Recession of 2002:Q1 – 2003:Q2

PEAK: 2002:Q1 | TROUGH: 2003:Q2 | DURATION: 5 QUARTERS | AMPLITUDE: 2.9%

Marked by the internal context, this recession reflected a decline in economic sentiment, accompanied by a significant drop in private investment. There was also a steep decline in public investment in the context of an adjustment to the public deficit after the limits of the Stability and Growth Pact were exceeded in 2001. The recession marked a turning point in the structure of the Portuguese economy with regard to growth trends, the unemployment rate and the use of macroeconomic policies to stabilise the cycle.

ENVIRONMENT

The entry into the Eurozone in January 1999 brought about an expansion in investment and consumption. In the years that followed, access to credit broadened with a permanent decline in interest rates and an expansionary fiscal policy. This period of growth ended with the peak of economic activity in 2002:Q1, at a time when the deferral of structural adjustments that would allow for compliance with the SGP could no longer continue. In the following five quarters, real GDP per capita fell by 2.9%.

At internal level, the immediate shock that triggered the recession was the unexpected fall of the government in December 2001, when the prime minister resigned following poor results in local elections. This brought political uncertainty. The new government took office in April 2002 and had to deal with the violation of the limit set in the SGP for the budget deficit (3% of GDP) in 2001. It responded with a restrictive fiscal policy that was marked, in the first phase, by a reduction in public investment, which fell 55% (chain-linked) between 2002:Q3 and Q4. From 2003 onward, there was an effort to contain the wage bill and freeze the progression of careers in the public sector.

Externally, the US experienced the brief dot-com recession between March and November 2001. No corresponding recession was observed in either the Eurozone or in Spain. The OECD business cycle indicators place France and Germany in deceleration from the end of 2000. In the German case, the period between 2000 and 2005 was one of stagnation, which had some impact on Portuguese exports, but by itself is insufficient to explain a recession in Portugal.

Monetary policy, now defined by the ECB, was accommodative, with the benchmark rates continuously declining between October 2000 and June 2003.

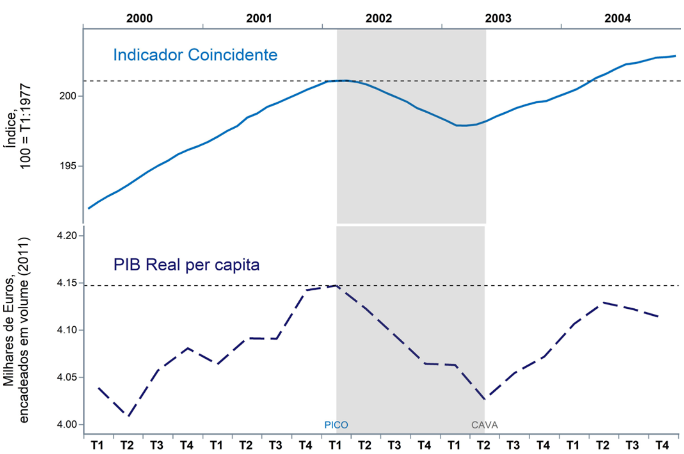
CALIBRATING THE PEAK AND TROUGH[1]

The real GDP per capita reached a peak in 2002:Q1 (Figure 1). The peak in the coincident indicator was more gradual and occurred between 2001:Q4 and 2002:Q1.

Unlike other recessions, the industrial production index did not show a clear contraction. There was a small local maximum in April 2002, which coincided with a slight slowing of external demand (Figures 2 and 3), but this contributed little to the recession.

