Understanding Portugal in the Context of the Euro Crisis

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Introduction

On 7 April 2011, Portugal became the third euro area Member State to request international financial assistance from the European Union and the International Monetary Fund. Roughly one year after the European Union had approved the first financial aid package to Greece and five months after Ireland had requested international financial assistance under the temporary crisis mechanisms that had in the meantime been set up by the EU (the European Financial Stability Mechanism, EFSM) and by the euro area (the European Financial Stability Facility, EFSF), Portugal could no longer resist to pressure from the financial markets on the financing conditions of its economy.

The past year had been one of resisting that outcome in a context of unfolding sovereign debt crisis in the euro area and increasing market pressure on its most vulnerable economies. This paper gives an account of the context and the events as they shaped that period leading up to Portugal's request for international financial assistance in an attempt to draw conclusions from that experience. It is an account based on public information and reports, but experienced from up close. Section 1 briefly looks at factors that have shaped divergent perceptions of the crisis, which have had a considerable influence on the political management of the sovereign debt crisis in the European Union. Section 2 goes through the economic situation in Portugal considering, in particular, the pre-global crisis' developments during the 2002–08 period. Section 3 gives an account of the crisis as it unfolded, seen from a Portuguese perspective, and looking at the evolution of European decisions and market sentiment. Section 4 tries to draw lessons from the Portuguese experience.

Section 1 – Euro Area Crisis vs. National Crises

Divergent perceptions of the crisis have influenced its political management within the European Union and the euro area. That this is a euro area crisis was not a view accepted by many of the political leaderships, especially in the central and northern European countries. It was often (and still is) depicted as a crisis of the fiscal profligate States. This is certainly partially the case. Those countries with higher public deficits and debts were and are the most vulnerable to this crisis. But it misses an important point: that this crisis is structural and political, as well as economic, and that it is closely linked to how the euro was built.

There were early on in the crisis circumstances that were preponderant in shaping divergent political perspectives on the crisis and in singling out individual situations and solutions at the expense of a more global and determined euro area approach.

- **A Greek Crisis**

The first can be traced to the origins of the sovereign debt crisis. The EU had tackled in a coordinated manner and with single purpose the global financial crisis in 2008 and the global economic recession in 2009. The general view was that those crises had originated in the United States and had spilled over to Europe. Not the 2010 sovereign debt crisis. This was triggered in the Europe Union and, in particular, in Greece. It was, of course, bad enough economically that the newly elected Greek Government found out in November 2009 that the country's public deficit that year would exceed 12 percent of GDP, doubling the level announced by the previous administration. Here was a country with a pre-crisis public debt level of 105.4 percent of GDP in 2007, the highest in the EU, in serious fiscal crisis.

True, budget deficits and public debts had dramatically increased everywhere in the developed world. The same had happened in the US (from 62 percent of GDP in 2007 to 93.6 percent in 2010) and in Japan (from 167 percent of GDP in 2007 to 199.7 percent in 2010). Moreover, increase in public spending had been the European Union agreed policy to avoid an economic depression in 2009, as is clear from the European Council conclusions at the time (see Box 1). Economic recession, automatic stabilizers, stimulus packages, and bailing-out insolvent banks in some countries, added up to considerably higher public deficits and debts. Even the most fiscally conservative countries in Europe saw their debt to GDP ratio jump by more than 10 percentage points between 2007 and 2010 (see Table 1). As a matter of fact, by 2010 every single euro area country had been put under an excessive deficit procedure, with the exception of Luxembourg[1]. But Greece's budgetary problems were of another order of magnitude altogether.

Additionally, the Greek government's admission that national statistics had been consistently unreliable for years added a devastating political effect. This immediately brought to mind the 2004 episode when after close EU scrutiny the then Greek government conceded that the country's budget deficits had never been below the Maastricht criteria of 3 percent since 1999, not even as Greece joined the euro in 2001, and compounded suspicions not only from the international financial markets but also from the European partners that Greek statistics were not to be trusted. This fact poisoned the debate within the EU and had an out-of-proportion effect on the way the sovereign debt crisis was dealt with politically.

- **Divergent Economic Performances in Europe**

But that was not the only reason why for so long many insisted that the troubles (and the solutions) were restricted to the euro area peripheral countries. The second reason had to do with diverging post-recession economic performance. In 2010 many euro area countries were fairing considerably well out of the recession. The central and northern euro area countries all posted annualised growth figures above 2 percent in the second quarter of 2010[2] (Finland, 5 percent; Slovakia, 4.7 percent; Germany, 4.4 percent; Belgium, 2.8

[1] Estonia entered the euro area on 1 January 2011.
[2] Real GDP growth rate; percent change q/q4. Source: Eurostat.

percent; Austria, 2.4 percent; the Netherlands, 2.1 percent). In the periphery[3] the picture was quite different, with Greece (–4 percent) and Ireland (–0.7 percent) deep in recession and Spain (0.2 percent) barely growing. Only Portugal showed healthier, but yet lower, indications (1.6 percent).

The situation fed into the narrative of the "after-party bust" that became popular and seemed to fit well the economies of Greece, Ireland and Spain that had seen strong growth in the past decade while at the same time also saw their international competitiveness and current account balances deteriorate quickly. Portugal had a slightly different story. Indeed, external balances continued to be highly negative since 1996, but strong growth had not been registered since 2001.

- **Ring-Fencing Strategy**

Thirdly, the EU leaders decided to differentiate each individual case. Naturally, it was not to the liking of the country negatively singled out at a specific moment. Greece, Ireland, and Portugal consecutively all had their situations described as substantially different from those countries considered to be next in line. It was an attempt to ring-fence the countries in bigger trouble from those that could soon be themselves in big trouble, as the speed of the crisis and the danger of contagion became clear and difficult to control. And as a matter of fact, the situations and the gravity of the financing difficulties were indeed (and are) considerably different from country to country. However, it was apparent that contagion was not going to be stopped by that strategy alone. The situation was all too reminiscent of the 1992 Exchange Rate Mechanism crisis. What then first seemed like a problem limited to the British pound exchange rate ended up reaching the French franc and becoming a fully-blown ERM crisis.

- **The Central Role of Sovereign Moral Hazard**

As the crisis unfolded the environment in the European Union was tense. Arguably with a lot of help from tabloid press and populist politicians, mistrust increased, national prejudices reinforced and intra-European solidarity weakened. In the fear of creating moral hazard by benefiting licentious fiscal behaviour, the debate was often entangled in moral duality. This was the case in initially pricing the financial assistance packages at considerably higher levels than, for example, interest rates in the European Balance of Payments Facility used to assist non-euro EU members.

[3] I use the expression "peripheral countries" throughout this paper to describe Greece, Ireland, Portugal and Spain. Not only does it match those countries geographical position in Europe as I find it a more elegant alternative to other expressions (or acronyms) used elsewhere.

Table 1. General government gross debt (percent of GDP; increase 2007-2010 in percent of GDP)

Geo \ Time	2007	2008	2009	2010	Δ percent
Euro area	66.2	69.9	79.3	85.1	**18.9**
European Union	59	62.3	74.4	80	**21**
Belgium	84.2	89.6	96.2	96.8	**12**
Germany	64.9	66.3	73.5	83.2	**18.3**
Ireland	25	44.4	65.6	96.2	**71.2**
Greece	105.4	110.7	127.1	142.8	**37.4**
Spain	36.1	39.8	53.3	60.1	**24**
France	63.9	67.7	78.3	81.7	**17.8**
Italy	103.6	106.3	116.1	119	**15.4**
Netherlands	45.3	58.2	60.8	62.7	**17.4**
Portugal	68.3	71.6	83	93	**24.7**
Finland	35.2	34.1	43.8	48.4	**13.2**
United Kingdom	44.5	54.4	69.6	80	**35.5**
Japan	167	174.1	194.1	199.7	**32.7**
United States	62	71	84.3	93.6	**31.6**

Source: Eurostat and OECD.

Box 1 One year of European Council conclusions (December 2008 – December 2009)

11-12 December 2008

§8. The financial crisis is now impacting on the economy. The euro area, and indeed the Union as a whole, are threatened with recession. (…) It will mobilize all the instruments available to it (…). In that context, Member States' policies on social protection and inclusion also have a vital part to play.

§9. The European Council agrees on a European Economic Recovery Plan (…) it is based on an effort equivalent in total to around 1.5 percent of European Union GDP.

18-19 June 2009

§11. It is imperative for the EU to continue to develop and implement the measures required to respond to the crisis. This should be done by building on the important achievements of the past months in line with the European Economic Recovery Plan agreed last December, which will amount to an overall budgetary support of around 5 percent of GDP in 2009/2010.

29-30 October 2009

§26. The incipient recovery needs close monitoring and the supporting policies should not be withdrawn until the recovery is fully secured.

10-11 December 2009

§6. The economic and financial crisis (…) resulted in the most difficult economic downturn since the 1930s. (…) The support measures have been crucial in restoring confidence in financial markets and ensuring their proper functioning as well as dampening the impact of the crisis on growth and employment.

§8. Fiscal consolidation should start in 2011 at the latest, earlier in some Member States where economic circumstances make this appropriate, provided that the Commission forecasts continue to indicate that the recovery is strengthening and becoming self-sustaining.

Section 2 – 2002–08: The Portuguese Economy

a) Out of Sync with the Periphery

Unlike Greece, Ireland or Spain, where economic growth had been sustainably high before the crisis, Portugal experienced low growth since 2001. In 2003 Portugal went into recession (–0.9 percent), the only euro area country together with Germany (–0.2 percent) to register negative growth that year. That same year, Greece's economy expanded by 5.9 percent, Ireland's by 4.4 percent and Spain's by 3.1 percent[4]. The difficult Portuguese case, described in a paper by Olivier Blanchard in November 2006[5], was one where productivity growth was anaemic, economic growth very low, the budget deficit large and the current account deficit very large.

The prospect of euro accession in the second half of the nineties had led to a sharp drop in interest rates with real interest rates approaching zero at the end of the decade. This triggered an unprecedented and substantial wealth effect strongly felt by all domestic agents, leading to rapid internal demand growth and a decrease of private saving. Non-tradable uncompetitive rent seeking sectors surged, diverting investment from tradable sectors and thus contributing to low productivity growth. With domestic demand sustaining the economic boom, unemployment shrank to less than 5 percent exerting a considerable upward pressure on wages. The economy became overvalued and current account deficits grew increasingly larger.

In addition to the macroeconomic consequences of a difficult adjustment to the new monetary setting, the Portuguese economy was hit in the late nineties by two important asymmetric shocks which added considerably to its external competitiveness deficit.

