## Recession of 1973-78: three crises in one

**PEAK: 1973; TROUGH: 1978.**

*After two decades of remarkable economic expansion, the Portuguese economy underwent significant transformations between 1973 and 1978, which led to a long recession. This resulted from the succession of three distinct, but consecutive and overlapping, economic crises. In the second half of 1973, Portugal suffered the effects of the increase in oil prices and the global recession, which reduced emigration and remittances from emigrants. The April 25 of 1974 revolution and the transition to democracy immediately triggered political instability and disruption of economic activity, as well as a demographic shock with the return of military personnel and civilians from former colonies. Finally, the accumulation of external imbalances culminated in a balance of payments crisis in 1977 and the request for IMF programs in 1977 and 1978. It was only from 1978 onwards, with the consolidated democratic regime, political and social stability, and the balance of payments correction program, that the Portuguese economy would grow again in a sustained manner, following one of the longest recessions in its history.*

### 1. CONTEXT

#### Internal context

In 1973, the Portuguese economy had been experiencing an unprecedented period of economic expansion for two decades. Not only had the last trough occurred in 1953, but these twenty years also witnessed the highest annual growth rate of real GDP per capita in Portuguese history. During this period, Portugal became industrialized and opened to international trade. Although Portugal was still one of the poorest and most closed countries in Western Europe in 1973, it was closer to other nations in those two indicators than it was twenty years before.

The Portuguese colonies represented 15% of exports and 10% of imports of metropolitan Portugal in 1973. The wars for independence in Angola, Guinea-Bissau, and Mozambique, which began between 1961 and 1964, dragged on and continuously mobilized between 50,000 (in 1961) and 150,000 (in 1973) potential workers each year, the majority of whom came from the mainland and were therefore subtracted from current economic activity to serve in the Armed Forces. In 1974, when the war ended, the deployed Portuguese contingent exceeded 170,000 military personnel. Military expenses associated with the conflict reached 8% of GDP in 1969 and coincided with continuous international pressure to end one of the last European colonial empires.

The 1960s and the early years of the 1970s were marked by significant emigration. Around one million Portuguese people left the country, partly in search of opportunities arising from the increased demand for labor in the more developed economies of

Western Europe, partly due to the economic opening that allowed it, partly because of the war and military conscription, and partly to escape repression and the lack of individual and political freedoms.

### External context

On August 15 of 1971, the US government suspended the convertibility of the dollar into gold. Right away, and permanently from March 1973 onwards, this started the end of the international fixed exchange rate system that had been in place since the post-World War II period, and in which Portugal participated by pegging its currency to the dollar since 1949. This allowed for exchange rate stability and price stability between the late 1940s and early 1960s, followed by a gradually accelerating rise in inflation. Monetary policy was subordinated to fixing the exchange rate. Negative trade balances were offset by high remittances form emigrants, allowing for the accumulation of a reasonably high stock of foreign currency and gold.

## 2. THE THREE CRISES

During the period from 1973 to 1978, the Portuguese economy underwent three distinct crises. Each of them would likely be sufficient to cause an economic contraction. Because they occurred successively and partially overlapped, the economy did not enter a period of sustained recovery that would allow for the identification of a clear trough between them, instead indicating a prolonged recessive period.

### The oil crisis of 1973

In October 1973, following the Yom Kippur War, OPEC restricted the supply of oil to the Western world in general and to some countries in particular, including Portugal, which had allowed the use of the Lajes air base during the war. The embargo led to long lines at gas stations. Three quarters of the country's primary energy source was oil at that time. The global economy immediately went into recession, not only due to the significant increase in energy prices but also due to a rise in the price of various other raw materials caused by the *El Niño* phenomenon, which affected global production. Portugal, which at that time already had a relatively open economy to foreign trade, suffered from the contraction of its exports, as well as from the deterioration of its terms of trade.

National macroeconomic policies reacted passively or even pro-cyclically. On the monetary policy side, there was an increase in the active interest rate at 180 days from 6.75% to 9.25% on December 1, 1973. This increase aimed to curb the accelerating inflation that had accompanied the expansion of credit and money supply, as well as a stock market boom during that year. Between November 1973 and April 1974, there was a sharp decline in stock prices and the trading volume. Nevertheless, credit to monetary institutions grew by 8.8% quarter-on-quarter in the first quarter of 1974, and commercial banks significantly reduced their excess reserves.

Fiscal policy did not respond to the oil shock. Military expenses were financed through a contraction in public investment and the issuance of domestic public debt. The government had not changed the tax system in years. Finally, the large volume of foreign exchange reserves meant there was no imminent risk of a balance of payments crisis, despite the impact of the oil shock.

### The political crisis during the revolutionary period of 1974-75

The April 1974 revolution brought enormous changes to the political, social, and economic structures of the country, which cannot be adequately reviewed here. For the business cycle analysis, it is important to highlight two phases during this period that had immediate impacts on economic activity, in addition to all the permanent changes in the structure of production. In a short period, Portugal experienced an accelerated increase in the power of trade unions, an increase in labor costs, price controls, a profound change in the corporate structure, and some capital flight.

Between April 1974 and February 1975, in addition to political and economic instability and uncertainty, there was a significant increase in public expenses and a flight of private capital. In 1974, there were 80,000 new public sector workers, many of which were associated with the integration of employees from the colonial administration, and this continued in the following years. In the private sector, the state intervened in several struggling companies by appointing boards and granting public credit. In May 1974, a national minimum wage was established for the first time, and, by the end of the year, several social benefits were created, dismissals were made more difficult, strikes were legalized, and new unions were formed. The government increased the nominal minimum wage by 20% in 1975, although there were still several exceptions in its coverage, and, at the same time, administrative price controls were imposed, leading to a sharp reduction in firm profits. In response to capital flight, limits to cash withdrawals were imposed, and the Escudo ceased to be freely convertible abroad in May 1975. This combination of policies resulted in high public deficits that were monetized, leading to an inflation spike of 37% in 1974.

In a second period, spanning from March to November 1975 (known as the "hot summer"), economic uncertainty increased. Land was collectivized throughout 1975, especially in the southern region of the country, reaching its peak in 1976 with around 40,000 permanent workers and 1,1 million hectares under the Collective Production Units (CPUs) in the Agrarian Reform Intervention Zone (ZIRA). Between 1974 and 1976, favorable weather conditions led to large wheat, oats, and barley harvests and supported considerable nominal increases in agricultural wages. The adverse weather conditions in the 1976-77 meteorological year contributed to a 70% and 55% decline in the annual production of wheat and oats in ZIRA, respectively, starting the process of returning the land to private ownership (Barreto, 2017). Lastly, almost all banks and insurance companies were nationalized, as well as industrial units in strategic sectors

(Amaral, 2019). The exact magnitude remains to be measured, but it is estimated that by 1978, 24% of the GDP was placed in state-owned enterprises (Pinho, 1976).

