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War Finance (Portugal)

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Portugal financed the extraordinary expenditures of the First World War in the same way as many other countries, i.e. running budgetary deficits, issuing debt, and printing money. By the end of the war, all nations were facing the same dilemma - they could either adopt a deflationary monetary policy or embark on a fairly aggressive policy of currency devaluation. Due to political weakness, successive Portuguese governments accepted the latter. This inflationary policy penalized mostly private savings and the share of the population relying on fixed incomes, but it also slowed down the contraction of the economy.

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Introduction

Unlike most western European countries, Portugal had already abandoned the gold standard by the outbreak of the First World War, as a consequence of insolvency and default of 1891. Portugal aspired to return to that system, but the hostilities put an end to such thinking. The means to finance the war, namely running budgetary deficits, issuing debt, and printing money, resulted in a dilemma. Portugal could either adopt a deflationary policy in order to restore quickly pre-war levels of financial balance and go back to the gold standard, or embark on an aggressive policy of currency devaluation and accept the impossibility of returning to the earlier exchange-rate parity. However, successive Portuguese governments, which were fairly weak politically, were unable to recover the pre-war levels of revenues, and the only recourse available to them for financing the deficit was an inflationary tax, issuing more and more currency. Portugal's soaring inflation, as well as that of other European nations, in the early 1920s was not so much the result of poor monetary policies as it was the fallout of a complex balancing act between social and political interests regarding the best way to share the costs of the war. As an instrument of distributing resources amongst social groups, deflationary and inflationary policies differed profoundly in their respective repercussions, John Maynard Keynes (1883-1946) pointed out in his work examining monetary problems in the aftermath of the First World War.[1] An inflationary policy coupled with currency devaluation would penalize private savings and the share of the population relying mostly

on fixed incomes, but it would also slow down the contraction of the economy. A policy founded on deflation and monetary stabilization would bring opposite pressures to bear, notably accelerating economic recession and unemployment.

Public Finances, Money and the War

From a financial point of view, the early 20th century in Portugal was a period of reduced elasticity of state revenues, chronic public deficit, and high debt, which weighed heavily on state finances.[2] The advent of the Republic in 1910 brought no immediate changes to the management of the state's finances, at least regarding two of the main problems inherited from the earlier regime: balancing the budget and reducing the public debt. The first two years of the new order showed little discontinuity with the constitutional monarchy (see table 1).

	Deficit(% GDP)	Expenditures(% GDP)	Revenues(% GDP)	Debt (annual growth rate)	Debt to BP (annual growth rate)	Inflation (annual growth rate)	Monetary issuing (annual growth rate)	Exchange rate (annual growth rate)
1900-1910	-0.6	17.4	16.6	0.2	-1.0	0.6	1.6	-2.3
1911-1913	0.2	17.1	17.3	-0.6	-3.0	1.4	8.6	2.3
1914-1918	-6.7	21.9	15.2	8.8	63.9	20.0	20.2	8.7
1919-1923	-8.7	16.2	7.5	49.7	43.5	46.7	42.4	75.2
1924-1926	-3.5	13.2	9.7	8.6	9.5	11.6	8.5	-2.8

Table 1: Evolution of the main monetary and financial indicators[3]

Afonso Costa's (1871-1937) policies as Finance Minister in 1913 included a brief attempt to use financial policy to break with the previous regime. During his time in office, he used the budget to achieve the long-desired goal of having public accounts without a deficit, hoping that the practice would become a hallmark of the new regime. He did this by cutting state expenditures, reforming public services, and restricting the parliament's legislative powers for adding expenses or reducing revenues at any time outside the period determined for debating the budget. By doing so, Costa turned the budget around in 1912-1913 and even reached a positive balance in the following year (1913-1914).

Portugal's currency underwent a significant change around this time too, altering one of the symbols of the nation's sovereignty. In 1911 the *escudo* replaced the *real* that had been created in 1435 and had therefore served as the nation's currency for five centuries. The Republic changed the name of its currency, but maintained a conversion rate that facilitated the changeover – 1 *escudo* equalling 1,000 *reais*[4].

The continuity thus established fell into disarray with the outbreak of the First World War, which had more disruptive effects on state finances than the transition from the earlier regime. Despite Portugal's moderate role in the actual military operations when compared to some of the other belligerent nations, the war's painful impact on the country's finances would haunt the nation for decades to come.

Not surprisingly, a sharp rise in war-related expenditures was the first effect. In the early days of the war, military spending stood at about 4 percent of GDP. By the end of the hostilities, this had risen to 14 percent, quite a steep increase, even if it was very different from the 38 percent and 53 percent of GDP in Great Britain and Germany,

respectively.[5] Other expenses drove up public spending too; the need to intervene in the market in order to ensure the supply of essential goods, as well as social security payments to soldiers and their families, strained still further the resources of the Treasury,[6] explaining the rise in public spending (see graph 1) to levels surpassed only in 1974.