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

Source: Banco de Portugal, Committee

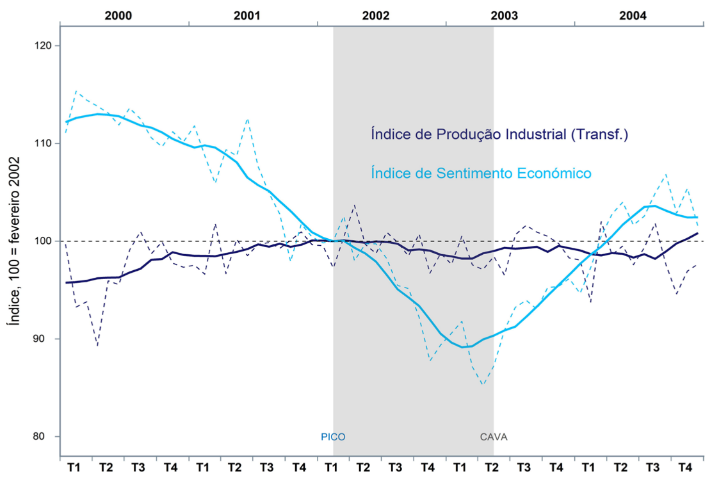


Note: the horizontal dotted lines represent the value of the indicators at the peak defined by the Committee. (2002:Q1).

[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.

Figure 2. Industrial production and economic sentiment indicators **(monthly)**

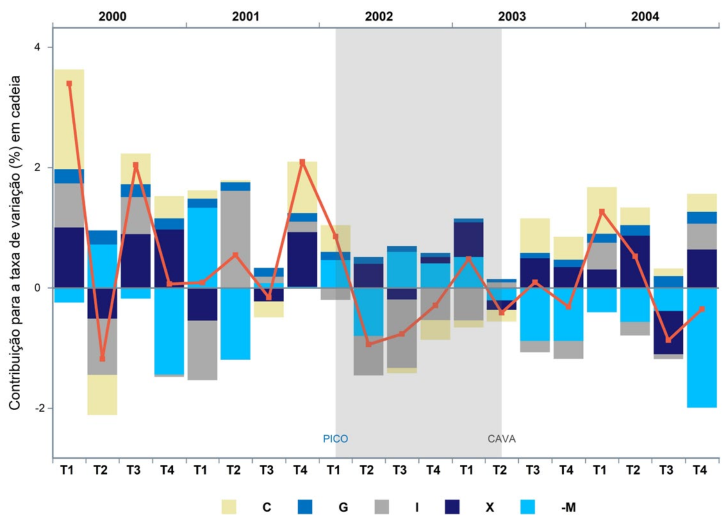
Source: Statistics Portugal, Eurostat



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.

Examining the macroeconomic aggregates, the recession initially manifested itself in investment (I), both public and private (Figure 3). The largest decline in investment occurred between Q2 and Q3 of 2002. During this period, there was also a sharp reduction in public investment. In the following quarters, there was a significant fall in investment in the transport materials sector.

Private consumption (C) also played a significant role in the recession, especially durable goods. In the final phase of the recession, exports and industrial production fell, in line with the decrease in demand in Germany and France, contributing slightly to extending the recession.

To calibrate the trough, note that both real GDP per capita and the economic sentiment indicator reached their local minima in 2003:Q2. Similarly, the coincident indicator, after smoothing out fluctuations, recorded a trough in 2003:Q2.

The jump in consumption in 2003:Q3 marked the end of the recession, but investment only rose continuously from 2004:Q1. Finally, the industrial production index reached a local minimum in June 2003, although this indicator appears to be less relevant in this crisis.

INDICATORS AND ADDITIONAL FACTORS

Between the speech given by the outgoing Prime Minister António Guterres in December 2001, in which he stated that Portugal was falling into a "political quagmire," and the speech given by the new Prime Minister, Durão Barroso, in April 2002, describing the country as being "picked clean", the economic sentiment index experienced a sharp decline. This recession was partially caused by a decrease in confidence, which impacted private investment. The economic sentiment indicator (Figure 2) showed a significant decrease between 2002:Q1 and 2003:Q1.

Another major factor behind this recession was the contraction of public investment in the context of the policies imposed by the SGP, due to the difficulty in controlling public finances in previous years. Figure 3 illustrates the second driver of this recession.

Less visible at the time, but noticeable in hindsight, was the fact that this recession marked a structural change in the Portuguese economy, both in economic growth and in business cycles thereafter. This change has three different dimensions.

