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Portugal – a phoenix rising from the ashes?

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International financial aid for Portugal ended in mid-May. In future, the country will be solely reliant on the capital market to finance its national budget – without the protection provided by a credit line from the European Stability Mechanism (ESM). This is a success of great symbolic power in a political sense for Portugal. However, the decision is also justifiable in economic terms.

Portugal had to be rescued with an international bailout package in November 2011. In return for receiving the support loans, it consolidated its national budget and initiated a series of ambitious structural reforms. These measures were radical and came at a very high cost. Indeed, the deep recession is only coming to an end now. The high and sudden loss of income still demands a great deal from the population.

Portugal is now back on course for growth, which, according to the forecasts, can be maintained for the foreseeable future. The state has already enjoyed success in issuing its first bonds. The two key prerequisites have thus been met to achieve a “clean exit”, following the example of Ireland.

Portugal's competitiveness has been continually declining since the Euro was introduced and, even more so, since the Eastern European states acceded to the EU. Real GDP growth persisted at an average of 0.7 % between 2001 and 2010 and the country lost shares on the export market. Real labour productivity per working hour rose by 8.4 % between 2004 and 2010, but labour costs increased by more, at 11.5 %, during the exact same period. Local production therefore became increasingly less competitive.

Goods and services were imported at an increasing rate, also due to the fact that access to financing was so easy. All investors expected a successful convergence process in Europe towards the economies with high incomes.

In expectation of this future high income and future growth, investments and consumption were frontloaded. Interest payments were low compared with the past due to the implicit assumption of a European joint liability scheme. Both the state and the private sector accumulated debt – both at home and abroad. Government debt as a percentage of GDP rose by 75 % between 2001 and 2010, while the debts of private households and companies rose by 84 % and 55 % respectively. Net foreign debt as a percentage of GDP more than doubled over the same period.

The crisis in Greece brought the illusion of total joint liability and the hope for more growth to an abrupt end. In 2010, both Greece and Ireland lost access to the capital market. Both states had to apply for assistance from the EU and the International Monetary Fund. The mistrust of the markets also spilled over into Portugal during the course of 2011. The ten-year government bond yields rose to just below 15 % and Portugal was no longer able to obtain refinancing from private investors. The country was bailed out by the EU and the IMF.

The EU and IMF assistance programme

As part of the assistance programme, Portugal obtained loans amounting to EUR 78 billion, which was equally split between the European Commission (via the European Financial Stabilisation Mechanism), the European Financial Stability Facility and the IMF. The loans are linked with a number of conditions, requiring, in addition to the long-term consolidation of the national budget, reforms in virtually all policy areas.

In the area of fiscal policy, numerous structural reforms had to be initiated in addition to complying with annual deficit targets. These reforms included more efficient public administration and financial administration, improved budget planning and sound financial management, new regulations for dealing with public-private partnerships and state-owned companies, the privatisation of

Table: Portugal in figures
(Before the crisis: 2001–2010. During the crisis: 2011–2013. Average values in each case.)

	Before the crisis	During the crisis	Latest value
Economic strength			
Real GDP per capita in EUR (2005)	14,799	14,476	14,249
GDP growth in per cent yoy	0.7	-2.0	-1.4
GDP per capita as a percentage of the EU average	79	78	76
Labour market			
Population in millions	10.49	10.53	10.49
Working population in thousands	5,117	4,662	4,562
Unemployment rate	8.2	15.1	15.2
Hours worked	39.2	39.3	39.4
Foreign trade			
Export growth in per cent yoy	3.1	5.4	6.1
Import growth in per cent yoy	3.6	1.2	2.8
Balance on current account as a percentage of GDP	-9.8	-2.8	0.5

Source: Eurostat

state property and a comprehensive reform of the public healthcare system. Compliance with the annual deficit targets was only achieved once these targets had been relaxed twice (see figure 1). The privatisation revenues of EUR 5.5 billion which Portugal aimed to achieve by 2014 were exceeded by 50 % through initiatives such as the sale of the airport operator ANA, a hospital service, the Portuguese postal service and a number of other companies. Further privatisations are in the pipeline. The reform of the healthcare system, with measures such as the increased use of generic products for prescription medicines or the comprehensive use of electronic medical files, is in progress.

