Carlos da Silva Costa: L'enjeu européen: stabilité, solidarité, prospérité

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Conference organized by Fondation Calouste Gulbenkian – Délégation en France, Paris, 17 April 2012.

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1. Introduction

Good Evening Ladies and Gentlemen. It is a real pleasure to be here and to have this opportunity to speak to you about an important topic that very much concerns all of us.

We are now entering the 5th year since the beginning of the global crisis and we still find it hard to "see the light at the end of the tunnel":

- Large current account imbalances persist in the world economy;
- Severe fiscal imbalances remain to be tackled, particularly in the US and Japan;
- The sovereign debt crisis continues to affect the euro area.

Global financial markets have been the transmission chain of the crisis in its different stages. Up to 2007, markets' tolerance, and even neglect, contributed to the build-up of large imbalances in the world economy. Since then lack of confidence and nervousness propagated the crisis and amplified its effects.

In the past two years, Europe has been the epicentre of the crisis. Three European Union Member-States - Greece, Ireland and Portugal – lost access to market financing and had to negotiate financial assistance packages with the European Union and the International Monetary Fund. The negative interplay between public finance and financial sector fragilities is not confined to these three countries and other euro area economies have suffered from intense market pressure.

Market pressure is not so much about unsound policies or unsustainable debt paths in the euro area. Taken together, the fundamentals of the euro area are stronger than those of the US or Japan. However, the crisis brought to the forefront severe inconsistencies in the governance model, the internal organization and the instruments available to manage the single currency. These flaws contributed to significant cross-country divergences in macroeconomic performance within the euro area.

The initial response of European leaders to the crisis was slow and hesitant putting a heavy burden on the European Central Bank, which was forced to act testing the limits of its mandate.

The euro area systemic crisis is threatening the very survival of one of Europe's greatest achievements – the single currency. While important and encouraging decisions were recently taken by European leaders, markets are yet to be convinced on the irreversibility of the euro. Failure is not an option: we would risk irreversible damage to the foundations of the European Union itself, with unpredictable geopolitical consequences.

The challenges ahead are huge and are well captured in the three words chosen for the theme of this talk: *Stability, Solidarity and Prosperity*. What I propose to do today is to take stock of the root causes of the global and European crises and then embark on the discussion of those three challenges.

2. The build-up of the global and European crises

The great moderation and regulatory failure

The causes of the global financial crisis are now well understood.

The mid-1990s marked the start of a decade of sustained economic growth and low inflation – a period that came to be known as “the Great Moderation”. Globalization favored benign macroeconomic conditions, creating the illusion of a new economic paradigm. Low consumer inflation eased the pressure on central banks – most notably the US Fed – to tighten monetary policy and rein in credit growth.

Rather than translating into consumer price inflation, credit expansion, deriving from the ample liquidity and low interest rates, led to fast rising asset prices. In particular, very low US interest rates promoted the rapid expansion of consumer and mortgage credit fuelling a widespread housing bubble.

Regulatory and supervisory failures amplified these developments. The financial bubble and the subsequent disruptions owe much to the wide-ranging financial de-regulation; the pro-cyclicality in regulatory frameworks; insufficient attention to financial interconnectedness and macro-systemic and liquidity risks; and, last but not least, the lack of market transparency. The emphasis was put on expanding lending, rather than on the borrower’s ability to pay reflecting the move from the “originate-to-hold” to the “originate-to-distribute” business model and perverse incentives from the self-regulation paradigm.

The accumulation of imbalances in the US economy mirrored the build-up of imbalances elsewhere in the world economy. Current account surpluses in emerging countries, most notably China, were invested in US securities and other low-risk assets further amplifying liquidity and depressing yields. This encouraged investors to turn to riskier assets in search for higher yields leading to severe underpricing of risk.

The impact of EMU

Beyond the global context, in Europe specific developments were also at play in the mid-1990s – the most notable one being the plans to set up an Economic and Monetary Union (EMU).

