MINISTÉRIO DAS FINANÇAS

Portugal: policies, achievements and challenges

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CIMB, Geneva
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Outline

1. On the way to become the difficult Portuguese case

2. The Economic Adjustment Program

3. Fiscal consolidation

4. Deleveraging and financial stability

5. Structural transformation

6. Conclusion: how will it work?

ON THE WAY TO BECOME THE DIFFICULT PORTUGUESE CASE

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

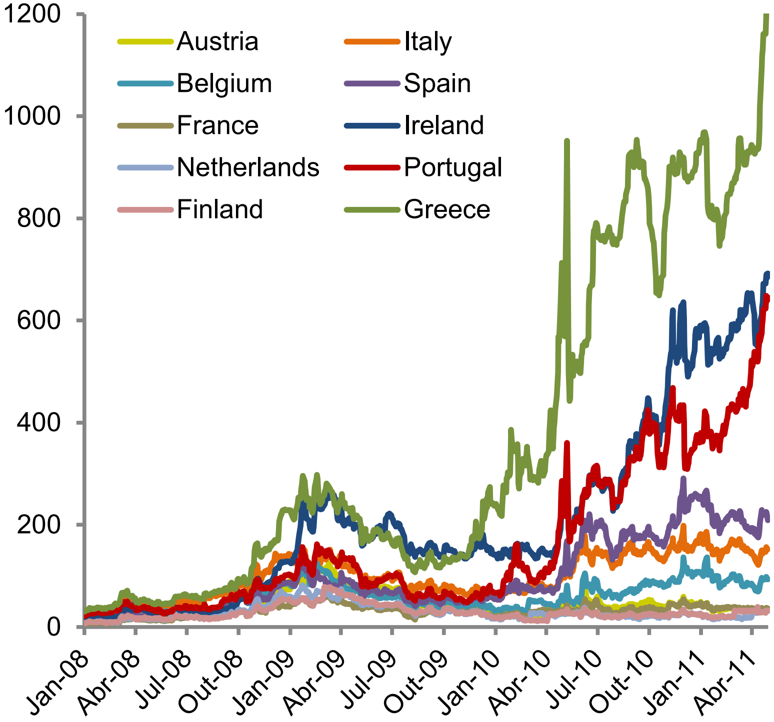
Macro-economic imbalances and structural weaknesses that have been accumulated over more than a decade

1. Unsustainable public finances

2. Over-indebtedness

3. Anemic economic growth and low productivity

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



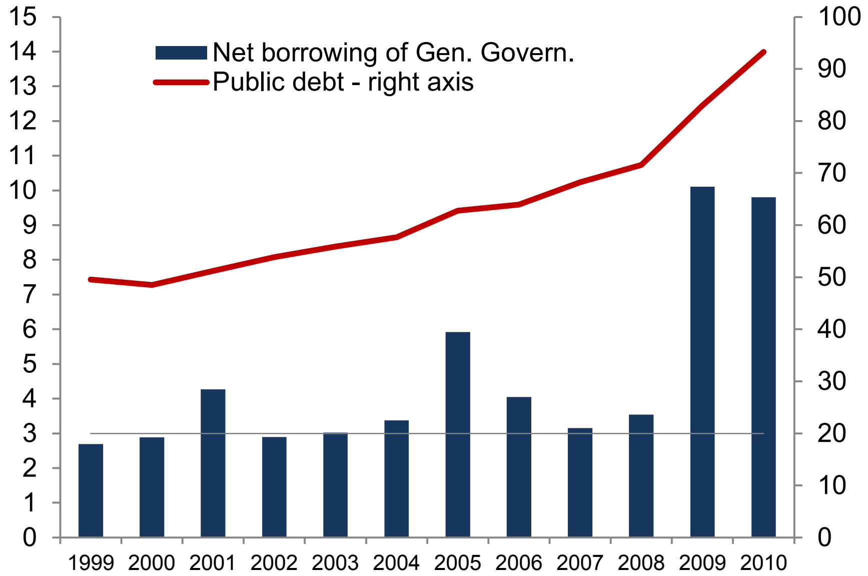
Source: Bloomberg

Unsustainable public finances

Persistent government deficits and increasing public debt

Deficit and public debt

As a percentage of GDP

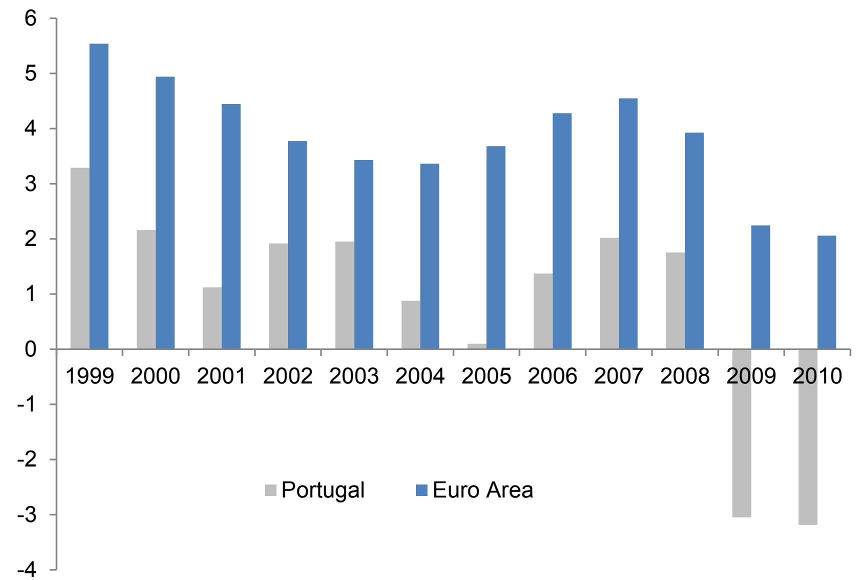


Source: INE, Bank of Portugal and Ministry of Finance

Fragile public finances

Structural Current Primary Balance

As a percentage of GDP



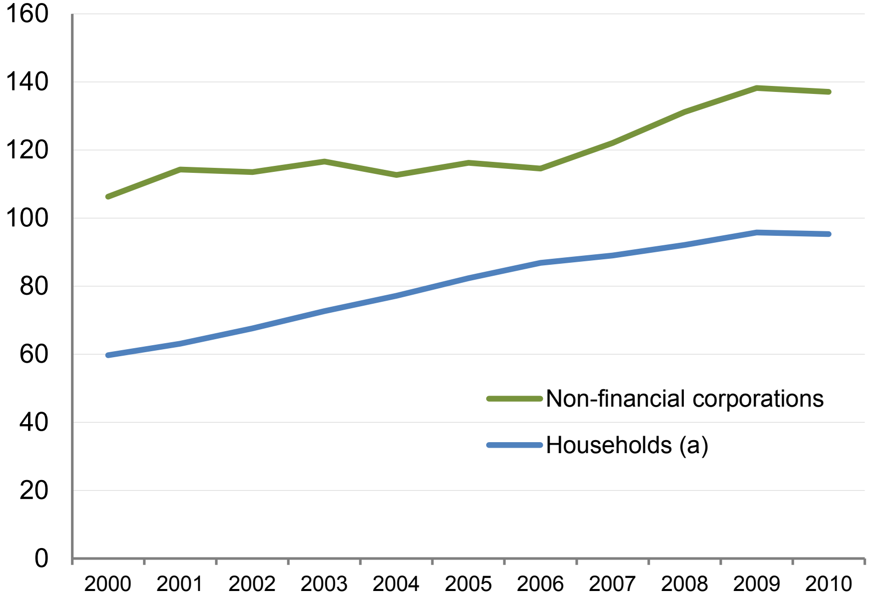
Source: AMECO and Ministry of Finance

Over indebtedness

Increasing indebtedness of the private sector

Debt of the Households and Non-financial Corporations

As a percentage of GDP



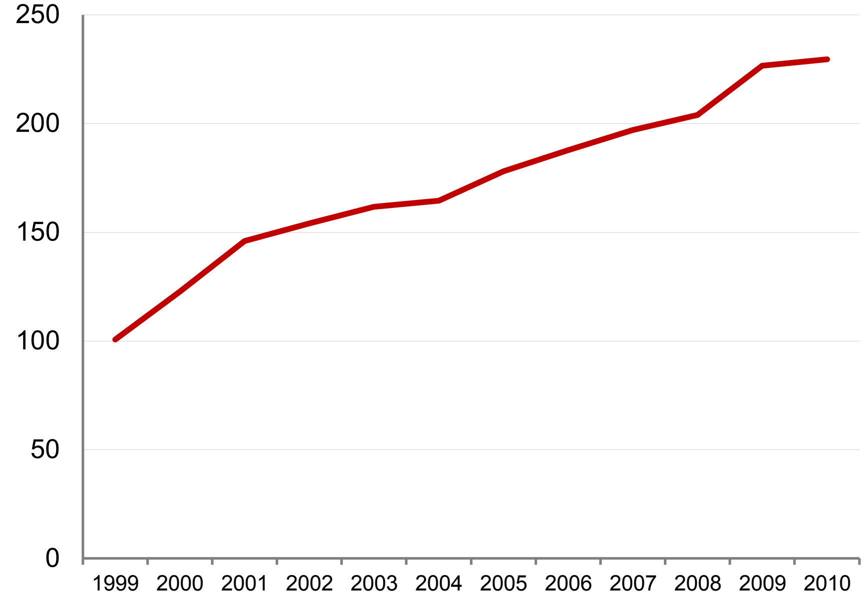
(*) Financial Debt

Source: Bank of Portugal

Increasing external debt

Portuguese gross external debt

As a percentage of GDP



Source: Bank of Portugal

Insufficient conditions to foster economic growth

Obstacles

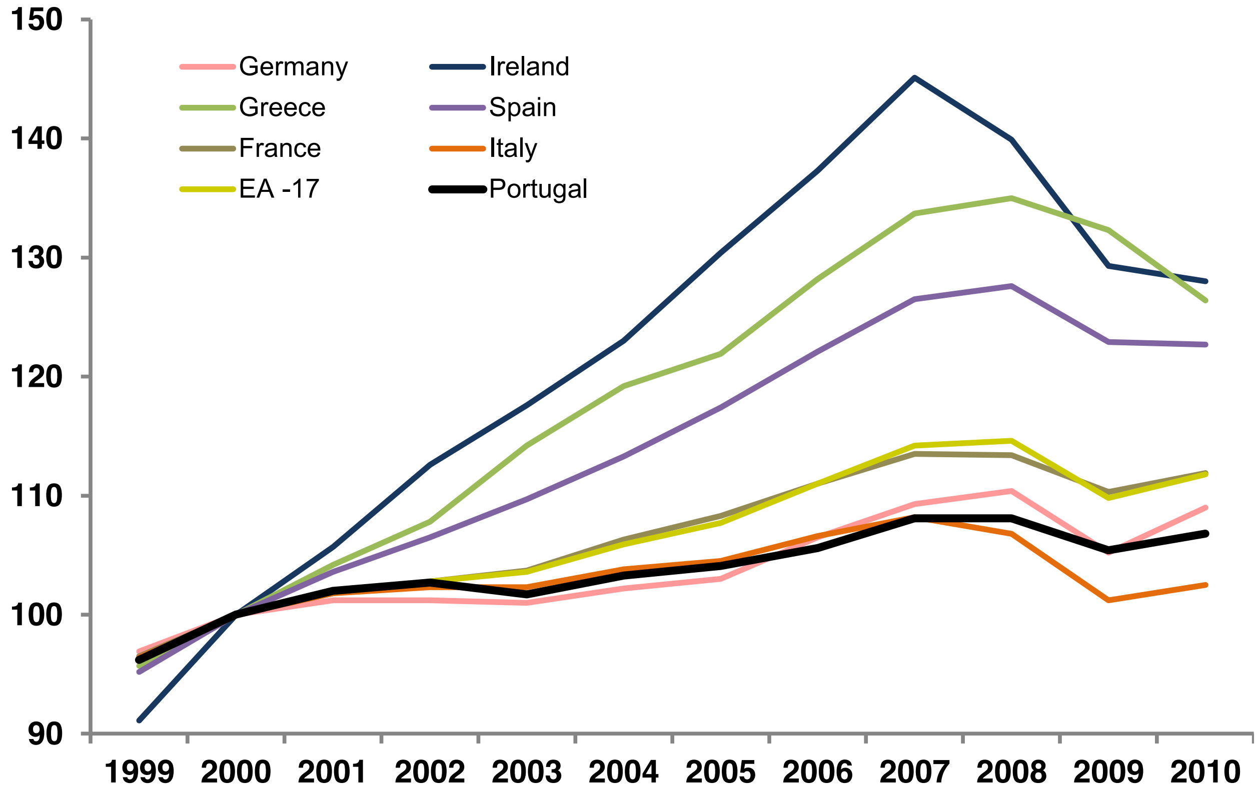
- Restrictions on the market for corporate control
- Protection of several sectors of the economy
- Weak conditions to entrepreneurial activity
- Poor functioning of the justice system
- Rigidity of the labor market

Consequences

- Insufficient attraction of direct foreign investment
- Capital accumulation in non-tradable goods and services sectors
- Lack of competition in several sectors
- Low levels of innovation and productivity growth
- High levels of youth and long-term unemployment

Disappointing performance of the Portuguese economy

GDP – Portugal and some of its European partners
2000 = 100



In the period 1999-2010, the GDP of **Portugal grew at an annual average rate of 1%**, compared with **1.4% in the euro area**

Source: Eurostat

THE ECONOMIC ADJUSTMENT PROGRAM

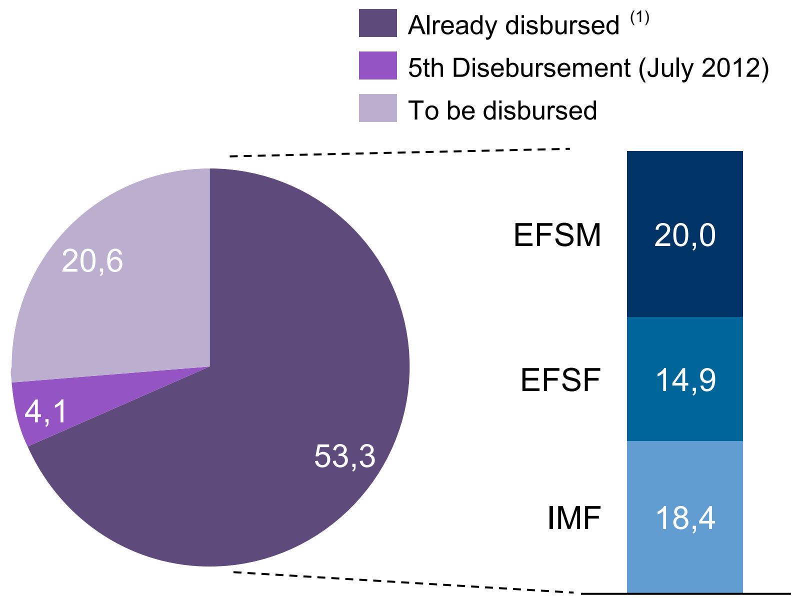
Adjustment Program agreed with the IMF, EC and ECB in April 2011

Key facts

- The Economic Adjustment Program covers the financing needs of General Government for the **period 2011 to mid-2014.**
- It comprises a financial package amounting to **EUR 78 billion in loans**, including EUR 12 billion for banking sector recapitalization.
- Each disbursement depends on the technical mission's **quarterly assessment about Portugal's performance** on the implementation of the Adjustment Program.

