Portugal's Economic Crisis: Diagnostics and Remedies

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Three obvious but important points:

- **Acknowledgements**. Much of what follows draws on work and analysis by Portuguese economists and officials.

- **Incomplete**. The exposition here is linear and partial. The full story of course is much more complex and nuanced.

- **Hindsight**. The passage of time always makes it easier to understand what went wrong. From the vantage point of 2001 or even, say, 2005 things looked different.

CRISIS DIAGNOSTICS

Portugal's current economic predicament is the legacy of policy and institutional weaknesses in a rapidly changing global environment

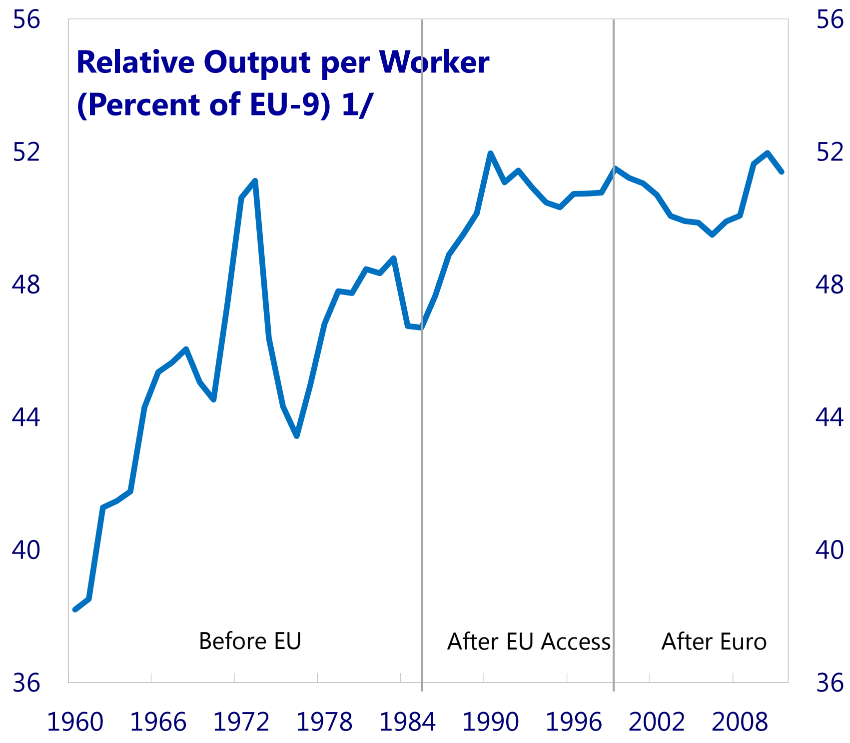
1970-86

1986
EU Accession

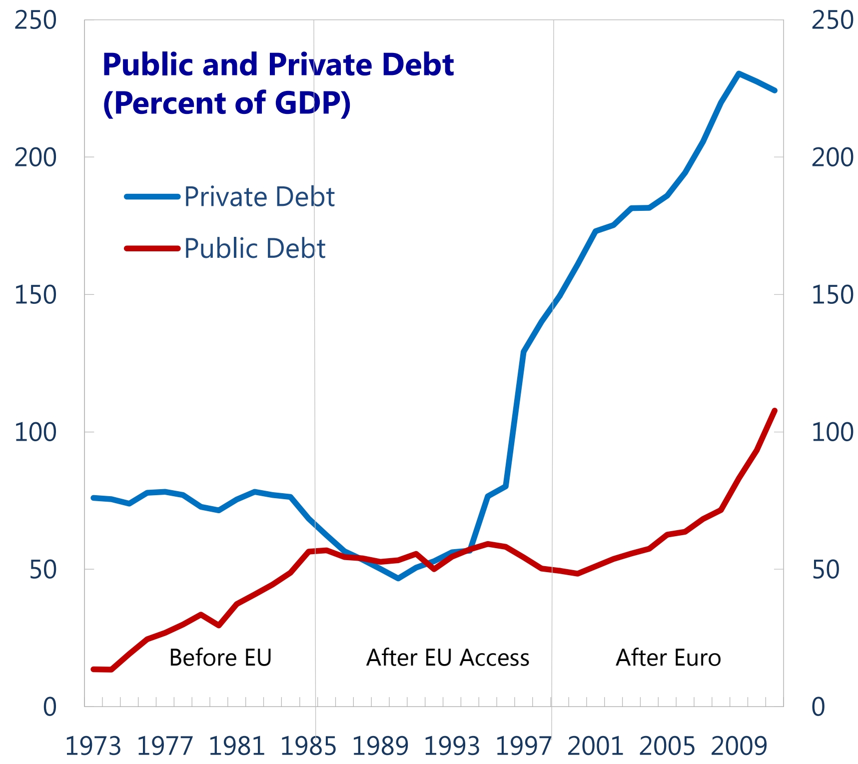
1999
euro adoption

Several other shocks (not specific to Portugal):
- **"Globalization"** (increasing trade openness and capital markets integration)
- **ICT revolutions**
- **Global financial crisis**

As monetary integration advanced, productivity and growth outcomes were very weak, while macroeconomic imbalances worsened

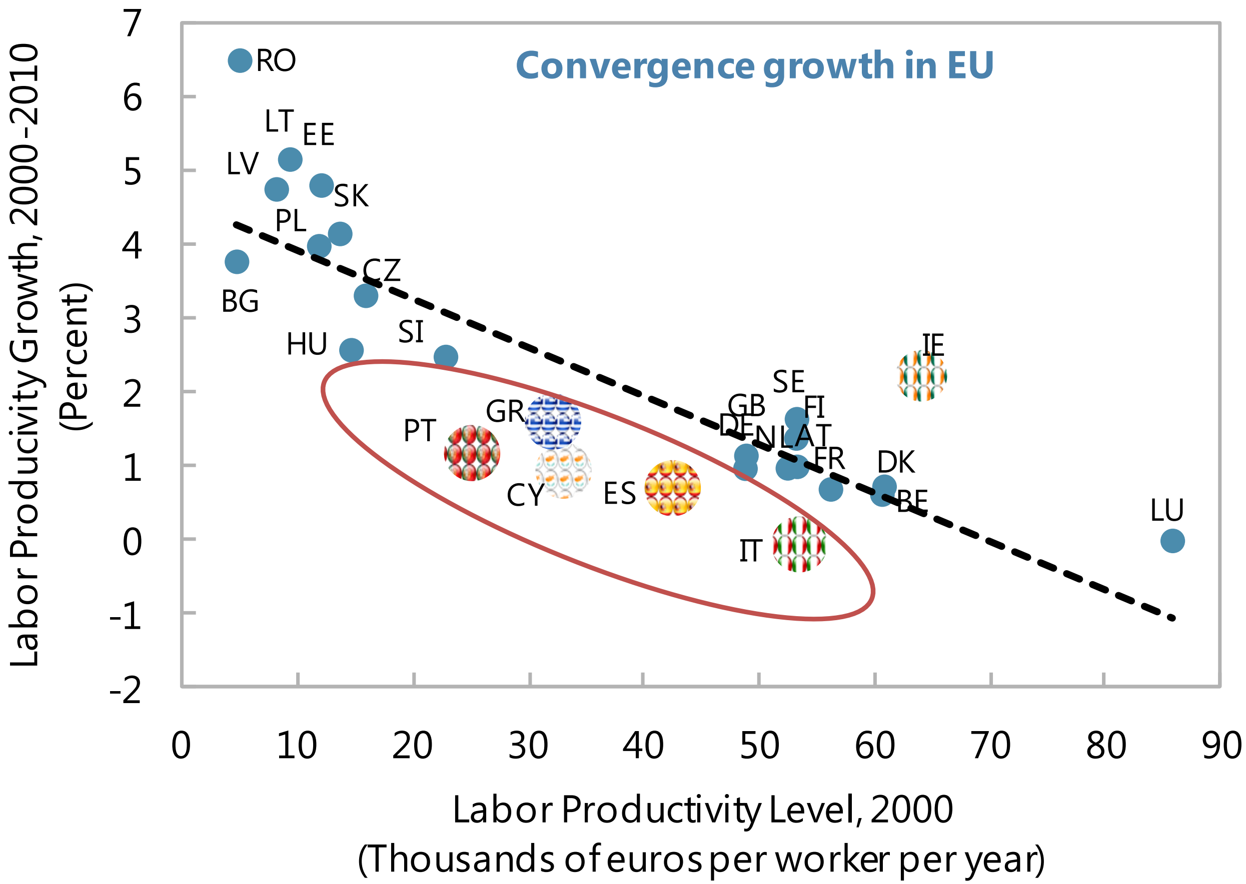


Sources: AMECO; and IMF staff estimates.
[1/] EU-9 includes Austria, Belgium, Finland, France, Germany, Netherlands, Denmark, Sweden, and the United Kingdom.



