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Post-Programme Surveillance Report

Portugal, Autumn 2018

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EUROPEAN ECONOMY

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Autumn 2018

EUROPEAN ECONOMY

Institutional Paper 097

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This report reflects information available up until 8th January 2019.

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([1]) The report was adopted as a Commission Communication C(2019)651 on 24 January 2019.

([2]) European Central Bank (ECB) staff participated in this mission and the drafting of this report in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

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	Portuguese Treasury and Debt Management Agency
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	Special Revitalisation Process for Enterprises
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	Technical Unit for the follow-up and monitoring of state-owned enterprises
UTAP	Technical unit for the follow-up of PPP projects
VAT	Value Added Tax
y-o-y	Year on year

EXECUTIVE SUMMARY

This report presents the findings of the ninth post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, which took place in Lisbon during 26-30 November 2018. *This visit also served as specific monitoring in the framework of the EU Macroeconomic Imbalance Procedure (Annex 2). Since the conclusion of the eighth post-programme surveillance mission in June 2018, growth has continued to moderate in line with developments in other EU markets. The short-term economic and financial situation of Portugal remains largely favourable but external risks have increased even further due to the more uncertain global environment. Overall, Portugal's economic adjustment is proceeding and its repayment capacity remains strong. However, sustained efforts to address impediments to investment, increasing productivity and further improving the business environment remain key for strengthening potential growth and competitiveness.*

Economic growth continued in 2018 albeit at a more moderate pace than in 2017*. After slowing to a y-o-y growth rate of 2.1% in the third quarter of 2018, the economic expansion is projected to moderate further in 2019 and 2020. This slowdown reflects a move towards the estimated potential growth as well as a projected slowdown in exports and investment on account of heightened uncertainty in the external environment. Although risks to the medium-term growth outlook are tilted to the downside, there are also some upward risks emanating from potentially stronger-than-expected positive labour market developments and the use of EU structural funds. The strong improvement on the labour market over the past several years has already created some wage pressures in certain market segments but overall wage developments remain rather moderate and inflation has stayed below the euro area average.*

Prudent fiscal policy remains essential to strengthen the sustainability of public finances*. The general government headline deficit is projected in the Commission 2018 autumn forecast to decline to 0.7% of GDP in 2018 and 0.6% of GDP in 2019. The 2019 Draft Budgetary Plan appears at risk of deviating significantly from the structural fiscal adjustment required by the Stability and Growth Pact. This risk is particularly evident in respect to net primary expenditure. This strengthens the case for an increased focus on expenditure containment, in particular via the ongoing spending review and more efficient expenditure control, including in state-owned enterprises and the health sector. While public debt is expected to remain on a downward path, the still high debt-to-GDP ratio and rising external risks reinforce the case for using windfall gains to accelerate debt reduction and build up fiscal buffers.*

Portuguese banks have steadily reduced their stock of non-performing loans while keeping their capital broadly stable. *Banks' profitability has also improved, mainly reflecting lower impairments. However, important differences remain in banks' capacity to generate profits, attract capital and further reduce NPLs. Over the past three years, banks' asset quality has improved markedly, helped by increased investor interest, favourable economic conditions and rising real estate prices. Despite the significant role of write-offs in reducing NPLs, sales and restructuring of NPLs are playing an increasingly important role. All major banks in the system have now accessed the secondary market for NPLs and are managing their NPL stocks actively. This trend is set to continue but the NPL ratio remains the third highest of all euro area countries. Therefore, further efforts with the reform of the insolvency framework and reducing legal bottlenecks to dealing with NPLs would be beneficial for the financial sector.*

Sovereign financing and the capacity to repay remain sound*. Despite some interest rate volatility, yields on Portuguese bonds have overall consolidated the relatively low level reached in early 2018. Portugal's bonds were also supported by the latest one-notch upgrade by Moody's in October, as the country is now at investment grade with the four major rating agencies. Furthermore, Portugal repaid in December 2018 all outstanding liabilities to the IMF ahead of schedule. This last early repayment to the IMF on liabilities due up to 2024 followed a series of other early repayments since 2015, contributing to a smoothening of the debt redemption profile and somewhat lower interest costs. However, yields are still vulnerable to financial market conditions due to the still high – although declining – private and public debt burden, particularly in the context of rising global economic risks.*

The next PPS mission is expected to take place in Spring 2019.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the ninth post-programme surveillance (PPS) mission to Portugal between 26 and 30 November 2018. The mission was coordinated with the IMF's post-program monitoring (PPM) mission. 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([3]). 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.

The PPS mission included specific monitoring under the MIP. The 2018 in-depth review (IDR) carried out under the macroeconomic imbalance procedure (MIP) for Portugal concluded that remaining imbalances require decisive policy action and specific monitoring. Annex 2 presents the results in the context of the specific monitoring under the MIP and the European Semester.

The autumn PPS reporting focussed on the most relevant macro, financial and fiscal updates. Structural reforms are only covered in the MIP annex inasmuch as they are MIP-relevant. An extensive assessment of these policies will be done in the European Semester Country Report. The objective is to minimise overlaps with work and reporting in the framework of the European Semester. The spring PPS reporting cycle will remain as usual.

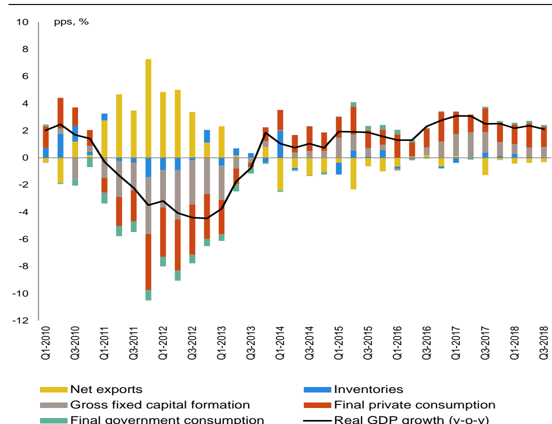
([3]) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid, which is expected in 2035.

2. ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Real GDP growth decelerated to 2.1% y-o-y in Q3-2018 mainly driven by weaker external demand. Household consumption growth in Q3-2018 eased to 2.3% y-o-y in line with some moderation in job creation and consumer credit growth. A significant deceleration in durable goods consumption indicates a normalisation in private consumption developments. This occurs after a prolonged period of strong growth mainly associated with delayed consumption behaviour. Total gross fixed capital formation (GFCF) growth accelerated slightly to 4.5% y-o-y, mainly due to stronger equipment growth. As expected, external trade growth continues to lose momentum, particularly in terms of services, while the net external trade contribution to growth moved from balance to negative (0.8 pps), mainly reflecting the slowdown in external demand. According to the Commission 2018 autumn forecast, economic growth is projected to moderate further in Q4-2018, reflecting the slowdown in external trade. For 2018, GDP growth is estimated at 2.2%.

Graph 2.1: Contributions to real GDP growth

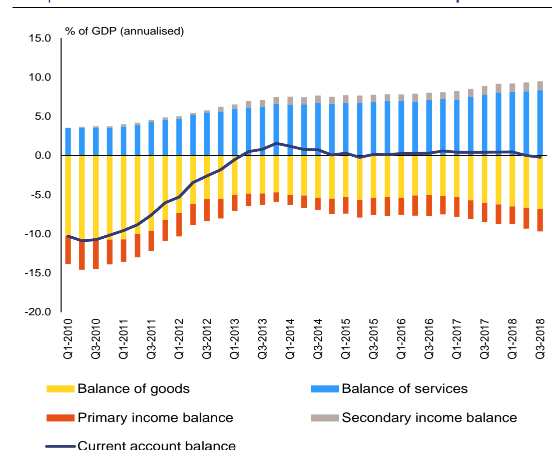


Source: INE

The moderate slowdown is forecast to continue further in 2019 and 2020. It is expected to be driven by lower external trade and the fading away of the strong cyclical tailwinds which sustained the positive macroeconomic performance over the last few years. The slowdown in job creation and overall still moderate wage developments point to some further deceleration in the growth of household spending. The household savings rate, which deteriorated since September 2018, is expected to stabilise over the forecast horizon. Private consumption growth is therefore forecast to weaken to 2.0% and 1.8% in 2019 and 2020. Investment is set to rebound somewhat in 2019, as the implementation of certain projects supported by EU structural funds scheduled for 2018 was postponed. Net external trade is expected to increase its negative contribution to growth in 2019, reflecting weaker export demand and solid import growth in line with still robust domestic demand evolution. Overall, GDP growth is forecast to slow to 1.8% in 2019 and to 1.7% in 2020.

The current account (CA) moved to a deficit of 0.6% of GDP in Jan-Sep 2018 relative to a surplus of 0.2% a year earlier. Dividend payments to foreign shareholders were the main factor behind this deterioration. The balance of goods and services remained positive at 1.8% of GDP and narrowed only marginally from a year earlier as the deterioration in trade with goods was largely offset by the increased surplus in services. Despite the significant slowdown in inbound overnight stays, tourism receipts grew by 11.4% y-o-y in Jan-Sep. The increase is explained by higher accommodation prices and some expansion in the range and value of services provided to tourists.

Graph 2.2: Current account balance and components



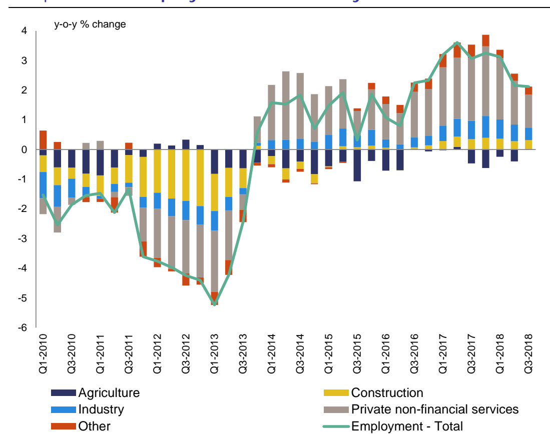
Source: Banco de Portugal

The external balance is expected to deteriorate slightly over the medium term. In full-year terms, it is projected to move from a slightly positive balance in 2016 and 2017 to a neutral

level in 2018 and a slightly negative position in 2019-2020, mainly reflecting a deterioration in the balance of goods and a slowdown in tourism. The projected increase in the absorption of EU structural funds and lower interest cost for domestic borrowers should only partially offset the negative evolution of other factors. As regards competitiveness, Portuguese exporters are set to continue gaining market shares in 2018 helped by the still strong nominal revenues in tourism and the capacity expansion in the automotive sector. At the same time, competitiveness gains in terms of unit labour costs accomplished during 2009-2015 have partially been eroded since 2016. Over the medium term, pressure on cost competiveness remains modest as unit labour cost continue to move broadly in line with trading partners and exports are projected to perform broadly in line with external demand.

The labour market keeps improving at a strong albeit slowing pace. Employment growth has gradually slowed down from 3.3% in 2017 to 1.9% y-o-y in October 2018. The pace of job creation is projected to moderate further, reflecting increasing signs of supply constraints in some market segments and the overall slowdown in the economy. The seasonally adjusted rate of unemployment for the age group of 15-74 dropped to 6.6% in October 2018 relative to 8.4% a year earlier. However, this decrease emerged to a very large extent in the first half of the year, with unemployment stabilising afterwards.

Graph 2.3: Employment evolution by sectors



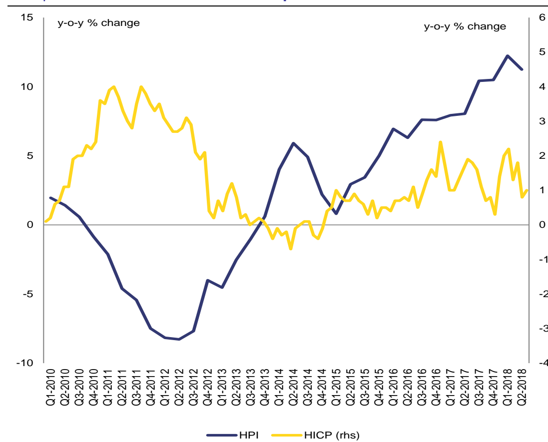
Source: Eurostat

The annual average unemployment rate is estimated to drop from 9.0% in 2017 to 7.1% in 2018, 6.3% in 2019 and 5.9% in 2020, according to the Commission 2018 autumn forecast. Labour productivity is expected to increase somewhat while wages are projected to gradually accelerate, supported by the unfreezing of career progressions in the public sector and further reduction in the labour market slack. While job vacancies remain relatively low at aggregate level, data by the Public Employment Service show that some sectors are already experiencing labour shortages. This is particularly evident in construction, transport and professional services and to a lesser extent in tourism and manufacturing.