Financial package

EUR Billions



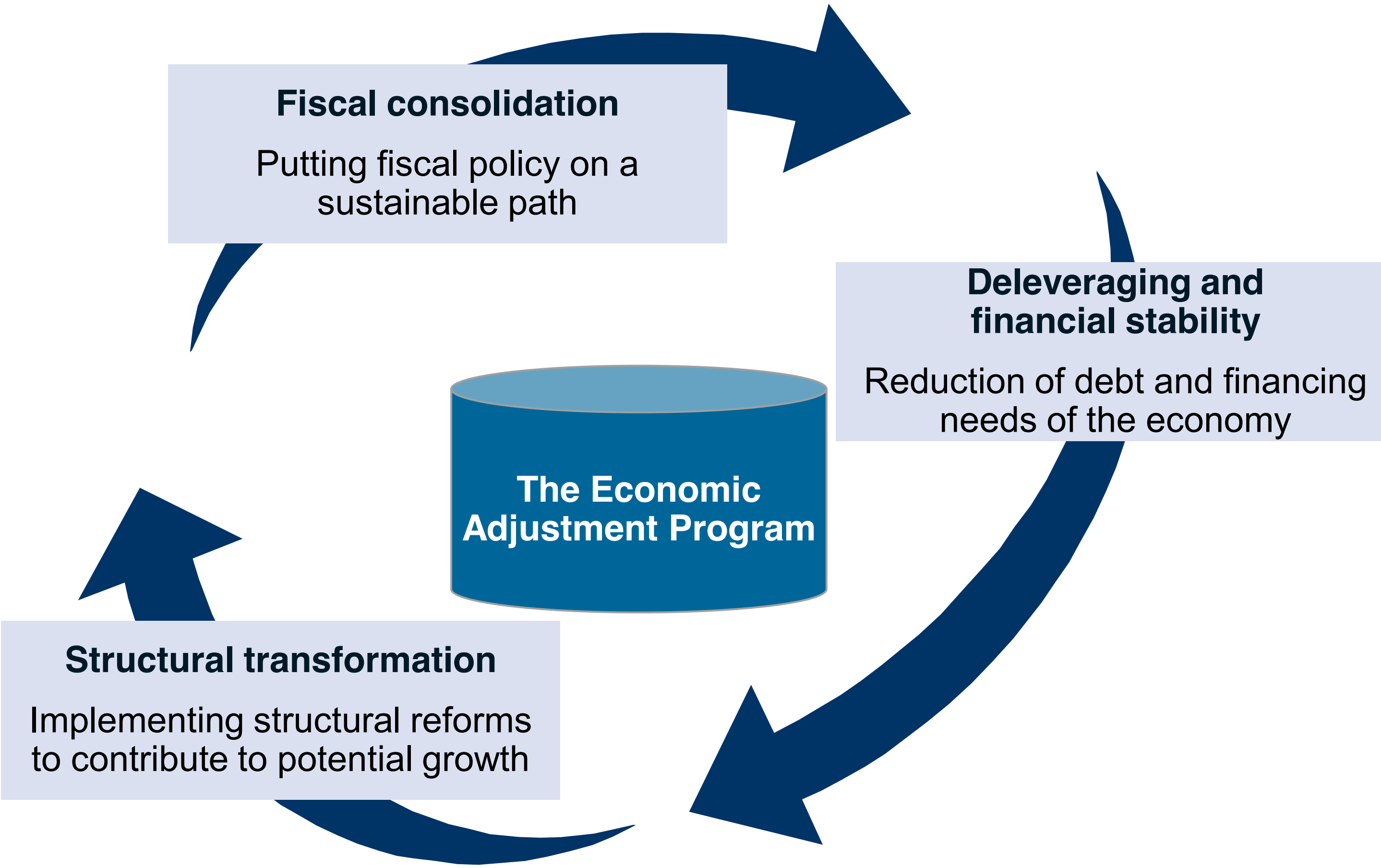
(1) Net issuances

Source: IGCP, May 2012

After the 4th **Review** (completed in June 4) the program implementation was ***on track***

Statement by the EC, ECB and IMF on the Fourth Review Mission to Portugal: http://www.imf.org/external/np/sec/pr/2012/pr12203.htm

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.**

Main macroeconomic indicators

4th Review, June 2012

	2011	2012	2013
GDP and components (in real terms, %)			
GDP	-1,6	-3,0	0,2
Private Consumption	-3,9	-6,0	-0,5
Public Consumption	-3,9	-3,2	-2,6
Investment (GFCF)	-11,4	-12,2	-0,5
Exports of goods and services	7,4	3,5	3,5
Imports of goods and services	-5,5	-6,2	0,9
Prices (%)			
HICP	3,6	2,7	1,1
Current and Capital Account (% GDP)			
Current Account	-6,4	-3,9	-3,4
Current plus Capital Account	-5,2	-2,7	-2,2
Labor market (%)			
Unemployment rate	12,7	15,5	15,9
Fiscal accounts (% GDP)			
Budget balance	-4,2	-4,5	-3,0
Public debt	107,8	114,4	118,6

Source: Ministry of Finance, June 2012

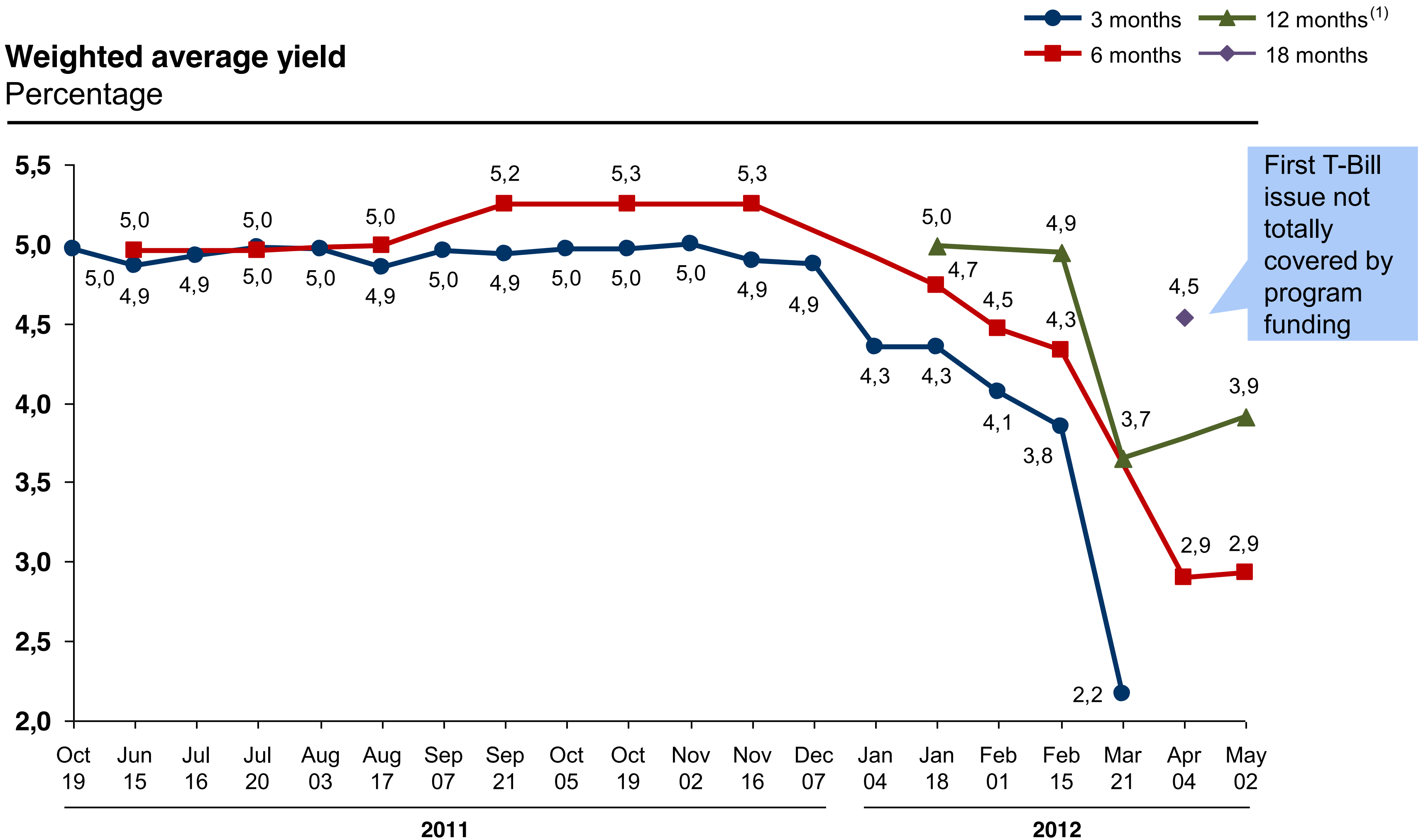
Reducing uncertainty: Portugal is delivering in all fronts

At the start of the Program (in May 2011), Portugal faced **a very uncertain outlook**

	Main risks	Major outcomes
1	Weakening of political support for the Program	▪ Broad political consensus ▪ Social support to the Program
2	Unfavorable macro-economic developments	▪ Milder recession than expected ▪ Stronger than expected external adjustment ▪ Dynamic exports
3	Missing the fiscal targets	▪ Major reduction in overall and structural deficits ▪ Progress in institutional reforms
4	Uncertainty regarding the stability of the financial sector	▪ Increase in banks' capital ▪ Reduction of credit-to-deposit ratio ▪ Increase in transparency: on-site inspections
5	Insufficient pace of structural reforms	▪ Success of privatizations process ▪ Labor market tripartite agreement ▪ Broad range of implemented measures

A turning point in Treasury financing

Portuguese Treasury Bills



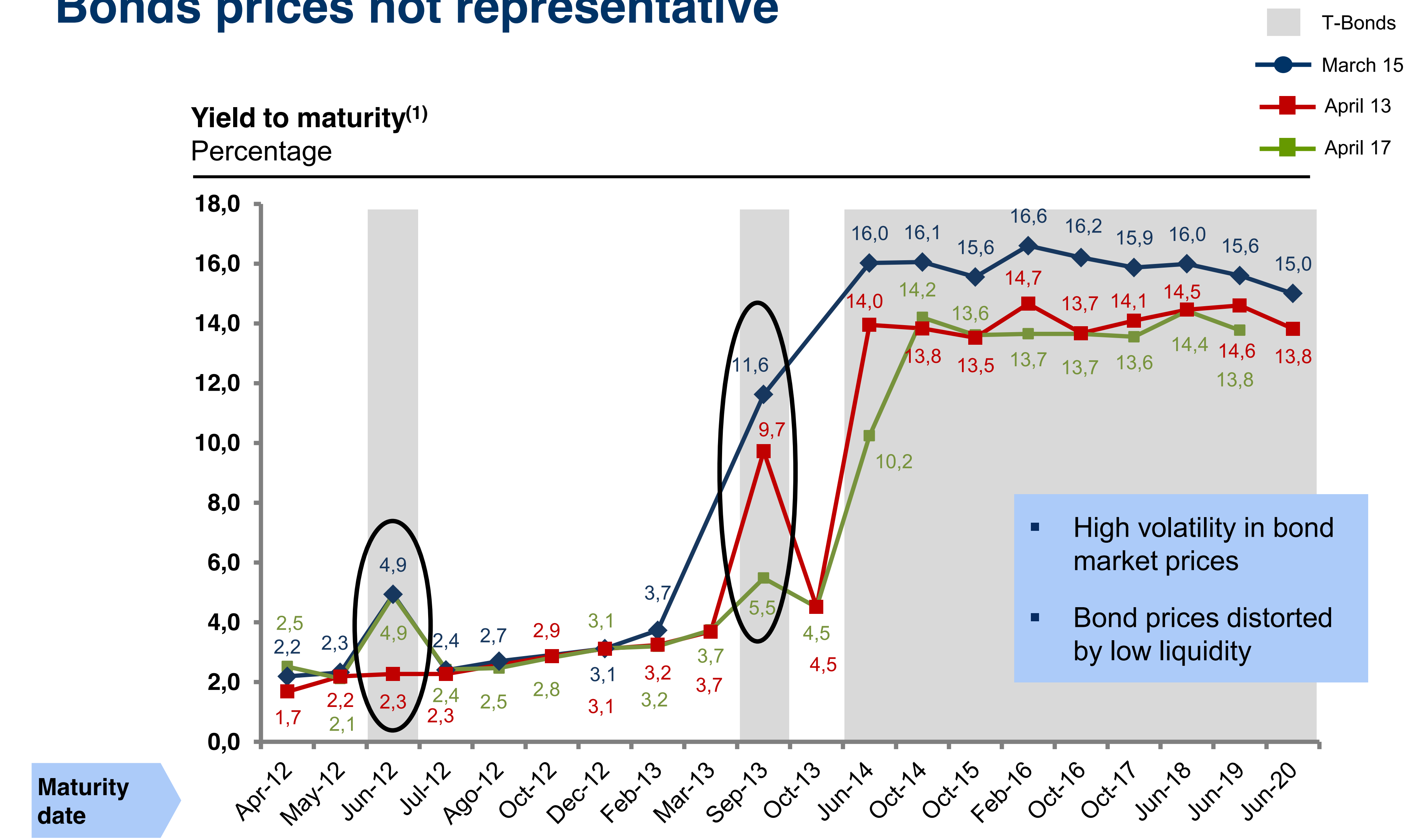
(1) The first auction maturity is 11 months

