GOVERNO DE PORTUGAL | MINISTÉRIO DAS FINANÇAS

Adjusting in the euro area: the case of Portugal

Vítor Gaspar

Trinity College Dublin

April 11th, 2013

Crisis and its aftermath: a chronology

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1999 // 2008	2009	2010	2011	2012	2013	2014	2015

POSTPONING THE ADJUSTMENT

Building up imbalances

Accumulation of macroeconomic imbalances and structural bottlenecks

- Unsustainable Public Finances
- Over-indebtedness
- Anemic Economic Growth
- Low Productivity

An error of judgment

Crisis as simple demand-driven contraction

- Expansionary Fiscal Policy
- Alignment of Sovereign and Banking Risks
- Further Postponement
- Leading to Near-bankruptcy

ECONOMIC ADJUSTMENT PROGRAM

Achievements

Strong compliance with the Program

- 7/12 reviews
- Over 80% of financing received(1)

Progress in all dimensions of the Program

- Fiscal Consolidation
- Deleveraging and Financial Stability
- Structural Transformation

Challenges

- **Constitutional Court ruling** on 2013 Budget Law
- **Return of the sovereign to the financial markets**
- Focus on **investment and credit recovery** to relaunch **employment and economic growth**
- Maintain **political and social support**
- Complete **public expenditure review**

AFTER CRISIS

Macroeconomic stability and sustainable growth

- Balanced budget and reduction of public debt
- Financial Stability
- Open and Competitive Economy

(1) Up to the 7th disbursement, following the 6th Review

Outline

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1. Slump and Bust.
2. The Economic Adjustment Program.
3. Macroeconomic developments.
4. Fiscal Consolidation.
5. Deleveraging and Financial Stability.
6. Structural Transformation.
7. Conclusion.

1. Slump and Bust

Portugal's imbalances exposed in the context of the economic and financial crisis

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I 1995-2008

Build-up of imbalances in the Portuguese economy:

"The Portuguese economy is in serious trouble: Productivity growth is anemic. Growth is very low. The budget deficit is large. The current account deficit is very large."

Blanchard, 2007

Sudden-Stop materialized in early 2011

II 2008-2010

An Error of Judgment in the conduct of policy:

1. Alignment of systemic risk in the Portuguese economy
2. Postponement of adjustment through expansionary fiscal policy
3. Heightened vulnerability in the context of the EA sovereign debt crisis

Blanchard, O. (2007). "Adjustment with the Euro: the Difficult Case of Portugal", *Portuguese Economic Journal*.

I 1995-2008: Build-up of imbalances in the Portuguese economy

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Portugal did not adjust to the specific requirements of the Monetary Union

Unsustainable public finances

- **Budget deficits over 3%** of GDP since the mid-1990s
- **Upward trend of General Government gross debt,** surpassing 60% of GDP in 2004

Over-indebtedness

- **Increase of Private debt since the mid-1990s**, reaching 240% of GDP in 2008
- Current account deficits of ~10% for a decade

Anemic economic growth and low productivity

- **Deteriorating competitiveness**
  - Increase in unit labor costs
  - Increase in the real effective exchange rate

*For too long, **Portugal preserved fiscal rules and procedures** developed during decades of monetary instability and limited capital mobility.*

*Such fiscal rules and procedures were **completely inadequate in the context of the euro area**.*

Anemic economic growth

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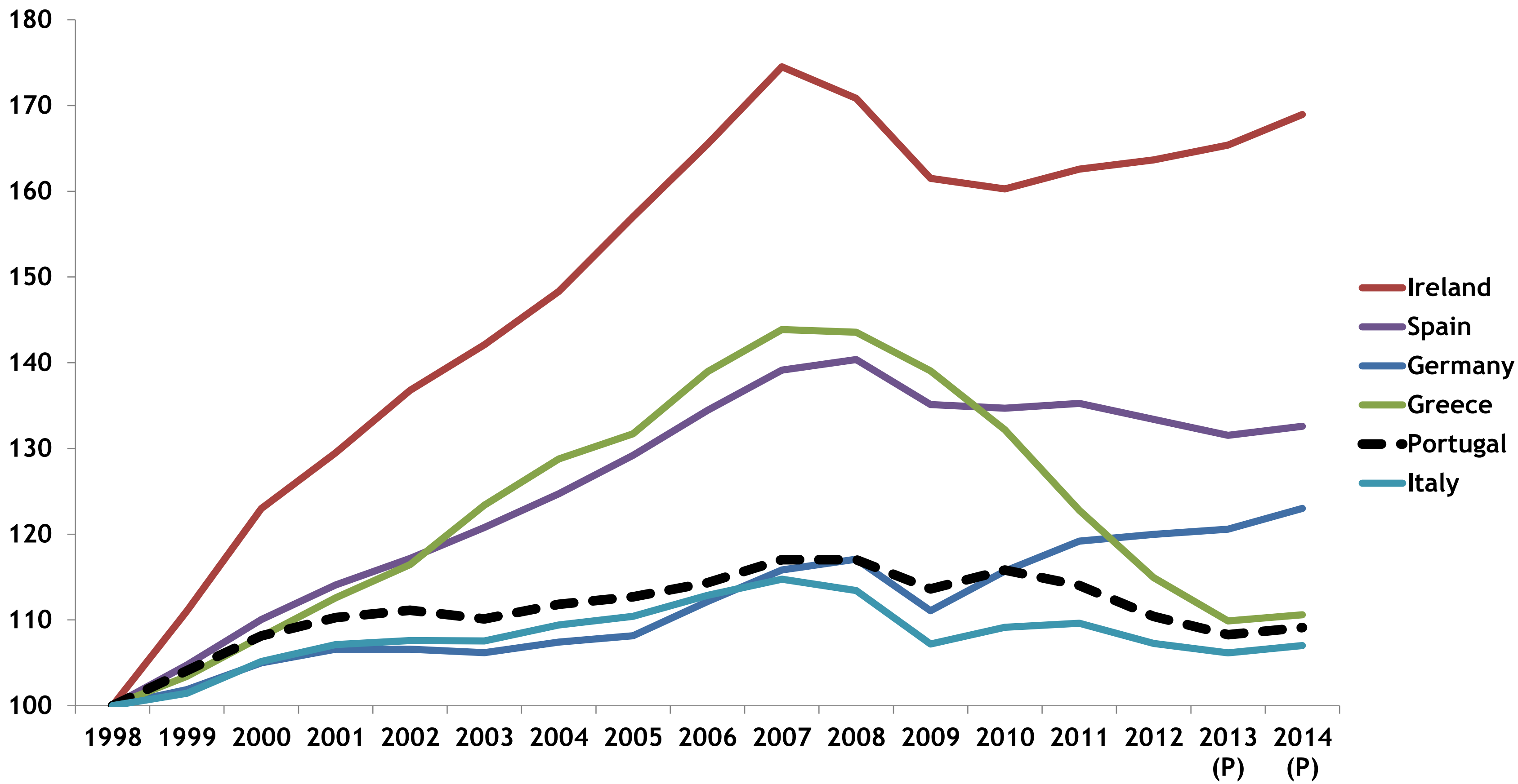
Gross Domestic Product
1998 = 100



Source: AMECO, April 2013

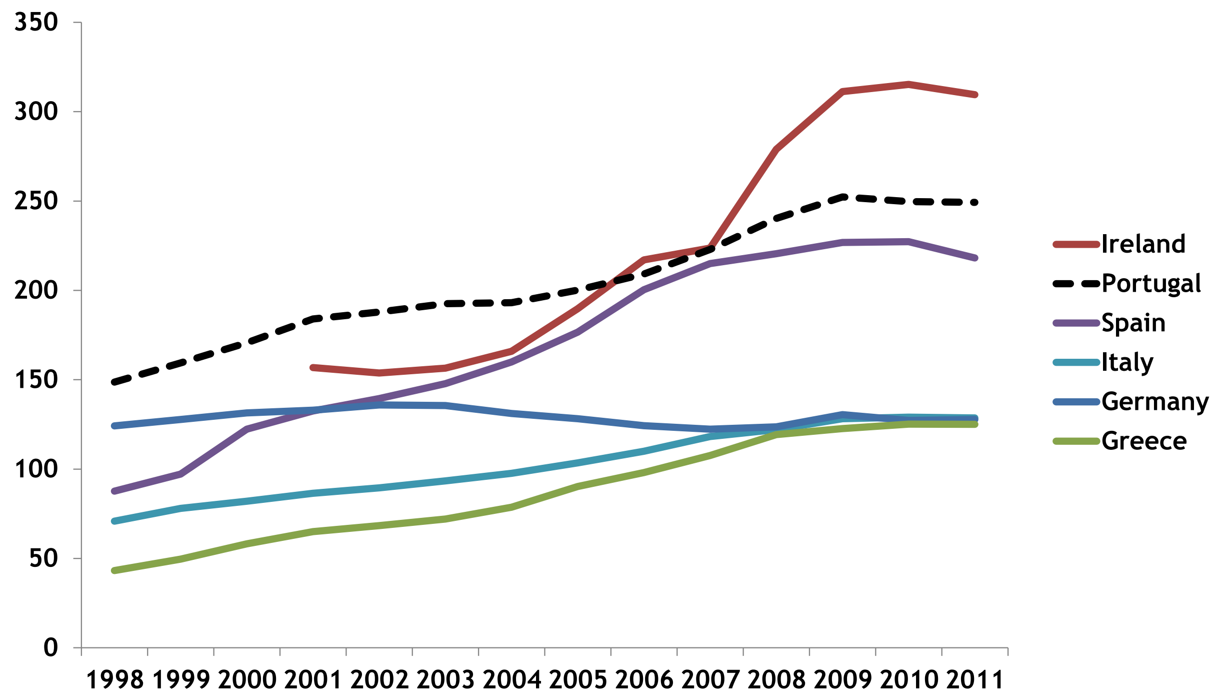
Excessive private debt accumulation

Portuguese households and non financial corporations did not have direct access to foreign financing.

The banking system acted as an intermediary.

This is the origin of the heightened systemic risk in Portugal, associated to an increase in the loan-to-deposit ratio.

Private debt, non consolidated, annual data
Percentage of GDP



Source: Eurostat, April 2013

II 2008-2010: An Error of Judgment in the conduct of policy

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Expansionary fiscal policy

Alignment of systemic risk in the Portuguese economy

- Sovereign provides **guarantees to the banking sector**
- Increase in **bank credit to the public sector**

Postponement of adjustment through expansionary fiscal policy

- **Effectiveness in the short run, but significant long run costs** in terms of lost activity and unemployment
- **Denial** about to the need to adjust

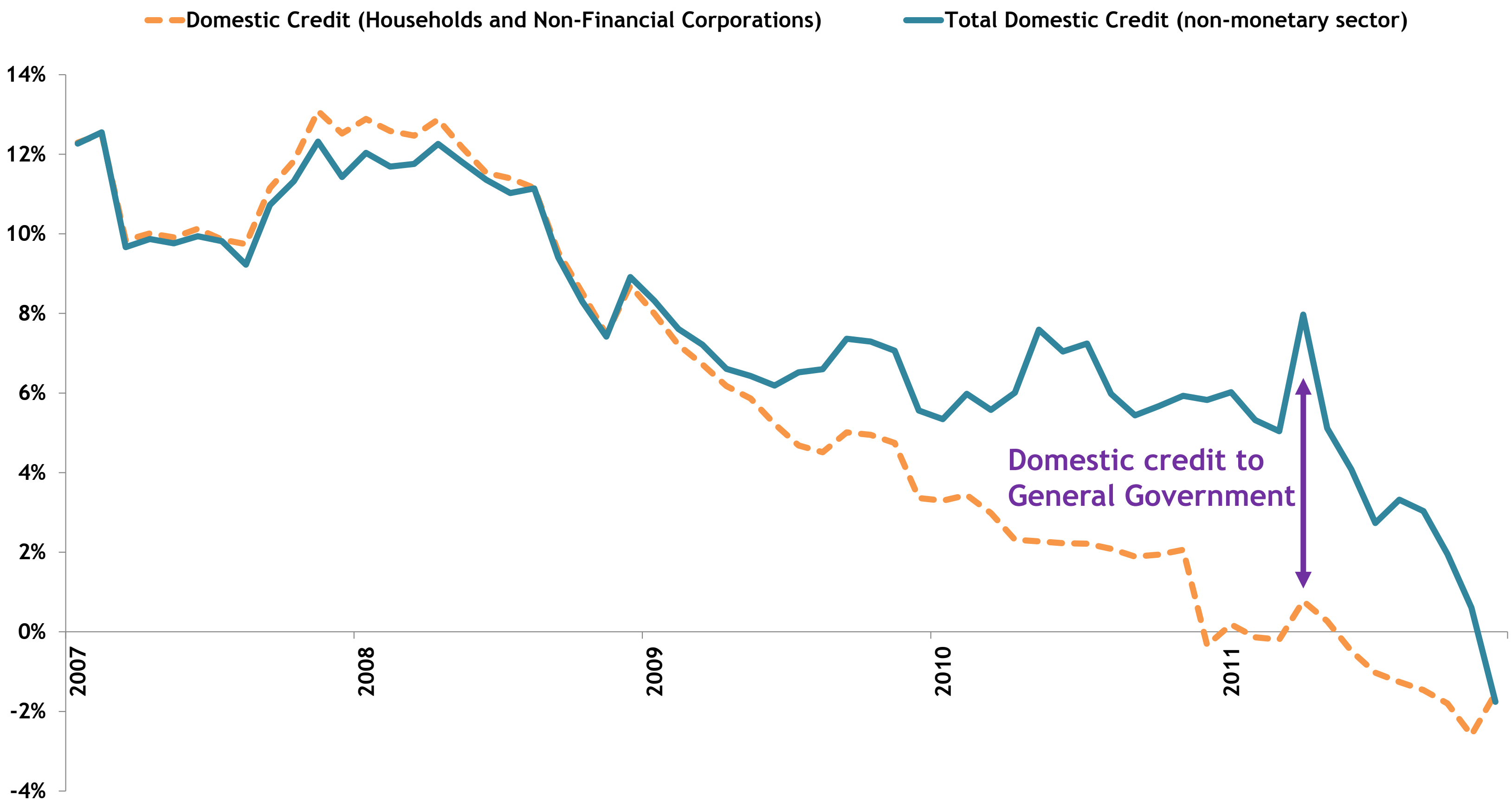
Heightened vulnerability in the context of the EA sovereign debt crisis

- Presentation of **2010 State Budget** as a defining moment
- **Increase of sovereign risk throughout 2010**, despite ECB support

*Considering the events of 2008-2010 as a simple demand-driven business-cycle fluctuation was an **error of judgment that proved to be expensive in the context of the euro area sovereign debt crisis.***

