Fiscal Issues in Portugal’s EU-IMF Program

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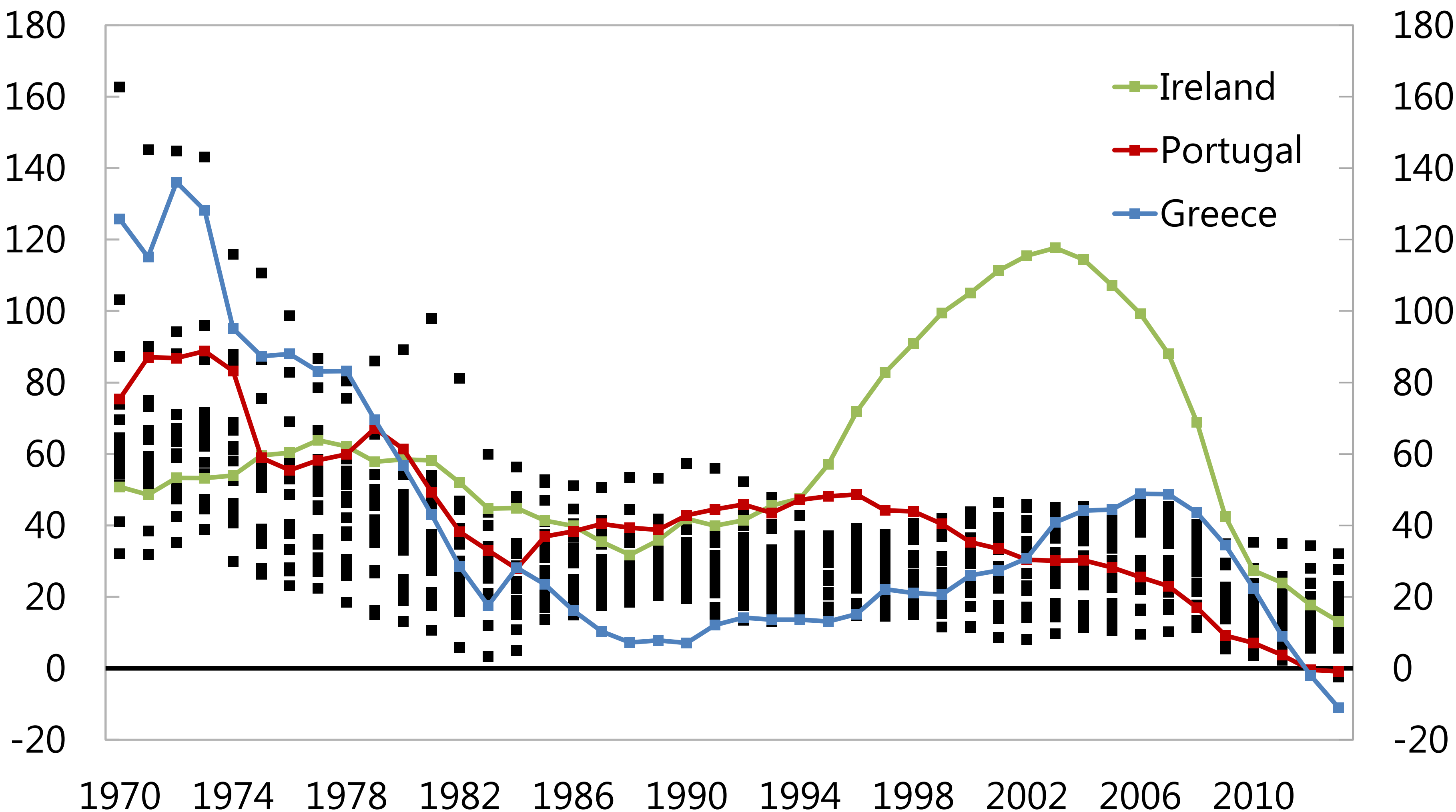
Why spend 1½ hours on Portugal's recent fiscal story?

- Fiscal history lesson: Very large fiscal imbalances can pile up gradually under supposedly strict fiscal rules.
- Policy design lesson: It's difficult to deal with large flow and stock imbalances when policy tool box is limited.
- Policy implementation lesson: Illustrates the twist and turns of policy implementation in the real world (Mike Tyson paraphrased: "everybody has a fiscal plan until they get hit by a bad surprise/shock").

Part I: The making of a fiscal crisis

Portugal: Slumping growth, 1970-2013[1\]