Sources: Eurostat; AMECO; and IMF staff estimates.

Of course, Portugal was not alone in struggling to achieve sustainable catch-up growth within the new constraints of monetary union



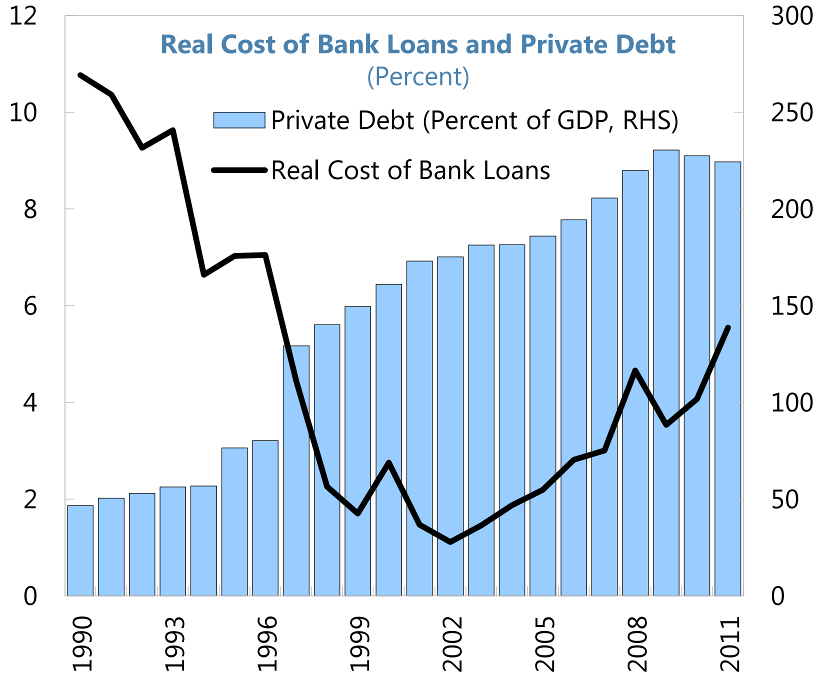
Sources: AMECO; and IMF staff estimates.

All happy countries are alike; but each unhappy country is unhappy in its own way. …

In Portugal's case …

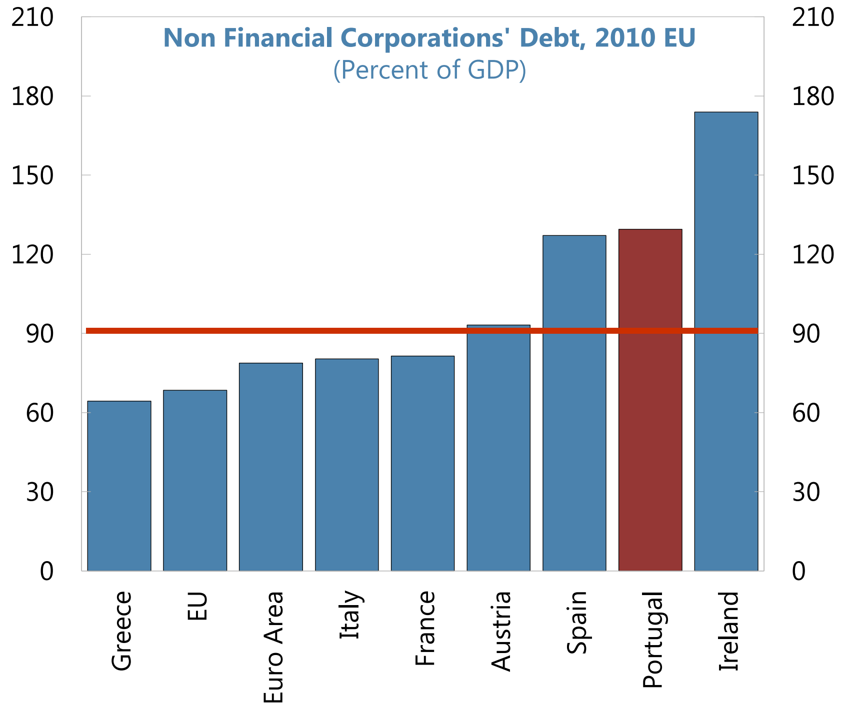
A distinguishing feature in Portugal was high private-sector leverage—something that was facilitated by indulgent international markets and domestic banks

Low lending rates since Euro adoption fuelled private leverage…



Sources: Eurostat; Banco de Portugal; and IMF staff estimates.

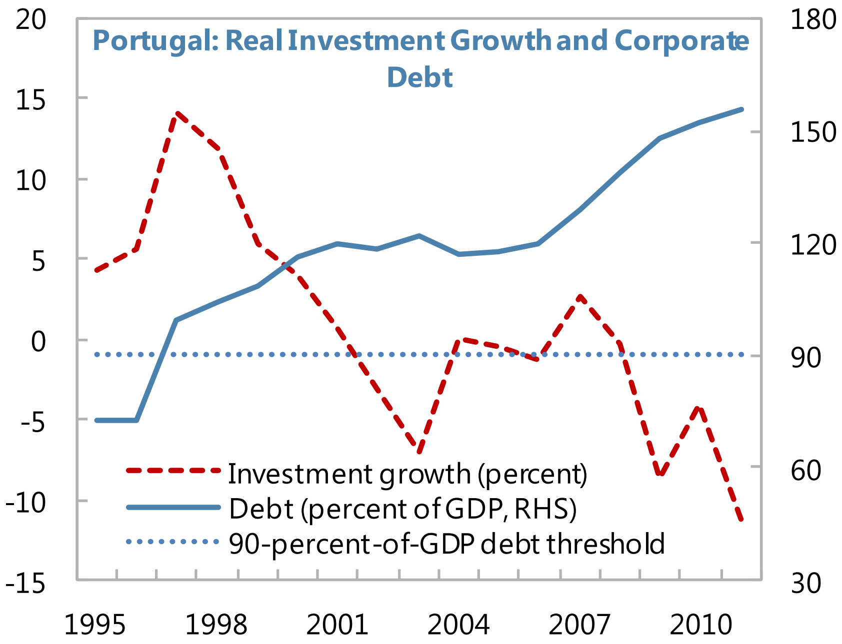
…beyond standard "safety" thresholds identified in the literature and EA peers



