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***SPEECH BY THE GOVERNOR OF BANCO DE PORTUGAL AT THE DINNER IN
HONOUR OF THE GOVERNING COUNCIL OF THE EUROPEAN CENTRAL BANK***

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Prime Minister,
Minister of State and Finance,
President of the European Central Bank,
Colleagues,
Ladies and Gentlemen,

It gives me great pleasure to welcome you all in this place full of history on the occasion of a meeting of the Governing Council of the European Central Bank. Look around. We are in a place that highlights two Portuguese adventures. Firstly, this monastery of Jerónimos was built in the XVIth century to celebrate our maritime discoveries and secondly, here, in this very cloister, was signed our accession treaty into the European Union in 1985. A few yards from here is the shore from where set sail the ships to launch the discoveries. For almost a century Portugal kept a monopoly of the spice maritime trade with India and the Far East, where our ships arrived in 1498. In 1500 the fleet of Álvares Cabral arrived in Brazil with all its riches. In 1501 the construction of this monastery began and was completed after several decades. As all major buildings of the time it was built to celebrate spiritual and earthly endeavours. On the northern side of this cloister we find symbols of the Passion of Christ. On the southern side we have the symbols of kingdom and Kings. The concept was that the history of Portugal and our monarchic dynasty interconnected with the history of Christianity. Appropriately, the King was called Manuel, from Emmanuel (meaning God



with us) announced by Isaiah as the Saviour, and the King's wife was named Maria like the mother of Christ. The Armillary Sphere is an instrument of navigation with the celestial orbits, used by the King as his symbol and combined with the Christian Cross it appears in different places. Empire, earthly power and religion come together. Politics also enters. The monastery was given to the Hermit Order of St. Hieronymus, a Spanish order of monks devoted to the perpetual service of the dynasty reigning in Castille. This is explained by the aim of our King of becoming the heir to the Castillian crown thus unifying the two kingdoms. He had after all just celebrated his second marriage to Maria of Castille, the sister of the great Queen Isabel. You see then how European history and politics are present in every stone. As this lengthy introduction shows it is difficult for me to resist the historic spell of the place. We are here in the cradle of the first globalization, the first adventure to articulate the unity of humanity. Denis de Rougemont, the great Swiss French European thinker defined Europe precisely by its «globalizing mission». The Delphic oracle, when asked by Cadmon about the whereabouts of his sister Europe who had been kidnapped by the Great God of the Greeks, answered: «You will never find her». From this answer and from the wanderings that Cadmon was advised to pursue until exhaustion, Rougemont concludes that «... it seems difficult to know where is Europe, if we understand by this bringing her, all ready and made by history: because it is the search itself that creates her. Seeking Europe, is to make her! ... and that is what I call: *Adventure*.»

This tendency for universalism, for the globalizing of Europe, is what our greatest poet Fernando Pessoa characterizes as the main contribution of our



country to civilization. Himself bilingual and with an English education, he wrote in the 1920's: « The Portuguese are essentially cosmopolitan. Never was a Portuguese only Portuguese: he was always everything» . An expression very similar to the one used by a 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 XIXth century until its unification, the sentence reflects the caution of many participants to avoid any kind of nationalism. Another echo of this can be found in another expression by our Fernando Pessoa: «To be Portuguese, in the decent sense of the word, is to be European without the bad manners of nationality».

In the same vein, we may recall what Ortega y Gasset said in his *Meditación de Europa*, delivered in 1949 in Berlin: «...Europe as a society precedes the existence of European nations. ... This historical space ...was created by the Roman Empire and the geographic configuration of the emergent nations coincides with the simple administrative definition of the dioceses in the Late Middle Ages».

It is important to reflect upon this: before being a political project Europe is a memory, a key to understanding our own past. 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 Prussian before there were Germans. At the time of the French revolution half of the



population did not speak French and only republican public schools completed the formation of Frenchmen. A form of civic community among strangers was somewhat artificially created to shape several European nation-states. Nothing proves that a similar process, certainly longer and more difficult, cannot occur at the European level. 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 and the European one as the essential background for our rationalist, universal values.

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 at those dramatic times and how we could never again trust reason the same way after the war. We live now in so-called postmodern times, which value more the sceptical side of reason. It is no surprise then that the greatest contemporary Portuguese thinker, Eduardo Lourenço, who has lived and taught in Germany, Brasil and mostly in France, a true «good European», spoke in 1989 about European culture as «a culture of *inquietude*, a culture of anguish and doubt, that is to say, a



culture of radical defiance of the gods as figures of certainty. And above all a culture of defiance to the being never defined or pacified that we are as human beings» This vision of Lourenço implies that our Faustian civilization that as he says «has spread throughout the world its torment and insatiable curiosity», does not have a well defined identity. We could say that he theorizes our non-identitary identity. In this way, modern high culture has robbed us of any lofty spiritual goals behind our endeavours to build a unified Europe.

