Vítor Constâncio: The future of economic governance in Europe in a global perspective

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the European Conference organised by the Gulbenkian Foundation, Paris, 7 December 2010.

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1. Introduction

I am grateful to the Gulbenkian Foundation for inviting me here tonight. It is a great pleasure for me to be able to address you on the future of economic governance in Europe in a global perspective. Economic governance is a highly topical issue that is being worked on at this very moment in both policy and academic circles.

European and global governance are of course interconnected, and the financial and economic turmoil sweeping over the world economy since 2007 is having fundamental effects on both. Accordingly, I will start by highlighting the lessons of the financial crisis for standard economic policy and theory, which will have a substantial impact on our methodologies for understanding the workings of markets and economies. I will refer to the changing paradigms of global governance, including the shift-away from the so-called "Washington consensus" towards a more inclusive, development-orientated "Seoul consensus" emerging from the November G20 summit. Turning to Europe, I will then address the challenges for economic governance as regards economic growth as well as macroeconomic imbalances. I will conclude, after also referring to the ongoing reform of financial regulation, with some observations on the role of Europe in global governance and what it means to be European at this point in time.

2. Lessons from the crisis for economic policy and theory

It is difficult in the time I have available to convey my understanding of the reach and depth of the crisis we have been experiencing. Let me, however, provide with you with some key figures.

The costs of the crisis, as estimated by Andrew Haldane of the Bank of England, in terms only of permanent loss of output, could amount to between one and five times the total value of present annual world output.[1] The direct support given by governments and central banks to the financial sector have been quantified by the same author as equivalent to 25% of world GDP, with very heterogeneous percentages in different parts of the world: 30% in the euro area, 50% in the United States and a staggering 75% in the United Kingdom.[2] Last week, the Federal Reserve disclosed that it lent USD 3.3 trillion to various financial institutions, and even hedge funds received USD 71 billion. Without this massive state intervention, the financial system would have collapsed with an accompanying depression in the real economy.

Among the various causes of the crisis, two main ones stand out.

- First, the excessive growth of a loosely regulated financial sector in search of risky high yields and profits from rent seeking.
- Second, the development of sizeable global macro imbalances, with the high savings of many emerging countries flooding the financial markets of advanced

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[1] See Haldane, A., *The $100 billion question*, Bank of England, March 2010.

[2] See Haldane, A., *The debt hangover*, Bank of England, January 2010, p. 15.

economies, especially the United States, and contributing to lower interest rates and asset bubbles.

The crisis taught us some important lessons that economic policy cannot now ignore:

1. the financial sector is not self-regulating and self-equilibrating and can generate very large economic crises;
2. excessive credit growth and leverage almost always ends in a crisis generated by a collapse in demand and an unavoidable deleveraging of balance sheets; and,
3. maintaining price stability in the market for goods and services, i.e. controlling inflation, is not enough to avoid overshooting and bubbles in the price of assets – from housing to the financial markets.

Humanity has been taught these lessons several times, but always seems to forget them. When this happens, regulation and supervision become loose and the financial system can then come off the rails on its own. This time in particular, this effect happened as a result of a "cognitive capture" of regulators by the dominant economic theories, which have much to answer with respect to the crisis.

The prevailing macroeconomic theory saw the economy as a simple system determined by fully rational individuals that could anticipate a future perturbed only by some random shocks with well-behaved distributions and by quickly self-equilibrating markets. The main macro model did not have a financial sector, as it was supposed to work efficiently and smoothly without creating turmoil or bankruptcies.

On the other hand, the so-called modern finance theory maintained the "efficient market hypothesis" (EMH), according to which financial markets process all relevant information for the proper valuation of assets. In consequence, market prices are always right, as they reflect fundamentals, thus precluding the possibility of bubbles and other irrational phenomena like herd behaviour or long periods of mispricing.

Another feature of modern finance theory is that only individual investors exist in the market and determine asset prices through their rational decisions. In the models, there are no financial intermediaries with their own interests, creating significant principal-agent problems and extracting rent through instruments of financial innovation that in some cases only redistribute value from taxpayers and non-financial clients, contributing ultimately to financial disasters with high costs for the general welfare. In the United States, for example, the weight of financial sector profits in total profits increased from 12% in the early 1980s to about 40% in 2007.[3]

These points were forcefully made by Lord Turner, Chairman of the UK Financial Services Authority, and Paul Woolley in a recent book published by the London School of Economics called "The Future of Finance". Turner writes that "It is possible for financial activity to extract rents from the real economy rather than to deliver economic value". While recognising that "financial innovation ... may in some ways and under some circumstances foster economic value creation", he insists that this "cannot be asserted a priori". Ben Bernanke, Chairman of the Federal Reserve Board, in his testimony to the US Congress Financial Crisis Inquiry Commission, made the similar remark that "some innovations amplify risk" and others "are used primarily to take unfair advantage rather than create a more efficient market".