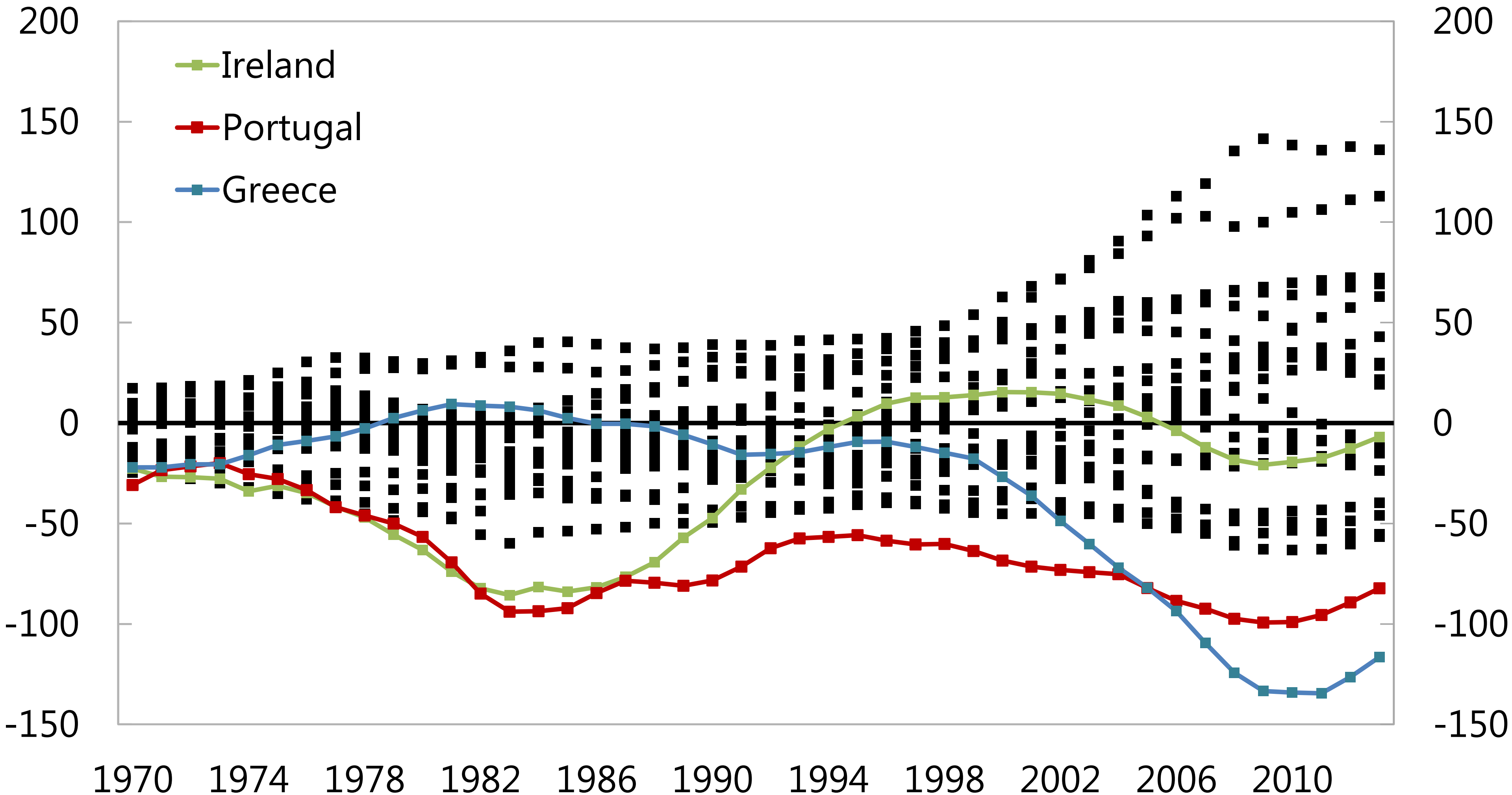
(Percent)



[1\] Cumulative 10-year GDP growth rates for 22 OECD countries.

Portugal: Persistent external imbalances, 1970-2013[1\]

(Percent of GDP)



1\ Cumulative 10-year current account balance for 22 OECD countries.

Early warnings

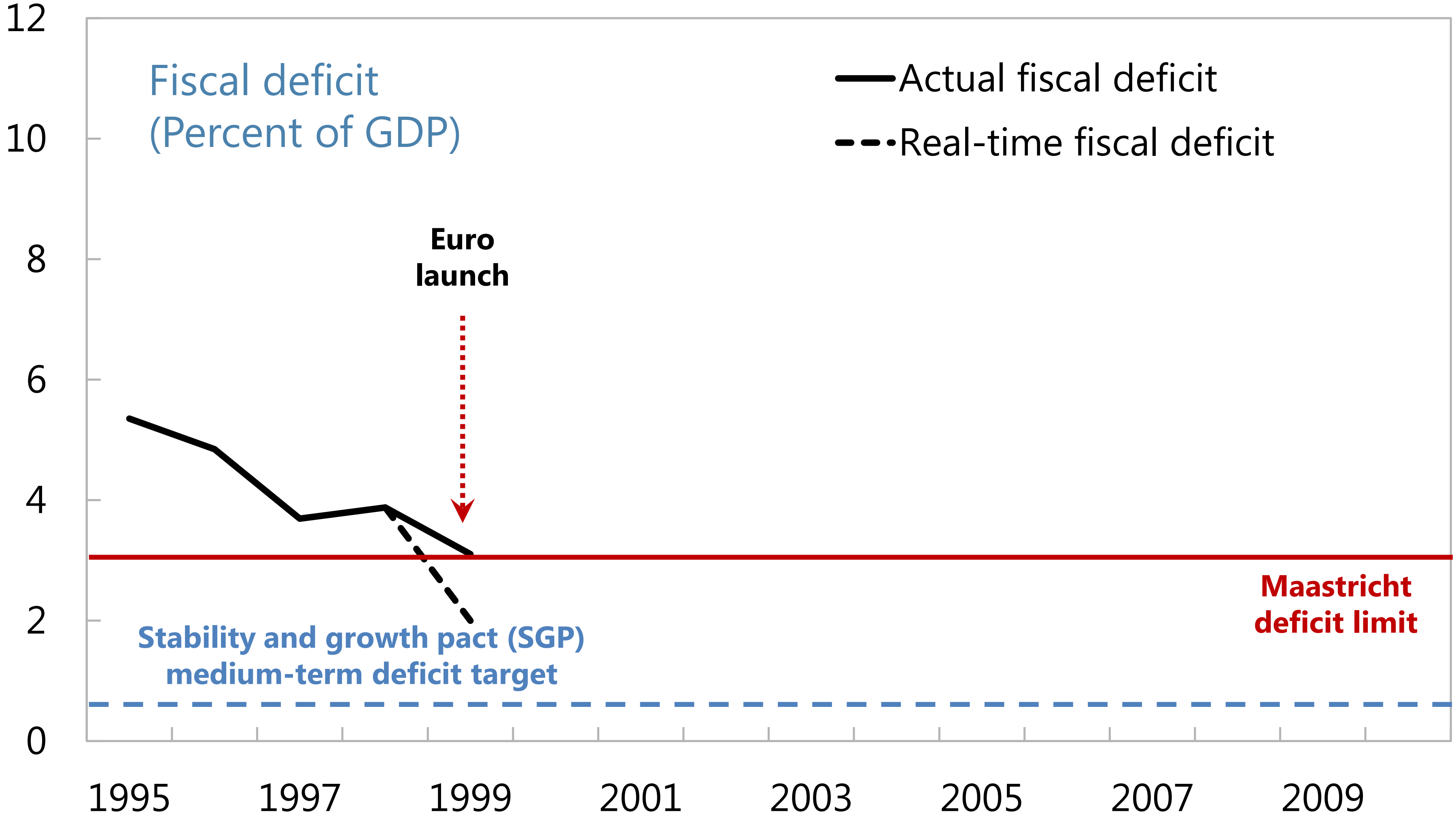
The Portuguese economy is in serious trouble … Growth is very low. The budget deficit is large. The current account deficit is very large. *Olivier Blanchard, 2007*

Whodunit?

