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Address by the Governor of Banco de Portugal at the "Portugal post-Troika" economists meeting[1]

5 July 2013

Thank you, Mr. President.

In my speech, I would like to address Portugal's situation in the post-Troika period, starting with an assessment of how we got there, i.e. "the day before". Indeed, the situation on the day before the conclusion of the Economic and Financial Assistance Programme is as important as the day after, given that it conditions subsequent developments.

I. The day before the conclusion of the Adjustment Programme

Taking into account the currently available economic projections, and using traffic lights as reference, we reach the time of transition with our external account indicators exhibiting a "green" light, economic activity indicators and a number of fiscal indicators a "yellow" one and unemployment and public debt a "red" one (Table 1).

Significant adjustment in external accounts (green)

The external rebalancing of the Portuguese economy is remarkable, having been quicker and stronger than in the two previous programmes, when the foreign exchange rate was used as an adjustment instrument. The current and capital account and the goods and services account – which in 2012 recorded positive figures for the first time in decades – should remain in surplus. This adjustment reflects both the impact of contracting domestic demand on imports and the increase in the market share of Portuguese exports. In fact, in a particularly adverse international environment, Portuguese firms made remarkable efforts to enhance the penetration and diversification of export markets.

[1] As prepared for delivery.

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Table 1

Macroeconomic outlook at the conclusion of the Economic and Financial Assistance Programme

		Banco de Portugal [1]					IMF (Seventh Review)	
		2010	2011	2012	2013P	2014P	2013P	2014P
Real GDP Growth Rate	%	1 9	-1 6	-3 2	-2 4	1 1	-2 3	0 6
Inflation Rate (HICP)	%	1 4	3 6	2 8	0 4	0 8	0 7	1 0
Unemployment Rate	%	11 8	12 7	15 7	17 9	18 0	18 2	18 5
Public Sector Balance	%GDP	-9 8	-4 4	-6 4	-5 7	-6 0	-5 5	-4 0
Primary Balance	%GDP	-7 0	-0 4	-2 0	-1 2	-1 4	-1 1	0 4
Interest rate expenditure	%GDP	2 8	4 1	4 4	4 5	4 6	4 4	4 4
Memo item: Public Sector Balance excluding temporary measures and special factors	%GDP	-8 7	-7 1	-6 0	-5 8	-6 0		
Public Sector Debt	%GDP	94	108	124	130	134	123	124
Average Interest Rate on Public Debt	%	3 2	4 0	3 7	3 5	3 5		
10-Year Government Bond Yield	%	-	-	10 6	5 8	5 8	6 0	6 0
Household Debt	%GDP	94	93	91	n a	n a		
Non Financial Corporations Debt	%GDP	129	131	133	n a	n a		
Credit to Deposits Ratio - Major Banking Groups	%	147	129	120	115	110		
Current + Capital Account Balance	%GDP	-9 4	-5 8	0 8	3 9	4 8	1 7	1 6
Trade Balance (G&S)	%GDP	-7 2	-3 8	0 1	2 9	3 7	2 3	3 2
International Investment Position	%GDP	-107	-105	-117	n a	n a	-116	-112
External Demand Growth Rate	%	9 9	3 5	-0 2	-0 3	3 6		

Note: June 2013 projections

Sources: IMF and Banco de Portugal.

Muted recovery in economic activity and continuation of the process of fiscal deficit reduction (yellow)

However, the dynamics of exports was not sufficient to sustain economic activity expansion. In fact, economic activity contracted more than initially projected and the current outlook points to a muted recovery in 2014.

Fiscal adjustment, albeit lower than initially projected, is very substantial. The primary fiscal balance, which excludes interest expenditure, improved substantially. The adjustment is also very significant if we look to developments in the structural balance of public finances. However, the fiscal consolidation process was slower than expected and its sustainability must be ensured through public expenditure-cutting measures.

