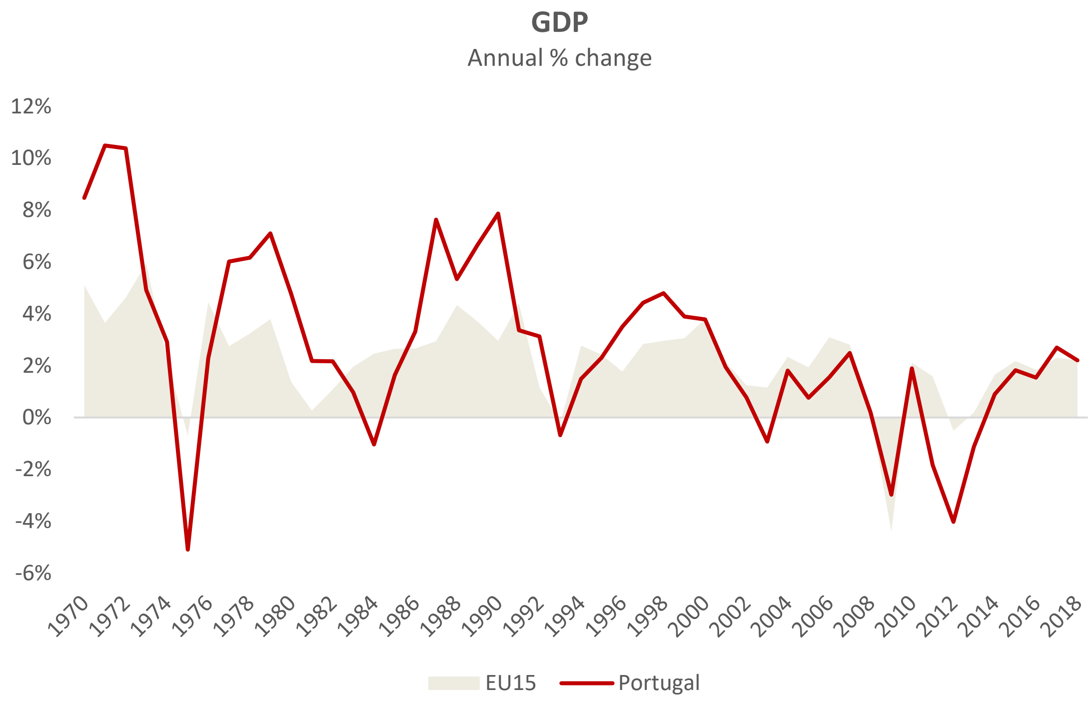
Support text

Parliamentary Hearing of the Superior Council at the Working Group for the Evaluation of Public and External Indebtedness of Portugal

Lisbon, 20 February 2018

PORTUGAL: SUSTAINABILITY PROBLEMS

Since the 1970's Portugal has shown a remarkable ability to recover from economic crises. Up to the end of the 1990's, each crisis phase was followed by a period of fast recovery, with growth rates exceeding those seen in the EU15 as a whole. However, in the noughties, that ability to recover waned, while macro-financial imbalances increased, making the economy more vulnerable to the impact of international crises.

