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# Portugal's Performance after the Macroeconomic Adjustment Programme

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# Portugal's Performance after the Macroeconomic Adjustment Programme

By Christian Weise

## Abstract

Portugal experienced a deep economic and financial crisis that led to an EU/IMF programme from 2011 to 2014. Key indicators had been improving significantly since about 2013 and, at the outset of the COVID-19 outbreak in early 2020, the country had reached a much better position in which unemployment was low, there was a balanced government budget, government bonds had a stable investment rating and net immigration was positive.

The developments after the end of the programme benefited, on the demand side, from a benign external economic environment, low interest rates and a boom in tourism. The economy's capacity to take advantage of these factors was decisively improved, on the supply side, by structural reforms, spurred mainly by the implementation of the EU/IMF programme and previous action. The pursuit of structural reforms boosted the skill level and export orientation of the economy. Financial stability improved through the recapitalisation of the banking sector and by addressing non-performing loans. Fiscal consolidation continued throughout the post-programme period but was focused on the headline deficit with only limited structural improvement, mostly relying on historically low interest rates and subdued public investment.

EU membership helped Portugal in overcoming the adjustment crisis with the single market, cohesion policy and the euro. European economic surveillance gave guidance and set a solid policy framework which also had positive signalling effects to financial markets. This paper does not address the impact of the COVID-19 pandemic and Portugal's reaction to it. It rather aims to show how a country that had been under an adjustment programme recovered from a severe crisis and which structural challenges remain. Macroeconomic vulnerabilities due to decreasing but still high public and private debt, a lack of convergence to the EU average income, low productivity levels, and unfavourable demographic trends will influence how the country manages the green and digital transitions and copes with the COVID-19 crisis.

**Keywords:** adjustment programme, fiscal consolidation, migration, Portugal, structural reforms.

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## Introduction

Portugal exited a comprehensive macroeconomic adjustment programme coordinated by the EU and the IMF in June 2014. The programme became necessary in 2011 after a combination of unsustainable trends led to the loss of financial market access for the country. In the years before the crisis, the Portuguese economy had been characterised by chronically weak public finances, low productivity growth, increasing unit labour costs and, thus, eroding competitiveness. Excessive deficits and misallocation of capital led to strongly increasing public and private debt without visible returns in terms of growth. GDP reached its pre-crisis peak in Q1-2008. Thereafter, declining output pushed up the unemployment rate and increasing budget deficits let the already high public debt-to-GDP ratio increase further. The adjustment programme was set up following a request for financial assistance by the Portuguese government in April 2011. It combined financial assistance of a total of EUR 78 bn with conditionality aiming at ambitious fiscal consolidation, stabilising the financial sector and tackling engrained structural weaknesses to increase potential growth (European Commission 2016).

Following a double-dip recession, many economic indicators started turning positive towards the later phase of the programme. The outlook at the end of the programme, in June 2014, was uncertain. Would the policy of structural reforms and budgetary consolidation, as pursued in the adjustment programme and implied by the rules of EU economic governance, lead to successful and sustainable economic developments?

Until the outbreak of the COVID-19 crisis in March 2020, Portugal showed strong economic data and appeared to have managed an impressive turnaround after a period of severe crisis (Centeno, 2018). GDP growth had been positive since early 2014, the unemployment rate was below that of the euro area, and public debt (as a share of GDP) had started to fall. Portugal left the excessive deficit procedure under the Stability and Growth Pact in 2017 and regained an investment grade rating according to all of the main rating agencies.

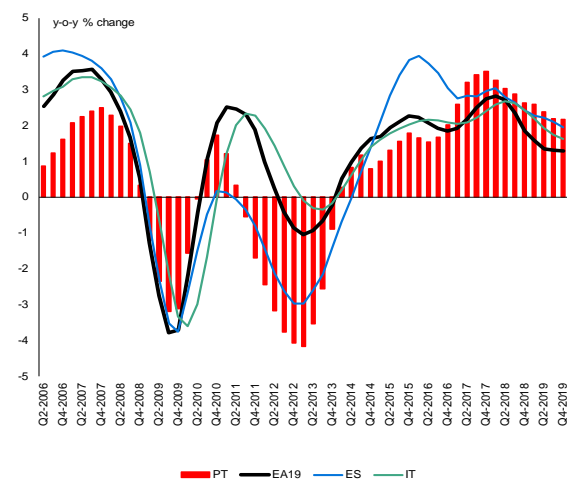
This brief analyses Portugal's economic developments since the crisis, the impact of structural reforms and the recovery in the labour

market. It discusses weaknesses in the continued fiscal consolidation as well as improvements in private debt levels and financial market stabilisation. It concludes by surveying the remaining challenges which will influence how the country manages the green and digital transitions and copes with the COVID-19 crisis.

## Economic growth has recovered

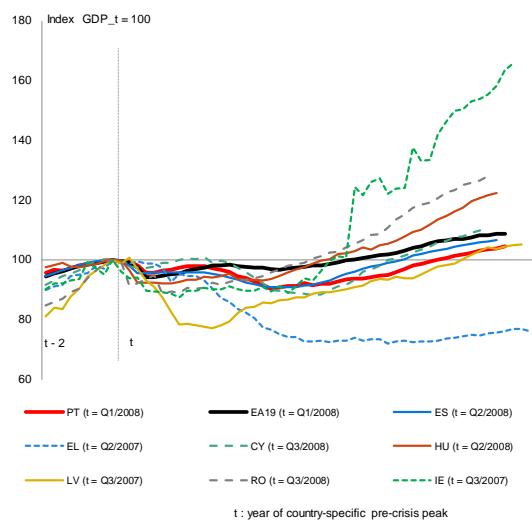
Core macroeconomic indicators improved substantially over the past few years in Portugal. The level of GDP decreased in a double-dip recession from its pre-crisis peak in Q1-2008 by 9.6% until Q4-2012 before GDP growth turned positive again in early 2014 (Graph 1). Portugal's GDP level reached its pre-crisis peak again in Q2-2018 (Graph 2).<sup>i</sup> This recovery took about as long as those for Latvia, Cyprus and Spain and was slower than for Romania, Hungary and the euro area aggregate. Outliers for this indicator are fast-growing Ireland and, for opposite reasons, Greece.