Labour skills continue to weigh on productivity. Labour productivity remains significantly restrained by the low investment ratio in Portugal, the overall low skill level of the labour force and existing skill mismatches. About 46% of the labour force has low qualification levels, according to Eurostat data. Nevertheless, the share of workers with skills that are not properly utilised is above the EU average. According to a recent OECD study, based on data for 2016, 23.6% of the Portuguese employees are considered overqualified for their jobs relative to an average of 16.8% for the OECD countries. In addition, 18.7% of the Portuguese employees are seen as underqualified for their jobs, which is very close to the average for OECD.

Consumer price inflation remains low. Consumer prices faced significant volatility on a monthly basis in 2018 but the annualised inflation rate remained below the euro area average. Apart from the impact of energy markets, inflation was strongly affected by abrupt movements in accommodation prices, reflecting calendar effects as well as methodological changes on the time horizon of hotel bookings. As a result, inflation increased from an annual average of 1.6% in 2017 to 1.8% y-o-y in Q3-2018. However, it dropped substantially afterwards to 0.9% in both October and November. The annual average inflation is therefore expected to remain well below 2% in 2018 and to increase only marginally afterwards. Core inflation was below the headline rate in 2018 but the situation is expected to gradually reverse over the forecast period, as service prices are expected to pick up in line with more dynamic wage developments.

Graph 2.4: HICP and House price index



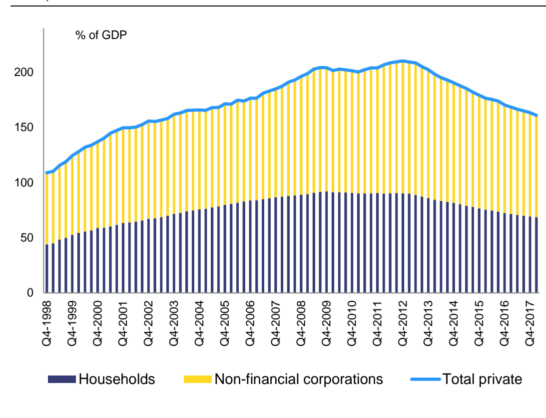
Source: Eurostat

Following a two-year period of acceleration, the rise in house prices moderated somewhat. The y-o-y growth rate moved from 12.2% in Q1-2018 to 11.2% in Q2-2018 and 8.5% in Q3-2018 relative to an annual average of 9.2% in 2017. The recent statistics on construction volumes indicate that supply of real estate is reacting while the slowdown in tourist visits has a moderating impact on demand. So far, the rebound in house prices is still seen as a correction from previously low levels of valuation and construction activity, and the stock of mortgage loans is still on a downward trend relative to GDP. House prices are therefore currently not classified as an imbalance in the framework of the Macroeconomic Imbalances Procedure (MIP). Nevertheless, a closer monitoring is warranted. The increase in house prices is to a very large extent concentrated in the main cities of Lisbon and Porto where tourism activities are expanding to residential areas, with a negative impact on the affordability of housing for socially vulnerable groups.

2.2. PRIVATE DEBT

Private debt retains a steady downward trend. The share of consolidated private debt dropped to 162.2% of GDP at the end of 2017. The ratio indicates a fast adjustment from the peak of 210.3% reached in 2012. The distance to the relevant MIP threshold of 133% was thus reduced by nearly two-thirds over the five-year period. The debt ratio is still exceeding the estimated EU average of 140.5% at the end of 2017 but the gap is steadily declining. In absolute terms, private debt is expected to slightly increase over the medium term, driven mainly by lending to households, with consumer loans growing at a fast pace. On the other hand, economic growth is projected to continue having a downward impact on the debt ratio.

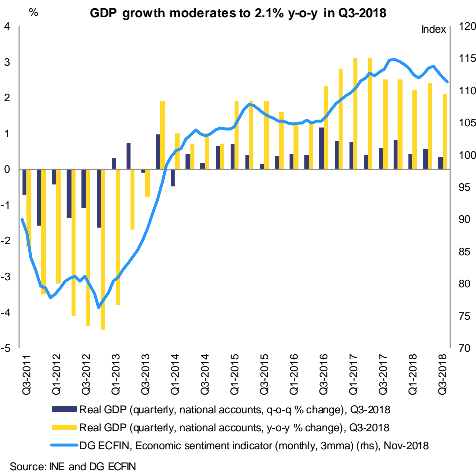
Graph 2.5: Private indebtedness



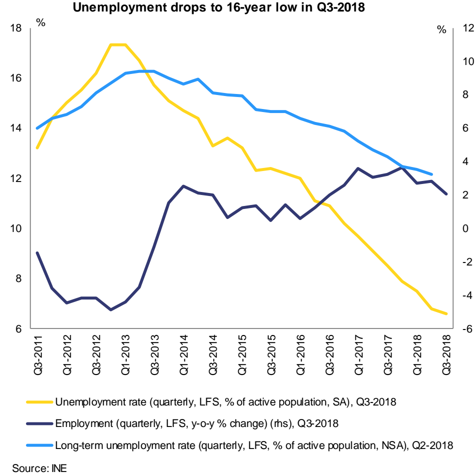
Source: Banco de Portugal

The corporate sector is deleveraging faster than households. At the end of 2017, consolidated corporate debt accounted for 93.3% of GDP relative to 68.9% for households. Both ratios are declining but the latest available statistics show that the corporate sector is deleveraging faster than households. This is seen from the fall in the non-consolidated corporate debt as well as in the stock of bank loans to non-financial corporations up to September 2018. On the other hand, the stock of household debt has slightly increased in absolute terms since the start of the year while still declining as a share in GDP. The faster pace of deleveraging in the corporate sector is driven by improved profit rates and FDI inflows allowing for non-debt financing of investments.

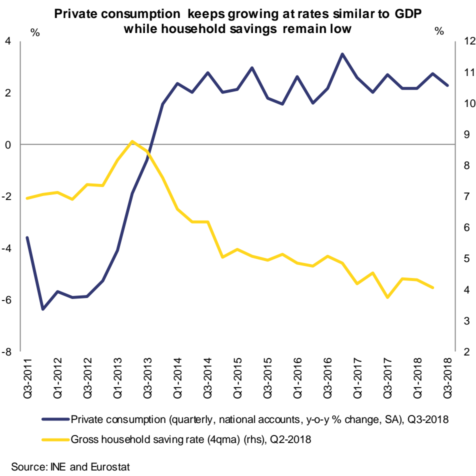
Graph 2.6: **Economic developments**



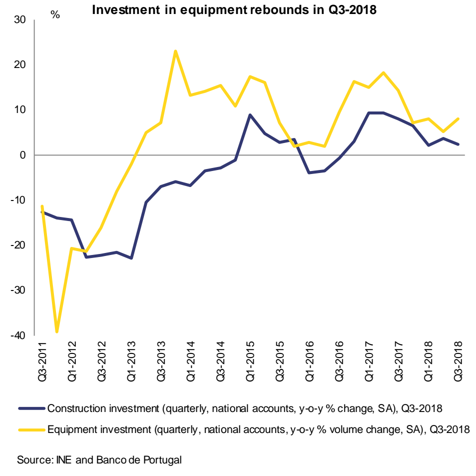
Source: INE and DG ECFIN



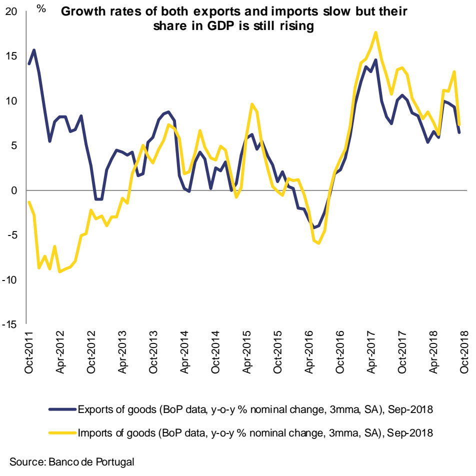
Source: INE



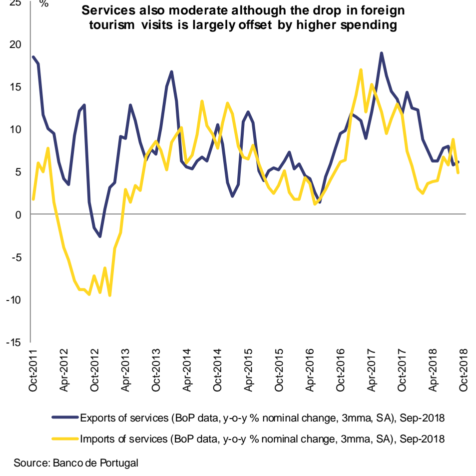
Source: INE and Eurostat



Source: INE and Banco de Portugal



Source: Banco de Portugal



Source: Banco de Portugal

3. PUBLIC FINANCES

3.1. FISCAL PERFORMANCE AND OUTLOOK

The general government budget deficit is projected to decrease to 0.7% of GDP in 2018, according to the Commission 2018 autumn forecast[4]. This mainly reflects higher business cycle-related revenue, decreasing interest expenditure and lower-than-budgeted public investment. However, the activation of the Novo Banco contingent capital mechanism had a negative budgetary impact (0.4% of GDP). Excluding this and other one-off operations, the deficit is set to improve to 0.3% of GDP. The 2019 Draft Budgetary Plan (DBP) projects a general government headline balance of 0.7% of GDP in 2018, thereby maintaining the target of the 2018 Stability Programme, as upward revisions of revenue and expenditure had a broadly neutral impact on the balance. Revenue was revised upwards (by 0.3% of GDP) as upward revisions for taxes and social security contributions were only partially offset by a downward revision of capital revenue and sales. Expenditure (in particular social transfers, compensation of employees and intermediate consumption) was also revised upwards by 0.3% of GDP. Overall capital expenditure remained broadly stable. Compared to the 2019 DBP, the autumn forecast projects only small differences in the breakdown by revenue and expenditure item.

The headline deficit is set to decrease to 0.6% of GDP in 2019, according to the Commission 2018 autumn forecast, while net of one-offs it is set to improve to 0.2% of GDP. The 2019 DBP maintains the headline deficit target for 2019 at 0.2% of GDP, unchanged as compared to the 2018 Stability Programme. The 0.4% of GDP difference between the DBP's headline deficit target for 2019 and the deficit projection in the Commission 2018 autumn forecast stems from more conservative assumptions in the latter regarding the evolution of some revenue items and higher pressures for some expenditure items. On the revenue side, the Commission projects 0.1% of GDP of lower indirect taxes and social security contributions in line with the Commission's more prudent macroeconomic forecast for 2019. The Commission forecast also has more conservative assumptions (0.1% of GDP) for revenue from sales and other current revenue, based on the recent track record for these items. On the expenditure side, higher spending is expected in particular on compensation of employees (0.2% of GDP based on the track record of continuously rising public employment in 2016-2018, the ongoing unfreezing of careers and the extension of the 35 hour work week in the health sector to private contracts). While better-than-expected revenue from direct taxes in cash terms up to October creates some upside risk to the achievement of the 2018 targets, risks to the budgetary targets in 2019 are tilted to the downside, linked to uncertainties surrounding the macroeconomic outlook and the potential deficit increasing impact of banking support measures[5].

The Commission forecasts the structural balance to improve by 0.4% of GDP in 2018 and to remain unchanged in 2019. For 2018, this is in line with the view of the Portuguese authorities who are, however, slightly more optimistic for 2019. For 2019, the DBP projects an improvement of the (recalculated) structural balance([6]) by 0.2% of GDP to a level of 0.7% of GDP. The difference to the Commission mainly reflects the difference in headline deficit projections, which is partially offset by a lower cyclical adjustment in the Commission forecast than in the DBP and a less positive variation of the impact of one-off measures. The projected improvement in the structural balance in 2018 is mainly due to falling interest expenditure while the structural primary balance stays stable according to the Commission forecast. In 2019, the Commission forecast even projects a deterioration of the structural primary balance by 0.2% of GDP.