Unemployment and public debt are very high and still growing (red)

The level of unemployment is clearly a cause for concern, namely given that it largely reflects structural unemployment. This situation calls for the implementation of a safety

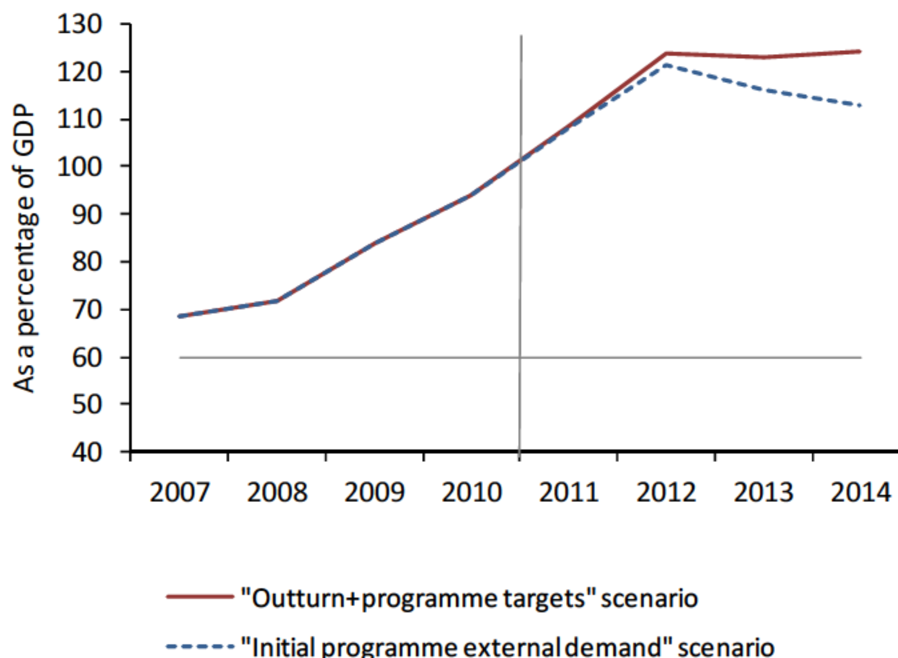
network that safeguards social cohesion, allows for the re-training of long-term unemployed and prevents them from falling into inactivity.

Public debt reached very high levels and is still growing. It is imperative that its developments ensure a sustainable path. This constitutes the main constraint on economic policy in the future.

I would here like to draw attention to one point which is of fundamental importance to me and deserves thorough consideration. As pointed out in Mr. Marco Buti's speech, our adjustment programme was strictly implemented. This notwithstanding, a perception of failure arose among the Portuguese population and social and political players, namely the perception that we have failed to meet the programme targets. This perception is incorrect. Therefore, in my opinion, it is not only necessary, but important to debunk this idea, stressing that:

- first, international economic developments were much more adverse than previously expected, which had very negative consequences for exports, investment, economic activity and, consequently, fiscal revenues and expenditure and public debt. As such, and by way of illustration, if external demand had evolved in line with what had been initially projected in the Programme, the effort of budgetary adjustment made to date would imply that the government debt ratio would already be on a downward path (the dashed line in Figure 1 below).

