10 years of the European System of Central Banks

The Portuguese Economy in Economic and Monetary Union

Prof. António de Sousa

First of all, I would like to thank you for the invitation to speak about a subject that is very dear to me, Economic and Monetary Union, which I watched very closely when I was Governor of Banco de Portugal and therefore on the BCE Governing Council. Using this experience, I will base my speech on historical experience, from the preparation of the euro in the EU to the present day.

In Portugal, the effort to prepare to join the euro was successful, but after the introduction of the single currency (1 January 2002) some things did not go so well. We can say that we arrived at the euro at the right time but probably not in the right place. We did not make the progress that we could or should have made for the country to continue to do well in EMU.

In historical terms, from 1992/93 to 1996/97, there was general and national preparation for the euro by governments at the time. They achieved highly significant budgetary consolidation but, more than this, they managed to ensure that budgetary consolidation was considered good in itself. In other words, budgetary consolidation that had been the subject of discussion for years was considered positive and has continued to be so throughout this period. Portugal also achieved the stabilisation of the escudo and control over inflation, which remained reasonable throughout the period and compatible with so-called price stability. We then had a period of preparation for the euro (which became a national goal) in which the necessary efforts were made to meet the essential criteria for joining the single currency. And so we and our 10 partners joined the single currency 10 years ago.

In addition to this brief historical introduction, I believe that, in view of the subject under discussion, the Portuguese Economy in EMU, it is worthwhile reflecting on the impacts of our joining EMU. In fact, these impacts were not felt when we joined the single currency. They were making themselves felt a year and a half or two years before we joined, when people began to think the unthinkable, that Portugal might actually be a founding member of the single currency. In 1994/95, when I arrived at Banco de Portugal, it was considered highly unlikely that Portugal would be a founding member of the euro. This perception gradually changed in the international markets and in 1996/97 we began to enjoy the advantages and also experience the problems of joining EMU.

What was the immediate impact of this perception just before 1998 and later, after we joined the single currency?

First, certainly the most important impact was a sharp drop in interest rates. Interest rates in Portugal, which were 12%, 13% or 14% in 1995, fell to European averages and then to euro levels after we joined. In other words, they went down to around 4% and even less. We are currently at around 1%. This means that in around two years, interest rates fell by about 8% to 10%, a very sharp drop. This also triggered a substantial reduction in spreads on short-and long-term interest rates. Spreads are the indicator normally used and their minimum reference rate is based on the value of German treasury bills. They went down to minimum amounts, around 10-20 base points and were practically the same as the German securities, when before there had been a difference of several percentage points (6%-8%). Before the 1990s, there were not even long-term Portuguese public debt issues, because placing them on the market was not thought feasible. It certainly wasn't possible to place 10-15 year debt on the market in the 1980s.

In short, there was a very sharp, rapid drop in interest rates, as has happened in few economies, though I should say that something similar occurred in two other founding countries of the single currency, Spain and Italy. This had a number of effects, causing several shock waves or immediate reactions in Portugal. The most important was the explosion of consumer credit in general and mortgages in particular.

However much we want to present different perspectives of the way in which households react to interest rates, the truth is that what they really care about is how much they have to pay the bank every month when they have a mortgage. The rapid fall in interest rates and also the possibility of extending the loan repayment times, both of which occurred at the same time, meant that the monthly repayment to the bank went down considerably. This situation benefited people who already had a mortgage and increased the number of people who were able to obtain one. There was a substantial rise in consumer credit, though not as great as in home loans, given that the increase in loans for this type of product had already occurred earlier, in the 1990s even while interest rates were relatively high. Even today, loans to households in Portugal are basically related to homes, which generally represent just over 80% of total credit to families. There was an exponential increase in loans to private customers, especially mortgages. This has had a number of effects, some highly positive, others not so much.

One positive effect was the rapid expansion of the economy in that period. It was essentially associated with two factors: the importance of the construction sector in the Portuguese economy, as the demand for homes increased significantly and, in general, a monetary policy with much lower nominal interest rates, in which finance conditions for companies improved. In fact, the economy expanded rapidly until 1999/2000, followed by a very long period of stagnation, which still continues and which I will address later on.

Let's say that the first impact of joining the single currency was quite positive and was linked to the increase in the number of home loans and the possibility of household budgets bearing this expense.

However, the rapid fall in interest rates brought another, less positive aspect, which was households' indebtedness. If we analyse the different players in the Portuguese economy in the last 15 years (1), we can say that households have been the market agents that have acted with the most economic rationality. It is interesting to examine the ratio between disposable income and costs of finance actually borne by households. We find that this ratio has not changed very much over the period, which means that households have been able to maintain a situation of containment, not in borrowing but the ratio between disposable income and monthly repayments.

