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Post-Programme Surveillance Report

Portugal, Autumn 2016

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Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Autumn 2016

EUROPEAN ECONOMY Institutional Paper 051

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This report reflects information available up until [15 February] 2017.

ABBREVIATIONS

ACE Allowance for Corporate Equity

AIMI Additional real estate tax

AWG Ageing Working Group

BdP Banco de Portugal

BFL Budget Framework Law

CET1 Common Equity Tier 1

CEGER Management Center for the Electronic Government Network

CGD Caixa Geral de Depósitos

CIT Corporate Income Tax

CP Comboios de Portugal

CSRs Country specific recommendations

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

IABA Alcoholic drinks tax

IDR In-depth Review

IGCP Agência de Gestão da Tesouraria e da Dívida Pública

IMF International Monetary Fund

IMI Immovable Property Tax

IMPIC Institute for Monitoring Public Procurement

INE National Statistical Office

IP Infraestruturas de Portugal

MIP Macroeconomic imbalance procedure

MTO Medium term Objective

NFCs Non-financial Corporations

NHS National Health Service

NPLs Non performing loans

NRA National Regulatory Authority

OECD Organisation for Economic Co-operation and Development

PER Processo Especial de Revitalização de Empresas

PERES Plano Especial de Redução do Endividamento ao Estado

PGB Portuguese Government Bonds

PIT Personal Income Tax

PPM Post programme monitoring

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
SIREVE	Sistema de Recuperação de Empresas por Via Extrajudicial
SMEs	Small and Medium-sized Enterprises
SOEs	State-owned Enterprises
UTAM	Unidade Técnica de Acompanhamento e Monitorização do Setor Público Empresarial
UTAP	Unidade Técnica de Acompanhamento de Projetos
VAT	Value Added Tax
y-o-y	Year on year

EXECUTIVE SUMMARY

This report presents the findings of the fifth post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, which took place in Lisbon between 29 November and 7 December 2016. *This visit also served as specific monitoring in the framework of the EU Macroeconomic Imbalance Procedure (Annex 1). Since the conclusion of the fourth post-programme surveillance mission in June 2016, growth has accelerated. Yet, economic performance continues to be constrained by a long-lasting low productivity growth, due to rigidities in product and labour markets, and remains held back by high debt levels in the private and public sectors. Some improvements in the banking sector are visible. Nonetheless, volatility in financial markets, delays and changes in the implementation of previously agreed reforms and the absence of measurable and time-bound targets for the structural reform agenda weigh negatively on the economic outlook.*

The economic recovery has been slower than expected in early 2016 but accelerated in the second half of the year and is set to continue in 2017. *Economic activity in the third quarter of 2016 was strong, mainly due to exports. However, given weak developments in the first half of the year, particularly for investment, annual growth was, at 1.3%, still lower than assumed earlier in the year, but higher than projected at the time of the 4th PPS mission. So far, private consumption has been the main driver for growth while investment remains subdued. Going forward, private consumption growth would be more moderate, while exports would continue their expansion and investment would pick up with the support of EU funds. As a consequence, real GDP growth is projected at 1.6% in 2017 and 1.5% 2018. Labour market indicators continue to improve, albeit at a slower pace, with the unemployment rate at 11.2% in 2016 and expected to reach 10.1% in 2017 and 9.4% in 2018. Consumer prices are set to increase driven by higher oil prices. Risks to the outlook are on the downside and may emerge from the sensitivity of investment to the volatile market sentiment and uncertainty related to the banking sector and the implementation of structural reforms.*

Public finances have improved but the fiscal outlook remains subject to downside risks. *The general government headline deficit is expected to have reached 2.3% of GDP in 2016, and to be around 2.0% in 2017. The authorities took effective action in response to the August decision by the Council by freezing intermediate consumption and managed to reduce the budget deficit to about 2.3% of GDP, due also to lower public investment and additional revenue from the PERES extraordinary debt settlement scheme. This is below the 2.5% deficit target set by the August decision by the Council. For 2017, the Commission expects a deficit of 2.0% of GDP, still higher than the authorities' deficit in their 2017 budget, on account of more conservative projections for the growth of some expenditure and revenue items. The structural balance is projected to remain broadly unchanged in 2016 and 2017. The Commission winter forecast projects a broadly stable debt-to-GDP ratio at 130.5% in 2016 and 128.9% in 2017. Risks to the 2017 fiscal outturn are tilted to the downside and, as in the past, can originate from uncertainty in the macroeconomic outlook, the potential impact of bank support measures and possible spending slippages.*

Fiscal-structural reforms are proceeding at a slow pace amidst delays and some backtracking of past measures (Box 1). *While expenditure is now subject to more controls, the implementation of the new Budget Framework Law (BFL), expected to be completed by 2018, is experiencing delays; and the current spending review would benefit from a more comprehensive approach. Some saving shortfall could result from delays and changes in public administration reforms including those related to the implementation of the civil servant rotation. The sustainability of the pension system in the short to medium term is not yet ensured and the stock of arrears in hospitals continues to increase. With debt at critical levels, SOEs would benefit from a framework on financial sustainability, especially for the transport sector. Finally, costs related to public-private partnership (PPP) contracts remain high.*

Despite some positive developments, the Portuguese banking sector remains fragile amidst weak profitability, thin capital buffers and high non-performing loans. *More efforts are needed to reduce the vulnerability of the sector which still displays high asset risk and poor asset quality and whose profitability in 2016 has weakened, putting pressure on solvency. Solutions proposed to reduce the stock of NPLs, while in the right direction, lack a comprehensive and forceful approach and would benefit from*

a timeline of targets for action. Some of the large Portuguese banks are undergoing important recapitalisation or attracting new shareholders which could help reinforce their capital base. Despite a favourable pick-up in new lending (in particular for mortgages and consumer credit), deleveraging efforts remain subdued and should be continued.

Structural bottlenecks in several areas of the economy weaken its adaptability, competitiveness and attractiveness for investors. *Progress has been made to enhance the efficiency of public administration, public procurement and the judicial system but efficiency indicators remain poor, especially for tax and insolvency courts. Transparency is still a challenge for PPPs and concession contracts. The business service regulation, including regulated professions, remains one of the most restrictive in the EU. Similarly, an unfavourable regulatory framework and weak links between the public and private sector keep curtailing innovation. Measures to decrease costs in ports and to improve the sustainability of the energy sector are being implemented but effective cost reduction has not yet ensued. As regards the labour market, increases in the minimum wage, while potentially reducing in-work poverty, might risk weighing on job opportunities, especially for young and low-skilled workers, as the minimum wage is growing faster than prices, productivity and compensation of employees. Despite stronger incentives for firms to hire through permanent contracts, some aspects of labour law might still act as disincentives to hire permanent workers, keeping the current segmentation, as recently also indicated by the OECD. The educational skill score for Portugal has improved in international rankings. Also, the implications of recent measures in the educational system on school outcomes and risks to the budget are not yet clear as they are still being assessed. Finally, the full benefits of the urban lease market reform undertaken during the programme have not yet materialised and it is still not possible to properly evaluate and monitor the Portuguese housing market: for this, a systematic monitoring and reporting tool underpinned by precise and relevant data remains essential.*

Debt management continues to be sound, but increasing and volatile borrowing costs weigh negatively on sovereign financing and the capacity to repay. *Debt management, including early repayment of IMF loans in 2016, has contributed to smoothing the redemption profile. Similarly, more stable bond issuances over recent months point to some positive developments in the market. Yet, market volatility in January 2017 called for a slight change in the debt issuance profile for 2017 and raised risks to medium-term sovereign financing.*

According to the assessment of the Commission, Portugal has made limited progress with the implementation of 2016 country-specific recommendations (CSRs). *Under the 2016 Macroeconomic Imbalance Procedure (MIP), the Commission found that Portugal has excessive macroeconomic imbalances requiring specific monitoring and decisive policy action. The execution of MIP-relevant Council recommendations is monitored through PPS. Overall, the Commission concludes that Portugal has made limited progress in addressing macroeconomic imbalances and structural reforms covered by the 2016 country-specific recommendations (Section 5 and Annex I).*

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

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the fifth post-programme surveillance (PPS) mission to Portugal between 29 November and 7 December 2016. The mission was coordinated with the IMF's post-programme monitoring (PPM) mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to assessing the repayment capacity of a country 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.

The PPS mission included specific monitoring under the MIP. The 2016 in-depth review (IDR) carried out under the macroeconomic imbalance procedure (MIP) for Portugal concluded that remaining excessive imbalances require decisive policy action and specific monitoring ([2]). In the context of the specific monitoring under the MIP and the European Semester more generally, the European Commission assesses that overall Portugal has made limited progress in addressing the CSRs. More specifically, limited progress has been made in ensuring the sustainability of public finances (CSR1); in ensuring that the minimum wage is consistent with the objectives of promoting employment and competitiveness across sectors (CSR 2); in addressing corporate deleveraging and non-performing loans (CSR4). Some progress has been reported in reducing labour market segmentation (CSR3) and removing regulatory barriers and improving business environment (CSR5). A detailed overview of the progress made with the 2016 CSRs is provided in Section 5 and Annex 1.

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

([2]) See communication from the Commission to the European Parliament, the Council and the Eurogroup: '2017 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No https://ec.europa.eu/info/publications/2017-european-semester-country-reports_en.

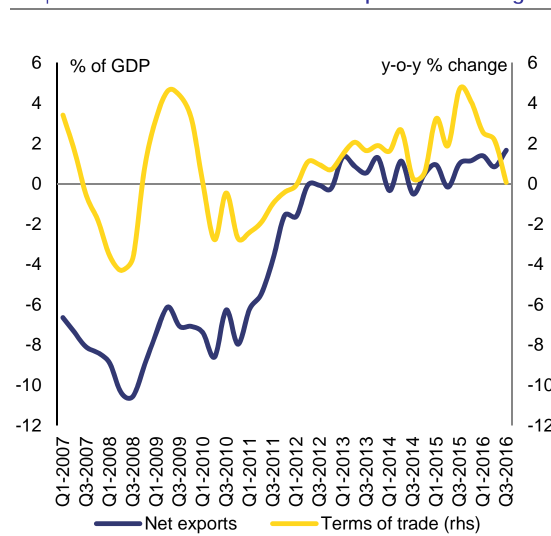
2. RECENT ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Portuguese real GDP growth is expected to be around 1.3% in 2016. After sluggish growth in Q1 and Q2, Portuguese real GDP growth accelerated to 1.6% y-o-y in Q3 and according to preliminary estimates to 1.9% y-o-y in Q4. This acceleration was due to a strong rebound in exports of goods and services in Q3, which outbalanced imports and caused an increase of the contribution of net external demand, and some recovery in investment in Q4. The contribution of domestic demand to economic growth improved only marginally to 0.9 pps in Q3-2016 vis-à-vis 0.8 pps in the previous quarter, while an overall weak investment outcome continues to be a drag on growth. Due to the strong performance in the second half of 2016, the Commission winter forecast projects real GDP growth at 1.6% in 2017 and at 1.5% in 2018.

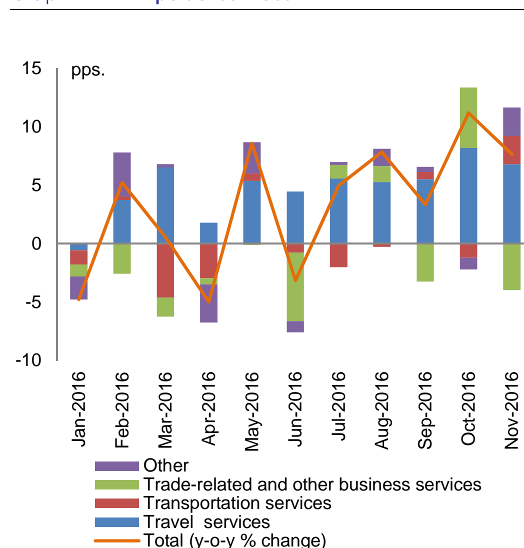
Robust export growth in Q3-2016 was partly driven by a one-off transaction and a rebound effect from the weak first semester performance. The export of military equipment to Romania of around EUR 70 m boosted goods export in Q3-2016, but this had a neutral impact on growth, as it was also reflected in a decline in public investment. Without this impact, total exports of goods and services increased by 5.0% y-o-y (instead of 5.4%). Within this, export to Spain accelerated to 9% y-o-y in nominal terms in Q3-2016 ([3]). The rebound in exports is also associated with the resumption of the activity of the oil refinery Galp in the summer which was interrupted at the beginning of 2016. An upward trend in oil export observed since July is expected to continue further, while an increase in oil prices will start to weigh on net export developments. Since the second half of 2015, price developments have significantly helped to improve the trade balance of goods (graph 2.1). Nevertheless, the positive terms of trade effect is assumed to eventually vanish in the upcoming quarters. Exports of services accelerated in Q3 and Q4 2016 mainly driven by exceptionally high tourism which is not expected to continue to the same degree in the coming quarters (graph 2.2). As a result, export growth would be more in line with foreign demand over the medium-term, whereas imports are expected to slightly outbalance exports, mainly due to increased investment.

Graph 2.1: Terms of trade and net exports rebalancing



Source: European Commission

Graph 2.2: Export of services



Source: European Commission

Domestic demand developments in 2016 were mainly driven by strong private consumption while weak investment continued to be a drag on growth. Construction investment declined by

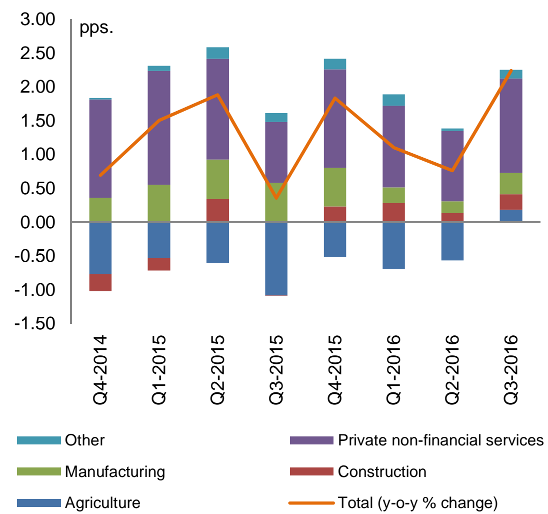
([3]) It is, however, worth noting that discrepancies in good transactions recorded by the Portuguese statistical office vis-à-vis imports from Portugal recorded by the Spanish statistical office increased significantly since mid-2015.