Figure 1
Public debt as a percentage of GDP



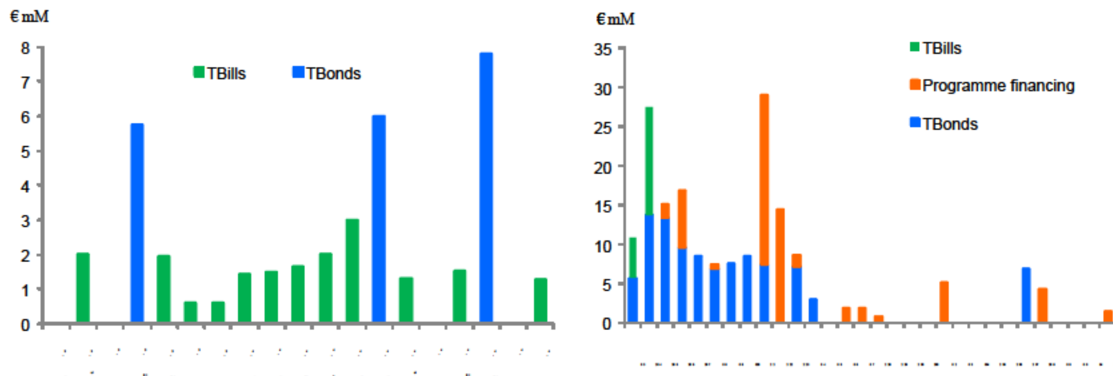
Source: Banco de Portugal.

- second, the Programme's projections relied on fiscal multipliers that were ultimately below those estimated ex post. Increased uncertainty among economic agents that resulted from the continued weakness of the external environment of the Portuguese economy and, in particular, the simultaneous fiscal consolidation process under way in those external economies, led economic agents to predict a higher fall in permanent income. As a consequence, the impact of fiscal consolidation measures on GDP – the multipliers – was underestimated.

The combination of these two adverse factors with the establishment of the Programme's targets as a percentage of GDP has made it necessary to revise those targets, on pain of triggering and feeding a vicious circle between fiscal consolidation and economic activity developments. This warrants some rethinking of the adjustment programmes' target set-up so as to prevent the return effect of GDP developments on compliance with the budgetary targets – through tax revenues and social spending – and debt targets – through tax revenues, social spending and the "denominator effect". My message, to Mr. Buti in particular, is: the fiscal targets of future programmes should not be set as a percentage of GDP, but in the form of limits to nominal public expenditure given that these targets can be controlled by fiscal policymakers and, as such, allow for an actual assessment of the results achieved and the consequent accountability for failures.

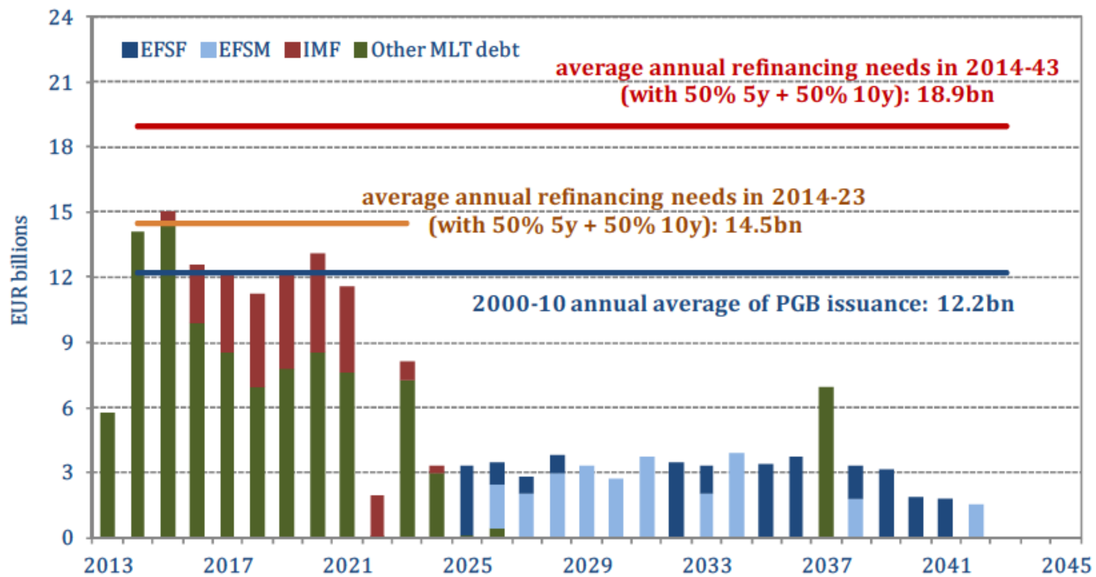
Still on the subject of the day before the post-Troika period, it is important to take into account the degree of financial market access by the sovereign issuer. If market access is not restored in a credible and sustained manner over time, upon the Programme's conclusion, a very painful process will begin. For this reason, the issuance of five and ten-year Portuguese Treasury bonds, in January and May respectively, are key milestones. They were crucial so as to gauge the market's "temperature" and to set up the progressive credibility enhancing of the Portuguese government debt. It should be recalled that, even after we balance public accounts, we will continue to depend on financial markets, given the substantial need to pay off existing public debt (Figures 2 and 3). This means that we will still need financial markets to be willing to refinance our debt. To this end, investors must feel comfortable with the public debt level, its development path and the consistency and credibility of the fiscal process. To sum up, creditors must feel that: our debt is sustainable, our fiscal policy accommodates the respective servicing, its reduction is consistent in the medium run and political players ensure compliance with the resulting liabilities. Given the state of our public finances, the leverage available to us is restricted to the pace of public debt adjustment.

