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The Economic Adjustment Program for Portugal: assessing welfare impact in a heterogeneous-agent framework

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Abstract The sovereign debt crisis, triggered by the 2007-08 global financial crisis, has affected several European Union (EU) countries, leading to unprecedented financial assistance programs. In May 2011, the Portuguese Government set an agreement with the Troika (a supranational institution composed by the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF)), through which, in exchange for external help, the Portuguese authorities committed to an Economic Adjustment Program (EAP). In order to assess the impacts of the EAP on welfare and, in particular, on inequality, this paper simulates the debt consolidation strategy proposed by the Troika using a general equilibrium model with heterogeneous agents. The model enables to explore the impacts of the fiscal adjustment on the endogenous cross-section distribution of income, wealth and welfare. Our results predict a positive net welfare gain, despite the existence of significant transition costs in terms of output losses and inequality, especially during the first years of implementation. Overall, the net positive welfare gains are biased towards the poorer, which means that the consolidation plan will be, in the end, equality-enhancing. These results reflect the instruments involved in the consolidation strategy: productive and unproductive expenditure cuts combined with a slight increase in social transfers. Furthermore, the simulation predicts a positive impact on the Portuguese net foreign asset (NFA) position. Assuming this prediction is correct, this strongly supports the motivation for the adoption of the Economic Adjustment Program which considers the large external indebtedness of Portugal as a central issue in the economic diagnosis.

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