Portugal after the Financial Crisis: Mission Unfinished

Albert Jaeger
International Monetary Fund, Lisbon Office

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Overview

- **Looking back: The path to financial crisis**
- **Looking ahead: Path to a balanced economy**
- **Mission unfinished: Structural reforms**

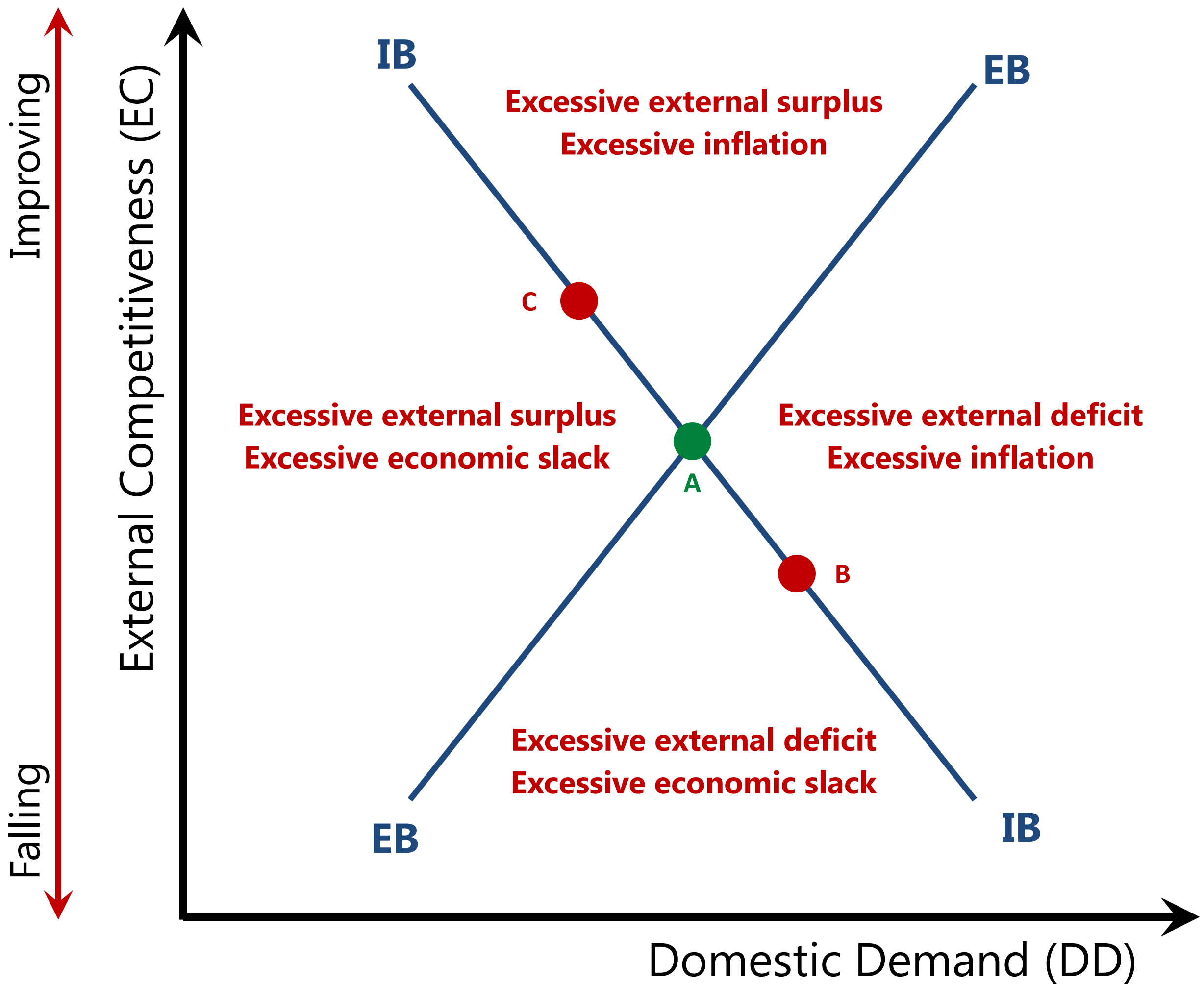
Three key takeaways

- Portugal’s economy went through a prolonged binge-slump-bust cycle, resulting in several difficult-to-deal-with flow and stock imbalance legacies.

- Policy makers should focus on increasing jobs and investment while making fiscal responsibility stick.

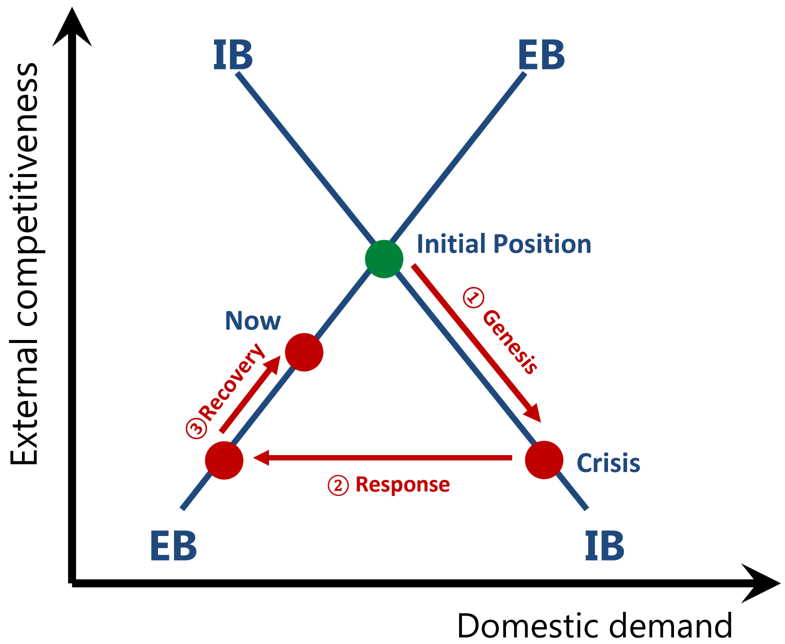
- To meet these challenges, more and well-designed structural reforms are needed.

