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Post-Programme Surveillance Report

Portugal, Autumn 2017

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Autumn 2017

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

This report reflects information available up until [18th December 2017].

ABBREVIATIONS

BFL	Budget Framework Law	NPLs	Non-performing loans
CET1	Common Equity Tier 1	PER	Processo Especial de Revitalização de Empresas
CGD	Caixa Geral de Depósitos	PIT	Personal Income Tax
CIT	Corporate Income Tax	PPS	Post-programme surveillance
DBP	Draft Budgetary Plan	PPP	public-private partnership
DGO	Directorate-General for Budget	q-o-q	Quarter on quarter
DMO	Debt Management Office	SGP	Stability and Growth Pact
DSA	Debt Sustainability Analysis	SMEs	Small and Medium-sized Enterprises
EC	European Commission	SOEs	State-owned Enterprises
ECB	European Central Bank	UTAM	Unidade Técnica de Acompanhamento e Monitorização do Setor Público Empresarial
EPC	Economic Policy Committee	VAT	Value Added Tax
ESM	European Stability Mechanism	y-o-y	Year on year
EU	European Union		
FDI	Foreign Direct Investment		
GDP	Gross Domestic Product		
HICP	Harmonised Index of Consumer Prices		
IGCP	Agência de Gestão da Tesouraria e da Dívida Pública		
IMF	International Monetary Fund		
IMI	Immovable Property Tax		
INE	National Statistical Office		
MIP	Macroeconomic imbalance procedure		
MREL	Minimum Requirement for own funds and Eligible Liabilities		
MTO	Medium term Objective		
NFCs	Non-financial Corporations		
NHS	National Health Service		

EXECUTIVE SUMMARY

This report presents the findings of the seventh post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, which took place in Lisbon between 28 November and 6 December 2017. This visit also served as specific monitoring in the framework of the EU Macroeconomic Imbalance Procedure (Annex 2). Since the conclusion of the sixth post-programme surveillance mission in July 2017, growth has further accelerated. The short-term economic and financial situation of Portugal has improved and important progress has been made in addressing near-term risks. Overall, Portugal's economic rebalancing building on the basis of reforms implemented during and after the macroeconomic adjustment programme has made good progress. Going forward, the challenge is to further strengthen the reform momentum. In this regard, ambitious growth-enhancing reforms and sustained fiscal structural consolidation are essential to improve the economy's resilience to shocks and the medium-term growth prospects.

GDP and employment are set to increase significantly in 2017 driven by exports and investment. Economic growth in 2017 picked up to 2.8% up to September due to a rebound in investment, acceleration in foreign trade and a moderate increase in private consumption. Employment grew faster than GDP until October 2017, particularly related to tourism, construction and manufacturing. Wage growth remained subdued at the aggregate level, as most of the job openings were in sectors with low skill profiles and lower-than-average salaries. The job-rich recovery reduced substantially both the headline and long-term unemployment rates and supported economic activity as the labour force increased despite a drop in the working age population. Economic performance is expected to slow down but to remain strong in 2018 and 2019 amid further export growth and lower unemployment.

Higher revenue and lower interest expenditure are set to allow for a further reduction of the headline deficit in 2017. The 2017 headline deficit is projected to decrease to 1.4% of GDP by both the Commission autumn forecast and the authorities 2018 DBP mainly based on the improved macroeconomic outlook and lower interest expenditure. Due to better than expected budgetary execution in recent months, the 2017 deficit might turn out lower than the 1.4% of GDP estimated in autumn, excluding any potential deficit-increasing impact of 2017 banking support measures. For 2018, the DBP foresees an improvement of the headline deficit to 1.0% of GDP while the Commission forecasts it to remain stable at 1.4% of GDP. The 0.4% of GDP difference stems from 0.1% of GDP lower indirect taxes revenue and 0.3% of GDP stronger expenditure pressures (mostly from compensation of employees and social transfers) in the autumn forecast. During the parliamentary approval process of the 2018 budget, a number of amendments have been accepted that, overall, are expected to have a deficit-increasing effect.

The structural adjustment in 2017 and 2018 is at risk of significant deviation from the recommended substantial effort. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, Portugal has been recommended to pursue an annual structural adjustment of at least 0.6% of GDP in both years. The structural balance is projected to improve slightly by 0.1% of GDP in 2017 by both the Commission autumn forecast and the DBP. For 2018, mostly due to the 0.4% of GDP difference in the headline projection, the autumn forecast projects the structural balance to remain unchanged whereas the DBP plans a (recalculated) improvement by 0.4% of GDP. The structural primary balance is projected to evolve 0.3% of GDP less favourably in both the DBP and the Commission autumn forecast given the corresponding decrease in interest expenditure.

Structural fiscal consolidation will be important for ensuring a steady decline in the still high public debt level. Following stabilisation at around 130% from 2013 to 2016, the debt-to-GDP ratio is forecast to decrease by an average 3pps in 2017 and 2018 according to both the DBP and the Commission autumn forecast. The Commission projects Portugal's gross public debt-to-GDP ratio to decline to 126.4% in 2017, 124.1% in 2018 and 121.1% in 2019. The latest Commission Debt Sustainability Analysis (DSA), which uses the Commission 2017 autumn forecast as a starting point, puts the debt-to-GDP ratio at around 115% by 2028 under a no-policy-change scenario, but at 95% under full compliance with the requirements under the Stability and Growth Pact.

Fiscal-structural reforms are progressing while indebtedness of State Owned Enterprises remains high. The scope of the expenditure review is broadening. Efficiency-enhancing initiatives have been taken in the health sector; it remains unclear to what extent these will contribute to stem the flow of hospital arrears. As regards the pension system, the Government has committed to duly factor in sustainability in any new initiatives. Net results of state-owned enterprises continue to improve and new measures are planned for 2018 while debt levels are still high. A systematic approach to budgetary transfers to State Owned Enterprises remains needed.

The sovereign's upgrade and continued economic recovery with the euro area have impacted the Portuguese banking system positively. Banks have continued to strengthen capital ratios, partly through capital injections and partly through further deleveraging. Cost reduction progressed as well. Yet, despite tangible progress observable, the sector continues to be weighed down by low profitability, limited capital buffers as well as still high, yet decreasing, ratios of non-performing loans. In this context, the momentum built-up in NPL reduction as well as corporate loan restructurings should be maintained. The platform to enhance coordination regarding non-performing loans management is a welcome initiative in this regard. Likewise, Portuguese lenders need to continue to improve their profitability in an environment of low interest rates and increasing digitisation.

Sovereign financing and the capacity to repay are currently not a reason for concern. However, yields remain vulnerable to financial market conditions and the private and public debt overhang. Active debt management is smoothing the debt redemption profile, with an accelerated early IMF repayment schedule also contributing to lower interest costs. State financing needs are projected to remain broadly stable until 2020, with the Debt Management Office planning to keep a significant cash buffer in the future. After episodes of higher and volatile interest rates, yields on Portuguese bonds have fallen steadily over the last 6 months, a development accelerated by Standard & Poor's and Fitch's decision to upgrade Portugal's rating to investment grade, as well as by the ECB's decision to continue its asset purchasing programme, even if with only a reduction in its scale.

Further strengthened structural reforms can support competitiveness. Active labour market policies are becoming more effective. Administrative burden on firms is being reduced through simplified procedures in their relation with the public administration, more business friendly legislation and decreasing case backlog in courts. While these are steps in the right direction, competitiveness improvements require further efforts such as an overall improvement in the judicial system namely through shorter procedures in court or a reduction in restrictions in business services. Measures to improve the qualifications of the adult population could also help with skill upgrading if they are broad in coverage and have a strong training component. Segmentation in the labour market remains high and measures being put forward by the authorities might not be enough to give significant incentives to hiring on open-ended contracts.

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

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the seventh post-programme surveillance (PPS) mission to Portugal between 29 November and 6 December 2017. The mission was coordinated with the IMF's post-programme monitoring (PPM) mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. PPS aims at a broad monitoring of economic, fiscal and financial conditions with a view to assessing the repayment capacity of a country that has received financial assistance⁽¹⁾. While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions.

The PPS mission included specific monitoring under the MIP. The 2017 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. Annex 1 presents the results in the context of the specific monitoring under the MIP and the European Semester.

The autumn PPS reporting is now more focussed on the most relevant macro, financial and fiscal updates. Structural reforms are only covered in the MIP section inasmuch as they are MIP-relevant. An extensive assessment of these policies will be done in the European Semester Country Report. The objective is to minimise overlaps with work and reporting in the framework of the European Semester. The spring PPS reporting cycle will remain as usual.

⁽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. RECENT ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

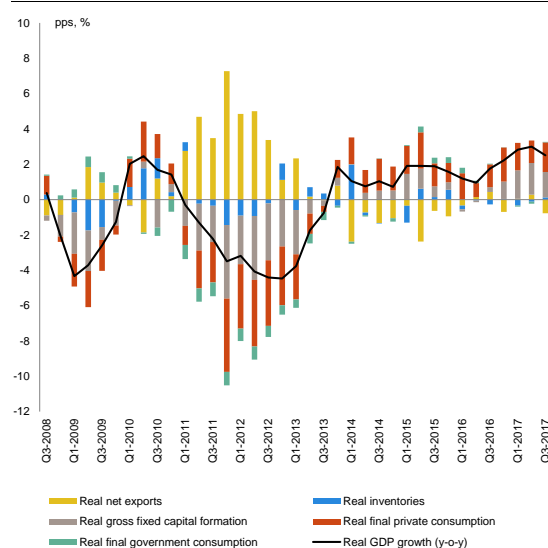
Economic growth picked up to 2.8% in the first three quarters of 2017, driven by a strong rebound in investment, acceleration in foreign trade and a moderate increase in private consumption. The figures are broadly in line with the Commission autumn forecast and keep on track the full-year projections for a GDP growth of 2.6% in 2017 and 2.1% in 2018. Domestic demand's contribution to growth improved in Q3-2017 due to some re-acceleration in private consumption. Moreover, investment and exports continue growing at much higher rates in annualised terms. Imports also recovered driven by a strong domestic demand growth. Thus, net exports contributions to growth turned negative in Q3-2017 again.

Despite significant improvements, the share of investment in GDP remains well below its long-term average. Investment is projected at about 16% of GDP in 2017 that is still one of the lowest in the EU and marks a substantial decline from the peak of 28% of GDP in 2000 when it was among the highest in the EU. A substantial part of the recovery in 2017 has been driven by the one-off capacity upgrade in the country's largest car producer Autoeuropa. Taking into account the base effect from this project, equipment investment is expected to moderate in 2018 and to accelerate again in 2019 driven by improved demand conditions, increased capacity utilisation and profits. The increased capacity in the automotive industry is also expected to keep exports growing well above global trade volumes in 2018. Over the medium term, export is however expected to move broadly in line with the growth in main trade partners. Imports are projected to follow domestic demand dynamics, except for a temporary pick-up in 2018 related to the high import content of car manufacturing.

The labour market continued to improve at a strong pace in 2017 as both employment and activity rates are benefiting from the job-rich recovery, particularly in tourism, construction and manufacturing. Unemployment is therefore set to drop from 11.2% in 2016 to 9.2% in 2017, the lowest level since 2008, and further on to 7.6% in 2019. Employment grew faster than GDP until October 2017 while wage growth remained

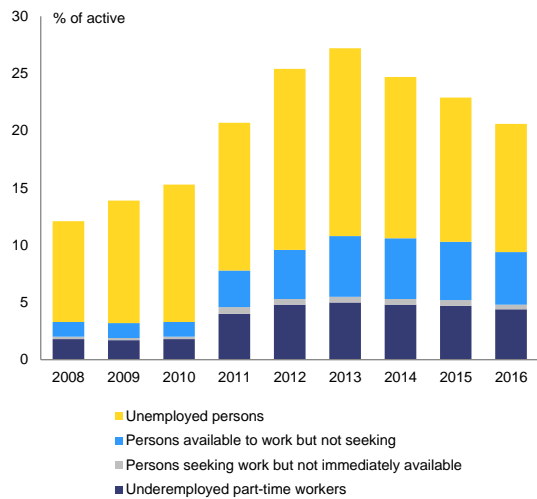
subdued at aggregate level, as most of the job openings were in sectors with low-skill profiles and lower-than-average salaries. In addition, some slack in the labour market still persists, preventing wage growth from a significant acceleration. Some of the broader measures of unemployment in Portugal have not fully recovered from the crisis levels and this is likely to continue to contain wage dynamics at least in the short run (see Graph 2.2). However, the continuation of a positive economic cycle could pose some risks of wage pressures in the medium term, particularly in sectors with higher demand for qualified staff.

Graph 2.1: Main factors contributing to GDP growth



Source: European Commission

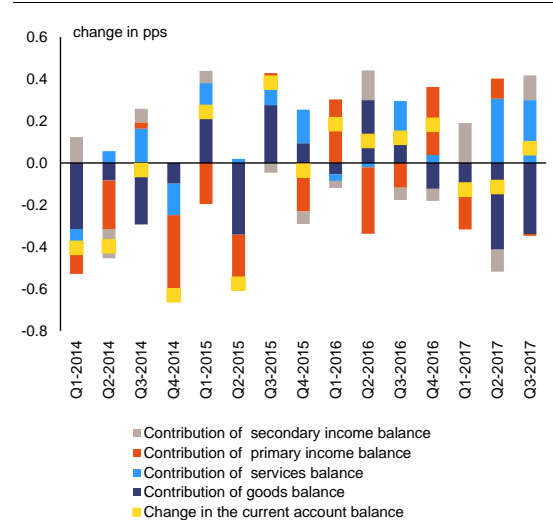
Graph 2.2: Supplementary indicators to unemployment



Source: European Commission

HICP inflation moderated in the summer. It is projected to remain relatively stable at 1.5% in 2017, 1.4% in 2018 and 1.5% in 2019. However, accommodation prices remained elevated after the end of the peak summer tourism season, raising the HICP inflation above expectations at 1.8% in November and thus bringing some upward risks to the short-term projections. Core inflation is expected to fluctuate slightly above the headline rate, reflecting the impact of accommodation services and moderate wage dynamics. House price inflation rose from 7.1% in 2016 to 8.0% year-on-year in Q2-2017, along with a significant increase in property transactions. Demand for real estate is expected to remain strong but the impact on prices is likely to be at least partly offset by growing supply from new construction. Construction of buildings increased by 23.2% y-o-y in Q3-2017 accelerating from 12.7% y-o-y in the first half of the year. In addition, the stock of mortgage loans is still declining, which dampens the upward pressure on house prices and shows that the price rebound is not generated by debt accumulation. At this stage, the major driver of house price increases is external demand and tourism-related investments, which is evident from the concentration of price hikes in tourist areas, including also projects for transformation of residential properties into accommodation facilities.