3.7% y-o-y in Q3-2016 mainly reflecting the weak public investment performance while equipment increased by 2.5% y-o-y. Excluding the one-off transaction of the export of military equipment from gross fixed capital formation (GFCF), overall GFCF would only decline by 0.4% y-o-y instead of by 1.5% y-o-y. Investment is expected to have improved somewhat at the end of 2016 as confidence indicators point to a rebound in construction and machinery and equipment. Private consumption accelerated to 1.9% y-o-y in Q3-2016 vis-à-vis 1.6% in Q2, and is projected to have speeded up further in Q4, with full-year growth expected at around 2%.

Growth is expected to accelerate in 2017 and 2018 to 1.6% and 1.5%, respectively, mostly driven by a rebound in investment and continued robust private consumption growth. Investment would gather pace in 2017 and 2018 driven by an expected acceleration of the absorption of EU funds in the new programming period. Most of the recent confidence indicators support a continuation of strong private consumption. However, still some moderation in private consumption development is expected in 2017 and 2018 in line with a more stable consumption of durable goods, sustained high household debt and increased oil prices. This year, exports are forecast to grow in line with foreign demand. Some positive development is expected from the Q4-2017 and in 2018 when the car producer *AutoEuropa* will launch a *new Volkswagen model.* The balance of risks to the forecast is however tilted to the downside due to the sensitivity of investment to the volatile market sentiment as well as to uncertainty related to foreign demand, to banking sector developments and to the implementation of structural reforms.

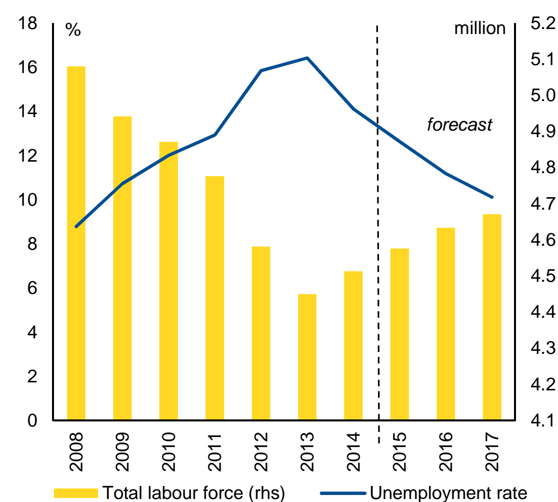
Job creation improved and consumer prices are set to increase driven by higher oil prices. Strong employment growth was mainly driven by resilient growth of services employment and a rebound of job creation in construction and agriculture (graph 2.3). Unemployment dropped to 11.2% in 2016, according to Eurostat data for the age group of 15-74, and is expected to continue declining to around 10.1% in 2017 and 9.4% in 2018 (graph 2.4). HICP inflation decreased to 0.5% in November from 1.1% in October and stood 0.1 p.p. below the euro area estimated average. The largest downward pressure on the overall annual growth came from decreases in the prices of clothing and footwear and energy prices while upward pressures came from changes in the prices of restaurants, hotels and communications. The HICP 12-month average rate was 0.6% in November, remaining stable for the third month in a row. In 2017, price pressure is expected to emerge again, mainly driven by higher oil prices.

Graph 2.3: **Employment evolution by sectors (domestic concept)**



Source: European Commission

Graph 2.4: **Employment and unemployment dynamics**



Source: European Commission

Table 2.1: **Comparison between the Commission Winter Forecast 2017 and the macroeconomic scenario underlying the Budget 2017**

Portugal	WF 2017		Budget 2017	
	2016	2017	*2016*	*2017*
Real GDP (% change)	1.3	1.6	1.2	1.5
Private consumption (% change)	2.1	1.6	2.0	1.5
Public consumption (% change)	0.6	0.4	0.6	-1.2
Gross fixed capital formation (% change)	-1.5	3.8	-0.7	3.0
Exports of goods and services (% change)	3.9	4.1	3.1	4.4
Imports of goods and services (% change)	3.9	4.3	3.2	3.7
Contributions to real GDP growth:				
- Final domestic demand	1.3	1.7	1.4	1.3
- Change in inventories	0.0	0.0	0.0	0.0
- Net exports	0.0	-0.1	-0.1	0.2
Potential GDP (% change)	0.4	0.7	0.6	1.1
Net lending/ net borrowing EDP (% GDP)	-2.3	-2.0	-2.4	-1.6
Employment (% change)	1.3	0.8	0.8	1.0
Unemployment rate (%)	11.2	10.1	11.2	10.3
Labour productivity (% change)	0.1	0.8	0.4	0.5
HICP inflation (%)	0.6	1.3	0.8	1.5
GDP deflator (% change)	1.5	1.4	2.0	1.5
Comp. of employees (per head, % change)	1.4	1.2	1.5	1.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.3	1.5	1.7	2.2

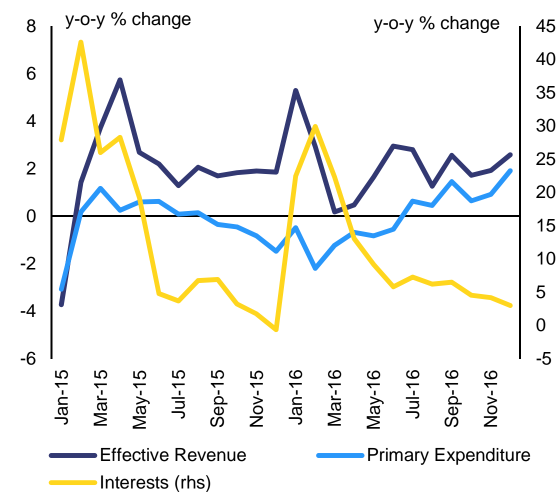
Source: European Commission Winter Forecast 2017 and Portugal 2017 Budget

2.2. PUBLIC FINANCES

Budgetary execution in cash terms through end–December 2016 points to a limited gap to the overall 2016 budget target (graphs 2.5-2.8)**.** Revenue increases fell short of the budget targets, but they were largely compensated by overall expenditure containment. Year-end pressures for some expenditure items were broadly compensated by the 0.25% of GDP revenue from the PERES debt settlement programme ([4]).

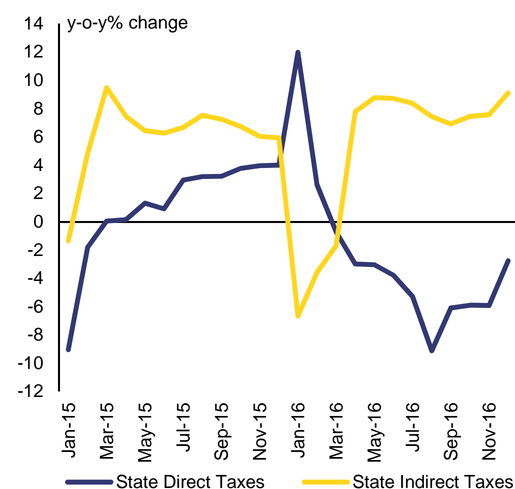
On the revenue side, the 2.7% increase in 2016 fell short of the budget target increase of 5%. The shortfall was mainly due to other current and capital revenues while for tax revenue and social security contributions the deviation from the budget target was partly compensated by the yield of the PERES extraordinary tax and social security debt settlement scheme. By the end of December, the scheme yielded around EUR 450 m, i.e. around 0.25% of GDP in additional revenue. Including PERES, overall tax revenue increased by 2.4% (as compared to the full-year target of 3.4%) and social security contributions were around the budget target increase of 4.4%. Excluding PERES, direct taxes saw a more significant shortfall to budget targets, following recent personal income tax (PIT) and corporate income tax (CIT) reforms. The increase of indirect tax revenue also fell short of budget targets, in particular for VAT ([5]).

Graph 2.5: Budget execution (General government)



Source: DGO

Graph 2.6: Budget execution (State)



Source: DGO

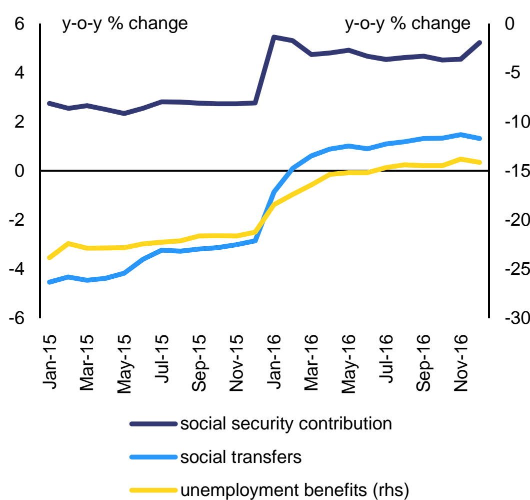
On the expenditure side, the overall increase in cash terms of 1.9% in 2016 also remains significantly below the 2016 budget projection of 5.6%. Such containment of expenditure was mainly due to lower capital expenditure (-5.2% vs a budget projection of +18.1%) and lower than planned current transfers and subsidies. Acquisition of goods and services has come close to the budgeted level, while expenditure for compensation of employees has increased above

([4]) Neither the authorities updated projections for 2016 in the 2017 DBP nor did the Commission autumn forecast contain any expected yield for the PERES debt settlement programme in 2016 due to the difficulties of any ex-ante quantification for this extraordinary scheme.

([5]) The effective revenue impact of the decrease of the VAT rate for meals in restaurants as from 1 July 2016 has not yet been fully quantified.

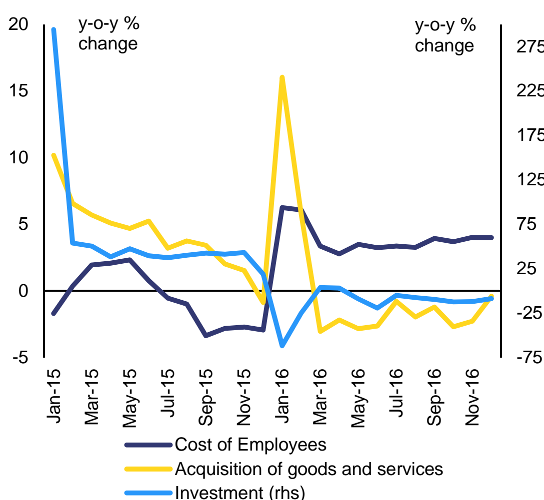
the budget target, in particular linked to increasing public sector employment.

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



Source: DGO

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



Source: DGO

Significant clearance of public sector arrears in December has led to an overall stabilisation as compared to end 2015. Following a decrease by around EUR 0.6 bn in 2015 to EUR 0.9 bn, public sector arrears increased almost steadily in 2016 to EUR 1.2 bn up to November. Release of substantial additional resources for arrears clearance in December has however brought the arrears level closer to its end-2015 level of EUR 0.9 bn. While arrears for local and regional administration were reduced by more than EUR 150 m in 2016, this was offset by an increase of EUR 90 m for state-owned hospitals. This brought the stock of arrears of the National Health Service (NHS) at the end of 2016 close to its level in July 2015 despite clearance of around EUR 0.2 bn in December. The recurrent under-budgeting of state-owned hospitals thus remains a challenge.

2.3. FINANCIAL STABILITY AND CORPORATE INDEBTEDNESS

The Portuguese banking system remains fragile amidst weak asset quality, thin capital buffers and low profitability. Asset risk has broadly stabilised at high levels penalising both profitability and solvency. In 2016 profitability has weakened substantially on a year-on-year basis, due mainly to a considerable reduction in income from financial operations. On a positive note, banks funding continues to display a healthy and balanced structure with a loan-to-deposit ratio close to 100% since end-2015. The funding structure continues to adjust with customer resources accounting for 63% of total assets in Q3-2016, some 2 p.p. higher than at the end of 2015, whereas funding provided by the Eurosystem has dropped to below EUR 24 bn at system level, a positive development given the strong reliance of Portuguese banks on Eurosystem funding over the past years.

Table 2.2: **Financial soundness indicators, all banks in Portugal**

(%)	2010	2011	2012	2013	2014	2015	Q2-2016
Non-performing loans	3.7	5.3	7.0	7.8	13.6	14.4	14.6
Coverage ratio	61.5	56.6	54.3	56.4	46.0	46.5	47.8
Loan to deposit ratio*	123.9	116.1	119.5	111.4	105.0	99.4	97.0
Tier 1 ratio	8.3	8.6	11.3	12.2	11.4	12.6	12.4
Return on equity	6.7	-4.2	-3.3	-9.3	-17.2	0.9	-0.6
Return on assets	0.4	-0.2	-0.3	-0.7	-1.2	0.1	0.0

(1) ECB aggregated balance sheet: loans excl to gov and MFI / deposits excl from gov and MFI
Source: ECB CBD

Banks continue the deleveraging of their balance sheets, against the backdrop of increasing new loans. Since the end of 2010, when the deleveraging process started, banks' assets have declined by 25%, albeit the pace substantially weakened in 2016. Similarly to previous years, the largest contribution to the drop in assets comes from the credit portfolio, in particular towards non-financial corporations (NFC) and mortgages. Looking at trends in lending

volumes by end-November 2016, total credit to households is still decreasing driven by the decrease in loans for house purchase (down close to 2.5% y-o-y) whereas loans in the segment 'consumption and other purposes' have turned positive, growing by about 2.3% y-o-y. At the same time, loans to the still highly leveraged Portuguese firms have dropped by 2.6% y-o-y. Nevertheless, gross flows of new bank loans increased considerably in 2016. The amount of new mortgage loans is now comparable to the average of 2011, while consumer lending is on an upward trend. The increase in consumer lending reflects better consumer confidence, easing credit standards and low interest rates.

