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$Assessment \ of \ the \ 2018 \ Stability \ Programme \ for$

Portugal

(Note prepared by DG ECFIN staff)

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1. Introduction

On 27 April 2018, Portugal submitted its 2018 Stability Programme (hereafter called Stability Programme), covering the period 2018-2022. The government approved the programme on 12 April 2018 and it was submitted to the Portuguese Parliament on 13 April 2018 where it was discussed on 24 and 26 April.

Portugal is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its Medium-Term Budgetary Objective (MTO). As the debt ratio was 129.9% of GDP in 2016 (the year in which Portugal corrected its excessive deficit), exceeding the 60% of GDP reference value, Portugal is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark during the three years following the correction of the excessive deficit (transitional debt rule). In this period it should ensure sufficient progress towards compliance with the debt reduction benchmark. After the transition period, as of 2020, Portugal is expected to comply with the debt reduction benchmark.

This document complements the Country Report published on 7 March 2018 and updates it with the information included in the Stability Programme.

Section 2 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2018 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on the Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Real GDP grew by 2.7% in 2017 supported by domestic demand, particularly investment, and exports. Investment growth reached 9.1% driven by an upturn in construction and equipment. Exports also increased significantly, by 7.8% in 2017, although their contribution to GDP growth was reduced by equally strong imports. Along with the continuous expansion in tourism, the automotive industry also contributed to the solid export performance. The strong momentum reinforced job creation and unemployment fell to 9% in 2017 amid moderate wage developments. HICP inflation reached 1.6%, largely driven by the energy and service sectors.

The macroeconomic scenario underpinning the Stability Programme sets real GDP growth at 2.3% per year in 2018-2020 followed by a slight moderation to 2.1% in 2022. Private consumption growth is expected to grow by 2.0% per year throughout the whole period. Investment is expected to be more volatile but rising at a much faster rate than private consumption, benefiting also from the expected increase in absorption of EU funds. Imports are forecast to rise slightly faster than exports while the share of external trade in GDP is set to increase over the programme horizon though at a slowing pace. Employment growth is forecast to gradually slow down from 1.9% in 2018 to 0.8% in 2022 while wage growth is expected to increase from 1.8% to 2.4% for the same period, including the impact of the unfreezing of career progressions in the public sector. Unemployment is set to steadily decline to 6.3% in 2022 while HICP inflation is expected to remain below 2%.

Compared to the Commission 2018 spring forecast, the macroeconomic scenario under the Stability Programme has an identical GDP growth projection for 2018 but becomes somewhat more favourable thereafter. As regards domestic demand, only investment is estimated to grow at a slightly higher rate in comparison with the Commission forecast in 2018, but this is offset by a slightly negative contribution from net exports. In 2019, private consumption and investment are expected to exceed the Commission forecast, but by a relatively small margin. In both 2018 and 2019, while employment growth is slightly higher in the Commission forecast, wage developments are somewhat more subdued in comparison with the Stability Programme. The output gap, as recalculated by the Commission based on the information in the programme, following the commonly agreed methodology, is estimated in a positive territory at 0.5% of GDP in 2018 and is set to gradually widen thereafter. According to the Commission forecast, the output gap is higher and is increasing faster. This difference is underpinned by higher potential growth estimates in the Stability Programme stemming from more optimistic economic projections over the medium run. Overall, the programme's macroeconomic assumptions are plausible until 2018 and somewhat more favourable thereafter.

Table 1: Comparison of macroeconomic developments and forecasts

| _ | 20 | 17 | 20 | 18 | 2019 | | 2020 | 2021 | 2022 |
|--|------|------|-----|------|------|------|------|------|------|
| | COM | SP | COM | SP | COM | SP | SP | SP | SP |
| Real GDP (% change) | 2.7 | 2.7 | 2.3 | 2.3 | 2.0 | 2.3 | 2.3 | 2.2 | 2.1 |
| Private consumption (% change) | 2.3 | 2.3 | 2.0 | 2.0 | 1.8 | 2.0 | 2.0 | 2.0 | 2.0 |
| Gross fixed capital formation (% change) | 9.1 | 9.1 | 5.7 | 6.2 | 5.3 | 7.0 | 7.1 | 6.4 | 5.5 |
| Exports of goods and services (% change) | 7.8 | 7.8 | 6.8 | 6.3 | 5.5 | 4.8 | 4.2 | 4.2 | 4.2 |
| Imports of goods and services (% change) | 7.9 | 7.9 | 6.9 | 6.3 | 5.6 | 5.0 | 4.5 | 4.5 | 4.4 |
| Contributions to real GDP growth: | | | | | | | | | |
| - Final domestic demand | 2.8 | 2.9 | 2.3 | 2.5 | 2.1 | 2.6 | 2.6 | 2.5 | 2.4 |
| - Change in inventories | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| - Net exports | 0.1 | -0.2 | 0.0 | -0.2 | 0.0 | -0.2 | -0.3 | -0.3 | -0.2 |
| Output gap ¹ | 0.3 | 0.1 | 1.0 | 0.5 | 1.3 | 0.5 | 0.6 | 0.8 | 0.8 |
| Employment (% change) | 3.3 | 3.3 | 2.1 | 1.9 | 1.3 | 1.1 | 0.9 | 0.8 | 0.8 |
| Unemployment rate (%) | 9.0 | 8.9 | 7.7 | 7.6 | 6.8 | 7.2 | 6.8 | 6.5 | 6.3 |
| Labour productivity (% change) | -0.6 | -0.6 | 0.2 | 0.5 | 0.8 | 1.2 | 1.4 | 1.4 | 1.3 |
| HICP inflation (%) | 1.6 | 1.6 | 1.2 | 1.5 | 1.6 | 1.5 | 1.5 | 1.8 | 1.8 |
| GDP deflator (% change) | 1.4 | 1.4 | 1.3 | 1.4 | 1.4 | 1.4 | 1.4 | 1.5 | 1.5 |
| Comp. of employees (per head, % change) | 1.1 | 1.1 | 1.8 | 2.1 | 2.0 | 2.1 | 2.2 | 2.4 | 2.4 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | 1.4 | 1.4 | 1.5 | 1.6 | 1.5 | 1.8 | 1.8 | 1.6 | 1.6 |

Note:

¹In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Commission 2018 spring forecast (COM); Stability Programme (SP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018

The general government headline deficit turned out at 3.0% of GDP¹ in 2017, i.e. around 1.5% of GDP above the targets of 1.5% and 1.4% of GDP in the 2017 Stability Programme and the DBP 2018 respectively. However, this difference was entirely due to the 2.0% of GDP impact of the public recapitalisation of Caixa Geral de Depósitos (CGD). Net of this and other one-off operations, the headline deficit would have decreased to 0.9% of GDP.

As compared to the 2017 Stability Programme target of 1.5% of GDP, the headline deficit reduction net of CGD was mainly due to expenditure developments, i.e. a further decrease in interest expenditure of close to 0.25% of GDP, further overall primary current expenditure containment of around 0.1% of GDP and a further decrease in capital expenditure by 0.1% of GDP. Overall, the revenue side only contributed by around 0.1% of GDP to the total improvement as compared to the 2017 Stability Programme as higher revenue from taxes and social security contributions (+0.7% of GDP) was mostly offset by lower than expected other current and capital revenue (-0.6% of GDP)².