Graph 2.3: Decomposition of the change in the annualised current account balance relative to GDP



Source: European Commission

The current account improved only marginally. It moved to a small surplus in Q3-2017, in annualised terms, reflecting a decline in the deficit of trade with goods and an increase in the surplus of services by 0.3 pps of GDP vis-à-vis Q2-2017. Export of services continued benefiting from the strong performance in tourism and transport. The secondary income surplus also increased in Q3-2017 reflecting a higher inflow from EU funds (see Graph 2.3). In addition, a reversal in terms of trade, which is mostly linked to oil price changes relative to the first half of 2017, also had some positive contribution to the current-account balance.

2.2. PUBLIC FINANCES

In cash terms, budget execution through end-October 2017 was marked by substantial revenue increases combined with temporary expenditure containment. Up to October, the general government cash balance improved by EUR 2.7 billion relative to the same period last year due to an increase in revenue by 4.2% while expenditure remained stable mostly due to a change in the payment schedule of Christmas supplement expenditure ⁽²⁾.

⁽²⁾ While in 2016 the Christmas supplements for salaries and pensions were entirely paid in twelve monthly payments, in 2017 only 50% of the Christmas supplements continue to

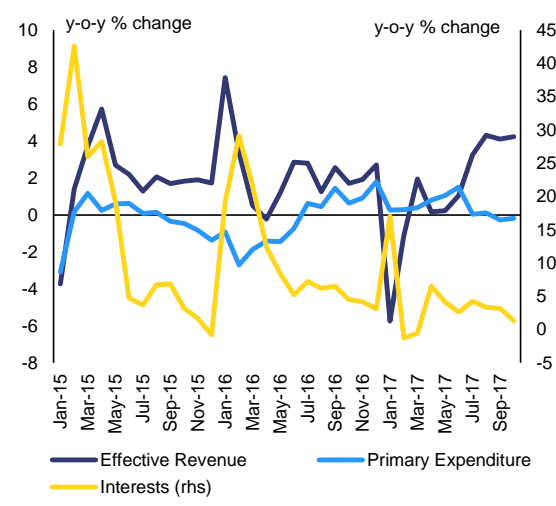
On the revenue side, the overall increase by October of 4.2% slightly exceeds to the 3.9% increase projected in the 2017 budget for the whole year. While personal income tax (PIT) came in clearly lower than planned (-0.8% as compared to the full-year budget target of +1.8%), this was more than compensated by corporate income tax (CIT) collection (+20.9%) being far above the full year budget target of +0.9%. As regards indirect taxes, the overall growth of revenue by 4.9% compares to a budget target of 2.1%. Overall indirect tax execution by October was in particular supported by the high increase in VAT revenue by 5.8%, clearly exceeding the full-year target of 1.4% in spite of higher VAT reimbursements. While the increase of social contributions also exceeded the annual target (+0.9% compared to -0.6%), other current revenue and capital revenue fell significantly short of the annual budget targets up to October.

On the expenditure side, there was an overall stabilisation up to October (0.0% variation as compared to the full-year increase of 4.4% planned in the budget) largely due to the temporary effect of the postponement of payment of 50% of the Christmas supplement for salaries and pensions to November and December respectively and lower than budgeted investment (+8.2% vs a full-year budget increase of +26.9%). As regards acquisition of goods and services, higher arrears in the health sector contributed to the moderate overall increase of +1.5% by October (below the budget target of 2.0%).

Public sector arrears are on the rise due to the health sector. Following a broad stabilisation in 2016 as compared to end-2015 at EUR 0.9 billion due to significant clearance payments in December, public sector arrears have again increased by a total EUR 416 million in 2017 to EUR 1.3 billion up to the end of October. The overall increase is entirely due to an increase by EUR 480 million for state-owned hospitals bringing the stock of arrears of the National Health Service above EUR 1.0 billion at the end of October 2017. Budgetary planning and control in state-owned hospitals remains a challenge.

Risks to cash based budget execution appear to be tilted to the positive side. On one hand the payment of the remaining 50% of Christmas supplements for salaries and pensions in November and December and the planned clearance of arrears in the health sector should lead to a significant increase in the growth of expenditure by year-end, which can at least partially be accommodated under the expenditure ceilings and by using the provisional allocations. On the other hand, the higher expenditure growth should continue to be compensated by overall strong revenue collection in particular from indirect taxes, allowing to reach or outperform the budgetary targets in cash terms as adopted in the 2017 Budget.

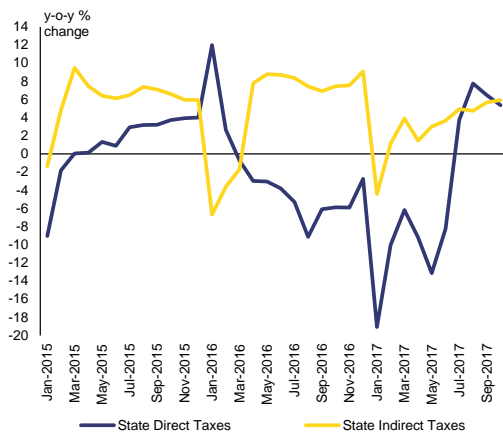
Graph 2.4: Budget execution (General government)



Source: DGO

be paid in twelve monthly payments whereas the other 50% are paid in November and December, respectively.

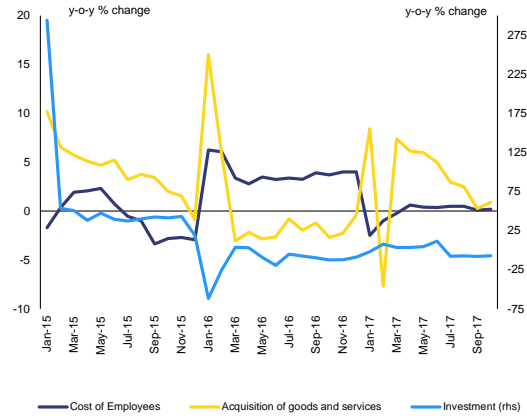
Graph 2.5: Budget execution (State)



Source: DGO and own calculations

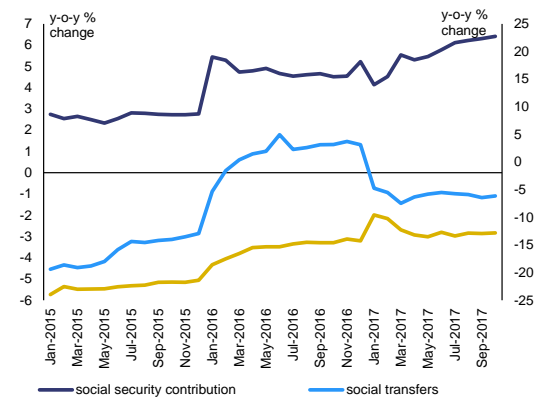
Source: DGO

Graph 2.7: Budget execution (Central administration)



Source: DGO

Graph 2.6: Budget execution (Social security)



Source: DGO and own calculations

Source: DGO

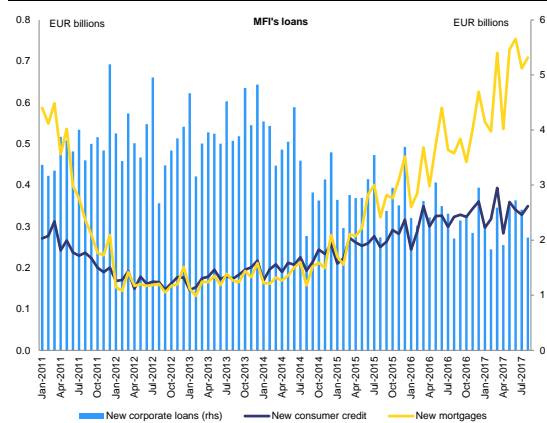
2.3. FINANCIAL STABILITY

Stronger economic performance helps banks to progress with their capital levels and asset quality. Portuguese lenders have benefitted from the economic recovery to improve capital levels and gradually restructure their business, mainly through resizing distribution networks (mostly local branches) and selling non-core business activities. Recent capital increases in four of the six largest banks are expected to support the clean-up of the banks' balance sheets. Novo Banco's sale should help further accelerate the process of reducing the legacy non-performing loans. The willingness of new and existing shareholders to provide additional capital to the Portuguese banking system is a positive sign. Nevertheless, the vulnerabilities accumulated before and during the crisis remain well present in the system and continue to affect daily business. Banks should seize the positive momentum to tackle them. Namely, banks remain burdened by unresolved balance sheet weaknesses including still high non-performing loan levels, relatively poor profitability and, overall, still weak capital buffers compared to European peers. Portuguese lenders need to continue to adjust to the low interest environment and reduce costs.

Credit to businesses is improving for the lower risk firms while deleveraging continues for higher risk ones. Loans and securities to the non-financial private sector slightly declined by 0.3% between June 2016 and June 2017. Resident banks'

exposure shrank by 2.4% whereas foreign institutions increased their loans by 2.2%, albeit on a smaller total volume. High NPLs do not seem to impact much the loan supply to healthy firms with good business models. Quite to the contrary, small business loans' interest rates are broadly in line with euro area averages. Already since mid-2015 corporate loans up to EUR 250 000 cost only marginally more in Portugal than in other euro area countries. As competition amongst banks for the best risks has become very intense, corporate loan interest rates have halved since 2012 together with a decrease in risk premium. The median interest rate for the best risk quartile of corporate borrowers was below 2% in September 2017. Banks increased their lending to the best risk quartile by 5% y-o-y. Loan stocks vis-à-vis the second best quartile stayed flat whereas they decreased for the two worst quartile, partially through write-offs and NPL work-outs. In sum, the banks corporate loan stock fell by 6.8% y-o-y in September 2017 because redemptions outweighed new loans which halved since 2011-2013 (see Graph 2.8).

Graph 2.8: **New lending per month (domestic business)**



Source: Banco de Portugal

Loan flows to households are recovering from the crisis slump with interest rates close to euro area average. From the total mortgages granted in 2017 a total of 40% have a fixed rate for the first 5 years. This trend started in early 2016. Before that, nearly all mortgages were at variable rates. Mortgage interest rates are below euro area average at around 1.6%. Consumer loan interest rates are at 8%, like in Spain, the euro average being 6%. Average monthly attribution of new consumer loans has doubled since 2012; new

mortgages have tripled since then. Consumer loan origination has now come back to pre-crisis levels in nominal terms and the stock grows again by 2.8% y-o-y in September 2017. Monthly mortgage origination is about half its pre-crisis average. Consequently, mortgage stocks shrank by about 2.3%, as new loans do not fully substitute for redemption and early repayments of old loans.

The NPL stock continues to decrease faster than the ratio due to overall deleveraging.

In June 2017, the NPL ratio stood at 15.5% of gross loans and further decreased to 14.6% in Q3 2017⁽³⁾. The coverage ratio continued to improve reaching 46.5% in Q3 2017, coming from 43% in June 2016. Banks managed to sell NPL portfolios, progressed on foreclosures and wrote off bad loans. Consequently, since June 2016 NPLs declined by some EUR 10.5 bn to around EUR 40 bn but the ratio did not fall accordingly because the amount of total loans decreased as well. Banks' NPL management strategy targets as priority sales of NPLs originating from non-financial corporations (over EUR 1.4 bn or 5.2 pp of these assets were sold alone in Q3 2017), which account for 65% of all NPLs. The corporate NPL ratio stood at 26.6% in September 2017, 3.5 pp lower than in Q3 2016 and associated with about EUR 7 bn decrease in the stock of corporate NPL. Their coverage ratio was 50.4%, coming from 46.8% a year before.

A strategy to reduce NPLs is being implemented.

Following a detailed assessment of the banking system's non-performing loan book, the Portuguese authorities designed a strategy to address them. This comprehensive strategy includes: (i) changes to the judicial, legal and tax system, (ii) prudential/supervisory actions led jointly by the SSM and the central bank and (iii) NPL management solutions. The third component includes an NPL management platform set up by Portugal's three biggest banks in the last quarter of 2017. Once it becomes fully operational in early 2018, the NPL management platform will be used to manage NPLs associated with firms that have a business relationship with at least two of the three banks. This platform will not become a game-changer for bringing down the NPL stock as loans will remain on the banks' balance sheets, but

⁽³⁾ This information in this paragraph reflects data published after the cut-off date.

will be helpful in the medium term for more challenging cases by expediting credit restructuring and/or NPL sales and by fostering the restructuring of viable firms.

Savings still grow despite the lowest deposit remuneration on record. Households' savings have shrunk since summer 2016; they fell 1.4% between September 2016 and September 2017. But aggregate deposits still grew by 0.5% as corporate savings increased by 8.3% and confidence in the banking system strengthened. Contrary to other EU-jurisdictions, Portuguese banks are by law forbidden to charge negative interest rates, not even for large companies. In a context of negative interest rates, this restriction increases the incentives for multinationals to deposit excess liquidity in Portugal. In July 2017, aggregate deposits reached a new all-time high transgressing the EUR 175 bn mark.

Portuguese banks have returned to the market in 2017. In 2017 banks issued 10 different covered bonds benefitting from the positive momentum created by rating upgrades. Banks issued to remain active in the market as investors would consider them as newcomers again after 2 years of absence. Borrowing from the ECB is predominantly through the targeted longer-term refinancing operations (TLTROs) mostly redeemable from 2020 onward and remains stable around EUR 23 bn mark, around 6% of banks' total liabilities.

Capitalisation of the Portuguese banking system has improved recently. The average CET1 ratio of the banking system rose by 1.1 pp since June 2016 to 13.2% in June 2017, not only thanks to capital increases but also due to falling risk-weighted assets. Since the last quarter of 2016, four out of Portugal's six biggest banks have seen capital injections adding up to EUR 7 bn⁽⁴⁾. Novo Banco will issue EUR 400 m in subordinated debt by the end of 2018. CGD also plans another EUR 430 m Additional Tier 1 bond issue in 2018. Portugal's aggregate bank capital and reserves amount to EUR 60 bn in September 2017 coming from a level of EUR 34 bn in September 2007. Despite improving the ratio between own funds and assets, the sector's capital

adequacy ratios are in general still very low in European comparison..

