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Ex Post Evaluation of the Economic Adjustment Programme

Portugal, 2011-2014

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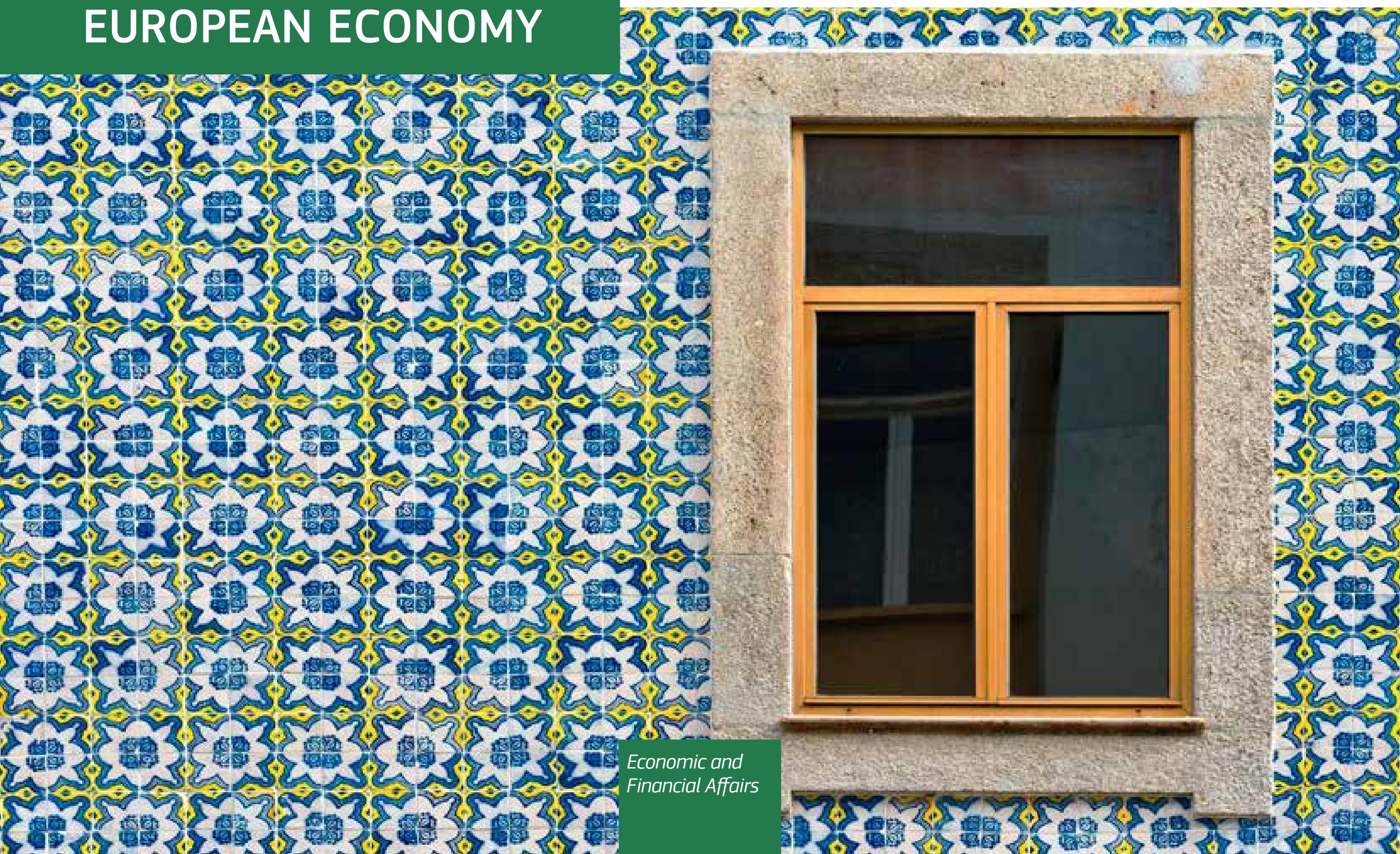

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ABBREVIATIONS

ALMP - Active Labour Market Policy

AMC - Asset Management Company

BANIF - Banco Internacional do Funchal

BCP - Banco Comercial Português

BdP - Banco de Portugal

BES - Banco Espírito Santo

BFL - Budget Framework Law

BIS – Bank for International Settlements

BPI - Banco Português de Investimento

BPN - Banco Português de Negócios

BRRD - Bank Recovery and Resolution Directive

BSSF - Bank Solvency Support Facility

CCL - Commitment Control Law

CdF - Conselho das Finanças Públicas

CES - Extraordinary Solidarity Contribution

CT 1 - Core Tier 1

CET 1 - Common Equity Tier 1

CGA - Caixa Geral de Aposentações

CGD - Caixa Geral de Depósitos

CIT – Corporate Income Tax

CoCos - Contingent Convertible notes

CS – Sustainability Contribution

DFI – Development Financial Institution

DG COMP - Directorate General 'Competition' of the European Commission

DG ECFIN - Directorate General 'Economic and Financial Affairs' of the European Commission

DG EMPL - Directorate General 'Employment, Social Affairs and Inclusion' of the European Commission

DG FISMA - Directorate General 'Financial Stability, Financial Services and Capital Markets Union' of the European Commission

DG TAXUD - Directorate General 'Taxation and Customs Union' of the European Commission

DGTF - Direçao –Geral do Tesouro e Finança

EA – Euro Area

EBA – European Banking Authority

EBITDA - Earnings Before Interest, Taxes, Depreciation and Amortization

EC – European Commission

ECB – European Central Bank

EFSF - European Financial Stability Facility

EFSM - European Financial Stabilisation Mechanism

EIB – European Investment Bank

EIF - European Investment Fund

ELA – Emergency Liquidity Assistance

EPL - Employment Protection Legislation

ESA - European System of Accounts

ESAME - Estrutura de Acompanhamento dos Memorandos (Program Monitoring Unit)

ESF - European Social Fund

ESFG - Espírito Santo Financial Group

ESI - Espírito Santo International

ESM - European Stability Mechanism

ETTRIC – Exercício Transversal de Revisão das Imparidades das Carteiras de Crédito

EU – European Union

FDI - Foreign Direct Investment

GDP – Gross Domestic Product

GGD – Gross Government Debt

HH - Household

HICP - Harmonised Index of Consumer Prices

HNWI - High Net Worth Individuals

IAPMEI - Agência para a Competitividade e Inovação

IGCP - Agência de Gestão da Tesouraria e da Dívida Pública

IMF – International Monetary Fund

INE - Instituto Nacional de Estatística

LME - Liability Management Exercise

LTD - Loan-To-Deposit ratio

LTRO - Long-term refinancing operation

MEFP - Memorandum of Economic and Financial Policies

MFI – Monetary Financial Institution

MIBEL - Mercado Ibérico de Electricidade

MIBGAS - Mercado Ibérico do Gás

MoU - Memorandum of Understanding on Specific Economic Policy Conditionality

NFC – Non-Financial Corporation

NGS - National Guarantee System

NHS – National Health Service

NIIP – Net International Investment Position

NIM – Net Interest Margin

NPL - Non-Performing Loan

NRA - National Regulatory Authority

NRP - National Reform Programme

OECD - Organisation for Economic Co-operation and Development

OIP - On-site Inspections Programme

OMT - Outright Monetary Transactions

PCA - Portuguese Competition Authority

PER - Processo Especial de Revitalização

PES - Public Employment Service

PIT – Personal Income Tax

PPP – Public-Private Partnership

PPS – Post-Programme Surveillance

PSPP - Public Sector Purchase Programme

REFER - Rede Ferroviária Nacional

Repo – Repurchase Agreement

RoRC – Return on Risk Capital

RSI - Social Integration Income

SDR - Special Drawing Rights

SECGEN - Secretariat General of the European Commission

SGP - Stability and Growth Pact

SIP - Special Inspections Programme

SIREVE - Sistema de Recuperação de Empresas por Via Extrajudicial

SME - Small and Medium-sized Enterprise

SOE – State Owned Enterprise

TAP - Transportes Aéreos Portugueses

TFP – Total Factor Productivity

TSCG – Treaty on Stability, Coordination and Governance

ULC – Unit Labour Costs

UTAM - Unidade Técnica de Acompanhamento e Monitorização do Setor Público Empresarial

UTAP - Unidade Técnica de Acompanhamento de Projetos

VAT – Value Added Tax

EXECUTIVE SUMMARY

This document presents an ex post evaluation of the three year EU/IMF financial assistance for Portugal, which ended in May 2014. The three-year Portuguese programme was designed to overcome the economic and financial crisis that led to Portugal requesting financial assistance in April 2011, when the sovereign and banking sector were cut off from market funding. The programme made available €52bn of European funding, split equally between the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) and €26bn from the International Monetary Fund (IMF). The Portuguese programme was the third economic adjustment programme for a euro area (EA) country and made use of stabilisation instruments that were less than a year old at its inception. An ex post evaluation of the design, implementation and outcome of the programme is required by the European Commission, under the Better Regulation agenda ([1]). The aim is to draw lessons for the future, in line with best practice.

The programme called upon Portugal to introduce reforms that were designed to address the weaknesses that had rendered it so vulnerable to the effects of the global crisis, and to set it on a stronger medium-term growth path. The assistance was made conditional on the implementation of policy reforms that were set out in a Memorandum of Understanding on Specific Economic Conditionality (MoU), accompanying the Memorandum of Economic and Financial Policies (MEFP). Amid a challenging external environment, the programme was intended to facilitate and buffer the substantial economic adjustment that was both inevitable and necessary for Portugal to return to economic soundness, by allowing for a more gradual unwinding of the unsustainable domestic and external imbalances that built up in the pre-crisis period.

The Portuguese economy was characterised by a combination of poor performance and weak competitiveness in the years preceding the crisis, alongside unsustainable public finances. Since the early 90s, low productivity growth had led to sluggish economic growth, with rising unit labour costs and deeply-rooted structural deficiencies eroding competitiveness. There were large and persistent fiscal deficits, funding a large and inefficient public sector. By 2010, public debt stood at over 90% of GDP – in part due to reclassifications. As the crisis spread, cracks appeared in the markets' faith of Portugal's ability to pay back already high public and private debt.

Portugal requested financial assistance as bad economic news and deteriorating market conditions priced the Portuguese banks and sovereign out of markets. As growth slowed and markets' appetite for risk declined, Portuguese banks started experiencing financing difficulties in the international markets from the beginning of 2009 due to the risk associated with their exposure to public and private debt. Banks virtually lost market access in mid-2010, relying on the Eurosystem to meet their financing needs. As borrowing and debt figures rose, the spreads on the Portuguese sovereign increased. The Portuguese caretaker government requested financial assistance from the EFSM/EFSF and the IMF on April 7th 2011, following the parliament's rejection of the government's stability programme.

The Portuguese programme correctly reflected the very difficult challenges that Portugal faced: to address immediate fiscal risks and to overcome engrained structural weaknesses which were responsible for Portugal's low potential growth. The programme rightly targeted an ambitious fiscal consolidation underpinned by a number of fiscal governance and structural-fiscal measures. Over a three-year period, the programme aimed at supporting progress in the orderly unwinding of the public and private, internal and external imbalances and in increasing the growth potential, while mitigating negative social impacts. In light of the need of correcting the country's imbalances, the programme aimed at strengthening the banking sector. The challenges faced by the Portuguese economy were deep rooted and tightly interwoven with vested interests; they could also not be solved through simple policy-levers.

([1]) "Better regulation for better results – An EU agenda" (COM(2015) 215 final), "Better regulation guidelines" (SWD(2015) 111 final).

The programme was effective in achieving its primary objective of restoring confidence in the Portuguese economy. It made tangible progress in putting the public finances on a more sustainable footing, improving competitiveness to support economic growth and addressing some of the weaknesses of the financial sector. Portugal was able to return to financial markets before the end of the programme, reflecting both the easing of the financial market conditions and the market perception that the economic weaknesses were being addressed. Portugal made good progress in addressing some of the structural impediments to growth that had built up over the years; however, not all the areas where reform was needed were effectively addressed during the three year programme horizon. Although it increased its resilience, the financial sector was still fragile at the end of the programme.

The programme financing envelope was sufficient to meet Portugal's needs during the three years, but only because the increased access to market funding and other funding sources covered the higher financing requirements of the early years. The €78bn financing envelope was calculated based on the assumption that Portugal would continue rolling over part of its existing stock of short-term debt and slowly return to longer-term bond markets during the last part of the programme. In the early years, Portugal ran higher-than-expected government deficits, which it was able to cover by tapping short-term debt markets more than initially planned. Over the later programme months, it also accessed more longer term market financing than foreseen. Its ability to do this was both a testament to the programme's implementation and the result of an easing of market conditions following monetary authorities' decisions. Without the additional unforeseen market access, Portugal would have struggled to stay within the financial envelope set out in the programme, particularly in the early years.

Portugal was able to effectively withdraw from the programme early thanks to the build-up of a substantial cash buffer. However, the reduced need for programme financing in the final months, contributed to a slow down of the pace of reforms, leaving the economy weaker than it would otherwise have been. Portugal exited its financial assistance programme in May 2014, without accessing the last €2.5 bn tranche of programme financing and without requesting any follow-up precautionary assistance. By the end of the programme Portugal had built up a sizeable cash buffer of €15.6 bn, which was more than the remaining deficit being projected in mid-2014 for the remainder of 2014 and 2015, put together. Taken together with the frontloading of the financing, it meant that the pressure on Portugal had eased by the end of the programme, which contributed to slow the reform process. This allowed the Portuguese government to avoid undertaking certain fiscal reforms and left Portugal with a looser underlying fiscal position at programme exit.

The initial conditions of the EFSM/EFSF loans were set up to be broadly equivalent to the IMF loans, with short maturities and mark-ups for risks on the interest rates; during the programme the margins were cancelled and the maturities were extended twice. Under the original programme, the EFSM and EFSF loans were set up to be broadly equivalent to the terms of the IMF loans. In October 2011, following decisions in the context of the Greek Loan Facility, the Council decided to cancel EFSM margins to programme countries and similar conditions were applied to EFSF loans, making all loans under these facilities considerably cheaper than the IMF ones. In addition, the maturities of the EFSM/EFSF loans to Portugal were extended twice, along with those of Ireland, in 2011 and 2013. By early 2015, Portugal's borrowing costs on the open market fell to below those of its IMF loans. In February 2015, the Eurogroup agreed to allow Portugal to repay over half of its IMF loans ahead of schedule, without an equivalent early repayment of its EFSM/EFSF loans. Portugal made its first early repayments to the IMF in 2015.

The programme aimed at reducing the budget deficit and stabilising public debt, by acting on both expenditure and revenue and by streamlining the public sector through a number of fiscal-structural measures. The initial programme called for the budget deficit to achieve the 3% of GDP threshold by 2013, with public debt peaking in the same year. Fiscal measures were to be supported by a number of actions qualified as 'fiscal-structural measures', which consisted of reforms to the way the public sector operates. Some of these measures built on plans that the Portuguese authorities had already developed.

Portugal broadly met its fiscal targets – which were revised twice due to the impact of events outside the control of the government – partly by making recourse to one-off and temporary measures, undermining the long-term benefit of its policy choices. To meet its targets, Portugal made use of one-offs and other extraordinary measures on both the revenue and expenditure sides, some of which were meant to be replaced by permanent measures over a longer time period. In 2012 and 2013, the fiscal targets were revised because of disappointing macroeconomic developments beyond the control of the government; the rulings of the Constitutional Court overturned several programme measures with significant fiscal impacts and hindered the achievement of the deficit targets. While the non-permanent measures improved sustainability via their immediate impact on the debt, they do not lead to the necessary lasting impact on the deficit. The alternative structural measures were not advanced promptly. Overall, the quality of the consolidation was weaker than planned, but did allow Portugal to stay within the financial envelope.

Portugal shied away from pursuing some of the most difficult measures that would help it over the medium term, although a number of important fiscal structural measures were introduced to improve the efficiency of the public sector. The inefficiencies in Portuguese public spending had accumulated over the years and had a negative impact on Portugal's key weakness: economic growth. Portugal did not make as much progress as desirable in addressing all these inefficiencies. However, the programme achieved structural improvements in State Owned Enterprises (SOEs), Public Private Partnerships (PPPs), the health system and fiscal governance. The absence of a comprehensive plan for a reform of the state, underpinned by an exhaustive and up-front spending review, weighed on the capability to achieve more consistent and sustained savings in the public sector and social security. For instance, expenditure cuts to the public wage bill and pension expenditure were mainly temporary.

The extensive package of structural reforms in the Memorandum of Understanding rightly reflected the broad-based economic inefficiencies and distortions at the root of the crisis, but implementation might have been better if there had been a sharper focus on critical areas. The Portuguese programme included numerous and deep structural measures that touched on all the main policy areas. This was because the Portuguese crisis was the result of broad-based economic inefficiencies, unlike in some other countries where the problems were concentrated in a few sectors, like housing and/or the financial sector. These weaknesses included a lack of adequate human capital, poorly functioning labour markets, declining labour cost competitiveness, inefficiencies in product markets characterised by excessive economic rents in many non-tradable sectors, an inefficient judicial system, malfunctioning housing market and deficiencies in the business environment. The programme partners agreed that all these areas needed to be tackled, at least in part, during the programme. The result was that even if more emphasis was put in some areas (i.e. labour, judicial and housing reforms) there was not a sufficient degree of prioritisation. The MoU envisaged a broad step change in the momentum of reform in a country in which necessary reforms had not been forthcoming. At the same time, ambition and pragmatism could have been better balanced, bearing in mind limits to administrative and political capacity to address all problems at the same time.

Implementation of structural conditionality was uneven, with labour market reforms being more strongly pursued, especially at the start of the programme. While many of the labour market reforms were implemented in the first part of the programme, progress on other reforms was slower and patchier. This was probably because the ground for labour market reforms was better prepared as already agreed with the social partners in March 2011 and because labour market reforms are administratively easier to implement. Delays in other reforms also appear to be partly linked to the relative strength of vested interests. The timing of many reforms was influenced by factors including the need to conduct social dialogue, the demands placed on the legislative system, or the desire for transitional periods or protections. An earlier and more determined implementation of some reforms, especially concerning the product markets, would have had benefits and increased Portugal's future growth potential.

The scope of the programme's labour market reforms was broadly correct in the sense that it matched the main challenges; important progress was achieved. Where programme performance was mixed, it seems to have been linked more to shortcomings in the detailed specification and implementation of measures – and long time lags – rather than major omissions in the programme design. Many of the measures in the MoU were based on a March 2011 tripartite agreement, between the government, employers and business representatives, and labour unions. While this limited the scope of the deregulation, it facilitated implementation. Important labour market reforms were adopted during the programme, and firms consider them to have had a significant impact. The momentum of reform, however, dropped over time and whilst progress has been made, further reforms are still needed.

The measures covering product markets and framework conditions were overall well designed, but implementation was not as strong as in other areas. The programme essentially tried to address every area where there were factors eroding competition and/or unduly increasing domestic production costs. Under the programme umbrella, significant progress was made in important areas where reforms had been long due, including housing and judicial sectors, the electricity tariff debt, transport SOEs and road PPPs and the business environment. Implementation was weakened where the intended policies turned out to be politically or socially sensitive and in key areas with strong vested interests. Many of these measures were still pending at the end of the programme (e.g. energy, regulated professions or ports). The scale of reforms also stretched the Portuguese authorities' implementation capacity. In the latter part of the programme, these existing challenges appear to have been compounded by reform fatigue.

Clearer communication on the necessity of structural reforms and their longer-term benefits might have helped overcome some of the resistance to reforms. Although the initial MoU linked the package of reforms with analysis of economic challenges and the necessity of adjustment, communication on the relationship between timely and effective implementation of structural measures and the programme goals could have been more consistent. At the same time, the scope of the reforms needed meant it should have been better communicated that a three years programme could only be the starting point of a necessarily longer-term reform process.

The programme appropriately targeted strengthening the banking sector. The banking sector was expected to face considerable challenges, as a consequence of the needed correction of the country's structural imbalances. The programme strategy envisaged increasing the banks' resilience to delink their market access from the sovereign one and to reduce reliance on Eurosystem financing, while ensuring adequate liquidity to avert a credit crunch. The programme envelope contained €12 billion to be disbursed to the Bank Solvency Support Facility (BSSF) to support the financial sector. While the programme correctly identified the key issues faced by the banking sector, the scale of the problem was underestimated and resulted in policy implementation that left the banking system with too much residual weaknesses at the end of the programme.

Both the programme design and the programme implementation should have pursued a more frontloaded adjustment of the banks' balance sheet. The programme design recognised the need to strengthen the banking regulation and supervision, and the banks' capital position, including through the combination of asset quality reviews and stress tests. The banks' capital levels increased during the programme. However, the asset quality reviews required repeated rounds to ensure adequate assessments. The stress tests did not foster prompt actions to improve the resilience of all the covered banks, including under stress scenarios. The supervisory authority did not require a more robust recapitalisation/ restructuring of the banks. With Banco de Portugal (BdP) responsible for the design and implementation of the bank recapitalisation, the programme could have better emphasized the importance of the different strategies, provided more detailed guidance and put more pressure on implementation. Bank supervision actions should also have been tighter with regard to provisioning and write-offs, especially when the problems related to the economic slow-down became more evident. A publicly available analysis, in the programme context, about the advantages and drawback of different options to tackle non-performing loans (NPLs) could also have been helpful, to support the implementation of the most effective policies.

A prompter adjustment of the troubled Banif and Banco Espírito Santo (BES) would have been beneficial, and a more forceful approach towards Caixa Geral de Depósitos (CGD) could also have been warranted. BES and Banif were resolved after the end of the programme. With the benefits of hindsight, a more forceful supervisory approach could also have fostered the adjustment of the two banks, although in the case of BES some elements leading to its resolution emerged only gradually. Prompter action could have reduced the potential costs, without causing financial instability; the resolution framework had been promptly put in place. In the case of CGD, a deeper streamlining of the bank, possibly accompanied by concrete steps towards its full privatization, could have helped reduce the contingent risks for the state and foster competition in the banking sector. Prompter supervisory or resolution action would have been manageable, within the envelope for the financial sector set up by the programme, since about half of it (€6.4 billion) was not used during the programme.

The programme rightly contained requirements to deal with high private debt and provide credit to the viable firms, but progress in developing financial instruments outside the banking system was limited. During the programme, bank lending decreased more and for longer than initially projected due to declining credit demand and supply. By 2013 credit flows were re-orientated towards more productive and tradable sectors, but the overall adjustment of the private sector balance sheet is yet to be completed. To maximize the short-term effectiveness, the Portuguese authorities targeted initiatives to foster lending through the banking channel. More progress in the development of the capital markets could have contributed to pave the way for a sustained recovery. Better coordination at the level of both the Portuguese and the EU authorities, together with the set-up of ad hoc task forces, could have been helpful.

Social and distributional considerations were rightly taken into account when designing many of the programme measures. Many programme measures included provisions with strong progressive effects and to protect the worse off. Tax increases, public wages and pension cuts were designed in a progressive way, minimum wages and the lowest pensions were untouched and the coverage of some social benefits was extended (e.g. unemployment benefits), while their generosity was reduced. However, some fiscal measures – such as the reform of the minimum income guaranteed scheme – were regressive and could have been avoided or limited in scope. The historically very high poverty and income inequality levels of Portugal indicated that there was scope for clear improvement of the social protection system. The efficiency of the social expenditure to ensure proper targeting to the most in need and adequate incentives could have been strengthened during the programme.

Mitigating the negative social impacts of the adjustment was part of the programme objectives, but no explicit social goals or specific requirements on monitoring social developments were set. Given the importance of fair burden sharing in maintaining public support for the programme, distributional issues could have been more clearly, explicitly and systematically addressed in programme reviews and reports. Setting hard targets in this area may be difficult. But more emphasis on monitoring and reporting on the social dimension would have been warranted. There is a public perception that the outcome of the programme was socially unbalanced. Since the monitoring and reporting aspects were largely overlooked, there is insufficient evidence to corroborate or refute this perception.

The Portuguese programme benefited from strong political commitment, including a strong organisational response. The negotiations on the Economic Adjustment Programme took place in a cooperative environment in consultation with the main opposition parties and other civil society partners. The Programme received public support from the then main opposition parties which suggested a broadly-based political ownership of the programme at its inception and a commitment to sound implementation. Portugal established promptly a special unit (ESAME), which reported to the Prime

Minister, with the task of monitoring the implementation of the programme, in liaison with the line Ministers. Taken together, this meant that Portugal was able to exploit the positive relationship with its partners.

Portugal made good reform progress over the programme years, but faced challenges that can only be fully resolved taking a longer-term perspective. Despite Portugal's commitment to change, its long-standing structural weaknesses would realistically have required ongoing reform beyond the programme period. The reforms undertaken in the programme should form a solid basis for the transition back to sound economic conditions, provided they are not rolled back. To capitalise on these improvements, it is important that Portugal continues to pursue reforms further strengthening its competitiveness and ensuring sustainable public finances.

The following lessons can be drawn from this ex post evaluation of the Portuguese financial assistance programme, in light of the relevance, effectiveness, efficiency and value added of the programme:

Financing Needs

Assumptions about financing needs should be prudent so as to reflect the uncertainties prevailing at the time, such as contingent liabilities of the public sector and market access developments. The size of the financial envelope should add credibility to the programme's overall objective of facilitating return to the sovereign financial markets.

Earmarking the financial envelope for the banking sector helps prevent its use for other needs especially in the presence of a delayed adjustment of the banks' balance sheet.

A specified target for cash buffer developments should be part of the programme envelope design. The latter contributes to market access and a clean exit from the programme, but can reduce the incentives for reform over time.

The intervention at EU level adds significant value in terms of expertise, credibility, coherence with other EU policies and provides for an adequate financing envelope at very low costs.

Fiscal Policy and Structural Reforms

When a crisis is rooted in broad-based economic and fiscal inefficiencies, programmes should include a wide package of structural and fiscal-structural reforms, embedded in a clear strategy which allows a focus on the most macro-critical weaknesses affecting the functioning of the economy and the sustainability of public finances. Including other reforms risks overstretching administrative capacity and making decisions on the completion of the regular programme reviews more complex.

At the very beginning of the programme, an overall strategic plan, underpinned by an in-depth spending review, should be set to steer and frame the ensuing fiscal effort. This plan should be immediately followed by further analysis to single out a few reforms on which political capital and administrative capacity should be prioritised. For these reforms, detailed implementation plans should become gradually part of the MoU with strong specific monitoring. The use of technical assistance should be considered.

When an upfront comprehensive strategy for expenditure cannot be undertaken quickly, it may be more effective to focus on revenue increases, even when there is a clear need for expenditure cuts. This should buy more time for implementing structural expenditure measures, while limiting the recourse to one-off and temporary measures.

When consolidation is excessively based on temporary measures, further improvements may still be needed after the end of the programme. In a climate of reform fatigue, the expiration of temporary measures or the unwinding of other measures without proper replacement is a sign of the insufficient leverage of post-programme surveillance. The corrective arm of the Stability and Growth Pact (SGP) can help deliver some of the needed improvements, as would be the case with any other EU country.

High levels of domestic political and social sensitivity and strong vested interests can lead to delays and mixed implementation of key structural reforms. Strong prioritisation and clear communication are necessary for maintaining national ownership of the reform process, overcoming resistance and achieving implementation of fair and efficient reforms.

The necessary labour market reforms should be implemented without delay. If product market reforms cannot proceed at the same pace, they must be accelerated as much as possible in order to make the overall process more effective and fair.

Banking Sector

Strengthening and cleaning the banking sector is a crucial part of facilitating the correction of a country's macro-imbalances. This correction also requires other policy measures, including fostering private debt restructuring and maintaining an adequate level of credit to viable firms.

The bank capital requirements should reflect credible assumptions on the losses yet to be realised. Independent top-down and bottom-up assessments are instrumental to increase transparency and confidence about the estimation of capital needs. Losses should, in turn, be promptly recognised.

A publicly available analysis about the advantages and drawback of different options to tackle NPLs is helpful. Reducing NPLs requires the prompt implementation of a balanced combination of different policies, including enhancing supervision, developing distressed debt markets, facilitating company restructuring.

Active capital markets are an important buffer for financing the real economy when the banking sector is under restructuring. Their development is difficult in a programme context, when other immediate pressures are high, and requires time and coordinated efforts from national and supranational authorities.

Restoration of banks' viability and market confidence go hand in hand, in a mutually reinforcing process. Policy aimed at addressing the weaknesses of a banking sector in a country subject to a macro adjustment should be implemented promptly and forcefully, in order to avoid delayed tackling of problems that could jeopardise the overall programme's achievements.

Social Developments

The social impact of the crisis and of the adjustment process should be regularly monitored and reported upon in programme documents.

While it is known that economic crises and the subsequent adjustment can have high social costs, the distributional and social implications are generally difficult to estimate accurately at the start of the programme. However, programme measures should be shaped to take equity and social considerations into account, aiming at progressive burden-sharing and protection of the most vulnerable.

Ownership

Sustained ownership is crucial for programme success. However, ownership can be negatively affected by several factors, including the absence of a strong plan for the most comprehensive reforms, of clear communication on structural reforms long term benefits and on the distributional impact of the reforms, as well as the relaxation of the financial constraints once the country returns to the market. Overall, reform fatigue and time needed for structural reforms to be implemented and yield results raise questions about the optimal duration of a programme and the trade-off between ownership and return to the market.

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1. INTRODUCTION

In June 2014, Portugal's economic adjustment programme supported by EU-IMF financial assistance ended. The programme was meant to overcome the economic and financial crisis that brought Portugal to request assistance in April 2011 when the sovereign and the banking sector were increasingly cut off from market funding. Amid a challenging external environment, the programme was intended to facilitate the substantial economic adjustment and to buffer its impact, including by supporting the unwinding of unsustainable domestic and external imbalances built up during the pre-crisis period. The primary programme objectives were to restore confidence, put the public finances on a sustainable footing, stabilise the financial sector and underpin competitiveness and sustainable economic growth.

The programme made available €52bn EU funding, split equally between the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) and €26bn from the IMF. The provision of financial assistance was conditional on Portugal implementing policy reforms that were set out in a Memorandum of Understanding on Specific Economic Policy Conditionality (MoU) accompanying the Memorandum of Economic and Financial Policies (MEFP).

This report presents the findings of the *ex post* economic evaluation of the programme design, implementation and outcomes. The purpose of this evaluation is to assess the adjustment programme in order to draw lessons to inform the policy debate and improve future policy-making, when designing and implementing adjustment programmes, whether in the euro area or elsewhere. To do so, it looks at how the design and implementation of the programme have contributed to the evolution of the Portuguese economy and the attainment of the programme's objectives. The approach is qualitative in the sense that the conclusions are based on economic judgement rather than on an econometric model. This is because it is not possible to construct a credible counterfactual at a time of such changing economic conditions in both Portugal and its partners. In addition, this approach allows the impact of aspects of the programme which cannot be quantified but may nevertheless be important – such as the political context – to be considered.

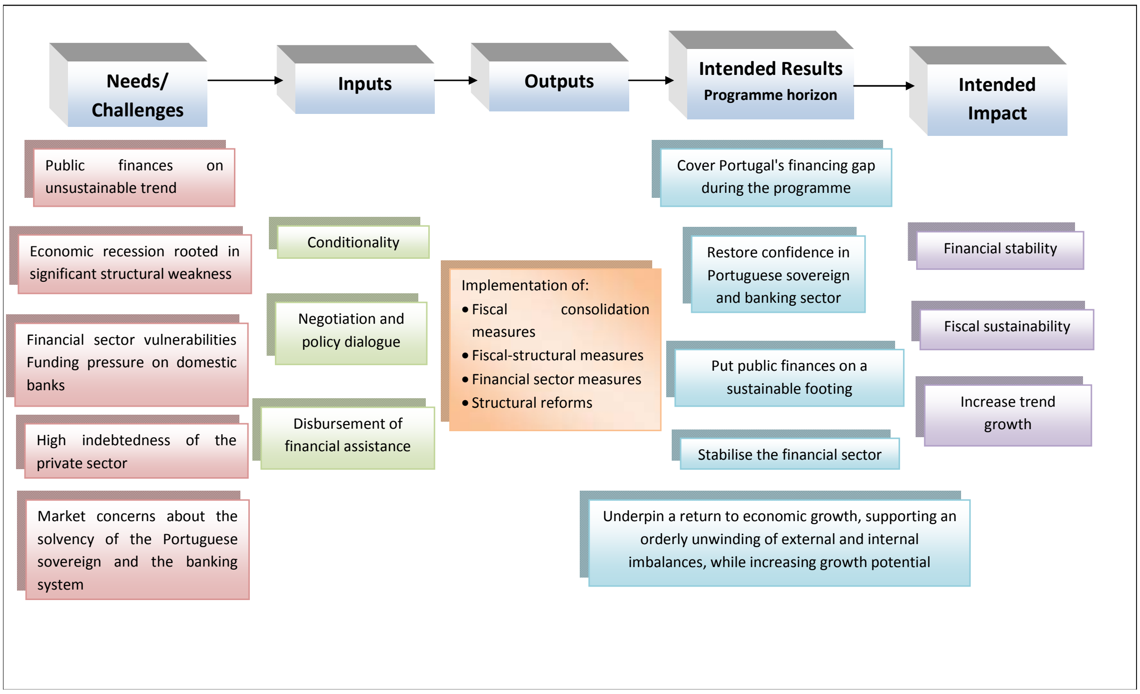
This evaluation is in response to the European Commission's requirement to evaluate the impact of its policies. ([2]) Programme conditionality was jointly developed by staff from the Commission, IMF, ECB and Portuguese authorities, and subsequently endorsed by the Eurogroup and the IMF Executive Board. In accordance with this process, the evaluation does not consider the action of the programme partners in isolation. The Commission's internal working arrangements, as well as those in relation to the IMF and the ECB fall outside its scope, as do the actions of the Portuguese authorities prior to the programme. In line with international good practice, particular care was taken to create an institutional separation between the evaluation and the implementation of the programme itself, to ensure the independence and impartiality of the exercise. Annex 1 provides more details on these arrangements.

Using the framework set out in the European Commission's evaluation standards, the evaluation considers the Portuguese economic adjustment programme under the structure set out in Figure 1, below. Over a three-year period, the programme provided financial assistance and aimed at addressing the imbalances of the Portuguese economy and the loss of market confidence, through the implementation of a number of fiscal, fiscal-structural, financial and structural measures. The financial assistance programme was intended to cover Portugal's financing gap and to allow the country to regain market access, while putting the public finances on a sustainable footing, stabilising the financial sector and underpinning a return to economic growth. The relevance, appropriateness (efficiency) and effectiveness of the programme's inputs are assessed in terms of their contribution to the programme's intended results over the programme period and their impact on the economy of Portugal. Whilst the programme was a response to a crisis scenario, the evaluation also draws conclusions on coherence and EU added value. Like all financial assistance programmes, the Portuguese one is extensive and complex. Flexibility is needed to enable the

([2]) "Better regulation for better results – An EU agenda" (COM(2015) 215 final), "Better regulation guidelines" (SWD(2015) 111 final).

programme to adapt to both internal and external economic development. For this reason, it is not straightforward to systematically disentangle the difference between the design of the programme and its implementation in the evaluation. Annex 1 discusses this in greater depth and provides more details on the overall evaluation approach. This evaluation is a performance rather than a compliance oriented exercise.

Intervention logic of Economic Adjustment Programme for Portugal 2011-2014



The remainder of the report is organised as follows. Section 2 gives a short overview of the roots of and run-up to the crisis. Section 3 considers the size and terms of the financing envelope. Sections 4, 5, and 6 assess policy design and results for the fiscal policy, structural reforms and financial sector, respectively. Section 7 analyses social developments during the programme period. Section 8 looks at the performance of the Portuguese economy and sheds light on the remaining challenges. Section 9 concludes by answering the evaluation questions about the relevance, efficiency, effectiveness, added value and coherence of the programme with other EU policies and discusses some broader lessons from the experience of the economic adjustment programme. The evaluation is based on information available up to the end of June 2016. The method and process followed for this *ex post* evaluation are described in Annex 1. The Portuguese authorities' views on the *ex post* evaluation are reported in Annex 2.

2. WEAK GROWTH AND RISING DEBT: AN ACCIDENT WAITING TO HAPPEN

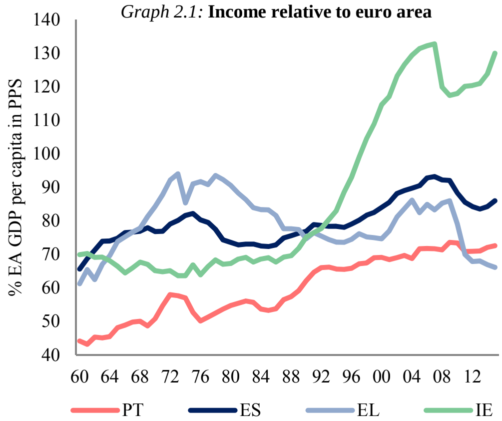
This chapter reviews the circumstances that led to Portugal's request for external financial assistance.

2.1. INTRODUCTION

The Portuguese crisis mainly resulted from a combination of poor economic performance and lack of competitiveness in the years preceding the crisis and unsustainable public finances. For many years the government ran large and persistent fiscal deficits often exceeding the limit set by the Stability and Growth Pact (SGP). ([3]) These public deficits came along with a decade of economic stagnation spurring doubts about the ability of the economy as a whole to pay back an already high level of public and private debt.

The poor economic performance had led to the accumulation of significant external imbalances. For many years, the economy had been performing poorly with very low growth with almost no catching-up process with the EU average. Despite its initial low level of income, EU accession and sizeable Structural Funds did not spur a strong convergence process. From 1992 to 2007 the Portuguese income per capita hardly caught up: it was at 66% to 70% of the euro area GDP per capita (in purchasing power standards – Graph 2.1). Moreover, at the turn of the millennium, cheaper borrowed funds thanks to the introduction of Euro were not used for productivity-enhancing investments and led to the accumulation of significant external indebtedness. The Portuguese economy entered a protracted slump associated with low productivity growth, while rising unit labour costs and deeply-rooted structural deficiencies eroded competitiveness.

Graph 2.1: **Income relative to euro area**



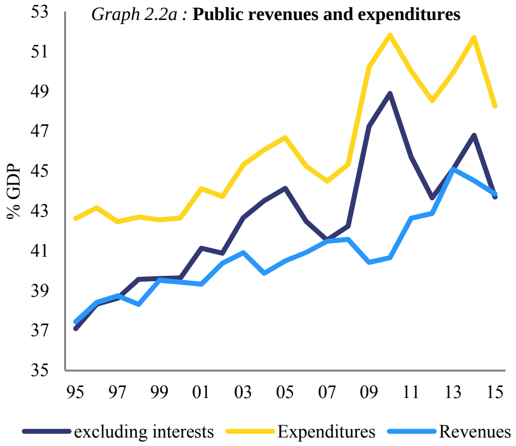
Source: Ameco

Poor economic performance was deeply-rooted in structural deficiencies affecting most of the functioning of the economy and in a large and inefficient public sector. As will be discussed in the subsequent sections, the list of structural weaknesses is long: wage setting mechanisms not reflecting changes in productivity, excessive and rigid labour market regulation, inefficient judiciary system, obsolete insolvency legislation, barriers to entry in regulated professions. The Portuguese economy was characterized by a large public sector with key areas dominated by large inefficient state-owned enterprises (SOEs) sheltered from competition and henceforth able to maintain high margins and wages.

([3]) If one considers the series after the reform that integrated in the government part of the state-owned enterprises, in fact it exceeded the limit systematically. See DG ECFIN (2008b) and IMF (2008).

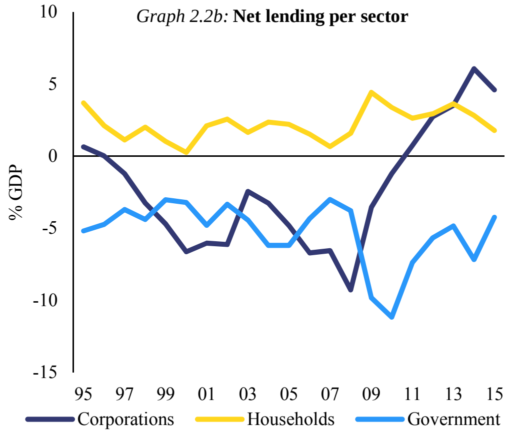
Large public deficits were associated to the crisis but before the crisis there was a persistent gap between expenditures and revenues. These deficits stem from a structural gap between revenues and expenditures: both grew during this period, with the exception of expenditures in a short-lived fiscal consolidation in 2006-2007, but revenues systematically fell short of expenditures (Graph 2.2a). As a consequence, at the outburst of the financial crisis in 2008 outstanding public debt amounted already to about 70% of GDP. The situation worsened significantly in 2009 and 2010 when the general government deficit increased to around 10% of GDP. By the end of 2010 public debt was exceeding 90% of GDP. Markets reacted to this deterioration of public finances; during 2010 the spread with German 10-year bonds grew from below 1 pp to around 4 pp despite the swift economic recovery after the initial contraction. The vulnerability of the government was aggravated by the relatively low average maturity of public debt that contributed to spur doubts about the ability of the government to roll-over its debt, and the uncertainty on the underlying fiscal dynamics, due to the relatively weak fiscal governance.

Graph 2.2a : **Public revenues and expenditures**



Source: Ameco

Graph 2.2b: **Net lending per sector**



Source: Ameco

The banking sector, like in many other euro area countries, acted as a risk transmission mechanism. The banking system was the main intermediary between the domestic financing needs and the external financing sources. The banks were exposed to the risks arising from the high domestic public and private debt, on the one hand, and the risks of not being able to refinance their own debt in the international markets, on the other hand. Increasing risk aversion in Europe and the slowdown of the Portuguese economy meant that the Portuguese banks started experiencing financing difficulties in the international markets already at the beginning of 2009. In a typical self-fulfilling prophecy, the financing terms of both the Portuguese state and banks deteriorated in parallel, until the banks virtually lost market access in mid-2010, relying on the Eurosystem to meet their financing needs.

2.2. A GRADUAL BUILD UP OF MACROECONOMIC IMBALANCES

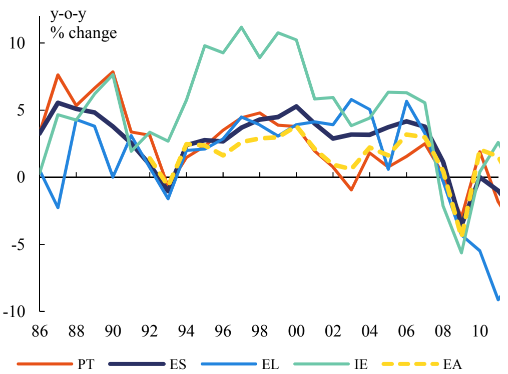
After accession to the European Union, Portugal experienced a short and mild boom in 1986-1992 due to increased trade and EU transfers, reforms of SOEs and a benign external environment. In 1986 Portugal entered the EU with a relatively low GDP per capita, significantly lagging behind the average economic development level of the EU Member States. SOEs were more prevalent than in other EU countries, with the non-financial ones accounting for 25% of value added and 12% of total employment. Over-extended public ownership reduced the level of competition and productivity in the Portuguese economy and was a (partly hidden) burden on the public finances. ([4]) In the first years after

([4]) A number of SOEs were monopolies. Public ownership reduced managerial incentives for cost reduction and technical advance. At aggregate level, SOEs were significantly loss making and accounted for the combined deficit of 8 percent of GDP in 1985-86.

accession, the Portuguese economy grew by an average growth rate of 5.3%, ahead of Ireland and Spain. This was due: firstly, to increased trade ties and the recovery from the crisis of the 1980s; secondly, to market-driven policy giving public enterprise managers greater autonomy and improving the financial situation of SOE with an aggregate effect of 7% of GDP; thirdly, favourable exogenous factors, such as lower oil prices, lower interest rates, and the depreciation of the dollar played a role; finally, funds allocated by the European Communities (averaging 1.5% of annual GDP during 1987-90) helped improve the country's infrastructure and professional training. This period of relatively high growth allowed Portugal to achieve an increase in the GDP per capita from 53% to 66% of (the future members of) the euro area (in purchasing power standards – Graph 2.1). The Portuguese relative boom years ended with the European exchange-rate crisis in 1992-93.

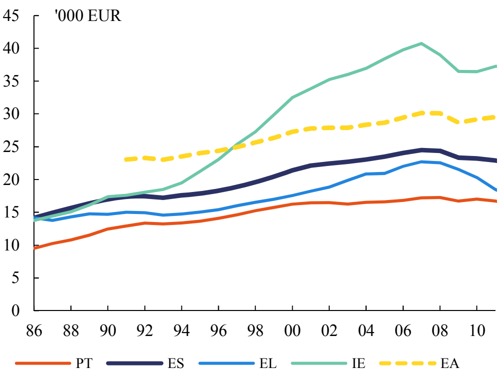
In the following years (1994-1999), Portugal's convergence to EU average GDP slowed, while the foreign indebtedness of the country increased. Reforms to the public sector stalled. In spite of muted growth (Graphs 2.3a and 2.3b), Portugal was steeply increasing its indebtedness towards foreign private investors. Since the beginning of the 1990s, both public and private (corporations) borrowing induced persistent high current account deficits – allowing domestic spending to outpace income (See Graph 2.2b and 2.4a). The reliance on foreign borrowing was accelerated by the sharp fall in Portuguese long-term interest rates from 10% in 1995 to around 4% before introduction of euro. Market participants deemed that the value of their investments in the country would no longer be vulnerable to erosion through currency depreciation. At the same time, the wage compensation growth significantly outpaced labour productivity, by more than in Spain though less than in Greece. (See Graph 2.5b) This only came to an abrupt halt when private foreign lending stopped flowing in in the context of the crisis.

Graph 2.3a: **Real GDP growth**



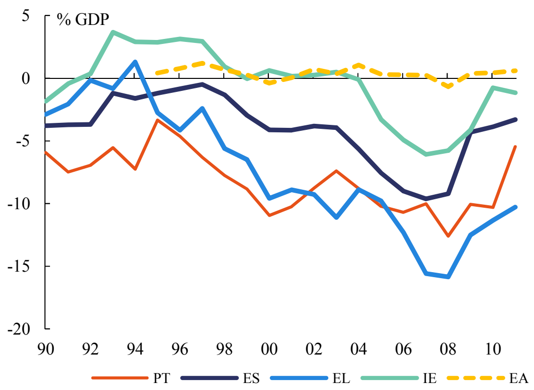
Source: European Commission

Graph 2.3b: **GDP per capita**



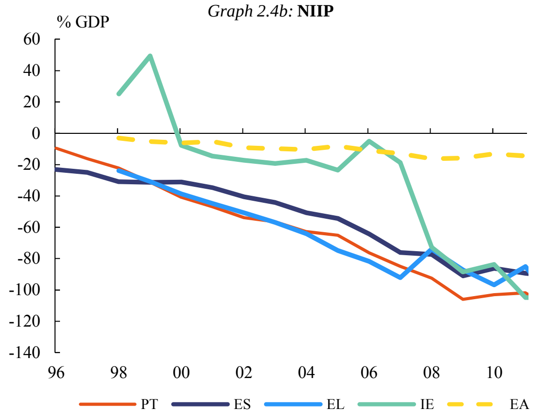
Source: European Commission

Graph 2.4a: **Current account balance**



Source: European Commission

Graph 2.4b: **NIIP**



Source: European Commission

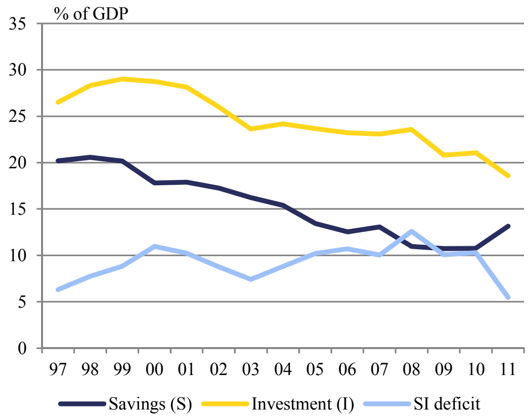
Membership in the euro area since 1999 did not trigger another catching up process of the Portuguese economy. Despite access to favourable financing conditions, Portugal grew in 1999-2007 less than other EU countries and the euro area on average and significantly less than Ireland, Spain, and Greece, which experienced a relative boom (Graph 2.3a). The productivity slowdown in Portugal was very pronounced: average growth of labour productivity fell from 5.7% in 1985-1992 to 0.8% in 1999-2006. Low productivity growth is the main source for the decline in growth of the Portuguese economy and persistently low living standard in terms of GDP per capita ([5]). Another factor was low labour utilisation due to increasing unemployment, reaching 9% in 2007. A large share of it was due to increases in long-term unemployment. The significant fall in total factor productivity (TFP) since 1999, represented the decline in technical, allocative and/or scale efficiency. ([6]) Having it stable, would have allowed the Portuguese economy to grow at an average rate of 3.5% instead of the observed rate of 1% in pre-crisis years (2002-2007). ([7]) Due to persistent current account deficits, net foreign assets of Portugal were sharply deteriorating (See Graph 2.4b).

([5]) Source: EU KLEMS database (Growth Accounting to 2007). The country files are based on the releases of November 2009 and March 2008 of the database produced by the Groningen Growth and Development Centre (The Netherlands).

([6]) Some authors emphasise lack of allocative efficiency in the Portuguese economy, notably in the largely non-tradable services' sector (Dias, D. *et al*, 2014), while other also point to lack of economies of scale due to policy measures favouring SMEs at the expense of large firms (Braguinsky, S. *et al*, 2011, Reis, R, 2013).

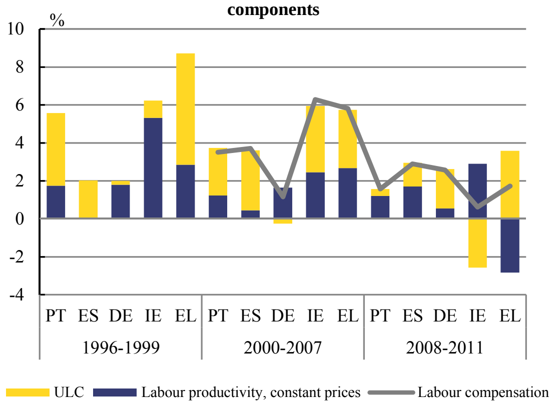
([7]) According to the European Commission estimates.

Graph 2.5a: **Saving and investment balance**



Source: Eurostat

Graph 2.5b: **Average growth in labour compensation components**



Source: OECD

Borrowed funds were not used for productivity-enhancing investments in the tradable sectors, which would have allowed a rebalancing through improved export performance. While it is not unusual for catching-up countries to run-up sizeable current account deficits when investing to build up their capacity, this should lead in the medium term to current account surpluses since investments increase performance in tradable sectors and have positive effects on growth. This did not occur in Portugal. At the end of the 1990s, Portugal had a very high investment spending as a share of GDP (above those of Spain, Ireland, Greece and Germany), which was falling in the 2000s. Foreign borrowing took also place because of relatively low levels of saving ([8]), supporting excess consumption and investment but at the cost of building up a debt burden (Graph 2.5a). The tax regime also favoured consumption and the accumulation of debt in the NFC sector. ([9]) Increasing indebtedness was a problem to the extent that higher investment did not result in higher growth or gains in export market shares.

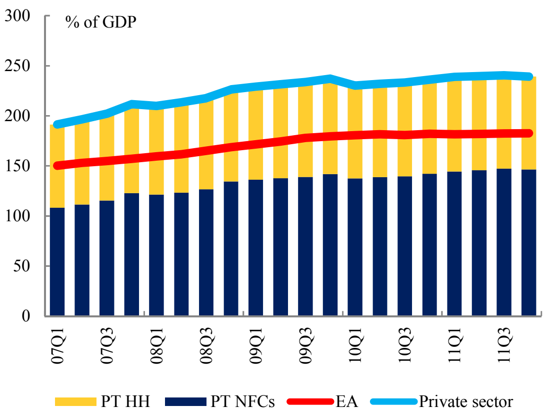
Favourable financing conditions also allowed banks, corporates, and private households to accumulate significant debts. Most of the capital inflows came through the domestic banking sector. Corporate capital market financing and foreign direct investment flows were marginal. Credit availability at low rates and low propensity to save fuelled consumer spending (Graph 2.6b). As a result, the indebtedness of both households and non-financial corporations already high in the beginning of 2000s (significantly above the euro area average) further increased (Graph 2.6a). The construction sector and real estate services were particularly leveraged, with the ratio of bank loans to gross value added of 195% in 2003-H1 2008 – again amongst the highest in euro area. ([10])

([8]) While most of the euro area countries had a relatively stable savings rate to GDP for the total economy of around 20-25% in 2000s, with the notable exception of Greece, in Portugal this ratio has declined from an already low level of 18% in 2000 to 11% in 2008. Investment fell as well but less than savings opening a gap filled-in by foreing borrowing (source: AMECO database).

([9]) The implicit tax rate on consumption was below EU and euro area averages, mainly due to extensive use of the reduced VAT rates. The Portuguese tax system had a significant debt bias, measured as the difference between the effective marginal tax rates for new equity and debt-funded investment. See Section 4.

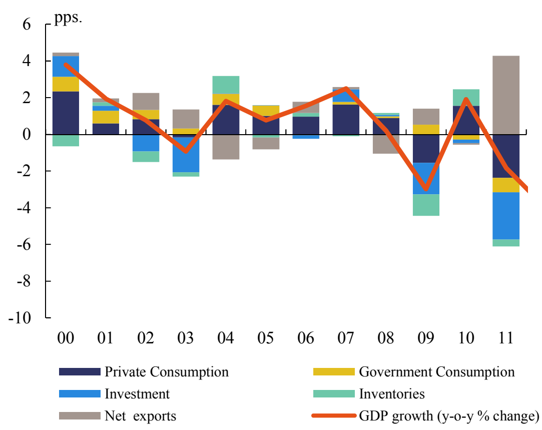
([10]) ECB (2013a). Once banks started deleveraging in the early stages of the crisis in 2008, this sector suffered the most, resulting in large increases in unemployment, as the employment in the sector reduced by around half. Source: Eurostat.

Graph 2.6a: **Private Sector non-consolidated Debt**



Source: European Commission, OECD

Graph 2.6b: **GDP growth and its components, Portugal**



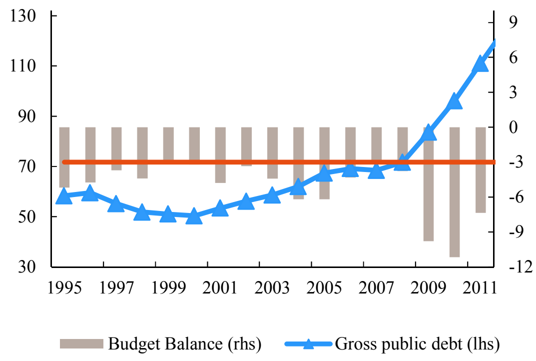
Source: European Commission

Portugal presented persistently high budget deficits. With hindsight, Portugal's budget deficit (net of one-off deficit decreasing measures) was above 3% of GDP in all years since at least 1995. ([11]) Fiscal deficits were driven by public expenditure increasing faster than public revenue, while tax revenues as a share of GDP also increased in the pre-crisis period (Graph 2.7b). Most of the rise in the public expenditure was coming from the safety net to the pensioners through the minimum pension and the rise in public sector pensions. ([12]) Since 1996, expenditures in old age pensions have doubled going from 5% to 12% of GDP. Over-employment in the public sector was also at the source of the problem, including in the education sector, security forces, and in lower qualification positions. Moreover, the public remuneration system was inconsistent with the skills and responsibility levels across public sub-sectors and profiles. ([13]) There also was a lack of control and efficiency of expenditure in the healthcare sector.

Costs linked to Public-Private Partnerships (PPP) and SOEs were weighing heavily on present and future public finances. Over time, Portugal had engaged into one of the largest PPP programs in the world, mainly to finance investments in infrastructure such as roads or hospitals. ([14]) The Portuguese SOE sector was very large, controlled by different players (State, regional and local governments), loss making, and hence contributing to an increase in Portuguese public debt through one-off recapitalisation measures and subsidies.

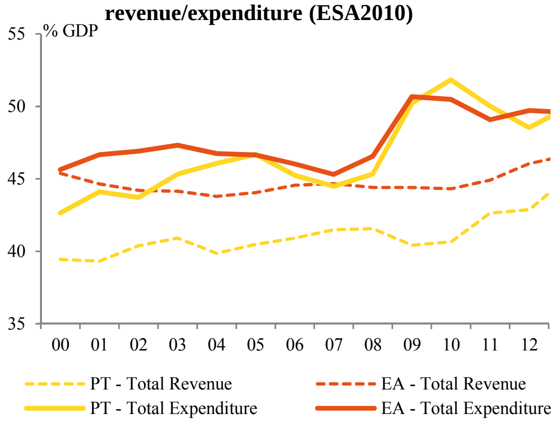
([11]) Taking into account the data as updated by the Eurostat, including retroactively. See also footnote 3.
([12]) Reis, R. (2013)
([13]) DG ECFIN (2012c), IMF (2013a), Mercer (2013). See also Giordano, R. *et al*. (2011) and De Castro, F. *et al.* (2013).
([14]) IMF (2011a)

Graph 2.7a: **General Government deficit and debt (% of GDP)**



Source: European Commission (AMECO), OECD.

Graph 2.7b: **General Government - Total revenue/expenditure (ESA2010)**



Source: European Commission

Since joining the euro area, Portugal's public debt had also been steadily increasing. High budget deficits and low economic growth put the debt-to-GDP ratio on a steadily increasing path since the beginning of the decade. The government debt-to-GDP ratio, which was below 60% in 2003, increased by 45 pp between 1999 and 2010, reaching 96% of GDP (Graph 2.7a). Reflecting the smaller pool of private sector savings, the share of foreign holders of sovereign debt was structurally high and increasing, reaching 75% in mid-2009.

