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Address by the Governor of Banco de Portugal at the 20th Lisbon Meeting

4 October 2010

Ambassadors, Governors, Ladies and Gentlemen,

Over the past three years, the international economy has been mired in the most severe crisis in seventy years. The impact on the economy of each of our countries has been huge, though far from uniform.

Today we are witnessing an economic recovery that is still fragile (given that there are still risks of a double dip), and varying from country to country. Economies are showing stark differences, both in output and employment growth and in their exposure and degree of vulnerability to loss of confidence and international financial market turmoil.

In my opinion, a reflection is thus warranted:

- On the determinants of the crisis we are either experiencing now or have just gone through;
- On the suitability of measures taken by central banks and governments;
- On the problems that remain, i.e. the monetary, financial and economic policy agenda which our countries will unavoidably face in the short to medium term.

1. The causes and dynamics of the crisis

Firstly, we must bear in mind that the economic and financial crisis stemmed from the financial sector of the most developed economies. It then spread to the goods and services-producing sectors and to the public finances of other countries, impacting again on the financial sector, affecting financing conditions and the quality of the credit portfolios of financial institutions that had not been directly exposed to toxic products – which had triggered a wave of insolvencies and lack of confidence in financial markets.

The way this phenomenon spread is in itself the best demonstration of the world's high degree of interdependence, most clearly seen in the degree of exposure of all economies to the instability of the cross-border financial system and, consequently, to the quality and nature of its supervisory systems.

This recent international economic and financial crisis has thus revealed significant flaws in market functioning and in the risk management of various financial institutions, with imperfect international rules on financial supervision also playing a part. Moreover, it has proven that the rules, disciplines and practices of financial supervision, as well as their scope of application do not only concern the home countries of financial institutions. These are issues of interest to all countries and therefore require close international coordination, with compliance on principles and minimum rules.

Before moving on from the causes and dynamics of the crisis, it should be noted that the underlying financial practices resulted not only from an unsuitable and complacent supervisory framework, but also from an array of fundamental imbalances that contributed to the development and placement of products that were high on risk and low on transparency.

The years preceding the crisis were marked by the fact that some of the major world economies were accumulating current account imbalances, with net exporting countries hoarding reserves and consumers in deficit countries indulging in bloated levels of indebtedness.

At a financial level, liquidity and saving surpluses channelled to financial investment on a global scale brought about a narrowing of risk premium differentials between different market segments and between different rating levels, as well as low financial volatility and low levels of interest rates across the maturity spectrum. Against this background, the international financial system served not only as a mechanism to stimulate latent demand, but also – insofar as it has benefited from a complacent supervisory framework – as an important driving force behind the development of a spiral in the financing of high risk assets.

The crisis has its roots not only in flaws in the supervision of financial institutions with international activity or influence, but also in the persistence of global imbalances. These also require an institutional framework of international coordination and mechanisms that lead countries to consider the external spillovers of their economic policy decisions and guidelines. External stability, after all, conditions and determines internal stability.

2. **Nature and suitability of measures taken by central banks and governments to respond to the international economic and financial crisis**

As previously stated, the international economic and financial crisis had its roots in the US financial system, spreading to most advanced economies and to a lesser extent to emerging economies. In the last quarter of 2008 it intensified. The collapse of the Lehman Brothers investment bank triggered a broadly based rise in uncertainty and risk aversion levels and an abrupt fall in agents' confidence and expectations, bringing in its wake a dramatic tightening of financing conditions across the globe. The consequences of this crisis quickly spread to the real economy, against a backdrop of highly integrated international productive chains. The result was a collapse in world trade and a sharp global economic downturn.

This situation threatened to develop into a second Great Depression – via a spiral of systemic effects stemming from the interaction between the economic and financial crises. It brought an unprecedented response by central banks and governments, with three major objectives:

- Money market stability;
- Financial system stability;
- Minimisation of the crisis impact on growth and employment.

