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Transcript

Portugal's Response to the Euro Area Crisis: Fiscal Consolidation and Structural Reform

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Robin Niblett:

Hello ladies and gentlemen. My name is Robin Niblett and I am the Director of the Institute. It is my very great pleasure to welcome you here this evening, a little later than some of our usual meetings, but none the less I can see from the turnout here that this is an important event. It is one that has followed a series of events we have been able to have with ministers of finance from the eurozone area and from outside as well. We started with the Chancellor, George Osborne; we've had Wolfgang Schäuble speaking here; and now, it is our great pleasure to welcome Vítor Gaspar, the Minister of Finance from Portugal as our guest here at Chatham House to discuss 'Portugal's Response to the Euro Areas Crisis: Fiscal Consolidation and Structural Reform'.

What we're going to do is split the evening today into two halves: the first half of the evening will consist of a PowerPoint presentation and remarks from the minister which will be on the record. Then when we go into Q& A, we will go under the Chatham House Rule where you can use the information that you hear today but you cannot attribute it to any individual. That goes for the Q&A as well for any affiliation from questions to the minister and any other comments that are made around the room.

Needless to say, Portugal is in the eye of the storm. I think all of the euro area countries – and maybe those on the outside as well – are all circling around the eye of the storm and this week is really a pivotal week. Maybe several other weeks have been pivotal as well, as I've been discussing earlier, but this week in particular you feel that these discussions are really coming to a particular sharp head at the moment.

In that context I think Vítor Gaspar is somebody who is particularly well placed to be in the saddle in the Ministry of Finance in Portugal. He is a professor of economics – I might call him Professor Gaspar – he holds a PhD in Economics from the Universidade de Lisboa. He has worked throughout the Portuguese Central Bank where he was Director of Research for four years, from October 1994 to October 1998, and he also worked as Director for Research in the European Central Bank from 1998 to 2004. He was Head of the Bureau of European Policy Advisers for the European Commission from 2007 to 2010, and then became an adviser in the Ministry of Finance before taking up his current position earlier this year in 2011.

He has published a lot on issues of financial stability and on other dimensions of economic policy. I was discussing this earlier with [inaudible] who is no longer on the Central Bank but none the less a well-known founder member of the European Central Bank.

So he is particularly well-placed to address these issues. Portugal has now taken its Economic and Financial Adjustment Programme funding in April of this year with a €78 billion package and a number of disbursements already made. I anticipate you're going to be commenting on this, Minister. As we discussed a minute ago, I think how individual governments are undertaking their structural reforms really has become central and critical to the credibility of the ability of the euro area to come out of this crisis. So I think it will be particularly important to hear how Portugal is addressing the structural aspects of its reform and not just the near term aspects of its crisis fighting.

Welcome, Minister, we look forward to your remarks. We will then engage in question and answer afterwards. Over to you...

Vítor Gaspar:

Thank you for your kind words. Thank you all of you for coming to this session and showing interest in discussing the experience of Portugal adjusting inside the euro area. The PowerPoint presentation that I have today is too long for the allotted time. I did present it this morning and it takes about 40 minutes to go through. The presentation will be available from the Chatham House website so you will be able to consult it if you are interested so that you can go through the details later on.

My plan is to take about 20 minutes so that we have ample time for debate and that will allow us to focus on the issues that are of interest to you. As a way of introduction I will give you a very brief outline of how Portugal adjusted to participation in the euro area before the crisis so that we have an idea where challenges and imbalances came from. Then I will give you an overview of the Economic and Financial Assistance Programme which has three main pillars: fiscal consolidation, financial stability and structural transformation - but I will be jumping over the details. I will be concluding my presentation today by going through the key question, which is: How will it work, how will we be confident that the programme will be successful at guaranteeing the necessary adjustments to Portugal's economy? So that is the plan.

The situation that Portugal found itself in at the beginning of 2011 has its roots in the process of adjusting to participation in the euro area that has marked the macroeconomic path of the country for the last 10-15 years. We see that the global crisis and the sovereign debt crises in the euro area has revealed a number of structural weaknesses and macroeconomic imbalances that accumulated in the country over a long period of time. The main process that took place works more or less like the following.

By participating in the euro area a country like Portugal benefits from an access to international capital markets and better terms of available quantities and costs of financing than would have been possible if the country were to have stayed on its own and outside the monetary union. Given this lower cost of financing, the country adjusted by increasing expenditure; households increased consumption, the household saving rate declined quite sharply and household indebtedness accumulated over the year. The same phenomenon happened to firms; firms had access to financing at better terms, they had access to finance projects quite easily and they could finance their current economic activities as well and therefore corporate indebtedness also increased quite substantially. Most of this household and corporate indebtedness was intermediated through the Portuguese banking system and so credit and monetary aggregates increased quite sharply during the period.

In terms of the macroeconomic balances, this translated into a persistent current account deficit for many years and this current account deficit in some of these years reached levels of about 10 percent of GDP. The pace of decline of net indebtedness of the country was quite sharp and the countries net debtor position reached very substantial levels by international standards.

