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Portugal and the Global Financial Crisis – short-sighted politics, deteriorating public finances and the bailout imperative

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Portugal and the Global Financial Crisis – short-sighted politics, deteriorating public finances and the bailout imperative*

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Abstract

The aim of this paper is twofold. On the one hand to explain the institutional, economic and political foundations of the Portuguese bailout in April 2011. On the other hand, to clarify the impact of the global financial crisis (GFC) in Portuguese public finances, and the interaction between domestic fiscal policy and monitoring and recommendations from the European Commission (EC) and the European Council (ECo). A long run perspective (1974-2011) on management of public finances shows that Portugal has some institutional and constitutional problems that should be sorted out in order to achieve sound public finances. Moreover, in the second half of the 90s fiscal policy was expansionary and the high conversion rate of the former currency (escudo) to the euro still hampers economic growth and competitiveness. With weak growth in the first decade of XXI century and persistent public and external deficits, Portugal came to the frontline of the negative impacts of the GFC. The total absence of political cooperation and the existence of some minority governments only made things worst. We conclude, with a brief overview of the bailout, its prospects of success, and some structural institutional measures that should be taken.

Keywords: H30, H50, H60

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1. Introduction

In April 2011 Portugal became the third country in a row, after Greece and Ireland, to receive a bailout from the 'Troika' of the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF). Financial markets began to become suspicious about the ability of the country to fulfill its sovereign debt liabilities, risk premiums increased up to a point where access to capital markets was no longer an option and a debt default soon became imminent. At this point the Portuguese minority Socialist government of José Sócrates had no option other than to negotiate a bailout in the form of a memorandum of understanding with the three lending consortia – the EC, ECB and IMF.

The natural question is why did Portugal suffer this fate? This paper aims to explain the economic, political and institutional foundations that led to this bailout by exploring two key dimensions: the *democratic institutions* and *fiscal policy of Portuguese governments* shaped within the context of the European Union's (EU) budgetary framework. Firstly, the paper examines the long-run trends in the management of Portugal's public finances. Secondly, it explores the economic and fiscal situation before the crisis emerged. Thirdly, it analyzes the impacts of the global financial crisis (GFC) on the Portuguese economy and how the government first reacted to the crisis in line with the European Commission's proposals. Thereafter, it explores how the government, in the emergence of the escalating sovereign debt crisis, weighed its policy priorities against competing claims (the need for economic stimulus, avoiding excessive deficits and stabilizing the financial markets), which measures were taken and why, when were they implemented and what was their impact. Finally, it will present the main measures included in the memorandum with the 'Troika' (EC, ECB and IMF) and concludes with the main shortcomings of the surveillance of public finance among EU member countries under the *Stability and Growth Pact* (SGP) and the need for institutional reforms in Portugal.

2. Democratic Politics and Public Finance in Portugal – an overview

Throughout the entire democratic period following the 1974 revolution, Portugal never had a surplus in the state budget. The other country with such a bad record is Greece. Deficits were the rule without exception, and were considered normal in Portuguese

political discourse even before this last crisis. Recall too, that Portugal became the first country in 2000 to be subjected to the EU's Excessive Deficit Procedure (EDP), a process commenced by the European Commission under the *Stability and Growth Pact* (although one year later France and Germany were also placed under the EDP arrangements).

Another peculiarity is the structure of fiscal federalism across the jurisdiction. The archipelagos of Madeira and the Azores have a special autonomous status, including the constitutional right to *all* tax revenues generated in their territories plus regional and local governments receive generous transfers from the State budget. This fiscal arrangement was embedded in the Constitution in 1976 and remains to this day despite several important amendments to other parts of the Constitution. Hence, Portugal is a unitary state but paradoxically has two 'mini-states (autonomous regions) within its borders with more tax powers and tax revenues than real states within federations. Since it is formally a unitary state, the EUROSTAT does not provide any separate statistics for these regions. They are mixed up with fiscal statistics of local governments which contributes for a lack of transparency in public accounts[i] and judicial litigation.[ii]

Since the restoration of democracy in 1976, the IMF has been involved in an enforced fiscal consolidation program in Portugal on three different occasions. The usual pattern of public finances was: firstly, a significant increase in public spending compared to GDP would occur leading to permanent deficits; secondly, higher deficits led to an increase of the debt to GDP ratio mainly in periods of low growth; thirdly, with the level of debt soaring, a privatization program was imposed on the government together with a restrictive fiscal policy (see Pereira 2012). The recent bailout of Portugal by the EC, IMF and ECB is, therefore, not a completely new story. Portugal was definitely not prepared for the GFC from the public finance point of view. However, as clarified below, the banking and financial sector was relatively robust and the housing bubble was not as important as in other countries. Figure 1 gives an overview of the long run evolution of public finances in Portugal.

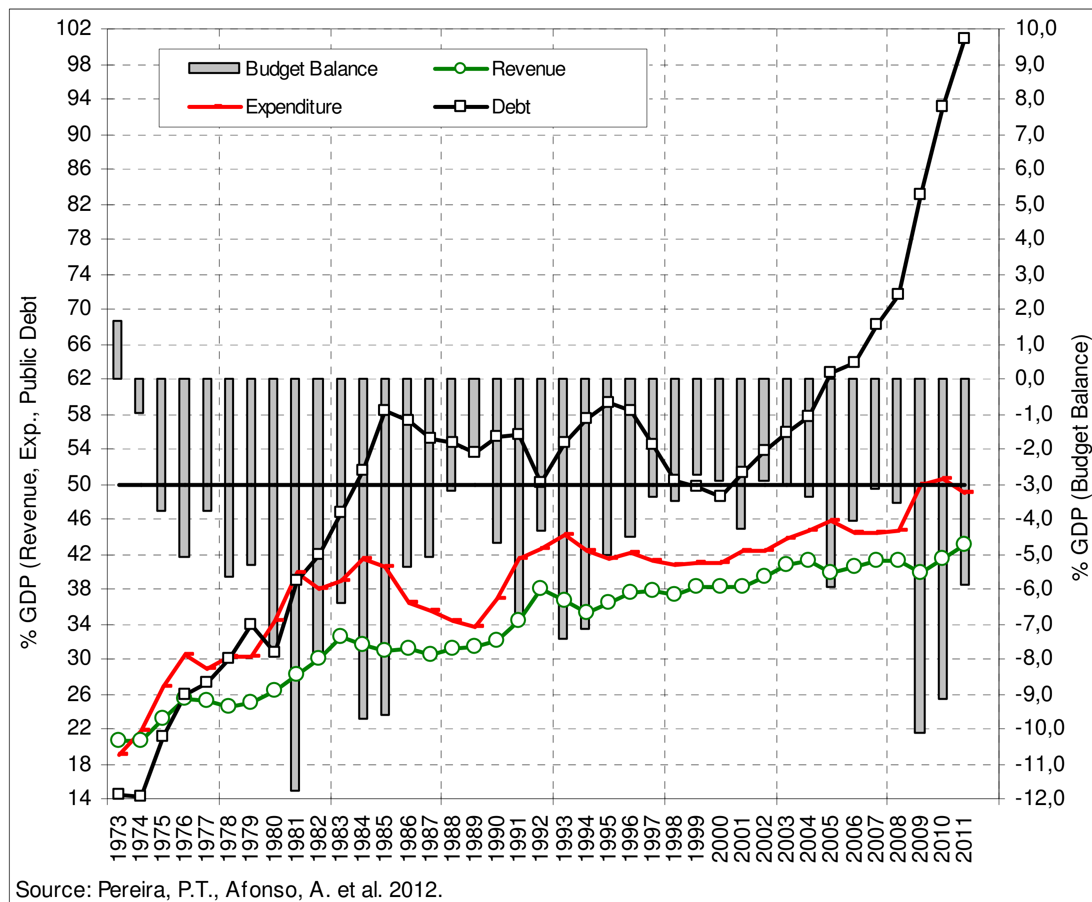

Figure 1 Portugal's revenues, expenditures, deficits and debt – 1973-2010

The reasons why Portugal was not prepared and could not respond adequately to the GFC were not only fiscal but also economic and political. A brief overview of economic and political constraints is necessary here.

