

Portugal: economic adjustment and challenges ahead



BANCO DE PORTUGAL
EUROSISTEMA

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Forum Europa





I. Adjustment of the Portuguese economy

II. Lessons to be drawn

III. Challenges ahead



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What has caused the crisis?

Imbalances

Private sector over-indebtedness and excessive bank leverage

Unsustainable public finances

Anemic economic growth and low productivity

In the context of ...

Global Crisis

Shift in the assessment of risk levels

have led to:

Concerns about the sustainability of public finances and the viability of banks

... and ultimately to

Sudden stop

In foreign private lending



The size and duration of an economic adjustment depend on:

- i) the size of the initial imbalances;**
- ii) the amplifiers in the economy;**
- iii) how rapidly policy and the economy respond.**



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ii) the amplifiers in the economy;

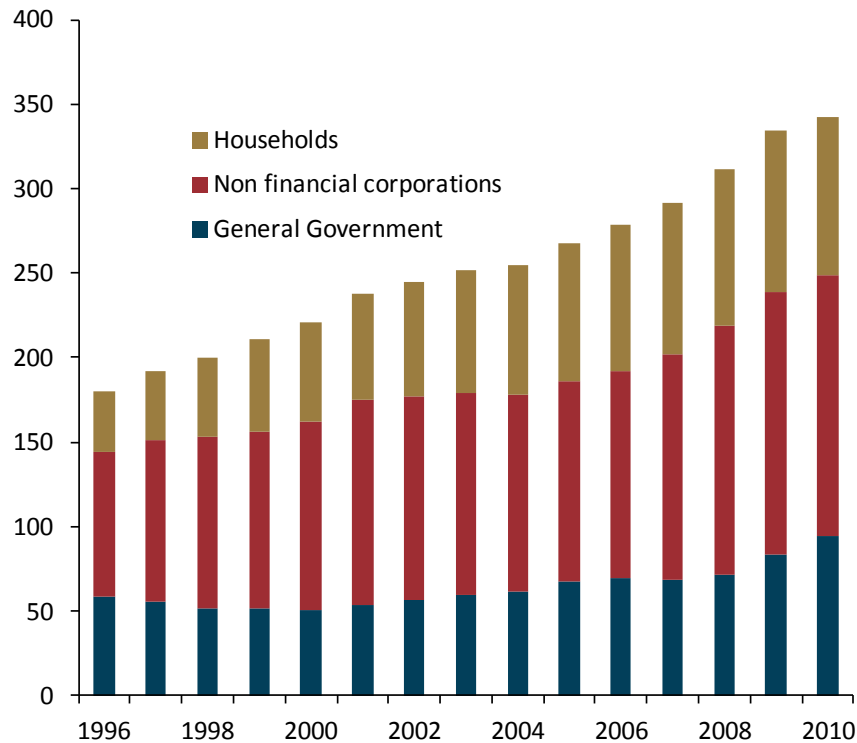
iii) how rapidly policy and the economy respond.



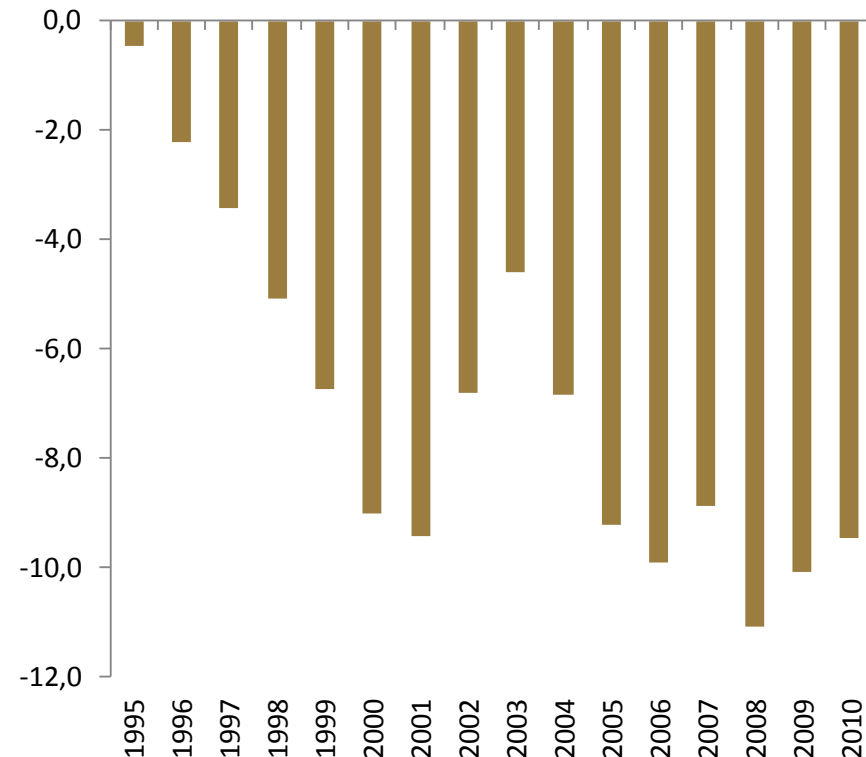
i) Initial imbalances

- Too much public and private debt, borrowed from abroad, mostly intermediated by the banks

Indebtness in % of GDP



External account in % of GDP
(current account+ capital account)



