

THE BROOKINGS INSTITUTION

PORTUGAL AND THE EURO AREA:
A CONVERSATION WITH PORTUGUESE MINISTER OF
STATE AND FINANCE VITOR GASPAR

Washington, D.C.

Tuesday, March 26, 2013

PARTICIPANTS:

Moderator:

WILLIAM ANTHOLIS
Managing Director
The Brookings Institution

Featured Speaker:

VITOR GASPAR
Minister of State and Finance
Government of Portugal

* * * * *

ANDERSON COURT REPORTING
706 Duke Street, Suite 100
Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

P R O C E E D I N G S

MR. ANTHOLIS: Welcome, everyone. It's great to see many old friends and new friends here today at Brookings and it's a real pleasure to have Vitor Gaspar, the Finance Minister of Portugal. He is a man of great talent, experience, and insight, and it's a real pleasure for us at Brookings to have him with us here today.

He has had a hard job. For the last two years he's been the Finance Minister of Portugal, which means he's the lead negotiator for Portugal as it works out, with the European Union and the IMF and the European Central Bank, a rescue plan for Portugal's financial woes.

That rescue plan has included widespread tax increases and austerity measures including in trying to improve the efficiency and effectiveness of public spending, cutting back on civil servants and the public sector's chronic over capacity, while still also making the right kind of adjustments to improve Portugal's competitiveness. In that sense, Portugal could not ask for a better negotiator with the EU, ECB, and IMF troika.

He has served in two of those places; the IMF has not yet successfully recruited him to work there, although we'll see, but I think he's happy -- he appears happy in his day job, which is hard for us on the outside to understand, but he is really making an enormous contribution.

He served as the European Commission's president in the Bureau of Policy Advisors, which he ran, and then at the ECB he was the Director General for Research for six years. So, he spans the world of research and public service and is a natural here at Brookings.

Still, there are great challenges ahead for Portugal and its economy.

Negative growth, very high unemployment, trade deficits, and then the political side of all that, strikes and protests, even for his boss, Pedro Passos Coelho's social democratic government. These are hard times. And then the longer-term challenges too.

Portugal's economy is plagued by a number of competitiveness challenges that were recently outlined in a paper released by the Brookings Papers on Economic Activity, the Portuguese Slump Crash and the Euro Crisis by Ricardo Reis at Columbia University. It's available on our website.

Just touching on a few of these -- lower years of formal schooling, overly healthy social benefits, and a rigid labor market, and then on top of that, the entry of cheap goods from Eastern Europe and China have put Portugal and the Portuguese economy behind the eight ball.

Of course, it could be worse; they're not Greece and they're not Cyprus. I say that as a Greek American who's followed the Greek crisis closely. While they have had -- while Portugal has had a high debt to GDP ratio, it's not close to where Greece's is, not to mention the deeper political and misgovernance challenges that the current Greek government is trying to clean up.

Still, that has left a lot of work for Portugal and its government to do, and then on top of all of this, the banking crisis has yet again sent shockwaves across Europe. So, with all of that, we look forward to Minister Gaspar's presentation. He'll talk for about 40 minutes or so, and then after that we'll have questions and answers.

So, with that, Finance Minister Gaspar.

MR. GASPAS: Thank you. So, many thanks to all of you for coming. In preparing this talk at Brookings, I faced a challenge similar to the one that Ricardo Reis' faced last Friday, which is, how best to present the case of Portugal to an American

audience that has an interest in Portugal, but also interested in the broader issue of the crisis in the Euro Area.

And both of us decided that the best way to do it is to present the case of Portugal in the context of the crisis of the Euro Area, so that I will be making remarks about the crisis in the Euro Area that I feel relatively strongly about, and I will be using Portugal repeatedly as my example. So, that's the strategy that I'm going to follow this morning.

Now, I'm going to make three points and three points only about the Euro Area, and the first point is about the primacy of the national dimension of politics in the European Union. The second point, which is related to the first, but different from it, is that the key aspect in order to move to stability in the Euro Area, is to make sure that each member state of the Euro Area keeps its own house in order, which means that the institutions underpinning stability have to be domestically produced. And the third point that I want to make is that in the European Union, the main driver of integration since its start in the '50s has been markets. And in the context of the Euro Area crisis, the role of market integration has been emphasized less than it should, and to my mind going forward, fighting financial market fragmentation is one of the key challenges that we face.

So, this is basically it. Let's go to the core of the presentation.

First point, the primacy of the national dimension of politics. I was first faced with this principle when the now Italian Prime Minister, Mario Monti, was making a report on the single market for the President of the European Commission when I was in his Bureau of European Policy Advisors that Bill told you about.

Mario Monti was basically saying that the process of integration in the European Union must be designed in such a way that national governments can ensure

the fundamental functions of the social state that allow them, national governments, to be accountable to their national constituencies.

The way Mario Monti put it was, if markets and social components do not find appropriate reconciliation, something has to give in. And so, at the very fundamental level, Europe must make space for national politics to play its role appropriately.

Now, Bill has also alluded to Cyprus, and Cyprus provides a wonderful example in this line. Now, if one looks at the events in the last week, there was a Euro group agreement about ten days ago and that agreement, at the level of the Euro group, was eventually rejected by the Cypriot parliament, and the way it was rejected by the Cypriot parliament was particularly telling in the sense that not one single member of parliament voted in favor of it.