Increase in bank credit to General Government

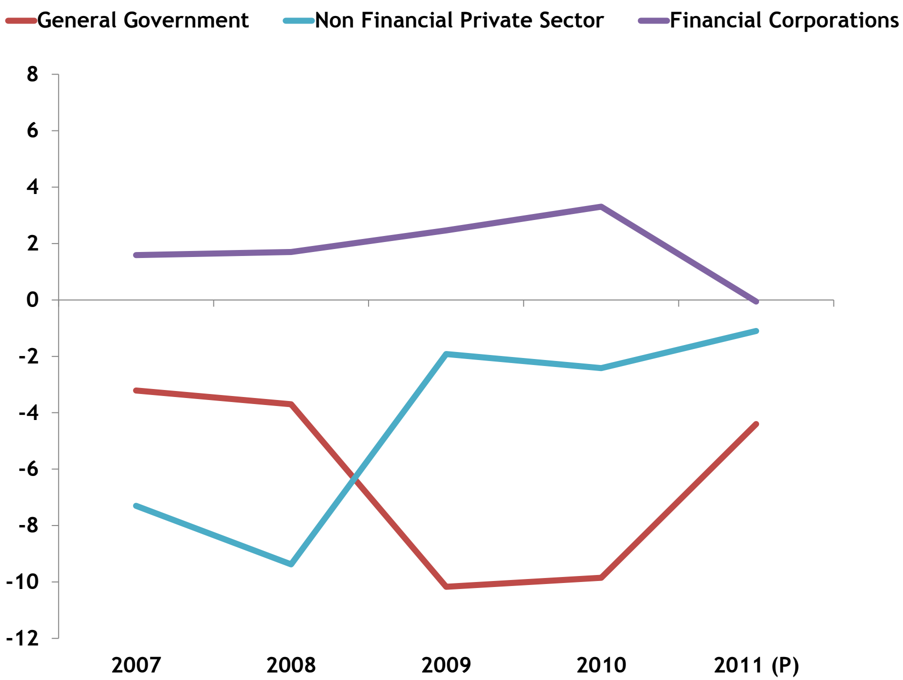
Domestic Credit
Year-on-year change, %

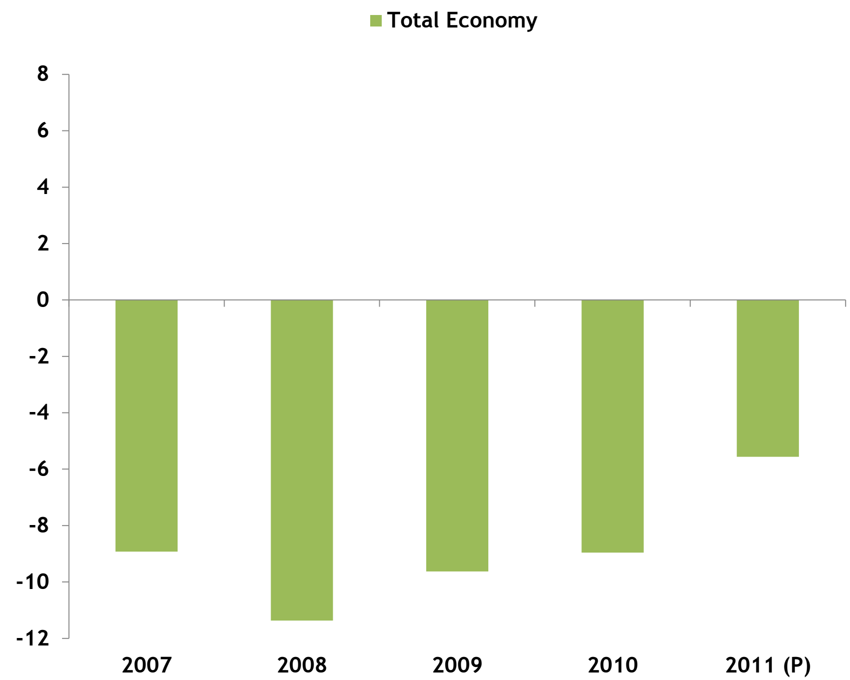


Source: Bank of Portugal

Public sector expansion offset private adjustment

Net lending /net borrowing by institutional sector
As percentage of GDP





Source: National Statistics Institute, April 2013

Successive upward revisions of 2009-2010 Budget deficits

			General Government Budget Balance (% GDP)		General Government Gross Debt (% GDP)	
			2009	2010	2009	2010
	GOP 2005-2009	Jul-05	-1,6		64,5	
	PEC 2005-2009	Dec-05	-1,5		66,2	
	PEC 2006-2010	Dec-06	-1,5	-0,4	65,2	62,2
	ROPO 2007	Apr-07	-1,5	-0,4	62,6	59,7
	EC autumn	Oct-07	-2,4		64,5	
	PEC 2007-2011	Dec-07	-1,5	-0,4	62,5	59,7
	EC spring	Apr-08	-2,6		64,3	
	ROPO 2008	May-08	-1,5	-0,7	62,5	60,5
	OE 2009	Oct-08	-2,2		64,4	
	EC autumn	Oct-08	-2,8	-3,3	65,2	66,6
	PEC 2008-2011	Jan-09	-3,9	-2,9	69,7	70,5
	EC spring	Apr-09	-6,5	-6,7	75,4	81,5
	ROPO 2009	May-09	-5,9		74,6	
General election (27-Sep-09)						
	EC autumn	Oct-09	-8,0	-8,0	77,4	84,6
	OE 2010	Jan-10	-9,3	-8,3	76,6	85,4
"PEC I"	**PEC 2010-2013**	Mar-10	-9,3	-8,3	77,2	86,0
	ROPO 2010	Jul-10	-9,3	-7,3	76,3	83,5
"PEC III"	**OE 2011**	Oct-10	-9,3	-7,3	76,1	82,1
"PEC IV"	**PEC 2011-2014**	Mar-11		-7,3		82,4
	IMF Staff Report	Jun-11	-10,1	-9,1	83,0	93,0
	INE/BdP Final Data	Mar-13	-10,2	-9,8	83,7	94,0

Note: The document known as "PEC II" corresponds to Law no. 12-A/2012 of 30 June.

II

The impact of the 2010 State Budget in financial markets

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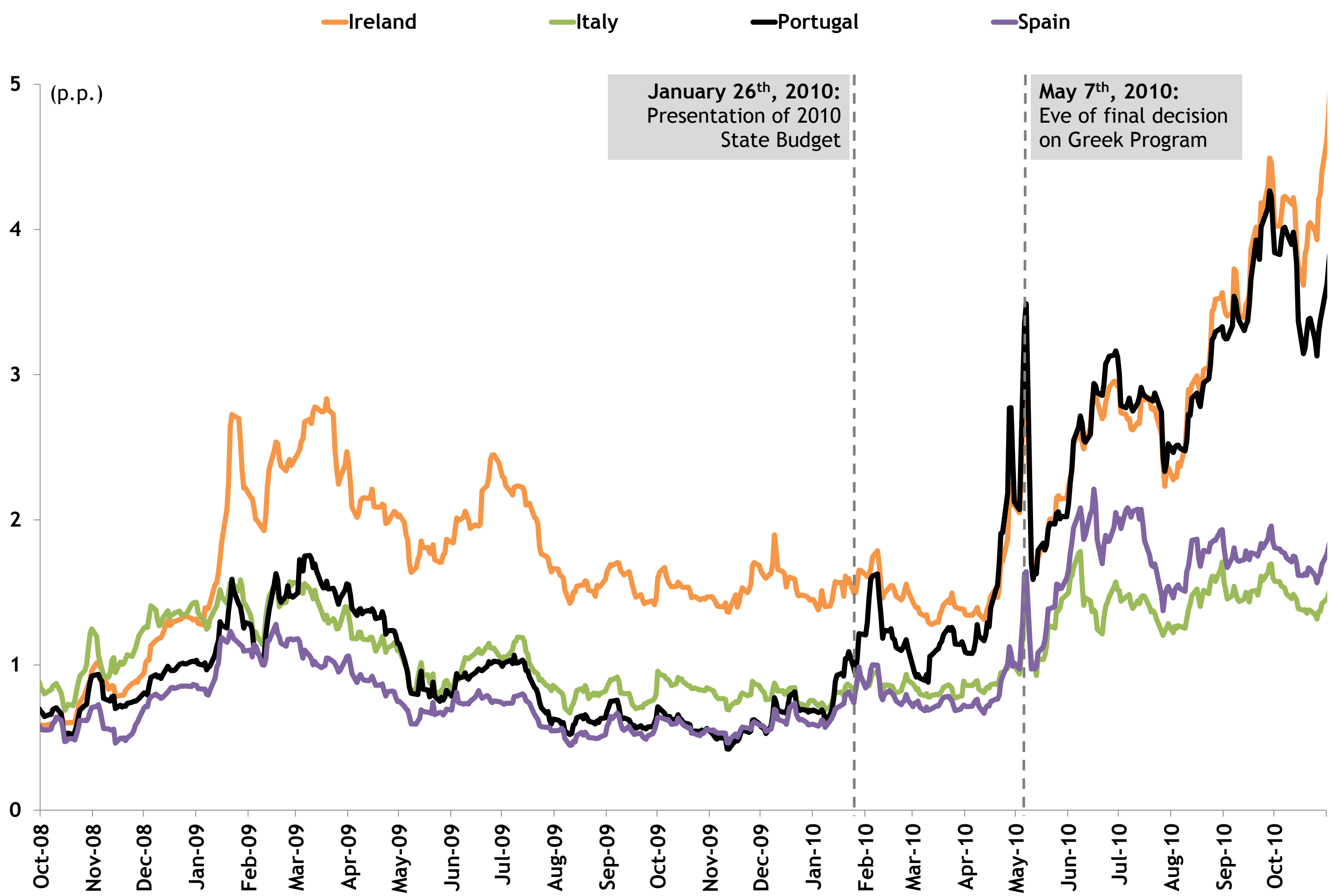
10-year Government Bond yields, October 2008 - October 2010
Spread against Germany in percentage points



Source: Bloomberg, February 2013 (generic yield indices, BID values)

The Error of Judgment led to a Sudden Stop in international private financing

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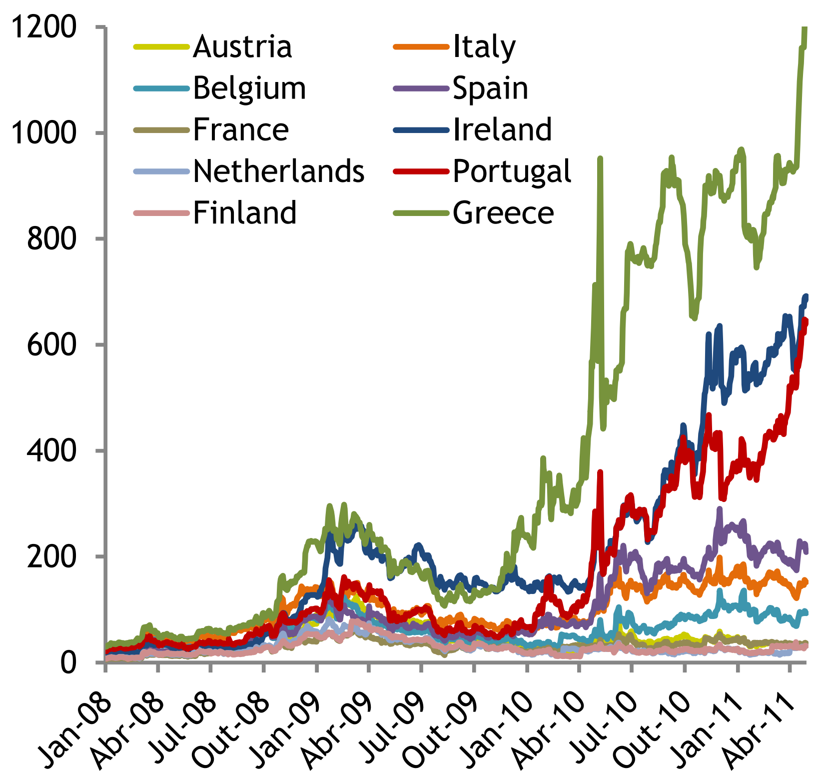
The **effects of expansionary fiscal policy** on public finance sustainability were revealed in the context of the **sovereign debt crisis in the euro area**, exposing Portugal's **structural imbalances.**

10-year Government bond yields
Spread against Germany in basis points



In April 2011, Portugal's request for financial assistance became inevitable to avoid bankruptcy.

Source: Bloomberg

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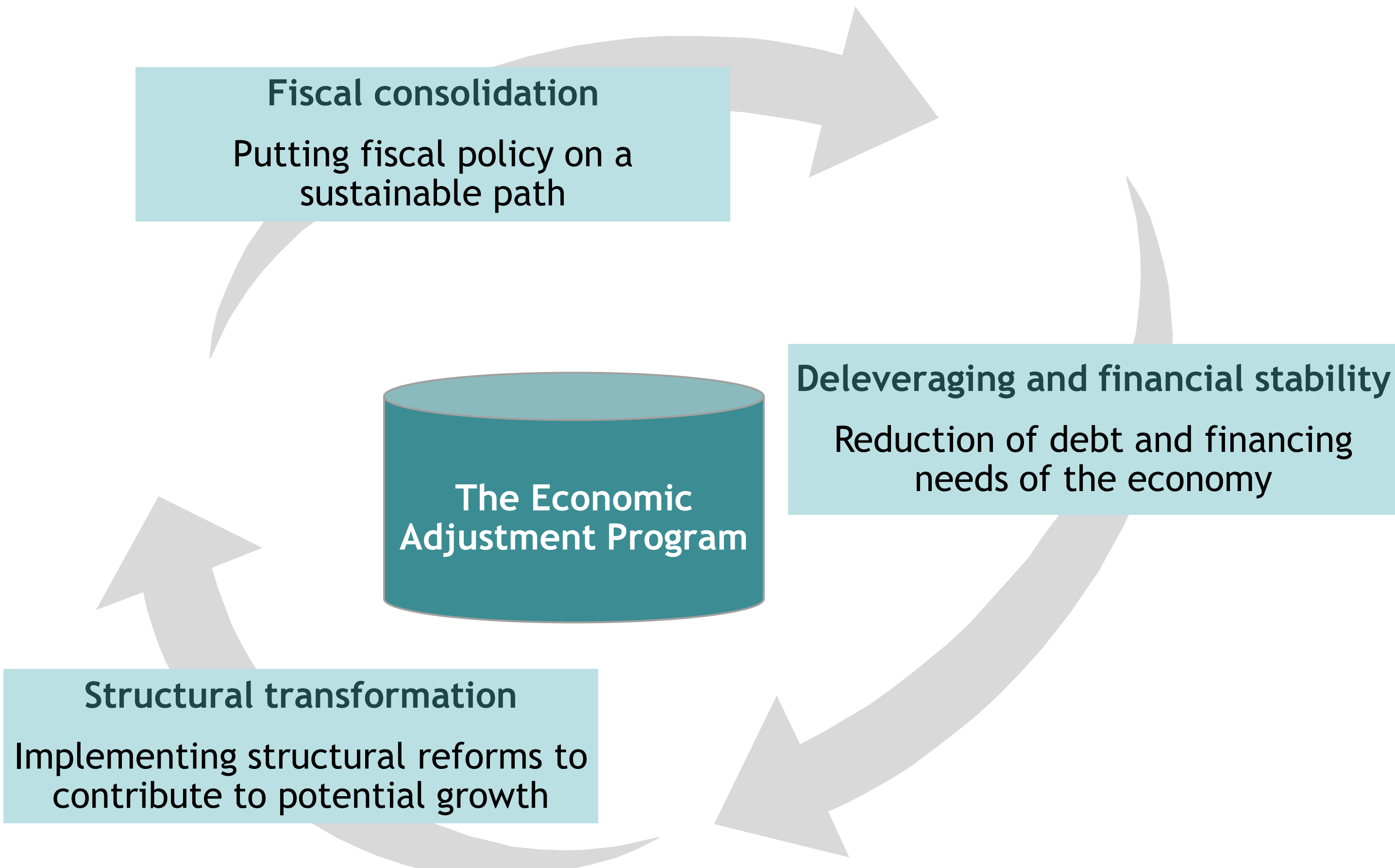
2. The Economic Adjustment Program

A balanced Program to cope with the major challenges of the Portuguese economy



The Economic Adjustment Program protects Government financing from market pressures, allowing an orderly adjustment of imbalances and time to build up confidence and credibility.

