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Post-Programme Surveillance Report

Portugal, Summer 2019

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Summer 2019

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Institutional Paper 113

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This report reflects information available up until 13th August 2019.

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([1]) The executive summary of this report was adopted as Commission Communication C(2019)6831 on 18 September 2019. The rest of the report reflects the findings of the Staff Working Document (SWD(2019)338) accompanying this communication.

([2]) European Central Bank (ECB) staff participated in this mission, and the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

ABBREVIATIONS

ACE	Allowance for Corporate Equity
BdP	Banco de Portugal
BFL	Budget Framework Law
CET1	Common Equity Tier 1
CGD	Caixa Geral de Depósitos
CIT	Corporate Income Tax
DBP	Draft Budgetary Plan
DGAL	Directorate-General for Local Administration
DGO	Directorate-General for Budget
DSA	Debt Sustainability Analysis
EC	European Commission
ECB	European Central Bank
EDP	Energias de Portugal
EPC	Economic Policy Committee
EPL	Employment Protection Legislation
ESM	European Stability Mechanism
EU	European Union
FAM	Municipality Support Fund
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
HICP	Harmonised Index of Consumer Prices
IGCP	Portuguese Treasury and Debt Management Agency
IMF	International Monetary Fund
IMI	Immovable Property Tax
IMPIC	Institute for Monitoring Public Procurement
INE	National Statistical Office
IP	Infraestruturas de Portugal
MIP	Macroeconomic imbalance procedure
MTO	Medium term Objective
NFCs	Non-financial Corporations
NPLs	Non-performing loans
OECD	Organisation for Economic Co-operation and Development
PER	Special Revitalisation Process for Enterprises
PIT	Personal Income Tax
PPS	Post-programme surveillance
PPP	public-private partnership
q-o-q	Quarter on quarter
RoE	Return on Equity
RoA	Return on Assets
SGP	Stability and Growth Pact
SMEs	Small and Medium-sized Enterprises
SOEs	State-owned Enterprises
ULC	Unit Labour Costs
UTAM	Technical Unit for the follow-up and monitoring of state-owned enterprises
UTAP	Technical unit for the follow-up of PPP projects
VAT	Value Added Tax
y-o-y	Year on year

EXECUTIVE SUMMARY

This report presents the findings of the tenth post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, which took place in Lisbon during 14-19 June 2019. *Since the conclusion of the ninth post-programme surveillance mission in November 2018, Portugal's economic performance has remained strong and growth moderated less than in the euro area as a whole. The short-term economic outlook remains broadly favourable but risks related to the external environment have increased. While Portugal made further progress in its economic adjustment, the recent deterioration in the current account merits attention, given the country's still high stock of external liabilities. Nevertheless, Portugal's repayment capacity is projected to remain strong.*

Economic growth in the first quarter of 2019 turned out marginally above the Commission forecast, staying still in line with the full-year projections for a growth of 1.7% in both 2019 and 2020. Portugal is thus projected to grow faster than the euro area but the risks appear to be tilted to the downside due to significant uncertainties in the external environment along with increased volatility in the country's industrial output and foreign trade. The labour market is set to continue improving, albeit at a slower pace, amid moderate wage developments and low inflation. Labour productivity is set to rebound slightly in 2019 but remains weak, thus limiting the country's competitiveness and growth potential.

The favourable outlook provides a window of opportunity to persevere with structural fiscal consolidation and the reduction of the still high public debt, in order to reduce Portugal's vulnerability to downside risks. The headline budget deficit declined to 0.5% of GDP in 2018 and the structural balance improved by 0.9% of GDP in 2018 (above the recommended 0.6% of GDP). While the nominal growth of net primary expenditure exceeded significantly the applicable expenditure benchmark, the ex-post overall assessment found that there was not sufficient ground to conclude a significant deviation in 2018. The headline deficit is projected to decrease to 0.4% of GDP in 2019 and 0.1% of GDP in 2020 while the structural balance is expected to remain broadly unchanged and public debt is set to retain a downward path. The evolution of the structural balance and the nominal growth of net primary expenditure points to a risk of significant deviation from the requirements in both 2019 and 2020.

As regards fiscal-structural reforms, the report analyses potential areas of improvement such as strengthening expenditure control and efficiency, tackling the persistently high arrears in hospitals, and ensuring effective monitoring of SOEs. Adequate measures in these areas could safeguard fiscal sustainability by creating space for growth-enhancing spending and debt reduction.

Portuguese banks have made significant further progress in reducing non-performing loans (NPLs), on the basis of sales, write-offs and cures. All major banks are now actively participating in the secondary market. Still, NPLs remain the third-highest in the euro area. Despite previous reforms, the efficiency of the legal system remains a concern, as lenders' inability to efficiently manage collateral is weighing on the prices investors are willing to pay for distressed debt. Banks' positive profitability trends continue, although this mainly reflects the reduction in impairments. Capital ratios are above regulatory requirements, but stronger buffers would make banks more resilient to a weakening in macroeconomic conditions or an increase in risk premia. Recently introduced borrower-based macro-prudential measures appear to have contributed to an improvement in credit standards.

Sovereign financing and the capacity to repay are currently sound. Active debt management has smoothened the debt redemption profile and reduced interest costs through swaps and early repayments. After clearing all liabilities to the IMF ahead of schedule, Portugal is now aiming at an early repayment of EUR 2 billion of the EFSF loan in 2019. Yields have dropped further over the past months but remain vulnerable to market conditions due to the still high, albeit declining, public debt.

The next PPS mission might take place in late autumn 2019 or early 2020.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the tenth post-programme surveillance (PPS) mission to Portugal between 14 June and 19 June 2019. 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([3]). 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.

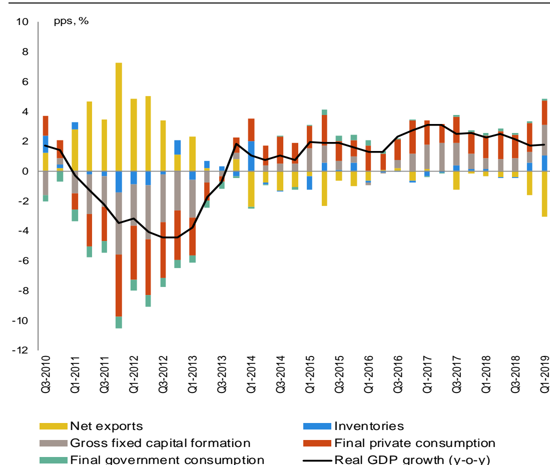
([3]) PPS is established by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid, which is expected in 2035.

2. ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Real GDP grew by 1.8% (y-o-y) in Q1-2019, marking a slight improvement from the previous quarter but slowing down in relation to the full-year growth in 2018. Private consumption growth slowed down slightly to 2.5% in line with some moderation in job creation and consumer credit growth. On the other hand, investment rebounded strongly by 11.7%, supported by all main components. This pushed up imports and contributed to a more negative contribution of net exports. On the supply side of the economy, services and particularly construction performed strongly in Q1-2019 while the value added in the industrial and agricultural sectors declined. Monthly indicators also showed significant volatility in the industrial output, as the pace of decline varied from 7% (y-o-y) in March to 0.7% (y-o-y) in May.

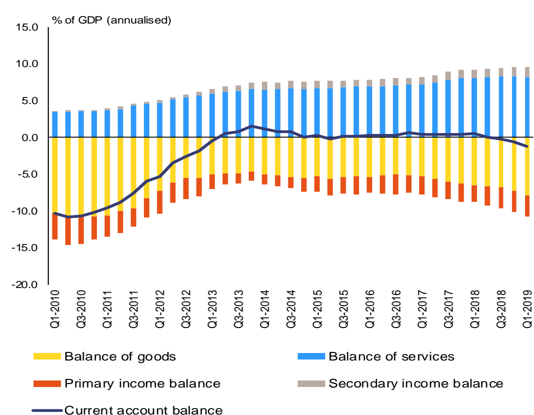
Graph 2.1: Contributions to real GDP growth



Source: INE

Economic growth is expected to flatten out in the short term against the backdrop of strong domestic demand amid a weakening external environment. According to the Commission 2019 interim summer forecast, GDP growth is projected to increase by 1.7% in both 2019 and 2020. These expectations are also supported by the Commission's Economic Sentiment Indicator (ESI), which declined in the first months of 2019 but recovered slightly in May and June. However, it remained below the level from a year earlier, in line with the projected slowdown in economic growth. Private consumption growth is set to weaken broadly in line with the expected deceleration in real disposable income growth. The household savings rate, which deteriorated to 4.5% of disposable income in Q1-2019, is set to improve only marginally over the forecast horizon. Investment is forecast to accelerate gradually, maintained by the absorption cycle of EU funds. However, despite a notable recovery, the share of investment in GDP is set to remain below pre-crisis level. Net external trade is projected to deteriorate further in 2019 and to keep the negative trend in 2020 in accordance with the projected demand in main trading partners. The overall balance of risks is tilted to the downside due to the increasing uncertainty in the external environment in the context of increased volatility in the country's industrial output and foreign trade.

Graph 2.2: Current account balance



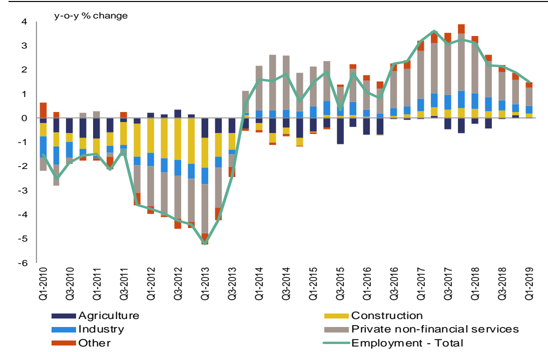
Source: Banco de Portugal

The current account (CA) deteriorated to a deficit of 0.8% of GDP in 2018 (national account terms) relative to a surplus of 0.2% in the previous year. This was largely due to the increased deficit in trade with goods while the service balance continued to improve. The primary income balance also worsened due to a substantial increase in dividend outflows outweighing the positive impact from lower interest rates paid to foreign creditors. The CA deteriorated further to a deficit of 3.1% of GDP in Q1-2019 relative to a deficit of 0.8% a year earlier, according to balance of payments data reported by Banco de Portugal. The gap widening was again driven by trade with

goods, particularly import of investment goods, which surged by 38.1% (y-o-y) in Q1-2019.

