



Banco de Portugal

EUROSISTEMA

**Initial Address by Governor Carlos da Silva Costa to the
Committee on Budget, Finance and Public Administration of the Portuguese Parliament
29 June 2012**

President of the Committee on Budget, Finance and Public Administration, Mr Eduardo Cabrita,
Members of Parliament,
Good afternoon.

In this initial address, I would like to outline some general considerations on the two key themes for this annual hearing of the Governor of Banco de Portugal: the performance of the Portuguese economy over the last year and its immediate and medium-term challenges; and assessment of Banco de Portugal's activity in 2011 against the 2011-2013 Strategic Guidelines announced previously.

I. The Portuguese economy: maintaining stability as a platform for sustained growth

The Portuguese economy's performance in 2011 was marked by the interruption of its access to market financing and the launch of the Economic and Financial Assistance Programme.

The Portuguese economy has accumulated significant macroeconomic imbalances, driven by an increase in public sector, corporate and household indebtedness, which rested on an increasingly leveraged banking system and a growing dependence on financing from the international money markets, both directly and through the banking system.

In 2000, public sector indebtedness was 50% of GDP, comfortably below the limit laid down by the Treaty of the European Union. In the space of a decade, the ratio almost doubled, reaching 93% of GDP in 2010. Between the mid-1990s and 2010, the international investment position fell sharply, from around -10% to -107% of GDP, and the Portuguese economy's gross external debt increased from 64% to 230% of GDP. Over the same period, the banking system's transformation ratio, measured by the ratio between credit provided and deposits held, increased from nearly 65% to around 160%.

These indicators are themselves a good illustration of the Portuguese economy's vulnerability to the international financial crisis and contagion from the other euro area economies.

Given the very low growth of potential output, the upward trend of external indebtedness generated increasing uncertainty among international financial investors as to Portugal's ability to service its debt. Uncertainty eventually led to the closure of the international financial market for Portuguese issuers, making the request for international financial assistance in April 2011 unavoidable.

The combination of factors explaining the Portuguese economy's performance since the middle of the 1990s is well understood today.

Since the mid-1990s, the economy was hit by two very powerful shocks: first and most important, the shock of monetary and financial integration into the euro area and the corresponding economic regime change. Second, the shock arising from the enlargement of the European Union and the intensification of the globalisation process.

The very substantial improvement in financing conditions resulting from monetary and financial integration led to a strong expansion in credit provided to the private sector and a reduction in savings. Consumption, in particular in durable goods, and investment, strongly focused in the construction sector, grew considerably. Increased private spending, without an offsetting increase in production capacity, resulted in a very strong expansion of imports, the channelling of domestic resources into the non-tradable goods sector, increasing unit labour costs and higher and lasting current account deficits.

The enlargement of the European Union and the globalisation process led on the one hand to intensified competition in international markets and the capturing of foreign investment, and on the other to an increase in the international price of raw materials, with a negative impact on the Portuguese economy's external imbalance.

The imbalances created by these two shocks were made worse by a budgetary policy that was almost always pro-cyclical and the lack of a macro-prudential policy – factors that were even more critical as they took effect in an unfavourable structural context, characterised by low levels of physical and human capital stock and by significant rigidity in the product and labour markets, particularly in the economy's sheltered sectors.

While taking nothing away from our individual responsibility, it is important to note that similar trends were at play in other euro area countries. The commonality of the shocks, a benign view of the adjustment mechanism within the Economic and Monetary Union (EMU) and an inconsistent EMU governance model contributed to the emergence of persistent imbalances between various countries in the monetary union, and ultimately, were behind the systemic crisis faced by the euro area today.