Concepts: Tracking an economy's external-internal balance (Swan diagram)



- Ana Karenina principle: Happy economies are all alike; every unhappy economy is unhappy in its own way.
- Political preferences: If one can't make it to A, try to stick to IB line. Result: Potentially unhappy monetary unions.

Looking back: Flow imbalances (very stylized)



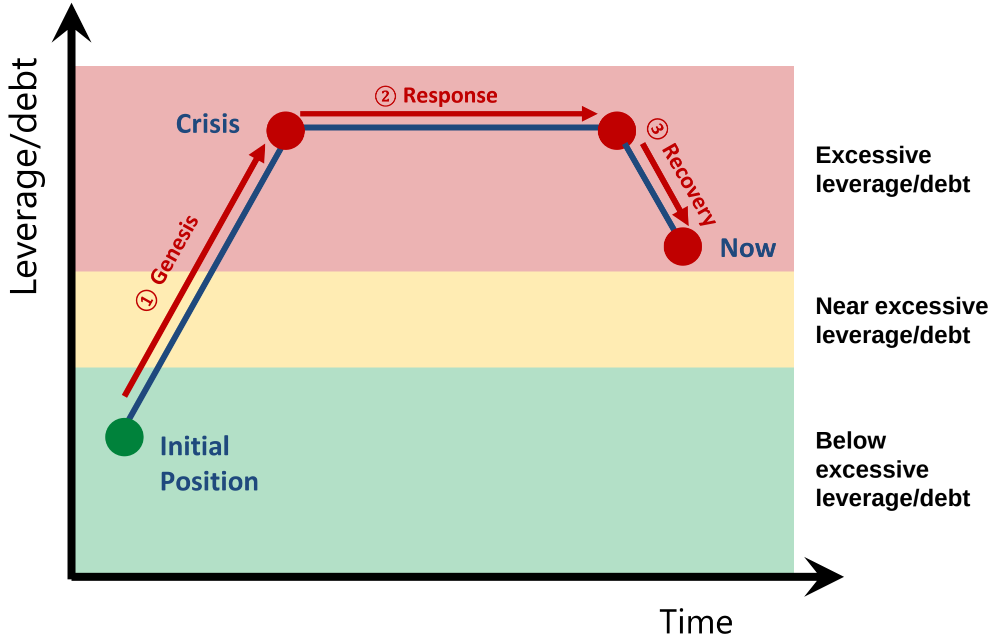
"In a monetary union … the balance of payments is no longer … a restriction." Banco de Portugal, 2004.

① **Genesis of crisis:** During 1995-2010, average current account deficits of about 9 percent of GDP. Some saw EB seen as irrelevant (see quote). No signs of overheating.

② **Response to crisis:** Adjustment program restored external balance. With no external (or fiscal) devaluation feasible, internal imbalance (high unemployment) opened up.

③ **Recovery**: Gains in external competitiveness and increase in domestic demand.

Looking back: Stock imbalances (very stylized)



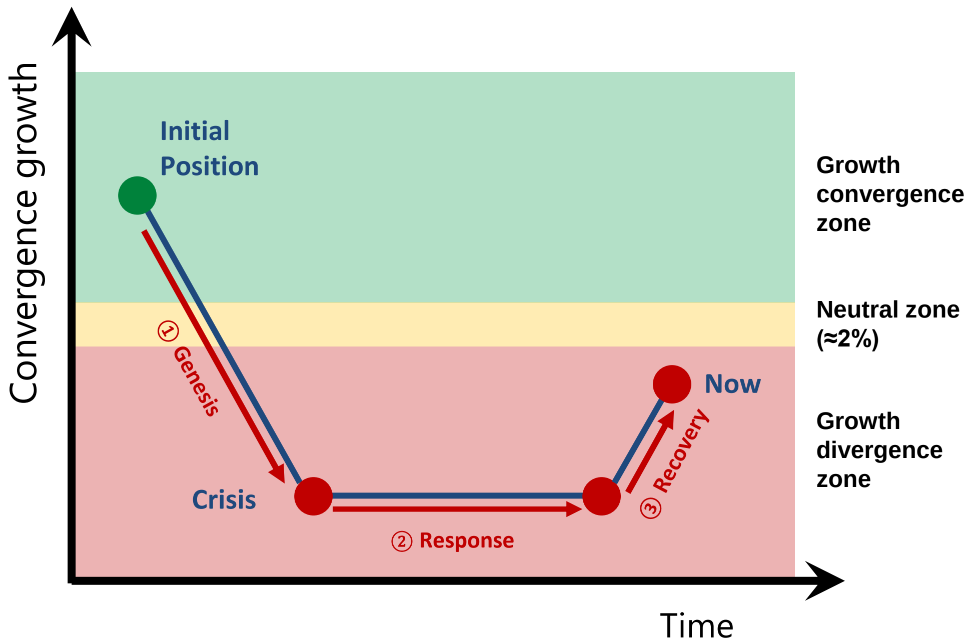
- Stein's Law: *"If something cannot go on forever, it will stop."*

① **Genesis of stock imbalances:** Fed by large and persistent external flow imbalances, both private (especially corporate) leverage and public debt rose to excessive levels. Sudden stop in 2011 (see quote).

② **Response to stock imbalances:** Adjustment program stabilized corporate leverage and public debt at excessive levels.

③ **Recovery:** Retrenchment of corporate leverage and public debt has started but stock imbalances remain excessive.

Looking back: Growth slump (very stylized)



- Within EU, Portugal is a relatively poor country. It’s per capita income is about 45% below EU’s per capita income.
- Poorer EU countries should grow faster, i.e. converge to average EU incomes.

① **Genesis of growth slump:** Despite large, persistent capital inflows + large per capita income gap, growth slumped during 2001-10.

② **Response to growth slump:** Adjustment program initiated many (494) structural reform actions.

