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Adjusting in the euro area: the case of Portugal

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Outline

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I The primacy of national politics

II Own house in order

III Markets as drivers of integration

I. The primacy of national politics

Towards a well-functioning euro area

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I

The primacy of national politics

European integration must be designed to ensure that national governments are in position to ensure fundamental functions of a social state.

- This point was made by Mario Monti in the report released two years ago:

  "If the market and the social components do not find an appropriate reconciliation, **something has to give in.**" (*)

- It is necessary to **ensure democratic legitimacy and accountability** given the primacy of the national dimension of politics.

* Monti, M. (2010). "A new strategy for the single market", Report to the President of the European Commission.

Cyprus is a paradigmatic example

March 19th, 2013: Cypriot parliament rejects the government's proposal for a one-off stability levy

Cypriot dimension	The Cypriot parliament rejected the assistance package agreed with the EU/IMF: • most MPs voted against (36 MPs) • the President's own party abstained (19 MPs, since one was absent)
European dimension	Euro area temporarily in gridlock.

In an extreme situation, **national politics prevailed**

Cyprus is a paradigmatic example

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March 25th, 2013: Agreement Eurogroup/Cypriot authorities *

After the Parliament's decision, the Eurogroup renegotiated the terms of the program.

Euro area out of gridlock.

"(…) The programme will address the exceptional challenges that Cyprus is facing and restore the viability of the financial sector, with the view of restoring sustainable growth and sound public finances over the coming years.

(…) the plans for restructuring the financial sector (…) **safeguard all deposits below EUR 100.000 in accordance with EU principles.**

(…) There will be **an appropriate downsizing of the financial sector**, with the domestic banking sector reaching the EU average by 2018. In addition, **the Cypriot authorities have reaffirmed their commitment to step up efforts in the areas of fiscal consolidation, structural reforms and privatisation.**

(…) The Eurogroup takes note of the authorities' decision to introduce administrative measures, appropriate in view of the present unique and exceptional situation of Cyprus' financial sector and to allow for a swift reopening of the banks. **The Eurogroup stresses that these administrative measures will be temporary, proportionate and non-discriminatory, and subject to strict monitoring in terms of scope and duration in line with the Treaty."**

* Eurogroup Statement on Cyprus: http://eurozone.europa.eu/newsroom/news/2013/03/eg-statement-cyprus-25-03-13/

II. Own house in order

Towards a well-functioning euro area

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II

Own house in order

Institutional changes at the European level must be translated into genuine national changes.

- National orders already embody the principles of democracy, human rights and the rule of law.
- These must apply in areas like economic stability and sustainability – in particular fiscal discipline.

Genuine regime change at national level is necessary

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Institutional Changes

It is imperative that Member States generate internal consensus on institutions able to effectively guarantee economic stability and sustainability.

- Institutions must become domestic and induce changes in perceptions, expectations, norms, rules and organizations **supporting permanent changes in regular patterns of behavior.**

- The principle that each country should keep its **Own House In Order** (OHIO) can be **supported by a European framework** but it must be generated by domestic politics.

The case of Portugal as a paradigmatic example

Portugal's imbalances exposed in the context of the economic and financial crisis

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1 **1995-2008**

Build-up of imbalances in the Portuguese economy:

"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."

Blanchard, 2007

Sudden-Stop materialized in early 2011

2 **2008-2010**

An Error of Judgment in the conduct of policy:

1. Alignment of systemic risk in the Portuguese economy
2. Postponement of adjustment through expansionary fiscal policy
3. Heightened vulnerability in the context of the EA sovereign debt crisis

3 **2011-2014 The Economic Adjustment Program**

Blanchard, O. (2007). "Adjustment with the Euro: the Difficult Case of Portugal", *Portuguese Economic Journal*.

1 1995-2008: Build-up of imbalances in the Portuguese economy

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Portugal did not adjust to the specific requirements of the Monetary Union

Unsustainable public finances

- **Budget deficits over 3%** of GDP since the mid-1990s
- **Upward trend of General Government gross debt,** surpassing 60% of GDP in 2004

Over-indebtedness

- **Increase of private debt since the mid-1990s**, reaching 240% of GDP in 2008
- Current account deficits of ~10% for a decade

Anemic economic growth and low productivity

- **Deteriorating competitiveness**
  - Increase in unit labor costs
  - Increase in the real effective exchange rate

For too long, ***Portugal preserved fiscal rules and procedures*** *developed during decades of monetary instability and limited capital mobility.*

Such fiscal rules and procedures were ***completely inadequate in the context of the euro area.***

1 Unsustainable public finances

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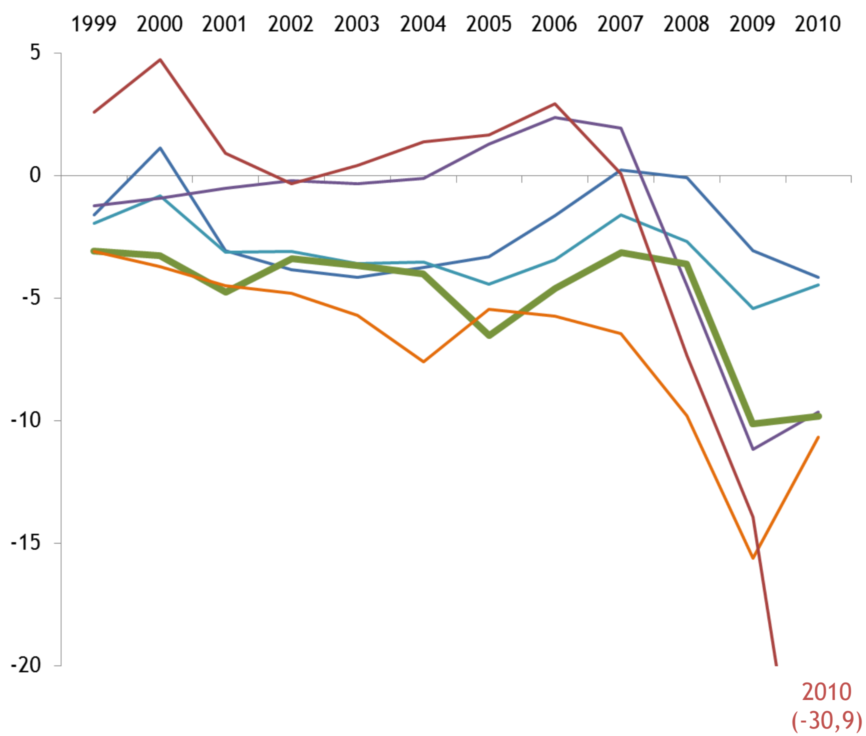
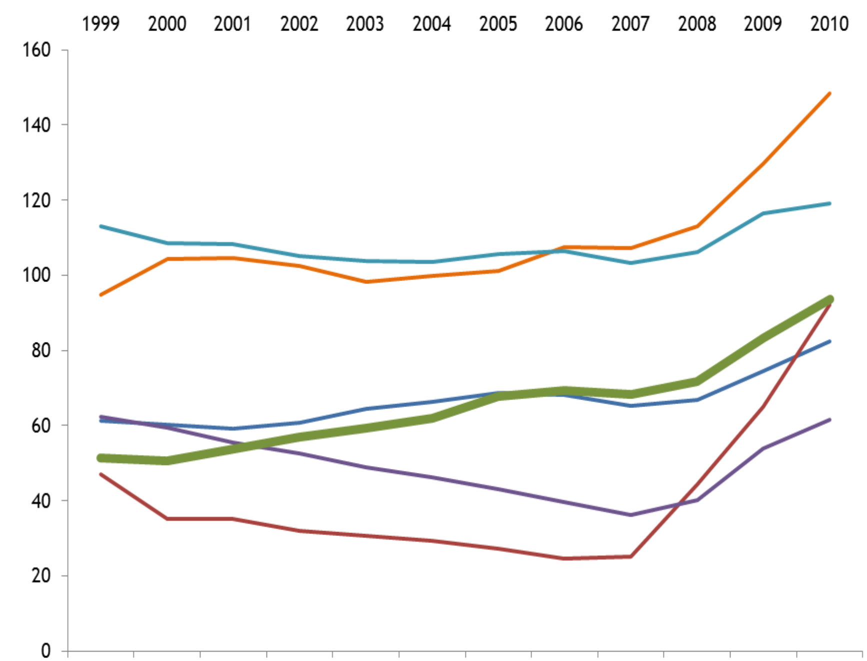
General Government Budget Balance
Percentage of GDP at market prices (EDP)



General Government Consolidated Gross Debt
Percentage of GDP at market prices (EDP)



Germany Italy Spain Portugal Greece Ireland

Source: AMECO, January 2013

1 Excessive private debt accumulation

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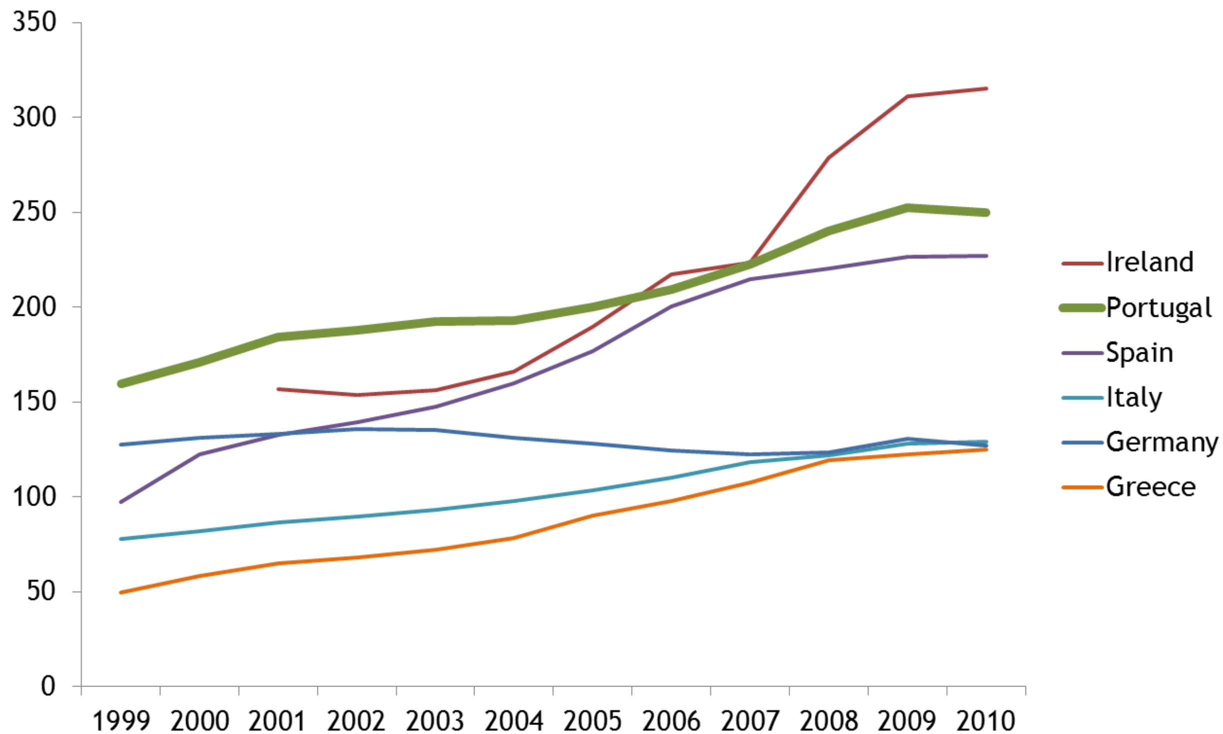
Portuguese households and non financial corporations did not have direct access to foreign financing.

The banking system acted as an intermediary.

This is the origin of the heightened systemic risk in Portugal, associated to an increase in the loan-to-deposit ratio.

Private debt, non consolidated, annual data
Percentage of GDP



Source: Eurostat, January 2013

1 Anemic economic growth

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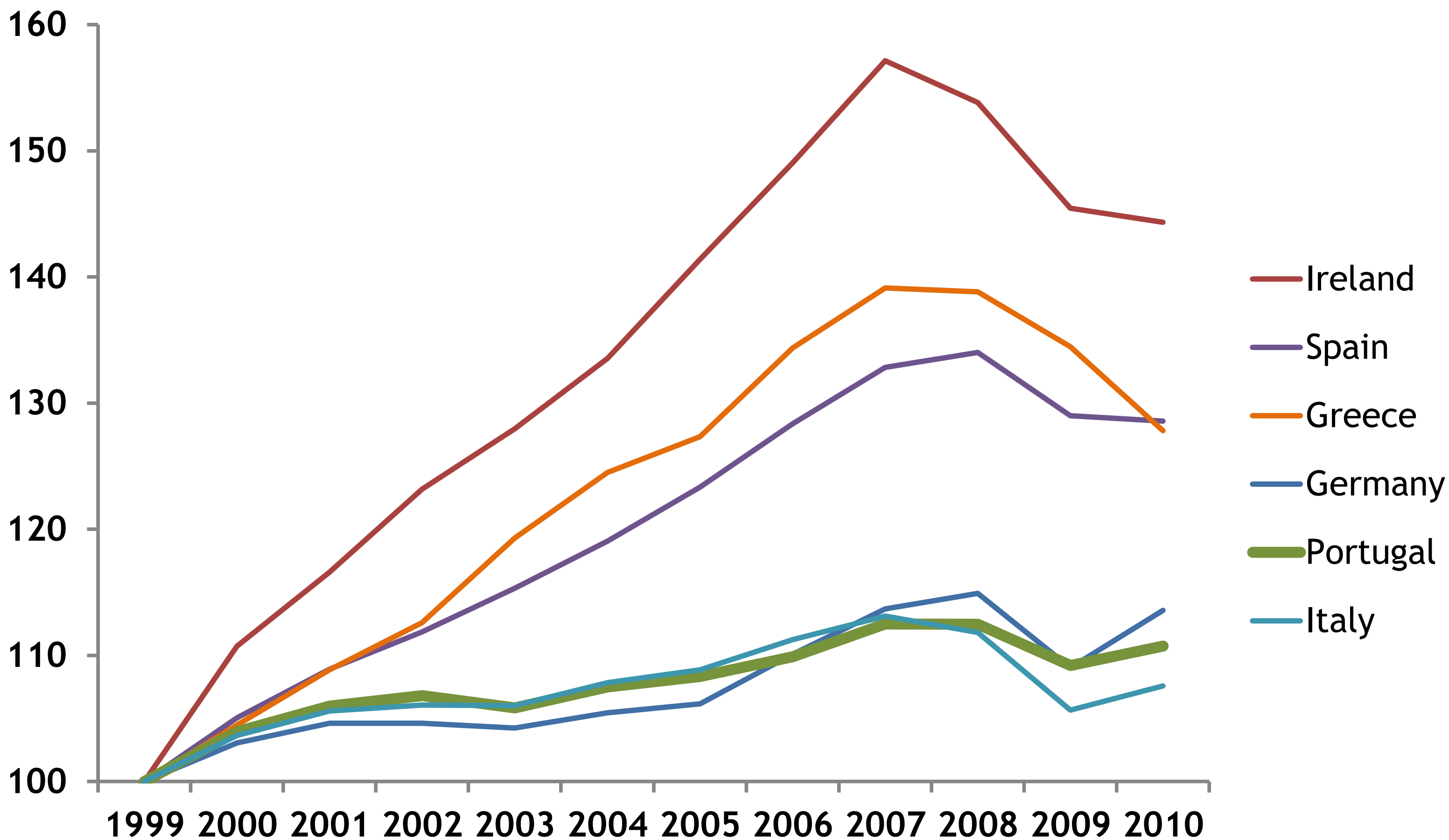
Gross Domestic Product
1999 = 100



Source: AMECO, January 2013

2 2008-2010: An Error of Judgment in the conduct of policy

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Expansionary fiscal policy

Alignment of systemic risk in the Portuguese economy

- Sovereign provides **guarantees to the banking sector**
- Increase in **bank credit to the public sector**

Postponement of adjustment through expansionary fiscal policy

- **Effectiveness in the short run, but significant long run costs** in terms of lost activity and unemployment
- **Denial** about to the need to adjust

Heightened vulnerability in the context of the EA sovereign debt crisis

- Presentation of **2010 State Budget** as a defining moment
- **Increase of sovereign risk throughout 2010**, despite ECB support

*Considering the events of 2008-2010 as a simple demand-driven business-cycle fluctuation was an **error of judgment that proved to be expensive in the context of the euro area sovereign debt crisis.***

2 Increase in bank credit to General Government

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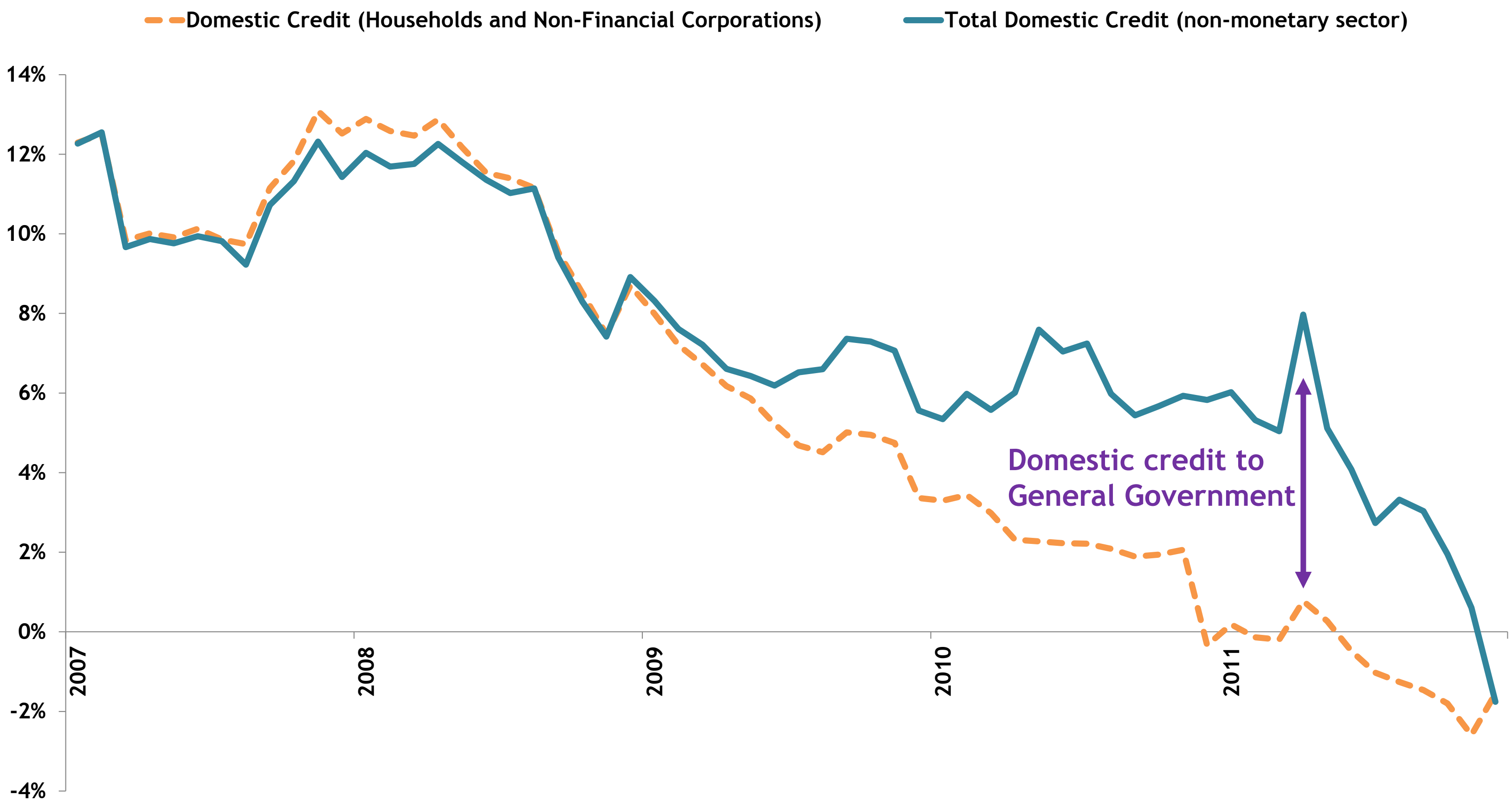
Domestic Credit
Year-on-year change, %



Source: Bank of Portugal, March 2013

2 Public sector expansion offset private adjustment

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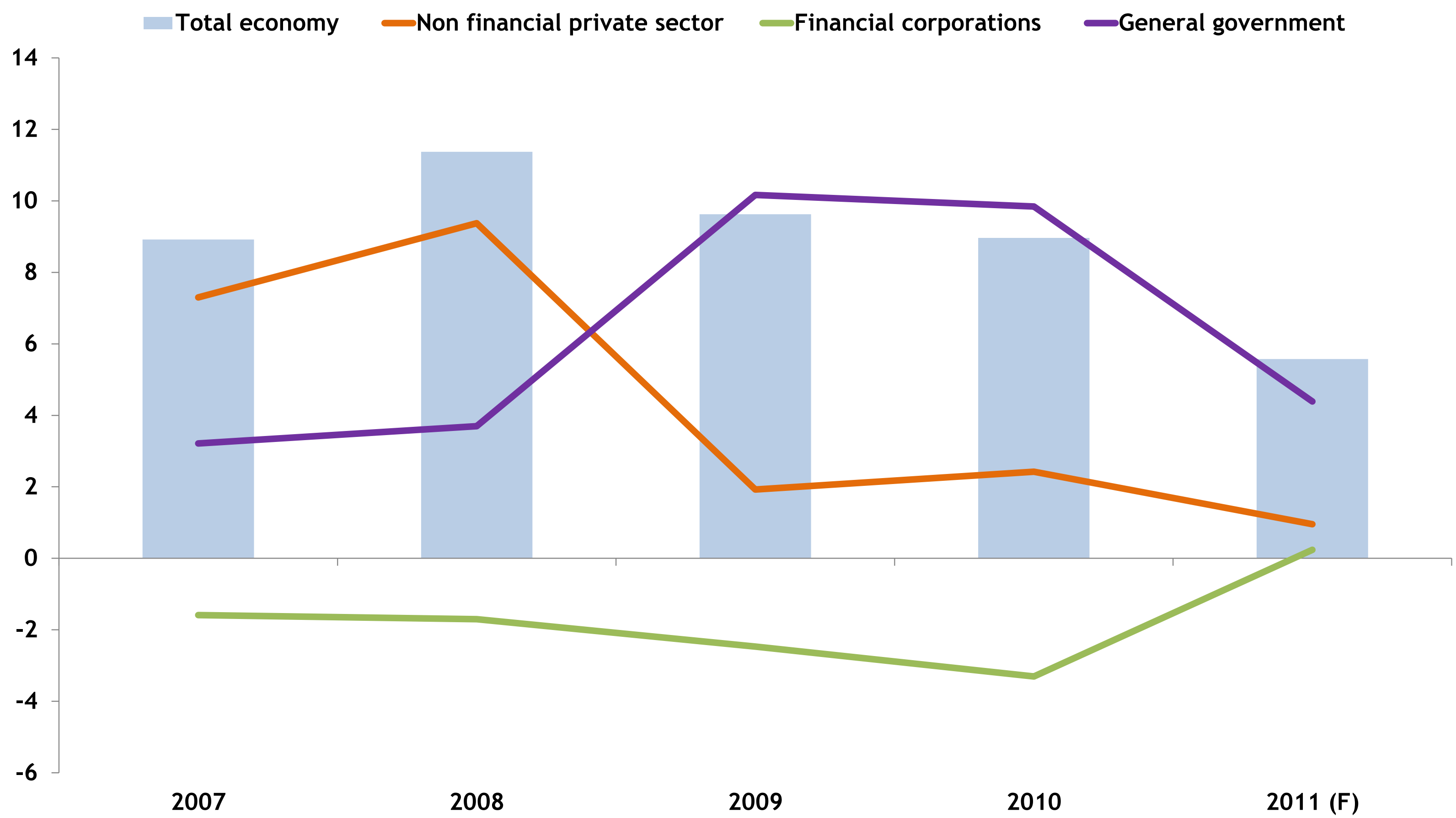
Financing needs by institutional sector
As percentage of GDP



Source: National Statistics Institute, March 2013

2 Successive upward revisions of 2009-2010 Budget deficits and Public Debt level

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Public finances were in a worse situation than previous statistics and forecasts indicated.

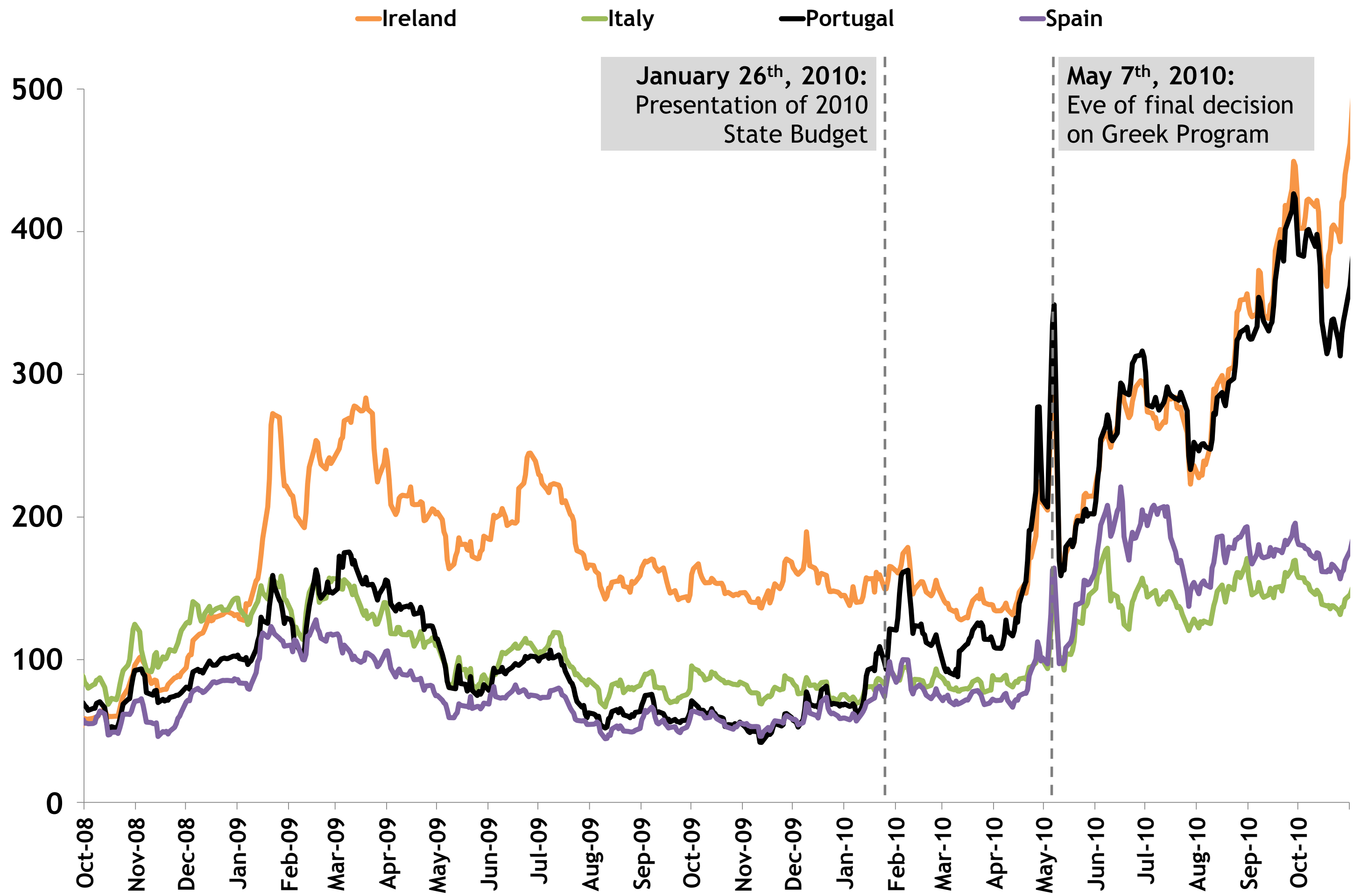
When the euro area sovereign debt crisis broke, Portugal was in a **situation of heightened vulnerability.**

			General Government Budget Balance (% GDP)		General Government Gross Debt (% GDP)	
			2009	2010	2009	2010
	GOP 2005-2009	Jul-05	-1,6		64,5	
	PEC 2005-2009	Dec-05	-1,5		66,2	
	PEC 2006-2010	Dec-06	-1,5	-0,4	65,2	62,2
	ROPO 2007	Apr-07	-1,5	-0,4	62,6	59,7
	EC autumn	Oct-07	-2,4		64,5	
	PEC 2007-2011	Dec-07	-1,5	-0,4	62,5	59,7
	EC spring	Apr-08	-2,6		64,3	
	ROPO 2008	May-08	-1,5	-0,7	62,5	60,5
	OE 2009	Oct-08	-2,2		64,4	
	EC autumn	Oct-08	-2,8	-3,3	65,2	66,6
	PEC 2008-2011	Jan-09	-3,9	-2,9	69,7	70,5
	EC spring	Apr-09	-6,5	-6,7	75,4	81,5
	ROPO 2009	May-09	-5,9		74,6	
General election (27-Sep-09)						
	EC autumn	Oct-09	-8,0	-8,0	77,4	84,6
	OE 2010	Jan-10	-9,3	-8,3	76,6	85,4
"PEC I"	PEC 2010-2013	Mar-10	-9,3	-8,3	77,2	86,0
	ROPO 2010	Jul-10	-9,3	-7,3	76,3	83,5
"PEC III"	OE 2011	Oct-10	-9,3	-7,3	76,1	82,1
"PEC IV"	PEC 2011-2014	Mar-11		-7,3		82,4
	IMF Staff Report	Jun-11	-10,1	-9,1	83,0	93,0
	INE/BdP Final Data		-10,2	-9,8	83,2	93,5

Note: The document known as "PEC II" corresponds to Law no. 12-A/2012 of 30 June.

The impact of the 2010 State Budget in financial markets

10-year Government Bond yields, October 2008 - October 2010
Spread against Germany in basis points



Source: Bloomberg, February 2013 (generic yield indices, BID values)

The Error of Judgment led to a Sudden Stop in international private financing

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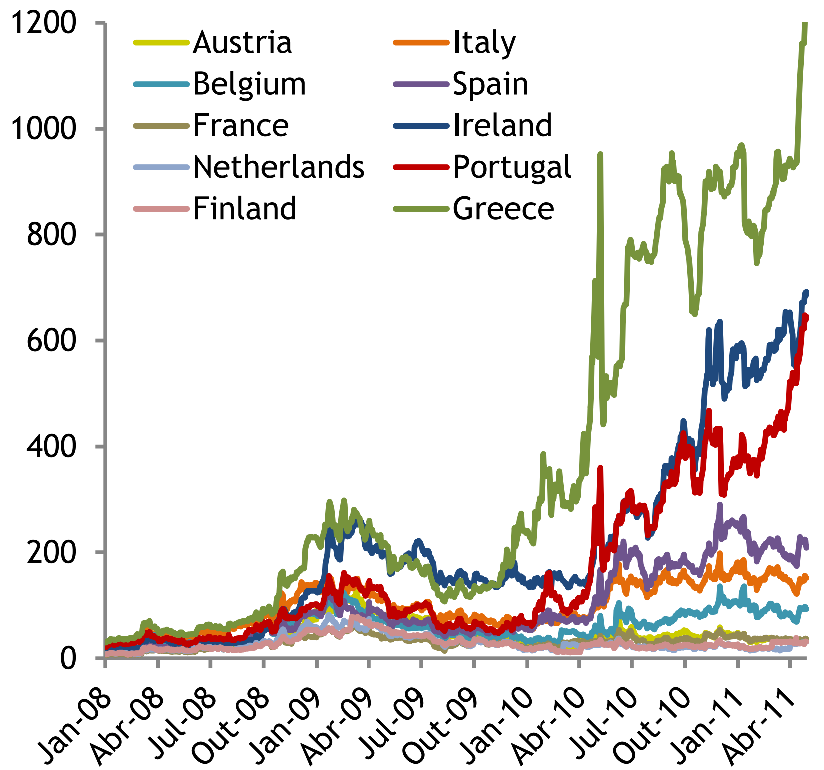
The **effects of expansionary fiscal policy** on public finance sustainability were revealed in the context of the **sovereign debt crisis in the euro area**, exposing Portugal's **structural imbalances.**

10-year Government bond yields
Spread against Germany in basis points



In April 2011, Portugal's request for financial assistance became inevitable to avoid bankruptcy.

Source: Bloomberg

Portugal is putting its own house in order

Fiscal consolidation

Putting fiscal policy on a sustainable path

The Economic Adjustment Program

Deleveraging and financial stability

Reduction of debt and financing needs of the economy

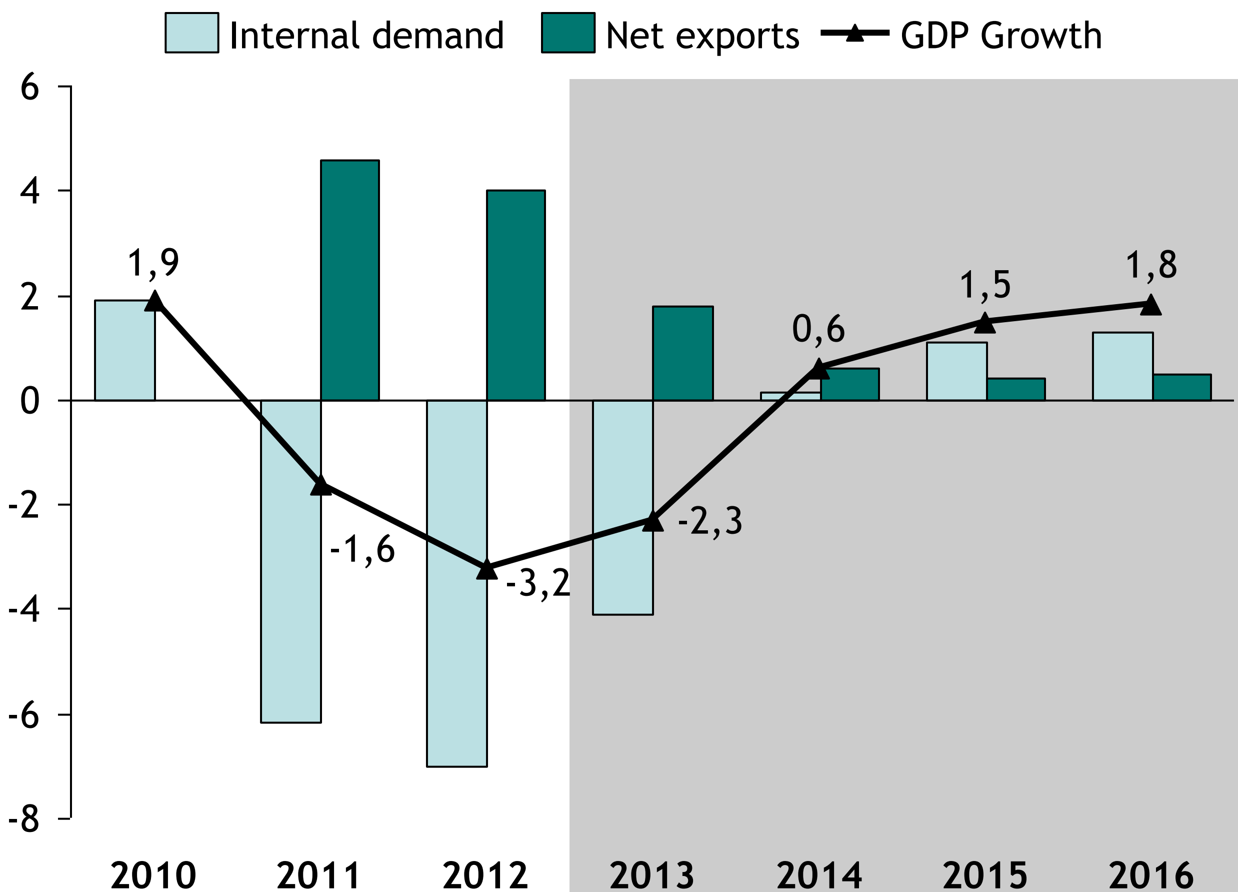
Structural transformation

Implementing structural reforms to contribute to potential growth

The Economic Adjustment Program protects Government financing from market pressures, allowing an orderly adjustment of imbalances and time to build up confidence and credibility.

3 Rebalancing internal demand and supply

Contributions to GDP growth
Percentage points



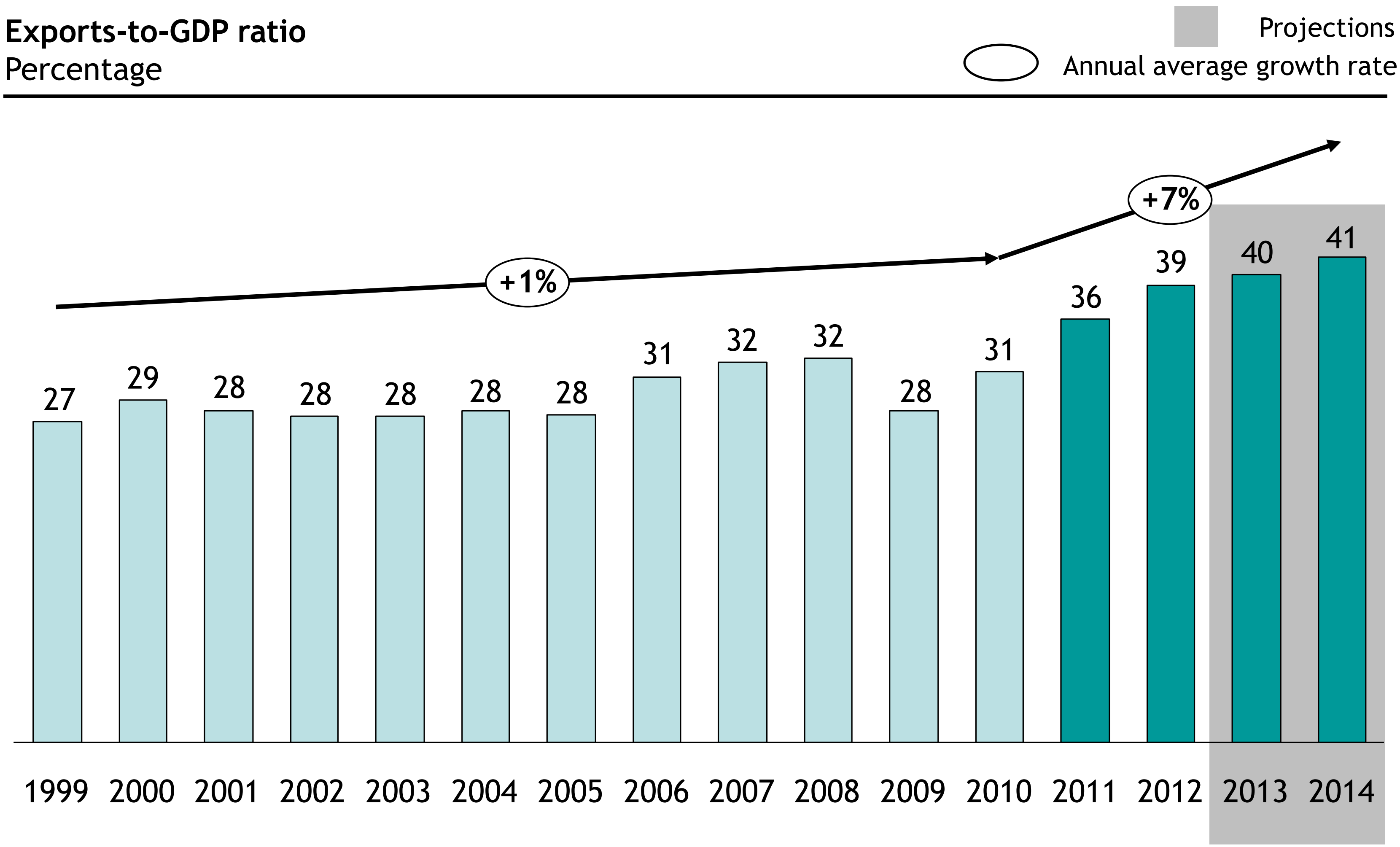
Projections for 2013-2016:

- Do not consider impacts from structural reforms
- Assume moderate export market share gains

Source: Ministry of Finance, March 2013

3 Strong increase in exports

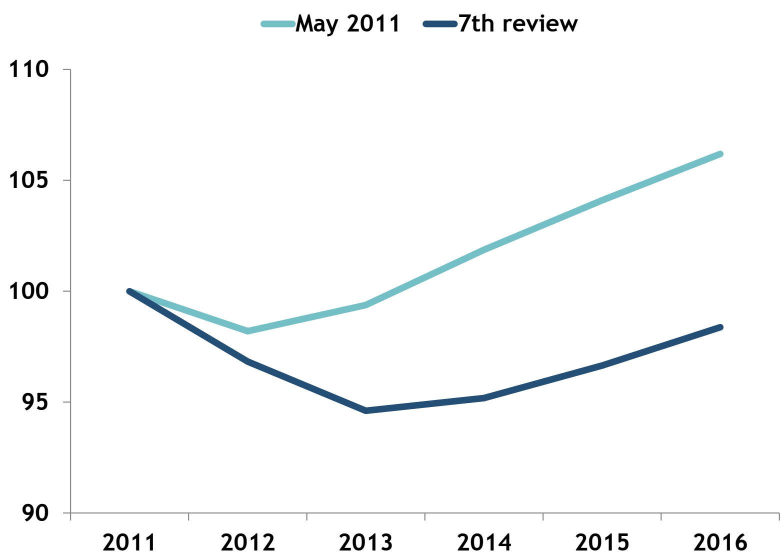
Exports-to-GDP ratio
Percentage



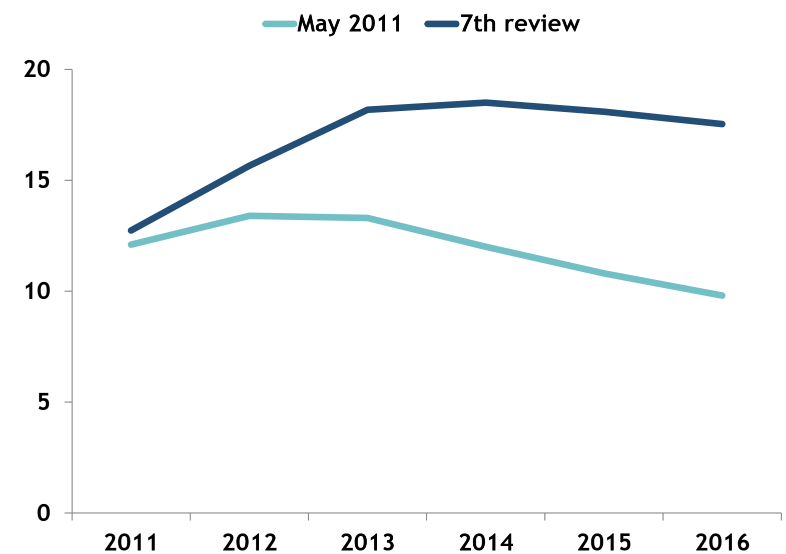
Source: AMECO, March 2013

3 Adjustment has come at a high social cost

Real GDP growth projections
2011 = 100



Unemployment rate projections
Percentage



Rise in the unemployment rate above original forecasts reflects:

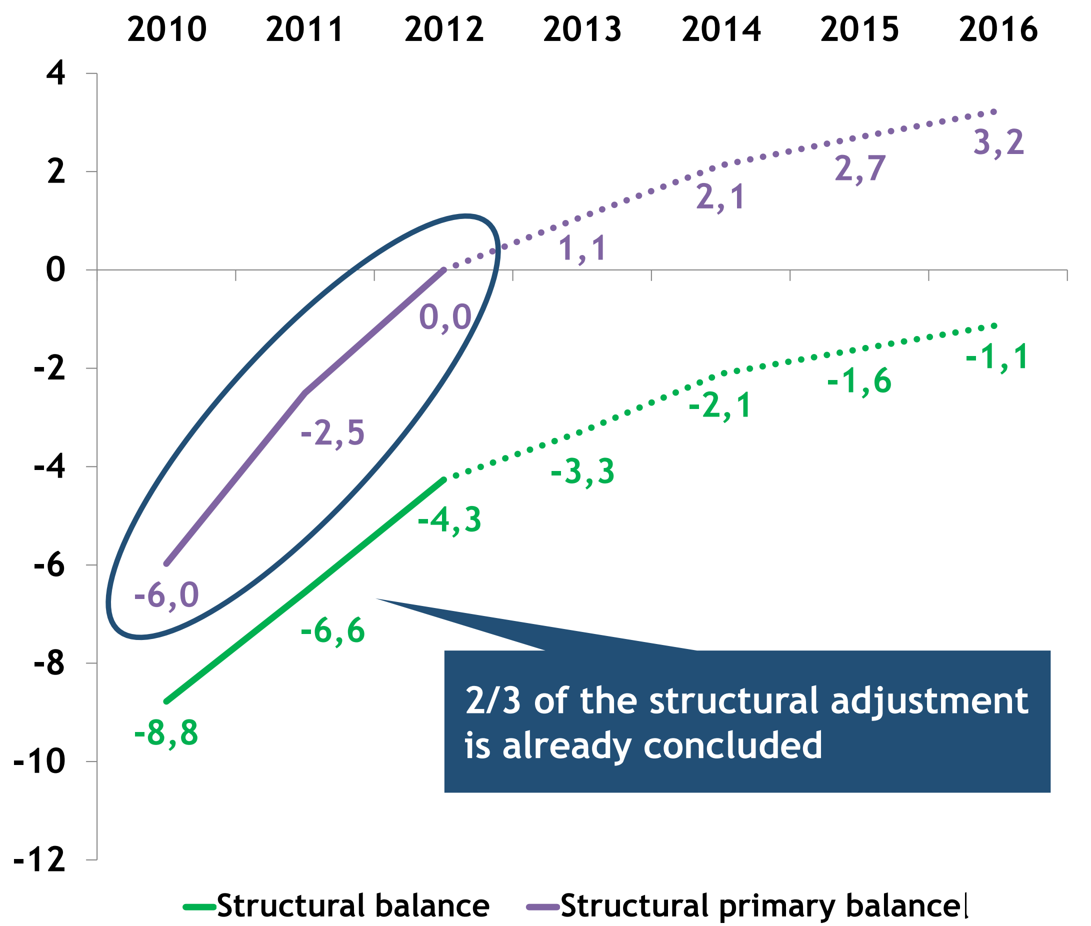
- Lower employment given firms' need to reduce costs (financing difficulties and uncertainty)
- Transfer of resources from the non-tradable sector to the tradable sector given the ongoing rebalancing of the Portuguese economy

Source: International Monetary Fund, Ministry of Finance

3 Fiscal adjustment is progressing at a good pace

Fiscal Consolidation

Structural budget balances
As percentage of GDP

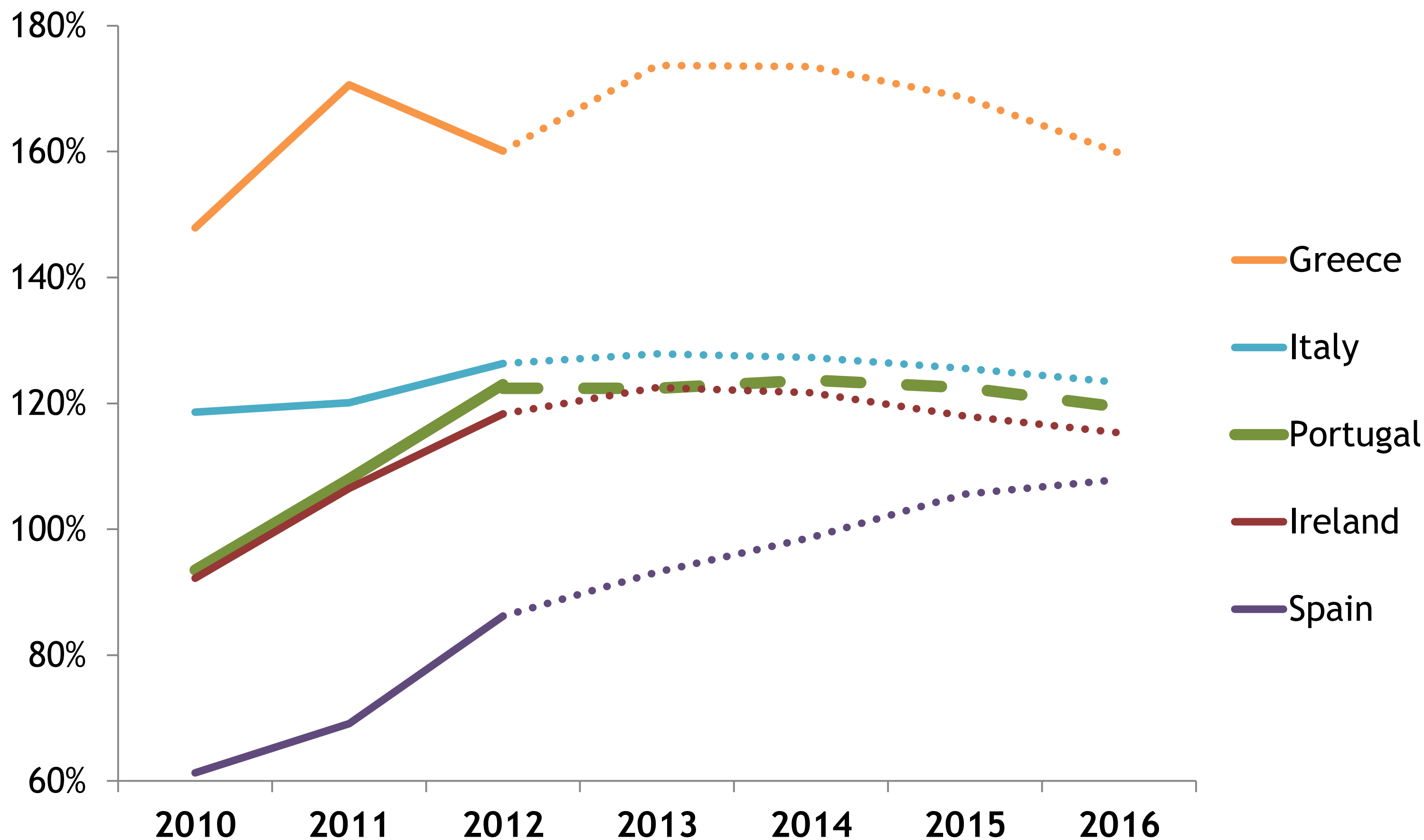


Source: Ministry of Finance, March 2013

3 Public debt: close to Ireland, lower than Italy

Fiscal Consolidation

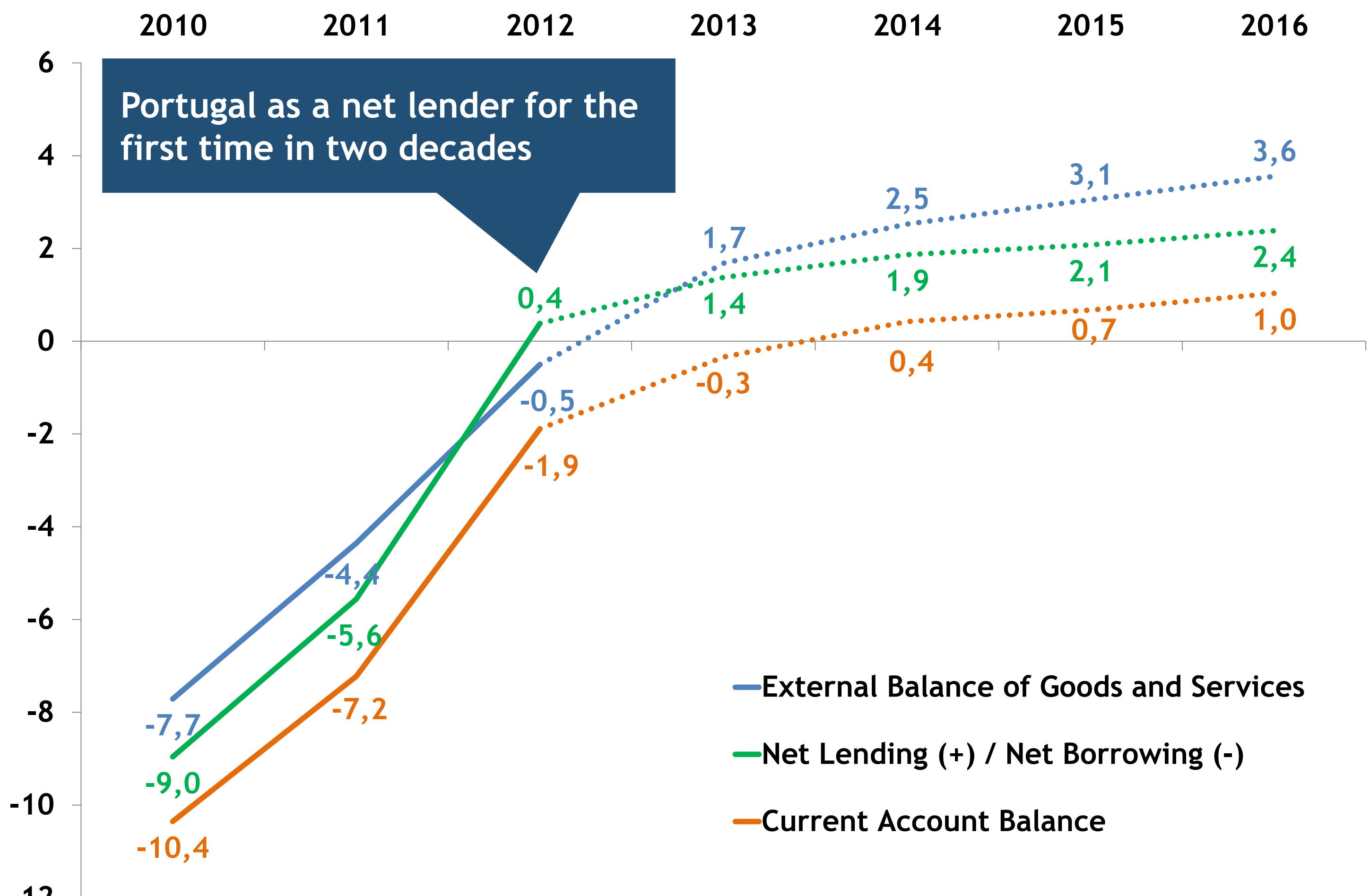
Public Debt
Percentage of GDP



Source: GR – EC, Dec-2012; IT, IE – IMF, Dec-2012; ES – IMF, Mar-2013; PT - Ministry of Finance, 7th review, Mar-2013

3 Fast correction of external imbalances

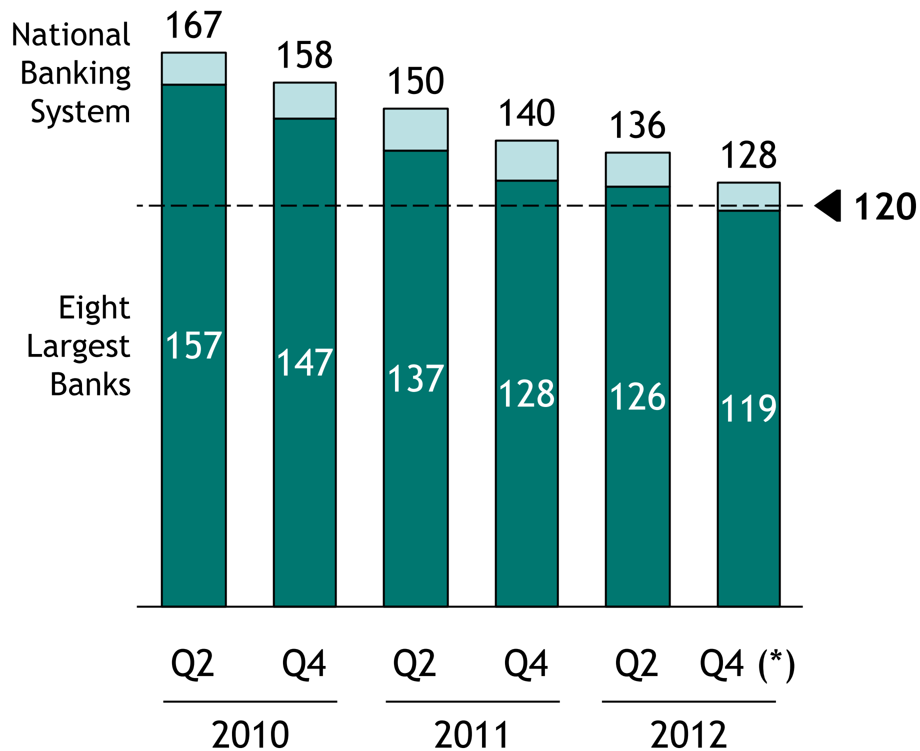
Balance of Payments, key balances
Percentage of GDP



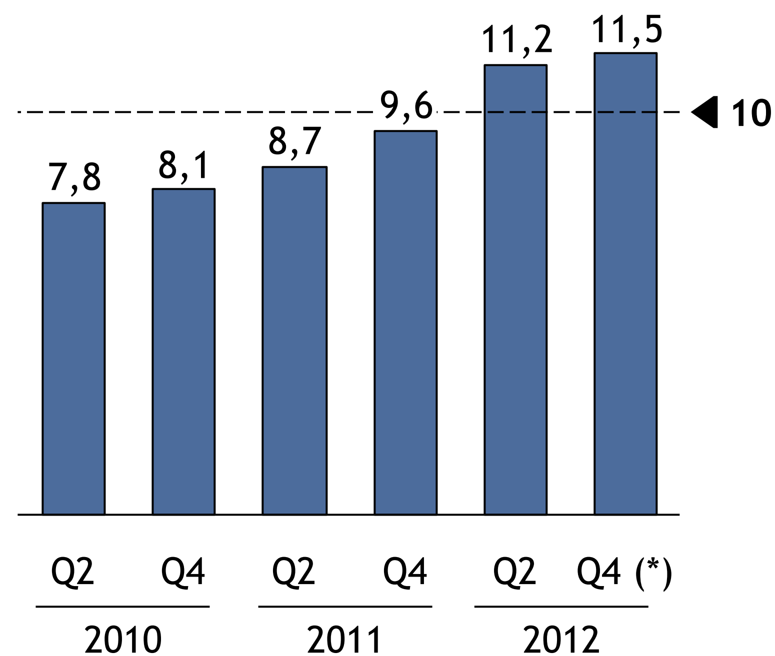
Source: Ministry of Finance, March 2013

3 Increasingly stable banking system

Loans-to-deposits ratio
Percentage



Core Tier 1 Ratio, Portuguese Banking System
Percentage



Banking system close to 120%.

This target was excluded from the Memorandum after the 7th Review.

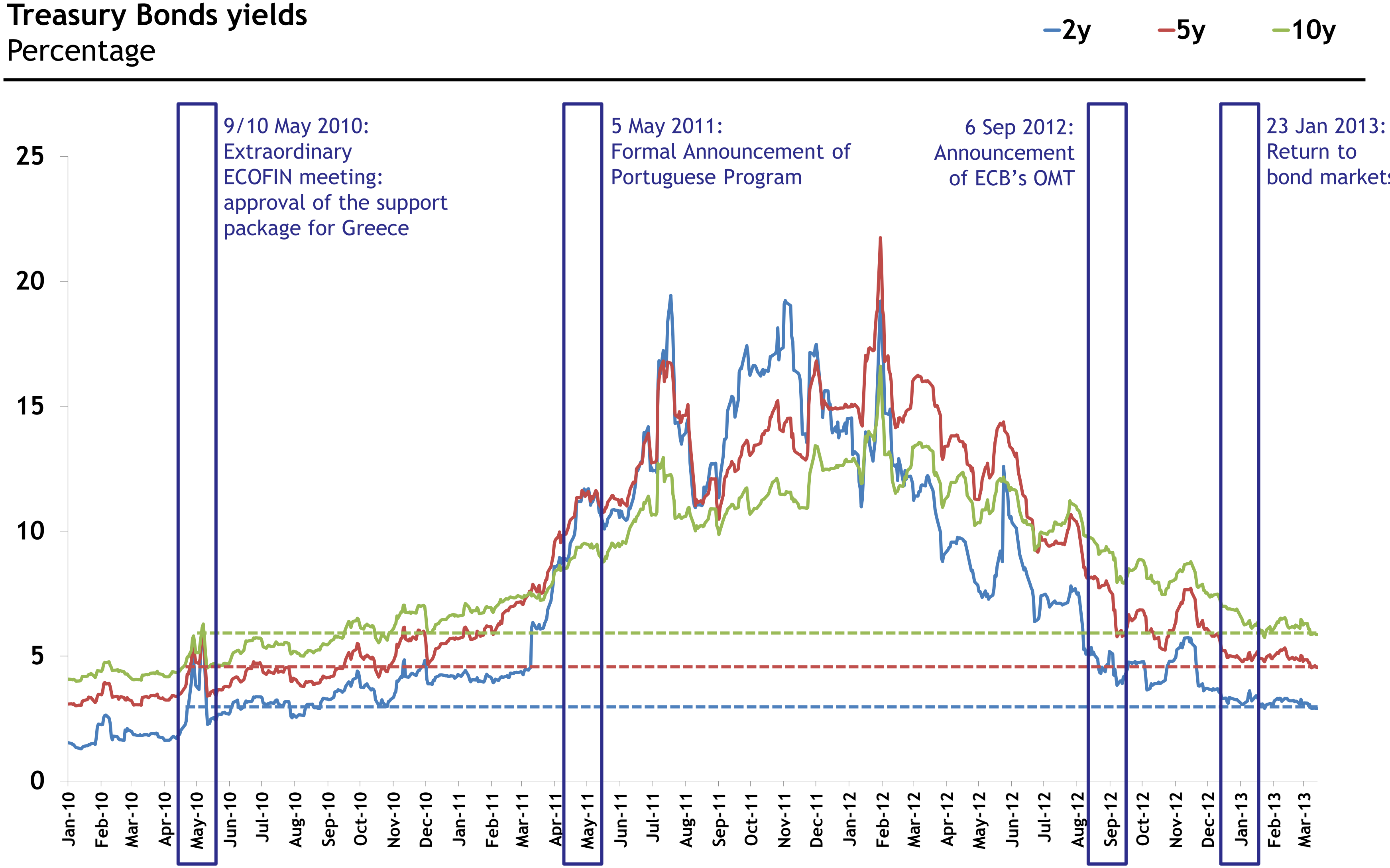
The 10% Core Tier 1 Ratio was reached ahead of schedule.

(*) Preliminary values for 2012Q4

Source: Bank of Portugal, March 2013

3 Treasury Bond Yields at 2010 levels

Treasury Bonds yields
Percentage



Source: Bloomberg (last observation: March 13th, 2013)

Better financing conditions of the Treasury start to be transmitted to the economy

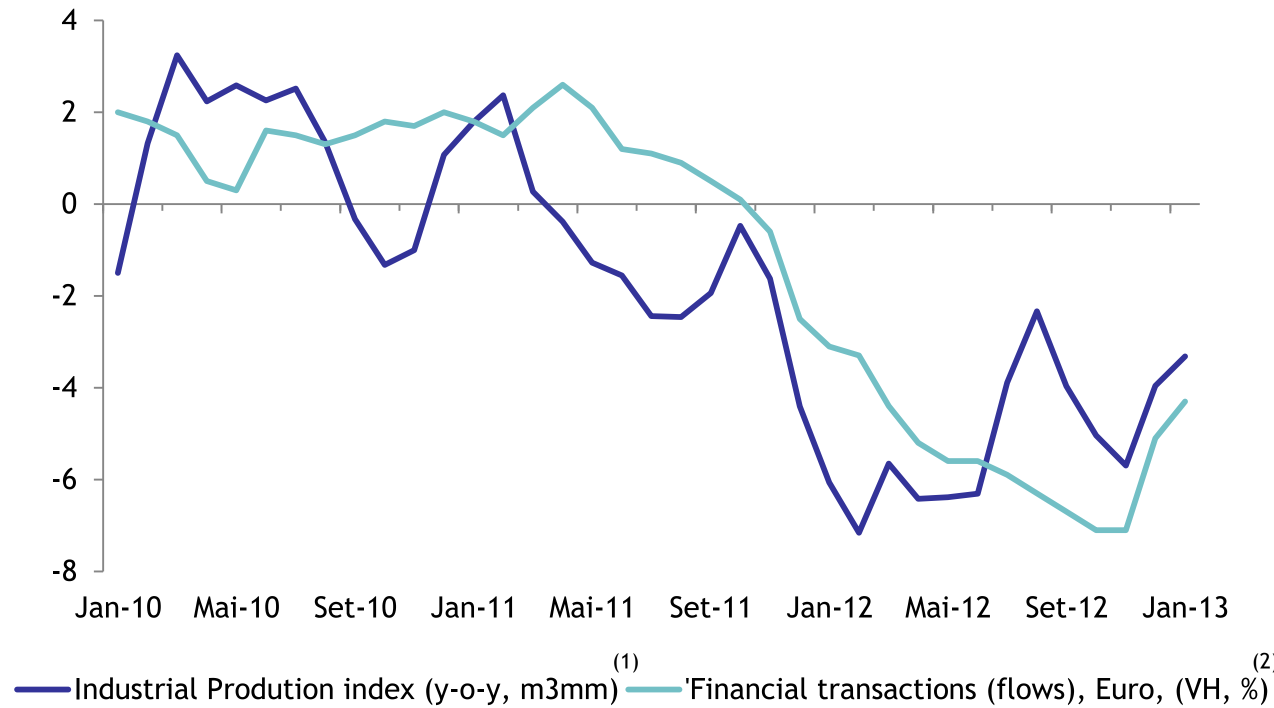
The progress in the adjustment allowed for:

- **Treasury:** access to markets before schedule
- **Banks:** issuance of senior debt and bonds in markets
- **Companies (big):** access to international markets

*Necessary to ensure that the **companies more dependent on banking credit (small and medium enterprises)** benefit from the better financing conditions*

Positive expectations start to materialize in the credit flow

Credit flow to non-financial companies vs Industrial production (%)



Note: (1) year-on-year variation, 3 months moving averages; (2) year-on-year variation

Source: European Central Bank and National Statistics Institute

3 Privatization program as a flagship of the structural transformation agenda

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Structural Transformation

Energy retail and production – edp

Energy retail and production – galp energia

Electricity distribution – REN

Air infrastructure – ANA Aeroportos de Portugal (1)

2013

Mail distribution – ctt

Railway logistics – CP CARGA

Air transport – TAP PORTUGAL

Waste management – Águas de Portugal

Insurance – Caixa Geral de Depositos Seguros (2)

Decisive concessions

- Urban Transportation (Lisbon, Porto)
- Maritime Ports

(1) Concession and privatization
(2) Expected completion date by "Caixa Geral de Depósitos"

Source: Ministry of Finance, January 2013

3 Compliance with all the quantitative targets of the Program…

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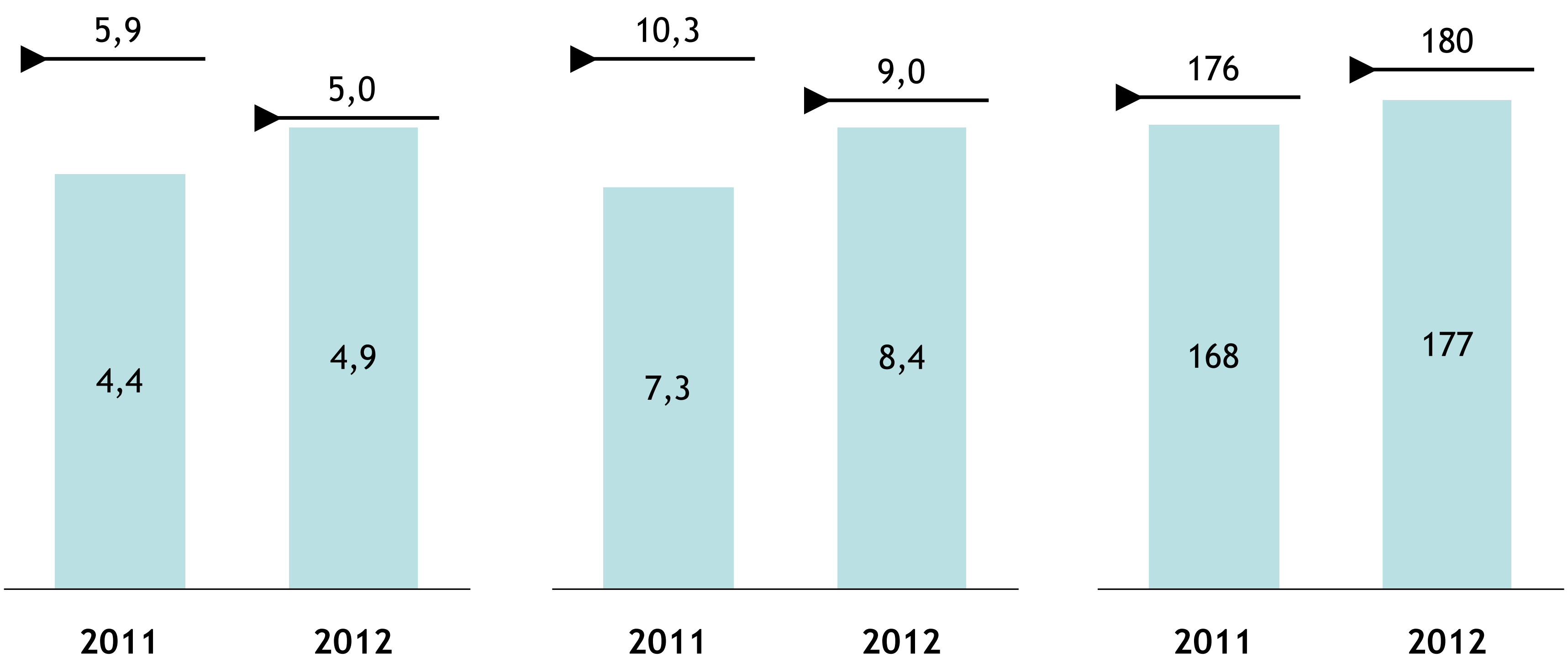
▶— Limits of the Program

Budget deficit

National accounts basis(*) — Percentage of GDP

Cash basis(*) — Billion euros

Public debt(*) — Billion euros



(*) Targets according to the definitions set in the Program
All the quarterly targets for the budget deficit on a cash basis and for the public debt ceiling were also met

Source: Ministry of Finance, March 2013

3 … and strong compliance with the agreed measures…

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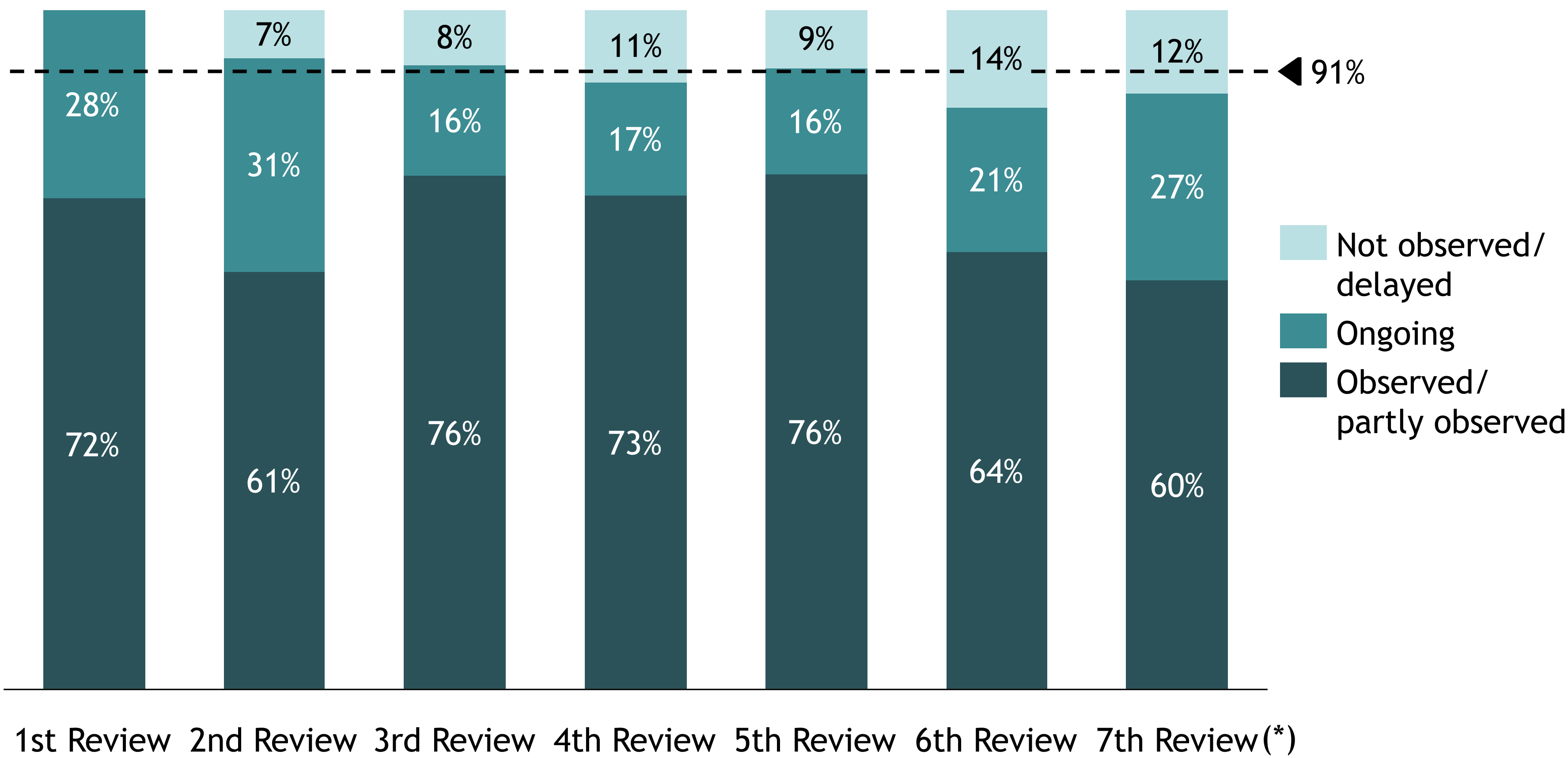
The Economic Adjustment Program – current status

Status of measures required in each review
Percentage



(*) Preliminary values for 7th Review

Source: European Commission, March 2013

3 …are key to obtaining European support in regaining full market access.

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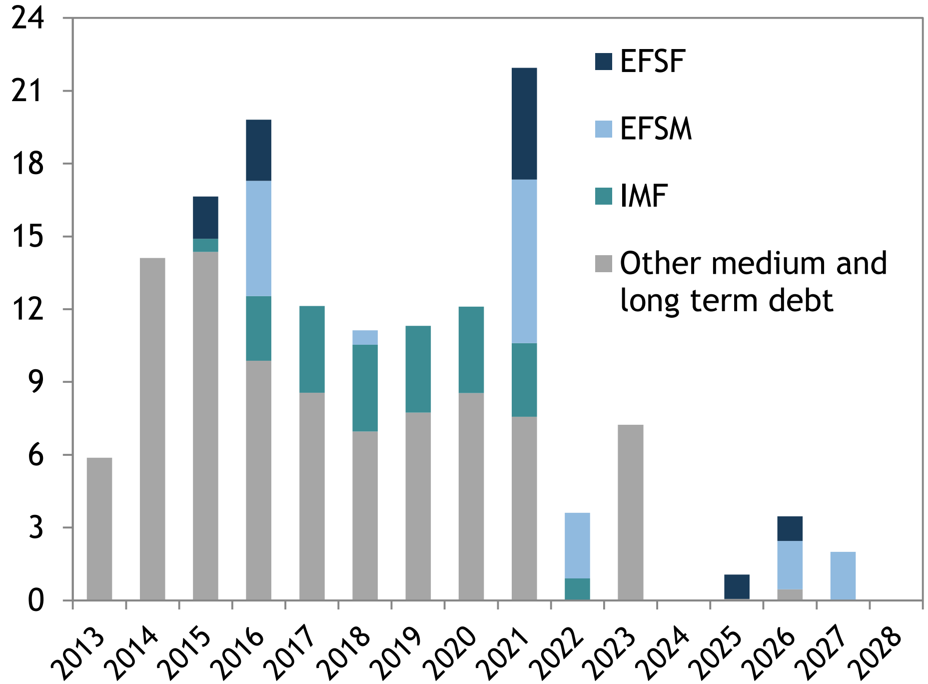
The Economic Adjustment Program - current status

Redemption profile *
Billion euros



Substantial increase of refinancing needs in 2014-2016 and 2021

Favorable developments in Portugal and Ireland:

- Significant progress in economic adjustment
- Strong compliance with the Program
- Ongoing strategy to regain market access

"The **Eurogroup ministers are determined to support Ireland's and Portugal's efforts** to regain full market access and successfully exit their well-performing programmes [… and …] **have agreed to an adjustment of the maturities of the EFSF loans** to both countries in order to smooth the debt redemption profiles of those countries."
(Mar 16th, 2013**)

Technical details to be further discussed

* Beyond 2028 -- 2032: 5,20 bn€. 2037: 6,97 bn€. 2038: 4,40 bn€. 2042: 1,50 bn€. 2050: 0,01bn€
** Eurogroup Statement on PT and IR: http://www.eurozone.europa.eu/newsroom/news/2013/03/eg-statement-portugal-ireland-16-03-13/

Source: IGCP (last update: January 23rd, 2013); Eurogroup

3 Towards sustainable growth and job creation

Confidence and Credibility

Improving perspectives for the EA: OMT, Banking Union, Agreement on assistance to Greece and Spain

Balanced budget, reduction of public debt and **financial stability**

Solid foundations for economic recovery

Gradually achieving better financing conditions:

- Main driver in the present economic context is financial
- Portugal is reversing the sudden stop

Creating an open and competitive economy:

- Positive impact from ongoing structural reforms
- Portugal as an attractive location for investment and foreign and domestic capital

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III. Markets as drivers of integration

Towards a well-functioning euro area

III

Markets as drivers of integration

When European integration moves forward, markets and political integration move in tandem.

- Financial markets have failed to play a stabilizing role in the process of adjustment within the euro area.

- The perverse dynamics feared by the authors of the Delors Report played out their mischievous role: market discipline was at first “too slow and weak” and afterwards “too sudden and disruptive”.

Insufficient financial integration in the euro area

Key facts

- **Financial integration has been concentrated in wholesale markets:** interbank market, sovereign bonds, corporate bonds. Retail market was kept at a national level.

- **Instruments to safeguard financial stability were designed to function on a national basis** (e.g.: resolution framework, supervisors, deposit guarantee fund).

- Financial integration in the euro area much **more limited than in the USA**, both in depth and scope.

For a long time, **integration in wholesale was considered to be sufficient.**

It would guarantee that **businesses with similar prospects and risk profiles** are offered similar financing conditions, regardless of location.

Inspired by Ron McKinnon, 2001, Optimum Currency Areas and the European Experience, Stanford, October 2001.

Market discipline may be “sudden and disruptive”

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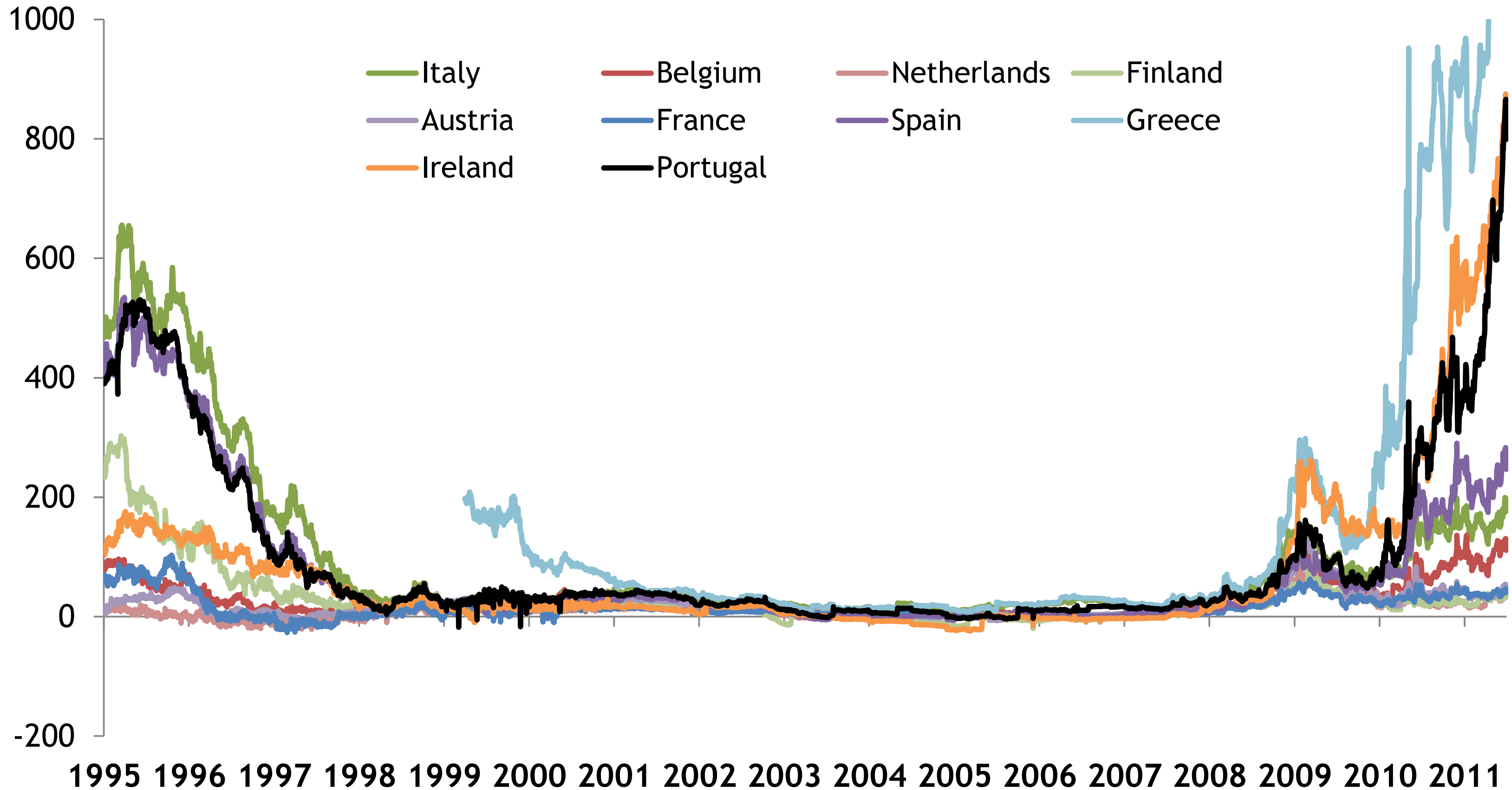
10-year Government Bond yields, 1995-2011
Spread against Germany in basis points



Source: Reuters

Market discipline may be “sudden and disruptive”

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Behavior of Government Bonds since the run-up to the EMU

- **Confirms the statement in the Delors Report:** “market discipline cannot be fully relied upon because it is likely to be too slow and weak (in tranquil times) and too sudden and disruptive (under stress)”.

Lessons learned

- There are periods when **market pressure is not perceptible.**
- But there are also exceptional times when **market discipline is “sudden and disruptive”.**
- When this happens, it is **often too late to avoid the negative consequences.**

Financial fragmentation is a serious problem for the euro area

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Fragmentation

- The euro area sovereign debt crisis led to the **fragmentation of wholesale markets.**
- The mechanism that ensured financial unity collapsed, because **it worked in a narrow band.**

Consequences

- Without financial integration, the **main conditions for a smooth functioning of the euro area are no longer in place.**
- The **monetary policy transmission** mechanism is not guaranteed.
- The **adjustment therefore has different characteristics** than initially assumed.

Main problem

- Impediment to the correct **functioning of a fundamental adjustment mechanism** in the euro area.
- **Adjustment is much more difficult:** the euro area is not working as an "optimal currency area".

High interest rates in peripheral countries (1/2)

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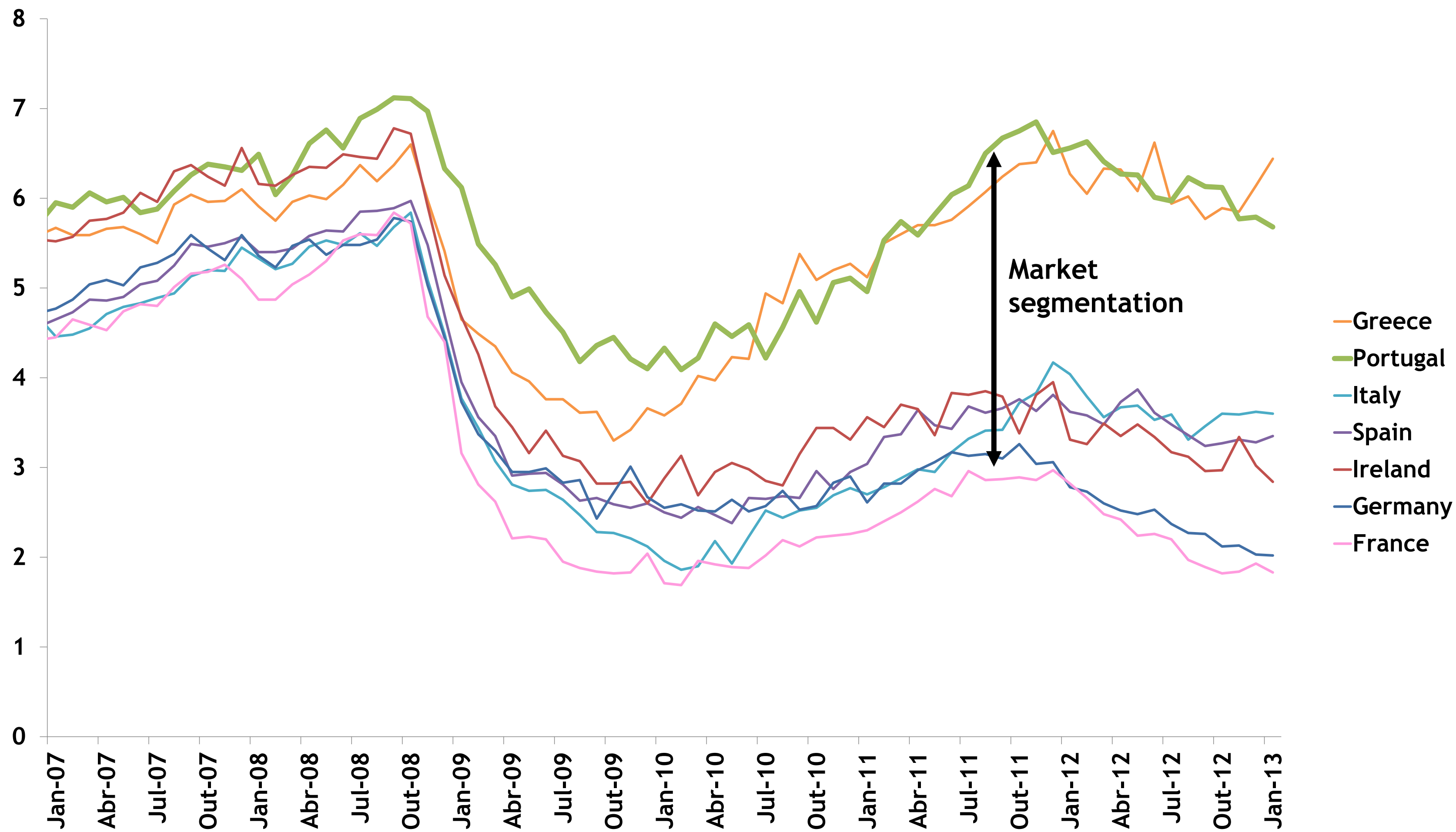
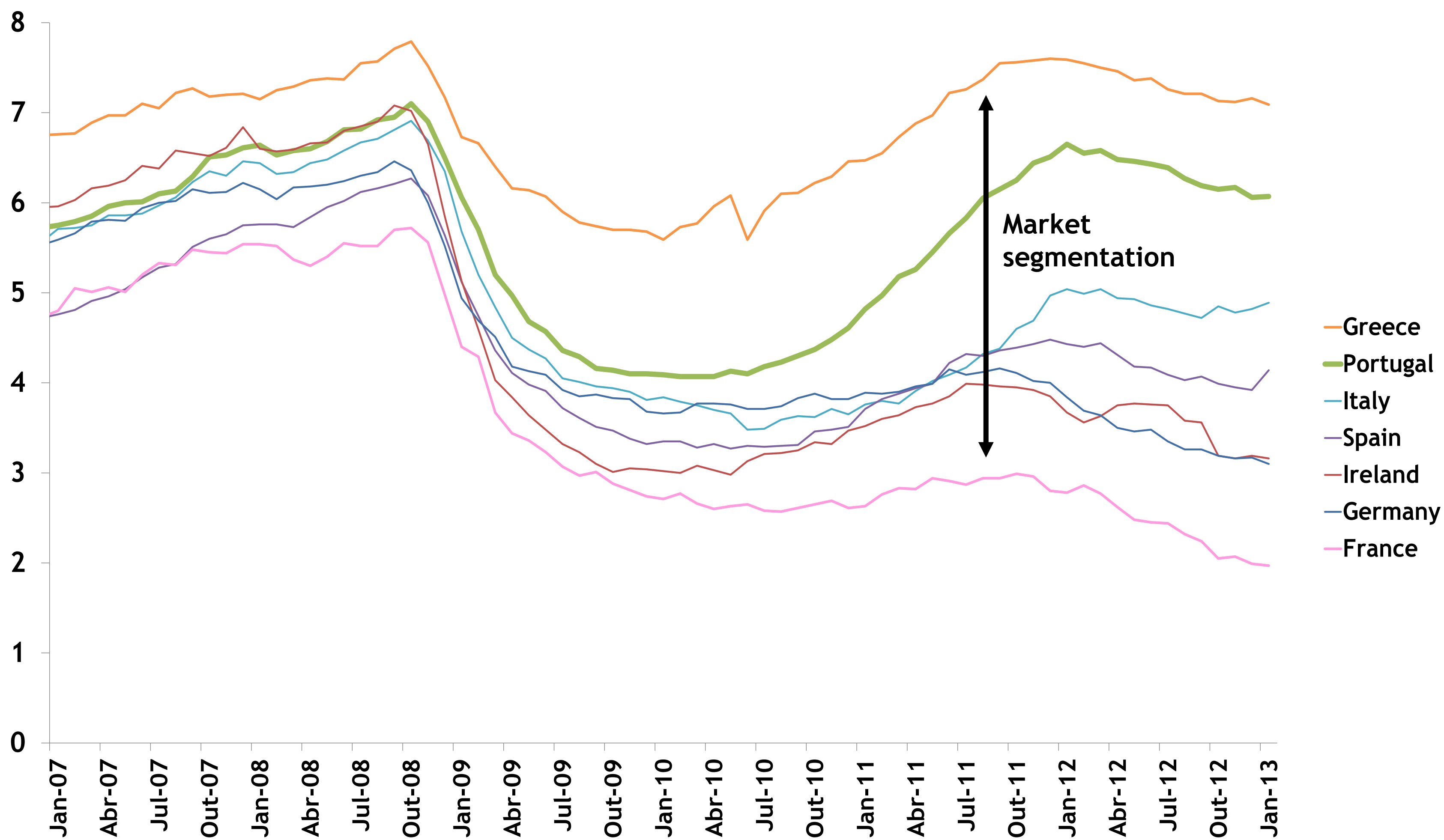
Interest rates on MFI Loans (≤1y) to Non-Financial Corporations | New Businesses only
Percentage



Source: ECB, March 2013

High interest rates in peripheral countries (2/2)

Interest rates on MFI Loans (≤1y) to Non-Financial Corporations | Outstanding amount
Percentage



Source: ECB, March 2013

Consequences to firms in peripheral countries

Consequences of financial fragmentation…

- The **link between sovereign and banking risks had a major role** on financial fragmentation at a national level.
- One main problem has emerged: a **profitable business/company does not have access to financing at normal cost** due to location and sovereign risk.

…are particularly severe to peripheral countries

- **Relevant problem for peripheral countries:** priority to the elimination of financial fragmentation in the euro area.
- **Severe consequences for its firms,** especially the smaller ones, more dependent on bank credit.

Overcoming financial fragmentation is a priority

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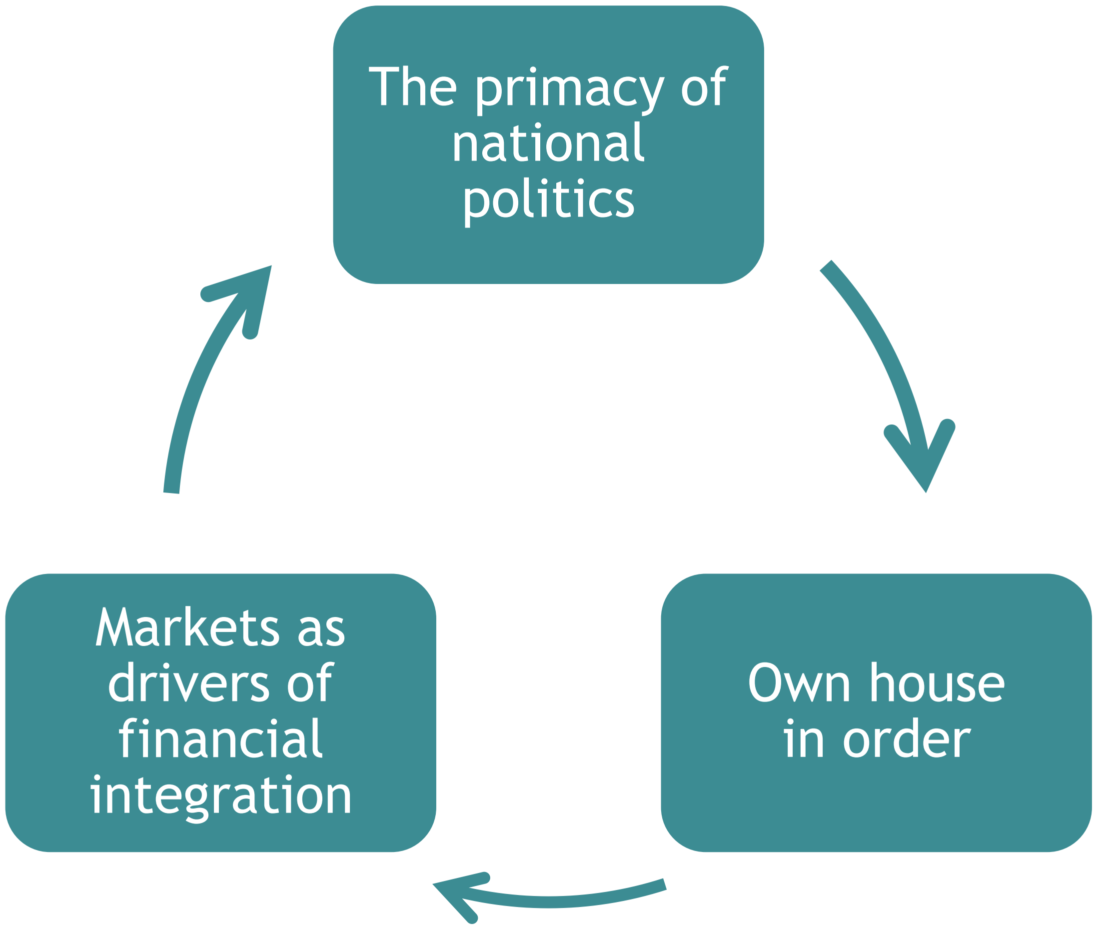
It is key to **restore the monetary transmission mechanism.**

Priority has to be placed

- Full realization of the **Banking Union.**
- Broaden its scope to develop a full **Financial Market Union.**
- Make full use of the dynamics of "**One Money, One Market**"

Conclusion: Towards a well-functioning euro area



BACKGROUND

The long run is urgent

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- Brad DeLong defines the long-run **as the moment when creditors consider whether the sovereign is worth financing.**

- Financing constraints became active for several European Countries that ceased to have access to bond markets - extreme crisis countries.

For these countries the Long Run started with the sovereign debt crisis.

These countries are living in the long run.

Europe must contribute to the sustainability of social models in Europe …

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Europe could consider the "Social Investment" paradigm in the context of the European Growth Agenda.

Institutional Changes

- Ensure adequate standards to the least favored and more vulnerable.
- Provide targeted insurance against social contingencies.
- Fair equality of opportunity for children and young people - emphasizing human capital.
- Active policies providing strong incentives for employment and labor force participation.
- Growth friendly public finance.

Eurogroup statement on Cyprus, 25.03.2013 (1/4)

The Eurogroup has reached an agreement with the Cypriot authorities on the key elements necessary for a future macroeconomic adjustment programme.

This agreement is supported by all euro area Member States as well as the three institutions. The Eurogroup fully supports the Cypriot people in these difficult circumstances.

The programme will address the exceptional challenges that Cyprus is facing and restore the viability of the financial sector, with the view of restoring sustainable growth and sound public finances over the coming years.

The Eurogroup welcomes the **plans for restructuring the financial sector** as specified in the annex. These measures will form the basis for restoring the viability of the financial sector. In particular, they **safeguard all deposits below EUR 100.000 in accordance with EU principles**.

The programme will contain a **decisive approach to addressing financial sector imbalances**. There will be an appropriate downsizing of the financial sector, with the domestic banking sector reaching the EU average by 2018. In addition, **the Cypriot authorities have reaffirmed their commitment to step up efforts in the areas of fiscal consolidation, structural reforms and privatisation.**

* Eurogroup Statement on Cyprus: http://eurozone.europa.eu/newsroom/news/2013/03/eg-statement-cyprus-25-03-13/

Eurogroup statement on Cyprus, 25.03.2013 (2/4)

The Eurogroup welcomes the **Terms of Reference for an independent evaluation of the implementation of the anti-money laundering framework in Cypriot financial institutions**, involving Moneyval alongside a private international audit firm, and is reassured that the launch of the audit is imminent. In the event of problems in the implementation of the framework, problems will be corrected as part of the programme conditionality.

The Eurogroup further welcomes the **Cypriot authorities' commitment to take further measures. These measures include the increase of the withholding tax on capital income and of the statutory corporate income tax rate.** The Eurogroup looks forward to an **agreement between Cyprus and the Russian Federation on a financial contribution**.

The Eurogroup urges the **immediate implementation of the agreement between Cyprus and Greece on the Greek branches of the Cypriot banks**, which protects the stability of both the Greek and Cypriot banking systems.

* Eurogroup Statement on Cyprus: http://eurozone.europa.eu/newsroom/news/2013/03/eg-statement-cyprus-25-03-13/

Eurogroup statement on Cyprus, 25.03.2013 (3/4)

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The Eurogroup requests the Cypriot authorities and the Commission, in liaison with the ECB, and the IMF to **finalise the MoU at staff level in early April.**

The Eurogroup notes the **intention of the Cypriot authorities to compensate potential individual victims of fraudulent practices**, in line with established legal and judicial procedures, outside the programme.

The Eurogroup takes note of the **authorities' decision to introduce administrative measures, appropriate in view of the present unique and exceptional situation of Cyprus' financial sector and to allow for a swift reopening of the banks**. The Eurogroup stresses that these administrative measures will be temporary, proportionate and non-discriminatory, and subject to strict monitoring in terms of scope and duration in line with the Treaty.

Against this background, **the Eurogroup reconfirms, as stated already on 16 March, that - in principle - financial assistance to Cyprus is warranted to safeguard financial stability in Cyprus and the euro area as a whole by providing financial assistance for an amount of up to EUR 10bn. The Eurogroup would welcome a contribution by the IMF to the financing of the programme. Together with the decisions taken by Cyprus, this results in a fully financed programme which will allow Cyprus' public debt to remain on a sustainable path.**

The Eurogroup expects that the **ESM Board of Governors** will be in a position to **formally approve the proposal for a financial assistance facility agreement by the third week of April 2013 subject to the completion of national procedures.**

* Eurogroup Statement on Cyprus: http://eurozone.europa.eu/newsroom/news/2013/03/eg-statement-cyprus-25-03-13/

Eurogroup statement on Cyprus, 25.03.2013 (4/4)

Annex | Following the presentation by the Cyprus authorities of their policy plans, which were broadly welcomed by the Eurogroup, the following was agreed:

1. **Laiki will be resolved immediately - with full contribution of equity shareholders, bond holders and uninsured depositors -** based on a decision by the Central Bank of Cyprus, using the newly adopted Bank Resolution Framework.
2. Laiki will be split into a good bank and a bad bank. **The bad bank will be run down over time.**
3. **The good bank will be folded into Bank of Cyprus (BoC)**, using the Bank Resolution Framework, after having heard the Boards of Directors of BoC and Laiki. It will take 9 bn Euros of ELA with it. Only uninsured deposits in BoC will remain frozen until recapitalisation has been effected, and may subsequently be subject to appropriate conditions.
4. The Governing Council of the ECB will provide liquidity to the BoC in line with applicable rules.
5. **BoC will be recapitalised through a deposit/equity conversion of uninsured deposits with full contribution of equity shareholders and bond holders.**
6. The conversion will be such that a capital ratio of 9 % is secured by the end of the programme.
7. **All insured depositors in all banks will be fully protected in accordance with the relevant EU legislation.**
8. The programme money (up to 10bn Euros) will not be used to recapitalise Laiki and Bank of Cyprus.

The Eurogroup is convinced that this solution is the best way forward for ensuring the overall viability and stability of the Cyprus financial system and its capability to finance the Cyprus economy.

* Eurogroup Statement on Cyprus: http://eurozone.europa.eu/newsroom/news/2013/03/eg-statement-cyprus-25-03-13/

2008-2009: Alignment of systemic risk in the Portuguese economy

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1

Common feature in the euro area following the Financial Crisis

- Sovereign provides guarantees to the banking sector.
- First link between sovereign and banking risks.

2

Error of judgment in national policy in 2009

- “Untimely, untargeted and non temporary” expansionary fiscal policy.
- Positive impact in the very short run, but also strong repercussions:
    - Increase in bank credit to the General Government, exposing the banking sector to sovereign risk;
    - Postponement of an inevitable adjustment given the accumulated macroeconomic imbalances for more than a decade.

2010: Portugal's imbalances exposed during the euro area sovereign debt crisis

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3

Sovereign debt crisis and Portugal's vulnerability

- In early 2010, the presentation of the State Budget revealed that public finances were in a worse situation than previous statistics and forecasts indicated.
- When the euro area sovereign debt crisis broke, Portugal was in a situation of heightened vulnerability.
- Sovereign risk increased throughout 2010, despite the direct support of the ECB:
    - ECB position in national banks: increased by ~24 bi€ between January 2010 and March 2011;
    - Eurosystem's SMP holdings: amounted to ~23 bi€ as of 31 December 2012;
    - Total (unpublicized) European support reached ~47 bi€ (about $^{2}/_{3}$ of the financial envelope of the current Economic Adjustment Program).

As financing conditions deteriorated for peripheral euro area countries, Portugal was forced to request financial assistance.

Adjustment was now inevitable to avoid bankruptcy.