For several years, the prevalent belief in academic and political circles and the financial markets was that persistent current account imbalances within the monetary union were no cause for concern, since they were the expected result of a deeper integration between countries with different economic development levels. The following quotation, taken from an article published in 2002 by two highly regarded European economists, Olivier Blanchard and Francesco Giavazzi, illustrates this line of thinking well:

“The fact that both Portugal and Greece are members of both the European Union and the euro area ... and the fact that they are the two poorest members of both areas, suggest a natural explanation for today’s current account deficits. ...” (Blanchard, O. and F. Giavazzi (2002), *“Current account deficits in the euro area: The end of the Feldstein-Horioka Puzzle?”*).

This benign viewpoint – that did not take into account the internal inconsistency of an EMU governance model based on national fiscal sovereignty in euro area countries, on no default, on no bail-out and on the irreversibility of the adoption of the euro (no exit) – was also at the heart of the accommodative response of the financial markets and policy-makers to the imbalances emerging inside the euro area.

The monetary integration which followed the creation of the single financial market did not lead to the formation of a transnational banking system in the euro area. The financial systems remained essentially national and continued to take most of the debt issued by the respective sovereign in the international financial market. Meanwhile, the preservation of each national banking system's stability continued to depend on the capacity of their respective States to capitalise them in case of need. Thus within the euro area, a mutual dependence formed between States and the banking system, with concomitant contagion risks: from the sovereign to the banks, through public debt, and from the banks to the sovereign, through capitalisation needs. A situation that went unobserved during the benign times of the Great Moderation.

As the international economic and financial crisis unfolded and spread from the USA to Europe, investors' attentions began to focus on the macroeconomic imbalances of the euro area's peripheral

economies, the inconsistencies and fragilities of the single currency's governance model and the correlation between sovereign risk and banking sector risk. As investor confidence fell, on the one hand, sovereign and national banking systems' access to the international financial markets became more unequal and, on the other, the interbank market in the euro area vanished. Thus a heterogeneous monetary union has emerged, with sharp differentiation among euro area countries in their access to financing and an increasing difficulty in transmitting conventional Eurosystem monetary policy. The ECB resorted to non-standard measures to restore operationality to the monetary transmission mechanism and provide liquidity to the euro area banks.

The origins of the crisis had a national and a European dimension; in the same vein, the adjustment process also will have to undergo deep reform in those two dimensions.

At European level, the strengthening of the budget discipline mechanisms and the creation of the European stability mechanism have been key to making the EMU's governance model stronger. Nevertheless, further steps are needed. The negative interaction between the financing of sovereigns and the banking system must be severed urgently and in a credible, effective way. This co-dependence, which in the euro area has turned into a vicious circle of reciprocal contagion, requires a decoupling of the 'fortunes' of banks and sovereigns. For that purpose, monetary union must be complemented by banking union, with a European authority, an integrated supervision process and shared deposit guarantee, resolution and bank capitalisation mechanisms.

Nationally, the adjustment involves lasting consolidation of the public accounts, the creation of conditions for financial stability and the structural transformation of the economy. These are exactly the three pillars behind the Economic and Financial Assistance Programme to Portugal.

The challenge is a difficult one, but the steps taken over the last year have begun to bear fruit. The European Union and International Monetary Fund assessment of the Assistance Programme's implementation has confirmed that in general it has been adhered to, thereby enabling financing of the economy to continue.

In 2011, the general government deficit was comfortably below the maximum limit of 5.9% set down in the Programme, even though it benefited from a considerable amount of extraordinary measures.

In the structural plan, a set of alterations to the regulatory framework was launched, covering areas as diverse as the financial sector, justice, competition policy and the labour market.

The process of deleveraging and strengthening solvency in the banking sector continued. The banks' capitalisation levels have substantially improved, continuing the trend seen since 2008. The Core Tier 1 ratio reached 9.6% at the end of 2011, improving 1.5 p.p. versus 2010. Thus the banking system comfortably passed the 9% threshold set in the programme for the Core Tier 1 ratio for 2011. The trend observed reflects the increase in core own funds, driven by debt-for-equity swap operations and retained earnings policies, the debt securities repurchase operations and above all the deleveraging undertaken by the banks. Indeed, the ratio between credit and deposits held by the eight largest Portuguese banking groups at the end of the year was slightly below 130%, a reduction of around 30 p.p. versus the highest value recorded in June 2010. As is known, the Programme set an indicative target of a 120% ratio by the end of 2014.