As compared to the DBP 2018 projections for 2017, that had mainly revised upwards both tax revenue and current primary expenditure, the 0.5% improvement in the headline deficit was mostly due to lower than projected primary expenditure (-0.8% of GDP). This expenditure containment more than offset the shortfall on the revenue side (-0.3% of GDP), where higher taxes and social contributions (+0.2 of GDP) could only partially compensate the lower than projected other current and capital revenue (-0.5% of GDP).

The deficit net of one-offs decreased by 1.5% of GDP in 2017 falling from 2.4% of GDP in 2016 to 0.9% in 2017. Taking also into account the impact of the cycle, the structural balance improved by 0.9% of GDP while the structural primary balance improved by 0.5% of GDP.

For 2018, the Stability Programme targets a revised headline deficit of 0.7% of GDP, i.e. 0.3% of GDP below the target of 1.0% of GDP in the 2017 Stability Programme and 0.4% of GDP below the approved 2018 Budget target of 1.1% of GDP³. The improvement compared to the 2017 Stability Programme reflects an upward revision of revenue by around 0.8% of GDP, more than compensating an upward revision of expenditure by around 0.6% of GDP. On the revenue side, an upward revision of around 1% of GDP for taxes and social

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¹ The Stability Programme submitted to the Commission differs from Eurostat's binding validation of the 2017 deficit which fixes the deficit at 3.0% of GDP. It shows instead a general government deficit of 0.9% of GDP while acknowledging in footnote 15 that according to the 1st EDP notification the CGD impact would bring the 2017 deficit to 3.0% of GDP.

² The 0.3% of GDP lower outturn for capital revenue was mainly due to the 0.2% of GDP impact of the postponement from 2017 to 2018 of most of the recovery of the State Guarantee granted to Banco Privado Português (BPP).

³ In addition to limited further revenue and expenditure measures with a broadly neutral fiscal impact, the parliamentary amendments also increased expenditure by around 0.12% of GDP to react to the 2017 large-scale wildfires (of which 0.05% of GDP for one-off emergency measures and 0.07% of GDP for preventive measures). As a result, the deficit target increased from 1.0% of GDP in the Draft Budgetary Plan to 1.1% of GDP in the final version of the 2018 Budget as approved by Parliament in November 2017.

contributions and 0.3% of GDP for capital revenue⁴ was partially offset by a downward revision of 0.4% of GDP for sales and other current revenue. On the expenditure side, as regards current expenditure, the downward revision of interest expenditure by more than 0.4% of GDP almost fully compensated the upward revisions of primary current expenditure. Capital expenditure however increased by 0.6% of GDP, which mainly reflects the 0.4% of GDP impact of the activation of the Novo Banco contingent capital mechanism.

As compared to the approved 2018 budget, the improvement by 0.4% of GDP mostly reflects the improved carry-over from 2017 on current expenditure mitigated by the 0.4% of GDP negative impact of the Novo Banco contingent capital mechanism. Thus, on the expenditure side, a downward revision by 0.8% of GDP of current expenditure is partially offset by a 0.3% of GDP increase of capital expenditure, resulting in an overall decrease of expenditure of 0.5% of GDP. This 0.5% of GDP improvement on the expenditure side is however accompanied by a slight downward revision of overall revenue by 0.1% of GDP as increases for taxes and social contributions (0.4% of GDP) and capital revenue (0.1% of GDP) are more than outweighed by strong downward revisions of sales and other current revenue (-0.6% of GDP).

The Stability Programme projects the deficit net of one-offs to improve to 0.3% of GDP in 2018. According to the programme, the planned headline deficit reduction in 2018 would be consistent with an improvement in the (recalculated⁵) structural balance by around 0.4% of GDP in 2018.

The planned headline deficit of 0.7% of GDP in 2018 compares to a projection of 0.9% of GDP in the Commission 2018 spring forecast. The difference is mostly related to higher expected compensation of employees in the spring forecast based on the track record of public employment increases in 2016 and 2017 (as opposed to planned decreases). The structural balance is projected to remain stable in 2018 according to the spring forecast. The 0.4% of GDP divergence is due to the difference in the headline deficit, a more positive output gap projection in the spring forecast resulting in a higher cyclical adjustment than in the Stability Programme and a difference in one-off expenditure, related to the inclusion of the "unusual event" exceptional wildfire prevention structural expenditure and of payments to Greece as one-off in the Stability Programme.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

Taking the 2017 headline deficit excluding the CGD impact of 0.9% of GDP as a starting point, the Stability Programme plans to gradually improve the headline balance by 2.2% of GDP over 2018-2022, reaching -0.7% of GDP in 2018, -0.2% in 2019, 0.7% in 2020, 1.4% in 2021 and 1.3% in 2022 (Figure 1). This would be consistent with a gradual improvement of the structural balance by an average of close to 0.4% of GDP per year over 2018-2022 allowing the MTO to be reached in 2020. The chosen MTO of a structural balance of 0.25% of GDP reflects the objectives of the SGP. Overall, following the higher than expected headline deficit reduction (net of CGD) in 2017, the Stability Programme plans a slower pace in 2018 and 2019 and then broadly replicates the pace of the 2017 Stability Programme in the outer years. Following a relatively slow pace of improvement in 2019 of around 0.3% of

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⁴ The upward revision for capital revenue mainly reflects the 0.2% of GDP impact of the postponement from 2017 to 2018 of most of the recovery of the State Guarantee granted to BPP.

⁵ Recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology.

GDP both for the headline and the structural balance, the nominal and structural balance improvement is planned to peak in 2020 at 0.9% of GDP and 0.6% of GDP, respectively, allowing to reach the MTO one year earlier than in the 2017 Stability Programme. The average nominal and structural adjustment then returns to a pace of 0.3% of GDP over 2021-2022 (as the headline deficit improvement of 0.7% which is largely due to a 0.4% positive revenue one-off of the repayment of EFSF prepaid margins is followed by a slight 0.1% headline deficit deterioration in 2022). As compared to the 2017 Stability Programme the pace of structural adjustment has been reduced by around 0.2% of GDP in both 2018 and 2019, slightly increased by 0.1% in 2020 and left at the same level in 2021.

