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SPECIAL EDITION: EMU AFTER CYPRUS

Belief evaporates as crisis deepens

EU now appears part of the problem

Christopher Tugendhat, Advisory Board

One of the greatest strengths of the European Union during its glory years was the widespread belief in member states that it was an integral part of the solution to their national problems.

Now, as made clear by the unfolding developments surrounding Cyprus, one of the saddest features of the euro crisis is the steady erosion of that belief. For Germans, the EU provided an alternative focus to nationalism, as well as a constructive role in the world. For Italians it offered a better and cleaner alternative to their own tarnished political system. For the Irish it was an escape route from Britain's dominance.

To the Spanish, the EU represented a return to the European mainstream and democracy after decades of isolation and dictatorship. And so on for other members. For all, Europe held out the promise of enhanced economic opportunities and prosperity. We now see changing perceptions across the board. In the northern countries public opinion is becoming increasingly fed up with bailing out their Mediterranean partners. And in these latter countries, the mood is epitomised by the 'No' emblazoned on the raised hands of Cypriots protesting against the terms demanded by EU institutions and the International Monetary Fund.

It is not that large numbers of people have become anti-EU as such, as in Britain. Rather, they dislike and resent what the EU's flagship policy involves.

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Cyprus bail-in opens new phase in EMU attrition

The €17bn Cyprus rescue package has set off a torrent of reaction. The bail-in of large depositors has raised concerns about the safety of savings in Europe. John Nugée (left) and Stefan Bielmeier (right) give their views in separate articles. Further opinions are given by David Owen, John Chown, and other members of the OMFIF Advisory Board. **SEE ARTICLES ON P.3-7 AND P.22-24.**

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Xi-Li in

Incremental change

Jonathan Fenby, Advisory Board

The ascent of Xi Jinping and Li Keqiang to the helm of China's Communist party state after a four month political transition has bred expectations of major reforms. This is unlikely to be the case.

Both men were earmarked for the top five years ago when they were elevated to the standing committee of the Politburo – Xi as party general secretary, state president and chair of the Military Commission, Li as prime minister. Li speaks a lot about the need for reform but change is likely to be incremental. This is in line with Xi's remark after getting the general secretaryship last November: 'Reform is a series of continuous adjustments, not a big event.'

However the reappointment of Zhou Xiaochuan as governor of the People's Bank of China (PBoC) points to an acceleration of financial reforms including internationalisation of the currency and capital account liberalisation.

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Jeroen's juggling

Frisson throughout Europe

David Marsh, Chairman

When Roel Janssen, our veteran Advisory Board member in Amsterdam, portrayed Jeroen Dijsselbloem, the new Dutch finance minister, in the February OMFIF bulletin, he spoke of a 'baptism of fire' for the freshly-anointed chairman of the Eurogroup of euro area finance ministers.

No one could have foreseen that, in addition to presiding over the nationalisation of SNS Reaal, the fourth largest Dutch bank, Dijsselbloem would shortly afterwards become a major player in a clumsy rescue of the Cypriot banking system that sent a frisson around Europe.

This has been a verbal and political juggling act of the first order. Soon after completing the package deal for a combined €17bn Cyprus bail-out / bail-in, Dijsselbloem gave an interview saying that in future depositors, perhaps even insured ones, would have to join contributions to repair failed banks. Many, including (somewhat disingenuously) Mario Draghi, the president of the European Central bank, have claimed that Dijsselbloem's remarks were misunderstood.

However, his message stands out loud and clear: it's a sign of things to come. 'Now that the crisis seems to fade,' he argued, 'I think we have to dare a little more in dealing with this.' No misunderstanding here, Mario. The patience of governments representing the taxpayers of northern Europe, who have provided the main sources of finance (whether guarantees or real money) for banking and state bail-outs in the past four years, is now wearing thin.

From now on, depositors in problem banks (in some cases, maybe even those with insured deposits) and other senior creditors must acknowledge that they may be called to account. Many believe that, if the going gets worse in Europe, the new Dijsselbloem doctrine could touch off capital flight and bank runs. But it certainly blocks moral hazard. We shall see how this juggling ends.

None of this has made positive headlines. Christopher Tugendhat examines the unfortunate tendency of European electorates to regard the EU as part of the problem not the solution. Ruud Lubbers and Paul van Seters take a more optimistic line, underlining the need for Europe to restore competitiveness through 'green growth'.

David Owen looks at the faults in the construction of monetary union that were there from the beginning. John Nugée tells us how Europe's sources of divergence can be healed. Stefan Bielmeier ponders the post-Cyprus crisis of confidence on financial markets. Michael Stürmer investigates the new anti-euro movement in Germany. John Chown warns that pensions will be key in eventual resolution of monetary union's problems. Pawel Kowalewski traces Europe's development in the light of history, through a new book by Ivan T. Berend.

We mustn't take our eyes off the wider world. Jonathan Fenby reports on the expectations surrounding China's new leadership built around Xi Jinpin. Gabriel Stein analyses the case against nominal GDP targets. Nick Butler writes that demand for oil is peaking not supply. Darrell Delamaide shows how the advocates of quantitative easing are flocking around Ben Bernanke at the Federal Reserve – although, as the US economy slowly improves, their time may be coming to an end. William Keegan is absent this month, pending a shoulder operation. We wish him well.

David Marsh

New path for Old Continent

Industrial renewal is the way ahead

Ruud Lubbers and Paul van Seters, Advisory Board

Economic stagnation is a spectre haunting Europe. The only way for Europe to escape is by investing in a new, more sustainable mode of economic growth: green growth. This provides a way forward to create jobs and motivate firms and citizens.

Not that long ago the Common Market was held to be necessary for a strong Europe; nowadays a low carbon economy is what is needed.

Politicians across Europe should be much more serious about this. The shale oil revolution is turning global energy markets on their head. Cheap coal is streaming from the US towards Europe. New technology should transform this into 'clean coal' and thus contribute to the transition to a low carbon economy. Everything that serves that goal will help achieve the aim of a genuinely sustainable economy. That is what an innovative Europe is all about.

We do not share in the general negative reaction from the continent to the February speech from UK prime minister David Cameron setting down conditions for a more competitive Europe. Some criticism directed at Cameron, from the French and German foreign ministers, for example, has been unfair. A plan to make Europe more attuned to the needs of today's ultra-competitive world and more in line with the wishes of its citizens cannot be called anti-European. However, Cameron should be far more ambitious and clear-cut in his proposals.

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The original goal of the European Union was to secure peace after the ravages of the first half of the previous century. Now that this goal, after 50 years, has been achieved and secured, there is indeed an urgent need to recognise a new goal, 'to secure welfare.' This is the principal criterion by which to assess any ideas for reinforcing Europe in the future. What was missing from Cameron's speech was a convincing analysis of the conditions that most immediately threaten Europe's welfare in the 21st century and some inspiring concrete proposals on how to overcome that threat.

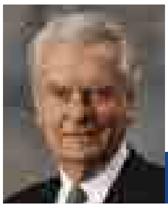
One way forward is to build on the rich tradition of the principle of subsidiarity – making sure that, where there is no specific reason for pooling sovereignty, European decision-making is devolved as far as possible towards regions and units that can be responsible for their own action.