In addition to the political and monetary instability, this two-year period was also marked by a demographic shock. Emigration, which had been a constant in the previous decade, suddenly came to a halt. Starting in 1974, and especially in 1975, military personnel and civilians from the former colonies were abruptly transported to Portugal. The integration of this entire population into the productive sector was not easy, especially considering the instability in the corporate sector. The admission of new public workers and the increase in public administration wage expenses put pressure on public accounts.

### The balance of payments crisis of 1976-78

Between November 1975 and July 1976, there was a clarification of the political regime towards the consolidation of democracy, which remains to this day. The country held its first parliamentary elections in April 1976. By the end of that year, a process of reversing indirect nationalizations began, and a public investment plan was presented. These changes reinforced budget deficits, partially financed by the central bank.

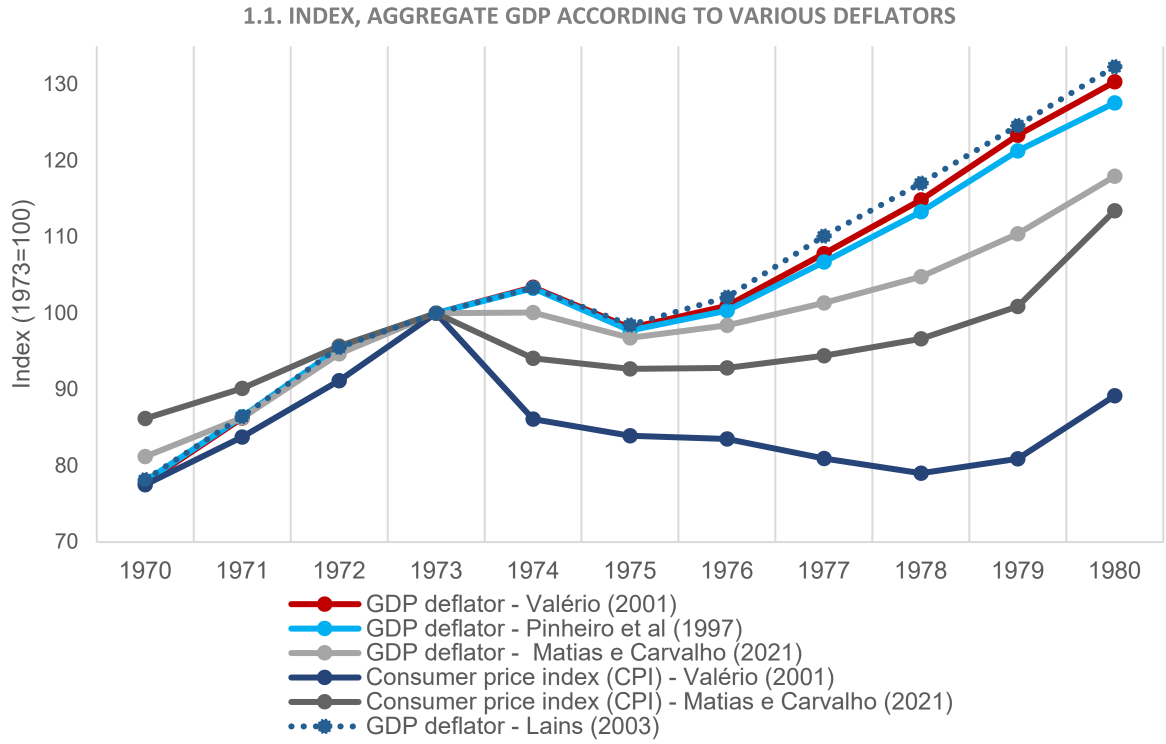
The fiscal and monetary expansions from 1973 to 1976 placed pressure on Portugal's balance of payments, depleting external reserves. At the same time, political instability had led to a lack of external financing. After obtaining credit lines from the European Investment Bank and the US Treasury in 1976, which proved insufficient, the country turned to the IMF for a $750 million bailout loan from a group of Western countries in April 1977. The program led Portugal to adopt a set of drastic austerity measures in 1978-79, including quantitative limits on credit, as well as a gradual devaluation of the Escudo to restore competitiveness.

## 3. MAIN INDICATORS AND PROXIMATE FACTORS

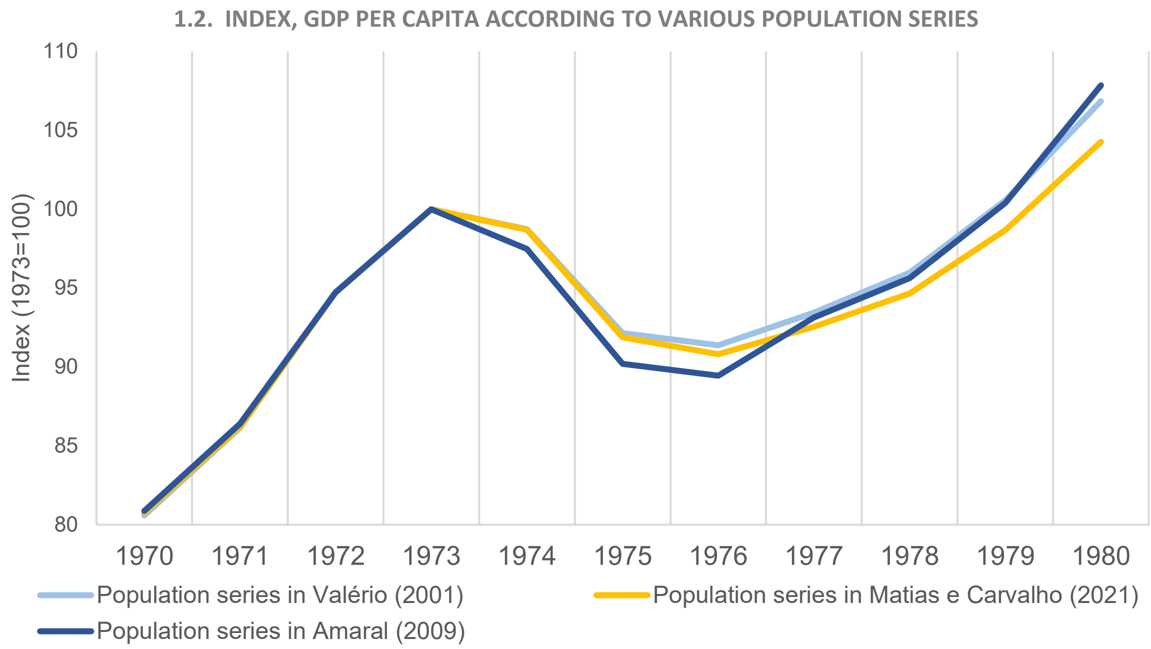
### Production and national income series

Before 1980, there is no consensual series for Portuguese real GDP per capita, but rather several estimates from different authors. The aggregated series in Escudos are similar, but there are significant differences in measures of price indices and population. Official statistics did not keep up with the soaring inflation and the enormous fluctuations in immigration and emigration, leading different historians to propose various ways to improve the reliability of the data.

