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Nikolai Levin pulls the curtain on Russian myth making

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THE GLOBAL TRADE AND FINANCE PLATFORM

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FOREWORD

What does history teach us?

As the old saying goes, if we don't learn from our past, we are doomed to repeat it. History provides societies with a sense of identity, a pride in past achievements and warnings about previous mistakes. It makes you wonder if the Western political elite are ignorant of the past, are too imbecilic to rule, or have ulterior motives? I will leave that to you. But what cannot be doubted is the drift of modern, healthy and prosperous economies from a golden future to the subsistent past, from plenty to poverty, from democracy to totalitarianism.

Lessons from the past abound. A possible 'winner' of the future is China, so let's find past errors that are religiously being repeated in the West. The Great Leap Forward was an economic and social campaign to reconstruct China from an agrarian economy into a communist society. You know the story. Officials blamed everyone else for their failures (think COVID, supply chain shortages, war in Ukraine, and you get the picture), and millions died.

Policy failures were blamed on bad implementation, and on 'rightists' (still the same, but we now have climate deniers, anti-vaxxers, white supremacists, or just plain racists), and opposition was removed. I suppose cancel-culture hasn't killed thousands of people. But we do have a modern version of the 'Four olds' policy; namely, the banishment of old customs, culture, habits, and ideas.

Anybody not white skinned is seemingly descended from slaves, and white supremacy is a fact, and slavery was a Western crime against humanity. No discussion or debate is allowed. Western culture is racist, and any successes in science, technology, health and wealth creation is to be dismissed. Authors are being cancelled, replaced with more acceptable writers. This is a dismantling of Western culture.

Unlike 50 years ago, the liberal technocrats in charge of the West have sophisticated technology to cancel opposition and debate. The birth of the planet's eight-billionth resident (a baby girl born in the Philippines) should be a celebration, demonstrating the huge advancements in public health, nutrition, personal hygiene and medicine that have extended lifespans and dramatically reduced maternal and child mortality rates.

And yet, for many in the Western intelligentsia and policy-making circles, this shows that human activity is destroying the planet's biodiversity, and outstripping its capacity to replenish natural resources, and more people on the planet means more pressure on nature. These very elites have found an ally in the struggle against the evils of anthropogenic activities: radical anti-capitalists, dubbed 'degrowthers' by some.

They believe capitalism's drive for profit is destroying the planet and only degrowth communism can repair the damage by slowing down social production and sharing wealth. Humans need to find a 'new way of living', and that means replacing capitalism.

A cultural revolution that is destined to create an Eastern hegemony. Europe in particular is trying its best to loose its seat at the top table. Will this result in a return of the Dark Ages, when societies went backwards, and there were no new ideas for a thousand years? Subsistence economies, with a rich elite and a downtrodden population? Interesting times indeed. ■

Pulling the curtain on Russian myth making

Nikolai Levin writes behind the Kremlin's threats and bluster lies a broken country that has never really made it to the 20th century, let alone the 21st

In Europe the fascination with Russia, its art, history, and literature runs deep. Russia sparks our imagination, calling to the mind images of the infinite Siberian steppes, golden domes, omnipotent tsars, and dystopian dreams. Ever since the Russo-European relationship has started to go off-track (notably since the invasion of Crimea in 2014), Russia has been impressively capable of capitalizing on this fascination via the use of a well-functioning propaganda machine, maybe the most capable industry of the whole state, as well as less elegant methods, of course.

The lengths to which the authors of Russian influence campaigns were willing to go could be witnessed in the wake of the collapse of Austrian Chancellor Sebastian Kurz's government in 2019 or the odd Moscow encounters between Russian officials and Italian politicians from Lega.

This combination of factors allowed the Russian president to carve himself into the pantheon of European nationalists as an archetypical incarnation of a sovereign, traditionalist leader free of the pesky counterweights of liberal democracies. Furthermore, he became a point of reference for those who dislike the United States enough to be forgiving towards Russia.

This cloak of idealization and myth that Russia is wearing abroad can be seen almost entirely in the video from the Spanish Russian embassy: *Time to move to Russia*; a country with an unshakable economy, traditional values, vodka, and without the hypocrisy of the politically correct. A vision in contrast with my experience and the stories of relatives and friends that have lived, in one way or another, in contact with Russian reality.

As for the unshakable economy, Russia has indeed been able to withstand sanctions better than forecast. Before calculating the impact of the sanctions, however, it is worth understanding Russia's economy in the first place.

Unsurprisingly, economic realities in many ways run counter to the picture Russia wishes to project abroad. Russia's GDP is close to the Italian one (c. 1.8 trillion USD, less than half of the German one) while having more than twice the population.

This author only understood what this meant when living in the countryside near Moscow: if there was a need for water, you had to go to the well, if there was a need for a toilet, you had to go outside, in a closet with a hole dug in the ground. When you realize that thirty million people – according to *Novaya Gazeta* – more than one-fifth of the population live in these conditions, it is possible to start understanding Russia.

It is a land spanning nine time zones where not just various cultures, but different epochs live together. Only with this in mind do the otherwise ridiculous stories of Russian soldiers discovering flush toilets in Ukraine start to make sense.

In essence, Russia is a state that embodies Europe's dreams, yet realized none of them

Looking beyond the opulent cities of Moscow and Saint Petersburg we see villages whose economy can only be described as medieval and whose power structure is essentially feudal. The only thing sewing the country together is the obligatory portrait of the president hanging behind the provincial official's desk and his never-ceasing omnipresence on state television.

Russia has long tried to hide this side of itself internationally. It has been helped in this mission by Western reporters focused on Moscow's powerful means of international force projection. But more so, the story machine on Russian greatness is homemade.

Russia Today, which had established itself as a source for alternative facts and carefully crafted fake reality on both the extreme left and the nativist right before it was banned in the wake of Russia's attack on Ukraine, had raked up more than ten billion views: the most followed news channel in the world. And this was just the most overt element of the Russian influence machine.

A moment of closer attention would quickly dispel the idea that Russia could be some kind of role model for the disengaged and sceptical portions of the European electorate. Nevertheless, its president still serves as a source of inspiration for too many European politicians, and to a certain degree, there is a logic to this fact.

Despite the ongoing war his approval rating, according to official polling, is solidly above 70%, numbers a liberal democrat would not dare dream of and elicits in some the desire for harmony and consensus-based decision making, where the political process of the people is freed from the constant conflict and bickering so present on Western news cycles. Even if the consensus is enforced and the bickering has given way to a silence that is less an expression of consent but rather of fear.

At the same time, we would do well to not elevate the president too much. When Westerners react with horror at the ban on 'LGBT propaganda' in Russia, they are reacting to an illiberal degeneration of the whole country more than an autocratic overreach. Russians are deeply homophobic, and the new laws are read better as a dictatorship of the majority, that that of a single man.

While this form of dictatorship is alive and well in Russia today, the other kind has started to show cracks. We can see this clearly in the aftermath of 'partial mobilization'. Since its announcement, the number of mobilized Russians was dwarfed by more than twice as many emigrated ones, 'how to break an arm' became the top Google search, and many hid away the best they could.

Among them was an acquaintance of mine, who sought cover in an abandoned house in the woods out of Moscow, and went through the lengths of living for a month without electricity or running water to avoid the draft.

Even if this example were not to discourage the most extreme populist, it should still warn against blindly following the will of the people, or in Russia's case, the majority's silent approval.

It comes at the expense of those young men who did not escape the mobilization and are now fighting and dying to keep alive the brutal whims of a tyrannical majority and the very narrow economic interests of a corrupt elite.

Where Russia departs, at least in theory, from the illiberal democracies aspiring to its international clout, is the verticality of its power structure. Citizens are coerced to think by force, quite directly, and the force of television. The vertical means, people don't need a voice - they are reduced to mere echos of predetermined politics, and every wheel in the machine works to ensure that it stays this way.

For a university student, the price of dissent is expulsion from university, for a friend of mine who is still in high school, the price was to never enter it, prevented by a threat made to her mother by policemen and the school director.

It is a thin layer indeed of performative democracy and rhetoric that covers a political system with naked power and contempt at its heart.

In essence, Russia is a state that embodies Europe's dreams, yet realized none of them. It is an invincible economy without hot water in hospitals, an illiberal democracy where the people listen to the elites, a state where no one gets 'cancelled' because no one can speak.

When in the XVIIIth century Denis Diderot defined Russia as a giant with feet of clay, he was referring to the biblical story in which Nebuchadnezzar dreamed of a giant made of precious metals. It had a golden head, large silvery shoulders, a bronze stomach, and iron legs, only its feet were made of clay. According to Diderot, the Russia of empress Catherina II rested on fragile foundations. Since then, many things have changed, but most did not.

Defending democracy these days also means stripping Russia of its masks and glittery self-presentation. Only by looking beyond the propaganda and the fearful aggression of its army alike, into the mud and clay of Russian reality, one can know how utterly undeserving the country remains of both fear and admiration. ■

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Containing trade

These are disruptive, challenging times. Graham Bright considers the role of the container ship in enabling global trade

As the world implements policies to cope and live with COVID-19 as it re-emerges in new strains, and battles with exponential rising prices for many raw materials and utilities, supply chain inflation, fragmentation, trade is still global.

Businesses across the globe, especially multinationals, cannot stand idle whilst fundamental costs are rising, as we witness an unprecedented era of geopolitical turmoil, recession in leading economies and bleak financial outlook.

With US dollar appreciation having almost reached parity with the Pound Sterling (the highest rate in almost 40 years), businesses are wary of committing to investment plans, as companies assess whether the artificially hiked prices of goods truly reflect the value of those goods.

Whilst the current situation is no doubt cyclical, it is bad news in the short term for most economies. However, the hiatus in trade and forced review of internal strategies has prompted progressive firms to re-evaluate how they will identify and harness future opportunities.

These include product positioning, reducing paper and manual processes, with investment in technology enablers such as trade blockchains which will be of fundamental benefit in improving competitiveness, cost-control and ultimately market share and sustainability.

Globally, trade is predicted to grow by 70% to almost US$30 trillion by the end of this decade with the majority transported by sea. Having encountered supply difficulties corporates have sought out new sets of suppliers, which were simply not in the supply chain before, often in land locked locations, with challenges of transport, customs and delivery.

But the race for new supplies has led to a new logistical issue, with news of a massive surplus of containers in the US. What this means is that ports in North America could become overwhelmed by a build-up of empty containers, as trans-Pacific supply chains and transportation times gradually return to pre-pandemic levels.

The humble container is the true star. Why? Its fundamental benefits in rationalising, standardising and its re-useability dramatically altered the cost and efficiency model for the industry

Whilst our institution has been involved in the document and instrument side of the business, for example dealing with compliance and operations with letters of credit, standbys, bonds and guarantees, it is hard to ignore the contribution, impact, versatility and simplicity of containers, the true enablers of international trade.

Containers

Just boxes you may think, but the humble container is the true star. Why? Its fundamental benefits in rationalising, standardising and its re-useability dramatically altered the cost and efficiency model for the industry.

As recently as 1956, an American trucking company owner named Malcolm McLean bought a shipping company. His requirement was simple, namely, to find an easier cheaper way to get his goods onboard ship, without damage or pilferage, quickly and cost-effectively. In the past, it took crews of specialist loaders, stevedores, and dockers and adherence to union rules to physically move goods from truck to hold.

The answer was to move a stackable storage vessel, regardless of contents (ie perishable, non-perishable, chemical, plastic or solid), not the goods, and the simple multi-use intermodal steel box (loaded with goods at its starting location, to be transported via road, rail, and sea to the final destination without the goods needing to leave the container) we know today was incepted and patented.

The additional breakthrough was the standardisation of size, through negotiations with the ISO Standards Organisation. The outcome was set the standard sizes that then allowed each ship, port and truck to be able to handle the dimensions with ease.

Today, whilst dimensions of containers have remained constant, a number of adaptations for types of goods have become common. And whole industries have been established to create the right environment for transport of goods requiring heat or refrigeration.

This ensure that goods, no matter how large, or dangerous, may be safely loaded and transported anywhere, to arrive in peak condition.

Containers carry general cargo by rail and sea and their size makes them ideal for storage, enabling liquid cargo or dry bulk shipping, and the wide variety of goods has led to the introduction of container variants.

Open or hard-top containers cater for cargo exceeding regular heights, which will incur higher rental and insurance fees due to the lesser strength of roof materials. Flat racks provide the support for excessive size goods, secured on strong platforms, whereas platform containers transport heavy and out of gauge cargo with high resistance mounting brackets to make transport safer.

Tank containers are commonly used to transport liquid chemicals and beverages, where a tank is constructed inside a general container, which, to avoid rapid movement of the cargo during transport, must be at least 80% filled.

Accidents will happen

Fleets are getting large and the physical size of ships has increased from the Emma Maersk, with a capacity of 15,000 containers (TEU) 10 years ago to Ever Alot, with a capacity of 24,000 containers.

The number of container ships in the global fleet increased from 4,966 in 2011 to 5,534 ships in 2021, while the carrying capacity of the global merchant fleet reached roughly two billion deadweight tons in 2020.

However, not all is well on the high seas. Between 2011 and 2020, some 876 vessels were lost at sea. The majority of ships lost during this period - around 348 - were cargo ships.

Containers stacked on giant vessels are falling over at an alarming rate, resulting in millions of dollars of cargo lost as pressure to speed deliveries raises the risk of safety errors.

Why the losses?

One immediate cause is the effect of global warming causing storms and unpredictable weather. And time pressure is encouraging captains to risk entering a storm rather than take lengthy diversions.

With megaships, more containers are being stacked higher and to capacity, putting undue pressure on operators to deliver faster as demand picks up for all manner of goods. Coupled with inadequate container locking, whole voyages may be put at risk as seen in the following examples:

- One Apus - weather caused the loss of more than 1,800 containers at an average of $50,000 per box, estimated losses are $90 million in cargo.
- MOL Comfort - broke in two and sank with its entire cargo of 4,293 containers into the Indian Ocean, resulting in $400 million claim.
- Maersk Essen - lost about 750 boxes valued at $12 million.
- Maersk Eindhoven - lost 260 containers when it lost power in heavy seas.

- Ever Given blocked Suez Canal traffic for a week, affecting hundreds of vessels. Although none of the 20,000 containers were lost, late arrival and disruption sent shock waves through the industry. The impact on global trade is ongoing, with financial loss calculated to be > €2 billion.

- Felicity Ace – carrying 4,000 luxury cars – cargo value of $400 million.

- MSC ZOE - about 200 containers fell into the sea, containing mainly TVs, toys, and furniture on the shores of the Netherlands.

The importance of insurance

These are just some of the cases, and as the old adage says *"worse things happen at sea,"* clearly showing that you cannot fully protect your cargo from accidents.

Even if it is not client containers that went overboard, those on the ship may be damaged along with the goods being transported inside the container. With this insurance, the importer can receive monetary compensation if the container suffers damage, provided they show the relevant documents.

Containers can be insured against adverse weather conditions or a breakdown. Freight forwarder or carrier liability insurance alone is not enough. If the cargo has not been properly insured, all costs, including rescue cost, pass to companies transporting the goods.

Environment impact

Pollution of the marine environment caused by overboard containers is a growing issue. Once breached, containers may be extremely hazardous to sea ecosystems; they may contain acid, alcohol, biological or radioactive goods, and heavy plastic manufactured products. They pose not only a threat to the environment, but also watercraft and coastal residents.

So far, none of the recent container accidents has been directly attributed to safety lapses. The International Maritime Organization said it is still awaiting results of investigations into the latest incidents and cautioned about making any conclusions before that.

But many experts say the situation has grown more dangerous because of pressure on supply chains since the pandemic. When ships approach heavy weather, captains have the option to steer away from the danger. But the attitude is *"don't go around the storm, go through."*

There's also the health and safety of the seafarers at stake. Raging storms can easily cause multiple tiers of 40-foot containers to displace and topple over causing panic and potential loss of life. The most effective way forward is for shippers to go around storms and maintain vessels properly.

Bottom of form

Countries whose flags the ships are sailing under are required to take responsibility for issuing safety certificates for vessels, while ports that the vessels call at are responsible for ensuring rules on loading containers are followed. This can clearly vary accordingly across the globe.

And spare a thought regarding the ships themselves. As tighter environmental regulations come into force across the globe, newer ships are needed to replace ageing vessels especially across Asia and the Mediterranean.

Conclusion

Moving containers on some of the largest ocean-going ships the world has ever seen, with their ever-increasing capacity, is still the safest and cheapest mode of transport for goods across the globe.

And even when containers have reached the end of their ocean-going or road haulage lives, the environment benefits as they can be repurposed as shops, houses, tool stores, playground structures and modern art, effectively recycled and re-used, albeit in a different guise.

Whilst electronic documents, blockchain, AI etc all have their place in making trade easier, it is still the containers, the ships and logistics that power world trade. ■

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Enlarging and deepening

Franz Mayer, Jean Pisani-Ferry, Daniela Schwarzer and Shahin Vallée consider the European Political Community and argue that it could act both as a bridge to a larger EU and as a framework for continental-scale partnership

Executive summary

France's President Emmanuel Macron and Germany's Chancellor Olaf Scholz have stressed the geopolitical emergency of re-designing the European Union's relationship with its neighbourhood. Both acknowledge that EU enlargement is necessary, but also emphasise that profound EU institutional reform is required beforehand, though deepening and widening the EU are complex processes that veto players could block.

The geopolitical challenges mean it is in the critical interest of the EU to bring stability to its neighbourhood by ensuring geopolitical alignment with the EU, limiting the blackmailing power of external, authoritarian states, supporting more resilient democracies and strengthening the rule of law.

Meanwhile, the EU's neighbours are seeking a political space in which challenges to collective security and stability can be addressed and concrete policies decided. Given the urgency, it is not enough to rely on lengthy EU accession processes.

A 'European Political Community' (EPC), which had its first summit on 6 October 2022, could act both as a bridge to an eventual larger EU and as a framework for continental-scale partnership. Leaders should use the summit to start the building of a platform that can combine political dialogue with policy delivery in a quick and flexible way and will thus structure more impactfully the relationship between the EU and its neighbourhood.

The EPC could start as a soft law agreement between states and the EU. It would work with existing institutions as far as possible, while aiming at more effective decision-making than currently in the EU. For instance, it could function without vetoes and could work in geopolitically relevant areas that are not yet EU competences.

An ambitious EPC would provide financial resources for deeper cooperation on energy and climate, security and defence, and economic and social convergence.

The EPC would not be, and should not be, regarded as a substitute for EU accession, but should be designed to work as an accelerator. For countries not seeking to join the EU, it would provide an ongoing framework that sustains structured cooperation with the EU.

1 The need for a new approach

The war in Ukraine has shown that the European Union needs a new approach to structuring relationships with its neighbours. Russian aggression led the bloc in June 2022 to grant candidate status to Ukraine and Moldova, showing that the EU is conscious of the extent to which the new geopolitical situation requires rapid and determined action.

But it is unclear if the EU can respond to these risks simply by adding new members. There is no consensus on speeding up the accession process and in any case, the process should not be rushed because a precipitous accession of Ukraine and Moldova with unchanged EU institutions and treaties would weaken the EU in the long run and put off candidate states that have been waiting for years at the door.

An unreformed EU of 36 members (adding only current candidate countries to the current 27) would be entirely dysfunctional. It would be hobbled by veto rights, a bloated European Parliament, and a hopelessly fragmented executive[1].

Indispensable prerequisites to enlargement include governance reforms regarding the scope of qualified majority voting, the distribution of seats in the European Parliament and the assignment of executive responsibilities within the European Commission. These issues must be at the heart of treaty reform.

However, just letting EU enlargement proceed slowly through the existing uncertain process will turn the politically significant commitment to Ukraine, Moldova and other candidates into a discouraging obstacle course. It will fail to take advantage of the geopolitical momentum, which calls for regular, credible and concrete high-level political engagement of the EU with its neighbours[2].

Indeed, until the accession process is completed, a candidate country is confined to a bilateral dialogue with the Commission[3]. In general, no candidate country or neighbour has a voice in the system, including on issues of first-order importance for its future (Ukraine's energy linkages for example).

In normal times, when the EU changes only slowly, this can be regarded as annoying, but inconsequential. In the current circumstances, it undermines the attractiveness and the effectiveness of the whole process and comes at a very high political cost for EU and accession countries.

The European Political Community may provide an opportunity to advance with defence cooperation in areas that have been stuck in the EU for years

The risk therefore is that putting Ukraine and other candidate countries through a long, slow and painful accession process, without ambitious policies and forums for strategic exchange, could fail to anchor them as long-term political, economic, energy, security and defence partners of the EU.

Moreover, the current lack of flexibility in designing relationships with third countries also hampers the establishment of structured partnerships with former EU members (the United Kingdom) and long-term accession candidates (Turkey).

In this context, French President Emmanuel Macron and German Chancellor Olaf Scholz have argued strongly for profound institutional reforms[4], though neither has suggested a roadmap. Building on an idea floated by former Italian Prime Minister Enrico Letta (see Letta, 2022), Macron on 9 May proposed to create a 'European Political Community' (EPC). European Commission President Ursula von der Leyen said subsequently the Commission would set out proposals on this[5], and also supported the idea of a convention to reform the European treaties, though she did not link it to the idea of an EPC.

We argue that a smartly defined European Political Community would be a suitable response to the new geopolitical situation. It can also help address the EU's internal deficiencies and the challenges in its neighbourhood.

A first meeting of the political community – meaning an informal summit of EU country and candidate country leaders – will be held in Prague on 6 October 2022. It should be used to set out key principles for the community and an ambitious timeline.

2 The European Political Community: a proposal

Since Macron's announcement of the idea, little progress has been made in spelling out the concept of the EPC. It runs the risk of becoming a leaders' forum that would meet once or twice a year, like the bilateral EU-Africa summits or Asia-Europe Meetings, but would not meaningfully define policy.

Creating a more formal structure relying on EU institutions to turn the EPC's leaders' dialogue into policy action, would however risk encroaching on the mandates of those institutions while infringing the principles underpinning the EU. Building the EPC more formally could thus expose it to lengthy legal challenges.

We suggest a middle ground between an intergovernmental agreement resting on EU institutions, and a loose leaders' forum. As illustrated by the G7/G20, one solution is to rely on existing institutions to implement decisions.

Another is to use a soft law agreement as a cooperation and experimentation framework. It could be formalised at a later stage by the combination of EU treaty reforms and a mixed agreement between the EU, its members and non-EU member states.

There is a precedent for such a cooperation framework: the Conference on Security and Co-operation in Europe in the mid-1970s was a meeting of leaders that eventually led to the creation of the Organisation for Security and Co-operation in Europe.

In another field – education – the Bologna Process started as a round of ministerial meetings to organise comparability of higher education standards and eventually led to the creation of a European higher education area.

It should be noted that a European political community was proposed already in the 1950s. The attempt to create it was contingent on the agreement to establish a European Defence Community, based on a treaty signed in 1952.

The failure by France to ratify this treaty in 1954 undermined both the creation of a collective European approach to defence and an ambitious framework for political and policy dialogue. Our approach today is the reverse: establish the foundation of a political and policy dialogue first, in preparation for future EU and international law processes.

2.1 Membership

The perimeter of the EPC will be central to its success. Clearly, geography cannot be the only criterion for deciding on its members. Given that the geopolitical conflict with Russia is the trigger for its creation, it is natural for the EPC to be based on shared values and geopolitical alignment.

To ensure this coherence, broad ex-ante entry criteria should be defined collectively, unlike for the EU accession process, in which the so-called Copenhagen criteria[6] serve as 'last hurdles' before eventual membership.

Assessing alignment of values and geopolitical stance is however hard to pin down with rules. Even when it can be done, applying the criteria raises difficult issues, as EU members, candidate countries and third countries cannot be dealt with in exactly the same way. Moreover, there are inevitably political choices that cannot be avoided.

We recommend that the EPC be as inclusive as possible, which implies extending invitations to all EU countries and all candidates, plus Georgia, Kosovo and also Norway, Switzerland and the UK. No country should be excluded at this stage, provided all participants are made aware that decision will be made on the nature of eligibility criteria and that invitation initially doesn't necessarily equate to guaranteed longer-term participation.

The preparation of a joint declaration setting out membership criteria and exclusion mechanisms should begin before the 6 October summit and should involve a diverse group of EU and neighbouring countries. The October meeting should have the goal of securing approval by a first group of countries by the end of 2022, before formally launching the EPC.

At minimum membership criteria should include:

1. Observance of democratic values and the rule of law as laid down in the political aspects of the Copenhagen criteria,

2. Respect for human rights (full participation in the Council of Europe)[7],

3. Geopolitical alignment with the EU stance on the Russian aggression (full-faith participation in sanctions).

When developing these criteria, it is important to consider that all EU countries are bound by EU treaty provisions. Respect for fundamental rights belongs to the values that are common to the member states according to Article 2 of the Treaty on European Union (TEU). According to Article 7 TEU, breaches may lead to the suspension of voting rights. In theory, this would suggest that membership in the EU is, by itself, a sufficient criterion for assessing compliance with the Union's values and principles.

In practice, however, effectiveness of this provision is blocked because it requires unanimity of the other member states. Hence the EPC should be able to suspend or withdraw the membership of certain countries, even if they haven't been sanctioned by the EU.

Non-EU members and non-candidate countries are not subject to any legally binding EU conditions, but as members of the Council of Europe, they are bound by the principles of the European Convention on Human Rights and subject to the jurisdiction of the European Court of Human Rights. This would in theory argue for the inclusion of the UK and Turkey.

The situation for geopolitical alignment could be even more complex because the EU treaties essentially deal with procedures rather than substance on foreign policy and geopolitics.

Moreover, while Finland and Sweden are becoming members of NATO, Austria and Ireland remain outside. Membership of the EU or NATO are therefore not substantively significant criteria for deciding on these matters: belonging to the EU or NATO is not a sufficient guarantee of geopolitical alignment.

These examples show that EPC membership cannot be rooted in pre-existing hard-wired rules, but should rather be based on the endorsement of a common set of principles covering fundamental values, democracy, the rule of law and compliance with key principles of international relations.

For geopolitical reasons, it would be highly preferable if all countries subscribed to the principles of the EPC, so that new divisions are not created in Europe as it makes progress towards stronger regional integration.

Ukraine, although at war, should be allowed to join the EPC, as it is there that the geopolitical conflict plays out most brutally. This would be coherent with the decision to grant it EU candidate status despite the view prevailing since the accession of Cyprus to the EU that no country involved in a territorial conflict, let alone a full-fledged war, should become an EU member. Sticking to this view would give Russia an indirect veto power over EU enlargement. The same reasoning should apply to the EPC.

Given the complexity involved in thinking about the perimeter of the EPC, and given the benefit of being inclusive towards countries in the 'grey zone' in the hope of leverage and change, there are, in principle, two ways for deciding on membership:

- There could be a formal process of inclusion/exclusion, but this would most likely make the EU, as the convener of the first meeting, into the prime decision-maker, which could result in the Council of the EU taking responsibility for deciding who to allow in and who to exclude.

- A more diplomatically elegant approach would be for the EPC declaration to be prepared jointly by, say, half a dozen countries from within and outside the EU. This agreement should at least be as ambitious as the EU and Council of Europe principles (see above). It would set the bar for commitment substantive enough that countries that do not sub- scribe to the principles and goals self-select out.

In any case, there should not be an arbitrary decision on participation. Countries that do not want to comply with the entry requirements should be welcome to join at a later date. Solving these fundamental issues in months may seem unrealistic.

But the first G20 summit, where essential principles were agreed on, took place only two months after the collapse of Lehman Brothers in 2008. Wars, like financial crises, are accelerators, and what seemed impossible to reach in years can be achieved in weeks.

2.2 Governance

Unlike the EU accession process or neighbourhood policy, which give no say to non-EU countries, all EPC participants would be on an equal footing. The EPC's decision-making rules would treat all members (irrespective of EU membership) as having equal rights.

Unless specified otherwise, political decisions should be taken by 'rough consensus'[8], and in any case without veto powers. The agreement on such decision-making is critical. Without it, the EPC would be limited by to an exchange of views and would fall short of being a real political and policy forum.

However, the EPC must not weaken EU process or institutions. The EU Court of Justice closely guards the autonomy of the EU legal order. A decision would have to be made between creating an independent intergovernmental secretariat (like, for example, the European Stability Mechanism), which would need to be anchored in hard international law, or giving this role to the European Commission on a softer legal basis.

Provided they agree on and are bound by the principles and mechanisms laid out in the EPC founding document, members should not be forced to participate in all of its policy programmes. A degree of flexibility should be retained and operationalised through opt-in and opt-out clauses.

For each of the three main cooperation areas (outlined below), the European Commission would play the central institutional role of secretariat and be given certain operational powers. By providing a modicum of flexibility, the EPC could act as a catalyst for a new and adequate modus vivendi between European countries.

Given the intertwined geopolitical and geoeconomic challenges Europe is facing, a 'whole-of-government' approach may be needed to foster cooperation and overcome the fragmentation of domestic and European policymaking[9].

2.3 Resources

To achieve tangible results, the EPC will require considerable budgetary and financial resources beyond what is already available to support EU accession. A limited commitment of resources from members can be envisaged – as for most international organisations – and/or could be channelled through the EU budget for EU member states.

Non-EU countries should contribute in proportion to their resources and their involvement in cooperation areas. Each area of cooperation should be endowed with its own funds, as the extent of participation will depend on the area of cooperation.

In-kind contributions to overcome the traditional donor-recipient logic between accession countries and the EU would be welcome. In some instances, this would be highly strategic: for instance, Ukraine would be able to provide excellent cyber and defence capacity.

Flexibility should be retained: EPC members could be called on to contribute in each area of cooperation, but retain the flexibility to be a net recipient in one area and a net contributor in another, while opting out from yet another.

However, given the currently limited size of the EU budget, this would undoubtedly trigger an acceleration of the debate on its reform, on the EU's own resources and on a common borrowing capacity.

2.4 Areas for cooperation

The first set of political priorities with clear deliverables could cover three main areas. Further areas of cooperation could be considered, such as research, but we advocate starting with just three areas which are geopolitically the most pressing ones and then building on experience gained and adding others.

2.4.1 Networks, energy and climate action

The current energy crisis is an opportunity to set up a new inclusive cooperation framework, to redefine the relative roles of the EU and its member states and to involve neighbouring countries in a unifying project (energy independence and climate transition) (McWilliams *et al* 2022).

Germany and France have a special responsibility, not least because of their opposite energy models. Finding a cooperative compromise that will lead to greater European solidarity beyond the EU's borders, while pro-actively supporting accession and neighbouring countries, is of utmost geopolitical importance.

The connection of Ukraine to the European electricity grid, the need for gas agreements with Norway and the need for green hydrogen infrastructure call for a broader cooperative framework.

