

BPEA Conference Draft, September 10-11, 2015

Looking for a success: The euro crisis adjustment programs

Ricardo Reis, Columbia University and LSE

Looking for a success: the euro crisis adjustment programs¹

Ricardo Reis

Columbia University and LSE

September 2015

From the start, the euro crisis posed a unique challenge to crisis management. In many ways, the events in 2010-11 in Greece, Ireland, Portugal and Spain resembled a classic sudden stop. But, to deal with the ensuing recession, there was no currency to devalue, no independent central bank to back up and resolve struggling national banks, few private bondholders to arrange for a debt write-down, and large and legally protected welfare states that are hard to reform. There were also no European institutions set up to deal with a crisis of this type and magnitude. As a result, the adjustment programs for these four countries were partly improvised, unique in their features, and their effectiveness was in question from the start.

Still, if the euro survives, there will surely be new crises in the future. In turn, as other regions in the world choose different forms of economic integration, they would like to learn what mistakes to avoid in following the European example. Inspecting the adjustment programs in place during the past few years is in order.

Looking for a failure is easy: no matter where the blame lays, it is undeniable that the Greek adjustment program has failed, with grim consequences for its population. In turn, Ireland's international loan was almost entirely devoted to recapitalizing its banks and adjusting future fiscal plans to deal with the large debt inherited from bailing out the financial system. There were few macroeconomic measures in the program. Similarly, Spain received financial assistance to recapitalize its banks, with conditions on implementing reforms in the financial sector, but there was no full-fledged IMF macroeconomic adjustment program.

This leaves Portugal as a potential example of success to counterbalance the failure in Greece. Portugal's adjustment program was extensive, mostly followed by the Portuguese

¹ Prepared for the Fall meetings of the Brookings Papers on Economic Activity. I am grateful to David Romer and Justin Wolfers for discussions and encouragement, and to Cynthia Balloch for research assistance. Contact: rreis@columbia.edu and www.columbia.edu/~rr2572

authorities and, coming after Greece and Ireland, benefitted from the accumulation of some experience. Looking back in its 2015 annual report, the IMF describes the adjustment program as a success (IMF, 2015a), and even Wolfgang Schäuble, the influential German finance minister, stated at the conclusion of the program: “This is a major success” (German Federal Ministry of Finance, 2014).

This article will argue that the verdict is more mixed and that appearances can deceive. While the main Portuguese aggregates indicate a success in stabilizing public finances but little gains in getting the economy out of its slump, evaluating the economy’s state relative to a diagnosis of its disease suggests the opposite: promising changes in the structure of the economy, while being far from a path that lowers the public debt.

1. Is Portugal a success?

Portugal requested international help in April of 2011, and officially signed it one month later. This came after a run up in 10-year interest rates on government bonds, which reached 9.6% in May, up from 5.0% one year earlier. The government had difficulty rolling over bonds that were coming due, and signed a 3-year agreement with the troika to secure financing of up to €78 billion, which expired on June 30, 2014.

It is hard to judge a program without knowing what the criteria are. From a narrow perspective of success, defined as being able to resume sovereign borrowing, Portugal delivered. By the end of the program, the Portuguese state was able to borrow again and at moderate 10-year interest rates, both at the end of the program (3.5%) and thereafter, with interest rates not exceeding 3% in 2015 so far, in spite of the Greek crisis. The budget deficit improved markedly from -11.2% of GDP to -4.5% between 2010 and 2014. Equally important, the troika extended the maturity of the Portuguese official debt and reduced interest payments, and the Portuguese debt office successfully extended the maturity of the outstanding debt, with 10-year issuances throughout 2014 and 2015. As a result, the average maturity of the debt increased from 6 years in 2010 to above 8 years at the start of 2015, reducing rollover risk (Reis, 2015).

However, from a wider perspective of success that focuses on resuming economic growth, it is hard to see reasons to rejoice. Looking at macroeconomic aggregates, GDP per capita is 6.3% lower in 2014 than it was in 2010, and total employment fell from 4.9 million to 4.5 million. Growth forecasts from the IMF for the next 3 years are a modest average of 1.5% per year.