Herman Van Rompuy, the president of the European Council, has put forward four 'building blocks' as part of his plan for reviving Europe outlined to governments late last year. These all need to be supported and driven forward.

Geopolitical issues also need to be addressed – and here the UK can doubtless play a role. Margaret Thatcher, the former prime minister, towards the end of the Cold War built up an excellent relationship with Mikhail Gorbachev. Cameron would be a more impressive figure on the European stage if he could arrange a rapprochement with Russian president Vladimir Putin. He should make clear to Putin that Europe is prepared for a positive dialogue on energy with Russia, in exchange for a no-fly zone above Syria.

But it is the field of green growth that is all-important. A substantive part of the new EU budget 2014–20 is earmarked for this area. But it is a good European tradition that like-minded countries join forces and move at a faster pace than Brussels. Today this could be the way to achieve a low carbon economy.

The UK, Germany and the Netherlands share the same problems and a common interest in solving them. In many areas these three countries could jointly stimulate low carbon technology. Such forms of collaboration would be the building blocks of the new Europe Cameron is proposing. He and others need to take concrete action to make it reality.



Weakness was foreseen

Political integration the only way forward

David Owen, Advisory Board

European banking experts always knew that economic and monetary union (EMU) would be characterised by stronger asymmetry across countries, especially the peripheral members. They knew, too, that EMU could rely only on weak adjustment mechanisms, especially reflecting low degree labour mobility and the absence of any risk-sharing arrangement.

Politicians were too complacent in designing the building blocks of what has turned out to be a perilously weak monetary union.

Optimism about euro area convergence was wrong. For nine years from 1999 to 2007, until the global crisis took over, intra-euro area differences were accentuated. Real exchange rate misalignments were aggravated and the traded goods sector shrank in southern Europe and grew in the north. Current account imbalances widened and net foreign asset positions were built up.

Monetary union strengthened incentives for fiscal laxity. The so-called no-bail-out clause was meant to give markets an incentive to price the risk of default, but the European Central Bank's collateral policy did not discriminate between sovereign bonds. The risk that a fiscal crisis would transform itself into a financial crisis was correct.

The ECB in 2007 did provide liquidity to the banking system. The ECB was strong enough to compensate for liquidity shortages, even though it never formally crossed the Rubicon of being the lender of last resort. Mario Draghi's July 2013 'do what it takes' statement held the ring of doubt for a while but it needs bolstering soon with concrete measures.

The belief that the euro can survive the next three years without Treaty amendment is a dangerous political gamble born of weakness in political structures. Politicians were too complacent in designing the building blocks of what has turned out to be a perilously weak monetary union. They expected and hoped that the single currency would spur integration across previously fragmented European financial markets – and this happened. But instead of leading to stabilisation, this caused a negative feedback loop between banking fragility and sovereign weakness. The correlation between fiscal and banking crises means that bank-sovereign interdependence has created the potential for self-fulfilling crises.

Member states, in keeping individual responsibility for the rescue of their national banking systems, underestimated the huge size of such systems in the euro area. The average EU bank assets-to-GDP ratio is 350%, which meant that the fiscal consequences of banking failures were potentially large enough to bring state solvency into question. This in turn weakened the value of the implicit guarantee provided by the state to the banking system and threatened the solvency of the banks.

At the same time, domestic banks still held on their balance sheets a considerable share of the debt issued by their domestic governments. The ECB did not have the power or the mandate of a typical national central bank to ease tensions by playing the role of lender of last resort to governments, making the euro area especially fragile.

Countries within EMU became subject to balance of payments crises. The type of investment financed in some European countries – mainly excessive residential construction – and the way they were financed – through volatile sources such as portfolio debt securities and bank loans – rendered the deficit countries particularly prone to unwinding of capital inflows. As a result, a reversal took place of the massive capital inflows invested in southern European countries over the last decade.

The policy response since the first cracks appeared at end–2009 has been on creating instruments for crisis management and resolution.

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Sinking feeling in Germany

New movement could make big difference

Michael Stürmer, Advisory Board

As part of the run-up to the German general election on 22 September, a wild card has been placed on the table, potentially upsetting the calculations of all electoral wizards, party strategists and, indeed, Chancellor Angela Merkel herself. Political and social unease about the euro, widespread throughout Germany, especially among the middle classes, has finally found an expression called, rather immodestly, 'Alternative für Deutschland'– Alternative for Germany.

While seven or eight years ago, 40% of Germans expressed doubts on the euro, today the rate is closer to 70%. The financial crisis has produced a much broader test for general trust in government. The endless sequence of crisis summits has eroded belief that muddling through will work forever. People have a sinking feeling.

The stage was set in March, in Oberursel near Frankfurt. The neat little town overshadowed by the Taunus mountains is a well-to-do, middle class suburbia. The organisers expected a couple of hundred participants to listen to a panel discussion on the euro's future. Instead, more than 1200 turned up to listen to the experts, median age around 70.

Germany is not Italy where a man like Beppe Grillo can rise to national importance, more or less overnight, or France where political parties are mostly organised around one powerful leader, with little attention to programmatic niceties. In Germany political parties receive state funds according to the votes they can collect – but only after they have won electoral success.

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On the one hand, Germany has an almost unadulterated system of proportional representation. On the other hand, a legal threshold of 5% minimum votes does not make things easier for an upstart. Therefore the convenient way to influence party politics and turn them into a new direction is to hijack a number of local or regional chapters and work from within the party.

So far, the leaders of Alternative für Deutschland have not yet decided whether to do that. Nor have they received any offers from Merkel's Christian Democrats (CDU) or from the liberals to join and forget an independent movement.

Setting up a new party in Germany is very difficult and, even if successful, can take a decade or two. Without a well-supplied war chest, the chances of a breakthrough are slim or non-existent. It took the Green party the best part of 20 years to make a difference. The minimum requirement is a number of well-known faces, especially on TV, working full time. Thousands of activists are needed to distribute posters and spread the message.

What are the options? It may well be that the political parties discover that there are millions out there who fear inflation and do not trust present policies. They could integrate and mobilise this protest vote, especially among the middle classes who have most to lose. The alternative would be for the protest movement to carry on regardless and make life difficult for the centre-right parties. That could then in turn carve out 2–3% of the vote for the present coalition. Since Merkel's centre-right alliance enjoys only a few seats majority, it can ill afford even the smallest of losses at the next elections.

At present it is still slightly ahead of the red-green opposition, and the far left 'Linke' is not considered clubbable enough to join a potential Social Democrat-led government.

The new movement could make all the difference. If German domestic affairs have looked a little boring recently, big changes are now conceivable, large enough to be within the previous margin of error. A change of 1% either way could change the whole equation. However, Merkel is a masterful tactician. She might come up with a big surprise.

Back to first principles

Pensions are the key in euro fiscal union

John Chown, Advisory Board

If, as now generally accepted, euro members move towards a fiscal union, it is imperative that each state maintains fiscal discipline, and remains responsible for its own debts ('no bail-out'). There must be adequate arrangements for emergency inter-state transfers and a central authority to coordinate banking regulation.

On the latest projections, by 2060 the French government will be paying out 16.8% of GDP to pensioners every year – double the UK figure of 8.4%.

Prof. Harold James of Princeton University, a member of the OMFIF advisory board, with the help of archives, shows that all these issues were fully discussed during the previous attempts to create a monetary union, from the early 1970s Werner Plan onwards.