The Energy Community[10], which provides the infrastructure and the technical cooperation to integrate European energy markets, provides an interesting precedent. It includes the EU and non-EU neighbours (including Ukraine, Moldova and Georgia; Armenia, Norway and Turkey are observers). It is based on a 2005 Treaty, has its own secretariat and is equipped with a budget. The EU is represented by the Commission, which serves ex officio as a vice-president.

The EPC should be assigned more ambitious tasks and it should be given more effective legal and financial instruments. Most importantly, the Energy Community shows that there is potential in variable-geometry arrangements.

The EPC should be a framework for deepening and extending energy cooperation in at least five directions:

- A new transnational cooperative framework with new governance that would take coordinated decisions on rationing and solidarity. As demonstrated by the current context, an integrated European market is much better equipped than national markets to mitigate risks. But it should be clear that the cooperative framework also involves risk-sharing, for which principles and mechanisms should be designed.

- Common framework agreements for the purchase of fossil fuels and hydrogen. The experience with COVID-19 vaccines demonstrated the benefits of a joint approach. It makes no sense for EPC members to attempt to outbid each other in bilateral negotiations with suppliers. Common principles should be defined and negotiated, to which individual contracts should make reference.

- The building of coordinated and sometimes common infrastructures that enhance electricity, gas and future hydrogen interconnections, production and storage capacity. It is essential to signal a move towards greater integration of energy markets and more cooperation in the development of critical infrastructure through the EU Trans-European Networks for Energy[11], the EU liquified natural gas strategy[12], the EU hydrogen strategy (European Commission, 2020) and the partnerships for green hydrogen[13].

- A common climate-action strategy based on the European Green Deal but with broader scope and differentiated targets. Both the EU and the EPC partners can gain by joining forces.

- Budgetary and financial instruments following the model of the EU's Just Transition Mechanism; these would provide equity finance, risk-reduction instruments and outright budgetary mechanisms to help the EPC members accelerate the energy transition and boost their energy security.

  This approach will require considerable financial solidarity, but can blend private and public financing, as well as financing from the EU budget and from individual member states.

2.4.2 Foreign and security policy, defence and democratic resilience

The war in Ukraine is exposing the weakness and incompleteness of Europe's security and defence architecture. Although some progress has been made with the EU Permanent Structured Cooperation on Defence (PESCO[14]) and with the recent national and European responses to the war, Europe still has a very long way to go.

To support the emergence of a new European security architecture in the medium term, the EPC could make several contributions in the short term. Cooperation in the area of foreign and security policy, defence and resilience of democracies should start as a coalition of the willing and expand over time.

As a starting point, members should discuss security and further geopolitical issues at their meetings. They could use as a basis for discussion the joint EU threat assessment laid out in the March 2022 Strategic Compass (EEAS, 2022).

The EPC's contribution would be to bring in the important perspectives of Ukraine, Moldova and the Western Balkans, which were not included in the EU emerging strategic debate. Most obviously, Ukraine's experience from its war against what was thought to be the second or third most capable military in the world should be incorporated into European defence and strategic thinking.

- Security should be understood in broad terms including energy, infrastructure, cyber and human security. Measures to address the resilience of democracies should also be addressed. The EPC has the potential to work across policy areas more horizontally than is usually the case on national and European levels. Through very targeted analysis, debate and action, it can potentially be a catalyst for a more holistic approach to complex problems.

- The EPC cannot replace NATO, which despite its weaknesses remains the most credible agent for military coordination, defence and nuclear deterrence. The NATO Secretary General should thus be invited to EPC meetings. The EPC can serve as an important forum for EU and NATO members and non-members, for which security is a matter of common concern.

In particular, the EPC can discuss how growing defence budgets, which in some countries may double, can be spent most usefully. Building capabilities and making best use of cooperation, division of tasks and synergies will be vital in the new security environment, and should be approached with flexibility among European countries.

- Cooperation in the areas of counter-terrorism, cybersecurity and digital connectivity (satellite, data centres, undersea cables) could yield important mutual benefits and enable countries like Ukraine to share with the EU their valuable advanced know-how and experience, proving that the partnership is not a one-way street. The EPC should also be open to learning from non-EU experiences on countering Russian propaganda – for example, from the NATO STRATCOM centre in Riga.

- The EPC may provide an opportunity to advance with defence cooperation in areas that have been stuck in the EU for years. Smaller groups, for instance involving Ukraine, could develop armaments projects of mutual interest. The EU's European defence fund should be made available to countries respecting the third-party participation rules[15].

- A common procurement policy would enhance European sovereignty best if it is paired with a strategy for the development of a European defence industry. Hard security threats on the EU's doorstep call for the Europeanisation of industrial capacities. Little progress has been made so far on this in the EU context, but the EPC could help create new avenues for cooperation.

- If Europe makes progress in building joint armament capacity, arms-export rules will have to be defined. Common policy and industry require common rules but strategic and diplomatic cultures vary greatly in Europe. Arms-export policy should eventually become a European competence.

By agreeing at minimum to cooperate, and at best to harmonise, the arms-control frameworks of members, and by subjecting them to qualified majority voting, the EPC could greatly expand the reach of its arms-export policy and bypass internal obstacles.

- Sanctions policy would benefit from deeper cooperation across Europe. Switzerland and Norway joining sanctions against Russia is an important precedent. Coordination of sanctions policy in the larger EPC group, and decisions taken by qualified majority in these areas, would be a real leap forward in foreign policy.

2.4.3 Framework for economic and social convergence

The EU has long viewed its market as its single largest source of appeal. Economic, social and political convergence are however interrelated. Beyond current levels of economic integration, a more structured framework is needed, going further than a customs union (Turkey is part of one with the EU) or a Deep and Comprehensive Free Trade Agreement (Ukraine is part of one), to ensure gradual and sustainable economic, social and political convergence.

The EPC should therefore build on existing initiatives, such as the Berlin Process and the accession process, to substantially upgrade economic, social and political cooperation. Trade and investment cooperation and treaties are the basis of the EU's partnership with its neighbourhood.

This approach gives a considerable place to market integration but sometimes neglects necessary investments in infrastructure and capacity building. Indeed, free trade should be pursued but must also be accompanied by a broader range of supporting and enabling policies. This could involve at least the following instruments:

- Convergence and cohesion policy have historically been accessible only to EU members, but it provides resources to encourage and finance economic convergence that could be critical in the accession process.

Critical infrastructure financing should be made available to EPC countries to accelerate their convergence and the cohesion of the EPC, over and above the modest pre-accession assistance that is available. This could be of particular importance to Ukraine for rebuilding after the war.

The EPC could provide an additional forum to help ensure that reconstruction happens with a focus on regional networking and resilient infrastructure, not only for Ukraine, but also for countries such as Moldova or Georgia that are likely to be suffer from fall-out from the war in Ukraine.

- To accelerate socio-economic convergence, additional conditional funding could be made available under the principles established and methods used for the EU's Recovery and Resilience Facility, which has been set up in the context of the still-underdeveloped area of coordination of the economic policies of EU countries.

  Additional conditional funding could, once legally stabilised in the EU, be exported to non-EU EPC countries. By setting out areas of policy coordination (climate, economic, social) and providing financing against agreed milestones, the EPC could be a powerful engine of convergence.

- Digital convergence between the EU and its neighbours should be happening a lot faster than the formal EU accession process allows. For instance, Ukrainians have been developing extensive collaboration with American tech firms, to the extent that Ukraine could end up closer to the US than to Europe in terms of digital and privacy standards after the war.

  At the same time, the fact that Ukraine is not covered by EU legal frameworks on platform regulation puts it at the mercy of large platforms on content moderation policies in relation to Russian disinformation. The EPC should find ways to address this.

3 Roadmap

Given the geopolitical context, the EPC's 6 October 2022 summit declaration should commit participating countries to meet twice a year at leaders' level and to prepare a founding document to be signed by spring 2023.

This should lay out areas of cooperation, budgetary resources, governance, voting rights, participation criteria and an exclusion process. Setting up the EPC is urgent, but it should be designed and launched with long-term objectives in mind, as presented in this roadmap.

The building of the EPC and the EU's own institutional reform agenda are in principle independent. But as deep EU internal reforms must be agreed and implemented before future enlargements, the EPC could be used as an arena to experiment with alternative policymaking and governance, for example decision-making without veto rights and by 'rough consensus' (see section 2.2).

The strength of the EPC would be in being flexible enough to be established rapidly and implemented effectively. By virtue of being rooted in soft law and taking the form of a joint declaration of heads of state and government, it would not require a lengthy formal ratification process, and the absence of a tight legal corset would allow for a more flexible framework.

However, this can only be a transitional arrangement. The EPC will subsequently need to move from a soft law agreement into a more formal concept at some point. This should be done alongside ambitious EU treaty reform.

Core elements of such a reform should be enhanced transparency and accountability of institutions for a more democratic EU, a greater role for the European Parliament and national parliaments, a strengthening of the EU's executive powers in a larger set of areas, the expansion of qualified majority voting to all critical areas (energy, security, fiscal and budgetary affairs) and an overall consolidation of the European integration project as a community of law, based on the rule of law.

These changes would then either have to be ratified by all willing member states, which would require changes to existing ratification procedures, or only the willing parties would enter into a new treaty. These changes are needed because the EU will otherwise fall prey to vetoes, which can block institutional reform and hence enlargement (Bribosia, 2009).

The EPC would then be based most likely on a mixed agreement between the EU, its members and non-EU states. This formalisation would allow even more durable relationships and cooperation to be established with states that would not want to join the reformed EU[16]. Ratification of the EU-EPC agreement – in fact a treaty – will take time. The transition from soft law to hard law can be smoothed out by means of a provisional application of the core elements of the new treaty, though.

It is crucial to anchor and align the EPC's emergence in a process of deeper EU institutional reform that could follow a roadmap combining the creation of a European Political Community, EU institutional reforms and enlargement:

- Statement of EPC leaders following the 6-7 October 2022 summit.

- Founding document for the EPC setting out participation criteria, governance, decision making, areas of cooperation, budgetary resources by end-spring 2023.

- Formal launch of the EPC by summer 2023.

- New convention to prepare an intergovernmental conference on EU Treaty reform by summer 2024, after the European elections.

- Launch of intergovernmental conference for EU Treaty reform in summer 2025.

- Agreement on new EU Treaty proposal by end of 2026, followed by ratification before the 2029 European elections.

- Agreement on new EU-EPC Treaty linking the reformed EU to non-EU EPC members.

- Enlargement of the EU to new member states after 2030. ■

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Endnotes

1. As noted by German Chancellor Olaf Scholz in a speech in Prague on 29 August 2022. See https://www.bundesregierung.de/breg-en/news/scholz-speech-prague-charles-university-2080752

2. See Sapir (2022) and Alexander Stubb, 'The case for a confederal Europe', European Council on Foreign Relations, 21 June 2022, https://ecfr.eu/article/the-case-for-a-confederal-europe/?amp

3. Except for the intergovernmental Berlin Process for the Western Balkans, led by Germany.

4. Macron in a 9 May 2022 speech in Strasbourg (see https://presidence-francaise.consilium.europa.eu/en/news/speech-by-emmanuel-macron-at-the-closing-ceremony-of-the-conference-on-the-future-of-europe/) and Scholz on 29 August 2022 in Prague (see https://www.bundesregierung.de/breg-en/news/scholz-speech-prague-charles-university-2080752).

5. See von der Leyen's State of the Union speech, 14 September 2022: https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_22_5493

6. See https://eur-lex.europa.eu/EN/legal-content/glossary/accession-criteria-copenhagen-criteria.html

7. Kosovo has expressed interest in membership in the Council of Europe and already has partial agreements eg. membership of the Venice Commission. It should not be excluded from EPC membership if is affirms its adherence to the norms and principles laid out for the EPC and continues to pursue Council of Europe membership.

8. 'Rough consensus', a concept created for deciding on technical issues related to the internet and intended to ensure that all stakeholders remain on board, is achieved when the group as a whole agrees, but the agreement falls short of unanimity, and opposing views are taken into account.

9. The whole-of-government approach is a concept first introduced in the UK in the late 1990s to emphasise the significance of collaboration and coordination between different public entities within a government.

10. The Energy Community is an international organisation that brings together the European Union and its neighbours to create an integrated pan-European energy market. The Treaty establishing the Energy Community was signed in October 2005 (see https://www.energy-community.org/legal/treaty.html). The main objective of the Energy Community *is to extend the EU internal energy market rules and principles to countries in south-east Europe, the Black Sea region and beyond, on the basis of a legally binding framework.*

11. The Trans-European Networks for Energy (TEN-E) policy seeks to link the energy infrastructure of EU countries. As part of the policy, nine priority corridors and three priority thematic areas have been identified. The EU helps countries in priority corridors and priority thematic areas to work together to develop better-connected energy networks, and provides funding for new energy infrastructure. See https://energy.ec.europa.eu/topics/infrastructure/trans-european-networks-energy_en

12. See https://ec.europa.eu/commission/presscorner/detail/en/MEMO_16_310

13. The Clean Hydrogen Partnership's main objective is to contribute to the European Green Deal and the EU hydrogen strategy through optimised funding of research and innovation activities. The Clean Hydrogen Partnership is the successor of the Fuel Cells and Hydrogen 2 Joint Undertaking (FCH 2 JU) and took over its legacy portfolio as of 30 November 2021. See https://www.clean-hydrogen.europa.eu/index_en

14. See https://www.pesco.europa.eu/

15. The EU's current defence policy allows third countries to take part in EU initiatives including the Permanent Structured Cooperation, the European Defence Agency, the European Defence Fund and European industrial policy. For background, see https://www.europarl.europa.eu/RegData/etudes/ATAG/2022/729348/EPRS_ATA(2022)729348_EN.pdf

16. See in this regard the proposal made in August 2016 by Pisani-Ferry et al (2016).

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Embracing financial inclusion

WCR interviews Josephine George, Managing Director of the Bank of St Helena, who discusses the Bank's embracing of financial inclusion in an ever-changing world

The Bank of St Helena has a vision to be known as the financial cornerstone from which their customers can confidently build a sustainable and prosperous economy for the Island of St Helena. Their mission is to develop and deliver banking products and services that are appropriate, affordable and accessible to all to enable sustainable development. *World Commerce Review* interviews Josephine George, Managing Director of the Bank of St Helena, the recipient of the *WCR* award *Best Bank for Financial Inclusion 2023,* who discusses the Bank's embracing of financial inclusion in an ever-changing world.

Please describe the financial inclusion initiatives that the Bank of St Helena have put in place.

Financial inclusion is at the heart of the business of Bank of St Helena. This is supported by the mission which is to develop and deliver banking products and services that are appropriate, affordable and accessible to all. Since its inception in April 2004, the Bank has progressively increased its product offering to customers to support their journey with us.

Prior to this time there were no banking services offered other than that by the Government Savings Bank which supported cash deposits and withdrawals. The lack of exposure beyond St Helena due to the geographic isolation, the high costs to leave the island and limited access to internet services are some factors that has had an impact on our customers' perceived need for or confidence in modern banking services.

However, as time passed there has been technological improvements, a migration of people on and off the island and the skills and experience of Bank staff has grown. These factors have supported a shift in customer expectation and has shaped the need for and the delivery of the banking products and services offered today.

Serving a resident population of approximately 4,200 and 1,000 on our sister island, Ascension Island, the Bank now offers a range of products and services which one might expect from a retail bank. This includes current and savings accounts, personal and commercial lending services, international remittance services, foreign currency exchange services, cash advances on all major international debit and credit cards, Local Debit Cards and Online Banking services.

Savings accounts includes Child Bond Savings which are designed to encourage our youth and their families to start saving from young towards their future aspirations and needs, whether this is their education, material goods or a nest egg for a rainy day. In the absence of a national pension scheme the Bank also introduced a savings scheme for customers to enable them to save towards life after retirement in the form of a New Life Account. Both the Child Bond Savings Account and the New Life Account offers an attractive interest rate. A Term Savings Account was introduced and allows our customers to save towards short-term goals.

A range of diverse lending products offered are aimed to support the island's long-term goals for development and sustainability. These include personal, mortgage and commercial lending products designed to ensure they are fit for purpose and suit the local needs and demands. The international remittance service allows customers to transfer funds from their local bank accounts to beneficiaries residing overseas and to receive funds into their local account from overseas.

In 2014 the Bank launched its Online Banking product in an attempt to provide customer convenience. The uptake was slow which could be attributed to unaffordable internet access and the product not fully meeting all expectations of an online platform.

However, being a local bank, it was deemed important to provide those customers residing offshore e-banking services to fulfil their local banking needs from abroad. With the introduction of the Bank's bespoke Local Debit Card and St Helena Pay Services in 2017, coupled with enhanced functionality of Online Banking, the uptake of the service began to see growth. Affordability, jurisdiction and the market size are challenges that makes it difficult for Bank of St Helena to operate an issuing license which will allow us to offer card association branded payment cards such as Mastercard and Visa to the local community, therefore a complete closed loop debit card solution was developed and launched.

With the inability to facilitate a card payment acquiring service to allow local merchants to accept tourist card payments, the Bank has created an innovative solution to make card payments available for tourists to avoid the necessity of having to use cash for every transaction.

This solution is the Tourist Card, a local prepaid GBP cash card enabling tourists to use the island's Local Debit Card payment services to pay for goods and services provided by local businesses. The imminent roll out of the Bank of St Helena's Tourist Card will enhance our financial inclusion one step further.

How will these programmes help those citizens previously excluded from modern banking facilities?

The introduction of the various products has allowed our customers to have access to finance in a way in which was never available before. For many, they now have access to finance to build or purchase their own homes quicker, have the ability to purchase goods and services that would have otherwise only be gained through years of saving, such as planned holidays. This was almost impossible for many before the Bank offered lending services. The offering of commercial lending products has also assisted the local economy in its development through various loan offerings.

St Helena Pay, Local Debit Cards and Online Banking has revolutionised how payments are now made on island, although bespoke, this service allows everyone on island to be part of the digital payment environment. Safety and security measures features very high on the Bank's agenda, with industry standards being followed. The introduction of products such as Local Debit Cards and Online Banking also equips customers who leave the island exposure to banking products and services which are a part of everyday life in the majority of the world.

How did the initiative come about?

The Tourist Card initiative has come about as a result of the Bank endeavouring to fill an island need. Until now, visitors to St Helena were limited to the options of carrying cash or taking cash advances of their debit/credit cards by visiting the Bank once on island. With a card payment acquiring service not feasible at this time and with the expected increase in tourists to St Helena in the coming years, the Bank needed an 'outside the box' solution to make card payments available for tourists to avoid the necessity of having to use cash for every transaction.

This development has been in partnership with the Bank's services providers International Financial Systems (IFS). It has been designed to provide convenience, be modern, be technologically based, keep costs minimal and puts compliance and safety as top priority. It has been built on the existing Local Debit Card infrastructure and there is no further expectancy placed on the locals for acceptance.

The Tourist Card is a prepaid GBP cash card using a virtual card which is downloadable to a mobile phone. It is envisaged the product will promote tourist spending and eliminate the previous impractical need to carry cash. The introduction of the Tourist Card will be one of the biggest achievements by Bank of St Helena.

Is this an ongoing programme?

Yes, this is an ongoing programme which sees Bank of St Helena being committed to ongoing development of its products and services that will continue to meet current needs and exceed the expectations of our customers, especially as we embrace and strive to become a bank that is digital by default.

What new developments are in the pipeline?

With mobile phones being introduced on island in 2015, one of our desired objectives is to offer various mobile banking services which will provide further convenience to our customers. However, at this time with internet connectivity not freely available, it does inhibit the possible uptake of these types of services. In the coming years with the introduction of the fibre optic cable it is hoped this will alleviate these concerns and Bank of St Helena will offer a range of apps to support customer banking needs.

What is your message to those individuals who are unbanked?

To those who are unbanked we would say get banked!

Please describe your career at the bank and how the banks structure has evolved over this period.

My career with Bank of St Helena spans fourteen years and began with me joining the Bank in 2008 in the role of Human Resources Manager. My previous work experience in various management and human resources roles provided me with the skills and experience needed to set-up the new function of human resources in the Bank at that time. This included implementing systems and processes for staff recruitment, development and retention.

Over the years I have used every opportunity to develop myself personally and professionally. This has enabled me to gain promotions within the Bank that has culminated to becoming successful for the role of Managing Director in 2017. During my years of employment with the Bank, the structure has seen much change to become the establishment we have today, one which supports the unique banking environment of St Helena. There have been changes in the organisational structure and product and services, all of which has been possible due to improved technological advancements, staff development, networking and more exposure to the world that operates outside of St Helena.

What developments and services have been driven by the internal and external factors of the St Helena economy?

The majority of development has been driven by either internal or external factors. Internal development of the Bank has been achieved from our growing knowledge and experience of the industry, upgrades of banking systems, professional development, customer feedback, networking and individual exposure to banking outside of St Helena.

The Bank endeavours to keep abreast with the local political, social, environmental, technological and legal environments in which we operate, to ensure it designs and offers products and services that are fit for purpose, which might mean they are not necessarily as one might find in traditional banking.

For example, the suite of lending products and services specifically caters to our customers personal needs as well as business needs for living on an island, whilst ensuring to comply to industry standards. Over the last five years there has been the introduction of a number of new or revised lending initiatives to support St Helena's emerging economy such as financial assistance for young entrepreneurs, initiatives to support first-time homeowners, short-term contract financing and reduced interest rates on loans to our farming community. In addition to the local economy, the Bank also monitors the global environment as these issues do impact on our island's economy and can have other financial implications for Bank of St Helena.

Global connectivity is clearly a key building block for the bank; what has been your strategy?

St Helena has felt the effects of limited global connectivity over the years whether through geographical isolation or technology isolation, all of which has had an impact on the development of the island's economy and its overall aim to become a vibrant economy. The Bank's strategy recognises that global connectivity is a key building block if it is to meet both the Bank's and island's aims and objectives.

Therefore, the Bank values and endeavours to develop the relationships we enjoy with various stakeholders and work towards expanding our network reach to better position ourselves in the global market. Expanding our networking ability through visits and bi-lateral meetings has enabled the Bank to work with others in the industry outside of St Helena to draw from their knowledge and experience, which in turn has allowed us to develop the service offered, but also supports others in gaining a better understanding of how banking operates and the challenges faced in a small environment. In addition to networking, professional development has been an important element to support our strategy to ensure that our staff have the right skills and experience to deliver on what the Bank promise.

What systems has the bank integrated into its infrastructure for the benefit of customers?

The Bank has integrated the SWIFT Platform into its infrastructure, which is the biggest international payment network in the world and allows our personal and business customers to send and receive monies in a standardised and secure way. The Local Debit Card solution also includes a local card issuance service and a bespoke merchant card terminal app and device which is supported by Online Banking for the benefit and convenience of customers.

St Helena is not in a position to offer ATM services due to various logistical and legal limitations and restrictions, and in the absence of such, the Bank introduced a cashback facility as part to the Local Debit Card solution. All transactions are real time, enabling local merchants to provide cash to customers outside of normal banking hours which benefits customers.

Bank of St Helena does not qualify to subscribe to existing BAC's infrastructures. As an alternative, the Bank has created an interface via the Online Banking service to accept BACs formatted messages from businesses on island, all of which is processed in real time and is yet another bespoke solution to the benefit of our customers.

What is the medium- and long-term programme for the bank's development?

The long-term aim for the Bank is to be known as the financial cornerstone from which our customers can confidently build a sustainable and prosperous economy for the island of St Helena. It is our mission to develop and deliver banking products and services that are appropriate, affordable and accessible to all.

What international programmes does the bank participate in?

In addition to the SWIFT international payments system, Bank of St Helena engages the services of an Investment Manager to manage Bank of St Helena's investments.

The Bank also supports the learning and development of their staff and supports affiliations and memberships with professionally recognised institutes such as Chartered Banker Institute, Chartered Institute of Marketing and Chartered Institute of Personnel and Development.

Your background is in developing personnel skills and human resources. How have you employed these initiatives in staff development?

With a Human Resources background, I am fully aware that a company's success is dependent on its most valuable assets, its people and it is vital that we manage and optimise this valuable strategic resource. Therefore, implementing a framework for managing, developing and optimising employee skills, abilities and competencies has been imperative.

Being a Human Resources Manager and now the Managing Director, I have found it is important to provide encouragement to individuals, ensure adequate resources are available to support staff training and development, give recognition and provide/support incentives for staff performance.

As individuals we are all different and will be motivated by different factors, but the one thing I have learnt from experience is as managers we should lead by example, which is also my philosophy. I am extremely proud to lead a team of highly skilled, motivated, committed and dedicated employees, all of whom have worked hard to ensure the continued success of the organisation. The design and implementation of products and services to date is a testament to the innovation, skills and experience of our staff to find and produce solutions to meet the needs of our customers.

How does the bank work with local businesses to help them develop products and markets?

Being a small island with a limited population, the Bank knows its customers in the truest sense of the word. Customer interaction, feedback gathered and knowledge and experience of our customers and the environment enables the Bank to work with local businesses to meet its product and market requirements.

In addition, the Bank works with the local Government to understand their national aspirations and endeavours to introduce products or service which support the island's national strategic objective.

What are the key strengths of the St Helena economy?

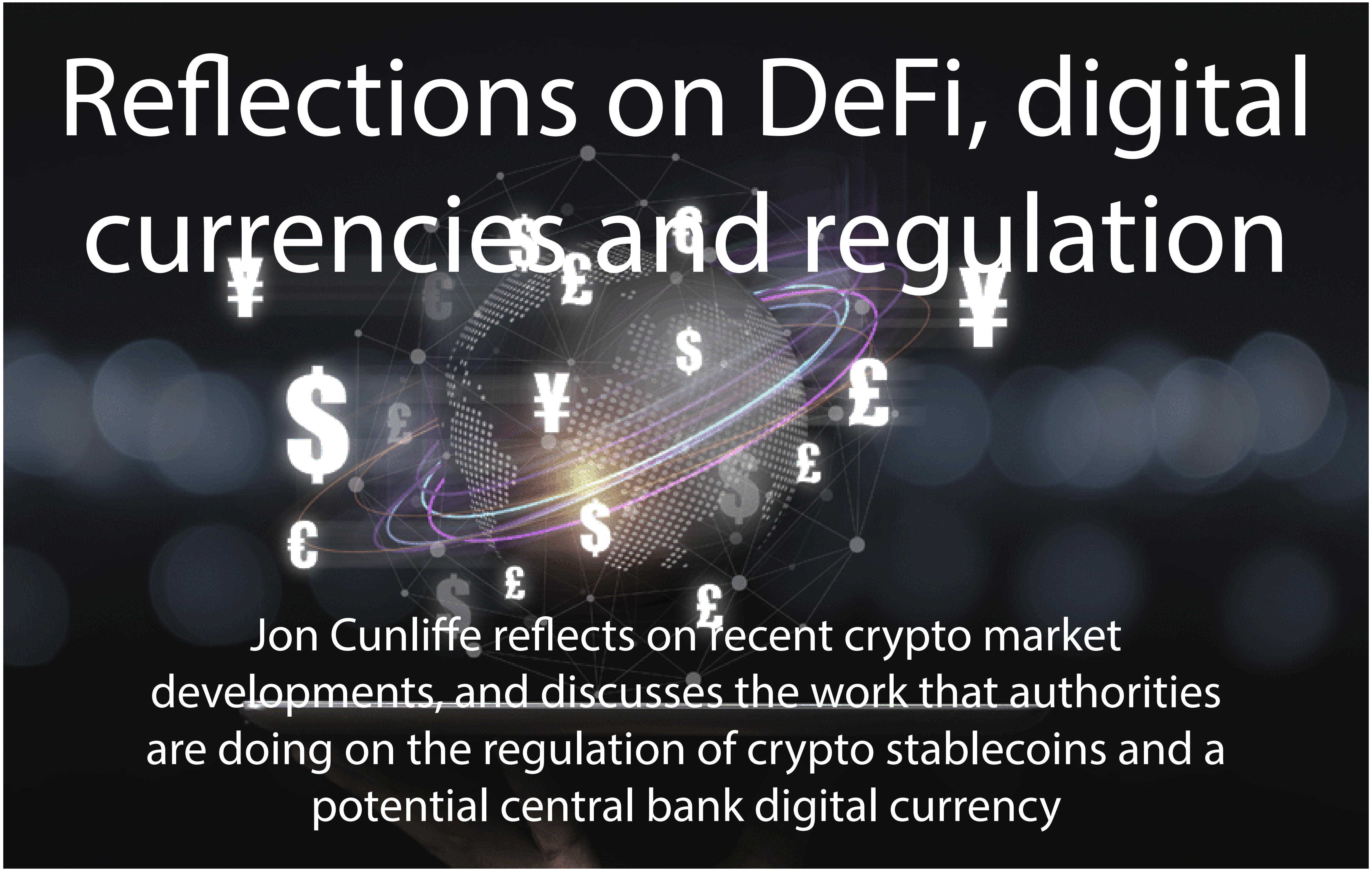
The key strengths of the St Helena economy are not yet fully realised, however as a fledgling economy the island has a lot it can draw upon to become a thriving economy. The island is a British Overseas Territory that uses the local currency of St Helena Pound (SHP) which is at parity with Great British Pound (GBP).

We are also an English-speaking island. With GBP being the fourth most traded currency in the world and English being one of the most spoken languages in the world, it places St Helena in an attractive position to live and trade.

There is the potential for business development in eco-tourism, coffee production and fishing, all of which could have a significant positive effect on St Helena's economy. However, the true potential is yet to be realised.

How do you think the bank will look in 10 years?

Bank of St Helena is optimistic about the future. In ten years, the Bank will become digital by default and would have been the key enabler to move to a cashless society. Bank of St Helena will be recognised as offering a modern banking service that continues to offer products and services to meet our customers' needs and expectations in an ever-changing world. ■



Reflections on DeFi, digital currencies and regulation

Jon Cunliffe reflects on recent crypto market developments, and discusses the work that authorities are doing on the regulation of crypto stablecoins and a potential central bank digital currency

I had intended to talk about the work the Bank of England, is doing with the Treasury, the FCA on the regulation of crypto stablecoins and our work on a potential central bank digital currency in Sterling. That remains the bulk of what I will talk about. But between beginning to draft these remarks and delivering them, we have seen what is probably the largest – and certainly the most spectacular – failure to date in the crypto ecosystem, by which of course I mean the collapse of the crypto trading platform FTX and most of its associated businesses.

So I thought it might be worthwhile to start with a brief look at the FTX implosion to frame some of the points I intend to make on regulation of the use of crypto-related technologies to provide financial services and on why, as a central bank, we are actively exploring the issuance of a digitally native Pound sterling.

