17, the share of the primary sector in total employment is plotted against its share in GDP for the four economies: Japan, Taiwan, South Korea and Mainland China. It is clear that there was much more surplus labour in Mainland China historically than in the other three economies. What this means is that Mainland China will be able to continue to benefit from its surplus labour for a while longer. The primary sectors of Japan, Taiwan and South Korea have already reached a point with a very low share of employment and an even lower share of GDP originating. The primary sector of Mainland China still has some distance to go before its share of employment drops below 10 per cent.

Chart 17: The Share of the Primary Sector in Total Employment versus Its Share in GDP, Per cent

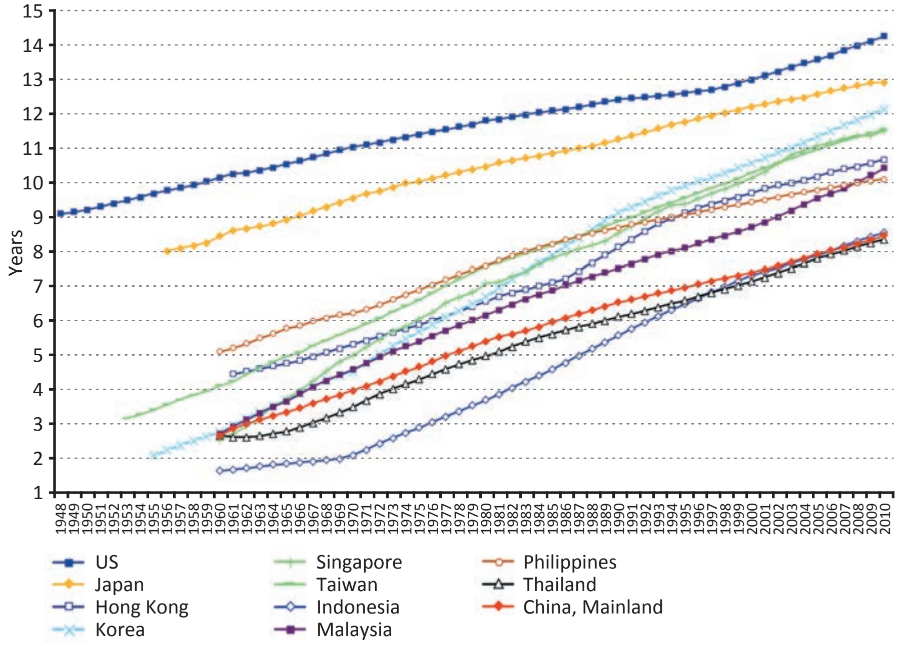


Investment in Intangible Capital

Innovation is the most important driving force of economic growth today, especially for mature developed economies with their already-high capital-labour ratios and little, no, or even negative growth in the labour input measured in terms of labour-hours. Sustained investment in intangible capital such as human capital and R&D is essential for the occurrence of economic innovation, reflected in measured technical progress or growth in total factor productivity in an economy. The East Asian economic development experience provides an example of created as opposed to natural comparative advantage. Japan, Hong Kong, South Korea, Singapore, Taiwan and Mainland China all had little or no natural resources. However, they have all shown that human capital and R&D capital can substitute for natural resources.

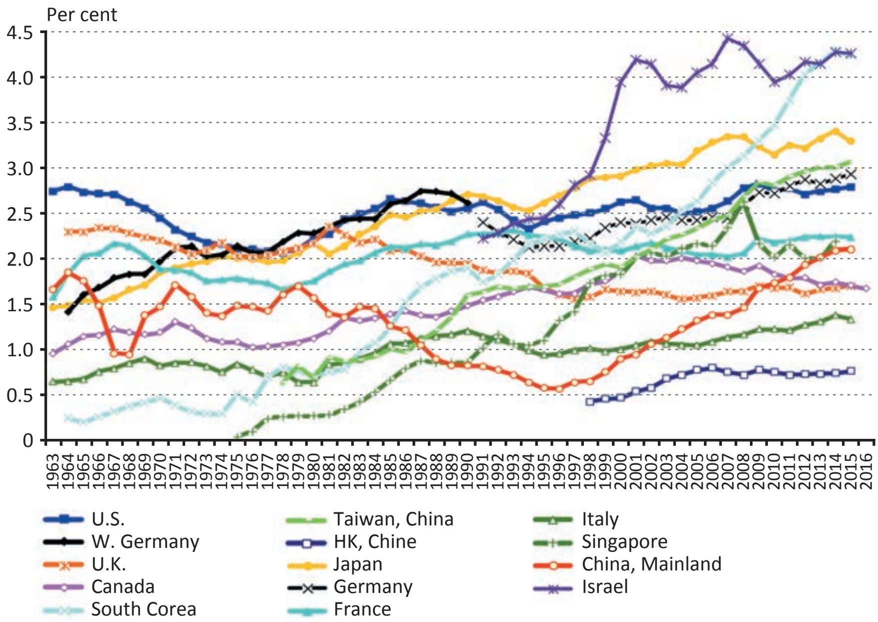
East Asians have a long tradition of valuing education. One indicator of the level of human capital in an economy is the average number of years of schooling per person in the working-age population. In Chart 18, the average number of years of schooling is compared across selected economies. By this measure, the United States and Japan are clearly the global leaders. South Korea and Taiwan have also been catching up fast. Most of the other East Asian economies also have quite rapidly increasing levels of human capital but it will take a while before they can catch up with the levels of human capital in developed economies.

Chart 18: The Average Number of Years of Schooling per Person in the Working Age Population, Selected Economies



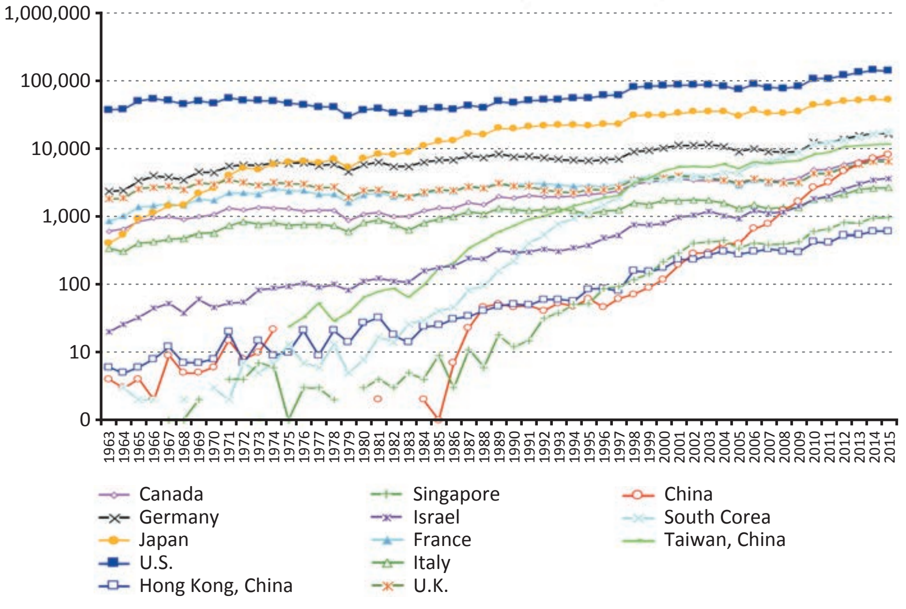
The annual expenditure on R&D as a per cent of GDP are presented for selected economies in Chart 19. It shows that the U.S. has consistently invested a relatively high per cent of its GDP in R&D. The East Asian economies, including Mainland China, have been catching up fast, with the exception of Hong Kong.

Chart 19: R&D Expenditure as a Per cent of GDP: G-7 Countries, 4 East Asian NIES, China & Israel



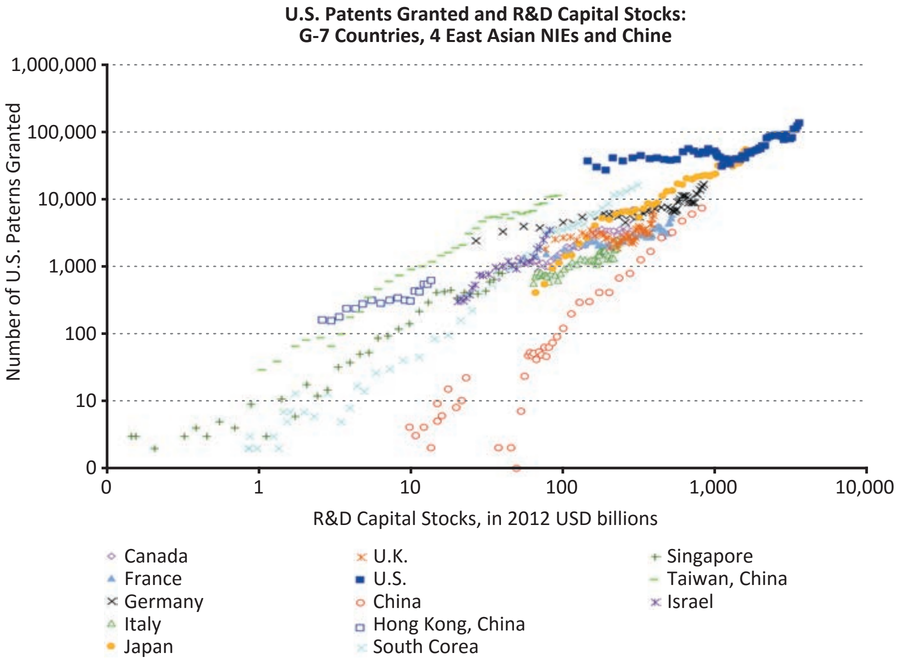
One indicator of the potential for technical progress (national innovative capacity) is the number of patents obtained each year. In Chart 20, the number of patents granted in the United States each year to the nationals of different countries, including the U.S. itself, over time is presented. The U.S. is the undisputed champion over the past forty years, with 140,969 patents granted in 2015, followed by Japan, with 52,409. (Since these are patents granted in the U.S., the U.S. may have a home advantage; however, for all other countries and regions, the comparison across them should be fair.) The number of patents granted to Mainland Chinese applicants each year has increased from the single-digit levels prior to the mid-1980s to 8,166 in 2015. The economies of South Korea and Taiwan, granted 17,924 and 11,690 U.S. patents respectively in 2015, are still far ahead of Mainland China. In contrast, the number of U.S. patents granted to Hong Kong nationals was only 601 in 2015.

Chart 20: Patents Granted in the United States: G-7 Countries, 4 East Asian NIEs, China & Israel



The R&D capital stock, defined as the cumulative past real expenditure on R&D less depreciation of 10 % per year, is a useful indicator of innovative capacity. R&D expenditures should quite properly be treated as investment since R&D efforts generally take years to yield any result. R&D capital can be shown to have a direct causal relationship to the number of patents granted. Chart 21, in which the annual number of U.S. patents granted is plotted against the R&D capital stock of that year for each economy, shows clearly that the higher the stock of R&D capital of an economy, the higher the number of patents granted to it by the U.S.

Chart 21: The Relationship between U.S. Patents Granted and R&D Capital Stocks: G-7 Countries, 4 EANIEs, China & Israel



4. Economic Development Policies

Even sound economic fundamentals do not guarantee successful economic development. The correct economic development policies must be adopted. For East Asian economies, three common economic development policies can be identified: maintenance of macroeconomic stability, opening of the economy, and export promotion on the basis of comparative advantages.