The President's own party, the Cypriot's President's own party, has 20 members of parliament, and one was absent from the voting, and the remainder 19 members of parliament, abstained.

Now, that clearly shows that in a very extreme crisis situation, national politics prevailed and the Euro Area was put in a position of gridlock. The Euro Area was not able to solve the problem immediately.

Now, at this point in time, we do have a workable agreement involving the Euro group and the Cypriot authorities, and that agreement is now in the process of being implemented in Cyprus and it does offer the promise of a successful solution to the financial stability challenge in Cyprus.

Now, the point that I want you to take away from this example is that national politics and well functioning national politics are a key ingredient for a well functioning European Union and that Union itself has to take that into account when

devising its institutional set up. I regard that as quite fundamental.

Now, my main -- the section of my presentation, which is going to take longer, is this section too about "own house in order" and I'm going to follow a line of argument in which I will hold that in order to have stability in a country, in order to have stability, say, in Portugal, one needs to develop Portuguese institutions that support stability.

Now, in the European Union, the general point is that when we look at fundamental principles like democracy, respect for human rights, and rule of law, that general principle that the institutional framework at the national level must be such that its fundamental principles are upheld is completely accepted and national courts in all member states of the European Union guaranty that that is the case.

Now, we must move beyond these fundamental principles and apply the same type of approach to economic stability and sustainability and, of course, we need fiscal discipline to underpin financial stability.

Now, in the case of Portugal, I believe it is clear that during the time -- the period of participation in the Euro Area, my country did not play the game of macroeconomic stability in accordance with best practice.

One of the best summaries of the situation in Portugal during the first decade of a monetary union is provided by a 2007 paper by Olivier Blanchard, now the chief economist of the IMF, who wrote, "The Portuguese economy is in serious trouble. Productivity growth is anemic. Growth is very low. The budget deficit is large. The current account deficit is very large."

This is a wonderful summary of the situation in Portugal during the first decade of participation in the Euro Area.

Ricardo Reis, last Friday here at Brookings, produced another piece of evidence in which he did show that if you start the path of Portuguese GDP back in 1999 and you go until 2012, and you compare with Japan during the last decade and the U.S. during the Great Depression, it turns out that the level of GDP in 2012 in Portugal is actually lower than either in the U.S. or Japan after the same number of years. So, clearly, Portugal had its own lost decade in quite a dramatic way.

So, summarizing and repeating the points of Olivier Blanchard, Portugal suffered from anemic economic growth and low productivity, which was accompanied by accumulation of excessive debt by Portuguese households and firms and unsustainable public finances. Clearly, such a situation could not be preserved forever.

Now, this basically shows you the figures. You have in the left inside panel the general government budget balance. Portugal is in green and you do see that Portugal is not an extreme case, but you do see that the sustainability of deficits and public debt were already challenged during this period that Olivier Blanchard was talking about.

The trends concerning private debt are also very pronounced. That's what you have in this slide. And here you have the most impressive slide of all, which is the level of gross domestic product. Again, Portugal is in green. And you see that the only country that grew less than Portugal during this decade plus was Italy. Apart from Italy, Portugal is the least performing country in the pack.

Now, there was further a very strong error of judgment on the part of the Portuguese fiscal authorities in the period from 2008 to 2010. The judgment was that what Portugal was facing in the context of the global crisis was a temporary demand contraction that could be managed through expansionary budgetary policy. So, instead

of regarding what was going on from 2007 onwards as an adjustment challenge, it was regarded as a stabilization challenge to be met by expansionary budgetary policy.

Now, you can see that in a number of ways. This chart shows that the private sector was clearly adjusting in terms of declining trends in credit to the private sector already from 2008 onwards, but in 2009 and '10, credit to government compensated for that trend that is the government was trying to offset the impact of adjustment by the private sector.

You see that if you focus on the financing needs by institutional sector, you have exactly the same trend, and if you focus on -- pardon me -- and if you would have a slide with the behavior of the various components of aggregate demand, you would get the same.

Now, initially for 2009, the government was in the mid 2000s presenting forecasts for the budget balance of around 1.5 percent of GDP. Still in 2008, the projection for 2009 was 2.2 percent of GDP and the final data led to a deficit of 10.2, which is an enormous deviation.

Now, clearly, this expansion proved unsustainable, but you can see that there is very clear evidence that markets do react to this type of information. I believe that this plot may be interesting in terms of how market expectations operate. So, you have Portugal in black in this plot, and what you see in the plot that has only four countries -- Portugal, Spain, Italy, and Ireland -- you may recall that Ireland was vulnerable at the beginning of the crisis because there was this enormous problem with Irish banks, and so Ireland was singled out at the beginning of the crisis. And Portugal, in black, is basically tracking what is happening with Spain and Italy.

So, up to the beginning of 2010, the market was not singling out Portugal

when compared with Italy and Spain.

Now, at the beginning of 2010, what happens is that the Portuguese government is presenting its 2010 budget. It's presenting the 2010 budget late because Portugal had elections in October 2009, so the usual timetable for the presentation of the budget is different.

In January 2010, what the Portuguese government does is it publishes a revised estimate of the budget out turn for 2009 that revises up the deficit quite sharply, and in line with that, the prospects for sustainability of public finances are revised quite substantially.

