

# Portuguese Economy Recent Developments and Challenges Ahead



**Carlos da Silva Costa**

**Handouts**



*Banco de Portugal*

EUROSISTEMA



## Outline

- I. The build-up of the crisis
- II. The Economic Adjustment Programme
- III. Challenges ahead

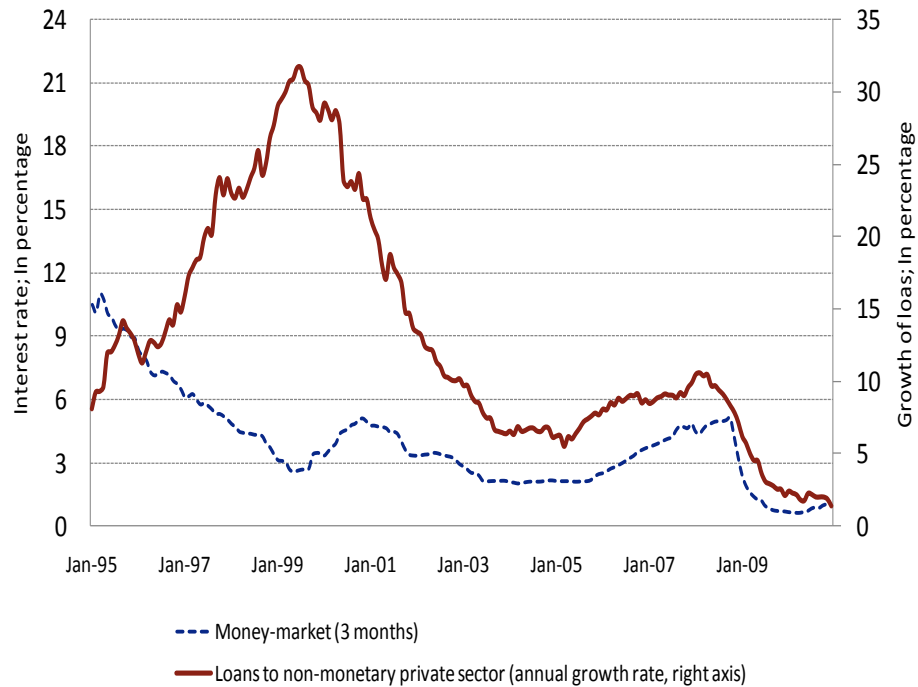


# I. The build-up of the crisis

# I. The build-up of the crisis

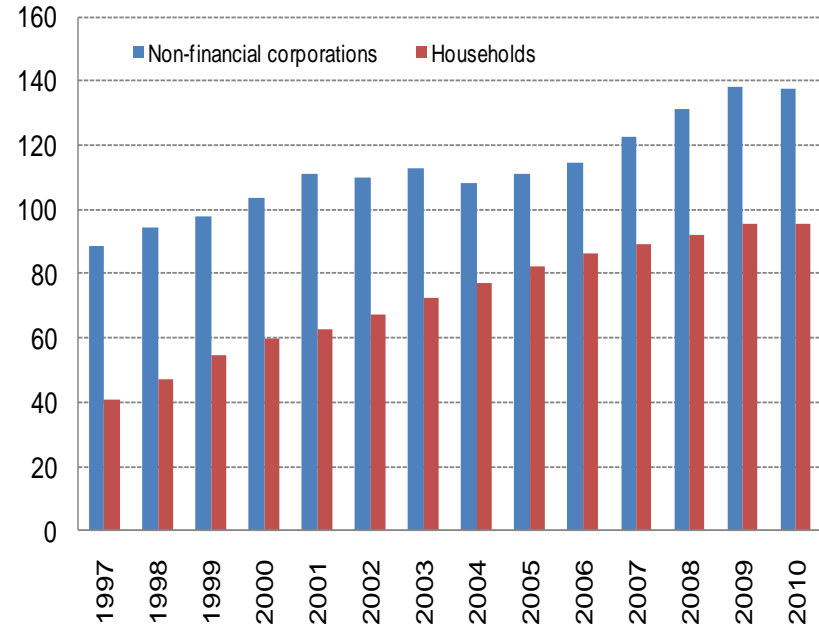
***EMU enlarged the financing possibilities of domestic agents ...***

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



Sources: ECB and Banco de Portugal.

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



Sources: INE (Statistics Portugal) and Banco de Portugal.

# I. The build-up of the crisis

## *Unfavourable composition of expenditure ...*

### Portugal - Composition of Expenditure (current prices)

(average rate of nominal growth)

	GDP	Private consumption	Public consumption	GFCF	Exports	Imports	<i>p.m. EA12</i> <i>GDP</i>
1996-2010	4,7	4,8	6,1	3,5	5,8	5,8	3,3
1999-2010	3,9	4,3	5,5	1,0	5,0	4,4	3,3
1996-2001	7,3	6,8	9,1	10,3	8,0	9,7	4,1
2002-2007	4,0	4,5	4,5	0,7	6,4	4,9	4,1
2008-2010	0,7	1,4	3,3	-4,3	0,1	-0,2	0,5

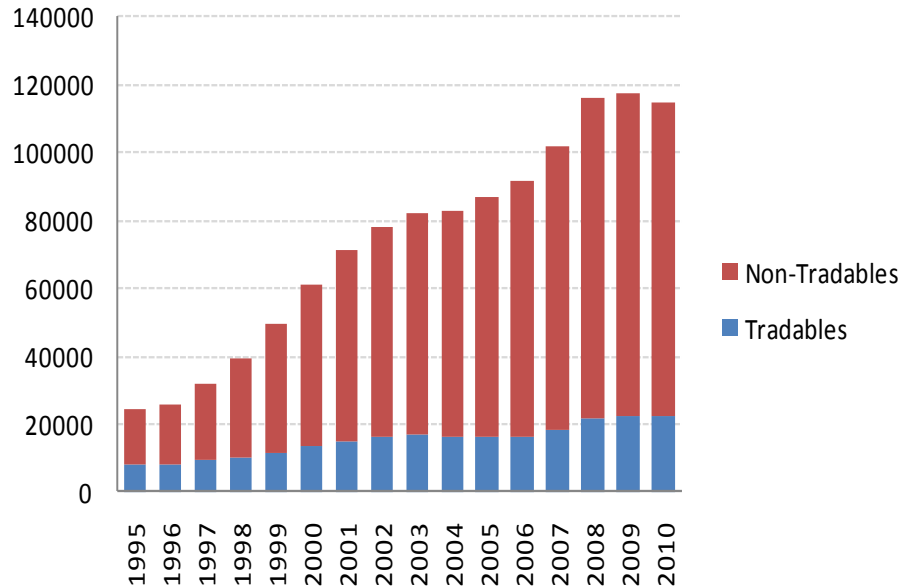
Source: INE and AMECO.

# I. The build-up of the crisis

**Capital flows were mis-allocated, leading to the expansion of non-tradable sectors ....**

## Loans to Non-Financial Corporations

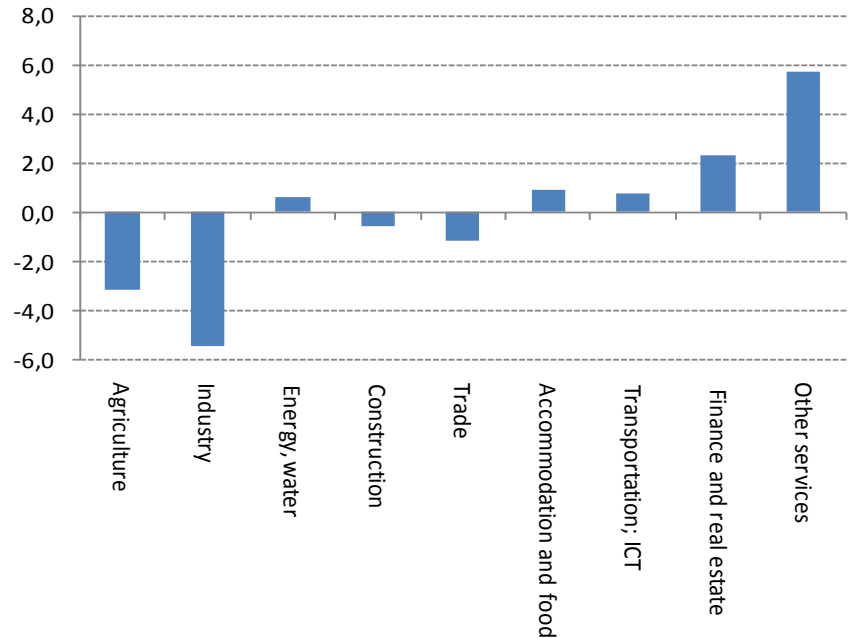
Million euro



Source: Banco de Portugal

## Weight in GVA

2010-1995; Change in p.p.

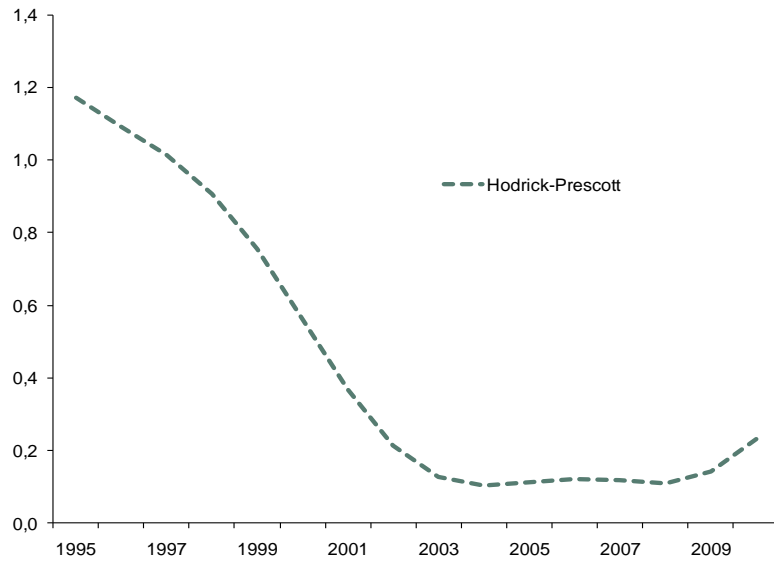


Source: Banco de Portugal

# I. The build-up of the crisis

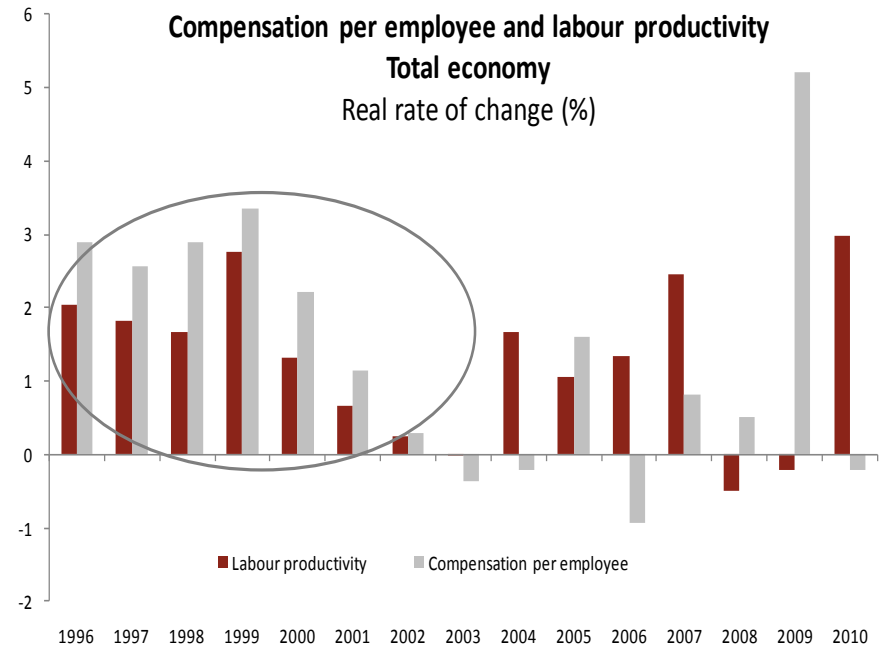
**Mis-allocation of capital led to a fall in productivity growth ... and the wage policy did not take into account productivity growth**

Trend TFP growth



Source: Banco de Portugal.

