The monetary and fiscal policies of portugal economics essay

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I. Introduction: Portugal macroeconomic situation before the crisis.

Despite economic and financial crises seem to be regarded as unusual and rare, in reality they are common events. Particularly, Portugal has already seen its worst financial crisis in 1891. This crisis led Portugal to abandon the gold standard and the country was banned from borrowing in international financial markets during 20 years (Lains, 2007, p. 485). Since then, Portugal has radically changed, however, its weakness in facing the crises has remained.

During the last economic and financial crisis that started in August 2008, the Portuguese economy was caught in the middle of a period of adjustment during which " was already facing up to the need to correct its fiscal and external imbalances within a phase of low growth with pro-cyclical policies" (Torres, 2009, p. 55). This period started in the second half of 1990's with the accession to the Economic and Monetary Union (EMU) and was characterized by an economic boom which was followed by a slump. As a matter of fact, Blanchard (2007, p. 1), two years before the crisis, stated that " the Portuguese economy is in serious trouble: Productivity growth is anemic. Growth is very low. The budget deficit is large. The current account deficit is very large."

Although, from 1995 to 2001, Portugal was in a catching-up phase benefiting from positive wealth effects of EMU (lower interest rates which supported the increase of the domestic demand), the current account deficit rose drastically and the unemployment rate fell to about 4% (figure 1). The

reason behind the increase in the current account deficit was, indeed, the low level of unemployment which boosted the nominal wages to increase more than the labour productivity provoking a huge raise in unit labour cost and a decline in competitiveness. Moreover, the indebtedness of households and non-financial enterprises was increasing because of the elimination of the exchange rate risk, the access to the euro bond market, and the lower interest rates, both nominal and real, set by the European Central Bank (Blanchard, 2007).

As result, from 2000 to 2003, savings dropped and investments increased, therefore the current account deficit slightly decreased. The Portuguese economy slowed down and then contracted in 2003.

The subsequent slump was the result of the large imbalances built up during the phase of boom. For instance, the high levels of consumption were not counterbalanced by the supply which had to deal with low productivity growth and increasing unit labour costs. As a matter of fact, figure 1 shows a combined upward trend of unemployment and current account deficit between 2003 and 2005, and the attempt to reverse it through the budgetary consolidation process re-assumed by the socialist majority government elected in 2005 (Blanchard, 2007) (Torres, 2009).

To sum up, table 1 and table 2 offer an overview of the macroeconomic imbalances during the phase of the boom 1995-2000 and the one of the slump 2001-2007.

Table 1. Macroeconomic evolutions, 1995-2001. Source: Blanchard (2007)

Table 2. Actual and projected Macroeconomic evolutions, 2001-2007. Source: Blanchard (2007)

The growth rate was rather high in the timeframe 1995-2000, then, since 2001 it started falling in the subsequent years. The current account and the budget surplus were in deficit over the whole observed period and the productivity growth started to be very low since the year 2000 causing the raise of the unit labour cost.

It was important to describe the macroeconomic situation of Portugal prior to the crisis in order to explain, in the next sections, how those problems have been aggravated since 2008. In fact, the phase of slump was prolonged by the financial crisis occurred in 2008.

II. Policy Responses

Prior to analyze the European and Portuguese policy responses to the major financial crisis that the whole world is facing since 1929, it is essential to point out what kind of crisis our society is dealing with. The main cause of the crisis may be ascribed to the crisis of derivative market in the United States. In particularly, it started from the so-called ' subprime mortgage crisis' which was the result of a speculative bubble in the housing market in the United States. Starting from the United Stated, it has spread by causing ruptures across many other countries in the form of financial failures and a global credit crunch.

" The main (systemic) Portuguese banks seem not to be particularly exposed to the so-called financial toxic assets and, unlike in Ireland or Spain, there was no speculative bubble in the housing market in Portugal nor is there a

subprime segment in the credit to the housing sector.” (Banco do Portugal, 2008 as cited in Torres 2009)

However, according to Torres (2009, p. 56):

Portugal, a small economy fully integrated in economic and financial terms, is particularly affected by the global financial crisis and economic recession. This is not so much due to the international exposure of the Portuguese banking sector (the Iceland syndrome) but primarily to the country’s long protracted correction of its fiscal and external imbalances, which worsen its creditworthiness and aggravate the costs of servicing the debt and the country’s perceived risk of insolvency (an Argentinean type of problem, without the risk of a currency crisis as long as the eurozone remains in place).