Now, you do see the immediate impact of that on the market that is the 10-year government bond yield for Portuguese bonds jumps from the neighborhood of Spain and Italy to the level of Ireland. And you may recall that we are at the beginning of 2010. What happened was that Greece was now under pressure; in May 2010, an agreement on Greece was reached, that was when the first adjustment program for Greece was agreed, and at that particular moment in time, Portugal was clearly vulnerable. And it turned out that Portugal was never able to recover from that position of vulnerability, which eventually led to the need for an assistance program for Portugal as well, which was agreed in April 2011.

So, the difficulties that Portugal is in are due, first and foremost, to a situation where the country failed to adjust to the demands from adjustment inside the Euro Area, that's the characterization that Olivier Blanchard presented in 2007, and then the country was particularly vulnerable in the context of the sovereign debt crisis of the Euro Area because it pursued unsustainable expansionary fiscal policies that delayed, but could not possibly avoid, the need for adjustment, and that's the short summary of

what went on.

Now, that basically means that a program to tackle the challenges of the Portuguese economy has to be based on three elements. First, structural transformation so that we have structural reforms that will contribute to increased potential growth and improve the competitiveness of the Portuguese economy. That's the part of the program that will enable Portugal to exit the anemic growth path that characterized the first decade of participation in the Euro Area.

Secondly, we need a very strong effort at fiscal consolidation so that we put public finances on a sustainable path.

And last in my ordering, we must deliver deleveraging and financial stability so that we're able to bring the level of national debt, private debt, to more sustainable levels. The adjustment program with these three pillars allow us a framework that we can use as a path towards a successful adjustment of the Portuguese economy.

Now, what you do see is that – remember: we started our program in 2011. What you see there is that the adjustment in domestic demand was quite pronounced. Those are the columns where you do have the contributions to GDP growth in 2011 and 2012. They're strongly negative and what you see is that from 2013 onwards, the difference between the contribution from internal demand and net exports starts to narrow. And from 2014 onwards, it becomes fairly neutral in the sense that from the viewpoint of macroeconomic balance vis-à-vis the rest of the world, the adjustment process will have been completed.

Now, in this process, Portugal has been able to increase the export to GDP ratio. We have also been able to consistently gain market share, and I call to your attention that in 2010, we had an export to GDP ratio of 31 percent, and we now project it

to be at 41 percent in 2014, which is an increase of 10 percentage points in only five years.

Now, up to now, you may feel very optimistic about the program and how it is proceeding, but for me to have an evenhanded presentation, I must be transparent that not everything in the program went according to plan. What you have here is the regional projections under the program and the projections that come out of the seventh review, and you do see that, both in terms of GDP growth and unemployment, the developments in Portugal proved much less favorable than anticipated at the beginning, which means that the adjustment is proving considerably more costly.

Still, the adjustment is taking place and if one focuses on budgetary indicators and structural indicators of adjustment, what we have up to now is a reduction in the structural primary balance from 6 percent of GDP to zero, which is quite substantial. And going forward we expect progress, first, of about 1 percentage point of GDP per year, and then of about .5 percentage points of GDP per year in line with the requirements of the European framework.

Now, here what you have is the public debt to GDP projections and you see that Portugal has projections of public debt to GDP very close to the projections for Ireland, below Italy, and obviously, much below Greece.

Here what we have is the projection for net lending of the economy vis-à-vis the rest of the world, and what you have is that at the end of 2012, Portugal became a net lender, which illustrates the fact that now we have the internal demand in domestic supply aligned. So, from now on, the priority to expenditure adjustment will not have to be as dramatic as in the first two years of the program.

Our banking system has been adjusting fast. It has been reflecting the

macroeconomic trends that I've put to you. On the left-hand side of this slide you have the loan to deposit ratio. The program had 120 loan to deposit ratio as an indicative target for the end of 2014. Basically what the chart shows is at the end of 2012, so two years in advance, the Portuguese banking system as represented by the eight largest banks, was already below that indicator, and the system as a whole was approaching that figure quite fast.

Because of that, because of the base of that adjustment, the indicative indicator was dropped from the program in the context of the seventh review.

What you see on the right-hand side is that capital has increased quite substantially in the Portuguese banking system. The Portuguese banking system, at the end of 2012, was among the best capitalized banking systems in Europe, which means that the banking system is now in a good position to extend credit to the economy.

Now, what we have is that we're regaining bond market access. What you see in this chart is that in terms of level of bond yields, we're back to levels that were prevailing in May 2010. Remember, May 2010 was the first period of dramatic turmoil in bond markets in the Euro Area.

Now, we do believe that this trend -- favorable trend in treasury financing will have important repercussions in the ability of banks to issue senior debt and bonds in markets, that's already taking place. The same applies to large, non-financial corporations, but what we need is a situation where credit will flow to bank-dependent, small- and medium-sized companies, in particular in the tradeable sector.

There is evidence that that is already taking place, but we would like that process to come stronger and faster.

Let me jump a few slides, if not, I'm going to have a problem with time,

but I need this one.

Now, one thing, which is very important, is that when it comes to the quantitative limits of the program, the quantitative limits apply to budget deficits and to debt, we have complied with the quantitative limits, both in 2011 and 2012, in accordance with the criteria defined in the program.

So, we have complied with the quantitative limits in the program for the public deficit and public debt. Moreover, in terms of implementing the various policy actions in the program, we have a strong track record of observing and actually carrying out 91 percent of the measures that have been agreed, that's the balance at the end, that's the tally at the end of the seventh review.