③ **Recovery:** Started in 2013, but still question whether economy will return to convergence growth.

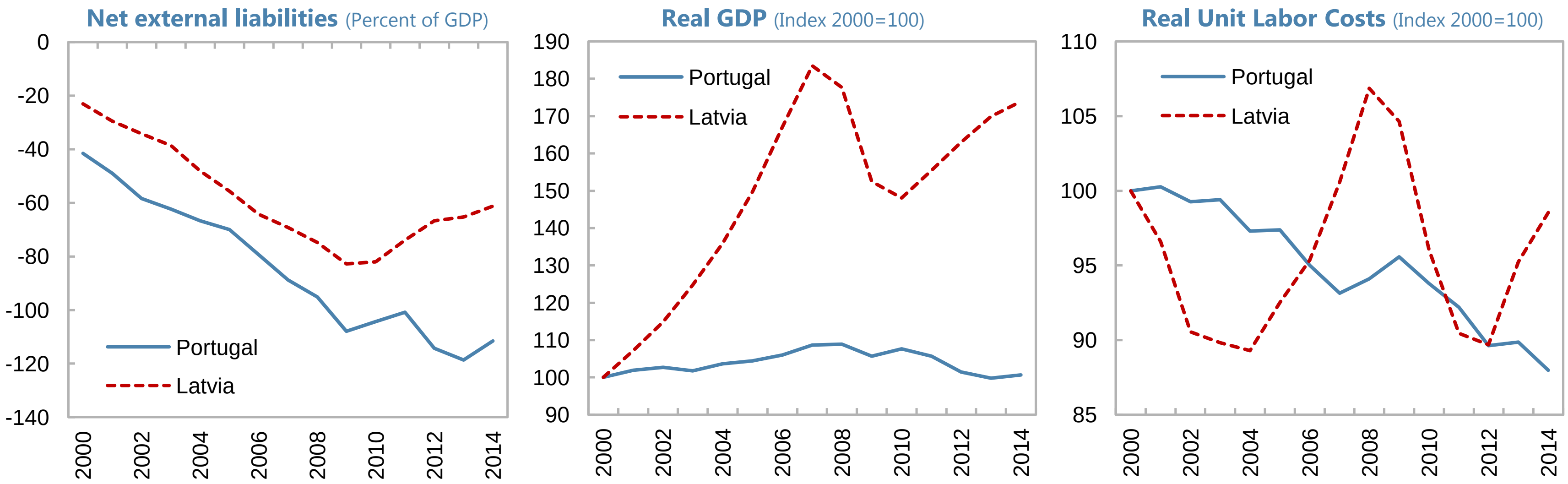
Looking back: Imbalances and growth

Digression: Was Portugal's macro experience unusual?

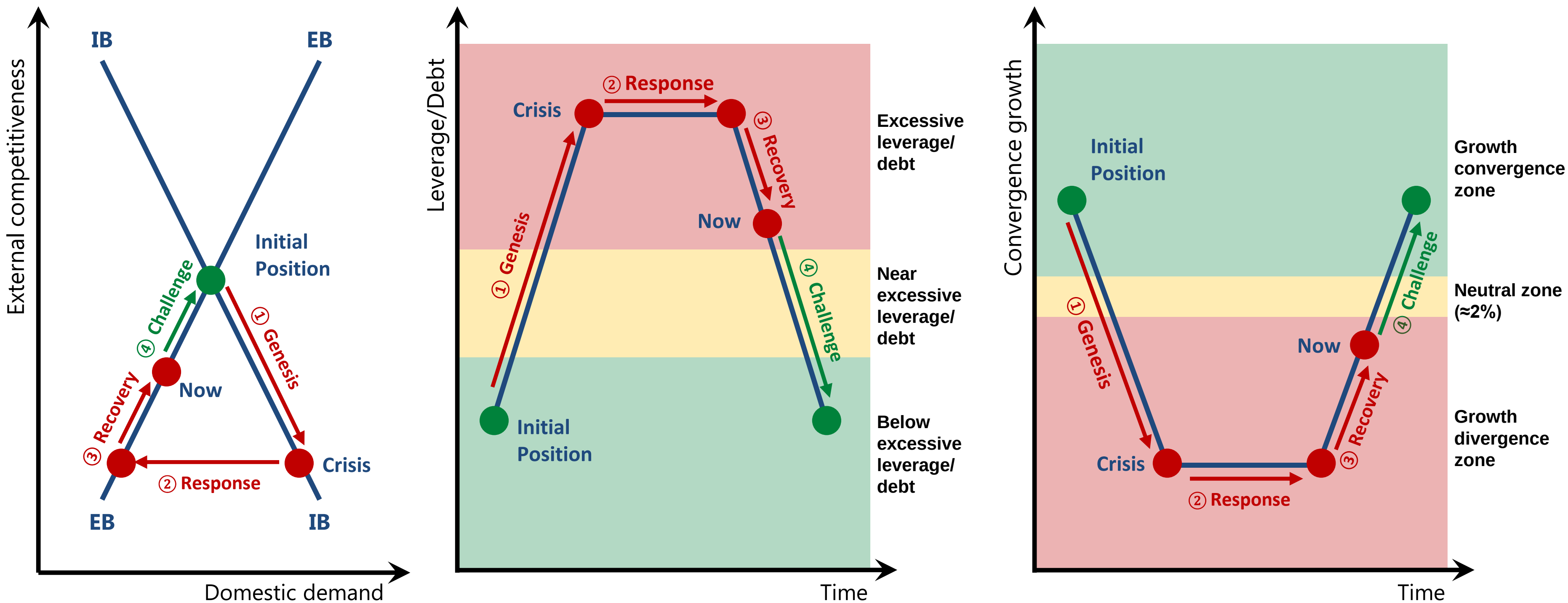
Conventional sequence:	Spending Binge	→	Growth Boom	→	Financial Crisis
Portugal's sequence:	Spending Binge	→	Growth Slump	→	Financial Crisis

- Prolonged spending binge + slumping growth generated exceptionally large debt overhang.
- With no signs of overheating, gradual build up of Portugal's debt overhangs may have duped observers.

