European
Commission

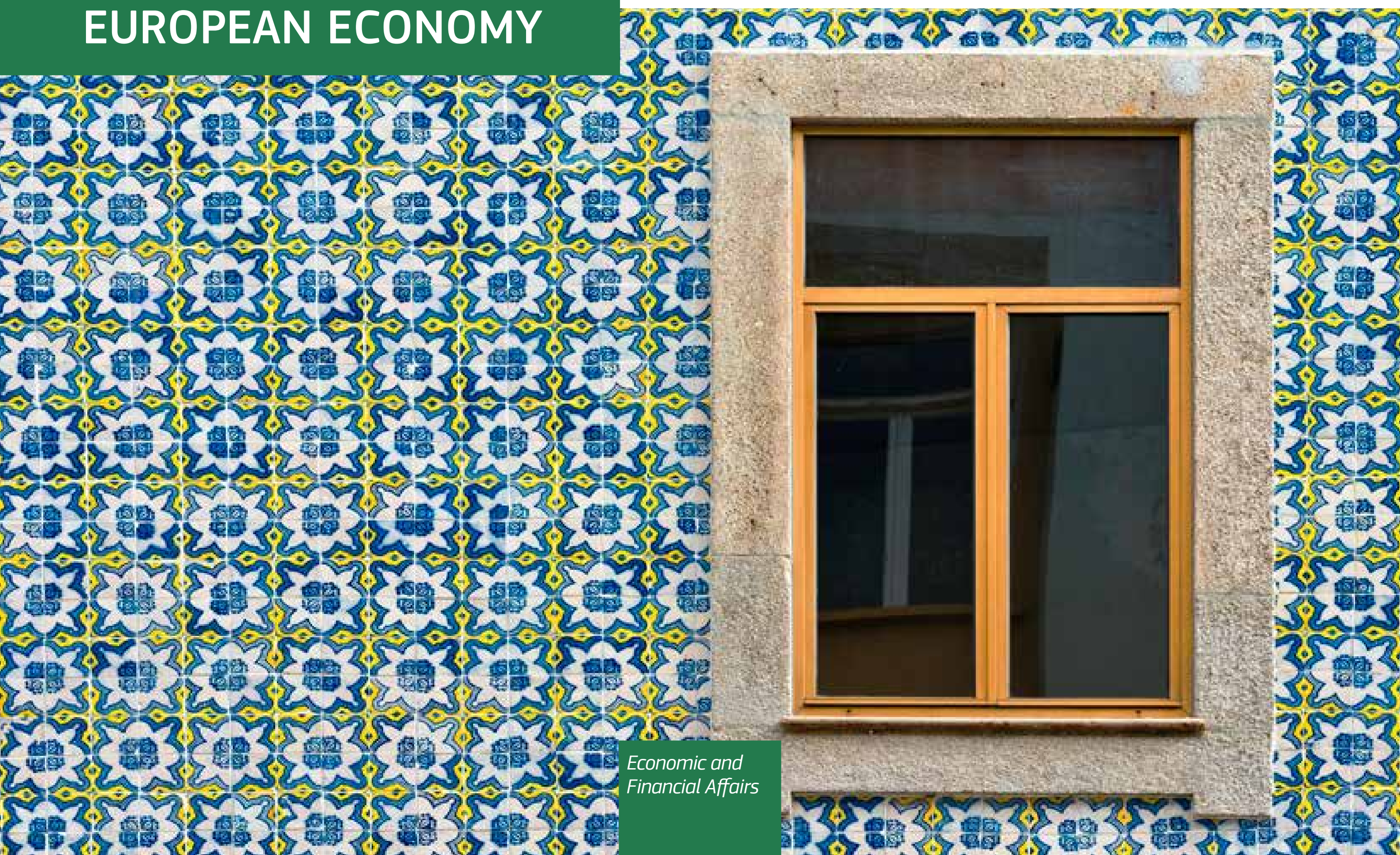
ISSN 2443-8014 (online)

Post-Programme Surveillance Report

Portugal, Summer 2016

INSTITUTIONAL PAPER 036 | SEPTEMBER 2016

EUROPEAN ECONOMY



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Luxembourg: Publications Office of the European Union, 2016

KC-BC-16-036-EN-N (online)
ISBN 978-92-79-54347-0 (online)
doi:10.2765/535215 (online)

KC-BC-16-036-EN-C (print)
ISBN 978-92-79-54346-3 (print)
doi:10.2765/400752 (print)

European Commission

Directorate-General for Economic and Financial Affairs

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ACKNOWLEDGEMENTS

The report was prepared in the Directorate General Economic and Financial Affairs under the direction of Servaas Deroose, Deputy Director General, Carlos Martínez Mongay, Director, and Christian Weise, Head of Unit for Portugal.

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

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This Report reflects information available up until 11 July 2016.

ABBREVIATIONS

AMT: Autoridade da Mobilidade e dos Transportes

AWG: Ageing Working Group

BdP: Banco de Portugal

BES: Banco Espírito Santo

BFL: Budget Framework Law

CAR: Capital Adequacy Ratio

CET1: Common Equity Tier 1

CGD: Caixa Geral de Depósitos

CIT: Corporate Income Tax

CP: Comboios de Portugal

CSRs: Country specific recommendations

CTeSP: Cursos Técnicos Superiores Profissionais

CT1: Core Tier 1

C/I: Cost-to-income

DGAL: Direção-Geral das Autarquias Locais

DGO: Direcção-Geral do Orçamento

DSA: Debt Sustainability Analysis

EBITDA: Earnings before interest, taxes, depreciation and amortisation

EC: European Commission

ECB: European Central Bank

EDP: Excessive Deficit Procedure

EFSF: European Financial Stability Fund

EFSM: European Financial Stability Mechanism

EPC: Economic Policy Committee

EPL: Employment protection legislation

ERSAR: Entidade Reguladora dos Serviços de Águas e Resíduos

ERSE: Entidade Reguladora dos Serviços Energéticos

ESA2010: European System of Accounts 2010

ESI: Economic Sentiment Indicator

ESL: Early school leaving

ESM: European Stability Mechanism

EU: European Union

FAM: Fundo de Apoio Municipal

GDP: Gross Domestic Product

HICP: Harmonised Index of Consumer Prices

IGCP: Agência de Gestão da Tesouraria e da Dívida Pública

IGF: Inspeção-Geral de Finanças

ILO: International Labour Organization

IMF: International Monetary Fund

INE: Instituto Nacional de Estatística

IP: Infraestruturas de Portugal

IPO: Initial Public Offering

MIP: Macroeconomic Imbalance Procedure

MTO: Medium-term objective

NEET: Not in education, employment or training

NFCs: Non-financial corporates

NPL: Non-performing loans

OECD: Organisation for Economic Co-operation and Development

PALOP: Países Africanos de Língua Oficial Portuguesa

PER: Processo Especial de Revitalização de Empresas

PIT: Personal Income Tax

PPM: Post-programme monitoring

PPPs: Public-private partnerships

PPS: Post-programme surveillance

PSC: Point of Single Contact

PSI: Portuguese Stock Index

REN: Redes Energéticas Nacionais

RoA: Return on assets

RoE: Return on equity

RWA: Risk-weighted assets

SCP: Stability and Convergence Programme

SGP: Stability and Growth Pact

SIREVE: Sistema de Recuperação de Empresas por Via Extrajudicial

SIRESP: Sistema Integrado das Redes de Emergência e Segurança de Portugal

SMEs: Small and medium-sized enterprises

SOEs: State-owned enterprises

SF: Spring forecast

SP: Stability Programme

SSM: Single Supervisory Mechanism

T1: Tier 1

UK: United Kingdom

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

UTAP: Unidade Técnica de Acompanhamento de Projetos

VAT: Value added tax

VET: Vocational and Educational Training

EXECUTIVE SUMMARY

This report presents the findings of the fourth post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, which took place in Lisbon between 15 June and 22 June 2016. This visit also served as specific monitoring in the framework of the EU Macroeconomic Imbalance Procedure. Since the conclusion of the third post-programme surveillance mission in February 2016, economic conditions in Portugal have not improved and risks are more tilted to the downside. Economic growth is mostly driven by private consumption, while investment and exports remain weak. High public and private debts and rigidities in labour and product markets still represent a major hindrance to growth. Despite the authorities' commitment to complying with European budgetary rules, more effort is needed to reduce the underlying structural budget deficit during the rest of the year. Amidst some backtracking, progress in structural reforms lost momentum since 2015. A more ambitious reform implementation is urgently needed to further enhance medium-term growth prospects, job creation and competitiveness.

The economic recovery is set to continue its moderate pace, mostly driven by domestic demand with risks stemming from a weakening external environment as well as macroeconomic and fiscal imbalances. Expansionary fiscal measures and positive developments in the labour market continue to support private consumption growth. On the other hand, investment growth disappointed in recent quarters and seems to be held back by high corporate debt and policy uncertainty. Moreover, on the back of declining growth in some main non-EU trading partners also export growth disappointed and is expected to remain feeble in the coming months. Overall, according to the Commission's spring forecast, real GDP growth would be 1.5% in 2016 and 1.7% in 2017. Despite robust job creation the absorption of the large pool of young and long-term unemployed remains a challenge. Low external price pressure and persistent slack in the economy are expected to hold down consumer price inflation in the short-term. Risks to the macroeconomic outlook are tilted to the downside and are mostly related to internal factors, such as high levels of private and public debt and uncertainty as regards the future consolidation and reform path of the government. On the external side, downside risks relate to the outcome of the UK referendum on the membership of the European Union, which could increase uncertainty and weaken Portugal's trade with the UK.

The general government headline deficit reached 4.4% of GDP in 2015, and is expected to be higher than the official targets in 2016 and 2017. Taking into account the revised budgetary plans, detailed specification of all measures of the 2016 Budget, and the 2016 Stability Programme, the Commission's spring forecast projects headline deficits of 2.7% and 2.3% of GDP, for 2016 and 2017, respectively. These are higher than the authorities' targets of 2.2% and 1.4% of GDP for 2016 and 2017. The divergence with the authorities' stems from the Commission's less optimistic macro-economic outlook and lower yields expected from some planned fiscal consolidation measures. Accordingly, while the Commission's spring forecast expects the structural balance to deteriorate by ¼% of GDP in 2016, the 2016 Budget projects an improvement by ¼% of GDP. Due to the limited volume of consolidation measures in 2017, the spring forecast projects a further deterioration of the structural balance in 2017. Macroeconomic uncertainty and possible costs associated with the financial sector weigh negatively on the fiscal outlook.

On 12 July 2016, the Council adopted a recommendation establishing that Portugal did not take effective action to correct its excessive deficit within the 2015 deadline established by the Council in 2013 (see Box 2.1). Consequent to this decision, at the beginning of August, the Council issued a decision regarding the imposition of a fine and a decision to give notice for the correction of the excessive deficit. Considering past efforts and the authorities' firm commitment to comply with the SGP in the future, the Council decided not to impose a fine on Portugal. Yet, it requested the authorities to adopt and implement consolidation measures amounting to 0.25% of GDP by the end of 2016, in addition to the savings already included in the Commission 2016 spring forecast. The Portuguese government is expected to present to the Commission a report on action taken by 15 October. Still pending is the decision regarding the possible suspension of the Structural and Investment Funds, which needs to be taken after dialogue with the Parliament.

The need for fiscal-structural reforms remains substantial and urgent. The implementation of the new Budget Framework Law (BFL), expected to be completed by 2018, is experiencing important delays. Thus, there is a risk that the efficiency gains resulting from improvements in budgeting and monitoring abilities of the public administration would materialise later than planned. The sustainability of the pension system is not yet ensured and might be challenged by the government's reversal of some measures. Other previous reforms are also being reversed, including the return to the 35 hours working week for the majority of civil servants and the freezing of the civil servant requalification scheme intended to boost mobility in public administration. In addition, the costs associated with recent public employment increases may not be fully compensated by the new civil servants hiring policy, indicated in the 2016 Budget, which implies a 2:1 replacement ratio of civil servants. The valued added tax (VAT) reduction for food at restaurants – a backtracking step from a decision taken in end 2011 – became effective as of 1 July. Recent backtracking in reforming state-owned enterprises (SOEs) and partial reversal of some sub concessions and a privatisation entails fiscal risks and could negatively affect the capacity to attract foreign direct investment. Moreover, in order to ensure a low stock of arrears, the commitment control law needs to be effectively enforced, notably in the health sector. As structural consolidation in Portugal requires a durable reduction of the high level of public expenditure, a comprehensive spending review with a clear political mandate and a set of concrete targets for savings is crucial.

The adjustment in the Portuguese banking sector is continuing but weak profitability, low efficiency and high non-performing loans remain a serious concern. The return on assets in the banking sector has been positive since early 2015 but remains very low on the back of weak credit fundamentals and weak asset quality. The average solvency level in the system stood at 12.1% of Common Equity Tier 1 (CET1) although major differences at bank level persist. Banks' financing has also continued to converge to a more stable and sustainable structure. The loan-to-deposit ratio is now close to 100% and total deposits stand at record highs. Despite these improvements, Portuguese banks remain very vulnerable to shocks and exposed to a set of challenges which should be promptly addressed building on past progress to further increase their profitability, efficiency and improve the quality of their capital base. Solutions to improve the quality of banks' balance sheet at system level are still in the drafting phase, whereas the excessive leverage of Portuguese firms is a persistent problem which limits the profitability and outlook of the non-financial corporations segment. A comprehensive plan with solutions to address the high stock of NPLs is urgently needed. The final impact of the sale of Novo Banco and a recapitalisation of Caixa Geral de Depósitos (CGD) on public finances and/or other banks is still unknown.

Notwithstanding some progress, regulatory barriers and rigidities in labour and product markets continue to considerably hamper business growth, competitiveness and investment in Portugal. Institutional bottlenecks remain in most areas, including the labour market, network industries, competition, services and regulated professions, the public administration and the court system. Those barriers are indeed a major factor behind the country's excessive imbalances. To facilitate economic adjustment, a wide range of structural reforms have been initiated during the programme, but implementation bottlenecks persist. In addition, due to the authorities' limited evaluation capacity the impact of those reforms on the functioning of the Portuguese economy remains difficult to assess. Since the end of the programme, reform fatigue has set in, and some backtracking of already agreed measures has set in, notably in the transport, services and judicial sectors. The 2016 National Reform Programme has put forward a number of reforms to tackle Portugal's excessive imbalances. However it fails to adequately spell out the details on the implementation timetable, making it difficult to gauge the efficacy of the reforms in reducing still persistent growth and investment bottlenecks. Reducing these bottlenecks is key for a country like Portugal that is experiencing excessive imbalances and is scrutinised in detail through the MIP specific monitoring. Overall, the government would benefit from detailed ex-post impact analyses to be able to assess the success of the reforms implemented so far and how their implementation could be enhanced.