So, we have a very strong record at implementing what we have committed in the context of the program.

Because of that very strong track record in compliance with the requirements of the program, we have signaled to our European partners and to the IMF, the ECB, and European Commission, that we believe that it's opportune for our partners to smoothen the profile of redemptions of official financing and the goal of that smoothing is to make sure that we have enough space in order to successfully issue bonds at 10-year maturities. And that is something that we regard as a crucial step in our process of regaining full, normal bond market access.

We are optimistic that we will get that support very soon and there is a firm commitment by the Euro group to deal with the matter expeditiously.

So, the goal here is to build confidence and credibility. On the European side, the confidence and credibility is underpinned by improving perspectives. For the Euro Area, the ECB has announced its outright market transactions. The banking union

process is ongoing. There have been agreements on assistance to Greece, Spain, and more recently, Cyprus. And we see better financing conditions coming forward.

Internally, we need, in Portugal, to develop rules and procedures underpinning public debt sustainability, but we do have a very broad support for that in the country that -- and that consensus includes not only the majority that supports the government, but also the largest party in the opposition, the Socialist Party.

Last element, we have already implemented most measures aimed at creating an open and competitive economy and we expect that to filter into improved prospects for potential growth going forward.

Very quickly, to conclude inside the time, markets as drivers of integration. In this point of markets as drivers of integration, I'm taking a very old theme from Hayek who basically saw market integration and political integration as co-determine and co-evolutionary and he saw markets as a key element of integration in Europe. That's the general argument and an argument that I agree with.

But in the context of the current situation in the Euro Area, I want to use the argument in a very specific way, so I want to move beyond the general argument of Hayek and look at how it works in the current context.

Now, many people have looked at the crisis of sovereign debt in the Euro Area as illustrating a very strong sentence that is included in the Delor's report that says that market discipline is not enough because market discipline is too slow and weak in normal times, and too sudden and disruptive in crisis circumstances.

Now, what you do see is when you look at bond yields for the Euro Area, is that you have exactly that. So, from the start of the Euro Area onwards, there was a tremendous convergence in bond market yields. The differentials were very, very low.

The market discipline was there, but it was too slow and too weak. And then when markets started being unstable from 2009 onwards, what we do see is that the behavior of markets has been too sudden and too disruptive. So, a perfect illustration of the mechanism that the Delor's report was concerned about.

Now, I would argue that financial integration in the Euro Area has been too narrow and we have focused too much on the inter-bank money market and on wholesale markets and that, in the context, of the crisis meant that integration proved fragile and financial markets in Europe actually fragmented.

Now, that is an issue of a fundamental relevance, not only from the viewpoint of micro efficiency, although it is that as well, but also in terms of the functioning of the adjustment mechanism itself. That is, for a proper functioning monetary union, you want countries, when they have to adjust, to adjust with the assistance from financial markets.

Now, given that in the crisis what we witnessed is a financial market fragmentation, the adjustment process is made harder by the financial fragmentation, which means that one faces financial headwinds in the context of the adjustment. Let me show you what I'm talking about.

So, again, you do have Portugal in green and you have a number of countries in the plot of interest rates, these are loan rates for Portugal, Greece, Italy, Spain, Ireland, Germany, and France, and what you do see is that interest rates in Portugal are very high, they're at about the same levels as those prevailing in Greece, and clearly, Portuguese firms have to pay loan rates a couple of hundreds of basis points above firms in Italy and Spain.

Now, this is a case of market fragmentation because arguably a firm in

Portugal with some business prospects and a risk profile will have to pay a substantially higher loan rate than a firm with the same business prospects and risk profile located in Germany and France. That is something that you would not expect to see in the context of the Euro Area and that is something that we should definitely try to modify with a sense of urgency. This is just another indicator of the same phenomenon.

So, last slide before we go to our debate, the point that comes from financial fragmentation is that we do have an unwelcome link between sovereign and banking risk, and that means that firms located in a given country have to pay an additional risk premium just because there is a public finance concern in the area.

Now, the problem that comes from this is fragmentation and financial market fragmentation leads to a situation where the monetary policy transmission mechanism does not work appropriately for the area as a whole, which is a problem.

Now, that affects peripheral countries, countries like Portugal, in a particular severe way and it has consequences for firms and the ability for the economy to generate employment, and in general for the way the adjustment mechanism proceeds.

Now, in order for us to move beyond this situation, we need first to realize fully banking union, we have already agreed on the single supervisory mechanism. We need to have a resolution scheme and a deposit insurance scheme for the union as a whole. In my view, we should broaden the scope of banking union and aim at a full financial market union in which we do have a broader set of instruments that operate at the level of the union as a whole, and only in that context we will be able to make full use of the dynamics of one money/one market, and have a Euro Area where the adjustment mechanism works and operates in the way it was envisaged at the

beginning.

So, just to wrap up, the points that I tried to make is that, one, the European Union must respect the primacy of the national dimension of politics and allow national governments to perform their fundamental functions of a social state so that the process of democratic accountability at a national level works properly. Secondly, in order for us to be able to underpin a stability culture in Europe, we need the various countries to keep their own house in order, which requires institutional change, which is domestically determined in each of the member states. That's exactly where the fiscal compact aims at.

And last, but not least, in order for the adjustment mechanism in the Euro Area to operate properly, we need to have a full fledged financial union where financial markets work in the way they should in the context of the adjustment processes within the Euro Area.