The adjustment of the public and private sectors' balance sheets led, as would be expected, to a sharp decline in domestic demand and a decline in economic activity, reaching 1.6% in 2011. Against this, exports of goods and services performed particularly well, gaining market share and showing increased diversification, both in terms of products and destination markets. In this context, the Portuguese economy's external financing needs fell considerably, with the combined current and capital account deficit falling from 8.9% of GDP in 2010 to 5.2% in 2011.

The downward trend in economic activity, the increased risk premium, the closure of the international financial markets and the balance sheet restrictions faced by the banking sector translated into a contraction of internal credit in the economy. The aggregate behaviour of credit masks high heterogeneity across companies and sectors however. Companies without access to the external credit market, typically smaller and with higher risk, and the non-tradable goods sector, which was hit harder by falling domestic demand and the structural adjustment in progress, recorded a larger fall in credit. Meanwhile, the companies with a better financial position managed to maintain access to financing, in part through recourse to the external credit market.

The labour market deteriorated significantly in 2011 and continues to worsen in 2012. Unemployment rose again, reaching 12.7% in 2011. Unemployment predominantly affects low-qualified and older workers, who have found it increasingly difficult to find work in recent years. In these conditions, structural unemployment continued to increase, which made reducing it even more critical.

The stagnation of output and total factor productivity, the fall in investment, both greenfield and for expansion, and the segmentation of the labour market resulted in a sustained increase in unemployment over the last decade and falling job creation. Thus it is key to place and analyse the recent behaviour of the labour market in the context of these structural trends, while bearing in mind, obviously, that the strong fall in domestic demand helps explain the fall in employment and rise in unemployment. The key issue is the fact that the Portuguese economy is currently not creating jobs in net terms. The jobs created are overwhelmingly temporary and, due to their nature and insecurity, do not enable growth in productivity nor lead to investment in human capital.

The most urgent challenge is to put in place the conditions for the Portuguese economy to regain access to market financing. Thus, the commitments undertaken in the Assistance Programme must be carried out in full and contribution must be made so that the institutional development at European level allows market confidence in the single currency to be restored.

In the medium term, the great challenge is to make Portugal a more productive country that creates jobs.

At the end of the Programme's horizon, the public and private indebtedness levels will still be very high. This means that the need for financial discipline in the public sector and the other economic agents will have to continue. Adjustment of the resident sectors' balance sheets must be sustained and this process will continue to restrict domestic demand.

In any case, we must bear in mind that the adjustment of the public and private sector balance sheets is a necessary but insufficient condition to help the Portuguese economy escape a prolonged process of relative impoverishment. A sustained growth trajectory involves a rebalancing of the resource allocation in the economy, based on expanding the tradable sector, which in turn depends on attracting investment.

The Portuguese economy is not very open, given its relative size. Penetration of Portuguese exports is particularly low in the geographies expected to grow the most in the next few years. This fact, along with the high capacity available and the adjustment of relative costs under way, suggests that there is very strong potential for economic growth based on exports.

Realising this growth potential will not however be automatic. While the State should act as a catalyst for the transformation of the economy, the leading role will need to be played by the private sector.

The State is expected to be a regulator and to ensure compliance with the rules of the game of a market economy, thus providing the level playing field required for relative prices to play their signalling role. The State must act to reduce uncertainty (namely through the stability of the structure and level of taxation), to improve the quality of the institutional framework and to increase transparency in the economy. All these factors are critical for attracting investment. To this end, a stable, highly qualified and highly regarded public administration is needed, as well as an organisational and management model based on delegation and accountability, providing the right incentives that promote productivity and efficiency in the provision of public services.