One of the main consequences of the financial crisis was, indeed, the credit crunch. During the last decades, the European banking system has changed from a system where the bank was the intermediary for investments between families and factories, into a new system where there are large money-centre banks which play the role of the intermediary amongst regional banks, in other words, they distribute funds among regional banks. The banking crisis has occurred in Europe because of two related reasons. The large money-centre banks that provide the backbone of the inter-bank lending market are undercapitalised. With their low capitalisation, they are vulnerable to even small swings in market conditions. Any liquidity problem, thus, turns almost immediately into a solvency problem. Because of this

vulnerability they did not trust each other, thus paralysing the inter-bank market.

2. 1 European Policy Responses

For the Euro-area countries, the monetary policy is unique and conducted by the European Central bank (ECB). Since the atmosphere of mistrust, caused by the crisis, was no longer confined to the interbank market, but it was also spreading among ordinary citizens and consumers, the European policy-makers figured out that one possible solution was to put into effect measures which contain two elements in order to restart the interbank lending: support for the liquidity management of banks and bank re-capitalisation. The first element concerns the extraordinary measures taken at European level and the second one the bank rescue measures adopted at national level.

As a matter of fact, firstly, the ECB has been reducing the rate for its main refinancing operations from 4, 25% to 1, 5%, in the timeframe October 2008 – March 2009, in order to prevent contagion by providing short-term liquidity support on the interbank markets. Such interest rate cuts have provided significant relief to the highly indebted Portuguese economy (Torres, 2009). However, if Portugal could have managed the monetary policy on its own, probably it would have set a lower interest rate which combined with the initiative for strengthening financial stability (discussed in detail in the next section) could have led to the reestablishment of bank lending standards at pre-crisis level. In other words, the upward trend of the credit diffusion index, starting in the last quarter of 2008, could have continued to increase instead of contracting in 2009 (figure 3).

Moreover, a dramatic reduction in real interest rates is the main channel through which fiscal consolidation can increase demand in the short run. Since this is not the case for Portugal, as the nominal interest rate is determined for the eurozone as a whole, " while a deficit reduction is needed, it would be unwise to expect it to lead, by itself, to higher demand and lower unemployment … or … to a boom in investment, and through capital accumulation, to a substantial improvement in competitiveness" (Blanchard, 2007, p. 8-9).

Secondly, the ECB has promoted coordination and cooperation between national supervisors through the European System of Central Banks' Banking Supervision Committee. As result, the promoted cooperation engaged both the Euro-area and the European Union (EU) in an expansionary coordinated anti-cyclical fiscal stance (Torres, 2009, pp. 56-59).

To further improve the EU coordinated approach, the European Commission's response was to launch the European Economic Recovery Plan (EERP) whose strategic aims is to avoid a deep recession by promoting " a counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the real economy". The plan consisted of an immediate budgetary stimulus amounting to 1. 5% of EU GDP, " a number of priority actions, grounded in the Lisbon Strategy, and designed at the same time to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth" and a set of EU guidelines to be followed by the member States (European Commission, 2008).

According to Bénassy-Quéré et al. (2009, p. 39), out-of-ordinary methods are used in a financial crisis because:

the traditional transmission of policy rates to lending rates is hampered by the dysfunctional state of money markets. This happens at two levels: first, the interbank rate (the rate at which banks lend liquidity to each other) diverges from the central bank's policy rate because banks fearing counterparty default price risk accordingly; second, the spread between the commercial banks' lending rate and the interbank rate increases both because of higher risk premiums and because banks seek to increase their profits.

According to Meier (2009, p. 6), a switch to unconventional policy may be motivated by the severe turmoil in credit markets. With the financial sector in crisis, policy rate cuts are not only constrained by the zero bound, but may also be less effective than during normal times. The reason is the sharp tightening of credit conditions, as lenders have curtailed loan supply and certain sources of capital market funding have all but disappeared. Indeed, such dislocations can provide a rationale for launching unconventional policies even before interest rates hit the lower bound. In sum, unconventional monetary policies serve both as a complement and as an extension of standard operations centered around the setting of short-term interest rates. One of the unconventional actions is the so-called outright asset purchase, a technique to decrease the discrepancy between interbank and lending rates.