Untangling exactly what happened at FTX will no doubt take a great deal of time, effort and investigation by the relevant authorities. For anyone interested in the scale of the challenge, I can only recommend a quick read of FTX's bankruptcy filing.

But while we will not know in full how it happened for some time, there do appear to be some general themes that are very familiar to those who regulate and supervise conventional financial firms and financial instruments.

The first are fundamental issues around how financial institutions should be organised, by which I mean their corporate structure, governance, internal controls and record keeping. Regardless of the financial service activity – be it banking, insurance, exchanges, clearing houses – regulation in the conventional financial sector imposes stringent/substantive requirements. Supervision aims to ensure that these are implemented.

These requirements reflect the risks inherent in financial services – risks to the users, risks to other financial firms and risks more broadly to the financial system. Technology in and of itself does not change the need for transparency in corporate structures, governance, audit and systems and controls – for example to protect customers' funds.

In a similar vein, and to prevent conflicts of interest, regulation imposes requirements and constraints on the connections between a financial firm and its affiliates, while also requiring controllers to be fit and proper. In this respect, transparency in corporate structures and the relationships between them is the key foundation.

Our aim is to ensure that innovation can take place but within a framework in which risks are properly managed and which safeguards the sustainability of such innovation

The connections between activities carried out within the firm matter also. Lending, brokering, providing an exchange platform, clearing and settlement perform different economic functions that carry different risks.

For financial market infrastructure firms, such as a central counterparty or an exchange or custody of assets (both/all of which activities FTX sought to undertake, the regulatory system and international standards in place aim to stop these important pieces of financial market infrastructure from taking on credit/liquidity/market risk beyond what is absolutely necessary to discharge their core functions. Where they happen within one group, regulation requires separate, independent governance, to ensure the risks inherent in each is properly managed[1].

FTX, along with a number of other centralised crypto trading platforms, appear to operate as conglomerates, bundling products and functions within one firm. In conventional finance these functions are either separated into different entities or managed with tight controls and ring-fences.

It is worth noting that this bundling appears to have been primarily organisational rather than technological – that is to say, the functions were offered by different parts of the FTX group but were not bundled in the sense of being run as one single piece of code performing multiple functions. I will return to the question of integration of functions in smart contracts later on.

I have mentioned some familiar regulation issues around the organisation and governance of conventional financial firms. There appear, in the FTX case, also to be familiar issues around the financial instruments involved.

Collateral performs a variety of vital function in financial services. It protects lending counterparties from credit risk. It can also serve as margin in clearing processes. The higher the credit quality and lower the volatility of assets used as collateral, the better suited it is to serving as assurance against risk. For this reason, there are stringent, material conditions on collateral that can accepted, for example, in central counterparty clearing.

Unbacked cryptoassets are highly volatile, given that they have no intrinsic value. They are subject to runs and their value can change very quickly as we have seen in recent months.

Moreover, a firm accepting its own unbacked cryptoasset as collateral for loans and margin payments, as there are indications may have happened with FTX, creates extreme 'wrong way' risk – ie. when the exposure to a counterparty increases together with the risk of the counterparty's default[2].

Indeed, in the FTX case, there are indications that it could have been a run on its crypto coin, FTT, which triggered the collapse.

Moreover, protection of client funds is crucial. In many of these platforms the platform takes possession of the cryptographic keys and manages transactions on the ledger for a pool of assets. It is far from clear whether these practices deliver the assurance of either custody of assets in the conventional finance world or of a claim on the balance sheet in the way that occurs with accounts at a bank.

'Crypto' was born in unregulated space: indeed, part of the objectives of its early developers was to create a financial system outside regulation. While not yet of systemic scale, the crypto ecosystem has grown very rapidly in recent years and broadened to encompass a range of financial services.

The experience of the past year has demonstrated that it is not a stable ecosystem. Part of this is because, its foundation is completely unbacked instruments of extreme volatility that can swing wildly in value. But part is also because the crypto institutions at the centre of the much of the system exist in largely unregulated space and are very prone to the risks that regulation in the conventional financial sector is designed to avoid.

It is in part for this reason that, since September, the FCA has warned publicly on FTX that *"this firm may be providing financial services or products in the UK without our authorisation… you are unlikely to get your money back if things go wrong"*[3].

Some, of course, would argue that the answer is not proper regulation of the risks in centralised crypto platforms, like FTX, but rather the development of decentralised finance in which functions like lending, trading, clearing etc. take place through software protocols built on the permission-less blockchain.

In such a world, it is effectively the 'code' that manages the risks rather than intermediaries. And indeed, there is some tentative and limited evidence that the failure of FTX has stimulated some transfer of activity to decentralised platforms.

From the standpoint of a financial stability authority and a financial regulator, I have yet to be convinced that the risks inherent in finance can be effectively managed in this way. That scepticism is greater if the activity in question is the trading, lending, etc. of super volatile assets without intrinsic value.

The robustness and resilience of the permission-less blockchain has not been demonstrated at scale and over time. And some of the protocols themselves may carry risks – for example automatic liquidation of volatile collateral, no matter how rapid, does not remove the need for liquidity providers to avoid the amplification of fire sale dynamics.

Moreover, it is not clear the extent to which these platforms are truly decentralised. Behind these protocols typically sit firms and stakeholders who derive revenue from their operations. Moreover it is often unclear who, in practice, controls the governance of the protocols.

More generally, as with driverless cars, they are only as good as the rules, programmes and sensors which organise their operations. We would certainly need a great deal of assurance before such systems could be deployed at scale in finance.

Against that background, the question – more pointed now, following the collapse of FTX - is whether we should bring the financial service activities and the entities that now populate the crypto world within the regulatory framework. And, if so, how?

My answer to the first question is that we should continue to bring these activities and entities within regulation, for three reasons.

First, and most obviously, the need to protect consumers/investors. Whether or not one thinks it is sensible to invest or trade in the highly speculative assets that make up most of the activity in the crypto world, investors should be able to do so in transparent, fair and robust marketplaces, with the protections that they would get in conventional finance.

There will probably always be some who prefer – for a variety of reasons – to invest and trade in an unregulated, opaque world. But we should not push the majority who do not want those risks into that world because there is no regulated alternative.

My second reason is the need to protect financial stability. While the crypto world, as was demonstrated during last year's crypto winter and FTX's implosion is not at present large enough or interconnected enough with mainstream finance to threaten the stability of the financial system, its links with mainstream finance have been developing rapidly.

We should not wait until it is large and connected to develop the regulatory frameworks necessary to prevent a crypto shock that could have a much greater destabilising impact. The experience in other areas of digitalisation has demonstrated the difficulty of retrofitting regulation on new technologies and new business models after they have reached systemic scale.

It is, of course, possible that neither of these two reasons - investor protection and protection against financial stability risk - will be relevant because the very instability and riskiness of the world of unregulated crypto finance, most recently demonstrated by FTX, will in the end ensure that the sector cannot grow.

Indeed, some have argued for regulators grappling with the crypto world to keep it outside the regulatory framework to ensure that users' 'caveat emptor' concerns prevents both growth and connection with mainstream finance[4].

And that leads to my third reason.

Forecasting the direction and pace of technological innovation is an even more uncertain game than economic forecasting. Promising technologies fall by the wayside; unexpected ones flourish. And technologies combine in ways that cannot be anticipated.

But the technologies that have been pioneered and refined in the crypto world, such as tokenisation, encryption, distribution, atomic settlement and smart contracts, not only seem unlikely to go away as our everyday lives become more 'digital', but may well have the potential to improve efficiency, functionality and reduce risk in the financial system.

A potential example of this is the integration of functions in 'smart contracts' that I mentioned earlier. A possible use case for such integration, which has been pioneered in the defi world is the combining the functions of trading, clearing and settlement of tokenised financial assets into a single, instantaneous contract, rather than being carried out in sequence by three separate institutions over a number of day.

This, if applied to 'real world' assets, like equities, could offer a substantial improvement in the efficiency of financial market infrastructure and reduce risks by enabling instant settlement – T plus now[5].

There are of course risks in such integration as I mentioned earlier, whether it happens organisationally or technologically. The Bank of England is working with the FCA and the Treasury to set up a regulatory 'sand box' for developers to explore whether and how those risks can be managed to the level of assurance we expect from the current system[6].

So my third reason for bringing the activities of the crypto world within the relevant regulatory frameworks is to foster innovation. This may appear counter intuitive to those who see regulation as opposed to innovation. But, as I have said before, 'people do not fly in unsafe aeroplanes'.

Innovation may start in unregulated spaces. But it will only be developed and adopted at scale within a framework that manages risks to existing standards.

And by holding innovative approaches, using technological advance, to the same standards as existing approaches we can ensure that the benefits of new technology and new business models actually flow form innovation rather than from regulatory arbitrage.

This in turn, determines the answer to the second question of 'how' regulation should be extended to these areas. The guiding principle should be 'same risk, same regulatory outcome'. The starting point should be our existing regulatory frameworks – for investment products, for exchanges, for payments systems and other financial functions – and the level of assurance we require that the relevant risks have been managed.

Technological change and different business models may mean we have to find new ways to deliver that assurance. We should be under no illusions that this will always be an easy process. For example, as I have said, it remains for me a very uncertain question whether use of the permission-less blockchain could deliver the necessary level of assurance for activities that are integral to the stability of the financial system.

Our approach as regulators should be open – by which I mean we should be prepared to explore whether and if so how the necessary level of assurance – equal to that in conventional finance - could be attained. But we should also be firm that where it cannot, we are not prepared to see innovation at the cost of higher risk.

This is very much the approach we are looking to take in the UK for the extension of the regulatory framework to the use of crypto technologies and business models in finance. The Financial Services and Markets Bill, currently in Parliament addresses the regulation of payment systems using 'digital settlement assets' defined as 'digital representations of value' – in other words digital tokens representing money.

The objective is to extend the current Bank of England and FCA regulatory regimes for e-money and payment systems to cover the use stablecoins for payments[7].

The powers in the Bill will extend not only to the systems for transferring such coins between parties to make payments, but to the issuance and storing of the coins. The Bank will have responsibility for such payment systems which are systemic or likely to become systemic. This will apply whether such systems exist to make payments for real things or for cryptoassets should the latter activity become systemic in scale.

We intend early next year to consult in detail the regulatory framework that will apply to such systemic payment systems and the services, like wallets, that accompany them. In doing so, we will be guided by the principle of 'same risk, same regulatory outcome' set out above.

In the case of stablecoins used as money to make payments, the regulatory outcome has been expressed by the Financial Policy Committee of the Bank as an expectation that stablecoins used in systemic payment chains should meet standards equivalent to those expected of commercial bank money. And that's in terms of stability of value, robustness of legal claim and the ability to redeem at par in fiat[8].

Some of the likely foundational features of the regulatory regime on which we will consult are already clear. The FPC made clear last year that to deliver that regulatory outcome *"regulatory safeguards will be needed for a non-bank systemic stablecoin to ensure that the coin issuance is fully backed with high quality and liquid assets, alongside loss absorbing capital as necessary, to compensate coinholders in the event that the stablecoin fails"*[9].

It also made clear that in the absence of deposit protection for coinholders, other elements of the regime would need to be strengthened to deliver the necessary level of assurance.

The consultation will set out in more detail how the coinholders' claims on the stablecoin issuer and wallets should be structured to deliver redemption at par in line with commercial bank money, how the backing assets should need to be managed to ensure they are always available to meet redemptions and, more generally the requirements for corporate structure, governance, accountability and transparency necessary to meet the standards we expect in other parts of the financial system that carry out the same functions. The FTX example underlines how important these aspects are.

The legislation covers the use of crypto technologies for the payments function. The Treasury intends to consult in the near future on extending the investor protection, market integrity and other regulatory frameworks that cover the promotion and trading of financial products to activities and entities involving cryptoassets. At present, in the UK, it is, to a large extent, only the anti-monetary laundering regulatory framework which applies to these activities and entities.

Finally, let me turn to our work with the Treasury on central bank digital currency, or, to put it more plainly on the issuance by the Bank of England of a digitally native pound sterling. Our plan remains to issue a consultative report around the end of year setting out the next steps that we propose.

Recently I have had a few comments both to the effect that the collapse of FTX shows that we need to get on and issue a digitally native pound – and to the effect that FTX shows that we do not need do so.

My initial reaction to both points of view was that there really was no connection between FTX and our work on a digitally native, general purpose form of Bank of England money, for use by households and businesses in making payments.

But on reflection, I think I understand the comments better. FTX in particular and the crypto ecosystem in general are emblematic of these new technologies and the possibility that they might revolutionise financial services and the forms that money takes in our economy.

For some perhaps the lesson is that tokenisation and digitalisation of finance should not take place in unregulated space and, moreover, needs to be underpinned by a robust and reliable of digital settlement asset.

For others, the message is perhaps that the crypto world and its technologies are a very long way from influencing, let alone changing, the way financial services, including payments, are delivered at scale in the real world.

It is, as I said earlier, very difficult to predict which technologies will be successful and when and how they might begin to change the way we do things. The bursting of the dot.com bubble in the early years of this century did not herald the end of the development of internet commerce though it took longer than its original enthusiasts imagined and emerged in a very different form, dominated by big tech platforms.

Our work on a digitally native pound is driven by the trends we now see both specifically in payments, including the reducing role of cash, and more generally in the increasing digitalisation of daily life.

It is motivated by two primary concerns.

First, that in a world in which new, tokenised forms of money emerge, enabled by new technology, we remain able to ensure that all forms of money that circulate in the UK are robust, interchangeable without loss of value and denominated our unit of account – the pound sterling.

Physical cash plays a role in ensuring that, at present, all forms of commercial bank money in the UK have to be redeemable in cash - Bank of England money - on demand in cash and without loss of value. Given the trends away from physical cash, which cannot be used in an increasingly digital economy, and, potentially, towards new forms of tokenised money, a digital pound may be needed in future to fulfil the same function.

Second, to ensure that there can be competition and innovation in the development of new functionalities using tokenised money. Given the network externalities around money and the likely cost of developing robust and risk managed tokenised money like stablecoins, it is possible that the development of digital settlement assets will converge on a few large players who will dominate and perhaps control innovation in payment services.

We have seen a similar dynamic in the emergence of large internet platforms and marketplaces. A digital pound would provide a digital settlement asset available to a wide variety of private sector innovators and developers of payment services.

The first concern is primarily for central banks, charged with ensuring the stability of money in the economy. The second is more of a concern for government. And of course there are other motivations, such as financial inclusion and resilience.

I do not have the time to go into those in detail, and, in any event, I do not wish to pre-empt the report on the next steps for this work that we and the Treasury intend to issue soon. But I do want to emphasise that this work, and any future decision to introduce a digitally native pound should not be seen in the context of the status quo but rather in the context how current trends in money, payments and technology might evolve.

And above all, in this, as in the work on regulation that I discussed earlier, our aim is to ensure that innovation can take place but within a framework in which risks are properly managed and which safeguards the sustainability of such innovation. The FTX events provide a compelling demonstration of why that matters. ■

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Endnotes

1. 'CPSS-IOSCO Review of Standards for Payment, Clearing and Settlement Systems. (2010)'.

2. The intuition here is generally quite familiar to people - you probably would think twice before buying fire insurance from a company being run out of the house next door for example.

3. Information for FTX customers | FCA.

4. For an argument of this position see for example 'Let Crypto Burn: Just say no to legitimacy-inferring regulation' – FT Alphaville (17.11.2022).

5. See the discussion of the potential risks and benefits in Cunliffe (2022): 'Innovation in post trade services - opportunities, risks and the role for the public sector'.

6. Financial Services and Markets Bill – Articles 21 and 22.

7. The Banking Act 2009 provides the statutory basis for the Bank's oversight of payment systems. It allows HM Treasury to recognise systems for supervision by the Bank of England as part of the Bank's objective to maintain UK financial stability.

8. Bank of England Record of the Financial Policy Committee Meeting 13 December 2019.

9. Bank of England Record of the Financial Policy Committee Meeting 24 March 2022.

The views expressed here are not necessarily those of the Bank of England, the Monetary Policy Committee or the Financial Policy Committee. I would like to thank Amy Lee, Teresa Cascino, Emma Butterworth, Katie Fortune, Bernat Gual-Ricart, Jenny Khosla, Grellan McGrath, Marilyne Tolle, Andrew Walters, Daniel Wright and Cormac Sullivan for their help in preparing the text. This article is based on a speech given at Warwick Business School's Gilmore Centre Policy Forum Conference on DeFi & Digital Currencies, November 2022.

The beginning of the end for cryptocurrencies

Jon Danielsson argues that cryptocurrencies have now reached the beginning of the end as the factors fuelling their success have come to a standstill

Cryptocurrencies have enjoyed a remarkable run from obscurity to a trillion dollar valuation in just over a decade. They are praised and condemned in equal measure by world leaders and have even become legal tender in some countries.

Crypto has had two stages in its short life: rapid price growth and elevation from obscurity, followed by a prolonged phase of global recognition, controversy and volatile prices fluctuating but with no long-term price increases. The signs now point to crypto commencing its final, terminal phase. Cryptocurrencies will leave a fine legacy even if they have not lived up to the crypto evangelists' promises.

The reasons why crypto has entered its final phase have much to do with why it has been successful and what it promises and fails to deliver (Bindseil *et al* 2022, Didisheim *et al* 2022). It is all down to politics, speculation, and efficiency.

Politics is fundamental to crypto. Its foundation myth is a world where technology replaces corrupt human beings and their organisations. Instead of fiat money abused by governments with their extra-low interest rates and repeated quantitative easing, we get digital money created and governed by an algorithm programmed to be fair.

Such a crypto financial system promises to be much more efficient than the setup we have today, with modern algorithms, programming languages, and systems replacing a costly, error-prone, corrupt banking system – one with centuries of legacy practices and more than half a century of incremental changes to its IT systems, with much still based on Cobol written half a century ago, running on IBM mainframes.

The third plank of the crypto mission is speculation, since the number of people buying into crypto's political and efficiency aspects is tiny – much too small to leave much mark on the world. While the true believers are essential for shaping the crypto narrative, success and failure come predominantly from speculators fuelled by Bitcoin's spectacular price rise from four cents to $16,000 today.

The foundation myth is essential for crypto's success. Not only because otherwise there is no need to replace the existing financial order, but even more importantly, it is why crypto is not a Ponzi scheme.

The crypto world is increasingly abandoning its politics. Just about every crypto exchange complies with anti-money laundering, know-your-customer and sanctions requirements imposed by the old school financial regulators

While crypto has become visible and made many speculators wealthy, it hasn't enjoyed the success promised by the foundation myth (Danielsson and Macrae 2022). They might not even make sense (Danielsson 2018). After all, the financial system is still almost entirely based on old school fiat money financial institutions.

And that is a problem because the high price of crypto is based on speculators betting on success. For that to happen, the promises of the foundation myth will have to be seen as within reach. Otherwise, speculators will likely lose heart and abandon crypto. Which can then become a vicious downward spiral. Both politics and speculation have been tested recently.

Start with politics. For the foundation myth to be believable, crypto has to be a credible alternative to the existing order and true to its political origins. However, the crypto world is increasingly abandoning its politics. Just about every crypto exchange complies with anti-money laundering, know-your-customer and sanctions requirements imposed by the old school financial regulators.

The old school financial authorities are just too powerful. Crypto is moving into the mainstream, and crypto evangelists are increasingly using the language of microprudential regulation when discussing how crypto needs to evolve.

While that does not destroy the foundation myth, it undermines and muddles the messaging. Is crypto money that is free from state control, or is it money that is managed with norms set by the state?

The efficiency aspect of the foundation myth has also been undermined. While crypto promises to be much better than the old school financial system, it has run into roadblocks because of the difficult trade-off between privacy, integrity, and efficiency.

The most popular cryptocurrency, Bitcoin, is inherently inefficient and can only handle a tiny fraction of the transactions needed by the economy. The second most popular, Ethereum, is more efficient and designed for smart contracts (crypto's primary vehicle for joining the mainstream).

However, Ethereum recently abandoned mining for proof of stake to pursue efficiency and political acceptability. While that does mean no more environmentally damaging mining, it is also a licence for Ethereum investors to print money for free, undermining the foundation myth. Meanwhile, its promises of smart contracts have run into serious roadblocks set by the financial regulators and the legal system.

The old school fiat system has not been standing still. The financial authorities and the private sector are alive to the threats crypto poses and have responded by proposing and even implementing much-needed reforms. After all, when financial intermediation is inefficient and exploitative because reform threatens the incumbents' rent, it leaves an opening for crypto.

To forestall that, the authorities have reacted. PIX in Brazil is an excellent example of what the old school system can do when pushed. We can thank crypto for central bank digital currencies.

Meanwhile, crypto is not as attractive to speculators as it used to be when they were motivated by the rise of the price of Bitcoin from four cents to $16,000. Bitcoin was also at $16,000 half a decade ago, going as low as $3,200 while reaching $67,000 at the peak. It doesn't look all that attractive as a speculative investment compared to, say, Amazon or Apple.

And then we have all the scandals. One of the biggest problems for crypto is that only the most technically competent and determined investors can manage self-custody, controlling their own keys. Most speculators need to use a crypto financial institution. And they have a habit of stealing people's money.

Lately it was FTX that loudly dismissed traditional practices – due diligence, protecting consumers, and the like – as belonging to the old school system, not the new crypto world. Very much a corruption of the crypto political philosophy.

The financial system has always attracted its share of corrupt and incompetent bankers, and there is no reason why it would be any different in the crypto world. The problem is that when speculators face substantial losses because of fraud and those losses are widely reported, it deters new speculation. Driving the price of crypto down.

Then a speculator might ask themselves, why not pick Tesla or Gamestop instead? Meanwhile, it reinforces the narrative of the old school system that its institutions are necessary for protecting the users of the system, further eroding the foundation myth.

The combination of the political mission undermined, efficiency not yet delivered, and speculators hurt suggests that crypto is about to enter its final, declining phase. Of course, that will not happen rapidly, and we will likely see crypto rallies. But unless something fundamental changes, it is the beginning of the end. Perhaps the financial authorities will lose even more control of inflation, boosting the foundation myth.

I don't think that would be sufficient by itself. The strength of crypto is decentralisation, but that is also the weakness. The crypto world can't prevent abusive firms like FTX from setting up shop. It even needs unregulated firms to facilitate speculation, and then has to live with the fallout when they fail. Meanwhile, the crypto enthusiasts have all their own views, diluting the messaging.

However, there is little public concern about crypto, either from a macro or microprudential perspective. Little suggests it poses a systemic financial threat to society. If anything, it is so small that it can't be systemic, unlike the old school, too-big-to-fail banks.

Crypto is a microprudential issue in so far as micro concerns itself with protecting the clients of the financial system. But people are allowed to take high risk – smoke, ride motorcycles, buy lottery tickets, jump out of aeroplanes, gamble and speculate on high-risk negative NPV investments. So if the authorities are fine with that, they should be OK with crypto too.

While it is the beginning of the end for crypto, it has brought much good by alerting us to all the inefficiencies and exploitation in the existing system, forcing the authorities and the private sector to reform. And that is the positive legacy crypto leaves. ■

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The BVI - resilient and rebuilding

Simon Gray discusses the BVI's financial services sector and its role as a pivotal cog in global trade and investment

The British Virgin Islands has long been a leading player in the international business ecosystem and global economy. For decades, the international finance centre has played a vital role supporting the growth of the global economy and facilitating investment, while remaining resilient in the face of fast-changing circumstances and seismic events.

This resilience was highlighted in September as the BVI commemorated the 5-year anniversary of Hurricane Irma. One of the most powerful storms ever seen in the Atlantic, Irma caused unprecedented havoc to the BVI, destroying or damaging 85% of the buildings on the islands and causing more than $3.6 billion in damage.

Looking back, one of the most extraordinary aspects of this period was the strength and tenacity displayed by both the business sector and local community. In a matter of days after the storm passed, key services of the financial service were back, including access to the company register via the online portal, VIRRGIN. The business community went above and beyond in supporting its staff and the community and by October, 73% of employees were back on the island and working.

This collaborative effort of the financial services sector was crucial for the overall recovery of the islands and played a huge part in supporting the economy whilst other industries – such as tourism – rebuilt. However, it was only two and a half years later when the BVI would be hit with another 'unprecedented' event, causing economic shockwaves through the jurisdiction – COVID-19.

Like Irma, the effect of the global pandemic in the BVI was immediate. The closure of borders and complete void of tourism shook the economy, with the GDP dropping 3.9% – broadly in line with major economies but significantly less than other Caribbean nations.

The impact of the pandemic on tourism exceeded that of Hurricane Irma. There were more overnight visitors to the BVI in 2018, when the islands were rebuilding than in 2020 and 2021 combined. Yet once again, the BVI demonstrated why it has stood as a world-leading business centre for decades, bouncing back stronger than before.

The BVI's unwavering success in drawing businesses and entrepreneurs from across the world lies in the depth and breadth of its services and expertise

Building resilience

The economic resilience displayed in the aftermath of these events highlights the competence of the financial services sector in rapidly adapting to shifting circumstances and the unique attractiveness of doing business in the BVI.

The BVI's unwavering success in drawing businesses and entrepreneurs from across the world lies in the depth and breadth of its services and expertise. The BVI financial services sector caters to the entire lifecycle of a company - from incorporation, mergers and acquisitions, public listings, privatisations, through to restructuring and insolvency - and is a trusted partner for companies across the globe due to its tax neutrality, agile framework and strong legal environment.

As a result, the BVI economy has bounced back. For example, in 2021 when the pandemic was still disrupting many elements of economic and social life, annual GDP growth was 2.2 per cent and this year, the BVI is expecting growth of 1.8 percent.

The second year of the pandemic also saw the highest level of new company incorporations by financial services in the BVI since 2018, and in addition, the number of new limited partnerships formed in 2021 was more than three times that of 2019 and 2020.

This continued success has provided the jurisdiction with some of the highest levels of prosperity in the Caribbean. The BVI's resilience and strength has also had global implications, with the BVI remaining a vital cog in facilitating growth and investment.

Looking ahead

Remaining resilient, however, requires staying with your finger on the pulse of international trends and developments. As an International Financial Centre, this requires keeping pace with the innovations that are transforming the financial and economic landscape and ensuring that the services of the jurisdiction can facilitate the new demands of emerging sectors.

From cryptocurrencies to fintech, the BVI has embraced innovative companies and emerging technologies, establishing itself as a trailblazer in the digital assets sector. For example, in 2015 when most jurisdictions were rejecting digital asset funds, the BVI Investment Fund Association was working with the BVI FSC to create new frameworks to facilitate them and as a result succeeded in created an ecosystem ripe for fast-growing businesses to thrive, attracting businesses from the West Coast to Hong Kong.

Earlier this year, the BVI Financial Services Commission also admitted Fusang, Asia's only fully regulated end-to-end digital securities exchange, to its list of recognized exchanges paving the way for Asian-based, BVI-registered companies to benefit from the efficiencies of listing their shares digitally via equity tokens.

The nature of the crypto and digital asset space has made regulation increasingly complex and the collapse of high-profile companies in 2022, Three Arrows Capital and mostly recently FTX, has underscored the importance of comprehensive frameworks and structures in the sector.

The BVI is well equipped to deal with the fast-moving landscape, with the litigation and restructuring capabilities to deal effectively with such incidents.

Earlier this year, for example, advisory firm Teneo BVI, by appointment of the courts, took control of high-profile Three Arrows Capital assets, the $10 billion crypto hedge fund that the courts ordered liquidated, and demonstrated the high calibre of the British Virgin Islands Court system and the jurisdiction's litigators and insolvency practitioners.

The crypto and digital sector is, in many ways, still in its infancy and as it matures, the BVI will continue to evolve its regulatory frameworks to cater to the emerging sector.

Moving forward

The BVI's continued success in recent years has been a testament to the strength of the financial services sector and its role as a pivotal cog in global trade and investment.

While geopolitical challenges and breakneck speed innovation continues to disrupt and shift the global economic landscape, the BVI remains steadfast in its commitment to facilitate economic growth, remaining agile in the face of any challenge. ■

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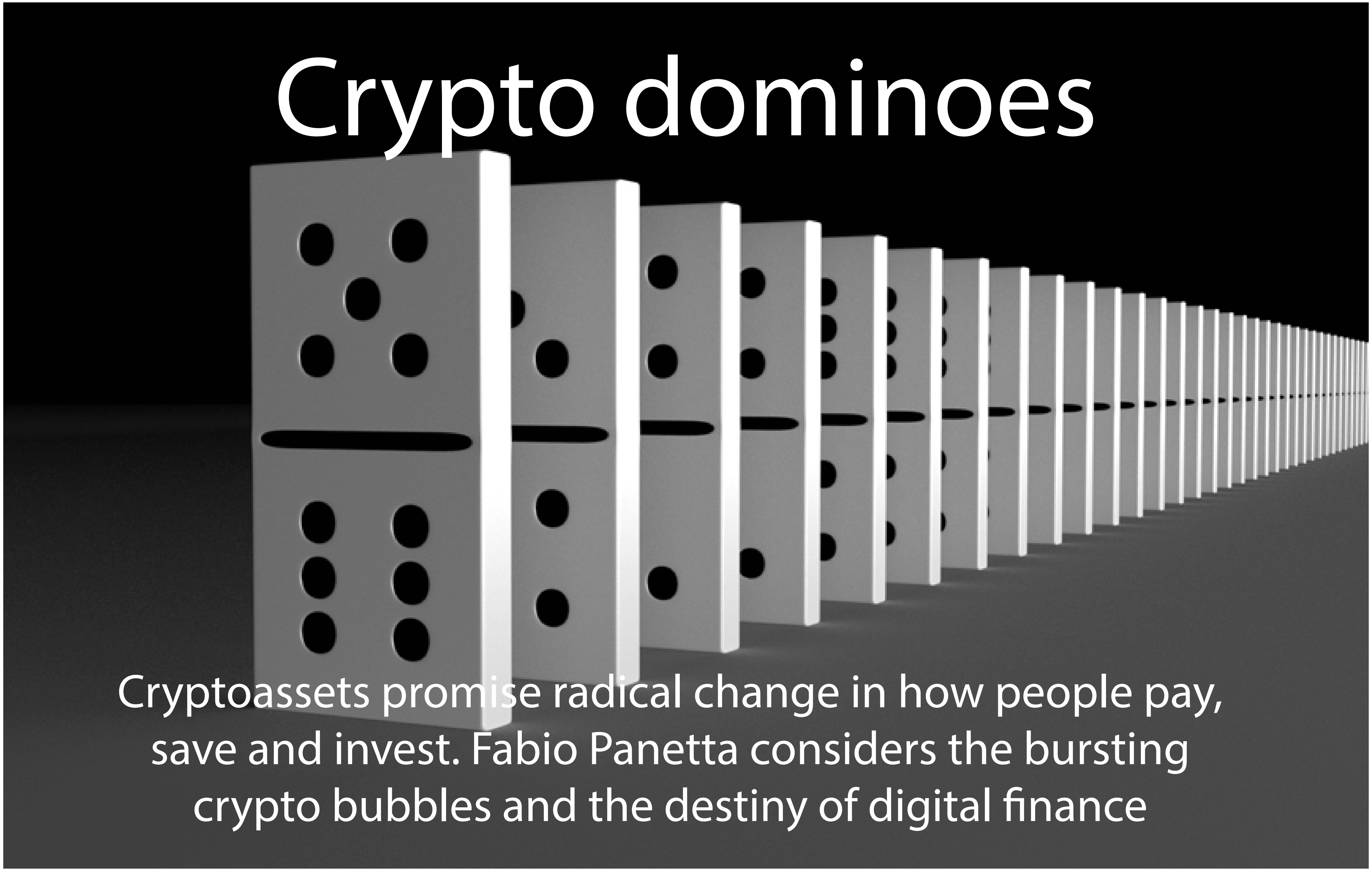
ABOUT THE AUTHOR

Simon and the BVI Finance team lead the efforts of the BVI in promoting the territory's international business and financial services both locally and overseas. Simon is a senior financial services professional with a strong international background with experience of Europe, the Middle East, North America, Asia, Africa and Latin America and an established track record of success.