Sovereign financing and the capacity to repay are currently not a reason for concern but recently more volatile market conditions point to Portugal’s vulnerable position in a more risk-adverse environment. Sound debt management, including early redemption of IMF loans in 2016, has contributed to smoothing the redemption profile and reducing gross financing needs. However, despite a stable bond issuance, bond yields have become more volatile since the beginning of 2016 and their spreads with other EU yields widened. Cash buffers are expected to decline over the medium term, which may increase risks. Portugal is supported significantly by inclusion in the Public Sector Purchase Programme of the ECB. To maintain sound refinancing in the medium run, ambitious and comprehensive measures covering fiscal, banking and structural issues are still needed.

Portugal is making progress with reforms and addressing macroeconomic imbalances, but more is needed to consolidate its recovery. Portugal has made some progress with the implementation of 2015 country-specific recommendations (CSRs), but excessive imbalances still remain, as confirmed by the Commission when presenting the 2016 Country specific recommendations in May 2016.The execution of MIP-relevant Council recommendations is monitored through PPS. Overall, the Commission concludes that Portugal has made some progress in addressing excessive macroeconomic imbalances and structural reforms.

The next PPS mission will most likely take place before the end of the year.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the fourth post-programme surveillance (PPS) mission to Portugal between 15 June and 22 June 2016. The mission was coordinated with the IMF's post programme monitoring (PPM) mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to assessing the repayment capacity of a country having received financial assistance([1]). While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions.

The PPS mission included specific monitoring under the MIP. The 2015 in-depth review (IDR) carried out under the macroeconomic imbalance procedure (MIP) for Portugal concluded that remaining excessive imbalances require decisive policy action and specific monitoring ([2]). In the context of the specific monitoring under the MIP and the European Semester more generally, the European Commission assesses there has been some progress in addressing CSR 1 on implementing fiscal structural measures, CSR 2 and CSR3 on labour market and active labour market policies as well as with enhancing more transparency in concessions and private-public partnerships (CSR 5). Limited progress has been found regarding enforcing CSR 4 on corporate deleveraging. A detailed overview of the progress made with the 2015 CSRs is provided in Annex 1.

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

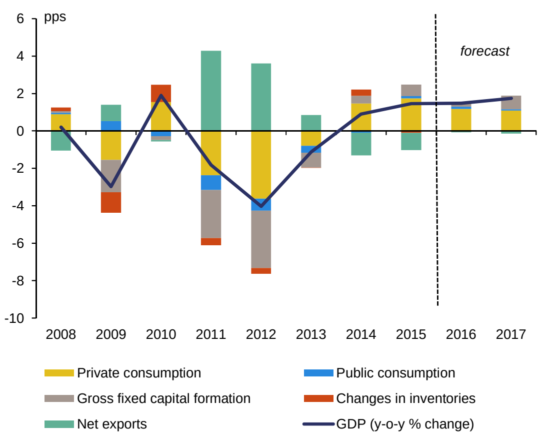
([2]) See communication from the Commission to the European Parliament, the Council and the Eurogroup:'2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011', http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_comm_en.pdf.

2. RECENT ECONOMIC DEVELOPMENTS

Macroeconomic situation and outlook

Growth in Q1-2016 was in line with the Commission 2016 spring forecast, but its composition points to a stronger-than-expected contribution from private consumption. Real GDP grew by 0.9% y-o-y and 0.2% q-o-q in Q1-2016. The high private sector indebtedness, political uncertainty and a drop in construction activities, explained by unfavourable weather conditions during the winter, contributed to a substantial reduction in investment, which was more negative than projected in the Commission 2016 spring forecast. Nonetheless, the contribution of domestic demand to output growth remained positive, supported by an increase in private consumption above expectations, a result from the surge in consumption of durables (mainly motor vehicles, influenced by anticipation ahead of a rise in vehicle taxes) and a slower pace of fiscal consolidation. Net external demand continued to display a significant negative contribution of -1.1 pps, reflecting feebler exports (2.2% y-o-y in Q1-2016). Such sluggish export performance is largely explained by the weak economic outlook in extra-EU markets (mainly Angola, Brazil, China and United States) and the temporary closures of a major oil refinery and the carmaker Autoeuropa.

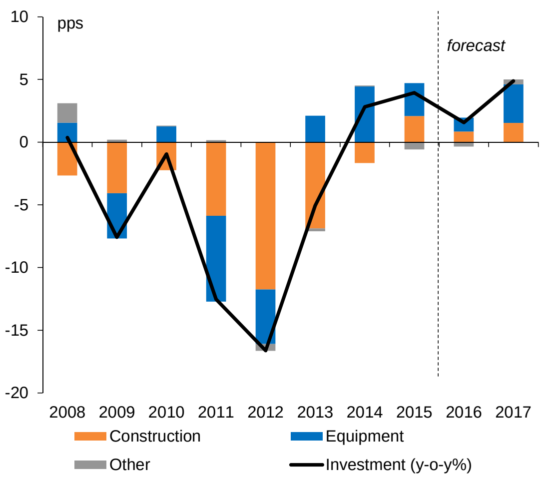
Graph 2.1: **Contributions to real GDP growth**



Source: European Commission

High-frequency economic indicators point to the continuation of the gradual economic recovery, supported by domestic demand. Recent consumer spending indicators show signs of stabilisation in private consumption which would remain strong as the impact of fiscal policy measures would fade away only later in 2017. Most investment indicators remained weak at the beginning of Q2-2016, with a reduction displayed by cement sales and equipment investment. Trade of goods has deteriorated until May 2016, mainly due to poor performance of the extra-EU trade (Graph 2.3). Yet, as the fall in exports to Angola seemed to have reached its floor in early 2016, some positive base effects are expected for the rest of the year. Overall, investments and exports are expected to slightly recover; but, were the risks associated with the outcome of the UK referendum to materialise, such pick-up would be unlikely.

Graph 2.2: **Investment growth and its components**



Source: European Commission

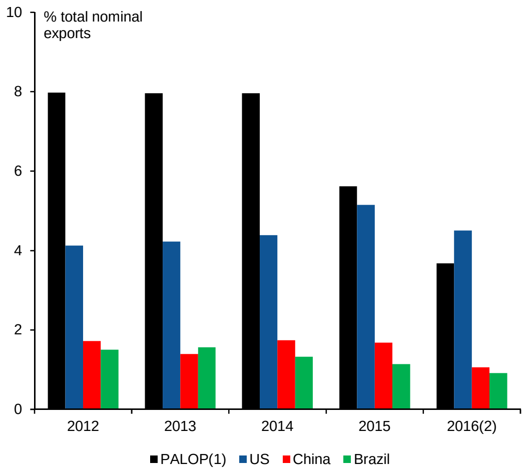
The Commission spring 2016 forecast is less favourable than the government's macroeconomic scenario underlying the Stability Programme. The authorities project real GDP growth of 1.8% in 2016 and 2017, compared to 1.5% and 1.7% in the Commission spring forecast 2016, due to a stronger growth in domestic demand. Taking into account less positive Q1-2016 outturn and risks related to substantial deleveraging needs, financial sector fragility and policy uncertainty the mission assessed the authorities' macroeconomic scenario as optimistic.

Table 2.1: **Comparison between the Commission spring forecast 2016 and the macroeconomic scenario underlying the Stability Programme 2016**

	SF 2016			*Differences (pps)*		SP 2016	
	2015	2016	2017	*2016*	*2017*	2016	2017
Real GDP (% change)	1.5	1.5	1.7	*-0.3*	*-0.1*	1.8	1.8
Private consumption (% change)	2.6	1.8	1.7	*-0.6*	*-0.1*	2.4	1.8
Public consumption (% change)	0.6	0.6	0.4	*0.5*	*1.1*	0.2	-0.7
Gross fixed capital formation (% change)	3.9	1.6	4.9	*-3.3*	*0.1*	4.9	4.8
Exports of goods and services (% change)	5.2	4.1	5.1	*-0.2*	*0.2*	4.3	4.9
Imports of goods and services (% change)	7.4	4.3	5.6	*-1.2*	*0.7*	5.5	4.9
Contributions to real GDP growth:							
- Final domestic demand	2.4	1.5	1.9	*-0.9*	*0.0*	2.4	1.9
- Change in inventories	0.0	0.0	0.0	*0.0*	*0.0*	0.0	0.0
- Net exports	-0.9	-0.1	-0.1	*0.5*	*0.0*	-0.6	-0.1
Employment (% change)	1.4	0.9	0.7	*0.1*	*0.0*	0.8	0.7
Unemployment rate (%)	12.6	11.6	10.7	*0.2*	*-0.2*	11.4	10.9
Labour productivity (% change)	0.1	0.6	1.1	*-0.4*	*0.0*	1.0	1.1
HICP inflation (%)	0.5	0.7	1.2	*-0.5*	*-0.4*	1.2	1.6
GDP deflator (% change)	1.9	1.4	1.5	*-0.7*	*-0.1*	2.1	1.6
Comp. of employees (per head, % change)	-0.6	1.6	1.4	*-0.8*	*-0.6*	2.4	2.0
Current external balance (% of GDP)	-0.1	0.3	0.5	*-0.1*	*-0.1*	0.4	0.6
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.1	1.5	1.7	*-0.1*	*-0.1*	1.6	1.8

Source: European Commission; Portugal's 2016 Stability Programme from 21 April

Graph 2.3: **Nominal exports of goods to extra-EU markets**



(1) PALOP includes Angola, Mozambique, Cape Verde, Guinea-Bissau, São Tomé and Príncipe, being Angola the biggest market at 665 so far in 2016.
(2) Data until May 2016.
Source: European Commission; INE

Labour market indicators point to a gradual convergence of employment creation with GDP growth rates as predicted in the Commission spring 2016 forecast. The unemployment rate fell to 12.1% as job creation increased by 0.8% y-o-y and labour force shrank by 1.1% y o y in Q1-2016. The estimated monthly unemployment rate remained at 11.6% in May 2016 (0.0 pps m-o-m but -0.8 pps y-o-y). Employment contracted by 0.3% y-o-y and by 0.6% on a monthly basis. The sectorial analysis confirms that employment in manufacturing and particularly construction continued to grow at a robust pace.

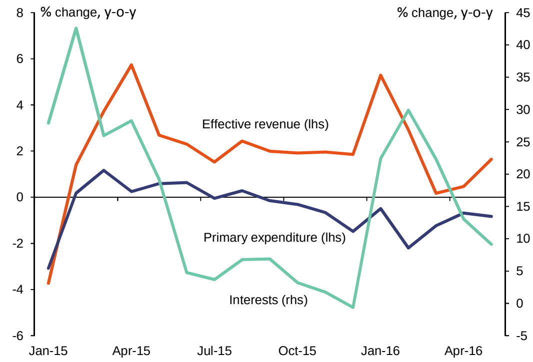
Consumer prices are projected to rise moderately in 2016. HICP inflation increased to 0.4% in May 2016, broadly in line with the expectations of the Commission 2016 spring forecast and significantly below the forecast underlying the Stability Programme 2016. As regards the GDP deflators, the private consumption deflator started to deviate from HICP in Q1-2016 again, as a consequence of the surge in imputed rents and financial intermediation services. Overall, the GDP deflator grew by 2.4% in Q1-2016, presenting some upside risks to the Commission 2016 spring forecast of 1.4%.

Public finances

In cash terms, budget execution through end-May 2016 was broadly in line with the 2016 budget. Up to May, the general government cash balance improved by EUR 0.5 billion relative to the same period last year, due to an increase in revenue by 1.6% while expenditure grew only by 0.1%. **On the revenue side,** the increase fell largely short of the 4.9% increase projected in the budget for the whole year. As regards direct taxes, thanks to higher withholding tax revenue, personal income tax (PIT) collection (+0.0%) was above the full year budget target of -2.4%, but compensated only partially the shortfall in corporate income tax (CIT) (-8.4% as compared to the full-year budget target of -1.0%). As regards indirect taxes, the overall growth of VAT revenue by 0.5% compares to a budget target of 3.2% while the other indirect taxes were overall on track, growing by 33% as compared to a yearly budget target of 31%. Overall, tax execution by May was however considered on track if corrected for the exceptionally high VAT reimbursements in January and February (that are mainly recorded in the previous year in terms of national accounts). While the increase of Social Security contributions fell slightly short of the annual target (3.8% compared to 4.5%), other current revenue and capital revenue fell significantly short of the annual budget target up to May. **On the expenditure side,** the overall low increase by 0.1% up to May (as compared to the full-year budget increase of 5.7%) was largely due to lower investment (-13.4% vs a budget increase of +11.9%) and lower purchases of goods and services (-2.9% vs +2.2% in the budget), which might also be explained by the late entry into force of the 2016 budget on 31 March. The corresponding underspending was however broadly offset by increases of interest payments (+9.2%) and compensation of employees (+3.2%) above the budget targets of 4.4% and 2.8% respectively.

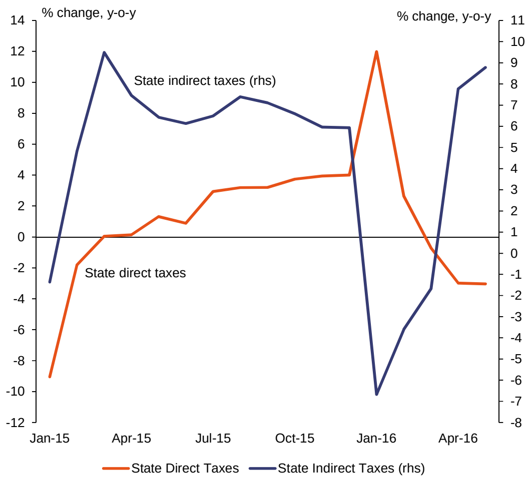
Various factors limit the comparability of the end-May budget execution with the full-year budget execution, and risks are tilted to the downside. As no major negative deviation has been identified so far, the authorities are confident to reach the budgetary targets in cash terms as adopted in the 2016 Budget. The late entry into force of the Budget, the still outstanding full effect of recent tax declarations for 2015 and the backloaded impact of some deficit-increasing measures (such as the quarterly reversal of public sector wage cuts and the VAT rate reduction for restaurants) however limit a full-year comparability of the cash execution up to May. As emphasised by the authorities, the higher amount of frozen appropriations (only releasable upon authorisation by the Ministry of Finance), at 0.2% of GDP, may also be used to compensate for potential deviations towards year-end in case of expenditure slippages or revenue shortfalls. To this outlook, risks are tilted to the downside and can materialise by a deterioration of the macroeconomic outlook, more volatility and uncertainty in the financial markets, but also by the still unclear financing needs for the bank recapitalisation.