It had been anticipated that enlargement of the European Union to the central and eastern European countries would have adverse economic effects on Portugal. In fact, repercussions were felt already in the second half of the nineties as the EU entered Association Agreements with those countries before actual accession in 2004. There were important impacts in diverting foreign direct investment and trade that had come Portugal's way since its own accession in 1986. A much higher skill and educational levels of the workforce, lower labor costs and a central geographical position relative to Europe's main markets meant that those countries, once within the EU framework, had considerable advantages in attracting FDI and being more trade competitive[6].

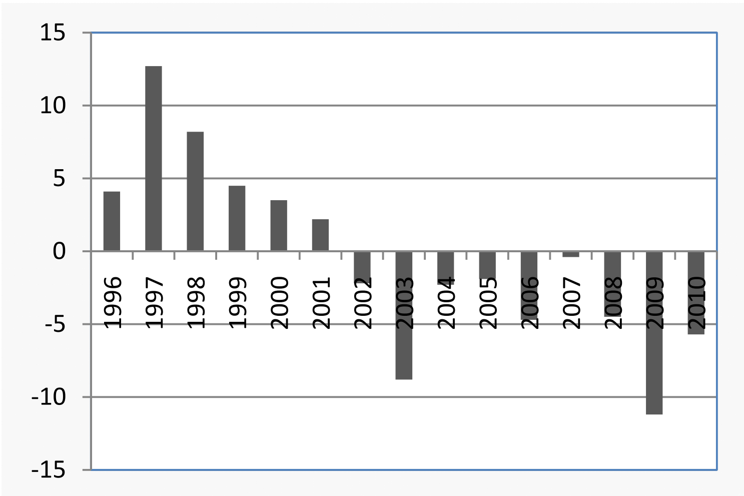
Additionally, the new century had brought the entry into the world market of China, India and other emerging low cost economies that competed in labor intensive areas of traditional specialization of the Portuguese economy. The end of the Multi Fibre Agreement following the WTO Uruguay round negotiations had an enormous impact on the Portuguese textile industry, its main export sector. The textile sector represented 33 percent of total Portuguese exports in 1990. It accounted for only 13 percent in 2006.

Developments in the macroeconomic context and in international trade signified that Portugal was not in a good position to profit from rapid European and world expansion in the nineties and the 2000's. When private domestic demand dropped sharply in 2001/2002 with it stalled the engine of recent economic growth. The country's landscape had changed immensely with public investment notably on roads and other

[4] Real GDP growth rate; percent change on previous year. Source: Eurostat.
[5] Olivier Blanchard, "Adjusting within the euro. The difficult case of Portugal", 11 November 2006
[6] For detailed studies on the impact of enlargement see: (i) Augusto Mateus e Associados, "A Economia portuguesa e o alargamento da União Europeia", Abril 2004; (ii) José Caetano, Aurora Galego e Sofia Costa, "Portugal e o alargamento da União Europeia: alguns impactos sócio-económicos", Análise Social, vol. XL (175), 2005.

public infrastructures spanning from north to south. So had consumption patterns changed dramatically and property ownership increased substantially in the past 10 years. As household indebtedness weighted on families that had been used to traditionally high rates of private saving, and a new political cycle started in 2002 underscoring the country's need to curtail past excessive consumption and spending, households' expectations adjusted suddenly. An example of the drop in domestic spending is clearly given by the evolution of investment in construction (Figure 1). Portugal is the only European country to register an annual decline in investment in construction every single year since 2002 until today.

Figure 1. Investment in construction (percent change on previous year)



Source: National Statistics Institute.

b) Slowly Getting Back on Its Feet?

By 2002 Portugal had been through the full cycle of boom, overvaluation and slump well before the other peripheral economies in the euro area completed that journey when their rapid expansion came to a sudden halt during the 2008–09 global recession.

To get back to growth, with domestic demand stalling, Portugal needed to regain competitiveness. To a large extent this had been done through currency devaluation in the seventies and eighties, but that was no longer available. This time it could either be done through salary disinflation or/and stronger productivity growth. Both actually occurred to an extent.

- **Lowering Wage Costs**

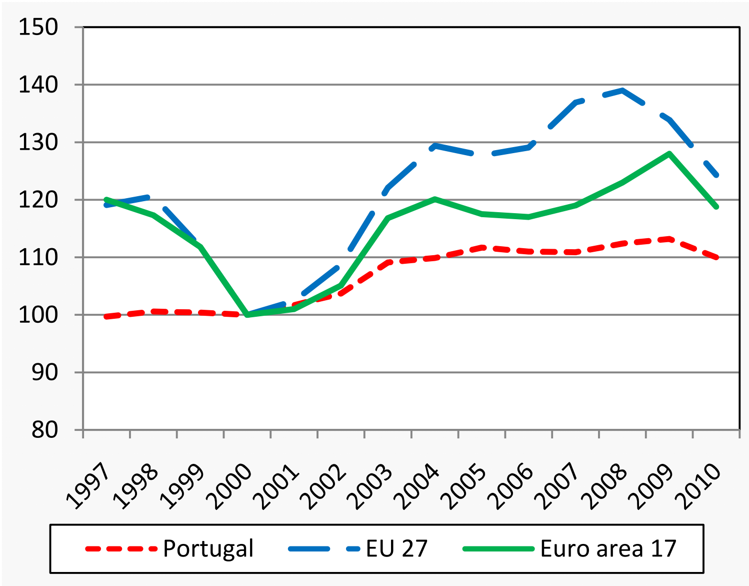
Beginning in 2002, wage costs' growth slowed down considerably. Accumulated real effective exchange rate in relative unit labor costs grew by 3.6 percent in Portugal from 2003 to 2008. This compares to 11 percent in the euro area, 11.4 percent in Greece, 12 percent in Spain, and 26.8 percent in Ireland[7]. Still far from Germany's real competitive disinflation of –4 percent for the same period, but bellow euro area average.

While still increasing, and far from the deflationary evolution in Germany, the differential with the euro area unit labor costs evolution narrowed significantly. Unit labor costs measured in terms of real effective exchange rates actually grew at slower pace than those in the euro area and main comparable economies. The measurement of nominal unit

[7] Bank of Portugal data.

labor costs for the total economy also shows a very different profile from 2003 onwards. While before labor costs had grown at a considerably faster rate than both the euro area and the European Union averages', starting in 2003 the trend is clearly reversed (Figure 2a).

Figure 2a. Nominal unit labor costs; total economy
(performance relative to the rest of 35 industrial countries; double export weights)



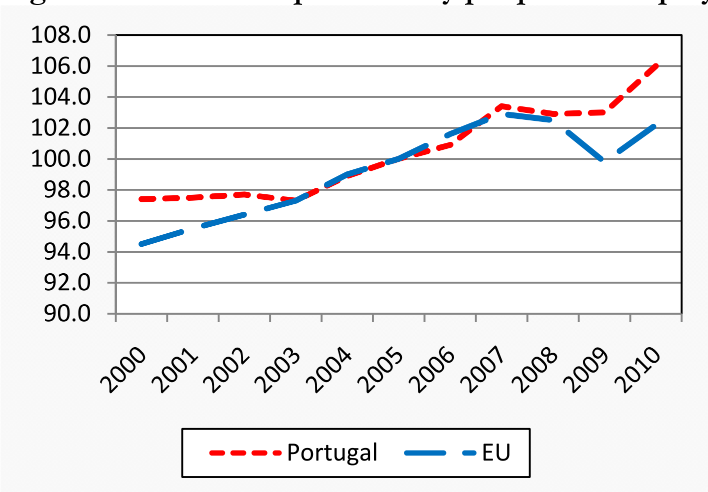
Source: DG Ecfin, European Commission.

- **Higher Productivity Growth**

As regards productivity growth the picture also started to change. Labor productivity in the second half of the last decade was catching up relative to EU levels, something which had not been registered for at least a decade. The indicator for labor productivity per person employed in PPS in relation to EU-27 average at 100 registered an increase from 72.6 in 2005 to 77.2 in 2010, while it had stalled, and even slightly declined, in the previous decade, from 71.1 in 1995 to 69.6 in 2004[8]. The same trend is also suggested by the labor productivity in terms of hours worked indicator, raising from 62.7 in 2005 to 65.2 in 2010 (62.3 in 1995 and 60.2 in 2004). Real labor productivity per person employed, a more reliable indicator for productivity international comparisons[9], confirms this trend (Figure 2b). For the first time in more than a decade, in the second half of the 2000's productivity in Portugal was again growing above EU average.

[8] A break in Eurostat series makes 2004-2005 comparisons difficult.
[9] There are limitations to international comparisons of productivity indicators based on PPS.

Figure 2b. Real labor productivity per person employed (index, 2000=100)



Source: Eurostat.

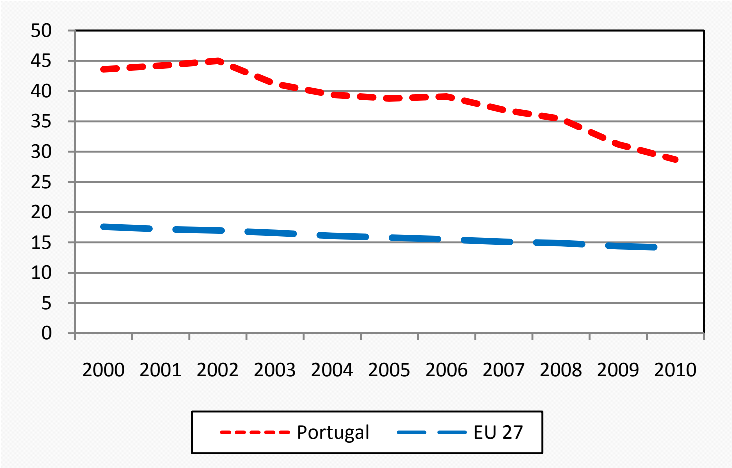
- **Portuguese Anaemia Spurs Structural Reforms**

In terms of policy, the rate and span of badly needed structural reforms also increased during the period of low economic growth in Portugal. These were important reforms for a country that not only had found itself in a macroeconomic quagmire but that also had substantial structural deficiencies from the past that needed to be tackled in order to successfully change the profile of its economy and the instruments of its competitiveness. The results recently achieved in some areas make worth noting some of those reforms.

