“THE DECADE OF CATCHING-UP: WITHIN THE EU”
“THE DECADE OF CATCHING-UP: IN ASIA”
THE DECADE OF CATCHING-UP: THE CASE OF THE EU AND ASIA

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

Budapest, 4 February 2019
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György Matolcsy, Governor, Magyar Nemzeti Bank  

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Foreword

In February 2019, the Magyar Nemzeti Bank organized the Lámfalussy Lectures Conference for the sixth time in honor of Alexandre Lámfalussy, a truly European economist and the co-founding father of the euro. The conference series, which has now become a tradition, attracts the attention of the world’s professional community, and provides a discussion forum for policy makers and academic researchers on current global macroeconomic and financial developments.

The central topic of this year’s conference was the convergence process that can be expected in the coming decade both in Europe and Asia. Within Europe, the main goal is to restore the convergence process which suffered a setback in the immediate aftermath of the financial crisis. For Asia, the main question is how they can continue the remarkable convergence process that was observed during the last decades.

The thought-provoking speeches of this conference contributed to further analyses of some of the most disputed issues such as weather the real economic convergence of these countries can continue in the next decade, or what kind of economic policy is required to maintain convergence in the longer term? One of the most important factors of this is the transition from a work-intensive growth model to a productivity based, capital-intensive economic growth model. There seem to be several possible channels that can facilitate the transition to a capital-intensive growth path, including investment into human capital and the support of innovation possibilities. Besides these, measures increasing general competitiveness may also make these countries more attractive. However, in order to reach a higher level of economic development, a comprehensive turnaround in competitiveness may be necessary while maintaining macroeconomic stability. In the course of planning the convergence process, special attention must be given to traps that may undermine the sustainability of convergence process.

Regarding convergence, it is worth to study the lessons learnt from the history of Europe and the Eurozone. We have a period of 20 years since the introduction of the euro, and we can perhaps divide these two decades into three sub-periods. The first chapter between 1999 and 2007 or 2008 was more or less a success story: economies were booming, and we experienced a quick convergence process especially in the
southern part of the Eurozone. The second chapter lasted from 2008 to 2012, just after the outbreak of the global financial crisis, when the convergence process suffered a setback and seemed to disappear. The crisis might have originated in the US, but it led to a deeper, longer and more painful recession in Europe. And the third sub-period started around 2012, since when we have been witnessing a period of very slow recovery in the less developed countries of the Eurozone.

I would like to highlight three lessons, related to the convergence process, that we can learn from these sub-periods of the Eurozone. First, one needs to sustain a booming economic environment to achieve a clear-cut convergence. Second, in order to ensure a booming economic environment, we need to have a strong Eurozone with which we can reduce the possibility of potential financial crises as much as possible. Third, since some crises are unavoidable even with the very best institutional setup, we need better crisis management tools at the European level to mitigate the potential consequences of future crises. The euro was designed for booming times, but it was not so well designed for the stressful crisis periods. Therefore, we need to improve upon the available tools in bad times and find better crisis management techniques than the recently used austerity-based approaches.

Several lessons can be learnt from the more successful crisis management in the United States. First, the US authorities acted very rapidly, and the US recession was already over by the end of 2009. Second, the cooperation between the US government and the Federal Reserve contributed to a much more effective crisis management. Even more importantly, the US crisis management was not based on austerity, which has also contributed to the quick recovery.

As a conclusion, the most important lessons that we could learn from the different crisis management techniques in the aftermath of the recent financial crisis should be put together. Hopefully, it will be years, and not just months, until the next financial crisis breaks. But whenever the next crisis arrives, a very quick and efficient crisis management will be necessary, without any delay. Furthermore, a very close cooperation will be needed between the governments and the central banks: some kind of strategic alliance between those institutions that also respects the independence of the central banks in normal operations. And perhaps most importantly, the same mistakes should not be committed again, and we shall not exclusively rely on austerity measures when managing the next crisis.
The distinguished speakers and panelists of this year’s conference discussed the possibilities and conditions for the continuing convergence process both in Europe and Asia. Despite the existing differences in their culture and level of development, Asian and European countries share certain similarities in their convergence strategies. After the excellent presentations and panel discussions of this year’s conference, a better understanding of the great economic transitions and convergence processes affecting the West and the East simultaneously or separately may serve as a starting point to establish the conditions of long-term sustainable development both in the West and the East.
LAMFALUSSY LECTURES
CONFERENCE
Speech by Yves Mersch, Member of the Executive Board of the European Central Bank, at Lamfalussy Lectures Conference of Lamfalussy Award at Central Bank of Hungary in Budapest, Hungary on 4 February 2019.

The changing role of central banking

John von Neumann, the Hungarian-born mathematician, once said: “there’s no sense in being precise when you don’t even know what you’re talking about”. I saw Alexandre Lamfalussy in many different roles over the course of 30 years, and I always admired his capacity to be extremely precise because he was simply knowledgable in a professional way.

It is therefore a great honour for me to be awarded a prize in memory of a man who made such an important contribution to European integration.

During many years representing my country of origin in the Belgian constituency at the IMF, I witnessed the intellectual strengths of Hungarian representatives, especially from the central bank. I therefore feel particularly flattered to have been awarded this prize by the Magyar Nemzeti Bank and its Governor, Mr Matolcsy.

I also want to express my thanks to Governor Ewald Nowotny¹ of the Oesterreichische Nationalbank, who is also a firm believer in the need to bring the people of our continent together without nations trying to dominate each other.

Indeed, I feel very humble and modest in this environment. I was lucky to be able to develop my views and opinions when accompanying my highest political authorities in their meetings for more than 20 years. Moreover, my family provided me with two solid foundations: resistance to illiberalism during World War II, and respect for the rule of law.

I have been veering between what Benoît Mandelbrot called “the two poles of human experience”, one driven by my legal background and the deterministic system of order

¹ Governor Ewald Nowotny hold a laudatory speech at the Lamfalussy Lectures Conference 2019.
and planning, and the other inspired by my lifelong experience with finance and the stochastic or random systems of irregularity and unpredictability. Trying to straddle the two poles with insights from political science brings me to today’s theme: the changing role of central banks which are accompanied by a changing role in their societies.

**Changing role of central banks**

Mandelbrot said of the great financial crisis: “Financial economics, as a discipline, is where chemistry was in the sixteenth century: a messy compendium of proven know-how, misty folk-wisdom, unexamined assumptions and grandiose speculation.” According to him, “financial markets are the machines in which much of human welfare is decided but so limited is our knowledge of how the financial system functions that resolved ourselves not to science but to shamans… a few elderly men called central bankers. We do not understand what they do or how, but we have blind faith that they can somehow induce the economic spirits to bring us financial sunshine and rain and save us from financial frost and pestilence.”

Are these bitter words from an insufficiently recognised genius battling the hysteresis effects of the “efficient market hypothesis”? Or, is this an expression of frustration that finance still largely operates under a Euclidean perception of the world when it comes to measuring risk because new theories take time to become operationally mature and stable? Whatever the motivation, it points to the difficulties of change management. The same reflections apply to all organisations – while they are designed on the basis of all knowledge available at the time, their designs age as the world around them evolves, and new experience lays bare weaknesses. Some of these weaknesses can be mitigated; others might be fundamental and need fixing without delay.

But it is difficult in the absence of consensus on what is essential, what is noise, what is cyclical and what is structural. These are precisely the questions that come up regarding the changing role of central banks.

The design of the modern central bank dates back to the consensus that arose around the disinflationary path of the 1980s – that central banks should be independent and have a

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narrow mandate to fight inflation. In Europe, there was a second layer of consensus on how to allocate what is done at the national level and what is done at the regional level.

However, the decision on shared sovereignty was driven by mostly political considerations. While the monetary leg was to be supported by an institutional setup, the economic and fiscal leg was left to coordination and a set of common rules. This was fertile ground for critics. Both Milton Friedman and Alan Greenspan gave the euro no more than ten years. But the euro has now been around for 20 years and has been a powerful instrument for keeping the European project afloat.

Nevertheless, the passage of time is inevitable. Globalisation has left its mark and the political factors in Europe have changed. European enlargement, the failures of economic coordination, the imbalances of the policy mix and the evolution of the European Commission from a technocratic body towards a more political one, among other factors, have shaped how the constitutional principles underlying Europe’s central banks are used.

But the biggest test was the great financial crisis, which is still shaking the foundations of our societies today. What has changed for central banks? How have they adjusted? What changes are still needed? And, what changes must be resisted?

During the first half of the ECB’s existence, it only saw a few changes. An important one was the forward-looking adjustment concerning how the decision-making process worked. A voting rotation principle was proposed, which would cap the number of voting members at 21. This amendment to the ECB Statute, proposed by the Governing Council, was adopted with no changes by the European Council, Commission and Parliament.

The Governing Council made use of the Statute’s flexible adjustment procedure again last year following a suggestion from the General Court on the interpretation of the role of the ECB regarding clearing and payment systems. This time around, the Commission started to interfere with the minimal changes the ECB had recommended, followed by more extensive changes by the Parliament and yet more by the Council, which even added a new objective to this chapter on monetary functions and operations. These amendments – if adopted – would bring monetary policy instruments under the control of the legislators – a clear violation of the independence principle of the Treaty. Obviously, the Treaty’s fundamental principles cannot be modified by this simplified amendment procedure. The discussion is ongoing. This is an example of changes that should be resisted.
Let me now turn to the operational side. In the ECB’s first ten years, there was only a slight clarification of the quantitative definition of price stability, the ECB’s prime objective, which was subsequently defined as headline inflation of below, but close to, 2% over the medium term. Throughout the crisis, no further attempts to change the strategy, definition or numerical value of our objective gained any traction. However, during the crisis one could see a trend developing around monetary policy implementation, with major changes to instruments, communication and accountability.

Outside the central banks, but influencing them on the institutional side, the major policy response to the crisis has been to strengthen EMU and to attempt to reinforce economic coordination and amend the fiscal rules. Additionally, a crisis management tool, the European Stability Mechanism, was created as an intergovernmental body outside the Treaties. At the same time, a banking union was set up with a single supervisor, a single resolution authority and a still-to-be-completed single deposit guarantee scheme. According to an empowering clause included in the Maastricht Treaty activated by unanimity, the ECB received specific supervisory powers, albeit only for credit institutions.

This transfer of sovereignty is still being challenged in the German Constitutional Court. It came hot on the heels of a first move towards greater coordination in the financial sector through the establishment of European agencies in the area of banking, of insurance, securities and markets, in which Alexandre Lamfalussy played an important role. Indeed, the governance structure of these agencies was modelled on the so-called Level 3 Committees introduced by the Lamfalussy Committee of Wise Men.

During this time, another trend became noticeable: the transfer of an increasing amount of new tasks to national central banks. Some of these had traditionally been performed by the central banks, but others were totally new. As the ECB has to issue an opinion on every change to laws governing national central banks, a conceptual framework evolved which establishes which tasks are governmental tasks, and which tasks are traditional central bank tasks, or which tasks could be considered ancillary to them. An undue transfer of tasks to central banks that belong to governments could indeed be seen as circumventing the monetary financing prohibition or threatening their financial resource independence. Therefore, the consent of NCBs and the funding of such new activities would need to be scrutinised.

The case law of our adopted opinions over recent years in many countries covers topics as diverse as buying paintings, financing culture, education or investments and the financing of resolution funds. We also gave opinions on establishing a central register
of bank account numbers, exercising asset management functions, insurance premiums, and protection of competition in the mortgage loan market, to name but a few. However, the biggest change in terms of conceptual evolution, strategic thinking and interaction with different policy fields concerns financial stability and macroprudential policy.

Under monetary policy, the Treaty foresees that the ECB shall contribute to the policies of competent authorities relating to banking supervision and the stability of the financial system. The Statute lists this as one of the tasks of the ECB. The concept of a financial cycle, as distinct from the business cycle, was only developed much later with the increasing financialization of our economies. The emergence of this reality of a financial cycle and its relation to central banking was acknowledged with the establishment of the European Systemic Risk Board (ESRB) at the ECB and supervisory tasks being conferred on the ECB, including some macroprudential instruments under the supervisory legislation.

The monetary response to the crisis, with negative interest rates and quantitative easing, sharpened the focus around who is responsible for financial stability, but numerous tensions are still unresolved. Since financial systems are largely determined by national features, questions arise about what should be done at the national level and at the centralised level. Who should be responsible for the use of which kinds of instruments?

Other elements of the multi-dimensional macroprudential and financial stability discussions relate to the interaction with microprudential and monetary policy actions, not to speak of the fiscal policy capacity in this respect. While Alexandre Lamfalussy as late as 1993 still supported a narrow mandate for monetary policy to safeguard its independence, banking supervision aside, just one year later he was claiming that “central banking has never been a static business. Throughout its long history it has performed different tasks in different periods.” He also mentioned systemic stability in this context.

But he firmly sees financial stability enshrined in monetary policy. In 2010, under the shadow of the crisis he called for “central banks to not regard their macroprudential duty as being less important than their mandate, to pursue price stability”. Still, he also saw risks saying, “The macroprudential mandate requires for the central bank a type of relationship with, and therefore a type of independence from the government that is different in substance from the one governing monetary policy.”

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In the past, I have advocated an interpretation of functional independence, distinguishing between monetary policy and prudential supervision. Should we also apply this to macroprudential supervision, which is currently still mostly enshrined at the national level?

A recent discussion on a possible macroprudential stance that is separate from the monetary policy stance would lend credit to this idea. On the one hand, it is true that banking systems will remain determined by national features for as long as banking union is not completed and the sovereign-bank nexus still exists. On the other hand, monetary policy supports the credit cycle euro area-wide, particularly through unconventional measures.

**Challenges ahead: the interaction of monetary policy with macroprudential policies**

While a stronger systemic orientation is essential if financial stability is to be assured, the definition of the problem to be solved is still blurred. Even if we can agree on a macroprudential objective, such as increased resilience of the financial system, we are still failing to measure the goal or define an operational target. Moreover, there remains a need to clarify the range of available tools, calibrate the balance between rules and discretion, and clarify governance arrangements, both nationally and internationally, as well as the potential interaction with other policy areas.

Many believe that central banks are best equipped to do this job. In pursuing their goal of preserving price stability, central banks are attentive to the evolution of real and financial markets, they are familiar with the credit and banking channel and their institutional independence shields them from political interference.

However, as central bankers we have to perform our tasks with the utmost responsibility. Before adjusting the conceptual framework underpinning possible policy action, we need tested, robust analyses. In macroprudential policy, we still lack this certainty that would allow for a macroprudential stance that is similar but different to monetary policy. We have no consensus on the definition and measurement of the objective. So how can we identify clear and well-defined policy goals linked to metrics and potential target levels? In the absence of a proper understanding of the transmission channels of different instruments and their potential interactions and spillovers, how can we credibly discharge our accountability requirements?
At this stage, the conceptual foundations lack the robustness to pursue a standalone or non-quantified objective with instruments that have unknown consequences based on assumptions and models full of unobservable factors and multidimensional equilibria.

Another open question in the European context addresses the level of governance and decision-making. Since we cannot measure risk or define resilience, how are we to distribute competence between the national level and the currency area level, or even the EU as a whole?

Currently, country-specific features of financial cycles certainly exist due to national financial systems and institutional, legal and fiscal frameworks. Financial booms and asset price bubbles indeed often occur within national borders, in spite of a union-wide single monetary policy stance. But neither deeper integration nor Banking Union is around the corner?

At the national level, the institutional architectures are a patchwork, they sometimes resemble to the “Tower of Babel”. I doubt that adding an additional European layer without a clear view of who is in charge, with what instruments and for what objective will advance the issue.

While modesty is advisable in the context of macroprudential ambitions, monetary policy has the more stable conceptual framework. And through our “two pillar strategy”, which takes account of real economic developments and money and credit, monetary policy is able to integrate financial stability concerns. By doing so, the ECB can assess the longer-term implications for future inflation and economic growth.5

**Conclusions**

Fast-moving times sometimes require adjustments. Central banks are not excluded from this. Sometimes minor amendments are sufficient, like the introduction of a rotation scheme across the larger currency union. Other changes might call for bigger reforms – as the financial crisis painfully highlighted. But often conceptual pendulums swing too far.

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While ambition is justified to acknowledge the importance of financial stability, humility is warranted when it comes to policy conclusions. The time is not ripe for an operationalised standalone macroprudential approach – inside or outside the central bank.

Completing the European deposit insurance scheme (EDIS) and the banking union, making progress with the capital markets union and deepening economic and monetary union will lead to a financial cycle that is less determined by national structures. So the most efficient level at which to address these issues will change. But that would not, in and of itself, warrant a separate institution making separate financial stability decisions and complicating the tasks of existing institutions.

In any case, the monetary policy function will need to be closely involved, and is probably best placed to contribute to the development of a more robust conceptual framework. This is a precondition for operationalising a macroprudential stance that would do more than just neutralise an efficient and effective monetary policy stance. Until these preconditions are met, the best solution is to integrate financial stability concerns into monetary policy at the European level – including possible corrections with instruments at national levels.

Such a transitional equilibrium is, however, subject to necessary changes depending on three factors:

1. Deeper knowledge of the determinants of the financial cycle.

2. Better understanding of macroprudential transmission mechanisms and policy instruments’ consequences, taking into account the institutional evolution of European integration.

3. A continuous reassessment of the evolution of the monetary policy toolbox and the consequences of its use for the financial cycle.
Economic convergence

The topic of this year’s conference is economic catching-up. As the world economy is gradually recovering from the Great Financial Recession, attention is turning again to the process of economic catching-up, particularly within the European Union and in Asia. However, economic growth is burdened by legacy problems: a looming trade war, Brexit uncertainty, high government debt levels and shaky banks in some countries. The economies of major countries are slowing, and an increasing number of observers warn that another recession is likely to occur within the next couple of years. Paul Krugman, for instance, in a speech delivered at the World Government Summit in Dubai in February 2019, said that the world economy was heading for a recession. His main concern is that economic policymakers are unprepared to have an effective response for the coming recession.

That said, the catching-up process is continuing and has attracted much attention. In the EU, the convergence between the old and new Member States is a constant topic of discussion, not the least because it involves issues of distribution of cohesion funds and intra-EU labour flows. As to the EU funds, the question debated is how much and in what form should the funds be granted to converging Central and Eastern European countries (CEEs). When it comes to labour movement, the problem is the large outflow of labour force from the CEEs to the more developed “old” EU member countries, creating serious labour shortages in several CEEs and potentially delaying their catching up. In Asia, China’s emergence raises geopolitical issues which has led to expressions of concern both in the United States and Europe.

As a moderator of this morning panel composed of highly qualified participants, I would like to briefly illustrate three convergence and one divergence stories. Chart 1 shows, on a weighted basis, the share in world GDP of the G7 countries and six South-East Asian countries: China, India, Indonesia, Korea, Malaysia and Thailand. The share of the G7 declined from about 60% to below 50% during 1990-2017, and is projected to further fall in the years to come. During the same period, the share of the six South-East Asian countries rose from about 5% to above 20%. More remarkable is the convergence over the past decades in per capita GDP calculated in real terms on a purchasing parity basis. While in 1980, the per capita GDP in purchasing power parity of the G7 was nearly 20
times higher than the per capita GDP of South-East Asian countries, in 2017, that ratio was reduced to less than 4 (Table 1).

Among Asian countries, China’s performance is spectacular. In 1990, its share in world GDP was less than 5%, by 2017, it increased more than threefold to 15%, fast approaching that of the United States (Chart 2). In 1980, the real GDP per capita on purchasing power parity was forty times higher in the United States than in China, by 2017, it was only four times higher. This is still a large gap, but the improvement in

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6 South-East Asia: China, India, Indonesia, Korea, Malaysia and Thailand. G7-countries: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
living standards has been enormous in China over the last decades. It is worth noting that the catching up of China started in the early 1990s, i.e., only about 25 years ago, making the rapid convergence even more remarkable.

The economic catching-up processes of the less developed countries will involve momentous changes. I would not venture to speculate about the nature of the new world order that the emergence of South-East Asia in general, and of China in particular will bring about. It is not an irrelevant question to ask though, what strains will it cause on the Earth’s resources when the consumption level of these large populations, amounting to several billions, will reach the level of the consumption of the G7 countries.