There are often inappropriate ratios, saying that households have debts of over 100% of their disposable income. This is of relatively little importance because no-one is thinking of paying back a mortgage in one year. It is not this ratio that we should take into account. The right ratio is the financial outlay that households have to make to meet their obligations to the banks and other credit institutions. This year, although to lesser extent than in the 1990s, the sharp fall in Euribor, the indexer used for these loans, caused the largest increase in households' disposable income of recent years, after they had made their monthly mortgage repayment. This is an original situation in the crisis that we are experiencing. This drop in Euribor brought a substantial increase in disposable income, considering that the average mortgages in Portugal are repayable over 30 years and the reductions were of around 30 percent. This represents a monthly reduction of around 350 euros, which is substantial, considering households' current average income.

While, on one hand, households' level of indebtedness maintained a certain economic logic, even though it increased, it leaves the country and households in a more vulnerable situation when interest rates go back up again, which they certainly will because, if they don't, it will mean that the depression will continue indefinitely. The rise in interest rates will therefore be perceived as a good sign for the world economy. Let's go back to the subject. While the households' indebtedness was relatively rational, as mentioned above, the indebtedness of companies and investors, especially stock exchange investors, in 2005 and 2007 was less rational and reached excessively high risk levels. This raised their level of indebtedness and substantially reduced our companies' resilience to variations in circumstances and interest rates. These investors suffered substantial losses and a number of cases are public knowledge.

On the other hand, all these factors led to a number of situations. We can consider that, in the mid-1990s, we entered a golden age for banks. Banks became a sector of excellence that could attract the best people. This happened in Portugal and in financial systems all over the world. It happened in Portugal not only in human resources; banks also became extremely efficient. For example, we have one of the most efficient payment systems in the world. An analysis by BIS in 1998 considered Portugal and Denmark the European countries with the best payment systems. It is enough to compare the operations that we can carry out on an ATM in Portugal with those available in other European countries, even the big ones like France, Germany or the UK. Our payment systems are highly sophisticated and the level of service provided by banks is much better and broader than in many other countries.

However, after this golden age banks began progressively to face other problems, due to the indebtedness factors mentioned above. The rapid expansion of the economy, a substantial increase in private spending and investment (2) resulted in serious deterioration in the balance of payments on current account. Imports rose substantially, while exports increased much less. There was even a loss of world market share.

And how did the state behave all this time, as it was also one of the main market agents? What happened to budgetary consolidation after the effort made immediately before the euro in 1997/98, when it was clear that we would be able to join the single currency?

In this period, the fall in interest rate on the product, which represented a reduction in the total budgetary deficit of 4% or 5%, was largely responsible for budgetary consolidation, i.e. the reduction in the budgetary deficit.

Around 1998 or 1999, it became clear that the model based on containment of costs without any actual reduction had run its course. As of 1999, there was an increase in spending and the model based on the benefits that came directly, almost arithmetically from the fall in the interest bill began to disappear. Banco de Portugal issued a warning at the end of 1998 drawing attention to the fact that the budgetary consolidation model used was no longer working. This caused some controversy. However, Banco de Portugal merely said that it was not possible to wait for interest rates to solve the problem and other measures would have to be taken, because the fall in interest rates would not last. What happened then was that the budgetary consolidation model that was still being used, consolidation in broad terms, took the form of a more efficient tax machine. This was remarkable because until then tax law and the taxation system were not being obeyed. After that, the tax machine began to fight tax evasion and made it possible to maintain a certain level of spending that would not have been possible otherwise. After the tax apparatus had been improved, there was a substantial reduction in tax evasion.

It's true that, when we look back at that period, we see an almost continuous increase in the weight of the state in the economy, with a few exceptions. This increase was sometimes insignificant and there was even a reduction of a few decimal points. However, if we analyse the whole period, from when we joined the euro until now, we find that there was indeed an almost continuous increase in the state's weight in the economy, or at least this was the long-term trend, with some exceptions in one or two years. Without taking the trouble to see in which year it went down 0.2% or up 0.3%, we can see clearly that the trend was growth in the state's weight in the economy.

After improving the tax machine, i.e. actually enforcing tax law to reduce tax evasion, we entered a phase of tax increases. First, the normal VAT rate went up from 17% to 21%, then down to 20%. Personal income tax also rose due to the abolition of a number of deductions. Car tax was raised for ecological reasons. Fuel tax also went up. In this period, only corporate income tax went down slightly, though the results were significant.