In the context of the global crisis, the previous Portuguese government interpreted the 2008-09 crisis as temporary, [one] that should be met with a budgetary policy stabilisation response. Therefore in 2009 the country engaged in a sharply expansionary budgetary policy. I would like to say that the initial presentation of the 2009 budget by the government foresaw a budget deficit of 2.2 percent of GDP and the outturn was a deficit above 10 percent of GDP. This was to a very large extent a deliberate budgetary expansion which did deliver the expected and desired Keynesian result in the sense that Portugal in 2009 had a less pronounced recession than the average of the euro area. So the fall in economic activity was less than in the euro area as a whole and the recovery in 2010 was stronger than what occurred in the euro area. However, this budgetary expansion proved unsustainable and the country was pushed into a request for financial aid in the spring of 2011. That request was made in April and the programme was approved in May. As a matter of fact the government that had asked for financial aid was already a care-taker government and elections were scheduled for 5 June.

So this is the story that precedes these slides that I'm going to show you. So now we have an economic and financial assistance programme and this programme is characterised – as our host has already pointed out – by the package that foresees the financing of €78 billion for the duration of the programme. The programme lasts from 2011-14 and does cover the general government financing needs for the period. At this point in time, Portugal has already received about €30 billion and the programme is reviewed on a regular basis, on a quarterly basis, and in November we have gone through the second regular review of the programme that finished successfully. The programme is broadly on track according to the European Union, the European Central Bank and the International Monetary Fund, which means that the staffs of these institutions are recommending disbursement of the third tranche, which is worth €8 billion euros to the package of external financing.

The programme has a number of quantitative performance criteria. It has a number of binding quantitative performance criteria and those include limits on the debt, the public debt to GDP ratio, the public debt in amount and the same for the budget deficit. There is a limit on the budget deficit both as a percentage of GDP and in euros.

I think it's timely for me to be here for you because at this point in time we have assurances that we're going to be able to have the 2011 budget deficit below the 5.9 percent limit. We have just had the 2012 budget approved. The 2012 budget has to meet a deficit limit of 4.5 percent of GDP. That is actually quite challenging because given the economic environment and the fact that we had some bad surprises concerning the 2011 budget [inaudible] that had to be compensated with one-off extraordinary measures, the necessary adjustment in 2012 will be quite severe. To give you an idea, the measures which are foreseen in the 2012 budget amount to something like 5 percent of GDP compared to the previous year and that is well above €8 billion in terms of adjustment. For a country the size of Portugal it is quite substantial.

Most of the adjustment effort comes from the expenditure side. In fact, more than two-thirds of the adjustment comes from the expenditure side. That is something that we regard as an absolutely fundamental characteristic of the programme because empirical evidence shows that programmes are more likely to be successful when they are based on expenditure cuts rather than tax increases. Another important feature of the 2012 budget is that in the year we will reach a primary surplus which will grow gradually over time and will ensure that the public debt to GDP ratio is on a sustainable path.

Now here basically what we list is the main pillars of the programme which I have already indicated to you: fiscal consolidation, financial stability and structural transformation. Fiscal consolidation is what I'm going to speak mostly about. Financial stability is also a very important aspect because we need to keep the main functions of the financial system supporting the economy through this difficult adjustment period. And pressure on structural reform is one of the distinctive characteristics of our programme in the sense that it amounts to a true structural transformation, and I will indicate to you why that is particularly key in the Portuguese case.

Here what you have is the path [referring to slide]. Some indicators of the path that I have indicated to you are of the building up of imbalances in Portugal in the run-up to the crisis. On the left-hand side you have most of the years since the beginning of the euro where Portugal has run an excessive deficit – that is, a deficit above 3 percent of GDP. Most of the years the deficit was close to the 3 percent ceiling but still above it and in 2009 and 2010 it was much above the ceiling. This explains the predicament we find ourselves in at this point in time. With the red line you see the public debt-to-GDP ratio; you see the debt at the beginning of [inaudible] at about 60 percent, which is the Maastricht debt limit. But it has unfortunately drifted up during the period and the pace of debt-to-GDP increase has accelerated in the recent past in line with the budget deficit. On the right-hand side you have the gross external debt, which has again increased substantially. This debt reflects the indebtedness of the general government, the household sector and the corporate sector in Portugal.

Now here is a slide that I would like to explain to you a little bit in detail because it shows something that I believe is very important in the Portuguese case. That is that the private sector has shown in the past, and in the current crises, a tremendous ability to adjust. On the left–hand side you have the experience during the IMF's sponsored adjustment programme that took place in 1983-84. That was the last adjustment programme that my country benefited from before this one. There you see as a blue line the adjustment of private consumption and if you would add a new line with private investment you would have an even more pronounced adjustment. So what you see here is that the private sector has adjusted more than the average of the economy and certainly more than the public sector – which you see as a red line in the chart – and reflects public consumption.

