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Post-Programme Surveillance Report

Portugal, Spring 2015

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European Commission

Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report
Portugal, Spring 2015

EUROPEAN ECONOMY Institutional Paper 006

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EXECUTIVE SUMMARY

This report presents the findings of the second post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, to Lisbon between 4 and 12 June 2015. *Economic and financial conditions in Portugal have further improved since the conclusion of the first post-programme surveillance mission in autumn 2014. However, the economic recovery is still hampered by the remaining macroeconomic imbalances. While the authorities reiterated their commitment to budgetary consolidation, efforts to reduce the underlying structural budget deficit need to be strengthened. The structural reforms undertaken during the financial assistance programme are increasingly having an effect. Nevertheless, the reform agenda to further enhance medium-term growth prospects, job creation and competitiveness remains challenging.*

The Portuguese economy is continuing its gradual recovery, driven by both domestic and external demand. *Domestic demand is being supported by low interest rates, reductions in personal income tax, the gradual reversal of some temporary consolidation measures, and improvements in business and consumer confidence. In parallel, a benign external environment and favourable exchange rate developments are providing a boost to exports. Real GDP is therefore expected to accelerate to 1.6% in 2015 and 1.8% in 2016. Risks to the short-term outlook are tilted slightly to the upside, related to the positive impact of the euro depreciation and the favourable financing conditions. The main obstacles to higher output growth are the deleveraging needs in the economy. The authorities' short-term macroeconomic projections are broadly in line with the Commission's 2015 spring forecast, but their medium-term projection appears optimistic.*

The mission maintained the Commission's 2015 spring forecast projection of a general government deficit of 3.1% of GDP in 2015, while the authorities are expecting a headline deficit of 2.7% of GDP. *The Commission retains a more cautious assessment of the expected yield of some of the consolidation measures included in the 2015 budget and of measures to combat tax fraud and evasion in 2015. At the same time, the spring forecast also projects the structural fiscal effort to be substantially below what is recommended by the Council. Moreover, there are risks to the effective compliance with the preventive arm of the Stability and Growth Pact in 2016 and thereafter, mainly due to the expected reversal of temporary consolidation measures implemented under the economic adjustment programme, for which compensatory consolidation measures have not been specified by the authorities. In addition, the stability programme is based on optimistic growth assumptions in the outer projection years and on expected interest savings that might not materialise with the current yield levels. To ensure durable compliance with the Pact, fiscal consolidation should focus on primary expenditure in particular via further increases of the efficiency and quality of public expenditure.*

Fiscal-structural reforms are advancing, but implementation needs to continue. *Building on already successful Public Financial Management reforms, a comprehensive revision of the Budget Framework Law is about to be completed and implemented with a 3-year transition period. Further efforts on revenue administration reform are being made, including measures to fight tax evasion and fraud; an ex-post quantification of the yield of these measures still needs to be developed. Public administration reforms are proceeding, but some of them at a slower pace and with less budgetary impact than initially expected. The operating balance of state-owned enterprises (SOEs) improved considerably despite headwinds. Privatisations of several SOEs are progressing. The implementation of local and regional administration reforms is making good progress, and renegotiations of several public-private partnerships (PPPs) are to be formally concluded. Following the Constitutional Court ruling of August 2014 rejecting the previous reform proposal and in the absence of a broad political consensus on an alternative design, discussions on a comprehensive pension reform have been postponed until after the next election. Health care system reforms with a view to ensure the sustainability of hospital SOEs are progressing, but reducing their arrears remains a challenge.*

Bank lending has continued its downward trend in volume while deposits are recovering and the loss absorption capacity of the Portuguese banking sector remains adequate. *Bank loans seem to be increasingly targeted towards least risky projects, reflecting the drive to improve credit quality. However,*

a large stock of non-performing loans remains in banking groups' balance sheets, and profitability remains a key challenge in an environment of low interest rates and subdued economic growth. Portuguese banks returned in Q1 2015 to profitability after three years of losses, but reflecting trading gains rather than core business performance. Thus operating costs and business models still need attention. In particular, the corporate debt overhang remains comparatively at excessive levels despite seven consecutive quarters of negative corporate debt growth and a gradual increase in the share of equity as a source of funding. Authorities should encourage a more ambitious approach to corporate deleveraging by enhancing and complementing the measures already in place. Adding to the challenge, Portuguese banks may need to increase their own funds levels to gain flexibility in provisioning and write-offs, while authorities need for instance to encourage earnings retention and equity injections in Portuguese firms and to reduce the debt bias in taxation. The macro-prudential toolkit was recently broadened and supplemented with instruments laid down in the regulatory framework of the EU's strengthened capital requirements rules (CRR/CRD IV package).

While there were no new major reform initiatives since the first PPS mission, some progress has been observed in recent months in the implementation of a number of growth-enhancing structural reforms initiated under the programme. *Authorities have further pursued efforts to monitor the housing market reforms and, continued to implement the planned easing of the administrative burden and foster the business environment. Monitoring of education outcomes and active labour market policies has also improved. Energy market liberalisation is advancing and, together with planned improvements in cross-border interconnections, it can contribute to decrease pressure on energy prices. The reform momentum seen under the programme needs to be maintained, also ensuring full and effective implementation of reforms which have been repeatedly delayed and in some cases attenuated. These reform areas include the evaluation of structural reforms, services and regulated professions, ports, and judiciary. Further efforts are also needed to tackle the remaining electricity tariff debt and to foster more flexible wage bargaining at the firm-level.*

There are no risks to reimbursement in the short-term. *Since the conclusion of the first PPS mission, borrowing conditions continued to improve for Portugal, in line with developments elsewhere in the euro area. By taking advantage of the favourable market conditions over recent months, the Treasury managed to extend maturities and lower implicit interest rates. This has strengthened Portugal's position in the sovereign debt market, avoiding the concentration of debt redemptions in time and increasing financing flexibility in the future. The authorities also began early repayment of the IMF loans and are planning further early redemptions. Nevertheless, debt dynamics can be subject to change in the medium term and remain dependent on strengthening growth, continuing fiscal consolidation and retaining market access on favourable terms.*

The results of specific monitoring under the Macroeconomic Imbalance Procedure (MIP) suggest that Portugal has made some progress in addressing the relevant imbalances. *The 2015 in-depth review (IDR) for Portugal carried out under the MIP concluded that the remaining excessive macroeconomic imbalances require decisive policy action and specific monitoring. This specific monitoring relies on PPS and was launched with the second PPS mission. Overall, there has been some progress in addressing the imbalances in the areas of public and private debt, unemployment and external competitiveness. However, additional reforms are needed to ensure a durable rebalancing of the economy.*

National elections are scheduled to take place in late September/early October. The next PPS mission will most likely take place in late November/early December.

1. Introduction 7

2. Recent economic developments 9

3. Policy issues 15

4. Sovereign financing and capacity to repay 25

A1. Specific monitoring in the framework of the Macroeconomic Imbalance Procedure 27

A2. Debt sustainability analysis 35

A3. Commission services macroeconomic and fiscal projections 2014-2016 37

LIST OF TABLES

2.1. Comparison between the EC Spring Forecast 2015 and the Stability Programme (SP) 2015 10

2.2. Financial Soundness Indicators 14

3.1. Fiscal adjustment 2010-16 17

LIST OF GRAPHS

2.1. Contributions to real GDP growth 9

2.2. Unemployment indicators 9

2.3. State budget execution: Revenue (cash-data) 11

2.4. General Government consolidated accounts (cash-data) 11

2.5. Budgetary outturn for Social Security (cash-data) 12

2.6. Central administration budget execution (cash-data) 12

2.7. The fall in the stock of company loans accelerated 13

2.8. Funding gap more than halved 13

2.9. NPL negatively correlate with loan growth 13

2.10. Deposits remain close to their all-time high 13

A2.1. Macroeconomic risks: growth and interest rates 35

A2.2. Fiscal consolidation and ageing costs 35

1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the second post-programme surveillance (PPS) mission for Portugal between 4 and 12 June 2015. The mission was coordinated with the IMF's post-programme 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 having received financial assistance ([1]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions. The first PPS mission took place between 28 October and 4 November 2014.

Specific monitoring of the adjustment of Macroeconomic Imbalances was also launched with the second PPS mission. The 2015 in-depth review (IDR) carried out under the macroeconomic imbalance procedure (MIP) for Portugal concluded that remaining excessive imbalances require decisive policy action and specific monitoring ([2]). A detailed overview of the policy actions taken to rebalance the economy is provided in Annex 1, following the relevant parts of the country-specific recommendations (CSRs) issued by the European Council in July 2014.

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

([2]) See communication from the Commission to the European Parliament, the Council and the Eurogroup: "2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011", http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_comm_en.pdf.

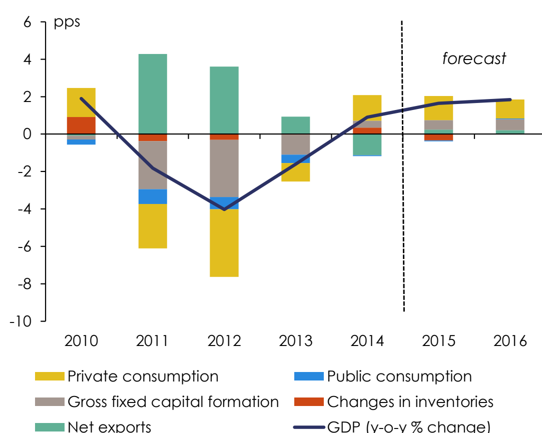
2. RECENT ECONOMIC DEVELOPMENTS

Macroeconomic situation and outlook

Portugal's real GDP grew by 0.4% q-o-q (1.5% y-o-y) in 2015Q1. Compared to the first quarter in 2014, a strong growth contribution from domestic demand (+2.8 pps) was partly offset by a negative contribution from inventories (-1.3 pps) while the contribution of net external trade was neutral. Private consumption increased by 2.5% y-o-y and fixed investment recorded 8.6% y-o-y growth, the latter driven by machinery and transport equipment investment as well as strong rebound in construction. Exports grew by 6.8% y-o-y and imports increased by 6.6% y-o-y.

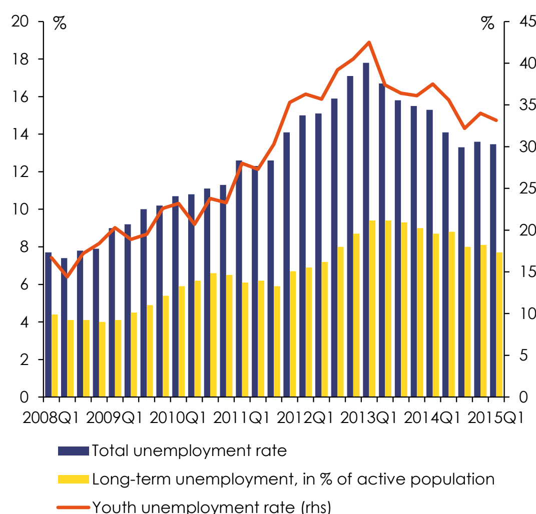
High frequency economic indicators point to a continuation of the gradual economic recovery, driven by both domestic and external demand. The Commission's Economic Sentiment Indicator slightly decelerated in May, but remains at high levels. Confidence in manufacturing is further improving and capacity utilisation has returned to its historical average. Cement sales have been booming since January and the index on construction activity has reached a six-year high in March. Exports of goods grew by 9.7% y-o-y in nominal terms in April 2015 as the substantial drop in exports to Angola was more than compensated by the acceleration of Intra-EU exports. Goods imports are in line with the continuation of the robust domestic demand recovery in 2015Q2, increasing by 16% y-o-y in April 2015.

