European
Commission

ISSN 2443-8014 (online)

Post-Programme Surveillance Report

Portugal, Summer 2018

INSTITUTIONAL PAPER 087 | SEPTEMBER 2018

EUROPEAN ECONOMY

Economic and Financial Affairs

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https://ec.europa.eu/info/publications/economic-and-financial-affairs-publications_en.

Luxembourg: Publications Office of the European Union, 2018

PDF ISBN 978-92-79-77468-3 ISSN 2443-8014 doi:10.2765/305795 KC-BC-18-019-EN-N

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ACKNOWLEDGEMENTS

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

This report reflects information available up until 23rd August 2018.

ABBREVIATIONS

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

EXECUTIVE SUMMARY

This report presents the findings of the eighth post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, which took place in Lisbon during 4-12 June 2018. *Since the conclusion of the seventh post-programme surveillance mission in December 2017, growth has moderated somewhat in line with developments in other EU markets. The short-term economic and financial situation of Portugal remains largely favourable but the risks to the outlook have increased due to the more uncertain external environment. Overall, Portugal's economic adjustment is proceeding at a steady pace. The country's indebtedness is decreasing and the fiscal position is improving. Nevertheless, debt levels remain high and the positive momentum needs to be sustained. Some progress is also achieved in structural reforms, particularly in the financial sector, but growth-enhancing reforms need to continue in order to improve the economy's convergence prospects and resilience to shocks.*

Economic growth moderates but remains robust*. Economic growth peaked at 2.7% in 2017, the highest rate since 2000, and is expected to moderate to 2.2% in 2018 and 2.0% in 2019, according to the Commission 2018 interim summer forecast. The economic growth is broad-based and is also benefiting from a continuous positive cycle in tourism and a more recent recovery in the construction sector. The labour market is expected to retain a strong, albeit slowing, rate of improvement, reflecting significant employment growth in labour intensive sectors. Risks to the economic outlook are tilted to the downside and have increased recently due to the uncertain external environment, including episodes of volatility in European bond markets and heightened trade protectionism at global level.*

Public finances have been improving but further fiscal consolidation will be important for ensuring a steady decline in the still very high public debt level. *Following a headline deficit outturn of 3.0% of GDP in 2017 (0.9% of GDP net of the recapitalisation of Caixa Geral de Depósitos – CGD), the Commission 2018 spring forecast projects deficits of 0.9% of GDP in 2018 and 0.6% of GDP in 2019. However, the assessment of Stability and Growth Pact (SGP) compliance points to some deviation from the requested structural adjustment effort in 2017 and to a risk of significant deviation for both 2018 and 2019, both on the basis of the Commission spring forecast and on the basis of the Stability Programme. The commitment of the Portuguese authorities to use windfall gains to reduce the general government debt ratio is therefore welcome. As such, the current favourable cyclical conditions together with the decline in interest payments would be used to build up fiscal buffers. After falling by 4.2 percentage points to 125.7% in 2017, the gross public debt-to-GDP ratio is projected to decrease further by around 3 percentage points per year in 2018 and 2019.*

There remains a need for fiscal-structural reforms to continue*. While the scope of the expenditure review has been increasing, planned further steps still need to be specified and a comprehensive ex-post evaluation of achievements is still outstanding. Cost-effectiveness continues to be promoted in the health sector as a whole, but the recurrent accumulation of hospital arrears has been only temporarily interrupted by clearance measures. The sustainability of the pension system appears ensured in the short-term but adverse demographic developments pose challenges in the medium-term. While state-owned enterprises continue to improve their operational results, their debt is still elevated and net results are still negative.*

Supported by the on-going economic recovery, Portugal's banks have made significant progress in strengthening their balance sheets, but vulnerabilities remain*. They have continued to deleverage, improved their capital positions, decreased non-performing loans, and further reduced costs. The banking sector as a whole returned to profitability in 2017 after many loss-making years. Despite this progress, the banking sector continues to be weighed down by low profitability, thin capital buffers, as well as still high ratios of non-performing loans. Consequently, continued efforts by banks to further improve their financial soundness and profitability as well as their internal governance are essential. A critical challenge will be to maintain the momentum in the reduction of impaired assets, which weigh on banks' profitability, funding and capital costs. High rates of non-performing loans also hinder a more efficient allocation of resources in the corporate sector and thus weaken investment and growth. Reforms in the tax and judicial areas were undertaken to facilitate the restructuring of viable firms and expedite* *the liquidation of non-viable ones; it is still too early to assess their effectiveness. While deleveraging continues, credit to non-financial corporations is growing, with the increase driven by less-indebted firms.*

***Structural reforms remain essential to boost potential growth and enhance the country's resilience to shocks**. Despite the improvement in the labour market and the progress reported in education, skill levels remain relatively low, having a negative impact on productivity. The segmentation of the labour market also remains a concern as the share of involuntary temporary contracts is high. To address the problem, authorities initiated legal amendments aimed at restricting temporary contracts and strengthening collective bargaining. However, this also entails risks that some temporary jobs may not be created anymore. In the context of rising house prices and rents, the government has also initiated legislative reforms addressing the main weaknesses on the housing market. The challenge is to keep the right balance between protecting tenants and ensuring a more efficient use of the housing stock. In network industries, the renegotiation of concession contracts is proceeding but it is too early to assess its impact. The authorities aim to improve the business environment by a wide range of measures, including continuing efforts for recapitalisation of potentially viable but highly indebted firms and support to internationalisation of SMEs. An ambitious set of measures for administrative simplification is being implemented which could contribute to decrease the burden on companies and increase the efficiency of the public administration. The business environment is still negatively affected by existing barriers to competition in services, particularly in regulated professions. The competition authority and the OECD have recently proposed a large number of reforms in this area.*

***Sovereign financing and the capacity to repay are sound but yields remain vulnerable to financial market conditions**. The overall favourable economic outlook and the ongoing adjustment, particularly in the public debt-to-GDP ratio, have clearly been supporting the country's financing terms. Moreover, early repayments to the IMF over the past two years contributed to smoothing the debt redemption profile and lower interest costs. Nevertheless, high private and public debt is still a burden for the country's position on the bond markets, notably in the context of contagion risks. Yields on Portuguese bonds have continued decreasing until April, helped also by rating upgrades. Portugal is now at investment grade with three of the four major rating agencies. However, after a spike at the end of May, yields have stabilised at a slightly higher level, which points to Portugal's vulnerability to volatile financial market conditions.*

The next PPS mission will most likely take place in November 2018.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the eighth post-programme surveillance (PPS) mission to Portugal between 4 June and 12 June 2018. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to assessing the repayment capacity of a country that has received financial assistance([1]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions.

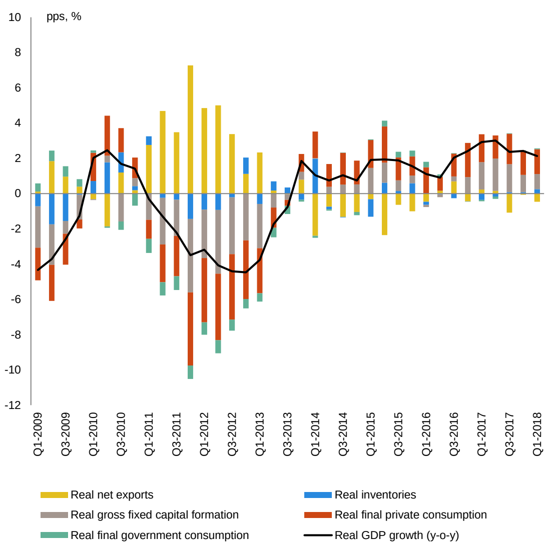
([1]) PPS is established by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid, which is expected in 2035.

2. RECENT ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Economic growth moderated to 2.1% y-o-y in the first quarter of 2018 and preliminary estimated 2.3% y-o-y in the second quarter. Domestic demand remained robust, driven by a re-acceleration of private consumption and strong equipment investment. The increase in gross fixed capital formation (GFCF) softened somewhat, as adverse weather conditions significantly slowed down construction activities early in the year. Exports were affected by weaker external demand and one-off factors such as temporary halts in car manufacturing and oil refinement as well as interruptions in port services in the first quarter of the year. Along with a less positive external outlook for both euro and non-euro countries, economic growth is expected to moderate to 2.2% in 2018 and 2.0% in 2019, after reaching a peak of 2.7% in 2017.

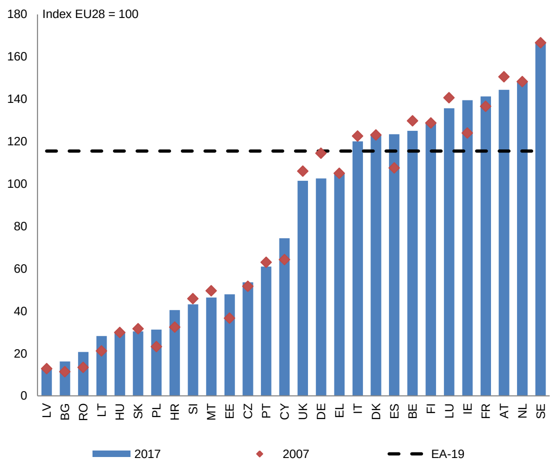
Graph 2.1: **Contributions to real GDP growth**



Source: INE

Domestic demand continued to display strength. Private consumption continues to grow strongly, in contrast to the weakening of external demand. However, the more recent consumer confidence indicators as well as the increase in oil prices point to a more moderate expansion in private consumption throughout the year. An improved financial situation of corporate and financial sectors, positive domestic demand conditions and increased capacity utilisation will continue to keep investment upward. However, the extended period of weak investment in the past depreciated the existing capital stock and slowed down the rate of capital deepening, which still stands significantly below the euro area average.

Graph 2.2: **Net capital stock per person employed**



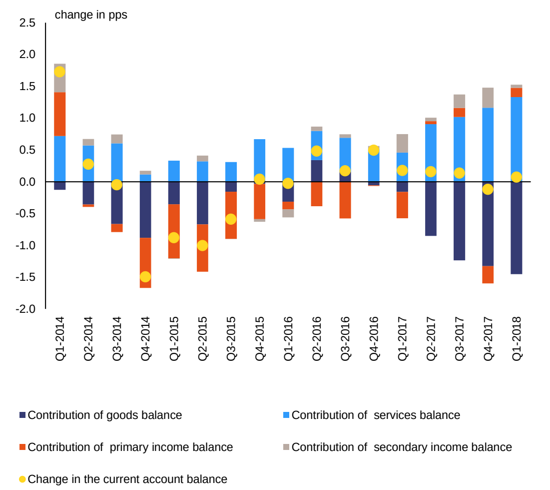
Source: Eurostat

The current account retains a small positive balance helped by services. The current account (CA) posted a surplus of 0.5% of GDP in 2017([2]). In the first quarter of 2018, the balance of trade of goods deteriorated relative to a year earlier while the surplus of services improved. The lost momentum in external trade over the first quarter of 2018 was a combination of the negative calendar effect, one-off factors and also a poor economic outlook particularly in extra-EU markets. Short-term external trade indicators in April improved, confirming that despite some weakness in external demand, exports growth is set to regain some strength. However, a less positive global outlook might negatively affect net export performance leading to a negative contribution to GDP growth in 2018. Overall, the CA is projected to retain a small surplus in both 2018 and 2019, reflecting some deterioration in the balance of goods and a negative impact from dividend

([2]) In national account terms, this marks an improvement from 0.1% in 2016 while in the balance of payments the surplus marks no change from 2016. Reflecting methodological changes in the national accounts, the two CA indicators are expected to be broadly identical in the future.

payments or retained earnings in foreign-owned entities, which is to be offset by further improvement in net travel inflows, the projected increase in absorption of EU structural funds and lower interest cost for domestic borrowers.

Graph 2.3: **Contributions to Current Account Balance**

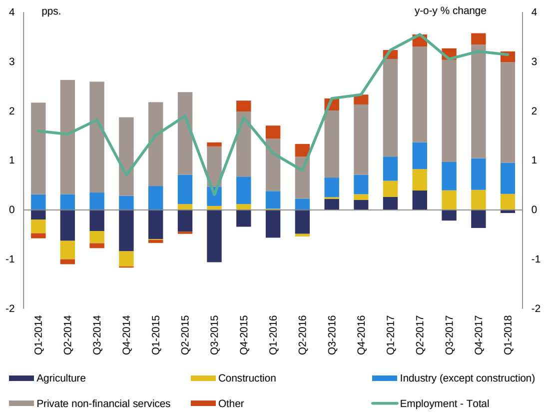


Source: Banco de Portugal

As regards competitiveness, Portuguese exporters are forecast to continue gaining market shares. The gains are helped by the positive cycle in tourism and the capacity expansion in the automotive sector. The weak dynamics in labour productivity over the last two years weigh negatively on productivity but unit labour costs have moved broadly in line with trading partners due to subdued wage developments. Although wage growth is expected to increase in the context of rapidly declining labour market slack, productivity is also assumed to improve over the medium run, keeping a broadly favourable outlook on competitiveness relative to trading partners.

Unemployment declined substantially from 11.2% in 2016 to 9.0% in 2017 and to seasonally adjusted 6.8% in June 2018([3]). Employment growth reached 3.3% in 2017 and remained above 3% in the first quarter of 2018 before slowing down to 2.6% in the second quarter of the year. Labour productivity continued its weak performance from the last two years due to the expansion in sectors with higher labour intensity. The job-rich recovery meanwhile improved the activity rate, as the labour force increased by 0.8% in 2017 despite the drop by 0.2% in the working age population. It is worth noting that net migration moved to a slightly positive territory in 2017 for the first time since 2010. However, it accounted for just 0.05% of the total population which is still insufficient to offset the negative demographic impact on the labour force stemming from the natural rate of change and the ageing of the population. According to the Commission 2018 spring forecast, the year-average unemployment is forecast to continue declining at a sound although slower pace to 6.8% in 2019 amid further employment growth and a higher activity rate. The latest available data suggest that the outcome could be even more favourable than projected. Unemployment is already lower than before the global financial crisis in 2008 though it is still above the historical low of 5.1% in 2000.

