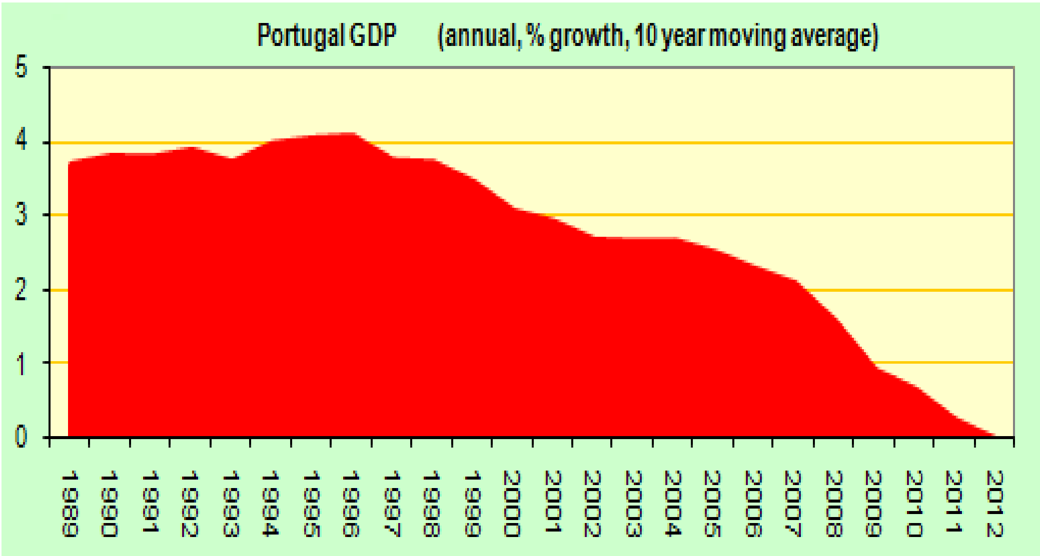
Portugal’s Looming Social and Demographic Crisis

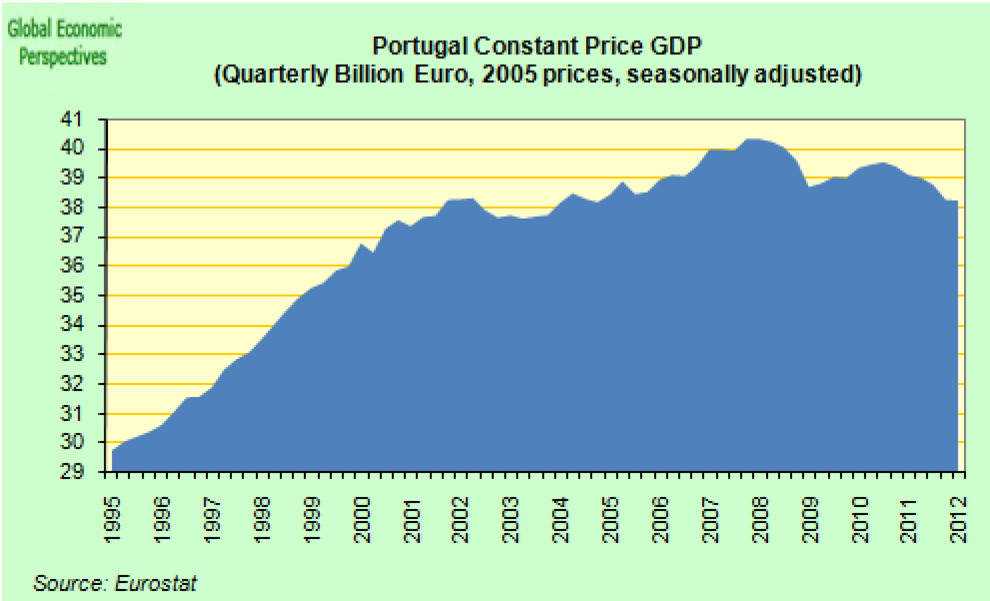
Edward Hugh - Brussels: June 2012

Here’s The Problem



Over the past ten years the Portuguese economy has been virtually stationery. The problem is not, note, simply a Euro one, since the decline started in the mid 1990s, and has never been reversed.

Here's another way of looking at the same issue. Portuguese GDP rose rapidly in the 1990s, and then much more slowly in the first decade of the 21st century.



Structural reforms undertaken as part of the bailout programme may help a little, but there is clear something more going on here than simply a small, temporary loss of growth dynamic. Could it be that as populations get older growth gets slower, or even turns negative?

In this presentation I will argue that

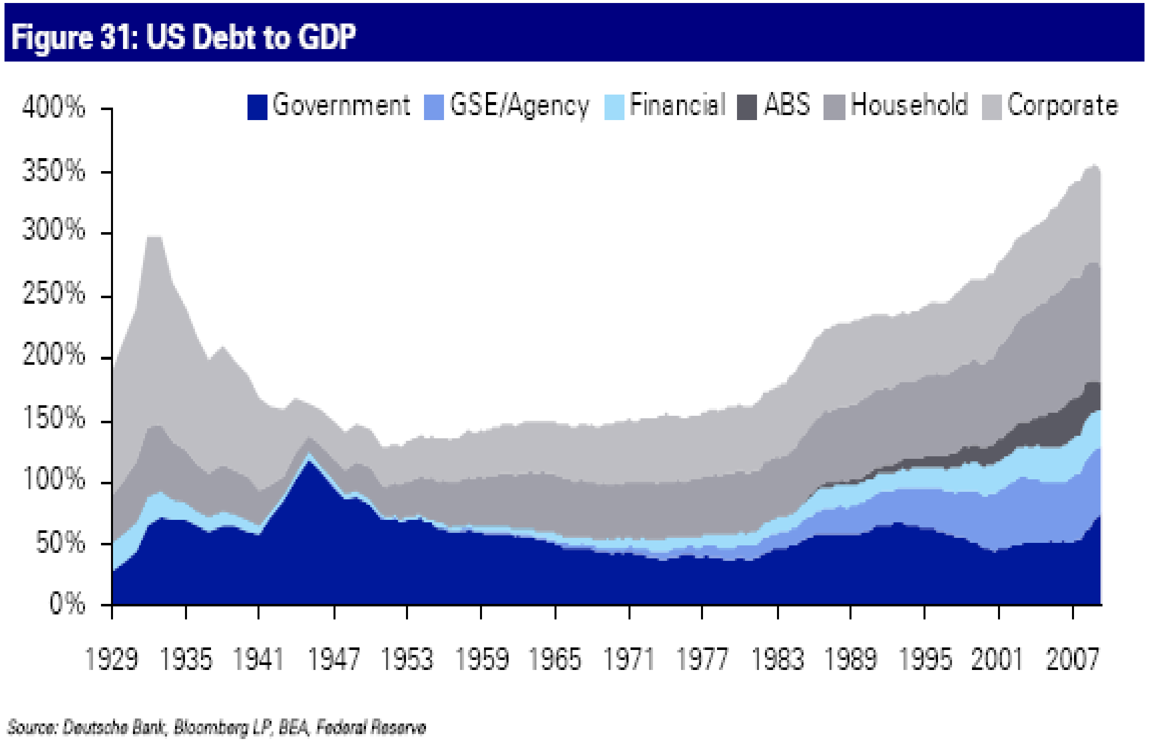
- The most recent crisis was not an arbitrary phenomenon
- There is an underlying process we need to understand
- Europe’s debt crisis is now entering a decisive phase.
- Unresolved issues will leave a legacy. One which could weigh down any recovery and lead to more serious problems in the future.

In particular:

a) The Existence of a Debt Overhang

b) The Impact of Ageing and Declining Populations

So What Was The Global Crisis All About?



