José Manuel González-Páramo: The ECB and the sovereign debt crisis

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the XXIV Moneda y Crédito Symposium, Madrid, 4 November 2011.

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1. Introduction

It is a great pleasure and honour for me to contribute to this year's 24th edition of the Moneda y Crédito Symposium.

There is no doubt that advanced economies, not just the euro area, are currently facing a period of exceptional economic and financial instability that requires swift, decisive and credible action by all concerned institutions, each with its own responsibilities.

On 26 October the Heads of State and Government of the euro area agreed on a comprehensive set of measures to restore confidence and address the current tensions in financial markets. These measures include:

First, an agreement to secure the decline of Greek debt to a level equivalent to 120% of GDP by 2020. This reduction will be partly achieved via a voluntary bond exchange involving a 50% nominal discount on notional Greek debt held by private investors. Euro area Member States will also contribute up to 30 bn euro to the PSI package.

Second, a new EU-IMF multiannual programme financing up to 100 bn euro will be put in place by the end of the year.

Third, a significant leveraging of existing EFSF resources via two different schemes in order to increase the fund's ability to extend loans, finance bank recapitalisations and conduct bond purchases in the primary and secondary markets. I will describe these schemes in a bit more detail later on.

Fourth, a commitment to increase the capital position of banks to 9% of Core Tier 1 by the end of June 2012 and to facilitate access to term-funding through a coordinated approach to bank liability guarantees at the EU level.

Fifth, a strengthening of economic and fiscal coordination and surveillance and a commitment to put in place a set of measures, going beyond and above the recently adopted package on economic governance.

In the period ahead, it is of paramount importance that this agreement is applied rigorously and quickly in all its dimensions.

Against this background, I would like to focus my intervention today – from my perspective as a central banker – on the challenging environment for monetary policy created by the ongoing euro area financial and sovereign debt crisis. In the first part of my speech I would like to recall some of the main policy "failures" leading up to the present crisis and briefly review the more recent policy actions undertaken by the ECB.

As the ECB has repeatedly stressed, the main responsibility for resolving this crisis lies with governments and the financial sector. Euro area governments' unwillingness to adapt their fiscal and competitiveness policies to the requirements of EMU very much lies at the heart of the current "sovereign debt crisis". Excessive risk-taking by an over-leveraged and inadequately regulated financial sector is, of course, the other source of the present "financial turmoil". I will therefore focus the second part of my speech on a discussion of the main reforms to the governance as well as the supervisory and regulatory frameworks that have been undertaken at the European and international level in response to the crisis.

2. Fiscal imbalances and the monetary policy response to the crisis

Growing fiscal imbalances

The economic and financial crisis has led to a severe deterioration of public finances across European countries. Governments which already had significant fiscal imbalances ahead of the crisis exited from the recession with the highest deficit and debt-to-GDP ratios recorded in times of peace. The aggregate fiscal balance of the euro area increased from an almost balanced budget in 2000 to a deficit of around 6% of GDP in 2010. Furthermore, the euro area's debt stood at more than 85% of GDP in 2010. Similar developments were also recorded in other advanced economies, for example the US and Japan, likewise as a result of the cyclical contraction as well as the adopted fiscal stimulus measures. However, it is useful to consider that the consolidated fiscal position of the euro area remains – overall – rather more favourable than that of the US and Japan. According to the Commission's spring 2011 forecast, the euro area deficit ratio is projected to decline to 3.5% of GDP by 2012 as compared to the US and Japan where fiscal deficits are expected to stand at 8.6% and 9.8%, respectively, in 2012. These forecasts are in line with those of the main international organisations.

The interaction between government finances and the financial system

Despite ongoing fiscal consolidation efforts across euro area countries, negative feedback loops between the financial sector and sovereigns are becoming more and more entrenched. Although in some countries it was financial system stress that happened first and later weighed on sovereign risk, in others the events took place in reverse order. Regardless of the exact chronology of events, since mid-2010 we have progressively begun to see a very close interaction between risks associated with the financial system and the sovereign.