The crisis has indeed struck a blow to standard economy theory. Many economic concepts and models will have to go through significant changes. Both in macroeconomic theory and finance theory, important revisions are underway to take better account of less-than-efficient

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[3] See Turner, A., "What do banks do?", and Woolley, P., "Why are financial markets so inefficient and exploitive – and a suggested remedy", in Turner, A. et al, *The Future of Finance*, London School of Economics, 2010, Chapters 1 and 3, (www.futureoffinance.co.uk).

markets, to replace rational robots with economic agents endowed with insights from behavioural economics, to go beyond the representative single economic agent and populate new models with heterogeneous agents, to acknowledge financial instability as a trigger of economic crises and the possibility of bankruptcies, and much more. For years to come, the crisis will generate new theories and models in the same way that the Great Depression led to the creation of macroeconomic theory by John Maynard Keynes.

Recently, Ben Bernanke described some of the changes that are necessary, stating that "more work is needed on the behaviour of economic agents in times of profound uncertainty; on asset price bubbles and the determinants of market liquidity; and on the implications of financial factors, including financial instability, for macroeconomics and monetary policy".[4]

3. The changing paradigms of global governance

Besides economics, other paradigms are also changing as a consequence of the crisis. Globalisation entered a new phase with an acceleration of the shift in global power towards emerging market economies that began in the last decade, giving these countries a seat at the leading table of world governance, most notably in the G20. So far, the potential for tensions and challenges within this new framework of governance, including between advanced economies, has by and large been contained by the urgency of the tasks ahead. As countries emerge from the economic and financial crisis, however, incentives for cooperation in the future may be reduced.

Another historic shift concerns the role of the State and its interplay with the market. The crisis made clear that the State is irreplaceable as risk manager of last resort and as regulator of irretrievable imperfect markets. On the other hand, instead of a continuing expansion of free markets we see in various parts of the world the progress of a kind of state capitalism with the accrued importance of state firms and sovereign wealth funds. "The Washington consensus is dead!" proclaimed the UK Prime Minister at the G20 London Summit in April last year, marking an end to the reign of principles unequivocally advocating free markets, privatisation, deregulation, smaller government and free capital movement.

In fact, the laissez-faire regime of the "Washington consensus" is giving way to a quite different system: the new G20 "Seoul consensus". At the risk of over-generalisation, the one-size-fits-all approach to economic management stemming from the belief in an optimal model is being replaced with an acknowledgment of the merits of policy diversity and tailoring to countries' circumstances. The over-reliance on the ability of markets to self-equilibrate and optimally allocate resources has foundered on the reality of asset prices decoupled from fundamentals, unsustainable credit growth, and precarious balance sheets. Instead, states have moved in to stabilise markets, manage national resources and provide growth impetus. The doctrine of unrestricted capital flows, which the IMF very nearly mandated for all its members in 1998, has been revisited and countries are experimenting with various controls – with IMF endorsement – to protect themselves from flows of potentially destabilising magnitude or volatility.

Amid all these historic changes, governance at the world level is facing three fundamental challenges:

1. The reform of the international financial regulation in order to tame a sector prone to excesses, whilst respecting the need to maintain the level playing field that is essential from the point of view of globalisation.

[4] See Bernanke, B., "Implications of the Financial Crisis for Economics", speech at a conference co-sponsored by the Center for Economic Policy Studies and the Bendheim Center for Finance, Princeton University, September 2010.

2. The reform of the international monetary framework to correct growing global macro imbalances and to stabilise the exchange rate system.

3. The creation of cooperative conditions to ensure sustainable international growth.

Much progress has been achieved since last year on the first two challenges, while the third seems to be a more difficult endeavour. Concerning financial regulation reform, under the aegis of the G20, a remarkable amount of work has been done by the Financial Stability Board and the Basel Committee. A major component of this reform was the adoption of the new Basel III framework with the aim of strengthening the capital base of banks and introducing stricter liquidity risk requirements and a minimum leverage ratio. This in itself will substantially reduce the probability of future banking crises, thereby improving long-term economic and social welfare.

All of these new measures, which will be introduced over a long transition period, should not have any unduly severe implications for the ongoing economic recovery. Although the agreement on Basel III constitutes a robust conceptual framework, much remains to be done. The potential implications of the leverage ratio and the liquidity risk framework still need to be assessed. Furthermore, since the leverage ratio is largely based on accounting information, the accounting standard-setters should strengthen their efforts to eliminate existing accounting differences. This is essential in order to ensure a level playing field.

