Rolf Strauch in interview with Jornal de Negocios (Portugal)

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28/06/2017
Interviews
Lisbon, Portugal

Interview with Rolf Strauch, ESM Chief Economist
Published in *Jornal de Negocios* (Portugal), 28 June 2017

Interviewer: Rui Peres Jorge

Jornal de Negocios: As creditor, do you think rating agencies are too negative regarding the risk attributed to the Portuguese debt?

Rolf Strauch: Recently there has been recognition of Portugal’s good economic and fiscal performance. However, it is clear that the Portuguese debt is still relatively high. We are monitoring this closely as well. In a monetary union, there are two ways of addressing this: follow a prudent fiscal path and work on growth. In our view, this is what Portugal should do: it should use the existing strong economic environment to create market confidence and fiscal space.

How relevant is the growth performance since the second half of last year?

The Portuguese success falls in line with what we see for Ireland or Spain. Recent developments since mid-2016 are driven by exports, and this is also the consequence of earlier gains obtained in competitiveness. The pick-up in consumption and investment is part of a cyclical development that was certainly also brought about by measures that the government has taken that stimulate demand. It is important to make sure that this is sustainable, and that is why it is so important to continue reforms to improve productivity.

So, the income strategy is working, as long as it is not seen as the only growth strategy?

The government has raised labour income through minimum wages and also in the public sector. That has a positive impact from a social perspective and on demand, namely through a confidence channel, but in order to be sustainable, it should not lead to a loss of competitiveness. That requires improvement in productivity.

Have you identified a loss of competitiveness in Portugal?

Unit labour costs have increased over the last quarters, and there has been a small reversal in the effective exchange rate compared to previous periods. So the government needs to monitor the situation closely.

In the EU's Country Specific Recommendations to Portugal, there is a warning regarding possible negative impacts of minimum wage increases on employment of the less skilled, but not on competitiveness…

The recommendation is to keep an eye on the minimum wage policies, not to push low skilled labour out of the market, and that is very much in line with what I was saying. When you raise minimum wages, there is a risk that this will worsen the employment opportunities of low skilled labour, which is not as productive as high skilled labour.

The government has to be careful, but is it not taking too much of a risk with these policies?

For this to work in the long run, you need productivity growth in order to keep competitiveness.

We have been hearing that the good performance of Portugal is a result of the reforms in the troika years. Do you think this is the main point?

The reform efforts made during the EFSF programme were very important and have put Portugal on the right track. You need to balance the economy in order to benefit from confidence effects. And there were also reforms that improved competitiveness. The effect on export performance often becomes evident over time. However, we also have to take into account that the Eurozone as a whole shows a strong growth momentum, which is of course very supportive.

Exports were growing and already performing well before the adjustment programme. It is difficult to make a statement that current export performance relates mainly to the reforms, or not?

The measures to improve technology and stimulate exports prior to the crisis were well taken and helped export performance. But on top of that, you have clear price competitiveness effects obtained during the adjustment period, pushing export growth further up.

Despite the reforms in the troika years, projections for potential growth have not been revised upwards in Portugal. Why?

For me the question is less about the precise figure for potential growth, which is difficult to measure. More important is the trend that we are seeing: currently growth performance is strengthening and unemployment is falling. That is in part a result of the rebalancing and the reforms made during the programme period. The structural efforts which started there should be carried forward.

To my knowledge, we have not had proper analytical work to support statements about the impact of reforms in Portugal and in other programme countries, have we?

Certainly more academic analysis is needed on the impact of these reforms. This comes often with some delay. But from our perspective when looking at the experience across all programme countries, the general notion that structural reforms only kick in after a long delay of time does not seem to be right. This can work much faster when you look, for example, at the growth performance of Ireland or Spain. Growth came back strongly with swift implementation of reforms and full ownership of the programme once the economy rebalanced.

The ESM has published recently an evaluation report of the adjustment programs. What have you learned from the Portuguese experience?

The key purpose of the evaluation report of Ms Gertrude Tumpel-Gugerell, the independent evaluator, is to draw lessons to inform future programmes. It is a forward-looking exercise. I would like to highlight three key takeaways. One is that we need proper financial planning and to cater for contingencies. We've learned, and this also relates to Portugal, that a cash buffer to facilitate market access after the programme is important. Another key finding is the need to set realistic and clear objectives, also in order to improve ownership. Some objectives are important to regain market access. But there are policy reforms that may take longer than what you can usually achieve within an adjustment program. Therefore, it is important to keep the reform momentum after the programme and avoid reversals. The third element is the need to have a timely comprehensive strategy to deal with the financial sector. In Spain, non-performing loans (NPL) started declining six quarters after the programme was launched, in Cyprus and Ireland it started 8 to 10 quarters later; in Portugal the NPL ratio is stabilising only recently.