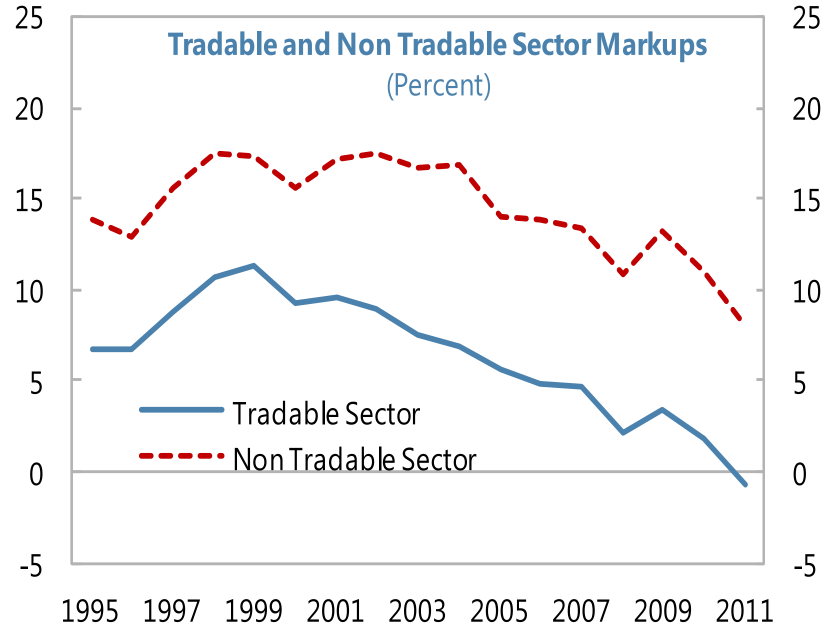
Sources: Eurostat.

Corporate debt overhang, in place by around 2000, served as a drag on growth and productivity

Debt was mostly directed to non-tradable activities—including housing, energy, and transport infrastructure—which enjoy relatively high mark-ups

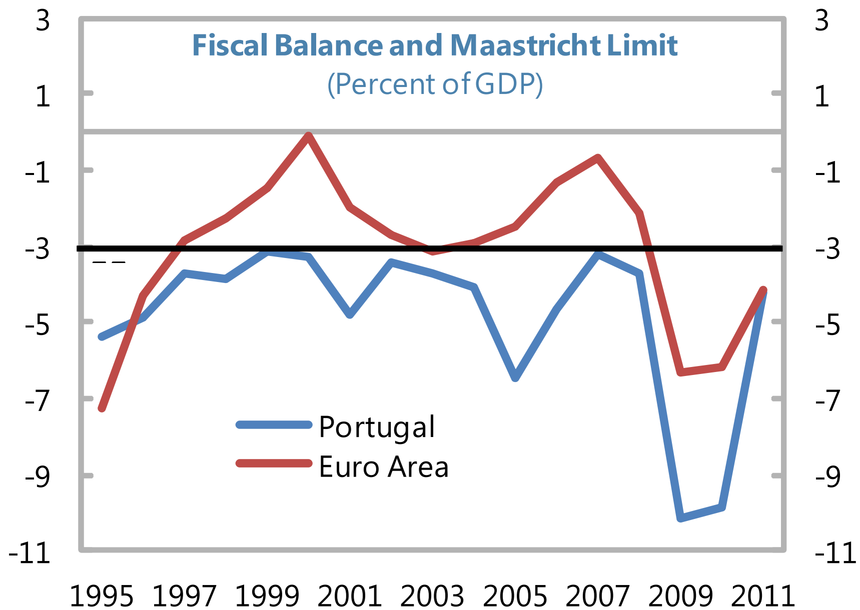


Sources: Eurostat; WEO; and staff own estimates.

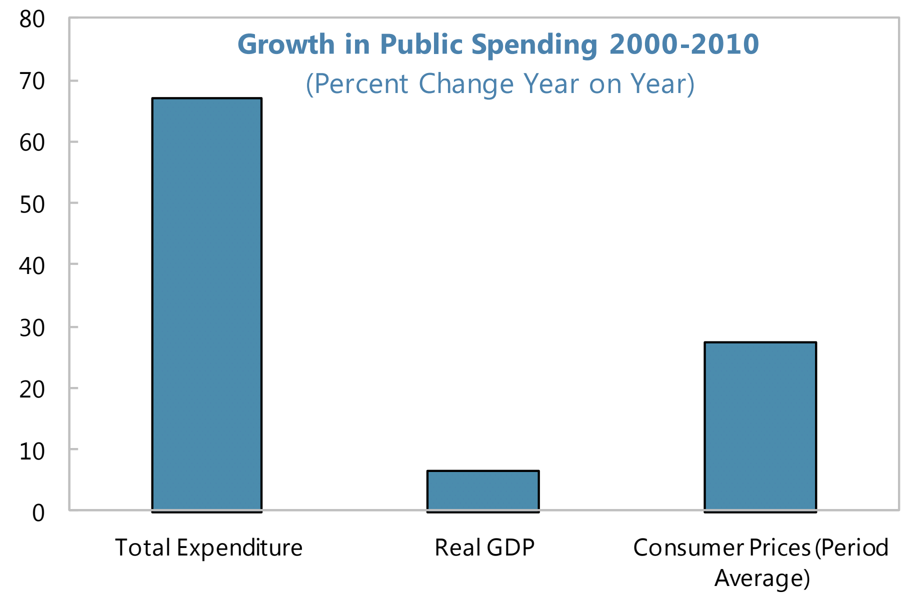


Sources: INE; Eurostat; Banco de Portugal; and IMF staff estimates.

Lack of fiscal discipline added further strains to an already unbalanced growth process