Banks profitability recovered in 2017. In June 2017 Return on Assets stood at 0.32% and Return on Equity at 3.9% with both coming from basically 0% one year earlier. Improved profitability stems from a diminished flow of impairments and better net intermediation margins helped by lower deposit remuneration. As Portuguese sovereign bonds increased in value, banks' trading results benefitted commensurately. The real estate market rebound also helps banks when disposing of foreclosed properties. Still, important differences across banks persist. While some bigger banks still post losses, others break barely even in 2017, whereas some banks earn double digit Return on Equity.

Cost to income ratios fell during the first half of 2017 by 1.4pp to 61%. Operating costs of Portuguese banks have been notoriously high, driven by an excessive number of bank outlets (among the highest in the EU in relation to population) and relatively high staffing costs. Nonetheless, over 2017 operating costs of banks have been decreasing faster than the revenue originated by net interest income and net commissions. Almost all banks are presently engaged in the process of restructuring their operations in Portugal. End 2016 the number of branches fell to below 50 per 100 000 habitants, slightly less than twice the European average whereas the number of employees per inhabitant is more in line with European average. Despite tangible cost reduction progress being already observable, pressure to continue reducing costs will remain high. Banks face increasing pressure to move their business online and need to invest more heavily in new digital technologies. This in turn implies higher investments in IT architecture supporting credit institutions' business model changes.

2.4. PRIVATE DEBT

Private debt is on a steady downward trend since 2012 though the distance to the MIP threshold is still significant. In consolidated

⁽⁴⁾ During the past 12 months CGD, BCP, Novo Banco, and Montepio strengthened their capital by EUR 4.5, 1.5, 1 and 0.25 bn respectively.

terms⁽⁵⁾, the share of private debt in GDP fell from 210.3% at end-2012 to 171.4% at end-2016. Both the corporate and household sectors contributed to the deleveraging process. At the end of 2016, the consolidated corporate debt⁽⁶⁾ accounted for 98.9% of GDP compared to 119.9% four years earlier. For the same period, the household debt ratio dropped from 90.4% to 72.5%.

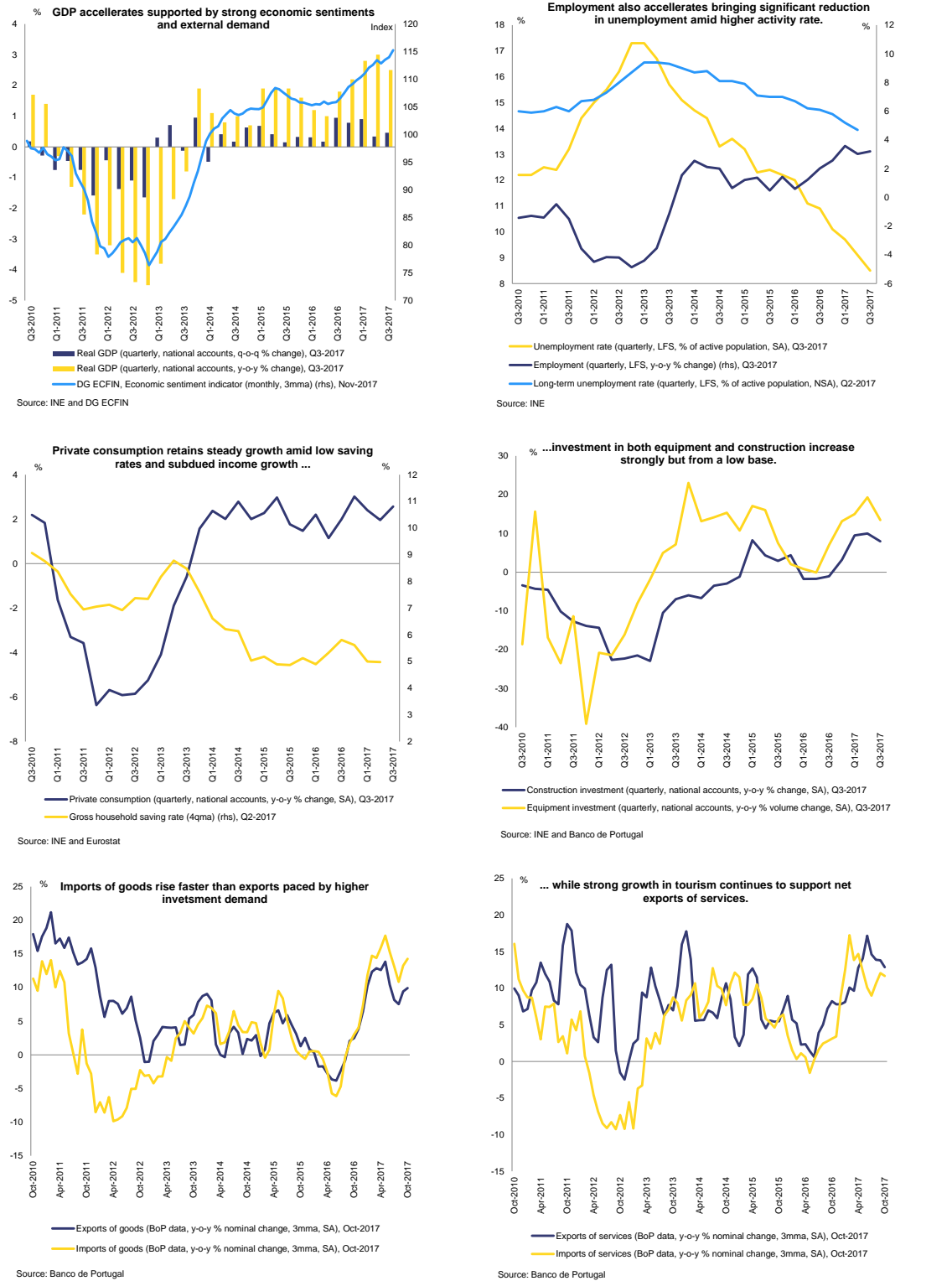
The latest available debt statistics show that the process of deleveraging continued in 2017. Apart from the banking statistics described in the previous section, this is also supported by the data of Banco de Portugal on the stock of non-consolidated debt, which dropped from a peak of 264.7% of GDP at the end of 2012 to 217.5% at the end of 2016 and further on to 212.0% at the end of September 2017. In the private corporate sector, the debt ratio dropped from 170.8% at the end of 2012 to 140.8% at end-2016 and 137.6% at the end of September 2017. The largest debt ratios as of September 2017 are reported in trade (22.8% of GDP), manufacturing (22.2%), and utilities (17.8%) The ratios for construction and real estate stand at 12.9% in each sector. Since 2012, the debt ratios have declined in virtually all sectors while the steepest drop is recorded in construction.

Despite the ongoing deleveraging, private investments increased from 12.0% of GDP in 2013 to 13.9% in 2016, helped by improved corporate profits and increased inflow of FDI. From January to September 2017, private investments increased substantially and are now expected to reach 14.5% of GDP for the whole year, according to the 2017 Commission autumn forecast, reflecting also a temporary impact from the capacity upgrade in the automotive industry financed primarily through external sources. Nevertheless, the level of investments remains among the lowest in the EU and continues to be restrained by the large stock of indebtedness.

⁽⁵⁾ Consolidated debt comprises loans and securities at market value while non-consolidated data cover loans, securities at face value and trade credits.

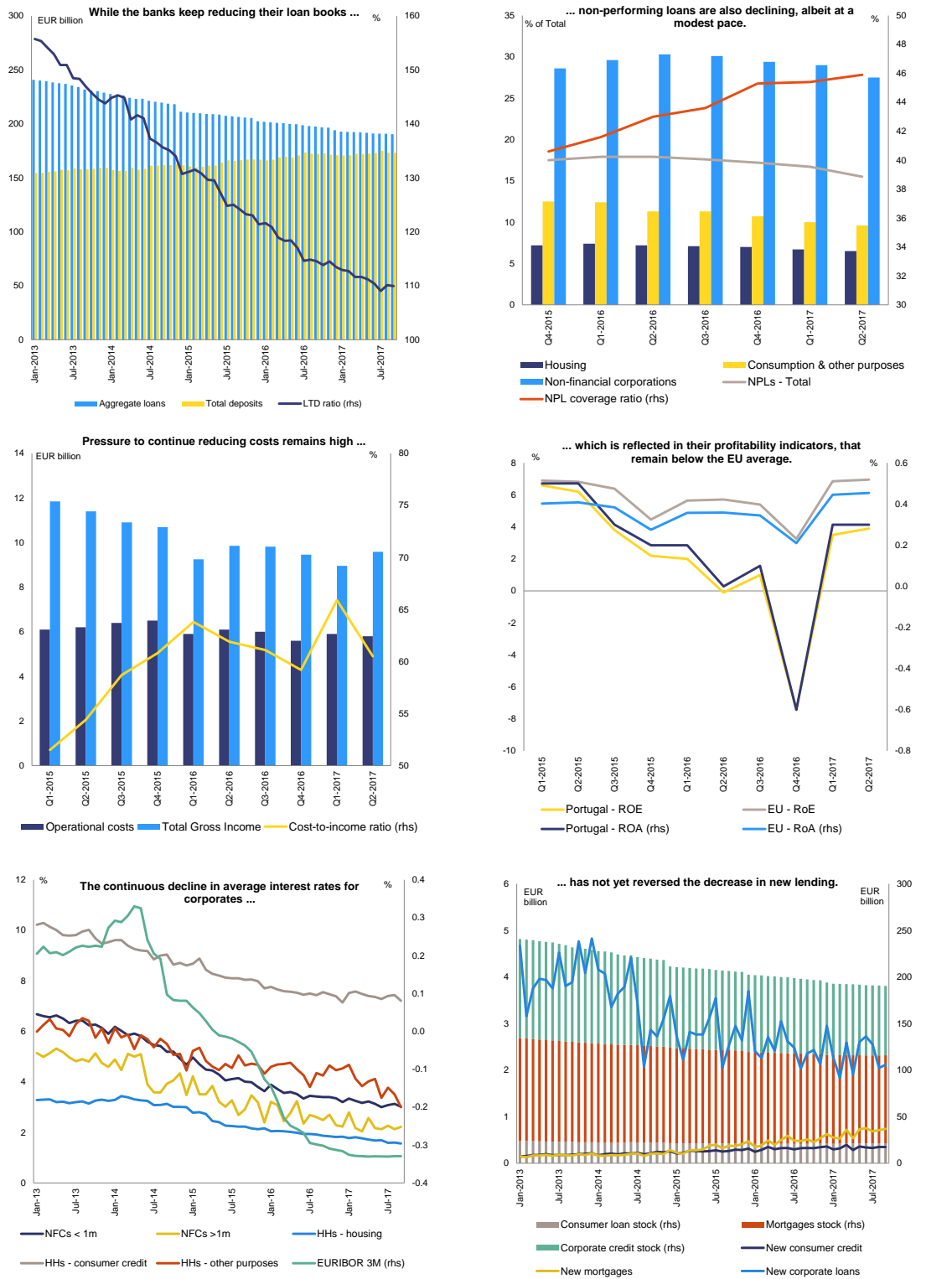
⁽⁶⁾ Corporate debt refers to non-financial entities, including public ones outside the general government.

Graph 2.9: Recent economic developments



Source: European Commission, INE and Banco de Portugal

Graph 2.10: Recent financial developments



Source: Banco de Portugal and European Banking Authority (EBA)

3. POLICY ISSUES

3.1. PUBLIC FINANCE

The Commission autumn forecast projects the headline deficit to decrease to 1.4% of GDP in 2017, mainly due to the accelerated economic recovery, decreasing interest expenditure and lower-than-budgeted public investment. The DBP 2018 also projects a slight improvement of the 2017 general government balance to -1.4% of GDP. While tax revenue projections have been revised upwards by a nominal amount worth 0.5% of GDP as compared to the Stability Programme and interest expenditure downwards by an amount worth 0.2% of GDP, this positive impact has been almost offset by an upward revision by 0.6% of GDP in current primary expenditure (in particular other current expenditure, social transfers and compensation of employees). Capital expenditure has remained broadly stable with a downward revision by 0.3% of GDP in gross fixed capital formation almost offset by an upward revision of similar size in other capital expenditure. The Commission autumn forecast projects only small divergences with the DBP 2018 in the breakdown by revenue and expenditure item; these concern the tax revenue breakdown and slightly higher current expenditure compensated by slightly lower capital expenditure. In the PPS meetings at the end of November the authorities pointed to positive risks as compared to the common DBP and Commission autumn forecast headline deficit projection of 1.4% of GDP for 2017, mainly linked to a more positive estimate for Local Government.

For 2018, the Commission autumn forecast projects the headline deficit to remain at 1.4% of GDP. The DBP 2018 maintains the headline deficit target for 2018 at 1.0% of GDP as the deficit-improving impact from mostly macro-related upward revisions of revenue and downward revisions of interest expenditure is broadly offset by increases in current expenditure. The 0.4% of GDP higher headline deficit in the autumn forecast projection stems from 0.1% of GDP lower indirect taxes (more conservative assumptions based on private consumption standard elasticity trends) and stronger expenditure pressures from compensation of employees (0.2% of GDP based on the track record of rising public employment in 2016 and 2017 as opposed to planned decreases) and social transfers (0.1% of GDP based on track record in 2016 and 2017). In the PPS meetings at the end of

November the authorities did not yet see themselves in a position to fully quantify the impact of the amendments included in the 2018 budget finally approved by Parliament on 27 November. They however expected a deteriorating impact of 0.1% of GDP on the headline deficit from new measures against wildfires worth EUR 124 million added in the parliamentary discussions following the October fires.