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



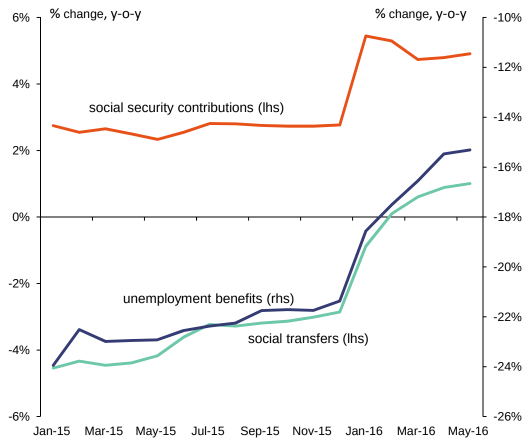
Source: Direcção-Geral do Orçamento

Graph 2.5: **State budget execution: Revenue (cash data)**



Source: Direcção-Geral do Orçamento

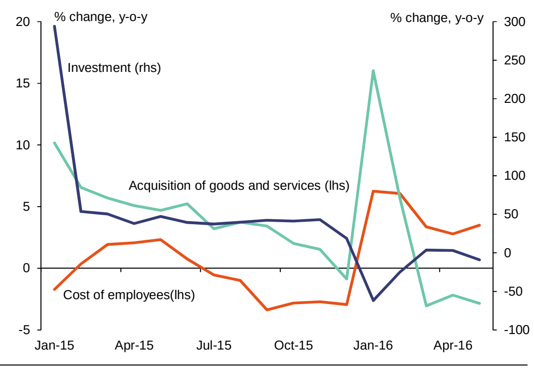
Graph 2.6: **Budgetary outturn for Social Security (cash-data)**



Source: Direcção-Geral do Orçamento

Public sector arrears are on the rise, especially in the health sector. Following a decrease by around EUR 0.6 billion in 2015 to EUR 0.9 billion, public sector arrears have increased almost steadily by a total EUR 166 million in 2016 to EUR 1.1 billion up to the end of May. The overall increase of arrears is almost entirely due to an increase by EUR 155 million for state-owned hospitals bringing the stock of arrears of the National Health Service at the end of May 2016 back to its level of around EUR 600 million recorded in early 2015. The recurrent under-budgeting of state-owned hospitals remains a challenge for the remainder of the year.

Graph 2.7: **Central administration budget execution (cash-data)**



Source: Direcção-Geral do Orçamento

Box 2.1: Portugal's compliance with the rules of the Stability and Growth Pact

On 12 July 2016, i.e. after the cut-off date of this report, the Council adopted a Commission's recommendation establishing that Portugal did not take effective action to correct its excessive deficit within the 2015 deadline set by the Council in 2013. It confirmed that Portugal did not reduce its deficit below the reference value of 3% of GDP by 2015, and it found that the fiscal effort was significantly short of what was recommended.

According to the EU fiscal rules, a Council decision establishing non-effective action by a Member State has three main consequences. Firstly, the Commission has to make a proposal for a Council decision requiring the Member State to pay a fine. Secondly, the Commission shall put forward a recommendation for a Council decision to give notice to the Member State, including a new deadline and a new adjustment path to eliminate the excessive deficit and recommend measures to achieve that. Thirdly, the Commission shall propose the suspension of part of the commitments under the European Structural and Investment (ESI) Funds.

In the first week of August, the Council, following Commission's recommendations, decided:

- not to apply a fine to Portugal for its failure to take effective action to correct their excessive deficit. The decision took into account the country's efforts in the past years and the authorities' commitment to complying with the EU budgetary rules as indicated in their reasoned request submitted to the Commission on 18 July 2016.

- to recommend to the Portuguese authorities to correct its excessive deficit by 2016 and to reduce the general government deficit to 2.5% of GDP in the same year, without including the impact of the direct effect of potential bank support. Portugal must implement additional consolidation measures amounting to 0.25% of GDP this year to reach the recommended budgetary targets. In particular, Portugal shall implement fully the consolidation measures incorporated in the 2016 Budget, including the additional expenditure control in the procurement of goods and services highlighted in the Stability Programme, and complement those savings with further measures of structural nature. The Portuguese government shall present to the Council and the Commission by 15 October a report on action taken, including the measures underpinning the adjustment effort.

The decision on the possible suspension of the ESI Funds will be taken following a structured dialogue with the European Parliament which will take place at the earliest possible opportunity after the summer recess, i.e. before a proposal for suspension is adopted by the College. In accordance with the relevant provisions of Regulation (EU) No 1303/2013, the Commission will ensure that the suspension is proportionate and takes into account the economic and social circumstances of Portugal.

Table 2.2: **Solvency and profitability indicators**

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014				2015				2016
										Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
CAR ratio	12.5	11.8	10.4	9.4	10.5	10.3	9.8	12.6	13.3	12.3	12.0	13.0	12.3	12.0	12.5	12.6	13.3	13.0
CET1 ratio										12.2	10.6	12.0	11.3	11.1	11.6	11.6	12.4	12.1
T1 capital in €bn	18.9	21.9	20.4	21.0	25.7	27.1	26.0	32.8	31.0	29.0	27.5	29.7	27.4	27.5	28.4	28.2	29.3	28.2
RWA in €bn										198.0	255.4	244.8	239.8	247.2	242.6	240.8	233.3	229.1
Capital to assets	6.2	6.6	6.5	5.8	6.5	6.7	5.3	6.7	6.9	7.4	7.2	8.1	7.7	8.0	7.8	8.1	8.5	8.5
NPL ratio			2.8	3.6	4.8	5.2	7.5	9.8	10.6	10.8	11.2	12.0	12.0	12.3	12.6	12.8	11.9	12.2
NPL in €bn				12.0	16.0	18.1	25.1	31.0	31.7	31.9	31.8	32.5	32.9	34.0	34.5	35.1	32.1	32.5
Gross loans in €bn				331.6	330.7	347.5	334.3	315.9	297.5	294.3	294.9	290.7	276.7	276.7	274.0	274.1	269.4	266.2
RoA - Return on Assets	1.0	1.3	1.2	0.3	0.4	0.5	-0.3	-0.3	-0.7	0.0	-1.8	-1.5	-1.3	0.5	0.5	0.3	0.2	0.2
RoE - Return on Equity	15.9	19.9	18.7	5.7	7.3	7.5	-5.5	-5.4	-11.0	-0.4	-24.8	-19.8	-17.9	6.4	6.0	3.6	2.7	2.4
Loans to Deposits ratio					161.5	157.8	140.2	127.9	116.9	117.2	113.9	111.9	107.2	106.9	106.0	104.6	102.6	102.5

(1) The NPL ratio is in line with international practices
Source: Banco de Portugal

Financial stability

Despite positive developments in the last years the Portuguese financial system remains exposed to a set of challenges and risks. The profitability of the Portuguese banking system resumed in 2015 with positive levels. Solvency levels in the sector have also gradually improved but still fall short of average ratios of European peers and the sector continues to operate in a difficult environment where the focus is on (i) low profitability and efficiency levels of the banking sector, (ii) the high stock of non-performing assets and (iii) improving the diversification of the portfolio. The low interest rate environment in combination with poor efficiency adds to the banking sector's low profitability. Given the constraints to income generation, more efforts are required to improve the cost structure of Portuguese lenders and to revise business models of some banks. The worsening quality of assets on the banks' balance sheets (non-performing assets amount to 12.4% of gross loans) remains another key factor holding down banks' performance. Weak overall profitability leads also, in some particular cases, to excessive risk-taking and above optimal exposure of Portuguese lenders to real estate assets, sovereign debt and assets related to specific geographic regions. From a financial stability perspective the gradual disinvestment from these exposures remains a favoured strategy.

The final impact of the planned sale of Novo Banco and the recapitalisation needs of Caixa Geral de depositos (CGD) on other banks and the public balance is still unknown([3]). CGD, with assets totalling EUR 100 bn, and which is 100% owned by the State, received EUR 1.65 bn State aid in 2013 and is under restructuring obligations until 2017. The authorities are in close contact with the Commission services to explore actual needs and solutions for a possible recapitalisation which conform to EU law and without a direct adverse impact on the government balance. According to whether the recapitalisation would be done through state aid (capital transfers) or financial transaction, then the impact would be felt in the deficit (and debt) or only in the debt. The impact for the banking sector due to the sale of Novo Banco will be known accurately only when the transaction is concluded. Any possible financial impact, in the form of contributions of banks to the Resolution Fund, could be staggered over several years.

Profitability and solvency

In 2015, the Portuguese banking system moved back to profitability following three years of heavy losses. Return on Equity (RoE) became positive again in 2015 and is now at 2.4% (March 2016); yet, the ratio is much below the double digit ratios of the pre-crisis years as banks are less profitable. In parallel, Return on Assets (RoA) turned positive in 2015 and stands at 0.2% in Q1 2016 (on aggregated level). The asset base of Portugal's banks shrank by over 20% since 2008. Profitability continues to be weighed down by low interest rates, the weak economic conditions and insufficient demand for new credit from a deleveraging economy. Portuguese banks continue to be mostly reliant on financial operations and

([3]) After the cut-off date of this report, the Portuguese authorities and DG COMP reached an 'agreement in principle' on a possible way forward regarding the CGD recapitalisation. Implementation of this agreement is work in progress.

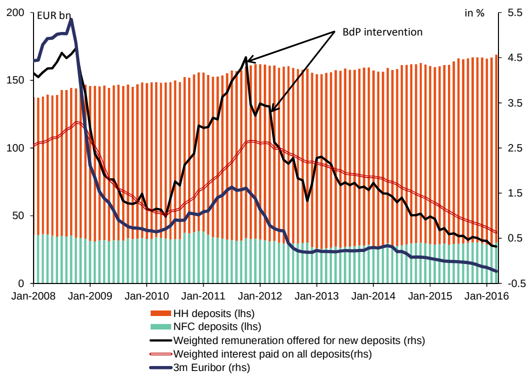
operations abroad. Moreover, the quarterly positive profit figures are not least due to one-off factors such as trading results or restructuring up-front cost or benefits. While many of the above factors, e.g. interest conditions and economic activity similarly affect other euro area countries, profitability indicators are more favourable in most other member states.

Portuguese banks' solvency is slightly increasing and the cost-to-income ratio is declining. In March 2016, banks' solvency stood at 12.1% Capital Equity Tier 1 (CET1) and 13.0% Capital Adequacy Ratio (CAR), a 1 percentage point higher than March 2015 for each indicator. These increases stem from a reduction in the denominator, as risk weighted assets shrank by 6.8%, as well as a significant increase in Novo Banco's capital ratios after five issuances of senior debt obligations valued at EUR 2 billion were transferred from Novo Banco to the legacy perimeter of BES. Following various cost cutting measures taken in many Portuguese credit institutions, operating costs have declined somewhat resulting in a Cost-to-Income (C/I) ratio below 60% (an improvement of 5.8 percentage points relative to 2015). Portuguese lenders are aware that much more needs to be done on the cost side – inter alia, reduction of branches, staff, and divestment of their least profitable businesses. On the income side, the turnaround is driven not so much by new profitable business, but rather by lower provisioning of non-performing loans (NPLs) and slowly improving net interest income (i.e. the margin between the remuneration of deposits and the income received from lending operations).

Funding, deposits and lending

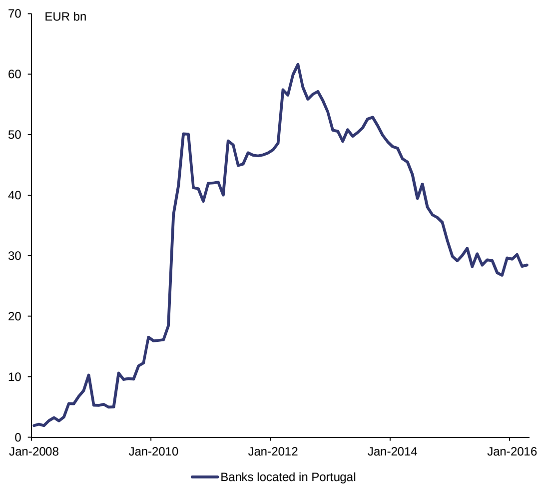
Despite declining remuneration, deposits are increasing. In Q1 2016, the remuneration for new deposits (deposits represent over 60% of Portugal's banks funding) have continued to fall to 40 basis points for households down from a post-Lehman peak of 4.5% offered for new deposits in October 2011 (Graph 2.8). Company deposits are remunerated below 20 basis points. Both rates are thus on aggregate comparable to euro area numbers. Yet some banks which are perceived riskier than their peers still offer 0.8% for new time deposits. Despite ever lower interest rates, aggregate deposits grew to a new record of EUR 168.9 billion in March 2016. The difference between loans and deposits fell to EUR 32 billion, the lowest ever since January 2003, whereas funding from the ECB continues to fluctuate around EUR 30 billion over the past five quarters (Graph 2.9).

Graph 2.8: **Deposits and deposit remuneration**



Source: Banco de Portugal

Graph 2.9: **Eurosystem borrowing**



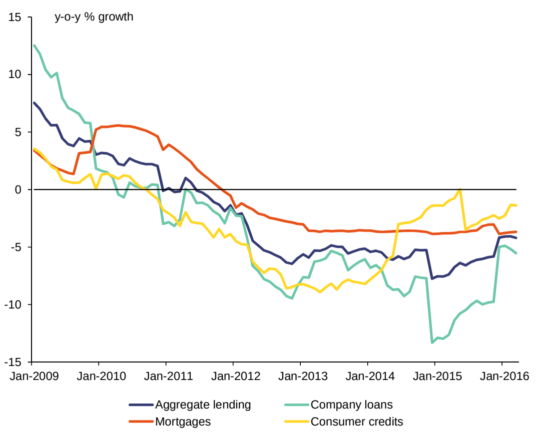
Source: Banco de Portugal

The loan stock shrinks less fast. Aggregate loans fell to EUR 200.9 billion in March 2016, a ten-year low. The loan stock decreased by 4.2% y-o-y in March 2016, but sub-categories fall at different speeds.

New loans are increasing at a slower pace than last year and are still less than half of what they were before 2008. New corporate loans shrank

12.8% within a year by March 2016. Conversely, lending to household is on the rise, about 30% higher than a year ago, mostly due to an increase in mortgages. As house prices recover in urban areas, newly granted mortgages stood above EUR 1.2 billion in Q1 2016 for the first time since programme start. The monthly average of new mortgages is now more than double of what has been seen during the programme but they sum up to less than one third of what was granted per month 2003-2008. As vehicle taxes changed in April many Portuguese anticipated their car purchase to Q1. Consequently, consumer loans, of which car loans make up more than half, increased 0.1% quarter on quarter but still fell 1.4% year on year.