[4] See also Commission Opinion of 21 November 2018 on the Draft Budgetary Plan of Portugal, C(2018) 8024 and Commission Staff Working Document accompanying the Commission Opinion of 21 November 2018 on the Draft Budgetary Plan of Portugal, SWD(2018) 524.

[5] This risk could arise from a further activation of the *Novo Banco* contingent capital mechanism beyond the amount already included in the DBP 2019 headline deficit target (around 0.2% of GDP), up to the annual limit (around 0.4% of GDP).

([6]) Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology

The 2019 DBP reports a package of new fiscal policy measures of a structural nature with a broadly balanced net impact. Both on the revenue and the expenditure side, relatively small deficit-increasing new measures (around 0.1% of GDP in total) are broadly offset by deficit-decreasing new measures. In addition to fiscal policy measures of a structural nature, the 2019 budget balance is also set to be impacted by 0.2% of GDP in estimated higher dividends from *Banco de Portugal* and *Caixa Geral de Depósitos* and by 0.3% of GDP in one-off capital transfer expenditure. Taking into account all fiscal measures, the 2019 DBP thus implies a slightly negative budgetary impact of revenue and expenditure measures of 0.15% of GDP on the headline balance in 2019. The Commission 2018 autumn forecast takes into account all new measures at their yield specified in the DBP. While not considering them discretionary fiscal measures, the forecast also factors in the estimates for higher dividends and interest expenditure savings. Overall, the planned volume of the reported measures appears limited in view of meeting the fiscal recommendations in the Council Recommendation of 13 July 2018.([7]) Windfall gains from lower interest expenditure and expected higher dividends from Banco de Portugal and Caixa Geral de Depósitos do not appear to be used for accelerating the reduction of the general government debt-to-GDP ratio but to compensate for reductions in tax revenue and increases in primary expenditure.

No major changes to taxation have been implemented in 2018 or are planned for 2019. In addition to the already previously planned full abolishment of the PIT surcharge also for higher tax brackets, new PIT reform measures were introduced in 2018 increasing both the number of tax brackets and the value of the net income guarantee (*mínimo de existência*). The combined revenue loss of the latter two measures is estimated by the authorities at EUR 230 million in 2018 and EUR 155 million in 2019 (i.e. when the 2018 PIT declarations are filled). No significant changes to PIT were included in the 2019 DBP. As regards CIT, the State surcharge was raised in 2018 from 7% to 9% for large companies (i.e. with taxable profits exceeding EUR 35 million), with additional revenue being estimated at EUR 60 million. The 2019 DBP included some relatively minor changes to CIT, notably the end of the special advanced payment (estimated revenue loss of EUR 100 million) and new tax benefits for inland regions, small and medium-sized enterprises (SMEs) and reinvested profits (around EUR 65 million as a whole). The revenue loss associated with the latter measures was to be only partially offset by additional revenue from a contribution on the renewable energy sector (EUR 30 million) and a planned higher taxation of enterprise vehicles (EUR 40 million). As regards indirect taxes, rate increases in excise duties and changes to the stamp tax on credit contracts are expected to yield EUR 75 million in 2019, while VAT rate reductions on energy and cultural services are planned to cost around EUR 27 million. Subsequently, further changes were introduced in the adopted 2019 budget, leading to an additional preliminarily estimated net revenue loss of around EUR 100 million. In particular, these include the reduction for gasoline of the temporary surcharge on petroleum tax (estimated additional revenue loss of EUR 48 million), facilitated modalities for the end of CIT special advanced payment (additional revenue loss of EUR 30 million) and the rejection of the proposed higher taxation of enterprise vehicles (revenue loss of EUR 40 million). This is only partially offset by the introduction of an additional bracket in the surcharge on the real estate tax (*Adicional ao Imposto Municipal sobre Imóveis, AIMI)* with an estimated revenue gain of EUR 30 million.

Public debt is declining but remains sensitive to shocks. After hovering around 130% of GDP between 2014 and 2016, Portugal's public debt-to-GDP ratio declined by 4.5pps. to 124.8% in 2017, on the back of the debt-reducing impact of the primary surplus, the favourable nominal growth-interest rate differential and the negative stock-flow adjustment mostly reflecting a reduction in the cash buffer. The general government gross debt-to-GDP ratio is projected to further decline to 121.5% in 2018, 119.2% in 2019 and 116.8% in 2020, according to the Commission 2018 autumn forecast, mainly due to primary budget surpluses and high nominal GDP growth. Thus, the decrease is expected to still exceed 3 pps. in 2018 but to decelerate by around 1 pp. in 2019 mostly due to

([7]) Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Portugal and delivering a Council opinion on the 2018 Stability Programme of Portugal, OJ C 320, 10.9.2018, p. 92–97.

Table 3.1: Fiscal adjustment 2010-2019

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Budget balance	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-3.0	**-0.7**	**-0.6**
Budget balance, net of one-offs	-11.2	-7.3	-5.6	-5.1	-3.3	-3.2	-2.4	-0.9	**-0.3**	**-0.2**
Structural balance	-11.2	-6.7	-3.6	-3.0	-1.8	-2.3	-2.1	-1.3	**-0.9**	**-0.9**
Primary balance	-8.2	-3.1	-0.8	0.0	-2.3	0.2	2.2	0.9	**2.7**	**2.7**
Structural primary balance	-8.3	-2.3	1.3	1.8	3.1	2.3	2.1	2.5	**2.5**	**2.4**
Fiscal adjustment	-2.4	5.9	3.6	0.6	1.3	-0.9	-0.2	0.4	**0.0**	**-0.2**
Fiscal effort	-2.4	4.5	3.0	0.6	1.3	-0.5	0.2	0.8	**0.4**	**0.0**

Note: Fiscal adjustment is measured as the change in the structural primary balance; fiscal effort defined as the change in the structural balance.
Source: Commission 2018 autumn forecast

higher debt-increasing overall stock-flow adjustments (resulting in particular from a higher projection for the State deficit on cash basis) and lower real GDP growth. The slightly lower decreases in 2018 and 2019 according to the Commission forecast as compared with the DBP mostly reflect the expected lower real GDP growth in both years and the higher headline deficit in 2019 in the Commission forecast. A debt sustainability analysis based on the Commission 2018 autumn forecast and other technical assumptions indicates that the projected moderately-declining path of the debt-to-GDP ratio remains highly sensitive to shocks to nominal GDP growth, interest rates and changes to the structural primary balance as compared with the Commission's no-policy-change baseline scenario.

3.2. POLICY ISSUES

Prudent fiscal policy remains essential to strengthen the sustainability of public finances. Portugal's still high public debt-to-GDP ratio makes it vulnerable to shocks, particularly in the context of rising global economic risks. Therefore, continued structural fiscal adjustment and the use of windfall gains to further reduce public debt and build up fiscal buffers become even more important. However, the 2019 draft budget appears at risk of deviating significantly from the structural fiscal adjustment required by the Stability and Growth Pact already if analysed on the basis of its own scenario. This risk is particularly evident in respect to the planned growth of net primary expenditure. This strengthens the case for an increased focus on expenditure containment, in particular via further progress in the ongoing spending review and more efficient expenditure control, including in state-owned enterprises and the health sector, in line with the Country-specific Recommendations by the Council.

The assessment of compliance with the Stability and Growth Pact (SGP) points to risks of significant deviation. This is the case for 2018 and 2019 and for both years taken together and independently of whether the assessment is based on the Commission 2018 autumn forecast or the 2019 DBP. Portugal has to ensure compliance with the recommended adjustment towards its medium-term objective (MTO) – a structural surplus of 0.25% of GDP. To this end, the nominal growth rate of government expenditure, net of discretionary revenue measures and one-offs, should not exceed 0.1% in 2018, corresponding to a structural adjustment of at least 0.6% of GDP. In 2019, the nominal growth rate of net primary government expenditure should not exceed 0.7%, corresponding to a structural adjustment of 0.6% of GDP. Based on the 2018 Commission autumn forecast, the expenditure benchmark pillar points to a risk of significant deviation in 2018 (gap of 1.5% of GDP) and the structural balance pillar points to a risk of some deviation (gap of 0.2% of GDP). For 2019, both the expenditure benchmark pillar (gap of 1.4% of GDP) and the structural balance pillar (gap of 0.6% of GDP) point to a risk of significant deviation. Taking into account the negative impact of medium-term potential growth on the applicable expenditure benchmark rate, which includes negative or exceptionally low potential GDP growth in and after the crisis years, and the positive impact of revenue windfalls and lower interest costs on the structural balance, both indicators would point to a risk of significant deviation in both years. In substance, the same results would also be found based on the DBP itself.

The spending review is planned to be continued in 2019. According to the 2019 DBP, it is expected to yield savings of EUR 236 million across several parts of the public sector in 2019. Around half of these savings are expected to come from health and education, while measures in the justice system, internal administration as well as the more efficient use of public assets and the growing use of centralised procurement are expected to contribute the other half.

Some measures specifically aim at addressing the underlying causes of persistent hospital arrears. Despite supplementary state budget transfers of EUR 1.4 billion between December 2017 and December 2018, hospital arrears have remained at around EUR 850 million since September 2018. Against this background, a new programme for 2019 intends to introduce an enhanced governance model for public hospitals, coupled with a substantial increase in their aggregate state budget allocation. It is intended to create management incentives to increase accountability, reduce moral hazard and reward efficiency savings. Although the programme represents a promising first step in the right direction, it remains to be seen whether it will lead to a sizeable reduction in hospital arrears in the short-term.

Progress in improving the financial sustainability of SOEs is lacking. The authorities project SOEs as a whole to approach a net income close to, but still below, equilibrium in 2019. This corresponds to a one-year delay as compared with earlier announcements aiming at a similar outcome already in 2018. A range of measures is envisaged to enhance the monitoring of SOEs and to ensure closer adherence to their initial budgetary plans. This involves moving forward with the automatic exchange of information between SOEs and *Unidade Técnica de Acompanhamento e Monitorização do Setor Público Empresarial* (UTAM) – a unit in the Ministry of Finance specialised on SOE monitoring. New incentives for employees and managers to improve reporting standards are also planned to be introduced. SOEs that have fulfilled their purposes, that are economically unviable or that can be merged to generate savings shall continue to be liquidated, while improvements in the capital structure are planned to be prioritised for those SOEs that have positive operational results but high levels of debt.

Overall, limited progress has been made in improving the financial sustainability of SOEs, with planned rationalisation efforts and enhanced monitoring still lagging to translate into corrective action where needed.

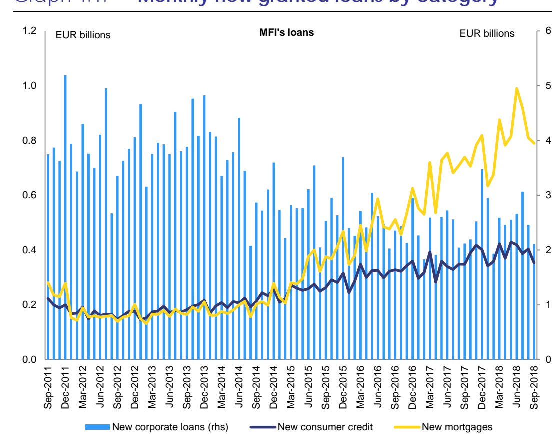
4. FINANCIAL SECTOR

4.1. FINANCIAL STABILITY

The profitability of the Portuguese banking sector is positive again but remains weak. The banking system's profitability increased in the first half of 2018 compared to the first half of 2017. Return on equity (ROE) and return on assets (ROA) rose by 2.9 pps and 0.3 pps, respectively, to 3.1% and 0.3% in the first half of 2018. The improvement in profitability metrics mainly reflects the significant reduction in the flow of credit impairments and provisions, which are still much higher than the European median, and a decrease in operating costs by 6% in the first half of 2018, compared to first half of 2017. The overall cost-to-income ratio dropped by 2.8 pps to 57.7%, which is below the euro area average of 63%. Fee income has also increased by 5.0%, and amounted to EUR 1.5 billion in the first half of 2018. By way of comparison, net interest income now stands at EUR 3.1 billion. Banks' net interest margin on outstanding loans, which has remained around 2% since September 2015, has been helped by falling deposit remuneration, which has effectively hit the zero lower bound in most banks. The loan-to-deposit ratio fell to 89% in June 2018, from a peak of 159% in June 2010. Unlike in the crisis years, when liquidity was a major issue, banks now face a problem of excess liquidity. Portuguese law prohibits banks from passing on negative interest rates to their customers, also for large deposits. Consequently, some foreign corporations that face negative remuneration in their home jurisdictions are depositing their excess liquidity with Portuguese lenders.