Weak asset quality continues to weigh on the aggregate balance sheet of the banking sector. The share of credit at risk as percentage of gross credit continued to increase (albeit at low pace and in part due to a denominator effect) in the first three quarters of 2016 to 12.6%, a rise by 0.7 p.p. compared to the end of 2015 and slightly below peak levels from the third quarter of 2015 (12.9%). The picture is very segment-specific. In fact, the rise in the aggregate non-performing credit ratio mainly reflects developments in the non-financial corporate segment, where the credit-at-risk ratio reached 20.2% in Q3-2016, against 19.7% at end-2015 and 19% at the end of 2014. High levels of non-performing loans persist among the least dynamic and least profitable sectors of the economy, which also exhibit a high share of loans that have been overdue for more than two years. Similarly to 2015, construction, real estate and trade continue to record rising levels of bad loans, whereas for manufacturing, hotels and restaurants the credit-at-risk ratio has stabilised or even improved. The quality of credit to households is relatively better (credit at risk ratio at 6.1% and 14.7% in the mortgage and consumer segments respectively) and seems to have stabilised over the past year. In addition to high levels of NPLs, some of the large Portuguese banks have a high share of foreclosed real estate assets on their balance sheet, which puts additional asset risk pressure on the banking system as a whole.

Portuguese bank profitability is still very weak. In 2015 the banking system became profitable following four years of losses, driven by a substantial decrease in impairments and provisions, and large trading gains booked from the sale of sovereign bonds. In the first three quarters of 2016, most banks were just breaking even, reflecting a significant decrease in income from financial operations and an increase in the flow of impairments. Income from financial operations until Q2-2016 was only about a fourth of what raised in all 2015. Within this, income from trading activities registered the largest drop. Although still positive, the return on equity (ROE) and return on assets (ROA) are now much lower than in 2015 (at 0.2% and -0.1%, respectively in Q3-2016, as compared to a 2% and 0.1% in Q3-2015), and continue to remain below the euro area average of 5.1% for ROE and 0.3% for ROA in Q3-2016. By contrast, net interest income increased in 2016 vis-à-vis 2015 by 5.8%, driven predominantly by a larger reduction in interest costs than in interest income, achieved through re-pricing of deposits at lower rates. In fact, the differential between the headline lending rate and the average remuneration rate paid by banks on deposits has been gradually rising since 2014. Comparing to Q3-2015, interest received from loans decreased by 13.1%, while interest paid on deposits fell by 30.6%. Despite banks' continued efforts to re-price retail deposits to current low spreads, this trend has only limited potential going forward because of the underlying capital guarantee on deposits, which makes it more difficult to charge negative interest rates on deposits. Income from credit to customers was affected by the ongoing deleveraging of the banking system and in particular by the corporate sector, as well as by the relative importance of loans with indexed interest rates and low spreads in the banks' credit portfolios, in particular mortgages. Overall, recurring revenues remain heavily impacted by the low interest rate environment and subdued business levels. Besides the low interest rate environment, profitability is also held back by structural bottlenecks and would benefit from strengthening internal bank governance frameworks and modernising bank business models.

Weak asset quality and low profitability continue to put pressure on the banking system's solvency. In Q3-2016, the banking system's Common Equity Tier 1 ratio stood at 11.7%, below the euro area average of 13.7% and some 0.1% lower than end-2015. The aggregate picture hides very different capital ratios at institution level. Portuguese banks belong to the

group of credit institutions with the lowest capitalisation levels in the euro area. This highlights the solvency pressures that Portuguese banks are currently facing. Solvency challenges will remain high on the agenda in the coming years. From 2017 onwards, in fact, Portuguese banks are facing increased regulatory and prudential capital requirements through additional capital buffers imposed on the systemically important institutions. Also, a series of transitional provisions laid down by the Capital Requirements Directive and Capital Requirements Regulation package, which allow lenders to gradually adjust to the final CET1 ratio requirements is gradually being removed by 2018. This will exert additional pressure on the capital levels of Portuguese credit institutions. Overall, Portuguese lenders need to generate capital or find investors to boost equity.

Recent positive developments in some banks could improve their capital levels.

- **Caixa Geral de Depósitos (CGD)**, the largest bank in Portugal and a public owned bank, has been loss-making for several years. In August 2016, the Portuguese government found an agreement 'in principle' with the European Commission enabling its sole shareholder, the Portuguese State, to launch a recapitalisation operation that would increase the bank's equity base by some EUR 5 bn. A first phase of the recapitalisation took place in early January 2017 and entailed the transfer of EUR 499 m of assets from the government holding company Parcaixa to CGD and the exchange into shares of EUR 945 m of Cocos that were already considered CET1. Two other operations, namely a direct recapitalisation by the State amounting to EUR 2.7 bn and the issuance of EUR 0.5 bn of additional tier 1 raised in the market from private investors are expected to take place in March. Another EUR 0.5 bn of additional tier 1 must be raised within 18 months. Depending on the National Statistical Office (INE) and Eurostat's assessment, the operation might have implications on the 2017 budgetary outturn.

- In September 2016, the State extended the maturity of its loan to the Resolution Fund to a period spanning for about 30 years and revised the interest rate aligning it with the sovereign cost of borrowing. Under the revised terms, the repayment of this credit line would only be done by means of regular contributions by Portuguese banks to the Resolution Fund, excluding the need for extraordinary contributions. By easing pressure on banks, this move could have facilitated the ongoing sale process of **Novo Banco**. The sale process has recently entered the next phase negotiating the details of the acquisition and expecting to inject new capital in the bank if the deal is finalised.

- **BCP Millennium**, the second biggest bank in Portugal, successfully concluded a capital issuance (new shares) amounting to EUR 1.3 bn in February 2017. This was made possible after legislation allowing for reverse stock split outside the framework of a Mandatory Tender Offer was enacted. BCP's biggest and strategic shareholder after this capital increase is now the Chinese financial conglomerate Fosun, with a capital share of 23.9%, followed by the Angolan oil company Sonangol with 15.2% and BlackRock with 3.0%.

- **BPI**'s former main shareholder, the Spanish Caixabank, successfully completed its Mandatory Tender Offer (MTO) on 8 February after legislation was approved to allow credit institutions shareholders the possibility to periodically re-evaluate the justification of statutory limits on detention and exercise of voting rights. CaixaBank holds now a total share capital of 84.5% in BPI, followed by the minority shareholder Allianz with 8.4% and remaining free float. Exposure to Angola was also reduced. Caixabank already announced several changes in BPI’s governance structure and going forward will control BPI as a subsidiary.

The cost-to-income ratio remains relatively high at about 60%. At system level limited progress has been recently made to improve banking operations efficiency. Cost-to-income stood at 60.2% in Q3-2016 and has broadly been stable since end-2015. There is however some progress when looking at the cost-to-recurring income ratio, which points to improvement in efficiency levels. Nonetheless, Portugal's banking sector compares rather unfavourably with most euro area countries when it comes to efficiency and the country

remains over-banked, when looking, for example, at the number of bank branches per capita. In this context, and taking into account the banks' limited capacity to generate gross income in the current macroeconomic environment, a recovery in bank profitability is likely to rely on continuously reducing operational costs helped by a modernisation of business models. At the same time, there is a need to safeguard the integrity of bank risk assessment and internal control processes.

The heavy debt burden of the private sector is decreasing slowly. The Portuguese private sector — households and private firms — is one of Europe's most indebted as a share of GDP. Total household debt was equivalent to 78% of GDP in early 2016 (and 85% at end-2014) whereas non-financial corporations' consolidated debt was over 111% of the Portuguese GDP (June 2016), down by 4 pps y-o-y. Given the low growth, low inflation environment, the deleveraging process remains challenging, in particular for Portuguese small and medium enterprises, of which over a third do not make profits. Nonetheless, lending to sectors with the highest leverage, such as construction, is decreasing at a rapid pace, by close to a third year-on-year in 2016. The excessive corporate leverage puts a constraint on firms' profitability ultimately resulting in higher NPL ratios (currently about one third of firms have overdue debt payments) and lower business investment. Most of the deleveraging over the past quarters has been due to GDP growth, while the level of indebtedness in nominal terms has remained broadly unchanged.

3. POLICY ISSUES

3.1. PUBLIC FINANCE

The Commission 2017 winter forecast estimates a general government deficit of 2.3% of GDP in 2016. Revenue shortfalls in taxes and other current and capital revenue are estimated to have been largely offset by expenditure containment and by additional revenue from the extraordinary tax and social security debt settlement scheme PERES. The 2017 Budget projected a general government deficit of 2.4% of GDP in 2016, 0.2% of GDP above the 2016 Stability Programme and the 2016 Budget target, mostly due to the authorities' revision of the macroeconomic outlook and only partly offset by the freezing of intermediate consumption. As announced by the Finance Minister to Parliament in February, the government now estimates the 2016 general government deficit to be below 2.1% of GDP.

For 2017, the Commission 2017 winter forecast expects a general government deficit of 2.0% of GDP. This is 0.2% below the autumn forecast projection but still 0.4% of GDP above the Budget target of 1.6%. While the winter forecast's macroeconomic scenario for 2017 is close to the 2017 budget projections, the remaining divergence results from more conservative projections for some expenditure reductions and revenue increases not explained by corresponding measures. This concerns, on the expenditure side, intermediate consumption, compensation of employees, social transfers in kind and interest payments and, on the revenue side, revenues from sales.

The reduction of the headline deficit from 2016 to 2017 stems from the positive impact of the BPP one-off measure, higher dividends from Banco de Portugal (BdP) and the economic recovery. As regards fiscal measures, the Budget included a package with an overall deficit-increasing impact of 0.1% of GDP. Main deficit-decreasing measures are the new supplement on the property tax, the new tax on soft drinks and other sugary drinks, the structural revenue from the multi-annual instalment part of the PERES, the 2:1 replacement ratio rule for civil servants and savings from the spending review. Deficit-increasing measures include the carry-over effect of the wage cut reversals, the gradual phasing out of the PIT surcharge, the indexation of pensions, an extraordinary pension rise and the annual carry-over effect from reduced VAT for meals in restaurants. The Commission forecast includes all measures at full yields except for the 2:1 replacement rule for civil servants for which a 50% haircut of the expected yield was applied in view of the 2016 track record for this measure.

The structural balance is projected to remain broadly unchanged in 2016 and deteriorate only slightly in 2017. This is in line with the (recalculated) structural adjustment of 0.0% for 2016 reported by the authorities in October but differs substantially from the (recalculated) authorities' DBP projections of a 0.3% of GDP improvement in 2017. Such difference for 2017 mostly reflects the Commission's forecast more conservative projections for some expenditure reductions and revenue increases not explained by corresponding measures. Risks to the Commission winter forecast are linked to remaining uncertainties surrounding the macroeconomic outlook, the potential budgetary impact of bank support measures and possible spending slippages.

The Commission winter forecast projects a broadly stable debt-to-GDP ratio at 130.5% in 2016 and 128.9% in 2017. Thus, the DBP debt-to-GDP ratio projection for 2016 is 1.5% of GDP higher than at the end of 2015. This increase is mainly due to the issuance of EUR 2.7 bn in government debt in view of the ongoing bank support to CGD. The debt-to-GDP ratios projected in the DBP were slightly lower than in the winter forecast mostly due to the DBP's more optimistic nominal growth assumptions.

Table 3.1: **Fiscal adjustment 2010-2017**

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Balance - EDP	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.3	-2.0	-2.2
Budget deficit, net of one-offs	-8.5	-7.3	-5.6	-5.1	-3.3	-3.1	-2.6	-2.2	-2.2
Structural balance	-8.5	-6.6	-3.5	-2.9	-1.7	-2.2	-2.2	-2.3	-2.6
Primary balance	-8.2	-3.1	-0.8	0.0	-2.3	0.2	2.1	2.5	2.2
Structural primary balance	-5.5	-2.3	1.4	1.9	3.2	2.3	2.1	2.1	1.7
Fiscal adjustment	0.1	3.3	3.7	0.5	1.2	-0.8	-0.2	0.0	-0.4
Fiscal effort (EDP definition)	0.1	1.9	3.1	0.6	1.2	-0.5	0.0	-0.1	-0.3

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

3.2. FISCAL-STRUCTURAL ISSUES

Spending control remains challenging and the benefits from the spending review are still to be seen. Expenditure controls and containment have somewhat improved further to the application of the commitment control law. However, arrears point to inadequate accounting as well as budgetary planning and controls over spending, especially in hospitals. Moreover, the potential savings identified by the recently launched spending review are relatively moderate (around 0.1% of GDP over a three-year period for the expenditure review according to the 2017 Budget). The review focuses at present on the health and education ministries, state owned enterprises, (centralised) public procurement and real estate management, all areas that are deemed by the authorities as potentially yielding large efficiency gains. This exercise would benefit from a more comprehensive approach that includes all layers of the public sector as well as a set of concrete targets for savings. A more comprehensive approach might include setting specific goals at each line ministry in order to improve ownership, establishing multiannual saving targets and related annual expenditure ceilings on the basis of expenditure reports prepared by line ministries. It should ensure that spending ministries adopt internal spending reviews under a strict budget constraint as well as reforming the budgetary process to be more in line with a performance-informed budgeting approach over the medium term. A higher degree of comprehensiveness would have covered almost the whole general government and several of its sub-sectors. It would have also explored various opportunities, including deletion of bodies whose mandate has become obsolete or of tax expenditure that provides incentives no longer needed.

Several reforms have improved the long–term sustainability of the pension system but its reliance on budgetary transfers remains high. Reforms taken before and during the adjustment programme contributed to lower the costs of the system in the long term by, among others, introducing disincentives to early retirement, raising the retirement age to 66, and linking future increases to life expectancy at age 65. Yet, costs in the short to the medium-term remain high. Although the authorities are committed to eliminate extraordinary budget transfers by 2019, possible revisions of the existing pension system, in particular the reduction of the penalty for early retirement for some categories of workers, might not ensure such reduction.