Graph 2.1: **Contributions to real GDP growth**



Source: Commission services

Graph 2.2: **Unemployment indicators**



Source: Commission services

Strong domestic demand and positive net exports are expected to boost real GDP growth to 1.6% in 2015 and to 1.8% in 2016 (Graph 2.1). Private consumption is projected to grow by 2.0% in 2015, supported by low interest rates, reductions in personal income tax and improvements in confidence, and then gradually decelerate to 1.6% in 2016, as deleveraging pressures for households remain high. The recent substantial increase in capacity utilisation, the accommodative monetary policy stance and the projected improvement in credit conditions are expected to reinforce investment in 2015-16. However, a partial correction of previously accumulated inventories is expected to weigh on GDP growth, as was already visible in 2015Q1. At the same time, robust export performance, related to the benign external environment and the depreciation of the euro, is expected to more than offset import growth over the forecast horizon. The mission maintained the Commission 2015 spring forecast of 1.6% real GDP growth in 2015. Going forward, economic growth is expected to accelerate marginally to 1.8% in 2016; on the back of positive external environment, robust domestic demand, also helped by the projected reversal of public wage cuts and of lower direct taxes, and a more neutral contribution from inventories. Risks to the Commission spring outlook are tilted slightly upwards**.** The main obstacles to stronger economic growth are deleveraging needs owing to

Table 2.1: **Comparison between the EC Spring Forecast 2015 and the Stability Programme (SP) 2015**

	EC Spring Forecast 2015			*SP15 Portugal*	
	2014	**2015**	**2016**	***2015***	***2016***
Real GDP (% change)	0.9	1.6	1.8	*1.6*	*2.0*
Private consumption (% change)	2.1	2.0	1.6	*1.9*	*1.9*
Public consumption (% change)	-0.3	-0.2	0.2	*-0.7*	*0.1*
Gross fixed capital formation (% change)	2.5	3.5	4.0	*3.8*	*4.4*
Exports of goods and services (% change)	3.4	5.3	6.1	*4.8*	*5.5*
Imports of goods and services (% change)	6.4	4.7	5.8	*4.6*	*5.3*
Contributions to real GDP growth:					
- Final domestic demand	1.7	1.7	1.6	*1.6*	*1.9*
- Change in inventories	0.4	-0.3	0.0	*-0.2*	*0.0*
- Net exports	-1.1	0.2	0.2	*0.1*	*0.1*
Output gap1	-5.1	-3.1	-1.4	*-3.5*	*-2.0*
Employment (% change)	1.4	0.6	0.7	*0.6*	*0.8*
Unemployment rate (%)	14.1	13.4	12.6	*13.2*	*12.7*
Labour productivity (% change)	-0.5	1.0	1.1	*1.1*	*1.2*
HICP inflation (%)	-0.2	0.2	1.3	*-0.2*	*1.3*
GDP deflator (% change)	1.2	1.3	1.4	*1.3*	*1.4*
Comp. of employees (per head, % change)	-1.4	0.5	1.1	*0.6*	*1.0*
Current external balance (% of GDP)	0.5	1.2	1.4	*0.5*	*0.4*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.0	2.6	2.8	*2.1*	*2.0*

(1) In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.
Source: Commission services; SP 2015 Portugal

high levels of public and private debt. On the other hand, there are upside risks related to the positive impact of the euro depreciation and the accommodative monetary policy stance.

The labour market improved further in the first quarter of 2015, albeit at a more moderate pace compared to 2014. According to national accounts seasonally adjusted data, employment increased by 0.7% q-o-q in 2015Q1 and the unemployment rate (Eurostat definition) declined to 13.5% in the same period, down by 1.4pps compared with 2014Q1. Recent labour market developments are broadly in line with the Commission spring forecast 2015, which projects a moderate increase in employment by 0.6% and the unemployment rate to decline to 13.4% in 2015, in line with the current economic expansion. However, unemployment remains high, especially for the youth cohort (Graph 2.2). A sustainable recovery of the Portuguese labour market requires stronger output growth and a further reallocation of workers towards the tradable sectors.

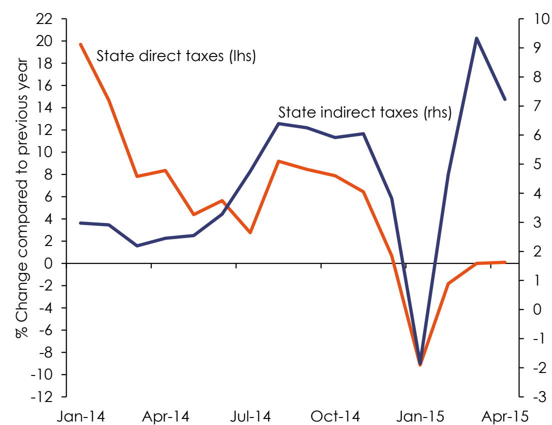
Inflationary pressures have intensified in the second quarter of 2015. HICP inflation reached 1.0% in May 2015 due to upward pressures on prices for transport, food, beverages and tobacco. The 12-month average HICP inflation rose to 0.0%, leaving behind the negative territory. The gradual rise of oil and commodity prices and wage increases are expected to support positive HICP inflation during the projection period. HICP is projected to grow by 0.2% in 2015 and to increase above 1.0% in 2016.

The authorities' macroeconomic projections are broadly in line with the mission's outlook, but their medium term projection appears optimistic. According to Portugal's Stability Programme, the authorities expect a somewhat stronger domestic demand contribution to GDP growth in 2016, mainly due to more robust private consumption. For 2017-19, the authorities predict an average GDP growth rate of 2.4%, due to strong domestic demand and buoyant exports as a result of continued gains in export market shares. Robust external demand would also boost investment activity, thereby contributing to the closure of the investment gap that opened during the economic and financial crisis. Moreover, the authorities consider that there are upside risks to their medium term forecast related to the positive impact of structural reforms and support from EU structural funds. The mission assessed the authorities' medium-term scenario as rather optimistic not least given the substantial deleveraging needs.

Public Finance

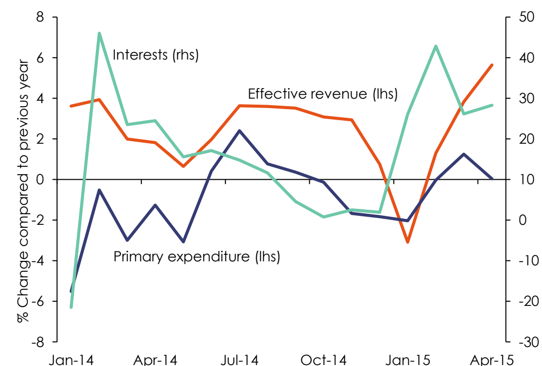
In cash terms, budget execution through end-April 2015 was overall in line with the 2015 budget. Up to April, the general government cash balance improved by EUR 0.2 billion relative to the same period last year (net of effects caused by the transition to ESA 2010). The cash primary balance of public administration recorded a surplus of EUR 0.9 billion. Due to transitory effects, expected to be compensated in the coming months, expenditure growth stayed below budget 2015 projections for most expenditure items in the first four months of the year, except for interest payments that increased in cash terms due to early redemption operations. Tax collection has overall evolved in line with the increases projected in the 2015 budget. As regards direct taxes, some remaining shortfall in Personal Income Tax (PIT) collection following a January one-off effect has been compensated by high Corporate Income Tax (CIT) performance in spite of a CIT rate cut by 2pps at the beginning of this year. The collection of indirect taxes, with an increase of 7.2% year-on-year in January to April, is substantially above 2015 budget targets, which is almost entirely due to stronger VAT collection. However, the improvement in VAT revenues is influenced by considerably lower refunds up to April due to stronger cross-compliance requirements regarding other tax obligations as a precondition for refunds to taxpayers. The over-performance of VAT collection as compared to budgetary targets is therefore expected to gradually decrease in the coming months, but some overachievement by year-end is not excluded by the tax authorities at this stage. As regards pension systems, while the public sector pension fund (CGA) projects a need for a higher contribution from the State Budget based on execution up to April, Social Security accounts are considered on track with budgetary targets. While Social Security revenue increases have slightly fallen short of targets up to April, this has been more than compensated by lower than expected expenditure for unemployment benefits. Budget execution for local and regional administration, while showing some deviations at item level, is considered globally on track. Overall, cumulative revenue and expenditure by end April are considered in line with 2015 budgetary targets. As no major deviations/pressures have been identified so far, the authorities are confident to reach the budgetary targets in cash terms as adopted in the 2015 budget. However, both revenue and expenditure need to be closely monitored and if necessary adjusted in the coming months to ensure the achievement of the overall 2.7% headline deficit which is expected by the government. The contingency reserves at central and decentralised level (frozen appropriations at line ministry level only releasable upon authorisation by the Ministry of Finance) may also be used to compensate for potential deviations towards year-end.

Graph 2.3: **State budget execution: Revenue (cash-data)**



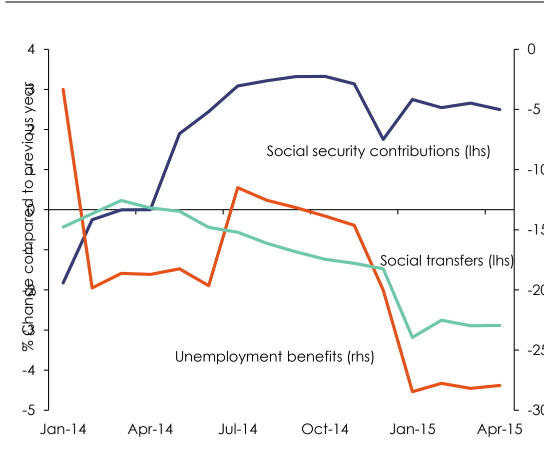
Source: DGO, Commission services

Graph 2.4: **General Government consolidated accounts (cash-data)**



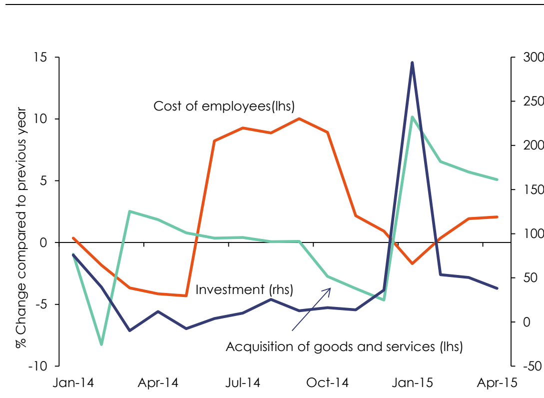
Source: DGO, Commission services

Graph 2.5: **Budgetary outturn for Social Security (cash-data)**



Source: DGO, Commission services

Graph 2.6: **Central administration budget execution (cash-data)**



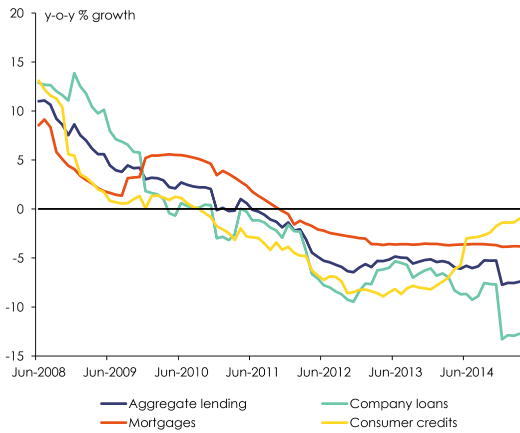
Source: DGO, Commission services

Following a small rebound in January the stock of arrears has continued its declining trend. Public sector arrears were reduced by another EUR 71 million in the first four months of the year. This decline has mostly been due to the steady reduction of arrears on Madeira and at local government level with a minor cumulative reduction at state-owned hospitals so far. To fund the financing needs of the relevant state-owned hospitals, the government launched a recapitalisation operation worth EUR 455 million in 2014, intended to stop the accumulation of new arrears. After a first capital injection of EUR 151 million in December 2014, another EUR 304 million are to be disbursed this year, which should in principle allow for an arrears reduction of the same size by year-end.

Financial stability

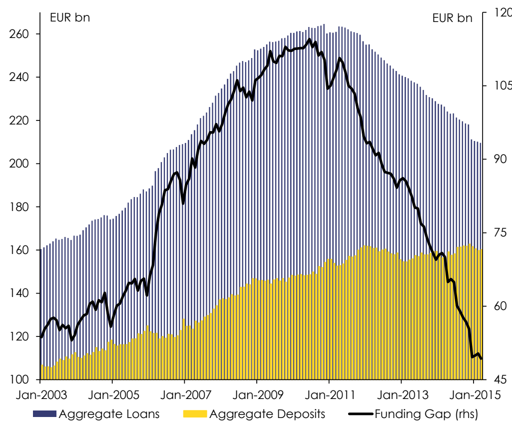
Aggregate bank lending has continued on its downward trend. Since end-2012, the annual average decline in the stock of mortgages was 3.6%, whereas consumer credit seems to follow the recovery in consumer confidence. Both mortgage and consumer lending fell sharply during the programme but the pace of the decline slowed down more recently. In 2015, freshly generated corporate loan volumes are only 59% of the past 12-years average (41% for household loans), leading the overall loan stock to decline (Graph 2.7 and 2.8). While corporate loan stocks fell by 27% since spring 2011 and were further reduced by around 13% y-o-y in 2015Q1, not all companies are deleveraging. Recently, gross fixed capital formation excluding construction registered strong growth, which is in line with the findings of January's Bank Lending Survey (BLS) diffusion index listing loan demand for fixed investment at its highest mark since 2004. According to the BLS published in April 2015 banks expect a growing demand for corporate loans which is mainly coming from SMEs while only one surveyed bank indicated an increase in demand for large company loans. The quartile of the least risky loans increased, while the second quartile stagnated and stark decreases are observed for firms classified as risky. This development indicates an improvement in the risk differentiation in the loan supply given the high level of non-performing loans (NPL) in the system (Graph 2.9). At the same time, fierce competition in the least risky segment seems to put pressure on interest margins decoupling the final interest rate from the risk level. NPLs reached 18.9% for corporate credit and 17.4% for consumer loans whereas non-performing mortgages remain flat at 5.8%. The flow of new overdue loans has decreased to levels last seen in 2011, indicating some stabilisation of the deterioration process. Interest rates continue to follow a downward trend. In 2015Q1, corporate credit was granted with an average interest rate of 4.7% for loans below EUR 1 million and 3.7% above that threshold. The average mortgages rate was 2.8% while consumer loans were sold with an average interest rate of 8.7 %. In March 2015, an average loan in Portugal yields 3.1% whereas banks remunerate their deposits stock with 1.2%.

