EXECUTIVE SUMMARY

This document presents an ex post evaluation of the three year EU/IMF financial assistance for Portugal, which ended in May 2014. The three-year Portuguese programme was designed to overcome the economic and financial crisis that led to Portugal requesting financial assistance in April 2011, when the sovereign and banking sector were cut off from market funding. The programme made available €52bn of European funding, split equally between the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) and €26bn from the International Monetary Fund (IMF). The Portuguese programme was the third economic adjustment programme for a euro area (EA) country and made use of stabilisation instruments that were less than a year old at its inception. An ex post evaluation of the design, implementation and outcome of the programme is required by the European Commission, under the Better Regulation agenda ([1]). The aim is to draw lessons for the future, in line with best practice.

The programme called upon Portugal to introduce reforms that were designed to address the weaknesses that had rendered it so vulnerable to the effects of the global crisis, and to set it on a stronger medium-term growth path. The assistance was made conditional on the implementation of policy reforms that were set out in a Memorandum of Understanding on Specific Economic Conditionality (MoU), accompanying the Memorandum of Economic and Financial Policies (MEFP). Amid a challenging external environment, the programme was intended to facilitate and buffer the substantial economic adjustment that was both inevitable and necessary for Portugal to return to economic soundness, by allowing for a more gradual unwinding of the unsustainable domestic and external imbalances that built up in the pre-crisis period.

The Portuguese economy was characterised by a combination of poor performance and weak competitiveness in the years preceding the crisis, alongside unsustainable public finances. Since the early 90s, low productivity growth had led to sluggish economic growth, with rising unit labour costs and deeply-rooted structural deficiencies eroding competitiveness. There were large and persistent fiscal deficits, funding a large and inefficient public sector. By 2010, public debt stood at over 90% of GDP – in part due to reclassifications. As the crisis spread, cracks appeared in the markets' faith of Portugal's ability to pay back already high public and private debt.

Portugal requested financial assistance as bad economic news and deteriorating market conditions priced the Portuguese banks and sovereign out of markets. As growth slowed and markets' appetite for risk declined, Portuguese banks started experiencing financing difficulties in the international markets from the beginning of 2009 due to the risk associated with their exposure to public and private debt. Banks virtually lost market access in mid-2010, relying on the Eurosystem to meet their financing needs. As borrowing and debt figures rose, the spreads on the Portuguese sovereign increased. The Portuguese caretaker government requested financial assistance from the EFSM/EFSF and the IMF on April 7th 2011, following the parliament's rejection of the government's stability programme.

The Portuguese programme correctly reflected the very difficult challenges that Portugal faced: to address immediate fiscal risks and to overcome engrained structural weaknesses which were responsible for Portugal's low potential growth. The programme rightly targeted an ambitious fiscal consolidation underpinned by a number of fiscal governance and structural-fiscal measures. Over a three-year period, the programme aimed at supporting progress in the orderly unwinding of the public and private, internal and external imbalances and in increasing the growth potential, while mitigating negative social impacts. In light of the need of correcting the country's imbalances, the programme aimed at strengthening the banking sector. The challenges faced by the Portuguese economy were deep rooted and tightly interwoven with vested interests; they could also not be solved through simple policy-levers.

([1]) "*Better regulation for better results – An EU agenda*" (COM(2015) 215 final), "*Better regulation guidelines*" (SWD(2015) 111 final).

The programme was effective in achieving its primary objective of restoring confidence in the Portuguese economy. It made tangible progress in putting the public finances on a more sustainable footing, improving competitiveness to support economic growth and addressing some of the weaknesses of the financial sector. Portugal was able to return to financial markets before the end of the programme, reflecting both the easing of the financial market conditions and the market perception that the economic weaknesses were being addressed. Portugal made good progress in addressing some of the structural impediments to growth that had built up over the years; however, not all the areas where reform was needed were effectively addressed during the three year programme horizon. Although it increased its resilience, the financial sector was still fragile at the end of the programme.

The programme financing envelope was sufficient to meet Portugal's needs during the three years, but only because the increased access to market funding and other funding sources covered the higher financing requirements of the early years. The €78bn financing envelope was calculated based on the assumption that Portugal would continue rolling over part of its existing stock of short-term debt and slowly return to longer-term bond markets during the last part of the programme. In the early years, Portugal ran higher-than-expected government deficits, which it was able to cover by tapping short-term debt markets more than initially planned. Over the later programme months, it also accessed more longer term market financing than foreseen. Its ability to do this was both a testament to the programme's implementation and the result of an easing of market conditions following monetary authorities' decisions. Without the additional unforeseen market access, Portugal would have struggled to stay within the financial envelope set out in the programme, particularly in the early years.

