

# Economic development, financing, credit cycles and financial crises *The Portuguese case*

30<sup>th</sup> Anniversary of *Afi*



BANCO DE PORTUGAL  
EUROSYSTEM

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## 1. 1995-2007

Capital inflows from euro adoption misallocated, leading to macroeconomic imbalances

## 2. 2008-2010

Global crisis tackled through fiscal expansion disregarding accumulated imbalances

## 3. 2011 onwards

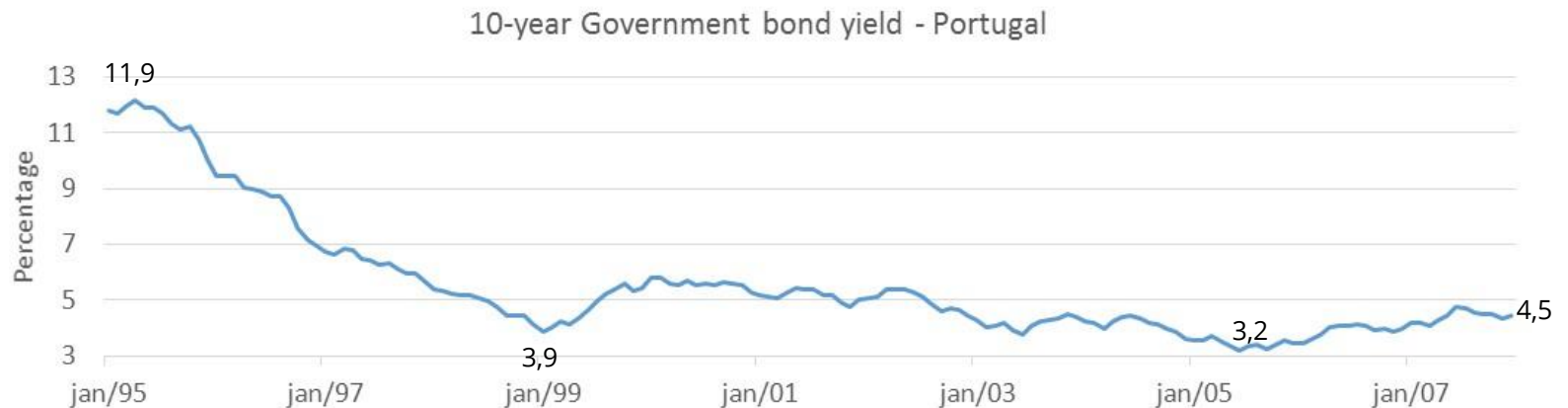
Macroeconomic rebalancing and financial deleveraging: notable progress, but no room for complacency



# 1. 1995-2007 – Capital inflows and macro imbalances

Euro brought **increased access to capital** since mid-90's.

***Interest rates plummeted...***



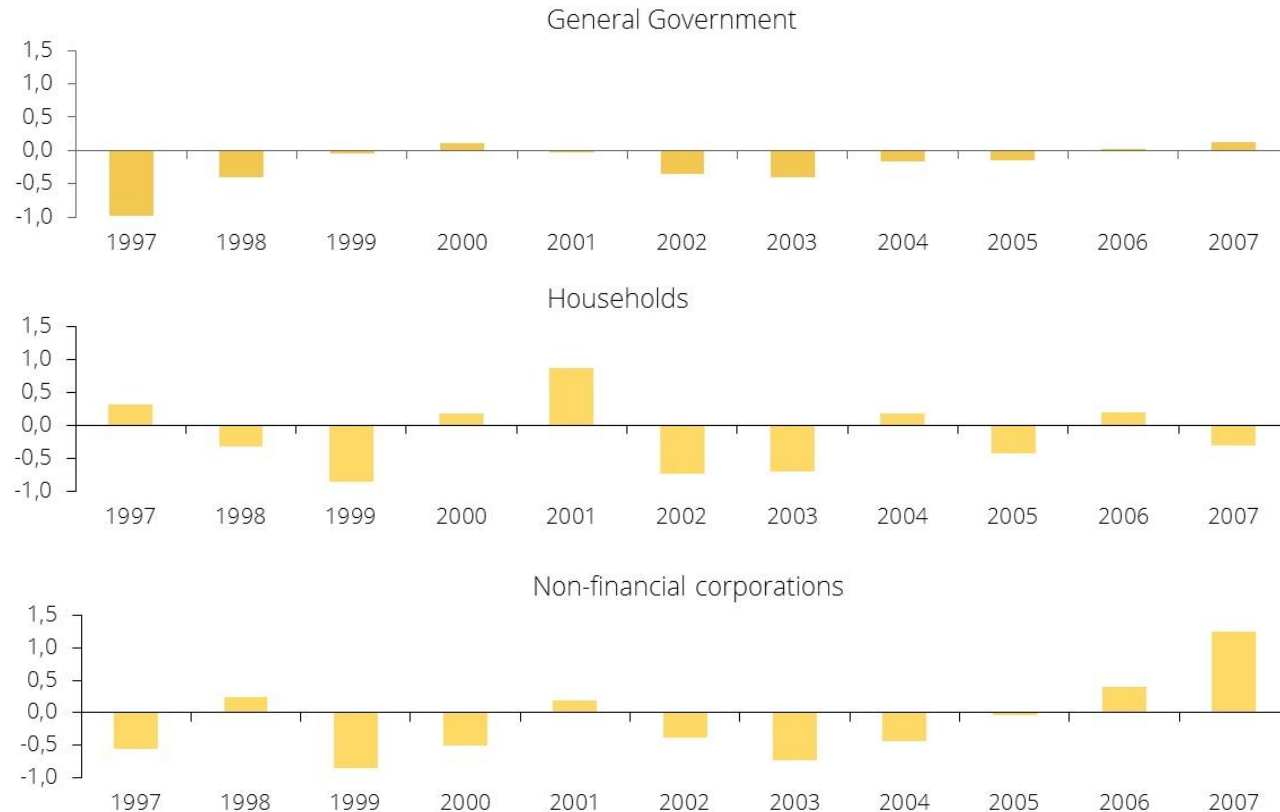


# 1. 1995-2007 – Capital inflows and macro imbalances

... providing **significant reductions in interest expenses**...

**Estimated impact of implicit interest rate evolution on interest expenses\***  
As a percentage of GDP

**Cumulative impact over the period**  
As a percentage of GDP



**-2,3**

**-1,6**

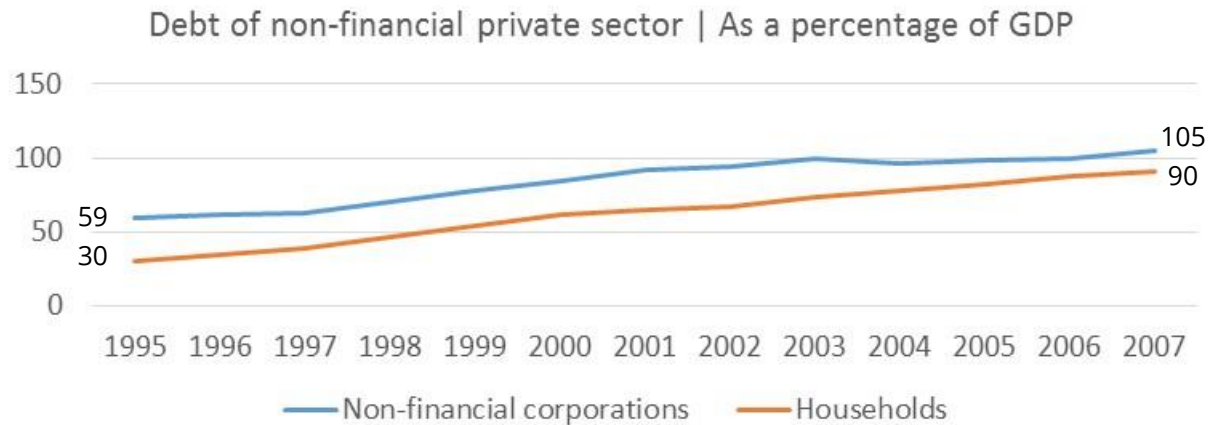
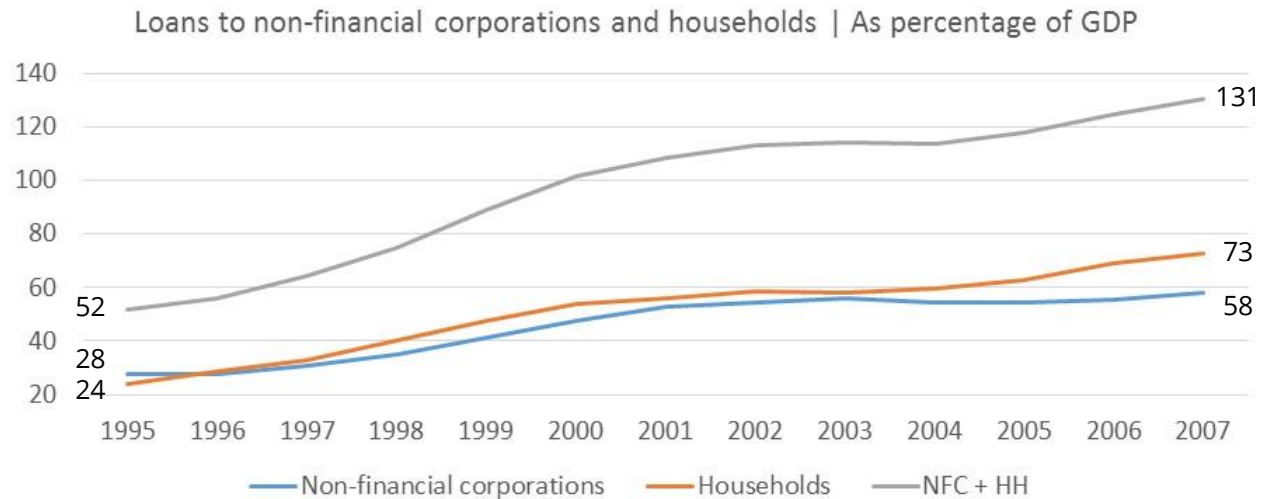
**-1,4**

\* In the case of Households, interest revenues and expenses are taken into account, producing an estimate of the impact on net losses from interests.