Graph 2.7: **The fall in the stock of company loans accelerated**



Source: Banco de Portugal

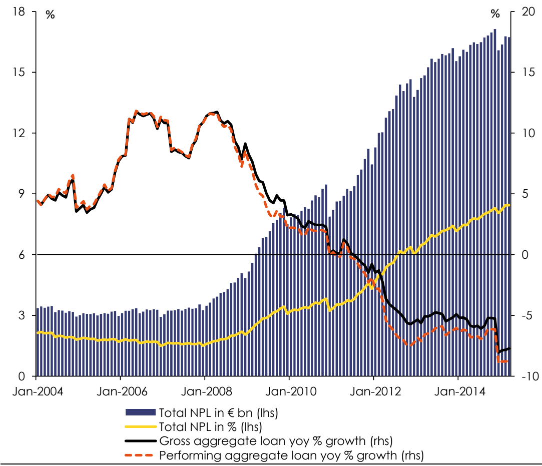
Graph 2.8: **Funding gap more than halved**



Source: Banco de Portugal

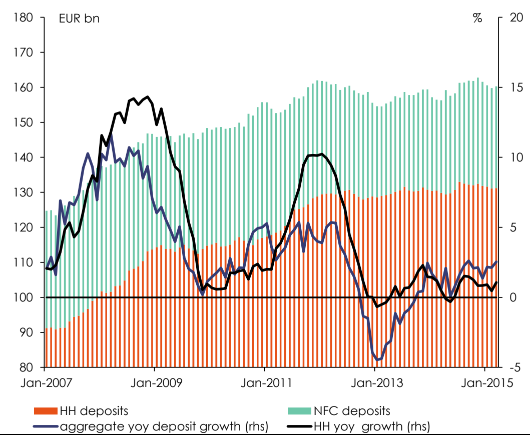
Deposits grew by 2.5% year-on-year in March 2015 in the context of historically low interest rates. Household deposits kept a 1% growth whereas company deposits grew by 9.7% between March 2014 and 2015, partly due to a statistical reclassification. In March 2015, new deposits were offered remuneration below 0.7%, prompting some clients to shift their savings into higher yielding insurance products, thus muting current deposit growth. Although the loan to deposit ratio decreased from over 160% before the economic adjustment programme to currently 107%, the Portuguese banking system is still the seventh most leveraged in the EU. In the same period, Portuguese banks halved their funding gap (Graph 2.8), as a result of which banks rely to a lesser extent on the Eurosystem to fund their business. ECB borrowing stood at EUR 28.2 billion in May 2015, less than half of the EUR 59.9 billion observed in May 2012.

Graph 2.9: **NPL negatively correlate with loan growth**



Source: Banco de Portugal

Graph 2.10: **Deposits remain close to their all-time high**



Source: Banco de Portugal

Table 2.2: **Financial Soundness Indicators**

%	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Return on equity (1)	6.3	0.9	-0.3	-4.1	-3.8	-7.1	-6.7	-10.3	-1.4	-21.8	-17.4	-16.9	3.9
Gross income on assets	2.6	2.7	2.6	2.6	2.1	2.1	2.2	2.1	2.5	2.3	2.4	2.4	2.8
Cost to income	56.2	53.0	56.5	58.8	67.1	68.7	69.7	71.8	58.5	65.8	65.5	65.6	51.4
Non-performing loans (2)	8.3	9.5	9.8	9.8	10.3	10.5	11.1	10.6	10.8	11.2	11.9	11.9	11.3
Coverage ratio (2)	51.6	49.6	50.5	54.1	53.8	53.8	52.8	56.0	57.5	62.3	62.4	64.0	60.4
Capital adequacy ratio	10.7	12.3	12.3	12.6	13.0	13.1	13.4	13.3	12.3	12.0	13.0	12.3	12.0
Core Tier 1 ratio	9.5	11.0	11.1	11.3	11.7	11.7	12.0	11.9	11.1	10.7	12.1	11.4	11.2
Loan-to-deposit ratio	136.9	136.3	133.3	127.9	124.0	122.6	120.7	116.9	117.2	113.9	111.9	107.2	106.8

(1) Annualised figures. Measured by earnings before minority interests.
(2) Does not include Novo Banco as of March-2015
Source: Banco de Portugal

Overall, the loss absorption capacity of Portuguese banks remains adequate. In the post-programme context, Portuguese banks are holding close to record high capital levels. The aggregate Core Tier 1 (CT1) ratio of the Portuguese banking sector was 11.2% (Common Equity Tier 1: 11.1%) at the end of March (Table 2.2), compared to 11.7% in the first quarter of 2013 ([3]). Challenges such as reducing the large stock of problem assets (Graph 2.9) and improving the profitability in the sector may require banks to continue to increase the level of own funds. Recent improvements in Portugal's macroeconomic conditions and the interest from foreign investors open a window of opportunity for banks to raise additional capital. By the same token, banks could also take advantage of the current environment to lower some of their exposure to Portuguese sovereign debt holdings representing 8.3% of assets in December 2014 against 7.5% in end-2013. Furthermore, at the current juncture limiting the banks' exposure to the Angolan economy and sovereign – now considered more precarious due to the low oil price – may well become an important strategic decision, even though Angola will undoubtedly remain a significant portfolio and direct investment destination for Portuguese banks and businesses. Lastly, banks could cut down more substantially their exposure to the Portuguese real-estate sector, which has recently seen a recovery. In its recent financial stability report, Banco de Portugal mentions that from a macroprudential perspective it is paramount that the value of exposures to the sovereign, to Angola and to the real estate sector are appropriately assessed and registered.

Portuguese banks returned to profitability in 2015Q1, driven by one-off trading gains, although at significantly lower levels than in the pre-crisis years. The Portuguese economy has been growing since 2014 and the restructuring in the three banking groups that heavily benefitted from state aid at the peak of the crisis is mostly finalised. While banks are still burdened with non-performing assets, capital levels are relatively high, for most banks above 11% of Common Equity Tier 1. Portuguese banks posted the first positive return on equity since 2012Q2, with profits primarily generated by trading gains rather than core business. Future profit growth will depend heavily on the management of banks' liabilities (provisioning and restructuring) against their capital position and how the cost to income ratios evolve. Since 2010, the banking sector decreased its branch network by 15% and the number of staff by 13%. On the assets' side, banks will continue to face pressure from the low Euribor, which serves as benchmark for most mortgage contracts. Portuguese banks could capitalise on the current supportive macro-economic trends and relatively cheap funding to accelerate the pace of the deleveraging in the corporate sector, which may allow them to allocate more resources toward the viable part of the Portuguese firms and, by doing so, accelerate the economic recovery.

([3]) Between 2008 and 2013, all analysed institutions have computed the capital adequacy ratio in accordance with Basel II criteria. Since 1 January 2014 the Notice of Banco de Portugal 6/2013 establishes a new, transitory, regime of own funds adequacy.

3. POLICY ISSUES

Public Finance

The Commission 2015 spring forecast predicts a general government headline deficit of 3.1% of GDP in 2015. The Commission's headline deficit projection has thus improved by 0.2pps since the assessment of the 2015 draft budgetary plan, essentially reflecting the improved carry-over from 2014 regarding tax collection and the revised macroeconomic outlook in early 2015. As compared to the authorities' projection of 2.7% of GDP, the spring forecast maintains, however, a more cautious assessment of the budget 2015 consolidation package, estimating its impact at 0.5% of GDP, and a more cautious assessment of the additional yields of the enhanced fight against tax fraud and evasion. Moreover, the Commission forecast also points to a significant deterioration in the structural balance in 2015 by 0.8% of GDP, well below the recommended improvement of 0.5% of GDP. The cumulative change in structural balance over 2013-2015, at 0.9 % of GDP altogether, also falls markedly short of the recommended 2.5% of GDP. Risks to the Commission's spring forecast budgetary projections for 2015 appear broadly balanced: slightly positive concerning the macroeconomic outlook but slightly negative related to the achievement of further efficiency gains in tax revenue collection, the implementation of tax reforms in a budget-neutral way, and possible expenditure slippages in an election year.

In the Stability Programme the Portuguese authorities kept their deficit projection for 2015 unchanged compared to the Draft Budgetary Plan at 2.7% of GDP. Only minor adjustments were made to most revenue and expenditure items taking into account updated information following the publication of the national accounts for the last quarter of 2014, in particular as regards local government accounts. The authorities also maintained the projected yield of all of the budget 2015 consolidation measures (except for the yield of the Oceanário operation ([4]) reclassified as non-deficit-reducing in terms of national accounts). Despite the improved macroeconomic outlook the authorities however have not revised down the projected headline deficit, which may indicate possible pressures on some expenditure items or some potential shortfalls as compared to the high additional revenue projected in the budget. Based on budgetary implementation figures and further relevant information available at early June, the authorities have not seen any reason to revise their budgetary projections for 2015 included in the Stability Programme. While a different final composition of the headline deficit in terms of revenue and expenditure breakdown is considered likely by the authorities, any negative variations for some items are at this stage expected to be compensated by positive variations for other items. Moreover, the authorities are confident that more significant negative deviations towards the end of the year could be accommodated by central contingency reserves and frozen appropriations at line ministry level (that can only be released upon approval by the Ministry of Finance).

As regards the medium-term outlook, the Stability Programme projects a steady improvement of the headline deficit from 2.7% in 2015 to 1.8% in 2016 and 1.1% in 2017, until reaching a surplus of 0.2% of GDP in 2019. According to the authorities, this would bring the structural deficit to the MTO of -0.5% of GDP already in 2016, keep it at the MTO in 2017, and allow for structural balances slightly above the MTO thereafter, up to -0.2% of GDP in 2019. The programme underpins the improving fiscal position in 2016 and the following years by enhanced economic growth, significant estimated savings in interest payments, broad nominal stability of compensation of employees and a series of fiscal measures.

([4]) The 2015 state budget included revenue estimated at EUR 40 million from the concession of the Lisbon Oceanário to a private investor. The award of the concession is projected to be concluded in the coming weeks with above EUR 20 million in 2015 cash inflows, however without deficit-reducing impact in national accounts.

However, about half of the programme's fiscal measures are deficit-increasing reversals of temporary consolidation measures undertaken during the economic adjustment programme (public sector wage cuts, PIT surcharge etc. ([5]), whereas the main primary deficit-reducing measures (pension reform, rationalisation of public sector) have a lower total projected size and are not further specified. As concerns budgetary pressures, i.e. specifically identified growing expenditure needs/decreasing revenue flows, for 2016 to 2019, the Stability Programme scenario specifically factors in significantly growing pension payments that are only partially covered by increasing social contributions. With nominal growth rates in pension expenditure still below the projected nominal growth rates of GDP, social transfers are nonetheless projected to decrease as a percentage of GDP. As further specifically identified pressure, the Stability Programme scenario also takes into account the transfer of a part of the banking sector levy to the European Resolution Fund from 2016 onwards. Overall, the authorities considered that the design of the Stability Programme budgetary path had to strike a balance between expectations for quick reversal of temporary consolidation measures and the efforts to comply with the requirements of the Stability and Growth Pact.

The Commission sees risks that the Stability Programme medium-term budgetary scenario may not ensure effective compliance with the preventive arm of the Stability and Growth Pact. Based on no-policy change assumptions (implying a full reversal of the wage cuts and the PIT surcharge bound to expire at end 2015), the Commission's spring forecast projects a headline deficit of 2.8% of GDP in 2016 and a deterioration of the structural deficit by 0.6pp to 2.1% of GDP. According to the spring forecast, if Portugal effectively achieves the correction of the excessive deficit in 2015, there would thus be a risk of a significant deviation from the structural adjustment target of 0.6% of GDP in 2016, as it is required by the preventive arm of the Stability of Growth Pact. For 2017-19 the Commission also sees risks as regards the Stability Programme's optimistic growth assumptions, the projected nominal stability of the compensation of employees without further decrease in public employment, the decrease in interest payments and the effective revenue impact of ongoing and planned tax reforms. Compensation per employee may suffer upward pressure as it may be difficult to maintain the complete freeze of public careers and wages (apart from the gradual reversal of public sector wage cuts for higher salaries) for another five years. Regarding savings in interest payments, the Stability Programme assumes an average interest rate on new issuance of 10 year-bonds of 2.4% in 2015 and 2.2% for 2016-2019. At the same time the Programme estimates the impact on interest payments of a 1pp rise in interest rates along the entire yield curve to reach 0.2% of GDP in 2015 and to rise gradually up to 0.5% of GDP in 2019. Should recent interest rate increases (to above 3% for 10 year sovereign bonds bonds) turn out to be permanent, a substantial part of the interest payment savings projected in the Stability Programme would not materialise. This would in particular also concern the projected savings from early repayments of IMF loans that would also have to be revised downwards accordingly. To ensure durable compliance of the budgetary path with the Stability and Growth Pact, Commission staff considers that fiscal consolidation should focus on primary expenditure, in particular via further increases in the efficiency and quality of public expenditure.

