Lorenzo Bini Smaghi: Addressing imbalances in the euro area

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Halle Institute for Economic Research, Halle an der Saale, 14 February 2011.

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Introduction

It is a pleasure to be here today and share with you my thoughts on a challenging topic: how to address imbalances in the euro area.

The euro area has been expanding: five countries joined EMU between 2007 and 2011, and this process will continue in the years to come. The enlargement process is one of the features that make EMU unique. The existence of a single monetary policy combined with national responsibilities for fiscal, structural and supervisory policies is the other distinct characteristic of EMU. But within this unique and evolving structure something has not been working properly. The accumulation of imbalances and vulnerabilities in some countries during the upswing culminated, after the global recession, in a severe sovereign crisis. What has not been working? And what should be done to prevent future imbalances?

To answer these questions I will organise my talk in three parts.

First, I will discuss how and why imbalances and vulnerabilities have emerged in the euro area. The point that I will make is that fiscal discipline and sound prudential supervision have been lacking. In addition, many national authorities failed to implement important reforms in the labour and product markets to make them more flexible and suited for the change of regime brought about by the adoption of the euro.

Second, I will consider the possibility of overcoming past failures via a more institutionally integrated monetary union, characterised, for instance, by a move towards a framework of fiscal federalism for EMU. I will emphasise that a deeper fiscal integration cannot be considered the only solution for adjusting current imbalances and for avoiding them in the future.

Third, I will argue that imbalances and vulnerabilities can and should be addressed by implementing, at national level, much stronger fiscal discipline, better vigilance of financial developments and effective reform measures that deliver increasing productivity, competitiveness, employment and long-term growth.

Let me now turn to the first part of my talk.

1. Imbalances in the euro area

The imbalances which have accumulated over the last few years in the euro area are the result of a combination of "good" and "bad" convergence. The so-called good convergence concerns the levels of per capita income. At the start of EMU the per capita income levels between countries differed significantly. Among the countries that joined the euro area in 1999 and 2001, three – Spain, Greece and Portugal – were considered "cohesion countries", i.e. countries that qualified for very sizeable structural support from EU funds to speed up their convergence to the European average per capita income levels. In 1999 GDP per capita (measured in purchasing power standards) was around 80% of the euro area average in Spain and around 70% in Portugal and Greece. In Ireland, the gap with the euro area differs depending on whether it is measured in terms of GDP per capita (110%) or GNP per capita (95%).

Neoclassical growth theory suggests that catching-up countries would experience faster economic growth. With the disappearance of the exchange rate premium, convergence within the euro area was facilitated by capital flows originating from wealthier euro area countries with higher GDP and per capita capital endowments.[1] Between 1999 and 2008 Greece and Spain witnessed a significant convergence of their per capita income to the euro area average. In Portugal this convergence came to a halt in 2003. Ireland continued to experience a tremendous increase of its per capita income between 1999 and 2007. On average, between 1999 and 2008 per capita GDP increased at a yearly pace of 3.4% in Greece, 3.4% in Ireland (GNP) and 2.0% in Spain, much higher than the average for the euro area (1.4%), which was broadly similar to that of the US (1.5%).

The "bad" convergence I referred to was the speed at which income increased in the catching-up countries, which largely took place through debt, either public or private. As a result, their debt with the rest of the world increased tremendously over the past decade. The most dramatic development took place in Ireland, which moved from a net creditor position of 52% of GDP in 1999 to a net debtor position of 71% of GDP in 2008. Greece increased its net debtor position from 33% to 76% of GDP; Portugal from 32% to 96% and Spain from 28% to 79%.

The expectation of higher levels of income led to excessive consumption and investment compared with the supply capacity of the economy. As a result, cost and price increases in the non-tradable sector exceeded productivity gains.[2] Higher inflation differentials in the catching-up countries could partly be attributed to Balassa-Samuelson effects[3]. However, the divergences in nominal developments were further fuelled by four pro-cyclical factors:

- First, low interest rates, especially in real terms, which resulted from the single monetary policy, and encouraged risk-taking behaviour;
- Second, fiscal policies assessed on the basis of nominal variables (deficit as a percentage of GDP) turned out to be pro-cyclical and contributed to excessive domestic demand growth and the accumulation of external imbalances;
- Third, supervisory policies in many countries did not counteract excessive risk-taking and the related excessive credit growth, which fuelled a housing boom and/or an overheating process;

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1 See, for instance, Blanchard O. and F. Giavazzi (2002), *Current Account Deficits in the Euro Area. The End of the Feldstein Horioka Puzzle?*, Brookings Papers on Economic Activity, 2002:2; and Abiad A., D. Leigh and A. Mody (2007 *), International Finance and Income Convergence: Europe is Different*, IMF Working Paper WP/07/64.