  - **Education**

First, on education and skills, this has been Portugal's biggest, and arguably costliest, deficit. In economic terms, this was the heaviest burden left from a 48 year dictatorship that democracy has been correcting, albeit not at the desired pace. In this context, recent and far reaching reforms in education have achieved visible and important results. The percentage of early leavers from education and training has been on a sustained and accelerated path of reduction towards EU average since 2002 (Figure 3). Tertiary educational attainment has more than doubled from 11.3 percent in 2000 to 23.5 percent in 2010. Portugal was the OECD country that most progressed in the three areas (reading, mathematics and science performance) of the 2009 PISA tests, with Portuguese students achieving for the first time in history the OECD average group of countries, together with the UK, Denmark, Sweden, Germany, France, Ireland and Hungary.

Figure 3. Early leavers from education and training by gender
(Percentage of the population aged 18-24 with at most lower secondary education and not in further education or training)

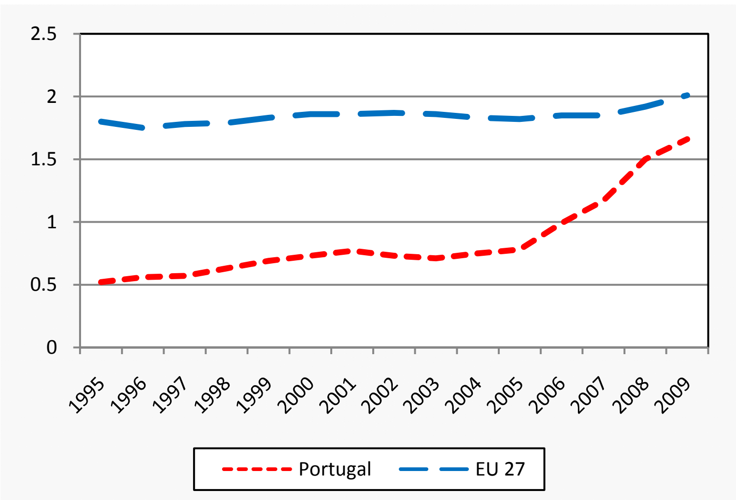


Source: Eurostat.

o Research and Development

Secondly, on research and development investment has also sharply increased, from 0.53 percent of GDP in 1995 to 1.66 percent in 2009, with the speed of catching up to the European average accelerating substantially in the latter years (Figure 4). These figures put Portugal, in terms of R&D development, ahead of Spain (1.38 percent), Italy (1.27 percent), Greece (0.58 percent[10]), plus all the more recent EU Member States with the exception of Slovenia (1.86 percent), and at par with Ireland (1.77 percent). It is relevant that the weight of private sector expenditures represented more than 50 percent of total R&D expenditures in 2007, up from little more than 20 percent in 1997, leading to a positive impact on the export profile towards more incorporation of knowledge and value-added and a technology balance improvement.

Figure 4. Gross domestic expenditure on R&D (percent of GDP)



Source: Eurostat.

[10] 2007 is the latest available.

- **Energy Dependency**

Thirdly, reducing energy dependency is also an area critical to Portugal. Energy imports account currently for almost half the trade deficit. The rapid promotion of renewable energies since 2005 is, thus, a relevant contribution to the correction of the economy's external imbalances. Electricity generated from renewable sources accounted for 53 percent of gross electricity consumption in 2010 compared to 23 percent in 2005.

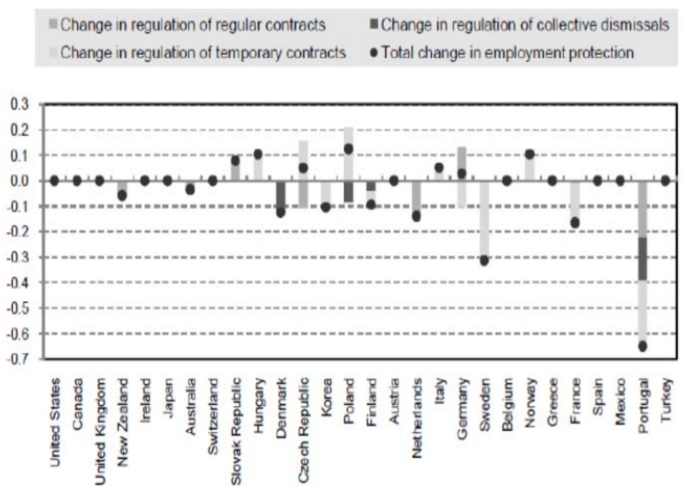
- **Cutting Red Tape**

Fourthly, the modernization and reform of public administration, cutting red tape, improving e-governance and business environment and reducing bureaucracy are areas where significant improvements have occurred. Portugal rose from the 48th to the 7th position in the ranking of on-line availability of services[11] and, according to the European Commission, became the leading EU country in terms of availability and sophistication of on-line public services[12], up from 16th in 2004. Also for starting a business, Portugal moved to the top of the scale with more than 60 percent of companies now being created in less than an hour[13].

- **Labor Market**

Finally, it is worth noting that Portugal began to change labor market legislation to increase flexibility, reversing the tendency of the previous thirty years. Labor legislation was changed in 2004 and, more substantially, in 2007[14], with flexibility increasing the most among OECD countries according to the organization's indicators (Figure 5). This improved market adaptation and should contribute to reduce segmentation, although Portugal remained a relatively rigid market in terms of individual dismissal.

Figure 5. Changes in employment protection in OECD countries, 2003-2008



Source: "Legislation, collective bargaining and enforcement: Updating the OECD employment protection indicators", Danielle Venn, 2009, www.oecd.org/els/workingpapers.

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11 Brown University Global E-Government Index, 2007.
12 Smarter, faster, better e-government, European Commission, November 2009.
13 The "company in the hour" measure earned Portugal the stamp of "Top Reformer" in the 2007 World Bank's Doing Business Report.
14 A proposal is now in Parliament for further reform of labor market legislation.

c) Vulnerability of Budgetary Consolidations

Portugal integrated the first group of countries that created the European single currency in 1999. Although budget deficits met accession targets (but by a slim margin: 2.7 percent in 1999) and public debt was reduced from 59.1 percent of GDP in 1995 to 48.5 percent in 2000 (in comparison, Spanish public debt was reduced from 63.3 to 59.3 percent during the same period), these budgetary figures were mainly sustained by rapid economic growth at the time.

As growth stalled from 2001 onwards Portugal was confronted with the difficulties of having to adjust late in budgetary terms to the new monetary regime. In fact, between 2002 and 2008, while Portugal was trying to consolidate budgets in a context of low economic growth, next door Spain was managing very low public deficits (under 1 percent) or surpluses under strong economic growth conditions[15].

- **Budgetary Moderation/Consolidation**

During this period, Portugal underwent two phases of budget moderation/consolidation, both in contexts of low economic growth: 2002–04 and 2006–08. These coincided with the two times that, before 2009, the country was subject to the corrective arm of the excessive deficit procedure under the Stability and Growth Pact of the euro. In the 1996–2001 period public consumption contributed on average 4 p.p. to annual GDP growth, while this was lowered to 1.5 p.p. in the 2002–04 period and 0.1 p.p in 2006–08[16]. It was during the 2006–08 period that total government expenditure actually decreased from 45.8 percent in 2005 to 43.6 percent of GDP in 2008[17]. Important structural reforms in the area of public spending with longer term impact were also implemented during this time. Two reforms, in particular, are worth noting.

- **Social Security Reform**

The first is social security reform. This reform targeted three main pillars: (i) it harmonized retirement age at 65 (previously at 60 for public servants) and eliminated special schemes; (ii) it introduced a sustainability factor that took into consideration the evolution of life expectancy when determining pension value, effectively resulting in an automatic annual increase in retirement age for workers wanting to access their full pension; and (iii) it introduced a new pension update rule indexing pensions to the development of inflation (only for lower pensions) and real GDP growth rate.

In 2009 the European Commission considered Portugal to be one of the EU countries to have implemented substantial pension reforms, with important reflexes on the country's long term fiscal sustainability[18]. Increase in age-related expenditure (Table 2) and public finances sustainability (Figure 6) indicators, as calculated by the European Commission in 2009, placed Portugal in better than EU average position.

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[15] Except for 2008 when Spanish deficit took off to –4.2 percent, coinciding with the burst of the real estate bubble.

[16] National Statistics Institute data.

[17] World Economic Outlook Database (IMF) figures for public debt: 45.8 percent (2005); 44.5 percent (2006); 43.7 percent (2007); 43.6 percent (2008). Eurostat figures (after March 2011 guidelines revision): 45.8 percent (2005); 44.5 percent (2006); 44.4 percent (2007); 44.7 percent (2008). Here I use the former figures for easier comparison with previous years, since Eurostat revision focused on 2007 onwards.

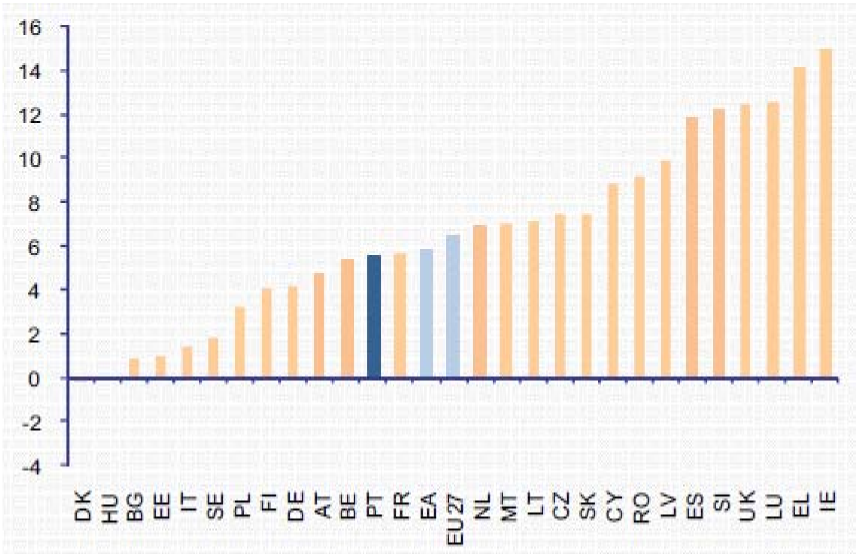
[18] Sustainability Report 2009, European Commission, September 2009.

Table 2. Increase in age-related expenditure
(percent of GDP 2007-2060)

Country	With pensions	Total
Greece	12.5	16.0
Spain	6.2	8.3
Ireland	5.9	8.7
Belgium	4.5	6.6
Netherlands	4.0	9.4
Slovakia	3.6	5.5
Euro area average	2.7	5.1
Finland	2.6	5.9
UK	2.5	4.8
Germany	2.5	5.1
EU-27 average	2.3	4.6
Portugal	**1.5**	**2.9**
Austria	1.0	3.3
France	0.6	2.2
Italy	-0.4	1.6

Source: European Commission.

