Carlos da Silva Costa: Crisis management, resolution and recovery in small European countries on an IMF programme. Comparative presentation - the experience of Portugal

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Conference held by the Central Bank of Iceland "Looking back and looking forward: How do we preserve monetary and financial stability?", Reykjavik, 12 July 2019.

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1. Introductory remarks

Good morning. I would like to thank Governor Már Gudmundsson for his kind invitation to participate in today's Conference and to share with you **the Portuguese experience** in regard to adjustment programmes, including those of the International Monetary Fund (IMF).

Ten years after the start of the great financial crisis, the Portuguese economy is in a growth phase, economic agents continue to benefit from favourable financing conditions, the public accounts have improved and the banking sector is stronger. Unemployment *is now below pre-crisis levels and private and public leverage ratios have improved.* **In the coming years, economic activity in Portugal is expected to continue to benefit from a relatively favourable economic and financial environment.** This is good news, because growth is a key ally in the process of rebalancing the economy.

However, not only in Portugal but in any economy, we cannot ignore the fact that growth periods also tend to lead to a greater propensity to take on excessive risk. And, **in the absence of a sense of emergency stemming from bad economic performance or imminent financial market pressure, policymakers' continued commitment to economic reform and social consensus becomes much harder**.

This is why it is crucial in the current environment to bear in mind the lessons learned from the crisis and, above all, to prevent the resurgence of the factors that led up to it. **The Conference today will certainly help enhance the level of awareness of all the participants.**

2. Portugal had to resort to assistance programmes on three occasions – with similar problems, but different monetary policy regimes and prescriptions

As you know, **in the first half of 2011, Portugal had to resort to official financing** under an assistance programme negotiated with the European Union (EU) and the IMF. Public and private indebtedness had accumulated as a result of a credit boom dating from the mid-1990s, and large current account deficits emerged. After twelve very difficult months, recourse to official financing under an assistance programme became unavoidable.

Before speaking about the 2011 assistance programme and the factors that led to it, let me say that this was not the first time Portugal had to resort to official financial assistance. **We had already negotiated adjustment programmes with the IMF in 1977–1978 and in 1983.** The root cause of the accumulated imbalances was then essentially the same: excessive domestic demand growth in relation to the productive capacity of the economy, leading to external debt accumulation.

However, given that **in the 1970s and 1980s Portugal was not part of a monetary union and had full monetary autonomy**, the symptoms of the crisis and the policy prescriptions at the time had some important differences when compared to the 2011 crisis.

In a context of monetary sovereignty, **the imbalances translated into currency depreciation, international reserves depletion and high and rising inflation rates**. With monetary policy fully available at national level, financial repression prevailed. The policy prescription consisted of interest rate increases, credit growth targets, capital controls and the devaluation of the escudo, to contain domestic demand and restore export competitiveness.

As a result of the adjustment strategy, the real value of wages, pensions and savings declined sharply and wealth was transferred from creditors to debtors. **Money illusion blurred the perception of the adjustment costs and of the fundamentally unbalanced burden-sharing.** Also, as nominal variables were targeted and competitiveness was restored in the short term, structural supply-side imbalances and long-term competitiveness failed to be properly addressed. As a consequence, the country's competitiveness remained fragile and anchored in low wages.

The 2011 programme was agreed in a completely different environment. Without the monetary instrument, money illusion was no longer there and the policy prescription had to be different. As a result, the need for deleveraging and structural supply-side reforms became inescapable.

To better understand the crisis that hit the Portuguese economy in 2011 and to draw lessons for the future, it is important to **analyse the factors and policies that led to it**.

3. The 1995–2007 period – the accumulation of macroeconomic imbalances

To find the deepest roots of the problem, we have to go back in time to the mid-1990s. The Portuguese economy presented no significant macroeconomic imbalances at that time. Meanwhile, financial liberalisation and the prospect of joining the single currency translated into **cheaper and more accessible financing**, leading to strong credit growth, and a fall in households' savings rates. From 1995 to 2007, the stock of credit to the private sector increased by more than ¾ of GDP, whereas households' savings rates almost halved during the same period.

Furthermore, 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 materialised**, without a corresponding increase in the economy's growth potential.