3. Macroeconomic developments

Strong increase in exports

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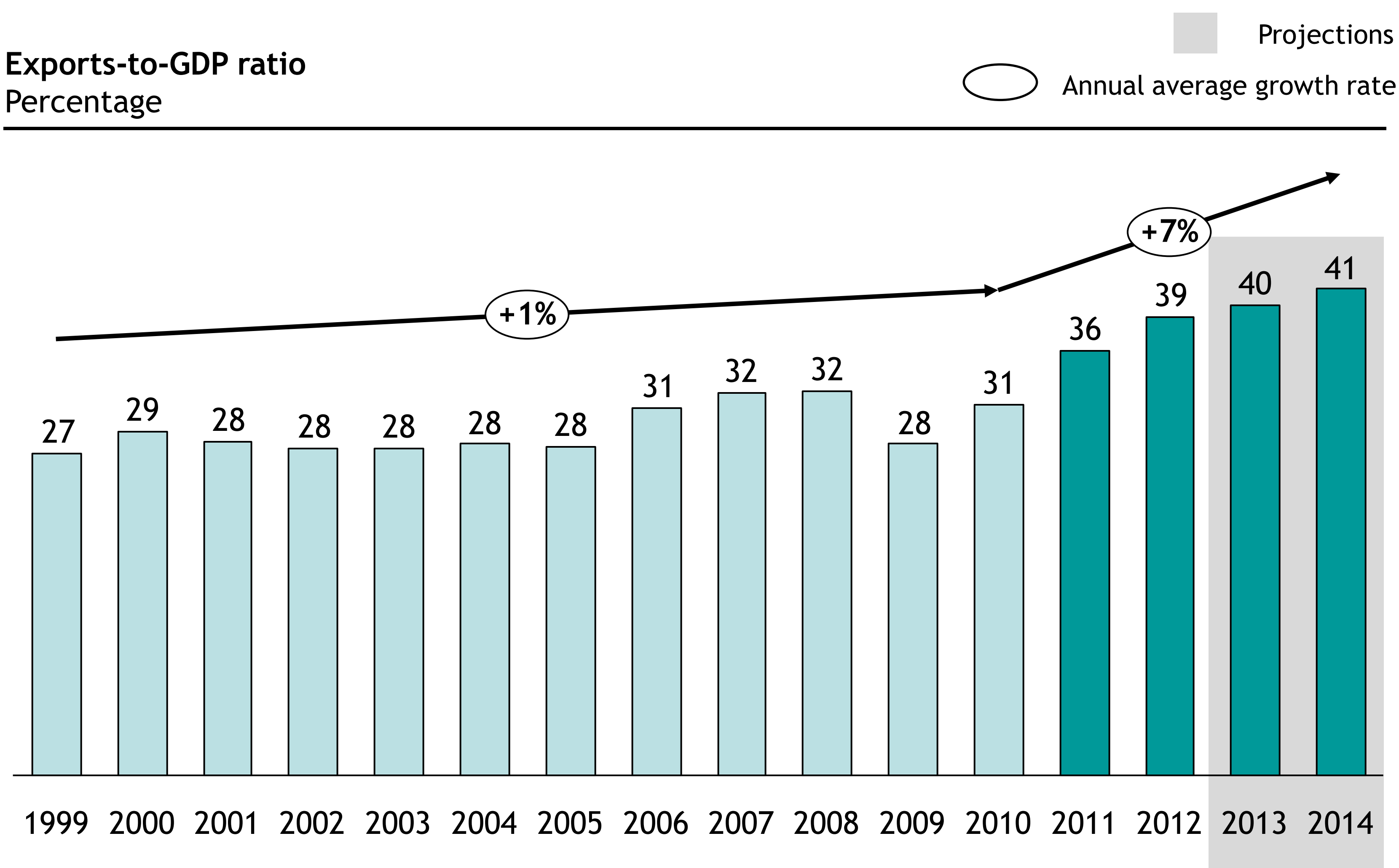
Exports-to-GDP ratio
Percentage



Source: AMECO, March 2013

Reversal in internal demand contraction

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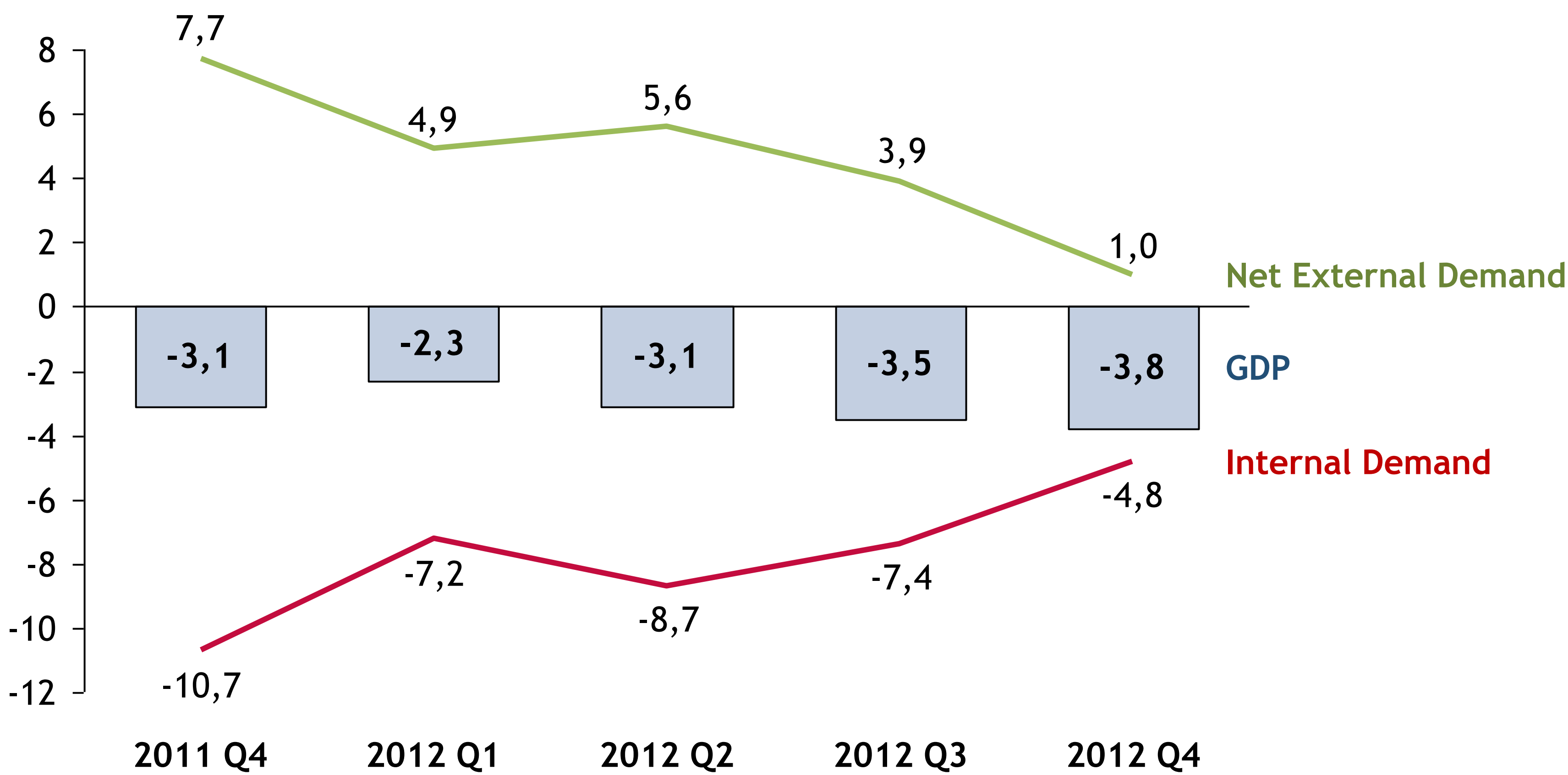
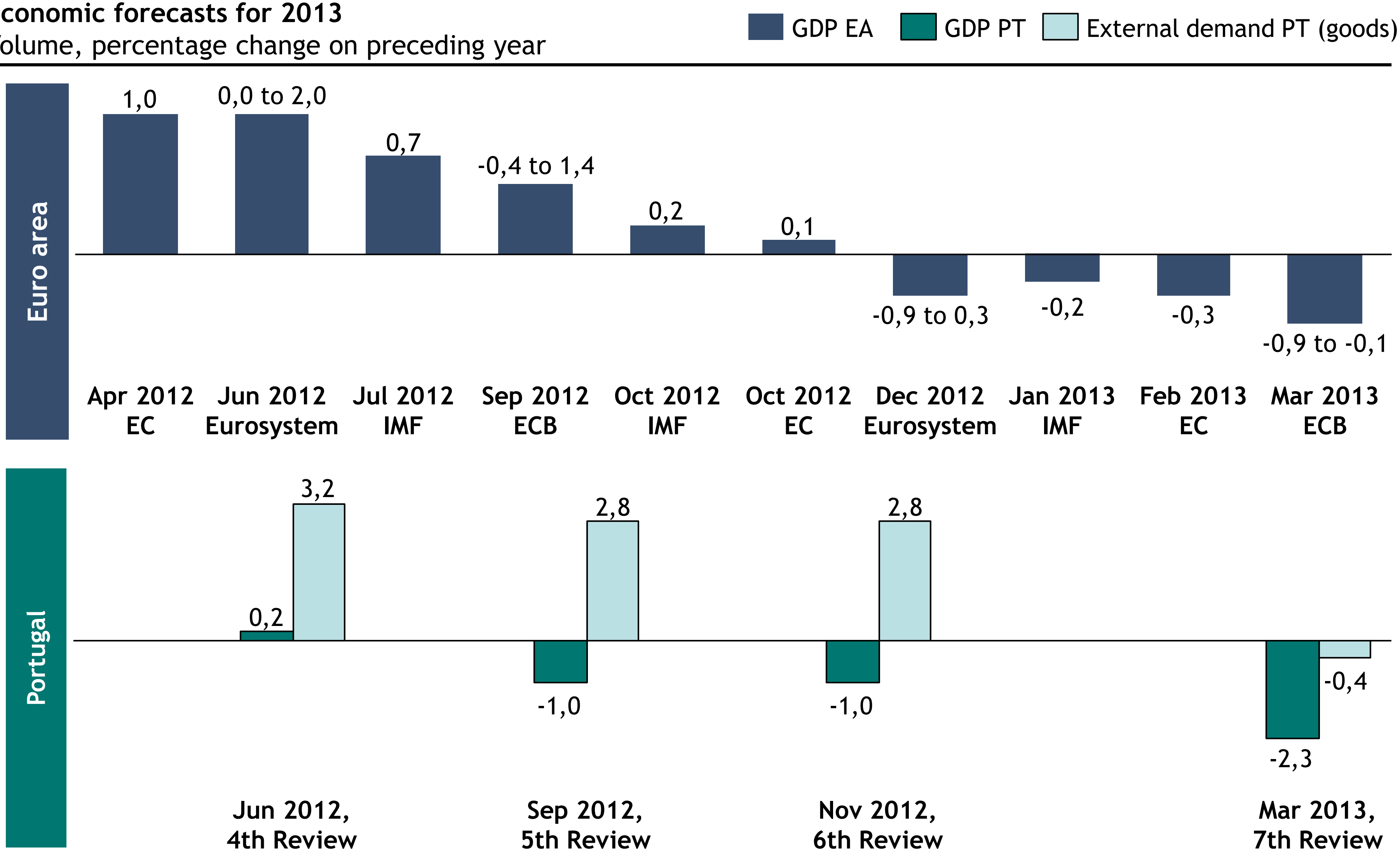
Contributions to GDP growth (year-on-year)
Percentage points



Source: National Statistics Institute, March 2013

Weaker growth prospects for the Euro Area…

Economic forecasts for 2013
Volume, percentage change on preceding year



Source: European Central Bank, International Monetary Fund, European Commission and Ministry of Finance

…led to a downward revision of economic prospects

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Economic forecasts in a context of risks and uncertainty regarding the adjustment process

	7th review: March 2013			5th review: September 2012		
	2012	**2013**	**2014**	**2012**	**2013**	**2014**
GDP and expenditure components (volume, percentage change on preceding year)						
Private Consumption	-5,6	-3,5	0,1	-5,9	-2,2	0,2
Public Consumption	-4,4	-2,6	-2,0	-3,5	-3,5	-1,5
GFCF	-14,5	-7,6	2,5	-14,1	-4,2	2,7
Exports	3,3	0,8	4,4	4,3	3,6	5,5
Imports	-6,9	-3,9	3,1	-6,6	-1,4	3,3
GDP	**-3,2**	**-2,3**	**0,6**	**-3,0**	**-1,0**	**1,2**
Contributions to GDP growth (percentage points)						
Domestic Demand	-7,0	-4,1	0,0	-7,1	-2,9	0,3
Net Exports	3,9	1,8	0,6	4,1	1,9	0,9
Deflators						
GDP	-0,1	1,7	1,3	0,3	1,3	0,9
HICP	2,8	0,7	1,0	2,8	0,9	1,1
Labor Market						
Unemployment Rate (%)	15,7	18,2	18,5	15,5	16,4	15,9
Employment Growth (%)	-4,2	-3,9	-0,5	-4,3	-1,7	0,4

