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Address by the Governor of Banco de Portugal, Carlos Silva Costa, at the SEDES conference cycle, 'Thinking Portugal'

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"What Macroeconomic Policy Should Follow the Programme?"

I. Introduction

I would like to start by thanking SEDES for inviting me to open this cycle of conferences on the topic 'Thinking Portugal'. This topic is particularly opportune – I would even say urgent – given that we are about one year and three months from the end of the Economic and Financial Assistance Programme, and, as a result, on the verge of a new phase in our collective lives.

On the one hand, the end of the Programme heralds the return of our independence in defining economic and social policy. But on the other hand it means the end of financing from our international partners and the resulting need for financing from the markets. In other words, it means that we will no longer be protected from the volatility of the capital markets and the disruptions originating there that affect the economy. Thus it is essential that we start considering the conditions for leaving the Programme prudently and sufficiently early, so that the sacrifices are justified and the continuation and sustainability of the adjustment are assured.

In reflecting on the post-programme period, questions arise such as: What are the implications of leaving the Programme? How do we ensure the exit is successful? What will the next stage be like? What will the 'new normal' be?

These issues relate to two time periods that should be distinguished.

In the initial transitional period, which begins in June 2014, we will have to continue the adjustment, but with the addition of a transition to full financing in the financial markets. The next period will correspond to a normal market access situation.

The first part of my address will focus on the transition period. The second part will be dedicated to the phase in which financing is fully provided by the capital markets. I call that period the 'new normal'.

2. How do we ensure the exit from the adjustment programme is successful?

The Economic and Financial Assistance Programme to Portugal (EFAP) was key to avoiding an abrupt adjustment in the Portuguese economy, at a time when we no longer had access to market financing. However, a Programme of this kind will always have to be seen as an exceptional situation. On the one hand it involves the loss of our independence in setting and deciding on economic and social policy at national level, and on the other hand, it restricts our influence on the policy debate at international level. Put another way, the country's position is 'diminished'. Thus the best outcome is a successful conclusion to the current Programme. This will be excellent news for the country.

However, the macroeconomic imbalances accumulated in the Portuguese economy will not be completely corrected by the end of the Programme, nor will our credibility in the marketplace.

Indeed, once the Programme finishes, according to the new budget deficit and public debt limits agreed in the 7th EFAP evaluation:

- The budget deficit has to be 4.0% in 2014; only in 2015 does it have to be lower than 3% of GDP (2.5% of GDP);
- The debt ratio is expected to reach a maximum of 124% in 2014 and to shrink gradually, falling only slightly below 120% in 2016.

Thus at the end of the Programme we will still have very high levels of indebtedness and, in the case of public debt, it will still be rising. Without official financing, we will have to find financing for the deficits and refinancing for the debt in the financial markets. For this we must build the markets' confidence in our economy during that period.

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International investors have shown increasing confidence in the Portuguese economy, a trend that will continue into the future. However, this does not preclude the possibility of excessive volatility arising in the financial markets, that may drive away investors in the Portuguese debt market, jeopardising the ongoing economic adjustment process. We should be aware that in the near future the financial markets will remain particularly sensitive to any deviation from expectations in economic, social and political developments, both in Portugal and in Europe.

Given this fragile situation, the question that arises is:

How can we ensure a successful exit from the Assistance Programme?

First of all, we must remember that our credibility will depend on the assessment of our policies, in particular the sustainability of public debt and external indebtedness. This means that we have to follow a credible fiscal policy, based on financial discipline in the public sector, which enables strengthened competitiveness and balanced external accounts. However, as I have maintained in other addresses, resolute political action is not enough to ensure the success of the adjustment in Portugal.[1] The European context has to support the credibility of the adjustment of each euro area economy, namely by limiting the systemic risk factors.

During the transition period, we cannot preclude the possibility of excessive volatility in the market. Thus it is vital that there are mechanisms for intervening in the primary and secondary public debt market to address contingent situations and prevent investors from fleeing from the Portuguese economy. In my view, the credibility of our macroeconomic policies and adjustment must be bolstered by putting in place the European mechanisms to intervene in the public debt market, which assumes the adoption of a Precautionary Programme as a corollary.