When the war ended and the soldiers mustered out, military spending decreased and by 1920 had retreated to its pre-war levels. What would explain the growing need after 1920 to obtain financing from the Bank of Portugal and the inevitable increase of the money supply? Two main things worked towards expanding the state's financing needs. On the expenditures side, there was a continuing need to subsidize certain essential goods and services, such as bread and transportation, and there was indeed a need to pay social security benefits to injured soldiers and their families, as well as pensions to the dependents of those killed in combat. These expenditures persisted for some time and partially accounted for the fact that public spending did not fall immediately after the return of peace. The second, and more important, reason for continuing to finance the public deficit through central bank loans resided in the worsening tax crisis which had been growing since 1915 and was the result of currency devaluations eroding tax revenues.

Great Britain financed a third of Portugal's military spending (22 million pounds sterling) as part of an aid package negotiated in 1916. However, other sources of funds had to cover the greater part of the added expenditures. Most of the hostile nations did not address their payment issues by raising taxes or issuing sovereign bonds in the world's financial markets. They chose, instead, to borrow in the short term, both domestically and from foreign sources of capital.[7] The same occurred in Portugal. The vast majority of the debt was secured through the Bank of Portugal and to a lesser extent through the *Caixa Geral de Depósitos*).[8] The *Caixa Geral de Depósitos* was a state-owned bank dedicated to the reception of compulsory deposits, but also to any voluntary ones made by the public in general. It was the largest financial institution in the country. The government's loan requests to the Bank of Portugal were granted through a series of decrees that raised the ceiling on paper money issues not in reserves from 120,000 *contos* (a *conto* was equal to 1,000 *escudos*) to 1,325,000 *contos*.[9] Money in circulation thus grew three-fold during the war. Moreover, the surge in printing money was even more pronounced between 1919 and 1924. In this last year the amount of paper in circulation was eighteen times more than it was at the start of the war.[10] One of the effects of multiplying the money supply by a factor of eighteen was, of course, rampant inflation that in turn eroded purchasing power. As much of the public revenue came from taxes with fixed values, state income ultimately fell in real terms to less than 20 percent of pre-war levels by 1920.

Even though public expenditures at this time had returned to pre-war levels, public revenue was showing no signs of recovery (see graph 1). Thus, Portugal's tax crisis moved to the fore of the country's worries in the aftermath of the war. Printing more and more money was the only way to finance the burgeoning public deficit (see graph 2). Lending from the Bank of Portugal, in tandem with successive authorizations for the central bank to raise the ceiling on currency in circulation, made it possible for a string of governments to gain some short-term leeway to deal with ever-greater deficits, but consistently fuelled the inflationary spiral.

Prices rose in the first year of the war and continued to rise until the armistice, when they were three times higher than they had been in 1914. From 1918 to 1924, inflation skyrocketed and prices quickly reached a level twenty-four times higher than they had been at the start of the war. Within Europe, Portugal's post-war inflation was second only to the "hyper-inflation" witnessed among the belligerent countries of Central Europe. In only fifteen years of existence, the *escudo* had lost 96 percent of its value, which was as much as the *real* had lost in the near half-millennium from 1435 to 1911.[11]

In parallel, the *escudo* lost ground in the exchange rate too, with an effect similar to that of inflation (see graph 2). Again, the two periods are easily discernible. During the war years, the *escudo* fell against the pound sterling to nearly half of its pre-war value, which was less than inflation and far below the post-war depreciation. The trade balance was not performing too badly, which clearly explains the exchange rate from 1914 to 1918.[12] Loans from Great Britain to meet

war expenditures, as well as the moderating effect of falling imports, explain why the trade balance was not worse and why it buoyed the exchange rate of the *escudo* reasonably well.

The second period begins with the war's end, which exacerbated the deterioration of the *escudo* regarding the pound sterling for two reasons. Firstly, a growing negative gap in the trade balance was driven by rising imports and dwindling emigrants' remittances. Secondly, the *escudo* was overvalued at the end of the war, which, coupled with doubts about Portugal's ability to service its short-term debt, unleashed speculation against the *escudo*. This in turn accelerated the flight of private capital, triggering political turmoil and social fears, which in turn worsened the foreign debt, all with predictable repercussions on the exchange rate[13].