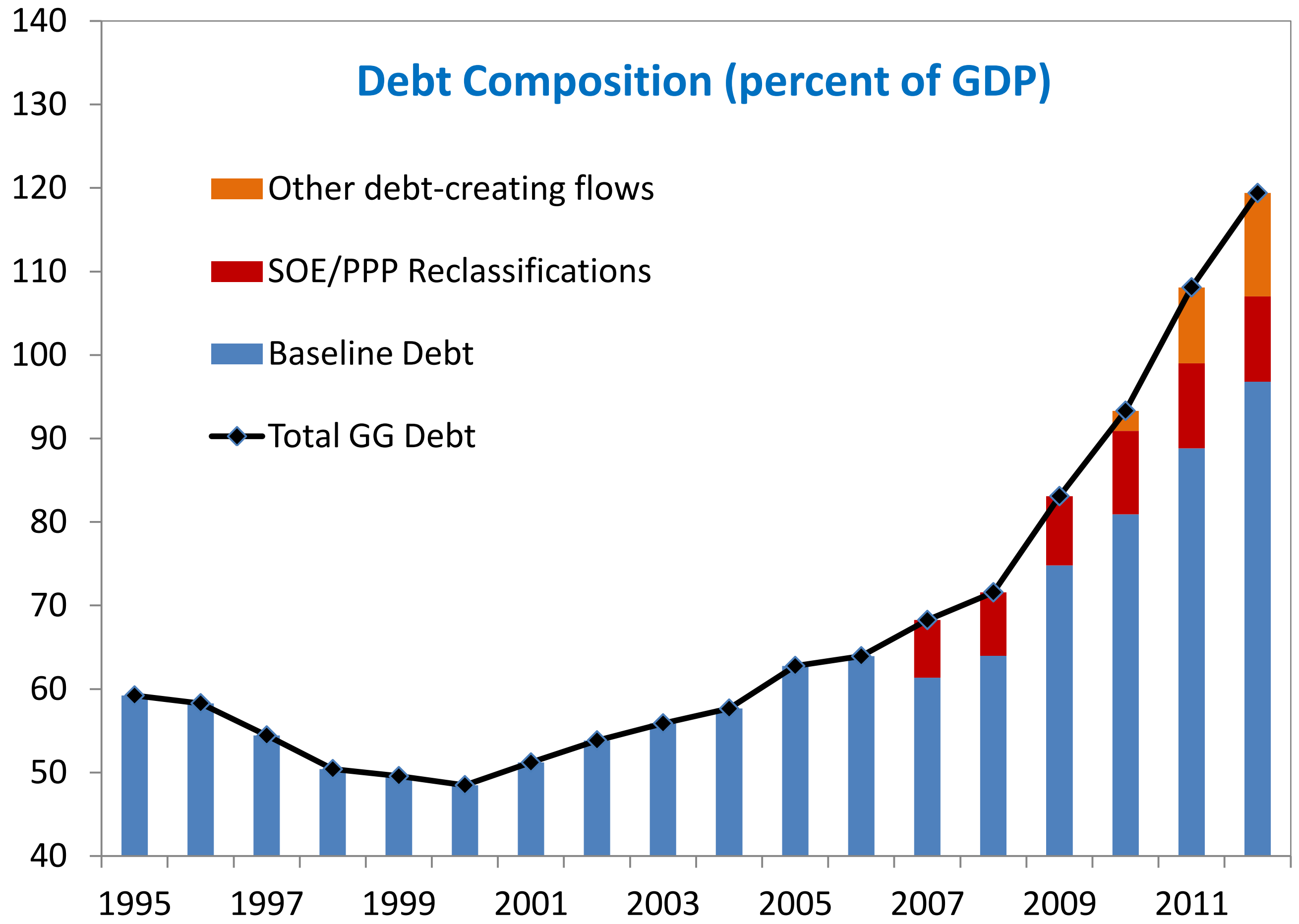


Sources: INE; and AMECO.



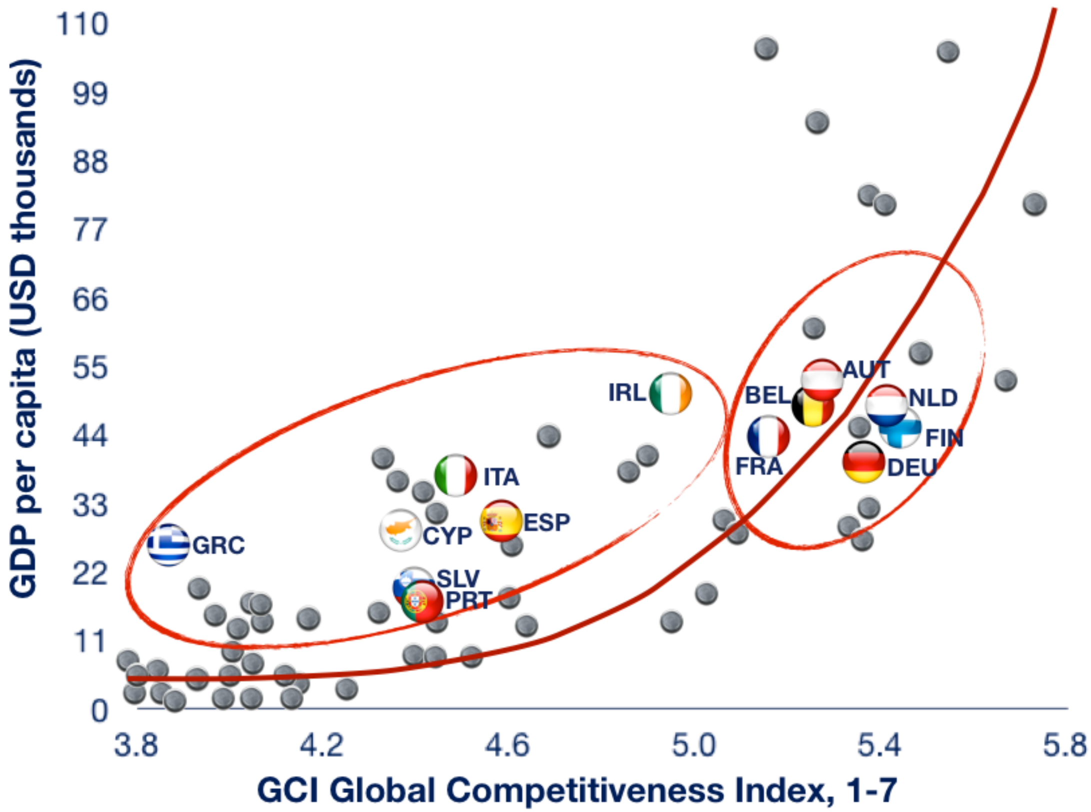
The reclassification of hitherto off-balance sheet items has weighed on the sizable increase in general government debt

Moreover, sizable contingent liabilities still pose risks to the sovereign



Growth was also constrained by structural bottlenecks

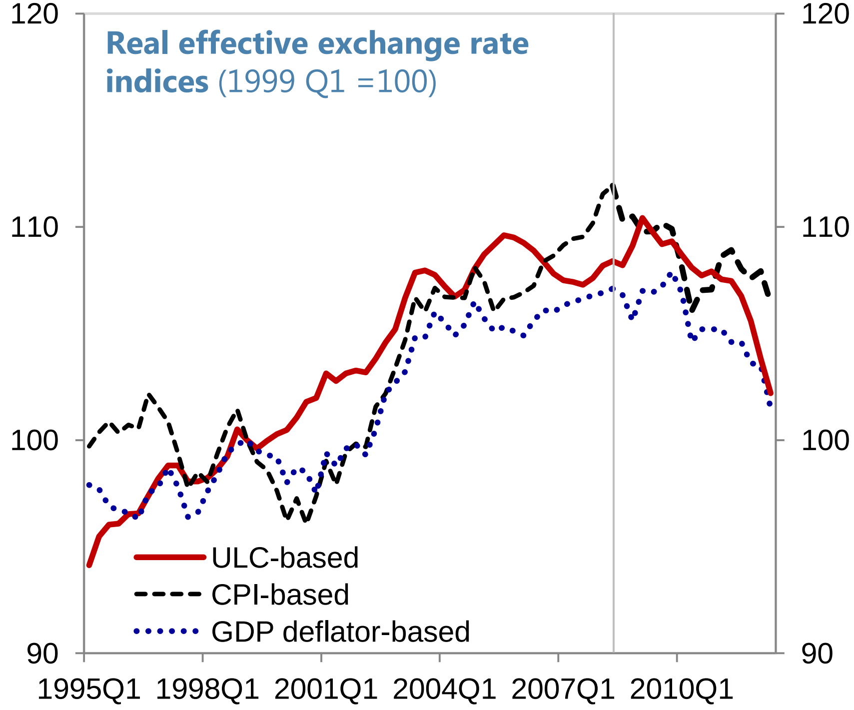
• *<u>Institutional weaknesses:</u> lack of competition, lack of labor market flexibility, weak business environment, and cumbersome judicial system*



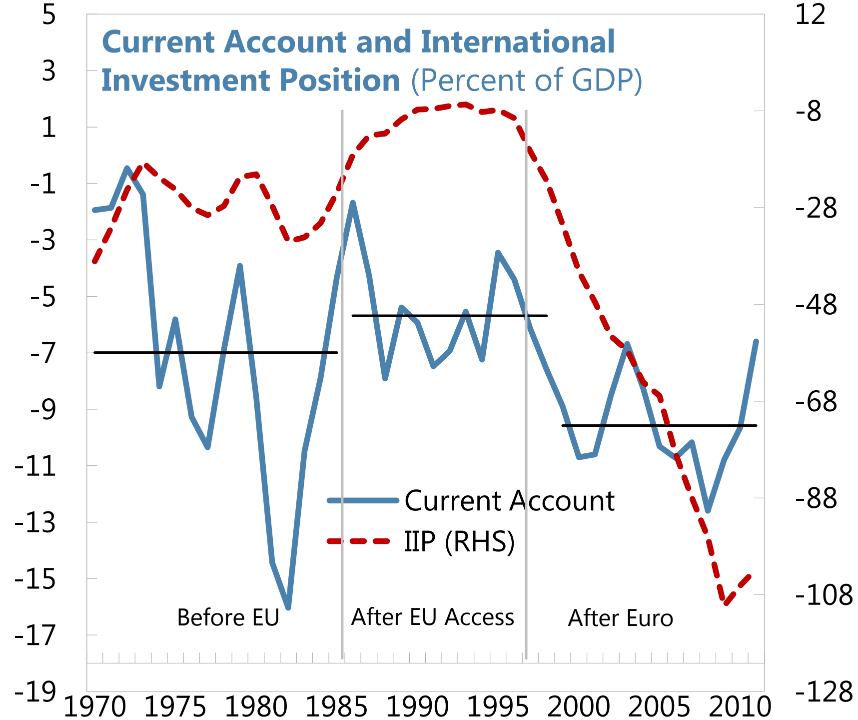
Sources: IFS and World Economic Forum.