Table 2: Composition of the budgetary adjustment

| (% of GDP) | 2017 | 20 | 18 | 201 | 19 | 2020 | 2021 | 2022 | Change: 2017-2022 |
|--|------|------|------|------|------|------|------|------|-------------------|
| | COM | COM | SP | COM | SP | SP | SP | SP | SP |
| Revenue | 42.9 | 43.2 | 43.2 | 42.9 | 42.9 | 42.9 | 43.2 | 42.7 | -0.2 |
| of which: | | | | | | | | | |
| - Taxes on production and imports | 15.0 | 15.2 | 15.2 | 15.2 | 15.2 | 15.2 | 15.2 | 15.2 | 0.1 |
| - Current taxes on income, wealth, etc. | 10.2 | 9.9 | 9.9 | 9.7 | 9.7 | 9.7 | 9.5 | 9.5 | -0.7 |
| - Social contributions | 11.8 | 11.8 | 11.8 | 11.9 | 11.8 | 11.8 | 11.9 | 11.9 | 0.2 |
| - Other (residual) | 5.9 | 6.3 | 6.3 | 6.1 | 6.2 | 6.2 | 6.6 | 6.1 | 0.2 |
| Expenditure | 45.9 | 44.1 | 43.9 | 43.5 | 43.0 | 42.2 | 41.7 | 41.4 | -2.4 |
| of which: | | | | | | | | | |
| - Primary expenditure | 42.0 | 40.5 | 40.4 | 40.1 | 39.7 | 39.0 | 38.6 | 38.3 | -1.7 |
| of which: | | | | | | | | | |
| Compensation of employees | 11.0 | 11.0 | 10.8 | 10.9 | 10.6 | 10.4 | 10.2 | 10.0 | -1.0 |
| Intermediate consumption | 5.4 | 5.4 | 5.3 | 5.3 | 5.2 | 5.1 | 5.1 | 5.0 | -0.4 |
| Social payments | 18.4 | 18.4 | 18.3 | 18.3 | 18.2 | 17.9 | 17.8 | 17.7 | -0.8 |
| Subsidies | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.0 |
| Gross fixed capital formation | 1.8 | 2.2 | 2.3 | 2.3 | 2.4 | 2.6 | 2.6 | 2.6 | 0.9 |
| Other (residual) | 4.9 | 3.2 | 3.2 | 2.8 | 2.8 | 2.6 | 2.5 | 2.5 | -0.3 |
| - Interest expenditure | 3.9 | 3.5 | 3.5 | 3.4 | 3.4 | 3.2 | 3.1 | 3.1 | -0.8 |
| General government balance (GGB) | -3.0 | -0.9 | -0.7 | -0.6 | -0.2 | 0.7 | 1.4 | 1.3 | 2.2 |
| Primary balance | 0.9 | 2.7 | 2.8 | 2.8 | 3.2 | 3.9 | 4.5 | 4.4 | 1.4 |
| One-off and other temporary measures | -2.1 | -0.3 | -0.4 | -0.1 | -0.1 | 0.0 | 0.4 | 0.0 | 0.0 |
| GGB excl. one-offs | -0.9 | -0.5 | -0.3 | -0.5 | 0.0 | 0.7 | 1.0 | 1.3 | 2.2 |
| Output gap ¹ | 0.3 | 1.0 | 0.5 | 1.3 | 0.5 | 0.6 | 0.8 | 0.8 | 0.7 |
| Cyclically-adjusted balance ¹ | -3.1 | -1.4 | -1.0 | -1.3 | -0.4 | 0.4 | 1.0 | 0.8 | 3.9 |
| Structural balance ² | -1.1 | -1.1 | -0.6 | -1.1 | -0.3 | 0.4 | 0.6 | 0.8 | 1.8 |
| Structural primary balance ² | 2.8 | 2.5 | 3.0 | 2.3 | 3.1 | 3.6 | 3.7 | 4.0 | 1.0 |

Notes:

Source :

Stability Programme (SP); Commission 2018 spring forecasts (COM); Commission calculations.

As compared to the DBP 2018, the Stability Programme has broadly maintained the planned structural adjustment of around 0.4% of GDP in 2018 with no major changes in the overall

¹Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

²Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

balance of structural measures. The Stability Programme plans an improvement of the structural balance by 0.3% of GDP in 2019 as compared to a slight deterioration by 0.1% of GDP in the Commission spring forecast. The 0.4% of GDP difference in the structural balance variation is mostly related to the difference in the evolution of the headline balance but also to the more positive output gap evolution based on lower potential growth estimates than in the Stability Programme (partially compensated by the offsetting of the 2018 one-off difference). The spring forecast projects a headline deficit of 0.6% of GDP in 2019, 0.4% of GDP above the 0.2% of GDP target in the Stability Programme. About half of the divergence is related to higher expected pressures for compensation of employees, another 0.1% of GDP for pressures on other expenditure items (as expenditure measures could not be fully factored in) and another 0.1% of GDP due to lower indirect tax revenue resulting from the spring forecast's slightly more conservative macro scenario and insufficiently specified tax measures.

The budgetary targets in the programme are based on a scenario including a limited number of specified measures with a broadly balanced impact while most of the consolidation is expected to be achieved via the general projection of a contained evolution of most expenditure items, in particular compensation of employees and social payments, below the relatively high projected nominal GDP growth.

The Stability Programme adjustment is planned to be done mostly on the expenditure side with a planned reduction by 2.4 percentage points of GDP from 2017 (net of the CGD impact) to 2022. About one third of this adjustment (0.8 percentage points) is projected to be due to a reduction in interest expenditure while two thirds (1.7 percentage points) would come from a reduction of primary expenditure. This reduction in primary expenditure in percentage of GDP would in particular be achieved by decreases for compensation of employees (-1.0 percentage points of GDP), social transfers (-0.8 percentage points of GDP), intermediate consumption (-0.4 percentage points of GDP) and for other items (-0.3 percentage points of GDP) in gross fixed capital formation. The adjustment appears to be mostly the result of expenditure growth for most items being contained below nominal GDP growth.

The revenue side is planned to have a slightly negative impact of 0.2 percentage points of GDP on the overall adjustment. Thus, the planned decrease of direct taxes by 0.7 percentage points of GDP is projected to be only partially compensated by a 0.5 percentage point increase for all other revenue items (0.2 percentage points of GDP for indirect taxes, 0.1 percentage points of GDP for social contributions and 0.2 percentage points of GDP for other revenue).

One-off measures, following a strongly negative impact on the headline deficit in 2018 (0.4% of GDP), mostly related to the 0.4% of GDP impact of the activation of the Novo Banco contingent capital mechanism, are planned to have a 0.1% of GDP negative impact in 2019 and a strongly positive impact in 2021 (0.4% of GDP) due to another recovery by Portugal of an EFSF loan prepaid margin.

⁶ Capital transfer expenditure related to the conversion of deferred tax assets and BES clients compensation

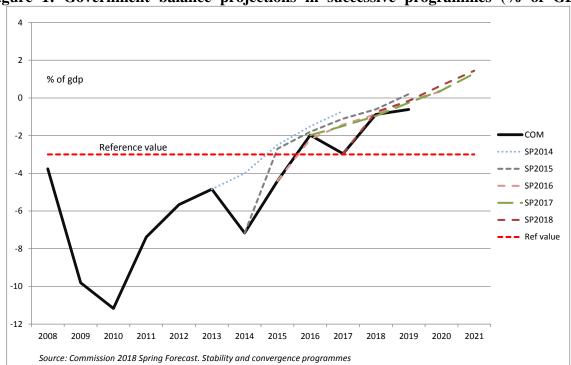


Figure 1: Government balance projections in successive programmes (% of GDP)

While earlier Stability Programmes have typically implied some delay in the nominal fiscal adjustment as compared to the previous updates, the 2017 and 2018 Stability programmes – building on the achievement of the 2016 and 2017 fiscal targets net of one-offs –, have maintained a fiscal path close to the 2016 programme (see Figure 1). While the overall trend of the outturn data follows the successive Stability Programme projections, it has been heavily impacted by bank support one-off measures in various years.