The Basel Committee has also decided that systemically important financial institutions, commonly designated as “too big to fail”, will be required to have a higher loss absorbency capacity than other institutions that are subject to Basel III. The ways and means of achieving this are going to be deliberated next year.

In relation to the second challenge of reforming the international monetary framework, a good start was achieved with the governance overhaul of the IMF, endorsed at the G20 Seoul Summit. The IMF’s move to better reflect the systemic importance of emerging market economies should lead to greater legitimacy. This could also have positive economic effects, such as a mitigation of precautionary reserve accumulation, which can otherwise contribute to the build-up of global imbalances. Exercises aimed at analysing spillovers from major countries and regions to the other partners will also gain new legitimacy. More generally, however, I do not see a major reform of the international monetary system on the horizon, as there is no real substitute for the US Dollar in medium term. The special drawing right (SDR) is not a promising option, and the insufficiently deep and liquid financial markets of emerging market economies will limit the role that their currencies can play in the foreseeable future. A more cooperative system of exchange rate regimes is essential but does not depend on unachievable radical reforms.

Concerning the third challenge, creating the conditions for growth, the G20 have approved the Framework for Strong, Sustained and Balanced Growth which, alongside a set of structural reforms, has at its core fiscal consolidation, which could lead to 1) internal rebalancing in advanced economies by substituting public stimuli for increased private demand; and 2) external rebalancing by promoting domestic demand in surplus countries and increasing external demand in deficit countries.

Such needs for rebalancing are sometimes presented in overly simplistic terms, namely that surplus countries should reduce savings and deficit countries should increase them, mainly through consolidation of public finances. The attempt to translate this into target ranges for current account deficits or surpluses failed at the Seoul Summit. The question is a complex one because it is not sufficient to change savings’ behaviour. The solution also has to involve movements in the exchange rate, as explained by John Williamson when he denied the

possibility of an "immaculate transfer".[5] In fact, the reduction of domestic savings implies a positive change in the capital balance, which requires a necessary negative development in the current account. The appreciation of the currency is what helps this to happen. This is why, at the G20 Toronto Summit, members with significant external surpluses committed themselves to strengthening their domestic sources of growth, as well as allowing greater flexibility in their exchange rate policies. At the Seoul Summit the G20 then pledged to "pursue the full range of policies conducive to reducing excessive imbalances", the "timely identification" of which will be facilitated by "indicative guidelines" to be agreed by finance ministers and central bank governors in the first half of 2011. The Summit also approved the Seoul Development Consensus for Shared Growth that sets out a commitment to work in partnership with other developing countries to help them maximise their growth potential.

There is, therefore, some progress in international cooperation but we are still far from the solution to the major question of correcting global imbalances and promoting the mechanisms of international adjustment that must be at the centre of a proper functioning international monetary system.

However, the challenges that the advanced economies face to achieve adequate future economic growth go far beyond solving these international problems. The crisis has reduced the growth potential of these countries and has challenged the more recent growth model based on the creation of demand through credit and indebtedness, which relies on expansion in construction, car production or financial services. The delocalisation of significant sectors of industry to emerging economies like China and India, increasingly of a non-traditional type, makes productivity growth in advanced economies more difficult, as productivity grows less in the services sector. This difficulty reflects the new phase of globalisation that we have entered.

In 2004 Paul Samuelson wrote an article that, in his own words, "deals some weighty blows *against* economists' oversimple complacencies about globalization".[6] He demonstrated again, as he had already done in his 1972 Nobel Prize lecture, that it is "dead wrong" to consider that the gains of those who benefit from trade are *always and necessarily* higher than the losses of those who are hurt by trade. This statement has nothing to do with the fact, which he also underlined, that the theories about free trade only apply in situations of full employment. It relates instead to the possibility that the less developed country will make a sudden jump in productivity (by imitation or other means) in sectors where the developed country previously had a comparative advantage. Samuelson uses the examples of the United States and China for his demonstration and concludes that: "this invention abroad that gives to China some of the comparative advantage that had belonged to the United States can induce for the United States permanent *lost* per capita real income …. And, mind well, this would not be a short run impact effect. *Ceteris paribus* it can be a *permanent* hurt."

These statements do not mean that Samuelson has abandoned his position in favour of liberalised trade, as he understands the dangerous consequences of any protectionist drive in the present circumstances. In a spirited answer to some of his critics, he explained that his point was just a lucid reminder of good theory, saying: "The result is not a Spenglerian "Decline of the West", but rather a trend toward (but not necessarily all the way) to geographical equalization. Bet for the future half century to be a repetition of what took place historically in the first half: continued growth in the advanced world but arguably at a lower

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[5] See Williamson, J., "Comment", in Bergsten, F. (ed), *International Adjustment and Financing: The Lessons of 1985–1991*, Institute for International Economics, 1991, p. 243.