Graph 2.4: **Employment evolution by sectors**



Source: Eurostat

The slack in the labour market is rapidly declining. The employment rate for the age group of 20-64 reached 75.0% in Q1-2018 and is already higher than the historical high of 74.0% reached in Q1-2001. Therefore, wage growth is expected to gradually increase over the medium run, also driven by the unfreezing of career progressions in the public sector. Nevertheless, wage developments have been quite subdued so far and none of the business sectors reported by the statistical office has experienced a substantial increase. In some sectors, labour unions are showing increased activity for wage renegotiations and the role of collective bargaining is likely to increase after the enforcement of the planned amendments to the labour code. On the other hand,

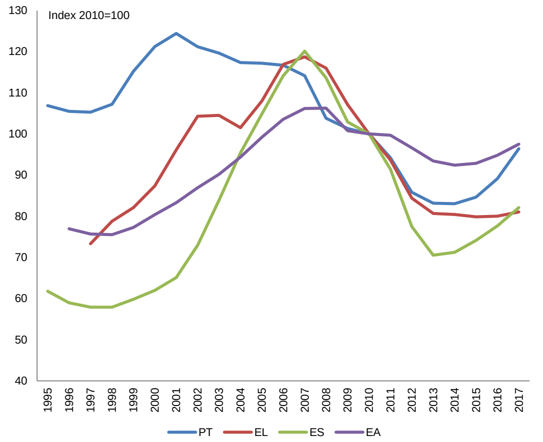
([3]) According to Eurostat data for the age group of 15-74.

the likely build-up of wage pressures in some sectors could be at least partly offset at an aggregate level by the strong job creation in sectors with lower-than-average wages. A relatively high share of temporary employment persists (most of it involuntary), when compared with the EU average.

Consumer price inflation (HICP) accelerated towards the middle of the year following a temporary dip by April 2018. The price dynamics mainly reflected the volatility in the currency and crude oil markets as well as a large base effect in accommodation prices in April. The latter was heavily influenced by the Easter holidays, whose impact in 2018 was much weaker than in 2017 due to the specifics of the price monitoring periods and also due to methodological changes. Subdued wage developments also contributed to the very low inflation in the first months of the year. After this temporary dip, inflation rebounded again to 2.0% y-o-y in June and 2.2% y-o-y in July. In year-average terms, inflation is projected to reach 1.4% in 2018 and 1.6% in 2019. Wage developments are expected to gradually push up service prices while energy prices are set to have a strong inflationary impact in the second half of 2018 and some disinflationary impact in 2019. Consequently, core inflation is forecast to move slightly above the headline rate in 2019 after a temporary dip in 2018.

House prices increased by 12.2% y-o-y in the first quarter of 2018 accelerating from 9.2% in 2017. Prices of existing dwellings increased at a higher rate of 13.0% in the first quarter of 2018 relative to 9.7% for existing dwellings. Transactions increased even more by 15.7% in volumes and 25.7% in value terms. The market is mainly driven by the booming tourist industry and foreign capital inflows, particularly in the main cities of Lisbon and Porto where the price hikes are well above the average. Rent continues to rise further, but more slowly than house prices. As the large majority of people in Portugal are homeowners, it is assumed that the recent increase in demand for rented accommodation is mainly related to the tourism boom.

Graph 2.5: **Ratio of house prices to rent prices**



Source: OECD

The impact from tourism is channelled through the growing investor interest for commercialisation of residential properties. It also includes the rapid increase in the use of online platforms for short-term property rents and the rapid expansions of low-cost airlines. This is moving prices not only in popular tourist areas but affects also residential quarters, with an impact on housing affordability in particular for low-income households. The impact of foreign demand reflects purchases of properties by both non-residents and non-habitual residents([4]). It is estimated that about 15 000 non-habitual residents have been attracted so far by financial incentives such as Golden Visa or tax relieves but there are also significant investments not related to any regulatory incentives. These factors explain the strong price increase over the past years in parallel to the decline in the stock of housing loans.

The increase in house prices is set to gradually slow down over the medium run, as the ongoing recovery in construction is set to add to the supply of housing. However, a more significant rebalancing effect from the recent growth in construction is likely to be seen as of 2019, as many projects are still in the pipeline and will not have an immediate impact on the market. The increase in the deflated house price index is therefore expected to exceed again the 6%

([4]) The Portuguese Non-Habitual Residents status applies to those who become tax residents in Portugal which requires them to live more than 183 days a year in the country. The status enables them to receive a preferential tax treatment over a period of ten years.

indicative threshold in the MIP scoreboard in 2018. This would mark the third consecutive breach of the threshold after 8.0% in 2017 and 6.1% in 2016. So far, the rebound in house prices is seen as a correction from previously low levels of valuation and construction activity and is not considered indicative of an imbalance. It is also accompanied by a continuous reduction in housing loans, as direct investments appear the main source of financing property transactions. Nevertheless, house price dynamics warrant closer monitoring, as a potential price correction would still have negative valuation effects on bank assets.

2.2. PUBLIC FINANCES

In cash terms, budget execution through end June 2018 appears broadly in line with full-year targets. Up to June, the general government cash balance improved by EUR 0.4 billion relative to the same period last year due to an increase in revenue by 2.5% while expenditure grew by only 1.3%, mostly due to a postponement in the payment schedule of Christmas supplement expenditure. The execution has been quite volatile early in the year due to various temporary effects.

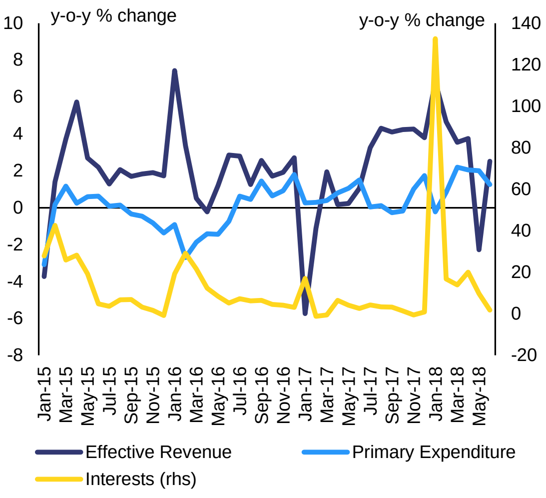
On the revenue side, the fiscal performance has been negatively affected by a shift in payment schedules for direct taxes while indirect taxes and social security contributions have performed rather strongly. The postponement of the deadline for corporate income tax (CIT) declarations from May to June combined with earlier reimbursements for personal income tax (PIT) led to a very substantial temporary year-on-year decrease for direct taxes by 25.7% up to May. This drop was however largely offset in June. Overall, direct taxes decreased by 0.8% up to June due to slight reductions in PIT (-0.3%) and CIT (-1.1%). However, indirect taxes increased by 4.3%, close to the full-year budget target of 4.7%, mainly due to the favourable behaviour of VAT (+4.4%), the tax on tobacco (+6.0%) and the stamp duty (+5.3%). Tax reimbursements increased by 6.4%, mainly influenced by refunds on VAT and PIT. While the increase of social contributions exceeded the annual target (+4.6% compared to +4.3%), other current revenue and capital revenue fell significantly short of the annual targets up to June.

On the expenditure side, there has been some slight deceleration as compared to last year. Overall expenditure grew by 1.3% up to June as compared to the overall 2017 growth rate of 1.8% and remaining largely below the full-year increase of 6.3% planned in the 2018 budget. The overall moderation up to June was strongly supported by the temporary effect of the postponement of the payment of the entire Christmas supplement for salaries and pensions to November and December([5]), the back-loaded impact of the unfreezing of careers and lower-than-budgeted investment (+3.7% vs a full-year budget increase of +21.8%). The corresponding underspending was however partially offset by increases of acquisition of goods and services and current transfers.

Risks to cash based budget execution appear to be broadly balanced. Some lower-than-expected revenues early in 2018 are expected to have been mainly temporary and have already been largely compensated up to June. The authorities are thus confident to reach the budgetary targets in cash terms as adopted in the 2018 Budget. In any case, the still outstanding full effect of recent tax declarations for 2017 and the time profile impact of some expenditure measures (such as the change in the payment profile of Christmas supplements in 2018, the back-loaded gradual impact of the unfreezing of careers and the extraordinary pension increases as of 1 August 2018) limit the full-year comparability of the cash execution. Over the whole year, risks to budgetary execution in cash terms appear to be broadly balanced as higher revenue from the strong performance of indirect taxes and social security contributions and lower-than-budgeted investment may offset spending pressures in particular for compensation of employees and acquisition of goods and services. The authorities also emphasised that the impact of some expenditure increases in national accounts would be lower than in cash accounts, in particular as regards the increase in acquisition of goods and services induced by the clearance of hospital arrears (partially already recorded in national accounts as intermediate consumption of previous years).

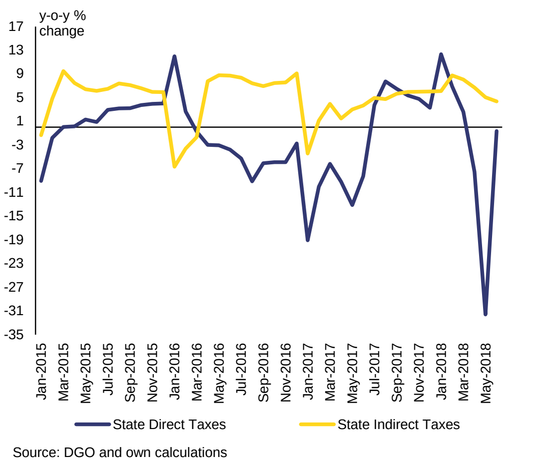
([5]) While in 2017 50% of the Christmas supplements for salaries and pensions were still paid in twelve monthly payments, in 2018 the entire amount of the Christmas supplements will only be paid in November or December, respectively.

Graph 2.6: **Budget execution (General Government)**



Source: DGO

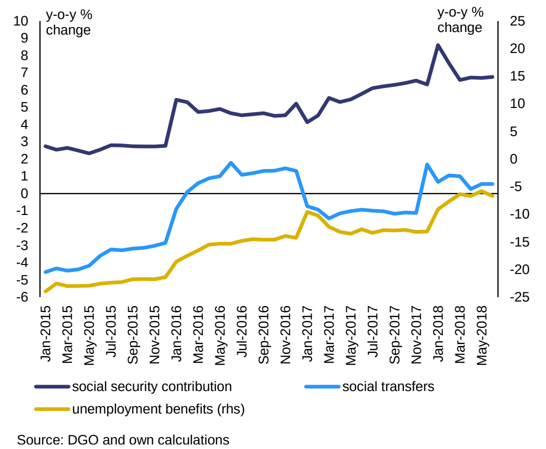
Graph 2.7: **Budget execution (State)**



Source: DGO

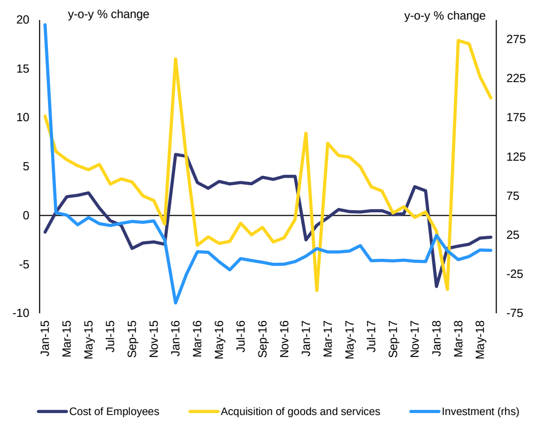
Mainly due to state-owned hospitals, the public sector arrears continue on a rising trend that is only mitigated by periodical ad-hoc clearances. Public sector arrears increased by around EUR 200 million in 2017 to EUR 1.1 billion in spite of a EUR 400 million ad-hoc clearance funds injection in state-owned hospitals in December. While the trend for further increases (by around EUR 200 million by February) could be temporarily reverted via a EUR 500 million capital injection into hospitals (bringing the arrears down to EUR 900 million by April) further increases of around EUR 50 million per month have been recorded in both May and June. Thus, by June 2018, the level of arrears has almost returned to the level of around EUR 1.1 billion recorded in June 2017 in spite of EUR 900 million in ad-hoc funding provided to hospitals since December. Budgetary planning and control in state-owned hospitals remain a challenge.