The debt-to-GDP ratio reached 130.2% at the end of 2014 and is set to decline in 2015. The economic recovery as well as debt-reducing operations should help in initiating a downward trend of the public debt-to-GDP ratio, which the Commission forecasts to reach 124.4% of GDP by the end of 2015 and 123.0% of GDP in 2016. The Portuguese authorities maintain slightly more positive projections of 124.2% of GDP by the end of 2015 and 121.5% by the end of 2016 in line

([5]) Following a first reversal by 20% in 2015, the Stability Programme projects the further gradual reversal over four years of the remaining public sector wage cuts (applicable for monthly salaries above EUR 1500). The incremental budgetary impact is estimated at EUR 153 million per year in 2016-2019 resulting in a permanent impact of EUR 600 million (0.3% of GDP). The Stability Programme also projects the gradual reversal by 0.875 percentage points per year of the temporary 3.5% surcharge on personal income tax over 2016 to 2019. The incremental budgetary impact is estimated at EUR 190 million per year, resulting in a permanent impact of EUR 760 million (0.4% of GDP). As according to the legislation in force both temporary measures are bound to automatically expire at the end of 2015, the Commission spring forecast, in line with no-policy change assumptions, assumes full reversal of both the remaining public sector wage cuts and the PIT surcharge already in 2016.

Table 3.1: **Fiscal adjustment 2010-16**

	2010	2011	2012	2013	2014	2015	2016
Balance - EDP	-11.2	-7.4	-5.6	-4.8	-4.5	-3.1	-2.8
Budget deficit, net of one-offs	-8.5	-7.2	-5.5	-5.1	-3.3	-3.1	-2.8
Structural balance	-7.7	-5.6	-2.4	-1.7	-0.8	-1.5	-2.1
Primary balance	-8.2	-3.0	-0.7	0.1	0.5	1.8	1.7
Structural primary balance	-4.7	-1.3	2.5	3.2	4.2	3.4	2.4
Fiscal adjustment	0.2	3.5	3.7	0.7	1.0	-0.8	-1.0
Fiscal effort (EDP definition)	0.3	2.1	3.2	0.7	0.9	-0.8	-0.6

(1) Fiscal adjustment is measured as the change in the structural primary balance; fiscal effort defined as the change in the structural balance
Source: Commission services

with their more favourable assumptions for the headline deficits. The reduction in the debt-to-GDP ratio in 2015 is mostly supported by projected stock-flow adjustments worth 5.2% of GDP, including the repayment of the resolution fund loan following the sale of Novo Banco and Social Security Fund purchases of national public debt. Overall, the authorities still assume the same size of stock-flow adjustments as in the Stability Programme. While in 2016 and 2017 there are still significant projected redemptions of contingent convertible bonds, the bulk of projected stock-flow adjustments for 2017 to 2019 consists of a gradual decrease of the debt agency's cash buffer, partially counterbalanced by the projected acquisition of other financial assets. Apart from the relatively minor contribution of stock-flow adjustments, the projected further decrease of the debt ratio in the Stability Programme scenario of around 4.5pps per year over 2017 to 2019 to 107.6% of GDP at the end of 2019 is mostly driven by high nominal GDP growth rates, a decrease in interest rate payments and increasing primary surpluses. Any materialisation of the risks to the programme's budgetary scenario presented above would impact the assumed steep downward path of the debt-to-GDP ratio accordingly.

Fiscal-structural issues

Building on successful Public Financial Management reforms, the focus is shifting to the implementation of the reformed Budget Framework Law (BFL). The adoption of the reformed BFL by the Parliament is expected for July. The law aims at streamlining budget appropriations, reducing the still high budget fragmentation, strengthening accountability of the different budget units and reinforcing the medium to long-term focus of public finances, including by a stricter definition of expenditure ceilings. The reformed BFL also aligns the deadlines for the presentation of the Stability Programme and the Draft Budgetary Plan to the Parliament with the European Semester requirements. The draft law foresees a three-year transition period for the application of the new elements. The Ministry of Finance will monitor the implementation of the reformed BFL.

In order to ensure the durability of the achieved reduction of arrears, the Commitment Control Law needs to be effectively enforced. The law has already helped to address the accumulation of arrears in various subsectors of the public administration by improving discipline and budgetary control of the entities. However, its underlying principles have not been fully enforced and its implementation in some ministries needs to be closely monitored so as to prevent a new accumulation of arrears.

The focus of revenue administration reforms has shifted to improving tax compliance. Organisational reforms are under way in the tax administration, including the planned integration of local tax offices into the *Aproximar* programme, the Risk Management Unit and the recently created Taxpayers' Service Department, both already fully operational. Ongoing measures to strengthen tax compliance include, in particular, increased efforts to combat tax fraud in the housing market, improving information-sharing arrangements with financial institutions and strengthening Portugal's anti-money-laundering framework. However, there is still ample scope for modernising the revenue administration and further strengthening taxpayer compliance. Authorities appear willing to undertake further organisational reforms in particular at regional

level, to be supported by a strengthened central back office.

Efforts to fight tax evasion and fraud have contributed to improved tax collection. The authorities estimate a yield of these measures between 0.2% and 0.4% of GDP in 2014 ([6]). The budget 2015 expects new measures to fight tax fraud to yield additional revenues of about 0.3% of GDP. Although the Commission, in their assessments of Member States' Draft Budgetary Plans, does not accept *ex-ante* anti-tax fraud measures as consolidation measures, it is still important that the Portuguese authorities develop a convincing method for the ex-post approximation of their permanent yield, both as an indicator of the effectiveness of the efforts to fight tax fraud and evasion and as a way to avoid overly optimistic reliance on such revenues. The authorities committed to launch such an analysis while not announcing a date by which they would report on their outcome. A solid ex-post quantification of the yield of measures against tax evasion and fraud could allow for their *ex-post* acceptance as consolidation measures, which could to some extent reduce the expected shortfall of the fiscal effort over 2013-2015 as compared to EDP recommendations.

Despite headwinds, the operating balance of state-owned enterprises (SOEs) ([7]) was slightly positive again in 2014 as the operational and financial restructuring of several SOEs is progressing. The comprehensive SOE restructuring initiated during the Programme has delivered considerable savings without major negative impacts on service provision. In particular, the operating balance of state-owned hospitals turned positive by end-2014. The neutral operating balance of SOEs was achieved despite a significant reduction in public service compensation from the general budget, due to a mix of cost compression and commercial sales improvement. SOEs debt declined by 5% (EUR 1.6 billion), mainly due to debt to equity conversions. Equity injections and debt to equity conversions are expected to add EUR 4.9 billion capital to SOEs in 2015 (out of a total of EUR 8.5 billion over the 2013-15 debt to equity conversion programme). The rail and road infrastructure managers were merged on 1 June 2015 ([8]), and a framework has been set up that aims at ensuring the financial sustainability of the merged company *Infraestruturas de Portugal* in the mid to long run. The water sector reorganisation is on track with the merger of 19 into 5 SOEs to be enforced by the end of June ([9]). A task force in the Ministry of Finance for SOEs monitoring (UTAM) is almost fully operational. It has taken first steps to collect data from both central and local SOEs and plans to report on a quarterly basis on SOE developments.

The privatisation programme is progressing. Privatisations of several SOEs (EGF, TAP, CP Carga, EMEF) are ongoing with a view to closing them still in this legislative period. The competitive environment on those tenders has been ensured. The government signed the contract for selling 61% of TAP on 24 June, although several steps are still needed to conclude the sale, including the standard procedure by which the Commission has yet to give its final approval. Carristur (tourist buses) was taken out of the privatisation list as it is considered to be a sound company which competes in the market and where the State ownership is not preventing its growth strategy. SILOPOR (silos terminals sale) will be launched during the current mandate but will probably see the financial close only after a new government takes office. Marina do Tejo privatisation is in the pipeline while Oceanário privatisation and its 30 years concession sale is to be awarded by July.

Renegotiations of several public-private partnerships (PPPs) remain to be concluded. Road PPPs renegotiations are behind schedule due to lengthy procedures and delays in getting the lending banks' waiver to each renegotiated contract. The government has recently approved

([6]) On the 30th June, after the cut-off date of the present report, the Authorities published a Report on Tax Evasion and Fraud 2014 (http://www.portugal.gov.pt/pt/os-ministerios/ministerio-das-financas/documentos-oficiais/20150701-mf-rel-combate-fraude-evasao-fiscal.aspx).

([7]) As agreed during the adjustment programme, the operating balance of SOEs is being measured by the adjusted EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortisation excluding severance payments.

([8]) Decree-law 91/2015 published in the 29th May Official Gazette.

([9]) 29th May 2015 decree-laws 92/2015, 93/2015 and 94/2015 create the multi-municipal water and sewerage systems of *Centro Litoral*, *Norte* and *Lisboa e Vale do Tejo* respectively. They also create the SOEs in charge of managing the concession of each system.

the first set of amended concession contracts, which are now awaiting the President's promulgation. Further renegotiated contracts are expected to be submitted to the Council of Ministers in the near future. Dealing at the same time with the renegotiations of road PPPs, the renegotiation of port concessions as well as with monitoring PPPs and concessions, the resources of the PPP taskforce within the Ministry of Finance (UTAP) are stretched.

Following the Constitutional Court ruling in 2014, the government has abandoned its plans for an ambitious pension reform during this legislature. Thus, the temporary extraordinary solidarity contribution on pensions (CES) that had been in place since 2011 was abolished in the 2015 budget, except for a contribution on the highest pensions, without compensation by any permanent replacement measure. Other plans like the envisaged adjustment factor linking pension developments to the short-run balance of the system have also been put on hold. Moreover, the freeze of early retirements in the private sector was lifted in the 2015 budget. While the Stability Programme includes a structural measure for the sustainability of the pension system worth 0.3% of GDP from 2016 onwards, this measure has not been further specified. Authorities maintain that the design of the measure will only be possible after the elections referring to the broad political consensus which needs to be found.

The sustainability of the health care system has been markedly improved since 2011, but considerable challenges remain. Although arrears in the health sector have been on a downward trend since August 2014, falling below EUR 550 million by April 2015, the use of the remaining EUR 304 million capital injections in those state-owned hospitals for debt redemption would not be sufficient to clear the arrears by year-end. In addition, state-owned hospitals are projected to run EUR 43 million negative EBITDA in 2015, putting further pressure on budget implementation and the design of measures to effectively halt and clear the arrears by the end of the year ([10]). The authorities reconfirmed their commitment to implement the ongoing reform in the national health system reorganisation in line with international institutions recommendations, focusing on primary and long-term care and thus diverting demand from more expensive hospital services([11]). The authorities have defined a strategic plan to reduce significantly the waiting list for a family doctor by December 2015. The agreement on the sustainability of the National Health Service reached with the pharmaceutical industry in November 2014 and the alternative "clawback law" are expected to deliver EUR 180 million savings through reduced expenditure on medicines in 2015. Public expenditure in medicines has steadily declined since 2010 towards the 1% of GDP target (having reached 1.19% of GDP in 2014).

Public administration reforms are being concluded, although with less ambition than announced during the Programme. Public sector employment increased by 0.1% q-o-q in the first quarter of 2015 (-2.1% y-o-y), mainly due to additional fixed-term contracts in the education and health sectors. The new single wage scale, which applies a new system of 115 remuneration categories across the whole government to improve transparency and fairness, has become effective at the beginning of the year. The new single supplement scale is planned to enter into force in January 2016. Neither of the two new scales is expected to render sizable budget savings in the short term since remuneration levels of current staff were guaranteed to be safeguarded. No new programme for the termination of contracts by mutual agreement was started this year. The number of employees in the requalification scheme and re-employed in other parts of the government has recently increased and is expected to continue doing so in the coming months. However, this number is still falling considerably short of the original assumptions made during the economic adjustment programme.

Local administration reforms are showing some positive effects. Continued budget surpluses since 2013 have led to a decrease of local debt and arrears. The few unresolved applications of municipalities for financing under the local arrears strategy (PAEL) will be taken up by the

([10]) Portugal is still not complying with the Directive 2011/7/EU on late payment of commercial debts by the public administration. An infringement case is ongoing, since the European Commission considers that Portugal has not properly transposed this directive into the national law.