The prospect of EMU fostered the rapid convergence of interest rates to the levels prevailing in Germany, the anchor country in the then Exchange Rate Mechanism. Prospective EMU members – especially those with worse policy track-records – benefited from a virtuous cycle between nominal convergence and the prospect of EMU participation.

In these so-called “converging” countries, policy efforts towards fiscal consolidation and lower inflation increased the likelihood of EMU participation, as these countries became closer to fulfilling the Maastricht criteria. In turn, a higher probability of joining EMU facilitated exchange rate stability, the decline of interest rates (reflecting lower risk premia) and the improvement of the budget balance (as a result of both lower interest payments on public debt and buoyant tax revenues).

The magnitudes involved were impressive: long-term interest rates in Portugal declined from over 12 per cent, in April 1995, to around 4 per cent, in December 1998, just before the country adopted the euro. During the same period, the 10-year interest rate differential against the D-mark narrowed from over 5 percentage points to about 30 basis points. Differentials remained very low for almost a decade – in 2007, the average 10-year differential between Portuguese and German government bonds was still below 20 basis points. Interest expenditure by the public sector more than halved, dropping from 5.6% of GDP in 1995 to 2.4% in 2005. Similar developments occurred in other converging countries like Italy, Ireland, Spain and, with some lag, also Greece.

As this “new world” of low interest rates and abundant financing appeared to offer a free lunch to the converging countries, severe imbalances and cross-country divergences started to build-up. The substantial easing of liquidity constraints led to booming private sector credit and lower savings. Households’ consumption of durables and housing investment soared and corporate leverage increased significantly. Large current account deficits emerged as a counterpart to the boom in private spending.

While private sector dynamics were very similar within the group of converging countries, imbalances took somewhat different shapes reflecting cross-country differences in fiscal, financial and structural policies and institutions.

In countries such as Portugal or Greece, fiscal imbalances became a major problem – even if the size of the problem was, and is, substantially different. Savings arising from lower interest rates and boom-related windfall revenues were used to finance new expenditure. When the initial impact of EMU on growth disappeared, the underlying unsustainable fiscal policies soon became apparent. Also, structural bottlenecks and lack of competition translated into a mismatch between wage and productivity developments and led to an overexpansion of the non-tradables sector.

In countries such as Spain or Ireland, fiscal policies were more prudent. Still, imbalances built-up, mainly taking the form of a real estate bubble. In Ireland, an oversized financial sector developed in tandem with the real estate bubble.

The subprime crisis and the sovereign debt crisis

The burst of the real estate bubble in the US in mid-2007 – the so-called sub-prime crisis – set in motion the current global crisis. Banks in northern European countries were hard hit by the loss in value of the structured products in their balance sheets. The collapse of Lehman Brothers in the summer of 2008 triggered widespread fears of contagion and massive help to these banks.

As the financial crisis developed into a global recession, policy authorities around the world responded with massive liquidity provided by central banks, fiscal expansion and the provision of public guarantees to banks' debts. The aim was to mitigate the impact of the crisis on output and employment and to prevent a fully-fledged crisis that could resemble that of 1929.

The resulting deterioration in the balance sheets of the public sector came at a time when markets had become much more rigorous in their risk assessment. Markets focused increasingly on the high external and public sector debt levels and low growth of several euro area countries, where the policy room for manoeuvre was limited. The associated sustainability concerns brought us to the current stage of the crisis – the sovereign debt crisis.

What lessons from the European crisis?

With the benefit of hindsight, how can we explain the developments of the past 15 years? How was it possible that such high current account deficits persisted in a number of euro area countries without financial markets questioning these countries' ability to repay their increasing debts?

We cannot ignore that EMU was a major regime change. As such, it had a major impact on the formation of expectations, the transmission channels and the equilibrium values of economic variables. This made it extremely difficult to evaluate developments in real time, causing very reasonable and competent people to disagree in their assessments and to advocate different policy responses.