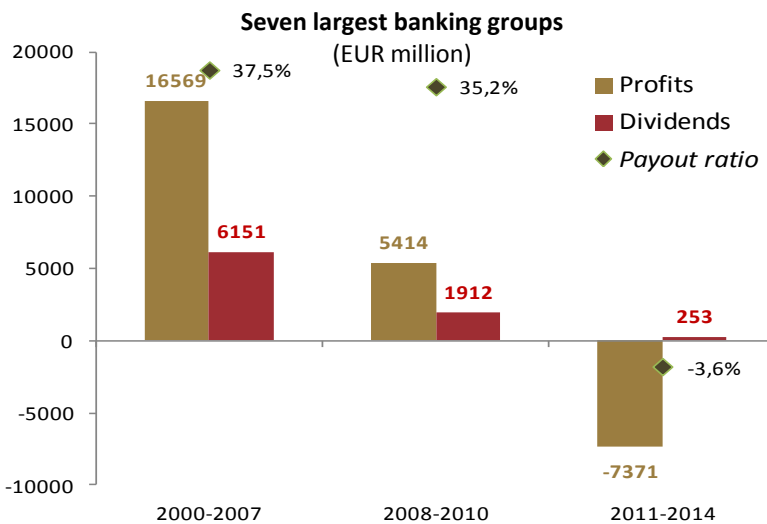
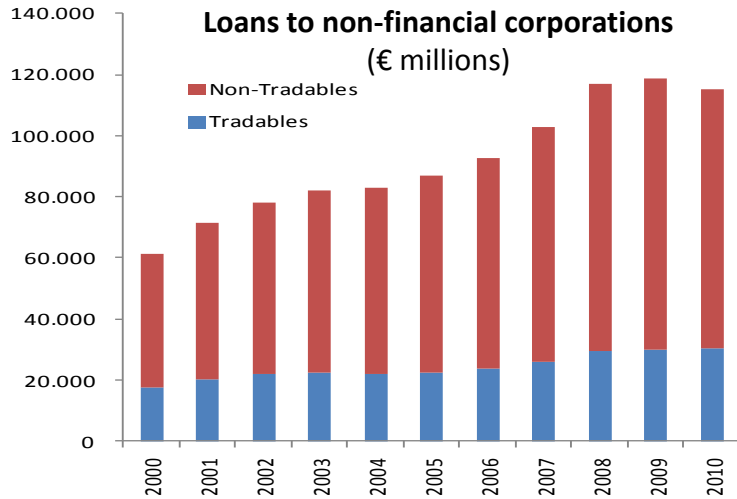


I. Adjustment of the Portuguese economy

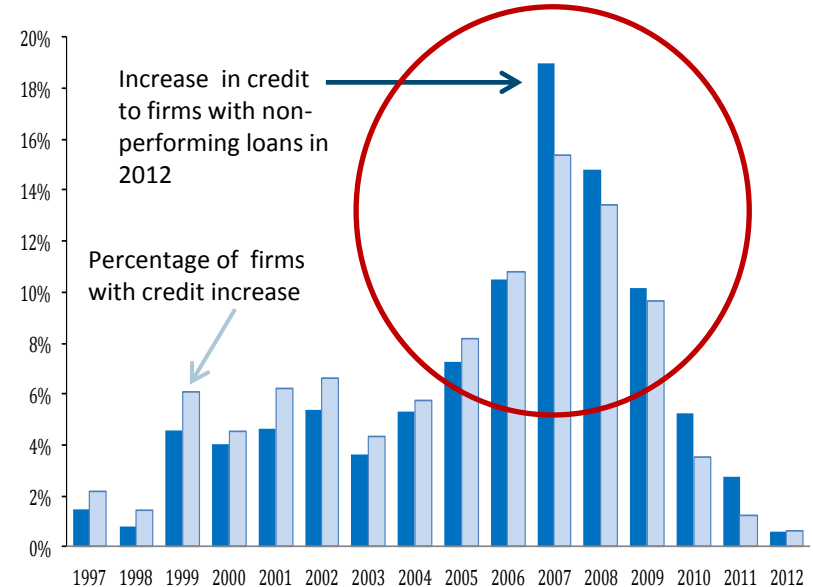
i) Initial imbalances

- Banks have focused on short-term results

- Overleveraged
- Underestimation of credit risk
- Concentration of credit in the non-tradables sector (construction, retail)
- Significant distribution of dividends



Contribution non-performing loans in 2012
Non-financial corporations



Note: each series totals 100% in the chart.



i) Initial imbalances

- Debt has been mainly used to finance consumption and investment in non-tradable sectors

Composition of expenditure
(average rate of real growth)

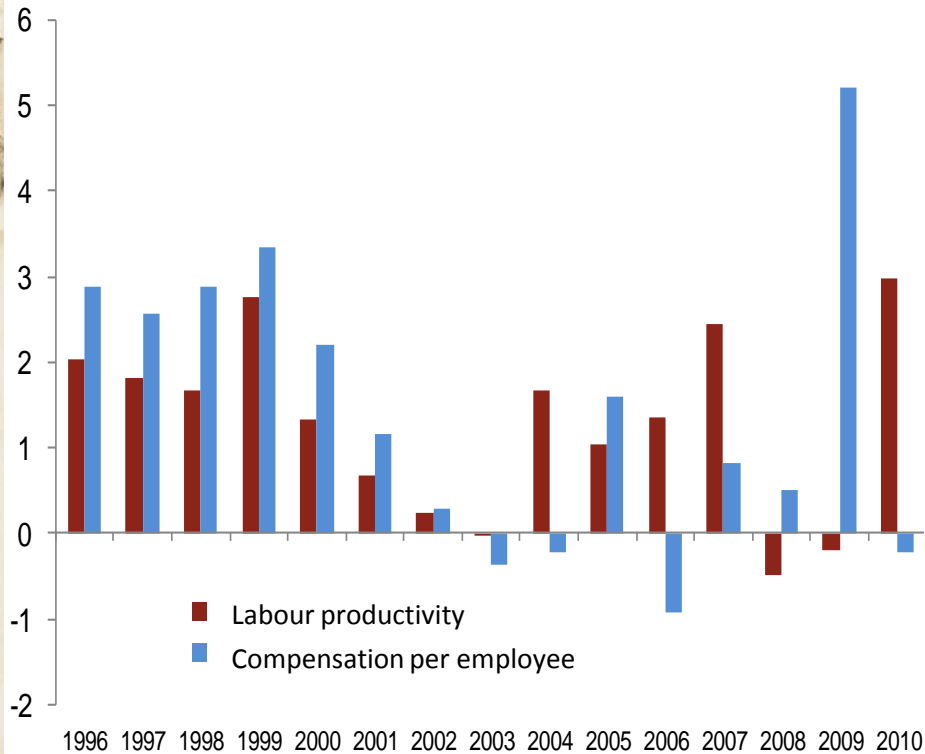
	GDP	Private consumption	Public consumption	GFCF	Exports	Imports	EA GDP
1996-2010	1,9	2,1	2,4	1,7	4,4	4,6	1,7
1999-2010	1,3	1,7	1,9	-0,4	3,7	3,2	1,6
1996-2001	3,7	3,6	3,9	7,0	5,9	7,8	2,7
2002-2007	1,1	1,5	1,7	-1,4	5,2	3,7	2,0
2008-2010	-0,3	0,5	0,6	-2,7	-0,3	0,1	-0,7