When the *Maastricht Treaty*, and the *Stability and Growth Pact* established the reference values for the ratio of debt to GDP (60 percent) and deficit to GDP (of 3 percent), economists and politicians looked to the past growth record and considered it reasonable to assume a 5 percent annual nominal GDP growth rate in European countries. If economic growth was maintained at that level public finances would be sustainable. Portugal had a reasonable growth record in the 1990s but than an appalling one in the first decade of this century, particularly in the years immediately preceding the crisis. Low growth was associated with low productivity and a significant loss of competitiveness related to several factors. First, low educational levels, which have been widely acknowledged (see OECD 2010) do not promote productivity increases. Second, a higher than expected exchange rate established for the conversion of the former Portuguese currency (the escudo) to the euro brought further damage to external

competitiveness. Third, an allocation of European Structural Funds, spent mainly on infrastructure and other non-tradable goods and services, which contributed to increase productivity in the former years after joining the EU (in 1986), but became a partial waste of resources in the last decade. Finally, rigidities in the labor and housing markets were also considerably damaging to economic growth, contributing to low mobility in the labor market and, along with low interest rates, promoted a high household indebtedness.

On the political front, Portugal faces some problems that are not common in European countries. The country has, like most European countries, a proportional representation system, which favors a fragmentation of parties in parliament when compared with majoritarian systems. However, two specific characteristics of Portuguese democracy are the lack of political competition associated with the closeness of the ballot[iii] and the difficulty in making coalitions, particularly the center-left Socialist party which never formed a coalition with other left-wing parties. Only once did the Socialists achieve an absolute majority in parliament (2005-2009). All the other years they were in power, they formed minority governments or a weird and unstable coalition with the more extreme right-wing party, the conservative Popular Party (*Partido Popular*). This succession of minority governments were more prone to lobbying from interest groups and other special interests, pushing for increased expenditure and tax benefits, and less able to implement necessary reforms.

3. The Situation in Portugal Before the Crisis Emerged

From 2000 to 2007 the size of general government increased by 3.3 percent points to an aggregate of 44.4 percent of GDP, and all this increase was explained by growing social expenditures. Low growth and persistent deficits implied soaring public debt (as was shown in Figure 1) and higher debt serving charges. In just those seven years the ratio of debt to GDP increased from 48 percent to 68.3 percent of GDP.

The Political Situation

The political situation did not help governments in their fiscal management of the economy. As Chart 1 shows, the decade started with a Socialist government with exactly half of the seats in parliament (115 out 230 members of parliament). This coincidence was not helpful, because on the one hand no-confidence motions could not

be carried to dismiss the cabinet, and on the other hand the government could not pass its proposed bills through the legislature. This eventually lead to the resignation of the Prime Minister Antonio Guterres in April 2002 and a right-wing coalition led by the center-right Prime Minister José Barroso took power. His government ended abruptly two years later in July 2004, when Barroso resigned to become the President of the European Commision. He was replaced, without elections by P. S. Lopes and supported by the same coalition of Social Democrats (center-right) and the Popular Party (conservatives). However, political unstability and erratic governance lead the President of the Republic to dissolve the parliament and call an early election which was won by the Socialists. A new government was formed led by socialist José Sócrates with an absolute majority in parliament. In short, in the period 2000-2007 Portugal had four different and usually unstable governments. This had important implications in the mismanagement of the economy and public finances.

Fiscal Policy

The first implication of the political instability – in particular the rotation from a center left-wing government to a right-wing government (2002) and vice-versa (2005), is that governments always like to present their inherited fiscal position in the worst light they can to provide a rationale for austerity measures.

In 2002 Prime Minister José Barroso implemented a restrictive fiscal policy, freezing public employees' wages and admissions, which had a pro-cyclical effect in 2003 when the country entered into recession. His successor from the same party, on the other hand, developed a slight expansionary fiscal policy (see Figure 2). When the

Box 1: Elections and Governments in Portugal 2000-2011

1999-2002 XIV Government – Socialist (PM A. Guterres, a split parliament 115/230 seats)

16 Dec 2001 Municipal and local elections

17 Mar 2002 Parliamentary elections XV Government – Center-Right (PM José Barroso; Majority Coalition)

XVI Government – Center-Right (without elections) (PM P.S. Lopes due to resignation of José Barroso)

22 Feb 2005 Parliamentary elections XVII Government – Socialist (PM J. Sócrates – Majority)

9 Oct 2005 Municipal and local elections (for a 4 years term)

22 Jan 2006 Presidential elections (for a 5 years term)

7 Jul 2009 Parliamentary elections XVIII Government – Socialist (PM J. Sócrates – Minority)

27 Sep 2009 Elections for the European Parliament (for a 4 years term)

11 Oct 2009 Municipal and local elections (for a 4 years term)

23 Jan 2011 Presidential elections (for a 5 years term)

5 Jun 2011 Parliamentary elections XIX Government – Center-Right (PM P. P. Coelho – Majority Coalition)

Socialist Prime Minister José Sócrates reached power, in March 2005, he asked the Bank of Portugal to conduct an audit of the public deficit. The Central Bank predicted that, if no further measures were taken, net borrowing for that year alone would amount to 6.56 percent of GDP. This auditing of the deficit partly explained the sharp increase in net borrowing in 2005 which reached 5.9 percent of GDP (up by 2.5 percent). Sócrates retained the policy of freezing wages and new recruitment in the public sector started by the Barroso's government in 2002. Just before the crisis (years 2005-2007) some fiscal consolidation was shown leading to an improvement in the structural primary balance and a reduction in net annual borrowing. The government also implemented an important reform to social security which significantly improved the long-run sustainability of the pension system. However, the short-run impact of this reform was very small. Additionally, there was a large scale reform program to central government (PRACE), changing the structure of all ministries. The aims were to make central government more efficient, to reduce expenditure and at the same time to increase its efficacy. However, since targets for expenditure cuts were not tightly quantified this particular objective was not achieved.

Data from Figure 2 does not indicate what happened in the state-owned enterprises and public private partnerships (PPPs), outside the general government, which have obvious implications both on deficit and debt. From the beginning of the decade, governments became increasingly involved in PPPs. Initially most PPPs had an immediate positive impact on the budget balance, since when the government signed the contract it received a lump sum payment. Later on, such projects have a negative impact when the infrastructure has been built and government starts paying for its availability particularly if provided free of charge to users. That happened with many PPPs in the road transport sector. The excessive use of PPPs led to an over-capacity especially of highways and put a burden on the budget. Also in the health sector, several hospitals were transferred out of the general government sector to become public enterprises (off-budget). The impact on the public accounts of this externalization of hospitals was that public expenditures decreased only slightly, because these hospitals were still funded mostly from current transfers from general government on a contract performance basis.[iv] However, the structure of public expenditure changed with such moves as, for example, hospital salaries no longer appeared as civil servants' wages. Finally, with these institutions 'off-budget' the level of public debt appeared to decrease because their borrowings were not taken into account. One of the main problems of Portugal, on the

verge of the economic crisis, was that the creation of public enterprises at central, regional and local government levels was effectively a legal escape from the rigid deficit and debt targets from the *Maastricht Treaty* and the *Stability and Growth Pact* (SGP), but with undesirable side effects.