Source: Ministry of Finance, National Statistics Institute, March 2013

Rebalancing internal demand and supply

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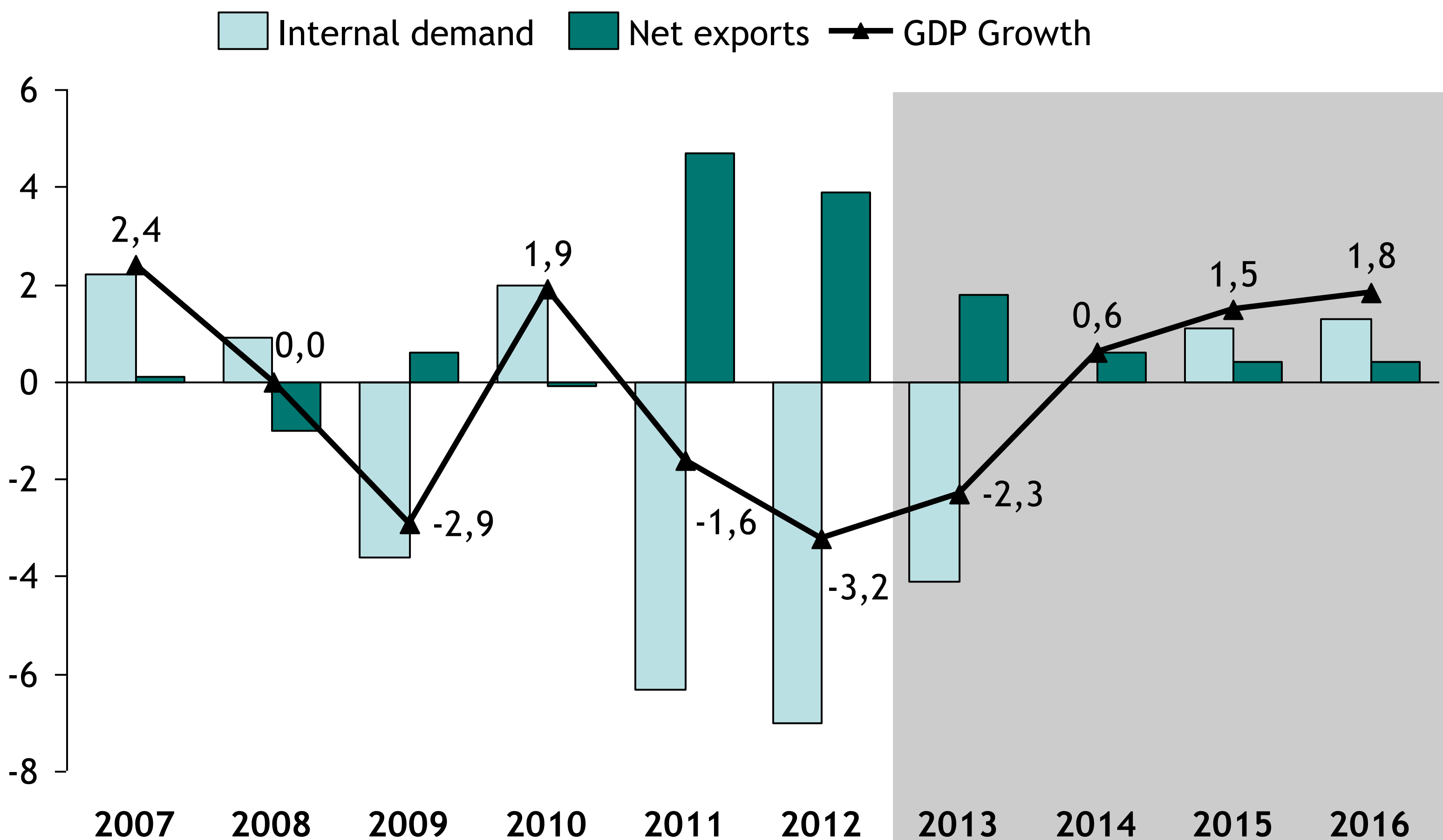
Contributions to GDP growth
Percentage points



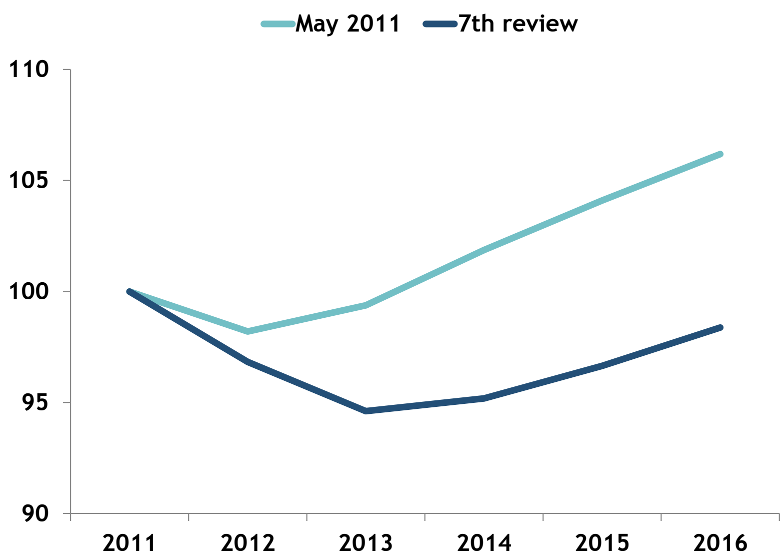
Projections for 2013-2016:

- Do not consider impacts from structural reforms
- Assume moderate export market share gains

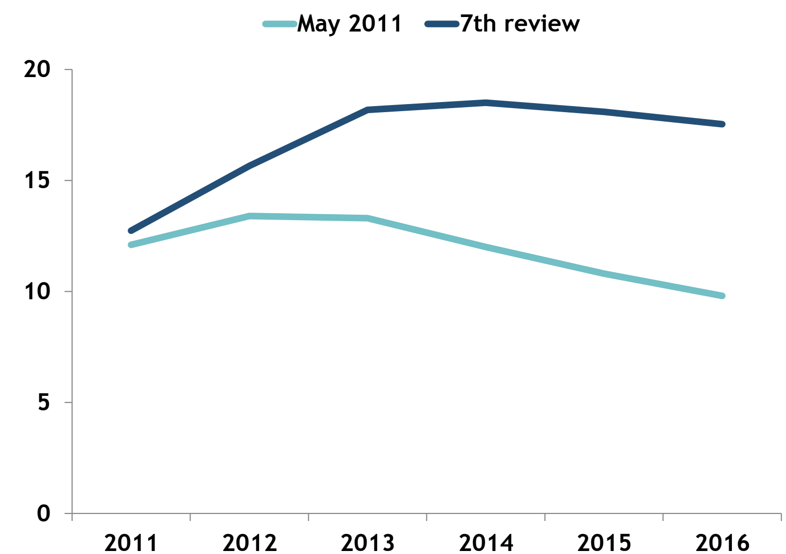
Source: National Statistics Institute (2007-2012) and Ministry of Finance (2013-2016), April 2013

Adjustment has come at a high social cost…

Real GDP growth projections
2011 = 100



Unemployment rate projections
Percentage



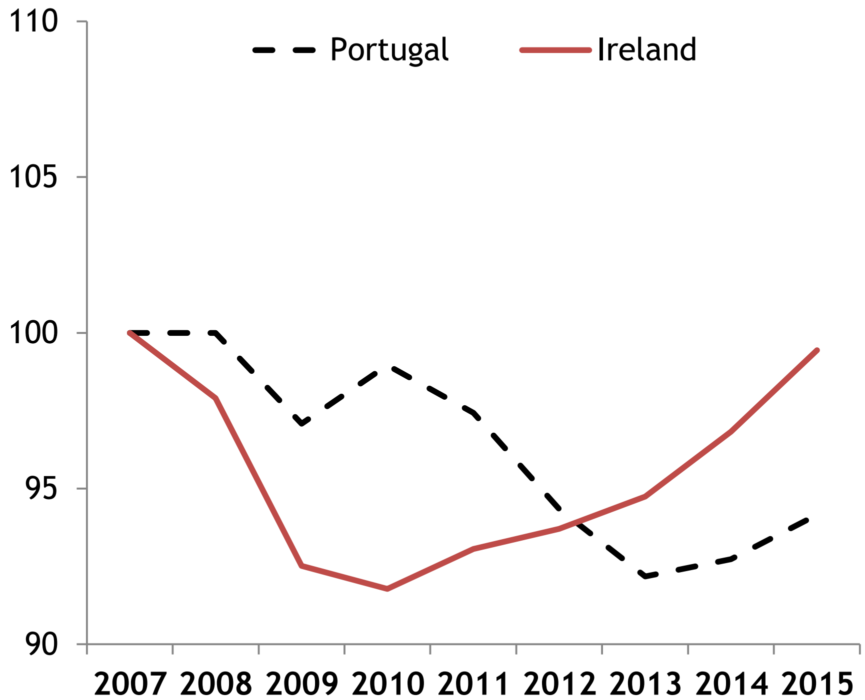
Rise in the unemployment rate above original forecasts reflects:

- Lower employment given firms' need to reduce costs (financing difficulties and uncertainty)
- Transfer of resources from the non-tradable sector to the tradable sector given the ongoing rebalancing of the Portuguese economy

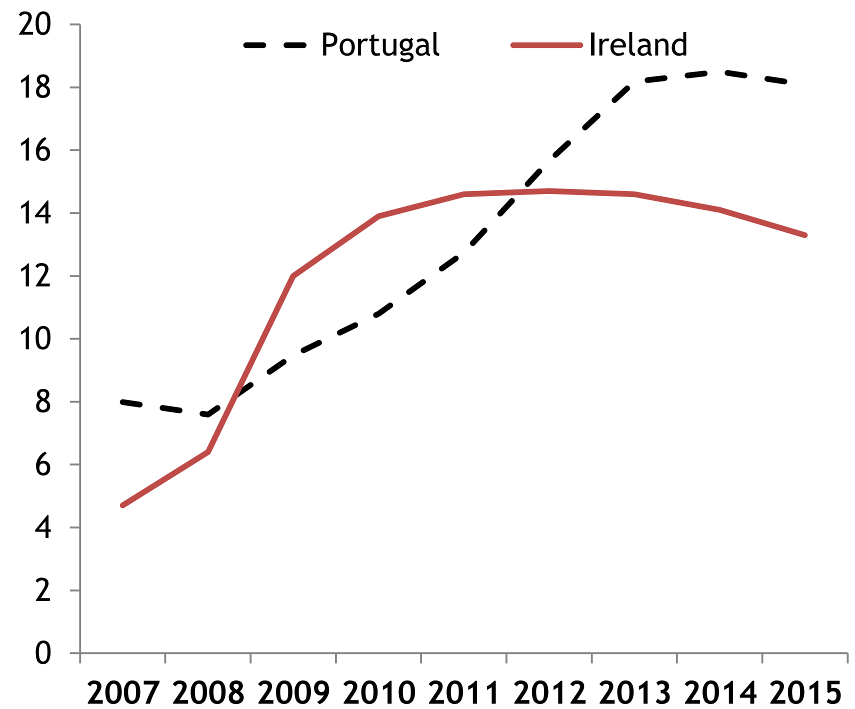
Source: International Monetary Fund, Ministry of Finance

…in Portugal and Ireland.

Real GDP growth
2007 = 100



Unemployment rate
Percentage



Note: 2013-2015 - projections

Source: Ireland – IMF, 9th Review (April 2013); Portugal - Ministry of Finance, 7th Review (March 2013)

4. Fiscal consolidation

“The end-2012 fiscal deficit target was met (…).”

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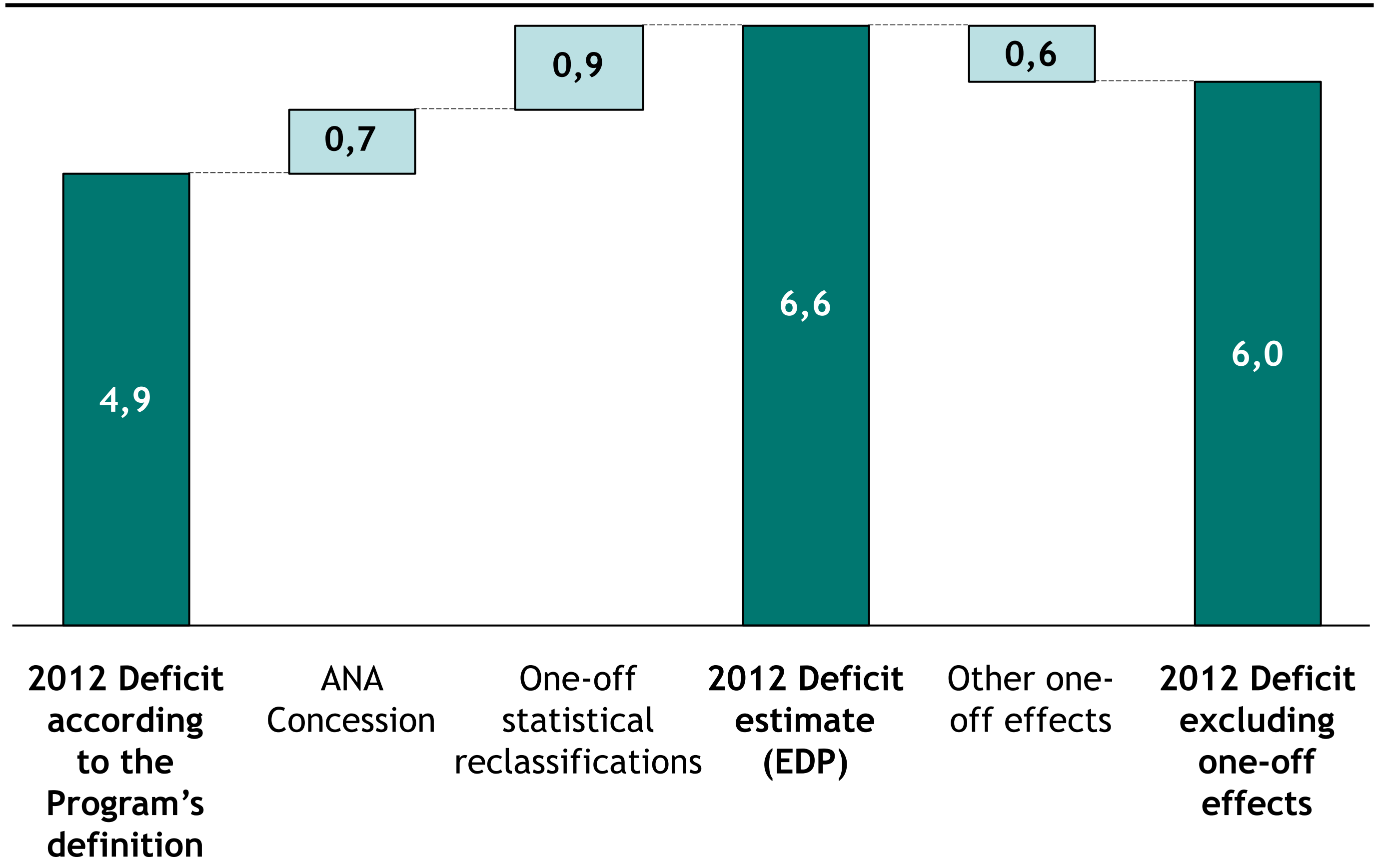
Statement by the EC, ECB and IMF on the Seventh Review Mission to Portugal (**):

“The end-2012 fiscal deficit target was met (…).”

2012 General Government Deficit (*)
As percentage of GDP (national accounts)



(*) After the 7th review, the 2012 general government deficit was revised downwards in the context of the EU’s Excessive Deficit Procedure. The effects on the trajectories of the general government deficit, the structural balances and the general government gross debt will be considered in the next complete forecast presented by the Ministry of Finance.