Portugal was able to effectively withdraw from the programme early thanks to the build-up of a substantial cash buffer. However, the reduced need for programme financing in the final months, contributed to a slow down of the pace of reforms, leaving the economy weaker than it would otherwise have been. Portugal exited its financial assistance programme in May 2014, without accessing the last €2.5 bn tranche of programme financing and without requesting any follow-up precautionary assistance. By the end of the programme Portugal had built up a sizeable cash buffer of €15.6 bn, which was more than the remaining deficit being projected in mid-2014 for the remainder of 2014 and 2015, put together. Taken together with the frontloading of the financing, it meant that the pressure on Portugal had eased by the end of the programme, which contributed to slow the reform process. This allowed the Portuguese government to avoid undertaking certain fiscal reforms and left Portugal with a looser underlying fiscal position at programme exit.

The initial conditions of the EFSM/EFSF loans were set up to be broadly equivalent to the IMF loans, with short maturities and mark-ups for risks on the interest rates; during the programme the margins were cancelled and the maturities were extended twice. Under the original programme, the EFSM and EFSF loans were set up to be broadly equivalent to the terms of the IMF loans. In October 2011, following decisions in the context of the Greek Loan Facility, the Council decided to cancel EFSM margins to programme countries and similar conditions were applied to EFSF loans, making all loans under these facilities considerably cheaper than the IMF ones. In addition, the maturities of the EFSM/EFSF loans to Portugal were extended twice, along with those of Ireland, in 2011 and 2013. By early 2015, Portugal's borrowing costs on the open market fell to below those of its IMF loans. In February 2015, the Eurogroup agreed to allow Portugal to repay over half of its IMF loans ahead of schedule, without an equivalent early repayment of its EFSM/EFSF loans. Portugal made its first early repayments to the IMF in 2015.

The programme aimed at reducing the budget deficit and stabilising public debt, by acting on both expenditure and revenue and by streamlining the public sector through a number of fiscal-structural measures. The initial programme called for the budget deficit to achieve the 3% of GDP threshold by 2013, with public debt peaking in the same year. Fiscal measures were to be supported by a number of actions qualified as 'fiscal-structural measures', which consisted of reforms to the way the

public sector operates. Some of these measures built on plans that the Portuguese authorities had already developed.

Portugal broadly met its fiscal targets – which were revised twice due to the impact of events outside the control of the government – partly by making recourse to one-off and temporary measures, undermining the long-term benefit of its policy choices. To meet its targets, Portugal made use of one-offs and other extraordinary measures on both the revenue and expenditure sides, some of which were meant to be replaced by permanent measures over a longer time period. In 2012 and 2013, the fiscal targets were revised because of disappointing macroeconomic developments beyond the control of the government; the rulings of the Constitutional Court overturned several programme measures with significant fiscal impacts and hindered the achievement of the deficit targets. While the non-permanent measures improved sustainability via their immediate impact on the debt, they do not lead to the necessary lasting impact on the deficit. The alternative structural measures were not advanced promptly. Overall, the quality of the consolidation was weaker than planned, but did allow Portugal to stay within the financial envelope.

Portugal shied away from pursuing some of the most difficult measures that would help it over the medium term, although a number of important fiscal structural measures were introduced to improve the efficiency of the public sector. The inefficiencies in Portuguese public spending had accumulated over the years and had a negative impact on Portugal's key weakness: economic growth. Portugal did not make as much progress as desirable in addressing all these inefficiencies. However, the programme achieved structural improvements in State Owned Enterprises (SOEs), Public Private Partnerships (PPPs), the health system and fiscal governance. The absence of a comprehensive plan for a reform of the state, underpinned by an exhaustive and up-front spending review, weighed on the capability to achieve more consistent and sustained savings in the public sector and social security. For instance, expenditure cuts to the public wage bill and pension expenditure were mainly temporary.