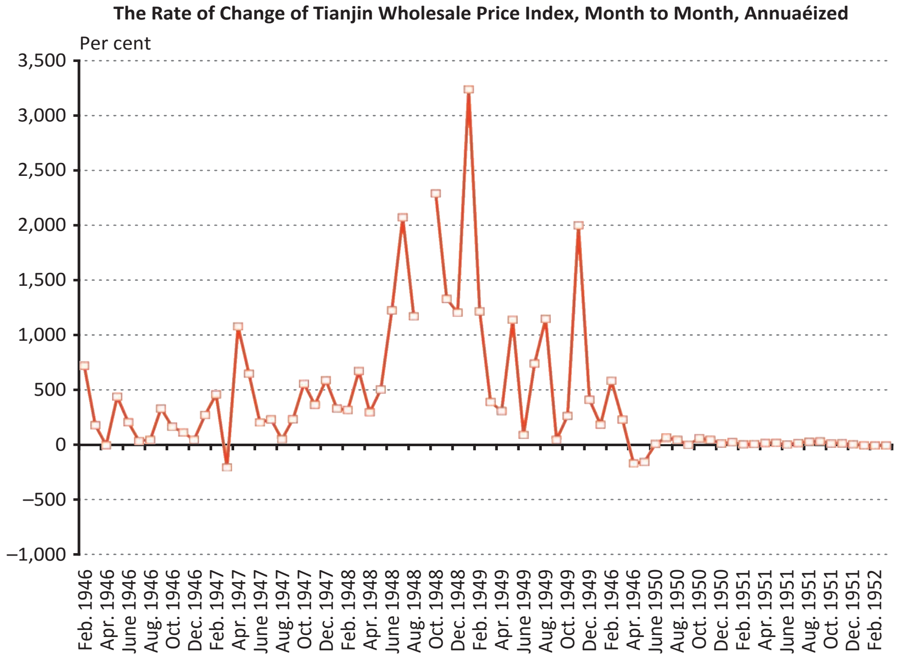
Maintenance of Macroeconomic Stability

Domestic macroeconomic stability is crucial for households, enterprises and governments to think and plan long-term. Without long-term planning, there will be no investment, public or private, and in particular, there will be no investment in the needed basic infrastructure. Moreover, opening of the domestic economy in the absence of a minimum degree of macroeconomic stability is risky because it will lead to massive capital flight, significant devaluation and even more inflation. The control of inflation is thus an integral part of maintaining macroeconomic stability. It is also essential for stabilisation of the exchange rate, which in turn makes it possible for the economic development policy of export promotion to be successfully implemented. Furthermore, a high rate of inflation often makes income distribution more unequal. Inflation favours net borrowers and penalises net savers. Low-income individuals and retired individuals are also the least able to cope with the effects of inflation.

In 1947, there was hyper-inflation in Mainland China. The late Professor Sho-Chieh Tsiang proposed the issuance of inflation-indexed retail bonds, with both the principal and interest tied to the rate of inflation, as a way to tame it. The key is that if the commitment of the government to fight inflation is perceived by the public to be credible, inflationary expectations can be changed. Regrettably, this proposal was not adopted by the Nationalist government at the time. But when the Chinese Communists came to power in 1949, they adopted and implemented the indexing proposal, launching a kind of bank deposit the principal and interest of which were indexed to the rates of change in the prices of a (weighted) basket of five goods–including rice, oil, salt and cotton cloth. These indexed bank deposits helped bring down the rate of inflation on the Mainland very quickly.

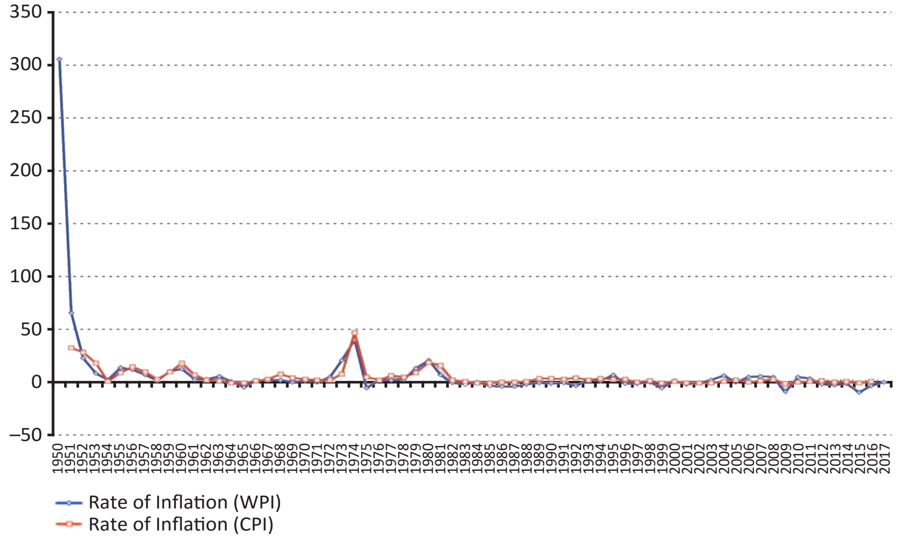
In January 1949, the rate of inflation on the Mainland was running at an annual rate of more than 3,000 per cent! By June 1950, the rate of inflation fell to only 10 per cent. By 1952, the price index began falling in absolute terms at which point the Chinese Government modified the rate of interest formula so that while it would go up with the rate of inflation it would not go down when inflation turned negative. In Chart 22, the wholesale price index of the City of Tianjin between 1946 and 1952, compiled by Nankai University, is presented. No nationwide price indices were available for China during this period, but the price index of Tianjin is believed to be broadly representative of the rates of inflation in other urban areas in Mainland China at the time. Chart 22 shows how the introduction of indexed deposits brought down the rate of inflation very quickly on the Mainland.

Chart 22: The Monthly Rate of Inflation on the Mainland, 1946-52 (Tianjin Wholesale Price Index)



Inflation was also very high in Taiwan in 1949-1950, it was also brought down relatively quickly by the government by maintaining a nominal rate of interest higher than the actual rate of inflation so that the real rate of interest would almost always be positive.

Chart 23: The Rates of Inflation of Taiwan, 1950-2017 as Measured by the Wholesale and Consumer Price Indices



Opening of the Economy

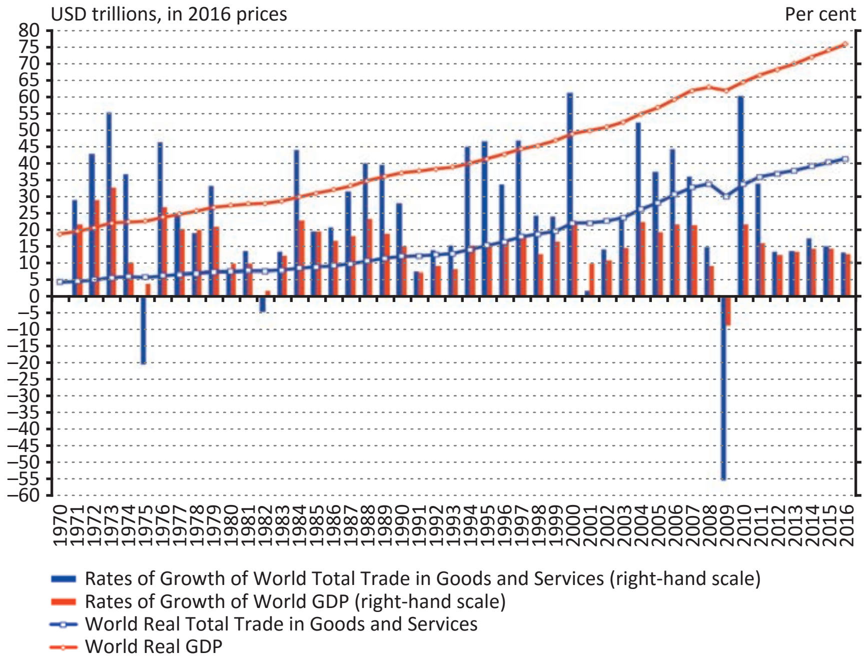
Japan, the East Asian "newly industrialised economies (NIEs)", and Mainland China all had little natural resources. Capital equipment, oil, and raw materials such as cotton, all had to be imported. Thus, an open economy is essential for their industrialisation. To finance these imports in a sustainable manner, there must be exports, and exports to the world must follow the principles of comparative advantage. In the case of these economies, they would begin with specialisation in the production of labour-intensive, light-manufactured goods. Opening the economy also attracted foreign direct investment (FDI) to augment domestic savings and facilitated technology transfer.

The Promotion of Exports

First Japan, and then Hong Kong, and then Taiwan successively and successfully adopted and implemented the economic development policy of export promotion. This was accompanied by a significant devaluation of the respective currencies and the introduction of various direct and indirect incentives for exporters. However, import substitution, rather than export promotion, was the policy of choice of Western development economists in the 1950s. For example, India was advised to engage in import substitution as a strategy for its economic development. It proved to be a failed strategy.

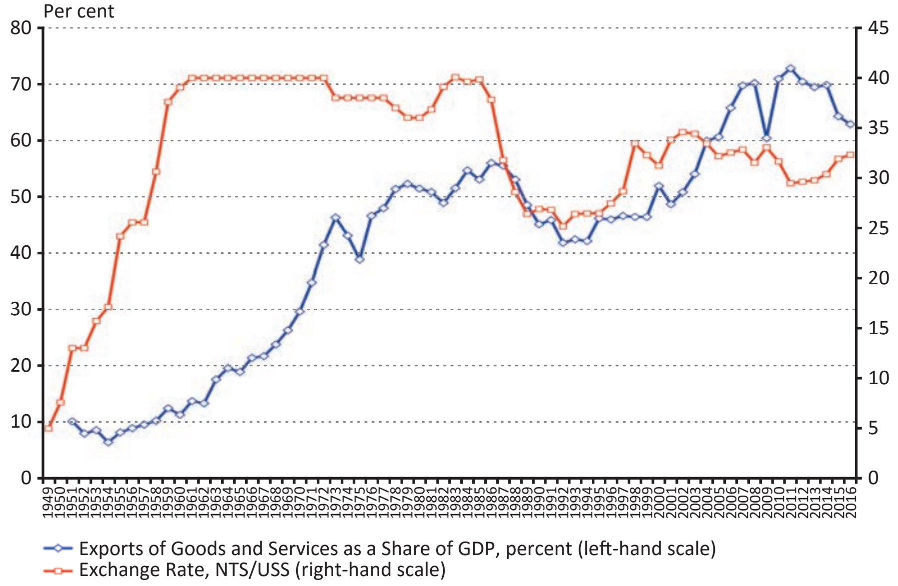
In Chart 24, the levels and the rates of growth of real world GDP and real world trade are presented. The red and blue lines in Chart 24 represent the levels of real world GDP and real world trade in 2016 prices respectively. The red and blue columns represent the rates of growth of real world GDP and real world trade respectively. It is clear that the blue columns are much higher than the red columns until the Global Financial Crisis of 2008, showing that the growth of world trade led the growth of world GDP until recently.

Chart 24: Real World GDP and Trade in Goods and Services and Their Growth Rates (2016 prices)



Among the instruments used by the examined countries for the promotion of exports is the exchange rate. It should be set at a level that makes an economy's exports competitive in the world market, consistent with its comparative advantages. In Chart 25, the weighted average exchange rate of Taiwan and its share of exports in GDP are presented. After a series of significant devaluations, the multiple exchange rates were finally unified around 1959 at approximately NTD 40 per USD. These devaluations enabled exports to increase rapidly in both absolute terms and as a per cent of GDP. By the late 1980s, exports constituted over 50 per cent of GDP. Subsequently the NTD appreciated as trade surpluses piled up. A further devaluation in 1996-1997, in response to the East Asian currency crisis, caused exports to rise further to approximately 70 per cent of GDP. Currently, exports are approximately 65 per cent of GDP in Taiwan.