Portugal’s external stability risks rose steadily, in the context of weak competitiveness

The negative IIP remained broadly stable until the 1990s at about 20 percent of GDP, but then deteriorated precipitously, while the real exchange rate appreciated



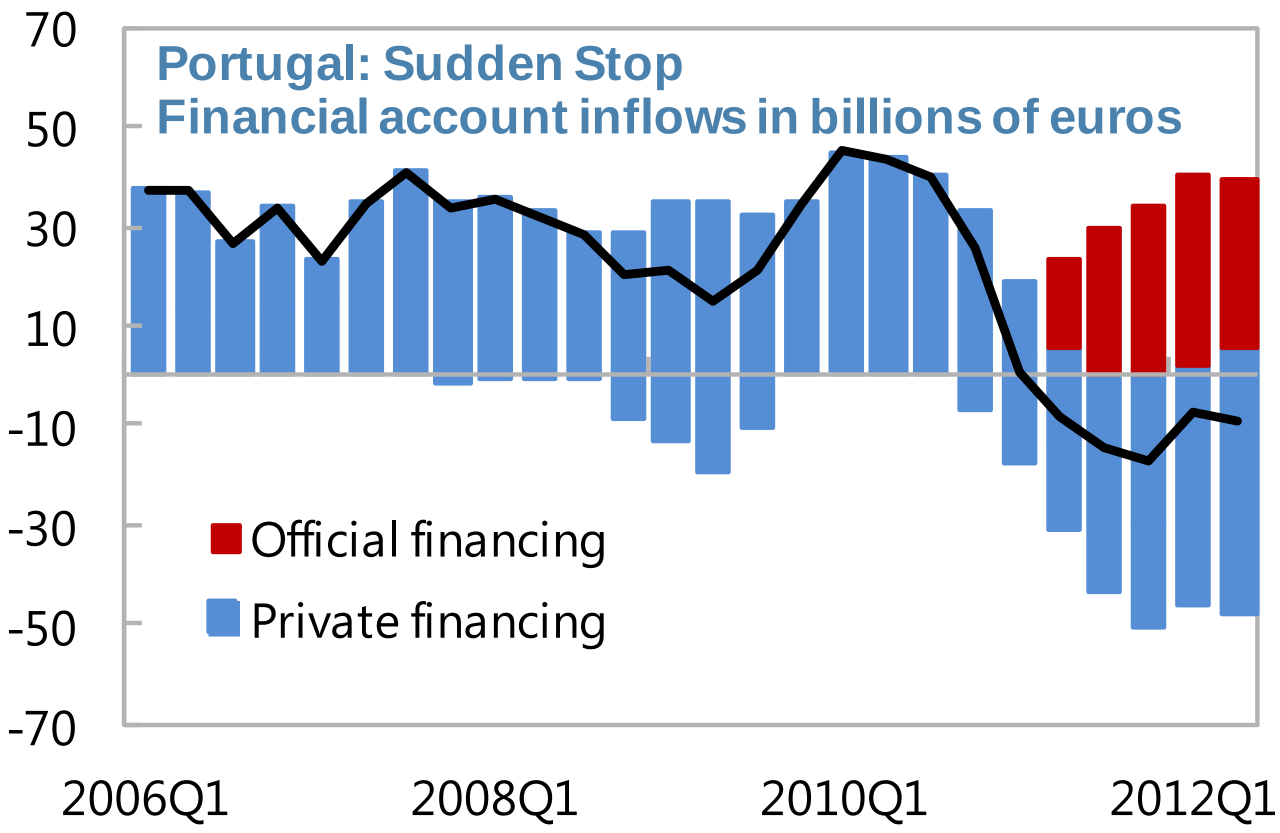
Source: European Commission *Eurostat*; European Central Bank; and IMF *International Financial Statistics*.



Sources: INE; AMECO; Banco de Portugal; and IMF staff estimates.

In early-2011, mounting funding pressures tipped Portugal into an acute economic crisis

Sovereign yields rose sharply, quickly followed by Portuguese banks being shut-out from wholesale markets. External financial assistance was needed to avert a full-blown financial crisis.



CRISIS REMEDIES

There is an impressive policy effort underway to reduce macroeconomic imbalances and address the long standing challenge of low growth

- **Program has three pillars**
  - Comprehensive structural reforms to improve growth and competitiveness prospects
  - Large front-loaded fiscal adjustment to contain public debt
  - Orderly and private sector deleveraging

- **Context in which program is being implemented is important**
  - No exchange rate adjustment to facilitate quick competitiveness gains
  - Large European **budgetary** and **financial** backstop
  - Euro area policy fissures

- **Considerable sacrifice to date of course, but also strong progress**

Near-term outlook remains uncertain and significant economic challenges lie ahead. Near-term downside risks include:

External:

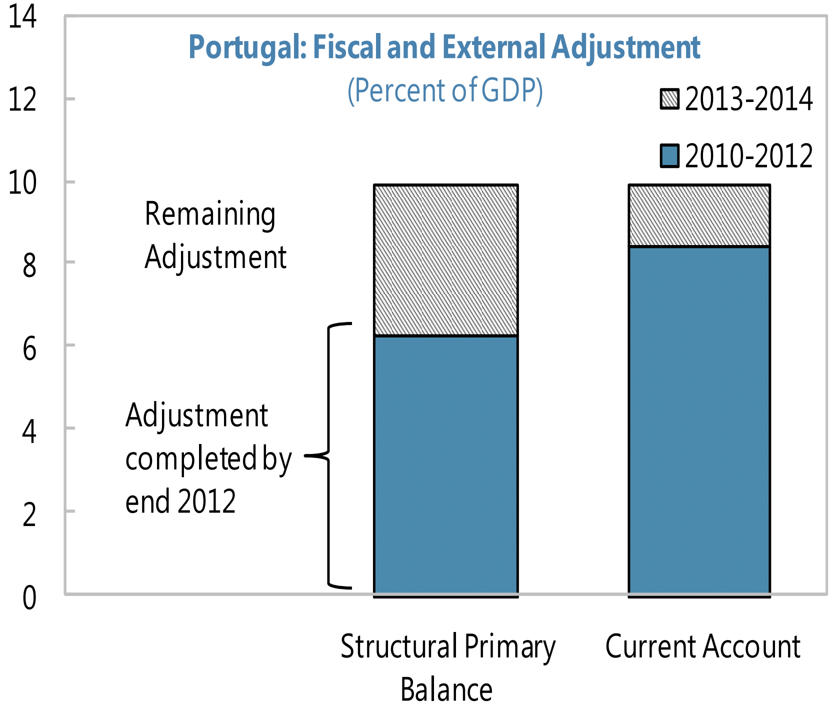
- Weaker external demand, particularly from the rest of the euro area
- Slow progress in addressing euro area fissures

Domestic risks (and thus amenable to mitigation):

- Further drag on growth from fiscal adjustment
- Corporate deleveraging weighing much more on spending and employment than currently assumed
- Migration of contingent liabilities to the sovereign balance sheet
- Weaker political and social consensus