For a number of years, the dominant view in academic and policy circles, as well as in financial markets was what we might call the "benign view". Many respectable economists and policy-makers claimed that current account imbalances were the expected result of deeper integration among countries with different levels of economic development. In a monetary union, a current account deficit reflecting the financial balance of the private sector would be no cause for concern. Credit risk monitoring would ensure adequate risk-pricing, and there would be no aggregate (and thus policy-relevant) macroeconomic imbalance.

This view found support in the predictions of standard macroeconomic frameworks. In a neo-classical growth model, an interest rate decline caused by a drop in the home country's

idiosyncratic risk premium leads to higher consumption (through the wealth and inter-temporal substitution effects) and stimulates investment (reflecting a permanently lower user cost of capital). The initial disturbance also causes an increase in the relative price of non-traded goods (an appreciation of the real exchange rate) and an increase in real wages. Excess demand is then progressively eliminated on account of both improved supply conditions (reflecting the initial higher investment) and lower expenditure on consumer durables and housing investment (as the latter has adjusted to new equilibrium levels). The implied adjustment process is slow and efficient.

An alternative explanation of the converging countries' adjustment to EMU can be obtained from a standard intertemporal macroeconomic model without a production sector. Such a model illustrates the crucial importance of the intertemporal substitution effects in consumption that dominated EMU's early years. Also in this setting, the implied adjustment process, which will eventually be triggered by the accumulation of foreign debt, is slow and benign.

The assumptions underlying the benign approach turned out to be highly unrealistic and misleading from a policy perspective. Indeed, the conceptual frameworks described abstract from the key realities of life such as complex expectations formation mechanisms, the possibility of default, frictions in product and labour markets or imprudent fiscal behaviour.

As it turned out, higher potential growth did not materialise as the investment boom was largely concentrated in non-productive investment, particularly in the construction sector. In addition, the fact that the domestic banking system intermediated the access of individual agents to the European financial market led to a concentration of risk and funding imbalances in the banking sector of the converging countries.

From today's perspective, it is clear that a more "prudent view" was warranted. Short-sightedness and overoptimistic expectations about future growth prospects, weak domestic institutions and real and financial frictions should have made a strong case for policy intervention aimed at mitigating the boom-bust pattern of monetary integration. Prudent fiscal management recommended that the boom in private spending be partly offset, even if only by letting automatic stabilizers play their role. Financial policies should also have played a counter-cyclical role.

The buffers that would have resulted from lower public debt and stronger capital in the banking sector would have put the converging economies on a much sounder position to face the financial storm. Also, a more ambitious and consistent approach to structural reform would have left these economies better equipped to face the challenges of globalisation and population ageing.

Shall we infer from this view that only domestic policy and institutional failures are to be blamed for the current state of affairs in Europe?

The answer is clearly negative. While it is true that inadequate – and in many instances irresponsible – domestic policies go a long way in explaining where we are, one must also acknowledge the role played by an incomplete and deeply unbalanced EMU architecture. The EMU governance model rests on four incompatible premises:

- Preservation of euro area countries' fiscal sovereignty – in contrast with monetary unification, Member States maintain responsibility for fiscal policy, subject to common rules and procedures at EU level;
- No default – the possibility of orderly sovereign debt restructuring has not been considered;
- No bail-out – no crisis management mechanism has been established;
- No-exit – the possibility of one member abandoning the euro is not envisaged.

The crisis has challenged economic governance in the European Union and exposed more clearly than ever the weakness of the economic pillar of EMU. Indeed, we have created a single currency resting on a full-fledged monetary pillar and an underdeveloped economic pillar. The monetary pillar has successfully fulfilled its role: the euro has established itself as an international currency and price stability in the euro area has been delivered. At the same time, the economic pillar – or lack thereof – was not able to prevent, or correct, diverging developments among euro area Member States and the accumulation of large and persistent imbalances. The crisis brought these imbalances into the spotlight and exposed unsustainable trends in many European countries.

The Maastricht Treaty drafters were perfectly aware that we could not rely on market forces alone to ensure discipline and the correction of imbalances. Numerous historical episodes have shown that financial markets tend to be too slow and weak in penalising profligacy in normal times, and can suddenly turn disruptive and cause overshooting during crises.