Latvia vs. Portugal: 2000-2014



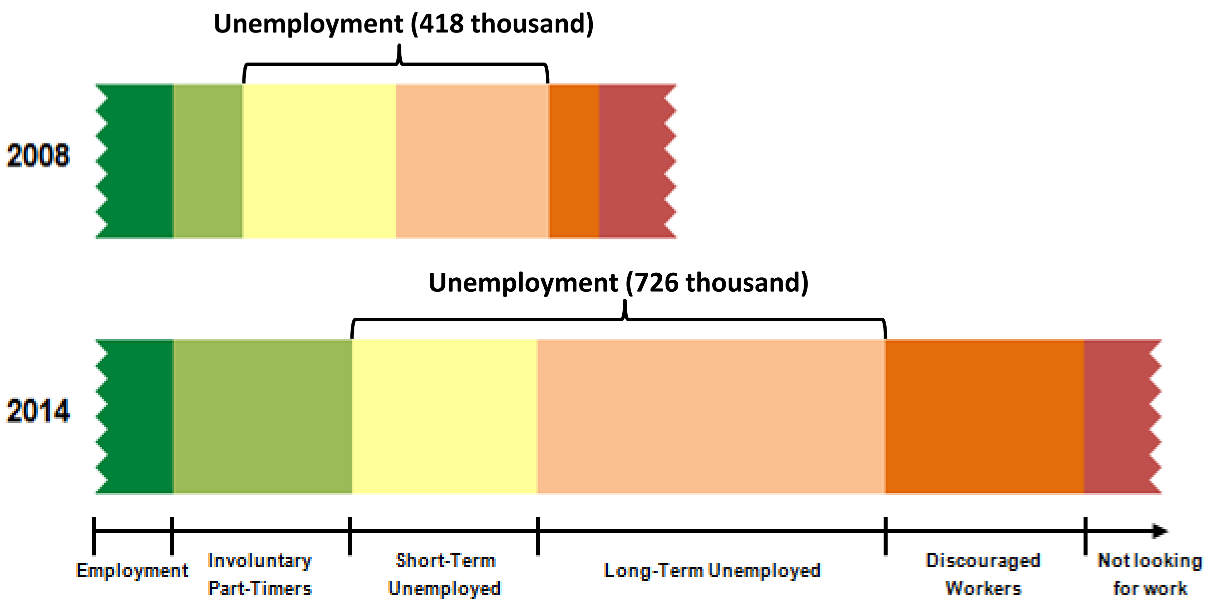
Looking forward: Mission unfinished

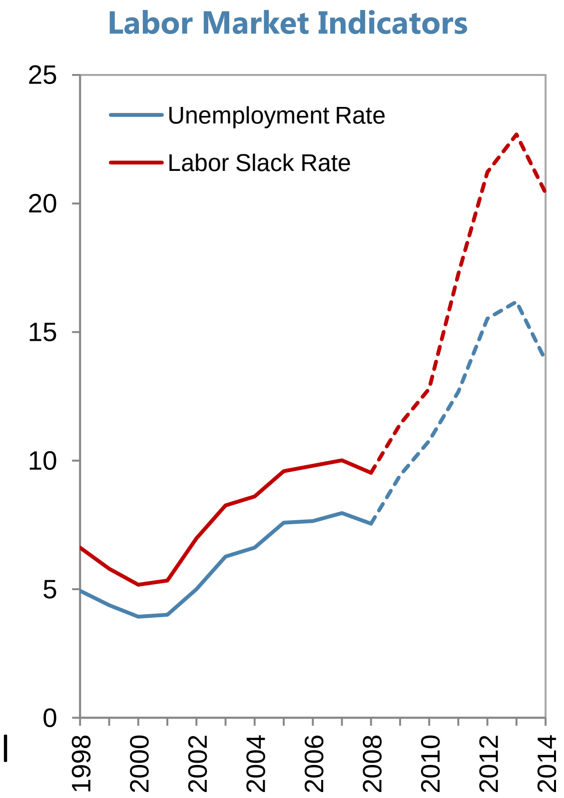


- Need to restore internal balance, raise convergence growth, and reduce corporate leverage, with all three issues interconnected.
- Need to put public debt-GDP ratio on a solid downward trajectory.

Policy challenge #1: Jobs

Sizing up the jobs problem



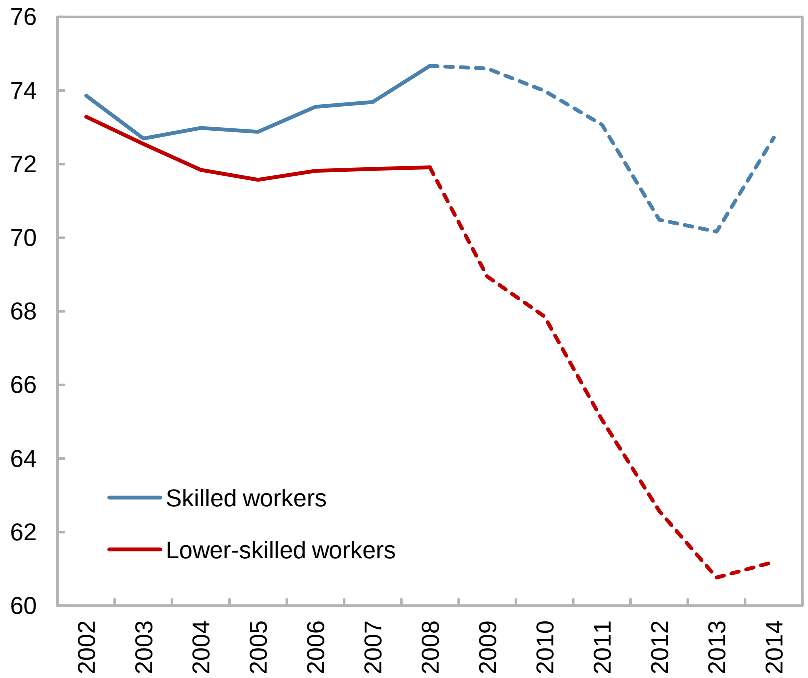


- Looking only at unemployment in a post-crisis economy misses the full extent of labor slack.
- Since 2010, surge in involuntary part-time and discouraged workers.
- Labor slack rate adjusts unemployment rate (chart), but slack measure still does not take into account of migration.

