Carlos da Silva Costa: Sovereign debt crisis, risks or opportunities

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the 2nd Reuters-TSF Conference: "Sovereign debt crisis, risks or opportunities", Lisbon, 28 February 2011.

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According to the latest data available for 2010, the Portuguese economic situation can be summarised as follows:

- A fiscal deficit estimated at around 7% of GDP compared with deficits of 6.3% in the euro area and 10.5% in the UK;
- A public debt around 83% of GDP, compared with 84.1% in the euro area;
- A growth rate of 1.4% in 2010, compared with 1.8% in the euro area;
- Financing needs of the Portuguese economy as measured by the combined current and capital account amounting to 8.7% of GDP in 2010;
- A net debtor international investment position above 100% of GDP, and a net external debt equivalent to 85.3% of GDP in 2010, of which 48.0% corresponds to the general government sector.

These figures only provide a snapshot, which needs to be considered in the context of the underlying driving forces. More specifically, to understand where we are today, we need to know where we came from and where we are going. There is no other way to assess and understand the size of the challenges faced by the Portuguese economy and the consistency of its path. Therefore, it is important to remember that in the last decade the Portuguese economy recorded:

- A weak rate of growth in the years that preceded the international crisis – with an annual average growth rate of 1% between 2001 and 2008;
- A steady decline in the potential growth rate, as a reflection of the reduction in the growth of labour productivity, capital and total factor productivity;
- An increase in public indebtedness from 48.7% of GDP in 2000 to nearly 83% of GDP in 2010, mirroring a rise in public expenditure of virtually 8 percentage points during the same period. This despite a reduction in debt servicing costs resulting from the adoption of the euro in conjunction with the benefits of the so-called Great Moderation period;
- An increasing level of household indebtedness, which rose from less than 80% of disposable income in 1999 to more than 120% in 2008, reflecting easier access to consumer and mortgage credit, in terms of both volume and cost;
- A rising level of external indebtedness, resulting from recurrent external deficits, as a reflection of the expansion of domestic, public and private demand, and a deterioration in the net international investment position, which shifted from –39.6% in 2000 to –108.5% in 2010.
- Finally, a gap between deposits and loans resulting in external financing dependency. Such gap mirrors the key role played by the banking system in the financing of the Portuguese economy and the increasing shortage of domestic savings to meet the financing needs of the State, corporations and households.

This is the background that should be borne in mind,

- First, to understand the questions raised by foreign investors about the sustainability of both public and external debt of the Portuguese economy;

- Second, to understand that the consolidation of public finances is inevitable and, hence that budget execution in 2010 is extremely important as well as the achievement of the objectives set for 2011 and 2012. At the same time, it is also vital to understand that achieving these objectives is important, but not sufficient to ensure medium to long-term sustainability of public finances;
- Third, to understand that the imperatives faced by the Portuguese economy go beyond fiscal consolidation, which is a necessary but not sufficient condition to solve our economic troubles. Solving the problems of the Portuguese economy, implies an increase in household savings, a rise in the self-financing capacity of corporations and a boost in the growth rate of potential output;
- Finally, to understand the importance of the stability and efficiency of the financial system for the dynamics of the Portuguese economy, namely to meet the financing needs of the productive sector and to enhance resource allocation.

Therefore, it is important to remember that the Portuguese economy must continue to rely on foreign investors, as it is not realistic to think that the external deficit can be immediately rebalanced. Thus, the confidence of foreign investors is crucial for the development of the Portuguese economy. Such confidence should rest on a sustainable path of public debt and, hence, of the fiscal deficit, as well as on the sustainability of external indebtedness. The sovereign debt crisis results from increasing indebtedness, in a context of heightened risk aversion and higher scrutiny of the repayment capacity of indebted countries. Investor confidence depends not only on the indebtedness level but also on the repayment capacity, which in turn depends on potential output growth and on the nature of the development process. That is, the confidence of foreign investors varies in direct proportion to the robustness of the Portuguese economy’s growth, or more specifically it depends directly on the sustainability of its development process.

Second, it should be borne in mind that the process of reduction of the fiscal deficit (which had been pursued over past years but was interrupted in 2009 in the context of the financial crisis) was resumed in 2010 and is an important step in the critical and wider process of reforming public finances. I have already referred to this process on other occasions, so today I will not go into further detail. I only insist that this process not only has an institutional and regulatory dimension but also it requires a multi-annual and binding programme that ensures the reduction of the public debt to GDP ratio, while setting a limit to the growth of public expenditure. The latter is crucial to restrain tax increases and to safeguard the attractiveness of the country as a destination for investments that support potential output and employment.

Third, there is a need to rebalance the development model, by creating favourable conditions for the expansion of the tradable goods sector; for the growth of capital and labour productivity, as well as total factor productivity; and for innovation as regards both production processes and technologies and products. It should be recalled that the growth and employment creation model of the past years is not sustainable: it relied on the expansion of public demand, reflected on the imbalance of public finances and on the expansion of private demand. In turn, the latter was fuelled by the favourable financing conditions enjoyed by households, mirrored in rising indebtedness and lower savings. The growth and employment creation model of the past years triggered an increasing indebtedness ratio, which would become unsustainable if it were not corrected. The Portuguese economy must create employment in the tradable goods sector, in order to:

- absorb the employment that, due to the adjustment of domestic demand, the nontradable goods sector will not be able to retain; and
- offset the reduction in the incorporation of labour per unit of output, which will result from a broad-based and imperative rise in productivity.