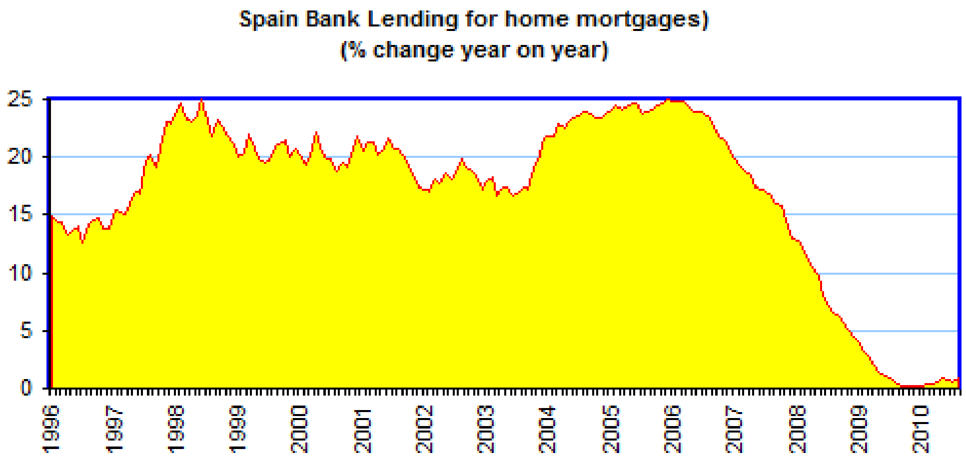
It was all about debt, and about how heavily indebted societies were going to be able to claw their way back to growth.

The Key Points To Grasp – This Process Is Structural, Not Cyclical, and it is a Developed Economy Crisis, Not Simply A Euro One

So Just Why Was There So Much Debt?

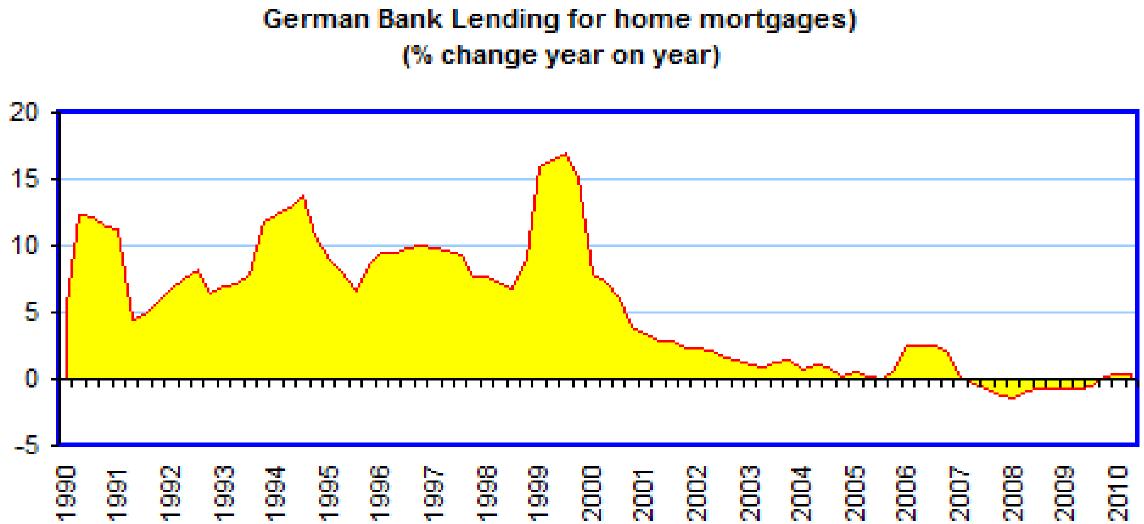
- Badly Structured Financial Products?
- Poor Regulation?
- Or Was There Something Else Going On?

Case Study: The Eurozone



Source:Bank of Spain

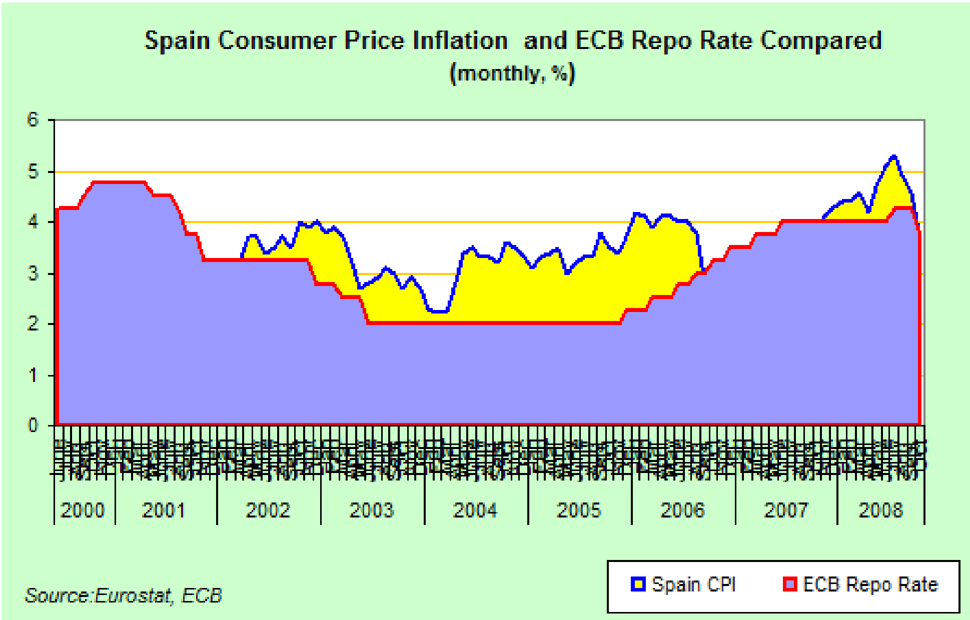
Here is a key part of the puzzle. During the first 10 years of the Euro some European countries borrowed heavily, while others lent. As a result Spain's households contracted a lot of debt. Yet German households didn't.



Source:Bundesbank

Why this difference?

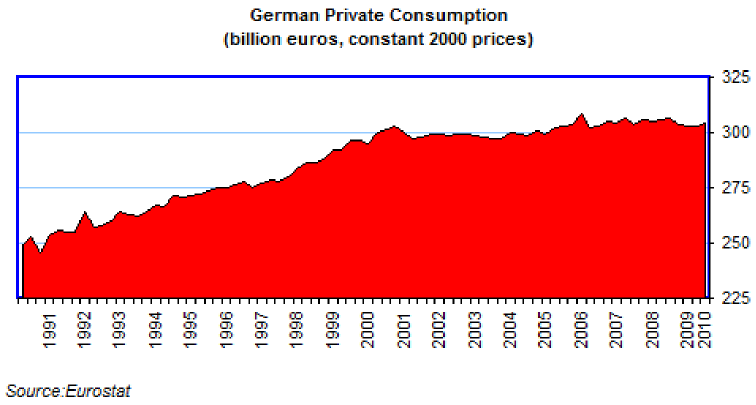
One Conventional Account



The "one size fits all" monetary policy didn't work. Spain had negative interest rates during the key years of the housing boom.

But that still leaves us with a question: why didn't it work?

Credit Driven Private Consumption Booms

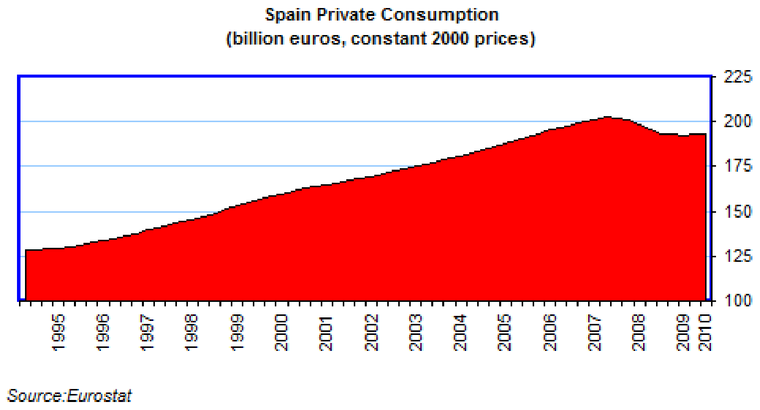


Why do some countries have these while others don't?