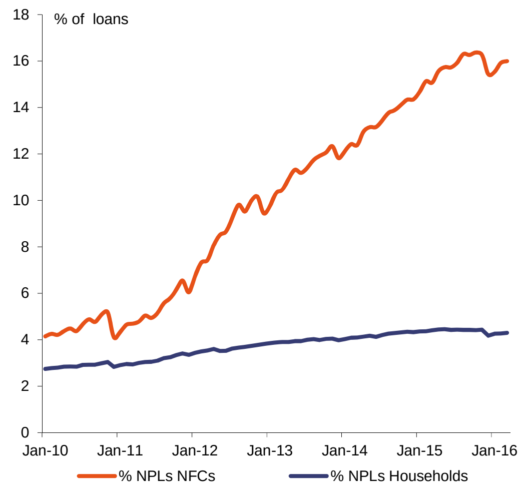
Graph 2.10: **Different loan categories**



Source: Banco de Portugal

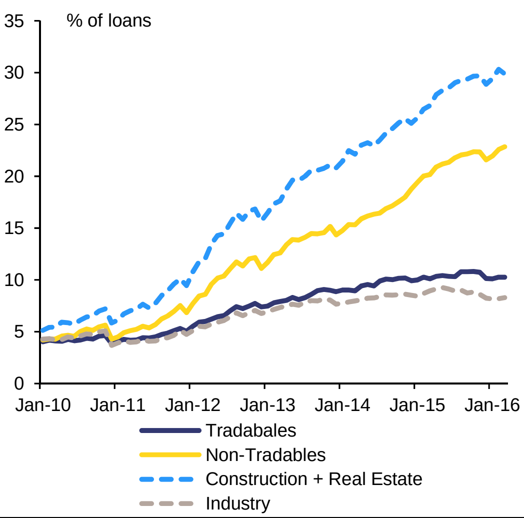
The stock of non-performing loans remains high. According to the Banco de Portugal more than 70% of the total NPLs are related to non-financial corporates (NFCs). In March 2016 the corporate NPLs represented 16% of gross loans to companies, 12 pps above their figure in early 2010 (Graph 2.11). Non-performing loans are predominantly a legacy of the financial crisis, stemming from many corporate defaults, which mostly occurred between 2011 and 2013. The high level of problem assets in the system is also a reflection of a very slow non performing debt resolution taking on average about forty months. Subsequently, many legacy non-performing loans are overdue for longer than one year and account for over 80% of the total value of corporate NPLs (mid-2015). In most cases, NPLs are associated with past excessive bank lending to the non-tradable sector, while NPLs in the tradable sector remain below 10% (Graph 2.12). The increasing share of loans to the tradable sector is a positive sign for the reallocation of resources from non-tradable to tradable sector, which is essential to successfully rebalance the Portuguese economy. The Portuguese banking system is expected to continue reducing credit exposures to sectors that have not improved in terms of efficiency or productivity in recent years.

Graph 2.11: **NPLs**



Source: Banco de Portugal

Graph 2.12: **NPLs by sector**



Source: European Commission; Banco de Portugal

3. POLICY ISSUES

Public finances

The Spring 2016 Forecast projection of 2.7% of GDP compares to a planned headline deficit of 2.2% of GDP in the 2016 Budget, as confirmed in the 2016 Stability Programme. The 0.5% of GDP difference as compared to the authorities' projection reflects the Commission's less optimistic macroeconomic outlook for 2016 and different yields expected from the planned fiscal consolidation measures (in particular as regards planned savings in intermediate consumption and other current expenditure). Due to the limited volume of fiscal consolidation measures, the spring forecast projects a deterioration of the structural balance by about 1/4% of GDP, compared to the improvement of around 1/4% projected in the 2016 Budget and repeated in the Stability Programme.

Under no-policy-change, the Commission expects the headline deficit to decline to 2.3% of GDP in 2017, while the Stability Programme forecasts, instead, a stronger reduction, to 1.4% of GDP. One reason for this discrepancy in the deficits is the different assessment of the yield of consolidation measures that according to the Commission have not been sufficiently specified in the Stability Programme. As a result, the Commission 2016 spring forecast projects then a 0.3% of GDP deterioration in the 2017 structural balance, compared to the improvement of 0.3% of GDP planned in the Stability Programme.

Risks to the spring forecast's fiscal projections are tilted to the downside, and are linked to uncertainties surrounding the macroeconomic outlook, possible spending slippages, contingent liabilities also related to the banking sector, and potential lack of agreement on further consolidation measures for 2016 and 2017. In addition, the outcome of the referendum in the United Kingdom on membership of the European Union has further increased uncertainties surrounding the macroeconomic outlook.

Based on optimistic assumptions, the 2016 Stability Programme projects a further steady decline in the headline deficit to 0.9% in 2018 and 0.1% in 2019, and a 0.4% of GDP surplus in 2020. As communicated to Member States at the beginning of the year, the new MTO for Portugal has been set to a structural surplus of 0.25% of GDP. According to the Stability Programme, the envisaged deficit reduction over the programme horizon would be consistent with a yearly structural improvement of 0.35% of GDP, which would allow attaining the MTO after 2020. The envisaged decrease of headline and structural deficits would be sustained by a nominal economic growth of around 3.5% per year, which would lead to an almost proportional increase in tax revenue, against a significantly slower growth of expenditure. Mostly on account of consolidation measures, intermediate consumption and interest expenditure are in fact projected to remain broadly unchanged in nominal terms and compensation of employees and social transfers would also increase below nominal GDP growth. Risks to this outlook are linked to the rather optimistic economic growth assumptions, the reduced amount of planned consolidation measures, and the impact of possible interest rate hikes on interest expenditure savings.

The gross public debt-to-GDP ratio fell only slightly to 129.0% by end-2015, due to the postponement of the Novo Banco sale, the Banif resolution operation and statistical revisions. The debt-to-GDP ratio is expected to decrease more markedly to 126.0% in 2016, mainly due to projected sales of financial assets, including Novo Banco, and further to 124.5% in 2017, due to primary budget surpluses and domestic demand growth. The Stability Programme's lower projections of 124.8% in 2016 and 122.3% in 2017 are due to the projected lower deficits and higher nominal GDP growth. According to the Commission's latest long-term projections based on the spring forecast, using the no-policy-change assumption as from 2017, general government gross debt is on a decreasing path. Nevertheless, given the very high starting point and the relatively low projected average yearly decrease, the debt-to-GDP ratio is expected to fall below 120% only in 2023. Assuming full implementation of the Stability Programme scenario, public debt would be on a considerably steeper downward path, implying that the debt-to-GDP ratio would fall below 100% already in 2023.

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

	2010	2011	2012	2013	2014	2015	2016	2017
Balance - EDP	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.7	-2.3
Budget deficit, net of one-offs	-8.5	-7.3	-5.6	-5.1	-3.3	-3.2	-2.8	-2.6
Structural balance	-8.0	-6.2	-3.1	-2.5	-1.4	-2.0	-2.2	-2.5
Primary balance	-8.2	-3.1	-0.8	0.0	-2.3	0.2	1.8	2.0
Structural primary balance	-5.1	-1.8	1.8	2.3	3.5	2.6	2.2	1.7
Fiscal adjustment	0.1	3.3	3.7	0.5	1.2	-0.9	-0.3	-0.5
Fiscal effort (EDP definition)	0.1	1.9	3.1	0.5	1.1	-0.6	-0.2	-0.3

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

Fiscal-structural issues

The government has launched a spending review of the public administration, as an attempt to further capture substantial expenditure savings. Priority areas for the review are the health and education ministries, state owned enterprises (SOEs), (centralised) public procurement and real estate management; other areas would follow in the years to come. To conduct the review, the authorities are relying on a bottom-up approach which identifies savings in each layer of the public administration. Going forward, it would be valuable to enrich the review by (i) adding a more comprehensive vision and targets for the public sector as a whole, including a clear and strong political mandate for the public exchequer; and (ii) gauging additional savings that could result from a more efficient use of available resources . Also, it would be important to take stock of those cost compression measures that have already been implemented in these areas during 2011-2015.

The sustainability of the pension system is not yet ensured. The public pension system still largely depends on budget transfers, and the reform announced in the 2015 Stability Programme was not developed. Although expected to improve by 2060, until then the generosity of the pension system measured by the benefit ratio – the average benefit of public pension earnings as a share of the average wage – remains above the EU average. In addition, in recent years lower pensions have been curtailed to a lesser degree than other social benefits, thus relatively protecting elderly people but increasing intergenerational inequalities in terms of risk of poverty or social exclusion. The government has plans to study the re-design the whole social security pension system, including through a re-assessment of the reforms recently implemented. Within this process, it would be key to consider alternative revenues to budgetary sources, and make progress in rebalancing intergenerational inequality.

The sustainability of the healthcare system improved notably since 2011, but arrears have been growing since the beginning of the year. Healthcare expenditure accounts for the largest share of ageing costs and is set to increase by 2.5% of GDP by 2060, the largest increase in the EU. To address long-term sustainability, some reforms to promote prevention and primary healthcare provision are progressing, in particular the expansion of access to a general practitioner. Yet, clearing the arrears in the sector and accurate budgeting in state owned hospitals remain challenging also with respect to the transposition of the late payments directive, which became fully applicable to the health sector on 1 January 2016. The effort to clear arrears made in 2015 (EUR 105 million) was already offset by its increase in the first five months of 2016 (EUR 160 million), raising the stock by 35% since December 2015 to over EUR 0.6 billion. In the same period, the share of health sector arrears in total government arrears increased by 7 pps to about 57%, highlighting the need for accurate and balanced budgeting as well as effective enforcement of the Commitment Control Law. The law has already helped limit the accumulation of arrears in various subsectors of the public administration by improving discipline and budgetary control of the entities. In the health sector however the enforcement has been weak and should be strengthened by increasing monitoring and audits. Despite additional cost compression foreseen for 2016 and the (yet insufficient) increased budget transfers, additional labour cost pressures in the second half of 2016 (including the restitution of previous wage cuts and the 35 hours working week for the majority of civil servants) and fewer revenues from lower moderating fees may result in a negative operating balance below the amount budgeted by EUR 179 million. These fiscal pressures call for swift implementation of the sustainability measures announced in the 2016 budget.

The implementation of the reformed Budget Framework Law (BFL) that entered into force in September 2015 has been delayed. The Law is in particular designed to make budget units more accountable, strengthen the medium to long-term focus of public finances by introducing programme-based budgeting, setting expenditure ceilings until the medium term, and aligning the deadlines with those of the European Semester. It allows for a three-year transitional period for applying most new features and should be fully enforced for the preparation of the budget 2019. The BFL and the ongoing pilot project of an integrated public accounting system will become a major tool to improve management ownership and ensure effective budgeting, as well as budget implementation, monitoring and reporting at all layers of public administration.

Some public administration reforms decided under the programme risk being reversed. The requalification scheme which was launched in 2013 for civil servants who were made redundant was frozen and now only covers very few employees. The law on the return to the 35 hours working week for public employees, which entered into force on 1 July, would entail an unequal treatment within public administration, as around 13% of central administration staff is hired under the general labour law to which this provision does not apply. Although the law includes a provision to limit the increase of the wage bill unless the Ministry of Finance decides otherwise, the wage bill can still increase. This could result from recent increases in public employment, the planned gradual reversal of the temporary public sector wage cuts, and the reintroduction of the 35 hours working week which in few sectors might require more personnel and overtime. Indeed, 2015 was the first year since 2011 with an increase in public employment (by 0.4% compared to 2014), and in Q1-2016 the increase was 0.8% y-o-y. Under these circumstances, the new civil servants rotation policy (2:1 replacement rule) included in the budget 2016 may be difficult to implement in the second half of the year.

While local and regional debt and arrears have declined steadily since 2013, progress in other local administration reforms has been slow. The recently created Municipality Support Fund (FAM – a debt workout mechanism for over indebted municipalities) has conducted its first disbursement, after solving several legal hurdles and control checks. Disbursements for the remaining eight contracts approved (for a total disbursement from FAM of EUR 305 million), are waiting for the Court of Auditors' authorisation. Members of the Fiscal Coordination/Consolidation Council, operational since January 2014, have been appointed only recently (15 June). Hence, the Council may not be able to support municipalities in drafting their 2017 budgets. The Directorate-General for Local Administration (DGAL; on local government) and Directorate-General for Budget (DGO; on regional government) have started to monitor SOEs and public-private partnerships (PPPs) and report on a quarterly basis only recently further to the new relevant legislation. The partnership between the Ministry of Finance's task force for SOEs monitoring (UTAM) and DGAL will be key to ensure good quality reporting; yet, effective monitoring is only expected to start in 2017. Finally, the government has created a working group to re-assess the merger of parishes (freguesias) that took place during the economic adjustment programme; however, the bottom-up approach used and the self-assessments from parishes and municipalities may entail additional reversal risks on this reform.

Revenue administration reforms are ongoing, focusing on further improving tax compliance. The large recruitment of new tax auditors has reached its final phase. The reorganisation of tax administration's presence at local level continues gradually with (1) more centrally organised rollout of citizen shops; (2) local organisation of these shops by municipalities (Aproximar); (3) citizen spaces within city halls with employees paid by municipalities; and (4) back office services being further centralised. The dedicated Taxpayer Services Department for large companies is now expected to take over wealthier households too. The current three-year plan for combating tax evasion and fraud is set to be replaced by an annual plan to be published soon. Preliminary information indicates further increase in the number of registered invoices and companies in the e-invoice system. No estimate of the fight against tax fraud and evasion in 2015 has been calculated so far and additional yields linked to the e-invoicing system tend to decrease over time. Portugal is implementing further duties for banks' data delivery regarding all bank accounts, exchange of information with other countries, limitations of payments in cash and end of bearer shares. Some Simplex measures should also contribute to fighting fraud and evasion, in particular (1) the currently studied option for companies to provide their accounting records in exchange of corporate income tax (CIT) automatic filing; (2) automatic filing of personal income tax (PIT) forms for individuals; and (3) new tools to facilitate tax payments which will ultimately contribute to avoid tax evasion by reducing compliance costs and the administrative burden for taxpayers.

Tax policy shifts are being studied that could affect PIT and other taxes, but no timeline has been set. The introduction of a lump-sum allowance per child replacing the family quotient introduced in 2015 is now effective. On 1 July, the value added tax (VAT) reduction in food at restaurants to the intermediate rate (13%) has entered into force.