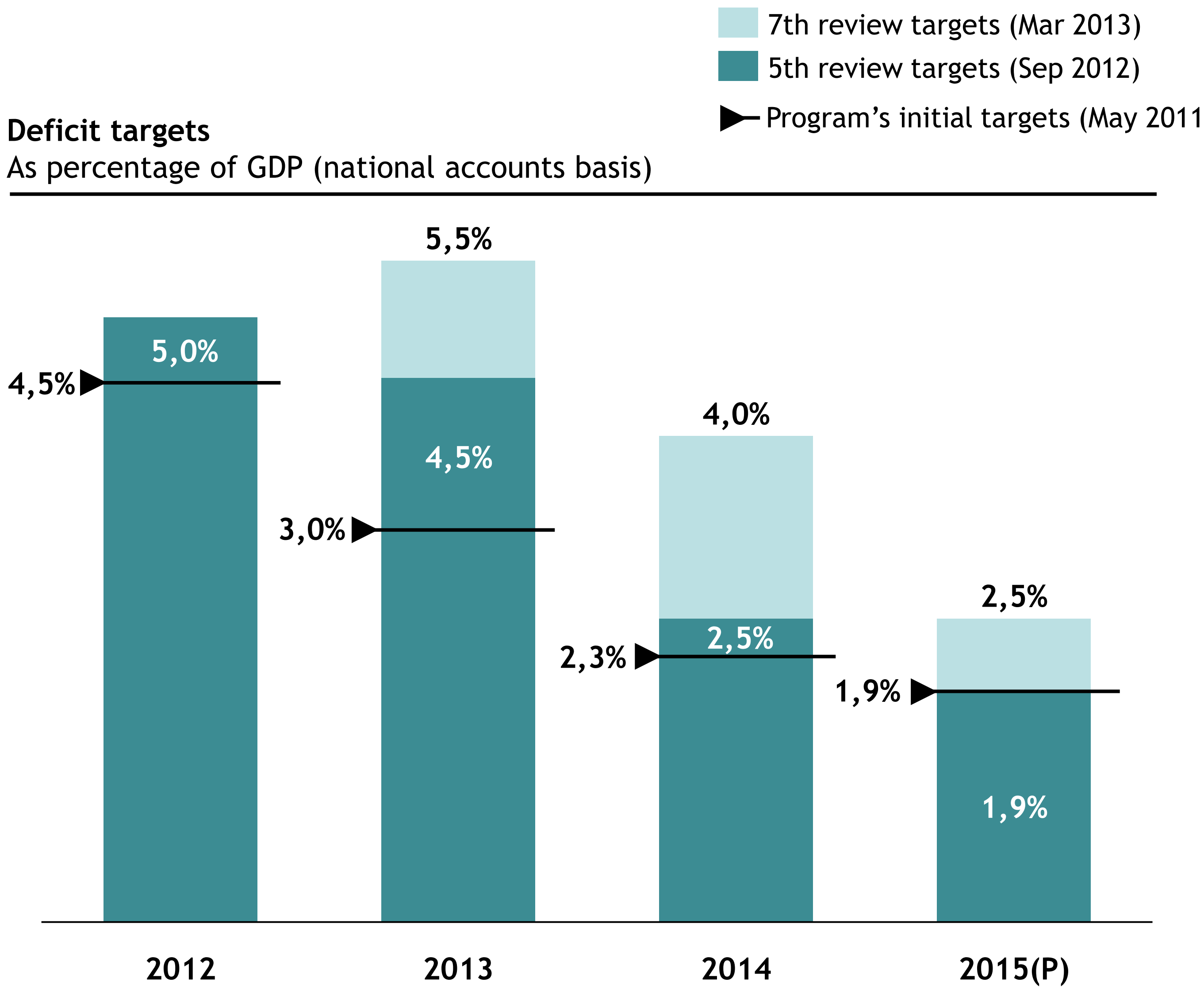
(**) Statement by the EC, ECB and IMF on the 7th Review Mission to Portugal: http://europa.eu/rapid/press-release_MEMO-13-226_en.htm

Source: Ministry of Finance, European Commission, March 2013

Adjustment of the fiscal path

Balancing act between:

- Economic and social costs of the adjustment
- Inevitability of fiscal consolidation: Portugal's financing needs and the repercussions on public debt sustainability



(P) Projection; not a Program target

Source: Ministry of Finance, March 2013

Structural adjustment will continue

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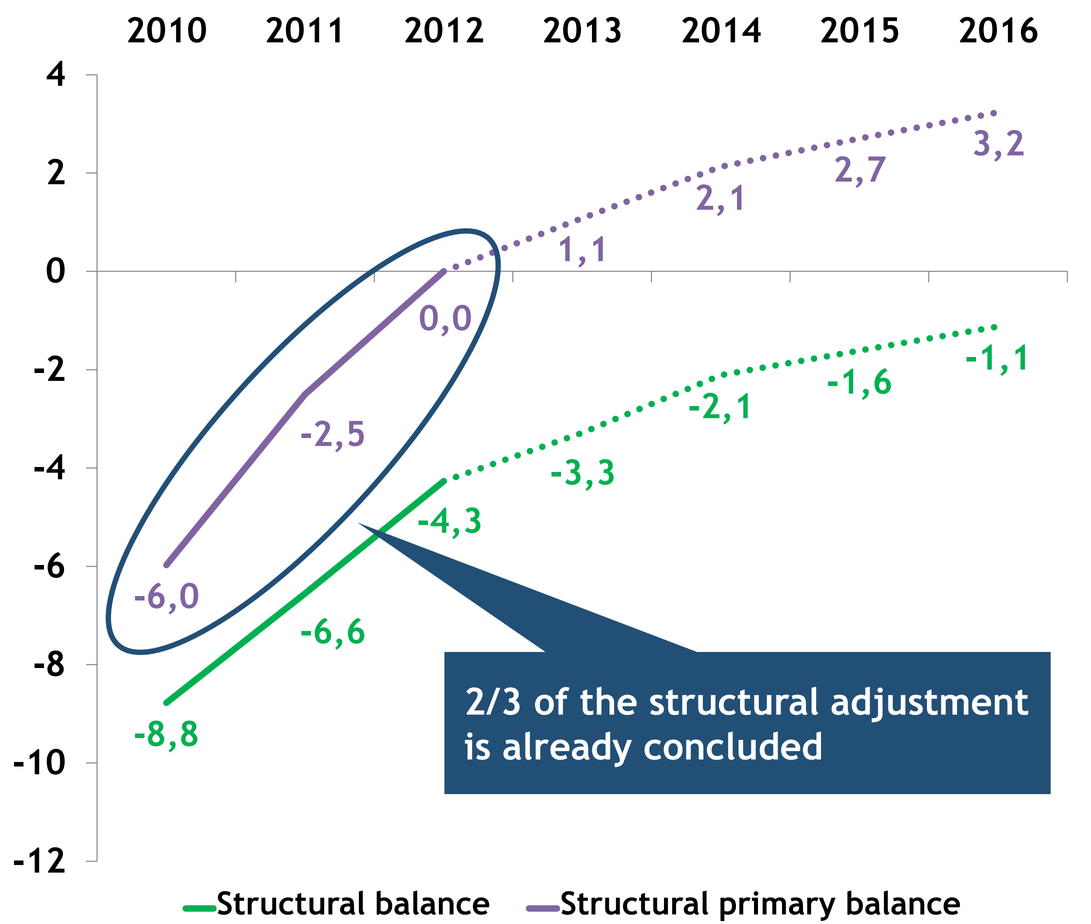
Structural balances (*)
As percentage of GDP



(*) After the 7th review, the 2012 general government deficit was revised downwards in the context of the EU's Excessive Deficit Procedure. The effects on the trajectories of the general government deficit, the structural balances and the general government gross debt will be considered in the next complete forecast presented by the Ministry of Finance.

Source: Ministry of Finance, March 2013

Fiscal adjustments progressing in tandem

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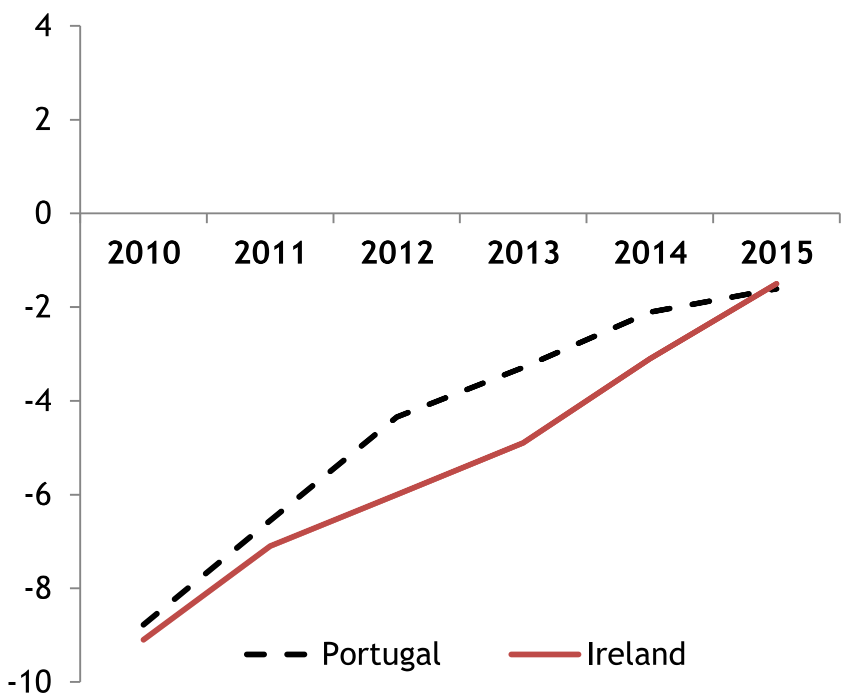
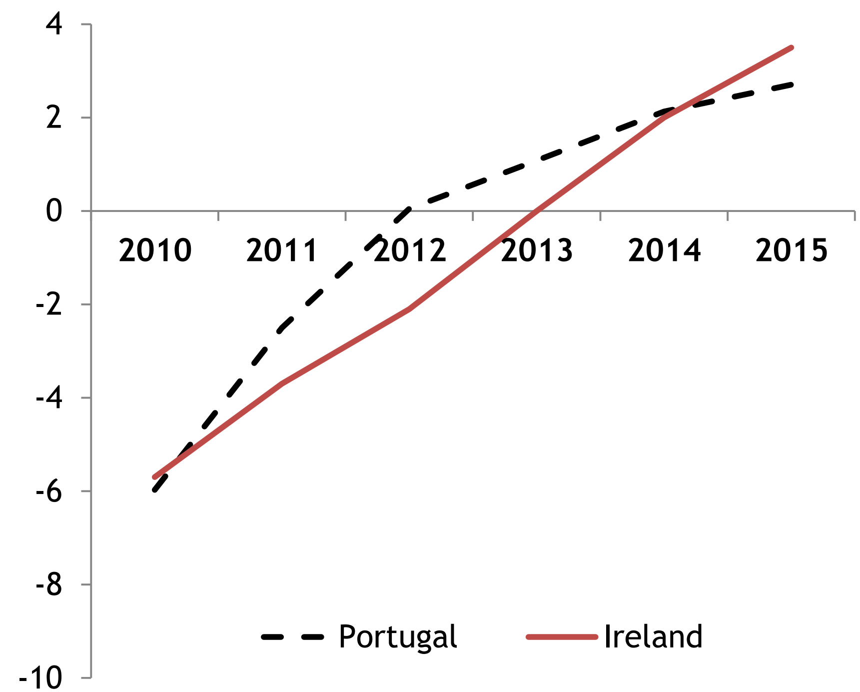
Structural balance
Percentage of GDP



Structural primary balance
Percentage of GDP

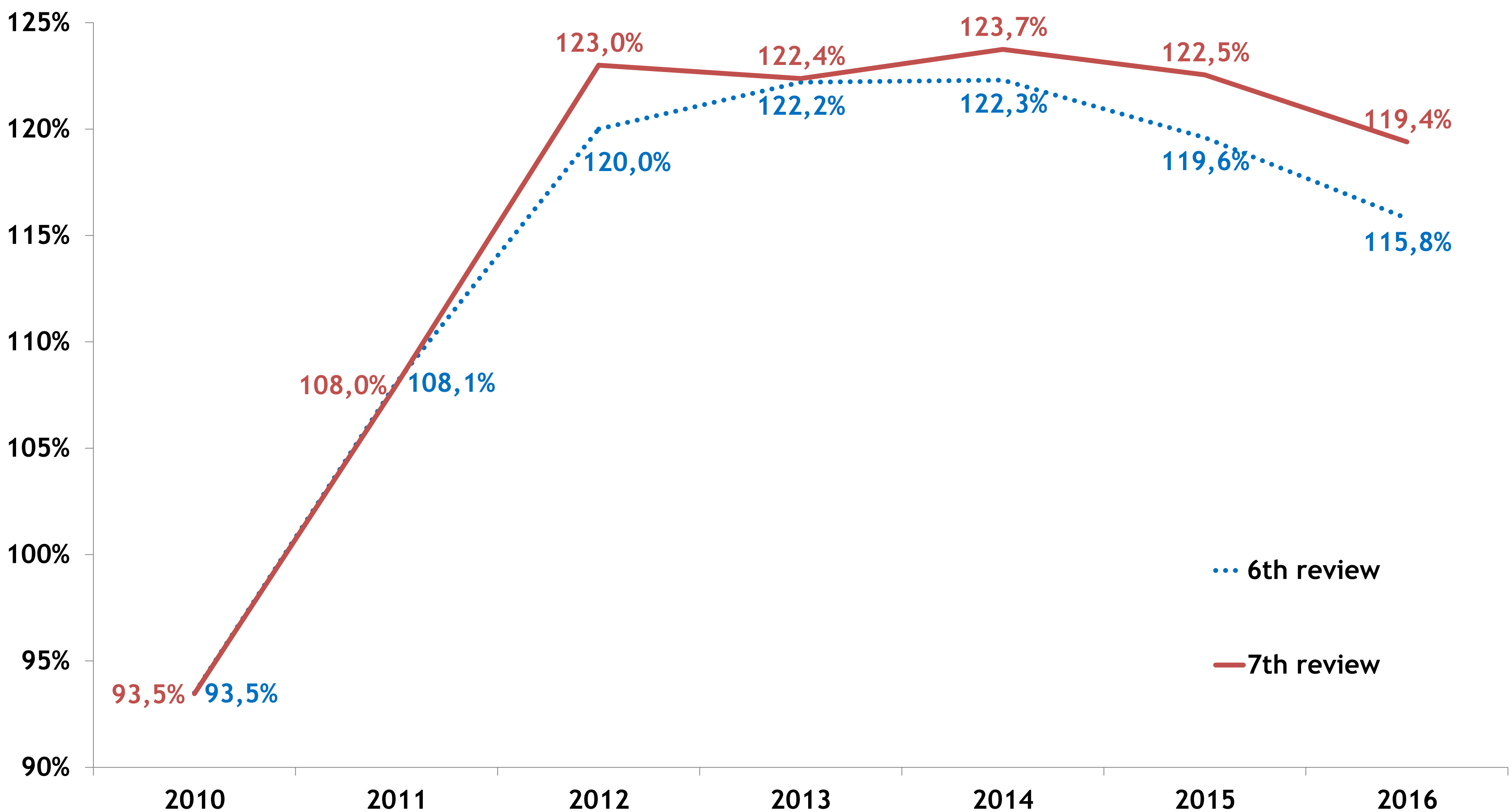


Note: 2013-2015 - projections

Source: Ireland – IMF, 9th Review (April 2013); Portugal - Ministry of Finance, 7th Review (March 2013)

Public debt peaking at 124% in 2014

General Government Gross Debt (*)
As percentage of GDP



(*) After the 7th review, the 2012 general government deficit was revised downwards in the context of the EU's Excessive Deficit Procedure. The effects on the trajectories of the general government deficit, the structural balances and the general government gross debt will be considered in the next complete forecast presented by the Ministry of Finance.