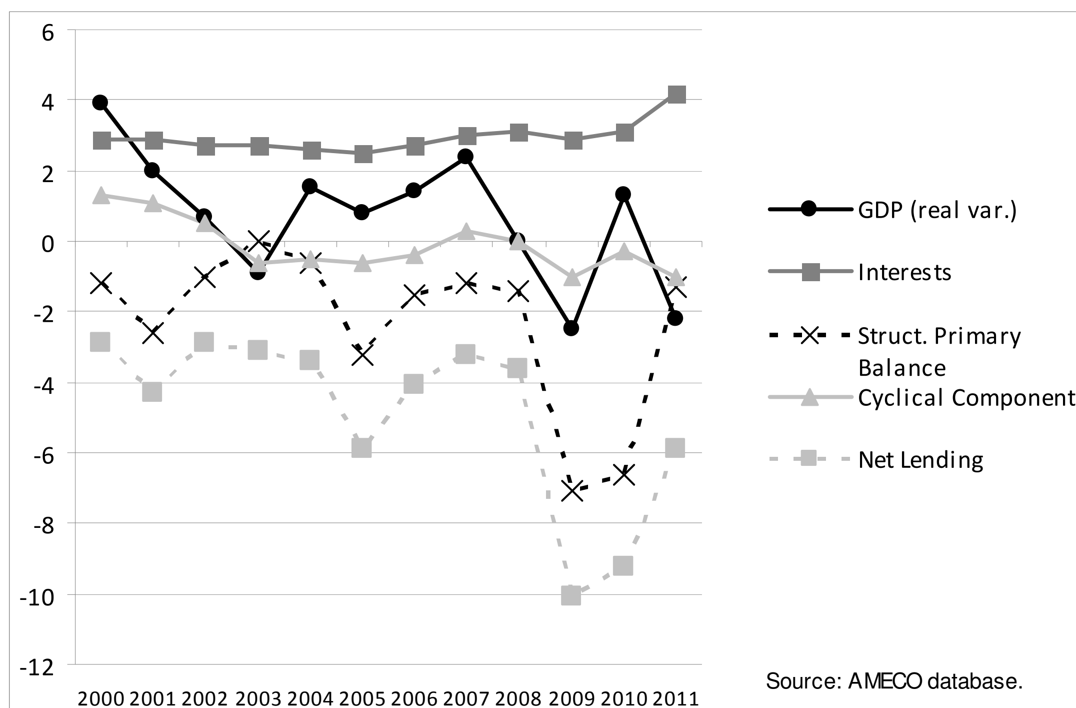

Figure 2 Portuguese main fiscal policy indicators – 2000-2011

Economic Situation

The Portuguese economy enjoyed a period of high growth rates, decreasing unemployment and a rapid catch-up to the EU average in the late 1990s. This was a result of stage two of the European Economic and Monetary Union heading to the euro. In fact Portugal benefitted from decreased nominal and real interest rates, which lead to an increased private and public demand and also increased indebtedness in both sectors. Fiscal policy in the second half of the 90s was expansionary[v], while other European countries profited from low interests to consolidate their public finances. Moreover, the Bank of Portugal and the European Monetary Institute (a predecessor of the European Central Bank) were overly optimistic about the ability of the Portuguese economy to withstand a high conversion rate of the former escudo.

The first seven years of the XXI century presented a quite different picture. Unemployment increased sharply from a low level of 4.5% in 2000 to 8.9% in 2007, and economic growth was anemic. There was a mild recession in 2003 (GDP contracted 0.9 percent) and growth rates were lower than 2 percent from 2004 until 2006.[vi]

As a result of this period of lower growth, there came a halt to the economic convergence to EMU standards. Between 1995 and 2000 the Portuguese per capita GDP was clearly getting closer to the EMU average (it rose from a low 47.6 percent of EMU average to 55.4 percent). However, in the following five years period (2000 to 2005) this convergence was much slower, rising only to 57 percent – a level at which it has largely remained ever since. Taking into account this low growth environment, the year 2007 was a particularly good one, as GDP growth was 2.4 percent that year. Moreover, exports indicated signs of improvement, posting growth rates of 11.5 percent and 7.6 percent in 2006 and 2007 respectively. Yet, even with an improvement in the trade balance, the country still presented a current account deficit of 10.1 percent of GDP in 2007.

4. The Global Financial Crisis – the European response and national politics

Framework of Action at the European Level

As the US subprime crisis burst in the summer of 2007, few predicted its effects would be felt so deeply and would spread as widely as they eventually did. In fact, financial markets faced important disturbances as early as August 2007, but it took several months before the cascading effects turned the subprime crisis into a global financial crisis of initially unthinkable proportions.

The TED spread,[vii] a credit risk indicator widely used to measure stress levels in financial markets (see Figure 3), spiked significantly at the beginning of the subprime crisis in August 2007, and when Bear Sterns was rescued in March 2008. These events were clearly severe disturbances in financial markets. But the major increase in this indicator was related to the aftermaths of the Lehman Brothers breakdown in late 2008. The last event clearly marked the tipping point into a full GFC, triggering government financial sector rescues in the developed and developing world. Chart 2 indicates a chronology of the main European and Portuguese responses to the disruptive effects of the GFC.

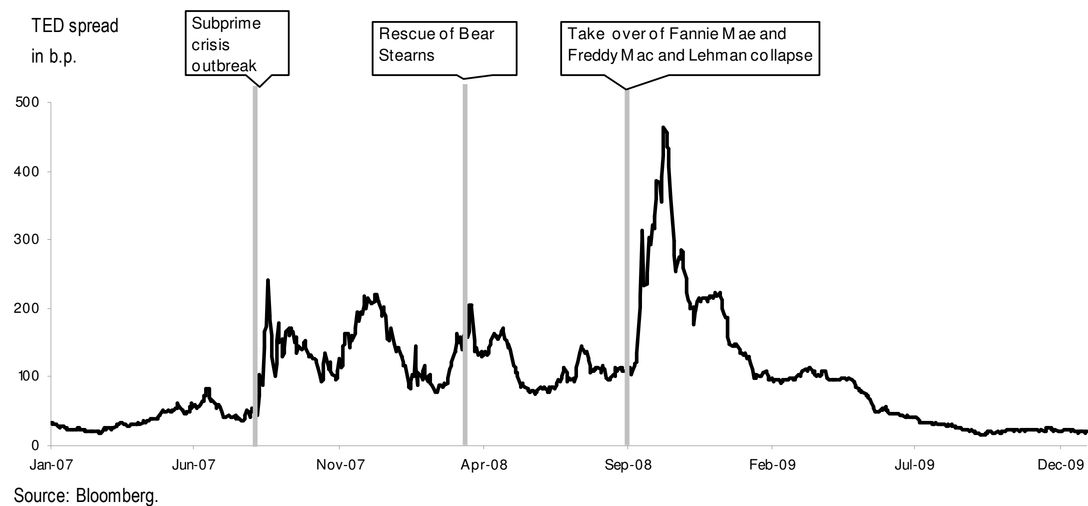

Figure 3 The financial markets stress – 2007-09

It was only after these disruptive events that EU leaders, faced with the imminent collapse of several important financial institutions, decided to act decisively to foster financial stability in Europe.