Note: Auction announcement date

Source: IGCP

Bonds prices not representative

Yield to maturity(1)
Percentage



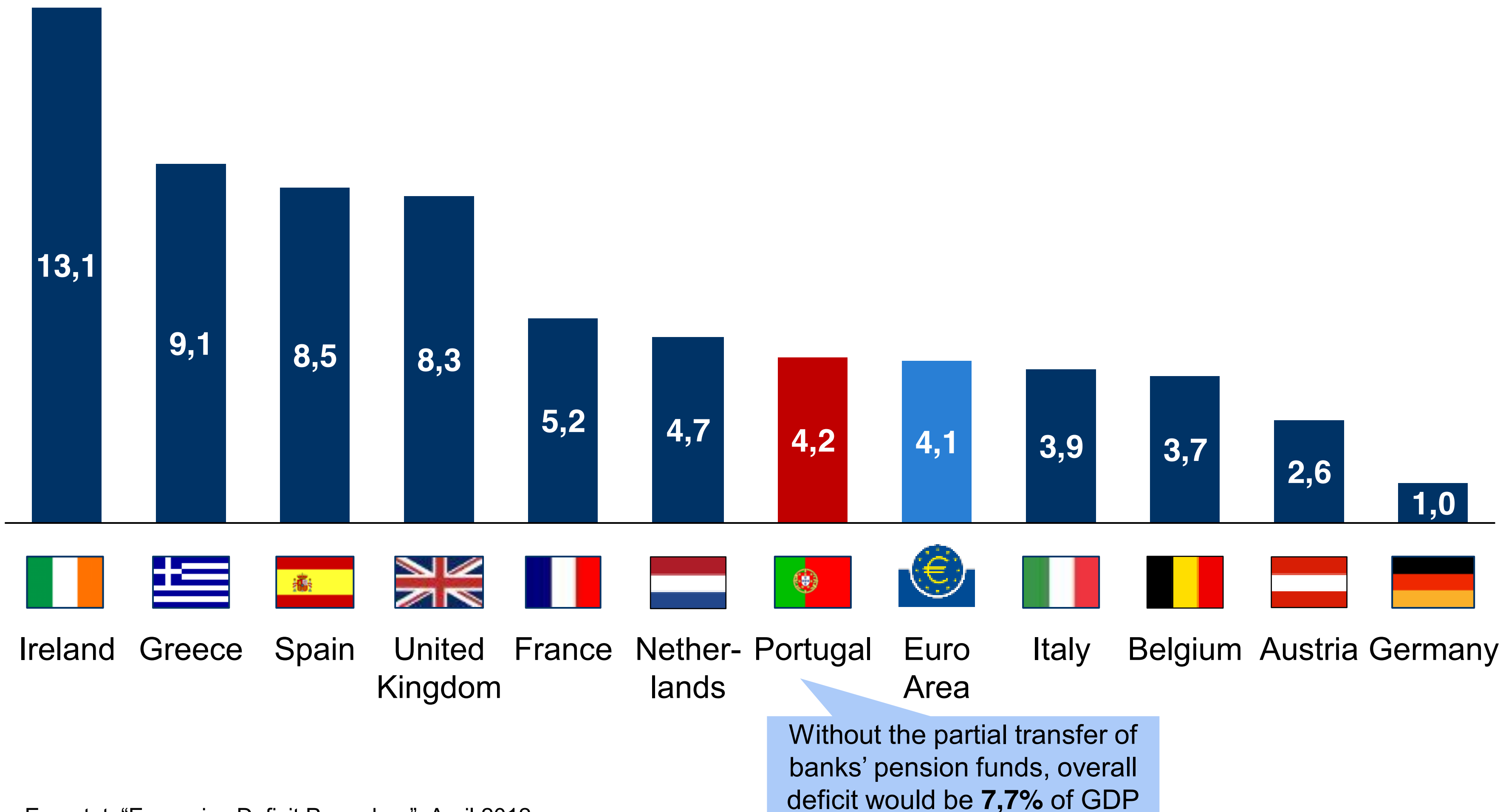
- High volatility in bond market prices
- Bond prices distorted by low liquidity

(1) Intra-day quotes
Source: IGCP

FISCAL CONSOLIDATION

Overall deficit in 2011 close to euro area average

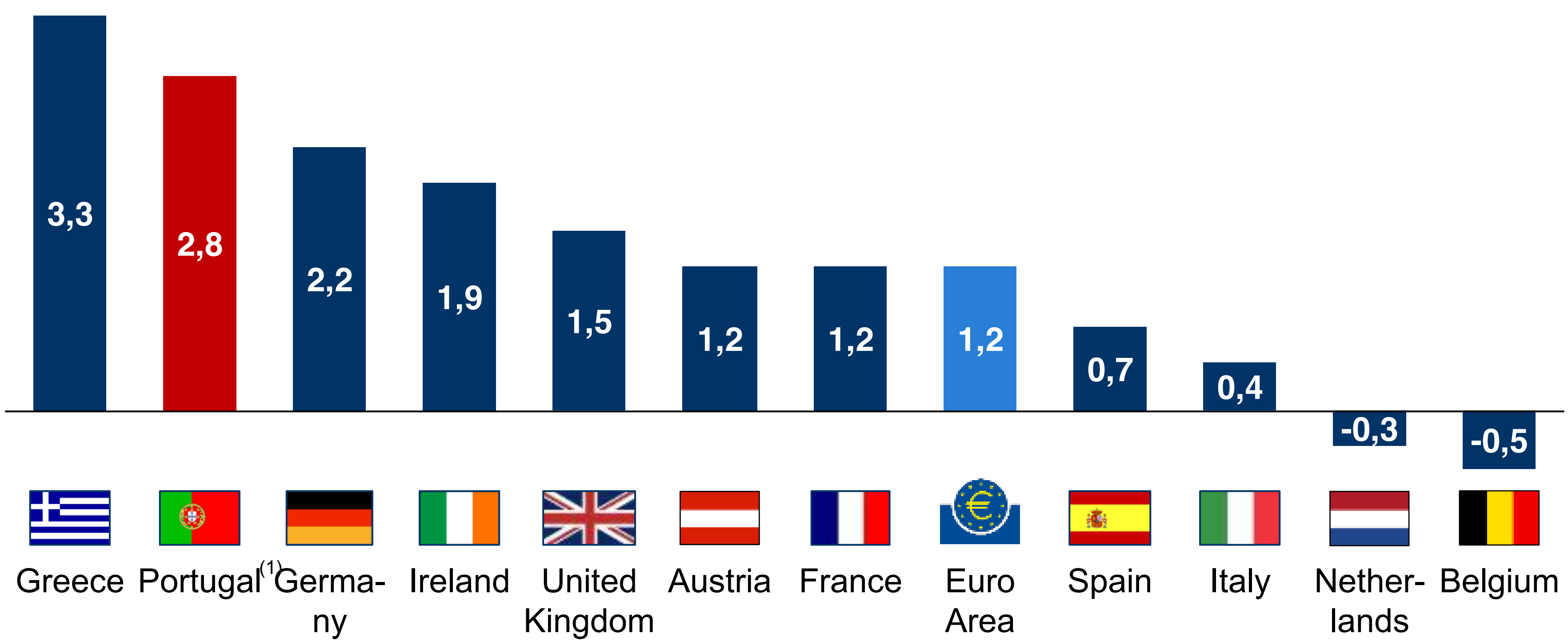
General Government Deficit 2011
As percentage of GDP



Source: Eurostat, "Excessive Deficit Procedure", April 2012

Portugal's fiscal adjustment was sizable in 2011…

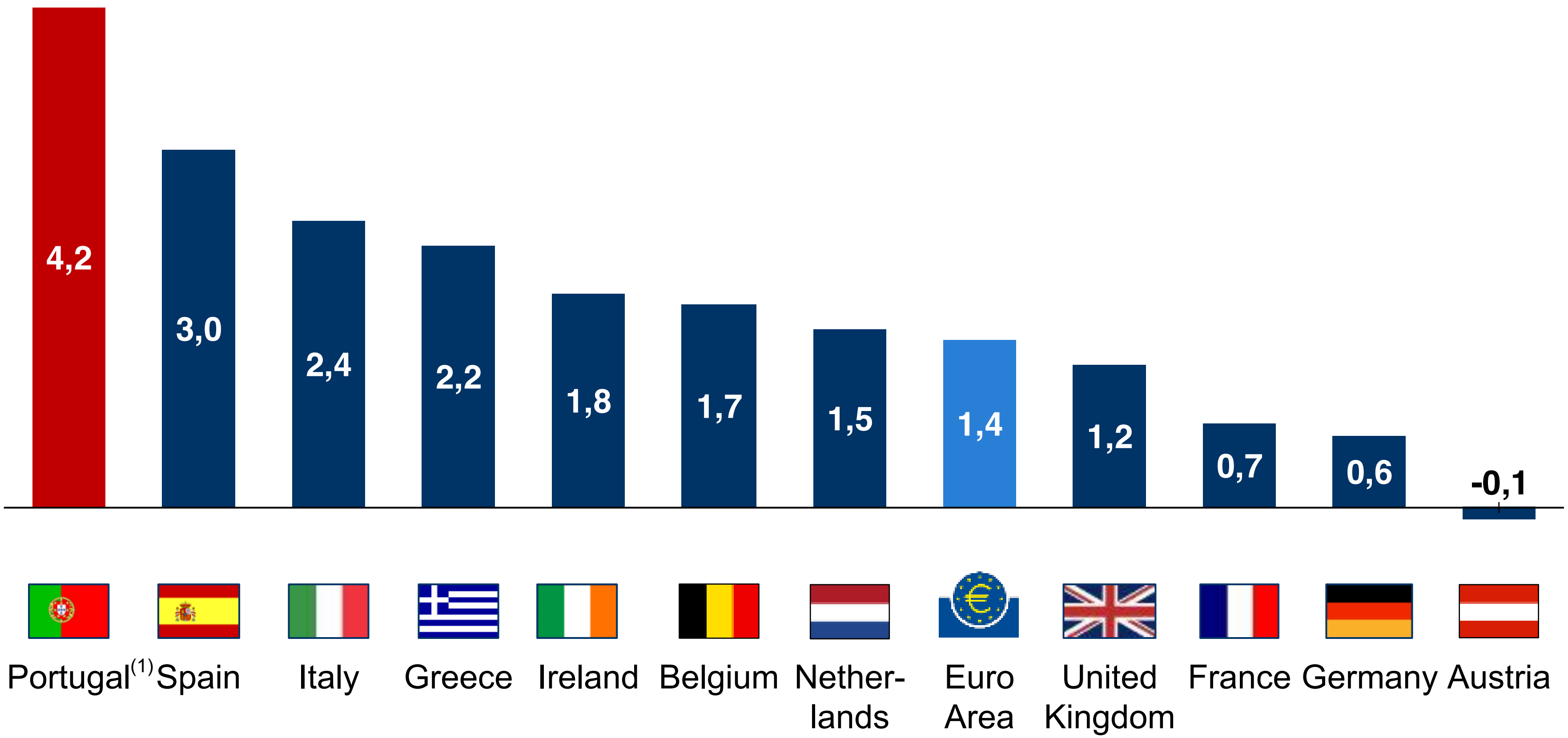
Fiscal Adjustment 2010-2011
Change in general government cyclically adjusted overall balance
Percentage points of GDP



(1) Portugal cyclically adjusted deficit in corrected for the transfer of banks' pension funds (3,5% of GDP)
Source: IMF, "Fiscal Monitor", April 2012

… and will be stronger in 2012

Fiscal Adjustment 2011-2012
Change in general government cyclically adjusted overall balance
Percentage points of GDP

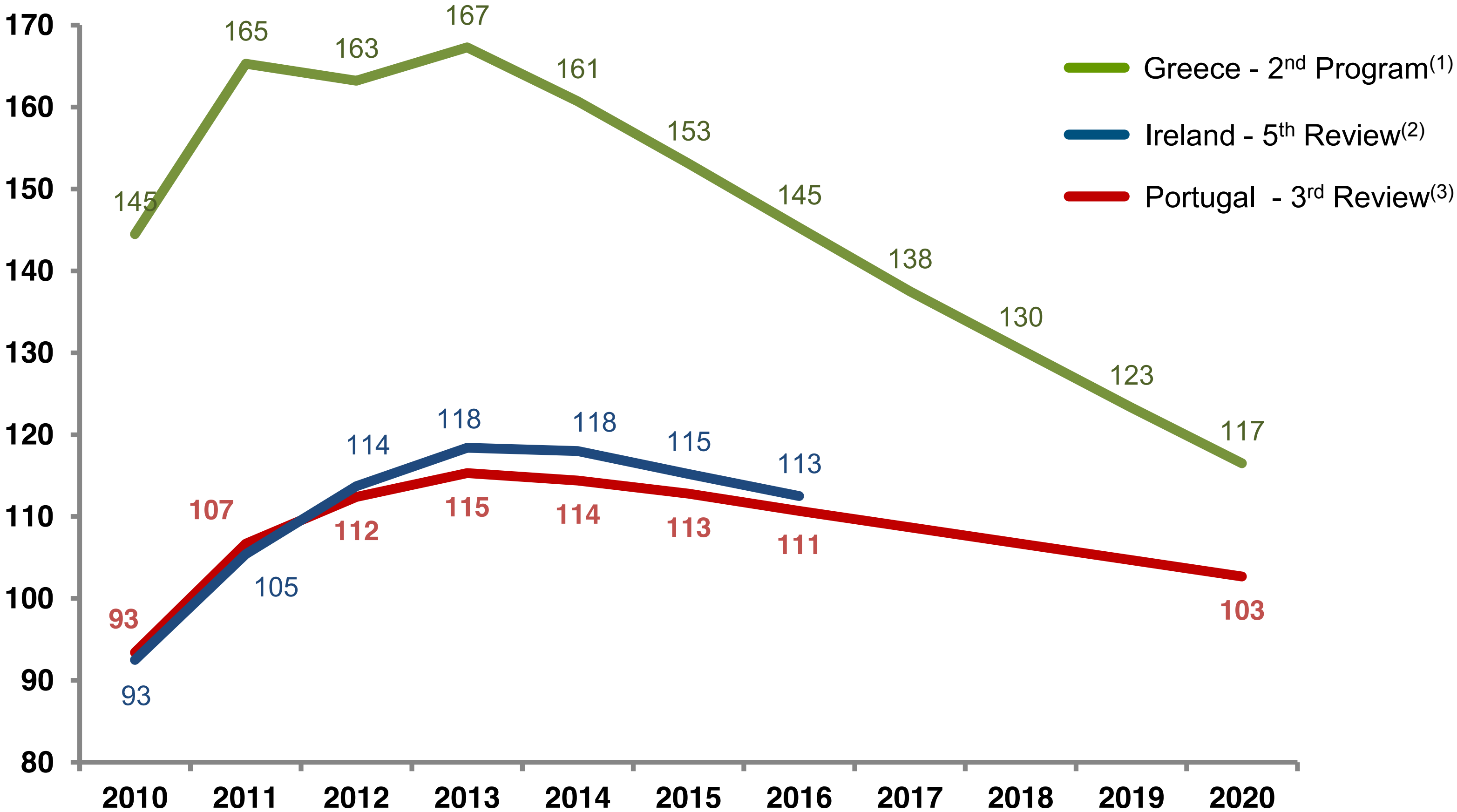


(1) Portugal cyclically adjusted deficit in 2011 corrected for the transfer of banks' pension funds (3,5% of GDP)
Source: IMF, "Fiscal Monitor", April 2012