There are several reasons behind the close interplay between these two risks. For a start, the burden on governments caused by their implicit and/or explicit guarantees to the banking sector, and the need to finance bank re-capitalisations with public funds, has certainly taken its toll on public finances. In some cases this burden was compounded by the adoption, earlier in the crisis, of discretionary fiscal stimulus measures and the parallel decline in government revenues caused by the economic downturn. In countries where the emergence of systemic risk originated in large fiscal imbalances, the deterioration of public finances weighed negatively on the market pricing of government bonds from these countries. This, in turn, had a negative impact on the balance sheets of banks that held these bonds in their portfolios.

The difficulties faced by some governments in financing themselves in the market also affected the ability of banks from these same countries to obtain financing in wholesale markets. Rating agencies traditionally link the ratings they give to banks to the ratings of the respective sovereigns. Moreover, markets link the interest rate at which banks are able to issue debt in wholesale markets to the interest rate required from the respective sovereign. This means that as soon as a government's rating begins to be downgraded and its funding cost begin to rise the same occurs to banks from that country. Even in collateralised funding markets, like for example, the interbank repo market, banks have grown increasingly averse to lend to banks who use their own government's bonds as collateral whenever that government is tainted by sovereign risk concerns.

Against the background of a deteriorating fiscal situation, market confidence in the sustainability of public finances has been progressively eroded – though not just in the euro area – and the growth outlook is now surrounded by downside risks.

Unsustainable government policies and the failure of governance

But let me be clear: Although the economic crisis significantly increased the burden on government budgets, the true "failures" leading up to the current sovereign debt crisis lie with the unsustainable fiscal and structural policies pursued by many of these governments before the crisis and with the governance system of the euro area.

The EU's economic governance framework failed to prevent and correct unsustainable national policies that contributed to the build-up of major imbalances in euro area countries. This applies in particular to the weak implementation of policy recommendations, the inadequacy of enforcement measures taken to discourage or correct deficit infringements, and the insufficient recognition by national policy-makers of the need to ensure mutual consistency between national policies in a monetary union, especially with regard to the issue of competitiveness. Moreover, as I will elaborate in more detail later on, existing fiscal rules have been weakened over time and procedures and measures that were put in place in order to enhance economic policy coordination have not been implemented with sufficient rigour.

Let us not forget that EMU is characterised by a high degree of economic and financial integration among its members, which in normal times is obviously beneficial to all. Yet, in times of crisis, close financial integration also means that unsustainable developments in one member state can easily spread to other members perceived as vulnerable by the market. The crisis has also made policymakers increasingly aware of the need to establish effective macro-prudential surveillance frameworks which can provide a strengthened systemic perspective to regulation and supervision and do not neglect the interactions within the financial system, and their relation to the real economy. Against this background, the European Systemic Risk Board (ESRB) was established at the beginning of 2011 and entrusted with the responsibility for the macro-prudential oversight of the financial system of the European Union. In addition to macro-prudential surveillance, strengthened fiscal and macroeconomic surveillance remains essential for guarding against destabilising cross-country spillovers which might stem from a loss of confidence in the sustainability of national policies.

The experience of the last few months has taught us that the possibility of market failures in the financial sector can never be ruled out, including self-fulfilling trend dynamics in the pricing of sovereign risk. Market failures are costly in a monetary union due to the potential for contagion. The experience of euro area sovereign bond markets in recent years is rather telling in this regard. Prior to the financial market tensions in autumn 2008, euro area sovereign bond spreads were clustered in close proximity to each other, in spite of sizeable cross-country differences in underlying fiscal and structural positions. This under-pricing of sovereign risk and, ultimately, failure of market discipline in a period of tranquillity quickly gave way to an abrupt and disorderly re-pricing of this same risk, without due regard to different underlying fiscal and structural positions. The fact that market discipline had been rudely awakened also meant that, in this environment of over-pricing of risk, a protracted liquidity crisis has the potential to easily become a systemic threat to solvency and sustainability if left unaddressed.