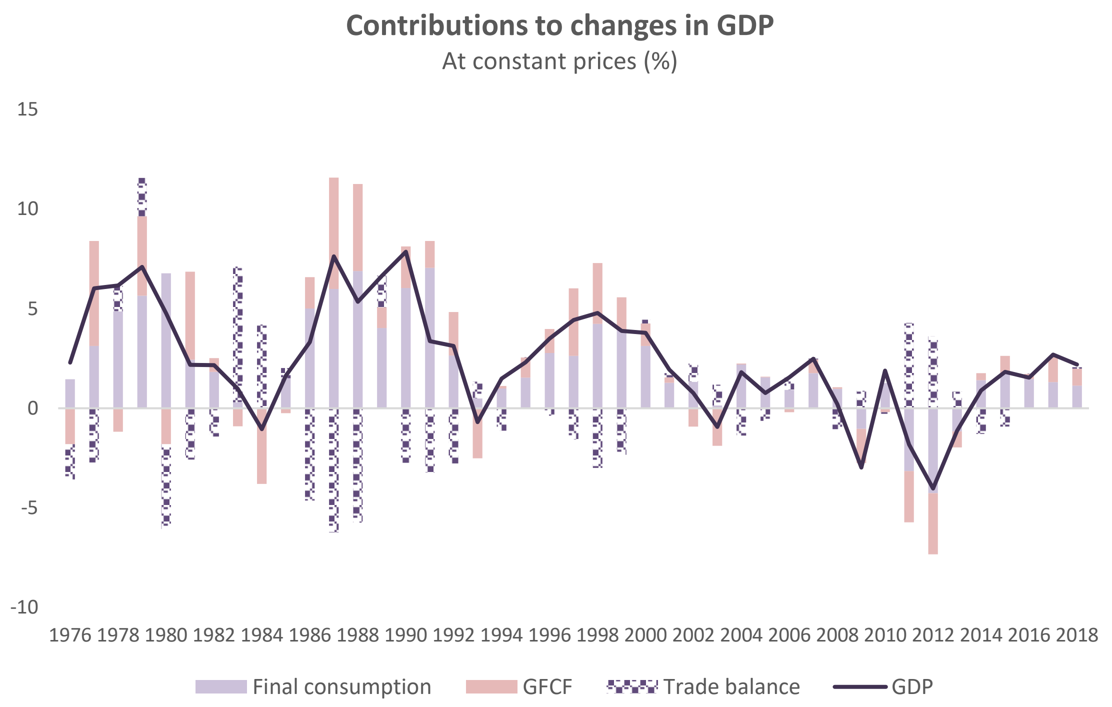


Source: Ameco

The correction of imbalances achieved in the aftermath of the latest crisis allowed confidence to be restored in the Portuguese economy's ability to return to an economically and financially sustainable path. As a consequence, the important goal of Portuguese public debt continuing to be viewed as sustainable by both the international institutions and the financial markets was achieved.

The analyses which sustain this conclusion are based in reasonable assumptions as to economic growth, interest rate levels and the primary balance to be maintained over a number of decades. The Portuguese economy is capable of achieving those goals, but to do so economic policies must consistently and comprehensively take their implications into account. Those policies must be based on an analysis of the way the economy developed up to the crisis, as well as taking into consideration the State's commitments and their implications for economic and financial sustainability, which is a prerequisite for social sustainability.

The developments seen in the Portuguese economy since the 1970's show that the cyclical recoveries have been driven by domestic demand, partially thwarted by the negative contribution of the external sector. However, during the crises – usually triggered by external developments – the economy's ability to stimulate domestic demand sufficiently to offset the external slowdown has been increasingly restricted by the indebtedness built up during the expansion phase. One reason behind this change was the weight of final consumption – private and public – as the main driver of the recoveries.



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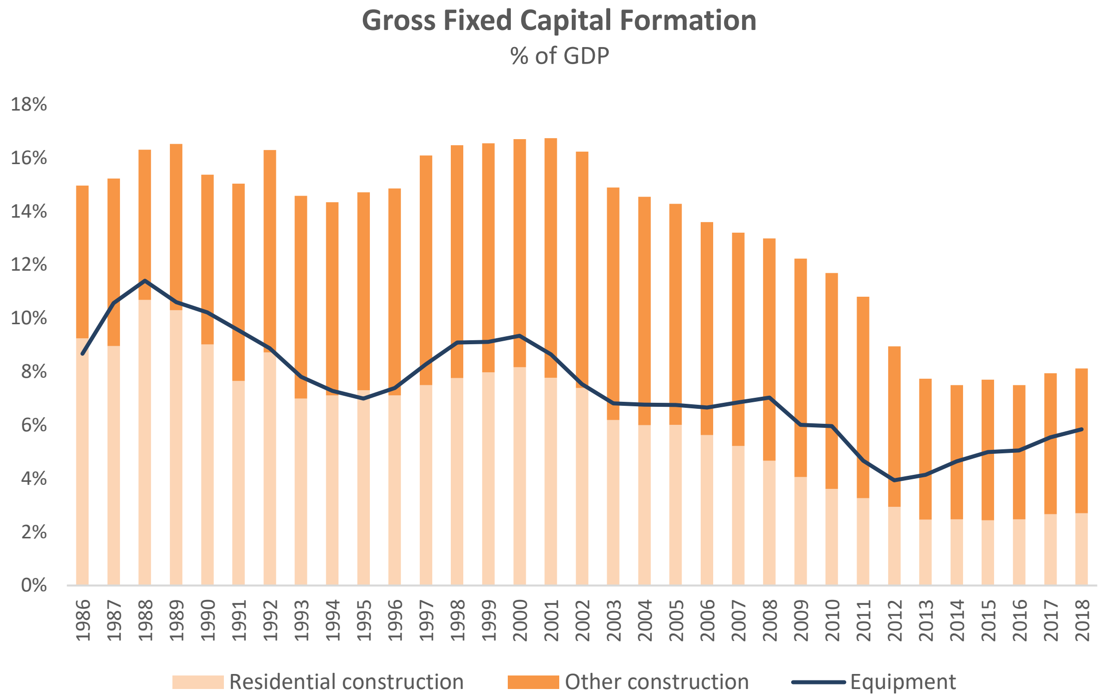
This resulted in investment being geared to satisfying domestic consumption rather than the external market, thus limiting its impact on the economy's potential growth. In fact, the small scale of the domestic market does not by itself attract investment increasingly dependent upon technological innovation and economies of scale.



