Recession of 1992:Q2-1993:Q3

PEAK: 1992:Q2 | TROUGH: 1993:Q3 | DURATION: 5 QUARTERS | AMPLITUDE: 1.1%

The first recession after Portugal joined the European Economic Community (EEC) was influenced by the international context, marked by the Gulf War, German reunification and instability in the European Exchange Rate Mechanism (ERM). The external shock to the balance of trade precipitated the recession, aggravated by restrictive reorientation of fiscal and monetary policies that caused investment to contract in the second phase of the recession.

ENVIRONMENT

After joining the EEC in 1986, the Portuguese economy expanded continuously, benefiting from opening up to the outside world, significant gains in terms of international trade and relative political stability. This expansion ended with a peak in economic activity in 1992:Q2. In the 5 quarters of the recession that followed, real GDP per capita fell 1.1% from its peak.

On the external front, the Gulf War, between 1990:Q3 and 1991:Q1, led to an increase in oil prices. The US was in recession during this same period. In Europe, the impact of German reunification and contractionary monetary policies led to tensions in the ERM and to another recessionary impulse. The main Portuguese trading partners, with Spain at the head, were in recession from 1992:Q1 to 1993:Q3, as was the Eurozone. Finally, the end of the Common Agricultural Policy transition phase led to a significant drop in the real prices of agricultural products.

Internally, the expansion phase that characterised the second half of the 1980s generated inflationary pressures, as evidenced by an inflation rate of 13.6% in 1990, 7 p.p. above the community's average. An anti-inflationary programme was implemented between 1990 and 1992, when a restrictive monetary policy with high real interest rates was complemented with capital controls, only removed in December 1992.

In the exchange rate policy, the crawling peg system ended and the escudo joined the ERM in April 1992. Thus, the escudo experienced the most troubled phase of the ERM, seeing its central parity devalued twice – in November 1992 and March 1993. Finally, fiscal policy was restrictive, reducing the public deficit from 6.5% to 3.3% of GDP between 1991 and 1992.

[1] The Committee bases its decisions on a subjective, multidimensional strategy, relying on a set of monthly and quarterly economic activity indicators, several computational algorithms and the assessments of its members. The evaluation is performed on a quarterly basis with a focus on output. For futher details, please see the Methodological Notes.

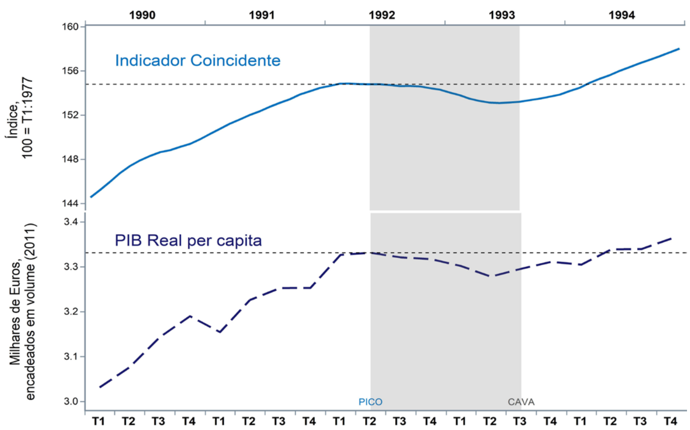
CALIBRATING THE PEAK AND TROUGH[1]

Real GDP per capita peaked in 1992:Q2, as illustrated in Figure 1. The coincident indicator peaked between Q1 and Q2 of that year. However, the economic sentiment indicator (Figure 2) fell sharply between 1992:Q2 and 1993:Q3. Finally, the industrial production index suffered one of its biggest historical falls in a single quarter, between Q3 and Q4 of 1992. Taken together, these indicators point to a peak in 1992:Q2, a quarter after the peak of activity in our main European partners.

In terms of macroeconomic aggregates (Figure 3), the recession was felt with greater intensity in net exports (X-M). The volatility of the balance of trade, typical of business cycles, coincided with instability in the ERM, especially from 1992:Q2.