Graph 2.8: **Budget execution (Social security)**



Source: DGO

Graph 2.9: **Budget execution (Central administration)**



Source: DGO

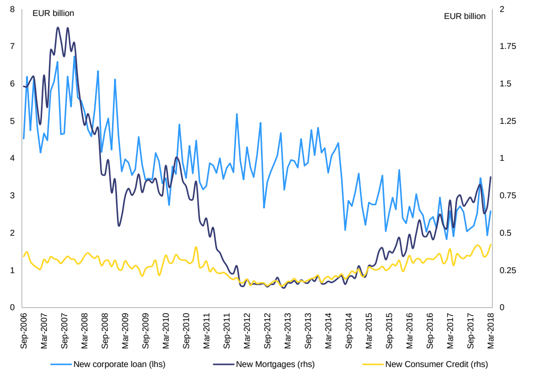
2.3. FINANCIAL STABILITY AND INDEBTEDNESS

For the first time since 2010 credit to the non-financial private sector stopped shrinking. It increased by 0.3% between Q1 2017 and Q1 2018, while credit to non-financial corporations increased by 0.1%. Resident banks' corporate exposure shrank by 3.1% between March 2017 and March 2018, whereas foreign institutions increased their loans over the same period by 5.5%, albeit on a smaller total volume. Credit is increasing, despite ongoing passive deleveraging, as the sum of loans and securities has grown less than nominal GDP. For the moment, the high level of non-performing loans (NPLs) on banks' balance sheets is not constraining the supply of loans to healthy firms with good business models. Indeed, competition amongst banks is very intense in this segment. Banks strongly increased their lending to firms with the best risk profiles, while decreasing their exposure to firms in the worst risk quartile, mainly through the write-off and restructuring of NPLs. Corporate loan interest rates have more than halved since 2012 and edge ever closer to European averages. The average interest rate on new corporation loans stood at 2.4% in March 2018.

Mortgage interest rates have fallen below 1.5%. As with corporate loans, mortgage interest rates have continued to fall since 2012, and reached a Q1 average of 1.5% compared to an average 1.8% in the first three months of 2017. Although 40% of mortgages granted in 2017 were on a fixed rate for the first five years, nearly all mortgages in Portugal are at a variable rate. In 2017, 43% of property purchases were financed through domestic mortgages. This figure has increased since 2013, when that share was only 25%. On a monthly basis, newly granted mortgages have trebled since 2012-2014 when they amounted to less than EUR 200 million per month. Between March 2017 and March 2018 the monthly average was above EUR 700 million, roughly half the monthly average in 2003-2007. At the same time, mortgage redemptions still stand at a higher rate, so the stock of outstanding mortgages shrank by 1.6% between Q1-2017 and Q1-2018.

The recovery in consumer lending remains strong. During the three years of the financial assistance programme, the stock of consumer loans fell by one-fifth. However, since early 2016 this category of loans has been growing again, partly reflecting pent-up demand. Even though average consumer loan interest rates were 7.3% in March 2018, nearly one-third higher than the euro area average, consumer credit stocks grew by 13.5% over that period compared to a 7.1% growth in the euro area.

Graph 2.10: **New loans granted**



Source: BdP

Non-performing loans have fallen by more than a quarter since their peak in June 2016, but still remain very high. Between December 2014 and June 2016, the stock of NPLs stood at around EUR 50 billion. In part because of a denominator effect, the ratio on NPL to all loans rose from 16.6% in December 2014 to a peak of 17.9% in June 2016. Q1-2018 figures show NPLs standing at EUR 34.6 billion, which translates to an NPL ratio of 12.7% of gross loans, with a coverage ratio of 52.2%. NPLs fell as recapitalised banks wrote-off bad loans, sold NPL portfolios and foreclosed properties. As the total stock of loans is increasing again, the denominator effect now also helps to decrease the ratio further. At the turning point in June 2016, corporate NPLs made up two-thirds of overall non-performing assets, translating into a 30.3% corporate NPL ratio. From a stock of EUR 33 billion of corporate NPLs in June 2016, by Q1-2018 some EUR 10.3 billion of loans had experienced some sort of work-out, decreasing the ratio from 30.3% to 23.8%, whilst adding 10.3 percentage points to the coverage ratio for corporate NPLs, which stood at 56.7% Q1-2018. Overall, NPLs are split 60:40 between overdue loans and unlikely-to-pay categories, whereas the euro area average is 33:67.

Table 2.1: **Financial stability indicators**

	2010	2011	2012	2013	2014	2015	2016				2017			
	Dec.	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
CAR	10.3	9.8	12.6	13.3	12.3	13.3	13.0	13.1	13.2	12.3	13.9	14.4	14.7	15.2
CET1					11.3	12.4	12.1	12.1	12.3	11.4	12.6	13.2	13.5	13.9
NPL	5.3	7.5	9.7	10.6	11.9	17.5	17.9	17.9	17.6	17.2	16.4	15.5	14.6	13.3
RoA	0.4	-0.4	-0.4	-0.8	-1.4	0.2	0.2	0.0	0.1	-0.6	0.3	0.3	0.4	0.3
RoE	6.4	-7.7	-6.2	-12.5	-19.7	2.1	1.9	-0.1	1.0	-7.4	3.5	3.9	4.7	3.5
C/I	61	66	60	72	68	63	68	66	65	62	70	65	64	58

Source: BdP; Until Q3-2015 NPL data reflects Banco de Portugal "Credit at Risk" definition. From end 2015 onwards, data follows EBA's NPL definition. C/I excludes one-offs.

Banks have high levels of deposits, despite rates of deposit remuneration at a low level in absolute terms. Contrary to other countries receiving financial assistance, deposits in Portuguese banks grew steadily throughout the years of the assistance programme. Aggregate deposits grew 2.6% between March 2017 and March 2018, boosted by corporate savings which increased 11.2%, whilst household deposits increased with 0.6%. Contrary to other EU-jurisdictions, Portuguese banks are legally forbidden to charge negative interest rates, even for large companies. This restriction increases the incentives for multinationals to deposit excess liquidity in Portugal. Sight deposits generally remain unremunerated in Portugal. Household and corporate deposits with up to 1 year maturity earned 0.2% and 0.1% interest, respectively, in March 2018.

Banks appear to have adequate liquidity. The system's loan-to-deposit ratio read 106% in April 2018, reflecting a 71 percentage points decrease from its peak in June 2010. The liquidity coverage ratio (LCR) stood at 173%. Borrowing from the ECB is predominantly through the targeted longer-term refinancing operations (TLTROs), redeemable in 2020. In May, this figure read EUR 22 billion, equivalent to 5.6% of banks' total liabilities.

Capital levels have increased but still remain low in comparison with most other euro area countries. The CET1 ratio increased by 2.8 percentage points to 13.6% in Q1-2018 Since autumn 2016, four out of Portugal's six biggest banks saw capital injections amounting to EUR 7.25 billion. Workout of NPLs and de-consolidation of subsidiaries also had the effect of decreasing risk-weighted assets in the denominator significantly. Despite observable and tangible progress by banks in strengthening their capital positions, Portugal has still the euro area's third lowest capital ratio relative to risk-weighted assets.

Banks' net income has turned positive. In 2017, return on equity (ROE) was 3.4%, while return on assets (ROA) was 0.3% in Portugal relative to euro area averages of 6.1% and 0.4% respectively. Portugal's banking system recorded losses almost continuously between 2011 and 2016 (the exception was 2015, when a small profit was recorded). Portuguese lenders have managed to break even due to cost reduction efforts and lower loan loss provisions. Despite falling loan stocks and increasing deposits, net interest income has increased, as deposit remuneration has fallen close to zero in most banks. Furthermore, banks' trading results also benefitted from an increase in the value of sovereign bond holdings over 2017. In addition, the recovery in the real estate market is making it easier for banks to sell foreclosed properties. Still, important differences persist between banks in terms of profitability.

Novo Banco's EUR 1.4 billion loss in 2017 stems mainly from a reinforcement of provision and impairments for loans, securities and equity participations. As Novo Banco fell below a certain capital threshold, the contingent capital mechanism was invoked to bring CET1 back up to the minimum designated in the said mechanism. The resolution fund injected EUR 792 million in Novo Banco in May 2018, out of which EUR 430 million needed to be borrowed from the state. For eight years, the national resolution fund can be called upon to inject up to a total of EUR 3.9 billion if specified assets within Novo Banco (valued at EUR 7.9 billion in June 2016), cause the CET1 to fall below thresholds agreed amongst the mechanism's participants. In Q1-2018 Novo Banco realised a EUR 61 million profit.

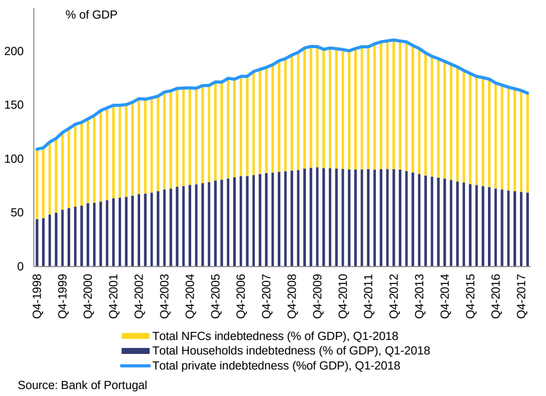
Almost all banks are presently engaged in the process of restructuring. In 2017, the cost-to-income ratio fell 6 percentage points to 53%, close to the euro area's median. Despite tangible progress in cost reduction, reducing costs further will remain high on the agenda of banks as their business model changes. As in other European countries, banks now face increasing pressure to move their businesses online and invest more in new digital technologies. This, in turn, implies higher investments in IT infrastructure to support changes in business models.

Private Debt

Private indebtedness retains a steady downward trend. In consolidated terms, the share of private debt in GDP fell from 210.3% at the end of 2012 to 170.3% at the end of 2016 and 163.5% at the end of 2017. The distance to the relevant MIP threshold of 133% was thus substantially reduced by an annual average of 9.4 percentage points over the last five years. Statistics for 2018, though available only in non-consolidated terms on monthly and quarterly basis, confirm the steady pace of deleveraging with only a minor slowdown in comparison with the previous years. This suggests that, at the current pace of deleveraging, the private debt ratio will move to about 155% at the end of 2018 and would be below the indicative threshold of 133% by the end of 2021.

Both the corporate and household sectors are contributing to the deleveraging process. At the end of 2017, consolidated corporate debt accounted for 94.1% of GDP and the stock of household debt was 69.5% of GDP. In absolute terms, the process of deleveraging is expected to slow down, particularly in the household sector where consumer loans retain a significant growth pace. On the other hand, the favourable economic growth projections are set to have a substantial downward impact on the private sector debt ratios (passive deleveraging), thus keeping an overall adequate pace of reducing the private sector indebtedness.