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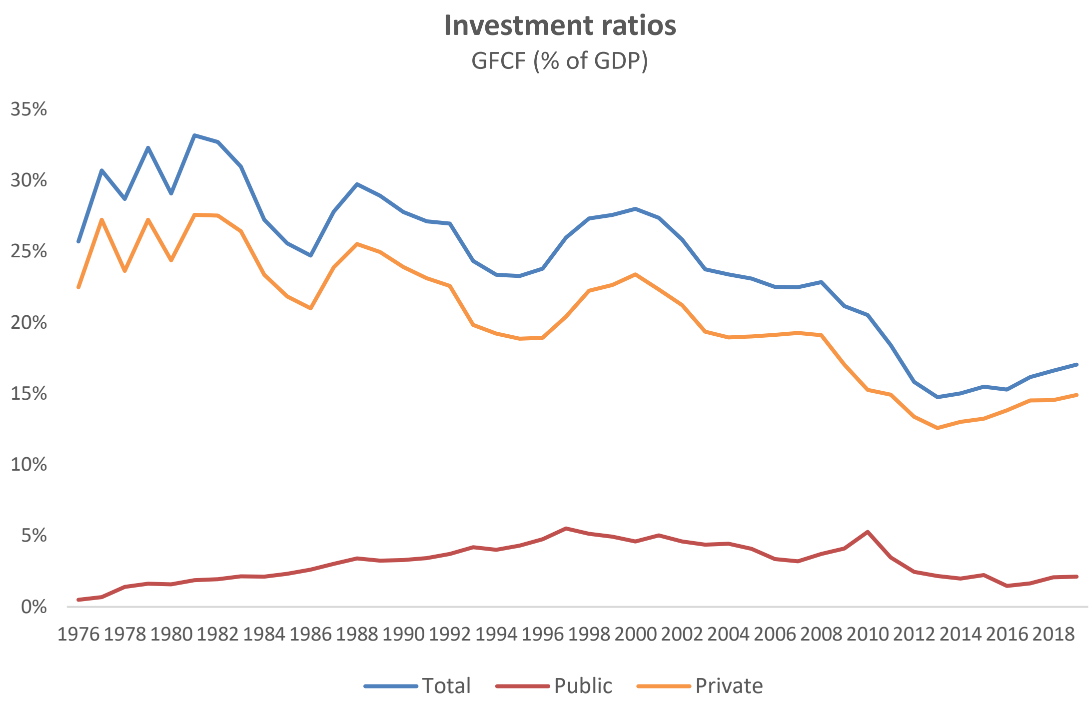
If we look at the history of investment first of all we note that construction prevails over equipment and, even during the period of heavy investment in infrastructure, residential construction carried considerable weight. These developments were justified by the country's previous shortcomings, the growing urbanization and, to a lesser extent, the rise in population. However, these were temporary phenomena which needed to be accompanied by a diversification in investment.

In fact, although new construction and maintenance are still businesses that have significant weight in the economy and in employment, the push they received up to the end of the 1990's would necessarily dwindle, a trend reinforced by the decline in the number of young people. Therefore, it is not surprising that investment ratios have tended to fall, especially in the case of private investment.