Furthermore, Meier (2009) provides a categorization of such operations, distinguishing between qualitative easing, as sterilized interventions that do not involve an increase in the central bank" s balance sheet, and quantitative easing, as unsterilized interventions implying an increase in base money. Unlike the US and the UK, in the Eurozone the direct purchase of government debt instruments is forbidden by art. 101 of the EC Treaty, therefore quantitative easing is not contemplated. Figure 2 shows how liquidity provisions and out-of-the-ordinary policies, adopted by ECB, Federal Reserve (FED) and Bank of England (BOE), increased the size of the central bank's balance sheets. Assets hold by the ECB are about 50% lower than FED and BOE because they executes quantitative ease operations (Bénassy-Quéré et al. 2009, pp. 42-44).

2. 2 Portuguese Policy Responses

With the financial crisis Portugal has re-focused its economic policy from budgetary consolidation to an anti-cyclical budgetary policy effort to support households, investment, employment and, last but not least, to strengthen financial stability (MFAP 2009 as cited in Torres 2009).

At the end of 2008, to guarantee stability of the financial system and to safeguard the household's deposits held by credit institutions, the Portuguese government, following the trend of the other member states, decided to save two banks: the Banco Português de Negòcios (BPN) and the Banco Privado Português (BPP). In particular, BPN was nationalized and BPP was granted a guarantee for a bank loan provided by a group of banks. Although the dimension of those banks was small, the government " feared

that the potential loss incurred by many small depositors could generate a run of bank depositors in general, putting at risk the stability of the financial system" (Torres, 2009, p. 61).

The second measure to strengthen financial stability was taken in October 2008 when the Portuguese Ministry of finance and public administration announced the endorsement of the Initiative for strengthening financial stability (ISFS) in order to respond to the substantial external shock, to which it was being subject, due to severe liquidity restrictions in international financial and money markets. The ISFS was aim to enhance conditions for credit institutions' access to liquidity in financial markets and was based on granting State guarantees for the financing of credit institutions.

According to MFAP(2008), this Initiative:

(i) Enhances the confidence in the domestic financial system;

(ii) Permits timely intervention adapted to market conditions;

(iii) Is temporary, remaining effective only while market conditions have not returned to normal;

(iv) Safeguards the interest of depositors and taxpayers;

(v) Allows the shareholders and managers of banks to be held accountable whenever necessary and fosters the adoption of good corporate governance principles, in accordance with best international practices;

(vi) Safeguards the interests of the market in general and a level playing field among competitors, in particular.

According to Torres (2009, p. 60), the aim of the coordinated guarantees on new issuance of bank debt was to address funding problems of liquidity-constrained but solvent banks. Thus, this initiative was a viable and less costly source of funding to allow banks to issue new debts.

A third measure was to take advantage of the increased flexibility of the Stability and Growth Pact (SGP) to pay outstanding state debts under the form of a program for the extraordinary settlement of the state's debts to suppliers (Council of Ministers Resolution no. 191-A/2008 of 27 November as cited in Torres 2009).

However, in my opinion the results of those initiatives were rather limited. I can, indeed, argue that, in Portugal, bank lending standards are tightening. In support to my opinion, figure 3 provides an evidence: the largest observed swing occurred from the last quarter of 2007 to the last one of 2008 when the diffusion index dropped sharply to the minimum observed value, representing the credit crunch. To evaluate the effects of the ISFS it is sufficient to look at the trend starting from the last quarter of 2008, the upswing lasts for only a quarter to stabilize at the level of about minus 45% compared to the pre-crisis conditions.

The 19th of January 2009, the Portuguese government updated the Stability and growth Program for 2008-11. Following the EU guidelines concerning EERP, the government incorporated in the SGP program the Investment and Employment Initiative Program (IEIP), as fully consistent with the National

Reform Plan for 2008-2010 (within the framework of the Lisbon Strategy), as it also aimed at contributing to addressing the country's structural weaknesses. The draft law creating the IEIP was composed of five structural measures including several projects or actions to support households and businesses next to those aimed at combating the rise in interest rates and in the price of raw materials and food products and credit restrictions, which had already been envisaged in the state budget for 2009.. The IEIP was expected to have a budgetary impact of about 0. 8 per cent of GDP in 2009 (about 0. 5 increase in expenditure and 0. 3 reduction in revenue in percentage of GDP).

The five measures were:

modernization of schools;

fostering renewable energies, energy efficiency and energy transmission infrastructure;

modernization of technological infrastructure and new generation broadband networks;

special support to economic activity, exports and SME;

protecting employment and strengthening social protection (Torres, 2009).

