The "New Escudo" Solution

- What shall we do the day after Portugal leaves the Euro

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Introduction

This book springs from the natural dialogue between different points of view.

One of us has been defending that leaving the Euro as the necessary measure to rescue Portugal, while the other has claimed that priority should be given to the restructuring of the debt, in order to articulate a landslide and to answer immediate difficulties. To the former (João Ferreira do Amaral), economic degradation as well as European difficulties confirms that the model of the Euro is not sustainable and demand the exit from it as an option. For the latter (Francisco Louçã), given that the model of the Euro is not sustainable, if debt restructuring keeps being blocked and reject, our choices will be limited to the exit from the Euro as the last option, however difficult it will be.

These are steps from a common path trying to present a democratic answer to the crisis, framed by a converging analysis on the nature of the economic and social difficulties that have been imposed to Portugal. One of the interpretations suggests a structural answer, in the long term, while the other proposes an instrument to bring together the necessary powers to impose a change of course.

In both cases, we acknowledge the severity of the crisis that has been imposed on us, and we work diligently to draw a plausible alternative. It is not a tradition in our country that people with different points of view come together in an attempt to understand each other in all clarity, recognising the difficulties, seeking the solutions. The authors of this book considered, however, that this dialogue was not only productive but also indispensable, and they offer to the public the demonstration of that process.

There are still two very good reasons for this unprecedented effort, besides the respect for the possibility of dialogue and scientific inquiry in order to find consistent solutions, namely that, besides holding different proposals to answer the national crisis, we both recognise that, be it by external imposition or by an imperative of national choice, exiting the Euro may happen in a shorter term. Moreover, it may even be the last and only alternative if all other strategies to correct the errors of austerity fail, and it may improve the economic performance, correct the external deficit, and guarantee a mode of financing that is sustainable and preserves democracy.

We have to get ready for that possibility. These are the essential premises of this book. Therefore, we underline that Portugal cannot accept further sacrifices in the name of the Euro, nor continue on the track of this same austerity that has been destroying economy and employment. We shall contribute for a survey of all possible alternatives, and we have a very strong motive to do so: the time to find a solution is running out.

We write to answer the following questions: if Portugal wants to or has to exit the Euro, what will happen in the following days? In which direction should we go? How shall we answer the new problems that will arise regarding economic, politics, and social management? Which action should be taken by the State and the social groups?

We depart, therefore, from a scenario where the exit from the Euro has taken place yesterday, without arguing here whether this is the best strategy, or even the best solution. We admit simply that this may turn out to be the solution imposed on us by the circumstances and that, if it becomes inevitable, Portugal should be able to take the best decisions, which we want to examine and to bring forth to the public debate as soon as possible. The following pages are dedicated to these issues.

The book that the reader is holding in hers or his hands is, therefore, on the difficulties and on some of the solutions, on strategies and possible measures, and, above all, on the necessary answers for an economy policy that respects people, that engages capacities, and that can solve essential problems, such as those regarding employment, financing, and investment.

This is a task that should have been started already and, as far as we are concerned, we are convinced that there is no more time to waste. We need a contingency plan. With that in mind, we suggest these departing points for debate and the engagement in finding alternatives, which we wish and believe will bring together and will make converge many other opinions.

On the other hand, we do no agree nor will we ever agree with federalism as Europe's repentance. It has never been, nor is it now a consistent alternative to the growing authoritarianism of the European Commission and Council, through which the governments of the most powerful States, especially Germany, impose self-interested visions, favouring financial income and degrading democratic participation.

On the other hand, federalism, or the idea of an "European government" or of a "European State" has always been the motive and the justification for the path the Union has been following. In its name, the Budgetary Treaty has been imposed or, paving the way to it, the rule of the *European Semester* which determines the submission of proposals for national budgets to previous examination by the Commission.

We did not accept nor will we accept a form of Union that disrespects the existence of States with history, nationalities, culture and democracies that should hold sovereignty over fundamental decisions of their concern. Therefore, we have always claimed that the treaties that constitute the Union should have been the object of referenda and we realise that the Portuguese political regime has promised them but has never fulfilled that promise.

As we shall see, the consequence of this authoritarianism and its policy was a structure for the Euro that imposes the necessity of an internal devaluation for the poorer economies, i.e., it reduces wages and income for the majority of the population as an answer to recession.

By imposing this policy together with the governments that enforced them, the European authorities pursue the old deflationist strategy of correcting recession with recessive measures. They have turned the Euro into that "barbarous relic", as Keynes would call the gold standard in the 20s of last century, and they repeat the same mistakes that caused the first great depression and the tragedies of the 30s.

On top of this, the institutional conditions of the European Union have been rapidly decaying. Thus, the treaty on the banking union deprives the States of one of their most important tools for the regulation of the financial system: the control over the main activities of the banks operating within their territory. On the other hand, the hasty negotiations for the new Transatlantic Trade and Investment Partnership lead us to an extra subordination of environmental and social rules to the conveniences of the markets, not to mention that they seem to have forgotten those monetary issues that are of great importance in the relations between the USA and the Eurozone.

To make things worse, the austerity obsession has already became a golden rule of Europe, promoting a path of impoverishment and internal devaluation, which in its turn constitutes a *status quo* that is harmful and unacceptable.

This internal devaluation increases the burden of the debt on those States that opt for such measures. This is absolutely clear in an example inspired by Tepper (2012): if a State has a GDP of 100 and a debt of 100, its debt ration is high, at 100%. If, through the adoption of recessive measures, it reduced its GDP to 50, the debt ration raises to 200%, and only the village fool would suggest this as a way to solve the problem.

To make things worse: recession does not fix the problems regarding external competition, it deepens them, rather, as it destroys the capacity of production and the power to invest in fundamental capital goods, while, at the same time, employment opportunities decrease, thus decreasing also productivity. Since we are being governed by the European authorities that adopted the policies of the fool, this book is a reflection and a manifesto against the devastation of our country at the hands of this destructive campaign.

It is our strong conviction that the strategy of austerity, before and after the Troika, is not viable, and that conviction is grounded in the facts. Internal devaluation means the desertification of the country and it cannot have a positive outcome. Only if the salaries dropped by 60% would the effect be the same for business costs as a devaluation of the exchange rate by 20%. The social impact, however, would be so high that it is clearly impossible and absurd to lead a policy based on further impoverishment. We clearly emphasise the idea that internal devaluation, in the form that it has been imposed on us lately, can never stand in place of a devaluation of the exchange rate, when the latter is not possible. In first place, unlike the devaluation of the exchange rate, internal devaluation is not an incentive for economic growth, and even less so for economic growth based on the production of exchangeable goods and services.

In the second place, again, unlike devaluation of the exchange rate, internal devaluation weights on the salaries in order to adjust (and, stemming from that, on pensions), and does so to an extent that quickly becomes socially unacceptable.

In the third place, it places society in the path of high unemployment, perpetuated throughout the decades, condemning hundreds of millions of people to a life without perspective, questioning the very existence of the welfare state.

Beyond what is stated above, there are two further reasons that warrant the survey of the possible effects of Portugal exiting the Euro. First, keeping the country as part of the Eurozone creates a paradoxical situation that has no match, neither in the modern world nor in the past, viz. the situation in which a country, in the context of free trading, while holding one of the biggest debts in the world regarding external debt, uses for that the strongest currency in the world. The paradoxical nature of this situation demands that we question its sustainability.

The second reason concerns the sustainability of the Eurozone itself. The present study presents our research on the effects of exiting the Euro, assuming that, in the meanwhile, the Eurozone remains, in spite of Portugal exiting.

The future of the Eurozone, however, is not certain either. There are many risks. It is enough to think that, in all probability, considering the austerity policies that have been followed and that are to be followed through the fulfillment of the Fiscal Compact, the next financial crisis will find the Eurozone extremely debilitated.

We do not anticipate when that crisis will take place nor how severe it may be. However, if we take into account the history of the last few decades, a new crisis will not take that long to be upon us. Its impact, thanks to the continued deepening of globalisation, will certainly be deep too, even if not as severe as the 2007crisis.

The Eurozone, in that almost certain event, will have little leeway to deepen the austerity policies. It will have little leeway both in social and economical aspects. At the same time, however, it will not have a way out, because the governments in countries such as Germany refuse any other alternative.

A serious disaster is, therefore, a possibility, and it may even imply the chaotic dismantling of the Eurozone. In this way, it is useful to think of an exit for Portugal, even if in a different context, since such enquiry will bring us useful tools to judge the effects of a potential general disaster.

In any case, exiting the Euro and adopting an independent currency is not an easy process. It has pros and cons that should be examined very carefully.

The main advantages are:

a) it would be possible to regain control of an essential tool (the exchange rate) in order to stimulate economic growth based on the production of exchangeable goods;

b) with seigniorage, it would be possible to guarantee that the State would never stop fulfilling its internal commitments (salaries, pensions, etc), even if it may find it hard to fulfill external commitments of to resort to financial markets;

c) by improving the country's external finance, it would be easier for the banks to finance economic activity, breaking the vicious cycle of financing restrictions.

The main disadvantage has to do with the hastening of inflation during the first few years after exiting the currency union, thanks to the internal impact of the devaluation of exchange rate. In any case, as it has been said before, it is not the goal of this study to evaluate in detail all the benefits and costs of exiting the Euro. However, the concerned reader will find here, we hope, useful elements to help them form their own opinion on this issue.

In case Portugal remains in the Eurozone, the complete absence of alternative approaches that guarantee the sustainability of the country from the economic, financial, social, demographic and politics points of view leaves on those who defend obeying the rules of the Euro the duty to clarify the conditions that would guarantee the sustainability of the country under the currency union.

As this sustainability is far from guaranteed at the moment, it is important to investigate the scenarios of a possible withdrawal from the Euro. We believe that we owe to the public debate this effort of formulating clear alternatives. We do not accept the maintenance of austerity, of privatisation of strategic goods and public services, of the furthering degradation of work contracts, of the decaying of employment, of the forced emigration for youth.

The answer begins by the creation of a strong public opinion, essential in democracy, and for the presentation of a plausible alternative. We are truly convinced that there is no other way but this effort and mobilisation for a nationwide answer that enables us to face the orientations of the directory and of the financial and economic interests it represents. In the arrangement of the European powers, no one will listen to the Portuguese people if it does not make itself heard.

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This is not a technical book. Even though it includes some specialist data, we have written it in a way that it may be read and discussed by anyone interested in the topic. We limit ourselves to chart the problems and the solutions we advance, which will need much more detail and figuring than what we present here. We hope the debate may be triggered by these considerations and that they help determining the best choices to solve the national and the European crises.

There is neither leniency nor condescendence in this book. We do not hesitate either in face of difficulty, because we are aware of the extent of the deep transformation that our answers represent. This is the cautious attitude that should inspire every democratic decision nowadays.

(The following is a summary of the book, originally published in Portuguese. Some chapters were excluded, although we believe this selection presents a fair overview of our argument. Thanks are due to Mariana Vieira for the translation).

Chapter 1

Leaving the euro and the immediate problem of creating the escudo

How did our exit take place

We assume that Portugal has quit the Euro yesterday, so that is a *fait accompli*. As we have done throughout this book, we will not discuss the political circumstances that would have surrounded or preceded this decision, but the future initiated by it. However, in this section we will contextualise briefly the institutional framework that precedes the decision, because it is relevant for the analysis that we shall make on the two alternative scenarios of economic policy, namely whether this exit is done in agreement with the European authorities or against them. This institutional context is important also for the definition of a strategy of mobilisation that allows the fulfillment of a condition stated above: the exit of the Euro requires a large consensus and a great popular engagement.

A mandatory decision

We depart from a single hypothesis: the preparation and the decision about leaving the Euro are the result of a democratic process that leads to a sovereign decision with complete authority. We exclude, therefore, a secret preparation and we admit, simply, that a government elected with that mission takes the decision. The electoral campaign would have been the time for confrontation of alternatives and for the electors' choice, and the inauguration of the new government would be the beginning of a process to fulfill the mandate to negotiate with the European authorities the eventual abandonment of the Euro.

We anticipate also that the winning party or coalition would not be able to run for the elections neither with a simplistic proposal nor an ultimatum on leaving the Euro. We admit, however, that this coalition would present itself unambiguously again austerity and the destruction of national economy, committing itself to initiate a round of negotiations with the creditor agencies. It would also be prepared to any solution that would prove to be necessary, including exiting from the Euro.

This negotiation would involve all institutional creditors. Faced with the pressure of the creditors, the new majority shall announce that it is prepared both to close a deal that accomplishes the mandate to invert the economic orientation, and to take vital measures for the protection of society, while respecting constitutional obligations, including Euro exit if neeede.