Portuguese public debt is sustainable…

Feb-Mar 2012 projections

Government Debt Sustainability Framework: Baseline
As percentage of GDP

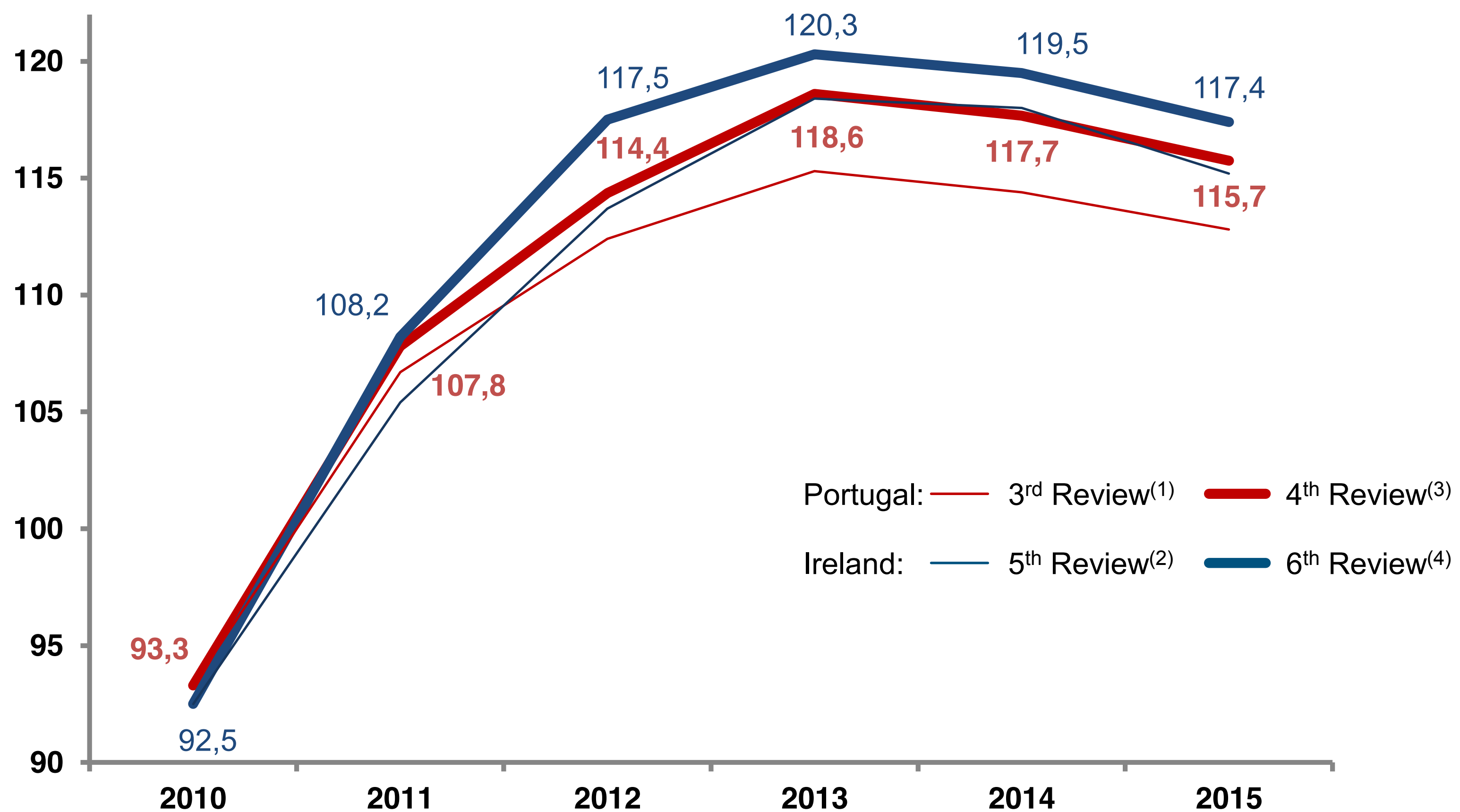


(1) Request for Extended Arrangement; March 9, 2012
(2) 5th Review; February, 13 2012
(3) 3rd Review; March 21, 2012
Source: IMF, Staff Reports

Portuguese public debt is sustainable…

Jun 2012 projections

Government Debt Sustainability Framework: Baseline
As percentage of GDP



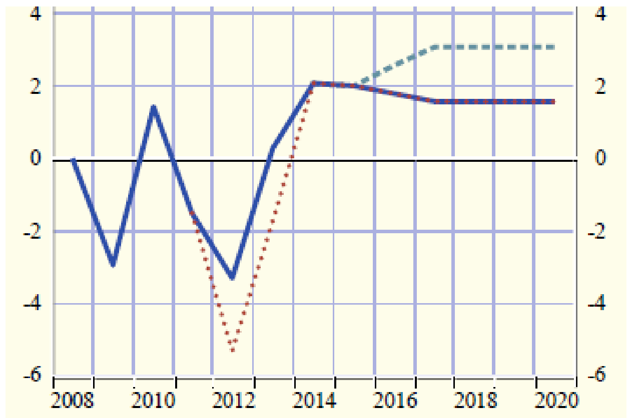
Source:
(1) IMF, Staff Report, 3rd Review; March 21, 2012
(2) IMF, Staff Report, 5th Review; February, 13 2012
(3) Ministry of Finance, Jun 2012
(4) DOF EDP & SPU Return, Jun 2012

… under different growth scenarios

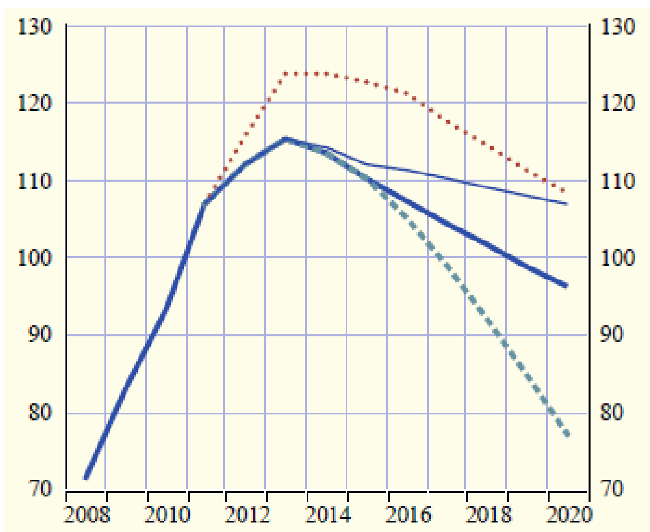
Baseline scenario
Adverse growth scenario
Impact of structural reforms
Baseline with smaller consolidation effort

ECB Projections

GDP growth scenarios
Annual percentage changes



Public debt scenarios
As percentage of GDP



Government debt dynamics for Portugal **quickly stabilize in all scenarios**

- **Without taking into account the impact of structural reforms on growth:** debt fall below 100% of GDP in 2020
- **In an adverse scenario of higher GDP decline in the short-term:** debt reach a maximum of 124% of GDP in 2013 and decline to below 110% of GDP in 2020;
- **Taking into account the impact of structural reforms:**
  - Real GDP growth increases from 2015 onwards (3% after 2017 against 1.6% in the baseline scenario)
  - Large impact on debt dynamics that fall below 80% of GDP in 2020

Sources: Eurostat and ECB calculations; ECB Monthly Bulletin March 2012

Important progress in the institutional reform front

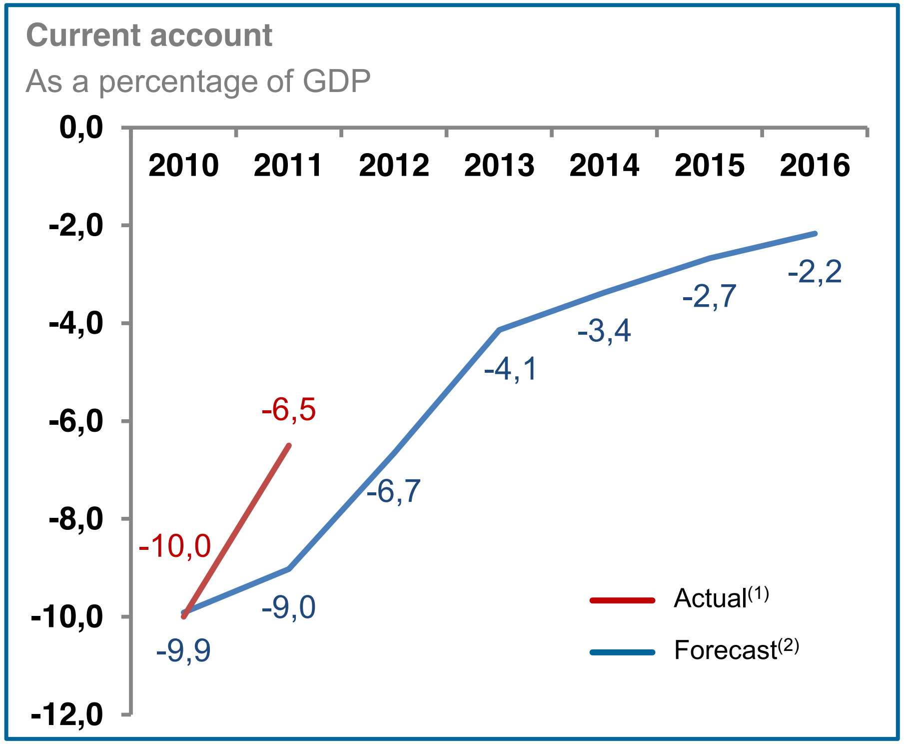
NON-EXHAUSTIVE

	Major actions	Next challenges
Public financial management	▪ Approval of the **Spending Commitments' Control Law** ▪ Adoption of medium-term **expenditure ceilings** ▪ Establishment of the **Portuguese Public Finance Council** ▪ **Adjustment Program** for the Autonomous Region of **Madeira** ▪ Creation of the new **Tax and Customs Authority**	▪ Improve **budgetary control** across all levels of Public Administration ▪ Reduction **of arrears** ▪ Changes to national law in order to include the golden rule and the debt reduction rule from the **Treaty on Stability, Coordination and Governance in the EMU** ▪ Develop a **public financial management strategy** for the next three years
Public Administration	▪ Reduction of **management positions** (27%) and **administrative units** in central administration (40%) ▪ Negotiations with public sector labor unions on **working time flexibility** and **geographical mobility**	▪ Extend streamline measures **to regional and local administration** ▪ Comprehensive **review of public pay scales**
SOEs and PPPs	▪ Significant **cost reductions in SOE** (e.g.: voluntary redundancy programs) ▪ New fiscally-prudent **PPPs institutional framework**: enhanced role of MoF ▪ Ongoing **revision of all PPP contracts** by a top-tier accounting firm (to be completed by end-June)	▪ **Operational balance for SOEs** as a whole by end-2012 ▪ Conditional on audit results, **renegotiation of PPP contracts**

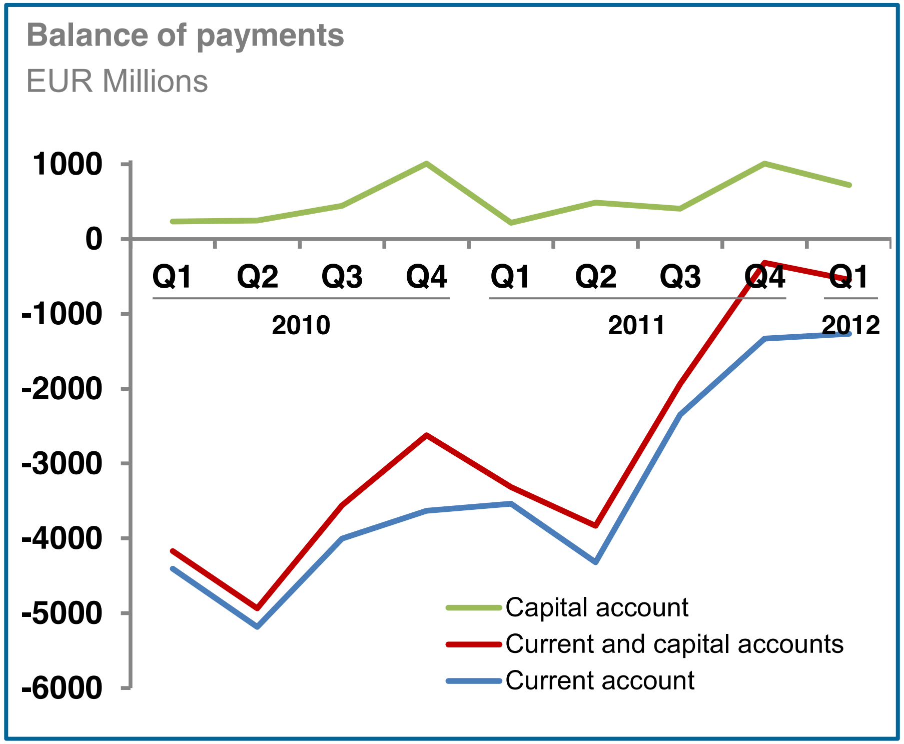
DELEVERAGING AND FINANCIAL STABILITY

Stronger than expected external adjustment

Better performance of current account than initial projections



Current and capital account close to balance

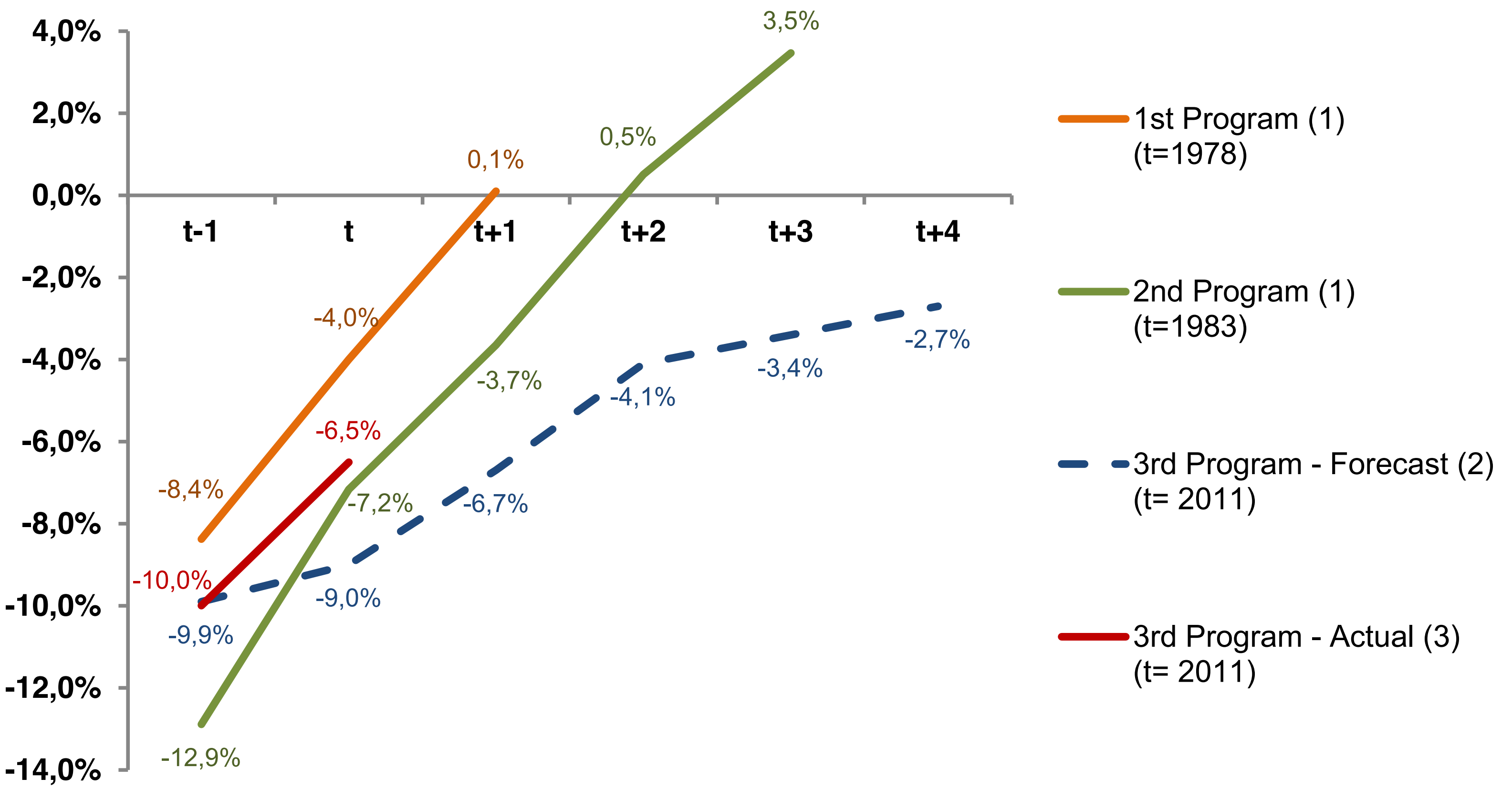


(1) Bank of Portugal, BP Stat, March 2012;