1). Higher investment in human capital help to avoid the risk of depression of productivity performance. In Portugal the educational attainment of the working-age population is low and the intergenerational educational mobility has been sluggish. Furthermore, the international student performance

survey (PISA) shows that Portuguese students are below the OECD average (figure 4). To increase efficiency, the smallest schools have been closed and changes to the teachers' timetable are allowing a more efficient allocation of human resources. Moreover, upper-secondary education has been diversified to incorporate technical and vocational courses (OECD 2009).

and 3). Portugal might take advantage of the temporary increase in spending under the recovery plan to promote a leap forward to new competitive ' green' goods and technologies. There is a clear case for the world, and for the EU to maintain its leadership in the process, and even more so for a small country like Portugal, to address climate change and the financial crisis at the same time by building up a competitive basis for sustainable development (Torres, 2009, p. 66).

Activity collapsed at the end of 2008 under the weight of the global economic crisis. The huge decline in external demand was caused by the falling activity in a number of Portugal's major export markets, particularly Spain which accounts for about 25% of portuguese total exports. Moreover, insufficient harmonization of regulations with major trading partners seem to have impeded trade, particularly in services. Despite the government's announcement of additional revenue measures the deterioration in economic activity without further reductions in government outlays, or a more rapid economic upturn, means that the budget deficit could rise above 4. 5% in 2010 and to increase further in 2011. The deterioration in economic activity was partly caused by the administrative burdens on business. Starting, running, and closing a business have been hampered by onerous regulation, including a cumbersome licensing regime that has weakened competition

and, thus, productivity growth throughout the economy (OECD, 2008, 2009a, 2009c; European Commission 2009). Figure 5 provides evidence that Portuguese burden on business in the form of regulation are higher than EU average.

Productivity growth has been sluggish during the last decade, lagging behind the OECD average with a decreasing trend since 1990 (figure 6), partly on account of labour market rigidities such as high employment protection and insufficient human capital accumulation. Those weaknesses have led to a further widening of the large productivity gap with respect to the Eurozone. The protection of workers against individual dismissal has been the most restrictive in the OECD, with very cumbersome procedures, as clearly highlighted in figure 7. The new legislation put forward by the Portuguese government is aimed to significantly simplify dismissal procedures. However, protection of regular workers against dismissals will remain more restrictive than in the average OECD country. Therefore, it is essential to enforce the reform measures because tighter credit conditions, weak exports, and subdued internal demand depressed business investment in 2009 and led to a labour shedding and an increase in the unemployment rate which is projected to reach a double-digit rate in 2010 (OECD , 2008, 2009c; European Commission 2009).

According to Blanchard (2007), Portugal is today in a scenario of ' Competitive disinflation', defined as " a period of sustained high unemployment, leading to lower nominal wage growth until relative unit labor cost have decreased, competitiveness has improved, the current account deficit has decreased, and demand and output have recovered".

If we look at the Real Effective Exchange Rate (REER) of a country, an instrument which can be used to assess price or cost competitiveness relative to the position of the country's principal competitors, it is easy to notice that Portugal has substantially lost competitiveness against Germany since 1995 (figure 8). A rise in the index means a loss of competitiveness taking into account productivity changes via the movement in comparative unit costs (Hugh, 2009). Therefore, as this trend is going on since 15 years it is hard to invert it without huge efforts and structural reforms.

In the context of the budgetary policy, in 2008, Portugal has also taken action to reduce taxes through the cut of one percentage point of the VAT rate, the creation of a general corporate income tax rate of 12, 5% and the reduction of advance income tax payments for SME (State Budget, 2009).

Nevertheless, the fiscal position has deteriorated significantly in 2009 reflecting weaker economic conditions, lower revenues and spending rises to support the economy. Fiscal stimulus measures focusing on public investment, support to companies and exports and social assistance will directly increase the budget deficit (OECD, 2009a, 2009b).

Torres (2009, p. 65) argued that:

In a small open economy like Portugal, fiscal policy has limited effectiveness with regard to influencing aggregate demand. This applies even more to the current environment of financial distress and uncertainty, where banks will try to de-leverage and households to save. Moreover, the Portuguese economy is already particularly exposed due to its fragile financial position, as reflected in its accumulated external imbalances, which puts at stake the

market's confidence in the sustainability of public finances. Given the risks involved for the costs of servicing the debt and ultimately for its solvency and permanence in EMU, it seems essential for the government to credibly pre-commit to medium-term budgetary objectives. It thereby signals its determination to pursue fiscal consolidation in spite of the temporary stimulating measures adopted within the EERP and to ensure that those exceptional measures do not mark a departure from budgetary sustainability.