Compensation per employee and labour productivity  
Total economy  
Real rate of change (%)

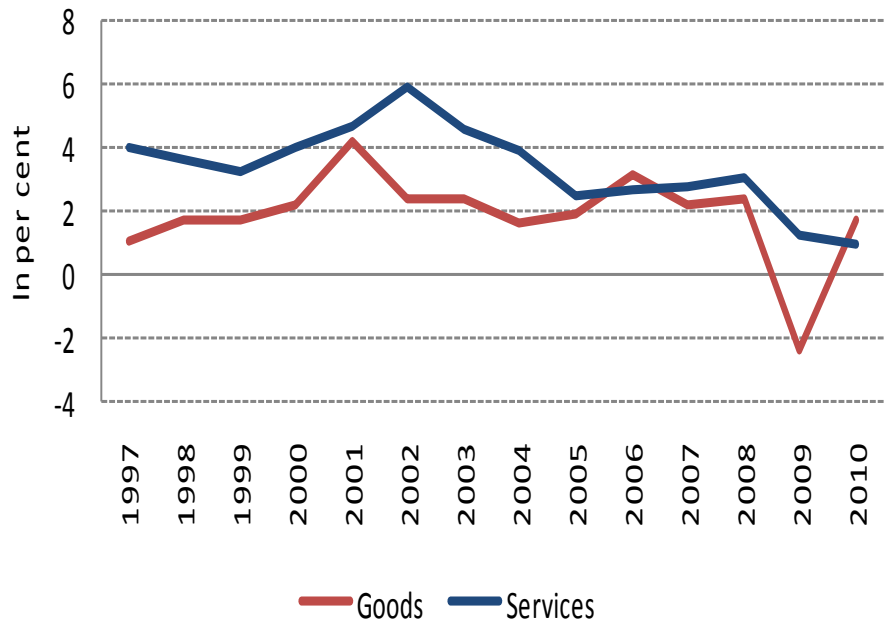


Sources: INE and Banco de Portugal.

# I. The build-up of the crisis

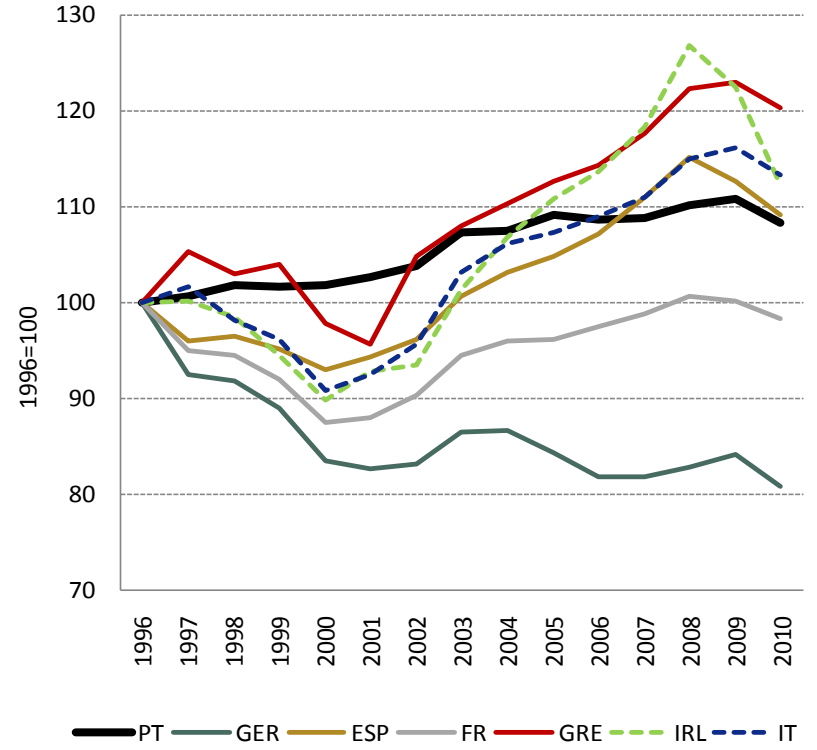
## Lower productivity and wage pressures hurt competitiveness

**Consumer Prices**  
average rate of change



Source: INE

**Real Effective Exchange Rate**  
(Deflated by Relative Unit Labour Costs)



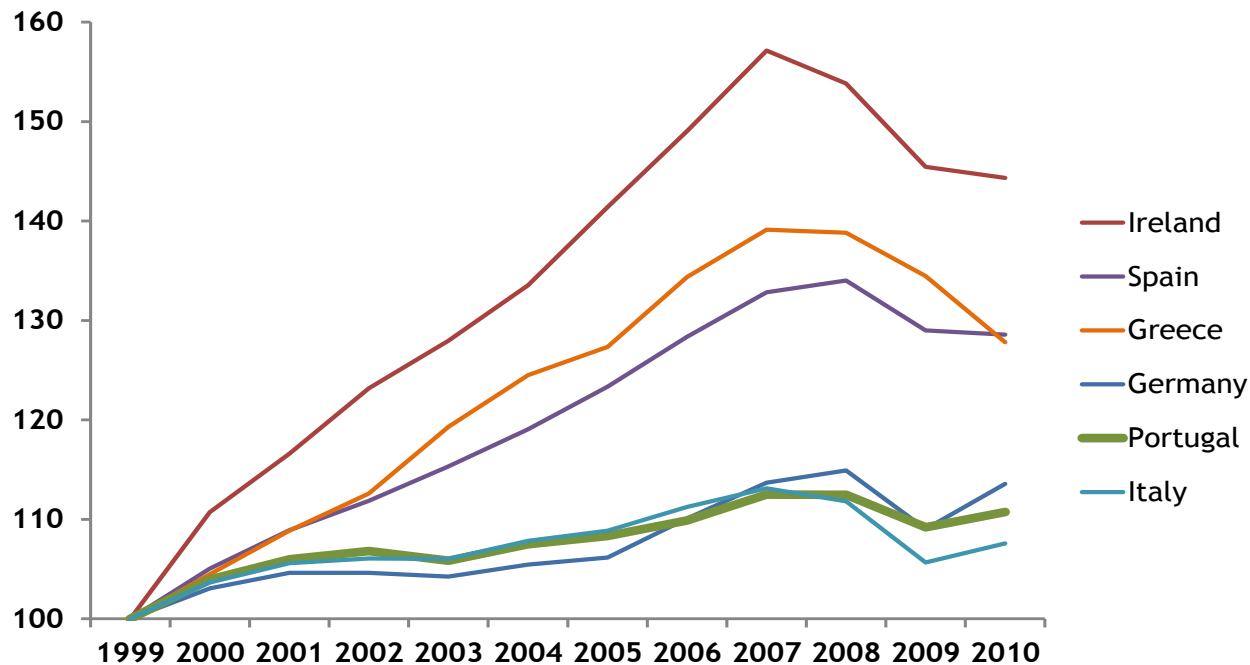
Source: ECB and Banco de Portugal



# I. The build-up of the crisis

***Thus, despite huge capital inflows, economic growth was very low***

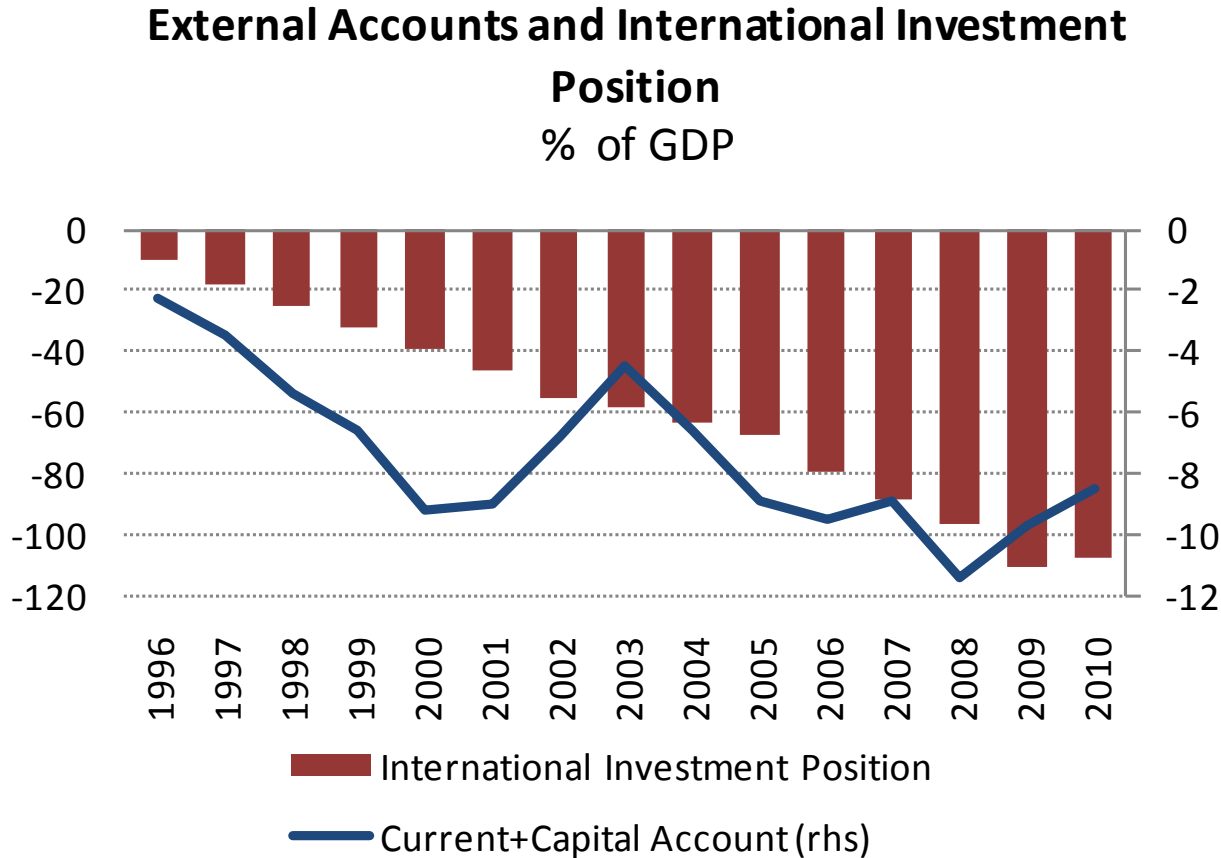
**Gross Domestic Product**  
1999 = 100



Source: AMECO

# I. The build-up of the crisis

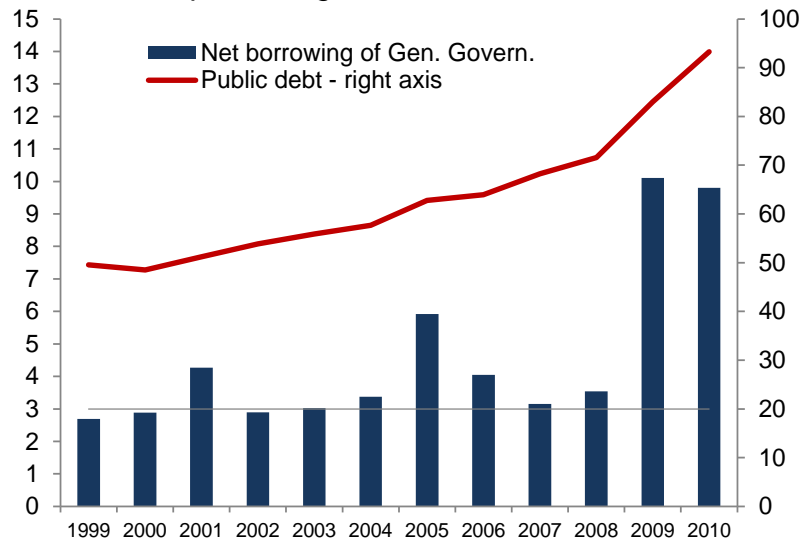
*Higher relative spending and lower relative output led to increasingly negative net foreign asset position...*



# I. The build-up of the crisis

## *Imprudent fiscal policies led to unsustainable public finances*

**Deficit and public debt**  
As a percentage of GDP



Source: Banco de Portugal

**Fiscal indicators 2007-2010**

% of GDP					Change 2010-2007
	2007	2008	2009	2010	
<b>Total balance</b>	-3,1	-3,6	-10,2	-9,8	-6,7
<b>Structural balance</b>	-4,3	-6,2	-11	-13,2	-8,9
<b>Structural primary balance</b>	-1,4	-3,2	-8,2	-10,3	-8,9
<b>Public debt</b>	68,3	71,6	83,1	93,3	25

Source: INE and Banco de Portugal.

