Towards Stability and Growth in the Portuguese Economy

Marta Abreu
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Outline

I. The seeds of the Portuguese crisis (1995-2010)
II. The global crisis and the closure of markets (2007-11)
III. The Economic Adjustment Programme (2011-14)
IV. Looking beyond 2014
I. The seeds of the Portuguese crisis (1995-2010)

The Portuguese crisis: A tale of...

2 Shocks
- Monetary and financial integration
- EU enlargement and globalization

2 Policy mistakes
- Imprudent fiscal behaviour
- No macroprudential policy

2 Illusions / misperceptions
- The CA doesn’t matter
- The EMU governance model
I. The seeds of the Portuguese crisis (1995-2010)

Shock 1: Monetary and financial integration

*EMU enlarged the financing possibilities of domestic agents*

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**Interest rate and loans to the private sector**

- **Money-market (3 months)**
- **Loans to non-monetary private sector (annual growth rate, right axis)**

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**Indebtness of the non-financial private sector (% of GDP)**

- **Non-financial corporations**
- **Households**

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Sources: INE (Statistics Portugal) and Banco de Portugal.
I. The seeds of the Portuguese crisis (1995-2010)

Shock 1: Monetary and financial integration

*Higher spending not matched by higher income*

### Portugal - Composition of Expenditure

<table>
<thead>
<tr>
<th></th>
<th>GDP</th>
<th>Private consumption</th>
<th>Public consumption</th>
<th>GFCF</th>
<th>Exports</th>
<th>Imports</th>
<th>p.m. EA12 GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996-2010</td>
<td>1,9</td>
<td>2,3</td>
<td>2,4</td>
<td>1,1</td>
<td>4,3</td>
<td>4,3</td>
<td>1,7</td>
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<td>1999-2010</td>
<td>1,2</td>
<td>1,9</td>
<td>2,1</td>
<td>-1,3</td>
<td>3,5</td>
<td>2,8</td>
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<td>1996-2001</td>
<td>3,8</td>
<td>3,8</td>
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<td>7,0</td>
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<td>2002-2007</td>
<td>1,0</td>
<td>1,6</td>
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<td>-1,6</td>
<td>5,0</td>
<td>3,6</td>
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<td>2008-2010</td>
<td>-0,4</td>
<td>0,8</td>
<td>1,7</td>
<td>-5,5</td>
<td>-1,0</td>
<td>-1,1</td>
<td>-0,7</td>
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</tbody>
</table>

Source: INE and AMECO.

*Unfavourable expenditure composition*
I. The seeds of the Portuguese crisis (1995-2010)

Shock 1: Monetary and financial integration

A growing weight of the non-tradable sector…
I. The seeds of the Portuguese crisis (1995-2010)

Shock 2: EU enlargement and globalisation

Lower productivity and wage pressures hurt competitiveness

Impact compounded by EU enlargement and globalisation

Sources: INE and Banco de Portugal.
I. The seeds of the Portuguese crisis (1995-2010)

Shocks 1+2: Persistent CA deficit and increasing external debt

Current and Capital Accounts
\% of GDP

External Accounts and International Investment Position
\% of GDP
I. The seeds of the Portuguese crisis (1995-2010)

Two policy mistakes …

*Imprudent fiscal policy*

*No macroprudential oversight*
I. The seeds of the Portuguese crisis (1995-2010)

Policy mistake 1

*Imprudent fiscal policies led to unsustainable public finances*

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**PT - Public Accounts**

% of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Public debt</th>
<th>Interest expenditure</th>
<th>Budget deficit</th>
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<td>1995</td>
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**Tax Burden and Structural Current Expenditure**

% of Trend GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Structural Primary Current Expenditure</th>
<th>Structural Tax burden</th>
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<tbody>
<tr>
<td>1995</td>
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<td>2010</td>
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</tbody>
</table>
I. The seeds of the Portuguese crisis (1995-2010)

Policy mistake 2

No macroprudential policy

International Investment Position by sector

% of GDP

1996 2010

International Investment Position by instrument

% of GDP

1996 2010
Policy mistake 2

*No macroprudential policy*

**Net financial assets % of GDP**

- **1996**
  - Total economy: -8
  - Public administration: -27
  - Financial sector: -10
  - Non-financial corporations: -104
  - Households: -104

