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Highlights in this issue:

- **The Portuguese economy caught up with the EU in the second half of the 1990s but has since lost those gains.**
- **The main trigger for the boom was the sharp fall in interest rates**
- **Portugal missed its opportunity mainly through policy choices based on overly optimistic expectations rather than shocks.**

Portugal's boom and bust: lessons for euro newcomers

*By Orlando Abreu**

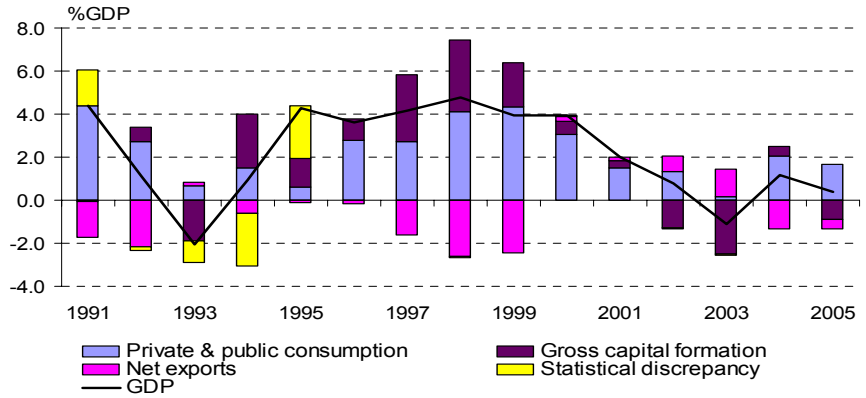
Summary

The Portuguese economy has shown a rather striking evolution in the last ten years. In the run-up to EMU in the second half of the 1990s, Portugal posted impressive results in both the real, budgetary and monetary areas. Its GDP per capita grew faster than the EU average and met the Maastricht criteria for EMU in good times. However, from 1999 the economy started to slow down and in early 2002 entered recession. Economic activity shifted from the tradable to the non-tradable sector with a corresponding loss of competitiveness, while public finances deteriorated: since 2001/2 Portugal has mostly been in excessive deficit. Inflation has remained above the EU average, unemployment was rising until recently, and households' indebtedness increased significantly in the first few years of the century. The strong demand stemming from the sharp fall in interest rates was fuelled further by budgetary policy in the nineties and early this decade. Demand was not followed by a parallel increase in potential supply, mainly due to insufficient reforms preventing productivity growth from supporting catching-up dynamics. Imports rose substantially, leading to high external deficits and debt. Over time higher external indebtedness led to lower domestically available income. The Portuguese example of demand led real convergence relative to supply side catching-up in EMU may provide important lessons for new Member States joining EMU.

Substantial fall in interest rates, the main trigger for the boom

The Portuguese economy went from a boom led by in the second half of the nineties to a marked slowdown in this decade (Chart 1). A major impulse for the

Chart 1: Contributions to GDP growth



Domestic demand generated a boom and bust cycle.

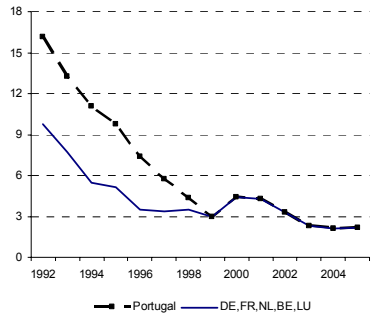
*** Directorate for the Economies of the Member States.**

expansion was the considerable fall in interest rates when the prospect of accession to EMU became increasingly self-validating. Nominal short-term interest rates fully converged to those at the common low level set by the ECB (Chart 2).

As nominal interest rates fell more rapidly than inflation, Portugal (and other peripheral EMU countries) have had lower real interest rates than the core EU countries since the late nineties (Chart 3), (Gaspar, 2006). The impact of this on the real sector of the economy was further boosted by financial liberalisation, innovation and competition in the financial sector in the same period. This easier access to credit at much lower nominal and real interest rates boosted domestic demand, especially housing demand, by households (Cardoso, 2005).

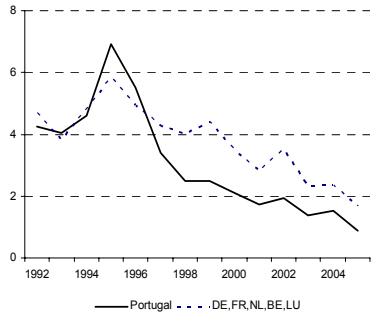
Nominal and real interest rates fell sharply in the run-up to EMU.