### **Huge fiscal expansion in 2007-2010**

- Success in stabilising the economy was short-lived
- Not timely-targeted-temporary.
- Risk of refinancing underestimated

# I. The build-up of the crisis

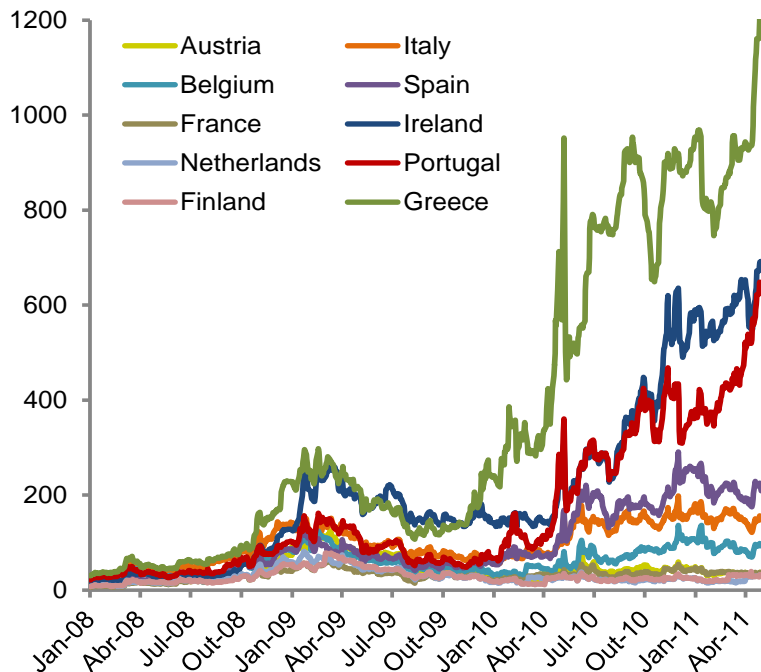
**Imbalances exposed in the context of the economic and financial crisis led to sudden deterioration of financing conditions**

**Unsustainable public finances**

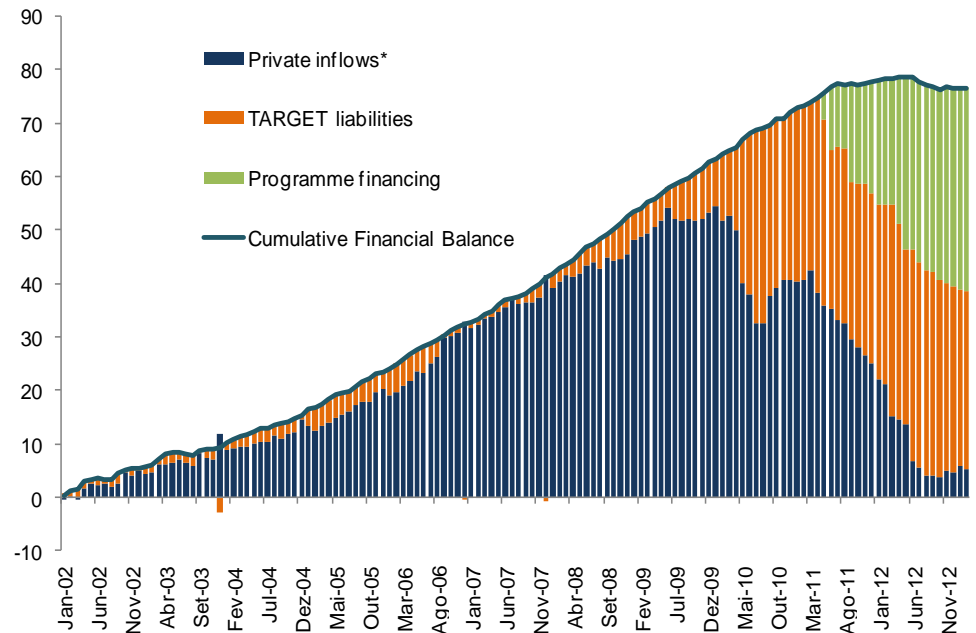
**Over-indebtedness and excessive bank leverage**

**Anemic economic growth and low productivity**

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



**Private capital flows, programme financing and Eurosystem financing**  
Percentage of 2007 GDP



\* Include other components not considered in the breakdown (mainly information pertaining to securities and other loans not obtained under the programme).

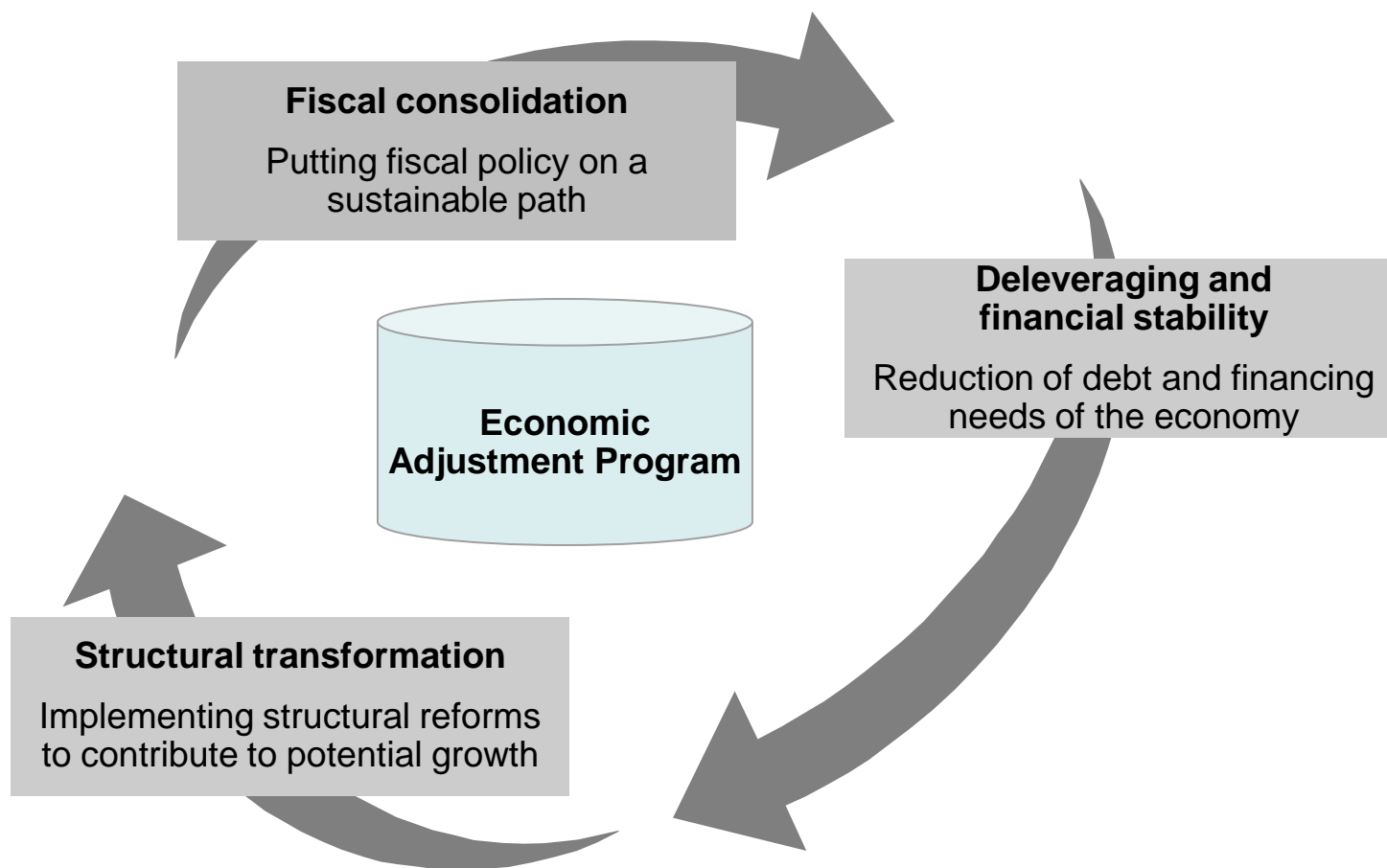
Sources : Banco de Portugal , Reuters



## **II. The Economic Adjustment Program**

## II. The Economic Adjustment Program

### *Addressing the challenges of the Portuguese economy*



**In April 2011:**  
Portugal requested for financial assistance

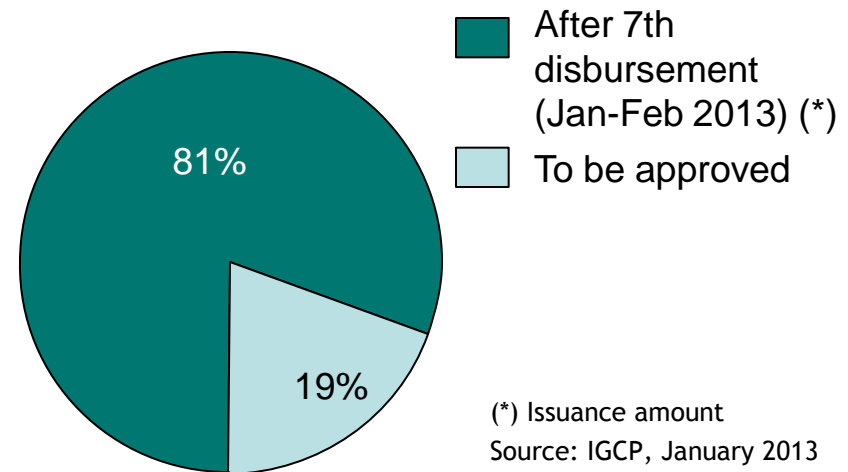
The Economic Adjustment Program protects Government financing from market pressures, allowing an orderly adjustment of imbalances and time to build up **confidence and credibility.**

## II. The Economic Adjustment Program

### *Seven regular reviews*

- The Economic Adjustment Program covers the financing needs of the General Government from 2011 to June 2014.
- It comprises a financial package amounting to EUR 78 billion in loans, including EUR 12 billion for a Bank Solvency Support Facility
- The implementation of the Program is assessed quarterly.

