Event Transcript

Portugal: Gaining Credibility and Competitiveness

Vitor Gaspar, Minister of Finance of Portugal

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[Edited portion of transcript]

C. Fred Bergsten: Let me welcome all of you to the Institute today. As many of you know, we’ve been having a very active series of programs to look at both the Euro crisis as a whole, and individual pieces of the Euro crisis. We had then Finance Minister Venizelos from Greece, now Prime Minister, of course. Last summer, we recently had Mario Monti. And today, we have the Finance Minister of Portugal, also one of the major players, to put it mildly, in the European economic and financial situation to bring us a report on what is happening in Portugal.

Minister Gaspar spoke to a small group here at the institute last September after he’d been in office only three months. I invited him at that time to come and give a large public presentation of this type and he promised to do so when he had results. So now he has results and he has fulfilled his promise to come and tell us about them. I noted to him that his government has been in office exactly nine months. It therefore had a pregnancy of producing these results and about to deliver and he is here to do so.

Minister Vitor Gaspar is not only Finance Minister of Portugal, but one of the most distinguished economists in Europe and indeed the world and has had a series of extremely important and key posts throughout his career.

Just before he became minister, he was head of the Bureau of European Advisers at the European Commission, a key position in Brussels he had fulfilled for three years. He had earlier been Director General for Research at the European Central Bank going back to the creation of the ECB in 1998 and the start up of the Euro. So he was there at the start and knows the Euro system, the Euro regime, the whole Euro environment as well as anybody in any of the key governments in Europe at this time.

He had prepared for that job by being director of the Research Department at the Banco de Portugal itself and earlier had been director of economic studies at the Ministry of Finance in Lisbon. So his experience covers the gamut Finance Ministry, Central Banks, Portugal, Europe, and therefore comes to his current position with enormous preparation.

All through that time he has been professor of economics at the Catholic University in Lisbon. He did his Ph.D. at the Universidade Nova de Lisbon. He has published widely on a variety of monetary and economic topics throughout his career. So Minister Gaspar is a uniquely qualified person to be playing a central role in Portugal at this time. In turn, that’s of course crucial to how Europe as a whole and the Euro crisis is going to develop. And Mr. Minister, we thank you for bringing your baby to us today. Welcome.
Vítor Gaspar: Thank you, Fred, for your most kind words of introduction. What I intend to do is to make a short introduction, as short as I possibly can. I will certainly be shorter than 30 minutes so that we have ample time to interact. In my experience, it is the interactive part of a session like this that is most illuminating, so I ask you to participate as openly as you are willing to do.

So my topic today, as Fred has already announced, is Portugal, and I’m going to be focusing on a major aspect of the adjustment program that my country is going through which is the aspect of restoring credibility and confidence. I mentioned that at the beginning and then I will spend some time at the end going through how exactly one can expect credibility and confidence to accumulate during the course of the program.

The outline of my presentation today is very simple. First of all, I will make some remarks about what forces, what drivers determine the situation that Portugal found itself in just before the summer of last year and this reference to the difficult Portuguese case is an acknowledgement of a paper that Olivier Blanchard, now chief economist of the International Monetary Fund, published on Portugal if I’m not mistaken in 2007.

Then I will give you a characterization of the economic adjustment program of Portugal and follow immediately through the three pillars of the program; fiscal consolidation, deleveraging and financial stability, and structural transformation. And then I will conclude by examining with you how the adjustment program will work. How will it deliver the results we’re aiming at. So the first part of the presentation has to do with the diagnosis how did Portugal find itself in a difficult position.

Now, to be very simple, the participation in the Euro area for a country like Portugal meant that the country was able access financing at much better terms than it could previously. In that context, Portuguese households, Portuguese nonfinancial corporations, found that they could get access to credit at much better terms and that lead to a quite substantial increase in expenditure. Interestingly enough, most of these added expenditure was not directed towards investment; it was basically current expenditure. And in terms of composition of investment, it was mainly concentrated in nontradables and services.

So it did seem like the expansion of the opportunity set which was created by Euro area, led to a situation where the degree of openness in the country was actually reduced in which trade unions, employers, and the government were able to explore rents in sheltered sectors and that led to a political economic equilibrium which was certainly stable for a while but it was not conducive to innovation, it was not conducive to productivity growth, it was not conducive to sustainable employment creation.

So the situation during the more than ten years that were dominated by the dynamics of adjustment to the participation in the Euro area were characterized by strong macroeconomic imbalances, unsustainable public finances and excessive debt on the part of Portuguese households and on financial corporations. At the same time, the economy was characterized by very low growth. As a matter of fact during the years of the Euro area, the only member state of the Euro area that grew less than Portugal, on average, was Italy.

So the situation was clearly not bright when the global crisis started in 2007. But as it turned out, the trigger for the crisis in Portugal was the decision by the Portuguese
government in 2008 to expand the budget quite aggressively in response to the global crisis. That attempt at expansion did deliver positive results in the short run in terms of economic activity but obviously led to unsustainable levels of deficit and debt and eventually to a completely unsustainable position in bond markets that made a request of international assistance unavoidable. So this is the story that led to the need for adjustment program and I will move to the second part of the presentation. I told you all of these, so don’t worry.