The private sector needs to define effective strategies to respond to changes in external competition, market opportunities and the evolution of knowledge and technology, allocating resources to the best opportunities. In the current context of strong global competition, in order to survive, companies need to be able to adapt permanently, which involves introducing technological developments and defining renewal and growth strategies. Those strategies will often require the recruitment of specialists in knowledge absorption, technology incorporation and organisation and management model reformulation; they may also involve opening up to new shareholders and partners that create operational and capital conditions that lead to a place higher up the value chain.

The infrastructures and support services are available, the investment in the non-tradable sector has been made, now that must be capitalised upon, creating capacity in the economy's tradable sector.

The evidence shows that there is a consistent relationship between companies' innovation capacity on the one hand and workers' skills/qualifications and organisational forms and strategies on the other. As they are the main vehicles for qualified workers, companies will have to intensify their connection with the education and professional training system, setting out their knowledge and skill needs and investing in research and development. At a time in which scientific and technological paradigms are being broken, innovation capacity decides what position a country will hold in the universe of international trade specialisation. Thus, the connection companies have with the national innovation system (the 'education/professional training/R&D triangle') and the rechanneling of this latter towards the reality of the corporate context, and in particular to the needs arising from a strategic and forward-looking approach by the manufacturing base, are key success factors for the Portuguese economy's structural transformation programme.

The companies also need to strengthen their self-financing. A strategy based on maximum leverage and profit distribution is a short-sighted one, because it is limiting and does not address the need to respond to new challenges. Portuguese companies' high leverage ratios, when compared to those of companies in most mainland European countries, lead to a double fragility in our corporate context: financial fragility, as companies are particularly vulnerable to alterations in financing conditions; and strategic fragility, given that high leverage is inconsistent with safeguarding the ability to respond to the changes in the respective environment, and as a result, jeopardises the company's sustained growth.

In this regard, one must mention that the Programme outlines the definition of measures that promote diversification of the ways the corporate sector can finance itself: one of the structural benchmarks set after the third review of the Programme consists precisely of the Portuguese authorities presenting a proposal in this area by the end of July. The Programme also emphasises the implementation of the alterations introduced recently into the Insolvency and Corporate Recovery Code. This is also a structural benchmark.

I would like to conclude this introduction on the Portuguese economy, stressing that the current crisis offers up an opportunity, which we cannot waste, to follow a development strategy that places the Portuguese economy on a path of sustained convergence with the average per capita income levels for Europe.

The main aim must be to create the conditions for Portugal to become a stable market economy that is highly competitive in the euro area. The fact that the adjustment under way has a backdrop of an ageing population and the strengthening of integration at European and global level, two medium and long-term trends with profound economic implications, increases the urgency and relevance of this challenge.

I now move on to a short presentation on Banco de Portugal's activity in 2011.

II. Banco de Portugal's activity in 2011

As is clearly obvious from my address so far, the context in which Banco de Portugal has been operating in 2011 has been particularly difficult and demanding.

Aside from the national and international developments that I have mentioned, at institutional level the new European financial supervision architecture entered into force, including the European Systemic Risk Board (in macro-prudential supervision) and the European Supervisory Authorities for the banking, insurance and securities sectors (in prudential supervision and market conduct supervision).

In this context, given the responsibilities allocated to it, Banco de Portugal developed a strategic planning exercise at the start of 2011 and established four general guidelines for 2011-2013:

1. Financial stability in the European context;
2. Effective and fully-fledged contribution to the Banks' functions as monetary authority within the framework of the Eurosystem;
3. Organisation and efficient management of resources; and
4. Communication and supply of services to the community.

I would like to describe briefly the key elements of this strategy and the main achievements of 2011.

1. Financial stability in the European context

In terms of financial stability, Banco de Portugal's priorities are to implement the Economic and Financial Assistance Programme (EFAP) measures that lie within the Bank's responsibilities; to strengthen the effectiveness of the financial system's regulation and supervision in its various aspects (macro-prudential, prudential and market conduct); to promote the smooth operation of the payment systems; and to work proactively in international representation and cooperation with the other national financial supervisors.