# 1. 1995-2007 – Capital inflows and macro imbalances

... and generating a **credit boom**.

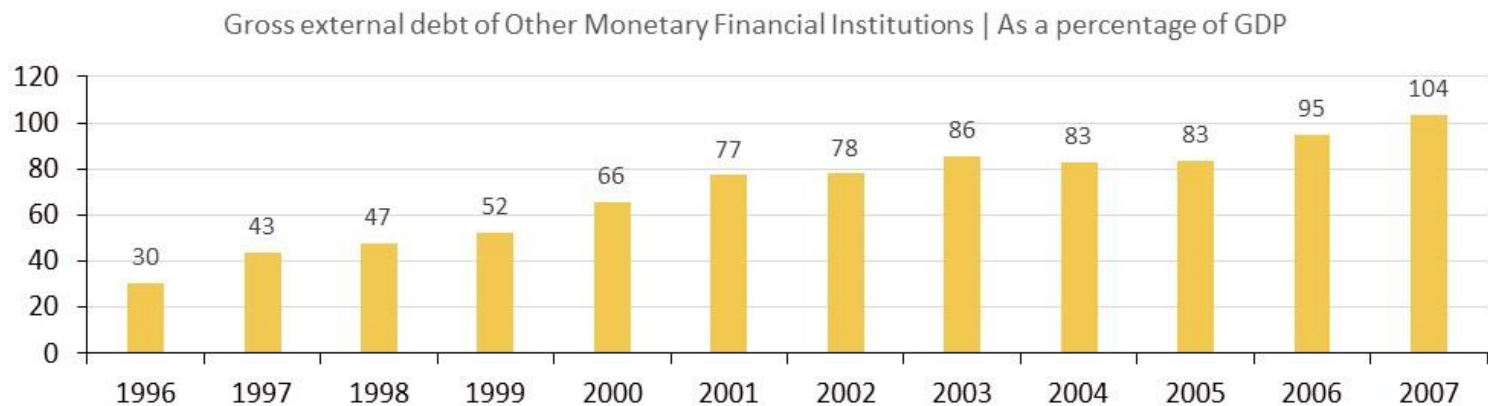
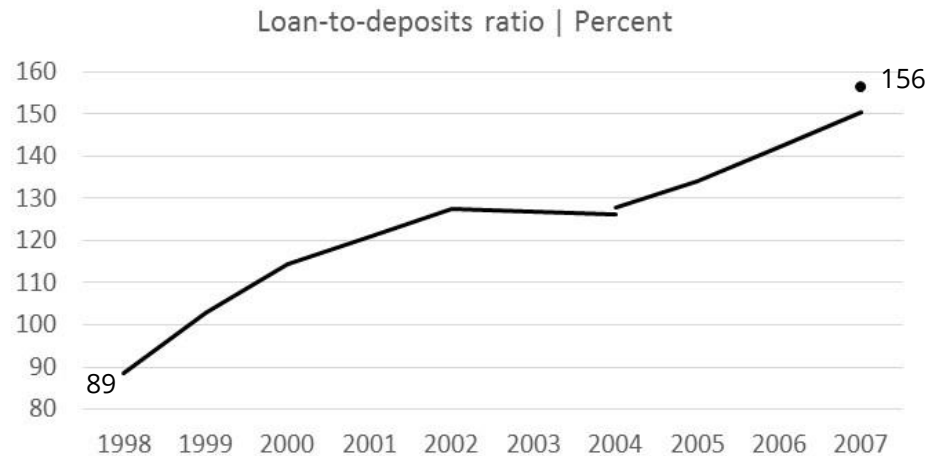




# 1. 1995-2007 – Capital inflows and macro imbalances

The banking system channeled foreign funds to domestic residents.

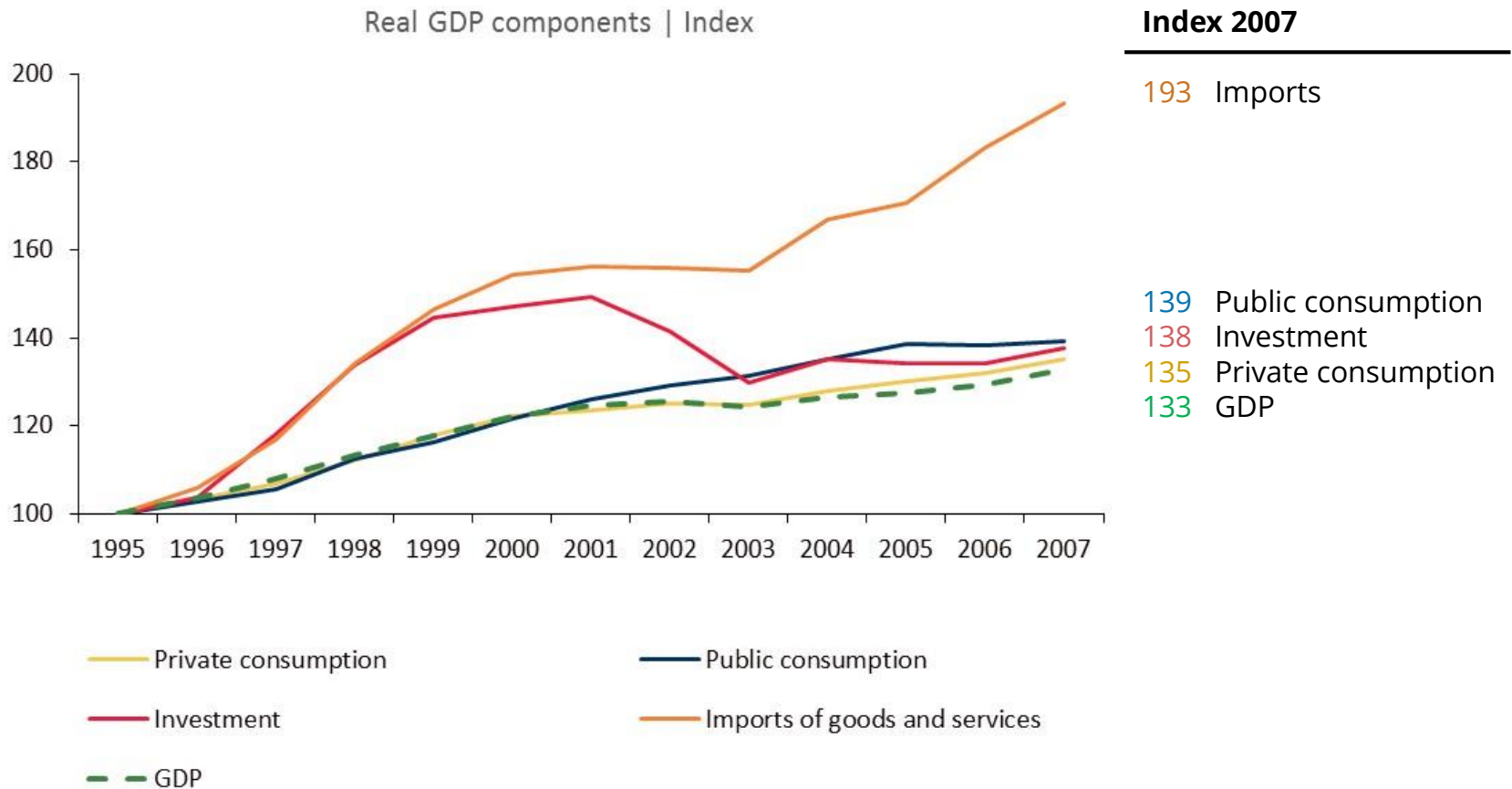
***(Short-term) loans used to finance (long-term) domestic credit.***





# 1. 1995-2007 – Capital inflows and macro imbalances

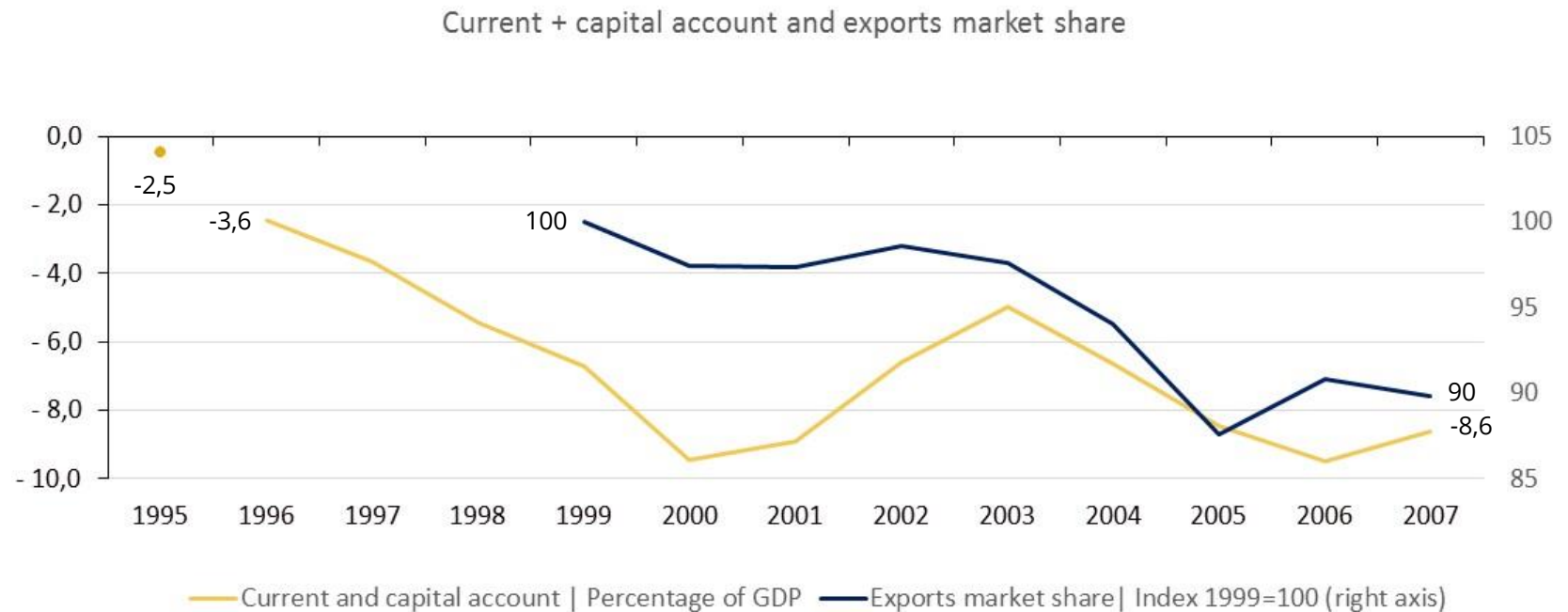
Credit expansion was used to **strongly increase consumption and investment**, which, in turn, **accelerated imports...**