(2) IMF, Staff report: Request for a Three-Year Arrangement Under the Extended Fund Facility, May 2011

Fast correction of external imbalances under adjustment programs

Current account
As a percentage of GDP, t = first year of the Adjustment Programs



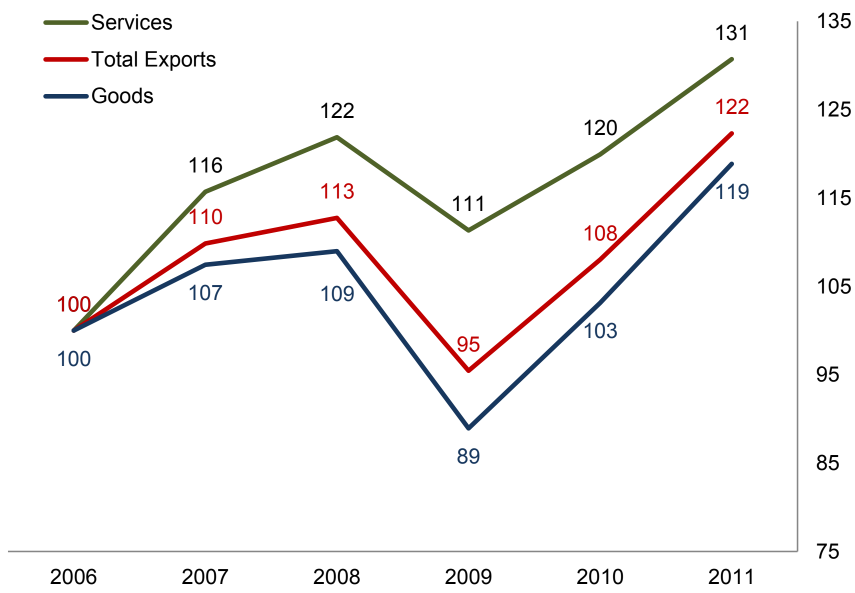
(1) Bank of Portugal, Long series
(2) IMF, Staff report: Request for a Three-Year Arrangement Under the Extended Fund Facility, May 2011
(3) Bank of Portugal, BP Stat, March 2012

Significant contribution from exports growth

Strong exports growth

Exports

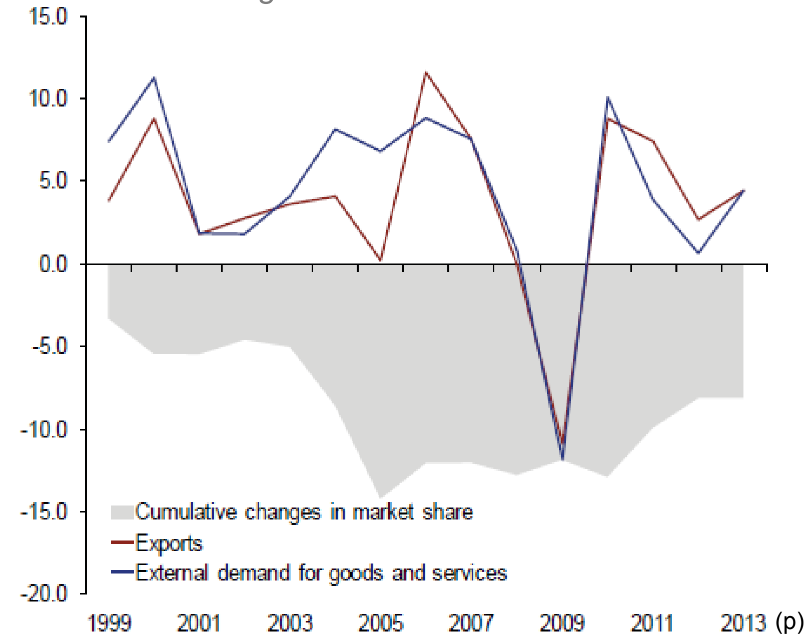
Index (2006=100)



Exports' market share is recovering

External demand and market share

Annual rate of change



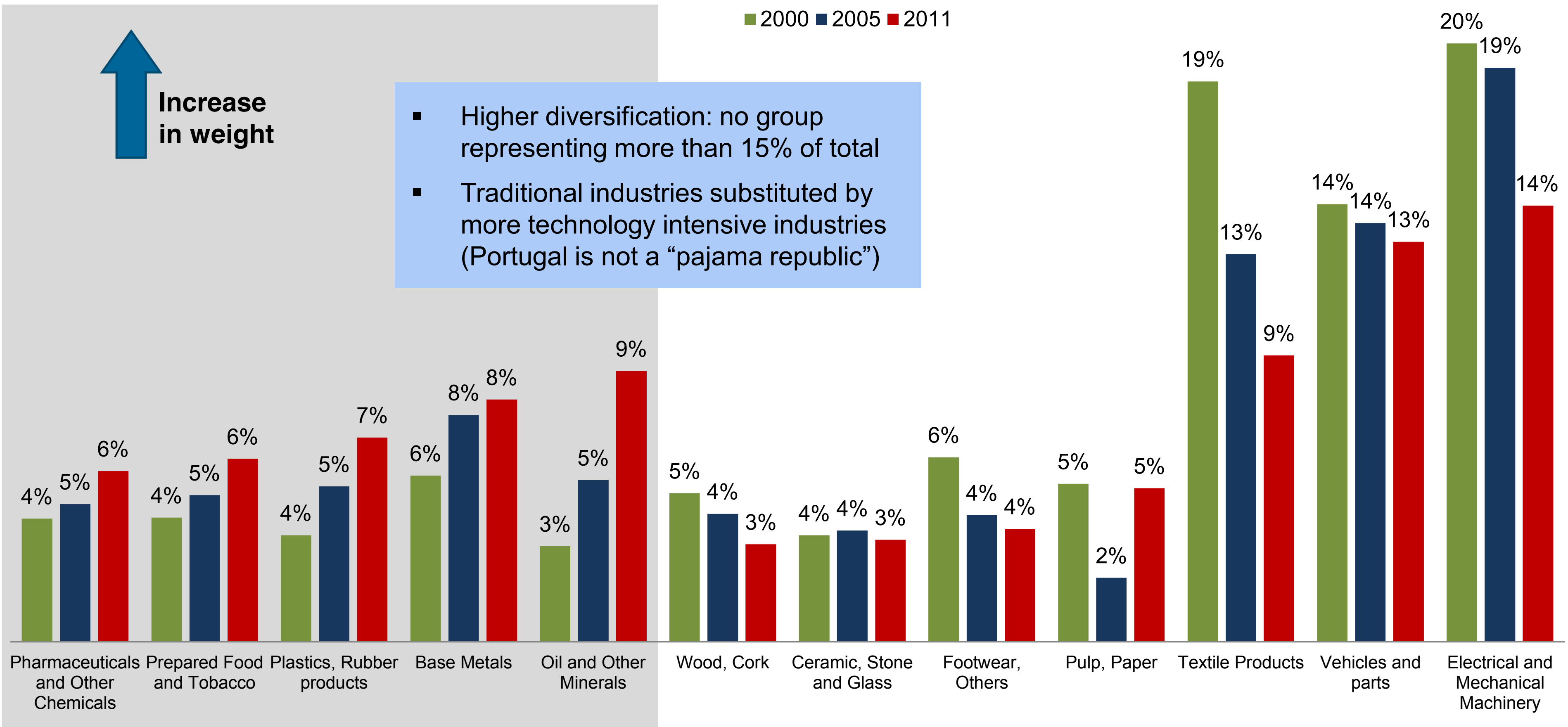
Source: Bank of Portugal

Source: Bank of Portugal, Economic Bulletin, Spring 2012

Export profile is considerably changing

Higher product diversification

Export composition by product, Goods
As percentage of total



- Higher diversification: no group representing more than 15% of total
- Traditional industries substituted by more technology intensive industries (Portugal is not a “pajama republic”)