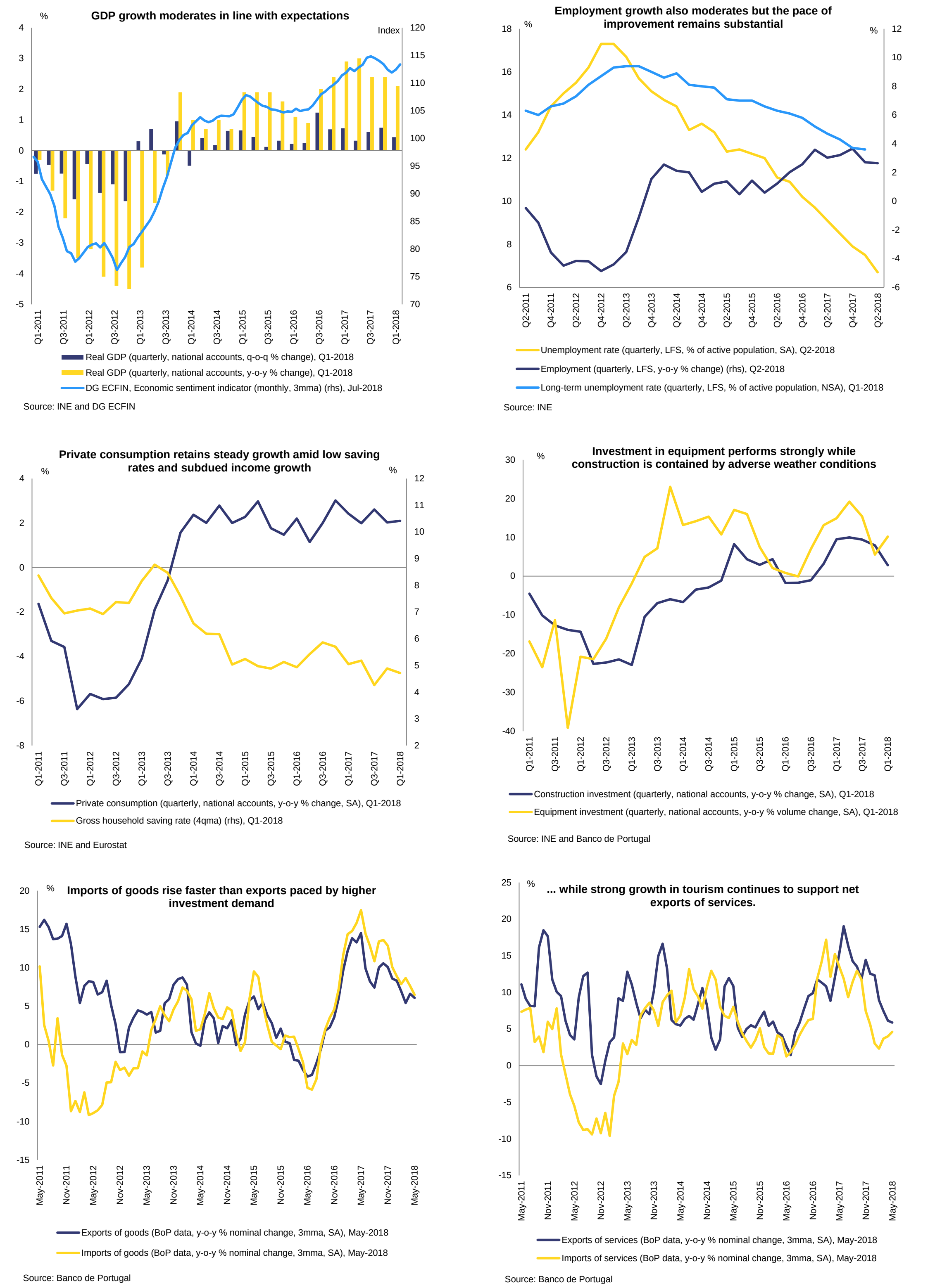
Graph 2.11: **Private indebtedness**



Source: Banco de Portugal

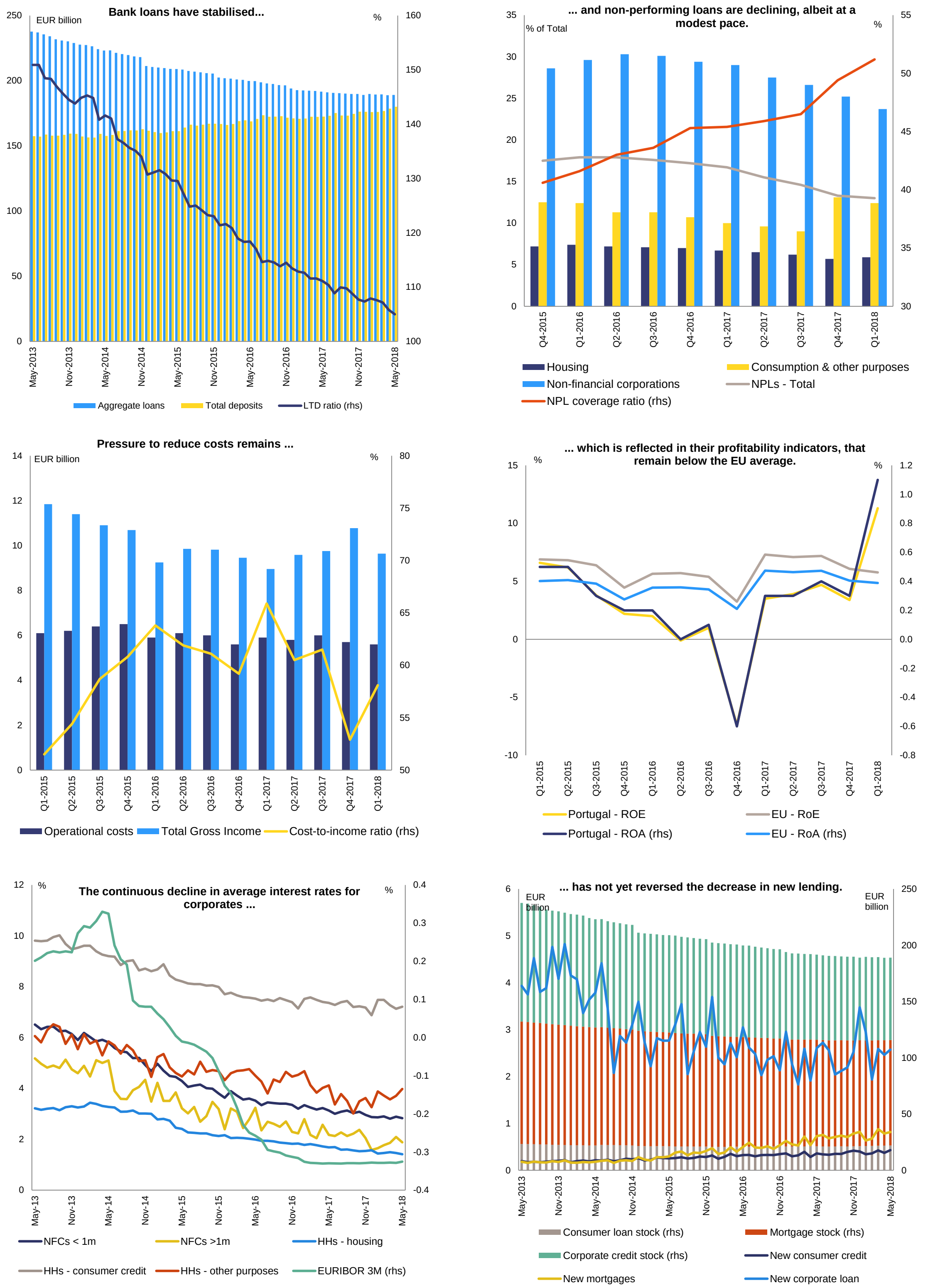
Non-bank financing is increasing. The share of debt securities in GDP widened from 17.3% at the end of 2016 to 17.8% at the end of 2017, while the share of bank loans fell from 41.4% to 38.0% for the same period. The increasing share of FDI in the net international investment position also indicates an improved access to loans from foreign-owned parent companies. The data thus imply that at aggregate level the ongoing process of deleveraging, particularly in the banking sector, is not having a significant negative impact on private investment, which have risen strongly in 2017 though from a low base. The potential for corporate investment is also supported by the improving profitability in many sectors of the economy. The high indebtedness is however still posing constraints on smaller firms, companies in a difficult financial situation as well as new entrants with limited access to alternative (non-bank) financing.

Graph 2.12: **Recent macroeconomic developments**



Source: European Commission

Graph 2.13: **Recent financial developments**



Source: European Commission

3. POLICY ISSUES

3.1. PUBLIC FINANCE

The Commission 2018 spring forecast projects the headline deficit at 0.9% of GDP in 2018, impacted by further banking support operations, in particular the activation of the Novo Banco contingent capital mechanism (0.4% of GDP), while the deficit net of one-offs is set to improve to 0.5% of GDP (see Table 3.1). As the impact of discretionary measures and savings in interest expenditure in 2018 is expected to be broadly neutral, the structural balance is projected to remain broadly stable. The Stability Programme targets a revised headline deficit of 0.7% of GDP for 2018, i.e. 0.4% of GDP below the approved 2018 Budget target of 1.1% of GDP. The improvement by 0.4% of GDP mostly reflects the improved carry-over from 2017 on current expenditure mitigated by the 0.4% of GDP negative impact of the Novo Banco contingent capital mechanism. Thus, on the expenditure side, a downward revision by 0.8% of GDP of current expenditure is partially offset by a 0.3% of GDP increase of capital expenditure, resulting in an overall decrease of expenditure of 0.5% of GDP. This 0.5% of GDP improvement on the expenditure side is however accompanied by a slight downward revision of overall revenue by 0.1% of GDP as increases for taxes and social contributions (0.4% of GDP) and capital revenue (0.1% of GDP) are more than outweighed by strong downward revisions of sales and other current revenue (-0.6% of GDP). The 0.2% of GDP difference between the headline deficit of 0.9% of GDP in the Commission spring forecast and the 0.7% of GDP target in the Stability Programme is mostly related to higher expected compensation of employees in the spring forecast.

The structural balance is projected to remain stable in 2018 according to the spring forecast while the Stability Programme projects an improvement in the structural balance by around 0.4% of GDP in 2018. The 0.4% of GDP divergence is due to the difference in the headline deficit, a more positive output gap projection in the spring forecast resulting in a higher cyclical adjustment than in the Stability Programme and a difference in one-off expenditure, related to the inclusion of the ‘unusual event’ exceptional wildfire prevention structural expenditure and of payments to Greece as one-off in the Stability Programme. The structural primary balance is expected to deteriorate by 0.3% of GDP according to the Commission spring forecast and to improve by 0.1% of GDP according to the Stability Programme.

For 2019, the Commission spring forecast projects a headline deficit of 0.6% of GDP in 2019 under the no-policy change assumption, 0.4% of GDP above the 0.2% of GDP target in the Stability Programme. About half of the divergence is related to higher expected pressures for compensation of employees, another 0.1% of GDP to pressures on other expenditure items (as expenditure measures could not be fully factored in) and another 0.1% of GDP due to lower indirect tax revenue resulting from the spring forecast’s slightly more conservative macro scenario and insufficiently specified tax measures. The Commission 2018 spring forecast takes fully into account the deficit-increasing measures included in the Stability Programme’s baseline scenario, i.e. the carry-over of the 2018 PIT bracket revision, the unfreezing of careers and the increases in other social benefits. It instead takes into account only half of the estimated budgetary impact of the impact of the spending review on intermediate consumption and other current expenditure, as this measure has not yet been sufficiently specified for 2019. Savings in interest expenditure, while not explicitly considered a measure in the Commission forecast, broadly coincide with those of the Stability Programme.

The Commission spring forecast projects a slight deterioration of the structural balance by about 0.1% of GDP in 2019 as compared to a planned improvement by 0.3% of GDP in the Stability Programme. The 0.4% of GDP difference in the structural balance variation is mostly related to the difference in the evolution of the headline balance but also to the more positive output gap evolution based on lower potential growth estimates than in the Stability Programme (partially compensated by the offsetting of the 2018 one-off difference).

After rising slightly to 129.9% in 2016, Portugal’s gross general government debt-to-GDP ratio fell by 4.2 percentage points to 125.7% in 2017. This results from a decrease of

2.1% of GDP in stock-flow adjustments (mainly a 1.5% of GDP reduction in the cash buffer), strong nominal growth and the primary surplus. The Commission 2018 spring forecast projects the gross public debt-to-GDP to further decline to 122.5% in 2018 and 119.5% in 2019, mainly due to primary budget surpluses and high nominal GDP growth. The Stability Programme expects somewhat lower ratios of 122.2% of GDP in 2018 and 118.4% of GDP in 2019, mostly due to projected lower headline deficits and higher nominal GDP growth in 2019. Risks to the fiscal outlook are tilted to the downside, linked to uncertainties in the external environment, including contagion from other developments in the euro area, and the further deficit increasing impact of potential banking support measures (in particular a renewed activation of the Novo Banco contingent capital mechanism).

The assessment of Stability and Growth Pact (SGP) compliance points to some deviation in 2017 and to risks of significant deviation for both 2018 and 2019 and over 2017-2018 and 2018-2019 taken together. Portugal is subject to the preventive arm of the SGP as of 2017 and has to ensure compliance with the required adjustment towards the Medium-Term Objective (MTO). To this end, Portugal is required to contain the growth rate in net primary expenditure corresponding to annual structural adjustments of at least 0.6% of GDP towards the MTO over 2017-2019.

In 2017, Portugal achieved an improvement of the structural balance of 0.9% of GDP, which is in line with the required adjustment towards the MTO. On the other hand, the growth rate of government expenditure, net of discretionary revenue measures and one-offs, exceeded the applicable expenditure benchmark rate, leading to a negative deviation of 0.5% of GDP in the underlying fiscal position. Following an overall assessment, both indicators point to some deviation from the recommended adjustment path towards the MTO in 2017.

For 2018 and 2019, the Commission spring forecast projects the growth rate of nominal primary government expenditure, net of discretionary revenue measures and one-offs, to exceed the applicable expenditure benchmark rate. This is estimated to lead to negative deviations of 1.4% of GDP and 1.0% of GDP of the underlying fiscal position in 2018 and 2019, respectively, as compared to the required annual structural adjustment of 0.6% of GDP. The structural balance is projected to remain unchanged in 2018 and to slightly deteriorate by 0.1% of GDP in 2019, below the recommended annual structural adjustment of at least 0.6% of GDP towards the MTO in both years. Following an overall assessment, there is a risk of significant deviation from the recommended adjustment path towards the MTO in both years and over 2017-2018 and 2018-2019 taken together based on the Commission 2018 spring forecast. An overall assessment on the basis of the Stability Programme also points to a planned risk of a significant deviation in both 2018 and 2019 and over 2017-2018 and 2018-2019 taken together.

Based on both the Stability Programme data and on the Commission 2018 spring forecast, Portugal is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2018 and 2019.

3.2. FISCAL-STRUCTURAL ISSUES

While the overall spending review was recently broadened and now shows more ambitious savings targets, future steps still remain to be specified. A series of initiatives across various public sectors (healthcare, education, state-owned enterprises, internal administration, justice) and areas (public procurement, real estate management, human resources) continue to be put in place. For instance, previously announced initiatives to reduce absenteeism in the public sector have started to be implemented. This includes the review of around 6 000 medical panels in the education sector in late 2017 to identify incorrect sick leaves, which has contributed to the return to work of over half of the assessed cases. Another 6 000 reviews were planned to be carried out between March and August 2018. A new monitoring system to assess absenteeism has also been set up. While savings and efficiency gains are foreseen overall, measures still need to be specified for the often substantial savings planned for future years. Furthermore, the exercise is not yet undergoing a regular and independent ex-post analysis. This has so far only been done for selected cases on an ad-hoc basis by the authorities.

The number of employees and the wage bill appear to remain under continued pressure to increase above budget targets. The 2017 wage bill increased by 1.9% in nominal terms, significantly above the 2017 budget while the average headcount of public employees increased by 0.8% in 2017 notwithstanding the planned decrease according to the 2:1 replacement ratio rule. This tendency of increasing numbers of public employees appears to be confirmed by the evolution in Q1-2018 that recorded a further 0.8% y-o-y increase in the number of public employees, (in particular due to high increases in the areas of health and education) as compared to the stabilisation targeted in the Stability Programme. At the same time, the wide-ranging programme to convert temporary contracts for permanent tasks in the public sector into permanent contracts is expected to be concluded by the end of 2018 (concerning an estimated 20 000 people) ([6]).The planned extension of the 35 hour week in the health sector to employees with private sector contracts (around 40% of the workforce) is expected to put additional pressure on the headcount and the wage bill (e.g. via extra hours compensation) as of 1 July 2018. The unfreezing of career progression – which had been frozen since 2010 – has started as of January 2018. The additional payments are gradually being phased in (25% as of January 2018, 50% as of September 2018, 75% as of May 2019 and 100% as of December 2019) with an estimated incremental cost of around 0.2% of GDP in both 2018 and 2019 and another 0.1% of GDP in 2020 according to the Stability Programme. The precise modalities of the unfreezing for some specific careers (in particular for teachers) are still under negotiation and might put some significant upward pressure on the overall cost of the unfreezing measure.

