Fiscal Issues in Portugal’s EU-IMF Program

Albert Jaeger, IMF, Lisbon Office
Joint Vienna Institute (JVI), July 11, 2014
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\(^{1}\) Cumulative 10-year GDP growth rates for 22 OECD countries.
Portugal: Persistent external imbalances, 1970-2013\(^1\)

(Percent of GDP)

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

\(^1\)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

Fiscal deficit (Percent of GDP)

- Actual fiscal deficit
- Real-time fiscal deficit

Euro launch

Stability and growth pact (SGP) medium-term deficit target

Maastricht deficit limit

1995 1997 1999 2001 2003 2005 2007 2009
Portugal’s fiscal policy under the euro: Rules and outcomes, 1999-2010

Fiscal deficit (Percent of GDP)

- Actual fiscal deficit
- Real-time fiscal deficit

Euro launch

Average fiscal deficit

Stability and growth pact (SGP) medium-term deficit target

Maastricht deficit limit

- 1995
- 1997
- 1999
- 2001
- 2003
- 2005
- 2007
- 2009
Portugal’s fiscal policy: Medium-term plans and outcomes, 1999-2010

Fiscal deficit (Percent of GDP)

- Actual fiscal deficit
- Real-time fiscal deficit

SGP medium-term deficit target

Maastricht limit

1999 2001 2003 2005 2007 2009 2011 2013
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

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real activity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP per worker (% euro area)</td>
<td>51.2</td>
<td>53.3</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>5.0</td>
<td>10.8</td>
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<tr>
<td><strong>Fiscal indicators</strong></td>
<td></td>
<td></td>
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<tr>
<td>Fiscal deficit (% GDP)</td>
<td>3.9</td>
<td>9.9</td>
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<tr>
<td>Public debt (% GDP)</td>
<td>51.8</td>
<td>94.0</td>
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<tr>
<td><strong>External indicators</strong></td>
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<tr>
<td>Current account deficit (% GDP)</td>
<td>7.6</td>
<td>10.4</td>
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<tr>
<td>Net international investment position (% GDP)</td>
<td>-24.7</td>
<td>-107.2</td>
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<tr>
<td>Real effective exchange rate (ULC) (1998=100)</td>
<td>100.0</td>
<td>109.0</td>
</tr>
</tbody>
</table>
10-year government bond yields, 1998-2011 (April)

(Percent)

7 percent “magic threshold”
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

- CA surplus
  - Low output
  - Inflation

- CA deficit
  - Low output
  - Inflation
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**

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

Fiscal deficit year \( t \)  
Fiscal deficit year \( t-1 \)  
Gap relative to deficit target  
State of economy

**Numerical example:** Program plan for 2011

\[ 5.9 = 9.1 - 0.5[9.1 - 0.5] - 0.5[-2.2 - 0.0] \]

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

<table>
<thead>
<tr>
<th>High $\beta$ now, low $\beta$ later (front-loaded adjustment)</th>
<th>Low $\beta$ now, high $\beta$ later (back-loaded adjustment)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Low policy credibility</td>
<td>• High multipliers (now)</td>
</tr>
<tr>
<td>• High initial public debt</td>
<td>• Risk of hysteresis (now)</td>
</tr>
<tr>
<td>• Risk of bad equilibrium</td>
<td>• Fragile political/social consensus</td>
</tr>
<tr>
<td>• Financing constraint</td>
<td>• Low quality of fiscal adjustment</td>
</tr>
</tbody>
</table>
Implementation: Actual fiscal adjustment speed
High $\beta$ first, then low $\beta$, then high $\beta$ (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:

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

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 and employers)
Design issue: Making fiscal discipline stick

- Incentivize political parties to present realistic fiscal plans before elections (Dutch example)
- A strong Ministry of Finance that can say “no” (German example)
- Anchor specific fiscal targets in the Constitution (Irish/Spanish examples)
- Threaten errant fiscal policy makers with serious sanctions (Brazilian example)

### Stages of Budget Process

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<tr>
<th>Political stage</th>
<th>Formulation stage</th>
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Implementation: Making fiscal discipline stick

Reform Measures

- Set up Fiscal Council; publish fiscal data and risk assessments
- More reliable fiscal information in real time; streamline spending appropriations (from 4,400); MoF monitors PPPs/SOE
- Reforms of budget framework law, sub-national finance laws
- More accountability of spending ministries and spending controls

Stages of Budget Process

- Political stage
- Formulation stage
- Legalization stage
- 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:

Null Hypothesis: 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.
### Portugal: Key economic indicators

#### Real activity

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
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<tr>
<td>GDP growth (%)</td>
<td></td>
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<tr>
<td>Program</td>
<td>1.3</td>
<td>-2.2</td>
<td>-1.8</td>
<td>1.2</td>
<td>2.5</td>
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<tr>
<td>Now</td>
<td>-1.3</td>
<td>-3.2</td>
<td>-1.4</td>
<td>1.2</td>
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<tr>
<td>Unemployment rate (%)</td>
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<td>Program</td>
<td>11.0</td>
<td>12.1</td>
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<td>Now</td>
<td>12.7</td>
<td>15.7</td>
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#### Fiscal indicators

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<tr>
<td>Program</td>
<td>9.1</td>
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<td>4.5</td>
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<td>Now</td>
<td>4.3</td>
<td>6.5</td>
<td>4.9</td>
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<td>Program</td>
<td>93.0</td>
<td>106.4</td>
<td>112.2</td>
<td>115.3</td>
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<tr>
<td>Now</td>
<td>108.2</td>
<td>124.1</td>
<td>128.8</td>
<td>126.7</td>
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#### External indicators

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<tr>
<th></th>
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<td>4.1</td>
<td>3.4</td>
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<tr>
<td>Now</td>
<td>7.0</td>
<td>2.0</td>
<td>-0.5</td>
<td>-0.8</td>
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<tr>
<td>REER (CPI) (2010=100)</td>
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<td>Program</td>
<td>100.0</td>
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<td>100.6</td>
<td>100.3</td>
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<tr>
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<td>99.5</td>
<td>99.6</td>
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Source: 11th Review
Program outcomes: Poverty indicators

Portugal: Risk of Poverty, 2004-2012
(Percent of Population below Poverty Threshold¹/)

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!