The factors of instability and social tension would, in this way, be significantly reduced in the framework of a negotiation with the withdrawal from the Euro as the outcome. The decisions regarding this exit could be taken with time, meticulously prepared, agreed between national and European centres of decision, without being spoiled by uncertainty. If, on the other hand, this negotiation did not lead to an agreement of any kind, uncertainty would be solved with a set of irreversible decisions to be implemented immediately, through a unilateral declaration exiting the Euro.

We exclude secrecy in the process of negotiation and regarding its outcome. Both because information and democratic participation in a choice of this kind demands total responsibility from the population and the State, both because no government whatsoever would be able to act legally if it would take definite decisions concerning the preparation of the new currency without a mandate. Issuing banknotes, for example, would be impossible from the legal point of view, and probably a vulnerable from the point of view of information.

The day of the exit

Before we proceed with the survey of the difficulties and possible solutions following the exit of the Euro, we shall present a brief note on the legal mechanisms that should be available in order to hold a vote in the parliament on the exit from the Euro, mechanisms which should be approved as soon as possible. The bill shall establish the new Escudo, with compulsory legal circulation in Portugal, which would turn the Euro into a foreign currency. It should also determine five other mechanisms.

First, it should establish which contracts and debts are redenominated in Escudos and which keep the Euro.

As this decision is potentially open to controversy, the legal grounding for it should be carefully studied. The Portuguese State will evoke 'Lex Monatae', the general norm supported by well-established jurisprudence, which defines that each State has the right to its own currency with compulsory legal tender within its borders, which may include all the contracts of that economic space, even though it does not include contracts made externally and subjected to foreign law. Therefore, fixing the scope of the redenomination of the contracts is a political choice. Later on in this book, we shall expand on our proposal regarding this choice.

Second, the bill must define new forms of control of capital that must be enforced immediately after approval. This law should come into force without further ado, or capital flight may reach dangerous proportions. In truth, in the event of the law having to be enforced, it would be convenient that capital control would be legally instituted as soon as possible, preferably even before the parliament votes exiting the Euro. This deliberation requires the institution of border control and, before that, the control over bank transactions across borders.

Third, the law must change the status and the legal powers of the Bank of Portugal. This status cannot correspond simply to the recovering from the situation before the Euro, because the new Bank of Portugal will be required to have a bigger intervention in the monitoring and the control of the financial and exchange movements, and even over the external trade if needed, thanks to the restrictions to the financing of this operation in foreign currency. It must, therefore, be strictly articulated with the economic policies adopted by the government.

Some authors go as far as to suggest the extinction of the actual Bank and the creation of a new juridical entity, in order to protect its stocks from the eventual punitive judicial actions moved by the creditors. We consider this solution inadequate, since it would not avoid lawsuits to be carried on by the creditors that collide with de sovereign decisions of Portugal. Furthermore, it would have a symbolic meaning that would be the object of controversy, and the legal status of the new Bank of Portugal has to be carefully drawn in order to protect its capacity of intervention and to define its new functions.

Fourth, the law should predict the shape of the bank resolution, predicting the models of public intervention that answer difficulties for the balances of the banks and, in particular, it should reinforce immediately the guarantee for the deposits.

Fifth, the law should define the criteria of management of monetary policy when faced with the risk of excessive inflation, and it should stabilise the emission of public debt securities in the future.

Previous agreement or unilateral exit

One of the authors of this book (Ferreira do Amaral) has been proposing and exit from the Euro based on a cooperation deal between the Portuguese State and the authorities of the European Union and the Eurozone. This agreement demands a programme of intense cooperation negotiated between these institutions and it should involve the European States, as it requires legal procedures that must be consensual, including those stemming from exception norms or rectifications of treatises, as we have seen above. This will be the first framework of our analysis, which we shall call Q1 and, in the following chapter, we shall present some of the mechanisms that are necessary for an agreement of this type to succeed. In the second framework, which shall be called Q2, we admit that it has not been possible to achieve this agreement, because it has been turned down by the European authorities and vetoed by some of the strongest States, or because its conditions were unacceptable for Portugal, or for any other reason. So the exit of the Euro would have taken place unilaterally and under conditions of confrontation, which form and intensity may also vary significantly. Both scenarios, as we shall see, have a different impact in the form of resolution of the problems and lead to different paths. In particular, in the first case, it is possible to negotiate a set of measures and procedures that, while not being the most desirable, are part of minimal compromises between the Portuguese state and its credits and partners in the European Union. In the same way, in the second case, some measures may become imperative, not because they bring more advantage, but because there will be no suitable alternative.

The creation of the new Escudo

Portugal has been through two changes in currency in the 20th century. However, the potential change to come in the 21st century with the introduction of the new Escudo cannot be compared to any of the previous ones.

The first one was on the 22nd of May 1911, when the new republican government declared the end of the Real ("Reis" in the plural) and created the Escudo, which was worth 1.000 reis. It was only in the following year that the new banknotes were made available. In the meanwhile, the old notes were kept in circulation, though their value was accounted for according to the nominal conversion into Escudos. Considering that the State that used to issue Real notes was the same that was now going to print Escudos, and that one currency would convert directly into the other, there was no major problem in the process.

The second change of currency in Portugal was the introduction of the Euro, which has been prepared for a long time. There was a period of three years between the fixation of the parities of existing national currencies, with the Euro serving as scriptural money, and the introduction of a physical new currency.

The printing of note and coinage started two and a half years before they reached the public, in fourteen factories at the same time. Banks received Euro notes three months in advance, and wholesale businesses got them one month before they were distributed to the public. Therefore, when the era of the euro officially begun, banknotes were already available for distribution, even though, for eight weeks, both currencies coexisted and it was possible to exchange the old one for the new.

Evidently, these choices solved significant problems, since the stronger currency was more sought after, thus creating an incentive for the exchange of old escudos for new euro coins, which happened in a generalised way. On top of that, the legal circulation of the old escudo would stop at the end of that period. Everyone wanted to exchange their escudos for the new euro.

In the case of the Euro, preparation took a long time, for several reasons, all of them unavoidable. First, note issuing obeys strict security procedures against counterfeiting, which, alone, take a long time to set in place. Secondly, the new notes and coins must be distributed throughout the whole of the economy from day one, so that there are no disruptions and trust in the new system is consolidated. But, in the third place, this preparation is long because the software (and sometimes the hardware) of thousands of machines must be upgraded, from ATMs to ticket vending devices, e.g. for public transport or food.

In the context of this book, we have reasons to presume that the two features that have put a damper on the previous transitions will not take place or will be impossible to arrange.

The first one is the coherence of the decisions and the management of the transition by the monetary authority. Since the entities in charge of issuing the euro and those that would be in charge of the new escudo are not the same, continuity between the two currencies cannot be assured, unlike what happened between the Real and the Escudo. Therefore, in the context of an agreement with the European Union for the Portuguese exit from the Eurozone, there would be the need for a further agreement with the ECB in order to continue issuing currency and providing it to the Bank of Portugal for unlimited circulation throughout the national territory. The scenario of such transition without the agreement will be analysed at a later point.

The second damper would be a long preparation that would assure the existence of the new currency on the same day it is declared legal tender, guaranteeing that there are enough notes already printed to assure all the necessary payments without disruption. This second condition will only take place if the agreement with the European authorities gives us enough time, keeping the Euro in circulation without restrictions.

Most of the authors that have studied the possibility of a new currency for a country leaving the Eurozone suggest an initial exchange rate of 1:1 (one Euro for one Escudo). This is also our proposal, for two reasons. First, it is the simplest conversion; it avoids information costs for the population, particularly amongst its most vulnerable sectors, and it avoids a type of inflation through the rounding of prices, even if the latter is a smaller risk when compared to others that we shall discuss below. So, one Escudo would start by having the same value as one Euro. The Escudo notes should also have the same dimensions as the Euro notes (though they must be clearly different to the eye and to the touch), in order to make it easier to adapt to the automatic payment machines and ATMs.

Issuing new banknotes and coining new pieces will take a long time. In the case of Greece, which has a population of similar size as the population of Portugal, the available calculations point at least six months in order to have enough notes (375 millions of notes), and two years for the coins (1500 millions of coins). Considering that there are 15.76 billion of Euro banknotes and 105 billion of coins in circulation through the several economies, and considering the represented proportion of Portugal in the Eurozone, we will assume that these estimates apply to us as well, and that it will take at least six months to produce Escudo notes, and many more months to issue new coins. In Portugal, Valora, a company owned 100% by the Bank of Portugal, has the suitable operational technology to print banknotes and for coinage. Therefore, the only issue is time, considering all the rules that must be followed when printing banknotes.

Our two different institutional frameworks, as a result of a negotiation that leads to an agreement with the European authorities or that fails achieving that goal, would have very distinct outcomes in the preparation of this transition. In the first case, these problems are solvable, since it would be announced (and respected) that financial applications in Portuguese institutions would keep their value in Euros, a guarantee to be offered by both national and communitarian authorities (Amaral, 2013).

In this case, there would be no major difficulty in the circulation of the new currency: during the whole period necessary for printing Escudo notes, there would be enough Euros circulating, assured by the ECB. Portugal would even be able to keep issuing Euro under the authority of the ECB (notes currently issued by the Bank of Portugal have the prefix M and can be identified, but their quantity is decided by the ECB), if the deal between the two parts would allow. Or the ECB would guarantee the necessary liquidity, by sending trucks filled with banknotes, according to the deal, in order to avoid a cash crisis, as it has done with Cyprus.

Even then, it is possible that there would be a necessity to impose stricter limits for cash withdrawals in Euros at ATMs or bank counters, in order to avoid runs to the banks caused by caution or panic.

In the absence of an agreement, however, introducing the Escudo will be much harder, and there will be several sorts of pressure. The first immediate problem is that, in the moment of the exit from the Euro, there will neither be Escudos available nor people wanting them, for they will prefer to have Euros. This will have two consequences. First, there will be a run to the banks in order to withdraw the Euros while it is still possible, or, when the Escudo becomes available, in order to exchange it for Euros or any other currency, to prevent losses by devaluation. In the second place, daily exchanges will not be possible materially while the new currency is not available (though they can be done scripturally), namely through ATM transfer, or by any other virtual access to standing orders).

In this way, we will always have a troubled transition, even if it will be possible and even easy to make any kind of payment. In any case, unlike what happened with the two previous changes of currency, incentive works in the sense of rejecting the new coin, not in the sense of seeking it.

Let us examine the problem of racing to the banks in order to take Euros. This may occur when it become self-evident that Portugal will create the new Escudo, a currency that will be devaluated in relation to the Euro. For that reason, a run may begin even before this decision is taken, for instance, the day after electoral results that mandate a new majority to negotiate a deal with the European Union, or after a round of frustrated negotiations. In the recent case of Argentina, the run begun nine months before the devaluation of the coin.

In the second place, if there are not coins nor Escudo note, some exchanges will take place in Euros, but the Euro has become a foreign currency whose circulation depend on foreign authorities, and whose exchange rate is being valued in relation to the national currency. In the case of conflict, these authorities may not give Euros to Portugal: in this scenario, it is easy to predict some difficulty.

Therefore, the regular mechanisms of circulation will mean that there will be Euros leaving the country to enter other countries that remained in the Eurozone. Furthermore, the bigger and more evident the conflict, the bigger the pressure for people to keep their Euros. Besides other consequences of this fact, this will create difficulties in payments. This tension must be avoided at all costs, even more so considering that bank deposits play an essential part in people's savings and liquidity. Almost everyone older than 15 years old (96.1%) has a bank account and does not accept it to be threatened. One of the most evident policies of the government must be to guarantee that the deposits will be safe.

Therefore, if there is a deal with the EU that ensures financing the economy and guarantees liquidity, without restrictions to the circulation of the Euro during the period of transition into a new currency, we admit that deposits remain denominated in Euros in conditions that we shall present below. This would be an important guarantee for the peace of mind of deposit holders.

In any case, exceptional limitations to the capital movements must always be imposed, including, if needed, the temporary interdiction of transfers into foreign accounts. If, in the meanwhile, disruptions take place, the emergency measures that can be taken, at different moments, are the following:

1) a temporary limitation will have to be imposed on withdrawal amounts, as soon as there is a sign that a bank run is about to take place, though keeping the amounts unlimited for electronic payments to economic agents inside the national territory;

2) banks may have to be closed for a few days, until they have reorganised their operations, or until the start of the transition process to the Escudo. As soon as the legal decision is established, the coinage and printing of Escudo must start immediately.