There has been progress in local administration reforms and the decentralisation package is planned to be gradually implemented as of 2019. Overall local and regional debt and arrears have continued their decline while the overall local and regional budgetary surplus has slightly decreased in 2017. Employment in local administration increased by 1.9% in 2017 as compared to 0.8% for overall general government. The Municipality Support Fund (FAM – a debt workout mechanism for over-indebted municipalities) has continued its disbursements reaching EUR 318 million. While the Financial Coordination Council set up in 2014 has not been convening, there have been quarterly meetings of the Regional Coordination Council. The Directorate-General for Local Administration (DGAL) supported by UTAM and the Directorate-General for Budget (DGO; on regional government) have improved the monitoring of local State-Owned Enterprises (SOEs) and PPPs supported by a decree law from July 2017 creating the obligation for local SOEs to provide direct information without going through the local authorities, while information on local PPPs has been reported quarterly since 2016. The decentralisation process on a wide range of domains, in particular education and health, with the purpose to increase the share of resources spent at local level, is planned to be gradually

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

implemented over three years as of 2019. The parliamentary approval of a framework agreement is expected to be concluded before the autumn in parallel with a revision of the local finance law to adjust human resources and local finances, and is to be complemented later by a series of sectoral decree-laws. The volume of financial transfers to the municipalities to compensate for the new tasks is planned to reach around EUR 1 billion to EUR 1.2 billion and to be implemented in a budget-neutral way.

The implementation of the Budget Framework Law (BFL) that entered into force in September 2015 is being postponed via an amending law in the Parliament due to cumulative delays. The Law is designed to make budget units more accountable and strengthen the medium- to long-term focus of public finances and allowed for a three-year transitional period for applying most new features. The BFL's implementation unit has convened regularly and preparatory work mostly in terms of IT systems setup has been progressing, in particular as regards the state accounting entity project ([7]). According to a draft law submitted to Parliament the government intends to delay the entry into force of the main provisions of the revised BFL by one and a half years to 1 April 2020. Thus, only the 2021 budget is planned to be prepared under the new rules. Some elements might however become operational at an earlier stage. In terms of regulatory preparation a series of decree laws will require adjustment and consolidation and the decree law on the setup of the new budgetary programmes will need to be prepared([8]). The full effective application of the new accrual-based public accounting framework that was last set to start in January 2018 has been rescheduled to January 2019 following delays in particular for local authorities and Social Security.

Except for PIT, only relatively minor shifts in taxation are being implemented in 2018. In addition to the already previously planned full abolishment of the PIT surcharge also for higher tax brackets, new PIT reform measures were introduced in the 2018 budget, increasing in particular the number of tax brackets and the level of the net income guarantee (*'mínimo de existência'*). The authorities estimate the cost of the latter two measures at EUR 230 million in 2018 and EUR 156 million in 2019 when the 2018 PIT declarations are made. While the 2018 draft budget did not include any major changes to CIT rules, Parliament adopted an increase of the State surcharge from 7% to 9% for large companies with profits exceeding EUR 35 million. This was accompanied by a measure increasing incentives for reinvesting profits. The 2% increase in the State surcharge is estimated to bring around EUR 60 million in additional revenue in 2018. The proposal for a major reform to deferred tax assets (DTA) rules and timelines, first brought up in autumn 2017 during the 2018 budget discussions, is still being evaluated. A new proposal might be included in the 2019 draft budget. While some small changes to CIT tax benefits may also already be inserted into the 2019 draft budget, more ample changes are only planned to be decided once the dedicated working group on the evaluation of tax benefits will have presented their report (expected for March 2019).

As regards indirect taxes, the new VAT exemption regime on imports is expected to lead to some short-term revenue shortfalls from customs VAT that are however expected to be compensated by lower reimbursements within the year. The "other taxes" with planned revenue of EUR 90 million in 2019 as shown in the Stability programme still need to be specified in the preparation of the 2019 draft budget.

Net revenues of taxes newly introduced in 2017 appear to have been lower than expected. The revenue of EUR 70 million in 2017 from the new tax on sugary drinks turned out to be close to the EUR 80 million target. However, the progressive additional real estate tax (AIMI) introduced in 2017 and earmarked for the Social Security's Financial Stabilisation Fund may bring significantly lower net revenue than expected. While gross revenues of around EUR 130 million are expected for 2017 only EUR 50 million have effectively been assigned to the Stabilisation Fund. The reduced transfer to the Fund reflects the expected impact of the deductibility of the additional real estate tax for rented-out properties in PIT and CIT declarations. The final net revenue impact of AIMI will thus only be known after

([7]) A first preliminary opening balance sheet has been established as of 1 January 2018.

([8]) The draft amendment to the BFL sets a new deadline by June 2019 for the approval of the corresponding decree law on budgetary programmes.

completion of the 2017 PIT and CIT declaration process.

Although the exact measures of further early retirement reform are still subject to change, their aim is to gradually further relax the conditions and penalties for early retirement for long careers. A first change of the rules for early retirement was implemented as of October 2017. This allows people who are now 60 years or older and that have made contributions for 48 years or more ([9]) to the social security or the legacy civil service pension system to retire early without penalty. This change is estimated to cover 11 500 early pensioners in 2018. The authorities are now discussing further steps with the social partners. The reforms will most likely be phased in over three years, from 2019-2021. According to the authorities, the affected cohorts are likely to diminish over time, and while budgetary impacts are planned to be limited, the reforms can be expected to result in a decrease in the effective age of early retirement.

Discretionary permanent increases in social security spending are currently matched by strong increases in social security contributions which are, however, not permanent but cyclical. In addition to the annual update to pensions as of 1 January, another extraordinary update of lower pensions that were not updated between 2011 and 2015 will be carried out in August this year (similar to the extraordinary update of August 2017). Several increases to the amounts and coverage of various social transfers in the non-contributory part of the social security system are also being implemented, such as in the areas of child benefits, inclusion of people with disabilities, low income pensioners and low income families. The relatively strong planned increases in expenditure however are more than offset by continued strong revenues from social security contributions, particularly supported by steady employment increases. For the medium term, the authorities have acknowledged the ageing-cost related challenge of the pension system and are currently working with the OECD on a report to be presented in early 2019 on possible ways forward.

([9]) Or those at 60 years or more with 46 years of contributions or more if they also started making contributions to the Social Security when they were 14 years or less.

Additional ad-hoc funding including capital injections continues to be administered regularly to mitigate the long-standing issue of rising hospital arrears. After a strong increase in hospital arrears during most of 2017, EUR 400 million were injected into the health system in December, followed by an additional EUR 500 million for capital injections into hospitals between March and April 2018. Another tranche of a further EUR 500 million for capital injections are planned to be released in the second half of 2018. Finally, a central reserve of EUR 300 million would be available at year-end bringing the total expected extra funding to around EUR 1.7 billion over the two years. The authorities thereby aim to prevent arrears from exceeding the level seen at the end of 2017. While the injections help to reduce the stock of arrears, their accumulation appears to primarily reflect a problem of under budgeting, monitoring and enforcement practices in certain hospitals.

A new mission structure for hospitals has been set up to tackle arrears and improve efficiency. In the short term, the cross-departmental mission structure will analyse the best way of administering the remaining EUR 500 million to be injected into the hospitals this year in order to maximise their impact and to minimise moral hazard. In the medium term, the structure will look into ways of progressively eliminating the creation of new hospital arrears. This will be done, for instance, by improving the budgeting process with more adequate financing, through better information of actual costs in the hospitals, and by optimising management and ensuring appropriate incentives for health professionals. This entity's initial proposals are planned before the 2019 draft budget. The implementation schedule for the previously announced Integrated Responsibility Centres, which seek to give more autonomy to hospital teams as a way of promoting organisational innovation and efficiency, still remains to be established.

In view of continuous spending pressures, cost-effectiveness continues to be promoted in the National Health Service and in hospitals in particular. The share of generics in the pharmaceutical market continues to increase, supported by incentives for pharmacies to promote generics and by a rising number of generics being approved at hospital level. According to the authorities, the use of generics is contributing to the reduction in expenditure per patient, which has been falling for a number of years. The use of biosimilars also continues to increase, with contractual incentives in hospitals and national guidance in place to promote their use. Centralised purchasing and annual price revisions also continue to yield savings, although this may tend to become increasingly difficult for the former over time. Continuous spending pressures remain, however, in particular related to the access to innovations and the 35 hours for all health personnel. In more general terms, pressures from the costs of ageing also represent an increasing challenge, as the long-term increase in public health expenditure in Portugal is set to be among the largest in the EU.

Despite continued progress in certain sectors, aggregated operational results of State-Owned Enterprises (SOEs) showed a mixed picture in 2017. Compared to 2016, overall EBITDA for SOEs fell by 6% in 2017, driven mainly by a significant deterioration in the results of health SOEs. While still negative by a significant margin, overall net profits improved by 17% in 2017, largely on the back of substantial improvements in the transport sector, which more than made up for the decreases in the health sector. The Portuguese authorities are committed to come close to eliminating negative net profits by the end of this year, which may be challenging. The non-consolidated debt of public corporations included in general government remains high despite having fallen from 19.8% to 18.3% of GDP between 2017 and 2018. It fell by a further 0.1% of GDP in the first quarter of 2018. Changes in working hours in health SOEs as well as the unfreezing of careers in general are already putting pressure on operational costs and can be expected to continue to do so beyond 2018.

Policy measures to enhance SOE monitoring are slowly being rolled out. Some of the updates planned for SIRIEF (the financial information transfer system from SOEs to authorities) have been implemented. The automatic uploading of data to the system, for instance, is now available, although it will take some time for all companies to start using this feature. It is estimated that the feature will be fully operational by 2019. In addition to the annual submission by SOEs of Activity and Budget Plans to the authorities, a more comprehensive risk assessment methodology is being introduced this year. Although it remains at an early stage, the aim is to eventually transform it into an early warning system for SOEs. Management incentives for good governance in SOEs remain frozen until financial results improve.

Public-Private Partnership (PPP) payments are projected to remain stable in 2018, although new projects are planned for the next few years. PPP payments turned out at around EUR 1.6 billion in 2017, with a similar amount being expected for 2018. While the trend of PPP payments overall is projected to decrease over time, the forecast does not include any new PPP contracts to be signed, and is limited to the 2017 PPP portfolio and does therefore not include the Metro do Porto operation and maintenance contract nor the ANA airport concession. A new Lisbon hospital PPP is expected to be awarded in 2020, with two new clinical services contracts to be tendered within the upcoming two years. All of these new contracts will be structured under the 2012 PPP law, which foresees more systematic costs-benefits analysis for PPP projects that are undertaken following the moratorium on PPPs during the adjustment programme. Over the longer term there is an expectation that as existing contracts expire and Infraestruturas de Portugal (IP) is likely to internalise the costs and responsibilities arising from the State’s road concessions, associated expenditures as a whole for the public sector should gradually fall.

3.3. FINANCIAL AND CORPORATE SECTORS

A policy-related factor supporting the reduction of NPLs is the authorities’ comprehensive strategy addressing the issue of non-performing assets. The NPL ratio remains among the highest in the euro area, despite a drop by more than a quarter in the stock of NPLs since June 2016. The decline has been driven by economic growth, write-offs and sales of non-performing loan portfolios and improved loan recoveries. The strategy is designed around three pillars: (a) a set of legal and judicial reforms to enable banks to sell, write off or maximise the recovery of non-performing credits; (b) an "intrusive" prudential supervision anchored in the SSM NPL reduction targets for banks; and, (c) the full use of NPL management solutions such as the creditors' coordination platform, a joint venture between three major Portuguese banks, which aims to accelerate NPL reduction through joint work on shared non-performing exposures. Continued implementation of the measures included in the comprehensive strategy would allow banks to make more rapid progress in dealing with their bad loans. In particular the limitation of access to PER by non-insolvent companies and allowing more flexibility for tax credits to be restructured should further allow the banks to deal with their bad assets. Nonetheless, despite the progress already achieved, the stock of NPLs in Portugal is still substantial, and authorities and banks should keep up the NPL reduction momentum.

Banco de Portugal has introduced a borrower-based macro-prudential measure covering new mortgage and consumer loans. The central bank aims at preventing excessive risk-taking by the financial sector, in a context where credit standards (in terms of loan-to-value (LTV), loan-to-income (LTI) ratios and interest spreads applied to new lending) have been eased over the past quarters, and this trend is expected to further continue. This macro-prudential measure is applicable to credit agreements concluded since 1 July 2018 and targets lenders and financial companies authorised to grant this type of credit in Portugal. The measure is aimed at promoting the adoption of prudent credit standards on loans granted to households in order to increase the sustainability of households' finances, and thus to bolster financial stability and mitigate systemic risk. More specifically, the measure introduces upper limits to: (a) the loan-to-value ratio; (b) the debt service-to-income ratio; (c) the maturity of loans; and (d) a requirement of regular payments of both interest and capital over the duration of the loan agreement.

Work on strengthening the future loss-absorbing capacity of Portuguese lenders is now entering the implementation phase. MREL([10]) is a critical part of each institution's resolution strategy, in addition to having a well-coordinated resolution plan. Significant institutions in Portugal have been informed about their respective preliminary MREL targets. The aggregate amount of bail-in-able debt to be issued over the next years is significant, and may put pressure on profit margins. Nevertheless, banks are confident they will meet the MREL regulatory requirements. For some lenders, MREL targets are already binding. Most lenders are expected to start issuing MREL eligible debt in 2018-2019. Achieving the mandated amounts by the end of the transition period in 2022 will in most cases imply a combination of a reduction in risk-weighted assets and wholesale funding issuance.