Now, what does the adjustment program do? The adjustment program does address the main problems and imbalances that I’ve just told you about. The adjustment program covers the period from 2011 to mid-2014. It foresees the financial package of 78 billion euros, of which 12 billion are earmarked for banking sector recapitalization.

Very importantly to my mind, and it will play a role in the argument that I’m going to present to you, each disbursement depends on the outcome from regular quarterly missions that look into the progress made on the implementation of the adjustment program. Those regular quarterly assessment cover fulfillment of the quantitative limits of the program, the structural benchmarks of the program, and even a thorough examination of the measures foreseen by the memorandum of understanding.

The regular character of these examinations means that the program itself has a regular procedure allowing the country to put progress on record in a well documented and transparent way. The relevant material is available from the website of the European Commission or from the website of the IMF. And those websites are updated regularly.

The economic adjustment program protects the financing of general government in Portugal from the vagaries of financial markets and that allows time to proceed with an orderly adjustment of the macroeconomic imbalances while at the same time it affords us time to build confidence and credibility. So that is how it is supposed to work.

Something that I believe is worth doing for an audience such as this one is to look back at the situation in my country in May 2011 and to see what progress has been made during this period.

In the left inside column under main risks, you have five risks which were listed. I believe five main risks that were listed in a document by Standard & Poor’s published, I believe, on the 31st of May associated with an examination of the rating of the Portuguese Republic. Standard & Poor’s was considering that the main risks were weakening political support for the program, unfavorable macroeconomic developments, missing fiscal targets, uncertainty regarding the stability of the financial sector, and insufficient pace of structural reforms. Now, the point of this slide is to persuade you first of all that the situation in May 2011 was very uncertain, and to persuade you that according to all these elements, the situation is much less uncertain now.

The program, as you may know, was requested in April 2011. It was decided in May 2011. It was formally signed in May 2011. Portugal had elections on the 5th of June. So we benefit from the fact that it was a very open debate about the characteristics of the program and what the program would entail before the elections.

The three major Portuguese political parties subscribed to the program and ran a political campaign on that basis. They got 80 percent of the vote in the elections and they got 90
percent of the members of Parliament. There were two left wing parties with parliamentary representation that campaigned against the program and they got less than 20 percent of the vote and they got less than 10 percent of members of parliament. Perhaps even more important than that, the social support for the program has been holding strong throughout the period and in my reading of the information that we get from the polls, the social support for the program has been broadly constant over time.

Standard & Poor’s was fearing unfavorable macroeconomic development and what we see in this period is that in 2011 the recession was milder than expected. At the time of the program, a contraction of 2.2 percent was expected and the outturn according to the latest estimates is 1.6. The current account was corrected much faster than in the program. As a matter of fact, the current account deficit at the end of 2011 is already below what the program foresaw for the end of 2012. The main driver behind these developments has been the dynamism of exports which suggests that the Portuguese economy is able to adjust faster than experts thought at the time of the design of the program.

The fiscal targets were not missed, but I will speak about that a little bit later. The adjustment of the financial system has been very successful. Finally, one of the emblematic areas of the program, an area that the government emphasized a lot, is the area of structural reforms where the privatization process and the social agreement on a very broad and deep change in the labor market framework which was reached in the environment of social dialog are very important symbols.

So, along all these lines, we have quite substantial progress. I will jump the relatively favorable developments in treasury-bill markets because I’m sure that you will ask me about that.

Now, when we come to the delivery of results, one aspect which I believe is very important has to do with indeed the compliance with the fiscal limits in the program. The program envisaged a ceiling, a limit, of 5.9 percent of GDP for the budget deficit in 2011. The outturn was well below 5.9, it is something in the vicinity of 4 percent. But that was only possible because of the partial transfer of bank’s pension funds to the general government that one-off operation has an impact of about 3.5 percent of GDP.

So you could say, perhaps from a structural viewpoint we have a substantial slippage to explain. But indeed, what you see if you use the IMF’s fiscal monitor update which was published in January this year is that the structural adjustment in 2011 for Portugal was four percentage point of GDP and that stands out and that’s what the slide shows you when you compare with other Euro area member states and the average of the Euro area.

The adjustment in Portugal was three times as large as the average of the Euro area which shows that we not only fulfill the limit in the program but also were successful at a quite strong adjustment in the structural budget deficit despite the fact that we had a change in government in midyear that makes clearly the budgetary implementation more challenging.

This slide basically shows that in terms of headline number, Portugal is below the average of the Euro area, but it is less significant in the previous slide because indeed we have a very large one-off effect that other countries do not have.

Now, this is one of my favorite slides, and I beg your pardon for that. This uses not the debt sustainability analysis of the third review because that’s not in the public domain and
because I want to compare Portugal with other countries. So this is the debt sustainability analysis that the IMF made public in December 7, 2011. Another one is about to be made public which is actually more favorable than this one but I want to use this one for comparison’s sake.

So what you have here is if you compare the public debt to GDP ratio is supposed to peak at 118 according to this projection in 2013 and then it will fall by about 2 percentage points year after year until 2016 which is the last year of the projections.

