European Commission

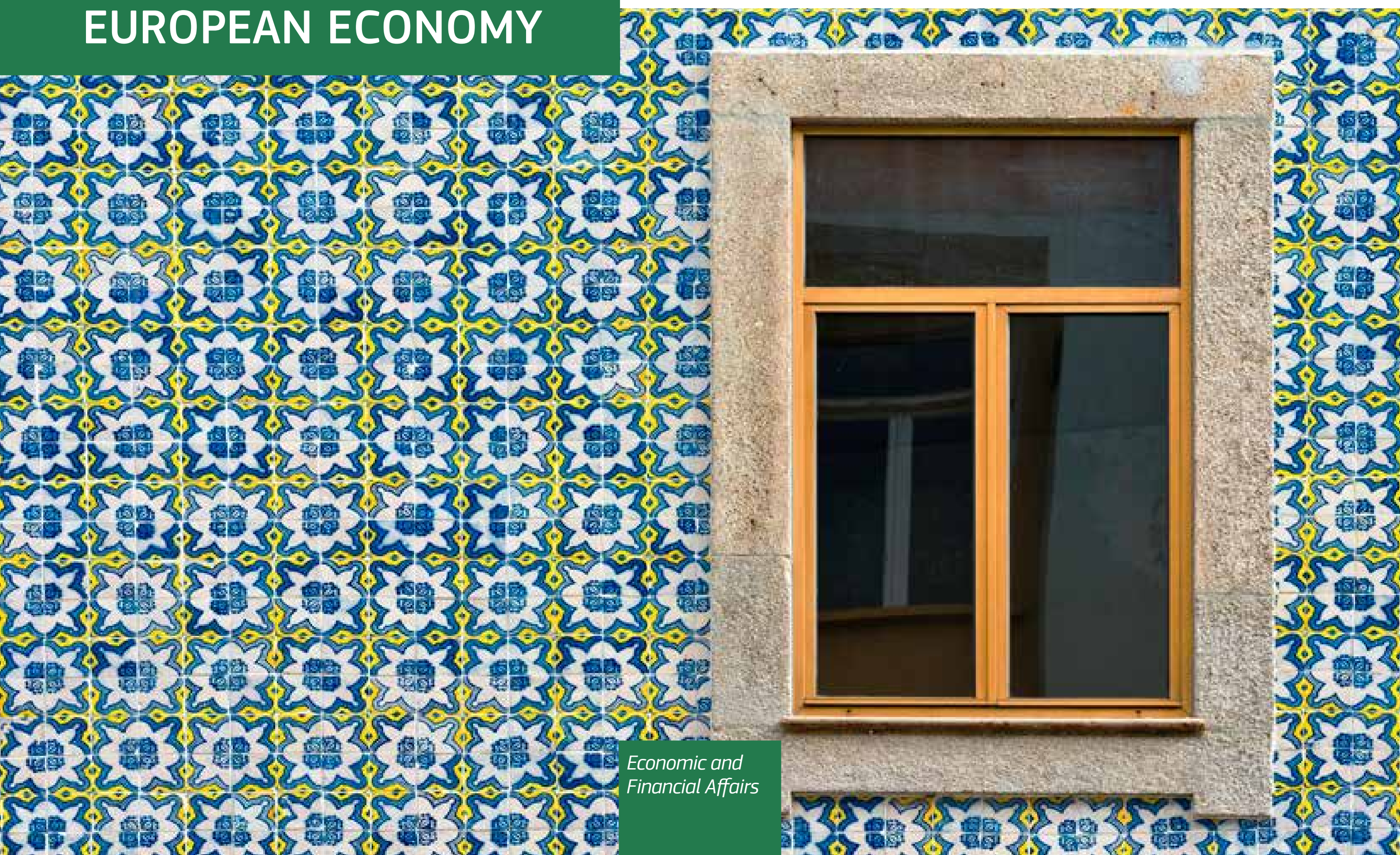
ISSN 2443-8014 (online)

Post-Programme Surveillance Report

Portugal, Summer 2017

INSTITUTIONAL PAPER 061 | OCTOBER 2017

EUROPEAN ECONOMY



Economic and Financial Affairs

Luxembourg: Publications Office of the European Union, 2017

KC-BC-17-061-EN-N (online)
ISBN 978-92-79-64706-2 (online)
doi:10.2765/492947 (online)

KC-BC-17-061-EN-C (print)
ISBN 978-92-79-64705-5 (print)
doi:10.2765/595209 (print)

European Commission
Directorate-General for Economic and Financial Affairs

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ACKNOWLEDGEMENTS

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The Post-Programme Surveillance assessment of the report was prepared in liaison with the ECB.

This report reflects information available up until 5th September 2017.

ABBREVIATIONS

ACE	Allowance for Corporate Equity
BdP	Banco de Portugal
BFL	Budget Framework Law
CET1	Common Equity Tier 1
CGD	Caixa Geral de Depósitos
CIT	Corporate Income Tax
DBP	Draft Budgetary Plan
DGAL	Directorate-General for Local Administration
DGO	Directorate-General for Budget
DSA	Debt Sustainability Analysis
EC	European Commission
ECB	European Central Bank
EDP	Energias de Portugal
EPC	Economic Policy Committee
EPL	Employment Protection Legislation
ESM	European Stability Mechanism
EU	European Union
FAM	Municipality Support Fund
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
HICP	Harmonised Index of Consumer Prices
IGCP	Agência de Gestão da Tesouraria e da Dívida Pública
IMF	International Monetary Fund
IMI	Immovable Property Tax
IMPIC	Institute for Monitoring Public Procurement
INE	National Statistical Office
IP	Infraestruturas de Portugal
MIP	Macroeconomic imbalance procedure
MTO	Medium term Objective
NFCs	Non-financial Corporations
NPLs	Non-performing loans
OECD	Organisation for Economic Co-operation and Development
PER	Processo Especial de Revitalização de Empresas
PIT	Personal Income Tax
PPS	Post-programme surveillance
PPP	public-private partnership
q-o-q	Quarter on quarter
RoE	Return on Equity
RoA	Return on Assets
SGP	Stability and Growth Pact
SMEs	Small and Medium-sized Enterprises
SOEs	State-owned Enterprises
ULC	Unit Labour Costs
UTAM	Unidade Técnica de Acompanhamento e Monitorização do Setor Público Empresarial
UTAP	Unidade Técnica de Acompanhamento de Projetos
VAT	Value Added Tax
y-o-y	Year on year

EXECUTIVE SUMMARY

This report presents the findings of the sixth post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, which took place in Lisbon between 26 June and 4 July 2017. *Since the conclusion of the fifth post-programme surveillance mission in December 2016, growth has further accelerated. The short-term economic and financial situation of Portugal has improved and important progress has been made in addressing near-term risks. Overall, Portugal's economic adjustment building on the basis of the macroeconomic adjustment programme has been commendable. Going forward, the challenge is to maintain the momentum. In this regard, further ambitious growth-enhancing reforms and sustained fiscal consolidation are essential to improve the economy's resilience to shocks and the medium-term growth prospects.*

Growth outlook improves. *Following a strong performance in the second half of 2016, Portugal's economic growth is set to rise further in 2017. Growth in the first quarter was stronger than expected by all major forecasters, picking up to 2.8% y-o-y, and has become more broad-based due to acceleration in exports and investment. Notwithstanding a deceleration in pace, private consumption remains also an important driver of growth. . The Commission's Economic Sentiment Indicator continued to improve in 2017 reaching a two decades high. The labour market is undergoing a broad-based improvement, underpinned by sound employment growth and higher activity rate. House prices have been increasing significantly but so far are not accompanied by debt accumulation. These recent economic developments point to more favourable growth dynamics as compared to the Commission's 2017 spring forecast and the Government's Stability Programme. But risks to stronger economic growth remain, namely the challenges faced by the banking system and the economy's vulnerability to external developments.*

Public finances have improved while challenges remain and further improvements both in nominal and in structural terms should be achieved. *Following a deficit outturn of 2.0% of GDP in 2016, the Commission spring forecast expects a deficit of 1.8% of GDP in 2017 as compared to 1.5% of GDP in the Stability Programme. Due to the absence of fiscal consolidation measures, the structural balance is expected to slightly deteriorate by 0.2% of GDP in 2017. Under a no-policy change assumption, the headline deficit is set to deteriorate slightly to 1.9% of GDP in 2018 and the structural balance is also expected to continue to slightly deteriorate. The spring forecast projects a debt-to-GDP ratio at 128.5% in 2017 and 126.2% in 2018. For both 2017 and 2018, positive risks to the Commission forecast could entail a continuous improvement in the macroeconomic outlook, positively affecting the headline deficit but not the structural balance. Negative risks to the fiscal outlook could originate from the potential budgetary impact of bank support measures and possible higher spending pressures.*

Fiscal-structural reforms are proceeding albeit slowly. *While expenditure is now subject to more controls, the implementation of the new Budget Framework Law, due to be completed by 2018, is delayed. The current spending review would benefit from a further broadening of its scope and the definition of savings targets. Insufficient enforcement of the civil servant replacement rule and delays in other efficiency-enhancing reforms of public administration weigh on the budget. The sustainability of the pension system in the short to medium term risks deteriorating if the budgetary impact of the new early retirement rules is not fully compensated. The stock of arrears in hospitals continues to increase. The financial viability of State Owned Enterprises remains fragile due to a high debt burden but the Government is putting forward measures to improve their sustainability.*

The recovery of the Portuguese banking sector is on-going, supported by a pick-up in economic activity. *Banks have further deleveraged, strengthened their capital base and aim to further reduce costs. Nevertheless, on average, the sector continues to be weighed down by low profitability, relatively thin capital buffers as well as still high, although somewhat decreasing, non-performing loan ratios. In this context, continued efforts by banks to further improve their financial soundness as well as internal governance are essential. Corporate loan restructurings for viable firms need to be accelerated while non-viable firms should no longer burden banks' balance sheets. The platform to enhance coordination of non-performing loans management, which is being developed by a number of banks and closely followed by the authorities, as well as the strengthened framework for corporate debt restructuring are important* *initiatives in this regard. Legislative changes in the tax and judicial areas are being undertaken to facilitate the restructuring of viable firms and the expedite liquidation of non-viable ones.*

Authorities envisage measures to foster competition in product markets and improve labour market conditions and these efforts need to be stepped-up to effectively improve mid-term growth prospects*. Employment is recovering fast and the Government is implementing a broad range training programme to upgrade the skills of the labour force. However, labour market segmentation remains high weighing on the career prospects of younger workers. A better framework is needed that fosters hiring on open-ended contracts. In network industries, measures are being taken to increase competitiveness in Portuguese ports and improve governance in urban transport. While the sustainability of the energy sector is improving no new costs can be added to the system if an early elimination of the electricity tariff debt is to be ensured. The Public Procurement Code revision can contribute to improve transparency, provided that administrative capacity of contracting authorities is improved; rule enforcement and monitoring remain essential to guarantee the best price and quality of the goods and services acquired. While most courts can deal now better with the backlog of cases, efforts need to continue to effectively reduce the caseload and shorten proceedings. As administrative burden decreases, competition in business services needs to be further strengthened.*

Sovereign financing and the capacity to repay are currently not a reason for concern but yields remain volatile and vulnerable to financial market conditions and the private and public debt overhang. *The capacity to repay remains sound in the short-term with falling - but still volatile - yields facilitating funding conditions. Borrowing costs for 10 year bonds returned to the yield level of early 2016 before the increase which started in August 2016 and peaked in March 2017. The IMF repayment has helped to smooth the debt redemption profile and Standard & Poor's has upgraded the Portuguese sovereign debt to investment grade after the cut-off date. In the medium term, the redemption profile is expected to improve and gross financing needs to decline. However, further efforts in fiscal consolidation and structural reforms would be key in ensuring a sound capacity to repay in the long-term against a slow reduction of the treasury cash buffer.*

The next PPS mission will most likely take place in November 2017.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the sixth post-programme surveillance (PPS) mission to Portugal between 26 June and 4 July 2017. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to assessing the repayment capacity of a country that has received financial assistance([1]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions.

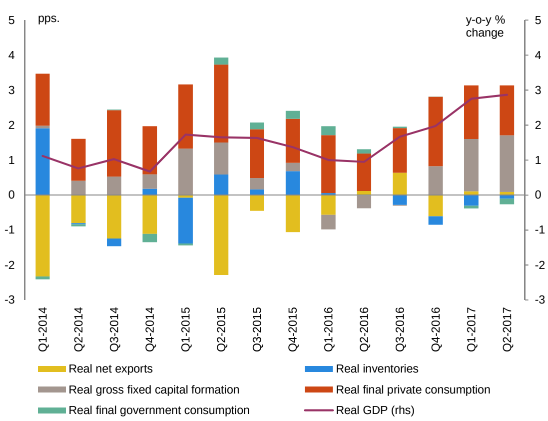
([1]) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid.

2. RECENT ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

GDP growth increased to 2.8% y-o-y in Q1-17 and 2.9% y-o-y in Q2 from 2.0% y-o-y in the last quarter of 2016, mainly supported by strong investment and export growth and complemented by solid private consumption. Exports accelerated significantly to 9.5% y-o-y in Q1 and 8.2% y-o-y in Q2. However, the change in export of goods was affected by several one-offs such as renewed activities in the oil refinery industry (*Galp*) and car production (*AutoEuropa*), as well as a steep rebound in exports to Angola and Brazil, which also caused significant volatility to the annual growth rates. Exports of services meanwhile continued to benefit from strong tourism and transportation services. The latter also reflected the solid rebound in transhipments at the main ports of Portugal. The annual growth in investment (excluding inventories) almost doubled compared to the end of 2016 supported by construction and equipment. While private consumption remained an important contributor to growth, it decelerated somewhat compared to Q4 2016. Household savings continued to decline at the beginning of 2017 alongside improving consumer confidence and low interest rates.