Fig. 1 - EVOLUTION OF REAL GDP ACCORDING TO VARIOUS SERIES




**Sources**: Nominal GDP: *Matias and Carvalho (2021);* Deflators: *see legend.*

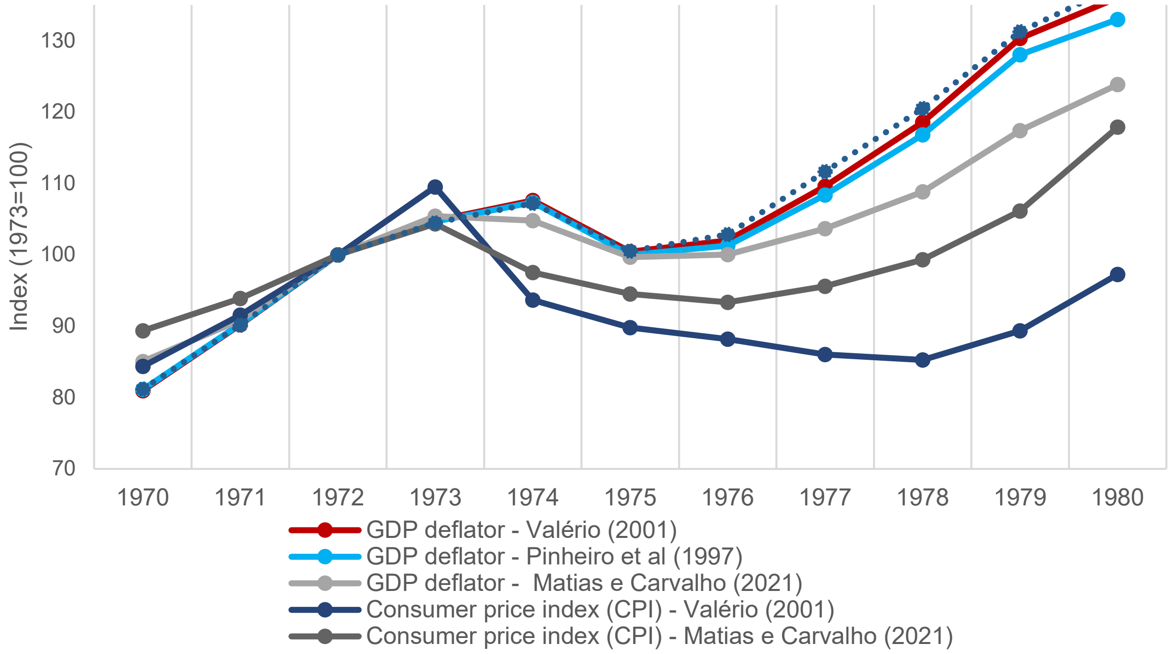



**Sources**: GDP and implicit deflator: *Matias and Carvalho (2021);* Population: *see legend.*

The top panel of **figure 1** uses the same nominal series to construct six different series of real GDP, corresponding to six different price measures. The bottom panel of the figure chooses one of the price indices but uses three different population series.

Although different population series provide different answers to several important questions, they coincide in the dating of the cycles by conveying a peak in 1973 and a trough in 1975 or 1976. However, the price indices yield significantly different messages, with some indicating a peak in 1973 and others only in 1974. The uncertainty regarding the trough is even greater, with different series showing local minima between 1975 and 1978.

Fig. 2 - EVOLUTION OF GROSS NATIONAL DISPOSABLE INCOME ACCORDING TO VARIOUS DEFLATORS



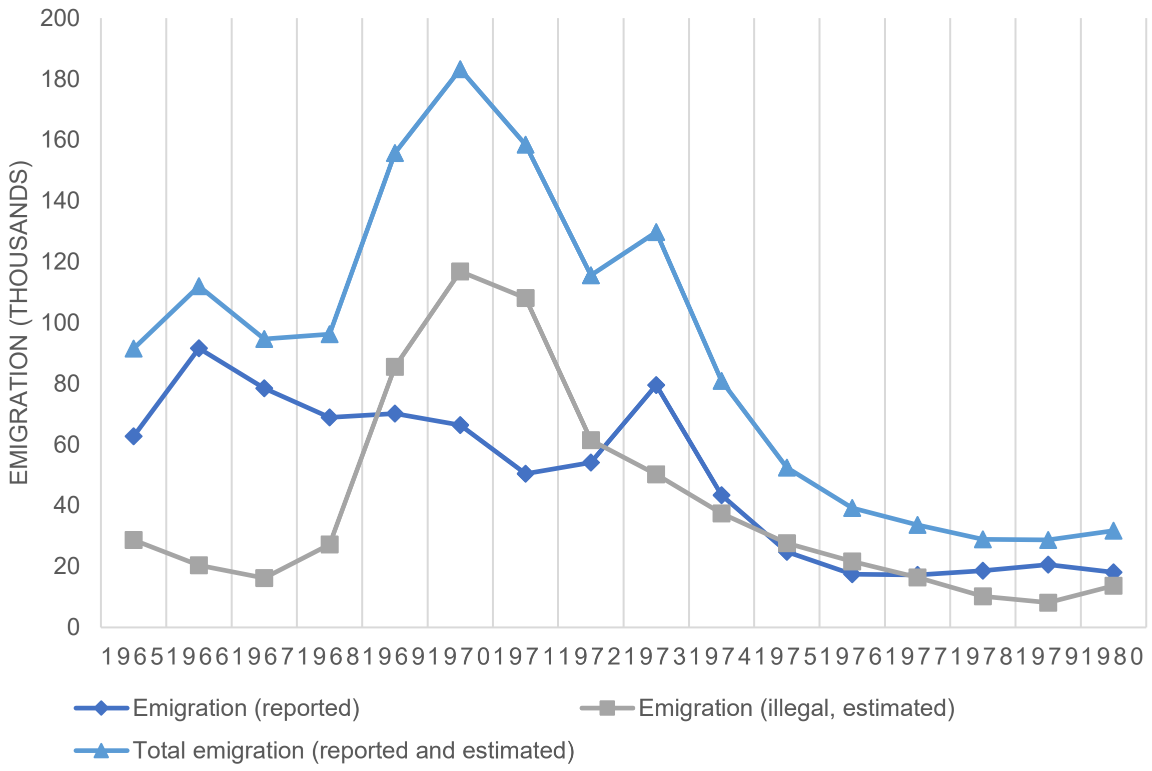

**Sources**: National Disposable Income: *Matias and Carvalho (2021);* Deflators: *see legend.*

With the unusual and significant changes in remittances from emigrants, which played an important role in the standard of living of the resident population, disposable income does not exhibit the same behavior as GDP during this period. **Figure 2** replaces GDP with a measure of gross national disposable income and again uses six different price series to obtain its value at constant prices. For dating the peaks and troughs, this series once again demonstrates the substantial impact of price indices. An analysis based solely on these aggregate measures would face considerable challenges in dating the peak and trough of the recession.