Another story of convergence I would like to point to is that of the CEE-8 countries which joined the EU in 2004 to the fifteen old member countries. Between 1995 – the year after the big drop in output in the CEEs in the wake of the break-up of the Soviet Union – and 2017, the GDP of the CEE-8 in the GDP of EU-28 rose only slightly from 74% to 78%, as the momentum of convergence was set back by the Great Financial Crisis (Chart 3). The real per capita GDP in terms of purchasing power parity displays a somewhat stronger convergence. It was about two-and-half times higher in the EU-15 than in the CEE-8 in 1995, the ratio declining to approximately one-and-half by 2017. Performances varied greatly among the CEE-8, Poland’s rapid growth boosting the reduction observed in the aggregate gap, but in most recent years, the pickup in growth

Chart 2. Share of China and the United States in World GDP, 1990-2023 (in percent)

Source: IMF World Economic Outlook, October 2018.
in the Visegrad-4 countries\(^7\) has contributed to the narrowing of the gap. The catching up of the CEEs can be regarded as a natural process of less developed countries, but the slow pace of convergence, so far, has left many people disappointed.

Next, let me show a case of divergence that does not augur well for the future position of Europe in the global economy. Chart 4 shows the share of GDP of the United States and the EU-28 in the GDP of the world. Naturally, both shares are declining, as the share of catching-up countries is increasing, but this is not the point. Rather, it is the fact that while until 2015, the share of the EU-28 was higher than the share of the United States, since then it has been below and is projected to remain below for the years to come (Chart 4). Furthermore, the US/EU ratio between the real per capita GDP in purchasing parity terms, although fluctuating since 1980, has been rising since the financial crisis (Chart 5). These trends, if continued, will have geopolitical implications for Europe going forward.

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\(^7\) Czech Republic, Hungary, Poland, Slovakia.

\(^8\) EU-15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom. CEE-8: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia.
The relative competitiveness of countries during the decades ahead will depend on how fast they can innovate and adapt to the digital economy and rely on knowledge-intensive sectors for growth. David H. Autor, professor of economics at MIT, did very thorough research on the evolution of wages of non-college and college-educated workers in
urban and non-urban sectors in the United States. His research showed that the nature of changes in the work brought about by technological changes have been less beneficial for non-college than college workers\(^9\). The picture below, which David Autor presented at the Annual Meeting of the American Economic Association in Atlanta in January 2019, is an incisive way of illustrating the evolution of jobs over the decades. “Where is the land of opportunity?” - Autor asks. He labels as ‘frontier jobs’ a rapidly growing occupation that involves producing, operating and maintaining new generations of technologies. This, in turn, involves research, innovation and skills which hinge on the quality of education and its effectiveness in providing the required skills and knowledge.

From that perspective, it is worth looking at the Pisa tests made by the OECD. The test is a triennial survey testing the skills of 15-year old students to evaluate education systems across countries. The last test for which detailed results are available refer to 2015. As can be seen from Table 2, in both mathematics and science, among the first ten countries or regions, seven are in Asia, five of which have a Chinese population, and only three are in Europe. While one should not draw far-reaching conclusions from these rankings, there must be some relationship between these and the technological achievements of Asia, particularly that of China. Although the United States’ ranking is close to the average of OECD countries, its lead in research and innovation reflects in part the more concentrated research activity around universities, such as Silicon Valley in California, the research triangle in North Carolina or the Boston area. In addition, equity financing for start-up firms is readily available. In contrast, research activity is

fragmented in Europe and equity financing is more difficult to secure. This makes the US a favourite destination of researchers and start-ups, draining away talent from Europe.

*Table 2. OECD PISA Test results, 2015*

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<td><strong>OECD-average</strong></td>
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*Note: Beijing-Shanghai-Jiangsu-Guangdong (China)*

A study of February 2019 by the European Political Strategy Centre reports that Europe has been comparatively slow in integrating digital technology into existing industrial processes and in understanding the transformative nature of digital technologies. For instance, in the area of platform economy, such as Microsoft, Apple, Alibaba, etc., Europe is a distant third behind the US and China. In part this is a consequence of the lack of single market in research and capital finance, but it also reflects according to the study a general shortage of highly-skilled professionals. To face up to the challenges of the future and maintain competitiveness, Europe needs retooling and reskilling.
Good afternoon to all of you! That disclaimer slide is to show you the constraints of intellectual independence under the issues you work on at the European Commission. First, I would like to start by saying a deep thanks to my old friend György Szapáry and to Governor György Matolcsy for the invitation. Allow me a comment on the title of the session and I will explain why. The notion of convergence within the European Union actually should be addressed as its “15th anniversary”, because in 2019 we are commemorating the 15th anniversary of the 2004 enlargement. And it is a very important date for us. So important that we are actually going to have a high level meeting, we will be kindly hosted by the Central Bank of Austria, many thanks to the governor of the Central Bank of Austria, sitting right here in front of me, on 8 April in Vienna and it will be followed up by a second day of the event in the capital of Slovakia, Bratislava, which should be opened by the next governor the of Central Bank of Slovakia. Many thanks for the cooperation of all of you on that, and allow me to convey the personal thanks of my boss, President Jean-Claude Juncker, to Yves Mersch for his wonderful presentation.

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**Chart 1. GDP Per Capita, PPP, as % of EU Average**

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*Source: European Commission*

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10 Speech by Lúcio Vinhas de Souza at Lamfalussy Lectures Conference in Budapest, Hungary on 4 February 2019.
So, with that allow me to start by saying that I have a perhaps more optimistic view of the process of convergence as to what has been perhaps conveyed by the previous speaker and I will highlight why. I think that it is clear that the European Union keeps on being, what in a famous report by the World Bank was called, a “convergence machine”. You have on the screen in front of you a subset of Central European countries, which I am using here as the benchmark for convergence, simply because of the catch-up notion, they start from lower levels of GDP per capita. So, the metric that I am using here is GDP per capita, not GDP. I am using PPP, if I were using nominal it would actually be clearer. Now, as is apparent from the figure that you have behind me, the process of convergence has remained uninterrupted even during the crisis. Even during the period in which we had the first contraction of global GDP since World War II, the process of relative convergence of Central European Countries, as is demonstrated here, remained uninterrupted. In particular countries, what you have was such a powerful process of convergence that is actually going to be on economic history books. Take a look at what has happened to the Republic of Poland, the largest of the Central European economies. They had an increase in terms of their relative share in relation to the EU average, in terms of GDP per capita of over 20 percentage points, between 2004 and now. The Republic of Romania had an even more impressive process of convergence: over 30-percentage point increase during this same period. Hungary is part of this story too.

I should also point out that shocks to process of convergence that were observed were actually independent from you having been a member of the euro area or not. If I had plotted on the slide behind me, the Czech Republic – or as I should say now, Czechia – and Slovakia, in other terms, a non-member state of the euro area and a member state of the euro area from the same region, it would become clear that the process of convergence is virtually indistinguishable between a member of the euro area or not. As a matter of fact, you can make a case that Slovakia, a member of the euro area converged even faster than the Czech Republic. On the same case, you can make the argumentation that the divergences and shocks that we observed during the euro area crisis were not related to euro area membership. I am a proud citizen of the Portuguese Republic. With all due respect to my beautiful beloved country, we had stopped converging before we became a member of the euro area, the same thing in Italy, this happened because of underlying domestic policy questions that were not properly addressed.

Now, as was previously indicated, I am the former Chief Economist of Moody’s, where I had during the period of the euro area crisis the dubious pleasure of downgrading the rating of one European country on average per week. The underlying question in the bulk of these situations were domestic convergence problems related to underlying non-
sustainable policies that in some cases had been there for over a generation. Now, that in no way denies the fact that we had in the beginning an incomplete response from the point of view of the European Union authorities to the great shock of the global crisis. And again, I have some examples of how this played out in actual history, I was joking with Bill White before that one day that when I write my memoires of my period as Chief Economist of Moody’s, you are really going to see that there were moments in which economic global history was on a knife edge. You could have gone through a different scenario in relation to what we have now.

But, I think it is undeniable that when we look at what we managed to do at the European Union and euro area level the set of tools that we have now is much more comprehensive, is much more powerful than we had back in 2007. This is not perfect, I am a good Catholic, so the only guy that is perfect is God, right? So, we can improve, as we are not perfect. Now, as I indicated before, it does not mean that we should not have concerns about the future of convergence. And some of this is actually natural and positive because convergence in some way gets constrained because you are getting closer to the frontier. The closer you are to the average levels of the GDP of the European Union, of course convergence becomes more problematic.

Now, I will try to talk a little about what is necessary in our view in terms of potential stresses on the convergence model of Central-Eastern Europe, a little bit later in my presentation.

But I would start by making the point that, in terms of macro-economic performance, Central Europe actually performs really quite well. Now, if you look at this comparison in terms of macro-economic environment, you are actually around the average level of the Union and the euro area. So, it is not necessarily the macro part that provides you with stresses in terms of the model. I actually should point out, without any inferences related to that, in terms of the formal criteria for euro area ascension, you are mostly compliant with the bulk of them, minus, of course, Exchange Rate Mechanism participation. We may have a test case for this proposition a little bit later in the year. Now there are however stresses which are in some cases related to the very process of economic development that may point to the need of revisiting the model of convergence that Central Europe has been using so successfully for the past generation. They are related to questions of overall competitiveness, unit labour costs, and in some cases a perceived decline on the level of governance and on the quality of institutions.

I will talk a little about each one of those components during the rest of the presentation.
Now, you remember how impressive the region was in terms of overall macro-
competitiveness. When you have a broader view of competitiveness, which includes
institutional quality, respect for the rule of law, etc., the relative competitiveness of the
region is not as impressive as if you just look in terms of overall macro performance.
Now, the underlying reason for that is that at least from the perception of market
operators you have had some constrains in terms of both the overall environment and
the enforcement of administrative quality. It is obviously necessary to realise that a
welcoming business environment is essential for you to attract external investment
and to effectively have domestic investment supporting your economy. A properly
functioning of domestic markets that avoids distortions to “level playing field” types of
situations also necessarily implies an effective level of domestic governance in respect
to the rule of law.

Another factor that has been underlying some stresses related to the development model
of Central Europe is the availability of cheap labour. We all know that the moment you
entered the Union you not only had large pools of underutilised and relative cheap
labour but labour of a high level of qualification in relation to the available labour pools
in other parts of the Union. Your competitiveness in terms of unit labour costs was one
of the great attractive factors from the point of European investment at the moment
of entry. This relative advantage, the relative cost of labour across Central Europe
has been progressively eroded during the past 15 years. For good reasons. Part of the
process of economic development is that your salary levels go up. So naturally, you do
have a tendency to reduce that advantage. There is also a more complex reason behind
that which is the very significant outward migration that we have had from Central
Europe. There are countries in Eastern Europe in which a full third of the working age
population actually migrated out. And it is easy to understand why it happened. First,
because of the wonders of the free movement of labour within the European Union.
But, for instance, if you are a Romanian code writer in the lively tech ecosystem in
Romania – and Romanian is actually the second most numerous nationality on Google
programmers at its headquarters in California. If you move away from Romania, even if
your salary has been increased quite considerably there, just moving away to Germany
will increase your nominal salary by a factor of twelve. When you are dealing with
this sort of difference it is quite natural that labour will move out. There are, of course,
certain policies that could be used to ameliorate that – among those, retraining, retooling
– but that clearly was one of the underlining sources of the convergence model.

Now, another thing that we can consider in terms of thinking forward in how we can
redo the model is related to the role of investment. Both foreign direct investment and
the usage of resources from the Union. It is absolutely true that you have healthy levels of investment and that they have been going up since the shock related to the crisis, but one thing that should be noted is the following: the average level of dependence of state investment on EU transfers across Central Europe is remarkably high. In this country it is around 55%. Just to show you that it is not really a regional phenomenon, my own beloved home country depends on European Union transfers for a full 85% of the public investment that happens nowadays in the Portuguese Republic. Not only is this a component of vulnerability to your growth model, but we should remember the following: the logic of a grant-based type of support of investment, which is the underlying traditional model of cohesion funds, is that we give away money. We are progressively evolving – also because of the higher levels of development – towards a more market-based type of support of the investment, so to, effectively, a model which is similar to what was introduced by the Juncker plan. In other terms, the leveraging of private investment by a limited usage of Union funds as guarantees. There is an ongoing discussion on our current MFF proposal and you should be part of the discussion to understand what is on the table going forward.

![Chart 2. Gross Fixed Capital Formation, Chain linked volumes, Index 2010 = 100](source: Eurostat)

Now, one thing that I want to make clear here, and this is not propaganda of the work of Brussels, is that the Union has several tools, policies and frameworks to support the countries of the region in this discussion of the convergence model going forward. That is our job, we are here to support EU Member States. In overall competitiveness questions, they go from the framework we have inside the European Semester, which are
dedicated Member States-specific discussion of vulnerabilities, to Council formations like the Competitiveness Council, and if you are a member of the euro area, the network of national Productivity Boards. The current Commission proposal for the next budget, as I just indicated, is effectively a part of this discussion on the switching away of the model of investment from a grant-based logic to more market-led investments. And of course, structural reforms in general are supported now by the no longer “newly created”, but still relatively fresh on the ground Structural Reform Support Service.

Now, given that this is a central banking meeting I would like to point out one sector of convergence that for central banks, member of the euro area or otherwise, is part of their core mission, namely financial stability. Especially in a setting in which you have bank systems which are largely “euroised”. And if I were to add Nordea, both Denmark and Sweden would actually be around a quarter in terms of assets which are from euro area banks nowadays. The implication of this is the following: participating in some of the key priority policies of the Union, namely Banking Union, has many practical advantages in terms of central banks providing this key common good for sustained convergence, financial stability. They go from Single Supervisory Mechanism participation to access to Single Resolution Board funds.

Now, concluding perfectly on time, there are many advantages of your EU membership, we all know that because we are members of the Union because we want to be. They are clearly demonstrated by the unbroken process of convergence in Central Europe. However, there are stresses, some of them derived from the very process of economic development, that point out of need a re-thinking, recalibration of this growth model. The Union is a partner: we are here to support you, we exist to provide services to Member States, we will always be a partner on those discussion issues. And there are also roles of central banks in making sure that this convergence continues.

Many thanks to all of you for your attention.
I am very pleased to have been invited to speak at this 2019 Lamfalussy Lecture Conference. I met Alexander Lamfalussy in the mid 1980’s, when I first started attending meetings at the BIS in Basel, and was impressed by his great wisdom, analytical capacities and his personal kindness. Accordingly, I was particularly honored to accept the position of Economic Adviser at the BIS in 1995, a position he had previously occupied. Yet, it was only last year, when I did a review of a book of his essays, that I really came to appreciate the greatness of this quintessentially modest man. Reflecting a lifetime of rich experience, and of constantly having to adapt his beliefs and policy recommendations to changing circumstances, his essays remain well worth reading by those charged with dealing with contemporary problems.

My comments today will be in three parts. First, I will take a brief overview of the convergence process between the CESEE countries and the rest of the EU since the demise of the communist system in the CESEE countries in the early 1990’s. Second, I will hazard some thoughts on the future of the convergence process, stressing the importance of the need to ensure that the CESEE economies are sufficiently resilient to inevitable economic downturns. Hoping for the best is not a viable strategy. Third, I will identify some current threats to both growth and convergence, some economic and some political, and will also suggest some policy remedies.

**Convergence to Date**

The Nobel prize winner Daniel Kahneman (2013) stresses that how a problem is “framed” has an important effect on the solutions ultimately suggested. The organizers of this conference have defined the problem in terms of “catching up” or “convergence” with Western Europe. This implies either a belief in the inevitability of this process or

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11 White (2018a)  
12 Maes (2017). The book was commissioned jointly by the Magyar Nemzeti Bank and the National Bank of Belgium.
a belief that there is something inherently good in achieving such a relative objective. It seems to put aside a possible alternative objective, of simply raising in a sustainable way the absolute quality of life for the citizens of the CESEE countries. This focus on “convergence” also threatens to draw attention away from remaining problems within individual countries in CESEE, not least the question of inclusiveness and the adequate sharing of the fruits of progress. If convergence for the average citizen comes at the expense of growing regional inequality, or a growing rural-urban divide, is this a good thing to do or not?

Even accepting “convergence” as a goal, the literature indicates that many questions remain. How to measure convergence? Most commentators seem to focus on the convergence of real GDP per capita, but this ignores exchange rate issues (market rates or purchasing power parity) and also different demographic trends that might create cross country differences in the relative size of the working age populations. Another contentious issue is, convergence with whom? Should the benchmark be the original EU5, the average of the “core” European countries, the average of the current membership, or simply the nearest rich neighbour? These different measures can give quite different estimates of how near, or far, the objective appears.

Looking back, however, there can be little question of how far the CESEE countries have advanced from what Rostowski (2007) has described as a “quite abominable” starting point. In terms of real GDP per capita, the Baltic states, Poland and Slovakia have converged the most. The Czech Republic, Slovenia and Hungary have also made great progress, albeit less in convergence terms because their initial levels of GDP per capita were significantly higher than some other CESEE countries. Broader measures of well-being, for example the OECD indices indicating a “Better Life”, have also improved significantly, with declining infant mortality and rising life expectancy playing an important role. Importantly, there seems to have been relatively little increase in income inequality, as measured by Gini coefficients. Admittedly, such measures do not include income gains from the “black economy” or corruption, and can give a quite different impression of inequality than measures of the distribution of wealth.

Broadly put, the increased rate of growth in CESEE seems to have resulted from a marriage between inflows of foreign direct investment, mainly in the form of “green field” investments based on modern technology, and an educated and flexible domestic work force. The fact that wage levels were initially low by Western European standards

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13 Mihaljek (2018)
14 Ritzberger-Grunwald (2018)
contributed materially to inducing those foreign inflows. Yet another, and more fundamental motivating factor, was an incredible array of legal and institutional reforms. In particular, legal reforms led to wholesale privatisation of previously state-owned enterprises and deregulation that encouraged private enterprise. New institutions were also introduced to enforce the new laws and to protect the rights given by the law\textsuperscript{15}. It was generally recognized that, without the protection of property rights and the consistent and equal enforcement of the law, there would be little investment\textsuperscript{16}. Nor would there be much of the related entrepreneurship and innovation which is at the heart of a process of dynamic growth.\textsuperscript{17}

The organizers of this conference have also drawn attention to the fact that the convergence process of the CESEE countries seems to have slowed since the onslaught of the Great Financial Crisis (GFC) in 2008\textsuperscript{18}. Whether this is a permanent trend is hard to determine since it depends on the differential rate of slowing of two different series and an evaluation of the factors affecting each. The recent literature\textsuperscript{19} seems to indicate that large economic downturns have hysteretic effects, though it is not clear whether it is a negative effect on the level of “potential” output, or its growth rate or both. Post crisis estimates of potential output, in virtually all regions of the world, have clearly been revised down from pre-crisis estimates. However, this has largely been based on a simple extrapolation of post crisis trends. This falls short of a careful evaluation of the underlying causal factors, and falls well short of whether they might exert a permanent influence or not.

There can be little doubt that the CESEE countries were affected more than the “core” European counties by the retrenchment of the Western European banks after the GFC, and in particular after the beginnings of the subsequent crisis which affected the “peripheral” European countries. Whether under the influence of perceived self-interest, or regulatory imperatives, previous capital inflows to the peripheral countries and to CESEE were sharply reversed. The expected negative effects on growth were amplified in some countries where a preceding “boom” turned to “bust”. In effect, in those countries the crisis revealed that some part of the observed pre-crisis growth was

\textsuperscript{15} See Rostowski (2007) and also Balcerowicz (2015) for intriguing descriptions of such developments by those who actually participated in them.

\textsuperscript{16} Balcerowicz (2019)

\textsuperscript{17} Phelps (2013) and Janeway (2018).

\textsuperscript{18} Ritzenberger-Grunwad (2018) confirm this, noting that the most important driver has been a sharp reduction in fixed investment.

\textsuperscript{19} Saxena and Cerra (2008)
simply not sustainable.\textsuperscript{20} Hopefully, these kinds of influences on growth will dissipate with time.

The OECD has also noted a slowing in the pace of structural reforms in CESEE in the post crisis period. It would not be unreasonable to link this fact to absolutely poorer economic performance over the same period. However, it is harder to link this to relatively poorer performance since the OECD has observed a similar slowing in the pace of structural reforms in many countries. Economic difficulties always constrain the government’s capacity to buy off the vested interests that oppose structural reforms. In the CESEE countries, the slowdown might have been accentuated by “reform fatigue”, unique to them after such a long period of massive structural change. Again, there are no grounds for belief that this will be a permanent force impeding growth, and convergence, in the future.

\textit{The Future of Convergence}

Expectations about future growth and convergence in CESEE, as well as the policies needed to support this objective, depend on the growth model we assume. As noted above, how a problem is “framed” can have a significant effect on the solutions proposed.