The consistent budget deficits over the years contributed to further build up macroeconomic imbalances. In the context of the creation of the monetary union, monetary policy tools are not available to help the economy adjust to domestic shocks so it is fiscal policy that has to stabilize the economy. However, Portugal chose to run large fiscal deficits pursuing a pro-cyclical fiscal policy (Graph 2.7a). As for long-term growth, while some attempts or plans for structural reforms were made in the areas of health care, public pensions in the years prior to the crisis, they did not prove to be effective or sufficient in the medium-term, leaving the economy structurally weak.

2.3. SURVEILLANCE FAILED TO TRIGGER THE CORRECTION OF EXTERNAL IMBALANCES

After the start of the EMU, surveillance did not focus on competitiveness. Current account developments, external imbalances and underlying factors were not at the core of surveillance. Prior to the EMU, competitiveness was perceived as a policy priority in view of the possibility of (potentially costly) nominal exchange rate realignments. Inside the euro area, up to the crisis, surveillance priorities shifted towards the sustainability of public finances. The attention to intra-area inflation differentials, real exchange rates and current accounts declined as pressure on exchange rates and risk premiums faded away. Due to persistent wage and price rigidities, in some cases the necessary intra-area movements in competitiveness positions were slow, with the building up of high external deficit or surplus positions implying large adjustment costs. ([15]) In the case of Portugal, persistent current account deficits combined with a lack of competitiveness resulted in increasing foreign indebtedness and a limited ability to pay back the debt. Also convergence of lower income countries towards higher income ones was expected to be facilitated by the intra-EA transfers, mainly through EU funds. However, the inflow of structural funds alone (even if reaching 1.5-2% of GDP) and the convergence of interest rates were not enough to promote convergence of Portugal in terms of GDP per capita (Graph 2.3b).

([15]) DG ECFIN (2008a)

The EU surveillance was mainly geared to monitoring the fiscal position of the Member States. In Portugal, it failed to ensure the necessary adjustment. Portugal was nearly constantly under the Excessive Deficits Procedure (EDP) from 2002 until the onset of the crisis, as its attempts to correct its deficit were centred on one-off measures. The SGP requirements were not effective in leading Portugal to a more balanced fiscal position in a timely manner. Prior to the crisis, the EU surveillance relied extensively on the Commission's macroeconomic forecasts and Member States' intentions to stabilise their fiscal position. However, in the case of Portugal, the outturn of the economic activity was systemically below forecasts and some under-budgeting of public expenditure was observed. The EU also lacked full information to properly monitor debt developments: part of the debt increase was not explained by budget deficit or GDP growth, likely attributable to SOE support through capital injections and other one-off measures.

At the EU level, there was no mechanism to enforce the implementation of structural reforms. In the absence of strong and forceful surveillance mechanisms with respect to macro-economic imbalances, EMU in its first years might have weakened the incentives to undertake structural reforms because intra-area competitiveness weaknesses no longer led to pressure on exchange rates and risk premia. ([16]) The broad economic policy guidelines lacked "carrots and sticks" and ownership of the recommendations at the Member State level was limited. ([17])

External surveillance was pointing to the weak productivity in the Portuguese economy, but concrete advice for reform remained limited and was not taken up by the Portuguese authorities. The IMF underlined the weak productivity and loss of the competitiveness by the Portuguese economy. However, it did not see the high risks associated with the high leverage of the banking system and expected that gradual readjustment would be sufficient. ([18]) The policy advice offered to increase the productivity of the economy was not precise in identifying the necessary measures. In 2008, the OECD was also pointing to the weak productivity of the Portuguese economy as the main culprit of its low growth. It recommended broader reforms than the IMF, mainly in the education, network industries and the services sectors, and to employment protection legislation, public employment conditions and tax system. The Portuguese authorities at the time recognized only partially the underlying problems so the agenda for reforms was delayed and progress remained limited (see Section 5).

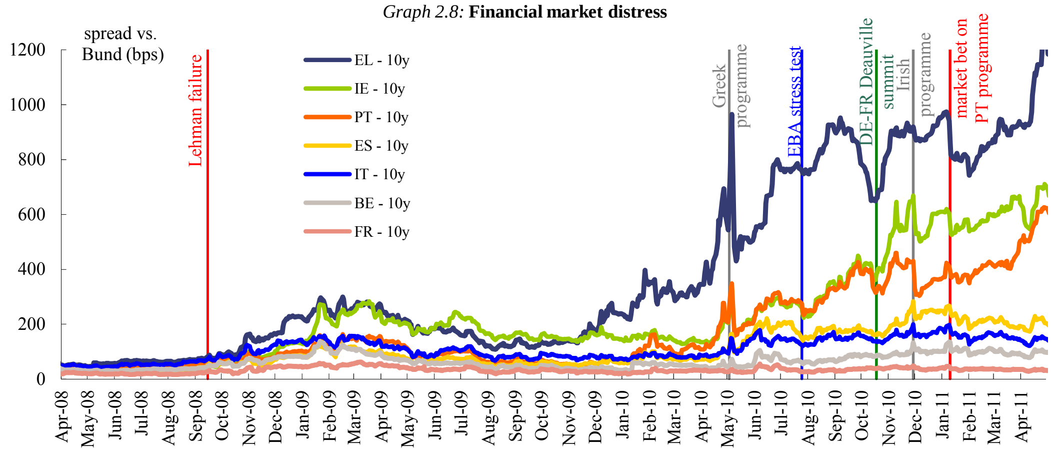
2.4. THE GLOBAL CRISIS AND THE RUN UP TO THE PROGRAMME

In 2008, the resilience of the economy proved elusive and gave way to a rapid deterioration. The Portuguese GDP continued increasing, although by only 0.2% in 2008, but it contracted by 3% in 2009. The weak economy and the steep increase in unemployment, coupled with a countercyclical fiscal stance, spilled into large government deficits, of about 10% of GDP in 2009 and 2010, up from 3.8% in 2008.

In the context of the sovereign crisis, triggered by concerns about the Greek fiscal position, the Portuguese sovereign financing costs increased sharply. In December 2009, the EU Council recommended Portugal to bring an end to the situation of excessive deficit by 2013. In 2010, Portugal passed fiscal consolidation measures with the aim of bringing the deficit for that year down to 7.3%. From late 2009, fears of sovereign defaults in other European states developed among the investors. In the first few weeks of 2010, there was renewed anxiety about excessive national debt, in case of Portugal, compounded by poor prospects of growth, with lenders demanding ever-higher interest rates (Graph 2.8) from several countries with higher public debt levels, public deficits, and current account deficits. The downgrades of the Portuguese sovereign by the credit agencies followed, in March by Fitch and in April 2010 by Standard and Poor's.

([16]) DG ECFIN (2008a)
([17]) Deroose, S *et al* (2008).
([18]) Similarly to the EU, the IMF considered that the Portuguese banking system remained sound and well supervised.

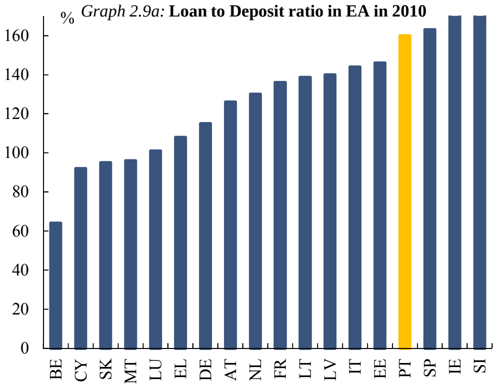
Graph 2.8: **Financial market distress**



Sources: European Commission; Bloomberg

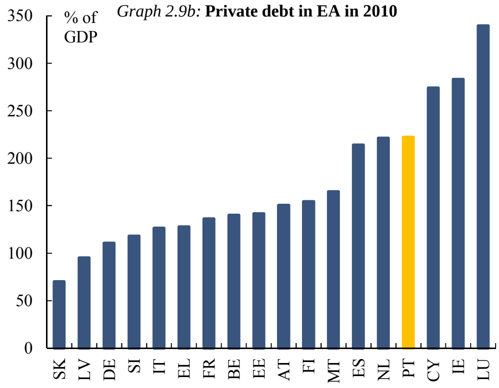
The international financial crisis triggered only a marginal adjustment of existing imbalances. In 2010, Portugal's GDP surprisingly grew at a rate of 1.9%. Along with strong export growth, this positive growth performance was due to exceptional factors that boosted private consumption, namely the anticipatory effects of the VAT increases in January 2011 and the relatively low inflation due to falling energy prices. However, the current account deficit remained at high level of 10% of GDP in 2010: while corporate net external borrowing decreased sharply compared to 2008 the public net external borrowing increased keeping current account deficit at high level.

Graph 2.9a: **Loan to Deposit ratio in EA in 2010**



Source: ECB

Graph 2.9b: **Private debt in EA in 2010**



Source: ECB

The apparent resilience of the Portuguese banks until 2010 to the crisis was the result of the slow adjustment of the country's macro imbalances. In the initial stages of the crisis, state recapitalisation was not needed, with the exception of a few smaller banks in the context of their operational and business model failures. ([19]) The return on equity remained positive for all major Portuguese banks until 2010. The need for price adjustment of real estate related loans and securities appeared initially marginal and negative repercussions for banks' balance sheets and household wealth remained limited. ([20]) However, since the banks had significantly contributed to finance the country's debt (as also reflected in their high LTD ratio), they were not shielded from the imbalances' correction (Graphs 2.9a, 2.9b and Table 2.1).

([19]) Notably, Banco Português de Negócio (BPN) and Banco Privado Português (BPP), respectively in November 2008 and July 2009.

([20]) Pereira, P.T., Wemans L. (2012)

Table 2.1:

2010: Banks in a snapshot	*CGD*	*BES*	*BCP*	*BPI*	*Banif*
Total Assets (€bn)	*126*	106	98	45	12
Core Tier 1 (%)	*8.8*	7.9	6.7	8.7	n.a.
ROE (%)	*5.0*	8.6	6.1	8.8	5.2

Source: Banks' Annual Reports

The deterioration of confidence and rating downgrades increased pressure on the funding conditions of the Portuguese banking system. The perceived risk of the Portuguese sovereign and that of the Portuguese banking system were closely related, as measured by the correlation of the respective credit-default swap rates (see Graph 2.10a). Since mid-2010, the banking sector's international market access was virtually shut down. This fostered an initial correction of banks' LTD ratio from the 167% peak recorded in mid-2010. ([21]) The full allotment by the ECB and the availability of eligible collateral allowed avoiding access to Emergency Liquidity Assistance (ELA) and a sudden liquidity squeeze. However, this situation would have been hardly sustainable over the medium-term, especially in light of the forthcoming roll-over needs (€30 billion alone for the five biggest banks in 2010-13, according to Bloomberg).

In March 2011, the Portuguese parliament rejected the Stability Programme, prepared by the government to strengthen the fiscal position, triggering the need for external financial assistance. In February 2011, in the context of increasing volatility in the euro area and the Greek and Irish adjustment programmes, the European Council called on Member States to make progress in strengthening their fiscal position and growth prospects. In light of a macroeconomic scenario that was turning worse than the projections underlying the 2011 budget, the Portuguese government prepared a Stability programme to cover the gap. The Programme targeted a reduction of the deficit from above 8% of GDP (net of one-offs) to 4.6% in 2011 and 3 and 2% in 2012 and 2013, respectively. On the 23rd of March 2011, the Portuguese Parliament rejected the Stability programme. The government resigned.

The uncertainty over the macroeconomic outlook, dynamics of public debt and the disappointing fiscal performance in 2010 accelerated the increase of the government bonds' yields up to unsustainable levels. At the end of March 2011, the Portuguese statistics institute revised upwards the previous years' figures for budget deficits and public debt, mainly to reflect the reclassification of a number of public transport SOEs in the general government ([22]) (INE, 2011a). This meant an upward revision of the 2010 public debt of about 10 pp, from 83% to 92.4% of GDP, and implied that the 2010 deficit target had been missed ([23]) (see Graph 2.10b and Section 4). In the end, despite the consolidation measures, the 2010 deficit was still at 10% of GDP. Weaknesses in reporting and management of the risks from SOEs and PPPs were adding to the uncertainty caused by the sheer size of these sectors. Compounded by the systemic risk aversion at the time ([24]), this uncertainty about the Portuguese public finances contributed to the spike of government bonds' yields (Graph 2.8).

([21]) BdP data, as reported by Programme documents. See ECFIN (2011b)

([22]) This followed Eurostat guidance on financial defeasance structures and guidelines on administrative public sector budgetary perimeter.

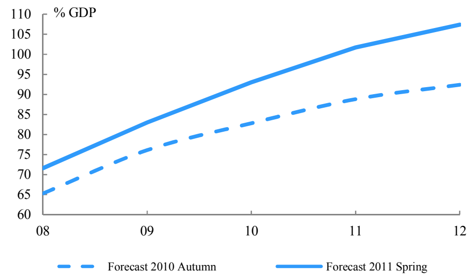
([23]) Taking into account revisions that occurred later in April and September 2011 (INE 2011b, 2011c), the missed deficit target in 2010 is mainly explained by reclassification of a number of SOEs and PPPs into the general government and other one-offs related to banks rescue and Madeira's unreported debt.

([24]) Between 24 March and 4 April, rating agencies plunged Portugal's rating, including because of a negative interpretation of the 24–25 March European Council conclusions that "sovereign debt restructuring is a potential pre-condition to borrowing from the ESM".

Graph 2.10a: **Portugal - CDS 5 Yr**

Source: Bloomberg

Graph 2.10b: **General Government debt**



Source: European Commission

On the 7th of April 2011, Portugal requested financial assistance from the EFSM/EFSF and the IMF. Negotiations between the caretaker government and the programme partners resulted in an agreement at technical level in early May 2011. Prior to the mission that started on the 11th of April, there was some contact between the programme partners (the European Commission, the IMF and the ECB), but they were not extensive. The negotiations on the Economic Adjustment Programme took place in a cooperative environment in consultation with the main opposition parties and other civil society partners. The Programme received public support from the then main opposition parties which suggested a broadly-based political ownership of the programme at its inception and a commitment to sound implementation. The programme was agreed at technical level on the 3rd of May and the Ministers endorsed it at the ECOFIN/Eurogroup meeting of the 16th of May 2011 ([25]). The signature of the Letter of Intent of the Portuguese authorities - accompanied by the MEFP and Technical Memorandum of Understanding (TMU) – and of the MoU (detailing the programme conditionality) followed during the same month. Portugal established promptly a special unit (ESAME), which reported to the Prime Minister, with the task of monitoring the implementation of the programme, in liaison with the line Ministers.

Over a three-year period, the programme aimed at supporting progress in the orderly unwinding of the public and private, internal and external imbalances and in increasing the growth potential, while mitigating negative social impacts.

([25]) Statement by the Eurogroup and ECOFIN Ministers on the 16th of May 2011, www.consilium.europa.eu

3. FINANCING NEEDS

In May 2011, the EFSF, the EFSM and the IMF agreed on a €78bn financing envelope to cover the financing needs of Portugal over a three years period, until June 2014. This funding envelope was deemed sufficient to cover over the three years period the projected government cash deficit, maturing public debt, the potential recapitalisation of the banking sector and possible contingent public-sector liabilities. The financing envelope was calculated based on the assumption that Portugal would continue rolling over part of its existing stock of short-term debt and slowly return to longer-term bond markets during the last part of the programme. Overall, the financial envelope corresponded to approximately 44% of Portuguese GDP.

The financial support was to be equally granted by the three institutions according to broadly similar terms; however changes during the programme led to substantial differences between the lending terms of the EU lenders and the IMF. The programme consisted of €52bn EU funding, split equally between the EFSF and the EFSM and €26bn from the IMF. All loans were to be disbursed over three years. The EFSM and EFSF lending terms were expected to be broadly similar to the IMF ones. However, as always, IMF financing was provided in Special Drawing Rights (SDRs), hence the amount to be paid back entailed some exchange rate risks. In the Portuguese programme case, exchange rate fluctuations added some €1.4bn to the value of the IMF loans over the course of the programme. More substantially, the terms of the EFSM and EFSF loans were changed twice during the programme, reducing the interest rate and extending the maximum weighted average maturities (up to 19.5 years for the EFSM and 20.8 years for the EFSF). This resulted in the EU loans being provided at substantially better terms than those of the IMF.

3.1. PROGRAMME STRATEGY

The amount of financial assistance was set to cover the estimated funding gap over the programme. These financing gap calculations were based on estimates of gross financing needs and sources as of May 2011. On the basis of macroeconomic and fiscal projections, estimates of gross financing needs amounted to €130.2bn. The main items included the amortisation of government debt, the cumulative state deficits and remaining needs of the wider public-sector and support for the recapitalisation of the banking sector. On the resources side, Portugal's own financing sources were estimated to amount to €52.2bn, based on assumptions about continued reliance on issuing debt in short-term markets, a gradual resumption of access to long-term debt markets over the programme horizon and privatisation receipts. The external assistance covered the resulting funding gap, which included an implicit contingency buffer to provide for unexpected deviations from the baseline financing scenario - for example, possible difficulties in rolling-over part of the short-term debt.

The most significant element of Portugal's gross financing needs during the programme horizon related to its maturing public debt. At the end of 2010, Portugal's gross debt stood at €162bn, corresponding to some 93.3% of GDP ([26]), the fifth highest level of gross public debt in the EU. It also had a debt structure that was skewed to the short term (at the end of 2010, 12.7% of the debt consisted of T-bills ([27])), resulting in very high financing needs just to keep rolling the debt over. Moreover, T-bills were largely held by foreigners, reflecting the high external indebtedness of the country. This debt structure was a major reason why Portugal had a weak position in sovereign debt markets and was unable to withstand market pressure once market rates started to increase significantly in 2011. In the three years from June 2011, Portugal was forecast to need €41.1bn for the amortisation of T-bills ([28]) and €38.2bn to amortise maturing long term debt. Repo operations added an additional €1.9bn to its needs and net redemptions of non-traded debt €2.1bn.

([26]) ESA-95 figures.
([27]) IGCP. Relatório Annual de Gestão de Tesouraria de Estado e da Dívida Pública. 2011
([28]) Gross figures, i.e. including rollover of T-bills raised during the programme period.

The forecast cumulative fiscal deficits contributed €22bn to the expected financing needs over the programme. The estimates were based on the delivery of the agreed fiscal consolidation path which would reduce the deficit so as to meet the EDP headline target of a 3% deficit by 2013.

The programme envelope also contained €12.9bn of expected financing needs for other areas of the public sector, including the clearance of arrears. Portugal had a large and complicated web of SOEs, many of which were loss-making, highly indebted and ultimately to be covered by the state. The initial programme did not include the debt of SOEs in the programme financing envelope as it was argued that the restructuring of the companies to achieve operational balance should take place first and state aid arguments might be at stake. Overall, although a number of these companies had been reclassified into the general government, the total needs of these companies were open to large uncertainties. The financing of the autonomous regions of Madeira and Azores was not fully transparent. In addition, the Portuguese government's reluctance to ask for financing earlier, had led to an accumulation of arrears which acted as a brake on economic growth. Most financing needs for these items were concentrated in the first six months of the programme, due both to the need to clear arrears as quickly as possible and to the expectation that some of the SOEs would be restructured and/or privatised under the programme.

The programme envelope included €12bn earmarked to meet potential recapitalisation needs for the banking sector. This estimate was set to ensure that financing would be sufficient to meet the worst case scenario (i.e. providing some kind of buffer in the programme), but at the same time the uncertainty of both the needs of the financial sector and their evolution meant significant risk as to whether this funding would be sufficient. The €12bn was earmarked in the Bank Solvency Support Facility (BSSF) so that it would not be available to the Portuguese authorities for other purposes. This choice reflected the necessity to avoid watering down the incentives to pursue reforms because of over-financing.

The financial envelope calculations assumed that Portugal would continue to roll-over part of its short term debt and gradually return to the longer term debt markets. Over the programme period, Portugal was expected to roll over its T-bills, hence keeping the Portuguese sovereign in the markets. However, given the large stock of short-term debt, the fact that it was largely held by foreigners and the initial limited access to the markets, refinancing of T-bills was not guaranteed and the programme initially projected an overall reduction of the stock of T-bills (to be covered by the financing envelope). The conservative assumption taken when designing the programme was that at the beginning Portugal would only rollover 50% of maturing T-bills, while later on the rollover rate would reach 100%. Furthermore, Portugal was expected to return to longer terms markets before the end of the programme, to ease the transition back to market financing. Overall, Portugal was expected to add €16bn to its coffers from medium and long-term borrowing starting from the second half of 2013 (100% rollover rate as from that date). Further to market access, the planned financing resources included around €5bn from privatisations, indicating the somewhat limited role of privatisation receipts for funding the programme in the initial programme design. The initial calculations of financing needs did not contain projections on cash balance developments or a target cash buffer by the end of the programme.

The disbursement of the financial assistance was expected to be heavily frontloaded, with around 2/3 of it to be disbursed in the first half of the programme. The largest financing needs were expected to occur at the start of the programme and at the same time, the return to the markets was assumed to gradually increase towards the end of the programme. The agreed disbursement schedule was deemed to strike an appropriate balance between covering the financing needs in the short-term while keeping incentives for Portugal to continue participating in debt markets and ensuring implementation of structural reforms.

The initial conditions of the EFSM/EFSF loans were set up to be broadly equivalent to the IMF loans, with short maturities and mark-ups for risks on the interest rates. Under the original programme, the EFSM and EFSF loans were set up to be broadly equivalent to the terms of the IMF loans, with margins of over 200bps and maximum weighted average maturities around 7.5 years. EU lending was to be provided through fixed bullet loans, set according to financial markets' conditions at the time of EFSM and EFSF borrowing. The IMF loans had an average maturity of 7.25 years and were based on the floating SDR interest rate plus a basic service charge of 100 basis points and a surcharge that rose to 300 basis points on the amount of outstanding credit in excess of 300% of quota for a consecutive period of three years ([29]). The effective costs of IMF loans could be substantially higher than the lending rates, as these loans are denominated in SDR and carry variable interest charges. Portugal was therefore exposed to both interest rate and exchange rate risk for the IMF lending. Taking these factors into account, it was assumed that the effective IMF lending rate to Portugal was around 5.5%, once expressed in financially equivalent terms. ([30]) Simulations at the time of the programme based on market rates at the end of April 2011 suggested that the EFSM and EFSF loans to Portugal would have effective interest rates of about 5.4% and 5.7% respectively.

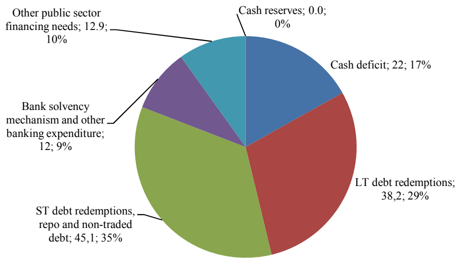
The EFSM/EFSF margins were cancelled and the maturities of these loans were extended twice during the programme. In October 2011, following decisions in the context of the Greek Loan Facility, the Council decided to cancel EFSM margins to programme countries and similar conditions were applied to EFSF loans ([31]), making all loans under these facilities considerably cheaper. The reduction in margin would apply not just to future instalments, but also to those that had already been disbursed. In addition, the maturities of the EFSM/EFSF loans to Portugal were extended twice, along with those of Ireland, in 2011 and 2013. The October 2011 extension of the maximum weighted average maturity added about 5 years in the case of the EFSM loans and about 6.3 years for the EFSF loans, while the 2013 extension added 7 further years, taking it to up to 19.5 years for EFSM loans and to up to 20.8 years for EFSF.([32])

3.2. OUTTURN AND POST-PROGRAMME DEVELOPMENTS

Portugal had access to much more market financing during the programme than assumed under the initial calculations. Short-term markets remained accessible during the whole programme period and Portugal was able to raise more funds than assumed in the programme design: by the end, the overall short-term debt rollover rate reached 100% for the whole programme. Domestic banks bought more T-bills than expected, in a context of relatively easy Eurosystem refinancing conditions (see later). As regards the medium and long-term debt markets, Portugal was able to issue a 5 and a 10 year bond in 2013 and made a more extensive return to the markets in early 2014. Overall, over the programme period, Portugal was able to access €47.8bn more than initially planned by increased borrowing (€37.5bn in short term borrowing and €8.1bn in long-term borrowing). This additional borrowing was not a net gain to the financing available to the Treasury as it also increased the amortisation needs, in particular for the short-term borrowing – a high share of this was to be rolled over during the programme. Taking this into account, the increased access to the market provided the Portuguese Treasury with about €14bn extra net funding over the programme period – just under €10bn from the T-bills and €2bn each from long term borrowing and other sources. Furthermore, the government benefited from other flows such as cash balances of public entities held in the Single Treasure Account and from repayments of BSSF funds ahead of schedule. At the end of 2013 the weight of the T-bills in total debt had been reduced to 9,3% and by the end of 2014 it had gone down to 7,5%. ([33])

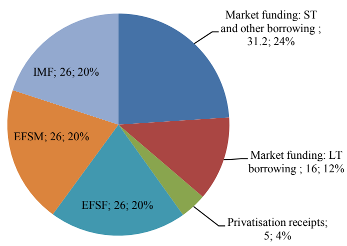
([29]) The 300 basis point surcharge has been applied since May 2014. At the end of the programme Portugal faced an interest rate on IMF credit of 4.8%.
([30]) Effective interest rate calculated based on IMF SDR floating rates being swapped into fixed rates in euro with 7.5 year durations.
([31]) The EFSF lending rate includes the EFSF borrowing rate plus an annual guarantee commitment fee of 10 basis points of the loan amount. This fee is not retained by the EFSF but passed on to the Guarantors.
([32]) http://www.efsf.europa.eu/mediacentre/news/2013/efsf-extends-loan-maturities-for-ireland-and-portugal-.htm
([33]) IGCP, Relatório Annual de Gestão de Tesouraria de Estado e da Dívida Pública. 2014.

Graph 3.1a: **PLAN - Use of funds, June 2011 - June 2014, EUR bn and % of total Funds**



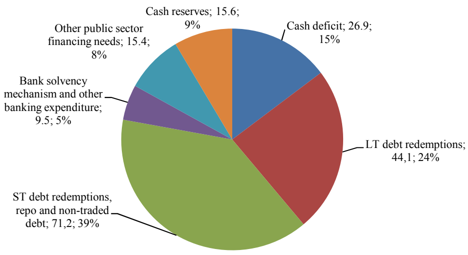
Source: EC own calculations

Graph 3.1b: **PLAN - Sources of funding, June 2011 - June 2014, EUR bn and % of total Sources**



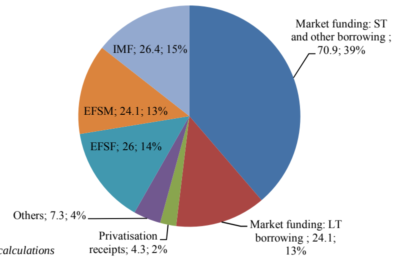
Source: EC own calculations

Graph 3.1c: **OUTTURN - Use of funds, June 2011 - June 2014, EUR bn and % of total Funds**



Source: EC own calculations

Graph 3.1d: **OUTTURN - Sources of funding, June 2011 - June 2014, EUR bn and % of total Sources**



Source: EC own calculations

The gross financing needs over the programme period also exceeded initial expectations. Compared to the programme initial projections, about €52 bn additional funding was used from June 2011 to June 2014. This came predominantly (two thirds) from the ST debt redemptions, due to more than projected roll-over, and special operations (e.g. buybacks) on LT debt. Furthermore, the cumulative government cash deficits were €4.9 bn higher than initially planned, as the deficit targets were revised twice. The financing needs of the SOEs, the autonomous regions of Madeira and Azores and the settlement of arrears were overall €2.5bn higher than forecast. Banking sector support outside of the BSSF scope ([34]), which had not been planned for, amounted to €3.9 bn for the recapitalisation of the CGD and the resolution of the BPN, two public sector institutions. The full €12bn included for the bank solvency mechanism was transferred to the dedicated account at the BdP, although by the end of the programme only €5.6bn had been used. The remaining €6.4bn stayed in the BSSF and remained available for bank recapitalisations after the end of the programme. (see Graphs 3.1.a and 3.1.c) €3.9bn was lent to the Resolution Fund and used to finance the capitalisation of Novo Banco in August 2014, in the context of the resolution measure applied to Banco Espírito Santo.

Portugal was also able to build up a robust cash buffer during the programme, which strengthened its financing position to face any short term financing challenges. By the end of the programme, the increased market financing, net of the increased needs, allowed Portugal to build up a sizeable cash buffer of €15.6 bn. This was more than the remaining deficit being projected in mid-2014 for the remainder of 2014 and 2015, put together. It meant that as long as Portugal was able to keep rolling its maturing debt over, it would be able to finance itself until at least the end of 2015 without additional market access, in case market pressures reappeared. Although there was no explicit cash buffer target in the early programme documents, the gradual build-up of the cash buffer was increasingly targeted by the programme partners which sought a prefunding of upcoming needs for at least a 12 months horizon. This was to provide reassurance to the financial markets that the country would be able to meet its forthcoming

([34]) The BSSF could not recapitalise some banks due to their public ownership.

obligations. Overall, the sizeable cash buffer allowed investors to be confident in the ability of Portugal to withstand market volatility without funding pressure, which in turn eased market access. ([35])

The comfortable position that the cash buffer left Portugal in was by no means a given over the early years of the programme, when the financing situation was rather tight. Although Portugal seemingly built up a cash buffer from 2011, this was partly due to delays to cover certain expenditure items. In the early months of the programme there were delays in clearing expenditures linked to the SOEs, since these needs were not rapidly identified. There were also funds held under BSSF which technically formed part of the cash buffer, but were earmarked for the banking sector where payments were below those set out in the financing plan during the programme years. Once the funds earmarked under the BSSF are set aside and the delays in the SOEs accounted for, the evolution of the cash buffer is more gradual and primarily driven by the increase in the T-bill issuance. Furthermore, in the early years of the programme, the higher-than-expected government deficits created higher short-term financing needs and by tapping short-term debt markets more than initially planned, Portugal compensated for some underfinancing of the programme. Without this additional market funding, the financing situation would have been much tighter during the programme years.

Portugal exited its financial assistance programme in June 2014, without accessing the last €2.5 bn of programme financing. In the run-up to the end of the programme, the government chose to delay further fiscal measures until the Constitutional Court had delivered its verdicts about the legality of some consolidation measures, expected in the summer 2014. At the same time, it decided not to request an extension and to let the programme lapse without formal conclusion of the last review and without disbursement of the last tranche of the assistance. The existing cash buffer towards the end of the programme allowed the Portuguese government to take this decision, as it not only ensured that it could cover its financing needs, but it also reassured markets that it would continue to be able to do so.

Portugal returned to the long-term bond markets during the programme and has since built a good track record of market access. Portugal did a bond exchange in October 2012 to extend the maturity, and returned to markets properly in 2013 issuing a 5 year and 10 year bond at yields of 4.89% and 5.67% respectively. Portugal reached the end of its programme when market conditions were favourable, and EU policy-making had reinforced the euro area's ability to deal with support of its economies during difficult times. The setting up of the ESM, the announcement of "quantitative easing" and purchase effects ([36]) and rising investor risk appetite pushed sovereign yields to record lows in the post-programme period. Over the course of 2014 and 2015, Portugal was able to issue 10 year bonds at interest rates falling to a 2.3% minimum. In 2015, the interest rates of 2-year bonds reached historical low in secondary market and 6-months T-bills even recorded negative yields.

In 2015, Portugal started to repay its IMF loans early, improving its debt sustainability by refinancing it at cheaper market rates. The improvement in the EFSM/EFSF loans terms was not accompanied by changes to the IMF loans, making them relatively cheaper. The EFSM/EFSF financial assistance framework agreement included a proportionate early repayment clause (the so called *pari passu* clause) requiring that all creditors be repaid proportionately in the case of early repayment. By early 2015, the general fall in euro area bond yields and in particular, the near historic lows in Portuguese yields, as the market recognised the implementation of reforms coupled with the role of other global and pan-European factors, reduced Portugal's borrowing costs to below those of its IMF loans. It was in Portugal's interest to partially repay the IMF early. In February 2015, the Eurogroup agreed to waive the *pari passu* clause and allowed Portugal to repay up to SDR 11.5 bn (€14.4bn at the end of Feb-2015) of its SDR 22.9 bn (€28.7 bn at the end of Feb-2015) IMF loans ahead of schedule over the next 2½ years,

([35]) Stakeholder consultation

([36]) According to ECB data (March 31, 2016), thanks to the public sector purchase program (PSPP) the ECB was able to buy €14,8bn worth of Portuguese bonds, with 10.18 years average maturity.

without an equivalent early repayment of its EFSM/EFSF loans. Portugal made early repayments to the IMF in 2015 totalling SDR 6.6 bn (€8.4 bn at the reimbursement dates).

3.3. ASSESSMENT OF THE PROGRAMME FINANCING

Overall, the programme financing envelope was sufficient to meet the financing gap during the programme, but only because the increased access to market funding and other funding sources covered the higher financing requirements, especially in the early years. The size of the Portuguese programme financing envelope proved sufficient to cover the country's needs and there was no need to top it up in the course of the programme. On the contrary, even the disbursed programme funds were smaller than initially planned and a cash buffer, surprisingly not explicitly targeted in the initial projections, could be built up. However, without the additional unforeseen market access, Portugal would have struggled to stay within the financial envelope set out in the programme. This is particularly the case in the early years when there was considerable uncertainty about whether the financial envelope would be sufficient in light of the much higher fiscal deficits than initially foreseen. The complex needs of the wider public sector remained both sizeable and unclear. This indicates that the assessment of risks in the initial calculations of the financial envelope may have been on the optimistic side and that the envelope did not provide suitable buffers against financing risks. Overall, the Portuguese programme met the sovereign financing needs in a dynamic and resilient way to changing circumstances.

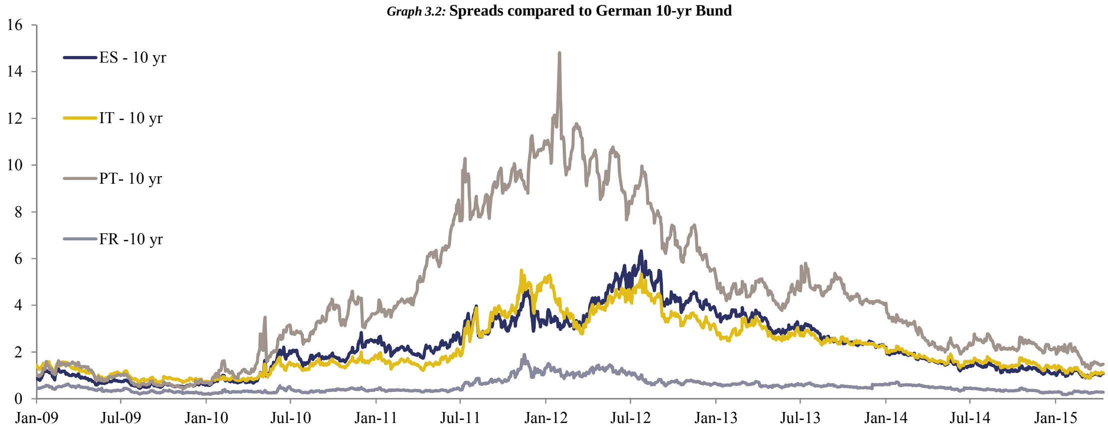
The frontloading of the financing meant that the programme had little leverage over the government by the end. In determining the time profile of the disbursements, the risks of underfunding need to be balanced against the risks of creating unnecessary cash buffers which can lessen the drive for reforms. In the Portuguese case, the government was able to bypass the final tranche as the frontloaded disbursements and return to market access allowed the cash buffer to be built up, which contributed to slow some of the reforms. This left Portugal's underlying fiscal position weaker than ideal at programme exit. It also probably contributed to a weakening of the reform effort in the structural field, where implementation fell short of addressing the deep rooted challenges in Portugal's economy.

Despite the premature ending of the programme, it is difficult to argue that a less front-loaded disbursement schedule was a plausible alternative. Portugal was able to decline the last disbursement and to return successfully to the financing markets in better conditions than expected, in part due to changes in monetary conditions which could not be predicted and which were outside the control of the government. Until the second half of the programme, the risks looked like firmly on the side of the envelope being too small rather than too large. Reducing the frontloading would have likely led to substantial pressure and uncertainty about Portugal's ability to follow the programme. This is particularly the case, as the relationship between financing risk and market access is not linear: the presence of any doubt can have disproportionate market effects.

The increased market financing was both a testament to the programme's implementation and the result of an easing of market conditions amid policy action by the monetary authorities. The adequacy of the financing envelope is contingent on the increased market borrowing that Portugal was able to tap. This market borrowing is endogenous to the programme – at least in part. From early 2011 (see Graph 3.2), bond spreads had started to increase sharply, leading to the financing request. By mid-2012, they were falling solidly, with a stronger fall coming after OMT and Mario Draghi's "whatever it takes". By early 2013, Portugal's access to market was undertaken under similar conditions to those that prevailed before the request for assistance. The improvement in the Portuguese profile was part of a general reduction in spreads in the Eurozone periphery. However, it is also a testament to the programme's implementation. Portuguese spreads fell more than all the other Eurozone countries except Greece, which underwent a debt restructuring. In Portugal's case, this represented renewed market confidence in its longer term sustainability.

Throughout the programme, the liquidity provided by the Eurosystem was crucial. From the summer of 2010 the banking sector was heavily reliant on Eurosystem refinancing operations as its access to market liquidity dried up. This remained the case until the second half of 2012, when the reliance on the Eurosystem started to decrease. With the downgrading of the rating of the Portuguese sovereign, the eligibility of debt securities issued/guaranteed by the Portuguese Republic was granted by the waiver of the minimum credit ratings normally applied by the Eurosystem. This allowed the banking sector to continue using these securities as collateral for Eurosystem credit operations. Throughout the programme the refinancing through the Eurosystem accommodated the banks' financing needs and was therefore instrumental to ensure the sufficiency of the original financial envelope. By the end of the programme the reliance on the Eurosystem was reduced, but the Eurosystem remained an important source of liquidity for the Portuguese banking system (see Graph 6.2a in Section 6).

Graph 3.2: **Spreads compared to German 10-yr Bund**



Source : European Commssion, Bloomberg

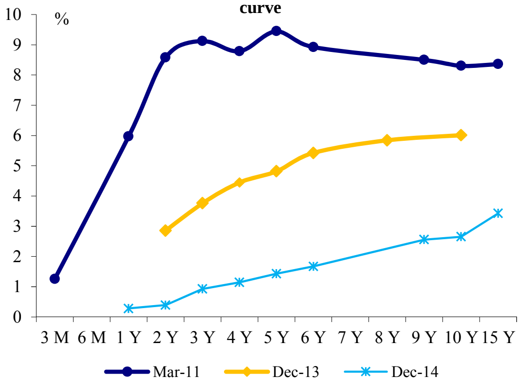
The set-up and operation of both the EFSM and the EFSF represented a major part of the added value of EU-level intervention. This is demonstrated by the significant spread between the average 10 year yield of the euro area countries' sovereign bonds and the 10 year yield of the bonds issued by the EFSM and the EFSF (see Graph 3.3b). ([37]) Tapping financial markets at the EU/EA level rather than relying on bilateral loans allowed Portugal to benefit from financial assistance at a very low cost once the interest rate margins were removed. This was possible because the EFSM is guaranteed by the EU budget, while the EFSF was supported by the explicit, irrevocable and unconditional guarantee of each Member State to back the issuance for up to 165% of its stake. The two facilities were originally assigned AAA rating, despite the high market volatility at the time. ([38])

Changes to the EFSM/EFSF lending terms aided Portugal's market access, but were made without strengthening programme conditionality. The changes to the EFSM/EFSF lending terms provided Portugal with a windfall, by reducing its interest payments and pushing back the point at which the EFSF/EFSM debt would need to be repaid and/or rolled over. This had a positive impact on its deficit and on its debt sustainability, aiding its return to the markets. ([39]) Of possibly even more significance, was the signalling effect that EU partners were ready to help the government's commitment to implementing the

([37]) Average is weighted for the GDP of each country. Smaller countries with a weight less than 1% are not included. Ireland, Portugal and Greece are also not included.
([38]) EFSF is rated by Moody's, Standard & Poor's and Fitch. Between November 2011 and November 2013, the agencies downgraded the credit rating of EFSF to Aa1/AA+, following the downgrades of some EA MS, notably France.
([39]) According to the behaviour of various debt market indicators before and after the announcement of the changes in the terms and conditions of the loans, these changes had a meaningful impact on debt markets. The ESM 2014 Annual Report shows that both after the July 2011 and March 2013 EFSF announcements of the loan changes, the Portuguese yield curve shifted down, especially in the shorter maturity. Thus, by providing cheaper and longer-term financing, the changes to the loans provided a temporary period of reduced sustainability concerns.

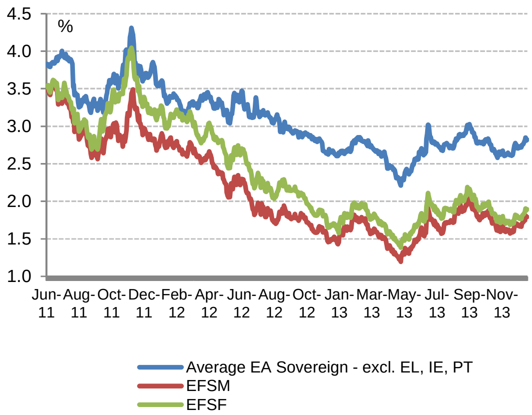
programme. (40) Portugal benefited from the better conditions that were negotiated as part of the Greek programme and which were extended to other countries too. But it also saw an extension of maturities by joining the request by Ireland in 2013 to benefit from better financing conditions due to the strong turnaround in its perceived sustainability. This allowed smoothening Portugal's debt redemption profile and lowering its refinancing needs in the period subsequent to the economic adjustment programme. Portugal benefited from its association with Ireland and its narrative of strong implementation, even if in the case of Portugal, the improvement in underlying economic conditions was not as evident. Conditioning the improvements in the lending conditions, in particular the second one, might have allowed to keep a better hold on government policy and thereby might have underpinned stronger reform momentum.

Graph 3.3a: **Evolution of Portuguese sovereign yield curve**



Source: Bloomberg

Graph 3.3b: **10-year yields**



Earmarking the amount available for the banking sector may have increased the incentives for Portugal to continue with the programme for as long as it did. In the absence of the earmarking, the unused €6.4bn would have been added to the amount of the cash buffer that could be used for general financing needs, possibly replacing some programme funds. If the Portuguese government had not felt that all this was necessary for the future needs of the banking sector, it would have been given additional leeway to decide to end the programme earlier.

The early repayment of IMF loans is another shift in the gradual differentiation of the roles of the IMF and the euro area in providing financing for euro area countries, shifting relative risk to the euro area. The interest margins on IMF and originally EFSF/EFSM loans were there to prevent moral hazard in the repayment; by making the loans reasonably costly, debtor countries would have the incentive to refinance these loans on the open market as soon as possible, rather than holding on to them and exposing the creditor organisation to default risk. However, the higher interest rates themselves reduce the sustainability of the public finances increasing the risk of default. Over the years of the Portuguese and other programmes, there has been a gradual divergence in the approaches taken by the IMF and euro area countries. The EFSF/EFSM loans are now set so as to maximise sustainability, subject to the creditors not directly subsidising the interest. IMF loans include interest rate margins which, with declining yields, make IMF loans increasingly more expensive than market financing. With the *de facto* waiving of the *pari passu* clause, Portugal was the second country (after Ireland) to set the precedent for accepting that euro area/EU (whether through the EFSF/EFSM or ESM) (41) gradually bears more and more of the risk associated with euro area assistance in the place of the IMF. These differences are not fully aligned with the G20 principles for cooperation between the IMF and regional financing

(40) Stakeholder consultation.
(41) ESM lending rates have very small interest margins on top of the cost of funding and operations by the ESM. For detailed information concerning the pricing of ESM stability support instruments, see 'ESM Pricing Policy', http://www.esm.europa.eu/pdf/Pricing%20guideline.pdf

arrangements ([42]), which foresee consistency of lending conditions to the extent possible, in order to prevent arbitrage and facility shopping.

([42]) As endorsed by G20 Finance Ministers and Central Bank Governors, 15 October 2011.

4. FISCAL POLICY

4.1. KEY CHALLENGES AND PROGRAMME DESIGN

At the beginning of the programme, the fiscal position of Portugal had severely weakened and was not on a sustainable footing. Since 2009, Portugal was subject to an EDP procedure. Portugal had expenditure levels roughly in line with the euro area average, but revenues were insufficient to cover such expenditure levels. In 2010 the budget deficit was still about 10% of GDP, including because of significant reclassifications of a number of SOEs and PPPs into the general government and other one-offs related to banks rescue and Madeira's unreported debt. These reclassifications meant an upward revision of the 2010 public debt of about 10 pp, from 83% to 92.4% of GDP. These developments were heavily affecting market confidence in Portuguese public finances. SOEs, PPPs and banks were exerting considerable pressure on the Portuguese public budget.

Many SOEs were structurally loss-makers. The extended use of PPPs shifted the related expenditure to future years. The SOEs' challenge was multifaceted as they were posing significant risks that arose from their negative profitability and high cumulated debt and that could not be fully assessed. The large and inefficient SOEs-sector was substantially feeding into public expenditure. In particular transport companies and hospitals were a matter of concern. Loss-making SOEs weighed on the public deficit mainly through intermediate consumption and compensation of employees, when classified within the general government perimeter, or through subsidies and capital transfers, when classified outside the general government perimeter and the state was called to cover their losses (see Box 4.1). Moreover, as it was already happening, economic and financial difficulties of SOEs could lead to the reclassification of their liabilities as public debt, reflecting increasing risks for the general government. Government's control over SOEs dynamics, especially at local level, presented significant weaknesses. The use of PPPs implied that the government could foster growth through investments in infrastructure (such as roads or hospitals), while moving accounting of related expenditures to future years, when the government has to pay for the availability of these infrastructures. There was a lack of adequate central control for creating PPP and weaknesses in the monitoring framework. In Portugal, the present value of this 'additional' future expenditure was estimated at 7 percent of GDP when the programme started (IMF, 2011a).

Inefficiencies in public expenditure affected a number of key areas. Over-employment was a cause of concern in the education sector and security forces. ([43]) Overall, most of the government workforce had at most secondary education qualifications. Furthermore, public wages were higher than in the private sector, especially for workers with lower qualifications.([44]) There were inefficiencies in the health sector, with regard to pharmaceutical, primary care and hospital expenditure. Past reforms had contributed to improve the sustainability of pension spending in the long term, but the pension system was still generating inter- and intra-generational inequities and excessive budget pressure in the shorter term. ([45]) Non-pension social benefits were not well targeted. The unemployment benefit system was granting little access to younger workers, while the benefits for those who qualified were relatively high and granted for a relatively long period. ([46]) A new Budgetary Framework Law had been approved in 2011, before the programme started. The law included important improvements, in particular by setting up a multi-annual framework, with expenditure and budget balance rules. However, vulnerabilities still existed with regard to weak line ministry accountability, accounting fragmentation among different levels of government, and fiscal risks, especially from SOEs and PPPs.

([43]) The education sector and the security forces accounted for a high percentage of the government workforce, significantly above EU comparators. The ratio of students per teacher was much lower than in most other countries, with no comparative advantages in terms of performance of the education system. The density of police forces was amongst the highest in Europe. IMF (2013a)
([44]) DG ECFIN (2012c), IMF (2013a), Mercer (2013). See also Giordano, R. *et al*. (2011) and De Castro, F. *et al.* (2013).
([45]) Past reforms had protected current retirees and had granted transition periods for those who had not retired yet, while placing the burden on next generations. The scheme for public employees appointed before 2006 (CGA) was more generous than the general system for private workers and for new entrants in the public administration.
([46]) IMF (2013a), Lemgruber, A., Soto, M. *et al.* (2012).

Tax revenues were below the euro area average and affected by inefficiencies. In 2011, the tax-to-GDP ratio of Portugal was 4 pp below the euro area average. The implicit tax rate on consumption was below EU and euro area average, including due to extensive use of reduced VAT rates. Revenue from recurrent property taxes, which together with consumption taxes are among the least detrimental to growth (Johansson, A. *et al* 2008), was still low. Concerning the corporate tax, Portugal had a significant debt bias, substantially above the EU average, measured as the difference between the effective marginal tax rates for new equity and debt-funded investment. In general, the Portuguese tax systems was characterised by extensive tax expenditures, narrowing tax bases and contributing to the need for higher tax rates. The shadow economy in Portugal was also significant, estimated at 17-24% of GDP ([47]), causing losses of government revenues. Tax verification function was understaffed, when compared with other OECD countries. ([48])

The programme aimed at reducing the budget deficit and stabilising public debt, by acting on both expenditure and revenue and by streamlining the public sector through a number of fiscal-structural measures. The programme called for the budget deficit to achieve the 3% of GDP threshold by 2013, with public debt peaking in the same year. This path was considered an appropriate trade-off between the need to take decisive action to restore market confidence while avoiding an excessive toll on growth and employment. Expenditure cuts and revenue increases were to be supported by a number of actions qualified as 'fiscal-structural measures', which consisted of reforms to the way the public sector operates. Some of these measures built on plans that the Portuguese authorities were already developing.

Fiscal conditionality was framed in terms of nominal targets for the overall budget deficit and included the estimation of the yield of the fiscal measures. These targets were appropriate in light of the debt sustainability consideration. The headline deficit net of one-offs had been about 8.5% of GDP in 2010, excluding measures in support of the banking sector. ([49]) (see Box 4.1). Under the programme, targets were initially set at 5.9% in 2011, 4.5% in 2012 and 3.0% in 2013. This fiscal trajectory was to be supported by consolidation packages amounting to 5.7% of GDP in 2011, 3.0% in 2012 and 1.9% in 2013. These targets can be considered ambitious, when compared with the Portuguese track record. An alternative could have been to set targets on structural deficits to let the automatic stabilisers work freely and allow negative surprises to be absorbed within the programme. Nevertheless, this approach has severe shortcomings at times of rapid economic adjustment. ([50]) Another alternative would have been to set looser nominal targets with the aim of helping credibility through over-performance. Given the uncertainty at the inception of the programme about the debt evolution ([51]), planning a more gradual consolidation path would have implied significant risks. The debt would have been projected to peak at higher levels and its subsequent reduction would have relied on the country's ability to deliver consistent primary surplus, over the subsequent medium term. Such a strategy would also have required a larger financial envelope.

The fiscal consolidation was intended to be frontloaded and clearly tilted towards a reduction of expenditure rather than an increase of revenues. More than half of the fiscal consolidation was to be implemented in 2011, while the rest was to be split between 2012 and 2013. In terms of the sum of the measures to be introduced, 2/3 of the fiscal consolidation was to be generated by savings in expenditure.

([47]) DG ECFIN (2014c) making reference to Schneider, F.(2013), the Portuguese statistics office (INE) and Barbosa, E. *et al.* (2013). See also Schneider, F.(2010) and Schneider, F., Williams, C. (2013).
([48]) Eurostat data, DG ECFIN and DG TAXUD (2012, 2013), OECD (2013b), OECD (2013c), OECD (2015a).
([49]) Programme targets do not take into consideration the support to the banking sector.
([50]) Large revisions in the potential output make the structural balance a very unstable measure for countries at a time of strong economic adjustment. In times of change, the concept of potential output is very difficult to quantify and elasticities are likely to vary over time. In addition, in uncertain economic times, there is also no reason to expect expenditure and revenues to follow standard patterns of behaviour captured by semi-elasticities as economic fundamentals are shifting.
([51]) According to the IMF, it was difficult to state categorically that there was a high probability that debt was sustainable over the medium term. IMF support was justified given the high risk of international systemic spillover effects. (IMF, 2011a)

The 2011 fiscal target was looser than previously envisaged by Portugal, but still very ambitious especially considering that this was to be achieved through significant expenditure cuts. The initial programme targets were looser than those proposed in February 2011 by Portugal in the Stability Programme (Table 4.1), partly to reflect the impact on the deficit of the SOEs reclassification that occurred between March and April 2011. However, for 2011 the target still implied an expected improvement of 2.7 pp in the deficit net of one-offs, mainly on the expenditure side.

In a climate of urgency, the programme aimed at addressing the most evident inefficiencies and immediate sources of risk. In the absence of an existing spending review, the programme targeted expenditure mainly through cuts to public staff, pension expenditure, social benefits, SOEs, PPPs and health system. Public staff was to be reduced by 2% per year during 2012-2014([52]), by limiting hiring and reducing fixed contracts. Savings in pension expenditure were expected from a reduction of higher pensions and the suspension of indexation. Savings in social benefits were to be generated through better targeting, including means-testing. With regard to SOEs, the MoU envisaged rationalising services and cutting operational costs. Similarly, PPPs had to be renegotiated to reduce contingent liabilities for the state. Further reduction of the general government perimeter was to be achieved through progress in the privatisation programme, which built on previous government plans. A wide range of actions, also built on ongoing initiatives, addressed areas of inefficiency in the health sector. The programme conditionality aimed at reducing the stock of domestic arrears, which were a concern especially for the health sector and local authorities. A comprehensive reform of the Budgetary Framework Law was envisaged by the end of 2013 with the aim of addressing the still existing vulnerabilities.

Some initiatives for tackling the underlying structural problems driving excessive public expenditure were introduced in parallel, but at a slower pace. The programme did not include a clear provision for an exhaustive spending review to design expenditure measures since the beginning. Conditionality required the upfront preparation of a plan to improve flexibility, adaptability and mobility of human resources. Despite indications of a positive public-to-private wage premium in Portugal, it took six months to include the requirement of an assessment, with a one-year deadline. There was no requirement to address the level and complexity of public wage supplements until two years into the programme. These assessments were not framed as part of a full civil service reform, including reviewing the structure of the public sector wages - in accordance to responsibility and expertise - recruitment, performance evaluation, and career expectations. The requirement for a comprehensive reform of the pension system was only included in 2013.

The programme included other measures that were arguably not the most important to induce the necessary change to public finances dynamics. The programme included the development of the use of shared services in the areas of financial, human and IT resources. At local level, parishes and municipalities were to be reorganised. The network of decentralised services of ministries was to be rationalised. A detailed cost/benefit analysis of all public and quasi-public entities, including foundations, associations and other bodies was to be prepared by 2011. While all these measures were needed to increase the efficiency of the public administration and, at least some of them, could contribute to improve the perception of the programme by the public opinion, their main purpose was not to generate significant savings, therefore it can be questioned whether they can be considered macrocritical in a programme context.

The programme included a wide range of appropriate measures to improve the revenue administration. The tax administration was appropriately required to develop upfront a strategic plan 2012-2014. A number of organisational changes were to be implemented to improve the collection of revenues. The programme included an upfront review of the state of the IT systems and the preparation of an IT strategic plan, with the support of technical assistance. A clear risk management approach for

([52]) For local administrations, special provisions were set in the state budget to reduce transfers in case of missed targets for employment reduction. The 2% target was a condition in the government's adjustment programme for Madeira.

taxpayer selection was to be adopted and resources devoted to auditing had to be increased to at least 30% of total staff, mostly through reallocations. A number of measures were included, in order to make the resolution of tax cases more efficient. In Portugal, the tax court system featured an excessive backlog and a low balance of cases won/lost. The programme appropriately included the implementation of a new tax arbitration law (to reduce the number of cases for tax courts) and the clearing of the backlog of cases worth above € 1 million (through a task force of judges). This was appropriate given the focus on compliance by large taxpayers and High Net Worth Individuals (HNWI). All these measures were relevant in light of the country's relatively low tax revenues, including because of the significant shadow economy.

A budget-neutral fiscal devaluation was included in the programme. As a member of a currency union, Portugal could not resort to currency depreciation to improve external competitiveness in the short term. The programme envisaged internal devaluation through a budget-neutral reduction of the employers' social security contributions (fiscal devaluation – see Section 4.2.1). In qualitative terms, this was expected to have a similar positive effect on the external balance, through the impact of the cut in production costs on final prices and therefore on external competitiveness. Furthermore, as one of the possibilities for achieving neutrality was through VAT increase, this measure would have improved the external balance also through lower imports due to lower consumption.

4.2. IMPLEMENTATION

4.2.1. Pace and composition of fiscal consolidation

During the programme, the headline deficit targets were revised twice, because of negative macroeconomic developments outside the control of the government. The first revision took place in September 2012 (Table 4.1), amid disappointing economic growth - in particular, for domestic demand (Table 4.2) - which fed into tax revenues coming in about 2pp of GDP lower than projected (Table 4.3). ([53]) The second revision of the targets took place in 2013 following a Constitutional Court ruling against the cuts of the 13th and 14th monthly payments to pensioners and public employees (see Box 4.2). The Court imposed a full reinstatement of these payments as from 2013. As the cuts had reduced expenditure by 1.5% of GDP in 2012, their reversal increased spending in 2013 by an equivalent amount. The decision was taken to extend the EDP deadline to 2015.

Table 4.1:
Fiscal Targets (% of GDP – ESA-95)

		2011	2012	2013	2014
General Government Headline Deficit [(1)]	*Stability Programme Feb. 2011*	-4.6	-3.0	-2.0	
	MoU	-5.9	-4.5	-3.0	
	1st Revision		-5.0	-4.5	-2.5
	2nd Revision			-5.5	-4.0

[(1)] Excluding support to the banking sector

([53]) Furthermore, reduced disposable income may have induced rebalancing of consumption toward lower-tax goods and tax compliance may have weakened (DG ECFIN, 2012c).