Graph 1: GDP growth (annualised quarterly)



Source: Eurostat.

Graph 2: Economic recovery of programme countries

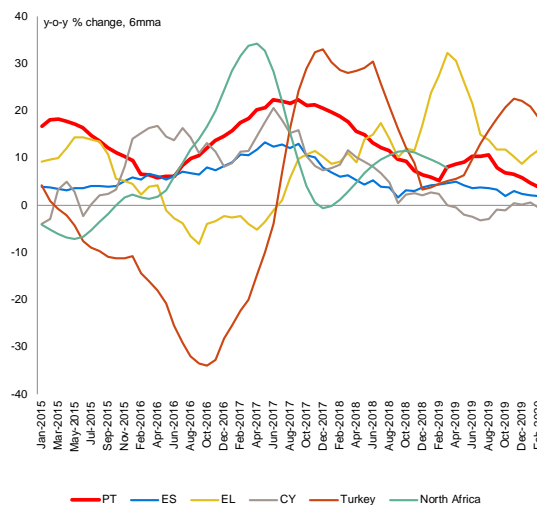


Source: Eurostat.

Being a small and increasingly open economy, Portugal’s recovery relied heavily on external demand. Portugal’s exports showed positive growth rates in almost every quarter during and after the crisis until early 2020, reflecting a structural shift from a previously oversized non-tradable sector to the tradable sector. This has been an important backbone of the recovery even if net exports contributed little to growth in accounting terms. Imports started growing as well once GDP stopped falling, partly because recovering investment and exports have a significant import content, partly due to slowly strengthening consumer demand.

Portugal’s most important export sector is tourism. Revenue from ‘travel’ in the balance of payments (i.e. mainly tourism plus business travel) increased steadily from about 4% of GDP in 2008-2010 to 8.7% in 2019. While tourism has increased following negative shocks in some competing tourist destinations, the data also show that the growth in Portugal was particularly strong (Graph 3). This has brought indirect positive effects to other sectors such as construction and real estate services. However, Portugal also managed to increase the export of other services, like ICT services and “other business services”, significantly. Main export goods came from transport equipment and industrial supplies while consumer goods and food & beverages also played a positive but less prominent role.

Graph 3: BoP - Current Account - Exports - Tourism



Source: BoP data – Central Banks.

### Structural reforms strengthened the economy

Structural reforms led to a significant strengthening of the Portuguese economy. The economic recovery from the crisis depended a lot on the positive economic environment in the euro area and beyond. However, this does not imply that the country simply benefitted from windfall gains. The extent to which the country could integrate itself into the world economy and draw advantage from positive external trends is remarkable, in particular given the deep-seated rigidities that drove Portugal into the crisis. Reforms partly started already before the crisis and the adjustment programme (Centeno/Coelho 2018). More comprehensive reforms were implemented under the programme. This related mainly to the areas of housing and the urban lease market, justice, some transport state-owned enterprises, the labour market and the business environment. Less progress was made, for example, in the energy sector, regulated professions or ports (European Commission 2016).

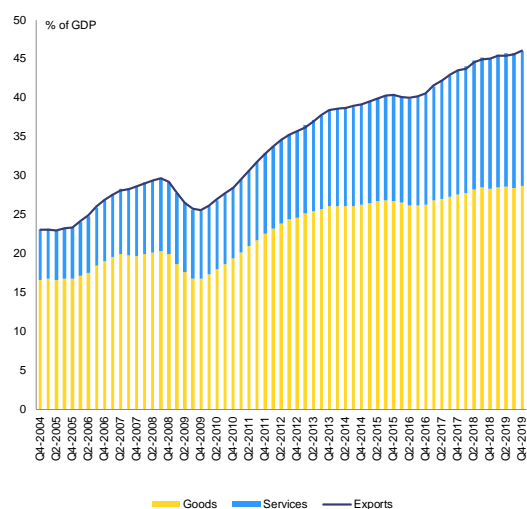
Two indicators capture this process in a comprehensive way: the increase in exports relative to GDP and the catching-up in education levels.

In the early 2000s, Portugal’s exports barely reached 25% of its GDP; since 2005, this indicator increased almost constantly and



reached 46% in Q4-2019 (Graph 4). The relative increase in services exports was particularly impressive. As pointed out above, tourism is an important, although by no means the only, factor behind this, with an impressive increase from 8.4 million visitors in 2013 to 16.2 million in 2019. This was not only caused by a shift in annual summer vacations from other destinations, as the share of visitors who came from June to August stayed relatively constant at one third.

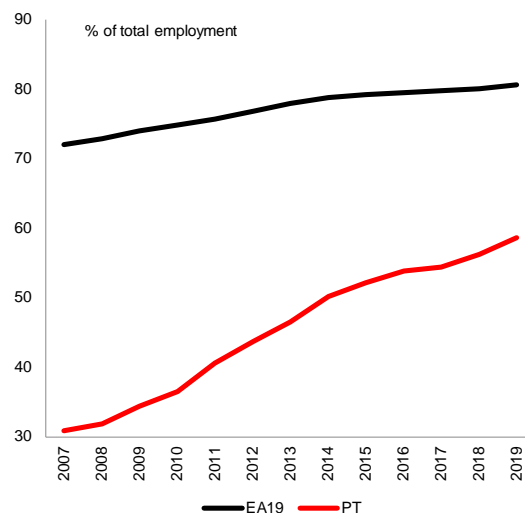
Graph 4: Exports of goods and services



Source: Bank of Portugal.

While Portugal’s labour force still has, overall, a relatively low skill level, this is improving relatively rapidly (Graph 5). The share of those with upper secondary to tertiary education in total employment increased in the euro area from 72% in 2007 to 80.6% in 2019. Portugal had a share of only 30.8% in 2007 but managed to increase it to 58.6% in the same period. This progress is impressive.