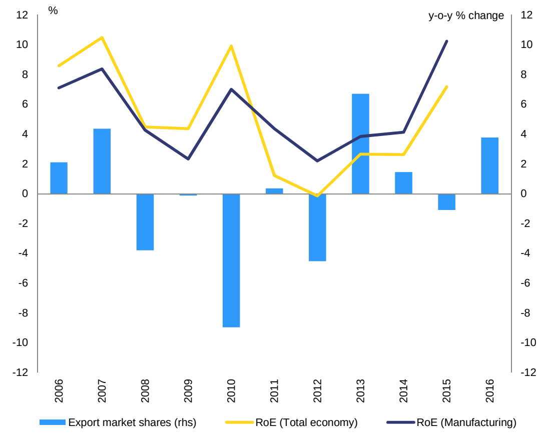
Graph 2.1: **Main factors contributing to GDP growth**



Source: European Commission

Export outlook remains favourable despite the upward trend in unit labour cost. Exports picked up above expectations leading to an increase in export market shares by almost 4% in 2016 (see Graph 2.2) and the trend continued at the beginning of 2017. As the first half of 2017 was strongly affected by the aforementioned one-off effects, their importance will gradually fade away in 2018-2019, resulting in some moderation in exports development, more in line with external demand. Nevertheless, the outlook on export performance remains positive and the projected moderate increase in unit labour cost is broadly in line with developments in trading partners. Exports of goods are also expected to benefit from the ongoing expansion in the automotive sector, particularly in 2018, and the reported significant increase in newly approved EU-funded projects in support of export-oriented SMEs (in the medium to long term).

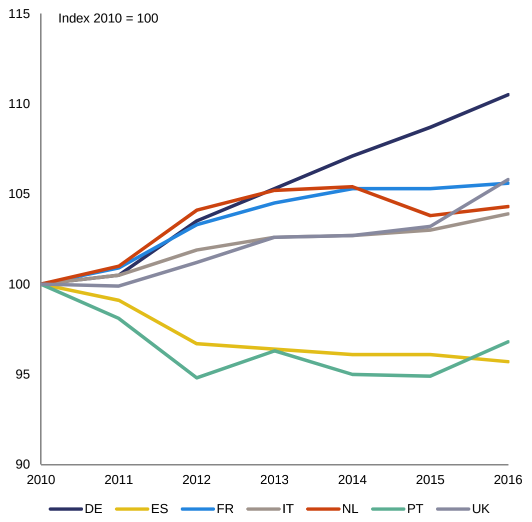
Graph 2.2: **Profitability and growth in export market shares (goods and services)**



Source: European Commission

Unit labour costs (ULC) developments are not considered a risk to competitiveness at this stage. The evolution of ULC, compared to main trading partners, does not indicate cost pressures (Graph 2.3). The positive trend is also supported by the improving market shares and corporate profits (Graph 2.2). There are, nevertheless, risks that the positive economic cycle could increase the upward pressure on unit labour costs, which is visible since 2015. This could slow down the export-led recovery of the economy over the medium and long run, even if some upgrade of exports quality is noticeable (European Commission Country Report Portugal, 2017). This warrants continuous caution on the side of policy makers for balancing income growth and competitiveness targets.

Graph 2.3: **NULC evolution in Portugal and main trading partners**

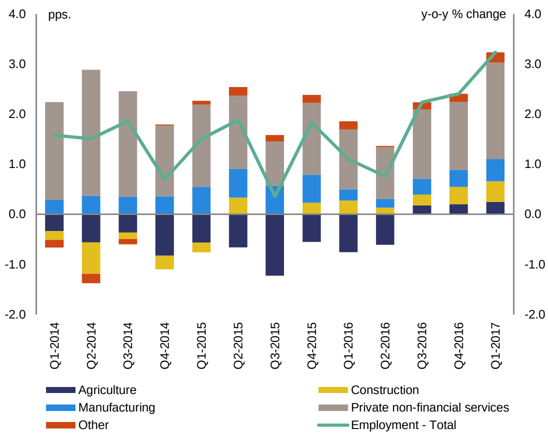


Source: European Commission

Balance of payments flows are expected to continue reducing the stock of external liabilities but still at a slow pace. The current account however deteriorated to a deficit of 1.5% of GDP in the first half of 2017 relative to 1.1% a year earlier, according to balance of payments data. The net international investment position (NIIP) remained significantly below the MIP threshold and deteriorated slightly in the first half of 2017 but is nevertheless expected to resume its upward path on full-year basis. The negative NIIP position moved from 116.5% of GDP at the end of 2012 to 104.8% at end-2016 and 105.2% as of June 2017 (against the MIP threshold of 35%). Net external debt (auxiliary indicator in the MIP scoreboard) moved from 101.8% of GDP at the end of 2012 to a peak of 106.2% as of March 2015 and then fell down to 94.4% at end-2016 and 93.6% as of June 2017. The structure of NIIP improved meanwhile due to the increased net inflow of FDI. The FDI component in NIIP widened to 32% as of mid-2017 relative to 30% at the end of 2016 and 22% at the end of 2012.

The labour market improved substantially in 2016 and the positive momentum gained further pace in the first half of 2017. In the first half of 2017, job creation picked up to 3.2% and unemployment dropped to 9.9% in Q1 and 9.3% in Q2 (seasonally adjusted). The robust employment growth was mainly driven by labour intensive industries namely services, which was related to the strong performance in tourism and construction (see Graph 2.4). The activity rate also improved as the labour force expanded by 0.8% y-o-y in the first half of the year. These developments are also indicative of some rebalancing in the migration flows, as the recent changes in the working-age population are broadly in line with the natural change in the population. The share of long-term unemployed declined but remained at a relatively high level of 59% in the first half of 2017. This level of long-term unemployment is indicative of significant structural constraints on the labour market although the recent rebound in construction and strong tourism performance is likely to reduce the slack caused by the long-term crisis and inefficiencies in the sectors. Average wage growth was moderate in the first quarter of 2017, and broadly aligned with inflation, but together with the sound increase in employment, pushed up unit labour costs by 0.7 y-o-y. The evolution of both indicators was broadly in line with the Commission's 2017 spring forecast and with the dynamics in main trading partners followed by a period of substantial downward adjustment.

Graph 2.4: **Employment evolution by sectors**



Source: European Commission

Consumer prices continued to accelerate. Inflation (HICP) picked up to 1.6% y-o-y in the first half of 2017, mainly reflecting the impact of crude oil prices. Inflation surprised on the upside in April rising by 2.4% y-o-y due mainly to temporary Easter effects on restaurants, hotels and transportation prices. This impact was corrected in the following months as the annualised inflation rate subsided to 1% in June. Overall, the year-average inflation in 2017 is expected to be in line with the Commission's spring forecast of 1.4%.

The housing market warrants close monitoring but does not trigger immediate concerns of imbalances. The level of house prices is close to the long-term average as they underwent a downward correction in 2010-13 that is not fully recovered yet. They accelerated to 7.1% in 2016 and 7.9% y-o-y in Q1-2017 driven by low interest rates, higher income and increased demand for properties by non-residents, particularly in tourist areas. The MIP scoreboard deflated house price index increased by 6.0% in 2016 and 6.3% in Q1-2017, marginally exceeding the underlying indicative threshold. The positive economic cycle and the booming tourist sector are expected to keep house prices on the rise. On the other hand a weak credit growth somewhat dampens this upward pressure. The increase in house prices is not accompanied by debt accumulation as the stock of mortgage loans continues to fall. Underlying financing sources are likely to continue to come from income growth and foreign investments rather than domestic debt creation. The recent rebound of construction activities as well as the steep increase in newly issued building permits are expected to gradually balance the market over the medium run.

Overall, the recent economic developments point to more favourable growth dynamics as compared to the Commission's 2017 spring forecast, where GDP is projected to grow by 1.8% in 2017 (in line with the Government's Stability Programme, the March projections of Banco de Portugal and IMF ([2])) and 1.6% in 2018. Meanwhile, the consensus forecast for Portugal's economic growth in 2017 improved from 1.7% in the spring to 2.6% in August. The volatility in the data is also significant, as one-off and calendar effects resulted in very strong quarter-on-quarter growth in the first quarter of the year (1.0%) followed by weak second quarter (0.3%) Consumer and business expectations remain favourable, as the Commission's economic sentiment indicator is standing well-above the long-term average. The labour market and, in particular, job creation are also exceeding expectations. On the other hand, major indicators affecting fiscal performance such as compensation of employees, inflation and private consumption are broadly in line with the Commission's spring forecast.

([2]) Banco de Portugal and IMF revised upwards their GDP growth projections for 2017 to 2.5% in June.

2.2. PUBLIC FINANCES

In cash terms, budget execution through end-July 2017 was marked by an accelerating revenue increase combined with temporary expenditure containment. Up to July, the general government cash balance improved by EUR 1.2 billion relative to the same period last year due to an increase in revenue by 3.2% while expenditure grew by only 0.5% mostly due to a change in the payment schedule of Christmas supplement expenditure.

On the revenue side, the overall increase by July of 3.2% has come close to the 3.9% increase projected in the budget for the whole year. While there has still been some underperformance in personal income tax (PIT) (-3.5% as compared to the full-year budget target of +1.8%, partially due to earlier reimbursements) this was more than compensated by corporate income tax (CIT) collection (+18.8%) being far above the full year budget target of +0.9%. As regards indirect taxes, the overall growth of revenue by 3.4% compares to a budget target of 2.1%. Overall indirect tax execution by July was in particular supported by the high increase in VAT revenue by 4.9%, largely exceeding the full-year target of 1.4% in spite of higher VAT reimbursements. While the increase of social contributions also exceeded the annual target (+0.5% compared to -0.6%), other current revenue and capital revenue fell significantly short of the annual budget targets up to July.

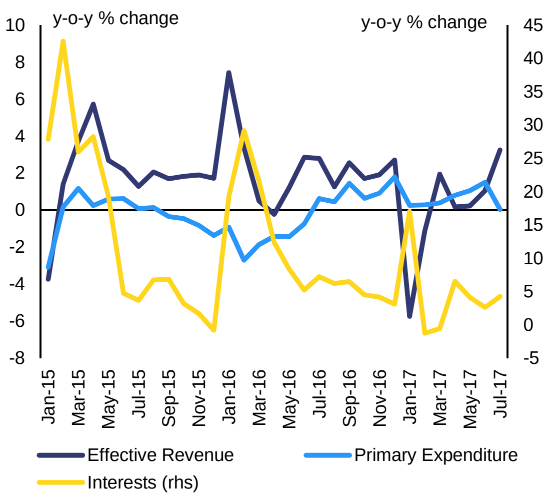
On the expenditure side, there was an overall very moderate increase by 0.5% up to July (below the full-year increase of 4.4% planned in the budget) largely due to the temporary effect of the postponement of payment of 50% of the Christmas supplement for salaries and pensions to November ([3]) and lower than budgeted investment

([3]) While in 2016 the Christmas supplements for salaries and pensions were entirely paid in twelve monthly payments, in 2017 only 50% of the Christmas supplements continue to

(+6.9% vs a full-year budget increase of +26.9%). The corresponding underspending was however partially offset by increases of acquisition of goods and services (+3.6%) and interest payments (+4.2%) above the budget targets of 2.0% and 0.7% respectively.

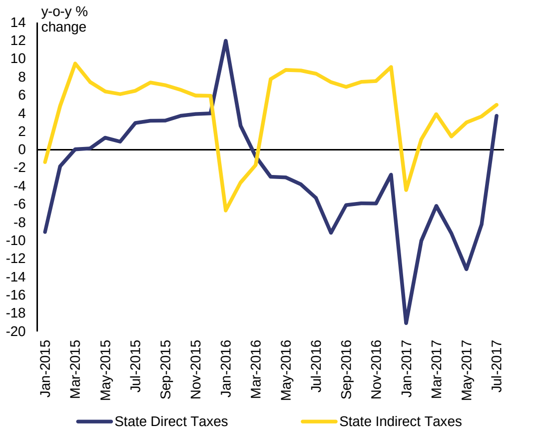
Risks to cash based budget execution appear to be balanced. As negative deviations on the expenditure side are expected to be compensated by more positive developments on the revenue side in the coming months, the authorities are confident to reach the budgetary targets in cash terms as adopted in the 2017 Budget. The still outstanding full effect of recent tax declarations for 2016 and the time profile impact of some measures (such as the change in the payment profile of 50% of Christmas supplements in 2017, the quarterly reversal of public sector wage cuts in 2016, the VAT rate reduction for restaurants as of July 2016 and the extraordinary pension increases as of August 2017) however limit a full-year comparability of the cash execution up to July. As emphasised by the authorities, the higher amount of frozen appropriations (only releasable upon authorisation by the Ministry of Finance), may also be used to compensate for potential deviations towards year-end in case of expenditure slippages or revenue shortfalls. Overall, risks to budgetary execution in cash terms appear to be balanced as higher revenue from the improved macroeconomic outlook may offset spending pressures in particular for compensation of employees and acquisition of goods and services.