([11]) OECD Reviews of Health Care Quality: Portugal 2015 (27th May 2015).

Municipality Support Fund (FAM), a debt workout mechanism for currently 42 eligible over-indebted municipalities of which about half are already negotiating adjustment plans and financing with the FAM as well as arrangements with their creditors to alleviate their debt payments. The *Aproximar* programme, which aims at reorganising the public services network at local level, is being implemented in many municipalities. However, the Fiscal Coordination Council is not yet delivering on its main objective of supporting municipalities in drafting their budgets. The revised legal framework for local authorities' SOEs and shareholdings (Law 50/2012), is being monitored. The authorities claim that budgetary risks from PPPs at local level are limited because of a total financial exposure of only EUR 400 million, and the new law reduces incentives for entering into new PPPs.

The Autonomous Region of Madeira could regain market access once its adjustment programme with the Government is terminated at the end of 2015. Compliance with programme conditionality, including budget targets that were met in 2013 and 2014, and the process of arrears settlement allowed a better control of Madeira's public debt burden between 2012 and 2015. However, PPP renegotiations, privatisations, and assets sales are still delayed relative to programme targets. Public finances in the Autonomous Region of Azores remain sound, with a budget broadly in balance and a small debt stock, as revenues are projected on the basis of prudent assumptions and public spending is tightly controlled.

Financial sector

The corporate debt overhang remains excessive despite seven consecutive quarters of negative corporate debt growth and a gradual increase in the share of equity as a source of funding. The authorities should encourage a more ambitious approach to corporate deleveraging by enhancing and complementing the measures already in place. Even though in 2014 corporate deleveraging accelerated – corporate debt (on a non-consolidated basis, excluding SOEs) is now around 153% of GDP – and the deleveraging framework is largely in place, Portuguese firms remain among the most indebted in the EU. This impedes economic growth as high corporate debt constrains business investment and pushes firms to default or delay debt payments. Currently one third of all Portuguese firms has overdue loans and on average one third of the firms' EBITDA is spent to service debt. There have been a number of positive changes to the corporate debt restructuring frameworks (PER and SIREVE), which should encourage firms to seek assistance at earlier stages than insolvency. However, bottlenecks persist in several areas. Firstly, banks may need to increase their own funds levels to be able to face increased provisioning and accelerated write-offs of corporate debt. Secondly, the authorities need to encourage earnings retention and equity injections in Portuguese firms, continue efforts to reduce the tax debt bias and finalise initiatives such as the introduction of Real Estate Investment Trusts. Lastly, more work needs to be done to accelerate debt workout procedures in courts, which would encourage investors to bid for such assets, which in turn would free resources that could be allocated to viable projects.

The Development Financial Institution (DFI) structure is now in place but not yet fully operational. The DFI will target market segments where market failure or market inefficiencies have been spotted and aim at improved credit access, in particular for SMEs. No new information has been made available during the mission.

The bidding for Novo Banco, the "good" bank created in August 2014 out of the healthy assets of Banco Espírito Santo, entered its final phase. Out of the initial 17 bidders for Novo Banco three entered the last bidding stage and are expected to submit binding offers by end June 2015. The bank's financial situation seems to have improved recently. Its capital position fell from 10.3% to 9.4% between August and December 2014 due to a EUR 230 million deficit. However, capital ratios should improve with the sale of BES' former investment bank, which is awaiting approval by the relevant authorities. Novo Banco regained savers' trust as deposits grew between August and December 2014 ([12]). As loans fell simultaneously its loan-to-deposit rate came down from 144% in August to 124% in December 2014.

([12]) Bank-specific data for 2015 have not been published yet at the cut-off date for this report.

The macro-prudential toolkit was recently broadened and supplemented with instruments laid down in the regulatory framework of the CRR/CRD IV package. Implementing the macro-prudential policy involves the definition of objectives, the identification of risks that may pose a threat to the achievement of these objectives and the selection of instruments to mitigate or prevent those risks. Banco de Portugal considers four intermediate objectives to be most relevant for macro-prudential policy in Portugal: (i) mitigate and prevent excessive credit growth and leverage, (ii) mitigate and prevent excessive maturity mismatch and market illiquidity, (iii) limit direct and indirect exposure concentrations and (iv) limit incentives for excessive risk-taking by systemically important institutions. Banco de Portugal defined a number of instruments for the implementation of its macro-prudential policy and some are available for implementation in January 2016. Others reflect Banco de Portugal's compliance with commitments assumed at European level (CRR/CRD IV package) such as the systemic risk buffer or the sectoral capital requirements. A countercyclical capital buffer and the buffer for systemically important institutions will be applicable as from 2016.

Structural reforms

On the labour market, new rules introduced in 2014 seem unfavourable to decentralised wage setting and no further initiatives are foreseen to foster collective bargaining at firm level. Although collective bargaining is slowly picking up, the number of workers covered by company agreements remains low. The temporary suspension of sectoral collective agreements at firm level was made possible, but it requires the agreement of the original signatories, potentially limiting its effective application (up to May 2015 no sectoral collective agreement was temporarily suspended). The extension of collective agreements no longer requires representativeness of signatories in the sector as it is now sufficient if SMEs account for 30% of the employers' association signing the agreement. The number of extensions in the first half of 2015 was already higher than in 2014 as a whole. Further efforts to improve the take-up of firm-level bargaining would allow a better match of firm-specific wages with firm-specific productivity.

An assessment of the effectiveness of recent labour code reforms in reducing segmentation is needed as the share of workers hired under temporary contracts remains high. During the crisis there was a decline in the share of temporary employment, explained by more intensive job shedding among temporary contracts. More recently, the proportion of temporary contracts has risen in line with the growth in employment. Temporary contracts have been on an increasing trend since 2012, reaching a two year peak in the third quarter of 2014. Therefore it is unclear if the recent labour market reforms had an effect in reducing labour market segmentation. An independent evaluation of recent labour code reforms with respect to their impact on labour market segmentation has not started although announced in the National Reform Programme; the competent authorities were not available to discuss this issue during the mission.

Improved effectiveness of active labour market policies and efficiency of Public Employment Services (PES) could increase employability. Steps are being taken to improve the monitoring of the transition from active labour market programmes into regular employment, which could help improving the effectiveness of PES in fostering the employability of participants in employment and training programmes. A legal framework for the cooperation between public and private employment services has been created and two pilot projects are in the pipeline. An internship programme was set up to target long term unemployed over 30 years old. Financial support has become available for geographical mobility within Portugal so as to foster relocation that improves labour market matching.

Measures are being implemented to improve the education system but a National Skills Strategy is still missing. A system to monitor student performance has been put in place, contributing to a better prevention of grade repetition and early school leaving. First pilots to decentralise school management will be launched together with a funding formula to foster improvements in school performance. Links with the business sector and the attractiveness of vocational training have been improved with the opening of business schools of reference, the approval of new study programmes for the professional technical courses as well as the

monitoring of courses' employability rate. Steps have been taken towards addressing skills mismatch, such as the publication of the national skills diagnosis report, including the implementation of some proposed measures. However, the launch of a comprehensive National Skills Strategy is not foreseen for the moment.

Reforms of the transport sector are advancing slowly. The framework law for the new transport regulatory authority (AMT) was adopted in 2014 and further amended in February 2015, but AMT is still not operational. The reforms under the ports chronogram, which aim at setting up a new governance model and regulation for the sector, were originally scheduled to be completed in March 2015. However this target was not met and the process is delayed in important areas such as the revision of the tariff system or the law on concessions. The renegotiation of the port concession contracts to lower port usage costs for shippers continues at a slow pace. A renegotiation was concluded for the Port of Sines, however without further reduction in port usage costs. No agreements were reached so far for other ports with long residual concession contract lengths (Leixões, Aveiro, Setúbal and Lisbon). The sub-concessions of the metropolitan transports in Lisbon and Porto are advancing. In Metro do Porto the new operator is planned to start in August and the STCP (Porto bus operator) contract was awarded in June. In Lisbon, the *Carris* and *Metro* sub-concessions have been granted and the new concessionaire is expected to start operating in the fourth quarter of 2015. The Transtejo/Soflusa sub-concession (Tagus river ferryboats) will be launched during the current legislative period but will probably see the financial close only after a new government takes office. The privatisation of *CP Carga*, the state-owned freight operator, is also advancing with the opening of a tender for direct sale with binding offers submitted in end-June.

As regards the energy market, efforts to improve international energy connections have been pursued further, but clearing the tariff debt by 2020 would require additional measures. Past liberalising measures seem to take effect, with consumers moving gradually from the regulated to the liberalised tariff both in gas and electricity. According to the energy regulator, the liberalised market represents already around 90% of the total energy market in terms of volume after a large number of industrial consumers and more than half of the households have moved to the liberalised tariff. New players are entering the energy market, which is contributing to some decrease in market concentration, but incumbents are still dominant. Following an agreement on the Iberian gas market rules, a draft treaty for MIBGAS is being discussed between Portugal and Spain. An interconnection project that will allow Portugal to reach the 10% electricity interconnection target with Spain, has been identified as a Project of Common Interest in the framework of the Connecting Europe Facility and is planned to start in 2016. Albeit with some delay, the second and third packages of measures to reduce the electricity tariff debt are being implemented and a decree-law to prevent fraudulent electricity consumption is in the legislative process. However, the electricity tariff debt will only start decreasing in 2016 and is forecast to reach EUR 1 billion in 2020, missing the target of clearing the tariff debt in that year. However, no new measures are foreseen that would further reduce excessive rents and help to alleviate pressure on energy prices.

A strong and efficient competition authority is essential to ensure a competitive situation in key markets. The new financing model appears to ensure a more sustainable base of resources for the Portuguese Competition Authority (PCA). However, there are some issues concerning its implementation that risk undermining the predictability of PCA’s funding and therefore require close monitoring. These issues concern in particular a revenue shortfall due to the fact that the Transport Authority (AMT) has not transferred the due amount and corrections in the resources to be credited from some sectoral regulators. Moreover, the current resources may not allow a modest growth of the PCA in 2016 and afterwards, taking into account that the public sector salary cuts will be progressively withdrawn and that new tasks, including more advocacy, will be performed by the PCA. Finally, the PCA is currently under the budgetary rules applicable to the budget of general government. These rules could limit the financial autonomy foreseen in the PCA’s bylaws and national regulatory authorities' framework law.

The judiciary has been reformed, but assessing its performance remains difficult. There are still serious operational problems due to the non-

functioning of the central database for court files (CITIUS) and the poor quality of the database for tax courts (SITAF). The authorities committed to indicating by the end of July 2015 a precise publication date of comprehensive judicial statistics, including 2014 data on: length of procedures, disposition time, clearance rate and number of pending cases in civil and commercial courts, insolvency courts, tax and administrative courts and for enforcement cases. These statistics are essential to assess the impact of judiciary reforms and underpin the first *ex-post* assessment to be carried out by a contracted university.

Measures to increase administrative transparency are advancing, although mainly at central level. The authorities are making efforts to make detailed data available on all public procurement contracts on the BASE portal and to address some existing gaps, mostly due to delays in publishing data on contracts awarded by local and regional authorities. Transparency in the area of concessions needs to be improved. As regards PPPs, while UTAP is monitoring ongoing PPPs managed by the central government, PPPs at the regional and local level are outside the scope of the Ministry of Finance's, i.e. UTAP's, oversight and there is no equivalent structure in place, despite significant risks. The Council for the Prevention of Corruption published in June 2015 a report on the implementation of the anti-corruption plans of public entities. The report concludes that, while a large number of public entities have set up such plans, there is still the need to adopt measures to strengthen the existing plans, in particular to improve the evaluation of corruption risks and to streamline the process of implementing and monitoring preventive actions. The newly adopted revision of criminal legislation (Law No 30/2015) is an important step to fight corruption, *inter alia,* by extending the statute of limitation for corruption crimes and by criminalising certain offences related to bribery and abuse of power.

Authorities continue efforts to establish databases for the monitoring of the housing market reform, however overall data are not yet sufficient to derive adequate evidence of its impact. It is not possible yet to fully ascertain the impact of the urban lease reform undertaken under the programme. The authorities set up a working group tasked with implementing a monitoring model for the housing market to systematically monitor the full housing market and rental sector in Portugal. The model is based on electronic receipts of all rents, data provided by the tax authority. The system of the electronic receipts of rents is currently in a pilot phase, mandatory only from November 2015 and fully operational in 2-3 years. Data and information from this system will enable also to carry out, by the end of August 2015, a comprehensive study on the shadow economy in the rental market, which was requested under the programme.