Banks's capital levels have been stable. Overall capital and reserves stood at EUR 35 billion in June 2018, which is close to the levels in the past years although still well above the lows recorded during the global financial crisis in 2008. Whereas the CET1 ratio fell from 13.9% to 13.4% during the first half of 2018, the total solvency ratio remained broadly stable at 15%, as two banks issued EUR 900 million in Tier 2 capital instruments. Nonetheless, the system's capital ratio is among the lowest in the euro area. As endogenous capital generation remains hampered by weak profitability, the issuance of capital instruments will remain a central avenue for boosting capital ratios. Regarding resolvability, preliminary MREL targets have been determined and banks are starting to prepare their strategies to address potential shortfalls during the coming years.

Graph 4.1: Monthly new granted loans by category



Source: BdP

Banks have made further headway in improving asset quality. By June 2018, Portuguese banks had reduced their aggregate stock of NPLs by some EUR 18 billion, equivalent

Table 4.1: Financial soundness indicators, all banks

(%)	2010	2011	2012	2013	2014	2015	2016	2017	2018Q2
Non-performing debt	3.7	5.3	7.0	7.8	13.6	14.4	14.4	11.0	9.5
Non-performing loans	-	-	-	-	16.6	17.5	17.2	13.3	11.7
Non-performing loans NFC	-	-	-	-	27.9	28.3	29.4	25.2	22.3
Non-performing loans HH	-	-	-	-	9.7	9.4	8.7	7.1	6.4
Coverage ratio	61.5	56.6	54.3	56.4	37.9	40.6	45.4	49.9	53.4
Loan to deposit ratio*	123.9	116.1	119.5	111.4	104.9	99.3	93.6	90.1	87.1
Tier 1 ratio	8.3	8.6	11.3	12.2	11.4	12.6	11.7	14.5	14.1
Capital adequacy ratio	10.3	9.8	12.6	13.7	12.3	13.3	12.3	15.2	15.2
Return on equity**	6.7	-4.2	-3.3	-9.3	-3.5	0.9	-5.5	-0.8	-
Return on assets**	0.4	-0.2	-0.3	-0.7	-0.2	0.1	-0.3	0.0	-

*ECB aggregated balance sheet: loans excl. to government and MFI / deposits excl. from government and MFI
**For comparability only annual values are presented
Source: ECB

to 36% of the NPL stock recorded in June 2016 (EUR 50.4 billion). The ratio of NPLs to total loans fell from a peak of 17.9% in June 2016 to 11.7% in June 2018, although this level remains well above the euro area average of 4.2%. Over the same period, the impairment coverage ratio rose by 10 pps to 53%, above the euro area average of 45%. The decline in the NPL stock has been driven predominantly by corporate loans, where the majority of the non-performing assets is concentrated (in this sector, the level of NPLs has fallen by EUR 12 billion from a peak in Q2-2016 to EUR 21 billion in June 2018). Banks have mostly used write-offs, cures or sales to reduce their corporate NPLs. In the household segment, on the other hand, NPL reduction was predominantly achieved through cures, followed by sales and write-offs. The improvement in banks' asset quality is notable, but the stock of NPLs is still quite heterogeneous among lenders given the differences in their starting level of NPLs, capital ratios and profitability metrics. Most banks have nonetheless made substantial progress in meeting their NPL reduction targets and are active in the secondary market for NPLs. Some banks managed to securitise parts of their NPL portfolios, paving the way for more securitisation transactions in the future.

Banks' balance sheets are still burdened with very heterogeneous portfolios of non-performing assets. The NPL breakdown continues to show a steady high proportion (65%) of corporate NPLs, which typically are somewhat more diverse than households' NPLs. In Portugal, the split of NPLs([8]) between past due loans and unlikely to pay (UTP) loans is 63% to 37%. This is close to the euro area average. The UTP category includes loans where the loan is less than ninety days past due, and loans which are not past due but where the borrower's financial condition has deteriorated to such an extent that she is judged unlikely to pay without realisation of collateral.

([8]) Non-performing exposures include material exposures which are more than 90 days past due, as well exposures where the debtor is assessed as unlikely to pay her credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.

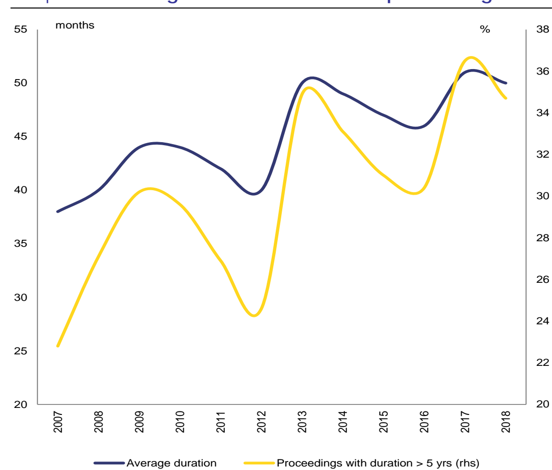
4.2. POLICY ISSUES

The recently established "coordination platform" (PNCB) is welcome, but has not yet produced substantial results. The PNCB is a private initiative by three leading banks and was created to optimise the recovery of their exposures to a common debtor and/or orchestrate the turnaround of viable debtors exposed to at least two of the three participating banks. The PNCB has been allocated in total about EUR 1 billion of exposures from twelve corporate debtors. Following the diagnosis of the debtors' business (actual and potential), a set of strategies has been proposed to the Restructuring Committee (December 2018). However, it is clear that there is no single solution to addressing these exposures given their heterogeneity, and there are many difficulties with providing fresh funds needed to turn around struggling debtors. Given this complexity, the resolution of loans allocated to the platform is therefore likely to take some time. While the establishment of the platform was a welcome initiative, it will need to demonstrate results to speed up the recovery of complex exposures rather than prolonging inevitable decisions about the viability of certain debtors.

The efficiency of the judicial system remains key for reducing non-performing assets, but the impact of previous reforms is being felt only very gradually. Over the past five years, the authorities have implemented a number of reforms in the legal and institutional framework for insolvency and debt enforcement. Recently, many of the reforms were placed under the government's "comprehensive strategy" to reduce the high stock of NPLs. Signs of progress include the adoption of measures focused on the recovery of viable businesses, a new legal framework to allow majority creditors to convert their credit into capital, and the revised framework for voluntary out-of-court settlements. At the same time, the average duration of proceedings remains persistently high, as does the number of pending court cases. Indeed, on these metrics as well as on enforcement of civil and commercial claims in the first instance and on payments between business to business, Portugal ranks among the lower third of

countries when compared to European peers.([9]) Furthermore, while the secondary market for NPLs is becoming more established, deeper and dynamic, inefficiencies in the judicial system complicate the recovery process and the prospects for efficient repossession of collateral. The long average duration of recovery proceedings weighs on the prices of non-performing loans in the secondary market. Discount rates tend to fluctuate between 45% and 97% of the original loan amount, depending on the asset class.

Graph 4.2: Length of civil enforcement proceedings

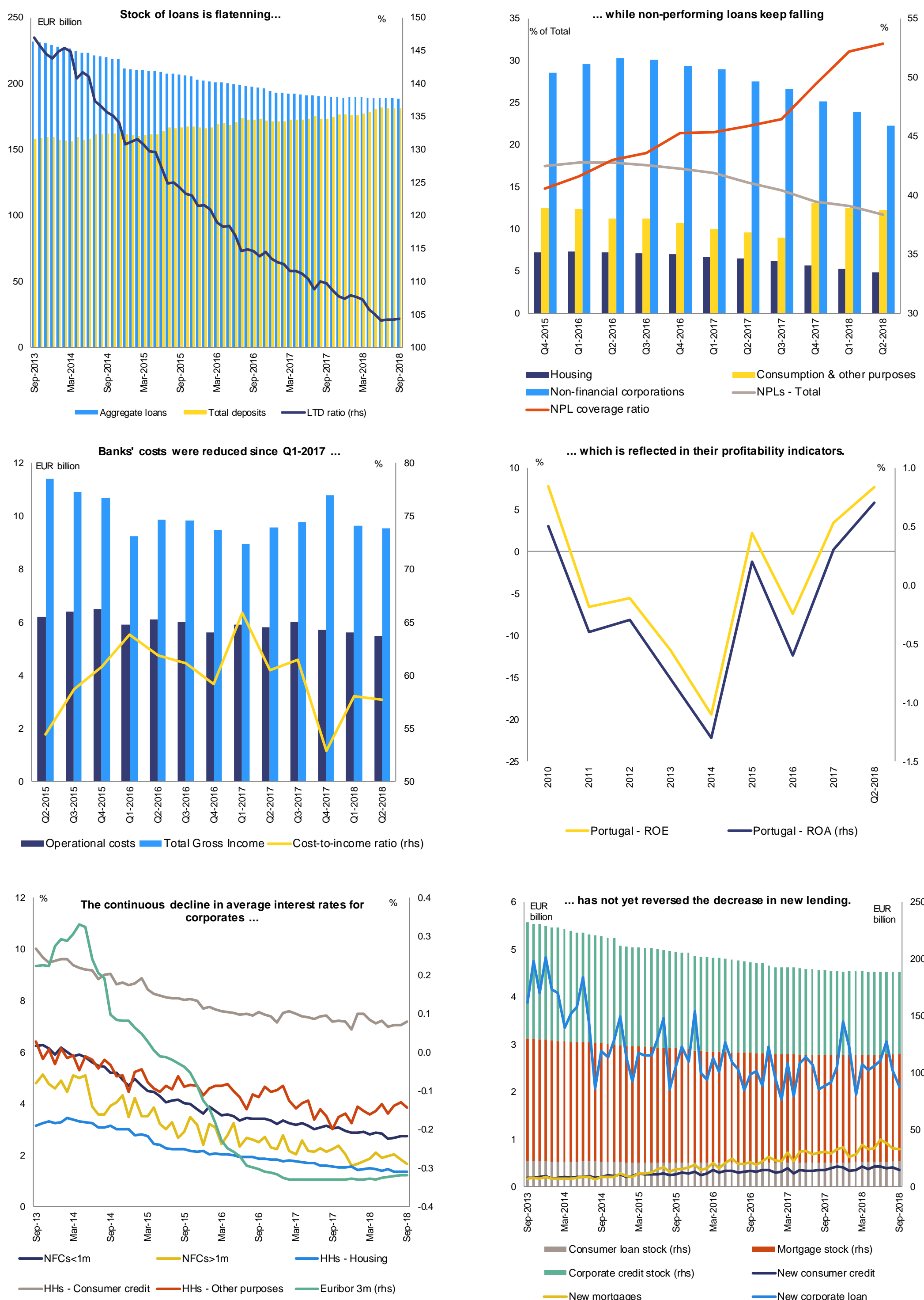


Source: DGPJ

The rapid recovery in real estate markets presents both opportunities and challenges. Whereas the recovery of real estate prices also reflects a normalisation process after a steep price decline earlier in the decade, prices have risen rapidly and warrant close monitoring, particularly in some areas. The ongoing economic recovery and the increased interest in Portuguese real estate by foreign investors have led to an increased number of transactions and supported the recovery of real estate price, making it easier for banks to sell NPLs with property as collateral. Although the stock of housing loans is still declining, the amount of new mortgages has quadrupled since the programme years. Nevertheless, they still amount to only half of their pre-crisis monthly averages. In July 2018, Bank of Portugal introduced macroprudential measures for consumer and mortgage lending. These recommendations included upper limits for loan maturities and loan-to-value (LTV) and debt-service-to-income (DSTI) ratios, as well as requirements for regular payments of interest and capital. These recommendations, which aim at protecting borrowers' solvency and the resilience of the financial sector, were communicated extensively to the public. Whether the measures have also an impact in decelerating mortgage and house prices will be subject to a more detailed assessment in 2019.