2.1. In terms of safeguarding monetary stability, most central banks responded to the impact of the crisis by:

- Firstly, setting official interest rates at levels close to zero;

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- Secondly, adopting non-standard monetary policy measures, specifically in Europe, increasing the maturity and amounts of liquidity-providing operations, as well as injecting liquidity through fixed rate tender procedures with full allotment and the widening of eligibility criteria for assets accepted as collateral;

- Thirdly, purchasing public and private debt securities; and

- Accepting new counterparties for monetary policy operations.

This raft of measures made it possible to keep money market tensions in check, to lower systemic risk in the banking sector and financial markets, and to reduce the uncertainty of economic agents and private debt risk premium, contributing in this way to stimulating or sustaining demand.

Consequently, central banks saw a considerable increase in their balance sheets and in their share in longer-term refinancing operations. The Eurosystem, for example, practically doubled its main refinancing operations.

This policy line of central banks, while not jeopardising the objective of monetary stability, was moulded as the crisis unfolded and particularly on the basis of the state of money and financial markets.

The **response of the Eurosystem NCBs can be divided into three phases**:

1. **October 2008 to November 2009**. The European Central Bank (ECB), through the national central banks (NCBs) of the Eurosystem, like the central banks of the United States and the United Kingdom, adopted a wide set of measures, in what was in part a joint coordinated international action. The measures were intended to provide ample liquidity to the markets, in order to counter the confidence crisis triggered by the collapse of Lehman Brothers. The failure of this bank had translated into an abrupt and substantial tightening of credit conditions in money markets, involving, among other things, tighter selection of counterparties, reduction of credit lines and stricter demand on collateral. By adopting these measures, central banks prevented a liquidity crisis.

Official interest rates were reduced at an unprecedented pace and magnitude, and the rates on liquidity-providing operations fell to historical lows. As a consequence, the level of central bank intermediation increased and their balance sheets expanded significantly, causing major structural changes.

2. **November 2009 to May 2010**. Given the improvement in the meantime observed in financial markets, the NCBs of the Eurosystem decided in December 2009 to gradually phase out the non-standard policy measures that had been implemented. The phasing-out of some of these measures was intended to prevent the emergence of distortions, among them a potential delay in the structural adjustments necessary in the balance sheets of banks. This decision implied a cut in the number of longer-term refinancing operations held in the first quarter of 2010. In March 2010, the ECB Governing Council decided to continue the process of gradual phasing-out of the non-standard liquidity measures. At the same time, they decided to return to variable rate tender procedures in the three-month longer-term refinancing operations, starting with the operation to be allotted in April 2010.

3. **May 2010.** Tensions in the public debt markets had been accumulating since the last months of 2009, and they mounted with the sharp increase in the interest rate on Greek sovereign debt and its contagion to other euro area economies, in particular those of Ireland, Portugal and Spain. Some banks were faced again with financing difficulties in international wholesale debt markets and the spread between unsecured and secured money market rates widened further. Confronted with these major disturbances in financial markets, the NCBs of the Eurosystem decided to go back on some of the decisions previously made and take new measures. The aim was to restore liquidity and depth in dysfunctional market segments and hence the normal functioning of the monetary policy transmission mechanism.

2.2. As for **safeguarding financial system stability**, the response was shared between governments and supervisory authorities, both at national and international level.

The response of EU Member States was closely coordinated and involved:

- two different timings: immediate action to bring the financial system back on an even level and longer-term action, with revision of the objectives, principles and rules of prudential supervision and of the institutional architecture for the coordination of supervisory authorities; and

- two levels: Community and international, specifically within the Framework of the Basel Committee on Banking Supervision (BCBS).

Safeguarding the stability of the financial system has led to active intervention by the financial authorities, framed by EU decisions, in order to restore confidence in banking institutions. This has involved providing guarantees and, in some cases, making capital injections in banks and ring-fencing severely impaired assets. Such measures had significant impact on the fiscal deficits and public debt of the countries that bore the brunt of the crisis.

In the case of Portugal, financial authorities intervened at six distinct points:

- A recommendation that the minimum ratio of Tier 1 capital for banks should be 8% as from the end of September 2009;

- Adoption of a public instrument to support increases in equity capital of solvent institutions and the provision of government guarantees for refinancing purposes;

- Increase in the guarantee provided by the Deposit Guarantee Fund, from EUR 25,000 to EUR 100,000, per depositor and per institution;

- Enhancement of transparency and reporting obligations of credit institutions;

- Strengthening of the coordination powers of the National Council of Financial Supervisors;

- Introduction of changes in the accounting principles applicable to assets held to maturity by credit institutions.