3.3. MEASURES UNDERPINNING THE PROGRAMME

As regards fiscal policy measures for 2019, the deficit-increasing impact of the carry-over from the 2018 revision of Personal Income Tax (PIT) brackets (0.1% of GDP), of the unfreezing of careers in the public sector (0.2% of GDP) and increases in others social benefits (0.1% of GDP) are considered in the programme's no-policy change baseline scenario. Starting from this baseline, the Stability Programme plans deficit-decreasing impacts from the spending review on intermediate consumption and other current expenditure (both items together yielding 0.1% of GDP) which together with savings from interest expenditure (the latter alone yielding 0.2% of GDP) are expected to broadly offset the deficit-increasing impact of the measures included in the programme's no-policy-change baseline. Finally, as the increase of public investment expenditure is to a large extent compensated by higher revenue from EU-Funds, its overall deficit-increasing impact is projected to be limited, also in line with the principle of budget neutrality of EU funds in national accounts.

The Commission 2018 spring forecast takes fully into account the deficit-increasing measures included in the Stability Programme's baseline scenario, i.e. the carry-over of the 2018 PIT bracket revision, the unfreezing of careers and the increases in other social benefits. It instead takes into account only half of the estimated budgetary impact of the impact of the spending review on intermediate consumption and other current expenditure, as this measure has not yet been sufficiently specified for 2019. Savings in interest expenditure, while not explicitly considered a measure in the Commission forecast, broadly coincide with those of the Stability Programme.

As regards the period 2020-2022, no major measures are planned on the revenue side apart from a 0.1% of GDP PIT reduction in 2021 compensated by minor yearly reductions of tax benefits on indirect taxes. On the expenditure side, the spending review's deficit-decreasing impact on intermediate consumption and other current expenditure is projected to gradually decrease over time. After one more incremental budgetary impact of the unfreezing of careers in 2020 no further measures are planned for compensation of employees. Following minor increases for early retirement reforms in 2019 and 2020, other social transfers are planned to increase by 0.1% of GDP in both 2021 and 2022. As regards interest expenditure, an additional 0.1% of GDP decrease in 2020 is expected to be followed by slight increases in the following years adding up to 0.1% of GDP over 2021-2022. The partially mutually-offsetting impact from higher revenue and expenditure associated with the EU funds would continue in 2020. Finally, in 2021 a further recovery of EFSF pre-paid margins would improve the headline deficit by 0.4% of GDP (this being a one-off measure).

Main budgetary measures

| Revenue | Expenditure |
|--|---|
| | 2019 |
| Changes to PIT brackets (-0.1% of GDP) Additional revenue from EU structural funds (+0.1% of GDP) | Unfreezing of careers (+0.2% of GDP) Other social benefits (+0.1% of GDP) Higher investment partially linked to EU structural funds (+0.2% of GDP) Expenditure review (-0.1% of GDP) Savings in interest expenditure (-0.2% of GDP) |
| | 2020 |
| Additional revenue from EU structural funds (+0.1% of GDP) | Unfreezing of careers (+0.1% of GDP) Higher investment partially linked to EU structural funds (+0.2% of GDP) Expenditure review (-0.1% of GDP) Savings in interest expenditure (-0.1% of GDP) |
| | 2021 |
| PIT reduction (-0.1% of GDP) Pre-paid margins EFSF (+0.4% of GDP) | • Other social benefits (+0.1% of GDP) |
| | 2022 |
| | • Other social benefits (+0.1% of GDP) |
| | • Increase in interest expenditure (+0.1% of |

| GDP) |
|-------|
| CDD |
| (JDP) |
| / |

<u>Note</u>: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.

3.4. **DEBT DEVELOPMENTS**

After rising slightly to 129.9% in 2016, Portugal's gross general government debt-to-GDP ratio has fallen by 4.2 percentage points to 125.7% in 2017, as a result of a decrease of 2.1% of GDP in stock-flow adjustments (mainly a 1.5% of GDP reduction in the cash buffer), strong nominal growth and due to the primary surplus. The Stability Programme projects the debt ratio to continue on a firm downward path, expecting it to reach 122.2% by the end of 2018, and to steadily decline to 102.0% of GDP by the end of 2022, with a particularly strong reduction in 2021. The debt reduction is mostly underpinned by primary surpluses that continuously increase up to 2021 and a steadily favourable snow-ball effect. The stock-flow adjustments are projected to have a relatively minor impact in most years of the programme horizon, with the exception of the high impact of the strong rise in the cash buffer in 2020 in view of sizeable amortisation payments scheduled for 2021 and the ensuing large reduction of the cash buffer in 2021.

The Commission 2018 spring forecast expects a somewhat higher general government debt-to-GDP ratio of 122.5% of GDP in 2018 and 119.5% of GDP in 2019, mostly due to projected higher headline deficits and lower nominal GDP growth in 2019.

Table 3: Debt developments

| (0/ of CDD) | Average | 2017 | 2018 | | 2019 | | 2020 | 2021 | 2022 |
|-------------------------------|-----------|-------|-------|-------|-------|-------|-------|-------|-------|
| (% of GDP) | 2012-2016 | 2017 | COM | SP | COM | SP | SP | SP | SP |
| Gross debt ratio ¹ | 128.9 | 125.7 | 122.5 | 122.2 | 119.5 | 118.4 | 114.9 | 107.3 | 102.0 |
| Change in the ratio | 3.7 | -4.2 | -3.2 | -3.5 | -3.0 | -3.8 | -3.5 | -7.6 | -5.3 |
| Contributions ² : | | | | | | | | | |
| 1. Primary balance | 0.1 | -0.9 | -2.7 | -2.8 | -2.8 | -3.2 | -3.9 | -4.5 | -4.4 |
| 2. "Snow-ball" effect | 3.3 | -1.2 | -0.9 | -1.0 | -0.6 | -1.0 | -1.1 | -1.0 | -0.7 |
| Of which: | | | | | | | | | |
| Interest expenditure | 4.7 | 3.9 | 3.5 | 3.5 | 3.4 | 3.4 | 3.2 | 3.1 | 3.1 |
| Growth effect | 0.1 | -3.3 | -2.8 | -2.8 | -2.4 | -2.7 | -2.6 | -2.4 | -2.2 |
| Inflation effect | -1.6 | -1.7 | -1.6 | -1.7 | -1.6 | -1.6 | -1.7 | -1.6 | -1.6 |
| 3. Stock-flow | 0.3 | -2.1 | 0.4 | 0.4 | 0.5 | 0.5 | 1.4 | -2.0 | -0.2 |
| adjustment | - , - | , , _ | | - / - | - ,- | - 1 | | | |

Notes:

Source:

Commission 2018 spring forecast (COM); Stability Programme (SP), Commission calculations.

¹ End of period.

² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

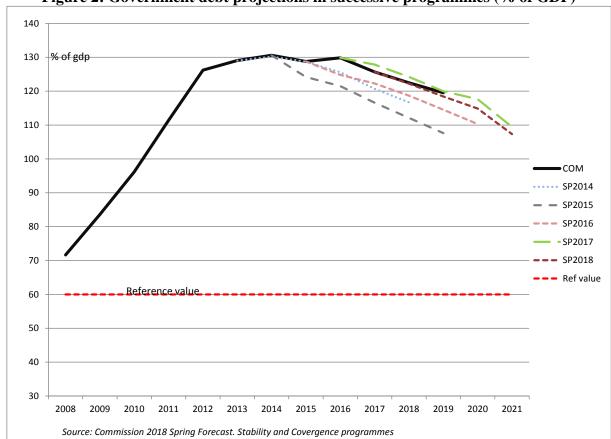


Figure 2: Government debt projections in successive programmes (% of GDP)

While the debt-to-GDP ratio had stabilised around 130% from 2013 onwards, successive Stability Programmes had planned similar debt reduction paths but the effective start of such a downward path was repeatedly delayed as compared to the previous programme. Following the substantial effective reduction of the ratio in 2017, around two percentage points faster than projected in the 2017 programme, the 2018 Stability Programme maintains from this lower starting point thereafter a similar pace of debt reduction as the 2017 programme over 2018-2020 (by around 3.5 percentage points per year) before some acceleration towards the end of the programme horizon.