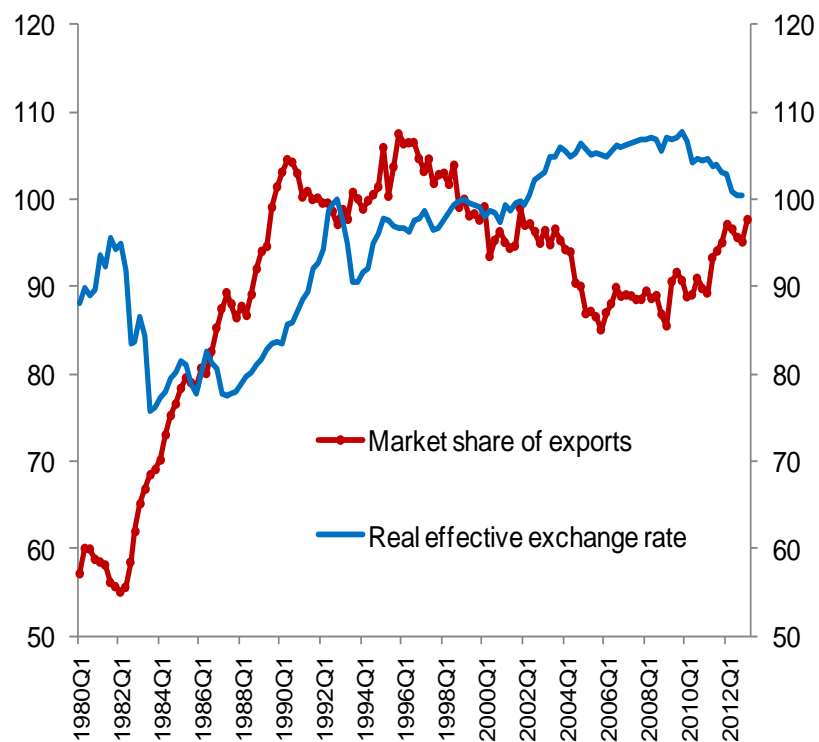
### Financial package



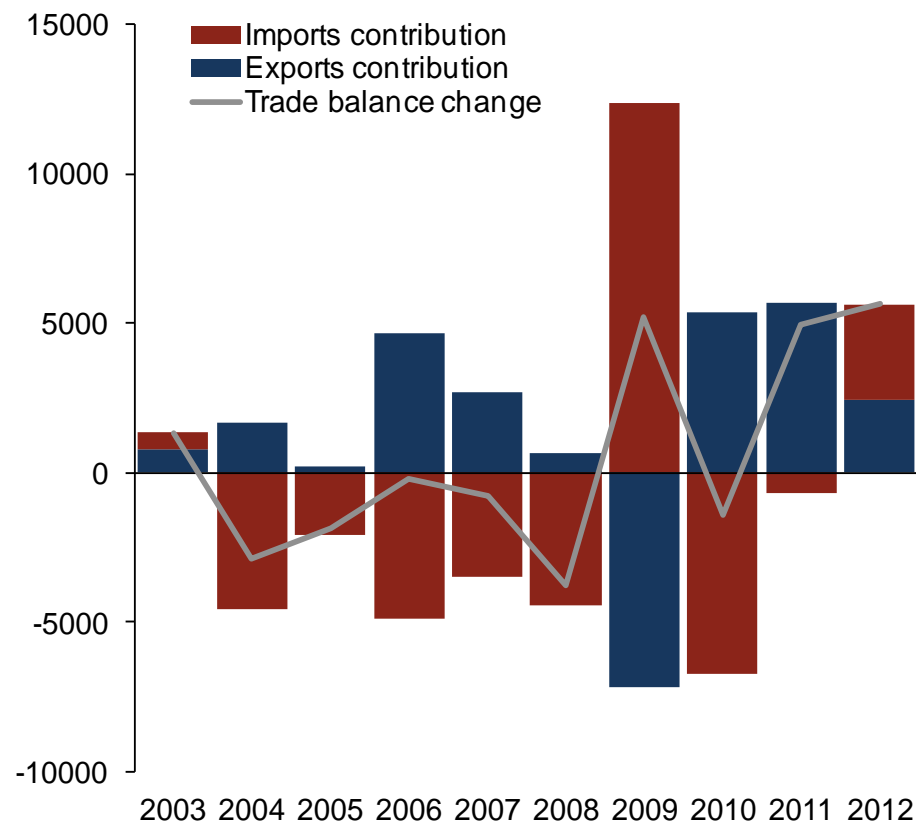
## II. The Economic Adjustment Program

### Strong export performance

Market share of exports and real effective exchange rate  
(Index 1991Q1=100)



Trade balance  
In Euro millions



Souces: AMECO, Banco de Portugal, INE

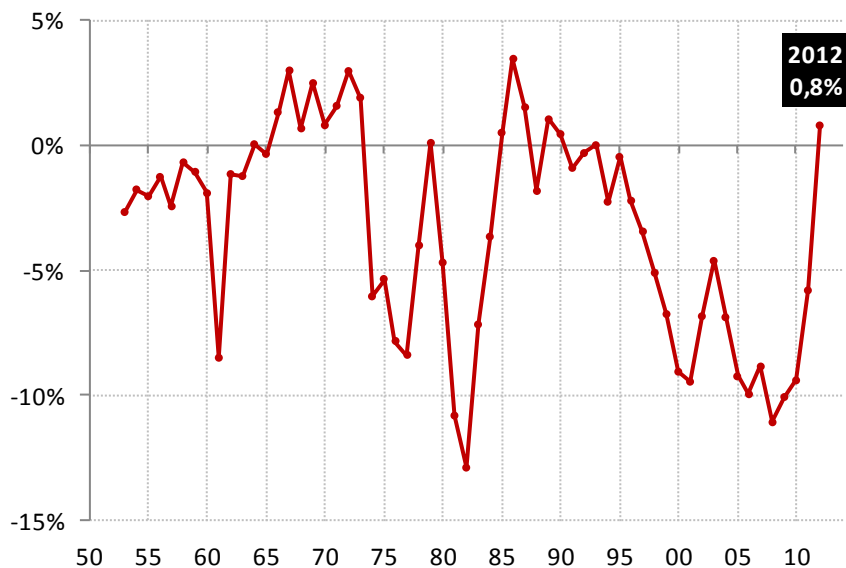


## II. The Economic Adjustment Program

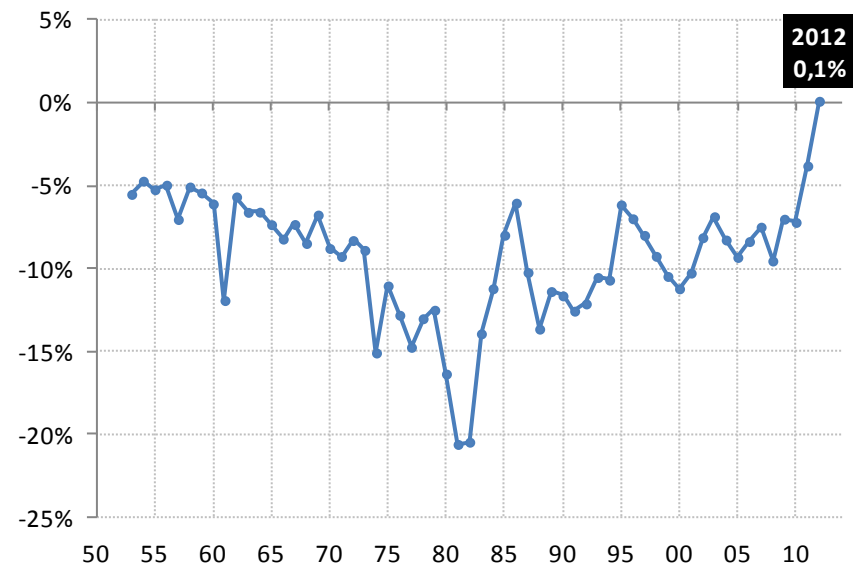
### *Fast correction of external imbalances*

*External balance of goods and services positive for the first time since 1953 (\*)*

**Current and capital account**  
% GDP, annual data



**External balance of goods and services**  
% GDP, annual data



(\*) 1953 is the earliest observation available  
Sources: Banco de Portugal, INE

## II. The Economic Adjustment Program

### *Significant Fiscal Adjustment in the period 2010-2012....*

#### MAIN FISCAL INDICATORS

In percentage of GDP

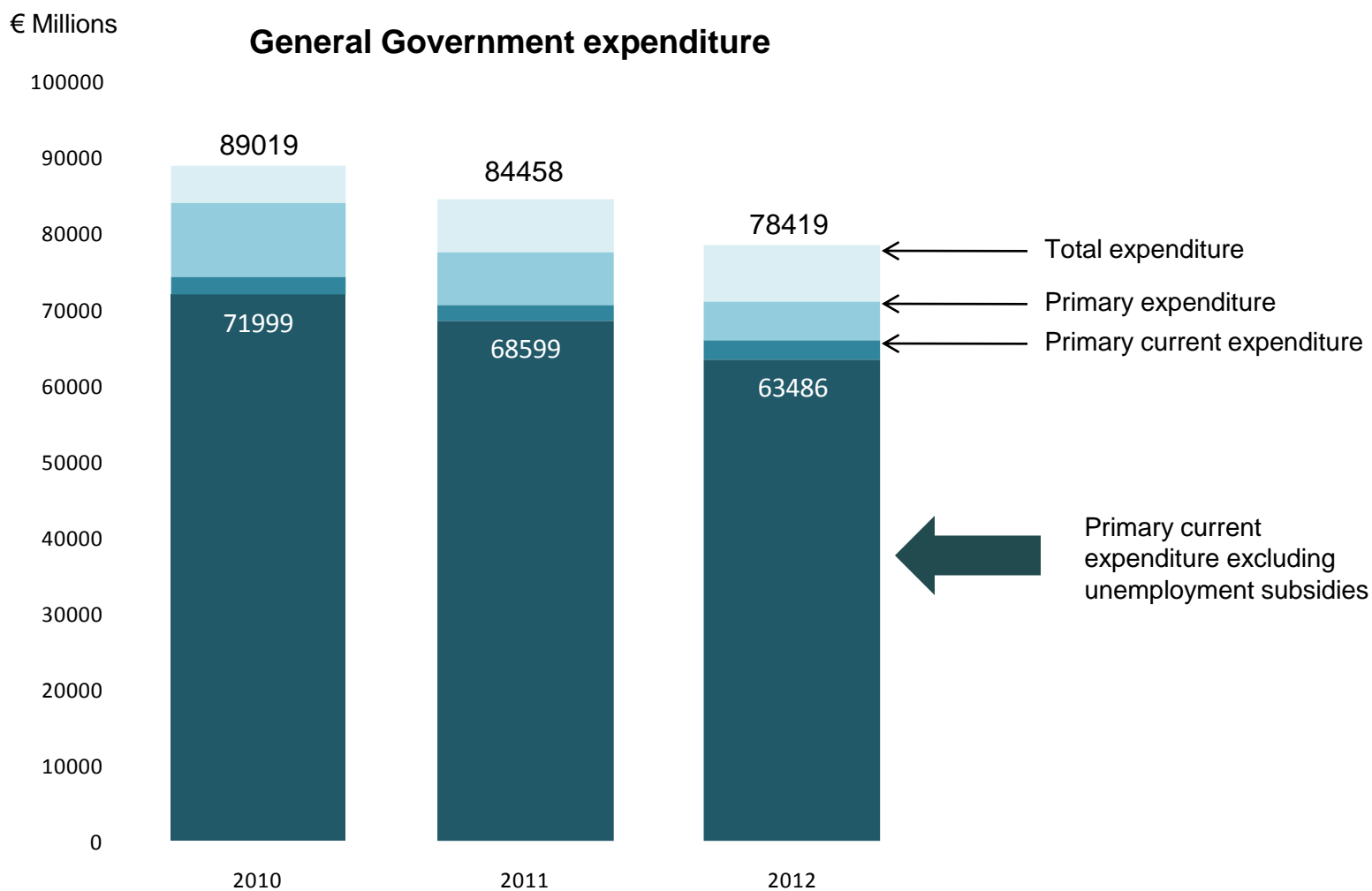
	2010	2011	2012	Change 2011-2012	Change 2010-2012
<b>Overall balance</b>	<b>-9,8</b>	<b>-4,4</b>	<b>-6,4</b>	<b>-2,0</b>	<b>3,4</b>
Temporary measures	1,7	3,9	0,6	-3,4	-1,2
Special factors <sup>(a)</sup>	-2,8	-1,2	-1,0	0,2	1,9
<b>Overall balance excluding temporary and special factors</b>	<b>-8,7</b>	<b>-7,1</b>	<b>-6,0</b>	<b>1,1</b>	<b>2,7</b>
Cyclical component	1,7	0,8	-1,1	-2,0	-2,8
<b>Structural balance excluding special factors<sup>(b)</sup></b>	<b>-10,4</b>	<b>-8,0</b>	<b>-4,9</b>	<b>3,1</b>	<b>5,6</b>
Interest expenditure	2,8	4,1	4,4	0,3	1,6
<b>Structural primary balance excluding special factors</b>	<b>-7,6</b>	<b>-3,9</b>	<b>-0,5</b>	<b>3,4</b>	<b>7,2</b>
<b>Public debt</b>	<b>94,0</b>	<b>108,3</b>	<b>123,6</b>	<b>15,3</b>	<b>29,6</b>
Change in public debt (in p.p.)	10,3	14,3	15,3	-	-
Primary balance effect	7,0	0,4	2,0	-	-
Interest expenditure effect - Impact of economic growth	0,7	5,0	8,1	-	-
Deficit-debt adjustments	2,6	8,9	5,2	-	-

(a) Special factors are considered to be transactions that have an one-off effect on the general government deficit but that cannot be treated as temporary measures in conformity with the Eurosystem definition. (b) Structural values are adjusted for the impact of the economic cycle and temporary measures. The cyclical component and temporary measures are computed by Banco de Portugal according to the methodologies adopted by the Eurosystem.