While the different population series may point to the same dates, that does not mean that population does not play a significant role in this cycle. On the contrary, due to a substantial increase in population in 1973, aggregate real GDP measures suggest a peak in 1973 or 1974, while real GDP per capita measures clearly indicate 1973 as the peak of economic activity. Similarly, the per capita series indicate a trough no earlier than 1976.

This does not mean that either aggregate or per capita output are individually more suitable than the other for dating cycles. They convey different information that is relevant for assessing the state of the Portuguese economy at that time and point to the need for an analysis based on multiple indicators and an investigation into the underlying factors behind the differences. **Figure 3** shows that behind these population fluctuations are variations in emigration and immigration, which are exceptional during this period. On the emigration side, with the revolution and the end of the colonial war, there was a decrease in the outflow of people for political reasons. Economic emigration also declined due to the global crisis. On the immigration side, thousands of civilians returned to Portugal from the colonies between 1974 and 1975, resulting in a population surge that would have been even greater if some of them had not stayed in Portugal for only a few months before emigrating to other destinations.

Fig. 3 - DEMOGRAPHIC DYNAMICS 1965-1980

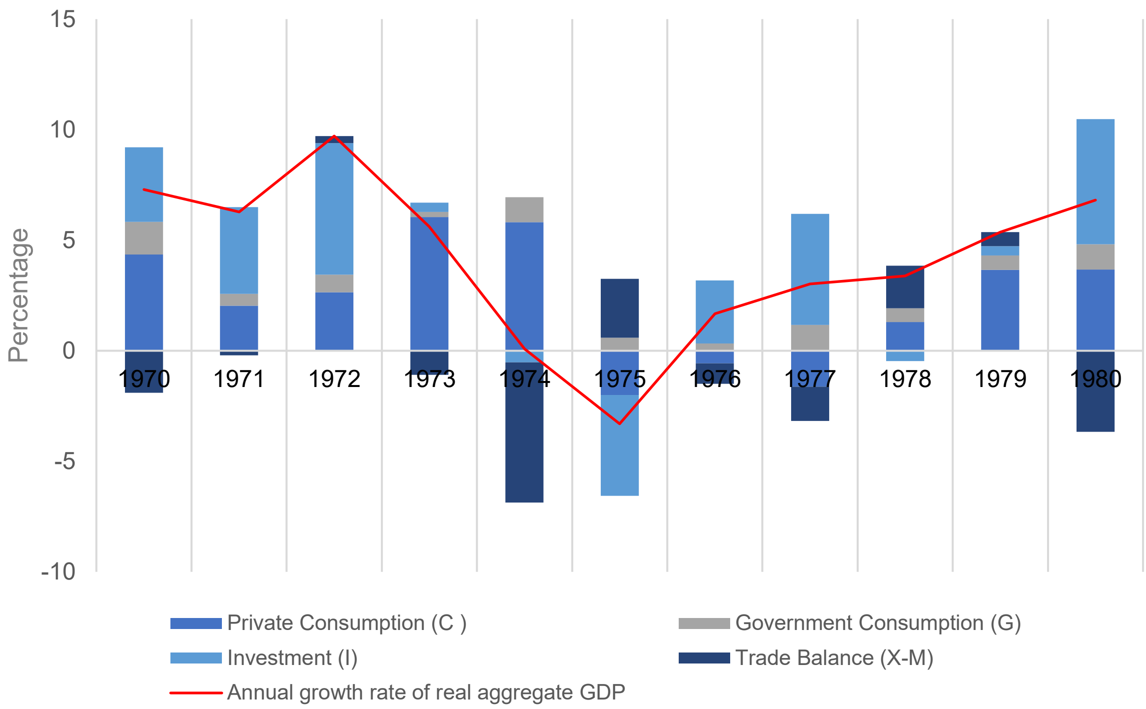



**Source**: *Valério (2001), based on Baganha (1994).*

## Decomposing economic activity

The composition of GDP in **figure 4** reveals the difference between the three crises that affected Portugal during this period. The trade balance deterioration between 1973 and 1974 caused by the oil crisis is clearly visible. Another small contribution to the reduction of GDP came from the decline in investment in 1974, probably caused by capital flight and political and labor relations' instability, which decreased the return on capital accumulation. This decline in investment intensified in 1975, following the nationalizations and the political and economic uncertainty, which was also accompanied by a decrease in household consumption, especially of durable goods. Consumption remained contracted during the balance of payments problems period (1976-77), until the trough in 1978, with a noticeable expansion of private consumption in that year, following the loans and adjustment program associated with the IMF mission.