Information on the financial status of state-owned enterprises (SOEs) improved since the last mission but challenges remain. The task force set up within the Ministry of Finance for monitoring SOEs (UTAM) has significantly expanded its activities. However, quarterly reporting on SOEs at central government level remains delayed mainly due to difficulties in getting accurate data from firms. The Q3-2015 report points to positive developments, yet the authorities propose to extend the reporting deadlines to 90 days after each quarter. Preliminary financial data for 2015 of central government SOEs and transport SOEs (including the road and rail infrastructure manager) show an improvement in EBITDA ([4]), which is expected to continue growing in 2016 for transport SOEs. Because the privatisation of Empresa Geral do Fomento and the positive evolution of bonds and financial instruments' fair value gave origin to an artificially inflated EBITDA indicator in 2015, central government SOEs are now expected to have a y-o-y decline of about EUR 685 million in this indicator in 2016. In the same line, by the end of 2016, the overall SOEs net income is now expected to deteriorate by EUR 0.6 billion to below minus EUR 0.9 billion, which is nevertheless EUR 0.4 billion better than in 2014. Liabilities are expected to further compress to a total of EUR 47 billion in 2016, adding another EUR 5.7 billion in 2016 to the EUR 2.3 billion reduction effort made in 2015 (explained by the EUR 2.6 billion capital injections that took place in 2015). The recently merged rail and road infrastructure manager Infraestruturas de Portugal (IP) has recorded EUR 12.5 million in net profit for 2015 (a EUR 85 million improvement from the 2014 outturn of the previously separated companies). Yet the company still lacks a well-defined framework that could ensure its medium term financial sustainability. The merger and inherent restructuring proposal for the ferryboat companies operating in the Lisbon area (Transtejo/Soflusa) is being reassessed with a decision expected in 2016, which will have to include a new public service obligation contract.

The recent spending review of SOEs can contribute to better shareholder control in the future, but it does not substitute the implementation of tailored made restructuring plans. The spending review of SOEs is being conducted by UTAM, the Directorate-General for Treasury and Finance as the shareholder role in central government SOEs and the treasury agency IGCP. The group is now working on the definition of additional information needs on companies' data related to the budgeting, implementation and monitoring processes to be collected and analysed on a regular basis. The objective is to improve shareholder's knowledge of individual businesses and centrally set tailored savings targets that may increase SOEs managers' ownership when implementing and reporting on the outcome. While the approach is interesting, the timeline is not clear.

Delays in the water sector reform will have an impact on the sustainability of water management. The authorities remain committed to the overall goal of the water and sewerage sector reform which was intended to raise

([4]) EBITDA stands for earnings before interest, taxes depreciation and amortisation.

efficiency by promoting the integration of bulk and retail activities. However, the number of municipalities opting out from the five recently merged regional water and sewerage bulk service systems seems higher than initially expected. The authorities are designing a tariff compensation mechanism/fund between the various bulk service systems to be implemented as off January 2017 and monitored by the independent sectorial regulatory authority ERSAR, which will also set tariff converging objectives. However, the government does not exclude taking measures to reduce the accumulated tariff debt of the systems, which may entail fiscal risks. The timeline proposed seems too ambitious in view of the municipal elections of September/October 2017. Therefore, proceeding with the second stage of the reform – merging water and sewerage municipal retail management services and promoting the integration of bulk and retail activities – may derail towards end-2017 in a best case scenario. The delay in implementing the second stage of the reform is a major concern not least because of the need to bring the sector into financial stability.

Regaining control over 50% of the flagship aviation company TAP and the annulment of urban transport sub-concessions are not exempt from debt and fiscal risks. There are still non-quantifiable fiscal risks related with the claims filed in Courts against the government's annulment of the awarding procedures for Lisbon and Porto urban transport sub-concessions. Authorities have not yet presented concrete plans to offset the potential negative fiscal impact of the recent annulment of urban passenger transportation sub-concessions in Lisbon and Porto. The re-purchase of shares to regain control over 50% of TAP have already increased public debt by at least EUR 30 million (the State subscribed part of a TAP's bond issuance in June and will also have to pay to reacquire 11% of the company). The contours of the operation are not yet fully clear namely in terms of each shareholder's economic rights, contribution to the capitalisation plans and effective management control of the company. The privatisation of 95% of the freight rail operator CP Carga was concluded in January. The remaining stake will be included in the pack in case its staff does not take the option to buy it. The monetisation of the IT network spare capacity managed by IP's subsidiary IP Telecom is to be launched after the summer and expected to be concluded until year-end, as foreseen in the 2016 budget.

PPP renegotiations are entering the phase of full completion enabling the materialisation of the agreed annual savings to the public exchequer. Renegotiations of nine motorways were concluded by end-2015 while the renegotiations of the emergency and security sector PPP (SIRESP) got the Court of Auditors visa in March 2016 only but already delivered sizeable savings this year also with reference to 2015. Several road sub-concessions are now expected to follow the same path throughout 2016, enabling the full materialisation of the agreed savings between grantor and sub concessionaires to start in the course of the year. According to the authorities, the new strategy to reduce motorway tolls in least developed regions will not have a significant impact on IP, the sub-grantor, due to demand price elasticity. There is however one motorway where implementation will not be straight forward because the sub-concessionaire bears all the demand risk. The delay in monitoring on PPPs and concessions identified during the previous mission is being recovered as a report on the situation at the end of 2015 has been recently published.

Financial sector

Policy initiatives addressing the issue of the stock of non-performing assets remain in the planning phase. In May 2016, the Commission recommended to the Portuguese authorities to take measures by October 2016 in order to address the current high levels of NPLs. The authorities' handling of NPL-related issues has been improving. However, it falls short of proposing and implementing a plan with deadlines and milestones. Instead, the authorities chose a comprehensive, but also time-consuming approach and a large consultation with various stakeholders is ongoing. Proposals aim to tackle all bottle-necks of the complex process of balance sheet repair. Discussions refer to changes to both PER and SIREVE, respectively the extra-judicial and judicial frameworks, in order to ensure one coherent structure. Furthermore, there is room to upgrade the role of the credit mediator to counsel in the pre-judiciary phase and put in place one or several NPL servicers that would take the role of evaluating and possibly managing NPLs and could intermediate between buyers and sellers of non-performing assets. Some banks have also been required to draft plans to gradually remove bad assets from their balance sheets. As an integral part of the NPL resolution strategy the Portuguese authorities also need to tackle the difficulties related to the judicial collateral enforcement proceedings, which still take in Portugal an excessive amount of time, on average 40 months against a European average of 8 months. While there are, generally, advantages in following a broad and systemic approach, the reduction of corporate debt, and in particular NPLs, is urgent and tangible results need to be achieved very soon.

Portuguese firms remain heavily indebted. In March 2016 the indebtedness of the total non-financial sector totalled 389% of GDP (EUR 709 billion), of which 165% of GDP was the non-financial public sector debt and 223% of GDP was the non-financial private sector debt, of which household debt was 80% of GDP and 143% of GDP was non-financial corporations debt. Portugal still has one of the most indebted corporate sectors in Europe. Given the low growth, low inflation environment, the deleveraging process remains challenging, even though lending to sectors with the highest leverage, such as construction, is decreasing at an elevated pace, by close to a third year on year. The excessive corporate leverage puts a constraint on firms' profitability ultimately resulting in higher NPL ratios (currently about one third of firms have overdue debt) and lower business investment. The authorities are aware that the corporate sector has to change its financing mix giving priority to equity financing rather than debt. Legal changes, inter alia the decrease of the debt bias in the fiscal code, are ongoing. Furthermore, new initiatives including the development of training programmes for entrepreneurs similar to the Irish IPO Ready and the promotion of listed holding companies with participation in Portuguese SMEs and mid-caps could be brought out.

Smooth and coordinated action should be taken to address difficulties in the two banks currently under discussion. To address current difficulties in CGD, the recapitalisation of this fully state-owned bank should take into account some private capital contribution, so as to reduce the costs to the budget, taking into account the EU current recapitalisation rules; a proper assessment of capital needs must be performed in a coordinated manner by the SSM, the Commission, the bank's management and the government. Authorities aim to arrange the sale of Novo Banco in the near term. Such an agreement would reduce prevailing uncertainties on the implications for the banking sector and the economy as a whole. Any potential financial impact for the overall banking sector could be facilitated by its staggering over several years.

Structural reforms

Labour Market

Despite generally improving labour market conditions, labour market segmentation remains high. Employees with fixed-term contracts represent 22% of total employees, one of the highest proportions in the EU. The youth is particularly affected with 67% of employees under 30 working on temporary contracts (while in the EU this percentage accounts for 42%). Portugal has made significant reforms in employment protection legislation (EPL) during the adjustment programme. As a result, Portugal is not any longer an outlier in the EU for the OECD indicator on the protection of permanent workers. Yet, regulation still remains among the strictest in Europe. While there has also been significant job creation in terms of permanent contracts since 2013, the share of temporary workers has failed to decrease. A detailed evaluation of the reform by an independent international institution was planned for last spring but has not yet been published. A thorough assessment of the results of past reform could determine whether high EPL on regular contracts may still be a barrier to the creation of permanent jobs. Changes to social security contributions to discourage the overuse (and abuse) of temporary contracts are being considered by the authorities, with the intention to reduce segmentation, but so far no concrete timeline for implementation has been specified. An ex-ante assessment of the impact of such a measure would be essential to ensure that it effectively helps to increase the proportion of permanent contracts and that it does not discourage legal hiring overall.

Active Labour Market measures continue to foster transition into employment although their effectiveness in creating stable employment needs to be assessed. The percentage of unemployed people following activation programmes has decreased, which could be a factor behind the slowdown in employment creation and unemployment absorption. An assessment study of Active Labour Market Policies is currently ongoing, with a view to further promoting integration of young people in the labour market and increasing the employability of long term unemployed. With the technical assistance of the ILO, Portugal is designing an outreach campaign for inactive young people not in education, employment or training (NEET).

Increases in the minimum wage are putting pressure on an already compressed wage distribution and reduce the employability of low-skilled worker. A report on the economic impact of minimum wage developments is being produced by the government services on a quarterly basis. According to the first report, the proportion of workers outside the public sector covered by the minimum wage was stable between 2010 and 2014, but since then it increased by almost 60% up to 2016. Also, while the minimum wage increased by 12% since 2010, the increase of consumer prices and labour productivity was much lower at only 8% and 2.1% respectively. The planned further minimum wage increases would reinforce this trend, thereby widening the gap of low-skilled workers' wages and their productivity. While inflation is forecast to increase by 1.2% and productivity by 0.6%, the minimum wage is projected to increase by 5% (from EUR 530 to EUR 557 since 1st January 2017) at a time when the number of workers covered has already increased from 16% to 19%, according to social security records. These increases will either lead to an increase of total labour costs, if the increase of the minimum wage creates a knock-on effect to higher wage scales or if not, it will compress the wage distribution. As the wage distribution in Portugal is already compressed, future increases not aligned with increases in productivity would lead to a situation in which the minimum wage is binding for a high proportion of the workforce, putting upward pressure on overall wages, potentially reducing incentives to invest in skills and risking harming the employment and competitiveness outlook.

Collective bargaining remains centralised at the sectorial level and limits flexibility for firm-level adjustment to shocks. The authorities intend to discuss with social partners changes to the collective bargaining system namely regarding the criteria and deadlines for extension of collective agreements and the rules and periods associated with their expiry and survival. As highlighted in previous reports, in spite of measures taken during the programme to promote firm-level wage setting, the collective bargaining system is characterised by a high level of centralisation at the sectorial level and it allows little flexibility for firm level adjustment in response to negative economic shocks. Since the relaxation of the rules in 2014, the number of administrative extensions of collective agreements has been increasing. Temporary opt-outs at firm-level are rarely used as they require the intervention of the original signatory parts of the sectorial agreement. Further increasing the rigidity of the wage bargaining system would harm firms' capability to adjust to economic developments. In order to boost productivity and reduce employment losses, an individual bank of hours had been introduced in 2012 to facilitate adjusting hours worked. The 150-hour bank of hours can be activated by agreement between employer and employee. The Government now intends to revoke this possibility making it harder to adjust hours worked. This loss of flexibility means it will be harder for firms to adjust working hours in order to prevent reduction in the number of workers.

Education and vocational training

In upper secondary education, Vocational Education and Training (VET) is improving its alignment with business while in lower secondary the government plans to reform the system. The government is planning to start eliminating already in September 2016 the vocational courses in lower secondary education so that vocational training starts only in upper secondary education. Basic vocational courses were one of the tools to tackle the problem of early school leaving (ESL). The new strategy proposed by the Government to address students' difficulties is to introduce tutors earlier in the school path for pupils at risk of ESL. Vocational courses have been quite effective since ESL dropped from 18.9% in 2013 to 13.7% in 2015. It is therefore important that the new approach is implemented effectively enough to keep this positive trend. The short-cycle higher education technical courses (CTeSP) seem to be reaching the objective of offering students at least half of the total number of hours in on-the-job training. The government now plans to better align VET offer with Higher Education in order to facilitate the transition between the two education paths. There is however so far no concrete measures planned to streamline the VET offer to make it easier for students to understand and select between the different options.

Some upside risks for education spending are appearing and the upcoming spending review seems not to be addressing the education system as a whole. The government plans a targeted reduction in class sizes by reducing the number of pupils per teacher where this can have a positive impact on education outcomes. In a bottom up approach, it will be up to the individual school to make proposals for class size reduction. The risk of such a decentralised approach is that it can result in an increase in the number of teachers at aggregate level, which stands in contrast with currently expected demographic requirements in the long-term. The limitation of the renewal of fixed term contracts for temporary teachers to five years, following the infringement procedure opened by the EU in 2014 can contribute to decrease segmentation in the teaching profession. The impact in terms of number of teachers of the new plan to replace vocational courses by a tutoring system is also still uncertain. These policies represent an upside risk to the number of teaching staff and how they are implemented will determine to which extent they will add further pressure in terms of number of teachers. Many factors affect the overall spending and effectiveness of the education system, including grade repetition, which is costly and has been proved largely ineffective in terms of education results; and, the increase in the proportion of older teachers which would automatically lead to higher costs, as salaries increase and the number of hours decreases with tenure, and hence would need to be taken into account in budgetary planning. The Portuguese authorities have announced that a spending review for the education system is being launched. One of the most relevant measures in terms of financial impact is the centralisation of salaries which is currently expected to reach its full yield in 5 years, the timeline needed to reach full completion. However, it seems that it will only focus on reducing administrative costs which represent only 25% of total costs, rather than implementing a more holistic control of the overall system which would boost efficient management of resources, including teaching costs.