The Economic and Financial Assistance Programme integrated into and deepened the strategy that Banco de Portugal had been following to ensure stability in the domestic financial system. This strategy is based on four key pillars:

- To strengthen the banks' capital base

- To ensure liquidity in the banking system
- To strengthen monitoring of the banking sector
- To improve the regulatory framework

The year 2011 saw marked progress across all these areas.

As I mentioned, capitalisation levels in the banking system improved substantially, continuing the trend seen since 2008. In parallel, banks continued to deleverage, leading to a substantial reduction in the loan-to-deposit ratio.

Transparency in the banking system was boosted significantly by a large quality inspection programme on the banks' assets, which involved contributions from external auditors and international partners; by the introduction of a new credit risk indicator, aligned with international standards; and by improved statistical reporting on the indebtedness of private individuals and companies.

The regulatory framework was greatly improved with the approval of legislation governing banks' access to public funds, early intervention, resolution, the winding-up of credit institutions and the deposit guarantee scheme.

To safeguard financial stability, Banco de Portugal also invested in bolstering financial education as a key element in preventing bank customers from taking on excessive risks and in increasing efficiency in the financial system. Accurate, transparent and complete information on the products and services offered for sale by credit institutions is key to the good operation of the retail financial markets. In financial literacy – an area of growing importance – the work undertaken has led in particular to the approval of the National Financial Education Plan, a joint initiative of Banco de Portugal and the other national financial supervisors, under the coordination of the National Council of Financial Supervisors.

In November 2011, the 1st Banco de Portugal Conference on Financial Literacy took place, announcing the results of the Survey on the Financial Literacy of the Portuguese Population and promoting reflection and debate on this topic. Banco de Portugal also started issuing leaflets on banking customers' rights and duties when entering into consumer credit and bank deposit agreements, distributed through credit institutions' branches. The 2011 Banking Conduct Supervision Report, published in May 2012, provides detail on the Bank's work in regulating and auditing the retail financial markets and in developing financial training projects.

2. Effective and fully-fledged contribution to the Bank's functions as monetary authority within the framework of the Eurosystem

Banco de Portugal fulfilled the goals it set itself in making an effective and fully-fledged contribution to its functions as monetary authority within the framework of the Eurosystem. Its work involved research and economic guidance, execution of monetary policy, management of financial assets and gold, payment systems, monetary issue, statistics and reporting duties, and international relations and cooperation, especially with Portuguese-speaking countries.

Of particular note were the activities involved in the Bank's participation in the decision-making process of the Eurosystem's monetary policy. The Bank took an active role in defining non-standard policy measures and monitoring resident institutions' liquidity situations, with particular involvement in the plans to reduce the need for financing from the Eurosystem, thereby ensuring a gradual and orderly deleveraging process.

In 2011, the Bank also invested in improving oversight of payment systems and promoting the good operation of TARGET2-PT, as well as its goals relating to its functions as monetary authority within the framework of the Eurosystem.

In statistics, the response to the new information requirements identified in EFAP was particularly important. The increased interconnection of the data contained in the Central Balance-Sheet Database, the Central Credit Register and the Securities Statistics Integrated System was an important factor in this.

Banco de Portugal also made notable progress in its cooperation activity in 2011: its geographical reach and the subject areas of cooperation were broadened to encompass all the Portuguese-speaking world (including Brazil) and to cover other key areas in greater depth, such as supervision and accounting.

3. Organisation and efficient management of the Bank's resources

In terms of resource organisation and management, Banco de Portugal decided to prioritise strengthening the internal organisational model, continuous improvement of its business, management and technological processes, and the development and motivation of its staff.