A traditional neoclassical growth model (of the Solow-Swan type) links growth to factor inputs assumed to have diminishing returns. Assuming that labour and capital can move freely to jurisdictions where returns are higher, convergence is inevitable. In this model, the efficiency of allocation is crucial, and all other policies and institutional developments are irrelevant. A fundamental shortcoming of the neoclassical approach is that all the other forces driving growth are assigned to the growth of Total Factor Productivity (TFP) – in effect a residual in the econometric estimation of the production function.

More modern approaches to explaining growth and the possibility of convergence (e.g. endogenous growth theory and complexity economics) make different assumptions\textsuperscript{21}. They admit to the possibility of increasing returns to scale, the importance of investment in human capital (education and training), the relevance of research/development and

\textsuperscript{20}Borio et al (2013) provide a new methodology for estimating “potential” in the context of a non-inflationary financial boom.

\textsuperscript{21}See for example Beinhocker (2006) and Kirman (2010)
innovation, and concentration effects among others. Under these alternative approaches, convergence is not inevitable but depends on the policies being followed by the nation in question. Cases in point are those African and Latin American countries which have failed to converge to richer neighbours over many decades. Moreover, what is crucial is not just getting on a good growth path, but staying on it through the adoption of policies which adjust to changing circumstances. Cases in point are those Asian countries which initially had investment and export driven growth models, but which are increasingly being forced to turn to domestic consumption to support demand.

While most of the narrative about growth and convergence focuses on policies to promote positive growth, increasing attention is now being focussed on policies that reduce the potential for negative growth. Economic history indicates that all economies have their ups and downs. Moreover, complexity theory predicts that all complex systems break down regularly according to a Power Law. This suggests that all economies will have periods of slower or even negative growth.

This fact is crucially important. Recent research by Broadberry and Wallis (2017), based on European data going back to the fourteenth century, shows that eighty percent of the difference in the longer-term growth rates of richer and poorer countries can be explained by the former economies not shrinking as much in downturns as the latter economies. Broadberry and Wallis attribute this to stronger institutions in the richer countries that maintain trust during downturns. This allows an orderly and cooperative adjustment that minimizes the potential for positive feedback effects to aggravate the downturn.

In a separate strand of literature, Funke, Schularick and Trebesch (2015) suggest that financial crises play a particularly important role in this regard. Such crises commonly lead to political polarisation, with nationalist and socialist extremists benefiting in particular. The authors state “These developments likely hinder crisis resolution and contribute to political deadlock. The resulting policy uncertainty may contribute to the much-debated slow economic recoveries from financial crises”.

Focussing on the potential harm done to longer term growth and convergence by downturns has another implication. Much more attention needs to be paid to crisis prevention, to crisis management and to policy measures which actually resolve underlying problems rather than disguise them or “kick the can further down the road”. I will return to this issue at the end of this presentation.
Current Threats to Both Growth and Convergence

Many such threats can be identified. Some of these are internal to the CESEE countries and merit a domestic policy response. In effect, these are efforts directed to crisis prevention. However, many of the identified threats arise from developments outside CESEE. Since there is nothing the CESEE countries can do to prevent such shocks, the emphasis must be on ex ante preparations to manage and resolve problems when and if the shocks materialize. Note that such preparations are also important for dealing with internally generated problems. It would be naïve to assume that preventive measures will always prove adequate.

Internal threats

Grieveson (2018) and Shotter (2018) draw attention to labour shortages in many countries in the region, reflecting unfavourable demographics accompanied by a significant degree of emigration from many CESEE countries. Their concern seems less that of rising inflation, which seems everywhere to be held down by global developments, than an eventual loss of external competitiveness. This has raised concerns about emerging balance of payments problems and the possibility that firms (especially foreign ones) might move to lower cost jurisdictions. This latter concern might, however, be mitigated by the natural advantages of the CESEE countries; their proximity to Western Europe, the large sunk costs of existing investments and stronger institutional foundations than countries further to the east or south. As well, real wages in CESEE remain well below those in Western Europe, even though productivity levels in foreign owned plants remain comparable.

While some countries (like Poland) have addressed the underlying labour market problem with increased immigration, there is widespread political resistance to this solution in much of the region. Providing better domestic working conditions, to restrain or reverse emigration would be helpful. So too would be improved education to increase the supply of skilled workers. Perhaps most important are policy measures that will facilitate the productivity increases required to justify continuing increases in real wages over time. Finding ways to accelerate the spread of technological innovations from “frontier” to “laggard” companies is a challenge throughout the OECD.

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22 Also see Johnson (2018)
23 Hille (2018)
24 Measures might include more investment in technology and innovation, and less investment in labour intensive (and low productivity growth) sectors like construction.
A second problem has to do with excessive levels of private sector debt, which create “headwinds” to spending and could also prove a threat to financial stability. This does not seem to be a current problem, given the slowdown in credit growth in recent years, though the level of non-performing loans in some countries indicates some unresolved issues from the past. Yet, I would flag private sector debt as a future concern, since debt driven crises seem increasingly endemic. Not only should the authorities keep a watchful eye, but they should not take too much solace from the availability of new macroprudential instruments of control. These instruments have many shortcomings. Not least, they seem less effective in resisting a credit boom than in making the financial system more resilient to the subsequent bust.

A third prospective problem is the level of sovereign debt. While it is true that only a few CESEE countries have ratios of debt to GNE greater than 60 percent (the Maastricht requirement), and the duration of that debt has lengthened, developing and transitional economies generally have lower thresholds for loosing market access. Moreover, looking forward, the poor demographics in many CESEE countries will imply a significant degree of tightening to get on a sustainable path. If existing medium-term targets are to be met, the need to run larger surpluses in good times is imperative. The tendency for sovereign debt stocks to ratchet up, in virtually all countries, is because fiscal stimulus in downturns is never adequately offset by restraint in good times.

A fourth issue has to do with the proportion of sovereign debt held by foreign entities with relatively short investment horizons, and/or denominated in foreign currency. This raises the possibility of sudden outflows and currency mismatch problems. Further efforts to develop domestic financial markets, especially in domestic currency, would be helpful. So too would derivative markets that might help governments trying to hedge their foreign currency exposure.

A final and crucial issue is possible backsliding (or even reversal) of previous legal and institutional reforms. In a number of countries, the independence of the judiciary

27 Hildebrandt and Lahnsteiner (2017)
28 White (2018c)
29 In many countries, macroprudential tightening has occurred against the backdrop of ultra-easy monetary policies which encourage regulatory evasion. This combination is totally different from how the implementation of macroprudential policies was originally conceived, as a complement to tightening monetary policies. See Group of Thirty (2015)
30 Beer (2018) and Eller and Holler (2018)
31 See Barisitz et al (2016)
32 Regling (2018) raises the related possibility of capital flight by resident deposit holders, and notes how cross euro deposit insurance might play a helpful role.
from the political process has been called into question. This could have important implications for the business environment, for investment in general and for foreign investment in particular. Foreigners are particularly aware, from painful historical experience, that deviations from the “rule of law” commonly act to their disadvantage.

**External threats**

As small, open economies, the CESEE countries are subject to the vagaries of events elsewhere. I present here a limited list of things to worry about. However, a central point to note is that, in a highly globalized world, problems anywhere are likely to trigger problems elsewhere. Put otherwise, some of these external shocks might be highly correlated. This increases the dangers they pose for CESEE and raises the importance of ensuring resilience.

Global trade tensions, particularly between the US and China but also between the US and Europe, are a major threat to growth going forward. Such tensions raise uncertainty and sap confidence, both of which lower investment. Threats to trade in cars could be particularly harmful, coming on top of sharp, recent slowdowns in demand for cars in both the United States and China. Given the importance of the automobile sector in CESEE, changes in the structure of global production could have an important negative effect.

Brexit is another issue\(^33\), with a no-deal Brexit looking increasingly possible. One set of negative effects would be similar to those from rising trade tensions. Around 20 percent of the cars made by German automobile companies in Europe are sold in the United Kingdom. EU budgetary problems will also be hit by Brexit, with negative implications for structural funding in CESEE in particular. More positively, Brexit will reduce the opportunities for younger workers in the CESEE countries to move to the UK. What is more ambiguous are the implications for Brexit for internal developments within the European Union\(^34\). On the one hand, it might show that leaving the EU is possible and so encourage others to do the same. On the other hand, the costs of a chaotic UK departure, to the citizens of the UK, might encourage efforts to make the EU work better than it currently does.

Issues internal to the EU also raise threats that might affect CESEE. Veron (2012) asserts that the institutional structures of the EU suffer form serious “analytical, executive and

\(^{33}\) Barber (2018a)

\(^{34}\) Barber (2018b)
democratic deficits” that make it prone to breakup35. To this must be added ongoing disputes about where (national or international) power should be exercised, about immigration, budget issues and how to deal with rising nationalist sentiments. Short of breakup, attempts to refigure the EU to make it more manageable could conceivably leave some CESEE countries as second or even third tier participants36.

Finally, there is the issue of global growth prospects in the next few years. Alternative, plausible scenarios all indicate some risks for the global economy and to CESEE. A more optimistic growth scenario, starting from low levels of excess capacity in many countries (not least the US), threatens inflation and higher interest rates. However, higher rates of interest lower the capacity of many highly indebted companies to service their debts,37 which could then lead to slower growth and financial instability in turn. A less optimistic growth outlook also leads to slower growth and the risks arising from financial instability, but more directly. As Warren Buffet remarked “It’s only when the tide goes out that we see who has been swimming naked”.

What could CESEE do to prepare for downturns arising from whatever source? Steps can be taken ex ante to allow the downturn to be better managed. Ensure that domestic deposit insurance arrangements are adequate. Build up fiscal buffers to allow sovereign deficits to rise without loosing market access. Similarly, raise the duration of sovereign debt to reduce rollover problems. Also raise the capital and liquidity buffers of banks to make them more resilient to a downturn. Negotiate with foreign providers of liquidity in foreign currency to ensure liquidity support when needed. Finally, keep the lines of communication open between “home” and “host “supervisors in cases where foreign banks play a big role domestically. More generally, it is always good to be able to count on the support of friends in tough times.

In many downturns, it quickly becomes apparent that attempts to service existing debt levels are having negative feedback effects on the whole economy. This is what Keynes described as the “paradox of thrift”. It is instructive that, in Greece since the crisis, massive bouts of fiscal restraint have actually led to the sovereign debt ratio rising sharply as GDP fell even faster. To avoid such outcomes, it is important to take ex ante steps to allow private sector debt to be more easily and quickly restructured or even written off. This involves, not only passing the appropriate laws, but also ensuring that an adequate administrative structure exists (of courts, judges, mediators etc) to give

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35 See also White (2017)
36 Barber (2018c)
37 See White (2018b)
effect to the laws. Similar measures should be in place to ensure the orderly resolution of financial institutions, perhaps even over a weekend as has often been necessary historically.

The broadest requirement of all, to support an orderly and resilient recovery from bad shocks, is a willingness to cooperate between private sector participants and between the private sector and the government. If this is replaced by an ethos of “every man for himself”, the resulting disorder will prove highly costly. Cooperation, however, must rest on a sense of trust in the integrity of other parties. Most importantly, it rests on the belief that the government is acting in the best interests of all its citizens and not just a favoured few.

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Observations on the Impact of the EU’s Four Freedoms on the Economic Convergence of Central Europe

1. Alexandre Lamfalussy’s Defence of European Integration

In late March 2010, at the onset of the euro area crisis, Edmond Alphandéry, France’s former minister of finance, convened a small group meeting which brought together representatives from European central banks, former and current policymakers such as the Greek minister of economic affairs, academics such as Charles Goodhart, Paul De Grauwe, Daniel Gros and Harold James, and a number of bankers and market participants. This discussion at the Fondation Universitaire in Brussels took place 18 months after Hungary had to apply for financial assistance to the European Union and the IMF because of its difficulties in refinancing government debt. And, it took place only a few weeks before Greece suddenly lost access to capital markets, very much to the surprise of its own government.

At this meeting in March 2010, key initiatives which came to dominate the economic policy agenda of the European Union in the following years were already floated, such as the mechanics of sovereign debt restructuring within the European Union, the creation of a permanent European Monetary Fund, the IMF’s participation in financial assistance programmes for euro area member states, the prohibition of uncovered shorts in sovereign credit via credit default swaps (a proposal which I put forward at the time), and the creation of a European Debt Agency.

These were constructive and creative proposals, which were all implemented in the following five years, apart from the creation of a European Debt Agency. However, the discussion in Brussels on that day was also marked by a lot of soul-searching about the way financial and economic integration in the European Union had progressed. It was already visible at the time that the years since the Baltic Three (Estonia, Latvia

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and Lithuania), the Visegrád Four (Czech Republic, Hungary, Poland, Slovakia) and the Southern Five (Cyprus, Greece, Malta, Portugal, Spain) had joined the European Union were not only marked by a convergence of income levels, but also by structural economic divergence through overconsumption in the accession countries, as evidenced by large current account deficits and, in some countries, large fiscal deficits as well. I remember a heated debate that questioned the very process of economic and financial integration and the merits of a common currency, since national fiscal authorities had clearly been acting irresponsibly, markets were tolerating this, and European policymakers had closed their eyes on falsified national accounts and unsustainable borrowing trends.

And, I also remember the way in which Alexandre Lamfalussy chaired this debate session. He listened carefully to the concerns and frustrations voiced by this group of policymakers, academics and bankers, and then he provided a firm and polite defence of the logic and necessity of European economic and financial integration. He explained how, over the past decades, it had become impossible for the nation state to conduct independent monetary and exchange rate policies, or to isolate its economy from trends outside of its borders. This was especially the case for small countries in the neighbourhood of Europe’s largest economy, Germany, as Alexandre Lamfalussy explained, using the examples of Belgium and the Netherlands. And one might add: this inability of the nation state to re-emerge as an independent economic actor also applies to the countries of Central Europe.

Apart from economic logic, Alexandre Lamfalussy’s defence of European economic and financial integration also seemed to be based on an understanding of Europe as “Schicksalsgemeinschaft”, as Jean-Claude Trichet likes to call it – Europe as a community of common destiny. This did not stop Alexandre Lamfalussy from voicing criticism of the European leadership, or rather: the lack of European leadership that became apparent during the financial crisis that started in 2010. But the tone of his criticism was very different from the tone that we often hear today, in my home country, and in other European countries. The way in which he framed current issues and the tone that he struck when it came to Europe left me believing that the European Union would overcome the crisis that lay ahead.

In preparing my remarks for today’s conference, I looked up my notes from that meeting nine years ago. As I left Brussels, I was convinced that Greece and the euro area as a whole would soon enter into a massive financial crisis, but more than anything, I was left impressed by Alexandre Lamfalussy’s intervention. His view of the inevitability of European integration, paired with his quiet optimism, or – to use the words of Pablo Neruda – ardent patience, was the most important take-away from the gathering for me.
With this memory in mind, it is a great honour for me to speak at today’s distinguished conference on the theme of “A Decade of Catching-Up” and I would like to offer some observations on the role of institutional arrangements in the process of the economic convergence of Central European countries, namely on the role of the four freedoms that stand at the core of the European Treaties.

2. The Four Freedoms of the European Union

The European project – which rose to strength after the destruction of democratic institutions, the horrors of racism, anti-Semitism, totalitarian rule, genocide and military aggression and the devastating war that Germany and its allies had spread across the continent – is driven by one key intention: Creating and safeguarding individual freedoms for its citizens. This intention is clearly stated in Article 3 of the Treaty establishing the European Economic Community, which was signed by the heads of state and governments of Belgium, France, Italy, Luxembourg, the Netherlands and Western Germany in Rome on 25 March 1957:

“The activities of the Community shall include […] the elimination, as between Member States, of customs duties and […] the abolition, as between Member States, of obstacles to the free movement of persons, services and capital”.

This commitment to establish four fundamental freedoms in the lives and economic activities of its citizens – the free movement of goods, of persons, of services and of capital, in that order – has had a profound impact on all countries that joined the European Union. In many respects, the four freedoms have been a double-edged sword. They set in motion a process of economic transformation which produced winners and losers, and the effects of this transformation came to shape the political debate in many member states of the European Union. It is unsurprising that the controversies surrounding Brexit are centred on the future institutional arrangements between the United Kingdom and the European Union with respect to each of those four freedoms. And it is logical that the European Union is not only associated with the promises of freedom and prosperity in the Central European accession countries, but also held responsible for many ills that have befallen their societies in the past twenty-five years.

In my view, the process of convergence in Central Europe can best be understood by analysing the economic and social impact of the four freedoms, which were brought about by accession to the European Union. In the following sections, I will make four
points on their impact on labour mobility, financial integration, economic integration and – more broadly – on the political role of those four freedoms.

3. Free Movement of Persons

The demand of citizens to travel freely across borders and to gain liberty to live and work in another country stands at the core of the peaceful revolutions that brought down communist rule in Central and Eastern Europe. However, from an economic point of view, it is impossible to ignore the negative effects that the free movement of persons has had for countries that joined the European Union. As György Szapáry and Dániel Plósz have shown in a recent paper, labour migration from Central and Eastern European countries to Western Europe is estimated to have reached around seven per cent of the sending countries’ total population and eleven per cent of their working-age population (Szapáry and Plósz 2018). A recent IMF paper (Atoyan et al. 2016) has confirmed that emigrants tend to be well-educated and young and that their exodus appears to be permanent. Those migrants have generally achieved higher incomes for themselves, and their move into more productive and better-paid jobs has also benefitted the economic development of the European Union as a whole. But by definition, this outbound migration has reduced the size of the labour force in sending countries, and since it is mainly skilled workers who have left, productivity has also been adversely affected. The IMF study indicates that for the period of 1995 to 2012, cumulative real labour productivity growth in Central and Eastern Europe would have been about six per cent higher without emigration. The result has been a decline in trend growth in sending countries and slower per capita income convergence.

This development is very visible in figure 1, which shows the evolution of Hungary’s labour force since the end of the centrally planned economy. In the first years of economic transition, there was an absolute decline in the labour force, which was partially due to outbound migration. But since 2000, we can observe a relatively steady increase in the labour force, and since 2014, there has been a rapid decline in unemployment, since Hungary’s economy is developing so well that it is now itself facing labour shortages.
A similar development can be observed in other Central European countries, most notably in the Czech Republic, where the unemployment rate has fallen to the extraordinarily low level of two per cent of the labour force (under ILO definition).

One of the factors explaining the widespread support in Hungary for accession to the European Union in 2003 may well have been the desire of citizens to travel freely and to work in other member states. Initially, this “first freedom” has been detrimental to the development of Hungary’s own national economy, since it led to outward migration. But today, Hungary’s total employment exceeds the pre-accession level by more than 600,000 workers and the domestic labour force is almost fully exhausted. As a result, labour costs are starting to outstrip productivity growth, leading to a decline in relative competitiveness (Vinhas Souza 2019). In January 2019, workers at Hungary’s Audi car factory reached a deal on an 18 per cent wage increase (Reuters 2019), a telling example of this development.

Central European countries thus face a policy choice between tolerating an economic slowdown due to labour shortages and allowing for greater inward migration. Labour market statistics demonstrate that Poland, aided by its cultural proximity with Ukraine, is doing a better job than Hungary or the Czech Republic in accommodating the inflow of migrant workers – this is one of the factors explaining Poland’s economic outperformance within the region.
4. Free Movement of Capital

Financial integration with other countries of the European Union and the free cross-border movement of capital has probably had an even larger impact on the economic development in Central Europe than labour mobility. From the fall of the iron curtain until the global financial crisis of 2008, most countries in Central and Eastern Europe were running very sizable capital account deficits, often to the tune of six per cent of GDP or higher.

It is useful to distinguish between two phases in that period. In a first phase, from the early 1990s until around 2003, those current account deficits were to a large extent related to foreign direct investment and the build-up of industrial capacity, which sought to benefit from comparatively low wages in the region. This export-led growth had a very positive impact on the region, from the perspective of economic convergence.

But from around 2004 onwards, a second phase set in, which was characterised by a boom in the non-tradable sectors of Central Europe that was fuelled by foreign capital inflows, primarily from Western European banks. In Hungary, the share of external funds of the banking sector grew from 14 to 33 per cent of total funds between 2002 and 2008 (Lybek 2017, page 10). This lending often took the form of foreign currency loans, which banks passed on to their customers and which fuelled a real estate boom.

The second phase of the financial integration of Central European countries with Western Europe was to some extent driven by very easy global financial conditions. Real interest rates in advanced economies were very low and financial institutions all over the world demonstrated high-risk appetite. But even by the standards of this exuberant period, credit growth in the Visegrád countries reached extremely high levels. Those countries had entered the European Union in 2004 and had removed any form of capital flow restrictions, which made it very easy for Western European commercial banks to extend credit lines and to fund an unprecedented borrowing boom. This development ultimately caused the financial crisis of 2008.

