Portugal's assisted adjustment: death on the beach?

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Outline: death on the beach?

- This presentation summarizes Portugal’s assisted adjustment since June 2011 with a question drawn from the popular expression “*morrer na praia*”, which refers to a swimmer dying from exhaustion upon reaching the shore.
- The answer to the question is organized in three parts, ocean, swimmer, beach with the understanding – familiar from ocean culture – that the swimmer connects the beach to the ocean:
  - the global economy includes the Euro Zone (EZ) and
  - the adjusting country includes its government, courts and people.
- Portugal’s adjustment should be completed in June 2014 with the return of the state to market financing and eligibility for the program of Outright Monetary Transactions of the ECB.
- If the government budget does not survive the scrutiny of the Constitutional Court (CC), however, it might is not enter into force in the new year and early elections might be called before the end of the adjustment period, say together with European elections in May.
- In sum, investors, voters and judges might not save Portugal from additional assistance even if the EZ is saved.

Part I the ocean
Exchange rate volatility and current account imbalances

Financial Stability

- The rolling 3 month volatilities (one of the most used measures of risk in e.g. currency option markets) estimated from daily market data through the Euro period and the pre-Euro floating rates period average about 10 percent in annual terms.
- These are lower than most assets volatilities. Only money market and short-to-medium term fixed income markets and other comparable assets are significantly less risky than currencies.
- Real estate markets, stock markets and commodities markets are typically much more risky than currency markets.
- Relatively short financial crisis periods generated higher volatilities, but these were smoothed out quite rapidly within the two estimation periods (pre-euro 9/1992-12/1998, euro 1/1999-9/2013), summarized in Figures 1, 2, 5 (rolling daily estimates of standard deviations in the two periods) and 3, 4, 6 (sample averages of standard deviations in the two periods).