Despite the weak current account performance, the stock of the net international investment position (NIIP) benefited from valuation gains and improved from -104.9% at the end of 2017 to -100.8% of GDP at the end of 2018 and retained this level by the end of March 2019. Nevertheless, the NIIP remains one of the most negative in the EU and the adjustment is projected to be slow given the recent deterioration in the external trade. The current account is projected to worsen further in the short term but at a slower pace than in 2018 and early 2019. This projection reflects the robust domestic demand and weaker prospects in global trade, while larger EU funds inflow and a further decline in interest costs are set to partly offset the negative trade impact. Despite the expected increase in the CA gap, exports are still projected to grow faster than GDP but the gains in market shares achieved over the past years are likely to diminish significantly.

Graph 2.3: Employment evolution by sectors



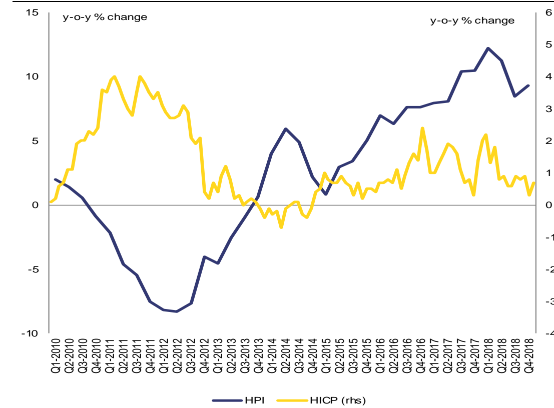
Source: Eurostat

Unemployment is projected to reach an annual average of 6.2% in 2019 and 5.7% in 2020, according to the Commission 2019 spring forecast. The slack on the market is meanwhile set to decline accordingly and wages to accelerate somewhat, helped also by the unfreezing of career progressions in the public sector. These expectations have been further reinforced by the wage reports for Q1-2019, pointing to a growth of around 3% (y-o-y) in Q1-2019 as compared to 2% in 2018. These estimates suggest that Portugal's labour productivity is set to improve somewhat in 2019 after two years of decline while unit labour costs are likely to continue rising at a moderate rate of about 2%.

Recent migration flows prop up labour supply. The latest data derived from the labour force survey point to a small increase in the working age population (15 to 74 years) in the first half of 2019. In the light of the ageing and the slightly negative natural rate of change in the population, the positive dynamics in the working age segment and the labour force are apparently driven by migration flows. They have started to improve since 2017 but their positive impact is more evident only recently. This is also confirmed by recent data of the foreign ministry showing an increase in the number of registered foreign residents in Portugal to 480,300 at the end of 2018, up by 14% from a year earlier, which is a significantly higher growth than in previous years. A substantial part of the registrations are from Portuguese speaking countries and their integration into the labour market could be relatively smooth. Yet, the currently available data do not provide a clear picture on the impact of migration on the structure of labour skills.

Inflation remains below the euro area average despite strong consumer demand. The headline index (HICP) dropped from 1.2% in 2018 to 0.7% (y-o-y) in June 2019 as compared to 1.2% for the euro area. The low inflation is however contrasted by a continuous increase in house prices where the growth rate moderated only marginally to 9.2% (y-o-y) in Q1-2019 (a more detailed analysis on the housing market is presented in chapter 5).

Graph 2.4: HICP and House price index



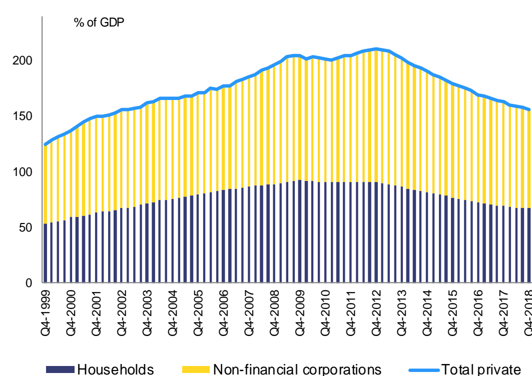
Source: Eurostat

Core inflation picked up only marginally above the headline rate despite rising domestic demand and wages. Core inflation is contained by the continuous decline in prices of industrial goods and the moderation in hotel accommodation prices. On the other hand, energy prices declined at the beginning of 2019 due to a downward impact from regulatory components in some items, particularly electricity and petrol. Administrative changes also contributed to a significant decline in the prices of public transport as of April 2019 and telecom services as of May 2019. All these regulatory factors are set to have a lasting effect on prices throughout the whole year. Inflation is therefore set to remain low at 0.9% in 2019 and to pick up to 1.5% in 2020 when demand factors are expected to have a more pronounced impact on core inflation.

2.2. PRIVATE DEBT

Private indebtedness continued to decline, driven mainly by passive deleveraging. Consolidated private debt dropped from 163.0% of GDP at the end of 2017 to 156.0% at the end of 2018. The latest data for the first quarter of 2019, available only in non-consolidated terms, show a similar pace of decline, reflecting a broadly stable debt stock in absolute terms while the debt ratio is pulled down by the growth in nominal GDP. In absolute terms, the debt level is expected to slightly increase over the medium term, driven mainly by lending to households where consumer loans retain a significant growth pace, although at a slower pace at the beginning of 2019. On the other hand, economic growth is projected to continue having a downward impact on the debt ratios thus contributing to an overall adequate pace of reducing the private sector indebtedness.

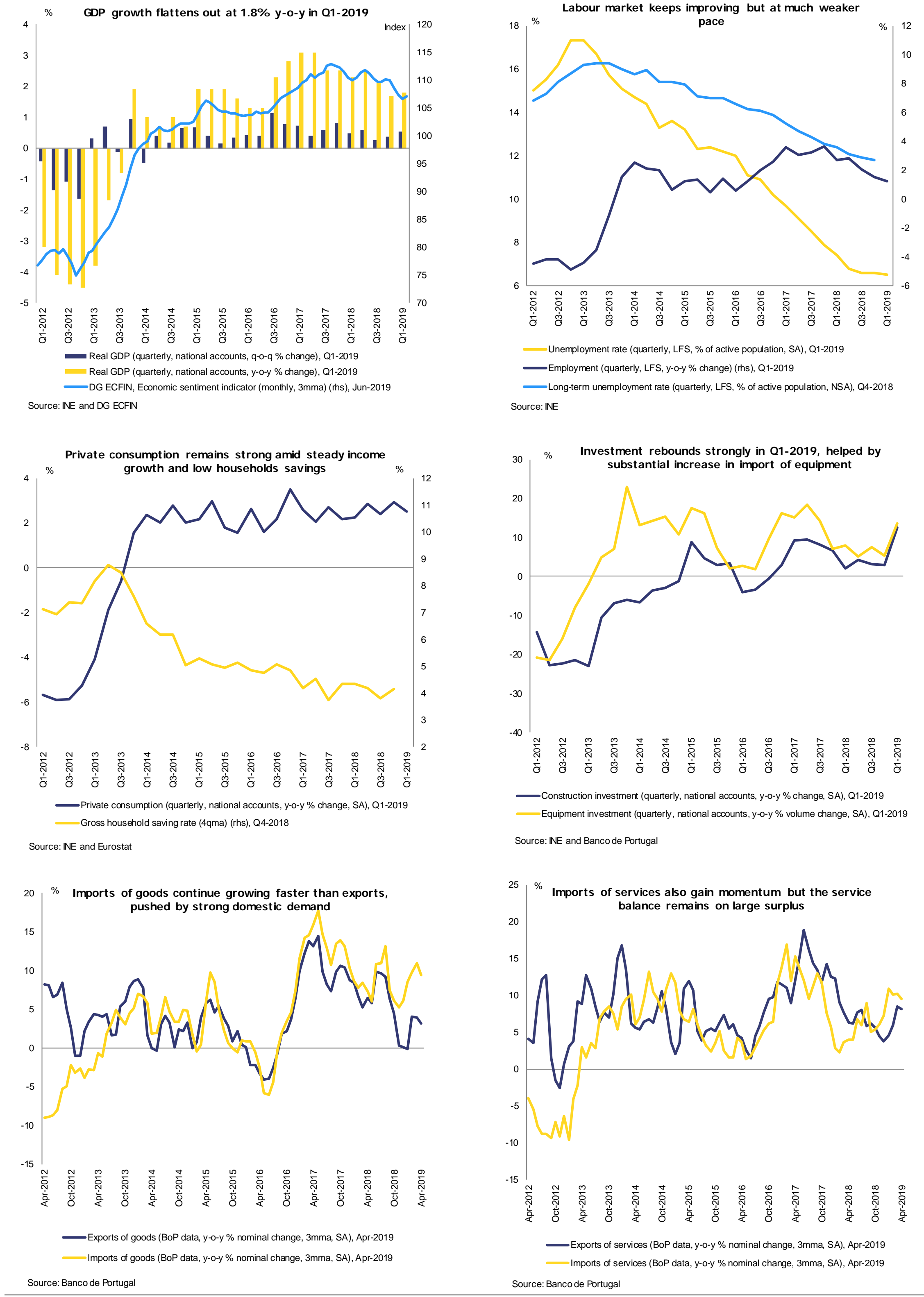
Graph 2.5: Private indebtedness



Source: Banco de Portugal

The corporate sector is deleveraging slightly faster than households, although the difference has narrowed since the start of the year. The debt ratios remain on a downward trend across most of the business sectors. The breakdown of data by the size of corporate debtors reveals similar dynamics for small, medium and large firms. The stable stock of corporate debt shows that the large increase in investment in Q1-2019 was largely financed by corporate profits and other non-debt sources, most likely linked to foreign direct investments.

Graph 2.6: **Economic developments**



Source: European Commission

3. PUBLIC FINANCES

3.1. FISCAL PERFORMANCE AND OUTLOOK

In 2019, Portugal's headline deficit is projected to continue decreasing, albeit at a more moderate pace. According to the Commission 2019 spring forecast, after -0.5% of GDP in 2018, the headline balance is projected to further decrease only slightly to -0.4% of GDP in 2019, as the impact of deficit-increasing one-offs (mainly the second activation of the Novo Banco contingent capital agreement) is expected to remain at almost the same level as in 2018 (0.6% of GDP). An increase in primary expenditure (+0.5% of GDP) is projected to be broadly offset by an increase in revenue (+0.3% of GDP) and a further decrease in interest expenditure (-0.2% of GDP). The buoyant revenue cash execution in early 2019 suggests that there may be some upside risks to the spring forecast, should the expenditure evolution be kept under control. However, the partial reliance on revenue windfalls raises the question whether the revenue over-performance can be sustained.