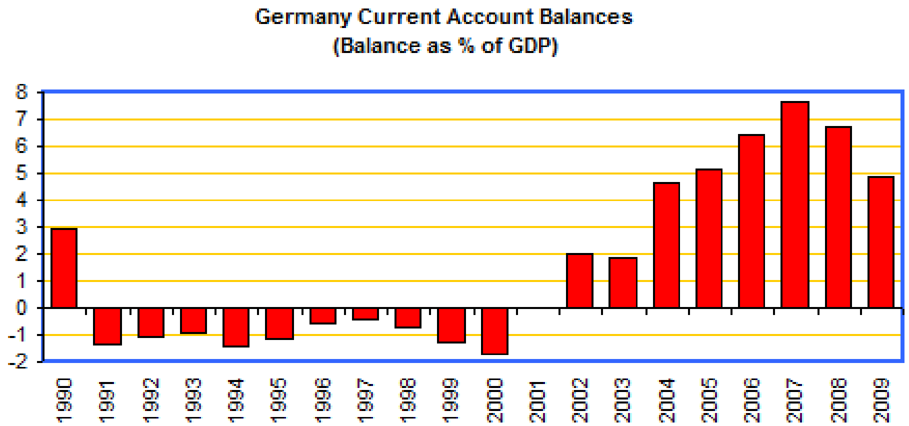
In fact both Spain and Germany have had these.

The only real difference is in the Timing.

Germany 1992 – 1999
Spain 2000 - 2008



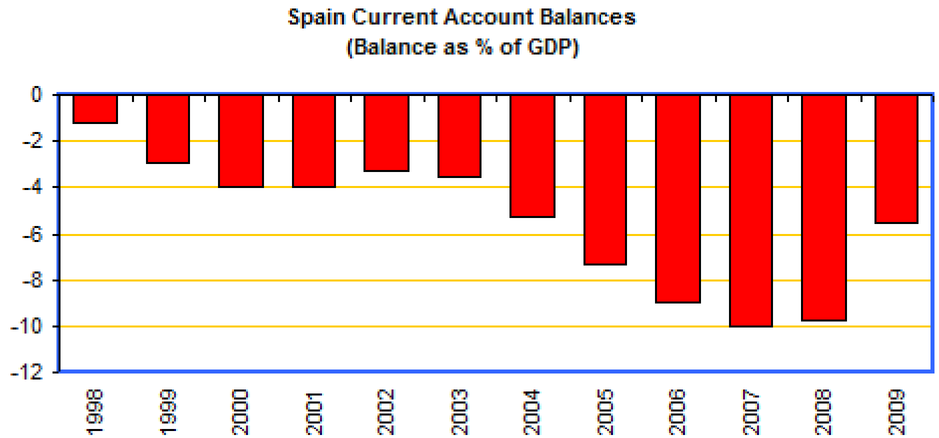
Current Account Blues



Source:IMF, post 2009 forecasts

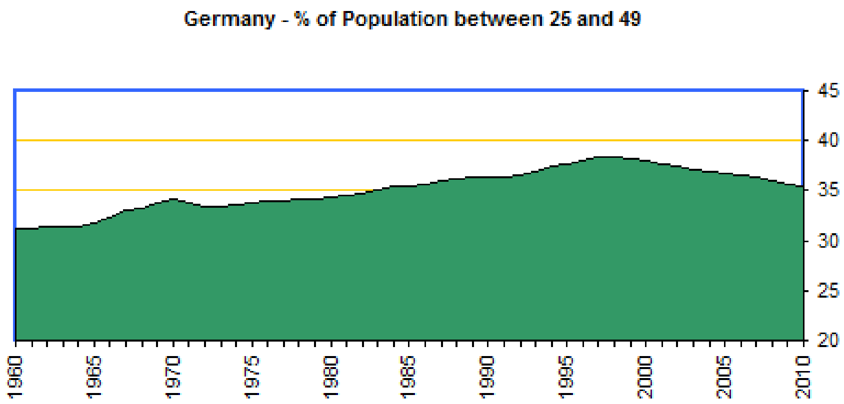
Germany didn't always run a current account surplus. All through the 1990s the current account was in deficit.

And Spain won't always run a current account deficit, even if that seems hard to believe right now.



Source:IMF, post 2009 forecasts

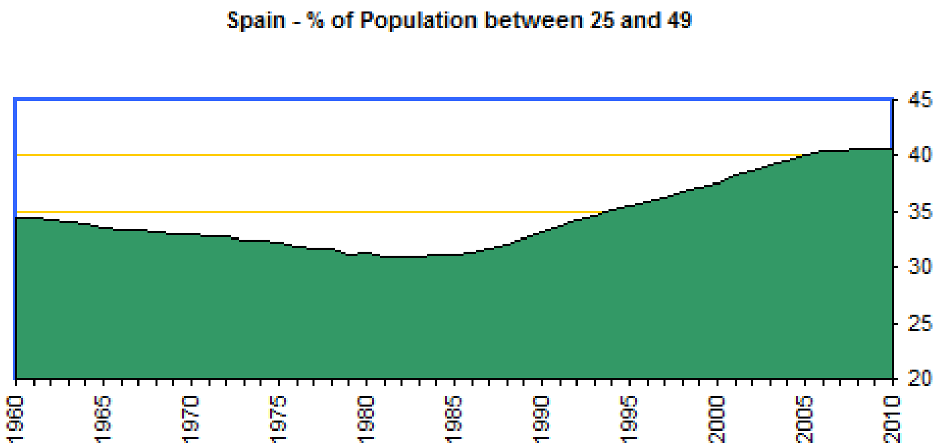
The Key 25 to 49 Age Group



Source:Eurostat

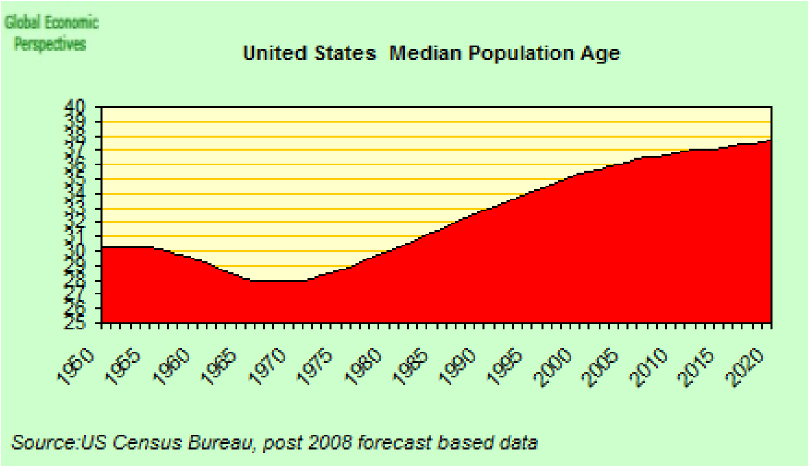
This group peaked in Germany – as a % of total population around the turn of the century.

And in Spain it peaked towards the end of the first decade of this century.



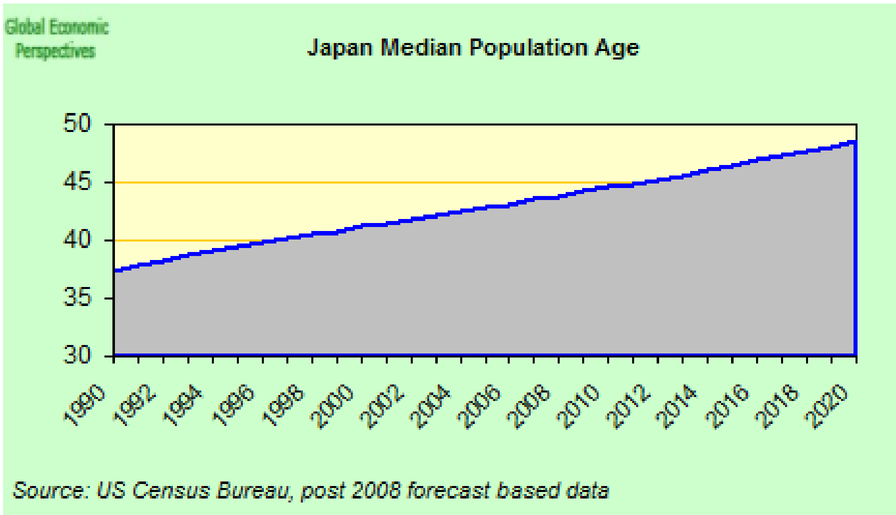
Source:Eurostat

Could Something As Simple As Median Population Age Help Us Understand?