If success is assessed as making another debt crisis unlikely in the near future, the program delivered. If success is instead judged as a rebound of the economy from its prolonged depression, then there is little to celebrate. The approach in the rest of this paper is instead to look at progress in solving Portugal's underlying structural problems. Success will be assessed *conditionally* on a diagnosis of Portugal's slump and crash, and by looking at whether the economy healed its diseases.²

2. Diagnosis of the crisis

The Euro-crisis arose as large capital flows from the core to the periphery of Europe, which had built up since the introduction of the euro, suddenly reversed in 2009-10. Without a currency to depreciate between different regions of the Euro-zone, the large and sudden contraction in the current account deficit required a large contraction in domestic consumption and investment, driving these economies into recession. A fall in the real exchange rate was required, but the usual rigidities that slow the adjustment of prices and wages led to a large and prolonged increase in unemployment. This the traditional side of the crisis (Shambaugh, 2012 and Blanchard, 2013).

New to this sudden stop (Brunnermeier and Reis, 2015), the capital flows across borders were intermediated by banks, and largely funded through the interbank market. In the European periphery, banks and capital markets lacked the depth to allocate the large funds that came with financial integration, likely misallocating them into unproductive non-tradable sectors. A flight to safety in response to higher risk aversion following the 2008 financial crisis had a cross-border dimension in Europe. The sudden stop came with fire sales in financial markets and falls in bank capital that led to large contractions in domestic credit.

² European Commission (2014) provides an alternative evaluation.

Another novel and unique feature to the euro crisis is what has been labeled the “diabolic loop” or the “doom loop” between banks and sovereigns (Brunnermeier et al, 2011, and Obstfeld 2013). European banks held large amount of sovereign bonds. As economic activity slowed and public deficits rose, fears about sovereign default led to falls in the prices of government bonds, large losses in banks’ holdings, and further fire sales and contractions in credit, deepening the recession. Once the crisis was in motion, the diabolic loop worsened because banks would offset the sudden stop of private capital by pledging government bonds as collateral at the ECB to obtain public financing. Together with the official troika bailout programs, this implied that within a couple of years, most of the public debt of the countries in crisis was held by either official creditors or domestic banks.³

Within this general diagnosis, what was special about the Portuguese crisis?⁴ First, Portugal’s economy slumped during the 2000-10 period, with almost zero growth in GDP per capita during this decade, and the unemployment rate reaching 11.3% by the end of the decade from a start at 5.3%. The extent of the economic calamity in Greece during the crisis has been often emphasized: Greek real GDP grew cumulatively by only 1.6% in between 2000 and 2013. But Portugal grew by only 0.9% during the same period. Second, partly because of this contraction in income without as large a contraction in consumption, private external debt was higher in Portugal than in the other euro-crisis countries: net international liabilities were already 86% of GDP by the end of 2010. A third difference is that there is little evidence of public profligacy in Portugal before 2007. All of the increase in public spending is accounted for by increases in the payment of old-age pensions and unemployment benefits, and both of these systems actually became less generous during this period. Moreover, taxes increased. Fourth, Portugal did not have a house price boom, nor a significant expansion of the construction sector before the crisis. The large expansion in nontradables and consequent appreciation of the real exchange rate happened in the wholesale and retail sector and community services (education, health care and social work). Finally, there was a relative political consensus in Portugal accepting the adjustment programs. It was signed by the three major center parties, and their share of the votes or polls only fell slightly during the program. No new or radical parties gained popularity during the adjustment program, unlike what happened in Greece and Spain.

³ For data on the increase in banks’ holdings of Portuguese debt, see Crosignani et al (2015).

⁴ See Fagan and Gaspar (2007), Bento (2010), Reis (2013) and Alexandre et al (2014).

3. Conditional success: paying past debts?

At the start of the program, Portugal had both large public debt and large external debt. With difficulties in rolling over either of the two felt by private and public sectors alike, and with debt overhang holding back new investment, adjustment required dealing with this debt.

Starting with paying for the national debt, the trade balance went from -7.1% to 1.1% of GDP.⁵ The country had not had a trade surplus since World War II, so this is no small accomplishment. At the same time, if this had been achieved through a contraction in imports, both because of a contraction in aggregate demand during the crisis as well as because of the reduced price of oil, one might worry that this improvement was temporary. An argument against this is that the ratio of exports to GDP increased from 30% to 41%, and Portugal improved its market share in most of its markets.