2 For a reference on the real interest rate mechanism, see European Commission (2006), *The EU economy: 2006 review. Adjustment dynamics in the euro area – Experiences and challenges*, European Economy No 6, pages 131–174.

3 The Balassa-Samuelson (BS) effect refers to inflation effects due to differences in relative productivity growth between tradable and non-tradable sectors. When productivity growth rises in the tradable sector, wages will follow without putting additional pressures on unit labour costs. However, due to labour mobility, wages in the non-tradable sector might rise as well and as productivity growth in the non-tradable sector is normally lower than in the tradable sector, wage increases in excess of productivity growth would tend to put upward pressures on unit labour costs and ultimately on inflation for some time. Several studies on the BS effect in the euro area, such as Rabanal (2009), Hofmann and Remsperger (2005) and Katsimi (2004) have found that the effect has been not very relevant during Stage III of EMU. The literature appears to suggest that the BS effect may have been somewhat more relevant during the 1990s. For the period 1992–2001, for example, Wagner (2005) finds a positive contribution of the BS effect which tends to capture the convergence during Stage II of EMU.

- Fourth, financial markets and rating agencies failed to differentiate sufficiently between euro area countries with different risks, contributing to the significant compression of risk premia in the sovereign debt securities markets. Ten-year government bonds were almost equally priced across all euro area countries between 2001 and 2007, while economic fundamentals continued to be very different.

Let me now expand briefly on some of these points.

The excessive demand boom, fuelled by private/public consumption and residential investment spending, led to persistent inflation and unit labour cost differentials, losses of competitiveness and asset price inflation – notably in the housing market – in the countries that had to converge to the euro area average and also in Ireland. And it led to a build-up of large external indebtedness. At the same time, the supply side was not able to catch up with demand because investment spending was not channelled towards activities able to generate high future returns, and also because of important structural rigidities, which policy-makers neglected to tackle in the boom years. The accumulation of external indebtedness was heavily financed by debt instead of FDI, which remained relatively low, another sign that little effort was being made to increase the supply side of the economies.

Just to mention a few figures, a property worth 100 in 1998 would have been sold in 2007 at 280 in Spain and Ireland and at 230 in Greece. Between 1998 and 2007 bank lending for house purchases increased by more than 400% in Spain, 500% in Ireland and 800% in Greece. In 1998 household debt was less than 40% of GDP in Spain and about 50% of GDP in Portugal, in 2008 it reached 84% in Spain and 96% of GDP in Portugal. In Ireland, household debt was 55% of GDP in 2002[4] and reached 110% of GDP in 2008. Corporate indebtedness also reached alarming levels at the outset of the crisis.

Banks did not seem to care about the rise in household and corporate indebtedness in the boom years. Lending to the private sector and investment in overvalued assets – namely construction – continued apace. The surge in lending activities and risk-taking by banks was facilitated by a sharp increase in cross-border banking flows, as the deepening of financial integration led banks to search for profitable investment in high-growth countries. And national regulators did not step in forcefully to curb excessive risk-taking in banks.

Another factor which contributed to the accumulation of imbalances was the rise in public sector wages. Between 1998 and 2007 civil service salaries increased cumulatively by 90% in Greece and by more than 100% in Ireland. Public spending growth systematically exceeded nominal GDP growth up to the 2008–2009 recession. Moreover, in several countries the authorities failed to implement important reforms in the labour and product markets to make them more flexible and suited for the change of regime brought about by the adoption of the euro. The ECB repeatedly warned about the risks arising from such divergences and called for sound fiscal policies and flexible product and labour markets to ensure the proper working of EMU.[5]

When the 2008–09 crisis hit the euro area, all these imbalances translated into higher public debt, either as a result of a sharp drop in revenues or the transformation of private debt into public debt. Just to remind you of a few figures, the Irish general government debt increased from 25% of GDP in 2007, to 97% at the end of 2010. The Portuguese debt increased from 63% of GDP to 83%, the Greek from 105% to 140%. The over-reliance on external borrowing made financing the increased public debt more difficult.