The ECB's response to the crisis

Central banks around the world, including the ECB, have reacted to the crisis in a swift and decisive manner. Before discussing some of the measures the ECB has taken, let me briefly discuss some more general principles that underlie the ECB's policy response.

The ECB reacted to the financial turmoil in full accordance with both its mandate and with key principles of modern central banking practice. First of all, the ECB's policies were always guided by its primary objective, which is to maintain price stability. However, we have learned from the financial crisis that while price stability is certainly a necessary condition for financial stability, it is not a sufficient one. The materialisation of systemic risk and financial instability triggered deep recessions with great economic costs. These developments carried risks for medium-term price stability which called for bold decisions by central banks around the world.

With regard to the nature of the policy decisions we took, our monetary policy framework distinguishes between monetary policy decisions, on the one hand, and the implementation of the desired monetary policy stance through open market operations, on the other. This facilitates the clear distinction between interest rate decisions taken to preserve price stability and liquidity measures adopted in the course of implementing this stance. This distinction is certainly useful under normal market conditions and has proven to be of great relevance in periods of financial turbulence, albeit for somewhat different reasons.

In normal times, this so-called “separation principle” allows the central bank to fine-tune operational procedures in order to steer short-term interest rates very close to the main policy rate, without risking that those adjustments are regarded by observers as changes to the monetary policy stance. In exceptional circumstances, when severe distortions in financial markets emerge and the level of uncertainty is higher, a more non-standard liquidity management by the central bank may be needed to prevent dysfunctional markets from interfering with the effective transmission of the monetary policy stance. These non-standard measures have to be conducted without compromising the central bank’s main monetary policy objective, which in the ECB’s case, is price stability.

The “non-standard” measures implemented by the ECB have not introduced any distortion into the general strategic monetary policy framework of the ECB and did not interfere with the aforementioned “separation principle”. On the contrary, “non-standard” measures should be seen as complementary to rates policy in times of financial crisis.

As you know, with the start of the financial crisis in 2007 banks became significantly more concerned about counterparty credit risk and liquidity risk. As a result banks also became increasingly reticent to lend to each other in the interbank market. This meant that short-term interest rates in the interbank market became disconnected from our main policy rate, the rate in our main refinancing operations, because many banks could not access market funding no matter what rate they were willing to pay for it. The ability of the ECB to influence financing conditions in the economy by determining short-term money market rates was thus seriously hampered.

In response to this situation, from August 2007 onwards, the ECB started to conduct additional and special liquidity providing operations with the objective of ensuring that solvent banks did not loose the ability to refinance themselves despite the fact that the interbank market had become dysfunctional. After the collapse of Lehman Brothers in October 2008 the ECB began to conduct these operations under the fixed-rate full-allotment procedure which allowed banks to determine through their own demand how much liquidity the Eurosystem provided to the interbank market. The list of eligible collateral accepted by the ECB in its refinancing operations was also expanded in order to allow banks to increase their access to our operations if needed. The ECB also introduced refinancing operations for longer maturities, including six month and one year maturities, so as to reduce the need for banks to roll-over their funding over short periods of time in an uncertain liquidity environment.

International cooperation with other major central banks has also allowed the ECB to provide liquidity and alleviate tensions in funding markets for currencies other that the euro. The swap arrangements with the US Federal Reserve, for example, have allowed us to conduct fixed-rate full allotment tenders in US dollars. These operations became very important following the collapse of Lehman. Demand in these operations declined in the course of 2010. Following the emergence of some signs of potential tensions in US dollar funding markets in 2011, as a precautionary measure, the ECB recently decided to re-establish 84-day fixed-rate full allotment tenders in US dollars, in addition to the 7-days tenders.