The sustainability of the development model implies more far-reaching structural reforms, with priority to those that have an immediate impact on competitiveness, on available capacity and on the value added of the goods and services export sectors. I would like to emphasize that there are no mechanical and definite causalities in the growth of potential output. The future is shaped by the way resources are allocated between alternative uses, by the quality of public policies (most notably, by their impact on incentives) and by corporate strategies.

In this regard, the role of the so-called national innovation system should be stressed, i.e. the network of public and private sector institutions and the interaction mechanisms behind the production, use, diffusion, absorption and exploitation of new knowledge and technologies by a company or group of companies. Empirical evidence shows that R&D expenditure, the level and type of education and the articulation between the educational and professional training subsystems are responsible for the position of countries within the international division of labour and, in particular, for the specialisation pattern (intersectoral specialisation, or as an alternative, intrasectoral vertical specialisation). On the one hand, the articulation between the three subsystems (research, education and professional training) should be enhanced. On the other hand, the articulation between the national innovation system and corporate needs, in particular in the tradable goods sector, should also be improved.

Finally, I would like to point out the critical importance of maintaining and strengthening the stability of the financial system. This system plays a fundamental role in the functioning of the Portuguese economy and, in particular, in an efficient allocation of internal and external resources, channelling them to the sectors and economic agents with funding needs.

The Portuguese banking system is solid. It was not exposed to the sub-prime crisis or to the speculative bubble in the real estate sector. Own funds are adequate given the current level of balance sheet risk: the Tier 1 capital ratio stood at 9% in 2010 and the core Tier 1 capital ratio at 8.2%. Obviously, the banking system suffered from the impact of the international crisis and the decline in growth. As expected, between 2007 and 2010, the total ratio of non-performing loans increased from 1.5% to 3.3% and the return on equity decreased from 14.63% in 2007, to 7.37% in 2010, after having dropped to 3.44% in 2008.

However, the Portuguese financial system shows some specificities that should be addressed.

First, as a reflection of the above-mentioned imbalance between domestic savings and domestic borrowing requirements – resulting from the development model of the Portuguese economy in the past few years – the transformation ratio of deposits into loans stands at 1.44 for the Portuguese financial system as a whole. Due to this fact, there is a significant dependence on external financing. This explains the reason why the Portuguese banking system became heavily exposed to the sovereign debt crisis.

Second, the capital adequacy of banks is a dynamic reality. Therefore, it must be seen in the context of both the current level of balance sheet risk and of the negative impact that a deterioration in the Portuguese economic situation may have on the quality of assets. Moreover, it must also be viewed in terms of the additional capital requirements arising from the new prudential rules, known as Basel III, and the fact that investors and their counterparties tend to consider the new prudential rules as financial soundness benchmarks even before their enforcement.

In this context, Portuguese banks must bear in mind that the environment in which they operate imposes the narrowing of the gap between deposits and loans and an increase in own funds.

Portuguese banks should therefore embark on orderly de-leveraging, through a selective sale of assets, namely credits, that will allow them to soften the impact on the financing of the productive sector, in particular of the companies more dependent on bank financing. In this regard, it would be welcome that the large companies that have or may have access to external financing and to the capital market would reduce their recourse to domestic credit.

Second, Portuguese banks, being aware that this will be key to the assessment by counterparties and investors, should further strengthen their own funds. We all know that conditions in the capital market are particularly difficult. Therefore, it is crucial that banks envisage other ways of expanding or reinforcing their shareholder basis.

Third, given the critical importance of preserving profitability as well as the rigidity of the financial margin that results from the relative weight of mortgage credit, Portuguese banks must pay particular attention to their efficiency ratios.

Finally, and in the very short term, Portuguese banks like the other European banks will undergo very tough tests. The new round of stress tests is aimed at examining bank performance under a far more adverse scenario than in 2010. It is crucial that banks show that capital shortages resulting from the accommodation of losses induced by a weaker economic environment can be adequately met. Therefore, and as a result of the commitment by EU Member States, we will have to prepare the mechanisms that, if needed, will be activated to reinforce banks' own funds. Such mechanisms may rely on the individual financial institutions or public funds (the so-called back-stop facility).

In sum, and as I mentioned at the beginning, the results for 2010 provide a snapshot that must be considered in the context of the underlying driving forces. We must keep in mind where we started and where we are going. We come from a growth path underpinned by the expansion of domestic demand. Now we want to be on a path of sustained development supported by an increase in value added per head and employment creation, coupled with sustainable public finances and external accounts. The first step was given in 2010. However, the way ahead is very hard, requiring more than fiscal consolidation: it implies a range of structural reforms inducing entrepreneurial dynamics and productive investment that strengthen the competitiveness of the Portuguese economy in a sustained manner. **That is the challenge.**