# 1. 1995-2007 – Capital inflows and macro imbalances

...with a consequent **deterioration in the current account...**



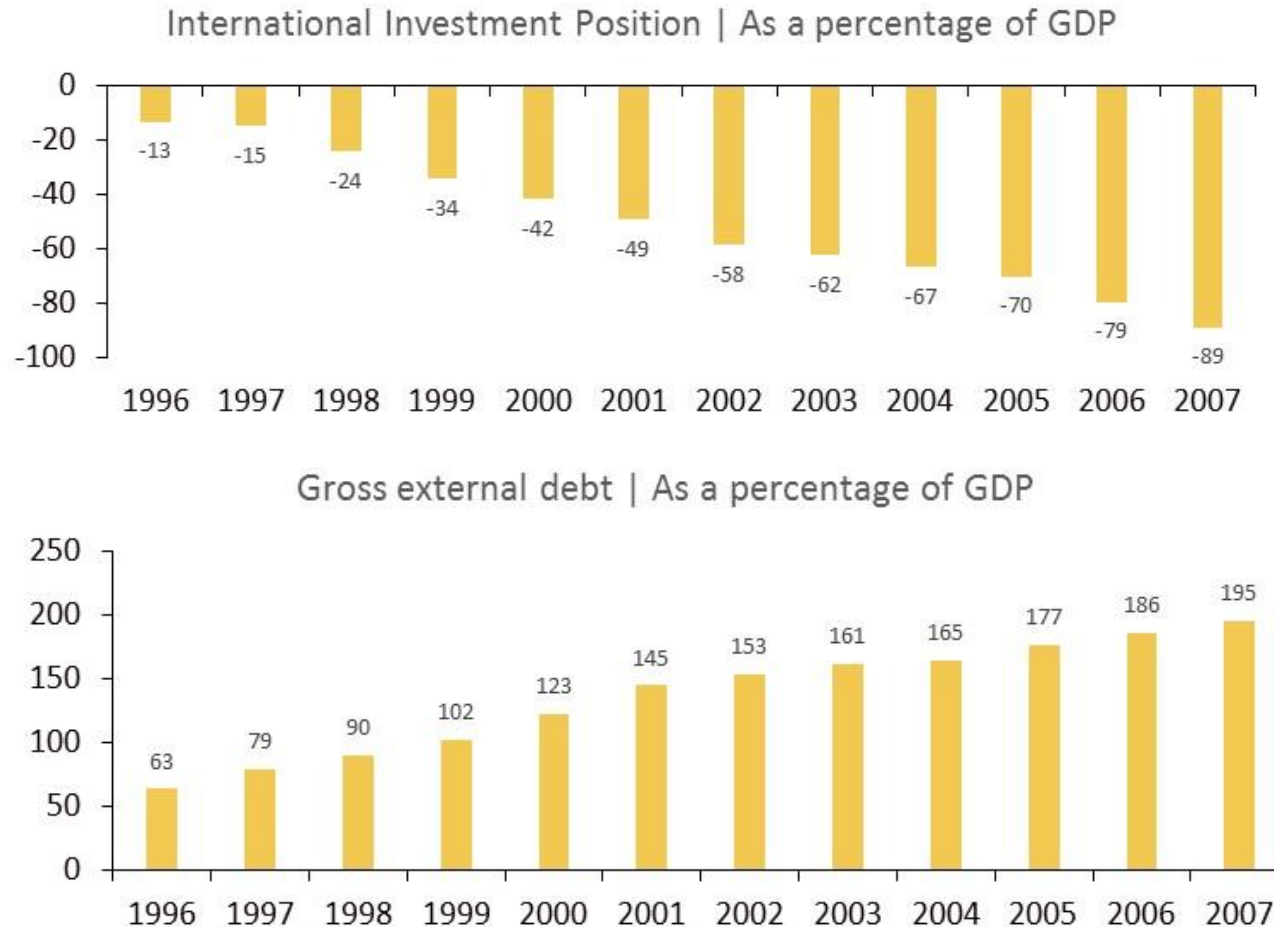
Note: the 1995 value reflects the current and capital account balance obtained using the methodology of the 5th edition of the Balance of Payments and International Investment Position Manual and is therefore not directly comparable to data for the following years.





# 1. 1995-2007 – Capital inflows and macro imbalances

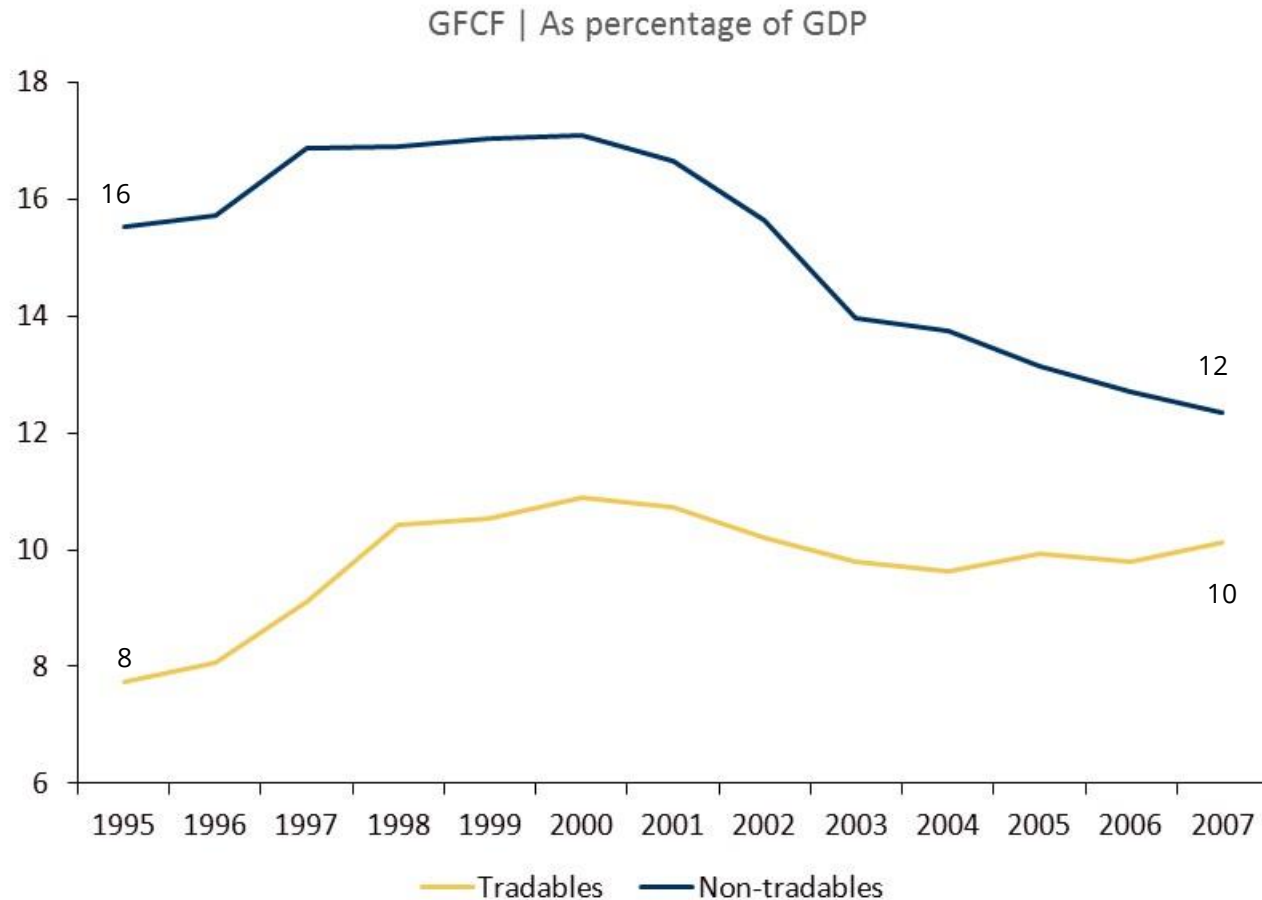
... and **increasing exposure to foreign markets** / dependence on foreign savings





# 1. 1995-2007 – Capital inflows and macro imbalances

**Investment surge** financed through the credit expansion mainly **channeled towards non-tradable sectors**, typically associated to relatively low returns...