Insolvency procedures require further improvements in terms of streamlining and effectiveness. While the number of insolvencies filed has been decreasing since 2014, the backlog of cases is sizeable and procedures tend to be lengthy. The average length for insolvency cases was 49 months at the end of 2017, whereas the average credit recovery rate for the creditor was below 6% of the nominal value of the original loan. Given that close to 90% of all insolvency proceedings concern amounts that are below the threshold of EUR 50 000, these indicators show that bottlenecks in the capacity of the insolvency system are likely to remain in place going forward. Inefficiencies in insolvency proceedings also have a major impact on the market value of non-performing loan portfolios – the longer the proceedings, the lower the value the market assigns to these exposures. Notwithstanding the many legislative amendments already introduced to both the insolvency system and executive proceedings, there is room for further improvements that would not only increase the marketable value of bad credits but also allow a truly fresh start for some of the debtors.

([10]) MREL, or the minimum requirement for own funds and eligible liabilities, set in place by the Single Resolution Board, is the minimum loss-absorbing funds financial institutions must hold.

3.4. STRUCTURAL REFORMS

Labour Market

The government and the social partners signed a tripartite agreement in June 2018 to address labour market segmentation and strengthen collective bargaining. The act followed extensive tripartite discussions, built on the Green Paper on Labour Relations (2016) and framed by the Tripartite Commitment towards a Medium-Term Agreement, signed in January 2017. The debate in parliament started in July and is expected to continue after the summer. Three strategic objectives underpin the agreement: reduce labour market segmentation and tackle precariousness; promote a greater dynamism of collective bargaining; strengthen the means and instruments of labour market regulation.

The proposed measures tighten the regulation of temporary contracts, but also extend the probation period in case of first-time hires and the long-term unemployed. Significant legal changes include reducing the maximum duration of fixed-term contracts from three to two years and limiting the justifications for the use of temporary contracts. The tripartite agreement also calls for taxing excessive labour turnover, whereby the definition of excessive (by sector) is to be defined under regulatory decree, with the involvement of Social Partners. Other measures aim to discourage informal or under-declared work and promote permanent hiring in seasonal economic sectors. Protection of temporary agency workers is also strengthened. At the same time, the probationary period of workers on their first job and newly hired long-term unemployed increased to 180 days (but professional traineeships would also count towards the probationary period). In parallel, the government presented a Resolution by the Council of Ministers on the approval of the Action Programme to combat precariousness and to promote collective bargaining.

Overall, the measures have the potential to reduce labour market segmentation, although there is a risk of new distortions being created. Overall effects may depend on details that are yet to be worked out. For example, the definition of "excessive turnover", on which a surcharge of social security contributions may be based, will be important. Tightening the rules on temporary contracts may reduce their use in favour of permanent jobs, but it involves the risk that some temporary jobs may not be created anymore. The continued reliance on extensive dialogue and social consensus is to be welcomed as it may help to strike the right balance between the needs of employees and employers.

The planned measures also tighten the rules regarding working time regulation. The package includes provisions to eliminate the so-called "bank of hours based on individual agreement" and the "collective bank of hours with individual agreement origin", creating instead a new bank of hours based on group agreements. Such working time schemes should in the future be negotiated in collective agreements (or the new group agreements) and would not be allowed on individual basis.

Further progress is reported on active labour market policies. The assessment of adopted measures like Contrato-Emprego and Prémio-Emprego since 2017 until March 2018 proved an increase in the total coverage of both measures. The implementation of the measure Contrato-Geracao targeting the employment of young people and older long-term unemployed is included in the tripartite agreement. The one-stop shops for employment are now implemented covering three areas of intervention: upgrade of the online interface, improved relationship with users (to promote a more personalised and integrated service) and stronger coordination with other services (notably Social Security).

The increasing minimum wage sets the wage level for an ever larger share of workers, but adverse effects on employment are not clearly observable to date. The minimum wage was increased by about 5% to EUR 557 per month in 2017, and by another 4% to EUR 580 as of 1 January 2018. The government intends to raise the minimum wage again in 2019. Increases since 2014 lead to a significant increase in coverage. According to administrative data (based on social security declarations), 22% of workers earned the minimum wage in 2017, up from 20.6% from 2016. Quarterly reports by the government monitor the effects of the minimum wage on the labour market. The minimum wage increases continue in a context of strong employment growth. In particular, the employment rate of low-skilled workers has rebounded strongly in the past three years. Still, the impact of (past and future minimum wage increases) on employability of low skilled workers and the wage distribution needs continuous monitoring.

Collective bargaining numbers are increasing towards pre-crisis levels. According to official data, the number of new or renewed collective agreements in 2017 revealed a substantial increase since 2015, especially at firm and sector levels. The number of covered workers has reached the highest level (around 821 000) in 2017 recovering from the lowest (around 242 000) in 2013 and the vast majority are covered by sector level agreements. After the new rules on the extension of collective agreements were put in place (namely the reduction to 35 working days of the administrative deadline to publish extension ordinances), the average number of days for the publication decreased from 53 to 34. In the first quarter of 2018, the number of workers estimated to be covered by renewed collective agreements is around 75 000, more than doubling the number of the first quarter of 2017.

Social policies

In order to improve and simplify access to social security, the government is implementing new functionalities. Following the 2018 National Reform Plan's strategy for "Simplifying the Social Security System", a wide range of measures (42) are planned, some of which are already under implementation. One of the most important consists of a new online simulator allowing estimating the amount of the pension to be earned when reaching retirement age. This measure is taken up strongly by the potential users, with a total of 1.03 million of simulations over the first month. Other measures include the online availability of various debt-related functionalities, including consultation of the contributory situation and debt management by citizens; a queue management system; and an online application and consultancy system for social and family benefits.

Portugal continues to pursue a strategy of reinstatement of social benefits along with social inclusion measures. The coverage of social protection for low-income families (RSI-Rendimento Social de Insercao) has increased mainly due to simplification of procedures as well as to specific measures aiming to improve the benefit take-up level. In addition, child benefits (coverage and amounts) for children up to 36 months of age as well as supplementary social benefits (CSI) for pensioners have increased gradually.

Education and vocational training

The Portuguese National Reform Programme addresses different levels of education and training. The main objectives are to reduce school failure and early leaving from education and training (especially those not in education, employment or training (NEETs) and to increase skills and employability of young people and adults. As regards vocational education and training (VET), the government proposes an adjustment of the system to labour market needs, meaning a close relationship between the National Catalogue of Qualifications, the establishment of an Anticipation of Labour Market Needs System and the European Quality Assurance in VET. The QUALIFICA programme is a main driver of the process, targeting low-skilled adults, unemployed people and NEETs. Until the end of April 2018, this programme accounted for 179 480 adults engaged, 98 275 oriented to education and training programmes, 42 034 on recognition of prior learning, and 13 452 already certified.

Portugal is one of the first member states to complete the action phase of the National Skills Strategy. In the final report presented in May, three main priorities were identified in the action phase: communication and awareness; access, quality and outcomes; and effective financing and governance. Although these priorities have mostly only long-term impact in of the actual implementation of reforms, the trends are already positive. The retention rate has been decreasing in the last three school years in all cycles and the early leaving rate from education has reached 12.6% in 2017 (getting near the 10% target of 2020). The National Programme to Promote School Success included action strategic plans in 663 out of 811 public school clusters across the country, including 585 new full-time teachers and other specialists. The Specific Tutorial Support reached already more than 80% of all the eligible students, engaging more than 2 700 tutors. For the 2016/17 school year, the tutorship programme reveals improved behaviour, assiduity, performance and satisfaction of students.

Measures to increase participation in Science, Technology, Engineering and Mathematics (STEM) are being implemented. For 2018, the government recommended higher education institutions to allocate increased national competition placements to STEM areas. In addition, 36% of the Professional Higher Technical Courses on offer were in STEM areas, representing 42% of the newly enrolled in 2018.

The spending on education has been reviewed, with the 2018 State Budget aiming at: demographic evolution of the teaching staff, reduction of absenteeism, rationalisation of Association Contracts, elimination of banking transfer commissions and saving on school management by the use of digital tools. These measures could account for EUR 50 million in additional savings.

Business environment

The efforts for improving the business environment involve measures for direct support to investors and reduction of the administrative burden. Direct support measures include the Capitalizar programme for restructuring and recapitalisation of potentially viable but highly indebted firms and a wide range of activities run by the investment agency AICEP in support of FDI and internationalisation of domestic companies, mostly SMEs. The reforms aimed at reducing the administrative burden are concentrated on the Simplex+ programme for modernisation and simplification of public services but cover also other areas such as regulated professions as well as measures described in other parts of this report, including the labour market, housing, and judicial reforms.

Following the expansion of the Capitalizar programme in 2017, some new measures have been introduced by June 2018. These include a business mediator to help debtors during insolvency and restructuring, new credit lines, tax incentives for reinvestment of profits, the reversion of the burden of proof for new management and insolvency administrators regarding the company's tax debit and the launch of business training to promote interaction between firms and new investors. New measures are also designed in support of access to equity financing, including venture capital and business angels, as well as the creation of a Business Gateway website to centralise the information on financial support. Besides, an early warning system to prevent insolvencies is set to be introduced by the end of 2018. It is estimated by the government that 87% or 73 measures under the Capitalizar programme were either implemented or in progress as of June 2018.

Support for export-oriented investments is expanding. The measures undertaken by the investment agency AICEP for internationalisation of domestic companies, mainly SMEs, are based on six pillars. These encompass general and tailor-made services related to: market research, human resources, financing, FDI, branding, and reduction of red tape. The agency is working with universities on development of online e-learning tools and tailor-made support programmes. A large number of internationalisation projects are also benefiting from EU funding. The agency thus estimates that the share of exports in GDP is set to rise from about 43% in 2017 to 50% by 2020-21, driven mainly by SMEs.

A roadmap to decrease administrative burden is being implemented. An evaluation of Simplex+ 2017 is ongoing following the evaluation of selected measures to Simplex+ 2016. Some planned measures under Simplex+ 2017 include: expanding Espaço Empresa giving customised services for businesses to local investment desks run by municipalities, with back office supported from the central administration; replacing paper files with digital ones for tax inspection or introducing templated electronic invoices. The Simplex+ programme is introducing some administrative simplification for public procurement and some horizontal issues relevant for business-administration relations, mainly through e-government initiatives of digitalisation and implementation of the once-only principle. The shift towards e-procurement is expected to increase SMEs participation in public tenders.

Administrative and regulatory barriers still restrict competition in professional services. The by-laws for highly regulated professions are more restrictive than the framework law setting the basis for the sector. Many activities are reserved to highly regulated professions, preventing competitors from provision of ancillary services and resulting in higher prices and lower choice, innovation and quality of services. Following a joint study with the OECD, released in July 2018, the Portuguese Competition Authority has drafted a large number of proposals to the government to further simplify regulations for highly regulated professions and transport services. However, the follow-up process may be relatively long and is likely to face resistance from interested parties.

Justice sector and public procurement

The efficiency of the justice system is improving but the length of proceedings remains among the worst in the EU. The data are heavily affected by the backlog, as the closure of old cases weighs on the average outcome while the disposition time on new cases is much more efficient. A three-pronged strategy started to be implemented in 2017, introducing changes to the judicial system to speed up insolvency and restructuring proceedings. Progress is reported in insolvency procedures, liquidation and corporate restructuring while no or very limited progress is observed in administrative and fiscal cases. Authorities are implementing ambitious reforms in all judicial areas but a more significant impact on outcomes is expected in only two or three years.

Administrative and tax courts still face significant challenges. It is estimated that more than 30% of the fiscal cases take more than three years to be resolved. There are also some purely technical or organisational issues slowing the efficiency of judicial procedures that need to be properly addressed, according to the progress evaluation presented by the state experts. Measures have been proposed such as new sections in the administrative court dealing with public officials' claims and the creation of two sections in the tax courts, one for execution and one for reviewing administrative infringement procedures. The shortage of human resources is also tackled as new staff is being hired and trained.

The use of direct awards declined since the entry into force of the new procurement code as of January 2018. Data show a decline by about 30% y-o-y in the first quarter of 2018 due to the lowering of the thresholds. The new code transposes the European Public Procurement Directives promoting transparency and better management of public contracts. In particular, a contract manager figure is set to give support in technically and financially complex contracts. The revision also brings stricter restrictions on the use of direct awards and it will include a prior consultation of three tenders mandatory for higher value non-competitive procedures. This is welcome given the shortcomings regarding transparency of public procurement procedures. However, the efficiency of the public procurement needs to be further improved in order to have a critical impact on the quality of publicly financed projects.

Corruption remains an area of concern for businesses in Portugal. The 2017 Eurobarometer shows that 58% of business representatives in Portugal consider corruption a problem for their company (EU average: 37%). The Prosecutor General continues efforts to improve the effectiveness of anti-corruption investigations. Measures in this area include digitalisation of the collection and analysis of evidence and strengthening cooperation with audit and control bodies. On the preventive side, prevention plans set up in each public institution have been largely formalistic and not adapted to each organisation nor complemented by adequate monitoring. Some efforts are being made by the Council for the Prevention of Corruption to improve the culture of integrity in public institutions. The ad-hoc parliamentary committee for improving transparency in public offices has not yet concluded its work and many of the anticorruption pledges introduced in the government programme (Governo de Portugal 2015) have not yet been adopted. These include dedicated lobbying regulation, a code of conduct to political offices holders, senior public officials and civil servants, a public registry of interests for local government officials and a ban on the acceptance of judicial cases against public bodies for Members of Parliament working as lawyers.

Transport

The transport sector is expected to attract significant investments in infrastructure over the medium run. Most of the funding will be directed to railways and ports where the value of projects in the pipeline is estimated at EUR 2.2 billion and EUR 2.5 billion respectively.