Figure 1 3 Month Rolling Volatilities for 1992-09-08 – 1998-12-31

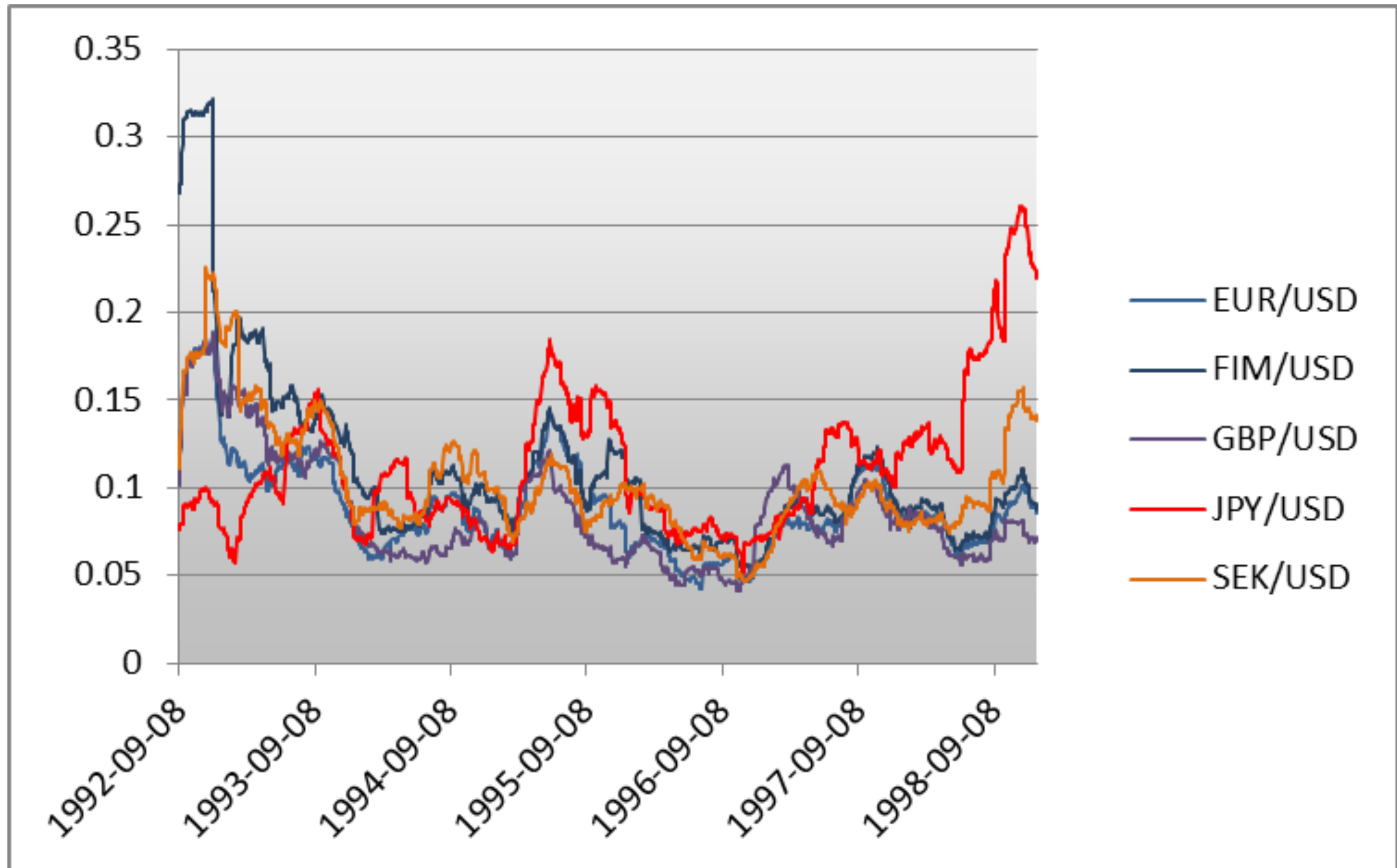


Figure 2 3 Month Rolling Volatilities for 1999-01-04 – 2013-09-30

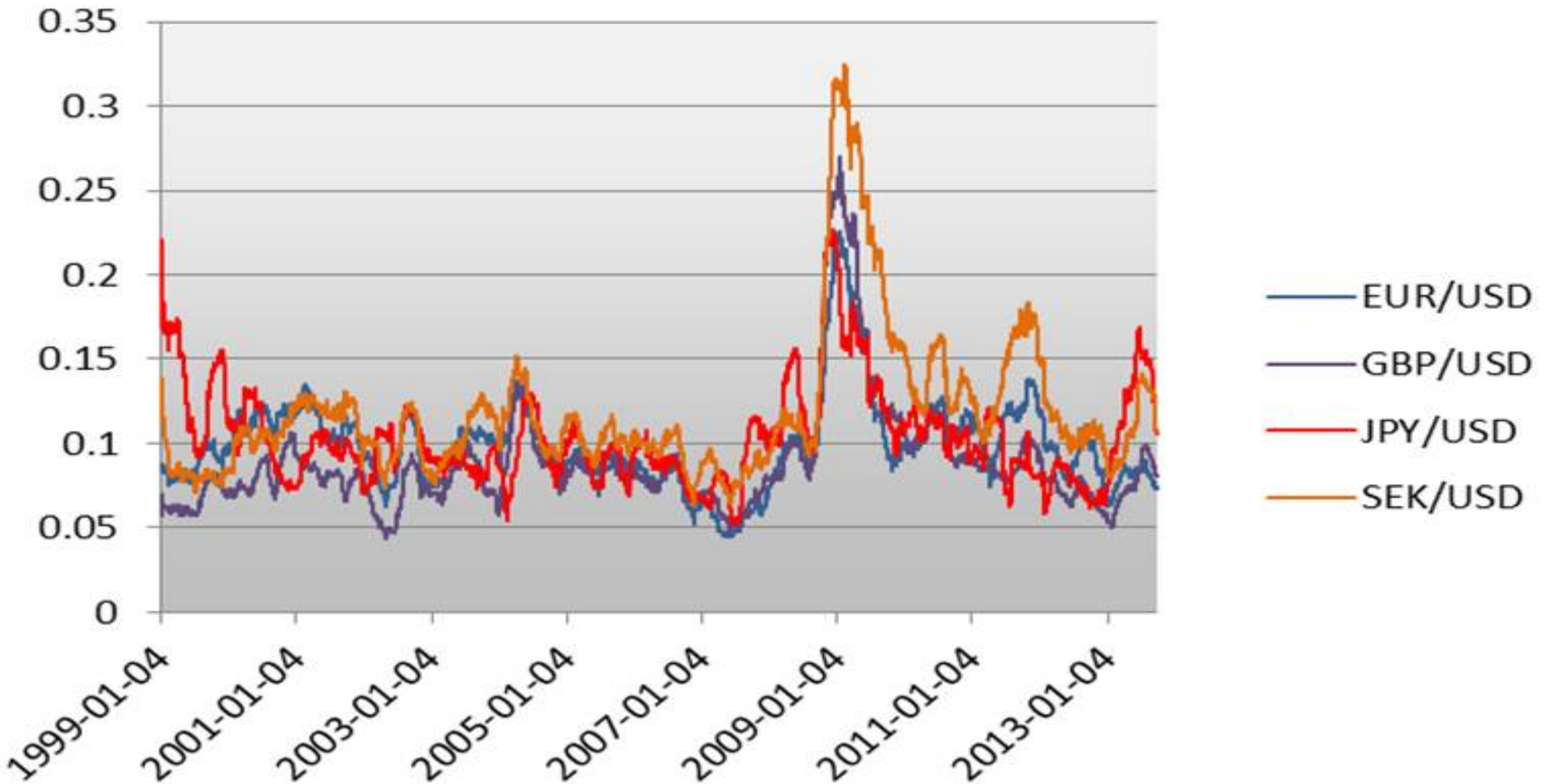


Figure 3 Averages of 3 Month Rolling Volatilities for 1992-09-08 – 1998-12-31

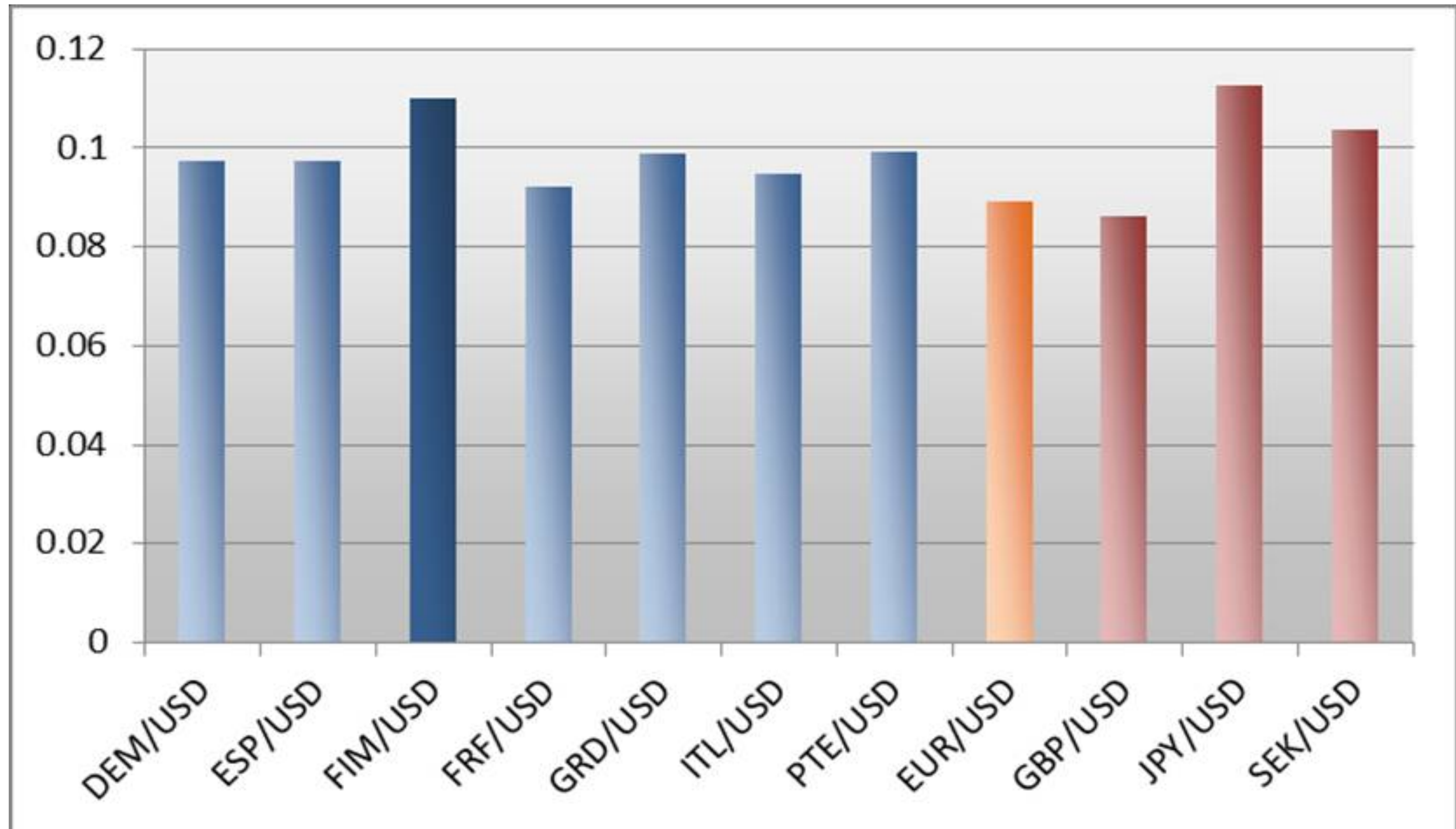


Figure 4 Averages of 3 Month Rolling Volatilities for 1999-01-04 – 2013-09-30

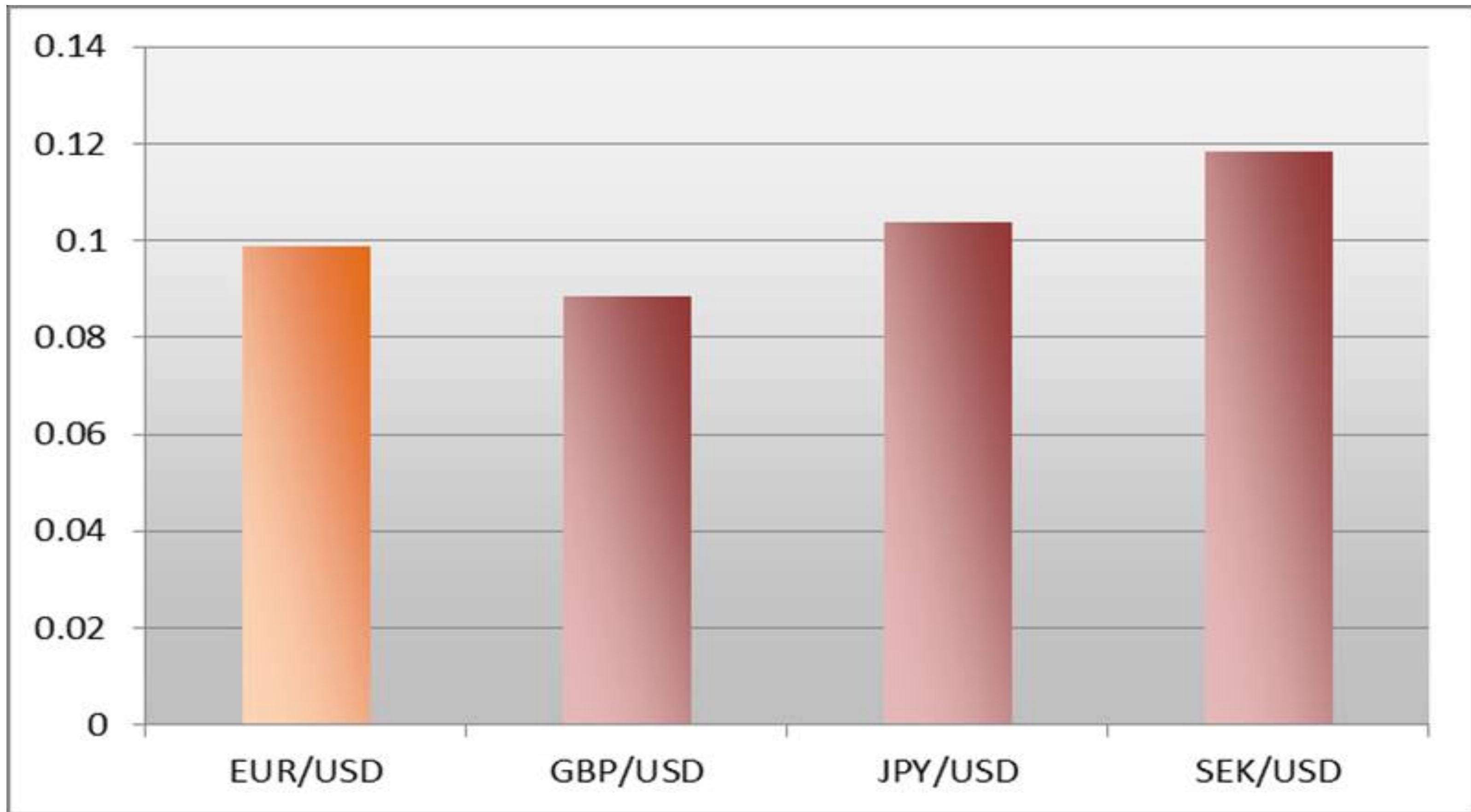


Figure 5 3 Month Rolling Volatilities for 1999-01-04 – 2013-09-30

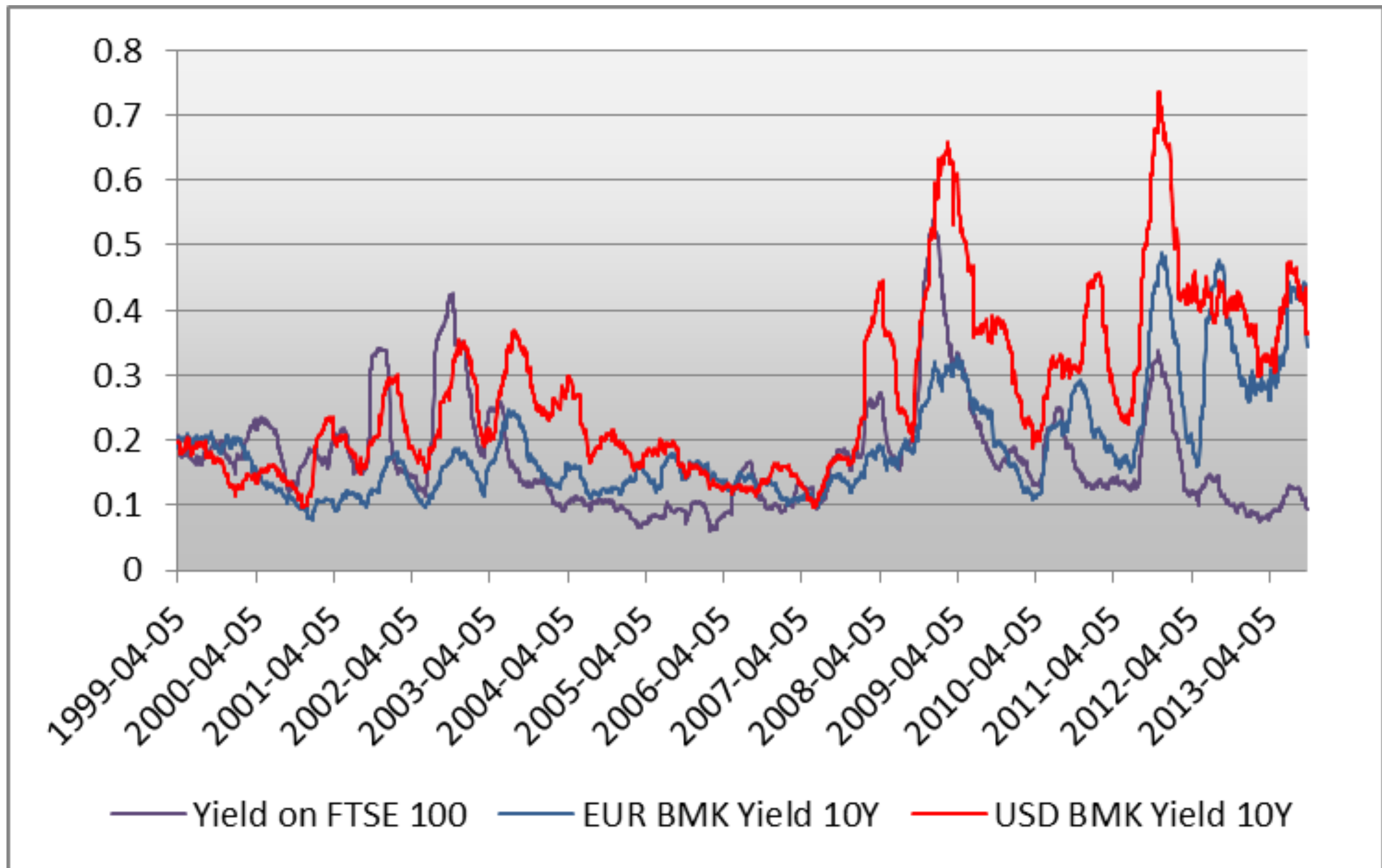
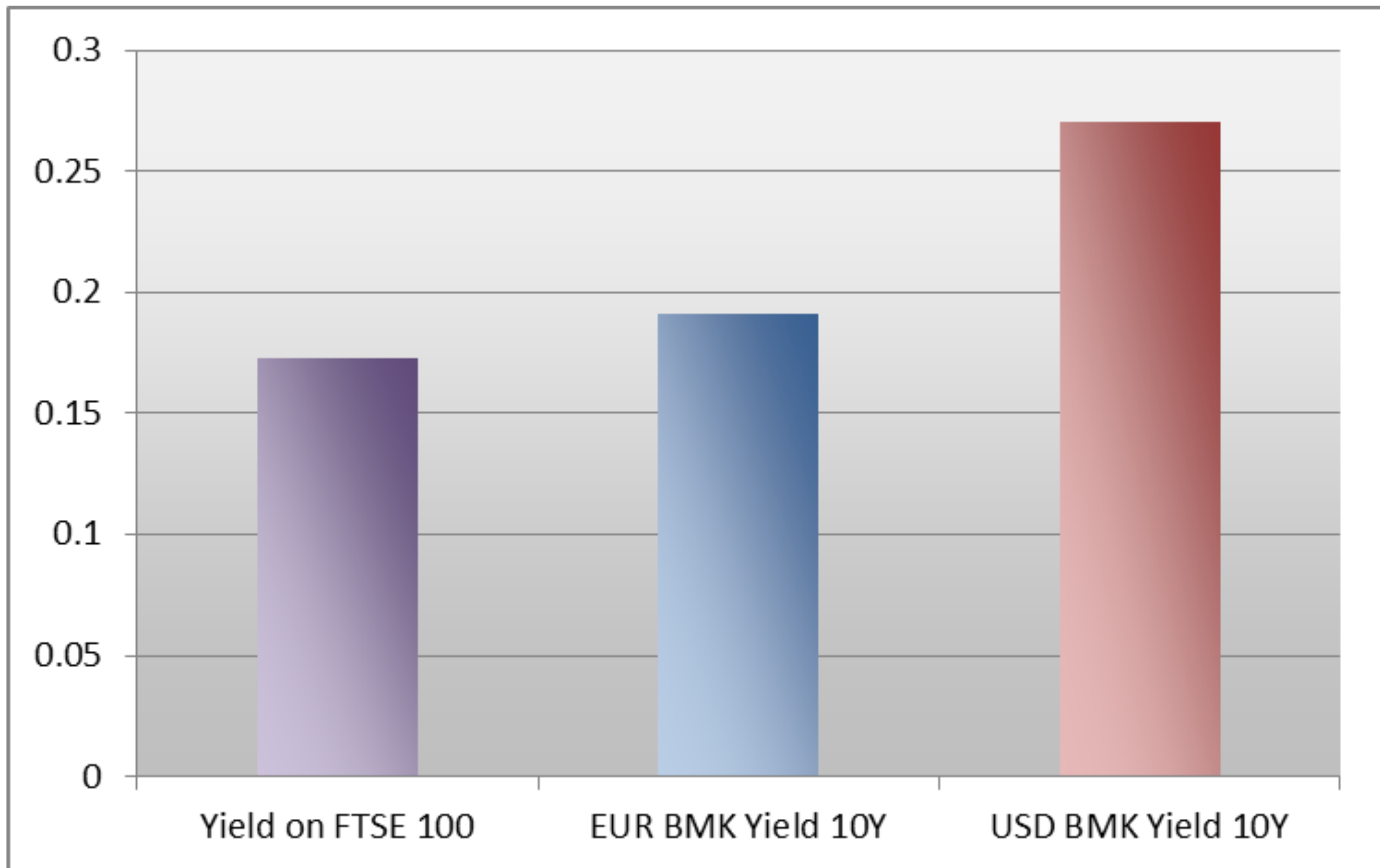


Figure 6 Averages of 3 Month Rolling Volatilities for 1999-01-04 – 2013-09-30



Shifting of global wealth

- Before the world financial crisis, three regions accounted each for one quarter of world GDP, US, EU and East Asia (EA = ASEAN + China, Korea and Japan), where trade openness excluding intra-regional was over 30% of GDP.
- The stock of foreign assets and liabilities was 100% of GDP, compared to 150% for US. EU was in the middle on both counts (annex table).
- Financial globalization erodes capital controls but imperfect substitutability between assets remains the rule between the US and China, on both sides of the North Atlantic, and even within the EZ (annex).

Fault lines in regional supervision