The Bank took the following action in 2011 in internal governance:

- reorganisation of the supervision function into three departments, banking prudential supervision, banking conduct supervision and legal enforcement. Giving these three supervisory areas autonomy reflects the guidelines of the European Union and other international entities and, as has been the case with other Member States, incorporates best practice and lessons learnt following the international financial crisis
- creation of the figure of the Ethics Adviser, embodying the strengthening of principles of integrity and ethical values
- increased importance placed on operational risk management, in order to prevent the occurrence of events that could seriously harm its financial situation, its image and reputation, or its ability to achieve its goals.

In the IT systems area, aside from various cross-cutting projects, the Bank executed various projects in 2011 to address the growing needs relating to the treatment of data in the areas of prudential supervision, statistics and payment systems.

Human resource management continued to be guided by the aim of ensuring a technical team capable of responding to the Bank's growing challenges and new responsibilities in a sustained way, particularly in the area of supervision and regulation of the financial system and the EFAP.

Naturally, Banco de Portugal is also aware of the difficult context facing Portuguese society. For this reason, the Board of Directors of Banco de Portugal decided, autonomously and in a spirit of solidarity, to join the adjustment effort that the country is making, and adopt salary containment measures. Those measures, along with other cross-cutting rationalisation initiatives, led to a significant reduction in personnel costs in 2011. The Bank's activity report and accounts for 2011 show that this goal was fully achieved, with a reduction of around 8% in personnel costs.

4. Communication and supply of services to the community

In the area of communication and services to the community, Banco de Portugal's strategic goals include a policy of communicating transparently and rigorously with the financial community and other domestic and international entities, with the media and society in general. Alongside these goals, the Bank aims to optimise the services provided to the community, in particular in its provision of economic and statistical information. In its relations with the community, the Bank places

importance on promoting social responsibility and environmental sustainability, two areas in which it introduced certain initiatives during 2011.

In external communication, Banco de Portugal favoured use of its websites. The Bank's institutional site sets out its organisation, mission, functions and activities and also publishes press releases and public speeches. The Bank Customer Website is a space dedicated to giving information to bank customers, offering financial education and services to the public. Both sites were rebuilt and broadened to provide more information, and received more visits than in 2010. The Bank's commitment to promoting transparency and greater interaction with the community is also reflected in the number of press releases and public speeches made in various Portuguese and foreign forums, which grew around 30 per cent versus 2010.

Final considerations

The context we faced in 2011 was complex and challenging. The future looks similar.

In Europe, we have to go further and create an institutional framework that ensures that, aside from monetary policy, budgetary and financial sector policies are also aligned with the euro area as a whole. We need a banking union to overcome the fragmentation of the monetary union and the obstacles to transmitting monetary policy and a common set of budgetary rules and institutions that safeguard the stability of the monetary union. The measures already adopted in 2011 and at the start of 2012, towards strengthening economic governance, and the proposals that are currently on the table are important steps in this direction. But naturally, the task of reforming the European institutions and governance is only now beginning.

In the specific case of Portugal, the measures and financial stability objectives outlined in the Economic and Financial Assistance Programme are well under way. But the challenges are still considerable and there is no room for complacency. Combining the growing needs for capital with the deleveraging requirements, while at the same time trying to avoid a sharp fall in credit in the economy, is a mission that requires a delicate balance between 'science and art' in setting economic and financial policy.

It is essential that while deleveraging continues, the banks continue to provide sufficient financing to the economy's more productive business sectors and companies. The banks' deleveraging strategy must therefore continue to focus on selling non-strategic assets, on selling credit, on using stable sources of financing and on capitalisation. Achieving the goals of budgetary consolidation and successful restructuring of the State's corporate sector are equally vital for avoiding a crowding-out effect on credit for the productive sector.

To conclude, I would just like to emphasise that the financial crisis has taught us many lessons and brought about significant change to the operation of the financial system. The global supervisory authorities have done everything possible to strengthen the resilience of the financial system. I am fully confident that Portugal is at the forefront of these efforts. I am also convinced that Banco de Portugal is now much better equipped to 'see the forest for the trees' and to act with determination in case of 'fire'.