[1] See for example the article published in *Diário Económico* on 31/12/2012, "A importância do reforço da integração europeia para o sucesso do ajustamento português" ("The importance of strengthening European integration for the success of the Portuguese adjustment"), available here: http://www.bportugal.pt/en-US/OBancoeoEurosistema/IntervencoesPublicas/Pages/intervpub20121231.aspx.

A Precautionary Programme is a programme for monitoring policies and economic developments of a country with particular weaknesses. It is not a financial assistance programme. It may be seen as an insurance mechanism, with an associated reserve credit line, which may be used during temporary disruptions in market financing, caused by contagion effects from phenomena external to the Portuguese economy. For a country like Portugal, which is leaving a Financial Assistance Programme, a Precautionary Programme works as a tool to strengthen the credibility of the macroeconomic adjustment process during the period immediately following the end of the Programme. The restrictions it imposes are a prerequisite for the solidarity of our European partners and contribute to building market confidence in our economic policies.

In the case of Portugal, the Precautionary Programme's restrictions should be those flowing from the Fiscal Compact – which includes in particular the balanced-budget rule for the structural budget and the public debt ratio rule – but with enhanced vigilance. It would be a kind of 'Enhanced Fiscal Compact'. Naturally, the Precautionary Programme would absorb the new budget targets agreed in the 7th assessment for the years after 2013.

2. How can we ensure a virtuous balance in the Economic and Monetary Union in the medium term?

After the transitional phase, it is important to reflect on the conditions that might ensure sustainability in the Portuguese economy within the Economic and Monetary Union. In this regard, questions arise such as:

What will the return to normality be like? What conditions would end 'stop and go' cycles under Monetary Union?

Firstly, one must understand that the return to normality will not be a return to the past. There will be no scope for additional indebtedness. Indebtedness levels among the public sector, households and enterprises are excessive and will remain high for a long time. Conditions in the international financial markets will be substantially different from those of the run-up to the international financial crisis. There will certainly be greater scrutiny of the risk of financing operations, both in the public and the private sector. This means that in the 'new normal', complacency regarding high levels of debt is likely to be small and reducing indebtedness must be a priority.

Furthermore, in the European context, we have to adapt and respond to a new institutional architecture which deepens financial, fiscal and economic integration, from the outset applying a set of strengthened rules and mechanisms for economic policy discipline, supervision and coordination.

It is clear that the return to normality brings various challenges that are at least as demanding as those that we have faced so far. Finding a virtuous balance without 'stop and go' cycles depends on the way we respond to these challenges.

The response to these challenges requires a new paradigm in defining economic and social policy, as well as in the behaviour of economic agents. The new paradigm must be based on three vectors:

1. Fiscal policy based on rules that ensure medium-term sustainability;
2. An income distribution policy based on rules that ensure maintenance of economic competitiveness, i.e. based on effective productivity increases;
3. The development of an institutional framework that promotes investment in areas of greater added value, which allows growth potential to be realised and thereby accommodates the consumption and social protection aspirations inherent to the European social model.

Fiscal policy

The lasting consolidation of the public accounts is key to ensuring the Portuguese economy's sustained growth within the Economic and Monetary Union. In the 'new normal', fiscal policy in Portugal will have to respect the new European architecture in terms of budget rules and procedures, especially with regard to the Fiscal Compact. A balanced budget is imperative, defined as a structural deficit no higher than 0.5% of GDP. Furthermore, the public debt ratio must fall to 60% of GDP. By way of example, assuming full convergence in 20 years and growth of nominal GDP and the debt interest rate of around 4 per cent per year (in both cases), the reduction of the debt ratio from 120% of GDP to the benchmark value requires primary budget surpluses of around 2 per cent of GDP, per year, throughout the entire period. This would be an unprecedented budget consolidation effort in the Portuguese economy's recent history.

Past experience shows that having fiscal discipline rules is not enough to guarantee the desired outcome. It is also essential to ensure they are applied effectively.