The extensive package of structural reforms in the Memorandum of Understanding rightly reflected the broad-based economic inefficiencies and distortions at the root of the crisis, but implementation might have been better if there had been a sharper focus on critical areas. The Portuguese programme included numerous and deep structural measures that touched on all the main policy areas. This was because the Portuguese crisis was the result of broad-based economic inefficiencies, unlike in some other countries where the problems were concentrated in a few sectors, like housing and/or the financial sector. These weaknesses included a lack of adequate human capital, poorly functioning labour markets, declining labour cost competitiveness, inefficiencies in product markets characterised by excessive economic rents in many non-tradable sectors, an inefficient judicial system, malfunctioning housing market and deficiencies in the business environment. The programme partners agreed that all these areas needed to be tackled, at least in part, during the programme. The result was that even if more emphasis was put in some areas (i.e. labour, judicial and housing reforms) there was not a sufficient degree of prioritisation. The MoU envisaged a broad step change in the momentum of reform in a country in which necessary reforms had not been forthcoming. At the same time, ambition and pragmatism could have been better balanced, bearing in mind limits to administrative and political capacity to address all problems at the same time.

Implementation of structural conditionality was uneven, with labour market reforms being more strongly pursued, especially at the start of the programme. While many of the labour market reforms were implemented in the first part of the programme, progress on other reforms was slower and patchier. This was probably because the ground for labour market reforms was better prepared as already agreed with the social partners in March 2011 and because labour market reforms are administratively easier to implement. Delays in other reforms also appear to be partly linked to the relative strength of vested interests. The timing of many reforms was influenced by factors including the need to conduct social dialogue, the demands placed on the legislative system, or the desire for transitional periods or

protections. An earlier and more determined implementation of some reforms, especially concerning the product markets, would have had benefits and increased Portugal's future growth potential.

The scope of the programme's labour market reforms was broadly correct in the sense that it matched the main challenges; important progress was achieved. Where programme performance was mixed, it seems to have been linked more to shortcomings in the detailed specification and implementation of measures – and long time lags – rather than major omissions in the programme design. Many of the measures in the MoU were based on a March 2011 tripartite agreement, between the government, employers and business representatives, and labour unions. While this limited the scope of the deregulation, it facilitated implementation. Important labour market reforms were adopted during the programme, and firms consider them to have had a significant impact. The momentum of reform, however, dropped over time and whilst progress has been made, further reforms are still needed.

The measures covering product markets and framework conditions were overall well designed, but implementation was not as strong as in other areas. The programme essentially tried to address every area where there were factors eroding competition and/or unduly increasing domestic production costs. Under the programme umbrella, significant progress was made in important areas where reforms had been long due, including housing and judicial sectors, the electricity tariff debt, transport SOEs and road PPPs and the business environment. Implementation was weakened where the intended policies turned out to be politically or socially sensitive and in key areas with strong vested interests. Many of these measures were still pending at the end of the programme (e.g. energy, regulated professions or ports). The scale of reforms also stretched the Portuguese authorities' implementation capacity. In the latter part of the programme, these existing challenges appear to have been compounded by reform fatigue.

Clearer communication on the necessity of structural reforms and their longer-term benefits might have helped overcome some of the resistance to reforms. Although the initial MoU linked the package of reforms with analysis of economic challenges and the necessity of adjustment, communication on the relationship between timely and effective implementation of structural measures and the programme goals could have been more consistent. At the same time, the scope of the reforms needed meant it should have been better communicated that a three years programme could only be the starting point of a necessarily longer-term reform process.

The programme appropriately targeted strengthening the banking sector. The banking sector was expected to face considerable challenges, as a consequence of the needed correction of the country's structural imbalances. The programme strategy envisaged increasing the banks' resilience to delink their market access from the sovereign one and to reduce reliance on Eurosystem financing, while ensuring adequate liquidity to avert a credit crunch. The programme envelope contained €12 billion to be disbursed to the Bank Solvency Support Facility (BSSF) to support the financial sector. While the programme correctly identified the key issues faced by the banking sector, the scale of the problem was underestimated and resulted in policy implementation that left the banking system with too much residual weaknesses at the end of the programme.

Both the programme design and the programme implementation should have pursued a more frontloaded adjustment of the banks' balance sheet. The programme design recognised the need to strengthen the banking regulation and supervision, and the banks' capital position, including through the combination of asset quality reviews and stress tests. The banks' capital levels increased during the programme. However, the asset quality reviews required repeated rounds to ensure adequate assessments. The stress tests did not foster prompt actions to improve the resilience of all the covered banks, including under stress scenarios. The supervisory authority did not require a more robust recapitalisation/ restructuring of the banks. With Banco de Portugal (BdP) responsible for the design and implementation of the bank recapitalisation, the programme could have better emphasized the importance of the different strategies, provided more detailed guidance and put more pressure on implementation. Bank supervision actions should also have been tighter with regard to provisioning and write-offs, especially when the

problems related to the economic slow-down became more evident. A publicly available analysis, in the programme context, about the advantages and drawback of different options to tackle non-performing loans (NPLs) could also have been helpful, to support the implementation of the most effective policies.