Any move towards a closer union will create a 'two speed Europe', raising two sets of questions. The first one is how the 'ins' can achieve their objectives without being impeded by, or damaging the economies and interests of, the 'outs'? What would be the implications for, and political issues facing, the latter, a far less homogeneous group? The second is what are the implications of a fiscal union for those considering joining? I suggest they will need to have to look at the small print very carefully, with particular reference to pensions.

In its negotiations, the UK will have to use subtle rather than confrontational diplomacy, with first-class advice from monetary economists and specialist lawyers. We certainly do not need to 'protect' our financial industry but we do want to make sure that other countries do not adopt a non-communitaire approach to national protection of specific industries so that each of us can use our strengths for the mutual benefit of ourselves and our neighbours. How the British handle the proposals for a financial transaction tax will be an excellent test.

Any country considering signing up should (like companies contemplating a merger) compare their properly calculated balance sheet as a nation with those of the others, looking beyond formal net debts, projected budgetary cash flows and the like, to examine 'off-balance-sheet' guarantees and liabilities, notably with regard to the banking system, pensions and public private partnerships. Another question is the scope each has for enacting future privatisations, raising more taxes without damaging enterprise and getting more value for money out of public expenditure.

A fiscal union does not need a common tax system. But part of the deal to make the euro sustainable will, and indeed already does, involve substantial fiscal transfers falling outside the scope of the original euro rules. Voters in the paying countries will not like this, while beneficiaries will take a different view. Such transfers should ease the transition while requiring the necessary internal remedial action, rather than allowing the funds to be used as an excuse for a delay.

During the first half of this century, the number of people at work across Europe compared with those drawing a pension will, on unchanged policies, fall from 4 to 1 to 2 to 1. To take an extreme example, the UK and France have very similar economic statistics, and expectations of earnings related pensions. British ones are (maybe inadequately) backed by some $2tn (about 80% of GDP) of independent fund assets, while in France these are an 'off balance sheet' liability of the state.

On the latest projections, by 2060 the French government will be paying out 16.8% of GDP to pensioners every year – double the UK figure of 8.4%. Most, but not all, euro members have 'Bismarckian' rather than 'funded' pension arrangements but even between them the differences are significant. Will the German taxpayer, for instance, be prepared to subsidise early retirement for the French? The Netherlands and Finland, which are expected to be part of an inner euro group, have about 100% and 60 % of GDP respectively in pension fund assets. These creditor countries with well-funded pension systems should be watching their position very carefully indeed.

New crisis of confidence

Cyprus effects run far and wide

Stefan Bielmeier, Advisory Board

Financial markets have rallied since last summer. According to the Bank for International Settlements, the global equity markets have moved up by 23% since June 2012, and the German DAX index has risen somewhat more.

The bond yields of the crisis-stricken countries of the euro periphery have fallen considerably in the same period, with investors obviously regarding the risks of a default by Spain or Italy as much smaller at the moment than only a few months ago.

Economic crisis management has played a major part in this calming process. This applies particularly to the European Central Bank's announcement last July that it would pull out all the stops to safeguard the euro, and the assurances given by heads of state and government that no country would have to exit the euro area. The latter assertion has, of course, been called into doubt again in the case of Cyprus.

True, Cyprus has been bailed out, at least for the time being. National bankruptcy was averted at the eleventh hour, but the creditors of the country's oversized banking sector have been asked to contribute. However, neither the flare-up of the Cyprus crisis and the dramatic struggle to find a solution, nor the post-election political stalemate in Italy has depressed market sentiment to any significant degree.

Why is this? Setbacks to the calming and normalisation process were to be expected. So far they have remained very limited. Nevertheless, the EU's decidedly clumsy management of the Cyprus crisis could still have negative repercussions.

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For this is the first time that, as a result of a political decision, account holders have been involved in the bailout of a country and its banks. Clearly, it has been possible to portray the problems of the Cypriot banks as a special case, rather than a template for events in other crisis-stricken countries.

It can only be hoped that savers in other periphery countries with troubled banking sectors continue to regard their deposits as secure and do not withdraw them.

Another onslaught on banking systems – especially in the periphery countries – is the last thing needed while attempts are under way to de-escalate the crisis. Another crisis of confidence could destroy the first signs of progress which are emerging, particularly since the periphery countries are not exactly well placed to provide major support.

So far, for example, Spain has managed to avoid going to the troika thanks to the support provided for its banking system by the European Stability Mechanism. However, recent decisions in this connection by euro politicians have increased the risks again significantly.

In general, the Cyprus example demonstrates exactly why the euro debt crisis is a crisis of confidence. If, as a result of political decisions, investor confidence is weakened, this may have major consequences which extend far beyond the country immediately affected and generally undermine confidence in the euro.

Weakness was foreseen *(...contd from page 4)*

It remains to be seen if a banking union will be sufficient to repair financial integration in the euro area. It is certainly necessary to protect the states from their banks – and the banks from their sovereigns – but this may not be sufficient to persuade investors to purchase bonds from countries they distrust. More market flexibility and a robust fiscal framework are needed. But will a concentration of production in fewer areas need to be compensated for by transfer payments? Will labour mobility develop sufficiently to help adjustment? It is hard to escape the conclusion that only far greater political integration will guarantee the euro survives.

Belief evaporates as crisis deepens (... continued from page 1)

For various reasons Cyprus can be classified as a special case as, up to a point, can Greece. But that Italy, a founder member of the Original Six, should have elected a parliament that appears to be incapable of fulfilling the obligations of membership is an extremely worrying development.

There is another disturbing phenomenon. Whereas in Britain criticism of the EU, of how it works and even what it represents is commonplace, hostility towards the peoples of other member states is rarely expressed or felt. By contrast, within the euro area, politicians, press and demonstrators trade insults and misrepresent national characteristics in the crudest terms.

In private conversation businessmen speak vituperatively of their partner countries' policies and leaders. Instead of the ever closer union the euro was supposed to promote, its recurring crises are driving the peoples using it further apart. Until now the EU has succeeded in creating structures involving far-reaching economic and, in some respects, legal integration despite the absence of Europe-wide demos.

There has been criticism of a democratic deficit in its decision-making procedures. But there was widespread belief in most member states that, whatever objectionable features the EU might from time to time display, it was in a fundamental sense in the national interest to be a member. So these criticisms never gained much popular traction.

The great majority of people, whatever their nationality, were content to leave it to their national ministers meeting in councils in Brussels to steer the composite ship of state. Those days are over. Each succeeding bail-out, culminating in the Cyprus fiasco, engenders increasing bitterness. We see grinding into each other the tectonic plates of conflicting domestic political constraints in creditor and debtor countries.

Yet if the euro area is to function effectively in the long run, it will require economic and financial structures involving unprecedented transfers of power and responsibility from the national to the European level. Across political life in the countries concerned, the upheaval will be so great as to amount to constitutional change.

To be effective, to endure and as a matter of principle, such change will require democratic approval to give it legitimacy. How can that be secured when, to so many, the euro appears less as part of the solution to their nation's problems, much more as a principal cause?