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4 For Ireland the available data for household debt start in 2002.

5 See ECB Monthly Bulletin Article (2007), *Output growth differentials in the euro area: sources and implications*, April 2007.

In Greece and Ireland, the adjustment towards a sustainable government debt path is currently being made with the help of an external financial assistance programme. In both countries the EU/IMF programme relies on very strong fiscal frontloading and comprehensive and far-reaching structural reforms which, in the case of Ireland, also include measures aimed at an overhaul of the banking sector. These programmes aim to correct the divergences which have accumulated over the past decade.

One issue which has emerged over the last few months relates to the extent that fragilities in the national economies that belong to the single currency may affect the overall euro area, in particular through contagion effects. The events which started last spring show that the euro area was not ready to face a sovereign debt crisis in one of its members. Since May last year, a series of measures have been implemented, starting with a €110 billion support package for Greece and the creation of the European Financial Stability Facility, and extending to a strengthening of the Stability and Growth Pact and finally a change in the Treaty to allow for a permanent European Stability Mechanism. Some of the discussions are still ongoing, and I will not comment further on this issue. The ECB's position has been made quite clear. We are in favour of a "quantum leap" in the governance of the euro area; it would ensure greater consistency between economic policies and the single currency.

How big should the leap be? Some go as far as saying that a single currency is viable only if there is a full fiscal union, with a common budget and a transfer system which can account for asymmetric shocks and avoid divergences in national/regional fiscal policies. The US would serve as a model here. There are indeed no precedents for a monetary union without a fiscal union. Consequently, many think that a monetary *and* fiscal union should be the longer-term model for the euro area.

The experience of German unification might also help us to understand whether a move towards full fiscal integration would indeed be desirable for the euro area.

2. Centralised fiscal policy and monetary union

The desirability of achieving a fully fledged fiscal union to complement monetary union can be assessed on the basis of the three main criteria characterising economic policy: stability, efficiency and equity. I would like to consider the first two and omit equity, which has a deeper political connotation and may be less relevant for the sustainability of a monetary union.

Let me start with stability.

The key economic rationale for having a fully fledged fiscal union is to establish a common pool of resources that can be used to insure its members against adverse macroeconomic shocks and to reduce macroeconomic imbalances. In a monetary union, fiscal policy is the only instrument that domestic policy-makers can use in response to country-specific macroeconomic shocks. Since monetary policy is uniform within the currency union, it cannot be tailored specifically to the economic conditions in each country. If, for example, a downturn proves to be especially pronounced in one country, the monetary stance adopted for the entire currency area may not be appropriate. This implies that fiscal policies may need to play an active role in stabilising macroeconomic developments at the domestic level. At the same time, the capacity of individual countries to adopt stabilising fiscal policies is very limited. In particular, if countries enter a downturn with weak budgetary positions, or if economic developments prove to be very unfavourable, market confidence in the sustainability of public finances can evaporate quickly. This is the experience of a number of countries in EMU which – after failing to exploit the good times prior to the crisis to consolidate public finances – very quickly faced excessive budget deficits when economic conditions deteriorated. In such a situation, fiscal expansion through the national budget would be counterproductive as the "negative confidence" effect from a further budgetary deterioration would outweigh any direct demand effect.

The separation between monetary and fiscal policy in EMU, which prevents the use of monetary instruments for solving budgetary problems, further tightens the sustainability requirements for the public finances of the Member States. Rising public debt cannot be curbed by keeping interest rates low or through inflation, but only through budget adjustment. Markets might be inclined to test the ability and willingness of the countries to maintain a tight control over their budgets even in a severe economic downturn. As doubts mount in the markets and credit spreads increase, self-fulfilling expectations may arise which worsen the debt dynamics.

A further problem in the euro area derives from the role played by governments as shock absorbers in the financial sector. Public funds are used to prop up banks which suffer losses in a financial crisis or to guarantee banks' liabilities in case of bank runs produced by outflows.

In a fully-fledged fiscal federation these problems do not arise, as asymmetric shocks are partly offset by cross-region transfers through a federal budget. Furthermore, the stability of the banking system does not depend on the soundness of local or regional finances, but on that of the federation. The smaller the size of local or regional authorities' budgets, the lower the risk that asymmetric shocks will endanger the stability of those authorities' finances as the stabilisation function is performed by the federal budget.