Table 4.2:
Overview of macroeconomic data (y-o-y % change - ESA-95)

		2010	**2011**	**2012**	**2013**	**2014** [2]
Private consumption expenditure	*Projections* [1]	3.9	-1.1	-2.6	-1.4	1.1
	Outturns	3.8	-0.2	-4.0	-1.4	1.5
Domestic demand	*Projections* [1]	2.0	-3.8	-5.0	-1.9	0.3
	Outturns	2.2	-4.1	-7.0	-1.3	1.0
Employment	*Projections* [1]	-1.5	-1.5	-1.6	-1.6	-0.5
	Outturns	-1.5	-1.5	-4.2	-2.8	2.0
GDP	*Projections* [1]	2.3	-1.2	-1.9	0.3	1.7
	Outturns	2.5	-1.0	-3.5	0.4	1.6

[1] Source for 2010, 2011: DG ECFIN (2011a, original MoU) / Sources for 2012, 2013, 2014: projections at the time of detailing fiscal consolidation for the following year without target revision = for 2012: DG ECFIN (2011b, Dec. 2011) , for 2013: DG ECFIN (2012d, Dec.
[2] Source: DG ECFIN (2014c, October 2014)

Table 4.3:
Overview of fiscal figures (% of GDP - ESA-95)

		2010	**2011**	**2012**	**2013**	**2014** [2]
Indirect taxes	*Projections* [1]	13.4	13.9	15.2	13.7	13.4
	Outturns	13.4	13.7	13.7	13.6	13.7
Direct taxes	*Projections* [1]	8.9	9.1	9.3	11.3	11.1
	Outturns	8.8	9.9	9.3	11.8	11.4
Social Contributions	*Projections* [1]	12.2	12.5	12.0	12.0	11.6
	Outturns	12.2	12.2	11.6	12.2	12.1
Compensation of employees	*Projections* [1]	12.2	11.5	10.0	10.3	9.4
	Outturns	12.2	11.4	10.0	10.7	10.0
Social transfer other than in kind	*Projections* [1]	17.0	17.4	16.7	18.3	18.5
	Outturns	17.0	17.3	18.0	18.8	18.4

[1] Source for 2010 and 2011: DG ECFIN (2011a, original MoU) / Sources for 2012, 2013, 2014: projections at the time of detailing fiscal consolidation for the following year without target revision = for 2012: DG ECFIN (2011b, Dec. 2011) , for 2013: DG ECFIN (2012d, Dec.
[2] Source: Outturns based on DG ECFIN (2014c, October 2014)

At the beginning of the programme, Portugal used positive one-offs to comply with fiscal requirements. In 2011, the deficit came in at 4.0% (Table 4.4 and Box 4.1), below the 5.9% of GDP target, due to the effect of the transfer of the banks' pension funds to the state (worth 3.5% of GDP). ([54]) Net of one-offs, the deficit stepped down by only 1.3% instead of the planned 2.7%. In 2012, Portugal missed the revised deficit target by 1 pp of GDP. This was accepted under the programme on the basis that at the time the statistical authorities had not classified the sale of ANA airport concession as deficit-decreasing offsetting factor; this would reduce the deficit by 0.7% of GDP bringing it closer to the target.

([54]) The transfer of the banks' pension funds increased future social security pension expenditure. In 2012, this translated in additional expenditure worth about € 0.5bn or 0.3% of GDP. On the other hand, revenues from social contributions benefitted from the inclusion of banks' employees in the general social security scheme. The transfer of the banks' pension funds also increased the banks' recapitalisation needs, because of the full recognition of actuarial losses accumulated over past years (DG ECFIN, 2011c and 2012a; CdF, 2013 and 2014b).

Table 4.4:
Fiscal targets vs outturns (% of GDP – ESA-95 unless otherwise stated)

		2010	2011	2012	2013	2014 [2]
General Government Balance [1]	*Revised targets*		-5.9	-5	-5.5	-4.0
	Outturns	-8.5	-4.0	-6.0	-4.5	-4.5
	Net of one-offs	-8.6	-7.3	-6.0	-5.3	-3.4
Total revenues	*MoU*		41.8	42.4	42.3	
	Outturns	41.4	45.0	40.9	43.7	44.5
Total expenditures	*MoU*		47.7	46.9	45.3	
	Outturns [1]	50.0	49.0	46.9	48.2	48.9

[1] Excluding support to the banking sector
[2] ESA-2010

Besides the recessionary European environment, the drastic horizontal cuts to achieve the initial target for 2012 may have contributed to weak growth outcomes. Despite the disappointing outcome of 2011, the programme did not change course: the original 2012 target implied an expected improvement of 2.8 pp in the deficit net of one-offs, mainly on the expenditure side. In the absence of ongoing reforms of the public sector that could be expected to deliver upfront such substantial tailored savings, the approach was to introduce horizontal and temporary cuts, such as the suspension of 13th and 14th monthly payments to pensioners and public employees. The worse than originally expected recessionary European environment, including in Spain – the main Portuguese trading partner –, weighed on the economic performance of Portugal. However, these cuts may have played a role in the dramatic fall of domestic demand in 2012. The cuts to public wages and pensions impacted on both current and expected disposable incomes of an important part of the population. Impaired access to credit during the financial crisis is likely to have further amplified the impact, while the income effect that would increase labour supply was limited with regard to public employees and pensioners.([55]) Following the reversal of monthly payments cuts and their replacement with revenue measures, the decrease in internal demand significantly slowed down in 2013 (Table 4.2). At the end of 2012, the programme partners accepted a deficit of 6% of GDP, missing even the revised target.

In addition to one-offs, the fiscal consolidation was heavily based on measures that were to be replaced by fiscal-structural reforms yielding permanent savings. However, progress on public wages and pensions reforms was slow. Exceptional budgetary measures would allow the deficit to be closed, while giving the Portuguese authorities the necessary time to develop structural measures that would deliver permanent savings. Budgetary measures were allowed by the Constitutional Court only temporarily, on the basis of urgency and extraordinary economic circumstances (Box 4.2). Notably, the suspension of the 13th and 14th monthly pension and public staff payments, introduced in 2012, was rejected by the Court as soon as in 2013. Alternative structural measures were not advanced promptly. A spending review was only started in mid-2012 and it was mainly based on proposals from the line ministries through a bottom-up approach. Following the assessment of the existence of a positive public wage *premium* for less demanding jobs and the opposite for more demanding jobs, the government only introduced the plan of a single wage and a single wage supplement scale, which was delayed until after programme expiration and safeguarded the remuneration of incumbent staff. ([56]) The comprehensive structural reform of the pension system was postponed until after the 2015 elections.

([55]) Reducing spending has a short-term contractionary impact that is greater than increasing taxes (Barrel, R. *et al.,* 2012). About the role of current and future disposable income in consumption behaviour, see Almeida, V. *et al.* (2011). About the effect of impaired access to credit, see Corsetti, G. *et al.* (2012). In 2010, public employees represented 11% of the total labour force (OECD, 2012a). In 2012, population over 65-year-old was about 17% of the population (and 30% of the working age population) (OECD data and OECD, 2013a)
([56]) The new single wage scale has become effective at the beginning of 2015. (DG ECFIN, 2015b). In the framework of the stakeholder consultation, the issue of the level and structure of the public wages emerged as particularly controversial. It was also mentioned that a comprehensive reform of the civil service was needed.

Despite lack of progress in permanent expenditure cuts, **fiscal performance was broadly in line with the targets in the second half of the programme, when it became more revenue-based.** In 2013, the objective of a 2/3 expenditure-based consolidation was finally abandoned. The revised target was overachieved by around 1% of GDP (Table 4.4), as tax revenues rebounded (Table 4.3), following the revision of PIT and partly as a result of a one-off tax measure. Without the latter, the deficit would have come around the target. After the programme expired, Portugal missed its 2014 target by 0.5 pp of GDP, while revenues kept on increasing (Table 4.3). The target would have been achieved without negative one-offs, which nevertheless contributed to prospective savings for the general government. Changes to debt management of the transport SOEs had an immediate negative impact on the deficit, but contributed to strengthening the sector's underlying position. Public staff departures implied upfront costs for financial incentives but contributed to reducing the public wage bill in future years.

PIT contributed the most to the revenue-based consolidation, driven by an increase in tax rates. Personal income tax was significantly revised in 2013: the tax rates were increased, particularly for higher incomes, through a new permanent rate structure and a system of temporary surcharges. ([57]) Other measures during the programme reduced benefits and deductions, broadening the base. As a result, receipts from PIT increased by 36%, from € 9.6bn in 2010 to € 13.1bn in 2013, despite employment, and gross wages and salaries per employee decreasing. Higher tax rates can have a negative impact on labour supply, but, at least in the short term, this impact is likely to have been limited by the large degree of slack in the economy. In 2013, the contribution of taxation to inactivity or unemployment traps was still relatively low. ([58])

The VAT structure has been made more efficient. The standard rate of VAT was increased from 21 to 23% in 2011. The base was broadened by narrowing the application of the reduced rate in 2012 and this was appropriate considering that the VAT policy gap in 2013 was still well above the EU average. ([59]) Despite the review of the rate structure, receipts from VAT declined in 2012 and 2013 as a result of declining consumption. In 2014 private consumption was growing again and this resulted in an overall increase in VAT receipts amounting to 8.5%, during the programme period. The VAT measures increased the efficiency of the VAT structure, because the tax base broadened and the list of items moving to higher rates included goods and services that are complementary to leisure, limiting the impact on labour supply.([60]) The slack in the economy is likely to have contained the inflationary impact.

Base-broadening measures to increase taxation on immovable property were appropriate but Portugal could have shifted more towards recurrent property taxation. Portugal concluded the reassessment of property values in 2013. Following the widening of the tax base, municipalities lowered their tax rates, while safeguard clauses prevented a too high increase for low-income taxpayers. During the programme period, taxes on immovable property increased by about 16%, as a result of a decrease in transaction taxes (-17%) and a significant rise in recurrent taxes (+33%). ([61]) This decrease in transaction taxes was due to the crisis, so more should have been done to shift taxation to recurrent property taxes.

([57]) This system included a surtax of 3.5% on income above annual minimum wage and solidarity rates applied on incomes subject to the marginal tax rate. When the programme expired, the gradual reversal of the temporary surcharge on personal income tax over 2016 to 2019 was projected to have a permanent deficit-increasing impact of 0.4%. In the framework of the stakeholder consultation, it was mentioned that the programme did not correct the instability and complexity of the tax system and that the tax hikes introduced during the programme are temporary.

([58]) DG ECFIN and DG TAXUD (2015). Other contributors to 'traps' being, e.g. withdrawn unemployment benefits, social assistance and housing benefits. In 2012, the only 'trap' above the EU and euro area averages was the unemployment trap at 67% of the average wage and the difference became even slightly worse in 2013. However, the contribution of taxation was still relatively low, pointing to the need for a targeted action on the social benefits side.

([59]) The VAT policy gap is the gap between the VAT theoretical tax liability and the 'ideal' liability without reduced rates or exemptions. (DG ECFIN and DG TAXUD, 2015)

([60]) A number of studies illustrate the welfare gains that can be achieved by means of broadening the VAT base, such as Mirrlees, J *et al* (2010) Research favours taxing complements to leisure at the highest rate, in order to make them unattractive compared to work. This is referred to as the Corlett-Hague Rule, (Corlett and Hague, 1953). See DG ECFIN and DG TAXUD (2011).

([61]) Calculations based on INE data.

The corporate income tax (CIT) has appropriately been made more growth-friendly. On competitiveness grounds, the statutory tax rate was reduced from 25 to 23% (21%, shortly after the programme). A system of progressive surcharges made taxation heavier for more profitable corporations. Tax expenditure has been reduced, through the reduction of deductions and special regimes. The deductibility of debt interest was limited, a tax deduction for retained and reinvested earnings was introduced, the allowance for corporate equity was kept in force for SMEs. These measures went in the right direction of reducing the debt bias. Given the need to increase productivity and competitiveness on the international markets, other measures such as the introduction of a tax credit for investment expenses and the extension of incentives for research and development up to 2020 were rightly implemented.

The move towards more revenue measures may have supported short-term demand, while giving more time for implementing expenditure cuts. Ultimately Portugal shied away from pursuing the difficult measures that would help it over the medium term. Increasing taxes could improve the budgetary situation at less immediate cost to aggregate demand, especially when impact on labour supply and prices could be expected to be subdued. However, following the achievement of the fiscal targets, Portugal has not finalised the structural measures on expenditure. The inefficiencies in Portuguese public spending were the result of years of political choices that required strong political will to address and that had a negative impact on Portugal's key weakness: economic growth. By raising current expenditure in 2013, growth was once again based on domestic demand (CdF, 2015b). This could have only been an intermediate step towards a durable solution on expenditure. By shying away from pursuing it, Portugal missed an opportunity to make the choices that would be most beneficial to it over the medium term.

Contextual factors might have contributed to weakening the reform momentum. These may include the relaxation of the financial constraints as Portugal returned to the debt market. This was facilitated by the announcement of the Outright Monetary Transactions (OMT) by the ECB in summer 2012, and the revision of the euro area official debt maturities to around 20 years, in late 2013. ([62]) In addition, reform fatigue kicked in, while the political context was weakening.

A budget-neutral fiscal devaluation was first postponed and then abandoned. The cost of each percentage point of reduction of the employers' contributions was estimated at €400 million. For 2012, the government considered offsetting the cost of the fiscal devaluation through a VAT increase or public expenditure cut, but these measures had to be used to cover the fiscal gap. Similarly in 2013, the fiscal devaluation would have required a substantial adjustment of the fiscal targets, in the absence of alternative offsetting measures. In September 2012, the government proposed the so-called 18/18 measure, which consisted in compensating the reduction of the employers' contributions (from 23.75 to 18%) through a substantial rise of the employees' contributions (from 11 to 18%). This proposal was dropped after it generated social discontent and brought the government on the verge of a crisis. The reduction in the disposable income of workers would have negatively affected internal demand, which in turn would have had a negative impact on the large majority of SMEs. ([63])

A non-budget-neutral fiscal devaluation would have implied significant risks for the public finances, while it might have not achieved its full potential and would not have contributed to changing the structural features of the economy. With hindsight, the overachievement of the revised fiscal target in 2013 could lead to the conclusion that there would have been fiscal space to accommodate a non-budget neutral fiscal devaluation. However, the overachievement was possible only after the deficit target revision in mid-2013, and thanks to revenue one-offs, whose dissipation could have led to another target revision in 2014. Moreover, while Portugal was benefitting from external factors, such as the adjustment of the terms of the official debt and the announcement of the OMT, it had yet to regain market access on a sustained basis. In general, the advantages of a fiscal devaluation depend on the translation of

([62]) Already in 2011, debt maturities had been extended from around 7.5 years to 12.5 (EFSM) and 15 years (EFSF). In the same context, the interest margins had been cancelled.
([63]) Economic analysts quoted by media when public debate on the proposed fiscal devaluation was ongoing.

lower labour costs into lower prices and/or higher supply, and consequently into more employment. However, this requires an adequate level of competition in the markets, and either gaps in the capacity utilisation or access to finance for further investment, while the Portuguese economy was featuring competition shortcomings and deleveraging pressure. This might have translated into higher rents, especially in the non-tradable sector. Moreover, even if fully successful, the fiscal devaluation could have borne benefits in the short term but it could have hardly contributed to change the low-productivity Portuguese business model. ([64]) A selective reduction of the employers' contributions targeted to the tradable sector, or parts of it, would have been less onerous for the public budget and more beneficial for an economy in need for change, but this approach should have been in line with the competition rules.

([64]) In the framework of the stakeholder consultation, it was mentioned that, in the short term, a fiscal devaluation would have been beneficial to the economy. It was also mentioned that, in a wider perspective, struggling for price competitiveness through this type of measures was not the best way forward.

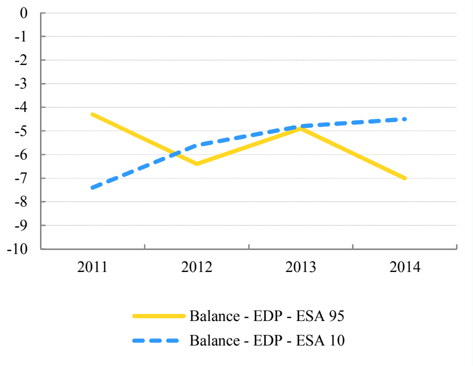
Box 4.1: Some considerations on the impact of the change from ESA-95 to ESA-2010 in Portugal

The ESA-95 accounting system was being used during the programme years, while ESA-2010 entered into force during the second half of 2014. The change in accounting systems heavily affected the amount of one-offs with an impact on the 2011-2014 budget balances. Consequently, the differences in terms of headline deficit are significant (Graph 1.a), while the dynamics of the 'balance net of one-offs' and of the 'structural balance' are far more consistent (Graph 1.b). The significant differences between headline budgets in 2011 and 2014 are mainly explained by:

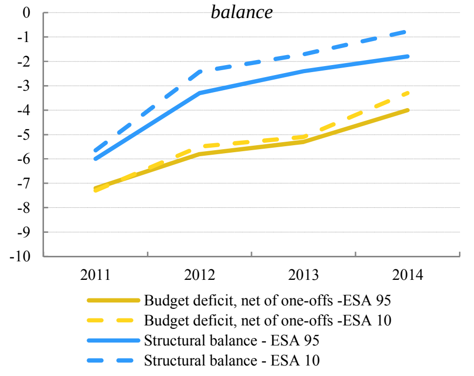
– The transfer in 2011 of banks' pension funds to the government. Under ESA-95, this is classified as a revenue-increasing operation, with a direct positive impact on deficit worth 3.5 percent of GDP. Under ESA-2010, this is just a financial transaction with no impact of deficit;

– SOEs reclassification. Under ESA-2010, many SOEs are reclassified into the general government perimeter, because of a 'strengthened' quantitative market/non market test (sales do not cover at least 50 percent of the production costs, including net interest charges) or 'strengthened' qualitative criteria (this applied to hospitals, public holdings, market regulatory bodies, etc.). ([1]) SOEs are retroactively reclassified as from the year when the criteria have been satisfied. Since then, subsidies or capital transfers from the State to these reclassified SOEs do not impact on the consolidated budget of general government, as they become just internal transfers.

Graph 1a: Headline Budget Deficit



Graph 1b: Net of one-offs and structural balance



Even if the ESA-95 and ESA-2010 'budget deficit net of one-offs' and structural balances follow far more similar paths (Graph 1.b), there are still differences in their composition. The ESA-2010 reclassification of many SOEs brought their expenditure and revenues directly into the general government budget. On the expenditure side, general government's intermediate consumption, compensation of employees and public investment shifted upward compared to ESA-95 (see Table 1). At the same time, the general government budget benefited from a significant decrease of the social transfers in kind supplied to household via market producers due to the reclassification of many health care providers within the government perimeter (no longer as market producers).

([1]) Comparison between DGTF (2014), page 29 and DGTF (2015), page 32. See also INE (2014a)

(Continued on the next page)

Box (continued)

Table 1:
Impact of ESA-2010 on selected items of expenditure (% of GDP)

		2010	2011	2012	2013	2014
Intermediate consumption	*ESA-95*	5.2	4.6	4.5	4.4	n.a.
	ESA-2010	5.9	6.0	5.8	5.6	5.8
Compensation of employees	*ESA-95*	12.2	11.3	10.0	10.7	n.a.
	ESA-2010	13.7	12.8	11.7	12.5	11.8
Gross fixed capital formation	*ESA-95*	3.8	2.6	1.7	1.4	n.a.
	ESA-2010	5.3	3.5	2.5	2.2	2.0

Source: Eurostat

Given the above, within this report, ESA-95 data are used when comparing the headline deficit targets with the related outturns, as this metric was prevailing when the targets were set and revised. The rest of the analysis is based on ESA-2010 data, as they include final data for 2014, projections for 2015-2016, and this metric is now adopted to assess current and future progress in terms of sustainability of public finances.

Box 4.2: Constitutional Court rulings on fiscal consolidation measures

Rulings of the Constitutional Court impacted on key fiscal policy measures included in the programme. ([1])

Reduction of the public sector workers' pay

The Court stated that in exceptional economic/financial circumstances and in order to quickly reduce the budget deficit, the legislator can lower the income of public administration staff, even if this leads to unequal treatment compared to the private sector. However, public costs must be fairly shared among society so there is a limit to this possibility (principle of equality). Furthermore, as time passes, the legislator is subject to a gradually increasing requirement to find alternatives to prevent the difference in treatment from becoming excessive.

The Court accepted the temporary average cut of 5 percent to public sector wages that had been introduced in 2011. In view of the principle of equality, the Court instead ruled against the suspension of the 13th and 14th month payments to public sector workers, but did not require reinstatement for 2012, in order to avoid endangering the State's solvency. The principle of equality applied also when in 2014 the Court rejected the attempt to replace the '5 percent' pay cut with another norm that would have extended cuts to lower wages and would have changed the progressive rates applied so far. Then the legislator tried to reintroduce the ‘5 percent’ pay cut for the period 2014-2018, with the cut reduced by 20 percent in 2015, but without specification about further reversal in the following years. The Court applied again the principle of equality and rejected the cuts for the period 2016-2018. In this case, the Court made reference also to legitimate expectations, as the pay-cuts had always been presented as transitional and justified by exceptional economic circumstances, which were improving in 2014.

Cuts to pensions

When ruling about pensions, the principle of trust was crucial, as dealing with acquired rights of persons for whom it is more difficult to adapt to new circumstances. Nevertheless, the Court clarified that new legislation can have repercussions on the past, when constitutionally protected rights and interests are deemed to prevail over the pensioners' legitimate expectations.

In view of the principle of equality, the Court ruled against the suspension of the 13th and 14th month payments to pensioners, but did not require reinstatement for 2012, in order to avoid endangering the State's solvency. On the contrary, the Court accepted the Extraordinary Solidarity Contribution (CES) for all pensions (above specific thresholds), as it was exceptional and transitory, to react to a situation of emergency. However, the Court stated again that the legislator had to look for alternative measures to prevent the prolonging of differentiated treatments.

In view of the principle of trust, at the end of 2013, the Court rejected the cut of the value of CGA pensions. The Court argued that the existence of diverging legal regimes in terms of conditions for retirement and calculation of the pension resulted from the recognition that, at the time of approval there were sufficient grounds to justify these differences. The cuts could not be justified either by the aim of safeguarding the sustainability of the CGA pension system - the system was closed to new beneficiaries as of the 1st of January 2006, so it could not be self-sustaining – or by the public interest in reducing the transfers from the State budget.

In light of the principle of trust, in 2014 the Court rejected the Sustainability Contribution (CS). The CS raised difficulties in terms of equality, internal fairness and intra-generational justice and did not solve inter-generational problems. The Court stated that CS affect recipients of future pensions, without weighing up of the serious effects that the successive changes in calculation regime and the introduction of the sustainability factor would mean for the determination of the amount of pensions and the retirement age.

([1]) Ruling 353/12 of 5/7/2012, ruling 187/13 of 5/4/2013, ruling 862/13 of 19/12/2013, ruling 413/14 of 30/5/2014, ruling 572/14 of 30/7/2014, ruling 574/14 and ruling 575/14 of 14/8/2014: summaries published by the Constitutional Court http://www.tribunalconstitucional.pt/tc/en/acordaos/

(Continued on the next page)

Box (continued)

In 2014, the Court rejected the reduction of survivors' pensions, but only because of its design (principle of equality). The size of the reduction was acceptable, but it applied only to accumulation with other retirement pensions and not with other income situations.

Overall considerations

As from mid-2013, the programme explicitly requested the Portuguese government to take a number of steps to mitigate the legal risks of future potential Constitutional Court rulings. This included justifying measures on compliance with the fiscal sustainability rules in the Treaty on Stability, Coordination and Governance (TSCG). Nevertheless, the Court made clear that the TSCG does not enjoy the status the Constitution grant to the Treaties governing the EU and norms issued by the EU institutions in the exercise of their competence. Another recommendation concerned the possibility of prior constitutional review of laws, thus allowing early reaction. The President of the Republic has the right to submit reform proposals to a prior legal review by the Constitutional Court which has to be completed within four weeks.

The Court draws its legal reasoning from general constitutional principles, such as the principles of equality, proportionality and trust (democratic state based on the rule of law). By nature, the margins of these principles are not clear-cut and their application to concrete cases is not straightforward. This translated in some measures being accepted, while others rejected. ([2]) In addition, in all the above mentioned rejections, dissenting judges expressed deviating opinions. The only unanimous ruling was the one about CGA, but two judges disagreed with the use of the principle of trust.

In general, it emerged that, within limits, the Constitution allows that the budget laws compress the principle of equality, but this can only be temporary and implies immediate progress towards alternative solutions. In addition, it is possible to overrule legitimate expectations through well balanced structural laws, but this requires proportionality and a clear link with constitutionally protected rights and interests that are deemed to prevail.

([2]) Other measures were subject to Constitutional ruling, such as the PIT reform (accepted), contributions on employment and sickness benefits (rejected), payment of overtime (accepted), suspension of pension supplements at SOEs with net losses in the last 3 years (accepted).

4.2.2. Flanking the expenditure effort

Public staff was significantly reduced, but this process was not led by an upfront and proactive strategy to focus on areas of over-employment. The public wage bill dropped during the programme period by more than 16%, as a result of temporary wage cuts and, more significantly, of staff reduction. As from 2011, government wages were temporarily frozen and cut by 5 percent on average. Promotions were blocked. Management positions and administrative units in the central administration were reduced upfront and the internal organisation of each entity was re-defined. ([65]) The target concerning the reduction of staff of the public administration was achieved, with less strong implementation in regions compared to central and local administrations (see Table 4.5). The restructuring of SOEs and the privatisation process helped. Several career-specific programmes for the termination of contracts by mutual agreement were launched for less qualified workers, teachers and senior experts in areas with over-employment. Nevertheless, the measure to reinforce this tool was included only one year after the start of the programme. The related terminations started late, only at the end of 2013, and gave a marginal and below-expectations contribution to the overall reduction. ([66]) Similar programmes were not adopted for defence (military and police), which was another area of overemployment.

Table 4.5:
Change in employment in public administration (y-o-y % change)

	2012	2013	2014 (p)	2012-2014
Central administration	-4.8	-5.9	-1.9	-10.4
Azores	-2.2	-2.3	0.0	-4.5
Madeira	-2.4	-3.5	-1.0	-5.8
Local administration	-3.6	-5.2	-2.3	-8.6
Total public administration	**-4.4**	**-5.6**	**-1.9**	**-9.7**

Source: DG ECFIN, European Economy, Occasional Paper 202/2014. Calculations based on SIOE database; (p) provisional

The new scheme for the re-orientation of careers towards the real needs in the administration was introduced late and had a marginal impact. Initially, new rules were submitted to Parliament to facilitate geographic mobility. Later during the programme period, focus shifted on the Special Mobility scheme ([67]) that was revised into a Requalification Scheme, with more emphasis on re-orientation of public employees' careers. The implementation of the new Requalification started very late and take-up was very limited, far lower than expected.([68]) This can be also due to the fact that a number of employees in areas of overemployment may have preferred acceding to mutual agreements on contract termination.

Some rules of public sector employment were revised along the structure of the private labour code. Changes included more flexible working time arrangements, less compensation for overtime, fewer holidays, elimination of compensatory resting time and new rules of compensation for the termination of temporary contracts. The working week was extended from 35 to 40 hours.

([65]) Similar cuts were introduced for local administrations - by a law which benchmarked these positions to the size of the municipalities - and for the region of Madeira – by conditionality of the related economic adjustment programme. According to the SIOE database, the number of high managers at mid-2014 was 16% lower than at end-2011 and the number of middle managers was 12.3% lower. (DG ECFIN, 2014c)

([66]) Up to February 2014 they attracted a below expectations amount of around 4.000 employees (DG EFIN, 2014b). By end-April 2014 about 2,300 contract terminations had been completed.

([67]) The Special Mobility Pool (SMP) is intended for people who are redundant as a result of reorganisation. Under the existing rules, the majority of workers could stay in the SMP (earning 50% of their previous salary and full SSC) until retirement. Usage of SMP has been low due to inappropriate incentives, including the cumbersome evaluation model it entailed. (IMF, 2013a)

([68]) Implementation started in April 2014, with some delay due to negative ruling by the Constitutional Court about disproportionate impact on job security. The new requalification scheme was estimated to involve 12,000 employees in 2014 and 2015. Actual numbers were very disappointing. During the first part of 2015, the number of employees in the requalification scheme and re-employed in other parts of the government increased. (DG ECFIN, 2015b)

Pension expenditures were contained, but not through permanent measures. Since 2011, the indexation mechanism was suspended, with the exception of the lowest pensions. The government introduced a temporary Extraordinary Solidarity Contribution (CES) on pensions higher than a threshold. CES was significantly increased in the course of the programme, until it was reverted in 2015. The sustainability factor linking the pension value to life expectancy was redesigned. The retirement age was increased to 66 years in 2014 and will vary according to life expectancy as from 2016. The government solutions to align the rules for public employees appointed before 2006 (CGA) with those in the general social security system and to replace Extraordinary Solidarity Contribution (CES) with a structural Sustainability Contribution were rejected by the Court.([69]) Consequently, the comprehensive structural reform of the pension system, that was needed to decrease the weight of current pensions on public finances and younger generations, was postponed and has not been adopted yet.([70]) In the meantime, the 2012 full suspension of early retirements was lifted in 2015, allowing early retirement through a flexible regime from the age of 60 (rather than 55).

Spending on non-pension social benefits was reduced, despite rising unemployment and declining incomes. Further efforts for better targeting would have been warranted. Reforms of the revenue administration can contribute to the effectiveness of means-testing. While spending on unemployment benefits increased due to the sharp rise in unemployment, other expenditure on non-retirement social benefits decreased by more than €2bn (12%), about 1.3% of GDP, during the period 2011-2013. ([71]) 2/3 of these savings came from sickness/healthcare, which is an area where benefits continued to be paid without means-testing. The second largest contributor to the overall savings was 'family/children' benefits, with a decrease of more than 15% from 2010 to 2013. In 2013, ¾ of these benefits were granted after means-testing, but the income threshold could still be more efficient in excluding non-poor households to the advantage of the poorest (OECD, 2014c). Significant savings were also made in the 'social exclusion' area, mainly tightening eligibility criteria of the social integration income (RSI). This impacted on the most vulnerable (see Section 7). At the end of the programme, there was still room for overall improvement through better targeting, consolidation of fragmented and overlapping programmes, capping of total benefits received by households (OECD, 2014c). A reform implemented in 2012 introduced some corrections to unemployment benefits, but the system still featured low coverage for young workers and relatively high benefits for long periods (IMF, 2013a)

The programme measures were broadly successful in containing health expenditure in a structural way. The programme measures addressed several areas, including the public health sub-systems of civil servants, pharmaceuticals' policy, primary care provision and the hospital network. Strong implementation translated in health public spending falling from 6.8% of GDP in 2010 to 6% in 2014, while private spending remained at around 3% (OECD data). Tax subsidies to health expenses were reduced and user charges were increased, while the scope of exemptions from co-payments was extended to a wider share of the population. A wide array of policies was implemented to reduce public pharmaceutical expenditure, which fell from 1.35% of GDP in 2011 to slightly above the 1% target, mainly as a result of reducing prices for patients. The use of generics rose from 35% to more than 45%, still below the 60% target. Primary care reforms included the reorganisation of health centres (reducing the use of emergency), promoting electronic medical records and e-prescriptions, use of indicators and benchmarking to monitor prescription behaviour, publication of clinical guidelines and reduce

([69]) In 2013, CGA pensioners represented about 17% of the total number of pensioners (DG EMPL *et al,* 2015) Besides adapting the formula to calculate pensions for future CGA retirees, these new rules included the recalculation of the benefits to current CGA retirees. Pensions in payment would have been reduced by about 10%, but the Court rejected these cuts of the CGA pensions (see Box 4.2)

([70]) The current contributions to the public pension systems cover less than 75% of pension-related expenditure (DG ECFIN, 2016a). In the framework of the stakeholder consultation, the temporary emergency nature of the adopted measures and the absence of a proper reform to ensure sustainability and equity were criticised.

([71]) Calculations based on data from the Eurostat database on social protection (data extracted in November 2015). Invalidity benefits are considered together with non-retirement social benefits. These data includes social transfers in kind. They decreased by more than € 0.5bn, including because of measures introduced in the National Health System (reducing the costs for conventions, pharmaceutical subsidies and corporate hospitals). CdF (2013) expenditure on overtime by better organisation. Other part of the health reforms targeted the hospital sector, consisting in concentration, specialisation and the reorganisation of services. Overall, the programme measures went in the right direction as they had a structural nature and strived for more than just short-run expenditure savings, aiming at increasing efficiency and providing more with less.

Access to health was not put at risk, but some structural problems, in particular relating to the hospital sector, are still to be solved. It seems that access to health services has not been dramatically affected, although some negative outcomes are reported. Operational losses of hospitals have not been fully eliminated (e.g. through their restructuring). The underlying problem of SOE hospitals' financing lacked a decisive response and under-budgeting still remains a challenge. ([72])

The restructuring of SOEs was started promptly and reduced expenditure and future contingent liabilities for the state. The initial focus was on the 10 companies (in the transport and infrastructure sectors) posing the largest potential fiscal risks to the state. The SOEs' restructuring process included rationalising services, increasing tariffs and reducing operational costs, in particular with regards to staff costs. ([73]) A 5-year Strategic Plan was put forward for the transport infrastructure sector, which accounted for around 75% of the SOEs' debt. In this sector, companies managed to reach operational balance as soon as in 2012 ([74]); after the operational restructuring, the balance-sheets of some negative-equity companies have been strengthened by means of state loans and partial conversion of loans into equity. Overall, this should lead to a better control of the future debt evolution, which is now also subject to explicit ceilings, with ensuing positive effects on the related state's contingent liabilities. At an aggregate level at the end of the programme, SOEs were still loss making as assets impairments (also related to the legacy derivatives contracts) still weighed on their profitability.

The renegotiation of the PPP projects was started promptly and generated significant savings in current expenditure during and beyond the programme period. After approval of the new framework law, restructuring negotiations started for the most significant PPP transport contracts, for the reduction of payments to private partners and the resolution of contingent liabilities. The negotiation lines included the freezing of investments, the reduction in scope of several contracts, the rationalisation of engineering standards and operational expenditure, the suppression of automatic payments for future capital expenditure (their substitution with future payments linked to the actual need and performance of extraordinary maintenance) and the reduction of the rate of return for the private partner. This was justified by the high standards previously included in the tender and the actual level and composition of traffic. The initial target was €7bn savings over the projects’ life cycle, in terms of PPP annual payments to the private partners (which feeds into public expenditure through intermediate consumption). These payments are estimated to start a slow decline in 2017. The renegotiation allowed for about €0.6bn savings in 2013-2014. Projects’ life cycle savings are estimated at about €5.3bn, while the process is still ongoing. ([75]) ([76]) .

A number of measures to improve the cost-efficiency of the public administration faced implementation difficulties. The use of shared services in the areas of financial, human and IT resources was delayed beyond the end of the programme. At local level, the reduction of parishes became effective

([72]) Stakeholder consultation and DG ECFIN (2016a)

([73]) Employment downsizing was one of the main features of the operating restructuring in many SOEs. It is possible that in a number of SOEs, underlying structural problems have not been fully addressed, but an in-depth assessment of specific SOEs goes beyond the scope of this overall evaluation.

([74]) In terms of EBITDA (earnings before interest, taxes, depreciation and amortisation) after adjusting for the severance packages related to the reduction in staff. In 2014, EBITDA decreased because of a drop in the turnover (including the decline in subsidies granted by the government), and an increase in fair value reductions and impairment losses of both commercial debt and assets (also related with complex derivative contracts that are being contested in court).

([75]) For €3.3bn out of these €5.3bn savings, the process is still pending. Three additional contracts are at different stages of negotiation and can add to these savings, with further progress towards the €7bn initial target.

([76]) At the end of 2015, claims from private partners amounted to about €2bn (similar to the level at the end of 2012). This is not to be interpreted as the expected actual impact, as the latter is very often lower than the initial amounts petitioned (UTAP, 2015) for the local elections in September 2013, but generated some discontent among the population. ([77]) The new legal provision for creating inter-municipal communities to exploit synergies in managing common services was approved, but experienced a very limited take-up. The reorganisation of decentralised services of ministries was based on the *Aproximar* concept. The latter implied the creation of one-stop-shops, covering more efficient geographical areas, ensuring the integration of services, relying on the use of digital government. Opening of the *'Aproximar'* branches was delayed and started after the end of the programme. In 2012, the framework law for the creation and functioning of foundations by the central and local administrations was approved. The initial objective of preparing by 2011 a cost/benefit analysis of all public and quasi-public entities was ambitious. With delays, this was done for foundations, generating some savings in 2014. In 2013, a new legal obligation to regularly report on benefits granted by the public administration to the private sector was introduced. ([78]) Then, the review of public financial support to private associations was started.

4.2.3. Getting a broader and deeper control of fiscal dynamics

Strengthening Portugal's fiscal framework was a complex and long process. A Reform Unit, supported by the technical assistance from the IMF, was set-up by the Ministry of Finance in view of the reform of the Budgetary Framework law. During the programme, the 2011 Law was amended four times to transpose the EU requirements for budgetary frameworks of the Member States (Directive 85/2011), the Six-Pack and the Fiscal Compact. ([79]) This contributed to delay the broader reform of the budgetary framework law, which was eventually postponed until after the end of the programme. The Fiscal Council was set-up and made operational in 2012. At the level of regions and municipalities, the new legislation on financial management was approved in September 2013, strengthening the monitoring and reporting requirements as well as coordination across levels of government. A Municipality Support Fund and a resolution mechanism for local bodies have been set-up. This should support stability and proper ex-ante risk assessment in future lending decisions.

The programme improved the control over the dynamics of central PPPs and SOEs. New initiatives were stopped until a comprehensive assessment of the ensuing fiscal risks was concluded and translated into a better institutional framework. As for the PPPs, in 2012, a new legal framework was put into place to reinforce the role of the Ministry of Finance over the PPP project cycle, to set up a new technical unit (UTAP) and eventually to improve control over the fiscal outcomes of these contracts. As for SOEs, in 2013, a new legal framework was put in place to improve SOE's financial planning and debt management (Decree-law 133/2013, changed by Law 75/A/2014). It was followed by the set-up of a new technical unit (UTAM), in the Ministry of Finance, which – in its role of shareholder – was tasked to oversee from a centralized perspective the activities of central SOEs. However, before the end of the programme, the government did not make enough progress in monitoring SOEs and PPPs owned or operated at local level. (DG ECFIN, 2016a).

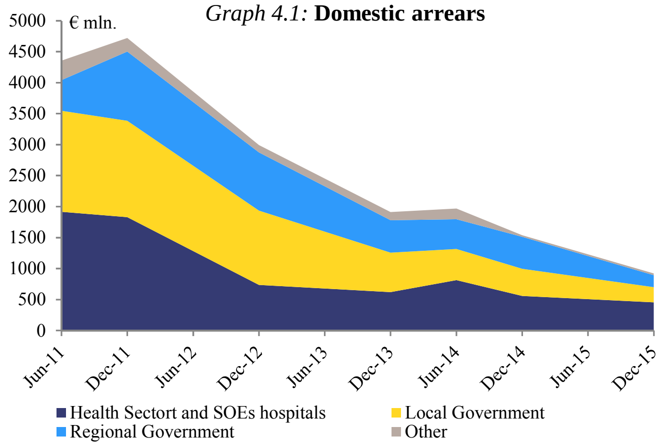
Significant progress has been made in settling arrears. The Commitment Control Law (CCL) was approved in 2012 and aimed at limiting additional build-up of arrears by linking commitments to available funds and allowing for a better control of the budget execution. Arrears decreased significantly in 2012 and 2013 (Graph 4.1), in particular thanks to the special settlement programmes. However, in the health sector, net of these programmes (worth about €1.9bn) the stock of arrears kept on increasing. At the beginning of 2014, programme conditionality required some technical adjustments to the Law so as to bring to zero the net accumulation of arrears (DG ECFIN, 2014a). A dedicated unit, within the Ministry of Finance, in charge of the expenditure arrears for the public sector has then been set-up.

([77]) The new government is re-assessing the merger of parishes. (DG ECFIN 2016a)

([78]) The total amount of public grants in Portugal in 2014 has been about €4.4 bn to about 50.000 beneficiaries, of which about €0.9bn to more than 5.700 private associations. The Inspectorate for Finances is competent for supervision and control of the activities of beneficiaries.

([79]) Law 41/2014, 10 July, published in Diário da República, 1.ª série — N.º 131 — 10 de julho de 2014

Graph 4.1: **Domestic arrears**



Source: PT authorities

4.2.4. Flanking the revenue effort

The tax administration properly developed and implemented the 2012-2014 strategic plan. This listed a wide array of measures to combat tax fraud and evasion, to strengthen audit and enforce collection based on risk management techniques. The plan included measures to improve rules for fighting tax evasion in the presence of complex cases. E-invoicing was introduced to provide the revenue administration with key information to check compliance. A large taxpayers unit was established, for all issues concerning this key segment. Other measures included specific risk analyses and the expansion of the sources of information for cross-checking. Auditing methodologies were developed. ([80])

The implementation of organisational changes in the tax administration was overall satisfactory. In 2012, the tax, customs and IT services were integrated in one single administration, whose set-up benefitted from technical assistance. The reduction of local tax branches (cut by 50%) faced significant implementation difficulties, also in view of implications in terms of logistics and human resources mobility. It was delayed until after programme expiration as this measure was embedded in the overall rationalisation of all public services provided at local level (*Aproximar* programme – see Section 4.2.2). Towards the end the programme period, the MoU included the creation of a Taxpayer Services Department, which was established in 2014, with the aim of centralising services and improving relationship with taxpayers. The cost of collection ratio significantly decreased during the programme, at least partly due to the PIT reform. The ratio between tax administration expenditure and GDP improved, reaching in 2013 the lowest value since at least 2005. ([81])

More could have been done to ensure that the increase in the number of tax auditors would translate in more and better audits. The objective of increasing resources for auditing was postponed and achieved only after expiration of the programme, through the recruitment of 1000 auditors. During 2011-2013, statistics about verification activities did not improve, including for large taxpayers. ([82]) Increasing the number of auditors is not sufficient to ensure a proportional increase of the auditing capabilities, especially for the most complex verifications targeting large taxpayers and HNWI. Even if some references to measures to improve quality were included in the 2012-2014 strategic plan, the programme could have requested a specific plan to improve capability for complex cases, especially in

([80]) MdF (2011). Information about measures that have been implemented is based on GovP (2015). In the framework of the stakeholder consultation, it was mentioned that the reform of the revenue administration was a positive development.
([81]) The cost of collection ratio decreased from 1.55 in 2010 to 0.99 in 2013. The ratio between tax administration expenditure and GDP decreased from 0.258 in 2010 to 0.226 in 2013. OECD (2015a), pages 181, 182
([82]) OECD (2015a), pages 191, 219-221. The large taxpayers unit was established in January 2012 and in 2013 had a ratio staff/large taxpayers of 1/5. In 2013, large companies represented 44% of total revenue collections.

view of this massive recruitment of new auditors. This would have induced strong and specific monitoring. Another premise to effective audits is that auditors are granted adequate powers.([83]) An analysis to identify possible gaps in terms of investigative powers, such as access to information during verifications, might have led to build the case for tailored changes in legislation.

It was appropriate to enhance the fight against tax non-compliance through the availability and integration of more information. Risk analysis was strengthened, but more resources could have been beneficial. During 2013, new information was made available to the revenue administration, through unified forms covering both social contributions and withholding taxes and thanks to the introduction of e-invoicing. In 2013, while gradually phasing in a modern approach to compliance management, the authorities started the analysis of compliance risks associated to different economic sectors and categories of taxpayers. This analysis was delayed and was still ongoing at the time of the last review. In parallel, two pilot compliance improvement projects were started for self-employed professionals and HNWI. ([84]) These two projects were taken over by the new Risk Assessment Unit that became operational in 2014, with a limited amount of staff. More upfront and bolder development of the risk analysis function, possibly including the recruitment of specialised professionals and the centralisation of most of the available analysts, might have been beneficial both to streamlining the quest for new, better, more integrated information and to timely improving taxpayers' selection.

The performance of the measures to increase the efficiency of the tax court system was mixed. There was no clear and stable decrease in the number of pending case. ([85]) Furthermore, during the period 2012-2014, despite the activity of a special task force of judges, tax cases worth above €1 million increased by 9% and their value climbed by 50%.([86]) The creation of special permanent chambers for large tax cases had initially been envisaged by the programme, but then submitted to the assessment of the experience with the task force, which was still active at the end of 2015. The authorities presented a plan to reorganise the state's representation in the tax courts, to improve the success ratio, which actually increased. The publication of statistics on recovery rates, duration and costs of tax cases was not achieved. In general, at the expiration of the programme, the IT system of the tax courts was not working properly yet and this was still hindering efficient management of workload and performance on the basis of reliable statistics.

4.3. OVERALL OUTCOME AND ASSESSMENT

The evolution of the 'budget net of one-offs' points to a closure of the deficit that was slower than envisaged. The budget balance net of one-offs closed by 1.3pp of GDP in both 2011 and 2012, by 0.7pp in 2013 and 1.9pp in 2014 (Table 4.4). However, the 2012 cut was driven by the abolition of the 13th and 14th monthly pensions and public salaries which were *de facto* turned into one-offs by the Constitutional Court (see Box 4.2). If these are counted as a 2012 one-offs, a much more back-loaded profile stands out, with most of the closure in the budget deficit shifting to 2013 and 2014, when consolidation became more revenue-based.

Overall, the consolidation effort turned out to be more revenue-based than initially projected. The programme envisaged consolidation measures on the revenue side worth €3.5bn in 2011, €1.5bn in 2012 and €1bn in 2013. However, budgeted consolidation revenue measures turned out to amount to €5.5bn in

([83]) The Government was just required to submit to Parliament a law to strengthen the auditing and enforcement powers of the central tax administration to exercise control over the whole territory of Portugal.
([84]) In 2013, the revenue administration devoted only 3 staff members for a population of 191 HNWIs. (OECD 2015a).
([85]) After being quite stable during the programme, in 2014 the number of pending cases increased by more than 10%, mainly because of a surge in new cases.
([86]) http://www.cstaf.pt/Paginas/Estatistica-Processual.aspx . Calculations based on *CSTAF (2011-2014).* As mentioned later, the IT system of the tax courts is not working properly yet. This may affect the reliability of statistics. See also stakeholder consultation (Annex 1).

2011, €3bn in in 2012 and €4bn in 2013. This was mainly due to significant VAT and PIT reforms. The latter implied a strong departure from the aim of the programme, which was to focus revenue measures on indirect taxes, while making the corporate income tax more growth friendly. The change in composition of fiscal consolidation is reflected in the evolution of structural revenue and expenditure (Table 4.6).

As a permanent expenditure cut was not secured, the structural balance achieved at the end of the programme was not solid. The structural balance moved from -8% of GDP in 2010 to -1.4% in 2014, which meant a fiscal effort of 6.6% (Table 4.6), broadly in line with the overall improvement requested under the EDP procedure for the same period. ([87]) Nevertheless, at programme exit, more than 1pp of the overall fiscal effort was exposed to high risk of reversal without proper replacement, due to the use of semi-temporary measures, in particular on the expenditure side. European Commission's 2016 Spring forecast indicated that the structural and structural primary balances deteriorated in 2015 and risked deteriorating further in the absence of adequate measures (Table 4.6). As fiscal consolidation tilted towards revenues, which consumed available tax space, it would be important to progress with permanent cuts to expenditure, as this tends to be more durable and growth-friendly in the long term (Wöhlbier, 2014). This is particularly the case of Portugal, where government expenditure can still be made more efficient.

Table 4.6:
Structural Balance (% of potential GDP at current prices – ESA-2010)

	2010	2011	2012	2013	2014	2015	2016	2017
Structural Revenues		*42.1*	*42.5*	*44.3*	*44.5*	43.7	43.8	43.3
Structural Expenditures		*48.3*	*45.6*	*46.8*	*45.9*	45.7	46.0	45.8
Structural balance	**-8.0**	**-6.2**	**-3.1**	**-2.5**	**-1.4**	**-2.0**	**-2.2**	**-2.5**
Fiscal effort		*1.8*	*3.1*	*0.6*	*1.1*	*-0.6*	*-0.2*	*-0.3*
Structural primary balance	**-5.1**	**-1.9**	**1.8**	**2.3**	**3.5**	**2.6**	**2.2**	**1.7**
Fiscal adjustment		*3.2*	*3.7*	*0.5*	*1.2*	*-0.9*	*-0.4*	*-0.5*

Source: Ameco 2016 Spring forecast (May 2016)

Gross public debt peaked in 2014. The primary balance continued to contribute to the increase in public debt, but in the second half of the programme this was mainly due to one-off support to the banking sector. ([88]) However, as it might be expected at a time of negative growth, the largest contributor to the increase in debt was the difference between the growth rate of the economy and the debt interest expenses (snowball effect). The return of economic growth, the reduction of the official debt interest margins and the accommodative monetary policy have resulted in the snowball effect turning more benign. ([89]) Despite this improvement, Portugal is the only country in the euro area forecast by the Commission services to still have a debt-increasing snowball effect in 2017, with the exception of Italy. The stock-flow adjustments played a significant role in the increase of public debt in 2011 and 2012, including due to loans to Greece and Ireland and the accumulation of cash buffer.([90]) In 2014, the repayment of CoCo bonds by BCP and BPI contributed to mitigate the impact on debt of the primary balance and the snowball effect. Public debt peaked at 130.2% of GDP in 2014 and started decreasing in 2015, including

([87]) Council Recommendations on 2/10/2012 and 18/6/2013 with a view to bringing an end to the situation of an excessive government deficit in Portugal.

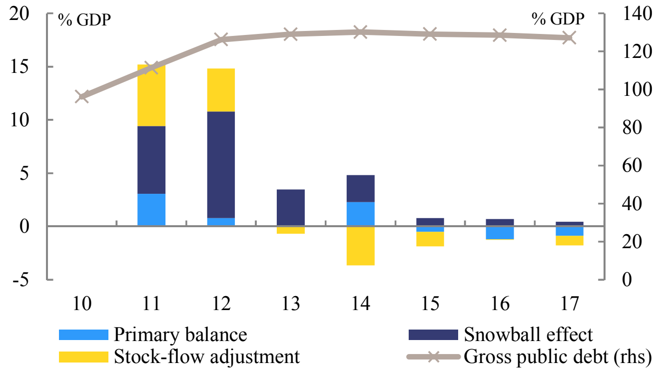
([88]) Primary balance includes support to the banking sector, which was not accounted when assessing compliance with the fiscal targets. In 2014, the cost of the resolution of BES contributed about 3% of GDP to the primary balance.

([89]) The EFSM margin was 215 bps (Council Implementing Decision of 30 May 2011 on granting Union financial assistance to Portugal 2011/344/EU) while the EFSF margin was 208 bps (Banco de Portugal, 2011a, www.efsf.europa.eu/attachments/faq_en.pdf). After debt sustainability and the financing situation in Greece deteriorated, official lenders decided to remove margins. To maintain the principle of equal treatment, the same policy was applied to Ireland and Portugal. On the 11th of October 2011, the Council decided to cancel the interest margins initially carried by the EFSM and EFSF loans. *Ceteris paribus*, continued application of these margins would have implied, in accrual terms, additional costs for Portugal that can be estimated to exceed € 2.5bn during the period 2011-2014.

([90]) The accumulation of deposits reflected the unused 'programme' loans allocated to banking recapitalisation, the transfer of banks' pension funds, as well as advances in the context of privatisations.

due to use of cash reserves to finance early repayments to IMF (Graph 4.2). ([91]) (CdF, 2015a) Net of government deposits, public debt increased also in 2015 from 120 to 121.4% of GDP. (IMF, 2016).

Graph 4.2: **Gross Government Debt Developments**



Source: European Commission 2016 Spring forecast (May 2016)

Privatization proceeds achieved their target and allowed a reduction of the debt and the ensuing contingent liabilities for the state. Under the programme, the target of €5bn privatisation receipts was achieved, reducing the public debt accordingly. Privatizations allow the state to capitalize the present value of the expected future income generated by the companies that are sold. This implies that the state renounces to potential future dividends. ([92]) However, it also removes the related contingent liabilities for the state and can result in improved management of these companies. In Portugal, privatizations have reduced the government perimeter, but they could have been accompanied by stronger reforms of the sectors, ([93]) so as to ensure higher competition and higher efficiency in the future, with positive effects on the whole economy. The privatization process attracted direct investments, from a diverse pool of international investors, in a variety of sectors, such as utilities, airport, postal, and insurance services, at a time where companies were experiencing difficulties to finance investments. ([94]) Some large privatisations were not implemented by the end of the programme. These included the national airline TAP and the cargo rail company CP Carga. ([95])

The consolidation of some corporates' liabilities in the general government perimeter should favour better control of the future dynamics of the public debt. However risks can still materialize from high contingent liabilities. The ESA-2010 reclassification of SOEs' liabilities led to an increase in general government debt, but also reduced uncertainty on its prospective trajectory, as the dynamics of these non-financial SOEs are now fully considered within the budget process. At the end of 2014, liabilities of non-financial entities controlled by central and local government, but still classified outside the general government perimeter, amounted to 3.6% ([96]) and 0.9% of GDP respectively and about half of

([91]) In addition it must be considered that in 2012 and 2013, Social security funds sold assets of other OECD states and bought Portuguese public debt, bringing the relative weight of the latter to 55% of their portfolio. This contributed to the decrease in the consolidated public debt, because debts between entities within the perimeter are not considered. The Portuguese authorities intend to bring this weight to 90%. (CdF, 2014a) These purchases bring forward the debt-reducing stock-flow adjustment that is generated by the sale of foreign assets and reduce portfolio diversification.
([92]) The multiples - calculated as ratio of the proceeds on EBITDA - have been broadly in line with those of comparable companies in other geographies. This is an indicator of the success of the process.
([93]) Some reforms were however implemented, in the transport, infrastructure, water and sewerage bulk service management sectors, as for example the framework law for the national regulatory authorities (NRAs). See Section 5.
([94]) In the framework of the stakeholder consultation, it was however mentioned that the privatisations were not led by a clear strategy and were not decided in the context of effective social dialogue.
([95]) After an earlier attempt failed in 2012, TAP was privatised, but, after the programme, the new government regained control. The privatisation of CARGA was concluded by the new government. (DG ECFIN, 2016a)
([96]) With reference to central government, this represented an increase from 2013, when this amounted to 3.44% of GDP.

them were owed by loss-making units. The liabilities of financial entities controlled by (and outside the perimeter of) the general government were far higher at about 74.8% of GDP, the highest value in the EU and on a steep rise with respect to 2013 (47.3%). The amount of general government one-off guarantees approximated 7.1% of GDP (decreasing with respect to 2013, when it was 13.3%). With regards to PPPs, the potential impact in case government would have to take over the assets slightly decreased to 4.8% of GDP. This was still the highest in the EU. ([97])

Besides being exposed to contingent liabilities, the debt trajectory is particularly vulnerable to a loosening of fiscal discipline and negative economic developments. Continued fiscal consolidation and sustained growth are essential to put debt on a clear downward slope. In 2015, public debt was still very high (the third highest in the EU). It is expected to decline moderately, on the back of favourable interest rates, continued economic recovery, expected structural primary surpluses (1.4% of GDP) and debt-reducing operations. ([98]) This trajectory is still vulnerable to macro-economic and financial market shocks. In case of a structural primary surplus at 0.9% of GDP ([99]), public debt is projected to stabilise at a high level, without a clear downward path. In this scenario, shocks to nominal growth and interest rates could more easily put the debt on an unsustainable trajectory. Continued fiscal consolidation - including to address past shortcomings in terms of a durable improvement of the structural balance - and the effectiveness of structural reforms in sustaining growth and rebalancing the economy to the tradable sector remain crucial to put debt on a clear downward path. ([100])

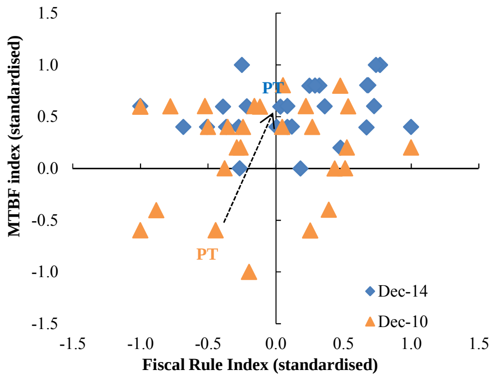
After the end of the programme, the unwinding of some of the main measures is posing additional fiscal risks. The new single supplement wage scale proposed under the programme, never entered into force, as the new government is reassessing it. After being reduced during the programme, public staff already increased in 2015. The three sectors with the largest growth were education, health and transportation. ([101]) Further pressure may come from the decision of the new government to return to the 35 hours working week. One of the tools introduced during the programme to support redeployment of public staff in relation to the real needs - the requalification scheme - was frozen with the re-integration of the first set of employees that were bound to be dismissed because they had not found a new job in public administration one year after their previous job was discontinued. Concerning privatisations, the new government cancelled the award of important urban transport concessions. These policy reversals have been occurring while Portugal is subject to Post Programme Surveillance (PPS).

Significant progress in fiscal governance has been achieved after the expiration of the programme, but weaknesses remain. Improvements in the fiscal rules and medium-term budgetary framework had moved Portugal to an average position within the EU (Graph 4.3a and 4.3b) by the end of the programme. In particular, control over the dynamics of central PPPs and SOEs improved. However, as the comprehensive reform of the budgetary framework law had not been implemented, weaknesses with regard to accounting fragmentation across different levels of government, commitment controls and fiscal risks from local SOEs and PPPs were still recorded. ([102]) Finally, in July 2015, the new Budget

([97]) Calculations based on DGTF (2015) and Eurostat data (consultation April 2016)
([98]) DG ECFIN 2016a. This debt sustainability analysis was carried out in April 2016 and uses the Commission's 2016 Winter forecast as a starting point and takes into account the 0.5% of GDP in additional structural fiscal consolidation measures announced by the government on the 5th of February 2016. Graph 4.2 is based on the following 2016 Spring forecast. From the Winter to the Spring forecast, projections concerning the primary balance improved (from 1.2 to 1.8% of GDP for 2016 and from 0.9 to 2.0% for 2017) and projections concerning the stock-flow adjustment improved for 2016 (from -0.1 to -2.0% of GDP), but worsened for 2017 (from -0.9 to 0.2%):
([99]) European Commission (2016). The debt sustainability analysis carried out around the end of 2014 just after programme exit was based on a structural primary fiscal balance at 2.1% of GDP (DG ECFIN, 2014d).
([100]) See public debt sustainability analysis in IMF (2016) and DG ECFIN (2016a).
([101]) DG ECFIN, 2016a
([102]) IMF, 2014c. Following prioritisation of the transport sector, not enough was done by the end of the programme to ensure adequate supervision of local and regional level PPPs and PPPs in the water/sewerage/waste businesses (European Commission, 2016). SOEs' operating balance fell short of the budget 2015 forecast by 25%. This slippage is mainly explained by state-owned hospitals. (DG ECFIN, 2016a). See also stakeholder consultation (Annex 1).