[6] See Samuelson, P., "Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization", *Journal of Economic Perspectives*, Vol. 18, No 3, American Economic Association, 2004, pp. 135–146, and Gomory, R.E. and Baumol, W.J., *Global Trade and Conflicting National Interests*. MIT Press, Cambridge, MA, 2001.

rate ceteris paribus due partly to competing imitative inventions abroad."[7] In the same text, he warns that trade theory points to the need for actual redistribution to compensate the losers, a trend he considers to be heading "…politically downward in our present-day democracies."

Among other factors, this has certainly contributed to the spreading of income inequality in our societies, a development that has led to increasing recourse to indebtedness by households. Raghuram Rajan, former IMF Chief Economist, in his new book describing the policies that resulted in this development (which won the 2010 Financial Times and Goldman Sachs Business Book of the Year Award), includes a chapter entitled "Let them eat credit", a pun on the infamous Marie Antoinette quote.[8]

The impossibility of continuing down the same route, now that all economic agents are deleveraging, generates enormous difficulties to improve growth prospects for all advanced economies. They may face the threat of a protracted period of low growth. Only two things could prevent this: 1) the resolution of the global imbalances conundrum with increased demand by emerging countries; or 2) a wave of technological innovations which create new needs and new markets.

The possibility of a long period of mediocre economic growth, raises the prospect of momentous social problems that will test our institutions. In the present post-modern culture where "higher values" tend to be depreciated, legitimacy comes primarily from performance in terms of offering permanent hope of higher living standards. As Benjamin Friedman indicated in his recent book, our democracies depend as much on economic growth as on the level of prosperity already attained.[9] In a recent study[10] that uses a dataset comprising 16 OECD countries for the period 1970–2002, the authors found a significant relation between variations in growth and support for extremist parties, mostly of the right. A one percentage point drop in growth results in an increase of just under one percentage point in votes for extreme right parties. The authors conclude that: "In most economies this is unlikely to have any lasting impact on the political outcomes", but we should remind ourselves of the 1930s and how events can sometimes evolve very quickly.

4. Challenges for economic governance in Europe

It is time to turn to Europe and discuss what all these developments and challenges mean for the future of governance in Europe. I intend to answer this in two ways.

First, I will address some of the challenges for economic governance in Europe, as revealed by the financial crisis. These are challenges that are linked to fundamental shifts in the international economy brought on by globalisation. The crisis has served to "unmask" them and bring them into clearer perspective, and now governance solutions are urgently called for. I see three areas that are critical for Europe:

i. establishing a growth model to address adverse demographic trends and declining productivity in Europe, which imply weak potential growth in the future;

ii. addressing macroeconomic imbalances in the euro area and establishing procedures that ensure macroeconomic stability and competitiveness; and

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[7] See Samuelson, P., "Response from Paul A. Samuelson", *Journal of Economic Perspectives*, Vol. 19, No 3, 2005, pp. 242–244.

[8] See Rajan, R., *Fault Lines: How Hidden Fractures Still Threaten The World Economy*, Princeton University Press, 2010.

[9] See Friedman, B., *The moral consequences of economic growth*, Knopf, New York, 2005.

[10] See Bruckner, M. and H.P. Gruner (2010) "*Economic growth and the rise of political extremism*" CEPR discussion paper n. 7723, March 2010.

iii. setting-up an effective system of financial supervision, which is commensurate with the realities of financial integration in Europe.

Second, I will address how the new developments in global governance accelerated by the financial crisis will affect European governance, and the role Europe can play in this new constellation.

4.1 Growth and demographics

The move to a new phase of globalisation that I described above, and the profound shifts in global production and financial intermediation that are associated with it, have shone a light on some of Europe's deep underlying challenges. It is now clear that, in hindsight, the good times witnessed in Europe the years before 2007 did not mark a shift to a new, higher, growth trend, but rather reflected a system off-balance, where markets were insufficiently regulated by the public sector and where unsustainable growth policies were insufficiently disciplined by markets. As the system rebalances, Europe's challenges related to long-term economic growth are being revealed once more, in particular its adverse demographics, and there is an urgent need to address them.

According to a recent growth projection by the European Commission, potential output growth in Europe would amount to 1½% per annum on average in the period 2011–20 – significantly below the rates observed in the EU in last 20 years and much below those recorded in the United States.[11] The projected potential growth for euro area over this period is worse still, amounting to 1¼% per annum on average.