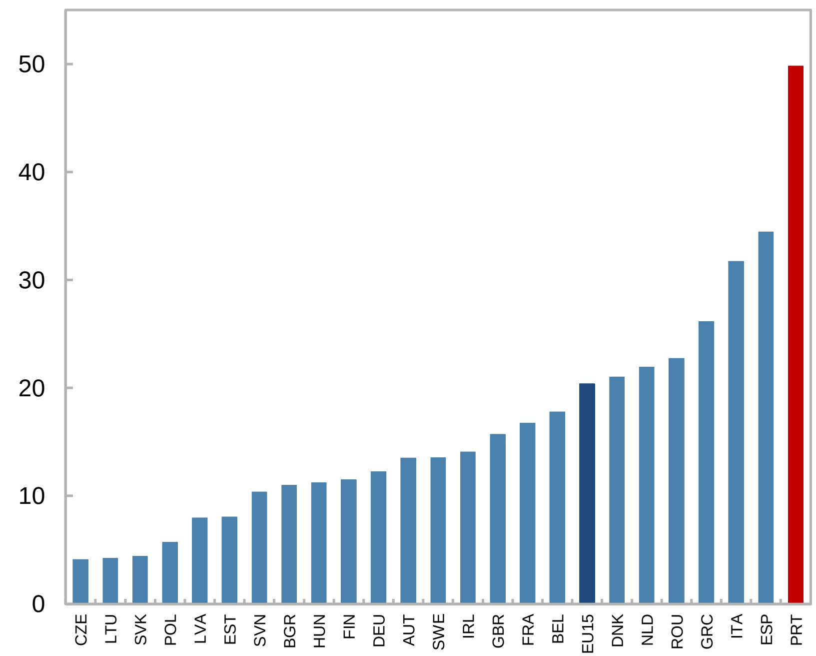
Policy challenge #1: Jobs

Digging deeper: Reversing lower-skilled jobs destruction

Portugal: Employment Rates Skilled/Lower-Skilled, 2008-2014



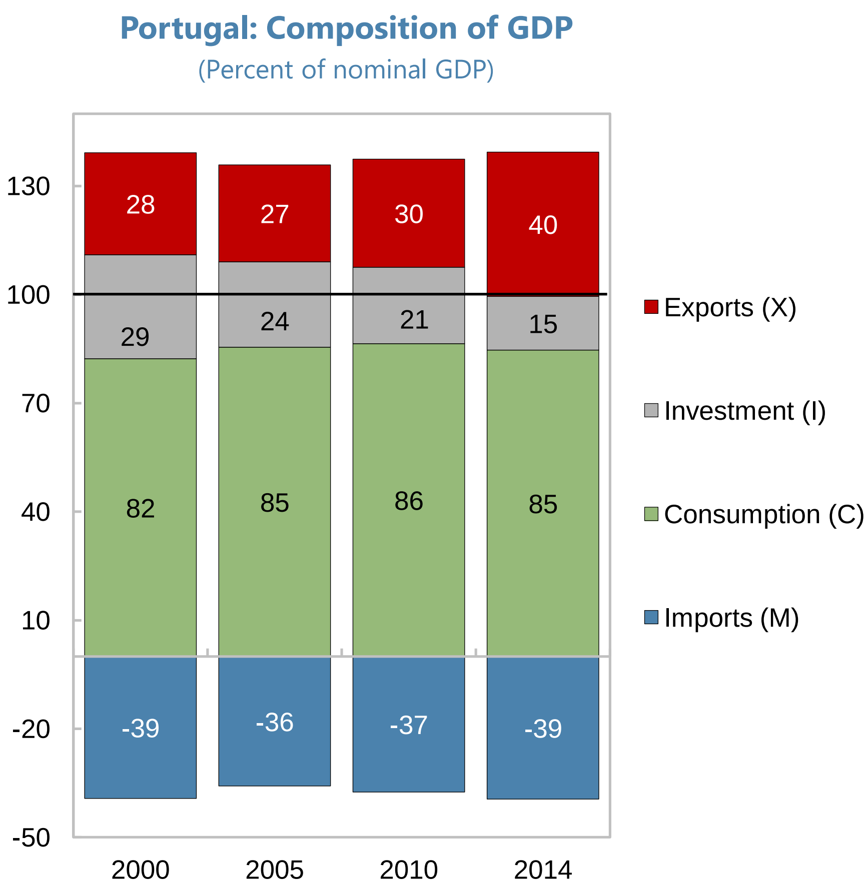
EU countries: Share of Lower-Skilled in Employment, 2014



- Two stylized facts: (1) In Portugal, high elasticity of substitution between lower-skilled and skilled workers. (2) Skilled workers' wages more flexible. Consequence: Job losses largely concentrated among lower skilled, which represent large share of employment in Portugal.
- Reversing lower-skilled job destruction will require comprehensive, home-grown, and politically difficult structural reforms (example: Germany's Hartz reforms).