In contrast, the reforms in the banking sector and on the property market, including a tenancy law reform and the standardisation of the guidelines to protect historical buildings and monuments, are completed. The government's task in this respect is simply to regularly monitor the measures taken so as to respond in good time to any problems. The same applies to the deregulation of the goods and services markets, particularly in the energy, communication and transport sectors. The next steps mainly involve making adjustments to the new regulations following a practical test.

In the labour market and education segments, unemployment insurance was reformed, protection against unlawful dismissal and working time regulations were made more flexible and the wage bargaining process was decentralised. Improving the quality of education is a longer-term project supported by means of regular evaluations of the existing measures and subsequent improvements where necessary.

Numerous measures are aimed at improving the framework conditions for companies. The first fully completed reform involved the justice system followed by the competition authorities and public procurement. Work is still ongoing with regard to simplifying a variety of approval procedures. These simplifications were added to the reform package at a later stage in return for the relaxed deficit targets.

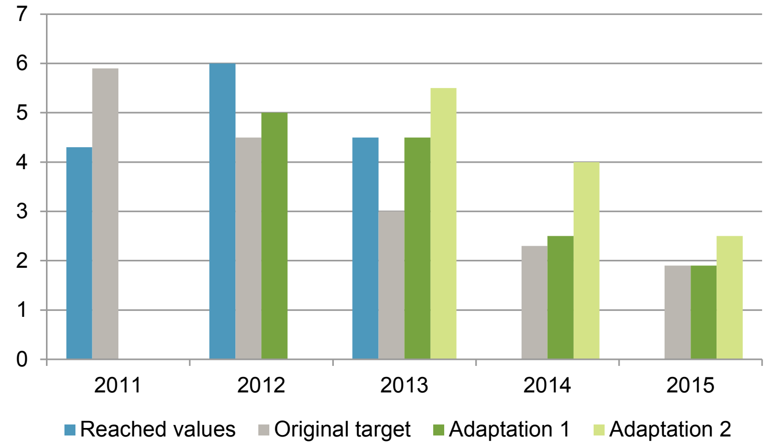
Economic recovery is gaining traction

The stringent consolidation requirements initially caused a deep recession in Portugal. But this has been overcome since the second quarter of 2013, from then on the country's economy has been growing at an average rate of 0.6 % compared with the previous quarter. Growth is predominantly driven by foreign trade. Exports have been increasing since 2010 and grew by 6. 1 % in 2013 compared with the previous year. Consequently, the current account improved considerably, from a deficit of 12.6 % of GDP in 2008 to a surplus of 0.5 % of GDP in 2013. As imports have also begun to rise again, the marked reduction in the current account deficit is indicative of Portugal's increased external competitiveness (see the table for development before and during the crisis).

This increased competitiveness is the result of the rise in labour productivity with more or less constant salaries and wages (see figure 2). The unit labour costs of the Portuguese economy as a whole have fallen by 3.5 % since their peak in 2009, while the unit labour costs in the manufacturing sector have even fallen by 12 %.

This decline is, of course, in part also due to the sharp increase in unemployment. The unemployment rate virtually doubled during the crisis and reached an annual average of 16.5 % in 2013. The peak has passed, however, and in March 2014 the unemployment rate was still 15.2 % and following a downward trend. The falling unemployment rate is actually due to the in-

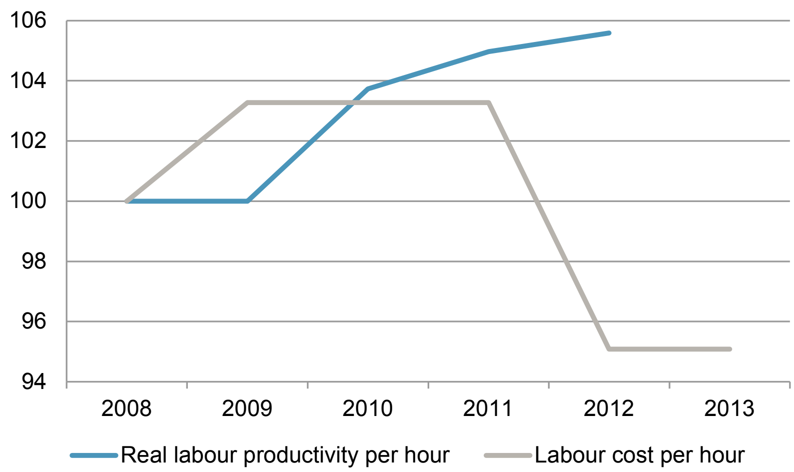
Figure 1: Evolution of the deficit and compliance with deficit targets
(as a percentage of GDP in each case; in the programme definition*)



*In the programme definition of national deficit, the deficit as calculated by Eurostat is adjusted for one-off items, e. g. expenses for bank recapitalisation or privatisation revenues.