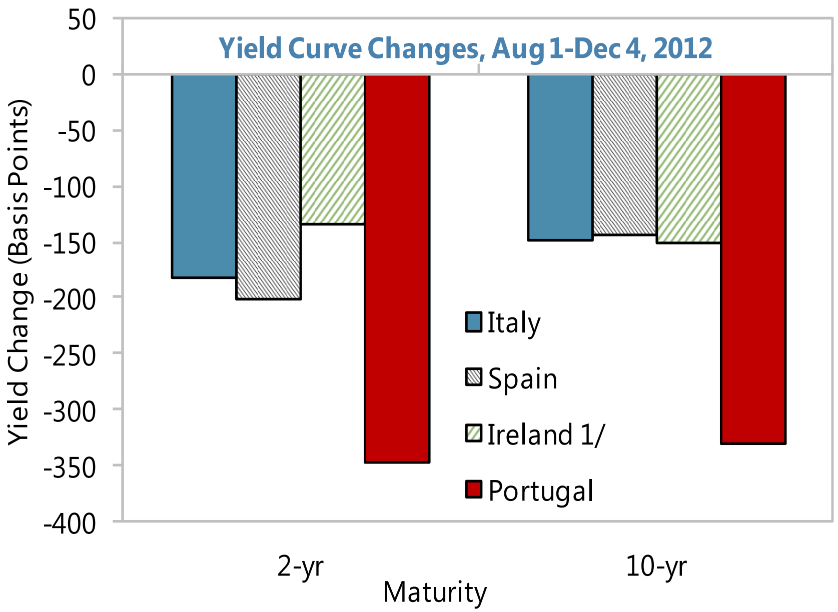
Progress in reducing near-term imbalances has been very strong

Fiscal and external adjustment have advanced



Sources: WEO; and staff estimates.

Spreads have reversed reflecting improving views on PRT and EA prospects

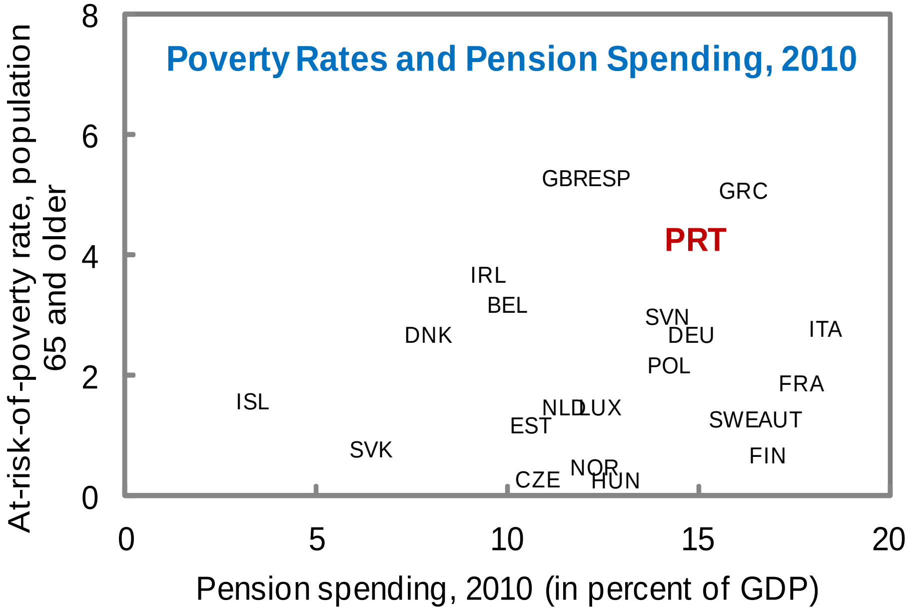


Source: Bloomberg
1/ 9-yr yield used as benchmark

Restoring and anchoring fiscal discipline poses two challenges:

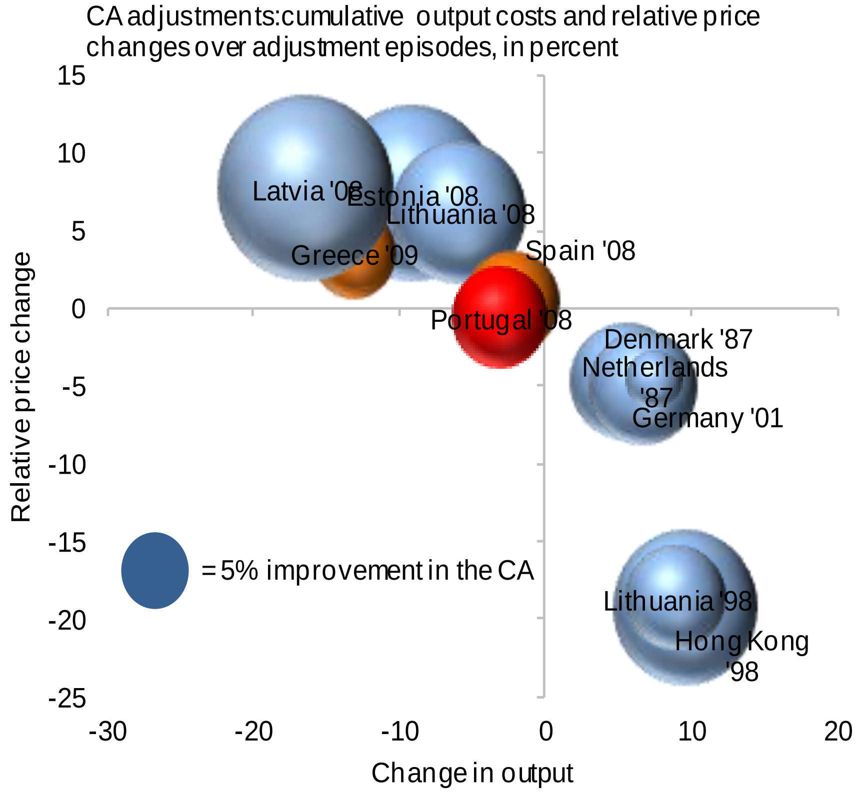
- Keep fiscal adjustment on track
  - Public dialogue needed on how to share the burden of remaining fiscal adjustment

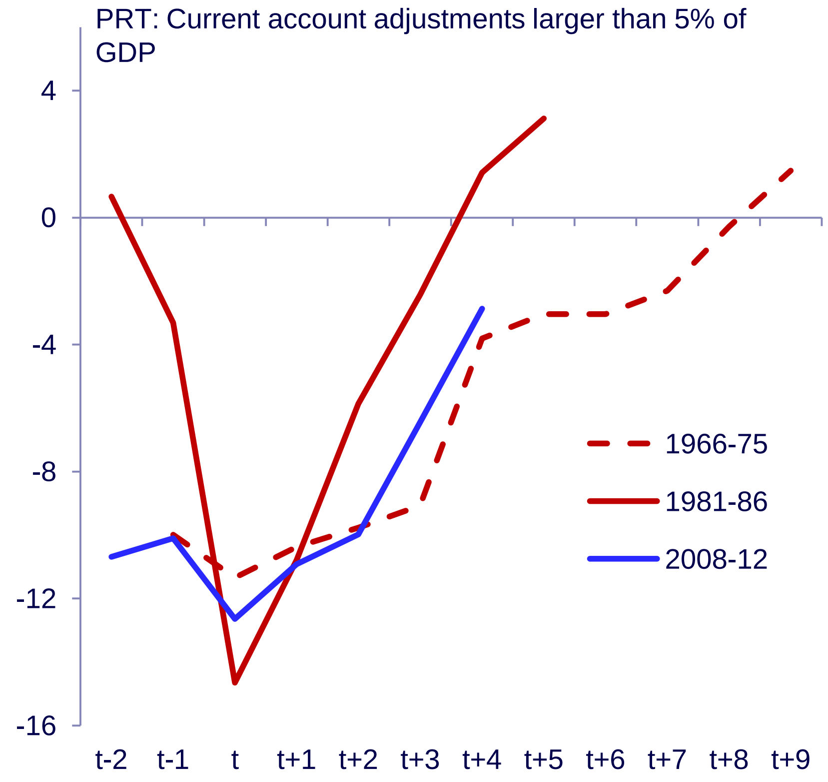
- Anchoring fiscal responsibility:
  - A stronger budgetary framework



Source: Eurostat and IMF staff calculations.