Source: National Statistics Office

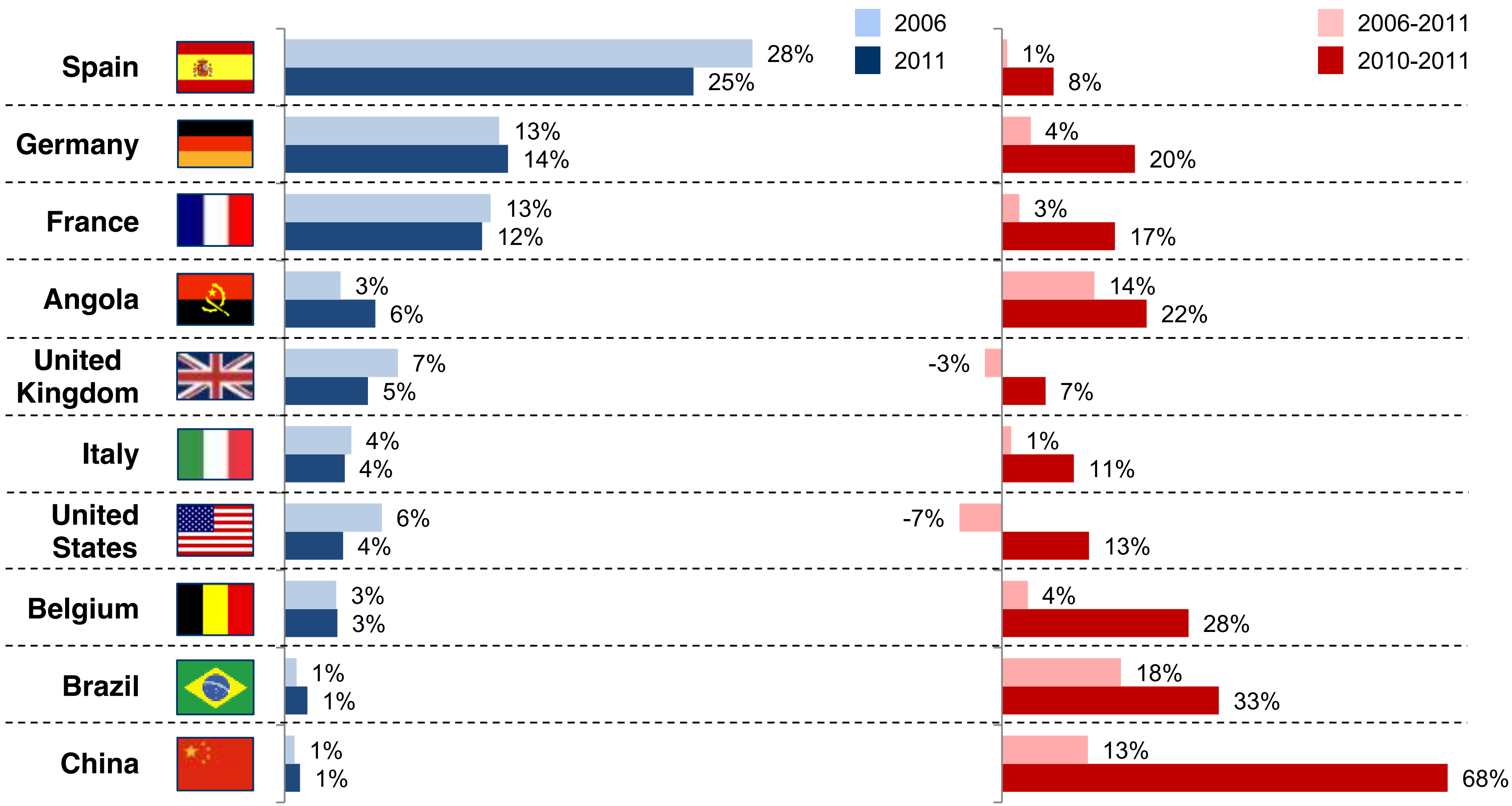
Export profile is considerably changing

Higher geographical diversification

Exports destination by country, Goods

As percentage of total

Average annual growth rate

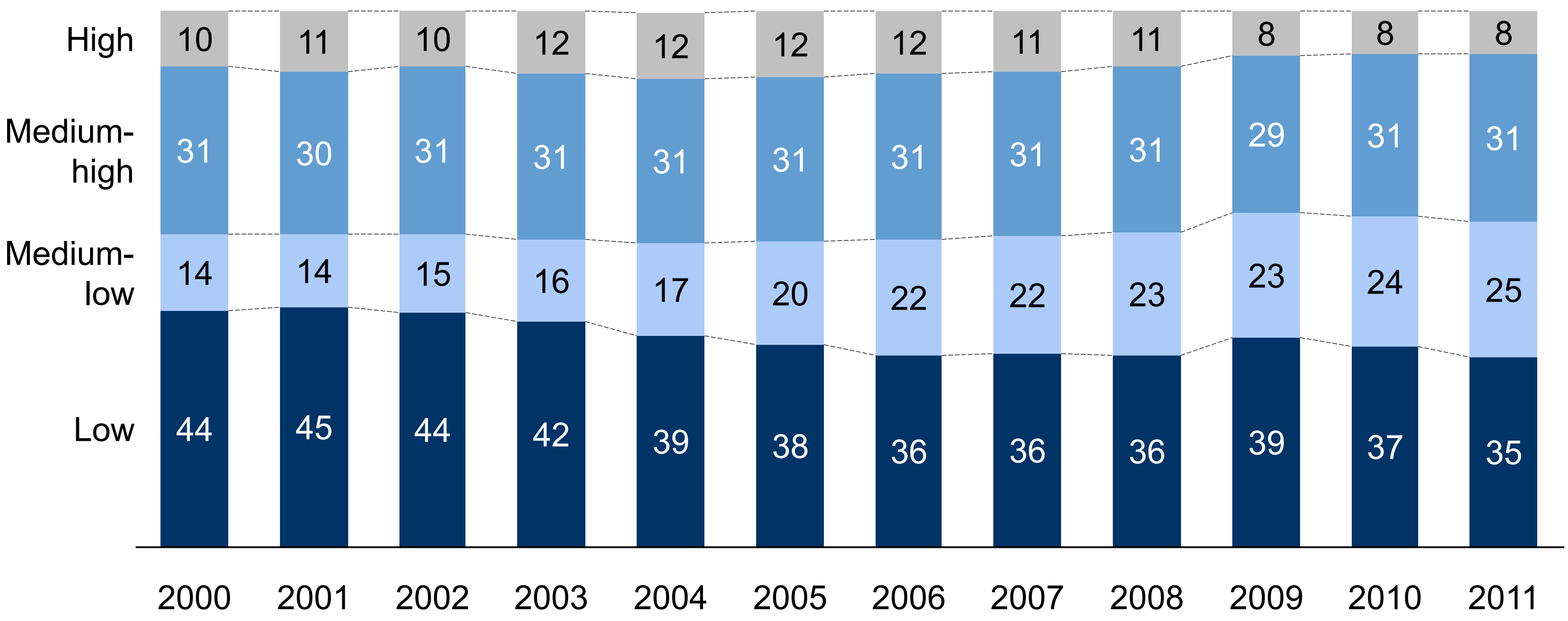


Source: National Statistics Office

Export profile is considerably changing

Higher technological intensity

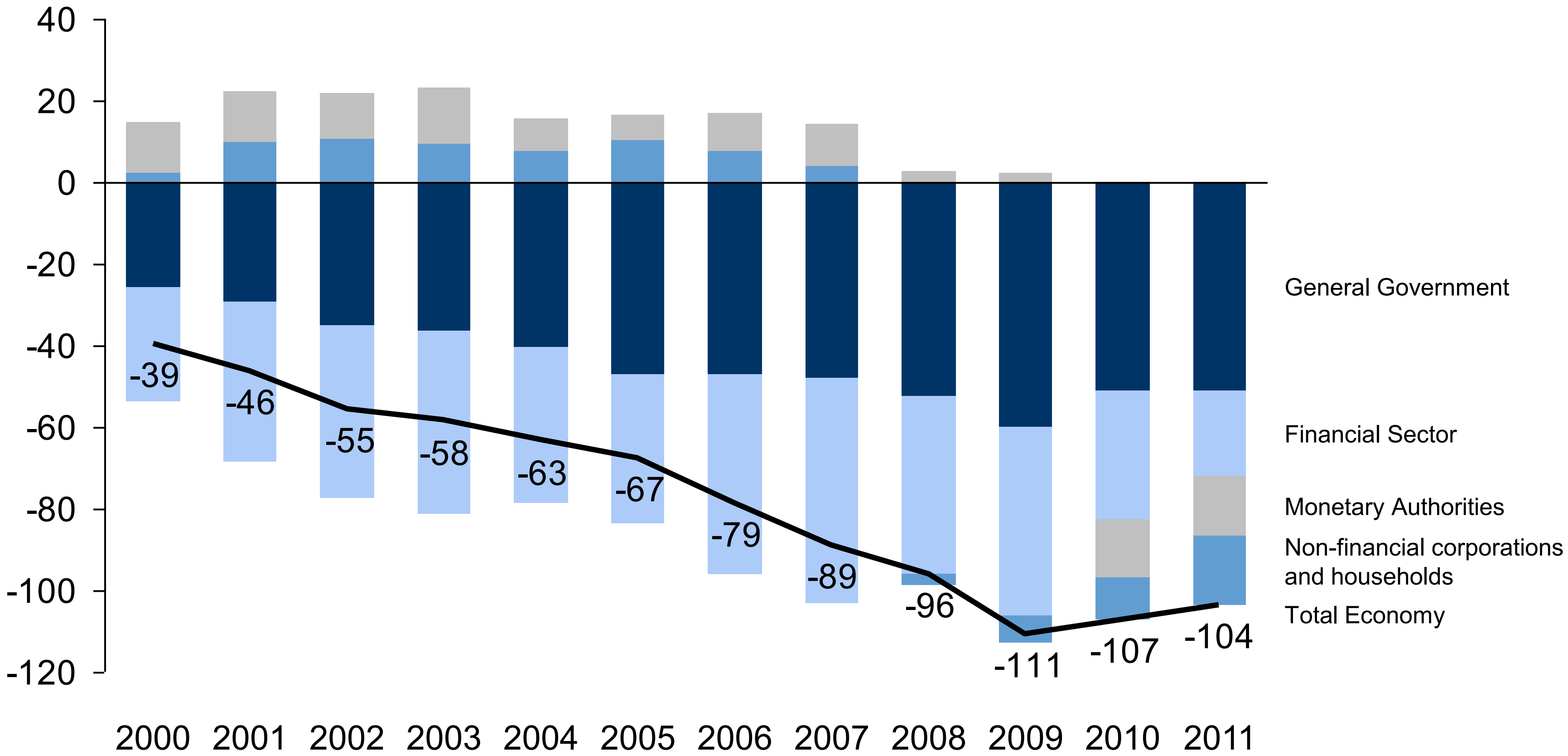
Export composition by technological intensity, Goods
As percentage of total



Source: INE and GEE, "Boletim Mensal de Economia Portuguesa", April 2012

International investment position is reversing

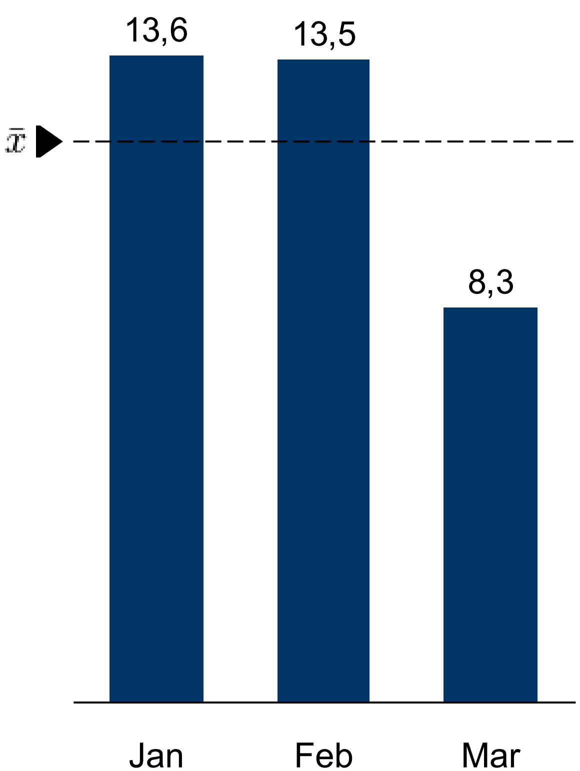
International Investment Position
As a percentage of GDP



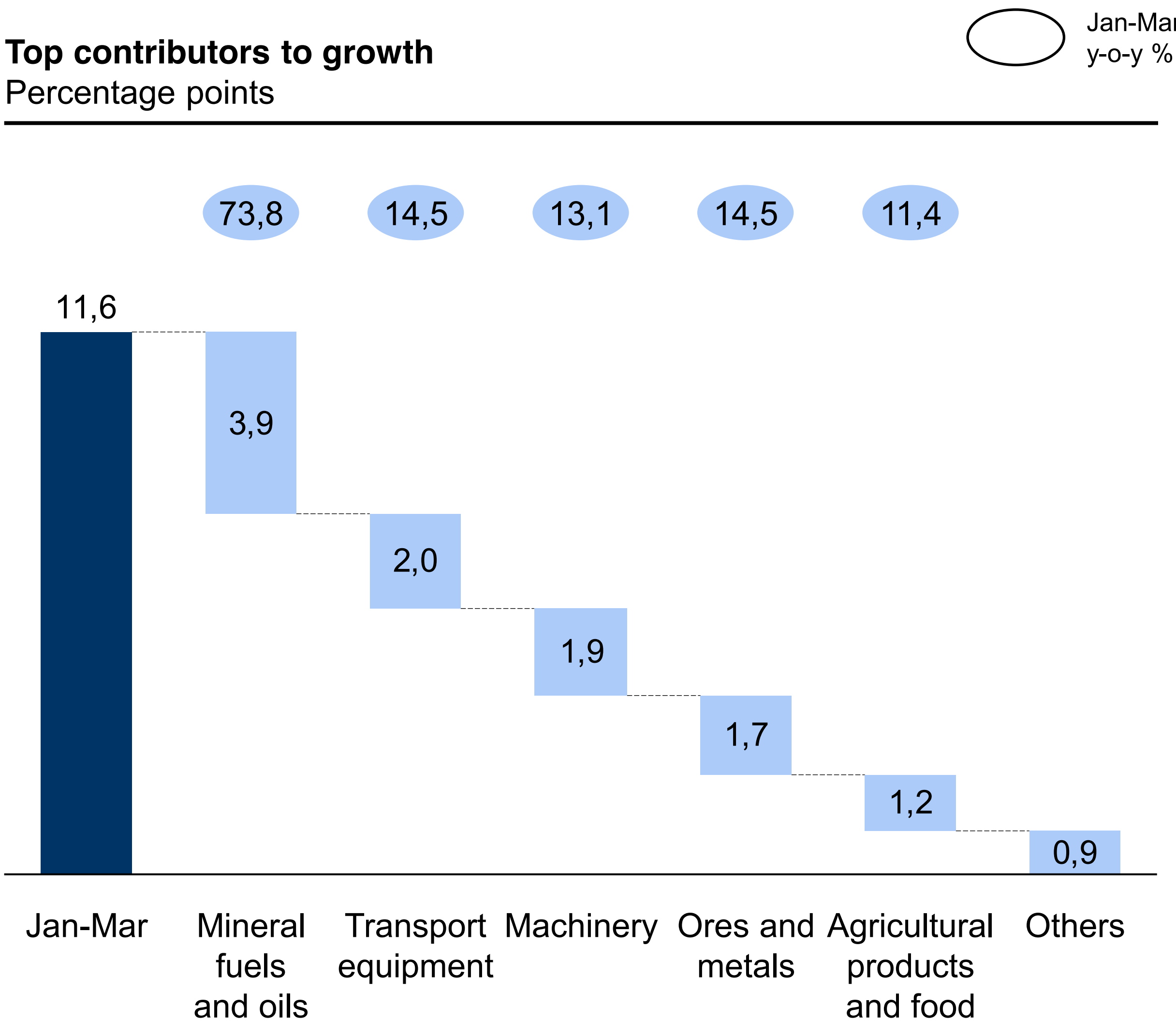
Source: Bank of Portugal and INE

In 2012 Q1, exports of goods continued dynamic

Exports of goods, 2012 Q1
y-o-y growth (%)



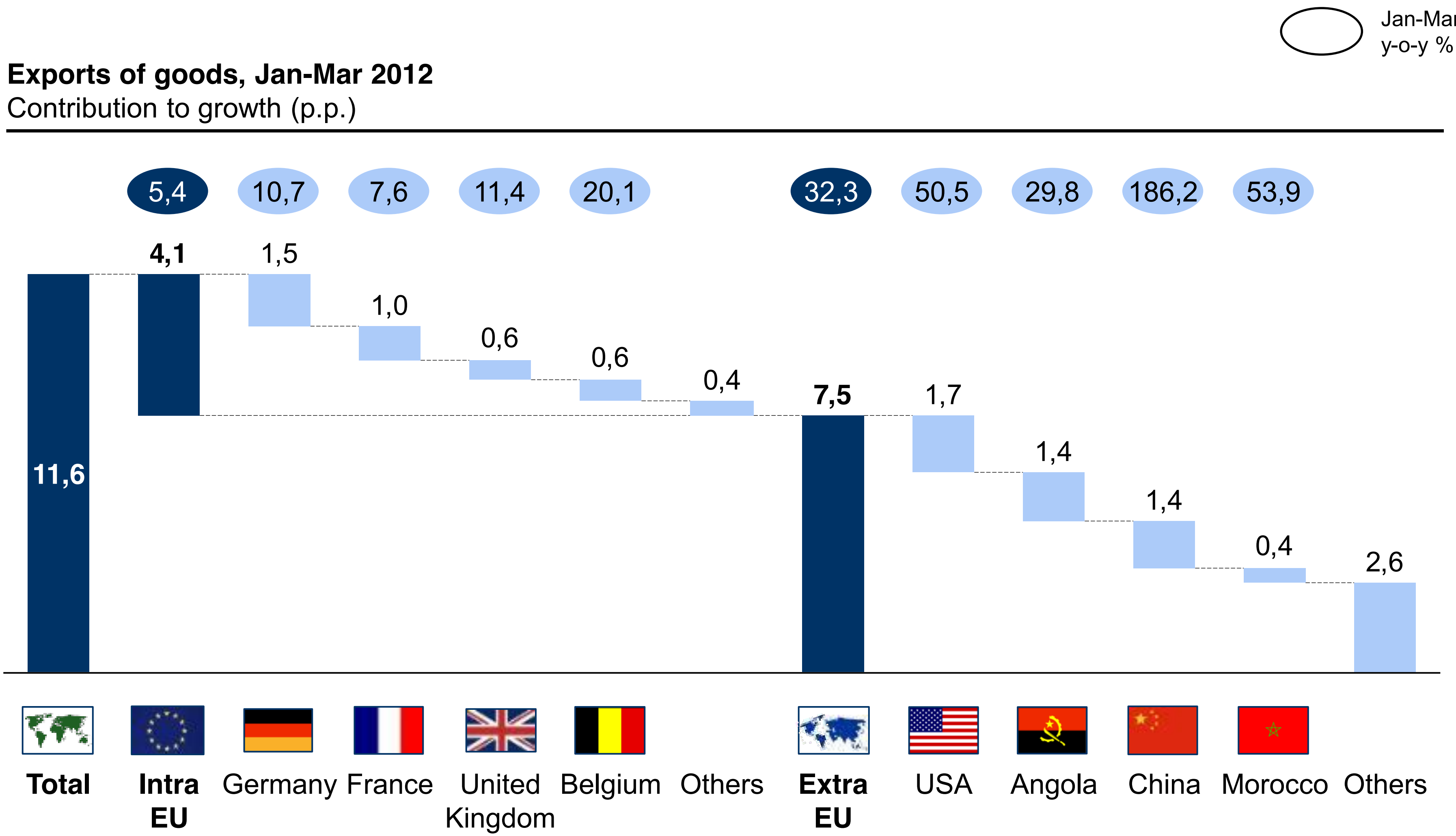
Top contributors to growth
Percentage points



Source: GEE, “Sintese Estatística de Comércio Internacional”, May 2012

Markets outside EU are being the main contributors

Exports of goods, Jan-Mar 2012
Contribution to growth (p.p.)