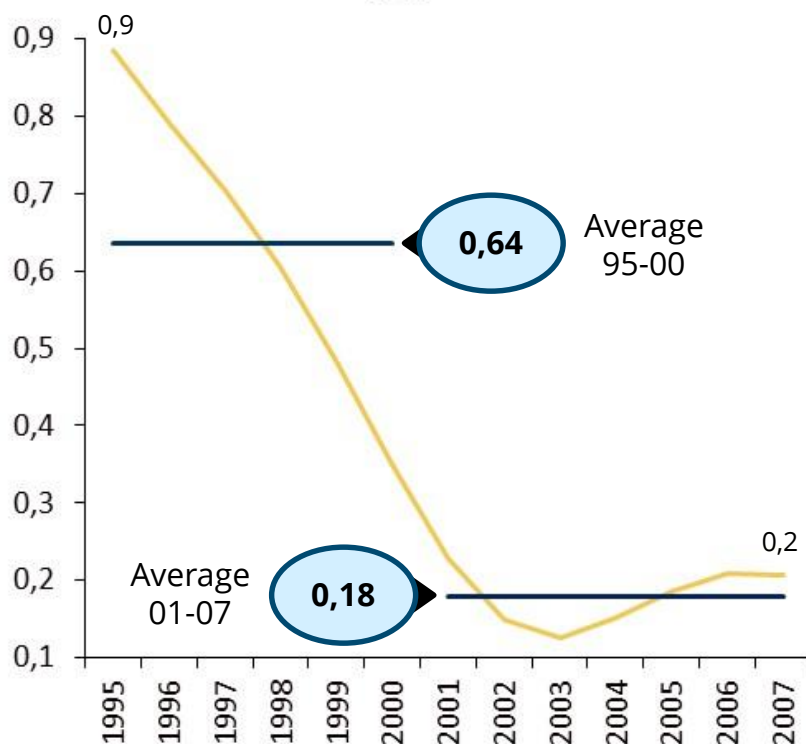




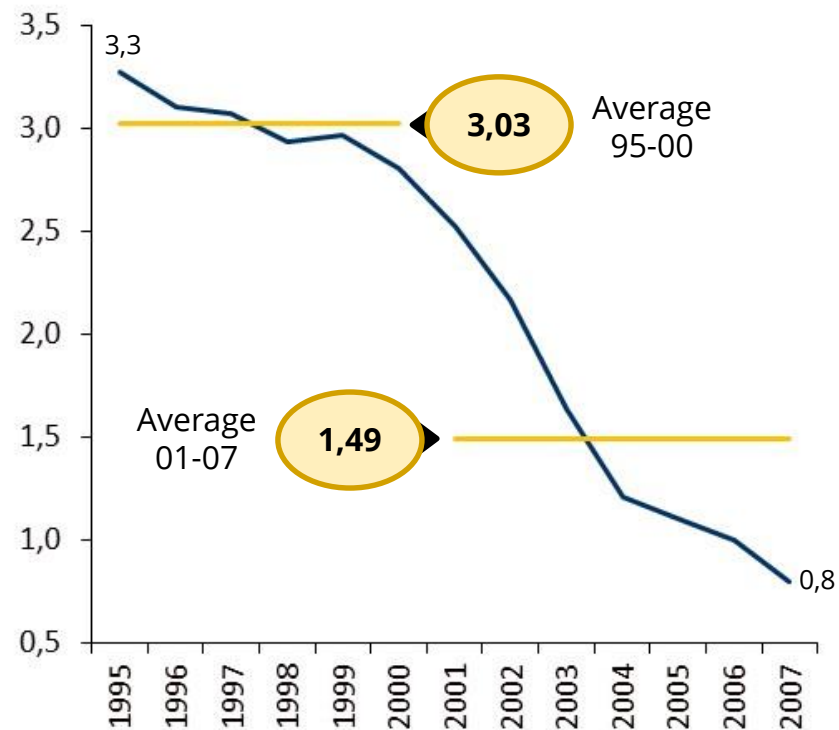
# 1. 1995-2007 – Capital inflows and macro imbalances

... **hampering productivity and potential GDP growth**, cornerstones of debt sustainability.

Trend factor productivity | Annual rate of change, percent



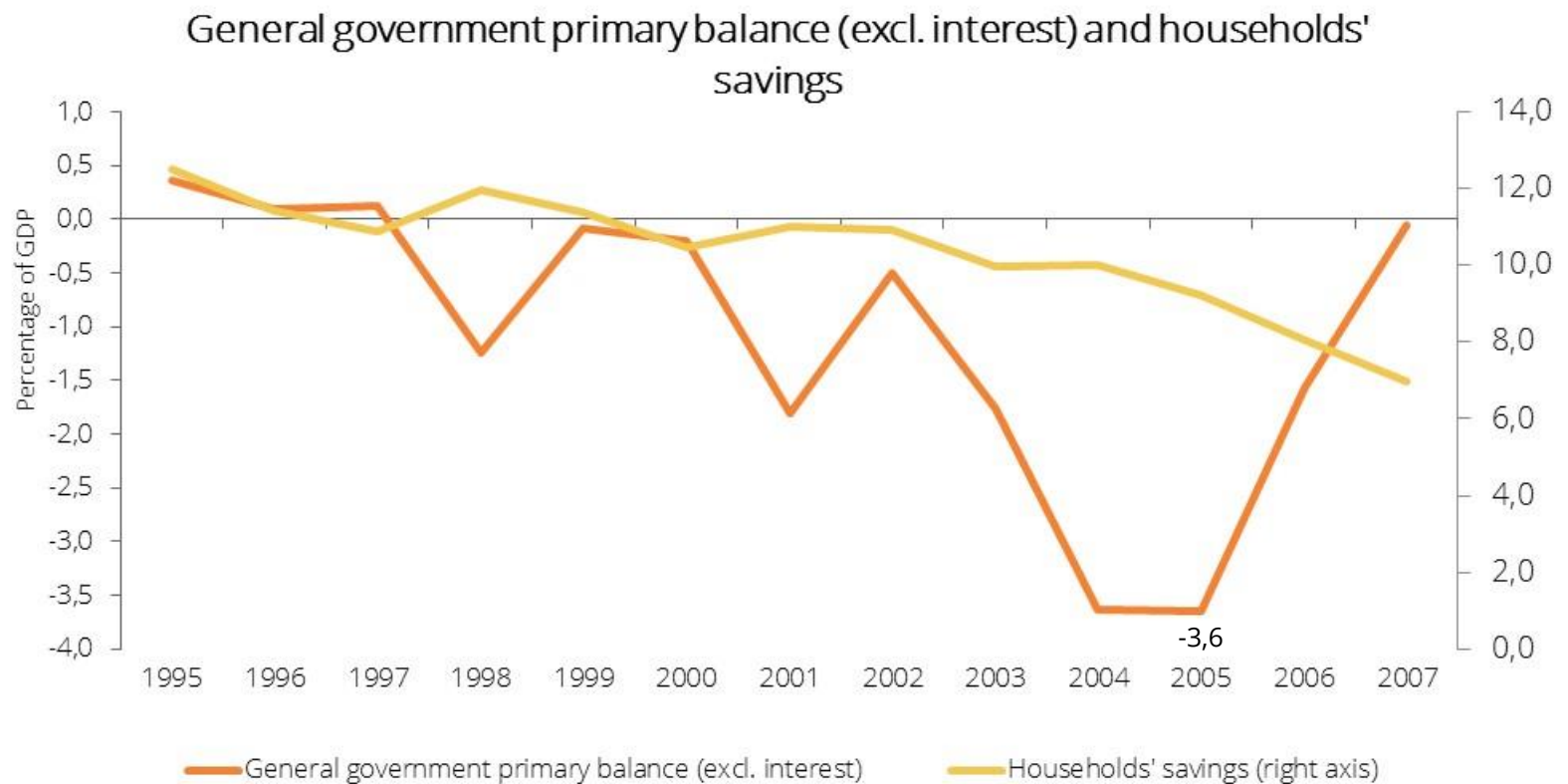
Potential GDP | Annual rate of change, percent





# 1. 1995-2007 – Capital inflows and macro imbalances

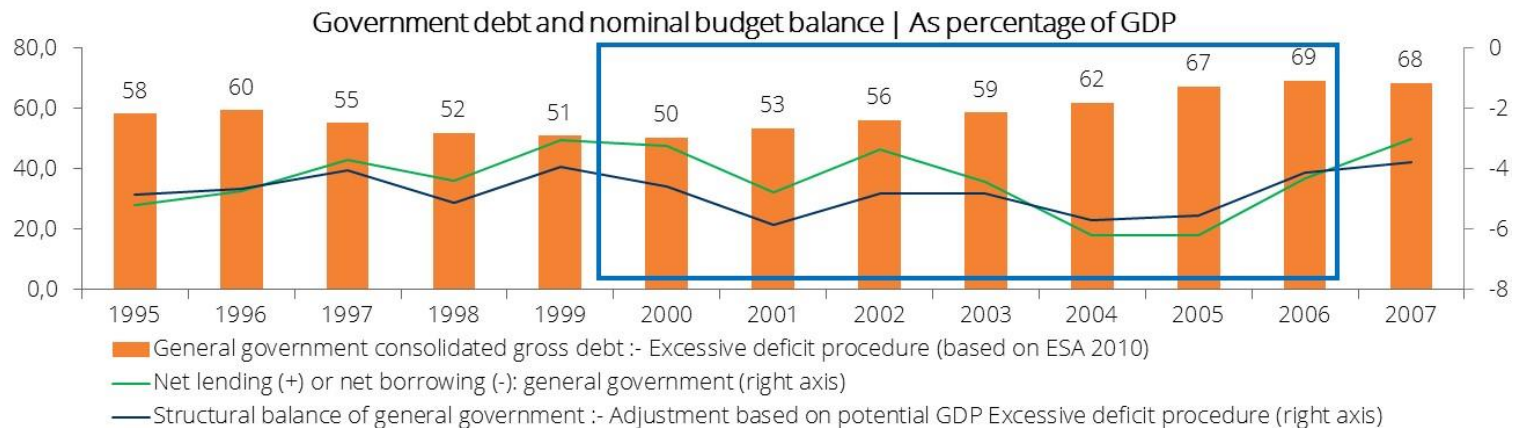
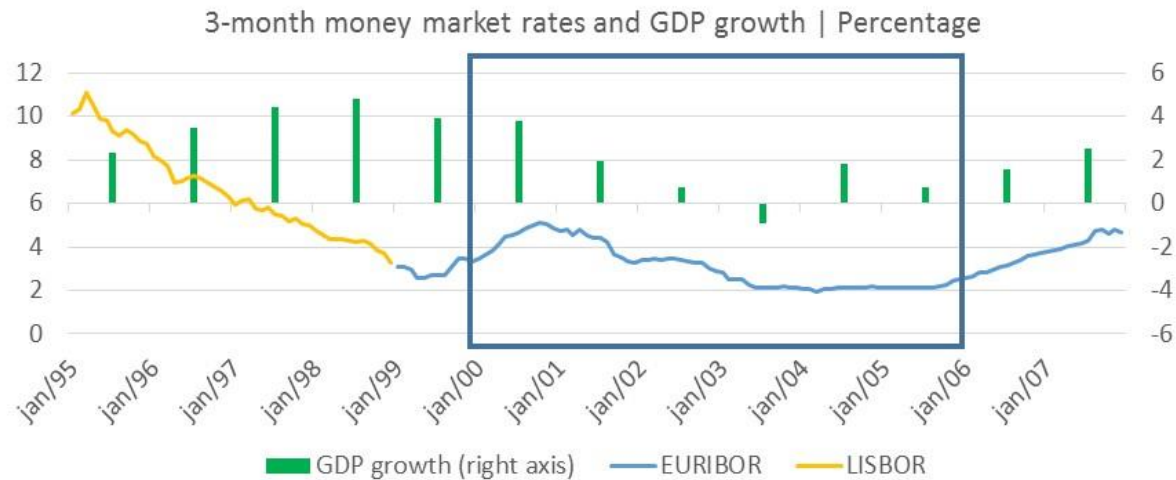
The public sector exacerbated the leveraging dynamics, adopting **fiscal expansion as private savings contracted.**