- Once the financial crisis originated in the US in 2007, the severity of the recession was not immediately recognized and, in the face of financial panic, successive bailout programs on both sides of the Atlantic were accompanied or followed by stimulus packages.
- The strong financial links across the North Atlantic magnified fault lines in financial supervision.
- The recapitalization of banks using taxpayer's money was finally agreed by the UK and adapted to the EZ.
- In 2012 the single market was finally complemented by a banking union but implementation had been hesitant, partly because of tensions within EU and EZ.

Fault lines in national supervision

- The different systems of financial supervision continue to prevent a common position in the EU.
- The issue of information sharing about systemically important financial institutions (sifis) is part of the macroprudential framework called for since 2000 by the Bank of International Settlements and the International Monetary Fund.
- The German model prevents central banks from acting as lenders of last resort because using taxpayer’s money might compromise their independence.
- Central banks are closest to commercial banks and other financial intermediaries, yet information on EZ sifis has been exacerbating the cost of delaying the banking union.

Germany as the perfect scapegoat

- German companies know that they will remain competitive as long as trade takes place under fixed exchange rates: over 1999-2010, the German economy has accumulated well over €1tril from the EU-27 countries and about €760 bil from the rest of the world (Macedo and Lempinen, 2012).
- This indicates that German companies have been much more competitive in intra-EU trade. Consequently the highest profit margins are also likely to come from intra-EU business. On these grounds German industries must be very much in support of the trade opportunities allowed by the fixed exchange rate within the EZ. This may require potential bail out and support expenses to maintain the structure stable.
- For Fratzscher, Germany is the perfect scapegoat because adjustment countries look for external culprit, Germany is large, doing relatively well, clumsy during crisis (history matters).

Inflation, Debt and Interest Rates

- Growth and inflation performance and the level of interest rates have mainly reflected the (weak) state of the global economy since the dotcom crisis
- The overall macroeconomic policy stance has been very expansionary with the result that by following this policy the global economy has so far been able to avoid the Great Depression on a global scale.
- Is it possible that the EZ (and the global economy) have avoided Keynesian Liquidity Trap but ended up in Japanese Debt Trap?