Figure 2
Public debt – maturity profile



Source: Banco de Portugal.

Figure 3
Medium and long-term debt annual repayment schedule
(after extension of the EFSF and EFSM loans)



Source: IGCP (Portuguese Treasury and Debt Management Agency).

By way of illustration, it should be noted that, assuming a long-term growth rate of nominal GDP at around 3 per cent, compliance with budgetary targets set in the programme for 2013-2014 and the fiscal compact commitments thereafter (in particular, a structural adjustment in the primary balance of at least 0.5 p.p. per year) would make it possible for us to reach a government debt-to-GDP ratio of approximately 60 per cent around 2030 (Figure 4). This means that, in a scenario of return to economic growth, compliance with medium-term commitments under the fiscal compact would imply a sustainability path in the medium to long run for the Portuguese public debt.

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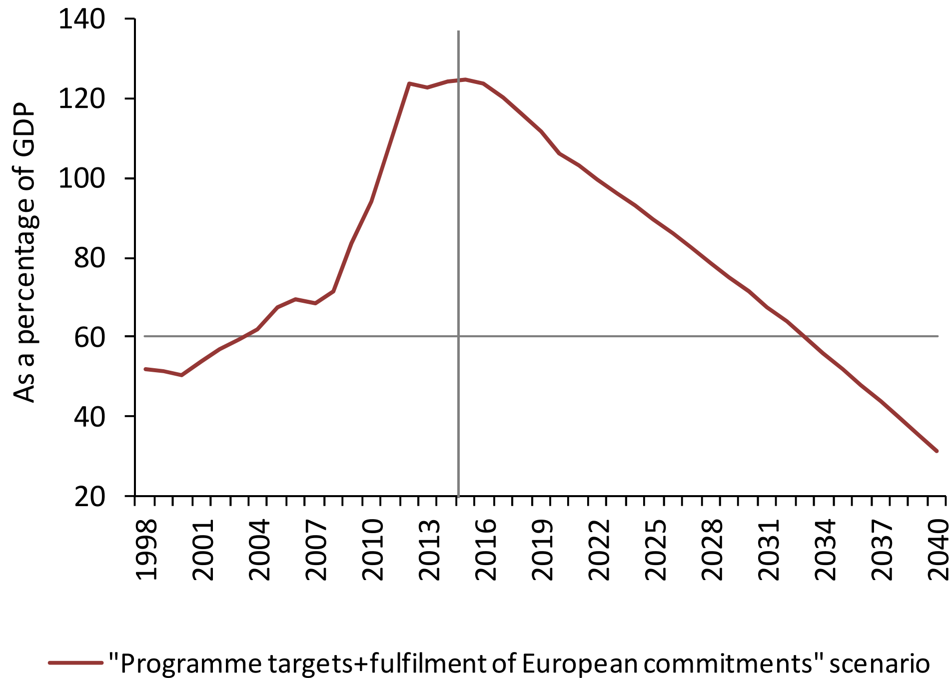
Figure 4
Public debt as a percentage of GDP