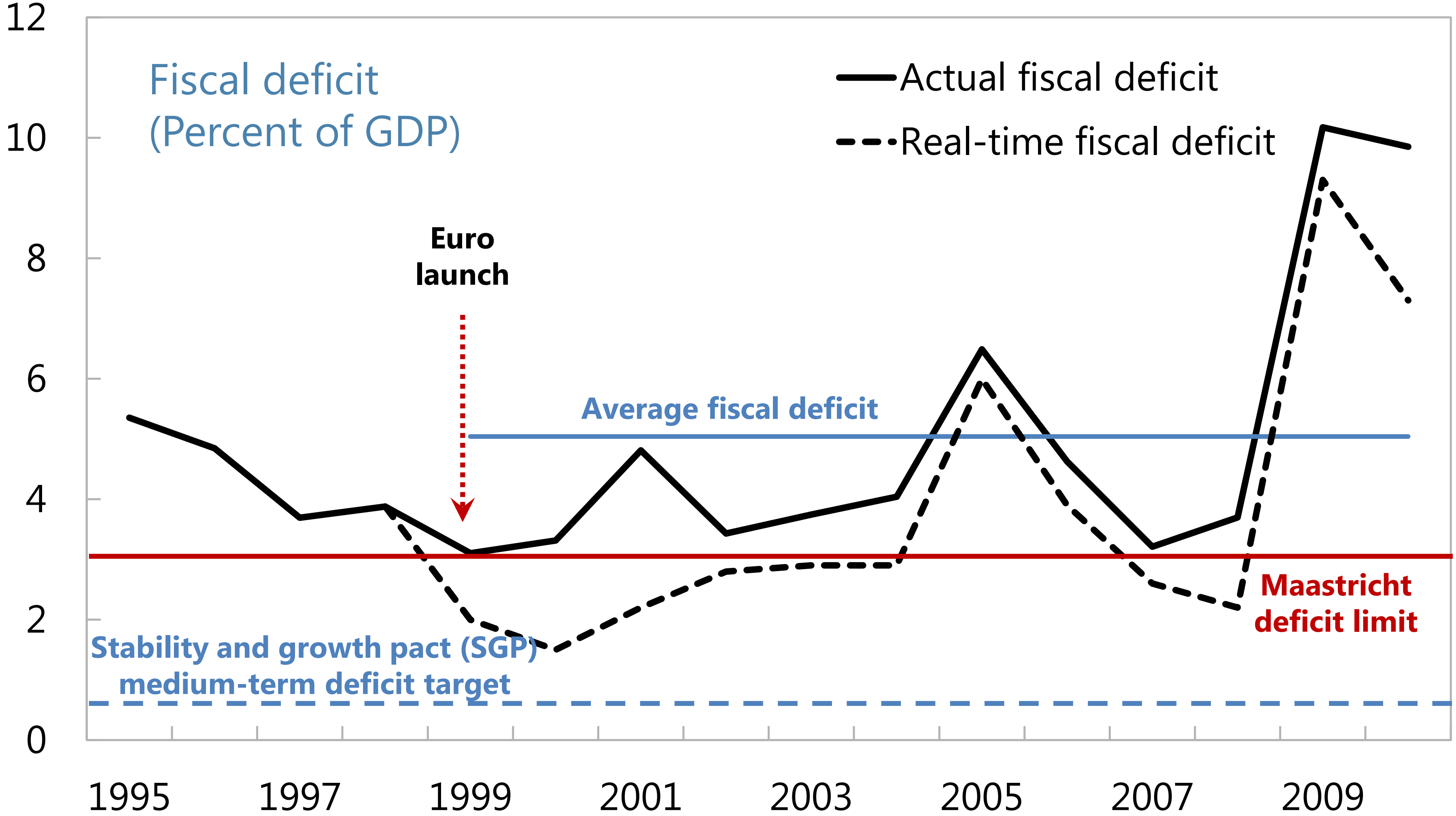
- Bad supply side (Blanchard, 2007)
- Bad international/local finance (Reis, 2013)
- Bad *de facto* economic/political institutions (although look ok on paper)

No widely shared simple, linear macro story has emerged.

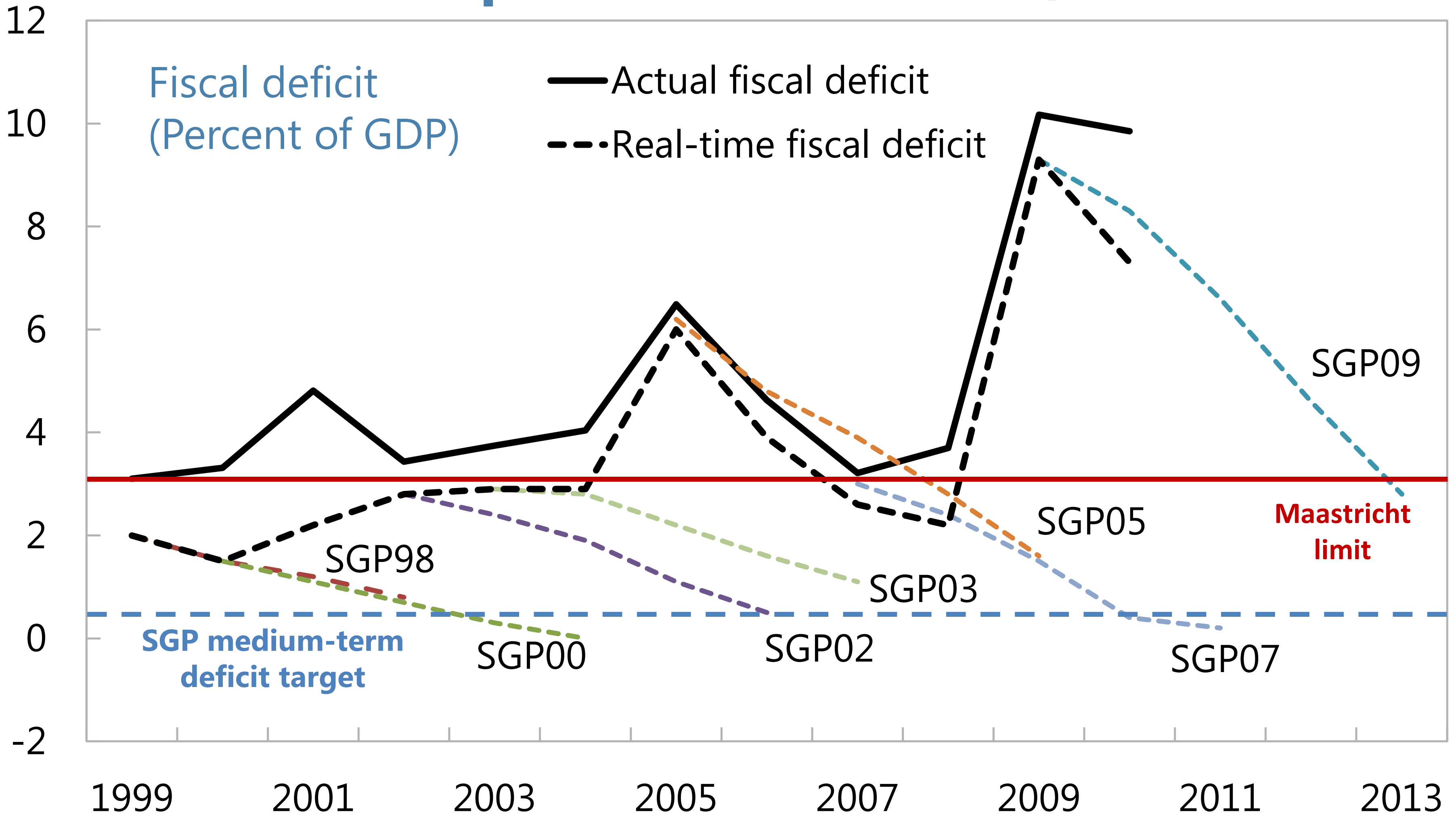
Portugal's fiscal policy under the euro: Rules and outcomes, 1999-2010