Now, what you see here is if you compare the public debt to GDP ratio path for Portugal and for Greece, you’ll see that the path for Portugal is uniformly below that of Greece. As a matter of fact, it’s below the level of 120 percent of GDP which was fixed as an indication of sustainability for the Greek case by 2020.

Now, also interestingly the orange line is Italy and, again, Portugal is always below the line for Italy. But perhaps the most interesting aspect of this slide is that there is almost a coincidence between the debt path as a percentage of GDP for Portugal and Ireland which in a sense illustrates the fact that both countries are found, according to this analysis, to have a sustainable debt position.

We will jump over this slide just to show you that indeed according to the latest numbers, the debt sustainability analysis of Portugal is more favorable than there. The results on the budgetary side are not only based on expenditure cuts made under immediate pressure. On the contrary, we have a very deep change in the rules and procedures that apply to the public sector so we have a structural change process going on in the general government that will lead to sustainable better results as time goes by.

On deleveraging and financial stability, I will not use slides because I want to save time. On deleveraging and financial stability, what is going on is a process of adjustment which is operating faster than foreseen in the program. Portuguese banks are at this point in time much better capitalized than they were at the beginning of the program and they have been able to deleverage in a relatively fast way by selling non-core assets and by attracting additional bank deposits.

If you compare Portugal with other program countries, Greece and Ireland, one of the features that Portugal has which is different from the other two countries, is that bank deposits have been increasing throughout the period. As a matter of fact, bank deposits in Portugal have increased more than in the average of the Euro area. So deleveraging and financial stability are progressing in accordance with the program. These issues were discussed in detail during the third review of the adjustment program. So there’s a lot more to be said. But in the benefit of time I will move on.

Structural transformation. I don’t want, to, again, spend much time discussing structural transformation because I really want to have a dialog with you. There are two issues that I have to cover. And the first one is that structural reform is really central to this program. As I indicated in the diagnosis part of my presentation, Portugal during the easy years of the Euro indulged in a situation where it tolerated deviations from competition and allowed rents to accumulate in sheltered sectors; non-tradable sectors. So markups in product and labor markets are quite considerable in Portugal.
Studies by the OECD and by the Euro system suggests that bringing those markups to average levels in reference economies would lead Portugal to have a benefit in terms of level of potential GDP of about 10 percent after 10 years. If you look at the chart on the slide, you’ll see that Portugal stands very close to Italy. So on this particular metric, Portugal and Italy are very close together. The impacts on growth after 10 years are quite sizable. We can expect significant impacts over the medium term and the medium term can be considered a period ranging from three to five years. And about half the effect can materialize over this medium term.

Now, the debt sustainability analysis that I showed to you is performed assuming that there is no change whatsoever in the potential output growth path. Since the case for substantial impacts on growth from structural reform is actually, at least to my mind, very persuasive, that’s a very important element of robustness in the program because indeed with this type of effects, adjustment will be faster and the debt to GDP ratio for example will be coming down faster than in the program.

Now, this aspect having to do with this reduction of markups in labor markets and product markets, have to do with labor market reform that I already mentioned to you but also with a systematic approach to the reduction of rents in the Portuguese economy and progress has already been made in areas like pharmaceuticals, like telecommunications, and we are going to be making further efforts to reduce rents for example in the energy sector.

The other aspect that I cannot fail to mention is the privatization program. We have already sold the participations of the government in EDP, that’s an energy-producing company, and REN, that’s a company that does electricity and natural gas distribution. So it’s a network. The revenues that we were able to gain through these operations are considerable by Portuguese standards and they constitute already 60 percent of the total amount of revenue from privatization which was foreseen for the whole period of the program.

I should probably say to you that the main actor in the privatization program is Maria Luis Albuquerque who is sitting there, and the most knowledgeable man about the structural reform agenda is Carlos Moedas who is also sitting there, so in case I need help for the question part I have excellent support. And so with your permission, I conclude. This is my last slide. How will this work? How can you be reasonably confident that the strategy will actually function as predicted?

First element is that for Portugal and for the Portuguese, the adjustment is regarded as unavoidable. And so the consensus on the need for adjustment is a very important asset and this consensus explains the broad popular and social support for adjustment which has been constant over time.

Secondly, as I already tried to argue, the program addresses the fundamental imbalances and deficiencies that led Portugal to the crisis. Therefore the adjustment program is the adjustment program of Portugal. It’s something that we regard as solving our main problems and challenges and therefore we have a very strong sense of ownership of the program. The program allows us to eliminate the budget deficit on a lasting basis and that change is supported by deep structural changes in the fiscal policy framework, part of those changes explained by changes at the European level including the fiscal compact.
We will have a situation in which the external deficit, the current account deficit, will be eliminated and in two or three years time we expect the current account to be in a position of surplus.

Finally, we want to implement the agenda of structural transformation as fast as we possibly can because we believe that that potential output and competitiveness and therefore it's the basis for employment creation and it turns out to be a fact that unemployment is the most acute problem that we're facing at the moment.

The program is—this is the third element—is robust. And it is robust because the favorable impact from structural reform on potential output and on the speed of adjustment are not taken into account while the evidence that we have from adjustment in 2011 suggests that the Portuguese economy actually adjusts much faster than one envisaged originally in the program.