After 20 quarters… How do you explain that in the Portuguese programme, the financial sector was not considered a major challenge from the beginning?

It is not fair to say the financial sector was not considered relevant or a major problem in the programme for Portugal. The magnitude of the problem in Ireland or Spain was bigger, but the Portuguese programme earmarked €12 billion to repair the financial sector. So existing difficulties were acknowledged, and then the evolution of NPL over the programme made it more evident.

Would you say that the financial sector was less important than the labour law? Because changes in labour laws were made during the first six months along with fiscal measures. This seems bit puzzling or not?

In Portugal back in 2011 there was clearly a problem of public finances and competiveness that had to be addressed. It was critical to act very quickly in these areas to reverse the negative and unsustainable vulnerabilities and reverse the imbalances of the Portuguese economy.

What should be the reform priorities for Portugal?

Portugal should follow and implement the Country Specific Recommendations agreed at EU level. This is true for all EU countries. Growth in Portugal was fairly weak even before the crisis compared to other countries. Therefore it is important

that Portugal keeps up with the reform track it created in order to ensure a continued pay-off.
I think priority should be given to reform measures that enhance productivity since this is the key to restoring competitiveness in a currency union.

How do you improve productivity?

You need to improve the business environment, and foster productive investment that pushes technological developments and you need to set proper education policies to raise the skillset in the economy. There are concrete steps you can take in order to have more investment. In the case of Portugal, it means certainly to deal with non-performing loans, and improve the situation of the banking sector. This will facilitate bank financing for strong, competitive SMEs and productivity growth. Efficient insolvency procedure, the improvement in the judicial system, and shorter trial periods will allow to better handle the NPL problem and improve the business environment.

That was tried during the adjustment program and has not worked. What is needed to deal with NPL? The Portuguese government needs a more forceful strategy? The European institutions ought to establish clear guidelines?

Here all relevant entities should work together to find an effective solution – in Portugal and elsewhere. First of all, it is a responsibility of the banks: they need to actively work on their portfolio of bad assets. Secondly, the government needs to create the right environment: that relates to the platform for NPL trading that is being proposed and to the work on insolvency procedures. Thirdly, the SSM is setting targets for banks to reduce their NPL exposure. Action on all three levels will help to accelerate the process of NPL reduction in Portugal.

How flexible should the government be in using fiscal windfalls from growth?

The government has managed to cut the deficit from 4.4% in 2015 to 2% in 2016. Correspondingly, the European Commission has abrogated the Excessive Deficit Procedure. This is a significant achievement for which we commend the government. Now Portugal should comply with the requirements under the preventive arm of the European fiscal framework. This means the Portuguese government should embark on a fiscal path towards a small structural surplus of 0.3% of GDP. The current strong economic environment should be conducive to creating fiscal space and market confidence. Portugal’s high level of debt requires a prudent fiscal path and further efforts to foster long-term growth in order to continuously lower the debt. Lower debt serves the Portuguese people because it lowers borrowing costs and therefore saves taxpayers money and it puts less burden on future generations.

If Portugal reduces the structural deficit, but not by the 0.6% as requested by the European Commission, is this still prudent?

Portugal needs to move towards achieving the medium-term objective and keep in line with the European fiscal framework. It is generally up to the European Commission to assess the adjustment needs and monitor them.

Recently, there have been two reports in Portugal discussing debt sustainability. The ESM said that lower interest rates for Portugal are not possible. But an extension of maturities and deferral of interest are feasible, or not?

I see no need to stage a discussion about debt restructuring for Portugal. In fact, one must be aware that staging such discussion risks creating less market confidence. We took notice the minister of finance does not subscribe to those reports. The government is actually already taking positive steps to improve debt sustainability. We welcomed the Portuguese effort to smoothen its repayment profile and to lower its financing costs by repaying earlier to the IMF. This will send a positive signal to markets.
Additionally, let’s not forget that our loans are contributing to debt sustainability because they provide long maturities – with an average maturity of 20.8 years – at very low costs, below 2% at this stage: this means an additional fiscal space for Portugal of €1.3 billion only in 2016. This benefit is expected to happen every year until the loan is repaid. Our rates reflect our funding costs so we cannot go below those because that would imply fiscal transfers.