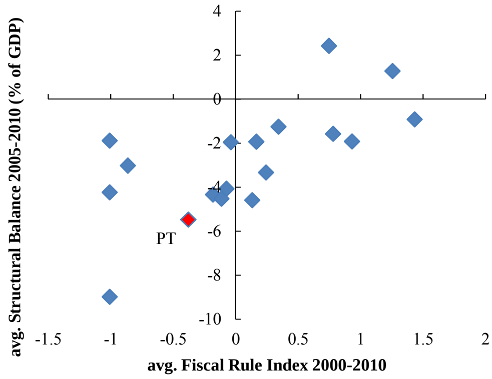
Framework Law (BFL) was reformed and other laws were introduced ([103]), with the aim of addressing outstanding vulnerabilities, but implementation is expected to take several years. Significant expenditure slippages still occurred in 2015. With reference to arrears, amendments to the Commitment Control Law were introduced in March 2015 (Law 22/2015). Pressure remained high in 2015 when the recapitalisation operation of state-owned hospitals only translated into a less than expected reduction of the stock. Non-compliance with the Late Payments Directive (which set 60 days for overdue payments as from mid-2013) is also an important outstanding issue.

Graph 4.3a: **The strength of fiscal frameworks**



Source: European Commission

Graph 4.3b: **FRI and structural government balances for euro-area member states**



Source: European Commission

The originally planned consolidation path and the subsequent flexibility of the programme partners were both broadly appropriate. The fiscal consolidation path that was set at the start of the programme can be considered ambitious, but was required in light of the debt dynamics (see Section 4.1). The programme partners gradually accepted a less frontloaded consolidation path, as Portugal's access to the sovereign debt market increased, also on the back of the more accommodative monetary policy and improved official lending terms. With hindsight, it can be concluded that a more gradual consolidation path than that originally planned would have been sustainable. However, given the information available at the time, the originally planned consolidation path was appropriate and the programme partners' subsequent acceptance of greater flexibility was pertinent. ([104])

A more balanced composition of consolidation during the first half of the programme would have been more efficient if coupled with stronger progress in structural reforms on the expenditure side. Portugal was nearly constantly under the Excessive Deficits Procedure (EDP) from 2002. There was a need for cuts to inefficient expenditure. A programme tilted towards expenditure-based consolidation could help building credibility. Nevertheless, it was not appropriate to frontload expenditure cuts in the absence of ongoing reforms of the public sector that could have allowed delivering such substantial savings in the short term. Relying on temporary expenditure measures proved inefficient. They did not lead to the ultimately envisaged permanent savings, while they arguably contributed to the weak economic performance early in the programme. Given the planned consolidation path, more revenue based fiscal consolidation, at the beginning of the programme, would have allowed more time to design appropriate expenditure measures to be implemented by the end of the programme. This could have also reduced the risk of negative rulings by the Constitutional Court, in a context of high uncertainty about the outcome of its scrutiny on complex and controversial structural reforms, such as the reform of the pension system. Nevertheless, this more revenue-based approach should still have been accompanied by strong plans and monitoring on the needed reforms to ensure that expenditure inefficiencies were properly addressed.

([103]) Law 15/2015, Decree-Law 92/2015
([104]) In the framework of the stakeholder consultation, the issue of the pace of fiscal consolidation emerged as particularly controversial .

The absence of a reform of the state, underpinned by an exhaustive spending review, weighed on the capability to achieve consistent and sustained savings. The initial MoU did not contain the requirement to set an overall vision of the state reform. The latter was only set out by the Portuguese authorities in October 2013, in very broad terms and without any practical follow-up. A comprehensive reform of the public administration would have helped achieving permanent savings in the public wage bill while safeguarding the effectiveness of public services and attracting and retaining people with the necessary skills (see also Section 4.2.2). A reform of social security could have allowed durable savings while minimizing distortive effects on equity and growth. Besides facilitating sustainable savings, rethinking the role of the state could have ultimately contributed to address the structural weaknesses of the Portuguese economy. ([105])

Programme design could have better envisaged the need to develop an overall vision of the state reform, to foster political consensus and sustained ownership on medium and long term objectives. The existence of a clear plan for a comprehensive reform of the state and an in-depth spending review could have helped optimise the selection of the measures to be included in the programme. The plan could have come and been presented to the stakeholders at the very beginning of the programme period so as to steer and frame the ensuing fiscal effort. It could have been immediately followed by further analysis to single out a few reforms on which political capital and administrative capacity should have been invested as a matter of priority. ([106]) For these reforms, detailed implementation plans should have become part of the MoU and a clear reference for strong monitoring. In order to address possible constraints in administrative capacity, the use of technical assistance could have been considered.

([105]) In the framework of the stakeholder consultation, the need for a deep reform of the state, including a civil service reform, and comprehensive spending review were mentioned. The plan for a reform of the state came too late and was not streamlined and detailed enough. A consolidation with fewer cuts in the short term and a larger reduction in the medium/long term would have been preferable. Another view is that the programme approach was justified by the need to intervene quickly in a climate of urgency combined with the limited duration of the programme.

([106]) A number of measures included in the programme - such as the use of shared services, re-organisation of local government and decentralised services of ministries, cost/benefit analysis of public and quasi-public entities - could rely on the authorities' ownership, but were arguably not the most important to induce the necessary change to public finances dynamics and still faced implementation difficulties, absorbing precious administrative capacity and sometimes political capital.

5. STRUCTURAL REFORMS

5.1. KEY CHALLENGES AND PROGRAMME DESIGN

Given deep-rooted economic problems that caused the accumulation of imbalances over a long period of time, structural reforms were a key pillar of the Portuguese programme. Chronic structural deficiencies were at the heart of Portugal's weak economic performance preceding the crisis, and of the feeble outlook for potential growth. These weaknesses included a lack of adequate human capital, poorly functioning labour markets, declining labour cost competitiveness, inefficiencies in product markets characterised by excessive economic rents in many non-tradable sectors, an inefficient judicial system, malfunctioning housing market and deficiencies in the business environment.

Portugal made limited real progress in structural reforms in the years before the programme, despite consistent messages on the need for deep reforms. In response to low post-2000 growth, the need for structural reforms had become central to discussions on Portugal's economic future. The obstacles to growth set out above had been clearly identified by successive Portuguese administrations, academics and other external experts. External policy advice ([107]) typically called for structural reforms to foster economic growth and correct macro-economic imbalances. The implementation of effective reforms was, however, very patchy.

The design of the programme benefitted to an extent from advance preparations and existing reform processes. As Portugal's situation deteriorated, the Portuguese authorities and different parts of the Commission had worked to draw up potential structural reforms. In March 2011, Portugal submitted a National Reform Programme (NRP) to the European Commission ([108]) and a tripartite agreement was signed between the government, employers and trade unions. Many of the structural measures planned in those works were integrated into the programme MoU, signed in May 2011. Thus, this advanced works helped most parts of the MoU related to structural reforms to be quite detailed from the start. But it still took Portugal and the creditors time to find common ground on what the scope and ambition of structural reforms in the programme should be.

The programme included a comprehensive package of structural reforms in light of the many structural weaknesses and inefficiencies. This Section reviews the design, implementation and impact of these reforms, which besides being numerous, often targeted complex issues that take time to fully address. The structural measures encompassed two main areas:

- **First, policies to enhance flexibility in the use of labour and reduce wage costs**. This included changes to employment protection legislation, working hours, unemployment benefits, wage-setting mechanisms, active labour market policies, vocational training and tertiary education; and

- **Second, policies to remove distortions to investment allocation**: this includes product market reforms in goods and services markets aimed at increasing competition and taking excess rents out of protected sectors; also reforms aimed at improving the framework conditions such as measures to reduce the cost of doing business, reforms of the judicial system, the improvement of public procurement processes, the enforcement of competition law and the reforms of the housing market.

The extensive package of structural reforms in the MoU reflected the broad-based economic inefficiencies and distortions at the root of the crisis. The Portuguese programme included numerous and deep structural measures that touched on all the main policy areas, rather than focusing on a few targeted macro-critical issues. This was because the Portuguese crisis reflected broad-based economic

([107]) See for example OECD (2010).
([108]) Portugal 2020 – National Reform Programme. http://ec.europa.eu/europe2020/pdf/nrp/nrp_portugal_en.pdf

inefficiencies, unlike in some other countries where the problems were concentrated in a few sectors, like housing and/or the financial sector.

Structural reforms were meant to be frontloaded. The initial programme MoU stated that structural reforms would be frontloaded, but there was no specific target on the sequencing between labour market and product market reforms. Studies of structural reform implementation have suggested it may be better if product market reforms precede labour market reforms, or at least happen in parallel. ([109]) There is also an argument that when a period of internal devaluation is required, there is a strong case to reform fast, rather than gradually, so that the internal devaluation takes place more quickly. Given the relatively short three-year programme horizon, and the importance of making good progress early, the programme partners were focused more on the overall degree of frontloading than on the sequencing of the reforms.

The programme partners expected that the impact of this broad package of structural reforms on potential growth would be gradual. The long-term benefits of structural reforms are broadly accepted. In contrast the effects on short-term growth are less clear and driven by opposing set of forces. ([110]) The macroeconomic scenario in the original Portuguese programme cautiously assumed that the effects of structural conditionality on potential growth would be marginal in the short-term, while they should bring long lasting benefits in the longer term, including a sustained reorientation of activity towards tradable sectors. ([111]) During the programme further analysis became available on the micro-level impact of different structural reforms in Portugal, which informed the programme's evolution. ([112])

5.2. REFORMING THE LABOUR MARKET TO CREATE JOBS AND HELP REBALANCE THE ECONOMY

The programme tackled long-standing problems with the labour market and skills that had been brought into sharper focus by the crisis. The biggest issues that Portugal faced prior to the programme were: excessive employment protection of permanent contracts, leading to dualism; uneven access to unemployment benefits; rigid working-time arrangements; inflexible and sometimes excessive wages, linked to sector-wide wage extension of collective agreements; inadequate active labour market policies and vocational training; and low skill levels. The impact of the crisis added a further challenge – reallocation and reskilling of labour. These rigidities, skills gaps and weak cost-competitiveness hampered effective adjustment and made the impact of the crisis on the labour market larger, more persistent, and arguably more unfair that would have been the case in a more flexible economy.

At a high level the programme covered the right areas, but it was a challenge to fully address in a three year programme a reform agenda of the breadth and depth that Portugal needed. The labour market reforms in the programme aimed to bring down unemployment and help Portugal to rebalance its economy and regain external competitiveness. This meant action to facilitate the reallocation of labour (and other resources) and to better align pay with productivity. The reforms to labour market regulation were front-loaded in comparison to other structural reforms. Reforms to secondary education were also included in the programme although the payoff is more long term.

The measures in the programme built on existing agreements between the Portuguese government and social partners, which were then updated in 2012. The MoU specified that reforms in labour and social security legislation would be implemented after consultation of social partners, taking into account

([109]) This is because the effects of product market reforms (in particular lower mark-ups and expanded investment) can mitigate the adverse short-term effects that (necessary) labour market reforms can have on employment and wages. Blanchard, O., Giavazzi, F. (2003).
([110]) One aspect is contractionary, as reforms lead to lower prices and higher real interest rates. This may postpone consumption and investment decisions and lead to GDP contraction (especially when monetary policy is at the lower bound). The other set of forces is expansionary, as reforms raise expectations of permanent income, so that firms bring forward investment and households consumption.
([111]) DG ECFIN (2011a)
([112]) See for example, Monteagudo *et al* (2012)

possible constitutional implications, and in respect of EU Directives and Core Labour Standards. As noted above, many of the measures in the MoU were based on a March 2011 tripartite agreement ([113]). This agreement was updated in January 2012 ([114]), during the programme. The Tripartite agreements effectively set the parameters for the changes to labour market regulation that were possible under the programme. The reforms in the programme involved compromises, and in some cases their design was not ideal or their scope could have been wider. But in the context of Portugal's social and political system, overall these Tripartite agreements were a positive factor for programme ownership and success, and for limiting the level of industrial action during the programme.

5.2.1. Labour market reforms

Wage Setting

An inflexible wage bargaining system led to an erosion of external competitiveness and limited adjustment capacity in a context of very weak productivity growth. Although overall wage growth was not especially rapid before the crisis, nominal Unit Labour Costs (ULCs) increased significantly in the pre-crisis period in a context of very weak productivity growth (see Section 2). Higher wage outcomes for protected "insiders" were partially masked by the downward pressure on average wages exerted by the growth of often low paid temporary employment. Portugal had a particularly high level of downward nominal wage rigidity ([115]), and relatively high wages in the non-tradable and public sectors. When the crisis hit, this limited the downward adjustment of real wage costs in response to rising unemployment, and hindered the scope for a shift in resources towards tradable sectors. As a result, in Portugal (unlike for example in Ireland) substantive structural reforms were necessary to facilitate an improvement in cost-competitiveness.

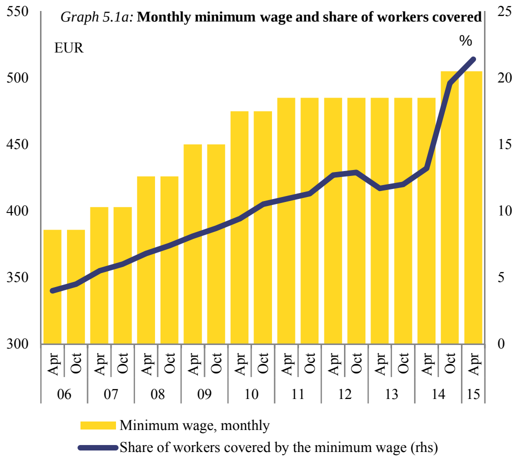
The measures in the programme sought to ensure that in future private sector labour cost developments would enable firms to be competitive and create jobs. The MoU did not envisage a cut in the minimum wage but it did entail the cancellation of previous government plans for further increases and stated that any future minimum wage increases should be compatible with the economic and labour market situation. The measures in the programme also sought to increase firm-level wage flexibility by reviewing the criteria for the extension of collective agreements across a sector, and the size limits to firm level negotiations. As set out below Portugal's Constitution and institutional set up influenced the type of reforms that were feasible.

The minimum wage was frozen during the programme, but sharp increases before the crisis hit meant its coverage was already quite high. The minimum wage for full time workers was frozen at €485 per month (in 14 payments per year) throughout the programme, but as Graph 5.1a shows it did rise sharply in the years before the programme. The minimum wage rose from €485 to €505 in October 2014, after the end of the programme, and to €530 in January 2016. Since 2006 the total increase in the minimum wage has outpaced that of average wages (Graph 5.1b). As a result the proportion of all workers earning the minimum wage rose from 4% in 2006 to 11% at the start of the programme, 13% at the end of the programme and 21% in April 2015 (Graph 5.1a). Coverage of the minimum wage is now quite high in comparison with other European countries. ([116]) Before the increases that took place in the minimum wage after the programme ended, the bottom part of the Portuguese wage distribution was already quite flat. The programme partners and Portuguese authorities discussed the idea of a lower

([113]) *Acordo Tripartido para a Competitividade e Emprego*, 22 March 2011. This Tripartite agreement was signed by the government, employer and business organisations, and most of the main trade unions. The General Confederation of Portuguese Workers (CGTP-IN) did not sign.
([114]) Compromisso para o Crescimento, Competividade e Emprego, 18 January 2012.
([115]) Of a sample group of 16 developed countries, Dickens, W.T. *et al* (2007) found that Portugal had the highest proportion of workers potentially affected by nominal wage rigidity. Messina, J. *et al* (2010) similarly found that, unlike other countries studies, Portugal had more nominal than real downward wage rigidity.
([116]) Hallett, M, (2016)

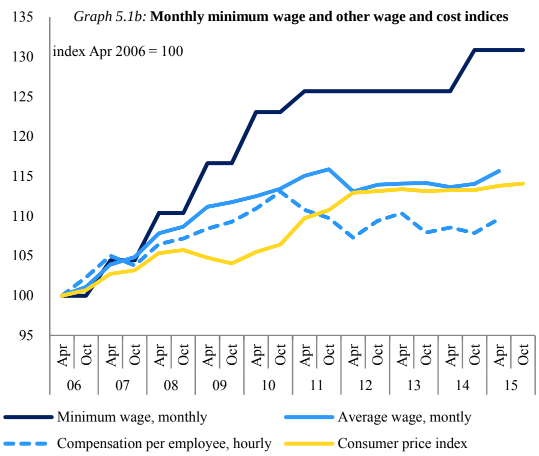
minimum wage for all young workers ([117]) but this was not pursued. Given very high youth unemployment, and the higher proportion of young workers earning at or near the minimum wage, there was an economic rationale for reducing the minimum wage for young workers, or even all workers. However there seems to be a consensus among Portuguese stakeholders that any attempt to reduce the minimum wage as part of the programme would have been misguided, as the negative impact on public opinion would have far outweighed any potential economic benefits. Given the importance of national ownership, restricting the MoU measure to a freeze was therefore understandable.

Graph 5.1a: **Monthly minimum wage and share of workers covered**



Source: European Commission

Graph 5.1b: **Monthly minimum wage and other wage and cost indices**



Source: European Commission

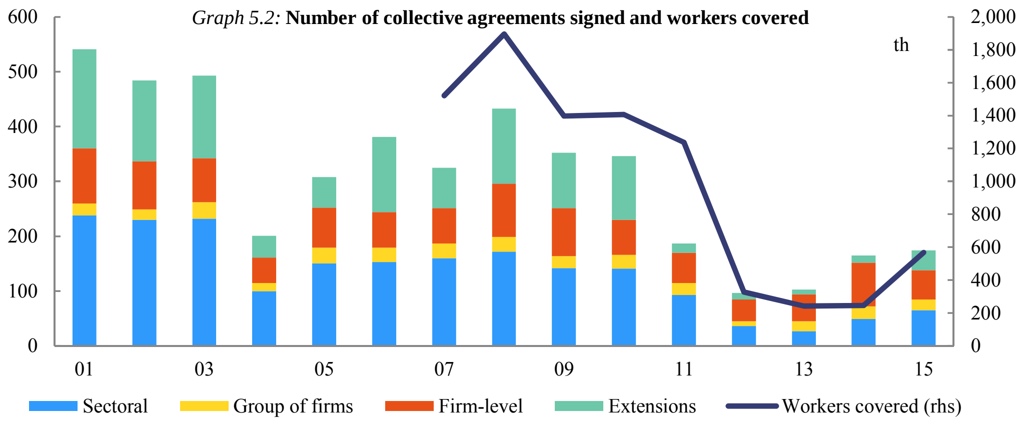
There has been a downward adjustment in average wage costs, but due in part to remaining rigidities this has not been distributed evenly. Wage growth slowed when the economic crisis initially hit (2008-11) and was on average negative during the programme period. As Graph 5.3b shows, Portugal's relative unit labour costs have fallen significantly. Due to nominal wage rigidity, linked both to collective bargaining agreements and to the restrictions that the Constitution and labour legislation place on the scope for permanent wage reductions ([118]), employers had little scope for reducing the wages of existing private sector workers (Section 4 discusses public sector pay). As an alternative means of reducing the nominal cost of labour the original programme MoU envisaged a fiscally neutral reduction in employer's social security contributions, paid for by a commensurate rise in VAT. This proposed "fiscal devaluation" is discussed in more detail in Section 4. In the end it was not implemented. ULCs were also reduced by an increase in working time resulting from the removal of four national holidays in 2012. This was recently reversed, after the end of the programme.

While there have been some reforms to widen the scope for firm level wage bargaining in the private sector, in practice the wage setting system is still quite rigid. As part of the programme, changes were made to reduce the extension of collective bargaining agreements to all remaining firms in a sector who were not original signatories. The new rules stated that a collective agreement would only be extended to cover all firms in a sector if the companies signing it represented at least 50% of the workers in the sector. As shown in Graph 5.2 the number of new collective wage agreements fell sharply from 2011, with a particularly sharp decline in extensions. It appeared that the social partners sought to avoid negotiating under the new system. Sectoral collective agreements can also be temporarily suspended if there is agreement to do this at firm level. However in practice this provision is rarely used as it requires the firm-level intervention of the original signatories to a sectoral agreement, in a country with a tradition

([117]) The full minimum wage rate kicks in at 18 in Portugal for most workers, but a reduction of 20% is applied for apprentices, trainees and interns.
([118]) Under Portuguese labour legislation firms cannot reduce contracted wages, even with the employee's consent. See Dias, D. *et al.* (2013)

of centralised social dialogue. The idea of allowing direct employer-employee agreements at firm level was discussed but not pursued. In June 2014, shortly after the end of the programme, the Portuguese authorities further changed the rules on collective agreements so that they will now be extended to the whole sector if at least 30% of the signatories on the employer side represent SMEs. The result is that the large majority of sectoral agreements will again meet the conditions for extension. This measure is likely to hinder efficient wage adjustment in lower-productivity firms and represents a major setback in the reform of collective bargaining in Portugal. In aggregate the legislative changes enacted since the start of the programme may therefore have a relatively modest impact on the responsiveness of wages to economic conditions at firm level. ([119])

Graph 5.2: **Number of collective agreements signed and workers covered**



Source: European Commission

The programme also included reforms to both reduce the cost of overtime and facilitate the flexible adjustment of working time. The cost of overtime in Portugal was among the highest in Europe and more generally working time arrangements were inflexible. Reforms undertaken during the programme reduced the cost of overtime ([120]) and increased working time flexibility, as well as temporarily increasing working hours in the public sector. This should help firms to accommodate economic shocks and shorter term fluctuations in demand, manage employment fluctuations over the cycle, better accommodate differences in work patterns across sectors, and become more internationally competitive.

Employment Protection Legislation (EPL)

Strict rules for individual dismissal of permanent workers were both a chronic and an acute problem for the Portuguese economy. They hindered the creation of permanent jobs and had helped to create a dual labour market. At the onset of the crisis Portugal had the strictest protection against individual dismissals in the EU. In contrast, at least on paper, protections against collective dismissals were much weaker. Two main elements made employers hire on temporary rather than permanent contracts where possible. The first was the very high level of severance pay for workers on open-ended contracts (30 days' pay per year worked). At the same time an earlier easing of the regulations relating to fixed-term contracts had intensified the asymmetry between permanent and temporary employees. The second was the narrow definition of fair dismissal for permanent employees, which further raised the risks for employers in giving open-ended contracts. The proportion of employees on temporary contracts increased from 10% in 1995 (below the EU average) to 23% in 2010 (the third highest share in the EU).

([119]) DG ECFIN (2014c).
([120]) In most cases the supplement for overtime paid in addition to standard hourly pay was halved.

Strict EPL also hindered job-to-job mobility, and was a barrier to economic restructuring in response to the crisis. If a worker moved to a different employer they lost the severance payment entitlements that they had acquired. This, combined with the difficulty in dismissing employees, hindered the reallocation of labour away from low-performing companies to sectors and firms with scope to expand. When the crisis hit this low level of labour market dynamism exacerbated an existing problem of long unemployment spells. It also made the restructuring of the economy more painful, and arguably more unfair. It was often not affordable or realistic for firms to respond to falling sales and profitability through dismissals or wage cuts. A high proportion of the reduction in labour income in the crisis came via struggling firms shutting down. ([121])

Comprehensive measures to relax strict EPL were therefore rightly a priority in the Portuguese programme. The measures in the MoU aimed to reduce labour market segmentation, foster job creation and facilitate investment and economic adjustment, in particular by moving towards a "single contract". As a first stage, building upon the March 2011 Tripartite Agreement, the severance payments due on open-ended contracts were to be fully aligned with those of fixed-term contracts. A second stage of reforms was then envisaged to: i) bring the level of severance payments closer to that of other EU countries; ii) make the definition of fair dismissal for open-ended contracts less restrictive; and iii) make part of workers' entitlement to severance payments portable to promote job-to-job mobility (by creating a fund financing notional individual accounts, similar to the Austrian system). The portable severance fund was not ultimately implemented, and some stakeholders consider that this is partly because the model proposed in the MoU was too complex. Given Portugal's starting position, and the importance of maintaining broad-based support for programme reforms, a "big bang" move to a flexible labour market during the programme was probably not feasible. It is therefore understandable that the MoU treated reforms to EPL as a staged process.

Severance payments for fair dismissals from permanent contracts have progressively been reduced. Severance pay was initially reduced from 30 days per year of service to 20 days. Since October 2013 the compensation rights accrued are either 12 or 18 days of service depending on existing length of service. And from October 2016, 12 days of severance pay will be acquired for each year of service. These are significant changes, which bring the level of compensation for severance in Portugal much closer to international norms. The rules do though still incentivise employers to preferentially fire workers who were hired more recently. As people with employment contracts predating the reforms retain the more generous rights they had previously acquired, this gives them an added incentive not to move jobs. However most stakeholders consider that the grandfathering of existing rights was necessary for the reforms that were implemented to gain and maintain support. Severance payments are now higher for fixed term contracts, which should encourage employers to hire on open-ended contract for jobs of a permanent nature. It is encouraging that most of the net employment creation since the start of 2014 has been in permanent contracts (Graph 5.3a), and these reforms have aided improvements in the labour market.

The definition of "fair" dismissal was expanded, but this reform was reversed after it was ruled unconstitutional. Before the programme, when employers attempted to carry out individual dismissals they were almost never classified as fair, even if the firm faced economic difficulties. As envisaged in the MoU, in 2012 the definition of "fair" dismissal based on redundancy or individual unsuitability for the role was expanded. The Constitutional Court reviewed this measure and ruled that it was unconstitutional and should be reversed. ([122]) The programme partners and Portuguese authorities did not anticipate this ruling. In response the Portuguese authorities introduced a different definition of fair dismissal. However some stakeholders consider that the current definition may not in practice make it much easier for firms to carry out "fair" dismissals without being subject to successful legal challenge as before the programme.

([121]) Carneiro A. *et al* (2013)
([122]) See Constitutional Court ruling no. 602/13 of 23 September 2013. Article 53 of the Portuguese Constitution states "Workers are guaranteed job security, and dismissal without fair cause or for political or ideological reasons is prohibited."

Compensation for unfair dismissal remains high and in practice it remains difficult for firms to carry out fair dismissals. The reduction in severance payments only applies to dismissals classified as fair. During the programme the Portuguese authorities were asked to explore reductions in the high level of compensation (and/or reinstatement) due for dismissals deemed to be unfair. The Portuguese authorities did not pursue any changes before the end of the programme, citing the difficulty of reaching agreement with the social partners. As was the case before the programme, workers who lodge a claim for unfair dismissal are highly likely to be successful. It often takes a long time for unfair dismissal cases to be decided and successful workers can be eligible for back pay and reinstatement. In practice, to avoid lengthy and costly legal disputes employers and employees often reach voluntary severance agreements. These involve severance payments higher than the legal minimum. The reforms to severance made during the programme were valuable and significant. Nevertheless, the programme could have had a greater focus on how to address the practical and incentive problems in the system. This issue was raised and discussed during the programme, but not ultimately addressed. Some stakeholders suggest that the operation of the judicial system is a bigger barrier to labour market flexibility than the labour code.

Unemployment Benefits

The programme included measures to bring the generosity of the Portuguese unemployment benefits system in line with the European average, while at the same time expanding its coverage. Before the programme Portugal had large disparities in entitlement to social benefits between different groups of workers. Many, mainly older, workers were eligible for generous unemployment benefits. This led to unemployment traps that could reduce work search effort and potentially entrench structural unemployment. At the same time other (often younger) workers had little access to social protection (see Section 7). This caused problems of unfairness, and also pockets of severe poverty in a crisis context. The MoU included measures to reduce the maximum duration of unemployment benefits and to taper the level down over time, but with existing rights protected. At the same time coverage of the unemployment benefits system was to be expanded, particularly benefiting the young and those with a short tenure in work. The MoU measures built on reforms that started before the programme, although benefits remain somewhat more generous for older workers. Activation conditions for unemployment benefit recipients have strengthened, but could still be applied more consistently.

Active Labour Market Policies

The quantity and quality of Portugal's pre-crisis Active Labour Market Policies (ALMPs) needed upgrading to respond to the challenges posed by the crisis. In an economic crisis it is critical to ensure the unemployed maintain their engagement with the labour market and do not slip into inactivity. The programme measures focused on improving Portugal's activation policies to strengthen job search efforts by the unemployed, enhance employability, and provide training to ease labour market mismatches. The programme measures built on steps that the Portuguese authorities had already taken in response to the crisis. As well as expanding employment services to respond to high and rising (long term) unemployment, the Portuguese authorities were to assess the performance of existing employment services and develop an action plan to make them more effective.

There is positive evidence on Portugal's expanded and refocused activation services, but there is still scope for further improvement. In March 2012, the Portuguese government launched an action plan aimed at the modernisation of its Public Employment Service (PES). One aspect was increasing the engagement of jobseekers with the PES. Another element was putting in place a number of fiscal incentives and short training courses to support the hiring and reskilling of job seekers. As the Portuguese labour market was depressed through the programme period it will tend to delay any clear positive impacts of reforms to ALMPs on hiring. There is though some encouraging evidence of a positive impact on reemployment rates from the activation programmes introduced in Portugal in 2012. ([123]) Total

([123]) Martins, P. *et al* (2014)

participation in ALMPs as a proportion of the registered unemployed rose from 5% in October 2011 to 25% in September 2015. Fighting long term unemployment remains a significant challenge for the PES, particularly given the low skill levels of Portuguese job seekers. As well as adapting policies in response to evaluation evidence when it becomes available, there remains scope to improve the effectiveness of career counsellors in job centres and to more consistently implement the activation and sanctions regimes.

In 2014 a Youth Guarantee was implemented to help fight the upsurge in youth unemployment. Portugal made substantial efforts to put the Youth Guarantee into practice, to help young people not in employment, education or training, and set up a monitoring system. Some challenges remain, including reaching all young people who would be eligible and ensuring that future skills needs are identified before youth guarantee offers are designed.

5.2.2. Education and skills

Measures related to the education system were included in the programme because Portugal has very low educational attainment compared to other EU Member States. Portugal has the second-highest proportion of working age adults with low skills in the EU. The programme focused on reforms that could raise the quality of human capital and facilitate better labour market matching in three areas: improving Portugal's approach to education policy evaluation; an action plan to improve the quality of secondary education; and reforms aiming to improve the focus and quality of vocational training.

Evaluation of education policy

The programme provided an impetus to a necessary overhaul of Portugal's approach to education policy evaluation. An apparently low cost-effectiveness of education and training systems was coupled with the government having a limited idea of what worked, and lacking the capacity to address underperformance. It was therefore appropriate to try to use the programme to help improve the future effectiveness and responsiveness of Portuguese public policy. The programme measures focused on setting up an analysis, monitoring, assessment and reporting system in order to accurately evaluate the results and impacts of education and training policies, including of policies already in place. The specific fields covered included cost saving measures, vocational education and training and policies to improve school results and contain early school leaving.

A new evaluation and monitoring system has been put in place but the move to more evidence-based policy making remains a work in progress. A new information system has been put in place to monitor and evaluate the performance of pupils in the educational system. Several stakeholders highlighted this as an innovative and valuable tool. The authorities have stated their commitment to continuing to improve the evaluation and monitoring of education and training policies, and in many cases the data is adequate to allow this. However limited pre-existing evaluation capacity also made it harder to assess the impact (realised or potential) of the reforms made under the programme as a whole. Arguably the MoU condition on improving evaluation and monitoring could have been generalised to cover all public policy, not just education and training.

Secondary Education

There was scope for improving the effectiveness of Portugal's education system. School results have improved over time in Portugal. However there was still significant scope for improving the effectiveness of schools without imposing additional budgetary costs. Levels of early school leaving have traditionally been high, although they fell substantially in the crisis due both to policy efforts and to the reduction in job opportunities for young people.. Education levels are clearly a major long term problem, but whether it is something to be addressed through an economic adjustment programme is more open to question.

Substantial progress has been made in modernising the educational system, though only time will tell how successful it proves to be. The programme built on substantive reforms that the government had already started. A comprehensive reform of the pre-university education system aimed to increase school accountability and tackle low achievement. Measures were introduced to improve incentives for teachers and the quality of teaching, give schools more autonomy while subjecting them to external evaluation, and strengthen the link between curricula and skill needs in the labour market. Tertiary education has also been rationalised, including by establishing stronger links to business. Despite recent progress, tertiary attainment could rise further. But the concrete impact of measures taken in the programme will only feed through in the longer term and one of the goals of the pupil monitoring system discussed above is to help curb early school leaving. Effective education reform and monitoring need to remain policy priorities in the coming years if Portugal is to deliver sustained economic growth and converge with high income Member States.

Vocational Training

The existing vocational training system was not adequate to address Portugal's chronic skills problems, or the growth in skills mismatch produced by the crisis. As in many other Member States, vocational training had a generally poor reputation for both quality and targeting. Programme conditionality focused on requiring the Portuguese authorities to present an action plan. The aim was firstly to ensure the quality, attractiveness and labour market relevance of vocational education and training through partnerships with companies or other stakeholders. The second main element was enhancing career guidance mechanisms for prospective students in vocational educational training.

Vocational training reforms have been undertaken that are supposed to enhance labour market matching. An action plan produced by the Portuguese authorities early in the programme indicated that some courses were not effective. As a result provision has been reorganised to link curricula to the concrete needs of the labour market, thus increasing quality and employability. Significant progress has been made in setting up the new vocational training schools of reference to improve the quality and attractiveness of educational and vocational training. The Portuguese are also moving towards "dual certification", and seeking to have academic and work-based training better complement each other. The total number of participants in the system doubled from 2011-14.

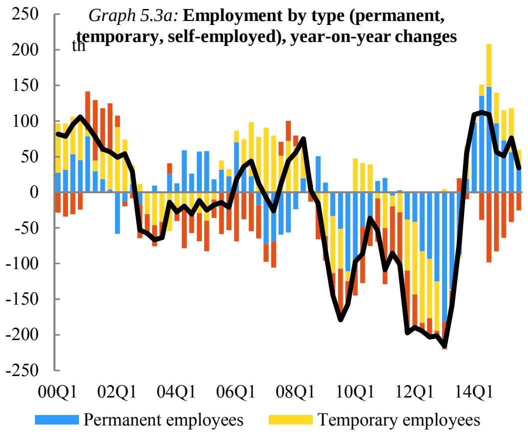
The reforms are positive, though it is not yet clear how effective they will be. In principle the programme reforms should improve Portuguese vocational education significantly. But within a programme period it is more realistic to develop a reformed skills system and put it in place than it is to expect to see concrete impacts on the labour market at a whole economy level. A lot of what was done specifically in the context of the programme was in line with the evolution of European Social Fund (ESF) programmes across the EU,

5.2.3. Overall assessment of labour market measures in the programme

The scope of the programme was broadly correct in the sense that the labour market reforms match the main challenges identified in other analysis. Where programme performance was mixed, it seems to have been linked more to shortcomings in the detailed specification and implementation of measures – and long time lags - rather than major omissions in the programme design. The Tripartite agreements were important in gaining support for delivering labour market reforms early in the programme, though they also set limits on how far the MoU conditions on labour market regulation could go. In some cases the compromise reforms implemented were somewhat weaker than the initial intentions of the MoU, but this can be justified by the importance of retaining the consent of social partners to the reform process.

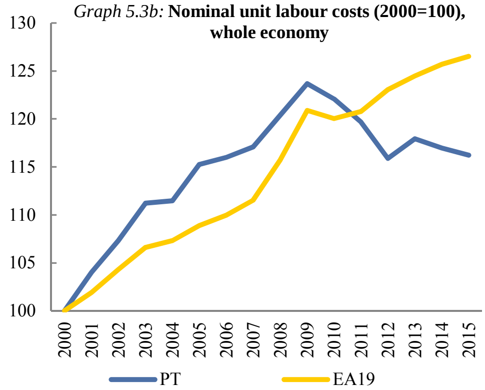
Important labour market reforms were adopted during the programme, and firms consider them to have had a significant impact, but the momentum of reform dropped over time. Administrative capacity was only rarely the primary reason if reforms were not implemented in full or on time. Severance payments have been reduced and individual dismissals eased; the duration and net replacement rates of unemployment benefits have been reduced while coverage has been enlarged; working time flexibility has been increased; and steps were taken to reform the wage-setting mechanism. This has helped to make the labour market more flexible, and to an extent to reduce undue protection of insiders at the cost of outsiders. Progress has also been made in improving the functioning of Public Employment Services and activation policies. This, and education reform, are ongoing processes. A survey of Portuguese firms undertaken by the IMF in March 2015 found that most thought there had been at least "some impact" from each of the main areas of labour market reform. ([124]) Labour market reforms were relatively front-loaded compared to other structural reforms. In part this was due to good progress at the start of the programme. However both legal rulings and government policy decisions set back the process of labour market reform towards the end of the programme and in its aftermath.

Graph 5.3a: **Employment by type (permanent, temporary, self-employed), year-on-year changes**



Source: European Commission

Graph 5.3b: **Nominal unit labour costs (2000=100), whole economy**



Source: Eurostat

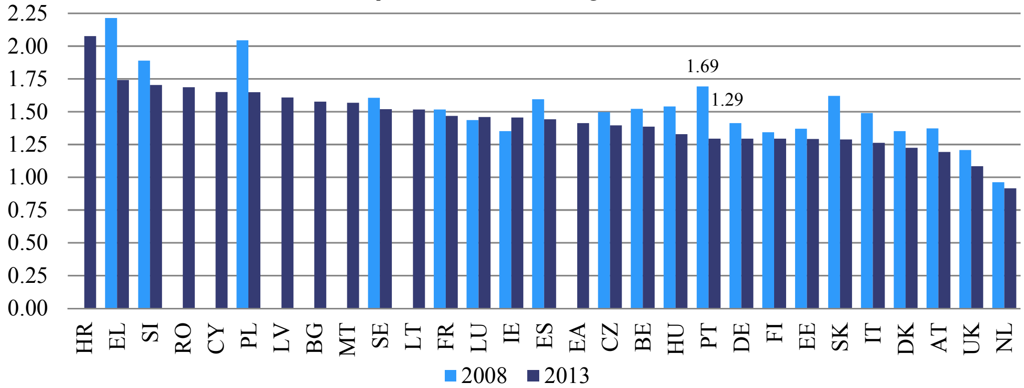
The labour market has started to strengthen but labour market reform is unfinished business. It takes time to see the positive effects of labour market reforms, particularly in depressed economies. It is unlikely that structural reforms could have prevented the continued rise in unemployment in the first part of the programme. In aggregate developments in the Portuguese labour market since the onset of the crisis have been driven more by changes to job separation rates than to job finding rates. Unemployment is now falling. As Graph 5.3a shows there has been an encouraging pick-up in permanent contracts since early 2014. Nevertheless, unemployment remains unacceptably high, especially when discouraged and under-employed workers are included. Significant net emigration since 2011 (see Section 7) may have helped mitigate cyclical unemployment, but it exacerbates existing long term demographic and skills problems. While Portugal's EPL has loosened more than other countries, it is still among the highest in the EU. In practice the capacity of companies to vary wages in response to firm-level conditions remains limited. Portugal's relative labour costs have fallen significantly since the onset of the crisis (Graph 5.3b), though nominal wage rigidity (confirmed by the Constitutional Court, which ruled some targeted and permanent wage reductions to be unconstitutional ([125])) continues to complicate the process of economic adjustment in a low growth, low inflation environment. Further reforms are therefore needed for Portugal to be able to absorb economic shocks within a monetary union more smoothly in future.

([124]) IMF (2015c)
([125]) See for example Constitutional Court Decision 353/2012, 5 July 2012, and Constitutional Court Decision 413/2014, 30 May 2014,

5.3. REMOVING DISTORTIONS TO INVESTMENT ALLOCATION: GOODS AND SERVICES MARKETS AND FRAMEWORK CONDITIONS.

The starting point was one with high level of rigidities in the goods and services markets and the business environment. According to the OECD indicators of Product Market Regulation, Portugal ranked as a highly-regulated country in the market environment in 2008 compared to peers (Graph 5.4).

Graph 5.4: **Product Market Regulation**



Source: OECD. Notes: Countries ordered by rank in 2013. Product Market Regulation indicator is a synthetic indicator summarising a wide array of different regulatory provisions of product markets (e.g. state control, barriers to entrepreneurship, barriers to trade and investment, etc.). A higher value means stricter regulation.

Product market reforms were considered key to support the adjustment process, lift productivity and foster sustainable growth and to share the burden of the adjustment across society. By facilitating the entry of firms and increasing competition, the transmission channels of product market reforms could kick in: reductions in mark-ups and input prices could expand tradable sectors, improve the demand for labour in tradable industries and increase real wages, stimulating higher aggregate demand and investment, and leading to higher output and employment. Product market reforms could also lift productivity as they can raise the quality and availability of intermediate inputs, particularly from services and network industries inputs. The indirect impact of liberalizing services and network industries on total factor productivity of downstream tradable industries could be large. ([126]) Furthermore, product market reforms could contribute to the social balance of the programme by reducing unwarranted sector protection and rents, so that all segments of the society shared the burden of the needed adjustment.

The overall objective of the programme in these areas was reducing barriers in sheltered sectors of the economy to improve competition and reduce excessive rents, to improve the business environment and to reallocate resources to the tradable sector. The main areas concerned included network industries such as energy markets, transport, telecommunications and postal services and other services sectors (including regulated professions). Other measures supporting the same objectives related to improving the framework conditions, which included reforms of the judicial system, the business environment and public procurement rules, as well as of the housing market. In many cases, the reforms mainly implied ensuring proper transposition and implementation of EU law (e.g. 3rd Postal Directive, Services Directive, Late Payments Directive, Energy Directive, etc.). The following reviews the challenges at the start of the programme in each of these areas, the programme approach to address them, implementation issues and outcomes in the various sectors.([127])

([126]) Arnold, J. *et al*, 2011.
([127]) Agricultural policies were excluded from the programme.

5.3.1. Goods and services markets

Energy markets

At the start of the programme, the main issue for both electricity and gas markets was weak competition, related to slow progress in liberalising markets. The historic electricity incumbent (EDP) remained dominant upstream and downstream. Although retail markets were open to competition, households and small enterprises could opt for the regulated tariff that EDP was obliged to offer. As this had historically been set at a low level, it acted as an effective entry barrier and contributed to an accumulated tariff debt (see below). In the gas market, the historic incumbent (GALP), was the sole importer of gas and the main player in the retail market. Portugal held a large energy balance deficit, due inter alia to structural features such as above-average energy dependence and energy intensity. Other issues related to the efficiency of support schemes for renewables and the inconsistency of energy policy instruments. An all-Iberia electricity market (MIBEL) had been established which had decreased prices between Portugal and Spain and there were plans for a similar market for gas (MIBGAS).

The electricity tariff debt was substantial and expected to rise steadily, posing risks to the sustainability of the national electricity system. Since 2006 the Portuguese electricity system had accumulated a tariff debt amounting to €1.8bn in 2011 and set to increase substantially over the coming years. This had resulted partly from misalignments between regulated tariffs (based on 1 year-ahead estimates of fuel costs) and actual market prices and from high so-called policy costs (production costs originated by government decisions). In particular, in the years prior to the programme, rising subsidies to renewable and conventional electricity had led to increasing electricity costs and enabled high rates of return for energy utilities. These subsidies included both support under the special regime (renewables and co-generation) and under the ordinary regime (such as power guarantee incentives and compensation for the early termination of former long term power purchase agreements – known as CMEC). In addition, implicit incumbents' market behaviours were also detrimental to a sound competitive environment and thus further enabled the persistence of excessive rents in the sector. The increasing costs of electricity production were not fully compensated by increased tariffs, resulting in the tariff deficits/cumulated debt ([128]).

Against this background, the programme integrated deep reforms to improve the functioning of the energy sector. The importance of reforming the energy sector to reduce the tariff debt, lower production costs and increase efficiency was clear early in the programme, which was designed so as to: ensure sustainability of the national electricity system by measures aimed at reducing excessive rents and eliminating the tariff debt by 2020; complete the liberalisation of the electricity and gas markets and the transposition of the 3rd EU energy package; ensure consistency of the overall energy policy, reviewing existing instruments (e.g. tax policy on energy) and further integrate the Iberian market for electricity and gas. Overall, the programme measures rightly reflected the main concerns regarding the energy sector. As the programme advanced, measures in this area became increasingly detailed, giving clear saving targets and guidance on how to achieve them. This may have been a way to increase pressure on the government commitment to take reforms forward as it soon became evident that there were important hurdles to achieve meaningful results and strong vested interests could be hampering progress.

A wide range of measures were adopted to eliminate the tariff debt by 2020 and remove restrictions to competition. The government approved three packages of measures, negotiated with producers, which aimed at tackling economic rents and eliminating the tariff debt by 2020, while limiting real price increases for electricity consumers at around 1.5 to 2% per year. The main measures included: moratorium on support to new renewable energy installations and elimination of power guarantee incentives; revised remuneration scheme for co-generation; agreement with EDP on reduced compensation for the early termination of former long-term power purchase agreements; levies paid by

([128]) Johannesson Linden, A. *et al* (2014) wind and small hydro producers until 2020; a special levy applied on the energy sector in 2014-2015 (set to continue in 2016). Other relevant measures affecting the energy markets included the phasing out of electricity and gas regulated tariffs, which should help to liberalise markets further; the streamlining of some energy policy instruments; the strengthening of the regulator to ensure independence and all powers foreseen in the EU law (3rd Energy package) and further integration of Portuguese and Spanish markets.

The costs of energy for end users remain very high and the tariff debt went up substantially during the programme. The number of consumers under liberalised markets represent now 71% of the total in Portugal ([129]). However, electricity prices have continued to increase significantly for households and for the industrial sector, also due to the tax increases ([130]). In order to limit price increases, part of the costs, namely those related with renewables and co-generation subsidisation, were converted into debt. Between 2011 and 2015, the overall tariff debt increased by €3.3bn, topping at about €5bn at the end of 2015 and is expected to start declining in 2016 and achieve clearance by end-2020. There have also been some cost reductions, mainly from reduced co-generation tariffs. Overall, price developments follow from the fact that 80% of the wholesale electricity is traded under pre-liberalization contracts or subsidized regimes, networks are regulated and liberalized activities represent no more than 10% of overall costs ([131]). Despite the three packages of measures, more control of state aid and stranded costs is required. Regarding the gas sector, the liberalised supply of natural gas increased considerably during the programme, fostered by high penalty factors in regulated transitory tariffs, to induce switching from regulated suppliers. However, prices have not become more competitive, in particular when compared to EU prices. Cross-border competition is still limited given insufficient integration with the Spanish market.

Overall, the implementation of the energy market reforms was insufficient and did not manage to skim off unjustified rents in a sector characterised by strong vested interests, impeding a more balanced sharing of the burden of the adjustment. The simultaneous privatisation process may have conflicted with stronger efforts to reform this sector. Despite efforts in the energy sector being shielded by a unique international legal framework, the government did not take sufficient ownership and missed the opportunity to reform more decisively this key sector. The government was resisting on decisive reforms of the sector on the basis of the ongoing privatization process and the fact that the existing tariff structure was the result of previous policies that aimed at developing green energy. Indeed, there was an underlying difficult conflict between the privatisations of electricity companies favoured by the programme and beneficial from the fiscal side and the structural reforms of the sector guided towards eliminating rents, which would make the sale of the companies less attractive. Overall, it is an open question if the sequencing between the privatisation process and the reforms of the sector was optimal. However, privatization conditions should not have been such that the government would have its hands tied up in the future if it was to try later to control policy costs. Moreover, there were frequent delays and insufficient achievements in delivering the targets. Eliminating the tariff debt, which is heavily weighing on the high costs of electricity for end users, remains a significant challenge if price increases are to be kept limited as desirable for firms' competitiveness and households' budgets. Consulted stakeholders also consider unsatisfactory the extent and pace of implementation of reforms in the energy sector, in particular to tackle the tariff debt and reduce excessive rents, mentioning that the government did not manage to overcome strong vested interests as a key reason for insufficient progress. While the government was quite efficient in cutting subsidies to small producers of renewable energies, it was much less so in tackling the grandfathered contracts for the big companies. The limited outcomes also weigh on the perception of an unfair sharing of the burden of the adjustment ([132]).

([129]) ERSE.
([130]) Between the second halves of 2011 and 2015, electricity prices in Portugal, including all taxes and levies, grew by 21.4% for domestic consumers (14% in the EU-28) and by 23.9% for the industrial sector (7.1% in the EU-28). Excluding VAT, prices grew by 13.6% for consumers (14.1% in EU-28) and by 14.1% for the industrial sector (6.4% in the EU-28).
([131]) Stakeholder consultation.
([132]) Stakeholder consultation.

Transport

The performance of certain modes of transport was not supportive of competitiveness and economic attractiveness. The degree of competition in transport services was quite low, partly due to anti-competitive regulations. In railways, the incumbent undertaking CP was not sufficiently independent from the State and the balance of the infrastructure manager (REFER) was not ensured (both CP and REFER were loss making and had high levels of debt). The performance of urban public transport could also be improved. In the maritime sector, the geographical advantage of Portuguese ports remained largely unexploited, with performance below potential, not necessarily linked to lack of infrastructure. Low competition and inefficiencies in port services due to strong interest groups contributed to underutilization of sea ports, as well as bottlenecks in hinterland connections to and from the main ports. Concerning aviation, at the onset of the programme the state still owned Aeroportos de Portugal (ANA) and the national airline TAP. Regarding roads, investment was significant in the pre-crisis period (1.1% of GDP on average between 2000 -2008). Within land, road dominance was above the EU average, in particular in freight, contributing to a poor performance of the Portuguese transport sector in terms of energy efficiency and transport externalities, notably congestion. Portugal had to correctly transpose EU law (Eurovignette Directive), deemed to improve competitiveness of the road haulage sector.

The programme objectives aimed at improving the efficiency of the overall transport system, improve the financial sustainability of transport SOEs and strengthen competition in key sectors. The MoU contained provisions to promote a better balance between modes of transport, including further use of railway and maritime transport and improved interconnections. In railways, the overall goal was to strengthen competition and attract more traffic by measures like rationalization of the network, revision of the infrastructure charging scheme and some privatizations. An issue of particular concern was the operational losses and mounting debt of transport SOEs, which were among the most-indebted state-owned companies and which could have potentially important fiscal implications, as it actually occurred towards the end of the programme.

The port reform became a top priority of the structural reform agenda for programme partners. This was rightly so, as this is a sector of particular importance for Portugal's competitiveness ([133]) and addressing its long-standing inefficiencies could play a key role in the strategy to promote exports. Implementation of the measures should result in an increased performance of port services, more jobs in port-related industries and enhancing competitiveness of Portuguese products.

Some progress was made in necessary reforms to the transport sector, but the pace of reforms was in general slow, with many delays and many key reforms pending at the end of the programme. Steps were taken towards more competition in the sector, including by establishing a new independent regulatory authority for transport. In the railway sector, some measures were implemented to achieve operational balance of the rail infrastructure manager, such as rationalisation of costs and closure of loss-making lines. However, many key reforms were repeatedly delayed or not fully implemented within the foreseen timeline, such as the handing over of CP Carga freight terminals to the network operating company (the unbundling was a precondition for competition in cargo rail services), followed by its privatisation, or the launch of new concessions for the provision of urban public transport services in the metropolitan areas of Lisbon and Porto. By the end of the programme, key milestones of the integrated long-term plan for Portugal's transport system had not been effectively implemented as initially foreseen.

In the port sector, key measures were implemented, though they have had limited impact so far. The adoption of a port labour law and the gradual elimination of the port user fees (TUP-Carga) were positive developments, allowing a downward adjustment of port operating costs, though actual achievements are far from the objective of reducing user costs by 25-30%. The pass-through of these

([133]) In terms of value, around 1/3 of incoming and outgoing goods are transported by sea, port-related costs often exceed 30% of total good transport costs and for some exporters, port user cost can reach 10% of production costs. Sources: European Commission (2013) and DG ECFIN (2014b).

cost-savings from port concessionaires to port users (especially exporting firms) was hampered by the delays in renegotiation of most of the existing port concessions, which is essential to bring about more competition and efficiency. The slow progress in implementing these reforms during the programme reflected among others the strong interest groups of the sector (namely, port concessionaires, holding to the status quo of their long-term concession contracts and port workers, strongly unionized and presenting strong resistance to reforms).

The transport sector reforms have not reached full potential so far, due to slow implementation pace, lack on incentives and narrow enforcement. The limited reach of these reforms reflects a mix of technical, legislative and political challenges. But also, the three institutions could have strengthened pressure for the enforcement of structural reforms in this area when confronted with mixed progress in implementation. More determined progress in these reforms was often given in during programme negotiations in exchange for further efforts from the authorities in other areas, in particular in the fiscal area ([134]).

Telecommunications and postal sector

The programme design took into account that the telecom and postal sectors should benefit from higher competition. Concentration was high in the telecom market as well as profitability rates. Competition was rather good in broadband internet, but the segment needed to be carefully regulated as most operators depended on the copper cable network of the incumbent. There was low consumer mobility between operators/service providers. Regarding the postal sector, Portugal had not yet transposed the 3rd Postal Directive, under which full market opening/liberalisation should have been reached by 2010. Against this background, the appropriate MoU objectives were to increase competition in the markets by lowering entry barriers, guarantee access to network/infrastructure and strengthen power of the National Regulator Authority to supervise the functioning of the markets and guarantee a level playing field.

The main measures targeted under the programme for these sectors were adopted. A new telecoms regulatory framework entered into force, termination rates were lowered, a mobile spectrum auction promoting market entry was launched – although it yielded no new entries in the market-, universal service contracts were assigned through a non-discriminatory tendering procedure and measures to alleviate the restrictions on mobility of consumers implemented. In the postal sector, the transposition of the 3rd Postal Directive was concluded and a new framework for the provision of the postal universal service was adopted, introducing competitive pressure in the provision of this service. Conditionality was in general complied with, although deadlines had to be often revised, e.g. for the renegotiation of contracts and launching of tender for the designation of universal services providers.

The impact of these measures on competition and prices has been mixed. There seem to be links between some measures and market developments: eg. the decrease of mobile termination rates contributed to reduce the difference between on-net and off-net mobile calls prices and to the increase of bundled offers, including mobile calls to all networks. Although the MoU envisaged measures to reduce barriers to consumers' mobility, the market developments and the amount of consumers' complaints show that consumers have not fully grasped the potential benefits of competition. Some years after the liberalization of the postal markets and in spite of the existence of nine formally authorized operators, there is still insufficient competition for standard post delivery services ([135]). A key reason for these limited achievements seems to be that market developments and the introduction of innovation in the telecommunications sector take place at a very fast pace and new competition challenges arise that will need to be evaluated in the coming years.

([134]) Stakeholder consultation.
([135]) Feedback on outcomes from stakeholder consultation.

Other services sector and regulated professions

At the onset of the programme, important barriers to entry remained in some sectors to the benefit of insiders in the market, which could be penalising the entire economy. Sectoral profitability showed that Portuguese firms in the construction, wholesale trade and hotels and restaurants sectors had been increasing in pre-programme years, indicating room for more competition and rents compression. The Services Directive provided an appropriate framework for liberalization and needed to be fully implemented. The estimated gains from its full implementation were large for Portugal ([136]). In particular, several sectors were still subject to sector-specific legislation which needed amendments to lift restrictions on cross-border providers and remove limits to competition (i.e. real estate and construction services). Limitations to exercising regulated professional services such as accountants, lawyers, pharmacists and architects also existed, which also had a negative effect on competition. In view of these challenges, the overall programme objectives were to eliminate entry barriers in order to increase competition in the services and regulated professions sectors through conditionality that was rather extensive and detailed.

Portugal adopted significant legislation aimed at liberalising services and regulated professions. The planned timeframe for implementing these reforms turned out to be too optimistic and did not take consideration of lengthy procedures and capacity constraints. The transposition of the Services Directive was relatively successful and relevant reforms to most sectors were implemented at the end of the programme. A new horizontal law on regulated professions was adopted in 2013, laying down the principles for reforming 18 statutes for 19 regulated professions. However, by the end of the programme, practical implementation lagged behind. The bylaws of some professional associations are not yet fully in line with the Service Directive. The programme was rather detailed and extensive on regulated professions, but the pace of reform was slower than expected. This indicates to a large extent an underestimation of the time needed once the real hands-on process of reform goes deeper, including lengthy negotiations with some professional bodies due to their strong bargaining power. The timeframe set for these reforms probably did not take full consideration of all these necessary steps and also capacity constraints in the Portuguese administration.

The recent reforms have had a positive impact on productivity. EC estimated that the EU Services Directive and the business environment reforms implemented up until mid-2013 have boosted labour productivity in the sectors affected by the Directive by around 9% in Portugal ([137]).

This area of structural reform exemplifies how the programme was an umbrella to push for certain pieces of EU legislation. Stakeholders considered that in areas like the Services Directive, among others, the EC was trying to accelerate its agenda for reforms. But the changes for a full transposition of the relevant EU Directives would have happened anyway in the absence of a programme, though probably at a slower pace. To certain extent this strategy filled up the programme reform agenda and implied losing target of the most urgently needed reforms.