This last point is important in general, and it's obviously particularly important for a country like my own, Portugal.

I'm ready for your questions and comments.

(Applause)

MR. ANTHOLIS: So, let me ask -- I'll ask a couple questions quickly and then we'll turn it right to the audience.

I think you started -- first of all, it was a terrific, lucid, clear, and very crisp presentation, and we really appreciated the thought and effort involved tying together a number of important strands, so I want to touch on a few and see if we can connect some dots.

You started with the important point of political space. Give us a little

sense of how the politics play out, not so much in terms of either electoral or coalition politics, but more narrowly. As you have taken particular reforms, particularly on the hard areas of adjusting the labor market, how does that affect your policy choices, both looking backwards and now looking forward?

You had one terrific chart up there where you express honesty about the fact that it hasn't met what you had initially forecast, both in terms of unemployment and economic growth. Does that require an adjustment in policy itself moving forward?

MR. GASPAR: Okay. So, that --

MR. ANTHOLIS: You should sit there, I think, too. It will be easier for the cameras to just stay back and forth, unless you need to have access to your charts.

MR. GASPAR: But then it's impossible for me to show you the chart. But that's absolutely fine.

So, I did not grasp the two aspects of your question, so I'm going to answer the question that I understood. Now, it's very clear from the chart that you were quoting, that there is indeed significant deviation, both in terms of economic activity, GDP, and in terms of how unemployment has worked.

Now, that was an absolutely central aspect in this seventh review of the program. So, in the seventh review of the program it became clear that it was crucial to adapt, quite significantly, the way we pursue policy relative to the emphasis at the beginning of the program. And the aspect which was agreed between the Portuguese authorities and the troika, right at the beginning of the seventh review, was that the emphasis should be moved from nominal limits to budget deficits and debt to structural indicators of the same variables.

So, that it was the structural adjustment effort that should be the crucial

variable and automatic stabilizers should be allowed to operate.

Now, you may think, if one is able to agree to that right at the beginning of a review, the review should be extremely easy. It turns out that since these structural indicators are based on unobservable variables, agreeing on the principles is just the start of a very hard discussion about exactly how to make that operational. And there you have to exercise judgment. It's a hard judgment call, and this was one of the elements why the seventh regular review of the Portuguese program was harder and took longer than previous reviews.

The second element that I want to highlight is that when you think about budgetary consolidation and adjustment, one has always to weigh on the one side the impacts from fiscal contraction on economic activity and employment, on the other hand, what are the impacts on public debt sustainability and access to financial markets.

Now, access to financial markets is particularly important for a program country that is shut off financial markets, but it's struggling to regain access, right. So, from that viewpoint, as time goes by, one gets some additional room to maneuver. The way I illustrate that in the Portuguese case is the following: In the context of the seventh review, we have been able to revise our nominal targets quite significantly while keeping exactly the timetable for the program, the program ends in June 2014, and the financial envelope.

How can you possibly have a situation where you revise nominal limits and still keep the official financial envelope unchanged? Well, that's because, in the meanwhile, because you have complied with nominal limits for the deficit and the debt, you have regained enough market access that you can actually manage that position in a more flexible way. So, one is always managing the tradeoff between the short-run

negative impacts from fiscal consolidation and the need to ensure sustainability and ability to finance the imbalances that one has accumulated along the way.

I missed your point on the labor market. That is worrying me.

MR. ANTHOLIS: Yeah, well, the point on the labor market -- I guess the question, which I didn't phrase crisply enough for you, or certainly not as crisply as your presentation is with some of the analysis about Portugal and its lack of competitiveness is that its labor market is not adaptable enough, it's hard to fire people, and in the middle of an economic crisis where unemployment is rising, making reforms where it's easier to fire people must be pretty hard. Yet, in an effort to prove competitiveness, one might still have to do those things. Has that affected your ability to make those deeper, longer-term, structural reforms in the labor market?

MR. GASPAR: No. Our effort at structural reform was very much front-loaded and the example of the labor market that you give is actually, again, a good example in the context of the seventh review.

We had a measure, which was foreseen in the memorandum of understanding, that had to do with severance pay, and the way the severance pay was agreed in the program and the way it had been interpreted in that context, created severe difficulties for the Portuguese trade union, UGT, who basically said that if one would go ahead with what was foreseen in the memorandum, as interpreted by the troika in various reports, that severance pay would be limited to 12 days per year of seniority, they would call into question the way we tried to maintain social consensus on labor and product market policies that in Portugal we call the social concertation process.

So, the government, because it's so important to maintain the consensus and the momentum behind social concentration, put a significant effort into reopening this

particular example with the troika during the seventh review. The troika proved flexible, and we have been able to have a situation where this 12-day rule applies to new, permanent contracts only, and for the remaining contracts, there is a schedule in which, for three years it's 18 days, then 12 days, with a cap of one-year.

And this was something that the secretary general of UGT labeled, and I translate from Portuguese, a manageable disagreement, he called this outcome a manageable disagreement, and that basically means that the process of social concertation in the country is in working order and going forward. It's going to be possible to continue a constructive dialogue with social partners.

So, to wrap up very quickly, we have front-loaded structural reform. Structural reform is key to regain competitiveness in Portugal, and when it comes to particular measures, we operate in a very pragmatic way and we try to build on a strong tradition of social concertation that actually works well in Portugal.