Figure 1. Coincident Indicator (monthly) and Real GDP per capita (quarterly)

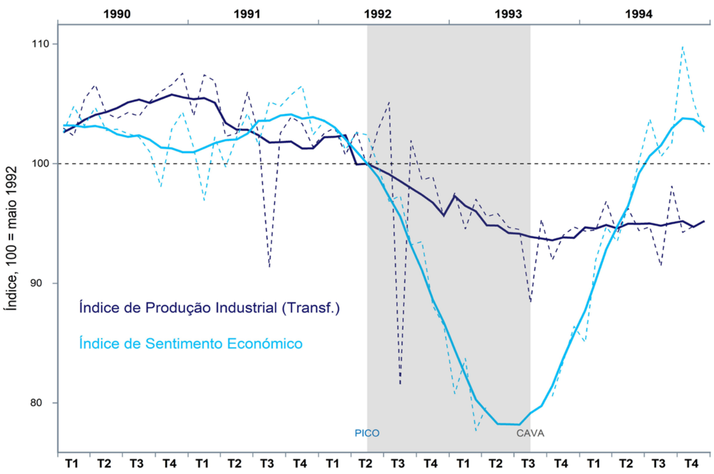
Source: Banco de Portugal, Committee



Note: the horizontal dotted lines represent the value of the indicators at the peak defined by the Committee. (1992:Q2).

Figure 2. Industrial Production Index and Economic Sentiment Indicator **(monthly)**

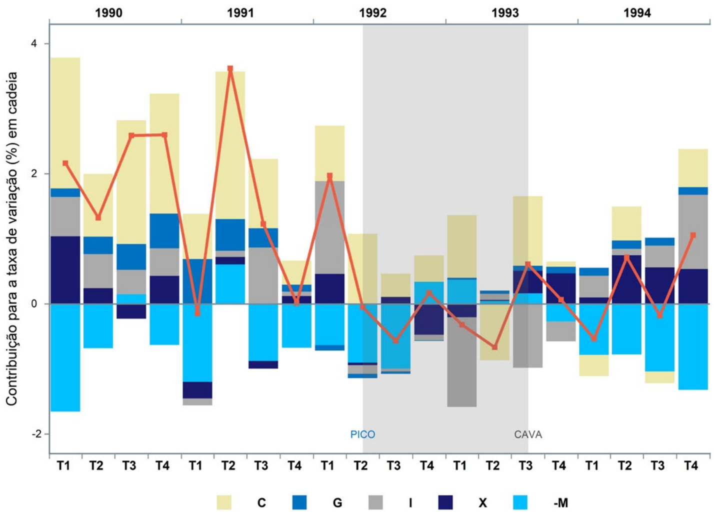
Source: Statistics Portugal, Eurostat



Note: seasonally adjusted (dotted line) and smoothed (solid line) series, by using a centred 9-month moving average. Both are indexed to 100 in the month before the peak quarter, for interpretation.

Figure 3. Breakdown of the quarter-on-quarter rate of change in real GDP – Expenditure Approach **(quarterly)**

Source: Banco de Portugal, Committee



Note: positive contributions from imports (M) reflect negative rates of change in this aggregate.

Investment also registered a steep fall at the beginning of the recession, which then deepened in 1993:Q1, contributing to a significant part of the decline in output. In line with the drop in economic sentiment, investment fell in the transport material and construction and real estate sectors. Finally, in the final phase of the recession, there was a sharp drop in public consumption.

The unemployment rate (Figure 4) started to rise a quarter before the peak, as early as 1992:Q1. The reversal in the labour market was most noticeable in the number of workers, which had been increasing continuously for several years. This trend was reversed between 1992:Q1 and 1992:Q3.

Calibrating the trough, real GDP per capita, the economic sentiment indicator and employment reached their local minima in 1993:Q2. Consumption also began to recover in 1993:Q2, although investment continued to decline for another year.

Looking instead at the coincident indicator, after smoothing out the surrounding fluctuations, the trough date was one quarter later, in 1993:Q3. Similarly, the industrial production index had a local minimum in 1993:Q3, after which it began a slow recovery, in line with investment.

The behaviour of the unemployment rate was somewhat atypical in relation to other cyclical indicators. The end of the recession led to a slight inflection in its growth, but it continued to climb for several months after the trough in the business cycle.

INDICATORS AND ADDITIONAL FACTORS

Between the fall of the Berlin Wall in November 1989 and July 1992, the German central bank raised interest rates from 5% to 8.75%, with 1.25 p.p. of this rise being concentrated in the final eight months. This monetary policy was a response to the rise in German inflation caused by public spending associated with the country's reunification.

To maintain the parity of the currencies that were part of the ERM with the German mark, the remaining European central banks had to raise their interest rates as well. Without benefiting from budgetary expansion, but with a restrictive monetary policy, these countries entered a recession. Demand for Portuguese exports declined, causing economic activity to contract. This recession was thus marked by the external shock that led to a drop in exports and investment.