Crypto dominoes

Cryptoassets promise radical change in how people pay, save and invest. Fabio Panetta considers the bursting crypto bubbles and the destiny of digital finance

I will discuss cryptoassets and the destiny of digital finance. When I last spoke about crypto finance at Columbia University last April, I likened it to the Wild West and warned about the risks stemming from irrational exuberance among investors, negative externalities and the lack of regulation[1].

Crypto markets have since witnessed a number of painful bankruptcies. The crypto dominos are falling, sending shockwaves through the entire crypto universe, including stablecoins and decentralised finance (DeFi)[2].

The crash of TerraUSD, then the world's third-largest stablecoin, and the recent bankruptcy of the leading crypto exchange FTX and 130 affiliated companies each took only a few days to unfold. This is not just a bubble that is bursting. It is like froth: multiple bubbles are bursting one after another.

Investors' fear of missing out seems to have morphed into a fear of not getting out. The sell-off is exposing those *"swimming naked"*[3]. It has laid bare some unbelievably poor business and governance practices across a number of crypto firms. It has revealed that some investors have been acting carelessly by investing blindly without proper due diligence. And similar to the sub-prime crisis, the crash has uncovered the interconnections and opaque structures within the crypto house of cards.

This is set to dampen enthusiasm in the belief that technology can free finance from scrutiny. The crash has served as a cautionary reminder that finance cannot be trustless and stable at the same time. Trust cannot be replaced by religious faith in an algorithm. It requires transparency, regulatory safeguards and scrutiny.

Does this mean we are witnessing the endgame for crypto? Probably not. People like to gamble. On horse races, football games and many other events. And some investors will continue to gamble by taking speculative positions on cryptoassets.

Today I will argue that the fundamental flaws of cryptoassets mean that they can quickly collapse when irrational exuberance subsides. We should therefore focus on protecting inexperienced investors and preserving the stability of the financial system.

Cryptoassets have become the bubble of a generation. It is now obvious to everyone that the promise of easy crypto-money and high returns was a bubble doomed to burst

Ensuring that cryptoassets are subject to adequate regulation and taxation is one path to achieving this. Here, we need to move rapidly from debate to decision and then implementation.

But even regulation will not be enough to address the shortcomings of cryptos. To harness the possibilities of digital technologies, we must provide solid foundations for the broader digital finance ecosystem.

This requires a risk-free and dependable digital settlement asset, which only central bank money can provide. And that is why the ECB is working on a digital euro while also considering new technologies for the future of wholesale settlement in central bank money.

Fundamental flaws in crypto finance

The philosophy behind cryptos is that digital technology can replace regulated intermediaries and avoid state 'intrusion'. In other words, that it is possible to build a trustless but stable financial system based on technology.

This is just an illusion, as was clear from the outset and confirmed by recent developments. In fact, it is precisely the absence of regulation and public scrutiny that blinded investors to the risks involved, leading to the rise and subsequent fall of cryptoassets.

The risks associated with crypto finance stem from three fundamental flaws. I will address each of them in turn.

Unbacked cryptoassets offer no benefits to society

The main structural flaw of unbacked cryptoassets – which form the bulk of the crypto market – is that they do not offer any benefits to society.

Despite consuming a vast amount of human, financial and technological resources, unbacked cryptoassets do not perform any socially or economically useful function. They are not used for retail or wholesale payments – they are just too volatile and inefficient[4].

They do not fund consumption or investment. They do not help fuel production. And they play no part in combating climate change. In fact, unbacked cryptoassets often do the exact opposite: they can cause huge amounts of environmental damage[5]. They are also widely used for criminal and terrorist activities, or to evade taxes[6].

As a form of investment, unbacked cryptoassets lack any intrinsic value. They have no underlying claim: there is neither an issuer who is accountable and liable, nor are they backed by collateral. They are notional instruments, created using computing technology, which do not generate financial flows[7] or use value for their holders. Therefore, their value cannot be estimated from future income discounted to the present, like for real and financial assets.

Unbacked cryptoassets cannot help to diversify portfolios. Recent developments show that their value does not increase when income becomes more valuable to consumers – such as in periods of high inflation or low growth. Cryptoassets are not digital gold.

Their price changes show increasing correlation with stock markets, with much higher volatility. And recent developments highlight their intrinsic instability: the first bitcoin exchange-traded fund lost more on its price since its launch than any other that has been issued[8].

Many investors have suffered significant losses from the crypto collapse and cannot expect any compensation. There are no insurance schemes. And in several instances, cryptoassets have been shown to offer little protection against IT and cyber risks[9].

On the whole, it is difficult to see a justification for the existence of unbacked cryptoassets in the financial landscape. Their combined features mean that they are just speculative assets. Investors buy them with the sole objective of selling them on at a higher price. In fact, they are a gamble disguised as an investment asset.

Millions of investors were lured by an illusory narrative of ever-rising cryptoasset prices – a narrative that was fuelled by extensive news reports and investment advice on social media, highlighting past price increases and features such as artificial scarcity to create the fear of missing out. Many invested without understanding what they were buying[10].

Irrational enthusiasm prospered on self-fulfilling expectations[11]: the textbook definition of a bubble. Like in a Ponzi scheme, such dynamics can only continue so long as a growing number of investors believe that prices will continue to increase. Until the enthusiasm vanishes and the bubble bursts.

The market value of cryptoassets has shrunk from €2.5 trillion at its peak a year ago to less than €1 trillion today. The price of bitcoin[12] has fallen by more than 70% from its peak.

Stablecoins are exposed to runs

The second structural flaw is the purported stability of stablecoins, which the entire crypto ecosystem has relied on to underpin trading in cryptoassets and liquidity provision in DeFi markets[13].

Although stablecoins represent only a small part of the cryptoasset market[14], crypto trading using Tether, the largest stablecoin, accounts for close to half of all trading on cryptoasset trading platforms (Chart 4)[15].

Stablecoins appeal to users because it is claimed that, unlike unbacked cryptos, they provide stability by having their value tied to a portfolio of assets – known as 'reserve assets' – against which stablecoin holdings can be redeemed[16]. Algorithmic stablecoins, meanwhile, aim to match supply and demand to maintain a stable value.

But the recent crypto crash has highlighted that – without sound regulation – stablecoins are stable in name only.

Digital innovation cannot, for example, build stable values on the basis of codes and mechanisms of dependency. This was the key takeaway from the collapse of the algorithmic stablecoin TerraUSD[17], which lost its peg to the US dollar in May and has since been trading for less than 10 US cents[18].

Tether also temporarily lost its peg amid the ensuing market stress[19]. This showed that, even for collateralised stablecoins, risks cannot be eliminated easily[20]. Without public backing[21], the risks of contagion and runs are widespread and the liquidation of part of the reserve assets can have procyclical effects and further reduce the value of the remaining reserve assets. These risks are magnified when the composition of the reserve assets is concealed.

Overall, this scramble for stability and the shortcomings of stablecoins underscore the importance of a settlement asset that maintains its value under stressed conditions. In the absence of a risk-free digital anchor, which only digital central bank money can provide, stablecoins represent an overambitious attempt to create a risk-free digital asset backed by risky assets.

Crypto markets are highly leveraged and interconnected

The third structural weakness is the fact that crypto markets may have incredibly high leverage and interconnections. This creates strong procyclical effects, given the lack of shock absorption capacity.

Crypto exchanges allow investors to increase exposures by up to 125 times the initial investment. As a result, when shocks hit and deleveraging is needed, they are forced to shed assets, putting strong downward pressure on prices.

These procyclical effects are exacerbated by the pervasive over-collateralisation adopted in DeFi lending to compensate for the risks posed by anonymous borrowers[22].

Moreover, funds borrowed in one instance can be reused as collateral in subsequent transactions, allowing investors to build large exposures. Shocks can propagate rapidly across collateral chains and are amplified by positions liquidated automatically using smart contracts.

These are precisely the dynamics we have seen at work in the recent crypto failures, which have sent shockwaves throughout the crypto universe, including in DeFi markets[23] used to build leverage[24].

The inadequate governance of crypto firms has magnified these structural flaws. Insufficient transparency and disclosure, the lack of investor protection, and weak accounting systems and risk management were blatantly exposed by the implosion of FTX[25].

Following this event, cryptoassets may move away from centralised to decentralised exchanges, creating new risks owing to the absence of a central governance body[26].

The destiny of digital finance

These fundamental flaws have led many to predict the demise of cryptoassets. But these flaws alone are unlikely to spell the end of cryptos, which will continue to attract investors looking to gamble.

Gambling is perhaps the second oldest profession in the world. It has been traced back to ancient China, Greece and Rome. People have always gambled in different ways: casting lots, rolling dice, betting on animals or playing cards. And in the digital era I expect them to continue gambling by taking speculative positions on cryptoassets.

We therefore need to mitigate the risks, while harnessing the innovative potential of digital finance beyond cryptos. There are two elements to this.

Regulating cryptoassets

The first is to regulate cryptoassets and ensure that they do not benefit from preferential treatment compared with other assets[27].

The recent failures of crypto entities do not seem to have had a material impact on the financial sector. But they have highlighted the immense potential for economic and social damage if we leave cryptos unchecked[28]. And the links between the crypto market and the financial system may become stronger, especially as major tech companies enter the sector.

That is why we now need – urgently – to regulate cryptoassets. It is crucial that the regulatory frameworks currently in the legislative process quickly enter into force and start being implemented so that words can be followed by deeds.

Addressing financial risks

Regulators must walk a tightrope. For one, they need to build guardrails to tackle regulatory gaps and arbitrage. But they also need to avoid legitimising unsound crypto models and refrain from socialising the risks through bailouts[29].

Regulatory efforts should primarily be directed at preventing the use of cryptoassets as a way of circumventing financial regulation. The principle of 'same functions, same risks, same rules' applies regardless of technology. This should be coupled with measures to ensure that the risks of cryptoassets are clear to all.

Potential buyers should be fully aware of the risks they take when buying cryptos and the services surrounding them[30]. Gambling activities should be treated as such. The other task is to shield the mainstream financial system from crypto risks, notably by segregating any crypto-related activities of supervised intermediaries.

The EU's Regulation on Markets in Crypto-Assets (MiCA) is leading the way in building a comprehensive regulatory framework. MiCA will regulate stablecoins, cryptoassets other than stablecoins, and cryptoasset service providers. It will subject stablecoin issuers of e-money tokens[31] and asset-referenced tokens[32] to licensing and supervision.

And it will regulate the reserve assets backing stablecoins in order to contain their risks. In turn, the regulation requires that buyers of cryptoassets are informed about the inherent risks involved. It is crucial that the regulation enters into force as soon as possible[33].

Looking ahead, the regulation of crypto activities will have to be adapted to the continuous evolution of crypto risks. Given the time needed to design and apply new legislation, it is important to empower regulators, overseers and supervisors to adjust their instruments to keep pace with market and technological developments.

The ECB is not responsible for regulating investment activities. But we are responsible for overseeing European payment systems, and we have already taken action in this field. Our oversight framework for payment instruments, schemes and arrangements – the PISA framework – that was launched last year addresses the risks of stablecoins and other cryptoassets for payment systems.

Since cryptoassets know no borders, their regulatory framework must be global. This requires rapid implementation of the Financial Stability Board's recommendations to make the regulatory, supervisory and oversight approaches to crypto activities consistent and comprehensive across different countries[34].

Swift progress is also needed to finalise the Basel Committee on Banking Supervision's framework for the prudential treatment of banks' cryptoasset activities.

Addressing and internalising social risks

Authorities also need to address the significant social costs of cryptoassets, such as tax evasion, illicit activities and their environmental impact[35]. The use of cryptoassets for money laundering and terrorist financing could be prevented by applying the standards set by the Financial Action Task Force[36].

The other task is to ensure that the taxation of cryptoassets is harmonised across jurisdictions and consistent with how other instruments are taxed[37].

In Europe, given the negative externalities that crypto activities can generate across multiple member states, the EU should introduce a tax levied on crossborder crypto issuers, investors and service providers. This would generate revenues that can be used to finance EU public goods that counter the negative effects of cryptoassets[38].

Such a tax could, for example, address the high energy and environmental costs associated with some crypto-mining and validation activities. This would be in line with the current EU priorities to address climate change and ensure energy security[39]. Cryptoassets deemed to have an excessive ecological footprint should also be banned[40].

Balancing innovation and stability: an anchor for digital finance

But even regulation would not be enough to provide a stable basis for digital finance. The second factor at play here is that, in order to harness the opportunities offered by technological innovation, we need to give digital finance – like other forms of finance – an anchor of stability in the form of a digital risk-free asset.

Only central bank money can provide an anchor of stability

Some commentators are of the view that adequate regulation would allow stablecoins to provide such a risk-free asset. This is a misconception.

Stablecoins invest their reserve assets in market instruments, which inevitably exposes them to several risks: liquidity, credit, counterparty and operational risks. Prudent investment policies can reduce but not eliminate such risks. The riskiness of stablecoins will over time lead to them being traded at variable prices, making them unsuitable as risk-free assets.

Risks could theoretically be eliminated by allowing full-reserve – or narrow – stablecoins to hold their reserve assets entirely in the form of risk-free deposits at the central bank. This would avoid custody and investment risks for stablecoins and underpin their commitment to reimburse coin holders at par value at all times.

But other fundamental problems would then emerge. In fact, this would be tantamount to outsourcing the provision of central bank money. It could even threaten monetary sovereignty if a stablecoin were to largely displace sovereign money. And narrow stablecoins could divert sizeable deposits away from banks, with potential adverse consequences for the financing of the real economy[41].

Only central bank money can provide an anchor of stability. The solution is to extend today's two-tier monetary system into the digital age. This system is built on the complementary roles of central bank money and commercial bank money.

Central bank money is currently available for retail use in only physical form – cash. But the digitalisation of payments is eroding the role of cash and its ability to provide an effective monetary anchor. Central bank digital currencies would instead preserve the use of public money for digital retail payments.

By offering a digital, risk-free common denominator, a central bank digital currency would facilitate convertibility among different forms of private digital money. It would thus preserve the singleness of money and protect monetary sovereignty. The ECB is working on a digital euro precisely for these reasons[42].

To preserve its crucial role, public money must also continue to be used as a settlement asset for wholesale financial transactions[43]. The Eurosystem currently provides settlement in central bank money for wholesale transactions with its TARGET services. And we are exploring what would happen if new technologies were to be widely adopted by the financial industry. Whether such a scenario will materialise is uncertain, but we must be ready to respond if it does.

Our response may include making central bank money available for wholesale transactions on one or more distributed ledger technology platforms, or creating a bridge between market DLT platforms and existing central bank infrastructures[44].

By ensuring that the role of central bank money as the anchor of the payment system is preserved for both retail and wholesale transactions, central banks will safeguard the trust on which private forms of money ultimately depend.

Conclusion

Born in the depths of the global financial crisis, cryptoassets were portrayed as a generational phenomenon, promising to bring about radical change in how we pay, save and invest. Instead, they have become the bubble of a generation. It is now obvious to everyone that the promise of easy crypto-money and high returns was a bubble doomed to burst. It turns out that cryptoassets are not money. Many are just a new way of gambling.

There is an urgent need globally for regulation to protect consumers from the risks of cryptoassets, define minimum requirements for crypto firms' risk management and corporate governance, and reduce the run and contagion risks of stablecoins. We should also tax cryptoassets according to their social costs.

But regulation will not turn risky instruments into safe money. Instead, a stable digital finance ecosystem requires well-supervised intermediaries and a risk-free and dependable digital settlement asset, which only digital central bank money can provide. ■

Fabio Panetta is a member of the ECB's Executive Board

Endnotes

1. Panetta, F (2022), "For a few cryptos more: the Wild West of crypto finance", speech at Columbia University, New York, 25 April.

2. A complex, interlinked but mostly unregulated crypto ecosystem of miners, wallets, tumblers and exchanges has developed, and a range of ancillary crypto services mimicking traditional financial services have come to the fore in the form of decentralised finance (DeFi). With DeFi it is now possible, for example, to lend, borrow and earn returns when "staking" or "yield farming" cryptoassets.

3. As Warren Buffett famously noted, "only when the tide goes out do you discover who's been swimming naked".

4. For example, transactions involving bitcoins are lengthy procedures, and the number of operations that can be completed over a specific period of time is comparatively very limited.

5. For example, producing and trading bitcoin alone wastes huge amounts of energy: the equivalent of the entire annual electricity consumption of a country that has millions of inhabitants, like Belgium. See Cambridge Bitcoin Electricity Consumption Index.

6. Europol notes that the illicit use of cryptoassets is predominantly associated with money laundering purposes, the (online) trade of illicit goods and services, and fraud. See Europol (2021), "Cryptocurrencies: Tracing the evolution of criminal finances", Europol Spotlight Report series. Chainalysis estimates that the amounts of cryptoassets exchanged for criminal purposes exceeded USD 15 billion in 2021 and notes that criminal activity appears to be more resilient in the face of price declines, with illicit volumes down just 15%, year on year, in the first half of 2022, compared with 36% for legitimate volumes. In the case of hacking, the value stolen was even higher in the first half of 2022 compared to the first half of 2021. See Chainalysis (2022), "Mid-year Crypto Crime Update: Illicit Activity Falls With Rest of Market, With Some Notable Exceptions", August. Chainalysis estimates are conservative. Europol emphasises that "estimations from Chainalysis are based on their own attribution datasets where transactions are tagged as illicit whenever linked to clearly illicit activities, such as the ones from and to dark web marketplaces and ransomware clusters. It is important to highlight that these figures are affected by a significant intelligence gap related to a lower level of detection of some criminal *activities, including frauds and money laundering" (see Europol (2021), op. cit.). Academic research suggests that as much as around 23% of all bitcoin transactions in the period 2009-17 were associated with criminal activities. For more details, see Foley, S, Karlsen, JR and Putniņš, TJ (2019), "Sex, Drugs, and Bitcoin: How much illegal activity is financed through cryptocurrencies?", Review of Financial Studies, Vol. 32, No 5, May, pp. 1798-1853. Finally, the Financial Action Task Force reports that variations in identified illicit bitcoin transactions from 2016 to 2020 range between 0.6% and 9.9% (relative to the number of transactions); see Financial Action Task Force (2021), "Second 12-Month Review of the Revised FATF Standards on Virtual Assets and Virtual Assets Service Providers", July.*

7. Examples of financial flows are dividends for stocks, coupon payments for bonds, and rental payments for real estate.

8. Johnson, S (2022), "First US bitcoin ETF loses record amount in its initial year", Financial Times, 26 October.

9. For instance, the hack on the Binance chain initially concerned coins worth USD 570 million and the hack on FTX soon after bankruptcy reached a value of more than USD 300 million; see Shukla, S (2022), "FTX Hacker Emerges as 35th Largest Holder of Token Ether", Bloomberg, 16 November. There have also been several cases of crypto-asset holders losing all their savings after losing their wallet passwords.

10. A survey showed that one-third of crypto-asset investors know little or nothing about these assets. See Cardify (2021), "All Aboard The Crypto Train: Who Are The Latest Crypto Investors?", February.

11. Satoshi Nakamoto was in fact open about this when saying the following about bitcoin in 2009: "It might make sense just to get some in case it catches on. If enough people think the same way, that becomes a self-fulfilling prophecy."

12. Bitcoin has generated more greed and enthusiasm among inexperienced investors than any other unbacked cryptoassets.

13. See the section entitled "Stablecoins' role within the crypto-asset ecosystem" in Adachi, M et al (2022), "Stablecoins' role in crypto and beyond: functions, risks and policy", Macroprudential Bulletin, ECB.

14. Less than 10% of the total crypto-asset market at present.

15. In September 2022.

16. These are collateralised stablecoins.

17. Holders could redeem USD 1 of Terra for USD 1 worth of the crypto-asset Luna, which would be issued to meet demand.

18. TerraUSD's market capitalisation fell from around USD 18 billion to less than USD 2 billion and, as at 30 November 2022, stood at just USD 209 million.

19. The price of Tether came under pressure amid the crypto market stress, with the largest stablecoin temporarily losing its peg on 12 May. Since then, Tether has seen outflows of more than €8 billion, which is equivalent to almost 10% of its market capitalisation.

20. Their liabilities are liquid and redeemable on demand, but their assets are longer term and less liquid.

21. Such as adequate regulation, public insurance and/or access to central bank liquidity.

22. The use of collateral helps align the incentives of the borrower and lender in markets with high asymmetric information. At the same time, the volume of lending is directly influenced by the dynamics of the price of collateral: it would typically increase in booms (when asset prices are high) and decrease in busts (when the value of collateral is lower). See Aramonte, S et al (2022), "DeFi lending: intermediation without information?" BIS Bulletin, No 57, Bank for International Settlements, 14 June.

23. For example: after the crash of the stablecoin TerraUSD in early May, TVL in DeFi fell by almost 40% or €80 billion, with credit and staking protocols suffering the biggest decreases.

24. For instance, FTX and Alameda Research were highly intertwined with the latter reported to have faced severe losses from leveraged positions related to the TerraUSD crash. On 28 November 2022 the crypto lender BlockFi filed for bankruptcy given the close connections to FTX.

25. The new CEO appointed following FTX's filing for bankruptcy stated in his declaration in support of the bankruptcy petition: "Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented".

26. *Shukla, S, Kharif, O and Ossinger, J (2022), "Billions of Dollars Flee to Crypto's Decentralized Roots After FTX Collapse", Bloomberg, 18 November.*
27. *See, for instance, Panetta, F (2022), op. cit.*
28. *For instance, Visa had announced in October 2022 that FTX-branded Visa debit cards would be linked directly to a user's FTX account to enable card holders to use cryptos to fund purchases at merchants. This agreement with FTX has since been terminated and the debit card programme is being wound down.*
29. *See Cecchetti, S and Schoenholtz, K (2022), "Let crypto burn", Financial Times, 17 November. The authors call for not even bringing cryptos under a regulatory framework to avoid the perception of any public support in a stress event, like a run on a crypto provider, such as FTX.*
30. *See the warning issued jointly by European Supervisory Authorities on the risks of cryptoassets for consumers.*
31. *E-money tokens aim at stabilising their value by referencing only one official currency.*
32. *Asset-referenced tokens refer to all other cryptoassets than e-money tokens whose value is backed by assets.*
33. *Market participants should already take into account prospective requirements, such as consumer risk information or the need for transparent and segregated reserves that can withstand stress.*
34. *Financial Stability Board (2022), "FSB proposes framework for the international regulation of crypto-asset activities", press release, 11 October.*
35. *The social value of cryptoassets may be negative as their opaqueness and lack of scrutiny makes them prone to tax evasion, money laundering, terrorist financing and the circumvention of sanctions, while they consume considerable amounts of energy, especially when relying on proof-of-work. For example, Digiconomist estimates that one Bitcoin transaction (using proof-of-work) has a carbon footprint equivalent to that of 804,367 Visa transactions. Following the recent switch to the proof-of-stake method, Digiconomist estimates the carbon footprint of one Ethereum transaction to be equivalent to that of 22 Visa transactions.*
36. *Financial Action Task Force (2022), "Targeted Update on Implementation of the FATF Standards on Virtual Assets and Virtual Asset Service Providers", June.*

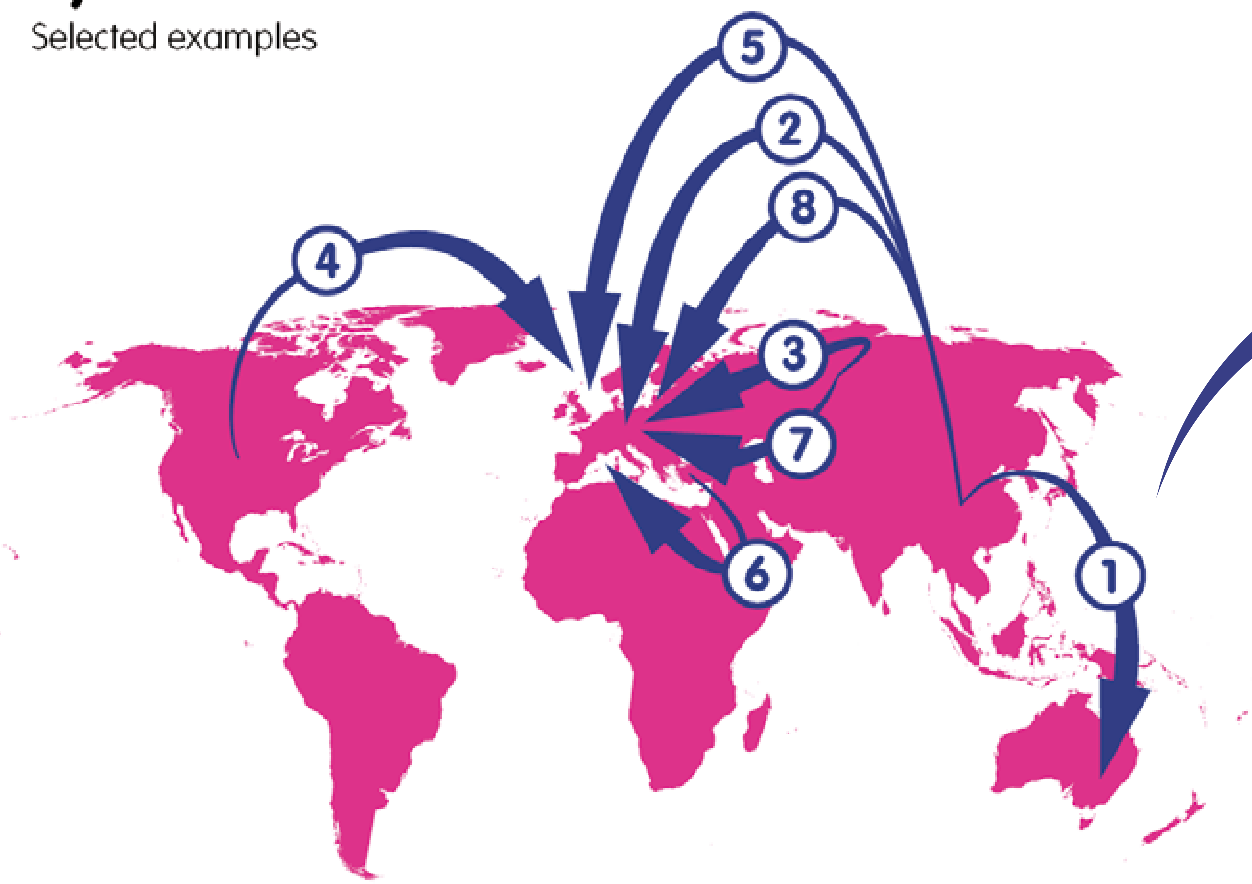
37. The OECD recently approved a Crypto-Asset Reporting Framework (CARF) which provides for the standardised reporting of tax information on transactions in cryptoassets and could help address the tax aspect.
38. See Panetta, F (2022), "Investing in Europe's future: The case for a rethink", speech at Istituto per gli Studi di Politica Internazionale (ISPI), Milan, 11 November.
39. See Panetta, F (2022), "Greener and cheaper: could the transition away from fossil fuels generate a divine coincidence?", speech at the Italian Banking Association, Rome, 16 November.
40. For now, the nearly final EU Regulation on Markets in Crypto-Assets (MiCA) includes a first step by mandating a follow-up on the environmental impact of proof-of-work.
41. Moreover, lenders might find it more attractive to put their money in stablecoin issuers instead of the overnight repo market, impairing market liquidity and amplifying run risks in times of stress.
42. See Panetta, F (2021), "The present and future of money in the digital age", lecture at Federcasse's Lectiones cooperativae, Rome, 10 December.
43. Panetta, F (2022), "Demystifying wholesale central bank digital currency", speech at the Deutsche Bundesbank's Symposium on "Payments and Securities Settlement in Europe – today and tomorrow", Frankfurt am Main, 26 September.
44. Proposed initiatives include DLT-based securities settlement in central bank money.

Annexe 1
Link to slides illustrating the speech can be found here.

I would like to thank Cyril Max Neumann, Patrick Papsdorf and Jean-Francois Jamet for their help in preparing this speech and Alessandro Giovannini, Antonella Pellicani, Pedro Bento Pereira Da Silva, Mirjam Plooij, Anders Ryden, Jürgen Schaaf and Anton Van der Kraaij for their input and comments. This article is based on a keynote speech delivered at the Insight Summit held at the London Business School, December 2022.

The EU is increasingly threatened by economic coercion

Selected examples



1. Chinese curb on Australian exports to push back against an investigation into the origins of covid-19 (2020)
2. Chinese threat of car tariffs to pressure Germany into accepting Huawei's 5G infrastructure (2019)
3. Russian ban on Polish imports of fruit and vegetables following EU sanctions over the war in Ukraine (2014)
4. US threat of section 301 tariffs to prevent France and other European countries from levying taxes on digital services (2020)
5. Chinese 'popular boycott' of EU companies (such as Adidas and H&M) following EU sanctions on Chinese officials involved in human rights violations in Xinjiang (2021)
6. Turkish boycott of French-labelled goods following President Emmanuel Macron's announcement of policies to combat extremism (2020)
7. Russian threat to ban Czech beer imports following Czech government's declaration of links between Russian intelligence services and the 2014 Czech warehouse explosions (2021)
8. Reported Chinese suspension of rail freight to Lithuania and block on export permits for Lithuanian producers in reaction to the announcement that a Taiwanese Representative Office would open in Lithuania (2020)

9

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What can we learn?