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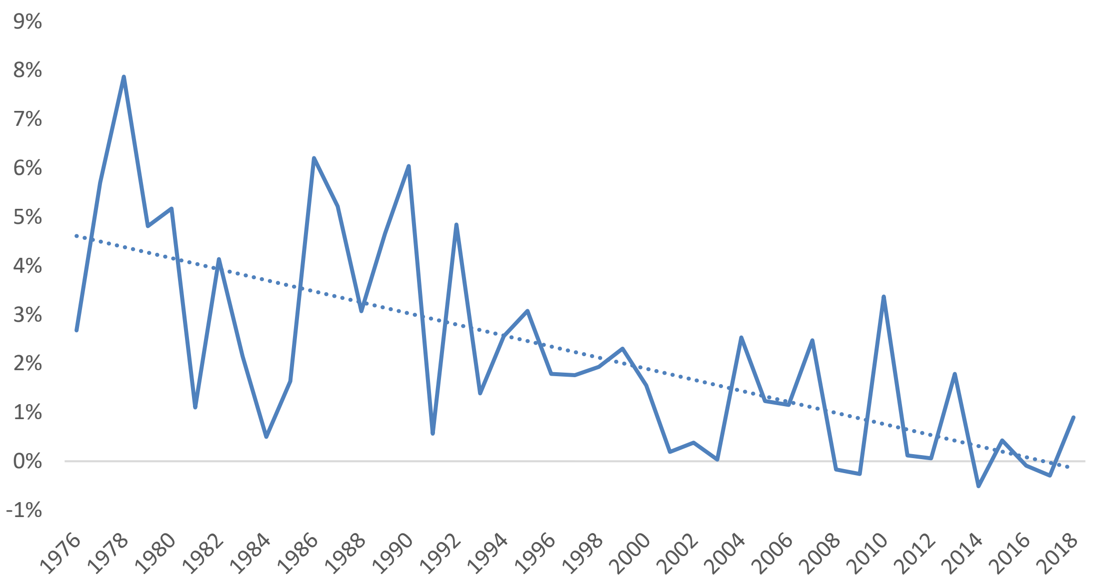
Nevertheless, mention must be made of some positive, correlated aspects in regard to the developments seen since the onset of the recent crisis. The first is the increasing weight of private investment and of investment in equipment from 2012/13 onwards. Although these developments benefitted (arithmetically) from the initial decline in the denominator, they are worthy of mention particularly because they coincided with a recession in domestic demand and serious financial difficulties. Secondly, the fact that the recovery was not accompanied by an increase in external debt, but rather was largely based on the favourable performance of exports, showing gains in competitiveness at a time when external demand was falling.

In the near future, once full employment is achieved, and the cyclical impact of the recovery is exhausted, economic growth will have to be based on two factors: the increase in the working population and/or improved productivity. In both cases the outlook raises concerns and is very demanding in regard to investment, on which productivity depends and which has to be directed at tradable goods and services.

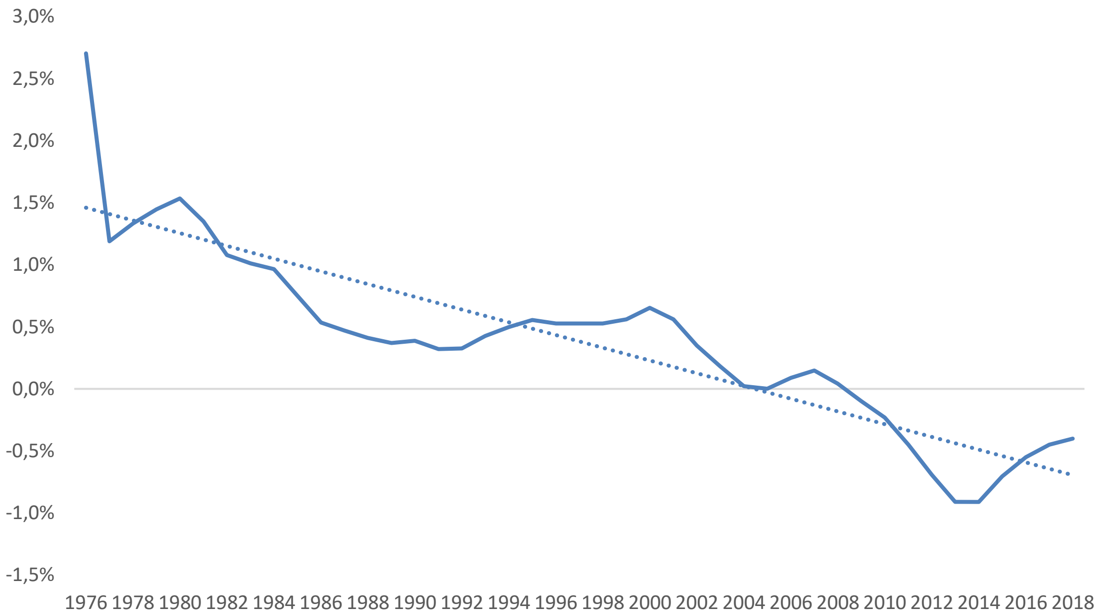
In recent decades, productivity has displayed a downward trend, a decline which accelerated after Portugal joined the EMU. The same is true of the working population which has even been falling for a decade.

