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The Causes of the Economic Crisis

by Dr Roger Bratenstein and Dr Manfred Fischer

The authors are attempting an objective elucidation of the economic crisis in Portugal. They are dealing with the influence of excess investment, with external economic factors such as the energy crisis and the recession in the industrial countries, and with the consequences of the revolutionary process.

Rapidly rising unemployment, inflation and balance of payments difficulties have been among Portugal's troubles since the middle of 1974. That a great deal is being written about Portugal at present has not been of much help in bringing the country's problems closer to a solution. This is probably because through ideological shortsightedness the changes and developments of the last few years are often given a partisan interpretation. But neither the market economic system as such nor the limited nationalization measures nor fascism or foreign forces can be blamed entirely for the crisis. A tangle of causes is at the root of the crisis. Its individual components are to be examined here in some detail.

Explanation by the Excess Investment Theory

The mistakes which were committed in the final stage of the Caetano regime are often treated too indiscriminately in the current debate. Talk of unscrupulous exploitation of the workers and incompetence of the dictators who turned Portugal into the "poorhouse of Europe" does not tally with the fact that the time before the revolution of April 25, 1974, especially since the late sixties, was one of rapid economic growth and steadily increasing investment (16.3 p.c. of GNP in 1968; 20 p.c. in 1972). The real national product rose by over 26 p.c. in 1968–1972 (especially from 1970 onwards), and the boom continued during 1973.

A large monetary expansion occurred at the same time. The amount of central bank money increased considerably because of the big rise from 1971 onwards in the central bank's currency reserves owing to larger earnings from tourism and remittances from a growing number of emigrants. Meanwhile the balance of trade stayed in deficit. The inflationary effect of the external factors which could have been avoided only by a revaluation of the escudo was magnified by the grant of big loans to the commercial banks by the Bank

of Portugal in 1972 and 1973 when the central bank might have reduced the liquidity in the economy by restrictive open-market sales or similar measures. The commercial banks used the two-fold liquidity influx for a large expansion of their credit business; their deposits doubled between 1970 and 1973.

Liquidity and Credits 1971–1973

Item	1971	1972	1973
Growth of total money circulation (in p.c.)	17.9	20.7	23.5
Increase in central bank currency reserves (in esc. mn)	8,664	9,901	7,971
Increase in the banknote circulation (in esc. mn)	2,612	5,085	7,917
Increase in central bank credits to commercial banks (in esc. mn)	32	364	1914
Growth of commercial bank lendings (in p.c.)	24.0	26.2	34.5

Source: Etudes Economiques: Portugal, published by OECD, Paris, July 1974.

The consequence was an accelerating inflationary development, especially in the second half of 1973. The wholesale prices rose between March 1973 and March 1974 by 28 p.c., and the cost of living went up by 25 p.c. between May 1973 and May 1974. The wages could not keep in step with this trend and therefore fell in real terms from 1971. To give an example, the purchasing power of industrial wages in Lisbon declined, after adjustments for the rise in the cost of living in the capital, by 1.3 p.c. in 1971, 2.3 p.c. in 1972 and 1.3 p.c. in 1973¹.

The profit explosions triggered off thereby for lack of properly functioning trade unions fed the fires of the investment boom which had already entered a critical phase. The excessive investments in 1967–1973 were chiefly concentrated in manufacturing industry, the building trades, transport

¹ Etudes Economiques: Portugal, published by OECD, Paris, July 1974, Table F.

and communications. The investments in housing and agriculture stayed at their low level. In 1968 8 p.c. of all investments had gone into agriculture; in 1972 it was 5 p.c. The contribution of agriculture to the national product fell from 18 p.c. in 1968 to 13 p.c. in 1972, and agricultural production declined also in absolute terms, so that more food had to be imported.

Such a strong and lop-sided investment boom is bound to engender imbalances and disparities in the economy, and this will happen especially if the boom goes hand in hand with a general inflationary progression which abrogates the directive and indicatory functions of the price and makes virtually all investments look profitable. Such a cyclical peak period comes usually to an end when the labour market has been exhausted and/or political developments ensue which suddenly cause businessmen to believe that their profit expectations are too great.

Avoidance of a Revaluation

That the labour market which had already been put under a strain by the large number of emigrants was relatively exhausted in 1973 is shown by the fact, that, especially in the second half of the year, the number of unfilled vacancies which had doubled in 1973 exceeded in some regions the number of applicants. Such an "overemployment" situation is highly unusual in a developing country with a mostly high number of unskilled workers. As early as December 1973 investment activity, which had still been rising sharply in the autumn, was receding fast. Besides, the state-programmed investments underwent an overall decline in 1973, which made the economy more slump-prone. In this context it is to be borne in mind that despite the manifest capital shortage one-third of the current expenditure under the 1972 budget (about DM 1.5 bn) was earmarked for unproductive military purposes.