Graph 5: Employment by attainment level (upper secondary to tertiary education)

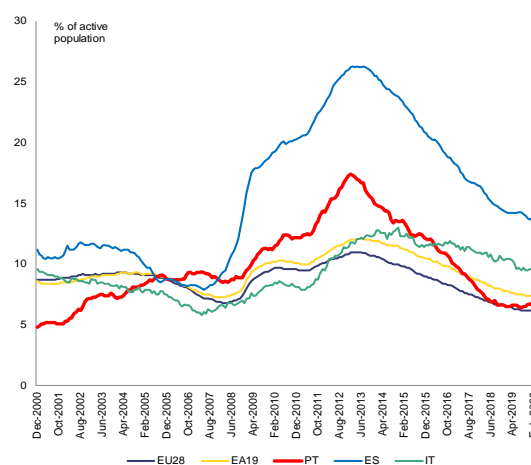


Source: Eurostat.

### Positive employment trends

Since 2013, unemployment dropped steadily and has reached even lower rates than the euro area (Graph 6). Similarly, youth unemployment fell from a peak of 41.4% of active population in early 2013 to 18.7% in Q4-2019<sup>ii</sup>, while long-term unemployment decreased from above 9% of the active population to below 3% in the same period. Unemployment used to be relatively low in Portugal until about 2002-2003 when it started to climb to reach some 10% by the eve of the crisis. It then increased to a peak of 17.4% in early 2013, clearly above the euro area but much lower than the level in Spain.

Graph 6: Unemployment rate

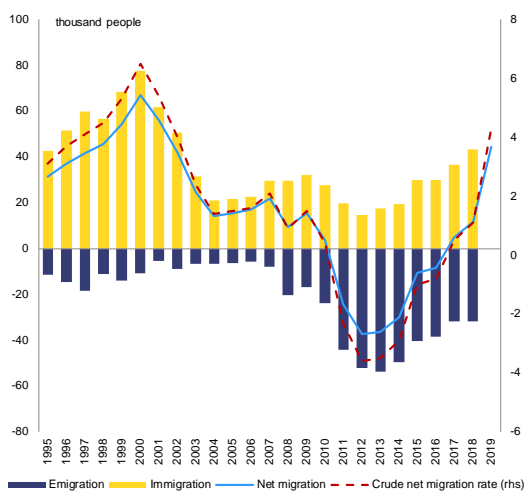


Source: Eurostat.

There are three main questions to be asked when assessing recent developments in the Portuguese labour market: How much of the positive trend is due to a possibly still strong outward migration? What is the role of remaining structural rigidities (i.e. mainly the labour market segmentation into temporary and permanent employment)? Does the strong increase of the minimum wage in recent years have a visible impact on employment?

The Portuguese labour market is influenced by migration flows, which were clearly impacted by the crisis. Portugal experienced strong net immigration before the crisis, peaking at a net inflow of some 67 000 persons in 2000 (Graph 7). This turned into net emigration in the year 2011, with a strong net outflow of up to 32 000 p.a. until 2014, when the net migration balance started to increase markedly, reaching small positive values as of 2017.

Graph 7: Migration flows



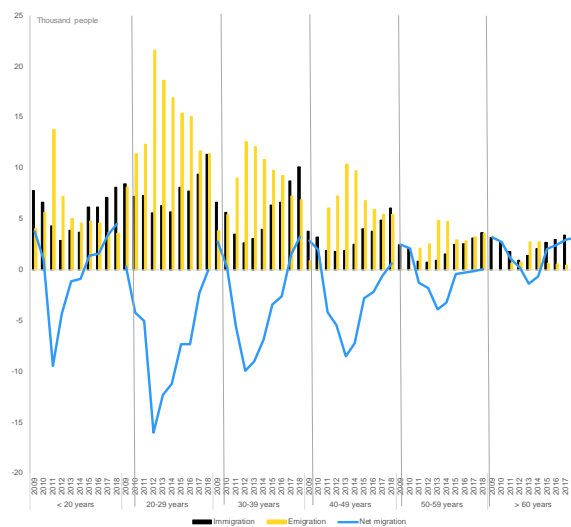
Source: Eurostat.

Official aggregates on migration do not give the full picture. On the one hand, they cannot cover illegal migration. On the other hand, some migration flows may not be properly registered, in particular if the migrating person keeps some form of registration in the home country. In addition, gross migration figures cannot be directly translated into a labour market impact. It is undisputed that many young and relatively skilled people left Portugal during the crisis in search for better job opportunities. If, at the same time, immigration would consist strongly of pensioners, a neutral migration

balance might still have a negative impact on potential growth. However, while migration figures by skill level are not available, data on migration by age group do exist (Graph 8).

Migration figures by age group are encouraging. They show that, while the net migration to Portugal in the age group above 60 was positive in the last years, gross migration of this group is quantitatively not relevant. Age groups 20-29 and 30-39 dominate gross flows on both sides. Net migration to Portugal is negative but the balance is decreasing in these age groups; 2017 even showed positive net inward migration for the first time since 2009 for those aged 30-39 (and, probably accompanying them, also for those below 20). In any case, while the absolute size of the labour force decreased during and after the crisis, it started to increase again in 2016 due to a combination of demographic factors, better job prospects and net migration.

Graph 8: Migration by age groups



Source: Eurostat.