Policy challenge #2: Investment

Sizing up the overall investment problem



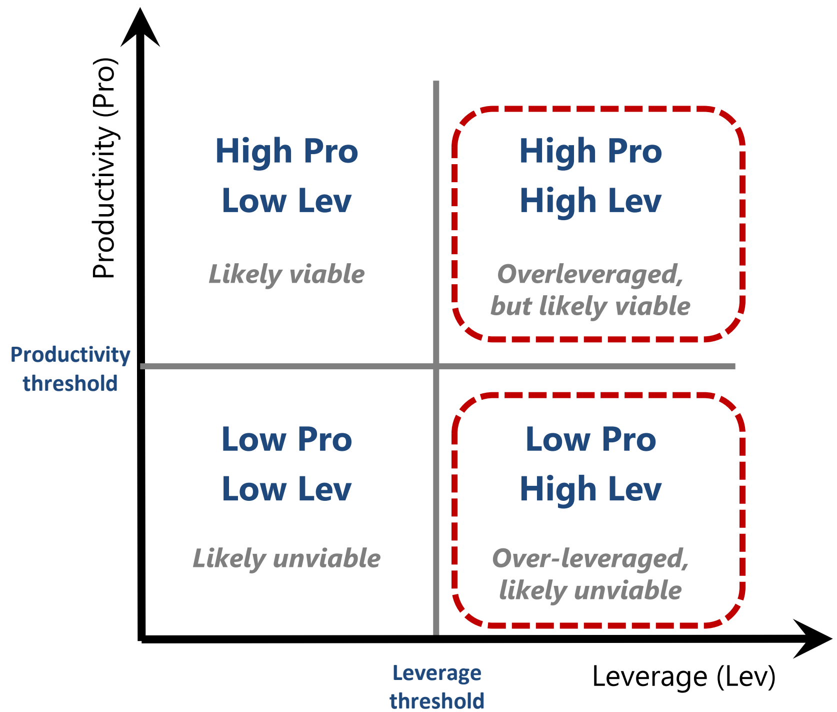
GDP = C + I + X - M

- External imbalance correction (via higher exports) has shrunk investment share.
- Economy's net investment (investment minus depreciation) negative. Capital stock shrinking.
- Raising investment share while keeping external balance requires lower consumption share.
- Could (historically) low investment share nevertheless generate convergence growth if it focuses on productive corporate investment?

Policy challenge #2: Investment

Digging deeper: Corporate investment and deleveraging

Segmenting firms by performance and leverage



Productivity threshold: Value added per worker = 12,000

Leverage threshold: Debt-to-asset ratio = 0.70

Portugal: Segmenting firms, 2010-12 averages

Productivity / Leverage	# Firms	Value Added	Employ-ment	Invest-ment	Debt
High / Low	77,142	49%	37%	37%	24%
High / High	59,378	46%	35%	50%	55%
Low / High	102,767	3%	18%	9%	15%
Low / Low	56,327	2%	10%	4%	6%
Total	**295,614**	**100%**	**100%**	**100%**	**100%**

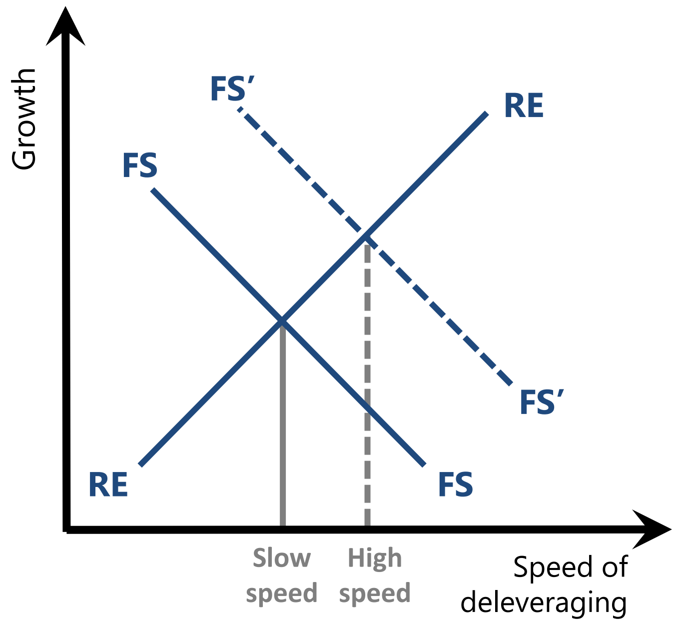
Corporate deleveraging would:

- Re-allocate real resources from over-leveraged and likely unviable firms to viable firms => higher growth.
- Reduce leverage in overleveraged, likely viable firms => higher growth.

Policy challenge #2: Investment

Digging deeper: Corporate deleveraging speed

What is the right speed of corporate deleveraging?



- Real economy (RE) curve: Faster speed of deleveraging raises growth.
- Financial stability (FS) curve: Faster speed of deleveraging lowers growth. But policies available that can shift FS curve.

Arguments for:

Slow speed/growth:

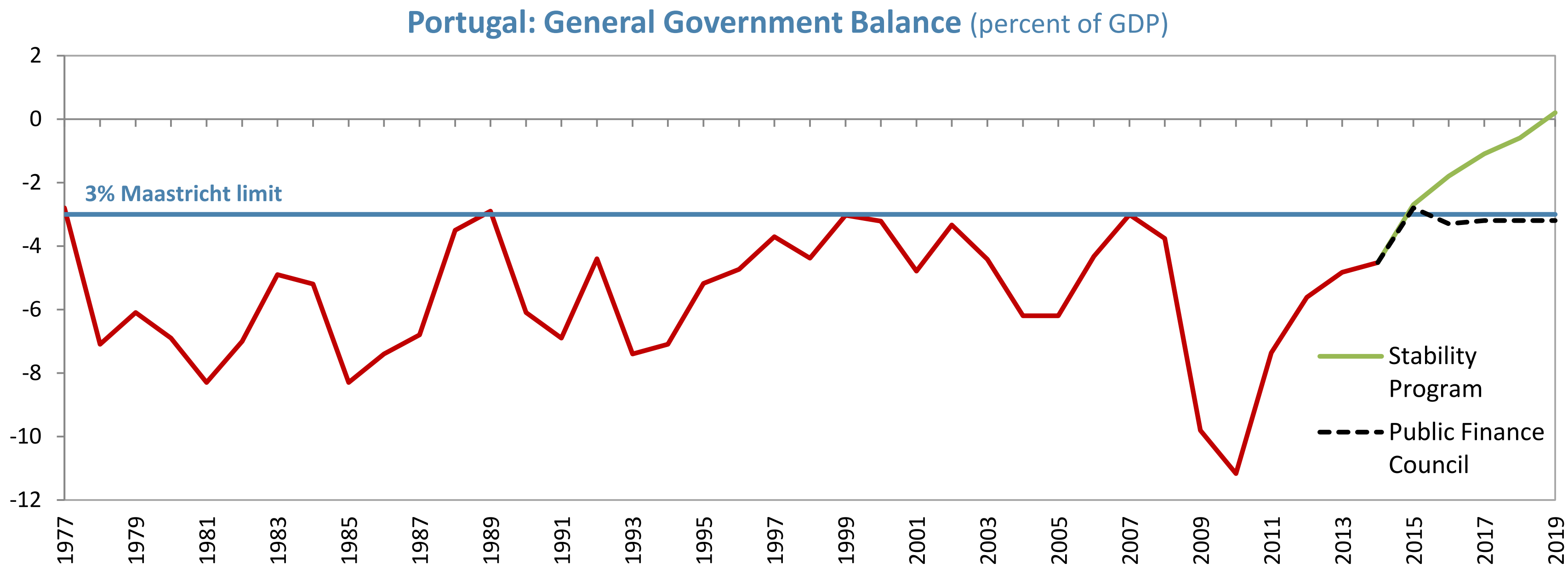
- Creditors (banks) don't have enough capital.
- Collateral values may recover.
- Avoids immediate political/social tensions.

High speed/growth:

- Corrects flow and stock imbalances faster.
- Lowers risk of bad equilibrium.
- Increases policy credibility.

Policy challenge #3: Making fiscal responsibility stick

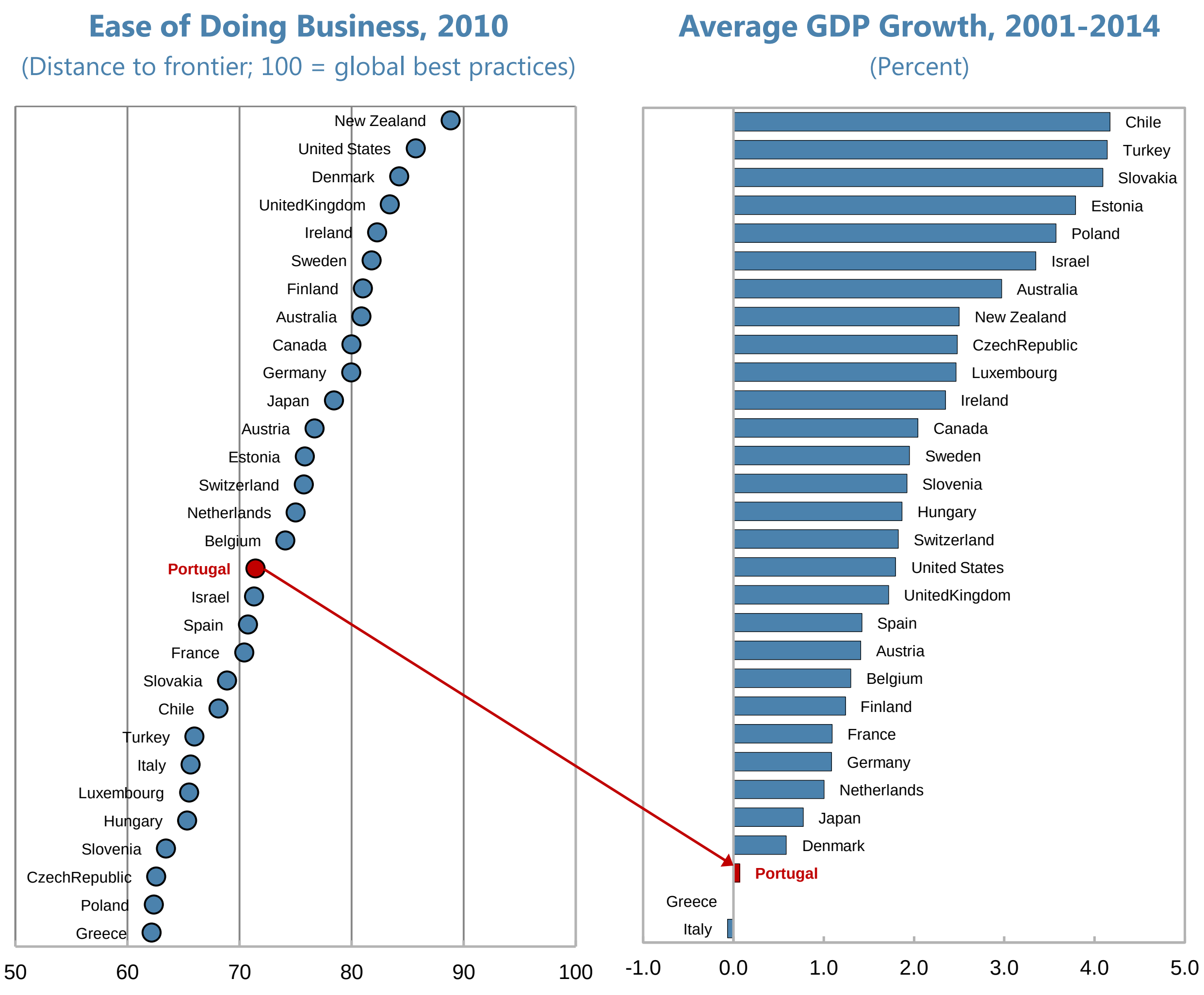
Sizing up the problem



- Over the last 40 years, Portuguese fiscal policy never managed to break through the 3% fiscal deficit limit established by Maastricht Treaty.
- Under unchanged fiscal policies, Public Finance Council projects deficits above 3% limit over medium term. Government's Stability Program (April 2015) projects surplus by 2019, but does not spell out specific policies to achieve medium-term deficit targets.