The national budget and EU funds are the main source for railway investments while most of the financing in ports (83%) is expected to come from the private sector. To a large extent the projects in the two sectors are complementary and aimed at improving the cargo links of Portuguese ports with Spain and expanding the range of business activities in port areas in line with the new port strategy adopted in 2017. The other major investments in the transport sector are the ongoing expansions of the metro lines in Lisbon and Porto and the main Humberto Delgado airport in Lisbon as well as the expected commercialisation of Lisbon's complementary Montijo airport as of 2022.

Railways are still underused, particularly in the connection with Spain. Consequently, freight rail traffic intensity remains among the lowest in Europe. A detailed joint strategy by Portugal and Spain, including the deployment of rail interoperability in the Iberian Peninsula and ultimately its connection with the French rail network, is still missing. However, investment commitments to three railway links with Spain have been defined and progress has been achieved with the adoption of the Commission decision in April 2018 on the cross-border section Évora-Mérida, connecting the port of Sines with Spain as part of the Trans-European Atlantic Core Network Corridor. As most of the current railway projects are moving from design to a construction phase, efficient implementation, also in the context of the new procurement code, provides a good opportunity to boost the international rail performance. This is crucial to address the peripheral situation of Portugal and exploit the potential of Portuguese ports, so far harmed by a 'road-only' model.

Port concessions renegotiations are progressing but a framework law is still lacking. The Leixões port concession has been renegotiated, apparently yielding positive results in terms of lower user charges, higher cargo volumes and further investment in the port. The goal of renegotiating the main remaining port concessions is included in the Memorandum of Understanding but the process is falling significantly behind schedule. For future concessions, a new framework law that would introduce performance oriented objectives in contractual agreements for concessions has been in the government plans for more than three years. However, the promulgation is being delayed. Port concessions have been meanwhile examined by the aforementioned joint study of the OECD and the Portuguese Competition Authority and have been outlined as one of the problematic areas in the sector, particularly as concerns the long period of concessions.

After a very strong performance of ports in 2017, cargo volumes dropped by around 10% in the first quarter of 2018, reflecting repair and maintenance works and bad weather. Port activities however rebounded in April and May and full-year growth is now expected at 3%, yet much weaker than in 2017. On the other hand, the cruise segment is expected to expand much faster as cruise ship activity in the port of Lisbon surged by 53% y-o-y in Jan-Apr 2018.

Energy

The energy market is clearly improving though prices remain above the EU average. In the electricity sector, the price margin relative to the EU average is relatively small for industrial users and more significant (8.9%) for household users, according to the latest available Eurostat data for the second half of 2017. The difference in the household sector is due to the larger burden of levies and taxes in Portugal, as the price excluding those charges is below the EU average. This burden is generated to a large extent by charges related to the need of repaying the tariff debt in the sector as well as the feed-in tariff reflecting financial commitments to power producers in the past. The tariff debt declined by 7% in both 2016 and 2017 and is projected to further decline by 17% in 2018. Under the current baseline scenario, the debt is expected to be fully repaid by the end of 2021. This would reduce the overall burden on the final price paid by household and industrial consumers. The feed-in tariff is also expected to decline, as all new contracts with producers are signed on market terms without any regulatory burden on final prices and commitments to past contracts affecting the feed-in tariff will gradually expire over the coming decade. Meanwhile the liberalisation of supplies has advanced with the share of users buying electricity from the free market growing well above 90%.

New investment projects might develop the electricity sector further. In addition to the large projects in the hydropower sector, new photovoltaic capacity for a total of over one gigawatt have been installed and approved on market terms by June 2018. The electricity interconnection with Spain is expected to be upgraded by a new link although the current export capacity restraints are linked mostly to the interconnection of Spain with France. Portugal is also contemplating a project for building a power link to Morocco in order to expand the options for exporting electricity in periods of excess supply. in addition, the heavy rainfalls in March and April were also positive for the energy market by boosting the country's electricity exports and filling up water reservoirs for balancing power supplies. This impact was particularly strong in March, where the renewable power production exceeded the monthly consumption of electricity.

As regards natural gas supplies, **the price for industrial users is similar to the EU average but significantly higher (26%) for household users**. The margins are identical with or without taxes and levies. The use of natural gas by households is however low in Portugal due to the very limited need for heating energy. In the household gas sector, about 96% of the customers are serviced on the liberalised market while the market for industrial users is fully liberalised. Therefore price fluctuations largely depend on external market factors with pipeline gas covering about two-thirds of consumption and the rest is covered by LNG.

Housing

The housing market continues facing a number of problems stemming from inefficient use of the housing stock and volatile property and rental prices. It is estimated that about 12% of the housing stock is underused due to various factors such as insufficient levels of investment in renovation, income disparities and rental market failures. While some of the problems are due to objective factors such as uneven market dynamics in tourist and residential areas, some of the inefficiencies are driven by the regulatory framework. The problems faced by property owners include non-payment of rents and slow procedures for contract enforcement. As a result, property owners are often not interested in long-term rentals and this tendency is further supported by the strong rise in demand for short-term rents in popular tourist areas. This is creating significant price pressures on the rental market, particularly in the city of Lisbon, while at aggregated national level rental prices are less dynamic than the house price index reported in chapter 2.1.

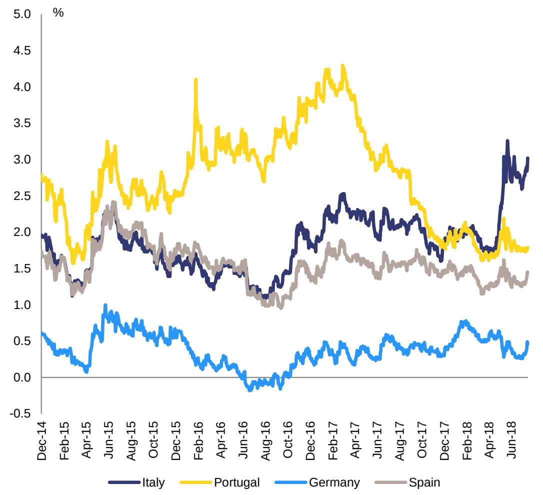
To address inefficiencies, the government adopted in April 2018 a comprehensive set of housing policies and market reforms. The so-called package of New Generation of Housing Policies comprises measures and programmes aimed at supporting access to housing, affordable rental prices, mobility, and social integration of neighbourhoods. The package includes a programme to promote public housing for low income families or direct financial support to low-income families, tax incentives to long-term rents and a new insurance instrument for non-payment of rents to be equally paid by tenants and landlords. There are also measures promoting refurbishment of properties. Overall, the legal package is trying to address the main weaknesses on the housing market and is also expanding the social element of the regulatory framework. However, the proposals have generated a heated debate with mixed reactions among property owners and tenants. In particular, the national and Lisbon associations of property owners expressed concerns that the measures will further shift the regulatory framework in favour of tenants and discourage property owners to rent out. There is a risk that the legal amendments might fail to strike the right balance between supply and demand in order to encourage a more efficient use of the housing stock.

4. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Active debt management is smoothing the debt redemption profile. Buy-backs totalling EUR 4.3 billion in debt with short maturity were carried out throughout 2017, of which EUR 2.8 billion through exchange operations and EUR 1.6 billion through outright buyback, with further outright buybacks amounting to EUR 250 million in the first quarter of 2018. Around EUR 10 billion were repaid to the IMF in 2017 and another EUR 0.8 billion in January 2018. As a result, 83% of the IMF loan has now been repaid and the waiver for early repayments has been fully exhausted. Both the IMF early repayments and the buy-backs, in addition to lowering interest expenditure, have also contributed to a substantial smoothing of the redemption profile, in particular as regards the redemption peak in 2021.

After a peak in 2017, state financing needs are projected to decline over 2018 to 2020 before rising again in 2021. The particularly high financing needs of EUR 27.9 billion for 2017 can largely be attributed to a front-loading of IMF early repayments of EUR 10.0 billion, which is projected to fall to EUR 0.8 billion in 2018. Both the deficit and the net acquisition of financial assets are set to rise slightly in 2018 (by EUR 0.7 billion and EUR 0.2 billion) before falling in 2019 (by EUR 3.9 billion and EUR 0.6 billion). The cash buffer (excluding cash-collateral) is projected to decrease from EUR 9.8 billion in 2017 to EUR 7.7 billion in 2018 and EUR 7.4 billion in 2019, before rising to EUR 10 billion in 2020 ahead of the high redemptions in 2021 (where a EUR 5 billion draw-down will bring the cash position to EUR 5 billion by year-end). Overall, the debt management office aims to maintain a cash buffer of at least 40% of yearly medium- to long-term redemptions, also to be able to face unexpected and strong market volatility.

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

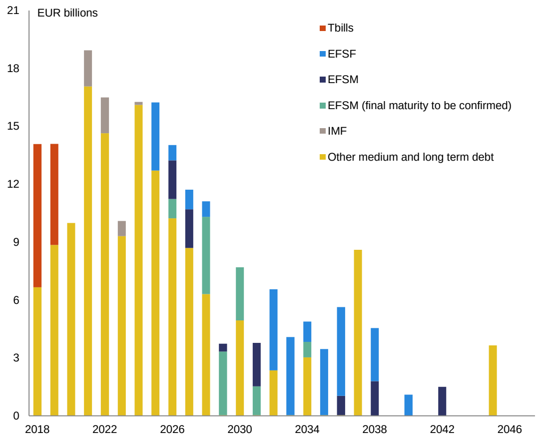


Source: European Commission

Portugal remains vulnerable to capital market conditions, as was illustrated by the interest rate surge in May. Despite some volatility, yields on Portuguese bonds have overall been on a declining trend over the last year. After peaking at 4.3% in mid-March 2017, yields on Portuguese 10-year bonds have decreased strongly to around 2% by the end of 2017 and declined further to around 1.7% in April 2018. Following apparent spill-over from developments in other euro area member states, however, Portuguese yields experienced a spike at the end of May, peaking at 2.2% before declining to an average of around 1.8% in July, which nonetheless remains 0.1% higher than the average observed prior to the spikes in May. The overall decreasing trend of the yields over the last year has been helped by a series of upgrades to Portugal's rating, in particular the upgrade to BBB investment grade by Fitch on 15 December 2017 following Standard and Poor's upgrade in September 2017. More recently, DBRS also announced an upgrade from BBB- to BBB in April 2018 while Moody's decided to postpone the review of their rating until autumn. Portuguese average yields in July (1.8%) have remained higher than those of Spain (1.3%) but have distanced themselves from the substantially increased monthly average yield of Italy (2.8%). Portugal's implicit interest rate on debt has fallen from a peak of 4.1% in 2011 to 3.0% in 2017, and is projected to decline further to 2.8% in 2018. The average residual maturity has declined slightly from 8.3 years at the end of 2016 to 8.1 years at the end of 2017.

Sovereign financing and the capacity to repay are currently not a reason for concern, but yields remain vulnerable to a worsening in financial market conditions given the private and public debt overhang. The capacity to repay remains sound in the short term with low yields facilitating funding conditions. The IMF repayments have helped to smooth the debt redemption profile and reduce interest rate costs. In the medium term, the redemption profile is expected to improve and gross financing needs to decline. Further efforts in fiscal consolidation and structural reforms would, however, be key in ensuring a sound capacity to repay in the long term.

Graph 4.2: **Redemption profile**



(1) Last update: 19/5/2018
Source: IGCP

ANNEX 1
European Commission Debt sustainability analysis

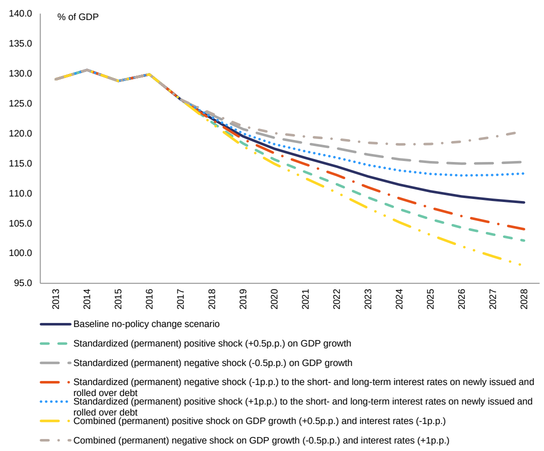
This Debt Sustainability Analysis (DSA) uses the Commission 2018 spring forecast as a starting point to ensure cross-country consistency and to take into account second-round macroeconomic effects. The debt ratio in 2017 turned out at 125.7% of GDP, a 4.2 pps. decrease from 2016, mostly due to higher growth, falling interest expenditure and substantial negative (i.e. debt-decreasing) stock-flow adjustments (in particular a decrease of the cash buffer). For 2018, the Commission 2018 spring forecast projects a ratio of 122.5% of GDP. This corresponds to a decrease by 3.2 pps., which is mostly due to an increasing primary surplus that is however partially offset by lower GDP growth, and slightly debt-increasing stock-flow adjustments explaining the deceleration of the decrease as compared to 2017. For the outer years, the analysis rests on the following assumptions: (i) the structural primary fiscal balance (before costs of ageing) remains unchanged at a surplus of 2.3% of GDP from 2019 under the no-policy-change assumption, (ii) inflation converges linearly to 2.0% by 2022 and remains at that level thereafter, (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5% by 2026 in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group, (iv) real GDP growth rates of around 1%, and (v) ageing costs develop according to the Commission and EPC 2018 Ageing Report.

