A CROSSROADS OF POLICIES

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BANCO DE PORTUGAL
EUROSYSTEM

September 2023

At the end of the first semester, the Portuguese economy stood out among its European counterparts. Public finances were among the most balanced; public and private debt were on a downward trajectory, and the financial system was stable and supportive of the economy. To reach this point, the country underwent structural changes. It invested in education, reinforced investment and restructured the financial sector. Currently, institutions promote best practices. However, we face a policy crossroads to reduce inflation and respond to the economic slowdown. A policy crossroads is nothing more than the need to use institutional cooperation, as Europe and Portugal did in the recent past, to ensure a successful outcome for our challenges.

In response to the pandemic crisis, Europe was an example of inclusion and integration. For the first time in this century, it managed to reconcile economic policies. It provided a response that was understood by all European citizens, who supported decisions as important as the issuance of European debt to finance European and national budgetary programs.

The pandemic crisis was followed by an inflationary process, unique in the euro's experience. Inflation reached 10% due to severe global supply constraints associated with the pandemic, an ignoble war that brought a second energy shock to the heart of Europe, and the destabilizing nature of economic policies in the United States, China, and the United Kingdom.

This sublime moment in European construction must be followed by the response to another crossroads. Economic policies must continue to address the causes of inflation, as it is a symptom, while minimizing the risks of destabilization for citizens and laying the foundations for a new economic cycle. In this difficult moment for geopolitics and the economy, the stability and predictability of policies are our greatest asset.

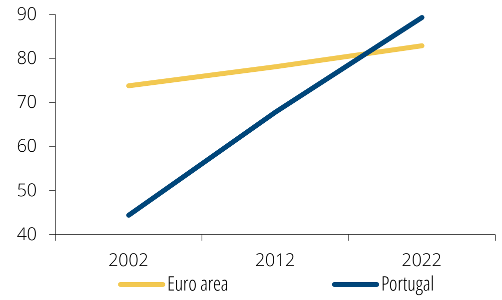
Luck: Preparation meets opportunity

We find ourselves at this crossroads, in one of the best moments for the Portuguese economy, as a result of the transformation of its institutions - legal, social, and cultural - which has led to the accumulation of structural factors for growth and sustainability: human capital, physical capital, and technological knowledge. In all these dimensions, Portugal has been able to make corrections.

While the euro area grew by 15% in the first 15 years of this century, Portugal only achieved a meager 1%! In contrast, since 2015, we have grown by 17% and converged with the euro area, which grew by 13%. After reaching a peak in 2019, economic activity quickly recovered from the pandemic. In 2023, activity, employment, and wages are at their highest, once again placing the economy above potential values.

We are accumulating and retaining qualified human capital. In the last twenty years, the education level of our youth has gone from the bottom to the top of the euro area (from only 40% of young people with at least secondary education to 89%). But we are only halfway through this silent revolution, one that we cannot abandon.

Chart 1 • Percentage of young people (20–24 years old) with at least secondary education

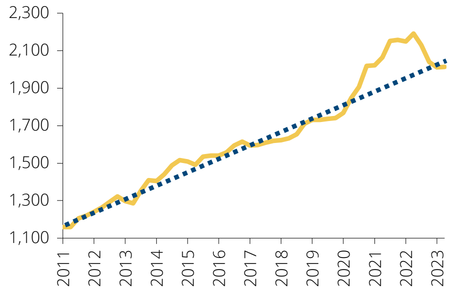


Source: Eurostat.

Recently, we have been confronted with a supposed 'reduction' in the number of college graduates in the population. However, this is merely a statistical error without socio-economic support.

Let's take a look. Between 2011 and 2019, the Portuguese population with higher education increased at a rate of 71,000 per year. But between late 2019 and mid-2022, this number would have increased to 180,000 graduates per year! Despite improvements observed in the higher education system, this figure is incompatible with the flow of students graduating each year. In the absence of massive migration inflows of graduates during the pandemic, this trend is not credible.

Chart 2 • Population with higher education | In thousands

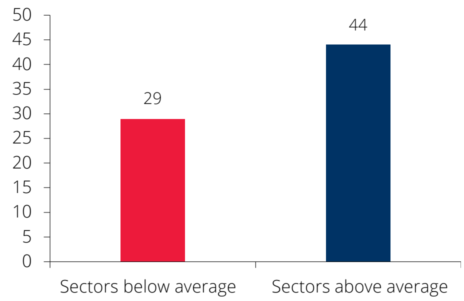


Source: Labour Force Survey, Statistics Portugal.

When the statistical error is corrected, the current two million graduates correspond to an increase of 71,000 per year since 2019. Nothing has changed. The country is not destined for qualifications that many thought were inherently limited, nor is it destined for emigration.

