FISCAL RISKS AND PUBLIC FINANCE SUSTAINABILITY

EXECUTIVE SUMMARY

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In compliance with its legal mandate, the Portuguese Public Finance Council has prepared this Report which analyses the main macroeconomic, fiscal and climate change risks to the sustainability of Portuguese public finances. This report is published every two years.

Macroeconomic projections and risks

Productivity growth in Portugal is identified as the main long-term macroeconomic risk. The CFP forecasts that between 2021 and 2035 real GDP will grow at an average of 1.9% per year. Over this horizon, in the absence of shocks, the pace of growth of the economy should converge to 0.7% in the long term, in line with the potential growth estimated for the Portuguese economy. In the CFP scenario, recovery from the pandemic shock and the convergence of labour productivity growth to 1.1% in the long run are dependent on the robustness of capital intensity. The contribution of capital accumulation, in the long run, presupposes the maintenance of favourable financing conditions and the stabilization of the investment to output ratio around the values projected for the end of the RRP implementation period (2021-2026) – which presupposes an efficient execution of the plan and absorption of the funds in the economy.

The direct and indirect impacts of climate change are a major challenge to economic activity and public finances in every country in the world. Portugal is no exception. However, the comparative studies already conducted show some contradictory results for Portugal. In this context, the short-term and long-term downside risks for the Portuguese economy and public finances are expected to increase substantially as a result of the physical and transition risks facing the economy, which imply the adoption of adaptation and mitigation policies with significant budgetary costs, but which are not yet sufficiently known.

In fact, although Portugal has already approved several action plans aimed at the transition to carbon neutrality of the economy, such as the Roadmap to Carbon Neutrality 2050, these present an insufficient survey of investment needs to be made, both by the public and private sectors, and the respective sources of funding. It is therefore urgent to develop its financial dimension to ensure that the agreed targets are met.

Risks on Expenditure

Between 1995 and 2010, Portuguese GDP at current prices doubled, while expenditure grew two and a half times. During the Economic and Financial Assistance Program (EFAP) period and in subsequent years until the pandemic broke out, expenditure growth rates were lower. In terms of expenditure composition, in 2019, personnel expenditure together with social benefits, two of the main expenditure components that can be typified as rigid expenditure, accounted for almost three quarters (74.4%) of adjusted primary expenditure, a weight that has been increasing since 1995, when they accounted for 66.8% of that aggregate. It is important to be cautious that, just like it happened between 2014 and 2019, the evolution of these more rigid expenditure components will continue not to grow as much as GDP. This is to avoid reducing the space for more flexible but no less necessary spending, such as investment spending, to maintain the public capital stock and cope with the aforementioned climate change.

Demographic change is a key determinant of the sustainability of public finances on the expenditure side. The combination of increased life expectancy, low birth rates and a smaller net migration flow accentuates the aging trend of the population, with direct consequences on public spending. Expenditures associated with population aging, mainly on pensions and health care, have shown a continuous increase over time, posing economic, fiscal and social challenges. According to the recent medium and long-term expenditure projections published in the 2021 Ageing Report, additional public finance efforts will be required to maintain the level of social benefits currently provided. This effort may even be underestimated in that exercise, since the expected decrease in the future value of old-age pensions in the contributory system puts additional pressures on the non-contributory system. In fact, as the value of pensions approaches the minimum legal value established, the greater the number of beneficiaries that will have access to complementary benefits provided by the non-contributory system. This would require an assessment of the adequacy of future benefits provided by pension systems, including the effects of the adopted reforms. The evolution of the system should seek to ensure an adequate sharing of risks between generations, as well as a fair distribution of income between the generation of old-age pensioners and future generations, for whom current projections indicate that they will have longer contribution careers and a lower benefit. In the area of health expenditure, the European Commission projects for Portugal an increase of 1.6 p.p. of GDP between 2019 and 2070, the fourth highest in the European Union as a whole (whose average increase will be 0.9 p.p. of GDP). Expenditure on long-term care in Portugal is expected to rise from 0.4% of GDP in 2019 to 0.8% in 2070, an increase of 0.4 p.p. of GDP, which compares to an expected growth for the EU as a whole of 1.1 p.p. of GDP.

Contingent Liabilities

Unlike fiscal risks that may result from changes in macroeconomic variables, contingent liabilities often take the form of public liabilities that, under certain conditions, require a government response based on a commitment, which may or may not be formalized. Since they give rise to potential liabilities for public finances, they differ from the fixed responsibilities, associated with actual liabilities, and it is difficult to estimate in advance the impact of their materialization on the deficit and debt, as well as to foresee the moment of their eventual occurrence. As they are, in any case, a risk to public finances, there has been an increase in the quantity and quality of information required in the European Union's Economic Governance framework, which has improved fiscal transparency and the understanding of the fiscal risks associated with this type of liability.

In the year before the pandemic crisis began, contingent liabilities in Portugal represented 42.3% of GDP reflecting a significant reduction when compared to 2016, when those liabilities reached 76.5% of GDP. The reduction in exposure to contingent liabilities of public financial entities not included in the general government sector was determinant to that progress. The lifting of support measures for the financial sector also benefited to a large extent from this evolution, contributing to reduce medium and long term risks to the sustainability of public finances, although there are still indirect risks associated with non-full provisioned non-performing loans.

In general, the response to the pandemic crisis required the government to adopt extraordinary measures to support the liquidity of households and companies. Public guarantees granted to credit lines created under COVID-19 and moratorium schemes under bank credit were the most common forms of liquidity support. According to information from the Budget Directorate-General, the stock of guarantees provided by the general government increased from 4.8% of GDP in 2019 to 6.4% of GDP in 2020, as COVID-19 guarantees (3.2% of GDP) more than offset the 1.8 p.p. of GDP reduction in the stock of guarantees provided to the financial sector.