In October 2008, consecutive meetings of several EU and Euro Area governing institutions led to a set of decisions designed to increase confidence in the banking sector by raising the threshold of guaranteed deposits, and to provide guidance to deal with the problems of the financial institutions in a way which would lessen financial instability. Moreover, Euro Area governments started anticipating the likely impacts of the financial sector rescue packages in public accounts and so began to invoke the provisions for flexibility due to 'exceptional circumstances' in the SGP.

At the end of 2008, it was increasingly acknowledged that financial market disturbances would wreak significantly damaging effects on economic growth and that the problems would not be solved simply by flooding the financial system with liquidity. It was then that it became clear to political leaders in Europe that both monetary and fiscal policy would have to be loosened promptly in order to avoid a deep and protracted recession.

Therefore, in December 2008, the European Council approved the European Economic Recovery Plan (EERP), designed to push national governments to increase public expenditure in a coordinated move. A communication from the European

Commission at the time gravely stated that: ‘We sink or swim together’ (COM 2008:2). This quotation clearly captured the urgency that European institutions put in the implementation of a significant fiscal stimulus in order to support economic growth. The Euro-wide fiscal stimulus was first planned at €200 billion (or around 1.5 percent of GDP), and some months later, in March 2009, this amount was revised upwards to around € 400 billion (or 3 percent of GDP).[viii]

Factors Contributing to the Initial Resilience of the Portuguese Economy

After recording the best performance in seven years in 2007, the Portuguese economy continued to grow positively during most of 2008. Indeed, it was only in the last quarter of 2008 that GDP declined, but even then the major drag to growth came from exports, as internal demand remained bullish. Accordingly, it is important to identify the main sources of this initial resilience. One factor is the more risk-averse stance of the major Portuguese banks, leading to a more conservative investment profile overall. This meant that they had relatively low exposure to highly complex financial products that were affected in the original subprime crisis. Moreover, the spillover effects to the economy from the instability of world financial markets were at this stage less severe in Portugal than in other European countries.

Moreover, the Portuguese real estate market had already faced major adjustments in the beginning of the decade and properties were considerably less overvalued than in other European countries. As a result, residential property prices, that had been growing at a slower pace after 2002, faced no more than a slight deceleration in 2009 (see Figure 4).

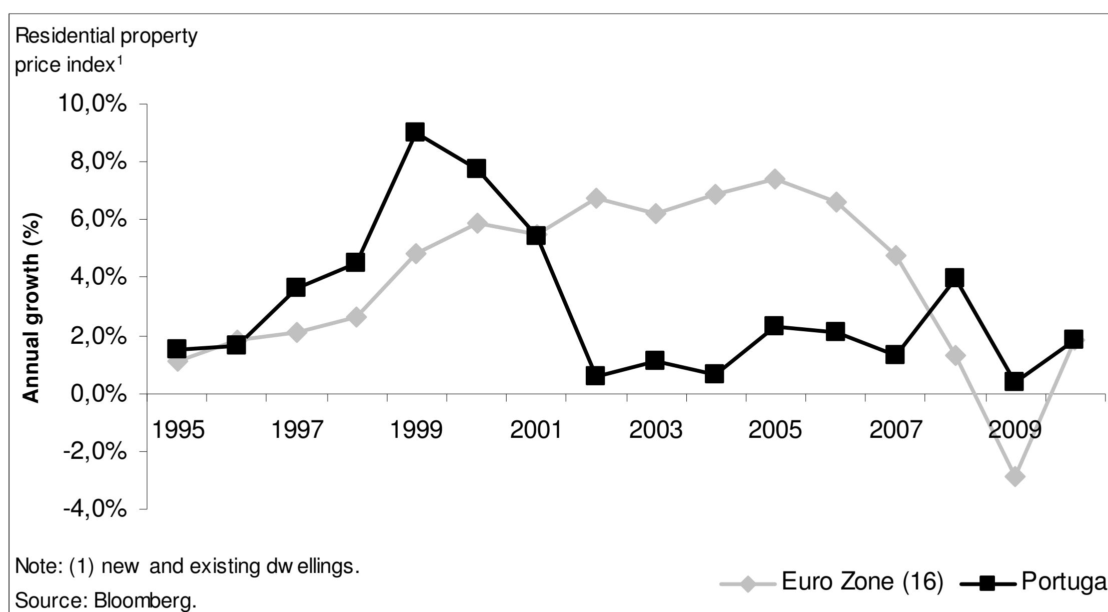

Figure 4 Residential Property Price Index, Portugal vs Eurozone 1995-2010

The resilience of the real estate sector was an important factor behind a better than expected performance of the Portuguese economy in 2008 for a number of reasons. First, negative spillover effects from this particular sector to other sectors, such as construction, were smaller than in other countries. Second, the banking sector did not have to deal with major downward revisions of the asset value of properties under mortgage contracts, as happened in other countries. Finally, confidence among Portuguese households was not shaken by a sudden loss of value of their major assets.

In order to perceive how prospects for the Portuguese economy evolved during the first two years of the GFC, Figure 5 shows the consecutive revisions of both the IMF and the Bank of Portugal forecasts for the Portuguese economy from October 2007 until the end of 2009.

	2008	2009	2010
IMF Oct 2007	2,0	2,2	2,2
BoP Winter 2007	2,0	2.3	-
IMF Apr 2008	1,3	1,4	2,2
BoP Summer 2008	1,2	1,3	-
IMF Oct 2008	0,6	0,1	1
BoP Winter 2008	0.3	-0,8	0,3
IMF Apr 2009	-0,5	-4,1	-0,5
BoP Summer 2009	-	-3,5	-0,6
IMF Oct 2009	-0,5	-3	0,4
BoP Winter 2009	-	-2,7	0,7

Source: IMF WEO database; Bank of Portugal BoP.

Figure 5 The evolution of forecasts for the Portuguese economy

In October 2007, two months after the subprime crisis manifested itself, the IMF forecasted that the Portuguese economy would growth at around 2 percent over the forecasting period (2008-10), and the revised outlook published in April 2008 presented only a slight downward revision of these projections. It was only on the last quarter of 2008 (October) that the IMF acknowledged that the Portuguese economy could face a standstill in 2009 and it took until April 2009 for a significant economic recession to be reported in the forecasts. By comparison, in October 2008 the IMF had already anticipated recessions in a number of advanced economies, namely in Iceland, Ireland, Italy, Spain and the United Kingdom.

In a nutshell, the Portuguese economy was slower than other economies to show clear signs of economic deterioration as two of the most important sources of the global contagion in this initial period (disruptions in the banking system and collapses in real estate sector) were less pronounced. Consequently, the domestic recognition of the real impacts of the crisis in the Portuguese economy lagged significantly behind other vulnerable nations such as Spain or Ireland.