All Central European countries found themselves on the receiving end of large capital inflows. However, the form of capital absorption and the magnitude of the subsequent crisis differed from country to country, depending on the respective monetary and macro-prudential policies. Western European banks as well as international investment funds, which played a much smaller role in cross-border financial intermediation, were primarily seeking a favourable combination of elevated yields and market volatility.
This is why Poland and the Czech Republic, which had relatively low domestic yields and had both opted for floating exchange rates, where spared from some of those capital inflows. In Hungary, on the other hand, the central bank had chosen to target a more stable nominal exchange rate to the euro between September 2001 and February 2008, thus greatly limiting market volatility. This monetary regime, combined with nominal government bond yields that remained close to eight per cent, made the country a perfect target for foreign investors. In the case of Hungary, a pro-cyclical fiscal expansion added fuel to the fire, which aggravated the process of overconsumption and led to overheating of the economy and overvaluation of financial assets such as real estate.

The years prior to 2008 may have been a happy period for Hungarians, as governor Matolcsy pointed out in his remarks at the Lamfalussy Lectures. But it was also a period of excessive deficits, both in the current account and in fiscal accounts, and a period of excessive reliance on foreign funds. As figure 2 shows, this period was followed by a “sudden stop” of capital inflows (Calvo 1998) and a subsequent reversal of the current account deficit as domestic demand contracted. In Hungary, the sudden stop started with a failed government bond auction in March 2008 and it went into full swing as banks came under funding stress following the bankruptcy of Lehman Brothers in September 2008. The sudden end of capital flows triggered a massive rise in non-performing loans (Backer and Klingen 2012), a 30 per cent decline in real house prices (IMF 2018) and a sharp increase in poverty rates, with the share of the population living in severe material deprivation rising from 17.9 per cent in 2008 to 27.8 per cent in 2013 (Eurostat 2019).

Figure 2: Foreign Portfolio Investments in Hungary
With hindsight, it appears that Hungary’s macroeconomic policy choices in the “happy years” before 2008 did not pay off. The country did enjoy slightly higher GDP growth rates than its regional peers from the late 1990s until 2007, but Hungary was much more severely impacted by the financial crisis due to its greater reliance on foreign funding, and its economic recovery was anaemic as the households tried to repair their balance sheets. In the period from 2007 to 2013, the Hungarian economy contracted by 0.5 per cent per year on average, while the economies of the Czech Republic, Poland and Slovakia expanded by 2.5 per cent per year on average (El-Ganainy et al. 2014).

The divergence in economic output losses across Central European countries is not only related to pre-crisis choices in the monetary regime, but also to differences in macro-prudencial policies. In this respect, it is interesting to contrast the experience of Romania with Croatia.

In Romania, the leadership of the central bank was very much aware of the problems that an unfettered inflow of foreign capital could create and it opted to tighten reserve requirements for Romanian commercial banks in order to reign in credit growth. However, this effort was largely ineffective since most of those commercial banks were under foreign ownership. These institutions responded to the increase in reserve requirements by extending credit to Romanian borrowers from their Western European headquarters instead of using their local subsidiaries. There was nothing the National Bank of Romania as a “host regulator” of those international commercial banks could do about this regulatory arbitrage, because the principal of free movement of capital had become legally binding since Romania’s accession to the European Union. Only the “home regulators” of those international banks, such as the Bundesbank or the Austrian National Bank, could have stepped in to curb credit growth abroad, and they chose not to get involved.

Croatia, on the other hand, was in a better position to prevent the build-up of a financial bubble precisely because it was not yet a member of the European Union in the years before the global financial crisis. The National Bank of Croatia put into place aggressive macro-prudencial measures, including heightened reserve requirements and restrictions on the free flow of capital, and was thus successful in preventing excessive credit growth in the country and in maintaining financial stability, once the tide of global capital flows turned against the country.

It is interesting to note that these problems, which Central European policymakers faced in the years prior to the global financial crisis, were very similar to the problems that
Alexandre Lamfalussy discussed twenty-five years earlier, when he chaired a working group at the Bank for International Settlements, which proposed to investigate direct controls on the growth of international bank lending. This working group popularised the term “macro-prudential supervision”, which was used six times in its final report of February 1980 (Maes 2009). As Ewald Nowotny, governor of the National Bank of Austria, laid out in his speech at the Lamfalussy Lectures in 2016, Alexandre Lamfalussy can thus be seen as the inventor of macro-prudential policies, which seek to lean against the build-up of financial crises, instead of just cleaning up after they occur, to use the terms popularised by William White.

At the time, Alexandre Lamfalussy’s proposal of direct controls on bank lending growth met resistance from the Bundesbank, which proposed changes in reserve requirements as an alternative (Maes 2009, 13), and it did not make it into the final report, which can now be seen as a wasted opportunity.

Considering the economic and political consequences of the financial crisis of 2008, we can conclude that the enthusiasm for full capital mobility that is reflected in the Treaty of Rome turned out to be somewhat misguided. In Central Europe, it contributed to a boom-and-bust cycle and it tied the hands of policymakers trying to prevent its excesses. It took a multitude of crises and about thirty-five years of reflection for the International Monetary Fund to acknowledge that there is merit to “capital flow management”. In Central Europe, alas, it also took the crisis of 2008 for most central banks and financial market regulators to accept that it is imprudent to allow for Swiss franc-denominated mortgages. Policymakers and their economic advisors should have listened more carefully to Alexandre Lamfalussy, who turned from an enthusiastic proponent of the mobility of capital in the early 1960s (Lamfalussy 1961, xiii) to a sceptic as early as 1979.

5. Free Movement of Goods and Services

The remaining dimensions of the four freedoms have been the most forceful factors in the economic transformation of Central Europe: the elimination of customs duties in the trade with Western Europe and the abolition of obstacles to the trade in services. The resulting integration of Central European countries into the supply chains of Western Europe is a strongly positive development. The impressive growth of Hungarian exports to Germany is depicted in figure 3. Hungary and its Central European peers have been able to attract large capital investments into the manufacturing industry, particularly
in the machinery and transportation sector. This has led to technology transfers and the build-up of domestic suppliers, and it has had a very positive impact on per capita income (IMF 2013).

Hungary has visibly made the most of its competitive advantage, namely the wage differential to Germany, combined with geographic proximity and the advanced skills of its labour force. During this path-dependent process of integration into Western European supply chains, Hungary has likely achieved a “lock-in” (Arthur 1989) of the position of its automotive industry that will persist even as the wage differential erodes. This is, however, associated with a certain risk of over-reliance on a particular industry, namely the car industry and combustion engines – a risk which Hungary now shares with Germany.

![Figure 3: Hungary’s Annual Exports to Germany, in Constant Prices](image)

**6. Towards a Freedom to Act**

My final remarks will touch upon the political role of the four economic freedoms of the European Union. Today, economic freedom is often understood according to a term developed by Isaiah Berlin in a speech in 1958, namely as “negative liberty”, as a freedom from restrictions (Berlin 1969). Following decades of political and economic oppression, many political leaders and citizens of Central European countries have indeed viewed accession to the European Union primarily as a big step towards an emancipation from such restrictions. In this sense, the European Union is seen as the
institutional guarantor of four “negative” freedoms that have been laid out in Article 3 of the Treaty of Rome: citizens shall no longer be hindered to travel freely, to purchase and offer goods and services abroad and to transact in currency across borders. One could add that, apart from instituting these “freedoms from restrictions”, the European Union has also facilitated the emancipation of Central European countries from certain “freedoms of want”, via its system of transfer payments.

But is this “freedom from restrictions” really the substance and the purpose of European unification? We can find an answer to this question in the preamble to the Treaty of Rome – words which also feature as a preamble to the accession treaty that was signed on 16 April 2003 in Athens. When the presidents of the Czech Republic, the Republics of Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland and Slovenia and of the Slovak Republic decided to join the European Union, they did so “determined in the spirit of the European Treaties to continue the process of creating an ever closer union among the peoples of Europe on the foundations already laid”.

As this preamble shows, the four “negative freedoms” laid out in Article 3 of the Treaty of Rome are a necessity, but not a goal in themselves. They are meant to guide the activities of the European Union for the purpose of “creating an ever closer union among the peoples of Europe” that will manifest itself in closer relations between its member states and in common action.

In Hannah Arendt’s understanding, “negative liberty” – the liberation from restrictions – is only a prerequisite for freedom, but not freedom itself.

“Freedom needed, in addition to mere liberation, the company of other men who were in the same state, and it needed a common public space to meet them in a politically organized world, in other words, into which each of the free men could insert himself by word and deed” (Arendt 1977).

By establishing four fundamental freedoms for its citizens, the European Treaties are creating the prerequisites for the common action of free men, and this common action is the substance and purpose of European unification. As Hannah Arendt put it, “men are free … as long as they act, neither before nor after; for to be free and to act are the same” (Arendt 1977).
In a world that is ever more integrated and increasingly dominated by two large powers – the United States and China – which are unilaterally pursuing their economic agendas, the member states of the European Union will need to come together in confronting common challenges, such as data protection, regulation of the digital economy, financial stability, border control or climate change.

One of the sources of current misunderstandings and tensions between Western European and Central European statesmen appears to be centred on different concepts of liberty. Against the backdrop of their own experiences with foreign occupation and totalitarian regimes, it is very understandable that Central European leaders are reluctant to buy into any vision of a “freedom to act jointly”, since those visions have been abused in the past. However, for the European Union to assert itself and to fulfil its role as guarantor of “negative freedoms”, it needs to continue to strengthen its governance structure and capacities – which explains the rigid insistence of European institutions on the validity of its rule of law framework in all member states.

The participation of Central European member states is indispensable for the future success of the European Union, and this success cannot be taken for granted. If the societies in Central Europe wish to continue enjoying the European Union’s “negative freedoms” – i.e. the freedom of the movement of people, goods, services and capital – then they will need to contribute to the European Union’s “freedom to act”.

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Introduction

When it comes to talking about the European Union and its success, there is little more discussed, researched and analysed than the idea of convergence. Despite rich literature, it is not straightforwardly clear what is meant by the concept of convergence. Economists have explored several dimensions that, in one way or another, talk about economies getting “closer” to each other. Usually, discussions revolved around such ideas as increased risk sharing, similarities in labour and capital rental rates, prosperity (happiness), innovation capacity, institutions, unemployment rates, productivity, competitiveness or, more traditionally, income or real GDP per capita.

Given this high dimensionality of the convergence idea, I will focus on the forthcoming contribution by Lastauskas and Marchesini (2019, forthcoming) which narrows down the focus on the Maastricht convergence criteria. It entered into force in the European Union legal framework in November 1993, lending official capacity to the term *convergence* in EU economic discourse. Maastricht criteria have ever since dominated the economic policy agenda of EU member countries on the route to joining the euro currency area along the path of further economic integration that underlies the Economic and Monetary Union (EMU). The criteria define reference levels of HICP inflation, government debt-to-GDP ratio, government budget deficit, long-term interest rates on sovereign debt securities, and exchange rate stability that need to be dynamically satisfied for candidate countries to accede.

These rules, as a matter of fact, also provide rich dimensionality that can be exploited to obtain a comprehensive picture of the trajectory of the European Union project, its past, and potential future success. Before turning to the analysis, let me briefly overview a few insights from the literature.

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39 I thank Camilo Marchesini for an excellent research assistantship.
Brief Literature Review

Due to space limitation, I will necessarily focus on only a few contributions, contextualising my main messages. Before EU expansion into Eastern and Central Europe, Barry (2003) looked at four EU countries over the period 1960-2000. A rather slow convergence was registered, the main reasons for that being inefficient labour markets, macro-economic policy and poor quality of public administration. Catching-up was claimed to be rooted in reforms of labour productivity and flexibility in wages, more disciplined monetary and fiscal policies, the public sector becoming more open, accountable and less corrupt, all of which make a country more attractive to foreign investors. Badinger (2005) expanded analysis to fourteen EU countries over the period 1950-2000. He found that GDP per capita in 2000 of EU countries would have been 20% lower if economic integration between EU countries had not taken place, and instead of the objectives of the Single Market only the agreements of General Agreement on Tariffs and Trade (GATT) were implemented. In a different study, Badinger (2007) looked at 10 EU countries over the period 1981–1999. He found significant competition effects (mark-ups fell from 1.41 to 1.28 or 32%) in manufacturing but not in the services sector.

Less economically developed EU countries had been catching-up to richer countries at a 4-6 per cent pace each year according to Crespo-Cuaresma et al. (2008), who looked at 15 EU countries over the period 1960–1998. One of the main conduits that helped convergence was intensified trade (enlarged market). Campos et al. (2014) in a broader set comprising of 17 countries over the period 1970–2008 found that EU membership has on average boosted GDP growth by 12%. There exists large heterogeneity, however: Ireland’s GDP would be 43% lower than it is now, while Greece’s GDP would be 15% higher if it had not joined the EU.

When dealing with a 28-country bloc until 2014, the ECB (2015) established some evidence of convergence except when external shocks hit. In such a case, countries with no solid institutional structures become more vulnerable (especially in terms of productivity growth). Capital flows to lower-income countries are shown to have a lasting impact on convergence if not misallocated. The Swedish National Board of Trade (2015) looked at a longer time horizon and found that national borders are still important, but less than before the Single Market. Increased competitiveness in the industrial sector has culminated in convergence in prices and innovation. Other sectors did not experience such pro-competitive effects, especially in the service sector. There was more evidence for the positive impact on the convergence of GDP levels and GDP growth, but significant differences between countries remained. Finally, Barkbu et al. (2018) has recently shown that the euro led to nominal convergence in the areas of inflation and interest rates. During the crisis, convergence has slowed down, and even...
divergent processes have been recorded. There was, however, no real convergence between the old EU members. Interestingly, the authors concluded that, despite some evidence of new member states convergence, German financial cycles have become more distinct from other EU countries. This data fact raises several concerns regarding vulnerabilities and joint reaction to adverse shocks.

**Modelling Convergence**

Given mixed evidence on some dimensions of convergence, I will now turn attention to modelling convergence with as few assumptions as possible. Traditionally, economists employed the so-called σ- and β-convergence tests. The first type (called “σ-convergence”) means a lower distribution of (usually) income per capita between different countries. “β-convergence” is recorded when poorer countries grow faster than advanced economies. Economists also define “Conditional β-convergence” when the economy is characterized by “β-convergence,” but that only holds conditional on other variables (e.g., investment rates and population growth rate). “Unconditional β-convergence” or “absolute β-convergence” exists when the economic growth rate decreases once it reaches a steady state. Figures 1-2 visualise the negative relationship between growth and initial income, measured just before EU entry, for the old and more recent Member States, just as predicted by the convergence theory.

*Figure 1: Growth Before EU Entry vs. Initial Income in 1951*
Since convergence assessment is based on the model it is only useful if the underlying model is correct. For instance, β-convergence, as argued by Pesaran (2007), is not an appropriate way to test for convergence due to stochastic properties of macro variables (e.g., potential unit root component in variables). Though the literature has entertained a few alternatives such as pairwise and multi-country co-integration methodology (Pesaran, 2007), I will base my further discussion on Phillips and Sul (2007), who proposed a nonlinear, time-varying factor model for assessing convergence.

This semi-parametric approach alleviates a problem of low power of unit root tests and admits a factor structure, likely to exist within European economies. Macro variables are characterised by both individual heterogeneity and time trends, and a common (but unobserved) growth component to which they converge. In essence, the test is constructed by subtracting the cross-sectional averages, thereby assessing the distance between an individual country and other countries, and its relative deviation from the overall growth path. One of the largest gains is that this method works for stationary and non-stationary variables and is useful to establish overall as well as conditional (clustered) convergence.

Figure 3 demonstrates an idea of convergence for two hypothetical countries, Country X and Country Y. If both countries come closer and closer to time-varying average,
we say those countries converge. If one or more countries move away from average behaviour within the union, we say that there is evidence for divergence. This is the idea of the Phillips and Sul (2007) test: let the relative transition parameter for each year and each country be defined as:

\[ h_{it} = \frac{y_{it}}{\sum_{i=1}^{N} y_{it}} \]

where \( y_{it} \) denotes a variable of interest (e.g., debt/GDP, real GDP/capita, etc.). Thus this parameter \( h_{it} \) measures the relative standing of the country relative to the other EU member states. Club-specific transition paths are derived by averaging over the relative transition parameter of the countries in the club for each year. For a variable \( y \), a value of \( h_{it} > 1 \), \( h_{it} = 1 \), or \( h_{it} < 1 \) implies that the country \( i \) has a level of \( y \) that is higher, equal to, or lower than the average.

![Figure 3: Model of Convergence](image)

**Results**

**Aggregate Convergence**

The outcome of the analysis draws heterogeneity in the spotlight: differences in country-specific underlying sources of investment risk and productivity per hour worked do not appear to fade over the long run. On the other hand, for variables that the EU can more closely influence, fewer clubs and relatively faster convergence are established. The **Stability and Growth Pact (SGP)** aims to enforce compliance to the standards of fiscal responsibility (government budget deficit not exceeding 3 percent of GDP and sovereign debt smaller that 60 percent of GDP) which are defined to be compatible with the primary monetary policy objective of price stability over the medium term.
The latter is pursued by the European Central Bank (ECB), which can leverage a wide array of instruments to influence prices in the euro area. However, the pass-through of monetary policy is conditional on local market conditions. This observation is consistent with our findings (see Lastauskas and Marchesini for more details): subject to the same legislative framework, almost all euro area countries have their national government debt ratios converging over the long run, but the price level of emerging economies is not converging towards that of more advanced economies. Of 19 countries that are members of the euro area, sixteen of them form two clubs, and thereby their price levels are converging to two separate steady states. In fact, the emergence of smaller, more open and less developed economies as one club is not too surprising. Hnatkovska and Koehler-Geib (2018, World Bank) argue that small countries are more volatile, more responsive to changes in trading conditions, as well as local shocks (government spending, trade balance, exchange rate, and interest rates), but such a size effect ceases to exist when a country reaches a higher level of development.

Out of 28 countries, 26 countries are converging, albeit slowly, to the same steady-state level of real GDP per capita. Differentials in real labor productivity are wide and persistent. Even worse, diffused divergence behavior is observed for long-term interest rates.

**Regional Convergence**

I will also conduct an exercise on income convergence at the regional (NUTS 2\textsuperscript{40}) level. Compared to the macro (country-level) analysis, there is much more heterogeneity across regions, slower convergence rates and potential traps for diverging regions. In fact, the speed of convergence is found higher at the macro level than across regions. There is emerging evidence of regional differentiation, which seems to be growing rather than diminishing. We also observe some changes in dynamics before and after the 2008 financial crisis (see Figures 4-6). Notice how the average level of growth has reacted for the EU-10 and EU-3 countries after the financial crisis (see Figure 6 and 7). There is less change in the average regional growth rate for the “old” EU countries with one caveat: the dispersion (variance) of regional growth has substantially increased for the “old” whereas it largely stayed the same or even dampened for the “new” member-state regions. This different reaction to the external negative shock across regions, including the level and variance effects, is neither well understood nor taken on board when sketching policy advice.

\textsuperscript{40}The NUTS (Nomenclature of territorial units for statistics) classification is a hierarchical system for dividing up the economic territory of the European Union into 281 regions at NUTS 2 level.
These findings, in turn, raise many future-threatening questions for the European project. First, any implication that is drawn from the aggregate analysis masks a number of crucial patterns (such as a diverging periphery from the center) and may lead to poor policy advice. Second, we require reconsidering economic theory: the deceptive equilibrating and unique convergence idea requires new impulses from as diverse fields as complexity economics, data science, disequilibrium models, connections between real business cycle and growth theories. All this should shed more light on the ways economic union, separate economies, regions, and cities as well as people adapt and interact within an ever globalized world, nature and patterns of the out-of-equilibrium dynamics, aggregation problems for non-ergodic and non-stationary variables, the role of expectations for outcomes as well as connections between cyclical and long-term phenomena.

*Figure 4: Real GDP per capita, EU-15 regions*
Figure 5: Real GDP per capita, EU-10 regions

Figure 6: Real GDP per capita, EU-3 regions
Conclusion

The preceding analysis has focused on policy-relevant variables set out by the Maastricht Treaty for the future of the European Union along the path of further economic integration to which it is formally committed. Such variables as real income per capita, debt-to-GDP ratios and price levels for members of the euro area are converging, with only very few exceptions, if looked from the aggregate perspective. This, at least indirectly, suggests that the EU converges, possibly due to its institutional impact by means of policy and law-making.

We also find substantial heterogeneity in economic structures across countries which affects convergence outcomes. When it comes to real labor productivity or long-term interest rates, persistent heterogeneity dominates with little evidence of convergence even at the aggregate level. This finding may be rooted in largely heterogeneous differences in industry structure, firm landscape, and wage-setting institutions prevalent across countries.