As regards the **revision of the objectives, principles and rules of prudential supervision and of the institutional frameworks for coordination in the financial field**, the discussion has been focused on the need to:

- Introduce a counter-cyclical element in some aspects of the regulation;
- Mitigate the systemic impact of some institutions that may be considered too-big-to-fail or too-interconnected-to-fail;
- Promote the correct alignment of financial system incentives, mainly in terms of risk management practices and remuneration policies;
- Revise the scope for application of the financial system regulations;
- Revise some aspects of the regulatory framework, in particular as regards capital adequacy, the degree of financial system leveraging, and liquidity risk.

As to the **institutional architecture for the coordination of EU supervisory authorities**, the financial crisis (in particular the crisis faced by some financial institutions in a number of EU Member States), has shown the importance of a close cooperation between countries that share responsibilities for the supervision of large financial groups. As a consequence, the reflection made on possible changes in the regulatory architecture at European level was followed by the **De Larosière report** published in February 2009.

The De Larosière report proposed the creation of an entity responsible for macroprudential policy and for the issuance of early warnings on macroprudential risks. It also proposed setting up three new European supervisory authorities, resulting from the transformation of the three already existing committees – i.e. Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions (CEIOPS) and Committee of European Securities Regulators (CESR) – followed by the strengthening of microprudential supervisory competences and powers, specifically:

1. Coordination of the work of national supervisors;

2. Resolution of potential conflicts between national supervisory authorities through colleges of supervisors focusing on issues related to cross-border financial groups;

3. Promotion of the harmonisation of national supervisory rules;

4. Supervision of some pan-European institutions regulated at EU level, such as credit rating agencies.

In September 2009, legislative proposals were put forward envisaging the creation of a new regulatory framework, based on two distinct pillars: **microprudential supervision** (including the European Banking Authority – EBA, the European Insurance and Occupational Pensions Authority – EIOPA and the European Securities and Markets Authority – ESMA) and **macroprudential supervision** (with the creation of the European Systemic Risk Board – ESRB).

In September 2010, the European Parliament approved legislation reforming financial supervision, slated to enter into force in the beginning of 2011.

2.3 The **minimisation of the impact of the crisis on growth and employment** was addressed by governments, having been dealt with in parallel and in cooperation with the monetary authorities.

The action undertaken by governments was essentially focused on the adoption of demand stimulus policies, i.e. on the adoption of an expansionary stance for fiscal policy. As far as EU Member States are concerned, the action enforced the European Council guideline that envisaged an increase in public expenditure to have an immediate knock-on effect, minimising the impact of the crisis on growth and employment. Such an increase should be of a transitional nature (i.e. through timely, targeted and temporary measures).

The nature and magnitude of the national fiscal stimulus programmes has varied from country to country.

In the short run, governments' response was effective, minimising the impact of the international financial crisis on growth and employment. Despite negative and painful developments, it can be safely argued that they were much better than they would have been had they met with governmental inertia. The crisis did not develop into a great depression as was the case seventy years ago.

Nevertheless, the successful response by governments was followed by the emergence of new problems. These reflect the fact that the policy lines envisaged at European and international level derived from the seriousness of the situation and the urgent need for reaction, implicitly conveying the idea that "one size fits all". In fact, it is reasonably safe to claim at this point in time that overall the programmes adopted took into account neither the starting point of the fiscal situation nor the fact that the measures implemented could only be of a transitional nature, to be unwound as economies regained momentum. As a consequence, a three-fold phenomenon was observed:

- Broadly based widening of general government deficits;
- Deterioration of cyclically adjusted primary deficits;
- Emergence of government debt paths that are out of line with the principle of sustainability over the medium term.

These developments in public finances, in a context of lower confidence in the markets and closer scrutiny of the risk of alternative financial investments, led to increased risk aversion on the part of international investors and higher differentiation of sovereign risk across euro area countries. Hence, as from late April, early May 2010, dysfunctionalities appeared across the entire maturity spectrum of public debt markets, including very significant rises in yields and the increasing difficulty experienced by some countries in issuing sovereign debt.