In essence, this mechanism aims to insure individual countries against idiosyncratic shocks which in turn could reduce macroeconomic volatility. Theoretically, this mechanism could even be designed so as to strengthen incentives to reduce macroeconomic imbalances such as unit labour cost divergence and high and persistent current account deficits. Contributions to intergovernmental grant schemes or access to joint bond issuance could, for example, be made conditional on a country's progress with its structural and fiscal reform agenda.

A federal budget does not necessarily mean, however, that the stabilisation function is better performed at the federal level, in particular when facing symmetric shocks. The experience of the recent crisis shows that the deficit and debt levels of several countries, some of them with federal systems, others centralised, have increased even further than in some countries of the euro area. For instance, both the UK and the US experienced larger deteriorations in their fiscal positions from 2007 to 2009 than the average in the euro area. Over this period, the budget deficit of the UK increased from 2.7% to 11.4% of GDP while that of the US increased from 2.8% to 11.2%. These deficit ratios are comparable to that of Spain, which is one euro area countries where the public finances have been particularly severely affected by the crisis.

It can actually be argued that, with the market pressure which arises in a monetary union, its members have to think more about the long-run stability of their public finances than they do if monetary policy eliminates the pressure by ensuring the financing of the deficit. Under pressure from the markets the euro area countries have adopted corrective measures which are expected to stabilise the public debt-to-GDP ratio in the coming years. In Spain, for instance, the latest available stability programme (which dates back to January 2010) aims at stabilising the government debt-to-GDP ratio at a peak of 74% in 2013. Moreover, since then, the Spanish government has responded to market tensions by frontloaded to 2010 and 2011 some of the fiscal adjustment planned for 2012 and 2013.

To sum up, a federal budget might ensure greater stability in the face of asymmetric shocks, but when such shocks are large enough to affect the whole economy a federal system might not necessarily provide greater stability.

Let me turn to the second criterion that characterises economic policy – efficiency in the allocation of resources. Here the experience of German unification may be interesting because it helps us understand the challenges that a union composed of countries in different economic conditions may face in integrating those economies and adopting the same currency. This experience suggests that a single fiscal regime may impose obstacles to economic integration, particularly for catching-up regions. In the euro area, countries which entered with a lower per capita income caught up with the average much more quickly, maybe too quickly, as I mentioned earlier, than eastern Germany and attracted capital and labour inflow. There are several reasons for that. One is that the budgetary integration entails a harmonisation of taxation and public expenditures which may have a differentiated impact across regions, depending on their level of wealth. A given distribution of the tax burden may be appropriate for a given level of income but not necessarily for a lower one, and may lead to larger rather than smaller differences. Regions with less physical capital may for instance require lower taxation, and maybe also lower expenditure, to attract the capital necessary for the catching-up. There is extensive literature on these issues, so I won't elaborate further on this.

Another aspect refers to all the effects that arise, in terms of harmonisation, as a result of fiscal integration, such as tariffs, administrative costs, public wages, etc. which weigh indirectly on the costs borne by business. If a country needs to grow faster, such costs should be reduced.

The same applies to other aspects of legislation which tend to be harmonised as a result of fiscal union and tend to penalise catching-up regions. These costs are offset by resource transfers, from the richest to the poorest regions. However, experience in Germany, Italy and other dualistic countries shows that if these transfers are not well designed and are only the result of the integration of the tax and public expenditure systems, they may create disincentives for growth and employment. These distortions lead to labour migration from the poorest to the richest regions. In countries like the US, labour migration used to be considered as a "good" and somewhat natural adjustment process, resulting from the country's westward expansion. The recent housing crisis has shown, however, the costs of an adjustment process which relies on such a mechanism: migrants have to sell their homes in depressed regions at depressed prices. In Europe, migration is valued if it represents an opportunity rather than a lack of alternatives. Given the prevailing cultural differences, sometimes even within countries, migration entails welfare losses.

In more general terms, some form of competition between regional budgets, in particular in terms of taxation, but also expenditure, may enhance efficiency and best practice. The fact that some countries have been able to better control public finances before and during the crisis may set an example to others. This applies also to the quality of public expenditures and to the reforms related to the costs of ageing, health care and unemployment. Decentralisation also enhances accountability and allows better supervision by the voters. It would be quite damaging if "Brussels" were to be blamed also for the poor state of public finances, rather than the capitals of the Member States.

