Carlos da Silva Costa: The Portuguese economy – structural saving gap and policy options

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the inauguration of the academic year of the University of Porto School of Economics and Business, Porto, 31 October 2012.

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I. Introduction

Good afternoon ladies and gentlemen.

I would like to begin by thanking you for the great honour of addressing you at this inauguration of the academic year of the University of Porto School of Economics and Business, which this year happens to coincide with World Savings Day.

There could not be a better occasion for an address on the structural saving gap of the Portuguese economy and the policy options which best ensure the success of the on-going adjustment.

II. Structural saving gap and policy options for the Portuguese economy

1. Public and private structural saving gap

Saving insufficiency is a structural trait of the Portuguese economy.

This is shown clearly in the external accounts: over the last 60 years, the current and capital accounts, which measure the economy's financing capacity, posted a surplus only twice in 16 occasions; meanwhile over the same period, the balance of goods and services was always negative.

The chronic external imbalance led to the two adjustment programmes negotiated with the International Monetary Fund in 1978 and 1983.

Over the last 15 years, cheaper and more accessible financing afforded by monetary union led to a strong expansion in credit, and to a lesser extent, the contraction of private saving. The increase in indebtedness and decrease in saving were mainly used to finance consumption and low-return investments, and therefore did not result in the expansion of the economy's growth potential. The strong increase in private spending translated into a deviation of resources to the non-tradable sector and persistent current account deficits.

These imbalances were aggravated by unsustainable budgetary policies. Between 1999 and 2010, the annual budget balance was on average –5% of GDP, and according to current data, the deficit was never lower than 3% of GDP. This behaviour is not very different from that observed since 1977.

In the first 10 years of monetary union, the current and capital accounts had an average annual deficit of 8.3% of GDP. The cumulative effect of these deficits was a sharp deterioration in the Portuguese economy's international investment position, which went from –10% to –107% of GDP from the mid-1990s to 2010. The behaviour of gross external debt over the same period – growing from 64% to 230% of GDP – is even more telling.

The growth of external indebtedness was intermediated for the most part by the Portuguese banking system, which captured resources in the international financial markets. The banking system's loan-to-deposit ratio increased from nearly 65% in 1996 to around 160% in 2010. The lack of a macro-prudential policy, coupled with complacency in the international financial markets, contributed decisively to the accumulation of macroeconomic imbalances.

The imbalances made the Portuguese economy extremely vulnerable to the international financial crisis and its contagion effects. With potential output growing very slowly, the trend of the economy's external indebtedness increasingly led investors to doubt Portugal's ability to service its debt. These doubts resulted, as is known, in the closure of the international financial market in the first half of 2011, leading inevitably to official financing under the financial assistance programme negotiated with the European Union and the International Monetary Fund.

Around a year and a half after the launch of the programme, the feeling is that we are at a crossroads. Undeniable progress has been made in three areas: budget consolidation, financial system stability and the Portuguese economy's structural transformation agenda.

The faster than expected adjustment in the external accounts shows important steps have already been taken: in 2012, the current and capital accounts should only register a minor deficit and the goods and services account will post a surplus for the first time. This trend not only reflects the fall in imports following the decline in domestic demand but also a very strong exports performance. The improvement in the Portuguese State's financing conditions also points in the same direction.

The progress achieved benefited from broad social and even political consensus over the programme's objectives. However, signs of disbelief and erosion of social support for the programme are beginning to appear. Aside from factors of a political nature, on which I will not comment, the unfavourable external environment and the macroeconomic developments, in particular increasing unemployment, have contributed decisively to this mindset.

2. What policy options are there?

1. Counter-cyclical policies are not an option

With economic activity, employment and the public debt ratio performing worse than was predicted when the financial assistance programme was drawn up, many have advocated slowing down the pace of budget consolidation, for fear of a negative spiral between budget consolidation and contracting economic activity, which will cause the adjustment to fail.