Effective access to a number of highly regulated professions and services is not yet ensured. There are still excessive restrictions to the access to some professional services, in particular concerning the statutes and internal rules of professional bodies. Eighteen bylaws for highly regulated professions have not yet been fully enacted and some of them are still non-compliant with the national framework law approved during the adjustment programme and with relevant European directives. This is especially evident for the professions of lawyers, legal agents and notaries. The authorities need to further increase competition in those services by amending the proposed bylaws on the legal professions, in particular as regards access to those professions by both natural and legal persons, multidisciplinary practices and fees. The authorities need also to amend some sector-specific decrees, notably fees for construction permits and the higher education legislation, to ensure compliance with the EU Service Directive.

The authorities have taken action to further reduce the administrative burden. Key administrative simplification initiatives concern the approval of the methodology for the impact assessment of legislation including the one-in/one-out rule, the SME test, and the extension of the existing inventories of regulatory burdens to sectors not yet covered (notably tourism, construction and agriculture). The scope of those simplification measures is however limited to the central public administration and does not cover local authorities. The new licensing framework is being implemented, but some potential execution bottlenecks need to be carefully monitored. This is the case for the commercial licensing law that contains provisions potentially entailing unnecessary administrative burden and high and disproportionate fees for larger retail areas, thus

impeding new players to enter the market. Progress to improve the Portuguese business environment continues, in particular as regards e-procurement procedures and the implementation of the Point of Single Contact (PSC), which is being enriched with newly adopted legislation and functionally improved to ensure that foreign providers can access this portal.

The authorities are committed to fully evaluating the impact of structural reforms to ensure measureable results, but plans could be more ambitious. A technical unit of the Ministry of Finance has been tasked with carrying out systematic and comprehensive *ex ante* and *ex post* impact assessments of reform measures, and additional staff will be hired to fulfil this mandate. Pending the completion of this recruitment process, the first ex-post assessments of selected reforms (in the judiciary and in education) will be outsourced to a still-to-be-selected Portuguese university with a view to discussing preliminary findings during the third post-programme surveillance mission. However, it remains unclear whether a sufficient data basis for a comprehensive assessment of the reforms will be available in due time. The authorities have also committed to complementing the 2016 National Reform Programme (NRP) with estimates of the impact of structural reforms, thus overcoming the shortcomings identified in the 2015 NRP, which does not provide systematic information on the impact of implemented or planned reforms.

4. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Since the conclusion of the first post-programme surveillance mission, borrowing conditions continued to improve for Portugal, in line with developments elsewhere in the euro area. Since November 2014, Portugal has successfully tapped the markets with several medium and long-term bond issuances. 10-year bond auctions have raised a total of EUR 3.9 billion (EUR 1.2 billion in November at 3.2%; EUR 1.2 billion in February at 2.5%; and EUR 1.5 billion in February at 2%) and a 6-year bond auction raised a total of EUR 1 billion at 1.6% in May. Syndicated long-term bonds were issued in January and April, totalling EUR 5.5 billion of 10-year bonds and 2.5 billion of 30-year bonds, and with improved conditions in the April transaction relative to January. Encouragingly, all these operations met healthy demand from stable investors. Through several exchange offers the Treasury has bought back short-term debt in exchange for longer-term debt. Issuances, exchanges and other financing sources not only helped Portugal to meet its 2014 funding target but put the country also on track to meet its 2015 target, including a partial repayment of IMF loans. The Treasury expects to finish this year and next year with a comfortable cash buffer. In the medium-term, the Stability Programme foresees a gradual reduction of the cash buffer over 2017 to 2019.

By taking advantage of the favourable market conditions over recent months, the Treasury managed to extend maturities and lower interest rates. The debt issued during 2015 has longer maturities than the issuances in 2014 as the weighted average maturity has increased to above 10 years. Extending debt maturity is a prudent strategy as it strengthens Portugal's position in the sovereign debt market, avoids the concentration of debt redemptions in time and increases financing flexibility in the future. Moreover, the weighted average yield of 2015 issuances has fallen compared to last year and the authorities expect further reductions in the future. The Stability Programme assumes a decline in the implicit interest rate on general government debt from 3.9% in 2015 to 3.6% in 2016 and by another 0.1 pp per year to 3.3% in 2019. The reduction is mainly due to the roll-over of T-bonds at much lower rates (the implicit interest rate on T-bonds is expected to fall from 4.5% in 2014 to 3.9% in 2016), whereas for new issuances, the Stability Programme assumes a 2.4% average interest rate in 2015 and 2.2% for 2016 to 2019.

The authorities began early repayment of the IMF loans and are planning further early redemptions. At the beginning of 2015, the Portuguese authorities sought support for an early redemption of about half of the IMF outstanding credit received under the financial assistance programme (i.e. around EUR 14 billion), requesting that EU lenders waive the proportional early repayment clause on their loans. The Eurogroup and ECOFIN agreed to this request by mid-February, on the account that the scheduled early repayment would result in net savings on interest payments of some EUR 0.5 billion and will have a positive impact on Portugal's debt sustainability. Subsequently, EUR 8.4 billion of IMF loans have been redeemed between March and June (29% of IMF total programme loan as calculated in SDR) and a further EUR 2.1 billion are currently planned to be redeemed at the end of 2015. The Stability Programme foresees an even more ambitious early repayment plan that would imply redemption of up to 87% of the total IMF loan (i.e. credit in excess of 300% of the Portuguese IMF quota on which a surcharge is applied). This plan would require a prior second waiver of the *pari-passu* clause on proportional repayment by the European creditors as cumulative repayments will exceed the amount of the first waiver. Early repayments of IMF loans are expected to result in interest savings, as the assumed rate for the replacement bonds is 2.2%, while the interest rate on the IMF loans exceeding 300% of the quota was 4.05% (on SDR). While the current plan is to repay early to IMF about additional EUR 10 billion until March 2016, the authorities acknowledge the possibility of adjustments in the calendar, depending on market developments.

Bond yields were at or near historic lows during the first months of 2015 (e.g., 6-months T-bills even recorded negative yields in May for the first time). Still, this seemed to have been driven by global factors rather than Portugal-specific conditions: a more credible European backstop, ECB quantitative easing announcement and purchase effects and rising investor risk appetite pushed sovereign yields to record lows. The

treasury's strategy followed to take advantage from that moment of easy borrowing and regained market access effectively eliminated any remaining financing concerns in the short-term. More recently, however, Portuguese 10-year bond yields rose slightly by about 150 basis points between the beginning of March and mid-June. However, according to the authorities, this rise would have a limited impact in 2015 and 2016. Overall, pressure on Portuguese sovereigns would be alleviated by relying on maintaining a comfortable cash buffer or slowing down the pace of early loan repayments to the IMF. There are no short-term financing risks. Nevertheless, medium-term debt dynamics can be subject to change and remain dependent on strengthening growth, continuing fiscal consolidation and retaining market access on favourable terms.

ANNEX 1

Specific monitoring in the framework of the Macroeconomic Imbalance Procedure

Specific Monitoring in the framework of the Macroeconomic Imbalance Procedure: State of Play of the implementation of relevant country-specific recommendations

The European Commission identified imbalances that require decisive policy action and specific monitoring in the areas external competitiveness, public debt, private debt and unemployment. It will conduct the required "specific monitoring" *uno actu* with the post-programme surveillance. In this context, this annex presents progress with the implementation of relevant country-specific recommendations. The overview is based on the CSRs of 2014 as the 2015 CSRs had not yet been approved at the time of the PPS mission.

CSR recommendation	Progress
CSR 1: Implement the necessary fiscal consolidation measures for 2014 so as to achieve the fiscal targets and prevent the accumulation of new arrears. For the year 2015, implement a revised budgetary strategy in order to bring the deficit to 2.5 % of GDP, in line with the target set in the Excessive Deficit Procedure Recommendation, while achieving the required structural adjustment. Replace consolidation measures which the Constitutional Court considers unconstitutional by measures of similar size and quality as soon as possible. The correction of the excessive deficit should be done in a sustainable and growth-friendly manner, limiting recourse to one-off/temporary measures. After the correction of the excessive deficit, pursue the planned annual structural adjustment towards the medium-term objective, in line with the requirement of an annual structural adjustment of at least 0,5 % of GDP, more in good times, and ensure that the debt rule is met in order to put the high general debt ratio on a sustainable path. Prioritise expenditure-based fiscal consolidation and increase further the efficiency and quality of public expenditure. Maintain tight control of expenditure in central, regional and local administration. Continue the restructuring of the state-owned enterprises. Develop by the end of 2014 new comprehensive measures as part of the ongoing pension reform, aimed at improving the medium-term sustainability of the pension system. Control healthcare expenditure growth and proceed with the hospital reform. Review the tax system and make it more growth friendly. Continue to improve tax compliance and fight tax evasion by increasing the efficiency of the tax administration. Review the tax system and make it more growth friendly. Continue to improve tax compliance and fight tax evasion by increasing the efficiency of the tax administration. Strengthen	Compliance with the SGP: In 2014, Portugal achieved a headline deficit of 4.5% of GDP, which was above the recommended target of 4% of GDP but included one-offs of about 1% that have no effect on the 2015 deficit while the fiscal effort indicators also point to a shortfall in the structural effort. Based on the Commission 2015 spring forecast, a timely correction of the excessive deficit by 2015 is not yet ensured, but within reach. At the same time, the fiscal effort is below what is recommended by the Council. Assuming that the excessive deficit is corrected in 2015, Portugal would be subject to the preventive arm of the Pact as of 2016. According to the Commission spring forecast there appears to be a risk of a significant deviation from the required adjustment towards the medium-term objective in 2016. Arrears: Accumulation of new arrears was halted with local and regional authorities as the main contributors. The stock of arrears has been decreasing also thanks to strategic hospital plans to address financial imbalances but operating losses forecast for the end of the year need to be addressed. Despite this progress, Portugal is still not in compliance with the Directive 2011/7/EU on late payment of commercial debts by the public administration. An infringement case is ongoing, since the European Commission considers that Portugal has not properly transposed this directive into national law. SOEs: The mergers between infrastructure operators in the water and sewerage SOEs as well as for rail and road are now effective; Hospital SOEs reached positive EBITDA by end-2014 as well as the whole SOEs (in bulk). Moreover, there was a re-focus in the core activities of several SOEs which led to the privatisation of non-core subsidiaries (most of them expected to be concluded by July 2015). The

the system of public financial management by swiftly finalising and implementing the comprehensive reform of the Budgetary Framework Law by the end of 2014. Ensure strict compliance with the Commitment Control Law. Effectively implement single wage and supplements' scales in the public sector from 2015 onwards.	recapitalisation strategy of several SOEs launched in 2012 brought SOEs' total equity to positive ground in 2014 and is expected to continue throughout 2015, further strengthening its balance sheets. Pensions: The comprehensive pension reform will only be discussed after the next national elections, scheduled for late September/early October. Health sector: The hospital sector reform is ongoing, as well as improvements to centralised procurement. Authorities remain fully engaged in implementing the ongoing reforms in the NHS reorganisation, reduce significantly the waiting list for a family doctor by Dec-2015 and further strengthen the sustainability through additional compression in pharmaceutical and medical devices expenditure in 2015. Tax system: some shift towards a more growth-friendly tax structure has been implemented (PIT reform, green taxation, CIT reform continuation). Tax collection was addressed by the Strategic Plan to Combat Tax Fraud and Evasion 2015-2017 being deployed, yielding 0.2% to 0.4% of GDP in 2014 and expected to further add in 2015. The reorganisation of tax services is ongoing. Fiscal framework: Budgetary Framework Law reform is expected to be adopted before summer break. Revision of the Commitment Control Law was approved in January, further strengthening budget control; Law on Single Wage Scale (TRU) published in September 2014 and applied since January; The Single Supplements Scale is planned to enter into force in January 2016.
CSR 2: Maintain minimum wage developments consistent with the objectives of promoting employment and competitiveness. Ensure a wage setting system that promotes the alignment of wages and productivity at sectoral and/or firm level. Explore, in consultation with the social partners and in accordance with national practice, the possibility of mutually agreed firm-level temporary suspension of collective agreements. By September 2014, present proposals on mutually agreed firm-level temporary suspension of collective agreements and on a revision of the survival of collective agreements.	The minimum wage increased by 4.1% in October 2014 but no information is available at this stage on the employment and competitiveness effects. A decision on the minimum wage level to be applied in 2016 will only be made later this year. Limited progress regarding wage setting decentralisation. Temporary suspension of collective agreements is now possible but is not being used and there has been an increase in extensions following the introduction of less strict rules on representativeness. The survival of collective agreements has been