Sources: Banco de Portugal, INE

## II. The Economic Adjustment Program

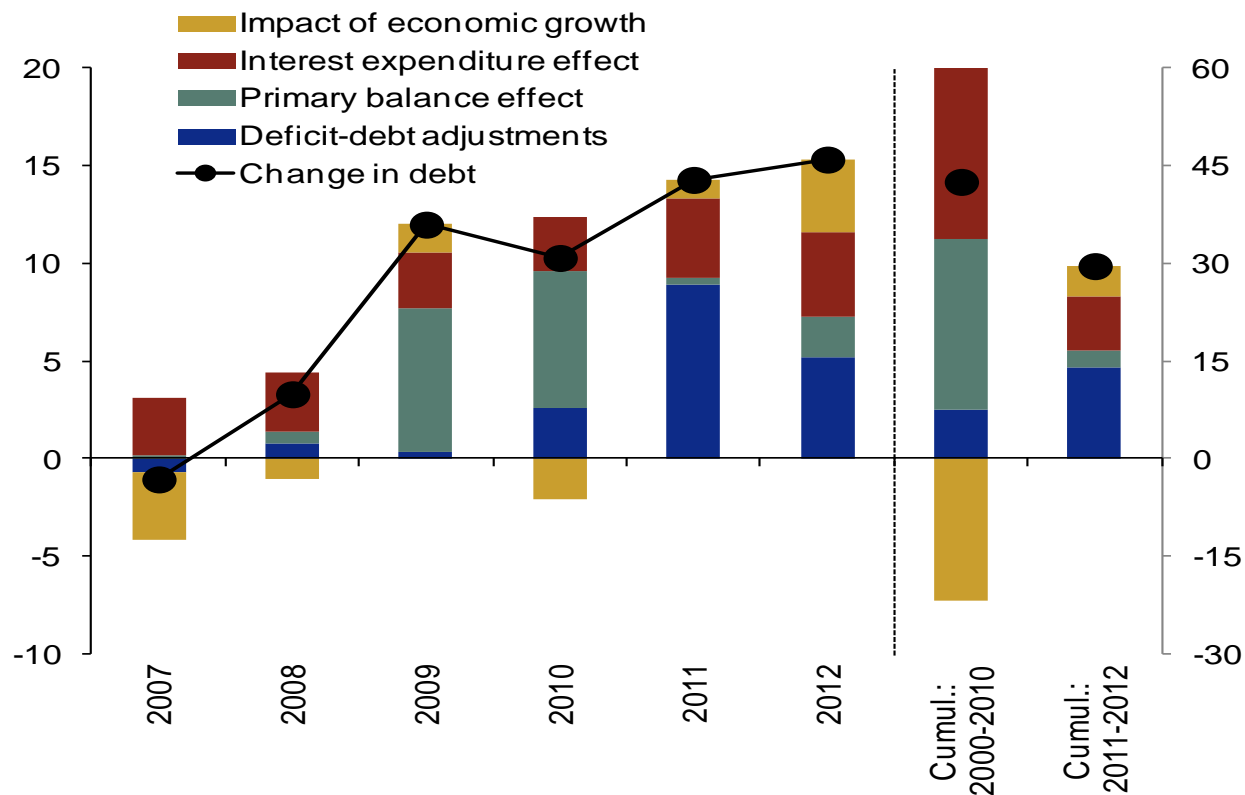
.... based on a significant reduction of public expenditure



## II. The Economic Adjustment Program

***Increase in public debt ratio in 2011-2012 reflects significant deficit-debt adjustments***

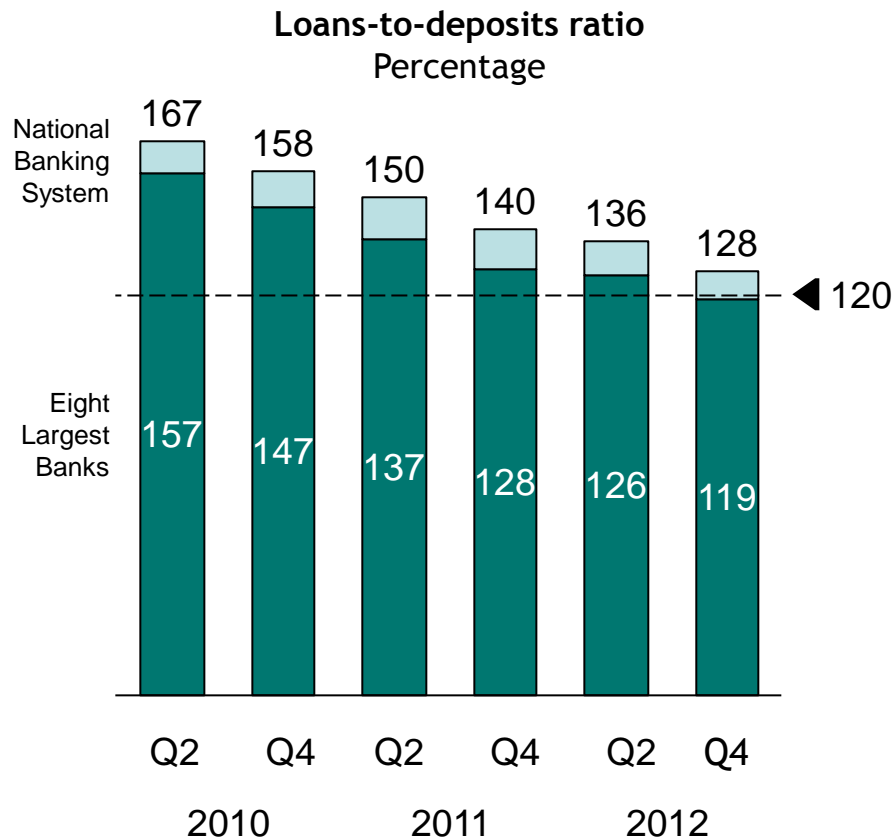
**Breakdown of the change in the public debt ratio**  
Percentage points of nominal GDP



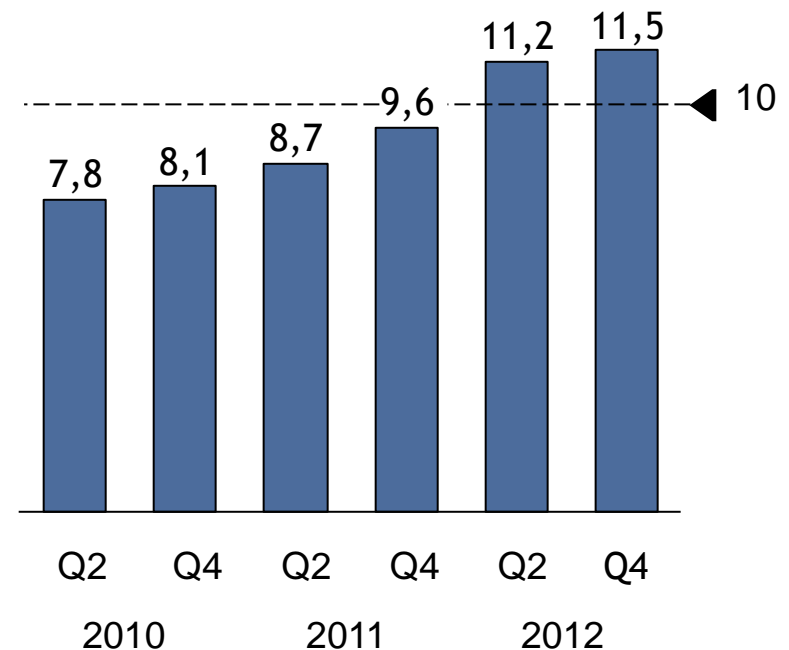
## II. The Economic Adjustment Program

### *Increasingly stable banking system*

- Reinforcement of capital
- Convergence to a more sustainable funding structure in the medium term



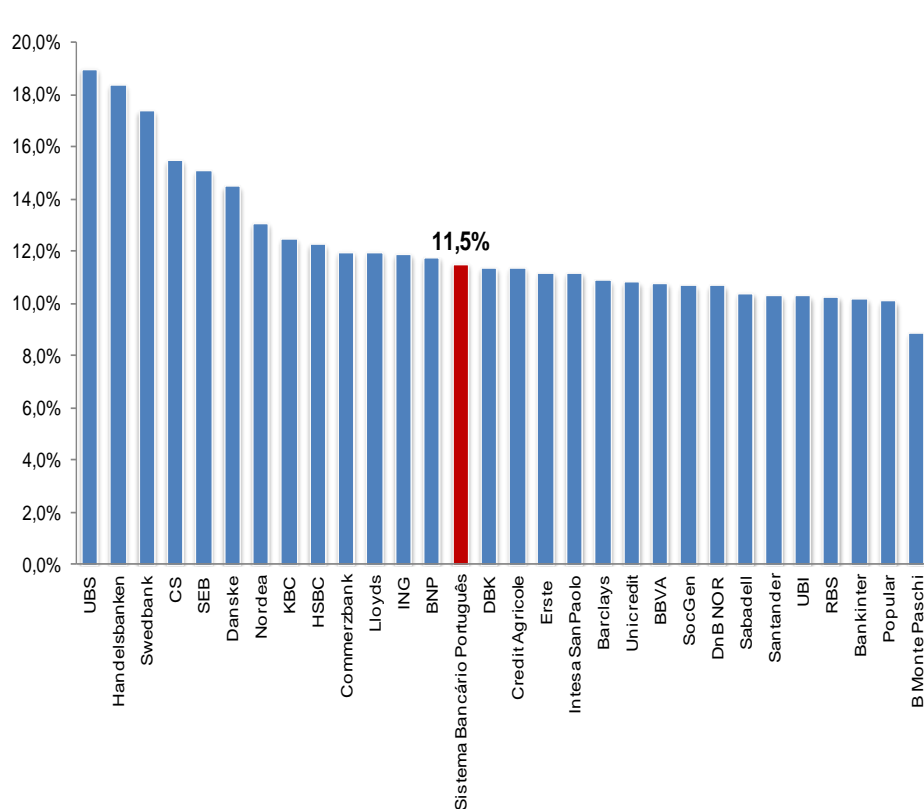
**Core Tier 1 Ratio, Portuguese Banking System**  
Percentage