These weak growth prospects are the consequence of two interrelated phenomena.

- First, population ageing is expected to result in a contraction of labour supply and to increase the fiscal burden of age-related expenditure.
- Second, in a no policy change scenario, productivity growth in Europe is expected to continue on the disappointing trend observed in the years before the financial crisis.

According to the latest Ageing Report (2009), which is produced jointly by the European Commission and the Economic Policy Committee (EPC), the number of elderly people in the euro area aged 65 and above will increase from about 59 million today to about 98 million in 2060. At the same time, the working-age population, which is defined as people aged between 15 and 64 years, will decline after 2010 and dropping by about 13.4% by 2060. Another set of projections made by the U.S. Census Bureau shows that by 2030 the total population in Europe will stagnate and the working-age segment will decrease by 12 million, in spite of the assumption made that Europe will take in 20 million immigrants over the next 20 years. By contrast, the US population is projected to increase by over 60 million with an expansion of the active population by a growth rate of 0.5 million annually. Of the other major countries in the world, China, Japan and Russia will have developments similar to or worse than Europe. Only India will follow the same pattern as the U.S. In the euro area, the so-called old-age dependency ratio, i.e. the ratio of people aged 65 or above relative to the working-age population aged between 15–64 years, is expected to increase from 28% in 2010 to 54% in 2060. As a consequence, euro area public expenditure on pensions, health and long-term care is expected to increase by 5.6 percentage points of GDP by 2060. About half of this rise is projected to come from governments' spending on pensions (around 2.8 percentage points of GDP), and the other half will come from spending on both health care and long-term care (each around 1.4 percentage points of GDP).

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[11] See European Economy 7/2010: *European Economic Forecast Autumn 2010*, pp. 48–60, European Commission Directorate-General for Economic and Financial Affairs.

Establishing a comprehensive strategy for growth

To arrest and reverse these trends requires an ambitious and comprehensive strategy in each Member State. In June of this year, the Commission presented the "Europe 2020 strategy", which is aimed at boosting the competitiveness and growth potential of the EU economies. The strategy provides a coherent policy framework for Member States to implement structural reforms and for mobilising EU policies and instruments. The strategy's overall goals have been translated into five headline EU-level targets. By 2020, the EU should increase its employment rate among 20 to 64 year olds to 75%, from about 69% in 2009. Equally, to promote new sources of growth in the future, overall investment in R&D should reach 3% of GDP each year. Further targets under the strategy are aimed at limiting climate change in line with previously agreed targets, increasing educational attainment and reducing poverty.

In its Autumn 2010 economic forecast, the Commission simulated the effects of closing the performance gap in the EU vis-à-vis the three best performing economies by one third on a number of relevant policy variables, such as enhancing competition in product markets, reducing the administrative burden, shifting tax burdens from labour to VAT, reducing benefit replacement rates and promoting R&D. The simulation results showed that by 2020 a comprehensive package of policy measures, encompassing both product market and labour market reforms, could lead to a 2.2% increase in GDP, compared to the base line scenario. Employment levels could rise by about 1.5% over the same horizon. Such an outcome would also greatly support the ongoing fiscal consolidation process. Importantly, it would also seem that a swift implementation of such reforms would lead to immediate sizeable welfare gains already in the period up to 2015.[12]

If Europeans are to reap these potential benefits, it is clear that reform efforts by national governments have to be reinforced. It is therefore welcome that the EU-level targets under the Europe 2020 strategy are being translated into precise country-specific targets to guide policy-making at the national level. Moreover, the simultaneous review of Member States' fiscal and structural reform policies in European fora prior to national decision making – the so-called European Semester – to be introduced as of 2011 is likely to lead to stronger and more effective follow-up and peer pressure.

An ambitious EU-level programme under the Europe 2020 umbrella will complement actions at the national level. This includes:

1. completion of the single market starting in 2012, twenty years after the 1992 deadline for establishing the internal market;
2. mobilisation of all available financial resources under the EU budget; and,
3. development of a new trade and external policy aimed at improving global market access for EU companies.

Finally, the Commission is currently rolling out seven so-called "flagship initiatives" targeting key policy areas of the strategy (including innovation, education and competitiveness) to complement national reform initiatives.