The Commission forecasts the structural balance to improve slightly in 2017 and remain broadly stable in 2018 with the Government being more optimistic for 2018. For 2017 the Commission forecast projects the structural balance to improve by some 0.1pp of GDP to -1.8% of GDP, broadly in line with the DBP. For 2018 the DBP plans an improvement of the (recalculated) structural balance by 0.4pps to -1.4% of GDP. For 2018 the Commission projects the structural balance to remain broadly unchanged at -1.8% of GDP, resulting in a difference of 0.4pps with the DBP. The structural primary balance in both the DBP and the Commission forecast is projected to evolve less favourably given the falling interest expenditure (-0.3% of GDP in both years). Thus, for 2018 the Commission projects the stabilisation of the structural balance (0.0% of GDP change) to be accompanied by a deterioration of the structural primary balance by 0.3% of GDP. As highlighted in the Commission's DBP assessment, the growth of primary government expenditure, net of discretionary revenue measures and one-offs, is expected to substantially exceed the recommended benchmark rates in both 2017 and 2018 according to the DBP and the Commission autumn forecast.

The table of fiscal measures included in the 2018 DBP shows structural fiscal measures decreasing expenditure (0.3% of GDP) more than offsetting the structural fiscal measures decreasing revenue (0.1% of GDP). On the revenue side, a 0.25% of GDP decrease in PIT (carry-over impact of the surcharge reversal plus change in brackets) is only partially compensated by a 0.1% of GDP increase in indirect taxes and revenue collection improvements. On the expenditure side, a 0.25% of GDP discretionary increase in public wages and social transfers (unfreezing of career progressions, extraordinary increases of pensions and social benefits) is

Table 3.1: Fiscal adjustment 2010-2019

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Budget balance	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-1.4	-1.4	-1.2
Budget balance, net of one-offs	-8.5	-7.3	-5.6	-5.1	-3.3	-3.2	-2.4	-1.6	-1.2	-1.2
Structural balance	-8.5	-6.6	-3.6	-3.0	-1.7	-2.3	-2.0	-1.8	-1.8	-1.9
Primary balance	-8.2	-3.1	-0.8	0.0	-2.3	0.2	2.2	2.5	2.2	2.3
Structural primary balance	-5.6	-2.3	1.3	1.9	3.2	2.3	2.2	2.1	1.8	1.6
Fiscal adjustment	0.1	3.3	3.6	0.6	1.3	-0.9	0.0	-0.1	-0.3	-0.2
Fiscal effort	0.1	1.9	3.1	0.6	1.3	-0.6	0.3	0.1	0.0	-0.1

(1) Fiscal adjustment is measured as the change in the structural primary balance; fiscal effort defined as the change in the structural balance.

Source: European Commission Services 2017 Autumn Forecast

planned to be more than compensated by 0.4% of GDP of expenditure-containment measures (nominal freeze of intermediate consumption and other current expenditure, spending review) and 0.15% of GDP in interest expenditure savings. In addition to fiscal policy measures of a structural nature, the 2018 budget balance is set to be impacted by a 0.1% of GDP one-off CIT revenue decrease, by 0.1% of GDP in estimated higher dividends from Banco de Portugal, by 0.1% of GDP in one-off capital transfer expenditure and by some EUR 50 million wildfire emergency costs (which had already been included in the DBP following the June wildfires).

The table of fiscal measures in the 2018 DBP reports a balanced budgetary impact of revenue and expenditure measures on the headline balance. The Commission autumn forecast takes into account most measures at their yield specified in the DBP⁽⁷⁾. However, the Commission forecast does not factor in ¼% of GDP nominal freezing of intermediate consumption and other current expenditure based on insufficient specification and the recent track record of these measures. The corresponding freezing measures do however not seem to have been taken into account in the DBP's own overall revenue and expenditure target table either as the corresponding expenditure items, in particular intermediate consumption show nominal increases above nominal GDP growth in 2018.

Public debt is set to decline as from 2017 and the headline deficit to improve slightly in 2019. After reaching 130.1% of GDP at the end of 2016, the Commission autumn forecast projects Portugal's gross public debt-to-GDP ratio to decline to 126.4% in 2017, 124.1% in 2018 and

121.1% in 2019, due to primary budget surpluses and higher nominal GDP growth. Under a no-policy-change assumption, the autumn forecast projects the headline deficit to improve slightly in 2019 to 1.2% of GDP. Risks to the fiscal outlook are overall tilted to the downside: while there appear to be some positive risks in the short-term related to budgetary execution in recent months, there are downside risks linked to uncertainties surrounding the macroeconomic outlook, potential additional spending slippages (in particular as regards the unfreezing of career progressions) and the potential deficit-increasing impact of the 2017 banking support measures (in particular the recapitalisation of Caixa Geral de Depósitos and the contingent capital mechanism included in the Novo Banco sales agreement).

3.2. FISCAL-STRUCTURAL ISSUES

The spending review is gradually being expanded into new sectors. Justice and internal affairs have been added to the already covered areas of education, healthcare, SOEs, public sector real estate management and centralised public procurement. Some progress has already been made in the justice sector, such as the introduction of efficiency-enhancing reforms in the courts, while plans to reduce the costs associated with the legal treatment of seized vehicles are under development, although the extent of estimated savings from the latter are unclear. A series of reforms in the internal affairs sector are being planned but have not yet reached the stage of implementation (See Annex 1 Section 2 for more details). Human resource management more generally (including recruitment procedures, incentives for staff to innovate) is being presented as a cross-sectorial area for savings, with a particular focus on reducing absenteeism. A range of new tools will be deployed to address the latter,

⁽⁷⁾ While not considering them discretionary fiscal measures, the forecast also factors in the higher estimates for Banco de Portugal dividends and interest expenditure savings.

including a review of medical panels as well as the roll-out of a new monitoring system, both of which should support the authorities in identifying unnecessary sick leaves. These tools will initially be implemented in the education sector, but will then gradually be extended to the rest of public administration should the measures be successful.

The more ambitious savings targets from the spending review in 2018 represent a positive development. According to the DBP, total projected savings from the spending review exercise in 2018 amount to around EUR 290 million (around 0.14% of GDP) in a single year, considerably higher compared to the planned cumulative savings of 0.1% of GDP over three years that were announced in the 2017 budget. Overall, while the inclusion of additional sectors and the introduction of more ambitious savings targets are welcome improvements, a broadening of the exercise to cover an even more significant share of public administration would represent another positive step forward.

A range of reforms have improved the long-term sustainability of the pension system in recent years. While a number of recent measures contribute to increase pension expenditure the government has expressed its commitment to duly factor in sustainability in any new initiatives. A new early retirement scheme without penalty for very long careers entered into force in October 2017. While it is estimated to result in 11500 early pensioners in 2018 that had been waiting to retire, the impact on subsequent years should be smaller. In addition to the regular pension update, an extraordinary update was implemented in 2017 for low pensions, in particular those which had not been updated between 2011 and 2015. Another extraordinary pension update for low pensions is planned for 1 August 2018. The lowest bracket of pensioners was expanded for indexation purposes, while the indexation of the index itself (The Social Support Index), which is used for a range of social transfers beyond pensions, was also unfrozen in 2017.

Extraordinary budget transfers to the Social Security system are set to end in 2018. The budget transfers to finance the Social Security deficit are projected to end in 2018. This positive development is being supported by the economic upswing through a large projected increase

(+5.6%) in social contributions. A substantial increase in pension expenditure (+5.1%) is also foreseen; however, which combined with the ending of the extraordinary transfers will lower the surplus of the Social Security system from around EUR 1.5 bn in 2017 to around EUR 1 bn in 2018.

Some specific tax revenue is being earmarked to the sustainability of the pension system. In 2017, the Portuguese authorities earmarked the revenue deducted from the additional real estate tax (*Adicional ao IMI – Imposto Municipal sobre Imóveis*) to the reinforcement of the Financial Stability Fund, which is expected to result in a net amount of EUR 50 m. In 2018, 0.5% of the corporate income tax revenue is set to be earmarked to the Financial Stabilisation Fund. This earmarking is planned to increase in a progressive way by 0.5 pps. per year until it reaches 2% in 2021. This is projected to transfer EUR 70 m to the Fund in 2018. The Fund will start financing current expenditure in the Social Security system in the mid-2020s.

Hospital arrears continued to increase during 2017, and the impact of proposed measures remains unclear. Hospital arrears grew by EUR 480 m to October 2017. While the authorities have highlighted growing personnel expenses and increased demand as factors, the continued accumulation of arrears also unveils a problem of under-budgeting, monitoring and enforcement practices in certain hospitals. The authorities have announced the release of around EUR 400 m to hospitals for the clearance of arrears before the end of 2017. This will be complemented by capital injections into hospitals of EUR 500 m in both 2017 and 2018, which should allow for a substantial decrease in the stock of arrears. The repeated injection of funds to clear arrears does not, however, address the underlying reasons that keep leading to their accumulation. Integrated Responsibility Centres, which seek to give more autonomy to hospital teams as a way of promoting organisational innovation and efficiency, will begin to be implemented in 2018. A joint Budget Analysis Unit by the Ministry of Health and the Ministry of Finance is also planned to be set up to tackle the hospitals arrears problem and to increase the quality of budget planning. Overall, it remains uncertain to what extent planned measures will be sufficient to stem the flow of arrears.

A series of cost saving measures are, however, being introduced in the NHS as a whole. The scope of centralised purchasing in the health sector has increased significantly, rising from EUR 167 m in 2016 to EUR 654 m in 2017, and is projected to reach EUR 702 m in 2018. This development is supporting cost reduction, with EUR 35 m of savings associated with the centralisation of NHS purchasing in the first quarter of 2017. Regarding medicines, the market share of biosimilars has seen a large growth in the last two years due to minimum-market share objectives and enhanced information about both generics and biosimilars to prescribers. More generally, annual medicine price revisions and agreements with suppliers continue to yield savings. The efficiency of hospital use has also been increased by the setting up of a shared resource management platform so as to facilitate the use of NHS facilities and reduce reliance on the private sector. In a similar vein, the enhanced use of centralised digital platforms appears to promote efficiency in some areas like vaccines, medical exams, e-prescriptions and appointments.

While SOE operational results continue to improve, debt levels remain elevated. The DBP estimates a total net income of non-financial public companies of EUR -461 m in 2017, which it projects to fall to EUR -118 m in 2018, down from EUR -1293 m in 2014. Although the unfreezing of wages is putting pressure on operational expenditures, operational results (EBITDA) of SOEs generally improved between Q1-2016 and Q1-2017, particularly in the transport sector, although the results for the health sector are worsening. While the DBP committed to limit the overall growth of public company debt to 2% per year⁽⁸⁾ (net of capital increases and the financing of new investments), total non-consolidated debt of public corporations included in general government remains high, at 19.0% of GDP (approximately EUR 36 bn) in September 2017. This represents a fall of 1.3 pp of GDP relative to September 2016, while the debt of private corporations fell by around 3.5 pps of GDP in the same period⁽⁹⁾

Public recapitalisations of SOEs are ongoing while a systematic approach to budgetary

transfers to SOEs remains essential. SOEs are being recapitalised to reduce indebtedness and improve financial results. To minimise moral hazard, promote the right incentives and underpin a solid, long-term improvement in SOE sustainability, the current ad-hoc practice of budgetary transfers to SOEs needs to be made more predictable. The reviews of the public service contracts in 2018 of Metro de Lisboa and Transtejo and Soflusa, for instance, represent opportunities to strike more stable and transparent agreements on the procedures for state transfers.

Net Public-Private Partnership (PPP) payments peaked in 2016, and the PPP framework law is being applied. Net PPP payments from the government amounted to around EUR 1.7 bn in 2016, and are projected to decrease slightly in 2017. Several new PPP contracts (up to four healthcare provision services, Hospital Lisboa Oriental) are foreseen but new potential payments arising from these contracts are not included in the net PPP payments forecast. The Metro de Porto operation and maintenance contract⁽¹⁰⁾, set to be signed in 2018, was the first new contract launched within the framework of the 2012 PPP law, which is projected to have resulted in savings. The health contracts mentioned above should also be structured according to the 2012 framework. Renegotiations of existing PPPs are also ongoing, particularly for motorways with the renegotiation of Baixo Alentejo motorway already concluded..

Measures to improve monitoring and reporting of SOE performance have been in the pipeline for some time and are expected for 2018. The implementation of an upgraded monitoring mechanism is not set to be complete until 2018. The evaluation of Activity and Budget Plans (PAO) submitted by SOEs to UTAM (the Ministry of Finance's task force on SOE monitoring) is set to be made more comprehensive. In 2018, the analysis of the impact of these plans on the balance of public accounts will be carried out in a more systematic way. Instruments ensuring the proper implementation of the Activity and Budget Plans will be put in place. In addition, a risk assessment methodology is being set up and, if necessary, a

⁽⁸⁾ According to UTAM, the debt target limit for individual SOEs is of 3% per year.

⁽⁹⁾ Bank of Portugal, Statistical Bulletin, December 2017

⁽¹⁰⁾ The sub-concession contract of Metro do Porto was attributed to Barraqueiro for seven years from 2018 onwards, giving the company the responsibility for all regular metro operations as well as major revisions of the fleet of rolling stock.

detailed cost reduction programme put in place for at-risk SOEs. Accountability will also be improved through the introduction of incentives for good governance and for reaching objectives. SOE investments will also be evaluated more closely on a case-by-case basis.

The implementation of the reformed Budget Framework Law (BFL) that entered into force in September 2015 is experiencing delays.

The Law is designed to make budget units more accountable and strengthen the medium- to long-term focus of public finances and allowed for a three-year transitional period for applying most new features. The BFL's implementation unit has convened several times and preparatory work mostly in terms of IT systems setup has been progressing, in particular as regards the state accounting entity project ⁽¹¹⁾. In terms of regulatory preparation a series of decree laws will require adjustment and consolidation and the decree law on the setup of the new budgetary programmes will need to be prepared. The effective application of the new accrual-based public accounting framework is set to start in January 2018. Given the cumulative delays in BFL implementation, in particular the absence of historical financial statements established in the new accounting system, the 2019 budget will not yet be prepared under the new framework. As full completion by the 2018 target is not achievable, the BFL will have to be amended to extend the three-year transition period.

3.3. FINANCIAL AND CORPORATE SECTORS

Portugal plans to overhaul its supervisory architecture in 2018. A working group was set up to put forward proposals on a new financial supervisory framework. Following four bank failures over the past decade, the Portuguese government is taking steps to revamp financial oversight. The government invited a large and diversified group of experts to present their contributions on the evaluation of the current Portuguese system of financial supervision and their ideas for the changes needed. Following these contributions, in January 2017, an independent Working Group was commissioned to draft a report with an assessment of the current system of

financial supervision and to present a proposal for the corresponding changes. This Working Group's report underwent a public consultation process in October. The Ministry of Finance together with the 3 supervisors will table a law to the Council of Ministers who will subsequently submit it to Parliament. Supervisors will be officially invited to further comment on the law in between these different steps.