Ours is an age of rapidly ageing societies. What is so modern about our current situation is not the ageing itself, but its velocity, and its global extension.

Does median population age have something to do with growth? Most professional economists deny this to be the case, but to many non economists the connection is intuitively obvious.



Population Ageing – A Unique Historical Challenge

The economic and social implications of the ageing process are going to be profound.

- **the process is seemingly irreversible.**
- **No other single force is likely to shape the future of national economic health, public finances, and policymaking over the coming decade**

Strangely, the issue receives only a fraction of the attention that has been devoted to global climate change, even though, arguably, ageing is a problem our social and political systems are, in principle, much better equipped to deal with.

As far as we are able to understand the issue at this point, population ageing will have major economic impacts and these can be categorised under four main headings:

i) ageing will affect the size of the working age population, and with this the level of trend economic growth in one country after another

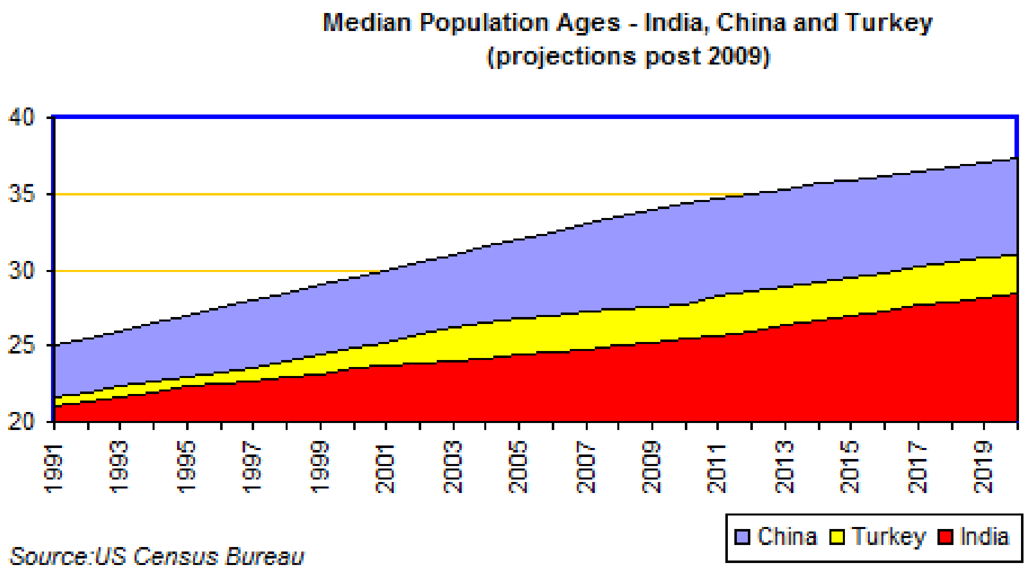
ii) ageing will affect patterns of national saving and borrowing, and with these the directions and magnitudes of global capital flows

iii) through the saving and borrowing path the process can influence values of key assets like housing and equities

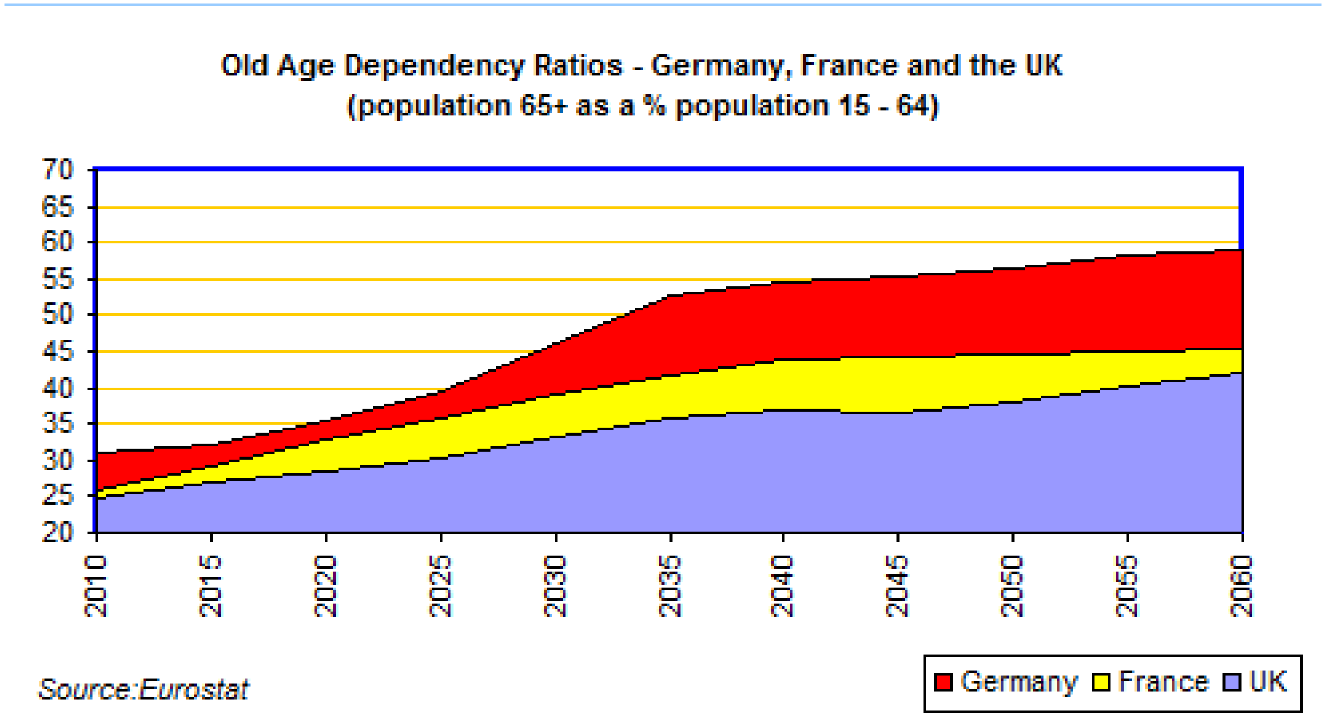
iv) through changes in the dependency ratio, ageing will influence pressure on global sovereign debt, producing significant changes in ranking as between developed and emerging economies.

While population ageing is **universal the short term impact will be much more localised**. The pace of aging **varies greatly across countries and regions**.

The effects of the process are expected to be most **pronounced in those countries that remained complacent in the face of ultra-low fertility rates** (total fertility rates of 1.5 and under), which in effect means Japan, the German speaking countries and much of Southern and Eastern Europe.



Another way of looking at these demographic changes is in terms of the dependency ratio, which can be defined in a number of different ways depending on the problem being addressed.



Importance Of The Prime Age Groups

The key groups are prime savers, prime borrowers, and prime productive workers. Where these actual age brackets lie, and the extent to which they may overlap, is still a subject of some controversy,

One of the key points to grasp, is that the proportion the population which is to be found in one of the 'prime' age groups at a given moment in time, is absolutely critical, and much more important for understanding the processes at work than the mere size of the working age population.

Estimates of the exact age extension of the different groups vary, but 25-40 would be a good rule of thumb measure of the borrowing range, 40 to 55 for the peak savers, and 35 to 50 for the prime age workers.