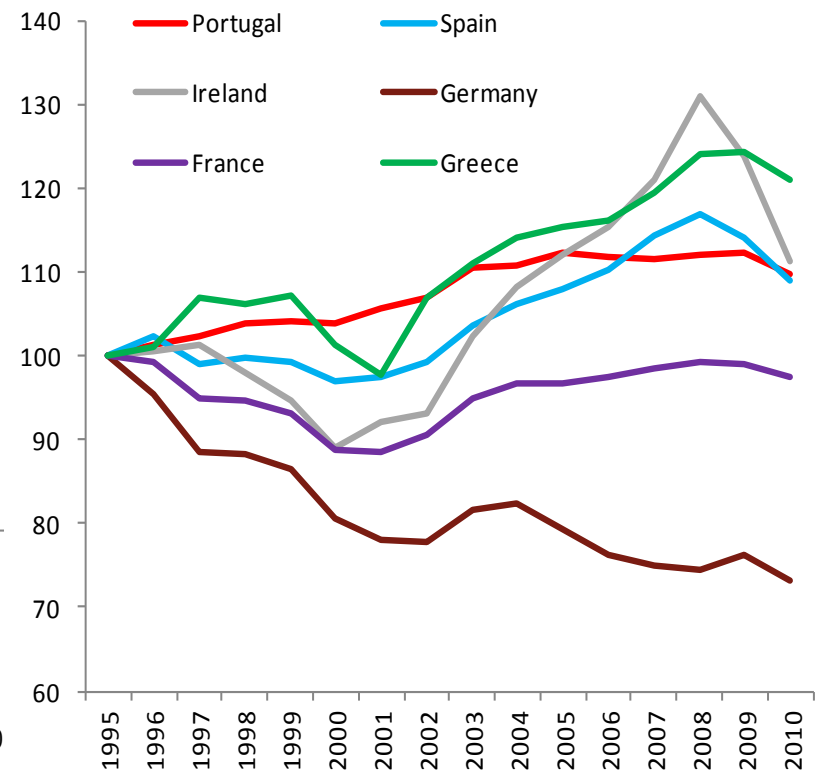
i) Initial imbalances

- Inefficient allocation of resources has pushed wages and costs upwards, harming competitiveness

Productivity and wages
(total economy, real rate of change)



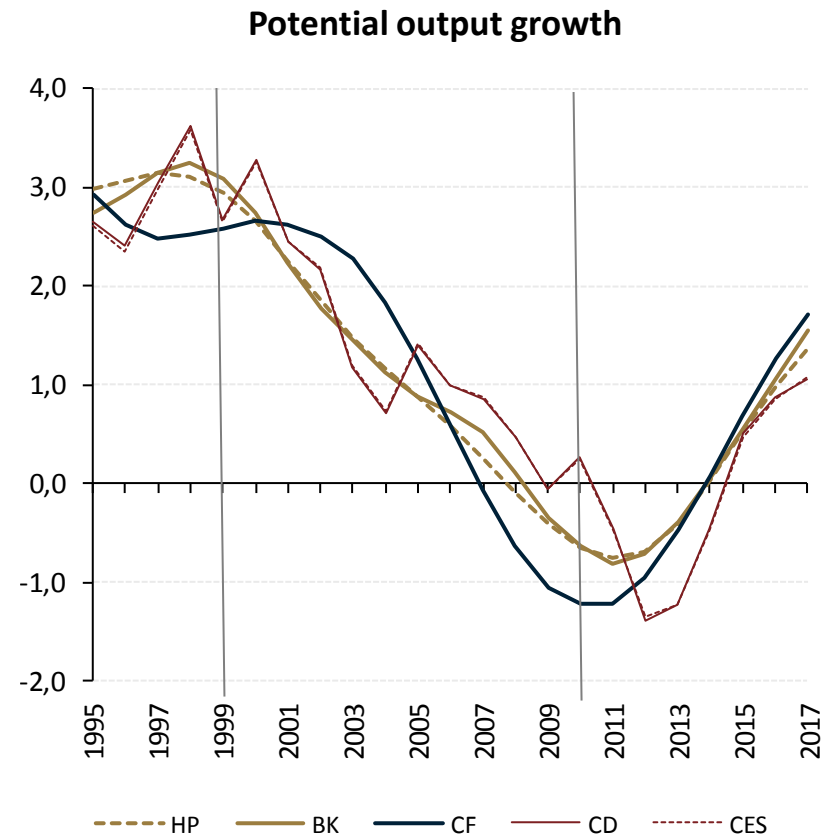
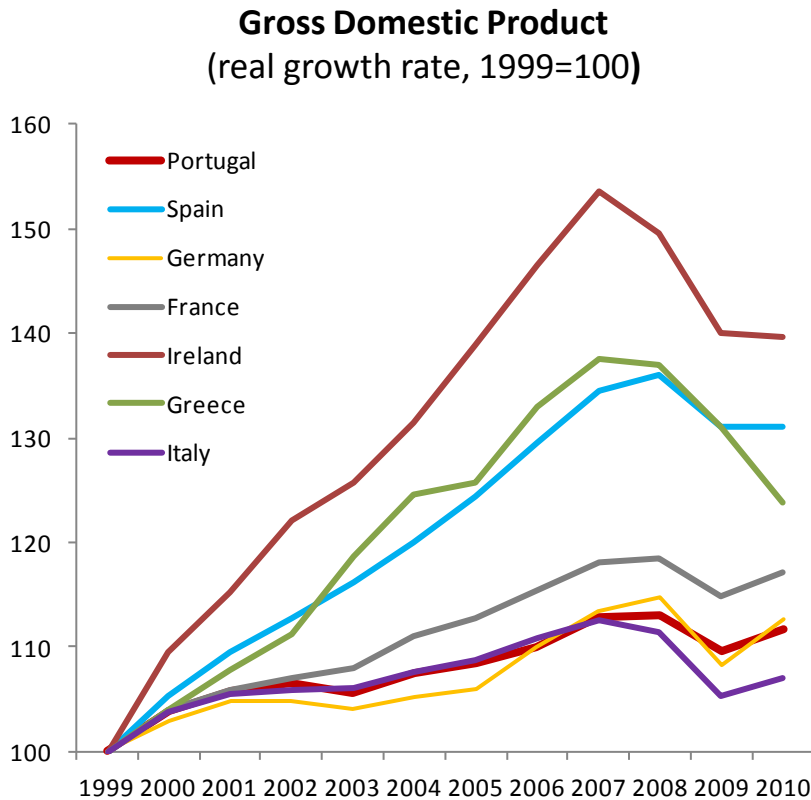
Effective exchange rate deflated by relative unit labor costs