# 1. 1995-2007 – Capital inflows and macro imbalances

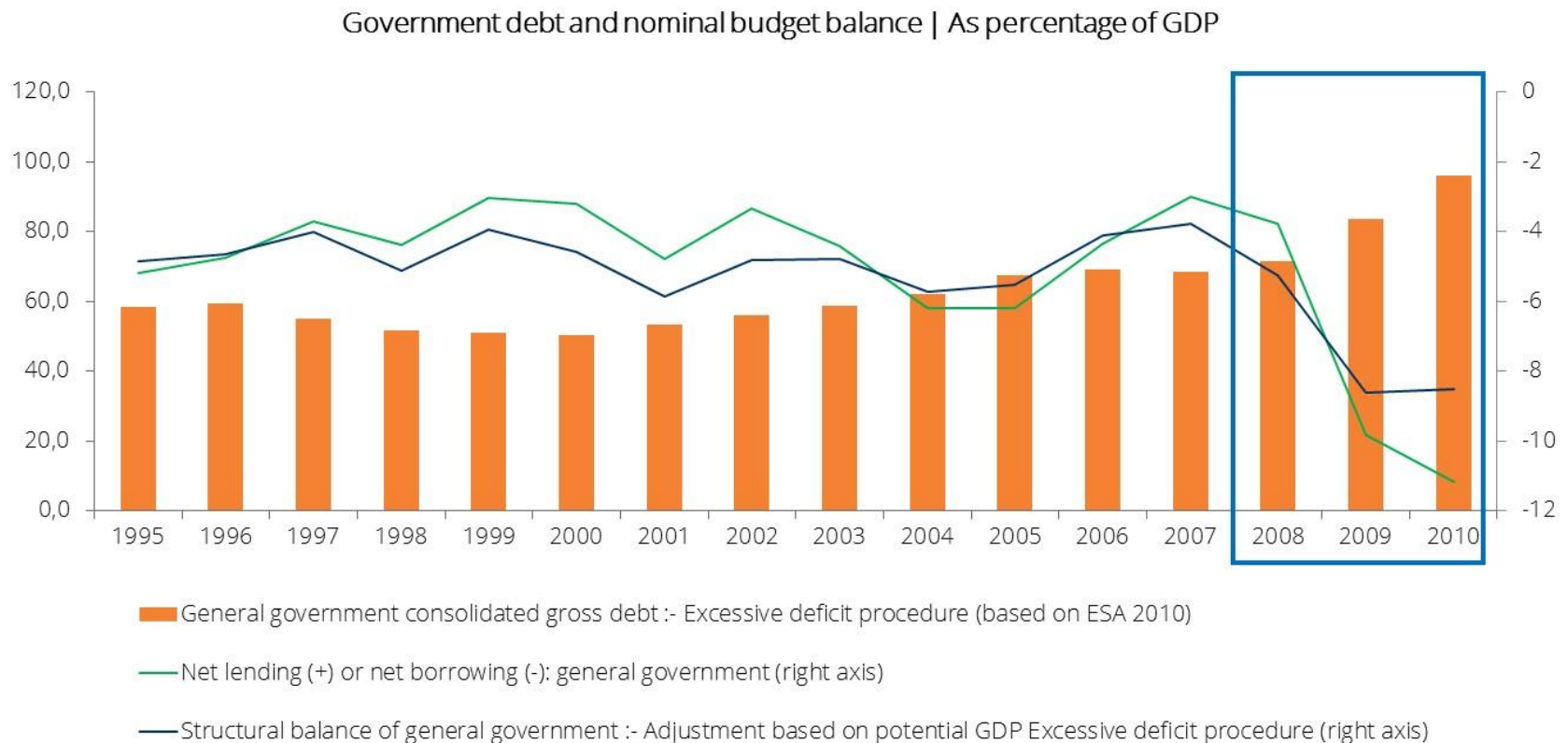
In the early 00's, **as interest rates stabilized and growth slowed**, general **government deficit and debt increased**.





## 2. 2008-2010 – A crisis leading to financial stress

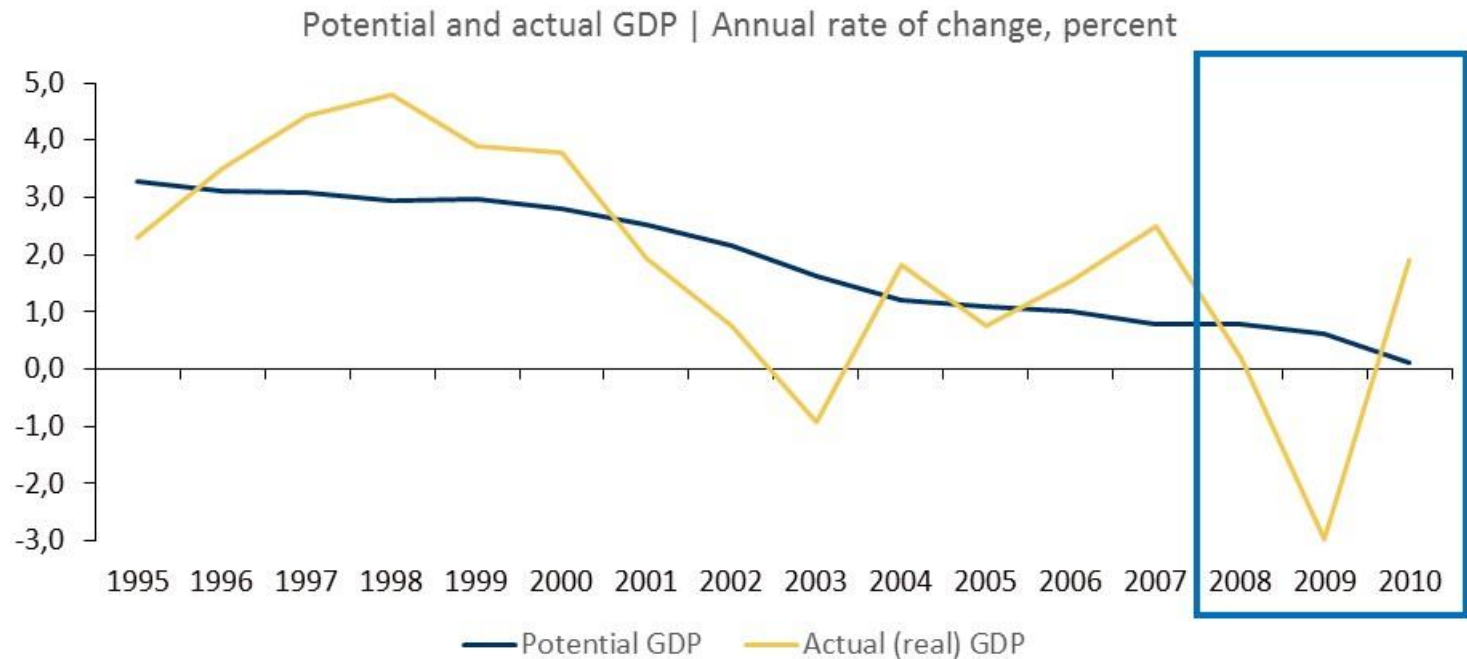
**Expansionary fiscal policy** adopted in response to the 2008 global crisis **disregarded indebtedness** levels, competitiveness **vulnerability and** investors' **fears**.