Figure 6. Sustainability gap S2 calculated by the EC (2009)
(baseline scenario, percent of GDP)

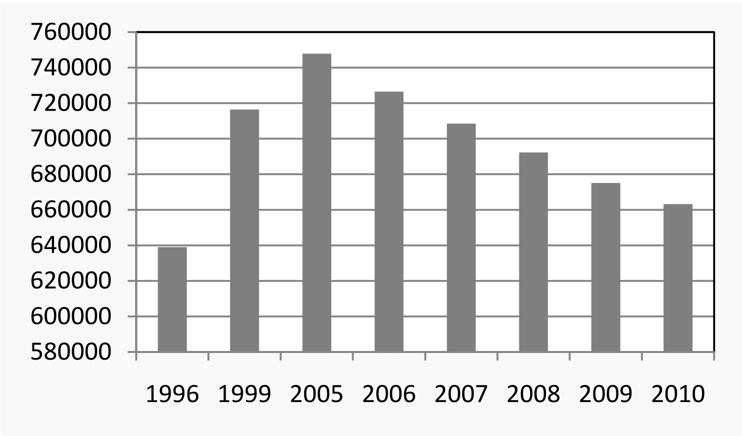


Source: "Sustainability Report 2009," European Commission, September 2009.

- **Public Administration Reform**

One other major area of reform was public administration. Public sector employment in Portugal had steadily increased since the seventies and became clearly overblown relative to output and to average European levels. Especially through tougher restrains on admission into public sector employment, the period since 2005 witnessed, for the first time, the reversal of this upward trend. By 2010 the number of public servants had been brought back to late nineties levels, with total numbers coming down approximately 10 percent from almost 750,000 in 2005 to below 670,000 in 2010 (Figure 7). Furthermore, the introduction of quota assessment systems and the end of automatic progressions also contributed to reduce spending on compensation of public employees from 13.9 percent of GDP in 2005 to 12 percent in 2008. 2009 registered an increase to 12.6 percent, the downward trend being resumed in 2010 (12.2 percent).

Figure 7. Number of public sector employees



Source: 2011 State Budget Report, Ministry of Finance.

- **2009: Budget Deficit Swells**

In 2009, public deficit consolidation efforts came to a halt. The deficit in 2009 increased to 9.3 percent of GDP from 2.7 percent in 2008[19]. The evolution of the 2009 budget projections shows that initial figures for revenue were clearly too optimistic, notably in an already declining economy. This, combined with an expansionary expenditure projection, to which the EU agreed Investment and Employment Initiative added, led to a drastic increase in the deficit to 9.3 percent of GDP in 2009 (Table 3).

Table 3. Evolution of the 2009 budget projections

		2008 Budget	2009 Budget (Oct -08)	(+IEI) (Jan-09)	(May-09)	(Jan-10)
Deficit	MEuros	-5,037.4	-3,850.5	-6,652.4	-9,659.0	-15,366.2
	percent GDP	2.9	2.2	3.9	5.9	9.3
Revenue	MEuros	69,966.9	75,997.7	74,562.5	71,112.0	65,507.6
	percent GDP	40.7	43.8	44.1	43.6	39.7
Expenditure	MEuros	75,004.3	79,848.2	81,214.9	80,771.0	80,873.9
	percent GDP	43.6	46.0	48.0	49.5	49.1
GDP	MEuros		173,683.8	169,092.5	163,073.0	164,879.6

Source: Ministry of Finance.

19 For better comparison, these are pre-revision figures. Final numbers, reflecting, in particular, Eurostat guidelines are 3.5 percent for 2008 and 10.1 percent for 2009.

d) Soft Approach to Correcting Imbalances

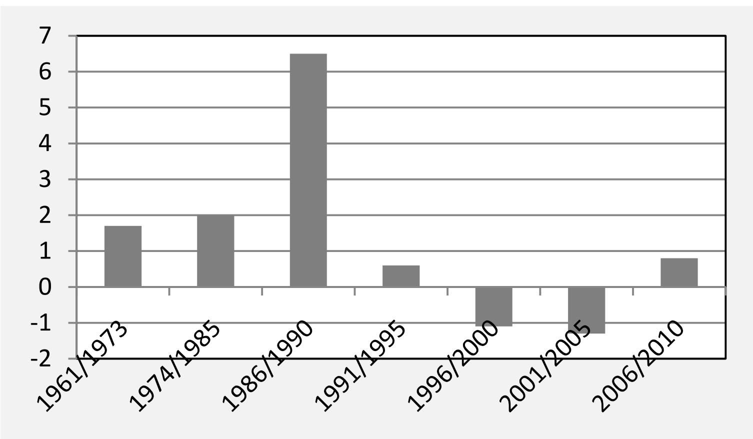
When economic growth stalled in 2001, Portugal had no option but to confront the economy's large structural deficiencies and declining external competitiveness and the need to adjust its fiscal policy to the new monetary regime within the euro. In previous years the country had been growing on the back of rapidly increasing domestic demand, and before that it had sustained external competitiveness to a great extent through currency devaluations. However, domestic demand was exhausted and currency devaluations no longer available.

2002 marks the beginning of a period of slow adjustment to this new reality. As was seen above, labor costs progressed at slower rates, and on average below the EU between 2002 and 2008. Starting in 2005, productivity growth trend was above EU average. Public expenditure, with the exception of 2005, was substantially less expansionary than in the past (contractionary only in 2006 with a -0.6 p.p contribution to GDP growth). Important structural reforms were also implemented with a view to increase sustainability of public finances and increase the economy's productivity.

- **Export Growth**

Export figures in the second half of the last decade indicate that, indeed, the economy entered a period of recovering competitiveness. For the first time in a decade, exports grew in the 2006/2010 period on average above EU 15 average, regaining a trend that had been lost since the second half of the nineties (Figure 7). Export to GDP ratio steadily increased from 27.8 percent in 2005 to 32.4 percent in 2008, its highest proportion ever in the Portuguese economy. After a steep decline in 2009 (28 percent), consistent with the fall in world trade, this ratio recovered its upward trend in 2010 (31 percent) and projections, as well as evidences up to 2011[20], indicate that exports will continue to rapidly gain weight on the Portuguese economy, an essential *de facto* pre-condition to redressing external deficits. Furthermore, and contributing to a more rapid export growth, Portugal diversified export markets towards fastest growing emerging economies. The EU's weight on total exports was reduced from a peak of 84.6 percent in 1999 to 74.4 percent in 2008 (Figure 8).

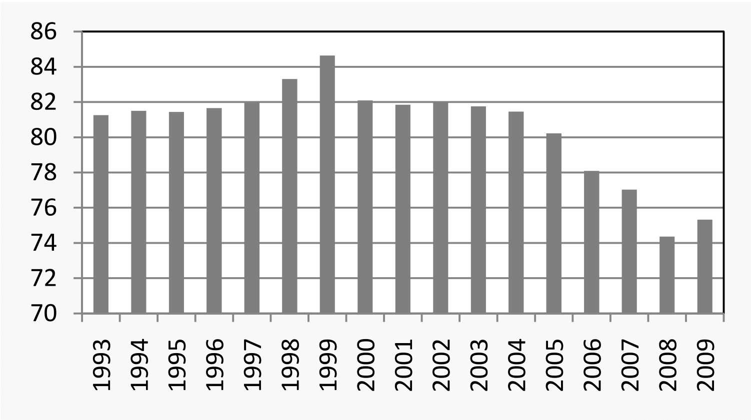
Figure 7. Growth export differential Portugal-EU 15 (Δ in percentage points)



Source: Statistical annex of European economy, EC, Spring 2011.

[20] Latest data shows post-global crisis rapid growth of exports. 2010 (Q1: 9.2 percent; Q2: 9.6 percent; Q3: 8.5 percent; Q4: 7.8 percent); 2011(Q1: 8.4 percent; Q2: 8.4 percent).

Figure 8. Exports to the EU-27 (percent of total exports)



Source: National Statistics Institute.

This positive behaviour in terms of exports is consistent with gains registered in productivity since 2005 as well as with structural change in Portugal's economy. In the past 20 years, medium and high technology exports as percentage of total exports have increased from around 37 percent in 1990 to almost 65 percent in 2010. This change is also a reflection of a rapidly changing workforce reality. While in the beginning of 1998 only 19.6 percent of total workforce had completed secondary education, figures for the first quarter of 2010 put this number at 33.9 percent.

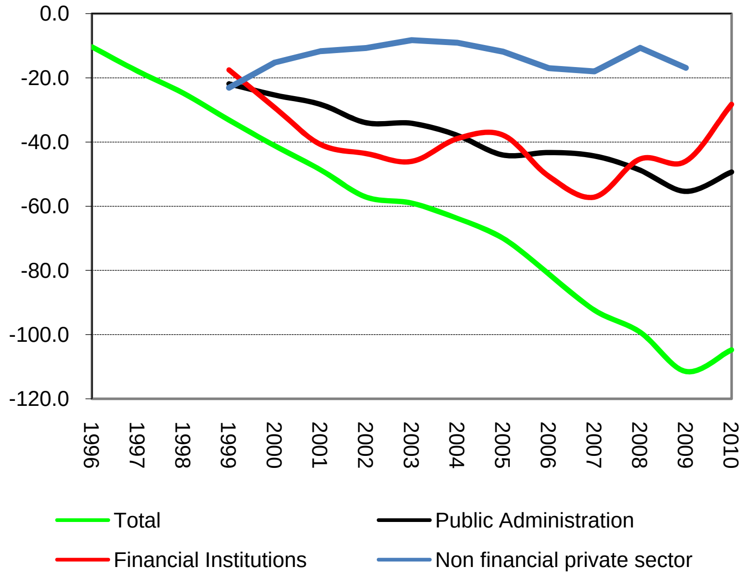
- **Current Account Deficits Remain High**

However, stronger export growth was partially off-set by higher energy prices, in particular oil, in the second half of the 2000s. In fact, the economy's external deficits remained very high even after 2002. Figure 9 shows the recent evolution of Portugal's international investment position and it can be seen that after 2002 public sector and financial institutions tended to compensate each other's contraction in international financing needs. Consequently, the international investment position of the economy continued to deteriorate throughout the period.