This is a debate which goes well beyond the Portuguese situation. In general, the discussion has been rather simplistic. The arguments put forward typically suffer from time consistency problems and rest on a partial equilibrium analysis. Therefore it is worth being clear and taking a complete and dynamic perspective.

Conceptually, the counter-cyclical use of budget policy, in particular by allowing the automatic stabilisers to work, finds broad consensus. It is also undeniable that budget consolidation always means austerity, insofar as it exerts a negative effect on economic activity in the short term.

This negative effect will be stronger if the variables that generally dampen the recessive impact of budget consolidation – I refer to the interest rate, the exchange rate and external demand – are constrained in some way. This is the current situation: various countries are undertaking budget consolidation simultaneously; interest rate levels in the main advanced economies are limited by the "zero bound"; and the countries most affected by the sovereign debt crisis do not have an independent monetary policy.

On the other hand, it is also generally accepted that above a certain threshold, which in the case of the advanced economies is estimated at around 90% of GDP, public debt levels negatively affect economic growth in the short, medium and long term. This negative effect is explained by three factors:

- Firstly, by the greater uncertainty over macroeconomic developments resulting from unsustainable debt paths. Uncertainty leads to postponement of investment projects and a bias towards investments with short-term returns, at the expense of projects which may potentially impact on economic growth, but whose returns tend to be long-term;

- Secondly, by the increase in risk premia, which increases the economy's financing costs and, in extreme cases, results in the interruption of financing;
- Thirdly, by the fact that high debt levels constrain the counter-cyclical use of budget policy, which in the presence of hysteresis, may have lasting effects on the economy's productive capacity, due to the depreciation of human capital and insufficient investment in physical capital.

Here I would like to take a moment to mention the following: It is odd that the intense public debate on the relationship between budgetary policy and economic growth, recently rekindled following publication of a box in the latest edition of the IMF's World Economic Outlook, has focused only on the size of the short-term budgetary multipliers, when the wider and more dynamic view of the problem, which considers the negative effects of the macroeconomic uncertainty and the high indebtedness levels on growth, is also widely covered by the IMF in the same report.

Given the high levels of public sector indebtedness in most advanced economies and the unfavourable dynamics that result from the ageing population, few will contest the idea that credible budget consolidation plans are urgent and necessary in these economies to reverse public debt's growth trend.

Therefore, the key question, which has led to great differences of opinion, is not about whether there should be budget consolidation, but how large and how fast the adjustment in the public accounts should be. In particular, the question is about whether additional consolidation measures should be adopted where growth was lower than expected, to ensure the initial budget goals are reached.

This is a difficult question, since assessing the effects of budget policy depends on the judgement made on a set of parameters, including the distinction between cyclical fluctuations, other temporary factors and structural trends; the size of the budget multipliers; the sustainability of the public debt path; and the credibility of budget policy from an intertemporal perspective.

The difficulties are aggravated by the fact that these parameters vary over time and depend on the starting position of each economy, i.e. on factors such as the degree of openness, the size of the automatic stabilisers, the operation of the labour market or the room for manoeuvre in monetary policy, among other things.

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For countries like Portugal, which belong to a supranational monetary area and have lost or are at risk of losing access to market financing, the leeway is extremely limited or even non-existent. External financing is the active constraint on economic policy and its strictness depends on the sustainability of public finances. For these countries, the priority must be a fast budget adjustment, mainly based on the reduction of structural spending, so as to restore credibility and bring public finances back to a sustainable path.

Let us be absolutely clear: any postponement of the adjustment involves new financing needs (which are not covered) and a worsening of public debt unsustainability with the consequent further loss of credibility.

It is true that in these countries, and this has also been the case in Portugal, the high starting position of public debt, the significant stock-flow adjustments and the fact that the budget multipliers are currently higher than usual, are leading to a deterioration in the public debt ratio in the initial phase of the consolidation process.