The projected headline deficit of 0.4% of GDP in 2019 in the Commission 2019 spring forecast compares with a projection of 0.2% of GDP in the 2019 Stability Programme. The resulting difference of 0.2% of GDP stems from the Commission forecast's more conservative assumptions regarding the evolution of some revenue items (+0.1% of GDP) and from higher pressures on some expenditure items (+0.1% of GDP). On the revenue side, the Commission forecast has more conservative assumptions for revenue from sales and other current revenue in 2019 (-0.1% of GDP), based on the recent track-record for these items, and for social security contributions (-0.1% of GDP), in line with standard elasticities. These lower projections are, however, partially offset by 0.1% of GDP from higher revenue from indirect taxes in the Commission forecast, consistent with its higher projection for private consumption growth in 2019. On the expenditure side, the Commission forecast expects higher pressures in 2019 (+0.1% of GDP) mostly in compensation of employees, based on the track-record of continuously rising public employment over the period 2016-2018 (as opposed to planned decreases), the ongoing unfreezing of careers and the extension of the 35-hour working week in the health sector to private contracts.

The structural balance is set to remain broadly stable in 2019, according to the Commission 2019 spring forecast. At the same time, the Stability Programme projects an improvement of the structural balance (recalculated by the Commission on the basis of the information in the programme, according to the commonly agreed methodology) by around 0.2% of GDP in 2019, to -0.1% of GDP. The divergence by ¼% of GDP between both projections for the evolution of the structural balance in 2019 is mainly due to the difference in the underlying headline deficit forecasts and marginally also due to a more positive evolution of the output gap in the Commission forecast, resulting in a higher increase in the cyclical adjustment compared with the Stability Programme.

For 2020, the Commission 2019 spring forecast projects a headline deficit of 0.1% of GDP under the no-policy change assumption, and a broadly unchanged structural balance. The difference of 0.4% of GDP compared with the target of a headline surplus of 0.3% in the Stability Programme mostly stems from the expenditure side. In particular, about half of this difference relates to higher expected pressures on compensation of employees and further 0.1% of GDP to pressures on other expenditure items (also because some announced expenditure-reducing measures could not be factored in). On the revenue side, the Commission's forecast more conservative projections for revenue from social security contributions, sales and other current and capital revenue are broadly offset by higher projections for revenue from both indirect and direct taxes. The Commission 2019 spring forecast projects a broadly unchanged structural balance in 2020 as compared with a planned improvement of the (recalculated) structural balance by 0.3% of GDP in the Stability Programme. The resulting divergence of 0.3% of GDP is partially related to the difference in the evolution of the headline balance but mostly to the more positive output gap evolution in the Commission forecast (based on lower estimates for potential GDP growth) than in the Stability Programme. As regards new fiscal policy measures for 2020 and outer years, the 2019

Table 3.1: Fiscal adjustment 2011-2020

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Budget balance	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-3.0	-0.5	**-0.4**	**-0.1**
Budget balance, net of one-offs	-7.3	-5.6	-5.1	-3.3	-3.2	-2.4	-0.9	0.2	**0.2**	**0.2**
Structural balance	-6.6	-3.5	-2.9	-1.6	-2.2	-2.0	-1.3	-0.4	**-0.5**	**-0.5**
Primary balance	-3.1	-0.8	0.0	-2.3	0.2	2.2	0.9	3.0	**2.9**	**3.0**
Structural primary balance	-2.3	1.4	2.0	3.3	2.4	2.2	2.5	3.0	**2.8**	**2.5**
Fiscal adjustment	6.0	3.7	0.6	1.3	-0.9	-0.2	0.4	0.5	**-0.3**	**-0.2**
Fiscal effort	4.6	3.1	0.6	1.2	-0.6	0.2	0.7	0.9	**-0.1**	**0.0**

(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 2019 spring forecast

Stability Programme broadly confirmed the plans already included in the 2018 Stability Programme.

Portugal's general government debt-to-GDP ratio is projected to remain on the steadily decreasing path initiated in 2017. After falling by 4.5 percentage points to 124.8% in 2017, Portugal's gross general government debt-to-GDP ratio has decreased by additional 3.3 percentage points to 121.5% in 2018, mainly as a result of the debt-reducing impacts stemming from the primary surplus of 3% of GDP and the favourable snow-ball effect (as the debt-ratio reducing impact of nominal GDP growth exceeds interest expenditure), while positive stock-flow adjustments had a debt-increasing impact of 0.6% of GDP. The Commission 2019 spring forecast projects a slowdown in the pace of debt reduction to 2 percentage points in 2019, due to an additional sizeable stock-flow adjustment and the expected moderation in nominal GDP growth, bringing the debt-to-GDP ratio down to 119.5% in 2019. Thereafter, the debt-to-GDP ratio is projected to decline faster, falling to 116.6% in 2020 mainly thanks to a more favourable snow-ball effect. The Stability Programme expects a somewhat lower general government debt-to-GDP ratio of 118.6% in 2019 and 115.2% in 2020, mostly due to projected lower headline deficits and higher nominal GDP growth in 2019.

3.2. POLICY ISSUES

Growth-friendly fiscal consolidation remains essential to strengthen the sustainability of Portugal's public finances. Portugal's still high public debt-to-GDP ratio makes it vulnerable to shocks, especially in the context of rising global economic risks and uncertainty. Therefore, continued structural fiscal adjustment and the use of windfall gains to accelerate debt reduction and build up fiscal buffers become even more important. The Commission's 2019 spring forecast however points to a risk of significant deviation from the structural fiscal adjustment required by the Stability and Growth Pact in 2019 and 2020. This risk is particularly evident in respect to the planned growth of net primary expenditure, which strengthens the case for an increased focus on the composition and dynamics of public expenditure.

While some indicators pointed to risks to compliance with the requirements of the Stability and Growth Pact, there has been no sufficient ground to conclude on the existence of an observed significant deviation in 2018. The nominal growth rate of government expenditure, net of discretionary revenue measures and one-offs, exceeded the applicable expenditure benchmark rate in 2018, leading to a negative deviation of 1.5% of GDP. At the same time, Portugal achieved an improvement of the structural balance by 0.9% of GDP, which is in line with the required adjustment path towards the MTO. After taking into consideration the factors explaining the difference between the two indicators, both indicators would numerically point to significant deviation from the recommended adjustment path towards the MTO in 2018. However, taking also into account further considerations, regarding in particular the distance to the MTO, the headline deficit and debt reduction, there has been no sufficient ground to conclude on the existence of an observed significant deviation in 2018. Portugal complied with the transitional debt rule in 2018.

Compliance with the preventive arm of the SGP is not yet ensured in 2019 and 2020. In 2019, based on the Commission 2019 spring forecast, the nominal growth rate of primary government expenditure, net of discretionary revenue measures

and one-offs, is expected to exceed the applicable expenditure benchmark rate in 2019, leading to a negative deviation of 1.5% of GDP from the requirements. The structural balance is projected to slightly deteriorate by 0.1% of GDP in 2019, falling significantly short of the recommended annual structural adjustment of 0.6% of GDP towards the MTO. Following an overall assessment based on the Commission 2019 spring forecast, there is currently a risk of significant deviation from the recommended adjustment path towards the MTO in 2019. This risk is confirmed by an overall assessment based on the 2019 Stability Programme. In 2020, based on the Commission 2019 spring forecast, the expenditure benchmark pillar points to a risk of significant deviation, while the structural balance pillar points to some deviation from the recommended structural adjustment of 0.5% of GDP to reach the new applicable MTO (set at a balanced budgetary position in structural terms). It is also estimated that there is currently a risk of significant deviation from the recommended adjustment path towards the MTO in 2020. On the basis of the Commission 2019 spring forecast, Portugal is expected to make sufficient progress towards compliance with the debt reduction benchmark in 2019 (as a result of the allowed annual deviation of 0.25% of GDP), but is *prima facie* not expected to meet the debt reduction benchmark in 2020.

Pressures on the expenditure side of the budget have been increasing. The unfreezing of careers in the public sector, the continuously accelerating growth of the public workforce (2.3% y-o-y in the first quarter of 2019) and the switch to the 35-hour working week for private contracts in the health system as of July 2018 put increasing pressure on compensation of employees. Moreover, special pension increases and the sequential broadening of pathways to early retirement have entailed further increases in pension spending on top of the underlying upward trend driven by ageing. In contrast, public investment has remained very low compared with EU standards and pre-crisis levels for a number of years, also turning out consistently below the authorities' plans. At the same time, the implementation of the new accrual-based public accounting framework, last set to fully start in January 2019, may possibly end up not being sufficiently advanced across all sectors of general government to ensure that the preparation of the State budget for 2021 be made using the new framework. Likewise, the entry into force of the main provisions of the revised Budgetary Framework Law, which was already postponed in 2018 by 18 months to 1 April 2020, risks once again to be further delayed.

The ongoing expenditure review is progressing slowly and is estimated to lead to rather modest further efficiency savings. The current bottom-up expenditure review in specific government sectors is planned to generate savings of EUR 236 million (0.1% of GDP), with half coming from the health and education systems, and the remaining from a greater reliance on centralised purchasing and measures in the judicial system and home affairs. In the 2019 Stability Programme, Portugal conveyed the objective to continue the expenditure review over the period 2020-2022 through, among other micro-level measures, scaling up centralised purchasing and identifying scope for additional economies of scale in shared services. The resulting efficiency savings so far are, however, planned to be lower than the targets for previous years and, consequently, risk falling short of the need to appropriately counterbalance the growing pressure on expenditure, emerging in particular from compensation of employees and social transfers.

The new programme to improve the overall financial sustainability of the health system needs to be implemented in a timely and forceful manner. The recent deterioration in the financial results of the health system is a source of concern. In 2018, a task force was appointed with the aim of designing and monitoring the implementation of a new fully-fledged programme to structurally address arrears in hospitals in the course of 2019. The programme is expected to introduce a new governance model for public hospitals, in combination with a substantial increase in their annual budgets. Implementation is being jointly steered by the Ministries of Finance and Health, and close cooperation and multilateral exchanges among the relevant stakeholders are considered key to the programme's ultimate success in this early stage. However, after having decreased to around EUR 500 million by December 2018 and having broadly stabilised until March 2019 as a reflection of sizeable extraordinary clearance measures, the stock of hospital arrears reverted to an increasing path in April and May 2019, before declining again in

June 2019. Therefore, at the current stage it appears unclear whether the programme will be able to contain and sufficiently decelerate the underlying strong arrear generation dynamics already in the short term. At the same time, the authorities intend to further promote cost-effectiveness in the overall health system in 2019, *inter alia* through increasing reliance on centralised purchasing of medicines and medical devices, in combination with further efforts towards greater use of generics and biosimilars.

