The Portuguese economy: a long-term creditor’s perspective - speech by Matjaž Sušec

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(*Please check against delivery*)

Good morning,

Let me start by thanking Fitch Ratings for inviting me to its Credit Outlook conference.

I have been visiting Portugal for post-programme missions for about three years and it is fair to say today that Portugal has reinforced its status as the country that is successfully leaving behind the consequences of the past crisis. This follows a track record of economic achievements and robust access to financial markets, which makes Portugal less vulnerable to economic shocks.

In my speech I aim to further elaborate on past developments and the outlook for the Portuguese economy going forward. Before that, let me briefly introduce why the European Stability Mechanism (ESM) is interested in the Portuguese economy and how the role of the ESM will strengthen going forward.

ESM’s role as the euro area’s crisis resolution fund will be strengthened

The ESM disburses loans only if the beneficiary country implements extensive reforms. In all its programmes, the ESM passes on its low funding cost, which enables significant savings in the budgets of beneficiary Members. Since 2011, five euro area sovereigns, including Portugal, benefitted from such loans totalling €295 billion. The ESM participates in regular post-programme surveillance missions with staff from the European Commission, in liaison with staff from the European Central Bank. The ESM runs its Early Warning System, which we use to analyse our beneficiary Members’ ability to repay the loans.

In December, the Heads of State and Government adopted a proposal from the euro area finance ministers, which included the strengthening of the ESM.

As part of these measures, the ESM will take on the role of a backstop in bank resolutions within the Banking Union - also known as the common backstop. The ESM will provide a loan to the Single Resolution Fund (SRF), which would only be used if its funds were insufficient. There will be no additional financial burden on taxpayers. This will further prevent episodes such as those witnessed in the past crisis where state budgets had to be used to save banks. The ESM would borrow funds in capital markets, while the SRF would raise the funds needed to repay the ESM by claiming contributions from all European banks within three to five years. By 2024 at the latest, the backstop should be fully operational.

Euro area finance ministers have also agreed to review ESM’s “toolkit”. In addition to introducing the common backstop, the effectiveness of ESM’s precautionary instruments will be enhanced.

Furthermore, the ESM will play a stronger role in future assistance programmes. In close cooperation with the European Commission, the ESM will also take part in the future design, negotiation and monitoring of policy measures to be pursued under the assistance programmes. The Commission and the ESM will jointly develop debt sustainability analysis. This work will build further on our expertise gained as part of the analysis of repayment capacity.

Overall, these measures will support financial stability and make the euro and the monetary union more resilient to future crises.

Let me now turn to the Portuguese economy. I will focus on its current state and the years to come.

Current policy mix

GDP growth in Portugal has accelerated in recent years to 2.8% in 2017. Private consumption and investments in the automotive industry supported the economic expansion to a large extent. The expansion continued in 2018, albeit at a more moderate pace than in 2017. The main explanation for the expected slowdown is the maturing economic cycle globally and in the euro area.

In the first half of last year, real GDP in Portugal grew by 2.3% year on year, decelerating from the second half of 2017. Data known for the third quarter point to a further deceleration. Private consumption is expected to remain the key driver given the historically high levels of consumer confidence, robust growth of household's real disposable income, employment growth and wage acceleration. Yet, consumption will gradually stabilise since its positive trend also coincides with high households' indebtedness.

Currently net exports' contribution to growth is slightly negative as import growth driven by domestic demand slightly outweighs export growth. Still, Portugal's export market share has witnessed considerable increases over the years and Portuguese exporters continue to gain external market share. This largely reflects gains in tourism and transportation. The share of exports in GDP is expected to continue rising though at a slower pace set by the external environment and moderating growth in tourism.

Labour market developments are definitely a positive result of Portugal's programme. Unemployment has reached its lowest rate since 2004 and is now below the euro area average. More and more people that were out of the labour market during the crisis are now motivated and returning. This allows confidence that the level of disposable income will support domestic consumption.

The banking sector is now more resilient, but challenges remain

Portugal has had a track record of bank restructuring, which benefitted financial stability. As a result of these efforts and due to the positive economic environment, banks are now significantly more resilient compared with previous years. The implemented measures include a series of recapitalisations, which improved banks' capital position and allowed them to clean-up their balance sheets. The stock of non-performing loans has been falling at a fast pace and is now more than one-third below its peak in 2016. The sale of a systemic bridge bank - Novo Banco - stabilised the banking sector and allowed the bank to progress with its restructuring. Banks' profitability in 2018 was the highest since the crisis.

Despite the progress made in the banks in the past years, Portugal still has one of the highest non-performing loan levels in the euro area. Further improving asset quality therefore remains crucial to improve banks' resilience and their ability to support the economy.

Sovereign debt and its management

In the past, the banking sector has had an important impact on Portugal's public debt level. Nowadays, financial liabilities for the State are reduced significantly and have become more predictable. Still, Portugal's public debt burden remains high. The ongoing recovery creates some fiscal space through higher revenues and Portugal continues to reduce debt in this environment.

Since the end of the programme, Portuguese authorities have done a remarkable job in sustaining market access and regaining an investment grade rating by the major rating agencies. Portugal's debt management office, the IGCP, increased the average debt maturity and maintained a high cash buffer. This has allowed the country to regain and retain full market access and confidence. The main policy achievements were clearly communicated to investors, who in turn kept their trust.

The prudent fiscal and debt management policies also enabled the country to early repay its IMF loan, which improved the public debt maturity profile and generated interest savings.

Continue to improve the potential of the economy

Let me now turn to the challenges for Portugal in the period ahead. The current investor confidence needs to be kept by continuing reform-oriented policies. Efforts to reduce the non-tradable part of the economy must continue. Labour productivity must increase, to act as a driver of growth. Prudent fiscal policies need to continue to ensure the sustainability of public finances. And finally, the high burden of private and public debts need to be reduced to pave the way for an improved business environment that supports investment.

Addressing these challenges remains key to increase potential growth, which is important when facing headwinds from a possible global slowdown. As a small open economy, Portugal is susceptible to the risks that also affect other euro area countries. Brexit, the further escalation of trade disputes, faster than expected tightening of global financial conditions or the gradual fading of private spending.

It is encouraging that today Portugal is in a better position to face these risks than it was before the programme.

Summing up, the main points of my intervention today:

- Portugal’s economic growth was relatively high in the recent years, even compared to the euro area. The successful completion of the Portuguese programme in 2014 has allowed the country to benefit the most from the recent favourable cyclical developments.

- Portugal’s sovereign debt burden is decreasing while the country managed to smoothen and extend its debt payments. This is the result not only of the accommodative monetary policy in the euro area but also the result of improved investor’s confidence.

- Same as other euro area countries, Portugal is entering a period of a less favourable economic cycle, bringing the pace of GDP growth closer to potential growth.

- This calls for a policy mix that will keep alive the reform agenda and will adhere to a continuously prudent fiscal policy, in line with the Country-specific Recommendations by the Council. This is also important to continue anchoring investors’ expectations about the positive prospects of the economy.

- The Portuguese banking system has stabilised in the last few years after raising fresh capital. Banks have returned to profitability and need to further decrease their non-performing exposures.

Thank you.

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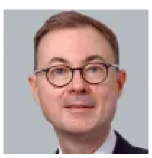

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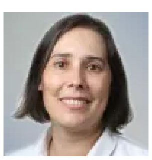

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