In order to contain moral hazard and prevent disruptions, the Stability and Growth Pact was agreed as a complement to the Maastricht architecture. The Pact set budgetary rules and procedures to reinforce fiscal discipline at the national level. It was intended to avoid gross fiscal policy errors, through peer monitoring and peer pressure, as well as through the threat of sanctions.

However, implementation of the Pact was rather weak in EMU's early years. Tensions emerged already in the early 2000s, and in November 2003, when action should have been taken against both France and Germany, the ECOFIN Council decided not to act, overruling the European Commission. This unwillingness to apply the rules was a "mortal sin": a clear message was sent to the other euro area members that the Pact was not there to "bite".

Weak economic governance in the euro area had three major consequences:

– First, inadequate domestic fiscal policies were tolerated, leading to unsustainable fiscal positions in some countries and tensions in the conduct of the single monetary policy;
– Second, insufficient attention was devoted to losses of competitiveness and the accumulation of current account imbalances within the euro area;
– Third, and probably most important, the correlation between the ability of the financial sector and of the sovereign states to obtain financing was largely ignored.

3. The European challenge: stability, solidarity and prosperity

Looking ahead, there is no easy or quick way to solve the problems of the European Union. These are undoubtedly very challenging times for us all. We have to learn from the past to safeguard our present and build our future. We need stronger and more resilient institutions and rules, better enforcement and control mechanisms and, above all, we must avoid making the same mistakes.

From what I have already said, it is easy to conclude that it is paramount to strengthen the economic pillar of EMU and to ensure that this pillar is robust and consistent to support the single currency.

The single currency and the close integration of European markets have increased the interdependencies among Member States and hence the potential for cross-border contagion. The EMU must have rules and these rules have to ensure that the policies of one Member State do not impact negatively on other Member States via the increased interdependence of their economies. Member States must regard their economic policies as a matter of common interest and coordinate them.

Together with the rules, the EMU has to be equipped with the means and the will to ensure compliance. The European Commission has to be at the centre of this new dynamics and the

EMU must be able to reconcile the individual responsibility of each Member State with the solidarity within the group. In this regard, I see with particular concern the weakening of the Commission's role in recent years.

In addition, neither stability nor solidarity will survive without sustainable and balanced growth in the European Union anchored in a widely-shared economic and social development model. We must not forget that monetary union or the single market are not the main purpose – la raison d'être – of the European Union. They are "simply" instruments to achieve the ultimate and higher purpose of the EU, which is to promote peace, the well-being of European citizens and the European values of respect for human dignity, freedom, democracy, equality and rule of law.

Let me elaborate on each of these three elements: Stability, Solidarity and Prosperity.

Improving stability through reinforced governance and surveillance

In order to restore stability, action is needed both at the national and EU level. To be successful, national and EU measures must be consistent, as regards both their design and timing.

At the national level, the utmost priority must be placed in restoring public debt sustainability, increasing domestic savings and enhancing potential growth, in particular in crisis-hit countries. These are necessary conditions to stabilize external debt and put it on a downward path. On the budgetary front, national fiscal frameworks have to better echo the priorities and guidelines of EU budgetary surveillance. In the case of my own country, these concerns are well-captured in the adjustment programme signed with the European Union and the International Monetary Fund in May 2011.[i]

At the EU level, although the rules and principles of the Stability and Growth Pact remain valid and very relevant, the crisis made it clear that a new economic governance model was needed to deliver fiscal discipline, to prevent continued losses in competitiveness and to promote financial stability.

Some very important steps have already been taken in recent months to fundamentally improve and strengthen economic governance in the EU and, in particular, in the euro area. Further work is still ongoing. Within the new framework, the closely interdependent EU economies should be in a better position to face current and future challenges.

One important benchmark for the whole process was the endorsement by the European Council, in October 2010, of the recommendations by the Task-Force on economic governance led by President *van Rompuy*. Building on these recommendations and on a number of proposals put forward by the European Commission, the EU has gradually reinforced its surveillance architecture with well-known initiatives such as: (i) the Euro Plus Pact; (ii) the European Semester; (iii) the Six-Pack; (iv) the Fiscal Compact; (v) the Two Pack.