MR. ANTHOLIS: One last question then we'll turn to the audience. The Ricardo Reis paper focuses on finance, that finance had gone to a less competitive sector, such as the service sectors, and not into things that could be more competitive -- tradeable goods, manufacturing and the like -- and you touch on that as well. Give us a sense of how you're trying to address that, how you see that moving forward.

MR. GASPAR: No, that's absolutely key. So, the mechanism in Ricardo Reis' paper is one in which the access to international finance interacts with elements of rigidity at home to exacerbate an allocation problem, and so the investment is actually channeled to the sectors where it is least productive. And Ricardo uses that to explain why total productivity growth was so low in Portugal during this period. It's an ingenious story.

Now, a further story that is told, which has a political economy basis, is the idea that since Portugal and other countries benefitted from cheaper financing with the rest of the world, could get foreign financing at better terms, that actually made the postponement of fundamental social and institutional changes at home affordable, and since it could be postponed, it was postponed.

So, contrary to the expectation at the beginning of monetary union, that structural change would have to take place because successful adaptation to monetary union requires structural change. The better financing conditions opened by participation in the Euro Area, actually made the postponement of such change possible. From a political economy viewpoint, change takes place in the context of crisis. You need the situation to be bad enough for change to take place.

In a sense, there is a very famous line here in the U.S. that says, one cannot let a good crisis go to waste, and that's precisely what is indicated by this story.

What we are doing is, number one, we're opening up the economy to outside competition and from that viewpoint we want the Portuguese economy that emerges from the crisis to be a much more open economy. We want much more competition internally. We want to see markups in product markets, markups in labor markets to come out. We want the level of competition and efficiency in domestic markets to improve quite substantially. And we have made important changes, for example, in the competition law in order to guaranty precisely that outcome.

We want labor markets to be more flexible, so we want the allocation of labor to good job opportunities to be easier in the Portuguese economy. And as I said, labor market reform as foreseen in the program has already been carried out. And we want this adjustment process, in all, to lead to a much more competitive Portuguese

economy.

Going forward, we need to see investment picking up, investment by Portuguese entrepreneurs, but also foreign direct investment. And I would expect to see good news coming from both investment by domestic entrepreneurs and foreign direct investment from now and before the end of the current year.

MR. ANTHOLIS: That's great. We'll start here and then -- microphone right there.

MR. LOWE: Hi. My name is Eric Lowe. I'm with the Fair Observer. And my question is that, you know, like the point you just pointed out about the situation in Cyprus, most of this is because of the banks and the situation has -- my question would be, you know, like, is there any kind of, like, rule or basically to limit the things in the banks, you know, what they can invest, or basically maybe in some countries, you know, like cross the investment banks and the deposit banks into two situations. Is that something that you would be thinking of in Portugal?

MR. GASPAR: No. Bank regulation in Europe is decided at European level. In the context of the point that I was making about banking union and financial union, it's absolutely key that we apply throughout Europe what we call the same rulebook and not only we apply the same rulebook, we apply the same rulebook using the same practices across the European Union. That is key so that we don't have a situation where markets are fragmented.

So, issues like the ones you raised concerning the separation of investment banking, the constraints on the portfolio of banks and all, and so on, so forth, all those issues are very actively discussed at the European level, and in order to have a single market that's exactly how it should be.

MR. ANTHOLIS: Right behind you.

MR. VERON: Nicolas Veron at the Peterson Institute here and at Bruegel in Brussels. Minister, one of the memorable quotes attributed to Napoleon Bonaparte is that if you want to keep your word, the best way is not to give it, and this is exactly what the eurozone has done in terms of deposit insurance. So, my question is about banking union and one of your last slides about the importance of banking and financial union. It's actually one main question and one side question.

The main question is, how do you think the developments in Cyprus will affect the broader banking union debate, especially as regards deposit insurance, which has been explicitly been left out of the banking union agenda so far, but seems to squeeze in, in some form? And the side question is: you referred to the broadening of the banking union debate to financial market union. Can you be slightly more specific on what you have in mind when mentioning this? Thank you very much.

MR. GASPAR: Thank you Nicolas. Nicolas Veron is one of the best experts in Europe on financial matters, so it would be much more appropriate that I would ask questions and Nicolas would answer. But what can I do?

We also have a competition for quotes, and the idea is that if one of us uses an old quote, the other is supposed to use an older quote, but given my present job, I suspend our competition with Nicolas' permission.

Now, on Cyprus and deposit insurance, the Euro Group has, in the context of the various communications that it has issued, while the Cyprus program was being negotiated, has issued a couple of very clear statements saying that deposit insurance in Europe protects bank deposits up to 100,000 Euros in accordance with European law, and as it turned out, the initial package of measures that was rejected by

the parliament of Cyprus was completely put off the table and at this point in time, the deposits up to 100,000 are fully protected by the measures which have been agreed in the case of Cyprus, and that precedent of deposit protection is precisely the precedent that the Euro Group favored when it emphasized the need to respect the limit that has been agreed at the European level.

Your second question that -- I'm not sure it was the side question or the central question. It seems to me the fundamental one, that is, the way I see it is the following: when you look at adjustment inside the monetary union in general, not in a crisis situation, not this particular episode of adjustment, but in general, a very strong argument for financial integration comes from the work of Ronald McKinnon, who, in a paper in 2001, argued strongly that if one has a very complete process of integration of financial markets, many of the arguments against monetary unification are not valid.

To the best of my knowledge, the best formalization of this intuition by Ronald McKinnon was provided by Marvin Goodfriend and Bob King who, in their contribution to the first ECB Central Banking Conference, have shown that for small open economies that participate in monetary union, idiosyncratic factors, factors that are specific to the country, do not matter for macroeconomic stabilization, assuming that financial integration is sufficiently complete.

So, my intuition is that we should have the broader possible set of instruments covered by financial integration because that's what you want to have for micro efficiency reasons, but also for macro adjustment reasons.

Now, the argument is not only theoretical. Empirical research about the United States shows that if you look at disturbances at state level in the United States, most of the disturbances are smoothed out and spread throughout union through the

functioning of financial markets exactly. And therefore, this idea of a broad scope of financial integration seems to matter a lot, both theoretically and empirically.

But you're a practical man, and so your question was not only what I was thinking about, it's how I would go about implementing it in Europe.

I believe that what is at stake most of all is the removal of the national barriers that have led to this fragmentation and the investment in some very basic aspects like market infrastructure, so the way of going about it, in my intuition, is to go very systematically through the various details, the various obstacles to integration, remove them, and then one has to go and provide the market infrastructure that will deliver the integration that we wish for and we need.

That's a challenge for you.

MR. ANTHOLIS: Here on this side in the front -- the row back, right there.

MS. SCOTT: Thank you. Heather Scott with MNI. You mentioned in your talk that you have asked the troika to help smooth debt redemptions. Can you explain specifically what you're looking for and what the timeframe is?

MR. GASPAR: Yeah. So, I also have a slide, but I'm prevented from showing slides, so I will use my hands. So, the idea is the following: if you were looking at the slide which is there, you would see that the profiles of redemptions for the Portuguese case there is a similar problem associated with Ireland, have, in the Portuguese case, peaks in 2016 and 2021. Clearly, the peak, in particularly the peak of 2021, is problematic in the sense that it would imply needs for refinancing above any amount that the country has ever raised in bond markets.

Now, the issue is not one of debt sustainability, it's just an issue of

profiling of the debt. So, one needs to be able to smoothen that out.

Now, our European partners have been clear that, assuming that Portugal and also Ireland, comply with the terms and conditions of the program, Europeans stand ready to help and assist our return to bond markets. In that context, in January, when I announced that Portugal had complied with the nominal limits for 2012, I also said that we want to move fast in terms of regaining market access and so we believe it's opportune to call on our European partners to deliver on their commitment to assisting that process.

Now, that has led to a signaling on the part of the Euro Group and ECOFIN that they're willing to look at the issue, and more recently, the Euro Group has said that the troika, so the IMF, the ECB, and European Commission, were invited to complete the technical work and make a recommendation on this very issue in parallel with the preparation of an adjustment program for Cyprus, and that's why I indicated in my presentation that I would expect significant progress in this dimension within the next few weeks.

MS. SCOTT: You don't have a preference on how that will be accomplished?

MR. GASPAR: We do. We've requested a lengthening of maturities and we want the lengthening of maturities to be sufficiently significant so that we can comfortably issue a 10-year bond.

MR. ANTHOLIS: This woman here in the third row.

MS. TER-MINASSIAN: Teresa Ter-Minassian, formerly from the IMF. I have two questions for Mr. Gaspar and actually a congratulation on an excellent presentation.

The first question is: how much of the impressive improvement in the current account do you estimate to be of a structural nature? (Inaudible) much of a more cyclical nature, which could be reversed as the economy gathers strength.

The second point has to do with the fiscal position. I very much applaud the shift in emphasis from nominal to structural targets, but I also wonder whether, you know, the sort of very negative impact that in the short-run composition -- the fiscal adjustment has had, is not partly related to the composition of adjustment in Portugal, particularly this year, with so much emphasis on tax increases as opposed to expenditure cuts. As you know, there is a strand of literature that suggests that the expenditure cuts have lesser negative effects on longer-term growth. Thank you.

MR. GASPAR: Two absolutely excellent questions. On the first question, it's very hard to tell. The estimates in real time of non-observable variables like potential output is hard. Clearly, the correction of the imbalance of the Portuguese economy was partly explained by the behavior of exports, partly by a contraction of imports, and the cyclical component is concentrated on the contraction of the imports.

Now, since we have been gaining consistently market share on the export side, a fair amount of the adjustment is permanent and structural and unrelated to the structural position of the economy, and we would expect most of it to be of that sort. But clearly, going forward, this type of decomposition is likely to change as we fine-tune our estimate of these non-observable variables. It's very hard to have a judgment in real time.

When it comes to the composition of fiscal adjustment, I completely grant you the superiority of adjustment based on expenditure reduction versus tax increases. In the Portuguese case, we have been able to reduce expenditure quite substantially.

The reason why we had to resort to tax increases was due to the fact that both in 2011 and 2012, we had to come up very fast with measures that would bridge the gap, but if you look at the revision in macroeconomic prospects that we have carried out, that was basically due to the behavior of the Portuguese economy in the last quarter of 2012, and revisions in the prospects for world demand directed to Portuguese exports for 2013 and following years.

If one focuses on the variables that would be most affected by the composition effect, by the increase in taxation that you talked about, there is basically no change. The revision in the profile of internal demand is almost unchanged. The revision is mostly due to external factors and the contribution of net exports to growth.

So, granting you completely that you're right on our conceptual point, it doesn't seem to be a driver of the type of issues that we were discussing with the troika during the course of the seventh review.

MR. ANTHOLIS: Last question right here, this gentleman in the front.

MR. KAR: Dev Kar formerly of the IMF and lead economist at Global Financial Integrity. The question I have for you, Minister, is, what, in your opinion, is the contribution of governance factors leading up to the Portuguese crisis? As you know, in the case of Greece, weak governance played a very strong impact -- had a very strong adverse impact on the economy. I'm talking about tax evasion and illegal capital flight, two important aspects of weak governance.

MR. GASPAR: Right. It's a very good question. I would say that tax evasion is something that we're -- is an issue, which we at the Ministry of Finance take very seriously. The reputation of the Portuguese tax authority is, and I believe deservedly, that they're very effective at fighting tax evasion.

The ability of the Portuguese tax authority to collect taxes is, I would not say beyond dispute, but it compares favorably with other patterns at the European level.

So, I would not say that that is a first order issue, but it's something that we are permanently concerned with. For example, at the beginning of this year, we introduced an electronic receipt system that allows the tax authority to monitor VAT compliance in real time, and that system seems to be extremely effective and we expect our ability to collect VAT to be improved through those means, and that will allow us to improve even further in terms of our tax compliance -- our position in the tax compliance rankings.

My favorite issue when it comes to changes of an institutional nature in Portugal would have, as Teresa well knows, to do with budgetary rules and procedures. We are now in the process of approving the budgetary framework law to incorporate the rules of the fiscal compact, and that is something which is very much a process, which is supported by the majority that supports the government, but also by the largest opposition party, the Socialist Party.

And at the end of the process, Portugal will have built institutions that will deliver sound public finances on a permanent basis, and with the support of the current majority and the largest opposition party, the support is so widespread that it will not be at the mercy of any political cycles, it will become a robust feature of the functioning of the Portuguese democracy.

That is a true example of institutional change that will have accomplished because of this adjustment process, that the sovereign debt crisis has imposed on the country.

MR. ANTHOLIS: I think we might have time for one more question if

you've got the patience for it.

MR. GASPAR: Sure.

MR. ANTHOLIS: Right here in the third row or fourth row, the gentleman in the blue tie.

Mr. POLLNER: Yes, Minister, I just had a question regarding the --

MR. GASPAR: Your name, please?

MR. ANTHOLIS: Please, tell us who you are.

MR. POLLNER: This is John Pollner from the World Bank Europe region. My question has to do with the credit situation and the enterprise sector.

Portugal has a pretty broad small and medium enterprise sector, and of course besides the lack of collateral that those firms don't have to obtain credit, you mentioned the high level of interest rates. So, what I was wondering is, in order for such firms to increase competitiveness and invest, you know, make capital investments, obviously they would need credit, but it seems that's still going to be a constraint. And I was wondering, do you see any market for credit insurance or something that the government could somehow develop or promote to, you know, channel credit to these enterprises at not an extraordinarily high cost, which then they really wouldn't be profitable for them?

MR. GASPAR: Thanks for that question. So, you're absolutely right. Your facts are correct. In Portugal, we have a very large sector of small- and medium-sized enterprises. The share of small- and medium-sized enterprise in, say, employment creation in Portugal is dominant. Those firms, as you say, do have problems in the production of collateral, and so that is a further difficulty they have in the access to credit.

I do believe that credit conditions will improve because macroeconomic

access to financing by Portuguese banks is going to improve, and that's going to be translated into better financing conditions for firms. But, as you indicate, on top of that we have a number of market failures that have to do with isometric information, undercapitalization of this segment of firms in Portugal, and issues to do with guaranty schemes and the possibility of insurance mechanisms across firms.

The program forces action in all these dimensions and the Ministry of Finance has been working with the Central Bank in these various elements in order to prove manners. For example, the Portuguese Central Bank has a very good central credit register that has very rich information set on Portuguese firms that can be made available to ease this information gap that creates a new information asymmetry problem. And the idea in the program is that we have the system operational before the end of the year.

Secondly, we do have a number of mutual insurance initiatives across small- and medium-sized enterprises and these schemes benefit from a complementary guaranty that is provided by the Portuguese treasury. That scheme is being broadened.

And last, but not least, we have a number of initiatives together with the banks in order to strengthen the equity base of Portuguese small- and medium-sized enterprises precisely to make them more robust from the viewpoint of the balance sheet and therefore improve their ability to generate collateral and therefore have access to credit.

So, in all these dimensions we are moving, yes.

Thank you.

MR. ANTHOLIS: Well, I want to thank the Minister. I want to thank you all for coming. I want to particularly thank and apologize for keeping you chained to your

chair and not having access to your charts. In an American presidential debate, Ross Perot once didn't have access to his charts and he was far less diplomatic and far less courteous than you were in this situation.

And then in the game of quotes, perhaps we should end by saying the famous Winston Churchill quote about the United States that the United States always does the right thing after it's tried everything else. It sounds, in the case of Portugal that you took a lot of the hard decisions early and hopefully that will work out, not just well for Portugal, but for the rest of Europe.

MR. GASPAR: Thank you.

MR. ANTHOLIS: So, with that, thank you all very much and we look forward to seeing you again.

(Applause)

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

Carleton J. Anderson, III

(Signature and Seal on File)

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2016

ANDERSON COURT REPORTING
706 Duke Street, Suite 100
Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190