Overview

Public Finance: Position and Constraints 2015-2019

CFP Report no. 3/2015

Lisbon, March 2015

OVERVIEW

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In recent years Portugal has taken major steps to consolidate its public finances. The nature of the problems stemming from the lack of access to market financing in a highly indebted economy called for emergency measures with a view to restoring normal borrowing conditions and establishing a new economic policy rationale, aimed at fostering growth within a context of fiscal stability. The goal of returning to market financing was achieved and important measures were also taken with regard to the budget process and to public financial management, as well as in important structural areas.

This programme was undertaken in an unfavourable international context, particularly in what concerned the demand for Portuguese exports, which made significant progress nonetheless. In the meantime, the external environment saw significant improvements, both in the financial field, through the creation of the European Stability Mechanism and the European Banking Union, and, more recently, in what regards growth prospects for Euro Area economies. These developments, combined with the progress made internally and with expectations of a sustained highly expansionary monetary policy stance, have resulted in a favourable context for devising a domestic economic policy programme aimed at completing and consolidating the progress made in the fields of public finance and competiveness, this time with a crucial component focusing on growth. This programme is all the more important as growth must take place in a particularly complex setting, which, in addition to the increase in productivity that is essential to economic development, must ensure a level of employment and a pattern of income distribution consistent with social stability.

In addition it should be noted that the current context is not devoid of risks. Firstly, growth in European economies not only remains insufficient, it is also contingent on a very uncertain international environment, as well as on complex structural adjustments, both at the Euro Area level as a whole – as is the case with the energy and defence sectors – and at the level of national economic policies, and, crucially, on the coordination of the latter.[1] The short-term growth stimuli, be they fiscal or monetary, must be implemented in a context of financial responsibility and structural policies which actively support productivity and employment, taking into account important constraints of demographic, technological, and geostrategic nature, as well as financial.

In the case of the Portuguese economy, the risks associated with easy credit must not be forgotten. While, at first, this allowed for fast growth, the fact that the latter was driven by public expenditure and non-tradable sectors also led to significant fiscal and external imbalances and to a sudden stop of market financing that could only be overcome by

[1] See in this regard the "Analytical Note" by the "four presidents" of the Euro Area of 12 February: Jean-Claude Juncker, in close cooperation with Donald Tusk, Jeroen Dijsselbloem and Mario Draghi, *Preparing for Next Steps on Better Economic Governance in the Euro Area*, available at http://ec.europa.eu/priorities/docs/economic-governance-note_en.pdf.

resorting to harsh adjustment measures. While the Economic and Financial Assistance Programme (EFAP) provided the conditions for a new starting point with respect to economic growth, if it is to be effective fiscal sustainability must be safeguarded and a balance between the tradable and non-tradable sectors in the private sector must be struck. As stated above, the adjustment made in recent years ensured a return to normal borrowing conditions, and monetary policy furthermore made the latter highly favourable. However, after joining the Euro, Portugal had already enjoyed a period of low financing costs, and the then adopted policies led to vulnerabilities which precipitated the crisis. As such, a thorough reformulation of economic growth policy is required.

This Report analyses the constraints facing fiscal policy, deemed as one of the pillars of the aforementioned reformulation. As stated before, Portugal has made important progress in this field. However, fiscal consolidation and the adoption of efficient methods of public financial management are still a work-in-progress, and still in the early stages in some areas.

A matter that deserves particular attention is the need to define and respect a multi-annual fiscal programme. A medium-term fiscal policy strategy is an essential component of sustainable macroeconomic policy and of balanced sectorial policies. On the one hand, it provides economic agents with the guidance and stability required to optimise their savings and investment decisions, and, on the other, it is essential to establishing efficient public management methods which encourage private ventures that are well adapted to market conditions and to the level of competitiveness of the economy.

Portugal's fiscal policy has usually been confined to the annual horizon. This has turned the Stability Programmes required by the Stability and Growth Pact (SGP) into a mere formality in which the starting point is revised every year, and another year is added to the trajectory towards stability, always projected to be achieved by the end of the programme. The revised SGP and the new European Semester rules seek to put an end to this practice. That should require economic policy to be formulated in the context of a broader framework, with the multi-annual fiscal programme regarded as a true commitment, compliance with which must be assessed and any deviations justified and corrected. This Report thus seeks to establish the practice of examining each new Stability Programme in the light of compliance with previously announced policies, while the State Budget should in turn be integrated into the broader plan set out in the Stability Programme.

According to its Statutes, the Portuguese Public Finance Council (CFP) is required to present a report on the Stability Programme and other procedures in the context of the European regulatory framework. In keeping with that requirement, CFP considered it would be useful for that document to be preceded by an analysis of compliance with the previous programme – which in this case is Fiscal Strategy Document 2014-18 (FSD/2014) – and by a projection exercise for the main fiscal variables over the next five-year period, based on the state of public finances at the end of 2014, on an updated macroeconomic scenario, and on a no-policy-change assumption. Note that, with the exception of the estimates relating to 2014, the scenario outlined in this report is not an attempt to forecast future outcomes or developments, since these will depend upon political decisions which have only been taken into account to the extent that they have already been approved and that their effects are quantifiable. Rather, the aim is to contribute to the defining of the backdrop against which new decisions will be taken and to identifying the relevant constraints they will face.

Thus, relying on a macroeconomic scenario consistent with available projections for the domestic and international economies, as well as with the latest developments, a fiscal scenario for the five-year period 2015-2019 was drawn up, based on the economic and fiscal policies already in place. The results clearly stress the need to continue the fiscal consolidation effort. Although the objective of achieving a deficit under 3% of GDP in 2015 and bringing the Excessive Deficit Procedure to an end seems feasible, in the absence of additional policies, and despite the convergence of the economy to its potential growth, the deficit will once again exceed that threshold from 2016 onwards. As a consequence, the debt ratio will fall considerably less than expected in FSD/2014 (to 121.9% in 2018, instead of 114%).

In fact, fiscal pressures stemming from demographics and from the high debt ratio continue to call for a major effort in the direction of increasing the effectiveness of public service provision, accompanied by a greater ability of the private sector to generate income and attract financing. Following the decision to join the single currency, Portugal benefitted from an enormous influx of foreign capital, mainly in the form of debt, either of the public sector or intermediated by banks. Thus, the country's International Investment Position, which aggregates its foreign assets and liabilities, deteriorated from a net liability of 10,000 million Euros in 1996 to almost 200,000 million by the end of 2014. Of these, the general government, whose relative weight increased when it took on the EFAP related debt so as to avoid the lack of payments which would result from the loss of access to market financing in 2011, is accountable for around 154,000 million.

The abundance of market financing that preceded the crisis fuelled domestic demand and stimulated investment in non-tradable sectors, which left the economy vulnerable in the face of the international financial crisis, without having contributed to ensure a stable approximation to the desired real convergence towards the European average. The restoring of normal borrowing conditions should now lead to a reflection on that experience, while taking into account the limits stemming from the high levels of indebtedness reached. Fiscal policy must pay particular attention to its intertemporal consequences, an outcome that the analysis here presented attempts to encourage.