Finally and most important, the program allows for a gradual buildup of credibility. The program shelters government financing from the vagaries of financial markets. The program allows us to be out of one markets until 2013. The program includes quantitative objectives and targets that are steered and monitored in the regular reviews of the program. And before the crucial date of September 2013, we'll have a total number of nine reviews and success on a quarterly basis nine times in a row will be compatible with quite a substantial increase in credibility and confidence and more generally compliance with the program and success in adjustment will change gradually markets expectations and perceptions and therefore will allow us to manage our path back to the bond market at close to normal market financing conditions in time for September 2013.

I'm at your disposal for questions and comments, whatever you may want to contribute. Thank you very much.

[Unedited portion of transcript]

Question and Answer Session

C. Fred Bergsten: So Mr. Minister, thank you very much for a very comprehensive picture of where Portugal is going. Let me start out by asking you to go a little deeper on a couple of the key timing issues.

The markets are notoriously impatient and more so than we economists would usually like, so talk a little more about two things; One is the return to growth. You mentioned Portugal's poor growth record over the past decade or so. You mentioned the medium term outlook for restoring growth.

But let me ask, if you could be more precise, when you think positive growth might return and is there a level of growth or a rate of growth that you think might be feasible for Portugal as it returns to a positive growth picture.
And then just picking up on your last point; talk a little more about your assessment of Portugal's ability to return to the private capital markets. You mentioned the key date of September 13. You might elaborate a bit on why that is so important and how you see the path from now till then, which is really the next 18 months, as your country resumes its access to the private capital markets in order to fulfill a basic objective of the overall program.

Vítor Gaspar: Many things. I’ve listed three questions instead of two because I would split your first on growth in two different aspects. The first aspect that I would comment on is: when is the program assuming a business cycle upswing to take place?

According to the program as it stands now, according to our best evaluation, we are in a position where the Portuguese economy is contracting as we speak and the pace of contraction is close to the strongest that is foreseen in the program. From this quarter onward, the pace of contraction will ease. During the course of this year, the quarterly growth rate will become flat and then the program envisage positive growth for next year already, so 2013.

Now, the way the program has looked at the business cycle recovery is in complete conventional terms, that is one does have a sharp recession which is caused by the contraction of internal demand. During that period, resources are transferred from the non-tradable goods sector to the tradables. As time goes by the tradables goods sector starts reaching capacity constraints that will put them under pressure to expand capacity in order to be able to profit from the markets that are opening, which these experts have been gaining market shares throughout, so that’s going to be the main driver of the recovery.

But what we are talking about in this particular mechanism is the simple business cycle driven classic recovery. It’s completely conventional, which is why I separated your question about potential growth.

In terms of the program, that effect as I tried to convey in my presentation, is not taken into account at all. We do not have a very good grasp of the impacts from structural reform in the short term, much less in the very short term. I believe it’s fair to say that we simply do not know.

Research conducted at OECD and Euro system suggest that from a long term perspective, their very sizable effects indicates that Portugal in excess of 10% in the level of GDP and according to studies of the dynamics of adjustment, more than half of that effect—sorry—about half of that effect can materialize after three to five years.

Now, if that’s the case, if that materializes according to that kind of scenario, what’s going to happen is that structural reform is going to help the recovery of the country being strong and will speed up the adjustment process. So that’s the concept.

In terms of return of the bond markets, you said that the markets are impatient. But fortunately, from our viewpoint, one of the benefits from the program is that market impatience does not affect the cost of financing for the country.

The country is effectively sheltered from bond market yields because the yields that you see in say Bloomberg or Reuter screens are secondary market bond yields which are not paid by the Portuguese government. Therefore they do not affect the sustainability of the debt path of Portugal contrary to what some academic researchers did claim.
So from that viewpoint, the program affords us time to manage this transition. In terms of how it may affect perceptions and expectations, I’ve tried to outline the mechanism in my presentation.

What we are doing right now in terms of debt management is the following: The program only envisaged that Portugal would be issuing treasury bills at a three-month maturity. So it was like a very residual presence in markets. What we have done already is issue treasury bills for six months and for twelve months.

And if you look at the path of interest rates with the cover ratios, participation of non-resident organizations in the auctions, all those indicators have moved quite favorably since the start of the year; that is interest rates are coming down [inaudible 00:07:02] are going up, the share of nonresident bank and organizational options have increased.

We intend to continue that process issuing treasury bills with a maturity of 18 months relatively soon. We don’t have yet the very detailed blueprint of our path back to markets before September 2013, but I can guarantee that they are working very hard at it.

C. Fred Bergsten: Okay. Let me ask you to elaborate on one piece of that that you’ve now mentioned twice: that exports have been doing very well. That seems to run counter to at least one strand of thought, which says that, “Portugal is not very competitive, needs a big internal devaluation.”

Comment on that a little more. How much comfort do you take from the export expansion? How much of it is within Europe? How much of it is to more rapidly growing markets around the world more broadly? What does that say about the underlying competitiveness of the economy?

Vítor Gaspar: That’s a complex question. Obviously, it’s good news. The fact that the turnaround in external position of Portugal is proceeding faster than envisaged in the program does suggest that the room for flexibility in the Portuguese economy is stronger.