Chart 25: The Nominal Exchange Rate and Exports as a Share of GDP: Taiwan



The patterns in South Korea, Mainland China and Vietnam are basically similar–a devaluation of the domestic currency leads to an increase in the share of exports in GDP (see Charts 26-28).

Chart 26: The Nominal Exchange Rate and Exports as a Share of GDP: South Korea

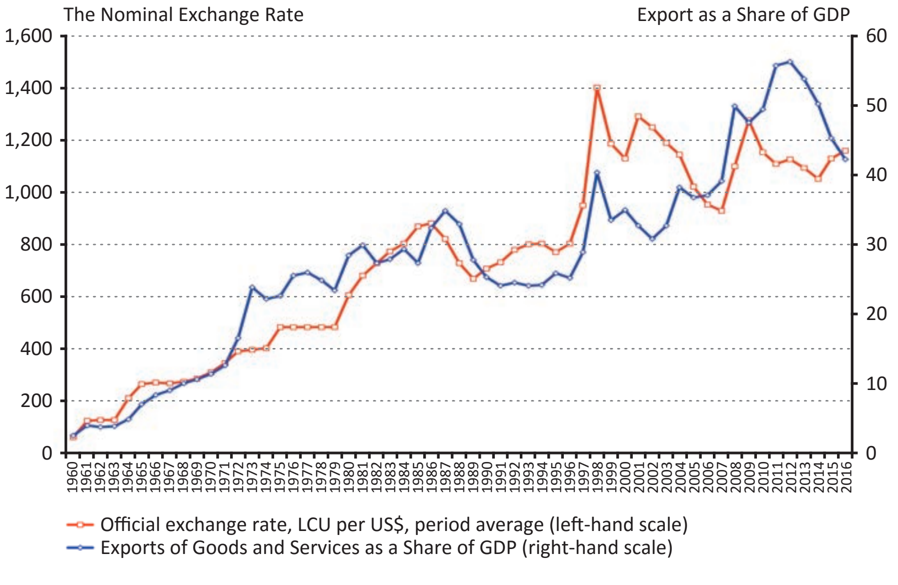


Chart 27: The Nominal Exchange Rate and Exports as a Share of GDP: Mainland China

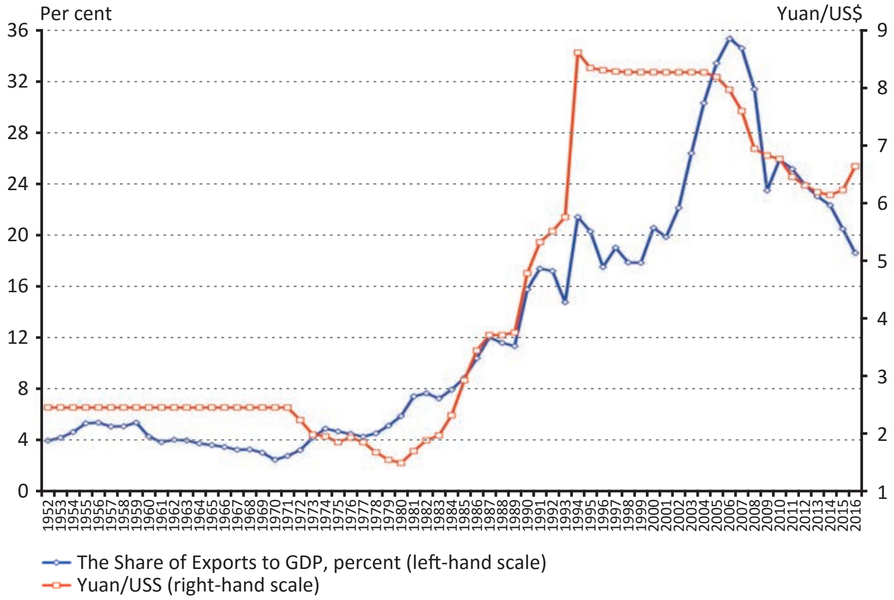
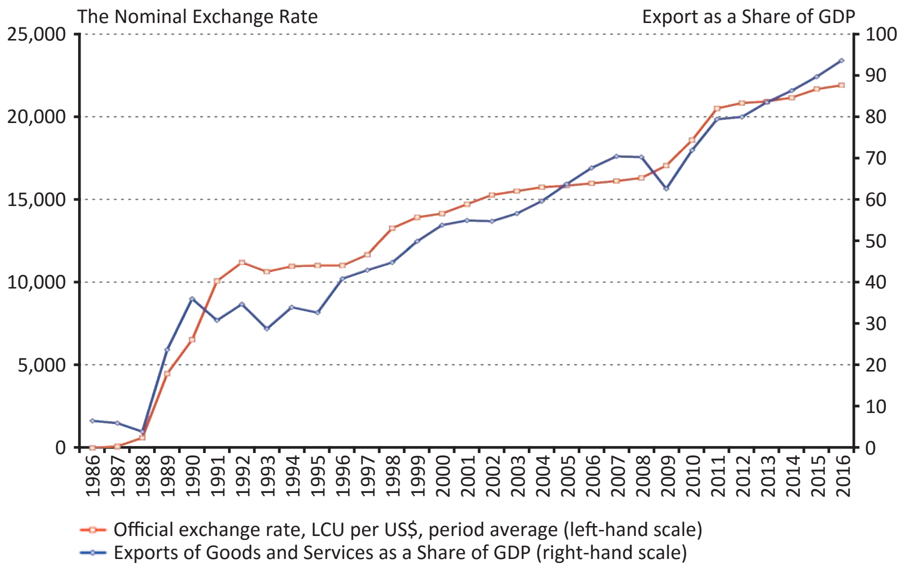


Chart 28: The Nominal Exchange Rate and Exports as a Share of GDP: Vietnam



5. The Sources of Economic Growth

Our research, starting with Kim and Lau (1994, 1995, 1996), indicates that the bulk of economic growth at the beginning stage of economic development can be attributed to the accumulation of tangible capital. There is little evidence of technical progress or growth of total factor productivity at the early development stage.[4] It is only after these economies had made significant investments in intangible capital such as human capital and R&D capital over a period of time that they began to have measured technical progress or growth in total factor productivity.

The exception would be an economy such as Mainland China, which used to operate under a centrally planned economic system, with significant inefficiency. With the launch of the economic reform in 1978, introducing producer autonomy and free markets, there was a significant increase in output through the improvement in efficiency, even in the absence of an increase in measured inputs. This increased efficiency in turn would be manifested in measured technical progress or growth in total factor productivity. Lau and Zheng (2017) attempted to estimate the degree of inefficiency on the eve of Chinese economic reform in 1978. They conclude that Chinese output could have been approximately 50 per cent higher if the Chinese economy were operating on its production possibilities frontier at the time.

6. Continuity of Governance

One common feature of the early development stages of East Asian economies is that they were all characterised by continuous one-party rule, beginning with the Liberal Democratic Party in Japan, the British Colonial Government in Hong Kong, the Kuomintang (Nationalist Party) in Taiwan, President Park Chung-Hee in South Korea, Prime Minister Lee Kuan Yew of Singapore, and then Mainland China and Vietnam, just to name a few.

The advantages of continuous one-party rule are: first, it is possible to plan long-term, without regard for the election cycle, as there is no need to settle for only short-term outcomes (basic infrastructure, so critical in the early development stage, can only be provided by a government with a long-term perspective); second, there is consistency, continuity and predictability in economic policy; and third, households and enterprises can share a common long-term vision and common expectations about the future, facilitating investment planning and coordination. Of course, this is not to say that

[4] See also Krugman (1994).

there are no disadvantages to continuous one-party rule. Many countries governed by dictatorships are among the poorest in the world. But when one-party rule works well, it is better and more efficient than any other system.

7. Concluding Remarks

The development experiences of East Asian economies show that an open global economy can provide the environment for developing economies to grow and prosper through international trade. East Asian economies have all benefitted significantly from economic globalisation since the Second World War. The East Asian experiences also show that domestic macroeconomic stability is important. Without macroeconomic stability, no one will think or plan long-term, and investment will dry up. Moreover, opening of the domestic economy in the absence of a minimum degree of macroeconomic stability is risky, because it will lead to massive capital flight, significant devaluation and even more inflation. A low rate of inflation is also essential to the maintenance of a relatively stable exchange rate and the success of an export promotion policy.

The development experiences of East Asian economies also confirm the importance of sound economic fundamentals: a high domestic savings rate, the existence of abundant surplus labour, and investment in intangible capital provide the necessary domestic conditions for an economy to grow and prosper. However, a source of aggregate demand is also needed in order to be able to make full use of the domestic resources, especially the surplus labour. Exports can provide the initial growth in aggregate demand. Today, no one argues seriously for import substitution as the sole policy to promote economic development. One important reason is the lack of sufficient domestic demand when the GDP per capita is still at a low level. Another important reason is that what needs to be imported can only be produced domestically at a very high cost, even if it is possible to do so at all. Most economies are better off exporting other goods that they can more easily make themselves, capitalising on their comparative advantages.

Finally, the continuity of governance has been an important factor in the early stage of development of East Asian economies, as it facilitates not only long-term planning but also faithful implementation of the plan once adopted. This affects, in particular, the investment in needed basic infrastructure such as highways, ports and power plants, which is especially critical at the early stage of economic development.

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GYÖRGY SZAPÁRY

Chief Adviser to the Governor,
Magyar Nemzeti Bank

Challenges of the European Integration Project

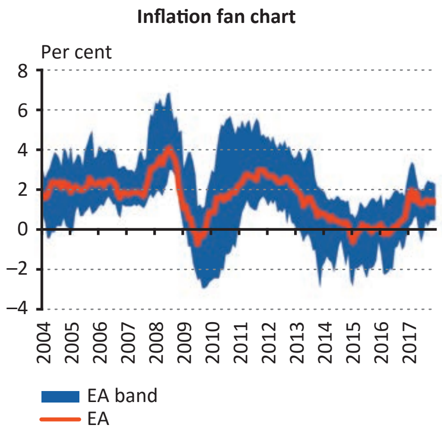
We have an excellent panel today with four speakers who have been closely involved with developments in the European Union for many years, even decades. As a moderator of this panel, I would like to put on the table some issues which the panel may want to comment on. It seems that the EU has weathered the worst of the great financial crisis, as Member States across the board have resumed growth. At one point during the depth of the crisis, there was talk about Greece leaving the monetary union, but those voices have been silenced as the country, at the cost of enormous sacrifices and helped by debt restructuring and massive financial support from the EU and the IMF, substantially cut the budget deficit and the economy has started to grow again. Nevertheless, many reforms still need to be implemented in Greece to put the country on a sustainable growth path. At the euro area level, several measures encompassing a vast area of economic management have been taken since the onset of the crisis in 2008 to make the monetary union and the EU at large more crises prone. The fiscal and macroeconomic surveillance procedures have been strengthened by introducing new rules, financial supervision has been reinforced and regulation tightened as part of establishing an EU-wide Banking Union. Furthermore, the European Stability Mechanism (EMS) has been set up with the intention of serving as a firewall for euro area countries to limit the spill-over effects of future financial crises.