New measures in the pension system are explored, but the expected impact on cost reduction is not clear. The budget for 2017 includes the earmarking of a new progressive tax on real estate assets (on top of the IMI) to the social security's Financial Stabilization Fund (worth EUR 160 m in 2017 according to the 2017 Budget). This earmarking is being presented by the government as an alternative to the overly reliance on classical budgetary transfers, but does not guarantee the needed reduction of pension outlays. In addition, the government has launched a comprehensive study of the pension system with measures expected to be applied not before 2018. These measures might entail a revision of the early repayment penalties for workers with about or more than 40 years of service. They could include the harmonisation of current benefit schemes and means-testing procedures. Overall, the authorities are committed to issuing a package of new measures that will be budget neutral and would not alter current plans to achieve zero extraordinary budgetary transfers by 2019.

The quality and access to healthcare has improved, but its financial viability has not. Several measures have been implemented to improve the efficiency and sustainability of the healthcare sector. These include the centralisation of the procurement of goods and services, a larger use of generics eligible for public reimbursement, reduced prices of pharmaceuticals, shorter waiting lists and a higher number of family health units. The access to primary healthcare and prevention measures continue to expand. Yet, while the hospital reform continues, weak controls of budgetary planning and implementation in hospitals are behind the large increase in arrears. From December 2015 to November 2016, health sector arrears increased by EUR 305 m. The use of some centralised budget appropriations contributed to a large repayment in December. Further, the earmarking of the extension of alcoholic drinks tax (IABA) to sweetened drinks (levy on drinks with added sugar should be worth EUR 80 m in 2017) is intended to address the sustainability of the National Health Service. Nonetheless, the use of appropriations at year end and revenue from the levy on sugary drinks, while helping to reduce the stock of arrears, do not address the factors behind its growing trend. This would require more accurate and balanced budgeting, enhanced controls and a more effective enforcement of the commitment control law.

The implementation of the reformed Budget Framework Law (BFL) that entered into force in September 2015 has been delayed. The Law is designed to make budget units more accountable, strengthen the medium to long-term focus of public finances by introducing programme-based budgeting, setting expenditure ceilings until the medium term and aligning the deadlines with those of the European Semester. It also allows for a three-year transitional period for applying most new features. Together with the ongoing pilot project of an integrated public accounting system, the BFL will improve management ownership and ensure effective budgeting, as well as budget implementation, monitoring and reporting at all layers of public administration. Although with almost a year delay, the authorities have recently approved the decree law on the operating rules for the new BFL's implementation unit, a first milestone in its implementation, and have set a calendar for 2017 activities. The decree law on the setup of the new budgetary programmes is however still outstanding. The full application of the new accrual-based public sector accounting standards has also been postponed by one year. Given the cumulative delays in BFL implementation, there are thus risks to its completion by the 2018 target.

The wage bill increase points to some inefficiency in the ongoing public employment reforms. This is mainly due to set-backs in public administration reforms that were undertaken during the economic adjustment programme, including the wage cut reversals. Further, shortfalls in projected savings might be the result of the civil servants rotation policy (2:1 replacement rule) introduced in the budget 2016 which has not effectively been enforced. At the same time, the return to the 35 hours working week can be expected to still contribute to a higher wage bill in the healthcare sector, but the effects are yet to be assessed.

A systematic response to structural problems in the administration is missing. Further work would be needed towards the rationalisation and modernisation of the public administration, within the limits of the budget, while ensuring an efficient delivery of public services by motivated and qualified staff. Possible policy options might include enhancing mobility schemes, merit-based career as well as personnel evaluation on the basis of performance.

While local and regional debt and arrears have declined steadily since 2013, progress in other local administration reforms has been slow. The Municipality Support Fund (FAM – a debt workout mechanism for over-indebted municipalities) has conducted its first disbursements, after solving several legal hurdles and control checks, including approval by the Court of Auditors. The legislation is planned to be revised in the first half of 2017 in order to accelerate the process. Following appointment of its members in June 2016, the Financial Coordination Council, set up in January 2014, has not been convening regularly. Hence, the Council has not yet been operational in supporting municipalities in drafting their 2017 budgets. The Directorate-General for Local Administration (DGAL) and Directorate-General for Budget (DGO; on regional government) have started to monitor SOEs and public-private partnerships

(PPPs) and now report on a quarterly basis. The partnership between the Ministry of Finance's task force for SOEs monitoring (UTAM) and DGAL will be key to ensure good quality reporting. Finally, the government created a working group with the participation of both municipalities and parishes' representatives, with the mandate of proposing criteria for the assessment of the merger of parishes (freguesias) that took place during the adjustment programme. However, the bottom-up approach used and the self-assessments from parishes and municipalities may entail additional reversal risks for this reform.

Box 3.1: Stock taking of changes to programme measures

Some steps implemented and/or agreed during the programme have been taken back or changed. Within budgetary policy the planned further annual decreases of the **CIT** rate agreed in the CIT reform adopted during the programme period (January 2014) were stopped. Some pro-investment fiscal incentives were modified, such as a required minimum shareholding of 5% to benefit from 'participation exemption' (now raised to 10%) and the reduction, applicable only to large companies, from 12 to 5 years for the minimum time required to benefit from the carry-forward of fiscal losses (now reset at 12 years). The temporary surcharge on the **PIT** established in the years of the programme was set to phase out from 2016 to 2019. In a specific law passed in December 2015 and confirmed by the 2016 Budget, the government decided to concentrate the unwinding in 2016 and 2017 (estimated budgetary impact of 0.2% and 0.1% of GDP respectively), while the 2017 budget has recently postponed the full unwinding for higher tax brackets to November 2017 (estimated budgetary impact of 0.1% of GDP). The 2012 increase of **VAT** paid on restaurant meals from the intermediate rate to the full rate was reversed in July 2016 and is now back at 13% as opposed to 23% (estimated budgetary impact of 0.1% of GDP in 2016 and another 0.1% of GDP in 2017). On the expenditure side, following a 2014 Constitutional Court ruling, the temporary public wage cuts implemented during the programme were set to be unwound by 2018. According to a specific law passed in December 2015 (Nr 159-A/2015 of 30 December), however, the wage cuts have been reversed entirely in four quarterly steps by 1 October 2016 (estimated budgetary impact of 0.2% of GDP in 2016 and another 0.1% of GDP carry-over impact in 2017).

Two **public administration measures** were affected. First, in July 2016 the working week for civil servants in the central administration was reduced back to 35 hours from the 40 hours to which it had been raised in September 2013. Second, the coverage of the revised requalification scheme adopted during the programme was significantly reduced and the scheme will no longer allow for wage cuts and potential dismissal. Four changes pertain to **SOEs reforms**. The sub-concessions for the Porto and Lisbon passenger transportation services have been cancelled. The awards were withdrawn early in 2016 and new solutions to guarantee the financial sustainability of the companies are still not implemented. The merger of the municipal water systems managed by Aguas de Portugal has been partially undone. The privatisation of TAP has not materialised as the State decided to maintain a 50% stake in 2016. Finally, the payment of pension supplements for SOEs was reinstated early in 2016. As regards the **labour market**, the expiration of collective agreements has been temporarily suspended under a social dialogue agreement, and rules for the extension of the agreements are being eased.

Other reversals regarded education, judicial and housing reforms. The government enacted a targeted reduction in some class sizes which could lead to an increase in the average class size. Some courts that had been closed during the programme to achieve economies of scale are now reopening. The urban lease law approved during the programme has been revised and the new amendments appear to work against more dynamism and efficiency in the housing market. These in fact entail extending the transitional period for old household and commercial lease contracts (from before 1995) by 5 years and enlarging the scope of exemptions. The government also decided to reintroduce 4 holidays that were eliminated in 2011.

Some relatively minor tax policy shifts have been introduced in the 2017 budget. Regarding PIT, the surcharge is going to be completely phased out also for higher tax brackets in 2017. CIT rules are broadly kept stable in 2017 except for a limited broadening of the scope of the allowance for corporate equity (ACE) intended to decrease the corporate debt bias. Following the value added tax (VAT) reduction in food at restaurants to the intermediate rate (13%) in July 2016, a new VAT exemption regime on imports is expected in 2017. The 2017 budget also introduced a new progressive additional real estate tax (AIMI) and the already mentioned tax on sugary drinks. Further tax policy shifts are being studied for later years that could affect PIT and other taxes, but no clear timeline has been set.

The indebtedness of SOEs remains at high levels particularly in the transport sector. State Owned Enterprises (SOEs) monitored by UTAM had a total indebtedness of more than EUR 30 bn in the second quarter of 2016. Transport sector firms contribute the most to this indebtedness. Rail and road infrastructure manager IP alone represents a quarter of total SOEs indebtedness reaching 60% when put together with rail transport company CP and Metros of Lisbon and Porto. IP has recently signed a 5 year Public Service Obligation contract for the rail infrastructure. Its short-term sustainability is shown by its positive operational performance in consecutive quarters. The authorities are revising the operating and financing model for urban transport SOEs in Lisbon and Porto. In the case of Lisbon bus transport Carris, a decision was taken to move ownership to the local government while the debt will remain with the central government. Concrete measures to tackle the remaining debt or the negative operational results of Metro of Lisbon and Porto are still not implemented. The authorities are also planning new investments and capital injections before having a governance or financial framework fully in place. Additional efforts for the long term sustainability of Metro of Lisbon, Metro of Porto, Transtejo and Soflusa are required. The re-purchase of shares to regain control over 50% of TAP have increased the pressure on public debt for at least EUR 30 m. The contours of the operation are not yet fully clear namely in terms of each shareholder's economic rights, contribution to the capitalisation plans and effective management control of the company.

A framework to ensure financial sustainability of SOEs is still not in place. There are risks that the SOEs burden on public finances continues rising in 2017. The reinstatement of career progression for SOEs employees can deteriorate the firms' financial situation. Extraordinary subsidies and compensations for national rail and road infrastructure are expected to more than double compared to 2016 in view of the 5 year Public Service Obligation contract recently signed. IP, the SOE with the largest outstanding debt still has not implemented a plan for long-term sustainability that would cover long-term investments and tackle the outstanding debt. The government intends to improve the oversight of SOE's expenditure through an ex-ante and ex-post assessment of investments, activities and their financial impact together with a regular monitoring. However, concrete targets to tackle indebtedness and long term financial sustainability have not been set.

Portugal has witnessed a vast improvement in water infrastructures but is lagging behind in terms of asset management efficiency and economic and financial sustainability. Some municipalities have accumulated high tariff deficits and debts due to economically and financially unsustainable operations. There are also visible inequalities between prices of services in inland and coastal regions, hampering social and territorial cohesion. The authorities remain committed to the goal of water and sewerage sector reforms, but they are being delayed. The second stage of the water sector reform would contribute to change the emphasis from infrastructure-building to efficient asset management. The aim is to merge water and sewerage municipal retail management services and promote the integration of bulk and retail activities, in order to ensure the financial sustainability of the system, including arrears. The reform would allow for tariff harmonisation at national level and economies of scale and scope stemming from higher synergies in the value chain. The timeline for such reforms remains however unclear without a commitment with concrete deadlines for 2017.

Renegotiation of road PPPs are advancing but costs related to PPP contracts remain high. Renegotiations of PPPs with the objective of lowering its costs to the public sector are entering

the phase of full completion. Road renegotiations for the 9 highway concessions have been finalised together with 3 road subconcessions. The negotiations of the remaining 4 road subconcessions are still ongoing. However, overall costs of PPPs contracts until their end were revised up by more than EUR 400 m between 2016 and 2017 due to a recalculation of amounts using 2017 prices. The Court of Auditors also recently alerted to the fact that the risk on public finances is not totally taken into account in the current monitoring.

3.3. FINANCIAL AND CORPORATE SECTORS

The national authorities have adopted some measures to address the large stock of NPLs. In July 2016, the authorities were recommended to present a strategy to address the large stock of NPLs by October 2016 (see CSR 4). In this vein, the authorities strengthened the collaboration between institutions with a view to streamlining a comprehensive and coordinated approach to deal with the situation. A task force was set-up devoted to the analysis of the NPL problem and tasked with providing solutions. The task force elaborated a tripartite strategy to address the problem, consisting of the following steps whose implementation is pending: (i) a revision of the existing legal and judicial package, including provisions to streamlining and accelerating processes under PER and SIREVE, expected to be implemented already in 2017; (ii) an internal review conducted by the banks under the supervision of the central bank of each non-performing loan to assess its viability and propose a restructuring solution for each case; (iii) provisions that encourage banks to outsource the servicing of their non-performing loans to external agents. In addition to these plans, some measures were recently taken, including improvements in the early warning systems for non-financial corporations and a recognition for tax purposes of write-offs for loans overdue for more than two years and with 100% impairments.

Despite these recent activities, a comprehensive strategy at the national level to address NPLs is still missing. While the granular examination of the loans goes in the right direction, a timeline is missing together with a clear framework of incentives for banks to undertake this costly process. It is also not clear whether there is an intention to establish a proper market for distressed assets, which may require further work on removing impediments to restructuring and enhancing the incentive for banks to sell non-performing credit. As an integral part of the NPL resolution strategy, the authorities also need to tackle the difficulties related to the judicial collateral enforcement proceedings, which still take in Portugal an excessive amount of time, at an average of 40 months against a European average of 8 months. On these grounds and given the extent of the issue, an overarching strategy with ambitious but credible concrete targets has become more pressing.

Regarding specific banks, progress in the ongoing recapitalisation of CGD together with the ongoing sale process of Novo Banco should be closely monitored and coordinated so as to contain possible negative setbacks on the financial sector and on fiscal sustainability. It is worth noting that the ongoing recapitalisation of major banks works in the right direction as it will create more leeway to address bad-loans.