Developments in sovereign risk markets, in tandem with a downward revision of sovereign issuer rating, have had a negative impact on the European financial system at different levels:

- First, the valuation of banks' sovereign debt portfolios has been negatively affected, and this has fuelled sales and curbed purchasing motivation; its impact has added to the negative developments in the corresponding sovereign debt market;

- Second, it has given rise to some market scepticism about the level of banks' exposure to sovereign issuers risk and, in particular, to sovereign issuers where the sustainability of the respective government debt is called into question;

- Third, it has signalled the growing difficulties faced by banks in countries affected by market mistrust when accessing wholesale debt markets, and this has increased financing costs, in some cases preventing such banks from gaining access to the markets;

- Fourth, it has led to a decline in the value of State guarantees given on the issue of debt by banks in those countries, thus curtailing their ability to implement new measures supporting the financial system, and thereby increasing their vulnerability to potential future shocks;

- As a result of the sovereign debt crisis and the difficulties faced by banks in gaining access to the markets, it has pushed towards financial system deleveraging in the countries in question, thus implying tighter credit standards applied to loans to the non-financial private sector, with a negative impact on the developments of domestic demand, output and employment on the one hand, and the value of assets on the other.

This range of implications for sovereign debt markets has particularly affected countries with structural savings deficits and, among these, those in which the non-public sector depends on the financial system to gain access to external financing and/or where productive structure and recent history point to low levels of economic growth.

In effect, the countries where domestic savings have exceeded the financing needs of domestic agents have not been under the same level of scrutiny as international financial markets, even when the level of their deficit and debt was higher than the level reported by sovereign issuers caught up in market turmoil.

In view of the above, the response by European Union governments may have brought an additional magnitude to the crisis relating to the sovereign debt problems of some countries and, subsequently, the refinancing difficulties of banking systems, even for short maturities and State-guaranteed or adequately collateralised operations. As a result, the credit crunch that had been avoided when the financial crisis spilled over worldwide became an imminent threat.

Since the end of the first quarter of 2010, European Union Member States and the Eurosystem have been confronted with three new problems:

- Sovereign debt market malfunctioning;
- Doubts on solvency among banks, above all those holding sovereign debt portfolios, in the wake of the drain on credit portfolio values;
- Difficulties in bank access to the markets in countries exposed to sovereign debt market malfunctioning.

Measures taken by Eurosystem's central banks are threefold:

- As deemed necessary, secondary market operations to acquire government securities issued by the countries exposed to market malfunctioning, thus ensuring seamless monetary policy transmission mechanisms;
- Implementation, in cooperation with supervisory authorities, of stress tests on banks, and publication of the results, in order to restore market confidence in the solvency of the European financial system;
- Maintenance of non-standard liquidity measures, covering the financing needs of banks whose market access had been hampered.

The measures taken by the governments hence became articulated at European level, given that, if the worst came to the worst, those countries regarded with suspicion by the markets would no longer have sufficient freedom or room for manoeuvre to respond separately to the difficulties of government deficit financing. This articulation would entail the creation of European response mechanisms and, as a result, efforts shared among European Union Member States and reliable commitments by recipient States.

These measures were precipitated by an escalation in the financing costs of the Greek government as of mid-April. The outlook for refinancing woes over a short-term horizon fuelled initiatives at the European level, in articulation with the IMF, with a view to providing a credit line to Greece to the amount of €110 billion.

The terms and conditions of this loan were defined in early May. Nonetheless, this was not enough to mitigate escalating tensions in sovereign debt markets. As a result, on 9 May the European Union Council announced a package of measures, as well as a fiscal consolidation commitment by Member States. This package included a financial stabilisation mechanism up to the amount of €500 billion (€750 billion with the IMF contribution). This support was to be subject to strict regulations defined by the European Union and the IMF.