Preparations for achieving the mandated stock of "bail-inable" instruments are on the horizon.

Although the exact amounts of the minimum requirement for own funds and eligible liabilities (MREL) are yet to be determined, most banks have an estimate of their magnitude. Achieving the mandated amounts by the end of the transition period will in most cases imply a combination of risk weighted assets reduction and wholesale funding issuance. Domestic and foreign banks will be operating on a similar timeline, and the aggregate impact on the market is as of now unclear. For Portuguese banks, most of which aimed to decrease over the past years their wholesale funding dependency, MREL may represent a potential challenge, implying the need for adequate timely strategies and a possible cost increase.

The authorities and banks should keep up the NPL reduction momentum.

The legal framework addressing the treatment of distressed corporate debtors in difficulties has been revamped. Changes include both out-of-court mechanisms (comprising options for loans to equity swaps and the replacement of the out-of-court regime for corporate recovery) and judicial mechanisms such as the pre-insolvency PER and the insolvency procedure itself. The supervisory authorities also facilitate the solution for NPLs through guidance on best practices, NPL reductions plans and acknowledgment of the NPL reduction effort in the supervisory review and evaluation process. Various NPL management solutions are being implemented including a creditors' coordination platform. With the new legal framework and supervisory guidance in place, swift implementation is now key to help accelerate NPL resolution.

⁽¹¹⁾ A first opening balance sheet is planned to be established for 1 January 2019.

Identification of firms that are viable and those that should be liquidated is crucial. The riskier enterprises are deleveraging the fastest, but still account for most of the corporate debt stock. A third of all SME NPLs is over three years past due. The recovery process of viable firms is being facilitated but the proceedings for insolvent firms remain long. The new set of rules for the judicial restructuring of firms (PER) are meant to prevent insolvent firms from misusing it. This will be ensured through new requirements including a declaration issued by an accountant or auditor certifying that the company is not insolvent and resulting in a first proposal of the recovery plan with the agreement of at least 10% of creditors. This should allow the distinction between solvent firms recurring to PER and court insolvency processes being used for insolvent firms. Besides, an out-of-court regime for companies' recovery (RERE) has been developed. Whether it will incentivise the use of faster out-of-court proceedings, remains to be seen: while PER and judicial liquidation result in a "judge-stamped" document enforceable towards everyone, currently out-of-court arrangements are only binding towards participating creditors. Other new instruments such as a Business Recovery Mediator providing assistance to SMEs and a legal framework for out-of-court collateral repossession could further contribute to facilitate firms' restructuring. Most difficulties remain on the side of the proceedings for insolvent firms. Their average duration is still high (around 40 months in 2016) with complex proceedings and the resulting credit recovery rates are lower than European averages.

4. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Active debt management, in particular via accelerated early repayments of IMF debt, is smoothing the debt redemption profile. In parallel to the buy-back of EUR 1.6 bn in debt with short maturity as well as repeated bond exchanges in 2017, a further EUR 4.7 bn in early IMF repayment has been added to the EUR 5.3 bn that were planned for 2017 at the time of the 6th PPS report. This results in a total IMF early repayment of around EUR 10.0 bn for the year. The IMF repurchasing schedule has been moved forward in view of above-target budget execution. Given the acceleration in IMF repayment in 2017, the planned amount for 2018 has been revised downwards from EUR 5 bn to EUR 0.8 bn. Both the IMF early repayments, the buy-backs and the bond exchanges, thus also contribute to a substantial smoothing of the redemption profile, in particular as regards the redemption peak in 2021.

While higher in 2017 and 2018, state financing needs are projected to remain broadly stable at around EUR 14 bn per year until 2020. The particularly high financing needs of EUR 27.2 bn for 2017 can largely be attributed to the front-loading of IMF early repayments. While lower than 2017, financing needs for 2018 are still high compared to those of 2019 and 2020. This can primarily be explained by a higher cash deficit and a higher acquisition of financial assets. Both the deficit and the net acquisition of financial assets are set to fall strongly in 2019 (by EUR 4.0 bn and EUR 1.6 bn, respectively), and by an additional EUR 1.1 bn and EUR 1.3 bn in 2020. The cash buffer is projected to decrease from EUR 7.8 bn in 2017⁽¹²⁾ to EUR 6.8 bn for 2018 and EUR 6.5 bn for 2019, before rising to EUR 10 bn in 2020 ahead of the high redemptions in 2021 (where a EUR 6 bn draw-down will bring the cash position to EUR 4 bn by year-end). Overall, in line with the expected broadening of the investor base following the improved credit ratings from Standard & Poor in September and Fitch in December, the cash buffer is thus planned to be decreased from around 50% to around 40% of yearly medium-to-long-term financing needs. The Debt Management Office (DMO) has indicated that it has no plans to further reduce this buffer at this stage.

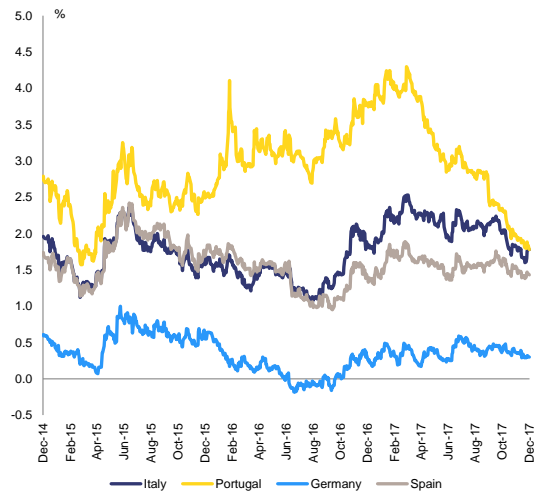
Despite past interest rate volatility, yields on Portuguese bonds have fallen steadily throughout most of 2017. After peaking at 4.3% in mid-March, yields on Portuguese 10-year bonds hovered slightly below 1.8% by mid-December (18 December). The decreasing trend of the yields preceded Standard & Poor's decision on 15 September to upgrade Portugal's rating to BBB-investment grade, although the latter clearly had an additional impact as Portuguese yields dropped by around 0.4 pps in the immediate days that followed. Fitch announced an upgrade to Portugal's credit rating on 15 December by two notches from BB+ (positive outlook) to BBB (stable outlook). The upgrade from a second major ratings agency allows Portuguese debt to re-join big bond indices and thus for a broadening of the investor base and lower funding costs. Portuguese yields have now fallen below those of Italy, although they remain somewhat higher than those of Spain (1.44%) (18 December).

According to the Portuguese Ministry of Finance, public debt is projected to fall by 3.9 pps to 126.2% of GDP in 2017, 2.8 pps to 123.5% in 2018 and by 4.3 pps to 119.2% of GDP in 2019. The Commission autumn forecast projects a similar downward path expecting Portugal's gross public debt-to-GDP ratio to decline to 126.4% in 2017, 124.1% in 2018 and 121.1% in 2019. It should be noted, however, that the latest Commission DSA (Autumn Forecast 2017) showed that the Portuguese debt trajectory remained highly sensitive to growth and interest rate volatility.

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

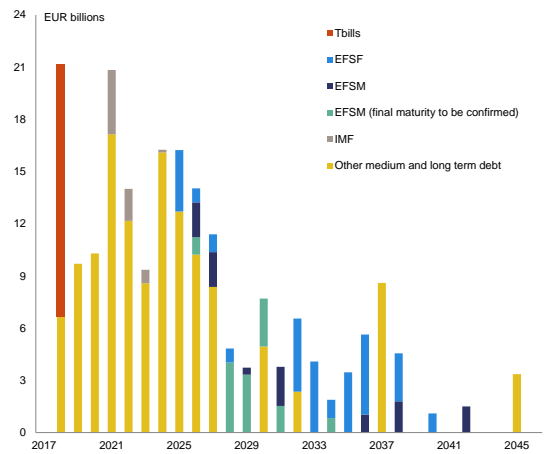
⁽¹²⁾ As of early January 2018, the authorities expect the final 2017 cash buffer to have significantly exceeded the estimate presented in early December 2017 (by around EUR 2bn).

Graph 4.1: 10-year government bond yields



Source: European Commission

Graph 4.2: Redemption profile



(1) Last update: 16 November 2017

Source: IGCP

ANNEX 1

European Commission Debt sustainability analysis

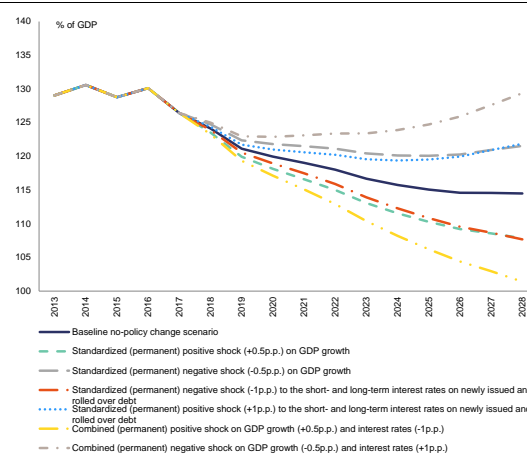
This Debt Sustainability Analysis (DSA) uses the Commission 2017 autumn forecast as a starting point to ensure cross-country consistency and to take into account second-round macroeconomic effects. The debt ratio in 2017 is estimated at 126.4% of GDP, a 3.7 pps decrease from 2016, mostly due to higher growth, falling interest expenditure and an increasing primary surplus. For 2018, the Commission 2017 autumn forecast projects a ratio of 124.1% of GDP, corresponding to a deceleration of the decrease to 2.3pps due to lower GDP growth, a lower primary balance and debt-increasing stock-flow adjustments. For the outer years, the analysis rests on the following assumptions: (i) the structural primary fiscal balance (before costs of ageing) remains unchanged at a surplus of 1.6% of GDP from 2019 under the no-policy-change assumption, (ii) inflation converges linearly to 2.0% by 2022 and remains at that level thereafter, (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5% by 2027 in line with the assumptions agreed with the Economic Policy Committee's (EPC) Ageing Working Group, (iv) real GDP growth rates of around 1%, and (v) ageing costs develop according to the Commission and EPC 2015 Ageing Report.

The baseline scenario results in an annual average decrease of the gross debt-to-GDP ratio by around 1pp of GDP from 2019 onwards and thus ensures a declining path down to 114.5% of GDP by 2028. This declining debt trajectory is sensitive to financial market volatility and vulnerable to negative economic developments. Graph A1.1 presents a sensitivity analysis with respect to macro-economic and financial market risks. More precisely, the graph illustrates the sensitivity of the debt trajectory to a shock to real GDP growth and hikes in interest rates as from 2018. The analysis suggests that a lower GDP growth rate by 0.5 pps or a one percentage point increase in the interest rate on maturing and new debt would increase the debt ratio by 0.7% and 0.3% of GDP, respectively, in 2018. In both cases, debt would be at about 122% of GDP by the end of the projection period. A combined negative growth and interest shock could put the debt-to-GDP ratio on an accelerating path, reaching 129.4% of GDP by end-2028. On the other hand, a positive shock to medium and long-term growth or permanently lower interest rates would result in a more solid path of debt reduction of around 1.63 pps per annum to around

108% of GDP in 2028. A combination of higher GDP growth and lower interest rates could further accelerate the pace of the debt ratio reduction to around 2 percentage points per year, thereby allowing for a fall in debt to around 101% of GDP in 2028.

Additional fiscal consolidation would clearly accelerate the debt reduction path as shown in Graph A1.2, illustrating the effect of alternative fiscal consolidation paths. Full compliance with the requirements of the Stability and Growth Pact (SGP) would considerably further accelerate debt reduction. The SGP scenario assumes convergence to the Medium-Term-Objective (MTO) according to the matrix of required fiscal adjustment in Annex 2 of the January 2015 Communication on flexibility in fiscal rules⁽¹³⁾. This would imply that the MTO of a structural balance of 0.25% of GDP would be reached in 2022 with a fiscal effort of 0.6% of GDP every year from 2019 to 2022. Maintaining the MTO over the longer term horizon would require structural primary surpluses of around 4% until the end of the projection horizon. Under these assumptions, the debt-to-GDP ratio would markedly accelerate its decline to around 3 percentage points per annum from 2022, falling to 95% by 2027.

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



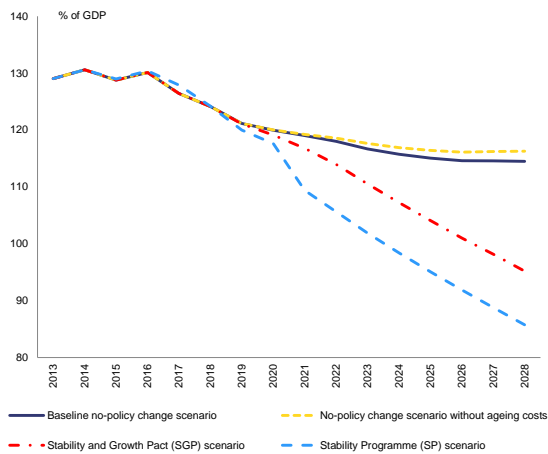
Source: European Commission

The 2017 Stability Programme scenario assumes a fall of the debt-to-GDP ratio to 127.9% in 2017

⁽¹³⁾ COM(2015) 12.

and 124.2% for 2018. Based on the assumptions of increasing primary surpluses, a context of low interest rates and real GDP growth at around 2% from 2019 onwards, the debt-to-GDP ratio in the Stability Programme is projected to decrease rapidly to 120.0% at end-2019 and 117.6% at end-2020. Such a scenario would be consistent with around 0.5% of GDP improvement in the structural balance for 2017-2020. From 2021 onwards, the primary structural surplus has been projected to remain at around 4% over the entire forecast period, which would contribute to a significant fall in the debt ratio to reach 86% of GDP by 2028.