It is also clear that a relatively deep restructuring of Portuguese external trade is taking place and that applies both when you look at the geographic composition of exports and you do see that the share of Intra-European Union at 15 has fallen significantly and other areas of the world, including the area represented by the Portuguese speaking countries, has been expanding relatively fast as has exports to Asia, which were not importing traditionally, have expanded fast.

Something that you also see is that, for example, when you make categories of products on the basis of technological content, the share of low technology content products, which used to be dominant and some years ago was about 50% of our trade, has come down quite significantly and the latest number I have available points to 37.5, and the expansion has been mostly in the medium low and medium high products.

And if you would look at, say, specific products or categories of products, one of the things that one of my professors at university used to say is that, “Portugal was not a banana republic. Portugal was a pajama republic,” because the exports were based on textiles. But according to my data, in 1995, textiles constituted 23% of Portuguese exports. In 2010, they constituted only 10%. So clearly, there is a relatively strong change in the composition of Portuguese exports and some of the structural changes are surprising.
For example, one of the most successful sectors in terms of Portuguese exports is footwear. In footwear, Portugal has been gaining market share and competitiveness quite substantially. Another sector that has been doing very well is paper exports—pulp wood and paper export. But if you look at the structure of Portuguese exports, it’s quite diversified.

Still, that doesn’t mean that there is no issue of competitiveness. Clearly there is an issue of competitiveness at this point in time. Part of the adjustment is taking place because internal demand is falling, which means that the relative price of non-tradables is adjusting. But in real time, it’s very hard to know whether that’s sufficient or not. And when it comes to competitiveness and the sustainability of the external position, it’s very important to be cautious and not to claim success before the time.

C. Fred Bergsten: Let me shift to a related topic: the neighborhood effects, what’s going on elsewhere in Europe as it affects Portugal. You’ve obviously been affected by what goes on in European economy as a whole, but also in some of the other debted countries, particularly the program countries.

So let me ask you specifically about the recent major events in Greece: the restructuring of its debt, the continuation of its program which after much debate is now continuing, though still lots of questions raised about it. How do all those recent developments in Greece affect your situation in Portugal? What pros, what cons, what’s the spillover effect to you from what’s going on at the other end of the continent?

Vítor Gaspar: I will give you the short general answer. If you’re not satisfied, we can discuss whatever details you would like to discuss. Now, first of all, the operation involving private sector involvement for Greece was a successful operation from the viewpoint of the voluntary participation of private sector creditors in the operation. The operation beat the expectations.

So the recent events were good news and the expectation is that that will continue quite substantially to stabilize the situation in Greece. And in accordance with the last computations performed by the IMF and our partner organizations, the operation does contribute quite decisively to restoring the sustainability of the Greek debt position.

From the viewpoint of my country, the aspect which I would like to stress is that the Greek PSI has always been regarded by Euro group as a unique initiative. So it’s something which is not to be repeated.

From that viewpoint, in Europe, it is always the case that when one is communicating about developments in the Euro area and refers to developments in Greece, one typically adds that the Euro group regards favorably the progress that the other program countries, Ireland and Portugal, are making in fulfilling their program and that in that context of continued compliance with the terms and conditions of the program that the Euro area stands ready to provide any additional support that may be required in order to manage a smooth return to bond market financing on the part of program countries in accordance with the program schedule.

C. Fred Bergsten: What about the recent developments in Italy? We had Prime Minister Monti here a month ago. I think the general view is that Italy’s situation is looking up in terms of its prospects for adjustment, early recovery, indeed even structural reforms. If that’s correct, does that lift confidence in general in the Euro in a way that will be significantly helpful to you?

Vítor Gaspar: Absolutely. So one of the expressions that we use in the context of macroeconomic dialog in Europe is that economic policy is a matter of common concern. And in the context of the
discussions that we have around Euro area governance and changes to Euro area governance that have been recently decided, that aspect of interaction is very much emphasized. From that viewpoint, success in structural reform, success in gaining credibility by a large European economy like Italy is absolutely fundamental.

C. Fred Bergsten: Let me ask one more question and then we'll open it up. I suspect most of the remaining discussion will be on Portugal but I don't want to miss the opportunity to ask you a broader question about how you see the evolution of the Euro zone as a whole over the medium to longer run.

As I mentioned in my introduction, you've been deeply involved at the ECB in the creation of the Euro itself. I could've mentioned that you represented your government during the negotiation of the Maastricht Treaty going all the way back to the origin. So you're one of the architects of the whole Euro zone and been involved in it from the start.

As you've now experienced the crisis and foresee at least the beginnings of a path out of that, what is all this going to mean for the Euro, the Euro zone, the European community as a whole? Are we going to see over time movement to a fiscal union, to economic governance institutions, toward a more complete economic as well as monetary union in Europe?

Where is all this going and do the crisis events significantly accelerate the process in a positive direction or by contrast are they going to make it more difficult to continue the forward movement of Europe?

Vítor Gaspar: I'm optimistic about the prospects for Europe and let me try to explain why. About two years ago we listed a number of challenges, a number of weaknesses that had been revealed by the crisis. That was a very ambitious list and people at technical level and politicians have been working very hard on that quite comprehensive agenda that includes fiscal discipline, macroeconomic coordination, changes in the architecture for financial regulation and supervision, also crisis management.