Graph 2.5: **Budget execution (General Government)**



Source: DGO

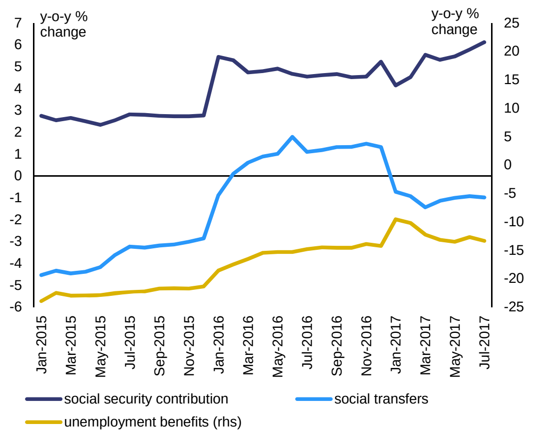
Graph 2.6: **Budget execution (State)**



Source: DGO

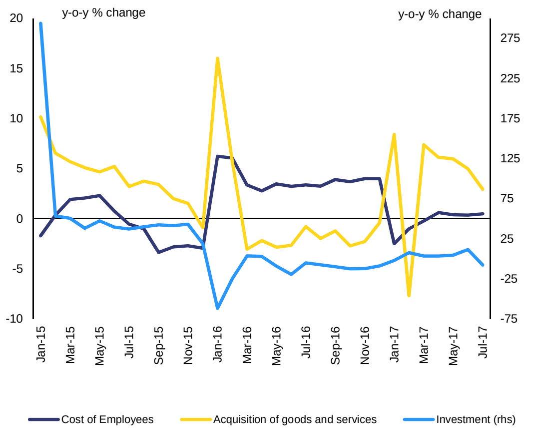
be paid in twelve monthly payments whereas the other 50% are paid in November.

Graph 2.7: **Budget execution (Social security)**



Source: DGO

Graph 2.8: **Budget execution (Central administration)**



Source: DGO

Public sector arrears are on the rise due to the health sector. Following a broad stabilisation in 2016 as compared to end-2015 at EUR 0.9 billion due to significant clearance payments in December, public sector arrears have again increased by a total EUR 249 million in 2017 to EUR 1.1 billion up to the end of July. The overall increase is entirely due to an increase by EUR 307 million for state-owned hospitals bringing the stock of arrears of the National Health Service above EUR 850 million at the end of July 2017. Budgetary planning and control in state-owned hospitals remains a challenge.

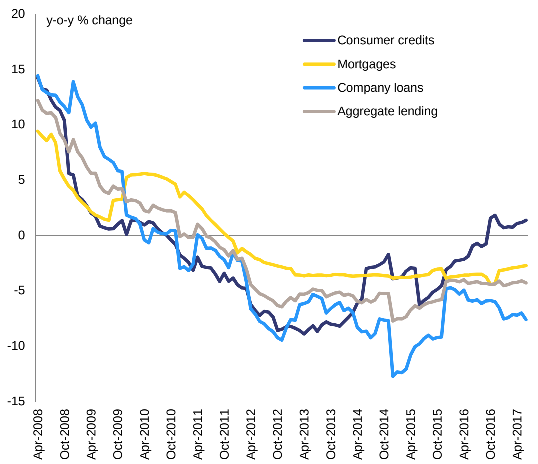
2.3. FINANCIAL STABILITY AND INDEBTEDNESS

Stronger economic performance coupled with legislative changes is reflected in banks' more confident outlook. Moreover, Portuguese lenders are also reaping the benefits from their improved capital standing which is facilitated by the economic recovery. Banks continue to gradually restructure their business, mainly through resizing distribution networks and selling non-core business activities.

Seizing this positive momentum could help addressing the remaining significant vulnerabilities in the financial sector. Notwithstanding the heterogeneity between lenders, Portuguese banks remain on average burdened by high non-performing loan levels, relatively poor profitability and still lower capital buffers compared to European peers. Portuguese lenders need to continue to adjust to the low interest environment by increasing income, including through higher non-interest income and reducing expenses.

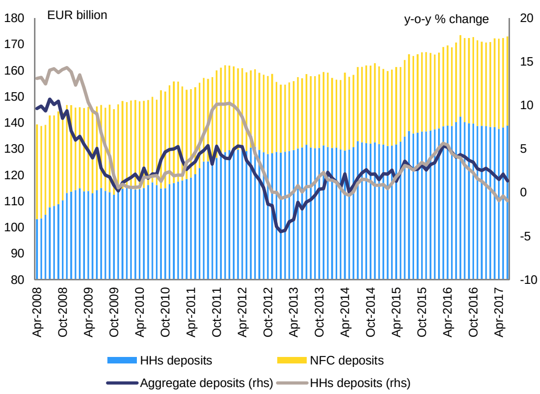
The overall stock of credit is decreasing due to write-offs and continued private sector deleveraging. Portuguese banks' overall lending fell by 4.1% (cf. Graph 2.9) in 2016, while their corporate loan stock fell by 6.4% over 2016. There are initial signs of a renewed momentum in credit growth. In contrast to the pre-crisis period, corporate credit is now more concentrated in firms with a lower risk of default. There is also evidence of larger corporates decreasing their reliance on domestic lenders. While redemptions still outweigh new mortgages, the amount of new mortgage lending is now triple the programme years' trough. This is in line with employment and confidence rising to their highest levels in a decade. Consumer and other purpose loans grew by 1.0% y-o-y in 2016, but their share in overall loans is only 11%. Savings still grow, driven by the corporate segment, despite the lowest deposit remuneration on record (Graph 2.10). Borrowing from the ECB is predominantly through the targeted longer-term refinancing operations (TLTROs) redeemable after 2020 and remains stable around EUR 22 billion, equivalent to 6% of banks' total liabilities as of end-2016.

Graph 2.9: **Domestic banks' loans fell 4.1% over 2016**



Source: Bank of Portugal statistical bulletin B.7.1.6

Graph 2.10: **Savings with domestic banks are still around the historic high-water mark**



Source: Bank of Portugal statistical bulletin B.7.1.8

The financial system increased its exposure to the domestic public sector securities remains substantial. While banks mainly increased foreign sovereign exposure (Italy and Spain) without further increasing domestic sovereign exposure (equivalent to 7% of total assets as of end-2016), the Portuguese insurers increased their domestic sovereign exposure to 23% of total assets.

Banks continue to consolidate and divest from their non-core operations. BPI continued deconsolidating its Angolan exposure and was acquired by the Spanish CaixaBank group which now owns 84.5% of the bank. Santander Totta is integrating Banco Popular's Portuguese subsidiary. Novo Banco has progressed further with the promissory agreement of purchase and sale now signed and the closing of the transaction is estimated to occur is estimated to occur in the coming months. Montepio bank is undergoing transformation into a limited liability company with a final solution regarding shareholding, governance and strategic orientation still being discussed.

Banks recently issued capital and debt instruments but overall remain below EU peers in capital position terms. CGD, Portugal's biggest bank, increased its capital in an operation that comprised the extinction of EUR 948 million of contingent convertible bonds (CoCos) and their interest payments, a group-internal EUR 499 million capital injection in kind (Parcaixa), and a EUR 2.5 billion cash capital injection from its sole shareholder, the Portuguese Republic. CGD also issued 500 million of Additional Tier 1 to private investors. Millennium BCP, the second biggest bank, repaid the last EUR 700 million CoCo tranche to the state through a EUR 1.33 billion private capital increase. Depending on Novo Banco's successful Liability Management Exercise (LME) conclusion, the potential acquirer, Lone Star will inject EUR 750 million into Novo Banco in 2017 and some further EUR 250 million until 2020. The country's fifth biggest bank, Montepio, has carried out a EUR 250 million capital increase with its main shareholder. Despite those capital increases the sector's Common Equity Tier 1 (CET1) ratio of 12.6% at the end of March 2017 is still low in EU comparison.

The profitability outlook for 2017 has improved. Most major banks had better results in the first half of 2017. The combined loss for the six biggest banks fell to EUR 340 million end-June compared to a loss of 730 million in the first half of 2016. At the end of March 2017, the system's return on equity (RoE) and return on assets (RoA) amounted to 3.5% and 0.3% respectively, which compares favourably to the final quarter of 2016 when profitability deteriorated due to an increase in impairments. The recent profit improvement is mainly due to lower deposit remuneration and significantly lower new impairment flows thanks to overall stronger economic growth. Income from fees and commissions also increased, even though the government has capped many fees to a percentage of minimum wage impeding the banks' ability to raise more revenue in that area.

Moreover, the repricing of deposits is limited by a ban on negative interest rates, both on household and corporate deposits. Following the reduction of political risks in Europe, bonds' secondary market valuation increased substantially translating into gains for Portuguese lenders. Banks' Credit Default Swaps (CDS) fell in line with the drop in sovereign spreads and yields.

There are signs of improvement in bank asset quality. In line with the economic recovery the flow of new NPLs has decreased further with a good first 2017 quarter, while banks successfully managed to sell bundles of legacy defaulted loans', in some cases achieving a higher sale price than book value. The economic upswing is helping with the legacy assets, especially repossessed real estate. As the NPL ratio denominator (total loans) is now reducing at a slower pace than in previous years (Graph 2.9), the reading of the NPL ratio is becoming to a lesser extent subject to the denominator effect which since 2011 ceteris paribus resulted in a mechanical rise of the NPL ratio. The size of banks' balance sheet reduction (down by 25% since 2010) is impressive with the corporate and household loan portfolio falling by more than 27%.

Despite NPL portfolio sales and write-offs, Portugal still has the EU's third highest NPL ratio ([4]). At the end of March 2017 the overall NPL ratio was 16.4% (EBA ITS definition) compared to 17.2% at end-2016 and 17.5% at end-2015. The average coverage ratio was rather stable at 45% in March 2017. Sectoral distribution indicates mortgage NPLs were at 6.7%, consumer NPLs at 10% and companies NPLs at a high 29% of total gross loans. Corporate NPLs account for 65% of the NPL stock. Moreover, about 60% of corporate loans, or close to EUR 7 billion, has been overdue for longer than three years ([5]).

Banks deleveraged and have been engaged in actively reducing cost. Operating costs of Portuguese banks have been relatively high, driven by the high number of bank outlets (still the fourth highest in the EU in relation to population) and relatively high staffing costs. The cost to income ratios have remained stubbornly high across the sector and stood at approximately 60% over the past few years Nonetheless, over 2016 the operating costs of banks have been decreasing faster than the revenue originated by net interest income and net commissions. Almost all banks are presently engaged in the process of restructuring their operations in Portugal. In aggregate terms, over the past 7 years, the numbers of both branches and ATMs declined at an average yearly rate of 2.5% and 1.7% respectively while the number of bank employees dropped by over 8% in 2016 alone and by one fourth since 2010.

Pressure on the cost side will remain high. Banks now face increasing pressure to move their business online and need to invest more heavily in new digital technologies. This in turn implies higher investments in the IT architecture supporting the credit institutions business model changes. It was confirmed that the cost of the banks' exposure to the Resolution Fund's loan to the Portuguese treasury – resulting from the gap between the capital injected into Novo Banco and the sale price to be agreed with Lone Star – will be covered through banks' regular contributions to the Resolution Fund while the loan maturity was extended until 2046.

Private debt

In contrast to the flat debt ratios in the public sector, the pace of deleveraging in the private sector is relatively fast. The Banco de Portugal debt statistics show that the non-consolidated private debt dropped from a peak of 264.7% of GDP at the end of 2012 to 220.2% at the end of 2016 and further down to 217.1% at the end of March 2017. In the private corporate sector, the debt ratio dropped from 170.8% at the end of 2012 to 143.4% at end-2016 and 141.7% at the end of June 2017. The largest debt ratios as of June 2017 are reported in trade (24.6% of GDP), manufacturing (22.0%), and utilities (18.3%). The ratios for construction and real estate stand at 14.8% and 13.0% respectively. The pace of deleveraging is sustained across all economic sectors. The debt accumulated by large companies accounts for 43.0% of GDP while the ratio for micro-corporations is 36.0% of GDP. Both groups are reducing their debt burden at similar rates.

As regards consolidated debt, the main indicator on private indebtedness in the MIP scoreboard, the

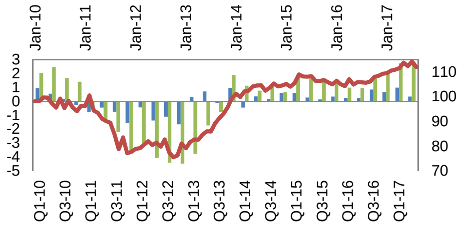
([4]) After Greece and Cyprus.
([5]) According to data from the Portuguese Central Credit Register

ratio fell from 210.3% at end-2012 to 172.0% at end-2016. The distance to the relevant MIP threshold of 133%, was thus nearly halved in 2012-2016 i.e. dropped 1/8th annually, which is fast if compared to the public debt reference pace (the SGP adjustment benchmark of 1/20th annually). Both the corporate and household sectors contributed to the deleveraging process. As of the end of 2016, consolidated corporate debt accounted for 58.2% of the total private debt compared to 57.5% four years earlier, indicating that both sectors are deleveraging at a similar pace.

Despite the ongoing deleveraging, private investments remained relatively stable at around 13% of GDP over the period of 2012-2016. The share of corporate investments even increased marginally from 9.6% in 2012 to 10.1% in 2016 helped by improved corporate profits and increased inflow of FDI. Nevertheless, the level of investments remains among the lowest in the EU and continues to be restrained by the large stock of indebtedness.

Graph 2.11: Recent economic developments

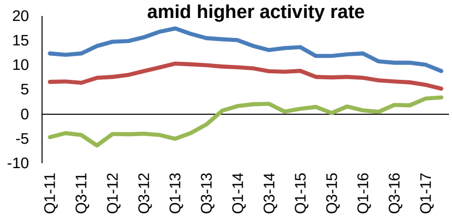
GDP accelerates supported by record high economic sentiment and improved external demand ...



GDP (quarterly, national accounts, q-o-q % volume change), SA Q2-17
GDP (quarterly, national accounts, y-o-y % volume change),SA Q2-17
Economic sentiment indicator (monthly) (rhs)Aug-17

Source: INE and DG ECFIN.

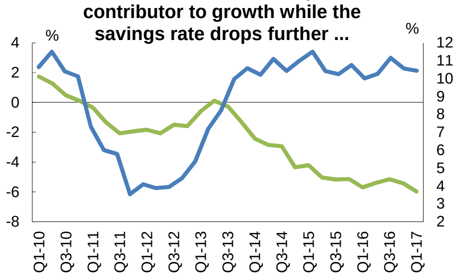
Employment also accelerates bringing significant reduction in unemployment amid higher activity rate



Long-term unemployment rate (quarterly, labour force survey, % active population)Q2-17
Unemployment rate (quarterly, labour force survey, % active population)Q2-17
Employment (quarterly, labour force survey, y-o-y % change) (rhs)Q2-17

Note: Non-seasonally adjusted data
Source: INE.