In 2009 the ECB launched one of its most innovative non-standard measures, our first Covered Bond Purchase Programme (CBPP1). Under this initiative the Eurosystem purchased €60 billion worth of covered bonds between July 2009 and July 2010. This initiative had four objectives: first, reducing money market term rates; second, easing funding conditions for credit institutions and enterprises; third, encouraging credit institutions to maintain or expand their lending to households and enterprises; and, fourth, improving market liquidity in important segments of private debt securities markets. The Eurosystem decided to target covered bonds because of the particular importance that this asset class has for the financing of banks and the real economy in the euro area.

CBPP1 was very successful in restarting issuance activity in primary covered bond markets. With the recent intensification of the sovereign debt crisis, however, covered bond markets have again come under significant pressure. This is why at its meeting on the 6th of October, the Governing Council decided to launch a second covered bond purchase programme, CBPP2, that will consist of €40 billion worth of covered bond purchases within the year starting in November 2011.

In addition to the aforementioned measures, after euro area sovereign bond markets became increasingly dysfunctional the ECB launched its Securities Markets Programme (SMP) in May 2010. The main purpose of this programme is to protect the functioning of the monetary policy transmission mechanism by addressing the malfunctioning of certain key government and private bond market segments. A key distinguishing feature of asset purchases made under the SMP is that their liquidity impact has been sterilised through the conduct of weekly liquidity absorbing operations. There has been no net injection of central bank liquidity to the market as a consequence of these operations. The SMP and its objectives therefore remain fundamentally different from quantitative easing.

Overall, the measures implemented in response to the financial crisis helped sustain financial intermediation in the euro area by safeguarding the refinancing of solvent banks and restoring confidence among financial market participants. This, in turn, helped preserve the viability of the banking system and important segments of the financial market. These measures were instrumental in supporting the availability of credit for households and companies, in spite of the moderation in credit growth in a number of countries, and, ultimately, they also contributed to maintaining price stability.

3. Institutional reforms in the euro area

Weaknesses in European economic governance

The success of monetary policy in containing the damage of the financial and sovereign debt crisis should not obscure a more fundamental lesson that the experience of the past few years teaches us: private and public sector imbalances may not only put at risk the longer-term sustainability of public finances, but also have implications for financial stability and, ultimately, monetary policy.

In Europe we have realised at a high cost that the governance to ensure fiscal soundness and macro-economic stability was simply insufficient.

The fiscal policy framework suffered from weak implementation of the Stability and Growth Pact (SGP), in particular after its reform in 2005. This was mainly due to two reasons:

First, at the national level, incentives for ensuring sound and sustainable fiscal positions have been insufficient. Some Member States had already accumulated large fiscal imbalances in "good times". The stability and convergence programmes were frequently poorly specified and overly optimistic. Furthermore, Member States failed to adhere to medium-term budgetary objectives and only slowly corrected excessive deficits. Future budgetary costs, arising from ageing populations, were also not sufficiently addressed with the necessary reforms.

Second, at the European level, the surveillance framework was never rigorously enforced. Weak peer pressure among Member States translated into a reluctance to attach sufficient importance to the joint responsibility for maintaining euro area stability. Allow me to remind you that in 2003 Germany and France substantially contributed to a watering down of EU budget rules. In 2003, they voted against proceeding with the excessive deficit procedure in spite of breaking the 3% fiscal deficit ceiling. The lack of an automatic trigger in case of non-compliance with the deficit rules left a great deal of discretion for the decision-making bodies at the EU level. All participating parties were reluctant to enforce fiscal discipline in line with the rules and procedures foreseen in the Stability and Growth Pact. In particular, financial sanctions that were due to be applied for cases of persistent failure to correct excessive deficits were never applied.

Apart from the weak fiscal surveillance mechanisms, the economic governance framework also failed to prevent the emergence of large and persistent macroeconomic imbalances. Some Member States experienced inflation rates permanently above the euro area average. In these countries, increases in wage costs, significantly exceeded productivity gains and this, in turn, led to a substantial rise in unit labour costs. As a consequence, competitiveness was gradually eroded and risks of adverse spill-over effects from individual countries to the euro area as a whole emerged.