Graph A1.2: Fiscal consolidation and ageing costs



Source: European Commission

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

ANNEX 2

MIP specific monitoring

A2.1. OUTLOOK AND EVOLUTION OF IMBALANCES

In February 2017, Portugal was identified as experiencing excessive macroeconomic imbalances in the context of the MIP. The identified imbalances mainly relate to the large stock of external liabilities, public and private debt, and the labour market adjustment process in a context of low productivity growth. Important vulnerabilities were also identified in the banking sector, particularly in regard to the high share of non-performing loans (NPLs). The Country-Specific Recommendations (CSRs) under the European semester provided guidance for the policy follow-up. These recommendations concern a wide range of policy domains: (CSR1) public finances, including state-owned enterprises; (CSR2) labour market; (CSR3) financial sector, particularly non-performing loans; and (CSR4) administrative burden and business environment. All CSRs are considered MIP relevant.

Portugal's economic growth picked up to 2.9% in the first half of 2017 and moderated to 2.5% in the third quarter of the year, mainly driven by investment and exports. Employment grew even faster than GDP, particularly in labour-intensive services related to tourism, while wage growth remained subdued. Despite some slowdown, economic performance is expected to remain strong in 2018 and 2019 amid further export growth and lower unemployment. HICP inflation is projected to remain relatively stable at around 1.5% over the forecast horizon with a slightly higher increase in service prices.

The current account (CA) has retained a small surplus over the past years contributing to a reduction in the negative international investment position (NIIP). The share of NIIP in GDP improved from 112.0% at the end of 2015 to 104.7% at the end of 2016 but reversed to -105.2% as of September 2017. This reversal in 2017 is due to valuation changes from the increased price of Portuguese government bonds held by non-residents, accounting for about 3% of GDP. The pace of adjustment is expected to remain insufficient to achieve a substantial improvement in the external position, as the CA is forecast at a surplus of 0.1% of GDP in 2017 and 0.2% in both 2018 and 2019. The structure of external liabilities improved in the past years due to the shift from

debt to FDI instruments. The FDI component in NIIP widened to 33.0% as of September 2017 relative to 29.9% at the end of 2016 and 26.3% at the end of 2015. The share of net external debt to GDP meanwhile contracted from 100.8% at the end of 2015 to 94.5% at the end of 2016 and 92.3% as of September 2017.

Private debt is on a steady downward path since its peak in 2012 and the outlook remains favourable. In consolidated terms, the private debt-to-GDP ratio fell from 210.3% at end-2012 to 171.4% at end-2016, declining in both the corporate and the household sectors. Data for 2017 is available only in non-consolidated terms but confirms that the process of deleveraging continues with a slight decrease in the absolute value of household debt stock (active deleveraging), a relatively stable value of corporate debt, as well as passive deleveraging linked to the accelerated economic growth, resulting in reduced debt ratios in both the household and corporate sectors.

The high stock of NPLs remains a key vulnerability of the financial system. While the aggregate NPL ratio dropped from 17.9% in June 2016 to 15.5% in June 2017 (Banco de Portugal data), it remains among the highest in the EU. Corporate NPLs are a particular concern as they account for 65% of the total NPL stock.

Following stabilisation at around 130% from 2013 to 2016, the debt-to-GDP ratio is forecast to follow a clear downward path by an average of 3pps in 2017 and 2018. Some limited risk to the debt reduction profile could arise from the contingent capital mechanism included in the Novo Banco sales agreement. The recent improvement in macroeconomic variables, in particular nominal and potential GDP growth, has made the structural adjustment needed to ensure compliance with the transitional debt rule less demanding.

The labour market continued to improve at a strong pace. Unemployment dropped to seasonally-adjusted 8.5% in September 2017 and the year-average unemployment is projected to decline from 11.2% in 2016 to 9.2% in 2017, supported by strong employment growth. The activity rate also improved and while the share of long-term unemployed is still more than half of total unemployment, it is decreasing in absolute terms. Labour productivity declined slightly in

2016 as job creation outpaced economic growth. Productivity is expected to drop further in 2017 due mainly to the high rate of job creation in labour intensive sectors such as tourism-related services and residential constructions. Unit labour costs (ULC) increased broadly in line with main trading partners as wage growth remained subdued.

The deflated house price index increased to 6% in 2016. The growth rate rose further to 6.9% y-o-y in the second quarter of 2017, along with a steep rise in property transactions. The hikes are concentrated in tourist areas, particularly in Lisbon. Demand for real estate is expected to remain strong but the impact on prices is likely to be at least partly offset by growing supply from new construction. In addition, the stock of mortgage loans is still declining, which dampens the upward pressure on house prices.

A2.2. POLICY MEASURES TAKEN TO ADDRESS MACROECONOMIC IMBALANCES

External balance and competitiveness

Policy measures aimed at improving the business environment would be important for both cost and non-cost competitiveness. Measures in this direction are being taken by the Portuguese authorities namely by further increasing administrative simplification, identifying ways to further reduce restrictions in business services and regulated professions and improving the judicial system. More details are provided further below in the section on the administrative burden and business environment. Measures directed at attracting FDI include the review of the Golden Residence Permit Programme to incentivise foreign business investment, simplification of the VAT system on imports or increasing the number of agreements for avoidance of double taxation and their effective implementation.

Measures to improve the value-added of Portuguese exports could further contribute to improve non-cost competitiveness. This would allow for larger CA surpluses and speeding-up the NIIP reduction. In this context, Portugal has launched an ambitious package of measures (Industry 4.0, Start-up Portugal, Capacitar a Indústria and Programme Interface) that target the main concerns regarding business competitiveness:

internationalisation, improving business environment, skills and innovation. All initiatives are however at a very early stage of implementation and the size of the competitiveness impact is unclear.

The Qualifica Programme aims at upgrading the skills of the labour force which could further contribute to improve non-cost competitiveness. Since 2011 there was a remarkable progress in improving the skills level of the labour force. From 61% in 2011, the percentage of low skilled (i.e. individuals with lower secondary education or below) decreased to 48% in 2016 according to Eurostat. However, the low skill level remains an important barrier to productivity increases which is evident when compared with the EU average where only 18% of the labour force is low-skilled. The new Qualifica Programme being implemented by the government is an improvement compared with previous qualification recognition programmes since it includes a stronger training component for participants. It has also a broad coverage, through an expanded network of qualification centres, expecting to reach half a million participants up to 2019 focusing on low-skilled workers.

Private indebtedness and access to finance

In order to improve access to finance, the government has launched in 2016 the Capitalizar programme. The programme is composed of a broad range of measures and is being implemented in different phases. A new measure being rolled out is the creation of a new type of listed companies (SIMFE) holding shares in unlisted firms (SMEs and Mid-Caps) and a new type of short term debt securities available to SMEs and Midcaps in which Investment Funds and Pension Funds may invest; the scope of the allowance for corporate equity system is being broadened to include capital increases through incorporation of reserves. The regime for applying to the reversal of tax liabilities on company directors is being revised to incentivise the changing in companies management by limiting the risk of reversal of past tax liabilities.

Following an exhaustive analysis of the banks' bad loans by type, vintage, size and sector of activity, the issue of corporate NPLs is being addressed by a three-pronged strategy: changes to the judicial,

legal and tax systems; prudential/supervisory actions led by the central bank following SSM guidance and NPL management solutions. The strategy is comprehensive in terms of the issues (see an overview in Box 1) being tackled and is already being rolled out as many of the measures announced have been either approved or are in an early stage of implementation. Therefore, it is still too soon to assess the strategy's effectiveness in decreasing NPLs. This can only be done once all of the measures are in implementation stage and start producing effects.

Box A2.1: Strategy for NPL reduction

The judicial pillar of the strategy focuses on facilitating early restructurings of firms and speeding up insolvency proceedings. In doing this it tries to ensure that non-viable companies are prevented from applying for various pre-insolvency proceedings and thus benefitting creditors' protection – often used as a strategy to delay the inevitable liquidation. This strategy is also focused on expediting insolvency proceedings. A pre-condition for many of the measures is an efficient identification of firms that are viable and those that should be liquidated. Measures include:

- 1) an early warning mechanism whereby managers of Portuguese firms receive user friendly information about the economic and financial health of their companies, together with actionable suggestions to deal with possible financial issues;
- 2) creation of a new group of insolvency practitioners–mediators assisting debtors in making a diagnosis of their firm's situation, preparing restructuring plans and mediating deals with creditors;
- 3) a new legal framework to allow majority creditors to convert their credits into share capital without the consent of shareholders and outside of an insolvency proceeding;
- 4) a new legal framework for voluntary out-of-court restructurings (RERE), which will benefit from the same insolvency protection and tax treatment which currently is only available for court sanctioned proceedings;
- 5) restricting access to the pre-insolvency proceedings (PER) to viable companies, preventing abuse by non-viable firms (PER is based on the UK's best practice allowing for cross class cram downs with a voting of a minimum of 50% of non-subordinated creditors);
- 6) expediting insolvency proceedings, through allowing creditors and insolvency administrators to claim and rank credits electronically to allow rapid payment of undisputed claims thereby reducing the cycle of cash-in-court;
- 7) flexibility for tax credits to be restructured and a common decision body between social security and the tax authority to participate in restructuring negotiations;
- 8) simplification of the transfer of NPL portfolios by allowing bulk registration of transferred collateral.

The supervisory pillar of the strategy focuses primarily on providing guidance to banks on how to efficiently deal with NPLs. The set of measures/guidelines include:

- 1) NPL reduction plans – the 6 Portuguese banks with the highest NPL ratios submitted 5 year NPL reduction plans (to Banco de Portugal/SSM). These banks have an average NPL ratio of 22% as of end-2016 and are planning to reduce it to 10% by 2021. The main measures comprise sales of NPLs and write-offs as well as cash recoveries and foreclosures. Banco de Portugal and SSM assess the plans as ambitious but realistic and the implementation so far is considered on track;
- 2) SSM Guidance on NPLs – leveraging on the best practices/processes currently followed by several member states;
- 3) improvements in data collection by Banco de Portugal supervision including for the purpose of IFRS9 implementation.

(Continued on the next page)

Box (continued)

Lastly, various NPL management solutions are part of the third pillar of the comprehensive strategy. The key measures are mostly system-wide proposals being put forward by private entities:

- 1) 'bulk transfer' of assets away from the system – it has limited potential given the heterogeneity of the NPL stock and constraints such as capital level, public finances and the EU regulatory framework (BRRD, State Aid). Nonetheless, targeted asset transfers may merit consideration for specific asset types and selected banks;
- 2) "coordination platform" – a specific approach initiated by the banks with most significant NPL levels to deal with NPLs from non-financial companies which are viable but under financial stress. The goal is to promote enhanced creditor coordination to expedite credit restructuring and/or NPL sales, while also attracting some public and private funds and technical assistance for the restructuring of viable firms;
- 3) steps have also been taken to tackle constraints to the recovery of NPLs:
 - a. the ability for banks to recognise for tax purposes write-offs once these are required from an accounting and regulatory perspective;
 - b. the incentive to the creation of a secondary market for NPLs, by facilitating the entry into the market of new servicing companies.

Public debt: fiscal structural measures and long-term sustainability of public finances

The public spending review in place since March 2016 is slowly being translated into implemented measures. The review was originally focused on education, healthcare, SOEs, public sector real estate and centralised public procurement, to which the government has since committed to add the justice and internal affairs sectors. For the Justice sector, a 'Closer Justice' Plan, announced on 1 March 2016, has so far implemented 47 measures out of a planned 150, with a final conclusion scheduled for 2019. It is estimated to save EUR 4.1 m per year. Additionally, the 'Tribunal+' project, which seeks to optimise the working time of the Officers of Justice, was expanded in 2017 from a single pilot area to more districts in Lisbon. Once it has expanded to 25 large and medium-sized courts by 2018, the projected savings in working hours would amount to about EUR 5.17 m per year. Furthermore, plans are currently being developed to better deal with the large amount of confiscated vehicles under public management. A range of measures are also planned for the internal affairs sector but still not in implementation phase. The planned reforms include the outsourcing of support functions to free

up resources for operations, the elimination of redundancies and replicated administrative tasks and an increase in efficiency through a more strategic use of public investments for the security forces within a multi-annual framework. Dealing with the costs associated with absenteeism is also being presented as a cross-cutting priority, in particular in the education sector via review of medical panels supplemented by the introduction of a new monitoring model flagging potential cases of false sick leaves. Following successful implementation in the education sector, the intention is to apply the use of these new tools across the remaining sectors of public administration. A performance-related scheme with the aim of incentivising civil servants to develop new ways of reducing expenditure without compromising public service provision has also been enacted. This scheme does not apply to SOEs, however, and therefore not to hospitals either.

Hospital arrears continue to increase while the implementation of cost-reducing measures is still outstanding. Hospital arrears increased by EUR 480 m in 2017 until October. The accumulation of arrears unveils a problem of under-budgeting, monitoring and enforcement practices. It should be

noted that the arrears are caused by a select number of underperforming hospitals and not by the National Health Service (NHS) as a whole. The announced release of around EUR 400 m to hospitals for the clearance of arrears before year-end, accompanied by capital injections into hospitals of EUR 500 m in both 2017 and 2018, should allow for a substantial decrease of arrears in the coming months. However, the pattern of periodic injections of funds for clearance of arrears appears to leave unaddressed the underlying reasons for the general trend of arrears accumulation. A joint Budget Analysis Unit by the Ministry of Health and the Ministry of Finance is planned to be set up to tackle the hospitals arrears problem. The implementation of the so-called Integrated Responsibility Centres, with the aim of increasing efficiency through enhanced autonomy to hospital teams, is also in preparation for 2018.

A series of reforms have, however, been implemented with the aim of reducing costs in the NHS. In the case of medicine, a series of measures including further incentives for the use of generics, continuation of paybacks, clawbacks and further renegotiations with the pharmaceutical industry have partly counterbalanced expenditure increases from innovations and thus allowed for a stabilisation of expenditure in percentage of GDP. An independent evaluation of the data for the first quarter of 2017 estimated EUR 35 m of savings associated with the centralisation of NHS purchasing. In 2017, new agreements were also negotiated in the areas of clinical analysis, Haemodialysis, Radiology, Pathological Anatomy and Nuclear Medicine with an annual projected cost-reduction of EUR 14.6 m. The financial management of the regional health administrations, which in the past had led to delayed payments and sometimes heavy financial penalties, has been centralised for a range of areas in order to reduce the creation of new arrears. The shared services have also increased efficiency of hospital use by setting up a shared resource management platform so as to facilitate the use of NHS facilities and reduce reliance on the private sector. Enhanced use of further centralised digital platforms tends to increase efficiency in a series of areas including vaccines, medical exams, e-prescriptions and appointments. Finally, steps have been taken in the fight against fraud through the creation of the Control and Monitoring Centre of the NHS, where virtually all payments will be verified. A newly

established Group on Prevention and Fight against Fraud has already identified and transmitted a set of cases worth EUR 21 m euros to the public prosecutor in the first half of 2017. The on-going process of digitalisation is also facilitating the detection of fraud. The earmarking of the extension of alcoholic drinks tax (IABA) to sweetened drinks (levy on drinks with added sugar that is expected to yield EUR 70 m in 2017) is intended to address the sustainability of the National Health Service.