4.2 Macroeconomic imbalances

These processes of globalisation and financial integration in Europe have facilitated increased leverage and more advanced financial engineering, which has made it possible to advance future consumption and maintain citizens' standards of living in the face of shifts in global production and increased income inequality. Regrettably, the latter phenomenon has

[12] See European Economy 7/2010: *European Economic Forecast Autumn 2010*, pp. 57–60, European Commission Directorate-General for Economic and Financial Affairs.

not facilitated a smooth transition to a new equilibrium, but rather fed distorted expectations of growth among private agents, leading to excessive debt and risk taking, masking the need for economic adjustment to adapt to these global changes. The large scale deleveraging that began in 2007 reversed this trend and laid bare large fiscal and broader macroeconomic imbalances that had built up across Europe in this period. It is these imbalances which subsequently fuelled the disorderly market developments we are seeing today.

The challenge for European governance is how to manage these macroeconomic imbalances, how to prevent them from arising again, and how to deal with their effects in a more orderly manner.

Imbalances should not be seen as a problem *per se*, as they may reflect natural economic adjustment related to "catching-up" phenomena and be self-correcting. Whilst some of developments in the euro area over its first decade reflected real economic convergence, in general they do not fall into this category. The symptoms of unsustainable positions were apparent in most indicators. Growing current account deficits were predominantly linked to an increase in net private borrowing requirements, related credit growth and the build-up of private sector debt. In some (but not all) of these countries, there were also sharp increases in domestic asset prices, particularly house prices. While house prices declined in Germany between 1999 and 2008, there was an average annual increase of more than 10% in Spain and Ireland. These factors also fed into a sustained loss of competitiveness in a number of countries, with unit labour costs in Ireland increasing by 30% more than those in Germany between 2000 and 2008. Fiscal policy was also expansionary, reinforcing these nominal developments. Indeed, hardly any euro area country managed to observe a budget position close to balance or in surplus on a structural basis between 1999 and 2008, despite government debt ratios above 60% of GDP in many countries.

Eliminating imbalances

Countries that have accumulated these imbalances face a long process of adjustment to more warranted levels of spending and debt in both the public and the private sectors. A process of de-leveraging and balance sheet repair will have to take place in several cases. These adjustments will inevitably entail a period of low growth in domestic demand. This, in turn, will necessitate corrective adjustments in relative prices and wages in order to foster net exports and rebalance the economies in question.

To make this process as short and effective as possible, decisive policy action is required on the part of governments.

First, convincing fiscal consolidation to redress the fiscal imbalances is essential. In the present situation, the scale of the fiscal challenges faced by many European countries puts them in "uncharted waters". In this context, adjustment is taking place in a number of euro area countries. According to the European Commission, the euro area average deficit ratio is projected to decrease to 4.6% of GDP in 2011 and 3.9% of GDP in 2012 under the customary no-policy-change assumption. This represents a sizeable improvement compared with the spring forecast, which stems mainly from expenditure measures announced or set out in more detail since then, in particular in the 2011 budgets.

Second, structural reforms should be introduced to increase wage flexibility and the adjustment of wages to appropriate levels. This could be achieved through measures to improve the functioning of labour markets, which would also facilitate the necessary transfer of workers from the non-traded to the traded sectors. In fact, we have already seen wage-setting developments in some European countries that many observers would have believed impossible just a few years ago. The adoption of measures to increase productivity growth is also essential.

Third, repairing the balance sheets of banks and making banks more resilient are crucial prerequisites for the resumption of growth and for financing the reallocation of resources from the non-tradable to the tradable sectors. Many policy initiatives have already been taken

in this respect, ranging from the establishment of "bad banks" to injections of capital and government guarantees' for bank debt. Of course, the liquidity policy of the Eurosystem has played a crucial role in supporting the financing of the overall economy since August 2007. Effective regulation has a key role to play in strengthening the financial system in the longer term.

Preventing imbalances

The experience of imbalances in the euro area in recent years, and the difficulties this has bequeathed, are convincing reminders that "prevention is better than cure". The economic governance framework at the EU level has not performed this function effectively, and there is an urgent need to reinforce economic governance to arrest the build-up of imbalances at a sufficiently early stage. To this end, EU governments have agreed on a number of proposals to strengthen economic governance in the EU and the euro area.

First, they have agreed to strengthen procedures for surveillance of fiscal policies, with a greater focus on government debt levels and new reputational, political and financial sanctions to enhance enforcement of recommendations. Sanctions for excessive deficits will come much earlier than before. There is also an expectation that national fiscal rules and frameworks should be improved, although non-binding. Government finance statistics will be improved by enhancing the auditing powers of Eurostat and giving greater professional independence to the European Statistical System.

For the surveillance of broader macroeconomic policies, governments have agreed to set up a new macroeconomic surveillance framework, with an alert mechanism based on scoreboard indicators that should identify macroeconomic imbalances and vulnerabilities at an early stage and pave the way for their correction. As imbalances are more detrimental in a single currency area, there will be a stronger enforcement framework for euro area countries backed up by non-financial sanctions.