With one of the most indebted corporate sectors in Europe, deleveraging needs to continue. The deleveraging process of corporate debt has to continue to allow viable companies to operate in a more flexible way as they gradually strengthen their capital ratio. This would yield decreased risk for Portuguese firms and consequently, lower liquidity constraints. The authorities are aware that the corporate sector has to change its financing mix giving priority to equity financing rather than debt. Legal changes to decrease the debt bias in the fiscal code are ongoing. In addition, some measures are expected to enter into force by April 2017. Besides those already mentioned in the case of NPLs, these include more resources to accelerate insolvency proceedings, including enforcement of collateral, and the use of new IT systems in the insolvency and liquidation procedures. In addition to these positive developments, some additional steps would be welcome, such as training programmes for entrepreneurs similar to the Irish IPO Ready([6]) and

([6]) IPO Ready is run by the Irish Stock Exchange since 2015 and provides support to companies to access market funding. It's targeted to CEO and CFOs to enhance their knowledge and skills in raising capital, investor relations and business management.

the promotion of listed holding companies with participation in Portuguese SMEs and mid-caps.

3.4. STRUCTURAL REFORMS

Labour Market

Labour market conditions are improving with a decreasing unemployment rate. The fall in the unemployment rate is faster than expected based on the past relationship between GDP growth and unemployment. Such job-rich recovery could be the result of labour market reforms and of hiring incentives provided by past wage adjustments. For long-term unemployment the evolution is not as positive, as, although decreasing in absolute figures (and below the Q2-2014 peak of 62.3%), it still accounts for 56.7% of the total unemployed (Q3-2016) and is 10 pps higher than the EU average. Persistent long-term unemployment may affect potential growth by pushing up structural unemployment and intensifying human capital deterioration. To tackle this, Public Employment Services are reallocating staff to increase personalised guidance to job-seekers, which is expected in turn to contribute to their activation.

Increases in the minimum wage, while potentially reducing in-work poverty, can have a negative impact on employment as they are not aligned with changes in prices, average productivity and compensation of employees. Following its 2016 increase, the minimum wage was raised again in January 2017 to EUR 557 per month (paid 14 months a year), and the authorities remain committed to the EUR 600 target for 2019. The coverage of workers with minimum wage has also risen from 12% in 2014 to 20.5% in September 2016 (a value most likely to increase in 2017) making the minimum wage increasingly binding. The government monitors the impact of minimum wage developments through quarterly reports published and discussed with social partners. In principle, increases in minimum wage can have a positive impact on aggregate demand, in-work poverty and inequality if not outpaced by possible negative employment effects, which depend on the relative position of the minimum wage in the wage distribution. The higher the minimum wage in the total distribution, the more binding the minimum wage becomes, making hiring harder at lower productivity levels. The potential negative effect on employment tends also to be stronger for young people and low-skilled workers, which is a concern in a context where the low skilled unemployment rate is almost 4pp higher than the one for the high skilled.

Despite recent reforms, some aspects of labour law might still act as disincentives to hire permanent workers. The share of temporary contracts in overall contracts is still not decreasing. The incentives to challenge dismissals in court remain, leading to uncertainty about firing costs which may provide disincentives to companies to hire on open-ended contracts. The employment protection legislation (EPL) reform implemented during the economic adjustment programme aimed at providing more incentives to hiring on a permanent basis by changing severance payments and compensation for dismissals. Yet, the full impact of the reform might take years to show results in terms of shifting the share between temporary and permanent contracts. As a step to reduce labour market segmentation, in January 2017 the Government redesigned its employment support programme to promote hiring on open-ended contracts, while restricting financial support for temporary contracts to specific cases such as the very long-term unemployed. However, the expected impact seems limited as only 15 000 people are foreseen to be covered by the programme. For more effective results, in addition to the financial incentives already in place, the authorities could consider changing dismissal rules to better foster hiring under permanent contracts. A preliminary assessment presented in January by the OECD([7]) on Labour Market reforms in Portugal identifies similar challenges. It finds that the regulatory gap between temporary and permanent contracts remains significant contributing to labour market segmentation. Clarifying the conditions under which employers can dismiss individual workers for economic reasons or reducing the compensation following unfair dismissal and the possibilities for reinstatement could further decrease disincentives to hire workers on a permanent basis.

A mid-term agreement on labour relations was signed between the government and social partners but concrete measures are still not

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

defined. The Portuguese collective bargaining system remains centralised. Since the representativeness rule for extensions was made more flexible, administrative extensions have increased but are still below pre-crisis levels. Also, the new agreement includes a compromise between social partners not to use the expiration of collective agreements for 18 months starting in January 2017. Concrete measures for the modernisation of the collective bargaining framework and labour legislation are still not defined. Wage bargaining would benefit from rules that increase flexibility in terms of wage adaptation to economic developments. Changes in EPL could open the door to measures that effectively tackle labour market segmentation. The same OECD assessment (OECD 2017) points again in a similar direction. According to the study, competitiveness would benefit from having collective bargaining processes more aligned with firm performance. The potential for negative effects of administrative extensions of collective agreements on non-signatory firms should be minimised, and the procedures for firms facing economic hardship to opt out of such agreements clarified.

Education and vocational training

An assessment of proposed new measures for education is important to ensure better school outcomes and reduce risks to the budget. Following a sharp decrease in the number of teachers (by 19%) during the adjustment programme, their number has been rising (by 6%) again since the third quarter of 2014. The 2016 increase is due to a more efficient system of teachers' hiring and replacement, an increase in medical leaves (currently being analysed by the authorities), the ageing of school teachers and the reduction of association contracts with private schools. The outcome of the last Pisa report was positive, although the skill level of the labour force, including digital, remains low. Moving forward, the Government has in view new policies that might, however, put upward pressure on resources. According to the authorities, a new tutoring system with larger coverage of students at risk of failing will more effectively reduce grade repetition, keeping students in the normal academic track. However, it will require more resources and might be a late response as only students in the second grade repetition will be covered. This together with a bottom-up policy to gradually reduce large-size classes might further increase the number of teachers needed. As the measures indicated would generate a non-negligible increase in resources, it would be important to ensure that they will contribute to a substantial reduction of costs linked to grade repetition, and that they will be targeted on mid to long-term effectiveness of the school system in terms of skills outcomes. A study is ongoing to assess how to maximise the pedagogical benefits of the measures (particularly in the prevention of school failure and drop-out) and to minimise the financial costs.

New school autonomy contracts have not been established beyond the initial set but are planned to be revived for the coming school year. Autonomy contracts for schools had been implemented during the programme as a system of incentives for schools to improve their financial and operational performance. They provide more financial autonomy to those schools that would not spend all of the allocated budget. The initially signed contracts are still in force but no new ones have been signed beyond the initial group. The government wants to couple them with school success plans so new contracts are expected to be signed for the year 2017-2018.

The spending review focuses on administrative costs and will be complemented by a resource management analysis. The reduction of administrative costs shall include the creation of central units for salaries and procurement and better control mechanisms for operational control such as sick leave as well as class creation and financial control ex-ante and ex-post. While these measures can improve spending efficiency, the spending review falls short of an all-inclusive revision of expenses by the Ministry of Education as it is rather limited to decreasing administrative costs. A School Resources Review was requested to the OECD. It might provide a way ahead in terms of a more encompassing improvement of resources provision, distribution and effective use in the education system.

Network industries

Measures to decrease costs in ports are being implemented but have not yet delivered reductions for port users. Portuguese commercial

ports continue to increase their freight throughput, which increased by 15% y-o-y in the first 3 quarters of 2016. The elimination of the port user tax (TUP Carga) did not contribute to reduce port user fees as it was absorbed by port operators. The renegotiations of port concessions seem to be taking finally speed with the finalisation of the renegotiation of port concessions for Douro and Leixoes. The renegotiation of port concessions would improve competitiveness of Portuguese ports only if it leads to a cost reduction for port users and not only for operators. To this end, a general framework for port concessions that would contribute to a better concession contract design is expected but still not in place.

Portugal is taking steps to reduce costs in electricity production. The Government is taking measures to correct for overcompensation given to energy producers. The cost recuperation would at least in part be allocated to reduce the tariff debt. The Portuguese Competition Authority concluded that there was market manipulation by EDP causing overcompensation to the firm's hydro-electric power plants with guaranteed production. It also advised the Government to recuperate part of that overcompensation and is now investigating undue profits obtained by EDP's market operating plants. Some renewable energy producers have been receiving subsidies on top of the feed-in tariff. As the feed-in tariff was set at a level that would compensate for the extra costs from production using renewable sources the Government now plans to end this type of double subsidisation. At the same time, all new contracts for renewable energy capacity will be done at market price under a tendering scheme with no feed-in tariff.

Efforts are being made to improve the sustainability of the energy sector. The remuneration method for electricity capacity mechanisms is being changed in order to decrease costs to consumers. Instead of a regulated capacity payment, a more market-based approach is being established based on auctions with a ceiling price so as to control the overall cost. Capacity payments should also no longer cover investment costs as there is already overcapacity in the system, but only short-term generation adequacy. The government is also considering decreasing the structural costs associated with the current interruptibility schemes. The interest rate paid for the accumulated tariff debt has decreased following renegotiation.

Despite these measures, the elimination of the tariff debt reduction has been pushed further away from the initial 2020 target. The measures planned would encompass only a fraction of the overall outstanding tariff debt. In fact, only under a surge in electricity demand or a significant cost reduction in renewable production would there be an effective front-loading of the tariff debt elimination without steep price increases. However, most measures are only valid for new contractual arrangements, thus maintaining the burden until current contracts expire, which for renewables will be beyond 2020. Accordingly, the outstanding electricity tariff debt will be eliminated at the earliest in 2022 as opposed to the original 2020 target, and in a pessimistic scenario in 2026, which would keep upward pressure on energy prices.

The phase-out of the regulated price was again postponed. The delay to 2020 instead of 2017 might however have some positive consequences. This is because under a very tight timeline, consumers would simply remain with the incumbent, while, given more time, they might choose new players. A common logistic operator for change of energy supplier had been planned for a long time. The legal basis has now been established opening the door for its effective rollout during 2017.

Administrative burden, regulation and red tape

The pace of easing administrative procedures for businesses is heterogeneous, in particular at a local level. A number of measures have been brought in under the economic adjustment programme, the aim being to improve the business climate and boost investment, by lowering firms' costs and increasing the return on their investment. Despite some progress, there have been delays in simplifying local and central administrative procedures with little coordination between the various layers of the public administration. At a central level, there is the need to request visa and approvals by various ministries on a single procedure. At a local level, reforms seem to have been implemented in different ways, resulting in different quality standards for municipal services. Moreover, not enough has yet been done to

ascertain the impact of the reform agenda implemented so far, so it is impossible to assess the extent to which this matches the original goals and to tackle corrective action if necessary. The authorities are implementing a system called "Monitoring +" aimed at ensuring a better interaction between public agencies and companies and citizens, but the concrete outcomes are not yet evident.

Municipalities have still high discretionary power in implementing land use rules. Absent a consistent implementation strategy, the time for obtaining licenses varies across municipalities. Further, construction fees for accessing and operating in the market are higher than in other Member States and have no link with the underlying administrative costs. At a national level, an evaluation of the fees and permit procedures is expected by mid-2017 as opposed to end 2016, as initially agreed with the Commission. According to a recent study([8]), the system of fees imposed on construction service providers in Portugal for initial registration and subsequent renewal is complex, linked both to the category of construction works to be performed and to a percentage of the wage salary index for public administration officials. Changing the category of construction works is subject to a fee based on a calculation methodology similar to that applicable to the initial fee. A recent reform has simplified calculation and partially reduced fees, but they remain high and linked to the category of construction works to be performed, with no direct link to the underlying administrative costs.

The implementation of the new administrative simplification programme lags behind ambitions. In recent years, major reforms were introduced to create an e-government system that would facilitate business creation (SIMPLEX and SIMPLIFICAR programmes) and to improve the business environment. Measures undertaken during the programme under the SIMPLIFICAR initiative seem to have stalled. These include the "one-in/one-out" rule for the elimination of an existing regulation with equivalent cost when a new one is created, an inventory and cost analysis of burdensome regulations, and a roadmap for problematic areas. A list of twelve administrative burdens was identified with particularly high context costs for business. For six of these, annual context costs were estimated at around EUR 150 m. The envisaged extension of this inventory to other sectors, including tourism, construction and agriculture, has not yet happened. In May 2016, the government published a new simplification programme called SIMPLEX + 2016 which introduces an ambitious package of simplification measures. However, the methodology to quantify the costs of administrative procedures is still not yet published. An ex-ante impact assessment methodology is being developed but still not implemented. Similarly, the priority of each measure and a detailed ex-ante impact assessment with quantified potential benefits are also lacking. The authorities have outsourced an impact assessment study to a Portuguese university. The aim of this assessment is to evaluate the impact of SIMPLEX measures, addressing administrative burden reduction, efficiency improvements and savings.

Competition in services and regulated professions

Ensuring adequate resources for the National Regulatory and the Portuguese Competition Authorities is key to increase Portugal's competitiveness. Under the programme a new framework law for the functioning of the National Regulatory Authority (NRAs) and the Competition Authority was adopted. To ensure stability of their finances, a new funding model was approved in 2014, which was based on transfers from the NRAs, as a percentage of the fees they charge. . In 2015, the Competition Authority was largely underfinanced, due to lower transfers from several entities (the security authority CMVM, the telecommunication authority ANACOM, the transport institute IMT and the transport authority AMT). Those entities suffered from financial resource constraints and revenue variations and could not meet their transfer obligations. Moreover, the Bank of Portugal is not included in the set of contributing authorities, despite the fact that the Competition Authority is also handling cases in the banking sector. Ensuring adequate funding to the NRAs and to the Competition Authority is key to maintaining their financial autonomy and independence as provided for in the relevant Framework Law. Therefore any

([8]) European Commission, Simplification and mutual recognition in the construction sector under the Services Directive, MARKT/2014/087/E, Final Report, November 2015.

implementation gaps or administrative hurdles should be removed, including by revising the budgetary framework law**.**

Administrative and regulatory barriers to competition in services and regulated professions remain. There are still restrictions for services and professions not covered by the programme or agreed upon under the programme and not yet approved or implemented as previously agreed([9]). The latter include the reforms of university, construction services and legal professions. The level of restrictiveness in Portugal([10]) is higher than the EU average also for civil engineers, architects, accountants, and tourist guides. It is lower than the EU average for patent agents and lawyers, although access to the latter profession is more tightly restricted than for any other profession in Portugal. Furthermore, the business churn (or turnover) rate for legal activities is lower than both the EU average and the overall Portuguese economy as a whole, thus pointing to relatively low dynamism and competition in the sector. Major reforms in this area are needed and reforms agreed under the programme should be promptly implemented.