The euro area's recent governance reforms

Against this background, on 28 September 2011 the European Parliament approved new legislation aimed at addressing weaknesses in the existing economic governance framework for co-ordinating fiscal and structural policies. I would like to share with you the ECB's assessment of these reforms.

Let me say from the outset that the new legislation, consisting of six parts, the so-called "Six-pack", is certainly a step in the right direction. The "Six-pack" consists of four proposals aimed at strengthening the Stability and Growth Pact and the budgetary surveillance framework, and two proposals which focus on monitoring and controlling macroeconomic imbalances.

The key improvements in the EU surveillance framework include: (i) the strengthening of the preventive arm of the Stability and Growth Pact, including through the introduction of earlier and gradual sanctions and of an expenditure growth benchmark; (ii) making the government debt criterion of the Maastricht Treaty operational; (iii) a new sanctions mechanism to strengthen the enforcement of the rules for euro area countries, (iv) new minimum requirements for the rules and procedures governing national budgetary frameworks and finally (v) the introduction of a new Excessive Imbalances Procedure (EIP) for the prevention and correction of macroeconomic imbalances.

The "Six-pack", however, falls short of the "quantum leap" that the ECB had long advocated for the euro area. A major drawback is that the new governance package still leaves the Council with too much room to apply discretion when deciding on the execution and enforcement of the surveillance procedure. Another vital shortcoming relates to the large amount of exceptions and relevant factors that need to be taken into account when it comes to applying the excessive deficit procedure. This creates loopholes and could endanger the transparency and therefore the accountability of the fiscal governance framework as a whole.

Looking ahead, the identification of the necessary reforms has to start from being clear about what the ultimate objective is: the need to establish institutional arrangements which provide credible incentives for sound fiscal and macroeconomic policies in a monetary union. In my view, a more fundamental deepening of fiscal and economic policy surveillance is necessary in the long run. This would involve a transfer of sovereignty to the European level of decision making, which should have much stronger powers, and would also mean stricter constraints on national budget policies.

This kind of reforms would require a comprehensive change to the EU Treaty but, above all, an adequate mechanism to ensure their democratic legitimacy. Let me outline the ideal cornerstones of such a governance reform. First, to ensure fiscal discipline, all planned deficits of more than 3% of GDP and those in excess of a country's medium term objective would need to be approved by all euro area governments. Second, past fiscal slippages would be automatically corrected in upcoming budgets without any room for discretion via the introduction of constitutional rules similar to the German "debt brake". Third, all Member States would also agree to implement fines and sanctions in a quasi-automatic mode. Finally, with the introduction in 2013 of a permanent crisis resolution mechanisms, the European Stability Mechanism (ESM) – I shall come back later to a more detailed discussion of the ESM –, those countries slipping over their macroeconomic adjustment programmes would be placed under financial receivership.

The institutional arrangements at both national and supranational level would also have to be strengthened. At the national level, independent budget offices would ensure reliable forecasts – a prerequisite for sound planning and implementation of budgets. At the euro area level this needs to be complemented by an independent entity with a clear mandate and a strong institutional framework to assess the implementation of fiscal rules. For instance, some form of European Budget Office or "EBO", which could potentially form the nucleus of what could become over time, and in a gradual manner, a European Ministry of Finance. Strong and independent institutions at the euro area and national levels serve to enhance transparency. They bring the necessary pressure to bear to ensure the conduct of sound policies and effectively counteract possible tendencies towards a lenient implementation of fiscal rules at the level of individual member states.