Network industries

The port concession renegotiations remain considerably delayed and don't seem to make progress, although its conclusion could significantly contribute to increasing the competitiveness of the sector. The renegotiation of the port concessions in four different ports would be important to effectively reduce ports' invoices to users. However, the renegotiations are still pending in a process that started already in 2014. The Court of Auditors ([5]) finds that there are excessive rents in the existing concession contracts, once again calling for the need to advance on the contract renegotiations. Also, a new general framework for port concessions is still on hold since the chronogram for port sector reform was published in 2014. Such a framework could set out more clearly rules and incentives for future port concessions and set criteria to reduce significantly the risk of contracts that generate excessive rents. According to the transport regulatory authority AMT and the analyses undertaken by the Court of Auditors, the 30 years cap for the time-length of concession contracts in the Portuguese legislation could limit the competitiveness of Portuguese ports in attracting investments. In comparison, its most direct competitors, the Spanish, German and Dutch ports have concessions that can go up to 50 or 75 years. However, it is still not clear how the authorities would put in place the incentives and checks needed to stimulate efficiency and ensure that the duration of any new concession is limited to the time needed for the recuperation of the investment. Also, the longer the concession contracts the more effective needs to be the system for control of compliance with the obligations included in the contract taking also into account investments to be made during the life of the concession. A new collective agreement with the port workers (stevedores) from the Port of Lisbon has been signed. Compliance with the main objectives of the port labour law will need to be ensured in order not to hamper the competitiveness of the Port.

([5]) Court of Auditors report published on 23 June 2016 at http://www.tcontas.pt/pt/actos/rel_auditoria/2016/2s/audit-dgtc-rel007-2016-2s.shtm.

The Portuguese government is reviewing the governance model for public passenger transport services in the metropolitan areas of Lisbon and Porto. The solution previously lined up was based on central government ownership. A public tendering for a sub-concession for the rendering of the services was launched to which both private firms and the municipalities could bid. In the case of the bus services, this solution was abandoned in favour of an overall decentralisation strategy to local authorities and direct award of the transport service provision to their internal operators. For compliance with European regulation ([6]), effective control of the transport service operator by the local authorities will need to be ensured. Yet, so far, only Porto bus line (STCP) has a Memorandum of Understanding to initiate the decentralisation process; while for the metropolitan area of Lisbon (Carris), there is still lack of clarity on which will be the chosen solution for the bus transport company. Regarding subway lines, the solution envisaged by the authorities is to keep central government ownership. For Metro do Porto a new public tender is being prepared for a sub concession to be awarded by 2018. Regarding Metro de Lisboa however, nothing so far has been decided. In order to comply with the above mentioned European regulation, one of two models will need to apply by 2019: either effective control by the local authority; or if it is to remain under central government control, a public tender will need to be launched. Regarding the overall regulation of the transport sector, the AMT is expected to be operational with a complete staff by the end of the year. As a newly established regulatory body, it will be key to ensure its analysis and opinions are fully independent.

The electricity tariff debt remains high, the energy market still shows a high degree of concentration, energy costs to consumers remain among the highest in the EU, and insufficient burden sharing exists between operators and consumers of the risks related to price changes. The total electricity tariff debt is expected to decrease for the first time in 2016 under an optimistic scenario and in 2019 under a pessimistic one when the total clearing of the debt may derail until 2025, and it would not disappear by 2020 as initially agreed. With the exception of the most relevant European financed ‘Projects of Common Interest’, the Portuguese energy regulator (ERSE) has given a negative opinion on most of the investments proposed by the electricity and natural gas network operator (REN) for the period 2016-2025, due to the prevailing overcapacity of the infrastructure energy system to cover the existing and expected demand. The final decision will be taken by the government. While some progress has been made in the liberalisation of the electricity and gas markets, there is still high market concentration, as the dominating incumbents still held important market shares by end-2015 (43% in the electricity market and 53% in the gas market). To promote more competition, a legal framework is underway, although the logistics operator that would facilitate the switch between energy suppliers and foster competition in the market is still not in place. Overall, further measures are needed to increase the risk sharing between grid operators and consumers. This is particularly necessary when drawing cross-country comparisons of the higher risks that operators take in other countries.

The government is considering new saving measures to further reduce the tariff debt. The possibility of renegotiating the interest rate on the stock of debt is being studied. Any measure in this regard should ensure no fiscal impact to the public exchequer while sharing with the electricity consumers the lower interest rates that the incumbent may be benefiting from when securitising the debt. The government has notified the electricity generators Galp and Iberdrola that it intends to keep the collateral given by the companies for the construction of two electric power plants that finally were not built. The feasibility of this measure will depend on the ruling of the courts since Iberdrola has already challenged the measure judicially. The government has also asked the energy regulator (ERSE) to evaluate the possibility of redesigning the existing capacity mechanisms in view of reducing costs to the system and thus to consumers. This measure would not only contribute to decrease the tariff debt but also decrease the costs of the system on a longer term basis. However, the final opinion from ERSE has so far not been given. An audit performed by the energy grid manager (REN) is almost finalised and will identify if there is overcompensation in the method used to give

([6]) Regulation (EC) No 1370/2007 of the European Parliament and of the Council, of 23 October 2007, on public passenger transport services by rail and by road.

compensations to some hydroelectric power plants regarding the participation in the secondary regulation reserve market, which may cause a distortion of the competition. The Government intends to change the rules for the future in case the audit concludes that overcompensation still exists and impose economic sanctions in case the audit finds that there was overcompensation in the past due to market misbehaviour. While these measures could be a step in the right direction, none of them has so far been implemented, nor has it been made explicit to fully assess their impact and in particular the amount of savings remains uncertain.

Competition and regulation

Ensuring an adequately financed Competition Authority is essential to effectively implement the government's reform agenda. Under the programme, a new funding model was adopted to ensure financial stability of the Portuguese Competition Authority. It entails transfers from Regulatory Authorities calculated as a percentage of the fees they charge. The implementation of this funding model requires close attention to ensure that all the regulatory authorities transfer the full amounts on the scheduled date. Currently, one transfer is still outstanding. The funding to the Portuguese Competition Authority should also reflect its growing needs related to stepped up action or additional tasks. Further efforts should be made to foster competition advocacy, including by legally entrusting the competition authority with the duty of delivering a opinion on government bills and regulations which introduce restrictions in terms of access to economic activities.

Judiciary

The efficiency of Portugal's justice system remains low. Despite some progress, the Portuguese judicial system is still characterised by a large backlog of cases and very long duration of court proceedings. In particular, in tax and administrative courts the backlog is high leading to a resolution rate of only about 80%. Insolvency proceedings also remain very long (approximately 40 months) and the insolvency tools PER and SIREVE being used to strategically delay resolution proceedings raise some concerns. The authorities plan to hire new judges, but the full benefits of filling up the judges' posts will only be visible in mid-2020 or later. Reform efforts have been recently focused only on efficiency gains (e.g. enhancing courts digitalisation, task based job organisation of court clerks), but the situation requires further legal and regulatory measures, in particular to improve efficiency indicators for civil, commercial and tax litigation cases. Upgrading the judicial monitoring and evaluation tools is also essential to help improve the speed and service of the justice system and, in this respect, the availability and quality of judicial statistics play a critical role.

Changes to the judicial map agreed under the Programme need to be closely monitored. In the context of the 2016 national reform programme, the Portuguese authorities envisage a reorganisation of the judicial map, referring to the number and geographical location of courts, which was one of the major and successful reforms introduced under the economic adjustment programme. More precisely, according to the national reform programme, 20 courts and over 20 proximity sections will reopen on the basis of a study outsourced to a Portuguese University that has identified remote areas in need of proximity courts. The authorities have committed to carry out an ex-post assessment on the necessity to keep the new courts after one year from the opening of these proximity courts (i.e. beginning of 2018). As a proper impact assessment evaluation and the study methodology are missing, there are doubts about the necessity to change Programme commitments. This amendment to the judicial map needs therefore to be closely monitored to ensure that it does not negatively impact on performance accountability, service delivery and cost affordability of the Portuguese judicial system.

Increasing transparency throughout the entire public procurement cycle is critical to improve productivity, investment and minimise the risk of fraud, corruption and mismanagement of public funds. Contracting authorities in Portugal often make use of direct award procedures. The General Inspectorate of Finance (IGF) indicated the need to improve the internal control system and risk prevention of corruption and related offences in the area of public procurement. The 2016 national reform programme aims at addressing this issue and presents measures that revise the public procurement code. A main goal is to revise the direct awards rules with a view to increasing competition and limiting their use above certain thresholds (use of e-procurement, preliminary market consultation, invitation of minimum 3 bidders, clearer justification for selection of the direct award procedure, limitation of the extreme urgency clause to exceptional circumstances non-attributable to the contracting authority, etc.). The announced revision of the public procurement code represents also a step forward towards the prevention of corruption. The measures under consideration include the obligation for all contracting authorities to take all the necessary measures to prevent and identify any conflict of interests by its staff and members of the jury involved in the preparation and execution of the tender procedures. The implementation of the revised public procurement code needs to be closely scrutinised after its adoption by the end of the year to ensure its full compliance with EU law and best practices.

Transparency in concession contracts and public-private partnerships (PPPs) at local and regional levels remains a challenge. PPPs and concessions are legally obliged to follow the usual procurement awarding procedure i.e. notice publication, ordinary tender, contract award and publication of the tender results. However, the lack of harmonised data collection and of a central oversight makes it difficult to assess the adequacy of transparency requirements of all PPPs and concessions. To tackle any execution and implementation problems in particular at a local level, the IGF is carrying out several audits of local authorities to be concluded by the end of this year. The national Court of Auditors is scrutinising awarding procedures to detect possible “false tenders”, i.e. formal tenders that might hide direct awards. The authorities are also setting up a new register that would give, for the first time, an overview of all PPPs and concession contracts at local level and related amounts. The 2016 budgetary execution decree-law, published in April, has introduced the obligation for the autonomous regions and municipalities to disclose information on a quarterly basis relating to PPP and concession type agreements to the Directorate-General for Budget and to the Directorate-General for Local Administration respectively. According to the Portuguese authorities, this reporting would enable them to decide on whether to expand the mandate of UTAP, which is currently tasked only with the oversight of PPPs and concessions at the central level and with a mere consulting role, on demand, for the other contracts.

Enhancing quality and accessibility of public procurement data is essential for better transparency and accountability in public procurement. According to data from BASE over the period 2013-2015 direct awards constituted 83% of all public contracts representing 47% of total amounts contracted. In the authorities’ view, this high proportion does not accurately reflect reality and is partly explained by entry errors, filing mistakes and problems of categorisation rather than irregularities in the implementation of public procurement rules. The reliability of BASE data collection and presentation is also affected by the lack of clarity on the type of registered contracts since there is no proper distinction between contracts classified under the category of direct awards (‘adjuste direto’). Apart from errors, these also include: (1) contracts awarded within a framework agreement (in principle not problematic); (2) contracts awarded by using some kind of competition procedure; (3) direct awards strictu sensu, that is, contracts that were awarded directly to one single bidder. The BASE portal could include also contracts awarded by private entities and bodies which are not contracting authorities under public procurement law. Finally, some contracts such as in-house, which are public contracts deriving from public-public cooperation relations, and old PPP contract awards are still not included in BASE. The authorities announced the intention to introduce mechanisms to improve the quality of data in BASE, without, however, providing detailed and time-bound initiatives.

Housing

Progress in the implementation of housing market reforms needs to be monitored. The authorities have recently announced additional public funds which are meant to financially support younger tenants and initiate housing rehabilitation projects. In particular the financial envelope envisaged for the ‘National Fund for Rehabilitation’ will need to be carefully monitored to ensure to significant budgetary impact. The ongoing discussions to extend the transitional period of old contracts of households (before 1995) of additional two years (from 5 to 7 years) stands in contrast to the initial objective of the urban lease law introduced after the end of the

Programme as it would further increase legacy privileges and dual markets, thus undermining the soundness and effectiveness of the overall framework. Moreover, it would reduce incentives for landlords to invest in renovation and thereby offset the objective of the publically funded initiative planned at the same time. As regards the ex-post assessment of the lease reform, the Tax Authority is implementing a dataset for collecting data on signed contracts that shows an increase of those contracts. However, it is still not possible to know the universe of the total contracts and out of this universe, the number of contracts that are contained in the tax administration database, the share of old contracts that are potentially covered by the transitional period and new contracts. Gathering more evidence on the shadow economy in the rental market would be important to tackle tax evasion and fraud in the commercial and housing lease market. It is therefore necessary to make further efforts to enhance monitoring procedures to have more comprehensive metrics enabling to assess the overall impact of the lease reform, including by linking up various data sources (buildings' registry, utilities' contracts, and means testing of households) and other databases such as the system administrated by the housing market observatory.

Services and regulated professions

Administrative and regulatory barriers to competition in services and regulated professions remain. Some restrictions to the access to some regulated professions (especially the legal professions) and services (construction and higher education) are detrimental to competition and investment in those sectors. No progress as regards those sectors has been observed compared to previous missions. The existing legal bottlenecks concern legislation on professional companies that still restricts the setting-up and operation of corporate groups. By-laws governing professional bodies, particularly provisions regarding their statutes and internal rules, are also restrictive and may prevent both natural and legal persons from gaining access to the professions concerned. They create obstacles to multidisciplinary practices and advertising which could affect fees. Regarding persistent barriers to establishment of universities from other Member States through franchising arrangements and high and potentially disproportionate administrative fees charged of construction service providers, a constructive dialogue is, nevertheless, ongoing.

Administrative simplification, licensing and business environment

A new set of simplification measures is expected to further reduce administrative burden for businesses. The 2016 national reform programme includes several initiatives to upgrade the Portuguese public administration in particular through a new SIMPLEX Program, building on the previous 2006-2011 programme. The new programme includes 255 simplification measures, most of them to be implemented by May 2017, that are targeted at citizens and businesses such as simplified business information, single environmental procedure, on-line judicial certificate, digital tool to settle debits and credits with the public administration. To quantify the cost of administrative burden, the authorities are in the process of setting up a new commission for legislative simplification (ICLS) that is finalising a methodology according to which the time spent by business on administrative procedures introduced by the simplex programme could be reduced up to 15%. However, the actual financial costs and yields cannot be ascertained before May 2017, when the measures are implemented. A detailed ex-ante impact assessment with quantified potential benefits to select the adopted measures and define their priority is also missing.

The impact of the ambitious reform agenda in relation to licensing procedures developed under the Programme is not yet fully evident. A first ex-post assessment of the single environmental regime will be carried out only in 2017. The implementation of the reformed licensing regimes for industry and tourism appears challenging since it requires a stronger cooperation between different ministries. The reformed commercial licensing regimes have increased the recourse to simplified procedures with a mere prior communication rather than prior authorisation. However, some requirements related to the authorisation of larger retail areas might entail high charges. Their impact on market entry needs to be assessed.