These measures, determined by the urgency of the situation, require an institutional framework and regulations to reinforce the discipline of all members of the group, thereby justifying the creation and application of joint mechanisms to respond to the difficulties of one or more members of the group. A number of proposals are presently under discussion with a view to enhancing the European fiscal surveillance framework, in addition to the provisions laid down in the Stability Pact. This debate should focus on key items regarding system credibility over time and, in particular, on the procedure applicable in the event of Member States infringing the regulations in force.

On 28 September, the European Commission published a set of proposals, containing two main guidelines:

- First, it proposed the creation of a mechanism for preventing and correcting macroeconomic imbalances (excessive imbalance procedure). This includes a regular review of the macroeconomic risks and imbalances of Member States, early-warning mechanisms, and regulations allowing for corrective action to be taken should such imbalances spread beyond fiscal policy. This mechanism allows for financial sanctions for the Member States that repeatedly fail to act in compliance with Council recommendations;
- Second, it proposed a reform of the specific fiscal surveillance framework – therefore amending some aspects of the Stability and Growth Pact. This is based on three pillars: anticipated implementation of sanctions in countries infringing fiscal rules, and introduction of fines to be paid as of the moment when the excessive deficit procedure is started; bringing the debt ratio criterion into

operation, with an explicit definition of the reduction deemed adequate to attain the 60 per cent GDP reference value; and proposals for compliance with the minimum requirements for fiscal procedures in Member States, among them the adoption of a multi-annual fiscal outlook, clear fiscal rules and transparency in responsibilities and contingencies.

3. The monetary, economic and financial policy agenda in the short and medium term and the imperatives confronting the Portuguese economy

The current recovery, which is fragile and uneven across countries, does not mean that the issues which were addressed during the crisis will fade out. In fact, the crisis revealed the structural fragilities of various economies, explaining its mixed patterns and fuelling its impact, as well as different macroeconomic policy stances. The structural fragilities are specific to each country and must therefore be addressed as such, under the scope of guidelines adjusted for monetary, economic and financial policies.

Against this backdrop, some common challenges should be highlighted:

1. Returning to regular monetary policy operating conditions, with a view to safeguarding nominal stability, which is a requirement for sustained development;

2. Bringing sustainability of public finances back on track;

3. Promoting conditions to foster growth and job creation;

4. Bolstering financial system stability.

The combination of these challenges with the specific fragilities of every economy underlies the short and medium-term agenda for economic and monetary policy priorities, in each of the European countries.

In the Portuguese case, the nominal stability imperative is grounded on our participation in the European System of Central Banks.

The most relevant issue in this respect is related to the adjustment of the national financial system to the discontinuance of non-standard liquidity measures. Portuguese banks – and through them the Portuguese economy – need access to alternative financing sources in order to reduce dependency on Eurosystem liquidity-providing operations. This means that the impact of the normalisation of the Eurosystem monetary policy will crucially depend on a shift in the external perception of Portuguese sovereign risk – and this will depend crucially on the consolidation of the nation's public finances.

In view of the above, the sustainability of public finances in Portugal today is the cornerstone of an agenda that includes other national imperatives: an increased household savings rate and corporate self-financing; rational allocation of resources and investment, in order to maximise growth and employment and reduce external imbalances; and strengthening of the financial system stability, considering that this is a key item in efficient financing of sustained development.

The first national imperative: to strengthen public finance sustainability

The current sovereign debt crisis has again highlighted the fact that sovereign risk assessment by financial markets has been somewhat uneven.

It has also shown that loss of confidence in a given country is all the more serious in the risk market, the higher its dependency on external financing, and the greater its share in external financing channelled by the banking system (or, on the contrary, the lower the capacity of corporations to have direct access to external financing or the smaller the autonomous capital inflows).

One particular feature of the Portuguese economy is its structural dearth of domestic savings. In such an economy, which is therefore dependant on external financing, the degree of strength of the government financial position determines the country's room for manoeuvre, to manage macroeconomic risks in a climate of instability and contain the levels of uncertainty in the economy. Possible doubts on the sustainability of public finances are much more significant than any government financing difficulty. In view of the role played by the State in the economic network, this also represents an increase in the risk of all other debtors and, as a result, an increase in financial system risk (the so-called ***contagion effect***).