3.5. RISK ASSESSMENT

Some short- and medium-term risks could affect the fiscal path planned in the programme. This concerns the achievement of the planned structural adjustment in 2018 and 2019, the materialisation of the expected favourable economic growth assumptions and expenditure containment over the programme horizon.

As regards 2018, in addition to general risks related to uncertainties surrounding the macroeconomic outlook (including vulnerability to external developments), risks are mostly related to possible spending pressures on compensation of employees (see also section 3.1).

As regards 2019 and onwards, in addition to continued spending pressures on compensation of employees, the macroeconomic assumptions of the Stability Programme are more optimistic than in the Commission 2018 spring forecast. Moreover, the planned yields of some measures have not been specified in sufficient detail. This regards in particular the future impact of the spending review on both intermediate consumption and other current expenditure, which lacks a detailed description, but also the revenue-increasing planned tax

measures. In addition, the projected continued savings in interest expenditure until 2020 are uncertain as they crucially hinge upon (domestic and external) market conditions, at a time where changes in monetary policy may be envisaged in the medium-term. Moreover, contingent liabilities from the banking sector, in particular further activations of the Novo Banco contingent capital mechanism, may create downward risks to the fiscal outlook over the programme horizon. Finally, the overall amount of planned consolidation measures may turn out insufficient to effectively achieve the planned moderate overall expenditure growth below nominal GDP growth and thereby fulfil the planned improving path for both headline and structural balances.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 1. Council Recommendations addressed to Portugal

On 11 July 2017, the Council addressed recommendations to Portugal in the context of the European Semester. In particular, in the area of public finances the Council recommended to Portugal to "Ensure the durability of the correction of the excessive deficit. Pursue a substantial fiscal effort in 2018 in line with the requirements of the preventive arm of the Stability and Growth Pact, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Portugal's public finances. Use windfall gains to accelerate the reduction of the general government debt-to-GDP ratio."

The Council noted that "In 2018, in light of its fiscal situation and in particular of its debt level, Portugal is expected to further adjust towards its medium-term budgetary objective of a structural surplus of 0,25 % of GDP. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal growth rate of net primary government expenditure which does not exceed 0,1% in 2018. It would correspond to a structural adjustment of at least 0,6% of GDP. (...) As recalled in the Commission communication on the 2017 European Semester accompanying these country-specific recommendations, the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of Portugal's public finances."

4.1. Compliance with the debt criterion

Following the correction of the excessive deficit in 2016, Portugal is subject to the transitional debt rule in the period 2017-2019. The recent improvements in macroeconomic variables, in particular nominal and potential GDP growth, as shown in both the Stability Programme and the Commission 2018 spring forecast, have made the structural adjustment needed to comply with the transitional debt rule less demanding.

Based on the Stability Programme, the transitional debt rule results in a negative required Minimum Linear Structural Adjustment (MLSA) for 2018 (-0.7% of GDP) and 2019 (-1.8% of GDP). In 2018 and 2019, based on the (recalculated) change in the structural balance as planned in the Stability Programme, Portugal is expected to make sufficient progress towards compliance with the debt reduction benchmark.

In turn, calculated on the basis of the Commission 2018 spring forecast, the required MLSA would be 0.0% of GDP in 2018 and -0.1% of GDP in 2019, while the structural adjustment would be 0.0% and -0.1% of GDP in 2018 and 2019 respectively. Thus, on the basis of the Commission's forecast, Portugal is projected to make sufficient progress towards compliance with the debt reduction benchmark in 2018 and 2019.

Table 4: Compliance with the debt criterion

| | 2017 | 20 | 18 | 2019 | | |
|------------------------------------|------|-------|-------|-------|-------|--|
| | 2017 | SP | COM | SP | COM | |
| Gross debt ratio | 126 | 122.2 | 122.5 | 118.4 | 119.5 | |
| Gap to the debt benchmark 1,2 | | | | | | |
| Structural adjustment ³ | 0.9 | 0.4 | 0.0 | 0.3 | -0.1 | |
| To be compared to: | | | | | | |
| Required adjustment ⁴ | 0.4 | -0.7 | 0.0 | -1.8 | -0.1 | |

Notes:

Source:

Commission 2018 spring forecast (COM); Stability Programme (SP), Commission calculations.

4.2. Compliance with the MTO or the required adjustment path towards the MTO

Assessment of requests for deviating from SGP requirements

Portugal's 2018 Stability Programme indicates that the budgetary impact of the large-scale wildfires that occurred in 2017 was significant and provides adequate evidence of the scope and nature of these additional budgetary costs. In particular, the Stability Programme indicates that the 2018 budget comprises exceptional expenditure amounting to about 0.07 % of GDP in relation to preventive measures to protect the national territory against wildfires. The Stability Programme sets out 2018 expenditure related to the emergency management, classified as one-offs (0.05% of GDP), and to prevention (0.07% of GDP). Due to the integrated nature of these expenditures and due to the direct link with the large-scale wildfires of 2017, the specific treatment of wildfire-prevention expenditure could be considered in application of the "unusual event clause". According to the Commission, the eligible

¹ Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

² Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

³ Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

⁴ Defines the remaining annual structural adjustment over the transition period which ensures that - if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

additional expenditure in 2018 amounts to 0.07 % of GDP for preventive measures. A final assessment, including on eligible amounts, will be made in spring 2019 on the basis of observed data for 2018 as provided by the Portuguese authorities.

Adjustment towards the MTO

Portugal is subject to the preventive arm of the SGP as of 2017 and has to ensure compliance with the required adjustment towards the MTO.

In 2017, according to the outturn data and the Commission 2018 spring forecast, the growth of real primary government expenditure, net of discretionary revenue measures and one-offs, exceeded the applicable expenditure benchmark of -1.4%, leading to a deviation of 0.5% of GDP and thus pointing to some (but close to significant) deviation. The structural balance improved by 0.9% of GDP, thus pointing to compliance with the recommended structural adjustment of at least 0.6% of GDP towards the MTO. This calls for an overall assessment. The difference between the two indicators stems mainly from two factors. First, the reading of the fiscal effort based on the expenditure benchmark pillar is negatively impacted by the medium-term potential GDP growth used therein (0.0% based on the spring 2016 forecast), which reflects negative or exceptionally low potential GDP growth in and after the crisis years. This estimate of 0.0% medium-term average potential growth reflects a very abrupt adjustment of the economy in the crisis that heavily distorted the time series and appears to be inconsistent with the trend growth prospects of Portugal before and after the crisis years. It therefore appears more appropriate to consider as a benchmark for growth of net primary expenditure the medium-term potential GDP growth rate of 0.7% arising from the Commission 2018 spring forecast for the same reference period (2011-2020), eliminating the impact of the crisis years. Second, the reading of the fiscal effort based on the structural balance pillar is positively impacted by revenue windfalls and declining interest expenditure. which are windfalls outside the control of the government and therefore excluded from the expenditure benchmark pillar, and negatively impacted by nationally financed gross fixed capital formation, which is smoothed in the expenditure benchmark. Taking these factors into consideration, both indicators would point to a risk of some deviation from the requirements. Therefore, on the basis of an overall assessment based on the outturn data and the Commission 2018 spring forecast, the ex-post assessment suggests some deviation from the adjustment path towards the MTO in 2017.

