Carlos da Silva Costa: The challenge of inclusive growth

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Delphi Economic Forum IV "The challenge of inclusive growth", Delphi, 1 March 2019.

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As prepared for delivery.

Good morning ladies and gentlemen,

I would like to thank the organisers for the kind invitation to join you today and to Mr Mitropoulos for his introductory remarks. It is an honour to be here.

Ten years on from the start of the great financial crisis, the Portuguese economy is in a growth phase. Economic activity has accelerated in recent years, economic agents continue to benefit from favourable financing conditions, public accounts are improving and the banking sector is getting stronger.

While growth is a critical ally in this rebalancing process, we cannot ignore the fact that growth periods involve a greater propensity to take on excessive risk. This is why it is crucial in the current environment to bear in mind the lessons from the crisis and, above all, to prevent the resurgence of the factors that led up to it.

With this in mind, I thought now was the right time to speak about: (i) the process leading up to the crisis that hit the Portuguese economy, (ii) the adjustment process initiated through the financial assistance programme, and (iii) the current challenges to sustainable growth.

1. 1995–2007 – Capital inflows from euro adoption were misallocated, leading to macroeconomic imbalances

This is a story that begins in the mid-1990s, a period when we might argue the economy was broadly in (internal and external) balance.

By then, the prospect of euro adoption translated into cheaper and more accessible financing, leading to strong credit expansion, and to a contraction in private savings. The stock of credit to the private sector increased by more than ¾ of GDP, whereas the private savings rate almost halved during this same period.

The increase in indebtedness was mainly used to finance consumption and low-return investments, mostly in the non-tradable sector. As a result, imports expanded and large current account deficits emerged, without a corresponding expansion of the economy’s growth potential.

Between 1995 and 2007, the general government budget deficit averaged 4.3% of GDP and, according to the most recent data, was never below the 3% upper threshold. The large interest savings and windfall tax revenue coming from the plummeting interest rates and booming private spending of the second half of the 1990s were used to finance higher current public spending. Following the introduction of the euro, interest rates stabilised as they had broadly converged to the best performers and tax revenue fell as a result of decelerating activity in the early 2000s, causing a sharp deterioration in the public accounts.

Large and persistent current account deficits translated into a sharp deterioration of the Portuguese economy’s international investment position, which also went from being close to net zero in the mid-1990s to almost –90% of GDP in 2007. The behaviour of gross external debt over the same period – growing from around 60% to 195% of GDP – is even more striking.

This rising external indebtedness was largely intermediated by the Portuguese banking system. Banks raised (mostly short-term) funds in the international financial markets and converted these into (long-term) loans to the private sector. The banking sector's loan-to-deposit ratio increased from nearly 89% in 1998 to around 156% in 2007. The public sector also resorted to foreign finance extensively.

2. 2008–2010 – Global crisis tackled through fiscal expansion disregarding accumulated imbalances

These imbalances made the Portuguese economy extremely vulnerable to the international financial crisis and its contagion effects.

When the crisis hit, a highly expansionary fiscal policy was pursued, disregarding the existing imbalances and the lack of fiscal space. In 2010, the public budget deficit was above 11% of GDP and gross public debt was around 96% of GDP – of which, more than half was external debt.

With potential output growing very slowly, rising external indebtedness fuelled investors' doubts about the country's ability to service its debt. As a result, domestic banks and the government found it increasingly difficult to obtain external financing: banks had to turn to the Eurosystem, whereas public debt was increasingly placed in domestic banks. A perfect doom loop embrace.

Investors' concerns eventually led the country to be shut out of the international financial markets in the first half of 2011, after the 10-year yields had nearly doubled in the previous year. This led to a request for official financing under a financial assistance programme negotiated with the European Union and the International Monetary Fund.

3. 2011 onwards – Macroeconomic rebalancing and financial deleveraging: notable progress, but no room for complacency

Notable progress was achieved with the implementation of the financial assistance programme:

- The budget deficit significantly declined and public debt is now on a downward trend;
- Private sector deleveraging is ongoing; and
- The banking sector is more robust, with a stronger liquidity position, higher solvency ratios and improved asset quality.

The adjustment programme has widely been regarded as a success. In my view, this success was due to three factors:

1. First, programme ownership. Portugal was committed to the implementation of the programme, which was accepted by the population. A constructive dialogue with social partners was possible and this was key to ensuring the success of the quarterly reviews.
2. Secondly, the speed and intensity of the response from the tradable sector, in particular exports, was key to the rapid rebalancing of external accounts and mitigation of the impact of lower domestic demand on the non-tradable sector.
3. Third, the maintenance of confidence in the banking sector, as evidenced by the behaviour of deposits. This was crucial to preventing the economy from collapsing with a credit crunch and avoiding the imposition of capital controls.

It is important to remember that an adjustment programme is always a short-term programme whose effects are only sustainable if there are structural and institutional adjustments that prevent repetition of the conditions that led to the need for adjustment.

As such, notwithstanding the undisputable progress, there is no room for complacency.

A lasting trajectory of growth and convergence towards our European partners depends on our capacity to generate and maintain high levels of employment and productivity. This is a necessary condition to (i) bring our workers' wage levels closer to European standards; and (ii) finance the welfare state in a context of unfavourable demographic developments.

The challenge is thus one of activating the 'levers' of employment and productivity. I will briefly highlight the four most critical ones.

1. First, investment. It is vital to increase both the stock of capital and investment in intangibles, learning from past mistakes, particularly by scrutinising investment projects in a far more demanding way. Of course, we cannot ignore the fact that the recovery in investment is constrained by the (still) high indebtedness level and low savings rate of the Portuguese economy. This means that higher investment will have to be financed through an increase in equity, either from existing shareholders, or the entry of new domestic or foreign shareholders.
2. Second, skills. In Portugal, employees' skills have improved considerably in recent years but important gaps remain in relation to European averages, which we need to continue to close.
3. Third, management. We need management frameworks that encourage openness to risk and favour decentralised decision-making. It is well documented that firms with a more decentralised management and higher educated managers are more open to disruptions and thus more innovative.
4. Fourth, innovation policies. Public policies that are innovation-friendly are also critical to stimulate productivity and employment.

Let me conclude.

The challenge we are confronted with is that of generating and maintaining high levels of employment and productivity to ensure a lasting trajectory of growth and convergence with our European partners.

We're talking about the deep institutional and structural foundations of the economy. The task is hard and will take time to complete before it bears fruit. This means we need to be determined and tenacious and focus on what really matters from a long-run perspective.

I will of course be happy to take questions, or listen to any comments you may have.

Thank you for your attention.