Source: European Commission

Figure 2: Evolution of Portugal's competitiveness
(index, 2008=100)



Source: Eurostat

crease in the number of employees, and only to a lesser degree to a shrinking working population due to emigration, for example.

Remaining challenges

Even if the economic recovery has picked up pace in the meantime, there are still a number of challenges for the country to overcome. The government deficit was 4.5% of GDP (4.9% as per the Eurostat definition) in 2013, just below the threshold agreed as part of the programme and less than half as high as its peak during the 2009 financial crisis (10.2%), but compliance with the Maastricht limit of 3% of GDP necessitates further efforts. At least Portugal's primary deficit, i.e. the public deficit minus interest payments and changes in assets, is down to 0.6%.

A positive primary balance and healthy economic growth are necessary to decrease the government debt from 129% of GDP in 2013 to a tolerable level. However, it is not only the Portuguese state that is severely in debt. Households and companies must reduce their accumulated debts before they can spend more money on consumption and investment. At the end of 2013, the debt ratios of households and of firms were 96% and 184% of GDP respectively. But unlike the state, the private sector has already been able to reduce its debts – firms by close to 2% compared with the peak in Q2 2013 and households by close to 10% compared with the peak in Q4 2009.

This debt reduction is also reflected in the loan portfolios held by Portuguese banks, which have shrunk by 20% since 2009. New loans, particularly for small and medium-sized companies (SMEs), are few and far between, even if the sentiment on the credit market has improved of late. A likely reason behind the weak lending activity is the loans at risk of default on the banks' balance sheets. At the end of February 2014, 4.6% of the volume of loans to households and sole proprietors and 13.3% of the volume of loans to companies was at risk of default. There are still no signs of this trend reversing.

The risks arising from subsequent rulings by the Constitutional Court and in politics ahead of the 2015 parliamentary elections are difficult to assess. Over the last few years, the Constitutional Court has repeatedly declared planned consolidation measures unconstitutional, so the government had to change its plans. As the country still needs to continue saving to secure the sustainability of its debt in the long term, further appeals to the Constitutional Court cannot be ruled out. Up until now, however, the government has succeeded in following the court rulings and still pursuing its saving targets.

Furthermore, a new parliament will be elected in spring 2015. Politics may well shift into campaign mode soon. Whether and how the reform programme will then be implemented is difficult to predict. Given that the budget cuts in particular were extremely unpopular among the population, it is to be assumed that there will be no further savings at least and that some of the implemented cuts will possibly even be reversed.

State financing secured until 2015

The Portuguese government quantifies the country's entire financing needs for this year as amounting to EUR 22.8 billion (as at: February 2014). Part of this will be covered by the last payments made by the assistance programme, while the rest is covered by cash reserves and the return to the capital market. Since the start of the year, Portugal has tapped existing benchmark bonds a few times, issued a few short-term papers and successfully placed a new ten-year bond on 23rd April 2014. Also, the financing needs for 2014 and 2015 were reduced via bond exchanges in December 2013 and at the start of this year.

In addition to the regular cash reserves, EUR 6.4 billion is available to finance banks, which is not credited to the funds available for state financing. These funds could be drawn upon if the European Central Bank's stress test were to establish equity gaps at the four tested banks.

The financing needs for 2014 thus are already covered in full and there are additional funds amounting to almost EUR 4.5 billion available. These can be used as a buffer for contingencies or already go towards financing the payment obligations for 2015, which are likely to be somewhat lower than EUR 20 billion. All of Portugal's additional capital market operations this year are contributing towards financing next year too.

A "clean exit" – the sensible option

Portugal thus has no severe financing problems. The economic upturn which started last year and the fact that the conditions stipulated by the assistance programme are being consistently implemented make it unlikely that new problems will occur over the next 12 months. From an economic point of view, the "clean exit" announced by the government is justifiable. In addition, it is extremely attractive to the government that it can announce a "return to independence" ahead of the elections being held next year. ■