Monetary and Financial Stabilization

Financial stabilization was finally achieved through a number of measures aimed at reducing the public deficit, breaking out of the inflationary spiral, and reversing the downward trend in the *escudo's* exchange rate. Early in 1922, António Maria da Silva (1872-1950) assumed the leadership of the government. He took several measures to reduce spending, increase tax revenues, and stabilize the exchange rate. The international environment was also now more favourable, helping to discourage speculation and stabilize finances. The Geneva Conference adopted the gold standard in 1922, seeking a return to fixed exchange rates. An accord was announced about reinstating the war reparations imposed on Germany, which came to pass in the next year. Portugal was entitled to sufficient funds to address its short-term foreign debt, but the full amount was never paid.

One of the chief worries of the new government curtailing the recurring policy to borrow from the Bank of Portugal – the only way to curb inflation and put a floor under the falling currency. In order to do these things, Silva needed to find a way to boost public revenues and cut public spending. Government subsidies were amongst his first targets[14]. A number of other measures were taken too, including freezing any new public servants' hiring, the so-called "strangle law",(*lei garrote*), and a sell-off of state-owned assets (such as the *Transportes Marítimos do Estado*, sold to Alfredo da Silva, of the CUF Group).

A few months into his tenure, António Maria da Silva's government pushed through the fiscal reform of 1922. The government presented the law as a sign of fiscal modernization, founded on the creation of a tax on personal income and another on transactions. There were also changes in the assessment of real estate and industrial revenues, in an effort to better capture real earnings through taxes.[15] The reform was rounded out in the following year with a hike in customs duties.

In summary, this package of measures was able to lower the public deficit for 1923 to a level in close to 4 percent of the GDP – still high, but far from the 15 percent figure at the end of the war. When Álvaro de Castro (1878-1928) replaced Silva as Prime Minister in December 1923, this budgetary consolidation policy was continued, achieving some further reductions in the deficit by eliminating additional public services. The deficit fell back to levels very similar to those before the war, at the very moment when the First Republic was in its final days.

The shrinking public deficit put an end to the need to seek loans from the central bank. Ending the borrowing cycle also brought the soaring inflation under control. Prices stabilized in 1924 and even showed a deflationary trend over the next two years.

Despite some shocks and alarming moments in 1926, the exchange rate and price stability remained relatively stable after 1924. Not only did the *escudo* cease its fall against foreign currencies, it appreciated nearly 40 percent in relation to the pound sterling.[16] Nevertheless, even after its stabilization and recovery, the *escudo* was kept out of the gold standard until the end of the Republic.

Even after inflation and currency devaluation were reined in and controlled, the financial situation was not entirely

stabilized – the result of the stubborn, high public deficit. Only in 1931 did Portugal adhere to the gold standard, as part of the financial stabilization policy undertaken by António de Oliveira Salazar (1889-1970) when he took over as Finance Minister in 1928. Salazar was able to achieve a definitive and long-lasting budgetary balance, mostly by boosting revenues by about 40 percent[17]. In June 1931, the *escudo* was redefined as 0.0739 grams of 900-parts-per-1,000 gold, thus 110 *escudos* equalling one pound sterling, which amounted to a slight devaluation in relation to sterling.[18] In order to preserve the competitiveness of the economy, Salazar opted to incorporate the earlier devaluation plus an additional slight decline, in order to avoid repeating the exchange stabilization of 1924, when the escudo was overvalued against the pound. Although Portugal abandoned the gold-exchange standard only three months later, in September 1931, this was not the result of any inability to maintain parity, but rather to follow Britain's lead in abandoning the standard. Once again, considerations of competitiveness prompted the move.

It is worth recalling that Portugal's stabilization program in the long run, ended up being one of the most successful of the day. After 1931, the country earned considerable financial and monetary credibility, ushering in a period of circa thirty-five years of balanced budgets, low inflation, and a strong currency. Significantly, the elements of stabilization from 1922 to 1931 would continue to characterize the Portuguese economy until roughly the mid-1960s – surviving even the Second World War.

Conclusion

Like the rest of the world, Portugal had to learn to come to grips with the political, economic, and social havoc brought on by the First World War. It is true that the country did not suffer the same degree of human and material destruction that wracked other countries; it did not have to struggle with the extraordinary political upheavals typical in central and eastern Europe after the peace treaties, nor did it struggle with any of the hardships that accompanied the installation of the first communist regime in history amid the ruins of Imperial Russia. But that does not mean that the country was spared from confronting situations and events that it was ill-prepared for, situations which any type of regime would be ill-prepared in the 1920s - a mobilization to arms of approximately 100,000 men which was about 2 percent of the entire population and later needed to be mustered out quickly. There would be about 25,000 war casualties including dead, wounded, and disabled veterans that required material compensation for themselves and their survivors, as well as labour unrest, which despite the low weight of industrial workers in the population, was one of the most important organized political movements of the era.[19] The financial problem that arose in the First World War and the decade thereafter brought Portugal face to face with the financial and monetary issues that would define the remainder of the century, not only in Portugal, but throughout the western World.

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