It remains a fact that a truly united Europe can still be the mobilizing utopia of our times, but for most people committed to the idea we are talking now of a more prosaic utilitarian project. Even the original mission of maintaining peace in our continent seems to many an implausible or unnecessary goal after so many years of democratic normality. What quietly dominates is the target of achieving a better management of individual national interdependences to promote national self-interest, or even more prosaically to create the conditions to maximize GDP growth. Do not misinterpret me. These are important objectives and we all live and work to serve them. However, advanced European democracies face a difficult period ahead of slow growth, high unemployment and deep reforms of their social and economic model. I worry, consequently, that by lacking more elevated values deeply rooted in the core of our humanity as rational, forgiving beings we may lack the ramparts necessary to face any deeper crisis that may defy the very foundations of our institutions. And we all know what Georges Santayana said: «Those who cannot remember the past, are condemned to repeat it»...



Even without considering long-term structural problems, we know how crises can emerge with threatening consequences. We are now going through one of the more acute episodes of turbulence in the short history of our monetary union. Investors in financial markets are trying to cast doubt on the capacity of the adjustment mechanisms within the monetary union to deal with the existence of macroeconomic imbalances in some member countries. They seem to forget that besides the functioning of the institutional framework that imposes corrective measures in any off-balance countries, there are endogenous mechanisms that in a currency area operate to restore a viable equilibrium between savings and investment. It has been known for quite a long time in economic theory that regions of a country with such an imbalance adjust, albeit through a recessionary process, to correct the disequilibrium. Imbalances that stem from private agents' decisions have market-driven self-correcting mechanisms that operate through changes of competitiveness and the effect of budget constraints monitored by the financial sector.

Naturally, countries must adopt policies that reinforce those spontaneous processes of adjustment by trying to prevent more serious problems to start with. As I wrote in 2000: «It can be said that the macroeconomics of a successful monetary integration is about the interiorization by economic agents of new rules regarding fiscal policy and wage behaviour. Fiscal policy needs to keep a countercyclical role to act as a shock absorber. Wage behaviour should take as a reference wage cost developments in the euro area as a whole and should deviate from those only if there is a productivity growth differential.» In reference to Portugal, our policies did not always



follow these principles. But independently of it, the initial shock of interest rate reduction after joining the euro coming from a previous regime of higher rates, implied an unavoidable explosion of private expenditure and debt that no sensible fiscal policy could completely offset. As I remarked in 2004, the initial boom of private expenditure was as unavoidable as the subsequent fall and adjustment. After a mild recession in 2003 and a big budget slippage in 2005, we implemented what has been so far the biggest fiscal correction since the inception of the euro and initiated a broad process of adjustment. In mid 2007, we had achieved a budget deficit below 3% in a consistent way, the economy was growing again at around 2% and our inflation rate was below the euro area average. Our relative unit labour costs against our main trading partners (21 countries) increased from 2003 to 2009 by just 4.4% which is well below the increase of 10.9% for the euro area average, using the same concept of the real effective exchange rate. Since 1999 the figures are 9.1% for Portugal and 15.9% for the average of the euro area. On a par with this, our inflation rate since mid 2007 has been below the figure for the euro area. Our economy has been in a mode of competitive disinflation throughout this period. At the same time our productive structure continued to progress in the value chain and by 2008, for instance, our exports of services to business already had a higher weight than the traditional exports of textiles and clothing. Unfortunately, the improvement in our balance of goods and services was not sufficient, as our savings rate continued to be very low and our energy bill and the outflows of the income balance combined to keep a very high external deficit that has to be significantly reduced, namely through the mechanisms I have already described. We have



lived beyond our means and, as Kenneth Rogoff recently said, «Financial regulation has been appropriate, otherwise the situation would be much worse». The point is, that we needed time to continue the adjustment and in principle, monetary union was supposed to give us that time for a gradual process of rebalancing. The international financial crisis that started in 2007 interrupted the process and the more recent market attacks on euro area countries vulnerable in terms of sovereign debt implies that time became a luxury: we have now to make a more abrupt, quicker and more severe adjustment. As I warned already in 2001: «Conceived for an infinite or very long horizon, the technical definition of external sustainability ends up not being truly operational because it only refers to the capacity of the economy to pay its debt within that time horizon. Operationally, what counts is the assessment made by investors about that capacity of repayment, which means that the possibility of financing depends on many factors, sometimes not fundamental ones». That is what we face now and so, we may need to ponder whether the recently approved Stability Programme should be reinforced by adopting upfront measures foreseen for later years. We must be resolute and clear-headed in recognizing the reality of how markets operate and, as captains of an embattled ship, we should not complain too much about the sea where we have to navigate.