A more competitive tradable sector is key to sustainable growth and reducing high unemployment





The program's structural reform agenda is comprehensive, and implementation efforts have been commendable

Reforms to improve the efficiency of the judicial system are on track

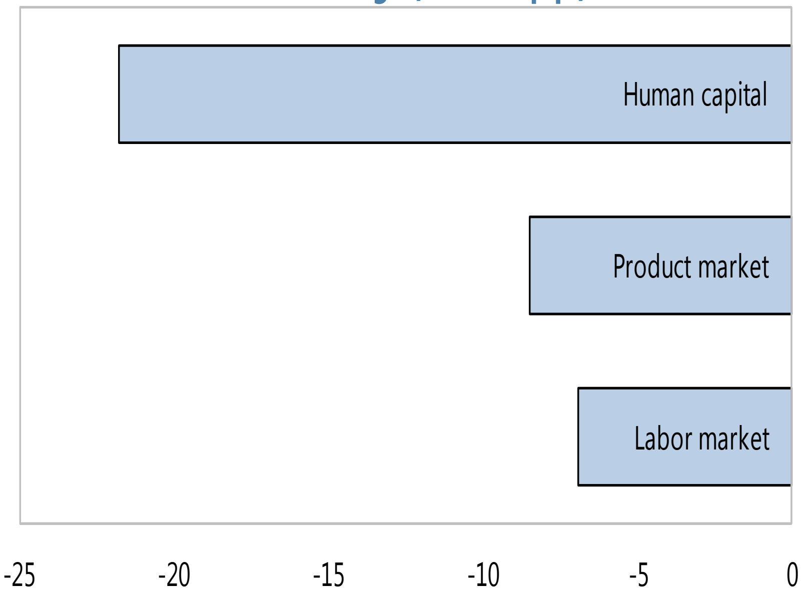
Wage bargaining has been reformed to ensure wages better reflect heterogeneous firm-level conditions

Efforts to contain price pressure and boost competitiveness in network industries are ongoing

Steps are being taken to foster competition

Structural reform efforts will need to be sustained well beyond the present program horizon.

Contributions of policies to GDP per capita gaps relative to OECD average (2009, in p.p.)



Source: Barnes, et al. (2011)

Potential yield of reforms

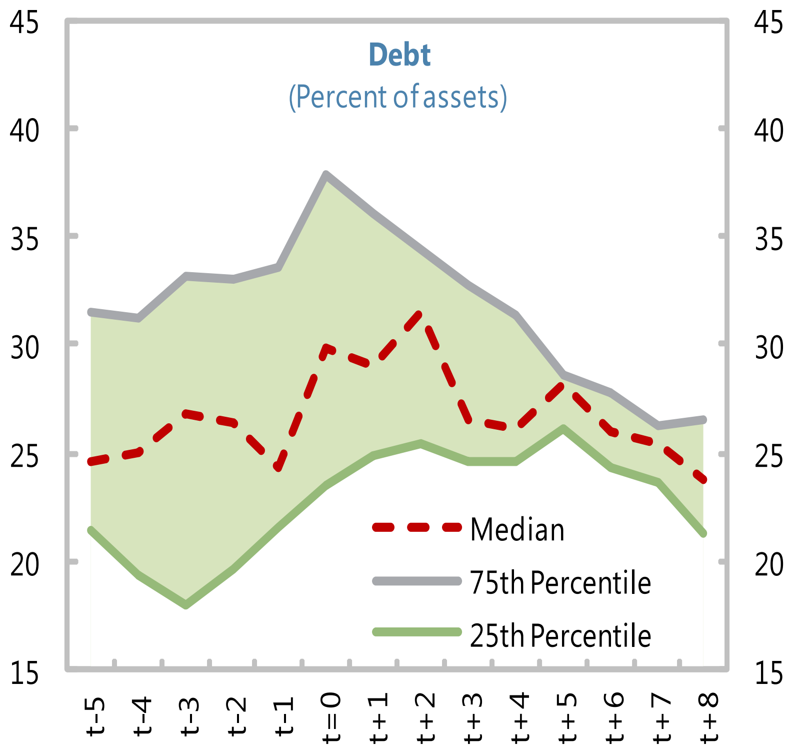
Reforms	Shock variables	In 5 years	In 10 years
Labor-Product market combined	GDP per capita, level	+6%	+14%
Labor market	Unemployment rate	-0.8 pp	-1.7 pp
Labor market	Labor productivity, level	+0.7 pp	+1.7 pp
Product market	Total factor productivity, level	+4%	+8%

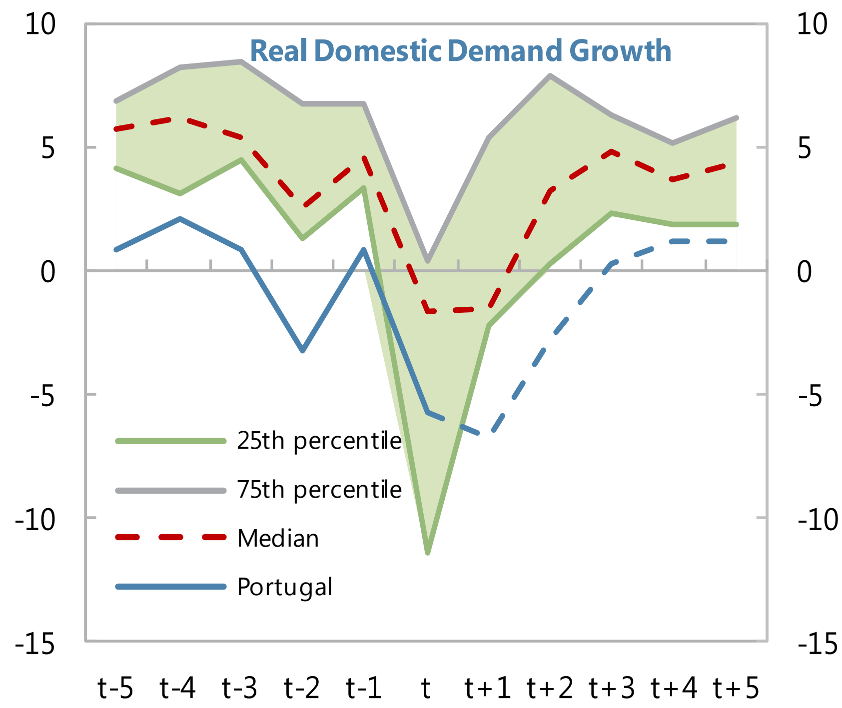
Source: Bouis and Duval (2011)

Corporate debt needs to be reduced to more sustainable levels over time

In past crisis episodes, corporate balance sheet adjustment lasted over 6-7 years