However, even if converging at the macro level, what about regional dimension? Aggregate measures mask developments at a more granular level. Instead of basing evidence and policy advice on macro measures, we should be aware that aggregate convergence is not sufficient. We are thus left with theoretically exciting but future-threatening questions from the policy and real-world perspectives, such as: What happens if we converge at the macro but diverge at other levels of granularity? Why has the growth rate slowed down after the recent financial crisis? Why “old” EU countries, though grow at similar rates before a crisis, experience divergent regional dynamics? Why is regional differentiation growing rather than diminishing? Do cyclical shocks, and policy interventions affect long-run phenomena such as convergence and, if yes, how? These are but a few core questions that will determine how successful the next 25 years of the post-Maastricht European Union will look like.
Bibliography


The Decade of Catching-up: in Asia

Today the world economy is gradually recovering and returning to the state it was before the global financial crisis. At the same time, certain processes which indicate systemic shifts in the global economy and politics are inevitable. Now with the world rapidly changing and global balance of powers being redefined, consistent and calculated economic policies are becoming more of the essence. New centres of economic growth emerge, along with new capitals of political influence becoming dominant in the world’s political arena. The new industries and trends are developing in an unexpectedly fast pace, which makes it virtually impossible to develop strategies beyond a 10-year perspective. Technological advancements and fast-growing connectivity make our world smaller as we easily cut distance and time using tech.

All this posits new objectives for financial market participants on: how to adapt rapidly to the new reality, how to adjust and improve goals, aspirations and expectations when the time is appropriate.

Adaptability and flexibility of policy direction are crucial for developing states. During this process, they shall take into account four factors:
1. The world economic and political power is shifting to Asia;
2. By today, developing countries have achieved a leading role in global development;
3. The integration process that originated in Asia is, by today, a worldwide phenomenon; and
4. There are rapid institutional changes.

The increasing importance of Asia

First of all, the shift of world economic and political development to Asia is undeniable. This rapidly developing region has attracted the attention of many governments and businesses around the globe, who now have developed “Pivot to Asia” strategies with a grand focus on the region.
The region has managed to accumulate vast amounts of foreign reserves. Foreign capital is seen to be pouring in through foreign direct and portfolio investments, thereby supporting the region’s exceeding trade flows. Asian financial spill-overs in equity markets have remained substantial even after the global financial crisis.

Historically, Asian countries have always been open to innovation, which partially explains the record-breaking GDP growth rates in the region. According to the IMF, growth in the developing countries of Asia in the next two years will be about 6.5%, and the continent will account for more than half of the growth of the global economy\(^{41}\).

By 2030, as predicted by many, 7 out of 10 leading economies of the world are to be represented by Asian countries. In fact, East, Southeast and South Asia may become the most prominent centres of world economic growth. Asia is already a recognised leader in six areas of industrialisation, the attraction of investments and new technologies, the use of environmentally friendly energy sources and by many other positive parameters. Since the end of the last century, the world has been studying the *Japanese economic miracle* with economists trying to retrieve the success formula of the so-called *Asian tigers*.

In the new millennium not only did Asia manage to sustain impressive growth rates, but also presented to the world the new *Asian dragon* or China, as well as the *Indian economic miracle*, and the *New Asian tiger* Vietnam.

The population of this part of the world today already exceeds 60% of the total number of people living on the planet. In the years to come, production and consumption in Asia will increase even further due to stable high growth rates of the economy.\(^ {42}\) Technological advancement in many Asian countries can bring about significant benefits with boosting productivity, stimulating growth rates and creating new jobs.

These factors explain the world’s interest in Asia, not just as a promising and rapidly developing market of goods and services on multiple levels, but also as a promising source of investments.

Looking into the example of China, certain conclusions are to be made. For a long time, China was firmly associated with the “world factory”, which cheaply and massively

\(^{41}\) IMF Report “Regional Economic Outlook: Asia Pacific”, May 2018
\(^{42}\) worldometers.info, UN
produced a huge variety of products based on outside templates and projects. But now this stereotype no longer reflects the reality. Modern China is one of the leaders not only in finance and industrial production but also in the field of scientific research and innovation. China systematically increases resources for innovative development, improves conditions for high-tech business and investments, moving ahead of many G-20 countries in innovative competitiveness. And even though the headlines of many foreign publications are full of predictions about the inevitable and growing crisis in the Chinese economy, the potential of this country and its centuries-old experience will help it successfully overcome all difficulties and reach a new stage of development.

India too is one of the most dynamically developing countries in the world. According to some forecasts, the country’s economy will be estimated at $5 trillion by 2025. India is now regarded not just as a promising country and one of the leaders of the region, but as a potential locomotive of the entire international economy. It is all due to the fact that the country can rely on the skilled and relatively inexpensive labour force, growing scientific and technical potential and a rapidly growing service sector. Today, India is the main exporter of IT services for transnational corporations, and the supplier of the most qualified IT specialists.

Considering all this, the fact that world economic growth is steadily moving to Asia is inevitable.

In addition, being firmly incorporated into the global supply and value chain, most Asian emerging and developing economies have benefitted from strong globalisation trends and open trade during the past decades.

In the wake of the rising of protectionist behaviours, political and economic tensions between the world’s largest economies, the need for market diversification has underlined economic security importance. In these terms, regional economic and financial integration trends in Asia are levelling up in parallel.

Today, interregional trade comprises 60% of the total trade of Asian countries, financial flows inside Asia have reached 25%. Looking further, currency swap agreements and clearing facilities are being built up as well.

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41 (business today.in, economictimes)
44 ADB “Asian Economic Integration Report 2017”
45 IMF Report “Regional Economic Outlook: Asia Pacific”, May 2018
The financial markets in Asia have become increasingly more integrated and deeper, as evident from the significant upsurge in local currency-denominated bonds across the region.

**Developing countries are now the engines of development**

Secondly, as seen previously, developing countries were forced to follow the process of modernisation on a catch-up basis, whereas now they form the global dynamics of development, based on the example of many Asian countries.

Considering an example from the historical experience of China, as well as the previously mentioned “Asian tigers”: South Korea, Singapore, Hong Kong and Taiwan, which were later followed by Malaysia, Thailand and Indonesia. Paradoxically, South Korea was considered relatively poorly developed in the middle of the last century, according to the classification of the World Bank. And the success of Singapore was not so apparent to most in the beginning. But the situation has changed since, as these countries are not just active participants in the world economic, political and technological processes, but they are often leaders and trend makers in many advanced and knowledge-intensive industries.

Companies like Alibaba, Tencent and Baidu provide a wide range of services, from e-commerce to financial and cloud computing technologies for customers in China and other countries. And Huawei is a global leader in 5G technology. Indonesian 10 billion dollar Decacorn “GO-JEK” was included in “Fortune’s 50 Companies That Changed the World” and has attracted investments from giants like Google, Temasek Holdings and Tencent.46

In general, many leading Asian companies are actively using the latest achievements in the field of artificial intelligence, robotics, cryptography and big data in various industries, which promise to change the face of the global economy and radically enhance our way of life and working methods.

For the rapidly developing countries of Southeast Asia, modern technologies will create the potential for increased productivity and will provide a platform for abandoning the middle-income country category. Less developed Asian economies could benefit from

digital technologies to eradicate poverty and other chronic problems. Digitalisation is becoming an immensely integral component of the GDP of Asian countries.

At the same time, Asian market participants are leading in almost every aspect of digitalisation. Japan, China, Korea, Hong Kong and Singapore are recognised as the world leaders in this field.

Special attention should be devoted to Asian players developing e-commerce and fintech. For example, China a little over a decade ago constituted less than 1% of the value of the global e-commerce operations, and today it exceeds 40%47. The share of e-commerce in total retail sales now in China reaches 15% compared to 10% in the United States. In India, Indonesia and Vietnam, the share of e-commerce is also growing rapidly. Platforms like Bukalapak, Lazada and Tokopedia are competing for the largest e-commerce market not just in the country, but in all of Southeast Asia.

**Worldwide integration**

Thirdly, the integrational processes originating in Asia today set the pace for development of the entire world trade.

By launching the Belt and Road initiative, China, in fact, showed the world a model of regional cooperation in a fundamentally new and promising format. Even though this initiative has often been criticised, it clearly provides countries with great opportunities and incentives for development along the Silk Road.

As a result, the system of international cooperation as a whole is changing – it is becoming truly global, with unlimited large-scale movement of people, goods and capital. In fact, many world economic leaders are starting to move in this direction as well. Countries such as the United States, India, Japan and even the European Union, in response to the Chinese initiative, develop and adopt their own strategies for further integration of trade and universal cooperation. Thus, such international economic processes are not the only opportunity for trade between our countries and regions. By and large, this is the basis for the consistent reconfiguration of the entire Eurasian geo-economy.

For developing regions, such as Central Asia and Eastern Europe, the mentioned trends are especially important, for today we have every opportunity to transform from the periphery of the global economy into its active centres. Trade and transport corridors through Central Asia and Eastern Europe will again bring together the remote regions of Eurasia building a strong basis for the completely new transnational production chains, effective transfer and creation of technologies, as well as capital inflows.

Kazakhstan and the countries of Central Asia with their clear geographical advantages have land access to large markets of CIS countries, China and the European Union, and now they are entering the markets of Iran and further into the Middle East and South Asia.

Hungary and the countries of Eastern Europe have both land and sea exits to the rich countries of the developed West and, moreover, to the large markets of North Africa and South America.

**Rapid institutional changes**

Fourthly, the institutional development in Asian countries is to be accounted to as well. Rapid growth and increase of financial markets call for better regulation, corporate governance, and rule of law.

The regional economic and financial integration policy is well pushed by the local economic communities. Required blueprints have been delivered. Financial integration process between the participants and member-states are well institutionalised, policies and legal base for unified regulations are under implementation both on the regional and national levels.

Crises strengthened the understanding and confidence of Asian countries in the necessity of the joint management of regional risks. This trend has led to the institutionalization of financial regional cooperation. Interstate agreements on the creation of new joint development institutions, such as the Chiang Mai Initiative, the East Asia - Pacific Central Banks Meeting, ASEAN + 3, the Asian Bond Market Initiative, the Silk Road Foundation, The Asian Infrastructure Investment Bank (AIIB), etc., have become an effective result. The activity of these institutions is aimed towards strengthening crisis management regimes, developing regional bond market, exchange rate cooperation and monetary integration. Under this reality, the emergence of the new financial centres is seen as a necessity.
Against the background of these processes, the role of Central Asia increases significantly from the perspective of bridging economic and financial cooperation between Asia and Europe. Emergence of the Astana International Financial Centre in Kazakhstan - the centre of our continent, is a timely and logical response to the requirements of this reality.

**Concluding remarks**

It is worth noting that the dynamics of events that have taken place in recent years suggest that the world will experience fundamental shifts, unique in their content and scope. The reality we are used to is constantly changing, and even now the world is in the process of critical and complex transformation.

Yet, it is clear that the international economic system did not manage to recover fully. General progress and recovery to the pre-crisis growth rates, unfortunately, are accompanied by such unprofitable trends as trade wars and sanctions. However, various crises lead not only to objective and sometimes inevitable losses but also to the strengthening of the economy and the emergence of the new opportunities for more rapid and dynamic development.

Therefore, constructive and pragmatic cooperation in difficult times of geopolitical crises around the world, especially collaboration among developing countries in the heart of Eurasia, should become a source of sustainable development. Moreover, it will remain the fundamental driver of progress in the long run.

Furthermore, the countries of Central and Eastern Europe in the future have an immense potential of increasing influence on the course of development in Europe. The CEE today is the fastest growing region in the Eurozone, without which it is no longer possible to speak about any serious development of the pan-European economy.

According to the European Commission, economies in Hungary, Poland and the Czech Republic in 2017 showed a much better pace of development than in the vast majority of Western European countries. In general, 9 out of 12 European countries, whose economy has grown by at least 3% over the past year, are in Eastern Europe. Due to these factors, the countries of Eastern Europe seem to be extremely attractive trading partners.

and economic partners, countries with high investment attractiveness. Recent forecasts state that cargo flows between East and West are to increase tremendously.

In many respects, the further success of development will depend on the level and quality of cooperation, as well as the active participation in modern transnational projects. At the moment, it is essential to concentrate our efforts on solving economic issues and the formation of interstate legal relations that will create the conditions for the sustainable socio-economic development of Asian and European countries. However, in order to fully realise the potential embodied in cooperation between the East and the West, many more important issues remain to be solved, where the developing countries of Central Asia and Eastern Europe have to play a special role, which will become a link between the East and the Big West.
The Decade of Catching up in Asia

In recent decades, the global economy has undergone a major transformation process. Among global trends, the increasing prominence of Eastern economies and the emergence of a multipolar global economy merit special attention. According to the World Bank’s forecasts, around half of the total 6.5 trillion USD global output growth projected for 2017-2019 is expected to take place in Asia, while the share of the US and the Eurozone will be limited to 18 and 8 per cent, respectively. The rebirth of old trading routes (e.g. the New Silk Road) provides a further stimulus for this transformation process. As a result the Asian countries are expected to become more powerful, and within 15 years, three out of the four or five largest world economic powers are expected to be in Asia.

Figure 1. Geographic distribution of global GDP between 1820-2030.

Source: Angus Maddison.
The geographic distribution of the global GDP among the main economic centers during the last two centuries illustrates this transformation process (*Figure 1.*). According to this analysis, Western Europe and the US gradually increased their combined GDP share before the World War I, and they kept this level of approximately 50 per cent until the end of the World War II. This trend reversed in the second half of the 20th century: first Japan (before 1990), then later China and India (since 1990) experienced a remarkable catching up process. According to reasonable forecasts, **by 2030 the economic importance of the three biggest Asian economies** (China, India and Japan) **will be bigger than that of the Western economies**.

*Figure 2. The World Economic Forum’s competitiveness index for the Asian economies in 2018.*

*Darker shading means higher competitiveness.*

![Map of the World Economic Forum’s competitiveness index for the Asian economies in 2018.](image)

*Note: The dark blue means higher competitiveness, and lighter shades of the blue stand for lower competitiveness.*


One obvious explanation for this remarkable recent performance of the Asian economies is their increasing competitiveness. In order to have a closer look at this, it is worth analyzing the competitiveness index of the World Economic Forum for all Asian economies in 2018 (*Figure 2.*). This competitiveness index is constructed...
from three sub-indices: the first is on basic requirements (institutions, infrastructure, macroeconomic environment, health and education), the second is on efficiency enhancers (higher education, goods and labor market efficiency, financial market development, technological readiness and market size), and the third on innovation and sophistication factors (business sophistication, level of innovation). It is apparent from the figure that although the situation within the continent is mixed, some of the most competitive economies are located in Asia.

In order to obtain an even better picture, we can compare the competitiveness indices of 137 economies from all over the world, as well as the regional averages (on Figure 3). The picture is very clear: first, there is a very deep competitiveness gap across the regions. The competitiveness of South Asia lags behind, together with other regions like the Middle East and North Africa, Eurasia and Latin America, while Sub-Saharan Africa is at an even lower level. Second, similarly to what we discussed previously, some of the most competitive countries can be found in East Asia: in fact, three of the ten most competitive countries can be found in Asia (Singapore, Japan and Hongkong SAR). And finally, the other region at the top of the ranking is Europe and North America, which is the host of the other seven countries in the top 10.

*Figure 3. The World Economic Forum’s competitiveness index for all countries, and regional averages in 2018.*

The IMD World Competitiveness Center is another institution that ranks the countries according to their competitiveness. It is perhaps instructive to compare their ranking with the ranking of the Global Competitiveness Report. Based on the collected rankings, among 63 evaluated countries, of all Asian economies in 2018, a similar picture emerges to what we have seen earlier: now there are two Asian countries (Hongkong SAR and Singapore) in the top 10, while China being 13th, but again there are significant competitiveness gaps even within the Asian continent.

Figure 4. The ranking of Asian countries in 2018 (and in 2017) in the IMD World Competitiveness Center, out of 63 countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong SAR</td>
<td>2(1)</td>
</tr>
<tr>
<td>Singapore</td>
<td>3(3)</td>
</tr>
<tr>
<td>China Mainland</td>
<td>13 (18)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>22 (24)</td>
</tr>
<tr>
<td>Japan</td>
<td>25 (26)</td>
</tr>
<tr>
<td>Korea Republic</td>
<td>27 (29)</td>
</tr>
<tr>
<td>Thailand</td>
<td>30(27)</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>38 (32)</td>
</tr>
<tr>
<td>Indonesia</td>
<td>43(42)</td>
</tr>
<tr>
<td>India</td>
<td>44 (45)</td>
</tr>
<tr>
<td>Philippines</td>
<td>50 (41)</td>
</tr>
<tr>
<td>Mongolia</td>
<td>62(62)</td>
</tr>
</tbody>
</table>

Source: IMD World Competitiveness Center.

The main driving forces behind global economic growth have been the Asian countries, especially China, for years. The concept of a New Silk Road initiated by China could support not only China, but other participating countries as well in their efforts related to economic growth and convergence. Besides this initiative, a number of programs appear in Central and Southeast Asia that can create the financial pillar of a closer co-operation among these countries, and may offer a comprehensive contribution to enhancing their competitiveness.

Due to its economic importance, it is worth paying special attention to China’s initiatives, especially as it is planning to facilitate the continuation of convergence with several measures. As Xi Jinping, the President of China said in December 2017, in the future China will increasingly focus on “high quality growth”, instead of the
so far typical “high speed growth”. While infrastructural developments continue to form an important pillar in Chinese growth, strong encouragement of technological innovation is becoming more prominent. In 2017, on an annual level, China already spent more than USD 250 billion on R&D, which made up more than one fifth of global research and development expenses. In addition, measures supporting economic convergence can also be detected at a number of other areas; for example, the projected reforms in the Chinese financial sector may also have significant impact in the next decade. Although China is a very important contributor to world economic growth, it is also worth paying attention to other regions in Asia, as we could observe impressive convergence episodes in both Central and Southeast Asia in the past decades. With the diversification of economies, with the strengthening of the quality factors of competitiveness, and, in some cases, with economic policies aiming for inclusive economic growth, further reserves may be identified in these regions.

The experience of the Asian countries provides useful lessons for other countries like Hungary. If these countries wish to accelerate their catching up process and make it more sustainable, then one obvious way of this is to increase their competitiveness. This is the very reason why the Hungarian government is focusing on competitiveness reforms, as well as why the central bank of Hungary has proposed 330 recommendations that can contribute to this process. Hungarian convergence in the past decade was mainly based on increasing the size of the country’s labor force and capital stock. Therefore, a significant share of recommendations of the central bank aim at improving the productivity, and expanding the knowledge base, making the economic environment more supportive for innovations, and creating institutions and infrastructure that can decrease the companies’ bureaucratic burdens. If these policies turn out to be successful, hopefully we can experience a similar catching up process to those that some of the Asian countries have recorded in the past 30–50 years.
The Decade of Catching-up in the Asia-Pacific Region: An APEC Perspective

Introduction

The Asia-Pacific Economic Forum (APEC) was established in 1989 and currently comprises of 21 member economies[^49] in the Asia-Pacific region. APEC is in one of the world’s most dynamic regions of which its members encompasses about 2.9 billion population or almost 38% of the world population and collectively contributes almost 60% of world GDP and 47% of global trade. APEC is a very unique economic grouping that operates on the basis of open dialogue, where there are no legally binding commitments and compliance is strictly voluntary. It has been a relatively successful incubator of ideas to advance trade liberalization and regional economic integration (REI). For example, the WTO Information Technology Agreement (ITA) started out as an APEC initiative to promote greater trade liberalization of IT products.

APEC’s initiatives can be organized along 3 main areas which are i) trade and investment liberalization and facilitation (REI and supply chain connectivity); ii) business facilitation (ease of doing business and structural reform); and iii) economic and technical cooperation (capacity building). In terms of achievements, APEC’s ease of doing business initiative has been very successful with the average time to start a business more than halving from 28.5 days in 2009 to 10.8 days in 2018. Another successful initiative has been the APEC Business Travel Card (ABTC) scheme, which currently has 270,000 holders and facilitates business mobility through visa clearance and fast track entrance through immigration for business professionals.

This paper examines what APEC has done over the past decade since the onset of the global financial crisis of 2008. It will also look at the region’s short-term economic outlook and possible downside risks to its growth prospects. This paper finds that trade

[^49]: APEC member economies are Australia, Brunei Darussalam, Canada, Chile, People’s Republic of China, Hong Kong China, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, Chinese Taipei, Thailand, United States and Vietnam.
— which has long been a driver of growth on the Asia-Pacific region — is no longer as reliable as before and provides suggestions of potential sources of growth for the future. Given that APEC’s vision of a free and open trade and investment region by 2020 is less than two years away, a group of experts were recently formed to assist APEC senior officials craft a new vision for APEC post-2020 (APEC Vision Group). As part of this process, they will need to take into account of emerging trends and challenges facing the region, some of which are highlighted in this paper.