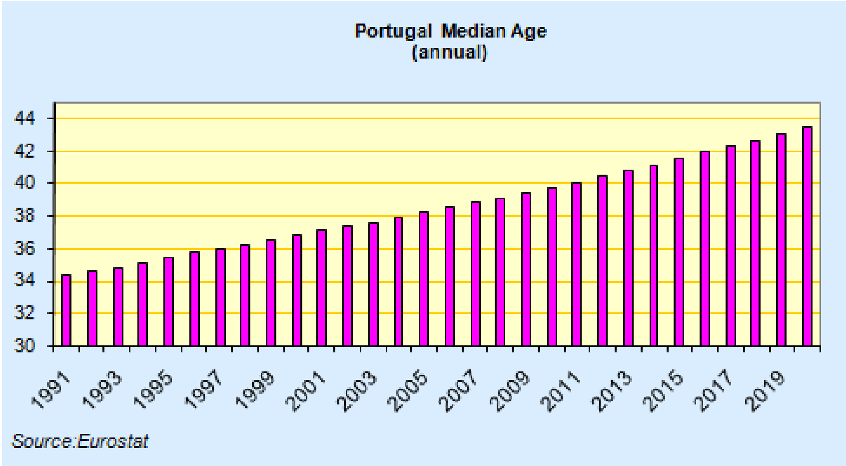
Beyond this, the question is an empirical one of measuring and testing to determine more precise boundaries and frontiers.

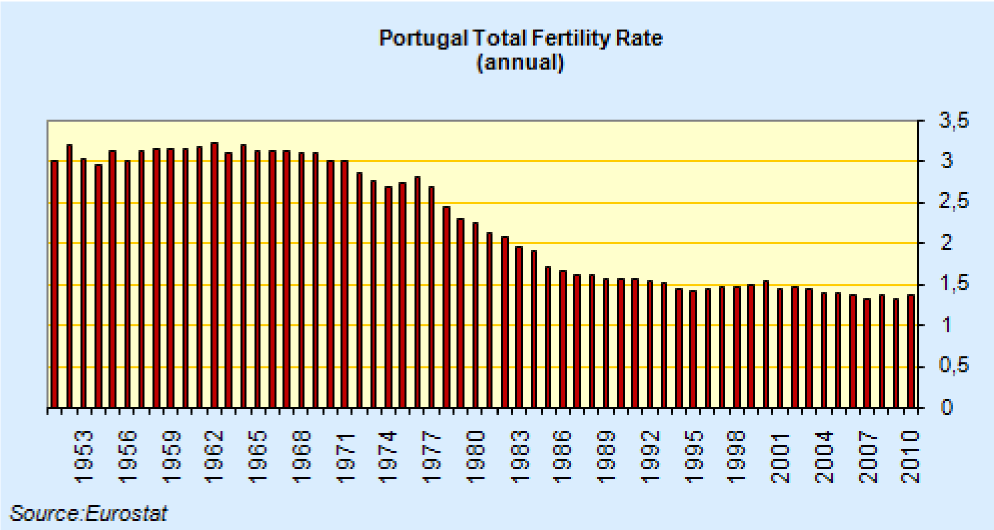
Life Cycle Effects

There is a generally accepted wisdom in academic work known as the “life cycle hypothesis” (Modigliani). This suggests that the population’s financial behaviour changes depending on age. In terms of adult life, those in their twenties and early thirties tend to be net borrowers as they are relatively low earners at the same time as they look to buy housing, expensive durables and fund their burgeoning families. At some point around middle-age this group then tends to move from being net borrowers to net investors as they move into their economic prime and accumulate financial assets to hopefully fund their retirement. As they approach retirement this group then start to shed the financial assets they’ve been accumulating to fund their nonworking days.

Case Study Portugal

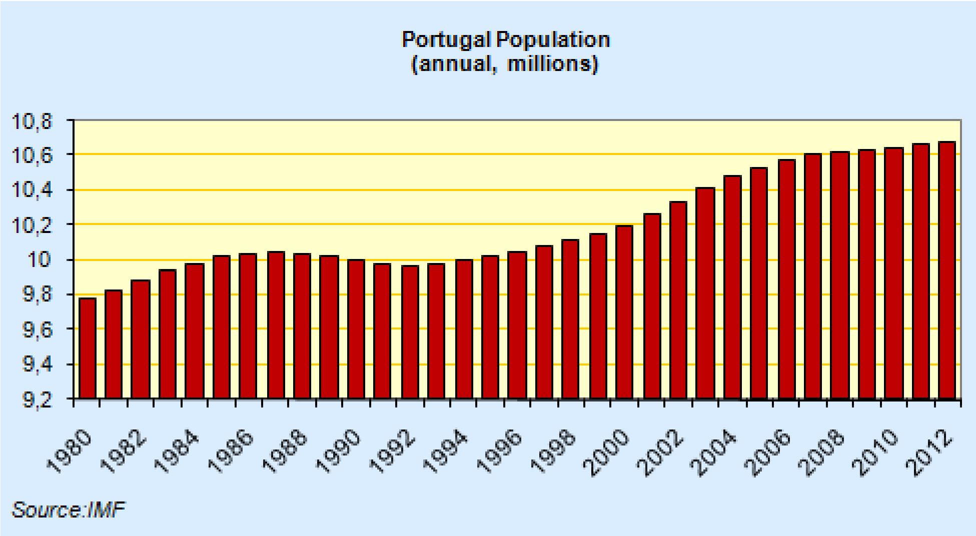
Portugal, like all European societies is ageing quite rapidly





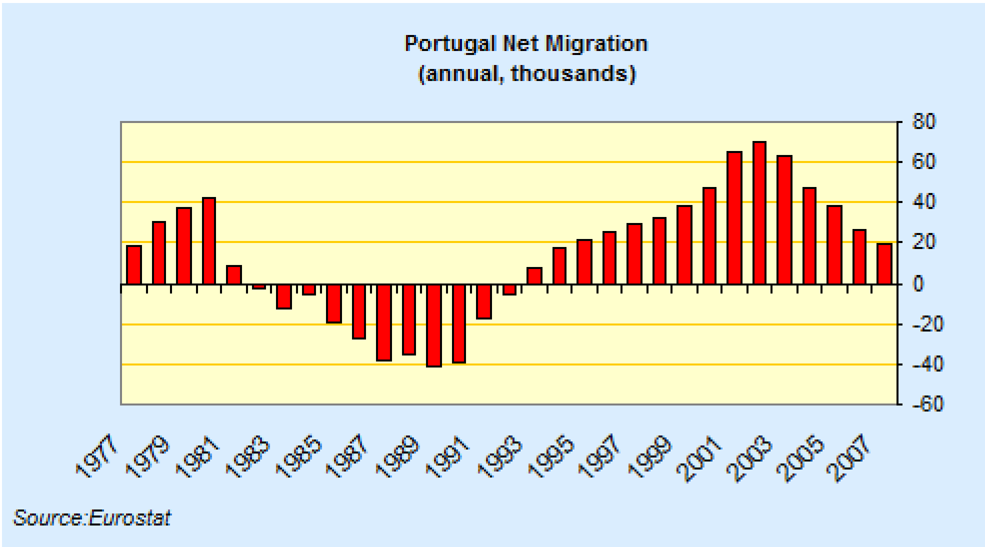
And the main reason for this is, of course, long term very low fertility