5.3.2. Framework conditions

Judicial system

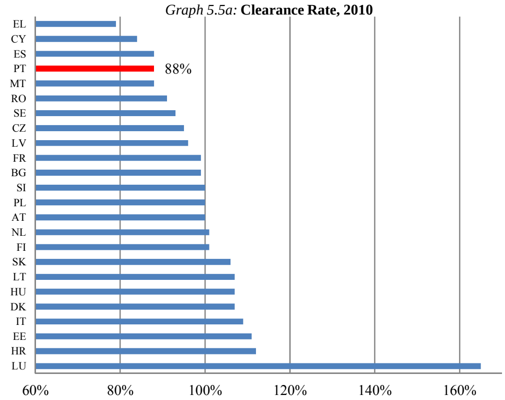
The extreme inefficiency and slowness of the judicial system was impeding the well functioning of the economy. At the start of the programme, the judicial system was exceptionally ill-functioning in comparison to peers (see Graphs 5.5a and 5.5b), with performance indicators among the worst in the EU. The system was extremely protracted (dispute settlement usually taking many years), costly in the legal enforcement of laws and contracts, archaic in its management and working methods, cumbersome and

([136]) Monteagudo, J. *et al* (2012).
([137]) DG ECFIN (2014e) and Varga, J. *et al* (2013)

surrounded by enormous uncertainty. Certain regimes/codes dated back to the last century, making the system very rigid, and court backlogs were significant, with 1 ½ million debt claims pending cases as the bulk of it. Given that the functioning of court procedures plays an important role in investors' decisions, the dysfunctions of the judicial system negatively impacted on the business environment and clearly acted as a major deterrent for investment, particularly for foreign direct investment.

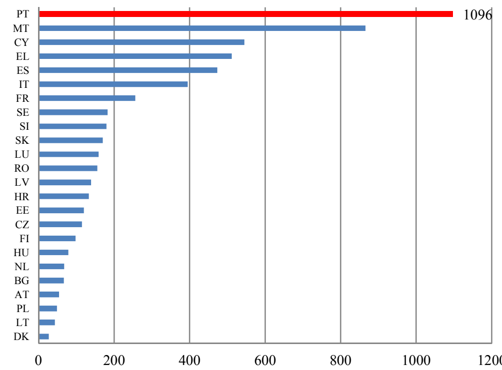
Improving the functioning of the judicial system became an immediate priority of the programme. An agenda for the judiciary reform was quickly set up, benefitting from the experience of programme partners with such kind of reforms. It also drew on the Judicial Reform Map that had been announced shortly before, adding additional steps to make the judicial system more efficient. The main areas of reform focused on: reducing slowness of the system by eliminating the backlog of courts' cases; improving the efficiency of civil case processing and ensuring effective enforcement of contracts; restructuring the court system and adopting new court management models; and making more transparent and sustainable the budget for the judiciary. The conditionality was framed as general objectives so that it would give the Portuguese authorities leeway on the best means for attaining the targets, which proved positive to increase ownership. However, no quantitative indicators suitable for reform monitoring were proposed. The conditionality was sometimes adjusted over time, which seemed warranted as it reflected, for example, the follow-up to the elaboration of reform plans after a first phase or reinforced efforts to meet targets (e.g. urgent measures to combat the remaining backlog of cases at 8th/9th review).

Graph 5.5a: **Clearance Rate, 2010**



Source: CEPEJ. Clearance Rate (%): Resolved Cases / Incoming Cases

Graph 5.5b: **Disposition Time, 2010**



Source: CEPEJ. Disposition Time (number of days): Pending cases / Resolved cases x 365. Non-criminal cases in first-instance.

The key measures for judicial reform stipulated in the programme were adopted. Cornerstone reforms were the new regulatory framework for the enforcement agents, strengthening the authority and financing structure of the oversight body; the new Code of Civil Procedure to speed up civil and commercial litigation; and the Judicial Organisation Act to streamline the judiciary. Other key reforms included strengthening alternative dispute resolution to facilitate out-of-court settlement and the establishment of specialised courts on competition matters and on intellectual property rights. Reforms often triggered changes in by-laws, new IT systems and applications and necessitated various temporary task forces. The implementation plan progressed largely as scheduled in the successive MoUs, even often ahead of schedule. However, the provision of statistical data (especially on tax cases) suffered important delays or insufficient implementation. Reforms often followed extensive consultation with stakeholders and experts (including Technical Assistance from the IMF/EC). The advances in the reform agenda were possible thanks to the good cooperation between the Portuguese authorities, the legal system's players and the programme partners. Stakeholders thought that there was a rather strong political will from the Portuguese authorities to conduct the reforms and, being aware of capacity constraints, they only committed to realistic targets which they delivered.

Judiciary reforms take some time to show in performance indicators, but the available data already show a positive trend. Judiciary reforms do not deliver visible results immediately, as first old legislation needs to phase out and statistical data is often lagged. However, performance indicators such as clearance rate/disposition, time/average resolution speed and number of outstanding cases are showing some improvements ([138]). Portugal's ranking in indicators such as 'enforcing contracts' and 'resolving insolvency' has improved in recent years. ([139])

However, quality indicators of the judicial processes are still weak in international comparisons and some inefficiencies of the judicial system are still among the main constraints to business activity in Portugal. Efficiency indicators for civil and commercial cases, which are relevant for resolving commercial disputes, are still weak. Furthermore, in practice, companies still consider that the judicial length is among the most important costs of contexts ([140]) and a key factor hampering competitiveness.

The programme was an important thrust for reforms of the judiciary but longer time is needed to solve long-standing inefficiencies. Overall, programme measures seem to have been broad and deep in scope and effective in improving the situation. The programme was an instrument to push reforms that would otherwise have taken longer or face more opposition, in particular when there were political interests at stake (e.g. reorganisation of judicial districts). Many of the positive impacts of these reforms are expected to come in the near future. At any rate, the deeply-rooted inefficiencies of the judicial system need to be effectively solved in a longer timespan than the three years programme. Effective implementation together with proper monitoring of developments is now the real challenge. The monitoring and evaluation of court procedures will be essential to help improving the functioning of the justice systems, which is an important structural condition on which to base Portugal's sustainable growth.

Competition policy

The speed and effectiveness of the enforcement of national and EU competition rules needed to be improved. Key challenges included the Portuguese Competition Authority (PCA)'s limited capacity to conduct inspections and the need to ensure its financial independence and appropriate financial means to attract and retain an adequate level of qualified staff. Competition rules' enforcement needed to be made more autonomous from other legislation and the competition law should be updated to reflect developments in national and EU law. Stronger and independent sectoral regulators were also considered essential to ensure a level playing field, in particular in network industries.

The overarching aim of the programme measures was to reinforce competition enforcement through legislative and institutional changes. The PCA's effectiveness would be raised by revisions of the competition law. Enforcement of competition rules would also be strengthened with the creation of a specialised court for competition issues. To accompany the liberalization and market-opening reforms, the role of sectorial regulators would be strengthened. The programme also contained measures to abolish "golden shares" and special rights by the State in private companies, in particular in the energy and communication sectors (EDP, PT Telecom and GALP) to foster a market-led functioning of these companies and eliminate obstacles to the free movement of capital.

Conditionality was overall fulfilled, with some delays in some measures. As part of the measures foreseen under the programme, a new Competition Act-Law entered into force in 2012, harmonising the Portuguese competition law with EU rules and international best practices and fostering the PCA's enforcement and advocacy powers. The new legal framework also led to the creation of a new specialised

([138]) See for example "*Destaque Estatístico Trimestral*", Bulletin nº 23, January 2016, Direção-Geral da Política de Justiça. Portugal.
([139]) *Doing Business*, 2015 edition (World Bank).
([140]) Costs of context are defined as negative effects resulting from rules, procedures, actions or missions that hinder business and that are not attributable to the investor, its business or organisation.

Court on Competition, Regulation and Supervision. Another milestone was the approval in 2013 of the Framework Law for National Regulatory Authorities (NRAs), which strengthened their powers to protect customers through regulating monopolies in key sectors. Following these developments, the bylaws of the PCA and the respective NRAs had to be amended to reflect the principles of the new legal framework. New financing models for the PCA and NRAs were also established. The alienation of the 1 percent share of CGD in Galp (a situation of special rights by the State that had long been maintained) was accomplished after several postponements.

The programme enabled a faster pace in these reforms, which are considered positive and adequate to improve competition law enforcement, though challenges remain. Overall, the programme measures were adequate to improve the competition framework and the programme accomplishments were substantial. A proposal for an amended competition law had been prepared by the PCA before the programme, which was revised so as to implement the orientations set out in the MoU. Stakeholders consider that the adjustment programme enabled a faster pace in the reforms. The experience with the new competition court and the enforcement of the 2012 Competition Act are considered positive ([141]). The new financing model was also a significant improvement, ensuring a more sustainable base of resources for the PCA, although it still incorporates uncertainty regarding the transfers from the sectoral regulators. Also, the current set-up still limits the financial autonomy of the competition authorities. Adequate resources to be able to act effectively against vested business interests are essential. A stronger solid basis is also necessary to avoid roll back of reforms.

Public procurement

At the start of the programme, public procurement processes were not fully transparent, fair and competitive and failed to ensure efficient public spending. Certain provisions of the Portuguese' Public Procurement Code (PPC) were not compliant with the EU Public Procurement Directives. Moreover, the effectiveness of the PPC rules was weakened by specific legislation permitting direct awards for certain types of contracting bodies (eg hospitals, colleges, etc) or special purposes, not subject to the market discipline of competitive tendering. Also there existed discriminatory practice distorting competition in favour of firms established in Portugal. Overall, several derogations and practices raised legal issues and failed to ensure best value for money on purchases by public authorities, undermined the efficient spending of public money and increased the risks of favouritism and corruption. Portugal was advanced in the use of e-procurement.

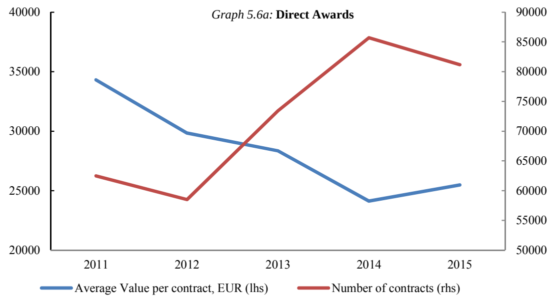
The overall programme objective was to ensure fair public procurement processes. The main measures aimed at revising the legal framework so as to address, in particular, the regime of the award of additional works and services, provisions on errors and omissions, and exemptions permitting direct awards. Other objectives were to strengthen ex ante and ex post audits on public contracts and to upgrade the public procurement portal (BASE) to improve transparency of procedures.

Programme measures were implemented as scheduled but some of the challenges remain unaddressed. Early in the programme the national public procurement legal framework was revised to improve award practices, enhance competition between potential bidders and increase transparency. This was accompanied by amendments to the Court of Auditor's regulations to strengthen its capacity to perform ex ante and ex post controls on public contracts. The online platform BASE was also improved, allowing for more transparency.

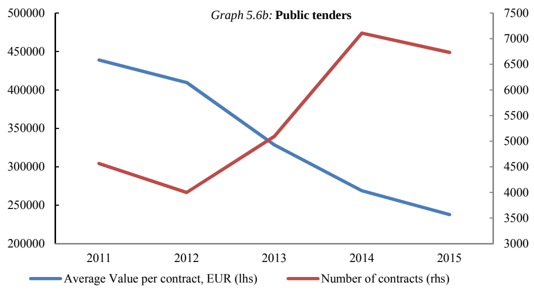
Indicators of public procurement processes seem to suggest a positive impact. The number of public tender contracts has increased and the average value per contract has fallen, which is one of the expected outcomes of improving award practices to ensure a more transparent and competitive environment. The

([141]) Stakeholder consultation.

average value of contracts from direct awarding has also fallen, though not the number of contracts, showing that the extensive resorting to direct awarding still prevails.



Source: Portal BASE, PT



Source: Portal BASE, PT

Despite these achievements, the programme could have gone much further in the fight against corruption, which is perceived as rather widespread in Portugal's public procurement sector. A majority of companies ([142]) believe that corruption is common among both national and regional authorities. Procedural irregularities in the awarding of public tenders are a recurring problem for the municipalities, some of which suffer from weak monitoring systems, preventing the identification of conflicts of interests and favouritism in tender decisions. At firm-level, more than 1/3 of Portuguese companies refrained from taking part in tenders due to the perceived tailor-made criteria. Many companies consider that corruption prevented them from winning a tender or contract, complain of impossible deadlines, collusive biding and deals being agreed upon beforehand, or report it being common practice to use bribery to win contracts. PPPs are widely used by the government to launch some public works. But weaknesses related to some PPPs at the local level point to insufficient transparency in tender procedures and unclear reasoning of award decisions. The programme failed to tackle these problems more decisively to reduce the likelihood of encountering corruption in Portugal's procurement process.

Business environment

At the onset of the programme, Portugal ranked low on many "ease of doing business" indicators. The business environment was unfriendly and could be substantially improved. Administrative burdens were high, more in the running of a business than in starting one, where major simplifications had already taken place ([143]). Portugal also demonstrated a very high level of licensing complexity ([144]), with licensing procedures discriminatory, not efficient and time consuming. Start-ups suffered from difficulty in getting credit and the high tax compliance costs and arrears incurred by public authorities contributed to relatively low enterprise survival rate after two years. Payment delays affected disproportionately SMEs as they were more affected by liquidity constraints, in particular new companies. Some measures had been taken during 2009-2010 to mitigate the effects of the crisis, especially on SMEs, to facilitate access to credits and export markets, but needed streamlining to improve efficiency.

The overall programme objective was to facilitate business by reducing administrative and regulatory burdens and support the internationalisation of companies. Measures aimed at rationalising existing initiatives dealing with export promotion and access to finance, in particular for SMEs, which were highly fragmented. Measures would be taken to promote liquidity conditions for business, in particular by the timely implementation of the EU Late Payments Directive. Simplifying initiatives, such as the Points of Single Contact, the Simplex Programme and the Zero Authorisation

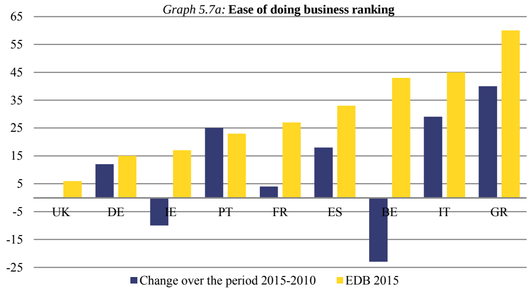
([142]) European Commission (2014b)
([143]) In the years before the programme, Portugal had eased business start-ups, reducing the time to start a business from 54 to 5 days. *Doing Business, 2011* – World Bank.
([144]) DG Enterprise and Industry (2010).

project, would be deepened. A specific measure to reduce excessive licensing requirements was introduced later in the programme at the request of the Portuguese authorities.

Action was taken to improve the business environment, though measures were often delayed. Numerous legal reforms were adopted to ease licensing requirements to businesses in many sectors. The scope and depth of these reforms was noteworthy, with a number of regimes (industrial, touristic) moving from an "ex ante" to an "ex post" authorisation. The reforms were often behind schedule, mainly because administrative capacity was strained for timely adoption. The Late Payments Directive was transposed, though the Commission later on launched an infringement procedure against Portugal for non-full compliance because of the excessive number of days allowed for payment in the health sector. Portugal claimed fiscal problems and incompatibility with the strategy for the settlement of arrears agreed under the programme ([145]). The one-in/one-out policy was introduced, according to which no new regulation is brought in without other regulation being cut by an (at least) equivalent amount. VAT refund procedures for exports were facilitated. A number of schemes for access to finance for SMEs was also adopted during the programme, mostly providing loan guarantees and reducing the cost of short-term financing. Despite these advances, the scope of simplification measures was limited to the central public administration, not covering the sub-national levels, and implementation of the new licensing regimes at the local level is heterogeneous.

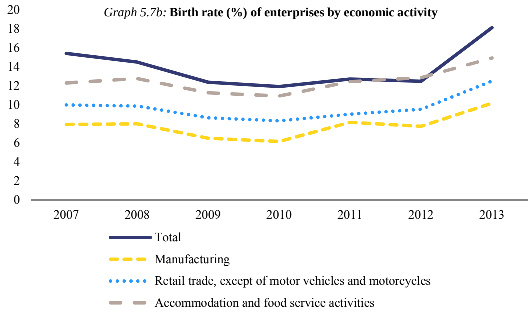
Some indicators demonstrate a positive impact of these measures. The 2011 "Zero Authorisation" project aimed at simplifying business establishment by abolishing prior authorisations/licensing, substituting them with a declaration in an online platform and only ex post compliance verification. This would increase the number of companies entering the market. Indeed, the evolution of birth rates seems to pick up slightly since 2011, in particular in economic sectors targeted by the project, like tourism, industry and commerce (see Graph 5.7a). Overall, Portugal's position in international rankings on ease of doing business has already improved (see Graph 5.7b).

Graph 5.7a: **Ease of doing business ranking**



Source: World Bank.Notes: Selected Countries ordered by ranking in 2015. A positive value of the change over the period 2015-2010 indicates an improvement in the ranking of the country.

Graph 5.7b: **Birth rate (%) of enterprises by economic activity**



Source: INE, PT

But overall, Portuguese firms perceive that by the end of the programme, costs of context were not significantly reduced. Costs of context ([146]) are among the factors that affect competitiveness more importantly. A recent survey ([147]) inquired about five thousand non-financial companies on the potential obstacles to business' activities and their evolution between 2012 and 2014. The main constraints to business activity were identified in the judicial system (e.g. judicial length), licensing and certification procedures, the tax system and the costs associated with the starting of an activity. Notably, companies did not perceive significant changes to these costs of context between 2012 and 2014 and often indicated

([145]) For programme purposes arrears were defined as overdue payments for 90 days or more (Technical Memorandum of Understanding). The Late Payments Directive, however, stated that as from 16 March 2013, Member States must ensure that in commercial transactions in the health sector the period of payment does not exceeds 60 days following the receipt of the invoice by the debtor.

([146]) See definition above.

([147]) INE (2015).

a slight increase in many obstacles. SMEs perceived slightly higher costs of context than large and micro enterprises.

Housing market

A dysfunctional rental market had characterized the Portuguese housing market for decades, with serious implications both on labour mobility and household indebtedness. The rental market was characterised by exacerbated tenant protection, including rent control ([148]), a tendency for perpetuity of lease agreements (open-ended contracts that could be transmitted to first degree relatives and were essentially not updated) and very restrictive eviction procedures ([149]). The lack of rental market hampered geographical labour mobility and contributed to structural unemployment ([150]). Strict rental regulations were also associated with lower quantity and quality of housing as rents were not sufficient to maintain dwellings in good condition ([151]) and a large number of apartments in city centres remained empty, causing a substantial waste of capital and additional costs in terms of transport, environment and tourism attractiveness as well as welfare. Moreover, mortgage subsidies through tax incentives had encouraged house purchases ([152]) and pushed the household indebtedness to the highest level in the EU. There was also a backlog of undervalued properties.

The programme housing market reforms aimed at opening up the rental market and provide incentives for improving the quality of the housing stock. The main programme goal was to liberalise the rental market by phasing out rent controls, while considering the socially vulnerable. In so doing, access to housing would be improved and labour mobility fostered. Another aim was to simplify administrative procedures for renovations as well as judiciary procedures related to rental contracts. Taxation would be modified to level incentives for renting versus acquiring a house and reduce the tax bias towards debt financing for homeownership. Another tax reform would rebalance gradually property taxation towards the recurrent real estate tax and away from the transfer tax. This would be underpinned by a crucial revaluation of the housing stock, so as to bring the taxable value closer to the market value. A critical issue was the social aspect. Means-tested social housing should ensure protection of the socially vulnerable, while not reducing job-seeking or discouraging low-wage workers from seeking higher paid jobs. Overall, the programme designed appropriate policies to tackle distortions in the housing market.

The long-needed reforms of the housing sector are a significant success of the programme, as they finally paved the way towards a more flexible and dynamic housing market. Implementation was broadly on target. Reforming the housing sector had been in the Portuguese public debate for decades, but no material changes were ever done. The programme served as a catalyser for these long-needed reforms. The new Urban Lease Act and a new legal framework for renovation works were updated in 2012. The redesigned legal framework would allow opening the rental market after a transition period (initially foreseen for maximum 5 years), by leaving more freedom to the parts to negotiate contracts, reducing the perpetuity of lease contracts, phasing-out rent control mechanisms and giving incentives for renovations. The most vulnerable groups of tenants (low-incomes, aged 65 or more or people with proven disability) remained relatively more protected. In general, the social aspects became a very sensible issue in the housing reform even if social policy is not to be carried out through rent control. The revaluation of 4.9 million properties was completed in 2013, a major achievement also key to support the planned increase in property tax revenues. Remaining tax incentives to home ownership were eliminated but the envisaged gradual shift from the transfer tax to recurrent taxation was abandoned without reason. Overall,

([148]) 58% of rental contracts had been set before 1990, mainly with rents frozen for decades due to a 1948 law suspending rent increases in Lisbon and Oporto.

([149]) The tenant-landlord relations indicator (accounting for the ease of tenant eviction, tenure security, deposit requirement) indicated one of the highest levels of tenant protection in the EU. Source: Andrews, D. *et al* (2011).

([150]) The share of households that had changed residence within the last 2 years was estimated at 5%, one of the lowest mobility rates among EU countries. Source: Andrews, D. *et al* (2011).

([151]) Dwellings with basic features amounted to 65% of the total in 2001, the lowest among OECD countries.

([152]) The owner-occupancy was up to 75%, one of the highest in EU, while the private rental market had shrunk to about 21% and the social rental sector had stagnated at around 4%.

the Portuguese authorities acknowledged and showed commitment to the long needed housing market reforms, though proper monitoring of the impact, including reliable monitoring procedures and data, was afterwards incomplete. It was particularly useful to implement the reform with a relatively long transitional period, as a shorter implementation timeframe would have had strong social impact and raise strong opposition. After the end of the programme, further amendments were introduced (eg expanding the universe of beneficiaries of the phasing out period) which are considered to have weakened the scope of the reform.

The reforms have produced only marginal results so far, although data and information to properly assess the outcomes is not available and it is widely accepted that this kind of reforms take time to materialise given the rather long transitional phase. Tenants' demand seems to have risen, but the rental market activity is only moderately picking up. Expectations point to a gentle acceleration in the pace of rental market growth in the near horizon ([153]), probably higher after the transition period into the new regime. According to information provided by the authorities, about 44000 out of the existing 250000 old contracts have been updated (February 2014). For stakeholders, the preference for home ownership has not changed under the new scenario. Actual rents paid by tenants are adjusting at a faster pace than the overall HCPI, but no more than the housing price index (that measures acquisition prices), which is growing since mid-2013. The incentives for urban renovation do not seem to be working. Large areas of the city centres, mainly in Lisbon and Porto, are still degraded and at risk of desertification. The shadow economy in the rental market is not yet properly evaluated, despite being part of programme conditionality. Stakeholders consider that the housing market reform facilitated the access to housing during the crisis to families that could not afford purchasing a property. Overall, the reforms were needed and went in the right direction, but have not brought the much needed dynamism to the housing market yet.

5.3.3. Overall assessment of product markets and framework conditions measures in the programme

The measures covering product markets and framework conditions were overall well designed to address existing challenges and were appropriate for the programme objectives. However, the programme could have prioritised better the most critical areas to render implementation more effective. The programme essentially tried to address every area where there were factors eroding competition and unduly increasing domestic production costs. Given that the root cause of the crisis was broad-based economic inefficiencies across many different sectors, it seems right to have covered all these areas of reform within the programme. This also reflects the appropriate goal of the programme of increasing longer-term potential output growth and boosting productivity. Opening different markets to competition was a way to foster productivity, and tackling rigidities in so many sectors was a way to improve the quality of the products and services provided and help the economy move up the value-added chain. However, not all areas had the same importance at the same time and by trying to cover too much, the programme may have put too much stress on limited capacity constraints, create reform fatigue and overall achieved too little. It also seems that the programme may have been used to push for a reform agenda that was on the table (e.g. transposition of numerous EU Directives). One can however question whether the role of a programme is also to embrace reforms which are meant to happen anyway and in some cases are not the most critical ones. In particular, in the Portuguese programme it seems that a better and deeper focus on the most critical issues within each area would have been warranted. Stakeholders have also reported that some areas were largely overlooked in the programme design. These include deeper and more systematic measures to fight corruption and fraud, as well as measures on research, development and innovation that could facilitate a shift towards a new economic model.

Despite relatively high commitment to structural reforms, there were important implementation failures. There were various reasons for insufficient or delayed implementation. Implementation was

([153]) Confidencial Imobiliário – RICS (2015) weakened when the intended policies turned out to be politically or socially sensitive. This was the case in key areas with strong vested interests where many relevant measures were still pending at the end of the programme (e.g. energy, regulated professions or ports). The scale of reforms also stretched the Portuguese authorities' implementation capacity. In the latter part of the programme, these existing challenges appear to have been compounded by reform fatigue.

5.4. OVERALL OUTCOME AND ASSESSMENT

Portugal has been one of the EU's top structural reformers in recent years and simulations suggest that recent reforms can have a sizeable positive macroeconomic impact. The OECD indices of competitiveness show improvements in Portugal's indicators on product market efficiency and employment protection (see graphs earlier in the Section) ([154]). Moreover, QUEST model simulations suggest that reforms implemented under the economic adjustment programme may raise GDP by 2.1% by 2020 and employment levels by 1.1%. The gains in output are substantial and would add on average more than 0.4 pp to growth rates over the next five years ([155]). The highest impact on GDP seems to come from reforms of the employment protection legislation, education programmes and reforms of the unemployment benefits. Other OECD analysis ([156]) also indicates that Portugal is a country with a rather high responsiveness to structural reforms.

Overall, the set of structural reforms set out in the MoU were a broadly adequate response to Portugal's long-standing challenge of low potential output growth. The Portuguese programme was a difficult one from the outset as it faced the difficult challenge of restoring growth in an economy plagued with inefficiencies. In view of this challenge, the programme MoU featured extensive structural reforms, which were central to the adjustment strategy. The reforms were necessary to facilitate rebalancing of the economy, promote investment and hiring, and ultimately raise potential growth. The high number and detail of the structural conditions in the programme design were warranted. Most stakeholders consider that they covered Portugal's principal challenges. It was also appropriate to make some compromises on reforms to get a decent level of buy-in to the MoU from Portuguese stakeholders. If the programme partners had pushed harder for a more radical package of measures it could have risked derailing the broad support needed to deliver a meaningful reform.

The extensive agenda for structural reforms was justified by the fact that one of the root causes of the crisis was broad-based economic inefficiencies and distortions. But reforms could have focused better on the most critical issues. The core stated objectives of the programme included increasing potential output and boosting productivity. To achieve so, the programme included numerous and deep structural measures rather than focusing on a few targeted macro-critical issues, reflecting Portugal's broad-based economic inefficiencies, which had in aggregate led to very low trend growth. Indeed, unlike some other countries, the Portuguese crisis did not just stem from one or two sectors (for example housing or finance). The programme partners agreed that all these areas needed to be tackled, at least in

([154]) While these indicators do not fully capture how markets operate in practice, they give a gauge of national progress on structural reforms. From a rather highly-regulated starting point, between 2008 and 2013, Portugal's score on the OECD indicator of product market efficiency declined by 0.4 points, from 1.7 to 1.3, taking the level of regulation to slightly below the euro area average. On the OECD indicator of employment protection Portugal has declined by 0.9 points, from 3.7 to 2.8. The Portuguese labour market is still more regulated than the euro area average, but its reform effort has been the largest in the euro area.

([155]) DG ECFIN (2016b). The analysis for Portugal focuses on structural and tax reforms implemented under the programme and expected to have the highest and more direct macroeconomic impact. They include labour market reforms (reforms to EPL and unemployment benefits), education reforms, product market reforms (liberalisation of professional services, services directive and administrative simplification), reforms in network industries (privatisations in communication sector and transport) and tax reforms throughout 2012-2015. Other reforms were not assessed because they could not be treated analytically in a rigorous manner but they could also have a non-negligible impact. Therefore the estimated impact may give a lower bound of the potential impact of all the reforms undertaken. At the same time, the estimates are surrounded by uncertainties and should be interpreted with caution.

([156]) OECD (2014d)

part, during the programme. The result was that, while more emphasis was put in some important areas (i.e. labour, judicial and housing reforms), there could have been better prioritisation. The MoU envisaged a broad step change in the momentum of reform in a country in which necessary reforms had not been forthcoming. At the same time, ambition and pragmatism could have been better balanced, bearing in mind limits to administrative and political capacity to address all problems at the same time. In that vein, in some cases delays in implementation were justified because they allowed better policy decisions to be taken.

Nevertheless, implementation of structural conditionality was uneven. The overall implementation rates of structural conditionality was quite high. About 2/3 of the programme conditions were assessed by the programme teams as being met without delay. However, there were delays and deficiencies in implementation in some key areas, which have limited the economic impact of the programme. It is clear that structural reforms were important but difficult to implement. Changing the structure of the economy following an economic crisis entails a transition period of low wage growth and high unemployment. Moreover, it is an open question how the programme design can ensure effectiveness and at the same time foster ownership. The latter is essential and cannot be replaced by other mechanisms. The Portuguese authorities and social partners showed some reticence about the scope of the structural reforms, limiting the programme partners' room for manoeuvre. An earlier and more consistent implementation of these reforms would have had a number of benefits, including improving the economic outlook and private investors' confidence in Portugal. At the same time, the presence of Tripartite agreements helped gain the consent of people affected by reforms and limit the level of industrial action during the programme.

In practice, some structural reforms may not always have been treated as the top priority in the programme, or were watered down by political and social constraints. It seems that other aspects of the programme (particularly the fiscal adjustment) were treated as more immediately pressing than structural reforms, in particular some product market reforms, by the programme partners. For example, some stakeholders said they found it hard to envisage that inadequate progress on specific structural conditions would ultimately lead to an assessment of non-compliance (and non-disbursement). In many cases this may have been due to the tension between the many reforms that would have been economically desirable and the apparent political and social constraints. On many occasions programme partners had to strike a difficult balance between pushing for more reforms and avoiding risks of a political crisis in the government coalition (due to an increasing reform fatigue), or of breaking the social consensus. In these cases the divergences were settled with rather weak compromises that watered down the initial scope of reforms.

Structural reforms were meant to be frontloaded, but in practice this was only the case for labour market reforms. While many of the labour market reforms were implemented in the first year of the programme, progress on other reforms was slower and patchier. This was probably because the ground for labour market reforms was better prepared as already agreed with the social partners in March 2011 and because labour market reforms are administratively easier to implement. Delays in other reforms appear to be partly linked to the relative strength of vested interests. The timing of many reforms was also influenced by factors including need to conduct social dialogue, the demands placed on the legislative system, or the desire for transitional periods or protections. ([157])

There was no specific target on the sequencing between labour market and product market reforms. There was awareness that it would in theory be better to do product market reforms first, or at least concurrently. However this was not judged to be a realistic priority for the programme design given the relatively short three-year programme horizon. On balance it was right to frontload those labour market reforms that could be implemented relatively quickly, rather than delay them for reasons of sequencing. There is also evidence that the short term impact of reforms to EPL and unemployment

([157]) Stakeholder consultation.

benefits is more favourable during economic upturns, ([158]) but again given the urgency of the need for reform and the limited duration of the programme this would not have justified delaying the reforms in Portugal. But the overall sequencing, effectiveness and fairness of reforms could have been improved by faster progress on reforms to product markets and protected sectors. Reforms that involved taking on organised vested interests – e.g. in protected sectors such as the energy sector – may have tended to be put in place later than those affecting more diffuse groups, or to still be incomplete.

In the short term structural reforms have contributed to some competitiveness gains, though to date growth, investment and productivity outcomes appear modest. Structural reforms have contributed to the improvement of the economic situation as marked by some correction of macroeconomic imbalances, in particular the closing of the current account deficit. However, these achievements are not yet showing signs of feeding into productivity, investment or potential output growth. Given the short-term horizon, it would be unfair to blame this only on shortfalls in structural reforms. Moreover, the pre-programme starting point was so low that, even where the degree of market efficiency and flexibility has improved, it often still falls short of what is needed to facilitate a smooth adjustment process within a monetary union and to deliver more growth and jobs. Many of the changes that Portugal has been seeking to put in place are intrinsically long-term endeavours, e.g. increasing productivity through better education or a more entrepreneurial culture. However Portugal's medium term prospects might be better had the implementation of key reforms gone further. In a number of cases they only touched the tip of the iceberg.

This suggests that there may have been some shortcomings in the focus of structural reforms, with more attention paid to cost competitiveness/external adjustment, and less to raising investment and productivity. While the overall theoretical programme design was probably broadly correct, an opinion shared by some stakeholders is that in practice structural reforms were too much focused on raising competitiveness through wage cuts and labour deregulation. In their view other essential measures were missing, including policies to promote research and innovation, renewable energies, workers' qualifications and skills, liberalisation of some markets and promotion of productivity-enhancing investment in knowledge-based capital.

From a firm-level perspective, evidence suggests that some structural reforms in the programme are perceived as having had a positive impact (in particular labour market reforms) but further progress is needed. Besides measures trying to link reform indicators to macroeconomic outcomes, the effectiveness of structural reforms can also be assessed from a firm-level perspective. At that level, structural reforms are expected to reduce costs, thus impacting on the firm's competitiveness and growth prospects. A recent IMF firm-level survey ([159]) suggests that firms perceived a most positive impact from programme labour market reforms and a less positive one from product market reforms. In particular, increasing work time flexibility, reducing the cost of hiring and firing and active labour market policies are perceived as those labour market reforms having had a strong positive impact, while reforms of collective bargaining received low scores. On the other hand, none of the product market reforms are perceived as having had a significant positive impact on firms' competitiveness.

Clearer communication of the necessity of structural reforms and its longer-term prospect might have helped overcome some of the resistance to reforms. Although the initial MoU linked the package of reforms with analysis of economic challenges and the necessity of adjustment, communication of the relationship between timely and effective implementation of structural measures and the programme goals could have been more consistent. At the same time, the scope of the reforms needed meant it should have been better communicated that a three years programme could only be the starting point of a

([158]) Duval, R., Furceri, D. (2016)

([159]) The survey was sent to non-financial firms at the beginning of March 2015, targeting a group of about 200 large firms and about 300 SMEs. The response rate was 17.4 percent. Objections to using firm surveys to assess the impact of structural reforms include that the answers may extract opinions not related to the outcomes of reforms and also firms not being able to disentangle cyclical effects of the crisis from the impact of reforms. IMF (2015c) necessarily longer-term reform process. The complementarity of reforms could also have been emphasised more. Some stakeholders in the consultation also supported this view.

At the end of the programme, there was still a lack of systematic assessment of the impact of structural reforms, though Portugal is making some progress. Evidence about the real economic impact of the programme reforms, which is important both for communication and further policy development, is scarce. Ex post monitoring and analysis of reforms implemented under the programme remains patchy, notwithstanding the good monitoring system put in place for schools. A clearer analytical framework for assessing the prospective payoffs from structural reforms ex-ante could help inform expectations and improve communication during the programme.

6. BANKING SECTOR POLICIES

6.1. KEY CHALLENGES AND PROGRAMME DESIGN

The Portuguese banking sector vulnerabilities mirrored the weaknesses of the domestic economy. The banks' positive profitability, recorded until 2010, was the reflection of the risks the banks had taken, domestically and abroad. In fact, banks had expanded their balance sheet during the first years of the crisis. The overextended public sector meant that the interconnection between the banks and the sovereign was stronger than suggested by the banks' holding of domestic government bonds, amounting to more than 4% of total assets in mid-2011. In fact, banks were lending to SOEs, some of which were structurally loss-making and covered by explicit or implicit government guarantees. Credit to non-financial corporations and households was mostly intermediated by the banks at conditions that eased over time, due to declining risk *premia* in the context of the Great Moderation. As a result, private debt exceeded 200% of GDP in mid-2011 and posed further potential risks on the banks' balance sheet. Banks had diversified around one fifth of their assets in foreign countries; while this helped protect them somewhat from the domestic slowdown, it resulted in the exposure to the then troubled EA economies of Spain, Ireland, and Greece, amounting to around 3.5%, 3.0%, 1.5% of total assets, respectively. Some banks had also significant South American and African operations, which were contributing to increase their profits as much as their risks. ([160])

The vulnerability related to the banks' unstable funding sources was already unfolding its effects. The role of the banking system in intermediating the country's financing needs with external financing, including through interbank lending, was reflected in the Loan-to-Deposit (LTD) ratio, which reached a peak of 167% in mid-2010. Then, the banks' financing difficulties, which had already started in early 2009, culminated in the loss of access to the international debt markets. Subsequently, thanks to the availability of eligible collateral, the banks increasingly relied on the Eurosystem financing, whose amount reached over €40bn (around 8% of banks' liabilities) in mid-2011. A prompt fixing of the situation required a decisive adjustment of the banks' balance sheet, which in turn required stringent supervisory actions, in the absence of other incentives for the banks to promptly move ahead.

The banking sector was rather concentrated and presented some inefficiency. The three largest banks - Caixa Geral de Depósitos (CGD), Banco Comercial Português (BCP) and Banco Espírito Santo (BES) - accounted for more than half of the total bank assets. Banks' inefficiencies were indicated, for instance, by the ratio between population and branches, which was among the lowest in EA, below 1,700. ([161]) CGD was state-owned. It accounted for more than 20% of the banks' total assets and had a leading position in customer lending and deposits, property leasing and insurance. In particular, it had a large presence in the SOEs and in the mass customer segments, and tended to record lower operating profits than its peers. As a result, CGD might have arguably played a benchmarking role, undercutting competition in the sector. BCP and BES were privately owned and presented complex ownership structures, with exposure to non-financial businesses.

The programme envisaged strengthening the banking sector in view of the need to address the country's economic imbalances. The banking sector was expected to face considerable challenges, as a consequence of the needed correction of the country's structural imbalances. The programme strategy envisaged increasing the banks' resilience to delink their market access from the sovereign one and to reduce reliance on Eurosystem financing, while ensuring adequate liquidity to avert a credit crunch. If banks failed to raise sufficient capital in the markets, temporary public provision of equity by the state was envisaged. For this purpose, the programme envelope contained €12bn to be disbursed to the Bank Solvency Support Facility (BSSF).

([160]) Source: BIS data.
([161]) Source: ECB (2010) and ECB (2013a).

Capital provisions by the State to the banks had to comply with EU state aid rules. This need was also stated by the programme conditionality. In accordance with the "2008 Banking Communication", the Member State granting the aid provided commitments to a set of measures, on the basis of a restructuring plan, that aimed at (*i*) ensuring the bank's return to viability, (*ii*) addressing distortions of competition, and (*iii*) minimising the use of public money through appropriate burden sharing by the bank. If the return to viability was not plausible, the bank was to be wound down in an orderly manner. Until 2013, state aid could be granted as rescue aid on a temporary basis before a restructuring plan approval; burden-sharing by subordinated debt was not required. ([162]) The "2013 Banking Communication", applicable since August 2013, complemented the framework, by generally requiring prior state aid approval before any recourse to public funds and burden sharing through conversion or write-down of hybrid capital and sub-debt holders.

Under the programme, the process of strengthening the banking sector was to start immediately and proceed gradually, under the supervision of Banco de Portugal (BdP). Before the programme, the required Core Tier 1 capital ratio was set at 8%. Under the programme, it was increased to 9% to be met by end-2011 and 10% to be met by end-2012. Banks were required to submit "solvency and funding" plans to BdP by June 2011, with the aim of detailing the paths to meeting capital requirements and stabilizing their funding profile. Being responsible for the banking supervision, BdP was envisaged to assess the banks' "solvency and funding" situation, including under stress scenarios, on a quarterly basis, with the support of the programme partners. BdP was also envisaged to design a special programme of on-site inspections by June 2011; and to enhance the disclosure requirements on provisioning by September 2011. It also committed to improve its governance and internal capabilities. With regard to bank resolution, a framework was to be introduced by November 2011 and the Deposit Guarantee Fund was to be strengthened by December 2011.

The programme contained specific conditionality for the state-owned Banco Português de Negócios (BPN) and CGD, aiming at reducing risks and costs for the state. BPN - a relatively small bank - had been nationalized and had been put under "deep restructuring" in late 2008. CGD had supported the restructuring of BPN, including by providing around €5bn financing lines. The BPN restructuring plan, as presented in September 2010, envisaged splitting the entity into a "bad bank" and a "good bank". The programme envisaged accelerating the process, allowing for more troubled assets to be transferred to the bad bank, with the aim of re-privatizing the good bank by July 2011. Under the programme, CGD assistance to BPN was to be phased-out, including through the settlement by the state of the liquidity support. Moreover, CGD was to be streamlined, by increasing its capital with its own internal resources, through a sale of its insurance and health arms, and – if needed – other non-core subsidiaries. The programme did not envisage the full privatization of CGD, which could have contributed to reduce further the cost and contingent liabilities for the state, and possibly fostered competition in the sector.

The programme contained requirements to deal with high private debt and provide credit to the viable firms. The MoU required to start monitoring the level and evolution of private debt and to define the principles of an out-of court debt restructuring framework by September 2011; and to amend the Insolvency law, with technical assistance from the IMF, by November 2011. This was intended to facilitate the orderly and efficient correction of the country's imbalances, supporting the shift of resources to the most productive sectors. The capital re-allocation also required consistent provision of credit to viable businesses. With regard to bank lending, while projecting some asset downsizing as a consequence of the banks' balance sheet adjustment, the programme partners envisaged BdP to monitor, with their support, the consistency of the adjustment process with the macro developments. The programme partners also encouraged the assessment of the existing system of government guarantees for SMEs and of the extra-bank financing alternatives, without indicating stringent deadlines and medium term objectives.

([162]) Such burden-sharing by subordinated creditors was implemented in Spain already in 2012, anticipating the EU legislative changes. See "Evaluation of the Financial Sector Assistance Programme Spain, 2012-2014", page 43 and Section 4.2.2

6.2. PROGRAMME IMPLEMENTATION

6.2.1. Strengthening the banking sector

Part of the banks' initial capital needs resulted from requirements that were defined outside the programme context and related to the banks' holdings of sovereign bonds. In 2011, banks' capital needs resulted mainly from the increased required capital ratio and the introduction of temporary sovereign buffers. The latter were designed by the European Banking Authority (EBA) and intended for all major EU banks. ([163]) Limited additional needs resulted from the transfer of the banks' pension funds to the social security system, and the impairment charges following the Special Inspections Programme (SIP). ([164]) No further capital needs resulted from the "solvency and funding" assessment and the related stress tests, as supervised and coordinated by the BdP. These stress tests were initially not as thorough as the situation might have warranted; they were not based on a comprehensive third-party modelling and lacked full transparency with regard to assumptions and granular results. ([165]) Covering the capital needs was expected to make the banks better equipped to deal with their vulnerabilities, such as the nexus with their own sovereign and the quality of their loan books. The prominent role of the temporary sovereign buffers in defining the capital needs can be seen as reflecting the high perceived importance and urgency of tackling the bank-sovereign nexus. The inspections and the stress tests played a marginal role and, with hindsight, underestimated the potential problems related to the banks' loan books, especially in the case of a worse-than-expected downturn.

Table 6.1:
Banks' recapitalization (1)

	CGD	BES	BCP	BPI	Banif	Total
CoCos (€bn)	0.9	-	3.0	1.5	0.4	5.8
Equity (€bn)	0.8	1.0	0.5	0.2 (2)	1.2	3.7
Total Capital contribution (€bn)	1.7	1.0	3.5	1.5	1.6	9.3
by the State (€bn)	1.7	-	3.0	1.5	1.1	7.3
by private investors (€bn)	-	1.0	0.5	0.2 (2)	0.5	2.2
Recap as % of CT1 Dec 11	25.0	17.0	68.0	66.0	172.1	40.0
2012 CT1	11.6	10.5	12.4	15.0	11.1	11.2

(1) The recapitalization of BPN amounted to €0.6bn. The bank is not included in the table as it was subject to a "deep restructuring process", which drove the recapitalization. It was not subject to either SIP or the EBA Capital Exercise. The capital injection occurred earlier than for other banks.
(2) The proceeds were used to repurchase EUR 200 million worth of CoCos.
Source: Standard and Poor's, Banks' financial accounts, Portuguese authorities.

Covering the banks' capital needs - as identified by the supervisory authority - occurred rather smoothly. The capital needs were to be covered by mid-2012. This in fact occurred, with the exception of Banif. As a result of its slow streamlining, strengthening the capital of the state-owned CGD required €1.7bn injection by the state, provided outside the BSSF facility. ([166]) The capital of the privately owned banks was strengthened mainly through new capital injections, from private funds (€2.2bn) and BSSF funds (€5.6bn). This was facilitated by the flexibility of the programme partners, which allowed accelerating the disbursement of the funds. The envelope was sufficient to cover the capital needs, as

([163]) In December 2011, EBA recommended to introduce exceptional and temporary buffers to reach 9% Core Tier 1 capital ratio by the end of June 2012, after a prudent valuation of sovereign debt exposures to reflect market prices as at the end of September 2011. Sovereign buffer for CGD, BES, BPI and BCP amounted to around €3.7bn.

([164]) In December 2011, BdP announced the results of the first phase of SIP, which consisted of (i) the validation of the credit risk capital requirement and (ii) the valuation of the credit portfolio of the 8 largest Banking Groups. The valuation was performed by two independent accounting firms, covered assets worth €281bn and yielded additional impairment of €840 million (i.e. 0.30% of the assessed assets, or 9.1% of the total impairment related to the covered investments).

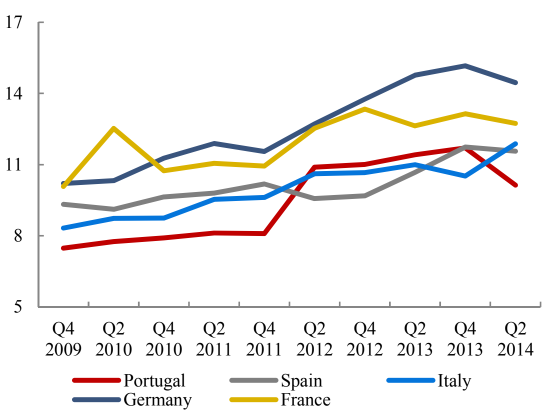
([165]) Initial tests were based on different banks' asset classification methods, risk parameters and deleveraging assumptions. The tests did not cover all risk factors, particularly with regard to some market and liquidity risks. In early 2012, the third SIP work-stream - performed by a specialised consulting firm - aimed at assessing the stress-test parameters and methodologies. Further improvements of the stress testing infrastructure were recorded in 2013. The 10th programme review recognized that a proper top-down stress testing framework had only been developed by then. See also IMF (2014a), Box 3.

([166]) The sale of the insurance arm (Caixa Seguros), initially intended for 2012, was completed in January 2014.

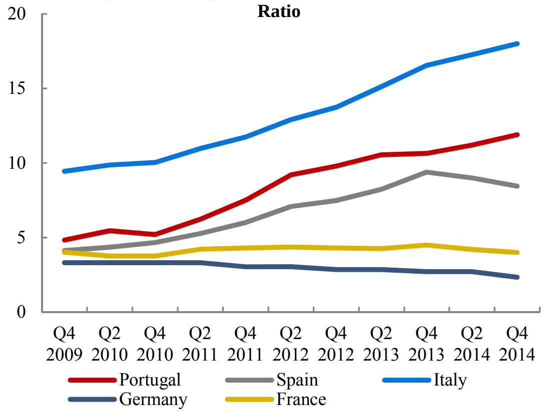
identified by the supervisor, leaving €6.4bn unused, until the end of the programme. Most (€5.8bn) of the public capital injection was in the form of contingent convertible notes (CoCos). ([167]) (Table 6.1) Bearing high interest rates and a strong dilution for existing shareholders, especially in the case of conversion, these instruments were expected to provide adequate remuneration for the State and incentives for the banks to improve their management and risk-pricing, in order to be able to repay them before conversion. By the same token, CoCos contributed, only to a limited extent, to lowering the banks' cost of capital.

Banks that received state aid were subject to restructuring plans that contributed to their return to viability. The restructuring plans of CGD, BPI and BCP were approved in mid-2013. ([168]) The aid to Banif was granted on a temporary basis as rescue aid, ([169]) while the draft restructuring plans did not dispel the prevailing doubts on the bank's viability. On the basis of the then applicable rules, burden sharing and compensatory measures were ensured through bans on coupon, dividends and buybacks, and dilution of existing shareholders (including by high CoCos coupons). ([170]) The banks' return to viability was to be ensured, over five years, through restructuring of the banks' business models and operations. The depth of restructuring depended on the amount of aid received. The restructuring plans were meant to address the banks' funding gap and restore adequate cost structures and margins, so as to reinforce their capital position over time. They foresaw disposal of non-core (mainly foreign) activities, while preserving core domestic lending activities, which were however expected to decline, also in view of the declining credit demand. With hindsight, the plans contributed to improving viability, in particular where the restructuring was deep, while the restructuring for some banks is still ongoing. However, in the view of some stakeholders, the combination of the CoCos remuneration and the planned assets' downsizing brought negative effects on the banks' credit supply and business diversification. Having covered its capital needs through private sources, BES was not subject to a restructuring plan approved by the EU Commission. (See Box 6.1)

Graph 6.1a: **Tier1 Capital**



Graph 6.1b: **Non performing to Total Gross Loans, Ratio**



Source: ECB, IMF

The extent of the troubled loans' problem was not immediately foreseen. It surfaced thanks to improvements in the banks' asset quality assessments. In 2011, as envisaged by the MoU, BdP issued

([167]) CoCos are subordinated loss absorption instruments, which contingently mandatorily convert into common equity or which contain contingent mandatory principal write-down features. In Portugal, CoCos bore step-up coupons between 8% and 10%; they contributed to the CT1 and were to be automatically converted if not repaid by maturity (2017).
([168]) See SA.35062, SA.35238 and SA.34724.
([169]) "The Commission considered that [such] a plan, […], needs to provide for a material overhaul of the bank's business model, […] or an orderly winding-up if the bank cannot return to viability." SA.34662 BANIF – Rescue decision of 21 Jan 2013.
([170]) In 2011, BES, BPC, BPI and Banif had launched voluntary Liability Management Exercises (LMEs), mainly in the form of exchange or tender offers with discounts between 30% and 50% of the bonds' nominal value, to meet the 9% minimum capital requirement; in 2013, Banif performed an additional LME.

a definition of non-performing loans (NPLs) that improved transparency and international comparability but remained arguably narrower than in other countries. ([171]) In late December 2013, following the EBA reporting standards on NPLs, BdP strengthened the criteria for a loan to be marked as restructured. Four yearly rounds of on-site inspections, performed under the BdP supervision, improved the banks' asset quality assessment and governance. These results were achieved gradually. The valuations' granularity and the ensuing impairment charges increased during the subsequent rounds. ([172]) The process of integrating the assessments in the "stress tests" also required time. In early 2014, following the completion of the inspections, BdP revised the guidelines on measuring credit portfolio impairment. ([173])

NPL volumes kept on increasing, as new troubled loans appeared while effective supervisory policies to tackle the existing ones were not promptly introduced. (Graph 6.1b) The problematic loans were initially concentrated in the construction and commercial real estate sectors, but they gradually extended to different corporate sectors, especially non-tradable, and - to a minor extent - to consumer financing, as the worse-than-expected macroeconomic outlook and the high debt levels unfolded their effects. NPLs increased in particular among small and micro companies. The increase of NPLs as a percentage of total loans partly reflects the reduction of total loans in the denominator. BdP promoted debt restructuring through Pillar 1/Pillar 2 but did not impose targets and/or capital (dis)incentives for not restructured or not written-off loans. These were not required by the MoU either. A more demanding reduction of NPLs would have been beneficial. It could have resulted in the crystallization of some losses for the banks, potentially triggering additional capital needs, but would have contributed to accelerate the balance sheet healing.

The banks' only gradual recognition of losses and the absence of both active distressed markets and alternative facilitating mechanisms contributed to limit the disposal of troubled loans. The set-up of a state-sponsored asset management company (AMC) to deal with NPLs was not introduced in the conditionality; besides the state's limited capacity to provide guarantees, due to its already high debt and contingent liabilities, the heterogeneity of the NPLs would have limited the benefits of an AMC. ([174]) In this context, the banks transferred only limited amounts of NPLs to "credit recovery funds", owned by pools of banks and specialized in companies' turnaround. Specific guarantees schemes related to performing but low yielding "tracker mortgages" were considered in the conditionality in early 2013, but eventually dropped; the state's scarce capacity to provide guarantees, in the absence of EA/EU risk sharing tools to provide supranational guarantees, impeded such a mechanism. ([175])

The need of adjusting the banks' funding structure was translated in a LTD target, which was met before the end of the programme. In line with their funding plans submitted to the BdP, banks had to gradually reduce their LTD ratio from around 150% to 120% by 2014, requiring an adjustment of around €40bn (or 23% of GDP) to be split between loans and deposits. ([176]) The government guarantees ceiling on newly issued debt was increased to €35bn, facilitating the banks' access to the Eurosystem during the

([171]) Instruction 22/2011, Banco de Portugal. The definition included (i) loans in arrears for 90 days or more, (ii) certain restructured loans whose overdue payments were capitalized, only if not adequately collateralized, (iii) weak loans, only if the borrower was under insolvency or bankruptcy. See also Barisitz, S. (2013).

([172]) In addition to the 2011 SIP, the 2012 On-site Inspections Programme (OIP) covered assets worth €69bn and required additional impairments of €860 million. Subsequently, The ETTRIC identified additional impairments of €1.12bn in 2013 and €1.0bn in 2014, bringing the total required additional impairment amount to €3.82bn.

([173]) In 2014, after the programme terminated, BdP established an early warning system with a view to ensure provisioning on the weakest exposure.

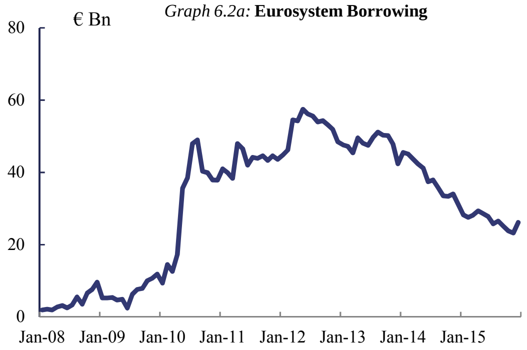
([174]) An AMC would also have been subject to EU state aid rules, in particular those on impaired asset measures, applicable since 2009. For the selective role of AMC in exploiting economies of scopes and supporting the development of distressed markets, see Klingebiel D. (2001) and IMF (2015c).

([175]) Tracker mortgages bore low (around 100bps) life-time margin over Euribor, not contributing positively to the net interest rate margin. The guarantees were expected to improve the credit rating of the senior tranches, resulting from the securitization of the mortgages, thus reducing their funding costs and/or increasing their disposal prices. The mechanism would have worked by embedding the remuneration of the guarantees probably with a form of aid, which would have been subject to state aid scrutiny.

([176]) The target was formally introduced with the 1st programme review, after the banks' submission of the funding plans detailing their deleveraging paths for the period 2011-2015.

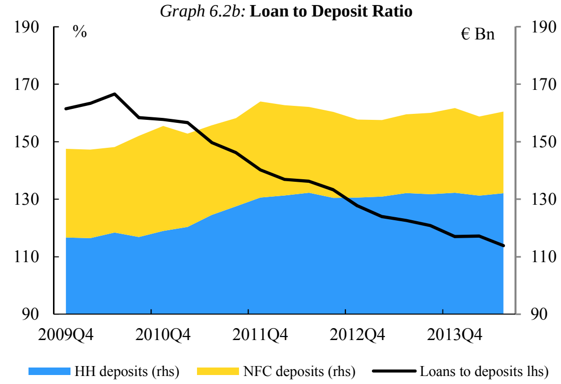
LTD adjustment process. ([177]) The initial banks' plans relied on increasing the deposit base, while continuing to support lending to viable firms; it worked initially, as retail deposits grew by around €1bn per month until November 2011, when the BdP introduced effective mechanisms to limit the increase of the interest rate offered by the banks on deposits. ([178]) Having been substantially met in 2013Q2, the LTD targets were dropped from the 7th review. (Graph 6.2b) The progress in LTD ratio helped reducing the reliance on the Eurosystem. By the end of the programme, the Eurosystem lending decreased from a peak of €60bn to around €40bn. (Graph 6.2a) Further reduction was constrained by the banks' continued and sizable buying up and re-financing of short-term domestic public debt, which was facilitated by the ECB non-standard measures and contributed to the government's financing needs and the banks' profitability. ([179])

Graph 6.2a: **Eurosystem Borrowing**

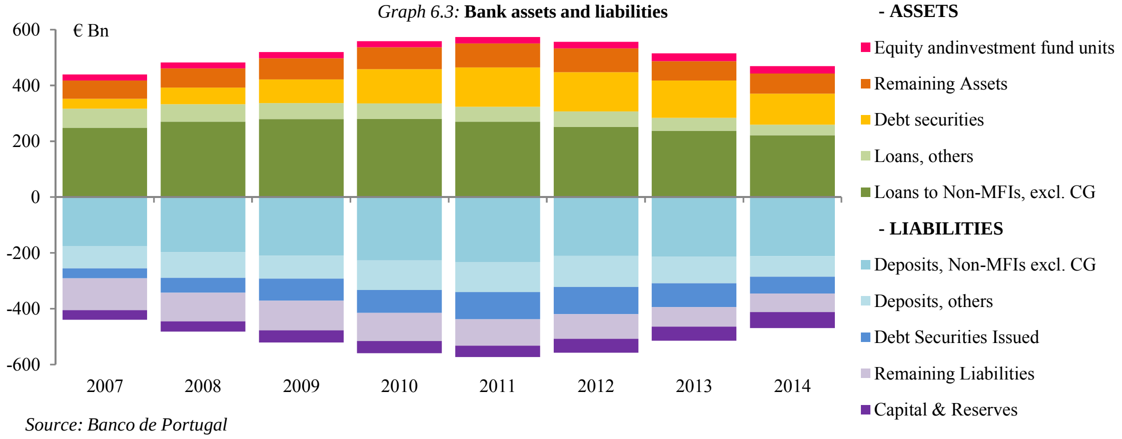


Source: Banco de Portugal, Programme documents

Graph 6.2b: **Loan to Deposit Ratio**



Graph 6.3: **Bank assets and liabilities**



Source: Banco de Portugal

Negative net credit flows drove the protracted reduction of the bank loans and total assets. The loans' reduction continued after the LTD target was met and amounted to almost 20% of the mid-2011 levels. (Graph 6.3) The reduction of the stock of loans did not result much from the NPLs workout and other loans' disposal, but rather from the negative net credit flows, which drove also the reduction of the

([177]) At the time, banks were allowed by the ECB to post government guaranteed bonds as collateral in the Eurosystem refinancing operations. In July 2011, ECB suspended the minimum requirements for credit quality thresholds of bonds issued or guaranteed by the Portuguese Government, ensuring their eligibility for refinancing operations irrespectively of the rating.