The APEC Growth Strategy

As an economic recovery response to the 2008 Global Financial Crisis (GFC), APEC promoted an inclusive growth agenda at the 17th APEC Economic Leaders’ Meeting in Singapore in November 2009. APEC leaders that year decided to take a more inclusive approach to growth in which the opportunities and benefits of globalization should be more widely spread out.

Figure 1. The APEC Growth Strategy

This approach gained traction with the launch of the APEC Growth Strategy in 2010, a multi-pronged approach to economic growth that is in line with APEC’s objectives of sustainable development, equitable growth, and strengthening of the Asia-Pacific community (Figure 1). The growth strategy identified specific and interconnected
initiatives that are expected to result in a balanced, secure, inclusive, innovative, and sustainable growth (Table 1).

**Table 1. APEC Initiatives under the 2010 Growth Strategy**

<table>
<thead>
<tr>
<th>Growth Strategy Attributes</th>
<th>APEC Initiatives (non-exhaustive)</th>
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<tbody>
<tr>
<td>Balanced Growth</td>
<td>- APEC New Strategy for Structural Reform (ANSSR)</td>
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<td></td>
<td>-- Ease of Doing Business</td>
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<td>-- Action Agenda on Promoting Infrastructure Investment through Public Private Partnership</td>
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<td>-- Investment Facilitation Plan (IFAP)</td>
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<td>-- Good Regulatory Practice (GRP)</td>
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<td>Inclusive Growth</td>
<td>- Initiatives for SMEs</td>
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<td></td>
<td>- APEC Scholarship and Internship Initiative</td>
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<td>- APEC Digital Opportunity Center</td>
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<td>Sustainable Growth</td>
<td>- APEC List of Environmental Goods</td>
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<td>- Low-Carbon Model Towns</td>
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<td>- APEC Marine Sustainable Development Report</td>
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<td>Innovative Growth</td>
<td>- APEC Initiative of Cooperation to Promote Internet Economy</td>
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<td>- Cross Border Privacy Enforcement Arrangement (CPEA)</td>
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<td>- APEC Initiative Toward Innovation-Driven Growth</td>
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<td>- APEC Electrical and Electronic Equipment Mutual Recognition Agreement</td>
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<td>- Business start-up and the development of entrepreneurial skills</td>
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<td>Secure Growth</td>
<td>- Travel Facilitation Initiative</td>
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<td>- Authorized Economic Operator (AEO) Systems</td>
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<td>- APEC Counter-terrorism and Secure Trade Strategy</td>
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<td>- Energy Security Initiative (ESI)</td>
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<td>- Healthy Asia-Pacific 2020</td>
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<td>- Action Plan on Food Security</td>
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<td></td>
<td>- APEC Network of Anti-Corruption Authorities and Law Enforcement Agencies (ACT-NET)</td>
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</table>

Source: APEC website https://www.apec.org/Topics/Growth-Strategy

**The APEC Strategy for Strengthening Quality Growth**

The 2015-2020 APEC strategy for strengthening quality growth builds on the 2010 growth strategy by identifying Key Accountability Areas (KAAs) to strengthen and sustain quality growth and to align the existing strategy with the UN Sustainable Development Goals. The KAAs include: i) institution building; ii) social cohesion; and iii) environmental impact. Moreover, the 2015-2020 growth strategy emphasizes the important role of the private sector in achieving growth that will foster innovation, create employment and promote greater social responsibility. Table 2 summarizes the initiatives launched by APEC under the KAAs.
Over the past decade, APEC’s efforts in promoting trade liberalization and business facilitation as well as implementing its growth strategy appears to be bearing fruit. APEC economic growth and trade performance have been outpacing the rest of the world since 2008 (Figure 2).

**Figure 2. Real GDP Growth Rates, (y-o-y, in %), 2000-2017**

Source: IMF World Economic Outlook (WEO), October 2018.
Note: GDP is measured in purchasing power parity (PPP) terms.
In terms of share of world GDP (in PPP terms) and trade in goods and services, APEC’s share has been also been increasing over the years (Figure 3).

![Figure 3. APEC Share of World GDP and Trade (in %)](image)

*Source: IMF World Economic Outlook (WEO), October 2018 for GDP in PPP terms; UNCTAD Statistics for trade in goods and services; and PSU staff calculations.*

East Asia and ASEAN-5 also reported rising share of world GDP and trade during the period 2005-2017 (Figure 4)\(^50\).

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\(^50\) East Asia in this paper covers China; Hong Kong, China; Korea; Mongolia; and Chinese Taipei. Meanwhile, ASEAN-5 covers Indonesia, Malaysia, the Philippines, Thailand and Viet Nam.
Short-term Economic Outlook and Risks\textsuperscript{51}

The APEC region benefited from the global economic recovery that took off on a firmer footing starting mid-2016, characterised largely by stronger global demand and supported by relatively low interest rates and inflation. These accommodative conditions fed positively into domestic demand, boosting consumption, trade and investment, translating into higher economic growth. This buoyant global economic activity led to APEC’s real GDP growth expanding by 4.0\% in 2017 from a growth of 3.5\% in 2016. Moreover, in 2017, APEC grew significantly faster than the rest of the world, which expanded at 3.4\%.

APEC is expected to maintain this robust growth in 2018 with a 4.1\% GDP expansion, propped up by the global economic momentum. However, growth is projected to moderate in 2019–2020, but still outpacing the rest of the world. Similarly, East Asia and ASEAN-5 are expected to grow at a moderate pace over the same period compared to 2018 (Figure 5).

\textsuperscript{51} Discussions in this section, particularly relating to the APEC region, are taken from the APEC Regional Trends Analysis (ARTA), November 2018. The ARTA, a semi-annual publication of the APEC Policy Support Unit (PSU), has two parts: the cyclical part which discusses recent macroeconomic trends, and the theme chapter which is an in-depth analysis of topical issues. The November 2018 edition of the ARTA is available here: https://www.apec.org/Publications/2018/11/APEC-Regional-Trends-Analysis--The-Digital-Productivity-Paradox
The balance of risks has tilted to the downside for both the short term and the medium term due to prolonged and heightened uncertainty. A substantial part of this uncertainty is attributable to intensified trade tensions around the world. Tariffs and retaliatory measures that cover a large and varied number of trade products are already starting to affect trade activity, with declines in trade volume even as trade values grew only marginally in the recent period.

This was the primary reason behind the WTO’s move in September 2018 to downgrade its near-term merchandise trade volume forecast to 3.9% for the whole of 2018 (from the April 2018 forecast of 4.4%) and 3.7% for 2019 (from 4.0%)\(^{52}\). Another adverse consequence of current trade tensions is the potential worsening of trade relations, which could dent business confidence and affect medium- and long-term trade and economic growth prospects.

Growth in the next two years is expected to be further weighed down by: i) uncertainty in the direction of trade policy amid ongoing trade tensions; ii) a greater-than-expected China slowdown; iii) prolonged Brexit negotiations and UK-EU post-Brexit relationship; and iv) episodes of financial market volatilities, which, coupled with rising interest rates,

could tighten credit conditions and dampen consumption. Against these downside risks is the upside potential of continued strength in global demand rebounding to sustained domestic consumption. However, this scenario is looking less likely amid the prevailing environment of heightened uncertainty, particularly in trade, combined with increase in global interest rates.

Potentially Drivers of Growth

For many years, trade has been the major driver of economic growth in the APEC region. Indeed, APEC trade growth rates were always above GDP growth rates from 2000 to 2011, with the exception of two years i.e. in 2001, when market confidence plunged as the dotcom bubble burst due to unrealistic valuations of start-up companies and market speculation and in 2009, during the global financial crisis period. However, from 2012 to 2016, trade growth has consistently lagged behind GDP growth. It was only in 2017 that APEC trade once again expanded faster than economic output, with a projected convergence in 2018–2019 (Figure 6).

Figure 6. APEC Trade Growth vis-à-vis GDP Growth (y-o-y, in %)

![Graph showing APEC Trade Growth vis-à-vis GDP Growth (y-o-y, in %)]

Source: IMF World Economic Outlook (WEO), October 2018 for GDP in PPP terms; UNCTAD and WTO for trade growth; and PSU staff calculations.

The same Trade-GDP growth relationship is observed among East Asia and ASEAN-5 economies (Figure 7).
This implies that trade is no longer the reliable driver of APEC economic growth it once was. In fact, when the responsiveness of economic growth to trade started to slow down, it was replaced by domestic consumption as the stable and strong source of growth among APEC economies.53

In a persistently uncertain external environment marked by dominating downside risks, which could dent an otherwise strong recovery in trade, economies need to boost current sources of growth while harnessing drivers of future growth. The recent escalation in trade tensions, not only in terms of tariff impositions but also difficulties in trade cooperation, has made finding alternative sources of growth more urgent.

On the demand side, consumption continues to be a reliable source of economic buoyancy. Sustaining domestic consumption entails maintaining a relatively accommodative environment. Policy actions to fuel consumption could differ across economies, depending on economy-specific conditions. For example, economies with benign inflation can opt to keep interest rates relatively low so as to support credit conditions and further spur consumption and investment. On the other hand, economies

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experiencing an upward trend in inflation rates could turn to fiscal policy measures where there is adequate room, such as reducing tax rates or implementing social protection initiatives to sustain consumer spending. In addition, economies with enough reserves and fiscal policy space could tap into government resources to implement projects or livelihood programmes that provide employment and augment household incomes.

There is also incentive for APEC to realise the economic potential of a growing middle class. A study by Brookings Institution shows that globally there are around 3.2 billion people who could be classified as middle class, with projections of another 160 million people added per year in the next five years.\(^{54}\) The market for middle-class consumption is estimated to grow at an average rate of about 4.0% in the long term, with expected purchases in consumer durables as well as services such as tourism, entertainment, health, education and transport.

On the supply side, boosting the services sector could unlock opportunities for both developed and developing economies. In APEC, trade in commercial services remained robust even as trade in goods showed signs of moderating amid prolonged and elevated uncertainty in merchandise trade policy. The services sector is also the largest employer by sector, employing 59% of APEC’s workforce in 2017, lending more urgency to boosting this sector. Enhancing the services sector so that it can become an engine of growth requires removing regulatory bottlenecks, harmonising standards, adopting best practices, upgrading education and skills, and developing infrastructure.

Many changes are happening all at the same time, encompassing economic growth, financial stability and rapid technological changes, which have the potential to transform economies, businesses and individual lives. As the region stands on the precipice of change, APEC needs to remain responsive and relevant by updating its framework and strategies to be able to address emerging challenges effectively.

**Digital economy**

There is immense opportunity in the digital economy. A study by McKinsey Global Institute estimated that e-commerce made up around 12 percent of total goods trade in 2013 alone, up from 3.0% in 2005.\(^{55}\) Moreover, digital and online platforms are

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\(^{55}\) James Manyika, Jacques Bughin, Susan Lund, Olivia Nottebohm, David Poulter, Sebastian Jauch, and Sree Ramaswamy, “Global flows in a Digital Age: How trade, finance, people and data connect the world economy” (McKinsey Global Institute, April 2014).
transforming businesses by expanding market reach to include the global market as well as introducing more efficient point-of-sale systems that guarantee transparency and real-time payments. Along with opportunities, there are also challenges inherent in the digital era, foremost of which is the reskilling of the workforce to cope with technological changes. The other challenge relates to putting in place the necessary digital infrastructure to widen access to broadband and smartphones.

Green Technology

APEC could promote green technology, starting with micro, small and medium enterprises (MSMEs). An APEC PSU policy brief published in February 2018 finds that MSMEs make up 97% of all enterprises and employ 50 percent of the workforce in the region, contributing between 20% to 50% of GDP growth. The aggregate environmental impact of MSMEs could be significant, so it might be useful to address associated challenges of defining green, sustainable and innovative MSMEs, which involves gathering baseline data; establishing a framework; assessing APEC work in this area thus far and determining gaps; and developing appropriate green growth indicators to have a benchmark with which to compare progress. Moreover, adopting a greener approach could make resources more sustainable, benefiting resource-dependent APEC economies. In fact, APEC has made decisive strides toward this end. In 2012, APEC Leaders agreed to cut tariff rates on 54 environmental goods to 5% by 2015. An assessment conducted in 2015 shows that most economies had successfully reduced their tariff rates while the rest had plans to do so.

Greenfield Investments

Greenfield investments have the potential to positively affect growth both in the short term and the medium term since these kinds of investments require the transfer of resources, equipment, technology and skills from the investor to the economy. Economies might benefit from understanding the whys and hows of greenfield investments: Why are they declining? How do economies attract greenfield investments? The answers may differ per economy, although macroeconomic stability, the peace and order situation, and the overall regulatory and business environment are some of


the factors that investors assess before they commit to new, especially medium-term, investments.

**Productivity-Enhancing Reforms**

Ensuring that economic growth is inclusive as well as sustainable requires implementing reforms that enhance productivity. Different economies in different development stages may adopt different strategies, mindful of what is both appropriate and feasible. Risks could be mitigated through careful examination of the economy’s level of economic, financial and technological development; proper calibration and sequencing of reforms; preparation of mitigating measures to support those affected by the reforms; and continuous monitoring of economic impact, especially among the poor and vulnerable groups.

Improving education, health and social outcomes could also transform an economy; for example, it could facilitate an easier grasp or adoption of technological advancements, with potential significant implications for development pace and phase – from largely agricultural to more industrial, financial or knowledge-oriented. This could also result in greater economic, financial and social inclusion as more people have the skills and education necessary to be able to participate fully in economic development.

Regulatory reforms that widen the space for and the depth of innovation remain crucial in any economy because they help facilitate the production of more goods and services at less cost, which could feed into productivity, business profitability and wages/incomes, leading to the sustainability of businesses and employment.

Reforms in infrastructure that result in increased investments continue to be a game-changer in economic development. Farm-to-market roads literally pave the way for small and large businesses to raise profits and improve household incomes. In this digital age, building and boosting technological infrastructure to increase the speed and reliability of internet connections or widen access to mobile technology are crucial not only to be able to adapt to dynamic changes but also to increase financial inclusion, which is one of the pathways toward inclusive growth.

Even as trade and investments continue to contribute to growth, it is crucial for APEC, and also for the rest of Asia, to diversify and foster other drivers of future growth to remain resilient and ensure that economic growth benefits all, including poor households, women, MSMEs and other vulnerable groups.
Concluding Remarks

When APEC was established thirty years ago, three broad strategic objectives were laid out by its founding members, which were: i) to develop and strengthen the multilateral trading system; ii) to increase the interdependence and prosperity of member economies; and iii) to promote sustainable development growth. These objectives were articulated in the APEC leaders’ meeting in Bogor, Indonesia in 1994, under the often referred to “Bogor Goals”, which envisioned that APEC would achieve a free and open trade and investment region by the year 2020.

APEC has made great strides in trying to achieve these goals, especially in the reduction of tariff rates. Average most-favoured-nation (MFN) tariffs have fallen from 17% in 1989 when APEC was established to 5.3% in 2017. The region has also made progress in promoting trade and investment liberalization and facilitation, and many sectors are now more accessible to foreign investment and services trade than before58.

While there may be some unfinished work as we approach 2020 such as tackling non-tariff barriers and structural and regulatory reforms, the progress made so far seem to indicate that the region is moving in the right direction in achieving these goals. However, the next decade looks more uncertain as the region faces emerging trends and new challenges. These include rising trade protectionism (reducing behind the border barriers to trade) and increasing trade tensions (hikes in tariff rates, longer times for custom clearance); structural unemployment due to widespread industrial application of digital technologies and artificial intelligence; middle income trap issues (such as moving up the technological ladder); environmental implications of rapid industrialization and urbanization; and anti-globalization sentiments due to rising inequality.

It is also worth noting that inclusion has often been cited as a reason for implementing protectionist trade policies. However, pursuing protectionism as a means for greater inclusion only benefit workers in protected sectors to the detriment of the wider economy. There is extensive research over the years that have identified a number of policy areas that do indeed contribute to greater inclusion. These policy areas include human capital development, improving access to economic opportunities, enacting

social inclusion policies, and promoting economic growth through trade and regional cooperation\textsuperscript{59}.

Moving forward, the APEC Vision Group of experts have been tasked to help APEC senior officials develop a new vision for APEC after 2020, taking into account the progress made by APEC in achieving the Bogor Goals as well as emerging trends and challenges that did not exist two decades ago. Most importantly, as APEC policy makers look ahead to the coming decade, it would be crucial to identify future drivers of growth and more inclusive policies while rethinking APEC’s role as a relevant regional institution in this evolving regional trade architecture.

May I first express my deep appreciation to the organiser and the Hungarian Central Bank for the opportunity to share my thoughts in this esteemed event!60

This is the fifth time I have visited Hungary since 2003. I want to offer you a view which may be quite different from that of the West. In Singapore, we have always believed that nobody owes us a living, and you have to stay relevant if you want to remain competitive. You cannot rely on market forces alone because a government with effective leadership is paramount. I therefore would like to share the Singapore experience with industry leaders, academics and civil servants of Western counterparts.

Firstly, I want to quickly say that we cannot afford to worry too much and to wait too long speculating on the final outcome of the US-China trade war. From the Asian perspective, what is more important is to see how in particular the ten Association of Southeast Asian Nations, or ASEAN-10 including Singapore, are able to navigate ourselves with minimum adverse impact, as this trade-war between the two biggest economies is likely to last on a protracted long period of time. Specifically, as to how ASEAN can stay relevant as an economic entity to take positive moves amidst this trade war, should opportunities arise with shifts in the regional production value chain and trends of foreign direct investment.

Secondly, ASEAN should continue to push for greater globalization in trade and investment rather than to raise the ugly head of protectionism or populism as the United States of America is counting on for America First. The World Trade Organization is still functioning and we should not abandon the international rule-based trading system, especially for a small trading nation like Singapore, ASEAN and including Eastern European counterparts too. One can discuss what will happen to the trade war and how much economies are going to be losing in terms of gross domestic products and jobs, but different economies would suffer differently.

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60 This is an edited version of the lecture given on 4 February 2019.
Thirdly, we have witnessed de-coupling of the GDP growth between developing and developed economies since the 1990s, but after 2015 economic growth between both groups have been converging. Business cycles used to be moving in tandem between developing and developed economies, but after the global financial tsunami in 2008, they are no longer moving in tandem. Perhaps we are seeing the end of the era of synchronized global growth to a synchronized global slowdown. We may be in the worst of times but we may also be in the best of times as crises usually also bring extended opportunities.

In my view, the US-China trade war is in fact a red herring. It is not about trade war, it is more about the United States of America as the biggest economy worrying about its position being threatened and overtaken, hence it wants to contain China, which is the second largest economy. Singapore has been arguing consistently that China is not containable. The economy of China is still growing at an impressive six per cent per annum and with a rapidly rising middle class after more than four decades of economic reforms. China’s big and growing domestic market of 1.4 billion is very attractive, it is therefore better for us to think on how we can constructively work with China instead of trying to stop its growth and emergence as an economic power.

We have extended the seminal work of Professor Maddison on shares of major economies amongst the world’s major economic powers over time. We estimated that by 2030, Asian economies including China, India and Japan are again going to exceed the Western economies including European Union, America and Russia; last time this happened in 1820. Again, according to projections by the Asian Competitiveness Institute based on different growth scenarios for the world’s major economic powers, by 2027 China will be the biggest economy in nominal GDP terms to overtake the United States of America. No doubt the US will continue to be the world’s biggest military power and strongest in technological innovation. When these two giant elephants continue to fight one another, small countries should find ways of how they can avoid being caught in between and they should not choose sides. That is fundamentally very important.

The flying-geese theory of development is highly relevant here, which is still ongoing. We can see how the US passed on their steel industry, car manufacturing and computer technology to Japan and Germany, and they in turn passed on the manufacturing of electronic components and automobile parts to the four East Asian Newly Industrialised Economies or NIEs (Hong Kong, South Korea, Singapore and Taiwan). The ASEAN tigers consisting of Malaysia, Thailand, Indonesia and the Philippines in turn benefitted
from relocation of low-tech labour intensive manufacturing from NIEs. As China’s opening-up gathered momentum in the 1990s, many labour, capital and technology intensive manufacturing activities started to shift to coastal Chinese provinces given China’s cheaper factors of production including land availability, and huge of both skilled and unskilled labour. As the US-China trade war intensifies, it is least surprising that developing economies from ASEAN such as Cambodia, Vietnam, Myanmar and Laos are flooded with relocation of foreign direct investment from China. As you can see, market and opportunities wait for no one!