Turning attention to the public debt, the primary surplus improved from -8.2% to 0.5% of GDP. Much ink has been spilled on the virtues and pitfalls of austerity in a debt crisis. One interesting feature on the Portuguese situation (and the euro crisis) is represented in Table 1. Aside from the primary surplus since 2010, it also shows its projected path according to different waves of IMF programs, as well as the fall in the deficit between 2005 and 2008, when Portugal was in violation of the Maastricht limits and had to bring its deficit in line. The pace of austerity was milder than what was planned, with constantly relaxed targets, and similar in 2011-14 to 2005-08. It is hard to make a case for unexpected austerity from the the start of 2012 onwards, or to see a dramatic reform in Portuguese public finances.

Lowering the debt can also be done by selling assets or by restructuring liabilities. As a sign of the first, Portugal's gross external debt fell by €1.3bn even as the net international investment position worsened by €5.3bn. Large companies, but public and privately owned were sold to foreigners, including the major electrical utility, the larger telecommunications company, the airline, and most large banks.

⁵ All comparisons are between 2010 and 2014, using annual data, unless stated otherwise.

Table 1. Public primary deficits: actual, IMF program forecasts, and prior to crisis

Year	Actual	Forecasts			Year	Actual
		June 2011	October 2012	January 2013		
2010	-7.0					
2011	-3.0	-1.7			2005	-3.64
2012	-0.7	0.3			2006	-1.56
2013	0.1	2.1	0.2	-0.2	2007	-0.06
2014	0.4	2.8	2.4	2.1	2008	-0.66

Source: IMF reports.

As for the second, in spite of the cut in the public deficit, the stock of public debt went from 96% to 130% of GDP. In 2012, the troika restructured the Portuguese debt (together with that of Greece and Ireland) extending maturities and lowering interest payment. Yet, with such high public debt and a meager primary surplus, it is difficult to see how Portugal can get public debt under control without a new reconfiguration of maturities and interest payments on the troika debt that would significantly reduce the market value of the public debt. The radicalization of European public opinion caused by the 2015 Greek crisis has made this harder to achieve.

4. Conditional success: public spending under control?

A large part of the reduction in the public deficit was achieved via increases in the tax rates on personal income and sales, as well as tighter enforcement. Overall government revenue increased from 40.6% to 44.5% of GDP. At the same time, government consumption purchases fell from 19.6% to 17.7% of GDP, and the cut in public investment was even sharper, from 7.2% to 3.2%.

Yet, transfers increased from 22.1% to 23.1% of GDP. This, in spite of the fact that all of the increase in public spending between 2000 and 2007 was already entirely accounted for by increases in old-age pension payments. As a result, while total public spending fell from €93bn to €85bn, excluding public investment, spending barely changed from €80bn to €79bn. Once

public investment returns to its pre-crisis levels, public spending will be almost unchanged mostly because of the increase in social transfers.

It is up for debate whether public spending should keep on increasing, accompanied by even higher taxes. It is more clear that given current trends, the pension system in Portugal will accumulate ever larger deficits and, absent reform, be responsible for any future fiscal crises. During the adjustment programs, the retirement age increased to 66 years, early retirement was suspended, and survivor pensions became means tested, but most reforms were either modest or generously grandfathered. The more meaningful impact on spending was an across-the-board cut in pensions. But these cuts were partly reversed by the constitutional court, and are expected to be fully reversed by next year. As a result, the permanent adjustment to public spending remains mostly to be done.

5. Conditional success: structural reforms and the labor market?

In the World Economic Forum competitiveness index, Portugal improved from being ranked 46th to 36th between its 2010/11 report and its 2014/15 report. This was the result of many legal reforms that were part of the extensive adjustment program. The IMF (2015b) documents 494 different structural reform actions, about half in the public sector, and half in deregulation of product, labor, and financial markets. Whether any of it leads to higher economic growth is an open question.

One distinguishing feature of the Portuguese labor market is its dual nature (Centeno and Novo, 2012). On the one hand, many workers benefit from protected contracts that make layoffs expensive, contribute to low job creation and destruction, and encourage low labor productivity. On the other hand, as many as half of all workers are on term contracts and switch jobs often. These include the large majority of jobs created in this century and are mostly held by people younger than forty.