Unique Portuguese Features

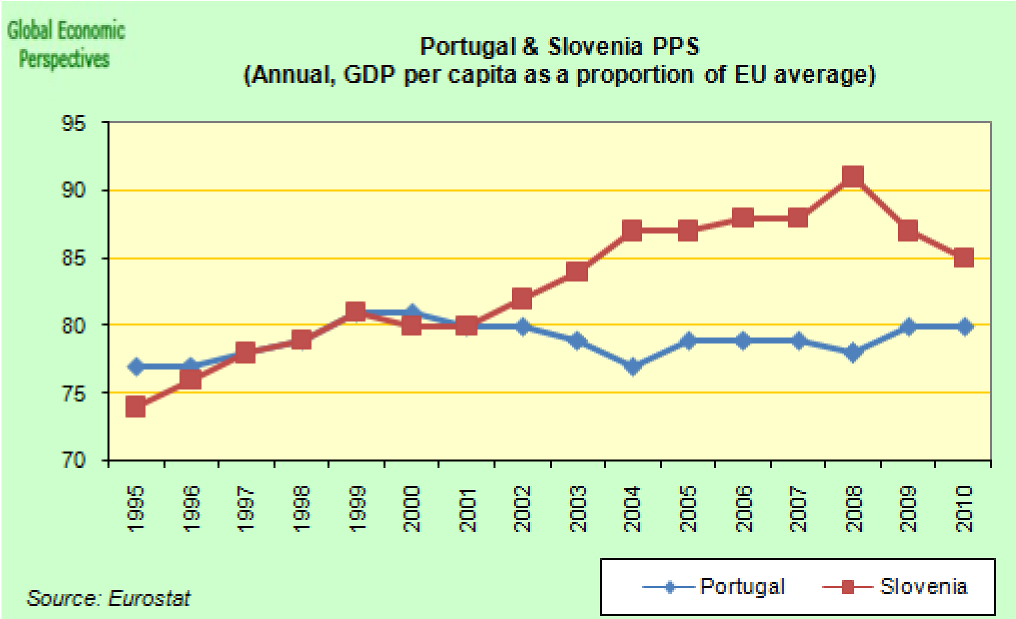


Portugal in some ways resembles East uropean societies. The country lost population during the EU "coupling" years, and the phenomenon has left a lasting scar on the economy and the society.

Portugal went from being an emigration society to being an immigration one. But now with the latest crisis this is once more reversing, in a way which is very serious for a low fertility society.

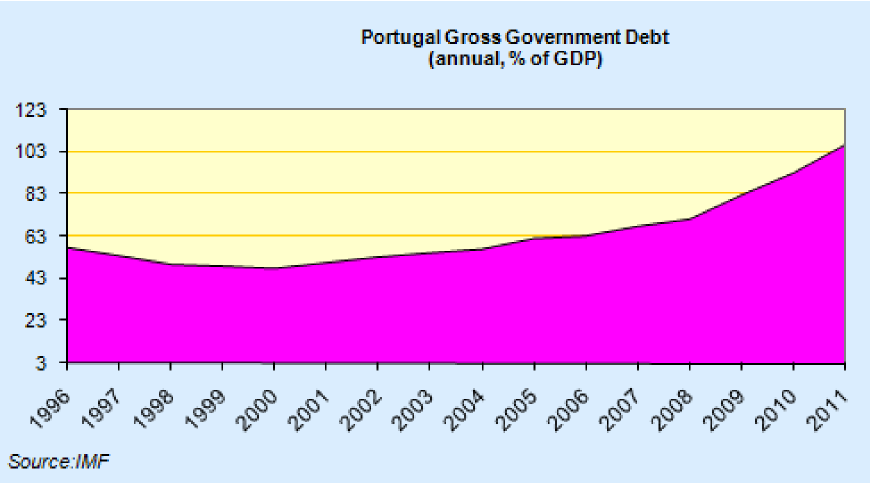


Portuguese Living Standards Have Stagnated Over The Last Decade



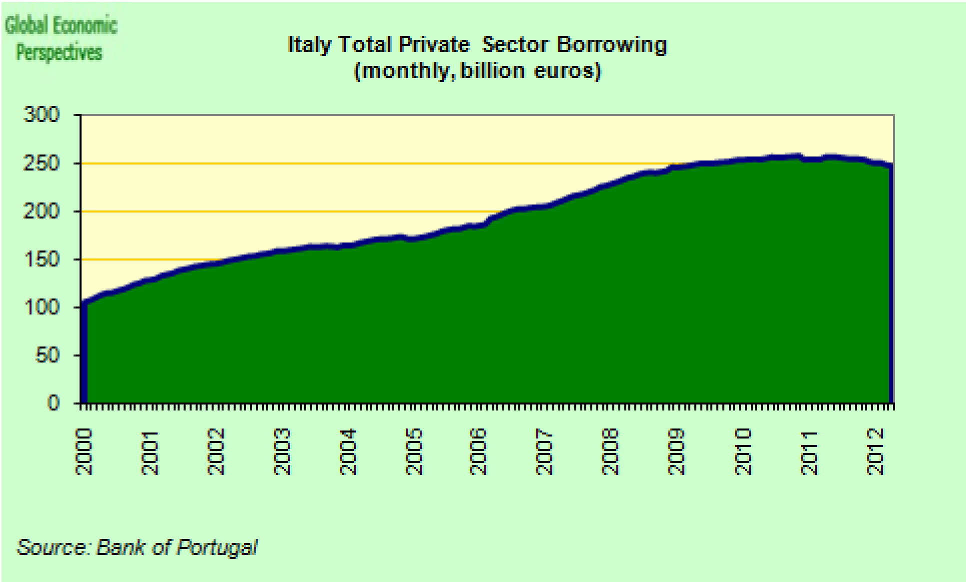
Far from Euro membership being an unmitigated success for Portugal, the country has seen a serious lack of growth in living standards and a loss of relative position in the “Euro league”.

As Elsewhere The Current Crisis Is Largely About Debt

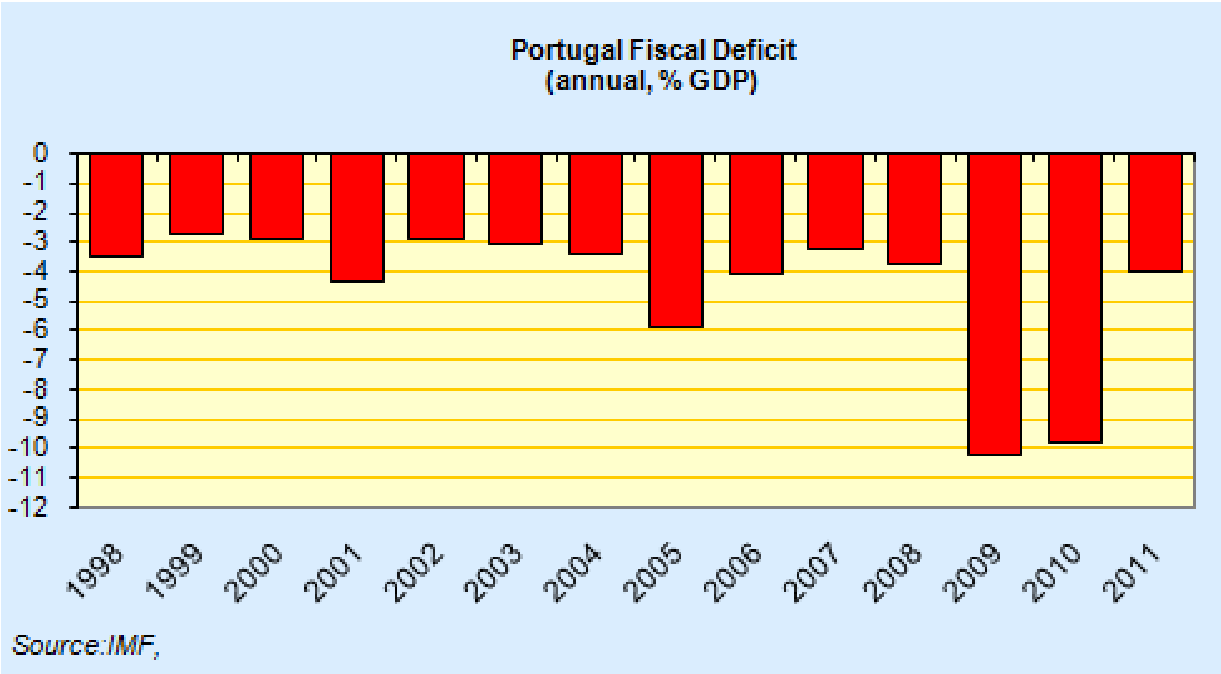


Portugal 's economy may not have grown, but the country has accumulated a large mountain of both private and public sector debt over the last decade.