If you look at that agenda, you see that almost all elements are now in place or have been agreed and the only substantive decision that is remaining, if my memory serves me right, has to do with the firewall. And as you may know, the decision on the capacity of the ESM joint with the FSF is going to be discussed by the Euro group meeting in Copenhagen at the end of the month, which means that the architecture is then complete.

Assuming, as I assume, that the new architecture is going to prove effective, then that means that the Euro area will progress in a much sounder basis because one of the weaknesses that was there from the beginning, which was its ability to prevent and manage crisis, will have been much strengthened.

At a more general level, you ask whether the crisis foster progress in European integration or hinders it. I have no doubt that it fosters it because if you look at the number of vocations where cross-country spillovers where of crucial importance during the course of this crisis, there is no doubt whatsoever in my mind that the relevance of effective collective action at European level has become much stronger and much easier to recognize. So I look forward to see deeper and better European integration.

C. Fred Bergsten: Okay. Let's open it up for questions and comments from the floor. I would ask you to go either to the standing mic in the back or speak into the traveling mic that will be brought
around. Please announce yourself, your name, and where you're from, and then we will put the questions through the minister.

I see two hands from my colleagues at the Institute. I'm just waiting to see if there's anybody else. Three from my colleagues at the Institute. Surely someone else must have questions, so I prefer to go to others. So there's one in the back and then I'll go to my colleagues. Please.

Alessandro Pio: Alessandro Pio from the Asian Development Bank. I think many of the reforms we have heard are essentially supply side reforms. But given that the recovery is still a bit fragile, especially we expect it for all of this year, isn't there some scope for some support to demand, and given the delicate fiscal situation of most of the countries affected, is there a scope for some European Union intervention in supporting demand?

We hear a lot about public-private partnership investment and infrastructure, is there scope for something like a Euro growth bonds backed by the European Union and by some of the common revenues that could give some support to demand at a time when the recovery is still delicate?

Vitor Gaspar: Thank you very much for your question. It's a difficult question because it includes comments on supply, demand, the national response at the level of Portugal and the response at the European level. So, many aspects to cover. I will do my best.

Starting with my country: if you look at Portugal, one of the striking aspects is that Portugal did have excess demand for a long period of time. Clearly, you could even argue that Portugal had consistently excess aggregate demand during the whole of the period that characterized the Euro area during the last ten years or so.

The remarkable fact is that did not create growth. GDP growth was very mediocre throughout the period, which means that clearly growth of demand is not a sufficient condition for GDP growth; certainly not for sustainable growth.

More recently, in a context which was already of a crisis, the Portuguese government decided again to expand aggregate demand, this time based on a very ancient argument that since the economy was shrinking, it was necessary to offset that impact and smooth the impact of the crisis on economic activity.

Now that, as a matter of fact, from a very short-term perspective did work. The recession in Portugal was at that time milder than elsewhere, but I've tried to argue that it proved self-defeating from the medium term perspective because that was precisely the trigger that led to the crisis.

Now, at this point in time, when it comes to my country, if one would try to support economic activity through demand, one would have exactly that problem. We simply do not have the fiscal space or the credibility that would allow us to play that game. That indicates that Portugal would be counterproductive and self-defeating.

One could argue whether in some other areas of Europe one would have fiscal space to have a more active business cycle smoothing-type of action. But there I find it ironic that it is typically the authorities from countries that do not have that fiscal space that claim others do while the ones that are supposed to have fiscal space think that either they do not have such fiscal space or that would not be wise to use it. It suggests that there is some bias in the stability which I find intriguing.
Now, when it comes to initiatives at the European level, you may know that the last European council was a very positive European council because it's the first in my recent recollection that was not devoted to crisis management; it was devoted to growth. And in that context, there are a number of initiatives that indeed will be taken at the level of each member state and at the level of the European Union in order to try to improve the prospects for growth from a medium to long term perspective.

I think it would be too long to look at some of the technical details around some of those initiatives, although some may be interesting from the viewpoint of bringing forward the process of European integration and I believe very much in the line of what you seem to favor in your comment.

Ian Talley: Ian Talley, Dow Jones. I’m wondering, Ireland, after Greece got a better loan rate said that it should get a better rate as well. I’m wondering if Portugal desires a similar rate reduction. And you’ve discussed all of the merits of the program and how Portugal is succeeding, but I’m wondering where you see perhaps risks arising that would create financing gaps.

Vítor Gaspar: Okay. Now, interest rates are not mostly driven by desires, so what I would desire interest rates to be is something that I don’t think is worth commenting on. The interest rates that I regard as crucial in this context are market interest rates and the decisive aspect is to be able to regain access to market financing at close to normal levels well in advance of September 2013.

Now, in order to do so, it seems clear to me that Portugal has to fulfill its program in a timely way. So it has to deliver the quantitative limits and the structural benchmarks of the program and it has to do so in time in order to build the credibility and confidence that is necessary for this transition to be successful.

You ask about risks and specifically risks that may create financing gaps. I’m afraid that here I can only give you a very general answer and I will explain why I will only give you a very general answer.