In March 2011, the euro area Member States and 6 other EU countries agreed on the so-called ***Euro Plus Pact***. The Pact, (which is part of the new economic governance framework), focuses on four key areas: competitiveness; employment; sustainability of public finances; and financial stability. The additional commitments taken therein – also in areas of national competence – are included in the National Reform Programmes of the concerned Member States.

The EU also agreed on a new approach to economic surveillance and on a new policy-making calendar, setting up the ***European Semester***. The first European Semester started in the first half of 2011. The new approach allows for a discussion of the economic and budgetary priorities at the same time every year, starting with the Commisssion's Annual Growth Survey.

A major step to fill some of the gaps of the Stability and Growth Pact – and "to give it more teeth" – was the approval of legislative package, the so-called "***six-pack***", which entered into force on 13 December 2011. The new legislation aims at strengthening both the preventive and corrective arm of the Pact, setting minimum requirements for national budgetary frameworks, and preventing and correcting macroeconomic and competitiveness imbalances (including the introduction of a new Excessive Imbalance Procedure)[ii]. Enforcement has also been strengthened by recourse to 'reverse qualified majority' voting[1].

On 2 March 2012, the "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union" (which includes the so-called "***Fiscal Compact***"), was signed by twenty-five Member States (all but the UK and Czech Republic). According to the Treaty, the annual structural balance of the general government must be balanced or in surplus (with a lower limit of –0.5 % of GDP at market prices). These Member States will have to enshrine this rule in their national legal system through provisions of binding force and permanent character, preferably constitutional. An automatic correction mechanism is triggered in case of a deviation from the fiscal objective.[2]

In addition, on 23 November 2011, the Commission proposed two new draft Regulations ("***two pack***"), which aim at further strengthening the surveillance mechanisms in the euro area, especially for those countries with excessive deficits, or/and that are experiencing/threatened with financial difficulties. Work is still in progress.

Strengthened economic and budgetary surveillance procedures are complemented by an enhanced regulatory and supervisory framework at EU level. The European System of Financial Supervisors was set up, comprising the new European Supervisory Authorities (the so-called ESAs) for banking, insurance and securities markets and the European Systemic Risk Board (ESRB) to address macro-prudential matters.

All these initiatives lay the foundations for stronger governance and a sounder euro area. The new rules and procedures should contribute to enhance fiscal discipline, prevent the emergence of large and persistent macroeconomic imbalances and safeguard financial stability in the euro area.

However, it is still premature to make judgments about the effectiveness of this setting as the potential benefits will very much depend on actual implementation and 0enforcement. One cause for concern is the complexity of the new economic governance structure. The new model needs to be well explained and well understood by all the actors involved and should promote equal treatment and a level playing-field. A further challenge concerns the need to ensure a smooth relationship between euro area and non-euro area countries within the new set up.

Solidarity is needed to preserve the cohesion of the group

We must also be aware that even with appropriate rules and institutions an economic and monetary union is not immune to exogenous shocks and to liquidity problems in its Member States. Indeed, when a country has its own free-floating currency, a loss in market confidence translates into a bond sell-off, which in turn leads to higher yields and exchange rate depreciation. Investors cannot precipitate a liquidity crisis forcing the country to default. In contrast, for a country belonging to monetary union, a loss of confidence and the resulting bond sell-off imply not only higher yields, but a shortage of liquidity, which can easily turn into solvency problems.

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1 A Commission recommendation or proposal to the Council is considered adopted unless a qualified majority of Member States votes against it.

2 This Treaty – which is an Intergovernmental agreement (not EU law) - will enter into force on 1 January 2013, provided that at least twelve euro area countries have ratified it. The Fiscal Compact and the six-pack complement each other and will run in parallel.