There is about 250 billion euros in private sector debt and 170 billion euros in public sector debt. Portuguese GDP is around 160 billion euros, so total debt to GDP is around 260%. Without growth this is clearly not sustainable.



Portugal has now had an initial 78 billion euro bailout and is in a deficit correction programme



And TheTroika Consistently Give The Country Glowing Reports

Portugal passes fourth EU-IMF bailout review

Portugal has passed a fourth review of its continuing spending cuts and economic reforms, the country's Finance Minister, Vitor Gaspar, has said.

The Portuguese are feeling the economic strain

Portugal had fulfilled all the bailout criteria set by inspectors from the EU, European Central Bank and International Monetary Fund (IMF), Mr Gaspar said.

It clears the way for the government to get another 4bn euros ($5bn; £3.2bn) of funds from the so-called troika.

Eurozone crisis

Along With The Deficit Even The Bond Yields Are Coming Down

Portuguese 10-Year Bond Yields Decline Below 10%: Lisbon Mover

By Emma Charlton and Joao Lima - Jun 22, 2012 6:18 PM GMT+0200

0 COMMENTS QUEUE

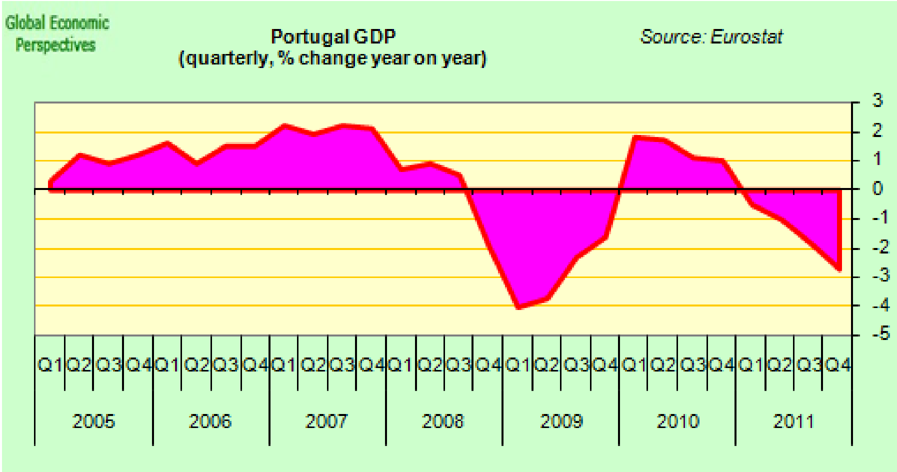
Portugal's 10-year bonds advanced for a seventh day, with the yield falling below 10 percent for the first time in more than a year.

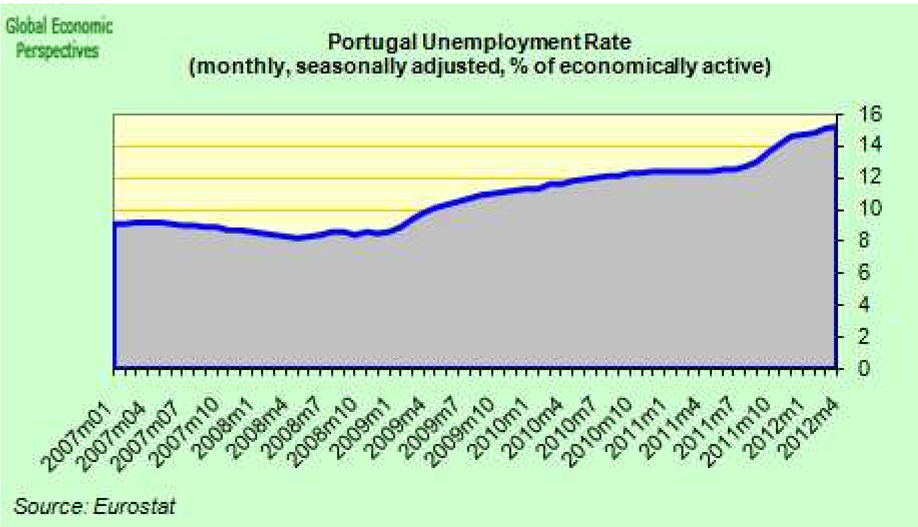
The 10-year rate declined 66 basis points to 9.49 percent as of 5:04 p.m. London time, the lowest since May 2011. Two-year Portuguese note yields fell 92 basis points to 6.94 percent, the lowest since March 2011.

"The successful completion of Portugal's fourth adjustment program review was followed by very favorable developments in the bond market," Portuguese Finance Minister Vitor Gaspar said late yesterday in Luxembourg after a meeting of euro-area finance ministers. "Since June 4 we have seen a very significant narrowing of the bond yields."

So Where's The Problem?

Well, the economy is in deep recession. The IMF expect the economy to contract by 3.3% in 2012, and return to timid growth in 2013 (0.3%). There are strong downside risks to the 2013 forecast, and it is not improbable the economy will once more contract.





Unemployment is now rising sharply. Apart from the social distress caused this surge in unemployment is having two consequences.

So A Second Bailout May be necessary

Unemployment spike sets Portugal up for second bailout

REUTERS By Sergio Goncalves | Reuters – Tue, Jun 5, 2012

We are utterly committed to fulfilling our obligations. But while we are optimistic, we must also be realistic and pragmatic. This is why we accept that we may need to rely on the commitment of our international partners to extend further support if circumstances beyond our control obstruct our return to market financing.

When will Portugal need a 2nd bailout?

April 19, 2012 3:25 pm by Peter Spiegel

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Largely overlooked amidst the handwringing over Spain this week was a piece written by Portuguese prime minister Pedro Passos Coelho in the FT that all but admits publicly what many officials have been saying privately for some time: Portugal is probably going to need a second bailout.

The connection between these two issues is that the rising unemployment is producing a deficit in the social security fund.

So the country may need a relaxation in the bailout programme fiscal targets.

In Addition Young Educated People Are Increasingly Leaving

Portugal's jobless graduates flee to Africa and Brazil

By Lucy Ash
BBC News, Lisbon

In May Portuguese and Spanish youths rallied in Lisbon against unemployment

Why is this a problem? Well think of the ageing society and growth problems I mentioned earlier. In fact economies exist in real historical time and not the ideal state space postulated by neoclassical economics. They are path dependent entitites and opportunities lost now have permanent consequences.

Of course, in Europe we need labour market flexibility, but we also need a common Treasury to make pensions sustainable.

There is no shortage of statistics, and they all point in the same direction: more and more Portuguese are leaving the country. Late in 2011, the Secretary of State for Portuguese Communities, José Cesário, acknowledged that this year alone between 100,000 and 120,000 Portuguese had departed. On EURES, the European Union's job mobility portal, Portuguese applications more than doubled between 2008 and 2011. And in just two years, from 2008 to 2010, Portuguese consulates abroad have seen 324,000 migrants come in to register.

Unemployed Portuguese told to 'just emigrate'

Portugal's prime minister has been criticised for suggesting that unemployed youth leave the country to find work.

Mario Queiroz Last Modified: 31 Dec 2011 10:25

And The Banking System Remains Overdependent On The ECB

ECB Financing To Portuguese Banks Increased To Record In May

By Anabela Reis - Jun 11, 2012 2:06 PM GMT+0200

0 COMMENTS QUEUE

The European Central Bank's financing to Portuguese lenders rose to a new record in May, the Bank of Portugal said.

ECB financing increased to 58.7 billion euros ($73.6 billion) from 55.4 billion euros in April, the Lisbon-based Bank of Portugal said today on the BPStat portion of its website. ECB financing levels had previously peaked at 56.3 billion euros in March.

So when Will The Second Bailout Happen?

Likely date September. Why? Well Portugal is programmed to return to the markets to finance bonds in September 2013, and the IMF has a "financing guaranteed 12 months ahead" rule.