A macroprudential policy and a countercyclical fiscal policy would have helped contain the risks associated with the expansion of domestic demand. However, macroprudential policy was simply not part of the standard toolbox and the mostly pro-cyclical fiscal policy that was followed aggravated the macroeconomic imbalances. In fact, **in the 1995–2007 period, the budget deficit was, on average, 4.3% of GDP** and, according to the most recent (revised) data, it was never below the 3% limit. 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 **severe deterioration of the Portuguese economy's international investment position**, which went from being close to balance in the mid-1990s to almost –90% of GDP in 2007. **Developments in gross external debt over the same period were even more striking**: external debt grew from approximately 60% to 195% of GDP.

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.

In hindsight, it is clear that the pro-cyclical fiscal policy and less demanding regulatory context, coupled with the complacency of international financial markets, contributed decisively to the **accumulation of important macroeconomic imbalances** from the mid-1990s.

4. The 2008–2010 period – the global crisis, fiscal expansion and increasing difficulty to access external financing

The imbalances that I referred to made the Portuguese economy extremely vulnerable to the international financial crisis that started in 2008 and to its contagion effects. When the crisis hit, followed by a global recession, an expansionary fiscal policy was once again adopted, and this time it was particularly intense, despite the imbalances hitherto accumulated and the absence of fiscal space. **In 2010, the budget deficit was above 11% of GDP and gross public debt was around 96% of GDP** – of which, more than half was external debt.

The high and rising level of external indebtedness, coupled with weak growth of potential output, **fuelled investors' concerns about the country's ability to pay back its debt**. 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.

This situation ultimately resulted in the **country's inability to fund itself in the international financial markets in the first half of 2011**, after the 10-year yields had nearly doubled those of the previous year, reaching over 9%. **Recourse to external official financing under a financial assistance programme became unavoidable**.

5. 2011 onwards – the adjustment programme

The Economic and Financial Assistance Programme was agreed in May 2011 between the Portuguese authorities, the EU and the IMF.

On the basis of a strategy aimed at restoring international financial market confidence in the Portuguese economy and fostering competitiveness and sustainable economic growth, **the Programme rested on three major pillars**:

- Fiscal consolidation;
- Safeguarding the stability of the financial system; and
- Structural transformation of the Portuguese economy.

Banco de Portugal participated in the definition and implementation of the Programme's **financial stability pillar, which aimed to**:

- Reinforce solvency, promote gradual and orderly deleveraging and ensure the stable financing of the banking system;
- Reinforce banking system supervision;
- Improve the regulatory framework.

Banco de Portugal's responsibilities in the Programme's implementation were mostly related to its mandate to safeguard the stability of the Portuguese financial system. The Bank also participated directly and indirectly in other ways – for example by providing economic and financial advice to the Government and reporting statistical data – and took part in different initiatives led by the Portuguese authorities. The Bank also shared responsibilities in processing the financial assistance disbursements and interest payments, acting as an intermediary between the financing bodies and the Portuguese Treasury and Government Debt Agency.

The total amount of financial assistance for the 2011–14 period was set at €78 billion, of which €52 billion corresponded to funding through the European mechanisms (the European Financial Stabilisation Mechanism and the European Financial Stability Facility) and €26 billion to assistance from the IMF, under an Extended Fund Facility. Of this total amount, €12 billion was allocated to a Bank Solvency Support Facility. Overall, eleven disbursements were made, which corresponded to approximately 97% of the agreed package. **The Programme expired on 30 June 2014.** During the programme years, 12 review missions took place.

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

- The budget deficit significantly declined and public debt was put 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 Portuguese adjustment programme has widely been regarded as a success story. In my view, this success was due to **three factors**:

- **Programme ownership.** Portugal was committed to the implementation of the programme, its urgency was understood and accepted by the general public and there was a constructive dialogue with social partners. This ensured the success of the quarterly reviews.
- **The speed and intensity of the response from the tradable sector**, in particular exports, was key to the rapid rebalancing of the external accounts and mitigation of the impact of lower domestic demand on the non-tradable sector.
- **The preservation 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.

