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MINISTRO DAS FINANÇAS

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M. Valdis Dombrovskis
Vice-President of the European Commission

M. Pierre Moscovici
Member of the European Commission

The ECOFIN Council approved on July 12th a proposal by the European Commission establishing that the Portuguese Republic did not take effective action in the period 2013-2015. With this letter the Portuguese Government addresses a reasoned request to the European Commission so that the fine referred to in Article 6 of Regulation (EU) Number 1173/2011 is cancelled.

The Portuguese Government expressed its position about the European Commission's assessment in both the Eurogroup and the ECOFIN Council meetings of July 11th and 12th. It also argued that the decision taken by the Council should have taken into consideration the fact that we are going through the most challenging period since the creation of the European Union; therefore our top priority should be to create confidence among all of us, rather than deciding on measures which will unavoidably be seen as divisive. This is the political point that we want to stress again.

This letter details the political arguments against eventual sanctions and reiterates the commitment of the Portuguese government to comply fully with its European obligations and to exit the excessive deficit procedure in 2016. Attached you will find a report that details the fiscal policy commitments for the 2016 budget and assesses how the impact of lower economic growth can be dealt within the framework of the current budget. It also briefly touches upon the fiscal strategy for 2017, which will be fully detailed in October in the context of the Draft Budgetary Plan, and presents a brief update on the financial sector and on the measures implemented to address the Country Specific Recommendations along the lines presented in the Portuguese National Reform

Program.

The recent Portuguese adjustment program

A potential decision to impose a fine would come after an Economic and Financial Adjustment Program, implemented between 2011 and 2014, that was repeatedly judged as successful by the European Commission. In fact, the European Commission was deeply involved in the definition of our economic policy, namely fiscal policy, during a large part of the period covered in the assessment of non-effective action.

In the context of this Program, Portugal reduced its public deficit from 8.6% of GDP in 2010 to just above 3% in 2015, excluding one-offs. It also implemented a large number of structural reforms. The immediate impact of these measures was a recessionary economy, an increase in unemployment and large flows of emigration of young qualified workers.

Fiscal policies included significant temporary cuts of civil servants wages, steep increases in taxation (most tax rates were increased) and a permanent reduction in the number of civil servants, twice as much as the figure initially required under the conditionality of the Program.

There was a great social cost endured by the Portuguese people with a reduction of the levels of welfare and consumption and an increase of poverty.

Wages were cut for the large majority of workers, even for those keeping the same jobs, and the number of new employment contracts witnessed a sharp reduction, leading to the highest unemployment rates ever recorded in Portugal.

In 2014, the country initiated a period of economic recovery that has however failed to gain momentum. The recovery decelerated in the second half of 2015 (cumulative growth of 0.3 percentage points in the two quarters), but is expected to pick up in the coming quarters.

A disproportionate measure about the past

Any measure should provide benefits that clearly outweigh its costs. Imposing sanctions to a country that is implementing a demanding path of deficit reduction is disproportionate. In particular because it's taking place in a difficult international environment and during a socially challenging period, which Portugal has been facing while maintaining a European engagement.

It is very clear that the adopted decision on non-effective action refers to the period 2013-2015. However, the impact of any action that might be adopted by the Commission, including pecuniary sanctions and the suspension of European Structural and Investment Funds, would be felt both in the present and in the future.

Sanctioning the past doesn't make political or economic sense in the case of countries that are already taking effective action, as is the case of Portugal. In 2016 we are reducing our deficit to levels clearly below 3%, in a path compatible with the Commission's forecast of a 2.7% deficit. Sanctions would be counterproductive since they would jeopardize achieving this target, and as such they would endanger the success of the ongoing fiscal consolidation process without any evident benefit.

On the current European and international environment

The high uncertainty arising from the exit option of the United Kingdom and the weakened attachment of a large share of the population to the European project leads to signals of a lack of integration. The ongoing refugee crisis is evolving and pressuring Europe to provide a proper solution that respects human rights and at the same time ensures safety and free movement of people within European borders.

These are structural changes that will affect Europe for a prolonged period and that will jeopardize the model of living and doing business that supported European growth over the past decades. We need action that promotes the well-being of our citizens.

The commitments of the Portuguese Government

The Portuguese Government is and has always been fully committed to the fulfilment of the requirements to a complete participation in the European Union and in the euro area and to continue working together with the European Commission.

The Portuguese government is fully committed to exiting the Excessive Deficit Procedure in 2016. In line with the commitments already expressed, the Portuguese government is ready to adopt fiscal measures to correct any eventual deviations on the budgetary execution. The Government has established in the Budget Law approved in Parliament an additional buffer of expenditure cuts amounting to 0.2 p.p. of GDP. These take the form of budgetary captives. At this stage, we strictly commit not to unfreeze these additional appropriations, as already highlighted in the Stability Programme, as long as they are needed to achieve the targets.

Hence, the Portuguese Government assumed a number of commitments in key economic policy areas that demonstrate our resolve to continue adopting effective action not only to pursue fiscal consolidation, in this case including the commitment to implement fiscal structural measures following the conclusion of the ongoing spending review, but also to create conditions for a sound and sustainable growth that is a key element in any successful medium-term fiscal strategy. This includes the financial system, where the stabilization of the banking system is crucial for economic growth, and the relevant measures included in the National Reform Program.

All these measures, including those relating to fiscal reforms, are also in line with the 2016 Country Specific Recommendations, to which the Portuguese Government subscribes in full and is committed to implement, as stated in our National Reform Program presented in April and warmly welcomed by the European Commission.

Conclusion

The Portuguese Government has been working in close cooperation with the European institutions. Coordination efforts are vital to show the markets our collective commitment to create the conditions for growth and social cohesion across Europe, while ensuring sound macroeconomic policies and fiscal sustainability.

The Portuguese Government shares the need to pursue national policies to promote fiscal responsibility and sustained economic growth. These goals have to be achieved within a framework of European policies that complete the construction of the euro area institutions and in close cooperation with the European authorities.

Adopting sanctions would be unjustified since the country is in the right path to eliminate the excessive deficit and would be counterproductive as it would damage the efforts to succeed in that task. In addition to the economic and financial damages, there would be a highly negative impact on the level of support for the European project in Portugal, which is largely consensual in Portugal since 1976. For all these reasons, sanctions would never be understood by the Portuguese people.

I remain available for any further clarification you may deem useful.

Yours sincerely,

Mário Centeno

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Finance Minister of Portugal

ANNEX

Report addressing the current commitments included in the Stability Program for 2016 and 2017, which presents a macro scenario, based on a simulation of GDP growth in line with the EC, and the way both expenditure and revenue will evolve in order to achieve the targets. The details on the fiscal, banking and structural reforms commitments are also included.