Public procurement, transparency and corruption

Measures to increase transparency and reduce corruption are promising but yet without visible results. The enforcement, monitoring and sanctioning ensued by existing provisions on transparency have been so far a major hurdle to improving the integrity framework in Portugal. Recent measures point to some progress in this direction. On the legislative side, an ad-hoc parliamentary committee was created in March 2016 to reinforce transparency, but results from its activity are not yet available. Nonetheless, some improvements in the current legislation are to be expected (e.g. for whistle-blower protection, asset declarations, conflict of interests and revolving doors). On the prosecution side, progress has been made. Anti-corruption appears to have become a real priority for t the national prosecution services and more efficient processes of case and resource management have been put in place. ([11]) It remains to be seen whether these will trigger improvements of final conviction rates for high-level corruption and the application of more deterrent penalties.([12]) On the preventive side, the corruption prevention plans set up in each public institution have been, however, largely formalistic: they fail to adapt to each organisation and lack adequate monitoring.

Despite efforts to improve public procurement data, the use of direct awards remains large. The authorities are making efforts to improve data quality and reliability in the online public procurement platform (BASE). In addition, the Institute for Monitoring Public Procurement (IMPIC) can correct data in BASE through a more systematic and automated system. Warning mechanisms are being introduced to reduce entry errors and filing mistakes which nevertheless remain significant. According to the 2015 report on public procurement published in November 2016 by the IMPIC, e-procurement appears to be well. Nevertheless, e-procurement platforms are not yet interlinked and the cost for using these platforms is high for small companies, according to the Government Computer Systems Administration (CEGER) which has received a number of complaints. This might be due to the fact that some service providers are charging fees for mandatory free services. With a view to fixing those shortcomings, the authorities have put forward measures within the SIMPLEX + Programme. According to the 2015 IMPIC report

([9]) When the programme ended in 2014 none of the 18 by-laws regulating 19 professions which were under revision during the programme was approved and enacted

([10]) The European Commission has developed a new composite indicator on the extent to which most existing barriers restrict access to and the practice of regulated professions. It is based on data collected from Member States, complemented by desk research. This new indicator has many similarities with the Commission indicator of barriers in business services published in 2015, but also differs from it in certain ways. COM (2016) 820

([11]) Examples of measures included in the 2015 Anti-corruption Action Plan of the General Prosecutor's Office are: allocating a single experienced magistrate to complex cases, creating joint investigative units under the coordination of a prosecutor, using secure information gathering and sharing between law enforcement officials, securing continuity of resources between the different phases of the judicial process and specialised recruitment of expert assistance for complex economic and financial crime cases.

([12]) Portugal has seen almost even rates of final convictions and final acquittals in corruption related cases and a rather high ratio of suspended sentences for corruption related-offences, with 73% of the final sentences being suspended in 2011, 61% in 2012 and 74% in 2013. Data for 2014 for Portugal is not yet available. http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=21215&no=2.

which uses BASE data([13]), contracting authorities still use direct awards, both for contracts for goods and services (90.3%) and for public works (87.0%). Portugal is still in the process of implementing the 2014 EU Directives on Public Procurement. The draft legislation includes provisions to increase the mandatory number of bidders and to restrict the use of direct awards. If effectively set up as prescribed by the draft legislation, biennial procurement plans would also be a key tool in limiting the use of direct awards to exceptional circumstances.

The monitoring and control capacities at the execution phase of contracts present gaps, especially for PPPs. Contracting authorities for PPPs lack the necessary expertise for structuring, negotiating and monitoring complex contracts. The mandate of the Ministry of Finance's unit for PPPs (UTAP) is restricted to PPPs managed by the central administration, and does not encompass concessions, regional or local PPPs. Nonetheless, since April 2016, all local authorities are obliged to report PPP and concession contracts to a central registry, an exercise that is still ongoing. The Central Purchasing Body (eSPap) has awarded Framework Agreements that include several suppliers to increase the transparency and competition in public purchases. However, Portugal still lacks a comprehensive public procurement policy for all layers of the public administration. To fill this policy gap, increase openness and avoid collusion in public tenders, the Portuguese Competition Authority, in co-operation with ESPap, is disseminating best practices and raising public procurement awareness within public entities, two activities which are within its mandatory advocacy capacity and therefore are not mandatory for the concerned public entities.

Judicial sector

The judicial system still weighs negatively on the business environment. Entrepreneurs still see the inefficiency of the judicial system as one of the main obstacles to doing business. Efficiency indicators for civil, commercial and tax litigation cases remain poor with a negative impact on business dynamics and FDI attraction. The efficiency of the tax and administrative courts remains challenging with lengthy proceedings and low resolution rates([14]). Claims enforcement and capacity of resolving court backlogs are still below the EU standards([15]). During the economic adjustment programme, the Portuguese authorities reformed the corporate insolvency and restructuring frameworks, giving it a stronger focus on the recovery of firms rather than their liquidation by introducing out-of-court insolvency frameworks (PER and SIREVE). According to data from the Ministry of Justice, the average duration of PER proceedings was 4 months and 19 days in Q2-2016; while insolvency court proceedings take still up to 40 months to be concluded. In May 2016, the Ministry of Justice published a first evaluation of the two insolvency tools, together with a set of recommendations. Policy responses to these recommendations, included in the Capitalisar Programme, aim at facilitating the restructuring of viable enterprises and the recovery of credits. Some revisions of the insolvency regime are also included, such as access for judicial administrators to the Citius dataset and access for insolvency administrators to various databases.

The availably and quality of judicial statistics is improving slowly. After its collapse, the Citius database has been made again operational. Work is ongoing to make the relevant judicial databases accessible to insolvency administrators and to complete the replacement of paper procedures with electronic certificates. However, statistical judicial data still do not cover tax and administrative tribunals. The High Council for Tax and Administrative Courts does not produce any statistical data yet.

Evaluation of structural reforms

Further efforts are necessary to evaluate the impact of structural reforms. There has been some progress on the (ex-ante) macro impact evaluation of structural reforms on the basis of general equilibrium models carried out by

([13]) BASE dataset does not include the totality of awarded public contracts.

([14]) According to the latest data produced by the Ministry of Justice, in 2015, the courts of first instance counted 34 850 new proceedings and, out of them, only 27 810 were completed. In addition, pending cases amounted to 75 372 at the end of 2015.

([15]) The proceedings for civil and commercial cases remain long (lasting on average 17 months) as well as the average duration of enforcement cases that is still 44 months.

GPEARI (a technical unit within the Ministry of Finance). However the current capacity of GPEARI appears to fall short of the original mandate (and the scope of past European Semester CSRs) that entailed systematic and comprehensive ex ante and ex post impact assessments, in particular with a more micro perspective. The authorities are also implementing measures to rationalise the legislative process to ensure less but better quality legislation, but they have not yet implemented (micro) ex post assessments of structural reforms. An overall effort is being conducted to eliminate obsolete legislative acts.

Housing

Progress in housing market reforms has stalled with signs of steps back. Concerns remain about the Parliament proposal to further change the original framework of the housing market ([16]) by further extending the transitional period for certain categories for 10 years (from 5 years). In particular the proposal concerns "old household" (contracts before 1990), namely tenants aged 65 or over or disabled, whose household income is below a certain threshold. For "commercial lease contracts" (from before 1995), it covers microenterprises; entities of public, national or municipal interest; shops and entities of historical and cultural interest. This would be an additional change to the original law, besides a number of amendments already implemented after the end of the economic adjustment programme which have weakened the original scope of the reform. The requested ex-post assessment of the lease reform has stalled and the universe of contracts covered by exemptions and benefits granted under the long transitional period is still unknown. During the economic adjustment programme, the authorities committed to provide a comprehensive study on the shadow economy in the rental market that was never submitted, but it would be important to have in order to tackle tax evasion and fraud in the commercial and housing lease market. To this end, enhanced monitoring procedures would be welcome together with more comprehensive metrics that enable to assess the overall impact of the lease reform, including by linking up various data sources (buildings' registry, utilities' contracts, and means testing of households).

([16]) The original framework aimed to make the housing market more dynamic by better balancing rights and obligations of landlords and tenants. It phased out, over a period of five years, the old system of open-ended leases in which rents were frozen and contracts could not be terminated by landlords, and provided for an updating of rents to achieve gradual alignment with market levels. It also introduced more flexibility in the choice of contract duration, set better incentives for renovation and provided a new and fast extrajudicial eviction procedure. A law which simplified administrative procedures for renovation works was adopted as part of the same package.

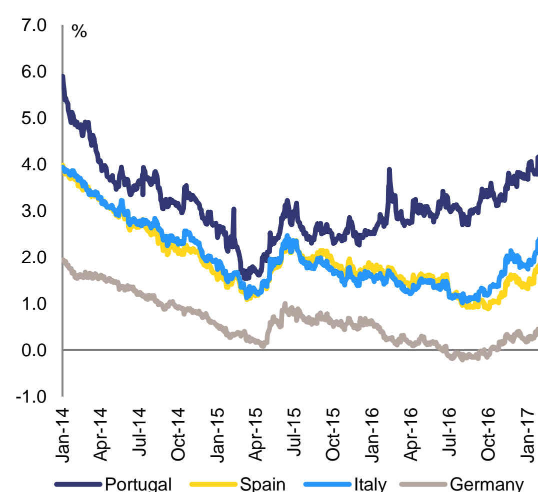
4. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Debt management smoothened debt redemption profile. Buying back EUR 3 bn in debt with short maturity and the early repayment of EUR 4.5 bn of IMF debt in 2016 have smoothened the debt redemption profile, and changed the composition of outstanding debt towards government bonds (47% of total medium and long term debt) and away from IMF-EU loans (30%) in 2016 and reduced financing needs down to EUR 22.5 bn in 2016 from EUR 29 bn. The 2016 early redemption of IMF debt was less than expected at the time of the fourth PPS report (EUR 8.6 bn). Adding redemption of medium to long-term debt of EUR 9.7 bn, financing needs for the deficit of EUR 6.3 bn and for the acquisition of non-financial assets of EUR 2.2 bn, the total borrowing requirements for 2016 amounted to EUR 22.7 bn, against EUR 29 bn in 2015. These were financed mainly by the issuance of government bonds (EUR 17.4 bn), floating bonds (EUR 3.5 bn) and retail products (EUR 3.5 bn). With financing in excess of borrowing requirements, cash deposits grew by EUR 3.6 bn, to a 10.2 bn stock by year end, much higher than the 6.2 bn projected in the 4th PPS report. At the same time, the larger weight that auctions have gained in 2016 compared to syndications signals improvements in the methods of issuance.

The capacity to repay remains sound in the short-term but with downward risks posed by increasing yields. For 2017, the debt management office foresees a total amount of borrowing requirements of around EUR 21.1 bn, which includes EUR 6.2 bn in government bonds maturing in October and EUR 1.7 bn of IMF debt repayment made in February([17]) and EUR 0.8 bn of PGB buybacks in January. These borrowing needs will be financed predominantly by government bonds (about EUR 15 bn) issued through auctions and syndications, a EUR 2.3 bn issuance of retail products and by a drawdown of cash deposits of EUR 3.8 bn, which would result in an end-of year cash position of EUR 6.5 bn.

Borrowing costs for 10 year bonds increased at the beginning of 2017. Indeed, a first issuance of 10 year bonds of EUR 3 bn took place on 11 January at a rate of 4.2%. Among others, such increase in Portuguese yields seemed to have reflected expectations regarding possible changes to the accommodative monetary policy of the ECB. Overall, the higher rate protracts the increasing trend in Portugal's borrowing costs since August 2016. From 2.7% in August 2016, yields for 10-year government bonds peaked to above 4% in February, and stabilised around 3% thereafter, but reached a new peak in January 2017 after one year. Similarly, the spread vis-a'-vis the German bund reached 3.74% (11 January 2017) from 2.16% (12 January 2016) and is much higher than the 1.67% spread for Italy and 1.20% for Spain. Such trend in the cost of borrowing denotes an unfavourable sentiment of the market, reflecting pressures from global volatility, domestic uncertainties and weaknesses in the financial and corporate markets. If protracted, higher and increasing rates could pose risks to the capacity to repay in the short to medium term and could constrain options for refinancing.

Graph 4.1: 10-year government bond yields



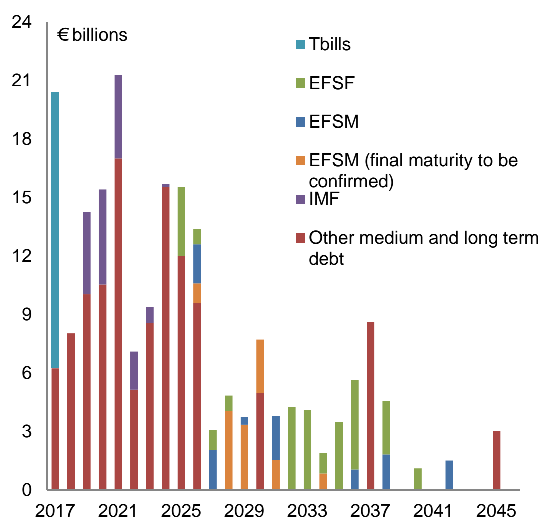
Source: European Commission

The medium to long term capacity to repay remain favourable but further efforts in fiscal consolidation and structural reforms would be key in ensuring a sound capacity to repay in the long-term. The average maturity of Portuguese debt is now at 8.5 years against the 7.2 years at the time of the 4th PPS mission. Similarly, the cost of new debt has reached 2.7% against the cost of

([17]) This payment would bring the overall amount of early repayments to the IMF to 50% of the initial disbursement. This corresponds to the full amount of the waiver of the *pari-passu* clause on proportional repayment granted by EU lenders in 2015.

outstanding debt at 3.4%, but it is higher than the 2.4% cost of new debt in 2015, reflecting the recent increase in the yields. The average gross financing needs for the period 2017 to 2020 has also increased from about EUR 15 bn at the time of the 4th PPS report to EUR 17 bn. The medium to long term redemption profile remains favourable. Yet, under continued interest rate volatility and the expected reduction in the cash buffer, consolidation efforts to enhance the sustainability of public finance and more structural reforms that could boost potential growth would be key in ensuring a sound capacity to repay in the long-term.