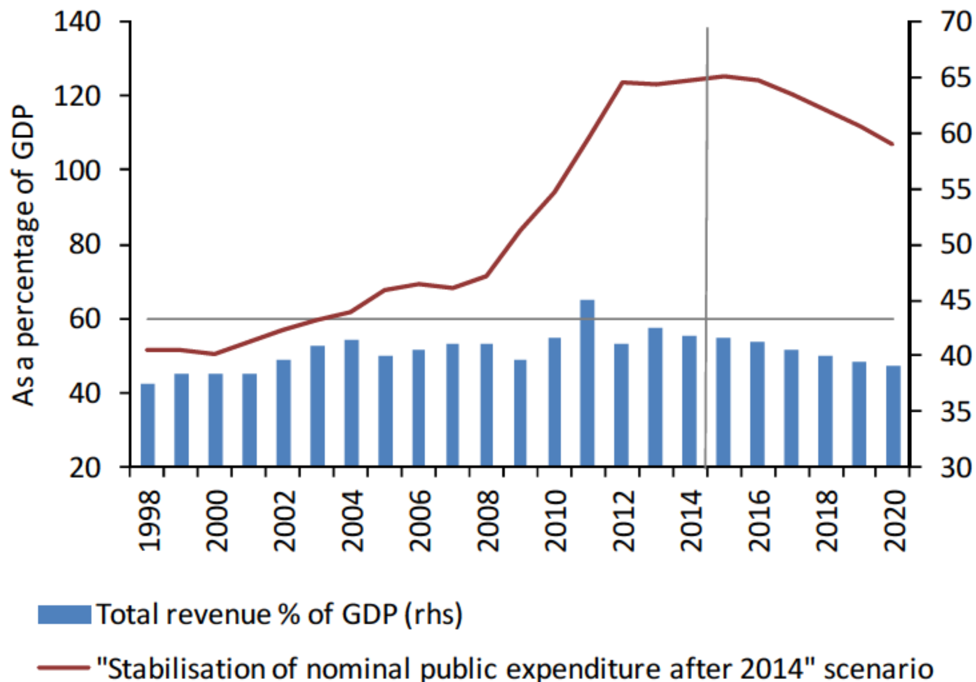


Note: Assumptions of this scenario: (i) fulfilment of the Programme targets in 2013 and 2014; (ii) increase of the structural primary balance by 0.5% of GDP per year until 2020, reaching the MTO; (iii) consolidation effort exclusively on the expenditure side; (iv) increase in the implicit interest rate on public debt to 4.4% in 2020 (3.9% in 2012).
Source: Banco de Portugal.

This exercise corresponds to an aggressive adjustment profile in terms of public debt reduction. My preference goes to a smoother debt adjustment path, compatible with a parallel decline in the tax burden. Figure 5 shows a scenario of gradual reduction of the tax burden over time resulting from a freeze on nominal expenditure, against a background of strict compliance with fiscal commitments. This scenario would result in a slower reduction of public debt, albeit on a sustainable path, which would have the advantage of allowing for a tax burden reduction.

It is common knowledge that I have advocated that the “bonus” resulting from economic growth should be divided between public debt cuts and tax cuts. Debt reduction is key to enhance our credibility with financial markets and, accordingly, ensure refinancing. In turn, a tax burden reduction is fundamental to unlock the growth potential and absorb structural unemployment in Portugal. It would be useful if we could arrive at a broad political consensus, in tandem with a broad consensus among social partners, whereby we would accept that the future economic growth bonus be used to reduce public debt and taxes.
To this end, one option would be to reach a compromise to maintain nominal public expenditure at a constant level from 2015 onwards, which corresponds to a decline in real terms equivalent to the inflation rate at that time.