Chart 2: Nominal short term interest rates



Source: Ameco

Chart 3: Ex-post real long term interest rates (deflator private consumption)



Source: Ameco

There was a strong cyclical upturn in Europe and elsewhere in the second half of the nineties (EU-15 GDP growth accelerated from 1.6% in 1991-95 to 2.8% in 1996-2000). Portugal, as a small open economy, tends to have more pronounced cycles than bigger countries, and this international expansion thus also contributed to Portugal enjoying higher growth rates than the EU average, as it caught up rapidly from 68.6% of EU-15 GDP per capita in PPS terms in 1995 to 73.5% in 1999 (Chart 4). This created expectations of a steady rise in permanent income. The labour market became tighter, with the unemployment rate falling rapidly from 7% in 1995-96 to 4% in 2000-2001. The public sector led the way, with wage increases higher than those in the private sector (EC, 2004b).

Chart 4: GDP per capita (PPP's, EU15=100)

Source: Banco de Portugal, Ameco.

Shortcomings of the expansionary phase and cyclical reversal

As Chart 1 shows, the expansionary phase of the Portuguese economy in the second half of the nineties was led by internal demand. This was spurred by lower interest rates and easier access to credit as a result of financing liberalisation and competition in the financial system. A concomitant expansion of potential output would have required a prudent fiscal policy and a liberalisation of the real side of the economy, but this did not sufficiently materialise.

The Portuguese boom was driven by domestic expansionary policies and the international economic cycle.

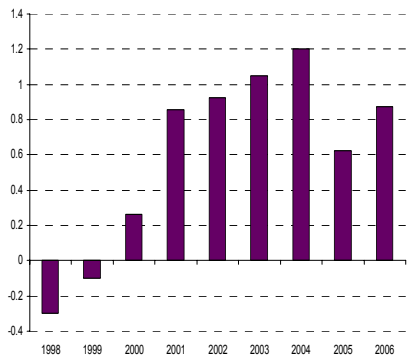
Portugal met the Maastricht criteria to qualify with the first group of EMU countries: the budget deficit fell from 7.7% of GDP in 1993 to 2.7% in 1999. However, in the second half of the nineties fiscal policy was not in fact contractionary but expansionary. The deficit reduction owed much to high economic growth and the substantial fall in interest rates and consequently in debt servicing costs. Indeed, the cyclically adjusted primary balance fell from 1.2% of GDP in 1994-96 to -0.6% of GDP in 1999-2001 (Chart 6).

Box 1: Revisions in the cyclical position and fiscal policy assessment

Reliable fiscal policy decisions depend on output-gap estimates in real time, which can be subject to ex-post substantial revisions. The issue was first put forward in Orphanides and Norden (2002) for monetary policy and in Forni and Momigliano (2005) for fiscal policy.

Contemporaneous information is not the same as that available later. For instance, the GDP forecasts available in 1998 were much more optimistic than turned out to be the case. Measured through the H-P filter with λ=100, the output gap for 1998 estimated at the time by the Commission services was -0.3% of GDP, compared to 0.9% of GDP estimated in 2006 (Chart 5). The corresponding potential output growth then estimated for 1998 was a yearly rate of 3.2%, compared with 2.8% estimated in 2006 for that same year. The estimate of the 1998 cyclically adjusted deficit was 2.2% of GDP at the time and 3.3% of GDP in 2006, and the year-on-year changes over the period are also now seen to be more negative. Thus, whereas fiscal policy in the late nineties retrospectively appears to have been clearly expansionary, it appeared less so in the light of the information available at the time (which suggested better future prospects). The conclusion is that expansionary policies were the result not only of policy makers' choices at the time but also of the more optimistic (pro-cyclical) growth and budgetary estimations then available. This represents a challenge for EU surveillance and suggests that serious caution should be exercised by new candidates for EMU. The authorities should aim for as accurate as possible an assessment of their country's cyclical position (for instance looking at a battery of relevant cyclical indicators), and a safety margin should be ensured in conducting budgetary policy in good times, as potential growth can be overestimated, the output gap underestimated and the cyclically adjusted budgetary balance

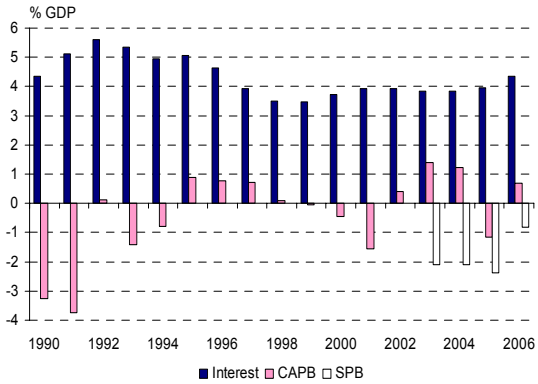
Chart 5: Successive EC estimates of the output gap for 1998 (% of GDP)



Source: Commission Services

The consolidation effort stalled since the mid nineties.