Private consumption slows down somewhat but remains important contributor to growth while the savings rate drops further ...

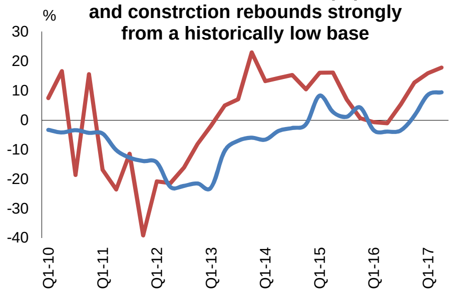


Gross household saving rate 4qma (rhs)Q1-17

Private consumption (quarterly, national accounts, y-o-y % volume change)Q2-17

Source: INE

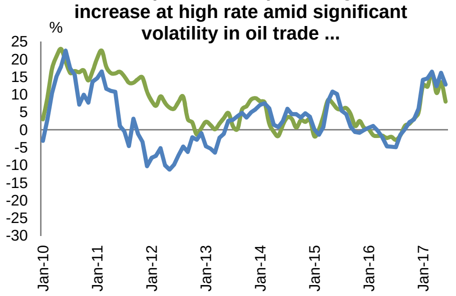
... and investment in both equipment and constrction rebounds strongly from a historically low base



Equipment investment (quarterly, national accounts, y-o-y % volume change) (lhs)Q2-17
Construction investment (quarterly, national accounts, y-o-y % change volume change) Q2-17

Source: INE and Banco de Portugal.

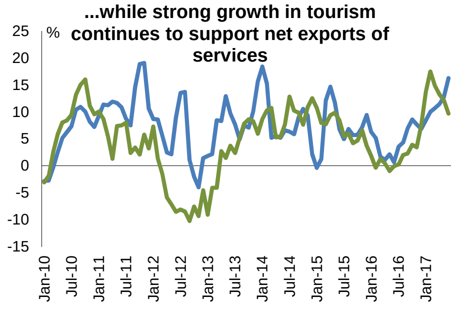
Both exports and imports of goods increase at high rate amid significant volatility in oil trade ...



Exports of goods (Balance of payments data, y-o-y % nominal change, 3mma)Jun-17
Imports of goods (Balance of payments data, y-o-y % nominal change, 3mma)Jun-17

Source: Banco de Portugal

...while strong growth in tourism continues to support net exports of services

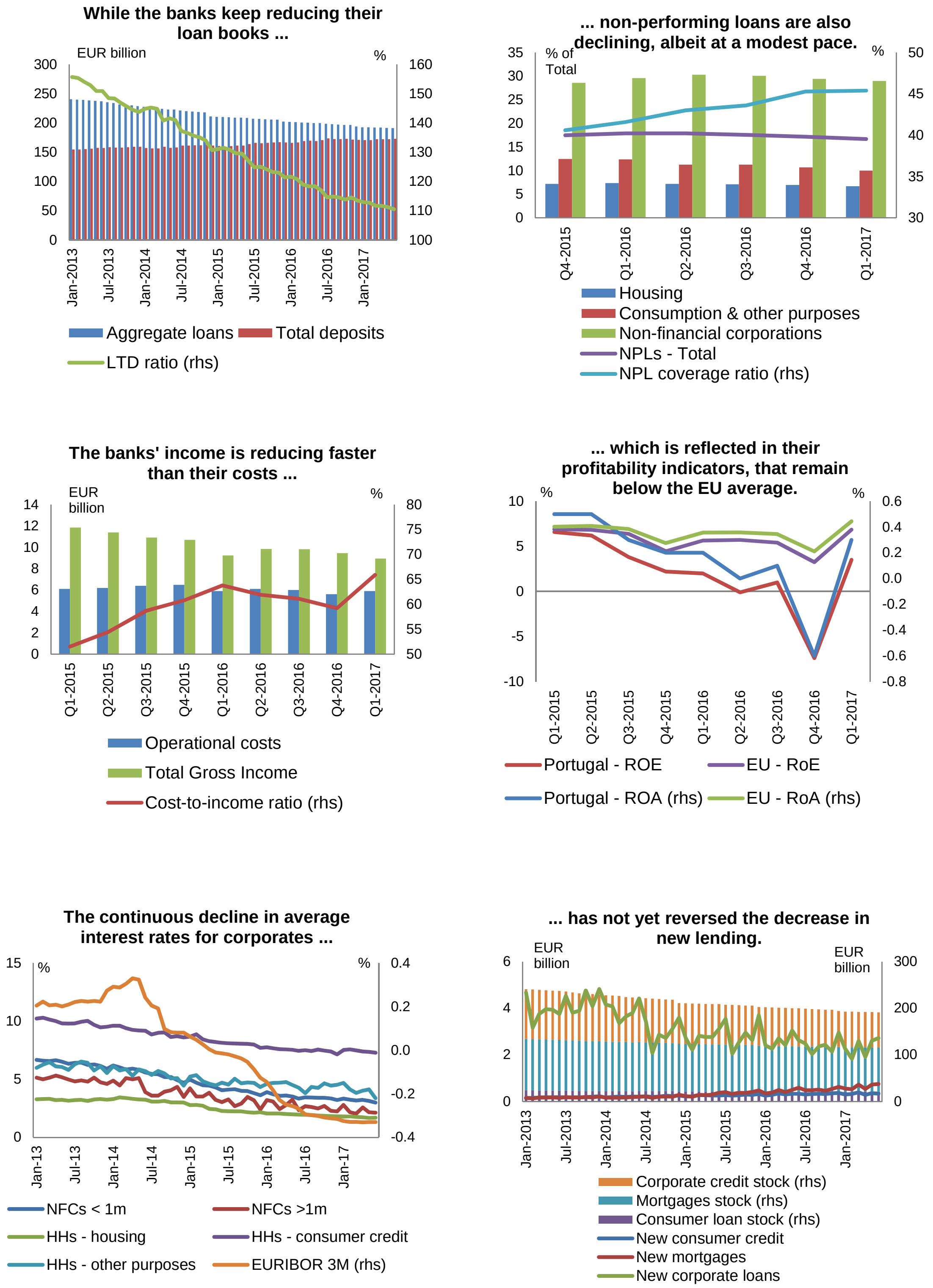


Exports of Services (Balance of payments data, y-o-y % nominal change, 3mma)Jun-17
Imports of services (Balance of payments data, y-o-y % nominal change, 3mma)Jun-17

Source: Banco de Portugal.

Source: European Commission

Graph 2.12: **Recent financial developments**



Source: European Commission

3. POLICY ISSUES

3.1. PUBLIC FINANCE

The Commission 2017 spring forecast projects a general government deficit of 1.8% of GDP in 2017. This compares to a projection of a general government deficit of 1.5% of GDP in 2017 in the Stability Programme, 0.1% of GDP below the 2017 draft budget. The revised target mostly results from the 2016 carry-over, the upward revision of the macroeconomic outlook and downward revision of interest expenditure, partially offset by lower revenue from sales and higher capital expenditure to partially compensate the carry-over from 2016 under-execution. The 0.3% of GDP divergence in the headline deficit projection between the spring forecast and the Stability Programme stems from lower growth of social security contributions in the spring forecast (0.1% of GDP) due to more conservative assumptions based on past elasticity trends, and expected pressures for expenditure (about 0.2% of GDP). The latter are mostly related to compensation of employees (based on the 2016 track record of rising public employment as opposed to the planned decrease) and to intermediate consumption and social transfers (as their planned spending containment is not fully explained by measures).

For 2018, the Commission 2017 spring forecast expects a general government deficit of 1.9% of GDP, 0.9% of GDP above the Stability Programme target of 1.0%. The discrepancy reflects the carry-over from 2017, a less optimistic macroeconomic outlook, less favourable expectations for revenue (-0.4% of GDP) and current spending (+0.5% of GDP) in the absence of sufficiently specified containment measures. As regards fiscal measures, the Stability Programme indicates as main deficit-reducing measures for 2018 0.2% of GDP in the freezing of intermediate consumption, 0.1% of GDP from the freezing of other current expenditure and savings from interest expenditure (0.1% of GDP). As deficit-increasing measures the Programme considers 0.1% of GDP in reduction of Personal Income Tax (PIT) for low income households and about 0.1% of GDP from the unfreezing of careers. Taking also into account the deficit-increasing carry-over from the 2017 reversal of the PIT surcharge on higher tax brackets (0.1% of GDP) and the higher expenditure from pension increases (around 0.1% of GDP) the Stability Programme implies a broadly neutral impact of measures on the 2018 deficit. The 2017 spring forecast factors in the carry-over impact of the PIT surcharge reversal and the pension adjustment and the impact of the PIT reduction and unfreezing of careers at full yields, but applies a haircut of 50% to the freezing of intermediate consumption and other current expenditure as the Stability Programme fails to sufficiently specify how the corresponding yields would materialise.

The structural balance is projected to deteriorate by 0.2% of GDP in 2017 and 0.1% in 2018 in the Commission spring forecast. This deterioration differs from the 0.3% and 0.6% of GDP improvement of the structural balance reported in the Stability Programme. The difference between the spring forecast and the authorities' projections stems from the differences in the headline projections and less optimistic assumptions on potential growth.

For both 2017 and 2018, positive as well as negative risks to the Commission forecast could emerge. Positive risks would stem from further improvements of the macroeconomic outlook while negative risks could originate from the potential budgetary impact of bank support measures and possible higher spending pressures. Based on the significant improvement of the macroeconomic outlook since April (based on Q1 outturn and early indicators for Q2) and the budgetary execution in cash terms up to May, the authorities expressed in the PPS mission meetings their confidence to be able to reach both the nominal and structural budgetary targets for 2017 planned in the Stability Programme. Potential mostly macro-related improvements of the headline deficit as compared to the Commission spring forecast would however tend to be accompanied by a more positive output gap and can thus not be expected to entail a corresponding improvement of the structural balance as compared to the Commission forecast.

The Commission forecast projects a debt-to-GDP ratio at 128.5% in 2017 and 126.2% in 2018. Portugal’s gross public debt-to-GDP ratio has slightly risen to 130.4% in 2016, mainly due to higher issuance of government debt for the public

Table 3.1: **Fiscal adjustment 2010-2018**

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Budget balance	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-1.8	-1.9
Budget balance, net of one-offs	-8.5	-7.3	-5.6	-5.1	-3.3	-3.1	-2.3	-2.0	-1.9
Structural balance	-8.4	-6.6	-3.5	-2.9	-1.7	-2.3	-2.0	-2.2	-2.4
Primary balance	-8.2	-3.1	-0.8	0.0	-2.3	0.2	2.2	2.4	2.2
Structural primary balance	-5.5	-2.2	1.4	2.0	3.2	2.3	2.2	2.0	1.7
Fiscal adjustment	0.1	3.3	3.7	0.5	1.2	-0.9	0.0	-0.3	-0.3
Fiscal effort	0.2	1.9	3.1	0.6	1.2	-0.6	0.3	-0.2	-0.1

(1) Fiscal adjustment is measured as the change in the structural primary balance; fiscal effort defined as the change in the structural balance.
Source: European Commission Services 2017 Spring Forecast

recapitalisation of the state-owned bank CGD finalised in March. The ratio is forecast to decline by around 2pp per year to 128.5% in 2017 and to 126.2% in 2018, due to primary budget surpluses and continued economic growth. This debt profile is less optimistic than the one laid out in the Stability Programme on account of lower primary surpluses and less favourable economic growth projections.

3.2. FISCAL-STRUCTURAL ISSUES

Spending control remains challenging and benefits from the spending review are set to materialise only gradually without predefined savings targets. Expenditure controls and containment have somewhat improved due to the application of the commitment control law. However, rising arrears point to inadequate accounting, budgetary planning and control, especially in hospitals. Moreover, the potential savings of the spending review launched in 2016 are set to remain relatively moderate (around 0.1% of GDP over a three-year period for the expenditure review according to the 2017 Budget) as no predefined savings targets are set. The review has so far focussed on health and education ministries, state owned enterprises, (centralised) public procurement and real estate management, all areas that are deemed by the authorities as potentially yielding large efficiency gains. The authorities currently (plan to) extend the scope to internal administration (catering, uniforms, special mobility, shared services etc.), and justice. Moreover, a new performance incentive programme has been launched, including premiums of up to one salary for innovative ideas bringing spending reductions above EUR 50 000. The spending review would benefit from a further broadening that would cover a significant share of general government spending across several policies as well as a set of concrete targets for savings. A more comprehensive approach might include setting specific goals at each line ministry in order to improve ownership, establishing multiannual saving targets and related annual expenditure ceilings on the basis of expenditure reports prepared by line ministries. It should ensure that spending ministries adopt internal spending reviews under a strict budget constraint as well as reforming the budgetary process to be more in line with a performance-informed budgeting approach over the medium term. It could also explore various opportunities, including deletion of tax expenditure that provides incentives no longer needed or streamlining of existing bodies as mandates become obsolete.

Several reforms have improved the long–term sustainability of the pension system in recent years but its reliance on budgetary transfers remains high. Reforms taken before and during the adjustment programme contributed to lower the costs of the system in the long term by, among others, introducing disincentives to early retirement, raising the retirement age to 66, and linking future increases to life expectancy at age 65. Yet, costs in the short to the medium-term remain high. Although the authorities are committed to eliminate extraordinary budget transfers by 2019, planned revisions of the existing pension system, in particular the reduction of the disincentives for early retirement will require compensatory measures to maintain the achieved level of sustainability.