To sum up, a federal budget is better capable of addressing *asymmetric* shocks, but not necessarily symmetric shocks, and may not be the most efficient approach in an area which catching-up countries will continue to join. On the other hand, if decentralised budgets are better attuned to the requirements of the catching-up countries, such budgets may lead to excessive pro-cyclicality and to instability if the catching-up is too quick and unsustainable.

The above considerations suggest that it would be risky for the euro area to move to greater fiscal and budgetary integration in order to avoid the instability associated with the current system. While solving some of the problems of the current system, the new regime could import new problems which might be politically even more difficult to tackle.

3. The way forward

If it is not desirable or feasible, at least in the current times, to move to a full fiscal federation – or a transfer union as it is called in Germany – like the US, how can the current system be made more resilient, in particular in the face of asymmetric shocks?

The crisis is, let's not forget, the worst since WWII. It has shown that some of the elements of our economic and monetary structure need to be improved. The framework as it used to be simply assumed that there would never be a crisis. That was done in good faith but proved to be naïve. The status quo is not an option. But it is precisely to avoid moving to a fiscal federation that some of the parts of the current system need to be modified.

First, let's consider the monetary part of the Union. It has worked very well. I won't repeat the statistics about price stability, but simply say that the figures are better than they were previously. The ECB has proved to be independent. It is a federal institution capable of acting very quickly, as we have shown over the last three years. The euro is a stable and safe currency.

It's been said that in some countries, notably Germany, many people feel nostalgic for the Deutsche Mark and believe that Germany would be better off with its old currency. This sentiment is purely emotional and not based on statistical or empirical facts.

The euro brought low inflation to Germany during the last decade, lower than ever before. More importantly, it has kept German exports very competitive, especially in the aftermath of the crisis. This is contributing to the pick-up in the German economy, ahead of the others in the euro area. The currency movements of, for instance, the Swiss franc in the last few months suggest that if the old national currencies still existed, German exports would risk becoming much less competitive.

Let me hasten to add that Germany's good economic performance is *not* solely attributable to the euro. In fact, the country's economy has proved more capable than others of exploiting the opportunities provided by the euro, in particular by keeping costs under control for many years and ensuring sound public finances in good times. Other countries haven't exploited the benefits provided by the euro so well, or they wanted too much too quickly and at a certain point they came face to face with reality. We need to make changes that prevent such excesses from happening again in the future.

To sum up, there is nothing to change in the monetary set-up. The problem is in the economic dimension of EMU. There are two fundamental elements to address to improve the "E" of EMU. One is public finances. There's been a lot of talk on this subject, and some decisions too. There is a need for more rules to constrain national budgets. There is also a need for an effective safety net, one that can prevent a crisis from spreading within the euro area as a result of a lack of discipline by one of its members. Several changes have been implemented and a few more are required to ensure that the system is effective. In this field we don't need to innovate. The IMF's experience should be a useful guide. European countries, including Germany, have been members of the IMF for more than 60 years. European taxpayers have never lost money from IMF operations.

The other element to consider is an avoidance of imbalances, such as those which have emerged over the last decade. They have been the result of a loss of competitiveness and excessive reliance on external borrowing. These two factors have to be tackled. In my view they cannot be addressed through simple rules and micro-management, because the various economies have different structures. They require a change in governance of the euro area along two dimensions, which I will briefly consider.

The first is competitiveness. The debate has rightly turned to that factor, especially in recent weeks. It's a welcome move. Last autumn, the European Council adopted a procedure to enhance macroeconomic surveillance in the euro area, on the basis of indicators such as unit labour costs, current account imbalances, etc. The ECB contributed to this debate by proposing a traffic light system to warn about emerging competitiveness losses.

The problem lies in devising a system of governance to assess competitive positions. It has to be restricted to the euro area, i.e. 17 countries at the moment. It cannot be at the EU-27 level. Why not? Because problems of competitiveness within a single currency are very different from those of countries with their own currencies. I suppose I don't need to give concrete examples to convince you of this. Currently, the only 17-country European body is the Eurogroup, an informal grouping consisting of the finance ministers of the euro area. The

Eurogroup mainly deals with issues for which the finance ministers are responsible, notably budgetary policies and international financial issues. Competitiveness depends on many other aspects, such as labour and product market regulations, which generally do not fall within the competence of finance ministers. The ministers who deal with these other matters are typically not faced with issues related to the euro area. And all Council formations in the EU meet in full composition only, i.e. at the 27-member level.