This counterintuitive and undesirable initial effect will only be reversed by the cumulative adjustment of the primary balance, the reduction of the interest rate (which in turn depends on the credibility of the adjustment) and last but not least the increase in the economy's growth potential.

The importance of economic growth for the trend of the public debt ratio may be illustrated with a simple calculation: starting with plausible values for Portugal in 2015 and keeping other relevant variables constant, a one-percentage-point increase in GDP growth over the period 2016–2020 leads to a debt ratio which is around 15 percentage points lower than the baseline.

2. A growth strategy for the Portuguese economy

Thus we need to refocus the public debate on the Portuguese economy.

The great challenge we face is to make Portugal a more productive country that creates jobs.

We all know that adjusting the public and private sector balance sheets is necessary to help the Portuguese economy avoid prolonged relative impoverishment.

It is necessary, but as we also know, it is insufficient.

Sustained growth involves rebalancing the allocation of resources towards the tradable sector. The infrastructure and support services are available investments in the non-tradable sector have been made; these now must be put to work to create capacity in the tradable sector.

On this issue, I would like to touch on three points that I will expand on thereafter.

- First, the potential for growth through exports is very high and the strong export performance over the last two years looks quite promising.
- Second, the private sector will have to be the main driver of the economy's structural transformation.
- Finally, it is up to the State to take a catalysing role in this structural transformation, namely by providing an institutional framework and macroeconomic conditions that foster high-quality investment and attract highly-skilled labour.

I would now like to develop each of these three points very briefly.

The potential for growth through exports

I will start with growth potential based on exports.

Contrary to common opinion, the Portuguese economy has a low level of openness considering its relative size. Thus, countries like Sweden, Austria, Switzerland, Denmark or Belgium have much higher export market shares than Portugal, adjusted for population size. Also, penetration of Portuguese exports is particularly low in the geographies expected to grow the most in the next few years.

This situation, along with the high capacity available in the manufacturing sector and the relative cost adjustments under way, suggest that the potential for economic growth based on exports is probably much higher than we tend to believe.

However, let us not be naive: realising the growth potential from expansion of the tradable sector is not automatic. It depends crucially on behaviours adopted by the economic agents.

The protagonist in the transformation of the economy will have to be the private sector.

In the current context of strong global competition, companies need to be able to adapt permanently in order to survive, which involves introducing technological developments, re-engineering processes and defining renewal and growth strategies.

It is down to the private sector to define effective responses to the challenges of external competition, the market opportunities and the evolution of knowledge and technology. In this regard, I would like to outline two aspects that I believe are particularly relevant.

Firstly, the capitalisation of Portuguese companies needs to be strengthened. Our companies' high leverage ratios not only reflect the fragility of Portugal's economic fabric (as firms are particularly vulnerable to changes in financing conditions), but also reflect strategic weakness (because high indebtedness limits the ability of firms to respond to changes in the external environment, jeopardising their growth potential).

Secondly, we need to tackle the problem of the corporate sector's fragmentation, particularly by finding ways for companies to cooperate and form associations so as to gain scale to compete globally.

The catalysing role of the public sector in the structural transformation of the economy

The role of the public sector is no less important.

It is not about calling for large public investment projects, new subsidies or additional tax benefits for companies.

The public sector is expected to be a regulator and to ensure the level-playing field, allowing relative prices to play their signalling role. It is also expected to introduce the reforms needed to ensure that the labour and product markets adjust efficiently to an ever-changing world. Finally it is expected to provide macroeconomic stability, especially in terms of the medium to long-term sustainability of the public finances and the stability of the financial system.

I would like to end my address by commenting on these two points in particular: sustainability of the public finances and stability of the financial system. Sustainability of the public finances necessarily involves improving the primary structural balance, as I have mentioned before.

The sectoral spending programmes will have to be resized, to ensure that Portugal's public spending level is compatible with the productive capacity in the economy, demographic trends and socially acceptable tax burden.