Fig. 4 - GDP ACCORDING TO THE EXPENDITURE APPROACH

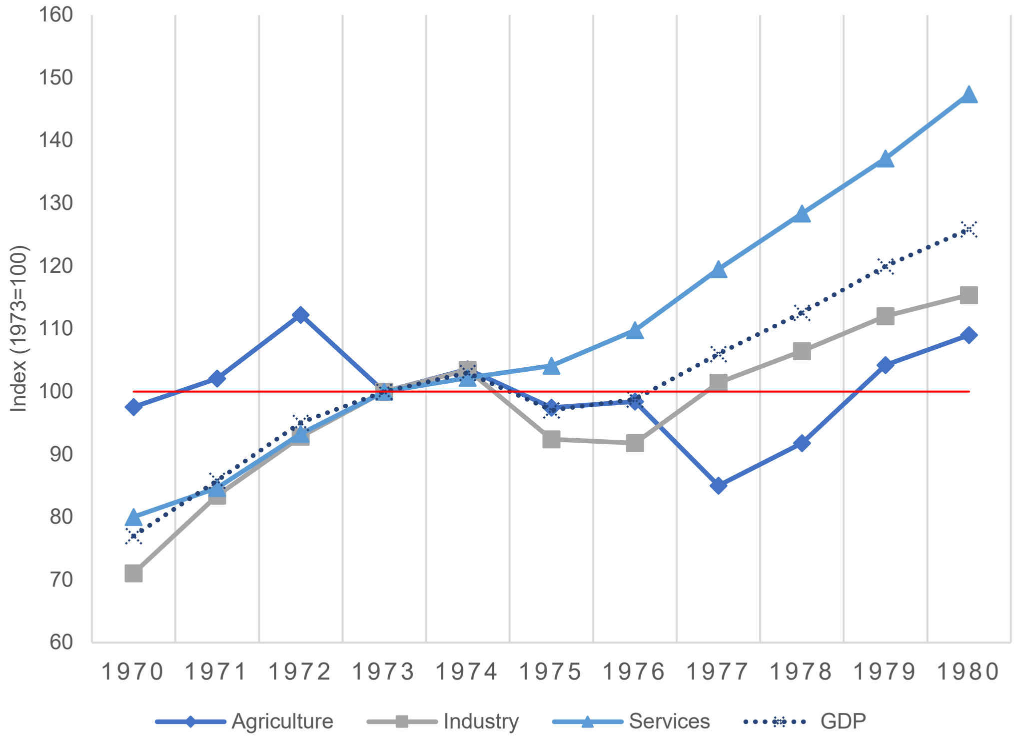



**Source**: *Matias and Carvalho (2021)* .

When it comes to the sectoral composition of GDP, it is noteworthy that although agriculture was only responsible for 11% to 12% of value added in this decade, it still accounted for 26% of employment. Portugal was an industrial economy, with the secondary sector contributing between 37% and 52% of GDP (according to different measures) and 36% of employment. In **Figure 5**, the effect of land occupation and nationalization of industries is visible. It is in these sectors that the economic contraction from 1974 to 1977 is concentrated: this recession is still an agricultural recession, although now the source is political, and the industry is equally or even more important in the cycle. The services sector expands continuously, although at a clearly slower pace in 1974 and 1975, during the nationalization of transportation and communications, as well as banking and insurance. In fact, the weight of the financial sector in GDP dropped from 10% in 1973 to half (5%) at the end of this recession.

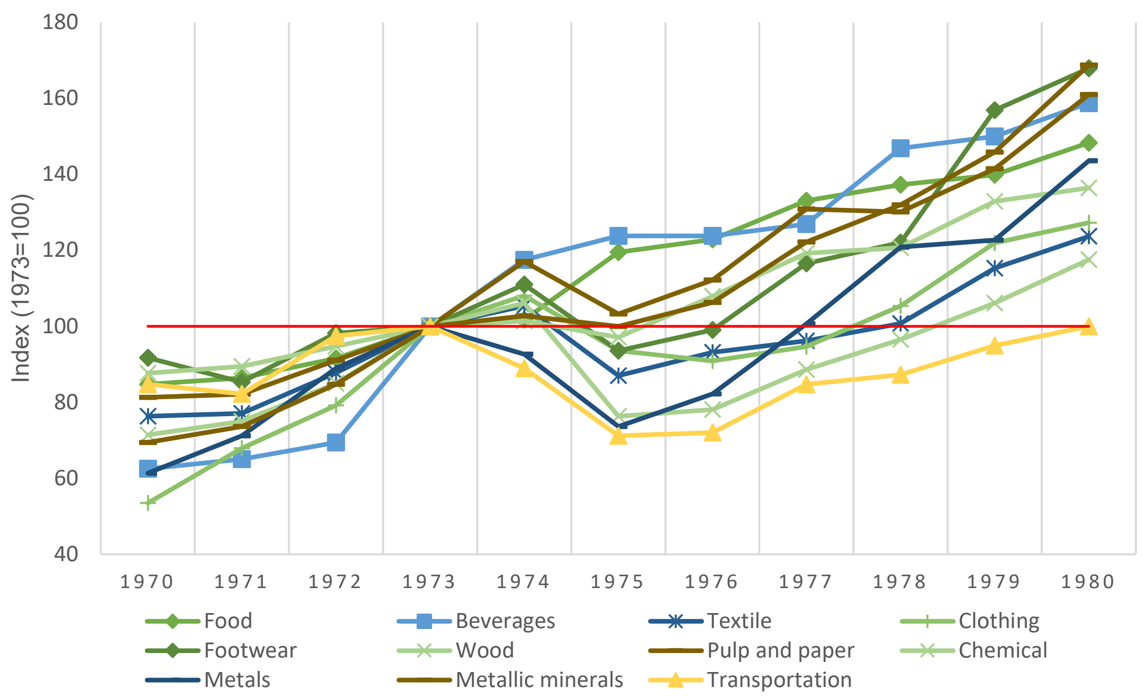
**Figure 6** shows the evolution of the main industries in the secondary sector. The ones that contracted the least (food and beverages) were the ones least exposed to the expansion of the public sector or to capital flight during this period. The largest declines (metallurgy and transport materials) coincide with the industries that experienced more extensive nationalizations, as well as where the increase in nominal wages and the rise in uncertainty may have had a greater impact because they were more export-oriented and therefore more sensitive to the loss of competitiveness.

Fig. 5 - EVOLUTION OF SECTORAL (REAL) OUTPUT




**Source**: *Valério (2021).*

Fig. 6 - INDUSTRIAL PRODUCTION INDICES (MAIN INDUSTRIES)

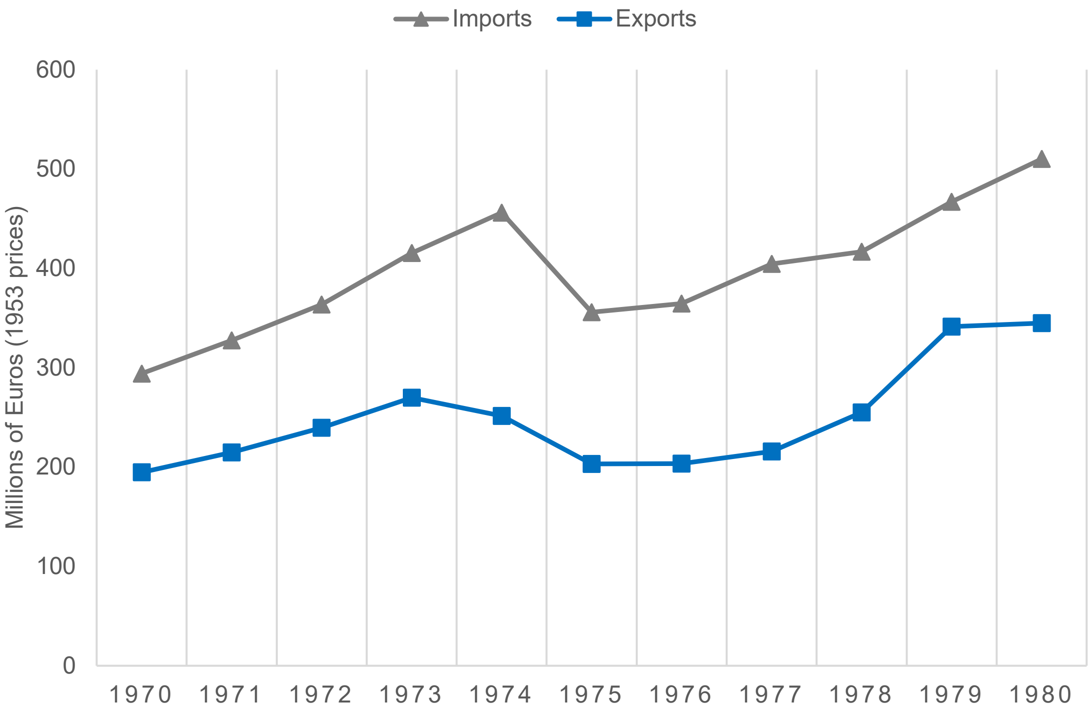



**Source**: Nominal series and corresponding implicit deflators: *Matias and Carvalho (2021).*

## External factors

Looking specifically at exports and imports, **Figure 7** shows that the main change occurred during the 1973-74 shock. At constant prices, the global recession resulted in less international trade. From 1975 onwards, imports recovered more quickly than exports, and the trade deficit worsened, accompanying the decrease in domestic production and loss of external markets. In current prices, the increase in oil prices reduced the country's terms of trade, as Portugal relied on oil imports as an energy source. Import values increased sharply, mainly due to the rise in their prices, while the global recession led to a clear decline in exports. Between 1975 and 1978, the trade deficit was high, well above the levels of the 1950s and 1960s, leading to a depletion of Portugal's international reserves prior to this recession.