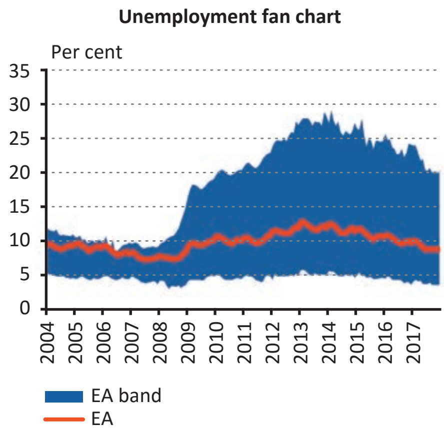
Recently, there has been a new push to revitalise the European integration project, spearheaded by President Emmanuel Macron. Ideas put forward on which there seems to be a certain consensus include the completion of the Bank Union by, inter alia, improving the single rulebook, strengthening the bank resolution regime and creating an EU-wide bank insurance regime. There also appears to be consensus to move toward creating a capital market union by reducing the fragmentation of the capital markets and to transform the EMS into a European Monetary Fund.

Ideas which garner less support are establishing a Eurozone budget, nominating a euro area Minister of Finance, providing financial incentives for joining the monetary union, creating euro area "safe" assets, tax harmonisation, pan European members of parliament and enlargement by offering EU membership to six western Balkan countries in the not too distant future. Other serious challenges facing European policy makers are Brexit and how to deal with mass migration into Europe. It is not my role as a moderator to enter into a discussion of these topics, but let me put on the table a couple of issues.

Prior to the crisis, large differences in domestic inflation rates and the ensuing losses of competitiveness, besetting mostly the Mediterranean Member States, were one of the causes of stresses within the euro area. With the worldwide moderation of inflation, the differences have been substantially reduced. At the same time, however, the differences in the unemployment rate have considerably widened, as can be seen from the fan charts on Chart 1. Many of the Member States with a high unemployment rate also have high debt levels which constrain their fiscal space for stimulating the economy. This creates a real challenge for the countries within the euro area where the common monetary policy is not backed by any type of common fiscal support at the Eurozone level. For the time being, there is little enthusiasm for a fiscal union on the part of countries which enjoy a larger fiscal space that could play a stabilising role at the euro area level out of fear that their taxpayers would have to foot the bill for bailing out fiscally irresponsible countries. The experience with fiscal rules has not been very encouraging so far, but the financial crisis has stimulated thinking about ways of enforcing fiscal discipline, coupled perhaps with some financial support, in order to maintain a healthy functioning of the monetary union.

Chart 1: Inflation and Unemployment in the Euro Area, 2004-2017





Source: Eurostat

Let me turn briefly to another issue that creates an increasingly difficult challenge for the EU, namely emigration from Central- and Eastern-European (CEE) countries to the old Member States. Table 1 shows the emigration in per cent of the total population and of the working age population of CEE countries. Based on 1 January 2016 data, emigration from CEE countries represented 11 per cent of the total CEE working age population. This means that every ninth CEE working age person lives in one of the old Member States. This can be even higher since it does not include persons who in the meantime obtained citizenship of the country where they work. The emigration ranges from 2 per cent of the working age population in Slovenia to 23 per cent in Romania. The largest recipient countries are Germany, the United Kingdom, Italy and Spain. Germany receives 26 per cent of the CEE emigrants, followed by the United Kingdom with 23 per cent (Chart 2). There are also guest workers who are sent out by their CEE employers for shorter periods of time to work in the old Member States.

*Table 1: Emigrants in per cent of population in CEE countries, based on 1 January 2016 data**

Countries	**Emigration to EU-15** ***(in per cent of total population)*****	**Working age (20-64 yrs) emigrants to EU-15** ***(in per cent of working age population)******
Bulgaria	10%	12%
Croatia	9%	16%
Czech Republic	1%	2%
Estonia	6%	7%
Hungary	4%	6%
Latvia	9%	13%
Lithuania	11%	15%
Poland	6%	9%
Romania	15%	23%
Slovakia	4%	5%
Slovenia	3%	2%
TOTAL (weighted)	**7%**	**11%**

** Data do not include the persons who in the meantime obtained citizenship of the country where they work.*

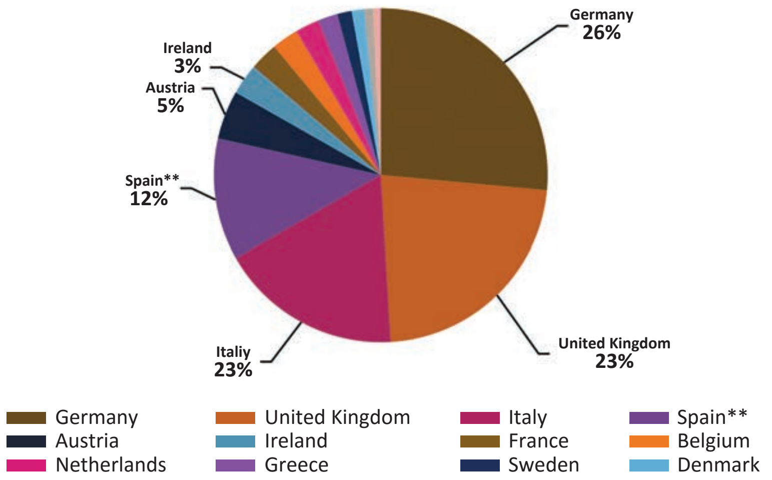
*** Emigrants to Spain are available only from selected CEE countries.*

**** Data are based on 2016 Annual Report on intra-EU Labour Mobility. For some receiving countries data for certain sending countries are not available.*

Source: Eurostat

*Chart 2: Emigration distribution from CEE countries, based on the whole population**

Total emigration is based on 1 January 2016 data (in per cent)



** Data do not include the persons who in the meantime obtained citizenship of the country where they live.*

*** Emigrants to Spain are available only from selected CEE countries.*

Similarly to capital, the labour force moves to places where its productivity is greater, which is awarded by higher salaries. In the old Member States, labour productivity is, by and large, higher than in CEE countries owing to more advanced technology and better work organization. CEE workers are attracted by the better pay which, in principle, optimises output at the EU level, but the income stays in the receiving country, that is only partly offset by the remittances of the emigrants. At the same time, there is a growing labour shortage in CEE countries which sets back their growth potential. It is difficult to say whether this large emigration to the old Member States represents a net gain or a net loss for the level of output in the EU as a whole. If it slows down the catching-up process of CEE countries, its effect is negative over the longer term and does not help the strengthening of social cohesion of the European Union. The EU transfers to CEE countries certainly helps with the catching-up process, but cannot offset the potential loss of output due to such large losses of the labour force.

There is also another anomaly worth pointing out. The unemployment rate is often lower in the sending countries, i.e., Bulgaria, Czech Republic, Hungary, and Romania than in the receiving countries, such as France, Italy and Spain. This can be due to insufficient labour mobility or the lack of skilled workers in the receiving countries; or simply because employers prefer to hire immigrant workers because they accept lesser pay which lowers the labour cost of production. Whatever the reason, it contradicts the labour mobility criteria of the optimum currency area thesis which states that labour should move from high unemployment to low unemployment areas, thus optimising the output in the single currency area as a whole.

I am raising these issues regarding intra-EU migration before handing over the discussion to the distinguished panellists, because I feel that it has not received the attention it deserves. Free labour mobility is one of the cornerstones of the single market. The issues outlined above provide strong arguments for maintaining the EU transfers to CEE countries in order to help with their catching up. The faster these countries grow, the more they will pay into the common EU budget and the faster they will become net contributors.

THOMAS WIESER

former President, Eurogroup Working Group
and Economic and Financial Committee of the EU

Globalisation and European Cooperation: Stand together or fall Divided

Thank you Mr. Governor and all our other hosts. Thanks György Szapáry, also for your introduction. Marco and I tried to slightly recalibrate our presentations in view of this morning's presentations so that they fit even more closely with what we have already heard.

A couple of years ago I read a book titled, *Why the West Rules - For Now*. The author Ian Morris wrote it back in 2010. Today in 2018, the book would probably have a different title. Nevertheless, it was rather prescient, and things have developed even more rapidly than the author may have imagined.

The changes we are experiencing may well be some kind of reversal to more historic normal times before, around 400 years ago, the Northern-Atlanticist economies started accelerating, and the historically high GDP per capita in China started declining, relative to what essentially was then Western Europe.

The rebalancing started some 20 or 30 years ago. Amongst others Branko Milanovic has summarised excellently how the developments over the past decades have impacted on global inequality, which has seen a very significant downward movement. On the other hand, in Western-European and Northern-American societies, by and large inequality has gone up.

For the broad population there is the populist or popular conception that globalisation is to be faulted for rising inequality. A year or two ago, there was an excellent study (or rather meta-study) by the IMF, in the Global Financial Stability Report, which showed the relative contributions of globalisation and technological change to these developments. For our economies, i.e. for the Western-European, Central-European, Northern-American economies, it showed that far more than trade or globalisation technological change was responsible for growing inequality.

Now, as we see very much from this conference we do not live on a continent in isolation, but which has historically been linked very, very closely to other parts of the world. In a very prescient manner Europe already some decades ago started its programme of the Internal Market, which people take for granted nowadays. At the time it was a strategic game changer. Its creators realised that a large internal market which follows the same rules, procedures, standards etc., leads to more efficient production, to economies of scale and which thus makes European firms more competitive on world markets.

So, long before the issue of globalisation emerged on the popular agenda, and long before people started reflecting on "what is the future of Europe because of the rise of China", politicians and policy-makers were addressing this issue. With all of our deep thinking about how to deepen, how to strengthen, how to do this that and the other, we should not forget that the Internal Market is one of the real economic backbones of Europe. Strengthening it is a pre-condition for a strong position by Europe in the world.

In addition to the Internal Market, amongst the EU12 successive waves of enlargement have significantly enlarged it and made it that much more efficient and welfare enhancing. György Szapáry has already made direct and indirect reference to this, and also how economic and monetary union added a high degree of exchange rate stability for 19 Member States of the EU.

The great financial crisis has had significant effects on our economies. This has been well documented, and I will not go into the details of the succession or concatenation of different crises we have experienced: The banking crisis, the debt crisis, the sovereign debt crisis and finally the Euro crisis. I leave it to other speakers today to comment on the relative roles of loose monetary policies, financial deregulation, or extremely bad financial supervision in causing the crisis.

But apart from these I would like to mention three additional factors leading us into the crisis, which I may characterise as follows: The first one is 'shop until you drop', that is the fiscal element of crisis, think for example of Greece.

The second one is 'fall asleep in the hammock'. Think for example of Portugal, where once you have joined monetary union the self-discipline one has outside a monetary union is replaced by complacency. This feeds through the whole economy via effects on wage setting mechanisms, price setting mechanisms and leads to an inexorable drift of relative unit labour costs, of widening current account imbalances, a loss of competitiveness and, ultimately, as we saw in the case of Portugal, a loss of access to capital markets.

The third problem which was very pronounced within monetary union could be called ’close your eyes and pray’, which has something to do with banking supervision, think of Ireland, think of Spain. So, we had three issues within monetary union which made the crisis much more pronounced than it was outside monetary union.

Put slightly differently: there was a lack of well functioning fiscal rules and coordination, some would say that there was a lack of a budget, there was no banking union, and the emerging imbalances were not acted upon by policy makers.

I will not go into all that has been done due to our time constraints. Suffice it to say that we have progressed significantly with banking union and a number of other initiatives. György Szapáry mentioned President Macron’s initiatives, papers by the Commission, discussions and decisions by heads of state and I think that Marco will go into these issues later.

We have also been confronted with the institutional lacuna of monetary union. These are quite existential questions, which will be with us over the next 10 years and which we have to solve together. The first big question is the relationship of ins and outs, i.e. between members of monetary union and those that are not part of monetary union. For now, there is a fairly stable relationship, but this will tilt dramatically once the UK leaves the European Union next year as the relative weight of the outs will go down. This will lead to perceptions, rightly or wrongly, of marginalisation in decision-making. We have to fix this issue very rapidly.