Conclusion

As we have seen, historical experience of exiting monetary areas have been fairly common in the second half of the 20th century, though for reasons very different from the ones that would determine an eventual exit of Portugal from the Eurozone. In all cases, it has been a matter of conquering or reconquering national independence, where the processes of creation of a new currency were developed in a context of broad legitimacy and a large internal consensus.

These experiences show that when a new currency is created (which should be exchanged initially in the proportion of one Escudo for one Euro), the legal procedure must be in place, that predicts a mode of eventual redenomination of contracts in the new currency, of capital control, of definition of functions and status of the new Bank responsible for issuing the coin, of bank resolution and of protection of account holders, and also of controlling of risks.

The circumstances in which such procedures may or may not take place can be substantially different, depending on whether or not there is an agreement with the European Union for the transition to the new Escudo. These two possible scenarios will be systematically analysed in the following chapters.

Chapter 2

Leaving the euro through an agreement with the European Union

In this chapter, and in the following ones, we shall discuss what shall happen in the context of both our scenarios under examination: the existence or not of a previous agreement with the European authorities to oversee the exiting process. The two alternatives are substantially different, but the choice between the two does not depend exclusively on the Portuguese State. This is one of the reasons (but we shall name others) for all this exercise of analysis to be uncertain and inaccurate regarding the eventual options of each of the agents of decision.

The goals for a negotiation of a deal for exiting the Euro

In its original formulation, the proposal that one of the authors of this book presents for an exit agreement predicted that the negotiations would be concluded in an environment where the required conditions would be in place and "when the Eurozone would be sufficiently stabilised" (Amaral 2013).

This condition seems extremely implausible these days. Instead, the Eurozone is going through a period of turbulence and uncertainty with no end in sight, both due to the cumulative effect of the prolonged recession and to the stagnation of the economy, and due to the very nature of the current difficulties, which are intrinsically connected to the structure of the Euro and will be forever reproduced and amplified as long as the rules of the Budgetary Treaty are being applied. Therefore, negotiation will be even harder.

The two main goals of this negotiation require a structural transformation of the Portuguese society and of the scope of its democratic decision: the devaluation of the new currency and correction of the current accounts, as well as the financing of the State itself and of the Portuguese economy. In this sense, we begin by presenting our proposal on the agenda of this negotiation, and we shall proceed by the discussion of its viability and detail. We shall study the possibility of reaching the necessary conditions for the negotiation to take place. Below, we will discuss the other dimension, which we do not explain in detail in this chapter, which would include the renegotiation of the sovereign debt.

Considering all the previous experience, namely that of the Club of Paris, where this negotiation took place amongst several States in the last few decades, Portugal will always benefit from obtaining a substantial reduction of the flow of payment of the public debt, while, at the same time, postponing the amortisation of the debt stock to a later time, thus reducing its actual value and its weight in the current account.

The deal obtained by Germany in 1953 suggests that there is advantage in a game of positive sum, which makes it possible to reduce the weight of the bent through a menu of measures agreed upon, while still offering favourable conditions in the event of the desired growth of

Portuguese exports.

All this public negotiation must be preceded by discreet consultations in order to prepare the case for the exit. We assume, in this chapter, that both sides will keep an attitude of good-faith and secrecy regarding the contacts and preliminary negotiations, considering that the speculation over the details of the negotiation could trigger movements of tension and harm the Portuguese State.

It is more advantageous for the European authorities to negotiate with a State exiting the Euro

The possibility of obtaining a deal with the European Union does not depend exclusively on Portugal. In fact, the difference between an exit under a previous agreement and the one without it is also important for the authorities of the European Union, as well as for the other international institutions, and they will always have a word in the matter.

It is natural that our readers will ask themselves if there is any possibility at all that this negotiation will work out. The experience of previous negotiations with the European authorities, for example when defining the memorandum of understanding which resulted in the loan in 2011, or the successive revisions that followed it, leads us to predict huge difficulties reaching any deal that satisfies the need of recuperation of the Portuguese economy. It may be hard to trust that a consensual change will be reached. We can, however, claim that these negotiations have always been led in the past by Portuguese governments that accepted and even promoted the strategy of austerity and recession and that, consequently, did not decent a national alternative for employment and for social recovering.

But the European Union may also benefit from this negotiation, for there is a factor that opens the possibility for an agreement for Q1: be it for the Eurozone or for the European Union, or even global economy, the risk of a chaotic and confrontational exit is very threatening.

There are two big reasons for this threat.

First, Germany and other States that have been benefiting from the Euro could be harmed both by the uncertainty and by the direct economic effects of breaking the union. The valuation of the Euro-Mark, which would possibly take place, would risk the dissipation of the outcome of the competitiveness of the German economy in the last few years. The second threat is that Euro would be shaken by the unilateral exit of one State, which would reveal the lack of capacity of the European authorities managing the currency and the political problems coming from it, which would cause a crisis that could be even bigger than those we have seen in the past. The European authorities want to avoid that shock.

In order to compare this risk with historical events, Tepper studied the weight of six of the dozens of economies that, in the past, have created a new currency. He noticed that, on average, they only represented 0.1% of the GDP worldwide (Tepper, 2012). The USSR, the largest of the monetary zones that has recently imploded, represented 2.5% of the GDP worldwide in 1992. Czechoslovakia, just before the seceding by the end of that same year, used to represent 0.4% of the global economy. Now, the European Union represents around 20% of the world GDP and, these days, global economy is much more intertwined, in particular from the point of view of its exchange system, financial and banking.

The PIIGS alone, the pejorative name grouping Portugal, Ireland, Italy, Greece and Spain, represent more than the double in the global economy than USSR used to, at the time of the implosion of the ruble. Together, they represent as much as 6.7%, and are certainly closely intertwined with other economies of the same political and monetary region. The clumsy exit of one of these countries would represent a more dangerous risk of a domino effect against the stability of the global economy than any of the processes before the creation of a national currency.

The risk of this domino effect is crystal clear. The Euro is an international currency, and not a regional one, and it represents around 25% of the worldwide stocks of foreign exchange. Furthermore, around 40% of the world trade and 34% of all bank loans are denominated in Euros. The risk of contagiousness of a Euro crisis, triggered or amplified by the exit of a State in conflict, would therefore be much larger than in any other case.

Creation of the Escudo and devaluation

Let us consider again what could be happening in our country.

Following a governmental request, the parliament has assembled at an extraordinary session, in order to deliberate, with the agreement of the President of the Republic, that today (or on Monday, depending on whether the announcement was made during the weekend) the legal currency becomes the Escudo. The bill, passing straightaway through the different stages in the legislative process, and finally passing after a global vote, will be promulgated and immediately published, once again with the agreement and engagement of the President. At the same time, there is an announcement or a reinforcement of the control of the movements of capital (that should be already in place). The devaluation of the Escudo will be one of the tools to improve the current accounts and to correct the external deficit in a permanent and structural way.

Our readers will have noticed that such an option would not exactly be a surprise to anyone. At the moment of the governmental announcement, the majority of people would already know about it, or at least suspect, which could require measures of control for the circulation of capital even before the formal decision of leaving the Euro.

It is worth pointing out, en passant, that there is a significant difference between this devaluation of the Escudo and the low-range effect of a devaluation of the Euro, which has always been refused by the authorities of the Eurozone.

In the second case, the effect over the price competitiveness of the products exported by Portugal would be relevant but greatly reduced, considering that the biggest chunk of these exports markets are in Europe and the prices would float in the same way within the whole of the Eurozone. On the other hand, remaining in the Eurozone does not allow the emission of one country's own currency. With the current rules, this means also the perpetuation of austerity. For Portugal, a devaluation of the European currency against the Dollar or the Yuan is not enough.

On the other hand, the alternative plan for an exit and for devaluation against the Euro, with the most advantages for the Portuguese economy, also has a higher potential for conflict with the other European states.

In Q1, according to a previous negotiation with the CEB and the European Commission, "we would enter the Mechanism of Exchange Rates II, which regulates the relations between countries within the Euro which have not adopted the European currency. This means that, with the help of the CEB, we would have to keep the new currency at a range of fluctuation of 15% in relation to the reference rate of the new currency in relation to the Euro; this reference rate would devaluate every month in a system of crawling peg, so that the devaluation of the new currency would happen progressively" (Amaral, 2013).

We would then have an initial devaluation that would aim at reconstructing or amplifying the competitive capacity of exporting companies, and then a crawling peg.

Several scholars have studied the value of this initial devaluation. The Bank of Portugal has calculated that the Escudo would have been overvalued by 15% at the time that its fixed parity with the Euro has been defined, in the preparation of the new European currency (Boletim de Verão, 2010: 28); other authors have presented similar calculations, in the order of the 16% (Nomura, 2012).

Considering these values and the exchange shock needed in order to stimulate exports, the values suggested by the different authors for the devaluation are in the order of 40% (Bootle, 2012), 47% (Nomura, 2011), or 50% (ING, Evans-Pritchard, 2011). In our case, we have departed from the calculation that the initial devaluation, if it took place in the frame of an agreement with the EU, should be 15% at first, and then another 15% in crawling peg, adding up to 30% in the first year (in the meanwhile, in the subsequent calculations, we have used the extreme example of an immediate devaluation of 30%, so that we would consider the most difficult scenario). Naturally, the intense use of the idle production capacity is the key to obtain the maximum impact of this variation of the exchange rate with the best effect in the economy.

The computation of the initial value of devaluation is a matter of great importance, since there is a threat. The risk is that the tensions and the suspicion raised against the new currency, for national and international political reasons, will be such that the devaluation may be exaggerated. If there is an overshooting, a higher than necessary devaluation, the increase of the prices on imports will be excessive, compressing even further the internal consumption and stressing the recessive effects.

Furthermore, in order to keep the price competitiveness, the crawling peg should follow at least the differential between inflation in Portugal and the Eurozone, to which the majority of the exports are directed. Therefore, a supplemental devaluation will be needed within a year or two, even if smaller than that of the first year, in the context of the rules of the band of fluctuation to which we will belong. This differential should be reduced progressively from the first few years on, after exiting the Euro.

Before we consider the agenda for these measures and their effects, we would like to leave a warning, which will back our arguments in the following sections.

Devaluation is a policy of aggressive exchange rates - in the case of our country, in legitimate defence against an aggression suffered by the imposition of harmful and unfair rules - and it is a temporary measure, even if its application can be extended in time. But it is not, on its own, a strategy for growth, since, if isolated, it assures the dispute for competitiveness increasing the risk of impoverishment. It can, for sure, restore de price competitiveness of the exports sector faster and with more substantial effects than those obtained through the internal devaluation with austerity. However, no policy socially consistent can base itself solely on this principle of devaluation. There is the need of structural measures that correct the economy. A country has to industrialise itself and to promote qualified investment; it has to create employment without curbing itself to adjusting the economy to benefit the capital-intensive industries that save by offering fewer job opportunities.

This combination of policies makes the exercise harder, and demands that it is pursued with great social support and great clarity of direction. In this sense, we must consider the internal effects of devaluation. In fact, if the goal of the economic policy is devaluation in order to benefit from the price competitiveness, then this policy will be pressured on in order to keep the wage restraint and even to prevent a wage recovery, which is a natural thing to expect from a new government, after several years under austerity. It is our opinion that the economic goals must be alternative and much broader.

For now, we shall mention only two of those goals. The first is the recovery of domestic demand, including wages, and therefore private consumption. In the structure of demand, consumption represents about 60% of the GDP, and exports reach now 40%. No reasonable policy can base itself only in exports, while ignoring domestic demand. Resetting the level of income for workers and pensioners has an aggregate effect that is anti-recessive, but its overall impact on the economy will also depend on the use of the idle capacity and especially of import substitution, which should be one of the most important directions of the industrial policy in the short term. The combination of the industrial policy with an investment policy that aims at creating jobs will be the key to reaching social protection against devaluation.

On the other hand, the effects of devaluation will be rather asymmetric. The most important positive effect is the reduction in price of the currency of the exported products, favouring their competitiveness. The second effect is the reduction of imports as a result of the increase of the prices (as we shall see in chapter 6, this raises difficulties in areas such as fuel and medicines). For some companies, including exporters, the final result depends on this combination: if they import products in order to transform them and export again, e.g. TAP or GALP, the impact of the devaluation will depend on these two effects, which will always mitigate the immediate advantage in price of the exports.

A third effect is the increase of the amount in Escudos of debt owned by companies or by the State that will be denominated in Euros or Dollars. This result can be a threat for some companies.