The labour market showed significant restrictions before the crisis. A considerable part of the programme conditionality addressed these, much of it based on a March 2011 tripartite agreement between the government and social partners. The main issue in this area still featuring in the Council's country-specific recommendations to Portugal in 2019<sup>iii</sup> was the segmentation between temporary and permanent employment. A high degree of protection of permanent employees motivates employers to rather offer temporary contracts. Apart from that,

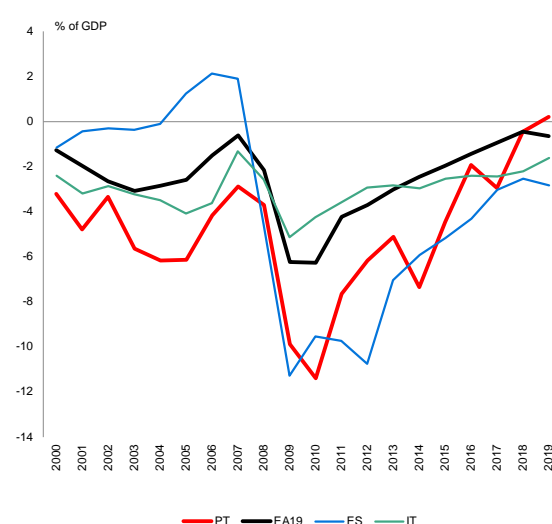
important sectors of the Portuguese economy, not least tourism, are seasonal. Both elements are likely to have contributed to a relatively high share of temporary contracts in the Portuguese labour market (17.6% of total employment, against 13.5% in the euro area and 11.5% in the EU as at Q4-2019). The upswing in the labour market since the trough of the crisis has mainly benefited permanent employment, from some 2.7 million in Q1-2013 to 3.3 million in Q4-2019, while temporary contracts went from below 700.000 to some 850.000 and might have levelled out there. The latest Commission Country Report on Portugal (European Commission 2020) notes some progress made by Portugal in tackling this form of labour market segmentation.

The minimum wage has been raised in several steps from EUR 485 in 2014 to EUR 635 per month<sup>iv</sup> in 2020. When it took office in the end of 2019, the government announced its objective to further increase the minimum wage to EUR 750 in 2023. The minimum wage is an essential income determinant for the poorest workers. However, setting a minimum wage also comes with several risks. To begin with, low-skilled job seekers might be priced out of the market. In addition, the whole wage structure might be pushed upwards and threaten price competitiveness. Alternatively, the wage structure might become too narrow so that investment in skills is insufficiently rewarded. The Portuguese authorities, therefore, monitor the use of the minimum wage (Ministério do Trabalho, Solidariedade e Segurança Social 2018). While the nominal level of the minimum wage might appear low, it amounted to a relatively high 61% of the median wage in 2019 (according to latest comparable OECD data). About 20% of employees received the minimum wage in 2019, i.e. before the latest increase. The minimum wage is most relevant for agriculture, tourism and construction. The strong employment growth in the Portuguese economy, and in particular in tourism, seems to indicate that the minimum wage has not negatively affected employment. However, the counter-factual remains unknown.<sup>v</sup> A negative impact of minimum wage increases on unit labour costs has not been noticed; possible disincentives to skill investments would require more time to take effect.

## Public finances: nominal consolidation, structural weaknesses

Public finances were weak in Portugal for a long time before the crisis. The headline deficit eventually always turned out at or above 3% of GDP since the creation of the euro and increased to above 10% in 2010 (Graph 9). However, since then and until the outbreak of the COVID-19 pandemic, budgetary data improved markedly. The headline deficit fell below 3% of GDP for the first time in 2016, allowing Portugal's exit from the excessive deficit procedure (EDP) in the spring of 2017. Portugal even achieved a small budget surplus in 2019.

Graph 9: General government budget balance



Source: European Commission.

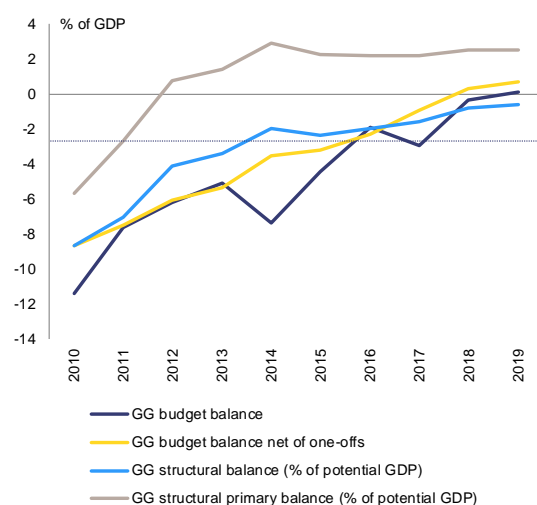
Portugal focused on reducing the headline deficit ('nominal consolidation') in the years since the crisis, with fiscal policy being mainly aimed at the exit from the EDP and, once that was achieved, at avoiding its immediate re-opening.<sup>vi</sup> At the same time, the government had decided to accelerate the pace of reversal of two main measures taken in the crisis.<sup>vii</sup> In February 2016, the authorities announced consolidation measures amounting to 0.5% of GDP (based on the Commission's assessment) when it became clear that the Draft Budgetary Plan from January had implied a structural consolidation effort significantly below the 0.6% of GDP recommended by the Council. These measures consisted mainly of increased revenues from specific taxes and social security contributions, and efficiency gains from administrative measures. In July, the Council decided that



Portugal had not taken effective action to reduce the excessive deficit and subsequently, in August, asked for additional consolidation measures of another 0.25% of GDP. Portugal implemented that requirement mainly by freezing public intermediate consumption. Later in the year, Portugal also set up a new tax debt settlement scheme, which resulted in another 0.25% of GDP of not previously planned revenue. On this basis, the country finally achieved in 2016 a deficit of 2.0% of GDP (later revised downwards to 1.9%)<sup>viii</sup>, which allowed the exit from the EDP in spring 2017. In that year, the costs from the recapitalisation of Caixa Geral de Depósitos (CGD), a large public bank, threatened to drive the deficit up again which might have made a new EDP procedure necessary. However, helped by strongly accelerating GDP growth and lower interest expenditure, the authorities managed to keep the final deficit at 3.0% of GDP in 2017. Helped by cyclical revenue, decreasing interest expenditure and subdued public investment, the government balance continued to improve to a deficit of 0.3% of GDP in 2018 and a small surplus of 0.1% in 2019.