A prompter adjustment of the troubled Banif and Banco Espírito Santo (BES) would have been beneficial, and a more forceful approach towards Caixa Geral de Depósitos (CGD) could also have been warranted. BES and Banif were resolved after the end of the programme. With the benefits of hindsight, a more forceful supervisory approach could also have fostered the adjustment of the two banks, although in the case of BES some elements leading to its resolution emerged only gradually. Prompter action could have reduced the potential costs, without causing financial instability; the resolution framework had been promptly put in place. In the case of CGD, a deeper streamlining of the bank, possibly accompanied by concrete steps towards its full privatization, could have helped reduce the contingent risks for the state and foster competition in the banking sector. Prompter supervisory or resolution action would have been manageable, within the envelope for the financial sector set up by the programme, since about half of it (€6.4 billion) was not used during the programme.

The programme rightly contained requirements to deal with high private debt and provide credit to the viable firms, but progress in developing financial instruments outside the banking system was limited. During the programme, bank lending decreased more and for longer than initially projected due to declining credit demand and supply. By 2013 credit flows were re-orientated towards more productive and tradable sectors, but the overall adjustment of the private sector balance sheet is yet to be completed. To maximize the short-term effectiveness, the Portuguese authorities targeted initiatives to foster lending through the banking channel. More progress in the development of the capital markets could have contributed to pave the way for a sustained recovery. Better coordination at the level of both the Portuguese and the EU authorities, together with the set-up of ad hoc task forces, could have been helpful.

Social and distributional considerations were rightly taken into account when designing many of the programme measures. Many programme measures included provisions with strong progressive effects and to protect the worse off. Tax increases, public wages and pension cuts were designed in a progressive way, minimum wages and the lowest pensions were untouched and the coverage of some social benefits was extended (e.g. unemployment benefits), while their generosity was reduced. However, some fiscal measures – such as the reform of the minimum income guaranteed scheme – were regressive and could have been avoided or limited in scope. The historically very high poverty and income inequality levels of Portugal indicated that there was scope for clear improvement of the social protection system. The efficiency of the social expenditure to ensure proper targeting to the most in need and adequate incentives could have been strengthened during the programme.

Mitigating the negative social impacts of the adjustment was part of the programme objectives, but no explicit social goals or specific requirements on monitoring social developments were set. Given the importance of fair burden sharing in maintaining public support for the programme, distributional issues could have been more clearly, explicitly and systematically addressed in programme reviews and reports. Setting hard targets in this area may be difficult. But more emphasis on monitoring and reporting on the social dimension would have been warranted. There is a public perception that the outcome of the programme was socially unbalanced. Since the monitoring and reporting aspects were largely overlooked, there is insufficient evidence to corroborate or refute this perception.

The Portuguese programme benefited from strong political commitment, including a strong organisational response. The negotiations on the Economic Adjustment Programme took place in a cooperative environment in consultation with the main opposition parties and other civil society partners. The Programme received public support from the then main opposition parties which suggested a broadly-based political ownership of the programme at its inception and a commitment to sound implementation. Portugal established promptly a special unit (ESAME), which reported to the Prime

Minister, with the task of monitoring the implementation of the programme, in liaison with the line Ministers. Taken together, this meant that Portugal was able to exploit the positive relationship with its partners.

Portugal made good reform progress over the programme years, but faced challenges that can only be fully resolved taking a longer-term perspective. Despite Portugal's commitment to change, its long-standing structural weaknesses would realistically have required ongoing reform beyond the programme period. The reforms undertaken in the programme should form a solid basis for the transition back to sound economic conditions, provided they are not rolled back. To capitalise on these improvements, it is important that Portugal continues to pursue reforms further strengthening its competitiveness and ensuring sustainable public finances.

The following lessons can be drawn from this ex post evaluation of the Portuguese financial assistance programme, in light of the relevance, effectiveness, efficiency and value added of the programme:

Financing Needs

Assumptions about financing needs should be prudent so as to reflect the uncertainties prevailing at the time, such as contingent liabilities of the public sector and market access developments. The size of the financial envelope should add credibility to the programme's overall objective of facilitating return to the sovereign financial markets.