Added to that there is, of course, the question of further enlargement, which is not for this year or next, but somewhere in the next decade further enlargement will be with us. The EU is institutionally not prepared for this step. A second issue which has been quite divisive over the whole crisis is the increased division of opinions between North and South, or between the Calvinists and the Catholics. This has led to a quite significant polarisation in policy approaches which somehow needs to be resolved.

Mention has already been made of a still perceived dichotomy between East and West, new Members States versus old Member States. You could possibly also say net contributors versus net recipients. From a perspective of the euro area I have not experienced this as a problematic dichotomy. Differences in approaches are lower than compared to the North – South divide.

Many of these problems also stem from our low growth and low productivity environment. On average potential output growth is somewhere between 1 % and 1.5 %, and at that rate we will not be making significant inroads, especially in some southern Member States, into existing unemployment stocks. Of course, there is also the question of the impact of low productivity growth and low growth on the process of further convergence between Central and Eastern European Member States and Western Member States.

As in many other areas, there is also in these issues the question of what the division of responsibility between Brussels and Member States is. I come from a country which is not so atypical, where – if in doubt – something difficult pops up you say Brussels has to solve it. If something unpleasant pops up, you say this was Brussels. But in reality if you look at responsibilities for economic polices, 90 % of the issues that influence our competitiveness, our productivity, lie with national politicians, lie with national economic policy. It is not by and large the fiscal stance that counts, it is the composition of the budget that will have a medium and long-term influence on your competitive position in Europe.

What has been exerting us more and more over the last one and a half years is the one big question: what is Europe's relationship with the rest of the world? Alicia mentioned this in her contribution this morning. It seems to me that we are still – and I say very much *still* – living in a world of multilateral rules and multilateral institutions and governance, which were designed by Northern-Atlanticist economies after the Second World War.

We have two pull factors. One is the increasing self-unilateralisation of the United States. The second question I increasingly ask myself is whether China and other large emerging economies will, in 10 or 20 years, still be willing to live and trade and produce in a world of such rules and institutions that were designed by countries which do not have the same economic model? Is the rulebook of the WTO, or of the IMF and other organisations compatible in the very long run with the economic model of China and others?

This leads to the question of whether one wants to have one set of rules globally, even if it may be not so perfect but to which everybody accedes. Or, are we faced with a danger that we may have different sets of rules globally in the medium term. If we have different sets of rules, then the globalised world that we trade with may start to be pulled apart. This would lead to a period, probably a very long period, of de-globalisation.

So, no matter what or how this develops it is clear to me that Europe has a choice. Europe can be a player in this large game of Europe, Eastern-Asia and the US working together or against each other in order to shape a system of rules and governance. But if Europe is not a player, then it is the football that is kicked around by the players. That is more or less the choice that we have. For me it is also quite clear that it is either Europe or it is nothing, because the individual Member States – be they such extremely large economies as Hungary or Austria, or even Luxembourg, or be they the smaller economies of France and Germany – we are all small. Either we are large together or we are small individually.

So, these questions, to come to a conclusion, these questions are not separate issues. If we want to have a good discussion and solution where Europe is a player in this trilateral game and discussion, we also have to solve the other questions that I mentioned: Ins and Outs, East and West, North and South, Brussels vs. National. If we do this together, I think we will be a significant player on a level playing field with Eastern-Asia and we will see in which direction the US will develop.

This is a two-step procedure: First, we need to continue our cooperation within Europe, we have to make people aware of what the huge costs of a non-Europe on a global scale are, and not only serve the nitty-gritty of intra-European day-to-day obsessions. And, then, I believe that a transformation of the East and a transformation of the West will be able to take place under global unified rules of governance.

Thanks very much.

MARCO BUTI

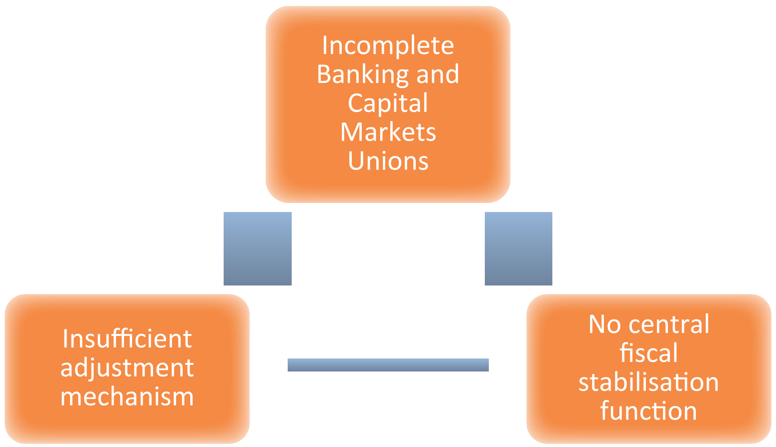
Director-General for Economic and Financial Affairs
European Commission

Deepening of the Economic and Monetary Union

Major steps have been taken to reinforce the integrity of the single currency since the financial and sovereign debt crisis. The crisis revealed various weaknesses in the Economic and Monetary Union's (EMU) construction and triggered some deep institutional reforms aimed at restoring and later safeguarding financial stability. First, the euro area was equipped with crisis resolution mechanisms. We now have the European Stability Mechanism (ESM) to provide financial assistance to euro area countries experiencing or threatened by severe financing problems. Second, several key elements of Banking Union were also put in place. We now have a Single Rulebook that provides a single set of prudential rules and is applicable throughout the EU. It also acts as a foundation for the single market in banking and for the Banking Union. We also have a Single Supervisory Mechanism (SSM) to supervise the most significant banks in the euro area. In case a significant bank fails, it is resolved centrally and according to the same standards through the Single Resolution Mechanism (SRM). Third, the Capital Markets Union (CMU), which is a key component of the EU's Investment Plan for Europe and is designed to boost European investment and create jobs and economic growth, has been launched. Many measures have been implemented since the start of the CMU to make it easier for companies to access capital and for individuals to invest their money in new ways. Fourth, the macroeconomic and fiscal surveillance of Member States has been significantly strengthened with the introduction of the Macroeconomic Imbalance Procedure, enhanced national fiscal frameworks, and stronger preventive and corrective arms of the Stability and Growth Pact, the set of rules designed to ensure that Member States pursue sound fiscal policies.

Although a lot of progress has been made, there is a broad consensus that the current setup of the EMU remains incomplete. A determined response to the crisis stabilised the situation, but some challenges still need to be addressed. The EMU today continues to rest on an unsustainable equilibrium. The incomplete nature of the financial union (Banking Union and CMU) and the absence of a fiscal stabilisation function for the euro area as a whole, imply insufficient mechanisms for the absorption of shocks. At the same time, the current asymmetric nature of the surveillance processes – which put more emphasis on correcting fiscal or external deficits and have less influence on how to handle significant surpluses – coupled with the absence of a central fiscal stabilisation mechanism, means that it is impossible to achieve simultaneously an appropriate fiscal stance for the euro area as a whole and an optimal distribution of the fiscal effort that enables the right balance to be struck between stabilisation and sustainability at the national level. Moreover, governance of the EMU has become too complex. The design of the EMU's architecture reflects a process of incremental integration over the past thirty years. As a result, the institutional architecture of the EMU is now a complex mix of EU and inter-governmental institutions. The common interest of the euro area is currently insufficiently represented within the governance of the EMU and the system is perceived in some quarters as lacking legitimacy and accountability at the appropriate level.

Figure 1: EMU today: an unsustainable equilibrium



Financial Union

Although the financial system has stabilised significantly over the past few years – due to the adoption and implementation of new EU banking legislation, the creation of the Banking Union and the policies of the ECB – some vulnerabilities in the financial sector remain.

One crucial vulnerability of the current structure of the euro area financial system, is that sovereigns and banking sectors in some Member States are still deeply interlinked, with, in some cases, high levels of sovereign debt held mainly by local banks. This leads to a strong correlation between the refinancing costs of banks and the value of their collateral on the one hand, and their respective sovereigns. This creates a "home bias" or "feedback loop" that works in both directions so that a problem arising in either of the two sectors unavoidably leads to a destabilisation of both. One of the objectives of the Banking Union since its inception has been to further loosen the interconnection between banks and their "home sovereigns". Supervision and resolution of larger and systemic banks within the Banking Union is now conducted centrally and no longer at national level. They are both indifferent to geographical factors in their supervision and resolution strategies. This should help banks to geographically diversify their investments and further weaken the "bank-sovereign nexus" and thereby strengthen cross-border risk sharing via the private sector. The Capital Markets Union should also reduce the "home bias" of banks' other activities and assets. Another source of vulnerability that requires policy makers' attention is the high level of public and private debt in certain member states, and particularly the high level of so-called "non-performing loans" (i.e. loans that may never be fully repaid).

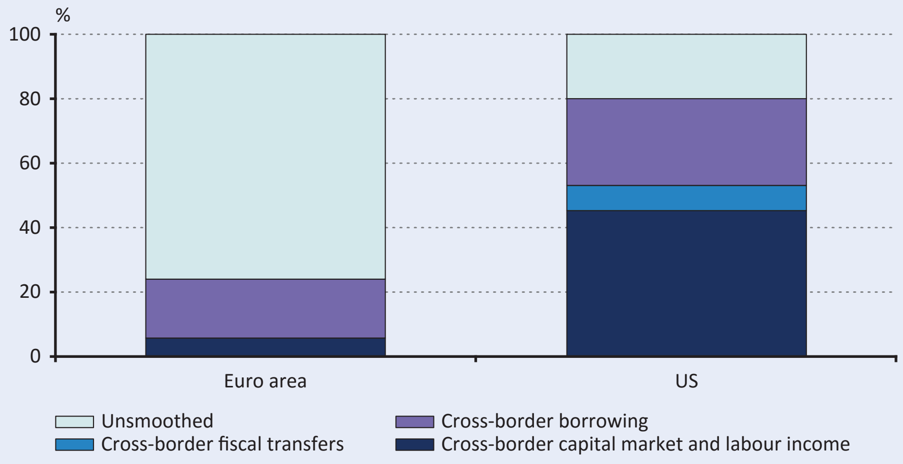
Risk-sharing and risk-reduction have been proposed to strengthen the resilience of the EMU and its financial sector. In November 2016, the Commission proposed a comprehensive package to reduce the risks carried by banks by further reinforcing prudential management and by strengthening market discipline. The Commission also suggested measures in relation to insolvency, restructuring and second chances. On the risk-sharing side, technical work on a backstop for the Banking Union, which would guarantee the credibility of the Single Resolution Mechanism and would intervene as a last-resort to shield taxpayers from paying for a failing bank, has begun. The European Commission also proposed a European Deposit Insurance Scheme (EDIS), which would enable all depositors across the euro area to enjoy the same degree of protection, particularly in case of large local shocks which might overwhelm a national scheme. Lack of progress in public and private debt reduction, however, seems to have limited the political appetite for solidarity and the introduction of risk-sharing mechanisms.