Recent experience also reveals the importance of anchoring fiscal policy to goals that are largely controllable by those responsible for policy-setting. Goal-setting for balancing the budget or for public debt, expressed in per cent of GDP, does not fulfil this requirement, making it very difficult to assess and communicate progress made in budget consolidation and to hold policy-makers to account for the results achieved.

Indeed, less favourable macroeconomic performance than forecast at the start of the adjustment programme has had two effects: on the one hand, it has forced the adoption of tougher budget consolidation measures, which in the short term further intensify the unfavourable economic trend; on the other hand, it has led to the revision of the goals announced for balancing the budget and has accelerated the deterioration of the public debt ratio. This gives the impression that the policies have been a failure and encourages a lack of faith in the adjustment process.

At the end of 2012, the gross public debt ratio stood at around 11 p.p. above that forecast in the initial version of the Programme. Around 3 p.p. of this discrepancy is explained by the direct effect of worse-than-predicted nominal GDP (the so-called 'denominator effect') and more than 6 p.p. result from a set of operations with direct impact on public debt, which had a much stronger effect than predicted. These operations were mainly capitalisation operations in the banking sector (which have an offsetting increase to assets belonging to the State) and the correction of several past situations.

When macroeconomic performance is better than expected, the situation is the reverse: it is easier to meet budgetary goals and the growth 'bonus' tends to be used to increase public spending, thereby worsening fiscal sustainability, although not in an immediately obvious way.

Recognising the pro-cyclical nature of budget balance and/or public debt goals expressed in per cent of GDP is at the heart of the increasing emphasis on 'structural adjustment' measures. These form the basis of the new European architecture for budgetary supervision. However, these measures too are not without problems, since measuring them is complex and brings significant challenges in terms of transparency and communication with the public.

Given these arguments, I believe that in Portugal's case, fiscal discipline must be based on defining a viable and effective Multi-Annual Budgetary Framework. This instrument has been used successfully in many countries and is now part of the Portuguese fiscal architecture, following initial tests in 2011 (if in a very mild form).

The viability of that Framework must be supported by a so-called 'Regime Pact'; an agreement between the main political forces which clearly defines the undeniable restrictions binding the party(ies) in government. For the reasons I have mentioned, this agreement must also set out rules for distributing any economic growth bonuses that might occur, as well as rules for reducing public debt and taxes. The viability of the Multi-Annual Budgetary Framework also depends on credible macroeconomic assumptions and the ability to assess the effects of the policy decisions on the public finances over time; in other words, technical soundness is also a key ingredient for a Multi-Annual Budgetary Framework. The Netherlands has an interesting institutional cooperation model, in which the political parties submit their multi-annual proposals to an inter-temporal consistency test from an independent and credible institution (the Central Planning Bureau).

I stress the importance in this regard of creating the Public Finance Council, an independent body tasked with assessing the public finances' coherence, compliance with set objectives and sustainability, from a financial-year and a multi-annual perspective, promoting their transparency and public scrutiny. It is very important that the Public Finance Council is given the technical means to allow it to carry out its tasks effectively.

In turn, the effectiveness of the Multi-Annual Budgetary Framework must be supported by binding limits on nominal public expenditure in the medium term. These limits must be respected in the State's annual budget proposals, and may only be exceeded in very exceptional circumstances. Anchoring budgetary strategy for public expenditure on multi-annual strategies has the advantage of addressing the main source of indiscipline in the public accounts that has plagued Portugal for decades. In addition, the approach makes intertemporal budget limitation more visible, both for politicians and for the public.

However, ensuring the political process creates State budgets compatible with pre-agreed multi-annual spending limits is not enough. Effectiveness also depends on the enforceability of the limits established, through control mechanisms and by holding public entities to account over strict compliance with the approved budgets for example.

Income distribution policy

It is now clear that accumulating successive competitiveness losses while at the same time preserving or improving the standard of living in a country in a lasting way is impossible. This means that the competitiveness of the economy must always be safeguarded in the natural debate over distribution of productivity gains – between capital and labour – as part of the social processes of income distribution. This safeguarding must be based on a 'Social Pact' established between the social partners that credibly defines the conditions governing the distribution of income over time.