The expected reform of early retirement rules is going to be applied progressively as from October 2017. In the framework of consultation with social partners, the Government has presented a proposal according to which new rules for early retirement comprise the elimination of the sustainability factor (a discount of around 14% on all early retirement pensions), a different scheme for the reduction in the legal age of retirement according to career length in combination with the general maintenance of the penalty of 0.5% per month of the distance to the legal retirement age. The minimum age for early retirement is 60 in 2017 but will evolve in line with the general legal age of retirement. Following the consultation with social partners, new rules for very long careers -the penalties are eliminated altogether or reduced ([6]) – are to be applied already as from October 2017. The minimum age for early retirement is 60 in 2017 but will evolve in line with the general legal age of retirement. The minimum career length is set at 40 years reached but can now only be granted by the age of 60. In order to better accommodate this estimated impact, the new model is planned to be introduced in a gradual approach([7]).Initially, the new model was only planned to be applied to the flexibility regime of Social Security but some degree of alignment of other regimes to the new model was also considered possible([8]).

The compensation for the financial impact of the new rules will need to be found in the 2018 budgetary process. The authorities have expressed their strong commitment to fully compensate the financial impact of the change of early retirement rules in order to maintain the achieved level of financial sustainability of the pension system. However, the potential yield of the new([9]) alternative financing sources already under discussion, i.e. regarding means testing, the review of contribution exemptions and discounts and the review of the self-employment regime would a priori appear to be limited, in particular as these areas have already been tentatively addressed at previous occasions. In order to ensure lasting sustainability, alternative compensatory financing with an adequate financial cushion to accommodate the financial impact of the new rules would therefore need to be found in the 2018 budgetary process.

The quality and access to healthcare has improved, but its financial viability has not. Several measures have been implemented to improve the efficiency and sustainability of the healthcare sector. These include the centralisation of the procurement of goods and services, a larger use of generics eligible for public reimbursement, reduced prices of pharmaceuticals, shorter waiting lists and a higher number of family health units. The access to primary healthcare and prevention measures continue to expand. Yet, while the hospital reform continues (including the use of hospital benchmarking tools), the large increase in arrears in the course of the year signals weak budgetary planning and control in hospitals. From December 2016 to July 2017, health sector arrears increased by EUR 248 m. Further, the earmarking of the extension of alcoholic drinks tax (IABA) to sweetened drinks (levy on drinks with added sugar should be worth EUR 80 m in 2017) is intended to address the sustainability of the National Health Service. Nonetheless, the use of appropriations at year end and revenue from the levy on sugary drinks, while helping to reduce the stock of arrears, do not address the factors behind its growing trend. This would require more accurate and balanced budgeting, enhanced controls and a more effective enforcement of the commitment control law.

The implementation of the reformed Budget Framework Law (BFL) that entered into force in September 2015 has experienced some delays. The Law is designed to make budget units more accountable, strengthen the medium to long-term focus of public finances by introducing programme-based budgeting, setting expenditure ceilings until the medium term and aligning the deadlines with those of the European Semester. It also allows for a three-year transitional period for applying most new features. Together with the implementation of an integrated public accounting system, the BFL will improve management ownership and ensure effective budgeting, as well as budget implementation, monitoring and reporting at all layers of public administration.

([6]) Eliminated if career is above 48 years or above 46 years if started before the age of 15 or reduced by 0.4% per month if career above 40 years and started before the age of 16.

([7]) From October 2017 applies to careers of 48 years or more and to early entrants into the labour market. Tentatively as of 2018 to workers from 63 years of age and as of 2019 to workers from 60 years of age upwards.

([8]) Thus, the Council of Ministers of decided on 24 August to extend the first phase also to public employees in the CGA pension system.

([9]) In addition to the new progressive tax on real estate assets (on top of the IMI) that is earmarked to the Social Security's Financial Stabilisation Fund and thus not covering current expenditure.

Following approval of the decree law on its operating rules the new BFL's implementation unit has convened several times. While work on the state accounting entity project has been progressing, the decree law on the setup of the new budgetary programmes is still outstanding. The authorities remain committed to decide the structure of the budget under the new BFL by August 2017, to start the effective application of the new accrual-based public accounting framework in January 2018 and to prepare the 2019 budget under the new framework. Given the cumulative delays in BFL implementation, there remain however risks to its full completion by the 2018 target, which may also lead to postponement of the application of some of the new features.

The wage bill increase signals that the public employment reforms are no longer aimed at reducing costs. Following the reintroduction of the 35 hours working week for public employees as of July 2016 and the gradual full reversal of public sector wage cuts by October 2016, the 2016 wage bill increased by 2.8% in nominal terms, significantly above the 2016 budget and the 2016 stability programme estimates. The average headcount of public employees increased by 0.9% in 2016 notwithstanding the 2:1 replacement ratio rule. This tendency of increasing numbers of public employees appears to be confirmed by the evolution in Q1 and Q2-2017 that recorded further 1.0% and 1.3% y-o-y increases in the number of public employees, in particular due to high increases in the areas of health and education. At the same time the government has launched a wide-ranging programme to convert temporary contracts for permanent tasks in the public sector into permanent contracts (concerning an estimated 20,000 people) ([10]). For 2018 the government plans to gradually unfreeze career progression – which has been frozen since 2010 - with a provisional estimated incremental cost of EUR 250 million a year from 2018 to 2021.

A systematic response to structural problems in the administration is needed. Further work would be needed towards the rationalisation and modernisation of the public administration, within the limits of the budget, while ensuring an efficient delivery of public services by motivated and qualified staff. Possible policy options might include enhancing mobility schemes, merit-based career, intensive training as well as personnel evaluation on the basis of performance as foreseen in the law. It would therefore appear important to already design the upcoming unfreezing of career progressions accordingly.

There is gradual progress in local administration reforms. Local and regional debt and arrears have declined steadily since 2013. The Municipality Support Fund (FAM – a debt workout mechanism for over-indebted municipalities) has continued its disbursements worth a total of EUR 215 million. The Financial Coordination Council, set up in January 2014 and with members appointed in June 2016, has not been convening regularly. The Directorate-General for Local Administration (DGAL) and Directorate-General for Budget (DGO; on regional government) have started to monitor local State-Owned Enterprises (SOEs) and PPPs. The partnership between the Ministry of Finance’s task force for SOEs monitoring (UTAM) and DGAL will be key to ensure good quality reporting. A decree law from July 2017 creates the obligation for local SOEs to provide direct information without going through the local authorities, while information on local PPPs has been reported quarterly since 2016. The government has launched a decentralisation process on a wide range of domains to increase the share of resources spent at local level. 20 sectoral are being prepared in parallel to parliamentary discussions on a framework agreement. A review of the local finance law that is needed to adjust human resources and local finances is being prepared together with the sectoral diplomas and may contribute to delay parliamentary discussions. The roll-out of "citizen spots" and "citizen shops" is progressing allowing inter alia local administration to reduce real estate needs.

Some relatively minor tax policy shifts are being implemented in 2017 and envisaged for 2018. Regarding PIT, the surcharge is going to be completely phased out also for higher tax brackets in 2017. CIT rules have been broadly kept stable in 2017 except for a limited broadening of the scope of the allowance for corporate equity (ACE) intended to decrease the corporate debt bias. A

([10]) While the temporary workers are already included in the public employment statistics, the conversion of their contracts into permanent contracts may increase the long-term liabilities of the State.

new VAT exemption regime on imports is expected to start in September 2017, without any expected impact on the government balance. The 2017 budget also introduced the new progressive additional real estate tax (AIMI) earmarked to the Social Security's Financial Stabilisation Fund. The tax collection up to May for the tax on sugary drinks was considered in line with the authorities' expectations. As indicated in the Stability Programme, a change in the personal income tax brackets in favour of low-income earners with a budgetary cost of EUR 200 million is planned to be included in the 2018 budget law. The revenue from other taxes included in the Stability Programme will also still need to be specified in the upcoming draft budget. Regarding CIT, while the expiry of some sunset clause legislation for tax expenditure is being considered, the rules are expected to remain broadly stable. Further tax policy shifts are being studied for later years that could affect other taxes, but no clear timeline has been set.

The financial viability of SOEs remains fragile due to a high debt burden but total operational results are positive exception for some sectors. As of the end of 2016, the non-consolidated debt in SOEs accounted for 23.7% of GDP and around half is from transport companies. The SOEs debt ratio dropped by 0.9pps in 2016 significantly slower than private companies and in comparison with 2014 and 2015 when the debt ratio of SOEs decreased by 2.2pps and 1.8pps respectively. In the first half of 2017, non-consolidated debt dropped marginally to 23.2% of GDP at the end of June, of which 19.8% for companies in the general government and 3.4% for those outside the general government. The high debt burden contributes to a consistently negative net income of SOEs. However, positive operational results for the whole sector show that most SOEs are financially balanced in the short term. Concerns remain on important parts of the sector where high negative operational results prevail such as the health sector, namely hospitals, and urban rail transport. However, according to authorities’ calculations, cost-coverage ratios of urban transport companies, particularly the metro transport in Lisbon and Porto compare favourably to peers in other countries. Also Q3 2017 saw a positive improvement in operational results of Metro de Lisboa due to an increase in revenues. The Government plans to revise Public Service Obligation Contracts with urban transport sector SOEs within the 2018 budget. This measure aims to increase the predictability of transfers from the State Budget to the SOEs with a positive impact in operational results of the companies.

The Government is putting forward measures to improve the sustainability of the SOEs. A debt management plan and recapitalisation is ongoing to reduce indebtedness and lower interest costs. The central Government takes over SOEs debt lowering interest costs. In some cases the credit given to the company by the central Government is then converted into capital reducing the indebtedness. This creates moral hazard risks as enterprises are less motivated to improve efficiency and financial performance. Therefore, to improve long-term sustainability objectives for better efficiency, improved net income and reduced burden on the State Budget would need to be put in place. A first step would be to have a more regular monitoring aimed at tracking progress over sector-specific efficiency targets, also using international benchmarks and best practices. Some steps are being taken to assess urban transport and port services using international metrics. Currently monitoring is focused on spending, with any increase in spending needing the approval of the finance ministry but there seems to be no clearly defined criteria for such an approval. In the context of the spending review the authorities are working on a new monitoring tool. However, at the time of the mission this was still not in place and the latest data available on SOEs was from Q3 2016. The authorities estimate that the aggregated net income of SOEs improved in 2016 relative to 2015 as some of the pending corporate results are expected to be favourable. Preliminary results for the first quarter of 2017 are also showing some improvement though quarterly numbers are volatile, with coverage and data quality issues, and cannot lead to strong conclusions.

Future PPPs and concession contracts should build on a realistic risk matrix to avoid repeating the high costs of current contracts. The decision making model for awarding PPP contracts by the central government has imposed a comprehensive decision making tree aimed at involving a wide range of stakeholders and assuring correct risk allocation and value for money and affordability evaluation. The model relies heavily on cost-benefit analysis and simulations reviewed also by independent private experts and the Court of Auditors. The model has only recently been tested in practice with the new PPP of the metro in Porto currently under tender. The decision making tree is not formally binding for other public contracts such as the port concessions and local governments but the national authorities are reportedly using main elements of the new approach at a larger scale. Given the large burden of inherited losses in relation to previous PPPs, namely motorway, it would be advisable for the state administration at all levels to apply the new decision making model once it is tested.

3.3. FINANCIAL AND CORPORATE SECTORS

The issue of legacy non-performing assets has been recognised by the authorities as a key vulnerability of the financial system, mostly concentrated in some of the largest lenders. The NPLs originating from non-financial corporations, which make 65% of all NPLs as of end-2016, are being targeted in particular. Following a detailed analysis (exhaustive overview of the banks' bad loans by type, vintage, size and sector of activity), the issue of corporate NPLs is being addressed by a three-pronged strategy: changes to the judicial, legal and tax system, prudential/supervisory actions led by the central bank following SSM guidance and NPL management solutions. All three work streams are either finalised or work in progress. Oitante, the asset management vehicle owned by the Resolution Fund, continues with its divestments. It has sold most of its financial stakes and is turning its focus on sales of NPL and real estate owned. On a five year horizon, it expects a return of about EUR 1 billion.

With the new legal framework and the SSM supervisory guidance in place, the focus moves towards active NPL management. The legal framework addressing the treatment of distressed corporate debtors in difficulties has been revamped. Changes include both the out-of-court mechanisms (comprising options for debt to equity swaps which can be enforced in court under certain conditions and a new out-of-court regime for corporate recovery) and judicial mechanisms such as the pre-insolvency PER and the insolvency procedure itself. The supervisor also facilitates the solution for NPLs through guidance on best practices, NPL reduction plans and acknowledgment of the NPL reduction effort in the supervisory review and evaluation process (SREP). Lastly, various NPL management solutions are being elaborated including a coordination platform where banks must work towards finding joint solutions for NPLs that have been outstanding with more than one lender. Details of the operational aspects of this platform are yet to follow. Moreover, the authorities committed to efforts towards developing a secondary market for distressed debt.

Identification of firms that are viable and those that should be liquidated is crucial. The riskier enterprises are deleveraging faster, but still represent the most of the corporate debt stock. A third of all SME NPLs is over three years past due, whereas that percentage increases to close to half for firms active in the construction and real estate segment. While there is continuous inflow into the over three years past due NPL category, there is also outflow due to resolution, mainly write-offs. Importantly, a substantial number of NPLs is shared among multiple banks.