Table 1 Equity, Efficiency and Sustainability of four European social models

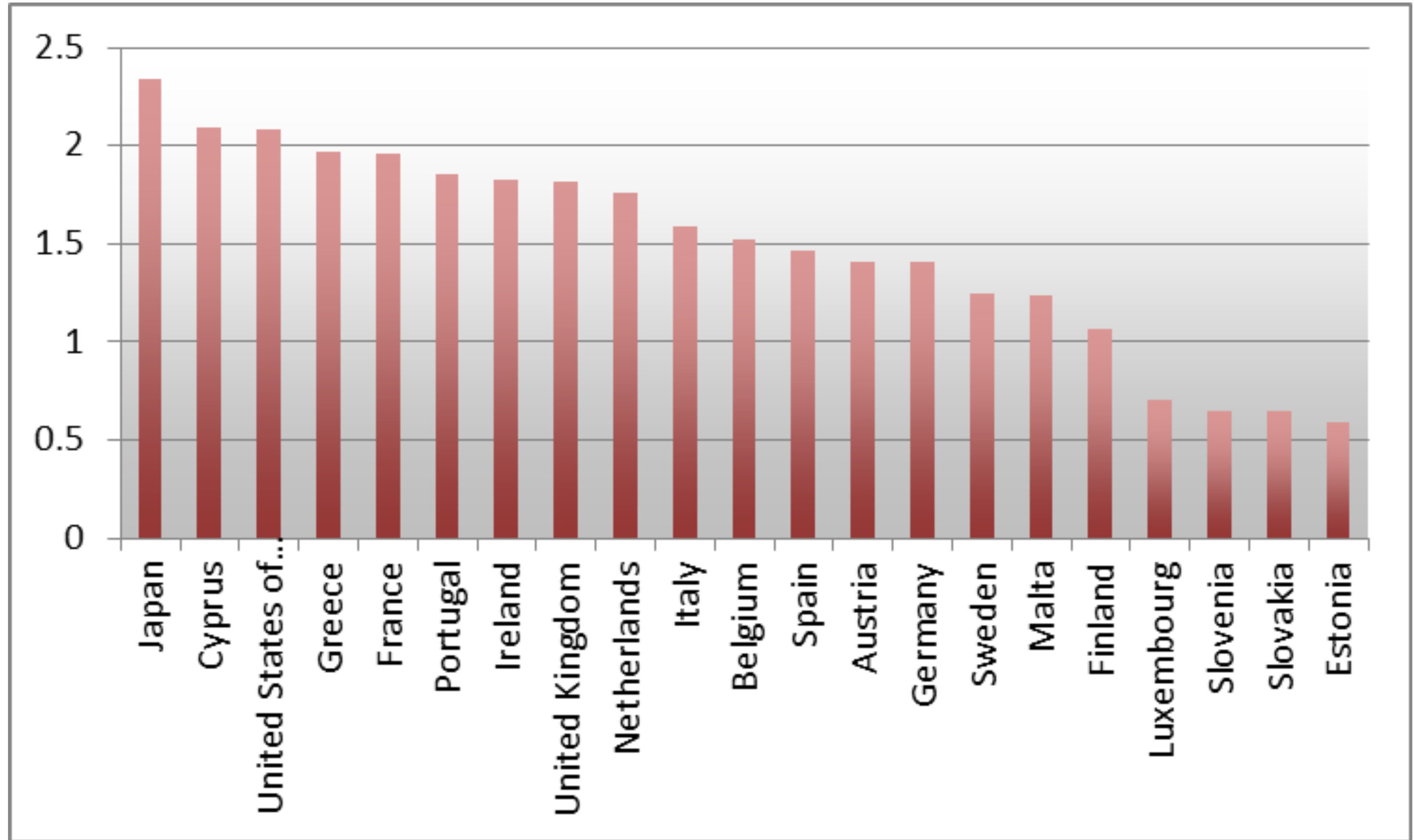
		Efficiency	
		Low	High
Equity	High	Continentals 75 to 90	Nordics 52 to 53
	Low	Mediterraneans 83 to 95	Anglo-saxon 42 to 81

Sustainability proxied by Public debt/GDP 2004 to 2010

Serious Debt Problems

- André Sapir warns that the crisis made the Anglo saxon social model as unsustainable as the Continental and Mediterranean (table 1) others make *ni austérité ni croissance* a rallying cry across the Atlantic.
- Figure 7 shows total debts of different economies as at the end of 2010, scaled by GDP: this includes public debt, housing loans and consumer loans, for which households eventually are responsible in any country
- It can be observed that e.g. Greece in fact is not in as bad a situation as e.g. Japan or US – and not very far from France, United Kingdom, The Netherlands or even Germany

Figure 7 Debt/GDP



Asymmetric effects of payments imbalances

- The environment of price stability (i.e. inflation around 2% p.a.) which has prevailed this century results from free trade as much as from the policy of major central banks policy. On the other side, current account imbalances have prevailed outside and inside the EZ.
- A country establishes its financial reputation when global investors judge the interaction between its economic and political governance to be credible.
- This implies that both aspects of governance are subject to the scrutiny of capital markets and credit ratings agencies but the traditional asymmetry between deficit and surplus countries remains acute outside and inside the EZ.
- The implications for policy design and implementation are known as *Juncker's curse*.

Shifting world wealth & financial freedom

- Aside from shifting world wealth from West to East, there is Juncker’s curse on EZ governments: "We all know what to do, but we don’t know how to get re-elected once we have done it.“
- Back in 2007, EZ policy makers were taking for granted that the electorate would punish them for bold reform in product and labor markets but, using data for 21 OECD countries, Marco Buti and others showed that their fear was unfounded provided “financial markets work well”.
- The degree of anti-competitive regulations in bank ownership, foreign bank competition, private sector credit and interest rate controls are the areas included in the Fraser Institute indicator of financial freedom.
- While such indexes are used below nobody in the EZ thinks financial markets work well in 2013…

The case for complementary reforms

- Buti's attempt at defying Juncker's curse established three additional results:
  - reforms appear to be more likely to receive a positive reception by the electorate if the economy is in a cyclical upturn, confirming the call to exploit 'good times' to accelerate the pace of reforms.
  - structural reform will positively affect the re-election probability of incumbent governments if the reform need is high, i.e. when the initial structural conditions are poor – and conversely when a lot of reform has already been implemented.
  - large government size and the associated presence of strong automatic stabilisers may also raise the election probabilities of reformist governments.
- Consequently, governments who design complementary reforms of product, labour and capital markets should be rewarded by the electorate.

Part II the swimmer

Portugal's achievements came in spite of a design flaw in the initial program, stronger than expected economic contraction and management issues decreasing the social acceptance of the program

Tradition of ambiguity

- The ambiguous response to globalization has been a distinguishing feature of Portugal in comparison to Greece or Spain (Bliss-Macedo, 1990).
- Until the Napoleonic invasions, complementary European and Atlantic allegiances preserved financial reputation (table 2).
- Then the clash between political and financial freedom generated an opaque fiscal constitution which has survived several redistributive revolutions.
- A gradual regime change towards currency convertibility began with the 1989 amendment to the 1976 Constitution allowing a reversal of the nationalizations without due compensation which followed the 1974 revolution.