Xi-Li in (... continued from page 1)

The new leaders are well aware of the need for reform to move the world's second biggest economy beyond the model inherited from the 1980s. The elements which drove China's success after Deng Xiaoping launched reform at the end of the 1970s have been overtaken by the growth they spawned. Labour is becoming more expensive, in part reflecting the government's policy of boosting wages to spur consumption and reduce reliance on fixed assets investment and exports for growth.

The cost of capital has risen, especially in the shadow banking sector which has been the main driver of funding for projects in the last 18 months and where interest rates are well above those charged by the state banks. Exports, the third element in the Deng formula, are not what they used to be. Even if the latest government plan sets the growth target at a moderately restrained 7.5%, achieving sustained expansion requires changes. The Xi-Li administration has embarked on measures to make party and state more efficient. These include a drive against corruption, calls on officials to live more frugally and to get closer to the people, and steps to streamline government unveiled at the annual plenary session of the National People's Congress.

Yet the two congresses – of the party and legislature – provided little concrete evidence of throughgoing change. Xi's first priority appears to be 'party strengthening' to make the Communist apparatus more effective. Some reformers earned promotion, notably former Guangdong party secretary Wang Yang, who has spoken out about reform and who became a vice premier. But widely-anticipated measures such as strengthening the Environment Ministry after the smog crises did not materialise.

Xi may calculate that he has time before undertaking reforms in land ownership and financial markets, which would cut growth, boost inflation and cause major friction with vested interests in the state sector. In the short run, China is likely to enjoy a relatively strong year, with growth rising to 8% or beyond. But inflation is also likely to increase in the second half of 2013, bringing some credit tightening and reducing growth to 7–7.5% in 2014.

On the monetary front, the policy stance for 2013 will remain 'prudent', meaning neutral. The M2 growth target is set at 13% for the year, one point below 2012. The importance of M2 as an indicator should not be overdone given the strong development of non-bank financing. Oversight of monetary policy and the financial sector is likely to be entrusted to another of the new vice-premiers, Ma Kai.

The higher budget deficit target of Rmb1.2tn (2% of GDP) for 2013 is part of pro-active fiscal policy rather than general fiscal easing. There is still ample domestic liquidity to support a further pick-up in investment growth and sustain the recovery in the property sector. The new leadership is likely to have a benign start. In good Leninist fashion, Xi Jinping is focusing on securing his base, including the military. He wants to pursue a more pro-active approach than his predecessor, Hu Jintao, without bringing into question the political structure he has inherited. Achieving that while dealing with the difficult challenge of adapting the economy to changed circumstances will be his true test.

Case against nominal GDP targets

Being fashionable doesn't make it less wrong

Gabriel Stein, Chief Economic Adviser

After a flurry of speculation over the past few months, George Osborne, Britain's chancellor of the exchequer, ultimately did not change the Bank of England's mandate in the UK Budget.

While some adjustments were made, the Bank's remit remains to target inflation. However, Osborne did leave the door open to future changes once Mark Carney, the new governor, has his feet firmly under the table.

The discussion about changing the Bank's remit gained momentum last October, when Sir Mervyn King, the incumbent, mused publicly about a wider remit than solely inflation targeting.

The debate is not restricted to the UK. In the US, the Fed has substantially shifted its emphasis from one of its dual mandates – stable prices – to the other – low unemployment. But in the UK, the debate quickly centred around a shift to targeting nominal GDP. There have always been some supporters of this idea in Britain, but the debate gathered life following comments by Carney, with support from Osborne and from a number of newspapers.

On the face of it, nominal GDP targeting (NGDPT) is a beguiling idea. You target, say, 5% growth in nominal income. If real income growth is too slow, you boost inflation to reach the target; if inflation is too high, you squeeze real growth to bring it down; or any combination thereof.

Nevertheless, this idea suffers from a number of flaws. First and most importantly, it assumes that you can indeed fine-tune an economy to the relevant extent by using monetary policy. That is highly unlikely.

However, this argument could be raised against any target. Is it possible to fine-tune an economy so that we achieve the inflation target we want two years (or so) down the line? Possibly, under normal circumstances – but not necessarily in a crisis.

However, inflation targeting, with all its flaws, at least has the advantage of simplicity. The concept of inflation is relatively easy to explain and to understand. The data are published monthly, with a lag of about three weeks in most countries. They are rarely revised. It is easy to see whether the target has been hit or not.

The policy instrument – the policy interest rate and how it affects the growth of broad money and hence activity – is also fairly straightforward. Finally the actions of the monetary authorities tend to have an immediate and noticeable effect on both households and companies.

By contrast, targeting nominal GDP is riddled with problems. For one thing, GDP is a flawed measure at best. For another, complications ensue from decomposition of nominal GDP into real GDP and inflation.

Instead of one variable – consumer prices – we have two – prices and activity. For the proponents of nominal GDP targeting, that is one of the advantages: if one of the components is 'misbehaving', you can adjust the other.

For an outside observer, however, this seems to add to complexity and hence make decision-making even more difficult. Moreover, this assumes that the authorities would indeed react in the same way to 4% real growth and 1% inflation as they would to 1% real growth and 4% inflation – something extremely unlikely.

Nominal GDP targeting assumes that you can fine-tune an economy to the relevant extent by using monetary policy. That is highly unlikely.

There is also the problem that NGDPT assumes that inflation accelerates when growth is below par and vice versa. In fact, it is much more the case that higher inflation comes as a result of above-trend growth and lower inflation from lower growth. (Incidentally, isn't nominal GDP-targeting just a way of targeting real GDP growth? If so, why not say so? But it still won't work. If governments and central banks could command a particular growth rate, why haven't they done so already?)

We need to consider that GDP is reported with substantial lags and subject to large revisions. Here, practice varies from country to country. In Australia and Sweden, GDP is reported with slightly more than a two-month lag. However, revisions are rare, usually taking place after multi-year intervals. For the euro area, a flash indicator is published six weeks after the end of the quarter, with a revised number published three weeks later. But minute changes are also published with each series, often going back 20 years or so.

Canada actually publishes monthly GDP data. For the US and UK, initial GDP data are published about one month after the end of the quarter, but that number is then revised twice over the next two months. The US also revises the last few years of GDP every year; and has a major ('comprehensive') revision every five years or so.

Using a target for monetary policy which at best is 9–10 weeks and, at worst, 12 weeks – one quarter of the year – out of date does not seem the best way forward. The need for timely information means that GDP would have to be reported more frequently; but this runs up against the need for more accurate information.

Using a target for monetary policy which at best is 9 – 10 weeks and, at worst, 12 weeks out of date does not seem the best way forward. The need for timely information means that GDP would have to be reported more frequently; but this runs up against the need for more accurate information.

It is worth looking at this with some precision. (The following calculations use US data because happens to be the easiest available.) Going back to 1996 (the extent of the archived releases published by the Bureau of Economic Analysis), the first ('advance') estimate of quarterly nominal GDP growth has averaged 4.5% at a seasonally adjusted annualised rate. The third ('final') estimate has averaged 4.7%. (See Chart 1.)

Chart 1: 'Advance' and 'final' estimates of US nominal GDP, quarterly change at seasonally adjusted annualised rate, %

As it happens, the very latest estimate (following all annual and comprehensive revisions since 1996) of average nominal quarterly GDP growth is 4.4%, so not too far off the original estimate. But this hides substantial revisions of the quarterly estimates.