The reduction of the headline deficit does not give a clear picture of the degree of genuine fiscal consolidation in Portugal as it was influenced by the business cycle and measures that were intrinsically non-recurrent ('one-offs'). One-offs (Graph 10; see also European Commission 2019a) influenced the deficit strongly during and after the crisis. These were in particular various cases of support to the banking sector. Excluding, for example, the bailout of BANIF in December 2015, with budgetary costs of some 1.4% of GDP, the deficit would possibly have turned out close to 3% already in that year. Similarly, the headline deficit was increased by 2.8% of GDP in 2014 due to costs implied by the failure of Banco Espírito Santo (BES) and by 2.0% in 2017 by the budgetary burden of the recapitalisation of CGD. More recently, bank support measures continued in view of the recurrent activation of the contingent capital mechanism of Novo Banco, the 'good bank' remaining from the failure of BES, with a deficit-increasing impact of 0.4% of GDP in 2018 and 0.5% in both 2019 and 2020.

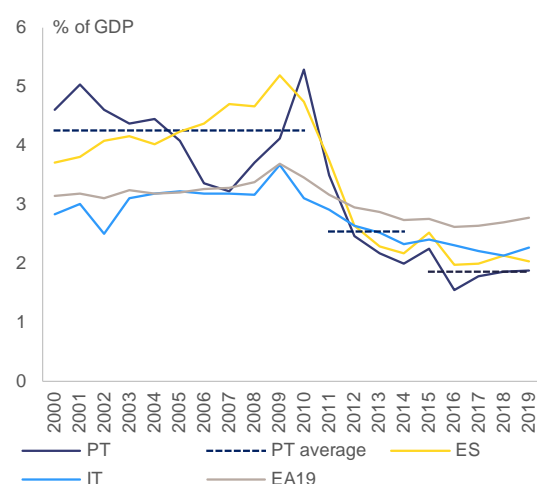
**Graph 10: Headline and structural balance and one-offs**



Source: European Commission.

While the headline deficit, net of one-offs, improved considerably, structural consolidation remained weak, in particular when measured against the expenditure benchmark.<sup>ix</sup> The decrease in interest expenditure by around 1.6 percentage points of GDP from 2015 to 2019 accounts for close to six sevenths of the improvement of the structural balance (around 1.9pp) over the same period.<sup>x</sup> As a result, the structural primary balance (i.e. the structural balance excluding interest expenditure) has remained broadly unchanged since 2015.

**Graph 11: General government investment**

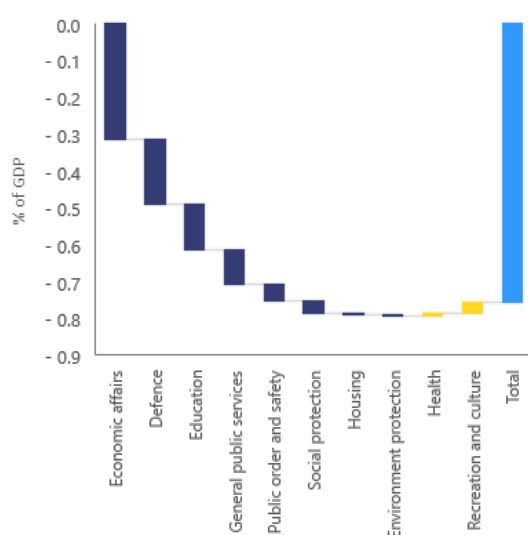


Source: Eurostat.

Public investment has been very low for a prolonged period. After sustaining very high levels during the first decade of the 2000s (at an average of 4.3% of GDP in 2000-2010,

compared with 3.3% for the euro area), Portugal's public investment was visibly reduced during the crisis (to an average of 2.5% of GDP in 2011-2014), swiftly converging to the euro area average (Graph 11). Public investment was contained further throughout the post-programme period (to an average of 1.9% of GDP in 2015-2019, compared with 2.7% for the euro area), remaining consistently below programme levels and government plans. Looking at the period 2015-2018 for the composition of public investment by economic function, gaps relative to the euro area benchmark are identifiable across most policy areas (Graph 12)<sup>xi</sup>, like in 'economic affairs' (mainly 'transport'), 'education', 'public order and safety' (including 'law courts'), 'social protection' and 'environment protection'. While the correction of public investment from the very high pre-crisis levels could reflect a greater focus on more valuable projects, public investment would be expected to increase after a protracted period of continuously very low levels to safeguard an adequate stock of public capital. Focusing on high-quality investment would be key to delivering effective public services, fostering the convergence of per capita income to the euro area and strengthening the resilience of public finances to potentially worsening economic and demographic trends in the future.

**Graph 12: Composition of general government investment, 2015-2018 – PT vs. EA19**

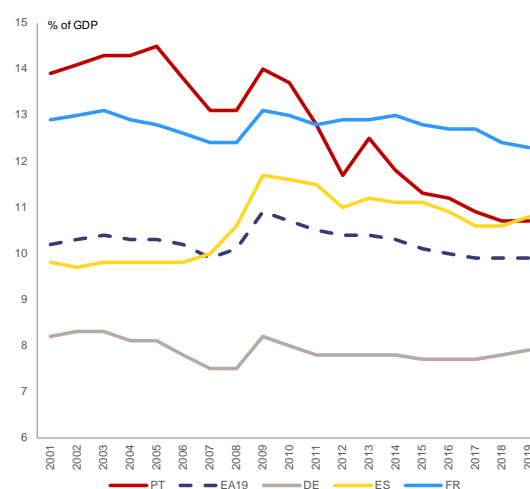


Source: data from Eurostat, European Commission.

Several fiscal-structural weaknesses remain (European Commission 2020). The 2015 Budgetary Framework Law is still not fully in

force. The (public) health system, in particular specific hospitals, has depended on recurrent discretionary budget reinforcements; a reform giving hospitals higher budgets and more autonomy while enhancing their monitoring had started before the COVID-19 outbreak. The fiscal sustainability of some state-owned enterprises remains weak. More comprehensively, the public wage bill spending has started to increase again in absolute terms. This increase could reverse the downward trend observed since 2009 in the public wage bill as a share of GDP, putting additional pressure on public finances (Graph 13). It is linked to a considerable degree to the shortening of the working week from 40 to 35 hours with full salary compensation which was introduced in 2016 (reversing the opposite move taken during the programme as a permanent measure, also to align the working time in the public and the private sector). A spending review has been ongoing but needs to become more comprehensive to deliver ambitious results.