Furthermore, in response to this increase in qualified supply, the labor market has created jobs in sectors with better pay; since 2015 private employment in sectors paying above-average salaries grew by 44% and 29% in other sectors. The education of our youth and the creation of qualified jobs are not instant processes; we must demonstrate all our patience.

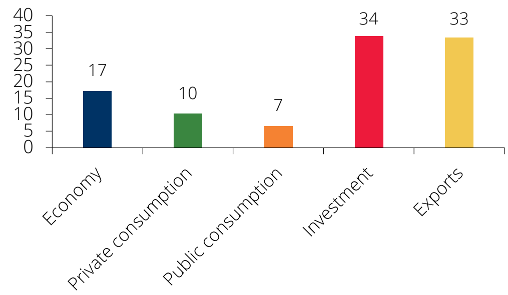
Chart 3 • Employment Growth – Sectors with above and below average national salary, 2015-2023 | In percentage



Source: Social Security (Banco de Portugal calculations).

The accumulation of productive factors extends to investment, which has grown by 48% in the last eight years, surpassing the 25% growth rate in the euro area, driven by criteria of efficiency and profitability. Private investment has increased by 54%, and in 2022, it accounted for almost 90% of the total. Simultaneously, companies have increased their financial autonomy. Until 2015, liabilities were more than twice the equity, but today, it has fallen to less than 1.5 times. During this period, openness to international trade has led to exports accounting for 50% of the economy in 2022. Exports and investment are the major contributors to growth.

Chart 4 • Cumulative Growth between 2015 and 2022 | Net import values, in percentage



Source: Statistics Portugal (Banco de Portugal calculations).

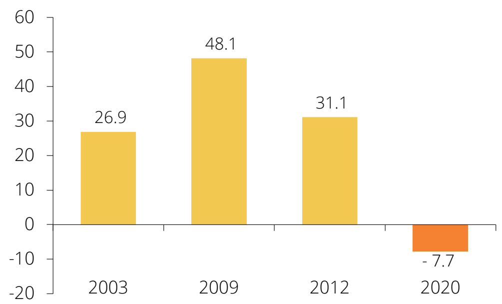
Not least, public investment has become more demanding and productive, with the recapitalization of Caixa Geral de Depósitos being a prominent example. The Recovery and Resilience Plan should become a unique moment of European integration and structural transformation; the days of 'roundabouts' are long gone.

In parallel, the incorporation of technological knowledge has promoted more productive organizations adapted to a globalized economy. Since 2012, the most critical point of the sovereign debt crisis, the operational profitability of Portuguese companies has nearly doubled. Still, the greatest success came through small and medium-sized enterprises whose profitability more than tripled (from 3.8% to 12.4%).

The accumulated social capital in nearly 50 years of liberal democracy promotes fiscal and labor market stability and improves coexistence among social partners, as evidenced by the response to the pandemic crisis and the collective effort to retain employment. The spirit of solidarity and rigor results in a reduced percentage of people at risk of poverty or social exclusion, with values lower than those of Germany or France, and in balanced public finances. Rare events in our history and the current European context.

In a time of possible economic cycle change, we cannot be caught unprepared, as has often happened. In the last recession episode, for the first time in many decades, total debt fell by 7.7 percentage points of GDP. Companies ended 2022 with nominal debt, net of deposits, lower than in 2019 by 4 billion euros, and households' debt was down by 9 billion euros.

Chart 5 • Debt Variation in 21st Century Economic Crises | As a percentage of GDP

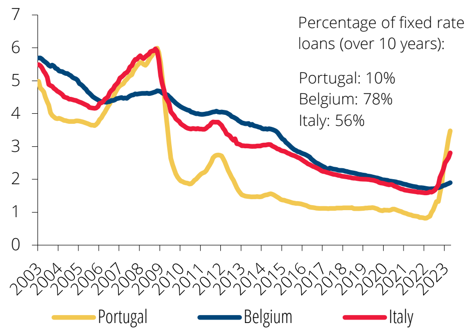


Source: Statistics Portugal (Banco de Portugal calculations).

The financial situation is characterized by a more capitalized banking system, thanks to investments made in 2016 and 2017 and the successful restructuring of the most relevant institutions. The proportion of non-performing loans in total credit is very close to that of the European Union (3.1% vs. 1.8%), and costs are much lower (cost-to-income ratios of 33% vs. 59%). After several years of depressed financial margins due to low interest rates, the profitability of the banking system has been restored.

As a result of a higher proportion of fixed-rate loans in other countries in the euro area, the average interest rates for housing loans in Portugal were consistently lower, but this situation has reversed since the end of 2022.

Chart 6 • Mortgage Interest Rates in Belgium, Portugal, and Italy | In percentage



Source: ECB (Banco de Portugal calculations).

In deposits, it is essential to continue creating conditions to stimulate savings. The average interest rate, close to zero a year ago, has been rising, reaching 1.7% for individuals and 3.0% for businesses.