The authorities are making efforts to further improve the content and transactionality of the Point of Single Contact for entrepreneurs. Work is ongoing to include information and e-procedures, including from regional and local administrations, in the Point of Single Contact (PSC), the e-government portal for businesses set up under the EU Service Directive framework. The authorities are also making efforts to roll-out a mobile digital key to enable use of the PSC, although access to it by service providers not holding a Portuguese ID card is still not possible through electronic means at a distance. A new pilot project is being established in Paris with a view to enable the access to e-procedures requiring e-ID and e signatures for service providers of all Member States, without moving physically to Portugal. Physical displacement to Portuguese consulates will nevertheless be required.

Evaluation of structural reforms

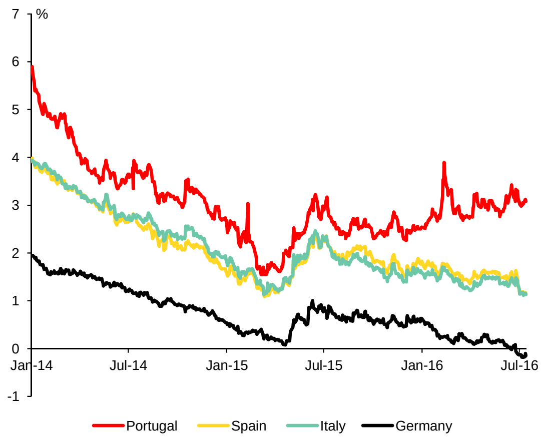
The evaluation of structural reforms is advancing, although with some delay. The 2016 national reform programme shows some improvement in evaluating planned reforms. It provides some estimates of the macroeconomic effects of selected reforms that have been obtained through the quantitative models used at the European Commission (QUEST III), although the scope of this exercise remains limited both due to the difficulties in simulating structural reforms and to some capacity constraints within the Portuguese authorities. The authorities, in cooperation with the University of Porto are also finalising the quantification of recent reforms in the area of education and justice. A systematic evidence-based evaluation of progress in the structural reform agenda is however still lacking in many fields, such as regards reforms in the labour market, judiciary, housing, services and network industries. More generally, a comprehensive government-wide strategy to evaluate reforms ex-ante and ex-post from a microeconomic perspective remains missing to complement the existing macro-modelling approach. In this context, various initiatives should be considered, including setting up a permanent body in charge of assessing the impact of (micro) policy measures and establishing a mandatory systematic ex ante and ex post assessments in the legislation process which encompasses SME and competition tests. Progress in this field remains crucial to increase the efficiency of policy-making and strengthen support and ownership for the necessary continuation of the policy of structural reforms.

4. SOVEREIGN FINANCING AND CAPACITY TO REPAY

The medium-term profile of gross financing needs has improved. A sound management strategy of the Portuguese Debt Management Office, (IGCP), has contributed to smoothening the debt redemption profile and reducing financing needs. Advanced repayments of IMF debt last year and earlier this year amounting to EUR 10.4 billion (or 38% of the original loan) have resulted in some interest savings and in substantial improvement in the redemption profile. For the rest of the year, the IGCP factored in further early repayments to the IMF than those indicated in the third PPS report (about EUR 6.6 billion for the rest of the year, for a total of EUR 8.6 billion in 2016 against EUR 4.6 billion in the third PPS report). Adding redemption of government bonds of EUR 8 billion and a state cash deficit of EUR 6.3 billion, gross financing needs for 2016 would amount to EUR 23 billion, slightly above the EUR 21.5 billion indicated in the third PPS report. The 2016 financing outlook includes the assumption of a successful sale of financial assets of a total amount of about EUR 4 billion by the end of the year. From 2017 to 2020, gross financing needs are now in fact expected to be at about EUR 15.5 billion on average per year, against EUR 18 billion expected at the time of the third PPS report. Large SOEs financing requirements still weight heavily on sovereign financing. To smooth the volatility of the redemption profile, the IGCP has conducted a series of bond buybacks and swaps of debt instruments with short maturity, including a EUR 1 billion bond auction on the 1 July. These operations contributed to a lengthening of the average maturity of market debt from 5.9 to 7.2 years. Given these developments and considering the extension of the ESFM debt maturity, the medium to long term debt redemption schedule is manageable at EUR 5-6 billion per year (Graph 4.2).

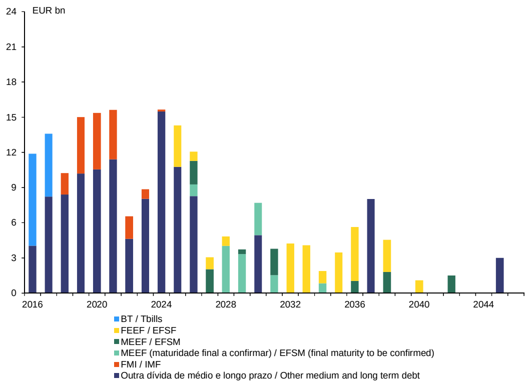
Demand for public funds has stabilised but interest rate volatility has increased also in the aftermath of the outcome of the referendum in the United Kingdom on membership of the European Union. By changing the retail products' remuneration and launching a new product with lower premium the IGCP promoted positive inflows to the government bond market. As a consequence, the government bonds issuance is gradually becoming more regular and the weight of auctions in the yearly funding program is recovering. Yet, since the end of the third PPS mission, interest rate volatility has increased and spreads have widened suggesting some nervousness in the markets. The yields for 10 year Portuguese government bonds remain at high levels. This reflects pressures from global volatility after the referendum in the United Kingdom on the membership of the European Union referendum, policy uncertainties and some weaknesses in the Portuguese financial sector. From 2.7% in January 2016, yields for 10-year government bonds peaked to above 4% in February also on account of international market volatility. After that bond yields stabilised slightly above 3 %, but the spread vis-à-vis the German bund and the Italian and Spanish bonds is widening (Graph 13). The outcome of the UK referendum triggered a negative impact on the Portuguese sovereign and stock exchange. Yields for 10-year government bonds increased by 27bps to 3.35% on the 24th of June, the second largest expansion after the Greek sovereign. The spread to the German bund widened to 346bps and the stock exchange, PSI20, dropped 7% on the same day, with losses broadly in line with most other EA members and lower than for other vulnerable countries such as Greece, Italy and Spain. As international markets stabilised, Portuguese yields and spreads returned to lower levels and the PSI20 went back to report gains.

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



Source: Data Insight

Graph 4.2: **Redemption profile**



Source: IGCP, last update 21 June 2016

Risks to sovereign financing and capacity to repay are manageable in the short term but recently more volatile market conditions point to Portugal's vulnerable position in a more risk-adverse environment. Under stable funding conditions, a smoother and lower redemption profile and smaller financing needs can be met by the increasing demand for funds. Yet, as cash buffers is set to decline and interest rates remain volatile, risks to sovereign financing may increase in the medium term. The projected cash position (excluding cash-collateral) for end-2016 stands at EUR 6.5bn. While this would be in line with the end 2015 amount, cash buffers are now much smaller than what they were at the end of the programme and are expected to decline in outer years, to about EUR 4.5 bn in 2019. Further, as pointed out in the IMF 2016 Country Report (16/97), Portugal's ongoing refinancing operations remain highly vulnerable to shifts in market sentiment which might reverse in case of delays in fiscal consolidation and structural reforms or policy reversals. Hence, ultimately the country's capacity to repay rests on the condition that the government complies with its commitments and takes all necessary measures to address any banking issues.

ANNEX 1

Specific monitoring in the framework of the Macroeconomic Imbalance Procedure

State of Play of the implementation of relevant country-specific recommendations

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

Commitments	**European Commission summary assessment** ([7])
2015 Country specific recommendations (CSRs)	
CSR1: Ensure a durable correction of the excessive deficit in 2015 by taking measures as necessary. Achieve a fiscal adjustment of 0,6% of GDP towards the medium-term budgetary objective in 2016. Use windfall gains to accelerate the deficit and debt reduction. Enforce the commitment control law to better control expenditure. Improve the medium-term sustainability of the pension system. Safeguard the financial sustainability of state-owned enterprises. Further improve tax compliance and the efficiency of the tax administration.	Portugal has made **some progress** in addressing CSR1 (this overall assessment of CSR1 excludes an assessment of compliance with the Stability and Growth Pact): There has been **some progress** in enforcing the commitment control law as arrears have continued to fall until end-2015. However, its underlying principles have not been fully enforced and its implementation in the health sector should be closely monitored and audited. In this sector the effort to clear arrears made during 2015 (EUR 105 million) was already offset by their increase in the first five months of 2016 (EUR 160 million), raising the stock by 35% since December 2015 to over EUR 0.6 billion again. The share of the health sector arrears in total government arrears accordingly increased by 7 percentage points in the same period to about 57% of the whole amount, highlighting the importance of addressing this issue through accurate and balanced budgeting as well as the effective enforcement of the commitment control law. There has been **some progress** towards making the pension system more sustainable in the long-term but the current government has plans to re-design the whole social security pension system and is therefore re-assessing the reforms recently implemented. Furthermore, the short to medium-

([7]) The following categories are used to assess progress in implementing the 2015 country-specific recommendations of the Council Recommendation: No progress: The Member State has neither announced nor adopted any measures to address the country-specific recommendation. This category also applies if a Member State has commissioned a study group to evaluate possible measures. Limited progress: The Member State has announced some measures to address the country-specific recommendation, but these measures appear insufficient and/or their adoption/implementation is at risk. Some progress: The Member State has announced or adopted measures to address the country specific recommendation. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases. Substantial progress: The Member State has adopted measures, most of which have been implemented. These measures go a long way in addressing the country-specific recommendation. Fully addressed: The Member State has adopted and implemented measures that address the country-specific recommendation appropriately.

	term sustainability challenges of the pension system remain unaddressed. Under this re-designing process, reducing budgetary reliance through new spending and revenue measures remains fundamental. Similarly, it should be ensured that any amendment to the recently implemented reform does not endanger its sustainability in all time-spans. Only after finishing this study will the authorities proceed with changes in the old civil servants' pension scheme to align it with the general social security pension framework. Any changes to the pension systems should always take into consideration reducing intergenerational inequalities. There has been **some progress** concerning the financial sustainability of state-owned enterprises (SOEs). As a result of rationalisation measures and mergers between companies, the operating performance of SOEs has been improving. Equity operations carried out by the state have also strengthened several companies' financial position. Partial reversal of the privatisation of the air carrier TAP may imply additional fiscal risks as well as pressure on the public debt. Notwithstanding its current sound operational situation and the recent signature of a five year public service obligation contract, the definition of a new framework for the recently merged rail and road infrastructure manager IP seems to have lost momentum and is being postponed. A decision on the merger and inherent restructuring proposal of the ferryboat companies operating in the Lisbon area (Transtejo/Soflusa) is being reassessed and expected during the course of the year, including also a new public service obligation contract as the previous one already expired. Authorities have not yet presented concrete and credible plans to offset the potential negative fiscal impact of the recent annulment of urban passenger transportation sub-concessions in Lisbon and Porto. These processes still face fiscal risks related to the claims filed in Court against the government's annulment of the awarding procedures. There has been **some progress** on improving tax compliance and making the tax administration more efficient. The planned reorganisation of tax services at local level is progressing. Measures are being taken to combat tax fraud in the housing market, improve arrangements for sharing

	information with financial institutions, and strengthen the anti-money-laundering framework.
CSR2: Promote the alignment of wages and productivity, in consultation with the social partners and in accordance with national practices, taking into account differences in skills and local labour market conditions as well as divergences in economic performance across regions, sectors and companies. Ensure that developments relating to the minimum wage are consistent with the objectives of promoting employment and competitiveness.	Portugal has made some progress in addressing CSR2: **Some progress** on promoting the alignment of wages and productivity. The most recent data available show that wage developments have been moderate and in line with productivity over a medium-term horizon. Collective bargaining at sectoral level has been supportive of this process. However firm-level bargaining is not picking up, potentially limiting the scope for wage differentiation according to the dimensions mentioned in the CSR. **No progress** as regards the minimum wage. It was further increased in January 2016 from EUR 505 to EUR 530, in a context of low inflation and high unemployment, putting upward pressures on the overall wage structure with the risk of affecting employment and competitiveness. A first quarterly report on the economic impact of minimum wage developments has been produced by the Government and further quarterly reports will be discussed with social partners regarding future increases in the minimum wage.
CSR3: Improve the efficiency of public employment services, in particular by increasing outreach to non-registered young people. Ensure effective activation of benefit recipients and adequate coverage of social assistance, in particular the minimum income scheme.	**Some progress** has been made in improving the efficiency of the public employment services through a reinforced performance management and an ongoing shift towards digital services. As part of the ongoing administrative simplification process, the creation of one-stop-shops for long-term unemployed is being considered, although it is not yet in an implementation phase. While partnerships with municipalities, training organisations and social economy actors are well developed, there has been limited progress in binding partnerships with private employment services and it is unclear if a tender procedure will be launched. **Some progress** has been made in increasing outreach to non-registered young people but challenges in its implementation still persist. A broad network of partners engaged in the implementation of the Young Guarantee has been set up to reach out to young people aged under 30 and not in employment, education or training (NEET). Another positive step has been the

	creation of a Youth Guarantee online platform where NEETs can register. An assessment of the effectiveness of activation policies in promoting a sustainable labour market integration, including of young people, is being made. There has been **some progress** in ensuring adequate coverage of social assistance, in particular through the minimum income scheme. There have been changes to the eligibility criteria of the minimum income scheme in order to extend its coverage. Further measures in this area include an increase in child benefits, including for single parents households. No new specific measures have been taken on activation for minimum income scheme recipients.
CSR4: Take further measures to reduce the corporate debt overhang, to address the corporate non-performing loans ratio in banks and to reduce the debt bias for corporates under tax provisions. Improve the efficiency of debt restructuring tools for viable companies by introducing incentives for banks and debtors to engage in restructuring processes at an early stage.	**Limited progress:** Authorities failed to provide a coherent strategy how to tackle the massive stock of non-performing loans debt overhang. Portuguese authorities currently work on several initiatives to treat new insolvency cases faster yet again no coherent roadmap with deliverables and deadlines was mentioned nor is there a strategy how to deal faster with the immense stock of already insolvent companies. The corporate debt bias in taxation remains high. A task force for the capitalisation of companies has proposed a strategy for the capitalisation of firms, currently under the government's assessment. This includes tax measures aimed at improving neutrality in the taxation of equity and debt. Insolvency proceedings remain very long and there are some concerns about the insolvency tools PER and SIREVE being used to strategically delay resolution proceedings
CSR5: Accelerate measures and increase transparency as regards concessions, including in the transport sector, and private- public partnerships at local and regional level	**Some progress** In the 2016 NRP, the Portuguese government has announced several measures to increase transparency in public procurement. They include: the consultation of at least 3 entities before granting direct awards; the preliminary consultation to the market; the preliminary use of electronic platforms; the use of terms of reference; safeguards to prevent conflict of interest and corruption when preparing and executing tender procedures. These measures will be included in the revised

	Public Contract Code that will be approved by the end of 2016, after a public consultation during the summer. The oversight of PPPs and concessions, particularly at the local level, remains challenging. To tackle execution and implementation problems, the Portuguese authorities are stepping up efforts. In particular, the General Inspectorate of Finance IGF is carrying out several audits of local authorities and the national Court of Auditors is scrutinising awarding procedures to detect possible 'false tenders', i.e. formal tenders that might hide direct awards. The authorities are also setting up a new register of all PPP and concession contracts at local level and related amount. The 2016 budgetary execution decree-law has introduced the obligation for the autonomous regions and municipalities to disclose information on a quarterly basis relating to PPP and concession type agreements to the central government. Implementing the Public Contract Code in line with EU law, ensuring quality data on public procurement and fully overseeing all PPPs and concessions are essential to increase transparency throughout the entire public procurement and investment in the country.