([9]) According to the 2018 European Commission Justice Scoreboard and Intrum Justitia Late Payments Report (2018)

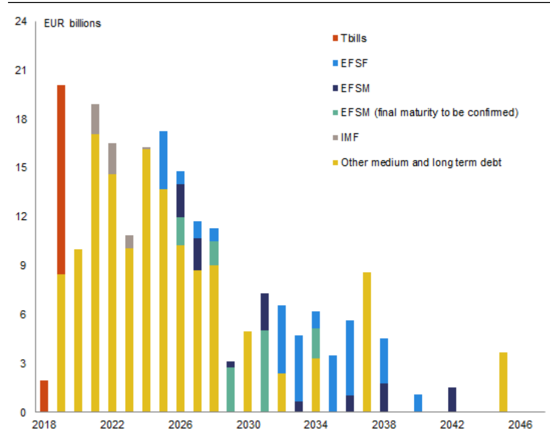
Graph 4.3: **Financial developments**



5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Active debt management is smoothing the debt redemption profile. Bilateral buybacks totalling EUR 1.6 billion in debt were carried out over 2017, with a further EUR 0.9 billion having been bought back from January to mid-December 2018. In addition, besides the two bond switches conducted in 2017, in December 2018, a bond exchange involving the repurchase of bonds maturing in 2020 and 2021, as well as the issuance of securities redeeming in 2023 and 2027 amounted to EUR 1.9 billion. After early repayments of around EUR 10 billion in 2017 and EUR 0.8 billion in January 2018, Portugal anticipated the full repayment of the outstanding IMF loan, amounting to around EUR 4.7 billion, to December 2018. The full early repayment of the IMF loan was possible due to the decision of the European creditors – i.e. the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) – to grant another waiver of the proportional repayment obligation. Both the buy-backs and the early repayment of the IMF loan contribute to a smoothening of the redemption profile of Portugal's public debt, in particular concerning the redemption peak in 2021. The Portuguese authorities confirmed their intention to invite the IMF to conduct staff visits up until the end of the originally envisaged Post-Program Monitoring period.

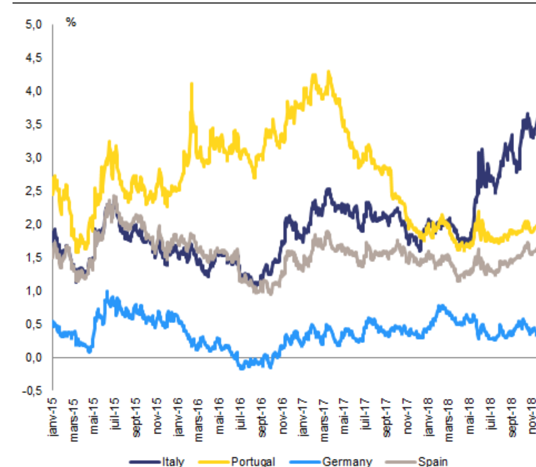
Graph 5.1: Redemption profile



(1) Last update: 17 Nov 2018
Source: IGCP

After the peak in 2017, Portugal's financing needs are projected to decline over 2018 to 2020 before rising again slightly in 2021. The particularly high financing needs of EUR 27.9 billion in 2017 mostly reflected the above-mentioned EUR 10 billion early repayments of the IMF loan. In 2018, the State's headline deficit on a cash basis is projected to decrease by around EUR 1.7 billion y-o-y, and the net acquisition of financial assets is expected to record a similar reduction (EUR 1.5 billion y-o-y). Subsequently, in 2019, both the State's headline deficit on a cash basis and the net acquisition of financial assets are planned to increase (by around EUR 0.5 billion and EUR 1.3 billion y-o-y, respectively). The cash buffer is projected to continue to gradually decrease from EUR 9.8 billion in 2017 to EUR 8.2 billion in 2018 and EUR 7.5 billion in 2019 and to temporarily rise to EUR 10 billion in 2020 ahead of high 2021 redemptions, notably in the first semester, before finally decreasing more substantially in 2021, when the high redemptions are planned to bring it down to EUR 5 billion by the end of the year (i.e. no more than 40% of the following year's gross financing needs).

Graph 5.2: 10-year government bond yields



Source: European Commission

Despite some interest rate volatility, yields on Portuguese bonds have overall consolidated the relatively low level reached in early 2018. After peaking at 4.3% in mid-March 2017, yields on Portuguese 10-year bonds hovered around 1.7% on average throughout December 2018. The yield's decreasing trend in 2017 and early 2018, as well as their broad stabilisation in 2018, have been helped by a series of upgrades in Portugal's credit rating. Following the upgrades by Fitch and by Standard and Poor's in the second half of 2017, DBRS

upgraded Portugal's credit rating from BBB- to BBB on 20 April 2018 and, more recently, also Moody's moved Portugal to investment grade (Baa3) on 12 October 2018. Portugal's average yields have nevertheless remained slightly higher than those of Spain (at around 1.4% in December 2018, leading to a difference of 0.3 pps. compared with Portugal). That notwithstanding, Portugal's average sovereign yields have since May 2018 perceptibly distanced themselves from Italy's yields (at around 2.9% in December 2018, leading to a difference of 1.2 pps. compared with Portugal). Portugal's implicit interest rate on general government debt has fallen from 4.4% in 2011 to 3.1% in 2017. The average residual maturity of State direct debt has declined slightly from 8.3 years at the end of 2016 to 8.1 years at the end of 2017.

Sovereign financing and the capacity to repay are currently sound. However, yields remain vulnerable to financial market conditions due to the high private and public debt overhang. In the short term, Portugal's capacity to repay remains sound, with relatively stable and low yields. Moreover, the full early repayment of the outstanding IMF loan has helped further smoothen the debt redemption profile and contain interest rate costs in the near future. In the short to medium term, the redemption profile is expected to improve and gross financing needs to decline, accompanied by a reduction of the cash buffer. Further fiscal consolidation and structural reforms to boost economic growth potential however remain key to ensure Portugal's capacity to repay in the long term.

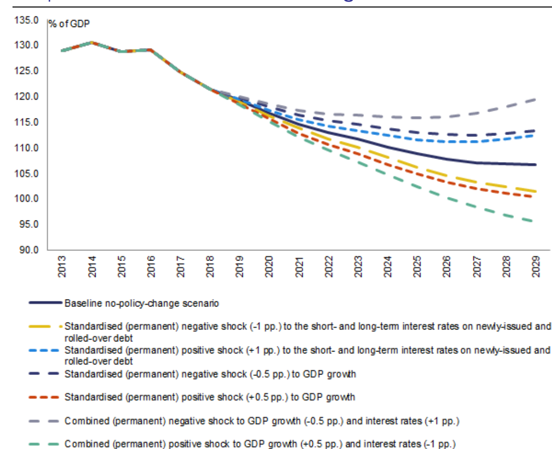
ANNEX 1

European Commission Debt sustainability analysis

This Debt Sustainability Analysis (DSA) uses the Commission 2018 autumn forecast as a starting point to ensure cross-country consistency and to take into account second-round macroeconomic effects. The general government debt ratio in 2017 turned out at 124.8% of GDP, which corresponds to a year-on-year decrease by 4.5 pps. This decrease was mostly due to a more favourable nominal growth-interest rate differential and a significant negative stock-flow adjustment (reflecting, in particular, a decrease of the cash buffer). For 2018, 2019 and 2020, the Commission forecast projects debt ratios of 121.5%, 119.2% and 116.8% of GDP, which correspond to year-on-year decreases by 3.3%, 2.3% and 2.4% of GDP, respectively. These decreases reflect, on the one hand, the debt-reducing impacts from the projected solid primary surpluses in these years, which, on the other hand, are partially offset by the effects of lower real GDP growth and the increasingly positive (i.e. debt-increasing) stock-flow adjustments. The latter two effects concur to a deceleration in the debt reduction path in the period 2018-2020, compared with 2017. For the outer years, the analysis rests on the following assumptions: (i) the structural primary fiscal balance (before costs of ageing) remains unchanged at a surplus of 2.3% of GDP as of 2020 under the customary no-policy-change assumption, (ii) inflation converges linearly to 2.0% by 2023 and remains at that level thereafter, (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5% by the end of the 10-year projection horizon, (iv) real GDP growth rates of around 1%, and (v) ageing costs develop according to the European Commission 2018 Ageing Report.([10])

In the Commission’s no-policy-change baseline scenario, the debt-to-GDP ratio is expected to gradually decline by around 1% of GDP per year from 2021 onwards and to reach approximately 107% of GDP in 2029, while still remaining significantly above the Treaty reference value of 60% of GDP due to the projected unfavourable growth-interest rate differential and increasing ageing costs in the projection's outer years. The Commission's DSA shows that the projected moderately-declining path of the debt-to-GDP ratio is sensitive to shocks to nominal GDP growth, interest rates and the structural primary balance as compared with the Commission's no-policy-change baseline scenario. Graph A1.1 illustrates the sensitivity of the projected debt ratio path to alternative scenarios incorporating plausible potential shortfalls/windfalls in nominal GDP growth or interest rate increases/decreases as of 2018. The analysis suggests that a lower GDP growth rate by 0.5 pps. or a 1 pp. increase in the interest rate on maturing and new debt would increase the debt ratio by 0.6% and 0.2% of GDP, respectively, in 2019; the debt ratio would be at about 113% and 112% of GDP respectively by the end of the projection period. A combined negative shock to GDP growth and interest rates could put the debt ratio again on an upward path, bringing it back to close to 120% of GDP in 2029. On the other hand, a positive shock to medium and long-term GDP growth or permanently lower interest rates would result in an acceleration of the reduction of the debt ratio to a pace of close to 2% of GDP per year bringing it down to around 101% of GDP in 2029. A combination of higher GDP growth and lower interest rates could further accelerate this reduction, thereby allowing for a fall in debt to around 95% of GDP in 2029.

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



Source: European Commission

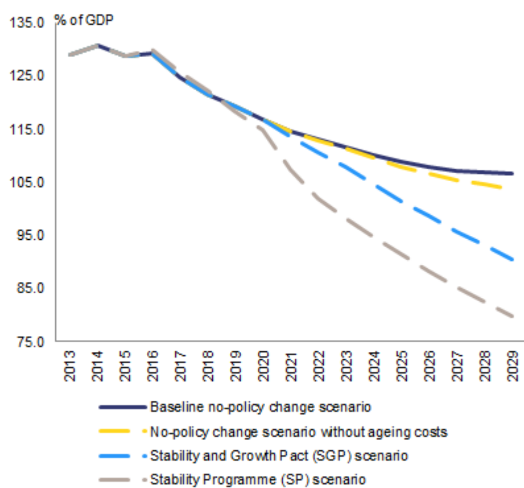
Additional fiscal consolidation would clearly accelerate the debt reduction path as shown in Graph A1.2, illustrating the effect of alternative fiscal consolidation paths. Full compliance with the requirements of the Stability and Growth Pact (SGP) would considerably further accelerate debt

([10]) “The 2018 Ageing Report: Economic and Budgetary Projections for the EU Member States (2016-2070)”, *Institutional Papers*, No 079.

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 ([11]). This would imply that the MTO of a structural balance of 0.25% of GDP would be reached in 2021. Maintaining the MTO over the longer term would require structural primary surpluses of close to 4% of GDP until the end of the projection horizon. Under these assumptions, the debt ratio would markedly accelerate its decline to around 3 pps. per year, falling to 90% by 2029.

The 2018 Stability Programme scenario assumes a fall of the debt ratio to 122.2% of GDP in 2018 and 118.4% of GDP for 2019. Based on the assumptions of increasing primary surpluses, a context of low interest rates and real GDP growth slightly above 2% from 2019 onwards, the debt ratio in the Stability Programme is projected to decrease rapidly to 114.9% of GDP at end-2020, 107.3% at end-2021 and 102% at end-2022. Such a scenario would be consistent with around 0.4% of GDP annual improvement in the structural balance for 2018-2022. From 2022 onwards, the primary structural surplus has been projected to remain at around 4% over the entire projection horizon, contributing to a significant fall in the debt ratio to reach 80% of GDP by 2029.

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 declines substantially in the short-term and moderately in the medium-term. However, it would still be at a high level and remain vulnerable to shocks to nominal GDP growth, interest rates and the structural primary balance. A steeper declining path for the debt-to-GDP ratio could be achieved by ensuring continuous compliance with the SGP requirements over the medium to longer term. In addition, a solid reduction of the debt ratio over the projection horizon crucially hinges on medium and long-term economic growth, which points to the need to persevere with the implementation of growth-enhancing structural reforms.