The fourth effect is the reduction of value in foreign currency of the assets of companies, private or State-owned, which will harm companies based nationally and will favour those who have savings or income abroad. On the whole, those who have debts abroad may suffer the most, such as those who have fixed income or whose income depends on administrative decisions (Frankel, 2005). We will examine these effects in the two following sections.

Consequences of devaluation and compensatory and redistributive policies

We shall discuss the effects of devaluation by distinguishing those that affect financial wealth from those which concern flows, such as inflation. In each case, we shall consider first their direct consequences, without compensatory measures, and then the distributive policies that would be needed. In the case of the effects over wealth, the basic principle we have adopted is the neutralisation of the effects on debtors and creditors through the State borrowing from the Bank of Portugal, namely by replacing the debtors by the size of the initial loss of the value of the credits according to devaluation. In the case of the effects on income, the basic principles are the neutrality in terms of public deficit and the consumption and disposable income for workers.

> Effects of an euro exit on financial wealth

In this and in the following sections, we discuss the impact on financial wealth of adopting our own currency and its respective devaluation. The analysis will be performed, at first, assuming that there is no policy that compensates for these effects. Secondly, we present some hypotheses of policies that could compensate the main adverse effects of devaluation.

In order to make the analysis simpler, we shall admit that the New Escudo will be immediately devalued after its introduction. This hypotheses, which excludes a gradual devaluation, is the worst and should be avoided if there is an agreement with the European Central Bank, as we will see bellow.

On the other hand, it was considered that a devaluation of 30% would be enough to obtain the main effect of encouraging the production and the investment in the production of tradable goods, making this kind of investment profitable in the production of goods non-marketable.[1]

A. Effects without corrective policies

The effects on the financial wealth of an Euro exit and an immediate devaluation of 30% of the new currency should be analysed in relation to the balances or financial position of the following entities:

- Consolidated balance of the banks (excluding the Bank of Portugal);

- Situation of public finances;

- Situation of individuals and companies regarding banking.

The following assumptions are admitted: deposits in banks and loans granted by banks maintain its equivalent in Euros; the new currency appears with the same value of the Euro, so that, when devaluation occurs, it would be the same to refer to billions of Euros or billions of the new monetary unit (Escudo).

We shall address later the question of the maintenance of the Euro equivalents for deposits and loans, especially regarding deposits. For now, it is enough to note that, in order to keep the balance sheets of the banks balanced, both the deposits and the credits must keep their equivalent in Euros.

A.1. Consolidated balance of the banks

In net terms, the assets of the banks increase by 12 billion Escudos, compared to the situation with the Euro.

A.2. The State

Concerning the State, the value of its debt was, in late 2013, of the order of 205 billion of Escudos, so the State will see its debt increased by 61 billion of Escudos. However, as it keeps in the banking system deposits worth 20 billion of Escudos, the amount will be increased by 6 billion of Escudos. In total, the financial situation of the State suffers a net degradation of 5% billion of Escudos.

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1 - Devaluation is considered here in terms of the exchange value: from 1 Euro = 1 Escudo we get 1 Euro = 1.3 Escudos after devaluation. This way of considering devaluation facilitates the reasoning. In terms of its inverse, we get, after devaluation, 1 Escudo = 0.77 Euros, that is, a devaluation of 23%.

A.3. Individuals and companies, depositors and borrowers

Concerning individuals and companies of the non-monetary sector, which hold deposits amounting to 218 billion of Escudos, they benefit from an increase of 65 billion of Escudos in their assets. As for the debtors to banks, whose debts reach 329 billion of Escudos, they will suffer deterioration in their financial position in the amount of 99 billion of Escudos.

A.4. Critical evaluation of these effects

It is important to keep unchanged the value in Euros of the net assets of the banks, and also of the Bank of Portugal, since it is a necessary condition to maintain their ability to act abroad, namely the capacity for obtaining external financing and, in the case of the Bank of Portugal, for meeting foreign debt.

B. Effects with corrective policies

In order to correct these negative effects, we propose the following set of actions:

a) the State becomes debtor in the national currency with the Bank of Portugal for an amount identical to that of the deterioration of its financial situation (55 billion of Escudos).

b) the State takes on the amount of the debt increase in national currency by resident debtors. In this way, debtors will lose nothing because of devaluation. But they will also win nothing, since they will pay, in national currency, an interest rate increased by inflation.

c) in order to reduce the increase of its debt, the State will charge a one-off special levy of 50% on the gains obtained by the resident depositors, in national currency, resulting from the devaluation (50% of 65 billion of Escudos).

d) During a period of possibly 20 years, the Bank of Portugal assumes the debt of the banks to the European Central Bank, and the banks are forced to sell to the Bank of Portugal, in exchange for Escudos, the necessary Euros for the Bank of Portugal to pay the burden of its debt and a fraction of the amortisation, according to a schedule to be agreed with the ECB. This means a direct intervention of the Bank of Portugal in the management of commercial banks to ensure this transition.

The consequences of these corrective policies will be:

a) the State's debt with the Bank of Portugal will amount to the sum of the three figures of a), b), and c), that is, a value resulting from the sum: 55+99+33 = 121 billion of Escudos. As we shall see below, there will be an additional increase of about 20 billion of Escudos resulting from the increase of public deficit, which in its turn results from depreciation. The total amount will then be of 141 billion of Escudos, corresponding to about 76% of GDP,[2] but it is a debt to the Bank of Portugal in the long term, bearing interest which may be fixed at relatively low values, needed only to keep the balance of the accounts of the Bank of Portugal, as we shall see below.

b) debtors to banks will lose nothing thanks to devaluation.

c) depositors in banks will lose, on the whole, 33 billion of Escudos in terms of international purchasing power, but they will lose nothing in real terms against the expected inflation (10% in the first year), since the deposits, net exceptional tax, increase 15% in Escudos.

2 - In the denominator we have considered the GDP in national currency, increased by 10% due to the internal price rise.

d) concerning money supply, there may not be an increase because of these corrective policies, and therefore there is no need for an acceleration of inflation.

Points c) and d) require additional comments. The fact that we admit that depositors would see the Euro equivalent being kept in their deposits means that, compared to the rest of the world, they get to keep their wealth. However, internally, to the extent that the expected inflation is about 10% (see below), the depositors have a profit of 18% in real terms of their wealth, which does not seem fair.

Taxation in 15% of the deposit makes it possible to reach a better balance, which will result in a loss of 15% in real terms to the outside, but internally it will mean a gain of 4.5%, also in real terms.

As for point d), the increase of the State debt with the Bank of Portugal in 135 billion of Escudos represents, in exchange, a money transfer from the Bank of Portugal to the commercial banks, aimed at the reduction of private debt.

In the balance sheet of these banks, the assets will become liquid. This liquidity will be good news, after a long period of recession make by credit restrictions and by lower investment. But to avoid that this additional liquidity leads to an excessive increase of credit, part or all of this liquidity may be dried through mandatory deposits with the Bank of Portugal, being paid an interest rate identical to that of the public debt placed in the Bank. These deposits are liable to be gradually raised over the years.

Flow effects

We consider below the effects on inflation and public accounts.

A. Impact on inflation

The direct impact on inflation of a devaluation of 30% — measured by the implicit price index of private consumption — is given by the product of m*0.3, where m is the direct and indirect import content of private consumption. The value of m is estimated at 0.25, so the direct impact of devaluation on inflation will be 7.5%.

However, wages and other income will react to this increase in import prices, and therefore the inflation rate will be higher. If we assume that the other income behave as wages, and we fix a target of a maximum inflation of 10%, using a simple approach, wages will have to increase at a rate not exceeding y, given by the equation: $p=0.75*y+0.25*0.3$, where p is the increase in consumption rates and 0-75 (obviously equal to 1-m) is the content in added domestic private consumption.

The value of y, which gives us the increase rate of the nominal wages, is therefore obtained when p equals 0.1, is 0.333, which means that real wages will decrease by 6.5%, i.e., in terms of payroll, a value of about 4.4 billion of Escudos.

This value should be compensated through the reduction of the IRS (personal income tax) on labour income and through the increase of social benefits for the families of workers with low income, to which the IRS reductions have no meaning. For example, the family allowance for the lower incomes should help improving the distribution of income and protecting the poorest families. With this set of measures, the reduction of real wages available will be canceled. The State would have a reduction of revenue/increase of expense of 4.4 billion of Escudos.

Other compensatory measures to recover the real value of wages, which is the goal of the authors of this book, would be the immediate return of bank holidays and rightful holidays lost under austerity, in order to reduce smoothly in the economy the unpaid work time, and increase of the minimum wage.

Similarly, other appropriate measures to protect the value of wages would be subsidising medicines and public transport, and the social tariff for energy, which we will develop bellow. The process of economic recovery should lead to the creation of employment and improvement of qualified wages, which were the most affected by the repressive wage policy in recent years.

B. Impact on public accounts

The effects on the State general account of devaluation are, essentially, these:

a) on the negative side:

> increase in interest paid due to devaluation and increased debt;
>increase in social benefits to offset the impact on low income;
>increased public transport subsidies and medicines, in the estimated value of 1.6 billion of Escudos;
>reduction of IRS charges to offset the decline in real wages.

b) on the positive side:

>the increased collection of VAT on imported products and other taxes on the consumption of such goods (cars, fuel, and tobacco), and some luxury items, plus the special tax on the value of bank deposits. In addition, there will be a sharp and immediate increase in tax revenue stemming from the growth in the tourism industry.

Balance of the Bank of Portugal

The assets of the Bank of Portugal will increase by 141 billion of Escudos, that is, the amount of credit extended to the State, plus the value of appreciation of 30% of its gold reserves, i.e. 30% of 11 = 3.3 billion of Escudos. In total, rounding the figures, the assets will increase by 144 billion of Escudos.

The liability will increase by the issue of currency made available to the State to pay to the banks and other charges, i.e. in 141 billion of Escudos,[3] plus the 30% increase in the value of coins and banknotes in circulation (21 billion of Escudos), that is, 6.3 billion of Escudos. In total, the liability of the Bank of Portugal will have a loss of 3 billion of Escudos,[4] which will, eventually, be possible to compensate partially by the appreciation of other assets.

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3 - If part of this value is compulsorily deposited in the Bank for Portugal to reduce liquidity, of course there will be no change in the value of the liability. The composition will be what may vary.

4 - The value of banknotes and coins in circulation increases by 30% which, with and inflation of 10%, would mean an increase of 18% in real terms, i.e., around 4 billion Escudos. This is a benefit that will be received by those who treasured Euros, without doing anything useful for that, but this does not seem to be a problem easy to correct. One option would be to offer a discount to those who would be willing to pay a part of the IRS and of the IRC in Euros, during the initial transition, in order to absorb this effect and to the hoarding of Euros, benefiting the generalisation of the Escudo as the form of payment from then on.

Conclusion: the first problem is the very short term

In early 2014, Portugal has a primary surplus, which would make it possible to avoid recurring to external financing in case of lack of payment of debt service, and still has the net cash of around 20 billion Euros, besides the gold reserves of approximately 12 billion Euros. On the other hand, Portugal has completed its "Memorandum" with the Troika, and began to resort to direct funding by the financial markets. Also, it will be from now on submitted to the Budget Treaty, which imposes more dramatic and permanent budgetary restrictions than those in force until 2014. This is why this is a key moment to negotiate a solution which prevents the extension of recessive policies.

The context of this negotiation, if conducted by a government which respects constitutional obligations and the priority of economic recovery and employment, is crystal clear: if there is no agreement amending these recessive conditions and reducing the burden of the debt, Portugal cannot have an alternative other than leaving the Euro. But this potential exit also has risks that may be contained: the economic agents can anticipate a devaluation and seek to place capital abroad; the European institutions can conduct a lobbying campaign and harassment against Portugal; there can be a race to the withdrawal of deposits in Euros, threatening insolvency of banks, amongst many other risks.

Moreover, even within the framework of an agreement for the transition, there may be surprises that force emergency measures, in this case temporary. This is what happened in Iceland (which is outside of the Eurozone), and Cyprus (in the Eurozone). In both cases, the control of capital movements was legally imposed, and they were simply banned during the period of disturbance. In the second case, the course of action included the speedy application of the device advanced by the Treaty on the Functioning of the EU, namely, the European Council authorised the introduction of this control and it has been immediately applied. This control of capitals will be necessary at least for the period of transition from the Euro to the Escudo.