Indeed, although the economy showed signs of correcting competitiveness deficits and of more dynamism in exports, current account deficits remained extremely high. A correction of current account deficits would have entailed a stronger downward adjustment of Portuguese domestic demand, either through a more contractionary fiscal policy or a tighter monetary policy, the latter being difficult within the context of a single monetary area. In 2004–05, after the 2003 Portuguese economic recession, financial institutions deleveraged, but the State didn´t. In turn, in 2006–07 it was the public sector that deleveraged, but financial institutions considerably deteriorated their investment position, profiting from lowering interest rates and higher consumer confidence. The tendency swung again afterwards, with the exception of 2010 when the whole economy deleveraged, a trend which is expected to continue in future years. The only year in the 2002–08 period when both State and financial institutions curbed their international financing needs was 2003, and the country went into a countercyclical recession.

In sum, during this period, a faster correction of the current account deficits, within the euro area, could have only been realistically done by means of a much more contractionary fiscal policy. This, in turn, would have probably led to recession, at a time when Europe and especially main comparable economies were growing at very solid rates, meaning such policies would have been politically very challenging to sustain. Policy wise, Portugal took the soft approach to correcting some of its imbalances, when a soft approach was still an option. It was, however, too late and too slow for when the global crisis hit.

Figure 9. International investment position (percent of GDP)



Source: Bank of Portugal.

Section 3 - Facing the Sovereign Debt Crisis

a) End 2009: Portuguese Bonds in Calm Waters

The 2010 Portuguese budget was presented to Parliament already into the year in January, approved in March, and entered into force only in May, having been delayed by elections. Unlike in the previous legislature, the new government (also of the Socialist Party (center-left), PS) did not hold parliamentary majority support, but the two main centre-right opposition parties (Social Democratic Party (center-right), PSD, and Democratic and Social Centre – People´s Party (centre-right), CDS-PP) abstained to allow for budget approval.

The initial budget included a small reduction of the deficit by 1 percentage point to 8.3 percent of GDP. Consolidation would start, but slowly, since it was still substantially an expansionary budget given that the economy had come out of recession in the second quarter of 2009. It was, however, one that was consistent with European guidelines as approved by the European Council in December 2009. It was then agreed that "fiscal consolidation should start in 2011 at the latest, earlier in some Member States where economic circumstances make this appropriate, provided that the Commission forecasts continue to indicate that the recovery is strengthening and becoming self-sustaining" (See Box 1 above).

In the sovereign debt market, 10 year Portuguese government bond yields[21] actually decreased in the second half of 2009, in a similar pattern to that of Spanish and Italian bonds, and the difference to German bonds was back at less than 100 basis points during that period. Portuguese bonds had not accompanied the wider divergence of Greek and Irish bonds to German bonds that had started at the end of 2008.

[21] Data for 10-year government bond yields from Bloomberg.

b) Early 2010: Greece Is Bailed Out; Portugal Enters the Spotlight

It all changed early in 2010 when the magnitude of Greece's difficulties became obvious. At the beginning of February, Greek 10 year bond rates spiked to more than 7 percent and Portuguese rates reached 4.725 percent on 4 February. Contagion from the Greek problems affected Portuguese bonds more than the rest of the peripheral countries mainly because figures for 2009, that became known at the time, indicated a much higher than foreseen deficit of 9.3 percent of GDP. In some respects, this was a turning point for Portuguese bonds that up to then had been at par with Spanish and Italian bonds and had not suffered as much pressure from international markets as Greek and Irish bonds.

The informal meeting of Heads of State and Government that took place in the Solvay Library, on 11 February, the first chaired by Van Rompuy, was dominated in and around by the financial pressure on Greece. The message was that euro area Member States would take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole. The emphasis was on Greece, with its government denying having requested any financial support[22]. This was as much a message to the financial markets as it was to the electorates of Germany and other central and northern European countries that opposed any bail-out of Greece.

Pressure on Portuguese bonds lowered in February and March, while for Greece it mounted again at the end of February in anticipation of the Hellenic government's austerity package. In 25 March, at the margins of the European Council, the Heads of State and Government of the euro area confirm the strategy of strong national austerity in Greece to reduce the deficit and fight-off market pressure, recognizing the ambitious consolidation measures taken by Greece and effectively hoping that these would be enough to regain market confidence.

But by the 25 March European Council it was obvious that Greece would need international financial assistance. Despite some European partners' resistance to any form of bail-out, euro area Member States announce their readiness to contribute to coordinated bilateral loans as part of a package involving substantial International Monetary Fund financing.

The conditions, however, are the reflection of the scepticism that such a mechanism raised in some capitals. The mechanism would only be used as *ultima ratio* and in case market financing proved insufficient. Disbursement on the bilateral loans would be decided by unanimity subject to strong conditionality. And it was made clear that financing would not be provided at average euro area interest rates, but would rather need to create incentives to return to market financing as soon as possible by risk adequate pricing[23]. The fear of moral hazard was behind the debate on pricing with sceptical countries afraid they would be rewarding profligate budgetary behaviour if setting much lower than market interest rates.[24]

Euro area negotiations followed and Finance Ministers finally reached an agreement on a 45 BEuros package, one third of which coming from the International Monetary Fund, the rest being bilateral loans from euro area member states. This figure would rise to 110 BEuros on 2 May after Greece's demand to activate the euro area/IMF loans came on 23 April. Despite the package agreement, the fact that its approval was dependent on national parliamentary confirmations for most participating Member States, many overtly

[22] See "Statement by the Heads of State or Government of the European Union", Brussels, 11 February 2010
[23] See "Statement by the Heads of State or Government of the Euro area", Brussels, 25 March 2010.
[24] The 25 March 2010 European Council also launched the debate on the new governance of the euro area which would lead to an important agreement at the 28–29 October European Council on mechanisms to reinforce budgetary discipline, introduce effective macro-economic supervision, and strengthen economic coordination in the context of the "European semester".

sceptical in relation to a bail-out to Greece (the then recent Slovak government deciding not to participate at all) and mounting public anger in Greece at the scale of cutbacks, meant that throughout April market pressure kept on increasing on Greece, with 10 year bond interest rates spiking above 12 percent on 7 May. The contagion affected all of the most vulnerable euro area economies, Portugal, Ireland and Spain in particular, Portuguese bonds reaching 6.285 percent on market close on Friday, 7 May.

On 7 May the EU Heads of State and Government came together on an emergency meeting in Brussels and agreed on the European Financial Stability Mechanism and the European Financial Stability Facility, totalling 750 BEuros, including one third from the IMF, to expire after three years. Ecofin ministers were left on Sunday, 9 May, to hammer the details, which they did after a long and tense meeting finishing just before the opening of the Asian markets on Monday. The immediate effect was positive, with interest rates lowering considerably for all the peripheral economies in the euro area and falling to 4.5 percent for 10 year Portuguese bonds.

At the margins of the 7 May meeting, Portugal, as well as Spain, responded to market pressure by signalling austerity at home. At the final press conference, new targets of 7.3 percent and 4.6 percent for the 2010 and 2011 deficits, respectively, are announced by the Portuguese prime minister, lowering by 1 and 1.5 percentage points the previous targets. Domestically, new measures are taken to adjust to the new target in 2010, notably through tightening government expenditure and personnel costs, as well as frontloading revenue side measures.

What followed was a period of apparent relative calm. Interest rates for Greece, which had been put under the umbrella of international financial assistance, quickly started rising again, actually reaching the 7 May level again early in September. Rates decreased in July both for Portugal and Ireland.

c) Irish Troubles, European Hesitations, Portugal Under Pressure

But by August, concerns with the Irish banking sector turned pressure on again. The decision by the Irish government, at the end of September, to bail-out the Anglo Irish Bank gave rise to a new spike in interest rates in Ireland and, by contagion, also in Portugal with 10 year government bonds yields closing little short of 6.5 percent on 29 September. Pressure only eased on Portugal with the presentation by the government of the 2011 austerity budget to parliament on 15 October.

Few days later, in the run up to the October European Council, Angela Merkel and Nicolas Sarkozy meet in Deauville, on 18 October. On that occasion, they issued a declaration stating that the establishment of a permanent crisis management mechanism to take over the temporary EFSF and EFSM, in 2013, was conditioned on an amendment of the Treaties that should provide for the necessary arrangements for an adequate participation of private creditors[25]. The same line would be taken days later in the 28/29 October European Council where it was decided that the role of the private sector should be included in the features of the future mechanism[26].

Private sector participation made perfect sense from the theoretical point of view. After all, tax payers had been bailing-out banks and private investors in virtually every European country since the beginning of the financial crisis. Arguably, private sector moral hazard, in particular in the financial sector with irresponsible risk taking behaviour and a unique "talent for privatizing gains and socializing losses"[27], had led to the 2007/2008

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[25] See "Franco-German Declaration", Deauville, 18 October 2010.
[26] See European Council conclusions, Brussels, 28–29 October 2010.
[27] Martin Wolf, "Regulators should intervene in bankers' pay", *Financial Times*, 15 January 2008.

financial crisis. However, to introduce that idea in the midst of an extremely volatile market and without detailing how it would work was like adding fuel to the flames.

Indeed, borrowing costs soared both for Ireland and Portugal after the Deauville meeting and continued to do so after the 28/29 European Council. Even the agreement reached late in the evening of Friday, 29 October, between the Portuguese government and the main opposition party (PSD) on the strong austerity 2011 budget, after very difficult and tense negotiations, had no positive effect on bond prices. It was clear by then that good news at national level could always be trumped by bad ones at European level, which made the fate of the more vulnerable countries' depended not only on their own deeds, but on those of their European partners as well.

With continued pressure from markets and as the extent of Irish public debt incurred by taking over enormous liabilities from bad banks swelled, on 22 November Ireland requested access to the EFSF for support to its financial system. An 85 BEuros package was agreed by the Eurogroup and Ecofin ministers on 28 November, meeting in Brussels, with emphasis on immediate strengthening and a comprehensive overhaul of the Irish banking system.

At the margins of that meeting on 28 November 2010, the Eurogroup issued a particularly relevant statement meant to allay market fears on the issue of private sector participation in the future European Stability Mechanism (ESM), by agreeing on the main guidelines for that mechanism. It was decided that the ESM would provide for a case by case participation of private sector creditors, consistent with IMF policies. In this context, Ministers made a clear distinction between solvent countries, for whom private sector creditors would be encouraged to maintain their exposure according to international rules and fully in line with the IMF practices, and insolvent countries, in which case the Member State had to negotiate a comprehensive restructuring plan with its private sector creditors, in line with IMF practices, with a view to restoring debt sustainability. It was decided that standardized and identical collective action clauses (CACs) would be included in all new euro area government bonds. Furthermore, it was made clear that any private sector involvement, including the use of CACs, would not become effective before mid-2013[28].

d) Portugal: Next in Line

In less than 10 months, by the end of 2010, the EU had agreed on fundamental changes to its economic governance and had achieved what one year before would have been considered little short of a revolution in terms of crisis mechanisms. Political agreement had been obtained on the new elements of economic governance, including new and stricter sanctions linked to budget discipline and macroeconomic supervision. A new framework for economic coordination in the context of the European semester was about to take off in the beginning of 2011. Perhaps more surprisingly, financial assistance facilities had been agreed, set-up and were being used to help euro members in difficulty. Moreover, agreement had been reached that these temporary facilities would be replaced by a permanent mechanism in 2013. These were, without any doubt, important and structural decisions.