The recovery process of viable firms is being facilitated but the proceedings for insolvent firms remain long. The new set of rules for the in-court pre-insolvency restructuring of firms (PER) are meant to prevent non-viable firms from misusing it ([11]). This should allow for a clearer distinction between non-insolvent firms recurring to PER and court insolvency processes being used for insolvent firms. Besides, an out-of-Court regime for companies' recovery (RERE) has been developed. However, it remains to be seen whether it will incentivise the use of faster out-of-court proceedings: while PER and judicial liquidation result in a "judge-stamped" document enforceable towards everyone, currently out-of-court arrangements are only binding towards participating creditors. Other new instruments such as a Business Recovery Mediator providing assistance to SMEs, a legal framework for out-of-court collateral repossession as well as for debt to equity swap could further contribute to facilitate firms' restructuring. Most difficulties remain on the

([11]) This will be ensured through new requirements including a declaration issued by an accountant or auditor certifying that the company is not insolvent and a first proposal of the recovery plan with the agreement of at least 10% of non-subordinated creditors.

side of the proceedings for insolvent firms. Their average duration is still high in European comparison (around 40 months in 2016) and the resulting credit recovery rates are below 8% of the nominal values.

Preparations for achieving the mandated bail-inable instruments stock are on the horizon. Although the exact amounts of the minimum requirement for own funds and eligible liabilities (MREL) and the applicable transitional period are yet to be determined, the authorities have been liaising with the largest banks to estimate future needs. Achieving the future mandated amounts by the end of the yet to be determined transition period will in most cases imply a combination of the risk weighted assets reduction and wholesale funding issuances. It is expected that banks, domestic and foreign, will be operating on a similar timeline, and the aggregate impact on the market is as of now unclear. As most Portuguese banks aimed to decrease their dependency on wholesale funding over the past years, MREL may represent a challenge, so adequate strategies should be developed timely.

A working group was set up to propose changes to the financial supervisory framework. Following the bank failures that have been stressing the Portuguese financial sector since mid-2014, the Portuguese government is aiming to revamp the financial oversight. A set of measures, including a possible new financial supervisor, are under consideration and will be discussed during a public consultation process ([12]) in the second half of 2017. As of the 5th September the draft proposal was not yet sent to the relevant European Institutions for their opinions.

Novo Banco's sale is under way. The Resolution Fund (RF) intends to sell 75% of Novo Banco (NB), the 'good' bridge bank carved out of Banco Espírito Santo in August 2014, to Lone Star, an American private equity firm. The agreement also depends on the success of a Liability Management Exercise (LME) that includes the conversion of circa EUR 3 billion of senior bonds into cash, creating a minimum CET1 of EUR 500 million thus strengthening Novo Banco's capital ratio alongside the capital injections the potential acquirer will have to do, according to the terms of the transaction, in the following years.

3.4. STRUCTURAL REFORMS

Labour Market

Employment recovery continues but labour market segmentation remains high, weighing on the career prospects of younger workers. The unemployment rate has been steadily decreasing, although youth unemployment (22.7% in Q2 2017) and long-term unemployment (5.3% in Q12017) remain high. Over the last quarters, employment has increased faster on open-ended contracts than on temporary contracts, but labour market segmentation remains high with 21.2% of employees on fixed-term contracts in Q1-2017 and 22.1% in Q2, one of the highest in EU. Younger workers are disproportionally affected by temporary contracts while also suffering from higher unemployment rates. This affects the career prospects of younger workers. More than two thirds of the people who emigrated permanently in 2015 were below 35 years old ([13]). This situation is particularly worrying in terms of growth and productivity since younger workers have on average higher skills than the rest of the labour force.

The Government's strategy so far relied mainly on financial incentives to reduce segmentation rather than tackling remaining rigidities in the legal framework. Already implemented is the re-orientation of employment support measures to promote hiring on open-ended positions. A reinforcement of labour inspectorates, aimed to prevent abuse of temporary contracts and "bogus" self-employment, is ongoing. As unemployment decreases the Government is looking at the possibility of revoking the Labour Code norm that allows hiring long-term unemployed and people looking for their first job on fixed-term contracts without further justifications. The authorities are also considering differentiating firms' social security contributions according to the type of employment contract used and making hiring on

([12]) Following expert contributions, in January 2017, an independent Working Group coordinated by the former president of the Portuguese Securities Market Commission was commissioned to draft a report with an assessment of the current system of financial supervision and to present a proposal for the corresponding changes.

([13]) Source: Observatory for Emigration.

temporary contracts relatively more expensive. If implemented, this measure would need to account for the fact that some job positions are inherently of a temporary nature. However, as highlighted in previous Post-Programme Surveillance reports and by the OECD ([14]), financial incentives would not tackle the underlying problem of remaining rigidities concerning individual dismissals of permanent workers. This includes for example the uncertainty in terms of firing costs highlighted in the 2017 Country Report, the lack of clarity concerning conditions under which employers can dismiss individual workers for economic reasons, or the still complex procedural requirements highlighted by the OECD. Measures to tackle labour market segmentation are currently under discussion with social partners, based on the Green paper on labour relations presented in March 2017.

The focus of active labour market policies is shifting towards permanent contracts and vulnerable groups. The planned one-stop-shops will provide an integrated set of services to individuals and employers giving different options depending on their profile, and ensure coordination with other public services, notably social services. Although still under technical development (implementation is planned only for Q1-2018), their main goal is to improve the effectiveness of activation measures and focus on the long-term unemployed, as well as younger and older workers.

In a context of moderate wage growth, wage floors are increasingly binding with the rise in the minimum wage. The Government will initiate discussions with social partners in view of an agreement for the level of minimum wage in 2018. The final decision needs to account for the possible impact on employment of lower skilled workers and on competitiveness in particular given the fact that the minimum wage increased already by 15% since 2014. The quarterly reports on the impact of the minimum wage produced by the Government provide a good basis for the discussions. According to the latest publication, 22.9% of workers were covered by the minimum wage in March 2017([15]). On average, wage increases agreed in collective agreements have been moderate (largely below 1% in real terms over 2016 and in Q1 2017).

Changes to the collective bargaining framework were recently introduced. In 2009 the rule for a collective agreement to expire if not renewed was introduced and the expiry period in 2014 further reduced. It contributed to avoid inertia in collective bargaining by perpetuating collective contracts and allowed wage setting to be more responsive to productivity developments. Even though the number of collective agreements is steadily increasing since 2012, the Portuguese authorities considered that the expiry rules had sometimes been used by employers as a way of inducing stricter conditions for workers and thereby hindering social dialogue. Therefore, in January 2017 the Government and the majority of social partners agreed not to use the expiry rule for collective agreements for a period of 18 months until July 2018. Their objective is to promote social dialogue and to increase confidence in current rules. This temporary suspension puts into question the future use of the expiry rule, which could introduce more rigidity in wage setting. The solution after this suspension period should allow for collective agreement to adjust to economic developments by encouraging regular negotiations. In the first quarter of 2017 an increase in the number of administrative extensions of collective agreements was recorded, amounting to almost as many extensions as in the entire 2016. The quasi-automatic extensions of agreements with low coverage rates of both employer organisations and trade unions can lead to the imposition of a large number of sector/occupation wage floors which do not necessarily represent the economic realities of non-signatory firms. However, a Government resolution of June 2017 (82/2017) introduces new time limits and criteria for the issuance of administrative extensions. It includes the analysis of a number of economic variables and revokes the proportionality criteria for extensions (having at least 30% of SMEs). The impact of these new rules will be monitored in the following quarters.

Education and vocational training

The Qualifica Programme can contribute to upgrade the skills of the labour force. Since 2011 there was a remarkable progress in improving the skills level of the labour force. From

([14]) OECD (2017), Labour Market Reforms in Portugal 2011-2015, Preliminary assessment.

([15]) GEP (2017), Acompanhamento do Acordo sobre a Retribuição Mínima Mensal Garantida, 31st May 2017.

61% in 2011, the percentage of low skilled (i.e. individuals with lower secondary education or below) decreased to 48% in 2016([16]). However, the low skill level remains an important barrier to productivity increases which is evident when compared with the EU average where only 18% of the labour force is low skilled. The new Qualifica Programme being implemented by the Government is an improvement compared with previous qualification recognition programmes since it includes a stronger training component for participants. It has also a broad coverage, through an expanded network of qualification centres, expecting to reach half a million participants up to 2019 focusing on low-skilled workers.

The increase in the number of teachers needs to effectively contribute to improve school outcomes. Due to its functions the Ministry of Education has the largest number of staff in central administration which has been steadily increasing since 2015. It should be ensured that the employment of new teachers serves better school outcomes and does not lead to an underuse of teaching staff.

Autonomy contracts will not be renewed. Signed during the adjustment programme with a pilot group of schools, they gave compensation in resources to schools able to make savings on their annual budget. These types of contracts will not be renewed. New agreements with schools are being created that do not include this type of financial incentives, focusing rather on pedagogical programmes to improve student performance.

Transport sector

Following a long period of standstill, the renegotiations of the port concessions are advancing. The renegotiations of Douro and Leixões Port public service concessions have been concluded. The agreement includes new investments paid by the concessionaire and the obligatory introduction of a minimum discount for port operations. The contract renegotiation for the Alcântara Terminal in Lisbon is now being initiated. The renegotiation of concession of two smaller ports (Setubal and Aveiro) is still outstanding. The challenge also remains to ensure that the gains from the renegotiations effectively benefit port users. The concession process is reportedly based on efficiency criteria and transfer of risks to the private operator but there seems to be no systematic form of reporting transparently on awarding criteria. Port concessions are also not fully covered by the decision model used at central government level for PPPs. A new framework law for port concessions that would introduce performance-oriented objectives in contractual agreements for concessions could help in this regard. Such a law has been in the Government's plans for more than three years however its drafting is being delayed.

Ports reported a significant growth of services in 2016 and the first quarter of 2017 led by Sines and Lisbon. Operations are supported by the country's growing foreign trade as well as international services related to transhipments. Expansions at Sines and Lisbon, access to new transhipment lines, and the positive economic cycle are expected to further support port operations, both on the cargo and cruise segments. A single invoicing model has been implemented at the beginning of 2017 to improve the efficiency of the port administration by simplifying and harmonising operations across ports. The authorities are meanwhile working on a new system for optimising costs – European Benchmarking of Port Costs – based on a comparison of major Portuguese commercial ports to international peers. The project is set to be finalised in the second half of 2017.

Investments under the new strategy for commercial ports competitiveness need a careful risk assessment. In December 2016, the government approved a strategy for boosting the competitiveness of the Portuguese ports. The strategy envisages ambitious investment plans in port operations and adjacent infrastructure as well as expanding the value added chain of ports by attracting investors in supporting activities not directly related to shipments. The projected investments are expected to be generated mainly by private companies, but the strategy also relies on developing related public infrastructure. While the strategy is aimed at supporting investments in mainly export-oriented activities, investment risks need to be carefully assessed. There are a large number of ports in the country operating in a very competitive environment.

([16]) Eurostat data: Employment by sex, age and educational attainment level (1 000) [lfsa_egaed]

The new governance models for urban transport SOEs are still being concluded. The bus transport SOEs of Lisbon and Porto are being transferred to the respective municipalities. This should reduce the burden on the central government budget of new expenses but the long-term debt is being totally integrated in the general government debt. At the time of the mission, the Transport Regulator (AMT) had not received for opinion the new contract for Carris (bus transport) to be signed with the Lisbon Municipality. The future operating and financing models for Metro de Lisboa were still being discussed at the time of the mission. Although highly indebted, new investments are being proposed with a financing scheme being developed but the governance framework is still not in place. The Government however expects that the new investments will have a positive impact on annual operational results. A new PPP contract for Metro do Porto replacing the current sub-concession is expected to be in force in April 2018 with some improvements, namely a risk allocation between public and private partner that should reduce contract costs. The AMT already gave a favourable opinion on the tender documents for the PPP contract currently under tender. The Government needs to ensure that the new governance models contribute to the sector's long-term sustainability.

Energy system

The electricity tariff debt is now decreasing and its early elimination requires that no new costs are added to the system. The electricity tariff debt decreased for the first time in 2016 and is expected to decrease again in 2017 from a peak of EUR 5.1 billion in 2015 to EUR 4.4 billion in 2017. In terms of its complete elimination, there is some degree of uncertainty since it could take up to 2025 in a negative scenario. The authorities however are committed to a more optimistic 2022 elimination target. For this to be possible no new costs should be added to the regulated component of the energy tariff. Further reducing rents where they remain excessive could facilitate a faster reduction of the electricity tariff debt. An extraordinary contribution on the energy sector paid by market players yielded revenues of EUR 208.7 million in 2016 and 2017 combined. However, only a third is allocated to reduce the electricity tariff debt with the remaining going to the general State budget.

Recent measures are contributing to improve the long-term sustainability of the energy system. Mechanisms to ensure that there are no electricity shortages are becoming more affordable. For example, payments to energy producers to keep capacity available are now based on an auction and no longer on administrative payments and a similar compensation system for large energy consumers to stop using energy when needed is being studied. The energy regulator ERSE will be responsible for the final adjustment in CMECs (compensation to the energy incumbent for the energy market liberalisation) which should ensure a fairer compensation based on market conditions. An audit is also ongoing to assess if the compensation granted so far was too high. If this overcompensation is confirmed, the amount to be recovered will revert in favour of the National Electric System. The double funding of renewable energy production will also be eliminated during 2017 recovering already granted subsidies of EUR 142 million.

The liberalised energy market is improving but a new law might allow consumers to return to the regulated tariff. In April 2017 almost 80% of consumers were in the liberalised market. However, a new law to be passed in Parliament will allow for consumers who already benefited from the liberalised tariff to go back to the regulated market which might delay the transition process. A new platform is being created that should foster competition in the market. It will allow for a smoother transition between energy suppliers also informing the consumer about the best offer depending on its consumption profile.

Business environment and reform impact

While administrative simplification measures under SIMPLEX+ improve the business environment, barriers to competition in business services remain. The measures being implemented under the SIMPLEX+ programme are set to decrease the administrative burden on citizens and companies. The programme covers a broad range of areas in the public administration and focuses mainly on horizontal aspects of business activity. An assessment of the impact of selected measures has been concluded with positive results. The by-laws of certain regulated professions are less ambitious than the framework law in terms of opening up to competition. This is particularly true for the most restrictive sectors such as accountants, architects and lawyers given their economic importance. A study undertaken by the Portuguese authorities with the OECD and the European Commission is ongoing to assess remaining restrictions in these sectors. Once the final results are ready, in April 2018, the authorities will assess the need for further action on this matter. Licensing has been further streamlined, particularly in tourism, land and environment, but its implementation across the country is heterogeneous and there is still room to reduce construction fees.