Public finance sustainability is a long-haul task, which requires immediate and credible action, a sustained path based on measures to create a foundation for reducing the primary deficit and stabilising/lowering the public debt/GDP ratio; it also requires an institutional framework enhancing the transparency of decisions with fiscal impact, thereby refocusing the budget discussion on its true mission: to decide on transparent options as regards the allocation of scarce resources to policy objectives vying for the same resources.

In the very short term, it will be necessary to ensure compliance with the fiscal targets announced for 2010 and 2011.

The wide range of fiscal measures announced last week is an important step towards the credibility of the fiscal consolidation strategy announced in May.

However, these measures are not sufficient. It is absolutely crucial to obtain credible political consensus for the 2011 budget. Since public finance consolidation is unavoidable, the resulting costs will depend on the timing and credibility of its implementation. The sooner this is done and the more credible the consolidation effort is, the weaker the impact of the sovereign crisis on the banking sector and, subsequently, on financing productive activity.

One cannot, however, look to 2010 and 2011 alone. A critical step has to be taken. Nevertheless, the real problem has not yet been tackled: the need to ensure the strength of public finances, thereby conferring upon the State the capacity to react to and manage macroeconomic risks and uncertainty deriving from external instability factors.

For this purpose, structural conditions must be created, allowing for timely preparation and effective control of fiscal policy, with special attention being paid to the quality of the procedures. This is all the more necessary as a range of factors may contribute, in the near future, to hampering the pursuit of sustainable fiscal policies, in the light of the present criteria for their implementation and definition. It should be recalled that demographic developments, marked by an ageing population, will imply increased pressure on public expenditure in forthcoming years. Health and social-related expenditure, such as eldercare, will tend to multiply significantly. National social

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cohesion-related commitments of an economic and social nature cannot be ignored and, therefore, strict compliance with fiscal targets will be all the more demanding.

Safeguarding socio-economic cohesion-related commitments requires a budget based on the prospects for stability and predictability, as regards both expenditure and financing. Some such experiences have been introduced in a number of countries, always as a response to budgetary difficulties. Sweden, which introduced a range of fiscal rules in the wake of the economic crisis in the early 1990s, is a prime example.

Sustainability of public finances requires a wide political consensus on the basic principles that should underlie a fiscal process geared towards sustainability:

i. Transparency, financing predictability and centralisation of the fiscal process in its initial stages (a top-down approach when defining expenditure limits) and a limit on expenditure by general government sectors unable to generate returns;

ii. Increased transparency when reporting and reviewing public account data, specifically through the regular, and timely supply of information on the corporate public sector; in turn, a wider scope of and more frequent information reporting according to National Accounts, as opposed to simple records;

iii. Creation of a multi-annual fiscal framework with short and medium-term mandatory objectives, preferably over a six-year period, consistent with the sustainability path of public finances;

iv. Finally, an institutional framework strengthening the transparency of decisions with an immediate or deferred fiscal impact.

In this vein, an interdependent agency should be created, with a remit to monitor developments in public finances, based on other successfully tested models. This would be an institutional innovation and a potential determinant of the quality of budget decision processes, and thereby of improved public finances. This type of institution, which is one of the most relevant segments of fiscal processes in some European countries, would significantly contribute to an increase in public finance information transparency, and to the evaluation of the long-term impact of fiscal options.

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This independent agency would be responsible for assessing compliance with existing fiscal objectives and rules, by carrying out an independent technical evaluation of the long-term financial impact of public policies and the different commitments taken on, thus contributing to the quality of budget discussion.

Bringing about such an independent agency requires wide political consensus on some basic fiscal rules, namely the possible implementation of nominal limits to expenditure, fiscal balance rules applicable at several general government levels, the use of budgeting principles by programmes subject to sound evaluation of the results (by using appropriate analytical/scientific methods), and the explicit creation of short and medium-term objectives through multi-annual budgeting.

These changes in fiscal procedures would contribute to strengthening national autonomy in defining fiscal policy in the European context. Recent changes introduced by the European Council of Finance Ministers, through the implementation of the so-called "**European Semester**", have made the evaluation process of National Reform Programmes much more demanding for Member States. The implementation of a range of fiscal reforms in line with these principles would help to address such changes.