Chart 6: Cyclically adjusted primary balance, structural balance and interest payments



Source: Ameco

As regards structural reforms to increase potential output, they were insufficient. Some new infrastructure, particularly roads and motorways, were very significantly improved, largely financed by the EU structural funds. However, not enough progress was made in product and service liberalisation or in a number of other reforms (health, education, public administration, social security and the legal system for instance).[1]

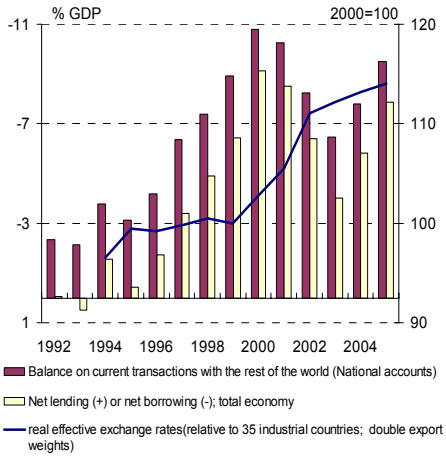
Some sectors did not prepare well enough for the long announced world trade liberalisation in sectors with a major impact in Portugal, particularly textiles and footwear. The financial system, which faced a boom in credit demand, sometimes allowed housing credit under excessively lax conditions, further fuelling the overheating.

The boom in demand was not paralleled by a corresponding rise in supply, as the economy approached full employment and economic activity shifted to non-

Demand for tradables largely leaked out through imports

tradables (construction and services accounted to 76.7% of total value added in 2002 against 75.5 % in 1995). Accordingly, the rise in demand for tradables was largely leaked to outside, through a high rise in imports leading to a high current account deficit and external indebtedness (Chart 7). The country was losing competitiveness. Wages were rising at higher rates than in the average of the EU in an environment of nearly full employment and high expectations of permanent income growth.

Chart 7: Current account, net lending and real effective exchange rate



Source: Ameco

Domestic and external shocks played a role in the boom and bust but the main responsibility lies with the management of the policy mix and insufficient economic reforms

Until 2000 their impact on competitiveness was largely lessened by the high growth of economic activity and the growth in productivity (yearly productivity growth of 2.2% in 1996-2000), partly limiting the impact of the increases in unit labour costs.

By the turn of the century the international cycle had started to reverse, particularly in Europe: EU-15 GDP growth fell from 2.8% in the second half of the nineties to 1.4% in 2001-2003. And, just as Portugal had rebounded more rapidly than its economic partners in the second half of the nineties, it decelerated faster once the international economic cycle started to turn down. Catching-up gave way to an increasing divergence in per capita income. (Chart 1).

Subdued performance since early the current decade

There are a number of elements which explain the Portuguese stagnation since the turn of the century. First of all, the appreciation of the real exchange rate which had already been under way for some years intensified as, in a context of nearly full employment and very optimistic expectations (rapid wage catching-up with the EU was widely seen as a kind of "natural right") wages did not react immediately to losses in competitiveness (Chart 7).

Loss in external competitiveness key contributor for recession

This loss of competitiveness, which is especially critical for a small open economy like Portugal's, (see EU 2006 where econometric simulations clearly confirm this), very much aggravated the impact of the slowdown in international trade. Expectations among consumers (who became overleveraged) and businesses started to deteriorate and exacerbated the downturn, as did the WTO's liberalisation of the global textile and footwear trade. In the late nineties, in the wake of the Asian crisis and the depreciation of the currencies of the countries affected, Portuguese products had already lost competitiveness. Exports of clothing and footwear fell from almost two thirds of total exports of goods in 1995-1996 to only slightly more than one third in 2004-05. And although total industrial exports account for only one fifth of Portuguese GDP, the wave of closures and firings dampened expectations as the social problems in the north of the country, where these industries are heavily concentrated, caught wide media coverage.

The expansionary fiscal policy until 2001 (Chart 5) curtailed the scope for flexibility during the subsequent downturn. In 2002 and to a lesser extent in 2003 and 2004 a number of measures were adopted which reduced the deficit, from 4.3% of GDP in 2001 to 2.9% in 2002 and 2003 (3.2% in 2004). However, the greater part of this deficit reduction was achieved by one-off measures amounting to more than 2% of GDP in each of these years (Ameco, EC 2004a, EC 2005, BP 2005, OECD 2006).