In any case, the answer to these pressures and to these problems requires a mobilising alternative for the Portuguese society. We know it will be a hard time; just like we have warned, there are no words of consolation or illusion to be found in this book. But we have options. They can be taken, largely, in the very short term: it is possible to establish the Escudo as legal tender, to control the process of devaluation, and to define the rules that will govern contracts and debts. It is these choices that we will continue to discuss in the next chapter.

Chapter 3

Leaving the euro by unilateral decision

In the case of an European agreement on the rules for Portugal to exit the Euro, two difficulties would be solved in this transition: the financing of the economy would be assured, including the banking system, and there would be no conflict with creditors. In this case, the contracts and the debt would remain in Euros for a given period — an option with consequences and costs that we have already surveyed in the previous chapter.

However, if there is no agreement with the EU, the government will have to take immediately strong measures, in order to meet the financial needs: the establishment of the Escudo as national legal tender, without the support of the ECB; the redenomination of debt public contracts; the restructuring of foreign debt and other measures to ensure the liquidity of the economy and the defence of saving deposits, including the public control of the banking system. These are the different measures that we shall analyse in this chapter, adapting the calculations that we have mentioned before and presenting the necessary solutions in the context of a unilateral decision.

The new Escudo

Following a possible failure of the negotiations with the European authorities, the decision to create the Escudo will have extra difficulties.

The new currency must be made immediately legal tender in Portugal, being created as a sovereign act based on the internationally recognised authority of the principle of the 'Lex Monatae', as we have already mentioned. But the Escudo does not exist physically and, as we have seen, it will take a few months until the definitive banknotes and coins are distributed. The hardest period of the creation of the Escudo will be these months when the new national currency is an accounting measure and not a mean of payment.

However, we reject the option for the stamp of Euro banknotes. It is not legal because, unlike what happened in the countries that adopted this interim system, the Portuguese State has no authority over the issuance of foreign currency, namely, the Euro.

But even if it were legal, it would have a detrimental and counterproductive effect, as it would accentuate the immediate disappearance of the Euro banknotes, whose holders would not allow to be stamped, since they would immediately lose part of its value. Therefore, we suggest the immediate printing, if possible within the timeframe of one month, of a temporary banknote in Escudos (of a low value, such as 10 or 20 Escudos), which is to be later completely replaced by banknotes printed respecting the best safety procedures.

The fact that there is only one cashless currency along with a physical foreign currency for at least a month, and that, during the following five months, there will only be a temporary banknote in Escudos, besides the Euros, involves additional risks. Even after the introduction of the Escudo, some of these risks remain, given the existence of two currencies circulating side by side

(Eichengreen, 2007).

The government's priority must be the complete replacement of the Euro by the Escudo in trade and domestic payments, to ensure that it will be the only currency in current account, and the one that is binding legal tender.

In the scenario under examination in this chapter, the moment in which is announced the coming into force of the law which determines that the legal tender in Portugal is the Escudo, all deposits will be given the same nominal value in national currency: if you had five thousand Euros in the bank, you will have five thousand new Escudos (unless the government has decided that a portion of each account is not automatically converted into Escudos).

But these five thousand Escudos will not longer be worth five thousand Euros, given the devaluation since the introduction of the new currency. Therefore, as we have seen, depositors will get suspicious. And that would be reason enough to trigger a bank run in order to withdraw the Euros even before the decision (in case the decision can be predicted at all), or ever shortly after, in protest or as a way of protection against it. Admittedly, for each person, the direct effect on the income of the devaluation of the Escudo against the Euro will depend on the weight of imported goods in their consumption, and on how the economy will react to the change.

One must also consider the impact of inflation on wages and pensions, as well as the real value of the deposits when compared to the price of goods and services that the population uses the most.

Thus, there will always be a loss of real value of deposits, as well as the income of most people who receive salaries and pensions in Escudos. We have seen in the previous chapter how to protect workers' income and savings through taxation and other measures targeted to offset the risks and effects of devaluation, namely through reducing the IRS at lower levels, and the extension of social protection and recovery of the value of working time.

We have referred to a set of measures that must be immediately adopted in order to restore the stability of the banking system and the assurance of the commitment of the authorities to defend the value of deposits. This is certainly the most important policy for the public policy priorities in the early days of transition, and also the one with the most immediate effect. It is essential to avoid a freeze on overnight deposits, because it could cause a collapse of the current operation of banks, which would have major social consequences.

The main immediate function of the Bank of Portugal will therefore be to prevent a liquidity crisis from turning into a bank solvency crisis, and to keep the credit system working. Accordingly, the measures to be taken are as follows:

- The value of bank withdrawals in Euros, ATM or at the counter should be limited to each person in the first few weeks or months. Note that, if each depositor could withdraw from an ATM the current daily limit (200 Euros), and if they would keep it, after less than a month of withdrawals there would be no Euros in circulation, nor would there be the capacity to ensure the demand generated by the economic activity.
- There should be no limit to interbank payment orders or cashless transactions within the national economy.
- In this way, most exchanges, including shopping in retail or payment orders, should

be made via bank transfer, using the availability of ATM terminals, which are already common practice of most of the population, and leading companies to pay and receive checks or transfers and to negotiate balances and shot-term credits from supplies, wholesales and retailers.

- Special attention must be paid to hypermarkets, both to ensure the continuity of the distribution of products, and to avoid speculative action against the new Escudo.

Trust in the new currency must be established both by its use as a mean of trade, and by the effects that funding in Escudos will have amongst the population in general. Therefore, in order to establish quickly the credibility of these exceptional measures, we propose the following measures, in the context in which there is no agreement with the European authorities:

1. An effective guarantee must be given that a portion of the deposits is denominated in Euros during the transaction, to protect depositors. If, for example, in the first year, two thousand Euros are kept in that currency from each current account, and only the remaining is redenominated in Escudos, small savings are relieved, totally or partially, from the impacts of devaluation, in spite of the high budgetary cost which implies the creation of a credit facility up to 4.3 billion Escudos (1.8% of GDP).

2. There can be no withdrawals from term accounts during the transition to the establishment of the new currency, except for extraordinary reasons.

3. Withdrawal from all accounts will be settled in Escudos.

Devaluation and its immediate effects

Without an agreement with the European authorities, the immediate devaluation will have to be higher than expected in the context of the inclusion of the Escudo in the mechanism of EU exchange rates.

In the case of an agreement, we have suggested a limited devaluation of 30%. Lacking such an agreement, immediate devaluation should be higher. We suggest that, in this case, the target should be a devaluation of 42.86% (that is, one Escudo is worth 0.7 Euros**,** or one Euro is now 1.4286 Escudos, which is the one that more clearly indicates the effect of the price variation for the buyers of national exports), in order to ensure a strong impact on the balance of goods and services. As the exchange rate between the Euro and the Dollar has been around 1 Euro = 1.38 Dollars, this level of devaluation of the new Escudo would have an impact all over the Portuguese foreign trade.

This shock is also necessary because the price of imports will increase shortly after, whereas the improving effect of exports will be deferred in time. Therefore, we try to strongly encourage the import substitution to answer its increase of price, for instance, through the production of clean energy or through the use of the productive capacity to offer new products in the domestic market.

At the same time, this change in relative prices structurally favours competitiveness of exports. That is why it is advisable that, lacking an agreement with the EU, a level of devaluation with a great impact should be favoured. As we shall see below, this unilateral attitude based on an exchange rate policy is not the reproduction of a mercantilism of old, especially because it is based on an ambitions answer involving re-industrialisation and the construction of a capacity of production, of employment and social welfare. In any case, after the devaluation, the government and the monetary authority must ensure the control over the exchange rate and over inflation, in order to manage further devaluation of the Escudo.

This devaluation also has important effects on wealth throughout society: the depositors lose value in currency terms, which is manifested in the reduction of their purchasing power for imported goods (or if they used their deposits to pay for expenses abroad our for travelling), and debtors gain value in foreign exchange terms. The balance between these two effects on the disposable income for a household is difficult to determine, but there is no doubt that it will be uneven across the population, and better, for example, for those families with fewer resources and with mortgage debt, and that it will be worse for those families that have bigger savings and smaller debts.

For this reason, there will be the need for short-term measures to correct the negative effect of redistribution, and to stimulate domestic savings, so that the economic recovery starts to be felt and employment increases. The defence plan for wages and pensions should be based on several points:

- the immediate return of bank holidays and periods of leave (which retrieves the real value of wages and has a neutral effect between sectors of the economy;
- reducing the IRS monthly retainer to lower echelons, anticipating their reduction and ensuring the immediate effect of the measure (increasing disposable income and stimulating demand);
- monitoring the wage response to inflation, namely raising the minimum wage and applying discretionary measures on social protection, such as family benefits and others (also with effect in the disposable income of workers and poorer social sectors, including the unemployed);
- extending collective contracts.

The redenomination in Escudos of contracts and debts

Without an agreement with the EU, the redenomination of public debt contracts will be required for the defence of the State, facing the pressure from creditors. As we shall see, an important part of these debt contracts depends on the national law and, therefore, the redenomination in Escudos may be immediate, even though this decision will certainly raise conflicts, especially with foreign creditors. In the beginning of the Troika programs, most of the sovereign debt of the countries under intervention was contracted under their national laws. For Greece, in late 2011, only 5% of the debt was under the jurisdiction of international law (Nomura, 2012), So it was across the Eurozone: in 2011, only 7% of the sovereign debt was contracted in reference to foreign law (Nordvig, 2012), but it has been growing in the countries under the intervention of the Troika and, in 2014, it is much higher.

Now, if there is no funding through an European agreement, nor an acceptable compromise with the international creditors, the answer of the Portuguese State must be very strong. In this context, it would be forced to apply immediately the authority conferred by law, to redenominate in Escudos the whole of the sovereign debt that is under the jurisdiction of the Portuguese law. However, the State cannot impose the same neither for the sovereign debt under sovereign law, nor to the external debt contracted by private national entities. In the following simulations, we assume, by default, that at least one half of the direct debt of the State may be included.

Therefore, considering the cumulative effect of devaluation, the value of direct State debt would be of 102.5 billion Euros (the part that would not be redenominated and that would be under foreign jurisdiction), and also of 102.5 billion Escudos (the part under Portuguese law, which value, after evaluation, will become 71.27 billion Euros, i.e. the holders of sovereign debt will lose 30.7 billion Euros).

In the national currency, the direct State debt will be of 248.9 billion Escudos, that is 104.8% of GDP. In other words, devaluation and redenomination combined decrease the debt in about 18% of GDP, but this is insufficient to balance the economy. Restructuring, in a way that reduces this value even further, is imperative, as we shall see below.

Redenomination has international and national effects that we shall survey. The international effect of this measure is equivalent to taxing foreign creditors of sovereign debt in the percentage of devaluation, also increasing its future uncertainty, but in the same way taxing the private national debtors to foreign entities by the effect of devaluation (or part of its effect, because it only affects their income in Portugal, since abroad they would continue to receive in foreign currency, like the Euro). However, this imposition of the reduction of the value of sovereign debt and, subsequently, the reduction of the flow of payments on the service of that debt, by the simple effect of the initial devaluation and the future crawling peg, is an immediate advantage for an indebted state.

This decision corresponds to a restructuring imposed on creditors and strictly complies with internationally accepted legal standards, repeating, even, what other states have done in the past. But if there were no agreement with the EU, the deposits would be devalued in terms of its purchasing power in Euros, given their redenomination in Escudos. This would trigger a bank run in order to withdraw Euros even before the decision of exiting the Eurozone has been taken. We have indicated above the necessary measures to prevent this situation in the short term, and other forms of compensation of depositors, which are more than 90% of the population, by changing the IRS and social benefits available to workers and pensioners on lower incomes. We want to provide, in this way, for a greater liquidity for families, immediately improving their disposable income.In the case of debts to the bank, contrary to what happens with deposits, the debtors will benefit, and those are also a significative part of the population.These will win by a fundamental way: inflation will reduce the real value of their debt over time. The impact of this effect will depend on its interest rate will be adjusted, for the most frequent contract linking the interest rate to Euribor should be replaced by reference to a national rate. Bellow we shall discuss the effect of the evolution of interest rates and we shall return to this issue.

Determining the value of mortgages poses yet another problem, which is the identification of the legal currency in which they shall now be denominated.

Experts have recommended that this redefinition of the contract shall be made according to the currency of the place of the property (Escudo, if in Portugal), and not according to the nationality of the bank. This is reasonable. That is how we should proceed, writing into Escudos all the mortgage contracts.