In this latter field, minimum quality and consistency must be ensured within the monetary union fiscal framework. Member States should follow a multi-annual fiscal perspective and establish explicit fiscal rules. In turn, they should ensure that the procedures apply to all sub-entities and public administrations, guaranteeing the transparency of the fiscal process, and supplying detailed information on funds that are not included in the budget, fiscal expenditure and contingent liabilities.

In this context of in-depth reform of the financial and economic supervisory framework, the Portuguese authorities must act in a timely fashion, adjusting the national regulatory framework to new realities. Domestic reforms will help to strengthen the external credibility of the Portuguese economy, specifically as a result of improved fiscal procedures and rules.

The second national imperative: to strengthen private sector savings, especially in non-financial corporations

Insufficient domestic savings to accommodate internal investment is a structural characteristic and a fragility in the Portuguese economy. It will always emerge and reach critical proportions whenever there is international financial instability or when the external perception of Portuguese risk deteriorates.

Simultaneous action is required at three levels:

1. Household savings should be strengthened, by introducing specific products and above all by motivating savings that may induce a cut in the proportion of income that is spent;

2. Corporate self-financing should be promoted, discouraging result-related distribution models that assume the persistence of financing models based on extreme leveraging, with the corresponding risk/cost for the financial intermediation system and the economy as a whole;

3. External fund raising through FDI and the external acquisition of stakes in national equity capital will help offset the domestic savings deficit without aggravating external indebtedness, with favourable effects on the potential growth of the economy, specifically through technology transfer and increased efficiency.

The third national imperative: to optimise allocation of resources and investment, in order to maximise growth and employment and reduce external imbalance

The quality of investment is of critical importance for defining the model and determining the strength of the economic development process. This may be understood by acknowledging that investment returns have a bearing not only on growth and employment, but also on the sustainability of public finances and thereby on the economic and social cohesion options of a given country – i.e. the social model evinced by the expenditure and revenue structure of the budget.

The quality of investment is all the more relevant in countries such as Portugal, which has a structural deficit of domestic savings financed through external borrowing.

The mechanisms for allocating savings to investment and the alignment of explicit or contextual incentives, as well as the maximisation of returns are critical for minimising the structural vulnerability of the Portuguese economy and creating growth dynamics that will generate employment and value.

In the case of the Portuguese economy, the contribution of investment to potential output growth is today conditioned by a number of factors:

- The share of non-productive investment (therefore with no return) by households, the State and even corporations;
- The absence of institutional mechanisms to rank public investment with an impact on the general conditions of production and productive investment, depending on expected economic return;
- The absence of an integrated approach to additional public investment with an impact on the productivity performance of the economy, culminating in fragmented investments where return is impeded or held back;
- The share of private investment targeting markets with administered prices or captive markets and return guaranteed by public payments.

The institutional and financial investment frameworks should be reviewed, and the opportunity cost of the different resource allocation options should be more perceptible, in such a way that households would opt for financial investments contributing to the productive investment of savings.

The model underlying public investment decisions should also be reformulated and centralised, in order to take on board restrictions arising from the sustainability of public finances. Taking account of these absolute restrictions, investment should be ranked depending on its expected economic return, calculated according to best practice methodologies. The independent scrutiny of public investment, the examination of past flaws and consideration of other investment alternatives are good principles to be adopted.

In addition, the State should only interfere with the rationale behind supply and demand, assuming the demand-related risk and, therefore, investment returns in order to correct market failures or to consider acknowledged investment externalities.

These principles are the basic requirements not only for maximising return but also for preventing the occurrence of a crowding-out effect, in a context of external restrictions, which would penalise investment in the tradable goods sector.

Moreover, there is scope for improvements in the internal capacity for strategic planning and investment evaluation on the part of both investors and sponsors, spreading beyond a culture that tends to measure risk through collateral adequacy. An incorrect evaluation of investment projects will inevitably lead to insufficient allocation of resources, and may even jeopardise the financial soundness of investors and sponsors, raising systemic concerns.

The rational allocation of savings also requires an update on the functioning of product and labour markets, eliminating obstacles that hinder the efficient reallocation of productive resources to more competitive sectors. This condition is of paramount importance to economic growth and successful integration into the global market.