In 2018, according to the information provided in the Stability Programme, the planned growth of nominal⁷ primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 0.1%, leading to a deviation of 1.1% of GDP in the underlying fiscal position and thus pointing to a risk of significant deviation. The (recalculated) structural balance is expected to improve by 0.4% of GDP in the Stability Programme, planning some deviation from the recommended minimum structural adjustment towards the MTO of 0.6% of GDP. This calls for an overall assessment. Similarly to 2017, on one hand, the fiscal effort based on the expenditure benchmark pillar is

⁷ As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

strongly negatively impacted by the medium-term potential GDP growth used therein. On the other hand, the fiscal effort based on the structural balance pillar is positively impacted by revenue windfalls and declining interest expenditure. In the opposite sense, the structural balance pillar is negatively impacted by the high planned increase in gross fixed capital formation in 2018, while this is smoothed in the expenditure benchmark pillar. Taking all these factors into consideration following the same approach as for 2017, both indicators would point to a risk of significant deviation from the requirements. Therefore, based on an overall assessment, the Stability Programme plans significant deviation from the recommended structural adjustment towards the MTO in 2018. This conclusion would not change if the budgetary impact of the exceptional wildfire-prevention expenditure was deducted from the requirement. Over 2017 and 2018 taken together, the expenditure benchmark points to a risk of significant deviation while the structural balance points to compliance. Following an overall assessment, taking into consideration the above-mentioned effects, both indicators would point to a risk of significant deviation from the requirements over 2017 and 2018 taken together. This conclusion would not change if the budgetary impact of the exceptional wildfire-prevention expenditure in 2018 was deducted from the requirement.

In turn, based on the Commission 2018 spring forecast, the growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 0.1% in 2018, leading to a deviation of 1.4% of GDP⁸ in the underlying fiscal position pointing to a risk of a significant deviation. The structural balance is expected to remain unchanged in 2018, thus also pointing to a risk of a significant deviation from the recommended minimum structural adjustment of 0.6% of GDP towards the MTO. Over 2017 and 2018 taken together, both indicators also point to a risk of a significant deviation from the requirements, albeit by a small margin for the structural balance. Taking into consideration the above-mentioned difference in potential GDP growth benchmarks following the same approach as for 2017, substantial revenue windfalls, lower interest expenditure and the impact of gross fixed capital formation, the risk of a significant deviation from the requirements in both 2018 and over 2017 and 2018 taken together would be confirmed. Therefore, based on an overall assessment, the Commission forecast points to a risk of a significant deviation from the recommended structural adjustment towards the MTO in 2018 and over 2017 and 2018 taken together. This conclusion would not change if the budgetary impact of the exceptional wildfire-prevention expenditure in 2018 was deducted from the requirement.

In 2019, according to the information provided in the Stability Programme, the planned growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 0.7%, leading to a deviation of 0.8% of GDP in the underlying fiscal position and thus pointing to a risk of a significant deviation. The (recalculated) structural balance is expected to improve by 0.3% of GDP in the Stability Programme, planning some deviation from the recommended structural adjustment towards the MTO of 0.6% of GDP. This calls for an overall assessment. The fiscal effort based on the structural balance pillar is positively impacted by higher underlying

⁸ The higher deviation as compared to the Stability Programme is due to slightly higher expenditure growth, a slightly lower impact of discretionary revenue measures and a slightly diverging amount of one-off measures (as a result of the non-inclusion of the unusual events clause and the ANFA and SMP payments to Greece) in the Commission spring forecast.

potential growth than the expenditure benchmark and by lower interest expenditure and negatively impacted by some revenue shortfalls. An overall assessment confirms that both indicators would point to a risk of significant deviation from the requirements. Therefore, based on an overall assessment, the Stability Programme plans significant deviation from the recommended structural adjustment towards the MTO in 2019. In addition, over 2018 and 2019 taken together, both indicators point to a risk of significant deviation, albeit by a small margin for the structural balance. An overall assessment confirms that both indicators would point to a risk of significant deviation from the requirements over 2018 and 2019 taken together. Therefore, based on an overall assessment, the Stability Programme plans a significant deviation from the recommended structural adjustment towards the MTO over 2018 and 2019 taken together.

In turn, based on the Commission 2018 spring forecast, the growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark of 0.7%, leading to a deviation of 1.0% of GDP⁹ in the underlying fiscal position pointing to a risk of a significant deviation in 2019. The structural balance is expected to deteriorate slightly by 0.1% of GDP in 2019, thus also pointing to a risk of a significant deviation by 0.7% of GDP from the recommended minimum structural adjustment of 0.6% of GDP towards the MTO. The structural balance benefits from higher underlying potential growth than the expenditure benchmark and lower interest expenditure in 2019, while being negatively impacted by some slight revenue shortfalls. Over 2018 and 2019 taken together, both indicators also point to a risk of a significant deviation from the requirements. An overall assessment confirms the risk of a significant deviation from the recommended structural adjustment towards the MTO, based on the Commission 2018 spring forecast, in both 2019 and over 2018 and 2019 taken together.

⁹ The higher deviation as compared to the Stability Programme is mainly due to higher expenditure growth, (partially compensated by the offsetting of the 2018 one-off difference) in the Commission spring forecast.

Table 5: Compliance with the requirements under the preventive arm

| (% of GDP) | 2017 | 20 | 18 | 2019 | | |
|--|------------|-------|-------|--------|------|--|
| Initial position ¹ | | | | | | |
| Medium-term objective (MTO) | 0.3 | 0 | .3 | 0 | .3 | |
| Structural balance ² (COM) | -1.1 | -1 | 1.1 | -1 | .1 | |
| Structural balance based on freezing (COM) | -1.8 | -] | 1.1 | | - | |
| Position vis-a -vis the MTO ³ | Not at MTO | Not a | t MTO | Not at | MTO | |
| (% of GDP) | 2017 | 20 | 18 | 20 | 19 | |
| , , , , | COM | SP | COM | SP | COM | |
| Structural balance pillar | | | | 1 | | |
| Required adjustment ⁴ | 0.6 | 0.6 | | 0 | .6 | |
| Required adjustment corrected ⁵ | 0.6 | 0 | .6 | 0 | .6 | |
| Change in structural balance ⁶ | 0.9 | 0.4 | 0.0 | 0.3 | -0.1 | |
| One-year deviation from the required adjustment ⁷ | 0.3 | -0.2 | -0.6 | -0.3 | -0.7 | |
| Two-year average deviation from the required | | 0.0 | 0.2 | 0.2 | 0.6 | |
| adjustment ⁷ | | 0.0 | -0.2 | -0.3 | -0.6 | |
| Expenditure benchmark pillar | | | | | | |
| Applicable reference rate ⁸ | -1.4 | 0 | .1 | 0 | .7 | |
| One-year deviation adjusted for one-offs ⁹ | -0.5 | -1.1 | -1.4 | -0.8 | -1.0 | |
| Two-year deviation adjusted for one-offs ⁹ | | -0.8 | -1.0 | -1.0 | -1.2 | |
| PER MEMORIAM: One-year deviation 10 | -2.9 | -1.5 | 0.2 | -0.5 | -0.8 | |
| PER MEMORIAM: Two-year average deviation 10 | | -2.2 | -1.3 | -1.0 | -0.3 | |

Notes

Source:

Stability Programme (SP); Commission 2018 spring forecast (COM); Commission calculations.