The evaluation of structural reforms is improving in particular through the assessment of the direct impact of reforms. This is particular evident in terms of Regulatory Impact Assessment (RIA) that will also benefit from the European Commission's technical assistance. So far, the framework for the evaluation of structural reforms focused on the macroeconomic assessment. Recently, a more comprehensive governance structure for designing and evaluating structural reforms is being implemented. The Ministry of Planning and Infrastructures coordinates the National Reform Programme and in that context works with the line ministries to assess the direct impact of the measures in reaching the reform objectives. A small but growing set of quantitative indicators will also be used to set ex-ante quantitative goals and targets for policy measures. In terms of macroeconomic assessment, the increasing focus on productivity is welcome given its relevance to foster potential growth.

Judicial sector, public procurement and corruption

Corruption prosecution is improving while gaps in anti-corruption measures remain. Case and resource management of the national prosecution services has become more efficient and anti-corruption appears to become a priority. Some indicators still point to weak final conviction rates for high-level corruption. Overall, data gathering on corruption is improving. The enforcement of existing provisions and an adequate monitoring and sanctioning capacity are also challenging. The implementation of a comprehensive anti-corruption strategy covering whistle-blower protection, asset declarations, conflicts of interest or revolving doors would allow for better tackling and preventing corruption cases. Also, corruption prevention plans set up in each public institution seem to be largely formalistic since they are neither fully adapted to each organisation nor complemented by adequate monitoring.

The Public Procurement Code revision can improve competition in public procurement and the focus should now turn on better enforcement of procurement rules. There are still shortcomings as regards the transparency and reliability of public procurement data and procedures. In particular, intense use of direct awards is often not justified and ex-post evaluation of public procurement execution is weak. Transparency in concession contracts and PPPs is also hindered by contracting authorities' lack of expertise to manage complex contracts. The Public Procurement Code was approved by the Council of Ministers in May 2017 with the objective of transposing the European Public Procurement Directive. The new rules aim at promoting transparency and better management of public contracts, including concession contracts and PPPs. In particular a contract manager figure will be created to give support in technically and financially complex contracts. The revision will also bring stricter restrictions on the use of direct awards and include a prior consultation procedure in certain cases. What the new revision seems to leave out is the obligation of a mid to long-term planning for public procurement by the contracting authorities. Audits by the Ministry of Finance identified irregularities in the application of public procurement procedures including violation of rules. These irregularities increase costs and put at risk the quality of the works and services delivered. Action should be taken to further tackle the weaknesses identified in the audit conclusions.

The capacity of the justice system to reduce length of proceedings and cases backlog is improving but administrative courts are lagging behind. The clearance rate in judicial and tax courts was above 120% during 2016 allowing for an overall decrease in the number of pending cases. The same happened in civil courts albeit at a slower pace (114%). The average time needed to resolve a case in a civil court (length of proceedings) has decreased between 2015 and 2016 from 17 to 15 months. A decrease in the disposition time was also observed in the tax courts. Challenges persist in the administrative courts where the backlog of cases further increased in 2016. The clearance rate in administrative courts in 2016 remained below 100%, resulting in an increase in the number of pending cases. Also the disposition time of administrative court cases increased slightly. Measures are planned to reduce the high volume of pending cases and the length of proceedings. This includes inter alia allocating rapid reaction teams of judges to reduce the number of pending cases, case consolidation, improved case and court management and simplified proceedings. While results are improving, the large backlog of cases requires efforts to continue in this domain.

Housing market

House prices accelerate driven by high demand. The growth rate of house prices picked up from 3.1% in 2015 to 7.1% in 2016 and 7.9% y-o-y in Q1-2017 driven by domestic and external demand, particularly in tourist areas. External demand is also lifted by the country's programmes for issuing residence permits to investors (Golden Visa). The increase is more pronounced for existing dwellings, where prices grew by 8.7% in 2016 and 9.0% in Q1-2017 relative to 3.3% and 4.2% for new dwellings. Prices in tourist areas were more dynamic, especially in the capital city of Lisbon. The number of transactions increased at a much faster rate of 18.5% in 2016 and 19.4% in Q1-2017. The market volumes approached the latest peak from 2010 and the city of Lisbon as well as the tourist area of Algarve even reached new highs. Apart from demand factors, limited supply of new properties due to the 10-year crisis in the construction sector is also contributing to the upward price pressure on the market.

Prices of commercial properties grew at a slower pace. Despite increasing investor interest in the tourist sector, prices of commercial properties did not follow the residential market pattern and increased at a much lower rate of 2.0% in 2016, from 3.5% in 2015. There are however indications that part of the real estate market in tourist areas is moved by purchase of dwellings for reconstruction and use as commercial properties. This could explain part of the difference in the price dynamics on the two market segments and could be indicative of supply restraints.

Rental prices are increasing with the market becoming more dynamic. The rental price in Lisbon and Porto is increasing both for tourist as well as residential areas. The higher rental price in tourist areas can be an effect of the increase in tourism demand which also has a trickledown effect for prices in residential areas. Other reasons for higher prices in residential areas could be the end of most of the controlled rents and renovation works in existing dwellings.

The transitional period for the end of the controlled rent was extended and the housing market public monitoring system is still not in place. The 2012 rental market reform is being implemented. The transitional period has however been extended to ten years (five more than originally foreseen) but covers only a small proportion of residential rental contracts. The total number of non-residential contracts still covered by the controlled rent remains is also decreasing and is now less than 10% of all non-residential rental contracts. The setting up of a comprehensive public evaluation and monitoring of the housing market is yet to be implemented. With the current increase in housing prices, its conclusion becomes more urgent to monitor possible imbalances.

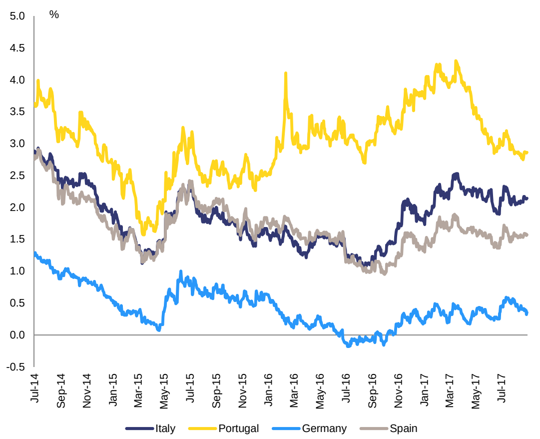
4. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Debt management has been smoothening the debt redemption profile. Buying back EUR 1.5 bn in debt with short maturity and the early repayment of EUR 5.3 bn of IMF debt in 2017 have smoothened the debt redemption profile, and changed the composition of outstanding debt towards government bonds (49%) of total medium and long term debt) and away from IMF-EU loans (26%) in 2017. Adding redemption of medium to long-term debt of EUR 7.7 bn, financing needs for the deficit of EUR 6.6 bn and for net acquisitions of financial assets of EUR 5.6 bn, the total borrowing requirements for 2017 are projected to amount to EUR 25.3, against EUR 22.5 bn in 2016. The increase relative to last year is due primarily to an increase in the net acquisition of financial assets. The borrowing requirements will be financed mainly by the issuance of government bonds (EUR 15 bn), floating bonds (EUR 2.2 bn) and retail products (EUR 2.5 bn). With the 2017 borrowing requirements in excess of financing, cash deposits are projected to decrease by EUR 2.8 bn before reaching a stock of 7.4 bn by year end. At the same time, auctions continue to make up a growing proportion as a method of issuance compared to syndications, which is an improvement.

Short-term financing needs are manageable. For 2018, the debt management office foresees total borrowing requirements of around EUR 17 bn, which includes EUR 5 bn of IMF early debt repayments. The 2018 borrowing needs are significantly lower than those of 2017 particularly due to lower net acquisition of financial assets and a lower deficit. These needs will be financed by a total of around EUR 16 bn in government bonds and retail products, as well as by a EUR 0.9 bn drawdown of cash deposits, which would result in an end-of-year cash position of EUR 6.5 bn. The gross financing needs (i.e. including the roll-over of short-term debt) are projected to reach around EUR 31 bn (16% of GDP) in 2018.

Falling yields, although still volatile, have significantly reduced borrowing costs for 10-year bonds since early 2017, improving funding conditions. A EUR 1 bn issuance of 10-year bonds took place on 12 July 2017 at a rate of 3.1% compared to the syndicated issuance in mid-January at 4.2%. Portugal has therefore returned to the yield level of early 2016 for 10-year bonds of around 3% before the increase which started in August 2016 and peaked in March 2017. Although the falling yields reflect improving macroeconomic conditions and fiscal outcomes, their evolution throughout late 2016 and early 2017 illustrates their volatility as well, and all credit rating agencies have maintained their previous ratings so far. ([17]) While the spread vis-a-vis the German bund reached 2.52% on 29 August 2017 compared to the peak of 3.85% on 17 March 2017, it remains significantly higher than the spread of 1.73% for Italy and 1.23% for Spain, although the gap between Portugal and the latter two countries narrowed by around half since the beginning of the year. As shown in the Debt Sustainability Analysis (Annex 1), the Portuguese debt-to-GDP ratio remains very sensitive to interest rate and growth fluctuations.

Graph 4.1: **10-year government bond yields**



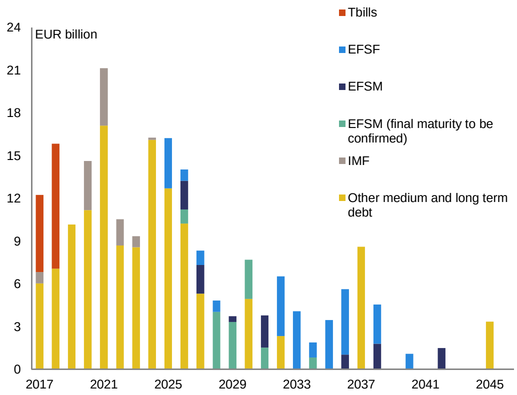
Source: European Commission

The medium to long term capacity to repay remains favourable and would be strengthened further by continued consolidation and structural reforms. The average maturity of Portuguese debt is at 8.1 years (July 2017) against the 8.5 years one year ago. The average cost of new debt has been increasing since 2015, with the IGCP projecting a rise to 3.1% in the first half of

([17]) While affirming its BB+ credit rating for Portugal, Fitch revised the Outlook from Stable to Positive on 16 June 2017. Moody's also revised Portugal's outlook from Stable to Positive on 1 September 2017. After the cut off date Standard & Poor's upgraded the Portuguese sovereign debt to investment grade.

2017 compared to the level of 2.8% in 2016. The cost of outstanding debt has been on a downwards path since 2014, falling to 3.2% in 2016. The medium to long term redemption profile remains manageable supported by longer average maturity and a declining implicit interest rate. Yet, under continued interest rate volatility and the expected reduction in the cash buffer, consolidation efforts to enhance the sustainability of public finance and more structural reforms that could boost potential growth would be essential for strengthening the capacity to repay in the long-term.

Graph 4.2: **Redemption profile**



(1) Last update: 17 August 2017
Source: IGCP

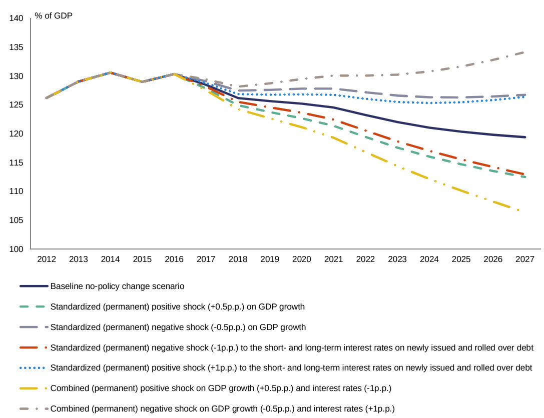
ANNEX 1
Debt sustainability analysis

This Debt Sustainability Analysis (DSA) uses the Commission 2017 spring forecast as a starting point to ensure cross-country consistency and to take into account second-round macroeconomic effects. The debt ratio in 2016 turned out at 130.4% of GDP, a 1.4 pps increase from 2015, mostly due to the issuance of EUR 2.7 bn in government debt in view of the bank support to CGD, which was finalised in March 2017([18]). For the outer years, the analysis rests on the following assumptions: it is assumed that (i) the structural primary fiscal balance remains unchanged at a surplus of 1.7% of GDP from 2018 under the no-fiscal policy change assumption, (ii) inflation converges linearly to 2.0% by 2021 and remains at that level thereafter, (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5% by 2025 in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group, (iv) real GDP growth rates of around 1%, and (v) ageing costs develop according to the Commission and EPC 2015 Ageing Report.

The baseline scenario results in an annual average decrease of the gross debt-to-GDP ratio by around 1 pp of GDP from 2017 onwards and thus ensures a declining path down to 119.4% of GDP by 2027. This declining debt trajectory is sensitive to financial market volatility and vulnerable to negative economic developments. Graph A1.1 presents a sensitivity analysis with respect to macro-economic and financial market risks. More precisely, the graph illustrates the sensitivity of the debt trajectory to a shock to real GDP growth and hikes in interest rates as from 2017. The analysis suggests that a lower GDP growth rate by 0.5 pps or a one percentage point increase in the interest rate on maturing and new debt would increase the debt ratio by 0.6% and 0.3% of GDP, respectively, in 2017. In both cases, debt would be at about 126% of GDP by the end of the projection period. A combined negative growth and interest shock could put debt-to GDP ratio on an accelerating path, reaching 134.2% of GDP by end-2027. On the other hand, a positive shock to medium and long-term growth or permanently lower interest rates would result in a more solid path of debt reduction by around 1.6 pps per annum to around 113% of GDP in 2027. A combination of higher GDP growth and lower interest rates could further accelerate the pace of the debt ratio reduction to around 2.2 percentage points per year, thereby allowing for a fall in debt to around 106% of GDP in 2027.