Source: Ministry of Finance, March 2013

Public debt: close to Ireland, lower than Italy

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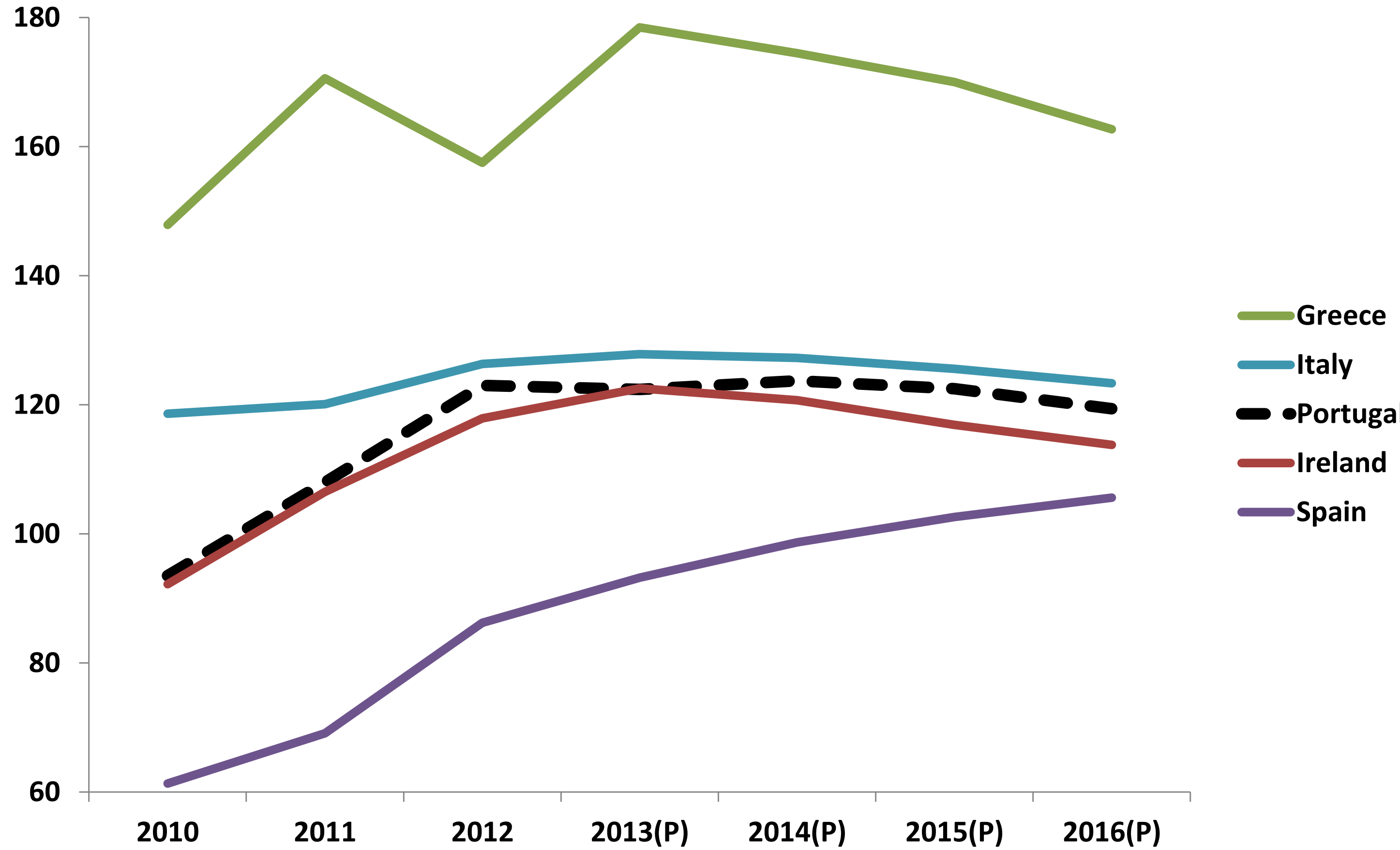
Public Debt
Percentage of GDP



Source: GR - IMF,Jan2013; IT - IMF,Oct2012; PT - Ministry of Finance,7th review,Mar2013; IE - IMF,Apr2013; ES - IMF,Mar2013;

5. Deleveraging and financial stability

Portugal as a net lender for the first time in two decades

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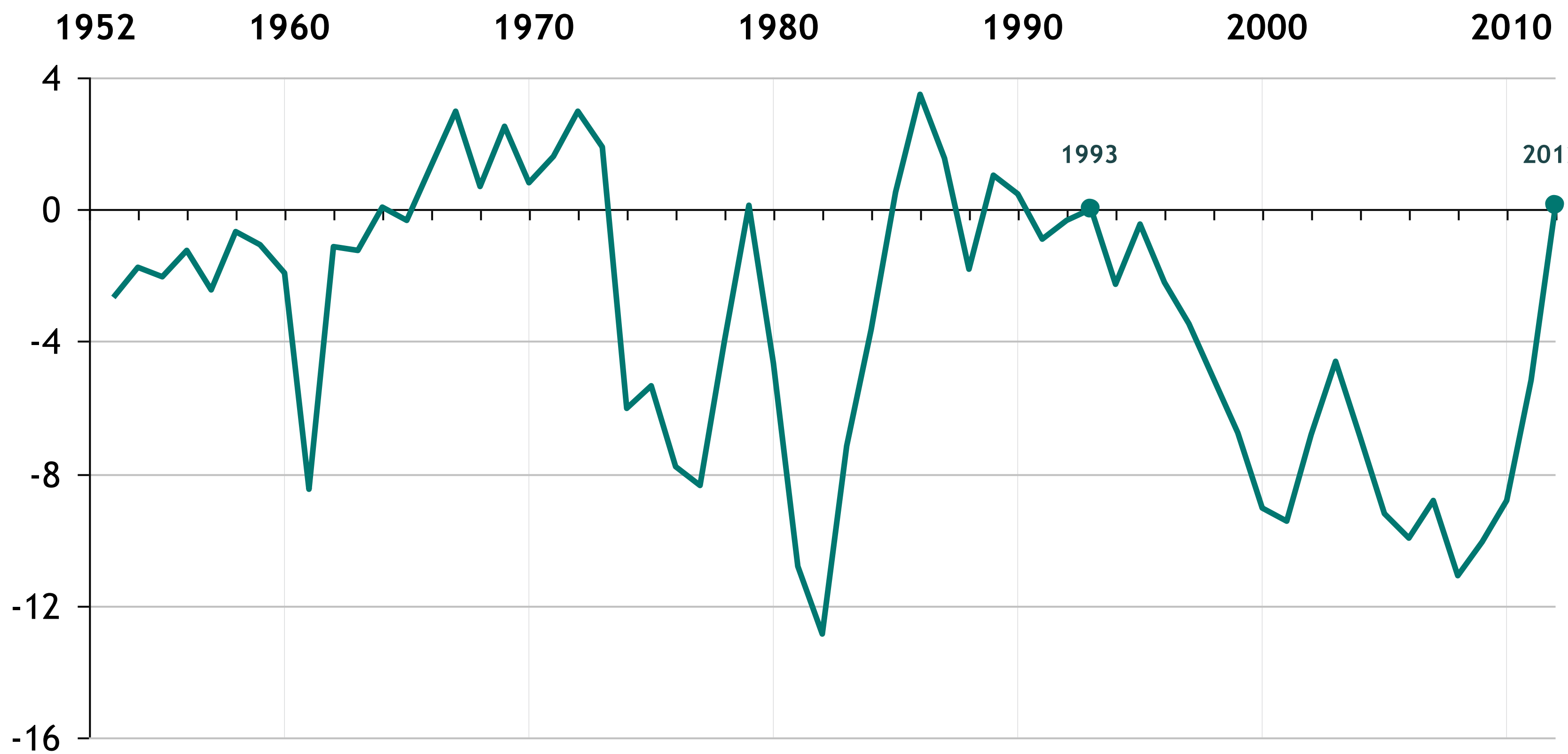
Current and capital account (*)
Percentage of GDP



(*) 1953 is the earliest observation available.

Source: Bank of Portugal, March 2013

Fast correction of external imbalances

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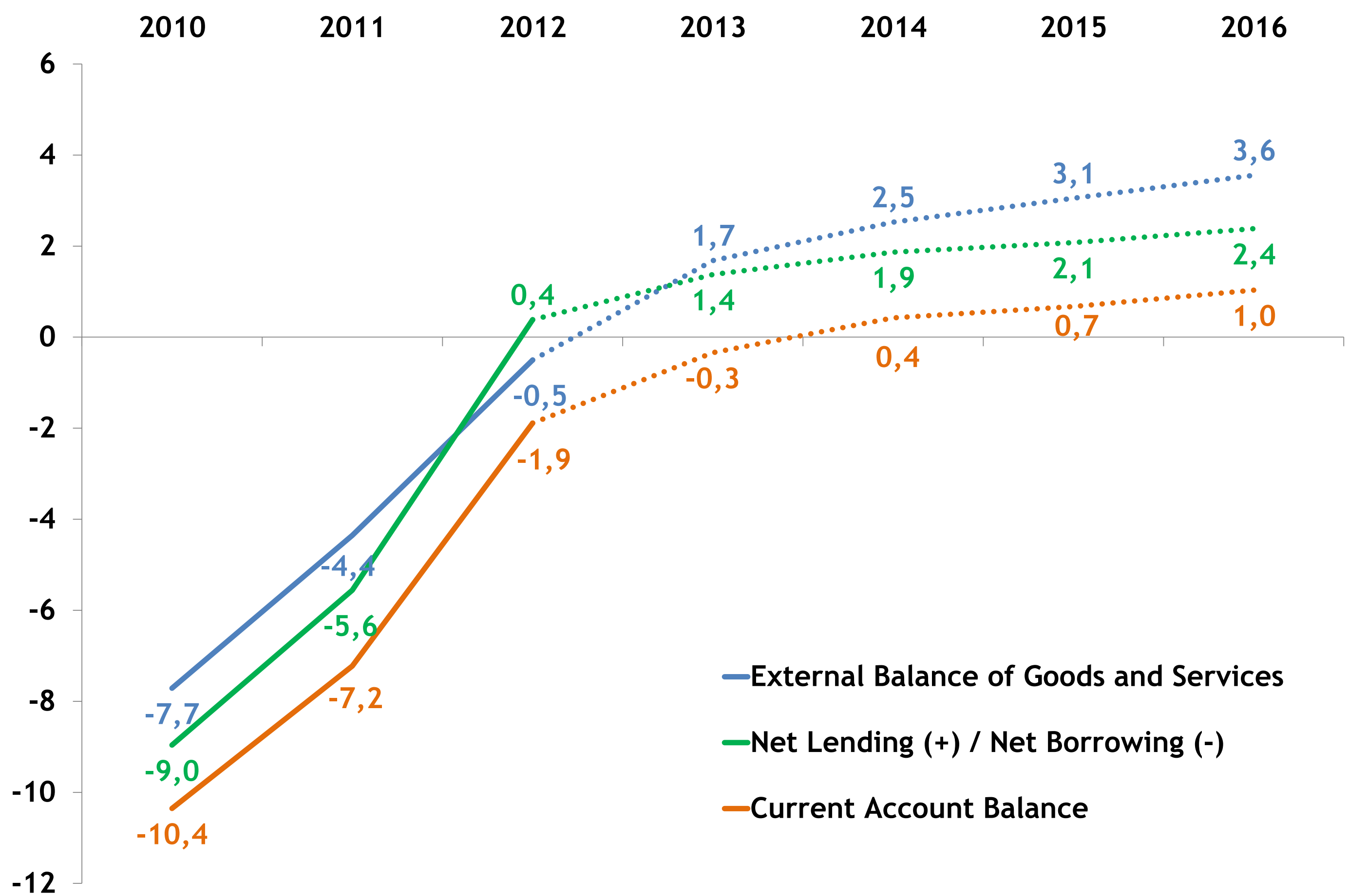
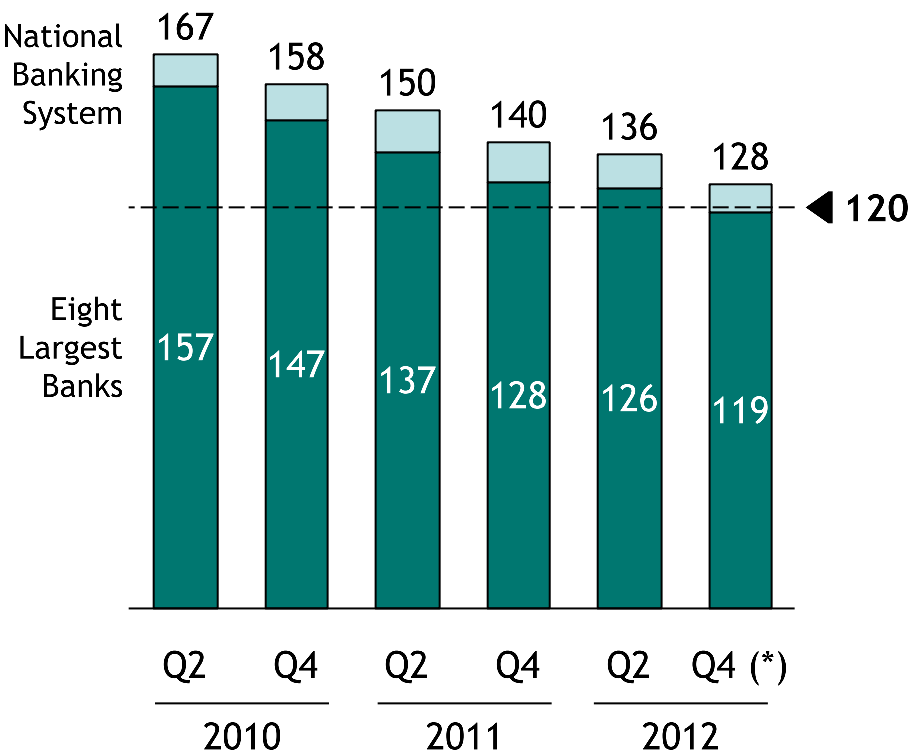
Balance of Payments, key balances
Percentage of GDP



Source: Ministry of Finance, March 2013

Increasingly stable banking system

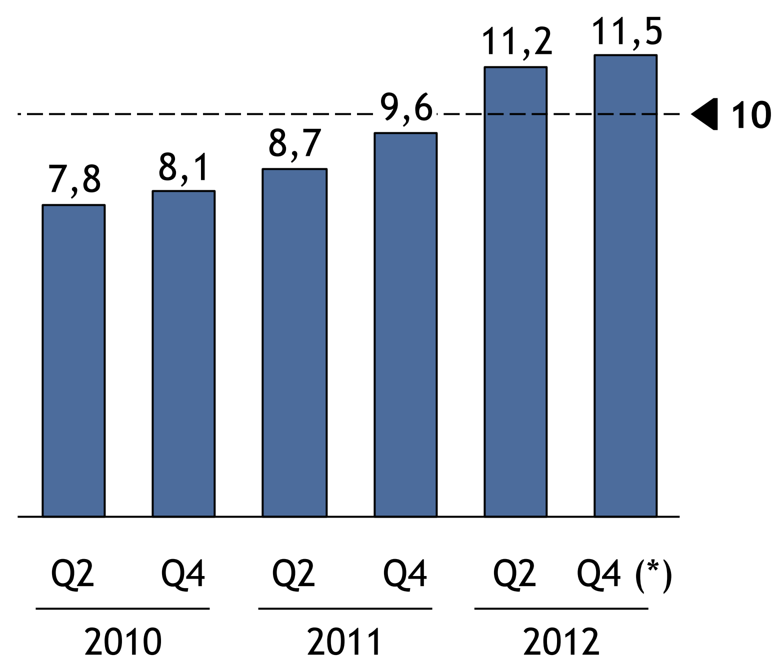
Loans-to-deposits ratio
Percentage



Banking system close to 120%.