Financial Sector Aid, Budgetary Reform and Discretionary Fiscal Stimulus

The Portuguese government was swift in responding to EU requests and took decisive actions in an extraordinary meeting held in the 12th and 13th of October, only four days after the Ecofin meeting of October the 7th in which European leaders established a course of action to deal with financial turbulences. Decisions by the Portuguese government included an increase of government guarantees on bank deposits from €25.000 to €100.000[ix] and a €20 billion facility to be used in guarantees to Portuguese banks.

In November 2008, in an environment of increasing surveillance of the banking sector's performance, the government decided to nationalize BPN, a medium size bank that was facing significant liquidity constraints and in which the Bank of Portugal had found a number of irregularities. Simultaneously, the government opened a €4 billion facility to buy preferential shares of financial institutions, in order to ensure that they would achieve minimum capital requirements.

Moreover, in the context of the European Economic Recovery Plan, the Portuguese government in December 2008 presented its own Investment and

Employment Initiative (IEI), which consisted of a plan to modernize secondary school buildings; boost economic activity and exports; raise social protection and employment and promote renewable energies and energy efficiency. The combined impact of these stimulatory measures on the public accounts was first estimated at €1.3 billion (or around 0.8 percent of GDP).

As the European Commission had recommended, these measures were designed to boost economic growth temporarily in order to avoid a deeper and more protracted recession in the country. Although meant to be temporary, some of these measures were maintained into 2010 and an important part of the fiscal stimulus was effectively deferred into that year.

In addition to discretionary fiscal stimulus prompted by the EU, there was an important fiscal impulse contained in the 2009 budget presented in parliament in October 2008. And this was where politics entered the scene. Anticipating elections by the end of 2009, the government agreed to a wage increase for civil servants of 2.9 percent at a time it was already aware the economy was stagnating. It was the first pay rise for public employees after several years of a salary freeze. The government also reduced the standard VAT tax rate by 1 percentage point in July 2009.

The combination of the EU-driven fiscal stimulus together with other discretionary policies, led to a significant increase in the public deficit. Apparently, the cyclical component of the budget balance in 2009, measuring the automatic stabilizing effect of the recession, only accounted for minus one percent of GDP, while the structural component accounted for -9.1 percent of GDP (see Figure 2 above). However, a more detailed analysis indicates that the state (mainly responsible for the general government deficit) had a revenue decline of 15 percent in 2009 and an expenditure rise of 6 percent suggesting that the cyclical (or non-discretionary) component of the budget balance should have been greater than one tenth. Nevertheless, a significant general government deficit of -10.1 percent, may have contributed to a less severe recession but it also escalated public debt in 2009.

At the end of 2009 the Socialist party again won the elections, but only with minority support in parliament. Although there was a political majority of left-wing parties in parliament, the fact that the Socialists refused to form a coalition with these parties, because they were far too distant on the ideological spectrum, led to a minority government with the same Socialist prime minister. A further political failure at this time was the inability or unwillingness of the Portuguese President of the Republic to

insist on a coalition government with majority support in parliament. Although Portugal is a parliamentary system the President retains some relevant powers, including the ability to dissolve the parliament in extraordinary circumstances. However, the President himself was running for re-election in about one year (January 2011) and did not want to create a political crisis by precipitating new general elections.

Box 2: A Simplified Chronology of the Main Disruptive Events of the Global Financial Crisis Together with the Main EU and Portuguese Responses [1]

Jul 2007 (GFC): First clear signs of disruptions in the subprime market

Feb 2008 (GFC): Rescue of Northern Rock (UK)

Mar 2008 (GFC): Rescue of Bear Stearns (US)

Sep 2008 (GFC): US government intervention in two major real estate agencies known as Fannie Mae and Freddie Mac (US)

: Investment bank Lehman Brothers (US) collapsed

: The take-over of AIG a worldwide insurance corporation (US)

: Several important banks and financial institutions have to be rescued in the aftermath of the Lehman collapse: in the US (Wachovia and Washington Mutual); in Europe (Fortis, Dexia and ABN-AMRO in Benelux; Bradford & Bingley in the UK; Hypo Real Estate in Germany; Glitnir, Landsbanki and Kaupthing in Iceland).

Oct 2008 (EU): ECB begins to loosen monetary policy in an unprecedented coordinated move with central banks from the US, UK, Sweden, Switzerland and Canada.

: Consecutive meetings of the Heads of State or Government of the EMU; Ecofin and the Council of Europe agree to: raise guaranties on deposits to a minimum of €50.000; provide guidance to deal with financial institutions' problems; and stress the flexibility of the GSP in exceptional circumstances.

Oct 2008 (PT): Portuguese Government increases the guarantees on deposits from €25.000 to €100.000 and set a €20 billion facility to be used in guarantees to banks.

Nov 2008 (EU): EU approves financial assistance to Hungary.

Nov 2008 (PT): Nationalization of BPN and provision of a €4 billion facility to buy preferential shares in order to reinforce the financial system's capital ratios.

Dec 2008 (EU): European Council approves the European Economic Recovery Plan (EERP) containing a fiscal stimulus of €200 billion (1.5% of GDP).

Dec 2008 (PT): Portuguese Government announces a fiscal stimulus package, the Investment and Employment Initiative, amounting to 0.8% of GDP (around €1.3 billion).

Jan 2009 (GFC): Nationalization of Anglo Irish (Ireland).

Feb 2009 (EU): EU approves financial assistance to Latvia.

Mar 2009 (EU): European Council re-evaluates the amount of the fiscal stimulus being pumped into the European economy to around € 400 billion (3% of GDP).

: EU approves financial assistance to Romania.

(1) Chart based mainly on information from the concise calendar of EU policy actions (page 57) of the report 'Economic Crisis in Europe: Causes, Consequences and Responses: European Economy, Nº7/2009'.

5. The Inevitability of the Bailout

Fiscal Developments up to the Budget 2011 (introduced in October 2010)

After the November 2009 elections, the Minister of Finance announced the need for a supplementary budget in order to allow for an increase net borrowing associated with an upward revision of the public deficit for 2009.

The budget, usually approved in December was only promulgated in April 2010, because of the late elections. This implied that for the first four months of the financial year, the budget was implemented with the same appropriations as the 2009 budget. This delayed the possibility of fiscal consolidation. Furthermore, with a minority government in office various active lobbies were pressing for expenditure increases, and becoming more successful in gaining concessions and favorable legislation. For instance, school teachers, the largest group of civil servants, opposed their model of performance assessment as too bureaucratic. They not only managed to change that model but also amend the career-path of teachers in a way that will see the wage bill increase. The autonomous regions of Azores and Madeira lobbied for a more favorable *Regional Finance Act* and were able to pass the bill in parliament, even against the will of the government and under threat from the Minister of Finance to resign. Means test procedures intended to better target social benefits were relaxed, and the opposition was successful in limiting the type of allowances subject to means testing, therefore reducing the selective impact of the rationing measures.

During the year 2010 the government presented successive measures trying to cope with the large deficit. In the middle of the year, the freeze on public sector salaries was continued and a new reduction in public managers' salaries was imposed (reduced by 5 percent); the government increased all VAT rates by a further one percentage point and, in the personal income tax scales, created an additional top bracket applying to high-earners.

Financial Markets Disturbances

The risk premium that investors required to invest in 10-year maturity Portuguese treasury bonds (compared to German ones) had been falling steadily since the EMU formation and was stable at very low levels before the crisis emerged. This risk

premium, or 'spread', began to widen as the global financial crisis deepened. This was a clear flight to quality move by financial institutions, which was expected to be reversed once risk aversion returned to normal levels, and, indeed, from April 2009 to the beginning of 2010 there was a significant correction to the risk premium, as financial markets regained some confidence. However, during 2010 the spread to the German bund started to rise again and in the end of the year this premium was more than seven times higher than in the end of the previous year as shown in Figure 6.