Although sometimes presented as such, risk-reduction and risk-sharing are not mutually exclusive approaches towards strengthening the EMU. In fact, the only viable solution – from both an economic and a political perspective – is to reduce risks and increase risk sharing in parallel. Overly focusing on risk-sharing or solidarity would create moral hazard, lack of policy discipline, and ultimately, higher risk. Similarly, excessive focus on risk-reduction measures would, ironically, lead to increasing risks. For instance, some far-reaching forms of risk-reduction, such as limiting the exposure of banks to their sovereigns, also require collective risk-sharing to minimise the risk of financial distress in more indebted Member States with the potential of a domino effect between Member States. After all the effort to regain financial stability, there are good reasons in favour of proceeding very carefully and ensuring that all available means to increase and preserve financial stability in the euro area are deployed, before any changes to the regulatory treatment of sovereign exposures are considered. The preconditions would include the completion of the Capital Markets Union and the Banking Union with a functioning backstop to the Single Resolution Fund and European deposit insurance – as well as the introduction of a suitable common European safe asset to secure stability in the euro area banking system and a continuous access of sovereigns to affordable financing. This is why the Commission emphasised in its reflection paper on deepening the EMU that any decision regarding a euro area safe asset and the regulatory treatment of sovereign exposures should be taken at the same time. A safe asset would be even more important if one were to contemplate introducing additional market discipline in the system through sovereign debt restructuring mechanisms.

Box: Smoothing income shocks in the euro area compared to the US

A study by the European Commission compared the relative roles of private and public risk sharing in the euro area and the US.[5] The results of the study clearly show that the euro area lags significantly behind in ensuring against asymmetric shocks, and highlights the untapped potential of private channels of risk sharing. A comparison with the US is relevant because the US can be seen as an economic and monetary union that has developed the necessary institutional framework for ensuring against large localised shocks by 'cross-border' means. It is a functioning banking and capital markets union and it also has provisions.

Figure 2: Cross-border risk sharing through different channels, in % of total asymmetric shock to output



Source: Buti et al. (2016). Smoothing economic shocks in the Eurozone: The untapped potential of the financial union, VOX August.

[5] Buti M., Leandro J., Nikolov P. (2016), Smoothing economic shocks in the Eurozone: the untapped potential of the financial union, 25 August 2016, https://voxeu.org/article/smoothing-economic-shocks-eurozone- untapped-potential-financial-union for smoothing of shocks by fiscal means.

- First, **the direct impact of output shocks on consumption is almost four times bigger in the euro area** – close to 80 %. In other words, a 1 % decline in GDP leads to a decline of about 0.8 % in consumption in the euro area, against only 0.2 % in the US. This shows the huge potential for improving cross-border shock absorption in general, including by completing the architecture of the EMU.

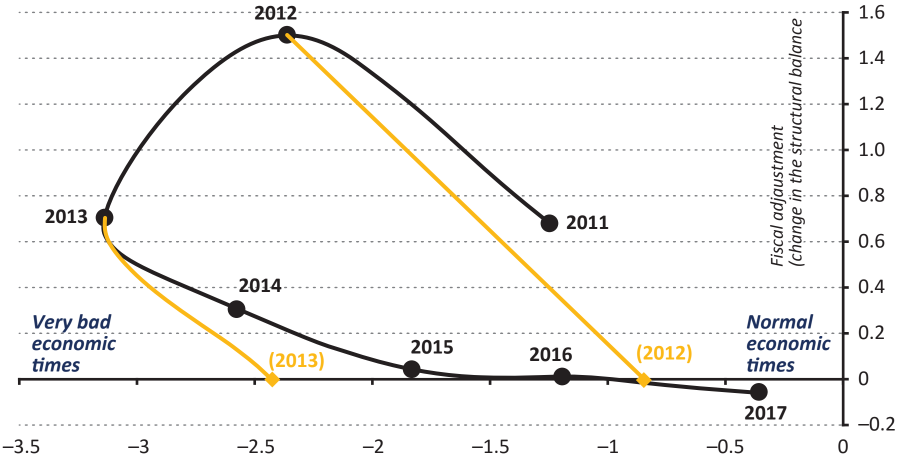
- Second, **cross-border risk sharing through fiscal means is virtually non-existent in the EMU**, though neither is it particularly strong in the US. This does not mean that fiscal policy does not have a stabilisation role within each euro area Member State, but that fiscal shock absorption takes place almost exclusively through national fiscal stabilisers. When large idiosyncratic shocks occur, as they did during the recent crisis, this can lead to a sub-optimal level of stabilisation not just for each Member State individually but also for the euro area as a whole.

- Finally, the difference in the US is particularly striking in terms of the **cross-border capital and labour income channels**. Shock absorption through these channels **in the euro area amount to around 6 % of the shock, while in the US it represents over 40 %**. So far as the labour income channel is concerned, there is a relatively high share of commuter workers in the US who cross state borders to work, whilst in the euro area this phenomenon is common only in Luxembourg. In addition, the US has very well developed capital markets that operate across state borders, whilst firm financing in much of the euro area is still predominately through banks, often based on established relationships with local branches.

Fiscal Union

Recent measures, including the so-called six-pack and two-pack legislative packages, have led to an improvement of fiscal surveillance in the euro area. As part of the work on the Fiscal Union, the European Commission and the Council have worked to improve existing rules. For instance, they looked at the evolution of the so-called public expenditure benchmark, which governments can control more easily and thus better reflects their intentions. The flexibility within the rules of the Stability and Growth Pact has been used in support of reforms and investment, as well as to better reflect the economic cycle. The Commission also called for a greater focus on euro area priorities at the start of each European Semester and a more active use of the fiscal stance for the area as a whole. The newly created European Fiscal Board supports the evaluation of the implementation of EU fiscal rules. Nevertheless, the work on Fiscal Union is far from completed. Three issues are still on the agenda: introduction of a stabilisation capacity, integration of the Fiscal Compact into the EU legal framework, and a more general discussion on simplifying fiscal rules.

Figure 3: Benefits of a central stabilisation capacity



Source: European Commission, Autumn 2017 Economic Forecast

Private and public absorption channels of economic shocks in the EMU are not sufficiently developed. Both channels are less developed in the euro area than in mature monetary unions (e.g. the USA, see Box). Moreover, the currently-fragmented financial sector amplifies shocks rather than mitigates them. The Banking and Capital Markets unions will enhance the capacity of private channels to absorb shocks, but only over time. Unlike in other functioning monetary unions, there are only limited collective tools available in the euro area to stabilise the business cycle. If national fiscal automatic stabilisers are insufficient and governments face difficulties in borrowing to absorb a shock, there are no common instruments at the euro area level available to help stabilise the cycle. This overburdens monetary policy with the responsibility of cushioning and counterbalancing economic developments and shocks.

The crisis exposed the limits of individual Member States in absorbing the impact of large shocks. Fiscal policy's role is to stabilise the economic cycle in the short-term without compromising the goal of long-term sustainability. During the crisis, national budgets, and welfare systems in particular, played the role of "automatic stabilisers", helping to cushion the shock. However, in several countries, the availability of fiscal buffers was limited and the market access to finance public debt was uncertain, reflecting fears of unsustainable fiscal policy. As a result, national fiscal policies in these countries were not able to counter the recession (see Figure 3). This is a major explanation behind the severe dent in recovery in the years 2011-2013. The lack of a stabilisation function increases the likelihood that a Member State hit by a shock loses access to capital markets and ends up with the European Stability Mechanism.

It is impossible to simultaneously achieve an appropriate fiscal stance for the euro area as a whole and an optimal distribution of the fiscal effort. Independent conduct of national policies in the crisis did not lead to an ex-post appropriate fiscal stance. Member States with fiscal space have not been using it because their economies run close to the potential, while Member States with economic slack usually have been fiscally constrained. Meanwhile, the euro area as a whole could not pick up the slack, due to the lack of a common stabilisation function. Figure 3 shows the potential benefits that a central fiscal stabilisation function could bring to the euro area. The horizontal axis presents the amount of unused capacity in the economy. The further left, the worse the economic situation that an economy faces. The vertical axis reflects fiscal adjustment. The higher the value, the more contractionary fiscal policy is. If it was in place in 2012 or 2013, the stabilisation function could have eased the fiscal adjustment and moved the euro area economy closer to its potential, thus reducing the severity of the recession.

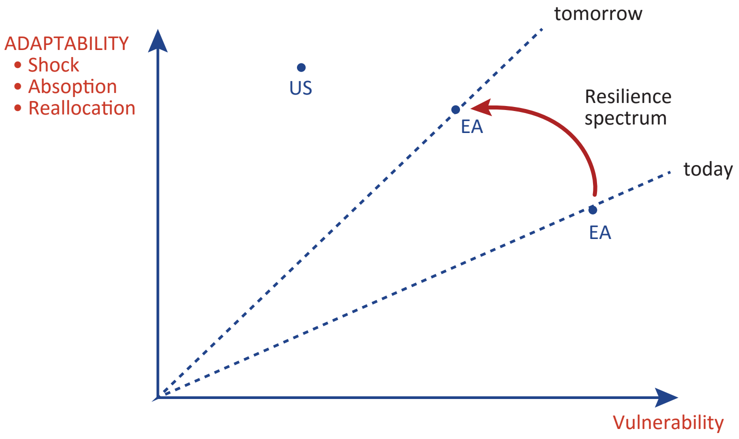
Economic Union

There is a growing consensus that convergence towards resilient economic structures would support real convergence in the euro area in the long-term. In the absence of nominal exchange rate policies, euro area Member States need to absorb economic shocks via internal adjustment processes. They need resilient economic structures to be able to weather shocks and to recover quickly thereafter. Resilient economic structures avoid persistent effects of a shock on income and employment levels. They also foster cyclical convergence and the effectiveness of the single monetary policy, increase risk-sharing and help resume long-term growth and promote social outcomes.

Several policy areas to strengthen resilience have been identified. Economic resilience entails three elements: vulnerability to shocks, shock absorption capacity, and the ability to recover quickly from shocks. This characterisation is useful for identifying more accurately the policy implications in terms of prevention, immediate reactions which minimise the impact of shocks, and a more prolonged adjustment or reallocation process in the case of more permanent shocks. Exposure to shocks depends on financial sector vulnerabilities, the structure of the economy, weaknesses in public sector, or exposures induced by taxation. Financial risk sharing, a reasonable fiscal policy during good economic times that creates space for automatic stabilisers to function properly, and flexible labour and product markets, all increase the shock absorption capacity of an economy. Finally, reallocation of resources following a shock would be facilitated by properly functioning product and labour markets, judicial systems and the Capital Markets Union. Analysis of country-specific characteristics helps to identify the relevant policies or structural reforms to strengthen resilience that should be applied in the financial sector, product market and business environment, labour market, public sector, or in the area of taxation in a given Member State, but without imposing a one-size fits all approach.

The ability of the euro area to adapt to the structural nature of shocks is currently low. Reforms at the European and national level have the potential to increase the resilience of the euro area and make it more adaptable. The US, thanks to its institutional set-up and the flexible features of its economy, is much less vulnerable to shocks.

Figure 4: The euro area resilience spectrum



In the area of European economic governance, several elements that should strengthen the resilience of euro area economies have been put in place. The macroeconomic and fiscal surveillance of Member States has been significantly strengthened with the introduction of the Macroeconomic Imbalance Procedure. Social considerations have been given increased attention, with specific recommendations and new social indicators as part of the European Semester. The European Commission has also made concrete proposals to create a European Pillar of Social Rights, which aims to promote convergence between Member States towards better working and living conditions. To inform and support the process of reforms at national level, the EU has recommended that euro area Member States set up advisory National Productivity Boards. The European Commission has also established a Structural Reform Support Service to pool expertise from across Europe and provide technical support to Member States. This service is encountering so much interest that the Commission has recently proposed to double its budget for the period 2019-2020.

Building resilient economic structures does not mean harmonisation of policies or a one-size fits all approach. All Member States need to adopt reforms based on their particular needs. For instance, some Member States should undertake reforms to boost domestic sources of growth resulting in higher domestic demand, such as supporting private and public investment. Other countries, by contrast, would do better to focus on increasing their competitiveness. A more balanced approach to euro area macroeconomic policy can be thought of as a more symmetric form of adjustment that would make it easier to tackle the euro area's greater vulnerabilities.