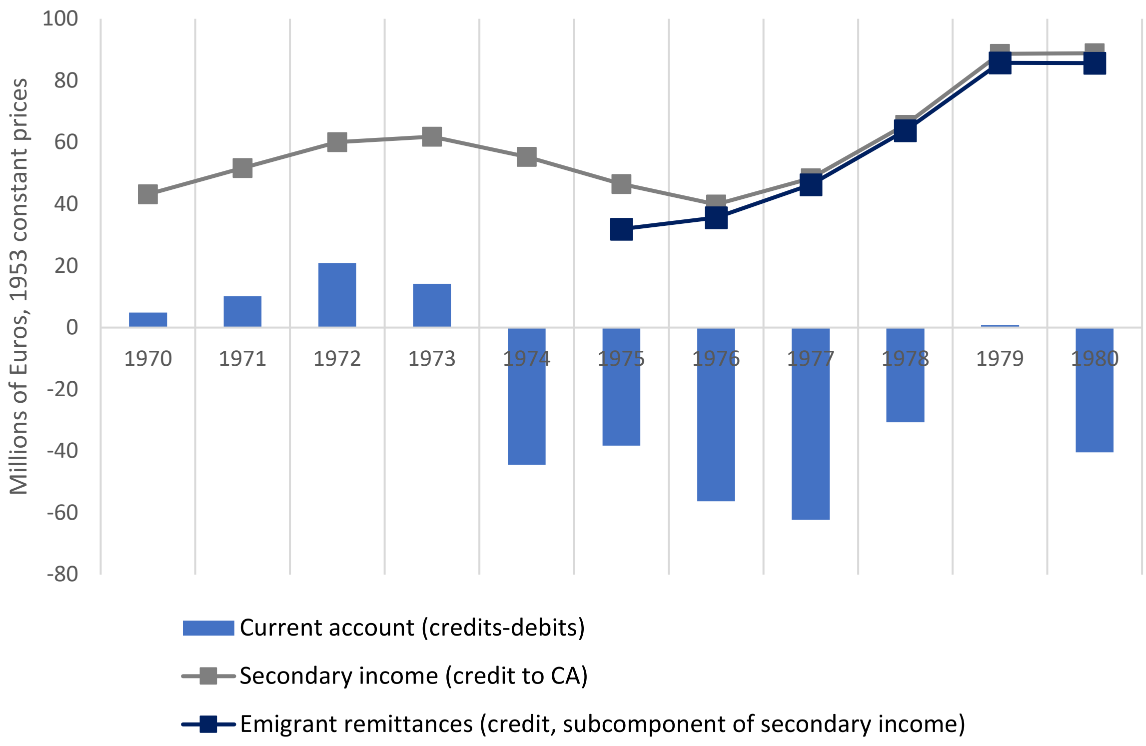
Fig. 7 - EXTERNAL TRADE




**Source**: *Matias and Carvalho (2021)* .

During this period, emigrant remittances were as important as the trade balance for Portugal's financial position. **Figure 8** shows the balance of payments, as well as emigrant remittances (only from 1975 onwards), which are credited to the current account balance, one of the components of the balance of payments. Since remittance data is not available before 1975, the figure also includes the secondary income series, which captures unilateral transfers and closely follows emigrant remittances. The transition from comfortable surpluses to significant deficits occurred in early 1973, and the deficits persisted throughout the recession until 1978. Emigrant remittances, which declined in 1974 and 1975 partly due to the global recession, began to rise again from 1976. However, this increase was not sufficient to offset the growing trade balance deficit.

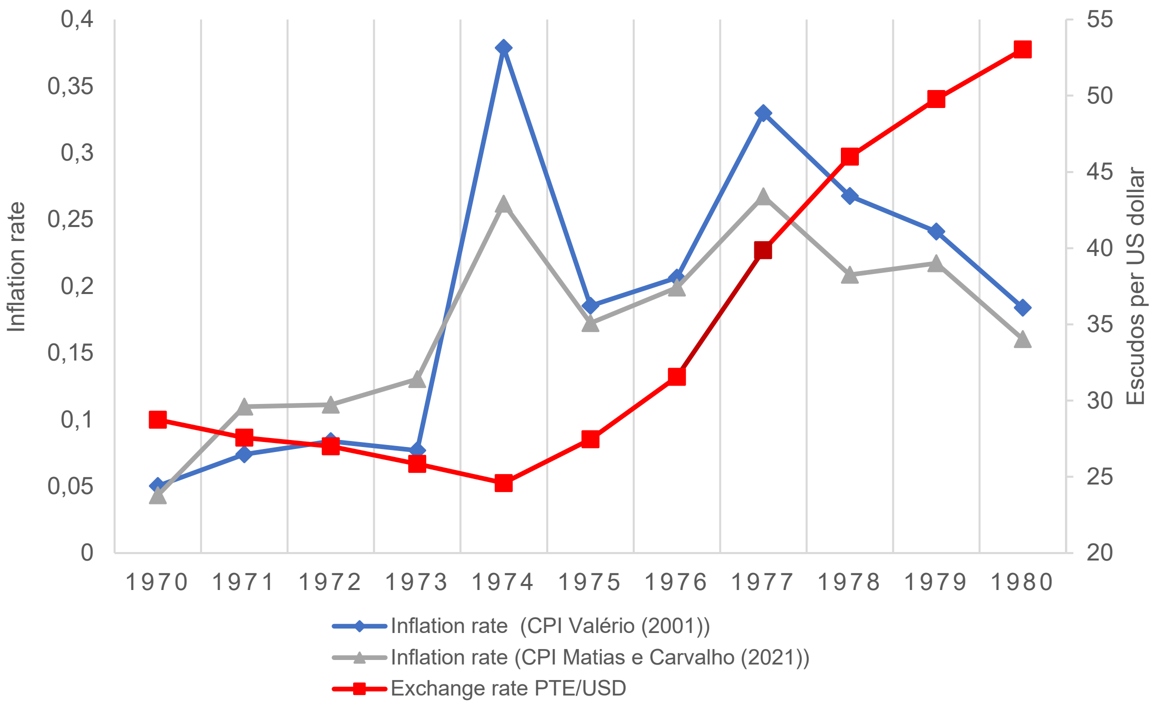
Fig. 8 - CURRENT ACCOUNT AND EMIGRANT REMITTANCES




**Source**: Nominal series for the balance of payments: *Matias and Carvalho (2021).*
Deflator: implicit GDP deflator in *Matias and Carvalho (2021)*.

