Banco de Portugal
EUROSISTEMA

ADDRESS OF THE GOVERNOR OF BANCO DE PORTUGAL AT THE 6TH ANNUAL CONFERENCE OF THE PORTUGUESE ECONOMISTS' ASSOCIATION ("ORDEM DOS ECONOMISTAS")

15 November 2010

Let me start by thanking President Murteira Nabo for the invitation to participate in the closing session of the 6th Annual Conference of the Portuguese Economists' Association ("Ordem dos Economistas") devoted to the analysis of the draft State Budget for 2011. This well-timed initiative will be the more relevant for having focused on medium to long-term issues.

Fiscal policy is of the utmost interest to Banco de Portugal, given its implications for financial stability. Financial stability is one of the functions entrusted to the Bank by the Constitution of the Portuguese Republic and by its Organic Law, within the framework of the European System of Central Banks. Hence, the nature and size of the fiscal balance, the public debt path and the impact of fiscal policy on Portuguese potential economic growth – the key determinant of the country's ability to pay its debt – are matters that Banco de Portugal not only has to monitor, but also to ponder when exercising its assigned responsibilities.

Having provided this brief background information, it should therefore come as no surprise if I consider the approval of the Budget very important for Banco de Portugal; moreover, taking into account the current financing constraints faced by the Portuguese economy, which I have addressed on 4 October last, the draft Budget for 2011 is critical for its developments not only next year but also in the following years.

Hence, I would stress that the draft Budget for 2011 (if enforced as planned),

- will represent an unprecedented fiscal consolidation programme in the history of Portuguese public finances in democracy;
- will be a major event in the fiscal consolidation process under way in most European Union (EU) Member States, aimed at putting the deficit and the debt-to-GDP ratio back on track with the guidelines of the Stability and Growth Pact;
- and finally, will answer the unavoidable question posed by international investors about the sustainability of Portuguese public finances.

The approval of the Budget for 2011 is a necessary and unavoidable step to restore the confidence of international investors in fiscal policy. However, as I said before: it is not enough! Additional measures are necessary to ensure sustainability.

Investors are continuously scrutinising the performance of the public or private entities they finance. As regards public entities, investors monitor in particular deviations in the budget outturns, the intertemporal consistency of financial policy and the sustainability of the indebtedness level. Hence, they tend to assess both a country's budget and financial policy announcements on the basis of its track record.

Therefore, the degree of investor confidence in the sustainability of public finances depends not only on the fiscal targets set for the following years, but also on a rigorous budget control and past evidence of fiscal consolidation.

This means that to maximise the impact on investor confidence of the fiscal deficit reduction planned for 2011 the questions still persisting on the investor side must be acknowledged and adequate and convincing answers provided. This is a further necessary critical step, if the full benefits of the fiscal deficit reduction planned for 2011 are to be reaped in terms of investor confidence.

To analyse investor doubts does not mean to blindly obey the markets. Instead, the reasons underlying such doubts must be understood, i.e. the reasons determining investor behaviour.

In the Portuguese case, the questions posed nowadays by international investors are basically five:

1. The frequency and size of deviations in budget execution;

2. The persistent nature of the structural component of the fiscal deficit and its deterioration over the past few years;

3. The increase in public debt as a percentage of GDP;

4. The worsening of the net international investment position, i.e. the aggregate level of debt ;

5. GDP and productivity growth rates, which have been persistently lower than those of the euro area in the past decade.

Therefore, the impact of the draft Budget for 2011 on the confidence of international investors will depend: first, on the willingness and capacity to effectively put it into practice; second, on the adequacy and nature of the fiscal consolidation policy over the medium term, in view of the need to ensure the sustainability of Portuguese public finances; and, finally, on the guarantee that the fiscal consolidation policy will be pursued, i.e. on the degree of social and political consensus underpinning it.

On the other hand, the fiscal policy will need to be supplemented by structural policies, which contribute to increase potential growth.

The willingness and capacity to deliver a strict budget execution is an unquestionable imperative faced by the country, which must be met at four distinct levels:

- First, **collection and processing of information** on the budget execution by:
    - applying the official plan of public accounting (*Plano Oficial de Contabilidade Pública POC-P*) in a systematic way;
    - implementing a system for the real-time collection and processing of information, covering all entities within the general government.
- Second, **human capital and information processing technologies**, in order to ensure that the budget is effectively executed both on the revenue and expenditure side, namely by:
    - improving the mechanisms used to combat tax evasion and fraud, pushing forward the progress achieved in the past few years;
    - monitoring compliance with the ceilings set for expenditure in each programme;
    - and assessing expenditure programmes in terms of outcome and performance in a pluriannual framework.
- Third, **transparent monitoring of the budget execution** by providing extended monthly information to the public on:
    - the budget execution of all general government bodies from a public accounts perspective and relevant financial information on all other bodies considered to be part of the general government from a national accounts perspective;
    - staff costs, disaggregated by wages and salaries, variable and contingent allowances, social security transfers, including not only the State but all subsectors;
    - the number of general government employees by subsector;
    - the collection of taxes, in particular gross revenue, reimbursements and amounts transferred to other subsectors.
- Finally, **revision of** the law on budgetary principles, as already announced.