This target was excluded from the Memorandum after the 7th Review.

Core Tier 1 Ratio, Portuguese Banking System
Percentage



The 10% Core Tier 1 Ratio was reached ahead of schedule.

(*) Preliminary values for 2012Q4

Source: Bank of Portugal, March 2013

Interest rates on bank loans still high (1/2)

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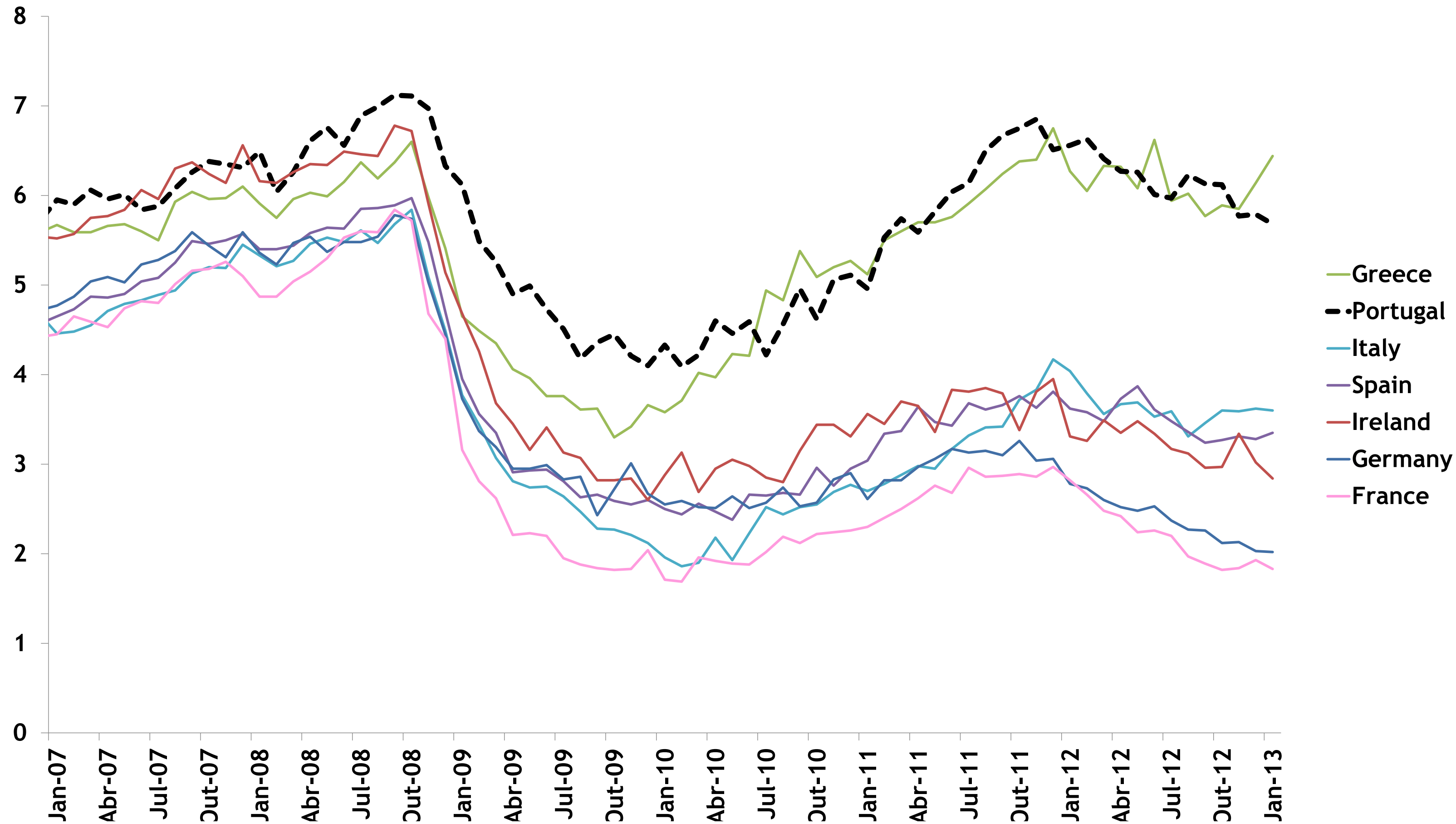
Interest rates on MFI Loans (≤1y) to Non-Financial Corporations | New Businesses only
Percentage



Source: ECB, March 2013

Interest rates on bank loans still high (2/2)

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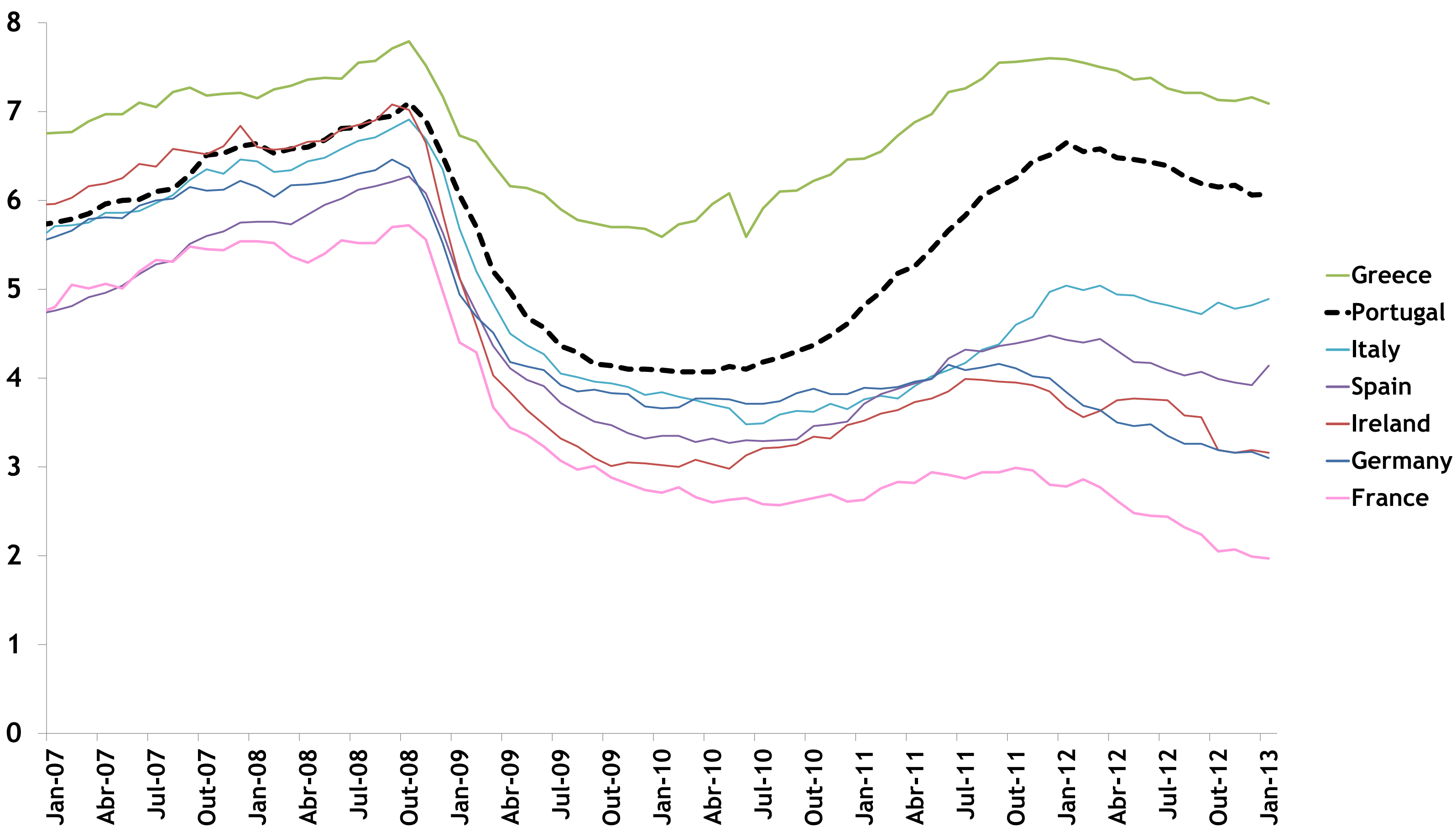
Interest rates on MFI Loans (≤1y) to Non-Financial Corporations | Outstanding amount
Percentage



Source: ECB, March 2013

6. Structural transformation

Structural reforms advancing at good pace

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NON-EXHAUSTIVE

	Implemented measures
Labor Market	• Increase in **working days:** up to 7 additional (3 vacation + 4 holidays) • Reduction of **restrictions to individual dismissal:** based on performance • Restrictions on **automatic extension of collective agreements**
Product Market	• Reduction of **rents in network and sheltered sectors** – **Electricity:** -1,4Bn€ NPV of future payments – **Mobile communications** networks: reduction of 80% since 2010 – **Pharmaceuticals:** expenditure from 1,5% (in 2010) to 1,25% of GDP (in 2012) – **Infrastructure PPP:** -1,3Bn€ NPV of future payments • Liberalization of the **energy and gas market**
Judicial system	• Adoption of a **law on arbitration** to facilitate out-of-court settlement • Approval of new **Code of Civil Procedure**, submitted to Parliament • Adoption of a new **Judiciary Map**, submitted to Parliament • Reduction of the **backlogged cases**
Business environm ent	• **Operational balance in 2012 achieved for the State-Owned Enterprises'** sector as a whole • New **insolvency code and corporate recovery** • New **Competition Law** harmonized with the EU legal competition framework • Liberalization of **regulated professions'** access and exercise • Approval of the **Public Professional Associations Framework Law** • Accomplishment of over two thirds of the implementation of the **Services Directive** • Reduction of firms' administrative burden: **licensing requirements and other legal formalities** • Adoption of the new **Urban Lease, Renovation works and Urban Rehabilitation Laws**

Main structural reforms discussed during the 7th Review

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	Keys facts
Reform of severance pay	• Importance of **maintaining social consensus:** social partners were consulted • Agreement on new **limits for severance payments**, to align with EU average: – New permanent contracts: **12 days** per year of service – For the remaining contracts, **18 days** per year of service in the first 3 years of the contract and **12 days** for subsequent years • **Cap of 12 months** will remain in place
Framework Law for Regulators	• Approval of a framework law against **best international practices** • **Reinforcement of the regulatory environment** to protect the public interest and to promote market efficiency • Ensuring the administrative, financial and management **autonomy of regulators** • Strengthening its organizational, functional and technical **independence**
Reform of the Corporate Income Tax	• Discussion of the reform of the CIT: create a **modern, stable and competitive tax** according to international standards • Aspects considered: i) reviewing the **rate structure**; ii) redefining the **tax base**; iii) reducing the **costs of context**; and iv) restructuring the **international tax policy** • Presentation of a **draft law** by end-June, to be sent for public consultation and discussion

Privatization program as a flagship in the structural transformation agenda

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Energy retail and production – edp

Energy retail and production – galp energia

Electricity distribution – REN

Air infrastructure – ANA Aeroportos de Portugal (1)

2013

Mail distribution – ctt

Railway logistics – CP CARGA

Air transport – TAP PORTUGAL

Waste management – ÁGUAS DE PORTUGAL

Insurance – Caixa Geral de Depositos Seguros (2)

Decisive concessions

- Urban Transportation (Lisbon, Porto)
- Maritime Ports

(1) Concession and privatization
(2) Expected completion date by "Caixa Geral de Depósitos"

Source: Ministry of Finance, January 2013

Privatizations results exceeding expectations in revenue obtained

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Selected bidders

	edp	REN	ANA Aeroportos de Portugal
% Equity	▪ 21,35%	▪ 40%	▪ 100%
Bidders	▪ China Three Gorges: China ▪ E.ON: Germany ▪ Eletrobras: Brazil ▪ Cemig: Brazil	▪ State Grid: China ▪ Oman Oil Company: Oman	▪ Vinci: France ▪ Atlantic Consortium: Germany, Australia ▪ Blink Consortium: Colombia, Portugal, Spain, Netherlands ▪ EAMA Consortium: Argentina, Portugal, Spain, Brazil ▪ Consortium Zurich Airport: Switzerland, Brazil, USA (1)
Revenue	▪ **EUR 2693M:** premium of 53.6% per share (2)	▪ **EUR 593M:** premium of 33.6% per share (2)	▪ **EUR 3080M** (3)
Financing	▪ **EUR 2000M** through Chinese banks	▪ **EUR 1000M** through Chinese banks	-
Investment	▪ **EUR 2000M** until 2015 in wind farms	▪ Strategic plan for national economy development (e.g. I&D center construction)	▪ Pre-existing investment plan for ANA to be fully respected ▪ ANA as the center of Vinci Group's airport activity

(1) List of five final bidders only
(2) Considering the closing price of the day before the Council of Ministers decision
(3) Equity Value (1200M) + Concession Fee (1200M) + Pre-Existing Debt (680M)