Portugal's fiscal policy under the euro: Rules and outcomes, 1999-2010



Portugal's fiscal policy: Medium-term plans and outcomes, 1999-2010



What drove fiscal imbalances?

- Weak institutional restraints on spending and deficit biases at all stages of budget process
- A welfare state set up during the high-growth 1990s faced with an unexpected growth slump (during 2000-10, spending on social benefits rose by 9 percent of GDP, from 13 to 22 percent of GDP)
- Proliferating off-budget deficits and debts (PPPs, SOEs) that were later brought on-budget

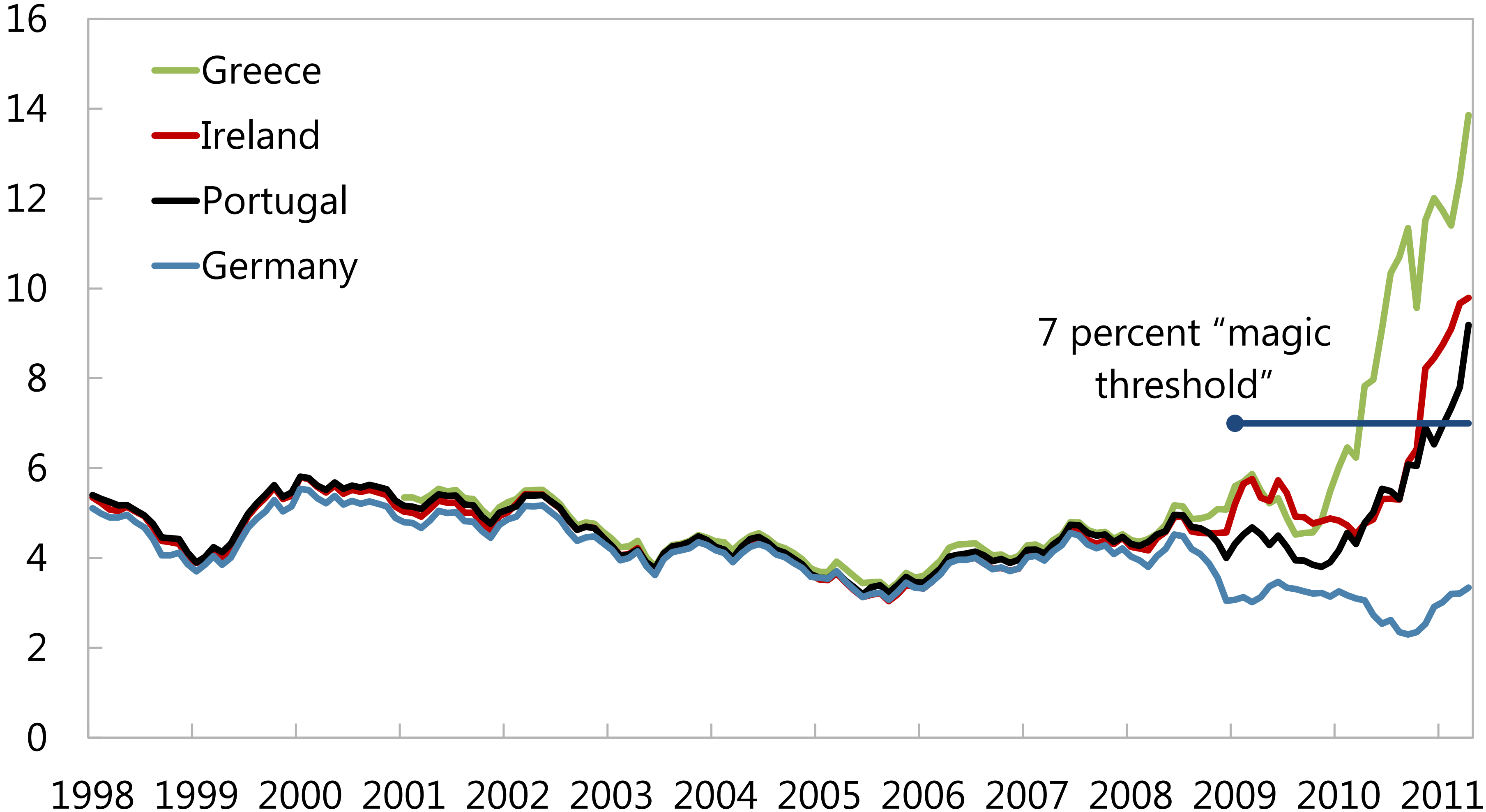
Heading for financial trouble

Portugal: Key economic indicators

Real activity	**1998**	**2010**
GDP per worker (% euro area)	51.2	53.3
Unemployment rate (%)	5.0	10.8
Fiscal indicators		
Fiscal deficit (% GDP)	3.9	9.9
Public debt (% GDP)	51.8	94.0
External indicators		
Current account deficit (% GDP)	7.6	10.4
Net international investment position (% GDP)	-24.7	-107.2
Real effective exchange rate (ULC) (1998=100)	100.0	109.0