In the East Asian development, I want to emphasize that leadership is very important. There are thee bottlenecks to overcome in the East Asian economic development model, namely the financing bottleneck, infrastructure bottleneck and the production bottleneck. Most East Asian economies (including Mainland China, South Korea, Japan, Macao, Taiwan, Singapore and Hong Kong) are able to overcome these three bottlenecks through export-oriented strategy and by keeping the sound and balanced budgetary conditions, very often by running government surpluses. However, for many Asian countries, and also many European countries, they have difficulties in overcoming these three bottlenecks.

As part of regional economic integration and interdependency, greater globalization in trade and investment is crucial. Based on our published econometric study using data over the past four decades, empirical findings revealed that whether you like it or not, trade and investment from China to ASEAN is getting bigger relative to those from the US, the European Union and Japan which are consequently getting smaller. So even without the Belt and Road Initiative, regional trade and investment from China to ASEAN has started gaining pace since the 1990s. In another study commissioned by the World Bank Group, we also found that before and after 2010, China has become more significant in terms of trade and investment with ASEAN, but OECD economies taken together are still far more important than China. It is thus very important for ASEAN to continue to stay engaged with OECD economies and I shall leave it to those interested readers to refer to the empirical impact we estimated.

Let me now share with you my views about regional and bilateral free trade agreements, in the current shift towards protectionism, unilateralism and populism, when many people are also showing concerns about Brexit. In Singapore, we are prepared to cooperate with United Kingdom constructively, on the very day of Brexit, I believe Singapore will be one of the first countries to sign a bilateral free trade agreement with
the United Kingdom. This is an example of how Singapore takes the opportunity to stay relevant whenever a trading opportunity presents to us.

Considering the latest US-China trade war, we must evaluate the impact and shift to ASEAN in terms of production value chains, especially if the US-imposed 25% tariff applies to the whole of China’s US$500 billion export, and as China has promised to retaliate in full. I can tell you that there are already relocations taking place by multinationals which are operating in China to ASEAN including Vietnam, Cambodia, Indonesia, Thailand, Malaysia and Myanmar and also to Central Asia, especially Kazakhstan. Taken together, given the rising production costs in China, further aggravated by the US-China trade war, there is a window of opportunities facilitated by the infrastructure-driven Belt and Road Initiative or BRI which must be seized. In this context, the Singapore government set up a statutory board in 2018 known as Infrastructure Asia where we aim to be a regional hub for conducting analysis on infrastructure investment, feasibility, evaluation, financing, sustainability and providing mediation for infrastructure-related business disputes.

As for Hungary, I think you must also seize the window of opportunities from the BRI as the gateway to Eastern European countries. However, such economic and business opportunities will not turn into reality until your government assumes a pro-active leadership as no one owes you a living. Relying on market forces alone is insufficient and you are likely to miss the boat or rather the train for becoming the leader of within-European connections!

Very often in Singapore, we do have the psychological barrier that we are from a small country. Yes, Singapore is a small county in terms of geography, but in terms of trade and investments, Singapore indeed leads the world! You may refer to the latest statistics of the International Monetary Fund, in 2017 Singapore is the biggest recipient of foreign direct investment with US$72 billion, followed by China with US$42 billion and Indonesia with US$12.5 billion. Singapore is also the second biggest exporter of foreign direct investment amounting to US$217 billion, after Japan’s US$264 billion, followed by the United States of America’s third place at US$134 billion. So a small country like Singapore can also become relevant, provided there is nimble leadership, fully capitalized on our position as the third most competitive financial centre in the world after London and New York.

I want to quickly go through what I meant by the window of opportunities for Eastern European countries, especially Hungary. I think your Central Bank did an excellent
job after 2013, as I studied how your economy turned around after the economic crisis. Now you have very good foundations to cooperate with China on resolving your three bottlenecks of development through the BRI. Many would say, oh yes, when you work with China you get into a debt trap! Whatever the case may be it is up to you to judge for the best national interests of Hungary, but I can tell you that China is also learning and adjusting to challenges to ensure that the implementation of the BRI is more transparent better managed.

Before I came to Budapest, an official from the Embassy of China in Singapore invited me for a discussion to share views on the BRI. I declined because I have already mentioned many positive aspects in the past on BRI, but the official said China wants to listen if there are any improvements that can be made or what has gone wrong during the of implementation. Why have so many countries cried about having fallen into the debt trap? I told the Chinese official that Singapore’s Infrastructure Asia could help China to conduct objective analysis on feasibility and sustainability of infrastructure projects before they decided to invest or implement in the third country. This way you do not have to worry about any accusation of China setting debt traps for its clients or countries that it is cooperating with because there is already a very objective and professional evaluation conducted in Singapore!

Now in Myanmar, they are studying the establishment of industrial parks where they will introduce a new element called the Swiss Challenge which means that when China proposes the infrastructure, if anybody can come up with a cheaper price by meeting all the requirements, they should do it. I think China is also learning that they have to be more pragmatic. The launch of BRI is largely due to China’s excess capacity and surplus capital, but we do expect China to export good governance. Indeed China is changing for the better. I want to preach to the unconvinced here that Eastern Europe in general, and Hungary in particular, should not resist the Belt and Road Initiative. If you do feel China is going to use the BRI for political dominance on the European continent, I disagree. Because China has enough problems at home including economic restructuring, income disparity and racial tensions.

Eastern European countries should quickly take advantage of this badly needed excess capacity and surplus capital of China. If we refer to the 2018 survey on infrastructure requirements conducted by the Pacific Economic Cooperation Council, it revealed that roads and electricity are the most important infrastructure items in many developing countries. China’s economy is clearly slowing down fast, but many people got it wrong by thinking this is caused mainly by the US-China trade war. This is not quite the case,
as five years ago China wanted to restructure its economy as they try to contain property bubbles. So financial services naturally slowed down due to a slowdown in funding for housing loans. Meanwhile, China’s export is decelerating faster than expected before domestic consumption could have increased.

China has lot of internal challenges but this does not mean that there are no opportunities. Last week, on 25 January, the Asian Competitiveness Institute signed a Memorandum of Understanding with the Shanghai Academy of Social Sciences for research cooperation. We know the next wave of development in China is urbanisation and the building of liveable cities with the setting of new standards for development. Singapore wants to stay relevant by participating in China’s urbanisation growth whereby we hope Singapore’s excellent city standards can also be relevant.

Regarding Eastern European countries, I think establishing of Special Economic Zones or Industrial Parks will be very interesting. The Asia Competitiveness Institute is currently helping Indonesia to assess and develop five Special Economic Zones. I look forward to meeting Mr Palotai in Singapore where I hope to explore how we can also pass on our experiences and exchange views with him on how industrial parks can be established in Hungary, and thus draw more manpower back to your economy once you are buzzing with economic activities.

Finally, I want to draw your attention that Asian people have been colonised for the last 500 years. Nevertheless economic growth accelerates, we are capable of looking after our own problems and development, and therefore I think catching up in Asia is an important topic today.
Learning from Catching-up Economies in East Asia

**Introduction: Growing World Economy**

The world economy has grown and is still growing. In history, even though there were some downturns such as the 2007-2008 Financial Crisis, it is obvious that there is a clear tendency that the world economy has been growing. The economic growth brings national wealth to a state, but the more important thing is that it also brings a better standard of living to the people.

![Figure 1. GDP per capita (current USD)](source: World Bank, World Development Indicators)

Even though the tendency of growing world economy is clear, one important issue has arisen – that is, unequal economic growth. It is also obvious that wealth resulting from world economic growth has been unequally distributed to people of the world. Once, so-called *dependency theorists* blamed developed wealthy states (or “the core” economies) for the inequality, claiming that the developed have exploited the underdeveloped poor
states (or “the peripheral” economies) and dominated most of the profits produced by the capitalist world system. According to the dependency theory, poor economies are bound to be tied to underdevelopment and poverty, and cannot get out of the exploitation unless the world system is fundamentally changed.

Figure 2. Unequal Economic Growth (GDP per capita)

However, none of the world society now believes in the assertions of dependency theory. The collapse of the Communist economy, which was elaborated as an alternative to Capitalism by dependency theorists, proved that liberal international order – that is, democracy in politics and capitalism in economy – would be the zeitgeist (the spirit of the age) or the norms of the present era. Now, the underdeveloped or developing countries are trying to catch up with forerunners by means of setting a national development strategy and restructuring domestic policies, rather than blaming others and the world system. In fact, before the advent of the post-Cold War, the world had already witnessed newly emerging economic powers, so-called catching-up economies, who were based on very much capitalist principles of international order.

This study is to explore how East Asian catching-up economies could successfully achieve economic growth in a short period of time, and to draw some instructive implications for developing and underdeveloped states who try to apply catch-up strategies to their own economic growth. Also, this study examines explicit and implicit challenges to catching-up strategies in the current twenty-first century.

Source: World Bank, World Development Indicators.
East Asian Catching-Up Economies: The Developmental States

The concept of “catching-up economies” comes from the classic economic theory, i.e., the convergence theory. Catching-up economies implies that poor or developing economies will grow much faster than wealthier economies and all states will eventually converge onto a certain degree of better economy in terms of the standard of living or *per capita income*. Catching-up to more robust economies could be possible by following so-called path-dependent strategy. Catching-up, or path-dependency, can be done by adapting an efficient mode of production and utilising other developed economies’ practices which have all previously proved successful.

*Figure 3. East Asian Developmental States (GDP per capita)*

![Graph showing GDP per capita for East Asian Developmental States from 1960 to 2016](source: World Bank, World Development Indicators)

In the study of catching-up economies, East Asian economies – well-known as so-called *developmental states* – such as Japan, South Korea, Hong Kong, Taiwan, and Singapore are exemplary cases, or even regarded as the prototypes of catching-up economies. For example, from 1971 to 2012, during the last four decades South Korea achieved an average of 7.1% annual growth in its economy. And, over the same period, there was a more than 81-fold increase in GDP per capita. Singapore made an average 7.2% of annual economic growth and about 50-fold increase in GDP per capita over the same period. None of the other advanced and developing economies made such a remarkable success in economic growth.
Numerous academic papers and case studies on East Asian catching-up economies proved that they have had a lot of commonality in their political economic institutions and practices. The common features in the political economy of developmental states might be primary reasons, or necessary conditions, for their noticeable economic success in catching-up with advanced economies. The success factors of developmental states’ economic growth consist of internal and external ones.

The first of internal factors is that their economic success was originated by the government, not by economic institutions. Thus, bureaucratic power and economic policies including financial and industrial policies always overwhelmed economic entities and the domestic market. The governments’ economic planning always came first and played a more primary role than market mechanism and competition. In East Asian catching-up economies, fortunately, the strong and ambitious bureaucratic power was backed up by the smartest and most competent human resources. In many ways, bureaucratic power was admired by the people, because the government officials were selected by the most competitive national exams open for all people, not by nepotism or cronyism.

The second, owing to strong bureaucratic power in the economy, was that their domestic market was heavily touched by the government’s control and management. Thus, with the so-called “controlled market”, development states could successfully implement the catching-up strategy by protecting the domestic market from foreign goods and services and by minimising excessive competition among domestic enterprises. Their regulation, registration, and certification policies were strong and exclusive enough to protect the domestic market from foreign competitors and maintain the market with only a few selected competitors. With the governments’ economic planning and policies, catching-up economies could not waste national resources, and focused their national economic interests on selected major industries in which a few selected and favoured players were competing.

The third, smooth and close relations between the government and business sectors were contrived through various business associations and so-called amakudari in Japanese (meaning “descent from heaven”) or revolving-door politics. Virtually every industrial and business sector created and managed a business association to represent its own business interests. But, almost all the business associations were governed by former high-rank government officials. The retired government officials in business sectors developed a very special linkage between the government and business sectors, and they were more likely to deliver the government policies and plans to their affiliated
business associations, instead of representing their own business interests. As a result, the government and business sectors, or the public and private sectors, of East Asian developmental states always rolled together as a massive but effective organism of political economy. The well-known word “Japan, Inc.” tells the same story.

The fourth, with consideration of their available national resources, catching-up economies strategically selected and supported some industrial and business sectors that had potential competitiveness in the world market or had a bigger and positive externality to other related industries. Also, governments supported the selected business and industrial sectors with various industrial policies including national R&D plans and periodical evaluations. All possible financial incentives and technological assistance were concentrated on the selected sectors, and even various industrial promotion acts were legislated to encourage and support the development of the selected sectors. In Japan and South Korea, for example, there were five major strategic industries: heavy and chemical industry, steel and iron industry, automobile and shipbuilding industry, telecommunications industry, and construction industry. In Singapore and Hong Kong, financial and trading industries were strategically invested by the governments. When catching-up economies developed their major industries, the governments even picked up the limited participants in the process of industrialisation to prevent excessive competition and to encourage profit maximisation.

The fifth, finance played a central role in connecting the government and private sectors of East Asian catching-up economies. Much of the analysis concludes that state control of finance, often called governed finance or controlled finance, was the most important aspect of East Asian catching-up economies, because finance was the tie that bound the state to the business and industrial sectors. Since there were not enough assets in catching-up economies, so-called credit-based financial structures supervised by the government were effective conduits of industrial policy. The advantage of the credit-based financial system was that the state could exert influence over the economy’s investment pattern and guide sectoral mobility, because in such a structure firms would rely on bank credit for raising finance beyond retained earnings and respond quickly to the state’s policy, as expressed in interest rate, exchange rate, and other financial policies (J. Zysman 1983). In addition, foreign capital flows were strictly controlled, and several types of policy-oriented and government-owned banks were established by the state.

Last but not least, East Asian catching-up economies’ export-driven strategy implied the destination of their industrialisation and the externality for their economic growth. It was mainly because their domestic markets were underdeveloped that people could
not consume what they produced. This export-driven strategy of catching-up economies really worked well during the early decades of economic growth, but it became a major cause of East Asian catching-up economies’ structural vulnerability to the world economy or overseas economies. Many catching-up economies still maintain the high degree of dependence upon foreign trade and international markets. For example, South Korea’s economy still depends on international trade and global markets for as much as around 70% of its GDP.

![Degree of Dependence on Foreign Trade, South Korea](http://stat.kita.net)

Besides these characteristics of East Asian catching-up economies’ political economy, there were external factors that should be recognised as favourable conditions for the economies’ remarkable success. First of all, facing the confrontation of the West and the East blocs during the Cold War era, the catching-up economies’ alliance or partnership with the U.S. was a very important factor for their economic growth, in that the U.S. provided catching-up economies with not only a security umbrella and financial, technological assistance, but also the U.S. market opened wide for catching-up economies. It might be owing to the U.S. political and ideological interest, but in doing so the U.S. economy sacrificed the domestic market to save catching-up economies until the so-called Neoliberal ideas became prevailing in the mid-1980s.

Also, along with catching-up economies, major powers of the Western bloc also enjoyed robust economic growth during 1960-1980, relatively higher than recent years, and
thus their markets and consumers became major and final destinations of catching-up economies’ mass-production.

Lastly, during the same period, the existence of various authoritarian regimes in the Middle East, Latin America, Africa, and Asia prevented political intervention in the economy of East Asian catching-up states from being regarded as a salient problem. This political climate played a role in defusing the problems of oppression of labour and human rights, corporatist government-business relations, and less-democratic political system in East Asian catching-up economies.

**Catching-up Economies in the Twenty-First Century**

In many aspects, East Asian catching-up economies would not be free from criticism made by liberal economies and economists, especially neoliberal critics, because free trade and free competition were intentionally neglected because of the need of protection of their national economy. East Asian catching-up economies were located somewhere between liberal market economy and controlled communitarian capitalism. The economies made a profit from a liberal international market, but domestically politics always intervened in economic affairs. As the global economy became ever more connected and integrated, their domestic markets grew to be distorted and malformed.

Most of all, the world political economy also changed. The input-oriented growth model based on the belief of *economies of scale* became outdated, and efficient mass-production and price-competitiveness no longer provided a guarantee of industrial success and economic gains. The so-called IT Revolution in the mid-1990s made knowledge- and architecture-based industries bigger and generated more economic profits and industrial externalities than mass-production and price-competitiveness, but the rigid, government-controlled markets could not be flexibly adapted for changes. Moreover, the international market environment became hostile to export-driven, catching-up economies, in that advanced economies would not provide their domestic markets for developing economies. The advents of Brexit and U.S. President Trump are extreme but indisputable cases that represent the change of international economic environment. In addition, the so-called millennial generation does not appreciate the developmental ideology based on “standard of living”, but they care more about “quality of life” which could not be solely improved by economic growth.
The success of East Asian catching-up economies does not imply that the catching-up strategy would be an omnipotent solution for economic growth, in that many unfavourable side effects also ensued. Sometimes, the side effects became very painful in the process of economic growth. For example, the Japanese suffered from long-term economic stagnation for almost two decades, and the South Korean financial crisis in 1997 compelled the economy to ask for a $55 billion bailout loan from the IMF. In both cases, it needs to be noted that the deregulation and restructure of political economic institutions which had been the engines for catching-up strategy were elaborated as solutions to revive their own economy. It is also worth noticing that former catching-up economies reversely turned out to be strong advocates for free trade and free markets in these days.

**Conclusion: Implications for Emerging Catching-Up Economies**

With the characteristics of East Asian catching-up economies, developmental states recorded unprecedentedly high and rapid economic growth. Since then, other developing economies, such as China, India, and Vietnam, have emerged as new catching-up economies, but the quality and speed of their economic growth cannot be compared to those of previous catching-up economies.

*Figure 5. Emerging Economies (GDP per capita)*

*Source: World Bank, World Development Indicators.*
It is a fallacy that if emerging catching-up economies follow the same steps as East Asian developmental states have done, they then could achieve the same success. Even though emerging economies try to adopt the same catching-up strategy of former catching-up economies, the changed international economic and industrial environments would not allow them to achieve the same economic success. It is because the current international economy has ripened, has become more competitive, and more liberalised than before. Also, the current world economy has new profit-increasing industries of the so-called Fourth Industrial Revolution Era, which differ in several aspects in the mode of production from that of its predecessor.

However, a successful strategy based on well-defined national competitiveness, well-structured and future-oriented industrial policies, and connection to the integrated world market will pave a way for newly emerging economies to achieve better and faster economic growth. The most important lesson from the previous success of catching-up economies is the positive role of the government in its economy and industrialisation. Despite the changed political and economic environments in current international relations, the pivotal role of the government in economic development and industrialisation is still very important and primary. The transparent and public interest-based political regime is always a positive factor for economic growth.

In addition, one more important issue that emerging catching-up economies should take into consideration, which the former did not care much about, is the economy’s sustainability. Sustainable economic growth without environmental degradation has become a matter of increasing quality of life in the twenty-first century. In the past, environment protection and social justice were calculated as social costs, so they have always been treated as issues and policies of secondary importance under the grand goal of economic growth by catching-up economies. The experiences of former catching-up economies, however, indicate that national consideration and response to post-economic growth issues would cost much more than previously expected. Sustainable development issue is a challenge for both developed and developing economies, but if emerging catching-up economies take it seriously in developing their strategy for economic growth, unlike its East Asian predecessors, they will be able to proactively and efficiently manage the sustainability of their economy from the beginning stage.
Asia from a Global System perspective

Thank you very much! Köszönöm! Like Yves Mersch, the previous speaker, that is the only Hungarian word that I know. I would like to express köszönöm very much to Governor György Matolcsy, the National Bank of Hungary, and all my good friends here this morning. This is a very emotional time for me because 30 years ago I first visited Budapest as a staff of the World Bank.

To begin with, the difference between the East and the West is that in the West, you always start a lecture with a joke. In the East, we always start with an apology. So let me apologise if I say something wrong this morning. When I visited Hungary on behalf of the World Bank to talk about the reforms in 1989-93, I discovered three things about Hungary and Hungarians.

Firstly, Hungary produces the best dessert wine in the world, the Tokaji. Thank you very much for giving me another taste of this wonderful wine last night that brought back many happy memories. Secondly, Hungary produces the richest of foie gras, so every time I came back from Budapest, I gained extra weight. Thirdly, I learned very quickly that Hungarians produce the best economists in the world and the best Hungarian economists are to be found in the Central Bank. If you think this is to flatter you all, actually I sincerely mean it.