Mission unfinished: Structural reforms

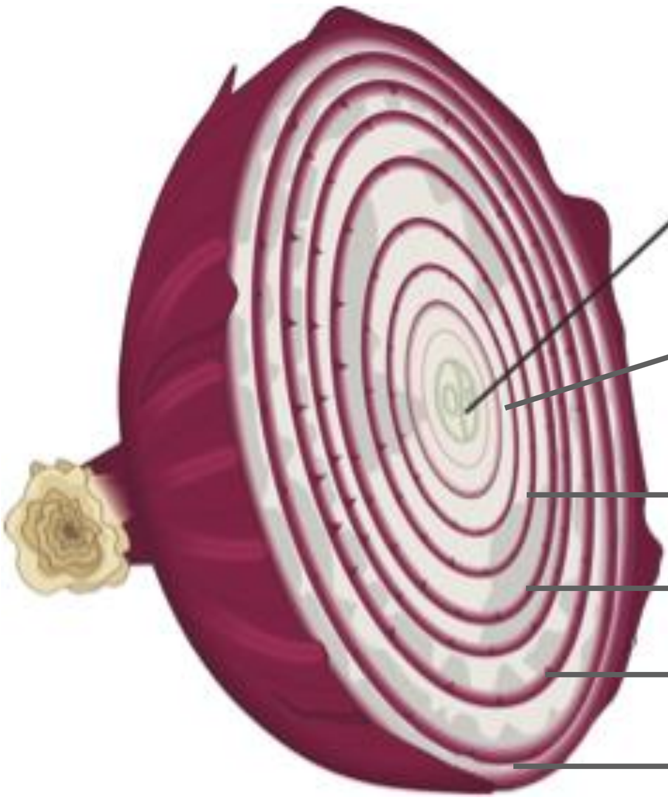
Is there a Portuguese reform paradox?



- Rules on paper suggest that Portugal has been a very reformist country, even before the crisis.
- But economic outcomes seem inconsistent with rankings.
- Is this the explanation? *"Lack of effective implementation is the reason why reforms in Portugal have little or no impact on firms' competitiveness."*

Mission unfinished: Structural reforms

Peeling the structural reform onion



- Structural reforms mainly change rules on paper.
- If deeper layers differ, same rules can generate different economic outcomes. Example: Divergence between statutory and effective retirement ages across countries.
- And rules can be shaped by the deeper layers. Example: Rigidity of employment protection laws and quality of firms' managerial practices seem (negatively) correlated across countries.

Mission unfinished: Structural reforms

Figuring out whether reforms are working

- Impact of reforms on international rankings
  - May capture only rule changes on paper
- Impact on Key Performance Indicators (KPIs)
  - KPIs may not be related to ultimate desired reform outcomes
- Impact on macro/micro outcome data
  - Difficult to disentangle effects of structural reforms from other factors affecting outcomes
- Given these limitations, why not look at impact of structural reforms on perceptions of firms?

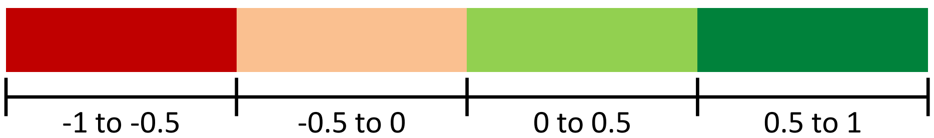
Mission unfinished: Structural reforms
IMF firm survey for Portugal

Design of the survey:

- Sample size: about 500 firms (response rate 17.4%).
- Questions on 34 structural reform areas. For example, regarding reforms of hiring and firing costs:

	Impacto				Necessidade de efetuar mais reformas			
	Nenhum	Pouco	Significativo		Nenhuma	Importante	Urgente	
	1	2	3	N/A	1	2	3	N/A
Custos de admissão e despedimento. Por exemplo: novas regras para despedimento individual; novas regras de compensação por cessação de trabalho. *								

- Scores were normalized to the range -1 to 1, where **-1** means no impact or urgent need; **0** means some impact or need; and **1** means significant impact or no need.
- A color code was assigned based on four uniformly spaced intervals:



Mission unfinished: Structural reforms

Summary of firm survey responses [1/]

Product market reforms	Impact of reforms	Urgency of more reforms
Licensing environment		
Energy costs		
Cost of telecommunication and postal services		
Cost of road use		
Cost of using railways		
Cost of using ports		
Cost of professional services		
Cost of other services		
Enforcement of competition		

- Firms indicate little impact of product market reforms; see some urgency for more reforms.

Labor market reforms	Impact of reforms	Urgency of more reforms
Increases in work time		
Increases in work time flexibility		
Collective bargaining		
Hiring and firing costs		
Active labor market policies		
Effectiveness of employment agencies		

- Responses indicate more impact of labor market reforms; see some urgency for more reforms.

[1/] For details, see: http://www.imf.org/external/pubs/ft/scr/2015/cr15127.pdf

Mission unfinished: Structural reforms

Summary of firm survey responses [1/]

Public sector reforms	Impact of reforms	Urgency of more reforms
Effectiveness of central administration		
Effectiveness of local administrations		
Cost of paying taxes		
Effectiveness of VAT refund		
Investment incentives		
Payment on time by central administration		
Payment on time by local administrations		
Payment on time by SOEs		
Quality of services provided by SOEs		
Privatization program		
Effectiveness of labor courts		
Effectivess of tax courts		
Effectiveness of civil and commercial courts		
Effectiveness of alternatives to litigation		

- Most public sector reforms are seen as having had some impact; but high urgency of more reforms in many areas.

Financial sector and insolvency reforms	Impact of reforms	Urgency of more reforms
Efficiency of insolveny framework		
Debt restructuring framework (PER)		
Out-of-court debt restructuring framework (SIREVE)		
Provision of alternative financing options		
Efficiency of credit allocation by banks		

- A similar picture for financial sector and insolvency reforms.

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Thank you!