The maximum upward revision on record was for Q2 1997, where the advance estimate of nominal GDP growth was 3.7%; three years later this was revised to 7.9%. The largest downward revision was Q3 2008, where the advance figure showed a rise of 3.8% nominal GDP, eventually revised to a fall of 0.6%. (See Chart 2.)

Chart 2: 'Advance' and most recent estimates of US nominal GDP, quarterly change at seasonally adjusted annualised rate, %

We must recognise that inflation targeting does work reasonably well. Not least because it implies the recognition that central banks cannot create output growth.

Assuming that monetary authorities had targeted nominal GDP growth; and assuming further a growth target of 5%, with a certain amount of leeway – eg, ±1% – it is clear that the key signal would on both occasions have been massively wrong. Nor are these the only occasions when subsequent revisions have shown even the 'final' estimate of nominal GDP growth to be substantially out of kilter.

Of course, the object of monetary policy is not to target the latest number, but to aim for a number some time – usually about two years – down the line. However, even with inflation targeting, in spite of central banks valiantly publishing future paths of inflation, the focus inevitably ends up on the latest number, even though all it does is to tell us what happened over the 12 months to last month, not what will happen over the next 24 months.

A look at the range of forecasts for any GDP release shows how difficult it is to get near an accurate forecast even at a time when we ostensibly know everything that happened in the relevant quarter. Trying to project growth two or more years in advance with any attempt at exactitude will almost certainly fail.

One other uncertainty concerns the impact of other influences. Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, said in a speech in January: 'In contrast to inflation, real economic growth and labour market conditions are affected by a wide range of factors outside a central bank's control. In fact, the effects of monetary stimulus on real output and employment are less than is widely thought; they consist largely of the transitory by-products of frictions that delay the timely adjustment of prices by businesses. Attempts to overstimulate real economic activity via monetary policy can instead run the risk of raising inflation.'

We must recognise that inflation targeting, with its flaws and problems, did and does actually work reasonably well. Not least, perhaps, because it implies the recognition that central banks (and governments) cannot create output growth. All they can do is to create an environment conducive to output growth, for example by providing stable prices.

By contrast, nominal GDP targeting is an attempt to do the impossible, i.e. create growth. It is therefore likely to be inherently more inflationary. And if we assume that the role of a central bank now includes financial stability, there is no reason why nominal GDP targeting would be more conducive to financial stability that inflation targeting.

Policy would almost certainly become backward-looking. And this would probably lead to less stability, not more.

Fed doves flock to defend policy

Still looking for improvement in labour market outlook

Darrell Delamaide, Board of Contributing Editors

With a veritable flock of Federal Reserve doves defending the continued policy of monetary accommodation on the home front, Fed Chairman Ben Bernanke (voter) took the opportunity at a conference in London to reject the notion that these policies were designed to promote a competitive devaluation.

'The benefits of monetary accommodation in the advanced economies are not created in any significant way by changes in exchange rates,' Bernanke said at a symposium co-sponsored by the Bank of England. 'They come instead from the support for domestic aggregate demand in each country or region.'

Ben Bernanke

He went on to drive the point home: 'Moreover, because stronger growth in each economy confers beneficial spillovers to trading partners, these policies are not 'beggar-thy-neighbor' but rather are positive-sum, 'enrich-thy-neighbor' actions.'

Bernanke drew attention to a revisionist view of monetary policy history that now considers the helter-skelter abandonment of the gold standard in the 1930s was not part of devaluation strategy, but rather freed governments to pursue a policy of monetary expansion that helped reflate individual economies to their mutual benefit.

FOMC keeps it steady as she goes

At his quarterly press conference following the meeting of the Federal Open Market Committee a few days earlier, Bernanke made it clear that monetary accommodation, including the monthly $85bn in asset purchases, was still the order of the day.

'Overall, still-high unemployment, in combination with relatively low inflation, underscores the need for policies that will support progress toward maximum employment in a context of price stability,' Bernanke said. In response to questions, he emphasized that changes in the flow of asset purchases would depend not on the headline jobless rate or any other single criterion, but on the outlook for the labour market into the foreseeable future, relying on a number of indicators.

William Dudley

New York Fed chief **William Dudley (voter)** emphasized this point in a speech to the Economic Club of New York. 'Our policy is based on the outlook for the labour market, not the level of employment or unemployment today,' Dudley said. 'In this context I note that the recent improvement in payroll employment growth, which gets much of the attention, is out-sized relative to the growth rate of economic activity that supports it.'

He recalled that when this disparity occurred in 2011 and 2012, growth in employment subsequently slowed. 'We have seen this movie before,' Dudley said. 'It is premature to conclude that we will soon see a substantial improvement in the labour market outlook.' The New York Fed chief, who is vice chairman of the FOMC, spelled out what this means for monetary policy: 'Currently we are falling well short of our employment objective and the restrictive stance of federal fiscal policy is a factor….As a consequence, we need to keep monetary policy very accommodative.'

Chicago Fed President **Charles Evans (voter)**, a leading dove on the panel, told reporters at a breakfast meeting that asset purchases should continue at the present rate for the time being.

'I think this is the point where we have to be patient and let our policies work,' he said, according to news reports. 'I prefer and think it is best that we continue to provide strong confidence that we are going to be doing appropriate accommodative policies to get the economy going again.'

His remarks were echoed by fellow doves **Eric Rosengren (voter)** of the Boston Fed and **Narayana Kocherlakota (non-voter)** of the Minneapolis Fed.

'I will argue that the Federal Reserve's policy of open-ended purchases of mortgage-backed securities and US Treasury securities…has contributed importantly to the gradual improvement in labour markets that we have seen, despite the fiscal headwinds,' Rosengren told an audience in New Hampshire. 'I will also argue that the costs of these policies are outweighed by their benefits, and by the costs likely to result if we did not pursue them.'

Kocherlakota called attention to the role of the Fed's forward guidance in affecting business decisions and urged even more monetary policy accommodation by making this guidance clearer.

'The FOMC could reduce the public's level of policy uncertainty by clarifying the nature of the economic conditions that would lead the committee to reduce or stop its current asset purchases,' Kocherlakota told a local chamber of commerce in Minnesota.

For one thing, he said, even though the target of 6.5% unemployment the Fed has set for considering a raise in the federal funds rate is a threshold and not a trigger, policymakers could make it clearer that any tightening would be slow by setting the threshold at 5.5% unemployment.

There were dissenting voices. Kansas City Fed chief **Esther George (voter)** once again was the sole dissenter among voting members of the panel in preserving the Fed's current forward guidance, but Philadelphia Fed chief **Charles Plosser (non-voter)** made his objections known in other forums.

'In light of what I believe are meagre benefits, should economic conditions evolve as I currently anticipate, I believe we should begin to taper our asset purchases with an aim of ending them before year-end,' Plosser told a local business group in Pennsylvania. 'This will allow for an orderly transition to a gradual reversal of our highly accommodative stance of monetary policy when economic conditions warrant it.'

'Overall, still-high unemployment, in combination with relatively low inflation, underscores the need for policies that will support progress toward maximum employment in a context of price stability'

New concerns over 'too big to fail'

The other focus of Fed policymakers was renewed concern that the big U.S. banks may be too big to fail. Lawmakers criticized the implicit subsidy these banks are receiving from the perception that the government would bail them out, again, if necessary.