This duality helps to understand two features of the adjustment in the labor market. First, it partly explains why, unlike in other European labor markets, Portuguese unemployment has fallen quite rapidly so far. The seasonally adjusted unemployment rate at the end of 2014 was

13.6%, still above the value at the end of 2010 (12.2%), but it was down to 12.1% by July of 2015 after falling almost monotonically from its peak of 17.5% in January of 2013. One interpretation of this quick fall is that, at the margin, the Portuguese labor market is actually somewhat flexible. The marginal worker is in a term contract. Job creation and destruction are easy and the unemployment rate can adjust quickly to major shocks.

Second, this duality requires looking at the composition of employment to see whether churn in the labor market during the adjustment program affected the average worker and average productivity in the economy. Total employment fell from 4899 to 4500 thousand workers but, looking across sectors, agriculture plus construction account for two thirds of this reduction. Looking by education level, employment of workers with a primary school education or less declined by 861 thousand. That is, employment among those with secondary schooling or higher education actually *increased* during these four years of crisis, by 205 and 257 thousand, respectively.

Third, complementary to the previous two points, wages fell the most (8%) for those with higher education, while they only slightly fell (1%) for those with primary education or less. On aggregate, real unit labor costs fell by 6.2% during these four years, mostly due to a fall in real compensation (5.3%).

These numbers suggest structural changes in the Portuguese economy, and perhaps a reversal of the misallocation of resources that had plagued it in the past 15 years.

6. Conditional success: capital reallocation?

Common to the four crisis countries, adoption of the euro came with large capital inflows partly directed to nontradables sectors. As a result, the real exchange rate appreciated. Noticeably, the current account change was very large for the modest increase in relative goods' prices. The movements in the effective real exchange rate were mostly due to changes in the value of the euro vis-a-vis other currencies, but most of the capital flows happened within EU borders, towards non tradable sectors in the periphery and to less productive and more protected industries (Reis, 2013, and Dias et al, 2014).

A more appropriate diagnosis of competitiveness than the real exchange rate is the relative price of nontradables. Between 2010 and 2014, it fell by only 2.2%. At the same time, as noted already, exports and the tradable sector expanded considerably, and the current account surplus went from -10.1% to 0.6% of GDP. Much as in the years before the crisis, there was a significant reallocation across tradables and nontradables during the adjustment in spite of small changes in relative prices.

Looking for signs of an improved allocation of resources, it would be desirable to have estimates of productivity and markups. Neither are available with current data. But, looking at the much more imperfect measure of labor productivity, output per hour increased by 2.7% in the overall economy. More interestingly, Reis (2013) emphasized that two sectors, retail and wholesale trade and real estate activities, had a large increase in markups and stagnant productivity in 2000-07 and yet absorbed large amounts of the capital inflow. These two sectors had the largest increases in output per hour between 2010 and 2014, 8.5% in wholesale and retail trade, and 13.5% in real estate. This is consistent with misallocation and inefficiency before the crisis, and with an improvement during the adjustment program.

As is typical in Europe, the financial system is dominated by banks, and they are crucial in allocating capital across sectors. Since 2010, the shareholders of most banks in Portugal lost almost all of their investment, after several waves of recapitalization and resolution of one of the major 4 banks, and they were subject to the ECBs asset quality reviews as well as more intense regulation. The fall in total loans is more than fully accounted by the decline in loans to the construction sector, and the ratio of credit to deposits increased.

Yet, there are reasons to be wary of the state of the bank's finances. First, nonperforming loans have increased almost continuously, from about 6% to 18%. Rather than rising sharply at the start of the adjustment program, as banks and regulators revalued assets, this slow and prolonged acknowledgment of losses suggests that banks may have been rolling over bad loans. Second, and confirming this fear, corporate debt stayed almost unchanged at 122% of GDP. By comparison, in Spain during the same period, it fell by than 20% of GDP. The IMF (2015c) partly attributed this to the lack of legal reforms allowing for corporate bankruptcies and debt write downs.

7. Conclusions

It is difficult to call an adjustment process a success when the country in question has barely grown in 15 years and unemployment is 12.4%. Yet, the Portuguese economy has changed in many directions that seem promising. The misallocation of resources that plagued it seems to have reversed, as export sectors have grown, employment shifted to more educated workers, protection of local interests declined, and output per hour increased in the least productive sectors.