The macroeconomic adjustment has continued after the programme ended in 2014, with encouraging results. After the end of the programme, Portugal was subject to post-programme monitoring/surveillance by the IMF and the European institutions. The post-programme monitoring by the IMF ended upon the conclusion of the early repayment of the IMF loan in December 2018. An early repayment strategy was possible thanks to a marked improvement in Portugal's market access conditions. This strategy sent a positive signal to the markets, improved the maturity profile of public debt and generated important interest savings.

6. What lessons has Portugal learned from the 2011 crisis and the adjustment programme?

The Portuguese experience shows that when **investors' concerns about the sovereign's capacity to pay back debts** intensify and a country is unable to fund itself on the international markets, an adjustment programme must be negotiated.

The country's authorities need to ensure **ownership of the programme** and a **fair distribution of costs across the society**, so as to create a collective sense of purpose.

The **reaction of the tradable sector,** in particular exports, is crucial for rebalancing the external accounts and mitigating the impact of lower domestic demand on the non-tradable sector.

Safeguarding **confidence in the banking sector** and the regular financing of the economy, i.e. preserving financial stability, is also a key factor in avoiding a credit crunch and a deeper economic recession.

It is also important to keep in mind that **adjustment programme goals are always short-term by nature**. Therefore, the adjustment will only be sustainable if there are structural and institutional changes that prevent the recurrence of the conditions that led to the need for adjustment.

This means that, despite the undisputed progress made during and after the 2011–2014 programme, **there is no room for complacency**. The experience of the past 40 years teaches us that the initial impact from an assistance programme will only be sustainable if there are structural changes that foster higher potential growth.

7. Major challenges ahead

Portugal has made remarkable progress since the time of its adjustment programme but several vulnerabilities and important challenges still remain.

The **crisis had a significant impact on the accumulation of capital**, with negative repercussions on potential output. Reducing the high levels of indebtedness, in parallel with creating conditions that allow investment to increase (both in quantity and in quality) is essential for improving the Portuguese economy's current situation.

In my opinion, the real challenge Portugal is confronted with is that of **generating and maintaining high levels of employment and productivity** to ensure a lasting trajectory of growth and convergence with its European partners. This is a necessary condition to (i) bring Portuguese workers' wage levels closer to European standards; and (ii) finance the welfare state in a context of unfavourable demographic developments.

This means that we need to activate the **four most critical 'levers'** of employment and productivity:

- **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);
- **Skills** (employees' skills have improved considerably in recent years but significant gaps remain in relation to European averages);
- **Management** (management frameworks must encourage openness to risk and favour decentralised decision-making);
- **Innovation policies** (innovation-friendly public policies are also critical to stimulating productivity and employment).

A long-lasting improvement in the economic welfare of the Portuguese people depends crucially on the **maintenance of a sustainable macroeconomic framework** that provides suitable incentives for economic agents and on following **a reform agenda that supports long-term sustainable growth.**

8. Concluding remarks

Although my intervention focused on the Portuguese situation, we should bear in mind that **there**

are also important challenges ahead at European level.

While we should not underestimate how much has been achieved in recent years, in the aftermath of the financial crisis, we cannot ignore the fact that **the foundations of Europe's financial architecture are still not sufficiently robust and need to be reinforced further to withstand the impact of a future crisis,** to preserve financial stability and safeguard social cohesion. Their strengthening should be a priority for policy-makers and relevant institutions.

In the case of both Portugal and the EU, we are talking about the deep institutional and structural foundations of the economy. The task is hard, and it will take time to complete and bear fruit. This means we have to start right away and be determined and tenacious, focusing on what really matters from a long-run perspective.

At EU level, decisive political will to move forward with the completion of the banking union is required. In the absence of this will, Europe must revisit its existing rules to safeguard financial stability. This is in the best interests of its citizens. Not many things can be more destructive to public trust in European institutions than threats to financial stability.

As I have already said, one of the key elements of Portugal's economic success through its adjustment programme was the political consensus in a time of crisis. **Given that today, at this Conference, we are talking about lessons from the crisis, I believe that the importance of collective ownership and consensus should be highlighted both for Portugal and for Europe as a whole.**

Thank you.