Figure 4. Labour market – employment index and unemployment rate (quarterly)

Source: Banco de Portugal, Committee

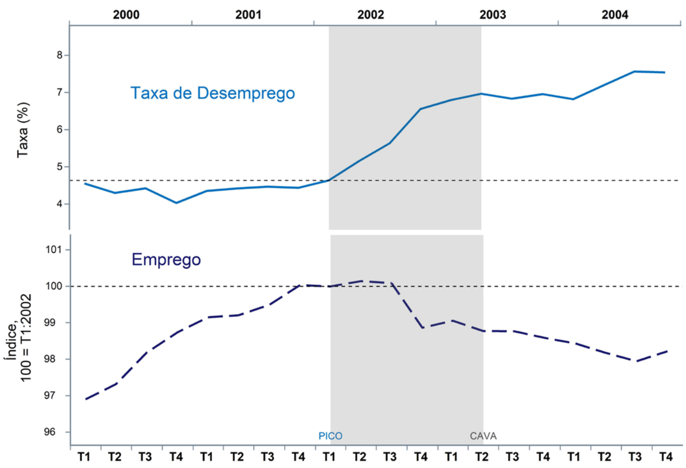
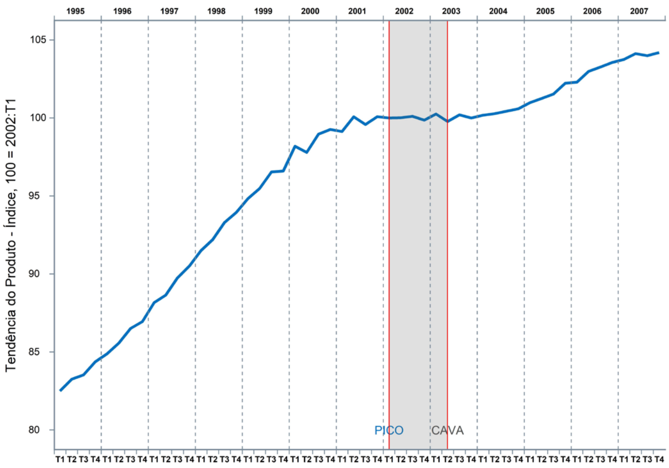


Figure 5. Real GDP per capita trend (quarterly)

Source: Banco de Portugal, Committee



Firstly, as shown in Figure 5, this recession marked a slowdown in the declining trend of real GDP per capita. The growth rate in the Portuguese economy fell close to zero in the nearly two decades that followed. This economic stagnation was predicted by few and accompanied by stagnation in productivity growth.

Secondly, in terms of economic policy, this recession is the first in the Eurozone context in which the macroeconomic policies that had been employed in the two preceding decades were no longer available. Monetary policy was now decided for the Eurozone as a whole, so national recessions caused by local confidence factors were no longer countered with interest rate reductions or currency devaluations. On the other hand, fiscal policy became subject to budgetary limits and the difficulty in creating a cushion to use in times of crisis frequently resulted in pro-cyclical fiscal policy, supported by cuts in public investment. As a result, the two main macroeconomic tools ceased to be countercyclical in response to a national but not European recession.

Thirdly, there was a profound change in the labour market (Figure 4). In the 20 years prior, the unemployment rate was only slightly countercyclical. After the 2002:Q1 peak, the unemployment rate increased rapidly. After the trough, the unemployment rate did not decrease.

CONCLUSION

Despite having the same duration as the previous recession (5 quarters), this recession had a much larger amplitude (2.9% versus 1.1%) and there was a sharp increase in the unemployment rate. This was not reflected in the balance of trade or in industrial production, as usual, but rather in a decline in investment (public and private). This was due to a decrease in economic sentiment and a contractionary fiscal policy, reflecting the national political situation and the change in available macroeconomic tools. The recession marked a break in the economic growth trend. At the same time, the recovery after the trough was slow: it was only in 2005:Q2 that the Portuguese economy would recover the real GDP per capita it had in 2002:Q1.