Managing crises

Reinforcing economic governance along these lines should give the EU and the euro area much greater resilience in the face of future challenges. But there will always be a risk that prevention will fail and that countries will be confronted with debt crises. In such circumstances, it is essential to have in place a predictable framework for managing crises that contributes both to financial stability and the correct pricing of risk.

In this context, the Eurogroup agreed on 28 November on the contours of a permanent European Stability Mechanism (ESM) for the euro area based on the existing European Financial Stability Facility (EFSF). The ESM will be capable of providing liquidity support for countries in financial difficulties, subject to an adjustment programme with strong conditionality. Decisions on ESM assistance will be made by the Eurogroup acting unanimously, and will be based on an upfront debt sustainability analysis allowing for a meaningful distinction between liquidity and solvency crises. The Eurogroup also agreed that standardised and identical collective action clauses (CACs) would be introduced in the terms and conditions of all new euro area government bonds starting in June 2013. This framework should help clarify market expectations about future developments and contribute to greater certainty.

The ECB position

For the ECB, the central objective of the reforms of economic governance is to achieve all that is necessary to ensure the smooth functioning of the Monetary Union. The proposals which have been put forward, namely by the Commission, are broadly appropriate for the EU countries not participating in Monetary Union. However, the ECB considers that the framework needs to be more ambitious still for countries in the euro area:

- On fiscal surveillance, there is a need to enhance significantly the enforcement procedures for fiscal discipline, which should include in particular the quasi-automatic application of sanctions on the basis of clearly defined criteria and without scope for discretion through "exceptional circumstances" or waivers.
- On macroeconomic surveillance, the procedures need to be straightforward and use a maximum of analytical intelligence. The framework should focus on countries with vulnerabilities, competitiveness losses and high debt levels. Vulnerabilities should be detected on the basis of a limited number of indicators, which should automatically trigger an in-depth analysis of the country concerned when potential problems are revealed. Graduated sanctions should also come into play at an early stage to reinforce compliance. Assessments and recommendations should be given broad publicity at all stages of the surveillance process.

Member States should anchor the new surveillance framework in national legislation by no later than the end of 2011. It is essential to introduce rules-based, medium-term frameworks and establish independent national institutions assessing fiscal policy. I hope that the final result of the legislation emerging from the dialogue between the European Parliament, the European Council and the European Commission will represent the required quantum leap in the governance of the euro area.

4.3 Financial supervision

The financial crisis has shown how the materialisation of systemic risks can have devastating effects for the financial sector and the broader economy. It has revealed the fragility of an apparently "healthy" financial system to collective behaviour by financial institutions, and the scale of the potential fallout when large financial institutions fail. It has also illustrated the severity of the adverse feedback loop between the financial system and the real economy.

These effects have highlighted the absence of a proper framework for macro-prudential oversight of financial systems and micro-prudential supervision of individual institutions which addresses the interdependencies of a closely integrated single European financial market. In response, the European Parliament and the Council established a new European System of Financial Supervision, which will enter into force on 1 January 2011. It will be composed of three European Supervisory Authorities (ESAs) respectively for the banking, insurance and securities markets, a European Systemic Risk Board (ESRB) that will focus on systemic risks, and national supervisors. The ESAs will be responsible for developing draft regulatory technical standards in order to ensure, through a single rulebook, a level playing field and an adequate protection of depositors, investors and consumers across the EU. In addition, they will have a general coordination role of national supervisors in order to ensure consistent practices as well as specific tasks that may be provided by legislation. The ESRB will be responsible for macro-prudential oversight of the EU financial system. It will monitor the EU's financial system as a whole and it will issue risk warnings and policy recommendations on how to address systemic risks.

The ECB has a strong interest in ensuring that the appropriate arrangements are in place for safeguarding the stability of the European financial system, since this is essential for a smooth transmission of monetary policy. The ECB will be closely involved in the functioning of the new supervisory framework. The ECB President will chair the ESRB and the ECB will provide analytical, statistical and logistical support to the ESRB, as well as its Secretariat. In addition, the ECB will also cooperate closely with the future ESAs, particularly in the context of its own statutory task to contribute to financial stability.

5. The role of Europe in global governance

As I noted above, the financial crisis has led to a profound shift in power towards the largest emerging economies. Indeed, although we often refer to the "global" crisis, emerging markets

in Asia and Latin America seem to have escaped unscathed. Brazil is forecast to grow between 5.5 and 6 percent this year; China is forecast to grow 10 percent; and India is forecast to grow 7%. According to the IMF by 2014 these countries plus Russia will account for 61% of global domestic product growth.