Graph 4.2: **Redemption profile**



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

5. PROGRESS IN ADDRESSING MACROECONOMIC IMBALANCES

Portugal has been identified as experiencing imbalances in the context of the Macroeconomic Imbalance Procedure (MIP). The Commission is of the view that Portugal continues to face excessive macroeconomic imbalances, in particular a strongly negative net international investment position, very high private and government debt levels, and still elevated unemployment, in particular for the young and the long-term unemployed. On these grounds, the Commission has called for an in-depth review of these challenges.

Imbalances in Portugal are unwinding at a slow pace. Despite major efforts since the onset of the crisis, the external imbalance remains wide, with a strongly negative net international investment position (-110% of GDP in 2015). The private debt-to-GDP ratio is still well above prudent levels (200% of GDP), and NPLs have not declined (about 20% of total loans). After sharply increasing in 2011 and 2012, the public debt-to-GDP ratio has stabilised at 130% since 2013, The unemployment rate is declining, yet, youth and long-term unemployment remain still very high (at 26% and 6%, respectively, compared to a EU average of 18.8% and 4.5%) and segmentation between permanent and temporary jobs is still an issue.

Country specific recommendations for Portugal aim to address the macroeconomic imbalances identified under the MIP. In July 2016, the Council adopted 5 country-specific recommendations (CSRs) for Portugal, all relevant for the MIP. They intend to address the major economic and social challenges Portugal is currently facing: fiscal policy and fiscal sustainability (CSR1); a minimum wage level that promotes employment and competitiveness as well as activation of long-term unemployed and lower labour market segmentation (CSRs 2 and 3); high corporate debt reduction and improved access to finance (CSR4); business and investment friendly environment, i.e. increased transparency, administrative burden reduction, improved cooperation between universities and the business sector and a more efficient tax judicial system (CSR5).

The Commission assessed that Portugal has made limited progress in addressing the 2016 CSRs. Excluding the assessment of compliance with the Stability and Growth Pact, limited progress has been made in ensuring the sustainability of public finances (CSR1), in ensuring that the minimum wage is consistent with the objectives of promoting employment and competitiveness across sectors (CSR2), and in addressing corporate deleveraging and non-performing loans (CSR4). Some progress has been registered in decreasing labour market segmentation (CSR3), and removing regulatory barriers and improving business environment (CSR5).

Some measures were successful in promoting the required adjustment to reduce some of the imbalances. These include reducing the long-term burden of age-related spending, notably the introduction of a higher retirement age and of incentives working against early retirement. Labour market performance benefited from the introduction of activation schemes and improvements in the employment services. The establishment of out-of-court procedures for insolvency eased the work of Portuguese courts on debt resolution, and measures to address tax compliance and fraud delivered some revenue gains.

The gains of some ongoing reforms are still to be ascertained. This regards for example the ongoing spending review which should provide some results by the end of February; similarly, the application of the Budget Framework Law has been delayed and its effects on the budgetary planning process shall be assessed only later in 2018. On the labour market side, the functioning and impact of one-stop shops for unemployed is still to be assessed, and so are the measures (still in the making) intended to provide incentives to hire on permanent contracts. Some promising steps have been recently taken to reduce the debt-equity tax bias and the impact of these legal changes is being closely monitored. Other actions in the pipeline for which it would be too soon to assess the effects regard the reform of local governments, measures applied to reduce the currently very high

energy-rents and the new strategy for university and business cooperation.

More efforts are still needed to sustain the closing of the imbalances at a faster pace. This refers to improving the financial sustainability of the health sector, in particular with a view to reduce the arrears. Similarly, the SOEs long-term financial sustainability remains critical and would warrant more efforts. It remains to be ensured that increases in minimum wages are aligned with productivity and competitiveness to reduce the risk of a backlash on employment. While some attempts to reduce NPLs have been presented, and some actions already taken at an individual bank level, given the gravity of the imbalance a forceful and comprehensive plan for the banking system at large would be needed. Finally, more steps could be taken to improve the efficiency of litigation cases (still very lengthy compared to the EU average) and public procurement control; public administration would benefit from further simplification, and restrictions in the business environment and regulated professions should be reduced.

Overall, in a context of fragile growth, volatile market sentiment and negative investment performance, a more forceful approach would be warranted to accelerate the adjustment of Portuguese imbalances.

ANNEX 1

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

The European Commission identified imbalances that require decisive policy action and specific monitoring in the areas external competitiveness, public debt, private debt and unemployment. It will conduct the required 'specific monitoring' *uno actu* with the post-programme surveillance. In this context, this annex presents progress with the implementation of relevant country-specific recommendations as assessed by the European Commission.

Table A1.1: **Progress with the implementation of relevant country-specific recommendations**

ANNOUNCED MEASURES	ADOPTED MEASURES	IMPLEMENTED MEASURES	SOURCE OF COMMITMENT
Fiscal policy and fiscal governance			
• [CSR1b] Improving the IT system (including eliminating duplicate records, records of deceased patients etc.), recruiting qualified staff in difficult areas, pilot projects in areas with gaps in the National Health Service. • [CSR1c] Revision of the early retirement penalties for workers with about or more than 40 years of service; harmonisation of current benefit schemes and means-testing procedures. • [CSR1d] A monitoring plan will be put in place to improve the oversight of SOE's expenditure through an ex-ante and ex-post assessment of investments, activities and their financial impact.	• [CSR1a] Spending review: The Government has launched spending reviews in health, education, public procurement and SOEs (expected yields included in the 2017 Budget). • [CSR1a] Budget Framework Law (BFL) Implementation: Adoption of operating rules for the new BFL implementation unit. • [CSR1b] Earmarking of the extension of alcoholic drinks tax (IABA) to sweetened drinks (about EUR 80 million in 2017) to the national health system. • [CSR1c] Earmarking of a new progressive tax on real estate assets (on top of the IMI) to the social security's Financial Stabilization Fund (about EUR 160 million in 2017).	• [CSR1b] Centralisation of procurement of goods and services; expansion of use of generics; reduction of waiting lists; higher number of family health units; more prevention campaigns; reduction of the health ministry non-financial debt and use of some MOF reserves to clear arrears. • [CSR1c] Disincentives to early retirement; pensionable age raised from 65 to 66 for both sexes, and future increases linked to life expectancy at age 65. • [CSR1d] The Portuguese road and rail infrastructure manager (IP) has signed a 5 year Public Service Obligation contract with the Portuguese state.	**CSR 1 – 2016 (Non-SGP related)** • [CSR1a] Conduct by February 2017 a comprehensive expenditure review and strengthen expenditure control, cost effectiveness and adequate budgeting at all levels of public administration; • [CSR1b] Ensure the long-term sustainability of the health sector, without compromising access to primary healthcare; • [CSR1c] Reduce reliance of the pension system on budgetary transfers; • [CSR1d] By the end of 2016, refocus ongoing restructuring plans of state-owned enterprises;

(Continued on the next page)

Table (continued)

Labour market adjustments			
• CSR 3] Increasing use of online platforms by Public Employment Service. • [CSR 3] Creation of one stop shops for unemployed. • [CSR 3] Decrease hiring incentives for temporary contracts. •	• [CSR 3] Assessment study of Active Labour Market Policies. •	• [CSR 2] The government is monitoring the economic impact of minimum wage developments through quarterly reports which are made public and discussed with social partners. • [CSR 3] Employment support programmes were redesigned to promote hiring on open ended contracts, while restricting financial support for temporary contracts to specific cases. • [CSR 3] Bonus support for the conversion of non-permanent/internships to permanent contracts. • [CSR 3] Reimbursement of the support scheme to be done in a phased fashion in order to guarantee the fulfilment of employers' obligations in terms of employment contract duration.	**CSRs 2 and 3– 2016** • [CSR 2] In consultation with social partners, ensure that the minimum wage is consistent with the objectives of promoting employment and competitiveness across sectors; • [CSR 3] Ensure the effective activation of the long-term unemployed and improve the coordination between employment and social services. Strengthen incentives for firms to hire through permanent contracts;

(Continued on the next page)

Table (continued)

Corporate indebtedness			
• [CSR 4a] Internal review of each non-performing loan by the banks under the supervision of the Central Bank to assess the loans' viability and restructuring arrangements. This could be also done by outsourcing the servicing of non-performing loans to external agents. • [CSR 4a] Mechanisms to facilitate the debt-to-equity swap within a recovery plan; more resources to accelerate insolvency proceedings, including enforcement of collateral; and new IT systems in the insolvency and liquidation procedures.	• [CSR 4a] Improved early warning systems for viable firms; creation of a task force on NPLs; bank recapitalisations and the entry of new shareholders in some of the large banks; revision of the existing legal and judicial package, including PER and SIREVE. • [CSR 4b] A National Strategy for Entrepreneurship (Startup Portugal) was launched in 2016 to improve the business ecosystem, provide alternative ways of financing, and promote the internationalisation of start-ups; the Capitalisar 2016 programme grants tax reliefs to individual investors who purchase shares in start-ups or small enterprises for at least two years. • [CSR 4b] The allowance for corporate equity (ACE) regime has been broadened and creates incentives to convert shareholders' loans into capital or quasi-capital. The new regime allows a higher investment amount, a higher deduction of taxable income, a higher time range and can be applied to all type of firms and investors.	• [CSR 4a] Recognition for tax purposes of write-offs for loans overdue for more than 2 years and with 100% impairments.	**CSR 4 – 2016** • [CSR 4a] Take measures, by October 2016, to facilitate the cleaning up of the balance sheets of credit institutions and address the high level of nonperforming loans; • [CSR 4b] Reduce the debt bias in corporate taxation and improve the access to finance for start-ups and small and medium-sized enterprises via the capital market;

(Continued on the next page)

Table (continued)

Public administration			
• [CSR 5b] An evaluation of the construction fees and permits will be made available by mid-2017. • [CSR 5c] Creation of collaborative laboratories, technological centres for engineering activities and new business innovation contracts.	• [CSR 5b] The Portuguese authorities have published the SIMPLEX+ programme to simplify administrative and licensing procedures. • [CSR 5b] The tax authorities have published a multiannual plan to combat fraud and simplify tax procedures. The 2017 Budget includes provisions to reduce response time of the tax administration.	• [CSR 5a] The government has enhanced monitoring and reporting procedures for local and regional PPP and concessions (decree law 18/2016); regional governments and municipalities have to disclose information regarding PPP and concessions on a quarterly basis. • [CSR 5a] The government is transposing the 2014 EU directive on public procurement with provision aimed at increasing transparency and competition. • [CSR 5a] Improvements are being made to the procurements databases to increase their reliability.	**CSR 5 – 2016** • [CSR 5a] Increase transparency and efficiency in public procurement as regards public-private partnerships and concessions; • [CSR 5b] By the end of 2016, improve and accelerate administrative and licensing procedures, accelerate tax litigations and reduce regulatory barriers, especially in business services; • [CSR 5c] Incentivise cooperation between universities and the business sector;

Source: European Commission

ANNEX 2
European Commission Debt sustainability analysis

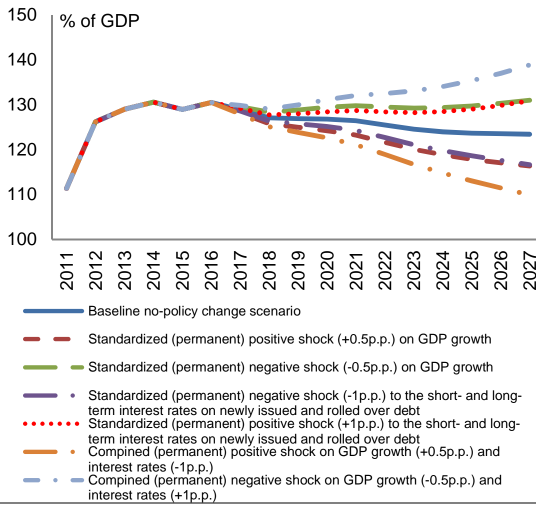
This Debt Sustainability Analysis (DSA) uses the Commission 2017 winter forecast as a starting point to ensure cross-country consistency and to take into account second-round macroeconomic effects. The debt ratio in 2016 is estimated to be at 130.5% of GDP, a 1.5 pps increase from 2015, mostly due to the issuance of EUR 2.7 bn in government debt in view of the ongoing bank support to CGD. For the outer years, the analysis rests on the following assumptions: it is assumed that (i) the structural primary fiscal balance remains unchanged at a surplus of 1.7% of GDP from 2018 under the no-fiscal policy change assumption, (ii) inflation converges linearly to 2.0% by 2021 and remains at that level thereafter; (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5% by 2025 in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group (AWG), (iv) real GDP growth rates of around 1%; and (v) ageing costs develops according to the Commission and EPC's 2015 Ageing Report.

The baseline scenario results in an annual average decrease of the gross debt-to-GDP ratio by around 0.6pp of GDP and thus ensures a declining path down to 123.5% of GDP by 2027. This declining debt trajectory is sensitive to financial market volatility and vulnerable to negative economic developments. Graph A2.1 presents a sensitivity analysis with respect to macro-economic and financial market risks as well as the effect of alternative fiscal consolidation paths. More precisely, the graph illustrates the sensitivity of the debt trajectory to a shock to real GDP growth and hikes in interest rates as from 2017. The analysis suggests that a lower GDP growth rate by 0.5 percentage points or a one percentage point increase in the interest rate on maturing and new debt would increase the debt ratio by 0.7% and 0.3% of GDP, respectively, in 2017. Under both scenarios, debt would be at about 131% of GDP by the end of the projection period. Moreover, a combined negative growth and interest shock could put debt-to GDP ratio on an accelerating path, while, a positive shock to medium and long-term growth, for instance as a result of structural reforms, or permanently lower interest rates would result in a visibly more solid path of debt reduction ([18]) by around 1.2 percentage points per annum to around 116% of GDP in 2027. A combination of higher GDP growth and lower interest rates could further accelerate the pace of the debt ratio reduction to around 1.8 percentage points per year, thereby allowing for a fall to around 110% of GDP in 2027.