## 2. 2008-2010 – A crisis leading to financial stress

**GDP responded** in the short-term, **but potential growth kept downward trend.**

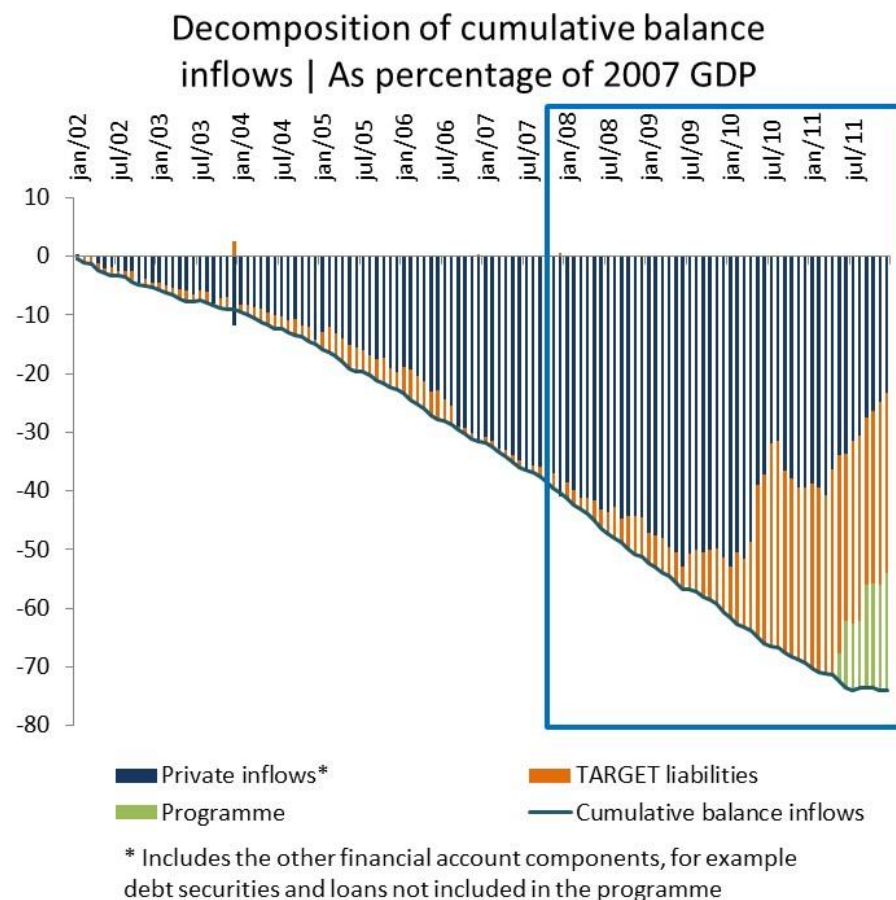
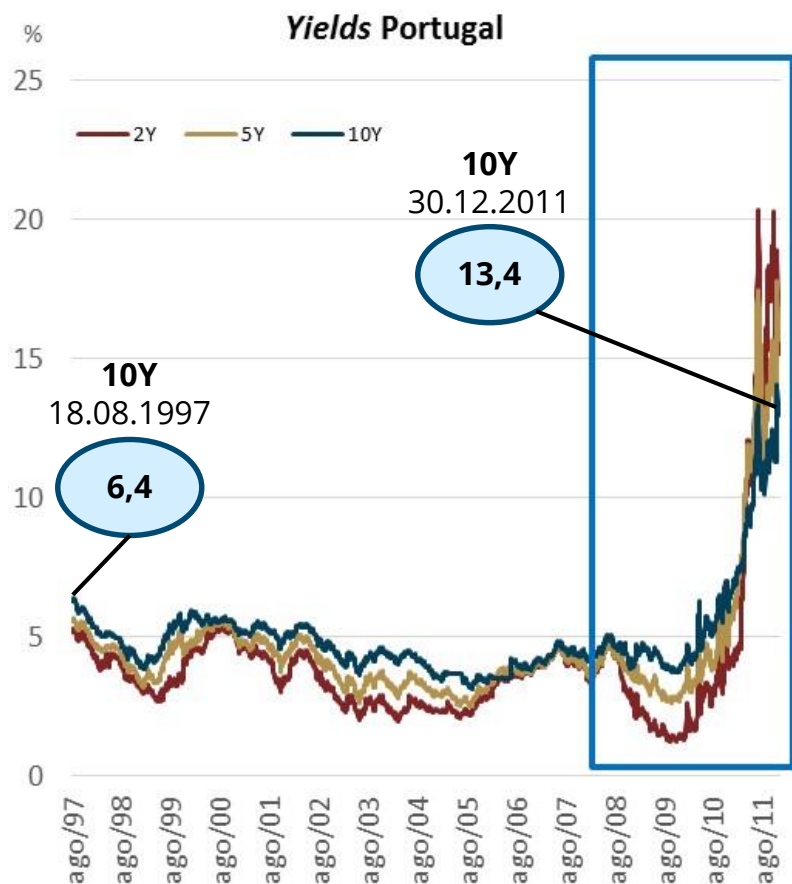






## 2. 2008-2010 – A crisis leading to financial stress

As investors' concerns grew, **public debt marginal interest rates increased**, up until the sudden stop in foreign lending and subsequent financial assistance program (April 2011).







- In the context of a monetary union, a sizeable **credit boom, coupled with** such an **imbalance between savings and investment**, immediately translates into **indebtedness** and **external imbalance**, putting macroeconomic stability and debt sustainability at risk.
- By priorly **channeling available capital to non-productive** – instead of productive – **and indirectly productive** – instead of directly productive – **investment**, economic agents limit and delay return.
- By **privileging non-tradable sectors** – instead of tradable –, **investors hinder** the economy's **ability to generate long-term sustainable growth**, the major guarantee of debt sustainability.
- On top of such a set of choices, two economic policy stances become indispensable: **macroprudential** and **fiscal countercyclical action**. In their absence, vulnerability mounts.



### 3. 2011 onwards – Rebalancing remains a challenge

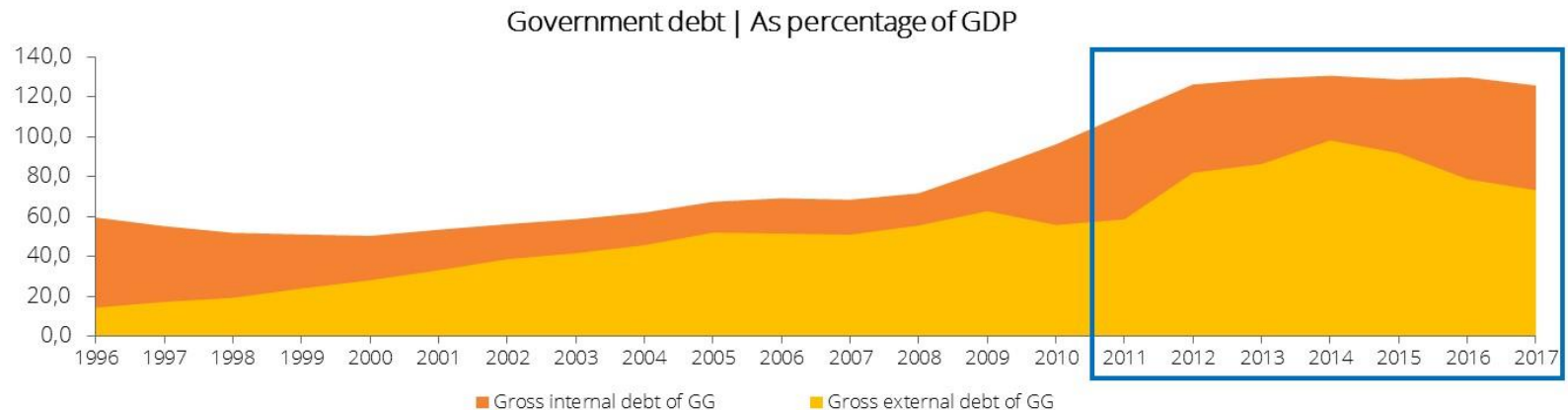
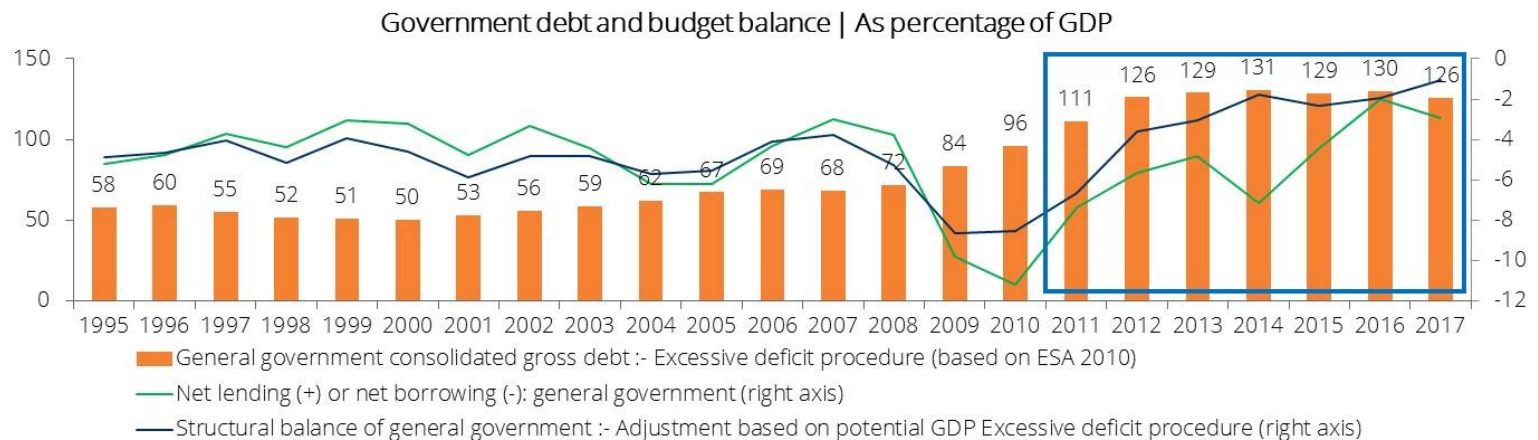
The **Economic and Financial Assistance Program (EFAP)** with the European Commission, ECB and IMF targeted three major adjustment needs:

- A. Fiscal consolidation**
- B. Financial stability**
- C. Structural macroeconomic reform**