Nevertheless, the feeling in December was that the European Union had been running behind events and sometimes even provoking them, as had been the case of the dispute over private sector involvement. In reality, political agreement had been, and continued to be, extremely difficult to achieve. Perceptions about the crisis, as well as economic situations, diverged considerably between the countries in the periphery and the central and northern European countries. In addition, interests were also different. Some

[28] See "Statement by the Eurogroup", Brussels, 28 November 2010.

euro members were not only posting healthy economic growth figures but were also far from suffering negative effects from the sovereign debt crisis on their financing. On the contrary, Germany and some central and northern European countries actually saw lower interest rates on their debts, considered safe havens by investors fleeing riskier bonds.

Furthermore, a significant part of the electorates in those countries saw the crisis almost singly as the result of fiscal mismanagement, an idea fuelled by much of the press and some political parties trying to profit from populist nationalistic sentiments. This obviously made European solidarity harder to achieve and tensed up the European political debate.

For Portugal, the Irish bail out and the 28 November statement by the euro group on private sector involvement meant some interest rate relief, however short, from just above 7 percent to just below 6 percent. It was not a comfortable feeling though. With Greece and Ireland under financial assistance programs all eyes were now on Portugal as next in line. Portugal was certainly the most vulnerable euro area member still financing itself in the markets.

In November 2010, the Portuguese Parliament approved the toughest austerity budget in almost 30 years, targeting a 4.6 percent deficit by the end of 2011, the equivalent to a reduction of 5 percentage points of the structural deficit. On expenditure, public sector salaries suffered an overall reduction of 5 percent, admissions into the Public Administration were essentially blocked and promotions or any salary progressions were forbidden. Social benefits and allowances were reduced and pensions were frozen. The National Health Service and public investment programs were particularly targeted for cuts. On the revenue side, measures included a 2 p.p. increase on the standard VAT rate and a 1 p.p. increase of employees' contribution to the civil servants social security scheme.

Early in 2011 indicators revealed that the 2010 deficit would be close to 6.8 percent[29], thus lower than the 7.3 percent target set in May, and that the Portuguese economy had grown at the reasonable rate of 1.3 percent in 2010, although pace had been slowing down throughout the year with the last quarter of 2010 registering negative quarterly growth.

Nevertheless, market sentiment was clearly that Portugal would soon have to request international financial assistance. In the beginning of 2011 a series of news reports, usually based on anonymous senior euro area sources or close aliases, reinforced that sentiment by repeatedly reporting either that core member states were pressuring towards financial assistance and that Portugal would not hold out for long or that a plan was somewhere being prepared for the imminent request for financial assistance. A good example early in January is Der Spiegel's widely divulged news report according to which Germany and France were trying to persuade Portugal not to postpone an inevitable bailout[30]. This report is denied by the three governments mentioned but still, four days later, when Portugal had its first government bond auction of the year, the international press piled up in Lisbon for the inevitability that does not occur. The 3 year bonds are placed at the relatively high price of 5.396 percent but below secondary market prices and with a bid-to-cover ratio of 2.6.

It was evident that fending-off market pressure would be extremely hard. The fact that the prevailing line within the European Union remained one that any assistance would be of last resort and that any other solution seen to pull together the weight of the whole of the euro area, and especially of its strongest members, in order to calm market fears was publicly rejected outright by several governments meant that Portugal would be facing market sentiment essentially on its own and would have to rely on itself to turn it around. In December 2010, Jean-Claude Juncker's and Giulio Tremonti's defence of Eurobonds as

[29] Including one-off measures.
[30] Der Spiegel, 8 January 2011.

a systemic response by the euro area to the crisis[31] was met with extreme scepticism even within some strongly pro-European circles.

The vulnerabilities of the Portuguese economy, its recent history of low growth and very high external deficits, reinforced negative market sentiment. That Ireland, not Portugal, had asked for financial assistance while Portugal's structural problems were far greater, in spite of the Irish banking problem, seemed to puzzle many in the global Anglo-Saxon media.

The fact that Portugal was a small economy in the European context did not make things easier either. After Ireland had gone under the international assistance umbrella, and although Portugal was considered next in line, main concerns did not seem to concentrate on Portugal but rather on Spain. It was the possibility of having to bail-out Spain that really scared European leaders.

e) Portugal Resisting: National Austerity and EFSF Flexibility

The sentiment in financial centres and communicated by market analysts and journalists on a daily basis was that Portugal could not resist. Unlike Greece or Ireland, there was no single decisive event to undermine market sentiment. Contagion and Portuguese economic vulnerabilities had added up to form negative market perceptions.

However, Portugal had reasons to resist to pressure from markets. Most importantly, the government deemed that Portugal had the conditions to avoid international financial assistance. Fiscal consolidation advanced in 2010 and the 2011 budget implied much harsher cuts which would inevitably be reflected in budgetary results. Indeed, budget implementation showed a substantially reducing deficit already in the beginning of the year, with both a decrease in expenditure and an increase in revenues.

Moreover, asking for a bail-out would not be financially profitable for Portugal under existing conditions at the time. International financial assistance interest rates' were high (around 5.2 percent for Greece and 5.8 percent for Ireland) and not much better than market conditions at the time for Portugal. Also, Portugal's implicit sovereign debt interest rate stood at 3.5 percent, lower than that of Belgium (3.6 percent) or of Italy (3.8 percent), for instance, which meant that there was margin to handle higher interest rates for some time. Simulations under the scenario that the entire 2011 bond issuance would be made at 7 percent showed that by the end of the year the implicit funding cost would still be below 5 percent. Ten year government bonds were issued in January at 6.716 percent interest rate and emerging economies had revealed an interest in Portuguese debt, thus allowing for some diversification.

Additionally, although European leaders were certainly more concerned at the prospects of an eventual Spanish bail-out, it was by then obvious that the ring-fencing strategy was not working. Putting Greece under international financial assistance had not stopped contagion nor had the Irish bail-out calmed down markets. On the contrary, not only did secondary market interest rates continued to increase substantially for Greek and Irish bonds, but also market fears seemed to turn their attention on to the next country in line. With contagion so obviously occurring, it was unlikely that financial assistance to Portugal would ring-fence it from Spain. It could, on the contrary, concentrate pressure on Spain and possibly on other economies like Italy and Belgium.

Domestically, resisting the bail-out was supported by a majority of the population, marked by the memories of the two previous IMF interventions' in Portugal in 1978 and 1983 following balance of payment crises. It was generally understood that such an outcome would hurt Portugal's European and international credibility for a long time to

[31] See Jean-Claude Juncker and Giulio Tremonti, "E-bonds would end the crisis", Financial Times, 5 December 2010.

come and would, in the short run, dampen the already very slim policy making margin of manoeuvre of the minority Portuguese government.

These reasons meant that it made economical and political sense for Portugal to continue access international markets for some months, while expecting that good results and continued reforms at home and good decisions at European level would start turning market sentiment around.

Indeed, although it was difficult to shake off a feeling of frustration at the lack of more decisive European decisions, member States positions' had evolved throughout 2010 as events unfolded and the crisis deepened. The fact that ambitious proposals like the emission of Eurobonds were being put forward and supported by high level European politicians in office (albeit rejected by several others) signalled that Europe was moving and still trying to find the right balance to respond to the sovereign debt crisis. At the margins of the 16–17 December European Council, euro area Heads of State and Government declared that elements of the euro area strategy, including ensuring the availability of adequate financial support through the EFSF pending the entry into force of the permanent mechanism, would be further developed in the coming months as a comprehensive response to any challenges and as part of the new economic governance[32]. What this sentence meant, even in its somewhat watered-down final version after insistence from the hardliners during the summit, was that the door was not completely closed to the possibility of increased flexibility in the EFSF support, notably through direct interventions in the debt markets.

The European Council met again on 4 February in a summit intended to focus on energy and innovation. Instead, the centre of attention was a new Franco-German idea to create what at the time was called a "Competitiveness Pact". Although details of the pact were left for later negotiations between "sherpas", euro area leaders endorsed the idea of achieving a new quality of economic policy coordination in the euro area to improve competitiveness, leading to a higher degree of convergence. The pact was targeted at euro members, although non-members were invited to participate[33]. The idea of a pact, presented to journalists by Angela Merkel and Nicolas Sarkozy in Brussels on the day of European Council, was aimed at stronger policy coordination but also at creating a blueprint for countries to converge towards the German competitiveness model, targeting four main areas: unit labor costs, notably by abolishing wage indexation schemes; pension systems, by raising retirement ages; increase the degree of tax harmonization, by creating a common base for corporate taxes; and fiscal discipline, by making it a constitutional violation to exceed limits on national debt.

Implicit in the European Council discussions, but turned explicit in the negotiations that followed on the competitiveness pact (or The Euro Plus Pact as its final version would be called), was that this would be part of a larger package that would include bolstering the capacity and flexibility of the EFSF—the so-called grand-bargain to be agreed at the European Council at the end of March. This was seen as especially important by many favouring a systemic euro area response. Interventions in Greece and Ireland had failed to calm down markets and it was generally accepted that the EFSF did not have the capacity to handle a possible bail-out of Spain in case it requested for financial assistance.

Strengthening the EFSF intervention capacity by raising its capital to match its initially announced capacity of 440 BEuros had been on the cards since December. EFSF's triple-A grade meant that the initial capital of 440 BEuros agreed in May 201 was

[32] See Statement by the Heads of State or Government of the euro area and the EU Institutions, Brussels, 16/17 December 2010.

[33] See Statement by the Heads of State or Government of the euro area and the EU Institutions, Brussels, 4 February 2011.

equivalent to a borrowing capacity of only around 255 BEuros, since only six were triple-A countries among the seventeen euro area members.