10-year government bond yields, 1998-2011 (April)

(Percent)

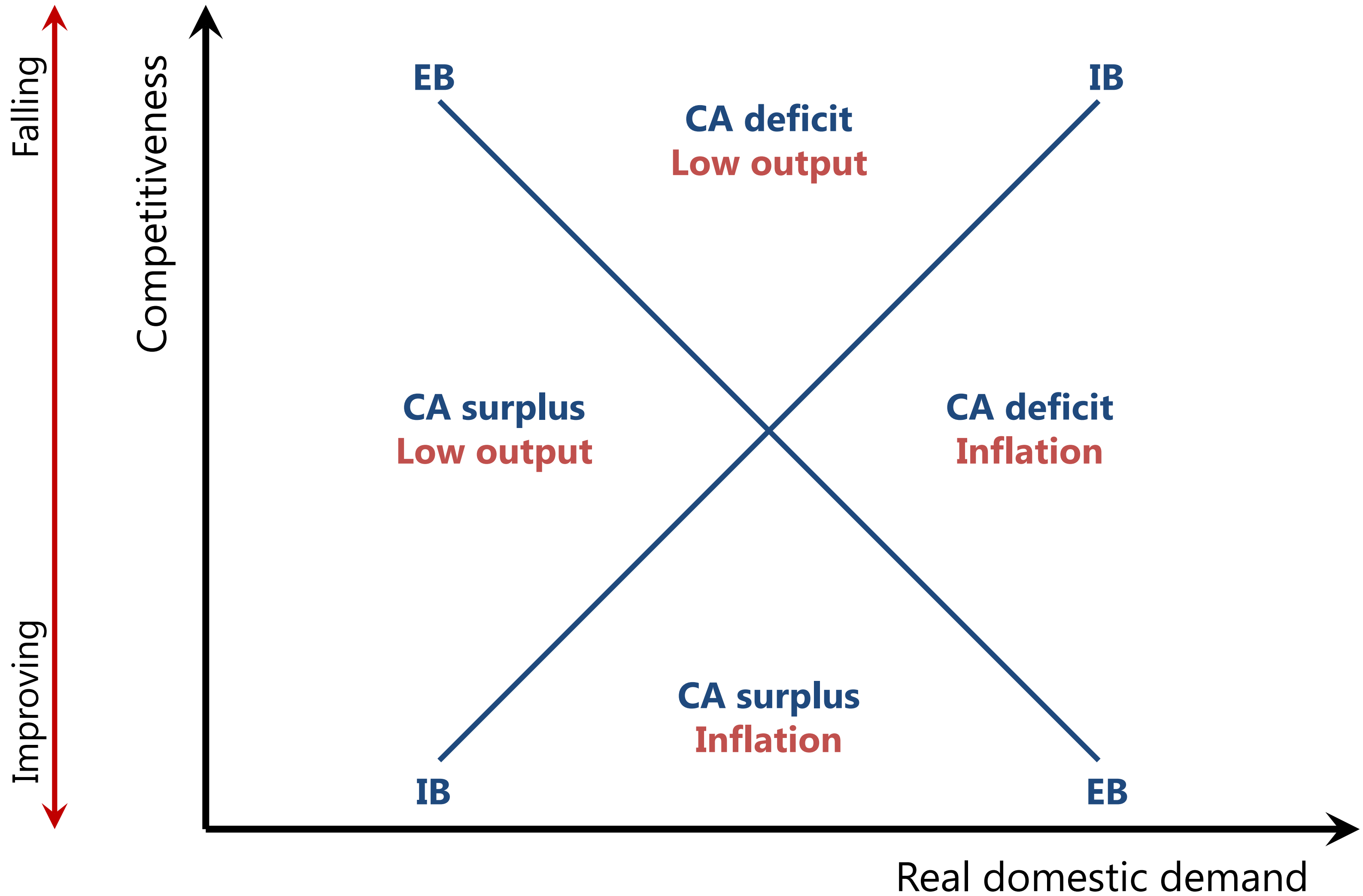


Part II: The program

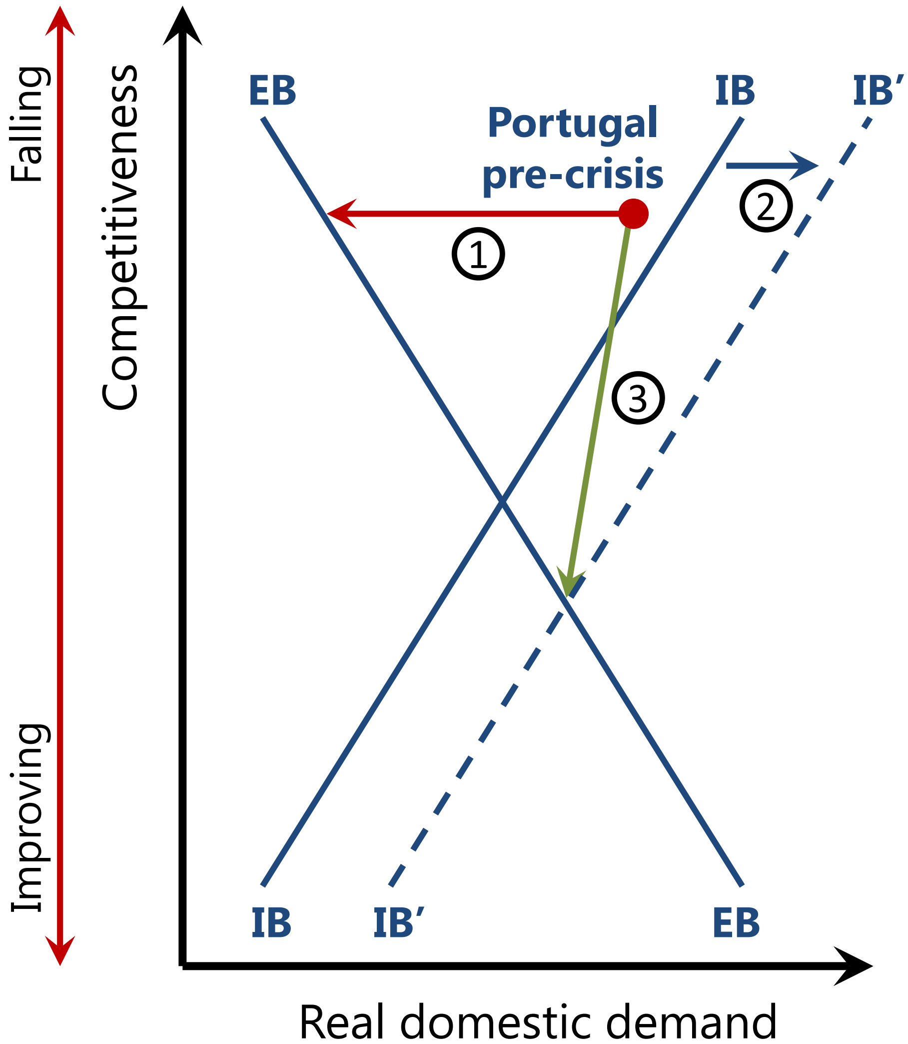
Portugal's program: Objectives, constraints, tools, and boons