There is identified scope to improve the transparency and economic rationale for tax expenditure in Portugal. Including the revenue foregone due to the considerable use of VAT preferential rates, tax expenditure in Portugal is estimated by the authorities to have reached 6.5% of GDP in 2018. Excluding VAT, tax expenditure would still be considerable at 2.6% of GDP in 2018. The Working Group on Tax Benefits has concluded its assessment in June 2019. They concluded that the tax benefit system is overall complex and insufficiently transparent. Importantly, more than 500 tax benefits have been identified, spread over more than 60 legal texts. On that basis, a methodology for assessing tax benefits has been put forward, defining guidelines for the creation of new tax benefits, their yearly monitoring and *ex-post* evaluation. At the same time, focusing on the current tax benefit system for R&D (*Sistema de Incentivos Fiscais à Inovação e Desenvolvimento*, SIFIDE), the findings were positive insofar as every euro of tax revenue foregone was estimated to have turned into more than one euro of R&D expenditure by the beneficiary firms. Overall, the conclusions of the Working Group are expected to further guide tax policy in the future.

Effective progress is needed to improve the financial sustainability of SOEs. In 2018, SOEs as a whole posted net losses of around EUR 800 million (i.e. 0.4% of GDP), reversing the trend of gradually improving performance observed in previous years. This outcome was strongly influenced by SOEs operating in the health sector, whose net losses fully offset net profits in some of the other activity sectors. In the 2019 draft budget, the authorities planned the net incomes of SOEs as a whole to approach a level close to, but still below, equilibrium in 2019, which corresponded to a one-year delay as compared with earlier announcements aiming at a similar outcome already in 2018. Currently, this objective appears particularly challenging in view of the unfavourable outcome in 2018. At the same time, helped by recurrent recapitalisations and conversions of loans into capital, the debt of SOEs as a ratio to GDP continued to decrease to 19.6% in the first quarter of 2019 and has been on a rather gradual, yet steady, declining path since the ratio of 27.3% observed in the second quarter of 2014. More generally, efforts to ensure adherence to initial activity plans appear slow in translating into corrective action where needed. Moreover, measures to ensure more timely, transparent and comprehensive monitoring of SOEs have not yet been fully implemented and appropriate *ex-ante* transparency regarding financing through recapitalisations and loans has not been ensured. Enhanced transparency would, however, be very useful to support the authorities' intentions to provide stronger incentives to staff members and managers, and to make them more accountable.

Deeper fiscal-structural measures would help to achieve a more growth-friendly path for fiscal consolidation. A clear top-down focus on containing overall expenditure growth, while promoting efficiency and adequacy at the sectoral level could be underpinned by the full and effective implementation of the Budgetary Framework Law and related legal provisions that are yet to be fully put into practice. Moreover, achieving more sizeable efficiency gains crucially hinges on comprehensive plans for public administration reform, aimed at better aligning public employment levels and skills with future needs, while ensuring effective and responding services. This would help create fiscal space to prioritise growth-enhancing spending, and notably much needed support to public investment, in line with the 2019 Country-specific Recommendations of the Council.

4. FINANCIAL SECTOR

4.1. FINANCIAL STABILITY

Banks' asset quality is improving, reflecting strong investor interest and bank-specific factors. The national strategy to tackle NPL continues to be based on the three pillars: supervisory, legal and judicial, and private NPL management solutions. The six banks with the highest NPL ratios in the system have continued the process of balance sheet cleaning while impairing non-performing assets to an average level of 52% as of the end 2018. The main strategies are cures, write-offs and NPL sales, implying more transactions in the secondary market and outsourcing to loan servicers. The Portuguese secondary market for NPLs has meanwhile become one of the most active markets in the euro area, with an aggregated transaction volume close to EUR 6 billion in 2018, and more transactions in 2019. The end of 2018 was also marked by the reduction in the NPL ratio below the psychological mark of 10% for the first time since the financial crisis in Portugal. The ratio dropped to 9.4% from a peak of 17.9% in the first half of 2016. In nominal terms, Portuguese lenders have been reducing bad loans at an average speed of about EUR 2.5 billion per quarter. Still, notwithstanding this significant effort, the NPL stock is high and the NPL ratio remains significantly above the average for the euro area.

Bank profitability has improved, mainly due to the considerable decline in impairments. Portuguese banks' total operating income (net) actually deteriorated in 2018, driven by pressure on net interest income, lower gains from financial operations, largely due to negative one-offs from NPL sales. Nevertheless, the pre-tax profit grew to EUR 2.5 billion, more than double the 2017 figure. The main driver behind the profitability increases is the lower cost-of-risk for the system. The year-on-year drop in impairment charges is substantial, close to 60%, leaving Portugal's lenders some much-needed room to build capital buffers. Operating costs continued on a downward path with the cost-to-core-income ratio decreasing mainly due to an increase in recurring operating income. The cost-to-income ratio is presently very close to the euro area average. More importantly, these results were achieved with a markedly lower leverage compared to 2008 (measured, for instance, by the accounting leverage ratio or by the loan-to-deposit ratio). The low interest rate environment remains challenging for banks' profitability, given their existing business models. At the same time, the low interest rate environment is also one of the key factors behind the improvement in macroeconomic conditions, which has helped profitability via the decline in impairments. Still, deposit trends remain favourable, and the banks' liquidity position has strengthened, with the aggregate Liquidity Coverage Ratio (LCR) rising by 23 percentage points in 2018 to 196%. ECB funding has been slowly decreasing, standing at around EUR 20 billion since summer 2018.

Capital ratios meet all supervisory requirements, but remain on the low side. The total solvency ratio stabilised at levels around 15% in end-2018, whereas the CET1 ratio reached about 13% and the leverage ratio 7.3%. Both capital adequacy ratios remain adequate but weaker compared to European peers, whereas the leverage ratio is higher than the euro area average.

Table 4.1: Financial soundness indicators, domestic banking groups and stand-alone banks (%)

	2014	2015	2016	Q1-2017	Q2-2017	Q3-2017	Q4-2017	Q1-2018	Q2-2018	Q3-2018	Q4-2018
Non-performing loans	16.6	17.5	17.2	16.4	15.5	14.6	13.3	12.7	11.7	11.3	9.4
o/w foreign entities	11.9	11.1	10.7	9.6	9.1	8.3	7.6	6.9	5.9	6.0	4.9
o/w NFC & HH sectors	17.8	17.9	17.5	17.1	16.2	15.6	14.6	13.8	12.9	12.6	10.5
o/w NFC sector	27.9	28.3	29.4	29.0	27.5	26.6	25.2	23.8	22.3	22.1	18.5
o/w HH sector	9.7	9.4	8.7	8.4	8.1	7.8	7.1	6.7	6.4	6.1	5.1
Coverage ratio	37.9	40.6	45.4	45.6	45.9	46.9	49.9	52.7	53.4	53.7	52.4
Return on equity	-3.5	0.9	-5.5	-0.3	0.5	1.5	-0.8	8.5	6.3	6.2	2.7
Return on assets	-0.2	0.1	-0.3	0.0	0.1	0.2	0.0	0.8	0.6	0.6	0.3
Total capital ratio	12.3	13.3	12.3	13.9	14.4	14.7	15.2	15.0	15.2	15.3	15.2
CET 1 ratio	11.3	12.4	11.4	12.6	13.2	13.5	13.9	13.6	13.4	13.5	13.2
Tier 1 ratio	11.4	12.6	11.7	13.2	13.8	14.0	14.5	14.2	14.1	14.1	13.9
Loan to deposit ratio	84.9	81.5	80.8	79.6	79.4	79.5	78.9	78.0	76.1	76.5	76.2

Source: ECB

Solvency ratios have markedly improved since 2016, but buffers relative to total capital requirements are limited in most cases. Fully loaded CET1 ratios range between 12% and 15% for the top six banks in the system. Some systemic banks continue to rely on a relatively large volume of deferred tax assets. In parallel, the average risk weight in the system dropped to 54.4% in December 2018, confirming the downward trend underway since 2013 while still significantly above the EU average. Lenders continued building their total capital buffers by issuing subordinated instruments, also contributing to the strategy to comply with the minimum requirement for own funds and eligible liabilities (MREL). Overall, the MREL-driven issuance seems manageable, and is likely to be spread over the next three years. Banks are likely to issue a mix of Tier 2, senior non-preferred and senior preferred instruments. The MREL challenge is significant insofar as it is compelling banks to go to the market early in order to test their ability to raise funds at a sustainable cost. Still, many lenders are waiting for better medium-term risk ratings.

The coordination platform set up by banks has not yet delivered meaningful results in helping them manage NPLs. The coordination platform (PNCB) is a private initiative by some of the biggest banks in the country. PNCB deals with shared exposures and its focal objective is to maximise the value of these exposures. A year and a half after its incorporation, the functioning of this coordination platform remains troubled by a set of challenges and constraints. All twelve exposures (together worth nominally about EUR 1 billion) allocated to PNCB were analysed and tailor-made strategies were elaborated. The implementation phase remains nonetheless the real test for both PNCB and the participating banks. While many of the exposures are deemed viable, the big haircuts required from lenders and the necessity of injecting new funds to ensure future operations of the firms complicate a swift resolution of these loans. Overall, the platform still needs to prove that it may play a material role in helping the participating banks deal with their non-performing debtors.

Novo Banco's losses have declined significantly, but challenges remain. Novo Banco's Contingent Capital Agreement (CCA) has been a key factor behind the decline in NPLs for this bank. After the loss of EUR 2.3 billion in 2017, Novo Banco received a payment of EUR 791.7 million from the CCA in May 2018. In 2018, the bank's losses declined by more than one-third to EUR 1.4 billion, reflecting mainly lower credit impairments and the sale of a large portfolio of NPLs amounting to EUR 2.2 billion. The Resolution Fund subsequently made a payment of EUR 1.1 billion in Novo Banco to restore its capital ratios. Although the pool of ring-fenced assets has already halved, there is a probability that the CCA will be used again. The Government has meanwhile provisioned a further use of the CCA of 1 billion in the 2019-2023 Stability Programme.

