Speech by Matjaž Sušec to Public and External Debt Evaluation Working Group of Portuguese parliament

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Speech to Public and External Debt Evaluation Working Group
Portuguese Parliament
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Good afternoon,

Let me start by thanking the Members of the Budget Committee of the Portuguese parliament for the opportunity to speak in front of this working group. I have been visiting Portugal for missions for about two years and can say that the country is doing well. The riskiness of Portuguese sovereign debt is significantly lower in the eyes of market participants compared to the crisis, despite recent market turbulences. I will explain what in the ESM's view has contributed to the improved environment and how we look at the years to come. I believe that our findings – as a crisis resolution mechanism and an institution present in financial markets – are also of interest to Portuguese citizens.

Past achievements, future challenges

We see Portugal as another success case of the programmes of the EFSF and ESM. Fiscal consolidation and structural reforms implemented during the EFSF programme have delivered good results. The economy is growing strongly, with GDP accelerating to 2.7% in 2017 from 1.6% in 2016. Unemployment has been falling steadily. It went down to 9% in 2017, considerably below the 16.5% peak reached in 2013 and we see the downward trend continuing in 2018. The recent dynamic growth has been led by a combination of exports, private consumption and investment. This is in line with what we have seen in other former programme countries, such as Ireland and Spain.

The banking sector has impacted Portugal’s public debt level. Yet, banks have become more resilient due to recent privatisations and restructurings. The average capital level is now above 13% of risk-weighted assets. The sector’s profitability has recovered in 2017 while non-performing loans have declined, although they remain high at above 14%.

The economic challenges ahead are linked to the less optimistic economic outlook for the coming years, as growth is expected to return to its potential level. The boost from private consumption will likely gradually fade in line with the euro area business cycle and the expected normalisation of policy rates. This reinforces the need to continue the reform path to strengthen growth and employment in Portugal as recommended by the European Council. Country-specific recommendations cover the following areas: 1) ensuring fiscal sustainability, in particular limiting government expenditure in line with the required structural adjustment, 2) implementing labour market reforms, promoting an environment conducive to hiring on open-ended contracts, increasing the skills of the population and improving the higher education intake, 3) continuing to address the level of non-performing loans in banks, by reducing the impediments for a secondary market for loans and increasing the efficiency of insolvency and recovery procedures.

Managing debt in good times, mitigating future risks

This brings me to Portugal’s high public debt burden. Fiscal performance in Portugal was strong last year. Government debt is expected to fall to 122.5% of GDP in 2018 from 125.7 % in 2017. Despite a temporary impact due to bank recapitalisation, the 2017 deficit stood at 0.9% of GDP, well below the 1.4% of GDP target originally set by the government. Strong economic growth, together with spending controls and declining interest costs, have been the main drivers of the improved budget outcome. Indeed, the ongoing recovery creates some fiscal space through higher revenues. As other countries in Europe, Portugal is asked to use this benign environment wisely and continue its efforts to reduce debt. This will lead to lower funding costs and reduce debt for future generations. This is also important from the

ESM's perspective as creditor.
According to the ESM's Early Warning System, which we use to analyse our beneficiary Members' ability to repay our loans, there are no concerns at this stage. Yet, we know that an environment of lower economic growth and higher interest rates makes debt reduction more challenging. This is why many institutions have called upon countries to prepare now for the future and maintain a prudent fiscal policy in line with the requirements under the European fiscal framework. Working on growth at the same time will generate more fiscal revenues and help to reduce sovereign debt.
Portugal has been conducting its debt management activities cautiously. The cash buffers accumulated due to fiscal over-performance were used to smoothen and extend the maturity distribution of government debt. Windfall gains also served to repay the expensive IMF loans. This produced savings and provides a good case study how managing sovereign debt in good times can help to mitigate refinancing risks further down the road.
Investors and rating agencies have noticed these achievements. In 2017, the rating agencies S&P and Fitch upgraded Portuguese government bonds to investment grade. This shifted the yield curve downwards. Portuguese bonds maintain a solid performance in comparison with other euro area sovereigns.

EFSF loans create budget savings
The ESM and EFSF have disbursed a total of €279 billion to euro area sovereigns since 2011. In all its programmes, the ESM passes on its low funding cost, which enables significant savings in the budgets of beneficiary Members, year after year. EFSF lending has improved debt sustainability, also for Portugal. At the time of disbursement, EFSF loans carried a much lower interest rate than those that would have been offered by the market.
These low rates, below 2% at this stage, have been generating substantial budgetary savings, supporting market access and debt sustainability. The state budget saved roughly 0.7% of GDP each year from 2014 until 2017. This is a real solidarity contribution by euro area partners – something people often overlook. Hence, Portuguese gross financing needs remain manageable over the medium term period also owing to repayment terms under EFSF loans.

Summing up the main points of my presentation today:

- Portugal’s economic growth is relatively high compared to the euro area as a whole and its debt is decreasing. This is due to successful fiscal consolidation and structural reforms. The EFSF programme has delivered good results and has helped the country to smooth and extend its debt payments.
- Yet, the pace of GDP growth is expected to ease to a level closer to potential growth.
- Portugal's sovereign debt burden and the stock of non-performing loans in banks remain high. As other European countries, Portugal is asked to use the current benign economic environment to engage in growth enhancing reforms and create fiscal buffers for the future.

Thank you.

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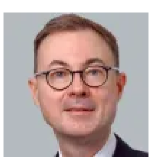

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