i) Initial imbalances

- Thus, despite huge capital inflows, actual growth was very low and potential growth declined throughout the period





The size and duration of economic adjustment depend on:

i) the size of the initial imbalances;

ii) the amplifiers in the economy;

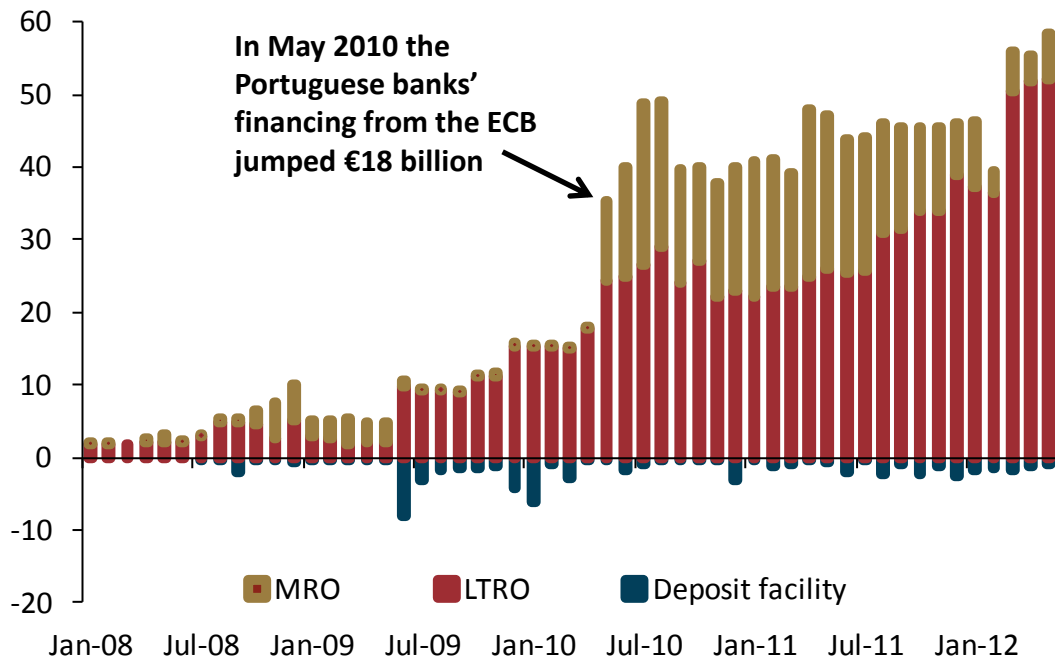
iii) how rapidly policy and the economy respond.



ii) The amplifiers

- **Close link between domestic banks and the sovereign – fears about the solvency of the sovereign have raised fears about the solvency of the banks in a feedback cycle**

Outstanding amounts of monetary policy operations of Portuguese banks
(€ billions)



- At a first stage access to capital markets by banks was **replaced by Eurosystem funding** and banks increased the **public debt share** in their portfolios.

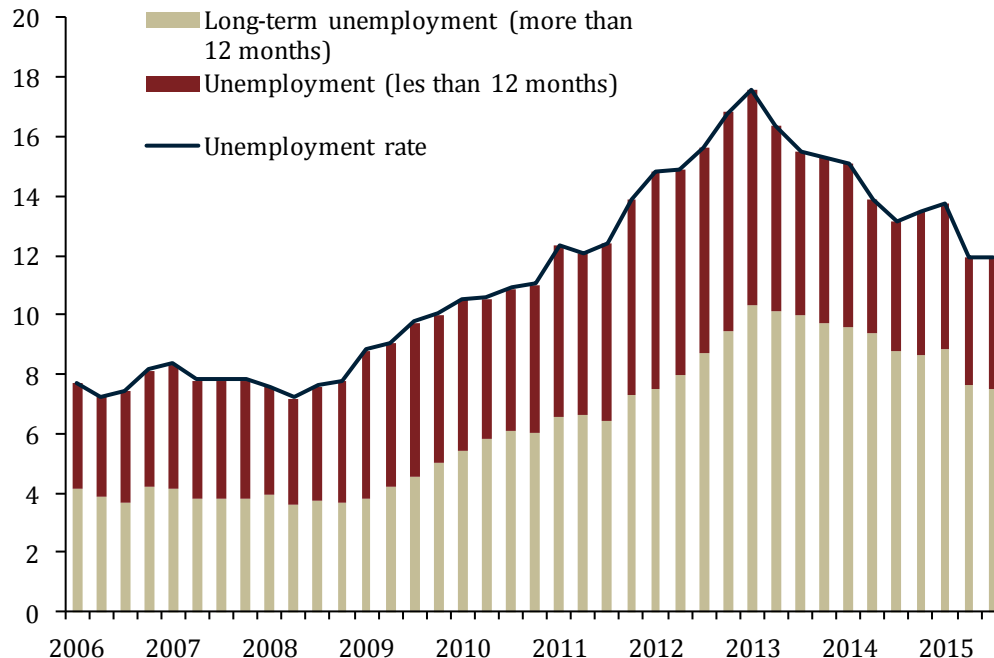
- At a second stage, **sovereign funding was ensured by official loans** under the financial assistance programme. The programme included a facility dedicated to the capitalisation of the banking system.



ii) The amplifiers

- Distortions in the labour market have resulted in an “overshoot” of unemployment – with further negative impact on domestic demand and hindering fiscal consolidation.