Additional fiscal consolidation would clearly accelerate the debt reduction path (Graph A2.2). Full compliance with the requirements of the Stability and Growth Pact (SGP) would considerably further accelerate debt reduction. The SGP scenario assumes convergence to the Medium-Term-Objective (MTO) according to the matrix of required fiscal adjustment in Annex 2 of the January 2015 Communication on flexibility in fiscal rules ([19]). This would imply a MTO of a structural balance of 0.25% of GDP reached in 2021 with a fiscal effort of 0.6% of GDP every year from 2017 to 2021, reaching a primary surplus of 4% of GDP in 2020. Maintaining the MTO over the longer term horizon will require structural primary surpluses of around 4.7% until the end of the projection horizon. Under these assumptions, the debt-to-GDP ratio would markedly accelerate its decline to around 3.4 percentage points per annum from 2020, falling to 100% by 2027.

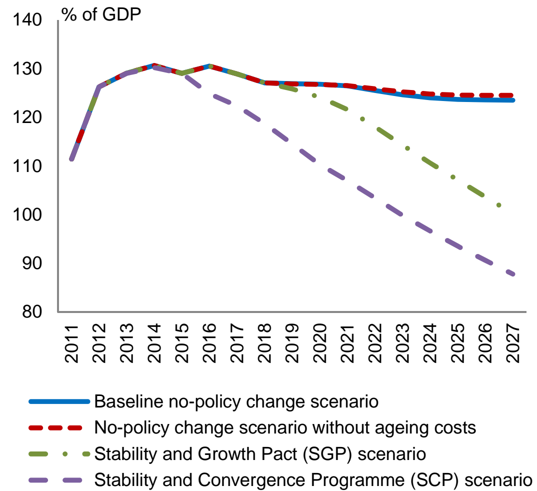
([18]) Not even taking into account the positive second round effects of the higher GDP growth on the fiscal balance.
([19]) COM(2015) 12.

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



Source: European Commission

Graph A2.2: Fiscal consolidation and ageing costs



Source: European Commission

The 2016 Stability Programme scenario had assumed a significant fall of the debt-to-GDP ratio to 124.8% already in 2016, in particular due to large stock-flow adjustments (mainly related to potential Novo Banco sales proceeds), and a lower headline deficit. Based on the assumptions of increasing primary surpluses, in a context of low interest rates and real GDP growth at around 1.5% from 2018 onwards, the debt-to-GDP ratio in the Stability Programme is projected to decrease rapidly further to 118.7% at end-2018, 114.5% at end-2019 and 110.3% at end-2020. Such scenario would be consistent with a 0.5% of GDP improvement in the structural balance for 2017-2020, which would be compatible with a primary surplus in structural terms of 3.5% of GDP. For 2021 onwards, the primary structural surplus has been set to remain at 3.5% over the entire projected period, which would be consistent with zero or marginal adjustments in the structural balance and a fast fall in the debt ratio to below 90% of GDP by 2027.

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

ANNEX 3

European Commission macroeconomic and fiscal projections (2017 winter forecast)

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

Annual % change	2015	2016	2017	2018
1. Private consumption expenditure	2.6	2.1	1.6	1.2
2. Government consumption expenditure	0.8	0.6	0.4	0.5
3. Gross fixed capital formation	4.5	-1.5	3.8	4.2
4. Final domestic demand	**2.5**	**1.3**	**1.7**	**1.5**
5. Change in inventories	--	--	--	--
6. Domestic demand	**2.4**	**1.3**	**1.7**	**1.5**
7. Exports of goods and services	6.1	3.9	4.1	4.2
7a. - of which goods	6.6	4.3	3.7	4.7
7b. - of which services	4.8	3.0	5.0	3.0
8. Final demand	**3.5**	**2.1**	**2.4**	**2.3**
9. Imports of goods and services	8.2	3.9	4.3	4.3
9a. - of which goods	8.5	4.6	4.4	4.4
9b. - of which services	6.4	0.5	4.1	4.0
10. Gross domestic product at market prices	**1.6**	**1.3**	**1.6**	**1.5**
Contribution to change in GDP				
11. Final domestic demand	2.5	1.3	1.7	1.5
12. Change in inventories + net acq. of valuables	-0.1	0.0	0.0	0.0
13. External balance of goods and services	-0.8	0.0	-0.1	0.0

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

Annual % change	2015	2016	2017	2018
1. Private consumption expenditure	3.3	3.3	3.2	2.7
2. Government consumption expenditure	1.4	2.5	1.7	1.7
3. Gross fixed capital formation	5.5	-1.2	5.5	5.4
4. Final domestic demand	**3.3**	**2.5**	**3.2**	**3.0**
5. Change in inventories	--	--	--	--
6. Domestic demand	**3.2**	**2.4**	**3.2**	**3.0**
7. Exports of goods and services	5.0	1.8	6.4	5.7
8. Final demand	**3.7**	**2.2**	**4.1**	**3.8**
9. Imports of goods and services	3.6	0.6	7.1	5.9
10. Gross national income at market prices	3.0	3.0	3.4	3.1
11. Gross value added at basic prices	3.4	2.5	3.0	3.0
12. Gross domestic product at market prices	**3.7**	**2.9**	**3.0**	**2.9**
Nominal GDP, EUR bn	179.5	184.7	190.3	195.9

Table 3: Implicit price deflators

% change in implicit price deflator	2015	2016	2017	2018
1. Private consumption expenditure	0.7	1.1	1.5	1.5
2. Government consumption expenditure	0.6	1.8	1.3	1.2
3. Gross fixed capital formation	0.9	0.3	1.6	1.2
4. Domestic demand	**0.6**	**1.1**	**1.5**	**1.4**
5. Exports of goods and services	-1.1	-2.1	2.3	1.4
6. Final demand	**0.1**	**0.2**	**1.7**	**1.4**
7. Imports of goods and services	-4.3	-3.2	2.6	1.5
8. Gross domestic product at market prices	**2.1**	**1.5**	**1.4**	**1.4**
HICP	**0.5**	**0.6**	**1.3**	**1.4**

Table 4: Labour market and cost				
Annual % change	**2015**	**2016**	**2017**	**2018**
1. Labour productivity (real GDP per employee)	0.2	0.1	0.8	0.9
2. Compensation of employees per head	-0.3	1.4	1.2	1.2
3. Unit labour costs	**-0.5**	**1.3**	**0.4**	**0.3**
4. Total population	-0.4	-0.4	-0.4	-0.4
5. Population of working age (15-74 years)	-0.4	-0.4	-0.4	-0.3
6. Total employment (fulltime equivalent)	1.4	1.3	0.8	0.6
7. Calculated unemployment rate - Eurostat definition	**12.6**	**11.2**	**10.1**	**9.4**

Table 5: External balance				
levels, EUR bn	**2015**	**2016**	**2017**	**2018**
1. Exports of goods (fob)	52.6	53.1	56.6	60.2
2. Imports of goods (fob)	60.3	60.7	65.2	69.2
3. Trade balance (goods, fob/fob) (1-2)	**-7.7**	**-7.6**	**-8.7**	**-8.9**
3a. p.m. (3) as % of GDP	***-4.3***	***-4.1***	***-4.5***	***-4.6***
4. Exports of services	20.2	21.0	22.3	23.1
5. Imports of services	11.2	11.3	11.8	12.4
6. Services balance (4-5)	**9.0**	**9.8**	**10.4**	**10.7**
6a. p.m. 6 as % of GDP	***5.0***	***5.3***	***5.5***	***5.5***
7. External balance of goods & services (3+6)	**1.3**	**2.1**	**1.8**	**1.8**
7a. p.m. 7 as % of GDP	***0.7***	***1.2***	***0.9***	***0.9***
8. Balance of primary incomes and current transfers	-1.8	-1.6	-0.9	-0.6
8a. - of which, balance of primary income	*-4.3*	*-4.3*	*-3.7*	*-3.5*
8b. - of which, net current Transfers	*2.5*	*2.6*	*2.8*	*2.9*
8c. p.m. 8 as % of GDP	*-1.0*	*-0.9*	*-0.5*	*-0.3*
9. Current external balance (7+8)	**-0.5**	**0.5**	**0.8**	**1.2**
9a. p.m. 9 as % of GDP	***-0.3***	***0.3***	***0.4***	***0.6***
10. Net capital transactions	2.0	2.0	2.0	2.1
11. Net lending (+)/ net borrowing (-) (9+10)	**1.5**	**2.5**	**2.9**	**3.3**
11a. p.m. 11 as % of GDP	***0.8***	***1.3***	***1.5***	***1.7***

Table 6: Fiscal accounts

	2015	2016	2017	2018
		% of GDP		
Taxes on production and imports	14.5	14.9	14.9	14.8
Current taxes on income, wealth, etc.	10.8	10.4	10.2	10.1
Social contributions	11.6	11.7	11.7	11.5
Actual	9.0	9.2	9.2	9.0
Imputed	2.5	2.5	2.5	2.5
Sales and other current revenue	6.2	6.1	6.5	6.4
Sales	3.7	3.6	3.7	3.7
Other current revenue	2.5	2.5	2.7	2.7
Total current revenue	**43.2**	**43.1**	**43.2**	**42.8**
Capital transfers received	0.9	0.9	0.9	0.7
Other (residual)	7.1	6.9	7.4	7.1
Total revenue	**44.0**	**44.0**	**44.1**	**43.5**
Compensation of employees	11.3	11.3	11.1	11.0
Intermediate consumption	5.8	6.2	6.1	6.0
Social transfers in kind via market producers	1.8	1.8	1.7	1.7
Social transfers other than in kind	17.4	17.2	17.1	16.9
Social payments	19.3	19.0	18.8	18.6
Interest paid	4.6	4.3	4.4	4.3
Subsidies	0.6	0.6	0.6	0.6
Other current expenditure	2.5	2.5	2.5	2.5
Total current expenditure	**44.1**	**43.9**	**43.5**	**43.0**
Gross fixed capital formation	2.3	1.8	2.2	2.2
Other capital expenditure	2.0	0.6	0.4	0.5
Other (residual)	4.6	3.0	2.9	3.0
Interest expenditure	4.6	4.3	4.4	
Total expenditure	**48.4**	**46.2**	**46.1**	**45.7**
General Government balance (ESA2010)	**-4.4**	**-2.3**	**-2.0**	**-2.2**
Primary balance	0.2	2.1	2.5	-2.2
		% change		
Taxes on production and imports	6.3	5.4	2.8	2.8
Current taxes on income, wealth, etc.	2.3	-0.8	1.1	1.4
Social contributions	1.6	4.3	2.6	1.5
Sales and other current revenue	-2.4	0.2	9.9	2.1
Total current revenue	**2.7**	**2.8**	**3.3**	**2.0**
Capital transfers received	-12.5	5.9	7.0	-23.4
Other (residual)	-3.7	0.8	9.5	
Total revenue	**2.3**	**2.8**	**3.4**	**1.5**
Compensation of employees	-1.2	2.6	1.7	1.5
Intermediate consumption	4.9	11.1	1.3	1.5
Social transfers in kind via market producers	1.2	2.0	-2.2	-0.5
Social transfers other than in kind	1.7	1.4	2.2	2.0
Interest paid	-3.4	-2.2	4.9	0.5
Social payments	1.6	1.5	1.8	
Subsidies	-9.7	-1.5	2.0	1.1
Other current expenditure	-3.5	0.3	4.2	2.8
Total current expenditure	**0.3**	**2.5**	**2.2**	**1.6**
Gross fixed capital formation	18.5	-18.6	24.7	5.7
Other (residual)	-31.6	-31.9	-1.2	5.6
Interest expenditure	-3.4	-2.2	4.9	0.5
Other capital expenditure	-49.8	-72.1	-25.3	23.5
Total expenditure	**-3.1**	**-1.6**	**2.7**	**2.0**
Nominal GDP, EUR bn	**179.5**	**184.7**	**190.3**	**195.9**

Table 7: Government debt developments

	2015	2016	2017	2018
ESA2010 deficit (% of GDP)	**-4.4**	**-2.3**	**-2.0**	**-2.2**
ESA2010 gross debt (% of GDP)	129.0	130.5	128.9	127.1
levels, EUR bn				
ESA2010 deficit	**-7.8**	**-4.2**	**-3.7**	**-4.2**
Gross debt	231.6	241.1	245.3	248.9
Change in gross debt	5.5	9.5	4.2	3.6
Nominal GDP	179.5	184.7	190.3	195.9
Real GDP	171.3	173.6	176.4	179.1
Real GDP growth (% change)	**1.6**	**1.3**	**1.6**	**1.5**
Change in gross debt (% of GDP)	3.1	5.2	2.2	1.8
Stock-flow adjustments (% of GDP)	-1.3	2.9	0.2	-0.3
% of GDP				
Gross debt ratio	**129.0**	**130.5**	**128.9**	**127.1**
Change in gross debt ratio	-1.6	1.5	-1.6	-1.8
Primary balance	-0.2	-2.1	-2.5	-2.2
"Snow-ball" effect	-0.2	0.6	0.5	0.6
of which				
Interest expenditure	*4.6*	*4.3*	*4.4*	*4.3*
Real growth effect	*-2.1*	*-1.7*	*-2.1*	*-2.0*
Inflation effect	*-2.7*	*-2.0*	*-1.8*	*-1.8*
Stock-flow adjustments	**-1.3**	**2.9**	**0.2**	**-0.3**
Implicit interest rate	*3.6*	*3.5*	*3.5*	*3.4*

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