- **2010**
  - Total economy: -1
  - Public administration: -62
  - Financial sector: -123
  - Non-financial corporations: -164

**Credit to deposits ratio**

- 1995: 40%
- 2010: 180%

- 1995-2010: Total economy, Public administration, Financial sector, Non-financial corporations, Households
I. The seeds of the Portuguese Crisis (1995-2010)

Two illusions / misperceptions …

Current account deficits don’t matter

“The fact that both Portugal and Greece are members of both the European Union and the euro area … and the fact that they are the two poorest members of both areas, suggest a natural explanation for today’s current account deficits. …”

I. The seeds of the Portuguese Crisis (1995-2010)

Two illusions / misperceptions …

*The EMU governance model*

- Fiscal sovereignty
- No default
- No bail-out
- No exit
The outcome

*Unsustainable financial position and allocation of resources*

**Financial imbalances**
- High public and private indebtedness
- Excess banking sector leverage
- Growing external deficits and debt

**Real imbalances**
- Growing demand-supply gap
- Lower productivity / trend GDP growth
- Excessive weight of non-tradables in terms of GVA and employment
II. The global crisis and the closure of markets (2007-11)

Policy mistake 1 – take 2:

*Huge fiscal expansion in 2007-2010*

<table>
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</thead>
<tbody>
<tr>
<td>Total balance</td>
<td>-3,1</td>
<td>-3,6</td>
<td>-10,2</td>
<td>-9,8</td>
<td>-6,7</td>
</tr>
<tr>
<td>Structural balance</td>
<td>-4,3</td>
<td>-6,2</td>
<td>-11</td>
<td>-13,2</td>
<td>-8,9</td>
</tr>
<tr>
<td>Structural primary balance</td>
<td>-1,4</td>
<td>-3,2</td>
<td>-8,2</td>
<td>-10,3</td>
<td>-8,9</td>
</tr>
<tr>
<td>Public debt</td>
<td>68,3</td>
<td>71,6</td>
<td>83,1</td>
<td>93,3</td>
<td>25</td>
</tr>
</tbody>
</table>

Source: INE and Banco de Portugal.

- *Success in stabilising the economy was short-lived*
- *Not timely-targeted-temporary*
- *Risk of refinancing grossly underestimated*
II. The global crisis and the closure of markets (2007-11)

*Macroeconomic imbalances came to the spotlight in the context of the global economic and financial crisis*

- Unsustainable public finances
- Over-indebtedness and excessive bank leverage
- Anemic economic growth and low productivity

10-year Government bond yields
Spread against Germany in basis points

Markets question the ability of Portugal to repay its debts

Source: Bloomberg
III. The Economic and Financial Adjustment Program (2011-14)

Addressing the challenges of the Portuguese economy: A strategy for sustainable growth in the euro area

- Fiscal consolidation: Putting fiscal policy on a sustainable path
- Deleveraging and financial stability: Reduction of debt and financing needs of the economy
- Structural transformation: Implementing structural reforms to contribute to potential growth

The Economic Adjustment Program protects the financing of the economy from market pressure, allowing an orderly adjustment of imbalances and time to restore credibility.
Portugal is delivering on all fronts...

- Banks more capitalized and less leveraged
- Significant structural adjustment of public accounts
- Structural reforms under way:
  - Fiscal framework
  - Privatization
  - Labour market
  - Utilities
  - Justice
  - Housing market

Sources: INE (Statistics Portugal) and Banco de Portugal.
III. The Economic and Financial Adjustment Program (2011-14)

The near term challenges…

• *Keep momentum on program implementation*
  - Reform design and enforcement are key

• *Key concerns*
  - Labour market developments
  - Financing of the economy

• *Return to markets in Sep 2013*
  - Depends also on EU institutional developments
  - Precautionary / contingent mechanism needed
The longer-term challenge

How to turn the PT economy into an attractive location to invest and work?

- Debt levels will remain high
- Consolidating a new economic model
- Re-balancing resource allocation
- An investment-friendly institutional framework
  - The State as a referee not a player
  - Highly qualified public administration
  - Stable tax system
  - Efficient labour market: flexibility and “safety nets”