4.2. POLICY ISSUES

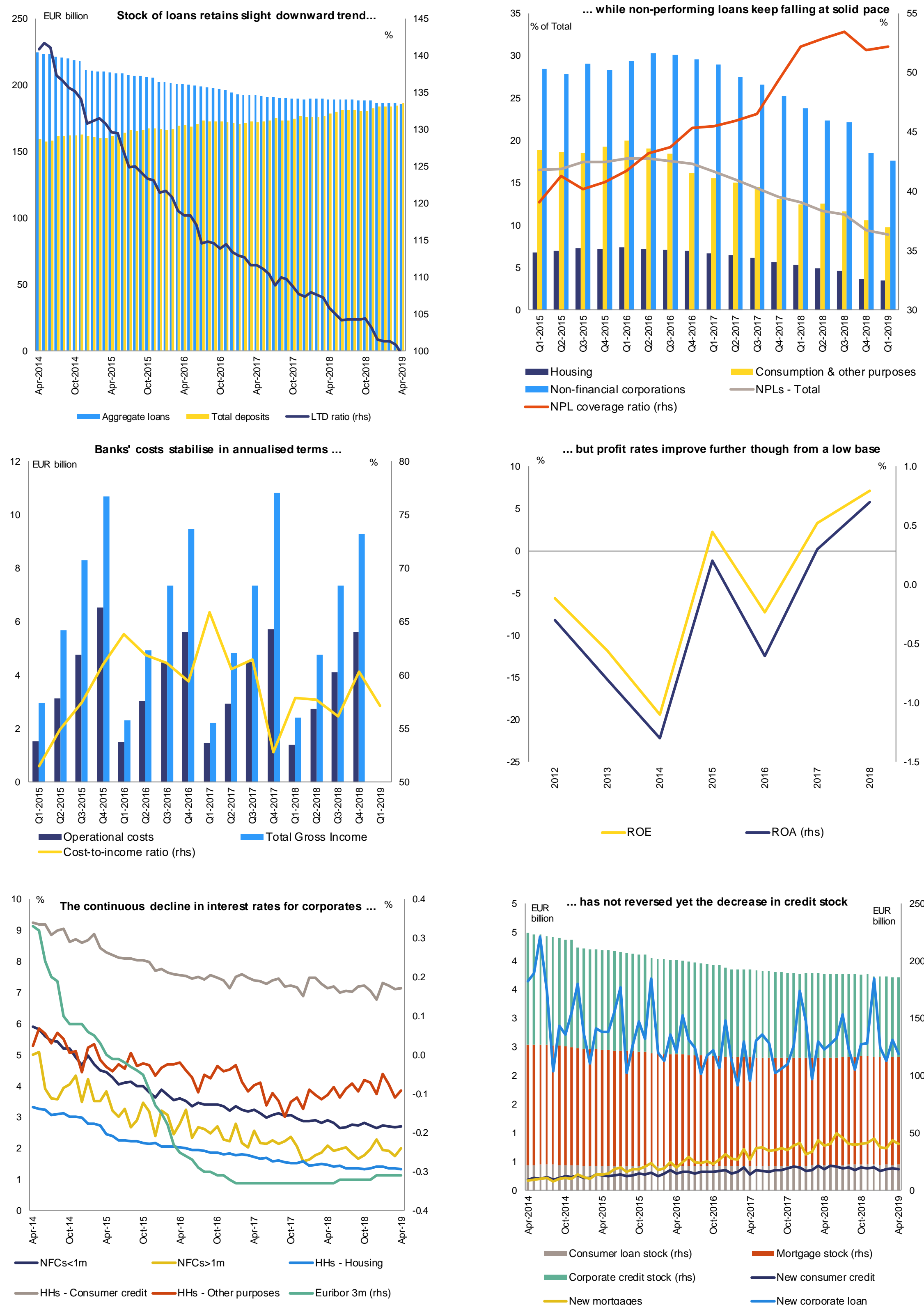
The recent macro-prudential measures seem to have contributed to more prudent credit standards, but risks related to house prices need to be monitored. Since July 2018, Banco de Portugal, acting as the macroprudential authority, has introduced non-mandatory upper limits for loan-to-value (LTV), debt-service-to-income (DSTI) ratios and loan maturities. These recommendations, which aim at protecting borrowers' solvency, were communicated extensively to the public. The aim of the measure, which applies to both new mortgage and consumer loans, was not to curb lending growth but to improve borrowers' risk profile. Thirteen lenders, covering about 80% of the market, submitted self-compliance reports presenting on average a high level of compliance towards the limits set in the recommendation. An assessment of the macroprudential measure was subsequently published by Banco de Portugal in May 2019. Overall, the implementation of the recommendation seems to have improved borrowers' creditworthiness and there is a visible change in culture regarding credit standards, which has become more focused on the repayment capacity of borrowers. One of the key takeaways from the report is the withdrawal of mortgage offers with maturities above 40 years with 96% of new mortgages being granted in the 20-40 years range. The measure's criteria will remain unchanged until the new assessment, which is planned for the first quarter of 2020. These measures may have contributed to taming the credit-driven demand for real estate. However, real estate developments still need to be closely

monitored, given concerns about some degree of overvaluation and strong demand, including from non-residents (a more detailed analysis on housing prices is presented in Chapter 5).

The review of the legal framework of the Portuguese financial supervisory system has been suspended with the end of the legislative period in July 2019. The project to revise Portugal's financial supervisory system was initiated three years ago. The government stated that the two main purposes of the draft law were to improve coordination among supervisors and to limit the risk of conflicts of interest between supervision and resolution functions. The draft law introduced new statutes for the Market, Insurance and Resolution Authorities and the National Council of Financial Supervisors (NCFS), which would have been responsible for coordination between supervisory authorities and would have also become the new macro-prudential authority. The draft law also introduced provisions for collaboration and exchange of information between the different authorities. Both Banco de Portugal and the European Central Bank expressed concerns over several elements of the draft bill, highlighting the complexity of the new framework and questioning whether it was compatible with EU legislation to preserve the independence of central banks, as well as with international recommendations envisaging a leading role for central banks in macro-prudential matters. Furthermore, the draft reform envisaged to de-facto revise the institutional governance of Banco de Portugal and the institutional framework for the Portuguese financial supervisory system as a whole, including by creating a new resolution authority. As a key consequence of the new structure, the central bank would no longer be the Portuguese macro-prudential authority or the Portuguese resolution authority while the government maintains that the draft law did respect a leading role of the central bank on macro-prudential matters.

The efficiency of the judicial system is an area where Portugal continues to face challenges. Over the past years, Portugal implemented a number of reforms to the legal and institutional framework for insolvency and debt enforcement. Most recently, the authorities successfully set up an early warning mechanism that monitors some of the key soundness indicators of Portuguese firms. Portuguese lenders also have (since July 2019) the possibility to make use of a special regime allowing them to transfer loan portfolios in bulk from one financial institution to another. Nevertheless, the critical challenges related to lengthy proceedings and a large backlog of cases, in particular in the administrative and tax courts, still remain. There is also an issue with excessive use of various delaying tactics by delinquent borrowers. Meanwhile, civil enforcement actions taking more than five years to complete represent 34.5% of the total as of the end of 2018, but the number of pending court cases is undoubtedly decreasing. The number of pending insolvency cases has been consistently falling since 2014 and currently is the lowest since statistics started to be compiled. According to the present methodology, 1,864 cases are pending, representing a reduction of 14.3% in 2018. The legal and judicial frameworks are still heavily affecting the recovery process and the prospects for efficient repossession of collateral. The long average duration of recovery proceedings and the level of uncertainty that accompanies these proceedings weigh on the prices applied by the market to non-performing assets. Hence, it is important to continue to focus on accelerating and simplifying the legal procedures.

Graph 4.1: **Financial developments**



Source: European Commission

5. STRUCTURAL REFORMS

Labour market

Labour market developments are still positive. Similarly to recent years, both employment and labour force are increasing. However, temporary employment is persistently high but several measures to address segmentation, coming from the 2018 tripartite agreement, were approved in July 2019. Given that they are more targeted towards penalising temporary employment than making permanent contracts more attractive, it remains to be seen whether labour market segmentation can be reduced without limiting employment growth. Moreover, internal and external competitions to reinforce the labour inspectorate are almost concluded and will increase the number of labour inspectors closer to the ILO ratio.

The share of minimum wage earners was under 20% as of the end of 2018. This allowed relieving slightly the wage compression observed in recent years. The authorities hold the view that consecutive minimum wage increases did not harm the employment growth of low-skilled workers. Both income and wage inequality have been decreasing and in-work poverty was reduced significantly in 2017. The risk of poverty was still almost two times higher for temporary employees than for permanent ones.

Some active labour market policies were updated and a new one was introduced. While the take-up of both traineeship programmes and hiring support measures (Estágios Profissionais and Contrato-Emprego) continues to increase (in force since 2017), changes to improve their efficiency and effectiveness came into force in the first quarter of 2019. The share of permanent contracts created under these measures is high (about 87%). In parallel, Contrato-Geraçao (a hiring support measure to promote the employment of first-time jobseekers and long-term unemployed over 45, on the basis of open-ended contracts) is being implemented since April 2019. The One-Stop Shop for Employment is now operational.

The renewed dynamism in collective bargaining continues, with the number of agreements increasing as well as their coverage. The share of new or renewed agreements at all levels (firms, group of firms and sectors) increased from 2017 to 2018, following a similar trend since 2015. The mentioned tripartite agreement also foresees fostering collective bargaining. Among several proposals, there is a measure that suggests eliminating the so-called bank of hours based on individual agreement and the collective bank of hours with individual agreement origin while creating a new bank of hours based on group agreements. This measure may entail a risk of reducing working time flexibility.

A package of measures aimed at tackling the gender pay gap, reducing occupational gender segregation and promoting a more effective work life balance is in place. A legal act to address the gender pay gap was introduced in August 2018 and measures are to be applied by companies with 250+ employees in the first 2 years and with 50+ after that. Specific actions from the labour inspectorate and sanctions against discriminatory treatment are envisaged. Recent legislation is being implemented which aims at fostering a gender-balanced participation in decision-making by establishing minimum thresholds of women and men in public and listed companies are.

The Qualifica programme is helping increasing the educational attainment of persons enrolled. With a 2020 target of 600,000 applications, this programme has currently over 350,000 applications and nearly 290,000 referrals to vocational education and training (VET) offers and recognition, verification and certification of competences (RVCC) (over 70% of the referrals were to VET offers). There are some novelties such as the Qualifica AP, which is a specific programme directed to the qualifications of public servants. Tripartite discussions with social partners about qualification and VET policy are foreseen, notably to strengthen and improve the training system.