Conclusion: proposed way forward

The steps required to complete the EMU need to be properly sequenced. There is now a growing awareness that further steps are needed. The Commission proposes to move forward in two steps. Certain elements, including the backstop to the Single Resolution Mechanism or EDIS, are indispensable and need to be put in place quickly to increase the EMU's resilience. Once these are done, a number of other elements should be addressed by 2025.

In 2017, the Commission laid on the table its proposals to deepen the EMU. The Commission provided its vision on the future of EMU, including the Financial, Fiscal and Economic Unions, in its May 2017 Reflection Paper. Then in September 2017, President Juncker indicated in his State of the Union address what the Commission intends to do to move forward in the coming years. The Commission's communication on Banking Union in October 2017, indicated a possible way forward for the European Deposit Insurance Scheme. Notably, the proposal suggested disentangling liquidity assistance and loss sharing. Under the revised first phase, the European Deposit Insurance Scheme would only provide liquidity, which would need to be repaid. Any form of loss sharing would only occur in a second phase and be made subject to adequate conditions.

The December 2017 EMU deepening package consisted of several concrete proposals, including four legislative acts. The draft legislative acts included:

- a proposal to transform the European Stability Mechanism into a European Monetary Fund anchored in EU law that would also provide the backstop for the Single Resolution Fund;

- a proposal to integrate into the Union legal framework the Treaty on Stability, Coordination and Governance (the so-called 'Fiscal Compact');

- proposals for new budgetary instruments for a stable euro area within the Union framework (a new reform delivery tool to give incentives to implement national reforms; expanded technical support to reform implementation at the request of Member States; a dedicated convergence facility for Member States on their way to joining the euro; a stabilisation function to maintain investment levels in the event of large asymmetric shocks). To pilot test the reform related elements, the Commission presented legislative proposals to extend the Structural Reform Support Programme and amend the Common Provision Regulation within the current Multiannual Financial Framework.

Finally, to enhance democratic accountability and oversight of the EMU, the Commission proposed to create a European Minister of Economy and Finance. The full proposals for the reform delivery tool, convergence instrument and for a stabilisation function will be specified in the context of the post-2020 Multiannual Financial Framework proposal of May 2018.

In March 2018, the Commission came forward with a package of measures on non-performing loans (NPLs). The package capitalised on the significant progress already made to reduce risks in the banking sector. The progress report on NPLs that the Commission adopted shows that NPLs are falling. The new measures are meant to sustain this trend and prevent their resurgence in the future. The package proposed a mix of actions in four areas:

(i) ensuring that banks set aside sufficient funds to cover the risks associated with NPLs from future loans; (ii) encouraging development of secondary markets where banks can sell their NPLs; (iii) facilitating debt recovery; and (iv) assisting Member States in the restructuring of banks, by providing non-binding guidance for establishing 'bad bank' Asset Management Companies. These proposals are now in the hands of the Council and the European Parliament. It is important that all the proposals on the table are discussed in a constructive manner by the co-legislators.

JOHN LIPSKY

Senior Fellow,
Johns Hopkins School of Advanced International Studies

US Views of European Markets and the Euro

It is a pleasure to be able to participate in this excellent conference that honors Alexander Lamfalussy, who played a key role in establishing the current European monetary and financial system. I had the very good fortune to have met with Prof Lamfalussy several times, and always benefitted greatly from our conversations. I want to thank Governor Matolcsy and his Chief Advisor György Szapáry (my good friend and former colleague) for their leadership in sponsoring and organizing this useful and stimulating event.

As you will have noted already from my accent, I am an American. However, my career has focused on issues in international economics and finance. I have divided my time nearly equally between the public and private sectors, and I spent the critical years of 1989 to 1992 based in London, where I headed European Economic and Market Analysis for Salomon Brothers (an American investment bank that in 1997 became part of what is now Citigroup).

I mention my background to emphasize three points: First, I am aware that there is an assumption among many Europeans that most Americans either are skeptical or negative about the prospects for completely implementing the elements that are generally categorized as constituting European Economic and Monetary Union (EMU). By inference, it is often assumed that Americans therefore are skeptical about the European Union's members attaining their goals in terms of economic performance and/or financial system development.

Second, I lived in Europe and worked on European issues at a dramatic moment in recent European history – and I consider that the process of European economic and financial integration will be of critical importance in determining Europe's future. Third, I would claim that a non-trivial portion of my career has included analyzing and attempting to explain the implementation of EMU to non-European audiences.

Today, I would like to discuss in a rather descriptive manner the evolving participation in European markets of US financial institutions, and in the process, provide a bit of nuance about US views regarding European developments. However, I will start with a brief and potted history of the development of US financial markets and the US economy. I would begin with the collapse of the Bretton Woods system in 1972, reflecting the so-called Triffin Trilemma (expressed as the unwillingness of the US authorities to accept the strictures placed on their policy flexibility by their central role in that system).

I was a graduate student at the time, and I recall seminars on the collapse of Bretton Woods that welcomed the event as likely to usher in “stabilizing speculation” in currency markets, and an enhanced ability of national monetary authorities – like the US Federal Reserve – to focus more effectively on their own inflation goals. Of course, the outcome was quite the reverse, with unprecedented inflation reflected in oil price shocks and the emergence of record-high OPEC current account surpluses. Two important financial developments ensued: A dramatic increase in the flexibility of domestic US financial markets through the end of usury limits on interest rates and the proliferation of floating rate instruments (such as negotiable certificates of deposit), and the growth of the syndicated sovereign loan market, enabling countries in Latin America and elsewhere to finance record high current account deficits.

Of course, the near-term results were negative – the so-called 1970s “stagflation” of high and variable inflation coupled with weak growth and morale-sapping instability, and the associated Latin American debt crisis that threatened the solvency of the so-called “money center banks”. The US policy response to these unprecedented challenges was decisive, however. Sharp policy tightening by the US Federal Reserve restored price stability, although accompanied by a deep downturn that eventually gave way to sustained growth. Support for aggressive stabilization programs in seriously affected debtor countries – underwritten by the International Monetary Fund, among other institutions – together with a period of US supervisory forbearance, spared the lending banks and eventually helped to create the emerging market sovereign debt market.

Financial markets in the United States during the 1970s and after were transformed by deregulation and restructuring. The emergence of huge pools of private savings in the form of pension funds, insurance company investments and institutional endowments gave rise to new demands for government securities. The successful securitization of US residential and commercial mortgages created the possibilities of securities trading on a hitherto unimaginable scale. These developments gave rise to financial firms that possessed the capital, risk appetite and risk management skills to provide the appropriate intermediary services between increasingly large and active counterparties.

My own employer at the time – Salomon Brothers – was a pioneer in this environment. By the mid-1980s, the firm was the lead manager in almost one-third of all US dollar-denominated fixed-income securities issued. The firm also began large-scale securities trading on a proprietary basis. Market imperfections allowed the firm to garner handsome profits. In 1985 – at a time when the firm's employees couldn't have totaled even 2,500 – our CEO was described by a leading business publication as the "King of Wall Street.'

Not surprisingly, US firms like Salomon Brothers began to think of themselves as possible "world-beaters", possessing skills that firms in other markets lacked. Thus, when London markets began their own large-sale deregulation – 1986's so-called "big bang" – many US firms moved aggressively to expand their own London-based operations. But these firms – including Salomon – were looking beyond the United Kingdom to future opportunities in Europe.

Europe's Single Market Act – enshrining the objective of establishing a single market in the European Union by 1992 – was signed in 1986 and promised important new progress. The inspiration was to help implement the "four freedoms" set out in the Treaty of Rome – the free movement of goods, services, capital and people. While it is often claimed that EMU is essentially political in inspiration, in fact economic and financial incentives were and are at least of equal weight.

In comparison to the US economy – that was enjoying sustained growth in the 1980s in the wake of the 1982 downturn – the EU was by comparison a group of relatively small economies with comparatively static domestic markets and rigid, compartmentalized financial systems. American financial firms that had led the transformation of US markets saw the prospect of repeating their success by providing European markets with much greater flexibility and speed, together with more advanced instruments and analytical tools. Moreover, US institutions hoped that their identity would not be tied to a specific EU country as their "home base". Thus, the emergence of a single European market appeared to represent a huge opportunity.

With the goal of promoting the economic and financial integration within a customs union, it was clear that there was a need for an enhanced means to stabilize real effective exchange rates within the EU. The Exchange Rate Mechanism (ERM) had been established among a core group of EU members in 1979, but its history had been rocky. The adoption of the Single European Act, with its 1992 goals gave rise to a debate over whether a single currency was needed to sustain a more complete single market.

One conventional view – that seemed to me was widely shared among interested American academics (among others) – was that the EU was far from an Optimal Currency Area (or OCA) because the prospective member economies simply were too diverse, and that any attempt to create a single currency in such a circumstance would be doomed to failure. An alternative view that was much more common among financial market participants was that the economic and financial underpinnings of the Single European Market project was the intention of EU members to convert their economies into an OCA, using the single currency as the fulcrum that would force the needed reforms and adjustments.

In this context, the 1990 collapse of the Soviet Union provided the primary catalyst for the agreement to move to a single currency, as enshrined in the EU's 1992 Maastricht Treaty. While the conventional view in London at the time of German reunification was that this would put discussion on EMU on hold for years to come, in practice key policymakers realized that reunification would make Germany the largest of all EU members in terms of both population and GDP, a gap that only would widen as the former East Germany developed. As a result, if there was no quick agreement to absorb the German financial and monetary systems into a European system, that the chances that Germany in the future would be willing to accept the implied constraints on its own policy priorities would be very uncertain at best.

If there was an aspect of this that was political, it was the willingness of Germany to accept the accelerated Maastricht timetable to a single currency by the end of the decade. From our vantage point in London, it looked as though Germany – with its high labor costs and rigid labor market rules – was going to be the big loser in economic terms from EMU, while Italy and Spain were going to be the big winners. Moreover, the incompleteness of the single market and the lack at the outset of many needed institutions was widely recognized. The expectation was that progress toward the goal of creating the needed institutions was going to be made in the pragmatic spirit of Deng Xiaoping – "crossing the river by feeling the stones".

Despite the skepticism of many academics about the advisability of EMU, many US financial institutions – including Salomon Brothers – profited very handsomely (to put it mildly) by taking positions based on the expectation that EMU was going to take place as scheduled, as bond yield spreads collapsed within the component markets of the new euro.

As the date of the single currency's 1999 promulgation neared, the EU responded to the recognition that that EMU's underlying institutional framework was incomplete by adopting the Stability and Growth Pact (SGP) in 1997. The idea was to create two *ex-poste* rules to compensate for the lack of institutional constraints over individual member fiscal policies and to the lack of any compensatory funding mechanisms to deal with potential financial system crises, together with the absence of any euro-area wide financial supervision.

The SGP limited fiscal deficits allowed to individual member countries and created an Excessive Deficit Procedure to sanction miscreants. This, in addition to the constitutional provision barring the central bank (still to be created at the time) from engaging in the primary financing of euro area governments – the so-called "no bailout" rule – was deemed by EU authorities to be sufficient to accomplish the task.

It might be of interest for you to hear that as far as financial market participants were concerned, neither measure had the slightest credibility. The notion that euro area finance ministers would be willing to apply fines to fellow members for excessive deficits, and that the threat of such an action would be stabilizing for financial markets always seemed far-fetched. At the same time, the prohibition on direct central bank purchases of new sovereign debt issuance – while remaining silent on the amount of potential secondary market purchases – seemed irrelevant.