	successfully reduced.
CSR 3: Present, by March 2015, an independent evaluation of the recent reforms in the employment protection system, together with an action plan for possible further reforms to tackle labour market segmentation. Pursue the ongoing reform of active labour market policies and Public Employment Services aimed at increasing employment and labour participation rates, specifically by improving job counselling/job search assistance and activation/sanction systems with a view to reducing long-term unemployment and integrating those furthest away from the labour market. Address the high youth unemployment, in particular by effective skills anticipation and outreach to non-registered young people, in line with the objectives of a youth guarantee. Ensure adequate coverage of social assistance, including the minimum income scheme, while ensuring effective activation of benefit recipients.	Nothing has been presented so far regarding the independent evaluation of the recent reform in employment protection legislation. Significant progress in terms of active labour market policies implementation. Effectiveness of employment and training measures are now being monitored, through the assessment of the employability rate. A legal framework was introduced for the cooperation between public and private employment services in order to increase PES effectiveness. The Youth Guarantee (YG) is progressively increasing its reach-out to young unemployed and strengthening the capacity of the YG partners' network. No progress in ensuring adequate coverage of the minimum income scheme.
CSR 4: Improve the quality and labour-market relevance of the education system in order to reduce early school leaving and address low educational performance rates. Ensure efficient public expenditure in education and reduce skills mismatches, including by increasing the quality and attractiveness of vocational education and training and fostering cooperation with the business sector. Enhance cooperation between public research and business and foster knowledge transfer.	Some progress in improving the quality and labour-market relevance of the education through: deployment of a monitoring tool of students' performance to prevent grade retention and early school leaving; improve labour market relevance of VET courses with monitoring of employability and programmes with a strong business sector link; development of a national skills diagnostic report that identifies ways to decrease the skills mismatch. Some progress towards a more efficient public spending. To better adapt schools to the local needs, the government is decentralising school management to municipalities. Spending from the central government should remain the same but a new funding formula provides incentives to better performing schools. Portugal needs to further enhance the cooperation between public research and business in order to strengthen the private sector capacity to develop more knowledge intensive activities.
CSR 5: Monitor banks' liquidity position and potential capital shortfalls, including by on-site thematic inspections and stress-testing. Assess the banks' recovery plans and introduce improvements to the evaluation process where necessary. Implement a comprehensive strategy to reduce the	Substantial progress was achieved in monitoring banks' liquidity and capital positions and assessing banks' recovery plans. Priorities, organisation and internal procedures of supervision (including on macro-prudential policies) have been updated.

corporate debt overhang and reinforce efforts to widen the range of financing alternatives, including for early stages of business developments, by enhancing the efficiency of the debt restructuring tools (particularly PER and SIREVE) for viable companies, introducing incentives for banks and debtors to engage in restructuring processes at an early stage and improving the availability of financing via the capital market. Ensure that the identified measures support the reallocation of financing towards the productive sectors of the economy, including to viable SMEs, while avoiding risks to public finances and financial stability. Implement, by end September 2014, an early warning system mainly with supervisory purposes, to identify firms, including SMEs, with a high probability of default due to an excessive level of indebtedness, and which can, indirectly, promote early corporate debt restructuring.	Some progress was achieved in widening the range of financing alternatives for corporates through the formal establishment of Development Financial Institution (DFI), intended to help address market failures which hamper SME access to finance (company licence issued in September 2014). However the DFI is not operational yet. Further measures are still under negotiations. The Early Warning System is fully implemented, which should help to encourage credit institutions to be proactive in using appropriate procedures and solutions in the treatment of identified companies. Furthermore, substantial progress was achieved in implementing measures to reduce corporate debt overhang through the adoption of the Strategic plan for Corporate Debt Restructuring and an overhaul of the corporate insolvency and restructuring framework with stronger focus on recovery of firms rather than liquidation.
CSR 6: Implement the second and third packages of measures in the energy sector aimed at reducing energy costs for the economy, while eliminating the electricity tariff debt by 2020, and closely monitor implementation. Improve the cross-border integration of the energy networks and speed up implementation of the electricity and gas interconnection projects. Implement the comprehensive long-term transport plan and the ‘chronogram’ setting out the ports sector reforms. Complete the transports concessions for the metropolitan areas of Lisbon and Oporto. Ensure that the renegotiations of the existing port concessions and the new authorisation schemes are performance-oriented and in line with internal market principles, in particular procurement rules. Ensure that the national regulatory authority for transport (AMT) is fully independent and operational by the end of September 2014. Ensure the financial sustainability of the state-owned enterprises in the transport sector. Strengthen efficiency and competition in the railways sector, by implementing the plan for the competitiveness of CP Carga, after the transfer of the freight terminals while ensuring the management independence of the state-owned infrastructure manager and railway undertakings.	Energy: Apart from the coal power plants contribution, tariff harmonisation in the Autonomous Regions and MIBGAS measures which are on-going, all other measures from the second and third packages in the energy sector were implemented. Despite these efforts the electricity tariff debt will only start decreasing in 2016 adding pressure on energy prices and will still be at EUR 1 billion in 2020. International energy interconnection is advancing: a high level group was set up to drive forward key energy infrastructure projects to link the Iberian Peninsula with the internal market. The identification of a project will help PT and ES reach the 10% of energy interconnection target. Transport: Limited progress in implementing the ports sector chronogram. The final version of the long-term transport plan was adopted in June. Overall, the strategy to improve the financial sustainability of transport sector SOEs is delivering. Operating and financial restructuring in these companies is ongoing with Q1-data showing significant improvement in terms of operating balance if net of public compensations (which were reduced significantly in the meanwhile but were partially offset by further cost compression). The rail and road infrastructure managers were merged on 1 June 2015, and a framework has been set up that aims at ensuring the financial sustainability of the merged company Infraestruturas de Portugal in the mid to long run. Progress has been observed in

	transports concessions for the metropolitan areas of Lisbon and Porto with contracts to be awarded until July. Limited progress has been made in the port concession renegotiations with agreement being reached only for the Port of Sines. Despite expected to be working as of September 2014, AMT, the new transport regulator is still not operational. The board has been appointed but it is still waiting confirmation.
CSR 7: Further improve the evaluation of the housing market, including by setting up, by the end of 2014, a more systematic monitoring and reporting framework and issue a comprehensive report on the shadow economy in that market. Continue efforts to carry out further inventories of regulatory burdens with a view to including, by March 2015, sectors not yet covered. Adopt and implement, by the end of September 2014, the outstanding licensing decrees and sectoral amendments. Remove, by the end of September 2014, remaining restrictions in the professional services sector and enact the professional bodies' amended by-laws which have not yet been adopted under the macroeconomic adjustment programme. Eliminate payment delays by the public sector. Ensure adequate resources of the national regulators and competition authority.	A working group has been set up to implement a monitoring model of the housing market, based on data from the Tax Administration, including electronics receipts of all rents. It is composed by representatives of the Tax Administration, INE and IHRU, the national housing institute. The model will enable the authorities to monitor the full housing market and provide information on the type of contracts (residential and commercial), the rental regime, the length and value of the contracts (old and new).A system of the electronic receipts of rents from landlords will be the core of the housing monitor. Preliminary information provided by the authorities show that the new system works well. Since the beginning of the year, 100.000 landlords with irregular rent registrations were invited to correct their declaration, 270.000 rent receipts have been issued, 120.000 contracts has been registered (of which 32.000 are new contracts). The reliability of the rent receipts will be ensured by cross-checking different tax data bases (PIT, real estate databases) and other data sets (utilities) as well as by tax inspections and controls. This system will help fight the shadow economy in the Portuguese rental market, phenomenon that will be analysed in a study to be delivered by the end of August 2015, as planned. The authorities plan to enact the outstanding bylaws for highly regulated professions by end-July 2015. Some pieces of legislation regarding legal profession are still a matter of concern, due to legal restrictions and administrative barriers in particular in terms of access to those professions by both natural and legal persons, multidisciplinary practices and fees of the profession of lawyers, legal agents and notaries. As regards the outstanding sector-specific decrees, the higher education legislation needs still to be amended in compliance with the EU Service

	Directive, but the authorities confirmed their intention not to carry out any changes. The legislation on precious metals is planned to be approved by end-July 2015. The framework law for professional companies is waiting for promulgation as well as the mining law and the construction legislation, the latter being linked to a decree on construction fees to be published soon after. Despite some progress in reducing arrears, Portugal is still not in compliance with the Directive 2011/7/EU on late payment of commercial debts by the public administration. An infringement case is ongoing, since the European Commission considers that Portugal has not properly transposed this directive into national law. There are some issues concerning the implementation of the new financing model of the PCA that was introduced at the beginning of 2015. Sectoral regulators have been transferring the amounts on the scheduled dates, with the only exception of the Transport Regulator (AMT) that is not fully operational yet and there is still uncertainty regarding the possibility of transfers by the existing IMT (Instituto da Mobilidade e dos Transportes). Concerns remain on the future funding of the PCA. From 2015 to 2019, salary cuts will be partially lifted at a rate of 20% per year. In 2016, this will account for a 2% increase in expenditure with staff potentially requiring additional resources. Also, the PCA is under the budgetary rules applicable to the budget of General Government that could limit the financial autonomy foreseen in the PCA's bylaws and national regulatory authorities' framework law.
CSR 8: Continue to rationalise and modernise central, regional and local public administration. Implement the reforms to enhance the efficiency of the judicial system and increase transparency. Step up efforts to evaluate the implementation of reforms undertaken under the macroeconomic adjustment programme as well as planned and future reforms. In particular, insert mandatory systematic ex ante and ex post assessments in the legislative process. Set up a functionally independent central evaluation unit at government level, which assesses and reports every six months on the implementation of these reforms, including consistency with the ex-ante impact assessment, with corrective action if needed.	Central administration: Public sector employment increased in the first quarter of 2015. The 2015 budget foresees a 1% reduction in public sector employment in this year, and the Stability Programme predicts a stabilisation in subsequent years. No new programme for the termination of contracts by mutual agreement was started this year. The number of employees in the requalification scheme and re-employed in other parts of the government has recently increased, but is still falling considerably short of the target established during the economic adjustment programme. Local and Regional Governments: local administration reforms are showing positive effects with continuous budget surpluses and decrease in

	debt and arrears since 2013; The debt workout mechanisms designed to address local authorities in a financial distressed situation are now being effectively implemented; Madeira and Azores Autonomous Regions' budget performance is also reassuring with the former envisaging regaining market access once its adjustment programme with the Government is terminated at the end of 2015. There are still some delays in the development of the methodology for effectively implementing the one-in one-out principle to reduce administrative burden. Portugal is using structural funds to provide capacity training on impact assessments of administrative burden to the relevant officials. The central government is advancing simplification measures and starts engaging in dissemination initiatives with local authorities that still remain outside the scope of its intervention. Activities to promote e-procurement are also ongoing, including meetings with stakeholders to develop a common culture and provide information on the functioning and scope of the e-procurement system. The Point of Single Contact (PSC) is being updated with new pieces of legislation relevant to businesses and it is being increasingly used. Currently 278 local authorities are using the PSC for local licensing regimes – municipalities in the regions of Azores and Madeira are to be included at a later stage. As regards the judicial sector, the relevant judicial data and indicators are still not available and there are still operational problems due to the non-functioning of the central database for court files (CITIUS) and the poor quality of the database for tax courts (SITAF) for which there is still no evidence on the distribution of cases over EUR 1 m and on a breakdown of court workloads per tribunals. The authorities have started synchronising the procedures between local databases and the central database and correcting the relevant datasets. By the end of July 2015, the authorities will indicate a precise date of publication of comprehensive judicial statistics. In terms of transparency, detailed data is available on all public procurement contracts on the BASE portal. Some gaps, mostly due to delays in publishing data on contracts awarded by local and regional authorities, are being addressed. The Council for the Prevention of Corruption published in 2015 a report on the implementation of the anti-corruption plans of public entities. Transparency in

	the area of concessions needs to be improved. UTAP is monitoring ongoing PPPs managed by the central government, but PPPs at the regional and local level are still outside its oversight. The revision of criminal legislation (Law No 30/2015) brings some improvements in the area of the fight against corruption, inter alia by extending the statute of limitation for corruption crimes and by criminalising certain offences related to bribery and abuse of power. GPEARI has been legally tasked with evaluating structural reforms (decree law 3/2015). When fully staffed, GPEARI is expected to carry out ex-ante and ex-post assessments of structural reforms, also on the basis of inputs from line ministries. Currently, GPEARI is not adequately equipped to completely fulfil its mandate and it is in the process of outsourcing a first ex-post assessment of selected reforms (judicial and education) to a university. Some universities have been short-listed on the basis of the best national rankings. A final decision on the selected provider will be made in July 2015. In terms of ex-ante evaluation, no substantial progress has been made since the last mission.