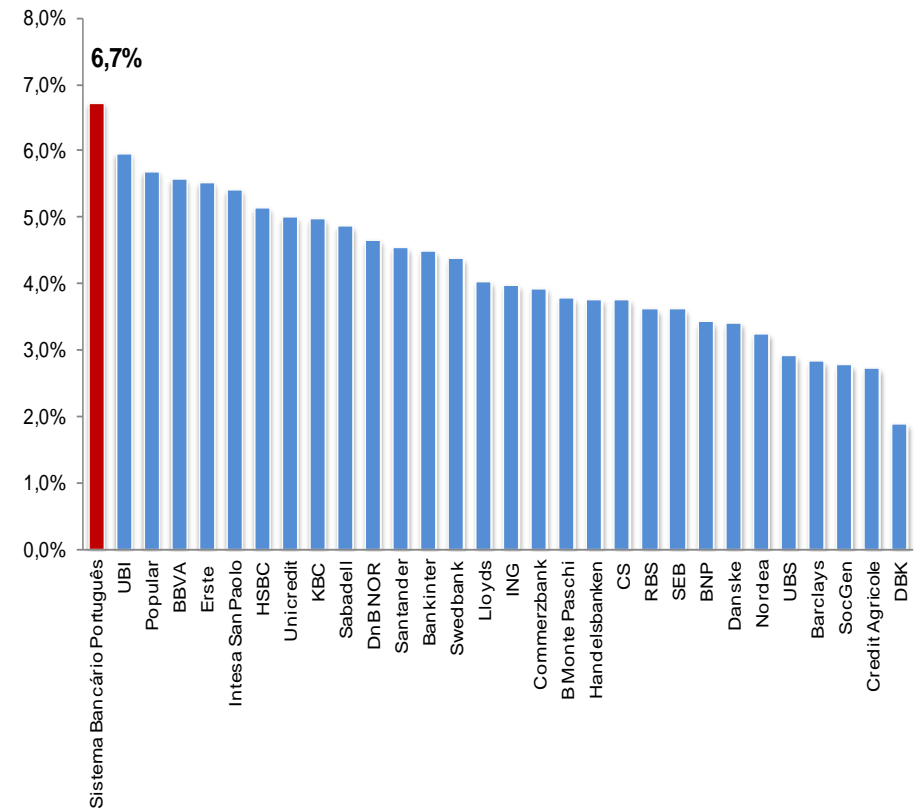
## II. The Economic Adjustment Program

**Portuguese banking system Core Tier 1 ratio compares relatively favourable with other European banking institutions**

**Core Tier 1 ratio**

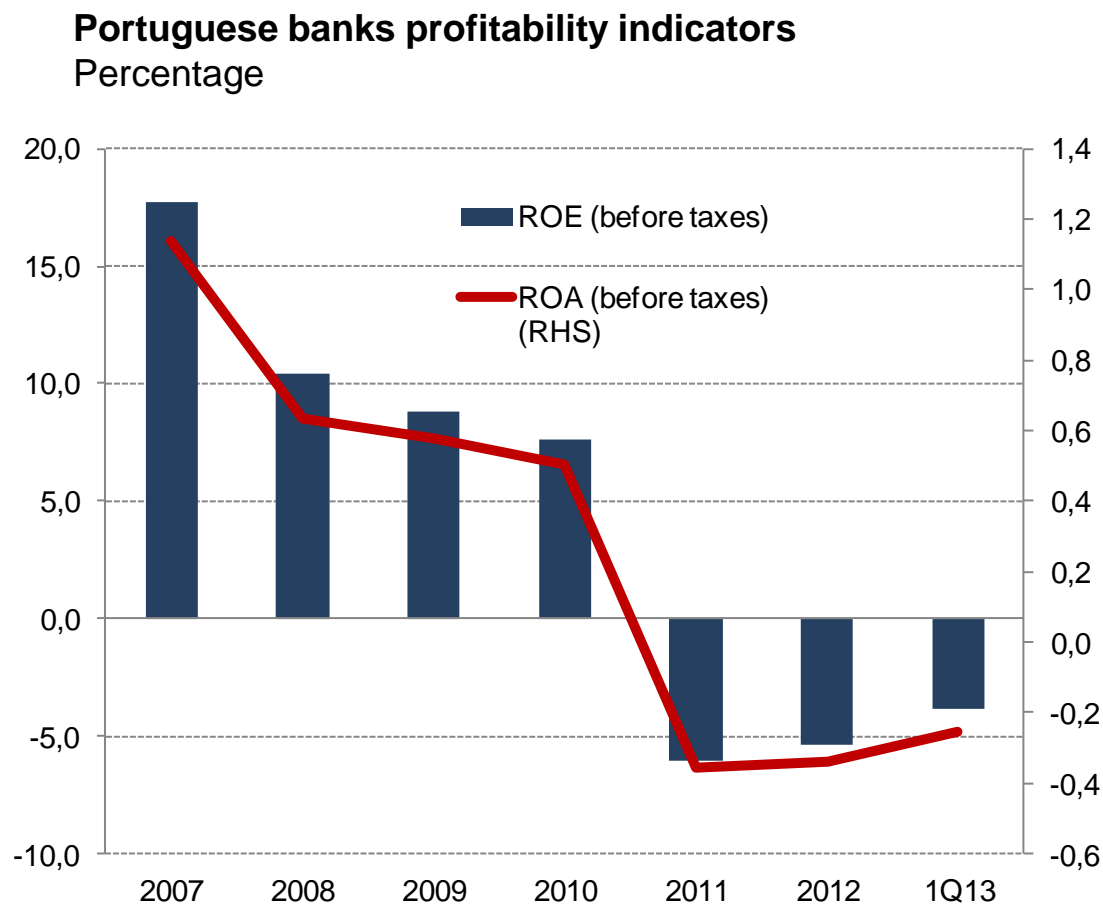


**Core Tier 1 capital vis-a-vis total assets**



## II. The Economic Adjustment Program

***Banks' profitability has been affected by adverse macroeconomic conditions and deleveraging***





## II. The Economic Adjustment Program

### *Wide range of structural reforms were implemented*

#### Examples

#### Labor Market

- Increase in **working days**: up to 7 additional (3 vacation + 4 holidays)
- Reduction of restrictions to **individual dismissal**: based on performance
- Restrictions on **automatic extension of collective agreements**
- Reduction of **severance payments to align with EU average** (from 30 days to 12 days per year worked for new permanent contracts; for remaining contracts 18 days per year of service in the first 3 years of the contract and 12 days for subsequent years)
- **Unemployment subsidy** entitlement period reduced from a maximum of 38 months to 26 months

#### Product Market

- Approval of measures aiming at **reducing the costs with energy** (partly eliminating the excessive profits in this sector)
- Improve **rental market legislation** (set transition periods for the convergence of rents and negotiation mechanisms between landlords and tenants)
- Liberalization of the **energy and gas market**

#### Judicial system

- Adoption of a **law on arbitration** to facilitate out-of-court settlement
- Approval of **new Code of Civil Procedure**, submitted to Parliament
- Adoption of a new **Judiciary Map**, submitted to Parliament
- Reduction of the **backlogged cases**

#### Business environment

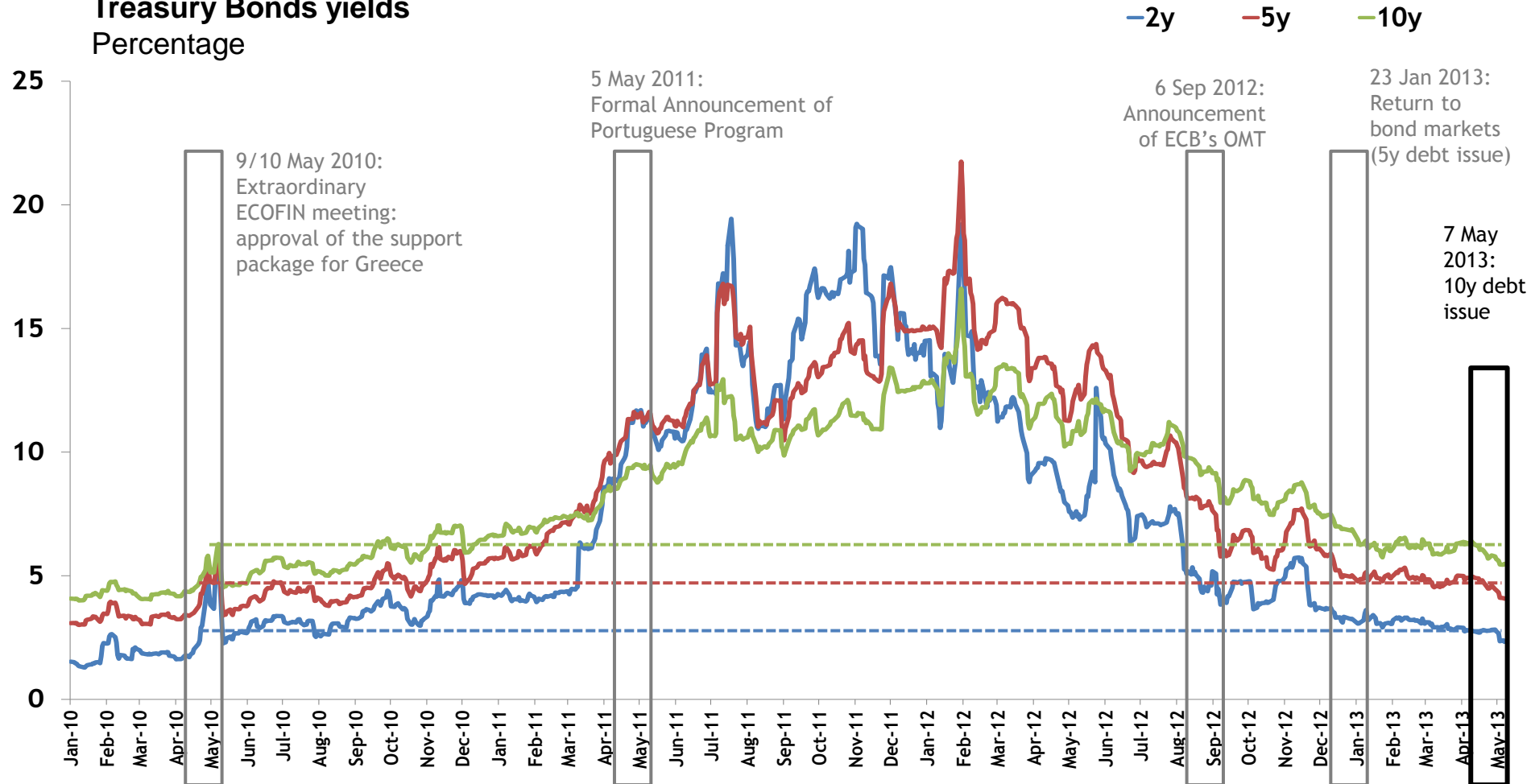
- New **insolvency code and corporate recovery**
- New **Competition Law** harmonized with the EU legal competition framework
- Liberalization of **regulated professions' access and exercise**
- Reduction of firms' administrative burden: **licensing requirements and other legal formalities**
- Adoption of the new **Urban Lease, Renovation works and Urban Rehabilitation Laws**