Table 2 Bankrupcies since independence

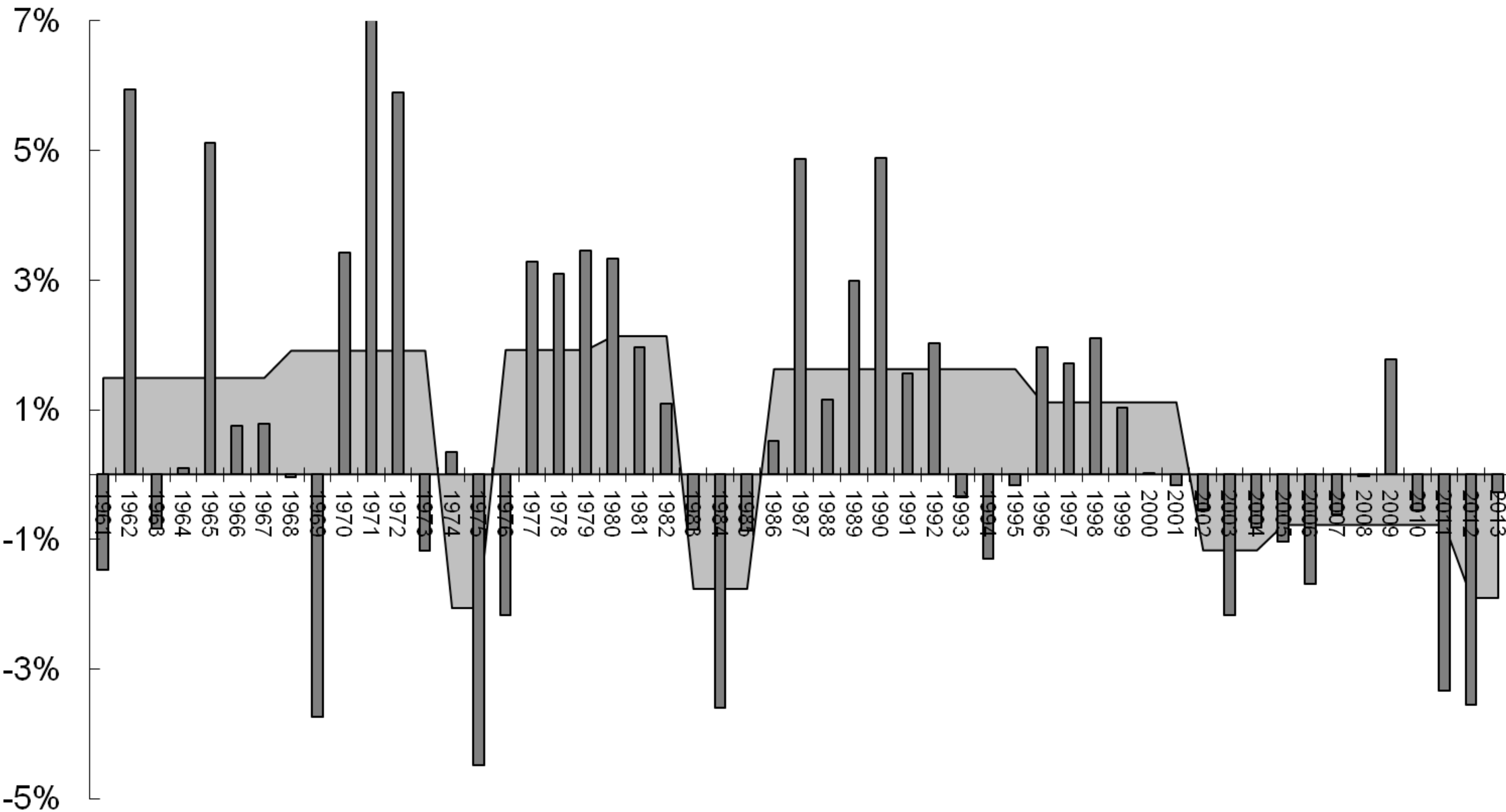
	1300-812	1813-90	1891-008	Total
Spain	7	7	0	14
France	9	0	0	9
Brazil	-	0	8	8
Germany	3	3	2	8
Austria	4	1	2	7
Portugal	1	6	0	7
Greece	-	3	2	5
UK	2	0	0	2
Netherl	0	1	0	1

Source: data from Reinhart and Rogoff (2009)

Convergence and divergence pattern

- The criterion for a government average in Figure 6 is the same Prime Minister except when tenure < one year (1974-75, 2004-05).
- Convergence was driven by EFTA membership and migrants' remittances in the 1960s. Then international recessions brought a pattern of delayed recovery observed in 1974-75, 1983-84,1993-94 and in divergence since 2001.
- Parliament was dissolved in April 2011 and a "broad coalition for change" was elected whereby almost 90% of MPs belong to parties committed to the Memorandum of Understanding (MoU) with the EC, ECB and IMF troika signed before general elections.
- As the recession was much worse than anticipated, the government narrowly avoided crisis in July and the opposition Socialist Party won September municipal elections.

Figure 8 CONVERGENCE AND DIVERGENCE WITH EUROPEAN UNION (rate of growth and government average since 1961)



Source: Data from AMECO Nov 2011 (GDP at 2005 prices in Portugal vs UE)

Time - & issue- interdependence of reforms

- Reforms have different time frames depending on the institutions which need to be changed. In addition, fiscal and monetary policies, macroeconomic and structural policies are closely interrelated (Macedo et al. 2013).
- Excessive primary government expenditure and state-led wage inflation led to reform procrastination and the reversion of a purely demand-led boom: the initial "€ hold up" interrupted convergence of incomes towards the European average.
- During the "lost decade", the current account deficit hovered around 10% of GDP - and nobody cared.

From Blanchard to Rodrik

- A taboo lasting since the 1983-84 IMF program was broken by Olivier Blanchard in February 2006 (before IMF) where he suggested a cut in nominal wages because of:
  - *Anemic productivity growth.*
  - *Very low growth.*
  - *Large budget deficit.*
  - *Very large current account.*
- During the adjustment program exports report strong growth, external deficit disappeared, wages fell across the board but unemployment became very large. The issue is consolidating return to market at the end of the program.
- Structural reforms are opening the economy: *Banco de Portugal* claims that decline in private sector wages during adjustment period was over 11%.
- South EZ countries had a bad productivity performance (table 4) but according to IMF (Rodrik 2013) they have made up only about ¼ of the loss in competitiveness since 2000.

Table 3 Labour Productivity level and actual rate of growth in South EZ (4% expected by reference to North EZ and East EU)

	level 2002	% 02-08
Italy	**49**	**-0,6**
Spain	**45**	**-0,5**
Greece	**35**	**-2,0**
Port	**26**	**-0,1**

Source: **Golden Growth: Restoring the Lustre of the European Economic Model**, World Bank report presented 08/12@CEIE.

Power over the government budget

- The government has been unable to reign in public expenditure: around 2000 a survey was carried out in the EU, according to which the Minister of Finance's power over the budget has the lowest score in Portugal.
- This budgetary "fragmentation" is certainly a factor in the pattern observed in Figure 8 after 1974: stop and go followed by divergence with the EU average.
- From the absence of a numerical rule, the score improves marginally in 2002 but remains well below the EU 27 average, constructed to be zero (Figure 7, from Debrun et al. 2008).