The Heads of State and Government have met, in euro area composition, on numerous occasions during the crisis, starting in October 2008, when they decided to intervene jointly in support of the financial system. There was concern about and even opposition, in Germany as well, to a more systematic role being given to the euro area composition of the European Council and possibly other formations of the Council. It was feared that this would interfere with, or be a counterweight to, the ECB, and would undermine its independence. The experience of the crisis, and of the first decade of the euro, is that the ECB has remained fully independent and has nothing to fear from a more cohesive euro area governance. On the other hand, the lack of a strong decision-making body at the political level may unduly constrain the effectiveness of and overburden the ECB's actions. The crisis has also shown what the founding fathers of the euro knew all along, i.e. that Monetary Union means much more than adopting a single currency. It entails a high degree of political union, for it requires many more decisions to be taken jointly, on account of the externalities and contagion that can result from sharing a currency.

I personally consider it very important that the political authorities of the euro area countries have decided to strengthen their ties and are seeking to extend their cooperation to other areas. Exactly what form this will take is still unclear, but the change in direction is important and welcome.

The second factor relates to the problems which have emerged in the crisis as a result of the imbalances that have built up within the national banking systems. Even when fiscal policy is sound, as it was in Ireland's case, a country's public finances can be derailed if its banking system is overextended, poorly regulated and insufficiently diversified. Furthermore, given the integration of Europe's financial system, contagion cannot be avoided. The euro area is characterised not only by the lack of a fiscal union but also by its decentralised supervisory system. The two aspects are to some extent linked. Supervision is decentralised, it is argued, because it is taxpayers who ultimately have to bear the burden of any supervisory failure. Thus, by extension, if a decentralised fiscal system is to be accountable, then supervision also has to be decentralised, albeit with cross-border cooperation.

The crisis has shown however that when a national banking system encounters difficulties, due to insufficient supervision or its size being out of all proportion to the country's economy, taxpayers may not be able to absorb the shocks and may ask for help from the other countries' taxpayers to tackle the situation. In addition, given the interconnections of the euro area money and financial markets, any failure to address the problems arising from the banking system in one country may quickly spread to the other countries, thereby burdening their taxpayers. As a result, a national regulator may be inclined not to impose limits on the size and activities of the respective domestic system, thus creating an externality for the euro area as a whole. This may in particular overburden the central bank in its role of lender of last resort.

To sum up, the crisis has shown that it is not necessarily true that national taxpayers ultimately bear the responsibility for supervisory failures or the foolhardy actions of bankers. This happens only if the domestic banking system is small and not interconnected with the other systems, which cannot be the case within a monetary union.

To avoid these externalities there is a need for a system of rules and procedures which binds the financial system, in the same way as the Stability and Growth Pact binds national fiscal policies. Some progress has been made towards implementing a single rule book within the EU, but margins for national discretion remain. Furthermore, the mechanisms for cooperation among supervisors mainly apply to large and complex banking groups and operate at EU level rather than the euro area level. It’s the smaller and local banks that have proved to be much more risky and burdensome for taxpayers.

These issues have not really caught the attention of the political authorities; no concrete proposals to address this issue have been made. But it’s an important and urgent matter.

Conclusions

To conclude, when looking at how to improve the institutional framework underlying the euro, we should avoid reasoning only by analogy, as that often leads to a comparison with the United States. The crisis has shown that even politically integrated federations like the US encounter major difficulties, and the fact of having only one decision-maker does not necessarily mean that the right decision is made. I actually think that although Europe’s cultural diversity and complexity might render the decision-making more cumbersome, in the end it’s wiser. Excesses in one direction or another, which would have been the case if decisions had been taken only at national level, have been avoided. Euro area members had to consult each other and come to an agreement. No country was allowed to fail like Lehman Brothers – but no country was bailed out for free and without strong conditionality. The decision to start the consolidation of public finances earlier rather than later, which characterised the transatlantic divide at the London 2009 G20 Summit, proved to be appropriate. Inflation expectations remain anchored. And the euro is viewed as a solid currency.

The adjustment process which started in Europe is tough and will require continued efforts, but it is changing the structure of our economies in a way which will make them more resilient and more efficient. This is the best way we can face up to the challenges of global competition.