## II. The Economic Adjustment Program

### *Financing conditions of the Treasury improved significantly*

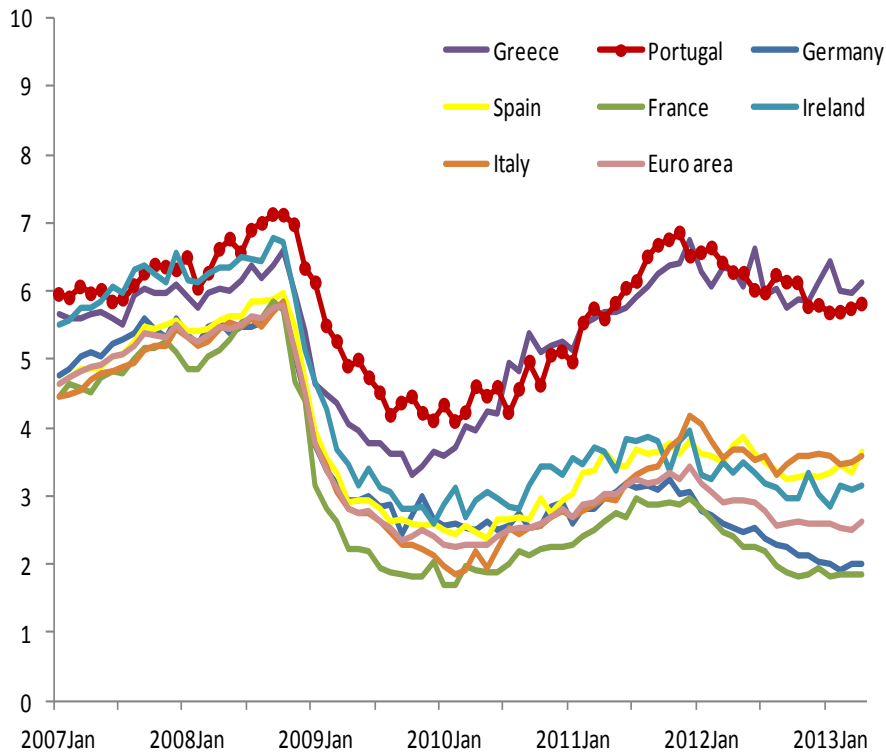
#### Treasury Bonds yields Percentage



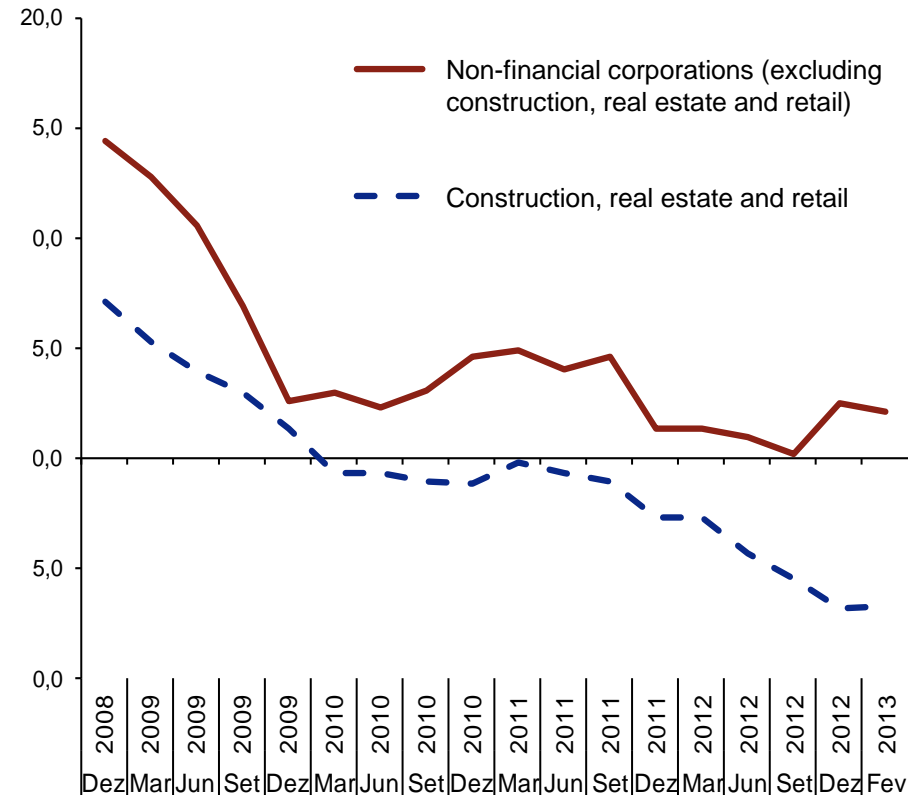
## II. The Economic Adjustment Program

**Interest rates on banks loans to non-financial corporations still high**  
**Total credit to non-financial corporations has been on a declining trend (stabilizing more recently)**

**Interest rates on MFI Loans ( $\leq 1y$ ) to Non-Financial Corporations -New Businesses**  
 Percentage



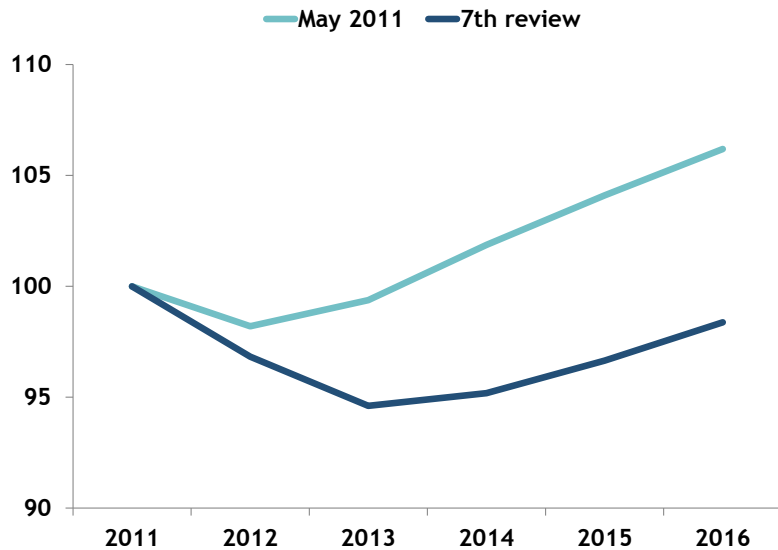
**Total Credit to Non-Financial Corporations**  
 Annual percentage change



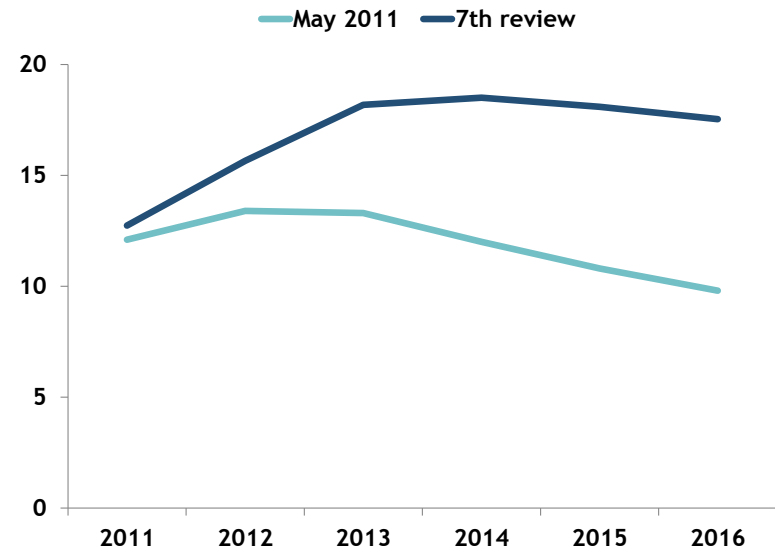
## II. The Economic Adjustment Program

*... adjustment has come at high social cost*

**Real GDP growth projections**  
2011 = 100



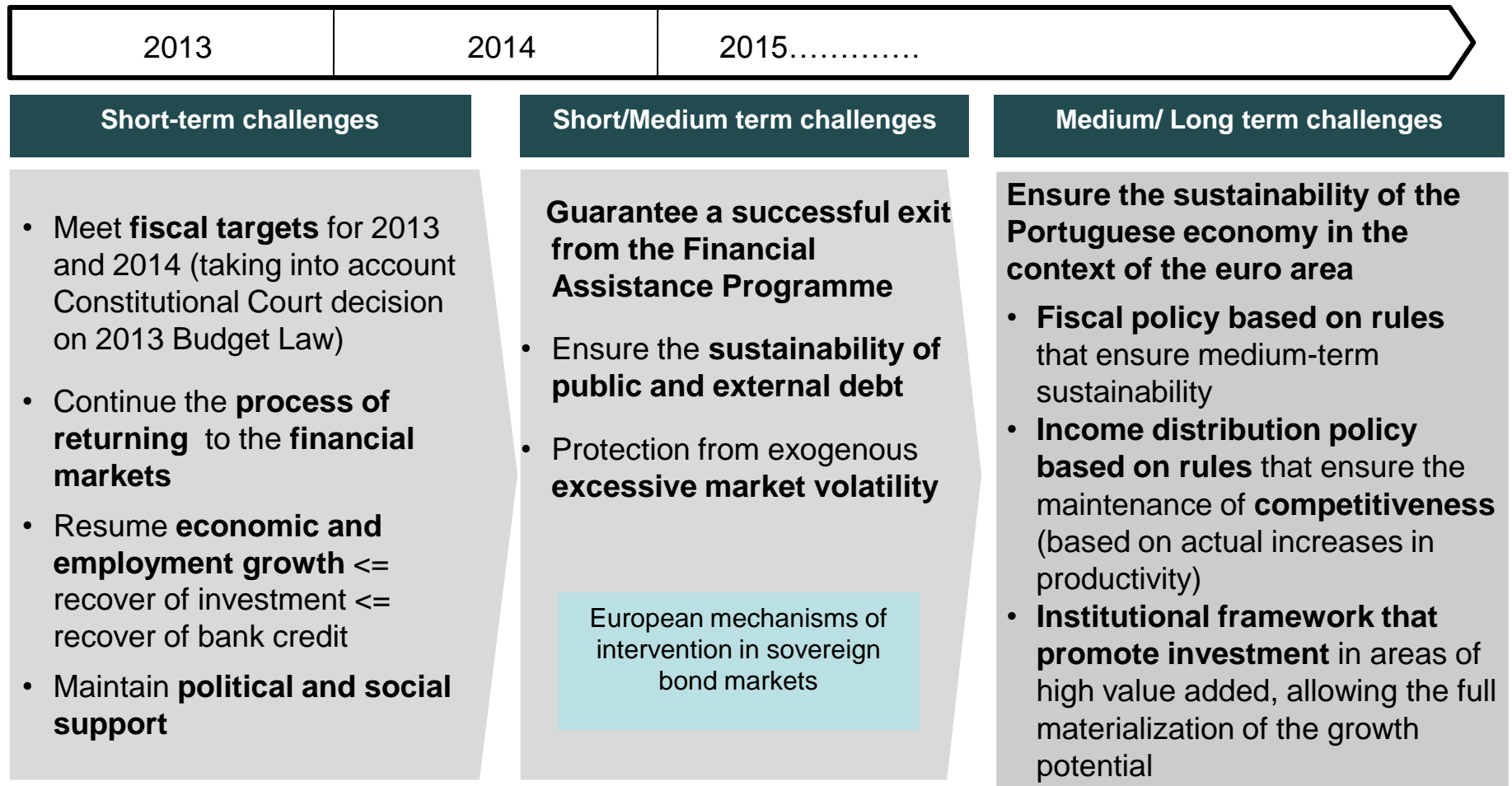
**Unemployment rate**  
Percentage





## **III. Challenges ahead**

## II. Challenges Ahead



European Framework needs to support the credibility of the adjustment

Banking Union, Fiscal Union, Economic Union .....Political Union



# Background slides

## II. The Economic Adjustment Program

### *Economic prospects, in the context of strong headwinds from abroad...*

	March 2013				Initial Programme – May 2011			
	2011	2012	2013	2014	2011	2012	2013	2014
<b>GDP and expenditure components (volume, %)</b>								
Private consumption	-4,0	-5,6	-3,8	-0,4	-4,3	-4,4	-0,8	1,2
Public consumption	-3,8	-4,4	-2,4	1,5	-6,8	-4,8	-1,7	0,0
GFCF	-11,3	-14,5	-7,1	1,9	-9,9	-7,4	2,4	3,8
Exports of goods and services	7,5	3,3	2,2	4,3	6,2	6,0	6,4	6,4
Imports of goods and services	-5,3	-6,9	-2,9	2,7	-5,3	-3,0	2,0	3,7
<b>GDP</b>	<b>-1,6</b>	<b>-3,2</b>	<b>-2,3</b>	<b>1,1</b>	<b>-2,2</b>	<b>-1,8</b>	<b>1,2</b>	<b>2,5</b>
<b>Contribution to change in GDP (p.p.)</b>								
Domestic demand	-6,2	-7,0	-4,2	0,4	-6,3	-5,0	-0,4	1,4
Net exports	4,5	4,0	1,9	0,7	4,1	3,2	1,6	1,1
<b>Prices</b>								
HICP	3,6	2,8	0,7	1,0	3,4	2,0	1,4	1,5
<b>Labour market (*)</b>								
Unemployment rate (%)	12,7	15,7	18,2	18,5	12,1	13,4	13,3	12,0
Employment growth (%)	-1,5	-4,2	-3,9	-0,5	-1,5	-1,1	0,4	1,1
<b>External accounts (% of GDP)</b>								
Current and capital account	-5,2	0,8	3,6	4,8	-8,1	-5,8	-3,2	-2,5
Balance of goods and services	-3,3	0,1	2,8	3,8	-3,6	-1,6	-0,3	0,3
<b>Fiscal Accounts (% of GDP) (*)</b>								
General government deficit	4,4	4,9	5,5	4,0	5,9	4,5	3,0	2,3
Public debt	108,1	123,0	122,4	123,7	106,4	112,2	115,3	115,0