([178]) The BdP required banks to hold additional capital against deposits offering more than 300 bps above Euribor. In February 2012, the cap was further narrowed to 225 bps.

([179]) ECB non-standard measures included the fixed-rate full allotment and the lengthening of the maximum maturity of the Longer Term Refinancing Operations (LTROs). See ECB (2011) banks' assets, amounting to around 15% of the mid-2011 levels. The downsizing was slower and more protracted than in some other programme countries, notably Ireland and, to a minor degree, Spain.

The implementation of the bank resolution framework occurred rather swiftly. The new regime for the resolution of distressed credit institutions was introduced in February 2012. ([180]) The measures set out in the new regime aimed at recovering or preparing the orderly winding-up of credit institutions and certain financial companies in situations of financial distress. The new toolbox included three stages of intervention by BdP, namely corrective measures, the appointment of an interim board and resolution measures. Banks were required to contribute to the Resolution Fund up to €200million in a year and up to €2bn in 10 years and to submit resolution plans to the supervisor. This was an important programme achievement, as also confirmed on the occasion of the post-programme resolution of Banif and BES.

The restructuring of BPN was slower than originally envisaged and left some legacies beyond the end of the programme. The attempt to sell the good bank by July 2011 failed, due to the lack of appropriate buyers' interest. The sale was completed in March 2012, following the recapitalization by the state of €0.6bn, the agreement with Banco BIC to buy the good bank, and the final approval of the restructuring plan by the European Commission under EU state aid rules. ([181]) The bank’s distressed assets were transferred at their book value of around €4bn to the Portuguese state and isolated in three special purpose vehicles (SPVs), Parvalorem (loan portfolio), Parups (real estate and other assets), and Parparticipadas (shares in companies). The disposal process of the distressed assets required outsourcing some management functions and did not progress much before the end of the programme. The liquidity support, extended by CGD, was transferred from BPN to the state-owned SPVs and was agreed - among the authorities and the programme partners - to be settled by the government only gradually, so as to reduce the funding pressure for the state. As a result, CGD was still financing the state-owned SPVs for an amount larger than €3.5bn, when the programme terminated.

([180]) Decree-Law No 31-A/2012 of 10 February 2012. This was followed by a number of operational instructions and notices by the BdP in 2012/13 and eventually supplemented by the Decree-Law No 114-A/2014 and No 114-B/21, after the programme terminated. The 2014 Decree Laws aimed at better aligning the national framework to the emerging BRRD, in particular by (*i*) introducing the no creditor worse off principle, (*ii*) clarifying the scope of the use of the Resolution Fund, and (*iii*) clarifying the scope of liabilities that could be transferred within the resolution process.

([181]) See SA. 26909 (2011/C), Commission Decision for the restructuring of Banco Portuguese de Negocios

Box 6.1: The process of adjusting BES and Banif

Despite the disappointing performance in the 2011 EBA stress test, ([1]) BES maintained a relatively positive outlook among credit and equity analysts, throughout the programme. ([2]) The convoluted structure of the Espírito Santo Group posed corporate governance's issues and - at the same time - contributed to mask its underlying vulnerabilities. In mid-2013, at the request of the programme partners, BdP moved to reform BES' governance structure. It ordered prudential provisions for intra-group holdings and the audit of the ultimate parent company's (Espírito Santo International - ESI) accounts, which identified - in the first half of 2014 - “omissions in the accounting of liabilities” and “overvaluations of assets”. ([3]) In July 2014, after the programme terminated, BES posted losses of €3.6bn, which lowered its capital ratio to about 5%. The main source of troubles leading to the record losses was represented by the leveraged and illiquid operations – especially in Angola – of some Group's holding companies (ESI, Rioforte, Espírito Santo Financial Group - ESFG), to which BES was exposed through loans, securities and guarantees. ([4]) In August 2014, the Portuguese authorities decided to resolve BES by splitting its operations into a bridge bank (Novo Banco) and a bad bank, which was set to receive some assets, related to the Espírito Santo Group, and junior liabilities. ([5]) The large amount of aid granted on this occasion was approved by the EU Commission, which will assess the viability of the resulting entity when Novo Banco is sold. The Commission decisions concerning Novo Banco did not approve a restructuring plan, which was not required given the nature of the aid and the bridge bank's temporary setup. ([6])

Differently from other banks, most of the capital needs of Banco Internacional do Funchal (Banif) resulted from losses recorded in 2012 as well as circular capital. ([7]) In light of the uncertainty on its viability, the resolution of Banif was considered already at the time. ([8]) The Portuguese authorities did not resolve the bank and granted Banif with the most significant public support, as a percentage of its existing capital, among the main Portuguese banks. However, the concerns on the bank's viability could not be dissipated. ([9]) In July 2015, the European Commission opened a formal investigation on the aid, as the banks' return to viability could not be demonstrated and the bank could not reimburse €125 million of CoCos due in December 2014. As attempts to sell the bank without further state aid were not successful, the Portuguese authorities put Banif into resolution at the end of December 2015. ([10]) In this context, BdP - the Resolution Authority - selected the bid of Banco Santander Totta to acquire about €11.1 billion of assets and liabilities, while transferring impaired assets of about €2.2 billion (net book value) to an asset management vehicle owned by the Resolution Fund. In the resolution, public support of up to €3bn was approved, in addition to the aid previously granted. ([11])

([1]) The 2011 EBA stress test covered BES' financial holding, EFSG. The 2012 CT1 capital was projected at 5.1% - the lowest of the covered Portuguese banks - under the adverse scenario. As the threshold had been fixed at 5%, the bank did not have to be immediately recapitalized, but it had to strengthen its capital position. Both ESFG and BES took actions to increase their capital in 2011, partly through intra-group operations.

([2]) In June 2014, the bank raised around €1 billion of new capital in a share sale. At the time, BES' credit rating was Ba3/B+ and the equity analysts' assessment was stable/positive (10% Sell, 50% Hold, 40% Buy).

([3]) http://www.ft.com/intl/cms/s/0/6d228e6c-e802-11e3-b923-00144feabdc0.html#axzz4BMVdpHFs

([4]) The exposure had increased in June and July 2014, despite the prohibition of BdP.
See: https://www.bportugal.pt/en-US/OBancoeoEurosistema/Esclarecimentospublicos/Pages/infobes.aspx

([5]) In December 2015, BdP - the Resolution Authority - completed the resolution measure; it made an adjustment to the perimeter of the assets and liabilities transferred to Novo Banco and imposed losses on some €2bn senior debtholders.

([6]) See SA.39250 and SA.43976 Resolution of Banco Espirito Santo

([7]) SA.34662 BANIF – Rescue decision

([8]) http://observador.pt/2016/05/17/vitor-gaspar-banco-portugal-determinante-na-injecao-fundos-no-banif-troika-nao-opos/; http://observador.pt/2016/04/01/banif-banco-portugal-preparou-resolucao-desde-2012/

([9]) "[…] the rating agency believes that there is a very high likelihood that further government support will be needed to ensure the bank's future financial viability." Moody's rating action of 15 April 2013

([10]) In Dec-15, BdP stated that "[…] the absence of an approved restructuring plan, worsened by a less favourable economic environment, led to significant negative deviations of Banif’s results from the projected amounts."

([11]) See SA.36123 Rentipar/BANIF – Restructuring decision – PT, SA.43977 Resolution of Banif

6.2.2. Unwinding the imbalances

The process of revising the insolvency frameworks was appropriate but not decisive in fostering private debt restructuring. The amendment of the insolvency law was introduced in spring 2012, with a limited delay compared with programme plans. Later in the year, both in-court fast-track mechanisms and out-of-court tools were made operational to facilitate the solution of the insolvency cases. ([182]) In light of the significant backlog of court cases experienced in Portugal at the start of the programme, it was appropriate to promote out-of court agreements. However, the tools experienced a mixed take-up, and required some amendment to improve the early recovery and the preservation of the most productive firms. After the end of the programme, room for improvement in the corporate restructuring tools was still recorded. ([183]) With regard to household debt, as envisaged by the conditionality, new general and extraordinary regimes were introduced in winter 2012/13 to encourage agreement between creditors and banks on debt restructuring. The general regime required banks to develop risk management systems to monitor and prevent borrowers' risk of default, hence contributing to shape a cultural change in banks' approach to household credit risk.

Initiatives to foster bank lending to the real economy brought mixed results. To facilitate bank lending to viable firms, the Portuguese authorities acted on both credit supply and demand. They sought to extend financing commitments from banks. ([184]) They also aimed at strengthening the risk profile of the borrowers by providing guarantees, through the National Guarantee System (NGS). This increased the state contingent liabilities, but did not boost lending activity. By the end of 2012, the government made available two tranches of guaranteed credit lines for SMEs totalling €3bn. In reaction to the low take up of these instruments, the conditionality - as updated in early 2013 - envisaged a reform of the NGS aiming at designing a more competitive, transparent and accountable system. ([185]) A further €2bn of guarantees was made available at a later stage. Further initiatives to facilitate banks' lending to SMEs were gradually introduced in the conditionality and properly implemented. They included the enhancement of the national corporate sector databases, notably the central bank-managed Central Credit Registry and the Corporate Balance Sheet Database, broadening the scope of data available to credit institutions with the aim of facilitating the credit risk assessment.

Initiatives to foster extra-bank lending were introduced relatively slowly, as the authorities and the programme partners increased their focus on this only after stabilizing the banks. In December 2012, an agreement with the EIB/EIF allowed Portuguese counterparts – including those suffering from credit downgrades as a result of the economic recession – to benefit from further external financing. ([186]) The authorities' assessment and preliminary proposals on the diversification of financing alternatives for corporates, envisaged under the original MoU, were also concluded in the second half of 2012. Subsequently, the conditionality – as updated in early 2013 - encouraged further analysis on developing the commercial paper market through regulatory and tax changes and the promotion of pooled issuance of corporate debt. At the beginning of January 2014, the authorities revised the regulatory and tax environment for commercial paper, but opted for not pursuing the promotion of pooled debt issuance, which would have provided an alternative long-term financing option.

The Development Financial Institution (DFI) was set-up only after the end of the programme, as ensuring a proper functioning of the institution required some effort. In addition to EIB/EIF

([182]) The SIREVE, mediated by IAPMEI, targets essentially micro and small firms. The PER targets larger and more complex firms, and also individuals.
([183]) European Commission (2016). See also the stakeholder consultation (Annex 1).
([184]) In the context of the restructuring plans, the Portuguese government agreed with CGD, BPI and BCP that each bank would allocate €30 million per year to a fund that would in turn invest in equity of SMEs and mid-cap corporates. Further specific lending targets were not defined.
([185]) The IMF recorded about €800 million of the PME Crescimento line not tapped in 2012 and another €800 million unused as of mid-October 2013. See IMF (2013d)
([186]) Global loans to support lending to midcaps and SMEs signed between the EIB and credit institutions operating in Portugal totalled €700 million in 2013 alone.

financing, the Portuguese authorities promoted an efficient use of EU structural funds, since early 2013. These efforts led to the project of setting up the DFI, with the aim of consolidating all government supported financing initiatives. The project was introduced in the conditionality only in early 2014 to be completed in the second half of the year, after the programme terminated. The protracted timing might have been due to some doubts about the potential usefulness of such an institution and the need of ensuring that it would not pose additional financial burdens on the state, it would adhere to safeguards of supervision and transparency, and it would not distort competition. ([187]) While, on the one hand, the DFI's late set-up might have reduced the short term potential effects on lending, on the other hand, its appropriate set-up should ensure that the effects are maximized and sustained over the medium term. The DFI was incorporated as a financial company supervised by the BdP, and tasked to on-lend to SMEs and manage financial instruments funded by EU structural funds, while not being allowed to take deposits from the public.

6.3. OVERALL OUTCOME AND ASSESSMENT

As a line was not drawn under the needs of the banks, the banking sector still represents a source of risk for the state. During the programme, the aggregate gross public capital injection was limited to around €8bn or 5% of GDP. ([188]) €4bn CoCos were already reimbursed by the end of 2014. ([189]) However, after the programme terminated, further public disbursements materialized, following the resolution of BES, in August 2014, and Banif, in December 2015. BES resolution required an immediate injection of €4.9bn, as share capital of Novo Banco - the bridge bank. This amount came from the newly set-up Resolution Fund that borrowed most (about €3.9bn) of it from the state (BSSF). ([190]) Banif resolution required a capital injection of €2.25bn, split between the Resolution Fund (€0.5bn) and the state (€1.75bn). ([191]) As a consequence of these resolutions, the Portuguese banking system has undertaken a contingent liability on the resolved banks, and the state has undertaken a contingent liability on the banking system, as it provides a backstop to the Resolution Fund. (See Box 6.1) Additional contingent liabilities for the state arise from the deposit guarantee scheme and the NGS, from the legacy SPVs following the resolution and sale of BPN and from the public ownership of CGD.

Banking sector's profitability remained negative during the programme, with the aggregate improvements in 2015 yet to be confirmed on a sustained basis and for all the main domestic banks. During the programme, the negative profitability has been driven mostly by the protracted impairments, but also by the low operating profits. Given the banks' cost of capital, downward pressures to the interest margin resulted from the limited new business volumes and the legacy "tracker mortgages", in a low rates environment; upward support resulted from the carry-trades on sovereign bonds. Eventually, the sector turned profitable in the first three quarters of 2015, before going back into negative territory in the last quarter of the year. The overall improvements are due to reduced impairment charges and increased gross income on average. In turn, the latter has been supported by one-off financial operations, including capital gains from debt securities, and income from abroad. Accordingly, the 2015 improvement of the cost-to-income ratio is mainly due to the increased income rather than to reduced operating costs. (Table 6.2) Going forward, business volumes are unlikely to promptly increase, as the deleveraging of the private sector is expected to last for some time, while low nominal interest rates would continue compressing the banks' margins. Carry trades would gradually reduce their profitability as sovereign spreads decline. In this context, cost reduction should continue: the ratio between population and branches has increased to

([187]) The European Commission approved the set-up of DFI in October 2014. See SA.37824 (2014/N) – Portuguese Development Financial Institution
([188]) This includes the recapitalization of CGD, BPI, BCP, Banif, BPN. Additional costs, amounting to around €1.5bn, resulted from the transfer of BPN troubled assets to the state-owned SPVs but were mostly recorded in 2010.
([189]) As of May 2016, BPI repaid the full €1.5bn amount of CoCos; BCP repaid €2.25bn, out of the total €3.0bn; CGD had to repay the whole €0.9bn CoCos originally received; Banif repaid €0.275bn out of the total €0.4bn, before being put under resolution.
([190]) Shareholders and debt holders of BES are also set to contribute to the resolution's costs.
([191]) Shareholders and debt holders of Banif are also set to contribute to the resolution's costs.

slightly above 1,700 but remains among the lowest in Europe. ([192]) However, the situation varies across the banks. The main private banks, which implemented deeper restructuring plans, returned to profitability in 2015. Novo Banco, which is a temporary institution, and CGD have remained loss-making in 2015 and their cost base is above average.

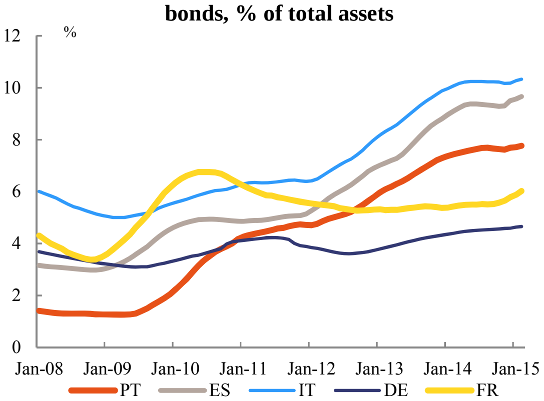
Table 6.2:
Portuguese banks in a snapshot

		CET 1 (1)	NPL Ratio (1)	NPL Coverage Ratio (1)	RoE (2)	Impairments-to-Assets (2)	Operat. profits-to-Assets (2)	Cost-to-Income (2)
2015	EU	13.6	5.8	43.8	4.3	0.4	0.8	63.5
	Portugal	11.9	19.1	39.4	0.9	1.0	1.0	60.3
2014	EU	12.5	6.4	43.2	3.0	n.a.	n.a.	63.6
	Portugal	n.a.	17.2	35.5	-17.2	1.9	0.8	66.5

(1) Percentage. Source: EBA (Risk Dashboard), main domestic banking groups. The sample may vary across years.
(2) Percentage. Source: ECB (Statistical Data Warehouse), all banks. The sample may vary across years.

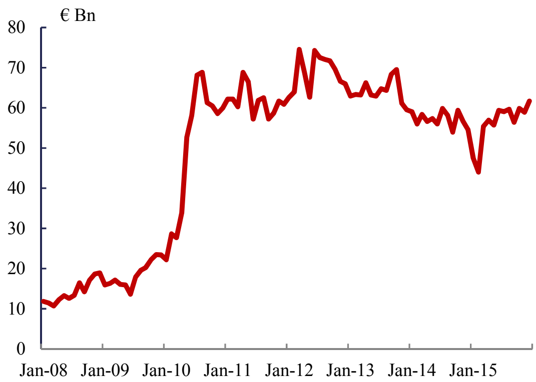
The high level of NPLs has remained a significant problem after the end of the programme, together with the high sovereign exposure. The NPL increase that occurred during the programme period has not been followed by a significant decrease. High NPL levels weigh – at different levels – on all the main Portuguese domestic banks and may reduce their lending capacity, impairing the transmission of monetary policy. The coverage ratio has gradually improved, but remains lower than the EU average, thus limiting the room for absorbing losses in case of further asset-quality deterioration. (Table 6.2) Going forward, it is important that a proper set of incentives is in place to ensure adequate provisioning and/or write-offs. Moreover, the banks maintained stable holdings of government bonds, mainly domestic, while significantly reducing their other assets. As a result, banks' holding of sovereign bonds increased to around 8% of their total assets, during the programme, and did not decline thereafter. (Graph 6.4a) Going forward, this sovereign exposure could become a weakness in case of a sovereign shock and, to some extent, monetary policy tightening. In general, the Portuguese banks have become more intertwined with the domestic economy, ([193]) while remaining exposed to emerging market countries, in particular Angola.

Graph 6.4a: **Banks' holdings of sovereign bonds, % of total assets**



Source: ECB

Graph 6.4b: **Target 2 (liabilities)**

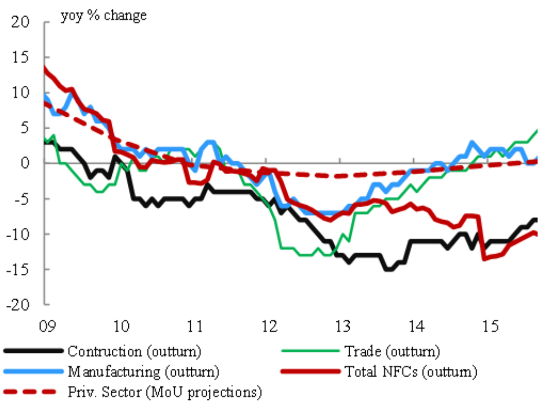


The programme contributed to support market confidence towards the Portuguese banking sector, but the sentiment did not improve after the end of the programme. During the programme, the ability of the main private banks to raise debt and capital, including to partially repay CoCos, signalled some

([192]) Source: ECB (2015b). See also IMF (2016) and DG ECFIN (2016a)
([193]) Source: Crosignani, M. *et al* (2015)

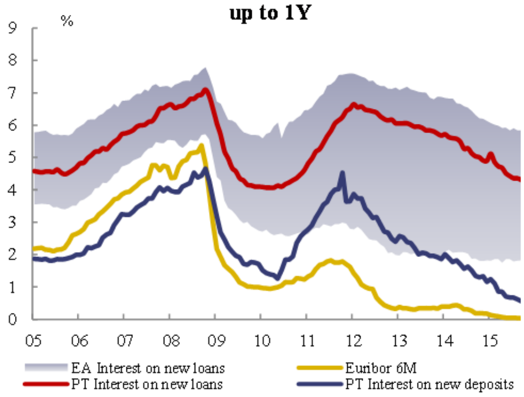
confidence in the banking sector's health. In fact, the aggregate sector's resilience improved throughout the programme. ([194]) In light of the progress made in the programme period, including through the enhancement of the Portuguese and EA firewalls, the resolution of BES did not trigger immediate systemic adverse effects. However, the protracted process of restructuring Banif and resolving BES, ([195]) compounded by the combination of aggregate low profitability and high NPLs, contributed to worsen the market sentiment, after the end of the programme: capital and the debt issuance activity did not pick up. This has posed further pressure on (risk weighted) assets and constrained the post-programme reduction of the Eurosystem financing, which stabilized above 5% of the aggregate banks' liabilities. In line with Eurosystem dynamic, Target 2 claims remain historically high, at 35% of GDP. ([196]) (Graph 6.4b) Confirming the banks' sustained return to profitability for the main domestic banks and progressing towards the reduction of NPLs would support market confidence. At the same time, negative developments could jeopardize this process and other programme's achievements, including the fiscal consolidation, in light of the existing contingent risks for the state.

***Graph 6.5a*: Portugal - Bank Loans to NFCs**



Sources: Banco de Portugal, DataInsight, Programme documents

***Graph 6.5b*: Interest Rates - Loans to NFCs, up to 1Y**

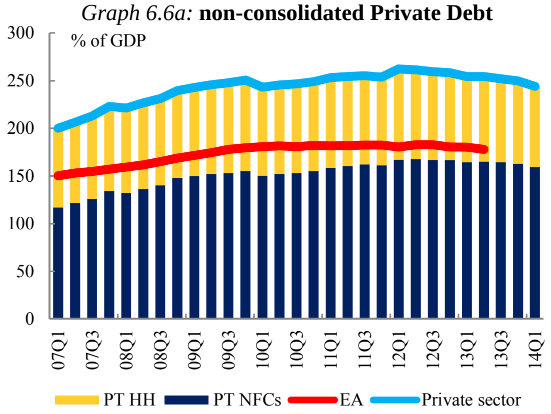


Lending conditions for households and corporations have been gradually improving since 2012. During the programme, bank lending decreased more and for longer than initially projected (Graph 6.5a) and access to debt financing remained difficult especially for companies seeking credit for the first time. Different studies and surveys explain this dynamic as a consequence of both the worsened credit demand, also in light of the worse-than-expected macroeconomic outcome, and the limited credit supply. ([197]) However, already in 2012 and more significantly in 2013, credit flows meant a gradual rebalancing towards more productive and tradable sectors, while lending conditions – as reflected in the interest rates charged on new loans – started improving, although remaining tighter than in other EA countries. (Graph 6.5b) The capital reallocation and the improvements of lending conditions continued after the end of the programme. Recent studies highlight that lending costs in Portugal are explained by banks' funding costs rather than by exogenous factors, such as the sovereign funding costs and the output gap. (DG ECFIN (2015a) While this can reflect a proper (re)pricing of the risk profile of the Portuguese companies, which tend to be more leveraged than in other countries, it also indicates that the overall adjustment of the private sector balance sheet is yet to be completed.

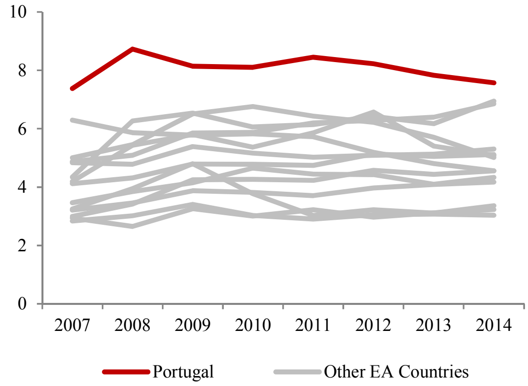
([194]) The ECB 2014 comprehensive assessment covered GGD, BPI and BCP. They all passed the stress test under the baseline scenario, but BCP fell short of the 5.5% CET1 threshold, under the adverse scenario. However, the bank had already raised sufficient capital in 2014 to cover for this gap.
([195]) Novo Banco was assessed separately by the ECB in 2015. It successfully passed the stress test under the baseline scenario, but fell short under the more adverse scenario (CET ratio of 2.43%).
([196]) Recent development in Target 2 balances is also explained by the ECB expanded Asset Purchase Programmes, i.e. the ECB Quantitative Easing tool, and particularly the Public Sector Purchase Programme, started in March 2015.
([197]) Sources: Farinha, L.,Felix, S., (2014); Augusto, F., Félix S. (2014); IMF (2013e); Antunes A., Martinho, P. (2012)

Private debt has been declining, but the slow pace means the debt level is still high. As a percentage of GDP, household debt reduction started before the programme, at the beginning of 2010, while corporate debt started to decline only after the end of 2012, and to a limited extent. (Graph 6.6a) The ratio between corporate debt and operating profits also declined, but remains higher than in other EA countries (Graph 6.6b). Non-financial corporations in a number of different sectors presented high debt, which was not promptly reduced by either companies' restructuring/insolvency or through growth, given the recessionary environment. In fact, corporate deleveraging was mainly achieved through negative credit flows. Going forward, the debt reduction could further accelerate if the reforms of the legal insolvency and restructuring frameworks give their full effects, ([198]) and the economy continues rebalancing towards the tradable sectors allowing a sustainable increase in corporate margins. The initiatives introduced by the government in the 2013 budget, of limiting the tax deductibility of corporate interest costs to companies up to specific ceilings, should contribute to discourage the future accumulation of financial leverage. The main risk to this scenario is represented by an economic slowdown, which - in light of the banks' relatively weak position in terms of NPL coverage ratio - could turn the feedback between the banks and the economy into a vicious loop.

Graph 6.6a: **non-consolidated Private Debt**



Graph 6.6b: **NFC Debt to Surplus, Ratio**



Source: Eurostat, OECD

Both the programme design and the programme implementation should have pursued a more frontloaded adjustment of the banks' balance sheet. The programme design envisaged the combination of stress tests and asset quality reviews to contribute to the estimation of the banks' capital needs. However, the stress tests did not foster prompt actions to improve the resilience of all the covered banks, including under stress scenarios. The asset quality reviews required repeated rounds to ensure adequate assessments. BdP was responsible for the design and implementation of the bank recapitalisation, but the programme strategy could have better emphasized the importance of its building blocks and provided more detailed guidance and pressure on their implementation. The bank supervisory actions should also have been tighter with regard to provisioning and write-offs, especially when the problems related to the economic slow-down became more evident. A publicly available analysis, in the programme context, about the advantages and drawback of different options to tackle NPLs could also have been helpful, to support the implementation of the most effective policies.

A prompter adjustment of the troubled Banif and BES would have been beneficial. With hindsight, a more forceful supervisory approach could also have fostered the adjustment of Banif and BES. For

([198]) Winter 2015/16 post-programme surveillance and 2016 Country Specific Recommendations called for a more ambitious approach to corporate debt workout (IMF (2016), European Commission (2016)). The reforms of the legal frameworks for the claims enforcement are helping improving processing speed and private debt recovery (Pompe, S. and Bergthaler, W. (2015))

instance, the doubts on the viability of Banif could have justified its prompt resolution. ([199]) More stringent stress tests, earlier and more intrusive requests to address governance weaknesses could have accelerated the adjustment of BES, although its late resolution was - in the view of some stakeholders - partially the result of elements that emerged only gradually, such as "material irregularities" in the accounts of the parent company. In turn, a prompter restructuring/resolution of the two banks could have reduced the potential costs arising from late actions and supported a sustained return of market confidence towards the Portuguese banking system, over the medium-term. It is unlikely that an earlier resolution would have caused financial instability, as the resolution framework had been promptly put in place and the action would have been limited - at the maximum - to two banks, one of which was relatively small and important only in certain regions of the country. (See Box 6.1)

A more forceful approach towards CGD could also have been warranted. CGD still holds assets amounting to more than 20% of the overall banking sector. It has neither reimbursed the CoCos nor returned to sustained profitability yet, including because of the high cost base. A deeper streamlining of the bank, possibly accompanied by concrete steps towards its full privatization, could have helped reduce the contingent risks for the state and foster competition in the banking sector. This strategy would have relied on a prompter delinking of CGD from BPN, in line with the initial programme's plan. With hindsight, the ensuing immediate financial pressures for the state would have been manageable, in view of the sizeable cash buffer accumulated by the state at the end of the programme.

The financial envelope for the banking sector was sufficient to support a more frontloaded adjustment. The post-programme needs, arisen from the resolution of BES and Banif and covered by the state, were close to the BSSF funds that were left unused by the end of the programme. Consequently, an earlier resolution of the two banks could have relied on the existing BSSF funds, even if the costs of an early resolution would have been as high as they eventually turned out be – which is unlikely. Additional potential needs, including from other banks as a result of the more frontloaded adjustment, could have been covered through earlier and wider losses for banks' shareholders and junior debtholders. However, in the view of some stakeholders, additional contingent buffers could have further strengthened financial stability and market confidence, especially given the absence of well-developed EA/EU risk-sharing tools. ([200])

More and better coordinated initiatives aiming at fostering extra-banking financing – especially equity – to viable business and reducing private sector debt could have also been warranted. To maximize the short-term effectiveness, the Portuguese authorities targeted mainly initiatives to foster lending through the banking channel. In this context, an earlier enhancement of the credit mediation functions could have improved access to lending to SMEs. More progress in the development of the capital markets would hardly have brought immediate significant effects on credit flow, also in view of the structurally depressed credit demand, but it could have contributed to pave the way for a sustained recovery in the medium term, in particular by promoting proper risk assessment and credit allocation, and addressing the debt-to-equity corporate bias, which was already unfolding its negative effects. Better coordination at the level of both the Portuguese authorities and the EU authorities, together with the set-up of ad hoc task forces, could have been arguably helpful, in particular with regard to the design of initiatives aiming at facilitating SMEs' raising of long-term funding, including through EU financing to address market failures; considering the set-up of markets/institutions to handle distressed debts; optimizing the corporates' insolvency process, including with regard to the role of tax claims and potential mechanisms to facilitate debt-to-equity swaps in the firms' restructuring.

([199]) More evidence on the process that led to the recapitalisation and resolution of Banif is expected with the finalisation of the inquiry of the Committee that has been established within the Portuguese Parliament (*Resolução da Assembleia da República n.º 16/2016, publicada no Diário da República, 1.ª Série, n.º 19, de 28 de janeiro de 2016*)

([200]) EU bail-in legislation came only in mid-2014 with full application in 2016; the mutualisation of the national "Resolution Funds" will occur gradually, over a transition period terminating in 2024. Direct bank recapitalization by the ESM was discussed in June 2012 but formally introduced only in late 2014. The ESM has not been provided with the possibility to extend guarantees.

7. SOCIAL DEVELOPMENTS

7.1. BACKGROUND AND PROGRAMME DESIGN

Portugal has historically had high income inequality. Portugal has been historically characterised by a higher at-risk-of-poverty rate than the EU (in 2011, PT: 18%, EU: 16,8%). But indicators of relative poverty and poverty or social exclusion were relatively stable and even on a slight downward trend until 2010 (see Graph 7.1a). Furthermore, the at-risk-of-poverty rate that anchors the poverty line at a fixed point in time (2005) fell from 19,2% in 2006 to 14,1% in 2010 ([201]). An absolute measure of poverty such as the severe material deprivation rate ([202]) was declining up to 2011, indicating resistance of (relative and absolute) income-related poverty measures to the first period of the crisis (Graph 7.1d). Portugal also has one of the most unequal income distributions in Europe ([203]), although from 2005 to 2010 inequality was on a downward path, with an average decline of the Gini coefficient of almost 1 percentage point per year. (Graph 7.1b)

The programme had room to improve the design of social protection expenditure to promote effectiveness and equity. The developments up to 2011 demonstrated the redistributive power of automatic stabilisers, such as unemployment benefits, and the redistributive impact of reforms aimed at protecting the most vulnerable social groups. In 2010, for example, indexation was frozen for all except the lowest pensions. Social protection spending as a share of GDP was on an upward trend until 2010, though it remained at a level below the EU-average (Graph 7.1c). On the back of population ageing, the main driver underlying this trend was old-age pension expenditure. Non-pension social spending accounted for a smaller and rather stable share of the total social spending and included different contributory (e.g. unemployment benefits) and non-contributory (e.g. minimum guaranteed income) benefits. There was some room to fine-tune social benefits to promote effectiveness and equity as a large number of programmes were fragmented, duplicated or overlapping, and some programmes were poorly targeted and disproportionately directed at the better off (e.g. housing allowances) ([204]). Also, means-testing applied to less than a third of non-retirement benefits in 2012 and represented only 10% of the social protection in value ([205]).

([201]) The at-risk-of-poverty rate is sensitive to changes of the poverty threshold which may shift due to changes in median incomes (e.g. real earnings of employees dropping due to increasing unemployment). The "anchored poverty line" isolates this effect, by fixing the real value of the poverty line at a fixed moment in time.

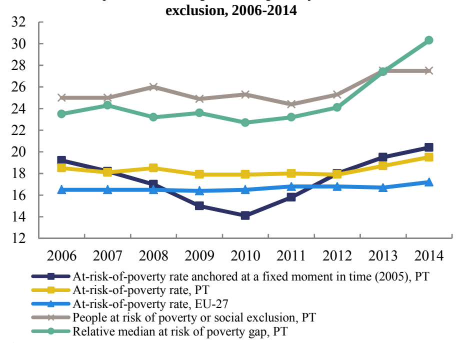
([202]) The material deprivation rate expresses the inability to afford some items considered by most people to be desirable or even necessary to lead an adequate life. It measures the percentage of the population that cannot afford at least three of the following nine items: to pay their rent, mortgage or utility bills; to keep their home adequately warm; to face unexpected expenses; to eat meat or proteins regularly; to go on holiday; a television set; a washing machine; a car; a telephone.

([203]) In 2011, Gini coefficient in PT: 0,342, EU-27:0.307; income quintile share S80/S20 ratio in PT: 5.6 in 2010; EU-27: 4.9.

([204]) IMF (2013a).

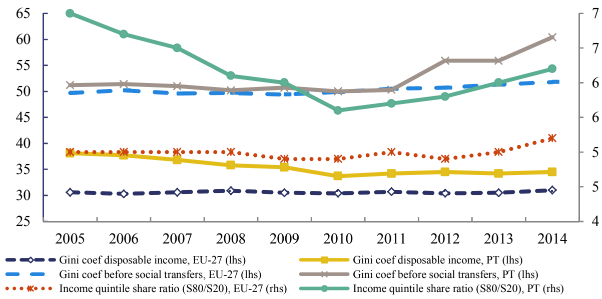
([205]) Source: EC staff calculations based on ESPROSS.

Graph 7.1a: **Developments in poverty and social exclusion, 2006-2014**



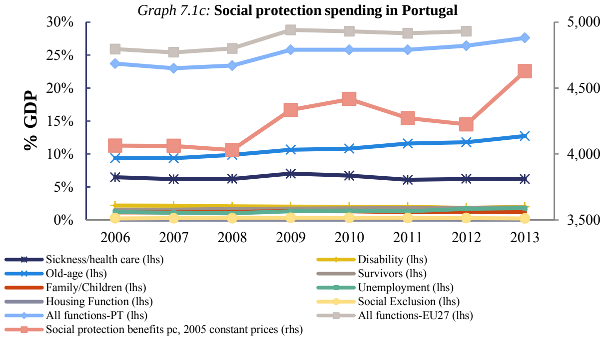
Source: Eurostat

Graph 7.1b: **Inequality indicators, 2005-2014, PT and EU-27**



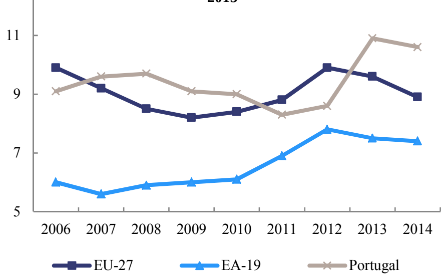
Source: Eurostat, EU-SILC. [EU-27 (instead of EU-28) is used for availability of a longer data series]

Graph 7.1c: **Social protection spending in Portugal**



Source: ESPROSS

Graph 7.1d: **Severere material deprivation, 2006-2015**



Source: Eurostat

Mitigating the negative social impacts of the adjustment was part of the programme aims, but no explicit social goals or specific requirements on monitoring social developments were set. An important aim of the programme was to mitigate the negative social impacts and in particular, to protect the weakest, while addressing fiscal, banking and structural imbalances at the same time. Tax increases were to be designed in a progressive way, minimum wages and lowest pensions were to remain untouched and social benefits extended to many that were unduly excluded ([206]). However, the programme did not include a requirement to assess the distributional effects of the measures (in particular key fiscal measures with potentially high social impact) and conditionality did not foresee a systematic monitoring or reporting of social developments.

Many programme measures took equity and social considerations into account. The following presents a synthetic review of measures undertaken under several key policy areas of the programme that had the potential to directly affect household incomes and other social outcomes. The objective is not to evaluate the impact of the various measures on the social situation in the country, but to assess to what extent the programme design took account of social concerns.

Health care reforms: (i) Income thresholds for co-payment exemption for NHS services were increased and co-payment levels set so as to protect individuals from excessive health expenditures. As a result more than 50% of the population is exempted from co-payments; (ii) Regarding access to care, several measures in the primary care area aimed at increasing the number of people covered by their own family doctor; (iii) The reduction of barriers to entry in the generics market allowed lower prices for medicines, savings for patients and improved access to medicines.

Labour market reforms: (i) The reform of the unemployment benefits aimed at balancing incentives to work with adequate social protection during unemployment spells. Hence, the programme reduced the duration of unemployment benefits (for new contracts) and reduced net replacement rates after six months

([206]) DG ECFIN (2011a).

of unemployment. At the same time, it reduced the necessary contributory period to access unemployment insurance and extended eligibility to some categories of workers; (ii) Measures to increase flexibility and wage moderation were designed so as to reduce the duality of the labour market, thereby contributing to a more shared burden of the adjustment; (iii) There was a genuine effort to increase and improve Active Labour Market Policies to boost the employability of the most vulnerable workers. EU structural funds participated to this objective and allowed financing of the measures in times of budget constraints.

Fiscal measures: (i) Wage and pension cutbacks were implemented in a progressive way ([207]); (ii) Indexation mechanism of pensions were suspended since 2011 except for the minimum pensions, in order to protect the purchasing power of those with lowest pensions; (iii) Many tax measures were designed so as to ensure that taxpayers with higher capacity to pay would bear a higher share of the burden: e.g. on the personal income tax, a 3.5% surcharge on income above the minimum wage, further solidarity surcharges on top-incomes and higher rates on capital income were introduced; tax exemptions were reduced, including for private education and health expenditures, which are overwhelmingly consumed by better-off households; VAT reforms that moved items consumed more by wealthier households to higher rates have been progressive ([208]).

Housing market reform: the changes to the urban rental law providing for more flexibility in the duration of contracts and evolution of rents ensured higher protection to tenants over 65 years and people with disability. Safeguards for low incomes were implemented in the reforms of the recurrent property tax. A stamp duty on high-value properties was introduced.

Some other measures (or lack thereof) failed to ensure progressivity in the burden-sharing of the adjustment or in protecting the lowest income groups. Some measures were repeatedly negotiated and even announced but never implemented by the government, like a cap on accumulated social benefits, including those provided by local governments. Furthermore, many of the product market reforms failed to reduce decisively unwarranted rents and sector protection (in particular in the energy sector, ports and regulated professions). This leads to the view ([209]) that not all segments of the society participated in the burden sharing of the needed adjustment.

Many social benefits were reformed, often tightening eligibility conditions. The MoU included provisions around cutting and reforming welfare benefits, mainly setting quantitative saving targets and general principles and letting the authorities design the way to achieve them. Various social programmes were revised, in particular covering the contingencies of sickness, maternity, paternity and death; the guaranteed minimum income scheme (RSI) and its means-testing conditions was also changed. The reforms often aimed at tightening eligibility conditions and improving means-testing. A transitional Emergency Food Programme was put in place in 2012 to provide support for those who were not able to obtain two daily meals for themselves or for their families.

Social protection spending grew during the programme years as a percentage of GDP, but it was overall reduced if compared to a scenario of no changes in legislation. Driven by old-age pensions, expenditure on social protection grew during the programme years in line with the EU-average trend. However, between 2011 and 2014, most social benefits were reduced compared to a "no policy change scenario" ([210]). This was not the case of unemployment benefits, which increased under the programme compared to a scenario of no changes in legislation. The number of beneficiaries fell for most benefits,

([207]) During 2011-2013 the public sector wage cuts ranged from 3.5% to 10% for monthly salaries above EUR 1500. In 2014 the cuts ranged from 2.5% to 12% for monthly salaries above EUR 600. The design of the extraordinary solidarity contribution from pensions (CES) changed several times over the programme but always ensuring the protection of lower pensions. In 2014 the progressive contribution rates started applying from EUR 1000/month and range from 3.5% to 50%.
([208]) OECD (2014c).
([209]) Stakeholder consultation.
([210]) Calculations from Instituto da Segurança Social, Portugal. "Impact Analysis of New Measures"

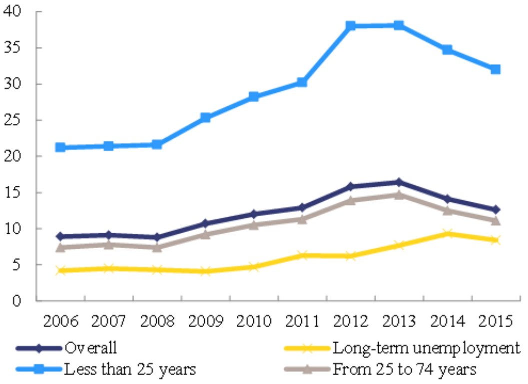
while it increased for pensions and unemployment benefits. The average value of most benefits was also reduced. Reforming some welfare benefits delivered some limited savings, but did not improve substantially the efficiency and targeting of the social safety net ([211]). In light of the increasing social needs arising from the crisis and the relatively low level of social spending compared to EU peers, the reforms of these benefits should have focused on improving targeting to the most in need to achieve efficiency and equity gains, and not on delivering spending savings.

7.2. DEVELOPMENTS IN SOCIAL OUTCOMES

The programme enabled Portugal to avoid a dramatic and immediate adjustment in the economic and social situation. In the absence of a programme, the Portuguese sovereign would have been unable to meet its obligations, leading to an immediate and dramatic adjustment with widespread economic and social consequences. While some of the social outcomes described below in this section (which focuses on the employment status, material poverty, the income distribution and access to public goods) may be related to the implementation of the programme, as highlighted in the analysis, it should be noted that developments are not always necessarily the result of programme policies. In particular, there is no account of a counterfactual scenario featuring what would have been the impact of the economic crisis on the social situation of the Portuguese population that can be used as a benchmark to measure the additional effect from the adoption of the MoU measures. Hence the assessment is necessarily somewhat speculative.

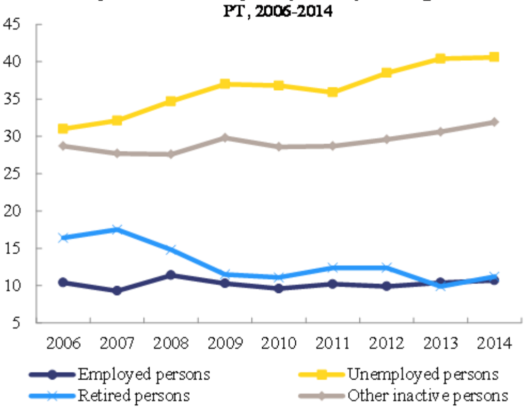
([211]) Stakeholder consultation.

Graph 7.2a: **Unemployment rates, PT, 2006-2015.**



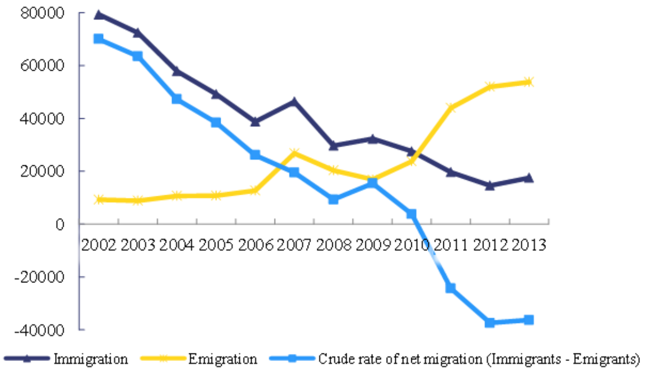
Source: Eurostat

Graph 7.2b: **At risk of poverty rates by working status, PT, 2006-2014**



Source: Eurostat

Graph 7.2c: **International migrations (long-term immigrants/emigrants), 2002-2013, PT**



Source: Eurostat

Over 2010-2013, a period that included a recession in the euro area, there was a fast increase in total unemployment, which was one of the main drivers of the increasing incidence of poverty. In 2013, the unemployment rate peaked at 16.4% overall and 38.1% for the youth. The more pronounced GDP contraction in the first years of the programme compared to the previous period was the main culprit of this job destruction. Long-term unemployment reached 60% of total unemployment in 2014 (from 44% of the total in 2009). Unemployment, especially long term unemployment, was one of the main reasons for raising inequality and social exclusion.

Emigration has been on the rise since 2010, easing pressure on unemployment developments. Between 2011 and 2013, 150,000 persons left Portugal on a long-term basis (i.e. for a period of at least 12 months). Total emigrants (long and short duration) amounted to 128,000 in 2013 ([212]), 1/3 of them women. The international migration balance turned negative in 2011. While there are not available official studies on the underlying reasons and components of these trends, a plausible assumption is that emigration has been driven by the search of better employment opportunities abroad. This is a hidden cost of the crisis that does not show up in some key social indicators like the unemployment rate or domestic poverty.

Portugal has experienced an increase in poverty and social exclusion in the last years. The percentage of people at risk of poverty has been increasing since 2012, reaching 19.5% in 2014 (the 7th highest in the EU, EU-average: 17,2%). A quarter of children lived below the poverty line in 2014 (20% at EU level). Likewise, risk of poverty or social exclusion is higher than in the EU (27,5% of the

([212]) OECD (2015b)

population in Portugal *versus* 24,5% in the EU, 2014), though it has remained relatively stable in recent years. A closer look at other poverty indicators gives a better picture of recent developments:

The poverty intensity amongst the poor has become higher, as measured by the poverty gap ([213]) which has been rising since 2010. A determinant of this result is the reduced effectiveness of the guaranteed minimum income scheme to reduce poverty, following the reforms introduced during the programme ([214]). Between 2011 and 2014, the number of beneficiaries was reduced by 30% and the monthly benefits per household by 11% ([215]). The changes hardly affected the level of relative poverty, since most recipients were already below the poverty line, but have made the poor poorer ([216]).

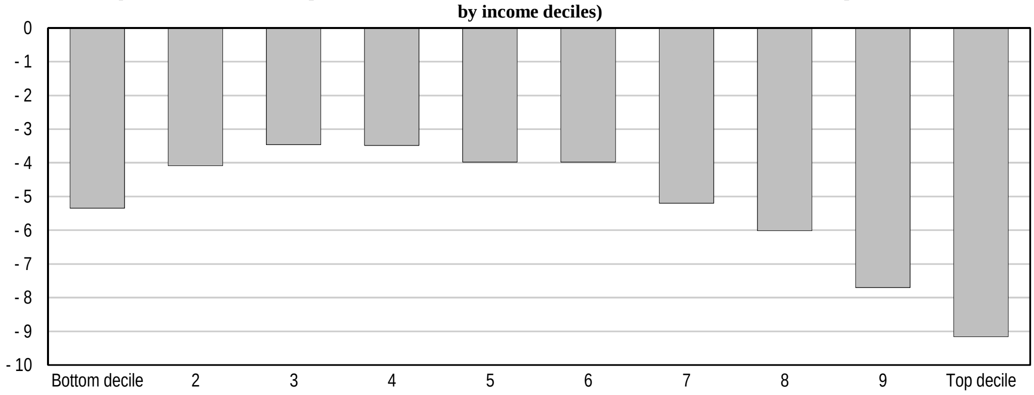
Some categories of the population suffered more than others from the adjustment. (see Graph 7.2b) The unemployed are those with the highest incidence of poverty: 40,6% of the unemployed lived at risk of poverty in 2014, on a rising trend since 2010; 10,7% of the working population was also at risk of poverty in 2014, explained by the significant number of low-paid workers; retirees by contrast were more protected from social hardship and saw their poverty levels decline as median incomes fell and low pensions were relatively well protected.

The risk of poverty using an "anchored poverty line" has increased much more than the relative at-risk-of-poverty. With a 2005-anchored poverty line, the at-risk-of-poverty has moved up from 14.1% in 2010 to 20.4% in 2014 (see Graph 7.1a). This is explained by the various effects of the economic crisis on household incomes (i.e. rising unemployment, decrease in real earnings of employees, etc).

According to available simulations, fiscal consolidation measures in the period from 2009 to 2012 had an overall progressive impact and in general, Portugal has prevented an increase in inequality (measured by the Gini coefficient) in recent years. The EUROMOD model has been used to simulate the distributional effects of fiscal consolidation measures on households' disposable incomes ([217]). For the period analysed (2009-2012, i.e. including pre-programme measures), the simulations include changes in direct taxes and contributions, VAT, social benefits, tax credits and public sector pay (including the suspension of the 13th and 14th months of pay in 2012). The results show that the burden of fiscal consolidation measures during this period fell more heavily on the richest and to a lesser extent on the poorest, than it does on those with middle incomes (inverted U-shape pattern). (Graph 7.3) Overall, the scale of the reductions in household income was large: around 5.5% drops for the poorest, 4% fall for middle income groups and up to 9% fall for the richest. The overall progressive impact was due to the emphasis put by the programme on progressive cuts in public wages and pensions, which offset the regressive cuts in social transfers that negatively affected households in the bottom decile. Household data reflecting changes after 2012 are not available, but it is likely that measures such as the 2013 personal income tax reform or reinforcement of the fight against tax fraud have made the tax system more progressive. Market income inequality has been growing since 2011 (as measured by the Gini coefficient before social transfers); however social transfers muted the trend and have prevented an increase in inequality (as measured by the Gini coefficient of disposable income, see Graph 7.1b).

([213]) Difference between the at-risk-of-poverty threshold (set at 60 % of the national median equivalised disposable income after social transfers) and the median equivalised disposable income of persons below the same threshold, expressed as a percentage of the at-risk-of-poverty threshold.
([214]) In January 2016 legislation was passed increasing the reference value and changing the equivalence scale of the minimum income scheme back to the 2012 level so as to widen its coverage.
([215]) Stakeholder consultation.
([216]) Arnold, J., Farinha Rodrigues, C. (2015).
([217]) Avram, S. *et al* (2013)

Graph 7.3: **Simulation of impact of 2009-2012 fiscal consolidation measures (% of household disposable income, by income deciles)**

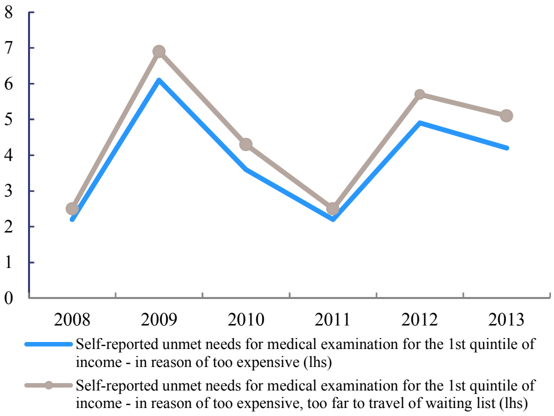


Source: OECD, from The distributional effects of fiscal consolidation in nine EU countries - Institute for Social and Economic Research (ISER). EUROMOD Working Paper Series EM2/13

As concerns access to public goods, certain indicators ([218]) point to an improvement of the situation in the case of education and access to health care, while affordability of housing deteriorated since 2010. The number of early school leavers ([219]) is on a downward trend since 2008 due both to policy efforts and to the reduction in job opportunities for young people (Graph 7.5a). Yet, Portugal still has the fifth highest rate (13,7% in 2015) of early school dropout in the EU-27. Regarding access to health care, amongst the lowest income group, self-reported unmet needs for medical examination because of affordability problems or waiting list being too long was going down until 2011 and increased thereafter, but stayed at levels similar to pre-programme period (Graph 7.4a). This indicator remains however based on a subjective assessment and all the related limitations. Recent pharmaceutical policies have made on average medicines less expensive for patients (Graph 7.4b). At the same time, Portuguese authorities' data ([220]) show that the number of drug packages have not decreased, ensuring that the access to medicines was not at risk. Overall, the reform of co-payment in 2011 seems to have achieved its objective of a more equitable financing, and the improvements in the primary care register have increased access for some excluded population. Some negative outcomes seem to be the lengthening of waiting lists for chirurgical interventions and increased unmet needs on access to health services ([221]). Developments in housing affordability show that the housing cost overburden rate ([222]) increased by 5 pp between 2010 and 2014 and even more for people at-risk-of-poverty, revealing a serious vulnerability of the population (Graph 7.5b). It is thus particularly welcome that housing market reforms within the programme endeavoured to take the situation of the most vulnerable into consideration, although no real assessment can be done thus far.

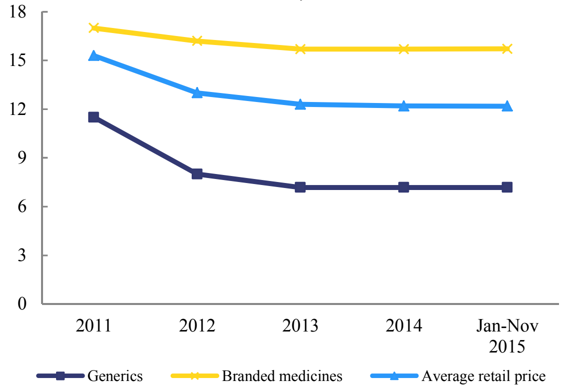
([218]) It should be noted that indicators presented here have limitations and do not provide a full proper assessment of the access to public goods.
([219]) Percentage of the population aged 18-24 with at most lower secondary education and who were not in further education or training during the last four weeks preceding the survey.
([220]) Stakeholder consultation.
([221]) Stakeholder consultation.
([222]) Percentage of the population living in a household where the total housing costs (net of housing allowances) represent more than 40% of the total disposable household income (net of housing allowances).

Graph 7.4a: **Access to health care - Unmet needs, PT**



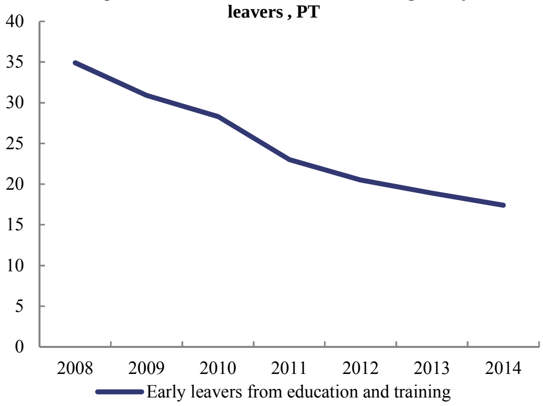
Source: Eurostat

Graph 7.4b: **Average price of medicines in NHS market, PT**



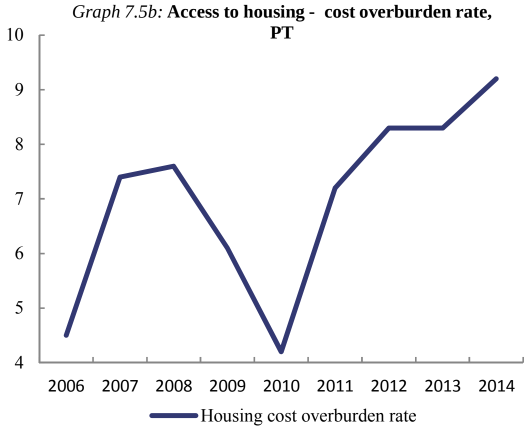
Source: INFARMED

Graph 7.5a: **Access to education and trainig - early leavers , PT**



Source: Eurostat

Graph 7.5b: **Access to housing - cost overburden rate, PT**



Source: Eurostat

7.3. OVERALL ASSESSMENT

Social and distributional considerations were rightly taken into account when designing many of the programme measures. The programme contributed somewhat to rebalance the share of the burden of the adjustment by stressing the need for stronger progressive effects and protecting the worse off. Hence, progressive elements in tax reforms (eg personal income tax surcharges on higher incomes) or in expenditure cuts (public sector wages and pensions progressive cuts) foreseen in the MoU reflected the programme aim of mitigating the social impact of the adjustment and protecting the weakest. The redesign of some social protection benefits like the unemployment benefits has been beneficial, insofar as it expanded coverage, particularly benefiting the young and those with a short tenure in work. However, other social benefits' reforms – such as the reform of the minimum income guaranteed scheme – were regressive and could have been avoided or limited in scope, as they mostly implied a sizeable loss of income for the lowest decile. As income inequality was already not negligible and the at-risk-of-poverty rate was rather high, there was not much room for adjustment to take place in that type of benefits without causing a further deterioration in social outcomes.