Housing

Following a strong recovery starting in 2015, the pace of house price increases remains high. The growth in house prices moderated slightly to 9.2% (y-o-y) in Q1-2019 from 9.3% in the previous quarter and an annual average of 10.3% in 2018. A more significant slowdown is observed in the prices of new dwellings to 6.0% (y-o-y) in

Q1-2019 from an annual average of 7.5% in 2018 while price increases for existing dwellings slowed from 11.0% to 10.0%, respectively. However, new dwellings account for about 15% of the overall number of transactions and about 19% of total value. The growth in the number of transactions slowed more significantly by 7.6% (y-o-y) in Q1-2019 from an annual average of 16.6% in 2018. In regional terms, the number of transactions even declined in the tourism region of Algarve and a major slowdown is observed in the metropolitan areas of Lisbon and Porto. This points to some moderation in demand which is most likely linked to the weaker outlook in the global economy, affecting market expectations for both tourism and property demand from non-residents. The price increase remained above the country average in Algarve and Porto but moved well below it in the metropolitan area of Lisbon.

On the supply side, the volume of residential construction increased by 2.0% y-o-y in Q1-2019, marking a slight deceleration from the previous year. The number of completed buildings increased by 7.2% for the same period. A substantial rebound is observed in the metropolitan area of Lisbon where newly completed buildings surged by 48.5% (y-o-y) in Q4-2019 and thus contributing to the price moderation in the area. Meanwhile, the overall size (in square metres) covered by new building permits rose by 6.4% at national level and 32.0% in the metropolitan area of Lisbon showing that supply would continue to rise at a strong pace. Yet, it is unlikely to fully catch up with demand in the short term and the pace of price moderation is likely to remain slow in the light of the low interest rate environment and increasing use of residential properties for short-term commercial rents.

The authorities have meanwhile progressed with the promulgation of the legal package on New Generation of Housing Policies. Most of the programmes designed to support affordability, renovation and long-term rental contracts have started to be implemented in 2019 but concrete results cannot be assessed at this stage. These programmes are aimed at addressing the main problems on the market such as low utilisation of the housing stock, including also in popular commercial districts, investors' perception of low return rates, and unstable rental market with increasing demand for short-term commercial rents, rising prices and cost overburden, particularly for vulnerable social groups. Current statistics suggest that most of these problems persist, as rental costs follow the growth in property prices and construction works remain focused on new buildings rather than refurbishment. Some positive developments could be seen in the aforementioned regional dynamics, where the pace of price divergence have slowed somewhat, driven mainly by supply adjustments. Real estate prices could be also affected by a possible weakening in demand by non-residents, resulting, for example, from an abrupt increase in risk premia. In this context, existing incentives to attract foreign demand to the real estate sector could also add up to the volatility in prices.

Energy

Prices of electricity declined substantially as of the beginning of 2019 due to a number of regulatory measures. This includes an average decrease of 14.3% in network tariffs, a 6% VAT cut applied also to natural gas users, a 3.5% cut in the tariffs on the regulated market, and a 33.8% discount on the tariffs for about 800,000 socially vulnerable households. As a result, it is expected that electricity prices for both households and industrial users would converge towards the EU average or could be even slightly lower in 2019. Natural gas prices are less affected by regulatory changes, excluding the VAT cut, and thus are likely to remain close to the EU average. The electricity tariff debt meanwhile dropped to EUR 3.7 billion at the end of 2018, down by 17% in a year and by 28% from the peak in 2015. With the current regulatory settings, the tariff debt is projected to drop by 12% in 2019 but the outcome will also depend on the sales volumes. According to the updated projections of the authorities, the tariff debt is expected to be fully repaid by the end of 2022 under the baseline scenario or by the end of 2025 under the pessimistic scenario.

Several policy initiatives guide new investments projects in Portugal, largely focused on renewable energy. Up to June 2019, new photovoltaic capacity for a total of over 1,700 megawatts has been approved on market terms, without any regulatory burden on prices. Future projects currently under evaluation include a power link to Morocco, which would allow exporting electricity in periods of excess supply, as

well as a new interconnection and network reinforcements with Spain, including a third natural gas link. Authorities also approved in 2019 a ten-year (2018-2027) investment plan on the electricity infrastructure. The total investment approved within the plan adds up to EUR 535 million for the next 10 years. In addition, the National Investment Plan (PNI 2030) includes the energy sector as a target for medium and long-term strategic investments. Specifically, the PNI 2030 identifies three key issues (networks, energy production and energy efficiency), involving investment beyond EUR 4.9 billion.

Justice system

The efficiency of the justice system in Portugal continues improving, but critical challenges remain with regard to the length of proceedings and the disposition time in Administrative and Tax Courts. Since 2015, the disposition time has decreased from 992 days to 927 in 2018, with the case clearance rate increasing from 80% to 111%. Portugal is implementing a strategy to reduce the number of backlogs, comprising of various elements. First, rapid reaction teams are set to bring together judges to expedite the resolution of pending cases in Administrative and Tax Courts. Other measures foster the use of arbitration: court fees can be waived if claims are withdrawn before the end of 2019. In addition, it allows pre-2017 pending cases in Tax Courts to migrate to a process of arbitration free of charge.

Another set of measures promote judicial specialisation and an advisory body within Administrative and Tax Courts. In September 2018, the government approved amendments to the legislative framework, fostering greater specialisation of courts. The proposal, awaiting parliamentary approval, would include 11 tax enforcement and infraction review chambers, 10 administrative social chambers competent for public employment and social benefits disputes and 2 public procurement chambers with wide territorial jurisdiction. Another planned measure is the establishment of advisory cabinets that would bring together experts from various fields (law, economics, accounting, finance, etc.) to counsel magistrates of Administrative and Tax Courts.

Portugal is also setting up legal and institutional measures to address the average duration and efficiency of insolvency proceedings. A key initiative on this issue is the creation of a business recovery mediator, which provides tailored legal advice to debtor firms, particularly small and medium enterprises. Laws enacted during 2018 also support the extrajudicial restructuring of firms and a legal regime for debt-to-equity swaps. These measures are yet to facilitate a reduction of the duration of insolvency proceedings.

Competition

Policy efforts to reduce the regulatory burden for highly regulated professions have varied overtime. Portugal made significant progress with the 2013 framework law. However, this early progress has been partially reversed, through initiatives that restricted competition in highly regulated professions, such as the bylaws for the individual professions or the ban on corporate groups. In this context, regulatory and administrative restrictions on business and professional services abound, with negative consequences over competition, price levels, innovation and service quality. In all, the margin for improving the business environment through competition policy is large.

The recent OECD and Portuguese Competition Authority study (OECD 2018) outlined various reforms in the regulation of professional services, covering issues like the scope of reserved activities, restrictions on legal form, shareholding, management, multidisciplinary restrictions and incompatibility rules. While so far there has been no formal commitment from the government to follow up on these recommendations, the study provides an adequate blueprint to guide future policy reforms.

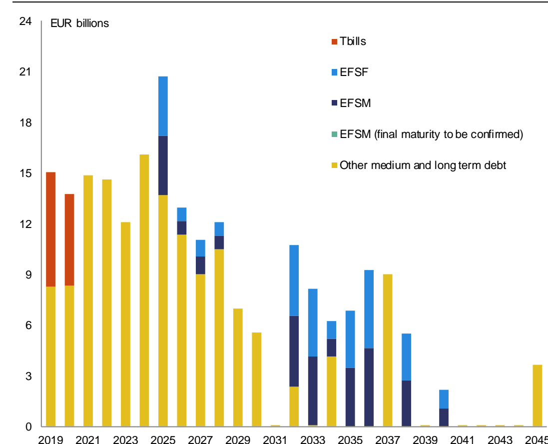
Barriers to competition also affect market access to specific sectors, such as construction. Certain construction services face complex authorisation schemes, as multiple overlapping procedures affect the installation services of lifts, telecommunications, water, sewage, alarms, etc. Prescriptive standards in construction are still prevalent, with performance-based standards being less frequent. The sector faces another regulatory burden from the procedural disparities in obtaining building permits across municipalities.

6. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Active debt management is aimed at reducing Portugal's interest expenditure, smoothening the debt redemption profile and diversifying the investor base. Thus, Portugal has deployed continuous efforts to reduce overall annual interest expenditure and cap upcoming annual peaks in the debt redemption profile. Following early repayments of EUR 0.8 billion in January 2018 and EUR 4.7 billion in December 2018, the financial assistance loans to the IMF have now been fully repaid. In parallel, Portugal carried out in 2018 outright buybacks of EUR 0.9 billion and exchanges of government bonds maturing in either 2020 and 2021 for others maturing only in either 2023 and 2027. This strategy has been continued in 2019 with recurrent exchanges in January, March and May of an overall amount of EUR 2.0 billion of government bonds maturing in either 2020 and 2021 for others maturing only in either 2026, 2028 and 2030. Helped by the improving credit rating (see below), Portugal is further diversifying its investor base in terms of type and geographical origin, progressively regaining traditional investors such as insurances and pension funds. Recently, in May 2019, Portugal has also issued a three-year bond in renminbi (as the first euro area Member State to do so), including a hedge instrument against exchange rate risks. The authorities consider that the resulting relatively high cost of the operation (4.09% annual interest in a context of negative interest rates for equivalent bonds issued in euro) have to be weighed against possible long-term benefits in terms of the diversification of the investor base.

Portugal intends to start repaying the financial assistance loans to the European institutional creditors already in 2019. A partial early repayment of EUR 2 billion to the EFSF, which otherwise would be due in 2025, is to be carried out in the fourth quarter of 2019. With this early partial repayment to the EFSF, Portugal will smooth out a repayment peak in 2025, achieve additional savings in interest expenditure and make an efficient use of the available cash buffer. In view of the benefits for Portugal's debt sustainability, the Commission intends to grant a conditional waiver of the *pari passu* mandatory parallel repayment to the EFSM. The accompanying conditions include the firm commitment to roll over the amount of EUR 6.75 billion due to the EFSM in 2021, a first repayment of EUR 500 million to the EFSM in 2022 and ensuring that there will be no additional costs to the EU budget. The schedule for the remaining repayments to the EFSM will be reviewed, smoothening the debt redemption profile and avoiding significant peaks in any given year.