- **Main objectives**
  - Restore /anchor fiscal discipline
  - Restore external competitiveness
  - Clean up/deleverage balance sheets
- **Main constraints**
  - Monetary union (fixed exchange rate)
  - High public and private debts
  - Constitution
  - Social and political consensus
- **Main tools**
  - Fiscal policy
  - Structural reforms
- **Main boons**
  - Large-scale EU budgetary and financial support
  - Euro-area policies overhaul

Internal-external balance: Swan diagram



Internal-external balance: Swan diagram



Four tasks:

(1) Reduce domestic demand
Main tool: Fiscal adjustment

(2) Increase potential growth
Main tool: Structural reforms

(3) Restore competitiveness
Main tools: Fiscal devaluation and structural reforms

(4) Make fiscal and financial discipline stick
Structural reforms

Design issue: Fiscal adjustment speed

Speed — *Automatic fiscal response*

$$FD_t = FD_{t-1} - {\color{red}\beta}[FD_{t-1} - FD^*] - \alpha[g_t - g^*]$$

Fiscal deficit year t | Fiscal deficit year t-1 | Gap relative to deficit target | State of economy

Numerical example: Program plan for 2011

$$5.9 = 9.1 - {\color{red}0.5}[9.1 - 0.5] - 0.5[-2.2 - 0.0]$$

Fiscal deficit 2011 | Fiscal deficit 2010 | Gap relative to target of 0.5% | State of economy

Getting fiscal adjustment speed right: Weighing the pros and cons

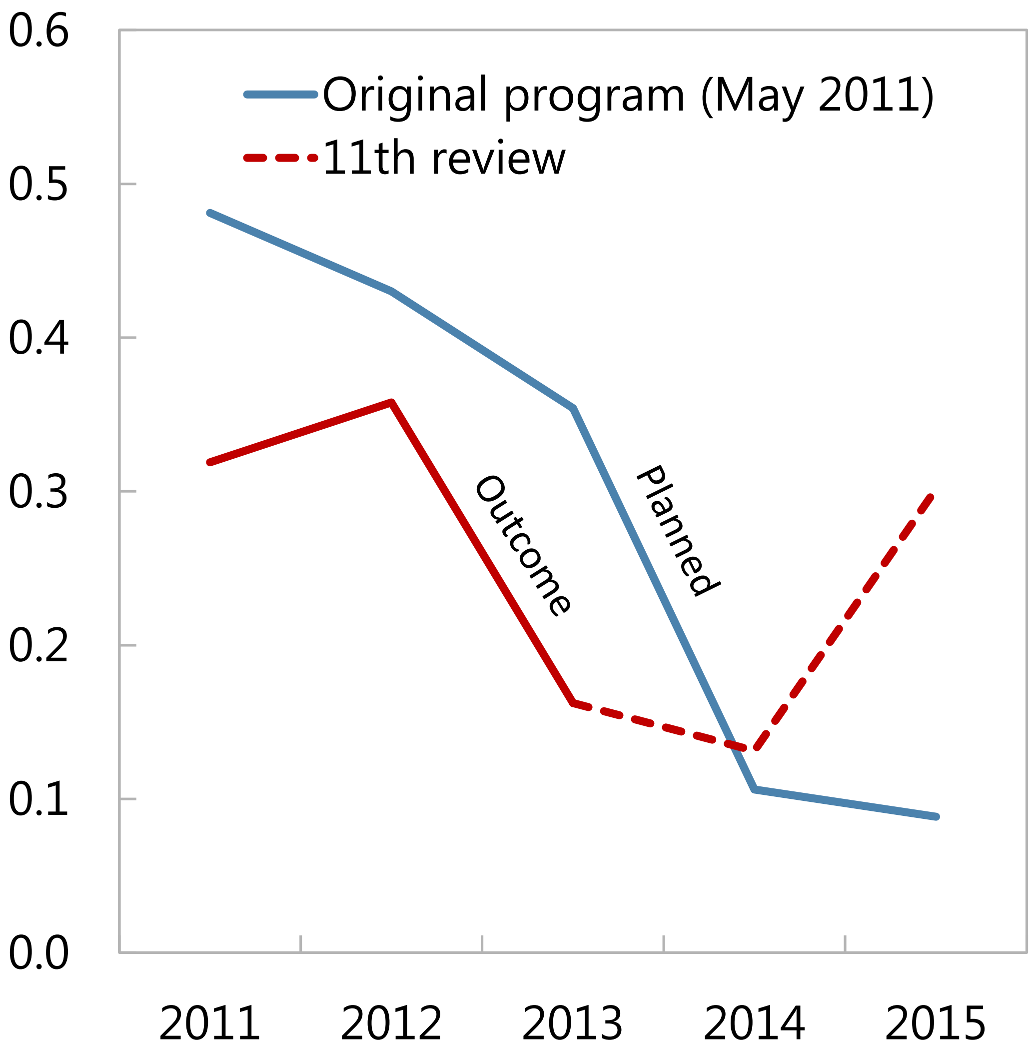
High β now, low β later (front-loaded adjustment)