In an unusual appearance at the highly partisan Conservative Political Action Conference in Washington, Dallas Fed chief **Richard Fisher (non-voter)** continued his crusade to break up the big banks.

'I am going to address what I consider the injustice of operating our economy under the thumb of financial institutions that are so large they are considered 'too big to fail,'' Fisher told the conference from a platform usually occupied by conservative politicians.

Fisher attacked the banks for representing 'not only a threat to financial stability but to fair and open competition,' adding that the Dodd-Frank financial reform intended to end too big to fail (TBTF) is 'counterproductive' and is 'an example of the triumph of hope over experience.'

The irony was that Fisher, taking the stage in a stronghold of conservative Republicans, was once a Democratic candidate for the Senate in his home state of Texas. But he argued that breaking up the banks deserves support across the political spectrum. 'For regardless of your ideological bent, there is no escaping the reality that TBTF banks' bad decisions inflicted harm upon the American people during the "awful moment" of the 2008–09 crisis,' he said.

Fed governor **Jerome Powell (voter)** was more moderate in his tone when he addressed the Institute of International Bankers in Washington, suggesting that the Dodd-Frank reforms could work given time.

'The too-big-to-fail reform project is massive in scope,' he told the group. 'In my view, it holds real promise. But the project will take years to complete. Success is not assured.'

Powell noted the calls for specific size limits and government intervention to break up the big banks, and concluded that such measures might be necessary if the current plan fails. 'In any case, too big to fail must end,' he said, 'even if more intrusive measures prove necessary in the end.'

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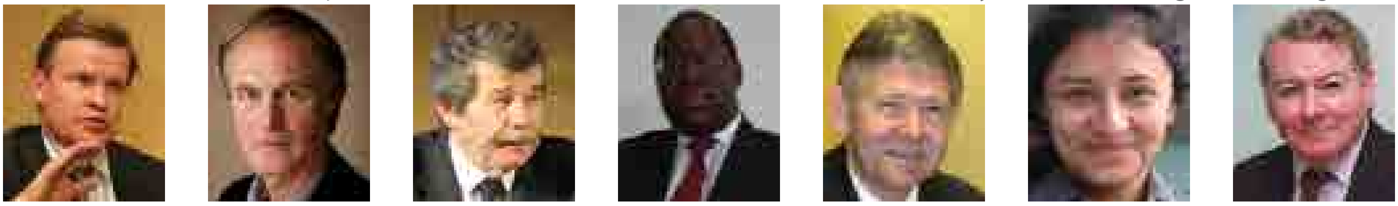

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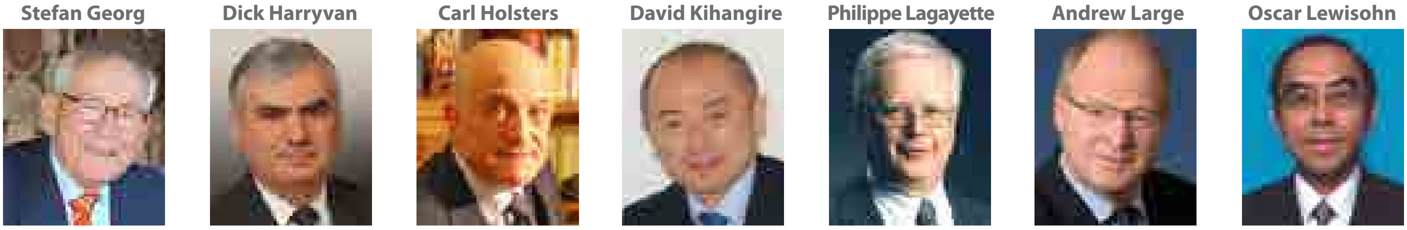

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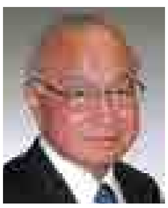

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The OMFIF Advisory Board is made up of over 120 experts from around the world and a range of sectors, including financial services, policy and editorial areas. The OMFIF Advisory Board includes people who contribute to OMFIF's output in many ways, and contains a wide-ranging group of active participants who take part in a cross-section of OMFIF's activities. They can be called upon to provide a variety of services to OMFIF members, including speaking arrangements and bespoke advice on specific subjects. They also take part in the OMFIF International Academy of Central Banking. Please contact Edward Longhurst-Pierce at the OMFIF secretariat for further details.

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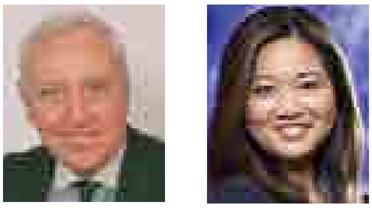

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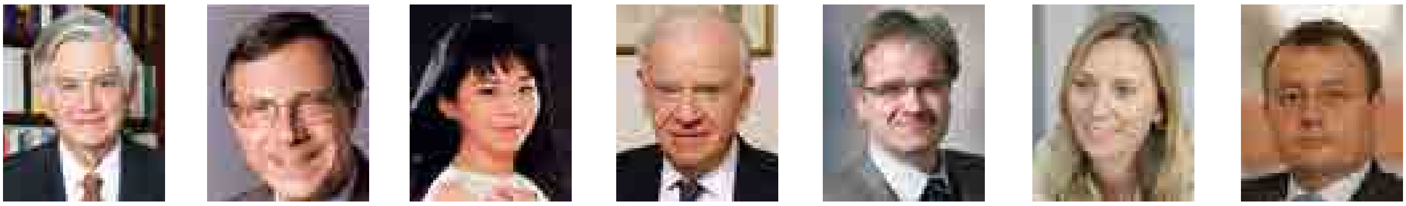

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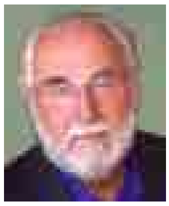
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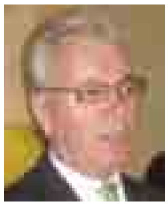
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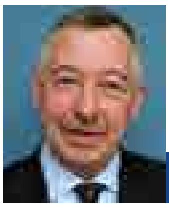


Decline of a theory

Demand for oil is peaking, not supply

Nick Butler, Advisory Board

Peak oil is coming – but it now looks more likely a peak in demand rather than in supply. Despite continuing sanctions against Iran which are keeping 1m barrels a day (bd) off the market, renewed instability in Iraq and sporadic trouble in Libya and Nigeria, the Brent oil price has continued to soften over the past two months.

In recent years demand has fallen in Europe, Japan and the US. Fears of a sharp price increase have been replaced by realisation that oil is not in short supply.

The theories of 'peak oil' were built around a study first published in 1956 by an American geologist M. King Hubbert. They suggested that oil supplies were limited and would inevitably peak and decline. These theories have been much used to support the idea that oil prices should be ever increasing. These old ideas ignore the reality of technical progress which opens new frontiers and reduces costs. Oil provinces (such as the North Sea) keep going well beyond their original schedule. Recovery rates keep rising. On average, even after some advances in reservoir management technology, barely 50% of the oil in place is recovered from most fields. So there's a long way still to go.

Thanks to technology, oil reserves are higher now than in 1956, despite half a century of production. On top of that, we now have tight oil (the oil equivalent of shale gas), which BP now expects to provide some 9% of global production in 2030.