The fourth and last imperative: to bolster the Portuguese financial system stability

As mentioned above, the soundness and efficiency of the Portuguese financial system are key items for the sustained development process of the Portuguese economy, given the critical role this system plays in the financing of the economy. Stability of the financial system is one the main objectives of Banco de Portugal, a point I made on the occasion of my taking office as Governor.

Generally, the new prudential rules are essential to ensure stability of the international financial system in the medium and long term, and to mitigate vulnerabilities that may have fuelled the effects of the current financial crisis.

It is important to ensure, however, that this reformulation process does not cause disruption of financial intermediation and therefore of the economy. Indeed, although most of these measures may contribute to making banks more resilient to shocks, preventing the disruption of credit flows to the economy during unfavourable periods, it is crucial to evaluate the effects of the simultaneous implementation of such measures on financial intermediation. It is also important to detect and evaluate possible competitive distortions arising from these changes, in view of the substantial differences in the measures to be implemented across different geographical areas and the various types of financial institutions.

One thing is sure: against the current backdrop of permanent international scrutiny, the soundness of the financial system is measured by compliance with the prudential rules originating from European and international coordination organisations. A country such as Portugal, where the financial system is pivotal for the external financing of the economy, cannot take the risk of failing to align with the best standards and the best prudential supervision practices. Failing to do so would further deteriorate financial intermediation conditions and, as a result, limit the potential for economic growth. This environment has motivated the strict implementation of CEBS guidelines, in order to evaluate the resilience of banks to adverse shocks.

I therefore believe that the Portuguese financial system must take measures to meet the new prudential rules arising from the commitments of the Basle Committee, which will be transposed into Community legislation. This means that necessary steps must be taken for timely compliance according to schedule. For that purpose, Portuguese banks should evaluate the implications of the new rules, specifically those aimed at strengthening the quality of their own funds (in particular, tier 1 capital), mitigating leverage, improving liquidity risk management and supervision and introducing counter-cyclical measures in the financial system regulation.

Still within the scope of supervision, I would like to stress that the agenda of international organisations, such as the OECD and the EU, have given increasing prominence to the regulations on retail banking products and customer protection. This prominence has been accentuated by the recent economic and financial crisis. Greater focus has been given to the credit market in the wake of the international financial crisis, above all due to the need to strengthen the regulation of credit institutions and intermediaries, as regards reporting requirements and product characteristics, as well as the importance of responsible credit granting and the evaluation of customer solvency.

Market-conduct supervision is under the aegis of Banco de Portugal, and will pose major challenges for the Portuguese financial system. I believe that the system should regard it as a further contribution towards strengthening customer confidence in the

Portuguese financial system and, along with financial literacy developments, as a factor promoting savings and financial investment decisions consistent with the risk preferences of savers.

In my opinion, some issues require pro-active initiatives by the banking system, namely through the adoption of good practice codes ensuring a transparent and balanced relationship with the customer. Banco de Portugal will be an attentive regulator, deeply committed to the efficient operation of the financial system, complying with the transparency and balanced principles of banking relations. It will use its powers whenever deemed appropriate, especially to strengthen customer confidence in the financial system, one of the cornerstones of its very stability.

Ambassadors, Governors, Ladies and Gentlemen,

The Portuguese economy is confronted with four major imperatives constraining its path towards sustained development: the sustainability of public finances, a rise in domestic savings, the maximisation of returns resulting from the allocation of savings to productive investment, and the strengthening of stability and efficiency in the financial system – which has proved to be sound and efficient.

These imperatives are likely to be interlinked. One imperative, however, conditions all of them: fiscal consolidation and public finance sustainability. This affects financing flows for productive investment and the ability of the financial system to continue to ensure access to external financing, to the extent needed to overcome the imbalance between domestic savings and investment financing requirements.

In other words, the strength of public finances determines the quality as well as the intensity and sustainability of the growth and job creation process. In short, fiscal consolidation and public finance sustainability are clear imperatives and the cornerstone of the country's future.

Carlos da Silva Costa

Lisbon, 4 October 2010