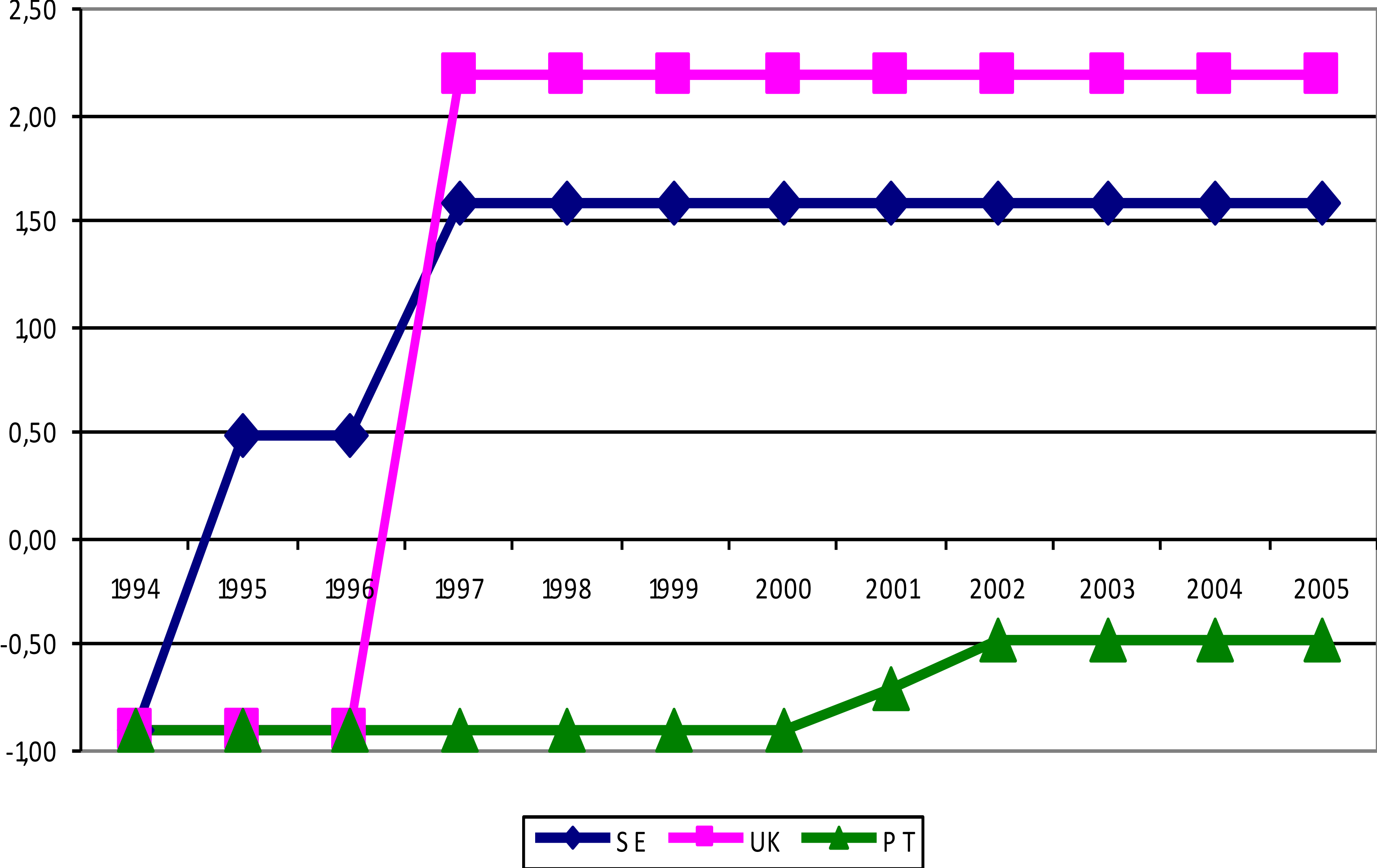


Figure 9 Fiscal rules in Portugal, Sweden and UK 1994-2005
2,50
2,00
1,50
1,00
0,50
0,00
-0,50
-1,00
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
SE
UK
PT

Export potential in manufacturing

- On top of a low aggregate output per hour worked, industrial productivity 1/3 of rich countries (=1).
- Other estimates in Causa and Cohen (2006) are Spain = .7; Greece = .5; Turkey = .4. Internationally traded investment goods are most relevant to aggregate productivity in the future.
- Total factor productivity in manufacturing during the 1990s is estimated as the product of physical capital per worker, human capital per worker, infrastructure (Z, measured by electricity generating capacity per worker), integration with the international trading system (T) and residual (Table 4).
- The attractiveness of Portugal as a platform for industrial production measured by ZT is then 9/10 of rich countries< Spain=1 but> Greece= .8; Turkey=.5.

Table 4 Industrial Productivity 1990-99 (Rich =1)

	Y	H	K	Z
Spain	0,70	0,78	0,91	0,97
Greece	0,50	0,81	0,97	0,94
Turkey	0,42	0,56	0,94	0,56
Portugal	0,26	0,61	0,85	0,94

	T	A	Z*T	H*A
Spain	1,05	0,98	1,02	0,76
Greece	0,87	0,78	0,82	0,63
Turkey	0,88	0,72	0,49	0,40
Portugal	0,94	0,56	0,88	0,34

Fonte: Causa and Cohen (2006) estimates for 51 countries on which rankings are based (Portugal) Prod=Y (30) ; Invest=H*Z*T*A (30) ; Export=Z*T (15)

€ did not change fiscal constitution

- Broad-based and sustained reforms did not begin until well after the world financial crisis and the request for external assistance: as reforms stalled or went into reverse, Portugal became a victim of the "€ hold up" and breached the Stability Pact.
- This was accompanied by a decline in aggregate savings and a shift in the composition of expenditure towards tradables, hurting export competitiveness in manufactures and services and discouraging **outward and inward** foreign investment.
- **The economy remains closed for its size**.

Check list of structural reforms

- Labor market and Housing rentals package
- Corporate bankruptcy
- Competition law
- Reinforcement of supervisory powers of *Banco de Portugal*
- Creation of Fiscal Council
- Transparent and Profitable Privatization: EDP, REN, ANA, CTT
- Evaluation of Public-Private Partnerships
- Judicial map
- Restructuring of state owned enterprises
- Recruitment and selection in public administration
- Framework for public institutes
- Creation of Strategic Council for Open Economy

Strategic Council for Open Economy (CEIE)

- Established in 2011, CEIE is chaired by the Prime Minister and includes six Ministers and six business organizations. The Agency for Foreign Trade and Investment (AICEP) serves as secretariat.
- CEIE approved four reports according to the *Doing Business* (DB) indicators of the World Bank:
  - (i) improve financing of the economy (DB get credit),
  - (ii) simplify administrative procedures (DB obtain licence)
  - (iii) simplify tax administration (DB pay taxes)
  - (iv) develop a coordinated and effective external economic policy (DB trade across borders).
- The reports with their 55 recommendations are available on the Prime Minister's web site and their implementation is monitored by the CEIE alternates.