Unemployment rate and contribution by duration



- Increase in unemployment has **exceeded what would be expected taking into account the drop in economic activity.**
- This has in part reflected the **transition to a more export-oriented economy.**
- The labour shedding during the crisis was accelerated due to the **high share of temporary workers.**



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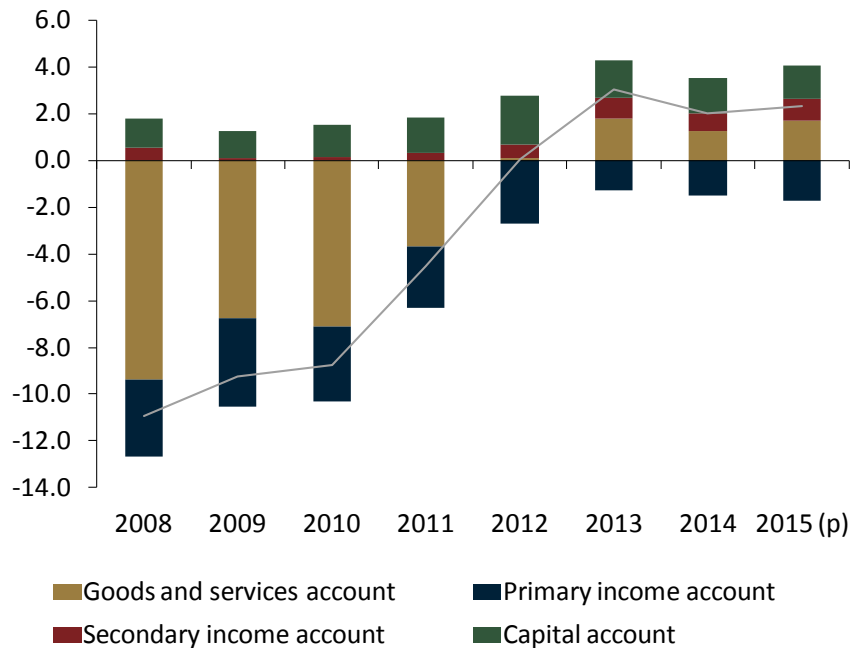


iii) How rapidly policy and the economy have responded

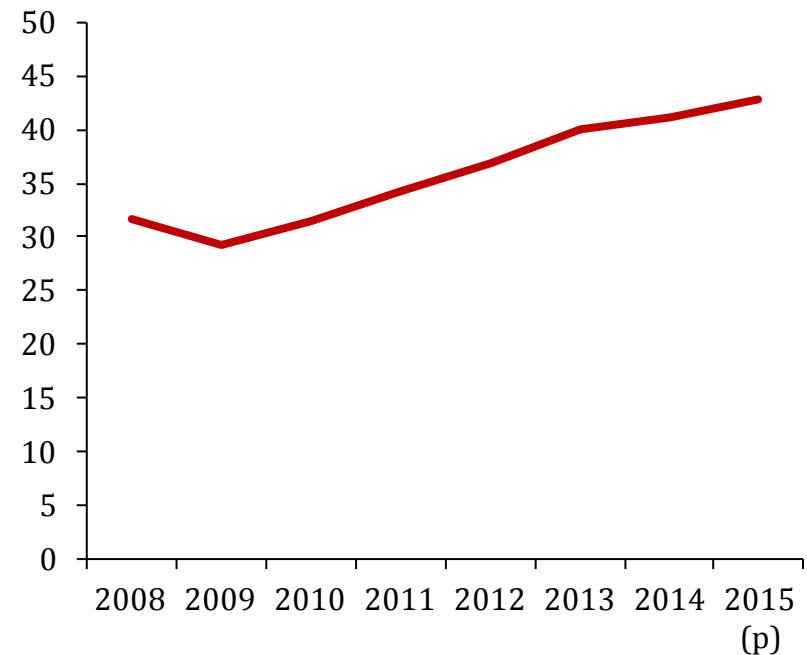
- **Sizeable adjustment of imbalances**

- Net lender position (improvement of around 12 p.p in the current and capital account between 2010 and 2014)
- Weight of exports in GDP increased by 10 p.p. between 2010 and 2014

Current and capital account
(% of GDP)