Lael Brainard considers the lessons learned from the pandemic, supply shocks, inflation, and the challenges for monetary policy

Policymakers and researchers have begun reassessing certain features of the economy and monetary policy in light of recent experience. After several decades in which supply was highly elastic and inflation was low and relatively stable, a series of supply shocks associated with the pandemic and Russia's war against Ukraine have contributed to high inflation, in combination with a very rapid recovery in demand.

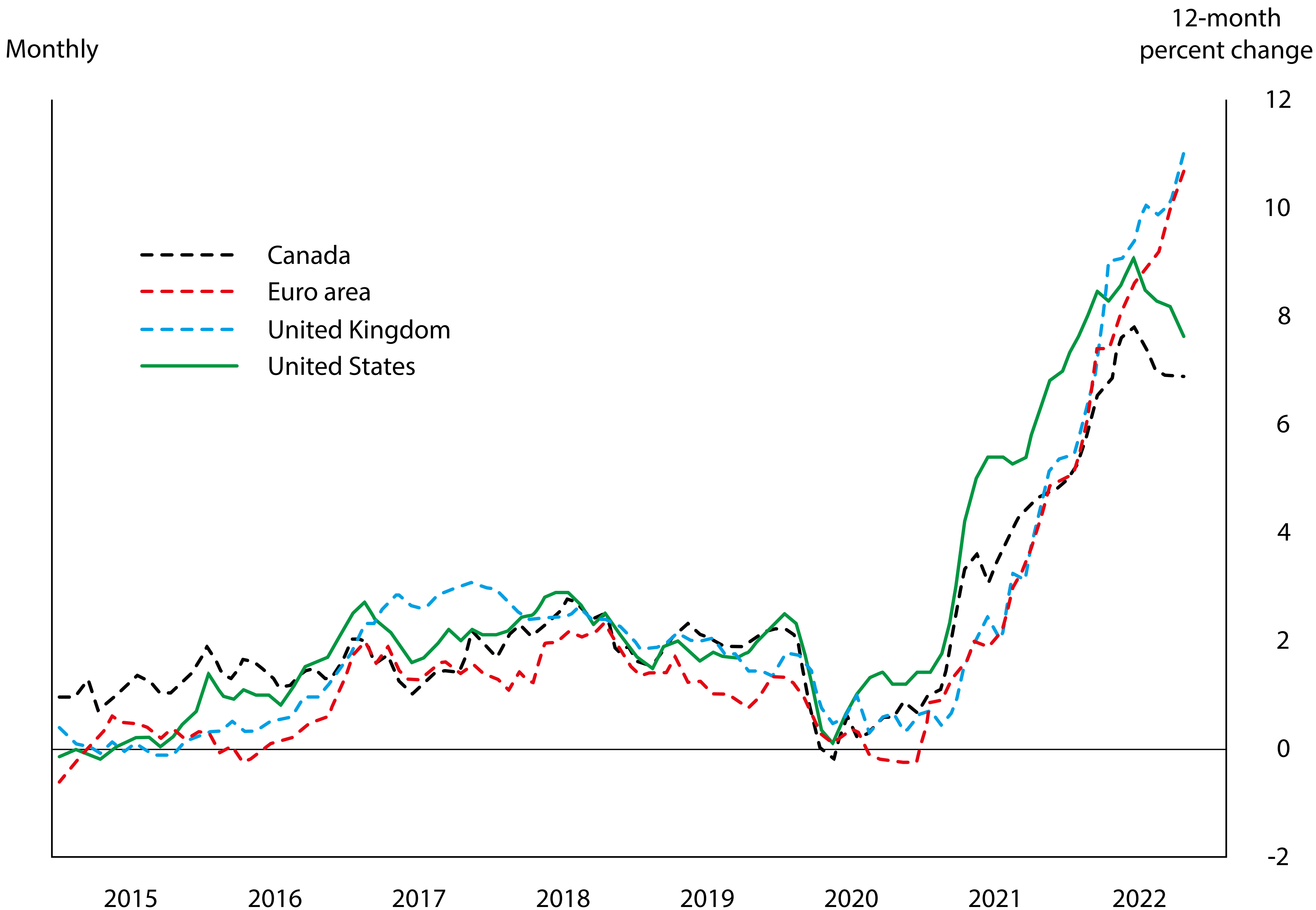
The experience with the pandemic and the war highlights the challenges for monetary policy in responding to a protracted series of adverse supply shocks. In addition, to the extent that the lower elasticity of supply we have seen recently could become more common due to challenges such as demographics, deglobalization, and climate change, it could herald a shift to an environment characterized by more volatile inflation compared with the preceding few decades[1].

Inflation in the United States and many countries around the world is very high (Figure 1). While both demand and supply are contributing to high inflation, it is the relative inelasticity of supply in key sectors that most clearly distinguishes the pandemic- and war-affected period of the past three years from the preceding 30 years of the Great Moderation[2].

Interestingly, inflation is broadly higher throughout much of the global economy, and even jurisdictions that began raising rates forcefully in 2021 have not stemmed the global inflationary tide[3].

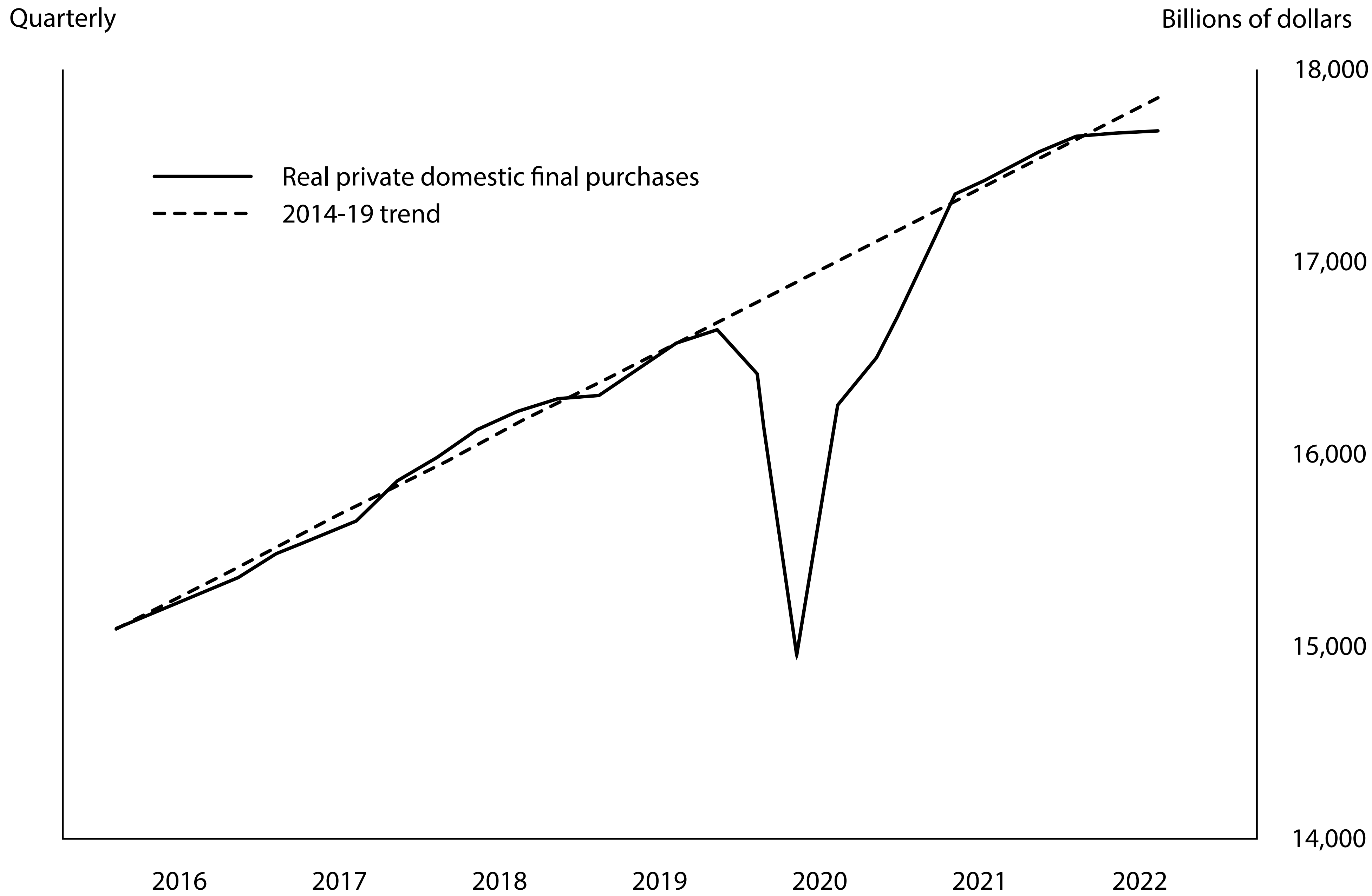
In the United States, as a result of significant fiscal and monetary support, the level of private domestic final purchases recovered extremely rapidly in 2020 and 2021 to levels consistent with the pre-pandemic trend before moving below trend in 2022 (Figure 2).

Figure 1. Headline inflation for selected countries



Note: Data go through October 2022.
Source: Haver Analytics.

Figure 2. Real private domestic final purchases



Note: Data go through October 2022:Q3.
Source: Bureau of Economic Analysis.

Although demand came in near the pre-pandemic trend on an aggregate level, the pandemic induced a shift in composition that concentrated large increases in demand in certain sectors where the supply response was constrained.

It is vital for monetary policy to keep inflation expectations anchored, because inflation expectations shape the behaviour of households, businesses, and workers and enter directly into the inflation process

The shift in consumption from services to goods was so pronounced that—despite plunging at the onset of the pandemic in March 2020—real spending on goods had already risen nearly 4 percent above its pre-pandemic trend by June of that year.

While a very slow rotation back toward pre-pandemic patterns of consumption has been under way for over a year, it remains incomplete more than two and a half years after the initial shutdown: in the most recent data, the level of goods spending remains 6 percent above the level implied by its pre-pandemic trend, while services spending remains a little more than 2 percent below its pre-pandemic trend (Figure 3).

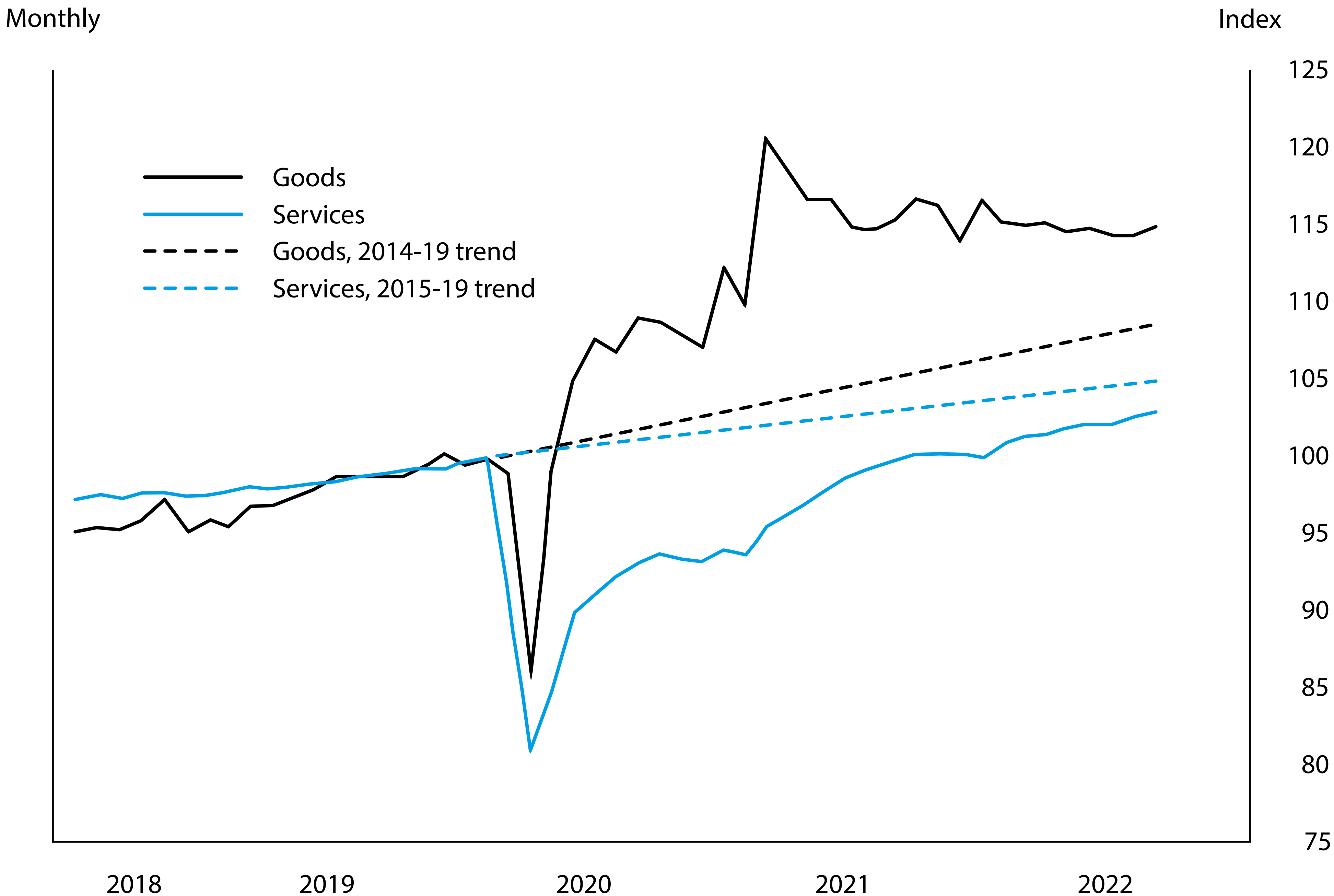
The supply shocks to goods, labour, and commodities have been accompanied by unusually high volatility in monthly inflation readings since the beginning of the pandemic. Since March 2020, the standard deviation of month-over-month core inflation has been 0.22 percentage point—a level of variation not seen in a 31-month period since the 1970s and more than double the standard deviation in monthly core inflation from 1990 to 2019.

The initial drivers of this high variation in monthly core inflation readings were a sharp drop in prices and subsequent bounceback in the first months of the pandemic, followed by a couple of bursts lasting three to four months each.

The first burst occurred around reopening in the spring of 2021, and the second occurred amid the effects of the Delta and Omicron COVID-19 variants in the autumn of 2021 (Figure 4)[4].

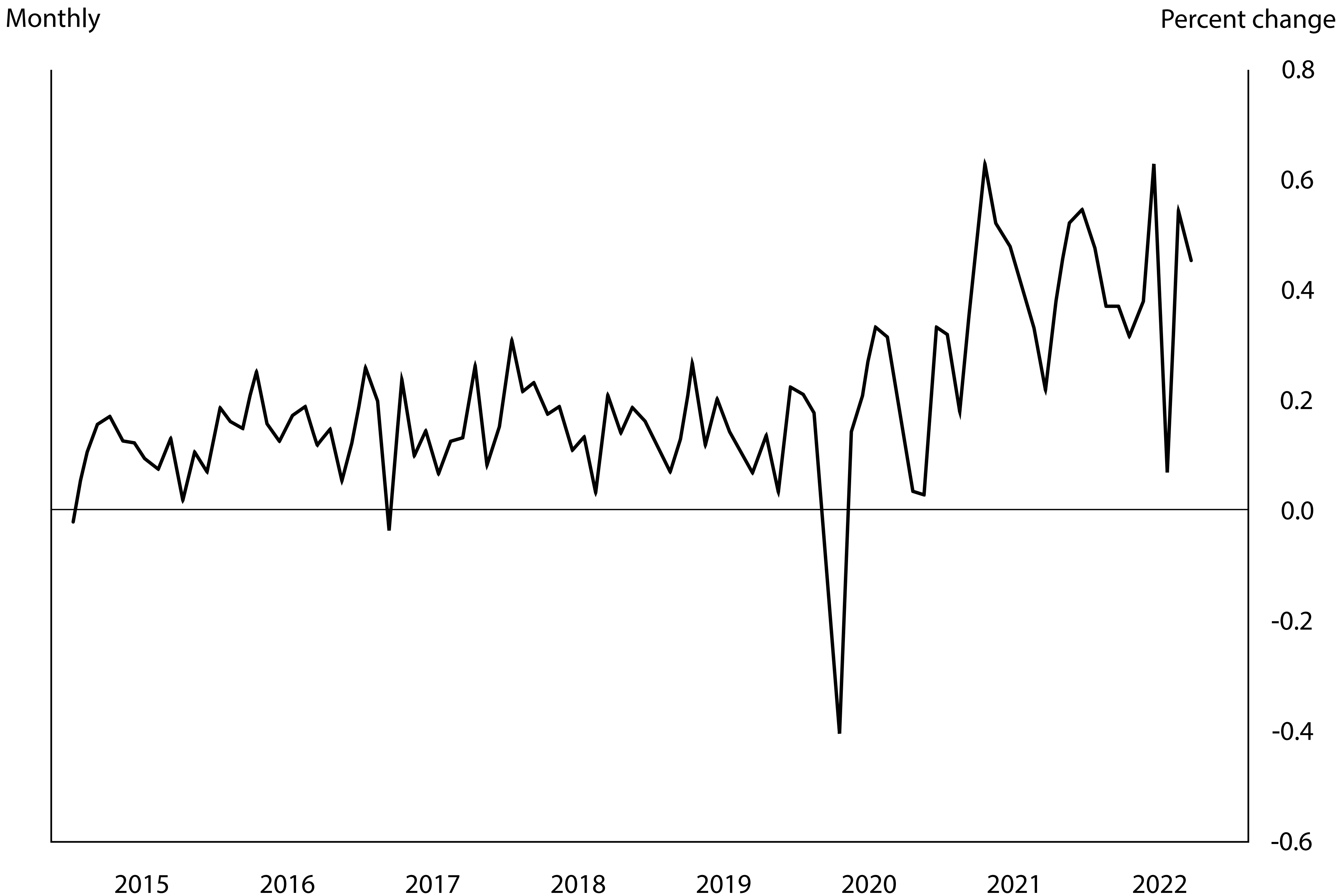
The evidence suggests that high concentrations of demand in sectors such as appliances, housing, and motor vehicles—where supply was constrained by the effects of the pandemic—played an important role initially in generating inflationary pressures.

Figure 3. Real personal consumption expenditures



Note: Data go through September 2022.
Source: Bureau of Economic Analysis.

Figure 4. PCE monthly inflation less food and energy



Note: Data go through September 2022. PCE is personal consumption expenditures.
Source: Bureau of Economic Analysis.

Acute constraints on shipping and on the supply of non-substitutable intermediate inputs like semiconductors were compounded by acute constraints on labour supply associated with the effects of the Delta and Omicron variants and later compounded further by sharp commodities supply shocks associated with Russia's war on Ukraine.

The standard monetary policy prescription is to 'look through' supply shocks, such as commodities price shocks or shutdowns of ports or semiconductor plants, that are not assessed to leave a lasting imprint on potential output[5].

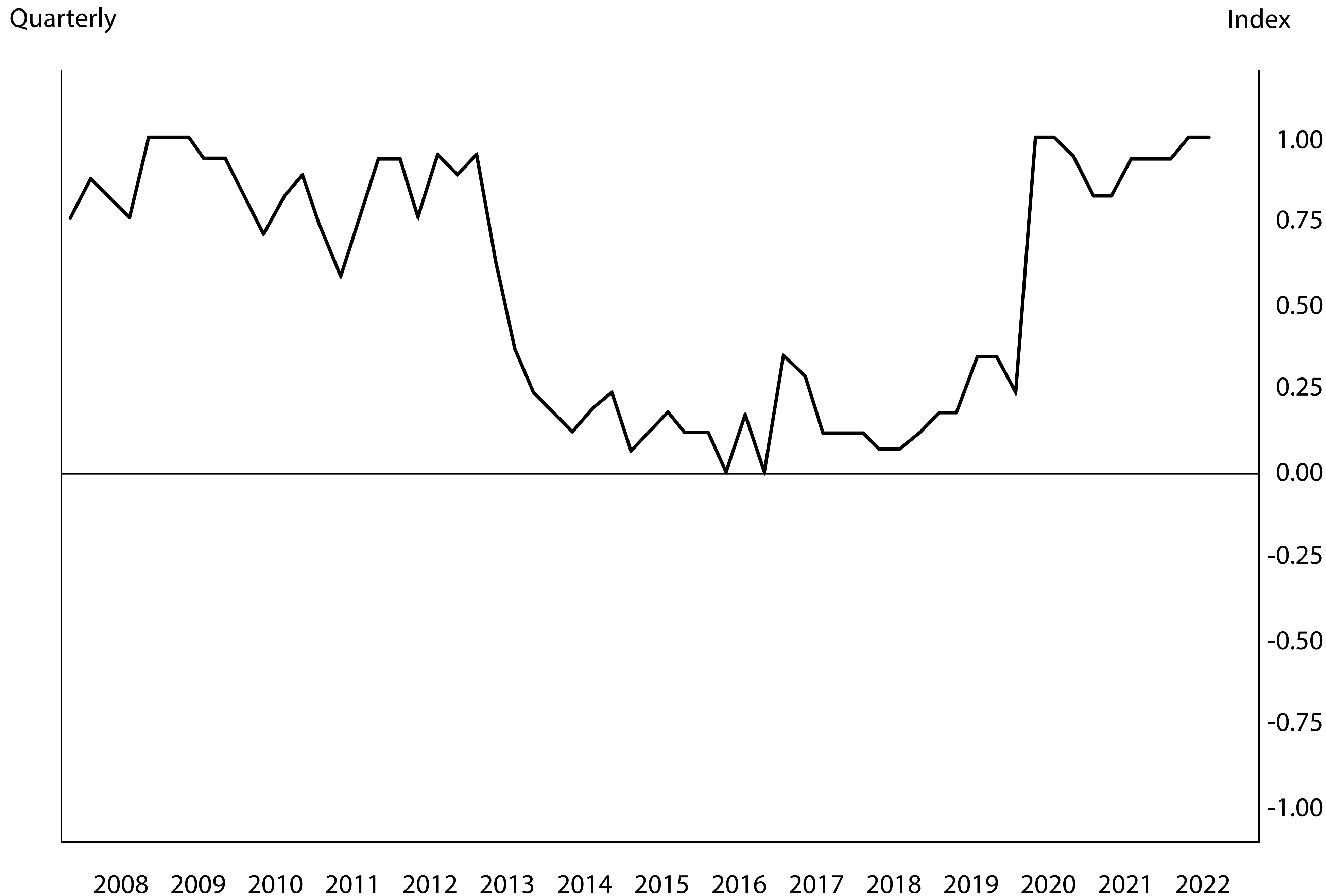
In contrast, if supply shocks durably lower potential output such that the economy is operating above potential, monetary policy tightening is necessary to bring demand into alignment with the economy's reduced productive capacity. Importantly, and separately from the implications for potential output, monetary policy should respond strongly if supply shocks risk de-anchoring inflation expectations[6].

Although these tenets of monetary policy sound relatively straightforward in theory, they are challenging to assess and implement in practice. It is difficult to assess potential output and the output gap in real time, as has been extensively documented by research[7].

This is especially true in an environment of high uncertainty. The level of uncertainty around the output gap varies considerably over time, and research suggests that more muted policy reactions are warranted when uncertainty about the output gap is high[8].

The unexpectedly long-lasting global pandemic and the sharp disruptions to commodities associated with Russia's war against Ukraine have contributed to substantial uncertainty (Figure 5).

Figure 5. Diffusion index of FOMC participants' uncertainty assessments for GDP growth



Note: Data go through 2022:Q3. FOMC is Federal Open Market Committee; GDP is gross domestic product.
Source: Federal Reserve Board.

Even so, the drawn-out sequence of shocks to the supply of labour, commodities, and key intermediate inputs, such as semiconductors, blurred the lines about what constitutes a temporary shock as opposed to a persistent shock to potential output.

Even when each individual supply shock fades over time and behaves like a temporary shock on its own, a drawn-out sequence of adverse supply shocks that has the cumulative effect of constraining potential output for an extended period is likely to call for monetary policy tightening to restore balance between demand and supply.

In addition, a protracted series of supply shocks associated with an extended period of high inflation—as with the pandemic and the war—risks pushing the inflation expectations of households and businesses above levels consistent with the central bank's long-run inflation objective[9].

It is vital for monetary policy to keep inflation expectations anchored, because inflation expectations shape the behaviour of households, businesses, and workers and enter directly into the inflation process.

In the presence of a protracted series of supply shocks and high inflation, it is important for monetary policy to take a risk-management posture to avoid the risk of inflation expectations drifting above target. Even in the presence of pandemics and wars, central bankers have the responsibility to ensure that inflation expectations remain firmly anchored at levels consistent with our target.

In monitoring inflation expectations for purposes of risk management, not only the median but also the distribution of inflation expectations can provide important information about how inflation expectations may be changing[10].

Survey measures suggest that the median of longer-term inflation has remained within pre-pandemic ranges consistent with 2 percent inflation (Figure 6). However, starting in 2021, there has been a greater dispersion than usual of views about future inflation in survey responses, as shown in Figure 6.

Although initially the increased dispersion reflected a rise in expectations for significantly above-target inflation, more recently, following substantial cumulative monetary policy tightening, the increased dispersion has also reflected increased expectations of no inflation or even disinflation.

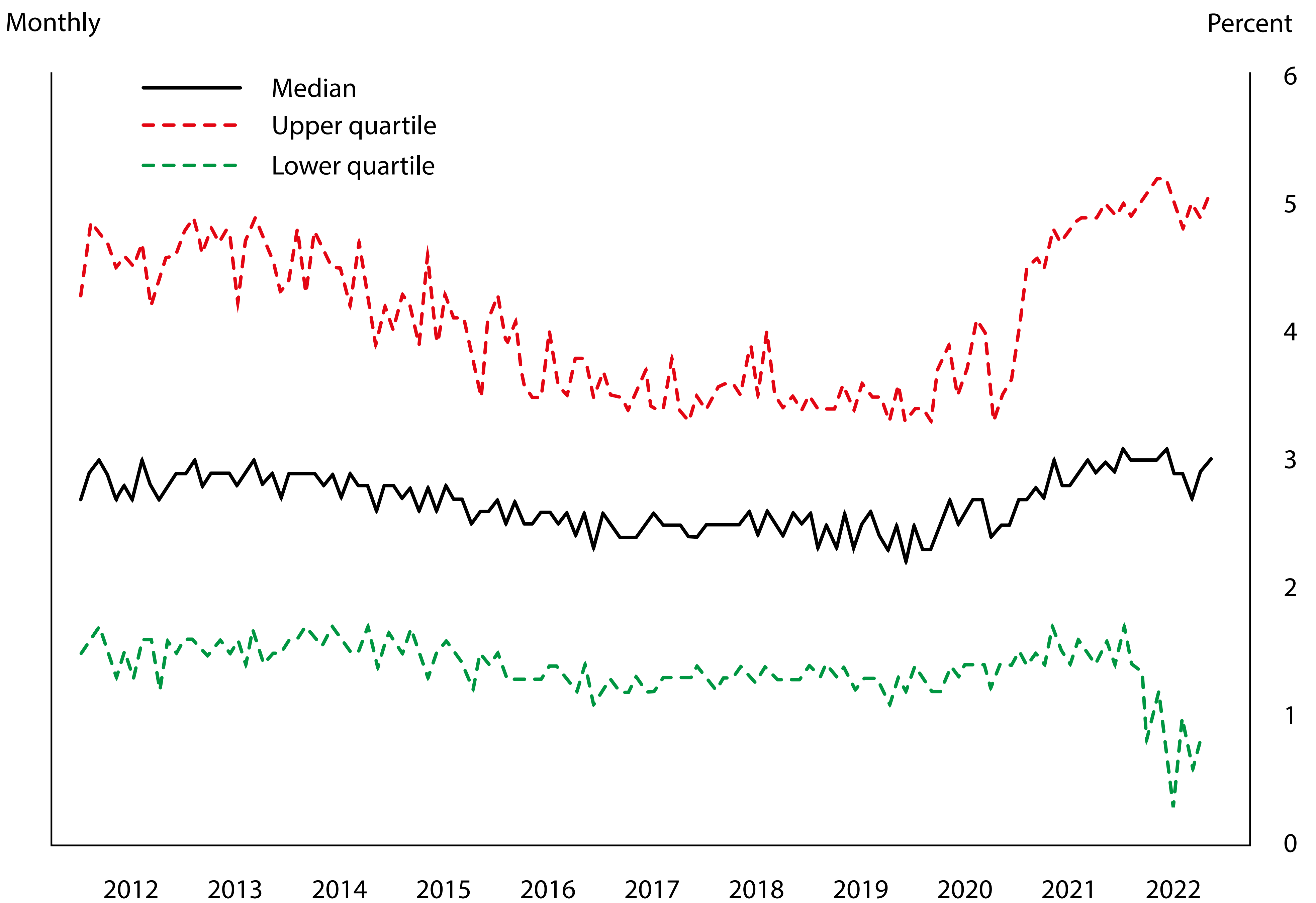
About one-fourth of respondents to the most recent University of Michigan Surveys of Consumers anticipate that prices are likely to be the same or below their current level 5 to 10 years in the future—roughly three times the average fraction that reported such expectations before the pandemic.

Finally, it is important to explore whether any features of the inelastic supply response associated with the pandemic and the war may have implications for potential growth and macroeconomic stability in the future[11].

In particular, despite the unprecedented pandemic policy support for businesses of all sizes that was directed at preserving the supply side of the economy, key sectors struggled to ramp up activity after reopening. The supply response was particularly impaired in sectors where supply chains are geographically fragmented and recurring foreign COVID-19 lockdowns have reduced the reliability of foreign supplies.