Demand is likely to peak at less than 100mbd before 2020, compared with 89mbd now, as the result of market forces. Energy markets can be complicated and slow but they still respond to price signals and the insecurity of supply. Energy consumers dislike high prices and supply uncertainties caused by repeated wars, conflicts and threats in the Middle East. As a result they look for alternatives and, in those places where price signals are effective. they look for ways in which to reduce costs.

The past decade has seen numerous shifts away from oil. In power generation there are cheaper alternatives – such as coal and gas. And even in the transportation sector, gas-powered buses and cars and electric vehicles are beginning to erode oil's dominance. The emergence of major supplies of both conventional natural gas and shale gas around the world opens up the prospect of much more gas being converted into oil.

Oil's share of world primary energy supply has fallen from about 50% in the early 1970s to less than 40% today, and is set to fall to less than 30% by 2030.

The conventional wisdom has been that oil demand will rise to 110 mbd or even more. But the assumptions behind such predictions look shaky. First, the potential for further substitution in transport may have been be underestimated. Already, it had been assumed that higher vehicle efficiency standards would cut back demand, but the process may be quicker than earlier estimated.

The second assumption is that demand will continue to increase in the emerging economies of Asia and in the Middle East. But this forecast ignores the wider issues that will shape demand trends. China and India are very wary of dependence on the Middle East and increasingly conscious of the heavy costs of urban congestion as vehicle numbers rise. If such policy shifts are made, global demand will never reach 100mbd and could peak at 95-98mbd within five years.

Gas rather than oil will dominate the energy economy of the 21st century with oil adjusting to the role of a specialist fuel – used overwhelmingly in the transport sector. For investors the key is to find projects and companies which are resilient to static or even falling prices and not dependent on predictions of scarcity and inexorable price increases.

Gas rather than oil will dominate the energy economy of the 21st century with oil adjusting to the role of a specialist fuel – used overwhelmingly in the transport sector.

Europe in the doldrums

As crisis bites, further downgrade in 2013 forecast

Michael Holstein, DZ Bank

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013	2014
US	1.8	2.2	2.0	3.0
Japan	-0.5	2.0	1.7	1.6
China	9.3	7.8	8.5	8.7
Euro area	1.5	-0.5	-0.5	1.1
Germany	3.0	0.7	0.4	2.2
France	1.7	0.0	-0.2	0.8
Italy	0.5	-2.4	-1.2	0.4
Spain	0.4	-1.4	-1.9	0.9
UK	0.9	0.2	0.4	1.4
Addendum				
Asia excl. Japan	7.4	6.1	6.9	7.3
World	3.7	3.0	3.1	3.9
Consumer prices (% y/y)				
US	3.2	2.1	2.7	3.0
Japan	-0.3	0.0	0.1	1.5
China	5.4	2.7	3.0	4.0
Euro area	2.7	2.5	2.1	2.3
Germany	2.5	2.1	2.1	2.6
France	2.3	2.2	1.6	1.9
Italy	2.9	3.3	2.4	2.5
Spain	3.1	2.4	2.3	1.7
UK	4.5	2.8	2.6	2.7
Current account balance (% of GDP)				
US	-3.1	-3.0	-2.9	-3.0
Japan	2.0	1.0	1.1	1.5
China	2.8	2.6	2.4	2.1
Euro area	0.1	1.4	1.9	2.1
Germany	5.6	6.3	6.0	5.6
France	-2.6	-1.9	-1.7	-1.8
Italy	-3.3	-0.7	0.0	0.5
Spain	-3.7	-1.9	0.8	1.5
UK	-1.4	-3.0	-2.5	-1.8

Produced in association with DZ Bank group, a partner and supporter of OMFIF

After a prolonged phase of market consolidation, the euro debt crisis has shifted back into focus for market players in recent weeks. The political uncertainty which followed the elections in Italy and the escalation of problems in Cyprus have made clear that a solution to the crisis in Europe is still some way off.

However, what has generally been a very muted reaction in the markets has also demonstrated that the measures taken by the European Central Bank and governments to calm the situation and combat the crisis have had a positive impact. True, risk premiums, for example on Italian sovereign bonds, are somewhat higher even than in January; however, they are still well below the levels of last summer.

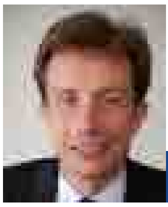
The worsening of the position in Cyprus showed for the first time that, as a result of a political decision, depositors can now be included in the bail-out of a country and its banks. Savers in other peripheral countries where the banking system seems to be unstable could now also regard their deposits as no longer safe, withdraw them and transfer them to other banking systems worldwide.

Other euro area economies will not remain completely unaffected by the current problems. This is evident from the most recent indicators. In Italy, the political confusion is having a detrimental impact on the economy and is likely to deter consumers and companies from major expenditure.

In France, the need for structural reforms is becoming increasingly evident, since the economy is suffering from a deterioration in competitiveness. We have therefore revised downwards our economic forecast for the euro area and now expect output to decline by 0.5% this year.

Growth is likely to be lower than originally expected next year at 1.1%. Economic trends in Italy and France represent the main factor behind the lower forecast. We expect GDP in Italy to decline by 1.2% in 2013, and economic output in France to contract by 0.2%.

In Germany, most of the economic sentiment indicators published for March are somewhat worse than expected. These suggest that increased optimism about the economy since the end of 2012 was overstated. The IFO business climate index suffered a setback recently after strong upward movement in the previous month, particularly in relation to business expectations for the next six months. We are maintaining our GDP forecast for Germany at 0.4% for 2013 – by historical standards, a lacklustre performance. Compared with most of the rest of the euro area, this would be a relatively comfortable outcome.



Keeping the miracle alive

Ray of hope via eastern Europe

Pawel Kowalewski, Advisory Board

The complex life of those brought up in central and eastern Europe and their overall faith in the European Union explain why commentators from that part of the world often have a more optimistic interpretation of developments shaping the euro's future. Ivan T. Berend, a renowned Hungarian-born expert on the European economy, associated for many years with the University of California, is no exception.

The conclusion of his latest book is that Europe will once again overcome another difficult crisis. After all, no one likes seeing the death of a miracle.

Berend stretches his analysis back to the 16th century. Throughout his life he has seen different processes in Europe, ranging from economic depressions, wars, bloody uprisings and dictatorships. All these bitter memories were compensated by the miracle of European integration, which he considers as the one of the greatest achievements in European history.

The book starts with a chronological review of the crisis, including case studies of the episodes in Iceland, the Mediterranean countries and Ireland. According to Berend, the crisis was 'made in the US' but flooded the globe. In Europe, the impact was deepest in the peripheries of the south and parts of the east, but affected all the major countries.

He sees the apparent division of Europe into north and south as a product of the complex history, culture and political environment of different countries and regions. Behavioural habits and deeply rooted values change much more slowly than the economy and the living standards.

Old habits and legacies are long-lived. For instance in the south, avoiding paying taxes is often considered to be a virtue because, in most cases, the state in peripheral countries was considered to be an enemy, not a protector; the same remarks can be applied to eastern Europe.

Berend warns the reader from drawing too many conclusions from the core/periphery division, pointing out that some advanced economies have made similar mistakes to those of less developed countries. Housing bubbles are the most obvious example. Between 2000 and 2007, house prices increased more than 80% in Sweden, Norway and Denmark, in France 108% and in Britain 135%.