Weight of exports in GDP
percent





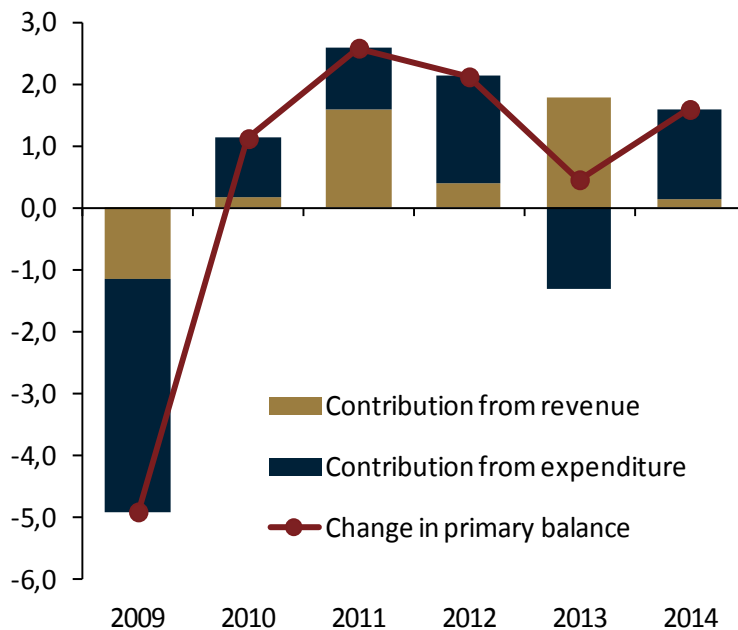
I. Adjustment of the Portuguese economy

iii) How rapidly policy and the economy have responded

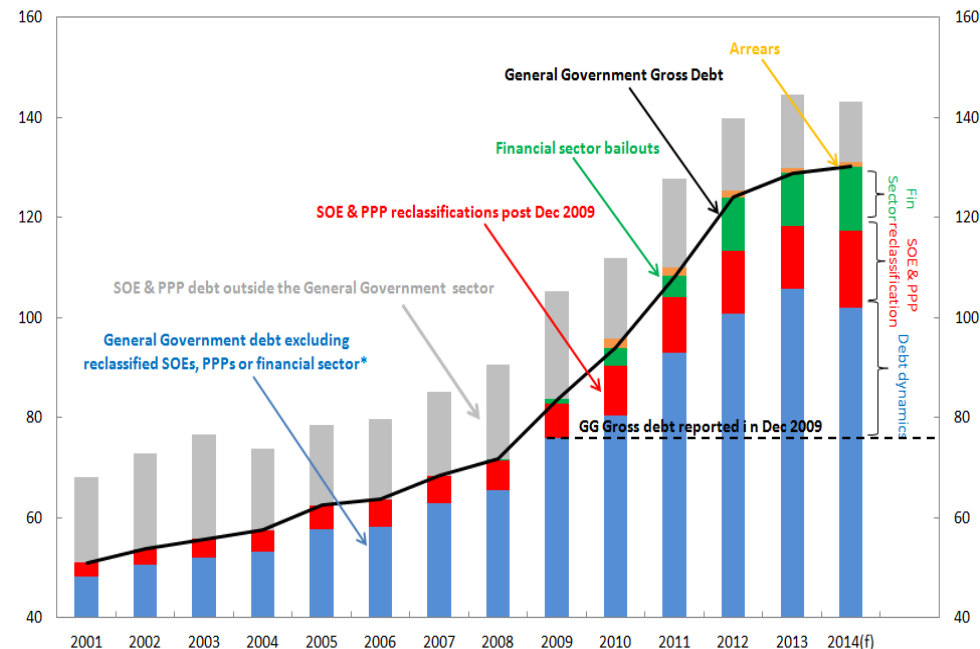
• Sizeable adjustment of imbalances

- Strong and unprecedented fiscal consolidation effort
- A significant part of the increase in debt in the period 2009-2014 was due to the reclassification of entities that were previously outside the general government and to the support to financial institutions