Figure 4. Labour Market – Employment Index and Unemployment Rate (quarterly)

Source: Banco de Portugal, Committee

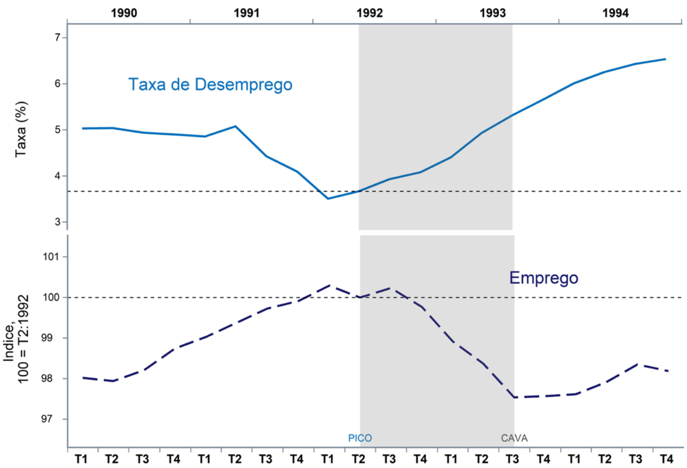
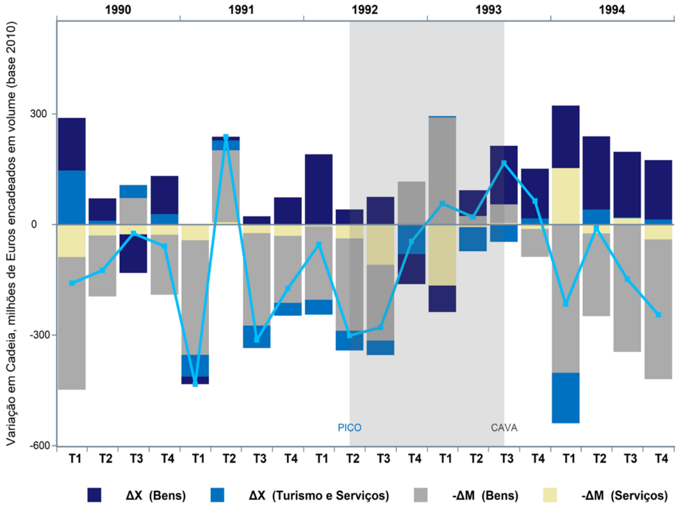


Figure 5. Breakdown of the Balance of Trade (quarterly)

Source: Banco de Portugal, Committee



The external origin of the shock is visible in the decomposition of the balance of trade (Figure 5). To maintain parity with the mark, the escudo was relatively revaluated, so foreign goods were comparatively cheap and domestic goods comparatively expensive. Exports declined more sharply than imports, contracting national output through the balance of trade.

In turn, Banco de Portugal also had to monitor the rise in interest rates by the German central bank. Furthermore, fiscal policy in Portugal was moving in the opposite direction than that of German policy due to the need for deficit reduction in order to start the convergence process dictated by the Maastricht Treaty. Both fiscal policy and monetary policy were thus moving in a restrictive direction. This deepened and prolonged the recession, with investment contracting sharply in the second phase of the recession.

With the devaluation of the escudo between 1993 and 1994, in the context of the ERM realignments, the reversal in both imports and exports can be clearly seen in Figure 5. In the second half of the recession, it was investment and public consumption that postponed the trough (Figure 3).

In recessions caused by domestic demand, the balance of trade tends to be countercyclical. In this recession, the balance of trade proved to be procyclical, a clear sign of the external source of the recession.

CONCLUSION

With a relatively short duration (5 quarters) and a relatively slight reduction in real GDP per capita (amplitude of 1.1%), this recession was mild compared to others, but remarkable because it interrupted a long phase of expansion of the Portuguese economy. It was associated with the external context, with a contraction in net exports and a drop in investment following the rise in oil prices and the recession in the Eurozone, associated with instability in the ERM. Domestic macroeconomic policies in response to the external context played an important contractionary role, with restrictive monetary and exchange rate policies, and a sharp reduction in the public deficit. Accompanying these policies and the international context, there was a sharp fall in economic sentiment. Only in 1994:Q2 would the level of real GDP per capita recover to the peak level of 1992:Q2.