([11]) COM(2015) 12.

ANNEX 2
MIP specific monitoring

In March 2018, Portugal was identified as experiencing macroeconomic imbalances in the context of the Macroeconomic Imbalance Procedure (MIP). The identified imbalances mainly relate to the large stock of external liabilities, public and private debt, the high share of NPLs and low productivity growth.

The 2018 Country-specific Recommendations (CSRs) under the European Semester provided guidance for the policy follow-up. These recommendations concern a wide range of policy domains: (CSR1) public finances, including fiscal-structural policies; (CSR2) labour contracts and skill upgrades; and (CSR3) NPLs and policies for reducing the administrative burden and improving the business environment. All CSRs are considered relevant to address the identified imbalances.

This section provides an overview of the state of play regarding progress with policy implementation to address imbalances as identified under the MIP framework. In order to avoid an overlap with other ongoing surveillance processes, it does not provide an assessment of compliance with fiscal targets.

A2.1. OUTLOOK AND EVOLUTION OF IMBALANCES

The country's net international investment position (NIIP) remains a significant source of vulnerability. It improved marginally from 105.5% of GDP at the end of 2016 to 104.9% at the end of 2017, only to deteriorate again to 106% of GDP as of June 2018 against the relevant MIP threshold of 35%. This reflected both negative valuation effects and a weakening in the current account, including a large outflow of dividend payments to foreign shareholders. The current account is forecast at a roughly balanced position in 2018 and to switch to small deficits of 0.1% of GDP in both 2019 and 2020, according to the Commission 2018 autumn forecast. This represents some deterioration from the previous forecast. Therefore, the external position is expected to adjust only at a relatively slow pace. On the other hand, the structure of external liabilities improved over recent years due to a shift from debt to foreign direct investment (FDI). The FDI component in the NIIP widened to 33.8% as of end-2017 relative to 29.2 % at the end of 2016. Accordingly, the NIIP excluding non-defaultable instruments improved to 61% of GDP at end-2017 from 66% at end-2016. The share of net external debt to GDP meanwhile contracted from 94.0% at the end of 2016 to 91.7% at end-2017.

Despite the projected downward path, the general government debt-to-GDP ratio is expected to remain at a very high level. Accompanied by improving credit ratings, Portugal's debt-to-GDP ratio saw a first substantial decline to 124.8% in 2017, down from around 130% in 2013-2016. Backed by steady primary surpluses and a favourable growth-interest rate differential, the debt-to-GDP ratio is expected to gradually further decline to 121.5% in 2018, 119.2% in 2019 and 116.8% in 2020, under the customary no-policy-change assumption. At such high level, Portugal's debt-to-GDP ratio is set to remain one of the highest in the EU. Continued commitment to growth-friendly fiscal consolidation and structural reforms is key to maintain the debt-to-GDP ratio on a durable sustainable path and safeguard against potential downside risks from higher interest rates, lower economic growth and adverse demographic trends.

The pace of private debt adjustment continues. In consolidated terms, the private debt-to-GDP ratio has fallen steadily from its peak of 210.3 % at the end of 2012 to 162.2% at the end of 2017, relative to an EU average of 140.5%. The debt is declining in both the corporate and the household sectors. At the end of 2017, consolidated corporate debt accounted for 93.3% of GDP and 68.9% for households. Data for 2018, available only in non-consolidated terms, confirm that the process of deleveraging continues albeit at a slower pace. This is seen from the fall in the consolidated stock of bank loans to private corporations up to August 2018. On the other hand, the consolidated stock of loans to households has slightly increased in absolute terms since the start of the year while still declining as a share in GDP.

The high NPL stock remains a key weakness in the financial system but the adjustment is advancing. The aggregate NPL ratio dropped, in line with guidance from the SSM, to 11.7 % in June 2018 from 13.3 % at the end of 2017 and 17.2% at the end of 2016, according to ECB data covering domestic and foreign-owned banks. However, it remains among the highest in the euro

area and well above the euro area weighted average of 4.2%. Corporate NPLs which stood at 22.3% in June 2018 are a particular concern as they account for about two-thirds of the total NPL stock. The authorities and banks are implementing a three-pillar strategy to reduce the burden of corporate NPLs. The reductions in NPLs are broadly in line with the targets in the strategy where the banks with the largest NPL ratios have submitted plans for substantial reduction in bad loans by 2021.

Labour productivity declined slightly in 2016-2017 but is set to improve as of 2018. The negative trend in productivity was the mirror image of strong growth of employment, also for low skilled members of the labour force. An improvement is now expected as decreasing slack in the labour market leads to a less strong and more broad-based increase in employment as well as due to a gradual improvement in education outcomes.

Unemployment decreased to a 16-year low in 2018. Despite some moderation in employment growth, unemployment decreased from an annual average of 9.0% in 2017 to seasonally adjusted 6.9% in Q3-2018 which is already well below the euro area average and very close to the EU average. Long-term and youth unemployment also decreased significantly. Overall, the data show that the labour market has recovered substantially from the crisis and the main concerns are now related to labour segmentation, skills and productivity.

House prices show first signs of moderation after a strong rebound. Following a two-year period of acceleration, house prices moderated somewhat from a y-o-y growth rate of 12.2% in Q1-2018 to 11.2% in Q2-2018. The deflated rates are estimated at 11.3% and 10.1%, respectively, relative to an annual average of 7.9% in 2017. The recent statistics on construction volumes indicate that supply of real estate properties is likely to gradually catch up with demand. So far, the rebound in house prices is seen as a correction from previously low levels of valuation and the stock of mortgage loans is still on a downward trend relative to GDP.

A2.2. POLICY MEASURES TAKEN TO ADDRESS MACROECONOMIC IMBALANCES

Public finances

Portugal's fiscal sustainability would benefit from the implementation of a multipronged strategy to tackle long-lasting inefficiencies on both the revenue and expenditure side. On the revenue side, while there were some improvements in tax administration in the recent past, there remains scope to make better use of the new information sources gained by the tax authority to more effectively curb tax avoidance, fraud and evasion. On the expenditure side, it would appear helpful to reinforce the efforts for the full and timely implementation of the reformed Budget Framework Law. In addition, it would appear essential to complement the ongoing spending review with vigorous policy action to address long-lasting pressures posed by the long-term sustainability of the pension system, the financial situation of state-owned enterprises (SOEs), the persistence of hospital arrears and the increasing wage bill.

It will be crucial to implement the recently announced measures in the pension system in an overall budget-neutral manner to ensure its long-term sustainability. A plan has been put forward to gradually broaden the early-retirement scheme for very long careers introduced in October 2017, with full implementation expected by October 2019. Among others, it intends to allow early retirement without the sustainability factor penalty to citizens aged 60 years old and who contributed to the Social Security or the legacy civil servants pension scheme for at least 40 years. Moreover, similar to 2017 and 2018, minimum pensions will continue to benefit from extraordinary updates in addition to the regular pension indexation linked to inflation and real GDP growth, with a particular focus on those pensions that were not updated between 2011 and 2015. The improving Social Security balance reflects cycle-driven higher social contributions and lower unemployment-related expenditure. It also still benefits from general transfers from the State budget and from consigned tax revenue coming from the additional real estate tax and from a percentage of the revenue from the corporate income tax (0.5% in 2018, rising by 0.5 pp. per year up to 2% in 2021). In view of the recently

announced balance-deteriorating measures and the pressures posed by the ageing population, compensatory balance-improving measures of a structural nature would be needed to strengthen the overall sustainability of the pension system.

While the net incomes of SOEs have remained negative on the aggregate, they are planned to approach a level close to, but still below, equilibrium in 2019. In 2017, significant improvements in the operational results of SOEs in the transport and financial sectors were noted alongside substantial and rising deficits in the health sector. By June 2018, the unconsolidated debt of public non-financial corporations included in general government decreased to 17.8% of GDP, from 19.7% in June 2017. For 2019, the authorities committed to liquidate SOEs that have already fulfilled their purposes, that are economically unviable or that can be merged to generate savings. Moreover, improvements in the capital structure are also planned to be prioritised for those SOEs that have positive operational results but high levels of debt.

The short-term financial sustainability of the health system remains a concern and, despite some improvements during 2018, arrears persist on high levels. For the year ending in October 2018, the balance of the Portuguese National Health Service deteriorated by EUR 133 million in cash terms compared with the same period in the previous year. Nevertheless, some savings were achieved through centralised purchasing (EUR 38 million of savings for the year ending in September 2018), a greater share of generics and a substantial increase in biosimilars. Although hospital arrears had stabilised at lower levels in mid-2018, they resumed their increase in September 2018 and remained at around EUR 850 million in October 2018. This was despite supplementary State budget transfers of EUR 900 million since December 2017 and the ongoing release of another EUR 500 million A hospital pilot project is being set up in 2019 to address the underlying causes of rising hospital arrears. The plan intends to use both positive and negative management incentives to increase accountability and reduce moral hazard. However, at around EUR 30 million in 2019, the planned efficiency gains from the hospital pilot project appear modest and are not expected to lead to a sizeable decrease in hospital arrears in the short term.

The number of civil servants and the wage bill remain under pressure to increase above the authorities' own budget targets. Notwithstanding the planned decrease according to the target 2:1 replacement rule in 2017 and the planned stabilisation in 2018, the headcount of civil servants rose by 1.1% y-o-y in the year ending on 30 June 2018, with more pronounced growth in the health and education sector. Moreover, a wide-ranging programme to convert temporary contracts into permanent is expected to be concluded by end-2018. Also, the extension of the 35-hour week in the health sector as of 1 July 2018 to employees with private sector contracts (around 40% of the workforce) is expected to put additional pressure on the headcount and extra hours. Together with the gradual unfreezing of career progressions, these developments are projected to translate into an increase of the wage bill by 2.6% in nominal terms in 2018 according to the 2019 draft budget, significantly above the initial target in the 2018 budget. The unfreezing of career progressions is to be fully implemented by December 2019, with an additional balance-deteriorating impact of 0.2% of GDP being planned for that year.

Financial sector

Non-performing loans (NPLs) are decreasing, helped by a comprehensive strategy and improving secondary market liquidity. To speed up the reduction of problematic assets and impairment needs the authorities have embarked on a “three pillar comprehensive strategy”: (i) Reforming the insolvency framework (to speed up recoveries and bankruptcy procedures); (ii) tackling legal and tax bottlenecks (such as enhancing the ability to write off bad loans); and (iii) motivating banks to deal with NPLs through a series of prudential/supervisory actions. In practical terms, Portuguese lenders either work out bad debts internally, jointly through a servicing platform or increasingly through sales in the secondary market. Helped by strong growth in the property market and increasing investor interest, the secondary market for NPLs (often backed by real estate) is becoming increasingly competitive. In 2017, the total value of NPL secondary market transactions reached about EUR 2.3 billion. Given the strong pipeline of new deals, this figure is set to be exceeded in 2018.

Reforms to the judicial system are ongoing. The Portuguese insolvency framework is perceived as a significant obstacle to quicker and more efficient reduction in NPLs. Debtors can still use different legal actions to materially delay the debt restructuring or liquidation of the indebted company. The average duration of corporate insolvency proceedings (around 53 months) is twice the EU average and the resulting credit recovery rates are below 11% of the nominal values on average. The new set of rules for the extrajudicial restructuring of firms (PER) are meant to prevent non-viable firms from misusing it. This should allow for a clearer distinction between viable firms recurring to PER and court insolvency processes being used for insolvent firms. Other measures include debt advising through a business recovery mediator and the simplification of the legal regime for debt-to-equity swap.

Several programmes are facilitating access to finance. A key measure on this area is the Capitalizar programme, whose credit lines were increased in 2018 to satisfy the unexpectedly strong demand. Other programmes include credit lines for specific sectors or activities. Within this more targeted focus, the Internacionalizar programme targets exporting firms, and the Valorizar programme supports investment in the tourism sector.

External balance and competitiveness

Policy efforts to foster export competitiveness include various measures, along with targeted support to firms entering global markets. Key measures in this area aim to reduce the administrative burden, increase competition in business services and regulated professions, and improve the judicial system. Supporting the internationalisation of Portuguese firms, the trade and investment promotion agency (AICEP) has developed an e-learning tool to enhance their corporate websites and enabling them to connect to digital retail platforms.