This means that, in economic terms at least, we are increasingly confronted with a "multipolar" world. Whilst the United States remains the world's sole military superpower, economic power appears increasingly diffuse. You may recall Charles Kindleberger's famous argument that the presence of a hegemon is a necessary condition for the provision of international economic stability. Does "multipolarity" therefore condemn us to a period of global instability?

My answer would be: not necessarily. The absence of an economic hegemon does not imply instability, but rather that more international cooperation is needed to ensure stability. This is where I see a crucial role for Europe in global economic governance in the future.

One of Europe's greatest strengths is its commitment to multilateralism and international cooperation, and this will be more valuable than ever both to secure European interests and bind emerging powers into an international framework of cooperation. Europe can also influence the conduct of global governance through its power of example. This is what Joseph Nye referred to as "soft power", "the ability to shape the preferences of others; convincing other actors to *want* the same things as you".

The most obvious example of European soft power is the policy of enlargement. Each new application for EU membership is a testament to the attractiveness of our community of values based on economic and political freedom, tolerance and the rule of law. The EU's process of unification and pacification of a continent is unique and exemplary. Europe also has the potential to exercise soft power through its response to the crisis. As I noted above, the "Washington consensus" has now been replaced by the Seoul Development Consensus for Shared Growth and a fundamental reappraisal of macroeconomic theory is underway. There is therefore a window of opportunity to enshrine new approaches to issues like ensuring sustainable growth and effective regulation of financial markets. If Europe can tackle its own challenges in a credible manner, this is a role it could play.

For many issues at both the European and the global level, I see the financial crisis as what political scientists call a "critical juncture": a rare period when the rules and principles that make-up institutions can be changed and new patterns can be "locked-in" for the future. The challenge for European governance, and for the global governance, is to get these patterns right.

6. Conclusion

To conclude. Europe is facing many challenges for which effective governance solutions are essential. Some of these challenges have arisen from the financial crisis. Others are of a more long-term nature, which the financial crisis has forced Europe to confront in the context of the new globalisation phase.

It is perhaps then appropriate to remind ourselves that Denis de Rougemont, the great Swiss European thinker, defined Europe precisely by its "globalising mission". This tendency for universalism, for the globalizing of the world, is what the great Portuguese poet Fernando Pessoa characterises as the main contribution of Portugal to civilization. Himself bilingual and with an English education, he wrote in the 1920s that: "the Portuguese are essentially cosmopolitan. Never was a Portuguese only Portuguese: he was always everything". A very similar expression was used by the German philosopher Johann E. Erdman, a disciple of Hegel and Wilhelm von Humboldt, who wrote: "Es ist undeutsch, bloss deutsch zu sein" (It is not German to be only German). Written in 1862, in the context of the debate about German nationality that occupied Germany during most of the 19th century until its unification, the sentence reflects the caution of many participants to avoid any kind of nationalism.

It is by overcoming narrow nationalisms that Europe has been built. Nations are a construct of man, not a natural reality. They reflect the social *a priori* that implies that our consciousness and our knowledge are socially constituted. Many nations were even the product of the action of a State. There were Savoyards, Bretons, Gascons before there were French, and Bavarians and Prussians before there were Germans. This does not imply that Europe could become a Nation, not even as Montesquieu pretended "une Nation composée de plusieurs" (a Nation composed of many). Europeans are too diverse and too self-critical for that to happen. We belong nevertheless to two societies: our own society and the European one as the essential background for our rationalist, universal values. Reason can built new realities.

In his famous Vienna address in 1935 on the existential crisis of Europe, Edmund Husserl underlines the fact that philosophical reason is the «original phenomenon that characterizes Europe». And his conclusion was: "The existential crisis of Europe has only two outcomes: either Europe will disappear in becoming ever more distant from its own rational signification, that is its vital sense, and will sink in the hatred of the spirit and in barbarity; or Europe will be reborn from the philosophical spirit as a result of a heroism of reason that will overcome naturalism".

We know very well what happened in those dramatic times and how we could never again trust reason the same way. We live now in so-called post-modern times, which value more the sceptical side of reason. So, it is perhaps more realistic to appeal to less lofty considerations and stress the dense network of interests that tie our nations together. At this crucial moment of the European project referring to the benefits of the "doux commerce" allows us to take comfort and prop our hopes in another piece of wisdom from Montesquieu when he reminded us that: "Les nations sont comme les hommes, elles aiment ce que satisfait ses passions mais elles préfèrent encore plus ce que garantit leurs intérêts".[13]

Thank you for your attention.

[13] "Nations are like men, they love what satisfies their passions but like even more what guarantees their interests".