**Graph 13: General government expenditure – Compensation of employees**

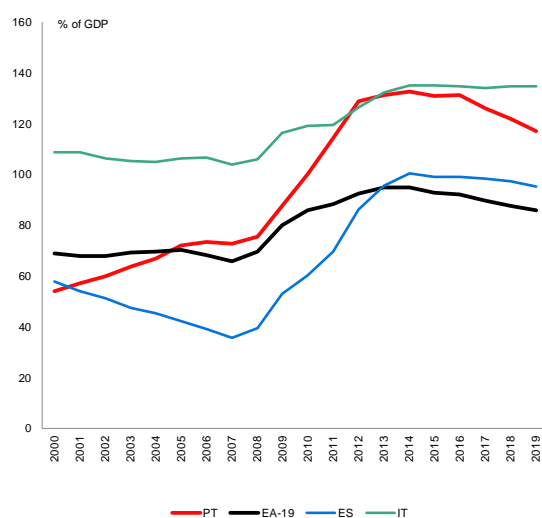


Source: Eurostat.

A structural strengthening of fiscal policy remains particularly important for Portugal. Debt had increased in the crisis to some 130% of GDP. It started to fall in 2017 and reached 117.2% in 2019, before the COVID-19 crisis hit (Graph 14). While this decrease is positive, the level of debt still constitutes an important vulnerability of the Portuguese economy. The regular debt sustainability analyses of the European Commission (see, for example, European Commission 2020) show how unfavourable macroeconomic shocks – a reduced GDP growth by 0.5pp or an increased interest

rate by 1pp – can slow down the decrease of the public debt-to-GDP ratio.

Graph 14: **General government debt**



Source: Eurostat.

## Private debt and financial stability have improved

In the run-up to the crisis, Portugal experienced not only an increase in public debt but also an accumulation of private debt of households and non-financial corporations (NFC). Household debt increased from a pre-crisis level of 84.1% of GDP in Q1-2007 to 92.1% of GDP in Q4-2009 while NFC debt grew from 92.4% of GDP in Q1-2007 to 119.9% of GDP in Q4-2012.<sup>xii</sup> Related to this, the external indebtedness of the Portuguese economy reached dangerously high levels, with a net international investment position going from -79.6% of GDP in Q1-2007 to -122% of GDP in Q1-2014.

The share of non-performing loans (NPLs) in Portugal peaked at 17.9% in Q1-2016, the third-highest value in the euro area, according to Bank of Portugal data. The ratio of NPLs in the corporate segment stood at 30.3%, while for the household segment the NPL ratios of consumer loans and mortgages stood at 19.0% and 7.2% respectively. Very high levels of debt create an obvious burden for the debtors as higher shares of income have to be used to serve existing loans and conditions for new credit tighten. High levels of debt lead to higher defaults, affecting banks' capital and reducing their scope and appetite to borrow, with negative impact on

credit supply and financing conditions which in turn has a negative impact on investment.

High levels of debt and NPLs placed a heavy burden on Portuguese banks during the crisis and afterwards. High operating costs (e.g. a high number of employees and of branches), weak risk control in credit provision and general mismanagement in some banks added to this. The financial assistance in the framework of the adjustment programme included a specific envelope for financial sector support, amounting to EUR 12 bn ('banking sector stabilisation fund'). Of these, EUR 5.6 bn were used during the programme. Actual bank failures happened in the early days of the global financial crisis (BPP and BPN in 2008) and after the end of the programme (BES in 2014 and BANIF in 2015) and were limited to banks with unsustainable business models or subject to gross mismanagement.

Several steps were taken to stabilise the financial sector since 2016. Private banks strengthened their solvency (European Commission 2017) whether by private capital increases (e.g. Millennium bcp), restructuring difficult foreign exposures (e.g. BPI) and/or by stronger involvement by foreign banks (e.g. acquisition of BPI by the Spanish CaixaBank group or the integration of Banco Popular's Portuguese subsidiary into Santander Totta). The duration of the public loans to pre-finance the national resolution fund for private banks was extended to around 30 years. The publicly owned CGD received a substantial recapitalisation. Large parts of Novo Banco could be sold to private investors in 2017. A comprehensive strategy to bring down NPLs is being implemented since 2017 (European Commission 2018a). This includes changes to the judicial, legal and tax system, prudential/supervisory actions led jointly by the Single Supervisory Mechanism and the Portuguese Central Bank, and new NPL management solutions. The latter comprises, for example, an NPL management platform where the biggest banks cooperate on cases associated with firms that have business relations with more than one of the big banks. While these steps were to some degree supported by the improved macroeconomic outlook, they depended on strong action by the authorities as well as private banks.

As a result, profitability of the Portuguese banking sector has been growing. Operating costs and impairments dropped and the liquidity

position improved. Nevertheless, some indicators (e.g. solvency and CET1 ratios) remained relatively weak compared to European peers (European Commission 2019c).

Improved macroeconomic conditions allowed a significant reduction of private debt and NPLs. (Consolidated) private debt dropped from its peak of 210.4% of GDP in Q4-2012 to some 150% in Q4-2019 (household debt was 64% of GDP and NFC debt 86% of GDP). NPLs fell below the mark of 10% (to 6.2% in Q4-2019), having been at 17% still three years earlier.

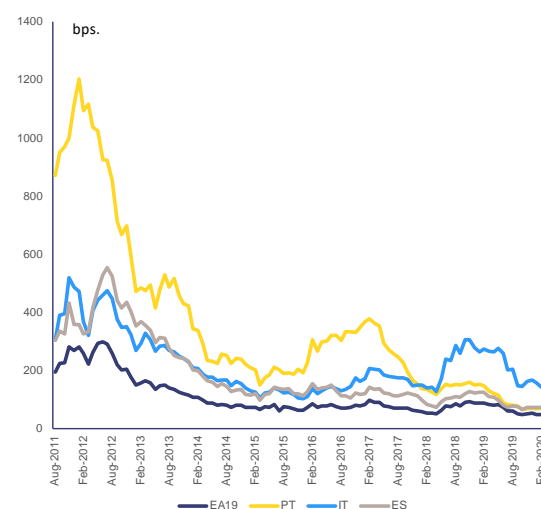
The external debt has also fallen, but its level remains high and further progress is doubtful given the again weakening current account. On the positive side, an increased inflow of foreign direct investment has improved the quality of the NIIP (European Commission 2020) and a substantial part of it consists of programme loans provided at sustainable interest rates, and is therefore less of a concern for investors and rating agencies.