This is why measures to reinforce the economic pillar of EMU also need to contemplate solidarity mechanisms to support individual Member States facing serious financial difficulties or market pressure, safeguard the stability of the euro area as a whole and preserve the cohesion of the group. Well-designed and robust firewalls should promote accountability, avoid moral hazard and be endowed with adequate financial means. The more robust and credible these firewalls are, the less likely will they need to be used.

Euro area governments agreed to establish the first European temporary mechanisms for euro-area countries (the *EFSF* and *EFSM*) in May 2010. The Treaty establishing a permanent stability mechanism in the euro area, the ***European Stability Mechanism*** (ESM) was signed on 2 February 2012 and the ESM is expected to be fully operational in July 2012. On 30 March 2012 the Eurogroup agreed on a further accelerated calendar for the payment of the tranches of ESM's paid-in capital, so as to ensure a timely availability of its lending capacity. The Eurogroup also decided to raise the combined EFSF/ESM lending ceiling to €700 billion.

Other institutional innovations have been proposed by academics, analysts and several bodies. Among these is the possible creation of ***Eurobonds***. The idea of joint issuance of government bonds by euro area countries is not new. Indeed, it was already addressed in the late 90s by the Giovannini group, whose report (November 2000) recognised the fragmentation in the euro-area government debt market and recommended greater issuance coordination. One of the possible ways to achieve this objective was the creation of a single debt instrument backed by joint guarantees. More recently – on 23 November 2011 – the Commission published its Green Paper on the feasibility of introducing stability bonds, intended to stimulate the debate on this subject.

Eurobonds are not a solution for the immediate challenges and difficulties faced by the euro area, even though they may be part of a medium term solution. The Eurobonds idea is appealing and brings to the forefront an important feature of European integration: "solidarity". However, the issuance of Eurobonds raises many political, legal and technical questions which need to be analyzed further.

Stability and solidarity will not endure without prosperity

Restoring stable macroeconomic conditions in the individual Member States and setting-up effective solidarity mechanisms to preserve the cohesion of the euro area and the EU are necessary conditions to overcome the current crisis. However, it goes without saying that neither stability nor solidarity will endure if not accompanied by sustainable and balanced development within the European Union. I will devote the final part of this talk to this third crucial dimension, which I call "prosperity".

We have seen that – not only in Europe but elsewhere in the world economy – growth since the early 1990s was to a large extent financed by increasing private and public debt. The resulting over-leveraged public and private sector balance sheets have eventually brought us to the crisis we have been facing in the past five years.

A new growth paradigm is needed, one that produces sustainable rather than illusive growth and allows us to preserve the essential features of the European social model. In other words, we need a growth and development strategy that will bring us closer to the "highly competitive social market economy" aimed at full employment and social progress, better environment and scientific and technological advance advocated by the EU Treaty.

This growth and development strategy could be built around three dimensions: institutional and structural reform; completion of the single market; and strengthening of Europe's external dimension.

(i) Institutional and structural reform

Institutional and structural reforms aimed at removing barriers to competition, promoting innovation and entrepreneurship and fighting vested interests are needed to support long

term growth, improve debt sustainability, promote competitiveness and rebalance the economy.

The fact that the crisis seems to have acted as a catalyst for reforms is good news. The pace of structural reforms has accelerated markedly in recent years and this renewed commitment to economic reform has been particularly strong in countries under EU-IMF adjustment programs and/or experiencing tensions in sovereign debt markets.

We are all aware that the road to reform is often bumpy and windy. In order to maximise benefits and minimise the risk of social upheaval, reform efforts should be pursued in a coordinated manner. The different initiatives at the national, European and international level have to be part of a well defined and consistent strategy where the right sequencing needs to be found.

(ii) Completing the Single Market

On the Single Market, let me quote President Barroso, who claimed that "The Single Market has always been the driving force behind our economic development and prosperity and, now more than ever, it remains our best asset in facing the crisis."

I could not agree more. It is almost twenty years now since the single market was established. And while the single market has brought us enormous benefits and created new opportunities, we have to acknowledge that a truly integrated European market is still lacking in some important fields, including services and energy. Legislation is missing and, more importantly, administrative obstacles and lacking enforcement leave the full potential of the single market unexploited.