In short, we had budgetary consolidation sustained at first by a fall in interest rates then by an improvement in the tax machine and prevention of tax evasion. Finally, in the last four or five years it has been sustained by substantial tax increases, such as VAT, which is one of the taxes that provides the state with the most revenue.

In terms of spending, what did the state do? Let's just say that the measures taken so far have been insufficient. While it is true that there has been some restraint in a few cases, in others the measures have increased spending.

We are in a situation in which the country is coming out of a period of stagnation and attempted budgetary consolidation of four or five years ago, before the exacerbation of the crisis in the second half of 2008. We had been experiencing practical economic stagnation for several years before that crisis with a real divergence from

Europe, as pointed out here in the presentation by Professor Pitta e Cunha. At a time when we could have been entering a more consolidated situation, we were affected by a global financial crisis that rapidly hit the real economy. As we know, this crisis affected the whole world and we were no exception.

Considering the generic theme of the conference and especially this panel on the Portuguese economy in EMU, I would like to stress that, without the euro and the protection that the single currency gave us and with its imbalanced external economy and a generally very fragile economic situation, particularly due to lower productivity than our main competitors, Portugal would not have managed at least two things. The first was avoiding the collapse of its financial systems, like those in other countries, especially in Eastern Europe where some of them disintegrated completely. And it was not only in Eastern Europe. Look at Iceland or Ireland (3). Secondly, the euro afforded us real protection, as it prevented our financial systems from collapsing from one moment to the next. It is not odd to see countries that did not like the idea of the euro or sometimes even of the European Union (such as Iceland) now wanting to join the EU and the euro as fast as possible, because they see that there is a safety net to help prevent these things. However, we have to realise that, while the euro made this possible, the truth is that it probably won't allow a recovery as fast as that we could have had if we had suffered a brutal shock to our economy (in which the escudo would have been devalued considerably) or brutal increases in unemployment. Unemployment is certainly going to rise, but not so sharply and there will be no sudden impoverishment of households like there was in 1983/84, when it was necessary to significantly devalue the escudo.

But this makes things much more difficult for the country. Why? While on one hand Portugal has gone from potential growth estimated at around 3% to 4% at the time to less than 2%, this means that, if we don't make some structural changes to our economy, there will most likely be an ongoing divergence, not convergence, of our economy from the European economy, i.e. Portugal's progressive impoverishment. On the other hand, productivity has stagnated at least in relative terms and has even deteriorated somewhat if we consider a longer period of time. The need to deleverage companies and the actual Portuguese financial system is clear, because they have reached very high levels, though not as high as other European countries. This deleveraging process is still under way in the other European countries and Portugal will have to do it too. The Portuguese financial system has been financing the country's foreign deficit every year. While we have heard of the American twin deficits, i.e. budgetary deficit and current account balance, in Portugal we have a similar situation with the disadvantage that we do not issue currency, but with the advantage that we use a currency that is backed by an economy of the same size as America's. However, we clearly have a need to deleverage and must soon start a new budget balancing process. In budgetary consolidation this cannot be done during an economic recession, which would once again be a pro-cyclical policy. Unfortunately, we have almost always lived with pro-cyclical policies, though that is certainly not advisable at the moment. We will have to see when we can go back to this attempt to at least not have twin deficits and help reduce the balance on current account.

I would like to conclude by saying two things. If Portugal were not part of EMU, the Portuguese economy would be suffering much more than it is. However, the fact that we belong to EMU entails certain rules of behaviour in terms of budget and competition, which we have not been able to implement. This has resulted in a progressive divergence from our European partners.

Within EMU, there are no easy solutions in the form of devaluation and brutal increases in interest rates, nor will we have that relatively painless formula of reducing real wages, because inflation rises 20% or 30% (this happened in Portugal in the early 1980s). Without these formulas we will have to find other more transparent ones that result in a national consensus.

Portugal will have to be able to restore its competitiveness, take a new attitude and realise that we will be able to keep up with the economic recovery that will come, though we don't know when.

If there is something that economists have trouble understanding, it's economic cycles. We know they exist, but they are extremely hard to predict. The central question, but that would have be another conference, is how we are going to achieve this national awareness and consensus that will enable us, within EMU and therefore without any sudden shocks, to get out of a situation of relative impoverishment and into one of stability, keeping up with development in other countries and getting back on track of the convergence that we achieved just after the start of EMU.

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(1) From the time the euro became a national objective, then went into circulation and to the present day
(2) Private investment highly oriented towards homes and long-lasting consumer goods
(3) This shows that the euro ceased to allow any quick fixes, i.e. the impoverishment of the entire country and a reduction in the value of the currency, as has been done for hundreds of years through devaluation.