The fundamental mistake committed in the 1970–1973 period however was the accumulation of huge foreign currency reserves. An escudo revaluation was avoided. But imported goods (especially machinery and equipment) would have been cheaper if the exchange rate had been raised, and increasing imports would have averted the expansion of the money circulation and thus the inflation and the cyclical overheating of the economy. Larger imports, especially of agricultural machinery, are needed to make progress with the overdue modernization of agriculture and for the cultivation of the vast areas of unused land. The question remains why the Bank of Portugal accumulated gold and foreign currencies to the value of eventually (at the end of 1973) nearly DM 7 bn, seeing that these kinds of assets

yield scarcely any interest and agriculture in particular was in urgent need of capital to finance tangible assets.

Energy Crisis and Recession in the Industrial Countries

For the politician concerned with economic matters it is always convenient if he can discover a foreign cause for an economic crisis. The attempt to establish a link between Portugal's present problems and the energy crisis of 1973/74 however must prove abortive. The oil crisis caused the motor fuel price in Portugal to go up from January 1, 1973 to February 4, 1974 by about 65 p.c., but consumption in the first four months of 1974 was 5.9 p.c. higher than in the corresponding period of 1973. The oil crisis accounted only for 1–2 percentage points of the rise of the general price index.

Official circles in Portugal are making much of the supposition that the recession in the industrial countries spilled over to Portugal, and attempts are being made to supply data to prove this. Major items of the balance of payments are picked out and their changes interpreted.

The embargo on guest workers, in Germany for instance, was clearly due to cyclical unemployment in the host country. Such an embargo tends to reduce the foreign currency remittances of the emigrants. In actual fact however their transfers were as high in 1974 as they had been in 1973. Although a decline was noticed in the last quarter of 1974 and early 1975, the transfers of escudos 5.4 bn in the first quarter of 1975 were still above the escudos 5.2 bn of the first quarter of 1973. In real terms the remittances declined in 1974 to the extent to which prices rose in that year. But in the absence of other information it is almost impossible to say whether the embargo on guest workers, unemployment among guest workers, reluctance to exchange foreign currencies into an escudo threatened by devaluation or political reasons were the cause. The political reasons alone can probably be ruled out because the transfers in the third quarter of 1974 reached their so far highest quarterly level (about DM 1 bn), which suggests that the Portuguese guest workers were welcoming and supporting the political changes in their homeland, but these figures cannot be taken as proof that the guest workers' remittances were a prime factor in originating the Portuguese crisis.

Falling Revenues from Tourism

The frequently expressed view that the subsidence of Portugal's earnings from tourism was also due to the economic setback in the industrial states

must likewise be rejected. They, like the guest workers' remittances, remained constant, in money terms, during 1974 although they fell off in 1975. Since the situation in the tourist sector was generally favourable, the explanation for the decline of the tourist trade as far as Portugal is concerned is probably that the would-be tourists derived a distorted picture of the political situation in Portugal from the mass media and kept away from Portugal because they did not want to become involved in bloody demonstrations and arson. Incidents of this kind were — insofar as they occurred at all — mostly confined to areas far removed from the tourist centres and largely staged by oppositional circles on the right. The shortfall in receipts from tourism has added to Portugal's balance of payments problems.

Changes in Foreign Trade

The conjecture that responsibility for the origin of the crisis in Portugal lies with the foreign trade is certainly plausible insofar as the principal buyers of Portuguese exports — Great Britain, West Germany and the USA which absorbed 41 p.c. of Portugal's exports in 1973 — are currently in an economic trough and may therefore be holding down their demand for Portuguese products. If exports decline, the national income and currency earnings will fall off and so will the import potential and the investments. Exports from Portugal however increased in 1974, both in volume and value, and the highest monthly figures were recorded at the end of the year (in December they were equivalent to about DM 1 bn). In the early part of 1975 the monthly exports fell back in value to the 1974 average (of about DM 0.5 bn equivalent). The relative stability of the exports may be due to their composition (textiles and foodstuffs account for about 50 p.c.) which makes them resistant to cyclical changes.

The balance of trade deficit however widened substantially in 1974 — a development which had already started in the second half of 1973 — not owing to rising prices but because of an enormous increase in the volume of imports the reason for which may have been that the escudo was not devalued as much as the inflation rates since 1973 required. Another reason for the escalating import surplus in 1974 may have been the fear among importers that in order to defend its constantly dwindling foreign currency reserves the State would tighten the import restrictions which had been introduced in May 1974 but relaxed in July. It was thus not the recession in the industrial states but the inappropriate escudo rate (in relation to the DM it was devalued by 10 p.c. only between the spring of 1974 and the spring of 1975 while

prices in Portugal went up by 25 p.c.) which caused the balance of trade problems.