The Country-Specific Recommendation adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances.

¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

² Structural balance = cyclically-adjusted government balance excluding one-off measures.

³ Based on the relevant structural balance at year t-1.

⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

⁶ Change in the structural balance compared to year t-1. Expost assessment (for 2017) is carried out on the basis of Commission 2018 spring forecast

⁷ The difference of the change in the structural balance and the corrected required adjustment.

Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

¹⁰ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Following the Commission's assessment of the strength of the recovery in Portugal while giving due consideration to its sustainability challenges, carried out in the context of its opinion on Country's Draft Budgetary Plan, no additional elements in that regard need to be taken into account.

Following an overall assessment, a significant deviation from the adjustment path towards the MTO is to be expected in the years 2018 and 2019 putting at risk compliance with the requirements of the preventive arm of the Pact.

5. FISCAL SUSTAINABILITY

Portugal does not appear to face fiscal sustainability risks in the short run. Nonetheless, there are some indications that the fiscal side of the economy poses potential challenges. ¹⁰

Based on the Commission 2018 spring forecast and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 125.7% of GDP in 2017, is expected to decrease to 108.5% in 2028, thus remaining above the 60% of GDP Treaty threshold. Over this horizon, government debt peaks in 2017. Sensitivity analysis shows similar risks. Overall, this highlights high risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would nonetheless put debt on a clearly decreasing path by 2028, although remaining above the 60% of GDP reference value in 2028.

The medium-term fiscal sustainability risk indicator S1¹² is at 4.4 percentage points of GDP, primarily related to the high level of government debt contributing 4.3 percentage points of GDP, thus indicating high risks in the medium term. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at 1.6 percentage points of GDP, leading to lower medium-term risk. Overall, risks to fiscal sustainability over the medium term are, therefore, high. Fully implementing the fiscal plans in the Stability Programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 is at 0.7 percentage points of GDP. In the long term, Portugal therefore appears to face low fiscal sustainability risks, primarily related to the projected ageing costs contributing 0.9 percentage points of GDP. Full implementation of the programme would put the S2 indicator at -1.5 percentage points of GDP, leading to a lower long-term risk. ¹³

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¹⁰ This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 5 for a definition of the indicator.

¹¹ Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Debt Sustainability Monitor 2017 for more details).

¹² See the note to Table 5 for a definition of the indicator.

¹³ The projected costs of ageing used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the updated projections, endorsed by the EPC on 30 January 2018, and to be published in the forthcoming Ageing Report 2018.

Table 6: Sustainability indicators

| Time horizon | | | Commissi | on Scenario | Stability Programme Scenario | |
|-----------------------------|----------------------------|----------------|----------|-------------|---------------------------------|-------------|
| Short Term | | | LOV | V risk | | |
| S0 indicator ^[1] | | | |).4 | | |
| | Fiscal subindex | | 0.5 | HIGH risk | | |
| | Financial & competitive | eness subindex | 0.4 | LOW risk | | |
| Medium Term | | | HIG | H risk | | |
| DSA [2] | | | HIG | H risk | | |
| S1 indic | ator ^[3] | | 4.4 | HIGH risk | 1.6 | MEDIUM risk |
| of v | vhich | | | | | |
| | Initial Budgetary Position | on | - | 0.4 | -2.8 | |
| | Debt Requirement | | 4 | 1.3 | 4.0 | |
| l | Cost of Ageing | | (| 0.5 | | 0.4 |
| | of which | | | | | |
| | | Pensions | (| 0.4 | | 0.4 |
| | | Health-care | (|).5 | | 0.4 |
| | | Long-term care | (| 0.1 | | 0.1 |
| | | Other | - | 0.5 | | -0.4 |
| Long Term | | | LOV | W risk | LOW risk | |
| S2 indic | ator ^[4] | | (| 0.7 | | -1.5 |
| of v | vhich | | | | | |
| | Initial Budgetary Position | on | - | 0.2 | | -2.3 |
| | Cost of Ageing | | 0.9 | | 0.7 | |
| | of which | _ | | | | |
| | | Pensions | - | 0.7 | | -0.9 |
| | | Health-care | : | 1.7 | | 1.6 |
| | | Long-term care | (| 0.6 | | 0.6 |
| | | Other | - | 0.6 | | -0.4 |

Source: Commission services; 2018 Stability programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2018 forecast covering until 2019 included. The Stability Programme scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2018 Ageing Report.

^[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

^[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

^[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 for Commission scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

^[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

 $^{^{\}star}$ For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.

6. FISCAL FRAMEWORK

As regards compliance with national numerical fiscal rules, the 2017 budgetary outcome appears to indicate that the change in the structural balance fully complied with the rule of a minimum annual adjustment of the structural balance by 0.5% of GDP as long as the MTO is not reached, as laid down in Article 12-C (6) of the currently applicable Budget Framework Law (BFL)¹⁴. Full compliance however does not appear to have been achieved for the expenditure benchmark rule as laid down in Article 12-C (6)-(8) of the BFL that refers to the Stability and Growth Pact definition. As regards 2018 and 2019, the improvement of the structural balance by 0.4% of GDP and 0.3% of GDP, respectively, as planned in the Stability Programme, points to a risk of some deviation from the 0.5% of GDP minimum improvement of the structural balance. The net growth of primary public expenditure planned in the Stability Programme in 2018 and 2019 points to a risk of significant deviation from the expenditure benchmark requirements.

For 2020, the planned improvement of the structural balance of 0.6% of GDP appears fully consistent with the 0.5% of GDP minimum improvement laid down in the BFL. As the MTO is planned to be reached in 2020, the 0.5% of GDP structural balance adjustment rule of Article 12-C (6) BFL would not be applicable to the planned adjustment of around 0.3% of GDP in 2021 and 2022.

As regards the debt rule laid down in Article 10-G(1) of the BFL referring to the provisions of Article (2) of Council Regulation (EC) 1467/97 for the preventive arm, the Stability Programme points to compliance with the transitional debt rule over the whole transition period 2017-2019.

Overall, based on the information provided in the Stability Programme, the fiscal performance in Portugal in 2017 appears to have broadly complied with the requirements of the applicable national numerical fiscal rules. Portugal also appears to plan full compliance with the transitional debt rule over 2018-2019. However, the planned targets for 2018 to 2019 appear to only partially comply with the national numerical fiscal rule for the structural balance and appear not to target compliance with the national numerical fiscal rule for net expenditure growth, i.e. with the expenditure benchmark, in both years.

The macroeconomic forecasts underlying the Stability Programme have been endorsed by the Portuguese Fiscal Council in an opinion attached to the programme. In the opinion, the Council points to downside risks for the period 2019-2022, in particular as regards the assumptions on the evolution of gross fixed capital formation and net external demand.

The Stability Programme does not explicitly state that it also constitutes the national medium-term fiscal plan in line with Article 4(1) of Regulation 473/2013. The legal references contained in the opinion of the Fiscal Council however indicate that the Stability Programme is assumed to also constitute the national medium-term fiscal plan.