Like all of you, I want first to pay tribute to the late Alexandre Lámfalussy. Forty years ago, when I first attended the Annual Meetings of the Bank for International Settlements as an aide or bag carrier for my governor, Dr. Lamfalussy was already economic advisor. His intellect with humility was already legendary – a god to us junior people. As Yves Mersch and Governor Nowotny said earlier today, Dr. Lamfalussy was very humble, and he took time to be kind to everyone who came to the Bank. I was awed by his fantastic ability to grasp the big picture, but at the same time he paid great attention to detail. His work on payment systems showed amazing grasp of the importance of financial infrastructure that were the foundations of sound central banking and financial stability.
He was a great believer in European integration and the stability and coherence of the international monetary system. These were issues that I and many others learnt from him. I last met him when I visited the Robert Triffin Foundation to discuss the future of the SDR, just before he passed away in 2014-15. It is therefore a very emotional moment for me to stand here to pay tribute to this great man.

Let me say how much I enjoyed this morning’s session, to learn the great vision and wisdom of Yves on why we really need to rethink our existing paradigm. I agree with him that we certainty do not have the answers, but allow me to touch on three underlying themes this morning on the subject of Asia catching up.

At the earlier panel, my very good friend Governor Kelimbetov mentioned that Asia is now on a maybe catching up trend, but perhaps it is also a rising and simultaneously falling trend. Given that Asia is one half of the world’s population and today the fastest growing zone, the subject of where Asia is going is an important issue that all of we need to deal with. In my view, Asia will be the place for the greatest experiment in technology, sustainability and environmental change.

But secondly, we must appreciate that the current paradigm of zero-sum geopolitical game is threatening this prosperity. When both sides of the Pacific cannot work with each other for the generation of global public goods, the trade and other conflicts will jeopardise the future of global prosperity.

Amazingly, the solution for this dilemma is not about an American view or a Chinese view or a European view, the narrative today is shaped by how two European thinkers at the end of World War II, Friedrich Hayek from Austria and Karl Polanyi from Hungary created two different worldviews. Since then, for the last 70 years, the world essentially adopted the Hayek free market liberal order view that pushed the primacy of free trade, capital flows, rule of law, electoral democracy and a minimalist state supporting a laissez-faire economy. But today we find that there are many problems with the Hayek view. So in discussing the rise of Asia, we need to go back to what Karl Polanyi was saying in his book The Great Transformation (1944), that the market is only a sub-set of a more complex society that is evolving or transforming. Human society evolves with higher orders of state or social organization that transforms through a double movement of market and social protection. He thought that self-regulating markets do not work. This Hayek-Polanyi debate is now central to what happens to the neo-liberal order. In my view, Polanyi is better in explaining the rise of Asia and how Asia and the rest of the world can evolve over time.
From a historical point of view, Asia sees its growth reverting back to the pre-1750 period. Post-1750, the West through science and technology (Industrial Revolution) enabled a much smaller population in Europe to control or colonize literally most of the non-European world. Up to 1820, Asia comprised more or less 50% of world GDP. By 1950, China, India and the rest of Asia’s share of world GDP fell to less than 20%. However, by 2016, their share of world GDP has revived back to roughly one-third of world GDP.

Let me stress that this revival was not just due to about governance, but more a demographic plus technology story. The generation of Asians, particularly East Asians, understood that growth and development can only be achieved under a condition of stability, inclusiveness and openness to trade, technology and learning from the advanced countries. After 1950, the West decided to share knowledge, know-how and information with the rest of the world. Essentially, any country that is smart enough to adopt science and technology with rising population must grow. Consequently, Asia with half the world’s population is now growing at more than 5% per year. On the other hand, the rich and advanced countries are ageing and are growing at less than 1-2%. Therefore, the question of Asia catching up with the West is not a prediction, it is just linear mathematics. Barring war and conflict, the catching up is a matter of time.

However, the social problem that we now have is that between regions, we are converging in terms of GDP, but diverging in terms of social inequality within every country. If this is the contradiction that we face, and within every country we blame foreigners for our own inability to resolve internal imbalance, then we are bound for conflict. How to resolve that looming conflict is the key issue today.

Governor Kelimbetov mentioned the McKinsey Global Institute study that has said that 8 out of 11 outperformers are Asian. But that is because they paid attention to education, education and education, which György Szapáry mentioned today. Asia learns new knowledge through open markets and trade. In terms of trade today, just China plus ASEAN, which is 600 million population and $2.5 trillion in GDP already engages in more international trade than the United States.

The macro picture that the world is converging but diverging at the same time is due to what I call “6G” mega trend disruptors. Most people do not appreciate that these six trends combined to produce an extremely complex world.
The first trend is the shift from a unipolar to the multipolar Geopolitical environment. This is already well known and accepted. I have already discussed the second Geographical shift from West to a younger and larger population in the East, causing a shift in the centre of economic gravity Eastwards.

The third Gender shift is much more powerful than most people realize. The World Bank and other development agencies realize that empowering women and getting them engaged in the work force is one of the drivers of growth and governance. Equality for women in terms of pay and opportunities are gathering momentum even in the United States. But because of the one child policy in China, going forward half of the private wealth of China will be inherited by women. That will change the whole worldview about consumption, education, and even conflict. Men like to fight; women like to conserve. The whole gender shift alone will change the world with very different values from when it was a male-dominated world.

As Charles Dickens said, we are living the best of times and the worst of times. Our generation has a time clock, with a rapid Generational shift to the Millennials, those born in the 21st century. The baby boomer generation has created the biggest wealth the world has ever witnessed, but is leaving the largest debt to the next generation. We have consumed most of the planetary natural non-renewable resources and we now witness the revenge of Mother Earth in terms of global warming and climate change. The stresses of Global climate change on food and security is driving migration northwards, which changes the political dynamics in Europe and North America. We never thought seriously about these consequences before.

And finally there is a tech shift. 5G technology, robotics, 3D printing, Artificial Intelligence and genomics all combined to change the nature of work, education and lifestyles. The rapid pace of technology is disrupting the business models, global supply chains and even the mode of governance. But not everyone is equipped to deal with the tech disruptions.

But think about all these six risks. Under the neo liberal order or free market order, the shadow prices for all these six risks were considered zero or negligible. In the past, businessmen did not consider at all national security risks in business models. We considered the geographical shift an opportunity for global markets, less of a threat. We hardly thought about the gender shift and the generational shift of wealth. Until recently, climate change risks were not high priority on the government agenda, until pollution, droughts, natural disasters and migration became more obvious. The world
was enthralled with technology as the solution to everything, but suddenly woke up that tech costs are non-zero in terms of competition, jobs, privacy and national security, as demonstrated by the issues with Facebook and Huawei.

The result of these 6G trends is that the world is in a transition from one order to the next. History has shown that such transitions are not orderly. We may be witnessing a global recessionary trend very much like the 1930s, in which the Great Powers decided to fight each other. However, even if China slows down to 5% growth, that is still 1.4 billion people growing at double the speed of the West. We cannot forget that India with another 1.3 billion is growing at 7% growth per year. ASEAN is growing at around 5%. Bangladesh, Vietnam, Philippines are each over 100 million, plus Indonesia at 250 million are all growing at 5-6% per year. So the demographics plus technology growth story could produce an opportunity of global development and hope rather than a risk.

The barrier to growth is the linear Cartesian mindset, in which the political and economic paradigm is stuck in linear zero-sum thinking with mainstream economics expressed in mathematical elegance to explain the messiness of human behaviour. That cannot be right. Where is it shown very clearly, is in artificial intelligence. György Szapáry has already mentioned that the biggest competition in research in artificial intelligence is between China and the United States. Even though Europe is very strong in technology and research and development, for various reasons, Europe does not have the financial platforms like Facebook, Alibaba or Tencent. The growth of AI and its impact on human behaviour will be non-linear.

Perhaps the biggest paradigm issue is not physical barriers of hardware or software infrastructure or rules and regulations. The biggest barrier may be the mental barrier to change and innovation.

We suffer today the biggest inequality in recorded history. In the last 30 years, 0.1% of the US population gained 12 percentage share in total wealth, most of it at the expense of the 90% of the population. Pay gaps between the CEOs and the lowest paid workers widened considerably. We have today the largest asset bubbles around the world, financed basically by $20 trillion of quantitative easing (QE) by central banks, which increased their balance sheets by $14 trillion since 2008. Almost all the so-called prosperity we have enjoyed since the last ten years is essentially supported by central banks’ loose monetary policy. If you take that away, you see how the S&P 500 index closely tracks the size of the major central bank balance sheets. As the central banks begin to normalize - the threat of taking QE away - the stock markets
are reacting negatively. By maintaining financial stability and appropriate monetary policy, traditional central banks exercise the role of “hard budget constraint” or financial discipline on the economy, complemented by fiscal policy to control fiscal discipline. The Hungarian economist Janos Kornai famously identified that the Soviet Union economies collapsed in the late 1980s, because they had a “soft budget constraint”, meaning lax fiscal and monetary policies. Now we find that the free market economies also have huge soft budget constraints, which essentially ask the reserve currency central banks to loosen monetary policy, when the advanced economies refused to tighten fiscal policy and make structural reforms that are painful but necessary.

The world is therefore running on growing trade and capital account imbalances, with the US and UK essentially running large current account and net debt to the surplus economies. There is a US savings deficit that is manifested in higher fiscal deficit and trade deficits. The US is able to finance its deficits because of the unique position of the US dollar (USD), which accounted for 44% of global daily (2016) FX transactions and 62.5% in official reserves in the first quarter of 2018. In contrast, the comparable numbers are 15.5% and 20.4% respectively for the Euro; and 4% and 1.4% for the Chinese RMB. Because of the power of the USD payment system, between 2009-2017, the US authorities fined global banks US$16.3 billion for “breaking sanctions”, rather than non-compliance with capital, liquidity or prudential rules. The risk is that if a major economy or an ally becomes a US enemy, all transactions in USD with that country will be subject to sanctions and possible confiscation of USD assets. This breakdown of trust in using a politically neutral reserve currency will further increase risks and costs in the global economy.

In the first quarter of 2018, BIS data showed that non-financial borrowers owed $11.5 trillion in USD debt outside the US, compared with EUR3.1 trillion in debt denominated in Euro. The fear is that if the USD strengthens, then the non-US borrowers will have to hedge their currency exposure, putting even greater pressure on all EME liquidity, as well as upward pressure on the USD. Historically, a strong USD has been deflationary on global trade and growth.

So far, the United States is not worried about this strong dollar issue, because the US economy remains the growth economy amidst the advanced countries, with low unemployment and inflation. The US corporate sector is not heavily leveraged, because the US has the most advanced equity market in the world. However, the US listed companies have been buying back their own shares to keep the value of the corporate managers’ bonus options positive. This has cut the amount of long-term investments
that traditionally kept growth positive. At the same time, the number of American listed companies is getting smaller, with fewer IPOs, which makes the US equity market more concentrated, exacerbating income and wealth inequality.

In the last 10 years, East Asia, led by Japan, South Korea and later China have accelerated their manufacturing and also distribution capacity in telecommunications and digital equipment. China in particular, because of the scale of her markets, has been able to move in speed, scale and scope to achieve advances in e-commerce. India, Indonesia and other countries are also beginning to become more digital, building on their mobile networks and billions of young users who are willing to adopt new tools and lifestyles.

Thanks to considerable investment in R&D, East and South Asia, particularly China, Japan and South Korea, have begun to narrow the gap in innovation and technology with the West. This has created nervousness, because such technology has also national security uses. In other words, superior technology will also lead to a narrowing of the military gap that currently exists, so there are defensive reasons to use all tools to disrupt the competition, including the use of sanctions, trade tariffs, and direct restraints or sanctions on individuals, companies and governments.

So this is where the big fight is. Who will implements 5G and become the dominant player in superior goods, services and users? So far, in terms of 4G, the West has maintained the lead, but as Huawei and others begin to leapfrog into 5G technology, moving from basic infrastructure to end-user products and services, then competition may be “winner take all”, rather than a level playing field. The trade dispute is therefore an accusation that US trading partners are using currency manipulation, unfair trading practices, excessive government subsidies and direct support for state-owned enterprises and the like to gain advantage over American business and trade. Furthermore, any success is also seen as taking jobs away from the US. The new business environment is not about fair competition, it is about disruption. How do you disrupt your competitor and what rules do you apply in this new game?

Allow me to quickly summarise. I am saying that the debate between the East and West is essentially about a paradigm debate. But that paradigm cannot be Asian values with Chinese, Indian or Islamic characteristics. You cannot talk to each other by talking a different language. You have to be on the same page. Consequently, I studied not so much the Chinese, Islamic or Indian ideas. I studied what went wrong with the dominant neo-classical model that runs through all economic thinking and the neo-liberal order
model. What is wrong with the neo-classical thinking that is blind to some of the many problems that we face today?

I discovered this wonderful economist by the name of Karl Polanyi. Karl Polanyi said that the self-regulating market does not work, and we have seen that it does not work. By explaining everything through “rational” agents operating through the self-equilibrating and self-order of the market, the concept eliminates the human and natural substance of society. A market is embedded in a society. Society is embedded in Mother Earth. The market-based theory has extended one part to the whole. By assuming away what you cannot explain, the theory seems infallible, until you hit reality. Climate change is not an externality, as famous economists have said. It is not a “market failure”. It is a human failure, because the excess carbon emission, the over-use of non-replaceable natural resources, are caused by human beings on the assumption that every supply will meet the demand. There are planetary limits to human consumption. An elegant economic theory that ignores politics and ecology is a toy, not a model of reality. And politics is always part of government, which cannot be separated from the market.

Today, human-induced climate change is existential, because beyond certain temperatures, biodiversity will deteriorate and life will cease to exist. You cannot say you just fix the market, you fix man, society and you fix Mother Nature. In fact, the free market system is consuming human beings and consuming Mother Nature. As Polanyi keenly observed, the market is part of a broader society. Government plays a role for the market to work. It is not either or, it is both. We need to move beyond the mechanical, linear or one-way causal thinking of neo-classical economics towards reflexive, non-linear and holistic, multi-dimensional paradigm of how to be sustainable in an ever-changing environment.

Neo-classical thinking reduced everything to “utility”, then represented utility into a standard called money. At the physical level, money was represented by gold, and then we used “fiatmoney”. But today, money has evolved into complex forms of financial derivatives, including digital or cyber-currencies. Economics has evolved into politics of who and how money can be created or used, but also what are the ecological and ethical questions of digital currencies? For example, the free market idea that anyone should be free to create digital currencies usually ignores how much energy is required to compute and operate digital currencies.

How do we move from these complex discussions and where does the gold standard and today the dollar standard play in this role of the modern economy is a universal question,
a dynamic conversation and an emergent discussion that we must have together. Not because the Chinese want to say this is Chinese, the Indians want to say this is Indian, the Arabs want to say it is Arab or the Europeans want to say it is European. We must discuss this as a universal world of complex diversity. Hence, Asia is catching up with the West, because time is catching up. History unfolds, as one order emerges from another, but it unfolds because of the complex interaction between the parts, East or West, North or South. Any partial paradigm is necessarily intellectually blind.

I am now 72 years old, with only 4,000 days left, not more than 10 years in expected average working lifetime, so the clock is ticking. So my question to myself is: at the end when time has caught up with me, what is society going to be? Will it be World War III or a richer and more civilised planet that everybody can enjoy? Human beings have much to ponder on the future of human civilization that is in harmony being Man and Nature.

On that optimistic note, let me say once again Köszönöm to the National Bank of Hungary and to all of you for listening. Thank you very much indeed!
THE
LAMFALUSSY AWARD
2019
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, then 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 pursuit of monetary and financial stability and fosters international cooperations. Since its establishment, the BIS has pioneered the reform of monetary and financial stability 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).

In 2018, the award was presented to Zhou Xiaochuan, then Governor of the People’s Bank of China. During his career, he has filled key positions in such institutions as the People’s Bank of China, the China Construction Bank or the China Securities Regulatory Commission. During the Asian financial crisis at the end of the 1990s, he greatly contributed to maintaining the stability of the Chinese currency, the yuan. He was central bank governor from 2002 to 2018, which makes him the longest-serving head of the People’s Bank of China. Zhou Xiaochuan is one of China’s most influential financial reformists who achieved tremendous results during his central bank governorship in the area of financial reforms, while he is also recognised as an important contributor to the internationalisation of the renminbi. While in office, the renminbi was added to the SDR basket of the International Monetary Fund, making the yuan an international reserve currency. Moreover, the awardee is an author of numerous books and studies and teaches in several institutions such as the prestigious Tsinghua University.
Yves Mersch is a member of the Executive Board of the European Central Bank (ECB). His eight-year term started on 15 December 2012.

He was the first Governor of the Banque centrale du Luxembourg (BCL) from 1 June 1998 to 14 December 2012. During his tenure as Governor of the BCL, in 2011 Mr. Mersch was elected Co-Chair of the Financial Stability Forum’s Regional Consultative Group for Europe.

He has been a member of the Governing Council and the General Council of the ECB since their creation in 1998. He is the longest-serving member of the Governing Council.

After obtaining post-graduate degrees, first in international public law and then in political science, he had a teaching assignment at the Université Paris-Sud. During this time he was admitted to the Bar of Luxembourg.

Mr. Mersch started his career at the Luxembourg Ministry of Finance in 1975. He was seconded to the International Monetary Fund (IMF) in Washington in 1976 and joined the Permanent Representation of Luxembourg to the United Nations in New York in 1980.
Upon his return to Luxembourg in 1981, he worked at the Ministry of Finance. From 1985 to 1989 he was Government Commissioner in charge of oversight of the Luxembourg stock market. Between 1983 and 1999 he was a member of the Council of the Luxembourg Monetary Institute, Luxembourg’s banking supervisory authority. As Personal Representative of the Minister of Finance, Mr. Mersch contributed to the design of the Maastricht Treaty.

He represented his country in the governance of international organizations like IMF, World Bank group, European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), etc., as well as in private sector companies in the areas of banking, insurance, telecommunications, satellites...

Mr. Mersch was appointed Honorary Professor at the University of Luxembourg. As of 2015, he assumed membership of the Central Bank Governance Group, established at the Bank for International Settlements. Mr. Mersch is a member of the Institut Grand-Ducal in Luxembourg; he is also a member of the Board of Trustees of the Institute for European Politics. He is Officer of the National Order of the Legion of Honour (Ordre National de la Légion d’honneur, France).

Born in Luxembourg on 1 October 1949, Yves Mersch is married to Tengku Khatijah Ahmad with two children.
THE
POPOVICS AWARD
2019
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, Deputy Governor (then 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.

In 2018, the Popovics award was presented to Péter Benő Banai, State Secretary for Public Finances of the Ministry for National Economy. He played a crucial role in the successful implementation of the fiscal turnaround commenced in 2010, in establishing fiscal and general government predictability and in formulating financial discipline. Taken together, these achievements contributed to establishing a balance between the two main branches of economic policy and provided the means for the growth turnaround.
KATALIN NOVÁK
Minister of State for Family and Youth Affairs, Vice President of FIDESZ – Hungarian Civic Alliance, Member of the National Assembly

Katalin Novák has been Minister of State for Family and Youth Affairs at the Ministry of Human Capacities since 2014, and she is Vice President of Fidesz since November 2017. As Minister of State and a mother of three children, she is personally dedicated to representing the interests of Hungarian families, the youth and the elderly. She believes it is crucial to support women in overcoming the challenges. One of her main objectives is to help reconcile work-life balance of women in society. Katalin and her husband consider it extremely important to provide the kind of upbringing that produce happy adults with a stable set of moral principles, who have a good understanding of their own past and traditions, and who are also open to the novelties in the world.

Katalin Novák earned her diploma in Economics at the Economics and Public Administration University of Budapest specialising in international relations and environmental management. She also studied law at the University of Szeged and completed a course in community and law at the Université Paris X. She also lived and studied in the United States. Katalin is also fluent in English, French, German and Spanish.

She carries out numerous tasks related to public life at international level: she is the Vice-Chair of the Political Network for Values’ Advisory Board, the founding member of the German-Hungarian Youth Association. In 2013 and 2014 she held the position
of Vice President for the Friends of Francophones, a group of ambassadors. She is the founding member and the Chair of Women for Hungary Club. The association was founded by women of civic values exercising a degree of influence to think and act together for the enrichment and protection of Hungarian culture and national identity.

Her work has been acknowledged with several national and international awards: She received the most prominent award of the National Association of Large Families, the NOE prize in 2018, and the Pro Familiae Hungariae of the Pro Familia Hungarian Scientific Society. In 2017, her efforts were recognised by the Association of Hungarian Nursery Schools with the Ágnes Akócsi award. She received the “Luchador por la Familia” (Fighters for Families) award in Catalunya in 2016 and the “Familia et Veritas” (Family and Truth) in Georgia. She was also awarded the memorial plaque of the French Chamber of Representatives in 2014 and in 2017, she received the commemorative coin of the French National Assembly. She has recently received the Chevalier degree of the French Legion of Honour.