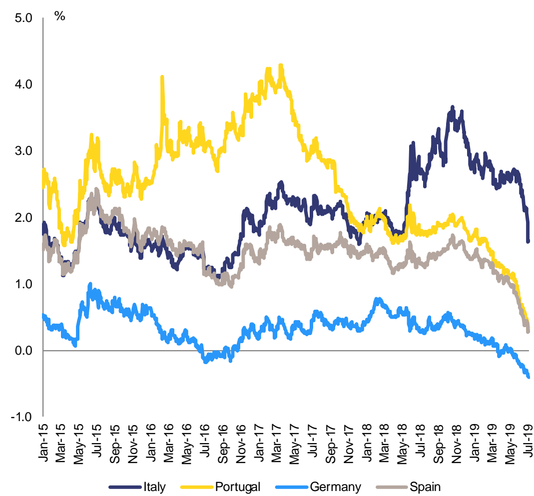
Graph 6.1: Redemption profile



(1) Last update: 17 June 2019
Source: IGCP

Portugal's financing needs have been on a downward path since 2017, before being expected to experience a hike in 2021. In 2017, Portugal's financing needs of EUR 28.3 billion were particularly high, mostly as a result of the early repayments of EUR 10 billion of the financial assistance loan to the IMF. In turn, in 2018, the lower financing needs of EUR 20.6 billion reflected equal-sized reductions by EUR 1.2 billion of the State headline deficit on a cash basis and the net acquisition of financial assets, coupled with the aforementioned early repayment of the outstanding EUR 5.5 billion in financial assistance loans to the IMF. In 2019, Portugal's financing needs are projected to decrease to EUR 18.2 billion, although the overall lower debt redemptions (already including the above-mentioned partial early repayment of the financial assistance loan to the EFSF) are partly offset by the planned higher State cash deficit and higher net acquisition of financial assets. The planned lower State deficit and net acquisition of financial assets are expected to exercise downward pressure on Portugal's financing needs over the period 2020-2023, although this positive trend is outweighed by a surge in debt redemptions over the period 2021-2022.

Graph 6.2: **10-year government bond yields**



Source: European Commission

Financing conditions are currently particularly favourable for Portugal. Since October 2018, Portugal's sovereign debt rating has an 'investment' grade by all four relevant rating agencies. More recently, on 24 May 2019, Fitch improved the outlook on Portugal's BBB rating from 'stable' to 'positive', following a like-minded change by DBRS on 5 April. Just before, on 15 March 2019, Standard & Poor's upgraded Portugal's sovereign debt to BBB, two steps from 'speculative', with a 'stable' outlook. Despite some volatility, yields on Portuguese 10-year sovereign bonds have been on a declining path since mid-March 2017 (see Graph 3.1). Following some consolidation in 2018, they have declined to historically low levels of around 0.5% in June 2019, further reducing the spreads vis-à-vis European peers (Graph 6.2).

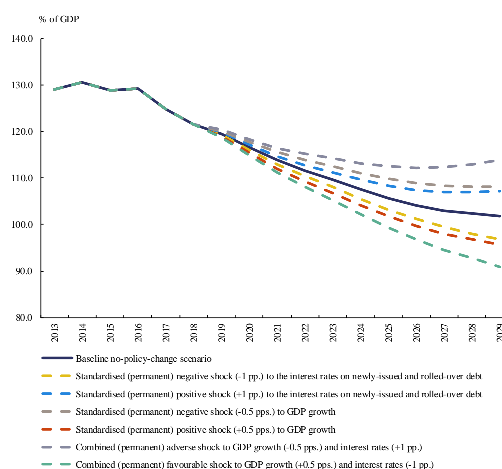
Sovereign financing and the capacity to repay are currently sound. Due to the high public debt, yields remain nevertheless vulnerable to financial markets conditions. In the short term, Portugal's sovereign financing and capacity to repay remain sound, with stable and low yields, a relatively smooth redemption profile and declining gross financing needs, accompanied by a somewhat declining cash buffer. In the long term, further progress with growth-friendly fiscal consolidation and fiscal-structural reforms would nonetheless be important to strengthen Portugal's capacity to repay.

ANNEX 1
European Commission debt sustainability analysis

This Debt Sustainability Analysis (DSA) uses the Commission 2019 spring forecast as a starting point to ensure cross-country consistency and to take into account second-round macroeconomic effects. The general government debt-to-GDP ratio turned out at 121.5% in 2018, which corresponds to a decrease by 3.3 pps. compared with 2017. This decline in 2018 mainly resulted from favourable impacts stemming from the primary surplus of 3% of GDP and the negative snowball effect (whereby the effect of nominal GDP growth exceeded interest expenditure), while a positive stock-flow adjustment had a debt-increasing impact of 0.6 pps. According to the Commission 2019 spring forecast, the debt-to-GDP ratio is projected to decrease at a slower pace in 2019, by 2 pps. down to 119.5%. This slowdown in 2019 reflects an additional sizeable positive stock-flow adjustment and the expected moderation in nominal GDP growth. For 2020, underpinned by the projected primary surplus of 3% of GDP and a more favourable snowball effect compared with 2019, the debt-to-GDP is expected to decrease at a faster pace, by 2.9 pps. down to 116.6% of GDP. For the outer years, the analysis rests on the following assumptions: (i) the structural primary surplus (excluding additional costs of ageing) remains unchanged at 2.5% of GDP as of 2020 under the customary no-policy-change assumption, (ii) inflation converges linearly to 2.0% by 2023 and remains at that level thereafter, (iii) the nominal long-term interest rate on new and rolled-over debt converges linearly to 5% by the end of the 10-year projection horizon, (iv) real GDP growth rates stand on average at slightly below 1%, and (v) ageing costs develop according to the European Commission 2018 Ageing Report.([4])

In the Commission's no-policy-change baseline scenario, the debt-to-GDP ratio is expected to gradually decline by close to 1.5 pps. per year from 2021 onwards, and to reach approximately 102% of GDP in 2029, while still remaining significantly above the Treaty reference value of 60% of GDP. Over the period 2021-2029, the Commission's no-policy-change baseline scenario projects that the pace of reduction of the debt-to-GDP ratio will be mitigated somewhat by the expected increasing ageing costs and positive snowball effects (whereby interest expenditure is expected to exceed the effect of nominal GDP growth).

Graph A1.1: **Economic growth and interest rate scenarios**



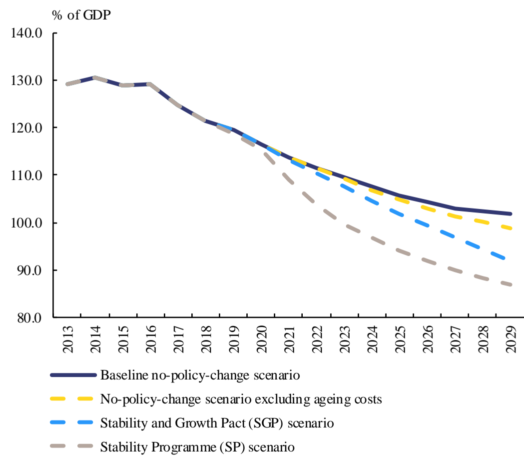
Source: European Commission

The Commission's DSA shows that the projected moderately declining path of the debt-to-GDP ratio in the no-policy-change baseline scenario is sensitive to shocks to nominal GDP growth, interest rates and the structural primary balance. Graph A1.1 illustrates the sensitivity of the projected path of the debt-to-GDP ratio to alternative scenarios, incorporating plausible potential shortfalls/windfalls in nominal GDP growth or sharp interest rate increases/decreases as of 2018. The analysis suggests that a lower GDP growth rate by 0.5 pps., or a 1 pp. increase in the interest rates on maturing and new debt, would increase the debt-to-GDP ratio in 2019 by 0.6 and 0.2 pps., respectively. Accordingly, the debt-to-GDP ratio would be at about 108% and 107%, respectively, at the end of the projection period. Moreover, a combined adverse shock to GDP growth and interest rates could put the debt-to-GDP ratio again on an upward path, bringing it back to close to 114% by 2029. At the same time, a favourable shock to medium- and long-term GDP growth or lower interest rates would result in an acceleration of the reduction of the debt-to-GDP ratio to a pace of above 2 pps. per year, bringing it down to around 96% by 2029. A combination of higher GDP growth and lower interest rates would further accelerate this

([4]) "The 2018 Ageing Report: Economic and Budgetary Projections for the EU Member States (2016-2070)", *Institutional Papers*, No 079.

reduction, thereby allowing for the debt-to-GDP ratio to decline to around 91% by 2029.

Graph A1.2: **Fiscal consolidation scenarios**



Source: European Commission

The Commission's DSA also shows that additional fiscal consolidation would accelerate the pace of reduction of the debt-to-GDP ratio, compared with the projected moderately declining path in the no-policy-change baseline scenario. Graph A1.2 illustrates the effect of alternative fiscal consolidation strategies on the projected path of the debt-to-GDP ratio. Full compliance with the requirements of the Stability and Growth Pact (SGP) would considerably accelerate the pace of reduction of the debt-to-GDP ratio. 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 within the rules of the SGP.([5]) This would imply that the MTO, set at a balanced budgetary position in structural terms, would be achieved already in 2020. Maintaining the MTO over the outer years would require structural primary surpluses of close to 3.5% of GDP until the end of the projection horizon. Under these assumptions, the debt-to-GDP ratio would decline at a markedly faster pace, by slightly below 3 pps. per year, down to 92% by 2029.

The 2019 Stability Programme (SP) scenario assumes a decline of the debt-to-GDP ratio to 118.6% in 2018 and 115.2% in 2019. Based on the assumptions of historically high primary surpluses, maintenance of low interest rates and real GDP growth of around 2% from 2020 onwards, the debt-to-GDP ratio in the Stability Programme is projected to decrease rapidly to 109.0% in 2021, 103.7% in 2022 and 99.6% in 2023, thereby reaching a level below 100% at the end of the programme horizon. Such a scenario would be consistent with an improvement of around 0.4% of GDP in the structural balance over the period 2019-2020 and with maintaining a structural primary surplus of around 3% of GDP over the period 2021-2029. These assumptions would concur to a significant decline of the debt-to-GDP ratio, by more than 3 pps. per year down to 87% by 2029.