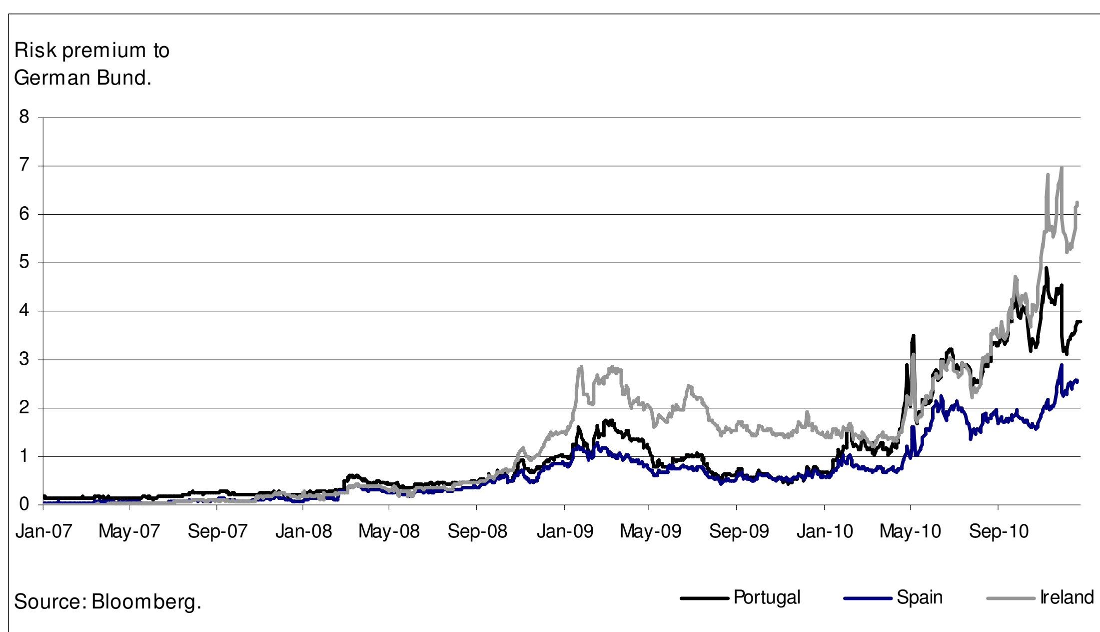

Figure 6. Risk Premium for Portuguese, Irish and Spanish ten year bonds

This widening of the risk premium on government debt markets was not exclusively Portuguese, as a similar movement happened in several other Eurozone countries and triggered the sovereign debt crisis that followed the GFC. Arguably, the main events triggering these severe increases in the Portuguese spread were related to Greece and Ireland bailouts, in May 2010 and November 2010 as Figure 6 indicates.

So, clearly, while the full impacts of the Eurozone debt crisis are yet to be revealed, its causes go well beyond the Portuguese situation. Here, however, the focus is solely on the impacts of this sovereign debt crisis to the Portuguese economy and in the fiscal response it ultimately triggered. One important point to bear in mind is that contrary to Portugal's relative resilience to the first shocks coming from the GFC, the sovereign debt crisis had an overwhelming effect in the Portuguese economy.

At the commencement of 2010, the Portuguese economy was starting to recover from the previous difficult year, with exports recovering at a faster pace than expected and public spending supporting investment and household incomes. Yet, high public and external debts and low growth prospects soon placed the country on the radar of the financial markets which pressured a steep deleveraging process. Soon Portuguese debt was spiraling out of control. The downward spiral was triggered by high risk premiums being charged for borrowings, which in turn significantly increased the costs to service public debt, that then amplified the doubts on the country's ability to keep up with its repayments (risk of default), which further increased the risk premium. It was a vicious circle amplified by constant downward reviews of the country's sovereign rating as Figure 7 indicates.

	Fitch	Moody's	Standard & Poor's
2010			
24-Mar	AA-	-	-
27-Apr	-	-	A-
5-May	-	Aa2	-
13-Jul	-	A1	-
30-Nov	-	-	A-
23-Dec	A+	-	-
2011			
15-Mar	-	A3	-
24-Mar	AA-	-	BBB
29-Mar	-	-	BBB-
1-Apr	BBB-	-	-
5-Apr	-	Baa1	-
5-Jul	-	Ba2	-

Source: Bloomberg

Figure 7 Calendar of sovereign debt negative reviews

Moreover, the erosion of market confidence was not confined to sovereign debt markets but affected the ability of Portuguese banks to secure finance in the marketplace, which immediately led to a shut-down in capital markets to Portuguese banks, making them ever more dependent of ECB funding as they were unable to restore their credibility in order to return with normal interbank market activity.

These financial developments triggered a complete somersault in Portugal's fiscal policy stance, as the government was pressed to remove the fiscal stimulus swiftly

and present a credible path of fiscal consolidation. The main events of this turmoil with effects on fiscal policy are described in Chart 3

Chart 3: Simplified chronology of the Portuguese way into the bailout[1]

Dec 2009: EU council opened excessive deficit procedures on a list of 8 countries, including Portugal.

Mar 2010 Approval of the 2010 budget.

May 2010 € 110 billion bailout to Greece and the establishment of the European Financial Stabilization Mechanism (EFSM); and the European Financial Stability Facility (EFSF).

May 2010 Deficit target for 2010 revised upwards to 7.3%.

A wide set of consolidation measures were announced.

Nov 2010 € 85 billion bailout to Ireland.

Nov 2010 Approval of the 2011 budget, including further consolidation measures were included in the 2011 budget.

Mar 2011 Additional consolidation measures presented in the informal meeting of Heads of State or Government of the EMU. These were then rejected in the Portuguese parliament and the Sócrates government resigned.

2010 deficit was revised upwards from 7.3% to 8.6% due to the inclusion of three State Owned Enterprises in the consolidation perimeter.

Apr 2011: Portugal requests a bailout – through the negotiation of an Economic Adjustment Program with the IMF/EC/ECB within the framework of the European Financial Stabilization Mechanism (EFSM).

2010 deficit was revised upwards from 8.6% to 9.1% due to the reclassification of several PPP contracts.

May 2011: The Portuguese government and the 'Troika' sign the Memorandum of Understanding that includes a financial package of €78 billion.

(2) Based mainly on information from the European Commission's report 'The Economic Adjustment Program of Portugal', DGEFA Occasional Paper Nº79, June 2011 (the sovereign debt crisis In Portugal – chronology of events page 15).

From the 2011 Budget to the Resignation of the Prime Minister

The 2011 budget, presented in October 2010, was the first budget with a clear fiscal consolidation objective. The new target for the 2011 deficit was reduced down from 7.3

percent of GDP to 4.6 percent (a fall of 2.7 percent on previous projections). The main consolidation measures included on the expenditure side were a progressive wage cut for civil servants with salaries above €1500 (their first ever salary cut in 37 years of democracy), and a reduction in social protection expenditures. In the revenue side, a reduction in tax benefits and an increase on the VAT normal rate from 21 to 23 percent were proposed.