Additional fiscal consolidation would clearly accelerate the debt reduction path as shown in Graph A1.2, illustrating the effect of alternative fiscal consolidation paths. Full compliance with the requirements of the Stability and Growth Pact (SGP) would considerably further accelerate debt reduction. The SGP scenario assumes convergence to the Medium-Term-Objective (MTO) according to the matrix of required fiscal adjustment in Annex 2 of the January 2015 Communication on flexibility in fiscal rules ([19]). This would imply that the MTO of a structural balance of 0.25% of GDP would be reached in 2021 with a fiscal effort of 0.6% of GDP every year from 2017 to 2021, reaching a structural primary surplus of 4.3% of GDP in 2021. Maintaining the MTO over the longer term horizon will require structural primary surpluses of around 4.4% until the end of the projection horizon. Under these assumptions, the debt-to-GDP ratio would markedly accelerate its decline to around 3.3 percentage points per annum from 2020, falling to 98% by 2027.

Graph A1.1: **Macroeconomic risks: growth and interest rate**



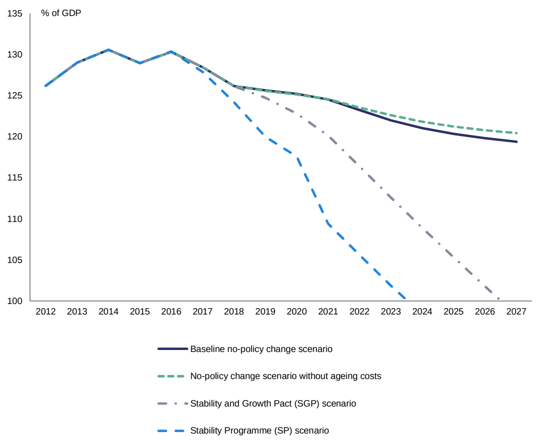
Source: European Commission

([18]) The 2nd stage of CGD's recapitalization was concluded in Mar-17, with issuance of EUR 0.5 bn of subordinated bonds and State capital injection of EUR 2.5 bn (DMO investor presentation July 4)

([19]) COM(2015) 12.

The 2017 Stability Programme scenario assumes a fall of the debt-to-GDP ratio to 127.9% in 2017. Based on the assumptions of increasing primary surpluses, a context of low interest rates and real GDP growth at around 2% from 2019 onwards, the debt-to-GDP ratio in the Stability Programme is projected to decrease rapidly to 124.2% at end-2018, 120.0% at end-2019 and 117.6% at end-2020. Such a scenario would be consistent with around 0.5% of GDP improvement in the structural balance for 2017-2020. From 2021 onwards, the primary structural surplus has been projected to remain at 4% over the entire forecast period, which would contribute to a significant fall in the debt ratio to below 90% of GDP by 2027.

Graph A1.2: **Fiscal consolidation and ageing costs**



Source: European Commission

Overall, the debt sustainability analysis shows that in the baseline scenario the debt-to-GDP ratio moderately declines in the short and medium-term. However, it would still be at a high level and is vulnerable to macro-economic and financial-market shocks. On the other hand, a solidly declining trajectory of the debt-to-GDP ratio can be achieved by maintaining fiscal discipline over the medium to long-term horizon. In addition, the solid reduction path crucially hinges on medium and long-term economic growth, which points to the necessity of persevering with the implementation of structural reforms.

ANNEX 2

European Commission macroeconomic and fiscal projections (2017 spring forecast)

Table 1: Use and supply of goods and services (volume)

Annual % change	2015	2016	2017	2018
1. Private consumption expenditure	2.6	2.3	1.9	1.3
2. Government consumption expenditure	0.7	0.5	0.4	0.5
3. Gross fixed capital formation	4.5	-0.1	5.4	4.7
4. Final domestic demand	**2.5**	**1.6**	**2.1**	**1.7**
5. Change in inventories	--	--	--	--
6. Domestic demand	**2.4**	**1.4**	**2.1**	**1.7**
7. Exports of goods and services	6.1	4.4	4.4	4.2
7a. - of which goods	6.6	4.7	4.3	4.4
7b. - of which services	4.8	3.6	4.7	3.7
8. Final demand	**3.5**	**2.3**	**2.8**	**2.4**
9. Imports of goods and services	8.2	4.3	5.2	4.5
9a. - of which goods	8.5	4.7	5.0	4.5
9b. - of which services	6.4	2.0	6.4	4.3
10. Gross domestic product at market prices	**1.6**	**1.4**	**1.8**	**1.6**
Contribution to change in GDP				
11. Final domestic demand	2.5	1.6	2.1	1.7
12. Change in inventories + net acq. of valuables	-0.1	-0.2	0.0	0.0
13. External balance of goods and services	-0.8	0.1	-0.3	-0.1

Table 2: Use and supply of goods and services (value)

Annual % change	2015	2016	2017	2018
1. Private consumption expenditure	3.3	3.4	3.4	2.8
2. Government consumption expenditure	1.3	2.3	1.7	1.7
3. Gross fixed capital formation	5.5	0.1	7.1	5.9
4. Final domestic demand	**3.2**	**2.6**	**3.7**	**3.1**
5. Change in inventories	--	--	--	--
6. Domestic demand	**3.2**	**2.5**	**3.7**	**3.1**
7. Exports of goods and services	5.0	2.3	6.9	5.7
8. Final demand	**3.7**	**2.5**	**4.6**	**3.9**
9. Imports of goods and services	3.6	1.1	8.2	6.0
10. Gross national income at market prices	2.5	3.9	3.6	3.1
11. Gross value added at basic prices	3.4	2.7	3.1	3.0
12. Gross domestic product at market prices	**3.7**	**3.0**	**3.2**	**3.0**
Nominal GDP, EUR bn	179.5	184.9	190.9	196.6

Table 3: Implicit price deflators

% change in implicit price deflator	2015	2016	2017	2018
1. Private consumption expenditure	0.7	1.1	1.5	1.5
2. Government consumption expenditure	0.5	1.8	1.3	1.2
3. Gross fixed capital formation	0.9	0.2	1.6	1.2
4. Domestic demand	**0.6**	**1.0**	**1.5**	**1.4**
5. Exports of goods and services	-1.1	-2.0	2.4	1.4
6. Final demand	**0.1**	**0.1**	**1.8**	**1.4**
7. Imports of goods and services	-4.3	-3.2	2.8	1.4
8. Gross domestic product at market prices	**2.1**	**1.6**	**1.4**	**1.4**
HICP	**0.5**	**0.6**	**1.4**	**1.5**

Table 4: Labour market and cost

Annual % change	**2015**	**2016**	**2017**	**2018**
1. Labour productivity (real GDP per employee)	0.2	-0.2	0.4	0.7
2. Compensation of employees per head	-0.3	1.4	1.5	1.5
3. Unit labour costs	**-0.5**	**1.6**	**1.0**	**0.9**
4. Total population	-0.4	-0.3	-0.2	-0.1
5. Population of working age (15-74 years)	-0.4	-0.3	-0.2	-0.2
6. Total employment (fulltime equivalent)	1.4	1.6	1.4	0.9
7. Calculated unemployment rate - Eurostat definition	**12.6**	**11.2**	**9.9**	**9.2**

Table 5: External balance

levels, EUR bn	**2015**	**2016**	**2017**	**2018**
1. Exports of goods (fob)	52.6	53.3	57.1	60.4
2. Imports of goods (fob)	60.3	60.8	65.7	69.7
3. Trade balance (goods, fob/fob) (1-2)	**-7.7**	**-7.5**	**-8.7**	**-9.3**
3a. p.m. (3) as % of GDP	***-4.3***	***-4.0***	***-4.5***	***-4.7***
4. Exports of services	20.2	21.2	22.6	23.7
5. Imports of services	11.2	11.5	12.4	13.2
6. Services balance (4-5)	**9.0**	**9.7**	**10.1**	**10.6**
6a. p.m. 6 as % of GDP	***5.0***	***5.2***	***5.3***	***5.4***
7. External balance of goods & services (3+6)	**1.3**	**2.2**	**1.5**	**1.3**
7a. p.m. 7 as % of GDP	***0.7***	***1.2***	***0.8***	***0.7***
8. Balance of primary incomes and current transfers	-2.7	-1.3	-0.6	-0.3
8a. - of which, balance of primary income	*-5.2*	*-3.8*	*-3.3*	*-3.1*
8b. - of which, net current Transfers	*2.5*	*2.6*	*2.7*	*2.9*
8c. p.m. 8 as % of GDP	*-1.5*	*-0.7*	*-0.3*	*-0.1*
9. Current external balance (7+8)	**-1.4**	**1.0**	**0.9**	**1.0**
9a. p.m. 9 as % of GDP	***-0.8***	***0.5***	***0.5***	***0.5***
10. Net capital transactions	1.8	1.8	1.8	1.9
11. Net lending (+)/ net borrowing (-) (9+10)	**0.5**	**2.7**	**2.7**	**2.9**
11a. p.m. 11 as % of GDP	***0.3***	***1.5***	***1.4***	***1.5***

Table 6: Fiscal accounts

	2015	2016	2017	2018
		% of GDP		
Taxes on production and imports	14.6	14.7	14.8	14.8
Current taxes on income, wealth, etc.	10.8	10.3	10.1	9.9
Social contributions	11.6	11.7	11.7	11.6
Sales and other current revenue	6.2	5.8	5.9	5.9
Total current revenue	**43.2**	**42.5**	**42.5**	**42.3**
Capital transfers received	0.7	0.5	0.7	0.5
Total revenue	**44.0**	**43.1**	**43.2**	**42.7**
Compensation of employees	11.3	11.3	11.2	11.0
Intermediate consumption	5.7	5.7	5.6	5.6
Social transfers in kind via market producers	1.8	1.8	1.7	1.7
Social transfers other than in kind	17.4	17.1	17.0	16.9
Interest paid	4.6	4.2	4.2	4.1
Subsidies	0.6	0.6	0.6	0.6
Other current expenditure	2.5	2.4	2.4	2.3
Total current expenditure	**44.0**	**43.1**	**42.6**	**42.1**
Gross fixed capital formation	2.3	1.5	2.0	2.1
Other capital expenditure	2.0	0.5	0.4	0.4
Total expenditure	**48.3**	**45.1**	**45.0**	**44.6**
General Government balance (ESA2010)	**-4.4**	**-2.0**	**-1.8**	**-1.9**
Primary balance	0.2	2.2	2.4	2.2
		% change		
Taxes on production and imports	6.8	3.9	3.9	2.7
Current taxes on income, wealth, etc.	2.3	-1.9	1.0	1.1
Social contributions	1.6	3.9	3.3	2.5
Sales and other current revenue	-2.4	-3.7	5.3	3.0
Total current revenue	**2.9**	**1.4**	**3.2**	**2.3**
Capital transfers received	-25.1	-27.9	40.7	-26.7
Total revenue	**2.2**	**0.9**	**3.7**	**1.8**
Compensation of employees	-1.2	2.8	2.2	1.5
Intermediate consumption	4.3	2.9	2.0	1.5
Social transfers in kind via market producers	1.2	-0.7	-1.4	3.0
Social transfers other than in kind	1.7	1.3	2.4	2.3
Interest paid	-3.4	-4.3	1.6	0.4
Subsidies	-9.7	-6.2	1.2	3.0
Other current expenditure	-3.5	-3.6	2.3	0.8
Total current expenditure	**0.2**	**0.8**	**2.0**	**1.8**
Gross fixed capital formation	17.5	-30.9	35.7	8.5
Other capital expenditure	-49.8	-76.9	-7.5	8.8
Total expenditure	**-3.2**	**-3.9**	**3.1**	**2.1**
Nominal GDP, EUR bn	**179.5**	**184.9**	**190.9**	**196.6**

Table 7: Government debt developments

	2015	2016	2017	2018
ESA2010 deficit (% of GDP)	**-4.4**	**-2.0**	**-1.8**	**-1.9**
ESA2010 gross debt (% of GDP)	129.0	130.4	128.5	126.2
levels, EUR bn				
ESA2010 deficit	**-7.8**	**-3.7**	**-3.4**	**-3.7**
Gross debt	231.6	241.1	245.2	248.1
Change in gross debt	5.6	9.5	4.1	2.9
Nominal GDP	179.5	184.9	190.9	196.6
Real GDP	171.3	173.8	177.0	179.8
Real GDP growth (% change)	**1.6**	**1.4**	**1.8**	**1.6**
Change in gross debt (% of GDP)	3.1	5.1	2.2	1.5
Stock-flow adjustments (% of GDP)	-1.3	3.1	0.4	-0.4
% of GDP				
Gross debt ratio	**129.0**	**130.4**	**128.5**	**126.2**
Change in gross debt ratio	-1.6	1.3	-1.9	-2.3
Primary balance	-0.2	-2.2	-2.4	-2.2
"Snow-ball" effect	-0.2	0.3	0.0	0.3
of which				
Interest expenditure	*4.6*	*4.2*	*4.2*	*4.1*
Real growth effect	*-2.1*	*-1.8*	*-2.4*	*-2.0*
Inflation effect	*-2.7*	*-2.0*	*-1.7*	*-1.8*
Stock-flow adjustments	**-1.3**	**3.1**	**0.4**	**-0.4**
Implicit interest rate	*3.6*	*3.4*	*3.3*	*3.3*

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KC-BC-17-061-EN-N

Publications Office

ISBN 978-92-79-64706-2