In addition to the "Six-pack" in March 2011 the Heads of State or government of the euro area agreed on a "Euro Plus Pact" to strengthen policy coordination in order to improve competitiveness and convergence. Under this agreement euro area governments commit to use a set of common indicators to regularly monitor each others progress in areas such as labour-market reforms, reforms to wage-setting arrangements and reforms aimed at improving the sustainability of pension, health care and social benefit systems. Governments who signed the Euro Plus Pact also committed to translate the rules set out in the Stability and Growth Pact into their national legislations. The reform of article 135 of the Spanish constitution in August 2011, which for the first time introduced the principle of budgetary stability into the fundamental law of the country, is a positive example of recent progress made in this area.

The new architecture for financial supervision

But as I said earlier, in the lead up to the present crisis governments were not the only ones to fail in their responsibilities. The functioning of our financial system also proved to have important shortcomings.

To address these issues a new EU architecture in the area of financial supervision has become operational in 2011. Let me recall that the EU institutional framework for financial supervision is based on two pillars. The first pillar is the European Systemic Risk Board (ESRB), which is the body responsible for macro-prudential supervision of the whole EU financial system. According to the founding legislation, the ESRB has to act with the logistical, analytical, statistical and administrative support of the ECB. Indeed, over the last year the ECB has made a considerable effort to strengthen its analytical tools and models in order to support the EU-wide risk assessment of the ESRB. The ESRB has just published its first set of policy recommendations concerning lending in foreign currencies.

The second pillar is the European System of Financial Supervisors, including the national supervisory authorities and the three European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). After an initial "set-up" period, the three ESAs are already proving to be effective in steering the coordinated efforts of the national supervisory authorities, for instance coordinating EU-wide stress tests.

At the global level, significant progress has also been made on banking supervision. The financial crisis clearly demonstrated the need to overhaul and complement the existing international regulatory frameworks. Against this background, the G20 Leaders called for broad regulatory reforms. As regards banking regulation, key elements of these reforms are the new international capital and liquidity frameworks, which are commonly referred to as "Basel III".

The new Basel III framework seeks to increase minimum capital requirements on banks, enhance the ability of the regulatory framework to capture different sets of risks, introduce a stricter definition of capital as well as entirely new concepts, such as a non-risk-based leverage ratios and mandatory liquidity requirements. The implementation of Basel III is expected to increase the resilience of the financial system and reduce the frequency of crises in the future.

The main challenge that lies ahead is the timely and consistent implementation of the new Basel III framework at the global level. The Basel Committee agreed to put in place a comprehensive and robust review process covering all aspects of Basel III implementation. In this context, I very much welcome the fact that the European Commission was one of the first, at the international level, to take the initiative in actively implementing Basel III by issuing a fully-fledged EU capital requirements regulation and directive on 20 July 2011. In the coming months the ECB will issue its official Opinion on this regulation by the Commission.

With the spill-over of the sovereign debt crisis to the situation of European banks, markets have become increasingly worried about whether banks have sufficient capital buffers to sustain losses stemming from sovereign risks. Market pressure for a front-loading of the Basel III requirements has also become manifest. To address some of these concerns, on the same day of the 26 October Euro Summit the EBA announced that it will require banks to build an additional temporary capital buffer against their sovereign debt exposures to reflect current market prices. In addition, as I already mentioned earlier, banks will be required to establish a buffer such that their Core Tier 1 capital ratio reaches 9% by the end of June 2012.

Further progress in financial supervision is also needed in other areas like the oversight of the shadow banking system and the treatment of systemically important financial institutions (SIFIs). As regards these institutions, I would like to highlight that the efforts at euro-area and EU levels to address the financial crisis are supported by the broader coordinated action of all G20 countries to reform key elements of financial regulation. In this context, the recent G20 meeting in Cannes was of crucial importance, as the G20 leaders endorsed a comprehensive framework to reduce the risks posed by SIFIs, including strengthened supervision, key attributes of effective resolution regimes, a framework for cross-border cooperation and recovery and resolution planning as well as additional requirements to absorb losses in the case of those banks classified as Global SIFIs. In addition to these initiatives, initial recommendations and a work plan to strengthen the regulation and oversight of the shadow banking system were also agreed upon.