The extension of maturities and interest rate deferral are possible?

Such a discussion is not on the table and as I said, I do not find it necessary because Portugal does not need it.

Another report points to the possibility of having the ESM buying bonds held by the

ECB, and then refinancing it at a lower interest rate. Should this be discussed?

We can only help a country under a financial assistance programme if necessary to safeguard the financial stability of the euro area and its Member States. We cannot go out and buy the bonds which the ECB has purchased of a country. There is absolutely no need to move in this direction and have such a discussion now.

Portugal has high gross financing needs in the next years, between 15% and 20% of GDP. How dangerous is that?

Portuguese gross financing needs are manageable over the coming years. The benchmark that is set for other advanced economies with regular market access in IMF literature is around 20% of GDP. Portuguese refinancing needs stay below that level over the coming years also due to the repayment profile of the EFSF loans. Portugal has to make its first amortisation payment only in 2025.

The ECB's QE tapering and its impact on interest rates is the biggest threat for the management of the Portuguese public debt?

The ECB is running this monetary policy for the euro area as a whole with the view of managing inflation and in line with their mandate.

But it does have an impact on the economy. As a creditor, is that a problem?

It not up to me to comment on the monetary policy of the ECB. I think the best Portugal can do at this juncture is to use the current positive environment to create fiscal space and run a prudent fiscal policy.

Portugal would be able to support interest rates of 5% on its 10 year-debt?

You know that not only interest rates matter, but also growth and the budget balance. Last year financial markets became concerned about Portuguese debt, which was reflected in increasing risk premia. That has rightly dissipated, also on the background of positive growth and fiscal developments. At the same time, there is no reassurance that market perception could not change in the future, depending on interest rates, but also on expectations about growth and the fiscal path. That is why it is important to strengthen the economy and keep fiscal discipline.

In the last years, we have seen many changes in the Eurozone governance: the Macroeconomic Imbalances Procedure, new fiscal rules, Banking Union. Of all of this, what is more urgent to be put to work more efficiently…

The euro area institutional infrastructure is now much stronger than before the crisis, and that needs to be acknowledged. Given the experience we are now gaining with this new setup, it is worth considering whether the fiscal framework has become too complex and therefore difficult to communicate, which might have consequences for its credibility and effectiveness. There is scope for carefully considering simplifying fiscal rules in order to make them more effective. A second element is Banking Union. The European banking sector has been made much safer through different measures since the start of the crisis. Then Banking Union was a final quantum leap to create a common European banking market. Currently, one element to be completed is the common backstop to the Single Resolution Fund (SRF). This will help to strengthen its financial credibility. In the medium term, on should also consider a common European deposit insurance scheme. But this can only happen after legacies of the crisis have been dealt with.

The new Eurogroup agreement on Greece aims at a 2% primary surplus for 37 years in a row. Do you think that is feasible?

Greece has already made a great adjustment effort, and there is a good basis for moving forward. For the time period after the adjustment programme, one needs to expect that Greece complies with the European fiscal framework. That is the context of what was agreed by the Eurogroup recently.

When you have economists saying it is very unlike that any country manages to deliver that kind of surplus for so many years, isn't that damaging to the credibility of the policies?

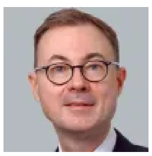
Everyone has subscribed, including the Greek government, to the Eurogroup statement which is based on the commitment of Greece to comply with the fiscal framework. In addition, the Eurogroup confirms last year's agreement that it will decide on further debt measures if needed at the end of the financial assistance programme. And in the long run, the Eurogroup may even consider further measures in case an unexpectedly adverse development happens. So there are various safeguards here that make sure the Greek situation is and will remain manageable.

Author

Rolf Strauch

Chief Economist and Management Board Member

Contacts

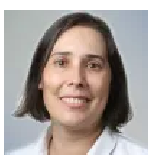


Cédric Crelo

Head of Communications and Chief Spokesperson

+352 260 962 205

c.crelo@esm.europa.eu

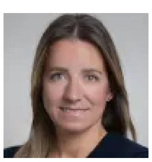


Anabela Reis

Deputy Head of Communications and Deputy Chief Spokesperson

+352 260 962 551

a.reis@esm.europa.eu



Juliana Dahl

Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu