



Lisboa, 31.10.2017

M. Valdis Dombrovskis
Vice-President of the European Commission

M. Pierre Moscovici
Member of the European Commission

Dear Valdis,

Dear Pierre,

Thank you for your letter regarding the Portuguese Draft Budgetary Plan (DBP) and for the opportunity to clarify the Portuguese Government's fiscal policy strategy.

I would like to reiterate the Government's commitment to the structural fiscal consolidation strategy that we have been implementing since we entered into office in November 2015. It is now widely acknowledged that the Government has been pursuing a consistent structural adjustment process. It managed to bring the headline deficit from above 3% in 2015 to 2% in 2016; and further reductions are expected, bringing it down to 1.4% and 1% of GDP in 2017 and 2018, respectively. This path reflects a significant and continued structural adjustment.

The Government has implemented a structural fiscal consolidation process on the expenditure side, which complies with both the Portuguese constitutional framework as well as European commitments. This process led the country to regain the internal and external confidence required for the sustainability of the ongoing recovery.

A comprehensive public expenditure review has been in place since March 2016. The implementation of efficiency-enhancing measures, most notably in the education and health sectors, and progressively expanding to other areas, is carried out by line ministries and services under their own responsibility. These initiatives derive from micro-level analysis and policy formulation designed to generate efficiency gains that deliver persistently lower levels of expenditure, as well as improvements in the quality of public services.

Hitherto, we are sure your assessment of the Portuguese fiscal policy in 2017 reveals a country committed to nominal and structural fiscal consolidation. In fact, we largely share the European Commission's assessment published in the 6th Post Program Surveillance Report. The monthly data, now available for the third quarter, confirm that the 1.4% target is within reach. This consolidation path will allow the public debt to GDP ratio to reach 126.2% by the end of the year, which will represent the largest reduction in 19 years (-3,9p.p. compared with 2016).

The fiscal consolidation process is taking place alongside an ambitious structural reform agenda, namely concerning the financial sector. At the end of 2015, the Portuguese financial system was crippled by a lack of capital, fragile shareholder structures, and an absence of



public strategy for the Resolution Fund and for the non-performing loans legacy. All of these problems have been effectively addressed.

The calculation of the Portuguese economy's potential output does not consider the impact of this structural reform; but the truth is that the dismal days of the Portuguese economy have been turned around largely as a result of the reform of the financial system. Both market players and institutions have acknowledged this structural change: credit ratings have improved, and interest rate spreads shrunk improving investment prospects. This is truly the result of structural reform.

By the end of 2017, not only can we not ignore the impact on potential growth of the financial sector stabilisation, but also the reforms that have been adopted in the context of the *Capitalizar* program, fostering a sounder financial structure and eliminating the debt bias in the financing of non-financial corporations. These are major reforms that, coupled with improvements in funding conditions, are revamping productive investment. In addition, the public expenditure review is already delivering results, generating savings in 2017 amounting to at least 75MEUR, as stated in the 2017 State Budget. These are key factors that change the landscape of the structural adjustment that are not captured by a mechanical implementation of the commonly agreed methodology.

In 2018, the discussion revolves again around the background of the potential output estimates. The difference between our own estimates for potential output and those of the European Commission is 0.1 pp. — a gap that is not statistically significant. Likewise, the difference between 0.5 pp. of GDP in structural effort (0.4 pp. according to the European Commission services) and the 0.6 pp. of GDP that results from the matrix is not significant against the statistical revisions in the structural effort reported in the recent past¹.

The draft budget for 2018 considers structural adjustment measures of a significant magnitude that are largely based on the public expenditure review. These measures include a program for mitigating sick leave fraud, sharing of back office services and broadening of IT systems in the automation of back offices, centralised public procurement, new travel and accommodation arrangements, centralised energy supply contracts for central government services, and optimisation of partnerships with private schools. Taken together the measures associated with the public expenditure review amount to savings of close to 287 MEUR in 2018, as stated in the 2018 State Budget proposal.

The draft budget for 2018 also considers a reduction in interest outlays amounting to close to 0.2% of GDP, reflecting a reduction in the cost of funding of the Portuguese Republic and the continued optimization of debt management that entailed early repayments to the IMF, while maintaining a conservative cash buffer and average debt maturity. All in all, these measures will allow a reduction of 2.8 p.p. of public debt in 2018, to 123.5% of GDP.

In addition, the expenditure developments in 2018 will also be affected by spending related to the 2017 forest fire catastrophe. The budget for 2018 will be fine-tuned in ongoing discussions in Parliament to accommodate the decisions took by the Council of Ministers

¹ For instance, in February 2016, by the time the budget was presented, the Commission services estimated a structural deterioration of 1% of GDP; by November 2016 the structural effort had been revised to -0.1% of GDP by the EC services, by February 2017 to 0.0% and by May 2017, the structural effort had been revised to +0.25% of GDP. More recently, the estimate for the structural effort in 2016 is +0.3%.



on the 21st of October. These decision are related to one-off expenditures on income support, house reconstruction and repairing of production facilities.

The expenditures related to the forest fires catastrophe will be accommodated in the budget proposal and we are currently evaluating the extent to which additional measures will be financed by centralised provisions included in the current budget proposal. This will result in a slightly larger structural adjustment that will bring the structural effort in 2018 in line with the requirements.

The 2018 fiscal target is based on a prudent macroeconomic scenario, the maintenance of efficient public expenditure management mechanisms, an active debt management strategy and the pursuit of economic-growth enhancing policies.

The Portuguese Government has been focused in reducing the headline deficit to safety levels below the 3% mark and to reduce debt, strengthening the ongoing recovery and ensuring the sustainability of Portugal's public finances. This has been achieved through rigorous budget execution. All windfall gains so far have been used to reduce the public debt. We have committed to continuing to do so in the future.

The commitment of the Portuguese Government to a structural fiscal consolidation strategy, based on (i) the deepening of the reform of the financial system, (ii) the fine tuning of previous structural reforms and new structural reforms (e.g. firm capitalization), and (iii) the structural spending reviews are the best guarantee I can offer you as we move into the future.

The Portuguese Government's track record in 2016 and 2017 demonstrates a full commitment to pursuing a growth friendly fiscal consolidation process that paves the way to further inclusive and sustained economic growth and job creation. Portugal's bright future demands a similar commitment not only for 2018, but also for the coming years.

With my warmest compliments,

Mário Centeno

Ministro das Finanças