More importantly, increasing the flexibility of the intervention modalities of the EFSF, notably by allowing it, under conditionality, to directly access primary bond markets and secondary bond markets, and in doing so relieving the ECB from its "non-standard" and contentious bond-buying program, was seen by many, including Portugal, as essential to stabilize the euro area sovereign bond markets. It was to this, not the Euro Pact, whose effects would only be long-term, that markets' attention had turned to after the European Council meeting.

For Portugal, something else was also at stake during the 4 February summit. Portugal had managed successful emissions of bonds and treasury bills in January with decreasing albeit high rates. 1 year Treasury bills had been subscribed at 4.029 percent on 19 January and at 3.71 percent on 2 February. But still market pressure and volatility were very high on Portuguese bonds with interest rates on 10 year bonds in the secondary market remaining just below 7 percent throughout the month. The ECB had assisted in reducing volatility by continuing its bond-buying program early in January as news reports of Portugal's imminent bail-out disrupted markets, although it later temporarily suspended bond buying in mid-January[34].

Bond-buying by the ECB was not popular among hardliners but the ECB's actions were effectively the best euro area tool against market volatility. Portugal's austerity 2011 budget negotiated between the two largest Portuguese parties in Parliament gave the ECB assurances that Portugal was firmly on the track of fiscal consolidation. The macro-economic scenario within the budget proposal presented to Parliament in mid-October 2010 included a 0.2 percent GDP growth projection for the country, considered too optimistic, but a more cautious assumption of –0.7 percent growth had been taken as the underlying scenario for fiscal revenues.

However, international institutions' forecasts coming later in 2010 and in the beginning of 2011 were more pessimistic than the –0.7 percent underlying assumption. In its autumn economic forecast, released on 29 November 2010, the European Commission predicted a –1 percent GDP economic recession for Portugal. The Bank of Portugal in its winter economic bulletin, made public on 11 January 2011, forecasted a -1.3 percent fall in GDP. Weak fourth quarter growth indications and, especially, the austerity measures included in the 2011 budget were being factored in by the institutions and being reflected in more negative scenarios for 2011. Different forecasts meant that there was a gap between the Portuguese government and the EU institutions in fiscal projections for 2011 in order to meet the 4.6 percent deficit.

Concerns with this gap were behind one of the paragraphs in the euro area statement of 4 February. As part of the "grand bargain" global package to be finalized in March was the assessment by the Commission, in liaison with the ECB, of progress made in euro area member States in the implementation of measures taken to strengthen fiscal positions and growth prospects[35]. It was a message for Portugal to speedily put forward contingent measures that took into account the lower growth projections.

After the 4 February summit market pressure increased with news of German resistance to strengthening and extending the flexibility of the EFSF[36] and the ECB restarted buying Portuguese debt in an attempt to contain yields[37] that went above 7 percent for 10 year bonds. Simultaneously, Portuguese government officials sat down in

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[34] See "ECB forced to buy Portugal bonds", Financial Times, 10 February 2011.

[35] See Statement by the Heads of State or Government of the euro area and the EU institutions, Brussels, 4 February 2011.

[36] See Berlin resists call for extended EFSF role, Financial Times, 28 January 2011.

[37] See ECB forced to buy Portugal bonds, Financial Times, 10 February 2011.

Lisbon with European Commission and ECB officials to discuss the 2011 fiscal gap, as well as the magnitude of the measures needed to meet the 2012 and 2013 deficit targets of 3 percent and 2 percent of GDP, respectively.

January 2011 had been the longest month so far in the crisis for Portugal and very few had thought the country could have resisted. Positive preliminary indications on the 2011 budget implementation and the show of strong national political resolve to do what it took to fend-off market pressure were contributing to signs from EU institutions and important European partners that Portugal's bail-out could perhaps be avoided. This slight change of mood was not, however, being accompanied by market sentiment.

If signs of a slight mood change were going to be translated into stronger and more vocal support from European partners and, possibly, a reversal of the trend in market volatility, the Portuguese government needed to definitively take on board the concerns of the EU institutions. Preliminary information relating to the implementation of the budget in the first two months pointed to levels consistent with the defined targets. Year-on-year tax receipts had increased by around 10.5 percent and total State expenditure had decreased by 3.6 percent with, in particular, expenditure in wages decreasing by 5.2 percent[38]. But it was indispensable to take a precautionary view on increased economic risks stemming from austerity and market volatility which the international institutions underlined in their forecasts.

- **Closing the Gap**

In this context, the Portuguese government agreed on expenditure side measures that corresponded to a further cut of 0.8 percent of GDP to be taken immediately in 2011 as precaution. Moreover, measures to meet the 2012 and 2013 targets needed to be detailed ahead of the 11 March euro area summit where the global package was going to be discussed, advancing the regular April timetable for Stability Programs' presentation. Concrete assurances by the Portuguese government on meeting fiscal targets and a positive assessment by the EU institutions on the credibility of the measures taken in 2011 and planned for 2012 and 2013 was part of the global package.

On 11 March, hours before the summit in Brussels, the Portuguese government announced the guidelines to meet the 2011, 2012 and 2013 fiscal consolidation targets[39]. For 2012 and 2013, the government anticipated an expenditure reduction of 2.4 percent of GDP (1.6 percent in 2012 and 0.8 percent in 2013) and an increase in revenue of 1.3 percent of GDP (0.9 percent in 2012 and 0.4 percent in 2013). On the expenditure side it included freezing salaries and most pensions as well as reducing higher pensions in the proportion of the 2011 salary cuts, plus savings in health, education, social benefits, public sector enterprises and local authorities. On the revenue side there would be a reduction in fiscal benefits, review of lower VAT rates, increasing excise taxes and total convergence of pension and salary taxes.

The government also committed to further structural reforms in particular in the judicial, competition rules and housing. On labor market reform it proposed changes, which were agreed with social partners before the 24–25 March European Council, to allow decentralizing certain collective bargaining aspects to company level, lower worker compensation in future contracts in case of dismissal, and to increase flexibility in the use of temporary lay-off instruments.

On the backdrop of these announcements, the President of the European Commission and of the ECB issued a specific press statement on the day of the 11 March

[38] Data released at the time by the Portuguese Finance Ministry.
[39] See "Note on policy guidelines and measures that the Portuguese Government will adopt to address main economic challenges", Lisbon, 10 March 2011.

summit welcoming and supporting the policy package[40] and euro area leaders did the same in the summit conclusions as a positive mood swing in relation to Portugal had been achieved around the European Council table.

- **But Limited EFSF Flexibility**

The summit further agreed on the Euro Pact. The Euro Pact, joined by Poland, Bulgaria, Denmark, Romania, Lithuania and Latvia two weeks later at the 24/25 European Council, laid out guidelines for convergence between its members in competitiveness, employment, public finances and financial stability, areas which would be monitored in the context of the reinforced economic governance through specific agreed indicators.

There was also an agreement on reinforcing the crisis mechanisms. The effective financing capacity would be increased in the case of both the ESM (to 500 BEuros) and the EFSF (to 440 BEuros). A first step was taken towards lowering the price on ESM and EFSF loans, with Greece being given lower interest rates (100 basis points less) and longer maturities (7.5 years). But increased flexibility of these instruments did not meet the expectations of those betting on a systemic game changer for the euro area. There was a reference to the possibility of ESM and EFSF interventions in the debt primary market but only exceptionally and in the context of a full assistance program with strict conditionality. No reference was made to secondary market intervention. The decision on flexibility fell short of what was needed to give the euro area an instrument to fight market disruptions. It remained in the hands of the ECB alone to try to do that job.

f) Request for Financial Assistance

As part of the European Semester, the Portuguese government adopted on 19 March the Stability and Growth Pact for 2012-2014 (known as PEV IV[41]), prepared on the basis of the austerity guidelines announced days earlier. On 23 March the Portuguese Parliament rejected the austerity package (PEV IV). Analysis of why the package was rejected falls outside the purpose of this paper. The outcome, however, was politically inevitable: the country headed to early elections.

Despite the PS, PSD and CDS-PP, the only parties to plausibly be part of a future government, clearly declaring full allegiance to fiscal consolidation and structural reforms, markets took badly at political instability and interest rates of Portuguese bonds soared. In little more than a week, between 24 March and 4 April, rating agencies plunged Portugal's rating. Fitch takes it from A+ to BBB-. Standard and Poor's from A- to BBB-. Besides the agencies' interpretation of the 24/25 March European Council conclusions that "sovereign debt restructuring is a potential pre-condition to borrowing from the ESM"[42], on more immediate terms they argued with political instability and possible difficulties for Portugal to accede to timely European support. Elections still being two months away, a possible financial assistance agreement would have to be negotiated by the caretaker government. Furthermore, bail-outs had become an issue in the co-occurring Finnish electoral campaign, with the nationalistic True Finns party apparently benefiting in the polls from its radically negative stance. Yields on 10 year government bonds moved from 7.367 percent on 23 March to 8.767 percent on 5 April.

[40] See Joint press statement by the European Commission and the European Central Bank on the Measures announced by the Portuguese government, Brussels, 11 March 2011.
[41] Known as "PEC IV" since it was the third revision – thus forth version – to the 2010-2013 Stability and Growth Pact.
[42] Standard & Poor's Research Update: Republic of Portugal ratings lowered to BBB-/A-3 on ESM lending conditions, 29 March 2011.

Adding to the gloomy picture, in 31 March 2011 and again on 24 April, following Eurostat guidance note on financial defeasance structures and guidelines on administrative public sector budgetary perimeter, the National Statistics Institute revised upwards the recent years' figures for budget deficits and public debts of Portugal. Although several other European countries were also affected, for Portugal these corrections implied 2009 and 2010 public deficit figures of 10.1 and 9.1 percent of GDP, respectively, instead of the comparable figures of 9.3 and 6.8 percent of GDP. Numbers for public debt were also raised to 83.0 and 93.0 percent for 2009 and 2010, respectively.

The new figures were the result of inclusion within the State's accounts budgetary perimeter of financial assistance to banks (Banco Português de Negócios and Banco Privado Português), of three public transportation companies (REFER, Metropolitano de Lisboa and Metro do Porto), as well as the full comprisal of three public-private partnerships toll-free motorways which, following the introduction of tolls, had to be considered public assets and be registered as investment expenditure.

With the financing conditions collapsing for both the Republic and its banks and companies, on 7 April the Portuguese government took the inevitable step of asking for international financial assistance from the European Union and the IMF.

Financial assistance negotiations took place during the pre-election period between the caretaker government and a technical team composed of the European Commission, the ECB and the IMF (the troika), with step-by-step consultations with the main opposition parties. The end result is a vast economic and financial adjustment program to which the three main political parties signed up to that includes strong budget consolidation, ambitious structural reforms and reinforcement of the financial sector. It came with a financing package of 78 BEuros, 12 BEuros of which for possible recapitalization of banks.