Overall, the Commission's DSA shows that in the no-policy-change baseline scenario the debt-to-GDP ratio is expected to decline at a decelerating pace over the period 2021-2029. Despite the projected sizeable decrease by 15 pps. over that period, the debt-to-GDP ratio would remain above 100% by 2029, and would be vulnerable to adverse shocks to nominal GDP growth, interest rates and the structural primary balance. A faster reduction of the debt-to-GDP ratio could be achieved by ensuring continuous compliance with the SGP requirements over the medium to long term. In addition, the reduction of the debt-to-GDP ratio crucially hinges on medium- and long-term nominal GDP growth, stressing the need to persevere with the implementation of growth-enhancing structural reforms.

([5]) COM(2015) 12.

ANNEX 2

European Commission macroeconomic and fiscal projections (2019 spring forecast)

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

Annual % change	2017	2018	2019	2020
1. Private consumption expenditure	2.3	2.5	2.3	1.9
2. Government consumption expenditure	0.2	0.8	0.8	0.5
3. Gross fixed capital formation	9.2	4.4	4.6	5.0
4. Final domestic demand	**3.0**	**2.6**	**2.4**	**2.2**
5. Change in inventories	--	--	--	--
6. Domestic demand	**2.8**	**2.7**	**2.4**	**2.2**
7. Exports of goods and services	7.9	3.7	3.2	3.5
7a. - of which goods	6.7	3.6	3.1	3.5
7b. - of which services	11.0	3.8	3.3	3.6
8. Final demand	**4.3**	**3.0**	**2.6**	**2.6**
9. Imports of goods and services	8.1	4.9	4.9	4.6
9a. - of which goods	8.1	5.1	5.1	4.8
9b. - of which services	7.7	3.6	3.5	3.3
10. Gross domestic product at market prices	**2.8**	**2.1**	**1.7**	**1.7**
Contribution to change in GDP				
11. Final domestic demand	3.0	2.5	2.4	2.2
12. Change in inventories + net acq. of valuables	-0.2	0.1	0.0	0.0
13. External balance of goods and services	0.0	-0.5	-0.7	-0.5

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

Annual % change	2017	2018	2019	2020
1. Private consumption expenditure	3.6	3.8	3.5	3.5
2. Government consumption expenditure	2.2	2.7	2.4	1.9
3. Gross fixed capital formation	12.0	6.5	6.4	6.6
4. Final domestic demand	**4.7**	**4.0**	**3.8**	**3.8**
5. Change in inventories	--	--	--	--
6. Domestic demand	**4.7**	**4.3**	**3.7**	**3.8**
7. Exports of goods and services	11.4	5.7	4.8	4.8
8. Final demand	**6.6**	**4.7**	**4.1**	**4.1**
9. Imports of goods and services	12.4	7.4	6.3	5.6
10. Gross national income at market prices	4.5	3.2	3.5	3.6
11. Gross value added at basic prices	3.9	3.4	2.9	3.3
12. Gross domestic product at market prices	**4.4**	**3.6**	**3.1**	**3.4**
Nominal GDP, EUR bn	194.6	201.6	207.8	214.8

Table 3: Implicit price deflators

% change in implicit price deflator	2017	2018	2019	2020
1. Private consumption expenditure	1.2	1.2	1.1	1.6
2. Government consumption expenditure	2.0	1.8	1.6	1.4
3. Gross fixed capital formation	2.6	2.0	1.7	1.5
4. Domestic demand	**1.6**	**1.5**	**1.3**	**1.5**
5. Exports of goods and services	3.3	2.0	1.6	1.2
6. Final demand	**2.1**	**1.6**	**1.4**	**1.4**
7. Imports of goods and services	4.0	2.4	1.4	1.0
8. Gross domestic product at market prices	**1.5**	**1.4**	**1.4**	**1.6**
HICP	**1.6**	**1.2**	**1.1***	**1.6***

*In July 2019 HICP was revised to 0.9% in 2019 and 1.5% in 2020

Table 4: Labour market and cost

Annual % change	2017	2018	2019	2020
1. Labour productivity (real GDP per employee)	-0.5	-0.2	0.5	0.9
2. Compensation of employees per head	1.6	2.0	2.2	2.3
3. Unit labour costs	**2.1**	**2.2**	**1.6**	**1.4**
4. Total population	-0.2	-0.2	-0.1	0.0
5. Population of working age (15-74 years)	-0.2	-0.2	-0.1	-0.1
6. Total employment (fulltime equivalent)	3.3	2.3	1.1	0.8
7. Calculated unemployment rate - Eurostat definition	**9.0**	**7.0**	**6.2**	**5.7**

Table 5: External balance

levels, EUR bn	2017	2018	2019	2020
1. Exports of goods (fob)	58.3	61.6	64.5	67.6
2. Imports of goods (fob)	68.8	74.1	79.0	83.6
3. Trade balance (goods, fob/fob) (1-2)	**-10.4**	**-12.5**	**-14.4**	**-16.0**
3a. p.m. (3) as % of GDP	***-5.4***	***-6.2***	***-7.0***	***-7.5***
4. Exports of services	24.8	26.3	27.6	28.9
5. Imports of services	12.8	13.5	14.2	14.8
6. Services balance (4-5)	**12.0**	**12.8**	**13.4**	**14.1**
6a. p.m. 6 as % of GDP	***6.2***	***6.3***	***6.4***	***6.5***
7. External balance of goods & services (3+6)	**1.6**	**0.3**	**-1.1**	**-2.0**
7a. p.m. 7 as % of GDP	***0.8***	***0.1***	***-0.5***	***-0.9***
8. Balance of primary incomes and current transfers	-1.2	-2.0	-1.1	-0.4
8a. - of which, balance of primary income	*-4.2*	*-5.1*	*-4.5*	*-4.1*
8b. - of which, net current Transfers	*3.1*	*3.1*	*3.4*	*3.7*
8c. p.m. 8 as % of GDP	*-0.6*	*-1.0*	*-0.5*	*-0.2*
9. Current external balance (7+8)	**0.4**	**-1.7**	**-2.2**	**-2.3**
9a. p.m. 9 as % of GDP	***0.2***	***-0.9***	***-1.0***	***-1.1***
10. Net capital transactions	1.7	2.1	2.3	2.5
11. Net lending (+)/ net borrowing (-) (9+10)	**2.1**	**0.4**	**0.1**	**0.1**
11a. p.m. 11 as % of GDP	***1.1***	***0.2***	***0.0***	***0.1***

Table 6: Fiscal accounts

	2017	2018	2019	2020
	% of GDP			
Taxes on production and imports	14.9	15.3	15.4	15.5
Current taxes on income, wealth, etc.	10.1	10.4	10.2	10.3
Social contributions	11.7	11.8	11.9	11.9
Sales and other current revenue	5.6	5.6	5.7	5.6
Total current revenue	**42.3**	**43.1**	**43.2**	**43.3**
Capital transfers received	0.4	0.4	0.6	0.5
Total revenue	**42.7**	**43.5**	**43.8**	**43.8**
Compensation of employees	10.9	10.8	10.9	10.9
Intermediate consumption	5.4	5.4	5.4	5.4
Social transfers in kind via market producers	1.8	1.8	1.9	1.9
Social transfers other than in kind	16.5	16.4	16.6	16.6
Interest paid	3.8	3.5	3.3	3.1
Subsidies	0.4	0.4	0.4	0.4
Other current expenditure	2.3	2.5	2.5	2.5
Total current expenditure	**41.3**	**40.8**	**41.0**	**40.8**
Gross fixed capital formation	1.8	2.0	2.1	2.3
Other capital expenditure	2.6	1.2	1.1	0.8
Other (residual)	4.9	3.7	3.7	3.3
Interest expenditure	3.8	3.5	3.3	3.1
Total expenditure	**45.7**	**44.0**	**44.2**	**43.9**
General Government balance (ESA2010)	**-3.0**	**-0.5**	**-0.4**	**-0.1**
Primary balance	0.9	3.0	2.9	3.0
	% change			
Taxes on production and imports	6.2	6.3	3.9	3.9
Current taxes on income, wealth, etc.	3.5	6.4	1.4	3.9
Social contributions	4.9	4.9	3.7	3.5
Sales and other current revenue	0.5	3.0	5.5	2.1
Total current revenue	**4.4**	**5.5**	**3.4**	**3.6**
Capital transfers received	-24.0	7.7	44.4	-8.4
Total revenue	**4.0**	**5.5**	**3.8**	**3.4**
Compensation of employees	1.9	2.2	4.1	3.6
Intermediate consumption	2.4	3.5	3.5	3.4
Social transfers in kind via market producers	2.6	3.7	7.3	3.0
Social transfers other than in kind	1.3	3.0	3.9	3.3
Interest paid	-4.7	-6.5	-1.9	-3.4
Subsidies	-16.3	-7.0	4.4	4.9
Other current expenditure	-5.7	11.0	5.4	4.2
Total current expenditure	**0.4**	**2.3**	**3.6**	**2.9**
Gross fixed capital formation	23.4	11.3	10.6	14.4
Other capital expenditure	586.4	-50.5	-4.6	-29.7
Total expenditure	**6.4**	**-0.3**	**3.7**	**2.6**
Nominal GDP, EUR bn	**194.6**	**201.6**	**207.8**	**214.8**

Table 7: Government debt developments

	2017	2018	2019	2020
ESA2010 deficit (% of GDP)	**-3.0**	**-0.5**	**-0.4**	**-0.1**
ESA2010 gross debt (% of GDP)	124.8	121.5	119.5	116.6
ESA2010 deficit	**-5.8**	**-0.9**	**-0.8**	**-0.2**
Gross debt	242.8	244.9	248.3	250.4
Change in gross debt	1.8	2.1	3.4	2.1
Nominal GDP	194.6	201.6	207.8	214.8
Real GDP growth (% change)	**2.8**	**2.1**	**1.7**	**1.7**
Change in gross debt (% of GDP)	0.9	1.0	1.6	1.0
Stock-flow adjustments (% of GDP)	-2.0	0.6	1.2	0.9
Gross debt ratio	**124.8**	**121.5**	**119.5**	**116.6**
Change in gross debt ratio	-4.5	-3.3	-2.0	-2.9
Primary balance	0.9	3.0	2.9	3.0
"Snow-ball" effect	-1.5	-0.8	-0.3	-0.8
of which				
Interest expenditure	*3.8*	*3.5*	*3.3*	*3.1*
Real growth effect	*-3.5*	*-2.6*	*-2.0*	*-2.0*
Inflation effect	*-1.9*	*-1.7*	*-1.6*	*-1.9*
Stock-flow adjustments	**-2.0**	**0.6**	**1.2**	**0.9**
Implicit interest rate	*3.1*	*2.9*	*2.8*	*2.7*

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