- Low policy credibility
- High initial public debt
- Risk of bad equilbrium
- Financing constraint

Low β now, high β later (back-loaded adjustment)

- High multipliers (now)
- Risk of hysteresis (now)
- Fragile political/social consensus
- Low quality of fiscal adjustment

Implementation: Actual fiscal adjustment speed High β first, then low β, then high β (planned)



Reasons why speed was different than planned:

- Lower GDP growth; shifts in Okun's Law
- Larger-than-expected fiscal multipliers
- Larger-than-expected automatic fiscal stabilizers
- Two relaxations of deficit targets (balance of pros and cons changed)
- Need to make up for past slower speed in future

Design issue: Fiscal devaluation

Tradable (T) and non-tradable (NT) sectors:

$$\begin{bmatrix} Output \\ prices \end{bmatrix} = \begin{bmatrix} Mark \\ up \end{bmatrix} \times \begin{bmatrix} Unit\ costs\ of\ labor, \\ capital, other\ inputs \end{bmatrix}$$

Problem:

T mark-up “too low” relative to NT mark-up

Fiscal devaluation idea:

Re-balance T and NT mark-ups by cutting employers’ social contributions and offset deficit impact by raising other taxes (VAT) or cutting spending

Fiscal devaluation in practice: Lessons

- Tried twice
- Four lessons:
  - Need large cuts in employers' contributions to have significant impact on T-NT mark-up differentials
  - Difficult to rebalance mark-ups between T and NT sector if NT prices are sticky
  - Restricting cut in employers' contribution to T sector not compatible with EU rules
  - Political economy: fiscal devaluation can be seen as unfair (by trade unions <u>and</u> employers)

Design issue: Making fiscal discipline stick

Stages of Budget Process

• Incentivize political parties to present realistic fiscal plans before elections (Dutch example)	**Political stage**
• A strong Ministry of Finance that can say "no" (German example)	**Formulation stage**
• Anchor specific fiscal targets in the Constitution (Irish/Spanish examples)	**Legalization stage**
• Threaten errant fiscal policy makers with serious sanctions (Brazilian example)	**Implementation stage**

Implementation: Making fiscal discipline stick

Reform Measures	Stages of Budget Process
• Set up Fiscal Council; publish fiscal data and risk assessments	**Political stage**
• More reliable fiscal information in real time; streamline spending appropriations (from 4,400); MoF monitors PPPs/SOEs	**Formulation stage**
• Reforms of budget framework law, sub-national finance laws	**Legalization stage**
• More accountability of spending ministries and spending controls	**Implementation stage**

Political economy of hard feelings

Pace of fiscal adjustment/structural reforms:

- Government sometimes felt that Troika was too rigid.
- Troika felt government was too willing to put program at risk.

How can both sides feel they are correct?

Assume two different perspectives on risks:

<u>Null Hypothesis:</u> Program is working fine.

- Government low tolerance for **type I error** (rejecting correct null).
  Legal analogy: The accused is not guilty. Want low type I error.

- Troika low tolerance for **type II error** (accepting wrong null).
  Medical analogy: The patient is not sick. Want low type II error.

Program: Plans vs. outcomes

Portugal: Key economic indicators

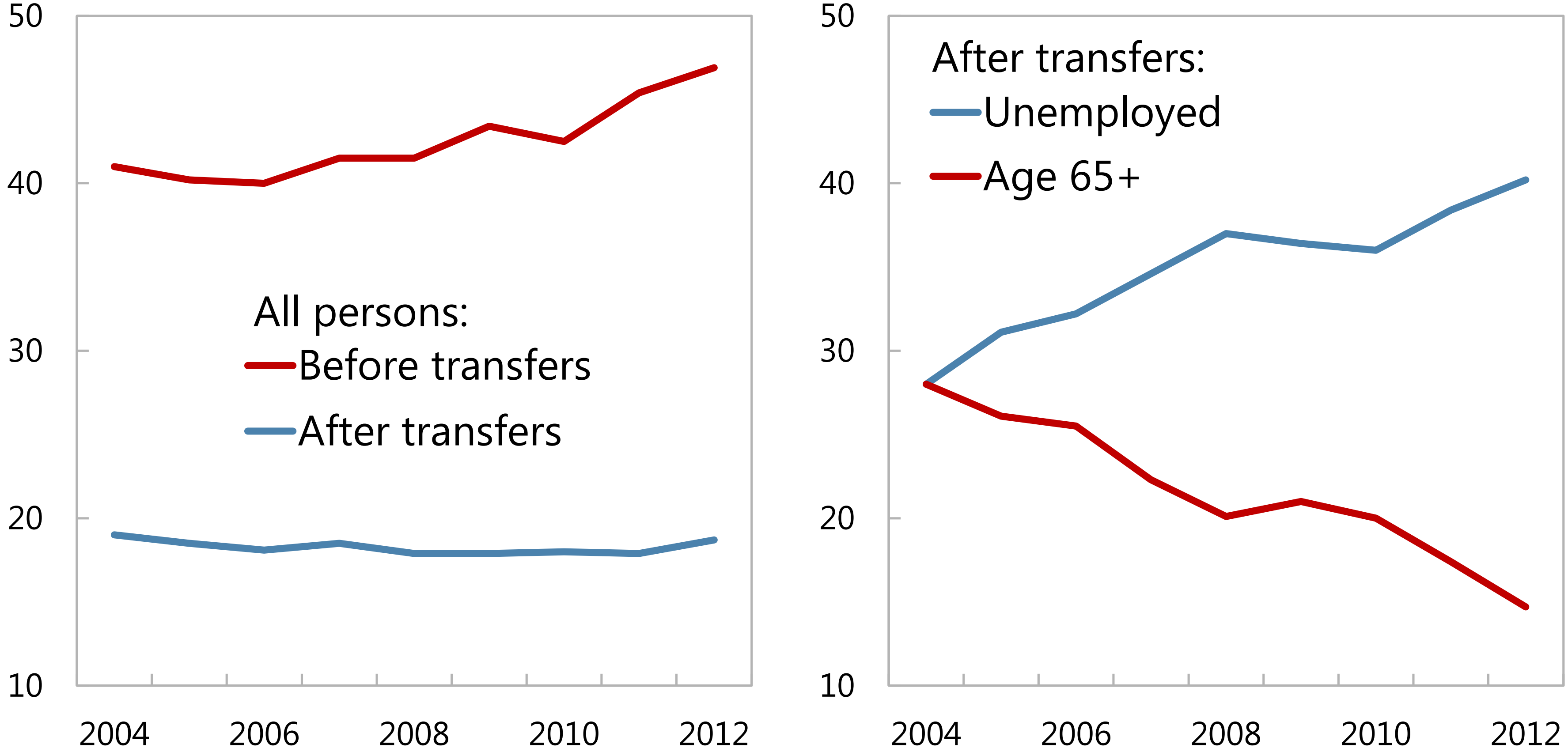
		2010	2011	2012	2013	2014
Real activity						
GDP growth (%)	Program	1.3	-2.2	-1.8	1.2	2.5
	Now		-1.3	-3.2	-1.4	1.2
Unemployment rate (%)	Program	11.0	12.1	13.4	13.3	12.0
	Now		12.7	15.7	16.3	15.7
Fiscal indicators						
Fiscal deficit (% GDP)	Program	9.1	5.9	4.5	3.0	2.3
	Now		4.3	6.5	4.9	4.0
Public debt (% GDP)	Program	93.0	106.4	112.2	115.3	115.0
	Now		108.2	124.1	128.8	126.7
External indicators						
Current account deficit (% GDP)	Program	9.9	9.0	6.7	4.1	3.4
	Now		7.0	2.0	-0.5	-0.8
REER (CPI) (2010=100)	Program	100.0	100.8	101.1	100.6	100.3
	Now		100.8	99.5	99.6	99.4