The point that one must recognize from the outset is that when you're in a crisis the conduct of policy is risk management. So the question that you raised about risks is the key central questions, a very legitimate question. Risks are very relevant in a situation like the one we are discussing.

If we were in a situation where nothing could go wrong, it would not be a crisis. On the other hand, if we were in a situation where it would go wrong for sure, it would not be a crisis either. It would be a catastrophe. So that basically means that in a crisis, policymaking is risk management.

That being said, a policymaker and I’m a policymaker, cannot possibly discuss potential scenarios at risk in a structured way because in terms of communication one is never able to convey the difference between conditional statement and commitment. So one can only discuss how to tackle a specific risk once it materializes in a very specific and complete context. So one should never discuss those things ahead of time.

But something which is very important is that we are not alone in this. As Fred was saying, some of the risks that we face are risks which are beyond our control. But there, we benefit from the solidarity of our European partners that have repeatedly claimed that they stand ready to support
the country in case it continues to fulfill its obligations in the program and faces difficulties in the management of the transition back to market financial. I hope I didn't disappoint you too much.

C. Fred Bergsten: Now I'll turn to my colleagues. Bill Cline.

Bill Cline: Mr. Minister, I suspect a lot of us think that the big unanswered question here is: why the ten-year risk spread for Portugal is still at 1,100 basis points more or less. Greece seems to be down at something like 550. Italy has backed off to something like 350. You can tell stories about how the downgrading took Portugal out of the portfolios of a lot of the index funds etcetera, but it seems like there's an incredible disconnect between the sustainability graphs that showed Portugal in a more favorable position than Italy and identical position to Ireland. And I may have said Greece before. I meant Ireland.

Query; what is your diagnosis of why there is such a lag between … let me push a little bit further and say that maybe this complete assurance by the public sector has got a downside because it means more and more the debt is taken over by the publics and then at some point when the crisis does arise, the haircut on the privates is extreme; maybe that's another way to look at this. But I'd be interested in your diagnosis. That's the first part of my question.

The second part of my question: are you going to take advantage of this and start buying that debt back if you have some positive surprises on the fiscal side? Because it seems like a good opportunity to do so.

Vítor Gaspar: Okay. Very good and relevant questions. The issue of the disconnect between fundamentals and market perception is something which is not specific to the Portuguese bond market. As a matter of fact, I was looking, in a very relaxed way, to a number of books about financial markets and I came across titles like Popular Delusions and the Madness of Crowds, Maniacs, Panics and Crisis, Irrational Exuberance, and many others.

When we were in the late ’80s preparing the path to the Euro area, there was a very influential paper written by Alexander [inaudible 00:35:37] that main meaning was that it was not possible to rely solely on market discipline because market discipline was too slow and weak in normal times and too sudden and disruptive under stress circumstances.

So very clearly the possibility of lasting and enduring departures from fundamentals on the part of markets and market participants is very well documented and relevant to this question.

In the specifics of this case, it turns out that turnover in this market is very close to zero. You have basically no trades. If you have basically no trades, you have a quoted price which is backed by basically no transactions. It's not a very representative price and I don't think it's a price that will offer much resistance to change once there will be some dynamics, some pressure pushing it in some other direction.

That leads to your second question on public debt management. And there I'm afraid I cannot give you a very specific answer for the following reason. What we are doing is just very slow transition to longer maturities in the treasury bill market. We are working on a concept of asset and liability management that may involve market action. But since we don't have that strategy fully worked out now, I cannot give you any specific answer to your second question. But of course if you have specific ideas that you would like to suggest, I am most interested in [inaudible 00:37:41] with you.
C. Fred Bergsten: Question up here. Please identify.

György Szapary: György Szapary, Ambassador of Hungary. I have a question on privatization. And I would like to mention the mistakes we made in Hungary in privatizing public services. And I wonder—I'm sure you are aware of it—but I wonder how you had solved it.

I noticed that you are planning to privatize or you have already privatized water distribution, gas distribution, and electricity distribution. This is where state monopolies in Hungary—and I presume there are state monopolies in Portugal—what we have done is we have privatized the monopolies.

In other words, we handed over the monopoly to the private sector. Even though we tried to divide the county by regions and we gave it to different private companies, the water distribution, gas distribution, electricity company, but in that particular region they have a monopoly.

So as a result, we have the highest water, gas and electricity price and one of the highest in Europe; higher than in Germany and probably higher than in Portugal. So how do you solve this problem? Have you thought about it? And if yes, how do you plan to solve it?

Vítor Gaspar: Thanks, György, for your questions. What we have privatized up to now is only the government’s stake in EDP. That’s the electricity producing company. And that one company is operating in a competitive market and the degree of competition in this market is going to increase over time. The market is going to be increasingly liberalized and prices of energy are going to be determined in markets.

At this point in time, the degree of integration in the Iberian energy market is already quite significant and my own personal guess is that the degree of integration at European level is also going to increase, as you know, across country interconnections are going to develop gradually over time. And according to some projections there will be a deficit of electricity in Central Europe. And in that context, it’s normal to expect competition in this market to develop. EDP is by far the largest company that is covered by this process and so for EDP your argument applies only in a limited way.