If you go to the right-hand side of the chart, what you see is the borrowing requirements by the institutional sector and this one I like a lot because, again, you have the non-financial private sector in blue and in red you have the general government. So what you see in this picture is that already in 2009 the private sector was adjusting quite strongly. The adjustment of the non-financial private sector here is more than 6 percent of GDP. What you see is that the red line is basically compensated for by the adjustment in the private sector; the public sector expansion – general government expansion – basically offsets that. That is the phenomenon that I described to you as the one that eventually led to the unsustainable position and this request for external assistance.

Now this is the last slide that I will show you before going to the three concluding slides. Here what you have is the deficit in 2011. It will be 5.9 percent of GDP or lower and then what you have is the decomposition of the effort needed in 2012. The 3 percent that you have in the column – which is second to the right in the original programme – is the adjustment of the 3 percent requirement in blue. Development since then has added an additional 2.3 percent of the necessary GDP. Most of it comes from development in the budgetary outturn in 2011 that we're compensating by temporary measures in 2011 but will have to be compensated by permanent measures in 2012 in order to put the programme on a sustainable basis. In the end that means that the effort which is necessary for budgetary consolidation in 2012 is almost double what was envisaged in the original programme. So you can see that what we have in store is quite a substantial adjustment which is explained to a certain extent by the fact that economic activity for the next year is forecast to be substantially lower than what was envisaged in the programme.

All of these slides are self-evident so we can jump over them. Now we can concentrate on the key questions: How will it work and why am I convinced that I can persuade you that this is a credible programme that can deliver the necessary adjustment?

First of all, in terms of budgetary consolidation, we have a medium term programme that will deliver quite substantial primary surpluses and will deliver a position of almost budget balance by 2015. The requirement of reaching a budgetary position close to balance in 2015 is actually a domestic requirement through our budgetary framework law, which requires us to have a medium term budgetary position close to balance. The law defines this as a deficit as no more than 0.5 percentage points of GDP. That entails in return quite a substantial primary surplus that is sufficient to put the general government gross debt on a downward path from 2012 onwards.

Now you can see that a substantial part of this adjustment is already well documented in the first part of my talk. The decline in the budget deficit from 2010 to 2011 is something that is already in our estimates for the budgetary outturn in 2011. That's something you can regard as quite certain so indeed the budget deficit for 2011 will be below 5 percent of GDP. What concerns 2012 is we have just approved the budget which is based on a prudent macroeconomic scenario. Realism of our examinations and our projections has been confirmed by an examination by the European Commission, the IMF and the European Central Bank. The adjustment which is required in future years – years later than 2012 – is much more gradual and we are committed to doing it. So in terms of budgetary consolidation over the course of this programme we will have eliminated the public finance imbalance that has characterised most of the period of Portuguese participation in the euro area. This is a very important point.

Another very important point is that the economy as a whole – its not just the government but also the private sector – has accumulated much indebtedness and, as I argued, the private sector started adjusting quite strongly already in 2009. The process of adjustment by the private sector and the public sector is going to continue in accordance with our forecast. The current account deficit will be eliminated by 2015 and the net foreign asset position will be consistently improving so the overall level of indebtedness will be coming down because the current account is coming down, but also because the country will be diversifying its means of financing away from debt instruments and will be relying more on foreign direct investment and investment in equity. So by taking these two charts together we have a situation where over the medium term the country has eliminated two basic macroeconomic imbalances that has characterised the economy for a relatively long period of time.

Now, this is my last slide. What it basically says is the following. We have a programme that protects us from the vagaries of the markets from now until 2014. So in 2014 we must be back in the bond market and have access to market financing at normal terms. Therefore, on the right-hand side at the bottom, we basically say that the crucial aspect of this programme is that we have to gradually build up credibility to make it possible for us to access markets from 2013 onwards.

We are very much last by a broad internal consensus on the need to adjust. Something that I want to remark before I conclude is that the Portuguese did know about this adjustment programme before the elections. The three largest parties subscribed to the adjustment programme, two smaller parties did not, and campaigned against the programme. In the end the Portuguese voters supported the three major parties that subscribed to the programme with a majority of about 80 percent which is overwhelming support and an overwhelming consensus. We benefited from the financial assistance programme because our international partners decided that we could benefit from this support for the period of the programme. So we have internal consensus and we have support from our international partners.

We are going to be able to deliver on the budgetary consolidation goals in accordance with the path that I outlined to you. We will deliver financial stability in accordance with a very detailed set of measures that we have in store but I didn't have time to go through. Budgetary consolidation and financial stability are necessary but not sufficient conditions to put the Portuguese economy back on a sustainable path. They are necessary but not sufficient to make the Portuguese economy a competitive economy in the global economy and the European economy. But for that we do have an agenda of structural transformation that aims at making Portugal a good location for foreign investment, a competitive location for physical and human capital.

We aim to deepen our integration in the single European market and, as I have indicated to you but cannot go through in detail, we have a set of quite comprehensive initiatives that include flexibility in labour and product markets, quite an ambitious privatisation programme, reforms in education, research and development and even quite an ambitious reform of the justice system. So putting together the three main elements of the programme – budgetary consolidation, financial stability and structural reforms – we are going to be successful in our adjustment process and put Portugal back on a path to sustained growth and prosperity. Thank you for your attention.