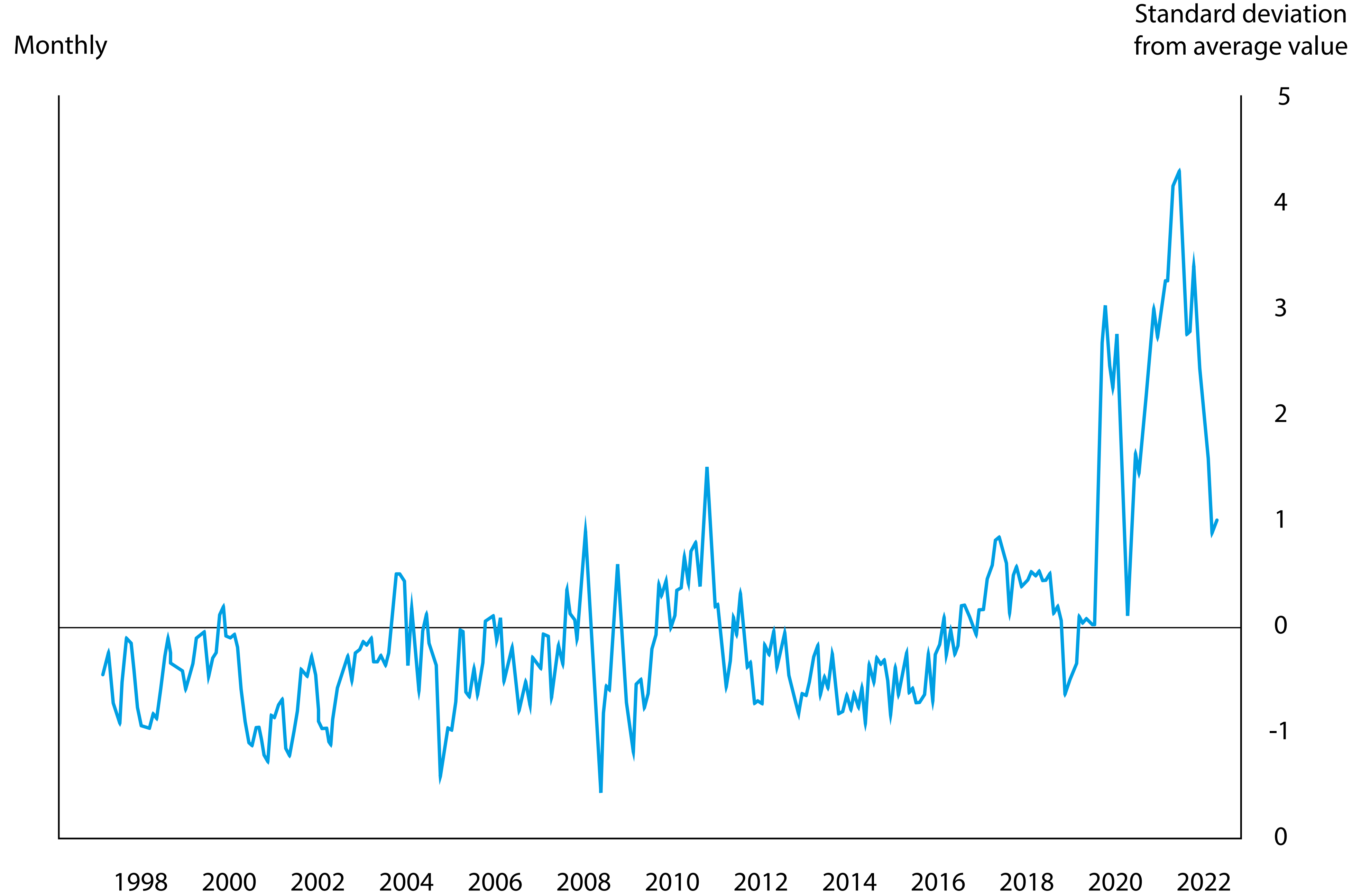
While conditions have improved dramatically from some of the worst periods in 2021, measures like the Global Supply Chain Pressure Index from the Federal Reserve Bank of New York indicate that total supply chain pressures still are elevated relative to pre-pandemic levels (Figure 7).

Figure 6. Expected price change, next 5 to 10 years



Note: Data go through November 2022.
Source: University of Michigan surveys of consumers.

Figure 7. Global supply chain pressure index



Note: Data go through October 2022.
Source: Federal Reserve Bank of New York.

The supply disruptions in key goods and commodities sectors associated with the pandemic and Russia's war against Ukraine have highlighted the fragility of global supply chains and the risks of inelastic supply at moments of stress. Conditions have improved dramatically over the past year, judging by the return of the ISM Supplier Deliveries index to its pre-pandemic range of values (Figure 8).

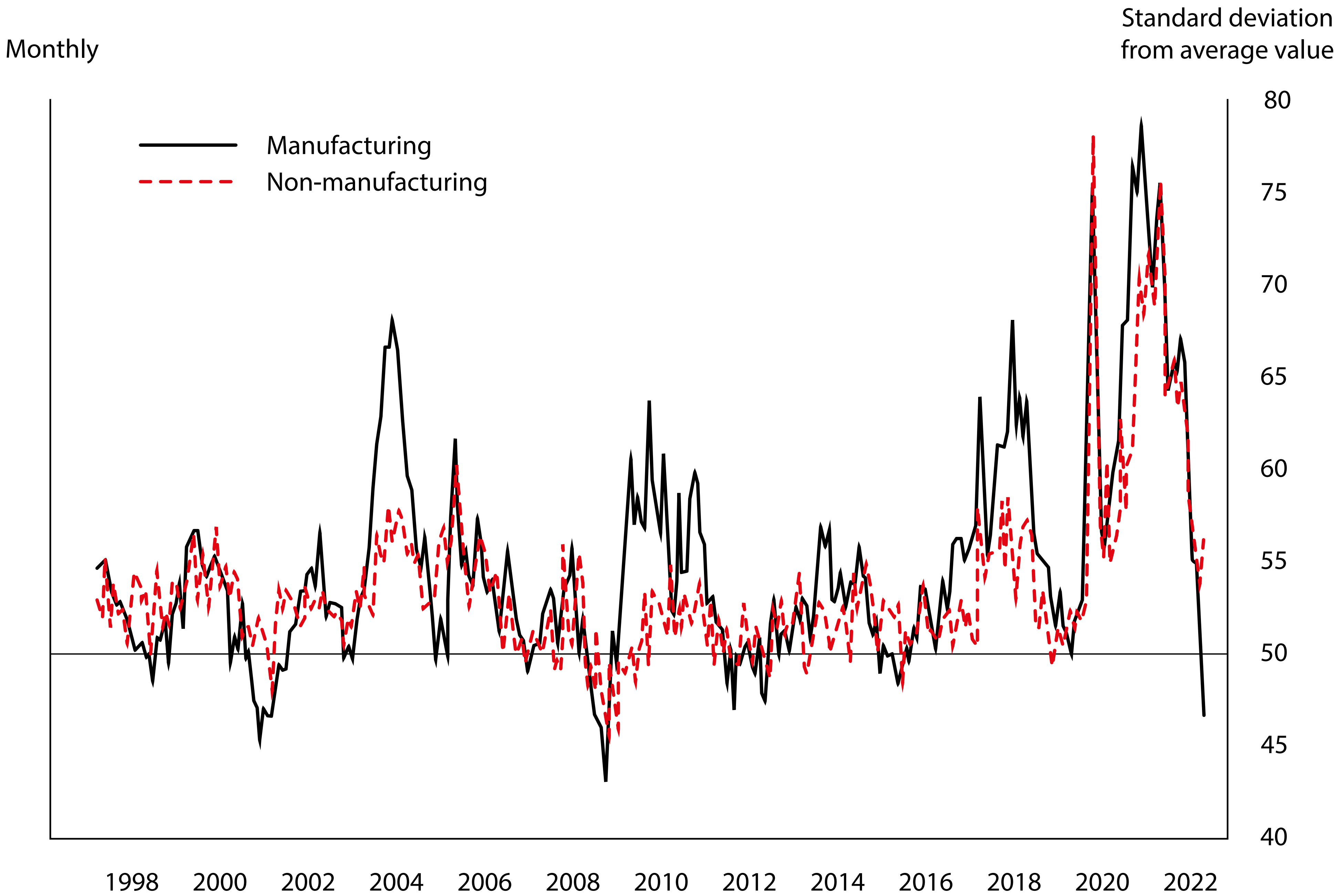
That said, ongoing discussions about moving from 'just in time' to 'just in case' inventory management and from offshoring to 'nearshoring' are raising important questions about the extent to which businesses are likely to reconfigure global supply chains based on a reassessment of the trade-off between cost efficiency and supply resilience.

Similarly, some have conjectured that the slow and incomplete recovery of the workforce over the course of the pandemic may be the beginning of a longer-term change in labour supply dynamics (Figure 9)[12]. In addition, the potential for more frequent and severe climate events, as we are already seeing, and for frictions in the energy transition could also lead to greater volatility of supply.

Together, a combination of forces—the deglobalization of supply chains, the higher frequency and severity of climate disruptions, and demographic shifts—could lead to a period of lower supply elasticity and greater inflation volatility.

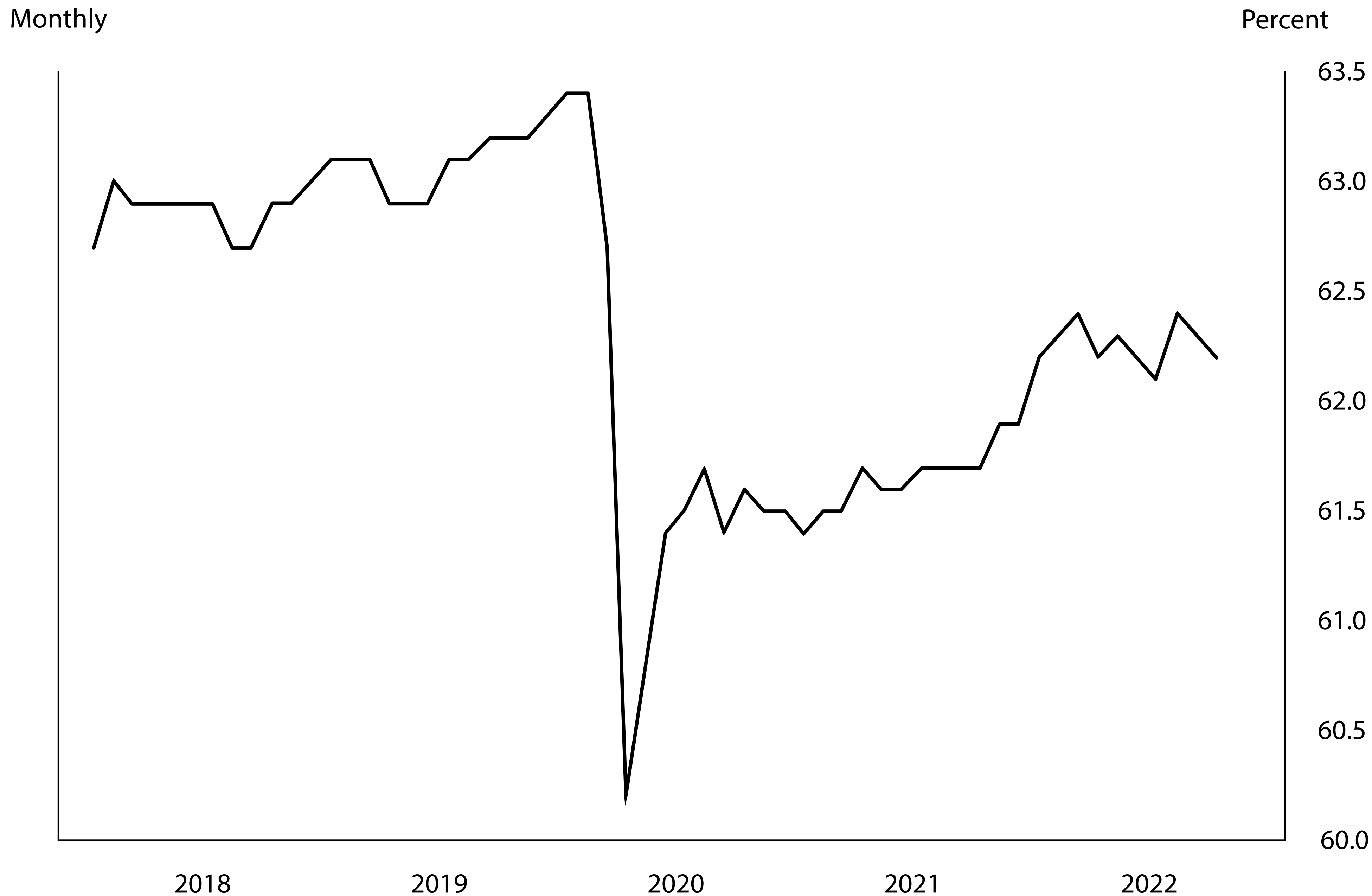
To conclude, the experience with the pandemic and the war highlights challenges for monetary policy in responding to supply shocks. A protracted series of adverse supply shocks could persistently weigh on potential output or could risk pushing inflation expectations above target in ways that call for monetary policy to tighten for risk-management reasons.

Figure 8. ISM supplier deliveries index



Note: Data go through October 2022. The ISM Supplier Deliveries Index is an inverse diffusion index, a reading above 50 percent indicates slower deliveries.
Source: Institute for Supply Management.

Figure 9. Labour force participation rate



Note: Data go through October 2022.
Source: Bureau of Labor Statistics.

More speculatively, it is possible that longer-term changes—such as those associated with labour supply, deglobalization, and climate change—could reduce the elasticity of supply and increase inflation volatility into the future. ■

Lael Brainard is Vice Chair of the Federal Reserve Board

Endnotes

1. I am grateful to Kurt Lewis of the Federal Reserve Board for his assistance in preparing this text and to Kenneth Eva for preparing the figures. This text updates the views that I discussed as part of a panel at the BIS Annual Meeting on June 24, 2022. These views are my own and do not necessarily reflect those of the Federal Reserve Board or the Federal Open Market Committee.

2. Research has generated a range of estimates on the contributions from supply and demand factors. For example, Shapiro (2022) finds that demand factors are responsible for about one-third of the surge in inflation above the pre-pandemic trend, while di Giovanni and others (2022) find a number closer to two-thirds. See Adam Shapiro (2022), "How Much Do Supply and Demand Drive Inflation?" FRBSF Economic Letter 2022-15 (San Francisco: Federal Reserve Bank of San Francisco, June); and Julian di Giovanni, Sebnem Kalemli-Ozcan, Alvaro Silva, and Muhammed Yildirim (2022), "Global Supply Chain Pressures, International Trade, and Inflation (PDF)," paper presented at the ECB Forum on Central Banking 2022, Sintra, Portugal, June 27–29.

3. The median year-to-date total policy rate hike within the group of Brazil, Hungary, New Zealand, Norway, Peru, Poland, and South Korea is 6 percentage points. All of these countries began forceful rate hikes in 2021, and the cumulative hikes have taken policy rates in some of these countries above 10 percent. Despite this, through September 2022 core inflation *in these countries was 9.5 percent year-over-year, rising 3.5 percentage points since March. See Economist (2022), "Even Super-Tight Policy Is Not Bringing Down Inflation," October 28.*

4. Pandemic fiscal measures played an important role in boosting demand, but the rapid deceleration of inflation over the summer of 2021 and subsequent rebound in inflation from October through the end of the year do not line up well with the fiscal demand impulse projected by most forecasters. For example, the Brookings Institution projected a smooth demand impulse from the American Rescue Plan that peaked at the end of last year. See Wendy Edelberg and Louise Sheiner (2021), "The Macroeconomic Implications of Biden's $1.9 Trillion Fiscal Package," Brookings Institution, Up Front (blog), January 28.

5. See, for instance, Martin Bodenstein, Christopher J Erceg, and Luca Guerrieri (2008), "Optimal Monetary Policy with Distinct Core and Headline Inflation Rates," Journal of Monetary Economics, vol. 55 (October), pp. S18–33.

6. Ricardo Reis makes the case that both these factors would have prescribed tighter policy in the current environment. See Ricardo Reis (2022), "The Burst of High Inflation in 2021–22: How and Why Did We Get Here?" CEPR Discussion Paper Series DP17514 (London: Centre for Economic Policy Research, July).

7. See Athanasios Orphanides and Simon van Norden (2002), "The Unreliability of Output-Gap Estimates in Real Time," Review of Economics and Statistics, vol. 84 (November), pp. 569–83.

8. For discussions of the time-varying nature of output gap uncertainty, see Travis J Berge (2020), "Time-Varying Uncertainty of the Federal Reserve's Output Gap Estimate," Finance and Economics Discussion Series 2020-012 (Washington: Board of Governors of the Federal Reserve System, February; revised April 2021); and Rochelle M Edge and Jeremy B Rudd (2016), "Real-Time Properties of the Federal Reserve's Output Gap," Review of Economics and Statistics, vol. 98 (October), pp. 785–91. For a discussion of tempering the policy response to the output gap in response to increased uncertainty, see Athanasios Orphanides (2003), "Monetary Policy Evaluation with Noisy Information," Journal of Monetary Economics, vol. 50 (April), pp. 605–31.

9. For two recent examples of assessing longer-term inflation expectations, see Michael T Kiley (2022), "Anchored or Not: How Much Information Does 21st Century Data Contain on Inflation Dynamics?" Finance and Economics Discussion Series 2022-016 (Washington: Board of Governors of the Federal Reserve System, March); and Danilo Cascaldi-Garcia, Francesca Loria, and David López-Salido (2022), "Is Trend Inflation at Risk of Becoming Unanchored? The Role of Inflation Expectations," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, March 31).
10. See, for example, Ricardo Reis (2021), "Losing the Inflation Anchor (PDF)," Brookings Papers on Economic Activity, Fall, pp. 307–61. The Board's staff recently updated the Index of Common Inflation Expectations to include the 25th and 75th percentiles of inflation expectations over the next 12 months from the University of Michigan Surveys of Consumers.
11. See, for example, Agustín Carstens (2022), "The Return of Inflation," speech delivered at the International Center for Monetary and Banking Studies, Geneva, April 5.
12. See, for example, Charles Goodhart and Manoj Pradhan (2020), The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival (Cham, Switzerland: Palgrave Macmillan).


The European Climate
Law and the ECB
The EU has adopted the European Climate Law. Frank
Elderson considers how the ECB will be affected

A topic close to my heart – apart from the law – is the ongoing climate and environmental crises. I am glad that we have long since moved on from the time when only scientists and activists were concerned with this topic. It is now high on policymakers' agendas, as we saw at the recent United Nations Conference of Parties (COP27) at Sharm el-Sheikh, at which – along with world leaders and a wide range of policymakers and interest groups – the ECB was also represented.

I was struck by one story in particular[1]. The tiny Pacific nation of Vanuatu is badly exposed to cyclones and rising sea levels. To the inhabitants of Vanuatu, climate change is a human rights issue. And, as Vanuatu's president, Nikenike Vurobaravu, stated, *"we are measuring climate change not in degrees of Celsius or tonnes of carbon, but in human lives."*

Vanuatu now plans to ask the UN General Assembly to seek an opinion from the International Court of Justice on the human rights implications of the climate crisis. That opinion could determine the rights of countries most exposed to climate change. It could also touch on the obligations of those most responsible for driving the climate crisis.

Let's now focus on Europe and the possible implications of these developments in international law for my own institution, the ECB. Under the Paris Agreement adopted at COP21 in 2015, many countries committed to the long-term goal of holding the increase in the global average temperature to well below 2°C above pre-industrial levels[2].

To fulfil its commitment as one of parties to the Paris Agreement, the EU last year adopted the European Climate Law[3]. The implications of the Climate Law are significant. Before going into why, let me first explain what the Climate Law does.

The Climate Law has three key elements. The first is its objective that the EU reduce its greenhouse gas emissions by at least 55% by 2030, with a new reduction target to be set for 2040. The EU should achieve climate neutrality by 2050 and aim to achieve negative emissions thereafter.

The second important element is to ensure that we move towards that objective. The European Commission has established a framework for assessing concrete progress and checking whether national and Union measures are consistent with the objective. It will issue regular reports on the conclusions of these assessments.

If we waiver, the costs will only increase both in a moral and financial sense. I will be even more forceful: our mandate requires us to be ready

The third and last element is to ensure that we use the most effective instruments to achieve the objective. The introduction of a European Scientific Advisory Board on Climate Change promotes the idea that all policies should be based on up-to-date scientific insights.

It is hard to overstate the importance of the Climate Law. The EU is setting the bar high. Allow me to quote what the law says about the transition to climate neutrality. It *"requires changes across the entire policy spectrum and a collective effort of all sectors of the economy and society […] all relevant Union legislation and policies need to be consistent with, and contribute to, the fulfilment of the climate-neutrality objective while respecting a level playing field"*[4].

We are starting to see this happen. From housing to energy and from transport to finance, the EU is introducing reforms to put Europe on track to become the first climate-neutral continent by 2050.

So how will the Climate Law affect the ECB? For me, as a member of the ECB's Executive Board and the Vice-Chair of its Supervisory Board, this question is relevant to both our monetary policy and banking supervision tasks.

This question matters because, in the field of the environment, the ECB is a policy taker, not a policymaker. So what does the ECB need to take from the policy and objectives reflected in the Climate Law? To answer this, we first need to consider whether the ECB is bound by the Climate Law. If so, the ECB would have to take measures towards achieving the climate-neutrality objective.

There is more, though. If the ECB is bound by the law, it would also have to ensure continuous progress in enhancing adaptive capacity, strengthening resilience and reducing vulnerability to climate change. Moreover, it would have to ensure that its policies on adaptation are coherent with and supportive of other such policies in the Union[5].

That is quite a full plate. So, is the ECB bound by the Climate Law? There are definitely indications that it is. The Climate Law is addressed to *"relevant Union institutions and the member states."* In the European Anti-Fraud Office (OLAF) judgment[6], the European Court of Justice made it clear that, in principle, the ECB is bound by all regulations which bind the Union. There is no distinction to be made between the different institutions, bodies, offices and agencies. All are equal under the law, so to say.

However, the word 'relevant' is ambiguous. Does it refer to any institution, where relevant? That would mean that every EU institution should comply with the Climate Law, whenever it develops policy or takes action relevant to the objective of the law.

Or does it refer only to those institutions with competence to create policy relevant to achieving the objective of the Climate Law? The ECB would be directly bound by the law under the first interpretation but not under the second.

The Climate Law is not crystal clear on this point. It does not define 'relevant institution'. But there are a number of strong indications that the ECB is not a relevant institution under the Climate Law. Let me explain why.

The Climate Law does not contain many specific obligations. The law sets out a destination: climate neutrality. It does not tell us how to get there. How we do so will depend on environmental and economic policymaking. This is a Union competence the ECB does not have.

There are further arguments that support this interpretation. If the ECB is deemed to be a relevant institution, then it would have to submit its policies to the Commission for assessment and the Commission would monitor progress.

That would be a fundamental change to the ECB's accountability framework. Under current law, the ECB is only directly accountable to the European Parliament and the European Court of Auditors[7].

A final reason for this view is institutional. If the ECB were deemed to be a relevant institution within the meaning of the Climate Law, this would be an implicit acceptance that the Council of the EU and the Parliament could set additional objectives for the ECB through the ordinary legislative procedure.

However, the ECB's objectives are laid down in the Treaty on the Functioning of the European Union (TFEU)[8], and their scope cannot be changed by secondary legislation. That would be a violation of the Treaty. Changing the ECB's objectives requires a special procedure.

The ECB is – it seems – not directly bound by the Climate Law. So, can we ignore it? Not at all. To do so would be a violation of the Treaties. Article 11 of the TFEU provides that environmental protection requirements must be *"integrated into the definition and implementation of the Union's policies and activities."*

This imposes an obligation on the ECB to take into account and consider the objectives of the Climate Law when performing its tasks. In addition, Article 11 could be understood as supporting measures which incorporate environmental considerations as secondary aims. This means the ECB could rely on Article 11 to support the climate neutrality dimension of measures falling within its monetary policy or supervisory competences.

But it does not go so far as to establish an autonomous competence to adopt environmental measures. In addition, under Article 7 of the TFEU, the activities and policies of the ECB need to be consistent with Union law and therefore also with the Climate Law.

We have diligently assessed how these provisions of the Treaty, together with the Climate Law, affect our tasks, always being guided by and staying within our mandate. The ECB is not an environmental policy institution. The ECB is a central bank and banking supervisor. As such, let me share with you what we have done to reflect these legal requirements in the common fight against the climate crisis within our mandate.

First of all, when defining and implementing monetary policy, we need to take into account environmental protection requirements, such as the climate-neutrality objectives contained in the Climate Law. And that is what we have done. Last year the Governing Council adopted a comprehensive action plan[9] to further incorporate climate change considerations into its monetary policy framework.

There are a number of actions to which the ECB is committed under this plan. Let me now give a very concrete example of how the ECB has taken into account climate change considerations in the context of its corporate sector purchase programme (CSPP).

Under the CSPP, the Eurosystem purchases corporate bonds for monetary policy purposes. Right now we are in the reinvestment phase which means that we are no longer increasing our portfolio but only reinvesting bonds that mature. Up until October 2022, the Eurosystem purchased these bonds in accordance with the 'market benchmark'.

However, owing to the way the corporate bond market functions, this 'market benchmark' has been criticised as leading to the purchase of a larger proportion of bonds from carbon-intensive firms.

Therefore, from October 2022, the ECB started to implement its decision to 'tilt' CSPP reinvestments to increase the share of assets from issuers with better climate performance, rather than those with poorer climate performance. There are two main reasons for this decision.

First, the ECB considered this essential in order to effectively pursue its primary objective of maintaining price stability. Given that carbon-intensive issuers are more vulnerable to physical and transition risks arising from climate change, large holdings of bonds from such companies pose higher financial risks to the Eurosystem's balance sheet, which has an impact on the implementation of its monetary policy.

Second, 'tilting' the CSPP also serves the ECB's secondary objective of supporting the general economic policies in the Union. 'Tilting' its corporate bond reinvestments towards 'greener' companies enables the ECB to align these reinvestments with the objectives set out in the Climate Law, which form part of those economic policies. This action was assessed as also being conducive, and not prejudicial, to price stability.

More generally, this measure ensures that the CSPP complies fully with the ECB's obligations under Article 11 TFEU by integrating the objectives of the Climate Law into the definition and implementation of the ECB's policies and activities.

This is one of the first steps in the ECB's climate action plan, but the ECB is also looking into other ways to take climate-neutrality objectives into account in its monetary policy – for example, through the collateral that we ask when providing liquidity to banks.

For banking supervision, there are several dimensions that I will briefly discuss. Again, we do not directly apply the Climate Law. The Climate Law does not directly relate to our tasks as a banking supervisor nor does it relate to prudential supervision. Therefore the ECB does not impose an obligation on banks to take the necessary measures to contribute to the achievement of the objectives of the Climate Law.

However, we cannot ignore it. Not only because we need to integrate environmental obligations into our policies due to Article 11 TFEU, but also since the law will have prudential implications. Therefore, the Climate Law and its consequences feature in our supervisory assessments, interactions with the banks and measures we take.

Why is that? Banks will be at the forefront of the energy and climate transition, whether they want to be or not. Their clients will face increasing hazards from climate change and environmental degradation as well as increasing regulation. Some clients will have to wind down their operations, others will be stuck with stranded assets.

A mandatory energy label has been introduced for real estate[10], affecting the value of banks' mortgage portfolios. Therefore, the ECB has identified exposure to climate-related and environmental risks as a key risk driver in the Single Supervisory Mechanism (SSM) Risk Map for the euro area banking system[11].

In order to guide banks regarding their risk management, the ECB has published supervisory expectations in its *Guide on climate-related and environmental risks*[12]. In addition, we have conducted a comprehensive review of banks' practices related to strategy, governance and risk management on climate risks – the 2022 thematic review.

We will continue to set expectations for banks to progressively manage risks on this front. These expectations are certainly not open ended. By the end of 2024, banks need to be in full compliance with all the supervisory expectations we set out in 2020.

Banks need to build their capabilities to withstand climate and environmental risks. We are happy that the Commission and the Council have acknowledged that this needs to have a foundation in prudential regulation as well. In the new banking package, the concept of 'transition plans' is important.

Under Article 76 of the proposed amendments to the Capital Requirements Directive (CRD VI)[13], a bank's management board is required to monitor and address environmental risks arising in the short, medium and long term[14].

Banks have to make sure that their business model and strategy are not misaligned with the relevant Union policy objectives towards a sustainable economy and they need to manage potential risks from such misalignments.

Article 11 TFEU, the requirement to integrate environmental requirements into the policies and activities of the Union, plays a role in supervision. The ECB has a duty to integrate the Climate Law's neutrality objectives into its supervisory policies and activities. However, we have some discretion as to how we do this.

After all, the climate neutrality objective affects the ECB's mandate in many respects and Article 11 TFEU does not prescribe how the ECB should integrate the environmental requirements. Do not expect us to act to regulate or enforce environmental policies.

We will stick to our mandate. Our mandate is to keep under control the risks that banks and the financial system are facing, and in that capacity we have to look closely at the risks that are building up in the banking sector as a consequence of the climate crisis.

Lastly, I would like to draw your attention to the work of the Central Banks and Supervisors Network for Greening the Financial System (NGFS). In November 2021 the NGFS published an important report on climate-related litigation[15] which seeks to raise awareness about the growing source of litigation risk for public and private actors not convincingly supporting the climate change transition.

Understanding the risks arising from climate-related litigation is clearly crucial for central banks and supervisory authorities, and the NGFS is continuing to monitor this field carefully. It plans to publish a further report next year with an update on the many developments since 2021.

I hope I am leaving you with the right impression. The ECB is not an environmental activist, but rather a prudent realist. It is our job to point out risks, whether they are macroeconomic, macroprudential, microprudential or related to litigation, and to ensure that the financial sector takes them duly into account.

Before I finish, let's turn back to the brave fight of Vanuatu. You cannot blame Vanuatu's president for seeking to defend the rights of countries most exposed to the ongoing climate and environmental crisis. Nor can we blame him for wanting to impose obligations on those most responsible for driving the crisis.

Vanuatu's mission is a stark example what the fight against the climate crisis is about. It underpins the task we have on our side. Europe has realistically no other choice than to deliver on the objectives of the Paris Agreement.

If we waiver, the costs will only increase both in a moral and financial sense. Speaking as a European citizen, I would like us to be ready for the challenge ahead. As European central banker, supervisor and scholar of the law I will be even more forceful: our mandate requires us to be ready.

Frank Elderson is a member of the Executive Board of the European Central Bank

Endnotes

1. "The looming legal showdown on climate justice", Financial Times, 10 November 2022.

2. Article 2(1)(a) of the Paris Agreement.

3. Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ("European Climate Law") (OJ L 243, 9.7.2021, p. 1).

4. Recital 25 of the European Climate Law.

5. Article 5 of the European Climate Law.

6. Case C-11/00, Commission v ECB, EU:C:2003:395.

7. Article 284(3) TFEU and Article 15.3 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.

8. Articles 127(1) and 130 TFEU.

9. "ECB presents action plan to include climate change considerations in its monetary policy strategy", press release, ECB, 8 July 2021.

10. Currently under revision. See Proposal for a Directive of the European Parliament and of the Council on the energy performance of buildings (recast) COM/2021/802 final.