Since the Socialists were in a minority government there were long budget negotiations with the major opposition party which eventually led to a formal agreement. It included the need to create an independent committee to analyze public-private partnerships, a commitment to reduce public expenditure and a lower reduction of tax benefits than that requested by the government.

March was the decisive month. On March 2nd the Prime Minister and the Minister of Finance went to Berlin for a private meeting with the German Chancellor Angela Merkel. The objective was to calm down capital markets and perhaps to talk about the austerity measures to include in the *Stability and Growth Program* (SGP) in exchange of a broad support from the *European Stability Mechanism* (ESM). The Prime Minister and the Minister of Finance decided to anticipate some strong austerity measures, which should be included later on in the Portuguese SGP. The objectives were twofold. On the one hand, the government sought to send signals to the markets that the country intended to succeed in fiscal consolidation and, on the other hand, to gain some bargaining influence at important EU meetings ahead.

On March 11th the government called a press conference and announced a large set of austerity measures. On the same day, without even consulting the President, the Prime Minister presented these measures at the Euro group meeting in Brussels. On the following day the leader of the main opposition party announced he would not support the so called 'SGP-IV'. On March 15th Moody's downgraded the sovereign debt rating of Portugal from A1 to A3. The government formally submitted the SGP to parliament on the 21st where it was opposed by all other non-government parties from the left and right. These parties moved a series of amendment motions against the SGP which were all approved with the combined votes of the opposition parties on the 23rd March, leading to the Prime Minister's resignation on the same day.

6. The New Fiscal Framework and the Memorandum (bailout)

Following the resignation of the Prime Minister, the President declared general elections for June 5th 2011. But two months was too much time for Portugal to languish with a caretaker government. There was a need to borrow in capital markets, and Portuguese bond yields were rising against German bonds. On 8th April the Eurogroup and ECOFIN ministers issued a statement, extending financial support to Portugal under a conditionality agreement (Memorandum of Understanding on Specific Economic Policy Conditionality – MoU). A €78 billion loan was agreed with an equal tripartite division between the IMF, the European Financial Stability Facility (EFSF) and the ESM. Although main negotiations were between the Portuguese minority government and the 'Troika' of the IMF, EC and ECB, the main opposition right-wing parties gave their formal agreement to the MoU. Notably, before the Prime Minister stepped down the rightist parties were against any further austerity measures (e.g. tax increases), but once he resigned, and even before general elections, they accepted everything they had opposed and even accepted further austerity measures. Such is politics!

The Introduction of a New Fiscal Framework

The lack of political cooperation was clear in that interim period (April-May) when a new and important change to the *Budget Framework Law* (LEO) was approved on April 6th with only the votes from the minority Socialist party. Nevertheless, it introduced an array of important changes. It established a relatively independent Council of Fiscal Policy (CFP), whose main functions were to develop its own macro-economic forecasts, to analyze the sustainability of public finances (including pensions), to verify whether the fiscal rules set by law were being violated or not, and to check whether the limits to indebtedness of regional and local governments were being surpassed or not. The LEO set fiscal rules not only for general government (including the structural balance) but also for central government and social security. With regional and local governments, since they have autonomy from the state budget limits, the LEO imposed limits only on indebtedness. It also stipulated that multi-year limits would apply to central government expenditure funded by general revenues with cascading limits to expenditure programs and groups of programs. The more ambitious task proposed by the LEO is the progressive implementation of zero-based budgeting not only across public administration, but also in public enterprises. Priority should be given, says the law, to

those programs which have deficits. The target of an almost balanced budget (adjusted for the cycle) should be achievable by 2015, and the annual SGP should update the consolidation path to reach that objective. The LEO also lays out the general chronology of the budget process, starting precisely with the presentation of the multi-annual SGP.

Memorandum, Consolidation Path and Main Measures to Reduce the Deficit

The bailout of May 2011 (MoU) has to date been mostly implemented by the new government with majority support in parliament that emerged from the legislative elections of June 5th. As an overarching consolidation document, it has a detailed, quantified and time-specified set of measures to be taken by the Portuguese government. Objectives are set by quarter, and after each quarter there is an assessment of the progress done. The measures included in the initial memorandum were very broad, including: (i) fiscal policy and fiscal structural measures; (ii) financial sector regulation and supervision; (iii) labor market and education; (iv) markets of goods and services (energy, telecommunications, transport); (v) the housing market; and (vi) the judicial system. Focusing on the first type of measures the MoU set a consolidation path until 2013 where the deficit should be no more than 5.9 percent of GDP in 2011, 4.5 percent in 2012, and 3 percent in 2013. The main measures directed to fiscal consolidation were the following:

i) Privatizations of public sector enterprises: energy producers, flight companies, the post office, etc.
ii) Targeted expenditure rationing: (e.g. a decrease in pensions above 1500 euros plus savings on health expenditures). In 2012 and 2013 a freeze has been imposed on recruitment, promotions and wages for the public sector. Transfers to local and regional governments have been reduced and controls over the expenditures of state-owned enterprises tightened. Capital expenditures have been trimmed and are to be funded mainly by own revenue sources or from increase European funding.
iii) Targeted revenue measures include: a revision of the list of goods and services subject to reduced VAT rates, increase revenues from personal income tax (increased marginal tax rates and reduced tax benefits)and corporate income tax (ending the reduced rate for small enterprises).

The idea behind the Memorandum was also to introduce measures that would increase competitiveness in the long-run. Among these more structural measures, mainly targeted at reducing rigidities in housing and labor markets, is a significant decrease in the employers' contribution to social security.

Although the austerity program was designed to curb some of the most important structural problems over the long-run (to improve internal efficiencies and liberalize sectors), there were some one-off measures (e.g. privatizations) that will have a short-run impact on reducing debt, but on the other hand reducing the assets of the public sector that in some cases generated dividends (a public revenue). Other measures that the government adopted in 2011 to help achieve the deficit target of 5.9 percent of GDP had an immediate impact on the deficit, such as the incorporation of pension funds in the banking sector into social security accounts, but created an implicit debt. In fact this incorporation of these pension funds was an important one-off revenue boost in 2011 but increased government liabilities in the future.

7. Conclusions

Portugal's problems with its public finances are closely connected with the level of external debt and the lack of competitiveness of the economy. In some part, the present difficulties arose from Portugal's past structural mismanagement of public finances, in particular in phases two and three of the EMU. The tolerance of a poor commitment to fiscal discipline and an overvalued currency (the euro) created major challenges both to the Portuguese economy and to fiscal policy.

The analysis of this paper has emphasized the shortcomings of the proximate institutional framework (at the international, European and domestic levels) that served to impinge on the nature, design and speed of fiscal policy as a response to the GFC. Insofar as European institutions are concerned, the Portuguese case is illustrative of how monitoring from the European Commission and European Council appears to have been flawed. They were slow in anticipating the scope of the GFC and its impact on Portugal, perhaps partly due initially to the smaller impact of the crisis on the banking system and the real state sector compared to other countries. The initial targets of the early version of the SGP were limited because they essentially focused on the public deficit and largely neglected the public debt. These institutions failed to take account of the debt of

public corporations which, at some stage may be outside general government ('off-budget'), but in a further moment can be included and therefore deteriorate the public finances of particular countries.[x] Moreover, the Ministry of Finance, and the National Audit Court did not gave due relevance to public corporations' debt.