Figure 5
Public debt as a percentage of GDP



Note: Assumptions underlying this scenario: (i) fulfilment of the Programme targets in 2013 and 2014; (ii) stabilisation of nominal expenditure from 2015 onwards; (iii) gradual decline in direct taxes throughout the horizon; (iv) increase in the structural primary balance by 0.5% of GDP per year until 2020, reaching the MTO; (v) consolidation effort exclusively on the expenditure side; (vi) increase in the implicit interest rate on public debt to 4.4% in 2020 (3.9% in 2012).
Source: Banco de Portugal.

II. The post-Troika period

The challenges that lie ahead after the conclusion of the Economic and Financial Assistance Programme are not smaller than those faced in the course of the Programme. More specifically, we must be able to answer the following questions:

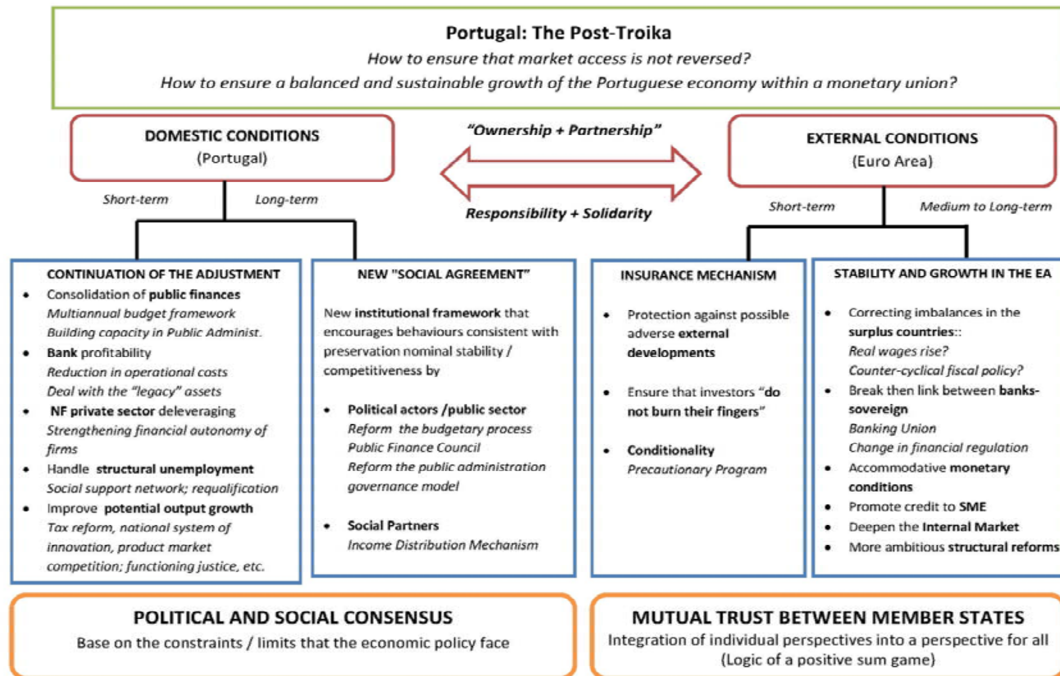
How can we ensure that the return to the financial markets is not reversed?

How can we ensure sustained and balanced economic growth of the Portuguese economy within the euro area?

As mentioned by the President and Mr. Buti, to answer these questions certain conditions must be fulfilled both at domestic and external level (Figure 6).

Figure 6

Conditions for a successful exit of the Programme



At domestic level, and in the short run, the adjustment process of the Portuguese economy must go forward. This means, inter alia, to proceed with the consolidation of public accounts, improve banking system profitability, push on with the household and corporate balance sheet adjustment, create a social security network for long-term unemployed and to set up conditions inducing potential output growth in Portugal.