GDP per person employed
Annual % change



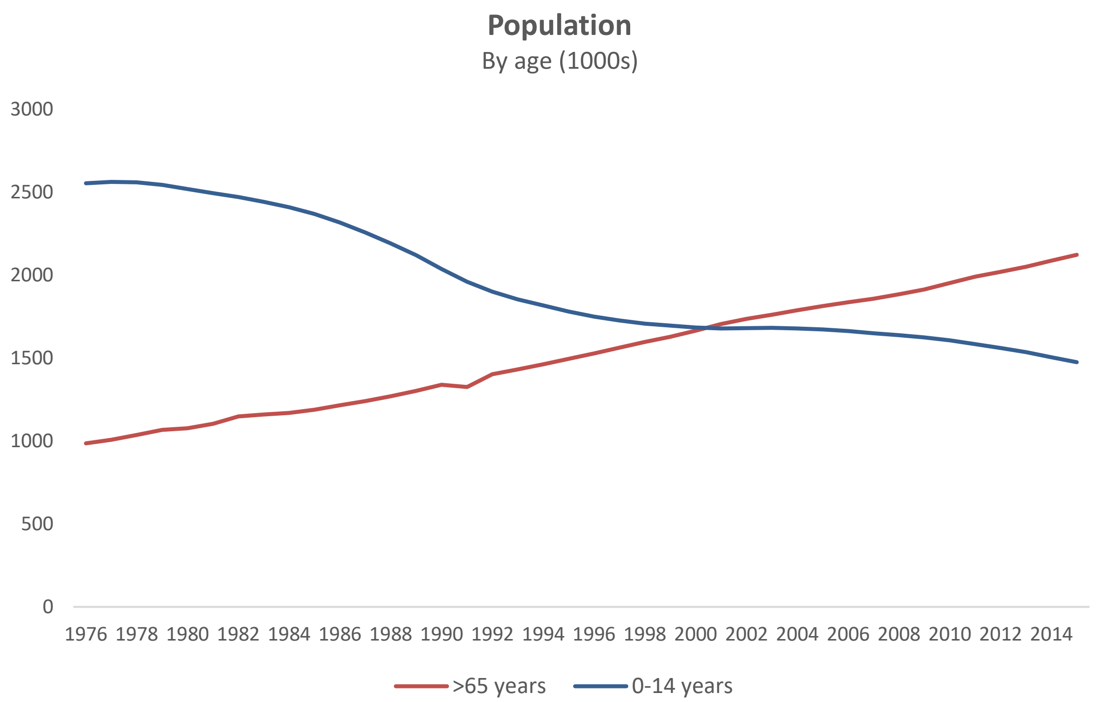
Source: Ameco

Population 15-64 years
Annual % changes



Source: Ameco

In addition to the decline in the working-age population, the demographic problem stems from the decrease in the number of people aged 0 to 14 (from 27% of the total population to 14% from 1976 to 2015) and the increase in the percentage of people aged 65 or more (from 10.5% to 20.5% over the same period).



Source: Ameco

The cyclical recovery is not yet over, and there is still some room for the additional rise in employment, while the favourable international climate is expected to continue. However, the first will come to an end just as quickly as the recovery strengthens, and even allowing for a favourable reversal of the migratory flow, it will be difficult to fill the void left by the change in the national demographics. Therefore, it is imperative to give priority to reversing the trends seen in productivity and in the population, because the ability to meet even modest economic growth targets is dependent on that reversal.

As past experience has shown, an increase in public expenditure does not solve these problems. In the short run it aids the cyclical recovery, but it diverts private investment towards activities that do not increase productivity and it ignores the demographics. Demographics, for their part, exert growing pressure on public expenditure, with a negative impact on the primary balance if nothing is done on the productivity side.

These are complex but not insurmountable problems. Over the years Portugal has strengthened important factors to attract investment capable of promoting improved productivity, such as the physical and human capital infrastructures. What is required now is to channel the efforts usually applied to solving short-term crises to dealing with root causes.