Source: 11th Review

Program outcomes: Poverty indicators

Portugal: Risk of Poverty, 2004-2012

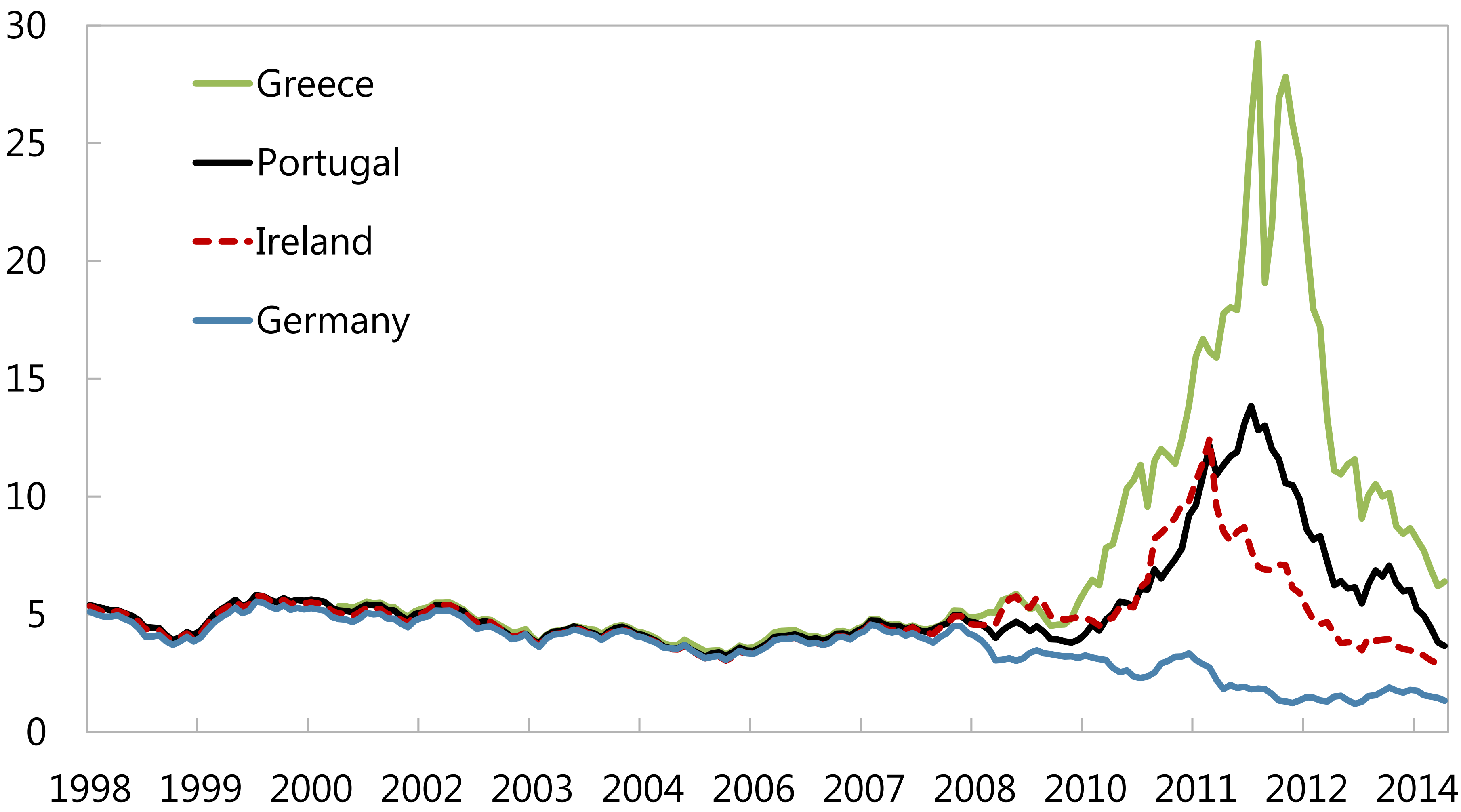
(Percent of Population below Poverty Threshold[1/])



[1/] The poverty threshold is defined as 60% of the median net income.

10-year government bond yields, 1998-2014 (June)

(Percent)



Final thoughts

- **Lessons in fiscal history**
  - Build-up of fiscal imbalances in a monetary union gradual
  - Lack of enforceability of fiscal rules
- **Lessons in program design**
  - Getting fiscal adjustment speed right is a balancing act
  - Restoring external/internal balance challenging
  - Fiscal devaluation difficult to implement in practice
- **Lessons in policy implementation**
  - Important role of political/social consensus
  - Constitutional constraints important
  - Programs need to be flexible given potential for surprises

Thank you!