The European single market is the largest in the world by value. The commitment and actions put forward by the European Commission in order to exploit the untapped potential of the single market are thus very much welcome and encouraging.

(iii) The EU external dimension

While it is crucial to complete and deepen the European single market, Europe must not leave the growth potential from external trade unexploited. The current crisis is unfolding against a background of population ageing. This is a long-term trend that cannot be rapidly or easily inverted, and which puts significant underlying pressure on Europe's growth potential and public finances. In contrast, other areas of the world are catching up with the advanced economies and offer a handful of opportunities to European businesses. Deepening Europe's economic ties with the most dynamic areas in the world in a context of strict reciprocity should thus be a clear priority in the European growth strategy.

5. Concluding remarks

Let me conclude with a word of confidence in the future.

Europe has experienced difficult crisis before. These crises have been a catalyst for deepening and strengthening the European project. While I've tried not to downplay the seriousness of the situation and the magnitude of the challenges we face, I believe that a stronger and fitter European Union will emerge from the current crisis.

The crisis has shown the urgent need for enhanced international cooperation and coordination, better economic governance, strengthened market supervision and increased discipline and transparency. Much progress has been made in this direction. However, neither of this will endure without sustainable and equitable economic growth and job creation. In other words, we need to ensure the EU is a positive-sum game and that the cross-country distribution of gains is well-balanced.

We cannot miss this unique opportunity to introduce fundamental changes and deep-rooted structural reforms, to complete the single market and to strengthen Europe's international

role. The EU would hardly survive a failure of the euro and this would not only be a European but rather a global problem with profound geopolitical consequences.

We have a huge responsibility towards present and future generations. The responsibility of safeguarding the conditions for prosperity and welfare and of ensuring that Europe has a leading role in the international arena. No Member State, irrespective of its size or economic importance, no European institution and no citizen is exempt from this collective responsibility.

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Endnotes

[i] *The Programme foresees action on three fronts: (i) putting fiscal policy on a sustainable footing; (ii) stabilization of the financial sector; and,(iii) in-depth structural reforms to support an orderly unwinding of external and internal imbalances and to raise potential growth.*

Less than one year since the beginning of the Programme, good progress has already being achieved: the correction of the "short term" variables (budgetary and external deficits) is on track, faster than expected; financial stability is being reinforced and structural reforms are ongoing, even though there is still a long way ahead.

As regards financial stability, measures and targets are well on track. Portuguese banks are now more capitalised, more transparent and less leveraged than a year ago. Monitoring and supervision were significantly enhanced and the regulatory environment has considerably improved.

This being said, the challenge remains huge and there is no room for complacency. Combining mounting capital needs with deleveraging requirements, while at the same time preventing a harmful credit contraction in the economy is not an easy task. It is a task that requires a fine balance between 'science and art' in policy-making.

In the fiscal/structural domain, an important step has been taken with the setting up of an independent entity (the Public Finances Council) responsible for assessing: (i) the consistency of macroeconomic and budgetary scenarios; (ii) the compliance with budgetary rules; (iii) the path of public finances and their long run sustainability.

[ii] ***Strengthening of the preventive arm of the Pact** – Member States are required to make significant progress towards their medium-term budgetary objectives (MTO); introduction of expenditure benchmarks; interest-bearing deposit of 0.2% of GDP imposed on non-compliant euro-area countries); **Strengthening of the corrective arm of the Pact** – An EDP can now also result from government debt developments; Member States with debt ratios above 60% of GDP should reduce their debt in line with a numerical benchmark; progressive financial sanctions at an earlier stage of the EDP, etc.); **Minimum requirements for national budgetary frameworks** – Need to comply with minimum standards and cover all levels of government; multiannual budgetary planning; numerical fiscal rules**; Preventing and correcting macroeconomic and competitiveness imbalances** – Introduction of a new Excessive Imbalance Procedure (EIP).*