In addition to ensuring strict implementation of the 2011 budget through stronger institutions, the draft Budget for 2011 must be an element within an effective and credible long-term strategy of public finance consolidation and fiscal discipline.

As it is known, I favour the creation of an institutional framework that guarantees an independent and transparent technical assessment of the immediate and lagged financial impact of political choices, given that such a framework tends to promote, on the one hand, a higher degree of accountability of political agents – due to the impact of their proposals on public finances – and, on the other, to increase the awareness of voters as regards the immediate or deferred costs of alternative political options. The issue is not to restrict the fiscal decision-making power incumbent upon parliaments, but to assess the financial impact stemming from exercising such power and, whenever there are ceilings based on political commitments, to clarify whether those commitments are being complied with.

In addition, this institutional framework, by promoting an independent assessment and also the transparency of the fiscal impact of political measures, strengthens the credibility of the fiscal policy for investors. Credibility will be higher if built upon a political consensus on the deficit or debt ceilings.

Therefore, it would be most helpful to reach a political consensus on a national strategy of fiscal discipline in the medium to long run, based on fiscal rules associated with enhanced control and correction mechanisms, involving pluriannual deficit, debt and expenditure ceilings.

However, to be credible and effective, a strategy of sustainable public finances based on setting short, medium and long-term fiscal goals implies an institutional reinforcement: the establishment of an independent agency – a "Fiscal Policy Council" –, whose specific responsibilities would include:

- Assessing the macroeconomic scenario underlying the annual budgets and the updates of the Stability and Growth Programme;
- Reviewing projections for tax revenue and public expenditure;
- Verifying compliance with the rules and targets set for the general government deficit, expenditure and debt;
- Assessing the sustainability of public finances in the medium to long run;
- Gauging the (immediate and lagged) fiscal impact of new measures/decisions and their consistency with (i) the targets set for the general government deficit, expenditure and debt, and (ii) the sustainability of public finances;
- Monitoring borrowing by the general government sector and public enterprises;
- Publishing evaluation results, in an open and transparent manner, thus facilitating an informed political debate and a responsible fiscal decision-making process.

All in all, the transition to an appropriate and demanding framework of fiscal discipline will depend on three additional factors:

- A stronger institutional framework governing the budget execution;
- A multi-annual political agreement that provides for ceilings on the general government deficit, debt and expenditure consistent with a sustainable path for government debt as a percentage of GDP; and
- An institutional reinforcement through the creation of a Fiscal Policy Council, i.e. a body with specialised technical expertise and independent status.

These three factors make a valuable contribution towards sustainable public finances and, as such, help restore investor confidence in the Portuguese sovereign debt. They are also crucial to the rebound in economic growth and job creation. Furthermore, such factors are indispensable for successful participation in the euro area and Portugal's constructive contribution to the European integration process. Indeed, these are the key aspects of the proposal submitted by the Task Force chaired by Herman van Rompuy to the European Council, at the meeting held on 28 and 29 October 2010. This proposal, aimed at strengthening economic governance in the EU – particularly in the euro area – and the Stability and Growth Pact, was endorsed by the European Council.

In the context of the new economic governance model of the European Union:

- fiscal discipline and, particularly, the sustainability of public finances are key for ensuring successful participation in the Economic and Monetary Union and sustainable growth;
- national institutions are the cornerstone of fiscal discipline, given that fiscal policy is a national responsibility; and
- the effectiveness of national fiscal discipline depends on the degree of social consensus achieved as regards its importance as a cornerstone for euro area membership and for sustained growth.

In order to lay the foundations for a social consensus on fiscal discipline and to enhance at the internal level the fiscal scrutiny that will take place at European level, within the framework of the so-called European Semester, the Van Rompuy Task Force has recently deemed that it would be advisable for Member States to establish an independent fiscal agency to produce independent analyses and forecasts for the relevant fiscal variables.

Strengthening the institutional framework for the execution of the budget and ensuring the sustainability of public finances are thus essential to give credibility to the financial strategy of the State in international debt markets, as well as for the State to comply with its obligations arising from participation in the process of European integration in general and in the euro area in particular. Above all, they are vital to ensure sustained economic and employment growth.

I started by drawing your attention to the need to analyse the State Budget for 2011 from a long-term perspective. The success of the fiscal consolidation strategy is instrumental in ensuring sustained growth and hinges, in turn, on structural policies to foster potential growth. The complexity of this interaction may be a topic for debate in future editions of this Conference.

I am confident that the Portuguese political institutions will be able to achieve a broad political and social consensus regarding the urgent need for sustainable public finances. It therefore seems legitimate to think that the approval of the State Budget for 2011 may be the starting point of an in-depth revision of fiscal rules and procedures and for changes in political practices underpinning the long run sustainability of public finances.

15 November 2010

Carlos da Silva Costa