A new early retirement scheme without penalty for very long careers entered into force in 2017. It allows citizens that are now 60 years or more and that have made contributions to the social security for 48 years or more to retire without penalty before the general retirement age of (in 2018) 66 years and 4 months. This new regime applies to both pensioners of the general social security scheme and pensioners of the public sector legacy regime (Caixa Geral de Aposentações) and will be fully operational from 2018. In 2017, the lowest bracket for pension indexation was expanded from 1.5 to 2 times the Social Support Index (the Social Support Index has been unfrozen reaching EUR 421.32 in 2017 and is set to be updated annually). In 2017, in addition to the regular pension update in January there was an extraordinary update in August. The extraordinary update was intended to compensate for the loss of purchasing power of the lowest pensions in particular those which had not been updated at all between 2011 and 2015, a measure that benefited around 2 million pensioners. A new extraordinary increase of lower pensions is planned for 1 August 2018, and is expected to cover again around 2 million pensioners. In the non-contributory part of the social security system, the reference value of the Solidarity Supplement for the Elderly (CSI) increased in line with the level of observed inflation in 2017, after having already been increased by EUR 150 per year in 2016. On the revenue side, in 2017 the Portuguese authorities earmarked the revenue deducted from the additional real estate tax (Adicional ao IMI – Imposto Municipal sobre Imóveis) to the reinforcement of the Social Security Financial Stabilisation Fund. A portion of the Corporate Income Tax is also planned to be progressively earmarked to the Financial Stabilisation Fund starting in 2018. According to the authorities, higher contributions, lower unemployment and a

more efficient system will entail that no more extraordinary transfers to the social security system will need to be made in 2018.

While the financial position of SOEs is improving, the implementation of new reporting mechanisms has been slow. A new data gathering system based on SIRIEF, which automatically draws information from the accounting systems of public companies, was in a pilot phase in 2017 and will be widely applied in 2018. Activity and Budget Plans (PAO), which are submitted by SOEs to UTAM (the Ministry of Finance's task force on SOE monitoring), are beginning to be evaluated more comprehensively and with a longer time horizon (3 years). In 2018 the analysis of the impact of these plans on the balance of public accounts will no longer be limited to larger companies or groups and will be carried out in a more systematic way. Beginning in 2018, instruments ensuring the proper implementation of the Activity and Budget Plans will be put in place. These include early warning mechanisms, which will enable a faster identification of deviations from the PAO and the adoption of corrective strategies. In addition, a risk assessment methodology is being set up, allowing public companies to be ranked by their degree of risk so as to prioritise the follow-up effort. If it is considered necessary, a detailed cost reduction programme could be required by at-risk SOEs, which should include measures to generate savings and improve efficiency. These savings must be quantified and explained. Accountability will also be improved through the introduction of incentives for good governance and for reaching objectives, such as financial rewards for successful managers.

SOE investments will also be evaluated more closely on a case-by-case basis, with due attention being paid to the return on investment from the perspective of the provision of public goods and services, the timing of investments and their financial details, and the financing structure and results to be achieved. A debt management plan and recapitalisation is ongoing to reduce indebtedness and lower interest costs with the central government taking over SOEs debt. In some cases the credit given to the company by the central government is then converted into capital reducing the indebtedness. This creates moral hazard risks as enterprises are less motivated to improve efficiency and financial performance. A series of reforms have been put forward, however,

to improve the monitoring and efficiency of SOEs as explained in the above paragraph.

Labour market: segmentation, long-term unemployment and wage setting

The government's strategy to reduce segmentation has relied mainly on changes in temporary contracts rules and its effectiveness remains limited. Discussions with social partners are ongoing regarding the possibility to revoke the Labour Code norm that allows hiring long-term unemployed and people looking for their first job on fixed-term contracts without further justifications. A reinforcement of labour inspectorates, aimed to prevent abuse of temporary contracts and "bogus" self-employment, is ongoing. Hiring support measures are increasingly restricting support if the employer offers a temporary contract. The authorities are considering differentiating firms' social security contributions according to the type of employment contract used and making hiring under temporary contracts relatively more expensive. Such a measure would need to take into account that some job positions are inherently of a temporary nature. Implementation will not be earlier than 2019.

While changes in temporary contract rules can be useful, they are not providing enough incentives to hire more on open-ended contracts. Changes in temporary contract rules do not tackle the underlying problem of remaining rigidities concerning individual dismissals of permanent workers. This includes for example the uncertainty in terms of firing costs highlighted in the 2017 Country Report, the lack of clarity concerning conditions under which employers can dismiss individual workers for economic reasons, or the still complex procedural requirements highlighted by the OECD 2017 report on labour market reforms in Portugal. Measures to tackle labour market segmentation are currently under discussion with social partners, based on the Green Paper on Labour Relations presented in March 2017. However, the issues for discussion being put forward by the government to the social partners are still focused on changing the framework for temporary contracts and not on tackling rigidities in permanent ones.

Active labour market policies are increasingly focused on long-term unemployed and other

vulnerable groups. The planned one-stop-shops for employment will provide integrated services to individuals and employers giving different options depending on their profile and ensure coordination with other public services, notably social services. Implementation is planned for Q1-2018 and the goal is to improve the effectiveness of activation measures focusing on the long-term unemployed, younger and older workers.

In a context of moderate wage growth, wage floors are increasingly binding with the rise in the minimum wage. The government has initiated discussions with social partners in view of an agreement for the level of minimum wage in 2018. The government's proposal is to increase the minimum wage in 2018 but there is still no agreement on the amount. The final decision needs to account for the possible impact on employment of lower skilled workers and on competitiveness in particular given the fact that the minimum wage increased already by 15% since 2014. The quarterly reports on the impact of the minimum wage produced by the government provide a good basis for the discussions. According to the latest publication, 22.7% of workers were covered by the minimum wage at the end of the first semester of 2017.

The reinstatement in June 2018 of the expiry rule should create the right incentives for a dynamic collective bargaining system. According to a rule introduced in 2009, if a collective agreement is not renewed it will expire following a legally set period after its end date. This expiry rule gave parties in new negotiations, and in particular workers, the incentive to reach an agreement given the risk of not being covered by a collective agreement. It prevented therefore the perpetuation of collective contracts allowing wage setting to be more responsive to productivity developments. Even though the number of collective agreements is steadily increasing since 2012, in January 2017 the government and the majority of social partners agreed not to use the expiry rule for collective agreements for a period of 18 months until June 2018. The objective of the government was to give an incentive to conclude negotiations which were stalling due to some pressure by employers. Discussions with social partners are ongoing to redesign the expiry rule by June 2018 in order to give workers and employers the incentives to engage in collective bargaining.

Quasi-automatic administrative extensions of collective agreements to the entire economic sector are increasing in a context of overall increase in collective bargaining. In the first half of 2017 an increase in the number of administrative extensions of collective agreements was recorded (31), amounting to more extensions as in the entire 2016. The quasi-automatic extensions of agreements with low coverage rates of both employer organisations and trade unions can lead to the imposition of a large number of sector/occupation wage floors which do not necessarily represent the economic realities of non-signatory firms. However, a government resolution of June 2017 (82/2017) revokes the proportionality criteria for extensions (at least 30% of the signatories of the agreement should be SMEs) and introduces the possibility of the issuance of administrative extensions by government initiative. The impact of these new rules will need to be monitored in the following quarters.

Administrative burden and business environment

Administrative simplification is ongoing and can improve the business environment. The measures being implemented under the SIMPLEX+ programme are set to decrease the administrative burden on citizens and companies. The programme covers a broad range of areas in the public administration and focuses mainly on horizontal aspects of business activity. An assessment of the impact of selected measures has been concluded with positive results. Further simplification measures are expected in 2018, in particular improved interoperability between the one-stop-shop for entrepreneurs and relevant competent authorities. An ex-ante legislative impact assessment started to be carried out as a pilot in March 2017 (Custa Quanto). The aim is to reduce the burden on businesses caused by new legislative acts. First results are positive; a more structured evaluation of the pilot project will be done in January 2018.

While there is still room to decrease construction fees, access to finance is reportedly the most significant barrier to construction. Licensing costs are not a significant barrier for construction firms. According to the companies in the sector, the lack of credit and difficulties in access to finance are a more important hurdle for new projects. The recent

rebound of construction activities as well as the steep increase in newly issued building permits is also largely influenced by the boom in the tourism sector.

Barriers to competition in business services remain but authorities are looking for ways to further reduce them. The by-laws of certain regulated professions are less ambitious than the framework law in terms of opening up to competition. This is particularly true for the most restrictive sectors such as accountants, architects and lawyers. A study undertaken by the Portuguese authorities with the OECD and the European Commission is ongoing to assess remaining restrictions in these sectors. Once the final results are ready, in April 2018, the authorities will assess the need for further action on this matter. Licensing has been further streamlined, particularly in tourism, land and environment, but its implementation across the country is heterogeneous.

The capacity of the justice system to reduce the length of proceedings and cases backlog is improving gradually but the number of pending cases is still high. In 2017 the European Council recommended Portugal to increase the efficiency of insolvency and tax proceedings. The clearance rate in judicial and tax courts was above 120% of new cases during 2016 allowing for an overall decrease in the number of pending cases. A decrease in the disposition time was also observed in the tax courts. While results are improving, the large backlog of cases requires efforts to continue in this domain. The "Tribunal +" programme aims at administrative simplification so that court clerks spend less time doing general administrative work and can focus more on their core tasks. In the pilot-project, 1/3 of the office clerks were able to drop completely administrative functions. The increased efficiency of the administrative services will allow further decrease the case backlog and lower disposition time. In May a Government Ordinance (178/2017) created the "one-stop" court services for the Administrative and Fiscal Courts which should help make internal procedures more efficient.

A2.3. CONCLUSION

Since spring 2017, measures were rolled out to stimulate the reduction in NPLs and improve some elements of the business environment. The

banking sector has started implementing a comprehensive strategy for the reduction of NPLs, including measures for improving the legal framework and speeding up insolvency proceedings as well as concrete reduction targets by banks. As most measures are still in an early stage of implementation it is still not possible to assess their effective capacity in reducing the level of NPLs. Simplification measures and an impact assessment (Custa Quanto) to reduce administrative burden together with improvements in the judicial system are being put in place to improve the business environment.

There is however uncertainty regarding the adoption and implementation of several key reform initiatives. Some important policy measures remain incomplete or are still at an early stage of their legislative approval. These include fiscal-structural reforms to improve the sustainability of public finances or measures to tackle labour market segmentation. In terms of labour market segmentation, measures taken have mostly covered changing rules to temporary contracts. To effectively reduce segmentation more direct legal incentives are likely to be needed to hire on open-ended contracts. There is also considerable scope to improve the sustainability of public finances, for example by implementing better expenditure control for state-owned enterprises, in particular in the health sector and ensuring medium- and long-term sustainability of the pension system. Portugal has requested technical support from the Structural Reform Support Service (SRSS) to implement reforms in the areas of budget framework and administrative burden.

Table A2.1: State of Play of the implementation of MIP relevant reforms

MIP objective: Public debt			
Public finances			
Fiscal policy and fiscal governance			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
Broaden the expenditure review to also include Justice and Internal Affairs. A special focus from 2018 onwards will be the management of human resources with the aim of reducing public sector absenteeism. The legal treatment of seized vehicles also constitutes an additional focus for 2018. In total, around EUR 290 m of savings from the expenditure review are estimated for 2018.	A performance-related pay scheme rewarding civil servants who contribute with ideas leading to lower expenditure without compromising public service delivery.	According to the authorities, some EUR 75 m have been saved by the expenditure review in 2017. The 'Closer Justice' Plan has, since March 2016, implemented 47 out of 150 measures. Conclusion is scheduled for 2019. It is estimated to save EUR 4.1 m per year. The 'Tribunal+' project, which seeks to optimise the working time of the Officers of Justice, was expanded in 2017 from one pilot area to several Lisbon districts.	CSR 1 – 2017: Step up efforts to broaden the expenditure review to cover a significant share of general government spending across several policies.
For SOEs with a negative EBITDA establish the objective of an EBITDA near zero for 2018. Reducing the weight of operating expenses in turnover by continuing a policy of optimisation. Review of economic and financial efficiency metrics per company. Review of public service contracts of a range of SOEs, particularly in the transport sector.	Upgrade to an automatic reporting mechanism is still in a pilot phase, and will not be fully implemented until 2018. Continuous recapitalisation of SOEs. Increase monitoring and reporting of SOEs.		CSR 1 – 2017: To increase the financial sustainability of state-owned enterprises set sector-specific efficiency targets in time for the 2018 budget, improving state-owned enterprises overall net income and decreasing the burden on the state budget.
Long-term sustainability of public finances			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
Savings of EUR 166 m are expected to be made in the health sector in the context of the expenditure review in 2018 through, inter alia, a review of prices and contributions; review of the NHS technology assessment system; medical devices; reinforcement of budget monitoring and savings associated with debt repayment. Strengthening of the monitoring mechanisms of the budgetary execution of NHS entities. To be achieved primarily through the creation of a Budget Analysis Unit designed for this purpose, in a joint initiative between the Ministries of Health and Finance. The State budget is envisaging the earmarking of up to 2 % of the Corporate Income Tax revenue to the social security system in a progressive way in 2018.		Centralisation of NHS purchasing; renegotiation of agreements in a range of medical sectors; centralisation of financial management to reduce flow of arrears; shared resource management platform set up so as to facilitate the use of NHS facilities and reduce reliance on private sector; Control and Monitoring Centre of the NHS established to combat fraud; creation of Group on Prevention and Fight against Fraud. The earmarking of the extension of alcoholic drinks tax (IABA) to sweetened drinks is intended to address NHS sustainability. The Portuguese authorities earmarked the revenue deducted from the additional real estate tax to the reinforcement of the Financial Stability Fund. Recent reforms to the pension system, such as the extraordinary increases to pensions and particularly the changes to the early retirement rules for long careers, risk deteriorating the long-term sustainability of the pension system.	CSR 1 – 2017: Strengthen expenditure control, cost effectiveness and adequate budgeting, in particular in the health sector with a focus on the reduction of arrears in hospitals and ensure the sustainability of the pension system.
MIP objective: improving the functioning of the labour market			
Labour market			
Employment protection legislation & framework for labour contracts			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
Revoke the Labour Code norm that allows hiring long-term unemployed and people looking for their first job on fixed-term contracts without further justifications. Differentiate firms' social security contributions by type of employment contract used making temporary contracts more expensive. To be implemented only in 2019.			CSR 2 – 2017: Promote hiring on open-ended contracts, including by reviewing the legal framework.
Active labour market policies			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
Support to the creation of entrepreneurial projects and self-employment will be evaluated and the re-evaluation of the Contratos Emprego-Inserção will be implemented to bring them back to their original goal in activating the unemployed and the inactive.	One-stop-shops integrating social and employment services with a stronger focus on activation of self-employment.		CSR 2 – 2017: Ensure the effective activation of the long-term unemployed.
Wages & wage setting			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
	Suspension of use of the expiry rule for collective agreements for a period of 18 months until July 2018.	Revoking the proportionality criteria for administrative extensions of collective agreements.	CSR 2 – 2017: Together with social partners, ensure that minimum wage developments do not harm employment of the low-skilled.