ANNEX 2
Debt sustainability analysis

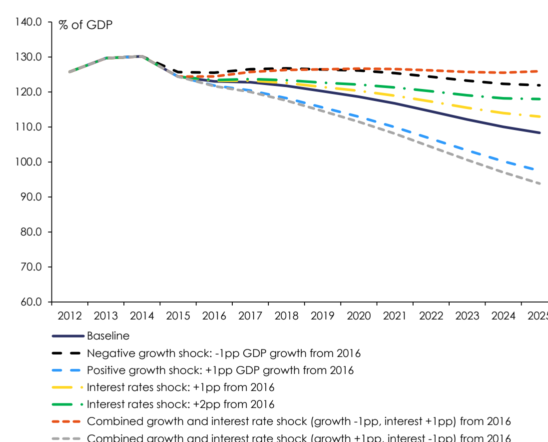
Debt Sustainability Analysis

According to the Commission's 2015 spring forecast, government debt is projected to reach 124.4% of GDP at the end of 2015, down from 130.2% of GDP at the end of 2014, and to continue declining thereafter. The decline of the debt-to-GDP ratio in the baseline scenario is supported by the projected economic recovery, expected primary budget surpluses as well as the projected stock-flow adjustments up to 2016. The baseline long-term calculations shown below incorporate the spring forecast until 2016, which includes fiscal consolidation measures in 2015 and reflects no-policy-change assumptions for 2016. The outer years are based on technical assumptions. In particular, it is assumed that: (i) the structural primary fiscal balance remains unchanged at a surplus of 2.4% of GDP as from 2017; (ii) nominal interest rates are around 4% (converging to 5.0% on new and rolled-over debt toward the end of the 10-year projection horizon); (iii) from 2018 onwards nominal GDP growth is between 3.0% and 3.9% (with medium-term real GDP growth projections based on the T+10 methodology agreed with the Economic Policy Committee and inflation converging to 2%); and (iv) ageing costs follow the Commission's 2015 Ageing Report projections.

The scenario of the Commission spring forecast and a medium-term nominal growth rate of 3.0-3.9% are compatible with a gradual decline of the debt ratio over a long-term horizon. The sensitivity analysis suggests that the declining debt-to-GDP trajectory is sensitive to financial market volatility and remains vulnerable to negative economic developments. The graphs below present a sensitivity analysis with respect to macro-economic and financial market risks as well as the effect of alternative fiscal consolidation paths.

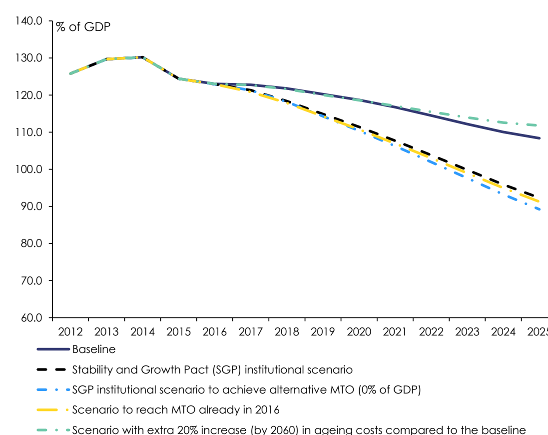
Graph A2.1 illustrates the sensitivity of the debt trajectory to economic assumptions by considering a shock to real GDP growth and hikes in interest rates as from 2016. The analysis suggests that a lower GDP growth rate by one percentage point could almost stop the declining debt-to-GDP trend in the long run and that a two percentage point increase in the interest rate on maturing and new debt would considerably slow down the decrease of the debt ratio. Moreover, a combined growth and interest shock could bring the decrease to a complete halt over the projection horizon. Conversely, a positive shock to medium and long-term growth, for instance, on account of the structural reforms undertaken, would result in visibly lower debt-to-GDP ratios and a faster pace of debt reduction ([13]). Combined with lower interest rates, the pace of the debt reduction could increase even further.

Graph A2.1: **Macroeconomic risks: growth and interest rates**



Source: Commission services

Graph A2.2: **Fiscal consolidation and ageing costs**



Source: Commission services

Additional fiscal consolidation would clearly accelerate the debt reduction path (Graph A2.2). In particular, compliance with the requirements of the Stability and Growth Pact "institutional scenario"

([13]) Not taking into account the positive indirect effects of the higher GDP growth on the fiscal balance.

(full compliance with EDP recommendations and 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([14]) would imply a MTO of a structural deficit of 0.5% of GDP to be reached in 2017 with a fiscal effort of 0.6% of GDP in 2016 and 0.4% of GDP in 2017, and a primary surplus of 3.5% in 2017. Maintaining the MTO over the longer term horizon will require structural primary surpluses of 4% until the end of the projection horizon. Under these assumptions, the debt-to-GDP ratio would accelerate its decline considerably. Aiming at a more ambitious MTO of zero percent within the SGP institutional scenario would further accelerate debt reduction to some degree. On the other hand, if ageing costs are allowed to rise significantly (simulated as a 20% increase), the fall in the ratio would almost come to a halt towards the end of the projection period in the absence of compensating fiscal consolidation.

Overall, the debt sustainability analysis shows that the debt reduction path of the baseline scenario is vulnerable in particular to macro-economic and financial-market developments. At the same time, the declining trajectory of the debt-to-GDP ratio can be supported by maintaining fiscal discipline over the medium to long-term horizon. In addition, the solid reduction path crucially hinges on medium and long-term economic growth, which points to the necessity of persevering with the implementation of structural reforms.

([14]) COM(2015) 12

ANNEX 3

Commission services macroeconomic and fiscal projections 2014-2016

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

Annual % change	**2014**	**2015**	**2016**
1. Private consumption expenditure	2.1	2.0	1.6
2. Government consumption expenditure	-0.3	-0.2	0.2
3. Gross fixed capital formation	2.5	3.5	4.0
4. Final domestic demand	**1.7**	**1.8**	**1.7**
5. Change in inventories	--	--	--
6. Domestic demand	**2.0**	**1.4**	**1.7**
7. Exports of goods and services	3.4	5.3	6.1
7a. - of which goods	3.6	5.5	6.2
7b. - of which services	2.7	4.6	5.7
8. Final demand	**2.4**	**2.5**	**3.0**
9. Imports of goods and services	6.4	4.7	5.8
9a. - of which goods	6.3	4.7	6.0
9b. - of which services	6.8	5.1	5.2
10. Gross domestic product at market prices	**0.9**	**1.6**	**1.8**
Contribution to change in GDP			
11. Final domestic demand	1.7	1.7	1.6
12. Change in inventories + net acq. of valuables	0.3	-0.3	0.0
13. External balance of goods and services	-1.1	0.2	0.2

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

Annual % change	**2014**	**2015**	**2016**
1. Private consumption expenditure	2.8	2.1	2.9
2. Government consumption expenditure	-0.2	-0.2	1.1
3. Gross fixed capital formation	2.1	4.1	5.8
4. Final domestic demand	**2.1**	**2.0**	**3.0**
5. Change in inventories	--	--	--
6. Domestic demand	**2.5**	**1.6**	**3.0**
7. Exports of goods and services	3.0	6.9	8.0
8. Final demand	**2.7**	**3.1**	**4.5**
9. Imports of goods and services	4.0	3.7	7.6
10. Gross national income at market prices	2.0	2.5	3.3
11. Gross value added at basic prices	1.7	2.4	3.1
12. Gross domestic product at market prices	**2.2**	**2.9**	**3.3**
Nominal GDP, EUR bn	173.1	178.1	183.9

Table 3: Implicit price deflators

% change in implicit price deflator	**2014**	**2015**	**2016**
1. Private consumption expenditure	0.7	0.2	1.3
2. Government consumption expenditure	0.1	0.1	0.9
3. Gross fixed capital formation	-0.4	0.6	1.8
4. Domestic demand	**0.4**	**0.2**	**1.3**
5. Exports of goods and services	-0.3	1.6	1.8
6. Final demand	**0.2**	**0.6**	**1.5**
7. Imports of goods and services	-2.2	-1.0	1.6
8. Gross domestic product at market prices	**1.2**	**1.3**	**1.4**
HICP	**-0.2**	**0.2**	**1.3**

Table 4: Labour market and cost			
Annual % change	**2014**	**2015**	**2016**
1. Labour productivity (real GDP per employee)	-0.5	1.0	1.1
2. Compensation of employees per head	-1.4	0.5	1.0
3. Unit labour costs	**-0.9**	**-0.5**	**-0.2**
4. Total population	-0.6	-0.5	-0.5
5. Population of working age (15-64 years)	-0.6	-0.5	-0.4
6. Total employment (fulltime equivalent)	1.4	0.6	0.7
7. Calculated unemployment rate - Eurostat definition (%)	**14.1**	**13.4**	**12.6**

Table 5: External balance			
levels, EUR bn	**2014**	**2015**	**2016**
1. Exports of goods (fob)	50.4	53.9	58.4
2. Imports of goods (fob)	58.0	60.0	64.6
3. Trade balance (goods, fob/fob) (1-2)	**-7.6**	**-6.1**	**-6.2**
3a. p.m. (3) as % of GDP	***-4.4***	***-3.4***	***-3.4***
4. Exports of services	18.7	19.9	21.3
5. Imports of services	10.2	10.7	11.5
6. Services balance (4-5)	**8.5**	**9.2**	**9.9**
6a. p.m. 6 as % of GDP	***4.9***	***5.2***	***5.4***
7. External balance of goods & services (3+6)	**0.9**	**3.1**	**3.7**
7a. p.m. 7 as % of GDP	***0.5***	***1.8***	***2.0***
8. Balance of primary incomes and current transfers	-0.1	-1.0	-1.1
8a. - of which, balance of primary income	*-1.9*	*-2.7*	*-2.7*
8b. - of which, net current Transfers	*1.9*	*1.7*	*1.6*
8c. p.m. 8 as % of GDP	*0.0*	*-0.5*	*-0.6*
9. Current external balance (7+8)	**0.8**	**2.2**	**2.6**
9a. p.m. 9 as % of GDP	***0.5***	***1.2***	***1.4***
10. Net capital transactions	2.5	2.5	2.5
11. Net lending (+)/ net borrowing (-) (9+10)	**3.3**	**4.6**	**5.1**
11a. p.m. 11 as % of GDP	***1.9***	***2.6***	***2.8***

Table 6: Fiscal accounts

	2014	2015	2016
		% of GDP	
Taxes on production and imports	14.2	14.7	14.9
Current taxes on income, wealth, etc.	10.9	10.9	10.3
Social contributions	11.9	11.8	11.7
Other (residual)	7.5	7.5	7.5
Total revenue	**44.5**	**45.0**	**44.4**
Compensation of employees	11.8	11.3	11.1
Intermediate consumption	5.9	6.0	6.1
Social payments	19.7	19.5	19.3
Subsidies	0.7	0.5	0.5
Gross fixed capital formation	2.0	2.3	2.2
Other (residual)	3.9	3.5	3.5
Interest expenditure	5.0	4.9	4.5
Total expenditure	**49.0**	**48.0**	**47.2**
General Government balance (ESA2010)	**-4.5**	**-3.1**	**-2.8**
Primary balance	0.5	1.8	1.7
		% change	
Taxes on production and imports	5.0	6.6	4.1
Current taxes on income, wealth, etc.	-2.4	2.4	-2.1
Social contributions	2.3	2.6	2.3
Other (residual)	-5.8	3.3	3.0
Total revenue	**0.5**	**4.0**	**1.9**
Compensation of employees	-2.7	-2.1	2.0
Intermediate consumption	4.9	5.2	4.8
Social payments	-1.2	2.0	2.1
Subsidies	12.6	-23.7	-2.0
Gross fixed capital formation	-1.3	18.6	-3.7
Other (residual)	1.5	-7.2	3.3
Interest expenditure	3.1	2.0	-5.0
Total expenditure	**-0.1**	**1.0**	**1.5**
Nominal GDP, EUR bn	**173.1**	**178.1**	**183.9**

Table 7: Government debt developments

	2014	2015	2016
ESA2010 deficit (% of GDP)	**-4.5**	**-3.1**	**-2.8**
ESA2010 gross debt (% of GDP)	130.2	124.4	123.0
	levels, EUR bn		
ESA2010 deficit	**-7.7**	**-5.5**	**-5.2**
Gross debt	225.3	221.6	226.3
Change in gross debt	5.6	-3.7	4.7
Nominal GDP	173.1	178.1	183.9
Real GDP	167.9	170.6	173.8
Real GDP growth (% change)	**0.9**	**1.6**	**1.8**
Change in gross debt (% of GDP)	3.3	-2.1	2.6
Stock-flow adjustments (% of GDP)	-1.2	-5.2	-0.3
	% of GDP		
Gross debt ratio	**130.2**	**124.4**	**123.0**
Change in gross debt ratio	0.5	-5.8	-1.4
	Contribution to change in gross debt		
Primary balance	-0.5	-1.8	-1.7
"Snow-ball" effect	2.2	1.2	0.5
of which			
Interest expenditure	*5.0*	*4.9*	*4.5*
Real growth effect	*-1.2*	*-2.1*	*-2.3*
Inflation effect	*-1.6*	*-1.6*	*-1.7*
Stock-flow adjustments	**-1.2**	**-5.2**	**-0.3**
Implicit interest rate	*3.9*	*3.9*	*3.8*

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