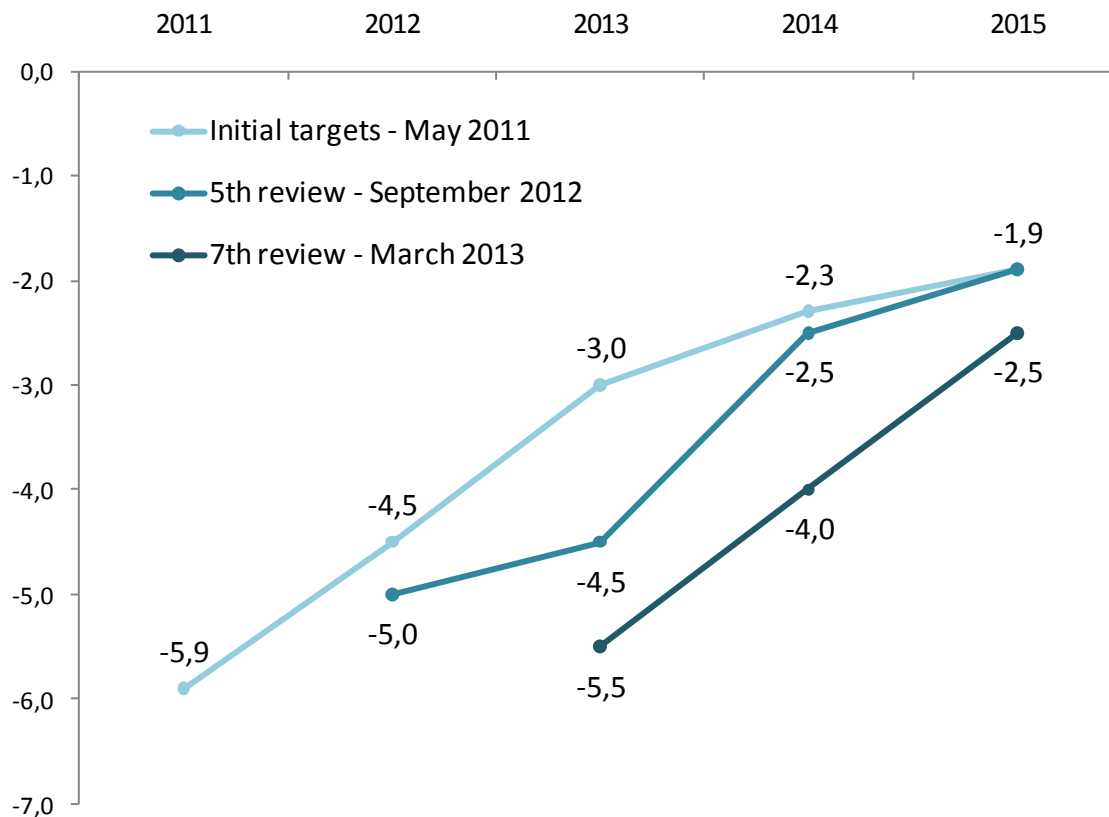
(\*) March 2013 projections for the period 2012-2014 are from the Ministry of Finance - 7th review

Sources: Banco de Portugal, IMF and Ministry of Finance

## II. The Economic Adjustment Program

*.... led to an adjustment of the fiscal path*

**General government deficit targets**  
% GDP

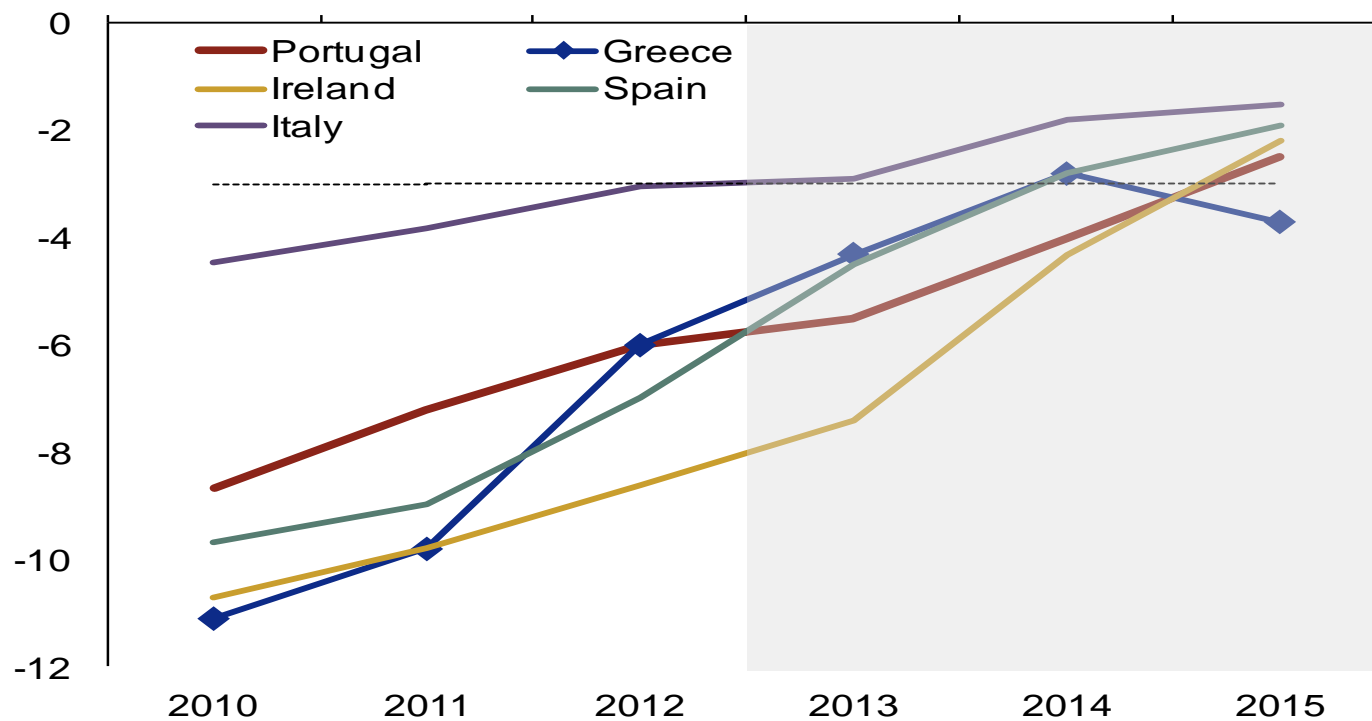




## II. The Economic Adjustment Program

### *Fiscal Adjustment in European countries under stress*

Official projections for the budget balance  
Percentage of GDP



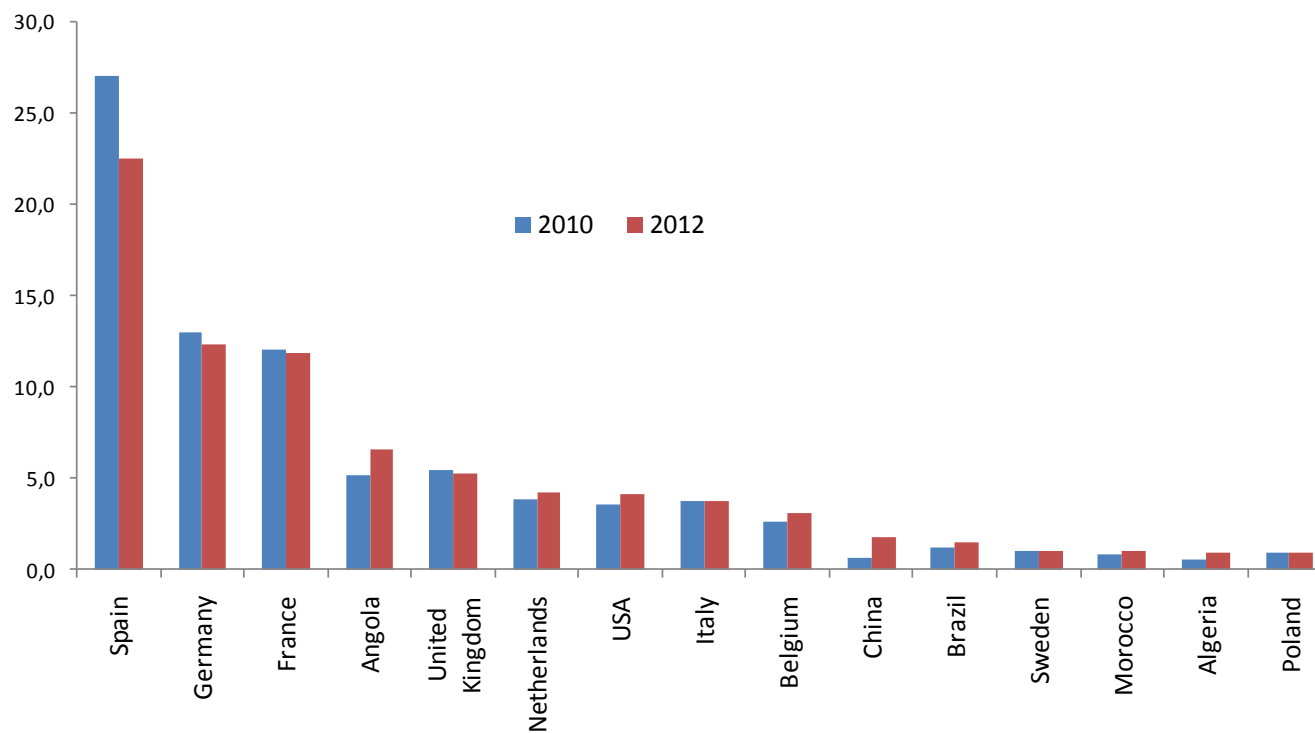
Notes: In the case of Portugal, the outturn for the 2010-2012 period is corrected for the impact of temporary measures and other special factors, according to Banco de Portugal estimates. The values for Ireland and Spain are corrected for the impact of measures related with the assistance to the financial sector

Sources: Portugal - 2013-2017 Fiscal Strategy Document; Greece - Medium-term Fiscal Strategy 2013-2016; Ireland - Update of the Stability Programme; Spain - Biannual Budget Plan 2013-2014; Italy - Update of the Stability Programme.

## II. The Economic Adjustment Program

### *Change in exports profile – new markets*

Country weights of Portuguese exports

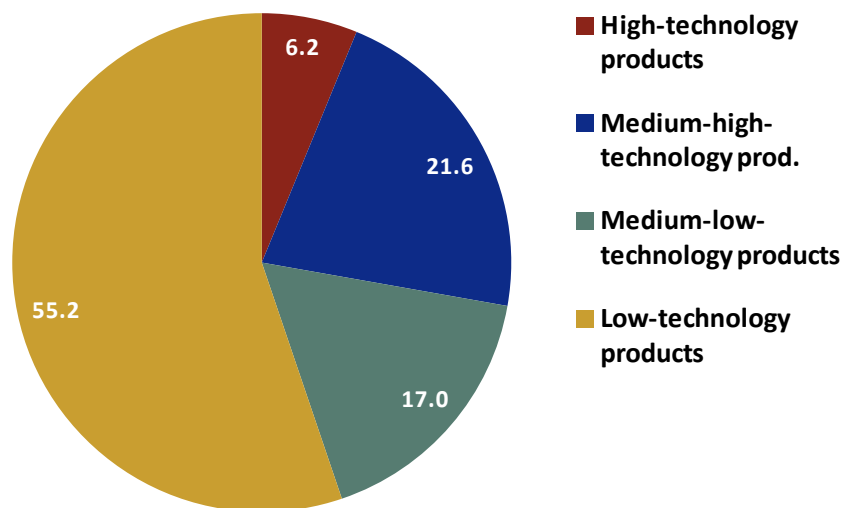


Source: INE

## II. The Economic Adjustment Program

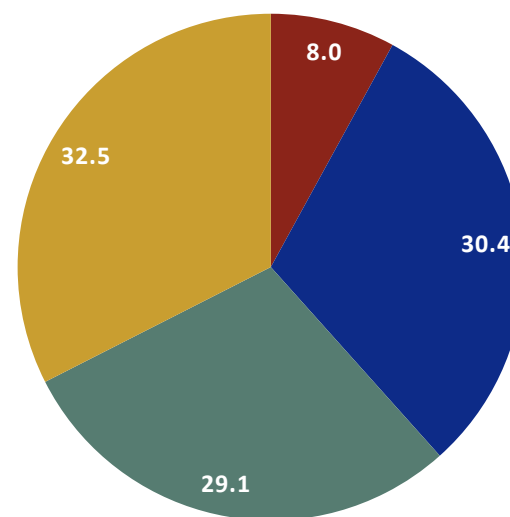
### *Change in exports profile – higher technological intensity*

**Structure of exports by technology content in 1993-1994**



Source: CEPII - Chelem database.

**Structure of exports by technology in 2010-2011 (in percentage)**



Source: CEPII - Chelem database.

## II. The Economic Adjustment Program

***Cyclical unemployment increased significantly***  
***Structural unemployment has been on an upward trend***