### Sovereign financing, ratings and confidence have improved

The perception of the developments by market participants can be seen in government bond yields, ratings and confidence indicators.

Spreads over German sovereign rates peaked in January 2012 at 1200 bps for 10-year bonds and then started dropping to an interim low of 150 bps in March 2015, also aided by the unconventional monetary policy measures of the Eurosystem. After another increase to 360 bps in March 2017, spreads for 10-year bonds were on a downward path until reaching some 70 bps in February 2020 (Graph 15).

Graph 15: Spreads over German 10-year bond yields

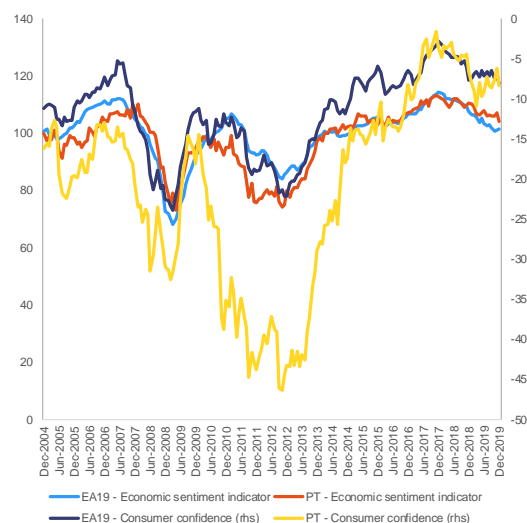


Source: Eurostat.

Since October 2018, all major rating agencies rate Portuguese debt again as investment grade. Three of the four main rating agencies (Fitch, Moody's and Standard & Poor's) had downgraded Portuguese sovereign debt to below investment grade during the crisis, with only DBRS maintaining an investment grade rating.<sup>xiii</sup> This was crucial for Portugal because participation in the ECB quantitative easing programmes required to be rated at investment grade by at least one of these four agencies.

Confidence was at its lowest in 2011-2012 in the early days of the programme but started to increase again between end-2012 and mid-2013 (Graph 16), whether measured with the Economic Sentiment Indicator or with specific confidence indicators (consumer, manufacturing, industrial, services, construction).<sup>xiv</sup> Confidence generally increased smoothly until 2015 before its dynamism slowed and the indicators started to decrease again in 2017. This follows very much the trend in the euro area.

Graph 16: Consumer confidence and economic sentiment indicator



Source: European Commission.

### Challenges ahead

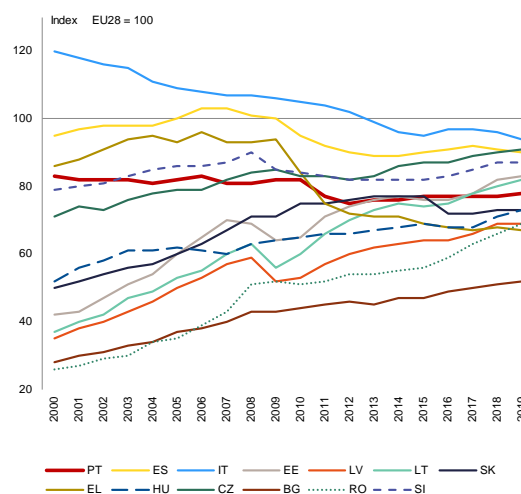
The positive economic environment, which helped Portugal’s recovery decisively, ended with the outbreak of the COVID-19 crisis in early 2020, putting the sustainability of recent developments to the test. Portugal is, as all other Member States, heavily affected by the COVID-19 outbreak. The European Commission Summer Forecast expects GDP to fall in 2020 by almost 10%, i.e. a similar order of magnitude as for the euro area, with risks to the recovery tilted to the downside. At the same time, the necessary green and digital transition holds challenges for Portugal, again, as for all other Member States. Reducing the high greenhouse gas intensity will require progress with renewable energy and increased energy efficiency, also to decrease the high dependency on imported energy. A low level of digital skills, in particular, holds back the economy which is characterised by small- and medium-sized enterprises. A policy of reforms and improved quality of public finances thus remains important as Portugal also faces several specific structural challenges:

- **Macroeconomic vulnerability:** While the external economic environment will always heavily influence a small and open economy such as Portugal, its high debt level is a specific vulnerability that can be reduced. As outlined above, both private and public debt were on a downward trend but the levels are still high. Ensuring debt sustainability is thus particularly important in the medium term; this is the background of the

recommendations of the Council to aim at prudent fiscal positions.

- **Convergence:** GDP growth in Portugal was slightly above the EU average in 2017-2019. However, in the longer run convergence to the EU average income (measured in terms of purchasing power parity) is still absent (Graph 17). GDP per capita stayed slightly above 80% of the EU average between 2000 and 2010, dropped to 75% in the crisis and has not yet clearly moved upwards since.

Graph 17: GDP per capita in PPP



Source: Eurostat.

- **Productivity:** Low productivity growth is the central reason behind lacking convergence (European Commission 2020). Labour productivity growth has been at or below the EU average in the last 20 years with the exception of the immediate pre-crisis years. Convergence would need clearly above-average levels. The investment performance during and since the crisis is mixed. Private investment as a share of GDP was above the EU average until 2006, reached its low point at 12.6% of GDP in 2013 and is now increasing (16.4% of GDP in 2019 vs. 19.1% for the euro area). Skill gaps, low R&D spending, some regulatory and administrative barriers as well as gaps in selected infrastructure (e.g. transport and energy connectivity) are seen as main constraints to private investment. Public investment as a share of GDP was below the EU average since the crisis, in particular as of 2016.
- **Demographics:** The Portuguese population is ageing relatively quickly. While the median age was 36 in 1995, it had reached 45 in



2018. The projections in the 2018 Ageing Report (European Commission 2018b) show for Portugal an increase in the share of those aged 65 or above in the total population from 20.9% in 2016 to 35.4% in 2070 (against 19.3% and 28.8%, respectively, for EU28).