Just how big would a second Portuguese programme have to be? Significantly smaller than the €174bn just agreed for Greece, that's for sure. After last month's €15bn EU-IMF aid payment to Lisbon, there is about €25bn left in the current bailout, and the programme anticipates Portugal would raise €24.2bn in longer-term bonds through 2014.

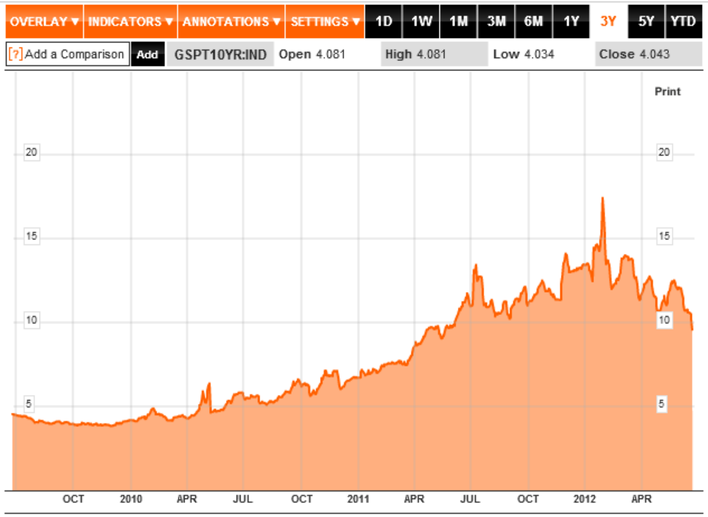
If we were to add 2015 to the second programme, since most bailouts are for three years, IMF figures show another €26.9bn would have to come from bailout loans instead of private creditors. All together, that's about €76bn, including €51bn in new funds. Not huge by Greek standards, but another significant bite out of the eurozone's €500bn rescue system.

And How Much Will It Cost?

More than likely in the region of 50 billion euros 24.2 billion for financing in 2013/14, plus another 26.9 billion euros for 2015.

PSI Unlikely At This Point

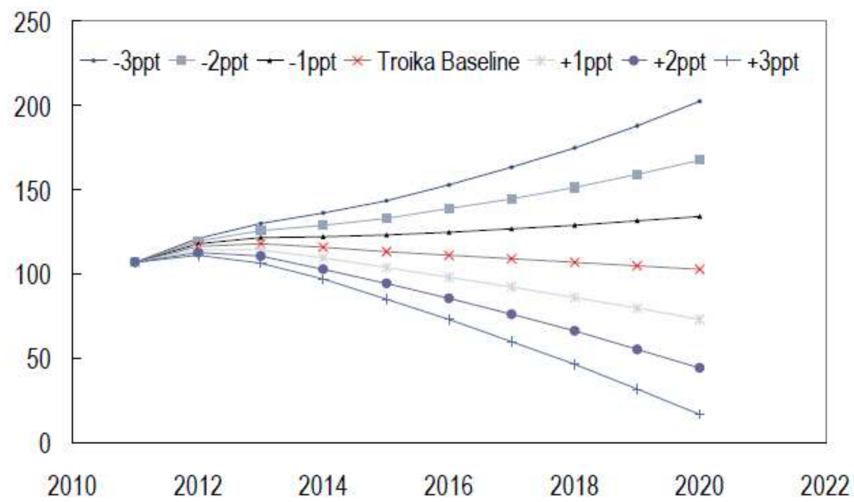
Interactive Chart for PORTUGUESE GOVERNMENT BONDS 10YR NOTE PORTUGAL PL (GSPT10YR)



The markets have pulled back since earlier this year, and are now not pricing in PSI.

But Portuguese debt is balanced on a knife edge , and PSI in the longer term is not improbable.

Figure 14. Portugal — Impact of Different Growth Assumptions on Debt-to-GDP



Source: Citi Investment Research and Analysis

Where Does All That Leave Us?

The 17-nation euro area is in real danger of disintegrating unless policy makers revamp the bloc's fiscal and economic ties, Economic and Monetary Commissioner Olli Rehn said. Photographer: Jock Fistick/Bloomberg

Bloomberg News

Euro Area Has Significant Risk of Breakup: Rehn

In a One Step Forward.... or several hundred billion steps back situation

Maybe world leaders have been exaggerating the time scale, but the risks are real

Lagarde: Less than three months to save the euro

What Can Be Done?

a) **Shotgun Wedding**
b) **Full Banking Union**
c) **Common Fiscal Treasury**
d) **Central Bank able to act like the BoJ, the BoE and the US Federal Reserve**
e) **Less austerity and common finance to support the various economies while much needed structural reforms are undertaken.**

This is just not doable say the critics. Well then, think about the alternatives for just 5 minutes and maybe you will change your minds.

September 22nd, 2011
11:47 PM GMT

'Dr. Strangelove' and the euro 'Doomsday Machine'

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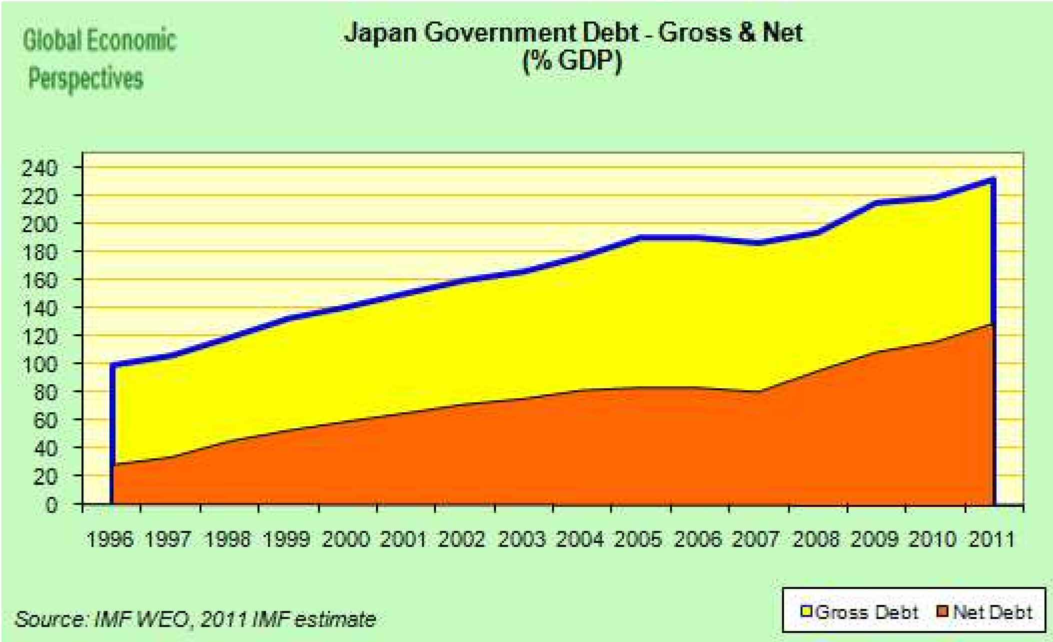
Comments (31 comments)

Posted by:
Edward Hugh, for CNN

No Easy Answers At This Point

Effectively I am suggesting turning Europe into a second Japan. But Japan's public debt path is not long term sustainable. Japan couldn't exit the Yen could it?



Basically we are faced with a complex set of problems which were never foreseen in economic theory. We don't live in a perfect world. Angela merkel is wrong on austerity, but is right that in the longer run debt needs to be sustainable and our economies stable, and not running on "funny money" in a way which will end in tears.

So What Can Be Done In Portugal?

Short Term:

- Continuing and Continuous Structural Reform

- Less Austerity More Growth Support
- Continuing Labour Market Reform
- Pension Reform
- Heath System Reform
- Immigration

Longer Term

- Raise Fertility Rates
- Global Rebalancing Initiatives
- Acceptance that the Modern Growth Era – like modernity itself – doesn’t last forever.

Thank You For Your Attention