Moreover, external debt has been high and rising (figure 9) and, thus, leading Portugal to become " the third eurozone economy to undergo a long-term credit rating reduction, to AA minus, by Standard & Poor's because of its failure to tackle deteriorating public finances" (Torres, 2009, p. 64).

Finally, last but not least, Portugal is undergoing a strong disinflation process which is highlighted by the fall of the Consumer Price Index to its minimum levels (figure 10).

European Central Bank council member and Bank of Portugal Governor Vitor Constancio is aware of the danger and has indicated that the ECB is prepared to reduce borrowing costs further to prevent inflation slowing " significantly" below its 2 percent ceiling, even going so far, if necessary, as to introduce some variant of quantitative easing. He still thinks it won't happen, but he is well aware of the possibility, as indeed we all should be (Hugh, 2009, p. 21).

To conclude, it is important to point out that the inflation is expected to be under the OECD average during the whole 2010 to catch-up with the OECD

countries after 2011 (figure 11). Furthermore, the danger of the risk of disinflation is real as shown in figure 12, where the harmonized index of consumer prices is expected to remain below the ceiling of 2% during the whole projected period.

Conclusions: What should be done?

The policy responses’ analysis has highlighted serious structural problems for Portugal and, as a matter of fact, Portuguese growth is expected to lag behind the OECD average during the whole 2010 and 2011 (figure 13).

SUM UP PROBLEMS

In fact, despite Portugal has made significant progress in fiscal consolidation and has launched important structural reforms to modernize the economy and enhance growth, in my opinion, additional structural reforms, in order to find a way out from the crisis, are still necessary, notably, in the following areas:

Education

The secondary education attainment should be improved since human capital represents one of the main durable determinants of growth in the long run. Moreover, reforming the educational system might enhance productivity performance. According to OECD (2009c), the reform should increase the proportion of education spending on non-wage items, continue to strengthen teachers on the job-training and to develop vocational and technical education and, finally, Portugal should fully implement a performance-based evaluation and career-progression system for teachers.

Employment

One of the clearest examples of the problems highlighted by the crisis is to be found in the stagnation of the labour market. It is essential to reform employment protection legislation with proposals aimed at enhancing the adaptability of the labour force, to address rigidities in labour market regulations and improve the efficiency of active labour market programs; otherwise the strictness of the Portuguese employment protection will continue to have negative effects on growth and productivity (OECD 2009c). Moreover, the unemployment rate is expected to be higher than the OECD average during the next two years (figure 14).

Concerning the slow productivity growth problem, Blanchard (2007, p. 8-20) suggests a decrease in nominal wages. Even if it sounds exotic, “ it can substantially reduce the employment cost of the adjustment”. However, “ in Portugal today, the labor law forbids ‘ unjustified wage decreases’ and in practice rules out decreases in nominal wages for economic reasons”.

Business

A deepening of the reform process is required to create a dynamic business environment by reducing the administrative burdens on business. Despite the importance of the recent reforms, a full implementation of them is essential. Competition in the whole economy should also be strengthened through investment “ in key infrastructure sectors, such as telecommunications, electricity and transportation, to enhance the quality, efficiency and quantity of the services they provide. This would have a direct effect on the cost-competitiveness of firms in Portugal, facilitate trade flows,

domestically and internationally and make Portugal a more attractive destination for FDI, which has the potential to boost productivity” (??).

Finally, OECD (2009c) recommends to harmonize regulations with major trading partners, including service sector standards and qualification requirements.

Tax system

A reform is necessary to simplify the tax system, broaden the corporate tax base and decrease tax expenditures in order to reduce fiscal imbalances. Designing and implementing fiscal consolidation remains a priority for Portugal because the deficit needs to be reduced. Silva (2008) provides empirical evidence that, in Portugal, taxes negatively affect productivity because an increase in the taxes decreases consumption, capital, output and welfare. Moreover, he states that for Portugal “ taxes are able to predict the pattern of the labour supply over the years”. Therefore, the government should take into consideration how a tax system reform might serve a double objective: raise the productivity and reduce fiscal imbalances.

Nevertheless, …

Table 3. Actual and projected Macroeconomic evolutions, 2001-2007. Source: OECD