Regarding the effects on debtors, it is true that, by reducing the value of the mortgage, the value of the property in Euros will also be reduced, in comparison to others abroad. In other words, it is now cheaper to buy in Euros a property in Portugal. This will encourage the possibility of purchase of undervalued assets by foreign investors or traders (or by Portuguese people who have deposits abroad) and measures to prevent such a distortion would be called for.

Restructuring the sovereign debt

As we have seen, the combined effects of the devaluation and of the partial redenomination of the sovereign debt are insufficient, and the imposition of a restructuring of the Portuguese debt is always unsurmountable in this case.

This restructuring must be wide-ranging, with three combined targets: (1) to ensure that the flow of future payments is sustainable, i.e., that the deficit in the income balance may be substantially reduced; (2) to ensure the reduction of Portugal's foreign debt at affordable levels; and (3) to make the country free from the need for future external funding. In the past century, or in the current one, Portugal has never been in this situation; therefore, there is the need for a strong shock, ensured by profound restructuring of the debt, followed by a reorganisation of the production system. In this section, we present our proposal for the restructuring of the direct debt of the State and in the next we discuss the restructuring of bank liabilities: a combination of both is essential for reducing the Portuguese net external debt of 103% to acceptable levels.

Under a typical agreement of the Paris Club, creditors may access a menu of possibilities, where the public debt bonds are replaced by others of smaller nominal value and taxes or, what is equivalent, by others that have a longer maturity and a much lower interest rate. To calculate the effects of such an agreement, we follow the negotiation proposal consisting in replacing all the instruments of sovereign debt by new bonds with the same face value, but with a much lower coupon of 1%, and that would be redeemed in identical installments between 2045 and 2054 (Cabral et al, 2014). Under a prudent discount rate that includes an anticipation of the value of future long term inflation in the nominal GDP growth, the present value of direct State debt would then be reduced by 61.1%. With this combination of interest and payment terms, the simple fact that there is a substantial expansion of the period of maturity of the bonds ensures that inflation, even if low, will decrease its real value when the payment takes place, as long as the interest is very reduced, as indicated. Of course, the same result could be obtained if the shares would be exchanged for other shares of smaller face value and, in that case, in shorter periods of time, or with a higher coupon.

The two main results of this restructuring are the ones we want. Regarding the effect over the stock, the debt would be settled at the end of this period. As for the effect on the flow of payments, current account deficit, through the reduction of interest payments, would be reduced by roughly 5 billion of Euros per year. Considering that the balance of income has had in 2013 a deficit of 7.7% of GDP, of which 4.7% are interest payments and 2.8% are paid dividends, this deficit would be halved.

The third objective of restructuring the debt is to cut down the flow of debt payments in a way that the financing of the economy becomes self-sustaining, eliminating the need to search for long-term foreign credits and avoiding the return to a new cycle of debt. Restructuring is only useful if it allows for a change in external accounts in such a way that it actually improves the balance of payments on a permanent basis. Another possible way of restructuring will be, lacking a positive answer from the international creditors to an invitation for negotiations, a set of measures that can range from the extension of the moratorium time to the cancellation of all, or most, of the bonds of sovereign debt. It is however possible to believe that an important part of the international creditors will prefer to exchange bonds rather than to lose their credits, as it has happened in all restructuring processes of the late twentieth century.

As for the creditors, it is an advantage that they are all treated in the same way, and it they should be offered the same exchange for their bonds. The main difficulty will arise from the negotiation with the European funds, the ESM-FEFF, and the IMF, which has never accepted the reduction of the debt of any country. However, if there is a debt restructuring, it should include the international creditors, because, were it to include only private creditors, it would never reach the amounts required to ensure the financial stability of this operation. In April 2014, the Portuguese debt held by international institutions is of 155.4 billion euros, 40% of the total gross debt, or 94% of GDP. Restructuring would be impossible if we did not include these creditors.

Next, we shall analyse the situation of other creditors. For the financial institutions that hold Portuguese bonds, negotiation should assume that losses to be recorded while restructuring should be, in any case, less than a total loss caused by the repudiation of the debt or by the extension of uncertainty generated by a moratorium.

There is yet another part of sovereign debt, which is internal and which should be treated with care. This debt has three main creditors: social security, the people who bought with their earnings certificates of saving and Treasury, and also the companies managing public-private partnerships.

In the case of pension funds that hold sovereign debt, such as the Capitalisation of Social Security Funds, if the exchange of bonds follows the model presented above, it should extend maturities and reduce interest accordingly. As this will involve both a decrease in the present value of bonds, as well as a minor flow of annual payments for these obligations, the recapitalisation of social security by the Sate will impose itself. The State shall ensure the management of all the pensions, in order to guarantee that all future pensions will be paid, without any doubt.

According to our calculations, this implies a recapitalisation of the order of 11.4 billion of Escudos in new bonds to pay over the years. With this guarantee, a reform of the financial system and of the social security should be considered, in order to expand its collection base and to strengthen the protection of pensions and its distributive effect against poverty.

As for the holders of certificates of saving certificates and Treasury shares, in order that their savings are preserved, the exchange for new certificates should be established within a period of three to six years. The aim would be to avoid a short-term flow of payments which would expand the public debt at a time when domestic savings to finance it would still be scarce. The interest would be set above inflation, with a premium benefiting those who remain in this saving system, attracting more applications. The recapitalisation of this system, from that period on, will be 17.4 billion Escudos, to ensure the preservation of the current value of the certificates.

As for the holders of debt secured in the long term, as is the case of public-private partnership contracts, the most obvious solution would be to rescue these contracts thereby terminating the flow of payments that should be replaced in the upcoming decades. Evidently, the price to be paid by the State, in bonds of restructured public debt, should discount previous gains that were granted to these consortia.

Thus, the companies that held contracts with guarantees of future rents in these partnerships will experience losses. To the extent in which, in this case, the banks will be under public intervention, the main pertinence of these contracts will be in the sphere of the State and shall not be an obstacle to the closure of the contracts. There will be the need to obtain a side agreement with the construction companies, which in turn also depend on future public contracts. Accordingly, the State shall save more than one billion escudos in the annual budget.

Public control of banking and deposit protection

Together, the Portuguese banks held, by the end of 2013, a total of 26.2 billion of Euros in public debt, with CGD holding the record with almost 10 billion, followed by BCP (6.8 billion), BPI (6 billion, a figure that decreased in the meanwhile), and BES (3.75 billion). These banks have profited in 2012 almost one billion Euros from the sale of some of these bonds of national public debt, but they have reported losses in 2013 and 2014. Should in take place, the restructuring of the sovereign debt would reduce the market vale of banking assets in 17.1%. Moreover, considering the effect of devaluation, which increases the burden of external debt on banking, combined with the redenomination in Escudos of the contracts subjected to the national law, an the restructuring of the sovereign debt, the balance of the banks will be immediately affected in the following way: on the asset side, loans to customers are now 329 billion Escudos, the availability in cash and the Bank of Portugal (15 billion Euros) are worth 21.6 billion Escudos, and deposits in other institutions are worth 32 billion of escudos, while financial assets will suffer the effect of debt restructuring; on the liabilities side, deposits and residents are now 218 billion Escudos, while financial liabilities are now 54 billion Escudos and the debt to the Eurosystem becomes 70 billion Escudos.

However, if one accepts that deposits and loans to non-residents remain in Euros, in order to favour deposits by emigrants and their flow in Euros and foreign exchange to the Portuguese economy, then these figures should be increased by 2.9 billion of Escudos, since the credit given to non-residents is higher than their deposits, which indicates a vulnerable situation.

On the other hand, if a small part of the deposits of residents would also be kept in Euros, by decision of the national authorities, in order to ensure trust in the banking system and to avoid reckless depositors withdrawing their savings, then, as we have seen, the State shall compensate the banks by creating a credit facility with the Bank of Portugal, up to 4.3 billion of Escudos.

In any case, if there are withdrawals of deposits, the liquidity of the banks will be affected. Since the banks will suffer the biggest impacts of the transition into the Escudo, the protection of a guarantee must be a priority.

For all this, it is necessary to proceed to the settlement of bank liabilities, besides restructuring the sovereign debt, in order to prevent the collapse of the banks. This will be the second instrument to reduce the Portuguese net external debt. This systemic bank resolution must deduce the net external debt of banks by about 21.7%, a value close to 30% of GDP. This affects the credit of institutions other than the central banks, shareholders, and a number of deposits over one hundred thousand euros, or any other higher value.

These liabilities will be converted, where appropriate, in capital. We admit that, as the value of shares of banks will fall sharply, its holders will want to sell them as soon as possible. The state should buy this part of the capital, reinforcing public control of banking.

In order for this to happen, there must be a law regulating the special bank resolution process, which will not be subjected to regular courts, since a normal judicial procedure would require a period of time so long that would jeopardise the safety of depositors. The Bank of Portugal, or a public agency created for this purpose, should therefore exercise the power to impose the bank sanitation without recourse to the courts, just as the law already predicts that it may happen. This public control, which may take a form of nationalisation, is needed for yet another reason, imperative by itself: the national banking system is critical to the recovery of the economy, for the investment credit and for the people, and it cannot be the core of an institutional conflict. It should be fully articulated with the strategy for economic recovery. If this bank resolution were conducted successfully, banks would have an expanded credit capacity, which would be strategic for the economy. For that reason, in the difficult context of the transition for the new Escudo without support from the European authorities, this process is an indispensable instrument of national sovereignty.

The administration of banks under direct control by the Bank of Portugal should be determined by the protection of the depositors. So, at least in the first phase of transition, it is advisable to keep the structure of the several banks just as it exists today, given that the customers are used to their banks and it is better not to have any change at the counter. An administration shall be appointed for each bank, even though subordinated to the Bank of Portugal. This rule does not cover direct public control over the delegations of foreign banks, even though it supposes that they are also subjected to the control of capital movements, as the entire economy.

In this context, as we have seen, it is also mandatory to take another measure from the start: the control over capital transfers abroad. Freezing cross-border capital transfers is necessary to prevent an immediate capital flight in Euros. For that same reason, it will also be temporarily forbidden to create new foreign accounts by Portuguese residents. Finally, in the event that the relations with the European Union become very difficult, the government may be forced to limit the expatriation of profits obtained in national territory, as suggested by Bootle (2012:49).

The effect in the State accounts

The combined effects on the direct debt of the State can be summarised as follows: after the redenomination and the debt restructuring, whose present value is reduced from 132% to 53%, there will be new debt creation in order to support the recapitalisation of the social security and, after three years, the recapitalisation of certificates of savings and Treasury. The credit facility to cover the devaluation of a portion of the deposits mobilises a commitment of 1.8% of GDP. Conversely, the contingent debt will be reduced by the redemption of the public-private partnership contracts. These debt increases can lead to an immediate fiscal spending, but in a reduced form, be it because there is a deadline for the redemption of certificates, be it because the social security revenues should benefit from the increasing employment and contributions. On the other hand, the budget balance is improved by the reduction of the payments in interest of the public debt (3% of GDP) and public-private partnership contracts.

Other effects on the budget deficit, which we have considered above, are the increased expenditure on salaries and pensions, the rejection of previous cuts (2.6% of GDP), and the fiscal costs of reducing VAT for the catering industry and of IRS to the lower echelons, which must be compensated by other taxes. Furthermore, the cost of contingency plans to support the prices of medicines and transport is 0.9% of GDP.

Some of these costs will be covered by the increased tax revenues, both through new taxes directed at some of the benefits of devaluation, and through the fiscal effect induced by the economic recovery.

The room for maneuver is, in either case, very limited in order to increase public investment, even though this decision ma be fundamental to the immediate recovery of the economy. Furthermore, this programme is very difficult to implement, because it depends on many variables and acts simultaneously on several levels. It is, however, necessary and unavoidable in case Portugal exits the Euro.

The beneficial effects of the recovery of domestic demand are not enough for an economic stimulus that would lead the way to a reorganisation of the economy: this recovery may have a quick effect on the import substitution and even on employment, but it is important to combine it with an increase of exports to sustain the new Escudo. The entire scope for investment must, therefore, be exploited in the short term, mostly by the increase of the lending capacity by banks under public control, directed to priority economic projects of shot-term impact.

Fiscal policy to support the new Escudo

Fiscal policy should be strongly used, in this context, with two goals: on the one hand, it should correct loss of revenue imposed by recent and regressive changes in the tax system and, on the other hand, it should fix or guide the distorting effects of income imposed by devaluation, to favour budgetary control targets, social recovery and economic stimulus.

In the very short term, it will be necessary to impose a Special Contribution on the property, to obtain the necessary resources for the transition into a new currency. Piketty has been suggesting a tax on wealth, as others have done before him, in order to meet the increasing inequality (Piketty, 2013), and we follow his suggestion. Inheritance taxes should also be reconstituted as a permanent rule of social redistribution.