The composition of the fiscal adjustment
Percentage points of GDP



Evolution of General Government Gross Debt
Percent of GDP



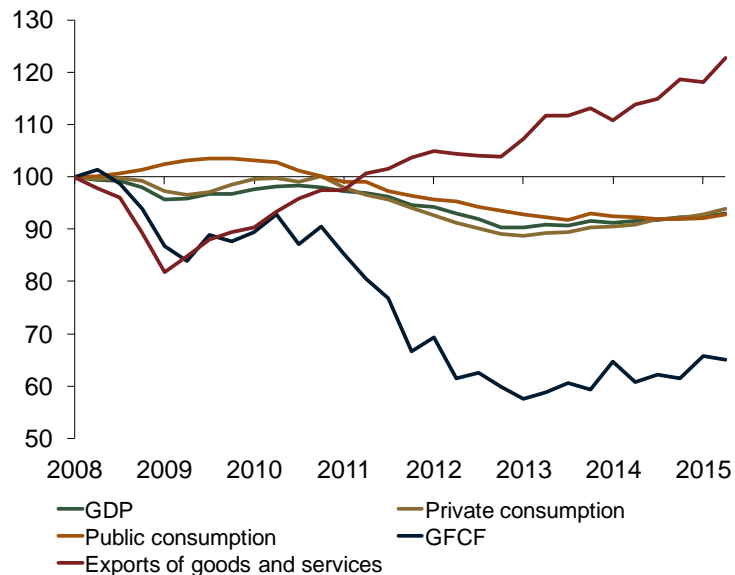


iii) How rapidly policy and the economy have responded

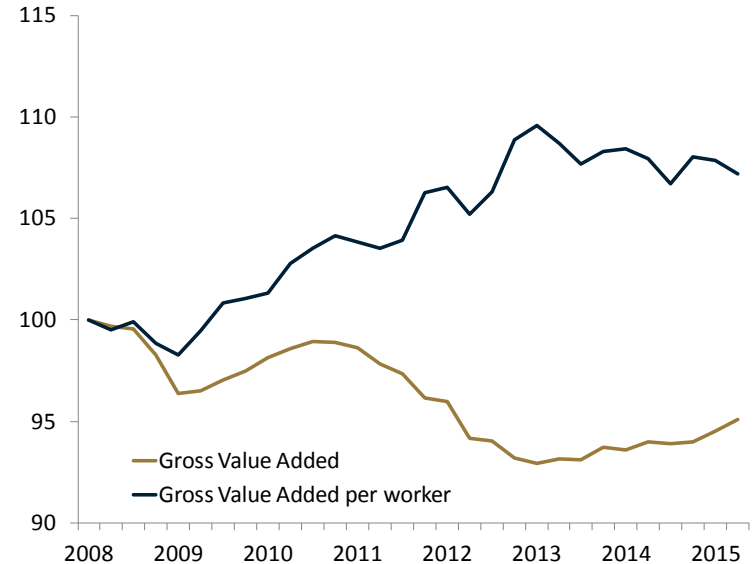
- **Restructuring of the economy**

- Reallocation of resources towards exports and more productive firms

**Evolution of GDP composition
(index: 2008Q1=100)**



**GVA and GVA per worker
(index: 2008Q1=100)**





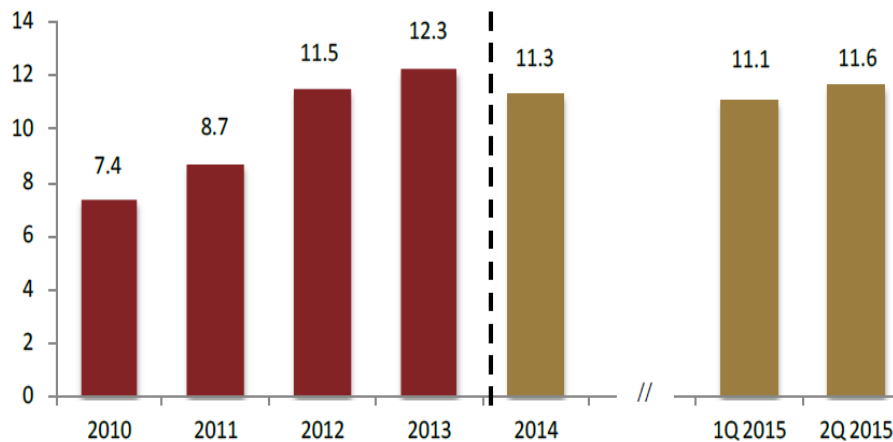
iii) How rapidly policy and the economy have responded

- **Strengthening of the banking system**

- Recognition of impairments (about €40 billion in the 2008-2014 period)
- Increased solvency and liquidity
- Orderly deleveraging process, consistent with private sector deleveraging

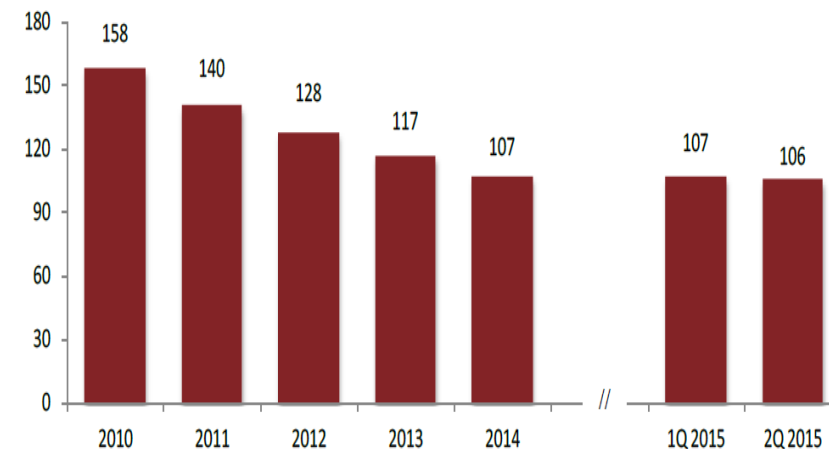
Core Tier 1 ratio (until 2013) and CET 1 ratio (2014)

End of period



Loan-to-deposits ratio (%)

End of period





iii) How rapidly policy and the economy have responded

- **Latest macroeconomic projections by Banco de Portugal**
 - GDP growth slightly above the euro area in 2015
 - Gradual recovery of domestic demand and strong export dynamics
 - Sustained correction of macroeconomic imbalances

Projection October 2015
(annual rate of change, per cent)

	<u>Weights</u>	<u>2014</u>	<u>2015^(p)</u>
Gross Domestic Product	100.0	0.9	1.7
Private Consumption	65.9	2.2	2.6
Public Consumption	18.5	-0.5	0.1
Gross Fixed Capital Formation	14.9	2.8	6.2
Domestic Demand	99.6	2.2	2.5
Exports	40.0	3.9	6.1
Imports	39.7	7.2	7.9
Current plus Capital Account (% of GDP)		2.0	2.3
Trade Balance (% of GDP)		1.3	1.7
Harmonized Index of Consumer Prices (HICP)		-0.2	0.5

Note: (p) – projected



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First lesson

An unsustainable economic policy has huge costs as it requires not only a cyclical adjustment but also a structural adjustment which is typically more painful and prolonged in time.

- *Resources need to be reallocated from the non-tradable to the tradable sector.*
- *Resources misallocation eventually leads to a significant waste of capital and to a rise in long-term unemployment.*



Second lesson

In the decision making process, policy makers must consider future implications of the various options at the macro level and the micro level.

Inconsistent policies generate inconsistent responses from economic agents, particularly in terms of investment, resulting in high (and often irreversible) costs to individuals, families and to society.



Third lesson

Past experience reveals that self-regulation and self-discipline of the financial markets do not work. This is particularly so in a context where incentives towards the short term predominate (credit volume is more important than credit quality; bonuses linked to the volume of credit; under-provisioning of credit risk; significant dividend distribution):

- ***Strengthen financial market regulation to reduce risks.***
- ***Adopt a more intrusive, forward-looking and risk-focused micro-prudential supervision approach (create buffers to absorb losses in adverse situations).***



Fourth lesson

From the point of view of a central bank that aims at safeguarding price stability and financial stability:

- *Past experience reveals that disturbances to price and financial stability are the mirror of decisions taken by economic agents.*
- *Macro-prudential policy is crucial to prevent behaviours that at the aggregate level have the potential to inflict serious costs to the real economy in the future.*



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1 Continue fiscal consolidation

- Fulfilling the Fiscal Compact ensures debt sustainability
- The quality of the policy measures is crucial to improve economic growth

Fiscal balance required to reduce the debt ratio by 1/20 of the difference relative to the reference value

		Public debt ratio to GDP	
		130%	
		Overall balance	Primary balance
Nominal GDP growth rate	1,0%	2,2%	7,0%
	1,5%	1,6%	6,4%
	2,0%	1,0%	5,8%
	2,5%	0,3%	5,1%
	3,0%	-0,3%	4,5%
	3,5%	-0,9%	3,9%
	4,0%	-1,5%	3,3%

For a debt ratio of 130 per cent and 2.5-3.0 per cent nominal GDP growth, we need to ensure balanced public accounts.