Looking further ahead, a new institutional framework must be established, on the basis of a broad consensus, fostering behaviours consistent with the maintenance of fundamental macroeconomic balances and the economy's competitive capacity.

In this context, the first point to have in mind is social cohesion. The ongoing sectoral shift in the Portuguese economy suggests that unemployment rates should remain high over a protracted period of time. Safeguarding social cohesion is key so we can manage unemployment in line with its structural nature. In fact, a mechanical exercise conducted in Banco de Portugal shows that an 8 per cent annual growth of external demand up to 2020 would have a cumulative reducing impact of 7 p.p. on the unemployment rate (to around 11 per cent), which means that the solution to our unemployment problem does not lie on the demand side. We must be able to free up and generate entrepreneurial skills, attract foreign direct investment and boost our productive sector. At the same time, we must create support schemes to re-train long-term unemployed with a view to increase their employability.
In addition to social cohesion, there are two other conditions which I find important. The first is the creation of a political consensus on the Portuguese economic policy leeway. This political consensus is not the same as "unanimity", it is, rather, the acknowledgment of economic policy limits and the curtailment of the political

discussion to those limits resulting from our external financing constraints and public indebtedness.

The second condition is consensus among social partners. We must enhance the dialogue between social partners, so as to ensure a realistic negotiation of the distribution of income, i.e. taking into account productivity gains in the economy. We can draw inspiration from the experience in countries like Belgium and Finland. These countries have in place systems that, in case of risks to competitiveness, subordinate wage settlements to the imperative of safeguarding competitiveness and employment.

At the same time, external conditions supportive of our adjustment must be put in place. These external conditions depend on the solidarity of our European partners, which can only be accomplished if we prove to have a sense of responsibility and the ability to comply with our commitments. The keyword in this whole process is “trust”.

Setting up the above-mentioned domestic conditions is important to strengthen our partners’ confidence in the fulfilment of our obligations over time and to win their solidarity.

As regards short-term external conditions for a successful exit of the adjustment programme, I consider it crucial that European mechanisms be in place so as to address incidental factors. To deal with any excess volatility in financial markets and, consequently, prevent investors from moving away from Portuguese debt, European intervention mechanisms in the primary and secondary Portuguese debt markets must be in place, which, in turn, entails the adoption of a precautionary programme. The precautionary programme will help enhance the credibility of the macroeconomic adjustment process in the period immediately after the conclusion of the Programme. The associated conditionality is, on the one hand, the counterpart to our European partners’ solidarity and, on the other hand, a key element to consolidate market confidence in the country’s economic policies.

Turning to medium-term conditions, it is crucial that the European Union implements mechanisms of economy policy coordination and establishes a process of cooperative European growth. In this context, European countries with a favourable economic situation should make use of the leverage available to them to expand their domestic demand, contributing to a more balanced and sustainable adjustment of the whole economy. The establishment of a Banking Union is a central pillar for fixing financial fragmentation in the euro area and breaking the link between sovereign risk and bank risk. This is a very important step towards enhanced competitiveness, given that it will make it possible for identical firms in terms of profitability and risks to have similar financing conditions, regardless of their geographical location. Moreover, structural reforms should be implemented that induce potential output growth across Europe (e.g. output market deregulation and tax system reforms).
In sum:

- For a successful adjustment of the Portuguese economy and to ensure its prosperity within the monetary union, certain domestic and external conditions

must be established. By proving that domestic conditions are in place, external conditions will ensue and be strengthened.

- In terms of domestic conditions, social cohesion must be ensured and consensus among social partners, as well as a broad consensus between political players, must be reached.

- The necessary political consensus does not concern policies to be implemented but only the limits and constraints to their definition and implementation (as I have said on other occasions, although we may have different opinions on how to decorate the living room, we must admit that the living room walls are our limit and our constraint; in terms of economic policy, the walls in the exercise correspond to the external constraints placed on any given country).

Thank you very much.