Innovation and skill upgrading policies can foster export value-added. Some of these policies promote the adoption of digital technologies by SMEs, through the Indústria 4.0 programme. Estimates of the programme´s impact point to EUR 700 million of additional exports. Portugal also aims to bridge innovation and the productive sector through the Interface programme, which fosters the employment of PhDs under long-term contracts; the SIFIDE fiscal incentive to firms hiring PhDs; and the Capacitar programme, which raises digital preparedness for both firms and individuals.

FDI is increasing helped by specific policies to investment. Despite some regulatory issues, Portugal is one of the least restrictive host economies to FDI and has taken tailored measures to attract this type of capital. Among the latter, AICEP is implementing a proactive programme of investment promotion and aftercare. Thus, the residence-by-investment scheme in Portugal, also known as Golden Visas, has drawn over EUR 4 billion between its inception in 2012 and October 2018. The vast majority of funds under this scheme entail real estate acquisitions. The programme contributes in this way to the shift from debt to FDI financing, but has limited capacity to generate spill-overs to the host economy, via technology transfer, exports, etc. Moreover, these investments may also lead to upward pressures in real estate prices.

Business environment

Portugal is introducing measures to achieve administrative simplification. The SIMPLEX+ programme remains the main policy package to reduce the administrative burden for citizens and to improve businesses-government relations. The programme's measures cover several areas, and for business the measures mostly focus on horizontal issues, mainly with e-Government initiatives for digitisation (i.e. pre-filled VAT forms, replacement of paper files with digital files for tax-inspection etc.). During 2018, the programme launched 175 new measures, which add to the 93 approved in 2017. The assessment of the measures enacted thus far shows significant savings. Yet, SIMPLEX+ measures showed limited impact in reducing the burden from complex procedural rules for licensing. Portugal is also performing ex-ante legislative impact assessment on firms through the programme Custa Quanto? According to such assessment, most of the new laws recently introduced yielded no extra costs to firms.

A recent study identifying barriers to competition in the Portuguese economy may

lead to reforms in professional services regulation. The study co-authored by the Portuguese Competition Authority and the OECD outlined a set of priority reforms in services regulation, covering reserved activities, legal form restrictions, etc. With regulatory barriers being one of the factors deterring productivity in Portugal, the study also unveiled a positive economic impact from enacting these reforms. While the government is expected to follow up on these reform recommendations, the timeline and depth of the policy response is still unknown.

Portugal is introducing new laws to face the growth of short-term rental accommodations and urban transport services intermediated through digital platforms. The new laws focus on curbing tax evasion while providing a clear set of rules for these activities. With regard to short-term rentals, the law 62/2018 introduced new requirements for consumer protection and enhanced powers to municipalities in granting authorisations of the service. To regulate the platforms providing urban transport services, the law 45/2018 introduces a regulatory framework that includes licensing of operators and professional qualifications of the drivers.

Although challenges remain, various policies continue improving the efficiency of the judicial system. A recent decree law (81/2018) embeds several initiatives to reduce the cases backlog. These include the creation of teams of judges to speed up case resolutions in administrative and tax courts. The new law also provides incentives to the voluntary abandonment of judicial cases, either through arbitration or case withdrawal. Other measures address the efficiency of the judiciary through the adoption of electronic filing of judicial proceedings (e-justice) and the creation of specialised courts in various areas (public procurement, public employment and social benefit disputes, and tax enforcement). Recent policy efforts also target insolvency proceedings. These include new legislation related to the creation of a business recovery mediator to advise debtors, the extrajudicial restructuring of firms (PER), and the legal regime for debt-to-equity swap. While these policies are improving the efficiency of the Portuguese judicial system, the disposition time in administrative and tax courts is still high and remains one of the main challenges.

Labour market

Policy measures aiming to reduce labour segmentation need to ponder the specificities of the labour market in Portugal. Following the signing of the tripartite agreement, a recent resolution of the Council of Ministers addresses labour market segmentation. The resolution envisages an action plan to reduce precariousness and promote collective bargaining through reforming various pieces of legislation (the labour code, the code of contributory schemes, the legal framework for protection of employees, and the framework of active labour market policies). Yet, for the plan to be effective, policy attempts to limit fixed-term and incentivise open-ended hiring will have to be attentive to the seasonality of certain sectors. In the latter, establishing excessively stringent hiring conditions could compromise job creation.

Low-skill employment keeps on increasing amidst minimum wage hikes. The minimum wage rose from EUR 557 to 580 in 2018, and it will reach EUR 600 in 2019. These increases leave Portugal with one of the smallest gaps between minimum and median wage among EU countries, leading to a sizeable compression of the wage distribution. Nevertheless, the low-skill employment rate increased nearly 3 percentage points year-on-year in the first half of 2018.

To foster inclusion and employability, the government is carrying out several skill-enhancing measures for adults. These include the integrated Digital Competencies programme and the Strategy and Action Plan for Digital Employability. Policies adopted in 2017 to expand the vocational education and training (VET) in STEM (science, technology, engineering, and mathematics) areas have resulted in a significant increase in enrolment. A final key initiative towards skills improvement is the Qualifica programme, whose initial results point to a significant coverage of the adult population, with approximately 230 000 adults involved in training, prior learning recognition, or skill certification. The latest developments of the programme include the ESF reprogramming to address the qualifications of the adult population, and the creation of a new branch focused on public employees.

Portugal is implementing policies to strengthen the attractiveness and completion rate in higher education, particularly in STEM areas. These include a substantial increase in scholarships, a programme for paying tuition fees in instalments, and a scheme supporting enrolment in regions less densely populated and with lower demand. Specifically for STEM courses, and in addition to the abovementioned measures on VET, various initiatives focus on increasing their attractiveness amongst primary and secondary students, through the creation of science centres and the integration of ICT in school curricula.

Table A2.1: **State of play of the implementation of MIP relevant reforms**

MIP objective: reducing the levels of public debt			
Public finances			
Fiscal policy and fiscal governance			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
The spending review for 2019 is expected to yield savings of EUR 236 m across a series of public sector areas. A new pilot project for addressing the underlying causes of persistent hospital arrears. New rules for early retirement without penalty are being introduced in 2019, applicable to pensioners over 60 and with at least 40 years of contributions. Another extraordinary increase in pensions is planned for 2019. On top of this, a new extraordinary pension complement was announced for 2019, applicable to minimum pensions started to being paid in that year.	The spending review for 2018 was broadened to include Justice and Internal Affairs, with a focus on reducing public sector absenteeism and the legal treatment of seized vehicles. Review of prices and contributions; review of the NHS technology assessment system; budget monitoring and savings.	The spending review has been expanded to new areas of the public sector over the last few years. According to the authorities, some EUR 75 m have been saved by the expenditure review in 2017. Mission Structure for health system sustainability. centralisation of financial management; Monitoring Centre to combat fraud. The eligibility for early retirement without penalty has been gradually broadened over the past two years. Minimum pensions benefited in 2017 and 2018 from extraordinary updates in addition to the regular pension indexation linked to inflation and real GDP growth, with a particular focus on pensions that had not been updated between 2011 and 2015. Some revenues earmarked to the Social Security stabilisation fund (additional real estate tax, and up to 2% of revenue from CIT).	CSR1 - 2018: Strengthen expenditure control, cost effectiveness and adequate budgeting, in particular in the health sector with a focus on the reduction of arrears in hospitals
Long-term sustainability of public finances			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Authorities project state-owned enterprises (SOEs) as a whole to approach a level close to a balanced net income by the end of 2019. SOEs that have fulfilled their purposes, that are economically unviable or that can be merged to generate savings shall be liquidated. Improvements in the capital structure are also planned to be prioritised for those SOEs that have positive operational results but high levels of debt Review of economic and financial efficiency metrics per company. Review of public service contracts of a range of SOEs, particularly in the transport sector. Reducing the weight of operating expenses in turnover by continuing a policy of optimisation. The new Budget Framework Law is only very gradually being implemented.	Upgrade to an automatic reporting mechanism is in the process of being implemented. Continuous recapitalisation of SOEs. Increase monitoring and reporting of SOEs, e.g. by more strict monitoring, control and execution of budget plans.		CSR1 - 2018: Improve the financial sustainability of state-owned enterprises, in particular by increasing their overall net income and by reducing debt.
MIP objective: improving the functioning of the labour market			
Labour market			
Employment protection legislation & framework for labour contracts			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Revoke the Labour Code norm that allows hiring long-term unemployed and people looking for their first job on fixed-term contracts without further justifications. Differentiate firms' social security contributions by type of employment contract used making temporary contracts more expensive. To be implemented only in 2019.			CSR 2 – 2017: Promote hiring on open-ended contracts, including by reviewing the legal framework.
Active labour market policies			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Support to the creation of entrepreneurial projects and self-employment will be evaluated and the re-evaluation of the Contratos Emprego-Inserção will be implemented to bring them back to their original goal in activating the unemployed and the inactive.	One-stop-shops integrating social and employment services with a stronger focus on activation of self-employment.		CSR 2 – 2017: Ensure the effective activation of the long-term unemployed.
Wages & wage setting			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	Suspension of use of the expiry rule for collective agreements for a period of 18 months until July 2018.	Revoking the proportionality criteria for administrative extensions of collective agreements.	CSR 2 – 2017: Together with social partners, ensure that minimum wage developments do not harm employment of the low-skilled.
MIP objective: reducing the debt levels of the private sector			
Financial sector			
Private indebtedness			

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Table (continued)

Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	The three-pronged NPL strategy addresses the efficiency of the insolvency and recovery proceedings Rapid Reaction teams of judges to reduce further the backlogs in the court system	Fiscal incentives for individuals investing in firms which are undercapitalised. "Coordination platform" by the main banks to deal with corporate NPL. A new legal framework to allow majority creditors to convert their credits into share capital. A new legal framework for out-of-court restructurings (RERE). Larger financial envelope to Capitalizar,	CSR3: 2018- Increase the efficiency of insolvency and recovery proceedings and reduce impediments to the secondary market for non-performing loans
Access to finance			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Facilitate access of SMEs to capital funds.	The conversion into capital of third party credits has now the same tax regime as firm capitalisation.	Continuous implementation and new measures under Capitalizar and Internacionalizar programmes.	CSR 3: 2018 - Improve access to finance for businesses.
MIP objective: improving competitiveness and productivity			
External balance and competitiveness			
Investment			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		Acceleration in the execution of the European Structural funds (NRP 2017). Measures: Portugal 2020 reprogramming is ongoing, and it is expected that public investment will reach 2.1% of GDP in 2018. Implementation of EU Funds: Execution reaches EUR 7 billion (August 2018), 28% of the total allocation.	Weak productivity dynamics weighs on competitiveness and potential growth, limiting the capacity to bridge the income gap with the EU average and to enable a more inclusive pattern of growth (Programa Nacional de Reformas 2018).
Innovation performance			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Guidelines for an Innovation Strategy launched via a Resolution of the Council of Ministers in March 2018. A new law proposal ("projeto lei") to revise the law of institutions developing R&I.	The Startup Portugal+ Programme was presented in July 2018, including startup visas for foreign tech entrepreneurs. Fifteen proposals have been approved under the Interface Programme. The Scientific Employment diploma was adopted to improve the attractiveness and stability of research careers. The Qualifica scheme and INCoDe.2030 to boost digital skills. Indústria 4.0 is the Portuguese strategy to develop industry in the digital area.	Measures under StartUp Portugal have been implemented since 2016 such as innovation vouchers and incubation vouchers. 20 Competitiveness Clusters were identified in 2017 in wine, fashion and footwear, mineral resource, health and sustainability. Hiring of researchers under the Scientific Employment initiative. Some measures under Industria 4.0 are already in place such as the applications for the "Industry 4.0 Voucher".	Measures to boost innovation are key to facilitate the transition towards a more competitive and knowledge-intensive economy (Programa Nacional de Reformas 2018).
Business environment			
Administrative burden			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		New measures under the SIMPLEX programme are being implemented to reduce administrative burden to citizens and businesses. Ongoing assessment of legislation (Custa Quanto) started in 2017 with the aim of reducing the burden from new measures	CSR 3: 2018 - Reduce the administrative burden by shortening procedural deadlines, using more tacit approval and reducing document submission requirements.
Regulatory barriers			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		A study by OECD and the Competition Authority assesses restrictions in 13 self-regulated professions and in the transport sector. It has been released in 2018.	CSR3 : 2018 - Remove persistent regulatory restrictions by ensuring a proper implementation of the framework law for highly regulated professions
Judicial system			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	E-justice (electronic filing of judicial proceedings; tax procedure simplification). Further specialisation of Courts: new Public Procurement Chambers, Social Chambers, and Tax enforcement Chambers. Advisory cabinets to provide counselling to magistrates. Insolvency: business recovery mediator, firm restructuring, debt-to-equity swap. Staffing strengthening and backlog reduction.		CSR3: 2018 - Increase the efficiency of administrative courts, inter alia by decreasing the length of proceedings.
MIP objective: improving the functioning of the labour market			
Labour market			
Employment protection legislation & framework for labour contracts			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*