**Figure 9** illustrates the deterioration of the economy's nominal anchor: the increase in goods' prices and the loss of currency value. The inflation rate surged in 1974 and remained high during the recession, following decades of price stability. The end of the Bretton Woods system and the rise in energy prices contributed to inflation accelerating, along with the significant increase in public spending and the printing of money to finance these expenses. As a result, despite nominal wages increasing, there was a stagnation in real wages and in household disposable income. This recession is characterized by stagflation, similar to most Western economies during this decade. On the other hand, the other side of inflation is the Escudo's exchange rate. After decades of financial stability and strict adherence to the gold standard, Portugal saw its currency depreciate by 43% against the dollar between 1973 and 1978.

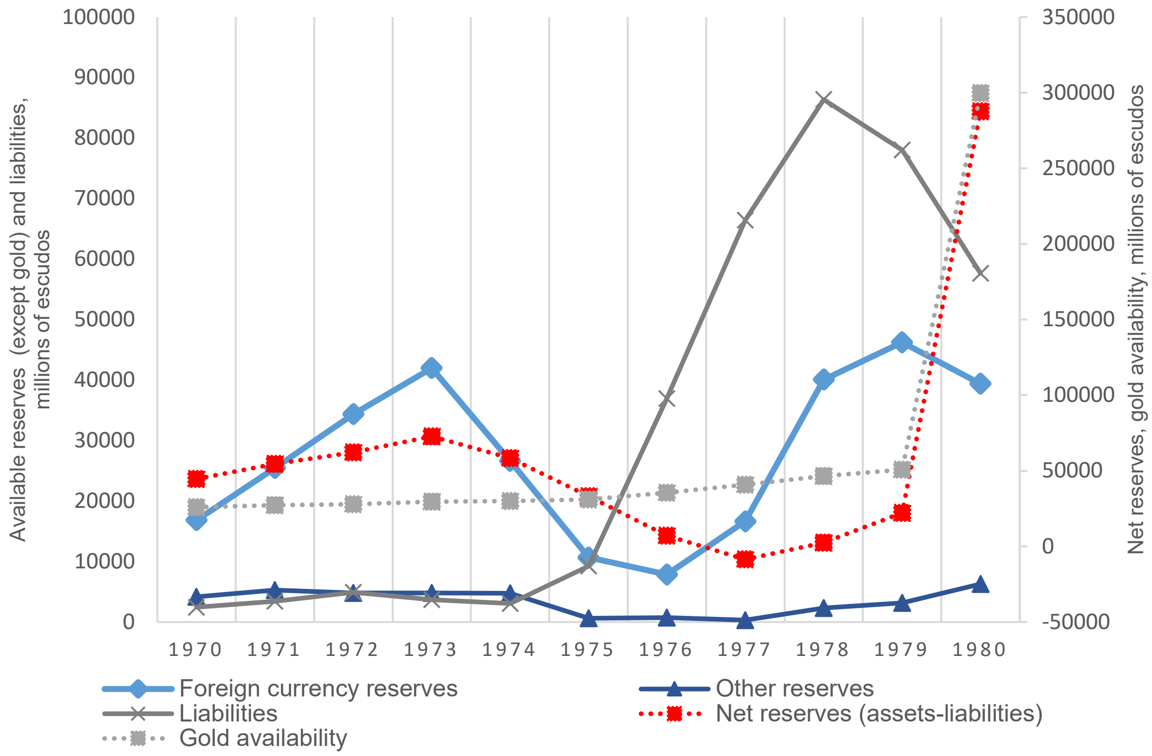
Fig. 9 - INFLATION AND THE EXCHANGE RATE




**Source**: Exchange rate: Valério (2001); CPIs: see legend.

The balance of payments crisis of 1977 was inevitable given these external indicators. **Figure 10** confirms this, depicting Banco of Portugal's official reserves. Since the onset of the recession after 1973, the decline in reserves has been continuous and intensified during the third phase of the crisis in 1975-77. The IMF program brought a turning point in 1978, aided by a revaluation of the nation's gold reserves, and there was a clear and rapid improvement in the national accounts from 1979 onwards.

Fig. 10 - BANCO DE PORTUGAL'S OFFICIAL RESERVES




**Source**: Pinheiro et al. (1997).

## Labor market

Finally, at a time when the role of the State in employment becomes significant, two final indicators inform the business cycle. The first, in **Figure 11**, is the employment data. Despite the hirings in public administration, the unemployment rate grows continuously during this recession, partly due to the increase in active population. This indicator clearly points to a peak in 1973 and a trough in 1978.

The second indicator is the share of labor and capital income in the distribution of output, represented in **Figure 12**. The second phase of this recession, in 1974 and 1975, is visible in the significant increase in labor income, whose share in disposable income rose from 55% in 1973 to 69% in 1975. From then on, the labor share declined continuously because real wages also continuously fell due to inflation, reaching pre-recession levels by 1980.