We have to take comfort from the fact that we are not alone in this. A monetary union is not a sort of multilateral currency board. All member countries have a common interest in the well being of our union and its currency. We all share the guilt related to the failure of governance in the preventive arm of the Stability Pact. We ourselves, have never tried to



hamper the functioning of the Pact and, when caught at fault, we have abided by the rules. The recent events revealed indecisions and surprising misinterpretations of self-interest, but the system worked and deserves our trust. The need for reforms in surveillance and crisis management became nevertheless apparent, including the creation of an European Monetary Fund that had been foreseen in very early discussions about monetary union, and I am sure this episode will have consequences for future institutional arrangements.

Everything must in fact be done to reinforce the euro area. We can all see how it was important to face the international financial crisis. From the beginning of the euro, the Eurosystem was able to consolidate a culture of stability that is so important to create the conditions for long-term economic growth. Since 1999, we have been able to deliver an average inflation rate of just 1.9%, an important achievement during an extended period of ten years. Very significant was also the way the euro and our common monetary policy helped Europe to face the financial crisis. The quick and bold decisions taken by the Eurosystem were instrumental in containing the risk of a deep recession or even a depression. Since May last year our monetary policy delivered an average overnight rate (EONIA) of just 0.4% and a three months Euribor of 0.8%. These low rates supported the income of indebted households and firms and were essential to shore up domestic demand. The unconventional measures taken in the area of liquidity provision were likewise fundamental to help the financial sector survive the test of a very serious market stress. In the end, academics and analysts had to agree that the ECB and the Eurosystem had performed well and strengthened its



standing as a professional central bank. In this connection, I think it is of elementary justice to single out the role played by President Trichet in leading our team throughout the turmoil. His leadership qualities, his experience, his knowledge of the markets and his communication skills were essential to the overall performance of the system. I am therefore very glad that our President of the Republic has decided to decorate him tomorrow for his role in steering the euro area during this trying period. It is for me also a great honour to be able to work with him more closely in the near future in my new capacity and alongside all my colleagues on the Executive Board of the European Central Bank. There is much work to do to deal with the evolving predicament in capital markets and to implement the reforms stemming from the lessons that the financial crisis has compelled us to adopt. The crisis made clear that monetary policy focused on price stability had to be complemented with new instruments of macro-prudential policies to ensure financial stability and asset markets less prone to price bubbles. The creation of the European Systemic Risk Board, alongside the General Council of the ECB, is the European response to that requirement.

At the same time, monetary policy will have to rely on a new vision of the transmission mechanisms and the economic models used to help the decision making will have to integrate in a relevant way the role of financial markets in our economies.

A complete overhaul of regulation of the financial sector became necessary. We must be aware of the main lessons that must be drawn from the crisis: a) the financial sector is not self-equilibrating or self-correcting; b) an unfettered financial sector can generate crisis on its own; c) extended periods



of high growth of credit and debt generate asset price booms that always end in a crisis; d) low inflation in the market of goods and services is not enough to guarantee financial stability.

Human societies have learnt and forgotten these lessons several times throughout history. Misbehaviour by big financial institutions, deregulation and perverse incentives created this time the perfect storm that will continue for a long period of time to cause low growth and severe unemployment. New regulation will have to contribute to the taming of the sector's tendency to expand beyond proportion.

Finally, a reform of the global monetary system is necessary to solve the recurrent problem of global macroeconomic imbalances that may lead to new crises in the future.

Regarding Europe, besides the already mentioned changes in economic governance and crisis management, structural reforms are required to create new sources of economic growth that are necessary to survive in a very competitive world and to keep essential parts of our social model in the face of Europe's collective demographic suicide.

Deep down, we all know that Europe is again in a defining moment and is going through an existential crisis. Last year, the German philosopher Jurgen Habermas in his new book *«Europe, the faltering project»* wrote: «For the first time in the process of European unification we face the danger of a regression behind the stage of integration already achieved.» This sense of impending crisis is recurrent in European history. In his great book *The Europeans*, Luigi Barzini, in 1983, described Europe in a very apt way: «It is pessimistic, prudent, practical, parsimonious, like an old-fashioned banker.



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...It always prefers to wait and see. It enjoys delving into the complexity of things; the more complexities it can find the better. Europe looks for nuances, the bad side of anything good, the good side of anything bad». This does not mean that Europe is paralyzed. In moments of doubt we can always turn to the great man of action, one of Europe's founders, Jean Monnet, who reminded us that «Men only act in a state of need and only recognize the need in a state of crisis». In fact, we all know that Europe has progressed through the process of overcoming crises. Like the mythical bird, Europe has been reborn several times. I started with Rougemont talking about search and adventure. I conclude now that Europe as adventure continues. In this place, thinking about the men who set sail from these shores in such small ships to go into truly uncharted waters, it is perhaps easier to feel this sense of adventure. To face our own problems now, we must have their courage, their resolve and their hope.

Lisbon 5th of May 2010.

Vítor Constâncio.