11. See "ECB Banking Supervision – Assessment of risks and vulnerabilities for 2021", ECB, 2021.

12. See Guide on climate-related and environmental risks, ECB, November 2020.

13. Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU (COM/2021/663 final).

14. See also Articles 73 and 74 CRD VI.

15. "Climate-related litigation: Raising awareness about a growing source of risk", NGFS, November 2021.

This article is based on a speech delivered at the Lustrum Symposium, organised by Dutch Financial Law Association, Amsterdam, 1 December 2022.

A global climate risk capital

Helen Souza discusses Bermuda's push to become the global climate risk finance capital

Bermuda is already known as the world's risk capital but now has its sights on becoming the world's climate risk capital, addressing critical needs in key markets, and closing the global protection gap while creating new economic growth opportunities.

Bermuda is unique because it is simultaneously one of the world's most significant property catastrophe (re) insurance markets, as well as a premier captive domicile and the leading global issuer of Insurance Linked Securities (ILS). The climate vertical perfectly complements Bermuda's globally recognised strengths, as well as the professional services expertise which has built up over multiple decades on the ground.

Helping to close the global protection gap

Just as Bermuda played a critical role helping high risk regions bolster their financial resilience to the rising tide of climate peril (ie. hurricane/tropical storm, wildfire, flood, and other climate-driven property risks) Bermuda will play a leading role in climate risk finance, supported by third party capital and potential new start-ups focusing on innovative technology.

The purpose of the Bermuda Business Development Agency (BDA) is to promote and protect, in collaboration with government and the private sector, sustainable and equitable economic growth, diversification, and prosperity in Bermuda. The BDA is seeking to attract new climate risk finance companies to the Island, offering exciting new career paths for Bermudians.

Bermuda's push to become global climate risk finance capital

To many, Bermuda's climate risk finance drive officially began with the Bermuda Government's climate change commitment announcements on Earth Day, April 22, 2021, and the BDA's first climate risk finance roadshow in New York City in September 2021.

Across four days, from September 27-30, the BDA delegation – led by Bermuda's then Minister of Finance, the Hon. Curtis Dickinson, JP, MP – held 16 meetings with key decision makers from some of New York's leading law firms, advisers, and asset managers. These firms represented revenues of $3.28 billion and maintain offices in 54 cities worldwide.

Bermuda has built a notable wealth of climate change-related risk experts on the ground over the past three decades

After this first strong showing of support, further outreaches were held at the 26th United Nations Climate Change Conference (COP26) in Glasgow as well as in London, UK in October 2021.

As COVID-19 restrictions started to improve on-Island, the BDA held its inaugural Bermuda Risk Summit from March 14-16, 2022, attracting over 80 delegates from overseas. It was so great to get off zoom and connect with everyone again, and the immediate economic impact of the event, which had a total of 350 delegates, including lodging, transportation, food and beverage, retail and recreation was estimated at over one million dollars, and supported around 200 jobs.

The successful Bermuda Risk Summit was followed by climate risk finance roadshows in San Francisco and Silicon Valley in April, and New York in May.

Also in May, the BDA led a two-day, invite-only Bermuda Climate Summit on May 24, that drew some 150 attendees, including 70 from overseas, to discuss myriad wide-ranging climate issues, including the science of climate change, the regulatory needs of green investors, and Bermuda's leadership role in this new era.

Building on these successes, the BDA championed Bermuda's climate credentials during business development missions to London in June, Toronto in September, and Singapore in October.

To round off a busy year, the BDA is excited to be heading to COP27 in Sharm El Sheikh, Egypt in November, to provide updates on Bermuda's vision to be a global leader in climate risk finance, including developing solutions, and financial mechanisms to mitigate the impact of climate risk.

Bermuda is already an expert in climate risk finance

At all of these speaking opportunities, meetings and events, the BDA reminded climate risk finance prospects that Bermuda has built a notable wealth of climate change-related risk experts on the ground, including scientists in the public and third sectors, over the past three decades.

For example, the Bermuda Institute of Ocean Sciences (BIOS) has a rich history of supporting the (re)insurance sector; reaching as far back as 1994 when it established the Risk Prediction Initiative (RPI) a collaboration of BIOS scientists and (re)insurance experts.

In addition, Bermuda's integrated financial services regulator, the Bermuda Monetary Authority (BMA) also understands the importance of climate change issues, and in April 2021 announced the creation of an innovation and ESG subject matter team to increase its focus on climate change matters. This work progresses; in May 2022, the BMA released its most recent *Climate Risk Exposure Report*.

Committed to climate – learn about our aspirations

As an isolated 21 square mile island, located 640 miles from the closest point of land, Bermuda feels the effects of climate change first-hand in the form of increasingly frequent and severe storms, erratic rainfall, and rising sea levels.

If you would like to find out more about Bermuda's aspirations to become the world's climate risk finance capital, or want to get in touch with the BDA's dedicated concierge service to make your entry into Bermuda as smooth as possible, please contact us at info@bda.bm

Helen Souza is the Business Development Manager at the Bermuda Business Development Agency (BDA)

To cap or not to cap

Simone Tagliapietra, Georg Zachmann and Jeromin Zettelmeyer argue that a EU gas price cap would be counterproductive, but the reasons why it is supported widely must be addressed

Since Russia's invasion of Ukraine, Europe has taken major steps to ensure security of energy supply and help families and businesses tackle rising energy prices. Gas storage facilities have been refilled, gas and electricity demand has declined, and prices have receded from their August peaks.

However, energy prices remain extremely high compared to 2021, and the EU is divided on how best to reduce prices while guarding against new disruptions. To resolve the division, it is important to understand the reasoning on either side and to adopt a mutually-satisfactory solution. This is what we set out to do here.

For several months, EU countries have been divided into two main camps. The first camp, which includes France, Italy, Spain, Poland, Portugal, Greece and nine other EU countries, would like to cap the wholesale gas price, arguing that this addresses the problem at source, can be implemented quickly and will help reduce inflation.

The second camp, led by Germany and the Netherlands, argues that such a cap would raise demand and make it harder for the EU to attract gas supplies.

This situation is unfortunate for many reasons. It is blocking agreement on a coordinated solution and undermining EU unity in the face of Russian aggression. And it is perpetuating divisions the EU has worked hard to overcome.

The split more or less aligns with the divide between the fiscally 'frugal' north and the less-frugal rest (the main difference being that eastern EU countries are now mostly aligned with the rest).

How is this possible, given that the geography of this crisis – with Germany, Italy and some eastern EU countries among the hardest hit, and Spain and France much less affected (Figure 1) – is so different?

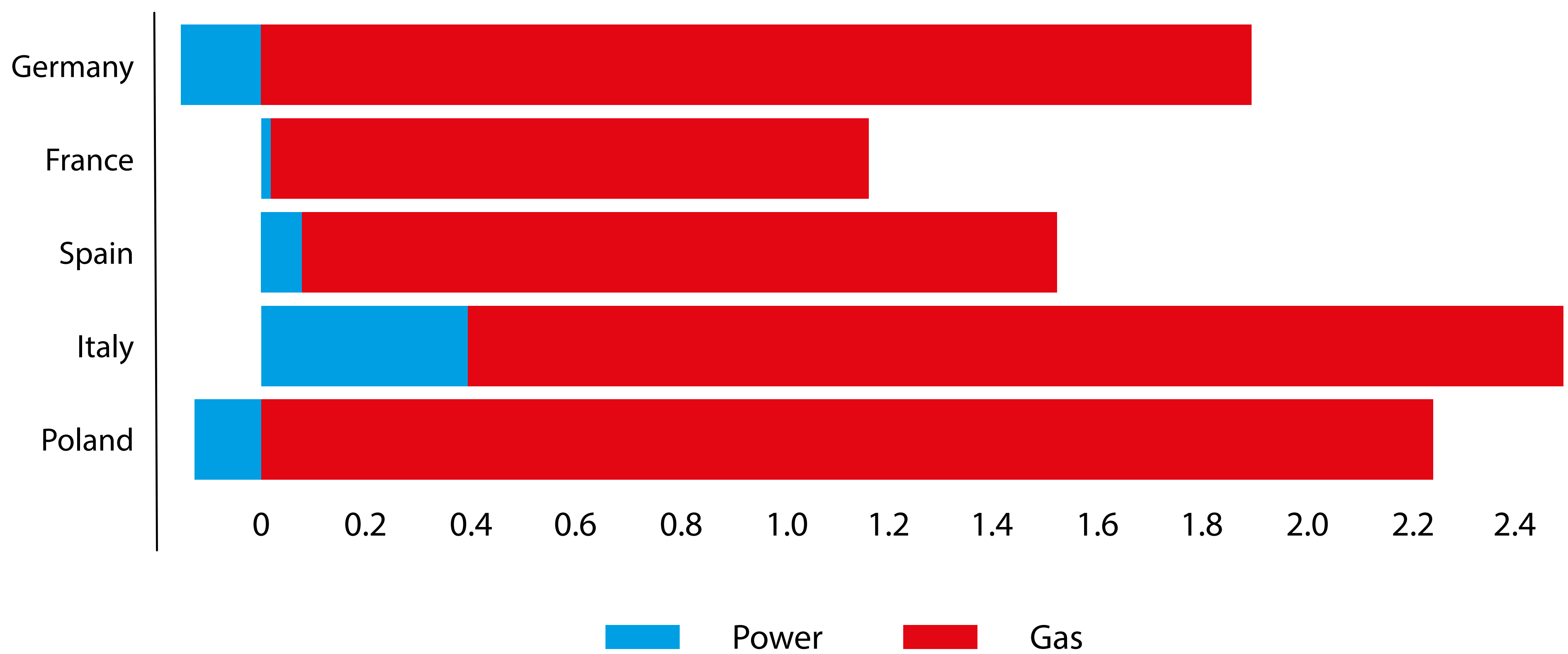
The answer has to do with differences in fiscal headroom, and the tensions and concerns created by these differences.

A wholesale price cap could in principle stabilise energy prices at low or even zero fiscal cost. For example, the so-called Iberian exception, implemented by Spain and Portugal since June 2022, caps the price of gas as an input to electricity generation. Because gas is the most expensive ('marginal') input, the effect of the cap is to reduce

Energy prices remain extremely high compared to 2021, and the EU is divided on how best to reduce prices while guarding against new disruptions wholesale electricity prices, the profits of electricity generators that use cheaper ('inframarginal') inputs such as renewables, and ultimately prices paid by consumers.

Gas suppliers then receive a subsidy that covers the difference between the market price and the cap, and the cost of the subsidy is passed on to consumers, who nevertheless remain better off because they subsidise only the gas input, but benefit from lower prices on all electricity consumption.

Figure 1. Change in net energy import costs (H1 2022 vs. H1 2021, as % of H1 2022 GDP



Note: based on average wholesale prices.
Source: Bruegel based on Bloomberg, Ember, Eurostat, IEA.

The state pays nothing. Such an approach would level the playing field between countries like Germany with a lot of fiscal space, and those like France, Italy and Spain with less fiscal space, by preventing a subsidy race that would be won by Germany.

Price cap problematic

This line of argument helps in understanding the geography of the price cap debate in Europe and offers support for such a cap. However, an EU-level gas price cap is a still a bad idea, for two main reasons.

First, it makes no sense from an energy policy point of view. While it would not necessarily raise gas demand relative to previous years (if the gas price is capped above the level in previous years), it would do far less to reduce demand than well-designed alternatives such as Germany's gas price brake, which would cap retail prices for 70%-80% of last year's consumption while exposing consumers to market prices for any additional consumption.

And as its opponents have argued, the cap might indeed harm Europe's ability to attract gas on global markets, putting at risk much-needed supply during 2023.

Second, a price cap could create more division than it prevents, by having large distributional effects, which would need to be compensated in some form. Consider, for example, the idea of applying the Iberian exception EU-wide.

Since France uses very little gas in the power sector, it's consumers would pay very little for the scheme. At the same time, France would benefit through low-cost electricity imports from Germany and the Netherlands. In effect, German and Dutch consumers would be paying to reduce the electricity bills of French consumers.

That said, advocates of a price cap are right to worry about the implications for the EU level playing field of subsidies given to firms. A subsidy race could harm fiscally weaker EU countries in two ways.

First, it could suck all the gas into the countries with the most generous subsidies. This is not what Germany has in mind; its subsidies are designed to reduce German demand, not to increase it, benefiting other EU countries.

Second, even if Germany manages not to suck in gas from other countries, it has plenty of fiscal space to support its firms – unlike Italy, for example. If German energy-intensive firms emerge from the crisis largely unscathed while their Italian competitors go under, a deep wound would be inflicted on the EU, on top of the scars that remain from the euro debt crisis.

Under pressure from member states to deliver a price cap that does not have massive adverse consequences, the European Commission has proposed a very restrained version of a price cap – essentially limiting the volatility of the main gas price index.

The effectiveness and side-effects of this relatively light intervention will depend on its detailed implementation. The costs may outweigh the upside, but the proposal contains sufficient safeguards to ensure that costs do not spiral out of control. But the proposal does not stack up either economically or politically.

It might win over a few countries, but does not address the concerns that are driving the call from more than half of EU countries for a price cap. EU leaders at a 15-16 December summit will seek a deal, in follow up to an energy ministers' meeting of 24 November. What would it take to resolve differences? In our view, the EU should drop the price cap ideas and instead tackle the level playing field concern, more efficiently and transparently.

This could take the form of an EU fund to protect consumers from high gas prices, while also incentivising energy savings and accelerating the roll-out of clean solutions. Or the EU should pool its gas demand in a joint purchasing scheme to give it more bargaining power relative to external supplies.

Energy crisis fund

An EU energy crisis fund should support three essential policy goals.

First, it should promote energy savings. The energy crisis is fundamentally a supply crisis and therefore reducing demand is imperative. Compensation schemes should be available to gas and electricity users to give them incentives to reduce their usage.

Second, it should provide a minimum level of support to all European industry, to ensure a level playing field.

Third, the fund should be used to help accelerate the rollout of clean tech, to fully decouple Europe from Russian fossil fuels. Fast tracking of renewable electricity generation, heat pumps and energy efficiency measures will reduce demand for Russian gas, simultaneously stabilising security of supply, pushing down energy costs and decarbonising the power and heat sectors.

Deploying a common EU fund would narrow the growing gap in capital costs for clean technology investments that arises because of lending rate differentials across the EU. Prioritising renewable capacity installation – that in the short term might face equipment shortfalls – could increase the positive impact.

This would be especially the case for countries where such investment can most efficiently displace large volumes of gas, such as Italy, which still burns gas even when solar electricity could be generated for free.

Europe's energy crisis fund could be financed primarily from the €40 billion already made available by Commission President Ursula von der Leyen for energy-price support, using the leftovers of EU cohesion funds. Member state contributions or common borrowing could add to the amount.

A complementary measure to reduce gas prices would be joint purchasing of gas through the EU energy platform tool. The European Commission proposed in October that joint purchasing should cover at least 15% of EU countries' storage requirements for 2023, but this is still subject to discussion by energy ministers on 24 November.

This initiative needs to be ready for the 2023 storage refilling operations, to put Europe in a better position at a time when global LNG market might be even tighter than in 2022. This initiative could prevent European countries outbidding each other to secure LNG cargos, and would facilitate the allocation of scarce gas volumes across borders in case of severe supply problems. This would reduce the risk of EU energy-market fragmentation, and of subsequent energy security, economic and political fallout.

Simone Tagliapietra and Georg Zachmann are Senior Fellows, and Jeromin Zettelmeyer is the Director, all at Bruegel

This article was originally published on Bruegel.

World Commerce Review is pleased to announce that the Bank of St Helena Ltd has been awarded the WCR Best Bank for Financial Inclusion 2023.

The World Commerce Review awards celebrate achievement, innovation and excellence across several fields of endeavour. Our award programs are tailored to provide a comprehensive analysis of the very best in each market.

The WCR awards are recognised as the principal indications of professional conduct and excellence. The selection panel took into account product innovation, on-going customer support and best practice criteria as well as a continuing commitment to deploying the best possible solutions for the benefit of their clients.

The business of government

Stephen Morgan discusses how China's response to the unprecedented zero-COVID protests could affect global business

The recent protests in China against the country's zero-COVID policy have been unprecedented in their scale, intensity and distribution. Protestors numbering in the thousands were reported in dozens of cities. Not since 1989's Tiananmen Square protests has there been such widespread civil disobedience.

The protests do not signify the imminent collapse of the Chinese Communist Party regime, but they are a big challenge to the authority of the party's general secretary Xi Jinping, the president of China. They also have far-reaching implications for China's domestic economy and society, as well as for international firms and the global economy.

International reaction to the protests was a mix of awe at the scale and fear about the consequences. But there was also hope that COVID controls might be loosened further, reopening China and unblocking recent global supply chain bottlenecks.

World stock markets dived initially on the Monday following the first weekend of protests on November 26 and 27. By Tuesday, a massive police presence at protest sites and early arrests of protestors led to a market rebound as foreign investors poured back into Chinese markets.

Investors now appear to have discounted further protests and are reportedly optimistic that Beijing will be forced to change course and open up the economy again. There have already been signs of a loosening of controls, with vice-premier Sun Chunalan quoted as saying the current virus iteration is less virulent.

However, enthusiastic investors risk ignoring the long-term challenges of China's current political culture, domestic economy and outlook for international business.

Shifting Chinese policy

At the heart of contemporary political culture in China is regime survival. Xi wants China to be rich and powerful, but believes controlling domestic politics and addressing geopolitical challenges matters most. The economy comes second to security, a view Xi has expressed many times and reiterated at the Party Congress in October. International investors need to realise this because China's domestic economy and politics affect international firms involved with the country, as well as global markets.

It's time to realise that the business of government in China ultimately rests on ensuring business serves the interest of the party-state and its goals

So it's important for investors and businesses to note that China is not prepared for a surge in COVID infections. Only two-thirds of the over-60s have had a third booster vaccination, although the government wants to increase this. But opening the economy again could bring a massive increase in deaths because of China's fragile health system, insufficient ICU beds and low natural immunity.

Any economic growth from the lifting of COVID controls is also likely to be short-lived for China. The domestic economy is floundering. Growth has been anaemic since 2020, after discounting initial bounces from periodic loosening. GDP grew just 3% for the first three quarters of 2022 and will miss the government's target of 5.5%.

House prices and investment have also been on a slide. Apartment prices have been flat or negative for most of the 70 largest cities in China since 2020 – both for new builds and resales. Investment in residential floor space is down 38.5% for the year to October. Property sector woes have squeezed the revenues of local government, which bears the costs of Beijing's dictates to control virus outbreaks.

Meanwhile, for the first ten months of 2022, consumer retail sales were down 0.5% and sales of food services were down 8.1% – although that is better than the 23% year-on-year fall during the spring 2020 lockdowns in Shanghai, Sichuan and Guangdong.

And the Purchasing Managers' Index (which gives an idea of how positive the manufacturing and services industries are feeling) declined in October to 49.2 and has been below 50 for six of the first ten months this year. Any number less than 50 indicates the economy is contracting.

China's global role

Internationally, China's role as the motor of the global economy could diminish. The continuing slowing of the Chinese economy – whether COVID controls are lifted or not – and Beijing's prioritising of security over the economy will push international firms to act.

While many firms have already relocated, others have stayed – such as Apple, which gets much of its new iPhone Pro stock from the large Foxconn-owned plant in Zhengzhou. This plant was the scene of battles between police and workers in November protesting COVID controls and lack of benefits.

Apple's share price has held up remarkably well this year, as have those of major carmakers, but all are heavily dependent on China as a market and manufacturing base.

For some politicians in the west, one solution is to accelerate decoupling from China. But doing so is neither feasible nor desirable despite their justified security concerns. Science and technology innovation is international in scope and depends on openness and exchange to a certain extent. It will be difficult to freeze China out if western firms want to share in Chinese growth and developments in these areas.

Recent US efforts to restrict the sale of semiconductors have come about only because of a belated realisation of how aggressive China has been acquiring technology since the 2000s. Too many people in the west were not reading Xi's speeches in the early 2010s, only waking up around 2016 after Beijing had laid bare its strategy in the Made in China 2025 plan.

The pursuit of profits in China's very large domestic market has led international firms to neglect the politics of the China marketplace. It's time to realise that the business of government in China ultimately rests on ensuring business serves the interest of the party-state and its goals.■

Stephen Morgan is Professor of Economic History (Emeritus) at the University of Nottingham

China's zero-COVID reckoning

Kent Matthews considers China's zero-COVID strategy and illustrates how economic growth may not recover

Many countries have had to navigate the balancing act of keeping the economy alive versus protecting citizens from COVID in recent years. In China, patience with its zero-COVID policy – one of the world's toughest strategies for dealing with the pandemic – are wearing thin among workers and students. Sporadic protests have erupted all over China in recent weeks, triggered by the deaths of ten people in a fire in an apartment block in Ürümchi, Xinjiang in November.

But even with signs that restrictions are starting to relax across the country, the impact on the economy will not be as straightforward as the Chinese government might hope.

The conundrum for China is that the state has promised its citizens safety from the virus through its zero-COVID policy, which has led to large sections of the vulnerable population being unvaccinated.

No government wants to concede it may have been wrong about something, but it's particularly important for the credibility of the social contract between the Chinese Communist Party and the people. The authorities guarantee social and economic stability and the freedom to get rich, in exchange for absolute power.

But with the slowing of China's GDP growth, rising graduate unemployment (youth unemployment reached 20% in July), and increasing economic hardship, China's social contract is starting to unravel.

Chinese government decision making

The upside of authoritarian governance is that decisions can be made quickly in times of crisis. The Chinese government was quick to react to the 2008 global financial crisis with a 4 trillion yuan (£470 billion) fiscal package.

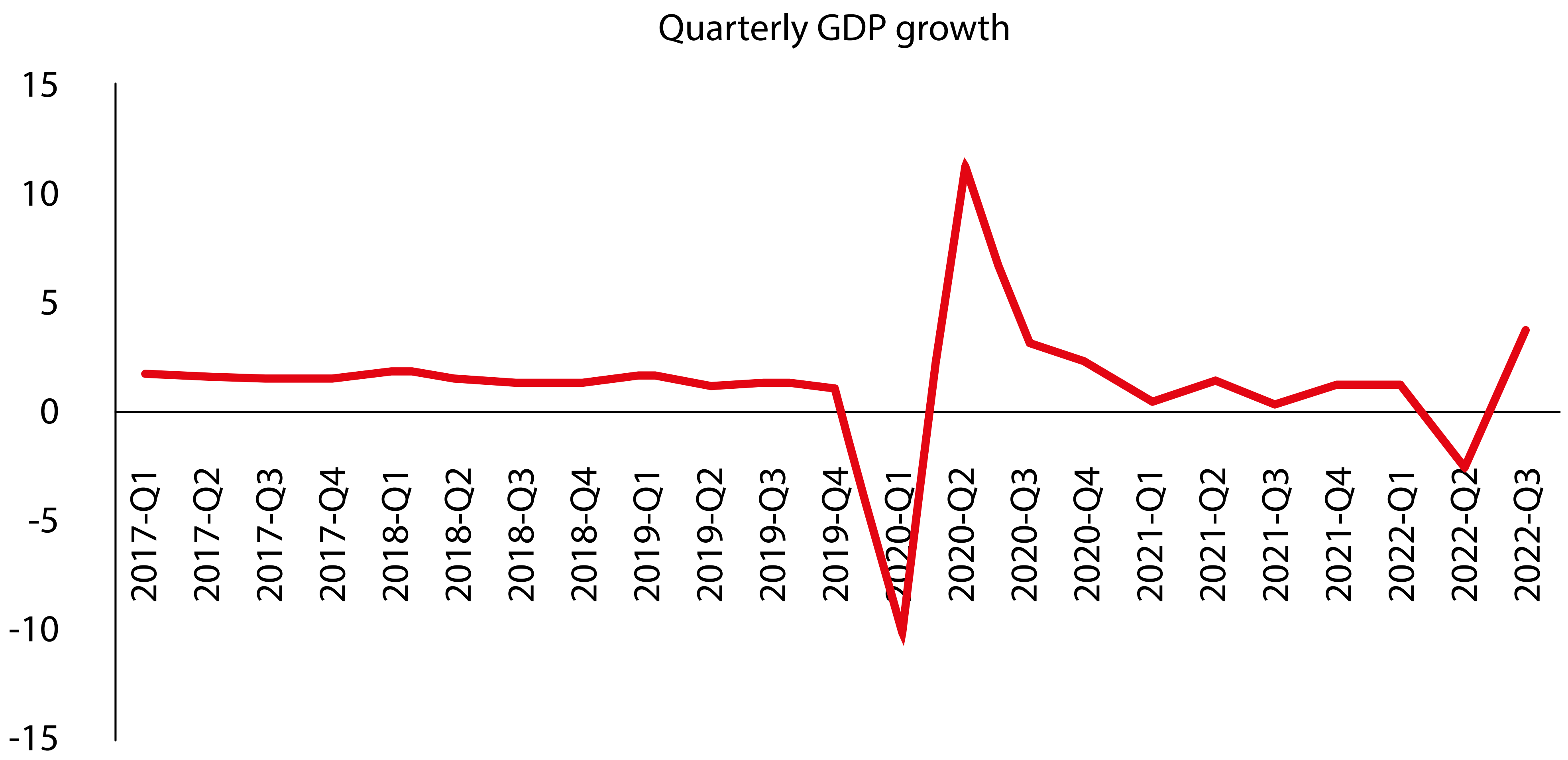
After a sharp fall in GDP in 2008, the economy grew by 8.7% in 2009 and over 10% in 2010. The rate of growth then settled at a healthy but sustainable 6.8%.

When dealing with the pandemic, after the initial confusion about its source and apportionment of blame, the government acted swiftly to lock down the economy and flatten the curve. The result was that only 5,233 COVID deaths had been reported as of December 2022, compared to 1.1 million in the US.

No government wants to concede it may have been wrong about something, but it's particularly important for the credibility of the social contract between the Chinese Communist Party and the people

But daily COVID cases in China were at 37,828 on November 30, 2022. This is higher than the peak in April when the economically damaging lockdown in Shanghai was imposed. And GDP fell by 2.6% in the second quarter of this year before recovering with a 3.6% rise in the next quarter.

Figure 1. Growth in China from the global financial crisis to COVID



Source: author provided, data from National Bureau of Statistics of China

So clearly there is a trade-off to consider between the economic and social cost of China's zero-COVID policy and the health benefits for the vulnerable. This means it's important to consider the short-term cost of the lockdown, as well as any long-term consequences.

The immediate costs have been the disruption to production and global supply chains, but the domestic service sector was also particularly hard hit. The chart below shows how economic growth has moved from a steady quarterly rate of 1.7% following the 2008 global financial crisis, to a collapse and recovery in 2020 and a second downturn in quarter two of 2022.

The likely long-term economic impact is the uncertainty caused by policy changes, which has affected domestic and foreign investment and caused supply chain disruption.

Real GDP per capita (real GDP divided by the population) is projected to grow at 6.3% a year in China and, according to my calculations using Federal Reserve Economic Data (FRED) and population figures from the World Bank, this would put the cost of long-term lost output at a massive 72% of real GDP per capita relative to 2018 GDP.

This is a huge loss for the Chinese economy and research shows that output loss on this scale is rarely recovered in the long term. Foreign firms are rethinking their supply chain arrangements and the all-important human capital brought by foreign workers to China has been heading for the exit. As with after the financial crisis, the pandemic could lead to a new, lower trend growth rate that will only emerge with time.

Other economic headwinds

Of course, repositioning supply takes time and China is secure in the knowledge it remains the workshop of the world for now. But there are other headwinds: debt to GDP rose to 270% in 2020 driven by credit advances to real estate developers and also to local governments for infrastructure spending.

Central government debt as a percentage of GDP has also risen from 20% in 1998 to nearly 70% in 2020. Government debt is set to rise to 78% in 2022. These are large figures for an emerging economy. And if China is to keep to its promise of protecting its vulnerable citizens, higher spending on health for its ageing population could cause this debt ratio to rise further.

The pandemic has raised government spending in China, as it has done in all countries. This has created business opportunities, but has also highlighted a difference between local government decision making and central government edicts.

Sometimes, an overcautious regional response goes beyond the guidelines set by central government – for example, when provinces enforce longer lockdowns than the recommended five days, or impose centralised quarantines rather than asking people to stay at home. This also affects the economy and must be taken into account by China's government.

But of course, this is not just about economic costs, people's wellbeing and health must also be considered. And things may even be worse in China than observers realise – recent research suggests that autocratic governments can overstate economic growth by as much as 35%.

China's anti-COVID protests are more than about COVID. They are expressions of frustration with a system that is opaque and unaccountable. Relaxing the restrictions is a step in the right direction, the effect depends very much on the decisions the government makes from now on. ■

Kent Matthews is Professor of Banking and Finance at Cardiff University

The flag of choice

World Commerce Review **interviews Cameron Mitchell who discusses how the Isle of Man Ship Registry adds real value in a rapidly changing global maritime environment**

The Isle of Man Ship Registry is one of the world's leading registers of ships and super yachts. A British register providing the very best in service to its valued clients; it is the flag of choice for owners looking for quality and partnership from a Flag Administration. *World Commerce Review* interviews Cameron Mitchell, the Director of the Registry, who discusses how they add real value in a rapidly changing global maritime environment.

How many vessels are currently registered under the Isle of Man flag?

The Isle of Man Ship Registry currently has 800 vessels with a combined tonnage of approximately 12.6 million GRT and is placed as the 17th largest Ship Registry in the world.

What services do you provide to owners of ships/yachts?

The Ship Registry's services include:

- Registration of ships and yachts.
- The Registration of mortgages.
- Different registration options for yachts (Commercial, Pleasure Yacht Charter Ready (PYCR), Pleasure Yacht Plus and pleasure yacht)
- The issue of statutory certification required by International Convention.
- Providing a robust, transparent and pragmatic regulatory framework for ship and yacht operation which meets International convention requirements.
- New build ship and yacht oversight.
- Ship and yacht in service survey and inspection. (Remote inspection and in person)

- Consultancy services for innovative designs/solutions leading to Alternative Designs and Arrangements and equivalent arrangements in line with International Convention requirements.
- Consultancy Services for large projects - Agreed Individual Memorandums of Understanding (MOU)'s, Statements of Work (SOW) and Non-disclosure Agreements NDA's)
- Endorsements of officer Certificates of Competency (not required for ship or yacht crew)
- 'Crew Matters' – Free Seafarer welfare App which provides a holistic approach to mental health and wellbeing, access to support 24/7 through ISWAN's SeafarerHelp and YachtcrewHelp and access to Chaplaincy services provided by Stella Maris worldwide.

Do (and if so how) the services you offer differ for commercial ships to those for pleasure or commercial yachts?

The only difference would be the increased options on the types of registration offered to yachts.