CC threat to recovery

- Adjustment achieved strong structural consolidation, rapidly reducing public expenditure in what was a highly demanded and frontloaded program entailing complex reforms.
- On October 15, 2013 when the 2014 budget was presented to parliament several observers feared a repeat of the July political crisis which almost led to new elections.
- The main reason was the threat of the Constitutional Court (CC) to veto several expenditure reducing measures contained in the budget and required by the troika in its 7th and 8th review ending September 2013.
- In an internal memorandum from the EC representative in Lisbon dated 15 October which caused a furore in the media K. Gönczy claims the CC may put at risk the MoU implementation because, though peer pressure is very relevant, constitutional judges are quite sensitive to their political affiliations and their political party's presence in government when voting (Garoupa et al., 2009 drawing on US experience as per Stone-Sweet, 2000 and Sunstein, 2009).

Part III: the beach
The EZ and the future of Europe

Crisis and € standard after 40 years of float

- The future of EZ is embedded in that of the international monetary system of flexible exchange rates which has prevailed over more than 40 years.
- To most Americans the presumption that the future of their currency is not in the hands of the US government would come as a shock: as John Connolly – ever the Texan – said at the IMF meetings in 1971: "the dollar is our currency but your problem".
- When the European Monetary System, devised as a facilitator of the single market and as a convergence instrument, was replaced by a single currency at the turn of the century, some European Commission officials may have seen the dawn of a "euro standard".
- Ten years after, the alleged irrelevance of the "blue-eyed crisis" to the emerging world could be gathered from an exchange in 2009 between the leaders of Brazil and the UK.

Maastricht after 20 years

- After decades of deepening and widening interdependence among the members of the OECD, the transatlantic partnership on trade and investment was impacted by the gradual rise of China and the almost simultaneous announcements of EU birth in Maastricht and USSR death in Minsk.
- On the 20th anniversary of the entry into force of the EU Treaty, it is fair to say that the union is deeper and wider than expected in late 1991, but certainly not as strong and close.
- The financial crisis caught the EU at the end of a decade of institutional soul searching, with the Lisbon treaty agreed in Lisbon in 2007 more than one year before ratification.
- Twenty years changed the link between the EU and the global economy through 3 main features of the EU treaty:
  - the three phases of monetary union, which were completed at the turn of the century
  - the cohesion fund, with conditionality and a national rather than regional scope
  - Intergovernmental mechanisms for external and home affairs.

The short- and long-run of the EU

- In a September visit to Lisbon Rodrik (2013) warned that a workable economic union requires
  - reduction in structural heterogeneity (in institutional arrangements, e.g. labor markets)
  - restrictions on national sovereignty
  - diversity
- He says countries need to look more like each other if they want to inhabit the same house (the "German argument") but what that house ought to look like is a political decision, which should be made by voters.
- But EZ faces a short-term problem of insufficient demand and too much focus on the structural problems will make the long-run German argument unachievable and hence irrelevant.

The short- and long-run of the EZ

- History and geography prevent us from blaming democracy for the rise of populism (Philip Stephens, **Financial Times**, May 10): not many Europeans would exchange the right to vote for a quick fix in the EZ even though “a benign autocrat might have done a better job than 27 elected governments” and “economic interdependence and borderless communications leave governments to compete with multinational organizations.
- Nevertheless, the quick fix happened because (id. ibid. Nov 1) “the hedged funds missed the sheer force of political will behind the project” but “it would be a mistake to say the game is over”.
- There is a Wicksellian flavor behind this diagnostic: whereas the technological forces underlying the global reach of the market make protection inefficient and inequitable, preferences between private and public goods are national (Cooper, 1974).
- The single market needs a single currency and banking union before it needs a budget union as long as national preferences about taxation are consistent with sustainable external imbalances: *the EZ crisis is a balance of payments rather than a sovereign debt crisis* (Krugman, 2013).
- If EZ is saved, what about non-EZ EU, especially UK?

Annex to Part I
Exchange rate dynamics

Table Trade to Finance ratio, 3 equal regions = ¾ world GDP

2006	EA	EU	US
TRADE (X+M % GDP) *	32	20	16
FINANCE (Fgn assets + liab % GDP)**	104	136	147
TRADE/2 FINANCE	15	7	5

[*] Intra-regional trade excluded
[**] Intra-regional holdings of foreign asset and liabilities excluded; data available only until 2004;

Exchange rate dynamics

- The dominating model presented by Dornbusch (1976) assumes flexible prices and perfect substitutability of domestic and foreign assets, so that only capital account shocks matter in exchange rate adjustments.
- With no correcting current account adjustments, high volatilities of exchange rates are expected.
- The ”acceleration hypothesis”, introduced by Kouri (1978), states that international capital flows must be financed by appropriate current account flows: when the trade to finance ratio is low, exchange rate adjustment may well take 30 years (Macedo & Lempinen, 2013).

Faster adjustment in general equilibrium

- In partial equilibrium, the acceleration hypothesis states that the rate of change of the exchange rate is proportional to the ratio of the current account deficit to the sum of holdings of foreign assets by domestic residents and holdings of domestic assets by foreign residents.
- In general equilibrium, the adjustment speed is higher: it is defined by the stock of domestic assets not held by domestic residents, adjusted for speculative (expectations sensitive) portfolio allocation terms.
- In the mainstream literature the volatility of real exchange rates is often benchmarked against the volatility of inflation indices and found to be very high.

Stylized facts of foreign exchange markets

- As it turns out, general equilibrium constraints on wealth and investment behavior reflect to a substantial degree the stylized facts of liquid foreign exchange markets.
- These are demonstrated by Monte Carlo simulations reported in Macedo & Lempinen (2013).
- A strong correction mechanism of the exchange rates through the current account implies that market disturbances originating in underlying shocks or in capital flows are quickly smoothed out.
- This is contrary to the made up image of foreign exchange market volatility among practitioners.

Testing environment for simulation experiments

- Autonomous factors are assumed to net each other so that only current account adjustments translate changes in fixed parameters and random shocks into the exchange rate.
- The testing platform includes two similar large, relatively open economies, mimicking the €/$ rate.
- In the Dornbusch formulation, the non-stationary nature of exchange rate behavior is seen in the pattern where the 90% variation range is approximately 200% of the median level at 30 years, whereas in the Kouri case it is about one half.
- Simulations of the general equilibrium case presented in Macedo & Lempinen (2013) show a faster adjustment process: already 2 years after the start of simulations the actual exchange rate is very close to the new steady state value. At the 30 years time point, it is about 20% of the initial steady state value.

International financial intermediation

- Even when assets are perfect substitutes, monetary policy-makers can strengthen the international financial intermediation required for an intertemporal view of current account adjustment.
- Instead, when shifts in asset demands are a source of exchange rate instability, costless changes in the mixture of asset supplies may forestall costly macroeconomic adjustments in output and employment.
- The case for intervention by central banks to facilitate the current account process is stronger the more significant are differences in asset preferences.

Current account imbalances

- Obstfeld (2012) warns that current account imbalances, while very possibly warranted by fundamentals and welcome, can also signal elevated macroeconomic and financial stresses, as was arguably the case in the mid-2000s.
- He adds that valuation changes in net international investment positions, ”while possibly important in risk allocation, cannot be relied upon systematically to offset the changes in national wealth implied by the current account”.

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