The MoU rightly addressed the social concerns through many of the policy areas covered by the programme. The programme used many different sectoral policies to achieve social objectives and/or mitigate the social impact of the adjustment: eg through housing, taxation, pension reforms, public sector, labour market and product market reforms. The fact that measures in many of these areas reflected social concerns indicate that the issue of a fair burden of the adjustment was rated as important by the authorities and programme partners.

Efficiency of the social safety net could have been further strengthened. The historically very high poverty and income inequality levels of Portugal indicated that there was scope for clear improvement of the social protection system. The programme could have made more progress in ensuring that public money is spent more efficiently and that the social benefits provide correct incentives. The driver of reforms in social benefits was mainly budgetary savings, although expenditure on social protection was below the EU-average and should not have been the focus of budget savings. Little was achieved in terms of reducing duplications, overlaps and capping of these benefits and improving means-testing.

Monitoring and systematic reporting of social outcomes was not set out as a requirement. Given the importance of fair burden sharing in maintaining public support for the programme, distributional issues could have been more clearly, explicitly and systematically addressed in programme reviews and reports. Setting hard targets in this area may be difficult. But more emphasis on monitoring and reporting on the social dimension would have been warranted (programme documents show no reference to the expressions "poverty" and "inequality"). There is a public perception that the outcome of the programme was socially unbalanced. Since the monitoring and reporting aspects were largely overlooked, there is insufficient evidence to corroborate or refute this perception.

8. MAIN MACROECONOMIC OUTCOMES AND REMAINING CHALLENGES

The EU/IMF support programme achieved its objective of Portugal regaining market access but the macroeconomic performance of the Portuguese economy is still far from buoyant. A key objective of the programme was to address the structural weaknesses that were holding back the economy before the crisis. This section examines the extent to which the programme has achieved to restore sound and sustainable fundamentals. It finds that there are signs of structural improvements taking place and that some of these are due to the implemented reforms. But economic performance has still to strengthen and important reforms are still pending. Whether the observed improvements will be sustained in the future or not will depend on whether the reform agenda is pursued. ([223])

Table 8.1:
Comparison of macroeconomic projections at the start of the programme with outturns and forecasts (y-o-y change if not otherwise indicated)

		2010*	2011	2012	2013	2014	2015	2016	2017
GDP at market prices (volume)	**(1)**	**1.9**	**-1.8**	**-4.0**	**-1.1**	**0.9**	**1.5**	**1.5**	**1.7**
	(2)	*1.3*	*-2.2*	*-1.8*	*1.2*	*2.5*	*2.2*		
Final domestic demand (volume)	**(1)**	**1.0**	**-5.4**	**-7.0**	**-2.0**	**2.2**	**2.4**	**1.5**	**1.9**
	(2)	*0.8*	*-5.7*	*-4.6*	*-0.3*	*1.4*	*1.0*		
Exports of goods and services (volume)	**(1)**	**9.5**	**7.0**	**3.4**	**7.0**	**3.9**	**5.2**	**4.1**	**5.1**
	(2)	*8.7*	*6.2*	*5.9*	*6.5*	*6.5*	*6.5*		
Imports of goods and services (volume)	**(1)**	**7.8**	**-5.8**	**-6.3**	**4.7**	**7.2**	**7.4**	**4.3**	**5.6**
	(2)	*5.2*	*-5.3*	*-2.8*	*2.1*	*3.7*	*3.6*		
Current account balance (% of GDP)	**(1)**	**-10.3**	**-5.5**	**-2.0**	**0.7**	**0.0**	**-0.1**	**0.3**	**0.5**
	(2)	*-9.8*	*-7.5*	*-5.2*	*-3.9*	*-3.1*	*-2.2*		
HICP	**(1)**	**1.4**	**3.6**	**2.8**	**0.4**	**-0.2**	**0.5**	**0.7**	**1.2**
	(2)	*1.5*	*3.4*	*2.0*	*1.4*	*1.5*	*1.5*		
Unit labour costs	**(1)**	**-1.2**	**-2.0**	**-3.2**	**1.8**	**-0.9**	**-0.6**	**1.0**	**0.3**
	(2)	*0.3*	*0.7*	*0.4*	*-0.4*	*-0.2*	*0.0*		
Labour productivity	**(1)**	**3.4**	**0.1**	**0.1**	**1.8**	**-0.5**	**0.1**	**0.6**	**1.1**
	(2)	*2.8*	*-1.4*	*-0.9*	*1.0*	*1.9*	*1.4*		
Compensation of employees per head	**(1)**	**2.1**	**-1.8**	**-3.1**	**3.6**	**-1.4**	**-0.6**	**1.6**	**1.4**
	(2)	*1.5*	*-0.3*	*0.1*	*0.8*	*1.3*	*1.0*		
Total employment	**(1)**	**-1.4**	**-1.9**	**-4.1**	**-2.9**	**1.4**	**1.4**	**0.9**	**0.7**
	(2)	*-1.5*	*-1.5*	*-0.9*	*0.5*	*1.1*	*1.3*		
Unemployment rate (%)	**(1)**	**12.0**	**12.9**	**15.8**	**16.4**	**14.1**	**12.6**	**11.6**	**10.7**
	(2)	*10.9*	*12.2*	*12.9*	*12.4*	*11.6*	*10.6*		

Notes: * Historical year when the Economic Adjustment Programme started, differences are due to backward historical revisions.
(1) Actual data and Commission Spring forecast 2016 for the years 2016 and 2017.
(2) Commission projections at the start of the Economic Adjustment Programme.
Sources: (1) European Commission Spring forecast 2016; (2) DG ECFIN (2011), "*The Economic Adjustment Programme for Portugal*", Occasional Papers 79/2011

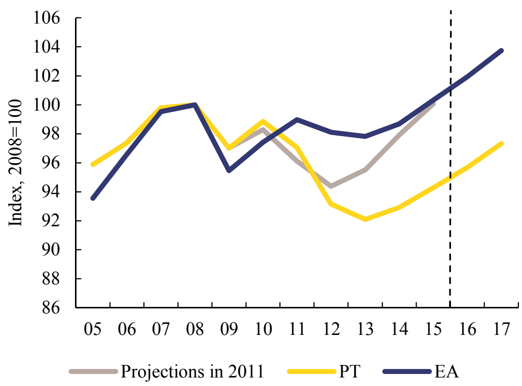
8.1. A SLOW RECOVERY

The initial programme projections in 2011 proved to be excessively optimistic. In the context of a worse than expected recessionary environment in the EU, growth resumed later than foreseen and only after a larger-than-expected contraction. Although the economy proved more resilient than expected in the first part of the programme, the recession that followed was considerably stronger and more prolonged than expected (Table 8.1 and Graph 8.1a). Until 2013 GDP fell 6.7% and began to recover in 2014, a year later than forecast. Similarly, unemployment, which was initially expected to peak at 12.9% in 2012, continued to climb, hitting 16.4% in 2013 (Graph 8.1b).

([223]) Portugal is subject to Post Programme Surveillance (PPS), which consists in a broad monitoring of the economic, fiscal and financial conditions with a view to assessing the repayment capacity. While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. Furthermore, as any other Member State, Portugal is subject the Macroeconomic Imbalances Procedure (MIP) surveillance mechanism and is part of the European Semester.

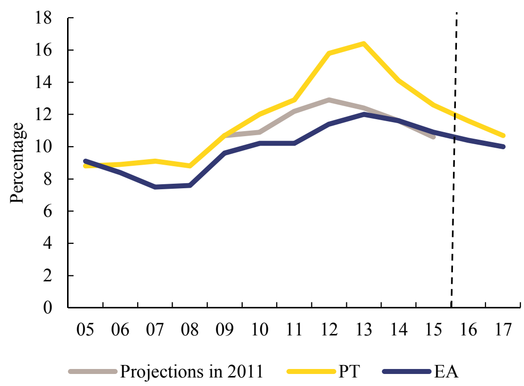
The Portuguese economy finally began to recover over the course of 2013 but growth remained close to the euro area average and a catching-up in terms of GDP levels has yet to start. Growth turned positive for the first time in late 2013, following eleven consecutive quarters of recession, though the first positive annual record was only in 2014. Growth continued in 2015 at the modest rate of 1.5% of real GDP. So far it is still difficult to determine whether the resumption is cyclical or the effect of growth-enhancing structural reforms. However, with growth barely at the euro area average, the rebound and catching-up that was expected is not taking place and GDP still remains below its 2010 peak (Table 8.1 and Graph 8.1a).

Graph 8.1a: **Real GDP**



Source: AMECO database, 2016 Spring forecast

Graph 8.1b: **Unemployment**

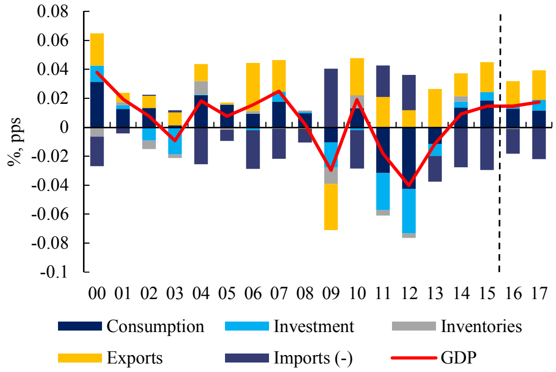


Source: AMECO database, 2016 Spring forecast

Exports helped moderate the contraction in income but the recovery only began once domestic consumption and investment resumed. The resilience of exports partly offset the effect of the contraction of internal demand during the second slump. Domestic demand experienced one the strongest contractions during the great recession with consumption dropping 10% from its peak. Imports collapsed by 12% and investment lost 30 additional pps. bottoming out at 60% of pre-crisis levels. The economy only began to recover when confidence returned allowing consumption and investment to rebound in 2014 (Graphs 8.2, 8.3a and 8.3b). Short term indicators point to some moderation of economic activity by mid-2016 but, as noted above, growth is now expected to remain at the euro area average until the end of 2017. Given the depth of the contraction, growth could have been faster. A possible reason for the relatively poor performance, at least partially, is the deleveraging pressures still weighing on the corporate sector.

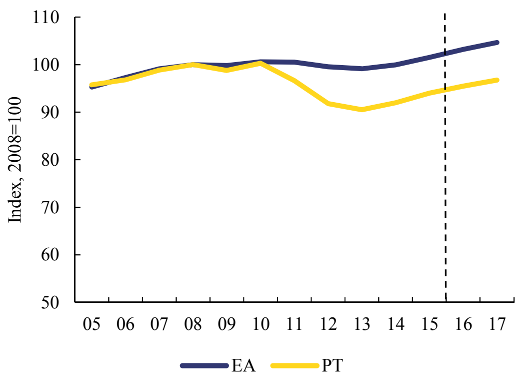
The recovery coincided with a slump in HICP inflation triggering fears of deflation and increasing the real value of debt. In 2013, HICP inflation dropped abruptly and went negative in 2014 (Table 8.1). More recently, the demand-driven recovery, several tax-increasing measures, and the weakening of the euro have exerted an upward pressure on consumer prices. HICP inflation is still subdued but is expected to grow 0.7% in 2016 and 1.2% in 2017 (Table 8.1). The behaviour of the GDP deflator, as expected, was more aligned with the income cycle: depressed during the 2011-2013 recession, it has recovered vigorously and is currently around the euro area average of 2%.

Graph 8.2: **Decomposition of short-term growth**



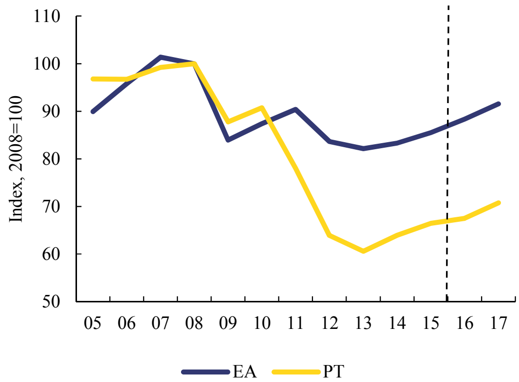
Source: AMECO database, 2016 Spring forecast

Graph 8.3a: **Consumption**



Source: AMECO database, 2016 Spring forecast

Graph 8.3b: **Gross capital formation**



Source: AMECO database, 2016 Spring forecast

After the sharp 2010-14 contraction, investment is growing but remains low and net capital formation remains negative. In part because of the sharp contraction in 2010-2013, real investment growth has been above the euro area average and is projected to grow faster until 2017 (Graphs 8.2 and 8.3b). The recovery in investment is led by increases in non-residential investment, transport equipment, and machines. Despite the recovery, the investment rate remains below the euro area average because of its low level already before the crisis: the investment rate still stands at 16% of GDP compared to 25% in the euro area. For this reason, net capital formation has been negative since 2012 and is expected to remain slightly negative in the near future. ([224])

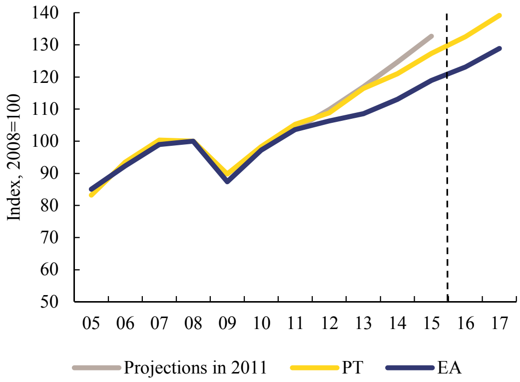
Before the crisis, investment was not very productive but structural reforms and new FDI may help improving the situation. Past current account deficits mainly fuelled spending on private consumption and investment in non-residential construction. Investment in machinery and transport equipment were at levels of peer countries but returns were disappointing as reflected in the low aggregate growth. Most of this investment was in the retail and wholesale trade and real estate sectors. But productivity in these sectors remained stagnant. This may explain the low aggregate returns on investment. Future returns may improve with the revival of FDI. During and after the programme, domestic investment has been complemented by a significant increase in FDI sparked by privatizations and improvements in the ease of

([224]) For gross capital formation, see the European Economic Forecast Spring 2016, and *Projections for the Portuguese economy: 2016-2018*, Banco de Portugal. For net capital formation, see AMECO database, Commission services.

doing business promoted by the programme. FDI should bring in new technologies and business practices to the economy, sustaining the recovery and eventually improving output growth.

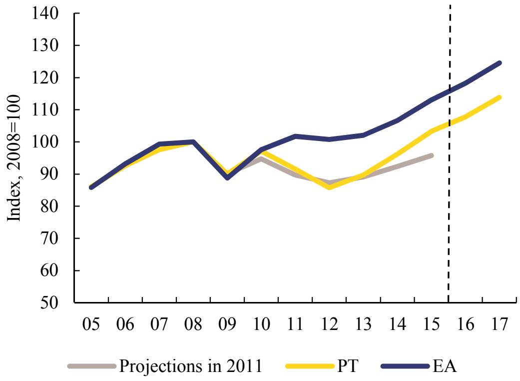
Cuts to public investment have exceeded plans but the possible negative impact on growth may be mitigated by the high level of public investment in the years preceding the crisis. During the period 2011-2014, public investment as a share of GDP more than halved. Since 2012, it has been below the euro area average. This was not envisaged by the programme. Given the extended perimeter of the state in Portugal, a significant portion of public investments related to SOEs. Hence, part of this drop in public investment was due to consolidation within the SOE sector. On the one hand it can be argued that cutting investment programmes may have been growth-detrimental, in particular given that Portugal is lagging behind in terms of productivity and competitiveness. On the other hand, strong public investment before the crisis has helped build a stock of infrastructures. Indeed, between 1995 and 2005 public investment in Portugal was on average at 5% of GDP, 2 pps. higher than the euro area. In addition, during the same period, a number of important infrastructure projects have been implemented through PPP agreements and, as such, were not recorded as public investment.

Graph 8.4a: **Exports**



Source: AMECO database, 2016 Spring forecast

Graph 8.4b: **Imports**



Source: AMECO database, 2016 Spring forecast

Exports grew slightly faster than the euro area average during the programme and continue to grow at a rapid pace. The resilience of exports contributed to the external rebalancing of the Portuguese economy during the programme (Graph 8.4a). The external sector supported national income despite its relatively small size. ([225]) The contraction of GDP combined with the stability of exports increased the size of exports over GDP but arithmetically. It is too early to say that a structural change has taken place and that the Portuguese economy is going to be more open. After the programme exports seem to have grown consistently faster than GDP, pointing to the possibility of an ongoing permanent change in the relative size of the external sector and a more open economy.

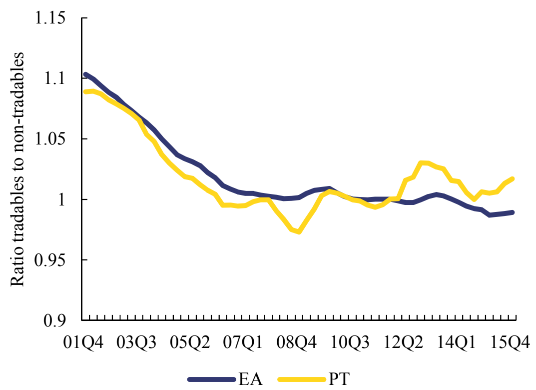
8.2. REBALANCING

Programme conditionality explicitly targeted internal and external rebalancing. The vulnerability of the Portuguese economy was deemed to be a consequence of the high levels of private debt, increasing ULC, an inefficient non-tradable sector, and a low level of exports. Some modest progress has been made in rebalancing the economy.

([225]) Prior to the crisis, exports of goods and services were around 20% and 6% of GDP respectively, which is about half of what countries of the same size export. Moreover, these percentages were quite stable: Portugal seemed to be losing the train of globalization.

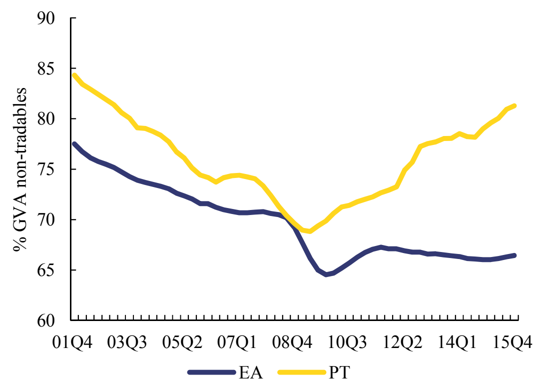
There has been some rebalancing from the non-tradable to the tradable sector both in terms of Gross Value Added (GVA) and employment. Since the beginning of the crisis, the GVA of the tradable sector has grown from 74% to 82% of GVA of the non-tradable sector (Graph 8.5b). The reason is partly the collapse of the construction sector, included in the non-tradable sector, but also the relative resilience of the tradable sector. The tradable sector weathered the crisis better than other sectors, most likely because of the support of external demand. Behind this increase of the tradable sector is the strong performance of the wholesale and retail trade and the manufacturing sectors. In terms of employment, the tradable sector has increased its share in the active population from 42% to 46%. Overall, it is too soon to conclude that there is some permanent sectoral shift but the current strong growth of the tradable sector points in this direction.

Graph 8.5a: **Relative price of tradables**



Source: Eurostat

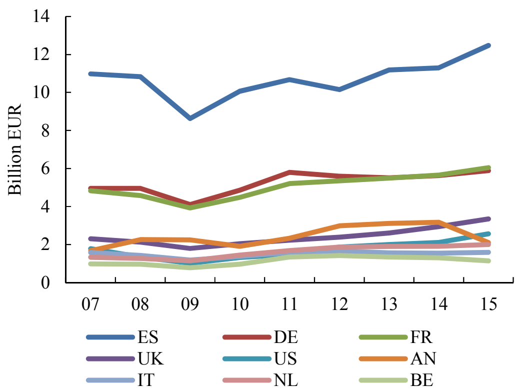
Graph 8.5b: **Weight of tradables**



Source: Eurostat

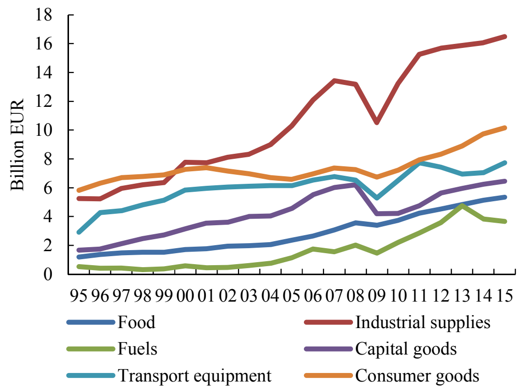
This positive reading is supported also by the good behaviour of exports across destinations and type of goods exported. There is no single export destination explaining this good performance. Even exports to Spain, Portugal's major trade partner affected by a severe recession, did relatively well. Portugal depends largely on EU trade partners and intra-EU exports are showing a strong dynamism since 2011. Most types of goods contribute to the good export performance after the crisis, even industrial supplies and capital goods. Exports of services have also increased, even faster than goods, rising from 24% to 28% of total exports, mainly because robust growth in tourism. Proceeds from travel services, including tourism, increased from 7 to 11 billion euros between 2010 and 2015 accounting for half of the increase in services' exports over the period. Other business services (26%), transport (17%), and telecommunications, computer, and information services (5%) are the other leading categories explaining the growth of exports. At the firm-level exporting firms have increased slightly their exports but the proportion of exporting firms has remained relatively stable across sectors. ([226]) This means, first, that exports were driven by external demand rather than searching for alternative markets to substitute for lost local customers. Second, it means that within tradable sectors there is no structural change ongoing: it is the sector as a whole that is performing well.

([226]) See Correia, A.L., Gouveia, A.F., (2016) *Graph 8.6a:* **Main goods' export destinations**



Source: Eurostat

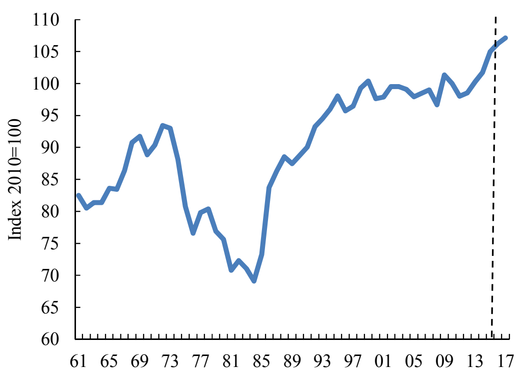
Graph 8.6b: **Exports of goods by categories**



Source: Eurostat

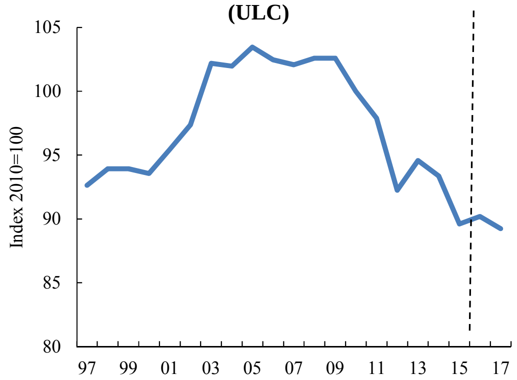
This rebalancing to the tradable sector is certainly related to external demand but there are signs of deeper changes, notably the improvement of the terms of trade after two decades of stagnation. The recovery of the terms of trade after twenty years of stagnation points to some upgrading of Portuguese exports (Graph 8.7a). Further, if high wages were a drag on the external sector before the crisis, it does not seem to be the case anymore: the real effective exchange rate has dropped to levels before EMU (Graph 8.7b).

Graph 8.7a: **Terms of trade**



Source: AMECO database, 2016 Spring forecast

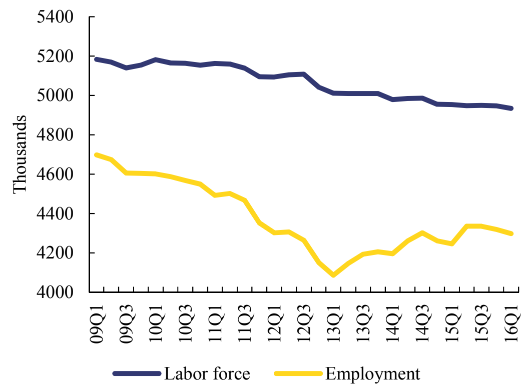
Graph 8.7b: **Real effective exchange rate (ULC)**



Source: AMECO database, 2016 Spring forecast

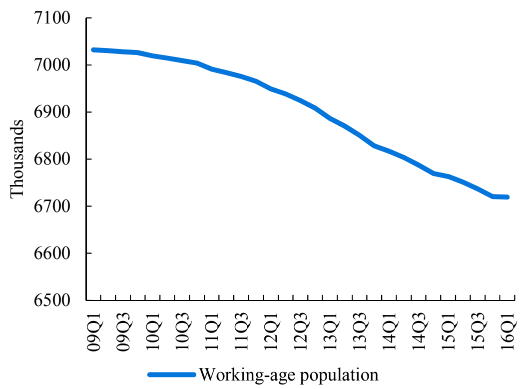
The labour market turned the corner in 2013 and has continued to improve after the programme, though long-term unemployment remains stubbornly high. Portuguese employment appears to react swiftly to changing economic conditions: the rapid rise in unemployment till 2013 was followed by a rapid reduction. The reasons for this include that adjustments in employment levels are concentrated among less protected workers, and the high level of nominal wage rigidity. However, labour market developments do also partly appear to reflect the impact of reforms implemented during the adjustment programme. In particular, recent increases in employment mostly took the form of permanent contracts, suggesting that the reform of the employment protection legislation has helped reduce the bias towards temporary employment contracts. For the first time in more than a decade, the youth unemployment rate fell in 2014, partially reflecting the successful implementation of the Youth Guarantee Scheme. However, despite the rise in employment (157,000 persons since 2013) increases in economic activity do not seem to be associated with more employment creation than before the crisis. ([227]) Furthermore, the sharp contraction in unemployment is partially due to emigration: since the recovery in 2013 to the (forecast) end of 2016 the labour force will have shrunk by 102,000 persons and the total population has fallen by 158,000 persons. Furthermore, long-term unemployment has been slower to decline, with very long-term unemployment (more than 24 months) still near its peak.

Graph 8.8a: **Labor force and employment**



Source: Eurostat

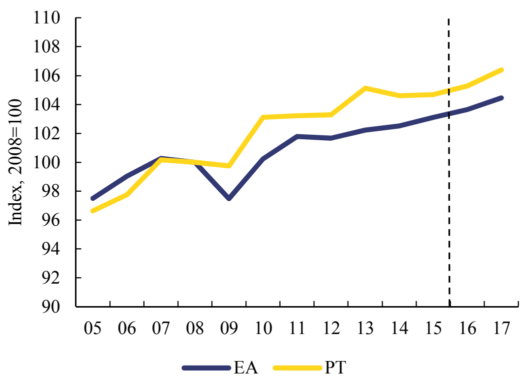
Graph 8.8b: **Working-age population**



Source: Eurostat

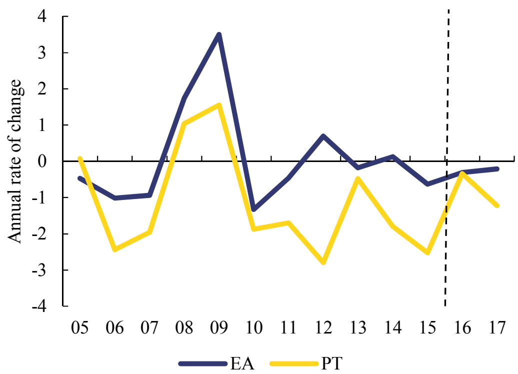
Real labour costs adjusted considerably in the private sector but public sector wages are still high and may distort labour allocation. The upswing in exports was supported by favourable trends in nominal unit labour costs (ULCs), particularly in the tradable sector, despite the presence of high nominal wage rigidity. This was also reflected in the continuing drop in real ULC (Graph 8.9b). However, the fall in ULCs in the tradable sector seems to have been reversed recently, highlighting the challenge of generating employment while containing price pressures. The correction of ULCs in the non-tradable sector was smaller in 2013 dampened by a partial reinstatement of wages in the public sector that had been cut to support fiscal consolidation.

Graph 8.9a: **GDP per person employed**



Source: AMECO database, 2016 Spring forecast

Graph 8.9b: **Real unit labor costs**



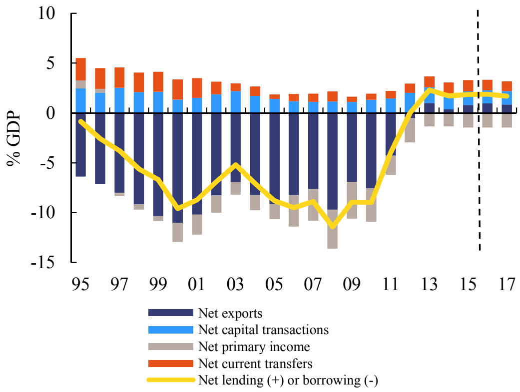
Source: AMECO database, 2016 Spring forecast

The current account balance displayed a surplus for the first time since the Second World War owing to the collapse of investment and a rebound of savings during the crisis. The collapse of aggregate investment and the rebound in savings are led by the corporate sector (Graph 8.10b). Corporate

([227]) A glance at the Okun curve with employment rather than unemployment reveals no structural shift in the relationship between changes in GDP and changes in employment (see European Commission, 2016).

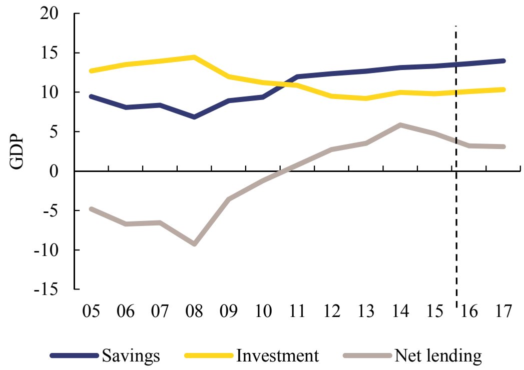
net lending experienced a large swing from –9.2% of GDP in 2008 to 6% in 2014, both because of increased corporate savings and decreased investment. Hence, despite substantial borrowing by the government, aggregate net lending has increased from –11% to 2% of GDP during this period. Households have been moderate net lenders both before and after the crisis so they have played no role in the rebalancing. The current account surplus is projected to remain stable over the forecast period (Graph 8.10a). From the perspective of income flows, Portugal's large external debt explains the negative net primary income partly offset by net current transfers (e.g. remittances) and net capital transactions (e.g. EU structural funds). All these flows are expected to remain stable so any future changes will come from changes in net exports, in turn reflecting changes in savings in excess of investment. For the time being, the recovery in investment has been offset by the rebound in savings. Further fiscal consolidation should support and consolidate this surplus.

Graph 8.10a: **Decomposition of net lending**



Source: AMECO database, 2016 Spring forecast

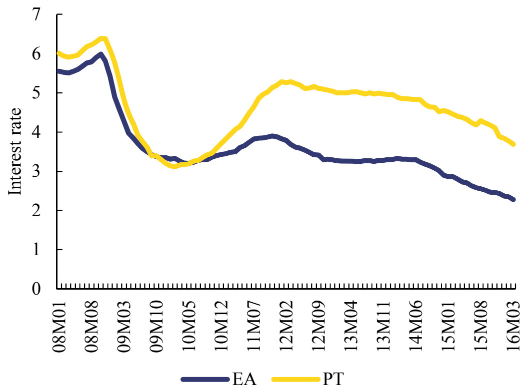
Graph 8.10b: **Corporate saving and investment**



Source: AMECO database, 2016 Spring forecast

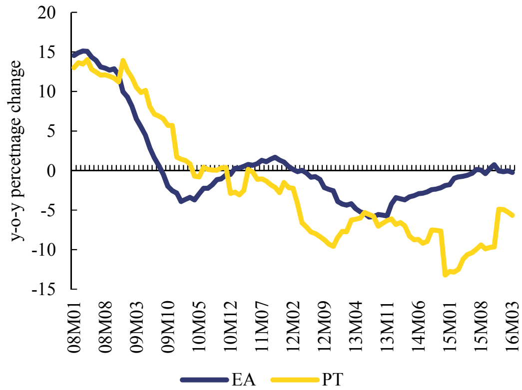
Deleveraging in the corporate sector has been going on before, during and after the programme and it is still continuing. The collapse of corporate net borrowing is most likely the consequence of deleveraging efforts of the private sector, particularly the construction sector. The stock of bank loans to non-financial corporations has been decreasing considerably (Graph 8.11b). Although the last year has seen a deceleration of this process, it is likely to continue for some time. Hence, some reduction of the still high private debt may be expected in the coming years.

Graph 8.11a: **Cost of borrowing for NFC**



Source: ECB

Graph 8.11b: **Changes in the stock of loans**



Source: ECB

8.3. MACROECONOMIC RISKS AND MEDIUM-TERM CHALLENGES

Despite some external rebalancing, the Portuguese economy continues to be characterised by low potential growth and high external debt. The main challenges remain high private and public indebtedness, high unemployment, subdued technological progress, and an unfavourable demographic outlook. There has been little progress in the skill-composition of the work force: although there has been significant progress for younger cohorts, it will take time to be felt at the aggregate level. Production and exports are still concentrated in low-tech, labour-intense sectors. The economy is showing early signs of fundamental changes but there is still a long way to go from the level of performance needed to sustainably correct the existing imbalances.

The high indebtedness of non-financial corporations remains a major vulnerability of the Portuguese economy. Despite deleveraging in construction and real estate, debt remains high in most sectors, especially manufacturing. Debt reduction has so far only been partially accommodated by the insolvency and restructuring frameworks, which lately have been revised to focus on the recovery of firms. Private corporate debt in Portugal stood at 146% of GDP on a non-consolidated basis in October 2015, some 20 pps lower than the peak level of 167.4% in 2012 but still more than 20 pps. higher than the euro area average. The fact that banks are nearly the only channel for lending in Portugal adds to the challenge. The other side of the coin of high corporate debt is represented by the level of NPL, especially in the non-tradable sector. Aggregate NPLs have been burdening banks' balance sheets, increasing from below 4% in 2008 to 11.9% by the end of 2015. ([228])

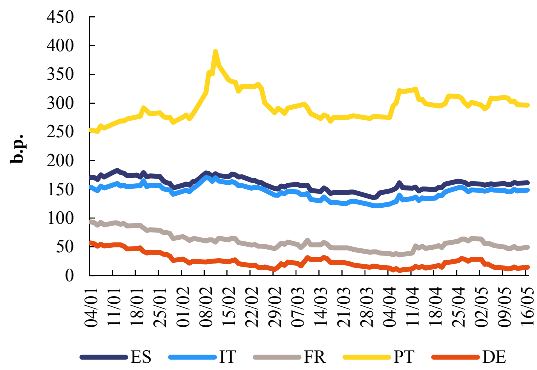
The situation of the banking sector remains fragile, although there are differences across banks. Market confidence has not been fully restored. Banks' access to debt and equity markets has remained limited. As a consequence, the Portuguese banks present lower capital ratios and higher Eurosystem reliance than the EU peers. The banking sector's current vulnerabilities extend beyond the high level of NPLs. One-off financial operations, including capital gains from debt securities, and the overseas operations have supported an increase in average income in 2015. However, the ongoing deleveraging of the private debt, compounded by the low nominal interest rates, is compressing the banks' profitability, while cost structures still present inefficiencies. Contingent liabilities for the state related to the banking sector are posing fiscal risks, which can undermine the consolidation achieved so far, in case of negative developments. The state-owned CGD remained loss-making in 2015. The resolution of BES is yet to be

([228]) Source: Banco de Portugal. NPL ratio, as published by EBA, was 19.1%, as of the end of 2015. The difference is mainly due to different definitions of non-performing loans and the covered banks.

completed, with Novo Banco also recording losses in 2015. The resolution of Banif started only in December 2015 and even the sale of the bad assets related to the resolution of BPN is not yet completed.

Public debt is still very high, which requires continued fiscal discipline and makes it more difficult to engage in extensive public investment programmes. Shortcomings in the implementation of structural fiscal measures left the public finances vulnerable. A moderate decline in public debt would require sustained primary surpluses (see section 4.3). Also, public finances are still vulnerable to macro-economic and financial market shocks, which makes continued fiscal consolidation crucial and limits the room to manoeuvre for public investment. The market perception that major challenges lie ahead is reflected in the high and relatively volatile risk-premium of Portuguese government bonds (Graph 8.12).

Graph 8.12: **Yield 10-year government bond in 2016**



Source: DataInsight

There is a risk that unemployment stabilises at high levels. Long-term and youth unemployment, combined with low-skills prevalence remain serious challenges. Unemployment in Portugal is high and the labour market is still segmented. The labour market continues to be relatively rigid and the functioning of the collective bargaining system is not leading to firm-level (or firm-specific) adjustments: firm-level bargaining is not picking up. The large proportion of young people and people unemployed for more than one year is becoming a structural issue. Stronger output growth and successful implementation of the reforms to active labour market policies and vocational education are needed to combat these types of unemployment. The low skill level of the Portuguese workforce weighs on productivity and hampers innovation and the redirection of production towards higher-value products. Improving the skills of the work force through continuing reforms in education will therefore be vital to durably lifting Portugal's growth potential.

The surplus in the current account is expected to partially reverse while external liabilities are still very high. Weak domestic demand explains a large part of the current account surplus. The recovery will most likely partially reverse it in the medium term. In itself the recovery of demand is a positive development but it means that the absorption of the external debt will require faster GDP growth. In the short-term, however, the European Commission's 2016 Spring forecast expects the current account to remain in a surplus below 1% until the end of 2017.

Sustainable growth requires further improvements in external competitiveness and the efficient allocation of resources. Stronger reallocation of resources towards the tradable sectors with higher-productivity is needed. Despite the resilience of exports during the crisis, Portuguese firms remain specialised in relatively low-tech goods. Service exports have gained in importance but as a proportion of GDP they are still lower than in other small and open European countries. It may be difficult for Portugal to rely on cost-based improvements in its external competitiveness, as further improvements in cost developments would have to take place in a low inflation environment. This may prove challenging given the inefficiencies and rigidities in the domestic market. Maintaining the reform momentum in product, services and labour markets and corporate restructuring could help ensure that capital is allocated efficiently to where it is most productive.

9. CONCLUSIONS

The formulation of the conclusions and lessons learned is based on the analysis conducted in Sections 2 – 8 of the evaluation. This Section presents the conclusions and lessons learned in the framework of the five original evaluation questions.

In spring 2011 Portugal lost market access at sustainable rates and requested external financial assistance. The Portuguese crisis mainly resulted from a combination of poor economic performance over a number of years and unsustainable public finances. Poor economic performance was deeply-rooted in structural deficiencies affecting the functioning of the economy and in a large and inefficient public sector. Funds borrowed abroad had not been used for productivity-enhancing investments in the tradable sector and had led to the accumulation of significant external indebtedness in all sectors. The banking system was the main intermediary between the domestic financing needs and the external financing sources. The 2008 international financial crisis triggered only a marginal correction of existing imbalances. The uncertainty over the macroeconomic outlook and the fiscal dynamics contributed to increasing funding costs for both the government and the banking system up to unsustainable levels. In March 2011, the Portuguese parliament rejected the Stability Programme, prepared by the government to consolidate the fiscal position. At the same time, 2010 figures for budget deficits and public debt were revised upwards, mainly to reflect the reclassification of a number of public transport state-owned enterprises (SOEs) in the general government. These events triggered the request for external financial assistance.

The programme objectives were relevant in relation to these economic challenges. They were: (i) Covering Portugal's financing gap during the adjustment; (ii) Putting the public finances on a sustainable footing; (iii) Underpinning a return to economic growth, supporting an orderly unwinding of external and internal imbalances, while increasing the growth potential of the economy through in-depth structural reforms; (iv) Stabilising the financial sector. These objectives aimed at restoring financial market confidence in the economy, the sovereign and banks. In the medium/long term, these objectives were seen as instrumental to secure macro-financial stability, achieve fiscal sustainability, and increase trend growth.

The evaluation considers the programme to be a relative success to the extent that Portugal has regained market access but challenges remain. The programme helped regaining market access at relatively low rates. However, doubts continue to linger in light of the need to further improve the structural soundness of public finances and the banking system. The assessment of the implementation and effects of structural reforms is mixed. The current yield of Portuguese government bonds, well above peers like Spain or Ireland, as well as the spike during the turmoil in early 2016 bears witness of the market concerns about the credibility of the adjustment and the challenges ahead.

How well did the objectives correspond to the challenges faced by Portugal (relevance)?

The evaluation found that the objectives of the economic adjustment programme were relevant and that the measures included in the programme were broadly focused on the appropriate issues. In the absence of market access at sustainable rates, Portugal could not cover the upcoming financing needs. This gap had to be closed and confidence in the sovereign had to be restored. Fiscal measures were necessary as public finances were not on a sustainable footing, given large and persistent public deficits, high and increasing public debt and significant weaknesses in fiscal governance. The uncertainty about the development of public finances was compounded by significant internal and external macroeconomic imbalances accumulated over a long period of poor economic performance. An extensive package of structural reforms was necessary. There was also a need to strengthen the banking sector.

Under tight constraints, the programme rightly targeted an ambitious fiscal consolidation, underpinned by a number of fiscal governance and structural reform measures. The programme aimed at rapidly bringing down the public deficit and putting public debt on a downward trajectory. The envisaged fiscal path was ambitious but a more gradual consolidation path would have implied significant risks, given the uncertainty at the inception of the programme about debt evolution. A comprehensive reform of the Budgetary Framework Law was envisaged to address the existing vulnerabilities in fiscal governance. Fiscal-structural measures targeted the most evident inefficiencies and sources of risk, but lacked a comprehensive strategy. On the one hand, conditionality did not immediately and comprehensively enough focus on a number of important structural drivers of expenditure inefficiencies, including in the social security and public wage bill. On the other hand, conditionality contained a number of measures that could hardly be considered as macro critical, such as the reduction of parishes or the cost/benefit analysis of support to foundations.

The comprehensive package of structural reforms included in the programme was a broadly adequate response to Portugal's long-standing weaknesses, but a sharper focus on the most macro-critical issues could have been warranted. Reflecting the broad-based economic inefficiencies at the root of the crisis, the programme touched on many policy areas covering the labour and products markets, with the overall aim of increasing potential output and boosting productivity. This represented a step change in the momentum of reform in a country in which necessary reforms had not been forthcoming. Nevertheless, this extensive coverage meant a lack of prioritisation of the most important macro-critical issues, especially in the product markets field. This may have been the result of using the programme to embrace reforms which were meant to happen anyway (e.g. transposition of EU Directives).

The programme rightly aimed at strengthening the banking sector and accompanying the correction of the country's imbalances. Banks were required to strengthen their solvency and funding profile, under the supervision of Banco de Portugal (BdP). The availability of the Bank Solvency Support Facility (BSSF) funds and the prompt introduction of an insolvency framework were expected to help preserve financial stability. In light of the existing high public contingent liabilities, the conditionality covered the state-owned banks. It required selling Banco Português de Negócios **(**BPN) and streamlining - but not to fully privatise - Caixa Geral de Depósitos (CGD), the largest Portuguese bank. The reform of the corporate insolvency framework was rightly envisaged, to facilitate the correction of the imbalances. Other initiatives aimed at facilitating the provision of credit to viable firms. In particular, the programme partners envisaged BdP to monitor the consistency of the adjustment process with the macro-economic developments, in light of the expected banks' balance sheet downsizing. They also encouraged the assessment of the system of government guarantees for SMEs and the consideration of extra-bank financing alternatives, but they did not indicate stringent deadlines and medium term objectives.

The programme rightly addressed social concerns in many of the covered policy areas but monitoring and systematic reporting of social outcomes was not set out as a requirement in the Memorandum of Understanding on Specific Economic Policy Conditionality (**MoU).** The programme used many different sectoral policies to mitigate the social impact of the adjustment. The issue of a fair burden of the adjustment was rated as important by the authorities and programme partners. Nevertheless, more emphasis on monitoring and reporting on the social dimension would have been warranted.

What has been learned:

When a crisis is rooted in broad-based economic and fiscal inefficiencies, programmes should include a wide package of structural and fiscal-structural reforms, embedded in a clear strategy which allows a focus on the most macro-critical weaknesses affecting the functioning of the economy and the sustainability of public finances. Including other reforms risks overstretching administrative capacity and making decisions on the completion of the regular programme reviews more complex.

Strengthening and cleaning the banking sector is a crucial part of facilitating the correction of a country's macro-imbalances. This correction also requires other policy measures, including fostering private debt restructuring and maintaining an adequate level of credit to viable firms.

The social impact of the crisis and of the adjustment process should be regularly monitored and reported upon in programme documents.

Was conditionality appropriate in relation to the intended outputs and results (efficiency)?

Given the information available at the time, the originally planned fiscal consolidation path and the subsequent flexibility were both appropriate. The programme partners gradually and rightfully accepted a less frontloaded consolidation path, as Portugal's access to the sovereign debt market increased, also on the back of the more accommodative monetary policy and improved official lending terms. A budget-neutral fiscal devaluation was abandoned because of lack of space for compensatory measures and strong political opposition. It was not replaced by a non-budget-neutral solution, which could have implied significant risks for the public finances, while not achieving its full potential and without changing the structural features of the economy.

Some measures to achieve a frontloaded reduction of expenditure were appropriate but consolidation was excessively based on one-offs and temporary measures. The ambitious consolidation path was intended to rely on significant expenditure cuts. However, in the absence of an in-depth reform of the public sector and social security, underpinned by an exhaustive spending review, that could have been expected to deliver upfront substantial savings, the frontloaded expenditure-based approach implied extensive recourse to one-off and temporary, horizontal measures. Some of these measures may have been inefficient and may have contributed to weaker than expected growth outcomes. Ultimately Portugal shied away from pursuing the difficult expenditure measures that would help it over the medium term. This being said, some areas of structural inefficiency were properly tackled. Reduction of public staff and health costs, restructuring of SOEs and public-private partnerships (PPPs) were the main drivers of the sustained improvement of public finances.

Given the circumstances in 2013, it was appropriate to also rely on revenue-based consolidation, through tax increases and measures to improve the efficiency of tax administration. During the second part of the programme, due to difficulties in securing expenditure savings, also explained by constraining rulings of the Constitutional Court, the consolidation effort appropriately turned to be more revenue-based than initially projected. Overall, this move may have supported short-term demand, while giving more time for implementing expenditure cuts. The main measures covered PIT, VAT, taxation on immovable property, CIT and the efficiency of the revenue administration. They were broadly appropriate.

A more balanced composition of consolidation already during the first half of the programme would have been more efficient if coupled with stronger focus on structural reforms on the expenditure side. Given the planned consolidation path, more revenue based fiscal consolidation at the beginning of the programme could have contributed to reduce recourse to one-off and temporary expenditure measures, while allowing more time to design appropriate structural expenditure measures to be implemented later in the programme. This approach should have been accompanied by an overall strategy to reform the public sector and social security, which could have helped foster political consensus and sustained ownership on medium/long term objectives. The existence of a clear strategic plan for a comprehensive reform of the state and an in-depth spending review could have helped optimise the selection of the measures to be included in the programme. Overall, this could also have reduced the risk of negative rulings by the Constitutional Court.

The conditionality for structural reforms was overall well designed but the lack of clear and properly communicated priorities contributed to uneven implementation of structural reforms. The structural reforms were overall well designed but there were important cases of insufficient or delayed implementation, especially for products market reforms. A number of intended policies were highly politically or socially sensitive or impacted on strong vested interests (e.g. energy, regulated professions or ports). Clearer communication on the necessity of structural reforms and their longer-term benefits might have helped overcome some of the resistance to reforms and contain reform fatigue.

Structural reforms were meant to be frontloaded, but in practice this was only the case for labour market reforms. The initial programme MoU stated that structural reforms would be frontloaded, but there was no specific target on the sequencing between labour market and product market reforms This was deemed not to be realistic for the programme design given the relatively short three-year programme horizon. On balance it was right to frontload those labour market reforms that could be implemented relatively quickly, rather than delaying them for reasons of sequencing. But the overall sequencing, effectiveness and fairness of reforms could have been improved by faster progress on reforming product markets and protected sectors. Reforms that involved taking on vested interests tended to be delayed.

Programme design and implementation should have pursued a more frontloaded adjustment of the banks' balance sheet. The programme design envisaged the combination of stress tests and asset quality reviews to contribute to the estimation of the banks' capital needs. However, the stress tests did not foster prompt actions to improve the resilience of all the covered banks. The asset quality reviews required repeated rounds to ensure adequate assessment of the banks' asset quality. With BdP responsible for the design and implementation of the bank recapitalisation, the programme strategy could have better emphasized the importance of the different strategies, provided more detailed guidance and put more pressure on implementation. A more forceful supervisory approach could have been beneficial in accelerating the balance sheet adjustment, including with respect to Banif and Banco Espírito Santo (BES). The implementation of the bank resolution framework occurred swiftly and represented an important programme achievement.

In particular, the issue related to the high level of non-performing loans (NPLs) should have been tackled earlier and more effectively. NPLs kept on increasing during the programme, as new problematic loans appeared while existing ones were worked out or disposed of in only limited amounts. The slow progress in reducing NPLs was accompanied by decreases in bank loans and a slow reduction of private debt. Effective supervisory policies to tackle existing NPLs were not promptly introduced, while mechanisms to facilitate the developments of the distressed debt markets might have been constrained by the state's limited capacity to provide guarantees. Bank supervision should have been tighter with regard to provisioning and write-offs. The revision of the insolvency framework occurred swiftly but required some amendments to improve the corporates' rescue and restructuring process. An earlier optimization of the framework and a more ambitious approach to corporate debt workout could have helped reduce both private debt and NPLs.

The slow progress in fostering extra-bank lending to viable business can be understood but more progress in developing the capital markets could have been arguably achieved. Bank lending to viable business declined as a result of decreasing credit demand and credit supply. Initiatives to foster extra-bank financing were introduced relatively slowly, as the focus on these measures increased only after stabilizing the banks. Moreover, the implementation of extra-bank financing tools required some time to ensure their proper functioning. Better coordination at the level of both the Portuguese authorities and the EU authorities could have further contributed to foster the development of the capital markets, which in turn could have been helpful in promoting proper risk assessment and credit allocation, and addressing the bias in the corporate sector that was favouring debt rather than equity.

The programme enabled Portugal to avoid a sharp immediate adjustment in its economic and social situation. In the absence of a programme, the Portuguese sovereign would have been unable to meet its obligations, leading to an immediate sharp adjustment with widespread economic and social consequences. Most programme measures took equity and social considerations into account, although some measures (or lack thereof) failed to ensure progressive burden-sharing of the adjustment or in protecting the lowest income groups. Overall spending on social protection was reduced if compared to a scenario of no changes in legislation. During the programme period, Portugal experienced an increase in poverty and social exclusion. One of the main drivers of the increasing incidence of poverty was the fast increase in unemployment. This being said, fiscal consolidation measures up to 2012 had a progressive impact and an increase in inequality (measured by the Gini coefficient) was avoided in recent years.

What has been learned:

At the very beginning of the programme, an overall strategic plan, underpinned by an in-depth spending review, should be set to steer and frame the ensuing fiscal effort. This plan should be immediately followed by further analysis to single out a few reforms on which political capital and administrative capacity should be prioritised. For these reforms, detailed implementation plans should become gradually part of the MoU with strong specific monitoring. The use of technical assistance should be considered.

When an upfront comprehensive strategy for expenditure cannot be undertaken quickly, it may be more effective to focus on revenue increases, even when there is a clear need for expenditure cuts. This should buy more time for implementing structural expenditure measures, while limiting the recourse to one-off and temporary measures.

High levels of domestic political and social sensitivity and strong vested interests can lead to delays and mixed implementation of key structural reforms. Strong prioritisation and clear communication are necessary for maintaining national ownership of the reform process, overcoming resistance and achieving implementation of fair and efficient reforms.

The necessary labour market reforms should be implemented without delay. If product market reforms cannot proceed at the same pace, they must be accelerated as much as possible in order to make the overall process more effective and fair.

The bank capital requirements should reflect credible assumptions on the losses yet to be realised. Independent top-down and bottom-up assessments are instrumental to increase transparency and confidence about the estimation of capital needs. Losses should, in turn, be promptly recognised.

A publicly available analysis about the advantages and drawback of different options to tackle NPLs is helpful. Reducing NPLs requires the prompt implementation of a balanced combination of different policies, including enhancing supervision, developing distressed debt markets, facilitating company restructuring.

Active capital markets are an important buffer for financing the real economy when the banking sector is under restructuring. Their development is difficult in a programme context, when other immediate pressures are high, and requires time and coordinated efforts from national and supranational authorities.

While it is known that economic crises and the subsequent adjustment can have high social costs, the distributional and social implications are generally difficult to estimate accurately at the start of the programme. However, programme measures should be shaped to take equity and social considerations into account, aiming at progressive burden-sharing and protection of the most vulnerable.

Was the disbursement of the financial assistance appropriate (efficiency)?

The amount of financial assistance was rightly set to cover the estimated funding gap over the programme. The programme was prudent in assuming limited recourse to short-term debt. The funding gap was estimated on the basis of the projected amortisation of government debt, cumulative state deficits, support for the recapitalisation of the banking sector and remaining needs of the wider public-sector, including the clearance of arrears. It was correctly based on the assumption of continued but reduced reliance on issuing short-term debt and gradual resumption of access to long-term debt market. Nevertheless, the financial envelope did not include potential needs arising from SOEs debt and the build-up of a cash buffer before programme exit.

Frontloading of disbursement was appropriate but it contributed to a reduction of the programme's leverage over time. It was appropriate to earmark the amount available for the banking sector. Together with the return to market access, the frontloaded disbursements allowed the cash buffer to be significant and enabled Portugal to forego the final tranche. This frontloading probably also contributed to a weakening of the consolidation and structural efforts during the second part of the programme. This being said, until the second half of the programme, the risks looked like firmly on the side of the envelope being too small rather than too large. Reducing the frontloading would have likely led to substantial pressure and uncertainty about Portugal's ability to implement the programme. In this context, it was appropriate to earmark the amount available for the banking sector.

Changes to the EFSM/EFSF lending terms were appropriate; consideration could nevertheless have been given to a parallel strengthening programme conditionality. The changes to the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) lending terms had a positive impact on deficit and debt sustainability, facilitating the return to the markets, including because of their signalling effect. Conditioning the improvements in the lending conditions might have allowed to keep a better hold on government policy and thereby might have underpinned a stronger reform momentum.

The early repayment of IMF loans is another shift in the gradual differentiation of the roles of the IMF and the euro area. IMF loans still include interest rate margins which make IMF loans, proportionally in a low interest rate environment, more expensive than market financing. These differences are not fully aligned with the G20 principles for cooperation between the IMF and regional financing arrangements, which foresee consistency of lending conditions to the extent possible, in order to prevent arbitrage and facility shopping. With the de facto waiving of the so-called *pari passu* clause, the EU gradually bears more risks.

What has been learned:

Assumptions about financing needs should be prudent so as to reflect the uncertainties prevailing at the time, such as contingent liabilities of the public sector and market access developments. The size of the financial envelope should add credibility to the programme's overall objective of facilitating return to the sovereign financial markets.

Earmarking the financial envelope for the banking sector helps prevent its use for other needs especially in the presence of a delayed adjustment of the banks' balance sheet.

A specified target for cash buffer developments should be part of the programme envelope design. The latter contributes to market access and a clean exit from the programme, but can reduce the incentives for reform over time.

To what extent have the objectives of the economic adjustment programme been achieved or can be expected to materialise in the medium / long term (effectiveness)?

In relation to the objective of covering Portugal's financing gap, the financing envelope was sufficient but only because of the increased access to market funding. Overall, the Portuguese programme met the sovereign financing needs in a dynamic and resilient way to changing circumstances. Contrary to projections, the short-term debt rollover rate reached 100% for the whole programme. State refinancing was facilitated by domestic banks buying more T-bills than expected, which in turn was facilitated by the Eurosystem refinancing conditions. During the second part of the programme, Portugal also made higher than expected recourse to the medium-long term market, on the back of favourable market conditions. This strongly contributed to meet higher than expected financing needs, including the build-up of a sizeable cash buffer.

In relation to the objective of putting the public finances on a sustainable footing, the programme succeeded in reducing the fiscal deficit, stabilising public debt and better controlling fiscal risks. The evolution of the 'budget net of one-offs' points to a reduction of the deficit, from 8.6% to 3.4% of GDP. The structural balance improved by 6.6 pps, broadly in line with the overall improvement requested under the Excessive Deficit Procedure (EDP) procedure for the same period. Privatization proceeds achieved their target and allowed a further reduction of the debt and of the ensuing contingent liabilities for the state. Gross public debt peaked in 2014 and started decreasing in 2015, including due to the use of cash reserves to finance early repayments to IMF. The programme improved the control over the dynamics of central PPPs and SOEs. Fiscal governance improved, but some weaknesses remained. Significant progress has been made in settling arrears, thanks to the special settlement programmes.

Challenges to fiscal sustainability remain. Partly because of the temporary character of some of the measures, continued fiscal consolidation and structural reforms for sustained growth remain crucial. According to the European Commission's 2016 Spring forecast, after programme exit, while Portugal is under post-programme surveillance (PPS), the structural balance deteriorated and was expected to worsen further, including due to the reversal without replacement of temporary measures adopted during the programme; other measures have been unwound. The consolidation of some corporates' liabilities in the general government perimeter should favour better control of the dynamics of the public debt, although risks can still materialize from high contingent liabilities. The new Budget Framework Law was reformed after the end of the programme but its implementation is expected to take several years, while significant expenditure slippages still occurred in 2015. The debt trajectory is particularly vulnerable to a loosening of fiscal discipline and negative economic developments. Continued fiscal consolidation and sustained growth are essential to put debt on a clear downward slope.