In parallel, the institutional framework for the public finances will have to be changed dramatically, to ensure that primary balance adjustments are not reversed. Budget rules and procedures are required so that (i) budgetary goals are compatible with the medium and long-term sustainability of the public finances in a context of stable taxes; and (ii) budgets are executed without major slippages.

Deep reflection is needed on the organisational model and management of the public sector, to find solutions offering efficiency gains in producing public goods and services, thereby minimising the impact on society of the reduction of the resources allocated to the main spending areas.

I do not want to take up much more of your time. However, as part of the debate about the conditions for sustained growth in the Portuguese economy, and given that today we celebrate World Savings Day, I have to say a few words on the importance of financial stability and the role performed by Banco de Portugal.

3. Financial stability and the role of Banco de Portugal

Safeguarding financial stability is a key aspect of the adjustment programme alongside lasting consolidation of the public accounts and increasing the economy's growth potential. These three aspects are inseparable and have to be seen as linked.

We have seen how sustainability of the public accounts is a necessary condition for sustained growth and how this is crucial for reversing unsustainable public debt trajectories.

The same kind of "dialectic relationship" exists between financial stability and sustainability of the public finances and between financial stability and sustained growth.

As the case of Ireland well illustrates, problems in the financial system require the intervention of the public sector, jeopardising the sustainability of public debt. Conversely, unsustainable public indebtedness affects the banking system's financing capacity, jeopardising financial stability.

An environment of financial stability reduces uncertainty, protects investors, contributes to lower, less volatile interest rates and ensures stable financing flows to the economy. These factors are decisive for promoting investment and an efficient allocation of capital, and moreover, promote sustained growth in the economy.

Sustained growth is also indispensable for preserving financial stability, by ensuring the wealth creation needed for paying down debt to the financial system. A protracted recessive environment leads to an increase in bankruptcies and unemployment, creating significant growth in non-performing loans which weakens the banks' balance sheets and jeopardises financial stability.

In this context, given its responsibilities in supervising the Portuguese financial system, Banco de Portugal has a key role in the Portuguese economy's adjustment strategy. Banco de Portugal's strategy for financial stability aims to respond to four key concerns:

- Safeguarding the liquidity of the banking system
- Ensuring capitalisation levels suited to the banks' risk profiles
- Incentivising the banks' restructuring, aiming to re-establish adequate profitability in the new business context that resulted from the international financial crisis
- Preserving the general public's confidence in the system

Conclusion

Allow me to conclude.

The crisis we find ourselves in is also an opportunity – which we cannot afford to miss – to define a development strategy that sets the Portuguese economy on a sustained path of convergence with the average per capita income levels of Europe.

We need a more productive country that creates employment within a stronger economic and monetary union. The fact that the ongoing adjustment is proceeding in a context of demographic transition and increased globalisation only adds to the urgency and relevance of the challenge.

The problem is structural and cannot be resolved with anticyclical policies. Any postponement of the adjustment involves new financing needs and the deterioration of public debt, with the consequent further loss of credibility.

Therefore it is urgent to refocus the public debate on the Portuguese economy and economic policy in Portugal.

Only a reallocation of resources within the economy based on expanding the tradable sector will avoid prolonged relative impoverishment. Growth potential driven by exports is very high and the strong performance of exports makes the point.

We must demand from the State that it promotes the institutional and macroeconomic conditions that attract high-quality investment and skilled labour. Simplicity and stability in the tax system, effectiveness of the justice system and competition policy, efficient labour market institutions and financial stability – understood as sustainable public finances and a solid and competitive banking system – are critical success factors.

But, the challenge of inclusive and sustained growth will only be accomplished if the private sector becomes the real driver of structural change in the economy.

To borrow from the famous quote of President John F Kennedy, now is the time for each of us to ask ourselves what we can do for our country.

Thank you very much.