

Assignment 3

Leonor Freire Costa, Pedro Lains and Susana Munch Miranda, *An economic history of Portugal, 1143-2010*, Cambridge, Cambridge University Press, 2016, Final subchapters of chapter 4.

The making of the liberal, fiscal state in Portugal was accompanied by civil wars and financial distress. Researchers have regarded the setbacks implied in this institutional transformation as a cause of Portugal's poor economic performance in the 19th century.

The queries on the reverse side will guide you in the writing of **one-answer** essay intending to discuss this view on the causes of Portugal's backwardness.

Keep in mind that quotations of the text that go beyond two sentences for each couple of questions may be taken as plagiarism (with, or without quotation marks). It will downgrade your work significantly.

(please see the reverse side)

1- Begin your essay by,

a) Pointing out evidences on Portugal's political and financial modernization throughout the 19th century.

Political modernization – evidence on checks on discretionary powers of the executive

The liberal revolution ensuing the French invasions.

The new constitution of 1822 established a system based on division of powers and on a parliament entitled to monitor the executive and the allocation of revenues

(Based on **p.272**;- “ *The state Budget had to be presented annually to the Cortes ...*

and on p. 275 second paragraph, several examples of administrative reforms making the executive accountable for expenditures)

Financial modernization – evidence on the economy's increasing financial deepness.

Conventional monetary system backed up by the enforcement of the gold standard

Portuguese banking system underwent a fast growth – many banks were created including a public bank – Caixa Geral de Deposits (**p. 277**);

The enactment of legal codes regulating the free constitution of joint stock companies (**p 277**).

Thus Portugal seemed to be equipped with an institutional framework that was not meaningfully distinct from that found in other European countries having higher growth rates and higher levels of financial deepness.

But,

b) Recall the limits of this modernization, whether by questioning the effective impact of public debt on the financial market in Portugal until 1880, or considering the characteristics of the banking system and its coping with a crisis in 1876.

The economy could evolve independently from the states' unbalanced budgets or bank crisis because

- 1- the development of the banking system and the investment of private savings were driven by the state's demand for funds (**p.274**), even so, if this would

have affected the economy (crowding out capital from the private sector), there “*would have been an upward pressure on interest rates and price*”, and there was not. (p.274);

As for evidence on the low level of integration of the financial system with the productive sectors: “*The 1876 banking crisis did not take a serious toll on the rest of the economy because only a fraction of the production depended on lending from banks – weak links between banking and agriculture (and business in general)* (p.278) “

(6 points)

2- Then, elaborate on the enlargement of the state’s functions as one of the cornerstones of the liberalism by:

a) Indicating the new functions expected from the state in Portugal

Recall what is stated on p. 276, last paragraph- “In Portugal as elsewhere in Europe, enlarging the state’s functions meant investments in infrastructures – railways, utilities, ports ...”. This asked for a comment:

Public investment was expected to foster economic growth, thus, even with low levels of integration between banking and productive sectors, the public policy aimed at promoting a market-oriented economy. This distinguished the financial cornerstone of the liberal state after 1850 from the first phase when public revenues waged military might against vested interests in preserving the old absolutist order (as it described on p. 270).

b) Explaining why the state’s functions were met by financial distress.

The rise of expenditures called for institutional changes on tax bases and on the levy of direct taxes, which probably did not keep up with the recovery of personal income.

Several social upheavals contributed to create financial troubles (p. 275) and the important wave of reforms the government carried out in the first phase of the *Regeneração* (1851 onwards) came to a halt in 1868, once again due to revolts opposing tax reforms (p.277).

This asked for a comment:

Formal modernization of political institutions is well documented, but the financial reforms needed to balance the budget faced civic opposition. This adds evidence on the political modernization limited reach – the state’s capacity to make people comply with tax reforms as a means of financing public goods was recurrently challenged

(8 points)

This part of the essay, addressing issues raised by questions 1 and 2 and scoring 14 points, delves into what is stated on page 273 “the deteriorating public finances should not be seen as an indicator of a deteriorating economy”. Political institutions and fiscal capacity are main factors for trends in public finance; whereas the economy can evolve according to factors independently the state’s fiscal capacity (extraction of surpluses to balance public budgets). Until the critical moment of 1891, the authors’ claim on pg 273-274, is that the true impact on the economy of a public policy driven by chronic deficits has been exaggerated, given the two sorts of evidence that were exposed in 1 b).

Recall that the whole essay is to be structured around the discussion proposed on the front page of this exercise: **The making of the liberal, fiscal state in Portugal** was accompanied by civil wars and financial distress. Researchers have regarded the setbacks implied in this institutional transformation as a cause of Portugal’s poor economic performance in the 19th century.

Therefore, the essay should consider as well the fact that the state’s low capacity to increase revenues to wage the debt service, as exposed in 2 b), led eventually to a financial crisis preempting the country’s access to foreign capital thereafter

This is the issue explored in the next group of questions, scoring the remainder 6 points:

- 3- Finally, provide an explanation of the 1890s events that gave rise to the Republican Party in Portugal, by**
- a) Summarizing the troubles affecting the financial system in 1891 (no more than 5-7 lines)**

Progressits party intended to face public deficits by means of expropriating the tobacco industry which operated under a regime of monopoly. This implied the payment of a large indemnity to the company that had purchased the monopoly rights (p.279) – which raised the public deficit immediately afterwards. The government fell after the British Ultimatum,

The second factor was an international crisis affecting the English bank that usually provided short-term credit to Portugal's state and the Bank of Portugal loss of gold reserves.

The third factor was the government's suspension of the currency convertibility - gold standard was not enforced, which raised the risk of the public debt.

The main consequence of this juncture was the government's lack of liquidity to service the payment of interests to national and foreign bondholders.

- b) Commenting on the authors' idea that the financial crisis shows “the power of the peripheral governments in the international economy of the late 19th century”. However, internally, the monarchy underwent a serious blow.**

The shortage of means to service the debt led the finance ministers to charge a tax on interests and finally to cut the interests paid on state bonds on gold. In practice the solutions did not enforce the creditors' rights and the political measures taken penalize more severely foreign than national bondholders “*When the finance minister decided to default on foreign bondholders he showed no concern about the effects of such a measure in the country's capacity to raise further loans in international capital markets* , p. 288, **lines 10-14**”

This was possible because international creditors had little means of enforcing their rights through trade retaliations. “*the government of a peripheral country could simply choose to default if the consequences were less harmful to domestic and economic interests than the alternative fiscal measures* p. **288 line 34-36**”

(6 points)