The most frequently offered explanation for Portugal's economic difficulties is that the crisis is the consequence of the revolutionary process, and this explanation is being supported by various statistics. The economic indicator of the GEEF (Gabinete de Estudos Económicos e Financeiros) which in April still showed 78 p.c. of "normal and above-normal" business activity fell in the next few months — in May to nearly 50 p.c. and in June to over 50 p.c. of "sub-normal" activity. The figures indicating "above-normal" activity had begun to decline as early as the autumn of 1973. The situation improved later in 1974 when the "normal and above-normal" activity rose to about 60 p.c., but in the first half of 1975 it fell to about 30 p.c.

The number of protested bills doubled between April and May 1974 and quintupled in the following 12 months. The decline in the number of protested bills from 1971 onwards had already come to an end by the middle of 1973. The number of unfilled vacancies fell sharply in April 1974 and continued to decline throughout the year. This indicator was stabilized only in early 1975 and then at a low level. The number of redundancies has been receding in 1975 but unemployment is rising fast (from 90,000 at the end of 1973 and 177,000 at the end of 1974 to 270,000 in the middle of 1975). This paradoxical trend is to be attributed to demobilizations from the army and the return of soldiers from the former colonies. Besides, the opportunities for emigration were greatly curtailed by the recession in the industrial countries.

The number of new enterprises declined after the huge increase in 1973, in the first quarter of 1974 slightly and in the second quarter substantially. In the third and fourth quarter it rose however so that the 1974 total was slightly above 1973 (1973: 4,500; 1974: 4,600). The industrial investments followed a similar course: they reached an annual low in May but in 1974 as a whole exceeded the 1973 figure by 3.3 p.c. in real terms. Both these indicators had started to decline before the revolution (the investments in December 1973 already), and this decline accelerated at first but soon made way for a recovery. This is in line with the movements of the GEEF economic indicator. In 1975 the overall trend was however downward.

Another indicator which points to the importance of April 25, 1974 for Portugal's economic problems are the statistics of commercial bank deposits. After a vigorous expansion in 1970–1973 they have been slightly regressive since April 1974. The lack of political security felt by the upper class is reflected by the relatively large withdrawals from accounts with deposits above escudos 1 mn (by

9.3 p.c. between the first and second quarter of 1974) while the deposits on accounts in the escudos 50,000–100,000 group rose by 5.9 p.c. There was also a shift towards longer-term and therefore higher-interest deposits. In 1974 the deposits declined also because the substantial wage increases resulted in some measure of redistribution between the firms which carry out money transactions without paying cash and the workers who for the most part have no cheque accounts yet.

The decline of deposits, tardiness in effecting payments and a strong demand for credit were bound to cause liquidity difficulties for the commercial banks. Late in 1973 their surplus reserves were already unusually low because they had increased their lendings excessively. In April 1974 the reserves were generally below the minimum, and the banks retained their solvency only with emergency assistance by the central bank which boosted its rediscount credits between March and December 1974 (in April about 10 p.c. of the banks' bills were rediscounted, in December 30 p.c.) and lowered the minimum reserve ratios. One reason why this had to be done was that the officially stipulated rise of minimum wages – which the smaller firms in particular had great difficulty in financing – would otherwise have caused unemployment to rise further. But with production stagnating a cost inflation was the consequence. The monetary expansion could not be maintained at the pace to which Portugal had become accustomed in the preceding year as the political and economic uncertainties induced the public to rely much more on cash (the ratio of deposits to banknote circulation fell between 1973 and 1974 from 486 p.c. to 309 p.c.). Even an increase in the banknotes in circulation by 50 p.c. in 1974 proved insufficient. The rate of inflation stayed at 25 p.c. however between May 1974 and May 1975, which is due to the decline in the supply of goods and increased velocity of money circulation. The decline of the central bank's foreign currency reserves made it more difficult to expand the money circulation. The re-

serves fell in 1974 by escudos 15.6 bn; escudos 11.8 bn were needed to balance the external payments, and the remaining escudos 3.8 bn were probably lost through the flight of capital from the country which the central bank involuntarily financed through changes in its assets (rediscount credits in the place of foreign currencies). In the first half of 1974 the flight of capital was also due less to international interest differentials than to the uncertainty felt about Portugal's future.

The abrupt change of trend of several indicators in April/May 1974 must be regarded as evidence of the economic repercussions of the revolution of April 1974 even though the repercussions cannot be interpreted as altogether negative (e.g. in regard to investments). Some of the programme items in the Law of May 15, 1974 (No. 203/74) had certainly a positive effect on investment:

- Liberalization of foreign trade and capital movements,
- Encouragement of the return of emigrants,
- Stimulation of private investment activity,
- Support for small and medium-sized enterprises,
- Stressing of the importance of private initiative,
- Equality of opportunities and abolition of protectionism,
- Restriction of public investments to the public sector,
- Assistance for the regions,
- Strengthening of the infrastructure.