However, market participants somehow imagined that in practice, governments running excessive deficits or otherwise deficient policies would be punished by rising interest rates on their debt. In the event, investors' faith in the force of market discipline proved to be fatally flawed, but this simply wasn't recognized *ex-ante*. Hence the willingness of – among others – euro area banks to acquire euro area government debts in almost any amount proved to represent the exact opposite of market discipline.

Thus, from the point of view of financial market participants, the 1990s were marked by substantial contrasts between developments in the US economy and that of the eurozone in formation. The US financial system was in dynamic flux, with innovation, securitization and globalization the dominant themes. At the same time, new technologies were taking hold in important parts of the US economy, as the productivity surge associated with the widespread adaptation of new data processing and communications tools began to bear fruit.

In Europe, the post-unification strain on Germany's economy slowed growth there and dented confidence. Growth elsewhere in the fledgling eurozone was disappointing, as was lack of progress on structural reforms, and the financial system was focused on absorbing the implications of the September 1992 shock to the Exchange Rate Mechanism and looking forward to the formation and launch of the ECB and the issuance of euro-denominated securities. Moreover, understanding about the pre-euro process was complicated by the lack of a single voice on eurozone developments and/or governance.

The new millennium not only brought the euro, but also a series of unexpectedly favorable developments in the new eurozone. The post-2002 global growth rebound, together with the flawless launch of euro-denominated money, equity and securities markets – itself a testimony to the quality of the authorities' preparations (not least thanks to the leadership of officials like Alexander Lamfalussy) – buoyed investor optimism. In response, the euro soared from a low of US$0.80 = 1E in 2001 to a high of US$1.60 = 1E in 2009.

Lulled by dropping yields on euro area sovereign debt and soaring real estate markets, many euro area financial institutions loaded their balance sheets with higher-yielding US dollar denominated assets, often asset-backed securities based at least in part on subprime real estate. Typically, these highly rated issues were financed with borrowed dollar liabilities. What they didn't see coming was the "mother of all financial crises", emanating from the United States, that began to unfold in 2007, following the onset of declines in the average price of US housing that began in early 2006.

As the crisis unfolded, the US interbank market ground to a halt, and many euro area financial institutions found themselves facing insolvency as they were unable to roll over existing dollar liabilities. Moreover, it became clear that many euro area banks had invested heavily in some euro area sovereigns' debts whose economies and markets themselves were slipping into crisis, with no euro area safety net in existence for either the euro area banks or their governments.

The crisis response basically was two-fold but appeared to many financial market participants either to be improvised and/or insufficient. In effect, the US Federal Reserve came to the rescue of those European financial institutions – many of them German banks – that were facing insolvency because of their inability to roll over US dollar borrowings. By extending an unlimited swap line to the ECB, for on-lending to euro area banks, this aspect of the crisis was averted. After unsuccessful attempts by the European

Commission to engineer a stabilization program for Greece and following much hand-wringing from many euro area authorities, the IMF was invited to become involved by an eleventh-hour plan to halt Greece's dramatic downward slide, and eventually to provide an innovative Flexible Credit Line facility to Poland, along with high access standby programs with Ireland and Portugal., while IMF quasi-programs were adopted for Italy and Spain.

At first, the EU reform process ground to a halt, with many financial institutions *de facto* retreating to their core national constituencies. Financial supervisors were cautious about forcing write-downs of dubious debts and build-ups of bank capital. But the severity of the Greek crisis forced the last-minute formation of the European Financial Stability Facility. Nonetheless, the post 2008-2009 crisis period was marked by weak growth, very low fixed capital spending and no productivity gains. It took the entire EU about a decade to fully recover the level of output (GDP) reached just prior to the crisis.

Eventually, the post-crisis stabilization in both financial markets together with renewed economic growth began to produce policy progress toward the implementation of the long-promised European Banking Union. This took the form of the conversion of the EFSF to the European Stability Mechanism, the creation of a Single Supervisory Mechanism for the entire euro zone banking system and plans for a single resolution mechanism for the liquidation of failed financial institutions. Still in abeyance are plans for a pan euro area deposit insurance scheme, or for a capital markets union.

Thus, the threat of a new euro area crisis has receded, while GDP gains accelerated somewhat in late 2017. The new worries are a result of the unexpected British vote to leave the European Union, although the difficulties of the ongoing Brexit negotiations must be serving as a kind of cautionary tale for any other contemplating a similar move. At the same time, the prospect of Brexit is forcing many US financial institution to restructure their London-centered European operations that date back to the 1986 Big Bang. However, the lack of clarity in the result of the German elections, the uncertainties implied by the latest poll results in the upcoming Italian elections, and the souring attitude of authorities in Hungary and Poland regarding EU actions has severely dampened earlier optimism about a possible period of new progress on EU institutional reforms. Hence it is my impression that US financial institutions are proceeding cautiously regarding their future expansion.

In analyzing the way forward for the euro, University of California at Berkeley economist Barry Eichengreen has identified two main contending approaches, that he identifies as “the idealists” versus “the realists”. The idealists tend to conclude that successful EMU will require real progress on a political union that will centralize more key functions in the eurozone and eventually in the broader EU. But the current environment hardly provides this approach with any near-term prospects for agreement. Realists, in contrast, have concluded that new progress at this time is going to have to occur through economic and market reforms undertaken at the national, not European, level.

From the US point of view, earlier existential debates about the survival of the euro have faded, while expectations about any prospects for fundamental EU reforms in the near future have faded, as well. Moreover, the likelihood of any quick progress towards the earlier project of negotiating a “Transatlantic Trade and Investment Partnership” (TTIP) seem to have been all but abandoned at present. In this context, the focus of US investors and financial institutions – as well as policymakers and others – most likely will shift toward Asia, where big near-term challenges loom, and some decisions will be reached, one way or another.

Nonetheless, the current scale of transatlantic trade, financial flows and investments guarantees that European developments will remain of vital interest to US financial institutions and firms. Moreover, renewed progress towards EMU in the post-Brexit environment would elicit significant interest from US firms for expanded involvement. As a result, there has been a return to the earlier stance of “crossing the river by feeling the stones”. This does not mean complacency, by any stretch of the imagination, as it is clear that the Eurozone and the EU are entering a critical moment.

THE
LAMFALUSSY AWARD
2018


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.

In 2017, the recipient of 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. 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 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).

2018 AWARD RECIPIENT

ZHOU XIAOCHUAN
Governor, People's Bank of China

Dr. Zhou Xiaochuan is Governor of the People's Bank of China and Chairman of the Monetary Policy Committee. In March 2013, he was elected Vice Chairman of the National Committee of the Chinese People's Political Consultative Conference. Dr. Zhou also serves as Governor for China to the International Monetary Fund (IMF), the African Development Bank (ADB), the Inter-American Development Bank (IDB), and the European Bank for Reconstruction and Development (EBRD). He sits on the Board of Directors of the Bank for International Settlements (BIS), and is a member of the Group of Thirty (G30) and the Chinese Economists 50 Forum. He was a member of the Committee to Study Long-term Financing of IMF, the Commission of Growth and Development of the World Bank, and a member of the High-Level Committee on World Bank Governance Reform.

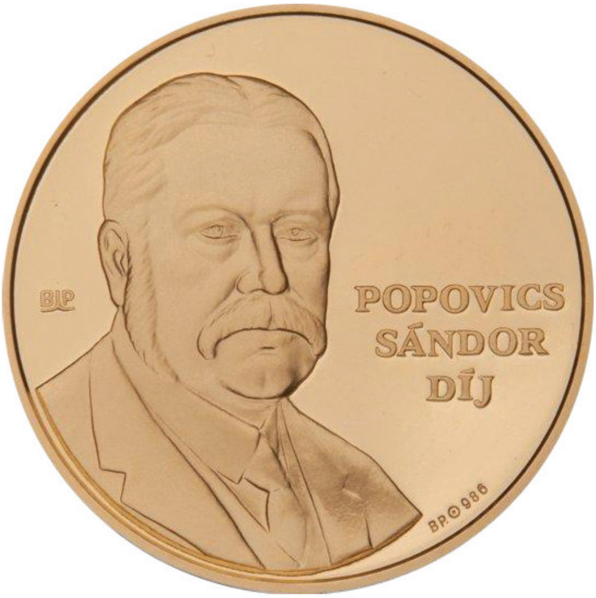
Prior to taking his current position, Dr. Zhou served as Chairman of the China Securities Regulatory Commission (2000-2002), President of the China Construction Bank (1998-2000), Deputy Governor of the People's Bank of China (1996-1998), Administrator of the State Administration of Foreign Exchange (1995-1998), Vice President of the Bank of China (1991-1995), and Assistant Minister in the Ministry of Foreign Trade and Economic Cooperation (1986-1989).

Dr. Zhou is a professor and advisor of doctorate candidates at the Tsinghua University's School of Economics and Management and PBC School of Finance. He is also an honorary professor at the Chinese University of Hong Kong. He graduated from the Beijing Institute of Chemical Technology in 1975 and received his Ph.D. degree in System Engineering from Tsinghua University in 1985. Dr. Zhou is among the first group of Chinese experts who are entitled to receive special government allowance, and the author of over 100 academic papers and more than 10 books, including Restructuring the Relationship between Enterprises and Banks (Sun Yefang Economics Essays Award, 1994), Towards an Open Economy (Ann Tse-Kai International Trade Essays Award, 1994), Social Security: Structural Reform and Policy Proposals (Sun Yefang Economics Essays Award, 1997) and The Global Financial Crisis: Observation, Analysis and Countermeasures (Sun Yefang Financial Innovation Award, 2015). As one of the major contributors of the „Theory of Holistic and Coordinated Reform", Dr. Zhou won the China Economic Theory Innovation Award in 2010.

THE

POPOVICS AWARD

2018


POPOVICS
SÁNDOR
DÍJ


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.

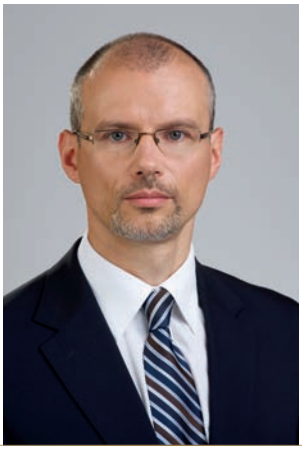
In 2014 the Popovics Award was awarded to Márton Nagy, Executive Director of the Magyar Nemzeti Bank, who played a major role in the shaping and development of the Hungarian financial system.

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. MKB Bank, reformed under his leadership, continues to operate in the domestic financial market as a competitive and profitable bank, fostering the stability of the financial intermediary system.

In 2017, 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. As a central banker, he has become a recognised expert in economic analysis and forecasting.

2018 AWARD RECIPIENT



PÉTER BENŐ BANAI
State Secretary for Public Finances, Ministry for National Economy

Economist with legal specialisation. He graduated as an economist at the Budapest University of Economic Sciences in 1998, earned his degree as an economist with legal specialization at the Eötvös Loránd University in 2001. He has suspended his Ph.D. studies at the Budapest University of Technology and Economics after gaining his absolutorium in 2010.

He has worked at the Ministry of Finance and Ministry for National Economy in various positions since 1998. Since 2010 he has been serving as Deputy State Secretary responsible for budgetary affairs. He was appointed State Secretary for Public Finances in 2014.

He is the vice-chairman of the Public Finances Section of the Hungarian Economic Association. He has published several professional articles mainly on EU budgetary affairs.

He is married, the couple is expecting their second child.