REN, on the contrary, is the network company that deals with the distribution of electricity and natural gas to it’s definitely a natural monopoly. And the issue of controlling monopoly power in the network of distribution of electricity and natural gas is something that we tackled through regulation.

The reinforcement of the independence of the regulators of the various sectors is something which is in the pipeline and in Portugal is actually central to the program.

Now, apart from that, what we’re going to do in the area of the water companies is probably to use not a pure model of privatization but one in which there will be a concession of the management of the water supply management to a private company, but not a privatization, which of course means that the means of controlling what’s going on are stronger.

Finally, the next steps in the privatization program have to do with the privatization of the airport concession and our airline, our flag airline company TAP and obviously TAP is very much under international competition and the same applies to national airports. Thanks, George.
C. Fred Bergsten: John Williamson.

John Williamson: John Williamson at the Institute. When Bill Kline was asked to comment first, I wondered whether he was going to ask his own questions as me because it arises out of this work that he and I did together last fall.

The point is that in Portugal the big disequilibrium isn’t in the fiscal accounts, it’s in the bounds of payments accounts. The fiscal accounts, I think, they look pretty good. As you showed in your [inaudible 00:43:13] before, the average fiscal deficit is actually above that in Portugal. The average fiscal deficit in the European community and moreover Portugal achieved a bigger than average reduction last year. So if that aspect is quite good, what is more problematic is the bounds of payments.

And here, there are two statistics that you quoted. First of all you quoted the improved statistics if I may say so. You mentioned that there had been a big increase in exports last year and you said a projection, you suggested that there would be no current account deficit in three or four years’ time.

I’d like to know what the basis of that … first of all, what the improvement in export last year was, how big it was. And secondly, what is the basis for the prognostication on the bounds of payments in three or four years’ time?

I think there are several alternatives, a possibility that if Portugal’s income is slower than world income, the possibility of a big gain in competitiveness. Although I’d note that fiscal devaluation, that’s to say a revenue for change, a cut in the payroll tax financed by an increase in the financial tax, that seems to drop off the agenda and it wasn’t mentioned by you today in the way that it was nine months ago.

Thirdly, it’s possible that you just extrapolate the increase or forth is it possible that you rely on faith as so often has happened in the past.

Vitor Gaspar: Okay. So, one step at a time. The explanation that you give—I don’t remember the number—that is based on probably was your explanation number one, the relative growth of demand in Portugal and in the rest of the Euro area and the rest of the world plays a very important role.

As a matter of fact, if you look at the period in which Portugal was losing competitiveness, what you do see is that you can explain most of it through the positive difference between growth of domestic demand in Portugal at the time and growth of demand elsewhere.

So what we have now is a process which is operating in reverse. So we are regaining competitiveness and we are rebalancing our external account through a negative differential between domestic demand and demand in the rest of the world.

The point that I’m making here, which is slightly different from the way you presented it, is that I’m linking the two. When you do have this differential between growth of demand domestically and abroad, you’ll have necessarily a adjustment in relative prices and that is something that you get in any standard general equilibrium model.
The mechanism which is probably most known here is the mechanism that you have in the paper by [inaudible 0:45:52] about the US external imbalance. But the argument is completely general.

You say that the fiscal situation is relatively good, the bounds of payment is more problematic. I would be slightly more balanced than you were comparing one and the other because this is not the first program that the country has sponsored by the IMF.

This is, as a matter of fact, the third program since 1974. There was a program in ’77/’78 and another in ’83/’84. And in the two first IMF-sponsored programs for Portugal, the Portuguese private sector adjusted always very rapidly. And one common feature of the programs is that the Portuguese general government didn’t. We could go into the details why that is so.

Now, if you look at the evidence for this particular process of adjustment, you see, first of all, that in 2008/2009 the Portuguese private sector was adjusting extremely strongly and fast, and the reason why there was not a strong macroeconomic adjustment is because the government has chosen to offset the adjustment of the private sector. And if you look at the results for 2011, the ones that I was describing, again, the surprising positive results reached come from the adjustment of the private sector, not the public sector.

So I would definitely not take public sector success in adjusting for granted. That’s the main feature of my job description. I’m supposed to make that happen. And you must believe me that that’s not easy. And when it comes to the adjustment of the private sector, the evidence that we have thus far seemed reasonably successful.

You asked me about the growth of exports in 2011. They are about 7%. You asked me about the current account deficit in 2011. It was still very high at 6%. But it came down from almost 10% so it went down from ten to six thereabouts, round numbers. I’m exaggerating but not much.

But the thing is that the program envisaged an adjustment from ten to nine, so no doubt whatsoever. The magnitude of adjustment is much stronger than we envisaged in the program and the magnitude of the adjustment is actually quite sizable.

We don’t envisage in the program a correction of the current account deficit in three or four years. It’s more like two to three years. So indeed, at this point in time, we believe that the Portuguese private sector will again be able to adjust relatively fast.

C. Fred Bergsten: Mr. Minister, there’s a lot more questions, but unfortunately we’re at our witching hour of two o’clock and we try to always let people go on time. I know you have further appointments.

Thank you very much for joining us. Thank you for the progress … I was going to say thank you for the progress report. More importantly, thank you for the progress and we look forward to the next installment when you have an even better story to tell. Thank you very much. Thanks to all.