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New Portuguese Government to Face the Challenge of Implementing the EU and IMF Bailout Conditions

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On 16 May, the ECOFIN Council and Eurogroup formally approved the financial aid package for Portugal of €78 billion. Thus, Portugal became the third member of the euro area to receive financial assistance from the European Union and the International Monetary Fund. Projections for the Portuguese economy remain pessimistic. A new government chosen in elections on 5 June will have to make difficult reforms under close monitoring by the European Commission, the European Central Bank and the International Monetary Fund.

Background. One year has passed since the first-ever eurozone bailout (€110 billion for Greece based on bilateral loans of euro zone countries and the International Monetary Fund) was approved. Another country that found itself in a difficult fiscal position, Ireland, benefited from a financial assistance package of €85 billion, coming from the provisional European Financial Stability Facility (EFSF), European Financial Stability Mechanism (EFSM), loans from the International Monetary Fund and bilateral loans from Britain, Denmark and Sweden. In the past few months, Portugal has been noted as another country that will be forced to ask for international financial aid because of rising debt service costs. Tactics adopted by the government, which consisted of postponing the moment at which Portugal formally asks for external assistance, recently have proved impossible to sustain. On 23 March, shortly before the European Council summit, the government resigned because of a lack of consent to adopt the next package of reforms aimed at improving Portugal's fiscal situation. This led to a negative reaction by financial markets, causing an increase in debt service costs and a further reduction of the country's already low debt rating. Shortly thereafter, on 7 April, Jose Socrates, acting head of the interim government, was forced to seek financial assistance from the EU and the IMF.

The Negotiations On the Aid Package. Portugal's request was considered at the informal Eurogroup and ECOFIN meetings on 9 April in Budapest, where the condition was formulated that given the uncertain political situation in Portugal parts of the rescue plan must be approved by all major political parties. Prime Minister Socrates tried to get permission to obtain a temporary bridge loan, which would allow Portugal to survive to the elections scheduled for early June, but this demand was met with strong resistance from other euro area countries and was denied.

The last phase of negotiations over the Portuguese bailout was conducted with the background of increasing uncertainty about prospects for the developments of the fiscal situation in Greece. Most analysts agree that the size of the Greek debt is impossible to handle in the long run. Currently, the aim is to maintain the public finances of Greece, at least until 2013, when a permanent mechanism for financial assistance for the eurozone countries—the European Stability Mechanism—becomes operational and, perhaps, the Greek economy enters a path of sustainable growth. Some form of soft Greek debt restructuring (*re-profiling*) also was taken into consideration, but the European Central Bank opposes this idea given its exposure to the Greek debt buyout. Because of the seriousness of the problem associated with Greek debt for the whole euro area, a further discussion of possible scenarios has attracted much more public attention than the negotiations on the details of financial aid for Portugal.

Initially, there also were doubts as to the acceptability of the aid package by the Parliament of Finland—Eduskunta. Before the recent parliamentary elections there, an announcement

by the national-conservative, eurosceptic party the “True Finns” (*Perussuomalaiset*) appeared to block aid to Portugal. Nevertheless, on 16 May the Finnish Parliament gave a green light to the package.

Finally, the three-year program of financial assistance from the EU and the IMF, which is the result of negotiations conducted by the European Commission, representatives of the European Central Bank and the IMF with the Government of Portugal, was formally approved on 16 May at a meeting of the ECOFIN and Eurogroup. On 20 May, the Executive Council of the International Monetary Fund gave a green light to the aid package. The arrest of IMF Managing Director Dominique Strauss-Kahn had no effect on reaching a final agreement.

Financial Assistance Programme for Portugal. The financial assistance program consists of a loan of €78 billion, derived in equal parts from the EFSF, the EFSM and the IMF, which, as in the case of Ireland, is based on the strictly observed conditionality rule that links financial support to a broad package of far-reaching reforms to improve the fiscal situation of the state. These reforms can be divided into three types: structural reforms to promote economic growth, measures to restore fiscal stability and safeguards for financial stability. A key challenge is to increase the competitiveness of the Portuguese economy to eliminate the basic problem, which is a negative balance on the current account. It is necessary to increase flexibility and productivity and to reduce labour costs. A special set of measures that must be implemented to restore fiscal stability consist mostly of strengthening precautionary procedures of the budget, increasing the efficiency of the tax authorities, boosting the effectiveness of the public-private partnership and better management of state-owned enterprises. Portugal also is committed to reform of the public administration and health care systems. One of the key elements of the program is a broad program of privatization. The aim of these actions is to reduce the Portuguese public-sector deficit from 5.9% today to 3% in 2013. Further measures rely on the recapitalization of the Portuguese banking sector through market-based solutions. The central bank has ordered that commercial banks need to raise Core Tier 1 capital to 10% by the end of 2012 and take action to support the liquidity of capital.

Perspectives. Portugal’s economy has been plagued for years by numerous structural problems, such as an inflexible labour force, high social benefits, administration inefficiencies and a costly health care system. These issues remained outside the interests of successive governments. In the latest ranking published by the IMD (the International Institute for Management Development) in Geneva, in terms of competitiveness, Portugal is 40th out of 59 classified economies, significantly worse than even some EU-12 countries like the Czech Republic and Poland (30th and 34th, respectively) However, Portugal is much better than Greece (56th). Although in the past year the government of Jose Socrates has introduced many structural reforms to improve its fiscal position, they have proven to be inadequate. The new government of Portugal, which will be chosen in elections on 5 June, will face the difficult task of carrying out reforms promised to the European Commission, ECB and IMF. The implementation of these reforms will be closely monitored on a quarterly basis by these institutions under threat of the suspension of subsequent tranches of the loan. Despite the formal approval of the bailout by the main political parties of Portugal (the socialists and the centre-right party), they remain in dispute as to the details, and the question of EU/IMF aid remains the main axis of the election campaign. This will not help bring about necessary reforms, especially since according to recent projections Portugal in 2012 will be the only EU country in recession. The projected level of public debt is expected to be more than 100% GDP and unemployment rates may exceed 13%.

In the context of stabilizing the situation in the euro area, the approaching Polish presidency will have little formal role to play because Poland does not participate in the third stage of the Economic and Monetary Union. Therefore, it does not participate in the Euro group, where important decisions are taken concerning the aid programs. The Polish presidency, however, should closely monitor the fiscal situation of the euro area, as it may happen that it will dominate the agenda of next semester, especially of the Economic and Financial Affairs Council (ECOFIN) and of the European Council meetings. Therefore it seems necessary for Poland to tighten cooperation with the only eurozone country of the next presidency holding the trio—Cyprus.