In a Turning Year

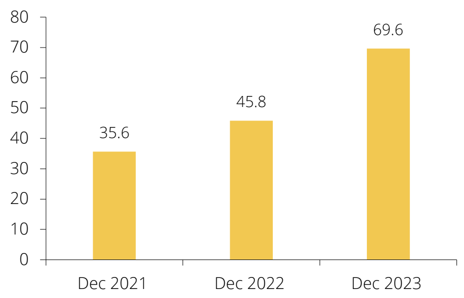
The conclusion of the recovery from the pandemic crisis, the cooling of inflation, and the need to find sources of growth in structural factors make 2023 a pivotal year.

The first half of the year saw rising interest rates, a slowdown in exports due to a hesitant global economy, but with nominal variables reflecting still relatively high inflation. The euro area economy almost stagnated despite a robust labor market. The Portuguese economy continued the economic convergence that characterized the years before the pandemic.

The second half begins with employment and wages at their peak. Private employment has grown by 9% since 2019, with 800,000 more jobs than a decade ago. Wages received by the Portuguese have seen even more significant growth: they have increased by 20% since 2019 and 67% in the last decade.

But the crossroads bring greater financial strain to households and businesses because of the monetary policy cycle. By the end of 2023, around 70,000 households could have expenses related to permanent housing credit servicing that exceed 50% of their net income; at the end of 2021, there were already 36,000 such households. Strengthening savings, reducing debt, public support, and the role of the banking sector in preventing default can mitigate these risks.

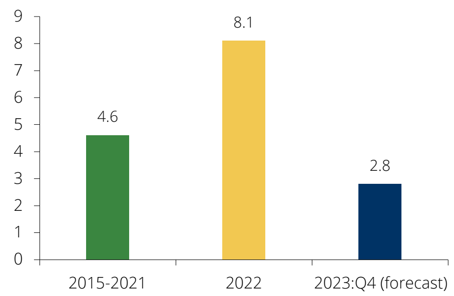
Chart 7 • Number of Contracts with Debt-to-Income Ratio Above 50% and Below 100% | In thousands



Source: Banco de Portugal.

Inflation is expected to approach 2%. In the absence of new shocks and with the transmission of monetary policy to the economy materializing, the medium-term objective is within reach in the near future.

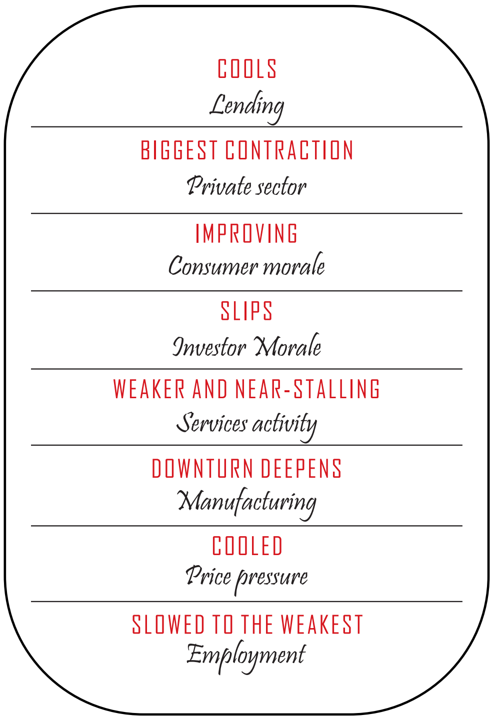
Chart 8 • Accumulated inflation over the period 2015-15, 2022 and the fourth quarter of 2023 | In percentage



Source: Statistics Portugal. Forecast, Banco de Portugal.

The economic environment (externally) shows signs of deceleration, even with recessionary dimensions. Economic indicators for the Eurozone released in July are not encouraging, but the scenario where we avoid a recession remains at the center of our assessments.

Figure 1 • Adjectives for Economic Indicators for the Euro Area Released in July 2023



Source: Trendingeconomics.com.

Policies

The current situation calls for policies focused on their stabilizing function. In the monetary dimension, the risk of "overdoing" is starting to materialize; inflation has been decreasing more rapidly than it rose, and the economy is adjusting to new financial conditions. On the fiscal front, maintaining balance should be a priority to reduce debt in a context of low inflation and higher interest rates.

Once price stability is assured, monetary policy should chart a predictable path of interest rate reduction, but far from the times of zero or even negative interest rates. Fiscal policy should continue to be guided by the notion that what was not affordable five years ago has not changed. The weight of permanent expenditure in the economy remains above 2019 levels but should be reduced to ensure sustainability throughout the economic cycle.

The existing scope for counter-cyclical action allowed for policy coordination to respond to the pandemic crisis; it should be rebuilt to act similarly when the cycle reverses. Financial stability and predictability of business models enhance investment. It is the responsibility of decision-makers to honor these principles.