Source: GEE, "Sintese Estatística de Comércio Internacional", May 2012

Measures contributing to a more favorable environment to credit expansion

	Action	Outcome
ECB measures	Liquidity support at longer maturities and broadening of eligible collateral	Help to improve banks liquidity position
Banks capitalization	Banks capital augmentation plans of three major banks already announced	Help to improve banks solvency
Partial transfer of banks pension funds'	Payment of arrears in the health and regional/local administrations sectors in the context of the partial transfer of banks pension funds to the State	Positive impact on the finance of others sector
BdP supervision	Measures to discourage evergreening of doubtful loans	Channel funds to more productive sectors of the economy

Easing of bank liquidity pressures

ECB Measures (8 December)

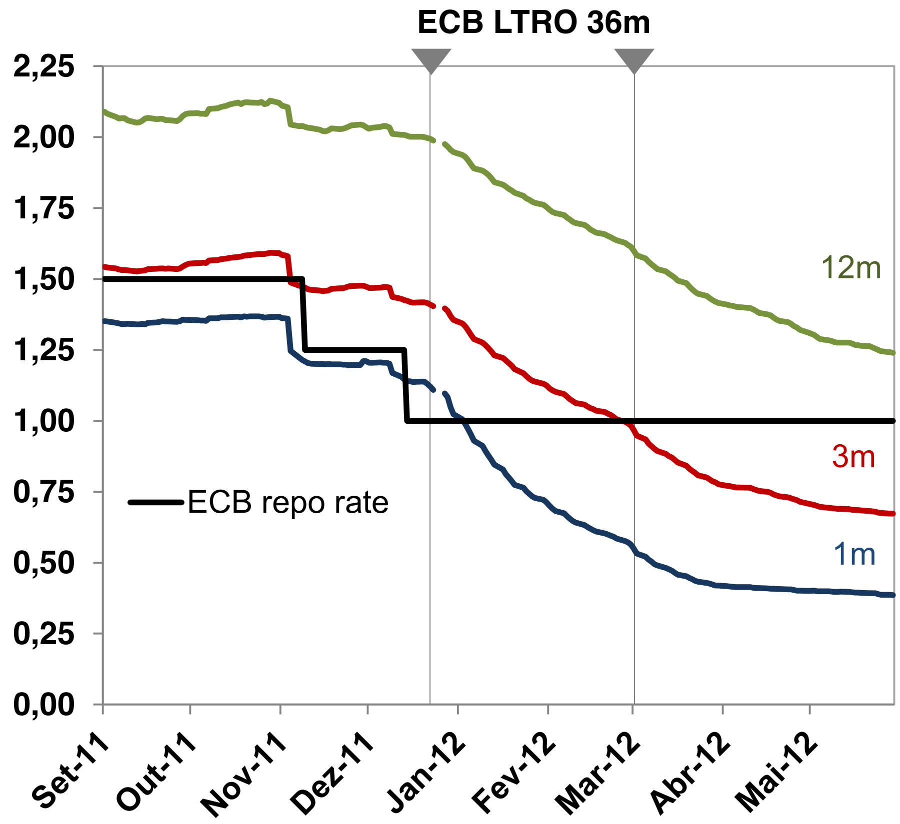
Longer-term **refinancing operations**: 36 months (December 22 and March 1)

Reduction of the **reserve requirements** ratio: from 2% to 1%

Broadening of **eligible collateral**

Euribor

Percentage



Source: Bank of Portugal, May 2012

Recapitalization of the banking system

Ministry of Finance Announcement: June 4, 2012

Banks	Injection of core tier 1 capital
Caixa Geral de Depositos	€1.65 bn
Millennium bcp	€3.5 bn (BSSF)
BPI	€1.5 bn (BSSF)

- Each bank will **exceed the EBA's capital requirements** coming into force at end-June
- The participating banks will become amongst **the most highly capitalized in Europe**
- They will be well positioned to **ensure the continued access to credit** for productive and tradable sectors of the Portuguese economy
- BCP and BPI will also each commit at least **€30 million per year to invest in the equity of SME**

The State remains prepared to support any other banks that meet the BSSF's criteria and will analyze any recapitalization plans that may be presented

Note: BSSF – Bank Solvency Support Facility

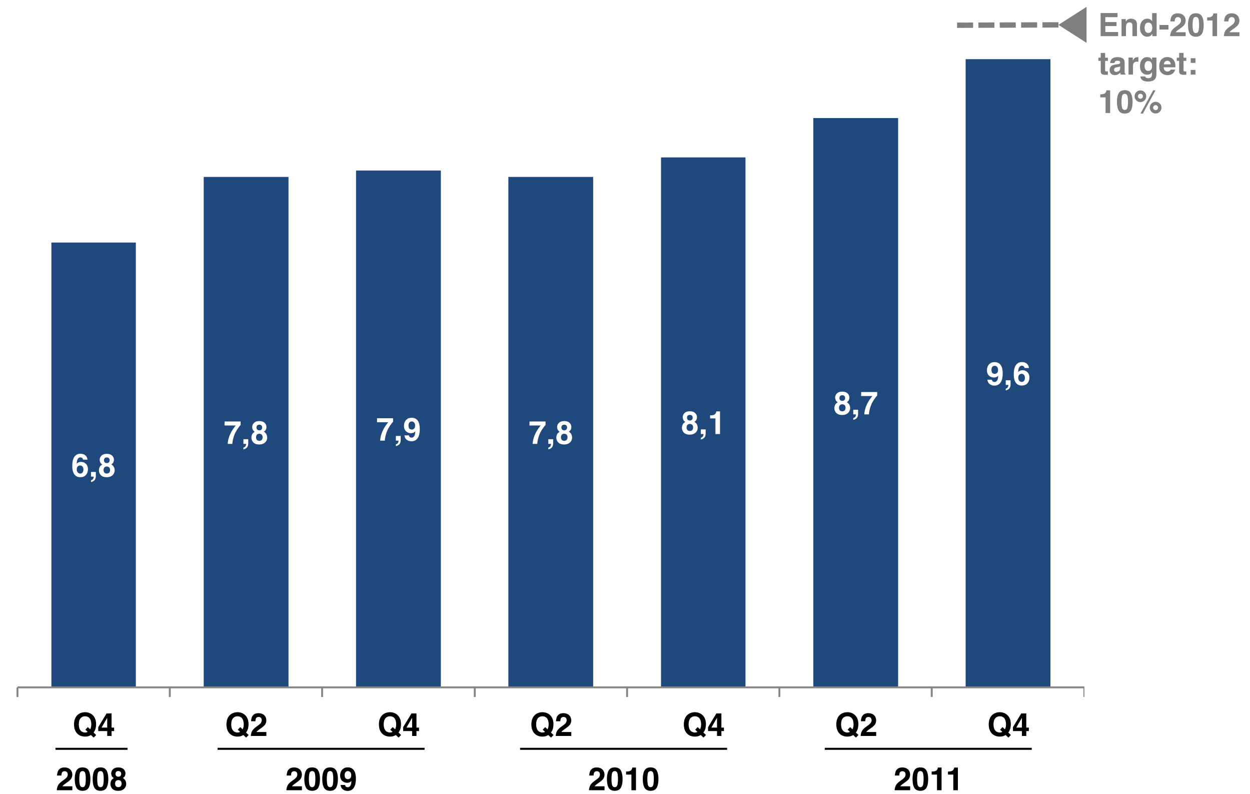
Source: Ministry of Finance, June 2012

Portuguese banks are stronger than before the crisis

Key achievements

- **Core Tier 1 target of 9% (EBA criteria)** to be reached by end-June 2012, following a prudent evaluation of sovereign debt exposures
- **Special on-site inspections** confirmed the robustness of capital adequacy
- **Regulatory framework was improved**: legislation on early intervention, resolution and deposit insurance

Core Tier 1[(1)], Portuguese Banking System
Percentage



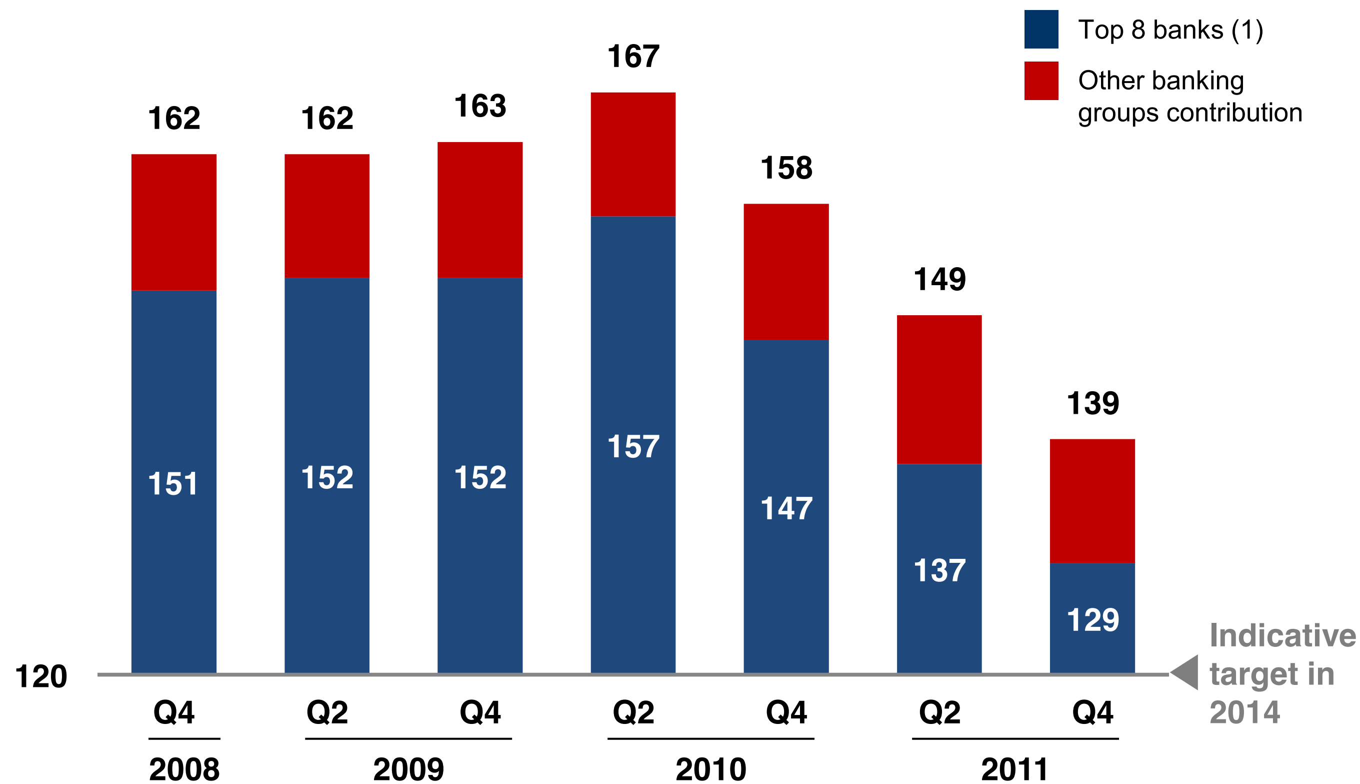
(1) Excluding BPN
Source: Bank of Portugal, April 2012

Deleveraging process is ongoing

Key achievements

- Adjustment is **progressing as planned**
- Important contribution of **higher deposits and sizeable asset sales**

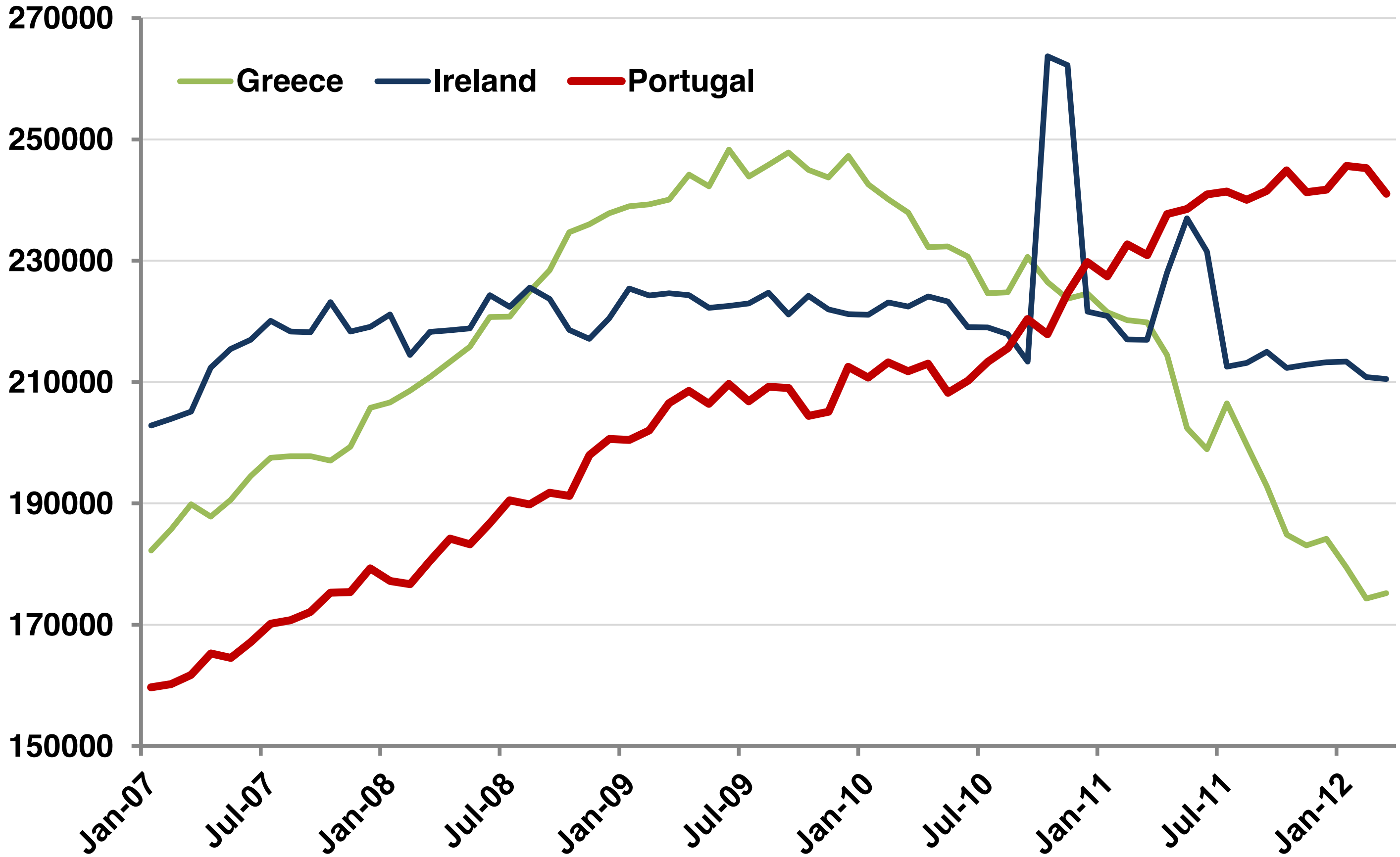
Loans-to-deposits ratio, Portuguese Banking System
Percentage



(1) About 85% of credit market share
Source: Bank of Portugal, April 2012

Depositors' trust in the Portuguese banking system

Total deposits (excluding deposits from financial institutions)
EUR Millions



Note: BS reference sector breakdown- MFIs excluding ESCB; BS counterpart sector- Non-MFIs; Data type- Outstanding amounts at the end of the period (stocks)
Source: ECB; May 2012