(Continued on the next page)

Table (continued)

	Signing of the tripartite agreement between government and social partners. Action plan to tackle precariousness and promote collective bargaining through advances in labour legislation.		CSR 2 – 2018: Promote an environment conducive to hiring on open-ended contracts, including by reviewing the legal framework in consultation with social partners.
Skills and education			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Qualifica AP, a new branch of the Qualifica programme for public servants was announced and is in the pipeline for adoption.	Reprogramming exercise of ESIF, notably ESF. The Qualifica programme is a center element of this exercise. National Digital Competences Initiative - Portugal INCoDe.2030. The 'Strategy and Action Plan for Digital Employability' Diversification and differentiation in higher education through VET. Various measures to foster enrolment rates in higher education studies (numerus clausus in the public higher education institutions; Programme +Superior: scholarships; special quota for disabled candidates for accessing higher education. Measures to foster higher education in STEM (boost the attractiveness of STEM areas amongst students; national network of Science Centres; Learning Laboratories initiative; the National Digital Competences Initiative - Portugal INCoDe.2030; the 'Strategy and Action Plan for Digital Employability'.	Qualifica Programme specialising in adult education and training and aimed at providing counselling, guidance and referral to learning pathways (NRP 2017).	CSR2-2018: Increase the skills level of the adult population, including digital literacy, by strengthening and broadening the coverage of the training component in adult qualification programmes. CSR2-2018 - Improve higher education uptake, namely in science and technology fields.

Source: European Commission

ANNEX 3

European Commission macroeconomic and fiscal projections (2018 autumn forecast)

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

Annual % change	2017	2018	2019	2020
1. Private consumption expenditure	2.3	2.3	2.0	1.8
2. Government consumption expenditure	0.2	0.9	0.8	0.5
3. Gross fixed capital formation	9.2	4.4	4.7	5.1
4. Final domestic demand	**3.0**	**2.4**	**2.2**	**2.1**
5. Change in inventories	--	--	--	--
6. Domestic demand	**2.8**	**2.4**	**2.2**	**2.1**
7. Exports of goods and services	7.9	5.5	4.3	3.6
7a. - of which goods	6.7	5.7	4.4	3.5
7b. - of which services	11.0	4.9	4.1	3.7
8. Final demand	**4.3**	**3.3**	**2.9**	**2.6**
9. Imports of goods and services	8.1	6.0	5.2	4.4
9a. - of which goods	8.1	6.5	5.6	4.7
9b. - of which services	7.7	3.4	3.1	2.9
10. Gross domestic product at market prices	**2.8**	**2.2**	**1.8**	**1.7**
Contribution to change in GDP				
11. Final domestic demand	3.0	2.4	2.2	2.1
12. Change in inventories + net acq. of valuables	-0.2	0.0	0.0	0.0
13. External balance of goods and services	0.0	-0.2	-0.4	-0.4

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

Annual % change	2017	2018	2019	2020
1. Private consumption expenditure	3.6	3.8	3.5	3.4
2. Government consumption expenditure	2.2	2.3	2.4	1.9
3. Gross fixed capital formation	12.0	5.7	5.9	6.2
4. Final domestic demand	**4.7**	**3.9**	**3.7**	**3.6**
5. Change in inventories	--	--	--	--
6. Domestic demand	**4.7**	**3.8**	**3.7**	**3.6**
7. Exports of goods and services	11.4	7.5	5.9	4.8
8. Final demand	**6.6**	**4.9**	**4.4**	**4.0**
9. Imports of goods and services	12.4	8.2	6.7	5.5
10. Gross national income at market prices	4.5	3.7	3.5	3.4
11. Gross value added at basic prices	3.9	3.3	3.3	3.2
12. Gross domestic product at market prices	**4.4**	**3.6**	**3.4**	**3.3**
Nominal GDP, EUR bn	194.6	201.6	208.4	215.3

Table 3: Implicit price deflators

% change in implicit price deflator	2017	2018	2019	2020
1. Private consumption expenditure	1.2	1.5	1.5	1.6
2. Government consumption expenditure	2.0	1.4	1.6	1.4
3. Gross fixed capital formation	2.6	1.2	1.1	1.1
4. Domestic demand	**1.6**	**1.4**	**1.4**	**1.5**
5. Exports of goods and services	3.3	2.0	1.6	1.2
6. Final demand	**2.1**	**1.6**	**1.5**	**1.4**
7. Imports of goods and services	4.0	2.1	1.4	1.0
8. Gross domestic product at market prices	**1.5**	**1.4**	**1.5**	**1.5**
HICP	**1.6**	**1.5**	**1.6**	**1.6**

Table 4: Labour market and cost

Annual % change	2017	2018	2019	2020
1. Labour productivity (real GDP per employee)	-0.5	0.0	0.5	0.8
2. Compensation of employees per head	1.6	1.8	2.1	2.1
3. Unit labour costs	**2.1**	**1.8**	**1.6**	**1.2**
4. Total population	-0.2	-0.1	0.0	0.0
5. Population of working age (15-74 years)	-0.2	-0.2	-0.1	-0.1
6. Total employment (fulltime equivalent)	3.3	2.2	1.3	0.9
7. Calculated unemployment rate - Eurostat definition	**9.0**	**7.1**	**6.3**	**5.9**

Table 5: External balance

levels, EUR bn	2017	2018	2019	2020
1. Exports of goods (fob)	58.3	62.8	66.6	69.8
2. Imports of goods (fob)	68.8	74.8	80.1	84.7
3. Trade balance (goods, fob/fob) (1-2)	**-10.4**	**-12.0**	**-13.5**	**-14.9**
3a. p.m. (3) as % of GDP	***-5.4***	***-6.0***	***-6.5***	***-6.9***
4. Exports of services	24.8	26.5	28.0	29.4
5. Imports of services	12.8	13.4	14.0	14.6
6. Services balance (4-5)	**12.0**	**13.1**	**14.0**	**14.8**
6a. p.m. 6 as % of GDP	***6.2***	***6.5***	***6.7***	***6.9***
7. External balance of goods & services (3+6)	**1.6**	**1.1**	**0.5**	**-0.1**
7a. p.m. 7 as % of GDP	***0.8***	***0.5***	***0.2***	***-0.1***
8. Balance of primary incomes and current transfers	-1.2	-1.0	-0.7	-0.2
8a. - of which, balance of primary income	*-4.2*	*-4.2*	*-4.1*	*-4.0*
8b. - of which, net current Transfers	*3.1*	*3.2*	*3.5*	*3.8*
8c. p.m. 8 as % of GDP	*-0.6*	*-0.5*	*-0.3*	*-0.1*
9. Current external balance (7+8)	**0.4**	**0.1**	**-0.1**	**-0.3**
9a. p.m. 9 as % of GDP	***0.2***	***0.0***	***-0.1***	***-0.1***
10. Net capital transactions	1.7	1.8	1.9	2.0
11. Net lending (+)/ net borrowing (-) (9+10)	**2.1**	**1.9**	**1.7**	**1.7**
11a. p.m. 11 as % of GDP	***1.1***	***0.9***	***0.8***	***0.8***

Table 6: Fiscal accounts

	2017	2018	2019	2020
	% of GDP			
Taxes on production and imports	14.9	15.1	15.2	15.3
Current taxes on income, wealth, etc.	10.1	10.2	10.0	10.0
Social contributions	11.7	11.8	11.8	11.8
Sales and other current revenue	5.6	5.5	5.7	5.7
Total current revenue	**42.3**	**42.7**	**42.7**	**42.8**
Capital transfers received	0.4	0.6	0.6	0.6
Total revenue	**42.7**	**43.3**	**43.3**	**43.4**
Compensation of employees	10.9	10.9	11.0	10.9
Intermediate consumption	5.4	5.4	5.3	5.3
Social transfers in kind via market producers	1.8	1.8	1.8	1.8
Social transfers other than in kind	16.5	16.6	16.6	16.6
Interest paid	3.8	3.5	3.3	3.2
Subsidies	0.4	0.5	0.5	0.5
Other current expenditure	2.3	2.4	2.4	2.4
Total current expenditure	**41.3**	**41.0**	**40.9**	**40.7**
Gross fixed capital formation	1.8	2.0	2.3	2.6
Other capital expenditure	2.6	1.0	0.7	0.4
Other (residual)	4.9	3.4	3.1	2.8
Interest expenditure	3.8	3.5	3.3	3.2
Total expenditure	**45.7**	**44.0**	**43.9**	**43.7**
General Government balance (ESA2010)	**-3.0**	**-0.7**	**-0.6**	**-0.2**
Primary balance	0.9	2.7	2.7	3.0
	% change			
Taxes on production and imports	6.2	5.0	3.9	3.7
Current taxes on income, wealth, etc.	3.5	4.6	0.7	3.8
Social contributions	4.9	4.7	3.8	3.3
Sales and other current revenue	0.5	2.2	6.9	2.8
Total current revenue	**4.4**	**4.5**	**3.5**	**3.5**
Capital transfers received	-24.0	62.0	0.5	3.4
Total revenue	**4.0**	**5.0**	**3.5**	**3.5**
Compensation of employees	1.9	3.6	3.7	2.3
Intermediate consumption	2.4	2.6	1.9	2.6
Social transfers in kind via market producers	2.6	4.1	3.3	3.2
Social transfers other than in kind	1.3	3.8	3.9	3.3
Interest paid	-4.7	-6.5	-1.1	1.0
Subsidies	-16.3	6.7	17.1	4.0
Other current expenditure	-5.7	7.6	2.8	3.2
Total current expenditure	**0.4**	**2.9**	**3.2**	**2.8**
Gross fixed capital formation	23.4	15.1	16.6	15.3
Other capital expenditure	585.9	-58.9	-27.5	-44.4
Total expenditure	**6.4**	**-0.1**	**3.1**	**2.6**
Nominal GDP, EUR bn	**194.6**	**201.6**	**208.4**	**215.3**

Table 7: Government debt developments

	2017	2018	2019	2020
ESA2010 deficit (% of GDP)	**-3.0**	**-0.7**	**-0.6**	**-0.2**
ESA2010 gross debt (% of GDP)	124.8	121.5	119.2	116.8
ESA2010 deficit	**-5.8**	**-1.5**	**-1.2**	**-0.5**
Gross debt	242.8	244.8	248.4	251.4
Change in gross debt	1.8	2.0	3.5	3.0
Nominal GDP	194.6	201.6	208.4	215.3
Real GDP growth (% change)	**2.8**	**2.2**	**1.8**	**1.7**
Change in gross debt (% of GDP)	0.9	1.0	1.7	1.4
Stock-flow adjustments (% of GDP)	-2.0	0.3	1.1	1.2
Gross debt ratio	**124.8**	**121.5**	**119.2**	**116.8**
Change in gross debt ratio	-4.5	-3.3	-2.3	-2.4
Primary balance	0.9	2.7	2.7	3.0
"Snow-ball" effect	-1.5	-0.8	-0.6	-0.6
of which				
Interest expenditure	*3.8*	*3.5*	*3.3*	*3.2*
Real growth effect	*-3.5*	*-2.6*	*-2.2*	*-2.0*
Inflation effect	*-1.9*	*-1.7*	*-1.8*	*-1.8*
Stock-flow adjustments	**-2.0**	**0.3**	**1.1**	**1.2**
Implicit interest rate	*3.1*	*2.9*	*2.8*	*2.8*

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