### 3. 2011 onwards – Rebalancing remains a challenge

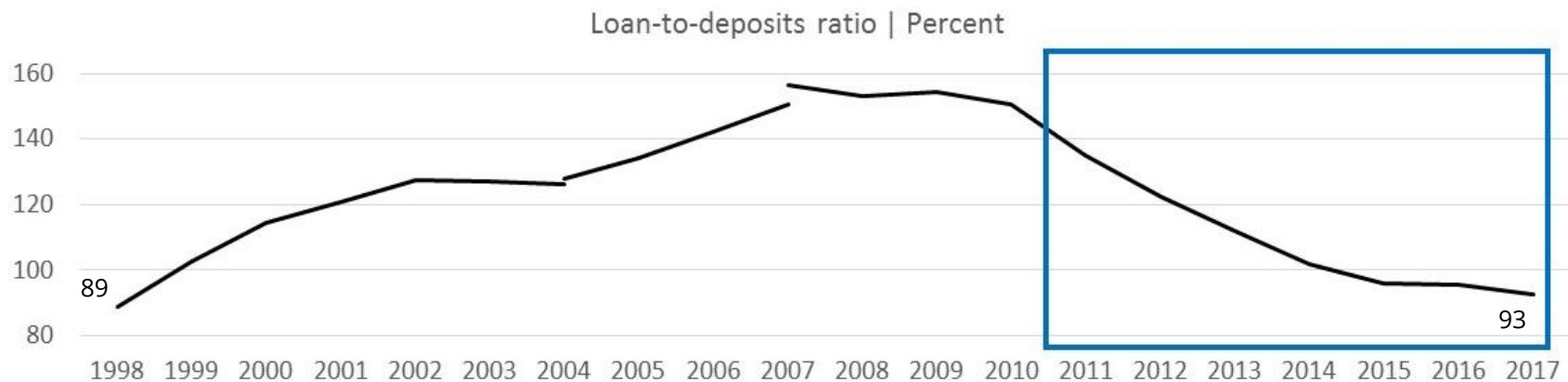
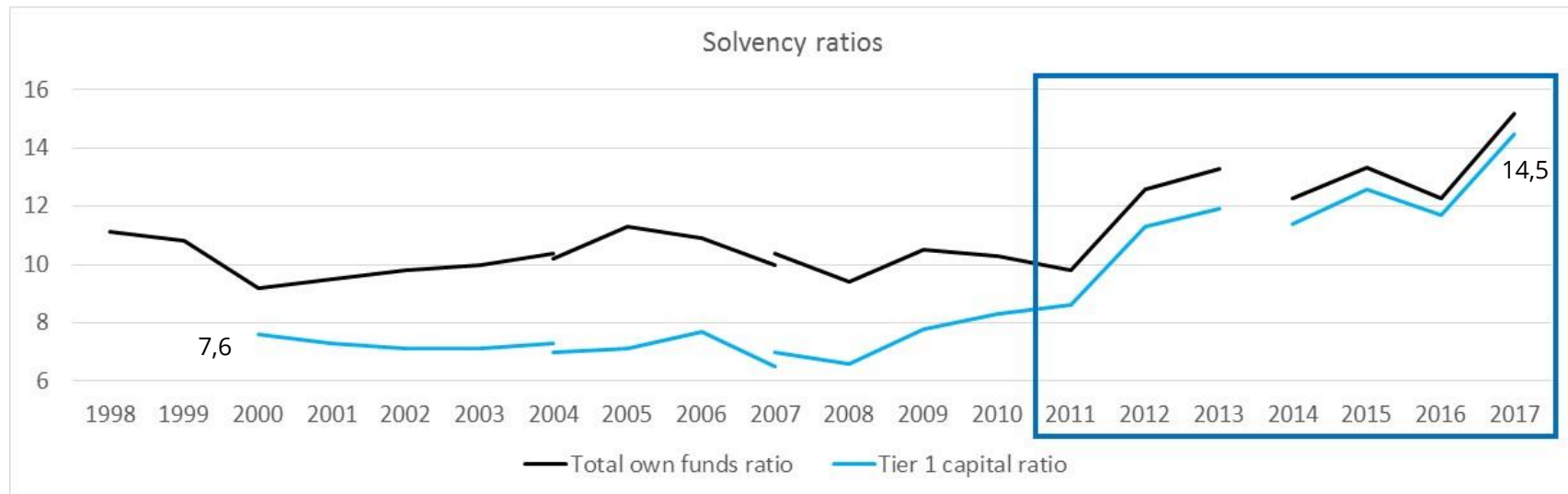
- A. Significant progress in **Fiscal consolidation**, but debt and external exposure remain high. Further progress is needed in order to fit (i) **public provision of goods and services** to (ii) **social needs** and (iii) **accepted tax burden**.





### 3. 2011 onwards – Rebalancing remains a challenge

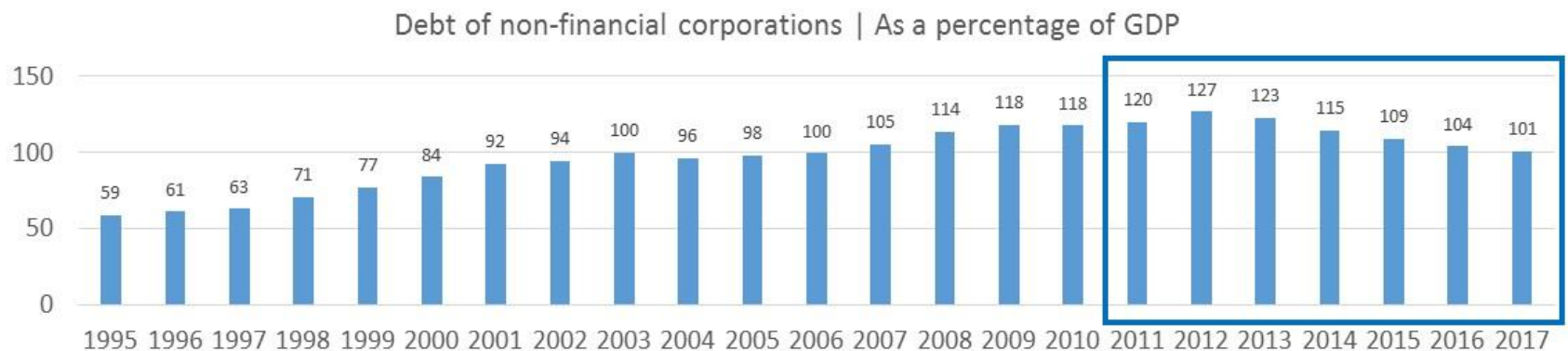
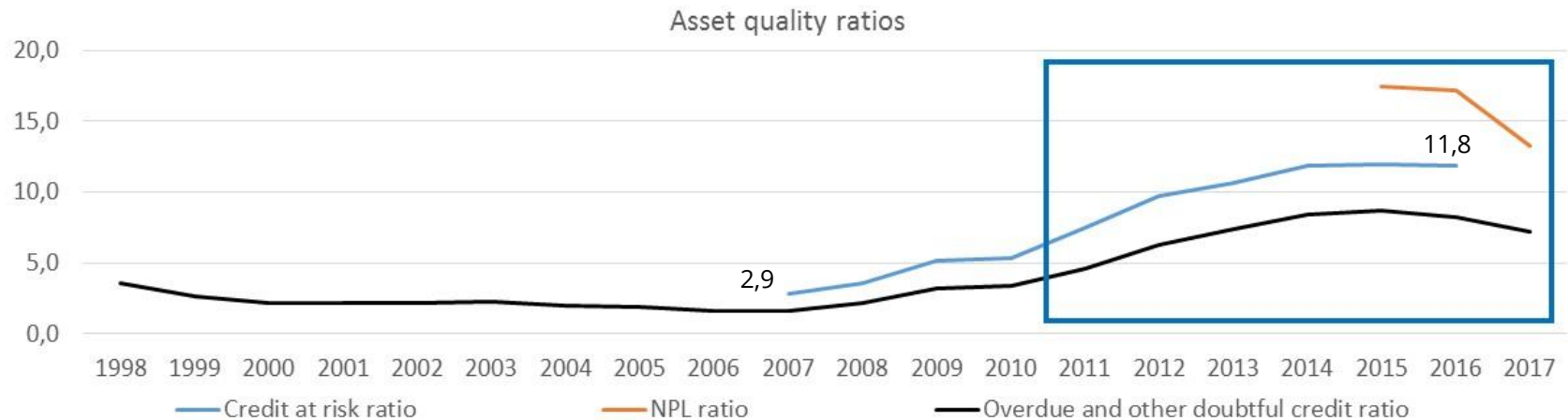
#### B. Financial stability conditions also improved markedly...