In relation to the objective of strengthening the banking sector, the banks' situation improved but vulnerabilities persist. The capitalisation of the Portuguese banking system increased and the funding structure improved during the programme, but not all weaknesses were promptly addressed, as also shown by the post programme resolution of BES and Banif. The NPL increase that occurred during the programme period has not been followed by a significant decrease. Banking sector's profitability remained protractedly negative, and 2015 aggregate improvements are yet to be confirmed on a sustained basis and for all the main domestic banks. All these elements weakened the process of fully restoring market confidence towards the banking sector, posing further pressure on (risk weighted) assets and limiting the reduction in the Eurosystem financing.

Despite the slow progress in developing financial instruments outside the banking system, lending conditions to viable companies have improved for more productive and export-oriented sectors. **Private debt remains high.** Continued rebalancing of the economy towards the tradable sectors would also help accelerate the reduction of private debt and NPLs and, in a virtuous loop, further improve lending conditions. The still high private indebtedness and the ensuing ongoing deleveraging efforts are set to weigh on the banks' balance sheets.

In relation to the objective of underpinning a return to growth, GDP started increasing in 2013 after a deeper and longer than expected contraction. Since then growth has been at the euro area average, so no catch-up has so far occured. The contraction of the Portuguese economy and the rise in unemployment exceeded expectations. Growth turned positive in late 2013 but real GDP in 2015 is still below its 2010 peak. The current account balance displayed a surplus for the first time since the Second World War owing to the collapse of investment and a rebound of savings during the crisis. During and after the programme, exports showed some remarkable resilience playing an important role in the recovery. The upswing in exports was supported by favourable trends in nominal unit labour costs

(ULCs) although the fall in ULCs in the tradable sector has recently partially reversed. The performance of exports induced some rebalancing towards the tradable sector but it is too soon to conclude that there is a permanent sectoral shift or that the economy will be more open in the future.

Structural reforms contributed to some competitiveness gains but their full effects will only appear in the medium-long term. Some structural reforms in the programme are having a positive impact (in particular labour market and housing market reforms) but further progress is needed. There is still a need for systematic assessment of the impact of structural reforms, while many of the changes that Portugal has been seeking to put in place are long-term endeavours. Simulations suggest that reforms implemented under the economic adjustment programme may boost GDP and employment by 2020.

Some macroeconomic risks and medium-term challenges have yet to be addressed to support the sustained recovery of the Portuguese economy. The net international investment position (NIIP) position has broadly stabilised at a very high level and its reduction will require persistent and sizeable current account surpluses. The high indebtedness of non-financial corporations remains a major vulnerability, as deleveraging started but it is set to continue. The banking sector is still vulnerable and can pose fiscal risks due to the existing contingent liabilities of the state. Public debt is still very high and its trajectory is still vulnerable to macro-economic and financial market shock. This requires continued fiscal discipline and makes more difficult to engage in extensive public investment programmes. Looking ahead, investment is recovering but the investment rate is still low when compared to the euro area. In the labour market, while the unemployment rate peaked in 2013 and has been improving since, partially due to emigration, there is a risk it will stabilise at high levels with a large proportion of long-term unemployment.

What has been learned:

When consolidation is excessively based on temporary measures, further improvements may still be needed after the end of the programme. In a climate of reform fatigue, the expiration of temporary measures or the unwinding of other measures without proper replacement is a sign of the insufficient leverage of post-programme surveillance. The corrective arm of the Stability and Growth Pact (SGP) can help deliver some of the needed improvements, as would be the case with any other EU country.

Restoration of banks' viability and market confidence go hand in hand, in a mutually reinforcing process. Policy aimed at addressing the weaknesses of a banking sector in a country subject to a macro adjustment should be implemented promptly and forcefully, in order to avoid delayed tackling of problems that could jeopardise the overall programme's achievements.

What was the rationale for an intervention at EU level and was it coherent with other EU policies?

Anchoring the action of the Portuguese authorities to a set of measures agreed with, and regularly monitored by, the European Commission and the other two partner institutions added to the credibility of the adjustment. This credibility allowed the adjustment to be implemented flexibly when needed. Credibility was mainly based on the content of the programme (including the size of financial assistance) and the ownership of the Portuguese authorities. As mentioned during the stakeholder consultation, the involvement of the European Commission, IMF and ECB (i) added expertise and a European/international perspective to the programme design; (ii) added to the credibility of the adjustment and allowed the adjustment to be implemented flexibly when needed. Monitoring by the programme partners reduced information asymmetries and allowed the necessary changes to conditionality not to be perceived as a sign of wavering commitments by Portugal.

Ownership of the programme by the Portuguese authorities weakened in the second half of the programme. Portugal implemented a wide range of measures during the first half of the programme. Consultation with the main opposition parties and other civil society partners before and during the negotiation of the adjustment programme contributed to this ownership. The setup by the Portuguese government of an *ad hoc* unit (ESAME) for programme monitoring improved coordination and implementation capability. Later in the programme, reform fatigue kicked in and the momentum weakened, when the finalisation of important structural reforms would have been necessary to consolidate achievements and progress further. The absence of a clear plan for a comprehensive reform of the state in the programme and of clear communication on structural reforms may have contributed to this outcome. Another contributing factor may have been the relaxation of the financial constraints as Portugal returned to the market.

The programme kicked in before the crisis really bit. This was appropriate, but may have had an impact on ownership. The macroeconomic adjustment was inevitable. Although it is not possible to construct a credible counterfactual at a time of such changing economic conditions in both Portugal and its partners, the programme made this adjustment less harsh. In the case of Portugal, the programme started before the economic and social impact of the crisis was clearly felt. While this early start was beneficial, it may have led to the programme being blamed for the worsening economic situation and may subsequently have had a negative impact on ownership of the most difficult adjustment measures.

The involvement of the EU was necessary to deliver an adequate financing envelope. The programme could not have been done by Portugal on its own, or by the IMF alone. The size of the financial assistance re-assured the markets, allowed the fiscal adjustment to be gradual, supported the stabilisation of the banking sector, and prevented an immediate and dramatic adjustment with widespread economic and social consequences. In addition, the use of financial resources at EU/EA level (EFSM/EFSF), rather than relying only on bilateral loans, allowed Portuguese to benefit from very low costs once the interest rate margins were removed.

The involvement of the EU programme partners contributed to ensure coherence with other EU policies and the Portuguese experience helped inform the design and clarification of new EU/EA frameworks. Wider EU initiatives contributed significantly to the programme's success. At the time when the Portuguese programme was put together, the so-called "Six Pack" of legislation was being negotiated at EU level. This contained the Directive on national budgetary frameworks. In May 2013, the Directive was supplemented by the "Two Pack". This mandated a role for independent bodies in the preparation of EA countries' budgets and in the monitoring of their fiscal rules. Initiatives at EU level, such as the Outright Monetary Transactions (OMT) programme, contributed to improve market sentiment on sovereign risk with positive spill-over in the banking sector.

The programme targets were aligned with the Stability and Growth Pact. In order to achieve this, the EDP was adjusted to reflect the evolution of macroeconomic conditions, by extending the deadline for achieving the 3% deficit. This was an important step in ensuring coherence.

What has been learned:

The intervention at EU level adds significant value in terms of expertise, credibility, coherence with other EU policies and provides for an adequate financing envelope at very low costs.

Sustained ownership is crucial for programme success. However, ownership can be negatively affected by several factors, including the absence of a strong plan for the most comprehensive reforms, of clear communication on structural reforms long term benefits and on the distributional impact of the reforms, as well as the relaxation of the financial constraints once the country returns to the market. Overall, reform fatigue and time needed for structural reforms to be implemented and yield results raise questions about the optimal duration of a programme and the trade-off between ownership and return to the market.

ANNEX 1
Evaluation process

1. Evaluation method/process

The purpose of the *ex post* evaluation was to assess the economic adjustment programme for Portugal (May 2011 – June 2014) in order to draw lessons for future decision-making and identify areas of improvement for similar on-going or possible future interventions. The evaluation consisted of an *ex post* assessment of the economic objectives, content and results of the programme. It assessed the relevance, efficiency, effectiveness of the fiscal policies, structural reforms and measures to support the banking sector, in the context of the macroeconomic situation of Portugal and the economic challenges it faced. The evaluation draws conclusions also on the added value of an intervention at EU level and coherence with other EU policies. The analysis is primarily economic and based on data analysis gathered from a broad range of sources. This has been supplemented by economically informed programme specific input obtained through a targeted stakeholder consultation. The evaluation is based on information available up to the end of June 2016.

The evaluation has been designed to comply with both the Commission's evaluation standards and international best practice. This annex describes the main procedural and methodological aspects of the evaluation introduced to ensure compliance with these principles. First, it describes the institutional arrangements to ensure the independence and impartiality of the evaluation exercise. Then it sets out the procedure that was followed in undertaking the evaluation. Finally it focuses on the targeted stakeholder consultation.

1.1 Evaluation Questions

The evaluation is structured around five evaluation questions:

How well did the objectives correspond to the challenges faced by Portugal? This question mainly aims at assessing the relevance of the intervention;

Was conditionality appropriate in relation to the intended outputs and results? This question mainly aims at assessing the efficiency of the intervention;

Was the disbursement of the financial assistance appropriate? (Efficiency);

To what extent have the objectives of the economic adjustment programme been achieved or can be expected to materialise in the medium/long term? This question aims at assessing the effectiveness of the intervention and considers the global picture, mainly from a quantitative point of view.

What was the rationale for an intervention at EU level? This question aims at assessing the EU added-value of the intervention and the coherence with other relevant EU policies.

1.2 Inter-Service Steering Group

The Director General of the European Commission's Directorate General of Economic and Financial Affairs' (DG ECFIN) appointed an Interservice Steering Group (ISG) to oversee the evaluation and guarantee its independence. It was composed of senior officials from DG ECFIN, and officials from DG Competition (DG COMP), DG Financial Stability, Financial Services and Capital Markets Union (DG FISMA), DG Employment, Social Affairs and Inclusion (DG EMPL) and the Secretariat General (SECGEN). The ISG provided guidance, ensured impartial supervision during the overall process and assessed the quality and usefulness of the final outcome of the evaluation. The evaluation was carried out by a team of ECFIN economists and not by the operational Unit in DG ECFIN in charge of the Portuguese programme.

1.3 Key Deliverables

In line with the EU Commission Better Regulation guidelines an evaluation roadmap was published on 21st October 2015. After revision by the ISG, the evaluation roadmap was approved by the Director General of DG ECFIN and published on the central, Commission Better Regulation website. The roadmap summarised the design, purpose, scope, issues to be addressed and the evidence to be gathered during the evaluation. Publication of the roadmap gave stakeholders an opportunity to provide feedback on the proposed evaluation.

The evaluation inception report was submitted to the ISG who discussed and approved it on the 16th of October. The inception report laid the groundwork for the subsequent data collection and analytical tasks. It outlined the reasons behind the request for financial assistance from the Portuguese authorities, presented the main elements of the programme, set out the evaluation methodology and put forward a tentative timetable for each of the steps of the evaluation process.

Following the approval of the inception report, the evaluator proceeded with the collection of data on which to base a comprehensive assessment of the programme. On the 17th of March 2016, after the data collection had been finalised, the ISG discussed the Interim report. The interim report provided a detailed analysis of the evidence gathered during the desk and field research that had been undertaken.

On the 31st of May 2016, the draft final report was discussed with the ISG. Overall, the draft final report was covering all the evaluation issues with proper analysis and was assessed as a proper basis for the workshop.

On the 14th of June 2016, the preliminary findings of the evaluation were discussed during a workshop with academics and experts. The workshop was organised by the evaluator under the guidance of the ISG. The final outcome of the evaluation benefited from the resulting open exchange of views.

After discussion on the 5th of July 2016, the ISG approved the final report. As mentioned, the ISG was composed of representatives from DG ECFIN, DG COMP, DG FISMA, DG EMPL, and SECGEN.

The Portuguese authorities were called to express their views on the outcome of the *ex post* evaluation. These views are published as an annex to the report.

1.4 Data Collection and Stakeholder Consultation

In addition to analytical work based on data and published documents, the evaluation team engaged in a wide stakeholder consultation, covering individuals and bodies involved in the programme, EU Member States, Portuguese authorities and other Portuguese stakeholders. The inputs into the analytical work included publically available data, Commission, ECB and IMF reports, documents published by the Portuguese authorities and other international organisations as well as private sector and academic research. European Commission staff members who were involved in the Portuguese programme participated in interviews and meetings with the evaluation team. ([229]). Meetings with relevant representatives of the ECB, the IMF, the ESM and EFSM also took place. In addition, a targeted stakeholder consultation, through written questionnaires, has been undertaken to contribute to a broad, multi-dimensional and triangulated understanding of the economic and financial issues surrounding the programme. This involved the Ministries of Finances of all EU Member States and a number of Portuguese stakeholders. Further details are provided later in this annex. From the 15th to the 17th of February 2016, meetings to collect information and assessments on a number of issues took place in Lisbon with relevant Portuguese authorities/agencies. The evaluator contacted the relevant Unit at the Ministry of Finance and sent the list of issues to be addressed during these meetings in advance. On the

([229]) This included officials working in the Portuguese country desk (Unit ECFIN.G.2) or in relevant horizontal units – both during the evaluation and previously – and officials working in other DGs who had been involved in the design and implementation of the programme.

basis of this list, this Unit provided assistance in identifying the relevant authorities/agencies and the appropriate interlocutors within and outside the Ministry of finance.

To answer the evaluation questions, the evaluator focused on the lines of enquiry listed below:

Match between the Programme's objectives and the challenges faced by Portugal: the evaluation considered the economic and financial situation in Portugal in the run-up to the request for financial assistance. The analysis of the build-up of external and domestic macroeconomic imbalances provided the necessary context. This served to assess whether the objectives of the programme were the right ones.

Appropriateness of overall programme design and outcomes: the evaluation considered the efficiency of the economic adjustment programme. It assessed the economic rationale linking measures with intended results with a view to looking at its efficiency. The intention and result of the measures were looked at in terms of how and whether they contributed to the original objectives. The assessment consisted of a qualitative analysis, supplemented by the examination of relevant economic and financial data. The evaluation took into consideration the development of the overall context, including the broader international economic outlook, spill-over effects, changes in the euro area institutional framework and the ECB monetary policy measures. The evaluation included assessing the focus ([230]), pace and timing ([231]), flexibility of conditionality ([232]) and comprised an analysis of the development of a number of key socio-economic indicators for a better understanding of the extent to which the burden of adjustment has been evenly shared across Portuguese society.

Achievement of the objectives of the economic adjustment programme: the evaluation identified and examined relevant economic/financial data and complemented this with a qualitative analysis. Considering that the evaluation started shortly after the end of the intervention, analysis focused on the results (short term) rather on the medium-long term impact of the intervention (which cannot be observed yet).

Appropriateness of the programme financial envelope: the evaluation assessed whether the financial envelope adequately covered the financing gap and the need to ensure financial credibility also under adverse scenarios. This included an analysis of the indicators on the Portuguese sovereign's access to market during the programme period and a comparison with other EA countries and the EFSF/EFSM.

Level of ownership and administrative capacity of the Portuguese authorities

Rationale for an intervention at EU level: qualitative analysis focused on identifying the added-value of an EU-level intervention, in terms of EU-led policy dialogue and monitoring and the collection of financial resources at EU/EA level rather than only relying on bilateral loans or IMF financial assistance. The analysis included the coherence of the main measures of the economic adjustment programme with other EU policies. ([233])

1.5 Qualitative Approach supported by Statistical Evidence

([230]) This entailed evaluating whether measures were relevant in relation to the economic challenges faced by Portugal (design) and whether significant relevant measures were missing from the programme (design).
([231]) This entailed evaluating whether important measures were only included at a later stage (design) or their implementation schedule was not appropriate (design) and whether their implementation was delayed compared to initial plans (outcome).
([232]) In relation to unexpected developments (exogenous factors) and/or results falling short of goals. This implied assessing the extent to which measures led to intended or unexpected consequences.
([233]) Qualitative analysis focused on assessing whether the main measures of the economic adjustment programme were coherent with previous assessments made and whether they were in line with the relevant EU policies - this analysis focused on the main policy fields where co-operation with other DGs had been pursued within the programme framework. It was based on interviews with the officials of other DGs who were involved in the programme context.

The evaluation is primarily qualitative, but strongly supported by statistical evidence. The evaluation is based on economic judgement, rather than on an econometric analysis of data. While qualitative analysis considered the possibility of alternative actions, the assessment was not based on building counter-factual scenarios. The use of a macro economic model is not appropriate in the context of an *ex post* evaluation of such a multi-faceted programme due to the exceptional nature of the crisis (especially in the euro area context of the time) and the importance of the political context and other unobservable and/or exogenous factors. For these reasons it would not have been practical to use DG ECFIN's QUEST model for this *ex post* evaluation. The approach taken allowed a much wider range of factors to be taken into account, which can deliver conclusions that are more relevant in terms of institutional learning. To the extent possible, the evaluation is placed back in the context that existed at the time of the programme, in Portugal and in the euro area in general.

1.6 Strengths and Limitations

The evaluation process has been robust and the data gathered has been reliable. The process has benefitted from the input of a wide range of relevant skills, expertise and experience – both in the team of ECFIN economists undertaking the evaluation and in the ISG overseeing the process. In addition, the evaluation has benefitted from the input of academics and experts who have stress tested and validated the analysis and provisional findings. A significant volume of relevant and reliable data was available on which to base the evaluation, including form a wide range of informed stakeholders.

Economic adjustment programmes must be flexible in order to react to both internal and external changes of economic circumstances, which are bound to be substantial in countries that have requested external assistance. Uncertainty is also very high and structural changes need to occur in countries experiencing crises. The quarterly reviews allow close monitoring of the implementation and prompt adaptation of the different sets of measures to evolving circumstances. There is a continuous loop between design and implementation which makes a programme a "living body". In this context, considerations about design and implementation are difficult to disentangle and do not necessarily allow useful conclusions to be reached.

This evaluation focuses on the initial design of the programme, how conditionality evolved during time, programme implementation and achieved results. The analysis in the different sections of the report is structured by distinguishing, to the extent possible, between the original design and the implementation of the programme. In assessing the original design, the evaluation compares the initial programme with the key challenges faced by Portugal. In assessing the implementation, the results achieved through the implementation of specific conditionality – as it has been adapted over the course of the programme – are analysed. Each section also includes an overall assessment with respect to the objectives of the programme (Section 1 sets out the intended results and impact within the intervention logic of the programme). These assessments are complemented by Section 8 where the macroeconomic outcomes and remaining challenges are analysed. Section 7 focuses on social developments. Drawing for the previous sections, the overall conclusions (Section 9) are then structured along the evaluation questions and directly provide replies in terms of relevance, efficiency, effectiveness, added value and coherence with other EU policies of the programme.

The evaluation encountered some limitations, particularly with respect to the non-availability of some individuals involved in programme design/implementation and the relatively short time since the end of the programme. This hampers the ability to draw strong conclusions on the sustainability of some programme's achievements. The programme dates back to 2011; in some cases officials who were directly involved in its design or in the early stages of its implementation are no longer working for DG ECFIN. This is also the case for staff of the other institutions and for Portuguese officials. Whenever possible these officials were called to participate in meetings, despite having moved to other assignments. The evaluation found out that, for the main issues, their replacements were generally able to provide the necessary information and assessments.

The fact that this *ex post* evaluation started one year after the end of the programme represents a limitation for making a definitive assessment about the medium-long term objective of return to sustainable growth. A number of structural reforms that are crucial on a medium-long term perspective and that started under the programme have not yet been finalised, making it difficult to reach concrete conclusions on their longer term impacts.

2. Summary of the targeted stakeholder consultation (responses to written questionnaires)

A number of bodies that can be expected to have an informed economic understanding of the Portuguese programme and the context in which it was implemented were addressed through written questionnaires. In this framework, the Ministries of Finances of all EU Member States (MoFs) ([234]) and a number of Portuguese stakeholders were consulted. ([235])

A non-exhaustive and non-specific summary from the replies is reported below. The reference to 'respondents' or 'stakeholders', 'MoFs' or similar references must not be interpreted as majority, tendency, unanimity or necessarily 'more than one'. This summary aims at providing an overview of the main controversial assessments mentioned in at least one reply. This is not a statistical exercise based on sampling, representativeness and questions with closed answers, so this kind of assessments would be inappropriate. ([236]) Of course, not all suggestions could be reported, but they have duly been taken into consideration in the analysis.

2.1 General on the economic adjustment programme

According to MoFs, the overall focus of the programme was appropriate, given the challenges that brought Portugal to ask for financial assistance. The programme was detailed and flexible enough, considering economic developments, political environment and exogenous factors, such as the 2012 Greek debt crisis. Nevertheless, reference is also made to occasional excessive leniency with respect to the fiscal efforts and the speed of structural reforms. Respondents from Portugal (PT respondents) are divided about the appropriateness of the overall focus, flexibility and level of detail of the programme. When PT respondents express negative assessments about the focus of the programme, this translates into remarks about a number of measures included in the programme (see later in this summary) and suggestions of other measures that would have been relevant, including measures to maintain/create jobs, help transition of the economy from low to high productivity sectors, improve access to finance especially for SMEs, support private investment in the tradable sector, encourage entrepreneurship, reform taxation and social security systems, introduce a guaranteed minimum income, increase the minimum wage and better tackle the SOE's debt overhang.

PT respondents acknowledge the improvement in public finances, the increase of exports and rebalancing of the external accounts, the restoration of confidence and of market access at favourable interest rates.

([234]) A written questionnaire was submitted from the 3rd of November to the 8th of December 2015. 8 Member States sent a written reply.

([235]) A written questionnaire was submitted to 19 Portuguese stakeholders. These stakeholders were: *Employers' organisations*: Confederação Empresarial de Portugal (CIP), Associação Empresarial de Portugal (AEP), Confederação do Comércio e Serviços de Portugal (CCP), Câmara de Comércio e Indústria Portuguesa (CCIP); *Workers' organisations*: União Geral de Trabalhadores (UGT), Confederação Geral dos Trabalhadores Portugueses (CGTP-IN); *Banking sector*: Associação Portuguesa de Bancos (APB); *Consumers' organisations*: Associação para a Defesa dos Consumidores (DECO); *Public authorities*: Autoridade da Concorrência (AdC), Conselho das Finanças Publicas, National Energy Regulatory Authority, National Authority for Mobility and Transport (AMT); *Charitable organisations*: Honra da União das Misericórdias Portuguesas (UMP), Santa Casa da Misericordia, Caritas, Fundação Francisco Manuel dos Santos; *Research/academia*: Professors of economics in different Portuguese Univesities.

The written questionnaires were submitted from the 3rd of November 2015 and replies were accepted until the end of the year. Direct contacts were made in order to ensure immediate consideration and maximise the rate of response. In the end, 13 of the above mentioned stakeholders participated to the consultation. Coverage was satisfactory.

([236]) Questions with closed answers are included in the questionnaire to the MoFs, which are a homogeneous population of stakeholders.

Respondents, including MoFs, acknowledge that the programme (including funding and monitoring) significantly contributed to the improvement in the investors' confidence and return of Portugal to the financial markets. This outcome was also supported by the ECB policy and the significant decline of interest rates at international level, by progress in the banking union and single supervisory mechanism and by the ownership and commitment of the Portuguese government coupled with flexibility of the EU partners. Nevertheless, PT respondents also mention that the programme led to unintended consequences, such as in terms of employment, growth, purchasing power of the middle and lower classes, children poverty, housing, access to services, credit to the economy and insolvencies. PT respondents are critical about the short-term perspective of the programme. It is mentioned that the importance of low productivity and highly debt-dependent activities in the Portuguese GDP growth was underestimated, while the private sector capacity to adjust to stricter credit conditions, lower public spending and higher taxes was overestimated. It is reported that the programme should have better communicated the impact of reforms in the medium-long term and should have been quicker in adjusting the macroeconomic scenario.

2.2 Fiscal Policy

MoFs assess that fiscal consolidation was appropriate in size and not too frontloaded. When PT respondents are critical about the excessive intensity and rapid pace of fiscal consolidation, the main supporting arguments refer to the consequences in terms of economic recession, unemployment, bankruptcies, loss of high quality jobs, emigration and excessive impact on middle class' income level and risk of poverty. PT respondents also consider that fiscal multipliers were overoptimistic and the sensitivity of tax revenues to domestic demand contraction was underestimated. It is mentioned that the effort should have been spread over a longer period of time to allow for a durable reduction of current expenditure, while safeguarding productive public investment. The opinion was also mentioned that the intensity and pace actually followed were the best possible, because as time passed political resistance to consolidation could be expected to grow.

PT respondents acknowledge that structural (instead of nominal) fiscal targets might make the adjustment less sharp, but correcting for the cycle is difficult, especially for an unstable economy in need for structural changes. It is stressed that fiscal consolidation has to go hand in hand with structural reforms. A scenario with less fiscal consolidation and more structural reforms may even be preferable. It is mentioned that the programme should have focused on both fewer areas and structural consolidation measures.

MoFs broadly agree that the composition of fiscal consolidation was appropriate and flanked by an adequate set of fiscal-structural measures. PT respondents stigmatise the excessive weight of tax-increasing measures. Nevertheless, it is also mentioned that the share of revenue-based consolidation was appropriate. On the expenditure side, PT respondents are critical about the emergency (non-structural) and easily reversible measures adopted during the programme (such as the cuts to wages and pensions) and the significant cuts to productive public investment([237]). It is also mentioned that the reduction in social transfers was excessive. An effective medium-term spending framework would have contributed to a consolidation more based on expenditure-reducing measures, with fewer cuts in the short-term, but a larger reduction in the m/l term, with a positive impact on the economy via less taxes and higher productivity. The need for the actual implementation of a deep reform of the State is mentioned. In this area resistance to change was strong and achievements are insufficient. An in-depth comprehensive spending review and a civil service reform should have been frontloaded.

([237]) Nevertheless, given the emphasis on public and SOEs' investment that preceded the crisis and the improvement in infrastructures following EU accession, it is also mentioned that relatively large cuts to capital expenditure were appropriate. The opinion is also reported that even more cuts to capital expenditure would have been appropriate to reduce the impact on current expenditure. Attention is drawn to the role of current expenditure in fuelling consumption.

Some criticism arises about the tax measures implemented during the programme. It is stated that, with the exception of property taxation and CIT reduction([238]), the revenue measures included in the programme did not consider enough the impact on the economy. The initial focus on indirect taxation instead of direct taxes would have been less harsh on the economy, but it had to be abandoned because of the need for additional revenue. It is mentioned that the programme did not correct instability and complexity of the tax system and the tax hikes introduced during the programme are to be considered temporary. The tax base is still limited and tax evasion is still strong. The opinion is also put forward that the strong increase in the tax burden on labour (also for lower incomes) was unfair, also in view of the concurrent CIT reduction.

2.3 Fiscal structural measures

PT respondents are positive with reference to the progress made under the programme on the control of expenditure commitments, reporting of fiscal risks, the establishment of an independent fiscal council and of a Budget Support Technical Unit. It is mentioned that the overall reform of the fiscal framework and public finances management was implemented later than it should have been. The need for accrual-based accounting and budgeting systems is still reported. It is mentioned that medium-term targets were substantially and frequently changed. The new Budget Framework Law should now reinforce the macroeconomic responsibility of the Minister of Finance, while giving line ministries more autonomy and responsibility for the management of their programmes. It is reported that the strategy for the settlement of arrears was beneficial, even if it could have been accelerated and more attention could have been devoted to the underlying dynamics of hospitals' funding.

It is mentioned that the programme provided for an integrated and consistent approach to reform the financial management of local administrations. The progress was weaker at the regional level. It is mentioned that, in general, further improvements are needed to strengthen alignment between national and local priorities and to ensure strong professionalism in the management of resources. Reference is made to problems that remain with respect to numerical fiscal rules (implementation of the new setting and frequent annual changes).

Despite the fact that discussions on the reorganization of public administration started long before the programme, PT respondents suggest that more structural progress should have been made in this area. It is mentioned that structural transformation was and is still needed. Measures should have been as detailed as possible, avoiding repeated postponements. The plan for the reform of the State came too late and it was not streamlined and detailed enough (no clear timetables and responsibilities). It is also mentioned that, in general, the reform of the State requires a serious social dialogue and should not impact on the quality of services to citizens and businesses or on the efficiency of the public administration. When it is mentioned that the quality of public services was impacted by expenditure cuts, reference is mainly made to the impact on services' proximity.

PT respondents acknowledge that PPPs re-negotiation allowed savings. The new framework law on PPPs and the set-up of a technical unit for project monitoring are considered positive developments. It is acknowledged that problems still exist. It is mentioned that re-negotiations may have implied contractual changes that may reduce future commitments of private partners and may increase future spending for the State.

PT respondents acknowledge that the measures implemented under the programme improved the framework conditions of the SOE-sector and contributed to reduce contingent liabilities. A number of privatisations took place and restructuring plans were implemented in several SOEs, allowing for better operating performance. It is also acknowledged that problems still exist. It is mentioned that important

([238]) Nevertheless, it is also mentioned that the CIT reduction may favour the low-productive non-tradable sector, while efforts should focus on exporting firms.

structural decisions seem to be still needed and cuts that improved performance can be reversed. Privatisations alone are not likely to solve SOEs' difficulties, because the public tend to consider these firms as a public concern and this gives a strong bargaining position to the private shareholders relative to the State. It is highlighted that costly contingent liabilities are still related to "swaps" that have been submitted to the judgment of the competent Courts. The opinion also emerged that expenditure savings should not be the leading factor in making decisions about the involvement of the State in companies that can be key tools for intervention in strategic sectors of the economy.

PT respondents mention that privatisations helped reducing the weight of the State in the economy, reducing public debt, were successful in attracting foreign capital and contributed to improve competition and quality of services in specific sectors. Nevertheless, it is also reported that the process was led more by the urgent need to reduce debt (in a period of financial distress) rather than by a clear strategy about which sectors should be entrusted to the private initiative, also considering the inflow of foreign capital. It is also mentioned that privatisation of public services should have been decided in the context of an effective social dialogue, including for the purpose of maintaining jobs and ensuring quality, access and appropriate costs of services. It is highlighted that more could have been done for the sale of properties of local and regional administrations and, in some cases, for earlier privatisations of public transport companies.

PT respondents are positive about the reform of revenue administration. It is reported that greater priority could have been given to the relation with tax-payers and to reducing the administrative burden for companies. PT respondents stress that tax cases above €1 million have not been significantly accelerated and that the tax and social security administrations have not been merged.

PT respondents are critical about the measures to reduce the public wage bill. Respondents acknowledge that staff of the central administration has been reduced (to a lesser extent at local level). For the purpose of reducing staff, limiting admissions is important, but a balanced approach for the renewal of available skills should be considered. It is mentioned that measures did not properly address problems in terms of structure of the public sector wages (including differentiation according to responsibility, expertise and performance), recruitment, mobility and career expectations. It is reported that the public sector has difficulties in attracting and retaining people with the necessary skills. This weakens the capability of public administrations and may have increased the need for external technical advice. The issue of remunerations is particularly controversial. It is reported that there is a public wage premium for less skilled occupations, while the relatively higher cuts on higher wages contributed to the loss of the most qualified employees. Nevertheless, it is also mentioned that in general the wage premium has been reduced. The opinions also emerged that corrections to public wages should be part of a proper negotiation process and that wages in the public sectors should be based on a different rational than in the private sector.

Concerning pension expenditure, PT respondents are critical about the temporary, emergency nature of the adopted measures and the absence of a proper structural reform to ensure sustainability and equity. It is also mentioned that cuts should have been more selective and focused on the highest pensions. It is suggested that cuts in pensions should have been subject to social dialogue.

PT respondents acknowledge that the inefficiency of the health system required intervention and that the programme contributed to the reduction of its costs. In particular, the reduction of public spending in pharmaceutical products is acknowledged as a positive development as well as the rationalisation of the health services network. There are concerns about the temporary nature of some savings and the need for further structural changes, for example regarding the hospital restructuring. The opinion that the programme measures have worsened access to health services for significant parts of the population also emerged. Nevertheless, it is also mentioned that changes were implemented without a significant drop in the quality or interruption of services.

2.4 Financial sector measures

MoFs are positive or neutral about the health and viability of the financial sector, and they consider that conditionality concerning the financial sector was properly designed and implemented.

Also PT respondents make reference to progress in the restoration of health and viability of the financial sector. Nevertheless, it is also mentioned that at the end of the programme there were still serious cases of weak financial institutions, while the system had not been restructured as it should have been. It is reported that, in general, financial institutions' leverage, funding, solvency and efficiency improved. In the context of an economic upswing in its early stages, profitability is still low, mainly due to the high volume of NPLs, low interest rates and high private indebtedness. It is mentioned that the availability of € 12 billion for recapitalisation was important to restore confidence in the banking system. The onerous conditions of the CoCos are highlighted. This had an impact on the financial institutions' performance and created incentives to repayments/capital increases in an unfavourable economic and financial context.

It is mentioned that the deleveraging of the financial sector should have been slower. Reference is made to insufficient bank financing to the economy, in particular SMEs and households. Nevertheless, it is also reported that the relative weight of lending to exporting firms increased. It is mentioned that the programme should have focused on the development of financial instruments alternative to bank financing, particularly for SMEs. The opinion emerged that credit shortage contributed to insolvencies that could have been avoided.

PT respondents are critical about the outcome in terms of reduction of NPLs and private sector indebtedness. It is mentioned that the schemes for non-judicial restructuring of corporate debt (PER and SIREVE) were revised, but at a late stage. It is acknowledged that PER has been successful, but the restructuring process is slow. Additional changes to the rules on recovery of claims by the State would have been warranted, as the tax authorities challenge the businesses' recovery plans. No specific mechanisms have been created to support personal insolvencies. It is mentioned that the less favourable tax treatment will contribute to contain private indebtedness in the future.

Reference is made to the measures that have been implemented to strengthen the banking supervision and resolution framework. PT respondents mention that at first the programme concentrated on liquidity and deleveraging issues, but not sufficiently on the structural weaknesses of the banks' balance sheets, linked to a large extent to those of the economy.

2.5 Structural reforms

MoFs are of the opinion that the structural reforms in the programme covered the major elements to address long-standing structural weakness of the Portuguese economy, in particular in terms of competitiveness. It is mentioned that the level of public and private debt is still high. On the adequacy of the programme in addressing long-standing structural weaknesses, PT respondent are divided. It is mentioned that there should have been clearer communication about the necessity of structural reforms to underpin future growth and competitiveness and about the logic of the interaction between the different reforms. The criticism arises that structural reforms were too much focused on raising competitiveness through wage cuts and labour deregulation, but other essential measures were missing, including policies to promote research and innovation, renewable energies, workers' qualifications and skills, liberalisation of some markets, a reindustrialisation plan and further productivity-enhancing investment.

MoFs broadly agree that the pace and sequencing of reforms were appropriate. It is mentioned that the pace of reforms should be maintained and the effective implementation stepped up. In view of PT stakeholders, structural reforms should have been more frontloaded and the pace of implementation accelerated. There were delays and deficit of implementation in some reforms, such as the measures to reduce rents in the energy sector so as to curb the high energy prices, which heavily weigh on Portuguese companies' competitiveness.

Regarding the outcome of structural reforms, opinions are divided. It is mentioned that some improvements are merely on paper (such as about competitiveness), while in other areas the programme was successful as marked, for example, by a return to growth and the correction of economic imbalances (e.g. current account and public finances). The economic outlook remains fragile. Structural reforms should remain top in the policy agenda. There is also a need to better evaluate the quality and impact of these reforms, their enforcement and the way they are financed. Attention is drawn to the latest IMF Art IV report showing that companies perceive labour market reforms as having had more impact on the reduction of production costs than product market reforms.

On labour market reforms: PT respondents both support and oppose the reforms to employment protection legislation for workers with permanent contracts. It is acknowledged that, because of uncertainty and depressed economic conditions, employers still tend to prefer temporary or fixed term contracts, but after a while some of them are converted into permanent ones. The number of permanent contracts is increasing. Nevertheless, the opinion is also reported that these measures did not bring about the expected improvements in terms of employment and reduced segmentation.

PT respondents are divided also about the measures taken to address benefit traps and incentivise return to employment. When the direction is assessed as appropriate, further progress is deemed necessary. The criticisms arises that cutting social benefits when labour demand is scarce results into less social protection for the most vulnerable with no improvement in employment. More attention is called for jobs' quality. No respondents think that the programme should have envisaged a cut in the minimum wage, due to the negative implications for in-work poverty, the political impossibility of implementing such measures or because it is productivity not wages that are the issue. It is mentioned that the measures to improve employment programmes have been beneficial, but also that further progress is needed.

PT respondents who think that the 'fiscal devaluation' measure (shifting the tax burden away from employer social insurance contributions) envisaged in the original programme should not have been implemented provide two main reasons: it would have placed an unfair burden on employees, and, in a wider perspective, struggling for price competitiveness through this type of measures was not the best way forward. PT respondents who support fiscal devaluation consider that it has the potential to facilitate restructuring of the economy in the short term. It is also mentioned that that poor design and presentation of the "fiscal devaluation" proposal was a major reason why it was not ultimately implemented.

PT respondents agree that improving low skills levels, cutting early school leaving and improving the relevance and quality of training provision are critical challenges for Portugal. It is mentioned that Portugal's early school leaving rate has fallen significantly, but still remains high. There are differing views on whether the measures in the programme were appropriate or would prove to have been effective. The respondents who are more positive on the contribution of programme measures to tackling Portugal's skills gap stress that there is still more to do. The doubt is also expressed as to whether to date the Portuguese authorities have committed to real reform to improve the skills of employed people. It is suggested that further measures should be taken to tackle the skills' gap.

On product market reforms: PT respondents acknowledge that the programme contained significant reforms of goods and services markets to remove restrictions to competition and reduce prices, but many of them often experienced delays, insufficient implementation and have delivered limited results for business and consumers so far. Vested interested in some industries remain and maintain their considerable influence.

PT respondents consider that liberalized supply of natural gas increased significantly, however prices have not become more competitive compared to EU prices. In the electricity sector, the impact of liberalization in terms of prices has been mild. Electricity prices have actually increased between 2011 and 2015, while the overall tariff debt increased by € 3.3 billion in that period. In the telecommunications sector all the measures foreseen in the Memorandum were adopted, but it is difficult to assess their impact on competition and prices. Also in the postal sector the programme measures were implemented, but in spite of liberalization of the market, there is still no competition for standard post delivery services, to the detriment of consumers. In the transport sector, most but not all programme measures were implemented and there were delays. Reforms in the ports system allowed some decrease of port operating costs, but the pass-through to port users is hampered by the non-renegotiation of existing port concessions. The new horizontal law on regulated professions was successfully implemented, although further actions to increase competition would be warranted.

PT respondents argue that progress in the reform of the judicial system was insufficient, as judicial procedures are still very slow and expensive, and inefficiency of the judicial system is quoted as one of the main factors discouraging investment in Portugal. The competition enforcement was reinforced during the programme with regard to institutional and legislative aspects and respondents consider that the reforms brought significant improvements. It is reported that the programme measures to improve public procurement processes increased publicity and transparency, although specific measures to further facilitate SMEs access would have been warranted. It is also mentioned that excessive centralisation is not the way to improve public procurement. It is noted that measures to improve the business environment allowed Portugal to move higher in international competitiveness rankings, but they have had limited impact on daily activities of Portuguese companies. PT respondents are broadly positive on the long-awaited reforms of the housing market aimed at increasing the offer in the rental market, also for its social impact as they allowed families to afford a home without further getting indebted.

2.6 Social impact

PT respondents consider that the burden of the adjustment has not been evenly distributed across the Portuguese society, with the middle and low strata of the population bearing most of the costs. It is mentioned that pensioners, civil servants and the most vulnerable were particularly penalised as a result of the significant cuts in pensions, public wages and social transfers (such as unemployment benefits). It is also deemed that austerity policies were felt in the budgets of social functions of the State such as health, education and social protection, hampering access of the population to these services. Furthermore, it is mentioned that the tax increases during the programme have fallen disproportionately more on the middle and lower income households. PT respondents criticize that the programme did not propose solutions to face the inevitable social consequences of the sharp recession. Nevertheless, it is also mentioned that measures were designed to protect minimum income standards, including updating basic pensions and the widespread application of means-testing.

Social outcomes of the adjustment mentioned by PT stakeholders include the drop in purchasing power of families, rising risk of poverty and social exclusion, worsening inequalities and higher than expected unemployment, which led many people to emigrate. The emigration of qualified staff is very negatively assessed for being very costly to Portugal.

Concerning social support expenditure, it is mentioned that programme measures focused on enabling short-term financial savings, but did not deliver a proper rationalisation of the welfare system.

The criticism arises about the lack of real social dialogue underpinning the programme, as the opinion of social partners had no material influence in the configuration of the programme measures. PT respondents mention that the programme should have benefited from more social dialogue and should have been more in line with the tripartite agreements for competitiveness and employment signed in March 2011 and January 2012. Nevertheless, the notable social peace experienced throughout the whole period is acknowledged.

2.7 Amount and terms of the financial assistance

According to MoFs, the amount of financial assistance provided to Portugal was appropriate. The relatively large cash buffer at the end of the programme allowed investors to be confident in the ability of Portugal to withstand market volatility without funding pressure, which in turn eased market access.

MoFs consider that easing the lending terms of EU loans proved beneficial, supporting investment confidence through two channels: direct impact on fiscal sustainability and signalling effect that EU partners were ready to help government's commitment to implementing the programme. The frontloaded disbursement schedule and the earmarking of funds for banking recapitalisation are deemed appropriate.

2.8 Ownership and added value

Most of MoFs agree that the level of ownership of the programme by the Portuguese authorities and their level of commitment to effective programme implementation were satisfactory.

MoFs are of the opinion that European institutions' involvement added value to the achievement of the programme's objective as it added expertise and a European/international perspective to programme design; added to the credibility of the adjustment and allowed the adjustment to be implemented flexibly when needed; ensured coherence with other EU policies; allowed a bigger financial envelope and lower costs of financing.

ANNEX 2
The Portuguese Authorities' views on the ex post evaluation

1. Introduction

The Portuguese authorities take note of the Ex-Post Evaluation (EPE) Report prepared by the European Commission (EC). This exercise, although focused on the EC's role, must also bear in mind the parts played by the European Central Bank and the International Monetary Fund, in view of the three entities' joint interaction with the Portuguese authorities.

The EC concludes that the Portuguese Programme was a "relative success". The Portuguese authorities welcome a more balanced view from the EC than the one expressed by the IMF in its Ex-Post Evaluation of the Programme. The Commission does point out to successes and insufficiencies of the Programme in a more open and constructive way. The Programme was successful in restoring market access and in generating a primary surplus. However, additional efforts are still required to stabilize the financial sector and to overcome structural bottlenecks. In its 2016 Country Report for Portugal, the EC clearly identifies those economic constraints, which hinder competitiveness, prosperity and social cohesion. As important as analysing metrics of the Programme, one should also take a closer look at its social spill-over effects and its monitoring, as the Commission does, since these help to understand the citizens' adherence to the measures.

Understanding drawbacks helps stakeholders to identify areas where action is still needed and to better design policy answers.

2. Weak growth and rising debt

One of the main goals of the Programme was to set the economy on a stronger medium-term growth path.

Since joining the European Union in 1986 Portugal has made enormous progress in economic and social indicators, largely closing the development gap with its European partners. During the 1990s the Portuguese economy converged with its EU partners. However, since joining the Euro, Portugal registered low growth intertwined with recession periods. As the report states, "*the Portuguese crisis mainly resulted from a combination of poor economic performance and lack of competitiveness on the years preceding the crisis and unsustainable public finances*". Poor economic performance led to the accumulation of external imbalances, with private and public debt levels increasing significantly and reaching unsustainable heights. The economy's resilience in face of a crisis was, therefore, strongly affected and Portugal had to request external financial assistance in April 2011, after the government's resignation following parliamentary rejection of a stability programme aimed at strengthening the fiscal position.

Such being the background, and from a formal point of view, one could hardly expect that a three-year Programme might have implemented the economic overhaul needed to boost competitiveness in a recessive environment. There was an over-optimism in target setting. Even reforms that were implemented during the Programme – for instance a comprehensive programme for corporate deleveraging (e.g. created SIREVE as an out of court procedure for debt restructuring, made changes to the insolvency framework and launched the PER) – will take time to produce effects. With the benefit of hindsight, these reforms will need to be fine-tuned and complemented. Programme Capitalizar, for instance, is targeted to fill-in a legacy issue from the Programme regarding the capitalization of firms.

From a substantial point of view, since the strategy was to adjust through the reduction of labour costs, in the hope of attaining quick competitiveness gains, one could argue that this fails to take into account the transformation of the Portuguese economy in the last two decades and to promote a sustainable development model for the future. Portuguese exports increased their weight on GDP from 34.3% in 2011 to 40.1% in 2014, driven by gains both in the extensive and intensive margins: the number of exporters increased by more than 20% between 2010 and 2013 and the share of exports on turnover also increased. Sizeable market share gains recorded in recent years were paired by gains in the terms of trade (export prices outpacing import prices), revealing a significant improvement in non-price competitiveness of the Portuguese economy. The path to be encouraged would be further added-value, not simply cost-competitiveness.

Even considering that internal devaluation takes time, the political and social consequences of that approach must be recognized. The Portuguese authorities welcome the lesson presented by the EC stating that programme measures should be shaped to take equity and social considerations into account, aiming at progressive burden-sharing and protection of the most vulnerable. This was not done in a comprehensive and sustainable way during the programme.

The labour cost-adjustment strategy proposed within the context of a monetary union led to a massive outflow of the labour force. Estimates vary and, according to independent studies, roughly 400.000 Portuguese left the country during the crisis, out of a population of 10.6 million in 2010 – more than the estimates put forward by the OECD. It is unanimous that emigration of qualified staff was very high. The Commission rightly points out that "the emigration of qualified staff is very negatively assessed for being very costly to Portugal." The emigration phenomenon was a direct product of the crisis and, probably, a by-product of the adjustment. This phenomenon is paramount to understand the lack of social adherence to the proposed adjustment. This legacy cost has to be overcome. The country has to create the conditions to promote the return of these workers.

Further thought is needed in order to better understand economic reform implementation during recessions, as well as the political and social impact of those changes. More time is needed to implement a broader reform agenda. Greater understanding of past reform efforts, made before the Programme, as well as convergence objectives with the EU, would contribute to better frame efforts that must be continuous. In this aspect the authorities highlight the analysis of the EC when stating that the "ground for labour market reforms was better prepared as already agreed with the social partners in March 2011", before the signing of the programme MoU in May 2011. Labour market reforms were precisely one of the areas where the Commission found the reform implementation more successful. One can conclude that the reform impetus can derive also from domestic will and from social consensus – something the report consistently downplays. This is paramount to promote ownership and understanding of the reforms. For this very reason the ongoing reforms, which build on efforts made in the past, are being discussed with Social Partners.

3. Financing needs

In May 2011, Portugal signed an agreement with European entities and the International Monetary Fund in order to fulfil its financing needs, as the sovereign was not able to maintain access to market financing under sustainable conditions. During the programme, Portugal managed to build up a significant cash buffer in order to increase its financing resilience to short term challenges.

Portugal managed to successfully complete 11 quarterly reviews and to return earlier than expected to markets. The restoration of access to markets cannot be the only measure to evaluate the success of the Programme. In order to obtain permanent and stable access to financing structural challenges need to be addressed. The National Reforms Programme renovates the commitments towards reform implementation.

4. Fiscal policy

The Commission argues that the Programme was set-up to tackle "broad-based economic inefficiencies" and hence envisaged actions in several areas. It is however undeniable that a clear priority was given to recover and stabilize the fiscal situation.

From the onset of the Programme, there was a sense that public accounts were at the centre of the crisis and, in the preceding years, Portugal had ran large deficits, breaching the 3% goal of the Stability and Growth Pact and accumulating an excessive and fast-growing public debt (compounded, in terms of public perception, be the gradual enlargement of its perimeter, encompassing layers that were not previously considered under the official definition of public debt).

Although a huge effort concerning the public accounts was required and implemented through a significant adjustment process, at the end of the adjustment programme several challenges remained, as goals had largely been set in a somewhat unrealistic way, leading to the recurrent amendment of fiscal targets. The EC also recognizes this.

In 2012 the target was -4.5% and the deficit was -5.7%; in 2013 the target was -3.0% whilst the outcome was -4.8%; in 2014 the target was -2.3% and the deficit reached -7.2%. Moreover, public debt rose from 96% in 2010 to 130% in 2014, above the programme target of 115%.

The proposed pace of adjustment seemed over-ambitious. Although the political line, centred on the 3% target, might have been beneficial to generate confidence, in practical terms goals must be set realistically.

In the public sector, a severe set of cost-cutting measures was applied. Nevertheless, contingency measures – such as the extraordinary cut in wages and pensions – should always be taken as temporary. Only then can they be understood by the public and find legal ground under the Portuguese Constitution.

The EC rightly points out that the structural reforms' "full effects will only appear in the medium-to long term". The authorities agree with the assessment. Some of the reforms started during the Programme – such as the new Budgetary Law, which is being implemented, the renegotiation of PPPs or the control of SOEs – take longer to yield effects. These must continue to be pursued beyond the end of the Programme.

5. Structural reforms

During the three-year adjustment Programme, Portugal took action to address its structural bottlenecks. Indeed, a large number of reform measures were implemented during this period, covering many reform areas such as the labour market, the product markets, the judicial system, education and fiscal structural reforms. While the report recognizes the progress achieved, it argues that in some cases the reforms undertaken fell short of what was needed, such as in the markets products. Also, the report argues that in some areas there is no evidence of positive results and cautions against reform fatigue. The authorities agree with the EC that a greater prioritisation of reform would have been positive to reinforce ownership.

The Portuguese authorities would like to comment on this assessment from three angles: the first refers to the results, the second to the focus and the third to the process.

Results

Concerning results, it is important to stress that structural reforms, by their very nature, are not expected to have positive short-term effects (at least to their full extent), and so there are limits to what a three-year programme can actually achieve within its timeframe. A proper assessment of the effects induced by reforms can only be done in a longer horizon, when the economy manages to fully adjust.

In any case, the visible signs are encouraging in a number of areas. To quote only some examples, Portugal ranks 13th (out of 189 economies) in the Starting a Business indicator of the World Bank, having climbed 11 positions in comparison with 2010; the same is true for the Resolving Insolvency indicator, where Portugal moved from 20th in 2010 to 8th in 2016; concerning Product Markets Reforms, and according to the latest information by the OECD, Portugal is ranked 12th among 33 OECD countries (up by 14 positions in comparison with 2008). Even concerning educational policies, where shifts take longer, Portugal made progress, with the share of early leavers from education and training decreasing from 28.3% in 2010 to 13.7% in 2015.

Although important, these results do not tell us what the effects of reforms in the economy were. However, existing evidence shows that structural reforms in the various areas selected are impacting positively the productivity growth of the best performing firms, which in turn impacts positively the productivity growth of the other firms through a process of catching-up.

The reforms implemented first were those with larger potential gains or for which implementation was easier. Thus, it is natural that the subsequent reforms took longer to be in place or have less incremental gains. In addition, and in the face of such a high number of structural reforms, national authorities need to assess carefully the reforms implemented in order to fine-tune them and to better design new reforms. Although time consuming, this step is crucial to ensure the quality of the reform process. These elements cannot be taken as reform fatigue but simply as a consequence of the process of implementing such an ambitious agenda.

Despite the progress achieved, the reform agenda − in Portugal as in any other country − is never a concluded process and a three-year programme could not be expected to allow for the implementation of all needed reforms without endangering ownership of the process or overstretching administrative capacity.

Focus

A main bottleneck of the Programme’s design concerns the social dimension of the reform process, which was not duly accounted for. Social fairness, and its perception, must be core in any reform programme, ensuring adequate protection for the most disadvantaged. The economic models on which most of the impact assessment was done do not allow for an evaluation of distributional considerations; therefore, the European Commission, together with national authorities, should aim at a more fit-for-purpose toolkit going forward.

In addition, the Programme’s focus on cost competitiveness measures was not appropriate, as a sustained structural adjustment should aim at non-cost competitiveness gains, with a focus on skills and innovation, two of the key areas in the current National Reforms Programme.

Process

There are a number of procedural issues that could have been better tackled and that should be kept as lessons for the future. In particular, the timing of reforms implemented during the Programme was not always optimal. Indeed, some studies show that specific reforms should not be taken in an economic downturn and that there are important sequencing and complementarity issues that need to be considered while setting the reform agenda, as they have a sizeable impact in the final results. Based on a strong quantitative assessment, an effective reform programme should maximize potential gains, while duly taking into account short-term costs, the effects of the cycle and distributional concerns. High short-term costs, on top of having important fairness considerations, harm the sustainability of the reform process, endangering ownership and support. A well communicated reform agenda – one of the lessons pointed-out by the EC - , with a clear identification of potential benefits, ensures ownership and therefore allows for a proper sequencing and bundling of reform measures, not only from a technical but also from a social and political point of view. Ultimately, this will allow for a more efficient, effective and equitable reform process.

6. Banking sector policies

The Portuguese banking system went through a significant adjustment process. For instance, the Programme helped to provide the conditions to regain market access and deposits remained resilient. However, at the end of the Adjustment Programme several challenges remained.

A fair assessment needs to consider the specific context of the Programme's design and implementation, while aiming for a balanced view of achievements and challenges. In particular, the unprecedented difficulties of the sovereign debt crisis need to be accounted for, as uncertainty and market volatility spiked in the absence of an established crisis management framework in the context of a monetary union. Consequently, although ex post assessments are necessarily made with the benefit of hindsight, this does not replace the consideration of a credible counterfactual which, as referred in the report, is not possible to construct.

In more practical terms, it is important to stress that only half of the EUR 12 billion of the Bank Solvency Support Facility were used. The situation of Banco Espírito Santo, to which a resolution was applied shortly after the end of the Programme, and of Banif further eroded public confidence in the Programme outcomes in this area.

Despite some positive signals observed more recently (in terms, for instance, of the banks' financing structure and of firms' deleveraging), the adjustment of the banking sector is still ongoing and some significant challenges persist, notably regarding their profitability and the high stock of Non-Performing Loans (NPL).

The turnaround in the liquidity profile of Portuguese banks is one of the most prominent features of their adjustment. Concerns resulting from the resolution measures applied to Portuguese banks did not have any impact on the retail deposit base of the banking system, thus providing evidence of the public's confidence in the system as a whole.

The Portuguese banking system also had some singularities: i) it was able to generate considerable gains during the first years of the crisis thanks to emerging markets; and ii) it benefited from having a large state-owned bank that functioned as guarantor of the system by absorbing deposits.

An assessment of the implementation of banking sector policies should always consider the evolving nature of prudential regulation and supervision, especially given the intensive reform agenda pursued in the aftermath of the international financial crisis. Supervisory action throughout the programme duly reflected these developments at a global level, becoming more intrusive, pro-active and forward-looking towards the banks' risk profile. The Portuguese authorities' adaptation to this changing environment, in constant interaction and collaboration with the EC and the other institutions, should be underscored.

7. Main macroeconomic outcomes and remaining challenges

Given that one of the main goals of the Programme was to enhance medium-to-long term growth it is important to highlight that, as the EC acknowledges, "in the context of a worse than expected recessionary environment in the EU, growth resumed later than foreseen and only after a larger-than-expected contraction". Real GDP is 4.5% lower in 2015 than in 2010.

Programme-design could not anticipate all the consequences of the proposed adjustment and could not adapt its course over its limited three-year period. The Programme itself proved also to be far too optimistic regarding economic recovery in view of its strong contractionary approach. Important challenges thus remain.

One of the main early macroeconomic accomplishments of the Programme was the swift external adjustment achieved. Positive results were seen regarding external trade, but the recovery only truly began when domestic demand resumed, which was delayed by the contractionary approach of the programme, with its focus on a relatively fast pace of fiscal consolidation and public debt stabilization.

Both public and private investment decreases had a strong negative impact on economic growth, which cannot be "*mitigated by the high level of public investment in the years preceding the crisis*" as the report states.

Labour market improvements after 2013 cannot be dissociated from the strong emigration outflow, namely regarding young highly qualified people, which cannot be seen as a success.

Several structural reforms launched under the Programme are being implemented – and should continue to be so (frequently with sound results becoming visible only in a medium-to-long-term horizon) – but did not manage to remove a number of considerable risks regarding the Portuguese economy, such as product markets' bottlenecks, high indebtedness of non-financial corporations, banking sector fragility, high public debt levels and public sector inefficiency, that still affect external competitiveness and the recovery of growth. This diagnosis is the basis of the National Reform Programme (NRP).

Reform efforts are necessarily a continuous process. In this context, the current National Reforms Programme (NRP) departs from that evaluation and presents an ambitious reform programme with concrete measures tackling the main challenges that the economy still faces (and as also identified by the European Commission in its 2016 Country Report for Portugal). Doing so the NRP already takes on board one of the lessons of the Adjustment Programme as presented by the EC: to set clear priorities and to communicate effectively, in order to increase ownership. The main reform areas are thus skills, innovation, firms' capitalization, modernisation of the public administration, qualification of the territory and social cohesion and equity. The ambition of reform measures in the NRP provides a clear sign that the authorities remain determined to tackle the lingering bottlenecks of the Portuguese economy.

8. Conclusions

Overall, even if the Programme was successful in restoring market access and generating primary surpluses, important challenges remain, particularly in the financial sector and in overcoming structural bottlenecks. The Programme has once again proved that the implementation of reforms should not be seen as an isolated act. Instead, policy stakeholders must focus on implementing reforms as a continuous process. Portugal will carry on pursuing reforms to foster economic competitiveness and social inclusion. This reform effort is comprehensively detailed in the National Reform Programme, which departs from an evaluation of reforms, identifies six priority areas and sets a clear timetable as well as goals.

The Portuguese authorities would like to highlight the commitment shown by the EC staff throughout the duration of the Programme, as well as their efforts to constructively engage with other partners. Portugal remains committed to deepening the dialogue and promoting a closer mutual understanding with the EC within the framework of the Post-Programme Surveillance Missions.

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