Fig. 11 . EMPLOYMENT IN PORTUGAL, 1970-1980

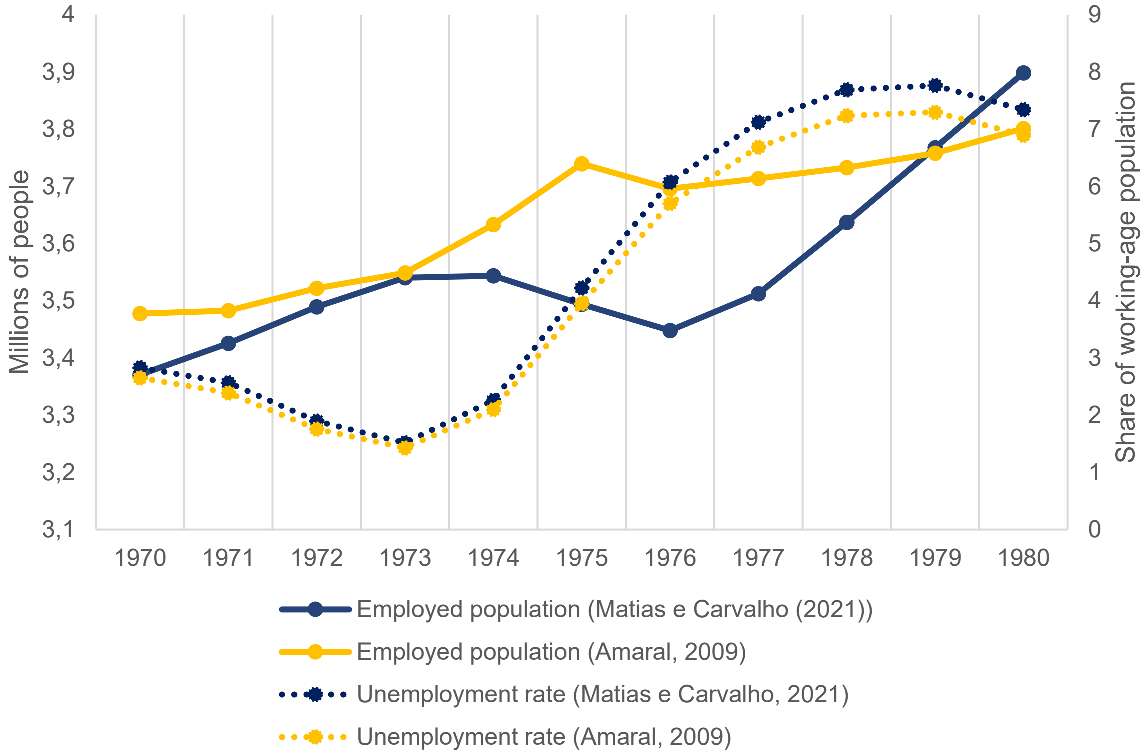
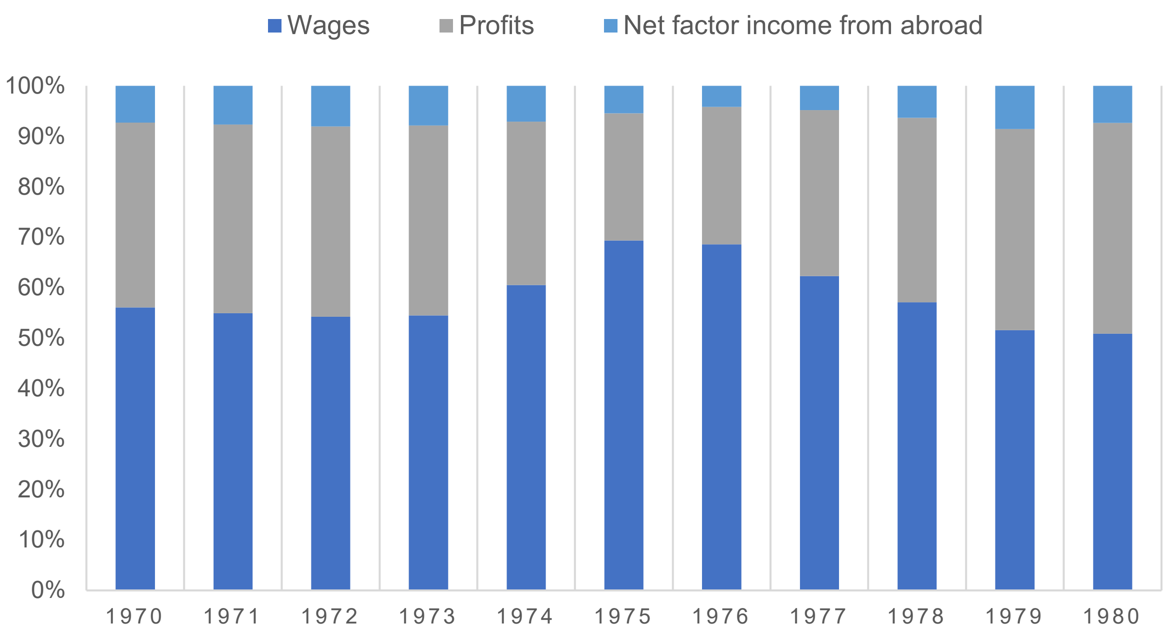



Fig. 12 - - GROSS DISPOSABLE (NOMINAL) INCOME COMPOSITION




**Source**: *Matias and Carvalho (2021)* .

## 4. CALIBRATION OF THE PEAK AND TROUGH

Looking only at the aggregate GDP series, the Committee considers it defensible to point to this business cycle's peak in either 1973 or 1974.

However, adjusting for the increase in population in 1974 resulting from the influx of population from the previous colonies and the decline in emigration, it appears clearer that per capita GDP is already declining in 1974, indicating that the peak occurred in 1973. Furthermore, when looking at the major exporting industries, as well as the behavior of investment, the contraction is evident and profound during the year 1974, with close shocks including the global recession and political instability during the transition to democracy. Finally, the contraction in emigrant remittances and the impact of the oil price increase on the country's terms of trade led to a sharper contraction in disposable income than in output. The Committee does not have sufficiently accurate quarterly data available for dating. However, all signs point to the peak occurring in one of the first three quarters of 1973, followed by a contraction in the last quarter caused by the oil shock.

In dating the trough, different indicators give different signals. Measures of per capita GDP and production indicators point to a trough in 1976, but labor market measures only recover from 1978 onwards. The Committee decided that 1978 was the turning point for a robust economic recovery. This recovery significantly slowed down in 1980, with a recession in Europe associated with the oil shock of 1979. However, expansionary policy (using the leeway provided by the 1977-78 adjustment program) and the recovery dynamics from the 1970s crisis allowed the Portuguese economy to continue growing before finally reaching a peak in 1983.

A difficult question is whether this five-year recession should be separated into two or even three distinct recessions. Considering the three distinct factors in the genesis of this economic contraction, as well as its phases, it would be understandable to do so. However, the Committee decided it was more appropriate to date only one recession. The three phases partially overlap, so the economy never experienced a trough followed by a period of expansion of at least one year that would allow for the identification of the end of the previous recession. In the absence of reliable quarterly data, it becomes even more difficult to detect expansions between the three periods.

## 5. CONCLUSION

The peak of economic activity in Portugal in 1973 coincided with the peak in most Western economies. The oil shock, which quadrupled the oil price, deeply affected economies like Portugal, which relied on oil as its main source of energy. Furthermore, the use of the Lajes air base by the US for providing military supplies to Israel during the Yom Kippur War led to a total embargo by OPEC countries on oil exports to our country.

However, while European economies recovered in 1974 or 1975, Portugal entered a profound process of social and political change. The April Revolution brought freedom to the Portuguese people and laid the foundations for a stable and solid long-term democracy. However, in the short term, the inherent instability of the revolutionary process kept economic activity depressed. In the specific case of Portugal, nationalizations, land collectivization, the rapid increase in nominal wages, and the abrupt population growth significantly reduced per capita output.

Finally, between 1975 and 1977, external account imbalances resulting from the two previous shocks worsened and led to a more conventional balance of payments crisis. The recourse to a first IMF loan in April 1977 and a second loan in June 1978 partially resolved this problem, allowing the Portuguese economy to begin the recovery process with the trough in 1978.

In the 1980s, Portugal became an increasingly integrated economy in the European Union and, therefore, experienced more synchronized cycles with other regions of the Union. The recession of 1973-78 was long and deep, but following that period, the Portuguese economy asserted itself as a more integrated economy with a structure similar to that of its European neighbors, after many decades of isolation.

## REFERENCES CITED IN THE TEXT

(For a more comprehensive list of sources, refer to the methodological note)

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