### 3. 2011 onwards – Rebalancing remains a challenge

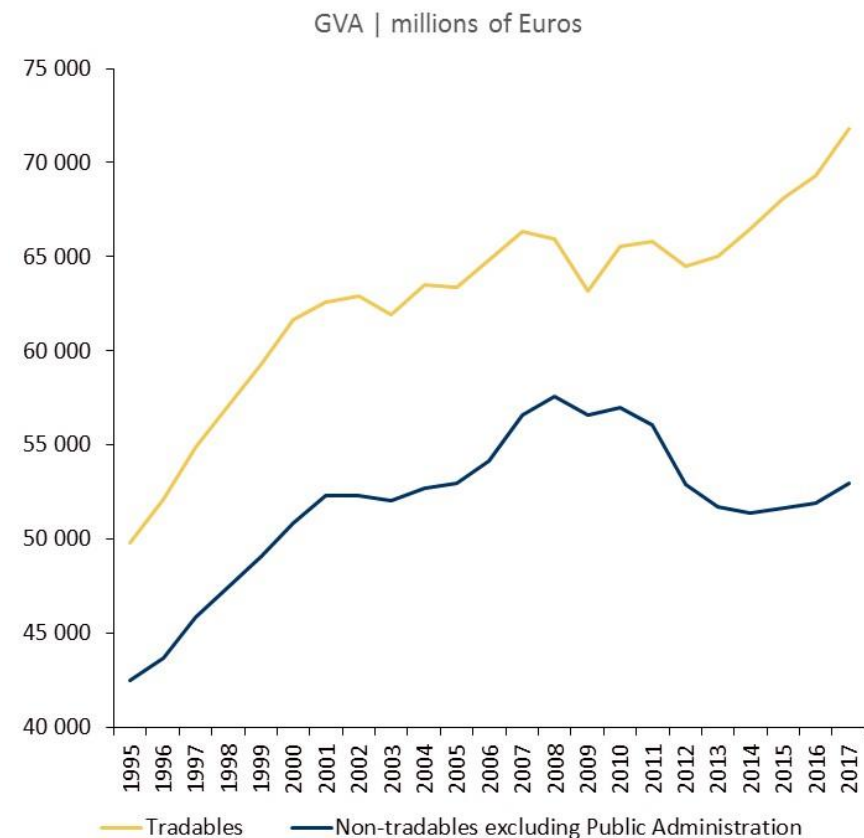
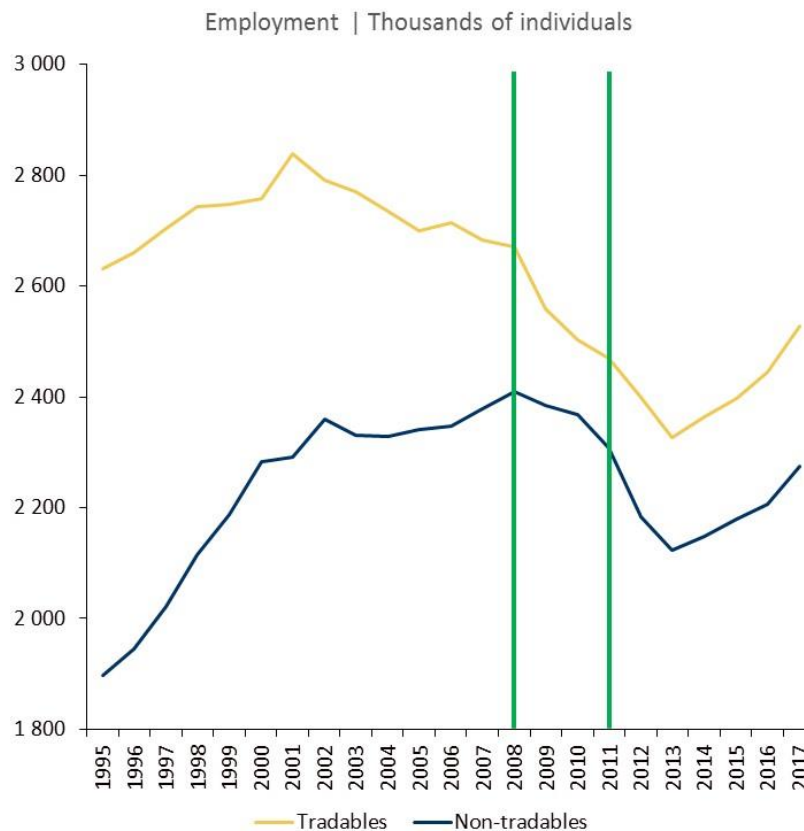
#### B. ... but risks still loom.





## 3. 2011 onwards – Rebalancing remains a challenge

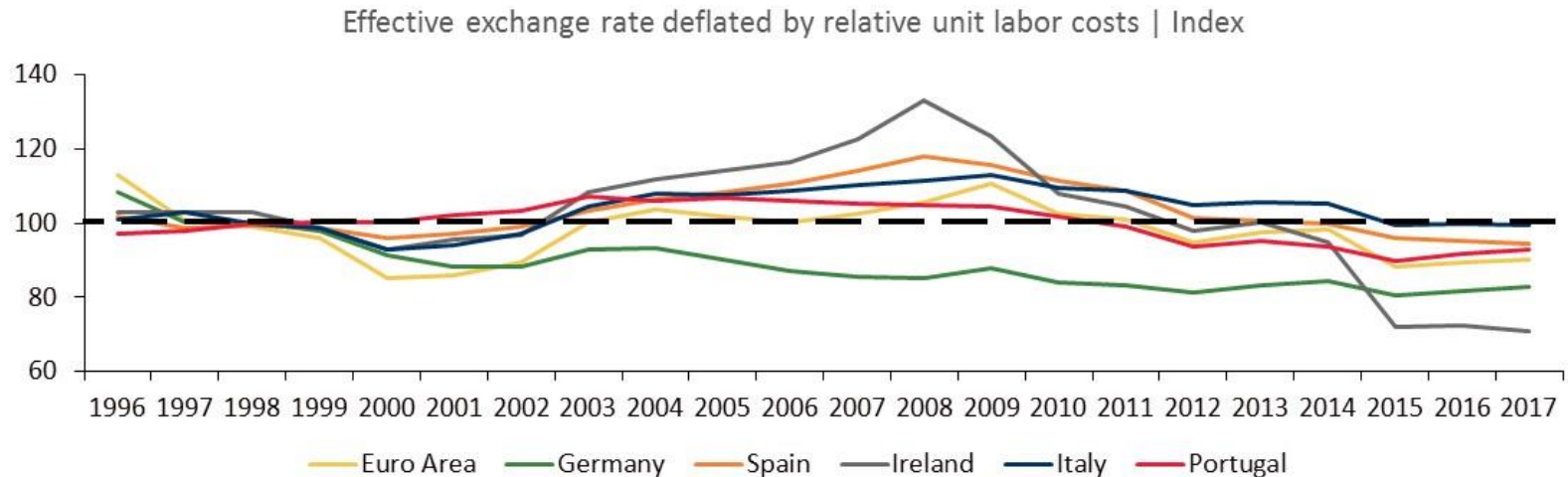
**C. Structural macroeconomic reform** poses continuous challenges. **Further resource reallocation towards tradable sectors remains urgent...**





### 3. 2011 onwards – Rebalancing remains a challenge

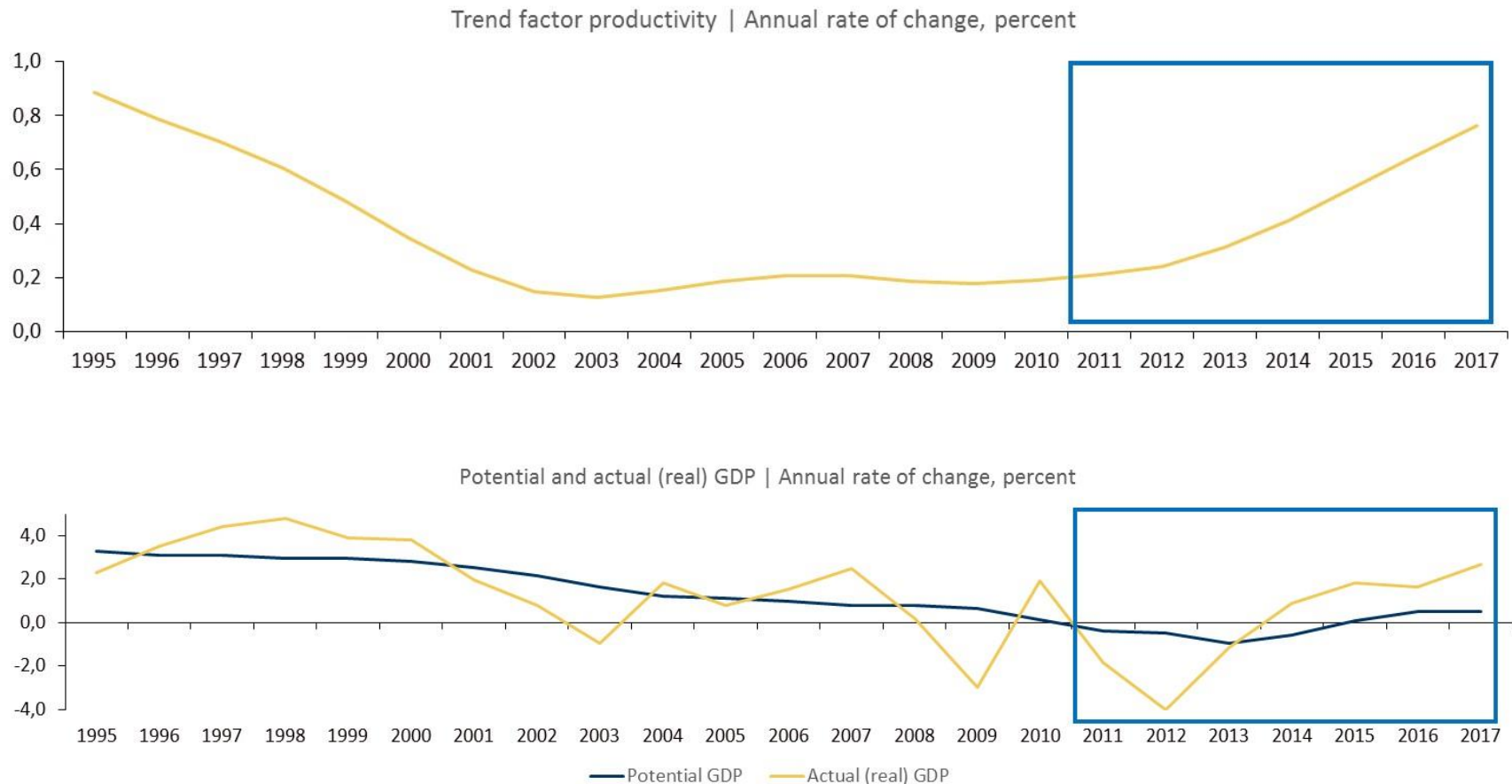
C. ... and although **competitiveness** has improved...





### 3. 2011 onwards – Rebalancing remains a challenge

C. ... both **productivity** and **potential GDP growth** must raise.







# Challenges for the coming future