In the short and the medium terms, we suggest also two major changes consumption taxes and corporate taxes: to lower VAT for catering businesses, and to accentuate some special taxes on luxury goods consumption; to create a new system of echelons on IRC, but to increase support for investment.

We admit the application of a tourism tax, one of the greatest national exports that will benefit immediately from devaluation, which will contribute to the increase of tax revenues, provided that it does not undermine the improvement of the competitiveness in the sector. In the case that we have addressed in this chapter, there is no room for a tax on foreign exchange gains of deposits, because they are redenominated in Escudos. Finally, the recovered sovereignty of Portugal allows Portugal to make decisions on customs protection of young industries or priority sectors.

Prevention of international litigation

This policy, as we have seen, is not without danger of judicial litigation and other threats. Foreign creditors lose out with this course of action and may use courts in their countries to try to obtain mandates to confiscate assets from the Portuguese State, in order to recover the amount lost, or simple to force a transfer.

In the case of the debt moratorium in Argentina, there has even been a court order from another country to foreclose one Argentinean armed ship anchored in a foreign port. This court order was quickly reversed. However, the example shows that contingency plans should include provisions to protect all national assets. If necessary, the State may also impose a unilateral moratorium on the payment of sovereign debt, and even limit the transfer of other payments to the outside, through the control of capital movements.

There will be five areas of risk of international litigation, following the devaluation, redenomination and debt restructuring.

First, it will be needed for part of the Portuguese capital in ECB and European funds to be returned. Secondly, it will be necessary to establish a long-term schedule of amortisation of the debts of the domestic banks, through the Bank of Portugal, to the Eurosystem.

It is likely that these files are negotiated together. In the context of a previous agreement with the European authorities, as we have seen in the previous chapter, these questions will be resolved between the parties, and there will be no judicial litigation in the international courts. Even without such preliminary agreement, Portugal should always insist on the implementation of a negotiation process that avoids conflict in international fora.

On the other hand, and third, for the duration of the moratorium on sovereign debt payments, it should be expected that the creditors will take seizure initiatives of national assets, be it part of the gold, or of the bank accounts of the Portuguese State held abroad.

These goods must be placed under institutions that ensure their protection.

Fourth, other assets of public companies (for example, TAP aircrafts) may be threatened with confiscation by international courts until there is an agreement with creditors. In this case, the same caution we mentioned in the case of the redenomination of contracts is needed. It is necessary, even before taking any action affecting external agents, to ensure the legal protection of public property against aggressive litigation of these creditors, including the change of legal status of such property, or any other measure to make them immune to any decision of an international court.

Finally, bank branches abroad may suffer an intervention by other governments. this happened in the case of the collapse of the Icelandic banks. However, this option is illegal and should be avoided or resisted, especially as the foreign bank branches maintain their operations in Portugal.

Conclusion

The three instruments that are necessary, in the context of devaluation and in case there is no agreement with the European authorities, are the redenomination in Escudos of all the debt subject to national law; the restructuring of the gross external debt; and the public control of the banking and financial system to prevent its insolvency. These are difficult measures that cannot be avoided.

As we have seen in the previous chapter, if there is an agreement with the European authorities, we hope that the exit from the Euro will be achieved through measures and mechanisms that have been negotiated and that are essentially neutral with respect to income distribution, or that correct its effects. If there is a conflict, and if the decision to exit is unilateral, we hope, on the contrary, that there will be measures in place to lead to a strong redistribution of income. This is the most difficult scenario. But this book does not try to avoid difficulties. Our aim is rather to help finding a solution. If Portugal leaves the Euro, this determination will be required, and this study on the feasible alternatives will be required, aware of their risks, their costs, and the specific paths it should follow.

Chapter 4

Risks and alternatives before, during, and after leaving the Euro

We have seen in the previous chapters how the exit of the Euro would happen and the immediate difficulties it entails. We will now survey other problems arising from those first days after the decision to exit the Euro and to introduce the Escudo as the new currency of Portugal.

We shall start by the relations between the Bank of Portugal and the European Central Bank. Then, we shall review some of the major issues of economic management: the impact of inflation; the protection of wages and pensions; the determination of interest rate; and the financing of employment creation and investment.

In all these points, we will consider the social effects, because that is the function of the economy, which should account for real people and improve their living conditions, protect their rights, and promote democratic accountability. Finally, we shall present the main contingency plans that must be set on the day of the exit from the Euro.

The relation between the Bank of Portugal and the European Central Bank

Our Q1 assumes an understanding that includes funding during the transition and the new institutional rules for the period immediately after. As we have seen, in this context, the agreement may provide for the maintenance of the sovereign debt or set a cut in the overall value of this debt. In case there is no such deal, and in case of a conflict with the European Union, one of the most difficult problems will be the separation of the Bank of Portugal from the European system of central banks and the ECB.

Then there will be three problems to solve. The first one is the recovery of the Portuguese share of the capital and assets of the ECB. At the end of the Austro-Hungarian Empire, in 1919, restoring the initial contribution made this division. Fifty years later, when India and Pakistan split, or 70 years later, when Czechoslovakia split, as there had been no initial contribution that could be reported to any of the parties, the division was made according to the percentage of the population.

In the constitution of the ECB, each country endorsed a part of capital: Portugal financed 1.750%, or 159 million, which now amounts to a set value of 2.5016% (Germany has 27.0647%). The Bank of Portugal should receive this amount.

Secondly, Portugal is part of a complex network of payments within the Euro system. One of the pillars of this system is the system of liquidity and short and medium term loans by the ECB, namely to Portuguese banks.

As they may fall within the scope of the Bank of Portugal, as we have seen, the responsibility for their own balance sheets may be transferred to the national public authorities. In the system of European interbank payments, Target2 (which stands for the Trans-European Automated Real-time Gross Settlement Express Transfer System), the Portuguese banks owe 51 billion Euros. These payment systems have allowed for significant deficits in the peripheral countries, which are generally debtors. Therefore, if there is an exit from the Euro and these debts are challenged, the ECB and the creditor central banks will register losses. In the context of a negotiation, as indicated above, Portugal would get a phasing out of this debt for twenty years.

In third place, Portugal has a credit in European funds set up during recession and the bailouts, which will amount to roughly 2 billion, and should also regain this value.

In these three matters, Portugal must lead the negotiation for the values that it must recover and that will be part of the necessary assets to sustain the value of the Escudo.

The effect of inflation and the defence of wages and pensions

The creation of the most recent national currencies has usually been accompanied by strong inflation processes and even, in some cases, by hyperinflation. This is what happened in Armenia during the transition to the new currency in 1992-4 (the maximum inflation in one month was 438%), in the Ukraine in 1990 (249%), in Kyrgyzstan in 1992 (157%), in Azerbaijan in 1991-4 (118%), in Tajikistan in 1993-6 (78%), in Turkmenistan in 1992-$ (63%), and in Kazakhstan in 1994 (57%) (Bernholz, 2006). An overly rapid inflation is a particularly violent form of taxing against fixed nominal income and the most vulnerable sectors of society, redistributing the resources to great advantage for some sectors with income that may be adjusted to the prices paid in foreign currency or with a greater bargaining power. Furthermore, if inflation corresponds to an economy with big problems of production and distribution of goods and products (i.e. with great imbalance between demand and supply) and in recession, the social crisis can become explosive. This risk should be avoided at all costs.

Even considering that the transition into the Escudo will be quite different from the events after the disintegration of the USSR and the creation of the new States in this region, the risk of political and financial pressure should alert the Portuguese government to prevent an excessively high inflation.

In this sense, the greatest danger lies in the combination of multiple and simultaneous inflationary processes. In particular, inflation may be generated or enlarged by three different routes.

The first and most immediate is the devaluation of the Escudo itself. Knowing that imports represent around 40% of the GDP, and that only a portion corresponds to domestic consumption products, as we have indicated in the fourth chapter, then a devaluation of 30%, considering an imported domestic consumption content of 25%, will generate directly a general rise in prices of 7.5%, which will add another 2.5% of effect through wage recovery.

In this case, several damping systems may operate. As some of the raw materials and imported components will be incorporated into production for exports, the variation of their prices will reduce the effect of the devaluation of the competitiveness of price of this exports, but it will not affect domestic prices. On the other hand, the rise in price of imported goods for domestic consumption will be recorded straightaway. There may still be companies focusing on the domestic market that will prefer to internalise part of the effect, to prevent the loss in their market share; others may try to benefit from the price rise and favour an inflationary spiral. Finally, it can generate an effect of mistrust and social tension which will stimulate this spiral, and which should be prevented and countered. In any case, it is impossible to avoid a first impact of the devaluation on inflation.

As we shall see below, it will take some contingency plans to limit this impact, especially in products or services whose cost has greater economic (fuel and transport) or social (medicine) effects. These plans require a committed budget or tax expenditure.

The second inflationary process may be created by the double circulation of currency and by the uncertainty it causes. Many traders will be tempted to raise their prices in Escudos, in order to be paid in Euros. In fact, for a certain period of time, there will be a coexistence of Euros (as a foreign currency widespread in the economy) and Escudos (as the national currency in which payments are made but that does not yet exist physically).

This is a fragile and dangerous situation, so this period should be as short as possible. If there is an agreement with the European authorities (our Q1), then there will be no lack of liquidity in Euros during the period of transition. If the agreement fails (our Q2), we will have a shortage of Euros.

In the previous chapter we have suggested some measures to reduce the time and the scope of this double circulation. We add to that now that, in the case of different systems to fix prices, the government must act quickly and safely to prevent speculative lawsuits against the Escudo.

The prices that are administered or regulated directly (bread, some basic goods, transport) should be kept in a controlled variation range. To this end it is necessary to maintain or to create the necessary capacity of production or of provision of services.

There are other prices that are set freely in the market, but which are associated to the large systems of distribution depending on imports (and therefore of cooperation with new Portuguese monetary authorities which ensure the availability of Euros for such imports). In this case, mutual advantage advises to avoid hoarding or retaliation. The fall in production and the decline of supply, with the shortage of products in the markets, would be a dangerous social threat, but it has also been one of the typical strategies of tension that have been used under situations of social change.

Finally, there are the contractual prices, and to them applies the same principle of precaution.

The third inflationary process may result in the intervention of the new government after the exit from the Euro, in case it is necessary to use an expansionary monetary policy. As the Sate has its own financing capacity and is no longer subject to the threat of suspension of payments, it will use this power but with a clear limit: the deficit cannot be permanently financed through currency issuing, because that strategy would accelerate inflation and, therefore, its unfair redistributive social effects, to which we have previously referred.

On the other hand, for the success of devaluation in price competitiveness of exports, inflation should not be an essential tool of domestic policy, and must first keep to a limited range.

Therefore, the printing of money by the new Bank of Portugal should be controlled by these parameters: it must be used to finance, as a last resources, the State expenditure, but this should be predominately funded by economic resources generated by increased production and by domestic fiscal redistribution.

Finally, let us consider the effects on inflation of wages and pensions. Evidently, the general rise in prices reduces the real value of income and of the savings and deposits. Bootle, for example, calculates that even moderate inflation of 6% per year would cause a drop in wages which could reach 20% during the transition into a new currency (Bootle, 2012:58), if it were not compensated. Now, for the same reason that made us criticise so far the austerity measures and the reduction of wages and pensions, we understand that this pernicious effect should be avoided and fought against.

Therefore, we suggest an immediate approach to labor income based on three pillars.

First, the pensions, starting with the lowest, which protect the biggest number of people, should recover their purchasing power. This recovery has beneficial effects: it is socially appropriate, generationally fair, and it has a favourable impact on domestic consumption, thus contributing to economic recovery. It carries a budget cost but, as written above, this cost should be compensated by a structural change in the long-term funding of social security.

Second, the value of wages, which has been hampered by confiscation measures over the past few years, must begin to be recovered. The most immediate measure may be the restitution of the annual working time that was imposed as unpaid labour, for example through the recovery of the holidays and weekly schedules.

Having a balanced effect in the economy, it is possible to restitute, in this way, part of the worker's life that has been confiscated (when the time of unpaid work time was increased), without any inflationary consequence. In any case, the overall recovery of wages, direct and indirect, as well as the standard of the collective contracts, should be one of the targets of the economic policy, together with job creation.