Investment in areas of greater value-added and increasing the economy's growth potential

But perhaps the greatest challenge we face is making Portugal a more productive country that can create jobs sustainably. Today there is no doubt that sustained growth involves greater balance in the allocation of resources between tradables and nontradables. In Portugal, growth potential based on increasing exports is very high. In fact, when we look at its relative size, the Portuguese economy has a low degree of openness. However, achieving this growth depends on the behaviours adopted by the economic actors.

The chief protagonist in this transformation is necessarily the private sector. It is up to private initiative to identify the best business opportunities and to scrutinise the investment projects carefully. The public sector is expected to provide favourable conditions for these projects to be carried out.

This means that primarily the State must provide macroeconomic stability, namely sustainability in the public finances and stability and soundness in the financial system. In parallel, it must promote an institutional framework that favours quality investment, both Portuguese and foreign, increases the efficiency of the manufacturing base and facilitates the reallocation of the resources to the most productive industries. In this regard, the simplicity and stability of the tax system, the transparency of the judicial system (meaning low levels of corruption and protection of property rights), the effectiveness of the justice system and of competition policy and the efficiency of the labour market institutions take on particular importance. Recent economic research indicates that an improvement of Portugal's institutional performance towards best practice in Europe would have a substantial estimated effect, of around 60 per cent growth in Foreign Direct Investment.[2]

But maintaining competitiveness in the context of globalisation also requires a constant drive for innovation. The scientific and technological paradigms become obsolete rapidly and companies have to adapt to constant flux in order to survive and grow. This change must not only involve restructuring but also launching research and development activities that lead to new processes, products and services, and to the opening of new markets. Although in the existing large enterprises most innovation is

[2] Júlio, P., Alves, Ricardo and J. Tavares, "Investimento estrangeiro e reforma institucional: Portugal no contexto europeu" (Foreign investment and institutional reform: Portugal in the European context), Economic Bulletin of Banco de Portugal, Spring 2013 (ready for publication).

incremental – through new models and processes – the small and medium-sized enterprises and the start-ups will have to develop radical innovation – new products and new technologies – in order to remain relevant in their respective areas, access new markets and create more and new jobs. Indeed, radical innovation has the potential to change enterprises' business opportunities radically, with growing evidence supporting the importance of this kind of innovation in enterprises' long-term success.

Thus, an environment must also be created that favours investment in research and development and the implementation of innovative projects. This requires dynamic and efficient financial markets, for example, that provide suitable alternative sources of financing, so that the innovative enterprises and start-ups can find funding, invest, innovate and grow. This need is particularly relevant for new enterprises and small and medium-sized enterprises, which are the main vehicle of radical innovation. From a more general viewpoint, a framework of rules and values must be put into practice that align with the interests of the innovators.

In the first decade of the 21st century, the Portuguese economy benefited from significant funding, both through European Union transfers (whose sums reached an average of 3% of GDP per year between 1995 and 2012, which equates to over 50% of GDP on a cumulative basis) and through direct and intermediated access to external saving. However, these funds were largely channelled to consumption and non-productive investment. We have to ensure that this 'returnless investment model' does not repeat itself in the future.

The relative scarcity of financing that we still face has made it more important for us to increase domestic saving and prioritise investment according to respective return in terms of potential output growth. The new European Multiannual Financial Framework for 2014-2020 constitutes an even more important instrument, in the current circumstances, for promoting the sustained development that will allow the financing restrictions we face today to be lifted in the short term. Here too we have to learn from past mistakes and invest in a model for allocating and managing the EU funds based on criteria of economic rationality.

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4. Conclusion

To summarise, the end of the period covered by the Economic and Financial Assistance Programme is approaching. The end of the Programme is an important waypoint on our adjustment process. However, our adjustment will not be complete at the end of the Programme. The sacrifices we have already made and the challenges we have ahead require a timely and careful reflection on the conditions for leaving the Programme successfully.

Allow me to end with a naval analogy on this period. The Assistance Programme has been like a period in which the ship PORTUGAL had to seek shelter in the dock of the Tagus. The challenge now is to set sail for the high sea. At the start of the journey we will need to help the navigators. Thereafter we cannot commit the same navigation mistakes that forced us into port. Thus we have to adopt a sustainable economic policy.