## Conclusion

Portugal has managed to leave the deep macroeconomic crisis of 2009-2013 behind, with the main macroeconomic indicators turning around already during the programme and improving steadily until early 2020. Bringing the public debt-to-GDP ratio to a downward path before the COVID-19 outbreak has improved the space for an adequate fiscal policy response to the current crisis. Nominal fiscal consolidation enabled the transition from the corrective to the preventive arm of the Stability and Growth Pact. It was driven by relatively benign macroeconomic circumstances (leading to savings in interest expenditure and windfall revenues) and contained public investment.

The performance since the crisis depended on demand and supply factors: benign external economic influences met an economy whose capacity to benefit from them had improved significantly. Structural reforms undertaken during the programme, partly started before the crisis, have helped to modernise the country and make markets more efficient. This trend has continued with the help of stable and credible policies since then.

Portugal benefitted in this process from EU membership, notably by frictionless trade in the single market, help from EU cohesion policy and the stabilising role of the euro. The adjustment programme supported the process of reform and modernisation. Post-programme surveillance and regular EU economic surveillance, including fiscal surveillance, gave guidance and set a solid policy framework. This also had a positive signalling effect on markets (e.g. Moody's 2016). Nevertheless, significant structural challenges (like the vulnerability from high debt levels, lacking convergence due to low productivity, and a relatively quickly ageing population) remain.

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<sup>i</sup> GDP per capita dropped by 7%, i.e. less than GDP due to net-emigration, from EUR 17260 in 2008 to EUR 16050 in 2013 before it started to grow again, exceeding the pre-crisis peak in 2017.

<sup>ii</sup> Eurostat, LFS Adjusted Series, SA.

<sup>iii</sup> In the framework of European economic policy coordination and surveillance ('European Semester'), the European Council issues country-specific recommendations to each Member State. Their implementation is analysed and assessed by the European Commission. For the 2019 recommendations to Portugal see: <http://data.consilium.europa.eu/doc/document/ST-10175-2019-INIT/en/pdf>.

<sup>iv</sup> As the minimum wage is typically paid 14 times per year, this amounts to a de facto monthly remuneration of EUR 740.83.

<sup>v</sup> For a recent analysis of the Portuguese minimum wage, see Alexandre et al. (2020) who find that minimum wage increases may have reduced employment growth and profitability, in particular for financially distressed firms. Thus, they may have had a supply side effect by accelerating the exit of low profitability and low productivity firms and, thus, contributing to improve aggregate productivity through a cleansing effect.

<sup>vi</sup> Portugal had been in the corrective arm of the Stability and Growth Pact, i.e. in EDP, since 2009. The focus in this situation is on the nominal deficit, which should be below 3% of GDP. Once this is achieved and the correction of the excessive deficit is considered to be lasting, the EDP can be abrogated and the country is placed under the preventive arm of the Stability and Growth Pact, where the focus is on the structural balance which should reach a country-specific medium-term budgetary objective.

<sup>vii</sup> A surcharge on personal income tax and cuts to public sector wages were introduced during the crisis. Both measures had been previously planned to be gradually withdrawn at a slower pace.

<sup>viii</sup> The initial Commission forecast of the 2016 deficit, based on the Draft Budgetary Plan from January 2016, of 3.4% of GDP thus proved to have been quite realistic, taking into account the additional consolidation measures of 1 percentage point later in the year and the fact that some measures from the initial plan, amounting to 0.2% of GDP, were also only later specified to a sufficient degree. Similarly, a comparison of the Commission forecasts for GDP growth and employment with actual outturns and with the forecast of the authorities has shown their realistic and unbiased nature.

<sup>ix</sup> The structural improvement of public finances can be assessed by the structural balance (i.e. nominal balance net of one-offs and the cyclical component) or by the expenditure benchmark (i.e. the containment of the net growth of primary government expenditure at or below the rate of medium-term potential GDP growth). The second indicator for Portugal has tended to clearly exceed its benchmark. It is considered to reflect more appropriately Portugal's underlying fiscal effort in recent years because the structural balance has been distorted by windfall gains, notably from low interest rates (European Commission 2019b). In addition, revenue windfalls outside the control of the government had a strong positive impact on the structural balance but do not influence the expenditure benchmark. Moreover, potential GDP growth affects the expenditure benchmark in a more stable way.

<sup>x</sup> Consolidation benefitted from low interest rates, associated with the accommodative monetary policy, that drove down sovereign refinancing costs throughout the euro area. Improving credit ratings reflecting positive macroeconomic and fiscal developments also helped Portugal to gradually decrease interest spreads as compared with Germany, bringing them down close to the level of Spain by the end of 2018. Public interest expenditure was around 4.5% of GDP in the first half of the decade, the highest value in the euro area in 2015 and 2016, before it started to drop. It was 3% in 2019, still the second-highest value (after Italy).

<sup>xi</sup> Eurostat collects data on general government expenditure by economic function according to the international Classification of the Functions of Government (COFOG) in the framework of the European System of National Accounts (ESA2010).

<sup>xii</sup> All private debt figures refer to consolidated debt.

<sup>xiii</sup> See e.g. DBRS (2016) which also refers to the importance of Portugal's compliance with EU fiscal surveillance rules.

<sup>xiv</sup> The Directorate General for Economic and Financial Affairs of the European Commission conducts regular harmonised surveys for different sectors of the economies in the European Union (EU) and in the candidate countries. They are addressed to representatives of the industry (manufacturing), services, retail trade and construction sectors, as well as to consumers and allow comparisons across different countries' business cycles. For Portugal, they are carried out by INE, the National Statistical Office.

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