(Continued on the next page)

Table (continued)

MIP objective: reducing the debt levels of the private sector			
Financial sector			
Private indebtedness			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
<p>The issue of corporate NPLs is being addressed by a three-pronged strategy:</p> <ul style="list-style-type: none"> changes to the judicial, legal and tax systems; prudential and supervisory actions led by the central bank following SSM guidance; NPL management solutions. 	<p>Fiscal incentives for individuals investing in firms which are undercapitalised.</p> <p>Setting up of a "coordination platform" by the main banks to deal with corporate NPL.</p> <p>A new legal framework to allow majority creditors to convert their credits into share capital without the consent of shareholders and outside of an insolvency proceeding.</p> <p>A new legal framework for voluntary out-of-court restructurings (RERE).</p> <p>Capitalizar, a strategic plan to support firm capitalisation is being implemented since 2016. For 2018 measures aim at promoting capital investment in SMEs.</p>	<p>Facilitate early restructurings; prevent nonviable companies from recurring to pre-insolvency proceedings and benefitting from their standstill protections (NRP 2017).</p> <p>The six largest banks with the highest NPL ratios submitted plans to reduce NPLs to 10% by 2021.</p> <p>Creation of a new group of insolvency practitioners—mediators assisting debtors in making a diagnosis of their firm's situation, preparing restructuring plans and mediating deals with creditors.</p>	<p>CSR 3: Step up efforts to clean up the balance sheets of credit institutions by implementing a comprehensive strategy addressing non-performing loans, including by enhancing the secondary market for bad assets.</p> <p>Reduce the private debt overhang (MIP Matrix 2017).</p>
Access to finance			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
Facilitate access of SMEs to capital funds.	The conversion into capital of third party credits has now the same tax regime as firm capitalisation.		CSR 3: Improve the access to capital, in particular for start-ups and small and medium-sized enterprises.
MIP objective: improving the external balance and productivity			
Business environment			
Administrative burden			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
		<p>The SIMPLEX programme is being implemented to reduce administrative burden to citizens and businesses.</p> <p>An ex-ante assessment of legislation (<i>Custa Quanto</i>) has started in 2017 with the aim of reducing the administrative burden on firms of new measures.</p>	CSR 4: Implement a roadmap to further reduce the administrative burden.
Regulatory barriers			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
	A study is ongoing to assess measures to reduce restrictions in business services. Implementation is expected for 2018.		CSR 4: tackle regulatory barriers in construction and business services by the end of 2017.
Judicial system			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
	Expediting insolvency proceedings, including reducing the cycle of cash-in-court.	"Tribunal+" is a measure that aims at reducing the time court clerks spend on administrative tasks so that more time is dedicated to their core functions.	CSR 4: Increase the efficiency of insolvency and tax proceedings.
Investment			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
Acceleration of the processes related to public investments to speed up project implementation.	Increase in public investment of 40% in 2018 to EUR 4.5 billion.	Acceleration in the execution of the European Structural funds (NRP 2017).	Weak productivity dynamics weighs on competitiveness and GDP growth (MIP Matrix 2017).
Skills			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
Launch the Qualifica AP initiative, responding to the needs of public administration staff through the establishment of protocols with the Qualifica Centers.		Qualifica Program specialising in adult education and training and aimed at providing counselling, guidance and referral to learning pathways (NRP 2017).	Bottlenecks to productivity growth also remain related to innovation performance and the low skill level of the labour force (MIP Matrix 2017).
Innovation performance			
Announced measures	Adopted measures	Implemented measures	Sources of commitment
	An ambitious package of measures (Industry 4.0, Start-up Portugal, Capacitar a Indústria and Programme Interface) was launched targeting the main concerns regarding business competitiveness: internationalisation, improving business environment, skills and innovation.		Improving competitiveness and decreasing external debt (MIP Matrix 2017).

Source: European Commission

ANNEX 3

European Commission macroeconomic and fiscal projections (2017 autumn forecast)

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

<i>Annual % change</i>	2016	2017	2018	2019
1. Private consumption expenditure	2.1	1.9	1.6	1.6
2. Government consumption expenditure	0.6	0.4	0.5	0.5
3. Gross fixed capital formation	1.6	8.1	5.3	4.9
4. Final domestic demand	1.7	2.6	2.0	2.0
5. Change in inventories	--	--	--	--
6. Domestic demand	1.5	2.6	2.0	2.0
7. Exports of goods and services	4.1	8.0	7.3	4.9
7a. - of which goods	4.3	7.5	8.4	5.1
7b. - of which services	3.4	9.3	4.5	4.3
8. Final demand	2.3	4.1	3.6	2.9
9. Imports of goods and services	4.1	8.0	7.2	5.2
9a. - of which goods	4.5	8.4	7.7	5.3
9b. - of which services	1.6	6.1	4.6	4.3
10. Gross domestic product at market prices	1.5	2.6	2.1	1.8
<i>Contribution to change in GDP</i>				
11. Final domestic demand	1.7	2.6	2.0	1.9
12. Change in inventories + net acq. of valuables	-0.2	0.0	0.0	0.0
13. External balance of goods and services	0.0	0.1	0.1	-0.1

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

<i>Annual % change</i>	2016	2017	2018	2019
1. Private consumption expenditure	3.1	3.5	3.2	3.1
2. Government consumption expenditure	2.4	1.7	1.7	1.7
3. Gross fixed capital formation	1.7	9.9	6.5	5.9
4. Final domestic demand	2.7	4.1	3.4	3.3
5. Change in inventories	--	--	--	--
6. Domestic demand	2.6	4.1	3.4	3.3
7. Exports of goods and services	1.8	10.6	8.7	6.3
8. Final demand	2.4	6.0	5.0	4.3
9. Imports of goods and services	0.9	11.1	8.6	6.7
10. Gross national income at market prices	3.6	4.1	3.6	3.3
11. Gross value added at basic prices	2.6	3.8	3.4	3.6
12. Gross domestic product at market prices	3.0	4.0	3.5	3.2
Nominal GDP, EUR bn	185.2	192.6	199.4	205.8

Table 3: Implicit price deflators

<i>% change in implicit price deflator</i>	2016	2017	2018	2019
1. Private consumption expenditure	1.0	1.5	1.5	1.5
2. Government consumption expenditure	1.8	1.3	1.2	1.2
3. Gross fixed capital formation	0.2	1.6	1.2	0.9
4. Domestic demand	1.0	1.5	1.4	1.4
5. Exports of goods and services	-2.2	2.4	1.4	1.4
6. Final demand	0.1	1.8	1.4	1.4
7. Imports of goods and services	-3.1	2.8	1.3	1.4
8. Gross domestic product at market prices	1.4	1.3	1.4	1.4
HICP	0.6	1.5	1.4	1.5

Table 4: Labour market and cost

<i>Annual % change</i>	2016	2017	2018	2019
1. Labour productivity (real GDP per employee)	-0.1	-0.3	0.9	0.9
2. Compensation of employees per head	2.1	1.6	1.7	1.8
3. Unit labour costs	2.2	1.9	0.8	0.9
4. Total population	-0.3	-0.2	-0.1	0.0
5. Population of working age (15-74 years)	-0.3	-0.2	-0.2	-0.1
6. Total employment (fulltime equivalent)	1.6	2.9	1.2	0.9
7. Calculated unemployment rate - Eurostat definition	11.2	9.2	8.3	7.6

Table 5: External balance

<i>levels, EUR bn</i>	2016	2017	2018	2019
1. Exports of goods (fob)	52.7	58.2	63.9	68.1
2. Imports of goods (fob)	60.8	67.9	74.0	79.1
3. Trade balance (goods, fob/fob) (1-2)	-8.1	-9.7	-10.2	-11.0
3a. p.m. (3) as % of GDP	-4.4	-5.0	-5.1	-5.4
4. Exports of services	21.3	23.7	25.1	26.5
5. Imports of services	11.5	12.4	13.1	13.9
6. Services balance (4-5)	9.8	11.3	12.0	12.6
6a. p.m. 6 as % of GDP	5.3	5.9	6.0	6.1
7. External balance of goods & services (3+6)	1.7	1.6	1.8	1.6
7a. p.m. 7 as % of GDP	0.9	0.8	0.9	0.8
8. Balance of primary incomes and current transfers	-1.5	-1.4	-1.3	-1.2
8a. - of which, balance of primary income	-4.0	-4.0	-4.0	-4.0
8b. - of which, net current Transfers	2.5	2.6	2.7	2.8
8c. p.m. 8 as % of GDP	-0.8	-0.7	-0.7	-0.6
9. Current external balance (7+8)	0.2	0.1	0.4	0.4
9a. p.m. 9 as % of GDP	0.1	0.1	0.2	0.2
10. Net capital transactions	1.7	1.8	1.8	1.9
11. Net lending (+)/ net borrowing (-) (9+10)	1.9	1.9	2.3	2.3
11a. p.m. 11 as % of GDP	1.0	1.0	1.1	1.1

Table 6: Fiscal accounts

	2016	2017	2018	2019
<i>% of GDP</i>				
Taxes on production and imports	14.8	14.9	15.0	15.0
Current taxes on income, wealth, etc.	10.3	10.3	9.8	9.9
Social contributions	11.7	11.7	11.7	11.6
Sales and other current revenue	5.9	5.8	6.0	6.0
Total current revenue	42.6	42.7	42.5	42.5
Capital transfers received	0.4	0.7	0.7	0.7
Total revenue	43.0	43.4	43.2	43.2
Compensation of employees	11.3	11.2	11.0	10.9
Intermediate consumption	5.6	5.6	5.7	5.6
Social transfers in kind via market producers	1.8	1.8	1.8	1.8
Social transfers other than in kind	17.1	16.9	16.8	16.8
Interest paid	4.2	3.9	3.6	3.5
Subsidies	0.5	0.5	0.5	0.5
Other current expenditure	2.5	2.5	2.6	2.6
Total current expenditure	43.1	42.5	42.1	41.8
Gross fixed capital formation	1.5	1.6	2.1	2.1
Other capital expenditure	0.4	0.6	0.5	0.5
Other (residual)	3.0	3.2	3.1	3.1
Interest expenditure	4.2	3.9	3.6	3.5
Total expenditure	45.0	44.8	44.6	44.4
General Government balance (ESA2010)	-2.0	-1.4	-1.4	-1.2
Primary balance	2.2	2.5	2.2	2.3
<i>% change</i>				
Taxes on production and imports	4.9	5.0	4.3	3.0
Current taxes on income, wealth, etc.	-2.3	3.5	-0.8	3.8
Social contributions	4.0	4.6	3.1	2.9
Sales and other current revenue	-0.9	2.5	7.1	3.3
Total current revenue	2.0	4.2	3.1	3.2
Capital transfers received	-43.1	64.5	-0.3	3.6
Total revenue	1.2	4.8	3.1	3.2
Compensation of employees	2.6	3.1	2.0	2.2
Intermediate consumption	4.2	3.8	4.4	2.1
Social transfers in kind via market producers	0.3	4.6	3.4	3.4
Social transfers other than in kind	1.2	2.7	3.0	3.0
Interest paid	-5.5	-2.5	-5.7	1.0
Subsidies	-13.2	1.2	8.3	4.0
Other current expenditure	1.2	4.4	6.4	3.1
Total current expenditure	1.0	2.6	2.4	2.5
Gross fixed capital formation	-32.4	16.1	30.7	6.0
Other capital expenditure	-77.4	51.8	-25.9	0.9
Total expenditure	-3.8	3.5	3.0	2.7

Table 7: Government debt developments

	2016	2017	2018	2019
ESA2010 deficit (% of GDP)	-2.0	-1.4	-1.4	-1.2
ESA2010 gross debt (% of GDP)	130.1	126.4	124.1	121.1
ESA2010 deficit	-3.7	-2.8	-2.8	-2.5
Gross debt	241.0	243.5	247.5	249.3
Change in gross debt	9.4	2.5	4.0	1.8
Nominal GDP	185.2	192.6	199.4	205.8
Real GDP growth (% change)	1.5	2.6	2.1	1.8
Change in gross debt (% of GDP)	5.1	1.3	2.0	0.9
Stock-flow adjustments (% of GDP)	3.1	-0.1	0.6	-0.3
Gross debt ratio	130.1	126.4	124.1	121.1
Change in gross debt ratio	1.3	-3.7	-2.3	-3.0
Primary balance	2.2	2.5	2.2	2.3
"Snow-ball" effect	0.5	-1.0	-0.7	-0.3
of which				
<i>Interest expenditure</i>	4.2	3.9	3.6	3.5
<i>Real growth effect</i>	-1.9	-3.3	-2.5	-2.2
<i>Inflation effect</i>	-1.8	-1.7	-1.7	-1.6
Stock-flow adjustments	3.1	-0.1	0.6	-0.3
<i>Implicit interest rate</i>	3.4	3.1	2.9	2.9

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