At the same time, it is easy to claim success when looking at the profile of stable and small payments that the Portuguese state has to make in the near term. Another debt crisis is unlikely. Yet, behind the low interest rates and longer maturities, public debt is 130% of GDP, austerity was far from being decisive and to generate large primary surpluses, and public spending will keep on rising given the lack of a reform of the pension system. Without a quiet restructuring of the debt to the European authorities over the next few year that lowers its market value without affecting its face value, there are reasons to be worried, and the Greek crisis of 2015 may have made this goal harder to reach.

In the long run, the definite tests of adjustment will be whether fast economic growth in the next few years is able to offset the stagnation of the last 15 years and whether public debt significantly falls. In the near term, as the recent Greek crisis illustrates, it is often politics that derails adjustment. In this regard, in the last four years the troika had in Portugal a very committed and cooperative government, and still they often had difficulty keeping popular support for the reforms. The troika insisted on changes in pensions that were repeatedly deemed unconstitutional, pushed for changes in the structure of payroll taxes that were very unpopular, and sent contradictory public messages on the need to adjust public finances. The elections in October of 2015 are not expected to lead to a dramatic reversal of the reforms so far, but there is uncertainty on whether what remains to be done will ever take place.

References

- Alexandre, Fernando, Bação, Pedro, Lains, Pedro, Martins, Manuel, Portela, Miguel, and Simões, Marta, 2014. *A Economia Portuguesa na União Europeia: 1986–2010*, Actual Editora.
- Bento, Vitor 2010. *O Nó Cego da Economia—Como Resolver o Principal Bloqueio do Crescimento Económico*. Bnomics.
- Blanchard, Olivier (2013). “Comment.” *Brookings Papers on Economic Activity*, 46, 194-197.

- Brunnermeier, Markus, Luis Garicano, Phillip R. Lane, Marco Pagano, Ricardo Reis, Tanos Santos, David Thesmar, Stijn van Nieuwerburgh, and Dimitri Vayanos (2011). "European Safe Bonds (Esbies)." www.euronomics.com.
- Brunnermeier, Markus and Ricardo Reis (2015). "A Crash Course on the Euro Crisis" Princeton University and Columbia University manuscript.
- Centeno, Mário, and Álvaro Novo (2012). "Segmentation." *Economic Bulletin and Financial Stability Report*, Bank of Portugal.
- Crosignani, Matteo, Miguel Faria-e-Castro and Luis Fonseca (2015). "Central Bank Interventions, Demand for Collateral, and Sovereign Borrowing Costs." NYU manuscript.
- European Commission (2014). "The Economic Adjustment Programme for Portugal 2011-14." *European Economy Occasional Papers 202*.
- Fagan, Gabriel and Vitor Gaspar (2007). "Adjusting to the Euro." *ECB Working Paper no. 716*.
- German Federal Ministry of Finance (2014). "Portugal exits IMF-EU programme / Finance Minister Schäuble welcomes decision." Available at <http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Europe/Articles/2014-06-12-portugal-exits-imf-eu-programme.html>.
- IMG (2015a). "Portugal: Concluding Statement of the 2015 Article IV Mission". Available at <https://www.imf.org/external/np/ms/2015/031715.htm>
- IMF (2015b) "Portugal: Selected Issues." *IMF Country Report No. 15/127*.
- IMF (2015c). "Portugal" *IMF Country Report No. 15/21*.
- Obstfeld, Maurice (2013). "Finance at Center Stage: Some Lessons of the Euro Crisis." UC Berkeley manuscript.
- Reis, Ricardo (2013). "The Portuguese Slump and Crash and the Euro Crisis." *Brookings Papers on Economic Activity*, 46, 143-193.
- Reis, Ricardo (2015). "Gerir a Dívida Pública." In *Afirmar o Futuro: Políticas Públicas para Portugal*, ed. by Paulo T. Pereira and Viriato S. Marques, Fundação Calouste Gulbenkian, 26-43.
- Shambaugh, Jay (2012). "The Euro's Three Crises." *Brookings Papers on Economic Activity*, 44, 157–211.