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Law n.° 41/2014 of 10 July (Eighth modification of Law n.° 91/2001, of 20 August) (Budget Framework Law)

7. SUMMARY

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

Portugal plans a growth rate of nominal primary government expenditure, net of discretionary revenue measures and one-offs, which exceeds the applicable expenditure benchmark rate in both 2018 and 2019 leading to negative deviations of 1.1% of GDP and 0.8% of GDP of the underlying fiscal position in 2018 and 2019, respectively. Portugal plans an improvement of the structural balance of 0.4% of GDP in 2018 and 0.3% of GDP in 2019, below the recommended annual structural adjustment of at least 0.6% of GDP towards the MTO in both years. Following an overall assessment, there is a risk of significant deviation from the recommended adjustment path towards the MTO in both years based on the Stability Programme. An overall assessment on the basis of the Commission 2018 spring forecast, also points to a risk of a significant deviation in both 2018 and 2019.

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

8. ANNEXES

Table I. Macroeconomic indicators

| Table 1. Macroeconomic indicators | | | | | | | | | | |
|---|--------|--------|--------|--------|--------|--------|-------|-------|--|--|
| | 2000- | 2005- | 2010- | 2015 | 2016 | 2017 | 2018 | 2019 | | |
| | 2004 | 2009 | 2014 | | | | | | | |
| Core indicators | | | | | | | | | | |
| GDP growth rate | 1.5 | 0.4 | -0.8 | 1.8 | 1.6 | 2.7 | 2.3 | 2.0 | | |
| Output gap ¹ | 0.7 | -0.2 | -2.4 | -1.7 | -0.9 | 0.3 | 1.0 | 1.3 | | |
| HICP (annual % change) | 3.3 | 1.9 | 1.6 | 0.5 | 0.6 | 1.6 | 1.2 | 1.6 | | |
| Domestic demand (annual % change) ² | 1.2 | 0.4 | -2.2 | 2.7 | 1.6 | 2.8 | 2.3 | 2.1 | | |
| Unemployment rate (% of labour force) ³ | 6.3 | 9.3 | 14.2 | 12.6 | 11.2 | 9.0 | 7.7 | 6.8 | | |
| Gross fixed capital formation (% of GDP) | 25.7 | 22.4 | 16.9 | 15.5 | 15.3 | 16.2 | 16.7 | 17.1 | | |
| Gross national saving (% of GDP) | 16.9 | 12.1 | 13.6 | 14.9 | 15.5 | 16.8 | 17.4 | 17.9 | | |
| General Government (% of GDP) | 10.5 | 11 | 10.0 | * | 10.0 | 10.0 | 27 | 2 | | |
| Net lending (+) or net borrowing (-) | -4.4 | -5.4 | -7.2 | -4.4 | -2.0 | -3.0 | -0.9 | -0.6 | | |
| Gross debt | 56.1 | 72.1 | 118.7 | 128.8 | 129.9 | 125.7 | 122.5 | 119.5 | | |
| Net financial assets | -44.7 | -59.1 | -87.5 | -110.0 | -104.9 | -109.3 | n.a | n.a | | |
| Total revenue | 40.0 | 41.0 | 43.2 | 43.8 | 43.0 | 42.9 | 43.2 | 42.9 | | |
| Total expenditure | 44.4 | 46.4 | 50.4 | 48.2 | 44.9 | 45.9 | 44.1 | 43.5 | | |
| of which: Interest | 2.8 | 2.9 | 4.4 | 4.6 | 4.2 | 3.9 | 3.5 | 3.4 | | |
| Corporations (% of GDP) | | | | | | | | | | |
| Net lending (+) or net borrowing (-) | -4.9 | -6.2 | 2.4 | 2.8 | 0.9 | 2.8 | 0.4 | 0.0 | | |
| Net financial assets; non-financial corporations | -109.0 | -131.0 | -135.8 | -127.1 | -124.8 | -124.5 | n.a | n.a | | |
| Net financial assets; financial corporations | -0.2 | 4.5 | 4.5 | 6.0 | 4.8 | 7.6 | n.a | n.a | | |
| Gross capital formation | 13.5 | 13.3 | 10.1 | 10.2 | 10.7 | 11.1 | 11.1 | 11.5 | | |
| Gross operating surplus | 19.6 | 20.1 | 21.2 | 21.9 | 21.3 | 21.0 | 21.3 | 21.8 | | |
| Households and NPISH (% of GDP) | | | | | | | | | | |
| Net lending (+) or net borrowing (-) | 1.8 | 2.1 | 3.0 | 1.9 | 2.0 | 1.5 | 1.9 | 2.1 | | |
| Net financial assets | 98.3 | 97.5 | 107.6 | 117.8 | 118.8 | 120.4 | n.a | n.a | | |
| Gross wages and salaries | 38.4 | 36.9 | 35.4 | 34.2 | 34.5 | 34.8 | 34.8 | 34.8 | | |
| Net property income | 4.4 | 5.9 | 5.9 | 6.3 | 6.0 | 5.4 | 5.1 | 5.2 | | |
| Current transfers received | 21.2 | 22.6 | 25.5 | 25.8 | 25.2 | 25.0 | 24.9 | 24.8 | | |
| Gross saving | 7.4 | 5.9 | 5.3 | 3.6 | 4.1 | 3.7 | 4.2 | 4.4 | | |
| Rest of the world (% of GDP) | | | | | | | | | | |
| Net lending (+) or net borrowing (-) | -7.5 | -9.5 | -1.9 | 0.3 | 1.0 | 1.4 | 1.5 | 1.5 | | |
| Net financial assets | 59.6 | 92.4 | 118.9 | 119.8 | 113.4 | 112.6 | n.a | n.a | | |
| Net exports of goods and services | -8.9 | -8.3 | -2.2 | 0.6 | 1.1 | 1.0 | 1.0 | 1.0 | | |
| Net primary income from the rest of the world | -1.7 | -3.1 | -2.2 | -2.7 | -2.4 | -2.2 | -2.1 | -2.0 | | |
| Net capital transactions | 1.7 | 1.2 | 1.5 | 1.2 | 0.9 | 0.9 | 0.9 | 0.9 | | |
| Tradable sector | 42.7 | 39.9 | 41.0 | 42.6 | 42.5 | 42.5 | n.a | n.a | | |
| Non tradable sector | 44.8 | 47.2 | 46.7 | 44.7 | 44.3 | 44.0 | n.a | n.a | | |
| of which: Building and construction sector | 6.5 | 5.8 | 4.4 | 3.5 | 3.4 | 3.5 | n.a | n.a | | |
| Real effective exchange rate (index, 2000=100) | 98.4 | 102.8 | 95.4 | 89.7 | 91.6 | 93.4 | 94.8 | 94.6 | | |
| Terms of trade goods and services (index, 2000=100) | 98.7 | 98.7 | 99.6 | 104.7 | 105.9 | 105.5 | 105.5 | 105.5 | | |
| Market performance of exports (index, 2000=100) | 99.0 | 95.4 | 108.4 | 114.9 | 115.7 | 119.3 | 121.5 | 122.7 | | |
| Notes: | | | | | Ů. | | | | | |

Notes:

<u>Source</u> :

AMECO data, Commission 2018 spring forecast

¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

² The indicator on domestic demand includes stocks.

³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.