Earmarking the financial envelope for the banking sector helps prevent its use for other needs especially in the presence of a delayed adjustment of the banks' balance sheet.

A specified target for cash buffer developments should be part of the programme envelope design. The latter contributes to market access and a clean exit from the programme, but can reduce the incentives for reform over time.

The intervention at EU level adds significant value in terms of expertise, credibility, coherence with other EU policies and provides for an adequate financing envelope at very low costs.

Fiscal Policy and Structural Reforms

When a crisis is rooted in broad-based economic and fiscal inefficiencies, programmes should include a wide package of structural and fiscal-structural reforms, embedded in a clear strategy which allows a focus on the most macro-critical weaknesses affecting the functioning of the economy and the sustainability of public finances. Including other reforms risks overstretching administrative capacity and making decisions on the completion of the regular programme reviews more complex.

At the very beginning of the programme, an overall strategic plan, underpinned by an in-depth spending review, should be set to steer and frame the ensuing fiscal effort. This plan should be immediately followed by further analysis to single out a few reforms on which political capital and administrative capacity should be prioritised. For these reforms, detailed implementation plans should become gradually part of the MoU with strong specific monitoring. The use of technical assistance should be considered.

When an upfront comprehensive strategy for expenditure cannot be undertaken quickly, it may be more effective to focus on revenue increases, even when there is a clear need for expenditure cuts. This should buy more time for implementing structural expenditure measures, while limiting the recourse to one-off and temporary measures.

When consolidation is excessively based on temporary measures, further improvements may still be needed after the end of the programme. In a climate of reform fatigue, the expiration of temporary measures or the unwinding of other measures without proper replacement is a sign of the insufficient leverage of post-programme surveillance. The corrective arm of the Stability and Growth Pact (SGP) can help deliver some of the needed improvements, as would be the case with any other EU country.

High levels of domestic political and social sensitivity and strong vested interests can lead to delays and mixed implementation of key structural reforms. Strong prioritisation and clear communication are necessary for maintaining national ownership of the reform process, overcoming resistance and achieving implementation of fair and efficient reforms.

The necessary labour market reforms should be implemented without delay. If product market reforms cannot proceed at the same pace, they must be accelerated as much as possible in order to make the overall process more effective and fair.

Banking Sector

Strengthening and cleaning the banking sector is a crucial part of facilitating the correction of a country's macro-imbalances. This correction also requires other policy measures, including fostering private debt restructuring and maintaining an adequate level of credit to viable firms.

The bank capital requirements should reflect credible assumptions on the losses yet to be realised. Independent top-down and bottom-up assessments are instrumental to increase transparency and confidence about the estimation of capital needs. Losses should, in turn, be promptly recognised.

A publicly available analysis about the advantages and drawback of different options to tackle NPLs is helpful. Reducing NPLs requires the prompt implementation of a balanced combination of different policies, including enhancing supervision, developing distressed debt markets, facilitating company restructuring.

Active capital markets are an important buffer for financing the real economy when the banking sector is under restructuring. Their development is difficult in a programme context, when other immediate pressures are high, and requires time and coordinated efforts from national and supranational authorities.

Restoration of banks' viability and market confidence go hand in hand, in a mutually reinforcing process. Policy aimed at addressing the weaknesses of a banking sector in a country subject to a macro adjustment should be implemented promptly and forcefully, in order to avoid delayed tackling of problems that could jeopardise the overall programme's achievements.

Social Developments

The social impact of the crisis and of the adjustment process should be regularly monitored and reported upon in programme documents.

While it is known that economic crises and the subsequent adjustment can have high social costs, the distributional and social implications are generally difficult to estimate accurately at the start of the programme. However, programme measures should be shaped to take equity and social considerations into account, aiming at progressive burden-sharing and protection of the most vulnerable.

Ownership

Sustained ownership is crucial for programme success. However, ownership can be negatively affected by several factors, including the absence of a strong plan for the most comprehensive reforms, of clear communication on structural reforms long term benefits and on the distributional impact of the reforms, as well as the relaxation of the financial constraints once the country returns to the market. Overall, reform fatigue and time needed for structural reforms to be implemented and yield results raise questions about the optimal duration of a programme and the trade-off between ownership and return to the market.