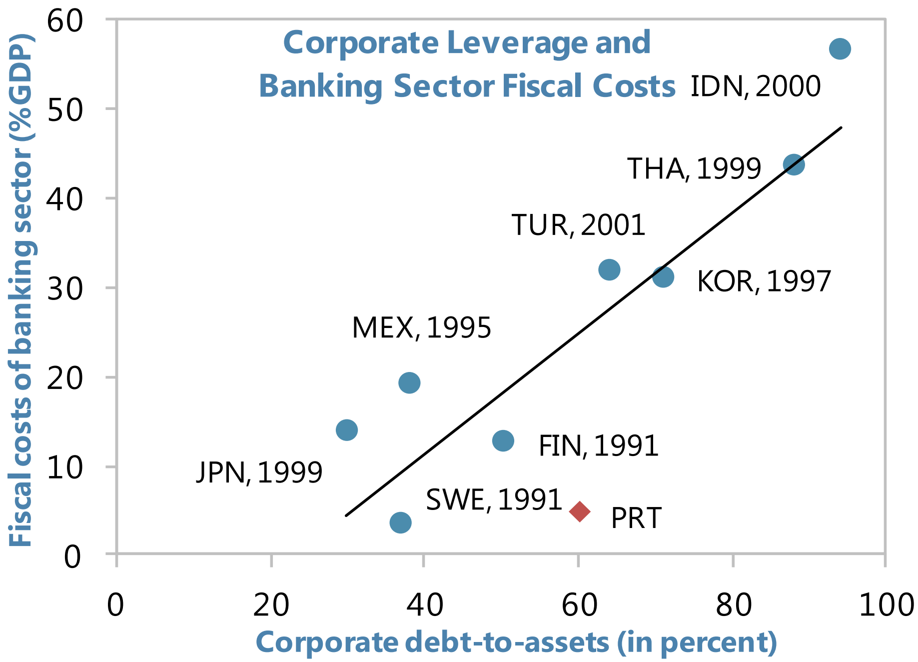
…with sizable macro-financial costs





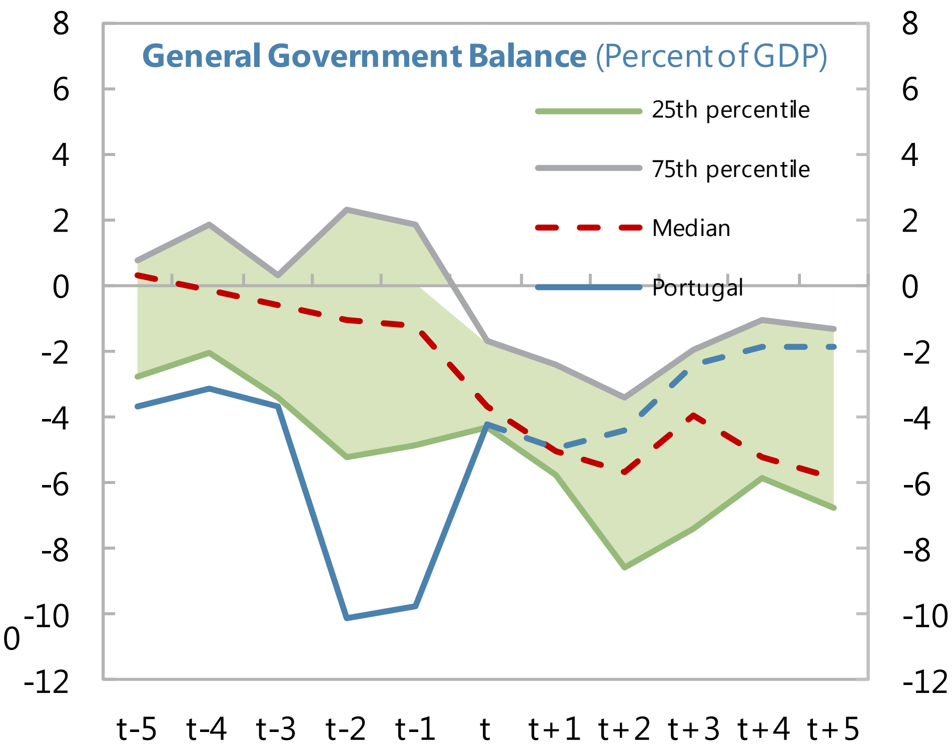
Unless carefully managed, the implications for banks' and sovereign balance sheets could be sizable

Past episodes saw large losses for the banking system and fiscal costs…



Sources: Claessens (2005), Laeven and Valencia (2008), BdP. and staff own estimates.

…resulting in a delay of at least 2-3 years in public sector deleveraging

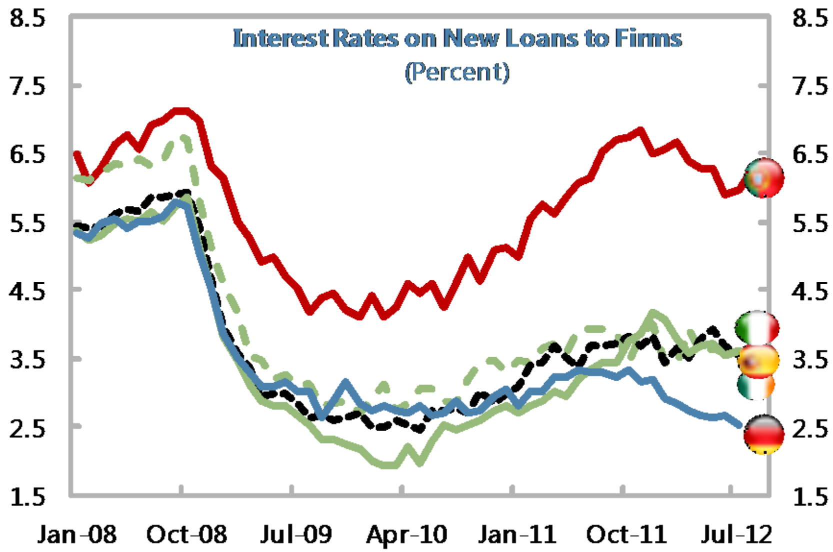


Portugal still as a lot more to do, but success also depends on progress with reforms to address euro area fissures

- There is already a commitment to provide adequate support to Portugal, provided the program is on track
- Progress towards banking union
- OMT (particularly important to restore monetary policy transmission mechanism)

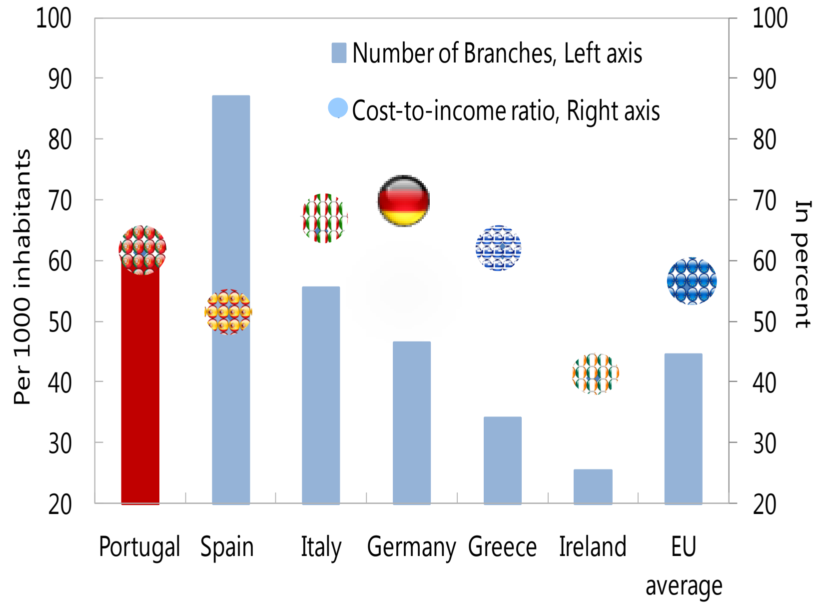
An example of actions needed at the euro area and local levels to promote orderly private sector deleveraging

Monetary transmission mechanism needs mending



Source: ECB.

But banks also need to change their business model if a new leverage cycle is to be avoided



Source: European Central Bank; European Banking Federation

Where things stand….

- Many significant challenges lie ahead given the longstanding nature of many of the causes of the crisis

- The gains to date have entailed considerable sacrifice (unemployment, household income declines)

- Despite headwinds, program implementation has been solid and outcomes are very encouraging

    - around 2/3 fiscal adjustment completed by end-2012
    - external account adjustment well ahead of expectations
    - financial stability has been preserved
    - a comprehensive set of structural reforms in place

Thank you