The liabilities of public corporations classified outside the institutional sector of the general government also constitute a budgetary risk. This stems from the possible inability of these companies to meet their responsibilities. The debt generated by these entities represented 3.3% of GDP in 2019, half of what it was at the beginning of the 2007-2008 financial crisis. As a result of the pandemic crisis that began in 2020, there has been a worsening of the debt of these entities to 3.6% of GDP, a higher level than that observed since 2016. Although the external and financial sectors account for almost three quarters of the financing of these entities, it was the general government sector that recorded the largest increase in risk exposure to these same entities (sometimes referred to as non-reclassified public companies or NRPEs).

Debt sustainability analysis

The health crisis caused by COVID-19, which took place in a context of gradual recovery from a rather vulnerable budgetary situation in Portugal, led to the need to adopt measures to combat the pandemic, which, as in other European countries, contributed to a significant increase in debt. However, the interruption of the downward trajectory of the national public debt ratio did not, contrary to what happened during the sovereign debt crisis, have repercussions on financing costs, as the Eurosystem's asset purchase and liquidity management programs, together with a joint response to the health crisis adopted by the European Council, were successful in keeping debt interest rates at low levels for euro area members, allowing continued access to market financing.

According to the debt sustainability analysis presented in this report, the CFP projects that, in the baseline scenario, the public debt ratio will assume a downward trajectory over the next 15 years, reaching 91.1% of GDP in 2035. This exercise is based on the values projected in a no-policy change assumption for the 2021-2025 period and extends this horizon to 2035 assuming that: the primary balance reacts to the evolution of public debt in line with what has occurred in the recent past (as estimated by a fiscal reaction function, implicitly requiring economic policy changes); and economic and interest rate developments evolve in line with what is projected by the CFP. According to this projection, public debt as a percentage of GDP shows a faster pace of decline in the first two years, driven by economic recovery of the effects of the 2020 recession. In 2023-25, a more gradual decline in the debt ratio should be observed, mainly due to a less expressive GDP growth, even if the primary balance turns positive again, contributing favourably to the decrease of that ratio. From 2026 until the end of the projected horizon, the growth effect and the primary balance effect more than offset the unfavourable impact of the interest effect, even if the implicit interest rate on the debt remains at historically low levels.

Despite the expected downward trajectory, the risks associated with the high level of indebtedness in Portugal persist. In addition to the debt-to-GDP ratio of 135.2%, among the possible risk indicators of the fiscal situation are the (gross) financing needs relative to GDP, as well as the long-term trend (measured through the dependency ratio, the fertility rate and projections for health and pension expenditure), which signal a clear need for structural policies to correct the imbalances in a timely manner and change the direction of their evolution. The current monetary policy of maintaining interest rates at historically low levels is a unique opportunity to, with a sustained fiscal effort, achieve a significant reduction in debt as a percentage of GDP. In Portugal, however, fiscal policy has not been sufficiently counter-cyclical in the favorable (growth) phase of the business cycle to build a sufficiently large fiscal space to prepare the country for the economic and fiscal consequences of an unfavourable shock. Such fiscal space would allow the free operation of automatic stabilizers, possibly aided by a counter-cyclical expansionary policy in the downswing of the business cycle (in recessions). In this way fiscal policy could effectively stabilize the economy by minimizing cyclical fluctuations rather than exacerbating them.

Simulating the sensitivity of the evolution of the debt ratio to various exogenous shocks, the sensitivity analyses presented point to a higher sensitivity of the debt ratio to shocks in the GDP growth rate and in the value of the primary balance. In both cases the unfavourable shocks lead to a debt ratio above 100% at the end of the projected horizon. In the first case, real variations of +1 p.p. and -1 p.p. in GDP growth imply that debt will be between 73.6% and 111.4% of GDP, respectively, at the end of the 15-year projection period, while variations of +1 p.p. and -1 p.p. in the primary balance imply that debt will be between 77.1% and 105% of GDP in 2035, respectively.

This clearly downward path of the government debt ratio in the central scenario shows that conditions are in place for the sustainability of Portuguese public finances as long as policy makers continue to take the necessary measures to achieve a sufficient primary surplus. As this report concludes, in the absence of a revenue windfall, these measures should ensure that the share in GDP of total public spending (except for investment fully financed by EU funds) is reduced from the maximum reached in 2020 to a value in line with that seen before the pandemic in 2019 (42% of GDP). This economic policy reaction, coupled with the favourable financing conditions now in prospect, creates a favourable dynamic for debt reduction, which is mutually reinforcing via credibility gains reflected in reduced spreads against German debt. The absence of this policy reaction, simulated by the CFP in an extreme scenario in which the indicators would return to their respective historical average since 1999 or in keeping the primary balance at the value estimated for 2021, would lead to an upward profile for the debt ratio from 2025 or 2028, respectively, although with a lower value than that of 2020 at the end of the projection horizon. These are, however, extreme scenarios whose adverse consequences can be avoided by pursuing an active strategy to ensure a downward path for the debt ratio, as evidenced by the various policymakers since the completion of the adjustment program in 2014 and which allowed for good market financing conditions. In fact, this concern of fiscal policy makers with the path of debt, as evidenced by the aforementioned reaction of the primary balance to its ratio, has been rewarded in the financial markets with a notable reduction in country risk. In a virtuous circle, the reduction in risk has reinforced the desired decrease in the debt ratio by lowering the weight of the interest burden. In short, maintaining debt sustainability is perfectly within the country's reach as soon as fiscal policy is conducted with this constraint in mind.