Note: The shaded cells indicate the different combinations of nominal GDP growth rate where the overall balance that fulfils the debt criterion is higher than the MTO.

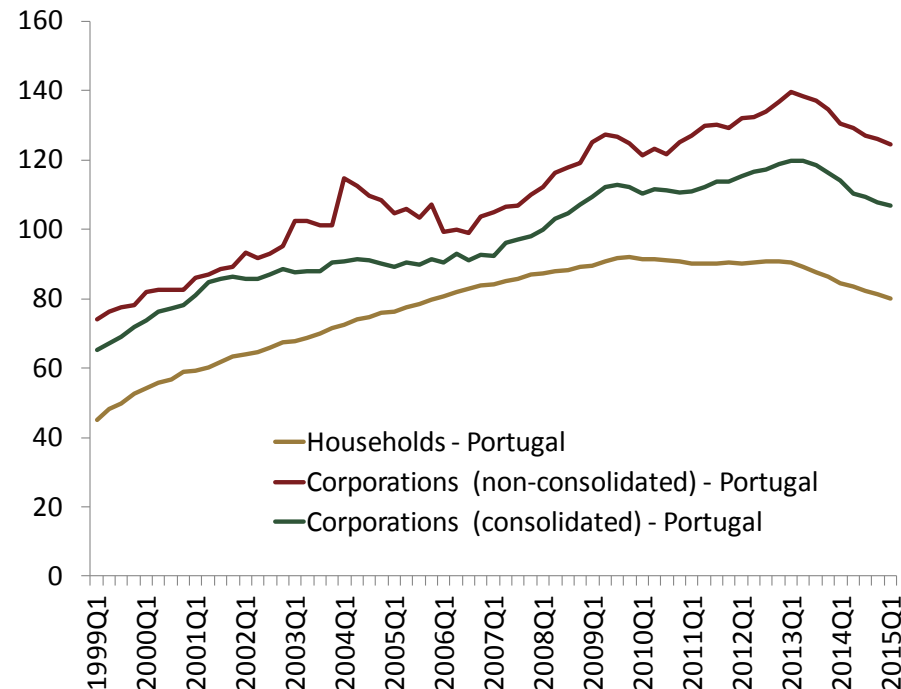


2

Continue private sector deleveraging

- Indebtedness levels remain above the euro area average
- They affect consumption and investment decisions of the most indebted agents

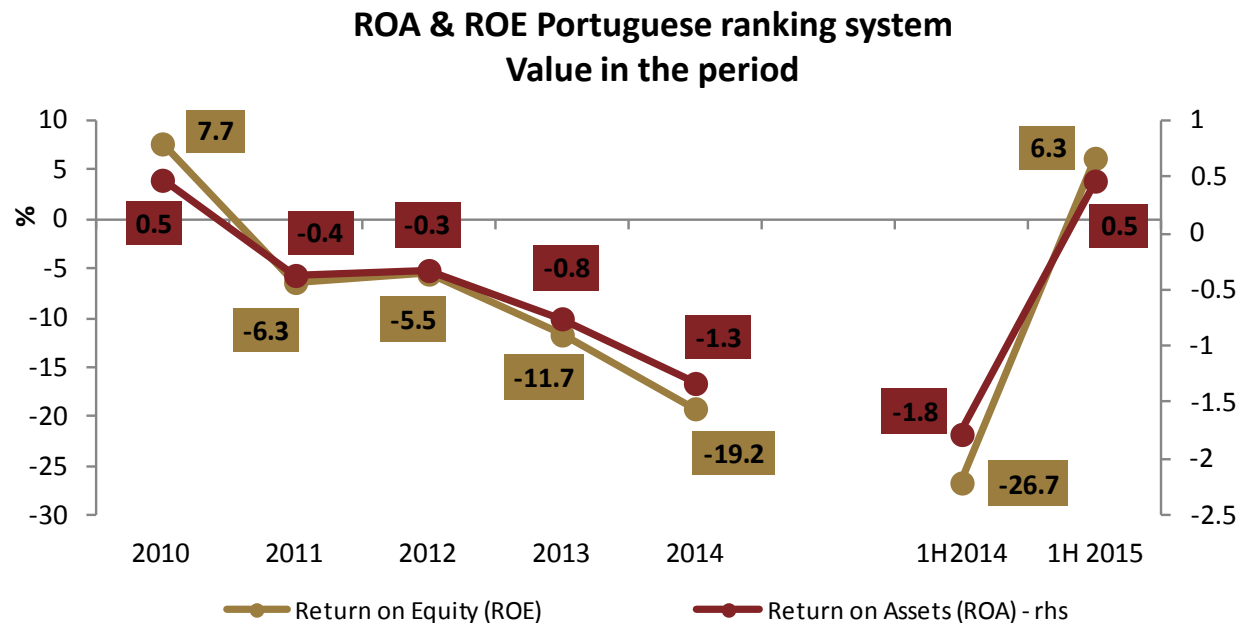
Financial debt in Portugal: households and non-financial corporations (% GDP)





3 Improve banking sector profitability

- **Assess the viability and sustainability of Business Model**
 - Improve cost to income ratio
 - Adapt business models to lower demand for credit, Banking Union and digital economy
- **Improve Governance and Risk Management**



Note: Return is measured by earnings before taxes and minority interests.



4

Improve long-run growth

- **Allocate savings in line with the optimisation of returns**
- **Increase investment in physical and human capital**
- **Upgrade firms position in the value chain**
- **Improve the quality of management**
- **Strengthen attractiveness of the economy for FDI**

Improving the long-run growth of the Portuguese economy is also crucial to alleviate the costs of the ongoing adjustment of accumulated imbalances .



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Thank you.

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