These monitoring and informational failures are not an excuse for not acknowledging the Portuguese government's mismanagement of public finances. Political instability and inherent weaknesses of the domestic political system helped paralyze responses and reforms. Portugal poor record in its economic and fiscal policy settings was related to the specific characteristics of the political system, in particular lack of political competition, difficulty of making coalitions (and majority governments) and absence of independent institutions to scrutinize fiscal policy. Moreover, a constant turnover of governments, many in minority status, did not help the nation's plight. So, before the crisis hit, instead of benefitting from decreasing interest rates in order to have increasing primary surpluses and decreased levels of public debt, governments used these savings to deteriorate their primary balances. They formally abided with the Maastricht budget deficit criteria by counting windfall or extraordinary revenues (e.g. third generation mobile licenses) rather than taking structural consolidation measures. Political failure and policy timidity exacerbated the eventual impact of the GFC and sovereign debt crisis.

The implementation of the "troika" program has had some achievements in what concerns the fiscal framework and Portugal has benefited from successive positive evaluations from the EC/ECB/IMF.[xi] Public deficit in 2011 should have decreased to 4,2% of GDP below the target in the MoU, although with one-off extraordinary revenues. The independent Council for Public Finances is now set up, although still lacking human resources. Some major privatizations were done with success. A program for restructuring of public corporations in the transport sector (responsible for the major part of the public corporations' debt) is starting to be implemented. All public finance data, is monthly delivered by the Ministry of Finance and available online in Portuguese and in English. In the 2012 budget, and for the first time, are included all public corporations which are considered within public administrations (because they are non market corporations). In one year the change in the fiscal framework has been impressive. The government also took some ambitious and controversial measures in the budget for 2012 announcing severe cuts in bonuses for both civil servants and pensioners, to which the main opposition party has abstained.[xii]

However, there are still some threats. The ratio of debt to GDP at the end of 2011 is high (107,8%[xiii]) and still increasing, and so is the unemployment rate (15,5%). The recession in 2012 is predicted to be higher (around 3,2%) than expected by the government in the Budget (2,8%) and the deficit target (4,5%) seems not to be achieved without some sort of one off measures given the fall in tax revenues, particularly from the Value Added Tax.[xiv] Achieving the deficit target for 2013 (3% of GDP) would require a deep fiscal consolidation policy with increasing taxes and further expenditure cuts which would have more negative effects on growth, unemployment and social cohesion. An alternative and more realistic strategy would be to shift one year the consolidation path. In any case, the real future challenge is to achieve sustainable economic growth.[xv]

What lies ahead is uncertain. Currently, the viability of the euro project is under scrutiny. It is not just Greece, Ireland, Portugal and Cyprus but also Spain and Italy which are under the pressure of the markets. The solution to the euro crisis has to be global, and the ECB, directly or indirectly, has to give guarantees that it will not allow that bond yields will surpass some target value, particularly for all the countries which are abiding with a reform of their institutions and following a consolidation path. The future of Portugal is integrally connected with the future of the EU and the solutions to be found in the euro area. These are not only financial but also and mainly connected with economic growth. Here, there are some ongoing worrying concerns which are related mainly to the inability of nations such as Portugal to undertake a fiscal devaluation within the Eurozone. At present such a policy does not appear a viable option and this could retard the nation's ability to increase its competitiveness and build economic growth after enduring the present period of fiscal austerity and recession. And, yet, there are some positive news. In Portugal, the government has an absolute majority in Parliament and enjoyed a larger consensus around the necessity to implement carefully the consolidation program. The parties that signed the agreement consist of about 80 percent of the members of parliament, although the actual majority supporting the government is smaller. This shows that there has been a wide political support for the fiscal consolidation program. However, there is neither a long run binding agreement between the three major parties on a consolidation path, nor much dialogue between them on the implementation of the consolidation program and the institutional and constitutional reforms needed to address the problems identified in this

paper. Such dialogue, cooperation and compromises seem critical to give sustainability and to guarantee the success of present reforms.

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[i] In the European System of Accounts (ESA), General Government (S13) is divided in Central Government (S1311), State Government (S1312), Local Governments (S1313) and Social Security (S1314). It is paradoxical that the Regional and Local governments are mixed up in S1313, when the Autonomous Regions have more tax powers and revenues than many States in federations (e.g. the German Lander) classified under S1312.

[ii] Litigation on this issue (Municipality of Funchal/Madeira vs. Ministry of Finance and Public Administration) reached the Supreme Administrative Court. The source of the litigation is a weird norm in the Constitution which is against the theory of fiscal federalism that states that certain regions (Azores and Madeira) have the right to all fiscal revenues generated in the territory. Moreover, municipalities have a share up to 5% of personal income tax yields generated in the territory. The dispute is where do these 5% come from: the regional government's budget or central government's budget? The decision (see *Supremo Tribunal Administrativo* (2012) based on a previous decision of *Tribunal Constitucional* (2008)) was in favour of the Ministry of Finance.

[iii] To understand why the Portuguese ballot structure is closed and gives very few freedom for voters to choose candidates see Pereira, P. and Silva, J. A. (2009).

[iv] See Eurostat (2010) to understand when hospitals may be considered public corporations outside general government and also the meaning of several financial operations between hospitals and general government.

[v] The primary balance adjusted for the cycle decreased 2,7 percentage points between 1995 and 2000 which exactly offsets the benefits of decreasing interests.

[vi] A good analysis of this shift "from boom to slump" can be found in Blanchard (2007). The discussion on the dilemmas of the Portuguese economy and the policy options available, are still of current interest.

[vii] The TED Spread measures the difference between what the market asks for lending to the banking sector and to the government for 3 months loans.

[viii] The practical impact of the fiscal stimulus was apparently small (see Afonso, A et al. (2010) and ECB 2010).

[ix] EU leaders had set the minimum guaranteed threshold in €50.000.

[x] This happened in 2011 when the Eurostat and the INE (European and Portuguese statistical authorities, respectively) have reclassified several public corporations and included them in general government.

[xi] There are quarterly evaluations and up to the 4th assessment, the overall appreciation was positive. We can anticipate that the 5th assessment (August 2012) will be much more cautious given the likelyhood that the deficit target cannot be achieved without some sort of extraordinary measures given the evolution of tax revenues, well below what was predicted in the State Budget.

[xii] These cuts go beyond the agreement with the 'Troika', and a group of Members of Parliament has approved to send the 2012 Budget to the Constitutional Court (CC) in order to appreciate whether these measures violate the Constitution and the Court has decided that it violates the Constitution (see Tribunal Constitucional 2012). However, the Budget will be enacted until there is a decision, which will not happen within the next four or five months.

[xiii] This value compares with 162% (Greece), 120% (Italy), 97,2% (Belgium) and 85,4% (France), data taken from AMECO in January 2012. The value for Portugal is more accurate than the one presented in AMECO, because it considers more updated information on public debt (European Commission 2012). The European Commission forecasts a maximum of this ratio of 118,6% of GDP in 2013 assuming no slippery on deficit targets.

[xiv] One of the authors has a monthly prediction of the annual deficit in national accounts for a national newspaper (*Público*). The July 2012 prediction is 5% of GDP without additional one off or other extraordinary measures. This target is achieved mainly with the two measures referred to earlier (the cuts of Summer and Christmas' bonuses of civil servants and pensioners) that cannot be replicated in the 2013 Budget.

[xv] The OECD (2012) predicts recessions in 2012 and 2013 of 3,2% and 0,9 respectively.