Deficit reduction in 2002-04 was chiefly achieved by one-off measures.

The credibility of fiscal policy was further undermined by both the relative political instability that prevailed in the first few years of the current decade in Portugal. Another element which seems to have contributed to the lower degree of efficiency in the conduct of fiscal policy is the finance minister's limited powers over the budget. According to research from Hallerberg et all (2004), adapted in Braga de

Macedo (2006), of all EU-15 finance ministers the Portuguese has the lowest control over the budget (formulation, approval, and implementation). This applies even when the government has an absolute majority in Parliament, as is the case currently

Some conclusions and lessons from the Portuguese experience

Portugal lost most previous gains in relative purchasing power.

In the run up to EMU and the first few years after its accession, Portugal experienced a strong expansion in domestic demand. This led to an economic boom for half a decade, with strong real catching-up with its EU partners. However fiscal policy was expansionary during the boom (admittedly partly due to an overoptimistic outlook based on the available forecasts) and the structural reforms implemented were insufficient. Easy access to cheap credit boosted demand for housing by households and a shift in resource allocation from tradables to non-tradables. Moreover, high wage increases (not least in the public sector) fuelled by a tight labour market and overoptimistic expectations caused large losses in external competitiveness and shifted economic activity further into non-tradables (services) with an additional negative impact on overall productivity. The result was unbalanced economic growth with strong internal demand significantly leaking to the outside through imports. Portugal's evolution in the current decade has thus been somewhat symmetrical to that in the second half of the nineties, as it has lost most of the relative income gains from that period.

The differential in interest rates between EMU candidates and members is now lower, but there is still a risk of credit-led unbalanced growth.

To what extent should Portugal's missed opportunity act as a warning to euro area acceding countries? Like Portugal, these countries (mostly also small open economies) will face lower interest rates and the loosening of credit constraints associated with EMU membership. This may potentially lead to a boom in credit lending, in housing demand and in over-indebtedness of households (possibly followed by a rise in their savings rates). As a result of high wage increases and inflation, losses in external competitiveness could occur in parallel with a shift in production from the tradable sector to services and construction (also impacting productivity).

Another similarity between the Portuguese case and that of the new EU members is the cyclical economic expansion: of Portugal in the late nineties, of new members at present. The main risk of a boom and a bust cycle in the new EMU countries, as was the case in Portugal, comes from potentially over-optimistic expectations of future permanent income. This could feed too-high wage increases and lead to overestimations of potential output and to expansionary fiscal policies.

That said, the differential in interest rates between the current euro candidates and the euro members is nowadays typically smaller (although with differences among countries) than it was between the peripheral and core countries in the nineties. Nonetheless, credit constraints may still abate considerably, so that the shock for these countries will be lower but not negligible.

The potential dangers very much depend on the specific situation, particularly the state of the labour market, in each country. The Portuguese labour market presented moderate slack in the mid-nineties, but this also diminished rapidly.

All these provisos notwithstanding, in line with the findings of EC (2006) some lessons can be drawn from the Portuguese experience):

Lessons for euro newcomers: good times do not last forever.

First, if a boom in demand arises, possibly linked to a strong credit expansion, budgetary policy should tighten, as prescribed by the Stability and Growth Pact for good times.

Second, potential GDP may be overestimated in a boom, which has an impact on the cyclical perception of the budget accounts. The budget may also benefit from the high weight of consumption in GDP and, in some cases, revenues stemming from asset market gains. These elements call for further caution in the conduct of fiscal policy in good times.

Third, structural reforms should not be delayed but rather speeded up in order to increase the private sector response to the demand increase, in both the short and the longer run. Otherwise the demand boom can simply leak out of the country through imports and aggravate the external imbalances.

Fourth, wage settings should not be based on naïvely optimistic expectations of higher permanent income, in order to ensure continued wage moderation (not least in the public sector), especially if the labour market is or becomes tight.

Fifth, action should be taken to avoid excessive exuberance and misallocation in financial markets: this can be difficult with open financial systems, but tight prudential supervision (including prudent provisioning policies and well-designed stress-tests) can clearly help – and so can the elimination or capping of interest rate subsidies on real estate credit.

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[1] This has been extensively reported in various publications, from the EC and OECD for instance (see European Commission, 2004b, and OECD, 2004 and 2006). See also Kröger and Redonnet (1994) on the required action for real catching-up.

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