The EFSF and ESM

This review of the main institutional, supervisory and regulatory initiatives that have been undertaken in response to the crisis would not be complete without also mentioning the creation of the permanent euro area crisis resolution mechanism.

As you know, on July 2013 the European Stability Mechanism (ESM) will take over the functions that are currently performed by the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). Both the EFSF and the EFSM were established in 2010 as temporary arrangements to tackle the urgent need to finance governments in the euro area that had lost access to market financing as a result of the sovereign debt crisis.

The main objective of the future ESM will be to provide financial assistance, subject to strict conditionality, to euro area countries experiencing severe financing difficulties. As with the EFSF, this assistance will predominantly take the form of loans known as ESM Stability Support (ESS) loans. These loans will be granted conditional on agreement to and compliance with a strict macroeconomic adjustment programme. The maturity of the ESS loans will depend on the nature of the imbalances and the beneficiary country's prospects for regaining access to financial markets. The interest rate on the loans, which may be either fixed or variable, will reflect both the funding cost of the ESM and the need to avoid moral hazard behaviour by borrower countries. More recently, the Heads of State or Government of the euro area and EU institutions have formally announced their decision to entrust the EFSM/ESM with the power to finance the recapitalisation of financial institutions via loans to governments, including those of countries not under an EU/IMF programme. The ESM will also be able to intervene in the secondary government bond markets on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability and on the basis of a decision by mutual agreement of the EFSF/ESM Member States, to avoid contagion.

As I mentioned at the beginning of my speech, on 26 October the Euro Summit also agreed to leverage existing EFSF resources by up to 4 or 5 times. This leveraging will be achieved via two different schemes which may be used simultaneously. The first is a credit enhancement scheme, through which private investors will be able to purchase risk insurance when buying new debt issued by Member States. The second scheme consists of the creation of an SPV which will combine resources of the EFSF with those of private and public financial institutions and investors.

The Eurogroup will finalise the terms and conditions for the implementation of these two schemes in November and further cooperation with the IMF will be sought to further enhance the resources of the EFSF.

4. Conclusion

I would like to conclude by highlighting that the financial turmoil and the ongoing sovereign debt crisis have reminded us how important effective institutions that ensure an efficient adjustment mechanism to economic shocks are. In monetary unions this is even more the case because countries share their monetary sovereignty and lack the possibility to manoeuvre the nominal exchange rate to correct internal and external imbalances.

The policy lessons for the future are clear:

First, monetary policy must remain focussed on its key objective of delivering price stability. Central banks can best contribute to financial stability, including containing contagion risks, by providing a firm anchor for inflation expectations as well as by supplying the financial system with the necessary liquidity. Monetary policy, however, cannot substitute for the need for governments and private agents to deliver on their own responsibilities.

Second, euro area governments must urgently bring forward necessary structural reforms and engage in sustainable fiscal policies within a strengthened euro area governance framework. A number of steps have been undertaken recently to strengthen economic governance. Fiscal policies should, however, be more grounded in a rules-based framework with clear medium term objectives, similar to monetary policy. In this regard, the recent adoption of fiscal rules by some euro area countries is clearly an improvement. Moreover, for the agreed rules and sanctions to be fully credible, they should be stricter and more automatic in nature.

Third, we should not forget about the financial sector. Throughout the crisis, financial institutions have benefited from the support of central banks and governments. Now the call is also on those financial institutions to improve on shielding themselves against market distress and turbulence. In this regard, the reform of financial supervision and regulation is crucial. Basel III is a very important step in the right direction, as it should provide for higher minimum capital requirements and better risk provisions by financial institutions. Yet, the regulation of the banking system and financial markets has not progressed sufficiently, particularly with respect to the so-called shadow banking sector and the treatment of systemically important financial institutions (SIFIs).

Having witnessed the determination shown by European leaders at the last Euro Summit to address the main challenges confronting Europe today, I am confident that we will soon be able to overcome this crisis.