What are the benefits of registering a vessel in the Isle of Man?

- The Isle of Man is politically and financially stable (OECD, MONEYVAL).
- British Register, the Red Ensign flag provides access to British consular support & protection of the British Armed Forces worldwide.
- Same day and out of hours registration available.
- Customer focused/streamlined registration process – single point of contact for registration and survey.
- Industry leading online systems – including digital certificates & online processes and finance.
- Digital Crew Endorsements – Fast and simple online applications.

- 24/7 Emergency Response
- The Isle of Man is a preferred flag for ship and yacht finance and insurance purposes.
- Not for profit flag administration – sole purpose of diversifying the Isle of Man economy.
- No consular or casualty investigation fees.
- Green ship incentive - fee reduction for ships and yachts using alternative fuels, wind and wind to power technologies.
- World class technical expertise.

What makes the Isle of Man stand out against other flag states and within the wider maritime industry?

The Isle of Man maintains white list status on the Paris and Tokyo Memorandums of Understanding on Port State Control and Qualship 21 status with the United States Coastguard – this status represents Low risk and therefore Isle of Man Ship and Yachts have a low target factors for Port State Control Inspections.

The Isle of Man Ship Registry is an international flag and not classed as a Flag of Convenience (FOC) – The Isle of Man Ship Registry maintains high standards of regulatory compliance and is fully financed by the Isle of Man Government.

The Ship Registry has incorporated four SDG's into our operating model (already ISO9001 and 14001 certified):

Use our influence as a regulator to support and nurture innovation

Change our Flag State operating model through the use of new technology and our global network of representatives to reduce our carbon footprint and consumption of resources

First and only flag to join the Getting to Zero Coalition and introducing new incentives (15 % Fee Reduction) for alternative fuel technologies including LNG/LPG dual fuel engines

The Ship Registry joined Eyesea.org as a member and the Director as an ambassador to track marine pollution and marine hazards to influence effective clean-up operations

In June 2022 the Isle of Man Ship Registry helped sponsor the expansion of the Luna Foundation's beach clean-up work. As an example of their work, Luna successfully collected 450kg of trash from the Vasai Beach area (Mumbai) - in just one day. This project is managed by Eyesea and is an example of how linking pollution mapping and clean-ups yields measurable outcomes.

How does the Isle of Man Ship Register differ to that in the UK?

We are both British flags and indeed the Isle of Man Ship Registry is sometimes referred to as the second British register. However, we are both unique in our own ways and have differing USP's.

The Isle of Man Marine Administration was renamed the Isle of Man Ship Registry in 2007. This new name and logo provided the Isle of Man with a readily identifiable and distinct image when exhibiting at marketing and promotional events. It also set us apart from other British Flags and competitors.

As the new image was launched the Ship Registry also redefined its operating model, where quality of service and putting the customer first became our key priority and objective. The Isle of Man redefined the modern Ship Registry model and continues to do so.

The Isle of Man Ship Registry is described as a 'Quality flag of choice', the Ship Registry ethos is based around client/customer choice, and therefore we have designed our systems, processes and procedures with client expectation and aspiration in mind.

Internally the Ship Registry refers to the three pillars which support our culture, behaviours and values they are:

I. Customer service.
II. Customer service, and
III. Customer service.

What benefits/advantages does being part of the Red Ensign Group offer?

Being part of the Red Ensign Group provides many benefits/advantages over other flag states which include:

1. Combined technical expertise; The Red Ensign Group (REG) meet twice per year at the REG Technical Forum (REG TF). REG TF discusses and makes decisions on technical matters affecting or likely to affect the group.

   This can range from the approval of Alternative Designs & Arrangements (Equivalent arrangements) through to the introduction of new mandatory instruments agreed at the International Maritime Organization (IMO).

2. The REG also has a Recognised Organisation (Classification Society) oversight programme which is the envy of other flags.

   The oversight programme received praise from the IMO within the last twelve months where the REG Cat 1 members were audited by the IMO for Compliance with the IMO Instruments Implementation Code.

3. The Red Ensign flag provides access to British consular support & protection of the British Armed Forces worldwide.

4. The REG receives support and guidance from intelligence services through the UK Department for Transport, International Shipping and Counter Piracy, Maritime Security Division.

5. Direct access to the UK Maritime and Coastguard Agency.

6. World class Casualty Investigation Services through an agreement with the UK Marine Accident Investigation Branch.

Tell us more about Crew Matters – your seafarer welfare app. What is it? Who is it aimed at? Will there be any new additions to the app in the near future?

Crew Matters provides structured social activities and welfare support for seafarers, through Tapiit's live and interactive studio streamed sessions with a full month's agenda of physical and mental wellbeing classes and educational trainings, including fitness and yoga sessions.

Seafarers can also log in their work and rest hours, and if they feel stressed or unwell there is a live SOS Welfare@Sea function which provides immediate access to the Seafarers Help Live Chat, which is free, confidential and available 24-hours-a-day, seven-days-a-week.

In addition, the APP connects with global seafarer charity Stella Maris and enables seafarers to find contact details for the organisation's chaplains in 54 countries around the world, with functionality to connect and make appointments pre-arrival, providing links to local port services and marine traffic to track voyage progress.

Crew Matters also tackles the problem of storing seafarer documentation in one place with reminder settings for crew endorsements and certificate expiry dates.

It provides a link to trade union Nautilus, with details of membership, news, careers and tax advice, training opportunities, as well as containing a wealth of information from the IOM ship registry including the master's handbook, shipping notices, IOMSR news feeds and contact details.

Crew Matters is free to use for seafarers on Isle of Man registered vessels. The App has recently been refreshed and has a new look and a slicker feel, new content is currently being considered, but at is very heart this will remain a Crew welfare App.

How does the Isle of Man Ship Registry deal with any issues involving the welfare of crew or problems with the vessels?

The Isle of Man Ship Registry has a robust Maritime Labour Convention Complaints process and procedure which we encourage all crew to use should they have any complaints regarding welfare onboard.

The complaint form can be found on our website and the dedicated email is: MarineMLC.DfE@gov.im

For any technical problems with vessels we have a dedicated email account: MarineSurvey.DfE@gov.im which is monitored by one of our Principal Surveyors.

For out of hours we have a dedicated emergencies only number +44 (0)7624 493467 and a full list of contact numbers and emails can be found on our website.

The Ship Registry prides itself on being available whenever our clients need us.

The Isle of Man Ship Registry continues to be a proactive and innovative flag state. In fact, it has been a flag state of many 'firsts' over the last couple of years – the first to join getting to zero coalition, the first to launch seafarer welfare app, the first to carry out and approve the periodical remote survey of a ship, the first to broadcast mass to crew, the first to accept modification to use LPG as fuel for older gas tankers and the first to offer a comprehensive list of discounted fees for ships using green technology... so what's next?

At the Isle of Man Ship Registry we strive to be different and offer different services and solutions to our international client base.

The most recent changes to service delivery are around providing 'consultancy services' on innovation and design projects where our in house technical expertise can assist our clients or third parties.

Consultancy services allow our clients the confidence of early flag involvement in any innovation or design project be that from testing the policy or legislative framework or providing technical expertise.

Our consultancy services are already in use and we have signed several NDA's on innovative design solutions where we are working with the maritime industry to deliver a cleaner, greener and more sustainable maritime future. ■

Business schools: an evolutionary perspective

Kai Peters and Howard Thomas ask what is management actually all about and why do practising managers need 'schools of management' rather than 'business schools'?

In the world of business schools, we do get ourselves in a muddle. Since shortly after the start of business schools in the United States around the beginning of the twentieth century following the establishment of schools of commerce decades earlier, and certainly in the last few years, business school academics and commentators have engaged in a wide-ranging debate about the mission, value and purpose of business schools.

This continuous self-criticism has taken in a range of perspectives over the years. As Pettigrew and Starkey (2016 p. 653) observe, there is a certain irony here given the prima facie success of the business school sector over the past one hundred plus years, with their estimates suggesting that there are between 12,000 and 13,000 business schools of significance world-wide.

Pointing to Pfeffer and Fong (2002), Mintzberg (2004) and Bennis and O'Toole (2005), they note *"it seems perverse that a worldwide education industry should also attract a minor industry of challenge and skepticism from its own professoriate."*

This criticism and attack has focused on the business school's value and impact on society. As the late Sumantra Ghoshal (2005) notes, describing business schools as teaching amoral values that were largely absent of a moral or ethical compass and thus destroyed sound managerial practice.

In one thread of the criticism, in 2018, Martin Parker pronounced *"shut down the business school."* As authors, we would like to suggest something which is related: namely to abolish or transform business schools and replace them with schools of management. We call for this repositioning for a number of reasons:

1. Management is needed in profit, not-for-profit and public sector organisations and is particularly important in facilitating collaboration across these sectors

2. Management, whether in business, government or in the third sector needs well-trained, professional managers with capabilities in a broad range of areas such as finance, operations and strategy as well as in the handling of people and resources in a trustworthy and ethical manner
3. Management implies longer term thinking and not short-term profit maximization – it requires a concern and responsibility for the impact of decisions across significant stakeholders

It would be much better for all involved if 'business schools' were not called 'business schools' but were actually more broadly oriented 'schools of management', returning full circle to their original orientation

This paper is structured around a number of key episodes in the development of management education. We will look at the original driving forces which led to the creation of institutions, particularly in the US, including the vision of their founders which would support our perspective in favour of schools of management.

We will then turn to the influence of the two world wars on management and how this affected management education and how the original purpose shifted.

Subsequently, we will look at the years following the Second World War and how the Ford and Carnegie 'Foundation Reports' as well as the Cold War led to further evolution away from a school of management to a business school mission.

We will then look at the period roughly from 1970 to 2000 during which US business school funding, which had been largely provided by the foundations, was replaced by significant donations from individuals seeking to attach their name to a prestigious business school and how this drove a further evolution away from the broad goal of a school of management to a narrow goal of the business school.

Finally, we will come full circle to a reflection on how management education curricula have developed since the beginning and through the phases mentioned above. We will conclude with some thoughts on what management is actually all about and why practicing managers need 'schools of management' rather than 'business schools'.

Historical origins

Despite the existence of 'Colleges of Commerce' in Europe during the 18th and 19th centuries, the categorization and concept of management education evolved from the growing interest in management as an academic subject in the United States at the end of the 19th and beginning of the 20th century when industrialization was in full swing.

The development of railroads and transport, of basic industries like steel, mining, and oil and gas, of food production and of manufacture were all increasing in scale and complexity and at a tremendous pace. The capacity to manage in these organisations, however, lagged behind.

Management was not considered a noble occupation like professions such as medicine and law. Thus, the often less intelligent and often less educated members of well-off families tended to assume management roles as a fallback: *"Business has become in part a catch-all and a dumping ground into which in the case of many families' inferior sons are advised to go"* (Donham 1927).

Nevertheless, over time, management became more popular among graduates of notable universities like Harvard University, the University of Pennsylvania and Dartmouth College. Once these graduates had established themselves in industry, they began petitioning their alma maters to establish graduate schools of management education and business administration.

The Wharton School at Penn was established in 1881, Dartmouth's Tuck School of Business in 1900 and Harvard's Graduate School of Business Education (now Harvard Business School) was formed in 1908. These schools would *"provide a setting for the education of a new kind of manager who, instilled with the sense of social obligation derived from an elite background, would run corporations in a way consistent with the broader interests of the country"* (Khurana 2007, p. 46).

This progressive-style reform was to replace the robber baron practices of the founders of some of the early corporations, seeking to ensure that management was a noble and worthwhile profession which also served society more broadly. In 1916, 17 leading business schools formed the Association to Advance Collegiate Schools of Business (AACSB) in order to establish standards and to certify management as a legitimate profession.

This concern for a broader conceptualization of managerial education was broadly carried by the early deans of business schools. Writing in 1913, Leon Marshall, the fourth dean of what had been founded as the University of Chicago's College of Commerce and Politics in 1898, and renamed as the School of Commerce and Administration during his tenure, stated:

"However important it may be to turn out businessmen who can make money, social workers who can command good salaries, civic workers who can rise to positions of influence and affluence, the most important task of all is to aid in promoting the progress and welfare of society." (Marshall 1913)

As late as 1933, Wallace Donham, an early Harvard Dean, sought to *"train men to study general social relationships with the broad vision and the philosophic view needed"* (Donham, 1933, p 435). Donham, according to Yogev, (2001), was particularly concerned by the aggressive and volatile nature of industrial relations at the time and regularly called for a progressive approach.

His colleague Lawrence Lowell, viewing social relations from the societal side, reinforced the need for a stable society. He said the school would train qualified public administrators whom the government would have no choice but to employ, thereby building a better public administration. (Yogev 2001).

While the goals of early management education had been outlined in a general way in seeking to improve management and to ensure progressive labour relations and a humanistic approach, translating this to the curricular level required improvisation and led to an evolution.

Some of the early subjects included classes like business English, commercial correspondence, accounts, office technique and stenography. Even by 1928, there was little agreement on what ought to be taught. Of the 34 schools studied, the only subjects they largely agreed on were Accounting, Economic Theory, English and Law.

Of note are two areas which would develop in different ways over time. Among other subjects, Foreign Languages, Government, Psychology and Social Science would recede while subjects like Mathematics, Statistics and Physical Environment (Operations) would grow significantly. (Khurana 2007, p. 159).

For the latter, the experiences of the Two World Wars proved critical. In particular, US business schools looked closely at the experience of their armed forces in these and other conflicts. It became obvious that strategic and logistical planning were key components for large scale activities. We will return to this development shortly.

For the prior case, effectively the humanities in management, this marked a high point. As Khurana notes, there were basically three approaches to management education all competing for primacy. The first was the humanistic approach in the liberal arts tradition involving subjects like history, philosophy, English and mathematics which already existed in many universities.

The second involved courses aimed at specific occupations like railroad transport, lumber management or banking. The third, which arose from the more quantitative subjects like Statistics and Operations, would subsequently be developed into an analytical and logical positivist 'science of administration'.

The post-war period

The key question which must be addressed is this section is why the third curricular path, the path of quantification, the path of the business school gained the ascendancy in the post-war period and displaced the humanistic, social science approach of the school of management that was more common in Europe and that had been advocated by Donham and colleagues at Harvard earlier.

A number of political and ideological paths need to be followed a few steps back. The first concerns the philosophical view taken by the different factions in the business school world. While Donham at Harvard was professing a laissez-faire humanism, Robert Maynard Hutchins, who became the President of the University of Chicago in 1929 at the age of 30, was, against his own intellectual preferences, laying the groundwork for laissez-faire economics.

Hutchins invited the radical free market economist Friedrich Hayek to Chicago in the 1930s. The motivation was to create an intellectually exciting environment. The unintended outcome was that the University of Chicago's Business School became increasingly free-market radical and libertarian.

This trend continued after the Second World War with an additional wave of free-market economists that included Richard Posner, Ronald Coase and Gary Becker, all of whom viewed not only economics, but pretty much everything else (the family, politics, crime, etc.) from an economist's rationalist point of view.

In parallel, the post-war period saw the establishment of a think-tank called the RAND Corporation. Basing itself on lessons learned in World War Two planning, RAND championed an approach whereby:

"… problems of national security and extending ultimately to a wide range of public concerns" were studied with *"a focus on the use of decision-theory, mathematics, statistics, and microeconomic analysis to improve choices made by leaders of social collectives (such as armies, firms, nations)."* (Augier and March, 2011 p. 74)

Invariably, there was a lot of movement between quantitatively oriented academics in universities and RAND. This should not come as a surprise as there had been a lot of movement between academia and the US military establishment during the war. Effectively, a revolving door was established between the military, academia and RAND which continued until well into the 1960s.

Early funding for RAND came from the Ford Foundation which had been set up in 1936 from a legacy donation from the founder of the Ford Motor Company. The Ford Foundation was strongly in favour of free-market capitalism and a small state, but also in economic improvement, freedom and democracy and world peace.

Similar but smaller foundations, notably the Sloan Foundation arising out of General Motors and the Carnegie Foundation arising from the steel industry, were also significant. It should be noted that by the mid-1950s, the 'Foundations' were the most important source of funding for a key group of influential graduate business schools: Stanford, Harvard, Chicago, Carnegie Tech, Columbia, UCLA, UC Berkeley and MIT.

With the Foundations providing significant funding, their opinions on management education were voiced and listened to. There were a number of areas of dissatisfaction: management education seemed incoherent, it was too based on 'war stories' rather than on academic rigour and too many faculty members were academically unqualified.

In 1959, the Carnegie Foundation's report (the *Pierson Report*) and the Ford Foundation's *Gordon and Howell Report* effectively called for the reform of business school curricula from a *"wasteland of vocationalism"* and unsubstantiated descriptive content to quantitative description based on rigorous data collection, computer-assisted mathematical modelling, and the foundational concepts of science: testable hypotheses, correlated observations and causal explanation (Mulligan 1987).

Unsurprisingly, given the financial dependence of certainly the main funding recipients, business schools fell into line and pursued the agenda which had been set for them by the Foundations.

Another factor was instrumental in the behaviour of the Foundations at the time. While Ford, Carnegie and Sloan all professed to support initiatives which encouraged education, freedom, democracy and world peace, their initiatives took place during the extreme Cold War era of Senator Joseph McCarthy and the related House Un-American Activities Committee.

Both McCarthy and HUAC were convinced that there were Communist enemies within the United States, having infiltrated government, film and media, education and pretty much everywhere else. Through a number of dubious attacks on individuals and organisations, McCarthy and HUAC aggression was met by paranoia and fear by those accused.

Already in 1952, a House of Representatives Select Committee (the Reece Committee) threatened the Foundations with the removal of their tax-exempt status should they engage in activities that were un-American and subversive, or for purposes not in the interest or tradition of the United States.

Hearings were held with Committee members questioning the Ford Foundation's involvement with academics and foreigners, particularly programmes in social science which implied, obviously, that this meant 'socialist' science. (Augier and March 2011, p.110). In fact, some members of the Committee accused the Foundation of showing *"symptoms of inadequate anti-communism"* (Augier and March 2011, p. 298).

It is thus no real wonder that the Foundations moved away from a social sciences school of management view to a more narrow business school perspective.

Within business education, they clearly saw benefit in promoting the quantitative vision of management which was aligned with RAND, military and red-blooded American capitalist viewpoints, and in downplaying any interest in any humanistic, liberal, social science aspects of organisational and managerial life.

Clearly academics like Economics professor George Stigler at the University of Chicago, who stated that *"it is hard for me to make sense out of any concept of social responsibility which does not rely exclusively on profit maximization and conformity with the law"* and who inspired the catechism that *"there is only one social science, and it is economics"* reflected the acceptable mood of the McCarthy era. (Augier and March 2011, p. 170).

Even some years later, another Chicago academic, Milton Friedman, wrote:

"Businessmen believe that they are defending free enterprise when they declaim that business is not concerned 'merely' with profit but also with promoting desirable 'social' ends; that business has a 'social conscience' and takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers. In fact, they are – or would be if anyone else took the seriously – preaching pure and unadulterated socialism." (Friedman 1970).

By 1960, these trends had led to a curriculum which was distantly related to the curricula in business schools in the between-the-wars period. Capon (1996) in his prolific description of curriculum development at Columbia Business School, outlines the core curriculum in place in 1960 following these developments.

Nine modules made up the core: World Resources: Physical, Technological and Human; Conceptual Foundations of Business; Business in a Dynamic Economy; Administration of the Firm; Business Decision Making; Human Behaviour in Organisations, Policy Determination and Operations, and three Quantitative Methods mini modules:

accounting, statistics and operations analysis. To note is that students at Columbia did not consider their school to be particularly quantitative at the time.

Nearly thirty years later in 1989, the Columbia curriculum had a core of Conceptual Foundations, Financial Accounting, Microeconomics, Macroeconomics, Organisational Behaviour, Probability and Statistics, Operations Research and Management Science and Policy. Amazingly, Human Resources, Finance, Marketing and Operations were all electives.

Of the 13 other major schools reviewed by Capon, the basic core was very similar to what was on offer at Columbia, but most others also required Finance, Marketing and Operations. Human Resources, Communications and International Business were all electives if offered at all.

In the wake of McCarthyism, the Foundation Reports and the ascendancy of Economics, the social sciences had pretty much disappeared completely from the management education curriculum.

On the tyranny of rankings and the naming of names

The trend towards the quantification of management education, towards the mission of business schools promoting profit maximization, and towards a strongly pro-capitalist libertarian attitude was further reinforced by an additional development.

Writing in 2005, Andy Policano, Dean Emeritus of both the business schools at the University of Wisconsin in Madison and of the business school at the University of California, Irvine stated that:

"Few people can remember what it was like before 1988 – what I call the year before the storm (of Business Week rankings). It was a time when business school deans could actually focus on improving the quality of their schools' educational offerings. Discussions about strategic marketing were confined mostly to the marketing curriculum. PR firms were hired by businesses, not business schools. Many business schools had sufficient facilities, but few buildings had marble floors, soaring atriums, or plush carpeting. Public university tuition was affordable for most students, and even top MBA programmes were accessible to students with high potential but low GMAT scores."

After 1988, unsurprisingly, ultra-competitive capitalism was not only discussed in business schools but became a feature of the environment in which business schools themselves competed. Competing on 'marble floors, soaring atriums and plush carpeting' is an expensive undertaking, and is the ever-increasing role of research and highly paid faculty members. This competitive landscape led to a search for increased sources of funding for business schools to pay for these investments.

As Burch and Nanda (2005) note, almost 50 prominent business schools were 'named' in the late 1980's and 1990's for sizable donations which supplemented tuition income and dwarfed any residual income that had been provided by the Foundations.

As an aside, the authors note that as the supply of nameable schools decreases, the price on remaining nameable schools increases. This is certainly true as some of the residual schools only named since 2000 have received substantial amounts.

Of the 57 schools reviewed, the authors helpfully provide some details on the donors of each of the schools. It is, of course, a who's who of American capitalism of the 1980's and 1990's: real estate developers, investment bankers, fund managers; retail, industry, and media barons.

Between 1980 and 2000, business schools at public universities received naming donations broadly in the range of $20 million to $30 million, while business schools at private universities generally received more.

As the authors rightfully predicted, the price of naming rights has increased since 2000. Of particular note are the Booth School at Chicago which generated $300 million in 2008 and the Ross School at Michigan which generated $100 million in 2004.

At the time of writing (January 2022), Harvard, Stanford, Yale, Columbia and a handful of other well-known US institutions remain 'nameless', it remains to be seen whether they will accept a donation and if so, for how much. Additionally, there are of course business schools elsewhere in the world that may well welcome being named.

There are a number of elements worth noting here. The first is largely philosophical and speculative. As authors, we would propose that the political orientation of many of the donors would be one of intense adherence to a pro-capitalist libertarian orientation which again promoted a narrow business school rather than broader school of management perspective.

It is not our role here to attempt to gain sight of their tax returns, but one expects that they keep a close eye on their levels of taxation. The fact that they are in a position to donate substantially of course also offers them tax offsets due to their charitable donations. In the US, these can go up to significant amounts, so well-timed donations can be of significant benefit in various tax years.

The second is obviously the 'immortality' bestowed through the naming convention. From a school's perspective, it obviously helps if the donor quietly passes away and no scandals are unearthed in or after life.

Unfortunate examples abound in life: the Georgia Institute of Technology was named 'DuPree' in 1996 for $25 million, but the name was stripped in 2004 because the money did not arrive. It was named Scheller in 2009 for $50 million. In the UK, Imperial College's business school was briefly named 'Tanaka' for £27 million in 2000, but the name was removed in 2008 when a fraud scandal erupted around said Tanaka.

Death is also no salvation. The business school at City University in London was named Cass in 2002 with a donation from the Cass Foundation. Alas, Cass's background as a slave trader led to the removal of the name in 2020, being replaced 'for free' with the hopefully upstanding name of 18th Century statistician and Presbyterian Minister Thomas Bayes. One hopes for the best.

What we have not yet addressed here is the basis of the naming conventions. It will come of no surprise that the vast majority of donors have chosen to name the institution "Name' School of Business' or similar. Of the 57 schools reviewed by Burch and Nanda, 42 are named in this manner. 15 are instead named 'School of Management'.

Of the top 100 business schools in the 2021 *Financial Times* global rankings, only four of the top schools from the US are schools of management, the rest are business schools. It would be interesting to speak to donors about their decision-making criteria.

Are they libertarian capitalists? Do they favour good management all around? Did they give this any thought at all? After all, what's in a name? Seemingly a fair amount. As Augier and March (2011, p.312) note:

"As more and more schools successfully solicited huge gifts from immensely rich individuals, more and more schools assumed the proper names of their benefactors and drifted toward the business, economic, and political prejudices that the donor embraced."

As one looks at other geographies, one sees different approaches. In the 2021 *Financial Times* ranking of European business schools, with the caveat that some schools are named in their domestic language, there is a much higher proportion, approximately 25%, that are called schools of management.

Many of these are outside of the UK, featuring regularly in Scandinavia, Germany, in the Benelux and in France. As Cornuel, Thomas and Wood (2021) note in their commentary, the European culture and environment encourages more direct cooperation with government in order to address such issues as social inclusion, inequality, poverty and environmental sustainability and hence, helps to enhance human, social and economic progress.

Because of these contextual and cultural differences there is both a discernable 'European identity' and welcome diversity in European management models. Just as there is no common North American model, there is no common European management model. (Thomas, Lorange and Sheth 2013).

That said, Europeans believe strongly in a balanced philosophy of management education in which important skills of analysis are nurtured alongside 'softer' management skills of creativity, criticism and synthesis. This balanced approach seeks to produce managers who possess a sense of social responsibility as well as a moral authority to guide and lead others.

Broadening out to look at the non-US or European schools in the 2021 Financial Times global rankings, it is notable that in India with the preponderance of the Institutes of Management, and also in China, a version of 'Schools of Management' dominates.

It is impossible to state categorically that these differences in naming conventions are the result of different concepts of how and where management education ought to be taught. That said, there has certainly been an ongoing debate between management educators in the US and outside of the US on what management is about, on whether sustainability is a proper subject, on the ethical responsibilities of managers.

As we have seen, the debate in the US is more capitalist and 'business school' while the debate in Europe reflects the social democratic systems of government and thus more 'school of management'.

In other cases naming conventions have historical roots that change with the times. A telling example can be found with SGH in Poland. Founded in 1906 as the 'August Zielinski Private Trade Courses for Men', it was renamed as Szkoła Główna Handlowa (effectively Main School of Commerce) in 1933. After World War Two, it was renamed Szkoła Główna Planowania I Statystyki (Main School of Planning and Statistics) before being re-renamed SGH in 1991. In English, the institute is known as the Warsaw School of Economics. Clearly, politics had much to do with the naming conventions of schools.

Interestingly, Kociatkiewicz, Kostera and Zueva (2021), academics originally from Poland and Russia and now spread across France, Sweden, the UK and Poland, make a three-fold argument: they argue that capitalism is a ghost in the walls of the business school; that capitalism's ghostly nature prevents the business school from offering a curriculum that serves more than the growth of financial capital; and thirdly that the naming of capitalism is integral to the exorcism of its ghost and the creation of curriculum that engages with the social and environmental challenges of our time.

In addition to noting that there is a greater emphasis on 'Schools of Management' outside of the United States than within, it is also worth noting that with a number of exceptions, very few business schools outside of North America are named.

Even in the UK, which always seems a hybrid between the United States and Europe, only Oxford Said, Cambridge Judge and Manchester Alliance come to mind. Continental Europe has a number of institutions that are named, but in most cases, the names arose from a founder or founding donor. Asia is largely similar although there are many private institutions or corporate funded institutions that do carry names.

In summary

In terms of curriculum, we have attempted to show how the original late 19th and early 20th century desire to train individuals as better managers, began as a relatively messy affair with no clear concept of what ought to be taught.

Within the first few decades of the 20th century, a number of competing visions arose: courses aimed at specific industries, courses largely based on the humanities, and courses taking a quantitative, economics-based approach.

Driven in part by the experience of the two World Wars, and hugely influenced by the post war interplay between think tanks like RAND, the cold war and individuals like Joseph McCarthy, and the Foundations, humanistic elements in the curriculum were exorcised as socialist, and a quantitative, capitalist, regulation-avoiding, free-market supporting vision of the role of business schools emerged.

The emergence of *Business Week* and *Financial Times* business school rankings accelerated this trend further. Hyper-competition in the management education landscape costs significant amounts of money. Schools were eager to receive donations in exchange for naming rights.

These donations, culminating to date in the $300 million donation by David Booth, a fund manager to the beacon of capitalistic business schools at the University of Chicago, embedded the capitalist vision further so that today only 4 of the top US schools are not named.

Unsurprisingly, given that the donations came from extremely wealthy individuals, their philosophical, social and political views became dominant.

Outside of North America, the historical experience has been different. The view of the role of business has been different, whether because of social democracy or because of communism. There was no McCarthy/HUAC era. The role of donors and the bestowing of names did not materialise in the same way.

However, there was a willingness among rectors and presidents of specialist universities for business and management, for example Paris Dauphine, WU in Vienna, Copenhagen Business School, St Gallen to *"without exception"* embrace inter-, multi- and trans-disciplinary curricula and have strong engagement with practitioners and public agencies (Cornuel *et al* 2021).

As a result, while the vast majority of institutions providing management education are named business schools across the world, a significant proportion, predominantly outside of North America are named schools of management.

The point we have tried to make is that it would be much better for all involved if 'business schools' were not called 'business schools' but were actually more broadly oriented 'schools of management', returning full circle to their original orientation.

Not only would this be beneficial in the long run for managers in businesses who need to understand more than micro and macro-economics and statistics by genuinely engaging with the society in which they are actors, it would also open up management education more widely to the not-for-profit and public sectors where management is also needed – probably more than ever.

Grey (2004) calls for managers to connect to a wider set of public duties than that of corporate performance alone, noting that this was the original vision of Joseph Wharton when he donated money for the Wharton School in the US in 1881, a vision of a school of management.

We concur. It is not realistic to imagine the unravelling of over 100 years of development within the management education sphere – there is too much path dependency involved – but it is nevertheless possible for many schools around the world to take on and verbalise a broader vision.

For example, Harney and Thomas's (2020) book contains a model of liberal management education developed at Singapore Management University (SMU) in which the more analytical, technological and specialised management aspects are balanced by a sound understanding of the wider world through studies in the humanities and social science. The Thomas *et al* (2023) study of the processes and actors involved in SMU's evolution of expands on this theme.

Perhaps it is, however, realistic for a number of institutions, assuming they are not 'named' by a donor, to change their own branding in a similar manner. Being called a 'school of management' does not seem to have hurt those that are named as such. It is hard to imagine a downside. The upside seems self-evident to us. ■

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