Table 4. Crisis timeline; its causes and effects

Timeline	Main cause	Other causes	Effects on Portuguese debt market
October 2008	*(US)* • Global financial crisis • Lehmann Brothers bankruptcy	–	PT vs. DE bond spread widens. But less than Greek, Italian and Irish bond spread.
Throughout 2009	–	–	PT debt market calm. PT vs. DE 10Y bond spread lowers back to less than 100 bp in second half of the year.
January 2010	*(Greece)* • Greek deficit swells. • Uncertainty as to Greek figures.	*(Portugal)* • Portuguese budget deficit is bigger than expected	PT 10Y bond yields increase above 4 percent.
4 February 2010	*(EU)* • EU HSG meeting avowals coordinated action to safeguard financial stability in euro area.	–	PT 10Y bond yields peek at 4.725 percent. Pressure lowers in February and March.
April 2010	*(EU)* • European scepticisms to	–	Pressure strongly increases on PT debt.

	bail-out mechanism. • Need for unanimous agreement, including national parliaments. *(Greece)* • More austerity in Greece, which demands for financial help.		
7 May 2010	*(EU)* • EU HSG meeting agrees EFSF/EFSM.	*(Portugal)* • Portugal signals austerity at home.	PT 10Y bond yields peek at 6.285 percent. Rates drop immediately. Follows calmer but volatile period. Trend is upward in May and June; but downward in July.
September 2010	*(Ireland)* • Concerns with Irish banking sector • Ireland bails-out Anglo-Irish		PT 10Y bond yields rise, though less than Irish ones.
October 2010	*(EU)* • Franco-German (18/10) + European Council (29/10) decision to include private sector in future crisis mechanism. *(Ireland)* • Magnitude of Irish debt swells.	*(Portugal)* • Portuguese government presents tough austerity budget (15/10). Government and main opposition party agree to approve it in Parliament (29/10).	European news on private sector involvement trump austerity agreement in Portugal. Pressure continues and PT 10Y bond yields are at 7 percent or close.
28 November 2010	*(EU)* • Eurogroup clarifies private sector involvement. Separation between solvent and insolvent countries.		Pressure immediately decreases with PT 10Y bond yields momentarily falling below 7 percent.
December 2010, January, February 2011	–	*(EU)* • Ambiguity at EU level, with possibility of EFSF strengthening and increased flexibility receiving contradictory reactions. • Start of Euro Plus pact negotiations. *(Portugal)* • Portuguese government determined to resist a bail-out. • Positive public deficit indications for 2010. • Negative economic growth forecast.	Volatility remains and rates resume upward trend in December, January and February.

		(Markets) • Market sentiment and news reports negative on Portugal's prospects of avoiding a bail-out.	
11 March 2011	*(Portugal)* • Portuguese government announces further cuts for 2011, and austerity plans for 2012, 2013. • Doubts as to whether package will be approved in Portugal. *(Europe)* • Euro group HSG welcome Portugal's commitment. • Euro Pact is agreed.		Markets in expectation of developments in Portugal.
23 March – 7 April 2011	*(Portugal)* • Portuguese Parliament rejects package proposed by Government.	*(Markets)* • Agencies plunge Portugal's ratings. *(Portugal)* • Revision upwards of Portuguese deficit and debt figures for 2009 and 2010, following Eurostat guidelines.	Yields on Portuguese debt spiral. Portugal request international financial assistance.

Section 4 - Conclusions

By 2002, with domestic demand stalling, Portugal had entered a phase of low economic growth. It was the third stage of a cycle of boom, overvaluation and slump that had started in the mid-nineties with the prospect of euro accession and was brought about by insufficient fiscal policy adjustment to the new monetary setting, compounded by the diverting impact of EU enlargement on FDI and trade, and competitiveness effects on the most important Portuguese exporting sectors of large emerging economies entering the world market.

In Section 2 it was argued that with growth stalled, and the country economically out of sync with the comparable European economies, Portugal followed a soft approach to correcting imbalances and regaining economic growth conditions. The country entered a phase of budget moderation/consolidation and structural reforms. Labor costs were contained, productivity grew above EU average, and the economy slowly recovered competitiveness.

Export growth was above EU average in the 2006/2010 period, something that had not occurred for a decade. Still, that period is evidence to the difficulties of correcting current account balances within a single monetary union. Despite stronger export growth (which was partially off-set by higher energy prices) the international investment position of the economy continued to deteriorate. Evidence shows that when the private sector deleveraged the public sector over compensated with larger budgetary deficits; and when the public sector consolidated, private sector borrowing boomed. The conclusion is clear:

Portugal would have needed a relatively prolonged recession brought about by a considerably more contractionary fiscal policy if it were to rapidly redress its current account imbalances[43].

Portugal followed a soft approach to correcting its imbalances when it politically still had that alternative. With the sovereign debt crisis hitting the euro area, that ceased to be an option. What results from the adjustment program agreed with the international institutions is a hard approach to redress the Portuguese economy imbalances (already implied in the 2011 budget) within the euro single currency area context.

The pre-crisis evolution showed an economy changing its profile and slowly regaining the way of competitiveness. These trends need now to be dramatically reinforced. Positive signs are being registered. The positive trend in exports, which have been growing at a sustainably strong rate since the beginning of 2010, is an essential element in the necessary rebalancing of the Portuguese economy. The inevitable retrenchment of domestic demand, visible since the beginning of 2011 and expected to accelerate further at least during the first part of the program's implementation, needs to be compensated to an extent by strong net export growth in order for the program to succeed.

The economic and financial adjustment program negotiated between Portugal and the troika (EC, IMF, and ECB) is an ambitious roadmap for fiscal consolidation and structural reforms. The program targets a 5.9 percent budget deficit in 2011, 4.5 percent in 2012 and 3 percent in 2013, corresponding to an overall structural adjustment of over 9 p.p. (4.5 p.p. in 2011; 4.6 p.p. in 2012/2013). Moreover, the Portuguese government has recently indicated deficit targets of 1.8 percent and 0.5 percent for 2014 and 2015, respectively (implicating a further 1.1 p.p. reduction of structural deficit)[44]. The programs' macroeconomic scenario foresees an economic contraction of 2.2 percent in 2011 and 1.8 percent in 2012, returning to annual growth in 2013. Inevitably, implementation of the program is very challenging.

The new government that resulted from the 5 June elections is supported by a large majority in Parliament of 132 members out of 230 (PSD, 108; CDS/PP, 24) and is committed to the full implementation of the program. The PS, that supported the previous minority government, now the main opposition party, elected 78 members to Parliament and has also declared its engagement with the adjustment program and its targets. Politically, it is thus relevant that parties representing 206 out of the 230 members of Parliament, despite political differences, are committed to the implementation and success of the adjustment program.

Portugal has the domestic political conditions to achieve timely implementation of the program and the economic conditions to succeed and come out stronger and more competitive economically. But Portugal is a small open economy in the euro area and

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[43] At this stage, it is interesting, for context, to recover a quote from the founding document of the economic and monetary union in Europe. In 1970, the Werner Report indicated that:
"For such a Union only the global balance of payments of the Community vis-à-vis the outside world is of any importance. Equilibrium within the Community would be realized at this stage in the same way as within a nation's frontiers, thanks to the mobility of the factors of production and financial transfers by the public and private sectors. (…)
For influencing the general development of the economy, budget policy assumes great importance. The Community budget will undoubtedly be more important at the beginning of the final stage than it is today, but its economic significance will still be weak compared with that of the national budgets, the harmonized management of which will be an essential feature of cohesion in the union. The margins within which the main budget aggregates must be held both for the annual budget and the multi-year projections will be decided at the Community level, taking account of the economic situation and the particular structural features of each country. A fundamental element will be the determination of variations in the volume of budgets, the size of the balance and the methods of financing deficits or utilizing any surpluses. In order to be able to influence the short term economic trend rapidly and effectively it will be useful to have at the national level budgetary and fiscal instruments that can be handled in accordance with Community directives."

[44] Budgetary Strategy Document 2011-2015, Ministry of Finance, Lisbon, 31 August 2011.

European Union context. One of the lessons from the current sovereign debt crisis is that Portugal's fate is not dependent on its decisions alone.

For Portugal, success will also depend on how the European Union continues to address the current crisis. In Section 1 it was argued that the European Union first approached this crisis on the basis of divergent and partially misguided perceptions.

However psychologically and politically understandable, the emphasis given to sovereign moral hazard was clearly overrated. Events in Portugal and Ireland, where governments resigned and were defeated in national elections provoked directly by the management of austerity or bail-out scenarios, are witness to that fact.

Moral duality has affected the management of this crisis. Indeed, the economic, political and institutional roots of this crisis can be found not only within the most affected countries but also in the construct and in the political management of the euro area as a whole. The narrative according to which some euro area countries are just being punished for their sins is certainly unhelpful to constructing a balanced approach. Nor does it correspond to reality. In fact, the question is as much one of disregard for existing rules (by many within the euro area) as much as one of insufficient rules and mechanisms.

It is clear from the unfolding of the crisis and the timeline of events, described in Section 3, that, once the crisis triggered, the European Union and euro area decisions were preponderant in its the evolution. From examining the Portuguese experience, in particular, it is reasonable to ask the question of whether Portugal would have needed to resort to bail-out if the EU had managed to anticipate the far-reaching decisions taken in the 21 July 2011 meeting of the Heads of State and Government of the euro area. For Portugal, especially, financial market pressure mounted throughout 2010 and in 2011 to a great extent due to causes outside its domestic economic situation. Certainly, the country has substantial structural problems and imbalances which have put it under the spotlight and which need to be addressed. But contagion effects are obvious from the crisis timeline. Stopping contagion and preserving the stability of the whole area is the Union's most pressing objective, and it has been declared as such.

Moreover, structural change in the euro area needs to be oriented not only at making similar crises much more unlikely to occur—and the ground breaking evolution on new economic governance rules does indeed that—but also intended at pulling the euro area's weight behind solving such crises if and when they occur. Europe has reasonably managed the former but not yet the latter, and it is the latter that is most urgent now if the euro area is to find its way back to stability. In this sense, the agreed decisions of the last 21 July meeting, which indeed amount to an important leap forward, need to be rapidly implemented. To build a system to avoid crisis is smart and indispensable. To believe that any system can make the occurrence of crisis impossible is naive. It is this idea as well as clear messages of the advantages of the euro for the whole of Europe that need to supersede the moral duality in which the debate has often been entangled.