These measures are of especially great importance for the viability of a market economy. On the other hand, there were some items which may have frightened away some investors because they affected firms' profits either directly or indirectly:

- Fairer incomes distribution,
- Counter-inflation measures,

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These demands are recognized as justified in all industrial countries and in part being fulfilled by them. The term "nationalization" occurred in the mentioned law only in reference to the central bank and a commercial bank which performs similar duties as the note-issuing bank — elsewhere the law only mentioned "intervention in vital economic spheres if required for the public weal".

Lack of Support by the Western Industrial Countries

In a country which for several decades had been ruled by a fascist dictatorship the mentioned items of the programme may seem extremist and possibly impair the propensity to invest of local and foreign enterprises, whose profits had never been endangered by trade union demands, but it was not to be expected that the western industrial states would also take alarm and put off giving the help which they had promised. But it must be pointed out that in 1974 the investments still increased although the changes which had occurred (bringing insecurity and wage rises)² should have given added impetus to the cyclical turn-round already signified by the economic indicators in the winter (1973/74). The events of April 1974 appear even to have led to a certain stabilization of the economic situation, at least in the second half of 1974.

The lack of support on the part of the industrial countries of the western world was however bound to cause the Provisional Government to veer to the left. Since March 1975 it has been nationalizing banks, insurance companies, electricity undertakings, the steel and shipbuilding industries, petrochemicals, some big transport firms and the large estates. Smaller and medium-sized firms were however expressly left in private ownership. As far as the nationalization of the big enterprises is concerned, it could be pointed out that they had had close links with the fascist dictatorship. Nevertheless the economic indicators showed an extremely negative reaction to the measures, and so a national employment programme was adopted in April 1975 because of the large increase in unemployment. Stress was laid on increased private

initiative but the need for public investments was also emphasized (20 p.c. of the expenditure under the 1975 budget was earmarked for investments). A somewhat problematic system of automatic financing through money creation by the central bank was devised to ensure early discharge of public debts. Provision was made for intervention in private enterprises in case their continuation as private firms was no longer assured.

Negative Influence of Foreign Enterprises

The problems to be tackled by means of this emergency programme, which was supplemented by a price stop, must unfortunately to a large part be attributed to the attitude of the foreign enterprises which had invested large sums in Portugal, especially since the late sixties. "Extrapolating from the dynamic development of German industrial investments seen in Portugal up to April 1974, it can be assumed that investments of the order of about DM 150 mn were deferred in 1974 alone, which corresponds to the loss of about 3,000 to 4,000 new jobs³." As from 1975 in particular Grundig, Hoechst and Siemens limited themselves in Portugal to "replacement and supplemental investments"⁴. Large-scale projects were in the meantime put on ice, by Hoechst for instance⁵. As this attitude also spread to trading, particularly in 1975 — "Nothing is being bought from Portugal because deliveries are too uncertain; nothing is being sold to Portugal because the buyers cannot obtain foreign currencies"⁶ — economic activity in Portugal which had recovered slightly in 1974 was bound to fall off sharply in 1975.

It is to be hoped that the new Government of Azevedo which has been in office since September 19, 1975 will break out of this vicious circle which has aggravated the crisis, the more so as the costs in Portugal — despite the additions from higher minimum wages, holiday pay, ban on dismissals, plans for a 40 hour week which the DEG (German Development Company) bemoaned in the FAZ⁷ — are still very favourable for Europe. A restoration of the conditions which prevailed before April 1974 cannot possibly be in the interest of the western democracies. Official quarters should therefore at last give succour to Portugal without imposing further political conditions⁸.

³ Handelsblatt, Düsseldorf, April 15, 1975.

⁴ Der Spiegel, Hamburg, April 14, 1975.

⁵ Handelsblatt, Düsseldorf, April 15, 1975.

⁶ Die Zeit, Hamburg, May 9, 1975.

⁷ Frankfurter Allgemeine Zeitung, Frankfurt, July 17, 1975.

⁸ The following material was used additionally to the quoted sources: Instituto Nacional de Estatística: Estatísticas para o Planeamento 1960-1970, Lisbon 1972; Indicadores Económico-Sociais, Lisbon, third year, No. 4, April 1975; Inquérito de Conjuntura ao Comércio, January-March 1974. Gabinete de Estudos Económicos e Financeiros, published by Banco Português do Atlântico, Conjuntura, January-February 1975 (No. 6), Conjuntura, May-June 1975 (No. 7).

² According to a report in "Wirtschaftswoche", it was still possible for Agfa-Gevaert before the putsch to pay Portuguese women workers DM 1.60 an hour; later the firm had to pay at least DM 2.30 (Wirtschaftswoche, No. 17, 1975).