The baseline scenario results in an annual average decrease of the gross debt-to-GDP ratio by around 1.4pps. of GDP from 2019 onwards and thus ensures a declining path down to 108.5% of GDP by 2028. This declining debt trajectory is sensitive to financial market volatility and vulnerable to negative economic developments. Graph A1.1 presents a sensitivity analysis with respect to macro-economic and financial market risks. More precisely, the graph illustrates the sensitivity of the debt trajectory to an increase of real GDP growth and hikes in interest rates as from 2018. The analysis suggests that a lower GDP growth rate by 0.5 pps. or a one percentage point increase in the interest rate on maturing and new debt would increase the debt ratio by 0.6% and 0.2% of GDP, respectively, in 2018. Debt would be at about 115% and 113% of GDP respectively by the end of the projection period. A combined negative growth and interest shock could put the debt-to-GDP ratio on an accelerating path towards the end of the projection period, again exceeding 120% of GDP in 2028. On the other hand, a positive shock to medium and long-term growth or permanently lower interest rates would result in a more solid path of debt reduction of close to 2 pps. per annum to around 103% of GDP in 2028. A combination of higher GDP growth and lower interest rates could further accelerate the pace of the debt ratio reduction to around 2.4 percentage points per year, thereby allowing for a fall in debt to around 98% of GDP in 2028.

Additional fiscal consolidation would clearly accelerate the debt reduction path as shown in Graph A1.2, illustrating the effect of alternative fiscal consolidation paths. Full compliance with the requirements of the Stability and Growth Pact (SGP) would considerably further accelerate debt reduction. The SGP scenario assumes convergence to the Medium-Term-Objective (MTO) according to the matrix of required fiscal adjustment in Annex 2 of the January 2015 Communication on flexibility in fiscal rules ([11]). This would imply that the MTO of a structural balance of 0.25% of GDP would be reached in 2021 with a fiscal effort of 0.6% of GDP every year from 2019 to 2021. Maintaining the MTO over the longer term horizon would require structural primary surpluses of around 4% until the end of the projection horizon. Under these assumptions, the debt-to-GDP ratio would markedly accelerate its decline to around 3 percentage points per annum, falling to 92% by 2028.

([11]) COM(2015) 12.

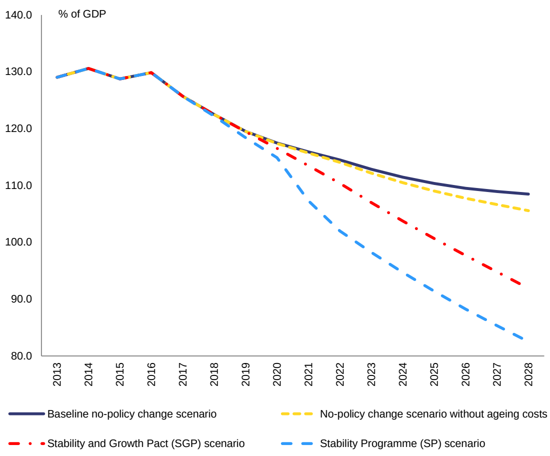
Graph A1.1: **Macroeconomic risks: growth and interest rate**



Source: European Commission

The 2018 Stability Programme scenario assumes a fall of the debt-to-GDP ratio to 122.2% in 2018 and 118.4% for 2019. Based on the assumptions of increasing primary surpluses, a context of low interest rates and real GDP growth slightly above 2% from 2019 onwards, the debt-to-GDP ratio in the Stability Programme is projected to decrease rapidly to 114.9% at end-2020, 107.3% at end-2021 and 102% at end-2022. Such a scenario would be consistent with around 0.4% of GDP annual improvement in the structural balance for 2018-2022. From 2022 onwards, the primary structural surplus has been projected to remain at around 4% over the entire forecast period, which would contribute to a significant fall in the debt ratio to reach 83% of GDP by 2028.

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



Source: European Commission

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

ANNEX 2

European Commission macroeconomic and fiscal projections (2018 spring forecast)

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

Annual % change	**2016**	**2017**	**2018**	**2019**
1. Private consumption expenditure	2.1	2.3	2.0	1.8
2. Government consumption expenditure	0.6	-0.2	0.7	0.3
3. Gross fixed capital formation	1.5	9.1	5.7	5.3
4. Final domestic demand	**1.7**	**2.9**	**2.3**	**2.1**
5. Change in inventories	--	--	--	--
6. Domestic demand	**1.5**	**2.6**	**2.3**	**2.1**
7. Exports of goods and services	4.4	8.0	6.8	5.5
7a. - of which goods	4.5	6.8	6.9	5.4
7b. - of which services	4.3	10.9	6.8	5.6
8. Final demand	**2.4**	**4.2**	**3.7**	**3.1**
9. Imports of goods and services	4.2	7.9	6.9	5.6
9a. - of which goods	4.5	7.9	7.2	5.7
9b. - of which services	2.3	7.5	5.5	5.2
10. Gross domestic product at market prices	**1.6**	**2.7**	**2.3***	**2.0**
Contribution to change in GDP				
11. Final domestic demand	1.7	2.8	2.3	2.1
12. Change in inventories + net acq. of valuables	-0.2	-0.2	0.0	0.0
13. External balance of goods and services	0.1	0.1	0.0	0.0

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

Annual % change	**2016**	**2017**	**2018**	**2019**
1. Private consumption expenditure	3.1	3.5	3.4	3.3
2. Government consumption expenditure	2.4	1.7	1.9	1.5
3. Gross fixed capital formation	1.6	10.2	6.9	6.3
4. Final domestic demand	**2.7**	**4.2**	**3.7**	**3.5**
5. Change in inventories	--	--	--	--
6. Domestic demand	**2.6**	**4.2**	**3.7**	**3.5**
7. Exports of goods and services	2.5	11.8	8.3	7.0
8. Final demand	**2.6**	**6.4**	**5.1**	**4.6**
9. Imports of goods and services	1.1	12.3	8.4	7.2
10. Gross national income at market prices	3.5	4.3	3.8	3.5
11. Gross value added at basic prices	2.8	3.6	3.5	3.8
12. Gross domestic product at market prices	**3.2**	**4.1**	**3.7**	**3.4**
Nominal GDP, EUR bn	185.5	193.0	200.2	207.0

Table 3: Implicit price deflators

% change in implicit price deflator	**2016**	**2017**	**2018**	**2019**
1. Private consumption expenditure	1.0	1.3	1.4	1.5
2. Government consumption expenditure	1.8	1.9	1.2	1.2
3. Gross fixed capital formation	0.2	1.0	1.2	1.0
4. Domestic demand	**1.0**	**1.4**	**1.3**	**1.4**
5. Exports of goods and services	-1.9	3.6	1.4	1.5
6. Final demand	**0.1**	**2.0**	**1.3**	**1.4**
7. Imports of goods and services	-3.0	4.1	1.4	1.5
8. Gross domestic product at market prices	**1.5**	**1.4**	**1.3**	**1.4**
HICP	**0.6**	**1.6**	**1.2***	**1.6**

*In July 2018, GDP growth was revised to 2.2% in 2018 and HICP inflation to 1.4% in 2018.

Table 4: Labour market and cost

Annual % change	2016	2017	2018	2019
1. Labour productivity (real GDP per employee)	0.0	-0.6	0.2	0.8
2. Compensation of employees per head	2.1	1.1	1.8	2.0
3. Unit labour costs	**2.1**	**1.7**	**1.5**	**1.2**
4. Total population	-0.3	-0.2	-0.1	0.0
5. Population of working age (15-74 years)	-0.3	-0.2	-0.2	-0.1
6. Total employment (fulltime equivalent)	1.6	3.3	2.1	1.3
7. Calculated unemployment rate - Eurostat definition	**11.2**	**9.0**	**7.7**	**6.8**

Table 5: External balance

levels, EUR bn	2016	2017	2018	2019
1. Exports of goods (fob)	52.8	58.5	63.3	67.7
2. Imports of goods (fob)	60.8	68.5	74.4	79.8
3. Trade balance (goods, fob/fob) (1-2)	**-8.0**	**-10.0**	**-11.0**	**-12.1**
3a. p.m. (3) as % of GDP	***-4.3***	***-5.2***	***-5.5***	***-5.8***
4. Exports of services	21.6	24.7	26.8	28.7
5. Imports of services	11.6	12.8	13.7	14.6
6. Services balance (4-5)	**10.0**	**11.9**	**13.1**	**14.1**
6a. p.m. 6 as % of GDP	***5.4***	***6.2***	***6.6***	***6.8***
7. External balance of goods & services (3+6)	**2.1**	**2.0**	**2.1**	**2.0**
7a. p.m. 7 as % of GDP	***1.1***	***1.0***	***1.0***	***1.0***
8. Balance of primary incomes and current transfers	-2.0	-1.0	-0.9	-0.7
8a. - of which, balance of primary income	*-4.5*	*-4.2*	*-4.2*	*-4.2*
8b. - of which, net current Transfers	*2.5*	*3.2*	*3.3*	*3.5*
8c. p.m. 8 as % of GDP	*-1.1*	*-0.5*	*-0.4*	*-0.4*
9. Current external balance (7+8)	**0.1**	**1.0**	**1.2**	**1.3**
9a. p.m. 9 as % of GDP	***0.1***	***0.5***	***0.6***	***0.6***
10. Net capital transactions	1.7	1.7	1.7	1.8
11. Net lending (+)/ net borrowing (-) (9+10)	**1.8**	**2.6**	**2.9**	**3.1**
11a. p.m. 11 as % of GDP	***1.0***	***1.4***	***1.5***	***1.5***

Table 6: Fiscal accounts

	2016	2017	2018	2019
		% of GDP		
Taxes on production and imports	14.7	15.0	15.2	15.2
Current taxes on income, wealth, etc.	10.3	10.2	9.9	9.7
Social contributions	11.6	11.8	11.8	11.9
Sales and other current revenue	5.9	5.5	5.6	5.5
Total current revenue	**42.5**	**42.5**	**42.5**	**42.3**
Capital transfers received	0.4	0.4	0.7	0.6
Total revenue	**43.0**	**42.9**	**43.2**	**42.9**
Compensation of employees	11.3	11.0	11.0	10.9
Intermediate consumption	5.6	5.4	5.4	5.3
Social transfers in kind via market producers	1.8	1.8	1.8	1.7
Social transfers other than in kind	17.1	16.7	16.6	16.6
Interest paid	4.2	3.9	3.5	3.4
Subsidies	0.5	0.4	0.4	0.4
Other current expenditure	2.5	2.3	2.4	2.4
Total current expenditure	**43.0**	**41.5**	**41.1**	**40.7**
Gross fixed capital formation	1.5	1.8	2.2	2.3
Other capital expenditure	0.4	2.6	0.7	0.5
Other (residual)	3.0	4.9	3.2	2.8
Interest expenditure	4.2	3.9	3.5	3.4
Total expenditure	**44.9**	**45.9**	**44.1**	**43.5**
General Government balance (ESA2010)	**-2.0**	**-3.0**	**-0.9**	**-0.6**
Primary balance	2.2	0.9	2.7	2.8
		% change		
Taxes on production and imports	4.9	6.1	4.8	3.3
Current taxes on income, wealth, etc.	-2.3	3.3	0.2	2.0
Social contributions	4.0	5.1	4.4	3.6
Sales and other current revenue	-0.9	-2.0	4.5	1.6
Total current revenue	**2.0**	**4.1**	**3.6**	**2.9**
Capital transfers received	-43.1	-7.8	96.8	-8.6
Total revenue	**1.2**	**3.9**	**4.4**	**2.7**
Compensation of employees	2.6	1.9	3.3	3.0
Intermediate consumption	4.2	0.5	2.6	2.1
Social transfers in kind via market producers	0.3	1.9	4.4	0.6
Social transfers other than in kind	1.2	1.4	3.4	3.2
Interest paid	-5.5	-3.7	-5.5	-0.4
Subsidies	-13.2	-11.1	2.0	0.7
Other current expenditure	1.2	-4.1	7.7	1.3
Total current expenditure	**1.0**	**0.5**	**2.7**	**2.4**
Gross fixed capital formation	-32.4	24.9	28.8	8.0
Other capital expenditure	-77.4	505.6	-69.8	-35.3
Total expenditure	**-3.8**	**6.2**	**-0.4**	**2.1**
Nominal GDP, EUR bn	**185.5**	**193.0**	**200.2**	**207.0**

Table 7: Government debt developments

	2016	2017	2018	2019
ESA2010 deficit (% of GDP)	**-2.0**	**-3.0**	**-0.9**	**-0.6**
ESA2010 gross debt (% of GDP)	129.9	125.7	122.5	119.5
ESA2010 deficit	**-3.7**	**-5.7**	**-1.8**	**-1.3**
Gross debt	240.9	242.6	245.2	247.4
Change in gross debt	9.3	1.7	2.5	2.2
Nominal GDP	185.5	193.0	200.2	207.0
Real GDP growth (% change)	**1.6**	**2.7**	**2.3**	**2.0**
Change in gross debt (% of GDP)	5.0	0.9	1.3	1.1
Stock-flow adjustments (% of GDP)	3.0	-2.1	0.4	0.5
Gross debt ratio	**129.9**	**125.7**	**122.5**	**119.5**
Change in gross debt ratio	1.1	-4.2	-3.2	-3.0
Primary balance	2.2	0.9	2.7	2.8
"Snow-ball" effect	0.3	-1.2	-0.9	-0.6
of which				
Interest expenditure	*4.2*	*3.9*	*3.5*	*3.4*
Real growth effect	*-2.0*	*-3.3*	*-2.8*	*-2.4*
Inflation effect	*-1.9*	*-1.7*	*-1.6*	*-1.6*
Stock-flow adjustments	**3.0**	**-2.1**	**0.4**	**0.5**
Implicit interest rate	*3.4*	*3.1*	*2.9*	*2.9*

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