Third, another immediate measure to change the income available for workers should be the reduction of the IRS to lower levels, or increased deductions for essential expenses at lower echelons, combined with policies for social support (family allowance, CSI, RSI), covering those workers whose income place them below the minimum bar for the IRS. Furthermore, there is a part of the savings that should be protected from the exchange rate, benefiting almost all workers and all small depositors. This instrument, as part of a more ambitious fiscal reform, should be used as a stimulus for domestic demand, improving wages and pensions, and protecting depositors and savers from the effects of inflation.

Control over the interest rate

As we have seen, high inflation is dangerous. But it could be even more threatening if a continued recession added up the effect of high interest rates, for it would reduce investment and the feasibility of immediate economic recovery. Interest rates would still affect the population that is committed to long-term mortgage debt.

However, the interest rate will be a tool to control inflation, and it should always keep higher values than the price variation, both to support the attraction of savings, and to demonstrate the commitment of the national monetary authority to control prices. However, as noted above, a high nominal interest rate affects particularly the social sectors that are indebted, and whose income is not updated at the same rate. This is one of the reasons to defend the reduction of the IRS and, hence, the deductions to the lower echelons, so that the effect is immediate and results in the protection of these sectors.

In any case, the medium-term inflation containment will depend not only on monetary instruments, but also and mostly on the evolution of the productive capacity. Priority measures should be concentrated on recovery and economic growth, ensuring the promotion of investment and the supply of goods and services that meet the increase in domestic demand (by improving the purchasing power of the social sectors whose income is predominantly used for consumption), developing the substitution of imports and increasing exports.

The financing of investment and job creation

We suggested above a reduction of the IRS for the lower echelons, in order to obtain an immediate real effect on wages and pensions, namely through a reduction in retention rates. One option could be a general reduction of VAT to affect prices, rather than wages, and to improve as well domestic demand. We prefer the first option for its redistributive effect.

It will be necessary, however, to reformulate the tax system as a whole, in order to reach two objectives; to endure tax revenues that are indispensable to fund public spending and to organise a system that is socially fairer, more transparent, more engaging and innovative.

In a more structural way, the taxation over capitals, profits and assets should be revised, as we have indicated above. We also suggest the creation of a green tax system, affecting emitting pollutants and generally promoting energy and environmental conversion, with impacts in some industrial sectors or in sectors that generate tax revenues on imported products. These protectionist measures will be one of the pillars of the reconstruction of the productive structure.

Fiscal policy should, in this way, be an instrument of impact directed to the creation of jobs and to the conversion of economy, generalising support to the creation of productive capacity and import substitution, that is, to investment to improve the domestic supply and the trade balance.

Thus, in the shot term, import substitution will be essential to keep the supply of the domestic market and to create adequate industrial capacity, with new jobs that match the skills available among the unemployed population. We admit that this import substitution can be quick in the case of agriculture, and it should be supported to stimulate change in other food products.

Conclusion: different timings for each problem

So far, in this chapter and in the previous one, we have discussed some of the problems that arise in different timeframes, which are summarised in this section. The problem in the very short term is the substitution of the Euro for the Escudo as legal tender in Portugal, because it will take a few months until it is possible to have the new banknotes and coins in circulation. We have seen how this problem can be addressed and minimised, but it will never be possible to prevent the tension multiplied by the circulation of two currencies during that period, especially if there is no agreement with the EU. The other short-term problem is that, with devaluation, the price of imports increases immediately, including those who have the greatest effect on people's shopping basket, such as fuel and medicine.

However, it will take a few months to feel the beneficial effects of devaluation to promote exports, by improving competitiveness of the domestic price and import substitution. Therefore, the effects generated by the improvement in the external balance of Portugal may take a year or a year and a half to take place.

During this period, we will get the most difficult social effects, and still not have the most beneficial effects on the economy. That is why we give so much attention to the immediate effects on the replacement of the disposable income for the sectors of population that have been hit the hardest by austerity, thus advocating a social justice that has been denied to them, and getting effects on domestic demand that can relieve the economy.

In this context, social mobilisation, awareness of the problems and the timeframes of the changes in the economy and public life are crucial in order to maintain the trust that is essential for achieving the objectives of the creation of the Escudo. Therefore, the government should seek to take prudent and justifiable measures, so that they maintain and expand the alliance supporting them, in order to lead the transition to the Escudo.

Chapter 5

Conclusion: who wins and who loses and how to raise the stakes

Throughout this book, we have always started from the same hypothesis: Portugal has exited the Euro. This could have happened for very different reasons. It could have happened by national choice, or by external imposition. Or even by the disintegration of the European Union or the Eurozone. It could also have simply been the only alternative to prevent further austerity.

Each one of these circumstances would impose very different frameworks for the Portuguese State. In this context, the aim of this book is to point out the best possible answers to the difficulties resulting from this exit, by presenting a social and economic strategy that can be at once feasible and mobilising. We have done it without any concession to the easy options, and without any condescendence, emphasising that these are demanding choices, which are also, up to an extent, unpredictable — the risk of disruption is real.

In any case, if the Budget Treaty is applied, which limits the budgetary and fiscal options of the signatory States, the consequences will be severe. We will suffer from the dismantling of the public services of the democracy, plus the privatisation of common property, and increased prices for health and education. In case this happens, the leeway for Portugal becomes even smaller than it was under the adjustment programmes of the memoranda with the Troika. On the other hand, the constantly repeated promises regarding different interpretations of the Treaty in order to make it more flexible (promises that have always been repeated whenever any of the previous treaties has caused economic disasters or has been rejected by national referenda) are not sufficient to prevent recessive politics. Moreover, if a country like Portugal has signed the Budgetary Treaty, and if its budgetary politics depends on an eventual benevolent interpretation of it, it will always place itself in a situation that is politically and diplomatically unsustainable, which means asking to breach its commitments and for a softening of the rules it has formerly subscribed to. There is no solution that can result from the very policies that generated the crisis.

Our peripheral situation, as well as the continued impoverishment would always be the price to pay for this continued dependence. This way of extension of the austerity, therefore, is the only way that must be excluded from our options.

In the context of uncertainty regarding the specific conditions, there are, however, two evident ways to exit the Euro: either with an agreement with the European authorities on the terms of the transition, or as a unilateral break up, being that agreement impossible to achieve. We admit that, under the current definitions of the European treaties that some of its leaders have in the meanwhile admitted that must be corrected, there would be a pressure for the unilateral exit from the Eurozone also requiring exiting from the European Union.

In the first case, where there is an agreement with the European Union, it is expected that a set of measures will be negotiated, in order to make devaluation neutral regarding income distribution. Therefore, we assume that, with the guarantees of liquidity provision by the European Central Bank, deposits and debts should be recorded in Euros, with no loss for the depositors. It is then up to the State to take the place of the internal debtors, for example concerning the mortgage credit, by the difference in the balance sheet of the banks between the amount in Euros and the payment obligations in Escudos.

We believe that, in this context, the agreement will include exceptional measures over the control of capitals movements would still be part of the European Union, considering that there would be the necessary political consensus to avoid judicial litigation and to accommodate the extraordinary situations.

In the context of being part of the Union but out of the Eurozone, Portugal would enter the European mechanist of exchange rates that, after the initial devaluation of the new Escudo, would allow a permanent adjustment of the terms of trade within their fluctuation bands.

To the extent that national decisions would no longer determine the budgetary conditions for Euro support, the leeway for policies of economic recovery and employment should be greater. In this context, emergency measures would always be required, such as the administrative control by the Bank of Portugal over the financial system or the supply of liquidity in Euros by the ECB, until the distribution of the new Escudos be completed. These measures should be detailed in the agreement.

In any case, the transition will never be easy. It must be rigorously prepared: on the day when it is declared that the new Escudo will be national currency with compulsory circulation, and that it will have the exchange rate or one Escudo for one Euro, the Bank of Portugal will become the monetary authority and the issuing bank for Portugal; the statutes for all the credit contracts in Euros must be defined, as well as the mechanism for bank resolution. The policy cannot leave any doubts regarding the solvency of banks.

If there is no agreement and, on the contrary, the European authorities oppose the choices that mandated the new Portuguese government, then the way for leaving the Euro may be to leave the Union as well. In this context, we would have to resort to three emergency devices:

- the redenomination, in Escudos, of all the sovereign debt contracts that are subjected to the Portuguese law;
- the debt restructuring in such a way that the flow of external payments may be reduced to affordable figures, correcting the deficit in the income account;
- and, finally, public control over the financial system.

With the first mechanism, the burden of debt would be reduced, but a wider restructuring would still be required in order to obtain the condition needed by the Portuguese economy: a decrease in the current value of the debt and its annual payments, through a combination of lower interest rates and longer deadlines, or through an exchange of bonds by a new issue of lower nominal value with reduced interest.

This is the only way for the country to stop depending on funds from the financial markets and to control its foreign debt. The public control of banks and insurance companies will be required by the effects in their balance sheets of devaluation and of restructuring, and because, in this way, they will not any more fulfill the mandatory capital ratios. In this case, the immediate intervention of the Bank of Portugal would be imperative to ensure the protection of deposits and the liquidity of the economy, and it could take the form of a nationalisation.

In both cases, we estimate that inflation will reach 10% in the first year, assuming that precautionary measures will be in place in order to prevent the aggravation of price fluctuation. Therefore, we have studied the effects on interest rates, which will be the fourth tool of public action to lead the economy to its recovery and for job creation.

For this reason, the real reference interest rate should always be positive, which means that it will be nominally higher than 10%, and that the sectors of the population that are in debt should be protected, especially concerning mortgages. This nominal tax rate and the corresponding inflation should tend to decrease, according to the decrease of the level of devaluation after a year into the transition to the new Escudo.

We assume that the import substitution will be stimulated by the devaluation and that agriculture will react very quickly to this incentive, increasing the national production of some food products and reducing their import. Tourism will be another sector benefiting from the immediate increase of demand on a large scale. On the other hand, one of the immediate negative effects of devaluation is the price rise in imported products of first necessity, such as medicines and fuel.

Regarding the prices or medicines, we suggest the application of a contingency plan to sustain the prices, in which the State would be in charge of the payment of the differential caused by devaluation, seeking to recover and increase the national capacity by realistic values. In another chapter, we indicate the reasonable target that can be achieved.

We do the same regarding the production of clean energy, which will become more competitive with the increased cost of imported fossil fuels. We calculated the fiscal effort necessary to support the prices of public transport and to support freight transport, assuming a 17% increase in the cost of petrol and diesel for private transport.

In the context of a unilateral exit, the State must be prepared to take all the necessary financial measures to ensure the recapitalisation of banks, of social security, and of the funds for saving certificates. It will also need to guarantee the support in Euros to the companies importing necessary goods that are irreplaceable in the short term, and the maintenance of the prices of medicines and transport, as well as the promotion of a support programme for investments for job creation in the very short term.

Thus, by making the inventory of who wins and who loses in both scenarios that we have presented (leaving the Euro with or without an European agreement), we record the advantage for the exporting sectors, mostly those with more added national value and who depend the least on the import of raw materials or intermediate goods; and the disadvantage of the importing sectors.

In this context, in order for the recovery of the investment to create jobs and to reach a quick relief in the disposable income of workers and pensioners, the government must maintain a vigorous policy of protection of domestic consumption and savings, along with investment decisions. Small and medium companies may recover quickly, given the recovery in demand, and exporters will benefit from the immediate stimulus. If the investment will follow this recovery, then employment will begin to rise.

Wages and pensions should recover its recent losses. We consider that the policy of redistribution that penalised labor in the last recession is wrong, following the structural errors of the adjustment dictated by the Troika Memoranda. This recovery should begin on the first day after the exit from the Euro, with the devolution of the non paid working hours — which has a neutral effect on the sectors of tradable goods — and with the reduction of the IRS for the lowest echelons, with immediate effects.

For the economic recovery, wages must be restored through new collective agreements. The recovery of pensions depends more directly on governmental action, and we present our calculations for the recapitalisation of the social security system and for an ambitious policy for pensions and social protection.

We cannot accept the continuation of internal devaluation. Therefore, we show what will happen if the exit from the Euro is, or will become, the only alternative. Facing the announced unfeasibility of Portugal, with another twenty years of austerity ahead, we demonstrate the actual feasibility of alternative and consistent answers. We do not pretend that these measures are not difficult, nor that there is not a margin of uncertainty, but we verify that they are achievable, only if the appropriate policies are adopted.

Some social sectors will oppose this democratic transition. We believe that, against any clientelistic logic, a broad alliance can win, gathering those who want to reject collaborationism and austerity, and who defend democratic restitution, with an economic policy that makes Portugal a viable country, ensuring the end of impoverishment and the recovery of democratic sovereignty of the people.

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