STRUCTURAL TRANSFORMATION

Economic growth: importance of the Structural Transformation Agenda

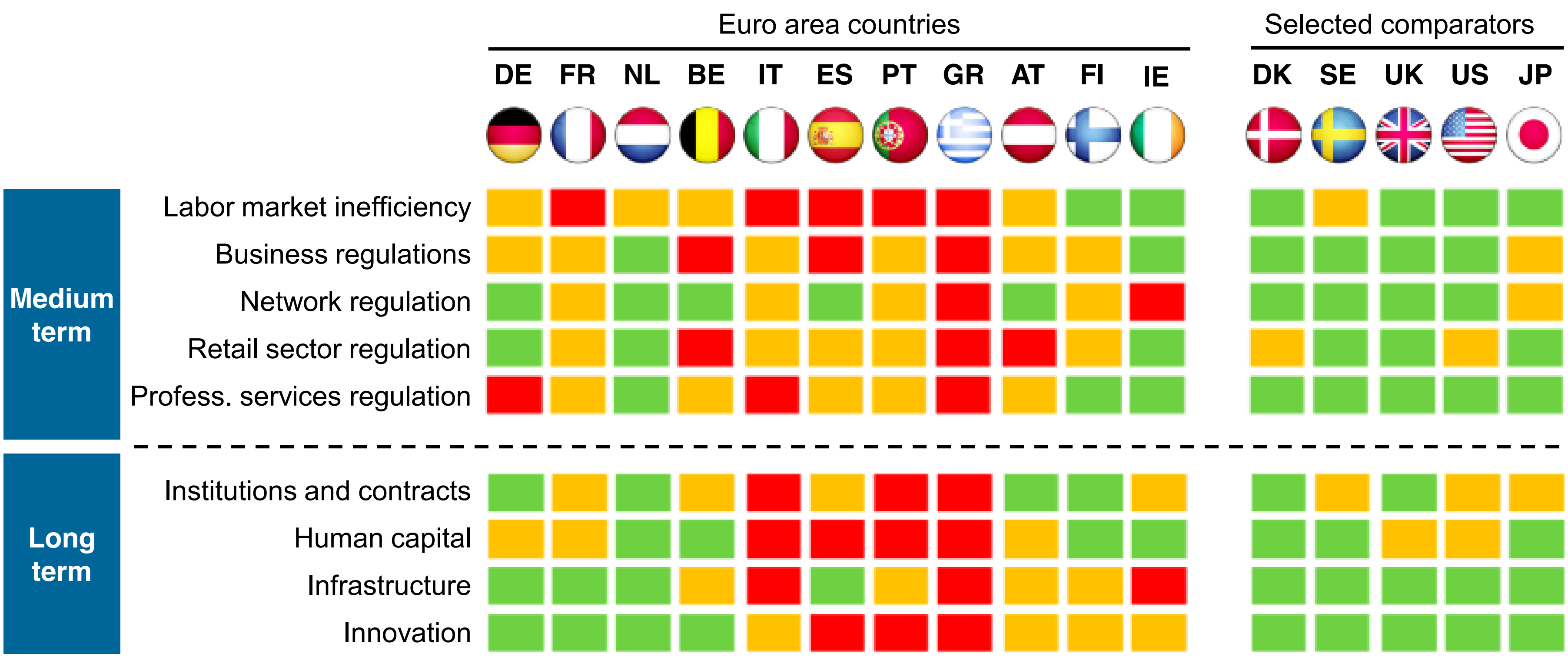
Pillars		Broad range of reforms
	**Confidence, credibility and justice**	▪ Judicial system
	**Openness, competition and competitiveness**	▪ Network industries: energy, telecommunications, transports ▪ Competition ▪ Housing Market
	**Entrepreneurship, innovation and labor market flexibility**	▪ Labor market ▪ Education and training
	**Limited State and economic democracy**	▪ Privatizations ▪ Special rights of the State ▪ Public procurement ▪ Administrative burden

Structural transformation

- Opening to **foreign investment** and to the challenges of **international competition**
- Competitive location for **physical and human capital**
- Fully integration in the **Single European Market**
- Development of a **stability culture**

Portugal needs a broad transformation agenda

Structural reforms gaps in European economies: a heatmap(1)

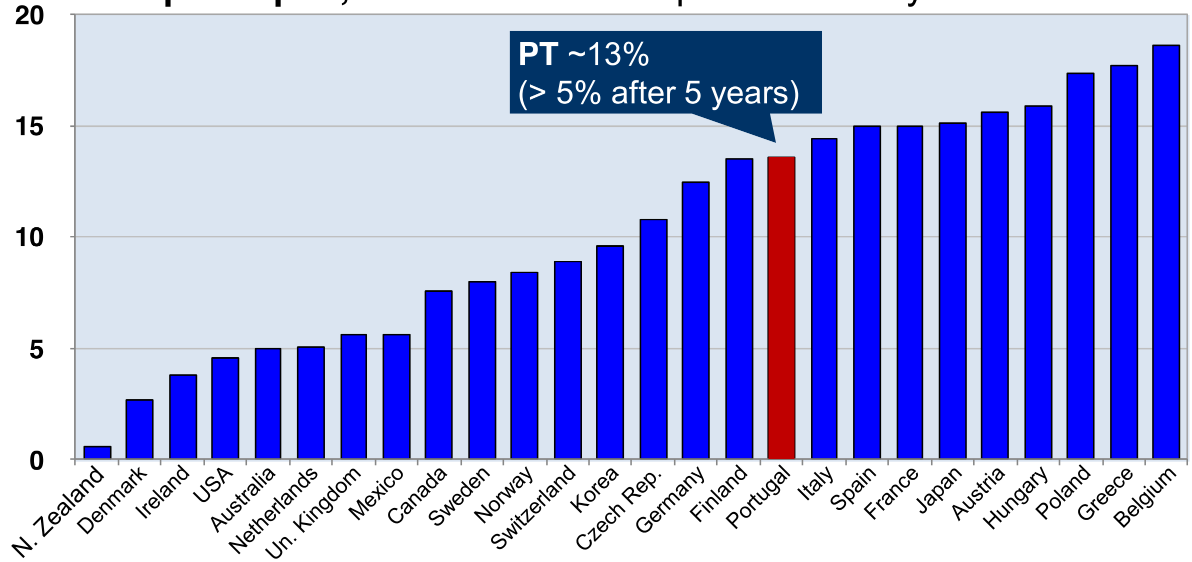


(1) The heatmap is constructed based on a variety of structural indicators from alternative sources in order to flag areas where a country has the greatest need to implement structural reforms. For a discussion of the methodology and detailed components, see IMF, 2010d, "Cross-Cutting Themes in Employment Experiences During the Crisis", IMF Report SM/10/274

Source: OECD; World Economic Forum; Fraser Institute and IMF staff calculations

Structural reforms: long-run potential impact

2 empirical studies for Portugal

	Approach	Results
Bouis and Duval (2011)	▪ No model: use empirical results from several studies ▪ Broad range of reforms that include reforms in product and labor market and reforms of benefit, tax and retirements systems	**GDP per capita,** increase in level in percent at 10-year horizon 
Gomes et al (2011)	▪ Multi-country DSGE Model ▪ Reforms of labor and services market	**Increase in long-term output of 7.8% , after 7 years** (8.6% in case of cross-country coordination of reforms in the euro area)

Source: Bouis and Duval (2011), OECD Economics Department Working Paper n.º 835; Gomes et al (2011), Banco de Portugal Working Paper n.º 13

In-depth labor market reform

Agreement on Growth, Competitiveness and Employment

NON-EXHAUSTIVE

Objectives

- **Tackle labor market segmentation**
- **Foster job creation**
- **Ease transition of workers across firms and sectors**

Implemented measures

Reducing labor costs

- Reduction of 4 national holidays
- Elimination of 3 extra days of vacation
- Decrease in 50% of compensation for overtime work and eliminate compensatory time off (previously 25% of overtime worked hours)
- Restrictions on automatic extension of collective agreements

Labor market flexibilization

- Implementation of individual and group working time management mechanisms
- Reduction of restrictions to individual dismissal
- Reduction of severance payments to align with EU average
- Implementation of labor arbitration mechanisms

Active Labor Market Policies

- "Estímulo 2012" program with incentives for hiring of medium and long term unemployed in return for on job training
- "Impulso Jovem" program specifically designed to help youth unemployed

The agreement between the **Government, Unions and Enterprises Associations:** an important step to implement reforms in an environment of **social dialogue**

Broad product market reform

NON-EXHAUSTIVE

Objective

Reduce excessive mark-ups in network industries and non-tradable

Implemented measures

Telecommunications

- **Reduce** mobile **termination** rates
- **Broad access** of all operators to **existing networks**
- **Auction** access to **new networks** (4G mobile network)

Energy

- **Speed up liberalization** of Gas and Electricity
- **Revise** remuneration scheme of **co-generation** to accelerate converge to market-based pricing
- **Redesign Power Guarantee** mechanism
- Foster **cross border market integration** to increase competition

Health

- **Revise margins** of pharmacies
- Set targets for **reduction** of pharmaceutical **profit margins**
- **Increase** share of **generic** drugs

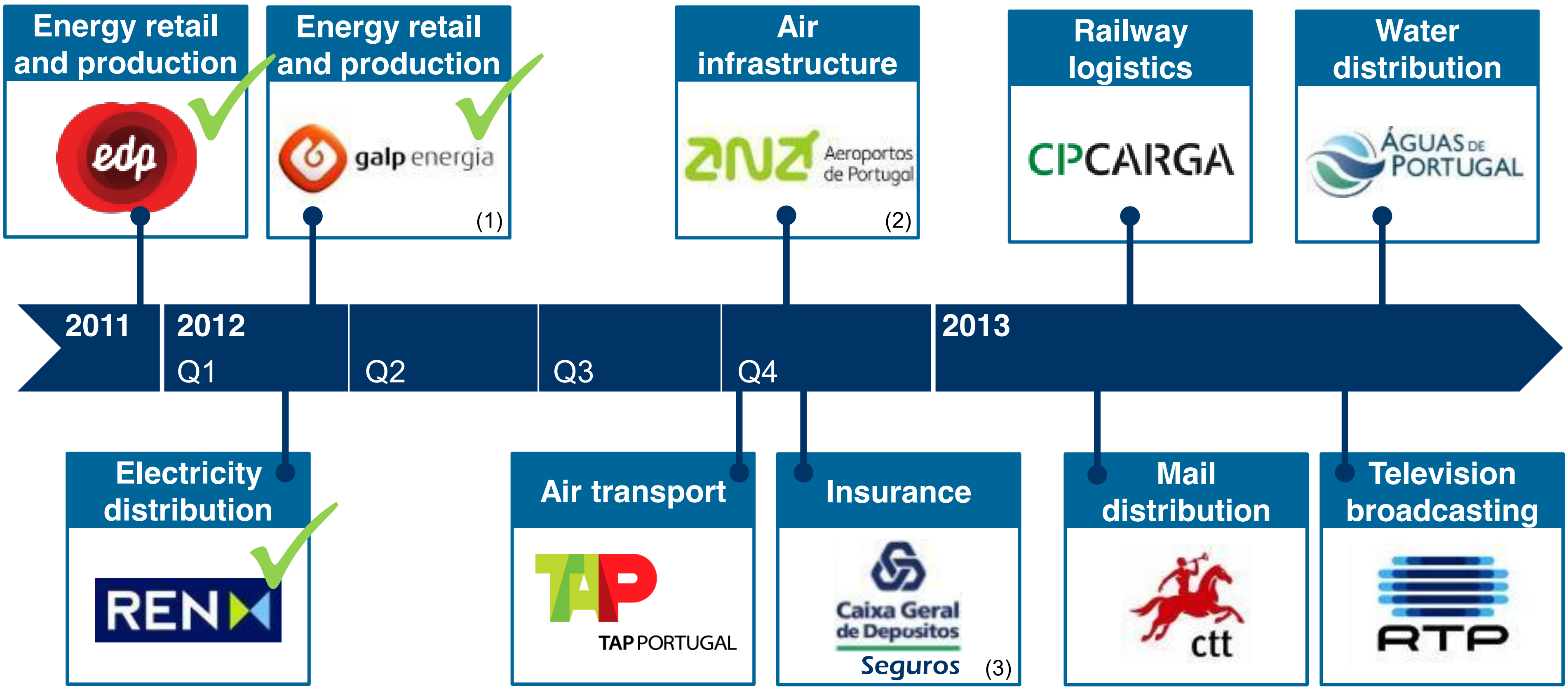
Increasing **tradable sector competitiveness** by reducing **non-tradable sectors excessive costs** cascaded through the economy

Improving business environment

NON-EXHAUSTIVE

Objective		Implemented measures
▪ **Foster investment and innovation** ▪ **Incentive a more efficient use of resources**	**Judicial system**	▪ Targeted measures to accelerate the **resolution of the backlog:** 50,000 enforcement cleared since November ▪ Adoption of a **law on arbitration** to facilitate out-of-court settlement ▪ New **insolvency code and corporate recovery**, focusing on speed, simplification and creation of an extra-judicial phase of corporate recovery
	Competition	▪ Approval of a new **Competition Law** harmonized with the EU legal competition framework which will come into force early July ▪ Strengthen the power of the **Competition Authority** ▪ Set up of a specialized **court on Competition, Regulation and Supervision** (already in operation)
	Other services	▪ Liberalization of **regulated professions'** access and exercise ▪ Fostering the development of the **European single market** for services and labor: already transposed 32 out of 69 legal acts regarding services and have completed all aspects of the qualifications directive ▪ Reduction of **firms' administrative burden:** licensing requirements and other legal formalities ▪ Approval of a new **Urban Lease Law** which is expected to come into force in October

Privatization program as a flagship in the agenda



(1) Sale of "Caixa Geral de Depósitos" participation of 1%; sale yet to be materialized but already decided: tag along to another shareholder's sale

(2) Concession

(3) Expected completion date by "Caixa Geral de Depósitos"

Source: Ministry of Finance, June 2012

Privatization results above expectations

Selected bidders (highlighted)

	EDP	REN
% Equity	▪ 21,35%	▪ 40%
Bidders	▪ Asia: China Three Gorges (selected) ▪ Europe: E.ON ▪ Latin America: Eletrobras and Cemig	▪ Asia: State Grid (selected) ▪ Arabia: Oman Oil Company (selected)
Revenue	▪ **EUR 2,693M:** premium of 53.6% per share[1]	▪ **EUR 593M**: average premium of 33.6% per share[1]
Financing	▪ **EUR 2,000M** through Chinese banking entities	▪ **EUR 1,000M** through Chinese banking entities
Investment	▪ **EUR 2,000M** until 2015 in wind farms	▪ Strategic plan for national economy development (e.g. I&D center construction)

The proceeds amount to about **60% of the initial estimate of privatizations revenues** foreseen in the Adjustment Program

1 Considering the closing price of the day before the Council of Ministers decision

CONCLUSION:
HOW WILL IT WORK?

Restoring credibility and confidence

The adjustment is inevitable	The Program addresses fundamental imbalances and deficiencies	Robustness of the overall Program	Gradual credibility buildup
▪ **Solid starting point** for the Program ▪ Broad **popular and social support** for adjustment	▪ Elimination of **budget deficit** on a durable way – supported by a new fiscal policy framework (at national and European level) ▪ Elimination of **external deficit** – current and capital account is projected to be in surplus in 2014[1] ▪ Deep and frontloaded structural reform agenda that will boost **potential output** and **competitiveness**	▪ The Program works disregarding **positive impact of structural reforms** on potential growth ▪ Structural reforms are likely to speed up **adjustment**	▪ The Program **shelters government financing** from the vagaries of financial markets ▪ Quantitative objectives and targets **steered and monitored** over time (9 reviews until Sep. 2013) ▪ Compliance with the Program will push for a **gradual change in markets' expectations and perceptions**

(1) Ministry of Finance", February 2012