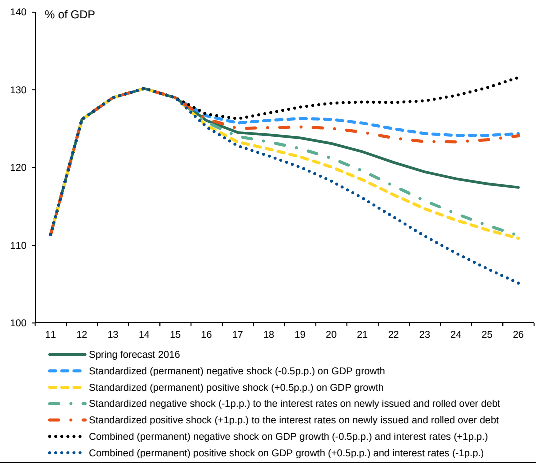
ANNEX 2

Debt sustainability analysis

The present Debt Sustainability Analysis (DSA) uses the spring forecast 2016 as a starting point to ensure cross-country consistency and to take into account second-round macroeconomic effects. The debt-ratio in 2016 is expected to decline to 126% of GDP, a 3pps decline from 2015, mostly on account of expected sales of some financial assets. For the outer years, the analysis rests on the following assumptions: it is assumed that (i) the structural primary fiscal balance remains unchanged at a surplus of 1.7% of GDP as from 2018 under the no-fiscal policy change assumption, (ii) inflation converges linearly to 2.0% by 2020 (year of output gap closure) and remains at that level thereafter; (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5% by the end of the 10-year projection horizon in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group (AWG), (iv) real GDP grows at the rate projected by the EPC's Output Gap Working Group until t+10 and thereafter according to the AWG's projections (level of around 1 1.5%); and (v) ageing costs develop according to the Commission and EPC's 2015 Ageing Report. Overall, this debt profiles rests on the assumption of substantial sales of financial assets later in 2016.

The baseline scenario results in an annual average decrease of the gross debt-to-GDP ratio by around 1pp of GDP and thus ensures a declining path down to 117% of GDP by 2026. This declining debt trajectory is sensitive to financial market volatility and vulnerable to negative economic developments. Graph A2.1 presents a sensitivity analysis with respect to macroeconomic and financial market risks as well as the effect of alternative fiscal consolidation paths. More precisely, the graph illustrates the sensitivity of the debt trajectory to a shock to real GDP growth and hikes in interest rates as from 2016. The analysis suggests that a lower GDP growth rate by 0.5 percentage points or a one percentage point increase in the interest rate on maturing and new debt would increase the debt ratio by 0.3 and 0.7% of GDP, respectively, in 2016. Under both scenarios, debt would be at about 124% of GDP by the end of the projection period. Moreover, a combined negative growth and interest shock could put debt-to GDP ratio on an accelerating path, while, a positive shock to medium and long-term growth, for instance as a result of structural reforms, or permanently lower interest rates would result in a visibly more solid path of debt reduction ([8]) by around 1.6 percentage points per annum to around 111% of GDP in 2026. A combination of higher GDP growth and lower interest rates could further accelerate the pace of the debt ratio reduction to around 2 percentage points per year, thereby allowing for a fall to around 105% of GDP in 2026.

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



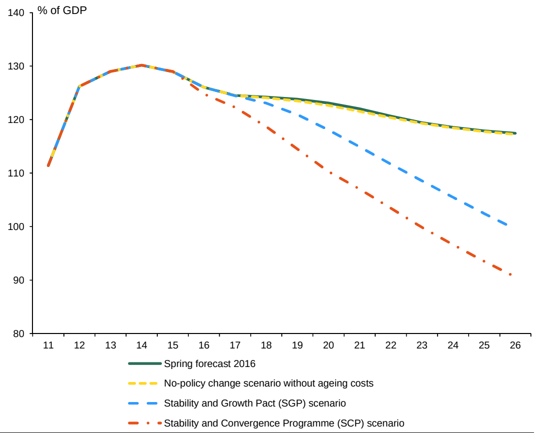
Source: European Commission

Additional fiscal consolidation would clearly accelerate the debt reduction path (Graph A2.2). Full compliance with the requirements of the Stability and Growth Pact (SGP) would considerably further accelerate debt reduction. The SGP scenario assumes convergence to the Medium-Term-Objective (MTO) according to the matrix of required fiscal adjustment in Annex 2 of the January 2015 Communication on flexibility in fiscal rules ([9]). This would imply a MTO of a structural balance of 0.25% of GDP reached in 2021 with a fiscal effort of 0.6% of GDP every year from 2017 to 2021, reaching a primary surplus of 4.4% in 2020. Maintaining the MTO over the longer term horizon will require structural primary surpluses of around 4.4% until the end of the projection horizon. Under these assumptions, the debt to GDP ratio would markedly accelerate its decline to around 3.7 percentage points per annum as from 2020, falling to 95% by 2026.

([8]) Not even taking into account the positive second round effects of the higher GDP growth on the fiscal balance.

([9]) COM(2015) 12.

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



Source: European Commission

The 2016 Stability Programme scenario had assumed a significant fall of the debt-to-GDP ratio to 124.8% already in 2016, in particular due to large stock-flow adjustments (mainly related to potential Novo Banco sales proceeds), and a lower headline deficit. Based on the assumptions of increasing primary surpluses, in a context of low interest rates and nominal GDP growth at around 3.5% from 2018 onwards, the debt-to-GDP ratio in the Stability Programme is projected to decrease rapidly further to 118.7% at end-2018, 114.5% at end 2019 and 110.3% at end-2020. Such scenario would be consistent with a 0.5% of GDP improvement in the structural balance for 2017-2020, which would be compatible with a primary surplus in structural terms of 3.5% of GDP. For 2021 onwards, the primary structural surplus has been set to remain at 3.5% over the entire projected period, which would be consistent with zero or marginal adjustments in the structural balance and a fast fall in the debt ratio to about 90% of GDP by 2026.

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

ANNEX 3

European Commission macroeconomic and fiscal projections (2016 spring forecast)

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

Annual % change	**2015**	**2016**	**2017**
1. Private consumption expenditure	2.6	1.8	1.7
2. Government consumption expenditure	0.6	0.6	0.4
3. Gross fixed capital formation	3.9	1.6	4.9
4. Final domestic demand	**2.5**	**1.5**	**1.9**
5. Change in inventories	--	--	--
6. Domestic demand	**2.4**	**1.5**	**1.9**
7. Exports of goods and services	5.1	4.1	5.1
7a. - of which goods	5.9	3.9	5.1
7b. - of which services	3.1	4.7	5.0
8. Final demand	**3.1**	**2.3**	**2.8**
9. Imports of goods and services	7.4	4.3	5.6
9a. - of which goods	7.9	4.5	5.8
9b. - of which services	4.3	3.8	4.5
10. Gross domestic product at market prices	**1.5**	**1.5**	**1.7**
Contribution to change in GDP			
11. Final domestic demand	2.4	1.5	1.9
12. Change in inventories + net acq. of valuables	-0.1	0.0	0.0
13. External balance of goods and services	-0.9	-0.1	-0.1

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

Annual % change	**2015**	**2016**	**2017**
1. Private consumption expenditure	3.3	2.5	2.9
2. Government consumption expenditure	1.1	2.5	1.7
3. Gross fixed capital formation	4.5	2.4	5.9
4. Final domestic demand	**3.1**	**2.5**	**3.1**
5. Change in inventories	--	--	--
6. Domestic demand	**3.0**	**2.5**	**3.1**
7. Exports of goods and services	4.1	3.1	6.5
8. Final demand	**3.3**	**2.7**	**4.1**
9. Imports of goods and services	3.1	2.2	6.1
10. Gross national income at market prices	2.9	2.9	3.4
11. Gross value added at basic prices	3.1	2.4	3.5
12. Gross domestic product at market prices	**3.4**	**2.8**	**3.3**
Nominal GDP, EUR bn	179.4	184.5	190.6

Table 3: Implicit price deflators

% change in implicit price deflator	**2015**	**2016**	**2017**
1. Private consumption expenditure	0.7	0.7	1.2
2. Government consumption expenditure	0.5	1.8	1.3
3. Gross fixed capital formation	0.6	0.8	1.0
4. Domestic demand	**0.5**	**0.9**	**1.2**
5. Exports of goods and services	-1.0	-1.0	1.4
6. Final demand	**0.1**	**0.4**	**1.2**
7. Imports of goods and services	-4.1	-2.1	0.5
8. Gross domestic product at market prices	**1.9**	**1.4**	**1.5**
HICP	**-0.2**	**0.5**	**0.7**

Table 4: Labour market and cost

Annual % change	2015	2016	2017
1. Labour productivity (real GDP per employee)	0.1	0.6	1.1
2. Compensation of employees per head	-0.6	1.6	1.4
3. Unit labour costs	**-0.6**	**1.0**	**0.3**
4. Total population	-0.5	-0.5	-0.5
5. Population of working age (15-74 years)	-0.5	-0.4	-0.4
6. Total employment (fulltime equivalent)	1.4	0.9	0.7
7. Calculated unemployment rate - Eurostat definition (%)	**12.6**	**11.6**	**10.7**

Table 5: External balance

levels, EUR bn	2015	2016	2017
1. Exports of goods (fob)	52.2	53.4	56.9
2. Imports of goods (fob)	59.8	60.8	64.7
3. Trade balance (goods, fob/fob) (1-2)	**-7.6**	**-7.4**	**-7.8**
3a. p.m. (3) as % of GDP	***-4.2***	***-4.0***	***-4.1***
4. Exports of services	20.1	21.2	22.5
5. Imports of services	11.1	11.6	12.2
6. Services balance (4-5)	**9.0**	**9.5**	**10.3**
6a. p.m. 6 as % of GDP	***5.0***	***5.2***	***5.4***
7. External balance of goods & services (3+6)	**1.4**	**2.1**	**2.5**
7a. p.m. 7 as % of GDP	***0.8***	***1.1***	***1.3***
8. Balance of primary incomes and current transfers	-1.6	-1.6	-1.6
8a. - of which, balance of primary income	*-3.8*	*-3.8*	*-3.8*
8b. - of which, net current Transfers	*2.3*	*2.3*	*2.3*
8c. p.m. 8 as % of GDP	*-0.9*	*-0.8*	*-0.8*
9. Current external balance (7+8)	**-0.1**	**0.6**	**1.0**
9a. p.m. 9 as % of GDP	***-0.1***	***0.3***	***0.5***
10. Net capital transactions	2.2	2.2	2.2
11. Net lending (+)/ net borrowing (-) (9+10)	**2.0**	**2.7**	**3.2**
11a. p.m. 11 as % of GDP	***1.1***	***1.5***	***1.7***

Table 6: Fiscal accounts			
	2015	2016	2017
		% of GDP	
Taxes on production and imports	14,5	15,0	14,8
Current taxes on income, wealth, etc.	10,8	10,3	10,0
Social contributions	11,5	11,5	11,4
Other (residual)	6,9	7,2	7,3
Total revenue	**43,9**	**44,0**	**43,5**
Compensation of employees	11,3	11,2	11,0
Intermediate consumption	5,9	6,3	6,1
Social payments	19,2	18,9	18,7
Subsidies	0,7	0,8	0,7
Gross fixed capital formation	2,2	1,9	2,0
Other (residual)	4,4	3,1	3,1
Interest expenditure	4,6	4,5	4,3
Total expenditure	**48,3**	**46,6**	**45,8**
General Government balance (ESA2010)	**-4,4**	**-2,7**	**-2,3**
Primary balance	0,2	1,8	2,0
		% change	
Taxes on production and imports	6,0	5,9	2,1
Current taxes on income, wealth, etc.	2,6	-2,5	0,7
Social contributions	1,7	2,8	1,9
Other (residual)	-6,5	6,2	5,2
Total revenue	**1,9**	**3,1**	**2,2**
Compensation of employees	-1,1	2,0	1,2
Intermediate consumption	5,2	10,2	-0,2
Social payments	1,2	0,8	2,4
Subsidies	-3,1	19,9	-11,6
Gross fixed capital formation	9,4	-9,7	8,6
Other (residual)	-32,3	-27,7	3,2
Interest expenditure	-3,7	0,4	-1,0
Total expenditure	**-3,5**	**-0,7**	**1,5**
Nominal GDP, EUR bn	**179,4**	**184,5**	**190,6**

Table 7: Government debt developments

	2015	2016	2017
ESA2010 deficit (% of GDP)	**-4,4**	**-2,7**	**-2,3**
ESA2010 gross debt (% of GDP)	129,0	126,0	124,5
levels, EUR bn			
ESA2010 deficit	**-7,9**	**-4,9**	**-4,4**
Gross debt	231,3	232,5	237,3
Change in gross debt	5,6	1,2	4,8
Nominal GDP	179,4	184,5	190,6
Real GDP	171,1	173,6	176,7
Real GDP growth (% change)	**1,5**	**1,5**	**1,7**
Change in gross debt (% of GDP)	3,1	0,6	2,5
Stock-flow adjustments (% of GDP)	-1,3	-2,0	0,2
% of GDP			
Gross debt ratio	**129,0**	**126,0**	**124,5**
Change in gross debt ratio	-1,2	-2,9	-1,5
Primary balance	-0,2	-1,8	-2,0
"Snow-ball" effect	0,2	0,9	0,2
of which			
Interest expenditure	*4,6*	*4,5*	*4,3*
Real growth effect	*-1,9*	*-1,9*	*-2,2*
Inflation effect	*-2,5*	*-1,7*	*-1,9*
Stock-flow adjustments	**-1,3**	**-2,0**	**0,2**
Implicit interest rate	*3,6*	*3,6*	*3,5*

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KC-BC-16-036-EN-N

Publications Office

ISBN 978-92-79-54347-0