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7. Conclusion

Treasury Bond Yields at 2010 levels

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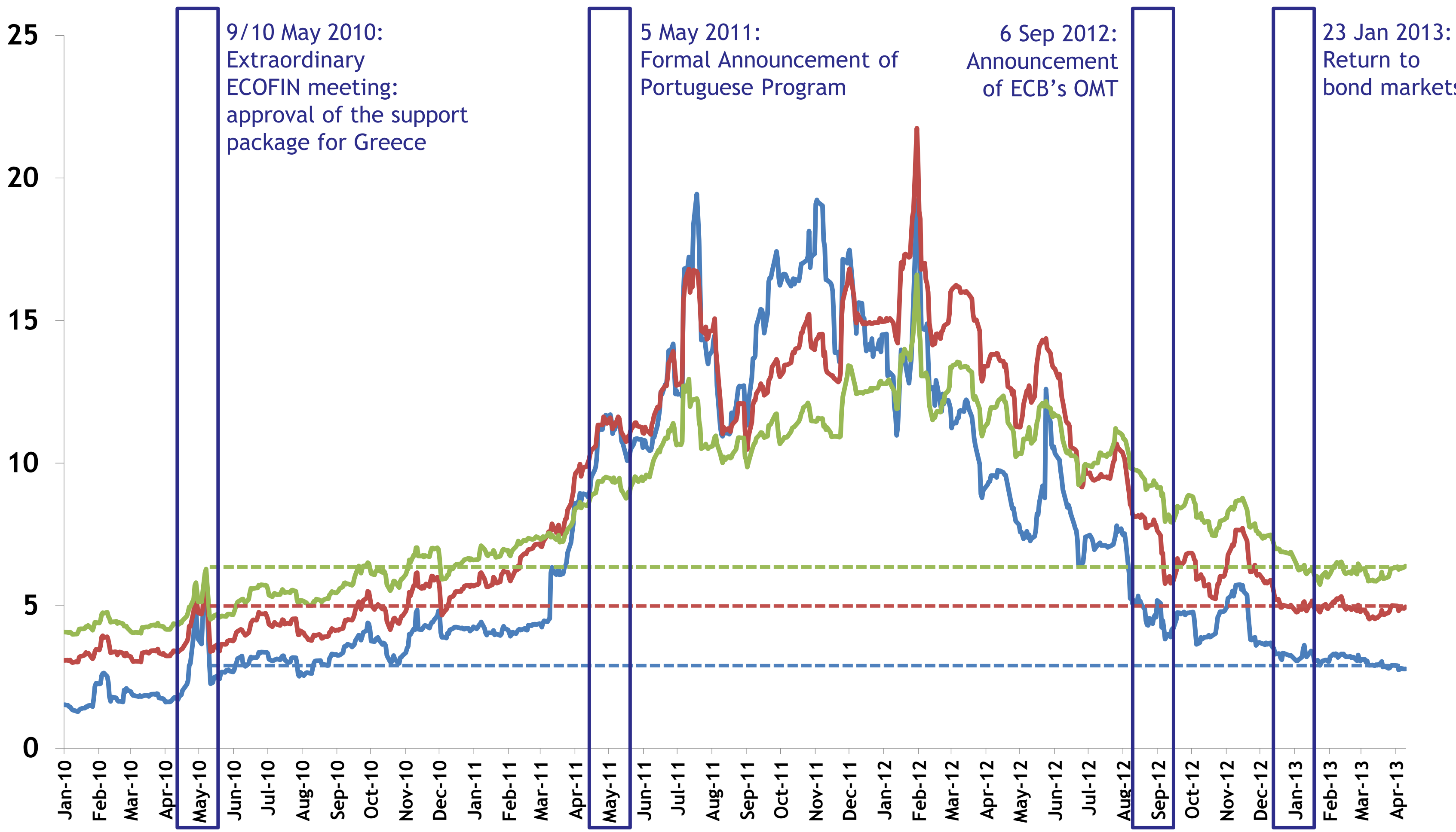
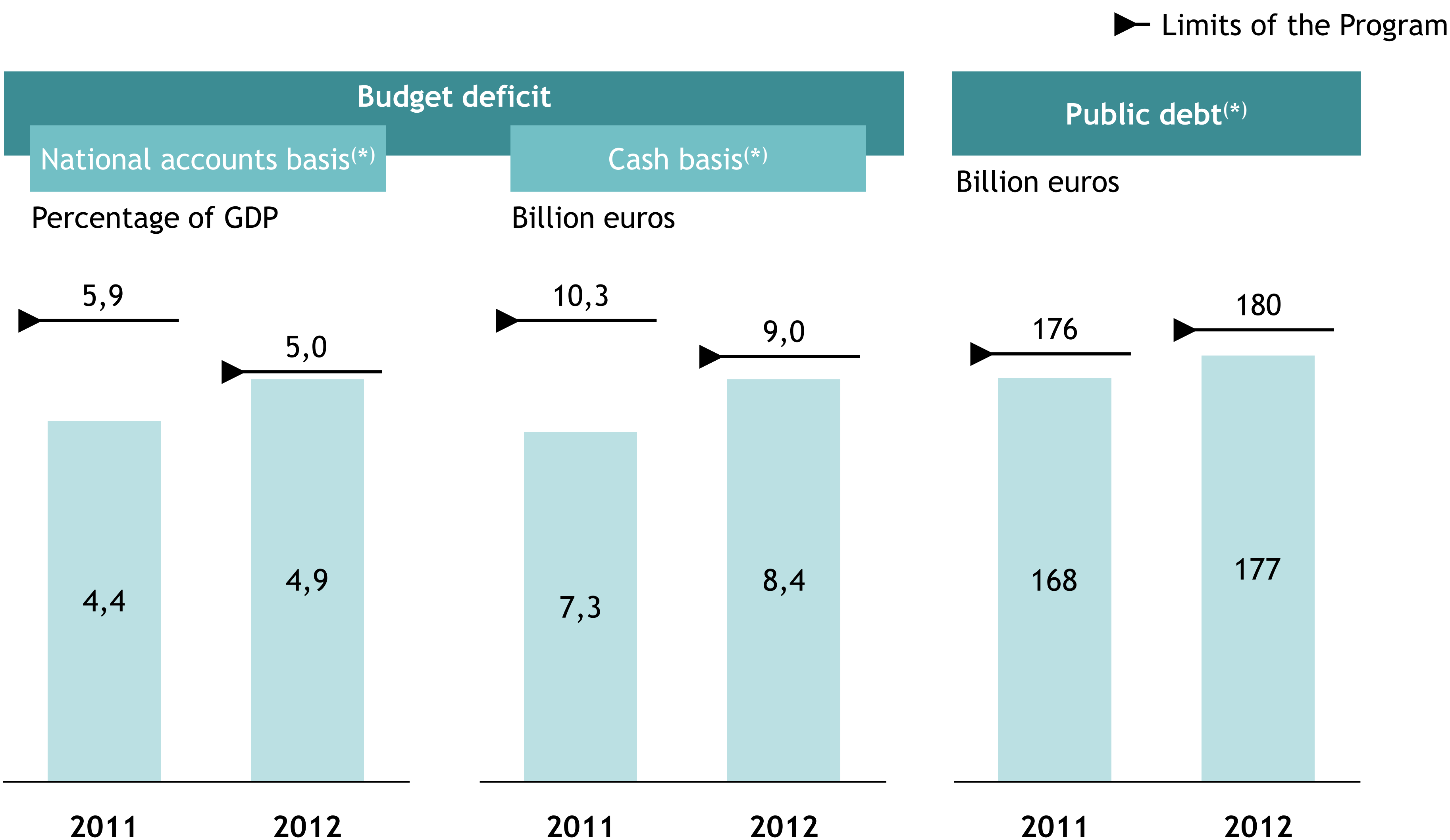
Treasury Bonds yields
Percentage



Source: Bloomberg (last observation: April 9th, 2013)

Compliance with all the quantitative targets of the Program…



(*) Targets according to the definitions set in the Program
All the quarterly targets for the budget deficit on a cash basis and for the public debt ceiling were also met

Source: Ministry of Finance, March 2013

… and the strong compliance with the Program…

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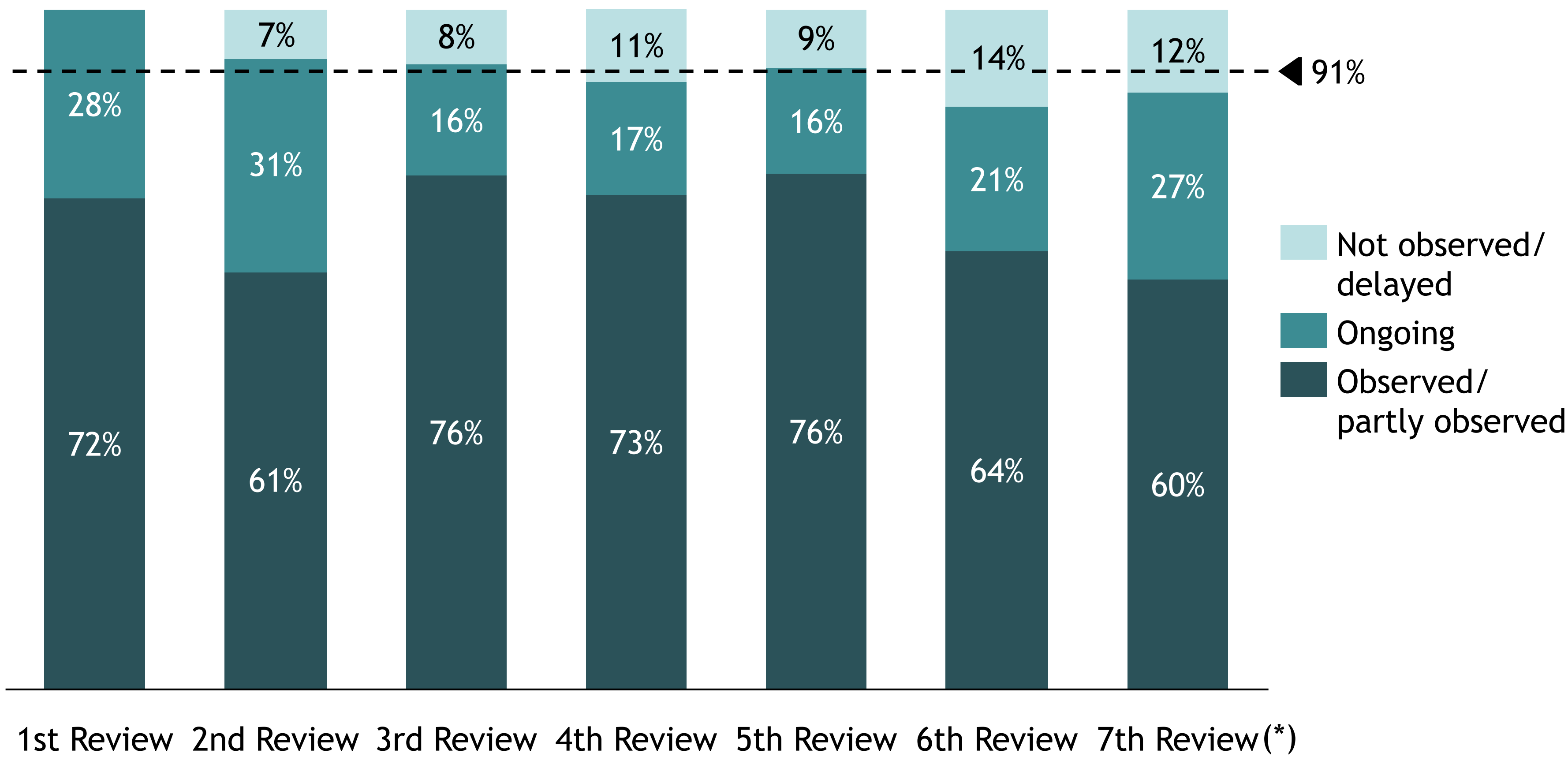
Status of measures required in each review
Percentage



(*) Preliminary values for 7th Review

Source: European Commission, March 2013

...are key to the European support in regaining market access.

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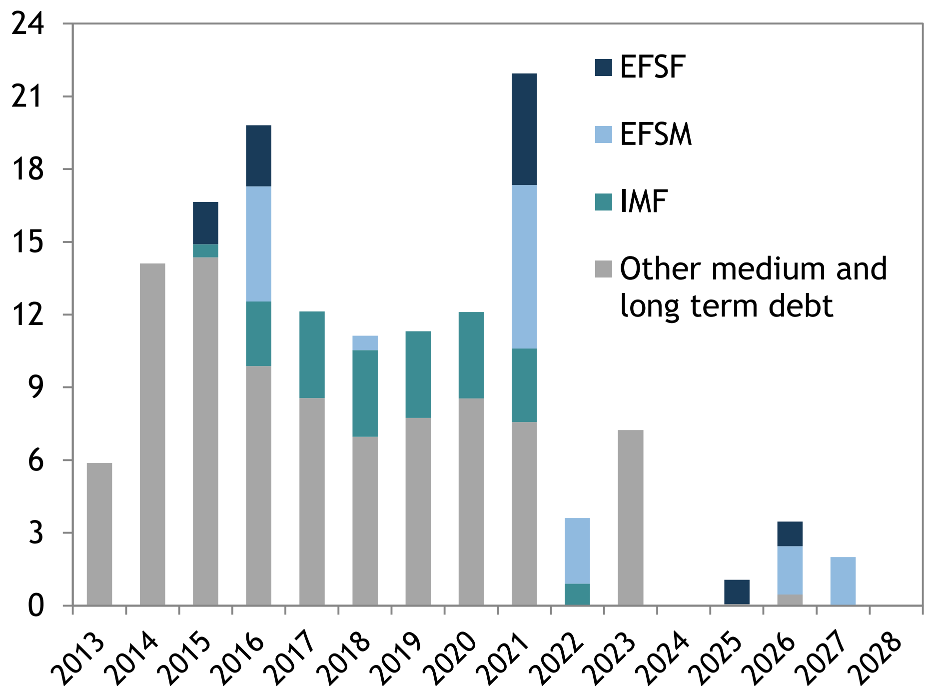
Redemption profile *
Billion euros



Substantial increase of refinancing needs in 2014-2016 and 2021

Favorable developments in Portugal and Ireland:

- Significant progress in economic adjustment
- Strong compliance with the Program
- Ongoing strategy to regain market access

"The **Eurogroup ministers are determined to support Ireland's and Portugal's efforts** to regain full market access and successfully exit their well-performing programmes [... and ...] **have agreed to an adjustment of the maturities of the EFSF loans** to both countries in order to smooth the debt redemption profiles of those countries."
(Mar 16th, 2013**)

Technical details to be further discussed

* Beyond 2028 -- 2032: 5,20 bn€. 2037: 6,97 bn€. 2038: 4,40 bn€. 2042: 1,50 bn€. 2050: 0,01bn€
** Eurogroup Statement on PT and IR: http://www.eurozone.europa.eu/newsroom/news/2013/03/eg-statement-portugal-ireland-16-03-13/

Source: IGCP (last update: January 23rd, 2013); Eurogroup

Towards sustainable growth and job creation

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Confidence and Credibility

Improving perspectives for the EA: OMT, Banking Union, Agreement on assistance to Greece and Spain

Balanced budget, reduction of public debt and **financial stability**

Solid foundations for economic recovery

Gradually achieving better financing conditions:

- Main driver in the present economic context is financial
- Portugal is reversing the sudden stop

Creating an open and competitive economy:

- Positive impact from ongoing structural reforms
- Portugal as an attractive location for investment and foreign and domestic capital