Berend warns the reader from drawing too many conclusions from the core/periphery division, pointing out that some advanced economies have made similar mistakes to those of less developed countries. Housing bubbles are the most obvious example.

Berend believes that the crisis was generated among other things by the decline of the significance of the real economy and a financialised, deregulated market system. In Europe, the position was made worse by flaws in the euro construction (the lack of a single fiscal policy as well as a political union) and the tendency of European consumers (and some governments as well) toward excessive profligacy.

Berend quotes British economist Joan Robinson, who believes that in the past, enterprise led, finance followed. Nowadays, financial flows are ubiquitous and heed no one. On this account, new technologies and pursuit of profit maximisation reversed the development up to the mid-1970s where economic advancement went hand in hand with industrialisation.

From then on, Europe's labour force proved too costly in comparison with developing economies. During the last third of the 20th century, the share of industry in the UK labour force declined from 42% to 16%, with similar patterns elsewhere in Europe.

As a result of the processes, banks turned to search for yield in processes no longer linked to industrial business, often with inadequate risk assessment and pricing. This was encouraged by market deregulation, creating great difficulties of adaptation for several European economies.

Berend sees different approaches to the financial sector in the US and the rest of Europe as rooted in history. Financialised and globalised market capitalism has spread following the gradual lifting since the 1980s and 1990s of controls and regulations that were originally imposed after the Great Depression of the 1930s and the Second World War.

Lifting this straitjacket, a matter of some reluctance in continental Europe compared with the UK with its longer history of financial capitalism, has led to a spectacular increase in financial crises. Between 1622 and 1990s, 39 major crises hit Europe.

Once capital liberalisation was no longer confined to mainly Anglo Saxon countries, increased volatility made currency, banking and financial crises a household phenomenon in today's capitalism. Between 1970 and 1995, the International Monetary Fund counted 158 currency crises and 54 banking crises.

Once capital liberalisation was no longer confined to Anglo Saxon countries, increased volatility made currency, banking and financial crises a household phenomenon.

Despite these shifts in the financial sector, little has changed in the way Europe is being ruled and governed. The European economy remained embedded in the traditional framework of nation states. True, sovereign states lost much of their power. But nothing has emerged strong enough to fill up the institutional vacuum.

Ironically, a significant reduction of power of the sovereign states did not prevent them from inflicting often irresponsible policies upon themselves, which contributed significantly to the recent upheavals. Berend sees structural weaknesses in European financial integration as an inescapable reason for the sovereign debt crisis.

Berend's analysis of cultural difference to help explain different economic behaviour is surely valid. Anyone who knows central and eastern Europe is aware that peasants in this part of the continent had no pronounced tradition of savings, as their time horizons were confined to the nearest harvest.

Berend points out that some social patterns inimical to free markets (such as clientelism or corruption) are rather long-lasting. The less a given sector of such economy is exposed to international competition, the stronger are tendencies towards this kind of opaque behaviour.

All these factors translate themselves into differences in labour productivity. In the last two decades, despite significant progress, the gap is far from being closed.

Berend looks, too, at the social causes of the crisis. The 20th century created more wealth than at any time before. The first half of the century was affected by two global conflicts and the Great Depression which cost Europe dearly. European consumption got going only in the second half of the century.

For a long time, Europeans wanted to follow the lives of more prosperous Americans, a trend that was strengthened by structural changes in the economy and society. Nearly 75% of the working population became white collar workers, stimulating demand for consumer goods. Shorter working hours helped to transform lifestyles. In advanced western societies, around 70% of GDP is now generated by private consumption.

A tendency towards consumption has recently been even stronger in peripheral Europe, and central and eastern Europe in particular – a region barred from consumer goods for almost half a century. Once consumption was fuelled by credit (in line with the mantra 'buy now, pay later'), it was a recipe that also played a role in the crisis.

The author concludes by describing efforts to solve the latest problems affecting the euro, including austerity measures and various structural and institutional changes.

Hegel once said that what history and experience teach us that people and government have never learned from anything from history. Berend takes a rather optimistic note, claiming that the last two thirds of a century of European history proved Hegel's words wrong. But recent events create some doubts whether this optimism proves to be realistic.

How to heal fractured Europe

Cyprus deal shows fading appetite for state rescues

John Nugée, Advisory Board

The Italian election in February may have discomfited the political class in Europe, but the travails of Cyprus have had a far larger impact.

The initial proposals caused shockwaves across the euro area, as the authorities were widely seen to be stepping back from two key commitments made earlier in the crisis.

The first of these was the principle, enunciated after the Greek debt restructuring in early 2012, of no further private sector involvement in financing bailouts. The second was the guarantee that smaller savers with under €100,000 in deposits would be kept whole in any bank resolution.

The attempt to position the levy on small depositors as a 'tax' further damaged confidence that the EU's word would be honoured in all future circumstances.

The later cancellation of the levy on small depositors did not restore trust: a precedent had been set and depositors in euro area banks now know that the EU views them as a legitimate source of reconstruction finance.

Follow-up statements by Jeroen Dijsselbloem, chairman of the Eurogroup, have clarified in icily precise tones that the wealthier parts of the euro area no longer have the appetite to finance by themselves state rescues of failing banks.

Not only has credibility with depositors been affected. The EU has suffered important damage in two other important fields: regarding the single monetary area, since Cyprus has been forced to erect exchange controls; and in the planned banking union, since common deposit insurance and bank resolution seem ever more distant.

We need to reflect on the process under which decisions were taken. The undemocratic nature of decision-making at the EU summit, and the dominant role of Germany, have been made abundantly clear.

Questions must be asked about whether or not the Germans were aware of the potential outcome of the initial proposal on taxing smaller savers. If they were, this suggests that the most important euro member is not concerned with what happens to other member states. If they were not, this implies that the Germans do not understand how banking works.

On a wider level, the Cyprus episode illustrates wider fracturing across the European landscape, which is divided into many levels: the nation state, the euro area, the Schengen zone, the EU itself (and even beyond that the EEA). The division of power, duties and responsibilities across these levels has gone badly wrong. There are three major disconnects in the EU. Actions which should be part of the same system are instead split awkwardly between the national and EU level.

First, in the realm of banking, we have Mervyn King's famous observation that banks are 'international in life and national in death'. Recent history has shown this does not work and leads to financial system fragilities.

Second, in the realm of EMU, we have euro area-wide monetary policy and national fiscal policies. Again, recent history has shown this does not work and leads to budgetary fragilities.

Third, in the realm of politics, we have power and policy-making without political accountability at the EU level, and politics without power at the national level. The consequence is that more and more national elections will be seen as protest votes that change nothing.

The solution is brutally clear. The EU has to reconnect power and political accountability. There are just two ways of doing this: either by returning policy-making to the national level (through breaking up the EU, which no serious politician wants); or by cementing politics and electoral consent at the federal level (which, in particular, would need a proper elected federal executive which the people of Europe can hold accountable.)

Of these three areas of fracture, the first is seemingly only technical, but is actually highly important; the second is fundamental to the EU's economies; the third lies at the heart of Europe's democracies.

Unless they are put right, there is a real risk that the EU will tear itself apart.